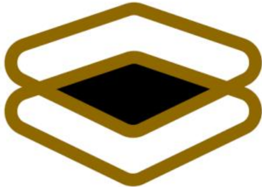
Egypt Macro Update

September 2018



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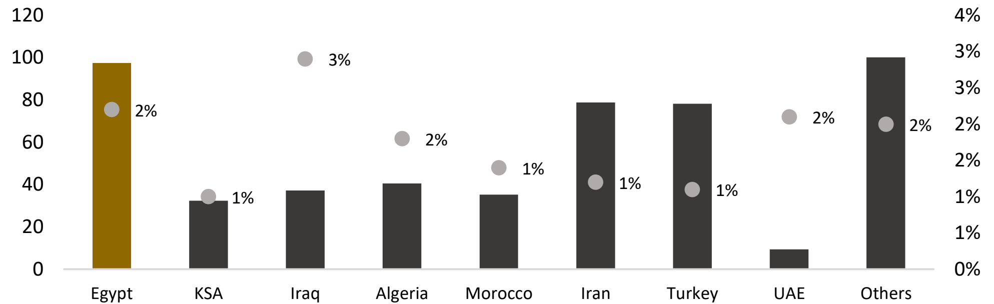
Since 2011, political and regional developments have taken a significant toll on the Egyptian economy…

The Egyptian economy is one of the largest and most diversified economies in the MENA region, benefitting from economic diversification, a cost competitive workforce, and the largest population base in the MENA region, that is in excess of 97.5mn people in 2017, plus a strategic geographical location, making Egypt one of the key investment destinations in the region. Egypt benefits from a young population, as 51% are below the age of 24 and only 4% are above the age of 65 which stimulates a growing and strong consumer base.

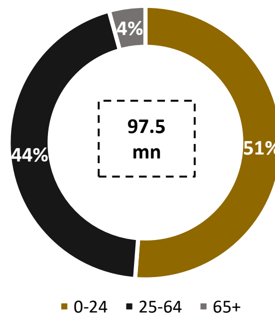
Moreover, the Egyptian economy has historically exhibited robust GDP growth and shown greater economic resilience than that of many countries in the region especially after the global financial crisis of 2008 and 2009. However, recent political transitions in Egypt (starting January 2011) did have a negative impact on the Egyptian economy with GDP growth rates plummeting compared to pre-2011 levels. However, with the IMF-backed reform program, Egypt's economy started showing signs of a recovery with a GDP growth of 4.2% in FY16/17 and 5.3% in FY17/18.

Population in MENA (mn), **Population growth rates** (%)



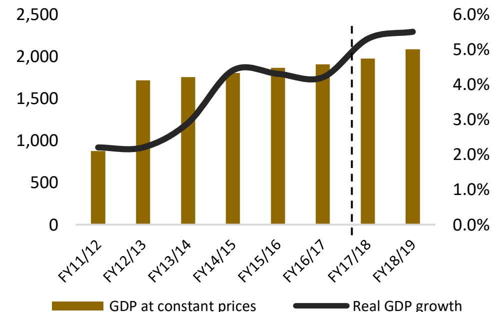
Source: CIA World Factbook

Population Age Breakdown (2017)



Source: CIA World Factbook

Egypt's GDP (EGP bn), **GDP growth rate** (%)



Source: CBE, IMF projections

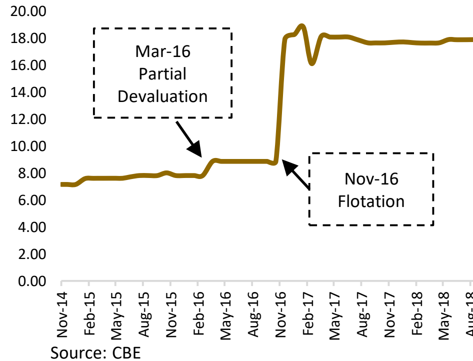
...however, IMF-backed structural reform efforts restored confidence in the Egyptian economy

The Central Bank of Egypt (CBE) decided to float the EGP in November 2016, while offering high yield CDs in banks (up to 20%), several subsidy cuts were carried out by the government, as part of the IMF backed economic reform program. These aggressive reforms resulted in a surge in inflation rates which reached historical highs (headline inflation peaking at c.33% in July 2017), eroding purchasing power, due to the significant surge in the prices.

After a period of tightening monetary policy to curb inflation rates, the Central Bank of Egypt started the year easing its monetary policy, by slashing interest rates (200bps in 1Q2018), on the back of a fall in inflation rates, which allows cheaper financing, in turn, motivating private sector investments and FDIs to stimulate economic growth.

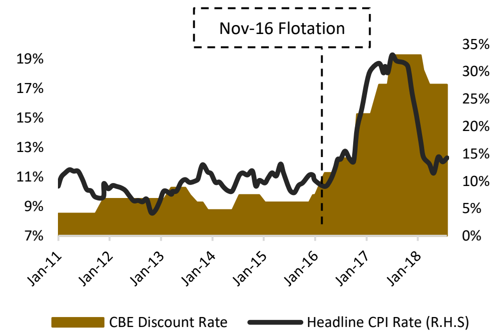
On the other hand, post flotation, the attractiveness of T-Bills yields attracted foreign investors and notable investments (hot money from carry trades) were made. Yet, long term FDIs are needed to replace short term carry trades which would exit the country once the EGP strengthens.

USD:EGP Exchange Rate



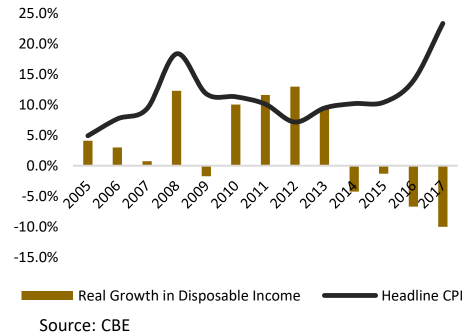
Source: CBE

Discount Rates, Headline Inflation (%)



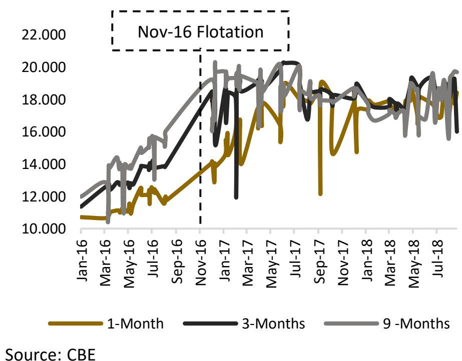
Source: CBE

Income Growth vs CPI Growth (%)



Source: CBE

T-Bills Average Yield (%)



Source: CBE

Commitment to reforms paves the way for a promising future

Starting 2016, the Egyptian authorities have adopted an economic reform program, supported under the IMF's EFF, to address longstanding challenges in the Egyptian economy (a BoP problem manifested in an overvalued exchange rate, and FX shortages, large budget deficits, rising public debt; and low growth with high unemployment).

The Central Bank of Egypt's (CBE) exchange rate reform has proved a turning point for the economy and Egypt's external finances; and macroeconomic stability has started to improve following an inflationary spike.

Such reforms have previously entailed backtracking risk from the government. We have seen such risk minimized as the government consistently showed its allegiance to the reform program.

Moreover, it was recently announced that Egypt recorded a full-year primary budget surplus of EGP 4bn for the first time in 15 years in FY2017-18, which shows that the reforms are beginning to reap benefits.

1. Monetary tightening

- The CBE adopted a monetary tightening strategy post the EGP flotation in order to quell inflation, with subsequent hikes in interest rates by a collective 700bps over the course of a year.
- However, with a gradual fall-off in inflation rates as the EGP floatation's effect started to gradually recede, the CBE started the year with a gradual easing policy, slashing rates by 200bps in 1Q18, while MPC meeting held in 2Q18 have kept rates constant, anticipating a minor hike in inflation rates due to the subsidy cuts that took place last June, as well as, the strengthening dollar and EM sell-offs.
- As a consequence, we do not see any rate cuts taking place this year as we expect the CBE to prolong the time before a cut can materialize.

2. Fiscal Consolidation

- Egypt's utilities and fuel subsidies bill burden alleviation demonstrate a continued commitment to fiscal consolidation and economic reform, backed by the country's IMF loan program.
- On the other hand, Egypt is planning to increase tax revenues by 131% in four years, aiming to maximize revenues to reach its budget deficit targets.
- We believe that such aggressive austerity reforms, coupled with the recent hike in oil prices, would restrain an immanent rebound in purchasing power and delay the phase out of subsidy cuts.
- Nonetheless, such restrained conditions can offer attractive long term investment opportunities (at lower cost) as the economy is bound to bear its reform fruits sooner or later.

3. Investment law

- Egypt ratified a landmark new investment law that will modernize and cut red tape for international investors.
- The law aims to expand economic growth, domestic production, exports and FDIs, and is designed to boost employment opportunities, increase Egypt's competitive edge across the region and enhance good governance and transparency.
- Once applied efficiently, we believe that such investment law incentives (offering tax breaks while cutting red tape) could indeed be the long sought attraction for FDIs (long term), and replacing risky carry trades inflows (short term).

4. Social Welfare

- Egypt introduced a social welfare program (Takaful and Karama program) worth USD 2.5bn to include increased subsidies and tax exemptions for the country's poorest as inflation reaches record levels.
- Takaful and Karama are cash transfer programs that are part of a social protection net implemented by the government to protect the poor from the negative effects of Egypt's reform program.
- Social welfare programs are hailed by economists as they diverge from conventional pension schemes, aim to deliver subsidies to those who need them most and limit waste and corruption in social spending.

Balance of Payments deficit softened, driven by higher exports, tourism and remittances

The current account continued improving in 9M17/18, with a sharp contraction of 57.5% in deficit, posting USD 5.3bn (versus USD 12.5bn during 9M16/17). This improvement was an outcome of mainly the Y-o-Y increase in both services balance surplus by 138.2% and net current transfers by 23.2%.

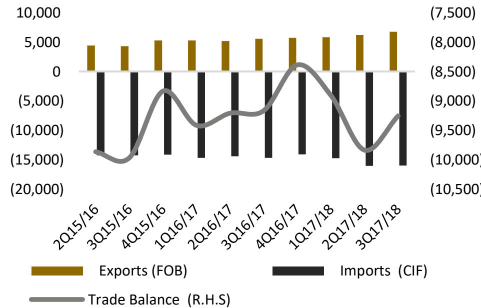
This reflects the continuous positive impact of the EGP flotation on the economy with the external world. The capital and financial account unfolded a net inflow of USD 19.0bn (compared to USD 24.8bn).

Exports during 9M17/18 increased by 18%, while imports have increased by only 7% compared to the same period of last year, however the difference in magnitude kept trade balance stable at the same level.

Additionally, remittances grew 23.1% Y-o-Y to USD 19.5bn for 9M17/18, up from USD 15.9bn a year earlier. Travel receipts recorded a surplus of USD 7.3bn, up from USD 2.8bn in 9M16/17, while Suez Canal revenues grew 11.9% Y-o-Y to USD 4.2bn.

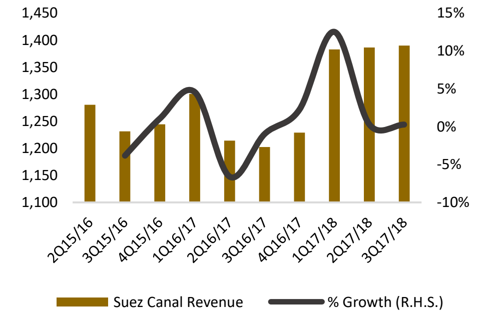
These developments resulted in an overall BoP surplus of USD 11bn in 9M17/18, and we expect the BoP to improve going forward, on the back of declining gas trade deficit, and higher remittances and tourism revenues.

Trade Balance (USD mn)



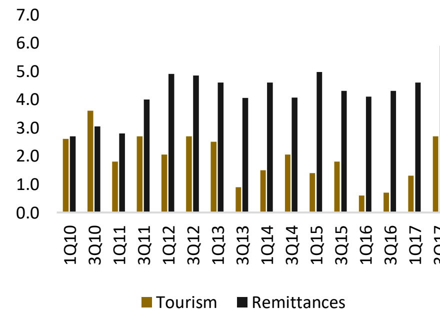
Source: CBE

Suez Canal Revenues (USD mn)



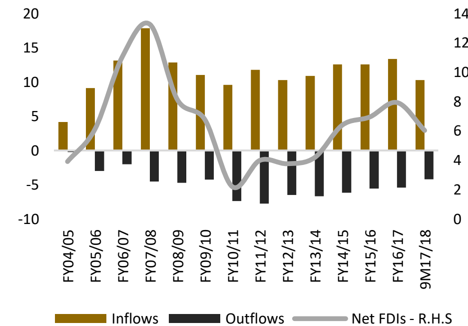
Source: CBE

Remittances, Tourism Inflows (USD bn)



Source: CBE

Foreign Direct Investments (FDIs)



Source: CBE

Egypt is facing exogenous factors…

Iran Sanctions

- The US is seeking a reduction in Iranian Oil exports to zero and does not intend to grant any waivers for companies or countries seeking exemptions. President Donald Trump pulled the US out of the Iran nuclear deal, which has led Iran's oil exports to drop so far by at least 500k barrels a day to below 2mn.
- Oil prices are set to rise more than previously expected in the second half of 2018, as the Trump administration aims to wipe out Iranian crude exports by November albeit OPEC's efforts to increased output, according to the latest Morgan Stanley forecasts.
- Oil prices are on constant rise in anticipation of the sanction and according to many analysts could rise over the USD 80/barrel mark, as markets tighten once US sanctions against Iran are fully implemented from November.

International Oil Prices

- The price of oil has hit its highest level since November 2014, reaching USD 80/barrel, as geopolitical fears cause concerns to rise over potential disruption to supplies, however these soaring prices are starting to cool off. Prices are at alarming levels that will eat into appetite for oil and forecasters have revised their expectations for demand growth this year. However, USA asked its oil producing allies to increase oil production, in order to curb inflating oil prices.
- Also, the decline in Venezuelan production could deteriorate even faster, the Iran November deadline will reveal more decisions taken by countries and companies with respect to Iranian oil purchases. It remains to be seen if other producers decide to increase their production.
- Moreover, higher oil prices continue to drive increased US shale production, and set the stage for yet another year of the OPEC-shale tug-of-war that will influence the price of oil. Despite such surges in prices, we believe there is a plateau to be reached where prices are attractive enough for shale producers to enter the market, setting a ceiling for price hikes as output rises.
- Egypt's budget for FY18/19 has projected oil prices at USD 67/barrel, and with the current prices, the state budget is facing strains, as well as, risks of higher inflation within the country, thus prolonging any interest cuts by the CBE.

Gas Discoveries

- Egypt's Zohr mega field kicked off on 16 December 2017, with an initial gas production of 0.35bcf/d rising to 1bcf/d by mid-2018e and 2.7bcf/d by end-2019e. This was preceded by another mega field, West Nile Delta (WND), coming on line in May 2017, with an expected production of 1.2bcf/d by the end of 2018.
- Additionally, Egyptian gas companies in 2018 signed import agreements with Israel and the government has signed a deal with Cyprus to import natural gas, liquefy it in Egypt then re-export it, aiming to make Egypt a regional energy hub.
- Furthermore, Zohr and WND gas fields collectively raise Egypt's total gas supply by a 2017-19e CAGR of c.20%, leading Egypt to re-emerge as a net exporter again by the end of 2019 after 8 years of deficits.

Trade War

- Talk of tariffs is in danger of developing into cries of trade war between the US and China. The US has hit USD 250bn worth of Chinese products with tariffs that reach up to 25%. Which has led China to retaliate and produce its own list, on several US products that amount to c. USD 60bn.
- The International Monetary Fund says an escalation of the tit-for-tat tariffs could shave 0.5% off global growth by 2020. There are signs that the trade dispute is already affecting the Chinese and US economies.
- The trade war between these two economic forces will be alarming to Egypt, as China's tariffed products will look for a new export market, thus dumping markets with their products, in addition to, having a negative effect on Suez Canal's traffic due to the decreasing trade between them, however, Egypt could slightly benefit from it on an export front, as Egyptian products can substitute US and Chinese products.

…along with the Emerging Markets crisis…

Emerging markets have been hit by a renewed wave of sell-offs in shares and currencies, with Argentina, Turkey, Indonesia, Saudi Arabia and China among the countries hit by trade war tensions and a strengthening dollar. Turkey's central bank attempted to draw a line under a lira collapse of almost 40% this year by hiking interest rates more than 6% to 24%. Argentina is struggling to shore up its peso, which has more than halved in value despite punitive interest rate rises to 60%. Other currencies have been caught in the slipstream, with India's rupee plumbing record lows and South Africa's rand, Russia's rouble and Brazil's real losing 15-20% this year so far.

Why are emerging markets suffering?

Simply money goes where it can get the highest return, flowing out of countries as fast as it flows in. This latest upheaval started when USA, Japan and Europe kept interest rates close to, or below, zero to help their stagnant economies recover from the 2008 financial crisis. That made returns on stocks and bonds unattractive, and drove investors to developing nations, where the risks were higher but the payoffs more inviting. Emerging markets, as a result, have enjoyed a rally in stocks, bonds and currencies. But the reverse is now happening as investors react to several signals from USA, faster growth, rising interest rates and a stronger dollar. All three indicate potentially higher returns on US investments and thus act as a magnet for money. They also undermine the attraction of riskier emerging markets. The turmoil in Turkey and Argentina has especially rattled investors. Moreover, many emerging markets countries borrow in US dollars despite having their own currency for domestic use, and with a strengthening dollar, emerging markets started to suffer.

Why are Turkey and Argentina in so much trouble?

Turkey has been one of the hardest-hit emerging-market currencies, shedding more than 17% of its value against the dollar this year. Turkey has a large budget shortfall and one of the biggest trade deficits in the G20 group of nations. Which prompted their central bank to take emergency steps to arrest the slide with an interest-rate hike to prop up the lira, and followed with a simplification of its interest-rate regime. All of this has made Turkey seem more risky to investors. On the other hand, Argentina has started talks with the IMF seeking financial rescue once again, as inflation soars and the currency sinks, with prices rising rapidly while the Argentine peso drops. The central bank announced incremental increases in rates, which finally reached 60%, as the 12-month inflation rate hit 25%. At the same time, since the start of the year, the peso is down by more than 20% against the US dollar.

Why did so many countries borrow in dollars?

Encouraged by near-zero interest rates after the global financial crisis, developing nations loaded up on what was then cheap debt. Selling bonds denominated in dollars rather than the local currency also attracted investors who favored the more stable dollar. Turkey's corporate sector, for example, has foreign currency debt in dollars, equivalent to 40% of GDP. Global investors, though, sometimes ignored danger signs, such as rising trade deficits and government spending sprees. They also brushed aside, until now, the fact that a stronger dollar would make it harder for emerging markets to repay their debt. That's because once they borrowed in dollars, they needed to buy dollars to repay the debt. As the dollar rises in value against the local currency, it costs more to obtain those dollars.

…Yet, Egypt is still resilient during sell-offs wave

Egypt has been under pressure since April 2018, in tandem with the EM debacle, higher oil prices, and slow pace of a broad-based economic pick-up.

The overall dynamics resulted in a drop in net foreign assets at Egyptian banks to a negative USD 1.1bn in July compared to USD 4bn in March, as foreign outflows of Egypt's fixed income market reached c. USD 7bn since the EM sell-off. Moreover, the strong IPO pipeline in the EGX (10 primary and secondary offerings) planned in 4Q18 raised concerns about the market's ability to absorb such issuances, amid current liquidity levels.

Although Egypt currently has the capacity to withstand volatility in carry trade flows and satisfy its short-term obligations, deterioration in any of the key EM countries will likely pose an overhang on the local market and could raise some questions in the market about the short-term outlook of monetary policy.

Egypt has managed to stay under the radar throughout the emerging-market rout, but that doesn't mean its assets are unscathed. Egypt's Ministry of Finance canceled three consecutive Treasury bond auctions, after investors asked for very high yields, leading demand for Egyptian debt across maturities has weakened in August and September compared to the average of the preceding 13 months, even though the currency has been relatively stable this year. That has spurred an increase in yields across the board.

Moreover, Egypt needs to figure out how to keep its debt attractive or else it faces the risk of seeing its yields rise further, which would make the government's plans to cut its deficit even more challenging, central to that may be holding interest rates stable in the long-term, despite inflation being on target.

The yields on 1-year T-bills have risen by about 160bps since the beginning of the year despite a 2% cut in benchmark rates. The government last sold 1-year and 6-month notes at a pretax rate of 19.296% and 19.501%, respectively, as well as, EGP 4.8bn worth of 9-month T-bills, with the average yield rising 12bps to 19.757%.

Analysts have said the spillover from the emerging markets rout prompted foreigners to sell Egyptian debt, helping push up yields. There could be a flip-side, however, that higher returns could make Egypt attractive to foreign investors once again, yet prolonging recovery in business activity.

On a similar note, the turmoil is seen as one factor rattling Egypt's stock market, which plunged 3.6% recently, its lowest close since 2016, as liquidity tightened.

Egypt is most likely to be more resilient than other emerging markets during this sell-off period, due to the economic reform program that is being implemented by the government, which has led GDP to grow by 5.4% during FY17/18, unemployment rate to fall from 12% to 10% and the current account deficit to improve.

EM Comparison	Egypt	Turkey	Argentina	South Africa	Indonesia	China
Inflation Rate	**14%**	18%	26%	5%	3%	3%
Interest Rate	**17%**	24%	60%	7%	5%	4%
GDP Growth Rate	**5%**	1%	-2%	0%	5%	7%
Unemployment Rate	**10%**	10%	7%	27%	6%	4%
External Debt/GDP	**36%**	53%	37%	50%	35%	14%
Current Account (USD mn)	**(1,904)**	(1,750)	(9,623)	(1,107)	(8,028)	58
Trade Balance (USD mn)	**(4,099)**	(5,980)	(789)	(322)	(1,021)	279

What do we make of this?

Egypt's SWOT Analysis

Egypt's medium-term growth is relatively positive, but growth will remain far below potential over the coming years.

Investment is expected to increasingly drive growth on the back of low base effects and pent-up demand, while government and household spending growth slows.

The long-term outlook is more positive, given significant growth opportunities in banking, housing and infrastructure.

Strengths

- Strong relations with most GCC countries which fortified inflows to support the economy when needed as was the case back in 2014.
- Low wages in global terms are advantages for foreign investors, particularly for those wishing to use Egypt as a base for export oriented manufacturing.
- With a population that exceeds 97mn, Egypt is the largest market in the Arab world, providing a strong demand base which attracts investors in multiple industries.
- Egypt became once more competitive (in terms of price) in the global market post EGP flotation as we see exports invigorating.

Weaknesses

- Unemployment is high, which subdues demand.
- Egypt has a large fiscal deficit owing to a significant subsidies bill and public wage costs.
- There are relatively high levels of corruption and bureaucracy.
- Relatively slow policy making process.
- The wide fiscal deficit ensures elevated costs for servicing debt, most of which is held domestically.

Opportunities

- Economic reforms undertaken as part of the IMF program entered in 2016 will help reinvigorate the moribund economy.
- The formation of a more representative government that is democratically elected could help reduce graft.
- Future tenders will likely be more transparent, helping those firms not politically connected with the government to secure lucrative contracts.
- The opening up of additional trade and bilateral agreements.

Threats

- The high level of unemployment may lead to political resistance to plans for privatization.
- Attacks on tourist sites pose a downside risk to revenues from the key tourist sector, although increased security-spending appears to have been successful in this regard.
- Soaring international oil prices.
- Piracy in the Gulf of Aden has resulted in large numbers of shipping companies opting for alternative routes that do not use the Suez Canal.

Selected Macro Indicators from the IMF's 3rd Egypt Review

Output and prices Annual % Change	**2014/15**	**2015/16**	**2016/17**	**2017/18** 2nd Review	 Revised	**2018/19** 2nd Review	 Revised
Real GDP (Market Prices)	4.4%	4.3%	4.2%	4.8%	5.2%	5.5%	5.5%
Consumer Prices (EoP)	11.4%	14.0%	29.8%	11.9%	12.6%	15.2%	13.1%
Consumer Prices (Average)	11.0%	10.2%	23.5%	21.0%	20.8%	13.7%	14.4%

Public Finances In % of GDP at Market Prices	**2014/15**	**2015/16**	**2016/17**	**2017/18** 2nd Review	 Revised	**2018/19** 2nd Review	 Revised
Gross Debt	88.5%	96.9%	103.0%	91.3%	92.4%	86.7%	86.2%
External	7.9%	7.8%	18.1%	16.7%	18.5%	17.7%	17.0%
Domestic	80.5%	89.0%	84.9%	74.6%	73.9%	69.0%	69.2%

Budget Sector	**2014/15**	**2015/16**	**2016/17**	**2017/18** 2nd Review	 Revised	**2018/19** 2nd Review	 Revised
Revenue & Grants	19.0	18.1	19.0	18.8	18.2	18.7	18.6
Expenditure	30.5	30.7	29.9	28.0	27.9	26.1	26.7
of which: Energy subsidies	*4.0*	*3.0*	*4.1*	*3.1*	*3.4*	*1.2*	*2.1*
Overall Balance	(11.4)	(12.5)	(10.9)	(9.2)	(9.7)	(7.4)	(8.1)
Overall Balance, excluding Grants	(12.5)	(12.7)	(11.4)	(9.2)	(9.7)	(7.5)	(8.1)
Primary Balance	(3.5)	(3.5)	(1.8)	0.2	0.2	2.1	2.0

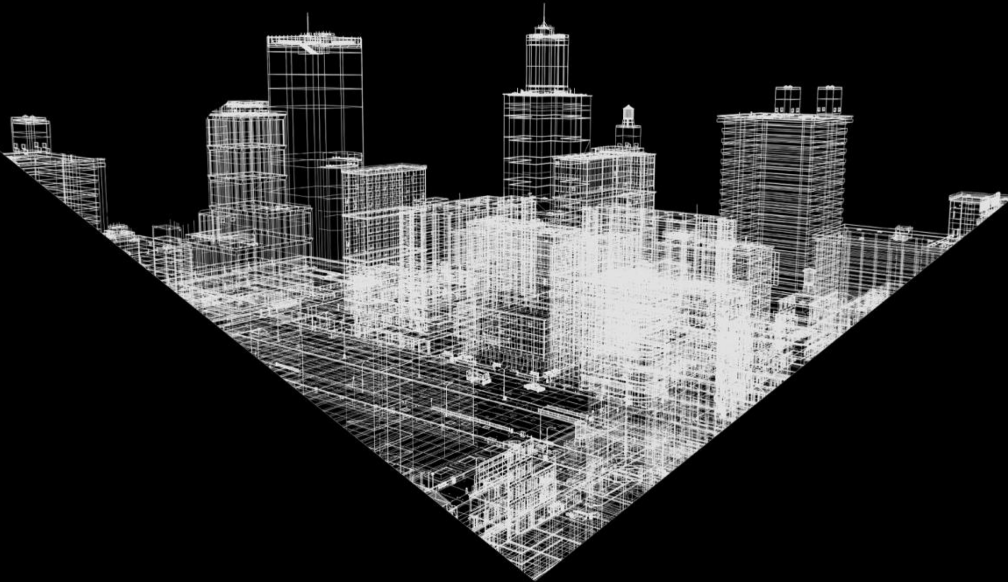
Monetary Sector Annual % Change	**2014/15**	**2015/16**	**2016/17**	**2017/18** 2nd Review	 Revised	**2018/19** 2nd Review	 Revised
Credit to Private Sector	16.7%	14.2%	38.0%	10.5%	7.5%	11.2%	18.2%
Reserve Money	33.3%	29.3%	-7.8%	39.4%	40.2%	17.8%	27.6%
Broad Money (M2)	16.4%	18.6%	39.3%	20.4%	23.4%	19.7%	19.8%
3-Month T-Bill Rate (Average, %)	11.4%	11.8%	17.5%	17.4%	18.5%	-	-

Selected Macro Indicators from the IMF's 3rd Egypt Review (continued)

External Sector In % of GDP (Unless Otherwise Stated)	2014/15	2015/16	2016/17	2017/18		2018/19	
				2nd Review	Revised	2nd Review	Revised
Exports of Goods (in USD, % Change)	-14.7%	-15.9%	15.9%	7.0%	13.8%	12.7%	16.5%
Imports of Goods (in USD, % Change)	1.9%	-6.4%	1.5%	-0.1%	4.5%	7.6%	10.0%
Merchandise Trade Balance	-11.8%	-11.6%	-14.3%	-13.5%	-14.5%	-12.5%	-12.5%
Current Account	-3.7%	-6.0%	-6.0%	-4.5%	-2.8%	-4.0%	-2.6%
Capital & Financial Account	5.5%	5.1%	5.2%	3.2%	5.0%	1.6%	1.8%
FDIs (net in USD bn)	6.2	6.8	7.7	8.4	7.8	9.9	9.5
Gross International Reserves (in USD bn)	19.5	17.1	30.7	34.5	44.4	33.0	44.8
In months of next year's imports of goods & services	3.5%	3.0%	5.2%	5.7%	6.8%	5.2%	6.1%
In % of short-term external debt	280.6%	157.7%	121.3%	89.3%	146.2%	76.9%	191.4%
Financing Gap (in USD bn)	-	-	-	-	-	2.6	1.1

Memorandum Items	2014/15	2015/16	2016/17	2017/18		2018/19	
				2nd Review	Revised	2nd Review	Revised
Nominal GDP (in EGP bn)	2,444	2,709	3,470	4,418	4,436	5,292	5,365
Nominal GDP (in USD bn)	332	332	256	-	-	-	-
GDP per Capita (in USD)	3,731	3,686	2,704	-	-	-	-
Unemployment Rate (Average, %)	12.9%	12.7%	12.2%	11.2%	11.1%	9.9%	9.7%
Poverty Rate (%)	27.8%	-	-	-	-	-	-
Population (in mn)	89.0	90.2	94.8	97.0	97.0	99.2	99.2
Crude Oil (% Change)	-	-	-	18.0%	-	-6.5%	-
Natural Gas, LNG (USD/mmbtu)	10.2	6.9	8.0	8.8	-	8.9	-
Non-fuel Commodities (% Change)	-	-	-	5.6%	-	0.5%	-

Source: Egyptian authorities; and IMF staff estimates and projections



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