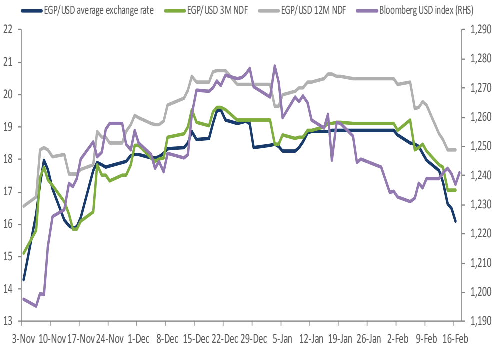
Why does the EGP appreciate?

In a previous macroeconomic flashnote, we explained the dynamics of exchange rate volatility following currency flotation. Back then, we anticipated that "the persistence of such a positive sentiment should help strengthen the EGP to average at EGP14.00-15.00 per USD in FY2016/17". We believe the current EGP rally is attributed to a combination of both internal and external factors:

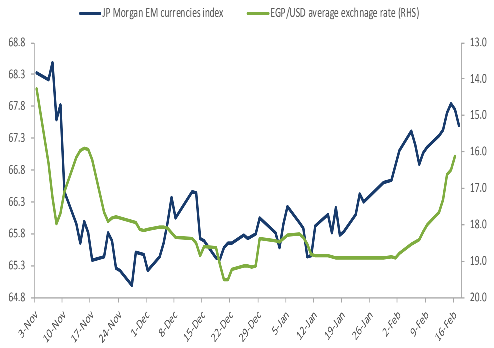
1. Dollar Trump rally reversal: Following the announcement of the US presidential election results, the USD rallied on the prospect of the new administration pro-growth fiscal stimulus. However, the USD rally was inverted following the inauguration speech. Moreover, the repercussions of the presidential executive order on immigration fueled further USD depreciation versus major global currencies. Meanwhile, emerging markets' currencies witnessed an appreciation versus the USD over the same period as shown on J.P. Morgan emerging markets currency index. Egypt is not isolated from the aforementioned developments (Chart 1 & 2).
2. Improved foreign currency liquidity domestically: Following the EGP flotation in November, commercial banks' FCY liquidity has improved significantly as reflected on exchange rate bid-ask spreads (Chart 3). Remarkably, foreign holdings of EGP-denominated treasuries witnessed a notable increase starting January. As the EGP exchange rate started to stabilize, foreign investors seized the opportunity of higher short-term interest rates.
3. Weaker local demand: We reiterate that diminishing/declining sales volumes across various sectors is yet another signal of weaker demand following the EGP flotation in addition to other economic reform measures undertaken last November, which helped pause the pressure of further EGP depreciation.

Chart 1| Bloomberg Dollar spot index captured the USD weakening versus leading global currencies



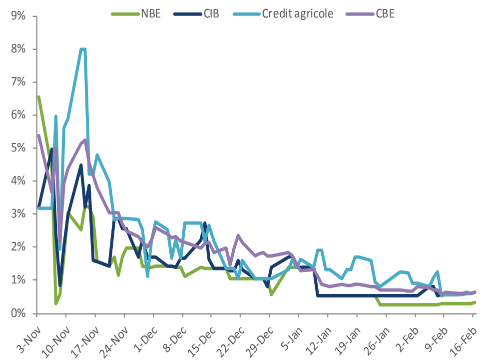
Source: Bloomberg, CBE

Chart 2| Emerging markets' currencies appreciation versus the green back



Source: Bloomberg, CBE

Chart 3| Commercial banks' exchange rate bid-ask spreads indicate improved FCY liquidity



Source: CBE, Pharos research

What to expect next over the next 3-6 months?

Exploring the outlook over a short time horizon, we underline the following external and internal dynamics.

Stronger USD may add some pressure on the EGP, but it won't be a free fall

In a recent testimony to the Senate, the Federal Reserve Chair reiterated that monetary tightening is not conditional upon fiscal plans. The FOMC dot plot originally suggested three interest rate hikes in 2017, while the market consensus hints for two hikes with a probability of 50%+ of a hike starting May. Not to mention, the sentimental impact of revealing more details regarding fiscal stimulus and tax reform plan. A strong dollar should add downward pressure on the EGP exchange rate, but we don't estimate a grave capital flight due to:

- The foreign investors' exposure to Egyptian assets is already small.
- The macroeconomic transformation story in Egypt is seen to attract more foreign currency inflow versus other emerging economies.
- The FOMC's forward guidance strategy means that any policy decision is smoothly communicated in advance.

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Mixed domestic factors may cause some volatility

Looking ahead, we highlight four different domestic events that will affect the EGP exchange rate over the short-run:

1. The Ramadan-seasonal effect (downward pressure): The holy month of Ramadan traditionally marks a relatively higher import and consumption levels compared with the rest of the year.
2. A pick up in import activity (downward pressure): The recent solid EGP appreciation may encourage importers to resume their activity, albeit slightly due to a notable decline in sales volume.
3. IMF loan second tranche (upward pressure): In an online press briefing following the release of the IMF staff report on Egypt, Chris Jarvis explained that "the next tranche of the loan is due to be disbursed in the spring". Such a second vote of confidence for the Egyptian economy would be positive for the Egyptian pound.
4. More FCY inflows in EGP-denominated treasuries (upward pressure): The sustainability of the current high foreign demand of local treasuries should increase the commercial banks' FCY liquidity and strengthen the Egyptian pound.

In that context, we would like to reemphasize the fact that economic agents' behavior and expectations play a decisive role determining the direction and the magnitude of the exchange rate movements, which makes short-term level projection a highly judgmental call. Finally, we reiterate our long run position that the Egyptian pound would strengthen over the next couple of years as it remains undervalued on REER analysis.

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