بنك الإمارات دبي الوطني
Emirates NBD

EGP Update

Economics

3 November 2016

Earlier today the Central Bank of Egypt (CBE) announced it had devalued the pound to 13.00 from 8.87 previously. According to CBE Governor Tarek Amer, the bank had decided to liberalize the exchange rate, with the EGP's level now set to be determined by supply and demand. In addition, the bank hiked interest rates 300bps, which brings the overnight deposit and lending rates to 14.75% and 15.75% respectively. The devaluation of the pound's official rate has been long anticipated, and marks an important step towards Egypt securing its USD12bn IMF program. As far as we can tell, the only remaining policy that needs to be implemented to secure the IMF's final approval is on energy subsidy reforms. Reports on Bloomberg later in the day indicated the IMF has welcomed the devaluation, and said the new system will improve external competitiveness and foster job creation and faster growth.

The magnitude of the devaluation was larger than anticipated, and is a positive sign for future reform momentum. Indeed, as the IMF deal had initially been announced in early August when the EGP was trading around 12.50 on the parallel market, expectations were for the CBE to weaken the currency to a level around 11.50, but not weaker than the parallel market. Since that point however, the EGP has fallen to roughly 18.00 on the parallel market, indicating fundamental pressures on the currency were still to the downside.

The most important development is not that the currency has been devalued, but rather that the CBE has said it intends on moving to a more flexible exchange rate regime. According to a statement on the central bank's website, '*Banks and other market participants are at liberty to quote and trade at any exchange rate*', and that '*the CBE will use the prevailing market rate for any transactions it undertakes*'. It should be noted that similar statements were also made back in March however, when the currency was devalued by 13%, but subsequently re-pegged to the USD. As a result, the real test will likely come next week to see the extent of volatility that is actually permitted by the CBE.

In terms of how this devaluation can impact the economy's near-term outlook, **the most important factor will simply be for the CBE to allow a market-clearing rate for the EGP to emerge, whatever rate that may prove to be**. The need to begin attracting foreign capital inflows requires the elimination of the parallel market, which in turn requires the official rate to be determined by demand and supply (and not a level determined by the CBE).

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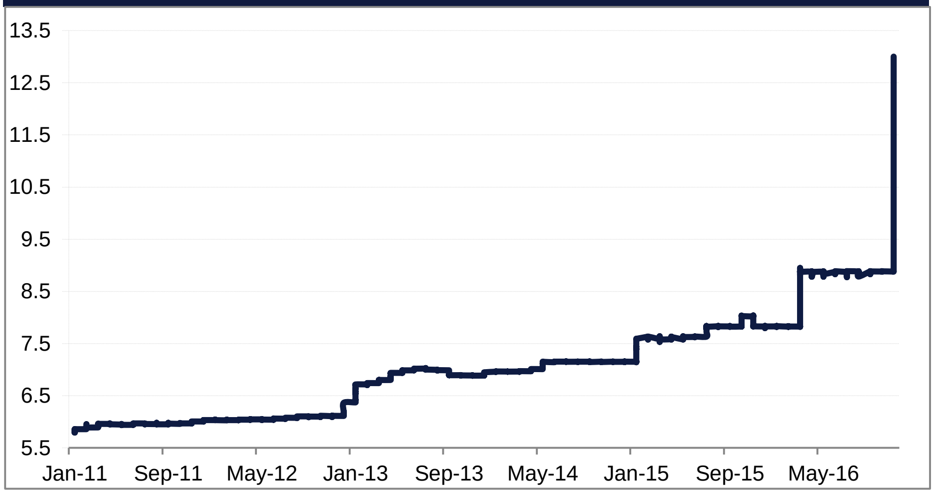
Egyptian Pound



Source: Bloomberg, Emirates NBD Research

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Indeed, a limited export-oriented manufacturing sector means the economic adjustment is not going to come in the form of the trade account (although imports are in fact declining), but rather through stronger foreign capital inflows. To this extent, although the 300bps of interest rate hikes today could be considered aggressive, additional policy tightening is certainly possible as the exchange rate policy shifts from a fixed peg to a more freely floating regime.

There are reasons to believe the currency will depreciate further in the near term. Most importantly, the pound has recently fallen to trade near 18.00 on the parallel market, which could be argued is a more accurate reflection of the pound's 'fair value'. That said, the sudden depreciation seen since the start of October (the EGP started the month trading near 13.00) **has likely been driven as much by uncertainty and risk aversion over the future direction of exchange rate policy as it has by any actual deterioration in economic fundamentals**. As such, while we would caution that near-term currency forecasts in the midst of an overhaul to an exchange rate policy are subject to a high degree of uncertainty, our bias is for gradual weakness towards 14.00 by the end of the year.

Overall, the devaluation seen today is a positive development. It marks the initial stages of the economy's recovery process, and brings Egypt one step closer to finalizing its IMF agreement. A weaker currency whose value is determined by market forces will not solve all of the economy's problems, however it is a necessary step.

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