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Exchange Market Pressure Index | Further Improvement in 3Q 2017

The Pharos Exchange Market Pressure Index (EMPI) declined from 156.4 in 2Q 2017 to 133.5 in 3Q 2017. The EMPI continued to improve for the second consecutive quarter reflecting:

- Net international reserve accumulation from USD28.5 billion by the end of 1Q 2017 to USD36.5 billion by the end of 3Q 2017. Meanwhile, the CBE's monetary tightening stance helped keep the money supply growth in check.

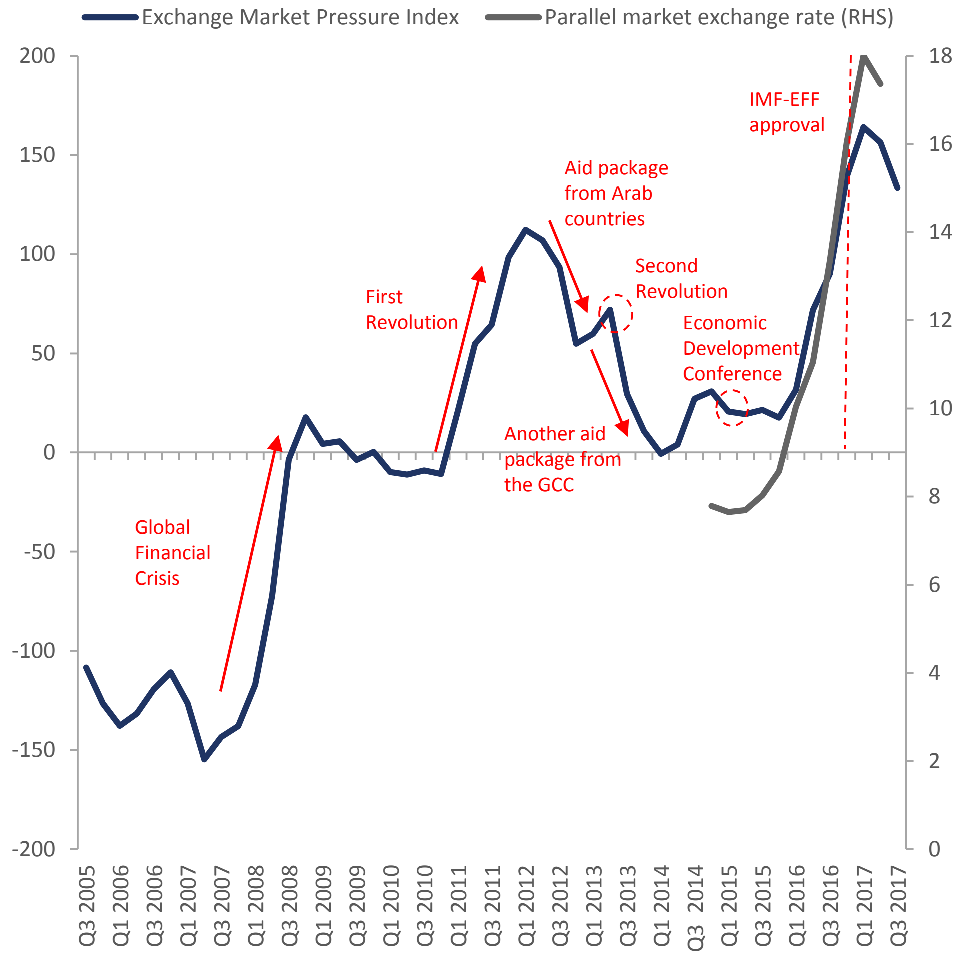
- The nominal interest rate gap, which we measure by the 6-month T-bill yield differential between Egypt and the United States, continued to decline as the inflation outlook in Egypt (the United States) drove yields lower (higher).

- The Egyptian Pound nominal exchange rate appreciated gradually from EGP18.2 per USD by the end of 1Q 2017 to EGP17.7 per USD by the end of 3Q 2017.

Going forward, we believe that further Balance of Payments (BoP) fundamental improvement would strengthen the sustainability of the EMPI downward sloping trend. On the other hand, we highlight two key risks in 4Q 2017:

- **A potential CBE policy rate cut / Fed policy rate hike:** We believe that the current yield levels already factor in the anticipated policy rate cut (hike) in Egypt (the United States) in 4Q 2017. Therefore, we do not expect a significant change in the nominal interest rate gap and, hence, expect limited impact on the EMPI.

- **The repayment of external debt obligations:** This would suggest a significant decline in the CBE's net international reserves, which could raise the exchange market pressure. However, the agreement to extend the maturity of the Saudi and the Emirati deposits at the CBE, the renewal of the Chinese swap and the repo deal, in addition to the disbursement of the IMF and ADB loan tranches would minimize such a risk.



Source: Central Bank of Egypt, Bloomberg, Pharos research

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Methodology

Exchange Market Pressure Index (EMPI) reflects foreign currency market pressure resulting from the economy's fundamentals, in addition to speculative attacks. EMPI is also a vital tool that helps capture the magnitude of the external sector imbalances even in the case of a fixed nominal exchange rate.

Our EMPI includes:

- The annual nominal exchange rate change (EGP per USD).
- The change of the Central Bank of Egypt (CBE)'s net international reserves (NIR) as a percentage of the monetary base (M0).
- The short-term nominal interest rate differential between Egypt and the United States, using the 6-month treasury yield.

Each of the three components was normalized by subtracting the mean and dividing by the standard deviation. The weight of each constituent was computed based on both the variance and elasticity approaches. Since both techniques produced homogeneous outcomes, we picked the former approach for simplicity. The EMPI increases when the nominal exchange rate depreciates, when NIR change (as % of M0) decreases, when the nominal interest rate differential increases.

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