ANALYSIS
19 MARCH, 2020

Brendan Meighan
Brendan.Meighan@moodys.com
Economist

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

Egypt's Interest Rate Play

Introduction

The Central Bank of Egypt announced its biggest rate cut on record and changes our outlook for the nation. This drastic rate cut comes with risks and rewards.

The Central Bank of Egypt announced Wednesday after an unscheduled monetary policy meeting that it was cutting interest rates by 300 basis points in response to the COVID-19 outbreak. This marks the biggest rate cut on record and changes our outlook for Egypt.

Faster depreciation

Prior to the cut, we had expected a gradual lowering of the interest rate as the domestic foreign exchange market matures and the economy adjusts to the lower value of the Egyptian pound, along with a gradual reversal of the last year's appreciation of the Egyptian pound against the U.S. dollar. With the dramatic and unexpected lowering of interest rates this week, we now expect a faster depreciation of the pound and more inflation pass-through.

Prior to the COVID-19 outbreak, the CBE had taken an exceptionally hawkish stance toward its interest rate policy. Capital inflows and an appreciation of the pound were prioritized over lower borrowing costs. Concern over the stability—and credibility—of the pound's value was paramount.

The cut suggests a belief by the CBE that, at least in the short term, investors will be seeking safe havens regardless of the returns on Egyptian assets. As a result of the exigent circumstances, the CBE has shifted its priorities toward blunting the slowdown in domestic economic activity.

There are a number of upsides and downsides associated with this decision. In upsides, the lowering of borrowing costs will help businesses deal with a deceleration of economic activity at home and abroad as the coronavirus spreads. In addition, lower borrowing costs for the government reduce the long-term costs of fiscal stimulus.

The Egyptian government recently announced increased energy subsidies for factories and reduced taxes on stock market transactions for domestic and foreign investors, among other things. This opens the door to more demand-side fiscal stimulus, which may explain a deceleration in the selloff in Egypt's equities market.

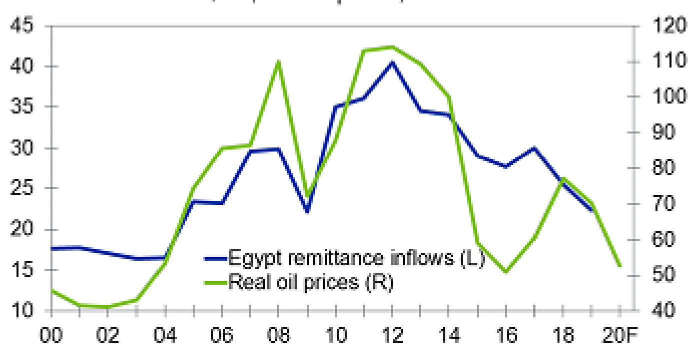
Foreign currency crunch

The downsides associated with the rate cut are more limited. Portfolio inflows—along with tourism spending, Suez Canal revenues, and remittances—have helped offset a consistent and widening trade deficit, but all of these sources of foreign exchange are expected to dry up as governments around the world look to limit the spread of COVID-19 and investors liquidate all but the safest investment positions. The size of the rate hike necessary to offset this impending foreign currency crunch would be prohibitively large as the supply of funds becomes more inelastic.

While February's tourist arrivals did not show a decline from the previous year, March's are dropping off precipitously as more countries enact travel bans. Egypt has announced a grounding of all passenger flights beginning Thursday. A slowdown in global economic growth will drag on international trade passing through the Suez Canal and the associated revenues Egypt earns from it. Remittances will also be driven down by a collapse in oil prices, exacerbated by a Saudi Arabia-Russia price war, as demand for Egyptian labor in the Gulf slows.

Remittances and Oil Prices Move Together

Remittances in 2018$ bil; real oil prices, 2014=100



Sources: World Bank, Central Bank of Egypt, Moody's Analytics

Prior to the ongoing economic tumult, real interest rates were the main draw of foreign capital flows into Egypt. Calculated as the policy rate less the rate of inflation, real interest rates stood at about 4% in 2019. With the rate cut and a pickup in inflation in 2020, we will see real interest rates falling to half that, although they will remain higher than those of most developed economies.

The increased subsidies and lower market prices for energy products on top of a slowdown in domestic demand will limit the inflation rise, but this will be more than offset by the depreciation of the pound and the inflation pass-through. The pound is already down from its late February high against the dollar, but has performed better than the MSCI emerging market currency index since that point.

If the number of COVID-19 cases slows in the next two months and Egypt's economy emerges intact, investors will return to the Egyptian market. But with conditions globally continuing to evolve rapidly, it remains too early to count on such an upside materializing.