

Egypt Faces higher borrowing costs amid emerging market pressures

Highlights

- Egypt cancelled four Treasury bond auctions in as many weeks before accepting the fifth auction last Monday.
- Investors' appetite for emerging market assets has diminished in view of currency market turbulence, US monetary tightening and trade tensions; investors are demanding higher yields than what the authorities had budgeted.
- Egyptian authorities considered the requested rate did not reflect Egypt's good economic performance as they try to strengthen economic growth and cut the budget deficit while securing financing at a lower cost.
- Achieving macroeconomic stability and forging ahead with the reform program and a possible return to stability in emerging markets more broadly could pave the way to lower financing costs.

Egypt's finance ministry cancelled four consecutive auctions of 5 and 10-year treasury bonds, the last of which was on September 24 worth EGP3 billion (\$167 million), after bankers and investors demanded high yields on the debt. The fifth auction on October 1 was accepted although the bid rates have not changed.

The Ministry of Finance had argued that the requested interest rates for the bonds exceeded the acceptable limits and did not reflect the good economic and financial performance or even the improvement in Egypt's credit rating, and these rates were not warranted by the level of risk in Egypt. Banks and investors have been seeking rates of 18-18.5%, while the authorities were betting on a 14-15% rate.

Why did Egypt cancel four T-bond auctions?

For the current 2018/19 budget, Egypt is planning to lower the interest rates on government debt instruments to 14.7%, compared to 18.5% under the 2017/18 budget. According to the state budget, interest payments are forecast to grow to EGP541 billion (\$30 billion) in the current fiscal year, making up 38% of total expenditure and 70% of tax revenue. The finance ministry estimated that for every 1 percentage point increase in average rates the debt service bill will rise by EGP4-5 billion.

According to the Ministry of Finance, the interest rates required were "not within the logical limits", although the demand for these bonds was high (1.6 times the offer). The shortfall due to the cancellation of September's auctions has been covered by the increased issuance of shorter-duration bills with an average yield of about 19% since the fiscal year began in July.

Historically, Egypt has gone for months without issuing bonds and relied only on short-term treasury bills. Central bank data showed that

the government raised EGP19.2 billion last Sunday at an auction of three and nine-month treasury bills. Although a risky strategy, this gives the government room for canceling bond auctions with the hope that they will be able to auction bonds at lower rates as the situation in emerging markets stabilizes.

However, the weekly auction of October 1 (USD 50.6 million) was accepted. The rates on 3-year and 7-year bonds were 18.432% and 18.431%, respectively. While the totality of the 3-year bonds was sold, the central bank sold only EGP153 million of the 7-year offering – well under the EGP500 million sought. Investors are reluctant to lock themselves into longer-term maturities and so is the central bank and that is why it accepted only the 7-year rate that was close to that paid on the 3-year rate bonds, which explains why the rates came out virtually identical despite the maturity gap.

In parallel, the government is seeking to tap international debt markets and an official delegation will go on a road show to Europe and Asia to promote these bonds next week. Egypt plans to sell \$5 billion in bonds overseas in the next few months, benefiting from relatively low-interest rates in developed markets, despite their projected increase in the short run. If successful, this will reduce the average interest rates on government debt.

Why Investors are demanding high yields on the debt?

It is clear that the current emerging market currency crisis is the main reason for foreign investors' demand for higher interest rates. Many emerging markets have been shaken by this crisis, stemming mainly from US monetary tightening – which is attracting funds back to the United States – on top of the uncertainty created by an escalating trade war between the US and China. The currencies of many emerging markets, especially Turkey and Argentina, have seen a huge drop in

recent months, contributing to the exit of foreign investors from these markets. While Egypt was not as badly affected as other countries, according to some reports, some \$6 billion in foreign holdings of local debt left in the three months ending in July.

The Central Bank of Egypt decided early in the year to cut interest rates by up to five percentage points this year as inflation slowed, with the aim of curbing returns on domestic debt instruments. This decision was taken before the recent tensions in emerging markets. In addition, the elimination of some subsidies in the summer and the rise in the oil price did not help as inflation is at 14% and expected to remain at that level next year, above the 10% originally projected. That is why, and after cutting the rate by 200 basis points in February and March, the central bank has decided to put the policy interest rate on hold. The Monetary Policy Committee kept interest rates unchanged for the fourth time this year at its September meeting, keeping the overnight deposit rate and the overnight lending rate at 16.75% and 17.75%, respectively.

The confluence of these factors made investors much more cautious and selective about emerging markets than they were in 2016 when Egypt adopted a comprehensive reform program supported by the IMF. At that time, money poured in to support the reform package with the IMF money serving as a catalyst.

In the present environment, investors are likely to ask for higher interest rates and a larger margin over the prevailing inflation rate. This is more the case at a time where global interest rates are on the rise and where investors think, justifiably or not, that emerging market contagion could put pressure on what is now a flexible exchange market.

Going forward

Egypt has adopted an ambitious and politically difficult economic reform program that won the praise of international financial institutions and its main economic partners. And much progress has been made on several fronts. Yet the repeated cancellations of bond auctions has likely not sat well with foreign investors, further eroding their interest in future auctions and undermining confidence in the country's economic management. This could threaten investment flows or disrupt them at the very least. The fact that even domestic banks are asking for higher interest rates may also dampen foreign investors' interest.

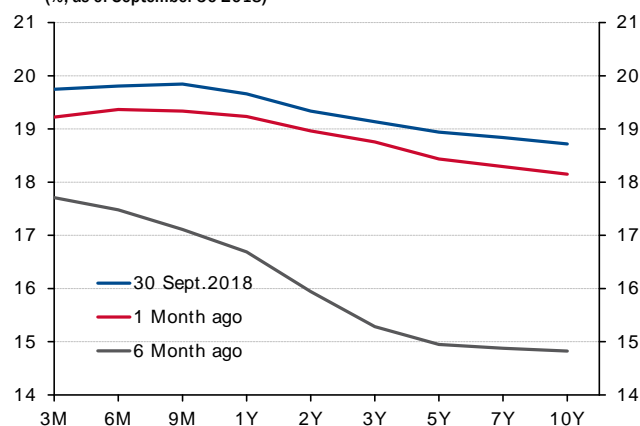
The position of the Egyptian authorities is understandable as they are trying to balance two (and maybe inconsistent at this time) objectives: securing financial resources (including foreign) to finance their budget deficits, which would require a higher interest rate, but at the same time, they want to enhance economic activities and growth, and avoid a sharp increase in the interest bill. Any increase in the interest rate will have serious implications for the budget deficit, which is targeted to be reduced below 9% of GDP this coming fiscal year, one of the objectives under the IMF-supported program.

It may not be possible in the current global environment to achieve these two objectives simultaneously. Experience has shown that for a country that adopts a strong adjustment program – like the one adopted by

Egypt – it is bound to have soft economic growth (and in some cases recessions) before macroeconomic stability is reached. Once stabilization is achieved, the focus will then turn to boosting economic growth. It is a difficult tradeoff socially and politically but often unavoidable.

Continued reliance on short-term budget financing by 3 and 9-month treasury bills instead of medium and long-term bonds is not ideal. This will complicate Egypt's plan to reduce its budget deficit, as the debt service burden mounts. In fact, yields on Egyptian pound-denominated short-term treasuries continued to rise, with the return on 3-month bills at 19.748% on September 30, while yields at the 9-month auction rose to 19.847%.

Chart 1: Egypt government bond yield curve
(%, as of September 30 2018)



Source: Central Bank of Egypt

The current interest rate structure shows an inverted yield curve, though less inverted than 6 months ago when inflation was expected to go down at a steeper pace. This may make investors less inclined to invest in medium- and long-term assets.

The authorities' intended strategy of tapping international debt markets is well placed. In the meantime, they should continue to create an environment whereby investors are reassured that things are going in the right direction and that Egypt will avoid the worst of the problems facing other emerging markets. This includes forging ahead with its economic reforms in order to address its macroeconomic vulnerabilities and help ensure a healthy investment climate that would encourage investors and secure financing hopefully at a lower cost.

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567, Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3JQ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

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