

## AFRICA RISK CONSULTING

### Egypt Monthly Briefing March 2016

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#### Egypt Summary 22 March 2016

***The Central Bank of Egypt devalues the pound 13% and adopts a flexible exchange rate. Investors warn that the currency remains overvalued, which has led to dollar scarcity encouraging currency black market. President Abdel Fattah Al-Sisi (2014- present) signs a series of investment and economic aid deals with Japan and the Republic of Korea. Prime minister Sherif Ismail dismisses staunchly anti-Islamist justice minister Ahmed Al-Zind.***

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#### Central Bank of Egypt devalues the pound

The **Central Bank of Egypt (CBE)** on 14 March devalued the currency 13% and adopted a flexible exchange rate.<sup>1</sup> An overvalued currency has discouraged foreign investment in Egypt, and the devaluation will increase external competitiveness. The CBE sold \$198m to commercial lenders at 8.85 Egyptian pounds (EGP) to the **United States (US)** dollar up from 7.73 fixed since November 2015.<sup>2</sup> The currency fell to 8.95 to the dollar in interbank trading, compared to 7.80 previously.<sup>3</sup> Under current rules, the pound is only allowed to fluctuate within 10 piasters of the rate set at the CBE sale. The CBE said it would not hesitate to use the tools and authority at its disposal *“to maintain order in the currency market and stability in price levels in the medium term”*.<sup>4</sup>

The CBE did not provide further information about what exchange rate tools it might adopt. However, it may make further changes to the rate.

*“While the market responded positively, [following the devaluation] the situation remains in flux and the pound could be devalued again to reflect its true value. In my opinion, this could help to restore confidence in Egypt internationally, but at a cost to ordinary citizens who would be further pinched by inflation.”*<sup>5</sup>

There is concern that the currency remains overvalued.

*“Despite the devaluation, which is a step, the pound remains overvalued. The rate on the black market is still holding steady. And the parallel market is often a good indicator of what a currency is worth.”*<sup>6</sup>

Despite the implications for increased costs for the Egyptian population, the CBE decision was taken with the backing of President **Abdel Fattah Al-Sisi’s** (2014- present) government.

*“There are two inner circles around Sisi, the security hardliners and the economic reformers. This had the backing of both circles. The reformers said it was a necessary move for investment and growth, and that they could manage any fallout from the increase in costs. The military backed it because most of their holdings are in dollars.”*<sup>7</sup>

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1 Financial Times, 14 Mar 2016.

2 Financial Times, 14 Mar 2016.

3 Bloomberg, 15 Mar 2016.

4 Financial Times, 14 Mar 2016.

5 Source, investment analyst, Cairo

6 Source, financial journalist, Cairo

7 Source, Egyptian consultant, UK

The devaluation is likely to increase investment. The benchmark **EGX-30** increased 7% on the back of the devaluation, the largest increase since 2013, while Eurobonds maturing in 2025 rallied, decreasing the yield 30 basis points to 7.65%.<sup>8</sup> Foreign portfolio investors had previously proved reluctant to invest in Egyptian equities and government securities due to concerns about the perceived overvaluation of the currency.

*"It is too soon to say what the latest move to devalue will do for the economy...While it is early days, there is the belief that now the pound is not seen as being overvalued this could stir renewed interest from foreign investors."*<sup>9</sup>

However, other sources strike a note of caution about the government's long-term economic planning.

*"It is the same show as usual: a government in crisis mode trying to do a quick fix. But the devaluation should raise questions about the leadership's ability to manage the economy. Furthermore, this government's handling of security has led the country into further instability... making Egypt less appealing to tourists and foreign investors – both formerly prime sources of foreign currency."*<sup>10</sup>

The state-owned **National Bank of Egypt** responded to the devaluation saying it will launch a financial product to enable foreign investors in local government debt to hedge their currency exposure.<sup>11</sup>

The CBE on 9 March had lifted the cap on cash deposits and withdrawals of foreign currency for companies involved in importing basic goods and for private individuals.<sup>12</sup> The easing of the banking controls will improve liquidity. The CBE directive is part of governor **Tarek Amer's** strategy of facilitating the rules on foreign exchange transactions. The capital controls will, however, remain in place for companies importing goods other than basic necessities. The CBE under former governor **Hisham Ramez** had in February 2015 imposed capital controls of \$10,000 per day and \$50,000 per month on cash deposits or withdrawals by individuals and companies. Ramez had hoped that the controls would eliminate the black market, which businesses were increasingly resorting to due to Egypt's decline in foreign reserves. However, the capital controls fuelled the parallel market and encouraged foreign currency inflows to remain outside the formal banking system. In January the CBE increased the ceiling for importers of basic goods to \$250,000 monthly with no limit on daily deposits. In February it increased the maximum limit to \$1m on deposits for exporting companies that require manufacturing imports.

The parallel exchange rate has decreased sharply in recent weeks. The black market rate reportedly reached 9.45 Egyptian pounds to the dollar on 3 March compared to 8.60 one month earlier.<sup>13</sup> Dollars are in short supply due to the sharp decline in the number of tourists visiting Egypt following the downing of a **Russian** aircraft in October 2015. The CBE has also increased its inspections of foreign exchange bureaux in recent months, making them less willing to buy dollars. The depreciation has also increased the reluctance of traders to sell.

*"As part of the devaluation strategy, the CBE has also used dollar auctions to increase liquidity, and while this can't hurt, there are concerns on whether it is enough. Scarcity remains a real problem and when there still aren't enough dollars companies will continue to use the black market."*<sup>14</sup>

Importers have warned that they will continue to use the black market:<sup>15</sup>

<sup>8</sup> Bloomberg, 15 Mar 2016.

<sup>9</sup> Source, financial analyst, Cairo

<sup>10</sup> Source, financial journalist, Cairo

<sup>11</sup> Bloomberg, 15 Mar 2016.

<sup>12</sup> MENA, 9 Mar 2016.

<sup>13</sup> Al Borsa, 3 Mar 2016.

<sup>14</sup> Source, financial analyst, Cairo

<sup>15</sup> Source, import company CFO, Cairo

*"I support this government..., but these measures (high tariffs recently put on imports and currency controls) are killing us. While the CBE scurries to reduce speculation, we are still forced to get the dollars we need from the black market to keep our business going. The message is temporary pain for longer term gains, but not everyone is convinced."*<sup>16</sup>

On the same day as the CBE lifted its banking controls, the state-owned banks **Banque Misr**, National Bank of Egypt and **Banque du Caire** simultaneously lifted the interest rate on three-year medium term dollar denominated certificates of deposit from 2.25% to 4.25%, and five-year certificates from 4.25% to 5.25%.<sup>17</sup> The CBE appears to be adopting a dual strategy of encouraging banks to offer high interest rates on foreign currency deposits to avoid a run on the bank, and allowing greater flexibility to importers in order to reduce the gap between the official exchange rate and the parallel market. There is some debate about whether or not this is sufficient:

*"This currency crisis is being temporarily managed when it needs to be solved with measures amounting to more than asking Egyptians abroad to deposit their money in state-owned banks."*<sup>18</sup>

### Sisi signs financial agreements during Asia visit

Sisi signed a series of deals with **Japan** and the **Republic of Korea** during a visit to **Asia** between 28 February and 5 March. Asia is a key source of investment and aid for Egypt as **The Gulf** states impose austerity measures due to the economic consequences of low oil prices. Japanese companies signed deals worth 2 trillion yen (\$17.6 billion) at the **Egypt-Japan Business Council** in **Tokyo**.<sup>19</sup> The business council meeting follows the meeting between prime minister **Shinzo Abe** (2006-2007/2012 - present) and Sisi.<sup>20</sup>

Three bilateral agreements are concerned with generating thermal energy, manufacturing electrical generators, and establishing a thermal energy plant in **Marsa Matrouh (Matrouh Governorate)**.<sup>21</sup> Egypt and Japan also signed a series of memorandums of understanding regarding the operation and maintenance of electricity generation stations, including a 1,300MW project in **Qena Governorate** and the 2,000MW **Sidi Shebib** thermal station.<sup>22</sup> Japan-based **Marubeni Corp** and Egypt-based electric equipment manufacturer **El Sewedy Electric Co** will additionally undertake a feasibility study into a 4 GW \$3.5 billion coal-fired plant in **West Matrouh** for the state-owned **Egyptian Electricity Holding Co**.<sup>23</sup>

Other agreements covered the rent of semi-submersible rigs, and the development of the **Suez Economic Development Zone**.<sup>24</sup> Egyptian media also reported that the **Japan Bank for International Cooperation (JBIC)** and Egypt had signed a comprehensive strategic partnership.<sup>25</sup> Egyptian media provided no additional detail as to the contents of the reported strategic partnership with JBIC.

During Sisi's visit, the **Japan International Cooperation Agency (JICA)** agreed with international cooperation minister **Sahar Nasr** loans worth 54.18 billion yen (\$479m) for three projects.<sup>26</sup> JICA loans worth \$243m will finance the installation and upgrade of electricity distribution systems for the electricity distribution companies of **Alexandria, North Cairo** and **North Delta**.<sup>27</sup> A JICA loan worth

<sup>16</sup> Source, import company CFO, Cairo

<sup>17</sup> MENA, 9 Mar 2016.

<sup>18</sup> Source, financial journalist, Cairo

<sup>19</sup> Egypt Independent, 2 Mar 2016.

<sup>20</sup> Al Ahram, 29 Feb 2016.

<sup>21</sup> Egypt Independent, 2 Mar 2016.

<sup>22</sup> Egypt Independent, 2 Mar 2016.

<sup>23</sup> MENA, 4 Mar 2016.

<sup>24</sup> Egypt Independent, 2 Mar 2016.

<sup>25</sup> Egypt Independent, 2 Mar 2016.

<sup>26</sup> Tenders Info, 3 Mar 2016.

<sup>27</sup> Tenders Info, 3 Mar 2016.

\$91m will also support the development of the **Hurghada Photovoltaic Power Plant Project**.<sup>28</sup> According to reports, Egypt will open a public tender open only to Japanese companies with demonstrable battery technologies for the 20MW plant which will have a 30MW capacity storage facility.<sup>29</sup> The plant will come online in 2019.<sup>30</sup> A 2015 Japanese government target calls on Japanese companies to secure 500 billion yen (\$4.4 billion) in revenue from storage technologies.<sup>31</sup> A JICA loan worth \$152m will also finance the construction of a new terminal at **Borg El Arab International Airport** that serves Alexandria.<sup>32</sup> JICA said the loans will have interest rates of between 0.1% and 0.3%, with a repayment period of 40 years and a 10-year grace period. Japan will also extend an additional yen loan to facilitate the construction of the **Grand Egyptian Museum**.<sup>33</sup>

After leaving Tokyo, Sisi visited **South Korea** where the finance ministry and **South Korea Export-Import Bank** presented a \$3 billion financial package including export credits and infrastructure finance.<sup>34</sup> The **Korea Economic Development and Cooperation Fund** will provide a \$700m concessional loan, and the Export-Import Bank \$2.3 billion worth of export credits for the transport and renewable energy sector.

### Justice minister Ahmed Al-Zind dismissed

Prime minister **Sherif Ismail** on 13 March dismissed justice minister **Ahmed Al-Zind**.<sup>35</sup> While Zind was notably anti-Islamist, his dismissal will not change the judiciary's aggressive stance towards the proscribed **Muslim Brotherhood**. Zind triggered social media criticism after a television interview with private satellite channel **Sada al-Balad** when he responded to a question about whether he would imprison journalists accused of defaming him, he said he would even arrest "a prophet".<sup>36</sup> The journalists – **Hesham Younis**, editor of **al Ahram**, and **Gamal Sultan**, editor of **Al Mesryoon** – had accused Zind of selling state land to relatives at low prices while head of the **Judges Club**.<sup>37</sup> The comment triggered allegations of blasphemy, with **Al-Azhar**, a prestigious seat of Islamic learning, issuing a condemnation of the comments.<sup>38</sup> The Judges Club defended Zind, describing the comments as an error that anyone could have made.<sup>39</sup>

Zind was a strong advocate of the judiciary's powerful position in Egypt. Despite his support within the judiciary, he was a contentious figure who had in January on the same television channel called for the "mass killing"<sup>40</sup> of Muslim Brotherhood supporters in retaliation for the death of members of the security forces.

Ismail on 16 March appointed legal and parliamentary affairs minister **Magdy al-Agaty** as interim justice minister. Agaty was previously vice president of the state council, a powerful judicial body. Ismail said the appointment of a permanent justice minister would not involve a wider cabinet reshuffle.<sup>41</sup>

### Implications

Investors, as well as importers and exporters, have warned that that even with the devaluation, the Egyptian pound remains overvalued; US dollars remain in short supply. Nevertheless, the devaluation

28 Tenders Info, 3 Mar 2016.

29 The Japan News, 22 Feb 2016.

30 The Japan News, 22 Feb 2016.

31 The Japan News, 22 Feb 2016.

32 Tenders Info, 3 Mar 2016.

33 www.mofa.go.jp

34 MENA, 5 Mar 2016.

35 Al Ahram, 13 Mar 2016.

36 Sada Al-Balad, 11 Mar 2016.

37 Daily News Egypt, 14 Mar 2016.

38 Al Ahram, 13 Mar 2016.

39 Reuters, 13 Mar 2016.

40 Al Ahram, 13 Mar 2016.

41 Aswat Masriya, 15 Mar 2016.

will increase Egypt's external competitiveness and facilitate trade. However, it will not curb the black market, which will remain prevalent. Further devaluations are therefore possible. It will also increase living costs for ordinary Egyptians, increasing the pressure on the government to address popular economic concerns and retain expensive subsidies.

Asia is providing Egypt with an alternative to The Gulf which is cash short and risk adverse due to the constraints of low international oil prices. The Gulf States are increasingly looking for returns on their existing investments in Egypt and are reluctant to add to their portfolios. However, Japan is economically stagnant with the **Bank of Japan's** (central bank) stimulus programme struggling to stave off another recession. This raises questions about its sustainability as a source of investment and aid.

The dismissal of Zind as justice minister will not necessarily mark the end of harsh sentences against Islamists, which are in line with Sisi's anti-terror legislation.

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