Macroeconomic outlook

Egypt: Economic growth stalled; IMF agreement offers new hope

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Overview and outlook

- **Growth is expected to have slowed to 3% in FY15/16; growth should improve to 3.5% in FY16/17 and 4.5% in FY17/18.**
- **Foreign currency shortages and a tourism sector hard hit by terror and uncertainty has hurt economic growth.**
- **The fiscal deficit is expected to have narrowed to 11% of GDP in FY15/16; it should improve to 9% in FY16/17 and 8% in FY17/18.**
- **Pressure on the external position remains a challenge; IMF agreement should ease pressures, but will likely include further devaluation.**

After experiencing a robust recovery in FY14/15 driven in part by a public sector investment push, growth in economic activity stalled in FY15/16 on a shortage of foreign exchange and a collapse in tourism. Little progress on fiscal and structural reform, a persistent government deficit and precarious security conditions have hurt investment and the economy. With foreign investors largely staying away, capital controls have remained in place as monetary authorities maintained a costly policy of stabilizing the pound.

The fiscal and external positions continued to face significant pressures. While the fiscal deficit appears to have finally begun to narrow in FY15/16, this was largely due to a drop in the cost of fuel subsidies, thanks to lower oil prices. Reforms to address the deficit have not moved quickly enough, though a number of initiatives are expected in the coming months. The external position also worsened in 2015, with the current account deficit widening and foreign reserves remaining relatively tight. A devaluation in March helped reduce the pressure on the pound, but appeared to do little to ease the severe shortage of foreign currency.

Following a cabinet reshuffle in March, the government has sought to rekindle reform efforts in an attempt to turn the economy around. The government is proposing a number of fiscal reforms whose aim is to narrow the large deficit and spark renewed foreign investor interest. Recent news that the government is working on a $12 billion three-year agreement with the IMF, has been well received by markets, with observers hopeful a deal will support renewed efforts to move ahead with much needed reform and ease pressures on the pound.

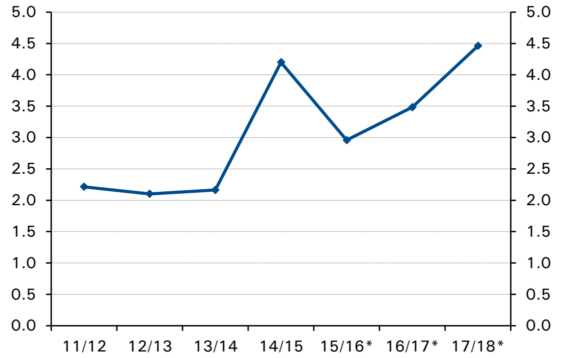
Table 1: Key economic indicators

		FY14/15	FY15/16e	FY16/17f	FY17/18f
Nominal GDP	EGP bn	2,264	2,502	2,858	3,254
Nominal GDP	USD bn	307	318	355	394
Real GDP growth	% y/y	4.2	3.0	3.5	4.5
Inflation	% y/y	11.4	14.0	11.0	10.0
Budget balance	% of GDP	-11.8	-11.0	-9.0	-8.0

Source: Central Bank of Egypt, Ministry of Finance, Ministry of Planning, NBK estimates

Chart 1: Real GDP growth

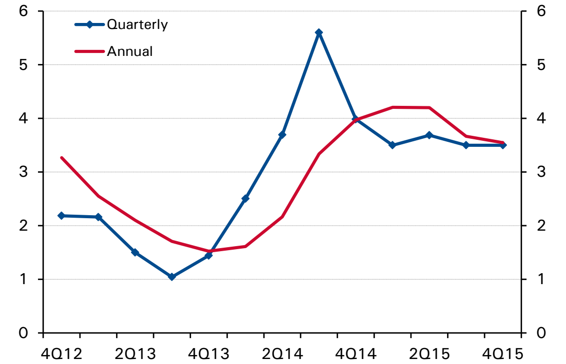
(% y/y, *estimate/forecast)



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 2: Quarterly GDP growth

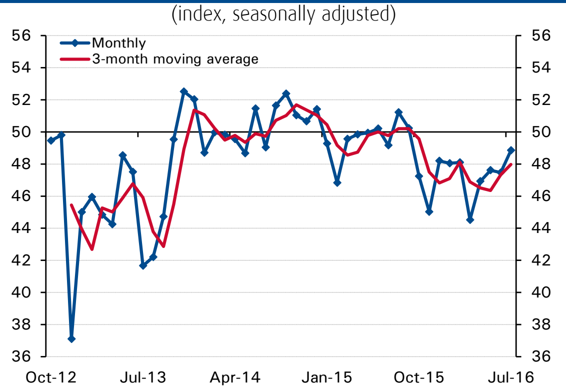
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index

(index, seasonally adjusted)



Source: Markit

Economy slows further in 2016, after losing steam in 2015

Economic growth is expected to have slowed notably during the first half of 2016 following a more modest slowdown in 2015. According to official data, real GDP growth slowed to 3.5% year-on-year (y/y) in 4Q15 (Chart 2), down from average growth of 4.2% in FY14/15. All indications are that growth slowed further since, to average around 2-2.5%; we estimate FY15/16 growth at around 3.0%. It is also expected to improve more slowly than we had been expecting a year ago, to 3.5% in FY16/17 and 4.5% in FY17/18 (Chart 1).

Growth appears to have worsened gradually over the last 9-12 months. The Ministry of Planning's production index has been in decline for most of the last twelve months. In May, the index was down by 16% y/y (Chart 5). According to the index, the slump has come mostly from a decline in tourism and the related transportation sector. Meanwhile, the manufacturing sector, which tends to be an important source of growth, has been essentially flat.

Markit's Purchasing Managers' Index (PMI) has also pointed to a slowdown in activity which appeared to worsen in 2016. The PMI has been below 50 since October 2015 (Chart 3). Indeed, the index has averaged 47.2 during the last ten months, a level consistent with GDP growth of around 2-2.5%. July may be seeing conditions begin to improve as the index rose to 48.9, its highest level in ten months.

Private credit growth has held up better than other indicators but it too has slowed recently. Credit growth eased to 14% y/y in June after registering growth of 17.5% y/y in December 2015 (Chart 8). Growth adjusted for Egypt's high inflation showed a notable slowdown to 0.1% y/y in June after recording real growth of around 6% in March.

Collapse in tourism key source of slowdown

A key source of slowdown in the economy is tourism. The tragic terrorist attack In October 2015 that downed a Russian plane shortly after takeoff in Sharm El-Sheikh has had a devastating effect on the tourist industry. The attack came at a time when Egyptian tourism was struggling to recover from years of political instability and security threats. Recent April data show that tourist numbers had yet to recover.

In April, the number of visitors was less than half its level of a year before, declining by 54% y/y. Those tourists who did come had shorter stays, with the number of "nights stayed" down by 75% y/y (Chart 6). As a result, receipts from tourism in 1Q16 were down by 62% y/y according to data from Egypt's balance of payments.

CBE hikes rates as recent devaluation pressures inflation

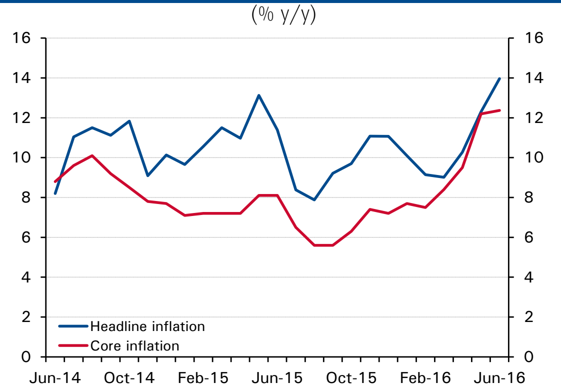
Inflation has picked up over the last year, reaching a more than 7-year high in June. Headline inflation in consumer prices rose to 14% y/y, while core inflation rose to 12.4% y/y (Chart 4). A devaluation of the pound by 12% in March was largely behind spiking inflation in recent months.

The Central Bank of Egypt (CBE) moved to hike policy rates several times in 2016, in an effort to combat higher inflation. The CBE increased rates by 50 basis points in January, the first such move since a rate cut a year before. Another two rate hikes took place after the March devaluation; 150 bps in March and another 100 bps in June. The CBE deposit rate now stands at 11.75% and the CBE lending rate at 12.75% (Chart 11).

Treasury bill rates have risen in tandem with the hike in policy rates. The 3-month treasury bill yield rose to 14%, up from 11.2% in December 2015. This increase is already being felt in the budget, where interest

Chart 4: Consumer price inflation

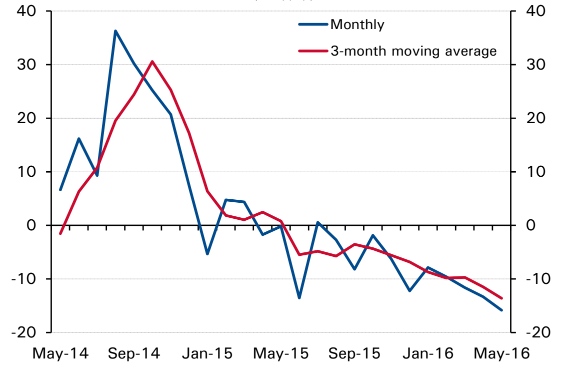
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

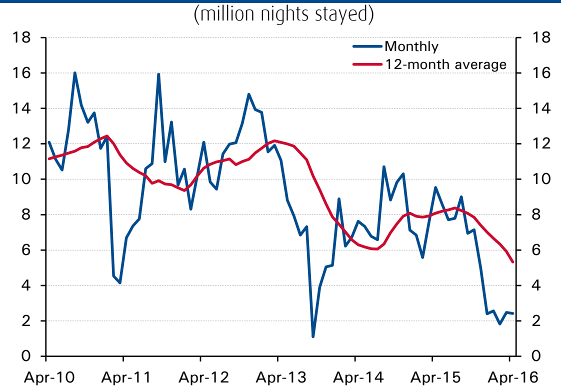
(% y/y)



Source: Ministry of Planning, Thomson Reuters Datastream

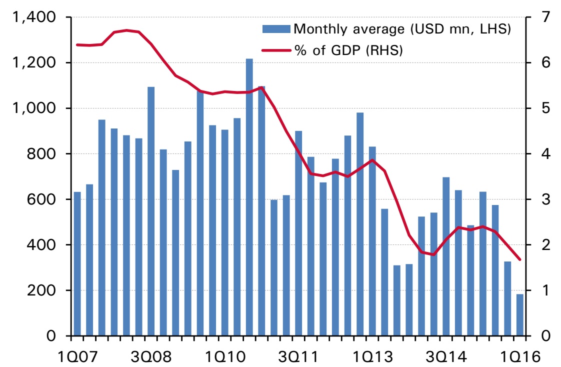
Chart 6: Tourism

(million nights stayed)



Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, NBK estimates payments have risen notably to account for 10% of GDP in May compared to 8.4% a year before.

Fiscal deficit has narrowed on declining cost of subsidies

The fiscal deficit has improved over the last year, thanks to lower oil prices and a decline in the cost of fuel subsidies as a result. Still, the large deficit remains a key concern for the country's outlook. A decline in official grants and rising interest payments have hurt the budget, while new revenue initiatives have stalled. The deficit narrowed to 12.7% of GDP for the twelve months ending in May 2016, compared to 14% a year before (Chart 9). We expect the outcome for the fiscal year ending in June 2016 to be lower still at 11% of GDP.

This improvement reflects the government's efforts to control spending growth which has been somewhat effective. Spending in the twelve months ending in May 2016 grew by only 0.5% compared to the same period a year before. While most of the improvement came from a decline in the cost of subsidies, which now account for 4.7% of GDP, down from 9.1% a year before, there were improvements elsewhere. Growth in wages and salaries was more than halved to 6.3% y/y even as inflation remains in the double-digits. Growth in "other expenditures" was also slashed to 3.9% y/y.

Some of these gains were offset by deterioration elsewhere in the budget. Revenue growth was weak at 0.6% y/y through May. While a decline in official grants was largely to blame for this, tax revenue growth also appeared to weaken to 1.8% y/y. As a result, revenues excluding grants during the twelve months ending in May amounted to 18.5% of GDP, down from 20.6% a year before. At the same time, the cost of servicing government debt rose from 8.4% of GDP to 10% in May.

The government is currently mulling a number of reforms that it hopes parliament will ratify in the coming months. One of those includes a value added tax (VAT) to replace the existing and less efficient sales tax. The initiative should, once in place, provide new revenues of around 0.7-0.9% of GDP. Other initiatives include further cuts in subsidies and public sector payrolls following the new civil service law passed by legislators recently. These reforms will be an integral part of the agreement Egypt hopes to sign with the IMF in the coming weeks.

Financing deficit has come largely from banks

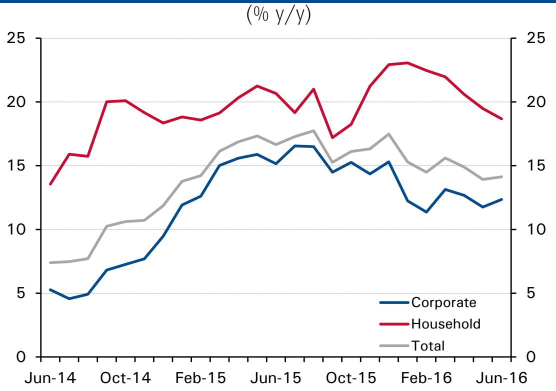
In recent years, the government has largely resorted to domestic issuance to finance its deficit and most of this debt has been absorbed by banks. This has come at a cost of crowding out lending to the private sector. Over the last six years, claims to the government have risen from 25% of assets to 58% in April 2016. By contrast, lending to the private sector accounts for only 25% of bank assets. To counter this, the government is seeking to issue international bonds later this year. Plans are to issue $3-5 billion in international bonds during the current fiscal year (FY16/17), probably starting in September.

Yields on Egypt's USD bonds rose towards the end of last year but began to ease even before recent news of an imminent IMF agreement. A USD bond maturing in 2040 yielded 7.6% in early August; this is slightly above the rate a year ago, but well below the 9.3% high seen in January 2016. Sovereign yield spreads to US rates, which also rose from below 370 basis points (bps) in mid-2015 to over 680 bps in early 2016, have since retreated notably to 550 bps in early August. Credit default swap (CDS) rates have risen from 300 bps to just under 500 bps.

Current account deficit widened in 1Q16

Chart 8: Private credit

(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

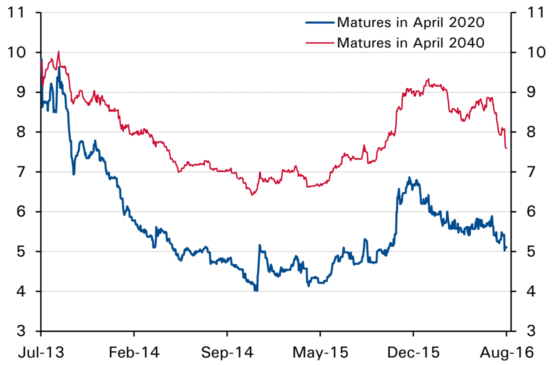
Chart 9: Fiscal balance

(% of GDP, 12-month trailing)

Source: Ministry of Finance, Thomson Reuters Datastream

Chart 10: USD sovereign bond yields

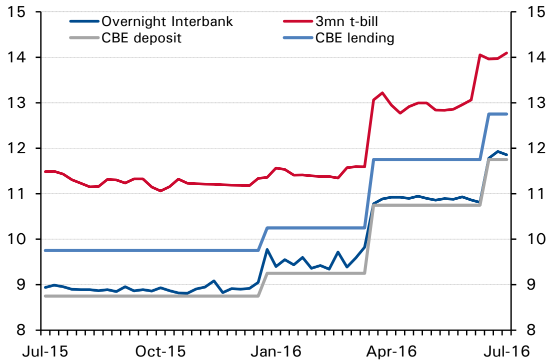
(%)



Source: Thomson Reuters Datastream

Chart 11: Interest rates

(%, weekly)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Egypt's current account weakened further in 1Q16, with the deficit widening to $5.5 billion. The 12-month trailing deficit rose to 6.1% of GDP compared to 3.4% a year before. The deterioration was due largely to a collapse in tourism revenues, and declines in worker remittances and foreign grants. By contrast, the trade deficit narrowed thanks in large part to a drop in imports. Meanwhile, foreign direct investment (FDI) continued to show strength (Chart 12).

The trade balance narrowed by 1% y/y during the twelve months through 1Q16. The improvement came mostly from a contraction in nonoil imports, which fell by 5% y/y. Meanwhile, the trade balance was hurt by deterioration in nonoil exports, which fell by 9.9% y/y. Lower oil prices also hurt the balance; while they resulted in mostly offsetting declines in oil imports and oil exports, on the net lower oil prices had a more detrimental impact on the trade balance.

The deterioration in the current account did not come from the trade balance, but from lower services receipts and transfers. Net receipts from services were down by 34% y/y, most of it from a decline in tourism receipts. Transfers declined by 28% y/y, with worker remittances down by 12% and foreign grants falling to zero.

Foreign direct investment (FDI) continued to increase, helping to finance a growing current account deficit. FDI rose to 2.4% of GDP during the twelve months ending in 1Q16, compared to 2.0% a year before. Egypt attracted $7.1 billion in FDI during the year through 1Q16, up from $6.1 billion the year before. Meanwhile, portfolio investment saw a relatively small outflow during the same period.

Official reserves see gradual improvement but remain tight

Official foreign currency reserves held by the CBE remained tight though they have seen some improvement in recent months. Reserves rose to $17.5 billion at the end of June 2016 or 3.5 months of imports, up from $16.3 billion in September (Chart 13). The position continued to benefit from generous support from GCC allies, who propped up CBE reserves with deposits of $4.4 billion between July 2015 and March 2106.

Capital controls have remained in place as monetary authorities continued a policy of supporting the pound; as a result, the market has suffered a severe shortage of foreign currency which has at times hindered business activity. The CBE devalued the pound in March in an effort to stem the pressure and improve access to foreign currency in the market (Chart 14). The Egyptian pound (EGP) fell by 12% against the US dollar on 16 March and has been steady since at 8.88. Through July, the trade-weighted value of the EGP was down by 9.4% y/y.

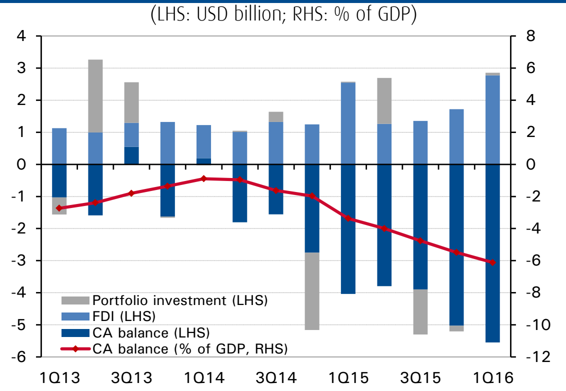
The pound continues to have an active unofficial market, where the currency trades at a substantial discount to the official rate. That discount has widened to over 30% (or 13-13.1 EGP/USD) according to press sources. Recent statements by the governor and confirmation of an IMF agreement have increased the chances of a devaluation in the coming months and even the possible floating of the currency.

Equities market has outperformed region thus far in 2016

The stock market has outperformed most of the region thus far in 2016, though it has come off its recent peak. The market rallied in March on news of a devaluation; it gained again in July when it appeared the CBE would move to devalue the currency again and when the government confirmed it was hoping to reach a new IMF agreement in the coming weeks. The EGX30 index was up 13% through 1 August (Chart 15); the MSCI total return index was up 29% ytd.

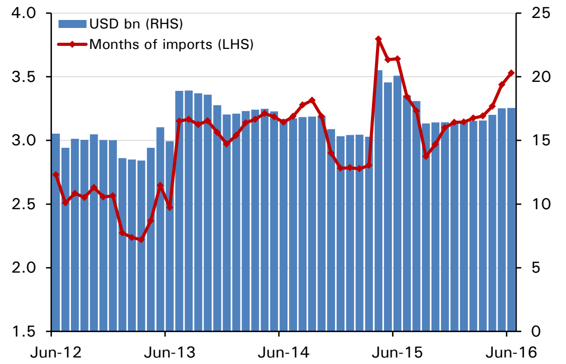
Chart 12: Balance of payments

(LHS: USD billion; RHS: % of GDP)



Source: Central Bank of Egypt, Thomson Reuters Datastream

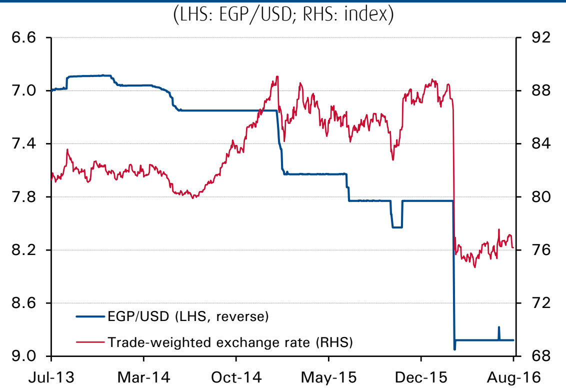
Chart 13: Official reserves



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30, thousand)

Source: Thomson Reuters Datastream

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