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MACRO MORNING BRIEFING

March 6, 2024

Special Briefing: Egyptian Pound Devalues

USDEGP breaches 50, aligns with informal rates

- CBE also hikes rates, indicating EM need to maintain high real rates
- Balance-of-payments stability expected as $8bn IMF package agreed
- Financial and geopolitical impact to be felt in region

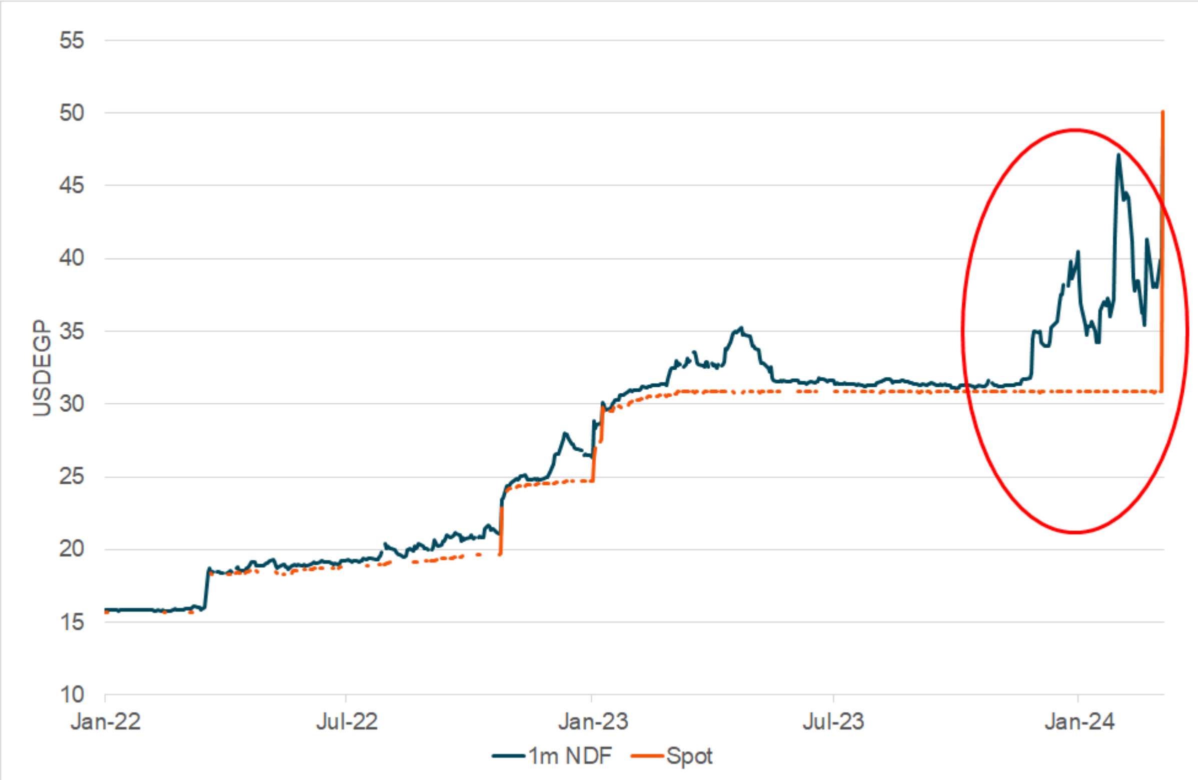
Central Bank of Egypt in de facto devaluation, moves to float

The Central Bank of Egypt on Wednesday surprised with a 600bp hike across its policy rates at a special meeting of its Monetary Policy Committee. The overnight deposit rate went up to 27.25%, the overnight lending rate to 28.25%, the main operation rate to 27.75%, and the discount rate to 27.75%. Keeping upward pressure on nominal and real rates was expected for Egypt, along with other countries experiencing material balance-of-payments stress. The recovery in the ‘higher for longer’ theme for the US dollar has only added to the urgency.

The CBE also stated (press release) that to “ensure a smooth transition” to a “flexible inflation targeting regime…the CBE will continue to target inflation as its nominal anchor, allowing the exchange rate to be determined by market forces”. More importantly, the CBE acknowledged the need to unify exchange rates and achieve “the closure of the spread between the official and the parallel exchange rate markets”, a de facto floating of the currency. The IMF has agreed on a new $8bn loan programme with Egypt, confirming that the devaluation was a necessary step to unlock the funding.

The message was abundantly clear that the spread between official and unofficial exchange rates had widened excessively and was heavily distorting the economy. As the latter rate is a better reflection of market supply and demand for the pound, allowing this method of “determination” inevitably led to a sharp devaluation. By early-afternoon Cairo time, the official spot market in USDEGP (exhibit 1) had breached 50.00 for the first time ever.

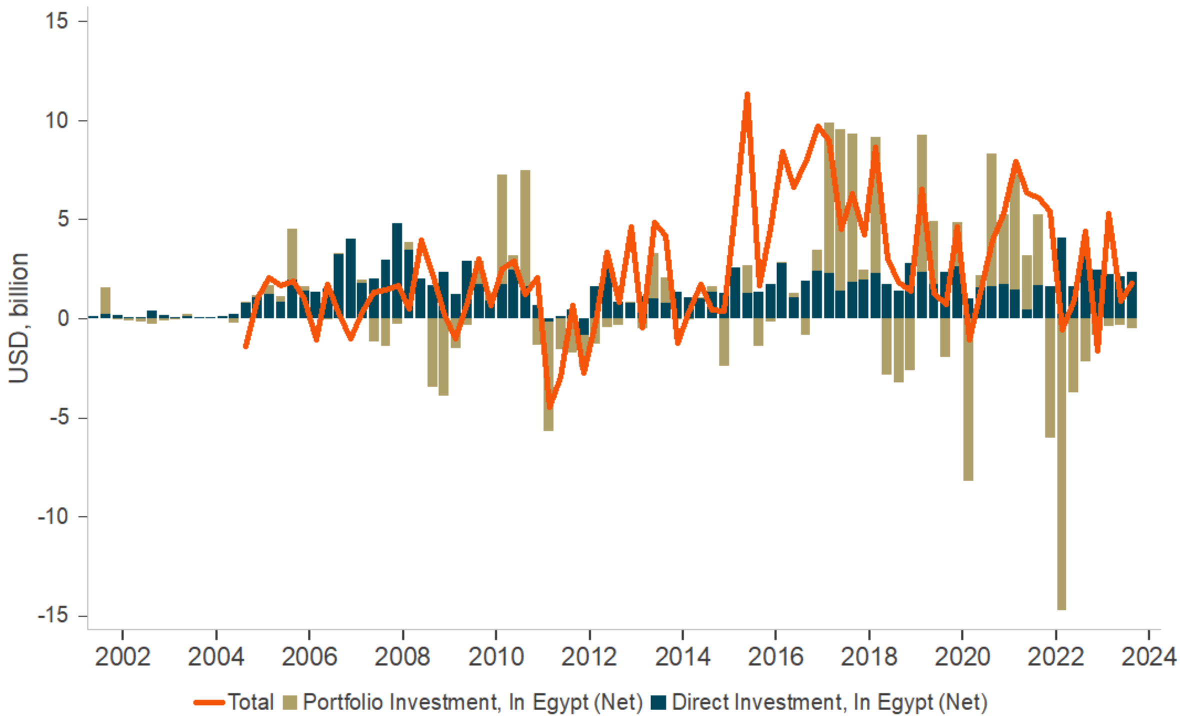
Exhibit #1: EGP Spot And 1m NDF Implied Rates



Source: Bloomberg BNY Mellon

Comparing the NDF rate vs. the official spot rate, we can see that the market was generally sanguine about any sharp USDEGP moves last year. The worst of the balance-of-payments pressures introduced by a surge in energy and food prices had passed, and high nominal rates served as a buffer for the currency amid repeated tightening by the Fed. The CBE's 300bp of tightening between January and August last year clearly signalled its bias, even though real rates left much to be desired. However, as we have seen with developments in the Turkish lira, high nominal rates coupled with very low levels of transactions under a restricted capital account regime can provide an extended period of stability. As shown in exhibit 2, the bulk of the capital flows out of Egypt took place in 2022. The financial account managed to stay positive in Q1-Q3 2023, based on the latest data available.

Exhibit #2: Egypt Balance Of Payments

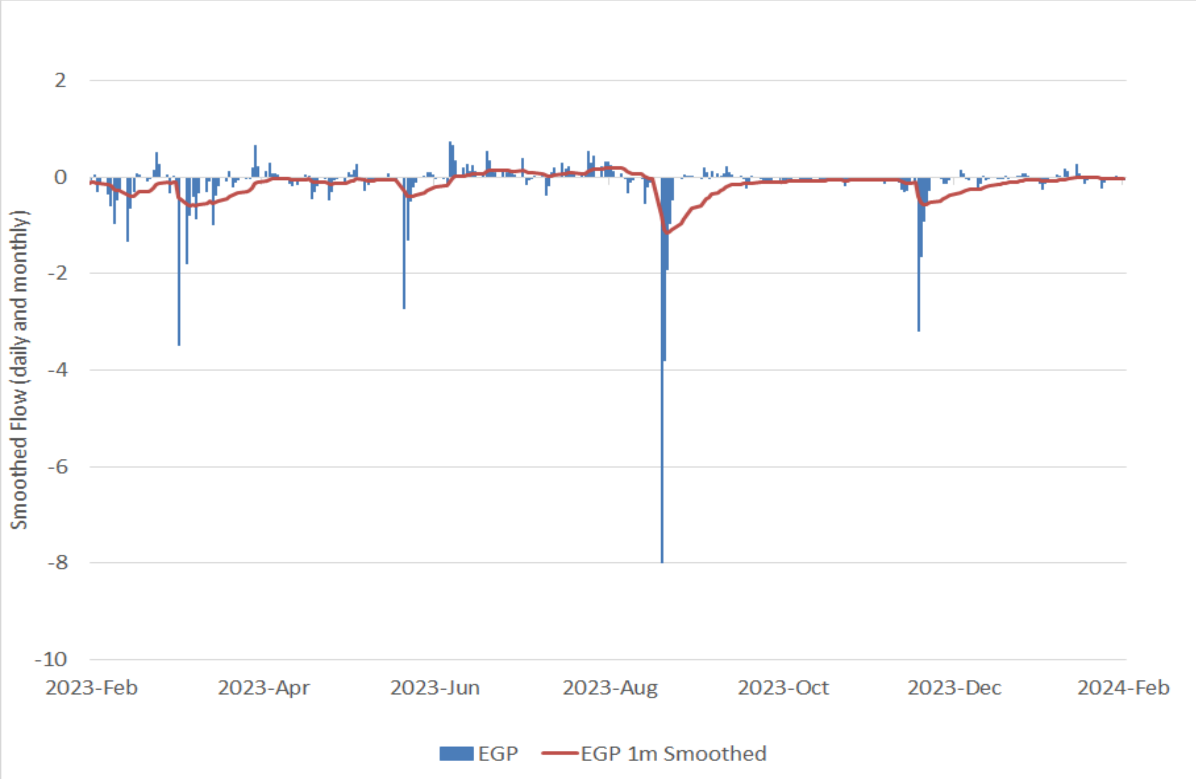


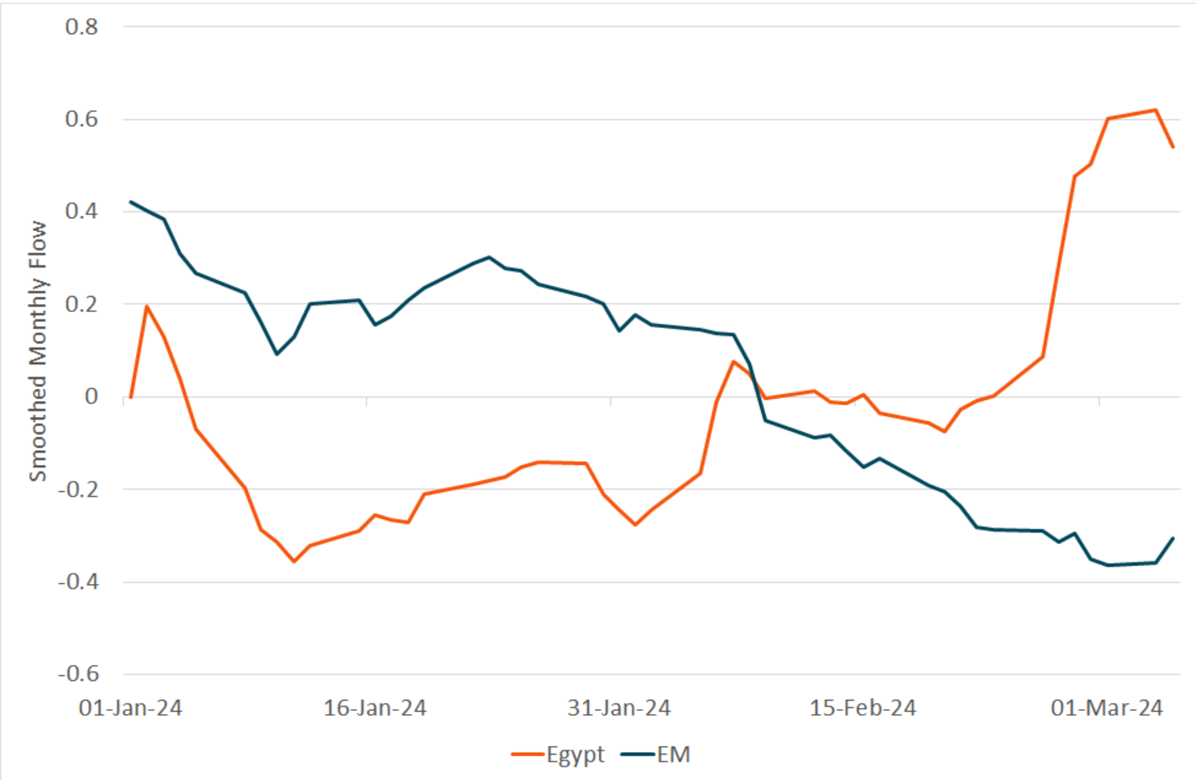
Source: Macrobond, BNY Mellon

Evidently, developments in the Middle East in Q4 changed the equation drastically due to Egypt's geographical proximity. The 1m NDF had already shifted higher, indicated above 40, and it was widely assumed that more EGP weakness was needed for the IMF to unlock additional funding, independent of other developments. Even so, the situation in the Red Sea has generated direct pressure on Egypt's balance of payments – as acknowledged by the CBE in its statement today. The sharp drop in shipping passing through the Suez Canal will lead to a sharp decline in transit fees, despite the 15% hike in prices in 2023. During the fiscal year ended June 30, 2023, total transit fees for Egypt hit $8.8bn, which is material for a country that only held $35bn in reserves as of end-January, according to CBE data, and equivalent to Egypt's entire financial account over the same period.

The CBE anticipates "lagged effects" from the 600bp rate rise. We expect the USDEGP NDF market to remain volatile, even though the CBE judges financial conditions "sufficiently restrictive". We would not over-emphasize financial risks to Egypt's economy for the time being, even taking into account what will likely be a material decline in financial receipts.

Exhibit #3: EGP And Egyptian FI Flows





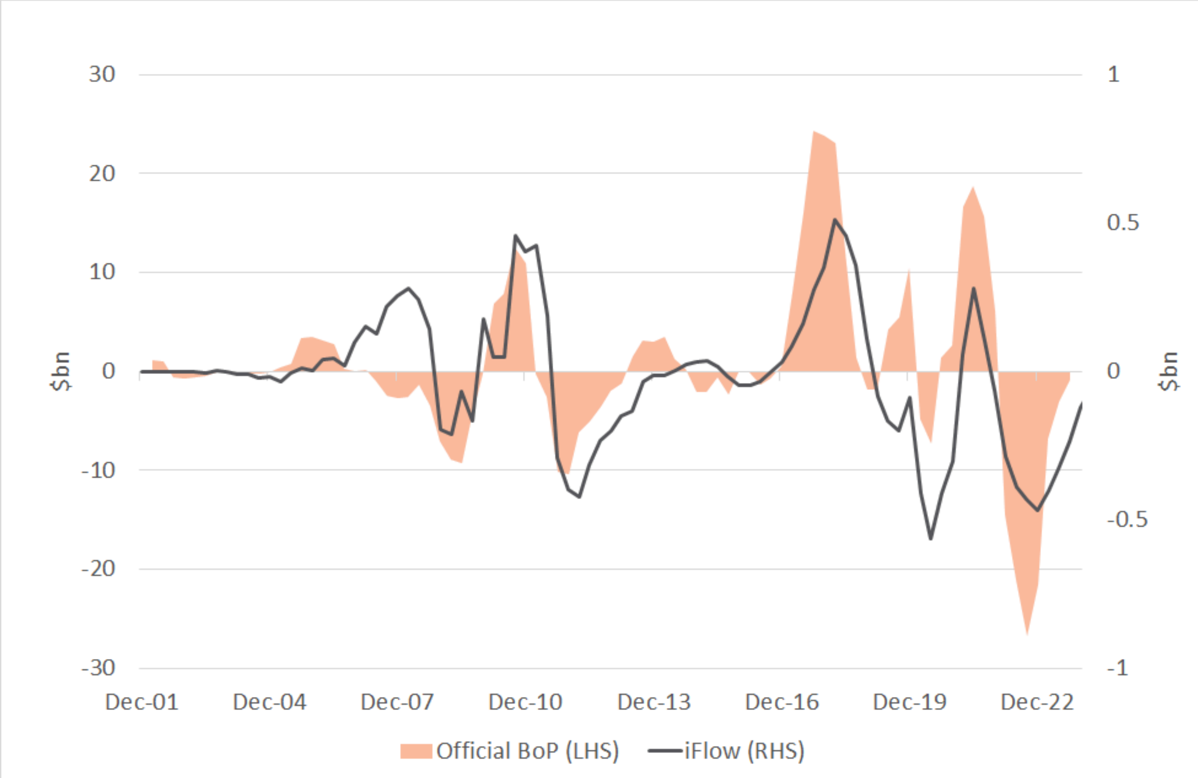
Source: BNY Mellon

Capital controls will likely continue to limit scope for domestic-based devaluation, and the cross-border component doesn't seem in a position to generate additional outflow pressure. Exhibit 3 shows our custody transactions data in Egypt FX and fixed income – neither indicates strong selling interest. There were large rounds of concentrated FX flows in 2023, including later in the year, but so far in 2024 activity has been light. Not only have net FX flows been neutral, but the range of flow scores has also been far narrower than in 2023. On a cumulative basis since 2021, positioning levels for non-local clients are extremely light. Additional positions could now benefit from higher carry when contracts are rolled, further reducing outflow incentives. If the CBE has succeeded in unifying exchange rates, it could also prove easier to manage volatility through transactions in the official market.

Crucially, we believe the financial account is robust. iFlow tracked strong flow surge in Egyptian bond interest towards month-end: monthly smoothed hit the best levels in the last 12 months by far. The strength of the flows in a short space of time could point to some large transactions, such as the recently announced investment by sovereign entities in the region. However, it is also apparent that fixed income demand has been improving over the past few weeks – and has managed to avoid strong outflows despite challenges from higher US yields. The IMF loan programme will support the portfolio balance further and may even 'stop in' additional investment flows on the financial account as valuations are more favourable. There are also sovereign and multi-lateral funding backstops in place. That the inflows have not been accompanied by strong currency sales suggests that hedging is light for now. Hedging ratios will likely be even lower after the rate hike.

Our iFlow EM framework shows ongoing improvement in the country's balance of payments (exhibit #4). As of March 4, the rolling 12-month sum of portfolio flows into Egypt was approaching flat for the first time in several years. Given the recent discrete investments into the economy the trend should prevail, assuming the devaluation itself is seen as part of the reform process that was necessary. In addition, much of the flow would for now be taking place in hard currency without direct currency exposure, with the view that servicing portfolio liabilities over time should ease as the currency's valuations begin to improve.

Exhibit #4: iFlow Indicates BoP Improvement



Source: BNY Mellon

Considering the recent trend of negative EM portfolio flow, Egypt should be viewed as a relatively strong performer. If marginal purchases continue, other economies with similar balance-of-payments stress, such as Turkey and Argentina, may need to revisit their current policy paths and broader reform programmes. Geopolitical developments will continue to play an outsized role in Egypt's economic stabilisation, but the financial and monetary policy elements are now in place. Those have the potential to free-up political space for Cairo to redouble efforts on pushing for a broader settlement in the Middle East region.

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