

Egypt Macro Update: Tracing A Path Through Uncertainty

19 Oct 2022

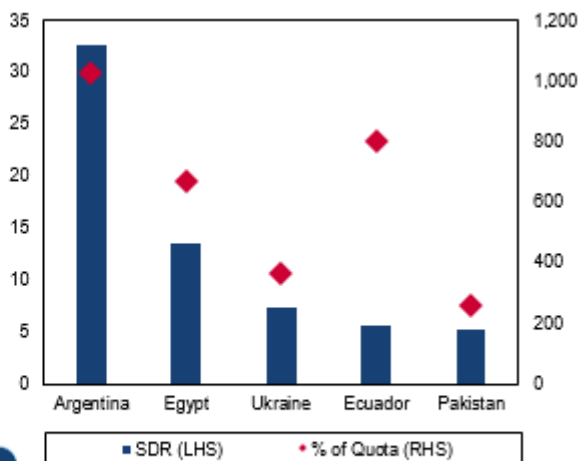
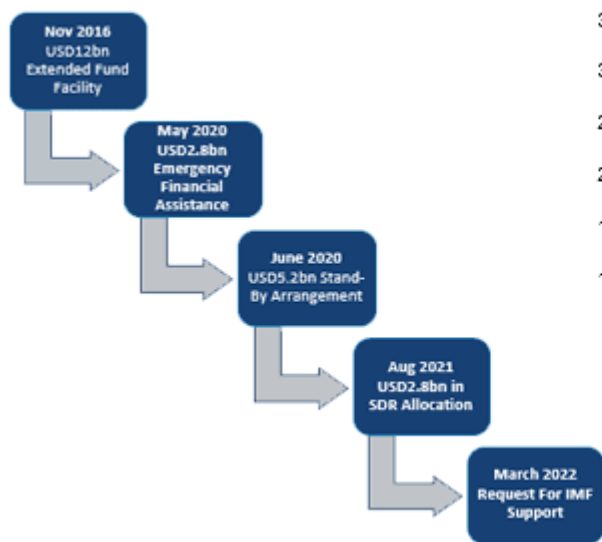
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1. What is the latest on Egypt's IMF deal?

The Egyptian government has been negotiating an IMF programme since March 2022, and according to government officials and the IMF spokesman, the two parties will reach an agreement “very soon”. Even so, the agreement will require the approval of the IMF Executive Board, which will likely take place in December (assuming a similar timeframe to the recent staff-level agreement between Tunisia and the IMF). To this date, the authorities have not specified the size of the programme. This is because we suspect that the IMF direct funding is unlikely to exceed USD6.5bn as Egypt is already seven-times above its IMF quota. This amount, spread over several years, will be insufficient to cover Egypt's funding needs. Thus, we believe the entire funding package will be announced at the same time, including IMF direct borrowing, other multilateral and bilateral funding, and materialisation of some investment pledges from Saudi Arabia, the UAE and Qatar (together they pledged more than USD20.0bn in investment). The IMF programme will encourage the return of portfolio investors to the local debt market and will help Egypt regain access to the international debt markets.

Egypt Is IMF's Second Largest Borrower

Egypt – IMF Lending [LHC] & IMF Exposure To Egypt [RHC]



Source: IMF, Fitch Solutions

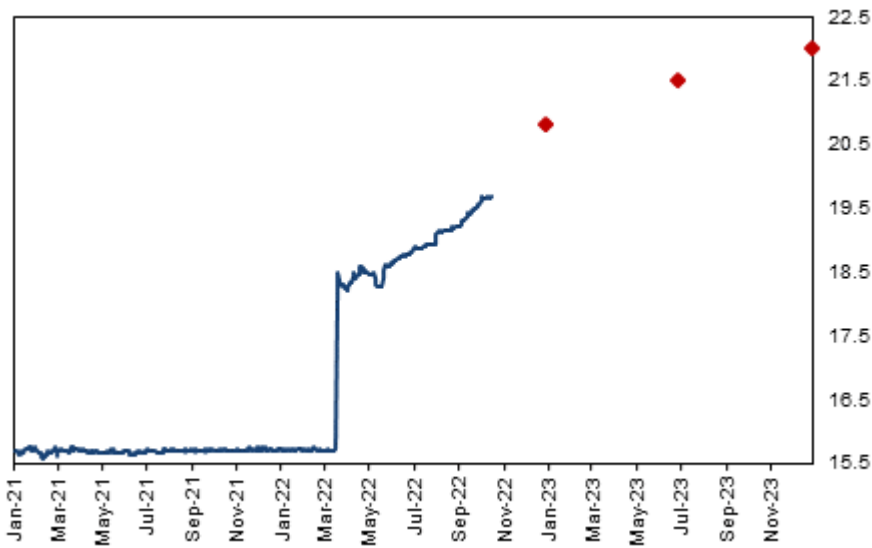
2. The curious case of the Egyptian pound: what will happen next?

We believe that the Egyptian pound will continue to weaken from EGP19.67/USD on October 18, ending the year close to EGP21.00/USD. After nearly two years of a stable exchange rate around EGP15.70/USD, on March 21 the authorities allowed the currency to weaken by 13.7% to EGP18.22/USD as the Russia-Ukraine war exacerbated Egypt's external vulnerabilities and triggered more than USD20.0bn in portfolio outflows. Since then, the currency has lost an additional 7.4% of its value. Even so, we think that the currency is still overvalued and will fall by another 6.3% by the end of the year due to a strong US dollar and shortages of US dollars.

As we have argued since Q222, while the authorities will allow the currency to continue weakening in the short term, this will happen only gradually gradually to ease inflationary pressures and social discontent. Given these social considerations, we expect that the IMF will also agree to a gradual shift, and will not push for a front-loaded adjustment like the one seen in March 2022. Overall, we believe that the period of stable exchange rate is behind us and that the authorities will allow for greater flexibility in the exchange rate. In this sense, the authorities will allow the exchange rate to react to positive and negative shocks. As a result, we expect the official and black-market rates will converge in H123 reaching EGP21.5/USD, before the pace of the depreciation slows. By that time, the strength of the dollar will have peaked, the Egyptian economy will have stabilized and capital inflows in the form of FDI and portfolio inflows will have started to materialise. We think that the currency will end 2023 at EGP22.0/USD.

Weaker Egyptian Pound Ahead

Egypt – Daily Exchange Rate, EGP/USD



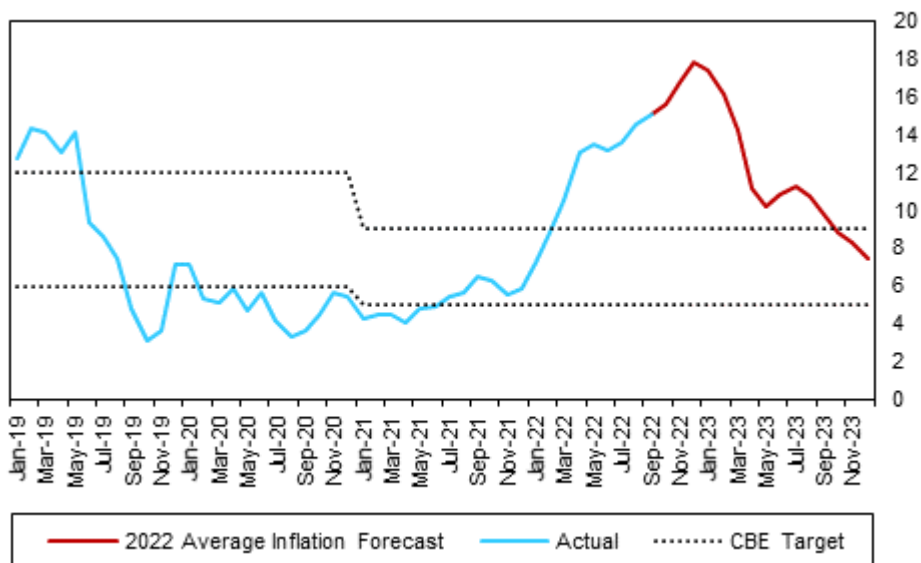
Red dot is FS forecast. Source: Bloomberg, Fitch Solutions

3. When will inflation peak?

We expect that inflation will peak close to 18.0% y-o-y in December 2022, and will remain in double digits at least until July 2023. Indeed, after averaging 12.2% y-o-y in the first nine months of 2022, we expect that inflation in Egypt will average 16.7% y-o-y between October and December 2022, bringing average inflation in 2022 as a whole to 13.4%. In 2023, we expect inflation will average 11.2%. While the weakening of the pound will continue to play a key role in sustaining inflationary pressures, the upward adjustment to administered prices, such as fuel, electricity, unsubsidised bread and other basic goods, will add to these pressures. As a result, inflation will likely fall back within the Central Bank of Egypt's (CBE) 5.0%-9.0% inflation target range only by Q323. Should the CBE adjust its inflation target, then it could refrain from further hiking the policy rate and resort to other monetary policy tools to keep financial conditions tight.

Inflation In Double-Digits For Longer

Egypt - Inflation, y-o-y %



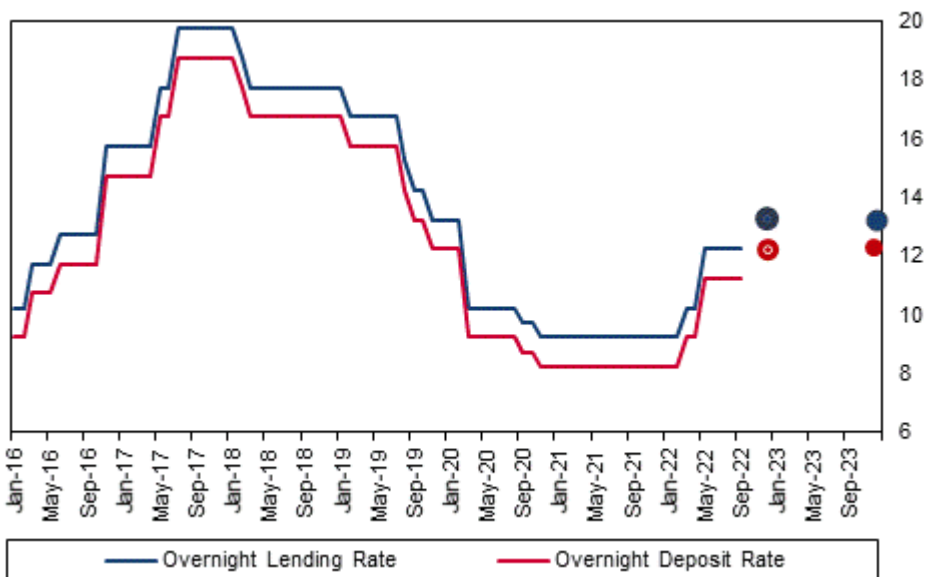
Source: CBE, Fitch Solutions

4. What is the direction of monetary policy?

We believe that the Central Bank of Egypt (CBE) will maintain a tight monetary policy stance given elevated inflation. While earlier in the year the CBE opted to hike its overnight deposit and lending rates by 300 basis points each to 11.25% and 12.25%, respectively, it held the rates in its last two meetings, in line with our view. Indeed, we believe that additional hikes, without an IMF programme, would only have a limited positive impact on foreign investors' appetite and instead would further depress economic activity by increasing borrowing costs. While some EGP-denominated debt instruments offer positive real yields, the prevailing uncertainty about the trajectory of the currency is making investors hesitant to return to the market. Confirming our view on the policy rate, in September, the CBE increased the reserve requirement ratio from 14.0% to 18.0% to tighten monetary conditions without directly increasing interest rates. We believe that the CBE will hike one more time once the IMF programme comes into force in Q422, likely by about 100 basis points to reflect tighter global financial conditions. In 2023, we now expect the CBE will hold the policy rate.

Financial Conditions Will Remain Tight

Egypt - Policy Rates, %



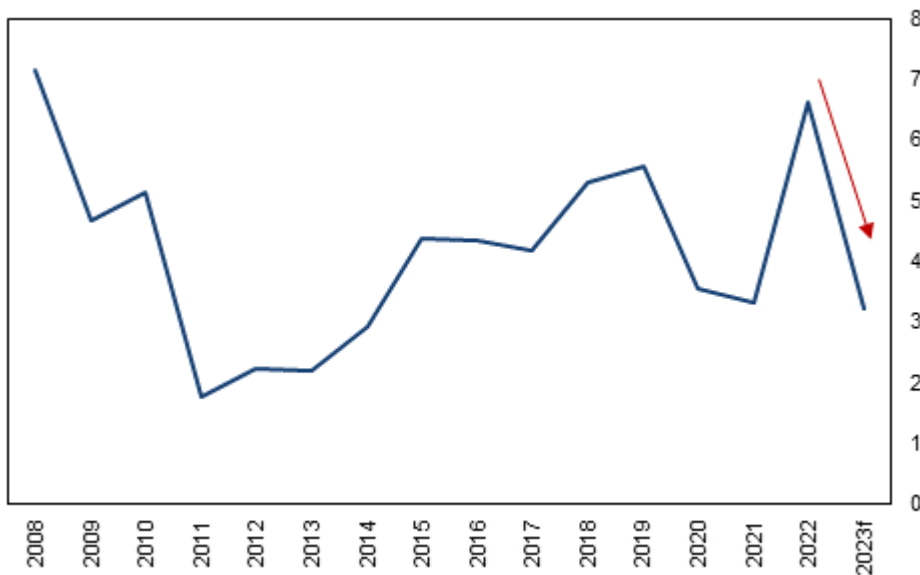
dotes represent FS forecasts. Source: CBE, Fitch Solutions

5. What is the growth outlook for Egypt in FY2022/23?

We expect a significant slowdown in Egypt’s economic growth from a 14-year high of 6.6% in FY2021/22 (July 2021 – June 2022), to a decade low of 3.2% in FY2022/23. This broad-based slowdown in economic activity will be driven by several factors. First, high inflation will weigh on consumer spending, while some shortages in basic and luxury goods will limit consumption altogether. Second, we expect that the government will cut capital spending. The authorities will attempt to reduce the budget deficit, but room to cut recurrent spending in the short term will remain limited. Indeed, elevated commodity prices will continue to inflate the subsidy bill and encourage authorities to expand the social safety net, while higher interest rates will increase debt servicing costs. This will reduce state-led investments and weigh on economic growth. Third, while a weaker currency would likely be beneficial for goods exports, weak external demand because of the recession in the US and the Eurozone will cap the potential of goods exports. Even growth in hydrocarbon exports, denominated in foreign currency, will also suffer due to capacity constraints. The silver lining lies in foreign direct investments (FDI), which Egypt will rely on to close its funding gap. The selling of state assets to Saudi Arabia, Qatar and the UAE will be the main source of FDI to the country and will pave the way for other foreign investors to enter the Egyptian market. This will offset some of the decline in state-led investments.

Significant Slowdown In Activity

Egypt - Real GDP Growth, %



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

6. What about the new auto regulations?

On October 13 2022, Egypt's government approved a draft law that will allow Egyptians living abroad to import a personal car into Egypt, stating that the vehicle will be exempt from import costs such as customs duties or taxes, including value-added tax. The ruling will allow each expatriate to import one vehicle, provided that they transfer the value of all related taxes and duties from abroad to the Finance Ministry bank account. These amounts are then converted to EGP and blocked for 5 years. Expats have a four-month window to benefit from this regulation. [Our Auto Team believes that this policy will be popular with expats](#) due to the cost and difficulty of importing vehicles caused by the CBE's requirement that importers provide letters of credit to finance imports. Indeed, some may use the scheme to import foreign-bought vehicles in order to resell them for a higher price in Egypt. We believe that the government's estimate of attracting USD2.5bn in deposits from this initiative is within reach. Consequently, we expect to see a decline in the price of used vehicles as a result of this ruling. Regarding new car sales, we expect sales will contract by 9.2% in 2022 and will rebound by 9.0% in 2023 as economic conditions improve.

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