Goldman Sachs | Economics Research

11 May 2022 | 9:01AM BST

CEEMEA in Focus

# Playing the Long Game: Five Takeaways from Cairo

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- We visited Cairo on Sunday and Monday of this week (May 8-9), meeting the usual mix of official and private sector organisations and individuals. This note highlights our five most important take-aways.
- **Take-away #1: Gulf Financing Has Given Egypt Breathing Space.** Egypt has received close to $13bn in financial support so far from the Gulf, staving off the need for a sharper economic adjustment to the balance of payments shock it experienced in the wake of Russia's invasion of Ukraine. This has provided breathing space to negotiate a new programme with the IMF and to consider longer-term measures to address structural vulnerabilities.
- **Take-away #2: Longer-Term Pressures Persist.** While Gulf funds secure near-term prospects, we did not sense any complacency that longer-term challenges, notably the structural trade deficit, posed a threat to future external stability and the currency in the medium term.
- **Take-away #3: Policy Makers' Focus Has Shifted to Structural Reform**. Policy makers appear focused on structural reforms, namely promoting private and foreign direct investment in the manufacturing/tradable sector. A range of initiatives are being launched to achieve these aims, including announced privatisations and a new traffic-light system indicating the state's degree of involvement in various sectors of the economy.
- **Take-away #4: An IMF Deal Appears Imminent**. Negotiations appear to be underway for a 3-year, funded programme of a size in the order of $3bn-$5bn. The authorities stressed that the programme was likely to emphasise structural reforms and expected the negotiations to be concluded by end-June.
- **Take-away #5: Rate and FX Policy Uncertainty Weakens the Investment Thesis in the Near Term**. Contrary to our expectations, the authorities do not appear to be prioritising a reversal of the portfolio outflows witnessed since the Russian invasion of Ukraine. In our view, this will reduce pressure on rates and the FX, although rising inflationary pressures have prompted us to raise our rate hike forecast for the CBE's May meeting from 50bp to 100bp. Ongoing uncertainty on this front weakens any local market investment thesis for the time being, in our view.

# Playing the Long Game: Five Takeaways from Cairo

Egypt has come under acute balance of payments pressure as investor concerns that its exposure to higher commodity prices, Russian/Ukrainian tourism and tightening global financial conditions have led to a sell-off in Egyptian risk assets. We think the direct impact of the Russia-Ukraine war on the current account will be to widen it by around 1.7pp of GDP this year, relative to our previous forecasts, to 4.1% of GDP. Moreover, since mid-February, we estimate that around $20bn in portfolio investment has exited the local t-bill and bond market, and yields on 5-year Eurobonds are currently approaching 11%, close to all-time highs. Net foreign assets in the monetary system have fallen sharply, prompting sizeable emergency financial support from the country's oil-rich Gulf neighbours and urgent discussions with the IMF. Meanwhile, the Central Bank of Egypt (CBE) has hiked rates by 100bp and allowed the Pound to depreciate by over 15%, exacerbating an already worsening inflation outlook.

It was against this backdrop that we visited Cairo on Sunday and Monday of this week (May 8-9), meeting the usual mix of official and private sector organisations and individuals. This note highlights our five most important take-aways.



### Take-away #1: Gulf Financing Has Given Egypt Breathing Space

Saudi Arabia, the UAE and Qatar have responded quickly and decisively in order to help stabilise Egypt's balance of payments. More support may be forthcoming in the near future, including from Kuwait, which is reportedly considering investments in Egypt in line with its neighbours. Our understanding of the support received or pledged so far is as follows:

- **Saudi Arabia:** The kingdom has deposited $5bn with the CBE and has pledged up to $10bn in investments. These sums are not additive: the initial $5bn deposit will be used to finance part of the investments.
- **UAE:** The UAE has deposited $3bn with the CBE and has in addition completed purchases of over $1.8bn of assets. With a total investment programme of $10bn in Egypt, we expect a further $5bn in commitments over the medium term.
- **Qatar:** Qatar has deposited $3bn with the CBE and is seeking to use this to fund investments in Egypt in the near term.

This amounts to close to $13bn in realised support so far, with a possible additional $10bn in further support coming in the medium term, $5bn each from Saudi Arabia and the UAE.

Gulf financing has helped limit the impact of portfolio outflows on external buffers and provided much-needed FX liquidity to the domestic market. In our view, this has staved off the need for a sharper and more painful external adjustment in the near term or a much steeper rise in domestic rates, providing the Egyptian authorities with the space to negotiate a new programme with the IMF and to consider longer-term measures to address its external vulnerabilities.

### Take-away #2: Longer-Term Pressures Persist

In addition to Gulf support, we heard in our conversations that a number of other factors have helped ease near-term pressures on the currency, including:

- The bottoming out of portfolio outflows following the depreciation and rate hike by the CBE in March.
- The CBE directive for banks to cease providing Inward Documentary Credit (IDC) to importers, and instead to require Letters of Credit (LCs) for all imports.
- A slowdown in imports as importers assess domestic demand in the light of recent price hikes.
- A seasonal increase in remittances observed by local banks (due to Ramadan, Eid, etc.).

That said, it was widely expected that many of these factors would provide only temporary reprieve. In the absence of a substantial pick-up in tourism receipts and an improvement in external financing conditions, pressures on the currency were widely expected to resume in the longer term.

### Take-away #3: Policy-Makers' Focus Has Shifted to Structural Issues

The impact of the Covid pandemic and the acute nature of the external pressures of the past few weeks seem to have shifted policy makers' attention to Egypt's twin external vulnerabilities, namely a structurally wide trade deficit and a reliance on volatile inflows, most importantly tourism and portfolio inflows. This shift appears to be being reinforced by ongoing negotiations with the IMF which are reportedly heavily focused on these issues. Many of those we met, including policy makers, argued that the country's poor export competitiveness and dependence on imports was largely due to a lack of private and foreign direct investment in the tradable/manufacturing sector, mainly because of a poor investment environment and excessive competition by state-owned enterprises. In our discussions, policy makers highlighted the following areas of reform to address this:

- Promoting private investment.
- Promoting foreign direct investment.
- Incentives for the manufacturing/tradable sector.

A range of initiatives are being launched to achieve these aims, including a number of recent announcements regarding the upcoming privatisation and divestment of state and military assets. An overarching strategy is being developed to define and restrict the role of the state in the economy and will reportedly be announced imminently, and will include a new traffic-light system that will distinguish between three tiers of state intervention:

- **Red**: this is to include industries/sectors in which the government believes that the state should continue to play a dominant role (e.g., infrastructure) and where further investments are planned.
- **Amber**: this is to include industries/sectors in which the state will play a limited role and in which no further state-led investment is expected.

- **Green**: this is to include industries/sectors in which the state will play no role beyond that of regulator, where appropriate, and where any current state-owned assets will be divested over time.

In our discussions, various views were expressed regarding the likely success of this reform initiative and the political will of the government to follow through, with many interlocutors stressing the need to bridge the trust gap between the private and state sector. In our view, this can be achieved with the establishment of a strong track record on the part of the government in following through on commitments, which will be measurable in the extent to which it achieves many of the privatisations/divestments/IPOs it has set out to do. A new IMF programme is also important in this regard, in our view, as it would provide an anchor for the implementation of these reforms.

### Take-away #4: An IMF Deal Appears Imminent

An IMF deadline appears to be imminent. We heard from the authorities that negotiations were currently underway for a 3-year, funded programme of a size in the order of \$3bn-\$5bn. The parameters of the programme were expected to be broadly in line with the previous EFF in 2016-2019, with quantitative targets including a primary balance initially of 1.5% of GDP rising gradually to 2% of GDP. The authorities stressed that the programme was likely to put a much greater emphasis on structural reforms, particularly those highlighted above. They expected the negotiations to be concluded by end-June.

### Take-away #5: Rate and FX Policy Uncertainty Weakens the Investment Thesis in Near Term

The breathing space afforded by Gulf financing, the easing of immediate FX pressures, the shift of focus to structural vulnerabilities and the expected conclusion of IMF negotiations all reinforced our impression (backed by repeated assertions to that effect in many of our meetings) that the authorities were not prioritising a reversal of the portfolio outflows witnessed since the Russian invasion of Ukraine. In our view, this has important implications for rates and FX:

- **Yields on local debt may not rise by more than 100bp-200bp** – the Ministry of Finance emphasised the need to maintain fiscal discipline over the desirability of attracting portfolio investments. While their expectation was that such inflows would materialise in the near future on the back of positive policy announcements and developments, they stressed that they would be cautious in the extent to which they would raise the yields offered in t-bill and bond auctions in order to facilitate this to avoid a negative impact on their debt-servicing bill and overall fiscal balance.
- **Policy rates going up** – There was a consensus among those we spoke to that the CBE would raise rates in the next meeting on May 19, but a wide variance in expectations regarding the magnitude of the rise. We heard arguments that the supply-side nature of the shock, measures to limit the risk of dollarisation (including the launching of 18% one-year CDs that have so far attracted EGP600bn in retail investment), and concerns regarding the negative impact on economic growth

would limit the extent of rate rises in the near term. Against this, higher-than-expected rate rises in the US and rising inflationary pressures (with April CPI rising to 13.1%yoy, surprising consensus expectations to the upside) are likely to require monetary tightening. On balance, we think the higher-than-expected April inflation number and steeper Fed hikes will push the CBE to raise rates by 100bp in their next meeting in May (our previous expectation was for a 50bp hike). We are sticking with our forecast of a further 50bp hike in June, but believe this will be data-dependent, with risks skewed to the upside.

- **FX likely to weaken marginally, if at all –** We did not come away with a clear sense of FX policy going forward. Risks to the currency appear to be skewed towards further depreciation in the near term notwithstanding the temporary easing of FX pressures, and local interlocutors were almost unanimously expecting such a move imminently. However, the authorities' tolerance for further FX weakening was not clear to us, and we think will be at least in part a function of IMF negotiations, with any move down on the FX a precursor to the conclusion of an IMF deal.

Overall, uncertainty regarding rate and FX policies remains high, in our view, and we think weakens any local market investment thesis for the time being.

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