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17 March 2016

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Government of Egypt

Egyptian Pound's Devaluation is Credit Positive

On Monday, Central Bank of Egypt (CBE) devalued the Egyptian pound by 14.4% to EGP8.85 to the US dollar and decided to adopt a more flexible exchange rate regime. The CBE's decision, which comes at a time of low net international reserves, slowing growth and a widening difference between official and black market exchange rates, is credit positive for Egypt (B3 stable) because it brings the official exchange rate closer to market rates.

This will limit the need to spend foreign exchange reserves to support a higher currency value and is likely to boost exports and foreign investment inflows. These positive results should outweigh the near-term negative effect from devaluation-induced inflation. At the same time, devaluation will have a limited effect on the government's debt stock or debt servicing costs owing to the low levels of foreign-currency-denominated debt.

Egypt has been experiencing strains on its external liquidity position because of a combination of slowing external donor support, a widening non-grant current account deficit and declining investment flows.

Export earnings suffered from a decline in tourism and Suez Canal receipts, lower petroleum exports and weaker global demand: for the third quarter of 2015, total goods exports in the balance-of-payments were 26.5% lower than a year earlier. The significant real exchange rate appreciation as a result of Egyptian pound's peg to the US dollar has exacerbated the decline in exports.

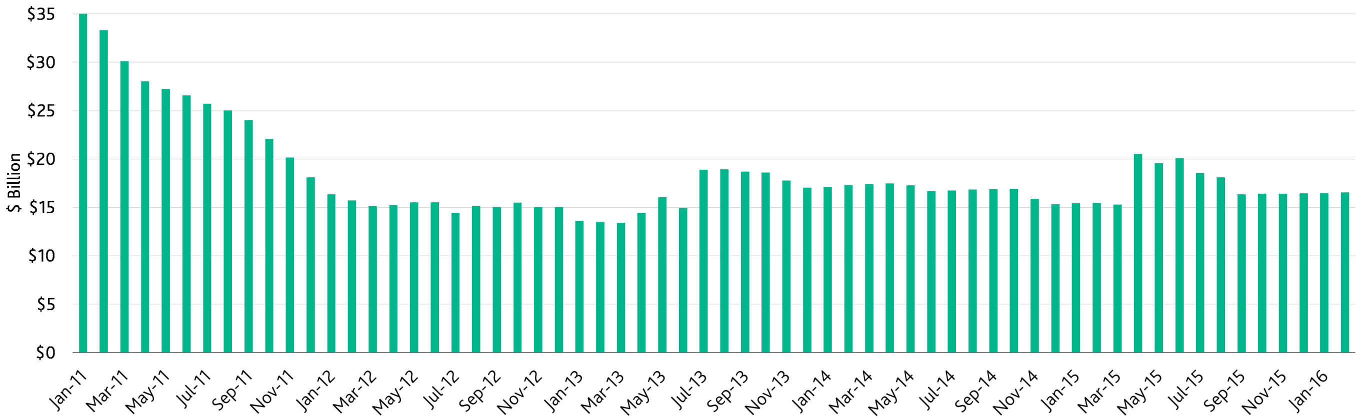
Investment flows have also stagnated following recent positive trends as capital controls and import restrictions prevented repatriation of earnings and import payments, and dampened investor sentiment.

Tightening external liquidity has made it difficult to import raw materials and this has hampered industrial activity. The government recently lowered its growth forecast for this year to 4.00%-4.25% from a previous forecast of 5.00%.

A more flexible exchange rate regime could offset some of the above challenges. A weaker currency is likely to improve trade competitiveness. Accompanying the adjustment in the currency regime is a removal of limits on foreign currency cash deposits and withdrawals for the import of essential goods, which had been in place since February 2015. Together, this action will support a revival in economic activity and investment.

The combination of improving external dynamics and a better growth outlook should reduce balance of payments pressures which have resulted in Egypt's net international reserves, stagnating at around $16.5 billion (see Exhibit 1).

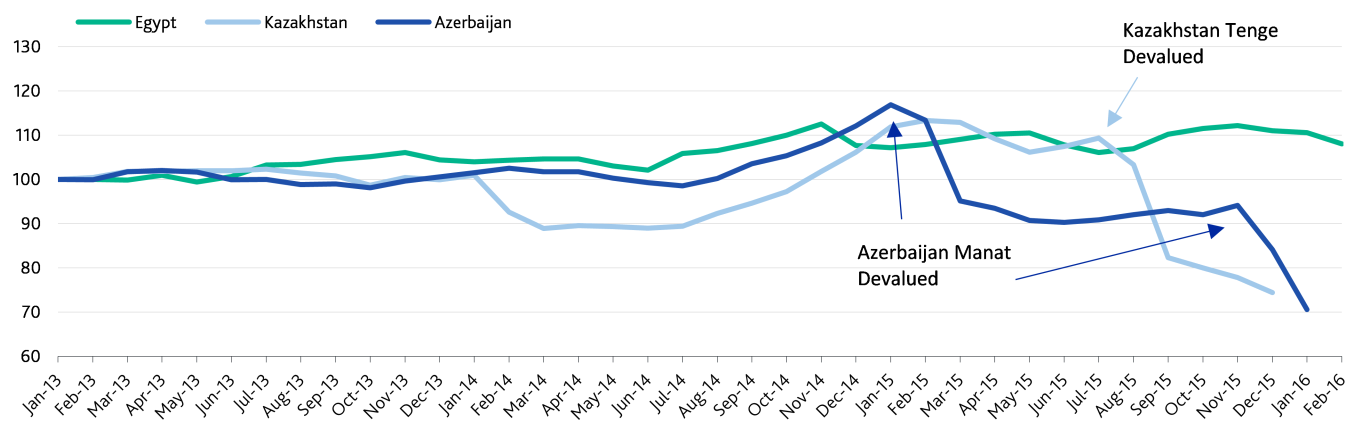
Exhibit 1
Egypt's Net International Reserves Have Stagnated at Low Levels



Source: Central Bank of Egypt and Haver Analytics

Although depreciation raises foreign currency debt repayment costs, low levels of external and foreign-currency-denominated debt will mitigate this effect in Egypt's case. Total external debt to GDP was only about 15% at the end of June 2015, while the share of foreign-currency-denominated debt in total government debt was around 13%. This compares with our 2015 estimates of total external debt to GDP of 95% for Kazakhstan (Baa2 RUR-) and 24% for Azerbaijan (Ba1 RUR-), two countries that devalued and floated their currency over the past year (see Exhibit 2).

Exhibit 2
Comparison of Egypt's Real Effective Exchange Rate with Kazakhstan and Azerbaijan
Indexed to 100 in January 2013



Source: National sources, JP Morgan, Haver Analytics

However, exchange rate devaluation and the prospect of further depreciation will put upward pressure on already-high inflation levels, which averaged 9.6% year-on-year during the first eight months of the current fiscal year. This, in turn, risks increasing domestic political risk and social instability, especially as growth slows and unemployment remains high at nearly 13%. Nevertheless, a more positive growth outlook and lower external pressures would outweigh the risk of lower purchasing power of households, particularly if accompanied by continued tightening in monetary and fiscal policy.

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REPORT NUMBER 1020222

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