7 August 2012 | 13 pages



# Egypt Macro View

## Can The Banking Sector Finance The Sovereign?

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- As Egypt goes through a complicated political transition which has increased economic uncertainty, the government is facing sustained difficulties in attracting foreign financing of any kind. Starved of foreign capital, the capacity of the local investor base, i.e. the domestic banking sector, to lend to the government has become an ever more crucial element of the sustainability of government finances.
- We undertake an analysis of banking sector capacity to lend to the government over the coming five years. We find that, based on our assumptions, the banking sector's ability to continue to hold government debt is likely to come under huge pressure by 2014, implying that Egypt's current fiscal stance is unsustainable from a domestic financing perspective.
- We hasten to add that this does not mean that we think that sovereign default is inevitable in this time-frame. To begin with, we believe that there are conditions under which foreign capital inflows could resume in the medium term, and alleviate some of the financing pressures on the government. Failing this, we believe the government is increasingly likely to crowd out private sector lending in the banking system, and fund itself directly through the central bank, both of which would allow it to avert default.
- The analysis therefore highlights to key factors in Egypt's debt sustainability: the importance of resuming foreign capital inflows, and the likelihood of government funding policies that could have negative implications for the economic outlook.
- We also caution that things could yet get worse. Our base case scenario assumes that the Egyptian banking sector continues to grow at 6% over the next five years, creating capacity to buy more government debt. It also assumes a steady decline in the deficit to around 5.3% by 2016. Any significant deviation from either of these assumptions would result in a considerable deterioration in the financing outlook for the sovereign.

# Can the banking sector finance the sovereign?

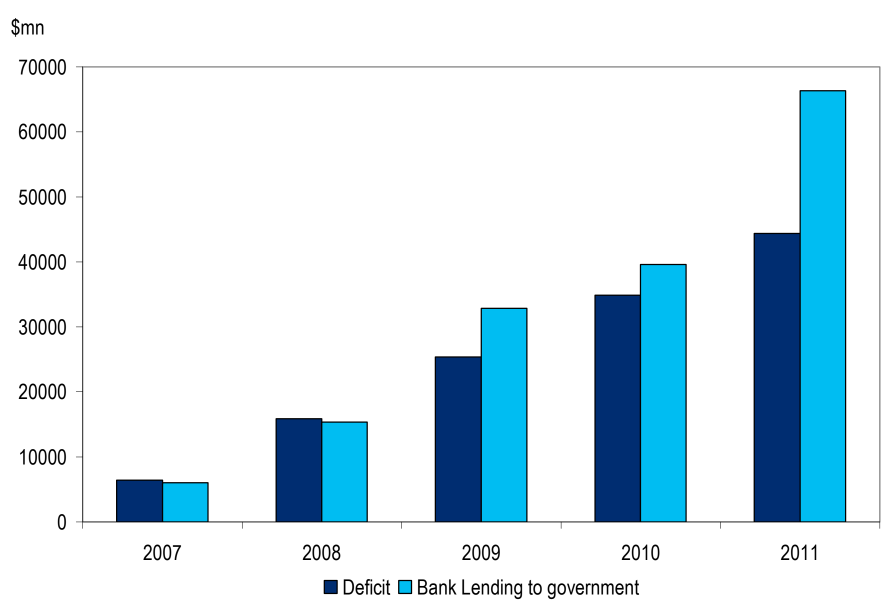
As Egypt goes through a messy political transition and associated economic uncertainty, the sovereign is facing sustained difficulties in attracting foreign financing of any kind. An IMF deal seems some way off, and we wouldn't expect significant official capital inflows in the absence of such an IMF-endorsed economic programme. Despite financial commitments from regional governments, particularly those of the GCC, actual transfers have remained fairly modest. Private investors, who exited local debt markets in 2011, appear unwilling to re-enter so long as the political situation has not stabilized, and the threat of a currency devaluation looms large.

Starved of foreign capital, therefore, the capacity of the local investor base to lend to the government has become an ever more crucial element of the sustainability of government finances. In a country where local institutional investors in debt markets are still relatively small players, this translates roughly into the ability of the domestic banking system to absorb sufficient amounts of sovereign debt to finance the government.

## Trends in bank financing of the sovereign

The banking sector is already a crucial source of finance for a government unable to reduce its deficit in recent years. Figure 1 shows the cumulative financing requirement of the Egyptian government between 2007 and 2011, and the amount of new government lending extended by the banking sector over the same period. Up to 2010, the two numbers tracked each other pretty closely, implying that the government's financing needs were fully covered by net lending from the banking sector during that period. During 2011, however, net lending by the banking sector far exceeded the government's financing requirement, reflecting the withdrawal of foreign investors from the Egyptian T-bill market from early 2011 and the fact that all the subsequent issuance was taken up by the local commercial banks.

**Figure 1. The government already relies on the banks to finance its deficit**

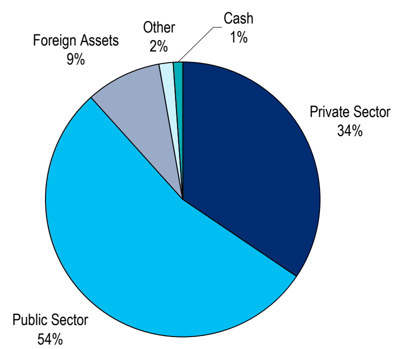



Source: Haver Analytics, Citi Research

Figures 2 now shows the extent to which Egyptian banks finance the government from a balance sheet perspective, while Figure 3 shows the change in this role over recent years. Claims on government represent 54% of total assets. Interestingly, the share of government lending in total credit has risen in recent years, increasing by 15%, to 65% of total credit, over the past four years.

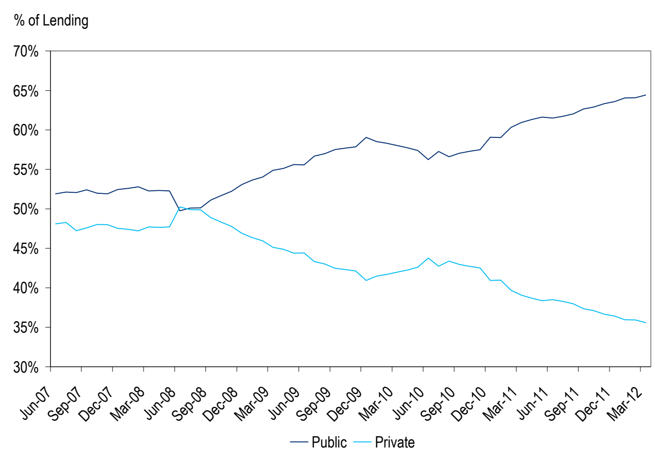
In short, banks have been a crucial source of government financing for some time, and the extent to which this is true had been rising long before the onset of political unrest last year. Given current political and economic uncertainties, we expect that the dependence on the domestic banking sector is likely to continue to increase in the foreseeable future. But arguably the more pertinent question is: how much can the government lean on its banking system to continue this, or how much capacity do the banks have left to lend to their sovereign?

**Figure 2. Egypt: Bank Balance Sheet Structure**




Source: Haver Analytics, Citi Research

**Figure 3. Egypt: Evolution of Public v Private Sector Lending**




Source: Haver Analytics, Citi Research

## What we mean by bank lending capacity

As Figure 2 shows, domestic lending (public and private) accounts for almost 90% of total Egyptian bank assets. The remaining assets are mainly foreign holdings, plus some fixed assets and a modest amount of cash in vaults held for liquidity purposes.

Holding the size of the balance sheets constant, the capacity of banks to increase their lending to the sovereign would come from drawing down foreign assets, and/or from shifting lending away from the private sector and towards the public sector. So should we consider that bank capacity to lend to increase lending to the sovereign should be equal to the stock of foreign assets plus the stock of private sector lending? We think not.

On foreign assets, some portion of foreign liquidity is necessary for the management of bank operations, particularly the banking system's management of FX risk. Drawing down the entire stock to finance the sovereign would thus result in a weakening of bank risk parameters and negatively impact financial stability.

On the extent to which banks can switch out of private sector lending to increase lending to the government, such ‘crowding out’ would not only typically be detrimental to banking sector asset quality (as calling in loans is likely to raise the level of non-performing loans), but would also choke off private sector development and investment, harming GDP growth and ultimately sovereign revenues.

For these reasons, we qualify what we mean by bank capacity in our analysis to that amount which banks can lend to the government without crowding out private sector lending or otherwise harming their own operations. In a static analysis, therefore, we consider that only some portion of foreign assets represent additional capacity to lend to the sovereign.

Over time, however, deposits flow into the banking system and expand bank balance sheets. The new sources of funds provide new lending capacity. But the extent of this capacity will depend on a number of variables, including the rate of growth of deposits/assets, the allocation of new funds between private and government lending, etc.

## A measure of bank lending capacity

In line with the above, we have estimated the capacity of the banking sector to lend to the government on a sustainable basis over the next five years based on the following assumptions:

- Asset/credit growth: We assume that over the coming five years, bank balance sheets expand at the same rate that they have done in the past year.
- Lending to private sector: to maintain our condition that crowding out is to be avoided, we assume that lending to the private sector also grows over the next five years at the rate it has done in the past year. This rate may be lower or higher than that for total asset growth.
- Foreign assets: we assume foreign assets grow in proportion to total assets, and that a proportion of these can be accessed by banks to provide financing to the sovereign without harming banks’ risk management. We assume this proportion to be 80% of foreign assets.
- Other assets: We assume these grow in proportion to total assets and cannot be accessed for lending purposes.

**Figure 4. Assumptions used in our analysis of bank sector capacity**

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| Government Deficit, % of GDP | -9.3% | -7.7% | -7.1% | -5.8% | -5.3% |
| Asset/credit Growth, %YoY | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Private Credit Growth, %YoY | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |

Source: Citi Research

With these assumptions in mind, over a five-year period, our measure of the capacity of a banking sector to lend to the government can be described by the following equation:

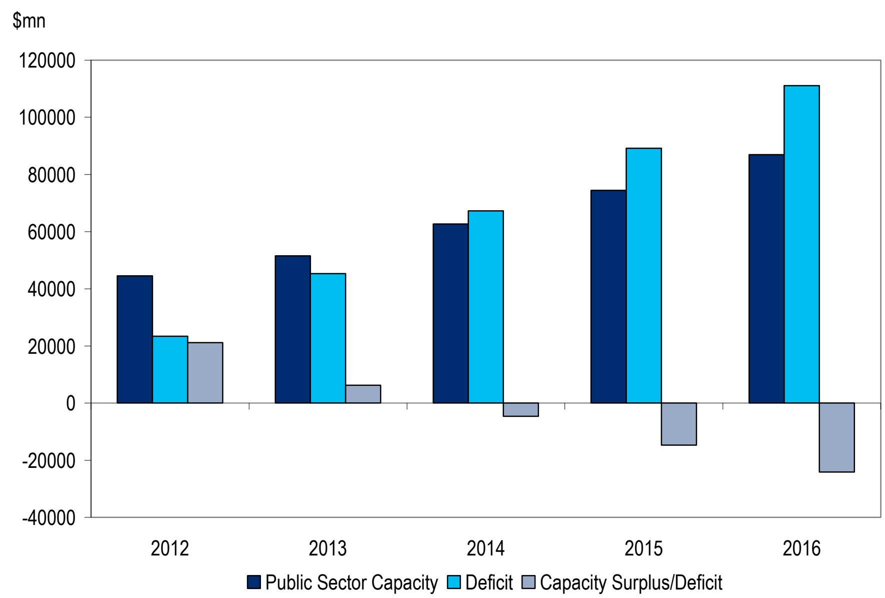
*$\Delta$ Lending Capacity = $\Delta$ Total credit - $\Delta$ Private Sector Credit + 80% Foreign Assets*

## Is there capacity to finance the sovereign?

The next step in our analysis is to compare our measure of lending capacity to our expectation of sovereign financing needs over the coming five-year period. If bank lending capacity is greater than the projected deficit, we consider the public finances sustainable over this period. Figure 4 shows our fiscal deficit projections for the period 2012-2016, expressed as a percentage of GDP.

In Figure 5, we show our projections for bank lending capacity and for the fiscal deficit (both on a cumulative basis). It is immediately clear that government financing requirements are accumulating at a rate far in excess of bank lending capacity growth. While extra lending capacity is present for the first two years in our projections, by 2014E the banking sector will have run out of capacity to extend new lending to the government (without having to resort to reducing lending to the private sector). Based on our definition, therefore, the current fiscal stance in Egypt looks unsustainable over a five-year period.

**Figure 5. Egypt bank lending capacity: insufficient to finance deficit by 2014E**



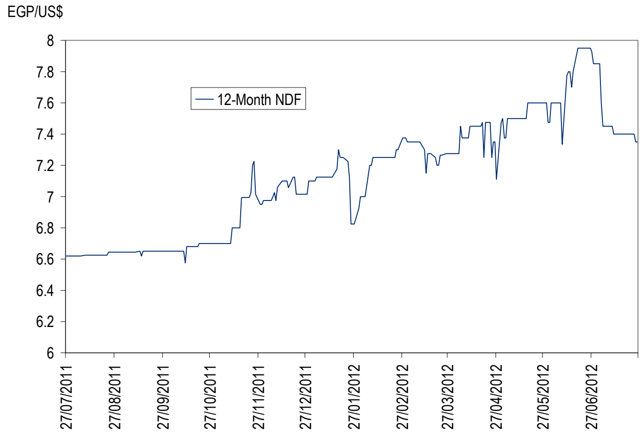

Source: Citi Research estimates

## Is Egypt on course for imminent default?

As discussed, our analysis suggests that at current trend growth, the capacity of the Egyptian banking sector to finance the government will be exhausted by 2014. This does not mean that we think that sovereign default is inevitable in this time-frame, however.

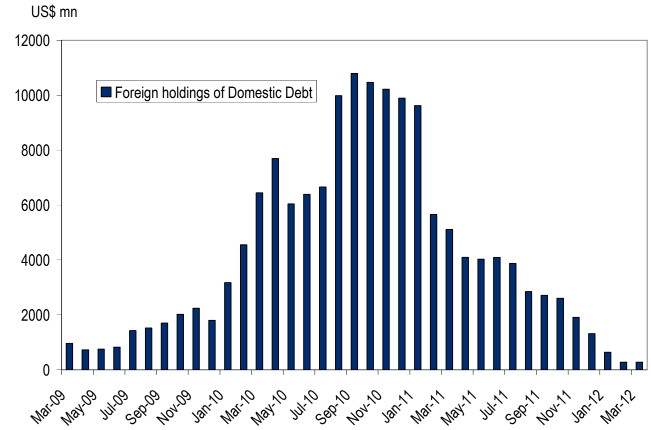
To begin with, we believe that, given the political will and the establishment of a consensus around an economic programme, official donors such as the IMF could well be willing to provide financing to the sovereign. This could, in our view, 'crowd in' further financing from other quarters, including bilateral lending and private capital. The sustainability of finances is thus intimately linked to Egypt's political trajectory in this regard, and, while the likelihood of such inflows seems remote at the moment, there remains the possibility that the political climate could become more conducive to foreign investment in the medium term.

**Figure 6. Markets are anticipating a sharp devaluation in the EGP**




Source: Bloomberg, Citi Research

**Figure 7. Foreign holdings of domestic debt peaked at almost US$11bn**




Source: Haver Analytics, Citi Research

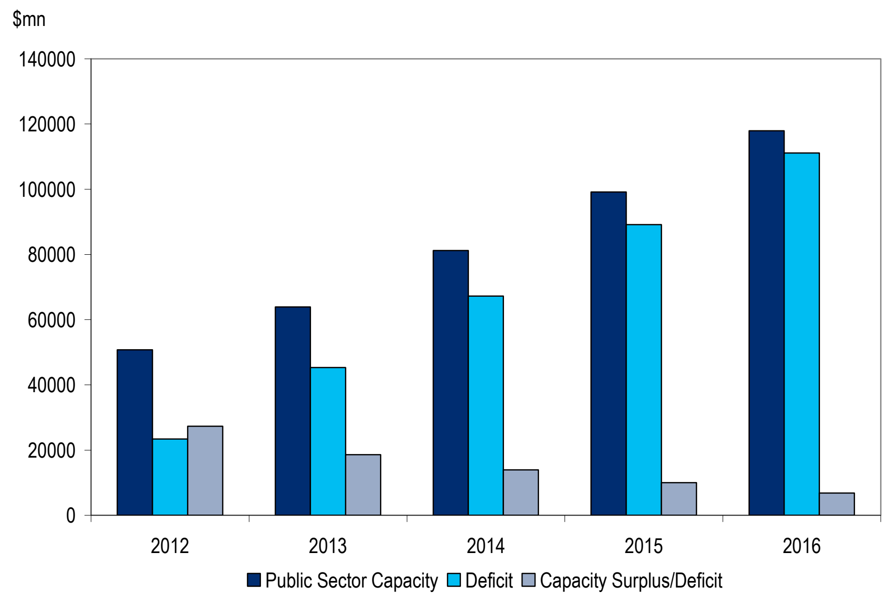
We also believe that, even in the absence of political stability in Egypt, it is possible that private inflows could return to domestic capital markets if Egypt's balance of payments position becomes clearer. The dramatic drop in reserves since the beginning of last year has led many observers, including us, to conclude that a devaluation in the Egyptian pound is highly probable in the near term. The non-deliverable forward market (NDF) is pointing to a valuation of around EGP7.3 to the US Dollar in one year's time. Without this, the possibility that the government could potentially impose capital account controls becomes more likely.

We consider this to be the single greatest deterrent to foreign investment in Egypt at the moment: international investors are adept at pricing and managing political risk, but a potential 25%-plus devaluation in the currency severely undermines any investment case in local markets. With a resolution to the uncertainty, either through a sustained improvement of the balance of payments or through a devaluation, we believe private capital would likely return and would provide an additional funding source for the government.

That said, it is worth bearing in mind that the scale of potential foreign inflows is small relative to Egypt's financing requirements. As shown in Figure 5, the shortfall in bank capacity to finance the government deficit under our assumptions should reach US$25bn by 2016. At their height, foreign holdings of Egyptian domestic debt reached just US$11bn. The IMF deal being discussed is worth US$3.8bn, much of which would not go towards direct budgetary support. In other words, while foreign funds could help support Egypt's budget financing options, they are unlikely, in our view, to make the current fiscal stance sustainable according to our definition.

Crowding out the private sector, on the other hand, could provide the government with significant breathing space. As mentioned above, we believe this could have detrimental effects for bank asset quality and would stifle economic growth through a reduction in private investment. However, it does provide a potential penultimate source of financing for a cash-strapped government. Figure 8 shows that reducing private sector lending by 5% per year over the next five years would provide more than enough lending capacity to finance the projected government deficit over this period, based on the assumptions outlined above.

**Figure 8. The financing capacity shortfall is eliminated by reducing private sector lending 5% per year**




Source: Citi Research estimates

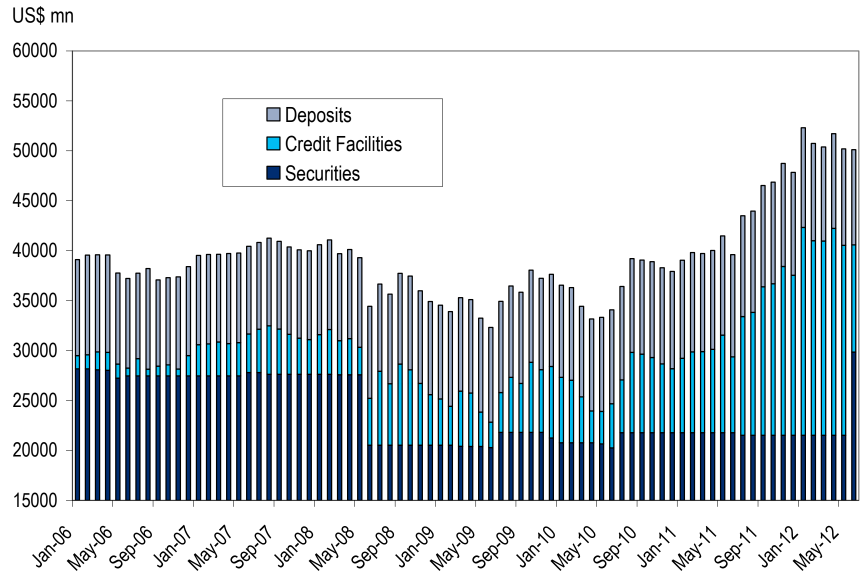
The willingness of the banks to make this shift, however, is less than clear. The government's sway over state-owned banks may be considerable, but private banks may be less easy to persuade. Yields on government debt would have to continue to rise sharply, raising sovereign borrowing costs and further eroding fiscal sustainability.

A final escape route is direct borrowing from the central bank. Indeed, as Figure 9 shows, this has already begun. Since January last year, central bank lending to the government has increased by 28% (US$11bn). We note that this is very close to the amount of money pulled out of the domestic debt market by foreign investors over the same time period. We see two main risks with this.

- First, if central bank financing of the deficit continues to gather pace, this is akin to the government printing money to pay the bills. Such monetization of debt typically has a negative impact on monetary stability, leading to inflationary pressures that, in Egypt's case, would be adverse to economic and political stability, in our view.

- Second, central bank financing of the deficit reduces central bank independence and could erode confidence in monetary policy, including management of the exchange rate.

**Figure 9. Central Bank lending to the government has risen sharply in recent months**




Source: Haver Analytics, Citi Research

To summarise, our analysis does not suggest that Egypt is on course for a sovereign default in the base case, but it does highlight two key factors. First, the importance of resuming foreign capital inflows for the government's fiscal sustainability. Second, the risk of crowding out private lending and continued monetisation of sovereign debt through the central bank, with potential negative implications for the economic outlook.

## Also, things could also get worse…

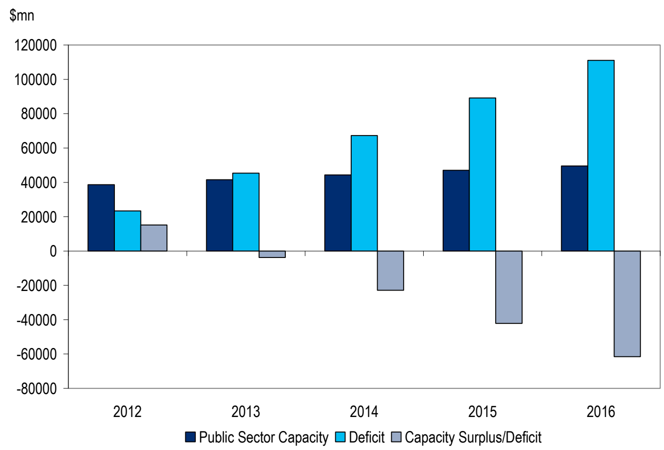
The analysis above assumes that the status quo prevails. Things could, however, get more difficult for the government on at least two levels.

First, banking sector growth could stall. In the above analysis, future lending capacity is being driven by banking sector growth of around 6%. We believe that given the uncertain political climate in Egypt, there is a risk of outflows from the banking sector, potentially stalling or potentially reducing asset growth. The impact on the ability of banks to finance the government could be considerable. Figure 10 shows what happens to the results of our analysis in the event that banking assets flat-line over the next five years. Not only that, it also assumes that lending is diverted from the private sector to the government (as in Figure 8). Even with this private sector crowding out, our analysis suggests a stalled banking sector would not have capacity to finance the government beyond the current year, and the cumulative shortfall in financing capacity over the five-year period would be a substantial US$62 billion.

Second, public finances could be worse than anticipated. Figure 4 shows that we are generously projecting a steady narrowing in the deficit to around 5.3% of GDP over the five-year horizon. Given the pressure on the government to deliver on some of the key goals of the revolution, such as employment and social justice, we believe risks to our fiscal projections are firmly on the upside. To gauge the impact of what this means for the banking sector's capacity to finance the government, Figure 11 repeats the analysis assuming continued 6% growth in the banking

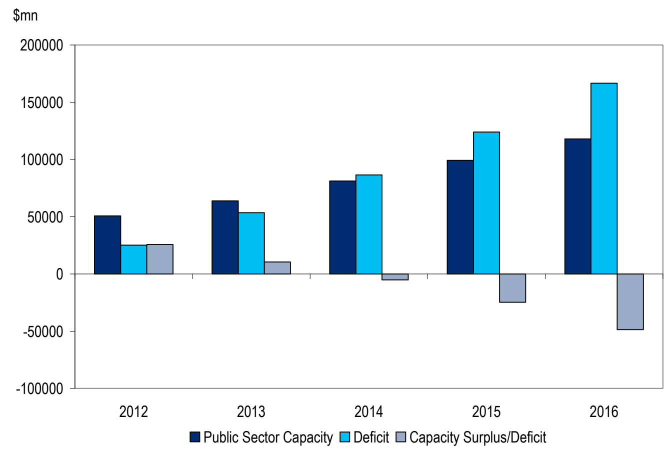
sector, but with a sustained government deficit of 10% of GDP over the period. Again, we assume private sector crowding out, and, despite this, our analysis suggests the banking sector would not have capacity to finance the government beyond next year, and over a five-year basis the cumulative shortfall in financing capacity would be US$49 billion.

**Figure 10. Downside scenario 1: bank assets flat-line**




Source: Citi Research estimates

**Figure 11. Downside scenario 2: the deficit widens**




Source: Citi Research estimates

# Appendix A-1

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