Economics in Focus
NBK Economic Research Department I 30 May 2019
Egypt

Egyptian pound strengthens against USD, trading at its highest in two years

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Highlights

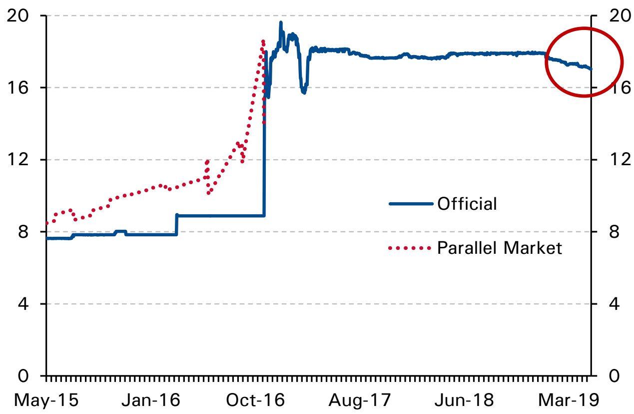
- The Egyptian pound has gained strength of late, reaching its highest in over two years against the US dollar amid more exchange rate fluctuations following the termination of the repatriation mechanism in December.
- The appreciation of the currency reflects strong economic performance under a bold reform program.
- A good level of foreign exchange reserves at the central bank and an increasing foreign cash in commercial banks have supported the pound's strength.
- After the capital outflows from some emerging countries in the second half of 2018, foreign investors are coming back to Egypt, including to take advantage of the current high interest rates.

Following the adoption of a comprehensive reform program that was supported by the International Monetary Fund (IMF) loan of $12 billion loan over 3 years, the Egyptian pound (EGP) plunged around 50% following its flotation in November 2016 (Chart 1). It was a critical step in resolving the shortage of foreign exchange and improving the economy's competitiveness. This decision ended several months of tensions in the currency markets, which had fostered numerous restrictions on trade and financial transactions, and encouraged the development of a parallel exchange market. Moreover, it helped to narrow the current account deficit, with exports slightly increasing and imports moderating. There have also been improvements in foreign capital flows, as well as a sharp increase in remittances and in the number of tourists. However, the floating of the exchange rate combined with subsidy cuts and tax reform pushed inflation to as high as 33% in July 2017, before easing to 13% in April 2019.After only a few months of fluctuations, the pound's value against the dollar remained steady at around EGP 17.6-18.0 for almost two years, even at the height of the crisis that gripped some emerging markets (Turkey and Argentina) in the second half of 2018. In fact, the EGP exchange rate remained stable despite a shift in investors' sentiment that led to a sharp decline in capital flows even in the presence of IMF support and the improvement of credit rating.

However, since the beginning of 2019, the EGP started to regain strength. On May 26, the Egyptian currency was trading at 16.81 to the dollar for buying and 16.96 to the dollar for selling, recording less than 17 pounds for the first time in two years.

Chart 1: Egyptian pound against US Dollars

(USD/EGP)



Source: Central Bank of Egypt

The reasons behind the EGP appreciation against the USD

While most of the traders and analysts projected a depreciation of the EGP to the range of 18 to 20 pounds per US dollar in 2019, there were many factors that led to its appreciation.

Terminating the repatriation mechanism. The Central Bank of Egypt (CBE) decided to terminate on December 4 the use of the "Repatriation Mechanism", which allowed foreign investors to repatriate their investment in dollars when they choose as guaranteed by the central bank (CBE). This mechanism provided some kind of stability for the EGP, limiting its movements in response to capital outflows that took place in the second half of the year. Once the repatriation mechanism was ended, capital flows (incoming and outgoing) are to be accommodated by commercial banks and the exchange rate started to respond more to market forces, with the exchange regime becoming more of a flexible exchange rate. However, given that some of the largest banks in Egypt are publicly-owned, they could intervene to moderate movements in the rate.

Egyptian economy on the right path. While the appreciation of the currency was supported to some extent by the change in the repatriation mechanism, such appreciation reflects more Egypt's strong economic performance. Egypt's ambitious and bold economic reform program over the past two and half years has addressed macroeconomic imbalances and restored international investors' confidence. Egypt's macroeconomic situation and risk profile have improved considerably under its IMF-supported program. According to the latest data, real GDP accelerated to 5.6% in 1Q19 from +5.5% in the previous quarter, while the budget deficit for the first nine months of FY18/19 shrank to 5.3% of GDP, compared to 6.2% in the same period a year earlier. The significant progress made so far won the praise of all and ushers in a new era for Egypt.

Growing investor confidence. The recent appreciation of the EGP could be also attributed to portfolio investment inflows. In fact, in a context of economic recovery, political stability and improvement in Egypt's sovereign rating, investors are flocking back to Egypt. In addition, with economic reform continuing economic fundamentals are not expected to have any adverse impact on the exchange rate, there is a lot of carry trade as investors take advantage of the current high interest rates compared to rates in other countries. Foreign investment in treasury bills increased to $16.9 billion in April 2019 returning to their levels that prevailed in July 2018 before some large capital outflows took place in the second half of the year.

A solid level of foreign currency reserves in CBE. Egypt's foreign currency reserves increased from around $42 billion in December 2018 to $44.2 billion in April 2019, covering about eight months of Egypt's commodity imports, higher than what is typically considered an acceptable level of three months.

Increasing foreign cash in the commercial banks. The ending of the repatriation mechanism redirected part of portfolio investment outflows from the CBE to commercial banks, which caused a sharp deterioration in banks' net external position in late 2018. But thanks to the narrowing of the external current account deficit in the FY18/19 and capital inflows in early 2019, the dollar liquidity has increased in the banking system. This has allowed some banks, especially state-owned, to sell its foreign currency assets to other banks in the interbank market, making dollars more available and supporting the pound's strength.

Currency outlook remains relatively stable

Continued good economic performance and forging ahead with the remaining reform measures will most likely foster foreign portfolio and direct investment into Egypt. Barring any major exogenous shocks, the EGP is expected to remain relatively stable and to move in response to economic fundamentals within a moderate range. However, given Egypt's strong dependence on foreign capital, any shift in investors' behavior and sentiment could lead to large swings in the rate. In such circumstances, it is likely that the authorities will step in to smooth out these fluctuations especially those that are not warranted by economic fundamentals.

With the inflation rate steadily coming down from the highs of 2017, the CBE will likely cut interest rates in tandem, reducing bond and T-bill yields and therefore ease the inflow of portfolio capital and that related to the carry trade, thus moderating the pressure on the exchange rate to appreciate.

The initial floatation of the pound in the context of the economic reform program has served the economy very well. The depreciation of the pound boosted exports, tourism and remittances and at the same time reduced imports leading to a noticeable improvement in the external current account. We believe that the authorities are cognizant of the fact that the appreciation of the pound beyond a certain level may undermine some of these achievements and will therefore stand ready to intervene when needed especially when large swings in the exchange rate result more from speculative and temporary factors and less from changes in economic fundamentals.

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