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Introduction

In 2017, Egypt emerged as one of the world's most attractive destinations for portfolio investors after the interest on short-term Treasury bonds exceeded 22%, as the Central Bank of Egypt (CBE) raised interest rates to curb the rising inflation.

Egypt's high-interest debt instruments have brought in large numbers of foreign buyers, and the hard currency that the country badly needs. It is known that Egypt relies on imports and counts on dollar inflows to finance the current budget deficit in light of the absence of large direct foreign investment.

By December 2017, foreign holdings of Egyptian treasury instruments jumped to about $ 20 billion, compared to only a little more than $ 60 million in mid-2016. With the government's flotation of its local currency and agreement to a $ 12 billion loan program with the International Monetary Fund, many investors – who had exited after the 2011 events – returned back to Egypt, and contributed to raising the foreign exchange reserves of the Central Bank of Egypt to the highest level ever ($ 42.524 billion) at the end of February 2018, supported by the sale of international bonds worth $ 4 billion recently. These funds helped Egypt cover the budget deficit, and boosted its foreign exchange supplies – which the Egyptian administration promotes as paving the way for economic recovery, to justify the painful reforms to many Egyptians.

"More than $20 billion from overseas have surged into short-term Egyptian local-currency debt since authorities floated the pound and secured an International Monetary Fund loan in 2016. The money has helped Egypt finance its deficit and boosted supplies of hard currency, paving the way for an economic recovery that

Abdel-Fattah El-Sisi says will vindicate reforms painful for many Egyptians," says Bloomberg in a report.

With the reduction of austerity measures through the CBE and through issuance of several laws and procedures that have contributed to raising the inflation rate to 33% (However, it has recently started to decline), and the subsequent two consecutive cuts of interest rates, questions arise about the future of hot money in Egypt.

This paper attempts to clarify this through the following points:

Low yield and alternative opportunities

Inflation fell to the range of the CBE's target for the first time at the beginning of this year. Therefore, the CBE has begun to reverse the tight monetary policy that dominated the public scene in 2016 and 2017, by cutting the interest rates starting from last month – for the first time since the liberalization of the exchange rate – by 100 basis points. This was followed by a new reduction at the end of March 2018 in the same amount; and economists expect additional reductions of up to 400 basis points this year. With inflation falling to within the central bank's target range for the first time last month, "the regulator has started reversing the tight monetary policy it presided over in 2016 and 2017. Officials shaved 1 percentage point off the benchmark interest rate in February, and economists expect additional cuts of as much as 400 basis points this year," according to Bloomberg.

CBE data showed that the average yield on Egyptian treasury bills for six months and one year fell on Thursday (February 8) to continue a downward trend to pay returns to their lowest levels since the country freed its currency exchange rate in late 2016. The yield on 182-day Treasury bills fell to 17.358% from 17.611% in the previous auction, and the return on the 357-day credit to 16.435% from 16.679%.

These returns are the lowest since Egypt freed the pound exchange rate under reforms linked to a three-year, $ 12 billion IMF loan program. After floating the currency, Egypt raised key interest rates by 700 basis points to combat price increases. Interest rate increases initially pushed up treasury bills and encouraged foreign investors to buy Egyptian government debt. But Treasury bills have fallen gradually in recent weeks. Treasury yields for six months fell from 19.14% and year-end orders fell from 18.186% at an auction on Jan. 3. Economists said they expected the CBE to start lowering interest rates amid slowing inflation. Egypt's annual inflation rate in January fell to its lowest level since the currency floated.

Based on the above data, it has become clear for the first time that investment in the Egyptian Stock Exchange can be considered as an alternative opportunity for investment in treasury bills, especially in light of reports that the public sector corporations will be soon traded in the stock exchange. A review of the names of the first group (of these companies) shows the existence of Banque du Caire, the Reconstruction and Housing Bank, and Bank of Alexandria. Because the main activity of these banks is trading in domestic debt instruments, it makes sense that investors prefer to buy their shares for trading in debt instruments in addition to other expected profits.

Moreover, many other profit-making companies are expected to be traded, some of which may be extending towards the strategic dimension in addition to the economic dimension. Trading in the state's land remains a classic alternative opportunity, especially after successive announcements by the government about its intention to benefit from the unexploited state assets under, pressure from the worsening budget deficit and fear from inability to repay its domestic and foreign debts.

The Egyptian Prime Minister decided on February 5, 2017 to form a committee under his chairmanship to make a survey of all unused lands and warehouses owned by the ministries and governorates and their bodies and entities, as well as the companies of the public sector, and the public business sector. The decision of the prime minister asked for preparing a plan on how to exploit them, especially as logistical and administrative areas, in accordance with the established rules and regulations in this regard.

In the context of this internal competition, in addition to the intensification of competition with many emerging markets due to the reduction in interest rates, there have been different views on the foreigners' trend to buy domestic debt instruments, or even to retain their current balances, which can be reviewed through the following:

Expectations of financial analysis companies on the future of debt instruments in Egypt:

A) Expectations of CI Capital Asset Management

The CI Capital Asset Management sees a 3-percentage point plunge through 2018 to 11.8 percent, it said in a report. If yields in competing countries rise by 1 percentage point in the same period, as CI Capital estimates, investors could begin to exit Egyptian debt unless authorities take precautionary measures, it said. "Authorities need to ensure yields don't fall at the same pace as rate cuts," said CI Capital. Ways to do that could include lowering or removing the 20 percent tax levied on foreign T-bill investors, and continued efforts by the central bank to absorb liquidity and reduce local demand for the debt.

Egyptian officials have said a drop in yields won't necessarily mean a foreign exodus, as investors are likely to accept lower returns in exchange for an improving risk profile.

The CI Capital Asset Management added that Egypt may lose its position as a major destination for emerging-market debt investors, and that interest rate cuts may undermine the attractiveness of Egypt's short-term treasury instruments to foreign buyers in the coming months. The company demonstrated that while the total value foreign holdings in debt instruments ranged between $ 19.8 billion and $ 20 billion, yet the monthly increases are now starting to significantly decline.

The report said that the economic conditions in rival emerging markets are expected to be in favor of Nigeria, Argentina, Turkey and Ukraine against Egypt. “The Economic conditions in emerging market competitors Nigeria, Argentina, Turkey and Ukraine meanwhile are expected to push their respective treasury yields several percentage points above Egypt’s over the next year,” the CI Capital report said.

The report added that in order for Egypt to maintain the necessary foreign exchange inflows after interest rate cuts, it should exempt foreigners from the current 20 percent tax on Treasury instrument profits, as some of its competitors have already done, or that the CBE absorbs domestic liquidity to keep the proceeds of bonds and bonds at high levels.

The report also stressed that the Egyptian authorities need to ensure that the returns would not decline similar to the interest rates.

B) Expectations of Bloomberg:

Bloomberg says that other emerging markets may outperform Egypt, which has been the preferred destination for bond investors over the past 15 months due to the interest rate cuts for stimulating the economy. ““Egypt, prime territory for risk-hungry debt traders for the past 15 months, could be upstaged by other emerging markets as it begins to cut rates to spur the economy,” Bloomberg said in its report.

Bloomberg also noted that Turkey, Argentina and Nigeria are among the countries that will grab the interest of investors and their money if the yields of Egyptian treasury bonds fell sharply this year. “Turkey, Argentina and Nigeria are among the countries that stand to capture investors’ attention, and their money, if yields on Egypt’s

Treasury bills fall sharply this year, especially as the prospect of higher interest rates in the U.S. fuels a battle for funds," Bloomberg added.

It is noteworthy that Bloomberg has excluded Egypt from the list of the most attractive countries, among the emerging markets this year, along with four countries, for lack of data needed to assess the attractiveness of emerging markets. According to some economists, Egypt may be the only country in a group that includes Turkey, Argentina, Ukraine and Nigeria, whose currency is expected to rise by the end of 2018, Bloomberg said.

C- EFG-Hermes outlook:

EFG Hermes has ruled out any significant decline in foreign investors' appetite for Egyptian treasury bonds (T-bonds) if the Central Bank of Egypt (CBE) continues its policy of cutting interest rates.

EFG Hermes Managing Director and Head of Research Ahmed Shams El Din announced that the total sales of Egyptian treasury bills (T-bills) to foreigners are expected to reach about $19bn, similar to 2017, according to the state-run Middle East News Agency.

The government's foreign exchange needs that would be provided through treasury bills may range from $15bn to $20bn in 2018, much of which will be used to pay previous benefits, Shams El Din explained, adding that T-bill sales to foreigners would be sufficient to cover those foreign exchange needs. However, Shams El Din clarified that the excessive reliance on the deluge of foreign inflows into Egypt's high-yielding debt is undesirable and carries serious risks.

"If interest rates declined to 13-14%, yields will consequently be lowered on Egyptian treasury bills to levels close to those rates. However, this would not affect the attractiveness of Egyptian treasury bills to foreigners, as they are low-risk investments," he explained.

He pointed out that the average yield dropped to 170 basis points from about 320 after the liberalisation of the exchange rate, pointing out that when comparing the return on Egyptian debt instruments—even after the interest rate cuts—it remains one of the highest returns in emerging markets.

If debt instruments (bonds and treasury bills) are higher in some countries such as Argentina, Nigeria or elsewhere, this does not mean that foreign investors and global investment funds will put all their money in these countries, but they will distribute it based on risk, Shams El Din added.

The CBE cut rates at its last meeting on 16 February by 1%, while further decisions by its Monetary Policy Committee (MPC) on interest rates are anticipated during its next meeting on Thursday.

The MPC decided to lower the overnight deposit rate, the overnight lending rate, and the rate of the CBE's main operation by 100 basis points to 17.75%, 18.75%, and 18.25% respectively. The discount rate was also reduced by 100 basis points to 18.25%.

More expectations by eexperts:

- Anthony Simond, who helps manage $13 billion of emerging-market debt at London-based Aberdeen Asset Management Plc said, "If yields drop enough, then Egypt's market could be compared to Turkey, for example," whose greater liquidity and longer history of foreign investment might swing sentiment in its favor. "That's something to watch out for, but we're not there yet." Simond added that the pound's direction may ultimately prove crucial. "It's too early to say now what we may do in six to 12 months time," he said. "Especially since the Egyptian pound is a large part of the investment thesis."

- **Oliver Weeks,** an economist at London-based Emso Asset Management Limited, notes that the improvement in the economy's fundamentals provide room for the central bank to cut rates without seeing outflows. "But they need to be cautious … [yields after tax] will need to remain in double digits even with much lower inflation," he said. Inflows into Egyptian debt might also be buoyed by the potential gains to the EGP.

- **Charles Robertson,** the chief economist at emerging markets investment bank, Renaissance Capital, said, "Yes the attraction of Egyptian debt has reduced, but only from 'extremely' to 'very' attractive," adding "We think inflation still has to fall from 14-12% in the next few months, the currency is 15% undervalued relative it owns history and is the third cheapest in emerging markets. It remains our top pick," he said.

- **Eman Negm,** an economist at Prime Holding and analyst, said that yields on Treasury bills are expected to fall in the coming months, especially with an expected 1% cut in interest rates again in March, and likewise in May. She believes that Egypt will continue to attract foreign investments in these debt instruments because Egypt's conditions are better than the conditions of the competing countries. She further considered that Egypt is the second highest in country over the world in terms of attractiveness of returns on debt instruments currently after tax, and the fourth without tax deduction. She added that with the expected decline in the returns on the domestic debt instruments during the coming period, investment conditions in Egypt will remain better than those of other countries, like Argentina, Nigeria, Turkey and Ukraine.

As for Argentina and Nigeria, they have difficulties with the exit of foreign funds, especially that the latter is affected by the decline in oil prices. Ukraine suffers many problems and has large benefits due in 2019. Although Turkey is better than Egypt, it has a program to stop borrowing through bills and bonds during In the coming period, and therefore the situation tends to be in Egypt's favor.

- Radwa Al Suweifi, head of research at Pharos Holding, an investment bank, predicted that yields on Treasury bills and bonds will continue to decline throughout the year as interest rates fall, and that interest rate cuts will not affect foreign investments in treasury bills because the difference between returns on these instruments and their likes In the developed countries will remain significant, in addition to the improvement in the Egyptian economic indicators that will encourage foreigners to invest in Egypt. The rate of lending and cuts determined by the central bank in any country is the most important factor, but it is not the only one in determining the interest rate.

Conclusion

There are several variables that could affect the curve of the demand on currency (Egyptian pound), the most important of which are government expenditure and inflation rates; and that the increase in the average yield on treasury bills and bonds issued by the Egyptian government during March 2018 is largely due to the increase in government demand for cash to meet its financing needs for various reasons, the most important of which is the financing of increased government investment and debt servicing, as well as the competition between Egyptian government banks to exploit their liquidity to invest in government debt instruments that are characterized by safety and high return.

Based on the above, we can say:

1- The CBE's successive cuts of interest rates have nothing to do with the yield on government debt instruments . Consequently, interest rates on these instruments are likely to remain at high levels, which is a competitive advantage for Egyptian instruments at the expense of competing markets.

2- The Turkish program to stop borrowing through bills and bonds during the coming period makes the situation more favorable to Egypt, especially in light of the difficulties experienced by Argentina and Nigeria.

3- The exit of some Arab businessmen from Saudi Arabia after the recent measures, and from China after the reduction of investment incentives, as well as signs of a commercial war between China and the United States may enhance the investment inflow to Egypt to invest in these safe debt instruments.

4- The real competitiveness with these instruments will not come from abroad, but it will be through putting the public companies on the stock exchange by the government. This is supported by much evidence, inter alia, the privatization of Egypt's public companies, which was characterized by a severe waste of assets, especially that most of these companies own large real estate assets. Also, the security and strategic dimension of some of these companies may enhance the demand for them.

5- It is not a requirement that investing in the stock exchange is a complete alternative to investing in debt instruments. However, it will depend on the rate of substitution between them, which I think will not be great, especially that it is expected that putting public companies on the stock exchange will attract new capital to Egypt.

6- It is not expected that there will be a significant decline in foreign inflows on the domestic debt instruments, albeit at lower rates; however they will be very adequate for the needs of the government during the current year.