Rating Action: Moody's places Egypt's B3 ratings on review for downgrade

09 May 2023

New York, May 09, 2023 -- Moody's Investors Service ("Moody's") has today placed the Government of Egypt's B3 longterm foreign-currency and local-currency issuer ratings on review for downgrade. Prior to this rating action, Egypt's ratings were B3

and the outlook was stable.

Moody's has also placed on review for downgrade Egypt's B3 foreign currency senior unsecured ratings and its (P)B3 foreign currency senior unsecured MTN program rating, as well as the (P)B3 senior unsecured MTN program rating of the Egyptian Financial Corporation for Sovereign Taskeek sukuk company, and its B3 senior unsecured rating which are, in Moody's view, ultimately the obligation of the Government of Egypt.

The review for downgrade reflects the sovereign's increasing liquidity and debt affordability risks. Slower than anticipated progress with the state-owned asset sale strategy, a key component of the 46-month IMF program that started in December 2022, risks undermining Egypt's financing plans, weakening the sovereign's foreign exchange liquidity and eroding confidence in the currency. Adverse feedback effects on inflation and borrowing costs, as well as adverse valuation effects on foreign currency debt caused by the weakening currency, exacerbate debt affordability risks. The review period will focus on the government's ability to finalize the targeted $2 billion in asset sales necessary to meet the IMF program's financing targets for fiscal 2023 (ending June) and demonstrate the viability of the program's external funding strategy that relies significantly on asset sales. The review period will also focus on authorities' ability to bolster net international reserves as per quantitative IMF program targets over a three-month period and support confidence in the currency.

Egypt's country ceilings remain unchanged at Ba3 for the local-currency ceiling and B2 for the foreign-currency ceiling. The three notch gap between the local-currency ceiling and the sovereign rating reflects the public sector's large footprint in the economy that inhibits private sector development and credit allocation, mitigated by a track record of implementation of structural, competitiveness related, reforms. The two-notch gap of the foreign-currency ceiling to the local-currency ceiling reflects the narrow foreign currency liquidity buffer. Potential risks of transfer and convertibility restrictions under scenarios of intensifying stress are mitigated by the agreed shift to a flexible exchange rate regime and the removal of letters of credit requirements that supports a gradual rebalancing of external accounts.

Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL476562 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE / FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

RATIONALE FOR INITIATING THE REVIEW FOR DOWNGRADE

INCREASING EXTERNAL LIQUIDITY RISKS

The drawdown of foreign-currency liquidity has resumed in the first quarter of 2023 after a temporary stabilization at the end of 2022, leading to intensifying currency depreciation pressures as evidenced in the widening gap between the official exchange rate and market-implied rates.

Liquid foreign exchange reserves have remained broadly stable at $26.2 billion in April 2023 from $26.7 billion in December 2022. However, net foreign assets (NFA) data for commercial banks indicate a deterioration by $3.8 billion to a net liability position at $15.5 billion in March 2023 from $11.7 billion in December 2022, as public sector banks have increased borrowings from abroad. In addition, the central bank's net foreign liability position remained large at about $9 billion in March from $8.3 billion in December, increasing the total monetary system's net liability position to $24.5 billion (including both the central bank and commercial banks). Given part of the banking system's role in supporting the economy's overall foreign exchange reserves, an inability to arrest the deterioration in the monetary system's NFA position over the review period is indicative of increasing demand on foreign exchange liquidity and is likely to result in continued currency depreciation pressures.

It has been credit positive that the current account deficit has declined significantly to an estimated deficit of below 2.5% of GDP at the end of December 2022 on a 4-quarter moving average basis from a deficit of 4.2% one year before because of significant import compression. Also positive has been that foreign direct investment increased to an annualized $11.4 billion from $5.1 billion one year before, reflecting previous investments by Abu Dhabi's ADQ sovereign wealth fund in April 2022 ($1.85 billion) and Saudi Arabia's PIF ($1.3 billion) in August 2022. However, sharp portfolio outflows, negative real policy rates and continued currency weakness since February 2022 have constrained the financial account and prevented a build-up in foreign exchange reserves from the postpandemic lows between $26-27 billion reached in June 2022. The more onerous external debt maturity profile in fiscal 2024 and 2025 will further increase the sovereign's external vulnerability risks in the absence of new inflows to bolster the economy's foreign exchange reserve buffers.

Specifically, the quantitative targets under the $3 billion 46-month IMF program signed in December 2022 aim for an improvement in net international reserves by $6 billion to $23 billion by the end of June 2023 from about $17 billion in March. Moody's approximates net international reserves by subtracting the central bank's net foreign liability position at about $9 billion as of March from the economy's liquid foreign exchange reserves at $26.5 billion in March. The targeted adjustment necessary to meet the IMF program target is thus equivalent to a reversal in the central bank's ne foreign liability position by $6 billion over a three-month period, reducing it to about $3 billion by June. The review period will focus on progress with the replenishment of net international reserves in line with the outlined targets, and on authorities' progress with meeting the requirements to conclude the first review under the IMF program which was initially scheduled for 15 March.

DELAYS IN DELIVERING ON PRIVATIZATION STRATEGY UNDERMINE CONFIDENCE, DISCOURAGING ANTICIPATED INFLOWS

Access to new official lending and state-owned asset sales are key to improving the economy's foreign currency liquidity while the economy undergoes a structural change toward a more private sector and export-led growth model in the wake of the central bank's official shift to a flexible exchange rate regime announced last October. Specifically, the IMF program envisions asset sales of $2 billion by June (i.e., end of fiscal 2023), followed by $4.6 billion in fiscal 2024. Thus far no material new privatization proceeds have been received since the start of the year amid market-implied expectations of further currency devaluations and the existence of vested interests within the public sector that have also led to delays in previously envisioned asset sale programs.

An inability to meet the asset sale target by 30 June risks undermining confidence that the asset sale strategy overall remains a viable funding strategy in the future: under the program parameters, state-owned asset sales are earmarked to cover $9 billion of the cumulative $17 billion external financing gap over the next four years. Only $8 billion are to be funded by new official loans ($5 billion) and the IMF ($3 billion), underscoring the importance of demonstrating the commitment to, and viability of, the government's privatization strategy considering limited alternative funding options.

While the government successfully issued its first $1.5 billion international sukuk bond on 24 February and unlocked additional official funding sources to meet its financing needs in fiscal 2023 and 2024, capital market access is sporadic and very costly, while continued access to multilateral funding sources is tied to conditionality and program compliance.

INTENSIFYING DEBT AFFORDABILITY CHALLENGES

Meanwhile, market-implied depreciation pressures continue to persist. The inability to secure inflows and reduce depreciation pressures entails feedback effects to inflation and domestic borrowing costs from already high levels. Notwithstanding the cumulative 50% depreciation of the Egyptian pound already witnessed since February 2022 – similar in scale to the 50% depreciation observed in November 2016 – futures markets point to mounting devaluation pressure, with non-deliverable forward contracts trading at over EGP40/$1 in April from the current spot rate of EGP30.9/$1, implying an anticipated depreciation of over 20%. Continued currency depreciation would trigger more severe inflationary pressures and increase domestic borrowing costs from already high levels. Namely, the 91-day T-bill rate is trading at over 22% as of 2 May, exacerbating debt affordability challenges considering very large gross financing needs at over 30% of GDP, of which 20% of GDP are short-term T-bill rollovers.

Budget execution data show that the central government's interest/revenue ratio for the period July 2022-April 2023 has increased to 59.3% compared to 51.2% one year before. In general government terms, Moody's expects the interest/revenue ratio at 45.2% in fiscal 2023 and 46.9% in fiscal 2024 from below 40% in fiscal 2022. However, continued currency depreciation would push borrowing costs higher for longer, eventually reducing the government's capacity to continue servicing the debt stock even if it remains committed to running primary surpluses. On the external side, continued currency depreciation adversely inflates the value of foreign currency-denominated debt, reducing the prospects of a meaningful reduction in the general government debt/GDP ratio from its current 91.3% projected for fiscal 2023. The review will therefore focus on authorities' capacity to adopt a greater degree of exchange rate flexibility as a condition to complete the next IMF review, without significantly undermining the government's debt affordability.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Egypt's ESG Credit Impact Score is highly negative (CIS-4), reflecting high exposure to environmental, social and governance risks. The sovereign's high debt burden, relatively low income levels and comparatively weak governance strength constrain its capacity to respond to environmental and social risks, although remedy strategies are being implemented.

Egypt's highly negative exposure to environmental risks, reflected in its E-4 issuer profile score, mainly relates to high water risk through its water dependency on the Nile and the high degree of air pollution in densely populated cities. The Nile flow has been affected by the decreasing rate of annual rainfall, leading to very high fresh water resource depletion rates which the government seeks to address via the installation of desalination plants and the application of strict rules for the cultivation of water-intensive crops such as rice and sugarcane. As climate change intensifies, Egypt is also among the sovereigns most exposed to rising sea levels in the future, with up to 10%-25% of the population or GDP exposed, thus increasing its sensitivity to environmental risk.

Exposure to social risks is highly negative (S-4 issuer profile score), driven by low employment rates that constrain the absorption of the young and expanding labor force, resulting in high youth unemployment rates at over 25% of the labor force, including among graduates. Relatively high poverty rates and gender inequality also contribute to social risks which have been exacerbated by the large economic reform adjustment costs borne by consumers over the past few years. As part of the government's reform effort, social risks are being mitigated by a more targeted social safety net, although the breadth coverage remains relatively narrow.

Egypt has a highly negative governance profile score (G-4 issuer profile), reflecting weak performance on voice and accountability and the perception of relatively few formal checks on the exercise of government power, including from the side of civil society. In the second half of the last decade, significant progress in the implementation of fiscal reforms denote improvements in fiscal policy effectiveness, albeit constrained by high debt levels and a large interest bill and after a period of relatively ineffective policy that had led to the build-up of imbalances. The government has more recently committed to transition to a flexible exchange rate regime to boost its competitiveness and expand its export base to enhance its external debt carrying capacity, but high inflation and already high domestic borrowing costs complicate the transition to an inflation targeting regime and a more flexible exchange rate.

WHAT COULD CHANGE THE RATINGS DOWN

An inability by the government to demonstrate the fundamental viability of the external financing strategy, for instance by making progress with state-owned asset sales to meet IMF program targets, or as a mechanism to support confidence in the currency, would magnify downward credit pressures. An inability to arrest a further drawdown in foreign currency liquidity in the monetary system or improve its net foreign reserve position that could jeopardize IMF financial support would likely lead to a downgrade.

WHAT COULD LEAD TO CONFIRMATION OF THE RATINGS AT THE CURRENT LEVEL

The ratings would likely be confirmed at the current level if the review concluded with sufficient confidence in the ability to generate necessary foreign exchange inflows, e.g. with the privatization program, to meet increasing external debt service payments over the next two years and bolster the economy's foreign exchange reserves. An ability to prevent, or at least limit, an increase in borrowing costs would engender confidence in Egypt's ability to navigate its elevated debt affordability challenges.

GDP per capita (PPP basis, US$): 14,256 (2021) (also known as Per Capita Income)

Real GDP growth (% change): 3.3% (2021) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5.9% (2021)

Gen. Gov. Financial Balance/GDP: -7% (2021) (also known as Fiscal Balance)

Current Account Balance/GDP: -4.4% (2021) (also known as External Balance)

External debt/GDP: 32.6% (2021)

Economic resiliency: baa3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 04 May 2023, a rating committee was called to discuss the rating of the Egypt, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's governance and/or management, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The systemic risk in which the issuer operates has not materially changed. The issuer has become increasingly susceptible to event risks.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

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Elisa Parisi-Capone
Vice President - Senior Analyst
Sovereign Risk Group
Moody's Investors Service, Inc.

250 Greenwich Street
New York, NY 10007
U.S.A.
JOURNALISTS: 1 212 553 0376
Client Service: 1 212 553 1653

Matt Robinson
Associate Managing Director
Sovereign Risk Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
U.S.A.
JOURNALISTS: 1 212 553 0376
Client Service: 1 212 553 1653

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