Russia-Ukraine War Will Hit Egypt's External Position Through Multiple Channels, Weighing On Currency Outlook

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Key View

- We at Fitch Solutions anticipate that Russia's invasion of Ukraine will result in a wider current account deficit in Egypt, coming in at 4.3% of GDP in FY2021/22 (July 2021 – June 2022) and 4.2% of GDP in FY2022/23.
- Higher wheat prices will increase the import bill while reduced tourist arrivals from the two countries will depress service exports.
- Global risk aversion and financial tightening have reduced capital inflows to Egypt that are needed to finance its current account deficit and preserve the stability of the exchange rate.
- As such, we now think that reaching an IMF agreement that would reassure investors is very likely, resulting in a devaluation of the pound by between 5.0% to 7.0%.

We believe that Russia's invasion of Ukraine will further exacerbate Egypt's external vulnerabilities and weigh on its currency. The conflict will affect the Egyptian economy through three channels: lower tourist inflows, higher commodity prices, and rising risk aversion towards emerging markets.

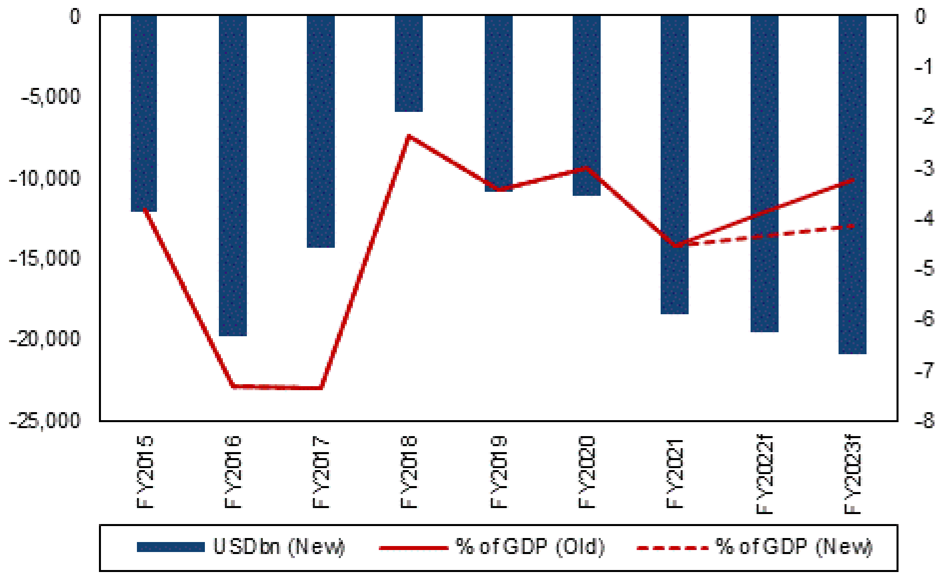
These channels will lead to a wider goods trade deficit and lower tourism receipts than we previously predicted, but most importantly they have already started to reduce portfolio inflows that authorities have relied on to finance this deficit and defend the currency. Indeed, while the Central Bank of Egypt (CBE) has been intervening in the exchange rate market to keep the pound stable at around EGP15.70/USD since September 2020, we believe that markets have become more worried about the CBE's capacity to preserve the stability of the exchange rate.

While we previously argued that Egypt could seek an agreement with the IMF to reassure investors and/or access cheaper funding, we now see this as the most probable outcome, especially as global financial conditions are tightening and the Egyptian financial sector's net foreign assets are declining. We think that the authorities will proceed with a managed depreciation of the currency under an IMF programme.

We now expect Egypt's current account deficit at 4.3% of GDP in FY2021/22 (July 2021 – June 2022) and 4.2% of GDP in FY2022/23, up from previous forecasts of 3.9% and 3.3% respectively (*see chart below*). The revision is mostly due to lower tourism receipts and higher import bill than we had previously expected.

Wider External Shortfall Ahead

Egypt – Current Account Deficit

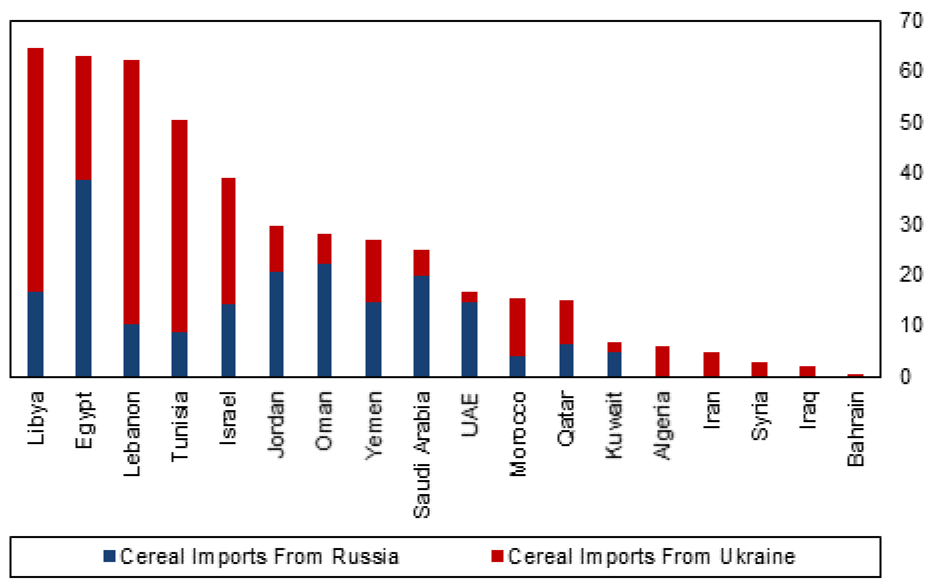


f = Fitch Solutions forecast. Source: CBE, Fitch Solutions

Higher wheat import prices will be the most important driver of the wider deficit. Not only is Egypt the world's largest wheat importer (and a large maze importer), but it also sources an important share of its cereal imports from Ukraine, which banned the exports of wheat this year (*see chart below*). The war will likely keep pressure on wheat prices elevated into 2023, creating lasting pressure on Egypt's import bill and keeping inflation in the country high.

High Dependency On Russia And Ukraine For Cereal Imports

MENA – Cereal Imports From Russia & Ukraine, % of total cereal imports

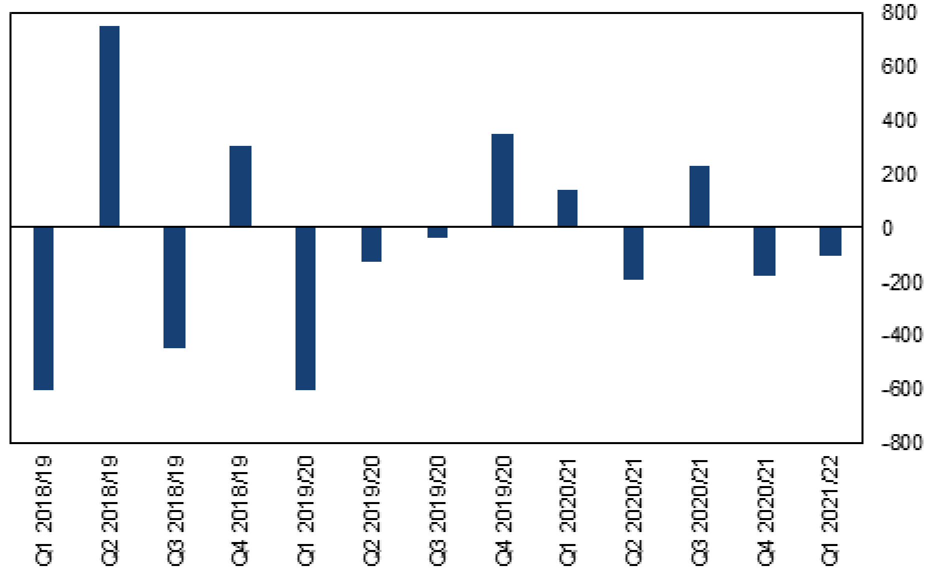


Source: Trade Map (2019 Data), Fitch Solutions

The recent increase in oil prices, by contrast, will have a limited impact on Egypt's import bill. Egypt's hydrocarbon trade balance has alternated between small deficits and surpluses since Q2 2019/20 (September – December 2019) (*see chart below*), and we expect this trend will continue into FY2021/22 and FY2022/23. This is because we anticipate broadly similar deficits in the oil trade balance and surpluses in the gas trade balance.

Hydrocarbon Trade Balance To Continue Alternating Between Small Deficits And Surpluses

Egypt - Hydrocarbon Trade Balance, USDmn

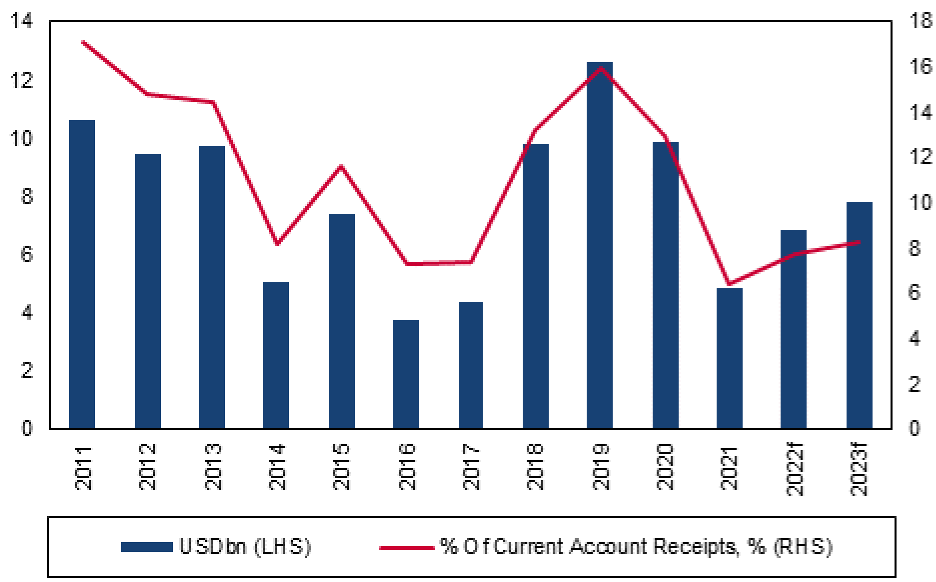


Source: CBE, Fitch Solutions

The impact of the Russia-Ukraine war on Egypt's goods exports will also be small, as just 2.0% of the country's exports are sent to the two countries. But **both Russia and Ukraine are key sources of tourist arrivals, and a disruption to this flow will delay the recovery of Egypt's tourism sector after the Covid-19 collapse until FY2023/24, weighing on tourism receipts** (*see chart below*).

Tourism Receipts Significantly Below Pre-Pandemic Levels

Egypt – Tourism Receipts



e/f = Fitch Solutions estimate/forecast. Source: CBE, Fitch Solutions

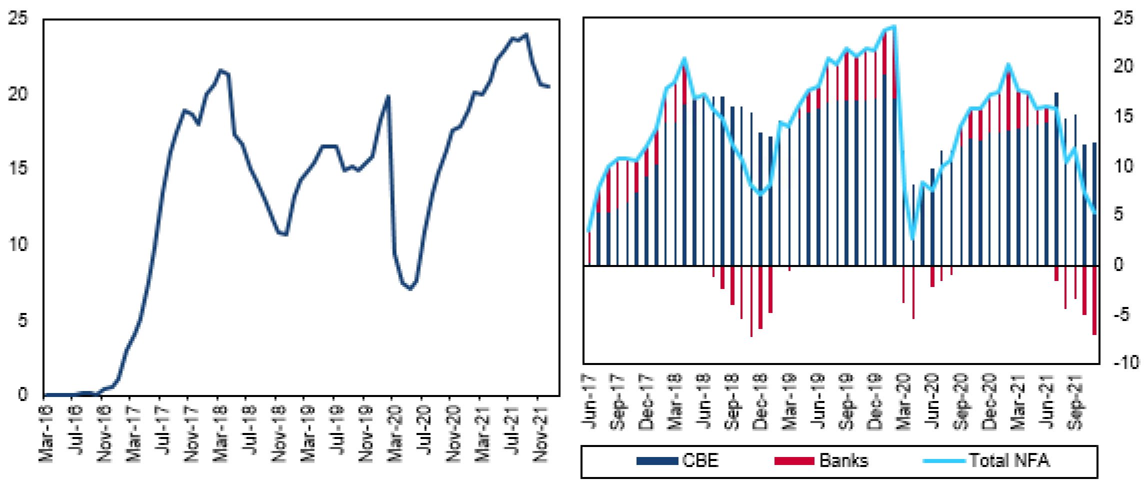
Indeed, tourists from Russia and Ukraine generated the largest share of tourism receipts in the country according to a statement from the Egyptian Tourism Ministry. We think that the war will prevent most Ukrainians from travelling abroad, while the weakening of the Russian rubble and Russia's partial exclusion from the international payment system (SWIFT) will discourage Russian nationals from travelling or spending money abroad.

With the current account deficit set to be wider, risk off sentiment towards emerging markets, including Egypt, will continue to cause portfolio outflows. Until recently, Egypt has relied on its favourable real interest rates (among the highest in emerging markets) as well as on its stable foreign exchange rate to attract portfolio inflows. While these inflows helped cover the country's external financing needs, they exposed Egypt to a shift in investor sentiment and tighter financial conditions, as we have been repeatedly signalling.

Indeed, foreigners' holding of T-bills in Egypt has been declining since October 2021 from USD24.0bn to USD20.5bn in December 2021 (*see chart below, left*). While the CBE's net international reserves continued to be broadly stable at USD41.0bn in February, they have remained below their high of USD45.5bn in February 2020. Also, pressure on the financial sector's net foreign asset position continue to rise (*see chart below, right*), reflecting in part the portfolio outflows.

Sustained Portfolio Inflows Since October 2021 Pressuring Net Foreign Asset Position

Egypt - Foreign-Held T-Bills, USDbn & Net Foreign Asset Position Of Financial Sector, USDbn

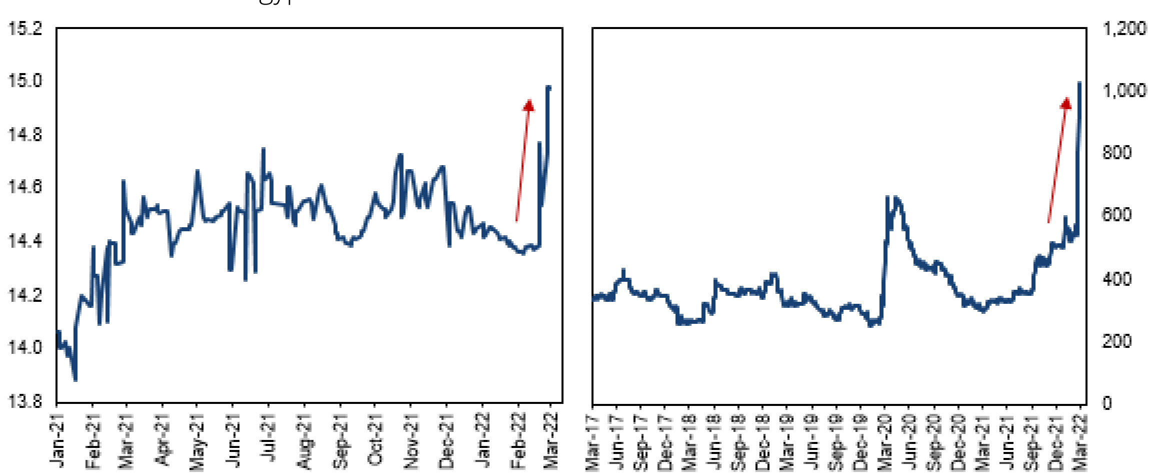


Source: CBE, Fitch Solutions

Moreover, a recent Reuters article estimated portfolio outflows from Egypt at USD3.0bn in early March in the aftermath of Russia's invasion of Ukraine. Indeed, yields on Egypt's government securities denominated in local currency have increased in recent months (*see chart below, left*), while the five-year CDS on Eurobonds have surged (*see chart below, right*).

Rising Risk Perception

Egypt – 10-Year Government Bond Yield & 5-Year CDS



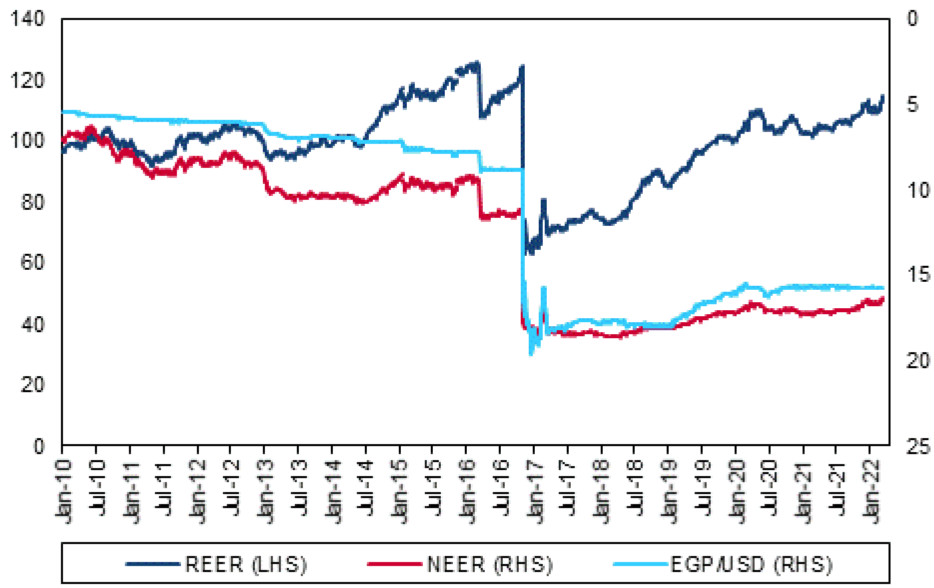
Source: Bloomberg

We expect that risk off sentiments towards emerging markets will persist over the coming quarters as the Russia-Ukraine war continues to create uncertainties, keeping commodity prices high and weighing on the external positions of net commodity importers. This, along with a more aggressive monetary policy tightening in the US – we now expect the US Federal Reserves to hike five times up from three times previously – will lead to sustained capital outflows from EMs.

Against this background, the CBE is unlikely be able to continue intervening in the currency market to maintain the exchange rate stable and to finance the economy. More so, we think that foreign investors are worried about the CBE's ability to maintain this strategy, given its limited sources of foreign currency now.

Overvalued Egyptian Pound

Egypt - Exchange Rate, EGP/USD



Note: EGP/USD scale is inverted. Source: Bloomberg

This makes us believe that Egyptian authorities will seek an arrangement with the IMF to reassure investors and bolster its foreign currency reserves. In this case, we think that authorities will devalue the pound likely by between 5% to 7% in 2022, a faster pace than we had previously expected. While the pound would still be overvalued (*see chart above*), we believe that high inflationary pressures would discourage the authorities from a more pronounced devaluation. Additionally, the IMF programme is likely to unlock additionally bilateral funding, such as deposits from Gulf Cooperation Council countries. This would reassure investors and even encourage the return of portfolio inflows.