PRIME

Mounting External Vulnerabilities

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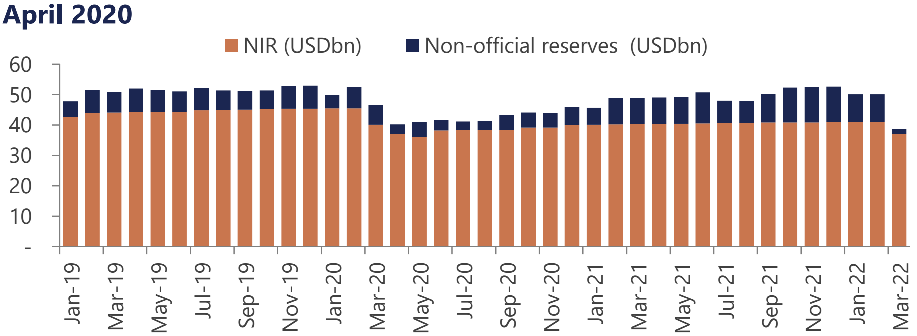
The EGP depreciation of March was unavoidable, and NIR figures were just the tip of iceberg. Egypt's net international reserves (NIR) fell for the first time in almost two years by USD3.9bn to USD37.1bn by end of March. The fall came to reveal the sizeable pressures on the country's external balance, prompting the monetary authority to deploy c.91% of its SDR stock in NIR. The country's existing SDR stock as of March 2022 is close to where it was before the IMF's latest SDR allocation in August. Furthermore, the stock of foreign currency declined by USD1.0bn to USD29.1bn, the lowest level since June 2017. However, the stock of gold remained at a high record of USD7.8bn, up from USD6.9bn, driven by higher prices by end of March 2022. **Despite the drop, NIR still covers more than five months of imports.**

Capital outflows that accelerated sharply in March aggravated the situation for the country's other external buffers, mainly non-official reserves. By end of March, non-official reserves plummeted to their lowest level since January 2017, falling by USD7.6bn to USD1.5bn. **This means the country technically has lost c.USD11.6bn from its overall reserves.** Overall reserves stood last at USD38.6bn by end of March 2022 vs. USD50.1bn by end of February 2022. This was the result of **(1)** a widening CAD, due to higher global commodity prices, **(2)** sustained geopolitical-induced outflows, **(3)** the Fed's hawkish stance, and **(4)** FX rate misalignment that put the country in a more vulnerable position compared to COVID-19 fallout and 2018 EM disruptions. Thus, the March decision to hike interest rates by 100bps and loosen the grip on the local currency was necessary to contain external pressures and safeguard the country's external buffers in the event of a more persistent and protracted crisis and given the state of total FX position in the banking sector and significant pressures on CAD.

As we expected in our note published last month, the worst is yet to be reflected on the country's NFA. According to most recently available data, NFAs at the banking sector fell into negative territory for first time since early 2017. Total NFAs fell to a negative USD3.2bn as the increase in CBE's liabilities drove its NFAs to fall to USD8.6bn by end of February from USD12.2bn in January, while the deterioration in banks' NFAs continued, but at slower pace as they registering a negative USD11.8bn by end of February from a negative USD11.6bn in January 2022. We can surely expect more deterioration in the country's NFAs in March 2022 due to significant fall in reserves.

Figure 1: NIR fell significantly by the end of March to its lowest level April 2020

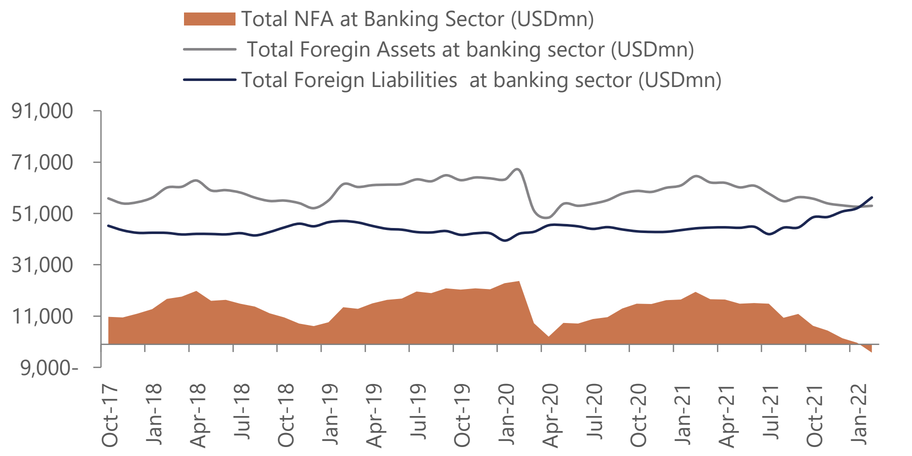


Source: CBE, Prime Research.

The escalation of geopolitical tensions in Eastern Europe, coupled with the drastic shift in global monetary conditions, implies that the CBE must adjust to new circumstances. Rebuilding NIR will not be easy, and the issue of FX misalignment and flexibility has become critical for external sector sustainability. We had predicted previously that the government would require financial assistance from its key partners and the IMF. Indeed, the government has received a total of USD22bn in planned investments from GCC countries a week or so ago, in addition to a USD5bn deposit from Saudi Arabia. While we are unsure whether or not the NIR data by end of March included the Saudi deposit, we note that this deposit will be eventually reflected as external debt and short-term debt commitments. **Additionally, we now estimate CAD to expand to 3.8% in FY22, up from our previous 3.1%. Despite the CBE's recent steps to curb in imports, higher global commodity prices continue to exert pressure on CAD, on top of the predicted decline in tourism income owing to the Ukrainian crisis.**

The IMF deal is crucial, but the global climate is challenging. At this stage, we expect the negotiation with IMF will address the problem of external vulnerability from two difficult angles: **(1)** exchange rate flexibility and **(2)** promoting private-sector and export-led growth. In this regard, we anticipate the USD/EGP rate to continue reflecting global risk aversion and an erratic appetite for emerging market assets, reaching an average of EGP17.3/USD in 2022. That said, we have to remember the IMF conditionality which mandated the establishment of a floor for NIR, reflecting the fact that one of the primary objectives of IMF programs is to ensure external viability. **Thus, it will be difficult for the CBE to continue supporting the local currency in the same way as it did before, at least in the near run, given the difficulty of recovering lost reserves in light of global monetary circumstances and expanding financing demands.**

Figure 2: The FX position in the banking sector necessitated the EGP depreciation



Source: CBE, Prime Research.

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