Egypt Foreign Currency System's Crisis

by

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1. Introduction

- Egypt has endured nearly three years of political upheaval since the uprising that overthrew Hosni Mubarak in February 2011 and eventually brought Islamists to power. Afterwards, the Military ousted President Mohamed Morsi following mass protests in July 2013.
- The credibility of newly appointed government by the interim president - and how well they do in forthcoming parliamentary polls - may rest on how they handle the economic crisis.
- The economic crisis affected the Egyptian pound dramatically during the political unrest. However, the foreign currency liquidity problem reached the peak (according to Central Bank of Egypt's data) as the pound has lost more than 4% of its dollar value since December 30, 2012 to July 2013, when the central bank introduced a new system for selling foreign currency to try to stop the fall in foreign reserves.
- The pound's slide has raised concerns about inflation in the food-importing sector in particular that could explode further unrest.
- In response to the current socio/economic difficulties facing Egypt, the newly appointed interim government has accordingly defined three key objectives, which are:
  - Stimulating the economy
  - Achieving social justice

- Implementing a fiscal consolidation plan to ensure economic stability

- ❑ However, without increased stability, the government will face an uphill task.
- ❑ The critical element in the business confidence and strengthening several economic indicators has been the pledge of US$12bn in aid from Gulf Arab states. The UAE and Saudi Arabia have already made interest free deposits totaling US$5bn with the Central Bank of Egypt (CBE).
- ❑ The Gulf Arab states have provided additional support through gifts of petroleum products and natural gas.

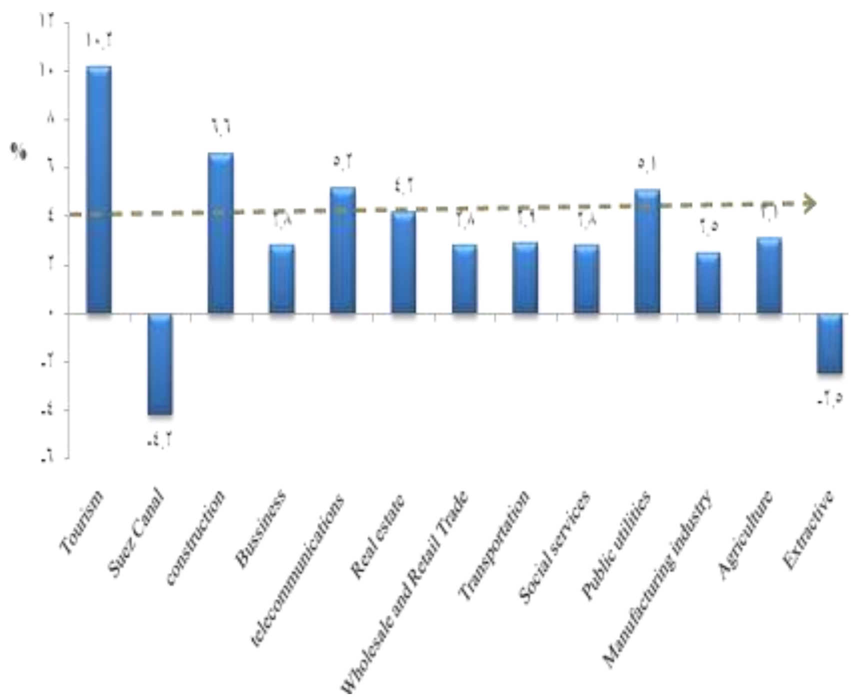
Overview of Macroeconomic Conditions (GDP Growth)

- Real GDP growth showed relative improvement during FY 2012/13, recording a growth rate of 2.3% compared to 2.2% during the same period last year, where public and private consumption remain the major contributors to the realized growth, as they comprise 92.5% of GDP.

Source: Ministry of Planning

- The GDP growth of (2.3%) was profoundly supported by the improvement in key sectors that contribute the most to GDP growth, including
  - tourism (10.2% growth as opposed to 1% decline during the same period of last year; 3.4% of GDP), construction (6.6% growth; 4.4% of GDP),
  - telecommunications (5.4% growth; 2.6% of GDP),
  - and real estate (4.2% growth; 2.4% of GDP).
- Other sectors witnessed a significant shift in their growth trends, yet their performance is still below potential, including manufacturing industries (2.5% growth; 15.6% of GDP).

- On the other hand, the growth was faded by the continuous, yet of lesser extent, deterioration of other sectors, including
  - Suez Canal (-4.2% growth; 1.9% of GDP),
  - And the extractive industry sectors (-2.5% growth; 16.6% of GDP).



2.1 Forecasted GDP Growth

- According to Economic Intelligence Unit (EIU) Forecasts, the pace of economic growth will begin to accelerate from 2014/15, as improved stability leads to a recovery in domestic demand.
- In addition, an improvement in the business environment should see a number of long-delayed projects get under way, including the electricity and hydrocarbons sectors.
- The improved security picture should also help to stimulate a bounce-back in the tourism sector.
- Meanwhile, the weakening of the pound should contribute to stronger services and manufacturing exports, which will be further assisted by a strengthening of global economic sentiment more generally.
- Consequently, EIU expect real GDP growth to recover markedly over the remainder of the forecast period, reaching 5.1% in 2016/17.
- Projected GDP Growth Rate (%)

	2013-2014	2014-2015	2015-2016	2016-2017
GDP Forecast	1.9%	3.3%	4.8%	5.1%

Source: Economic Intelligence Unit (EIU)

2.2 Fiscal Deficit

- The overall budget deficit to GDP ratio increased to 13.8%, reaching LE 239.9 billion, compared to LE 166.7 billion during FY 2011/2012.
- This notable increase in deficit comes as expenditures increased at a higher rate than the growth in fiscal revenues. In addition, the primary deficit to GDP increased during the year of study to 5.4% compared to 4% during FY 2011/12.
- It is noteworthy that the recorded increase in expenditures can be explained mainly in light of the increase in three main categories:
  - First, an increase in Compensation of Employees chapter due to an increase in rewards and employees incentives by LE 7.8 billion up to LE 60.5 billion, in addition to the increase in Permanent Staff (basic pay) by LE 3.4 billion up to LE 23.3 billion, and the increase in Specific Allowances by LE 5.9 billion up to LE 17 billion.
  - Second, the increase in interest mainly due to the increase in interest on treasury CBE Bonds by LE 11 billion up to LE 22.2 billion during FY 2012/2013, in addition to the increase in interest on treasury bills by LE 15 billion up to LE 51.3 billion during the year of study. And finally, an increase in treasury bonds by LE 12.4 billion up to LE 37.4 billion during the year of study.
  - Third, an increase in Subsidies Grants and Social benefits due to an the increase in petroleum subsidies by LE 24.5 billion to LE 120 billion, in

addition to the increase in social insurance pensions and contributions in pension funds by LE 10.2 billion.

2.3 Domestic Debt Profile

- ❑ Recent statistics show that domestic budget sector debt increased to 83.4% of GDP as of end of June 2013 to some LE 1446.9 billion compared to LE 1155.3 billion as of end June 2012 (74.9% of GDP).
- ❑ As for net domestic budget sector debt, it reached LE 1269.3 billion (73.2% of GDP) compared to LE 990.5 billion (64.2% of GDP) as of end of June last year.
- ❑ Accumulated budget sector debt at end of June 2013 was mainly attained via increasing issuances of T-bills and T-bonds;
  - Outstanding stocks of T-bills and T-bonds at end of June 2013 amount to LE 425.8 billion and LE 315.5 billion respectively versus LE 408.6 billion and LE 270.6 billion at end of June last year reflecting government's growing borrowing needs.

2.4 Egypt External Debt Indicators

- Egypt External Debt indicators almost stabilized compared to December 2012, while increased notably if compared to June 2012. External debt stock recorded US$ 38.4 billion in June 2013, increasing by 14.8%, compared to US$ 33.4 billion at end of June 2012.

- Moreover, the ratio of external debt to GDP increased from 13.1% of GDP at end June 2012 to 15% of GDP at end June 2013.

- The notable annual increase in non-government external debt is significantly attributed to a Qatari deposit in CBE amounting to US$ 4 billion as part of a financial assistance pledge that was deposited in CBE during the second quarter of FY 2012/13, in addition to an amount of US$ 2.5 billion of Qatari Funds converted into T-bonds that was deposited in the third quarter of the same year.

- Meanwhile, government external debt increased slightly by 1% to reach US$ 25.9 billion (67.1% of total external debt) as of end of June 2013 compared to US$ 25.4 billion (76.2% of total external debt) at end of June 2012.

2.5 Interest Rates – Monetary Policy

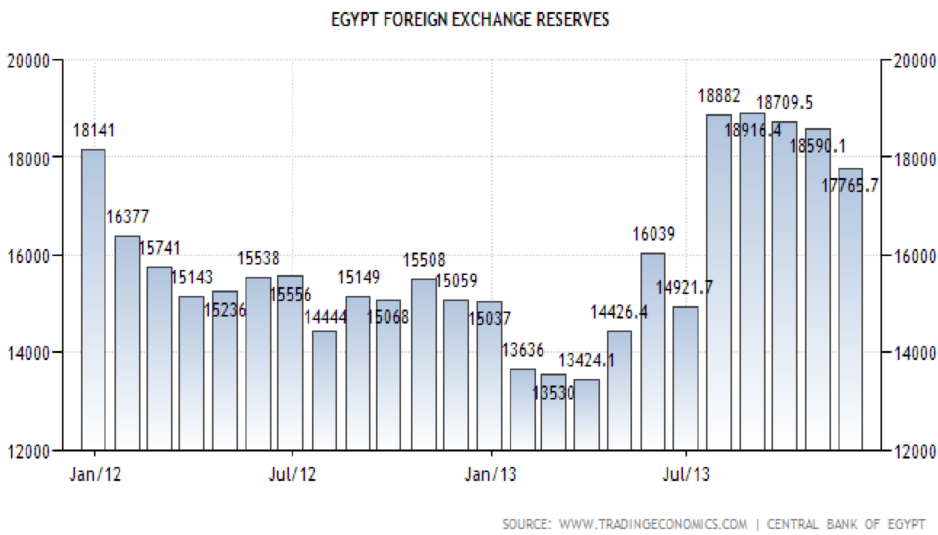
- As the ultimate aim of the monetary policy is price stability, the CBE seeks to bring inflation to an appropriate and stable level conducive to fostering confidence, stimulating investment, and achieving the targeted economic growth.

- The overnight interbank interest rate is considered the operational target of the monetary policy, whereby a framework based on the corridor system is applied, within which the ceiling is the overnight interest rate on lending from the Central Bank, and the floor is the overnight deposit interest rate at the Bank.
- The CB took a decision in July/September of 2012/2013 to lower interest rates responsive to the changes in inflation and the estimates of inflationary pressures.
- In these continuous meetings, the CBE's key interest rates (overnight deposit and lending rates) unchanged at 9.25% and 10.25% per annum, in order. Also, the lending and discount rate was maintained at 9.50% per annum, and the repo rate at 9.75% per annum.
- Subsequently, in the meetings of 18 October and 6 December 2012 and 31 January 2013, the CB committee decided to continue with the last interest rates (July/September of 2012/2013 decision).
- The weighted average of the market interest rate on three-month deposits has increased from 7.8% January 2013 to reach 8.1% June 2013 and remained stable till the end of August 2013, while the weighted average of the market interest rate on six-month and one year deposits rose to 9.3% and 9.4%, in order, in June andAugust 2013 (against 9.0% and 9.1% in January and March 2013) before going down again to 9.3% in October 2013.
- Also, the weighted average of the market rate on one-year loans increased to 12.6% in June 2013 (from 12.1% in January 2013).

2. Foreign Reserves

- In Egypt, Foreign Exchange Reserves are the foreign assets held or controlled by the central bank of Egypt (CBE). The reserves are made of gold or a specific currency. They can also be special drawing rights and marketable securities denominated in foreign currencies like treasury bills, government bonds, corporate bonds and equities and foreign currency loans.
- Foreign Exchange Reserves in Egypt decreased to 17.76 USD Billion in November of 2013 from 18.59 USD billion in October of 2013.
- Foreign Exchange Reserves in Egypt is reported by the Central Bank of Egypt.
  - Reserves in Egypt averaged 24.16 USD Billion from 2003 until 2013,
  - reaching an all time high of 36.038 USD Billion in December of 2010
  - and a record low of 13.42 USD Billion in March of 2013.
- CBE Net International Reserves (NIR) almost stabilized at end of June 2013 compared to last Year
  - Increasing by only US$ 300 million – to record US$ 15.8 billion compared to 15.5 billion in June 2012.
- At end of August 2013 CBE net international reserves (NIR) almost stabilized compared to last month
  - Increasing by only US$ 30 million – to record US$ 18.91 billion.

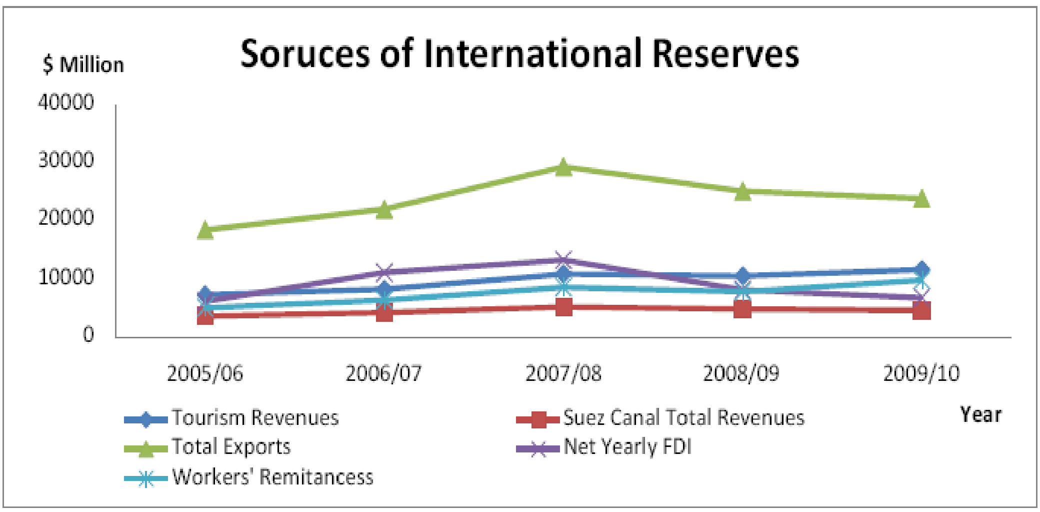
- ❑ The rise witnessed in NIR during the FY 2012/2013 was mainly due to the positive performance of FX earners in addition to lower import prices as the currency strengthened when compared to the FY 2011/2012.
- ❑ It is worth mentioning the Egypt's NIR reached its highest level of US$ 18.88 billion in July 2013 since November 2011, which stood at US$ 20.1 billion.
- ❑ It is important to highlight that CBE received a sum of US$ 4 billion from Saudi Arabia and UAE in July 2013
  - US$ 2 billion received from each country in form of interest-free deposits,
  - In addition to US$ 1 billion grant from UAE.



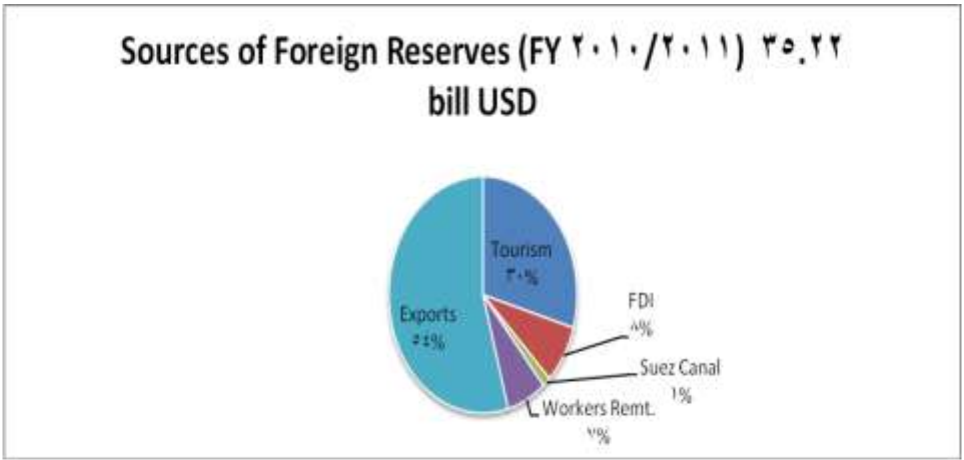
The main sources of International Reserves:

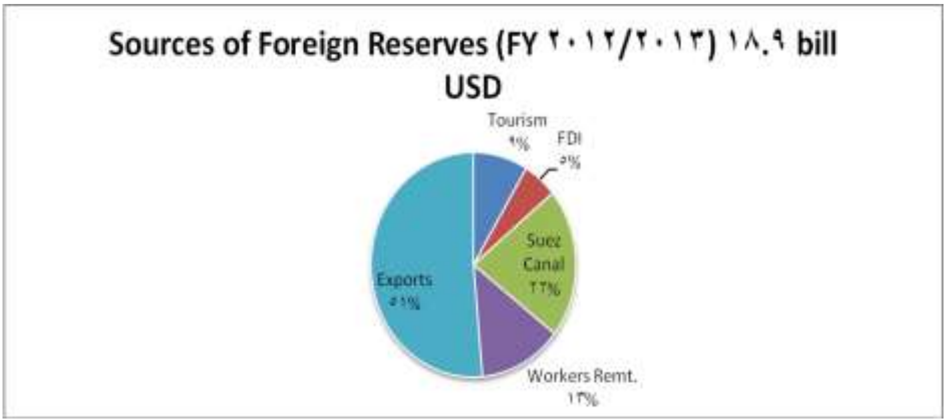
- The main **sources** of foreign currencies that the Net International Reserves (NIR) in Egypt depends on the Suez Canal, Tourism activities, Exports, workers' remittances, Foreign Direct Investments.
- Those sources were the main reason why the international reserves in Egypt were accumulating through the last 6 years before the political unrest in 2011, reaching the peak in **June 2010** when a total value of **USD 35.22Billion** was achieved.
- After the political unrest in 2011, some of these sources, if not all, at some periods of time during the past 3 years faced dramatic deterioration, which affected on the foreign currency inflows. Specially, Tourism and Foreign direct investments (FDI).

Source of the following charts: Central Bank of Egypt.



Source: Central Bank of Egypt





3. Foreign Exchange System in Egypt

- Egypt's exchange rate has been historically characterized by a large degree of rigidity,
- In January 2003 the Central Bank of Egypt (CBE) announced a float of the Egyptian Pound (LE).
- Although this move meant that exchange rate should cease to be the explicit nominal anchor for monetary policy, there has been no announcement of any other.

- Even more, there is an increasing public perception that it remains an implicit target of monetary policy.
- Egypt maintained a peg of its currency to the US$ for over forty years, since the sixties until 2003.
- During this period, the exchange rate has been relatively stable over time, except for periods where devaluations occurred to reflect a more competitive value for the exchange rate.
- More accurately, it behaved like a “fixed adjustable peg”, regardless of its official classification.
- The nominal exchange rate also exhibited very limited volatility, of almost 3%.
- After the 2003 float, it declined to 2.8% from 3.6% before.
- The announcement of the float in January 2003 was followed by depreciation until October 2004 to LE/US$ 6.23 (by 15.6%).
- Since then and until August 2008, the exchange rate continued to appreciate and reached LE/US$ 5.32.
- The substantial increases in foreign exchange earnings (oil exports, Suez Canal, tourism and FDI inflows) led to an unprecedented accumulation of international reserves (from US$15 billion to US$35 billion) between 2005 and 2008.
- However, the LE/US$ has only nominally appreciated by 8.4%, but at a much quicker pace in real terms, by about 14%.
- During the global crisis (between September 2008 and March 2009), Egypt experienced a sharp fall in

Egypt's external demand on goods and services as well as a sudden stop in capital flows.

- In fact, portfolio outflows were significant (down by 5% age points of GDP),
- the stock market jumped by 63% and the foreigner's holdings of T-Bills fell from LE 32 billion to LE 11 billion.
- Foreign direct investment inflows fell by more than 50%.
- However, the exchange rate depreciated by just 3.3%. Following central bank intervention in the foreign exchange market in March 2009, the exchange rate stabilized at LE/US$ 5.62 and started appreciating since May 2009.
- Moreover, official international reserves which continued to accumulate (although marginally) until October 2008 started to decline afterwards, though slightly (by 8% between October and March 2009) and stood at US$ 31.3 billion in June 2008 (down by almost US$ 3 billion).

❑ The float allows the CBE to intervene in the foreign exchange market only to counter major imbalances and sharp swings in the exchange rate.

❑ However, the stability of the exchange rate since 2005 always raises the question of whether it is the outcome of continuous intervention to resist appreciation.

Foreign exchange rate chart (EGP/USD) – January 7th, 2013 to December 17th, 2013

(Source: Exchange rates – UK)

4. Egypt Sovereign Ratings

- The present and anticipated foreign exchange risk:
  - Disruption of economic activity, security failures, and lingering uncertainty have taken their toll on growth during the past three years and resulted in downgrade of Egypt's rating by several agencies to reach CCC+/C in 2012 by Standard & Poor's
  - The country's ongoing economic weakness and financial deterioration, as reflected in the sharp loss in official foreign exchange reserves since the beginning of 2011, the likelihood of continued macroeconomic weakness and instability, and the rising pressures on budgetary and financing.

- The continued unsettled political conditions and the uncertainty over the transition to a stable, civilian government.
- However, Standard & Poor’s raised Egypt’s long and short-term foreign and local currency sovereign credit ratings to B-/B on November 2013 with Stable outlook.
- Egypt was given a “stable” rating outlook by S&P’s due to the considerable aid it has received from the Gulf Arab States, which is expected to weigh against significant external financing pressures.

❑ Egypt's new rating is still located in the "junk" status end of the credit rating spectrum.

❑ The agency's optimism was tempered by structural weaknesses in Egypt's economy, such as

- "Weak" government finances, a central bank which will continue to monetize much of the government's local currency debt.
- "Central bank claims on the government and public sector increased to about 23% of GDP as of July 2013," a trend which would generate 10% average annual inflation over the next few years, alongside supply-side constraints.

❑ The agency also cited Egypt's high and expensive government debt, which it expects to reach 76% in 2013 and peak at 78% in 2014, as the government increases its debt "to meet its significant fiscal deficits while using some of its borrowings -- namely from the GCC states -- to support the level of foreign currency reserves at the central bank."

- ❑ Standard and Poor's also highlighted the government's limited ability to raise revenues or cut spending, and its inflexible monetary policy given the Central Bank of Egypt's heavy support of the Egyptian pound since 2011 and the banking sector's high exposure to the government.

The Foreign Currency Liquidity Problem (Market Analysis)

6.1 Central Bank Decisions to control the crisis:

- ❑ By January 2013 the Egyptian pound (EGP) had depreciated by over 12.5% of its value since the uprising in 2011. In addition, the Central Bank’s foreign reserve kept on declining since the 2011 uprising due to the political and economic disturbance.
- ❑ The increasing gab between the supply of foreign currency and the demand of the market is due to the fact that the tourism and industrial sectors (main generators for the foreign currency with the Suez Canal) are facing dramatic decreases in revenues since 2011 uprising. On the other hand, Egypt's trade balance deficit increased as the imports increased to cover the decreasing production of the industrial sector. (Tourism Index shows the huge decline in the sector starting from February 2013).
- ❑ As a result, the Central Bank decided to limit financing the country’s imports of goods and services to the following list:
    - Essential food and beverages products
    - Intermediate and production products used for production by factories (That has no domestic substitutes)

- Heavy machinery and spare parts for factories.
- Pharmaceutical products
- Gas and Petroleum products
- Industrial materials and chemical product.

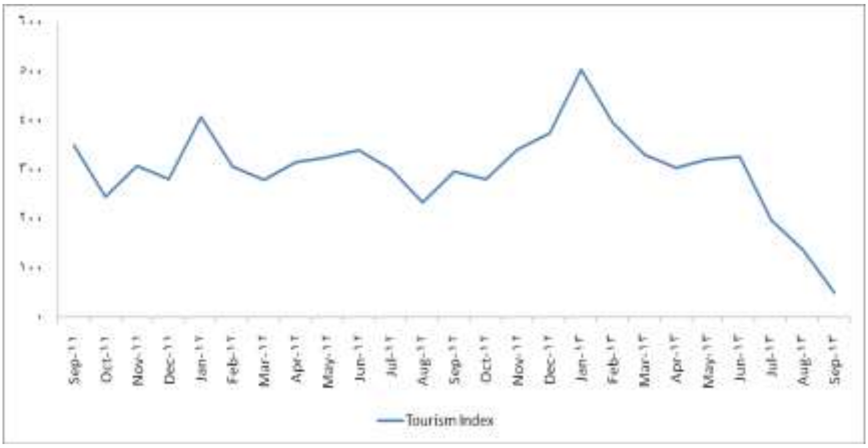
❑ The CB also is holding auctions for banks to distribute the foreign funds needed to meet the banks transactions.

- The auctions are aimed at rationing Egypt's supply of dollars and giving priority to staple food imports
- However, these auctions were not enough to cover the demand of foreign currency in the Egyptian market with continuation of the decreasing revenues of the Tourism and the low export figures.

Tourism Monthly Index (Major Sector in Egyptian Economy)

September 2011 – September 2013 (Base Year – Year/Month 2002 = 100)

(Source: Ministry of Planning, Egypt)



6.2 Banks:

- Banks are restricted by the list of goods issued by the Central Bank to open letters of credit (LCs) and making remittances.
- The banks' foreign currency shares and the Auctions held from the CBE are not enough to meet the demands of the LCs. Although the auctions are the government's solution to saving the Egyptian pound from the currency crisis,it only covers up to 25%.
- Sometimes the CB holds an Auction of foreign currency for the banks, but still it does not cover all the LCs.

- The companies' LCs are put on a waiting list (first come first serve strategy) with reference to the essential goods list. (There is no time limit for this list)
- If the client is not importing an essential good, the remittances are either rejected or listed at the end of the waiting list. (Depending on how important the client to the bank)
- For the enhanced letters of credit, the banks are obliged to make remittances, but during the crisis there is no time limit. Some banks refuse this type of credit and use another types:
  - Use the clients' deposit accounts to finance the credit.
  - Other banks, such as the Gulf Egyptian Bank, use the Collection format (form no. 4) instead of the enhanced letters of credit.
- The public banks have no problems in financing the foreign currency LCs for the essential goods list due to the strong financial position.

6.3 Companies:

- There are three categories of companies that need the foreign currency for importation, and accordingly these companies deal with the liquidity problem differently.
  - Industrial companies, who have export revenues that covercertain limit of their needs of foreign currency to import intermediate goods, raw materials, spare parts and machinery.

- Medium size companies, who either depend completely on exports to pay for the cost of imports, or exports revenues with the bank to pay the cost of imports.
- Small size companies (or importers), who completely suffer from the foreign currency liquidity problem,

❑ Companies that have exports revenues ranging from 25 to over 50%, do not face problems with the banks in financing their imports credits.

❑ Less than 25%, these companies are listed on the bank’s waiting list, and as mentioned earlier in the Banks section, it depends on the type of products they are importing.

- Essential products, and products mentioned at the CB list have the priority.
- Production and industrial raw materials have the second priority for the banks.
- Other kinds of products that have local substitutes are rejected by the banks.

❑ Companies that cannot wait till the banks secure the funds needed for the credits (on average two to three weeks), they have two options:

- Secure the currency from the black market at higher prices that increases the costs.
- Communicate with the foreign supplier to extend the credit period, which means more guaranties and securities demanded by the suppliers.

- ❑ Measures taken by the companies to secure the needed funds for the imports credits depend on the financial position of the company.
- ❑ These measures are:
  - Depend on the bank deposits by withdrawing the amounts needed.
  - Open LCs guaranteed by the company's Egyptian pound bank statement to make the remittances till the foreign currency is available to cover the credit.
  - Set priorities for the bank to cover certain receipts and credits whenever the funds are available.

Companies	Exports Revenues	Banks	Black Market
Industrial	✓	✓	×
Non Industrial	✓	✓	Sometimes
Importers	×	✓	✓

6.4 The Foreign Currency Liquidity Problem (When the crisis will be solved?)

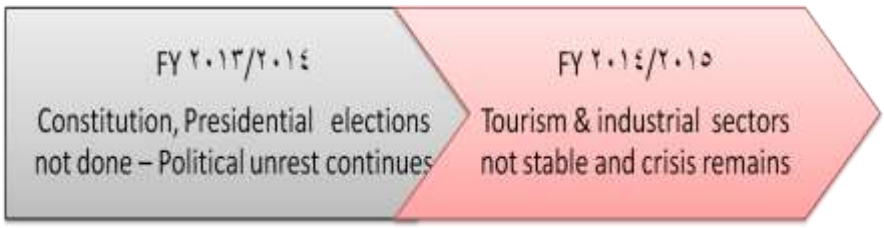
a) Positive

- The road map declared by the government is being executed as planed, then by the end of the fiscal year 2013/2014;
  - The political and socio-economic situation stabilizes as result.
  - Continuation of Gulf countries financial support. In addition, EU aid and IMF financial support.
  - The tourism and industrial sectors start generating revenues in foreign currency.
  - Egypt’s long and short-term foreign and local currency sovereign credit ratings rise to the stable level.
  - The foreign exchange rate risk will decrease
  - Increase in the foreign direct investments

b) Negative

- The road map declared by the government will not be executed as planed, then by the end of the fiscal year 2013/2014;

- The political and socio-economic situation deteriorates as result.
- Lower aid from the EU and lack of financial support from the IMF.
- The tourism and industrial sectors stay on the stagnant situation not generating revenues in foreign currency.
- Egypt’s long and short-term foreign and local currency sovereign credit ratings will be lowered again
- The foreign exchange rate risk will increase
- No Foreign direct investments inflows



c) Current

- ❑ Continuation of the political and socio-economic situation with a delay in the Road map till the end of FY 2013/2014
- ❑ The tourism and industrial sectors do not improve from the deteriorating stage, and not generating revenues in foreign currency.
- ❑ The foreign exchange crisis keeps on affecting the liquidity of funds.

- ❑ Egypt’s long and short-term foreign and local currency sovereign credit ratings will be lowered again
- ❑ No Foreign direct investments inflows

5. Recommendations

a) For Foreign supplier and importing companies:

- ❑ More flexibility from the foreign supplier to
    - ❑ Extend the credit period
    - ❑ Rescheduling the importers debt (Payment deadlines and facilities).
- ❑ To reduce the cost of finance for the supplier, it is advisable to consider establishing a factory in Egypt starting from FY 2014/2015.
    - ❑ It will also cover the MENA region.
- ❑ Companies need to give the required guaranties and securities demanded by the suppliers.
- ❑ Over draft the company's USD current account with the Egyptian Pound.

b) For Central Bank:

- ❑ Redefining the essential products list to include industrial raw materials and packaging materials, even if they have domestic substitutes.
- ❑ Foreign currency auctions on a regular basis.
- ❑ More control on the foreign currency market to decrease the effect of the black market.

6. Egypt Economic Indicators

	2010/2011	2011/2012
Population (m)	81.12	83.66
GDP growth (%)	1.9	2.2
Unemployment Rate	12	12.5
CPI (% change)	11.1	10.6
Exchange Rate (L.E vs $) - Ave	5.9	6.89

Source: Central Bank of Egypt (CBE) – Central Agency for Public Mobilization & Statistics (CAPMAS)

7. Banks & Companies Surveyed

Banks	Companies	
Bank Misr	Guhayna	Domty
Bank Ahly	PepsiCo	Tetra Pak Egypt
CIB	SidyCo (SewidyGroupt)	Universal Group
QNB Ahly	Al Hekma Pharmaceutical Co.	Kiro''s Sanitary - Meshmesh Group
Egyptian Gulf Bank	El Rashydi El Mizan	RabeaPoltary
Arab Investment Bank		
Credit Agricole Bank		

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