Market Pulse:

The Liquidity Shortage

The Egypt Capital Markets Development Project

CHEMONICS INTERNATIONAL INC.

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MARKET PULSE: THE LIQUIDITY SHORTAGE

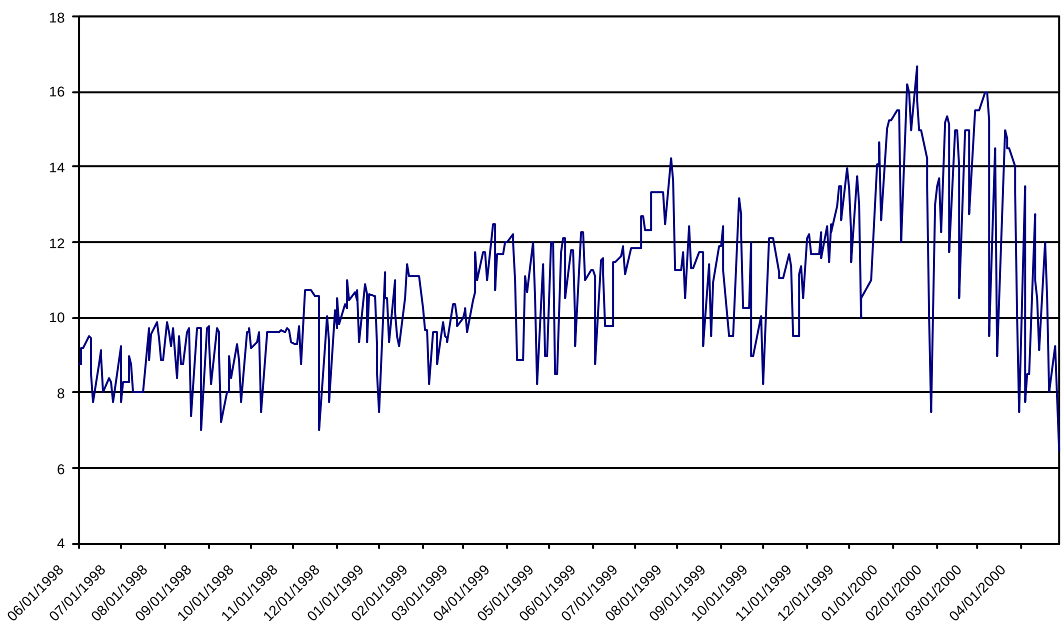
A. Summary

The banking system has undergone several dramatic changes since the beginning of Egypt's reform program in 1991. The reforms eliminated controls on credit and interest rates, lifted ceilings on fees and commissions, and allowed foreign banks to deal in local currency. In addition, legislation passed in 1996 permitted joint-venture banks to be 100% foreign owned. Amendments passed in 1998 also allow for the privatization of state-owned banks.

The Egyptian government's chronic budget deficit—in conjunction with a fall in tourism revenues following November 1997's terrorist attack in Luxor, dip in oil prices from 1998 through 1999, and decline in Suez Canal receipts—had an adverse impact on the Egyptian economy. As foreign exchange earnings declined throughout 1998 and most of 1999, a dollar shortage developed in the local market, putting pressure on the pound. Subsequently, dual exchange rates emerged, and by mid-1999, the unofficial exchange rate rose to approximately LE3.7 against the dollar. The CBE countered the drop in hard currency inflows by using Net Foreign Reserves (NFR) to maintain the pound. The injection of US$5 billion in NFR resulted in an equivalent transfer of local currency out of the banking system to the CBE.

As a result of the liquidity shortage in local currency, median overnight interbank interest rates soared to 17% in the first few months of 2000, the highest level in three years (see Exhibit 1). Overnight rates averaged 11 to 13% during 1999. As noted above, the rise in domestic interest rates was exacerbated by the CBE's sale of dollars to ease the recent dollar shortage. As banks rushed to buy dollars, they depleted their supply of pounds, forcing them to bid up interbank rates to cover their reserve requirements at the CBE.

Exhibit 1: Overnight Interbank Rates (%)



Source: EFG-Hermes

In interviews with the Capital Markets Development (CMD) project and publications, market participants attribute the liquidity problem to a variety of factors, including over-spending on mega projects, the collapse of oil prices, low Suez Canal receipts, a decrease in tourism revenues, a decline in workers' remittance, strong domestic demand, and a deterioration in exports. The liquidity shortage revealed itself in the sky-high interbank rates as banks rushed to cover the reserve requirement held at the CBE, limiting their ability to supply capital to the market. In an attempt to combat this liquidity shortage, banks increased interest rates on deposits to 10.5%. Some Egyptian banks borrowed from international banks and expanded saving vehicles to attract the household sector. While this move may relieve the demand for U.S. dollars, some participants fear that it may also impact the stock market adversely.

Bankers, officials, and market participants all called for measures to tackle the liquidity problem. Bankers called for lowering the percentage of bank reserves held at the CBE, currently at 15%, noting that the percentage retained in Egypt is the highest among developing countries. Others suggested allowing banks to include banknotes as a component of the reserve requirements and conducting repurchase transactions against T-bonds, as the CBE currently does with T-bills. Some participants advised the government to de-link the pound from the dollar, recommending the adoption of flexible exchange rate regime. Market participants also called for the enhancement of transparency, disclosure, and regulations to encourage more direct investment. Generally, many urged the government to adopt export incentive policies to attract foreign exchange inflows and lower the demand for imported goods.

B. Reasons for Liquidity Shortage

Following reports of a liquidity shortage, President Mubarak assured Egyptians at the end of 1999 that the nation's banking system was sound. Local newspapers reported that several commercial banks failed to meet customers' demand for cash. Some economists attributed the cash crisis to big businessmen defaulting on debts, while others said the government had overspent on national projects (*Dow Jones*, *Al Ahram*, December 3, 1999).

In an interview, EFG-Hermes' David Shelby attributed the roots of the liquidity problem to the emerging markets financial crisis of 1997. While Egypt escaped contagion from Asia, both its current accounts and balance of payments account were hit hard during the crisis. To defend the Egyptian pound, the CBE pumped dollars into the market. When the CBE slowed the supply of foreign exchange in September 1999, multiple exchange rates developed. To counter this development, the new government again provided dollars. While the policies of the new government have not solved the problem, they have eased pressure on the pound considerably. Shelby said that the free-market exchange rate for dollars leaped to LE3.70 in August 1999, as opposed to the LE3.44 officially offered by banks. The subsequent injection of dollars into the market produced a rise in overnight rates, as Egyptian pound liquidity was mopped up.

Shahinaze Foda, assistant general manager of the Treasury Department at the Egyptian American Bank (EAB), argued that the liquidity shortage started at the beginning of 1999 because of the Y2K related concerns. Banks accumulated bank notes in anticipation of clients' demand for cash. To respond to the demand for dollars, the CBE has pumped over US$5 billion into the banking system from 1998 to present. This operation depleted the net foreign reserves (NFR) from US$20 billion to approximately US$15 billion, causing the drainage of an equivalent amount in local currency from banks (approximately LE17 billion). Foda added that inefficient and bureaucratic open-market operations coupled with the negative psychological effect of an expected devaluation seriously escalated the liquidity problem.

Some analysts also argue that the pound liquidity squeeze is partly connected to over-spending on mega projects, such as Toshka. Partly as a result of increased spending on mega projects, total government expenditures increased to US$856 billion in 1998, compared to US$215.6 billion in 1994.

In a press interview, Mohamed El Barbary, senior advisor to the CBE Governor, added that the local currency liquidity crisis has accelerated due to transfers of government deposits from the banking system to the CBE. Other banking officials, like Gaball Al Desouki, an assistance general manager at the Export Development Bank, agreed, citing the withdrawal of LE1.7 billion of GOE's bank deposits. The expansion of loans and banks' purchases of LE4 billion in T-bonds also contributed to the transfer of funds out of the banking system. CBE Advisor El Barbary added that the four public banks suffered the most from the liquidity shortages because many other banks depend on them for cash (*Al Alam Al Youm*, May 4, 1999).

Analysts have also cited other reasons for the liquidity shortages—for example, an increase in the number of non-performing loans. Another factor cited is the CBE's requirement that importers provide 100% collateral in local currency to obtain letters of credit, a requirement the CBE initiated to curb the growth of imports. Banks attempted to combat the liquidity shortage by increasing interest rates on deposits to 10.5%, as corporations issued bonds at rates reaching 12% (*Al Ahrar*, July 15, 1999).

B1. Balance of Payments

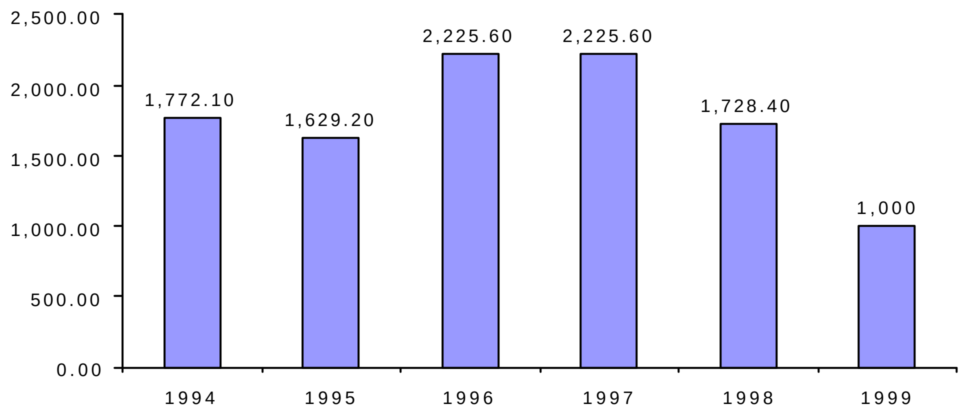
According to an HSBC report on the MENA region, the Egyptian economy suffered from a fall in tourism revenues following the November 1997's terrorist attacks in Luxor, the oil price collapse from 1998 through 1999, weak demand from the E.U. for Egyptian exports, and declining workers' remittances as Gulf economies 'nationalize' their labor forces. All these factors put increasing pressure on the balance of payments. Strong domestic demand and deteriorating exports led to the trade deficit's widening to approximately US$12 billion in 1998. Import growth has averaged nearly 10% in the last three years, while export growth has languished at 2%. The net result has been that the trade deficit has widened by an annual average of 15% since 1996 (*Egypt's Rally into the Millennium*, 1999).

EFG-Hermes analysis of the balance of payments, based on CBE statistics, concludes that Egypt has run a chronic trade deficit for tangible goods over several decades. In 1999, it amounted to US$12.5 billion or 14% of GDP. Historically, both official unilateral transfers to the government and remittances from expatriate Egyptians workers have financed the trade deficit. To boost exports, the government has adopted a number of export incentives policies, including tax breaks for export production companies and tariff waivers on inputs imported for export production purposes. However, export growth has not yet resulted from these new initiatives. Many obstacles still hinder the promotion of exports. The main obstacles cited by participants are an inadequate infrastructure, insufficient quality control, the lack of marketing expertise, lingering bureaucratic barriers, and the under-publicized export promotion objectives (EFG-Hermes website).

Drop in Oil Revenues

According to EFG-Hermes, petroleum products have accounted for roughly half of all merchandise exports in recent years. The severe drop in oil prices during FY1998 caused petroleum revenues to decline 34%, from US$2.58 billion to US$1.73 billion. This had a serious impact on revenues. However, the rebound in prices between December 1998 and end-March 1999 did not helped ease the contraction in revenues, which fell to LE1.0 billion in 1999. Furthermore, despite the drop in oil prices, there were developments in the petroleum sector, most importantly new exploration concessions were offered and attracted a sizable number of bids. The drop in oil prices, meanwhile, prompted a greater concentration on natural gas as well as on the production of refined products as a way of reducing Egypt's vulnerability to swings in crude oil prices. Actually, new gas discoveries may lead Egypt to become a net gas exporter in the future (*A View on the Market-Egypt*, January 1999, p.2; *Egypt: Moving Fast Along the Learning Curve*, May 2000, p.24).

Exhibit 2: Petroleum Exports (US$ million)

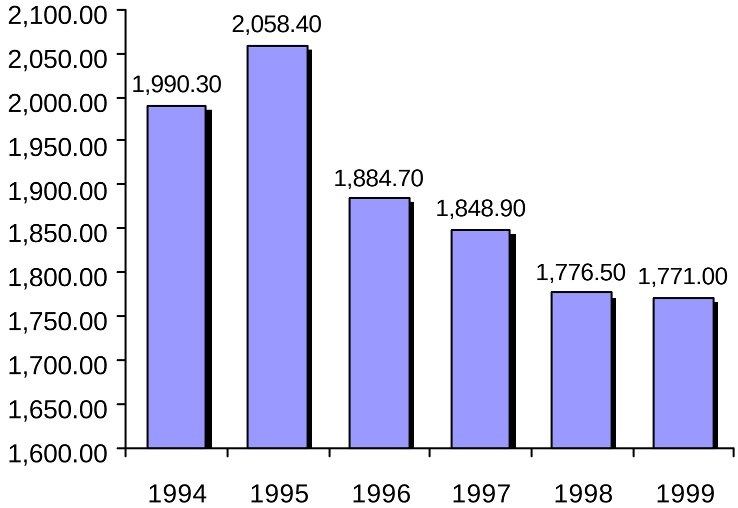


Source: EFG-Hermes

Decline in Suez Canal Revenues:

According to EFG-Hermes, another area hurt by the surge in crude prices was the Suez Canal. The canal fees are primarily tied to oil prices and freighter traffic. Thus, the rise in oil prices was coupled with a decline in the revenues from the Suez Canal. Canal revenues fell below US$1.7 billion in 1999, versus US$2 billion in 1995 (*A View on the Market-Egypt*, January 1999, p.2; *Egypt: Moving Fast Along the Learning Curve*, May 2000, p.24).

Exhibit 3: Suez Canal Revenues (US$ million)



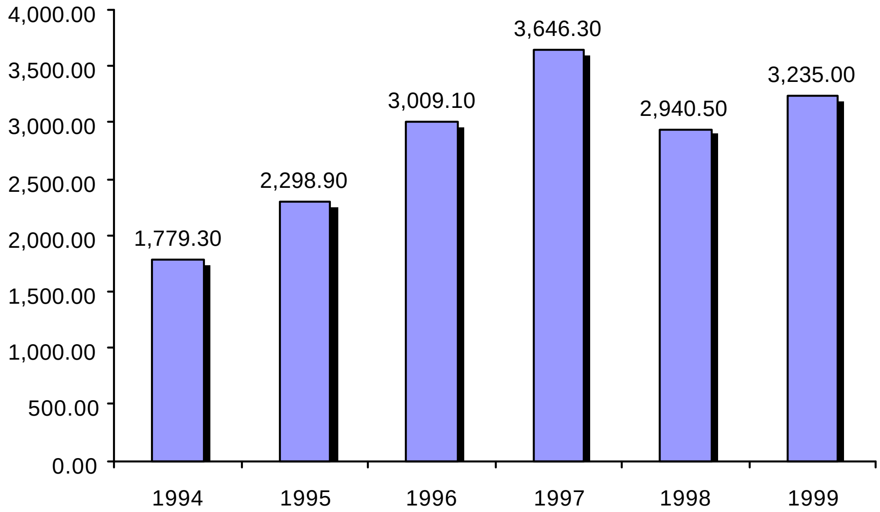
Source: EFG-Hermes, Ministry of Economy

Collapse in Tourism Revenue

EFG-Hermes further reported that revenues from tourism dropped significantly. In 1997, revenues reached a record US$3.6 billion, but due to the Luxor attack, proceeds dropped to US$2.9 billion in 1998. In relative weight of tourism to GDP, revenues fell from 1.6% in FY1997 to 1.1% for FY1998. Recently, tourist arrivals have rebounded due to deep discounts used to draw tourists, and occupancy rates are approaching their pre-Luxor levels. However, revenues have not witnessed the same level of recovery (*A View on the Market-Egypt*, January 1999, p.2).

Realizing the potential of the tourism industry, the government and private investors have embarked on projects in recent years to expand and improve Egypt's tourist facilities. Most of this development is taking place in resort areas like South Sinai and the Red Sea Coast. However, EFG-Hermes believes the tourism industry has yet to fully exploit the vast draw of Egypt's wealth of archeological treasures. Tourism revenues rebounded to US$ 3.235 million in 1999, and EGF-Hermes forecasts that the tourism sector continue to grow, with expected revenues of US$4.234 million in 2000 (EFG-Hermes website).

Exhibit 4: Tourism Revenues (million US$)



Source: EFG-Hermes

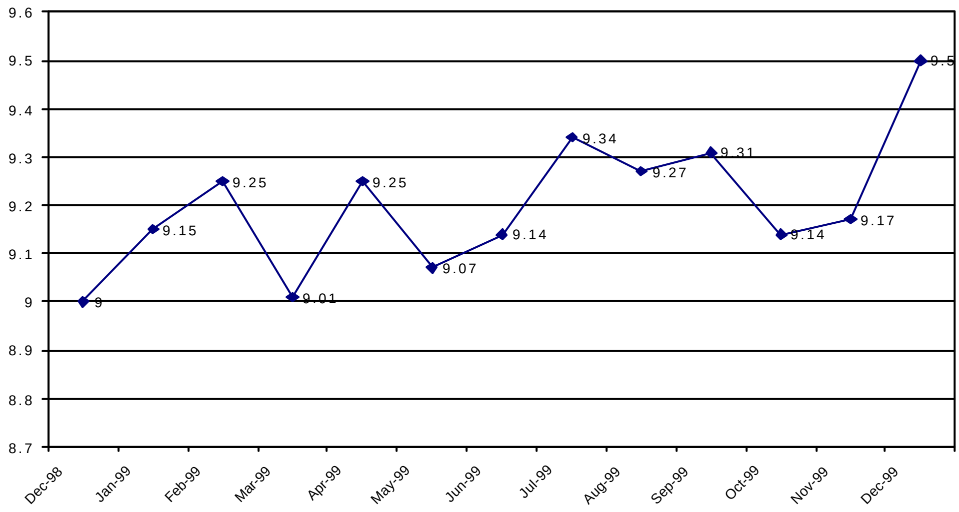
C. Symptoms of Illiquidity

Participants argued that the market is currently saturated with public-sector shares and that the liquidity shortage has left international investors wary of entering the market. Some warned that the liquidity shortage and an expected increase in interest rates are likely to adversely affect the capital markets, and emphasized the importance of CBE intervention to forestall a crisis.

C1. Interest Rates and the Availability of Credit

Banks raised interest rates on deposits in local currency by 0.25-0.50% to an average of 9.5%. This follows the 0.5% interest rate hike on passbook accounts and investment certificates by banks and the Postal Authority in early-October 1999. Most banks raised the rate on 3-month deposits from 9% to 9.5%. Other banks announced increasing the rate on short-term deposits to over 10%. Mohamed Madboli, president of National Société Générale Bank, expressed concern that direct investments may be adversely affected but stated this move may relieve demand for U.S. dollars (*Al Alam Al Youm*, October 28, 1999).

Exhibit 5: Interest Rate on 3-month Bank Deposits (%)



Source: EFG-Hermes

In a press interview, Mamdouh Habsa, a CBE general manager, attributed the rise in interest rates to the increased demand for credit in local currency. Habsa said the increase would raise the level of savings, one of the government's macroeconomic objectives. He further added that the rate increases would help lower inflation, limit the consumption of imported goods, and decrease the demand for dollars (*Al Alam Al Youm*, May 4, 1999).

In response to the dual liquidity challenges, many Egyptian banks borrowed from international banks and expanded their savings vehicles to attract household deposits. Fathy Yassin, a member of NBE's Policy Committee, said that the bank had received 3-year medium-term loans, totaling $250 million, from over 30 international banks. He added that the liquidity shortage is reflected in both the high inter-bank interest rates and the increased issuance of long-term bonds. Yassin said the NBE looks to expand individual savings by introducing new savings instruments into the market.

CASE board member Abdel Satar Bakri warned that the introduction of new savings instruments would adversely affect the exchange (*Al Alam Al Youm*, June 5, 1999), and mutual fund managers complained that most banks have stopped supplying capital to the market as a result of the liquidity shortage (*Al Alam Al Youm*, September 9, 1999). Nonetheless, capital market professionals said they do not expect the rise in interest rates to adversely affect the stock market, stating that the return on investments in equities is still attractive at 15 to 20%. In addition, many added that the diversion of capital from the exchange to banks is unlikely, as investment on the exchange by families and individuals is limited (*Al Alam Al Youm*, October 28, 1999).

Several banks have eyed issuing bonds to resolve the ongoing liquidity shortage. There were requests for issuance by the Export Development Bank, for LE485 million in bonds, International Credit Bank for an issuance worth LE125 million; Misr Iran Bank for a LE150 million issuance; and Société Générale for an issuance worth LE150 million. Bankers said that credit availability is limited to 65% of bank deposits, with 15% reserved for the CBE and 20% directed to T-bills and T-bonds (*Al Wafd*, August 11, 1999).

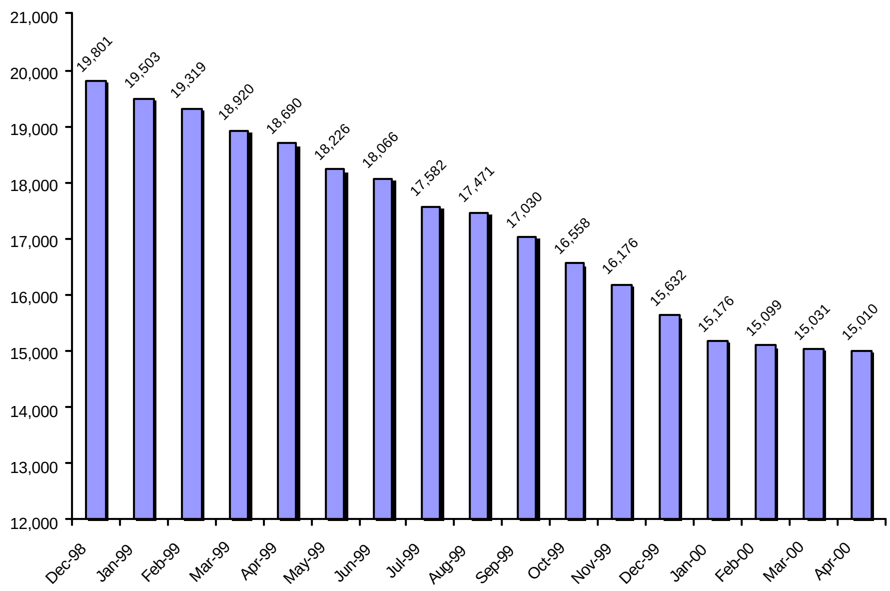
C2. Foreign Exchange Market and Net Foreign Reserves

Following the several devaluations of the pound—one in 1990, two in 1991, and a small adjustment in 1994, the currency has been effectively pegged at a rate of LE3.42/US$1. As a result of this peg, Egypt had been receiving inflows. These capital inflows built NFR from US$1.5 billion in 1990 to US$21 billion in 1998. The reduction in inflation from over 20% in the late 1980s and early 1990s to below 3% was achieved by continued implementation of tight monetary and fiscal policy. EFG-Hermes argues that the government's continued restrictive monetary policy is likely to maintain a low rate of inflation. However, the success of this policy in attracting foreign reserves ceased in the course of the last year, and NFR declined to US$15.5 billion by the end of February 2000 (EFG-Hermes website).

According to EFG-Hermes, the government policy of pegging the pound to the dollar at LE3.42/US$1, coupled with an Egyptian inflation above the U.S. inflation rate, resulted in considerable real appreciation of the pound. This inflation differential has resulted in the pound's becoming increasingly overvalued. Further, EFG-Hermes argues that the dollar has been appreciating with respect to the currencies of Egypt's European trade partners. Accordingly, they think it possible that the government may link the pound to a trade-weighted basket of hard currencies (EFG-Hermes website).

The Egyptian pound's appreciation relative to the currencies of its major trading partners is undermining Egypt's competitiveness, according to EFG-Hermes. The fall in Egypt's share in world exports is the highest in the region. Between 1991 and 1997, Egypt's share fell more than 32%, compared with falls of 5% in Morocco and 17% in Tunisia. Turkey's share rose by 21%. Of these economies, Turkey is the only one that has not pegged its exchange rate (*A Game of Two Halves*, 1999, p.5).

Exhibit 5: Net Foreign Reserves (US$ million)



Source: EFG-Hermes, CBE

The shortage of dollars has prompted the periodic emergence of multiple foreign exchange rates in the domestic market. Recently, rates have risen as high as LE3.54/US$ in private currency exchanges versus the official rate of LE3.42/US$. This has prompted increasing uncertainty about the foreign exchange rate peg and sporadic attempts by the government to arrest this process by mandate. However, while the fundamental case for adjusting the current exchange rate policy has been made by many, including World Bank officials, Egyptian monetary authorities have been unwilling to consider any change to the regime (*A Game of Two Halves*, June 1999, p.7).

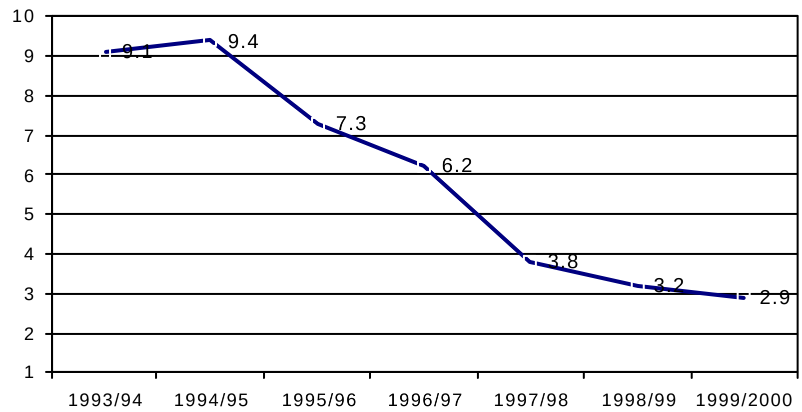
While the interest rate on T-bills remains at approximately 9.091%, overnight inter-bank rates have shown increased volatility and upward trend since the emergence of the dollar shortages in 1998. Since T-bill yields are not market determined, the overnight rate is the closest to a market-determined fixed-income instrument (*A Game of Two Halves*, June1999, p.8).

C3. Inflation Rate and Money Supply

As part of the economic reform program in the early 1990s, the CBE increased interest rates to a high of 20% as a way of lowering inflation and preventing capital outflows. They succeeded in both. Inflation fell from 20% in early 90s to 2.9% in 1999. The dollarization ratio dropped from 50% of the money supply in early 90s to 18% in 1998 (EFG-Hermes website). Flemings has projected a slight rise in inflation in 2000 as a result of higher commodity prices, and the currency is forecasted to depreciate slightly. This trend will persist as the monetary authorities try to reduce the tendency to real depreciation (*A Game of Two Halves*, June 1999, p.6).

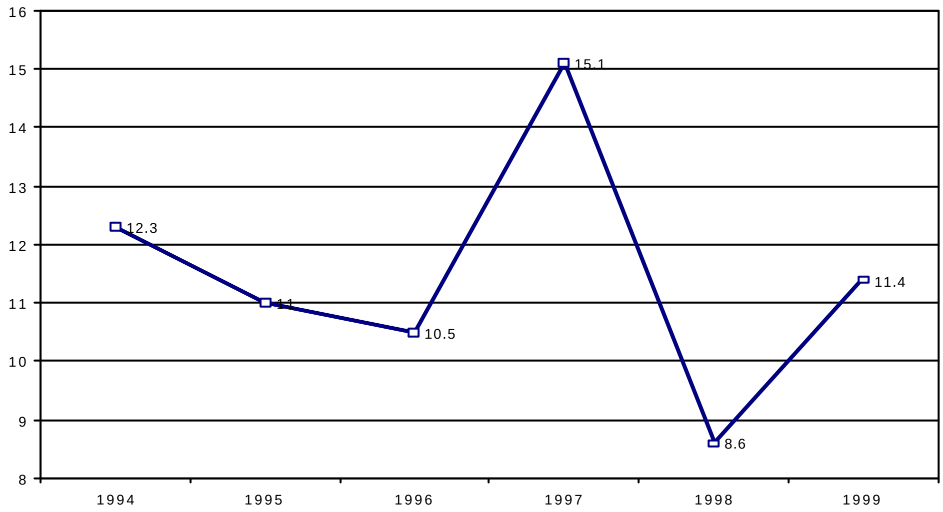
During the 1990s, the CBE bought dollars generated by tourism and petroleum, expanding the money supply. However, following the Luxor incident, the CBE began pumping foreign currency into the market, causing tighter liquidity in the pound. The broad money supply grew 8.6% in 1998 and 11.4% in 1999, versus an average of 12% in previous years (EFG-Hermes website).

Exhibit 6: Average Annual Inflation Rate (%)



Source: Central Bank of Egypt

Exhibit 7: Broad Money Supply Growth (%)



Source: EFG-Hermes

D. Recommendations from Market Participants and Observers

In interviews with CMD and in publications, market participants argued that Egypt accelerated the pace of privatization in the mid to late 90s to avoid the necessary adjustments to the monetary policy, which would have required either raising the official interest rate or adjusting the currency regime. In the long run, most observers argue that adjustments to monetary policy may prove necessary. However, an improvement in oil prices as well as increased import restrictions may prove effective in avoiding a balance of payments crisis. Furthermore, if the privatization program were to follow a faster pace, it would attract significant foreign direct investment, thus enabling the current account to be funded.

D1. CBE Policies

Bankers have called for lowering the CBE's reserve requirement (currently 15%), noting that the percentage retained in Egypt is the highest among developing countries. A successful monetary policy, stabilized expansion of the monetary base, and the drop in inflation below 4% were cited as factors making a change in the reserve policy possible now. The percentage of reserves in local currency has been adjusted before. In 1958, the percentage of reserves was set at 7.5%. This was raised to 12.5% in 1960 and to 17.5% and 25% in 1962, before the reserve requirement was stabilized at 15% at the outset of the economic reform program in 1990. The percentage of banks' reserves at the CBE in foreign currency was lowered from 15 to 10% in 1993. (*Al Alam Al Youm*, August 14, 1999).

The CBE is currently reconsidering the 15% reserve requirements for banks. A study being prepared by the bank recommends either lowering the requirement or offering banks interest on their deposits. Fathy Yassin, a member of the NBE's Policy Committee, said the CBE should lower the reserve requirement to 10% or offer banks 5% interest on their deposits (*Al Alam Al Youm*, January 11, 2000).

Shahinaz Foda, assistant general manager of the EAB Treasury Department, advised that several measures be taken to increase the efficiency of the CBE's operations. She recommended conducting repurchase agreements against T-bonds in addition to those using T-bills. She also noted that banks must pay a 1% tax when making loans against T-bonds, a prohibitively high cost that should be eliminated. In addition, she suggested that custody of T-bonds should be in the hands of the CBE, which should also take charge of the T-bond clearing and settlement process. Both measures would increase the CBE's ability to transact open-market operations.

D2. Exchange Rate Regime

As noted earlier in this paper, many market observers are recommending that Egypt modify its exchange rate policy. David Shelby, economic analyst at EFG-Hermes, recommended the adoption of flexible exchange rate to relieve the pressure of the economy generally and the banking sector in particular.

A senior trader at a major international bank agrees with EFG-Hermes perception of the liquidity problem. The trader said that increasing interest rates, which originally aimed at slowing down the economy, would reduce the demand for dollars. "The exchange rate seems to top the government's agenda" said the trader, who recommends that the solution lies in disengaging the unsustainable link between the pound and the dollar.

In a June 1999 report, Flemings argued that given the level of the Central Bank's reserve position (currently US$15.5 billion) and the improving external conditions, changes to the foreign exchange regime are unlikely in the near term. During mid-1990s, a large part of the growth in liquidity was fuelled by hard currency inflows from rising tourism and portfolio investments. The CBE capitalized on these inflows to build up foreign currency reserve in excess of US$20 billion. As mentioned above, during 1997 and 1998, a number of events resulted in the decline of currency inflows. Recently, a slight depreciation has been seen in the official central bank exchange rate versus the dollar. The pound has slipped from LE3.39 per dollar to LE3.42 since the beginning of the year. Flemings' June 1999 report expected this trend to continue over the next two years, with the currency depreciating in line with the inflation differential between Egypt and the U.S. However, in the medium term (18 to 24 months), it argues that the need for exchange rate regime adjustment is becoming more pressing. Flemings perceives the solution as a move to a crawling peg depreciation regime with a bias to mild annual real depreciation such as occurs in Poland, Israel, and Turkey (*A Game of Two Halves,* June 1999, p.7).

In a March 2000 report by Fleming's Research in London, the firm increased its estimate of how far the pound is undervalued. The report, entitled "*Downgrade to Underweight—Macro Risk Too High*," argued that the Egyptian pound is 40% overvalued, stirring strong reactions among government officials, who demanded a full retraction of the conclusions. The Flemings' Cairo office distanced itself from the report's findings, especially the 40% conclusion. Although most local economists and financial analysts have been urging a gradual devaluation, they believe that a 40% devaluation is much too aggressive (*Business Monthly*, May 2000).

EFG-Hermes argues that there are several factors mitigating against an outright devaluation of the pound. First, such a devaluation would result in investment capital outflows. Second, such a devaluation would increase the debt burden, approximately 40% of which is denominated in dollars, in terms of local currency. Third, because more than half of Egypt's exports is dominated in dollars, a devaluation would have only a limited effect the competitiveness of the Egyptian goods. Fourth, the cost of imported inputs following a devaluation would drive up local production costs because Egypt is a net importer. Fifth, a devaluation may undermine investors' confidence in the fundamental strength of the Egyptian economy (EFG-Hermes website, MOE Monthly Economic Digest, March 2000).

D3. Repayment of Government Debts

On April 24, 2000, President Mubarak attended a Cabinet meeting to outline policies in response to domestic and foreign exchange liquidity. The meeting concluded that the government should start paying debts and arrears amounting to LE25 billion, at LE2.5 billion monthly. Officials have committed to settling the debts through non-inflationary sources, which is expected to ease the liquidity problem. The government arrears have been a major constraint to economic activities and are hindering stimulation of consumption and investment (*Al Ahram*, April 25, 2000).

Following the government's recent announcement of the repayment of LE25 billion of debts to the private sector. At the beginning of June 2000, it had repaid LE8.5 billion. The repayment of remaining amount will likely be financed through the collection of tax arrears, proceeds from the sale of stakes in Egypt Telecom and joint-venture banks, and funds from the FY2000/2001 budget. The government may also use long-term loans to finance part of the repayment according to some observers (HC Brokerage Newsletter, May 7, 2000, *Al Ahram*, July 2, 2000).

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David Shelby, Economic Analyst at EFG-Hermes.

Farid Ibrahim, Chairman of Farana Investment & Securities.

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Shanihaz Foda, Assistant General Manager, Treasury Department at the Egyptian American Bank.

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