Rating Action: Moody's changes outlook on Egypt's rating to positive, affirms B3 rating

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New York, August 28, 2018 -- Moody's Investors Service ("Moody's") has changed the outlook on the Government of Egypt's long-term issuer ratings to positive from stable and has affirmed the B3 issuer ratings.

At the same time, Moody's has affirmed Egypt's senior unsecured ratings at B3, and its senior unsecured MTN program rating at (P)B3.

Moody's decision to change the outlook to positive reflects the continuing structural improvements in the fiscal and current account balances, resulting from the ongoing implementation of the home-grown IMF-backed reform program. Moreover, early signs of business environment reforms offer the prospect of a sustainable, inclusive growth path capable of improving competitiveness and absorbing the country's rapidly expanding labor force.

The decision to affirm the B3 rating balances Egypt's longstanding strengths -- flowing in particular from its large and diverse economy -- against the low-probability risk of sudden political upheaval that could have implications for the direction of policy, and very pronounced fiscal weakness, reflected in a high debt burden, low debt affordability and very large annual financing needs. In turn, such fiscal weakness creates high refinancing exposure in an increasingly turbulent global financial environment, notwithstanding a deep and stable domestic funding base in its large banking sector.

The foreign and local-currency bond and deposit ceilings remain unchanged. Specifically, the foreign-currency bond ceiling remains at B2, the foreign-currency deposit ceiling at Caa1, and the local-currency bond and deposit ceiling at Ba2. The short-term country ceilings for foreign-currency bonds and deposits remain unchanged at NP (Not Prime).

RATINGS RATIONALE

Egypt's credit profile presents a stark contrast between, on the one hand, an economy which is large and diverse in comparison to rating peers; and, on the other hand, high refinancing risk created by a high debt burden, and a very high interest burden, resulting in very large annual financing needs (although a substantial share will continue to be met by the domestic banking system).

Those latter features have dominated Moody's assessment of Egypt's credit profile in recent years. The country's refinancing risk remains a key credit challenge for the sovereign in an increasingly turbulent global financial environment created by, among other things, the prospect of rising interest rates and shocks to global trade.

However, the substantial progress made by the government in implementing reforms agreed with the IMF has imparted a degree of financial stability not present earlier in the decade. Primary deficits have shrunk and the debt burden has begun to fall. Foreign exchange buffers have been rebuilt. The government is in the midst of an ambitious structural economic reform program. And a degree of political stability has been achieved and seems likely to be sustained, increasing the likelihood that the general policy direction will be maintained.

If sustained, the authorities' commitment to reform has the potential to impart to the credit profile a degree of resilience to economic and financing shocks, which could support a higher rating notwithstanding what are likely to remain high annual refinancing requirements.

RATIONALE FOR THE POSITIVE OUTLOOK

SUSTAINED FISCAL REFORM IMPLEMENTATION SUPPORTS A LASTING SHIFT TO PRIMARY FISCAL SURPLUSES AND OFFERS THE PROSPECT OF LOWER REFINANCING RISK

The government of Egypt's continued implementation of fiscal reforms offers the prospect of a return to sustained primary surpluses starting from the fiscal year ending June 2019 (FY 2018/19) after almost 20 years of persistent deficits. The nature of the reforms is such that government expenditure should become more efficient and predictable through economic and commodity price cycles. A resulting sustained and rapid downward trend in the debt burden would diminish Egypt's elevated refinancing risks.

In addition to the implementation of the value added tax in 2016 and the increase in the tax rate to 14% from 13% in July 2017, the enactment of the civil service law will continue to contribute to containing the public sector wage bill.

Moreover, the government's fiscal consolidation strategy is supported by a comprehensive energy subsidy reform agreed under the IMF program. Moody's expects that the energy subsidy bill will fall to below 1% of GDP by fiscal 2020 from 4.1% of GDP in fiscal 2017. These savings will be partly offset by increased cash transfers to lower-income and more vulnerable households, which should help maintain public support for reforms and result in better controlled and more effective government spending.

In the fuel segment, the government reached cost recoveries in the range of 70-80% as of July 2018 from about 30% in 2013, after several rounds of price hikes. The achievement of full cost recovery by the end of fiscal 2019 and the adoption of an automatic fuel price adjustment mechanism as currently planned by the government will, if implemented, further shield the budget execution from future oil price volatility.

Overall, with fiscal reforms combined with high nominal GDP growth, Moody's projects that debt burden, while remaining elevated, will decline to around 82% of GDP by the turn of the decade, from around 86% in FY 2018/19 and a peak of 103.5% of GDP in fiscal 2017.

STRUCTURAL REFORMS POINT TO LOWER EXTERNAL VULNERABILITIES

Continued success in implementing planned economic and monetary reforms should lower Egypt's vulnerability to a shift in external economic and financing conditions. Egypt's foreign exchange reserve buffer improved to 6.5 months of import cover as of March 2018. A shift in the sources of financing of Egypt's external payment needs towards foreign direct investment, rather than external debt, would further bolster the external position.

Following the flotation of the Egyptian pound in November 2016, the currency depreciated by 50% against the US dollar in nominal terms and by over 30% in real effective terms. While inflation increased substantially as a result, price competitiveness has materially improved. The central bank's conduct of monetary policy is enhancing policy credibility and anchoring inflation expectations, as shown in the subsequent decline in inflation. As a result, Moody's expects Egypt to maintain significant price competitiveness gains, in turn reducing the risk of material external imbalances building up, while the flexible exchange rate acts as shock absorption mechanism against external shocks.

Combined with renewed natural gas exports from the Zohr field starting in 2019, Moody's expects that the current account balance will hover around 2.5%-3.0% of GDP in the next few years, compared with 6% or more in the last two. The almost complete repayment of arrears to International Oil Companies (IOCs) and new investment commitments of almost $10 billion annually over the next four years in the energy sector increase the prospect of new discoveries and contribute to fostering Egypt's role as a regional energy hub, which would further strengthen Egypt's external position.

REFORMS ALSO POINT TO HIGHER, SUSTAINABLE GROWTH

The continued implementation of economic and fiscal reforms should sustain GDP growth at higher rates, converging toward 6%. This level would help absorb the country's rapidly expanding labor force, notwithstanding significant remaining structural labor market rigidities.

Measures such as the implementation of the investment and bankruptcy laws and an improved land allocation mechanism have contributed to improving Egypt's competitiveness in the World Economic Forum's ranking over the past year and should foster investment, including foreign direct investment, in non-energy sectors, such as tourism, agro-processing and manufacturing. The implementation of large infrastructure projects, such as the New Administrative Capital City led by state-owned Economic Authorities, will also contribute to fostering growth and employment in the construction sector.

RATIONALE FOR THE B3 RATING AFFIRMATION

Moody's decision to affirm the B3 ratings at this juncture balances Egypt's credit strengths including its large and diversified economy, and robust and rising growth potential that provide a high degree of resilience to economic shocks, against persistently weak fiscal indicators in comparison with peers, in particular debt affordability. Moody's expects interest payments on debt to continue to absorb 30%-40% of revenue over the next few years, albeit to a declining degree, which significantly constrains fiscal flexibility. According to Moody's, very weak debt affordability will maintain the government's annual gross financing needs at very high levels, of about 30%-40% of GDP.

Weak debt affordability in turn constrains the prospects of significantly lengthening the average maturity of the domestic debt stock, that is currently very short at about two years. The combination of a high debt stock, low debt affordability and short average maturity points to heightened sensitivity of Egypt's fiscal strength to a potential shock to borrowing costs.

However, Moody's believes that the adjustment in the real exchange rate achieved in late 2016 and the re-establishment of the foreign exchange reserve buffer in excess of upcoming external maturities have improved Egypt's resiliency to a possible increase in external financing costs, including via a depreciation of the exchange rate linked to capital outflows.

On the domestic financing side, Egypt benefits from a deep and stable domestic funding base in its large banking sector, with an established track record of financing support to the government, including in times of stress.

The B3 ratings also capture the risk of sudden political upheaval that would have credit negative implications for the direction of policy. That said, Moody's believes that a combination of factors, including the measures taken by the government to distribute the proceeds of strong growth more effectively and provide jobs to a large and fast-rising number of new entrants in the labor force, have lowered the risk of reform reversal over the next few years.

WHAT COULD CHANGE THE RATING UP

An upgrade would most likely be driven by Moody's heightened confidence in two areas. First, that the government's commitment to fiscal prudence and to structural economic reform will be sustained through fluctuations in the economic environment. Second, that the country's susceptibility to external financing shocks will remain manageable, including through the maintenance of adequate external buffers.

To that end, over the remainder of this year and at least into the first part of 2019, Moody's will monitor the government's progress in achieving planned fiscal, monetary and economic reforms; its success in sustaining external investor confidence as reflected in trends in foreign reserves and foreign direct investment; and the social acceptance of the government's reform program and the absence of pressures that could eventually halt or reverse economic and fiscal reforms.

WHAT COULD MOVE THE RATING DOWN

The positive outlook signals that a downgrade is currently very unlikely. However, a stalling or reversal in reform commitment, with negative repercussions on the pace of fiscal consolidation and debt reduction would likely prompt a change in the rating outlook to stable. The emergence of more severe external or domestic liquidity pressures that result in significantly higher borrowing costs and in a further reduction in debt affordability would likely also put downward pressure on the rating, as would renewed and lasting social and political instability or a material deterioration in the security situation.

GDP per capita (PPP basis, US$): 12,777 (2016/17 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.2% (2016/17 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Jun/Jun): 29.8% (2017 Actual)

Gen. Gov. Financial Balance/GDP: -10.4% (2016/17 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -6.3% (2016/17 Actual) (also known as External Balance)

External debt/GDP: 32.4% (2016/17 Actual)

Level of economic development: Moderate level of economic resilience

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

On 23 August 2018, a rating committee was called to discuss the rating of the Government of Egypt. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's institutional strength/framework have not materially changed. The issuer's governance and/or management have increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The systemic risk in which the issuer operates has materially decreased. The issuer has become less susceptible to event risks.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.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.

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