A Managed Float Looks More Politically Appropriate

Steer Ship to Stability

This is not March 2016 in replay

In our previous research publications, we explained that improving the FCY liquidity within the banking system is a key objective whether the Central Bank of Egypt (CBE) will let the EGP float freely or will manage the EGP float (see 'Why Devaluation is Not Going to Solve it All' published on October 18). We also noted that a full EGP float is preferred from a macroeconomic perspective, but a managed float looks to be more politically appropriate. We reiterate that exchange rate flexibility is part and parcel of the International Monetary Fund (IMF) reform programme. That is why we expect more frequent exchange rate adjustments in the coming weeks, even under a managed float scenario.

Hence, we believe that the CBE's strategy will include a sharp and frequent, albeit less-than-expected, exchange rate movements, in addition to more-than-expected and frequent FCY injections.

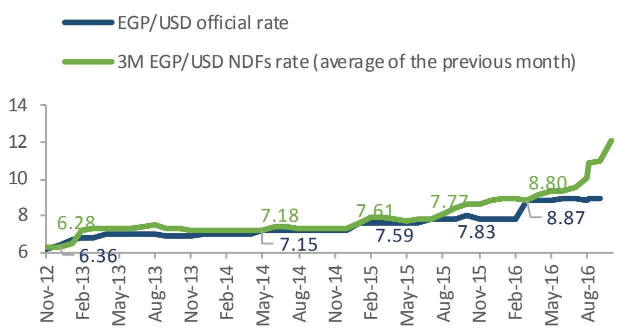
Devaluation should be penciled in for November

Previously communicated dates by government officials show that devaluation should be penciled in for November. Finance Minister, Amr El Garhy, noted that the Eurobond issuance should happen after mid-November. In addition, the MPC meets to decide on interest rates on November 17, which we estimate would be the time for a significant rate hike (c.200bps), in a bet to raise the attractiveness of the EGP as an investment vehicle and attract fixed income portfolio inflows from international investors. These dates tell us that a devaluation in November is, now, very probable.

Keep an eye on the 3-month non-deliverable forwards (NDFs) exchange rate, not just the parallel market exchange rate

Monitoring the 3M NDFs provides a less-speculative picture of the real market value of the EGP/USD exchange rate. More importantly, previous rounds of the EGP devaluation did show that the 3M NDF exchange rate can be used as a strong indicator for the magnitude of the CBE's next official rate adjustment (Figure 1). For example, the 3-month NDF rate averaged EGP8.80 per USD in February 2016, just before the exchange rate went officially to EGP8.88 versus the USD in March 2016. The 3-month NDFs exchange rate averaged EGP11.00 per USD in September 2016 and EGP12.05 per USD as of October 24, with the one-month moving average recording EGP11.80 per USD. The aforementioned readings suggest that the next exchange rate move could be somewhere between EGP11.00 - 12.00 versus USD. In that context, we note that the reported 'parallel market' rates are quite useful in defining the EGP/USD trend, rather than the exchange rate value, due to unrealistic speculation and the high risk premium.

Figure 1 I 3-month NDFs exchange rate is a better indicator to follow than parallel market exchange



Source: Bloomberg, Pharos Research

NIR build-up and FX intervention limitation represent the other side of the coin

For a managed float scenario to be successful, an exchange rate readjustment should be frequent and accompanied by an adequate FCY injection to support the new exchange rate. Generally, the IMF supports that the NIR would secure an import coverage ratio of 4.5-5.0 months. Such a target, we believe, could act as the NIR floor set by the fund, which points to an NIR floor of USD 21.0-23.0 billion. Accordingly, we believe that the CBE's ability to intervene in the FX market will be limited, but not zero.

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Mechanism: One large leap, followed by limited frequent injections to avoid NIR depletion

Assuming that Egypt has secured the USD6 billion required by the IMF in October, we estimate the CBE's NIR import coverage level at that point would hit 4.6 months of imports. Hence, together with the disbursement of the IMF facility's first tranche (USD 2.5 billion) and the international bond issuance (USD 2.5 - 3.0 billion), the CBE's FCY ammunition is well above the set floor for a few months until the official exchange rate policy would have gained better ground, leading to weaker speculative attacks. One important note is that we believe that FCY injection will walk hand-in-hand with more flexible movements in the exchange rate to ensure NIR preservation. The larger the EGP devaluation, the less CBE's FCY injections.

In brief, we believe that applying a flexible exchange rate regime, in addition to suppressing speculative attacks entail the implementation of the following measures altogether in a very narrow timeframe:

(1) An initial sharp, but less than expected, EGP devaluation,

(2) A more than expected FCY injection according to the above-mentioned mechanism,

(3) A domestic interest rate rise of 200 basis points to raise local currency appeal, anchor inflation expectations and attract foreign fund inflows, and

(4) Utilise the positive sentiment following the IMF loan approval and receiving the first tranche of the loan to stabilise the official exchange rate.

Finally, we reiterate that Egypt's external sector outlook remains 'negative,' meaning that the EGP will continue to weaken in FY2016/17, hence, "flexibility" on exchange rate movements will continue be required.

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