MOODY'S

Rating Action: Moody's changes outlook on Egypt to negative, affirms Caa1 ratings

18 Jan 2024

New York, January 18, 2024 -- Moody's Investors Service (Moody's) has today changed the outlook on Government of Egypt to negative from stable and affirmed the Caa1 long-term foreign and local currency issuer ratings. Moody's has concurrently affirmed Egypt's foreign-currency senior unsecured ratings at Caa1, and its foreign-currency senior unsecured MTN program rating at (P)Caa1. In addition, Moody's has affirmed the backed senior unsecured ratings of the Egyptian Financial Corporation for Sovereign Taskeek sukuk company at Caa1 and its program rating at (P)Caa1 which are, in Moody's view, ultimately the obligation of the Government of Egypt.

The change in outlook to negative reflects increasing risks that Egypt's credit profile will continue to weaken amid difficult macroeconomic and exchange rate rebalancing, despite continued fiscal consolidation efforts and official sector support. Since the rating agency's last rating action in October 2023, a significant increase in interest payments (projected to consume two thirds of revenue at the end of fiscal 2024) and mounting external pressure (with the gap between the official and parallel market exchange rates widening further) have complicated the macroeconomic adjustment process. Even with an anticipated increase in financial support from the IMF and the government's continued commitment to primary surpluses, the negative outlook reflects the risk that policy actions and external support may prove insufficient to prevent a debt restructuring given Egypt's very weak debt metrics and elevated exposure to foreign exchange and interest rates risks, even though a restructuring in the near term is not Moody's current baseline expectation.

The affirmation of the Caa1 rating captures the government's track record of fiscal reform implementation capacity that Moody's expects will unlock an enhanced financial support package from the IMF and other official lenders, and the potential for it to mitigate higher debt affordability and balance of payment risks. A large domestic funding base helps mitigate domestic refinancing risks, despite large local currency rollover needs.

The local-currency ceiling is unchanged at B1, and the foreign-currency ceiling at B3. The three notch gap between the local-currency ceiling and the sovereign rating reflects a large and diversified economy with a large public sector footprint that generates significant financing requirement that inhibits private sector development and credit allocation, notwithstanding recent reforms to level the playing field with public sector entities. The two-notch gap between the foreign currency and local currency ceiling reflects transfer and convertibility risks given persistent foreign exchange shortages and weakening policy effectiveness.

Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL484708 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

RATIONALE FOR THE CHANGE IN OUTLOOK TO NEGATIVE

WEAKENING KEY METRICS FLAG INCREASED RISKS OF SHARPER ADVERSE EFFECTS OF RENEWED MACRO REBALANCING

The further deterioration in government debt affordability and rising external pressure have complicated Egypt's macroeconomic adjustment, increasing risks that Egypt's credit profile will continue to weaken. Moody's anticipates that the authorities will remain committed to fiscal consolidation and that continued support from multilateral and bilateral partners will be forthcoming. Nonetheless, these recent developments raise the adjustment costs from macroeconomic and exchange rate rebalancing on Egypt's credit profile, increasing downside risks. While a debt restructuring in the near term is not Moody's current baseline expectation, the risks have increased in Moody's view, despite an anticipated increase in financial support from the IMF and the government's continued primary surpluses, given Egypt's very weak debt metrics and elevated exposure to foreign exchange and interest rates risks.

Since the rating agency's last rating action in October 2023, the parallel market rate has further weakened reflecting persistent FX shortages that intensify convertibility risks. From a parallel rate at EGP40/$1 at the time of the downgrade to Caa1, the currency has further depreciated to EGP59/$1 compared to the official rate at EGP30.9/$1. This points to the potential for even sharper macro rebalancing requirements than projected in Moody's central scenario. Persistent FX shortages coincide with peak external debt service payments in fiscal 2024 and fiscal 2025, indicating potentially larger external refinancing risks in case of a sharper devaluation than estimated in Moody's baseline scenario at the Caa1 rating level, and higher future credit risk in the absence of increased FX generation capacity.

Monthly FX liquidity indicators show that, depite the $4 billion in asset sales achieved since July 2023, liquid FX reserves (gross reserves minus gold) have remained stable at just below $27 billion at the end of December while the monetary system's net foreign liability position (comprising that of both the central bank and commercial banks) has not improved as expected, pointing to the existence of an FX backlog. Moreover, the recent intensification of regional hostilities in the wake of the 7 October attacks on Israel add to Egypt's balance of payment risks by impacting the economy's key FX generating sectors, including the travel industry and Suez Canal revenues that have hitherto largely compensated for the continued slump in current transfers and remittances from abroad as a result of incentive distortions created by the existence of the parallel currency market.

On the fiscal side, budget execution data for July to December 2023, i.e. the first half of fiscal 2024 (ending in June 2024), shows a much sharper-than-expected deterioration in debt affordability as measured by interest/revenue, increasing fiscal accounts' shock exposure and lifting the share of revenue dedicated to interest payments to levels which in the past have proven unsustainable for many sovereigns. The government's full-year projection for interest/revenue in fiscal 2024 has increased to almost 65%, from 52% in the original budget, and to about 10% of GDP from 7.7% recorded in fiscal 2023. Although the government has a track record of managing high interest payments, these levels far exceed previous instances and increase fiscal accounts' sensitivity to future shocks in the context of the government's macroeconomic rebalancing under the IMF program. In Moody's view, they also point to complex policy decisions about prioritizing interest payments at the expense of essential social spending, notwithstanding the large domestic funding base that mitigates debt rollover risks.

RATIONALE FOR THE Caa1 RATING AFFIRMATION

The affirmation of the Caa1 rating captures the government's track record of fiscal reform implementation capacity that Moody's expects will help unlock an enhanced financial support package from the IMF and other official lenders to backstop the implementation of the previously stalled $3 billion 46-month External Fund Facility (EFF) program approved in December 2022, of which only $347 million was disbursed. Moody's expects the completion of the first and second reviews in coming weeks to be accompanied by renewed adjustment in the official exchange rate and by tighter fiscal and monetary policies, with the ultimate objective to remove the macroeconomic distortions created by the parallel currency market.

Benefiting from the 50% proportional quota increase approved by the IMF in November 2023 that broadens the government of Egypt's borrowing space from the IMF, Moody's assigns a high likelihood to a program enhancement to up to $10 billion from the previously approved $3 billion EFF. This amount broadly covers Moody's estimated external funding gap in fiscal 2024 and 2025, assuming a current account deficit of about 2% of GDP in both years, helping to mitigate higher debt affordability and balance of payment risks.

On the domestic side, in contrast to lower-rated sovereigns with similarly weak debt affordability trends, Egypt's credit profile benefits from a large and dedicated domestic banking sector with assets at almost 130% of GDP to meet the government's large financing needs at over 30% of GDP annually generated by large T-bill rollover needs as a result of the shift to short maturities in a high interest rate environment. However, the shift to primarily short-term funding limits the government's funding base and makes it highly susceptible to shifts in market conditions as a result of the projected macroeconomic rebalancing.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Egypt's ESG Credit Impact Score of CIS-4 reflects 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 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 th 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 (S-5 issuer profile score) has increased in the wake of the economic fallout from the Russian invasion of Ukraine, resulting in sharp price increases and an erosion in households' purchasing power. Low employment rates 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. As part of the government's reform effort, social risks are being mitigated by a more targeted social safety net and social protection measures, although the breadth of coverage remains relatively narrow.

Egypt's governance profile score of G-4 reflects 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.

GDP per capita (PPP basis, US$): 16,174 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 6.7% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 13% (2022)

Gen. Gov. Financial Balance/GDP: -6.1% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -3.5% (2022) (also known as External Balance)

External debt/GDP: 32.8% (2022)

Economic resiliency: ba1

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

On 15 January 2024, 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 has not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's susceptibility to event risks has not materially changed.

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

FACTORS THAT COULD LEAD TO AN UPGRADE

Confidence in the ability of the government to generate necessary foreign exchange inflows, e.g. with the privatization program or enhanced external financial support, to meet increasing external debt service payments and bolster the economy's foreign exchange liquidity would likely prompt a change in the outlook to stable. A marked and durable improvement in debt affordability, including via higher revenue generation, would engender confidence in Egypt's ability to navigate continued FX pressure and the difficult decisions on prioritization of government spending, paving the way for a return for the outlook to stable. In addition, signs of a rebalancing in banks' net foreign asset position would also help return the balance of risks to stable.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Persistently weak debt affordability that undermines confidence in the government's capacity to service its local currency debt stock would likely lead to a downgrade, as would an inability to reduce foreign exchange shortages via improved FX generation capacity or an inability to strengthen FX buffers to meet external debt service payments on a sustainable basis. Reduced confidence in the government's ability to reduce the very high interest bill without a debt restructuring would also lead to a downgrade.

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

The List of Affected Credit Ratings announced here are a mix of solicited and unsolicited credit ratings. For additional information, please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website https://ratings.moodys.com. Additionally, the List of Affected Credit Ratings includes additional disclosures that vary with regard to some of the ratings. Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL484708 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and provides, for each of the credit ratings covered, Moody's disclosures on the following items:

• EU Endorsement Status

• UK Endorsement Status

• Rating Solicitation

• Issuer Participation

• Participation: Access to Management

• Participation: Access to Internal Documents

• Lead Analyst

• Releasing Office

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology

Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

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