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Egypt: Interest Rate Cuts and Central Bank Losses

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The Central Bank of Egypt (CBE) surprisingly cut interest rates on Thursday 14 February 2019, citing a strong drop in inflation and an improvement in other macroeconomic indicators; and some expect similar or maybe many-fold cuts throughout the year.

The central bank has lowered the overnight deposit rate by 1 percentage point, from 16.75% to an annual rate of 15.75% and the overnight lending rate from 17.75 percent to 16.75, the first cuts since March 2018 the first reduction since March. The CBE said its decision, which was mainly based on the decline in inflation rates, targeted attracting more investments.

The decision to cut the interest rates came contrary to the expectations of most economists interviewed by Reuters and Bloomberg, especially with prospects for cuts in fuel subsidies in mid-2019, which means that inflation indices are likely to increase again, and the CBE will probably need to contain this again.

Supporters of this decision said it is expected that inflation rates will stand at a level of 12 to 14 percent as a maximum rate, and that more interest rate cuts will probably be made. They believe that lowering interest rates will positively affect the performance of Egypt's real economy, that is, the productive process in terms of creating and operating companies will benefit so much from lower interest rates. They predicted that different sectors of the Egyptian economy would benefit from lower interest rates, most notably the food companies listed on the Egyptian Stock Exchange which will witness an increase in their profits by 20%.

Proponents of the CBE decision to cut interest rates further noted that the decision was a first step in several likely interest rate reductions in light of the drop of inflation, which will be in favor of industrial companies that have investment plans.

However, critics of the CBE decision referred to a looming rise of inflation indices – which has already hiked in January – especially after the implementation of the remaining stages of the government's agreement with the International Monetary Fund (IMF), including lifting subsidies on hydrocarbons and electricity.

Effects of interest rate cut on some economic sectors

The lowering of interest rates will undoubtedly have a significant impact on different economic sectors, as follows:

1- Stock Market:

The interest rate cut comes amid devaluation of the Egyptian pound reaching LE17.546 against the US dollar, the highest level since March 2017. Analysts attributed this to revival of foreign investment in domestic debt following sharp sales in Egyptian treasury bills and bonds last year.

They also pointed out that the shares traded in Cairo, ranging from real estate to consumer-focused companies, industries and banks, are expected to outperform their domestic and emerging counterparts in market with the recent interest rate cut. Investors are also likely to motivate the stock market to replace returns on high-yielding deposits. Companies will also benefit from obtaining cheaper credit in Egypt.

After the CBE decision, EGX increased by 1.7% after the central bank cut 100 basis points in the main interest rate on 15 February, the first cut since the government floated the local currency in November 2016 (Egypt allowed in November 2016 full floating of the Egyptian local currency to limit shortage of foreign currency). Since then, the stock index has risen more than 70%.

As for the consumer stock sector, while lowering the interest rate may not be enough to help producers resume expansion plans that are hampered by the high borrowing costs, the central bank's cut-off cycle would inject optimism into a sector strongly hit by the devaluation of the Egyptian pound.

Although reducing the interest rate by 1% is not a major change, however, amid interest rate cuts that have already started, which is likely to reduce the borrowing costs and help boost performance, and increase liquidity and purchasing power, which will lead to bringing about a market rebound.

2- Banks:

According to experts, Egyptian lenders are likely to maintain high levels of profits due to the expected increase in fees and commissions resulting from the increased lending and the progressive narrowing of interest margins, a sign of change in Egypt's monetary policy, which is a positive step to banks, which will increase lending in capital expenditures in the first quarter of 2019, with continued low interest rates and more stable exchange rates.

3- Real Estate:

The low interest rate means low borrowing costs for developers and this has a direct impact on profitability; and it is also likely to reduce the return on deposits which makes them less attractive, so the money will turn to what has proven to be the Egyptians' favorite investment, i.e. the real estate sector.

Investment in the real estate sector will be the primary refuge for those interested in maintaining the value of their money after the low return on savings

4- Industrial Sector:

Because of presence of a high percentage of debtor companies, lowering the interest rate will enable them to refinance at lower levels; and companies operating in heavy industries that have strong capital expenditure plans would see this as an incentive to start developing growth plans and expand their work.

Main beneficiaries of the CBE decision

1- Government to gain most benefits

Bank employees assert that lowering interest rates will lower the cost of government borrowing and the local debt, which goes in line with the government trends that seek to control the worsening of domestic borrowing rates.

Lowering the interest rate on deposit and lending will decrease the return on treasury bills and government bonds, reducing the budget deficit, especially as the government is currently the largest borrower from banks.

The Egyptian Ministry of Finance had raised its forecast for the budget deficit to 9.4% in the fiscal year 2017-2018 due to the rise in world oil prices and local interest rates, against 9% previously.

Regarding the impact of interest rate reduction on investors' turnout on the purchase of Egyptian treasury bills and government bonds, experts confirmed that interest rates are important for the foreign investor, but the inflation threats are more important, as the decline in inflation means a lower risk of devaluation of the local currency in the future.

For the local investor, the rates of return are still high and competitive, so the current rates of the purchase of local debt instruments are expected to continue.

2- Stock Exchange

The Stock Exchange is the second largest beneficiary of interest rate reduction, as the Egyptian stock exchange is expected to continue its upward performance, after the central bank had reduced interest rates, amid prospects for new reductions in the future, where reduction of interest rates is likely to increase small investors' desire to invest in the money market.

who had expanded during the past period in the purchase of high-interest saving certificates provided by banks after floating the Egyptian pound with an interest rate of 20%.

3- Investment

It is assumed that lowering interest rates result in lower costs to investors for starting new projects in the light of reducing the return on bank finance needed for building or expanding the project, and thus lead to injection of more investments.

It should be noted that the effects of interest rate reduction will not appear quickly, but it could be a positive sign that the situation in Egypt is returning to normal after reviewing many decisions that have been taken since the Egyptian pound floating in November 2016.

The CBE reduction of the interest rate will also help banks to provide better interest rates on loans, which will boost production and industrialization, bearing in mind that the decision to cut interest rates is "a good step but not sufficient", as industries continue to suffer from higher interest rates on loans.

4- Increased Investment in gold

The interest rate cut is expected to affect the gold market, after cancellation of the 20% saving certificates, where people resort to gold as a store for maintaining the value of their money against potential inflation.

International Monetary Fund forecasts on Egyptian economy

The International Monetary Fund (IMF) warned of potential risks, including a premature easing of monetary policy and deterioration of the security situation, and warned Egypt against cutting interest rates prematurely.

The IMF predicted that the inflation rate in Egypt will be reduced to 12% by June compared to 35% in July 2017, and that inflation is expected to continue to fall below 10% in 2019.

The IMF predicted that the oil prices would be raised by December, and the fuel subsidies would be completely cut by the end of June 2019, thus reducing the budget provided for energy subsidies in the next fiscal year by 52.2% to 65.6 billion pounds against 138.2 billion pounds in the current fiscal year. According to the IMF, the government plans to lift subsidies on energy products, except for the liquefied natural gas, with the end of the IMF economic reform program in 2019.

Based on the IMF expectations, the inflation rate will undoubtedly rise, which led the Fund to warn of the CBE reduction of interest rates. This goes in line with concerns of experts that predicted a new wave of rising prices and a new increase in inflation rates in next July in coincidence with expected economic decisions aimed at lifting subsidies of energy. Therefore, experts believe that postponement of this reduction and stabilization of interest rates is much more important than attracting foreign investors.

Central bank losses

Despite controversy over the impact of interest rate cuts, the Central Bank of Egypt's losses announced this week has strongly drawn attention to the CBE decisions and the consequences that were behind these losses. The CBE's financial statements revealed that the bank suffered losses of EGP 33bn in FY 2017/18 – related to the 20% saving certificates – versus profits of EGP 12.6bn in FY 2016/17. The CBE attributed its losses to recording a net yield of EGP 10.4bn after deducting interest payments of EGP 129.2bn, while the bank's revenues reached EGP 118.8bn, including EGP 11.6bn of loans and balances at the banks, in addition to EGP 107.6bn of treasury bonds and bills. The CBE expanded in raising Deposit Operation in the last fiscal year to absorb the excess liquidity in banks due to their high interest prices amid the growing inflation rates and the bank's initiatives to support low-income housing and SMEs. According to the CBE, the value of interests on Deposit Operation amounted to EGP 114.4bn at the end of June 2018 compared to EGP 49.6bn at the end of June 2017. At the same time, the CBE's financial statements revealed that it paid EGP 30.8bn in taxes on yields of its investments in government bonds.

The CBE also borrowed from local and regional banks as it decided to increase its capital by EGP 7.6bn to reach EGP 21.6bn at the end of June 2018 compared to EGP 14bn at the end of June 2017. This is the largest increase in capital by the CBE. It was applied in coordination with the Ministry of Finance as the state treasury contributed with about EGP 6bn to this hike.

Experts believe that the losses made by the central bank, estimated at 33 billion pounds in FY 2017/18 is an unprecedented economic catastrophe. Also, it appears that the reports on lowering interest rates was an introduction to announcing the losses of the central bank and commercial banks in an effort to duck responsibility.