Fundamentals

10 October 2022

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Squaring the Circle

IN BRIEF

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- We spent the week of 25th – 29th September in Cairo meeting policymakers; financial services' professionals, the media and multilateral institutions. Amid the global economic fallout, our primary task was to pick any white smoke, if any, in Egypt's macroeconomic shape. This note highlights our 5 take-aways from our Egypt trip.
- Egypt is targeting to start an IMF program latest November 2022, and the impression we have is that the country's exchange rate mechanism is the remaining hurdle in the discussion.
- The rising inflationary environment has seen the government increasing its targeted social assistance programs in FY23 to protect the most vulnerable households
- We estimate gross external financing in FY23 at USD 34.7bn. That notwithstanding, the projected FY23 current account deficit (USD 16.6bn) is mainly funded with the expected USD 10.0bn foreign direct investment, based on Ministry of Finance baseline.
- The twin combination of a global rate tightening stance and negative spill over of an FX rate policy shift is a perfect setup for a rate tightening tilt in the final MPC meeting of the year to be held in November 2022.
- We see inflation normalization, exchange rate adjustment, and IMF program, in no particular sequencing, as triggers for local-currency attractiveness.

Cairo: Modernity blends with antiquity

Egypt is the most populous Arab nation. Downtown Cairo, where we put up during our stay, is a dense mass of high-rise buildings. One of the salient things that caught our attention is the outsized number of stray cats and dogs roaming the streets of Downtown Cairo, with locals offering a litany of reasons behind that phenomenon. We admired the variety of the city's architectural designs and statues, which not only celebrated heroes across centuries, but belied one of the continent's oldest civilizations.

River Nile, as it flows to the Mediterranean Sea to the north, separates Cairo and Giza Governorates. One of the world's seven wonders lies in the latter; the Great Pyramid of Giza. The pyramids of Giza – 3 in total, but 2 open to the public – are among 118 such structures that dot Egypt and served as the burial places of Pharaohs. The sheer intensity of ancient Egypt to build pyramids was a marvel to behold.

We did not get an opportunity to visit the New Administrative Capital, about an hour's drive from Downtown Cairo. Still, discussions with locals left us with the sense that the new capital – built to decongest the current city of between 20-25mn residents – is the contemporary 'the Great Pyramid'. Hopefully, we shall visit the new capital in our next Cairo trip.

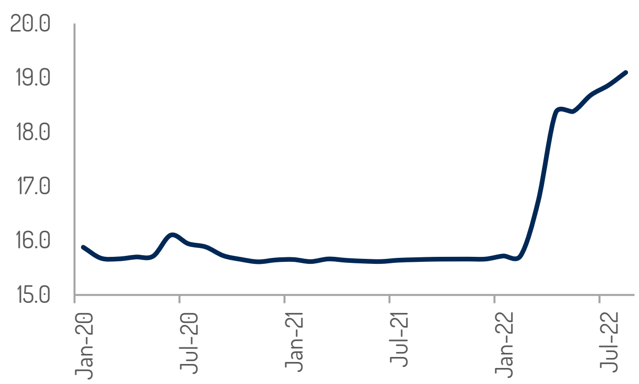
Back to the present, we couldn't help but notice the inordinate number of used cigarette butts littering the streets. Our primary task was not to estimate the number of smokers in Cairo, but to picky any white smoke in Egypt's macroeconomic shape in the backdrop of the latest round of global economic fallout. We spent the week of 25th to 29th September in Cairo, meeting policymakers, financial services professionals, the media and multilateral institutions. This note highlights our 5 take-aways from our Egypt trip.

1. IMF program still on the cards

Egypt is targeting to start an IMF program latest November 2022, and the impression we have is that the country's exchange rate mechanism is the remaining hurdle in the discussion. We believe that this week's IMF/World Bank Annual meeting should give some clarity regarding the Egypt IMF program, with the discussion seemingly gone off the boil in the last three months. The protracted discussion slowly ushers some self-fulfilling prophesy; devaluating of the Egyptian Pound ("EGP"). EGP devalued by 13.7%, from 15.7 to 18.2, in March but has since weakened an additional 7.3% to 19.6 levels. Non-deliverable Forward (NDF) has pencilled in EGP at 21.95 at year-end, effectively a further slide of 10.4%.

These end-year projections have been fortified by recent news flow from the central bank. The abrupt resignation of the previous Central Bank Governor, Tarek Amer, signalled a potential pivot to a free-float regime regarding Egypt's FX regime. Anecdotal evidence by locals pointed to thinned FX supply over the last two months, suggesting that the real sector is anticipating further weakness in the Egyptian pound. That said, the CBE would midwife a gradual adjustment on the FX to avoid an abrupt FX passthrough on domestic inflation.

Evolution of the US dollar/Egyptian Pound (spot rate)



Source: Central Bank of Egypt (CBE)

The other key plank of the IMF program will be on structural reforms to mainly increase private sector involvement in the economy. The government intends to rollout an ambitious privatization plan, selling assets totalling USD 10.0bn a year over the next four years. We think the privatization plan will blend outright asset sales and Foreign Direct Investment (FDI), with Gulf Cooperation Council (GCC) countries playing a pivotal role. To be sure, GCC countries pledged USD 22.0bn as deposits with the Central Bank of Egypt (CBE), part of which will be directed towards investments.

Overall, the size of the IMF program will be under USD 5.0bn with a duration of 3-4 years. We believe the program's structural benchmarks will get a one-time boost at the onset with the impending GDP rebasing later this month. In our calculations, the rebased figures will dial FY21[1] GDP upwards by 9.2%, from EGP 6.2trn to EGP 6.9trn. The GDP rebasing intends to bake in the last economic census (held in 2019) and partly to hem in both the digital and informal sectors. This will lower the public debt burden to 87.2% at the end of FY22.

[1] The Fiscal Year starts in July to June. Thus 'FY21' is Fiscal Year between July 2020 and June 2021

2. Targeted social assistance to support the most vulnerable

The Ministry of Finance estimates a fiscal deficit of 6.0% in FY23 (FY22: 6.0%). The fading of the COVID-19 risks, increased private consumption, improved tax administration efforts and the widening tax base should boost tax revenues in FY23 (target: EGP 1.5trn). This should be on the backpedal of an improved tax revenue performance (+19.6% y/y) in FY22. That said, interest payments (EGP 690.1bn) remain a major drag on the expenditure, accounting for a third of total FY23 spending of EGP 2.1trn. We still see no respite in the foreseeable future, with interest payments expected at EGP 939.0bn in FY27.

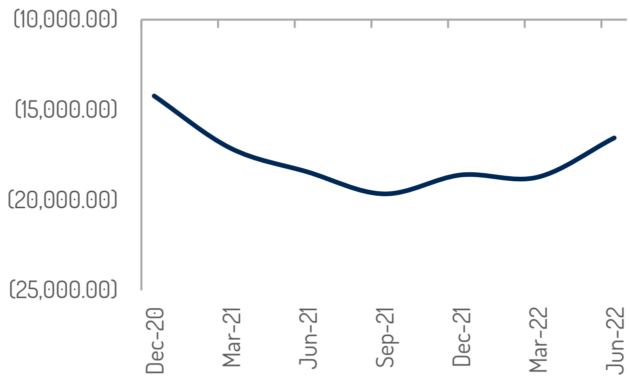
Amid the fallout from the Russia-Ukraine war, EGP130.0bn has been allocated from the contingency fund in FY23 to address exceptional expenses due to elevated higher energy and food prices. Food subsidies in FY22 overshot the target – EGP 96.8bn against the target of EGP 87.0bn – as the government supported the vulnerable, particularly against the runaway wheat prices. Between September 2022 and March 2023, the government will spend an additional EGP1.0bn per month to increase the food ration card allowance, for poor households under the food subsidy program. The government has also scaled up its social protection program under Takaful and Karama - conditional cash transfer program - to net in additional 1.0mn households to bring total coverage in the program to 5mn households (20.0% of total households). Overall, subsidies, grants, and social benefits have been allocated EGP 356.0bn, 17.2% of overall FY23 expenditure.

3. FY23 gross external financing; steady and financed

We estimate gross external financing in FY23 – assuming the FY23 12-month current account deficit stabilizes at FY22 levels and FY23 external debt amortizations – at USD 34.7bn. We see the FY23 12-month current account deficit on a rolling basis steady at FY22 levels (USD 16.6bn). The global pick-up in natural gas prices (+84.5% YTD) coupled with the opening of newer European markets boosted the oil trade balance that hit a surplus of USD 4.4bn in FY22. A combination of moderating natural gas prices and runaway crude oil prices following OPEC+'s recent announcement of global oil production cuts will narrow the oil trade surplus in FY23.

Furthermore, the recent ease in import regulations – effected in February 2022 that required importers to have letters of credit as a prior condition for imports – should boost import recovery. These seemingly drag on the trade balance should be partly offset by a rebound in Suez Canal receipts, with fees expected to be hiked by 15.0% in 2023 and a sturdy tourism recovery. With global wheat prices back to levels preceding the Russia-Ukraine fallout and adequate wheat reserves (6.3 months' cover), this should ease pressure on elevated value of wheat imports.

Evolution of 12-month cumulative Current Account Deficit (USD, mn's)



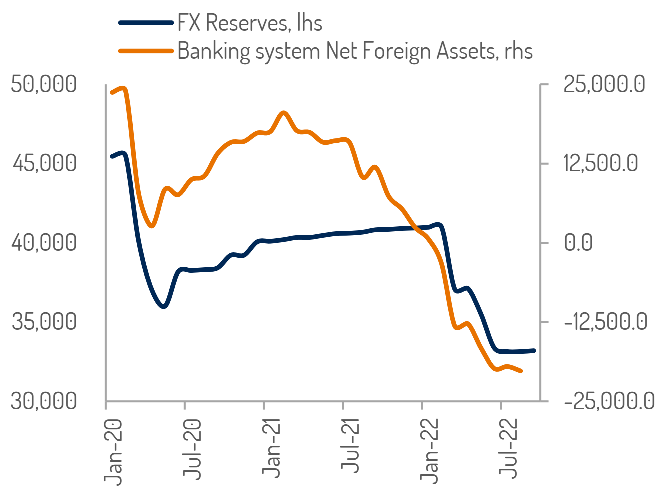
Source: CBE

That notwithstanding, the projected FY23 current account deficit (USD 16.6bn) is mainly funded with the expected USD 10.0bn foreign direct investment, based on the Ministry of Finance baseline. The recently launched Pre-IPO Fund, managed by The Sovereign Fund of Egypt, is a step in the right direction to scale up the targeted state assets sales to the tune of USD 6.0bn in FY23. Though Egypt tapped the Eurobond market at the front end of FY22, we are sceptical that the current dire global macroeconomic environment will be conducive for a Eurobond issuance in FY23. Nonetheless, we like the proactiveness, with the proposed diversification of external financing instruments into Samurai bonds (USD 500mn), Panda bonds (USD 500mn) and Sukuk issuance (USD 1.5bn), in addition to its suite of multilateral creditors. It will be remiss of us not to point out that a gradual FX adjustment, which we think the authorities will adopt ahead of inking an IMF program deal, should ease the pressure on the current account deficit (CAD) over the medium term.

4. Underlying pressures imply upward policy tilt in November MPC

We believe that the Central Bank of Egypt will have an upward bias in its November monetary policy meeting, after pausing its stance in the September meeting. The twin combination of a global rate tightening stance and negative spill over of an FX rate policy shift supports a rate tightening tilt in the final MPC meeting of the year to be held in November. The real policy rate (overnight deposit rate minus inflation rate) perched in negative territory, should be a concern for the country that hitherto was appealing for carry trades. That as it may be, the authorities have made it clear, at least with their actions, specifically the structural reforms towards FDIs, that it is building a buffer against portfolio flows that are less sticky in turbulent times. Specifically, the 1Q22 period witnessed a record USD 14.8bn in debt portfolio outflows in the aftermath of the Russia-Ukraine fallout.

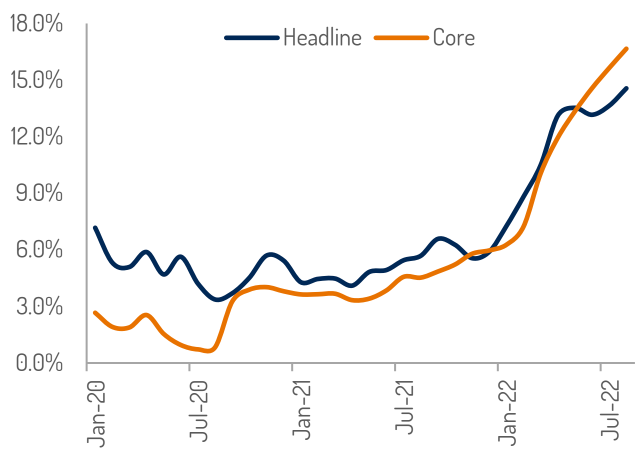
External buffers metrics (USD, mn's)



Source: CBE

Headline inflation is expected to remain elevated this quarter above CBE's target of 7.0% (+/- 2.0%) average in 4Q22, majorly on account of the FX passthrough. FX reserves have fallen by USD 7.8bn from February 2022 to USD 33.2bn (Sept 2022) and roughly 4.5months of import cover, exposing EGP to near-term shocks. Furthermore, the widened net foreign assets in the banking sector at negative USD 20.2bn (Sept 2022), down from positive USD 2.4bn at YE 2021, is a proxy for near-term EGP distress. That as it may be, the Sept 2022 MPC decision was not strictly a neutral monetary policy stance. Effective 4th October 2022, the apex bank increased the reserve ratio requirements by 400bps to 18.0% and is estimated to mop out EGP 150.0bn of excess liquidity.

Evolution of Inflation

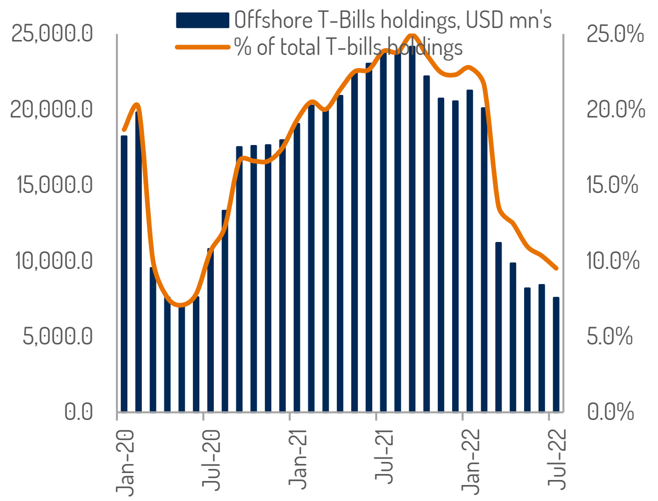


Source: Central Agency for Public Mobilization and Statistics (CAPMAS), CBE

5. Shrunk real returns in short-term local rates; a put-off to offshore

In no particular sequencing, we see inflation normalization, exchange rate adjustment, and IMF program, as triggers for local-currency debt attractiveness. The cumulative 300bps rate hike in the year has seen a steep inversion of the yield curve, with rates shooting up at the short end (the most liquid segment of the yield curve). Foreign holdings of T-Bills, have declined to USD 7.6bn as of July 2022 (USD 24.2bn: Sept 2021 peak) representing 9.5% of T-bills holdings (24.9%: Sept 2021). With 364-day T-Bills at high 16.0%/low 17.0% levels against an inflation rate of 14.6%, coupled with the global rate tightening cycle, we do not see scope of robust offshore holdings of local debt in the near-term.

Offshore holdings of T-bills



Source: CBE

Although the government intends to lengthen its debt maturity profile from the average time to maturity of 3.14years (August 2022) to five years (by FY27), it is high time it walks the talk. The issuance calendar for the current quarter has an abysmal allocation for Treasury bonds. Granted, with the high liquidity environment in the market, a credible allocation shift towards Treasury bonds should increase attractiveness at the back end of the yield curve. We see a still birth in the proposed bond extension (rolling over of FY23 maturing bonds into 5-year floating rate bond); a target of EGP 2.0bn as the offer amount in the 5-year floating rate bond against EGP 46.6bn maturities this quarter.

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