

## AFRICA RISK CONSULTING

### Egypt Monthly Briefing December 2016

#### Egypt Summary 1 December 2016

*The International Monetary Fund (IMF) board approves a three-year \$12 billion extended fund facility (EFF) for Egypt. The IMF immediately disburses \$2.75 billion, and will disburse the remaining balance in \$2 billion installments twice a year subject to reviews. Prior to approval, the government makes progress towards the four pillars of its economic reform programme. The Central Bank of Egypt (CBE) devalues the currency 32% and allows it to float freely. The government cuts fuel subsidies, but lowers the age for receipt of pension benefits, and increases food subsidies. The Supreme Investment Council adopts 17 pro-investment policies. The CBE reaches agreement on a \$2.7 billion currency swap agreement with China.*

#### IMF board approves \$12 billion extended fund facility

The **International Monetary Fund (IMF)** board approved a three-year \$12 billion extended fund facility (EFF), accounting for 422% of **Egypt's** IMF quota, on 11 November.<sup>1</sup> The EFF has a number of implementation risks including the need to secure house of representatives (parliament) approval, increased inflation, and political and popular acceptance of fiscal tightening. However, the IMF has mitigated many of the implementing risks by including securing additional capital and introducing reforms as pre-conditions (see below). Chair of the house of representatives budget committee **Hussein Eissa** said on 12 November that parliament will begin to discuss the EFF within 10 days.<sup>2</sup> Once signed, the IMF will disburse approximately \$2 billion in funds twice a year over the programme's duration and subject to five reviews, with the first scheduled for April 2017.<sup>3</sup> The **Central Bank of Egypt (CBE)** received the first \$2.75 billion tranche on the same day as the IMF board approved the EFF.<sup>4</sup> The CBE has said this contributed to increasing foreign reserves from \$19.04 billion at the end of October to \$23 billion.<sup>5</sup> The CBE expects to receive a second \$1.25 billion tranche in April to May 2017.<sup>6</sup> The CBE will receive the funds in dollars before transferring them to the finance ministry in Egyptian pounds. According to finance minister **Amr El Garhy**, the first review will take place in March 2017 and the second in September 2017.<sup>7</sup> According to the finance ministry, the EFF's repayment period is ten years, including a 4.5-year grace period.<sup>8</sup> Egypt will repay the EFF in 12 equal installments.<sup>9</sup> Interest and service fees stand at between 1.55% and 1.65%.<sup>10</sup>

Investors have welcomed the EFF.

*"It is a positive sign to the markets, and politically significant that Egypt is realising its own predicament, and acting accordingly."<sup>11</sup>*

<sup>1</sup> Aswat Masriya, 11 Nov 2016.

<sup>2</sup> Al Borsa, 12 Nov 2016.

<sup>3</sup> Al Borsa, 12 Nov 2016.

<sup>4</sup> Al Borsa, 11 Nov 2016.

<sup>5</sup> Al Ahram, 11 Nov 2016.

<sup>6</sup> Al Borsa, 11 Nov 2016.

<sup>7</sup> Al Mal, 11 Nov 2016.

<sup>8</sup> Al Mal, 11 Nov 2016.

<sup>9</sup> Al Mal, 11 Nov 2016.

<sup>10</sup> Al Mal, 11 Nov 2016.

<sup>11</sup> Source, investment banker, Cairo

IMF managing director **Christine Lagarde** said an accompanying economic reform programme will address structural economic challenges including: the overvalued exchange rate, foreign exchange shortages, persistent budget deficits, low growth and high unemployment.<sup>12</sup> According to Lagarde, prime minister **Sherif Ismail**'s administration's reform programme is based on four pillars:<sup>13</sup>

- Policy adjustments: the liberalisation of the foreign exchange system to curb foreign exchange shortages to encourage investment and exports; monetary policy to contain inflation; and fiscal consolidation to curb public debt.
- Strengthened social welfare: increased spending on food subsidies;
- Structural reforms: to accelerate growth and result in increased employment opportunities;
- External financing: to meet financing gaps.

The IMF package was preconditioned on deliverables towards these pillars (see below). While the speed with which the Egyptian government embarked on the pillars is impressive, some observers warn that this was only out of necessity after it had failed to recognise the extent of its economic problems and delayed action.

*"Finally [the EFF has] been done, but after significant muscle has been applied. It is both worrying and telling that president **Abdel Fattah Al-Sisi** (2014-present) let it get this far. It was not until the **Gulf Cooperation Council (GCC)** closed its pockets that [Sisi] began to consider caving into the demands of the IMF. They should have done this a long time ago when they would have been better able to cope with the aftershocks. But they waited so long, that it became a now or never scenario."*<sup>14</sup>

Lagarde noted the policy package would restore investor confidence, decrease inflation, rebuild international reserves, strengthen public finances and encourage private sector-led growth.<sup>15</sup> The IMF said on 12 November that effective implementation of the package would result in growth recovering to 5.5% in 2018/2019 and 6% by 2021, similar to levels between 2005 and 2010.<sup>16</sup> The IMF based its package on the following projections:

- Foreign direct investment will increase from \$6.7 billion in the 2015/2016 fiscal year to \$9.4 billion in the current year;
- Inflation will increase from 14% in 2015/2016 to 16.6% before decreasing to below 10% by 2018/2019;
- The deficit will improve from negative 3.4% in 2015/2016 to a surplus by 2017/2018.<sup>17</sup>

The finance ministry published its guidelines for the 2017/2018 budget on 13 November, targeting a budget deficit of between 8.5% and 9.5% of gross domestic product (GDP) compared to 9.8% in the current financial year, and 12.1% for 2015/2016.<sup>18</sup>

In response to the IMF board approval of the EFF, ratings agency **S&P Global Ratings** revised Egypt's sovereign credit outlook from negative to stable, but retained the credit rating at B-.<sup>19</sup> S&P noted that the credit rating remains constrained by "*wide fiscal deficits, high public debt, low income levels, and institutional and social fragility*".<sup>20</sup> S&P additionally warned of short-term inflationary spikes due to

<sup>12</sup> Al Borsa, 12 Nov 2016.

<sup>13</sup> www.IMF.org

<sup>14</sup> Source, capital expert, Cairo

<sup>15</sup> Al Borsa, 12 Nov 2016.

<sup>16</sup> IMF statement, 12 Nov 2016.

<sup>17</sup> Al Mal, 12 Nov 2016.

<sup>18</sup> Reuters, 13 Nov 2016.

<sup>19</sup> Reuters, 11 Nov 2016.

<sup>20</sup> Reuters, 11 Nov 2016.

the currency devaluation, subsidy cuts and interest rate increases.<sup>21</sup> Observers also warn against expecting short-term economic improvements.

*"It will be tough, but it is necessary. Price shocks will continue for some time. This is a long game, meaning that it will be some time before the economy shifts. There is much more to be done yet still. Successfully attracting foreign investors, and tourism are two big issues. They [the government] still have a long way to go and effectively managing the fallout of austerity on an already very poor population will be crucial. So we will wait and see, this is just the beginning, only time will tell if the government is capable of keeping the country afloat."*<sup>22</sup>

### Pillar 1: CBE floats Egyptian pound

With regard to policy adjustments, the CBE on 3 November lifted capital controls to allow the free floatation of the Egyptian pound (EGP).<sup>23</sup> The CBE said the liberalised exchange rate would allow market supply and demand to facilitate a reliable supply of foreign currency. The IMF and the **European Bank for Reconstruction and Development (EBRD)** both welcomed the floatation. The CBE devalued the EGP to 13.00 to the dollar, a 32% devaluation, and allowed it to trade within a 10% band before holding an exceptional currency auction on the same day to allow the market to determine its value.<sup>24</sup> During the auction, the CBE sold \$98.7m at an average bid price of EGP14.65.<sup>25</sup> Subsequent to the auction, the CBE allowed the rate to float freely. State-owned **National Bank of Egypt (NBE)** and **Banque Misr** sold dollars for 15.75, while privately owned commercial banks sold dollars for around 16.00.<sup>26</sup> This has reportedly resulted in increased foreign exchange inflows, reducing the pressure on the CBE to use the proposed IMF extended fund facility or bilateral financing to increase foreign exchange liquidity.<sup>27</sup> The EGP has gone from the fourth most expensive emerging market currency to the third cheapest.<sup>28</sup> Investors have welcomed the floatation, although they acknowledge the political sensitivities:

*"Foreign investors are already moving to buy into the local market. It should also aid exports. The government, however, is going to find it tough, as the float will affect its own purse when it comes to large scale imports on commodities like food."*<sup>29</sup>

The banking sector expects the foreign exchange markets to be volatile over the next few weeks, with dealers overshooting and under-pricing until the currency's fair value is determined. The NBE, on 7 November, was offering a selling price of 17.25 to the dollar. **Reuters** has suggested that the market clearing rate is approximately 18.00 to the dollar.<sup>30</sup>

The equity market will also probably be volatile, as investors with previously trapped capital choose to exit, or investors stop using equities as a foreign exchange hedge.<sup>31</sup> The market welcomed the devaluation, with the benchmark **EGX30** closing 7 November 5.4% up, after heavy trading. Ratings agency **Moody's** on 7 November welcomed the impact of the floatation on the banking sector, noting that increased availability of foreign currency will support economic activity and therefore banking business.<sup>32</sup> Moody's noted that this would offset the impact of the devaluation on capital adequacy ratios and asset quality due to increased inflation (see above) and the appreciation of dollar-denominated banking assets.

<sup>21</sup> Reuters, 11 Nov 2016.

<sup>22</sup> Source, economic journalist, Cairo

<sup>23</sup> Aswat Masriya, 3 Nov 2016.

<sup>24</sup> Aswat Masriya, 3 Nov 2016.

<sup>25</sup> Aswat Masriya, 3 Nov 2016.

<sup>26</sup> Al Mal, 4 Nov 2016.

<sup>27</sup> Al Mal, 4 Nov 2016.

<sup>28</sup> Enterprise, 4 Nov 2016.

<sup>29</sup> Source, investment banker, Cairo

<sup>30</sup> Reuters, 8 Nov 2016.

<sup>31</sup> Enterprise, 4 Nov 2016.

<sup>32</sup> Daily News Egypt, 7 Nov 2016.

The CBE, in a separate directive, confirmed that it would not impose any conditions on banks selling foreign exchange, and that it would guarantee savings in either local or foreign currency.<sup>33</sup> Neither retail nor corporate clients face restrictions on the withdrawal or deposit of foreign goods. Banks have subsequently begun to lift their foreign exchange restrictions. The NBE has tripled the amount of foreign exchange it will sell travellers from \$300 to \$1,000.<sup>34</sup> The CBE forced banks to remain open during the weekend of 4 – 5 November to handle foreign exchange transactions. The CBE, however, retained its \$50,000 monthly deposit limit and \$30,000 daily withdrawal limit for importers of non-essential goods.

## Pillar 2: Government cuts fuel subsidies

With regard to social welfare, the government has begun to restructure its subsidy programme. The government cut fuel subsidies overnight on 3 November as part of the IMF's emphasis on fiscal sustainability.<sup>35</sup> Increased fuel prices will probably prove inflationary. The last round of fuel increases in July 2014 resulted in transport and food price increases for lowest income households. The new prices are:

- 95 octane petrol: 6.50 Egyptian pounds (EGP) (\$0.47) per litre, but allowed to float;
- 92 octane petrol: EGP 3.50 (\$0.26) per litre, a 47% increase;
- 80 octane petrol: EGP 2.35 (\$0.17) per litre, a 47% increase;
- Diesel: EGP 2.35 (\$0.17) per litre, a 31% increase;
- Kerosene: EGP 2.35 (\$0.17) per litre;
- Compressed natural gas for automobiles: EGP 1.60 (\$0.12) per cubic meter, a 31% increase;
- Mazot (fuel oil): between EGP 1,500 (\$109) and EGP 2,500 (\$182) per tonne.<sup>36</sup>

The new fuel prices will increase pressure on the government to stop inflation negatively impacting ordinary households. Analysts project that inflation may reach 20% in the next few months before tempering in mid-2017.<sup>37</sup>

*"Sisi's government has made a lot of mistakes.... fumbling around on this issue, and letting **Tarek Amer** [CBE governor] mouth off to the press included. But this [the float and related reforms] isn't one of them. It is a very important step and despite the potential for unrest at a time when Sisi is not as popular as he was, this is brave... The float, enacting the value added tax (VAT), slashing fuel subsidies, all in one swoop...what was once inconceivable has been done."<sup>38</sup>*

Limited demonstrations over living costs took place on 11 November amid a heavy security presence. The government appears to be taking the threat of popular discontent seriously. Sisi on 7 November instructed power minister **Mohamed Shaker** to ensure that electricity prices do not increase before the next fiscal year, beginning in July.<sup>39</sup> This followed a report that 20% of consumers have not paid their October electricity bill due to the impact of inflation.<sup>40</sup> Energy sector investors have warned that the currency devaluation will jeopardise the commercial viability of their projects with regard to the price of feed-in-tariffs.<sup>41</sup>

<sup>33</sup> Al Mal, 4 Nov 2016.

<sup>34</sup> Al Mal, 4 Nov 2016.

<sup>35</sup> Al Shorouk, 4 Nov 2016.

<sup>36</sup> Al Shorouk, 4 Nov 2016.

<sup>37</sup> WSJ, 7 Nov 2016.

<sup>38</sup> Source, policy commentator, Cairo

<sup>39</sup> Al Shorouk, 7 Nov 2016.

<sup>40</sup> Al Borsa, 8 Nov 2016.

<sup>41</sup> Source, development finance institute executive. UK

The government has additionally moved to assuage public anger over subsidy cuts by lowering the age for the receipt of pension benefits from 65 to 60 years.<sup>42</sup> The government has also, from 1 December, increased the amount allocated per food subsidy card from EGP 18 (\$1.12) to EGP 21 (\$1.36).<sup>43</sup>

*“The recent reforms are going to significantly relieve pressure on the public purse, and will hopefully create a gradual shift in workers from the public to private sector. Now we need see how they control food prices and supply. This is the time for them [the government] to communicate with the people, as they never have before, so the situation doesn't disintegrate. But my sense right now is that Egyptians are weary, they are frustrated, they don't want to protest, but they do expect the situation to shift and they expect the government to be accountable.”<sup>44</sup>*

### **Pillar 3: Government introduces pro-investment policies**

With regard to structural reforms, the government has moved to improve the investment environment. The **Supreme Investment Council** adopted 17 pro-investment policies on 1 November.<sup>45</sup> The policies will bolster investor sentiment ahead of the government's planned initial public offering of state-owned enterprises. The Supreme Investment Council provided no details about the timeframe for the implementation of the policies, or whether the policies would be separate to the proposed investment law.<sup>46</sup> The adopted policies include:<sup>47</sup>

- Establishing a **National Payments Council** that will work to restrict the handling of foreign exchange outside the banking sector;
- Suspending the introduction of a 10% capital gains tax on stock market – originally introduced in July 2014, then suspended for two years in August 2015 – for three additional years;
- Tax exemptions for producers of agricultural crops that Egypt imports or exports;
- Five-year tax exemptions for manufacturers of “strategic” goods that Egypt imports or exports;
- Five-year tax exemptions for agriculture and industrial investments in **Upper Egypt**;
- Minor tax for small and medium enterprises to encourage them to file tax returns and be eligible for CBE funding;
- The possible initial public offering within three years of the **Egyptian Rural Development Co**, the **New Administrative Capital Co**, the **New Al Alamein** development company, and companies managing the **Germany**-based **Siemens AG** combined cycle power plants;
- 25% concession on land in the **New Capital**, **East Port Said** and other new urban developments for three months;
- The **Industrial Development Authority (IDA)** will issue temporary manufacturing permits for unlicensed factories for one year, to allow them to obtain full permits;
- The IDA will begin the free tendering of land with utilities for industries in Upper Egypt;
- Greater powers for public-private partnership units in the government;
- 35% concessions on settlements reached with the **Committee to Repossess Illegally Occupied Land**;

<sup>42</sup> www.albawaba.com

<sup>43</sup> www.albawaba.com

<sup>44</sup> Source, journalist, Cairo

<sup>45</sup> Al Mal, 1 Nov 2016.

<sup>46</sup> Al Mal, 1 Nov 2016.

<sup>47</sup> Al Mal, 1 Nov 2016.

- Ensuring all ministries, departments and agencies back government-brokered solutions on investment disputes.

Sisi heads the Supreme Investment Council, which also includes finance minister el-Garhy, investment minister **Dalia Khorshid**, trade and industry minister **Tarek Kabil**, interior minister **Magdy Abdel Ghaffar**, justice minister **Mohamed Hossam Abdelrehim**, defence minister **Sedki Sobhi**, CBE governor Amer, and **General Intelligence Directorate** director **Khaled Fawzy**.<sup>48</sup> Sisi established the Supreme Investment Council by presidential decree in July to supervise government investment policies. It is directly accountable to the presidency.<sup>49</sup> This was the Supreme Investment Council's first meeting and it will convene every two months.

#### **Pillar 4: Government diversifies external financing**

With regard to external financing, the government continues to diversify its sources of funding. The CBE confirmed on 30 October that it reached an agreement for a \$2.7 billion currency swap agreement with **China**.<sup>50</sup> The CBE has not provided detail about the specific terms of the agreement or when it expects to receive the funds.<sup>51</sup> Under the currency swap, China will provide the CBE with yuan (CNY) in exchange for an Egyptian pound (EGP) equivalent using CNY/ dollar and EGP/ dollar exchange rates.<sup>52</sup> The CBE will then offer local Egyptian banks yuan to settle import transactions from China.<sup>53</sup> During the term of the agreement, both parties will exchange fixed or floating interest payments on the principal amounts.<sup>54</sup> When the swap matures, the CBE will repay the initial CNY-denominated amount, and receive the initial EGP-denominated amount.<sup>55</sup>

Analysts have noted the swap agreement has two constraints that will limit its impact on the ongoing foreign exchange shortage. The first is that Egypt will not be able to use it to settle dollar-denominated debt.<sup>56</sup> The second is that it is limited to the import of goods and services from China, although China is a major trading partner for Egypt.<sup>57</sup> China represented approximately 7% of Egypt's total foreign trade in the 2015/2016 financial year, with total trade increasing by 30% between 2013 and 2015.<sup>58</sup> Nevertheless, there are mutual benefits. For China, currency swaps have increased the use of the renminbi in the international market.<sup>59</sup> For Egypt, it will ease pressure on the CBE's foreign currency reserves and ease, though marginally, dollar demand.<sup>60</sup>

Separately, the finance ministry raised \$4 billion in a private placement of bonds in the **Irish Stock Exchange** on 10 November.<sup>61</sup> The finance ministry raised the funds for CBE as security for a \$2 billion repurchase transaction with a consortium of international banks to increase its foreign reserves.<sup>62</sup> The private placement consisted of \$1.36 billion in 13-month bonds with a coupon of 4.62%, \$1.32 billion in eight-year bonds at 6.75%, and \$1.32 billion in ten-year bonds at 7%.<sup>63</sup>

<sup>48</sup> Al Mal, 1 Nov 2016.

<sup>49</sup> www.al-monitor.com

<sup>50</sup> Bloomberg, 30 Oct 2016.

<sup>51</sup> Bloomberg, 30 Oct 2016.

<sup>52</sup> Pharos Holding, 30 Oct 2016.

<sup>53</sup> Pharos Holding, 30 Oct 2016.

<sup>54</sup> Pharos Holding, 30 Oct 2016.

<sup>55</sup> Pharos Holding, 30 Oct 2016.

<sup>56</sup> Pharos Holding, 30 Oct 2016.

<sup>57</sup> Pharos Holding, 30 Oct 2016.

<sup>58</sup> Multiple sources: Bloomberg, 30 Oct 2016; Pharos Holding, 30 Oct 2016.

<sup>59</sup> Pharos Holding, 30 Oct 2016.

<sup>60</sup> Pharos Holding, 30 Oct 2016.

<sup>61</sup> Finance ministry statement, 10 Nov 2016.

<sup>62</sup> Finance ministry statement, 10 Nov 2016.

<sup>63</sup> Finance ministry statement, 10 Nov 2016.

## Implications

The IMF extended fund facility will reduce immediate pressure on the government's fiscal position. However, fiscal sustainability will depend on more structural economic reform to encourage growth. This will test both the government's political will and capacity to deliver politically sensitive reforms. The progress so far on the four pillars is a positive start, but no more than that.

The currency devaluation will curb the parallel market, ease pressure on imports, and increase investments, especially foreign inflows.

The liberalisation of fuel prices will facilitate government efforts to decrease the budget deficit. When combined with the impact of devaluation on the cost of food and electricity, restructuring of subsidies may increase social tensions. However, the subsidy programme, as it currently stands, too often does not benefit the poorest households. It is wealthy Egyptians with imported first-hand vehicles who unduly benefit from fuel subsidies. Notably, the government's reform programme calls for a recalibration of subsidies, mitigating the impact of cuts on those households most dependent upon them.

Investors will welcome the Supreme Investment Council policies, which are indicative of a political commitment to improve the business environment. However, their effective implementation remains uncertain. The settling of the currency volatility will be as significant in terms of investor sentiment.

The China currency swap deal and the private bond placement are innovative ways to ease the hard currency liquidity crisis.

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