

EGYPT ECONOMIC REPORT

IMPROVING RISK PROFILE AND MACRO PROSPECTS IN A REFORMING ECONOMY

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- Real sector activity on the upside**
Egypt's macro environment continued to improve over the past year within the context of the continuation of adjustment reforms and the amelioration of the investment framework, supporting the country's economic prospects on the back of a relative improvement in macro and fiscal fundamentals. As a matter of fact, all indicators point to a relatively bullish economic cycle. At the real sector level, growth has been revised upwards by the IMF to 5.3% for FY 2018, the second highest in the Middle East and North Africa, up from 4.2% in the previous year.
- Narrower current account deficit mainly driven by surging services balance**
Exchange rate liberalization, a weaker currency, and a higher domestic gas production along with an improved security environment, have helped reduce Egypt's external imbalances in 2018, as current account receipts surged over the first nine months of 2018 mainly on the back of a strong rebound in tourism receipts, remittance inflows and Suez Canal earnings. As such, the current account deficit shrank from US\$ 6.1 billion in the first nine months of 2017 to US\$ 4.1 billion over the first nine months of 2018.
- Fiscal adjustment on track, yet challenged by higher interest payments and oil prices**
Egypt's fiscal consolidation efforts have been pursued during FY 2018, resulting in a primary budget surplus (0.1% of GDP) for the first time in eighteen years, along with a fall in overall fiscal deficit from a peak of 12.5% of GDP in FY 2016 to below 10% of GDP in FY 2018, for the first time in six years. However, higher oil prices and tight monetary policy resulted in higher fuel subsidies and interest costs, which partly offset the fiscal gains during FY 2018.
- Declining inflation while FX reserves reach a new historical high**
Amid improved macro fundamentals, stable exchange rate and abated inflation (12% in December), the Central Bank of Egypt started easing its monetary policy in 2018 after adopting an aggressive monetary tightening since the currency floatation in November 2016. In parallel, the CBE's foreign exchange reserves have been on an upward trend over the year 2018, hitting a new historical high of US\$ 42.6 billion in December amid rising remittances and touristic receipts that have triggered contractions in the current account deficit.
- Strong deposit and lending growth amid a continuously expanding economic activity**
Egypt's banking sector witnessed a good year during 2018 on the back of relatively ameliorated domestic conditions and continued healthy economic activity at large. Banks benefited from increased liquidity at hand through deposits to enhance their financial intermediation role and extend new waves of loans to the economy while continuing to lend to the public sector. On the funding side, deposits at banks rose by 13.0% in local currency terms over the first 11 months of 2018 to reach the equivalent of US\$ 209.9 billion at end-November 2018. In parallel, credit facilities extended by banks grew by 21.0% in local currency terms over the period to reach the equivalent of US\$ 98.8 billion.
- Relative price falls in Egyptian capital markets in 2018, tracking wide emerging market sell-off**
Egypt's capital markets reversed in 2018 the upward trend that was prevailing over the past couple of years, mainly weighed down by an emerging market sell-off, US Treasuries declines amid a sustained US monetary policy tightening, and lingering fears about a global economic slowdown. The bourse main benchmark index (EGX 30) closed the year 2018 at 13,036 as compared to 15,019 in 2017, down by 13.2%, despite attractive market valuations. As to the cost of insuring debt, Egypt's five-year CDS spreads saw expansions of 75 bps in 2018 following two consecutive years of contractions.
- Promising macro prospects over next couple of years**
Looking ahead, Egypt's growth recovery is likely to be extended throughout the year to come. As several base effects fade (of which the tourism sector), the expansion of gas production and construction should drive the uptrend. Within this context, real growth is forecasted at 5.5% for 2019 and 5.9% for 2020, among top performers in the MENA region.

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Egypt's macro environment continued to improve over the past year within the context of the continuation of adjustment reforms and the amelioration of the investment framework, supporting the country's economic prospects on the back of a relative improvement in macro and fiscal fundamentals.

As a matter of fact, all indicators point to a relatively bullish economic cycle. At the real sector level, growth has been revised upwards by the IMF to 5.3% FY 2018, the second highest in the Middle East and North Africa, up from 4.2% in the previous year. It is set to slightly but gradually improve over the next couple of years, with the IMF forecasting it at 5.5% in FY 2019 and 5.9% in FY 2020. It is worth mentioning that the uptrend in real GDP growth is broad-based reflecting the recovery's stronger footing.

At the external level, on the back of improved security, a more competitive pound, and rising hydrocarbon production, Egypt's current account deficit, driven by a significant rise in remittances and touristic receipts, eased to 2.4% of GDP in the 2017/18 fiscal year, from 6.1% of GDP a year earlier. The current account deficit is forecasted to improve further this fiscal year and swing to a surplus in 2021, assuming that the security situation remains stable.

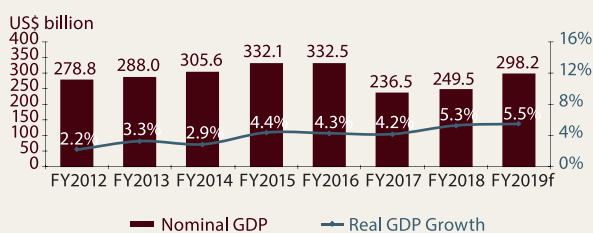
At the fiscal level, public finances continued to improve within the context of the overall IMF program for Egypt. The overall fiscal deficit to GDP ratio declined from 12.5% in 2016 to 10.9% in 2017 and to 9.8% in 2018, while the primary balance to GDP moved from -3.5% in 2016 to -1.8% in 2017 and to +0.1% in 2018. Subsequently gross domestic debt to GDP contracted to 83.3% in 2018 (against 91.1% in the previous year).

At the monetary level, Central Bank reserves have been on an upward trend while inflation has abated. FX reserves reached US\$ 42.6 billion in December, more than tripling in a couple of years, driving a US\$ 12 billion surplus in the balance of payments over the past year. Headline inflation has been falling gradually to reach 12.0% in December, after it hit 33% during last year, though it is still high by comparative developing countries' standards.

At the capital markets level, equity and fixed income markets did not mirror the improvement in macroeconomic conditions. The Stock Market Price Index contracted by 13% in 2018 but amid higher turnover and better market liquidity and efficiency. The annual trading value rose by 7% year-on-year to reach US\$ 20 billion in 2018. As to fixed income markets, the 5-year CDS spreads, a measure of the market perception of sovereign risks, rose by 75 bps in 2018 to reach 391 bps at end-year.

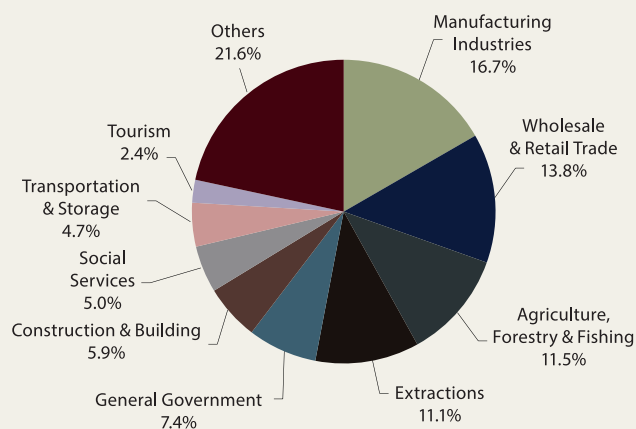
At the banking sector level, activity has been expanding at sound levels, with assets, deposits, loans and profits growing by double-digits annually in USD terms. Deposits grew by 12% in USD terms over 11M 2018. Loans grew by 20% over the same period. The aggregate net profits of 13 banks that issued 9M

GROSS DOMESTIC PRODUCT



Sources: IMF, Bank Audi's Group Research Department

GDP BREAKDOWN BY ECONOMIC ACTIVITY (FY 2018)



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

results rose by 20% in the first nine months of 2018 relative to the same period in 2017, according to the aggregation of Moody's - Bureau Van Dijk figures. It is worth mentioning that Moody's has changed the banking system's outlook from "stable" to "positive" as a result of an improvement in the government profile to which the system is exposed, in addition to an improving economy supporting loan growth and profitability.

The detailed developments in the real sector, external sector, public sector and financial sector follow next, while the concluding remarks are meant to address the near term macro outlook looking forward.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture

Primary sector maintains its position regardless of some water supply challenges

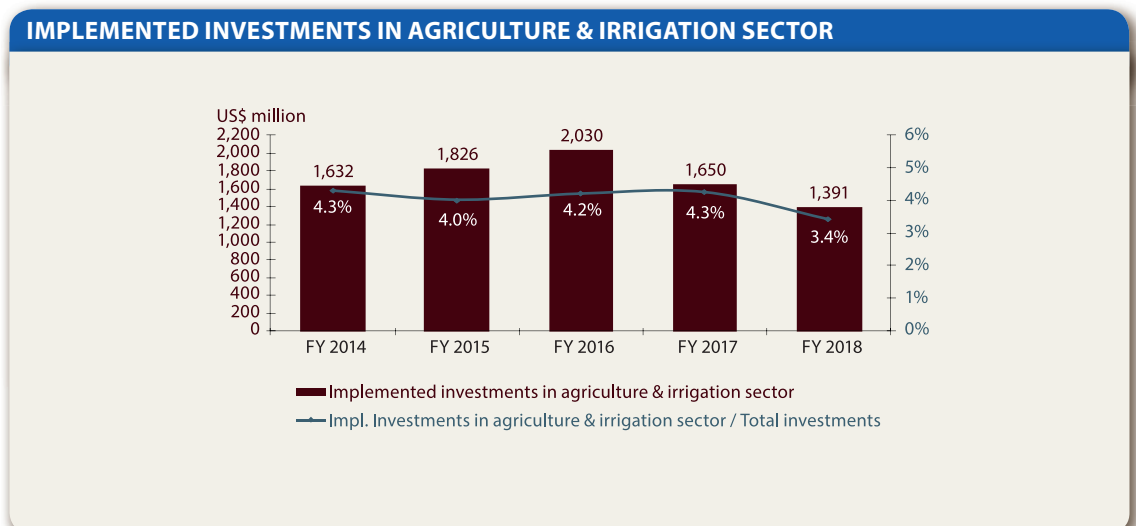
In FY 2018, the primary sector contributed by 11.5% to the Egyptian economy, slightly down from 11.7% in FY 2017. Hence, the sector ranked as the third largest contributor following manufacturing and wholesale and retail trade. Agriculture grew at a yearly 3.1% compared to a growth of 3.2% posted a year earlier.

Total implemented investments in the agricultural and irrigation unit improved by a yearly 13.0% in FY 2018 in local currency terms reversing its decrease in FY 2017. In parallel, the share of bank credit facilities to the sector stood at 1.4% at end-November 2018, edging marginally up from its level in the same period of the previous year.

Looking at the crop production, wheat production will be supported by government programs aimed at improving water irrigation and the shift away from rice production. In 2018, authorities decreased the area of rice production in the coming season by more than half the previous area. In this context, rice production declined by 10.4% year-on-year from 4,800 thousand tons in 2017 to 4,300 thousand tons in 2018, while wheat production improved by an annual 4.3% from 8,100 thousand tons in 2017 to 8,450 thousand tons in 2018. Corn production adopted a rising trend in 2018, increasing by 6.7% year-on-year to stand at 6,400 thousand tons. This highlighted the fact that better water management practices, improved mechanized farming bed practices and high-yield varieties support grain output, as per Fitch. Furthermore, sugar production rose by 6.6% to 2,420 thousand tons in 2018.

It is worth noting that the Egyptian government remains committed to conserving water and enhancing farming practices. In this context, the World Bank funded farm level irrigation modernization project that aims to raise the efficiency of Egypt's irrigation system by 75%.

In conclusion, the Egyptian authorities listed the development of the sector as a priority, ensuring continued levels of investment. However, the sector which remains the third largest contributor to the country's GDP is faced with challenges due to the construction of the Grand Ethiopian Dam which threatens Egypt's water supply via the Nile, hence, emphasizing water security concerns in the country.



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

1.1.2. Industry

Manufacturing and extractive industries see strong performances in FY 2018

In FY 2018, Egypt's manufacturing and extractive industries witnessed strong performances, despite a relatively challenging operating environment, which impacted businesses via high, yet easing, inflation rates.

To start with, Egypt's manufacturing industries maintained a positive growth trajectory over the previous seven fiscal years. Manufacturing industries grew by 4.8% in the past fiscal year relative to a growth rate of 2.1% in FY 2017. It is worth noting that manufacturing industries consist of petroleum refining and other manufacturing subsectors.

The country's petroleum industries grew by 4.1% in FY 2018, compared to a contraction of 3.1% in the previous fiscal year. Other manufacturing industries posted an increase of 5.0% in FY 2018, compared to a 3.7% rise in FY 2017.

The country's extractive industries expanded by 7.7% in FY 2018 compared to a 1.8% contraction in the previous fiscal year. Egypt's extractive industries comprise petroleum industries, gas industries, and other extractions.

The country's petroleum industries witnessed a growth rate of 0.7% in the past fiscal year against a 6.5% contraction in FY 2017. Furthermore, gas industries performed positively, rising by 17.9% in the past fiscal year relative to a 2.1% expansion in the previous fiscal year. Other extractions, the third subsector of extractive industries, grew by 3.1% in FY 2018 against a 3.4% growth in FY 2017.

As for implemented investments, Egypt's crude oil, natural gas and other manufacturing industries were on a mixed path in FY 2018. Implemented investments in crude oil projects contracted by 50.0% in the past fiscal year to reach a total of LE 4,264.6 million. On the other hand, implemented investments in natural gas expanded by 13.8% in FY 2018 to reach LE 75,013 million. Other manufacturing industries contracted by 14.9% in the past fiscal year.

On a different note, the General Authority for Suez Canal Economic Zone signed an LE 10.0 billion (US\$ 557.0 million) contract with Cairo Egypt-based Elsewedy Electric Company to develop land at Ain Sokhna, located 120 km east of the capital. As per the deal, the Egyptian cable maker would construct an industrial city on the sprawling 10-km land and market it at an international and domestic level in a bid to attract foreign and domestic investments to Egypt.

Additionally, the Egyptian Ministry of Electricity and Renewable Energy signed an Engineering, Procurement, and Construction (EPC) contract with a consortium of Dongfang Electric Corporation of Sichuan and Shanghai Electric Group for the construction of the 6,600 MW Hamrawein ultra-supercritical coal-fired power plant. The US\$ 4.4 billion project is estimated to take six years to complete.

In conclusion, with inflation expected to further ease this year, Egypt's industrial sectors are anticipated to remain on an expansionary path as consumer and investment sentiment improve. Egypt's extractive and manufacturing industries would also benefit from the government's remarkable initiatives and industrial investment projects going forward.

1.1.3. Construction

Construction & building sector continues performing strongly in past fiscal year

The Egyptian construction and building sector continued performing strongly during FY 2018, contributing to 5.9% of Egypt's GDP. As a matter of fact, the sector grew by 10.0% in the past fiscal year, against a growth rate of 9.5% in FY 2017.

The value of investments in the country's construction sector remained unchanged from the past fiscal year, in local currency terms, to attain LE 12.6 billion in FY 2018, as per Central Bank data. The share of investment in construction out of total investments in Egypt stood at 1.7% in FY 2018.

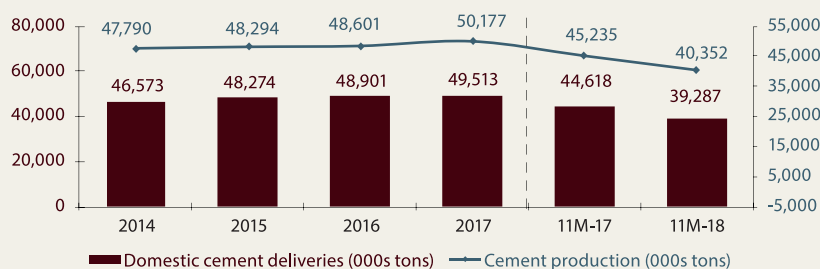
Also, the lion's share of investments in Egypt's construction sector came from the private sector, with its share out of total investment rising to 90.4% in the past fiscal year, almost unchanged from FY 2017.

It is important to note that strong economic growth, ongoing political and macro-economic stability, and a young and growing population boosted international investor confidence in the Egyptian construction sector in 2018. It is worth mentioning that more advanced infrastructure is a central pillar of the Egyptian government's economic diversification agenda.

Within this context, a two km long tourist marina in Egypt's New Mansoura City is scheduled to be opened in 2020. The marina project is being executed by the Egyptian Navy. When open, the marina would have a capacity to handle 1,000 yachts. The first phase of the New Mansoura City is being implemented at a cost of around LE 45 billion (US\$ 2.51 billion), and would be completed within three years.

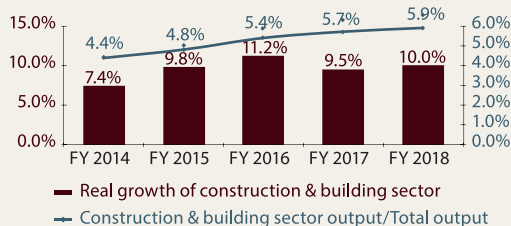
Furthermore, China is expected to increase its market share in Egypt's infrastructure sector over the coming years. The Egyptian Ministry of Electricity & Renewable Energy has resumed negotiations with

CEMENT PRODUCTION AND DELIVERIES



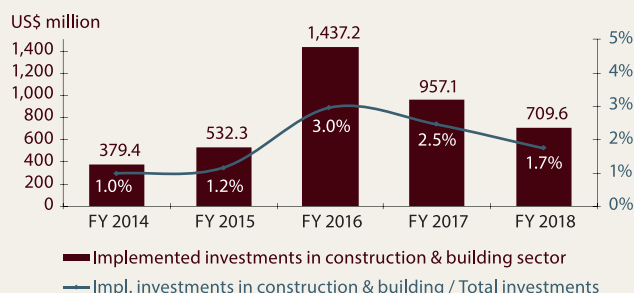
Sources: Central Bank of Egypt, Bank Audi's Group Research Department

CONSTRUCTION & BUILDING SECTOR OUTPUT



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

IMPLEMENTED INVESTMENTS IN CONSTRUCTION & BUILDING



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

China’s GCL Group for a 5 GW solar panel complex. The talks for the integrated solar panel complex were stalled because of GCL’s request to sign a contract with the Egyptian Ministry of Military Production to purchase the entire production from the plant.

In parallel, EgyptAir signed a partnership agreement with KMK Investment and Safe Ports to build a logistics village at Cairo International Airport. KMK would be responsible for the finance, design and construction of a logistics village at the airport. The firm would also be in charge of operating and supervising EgyptAir’s cargo, export and other projects in cooperation with Safe Ports. The project is expected to improve the efficiency, as well as the absorptive capacity, of Cairo International Airport.

Moreover, the Egyptian Ministry of Transport signed a LE 22 billion agreement for supplying and manufacturing 1,300 new railway passenger vehicles, in what might be considered the biggest deal in country railway history. The new agreement was signed with a Russian-Hungarian alliance, led by Russia’s TransMach Holding.

In conclusion, Egypt’s construction sector is anticipated to remain on the upside. The need to manage a quickly growing population would motivate the government to allot State resources and push for international investment in major infrastructure projects, particularly in Egypt’s power and water segments.

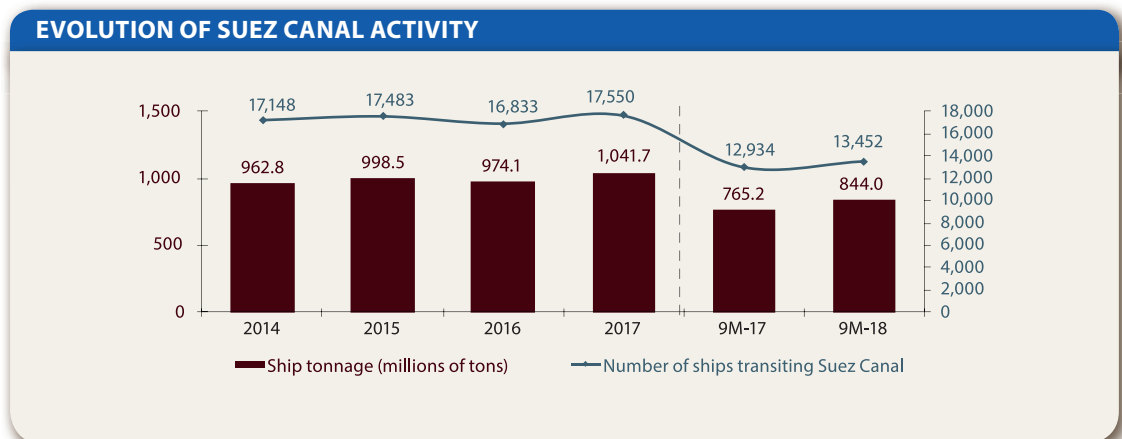
1.1.4. Tourism

Recovery in tourism serves economic growth in Egypt

The tourism sector continued its recovery in 2018, with increases reported in most of the sector’s indicators. Tourism remains one of the main drivers of economic growth in Egypt in recent quarters. However, the sector is highly reliant on a stable security environment.

The sector contributed by around 2.4% to the Egyptian economy in FY 2018 and grew by a real 37.7% over the same year. Moreover, tourism revenues reported growth as well during the first three quarters of 2018 and maintained the path of recovery. Furthermore, tourist arrivals ameliorated from 4,342 thousand tourists in the first seven months of 2017 to 6,146 thousand tourists in the same period of 2018, dragging tourist nights up from 39,439 thousand nights to 63,324 thousand nights over the covered period.

Breaking down the tourists by region, it can be seen that tourists from European countries took over the lion’s share of 59.5% in the first seven months of 2018 and tourists from the Middle East came in next with a share of 22.2%. Tourists from African countries contributed by 7.5% of the total number of tourists, while Asia and the Pacific followed with 6.1%. Americas and other countries took over the last positions with around 4.6% combined of the total number of tourists in the previously mentioned period.



Sources: Central Bank of Egypt, Bank Audi’s Group Research Department

The performance of four and five stars hotels reported improvement. The 11M 2018 hotel benchmark survey issued by Ernst & Young showed that the hospitality sector in Cairo adopted an upward trend whereby hotel occupancy rose by 7.5% from 65.0% in 11M 2017 to 72.4% in the same period of 2018. Alongside, both the average room rate and the rooms' yield in Cairo's four and five star hotels registered increases with the former rising by a yearly 8.5% to stand at US\$ 104 in 11M 2018 and the latter reporting a double-digit rise 20.9% year-on-year to register US\$ 75 in 11M 2018.

According to EY, the significant increase in hospitality performance since the beginning of the winter season may be attributed to the increase in demand due to the winter tourism along with introduction of direct flight services and new air routes to cities in Saudi Arabia, China and Kenya.

The rebound in the tourism sector over the past two years served well the observed growth in the country over the past year, playing an important role in supporting overall investments in Egypt.

1.2. EXTERNAL SECTOR

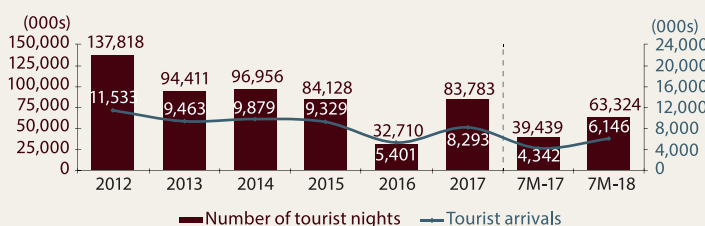
Narrower current account deficit mainly driven by surging services balance

Exchange rate liberalization, a weaker currency, and a higher domestic gas production along with an improved security environment, have helped reduce Egypt's external imbalances in 2018, as current account receipts surged over the first nine months of 2018 mainly on the back of a strong rebound in tourism receipts, remittance inflows and Suez Canal earnings. As such, the current account deficit shrank from US\$ 6.1 billion in the first nine months of 2017 to US\$ 4.1 billion over the first nine months of 2018.

In details, Egypt's foreign trade activity reported during the first nine months of 2018 a yearly rise in total imports by 11.8%, reflecting a steady inflow of capital inputs for infrastructure projects, alongside a 20.0% rise in exports, boosted by a more competitive pound and rising hydrocarbon production led by the Zohr gas field, according to the latest statistics released by the Central Bank of Egypt. As such, Egypt's trade deficit went up by 6.5% from US\$ 26.7 billion during the first nine months of 2017 to US\$ 28.4 billion during the same period of 2018.

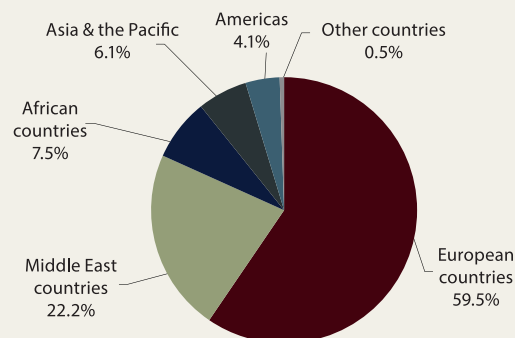
In parallel, total imports reached US\$ 48.9 billion during the first nine months of 2018, compared to US\$ 43.8 billion during the first nine months of 2017. As such, the breakdown of imports by product suggests that the most significant increase among the major categories was reported by imports of intermediate goods with a hike of 20.0% year-on-year to make up 32% of total imports during the first nine months of 2018, followed by imports of consumer goods with a rise of 11.6% over the same period. The breakdown of imports by geographic distribution shows that most of the inward merchandise came from the European

EVOLUTION OF TOURISM ACTIVITY



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

TOURISTS BREAKDOWN BY REGION (7M-18)



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

Union with 26.3% of the total, followed by Asian countries (excluding Arab countries) with 20.8% of the total, and Arab countries with 19.9% of the total over the first nine months of 2018.

At the level of exports, a total of US\$ 20.6 billion was registered during the first nine months 2018, compared to US\$ 17.1 billion during the same period of 2017. As such, the breakdown of exports by product suggests that the most significant increase among the major categories was reported by petroleum exports with a surge of 42.9% year-on-year to make up 37.8% of total exports during the first nine months of 2018 (from 31.8% over the same period of 2017). The geographic distribution of exports indicates that 36.2% of total exports went to the European Union, followed by the Arab countries with 21.2% of the total, and Asian countries (excluding Arab countries) with 11.8% over the first nine months of 2018.

Within this context, the current account deficit narrowed by 31.9% during the first nine months of 2018 relative to the same period of 2017 as per the latest available statistics. The drop in the current account deficit was mainly attributed to a significant surge in services balance by 50.6%, on the back of a hike in tourism receipts by 59.4% due to an overall accelerated tourism activity, and along with an increase in Suez Canal dues by 14.9%. In addition, workers' remittances, a major source of foreign currency, reported an increase of 9.9% in the first nine months of 2018, to reach US\$ 19.4 billion. Within this context, the current account deficit shrank from 6.1% of GDP in FY 2017 to 2.4% in FY 2018, as per the Central Bank of Egypt, while the deficit is expected to narrow gradually and swing to a surplus in the next couple of years, when considering a reduced energy import bill, rising tourism receipts (barring a worsening perception of security risks), and resilient remittances.

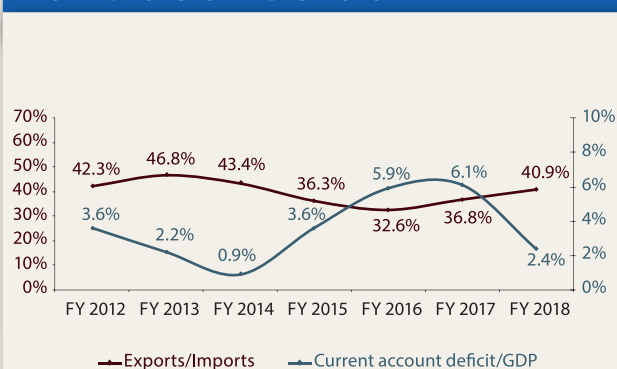
In parallel, the capital and financial account surplus went down by 33.2% during the first nine months of 2018, moving up from US\$ 19.7 billion to US\$ 13.1 billion, as Egypt has struggled to attract major foreign investments outside the oil and gas industry, therefore net foreign direct investment (FDI) contracted by 7.9% over the first nine months of 2018 compared to the same period of 2017. Accordingly, Egypt's balance of payments registered a surplus of US\$ 7.5 billion in the first nine months of 2018, compared to a larger surplus of US\$ 11.8 billion during previous year's corresponding period.

1.3. PUBLIC SECTOR

Fiscal adjustment on track yet challenged by higher interest payments and oil prices

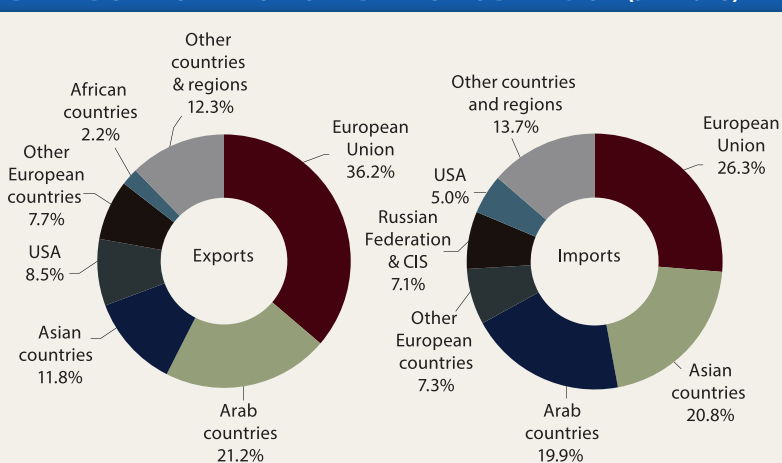
Egypt's fiscal consolidation efforts have been pursued during FY 2018, resulting in a primary budget surplus (0.1% of GDP) for the first time in eighteen years, along with a fall in overall fiscal deficit from a peak of 12.5% of GDP in FY 2016 to below 10% of GDP in FY 2018, for the first time in six years. However, higher oil prices and tight monetary policy resulted in higher fuel subsidies and interest costs, which partly offset the fiscal gains during FY 2018.

FOREIGN SECTOR INDICATORS



Sources: Central Bank of Egypt, IMF, Bank Audi's Group Research Department

BREAKDOWN OF EXPORTS AND IMPORTS BY REGION (9M 2018)



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

Going further into details, total budget revenues went up by a solid 22.2% in local currency terms during FY 2018 as compared with FY 2017, to reach LE 806 billion (US\$ 45.4 billion) or the equivalent of 18.3% of GDP, according to actual figures issued by the Ministry of Finance. The significant rise in budget revenues was due to a hike in tax revenues by 35.9%, boosted by the introduction of the VAT and better tax administration. In parallel, non-tax revenues went down by 9.9% during FY 2018 as compared with FY 2017, mainly due to a drop in property income by 26.1% over the period.

Total budget expenditures were up by 19.1% in local currency terms during FY 2018 relative to FY 2017, to reach LE 1,229 billion (US\$ 69.3 billion) or the equivalent of 27.9% of GDP. The rise in public expenditures was to a significant extent the result of an increase in interest payments on external and domestic debt by 38.1% (representing 35.6% of total expenditures), accounting for more than 60% of the overall increase in public spending and absorbing 84% of the overall increase in tax revenues. For all of the positive policy initiatives, the scale of this debt burden will cap the improvements in the overall budget balance, particularly if the Central Bank proves unable to deliver rate cuts.

In addition, subsidies, grants and social benefits increased by 18.9%, as the fuel subsidy bill has also increased over the last year, owing to higher oil prices. In parallel, workers' wages and compensations grew by a moderate 5.1% (compared to a 5.5% rise in FY 2017). As such, this resulted into an expansion in the overall deficit in local currency terms of a 14.0% in FY 2018, to reach the equivalent of LE 433 billion (US\$ 24.4 billion) and accounting for 9.8% of GDP in FY 2018, down from 10.9% of GDP in FY 2017.

Accordingly, Egypt's gross domestic debt rose by 16.9% in local currency terms in FY 2018 following a 20.6% expansion in FY 2017, to reach the equivalent of LE 3,694 billion at end-June 2018 (or US\$ 206.9 billion). This was mainly triggered by a 12.5% growth in the balances of bonds and bills, within the context of sovereign debt sale aiming at funding the country's fiscal deficit. As such, the gross domestic debt to GDP ratio went down from 91.1% as at end-June 2017 to 83.3% as at end-June 2018, as per the Central Bank of Egypt. In parallel, the external debt went up by 17.2% from end-June 2017 to end-June 2018 (from 33.6% of GDP to 37.0% of GDP between the two periods), to reach US\$ 92.6 billion at end-June 2018, as Egypt has sold more than US\$ 13 billion of foreign-currency denominated bonds since it liberalized the currency in 2016 (of which US\$ 9 billion in 2018), while the country plans to start its foreign currency bond issue offering in the first quarter of 2019, between February and March, to collect between US\$ 3 and 7 billion, as per the Minister of Finance.

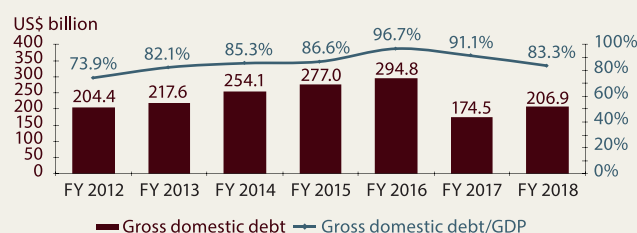
Last but not least, Egypt's Parliament passed the State budget for the FY 2019 with a budget deficit target of 8.4% of GDP (from an actual 9.8% in FY 2018). Total revenues are expected to reach LE 989 billion (up from LE 806 billion in FY 2018), as tax revenues are expected to reach LE 770 billion (up from LE 628 billion). Total expenditures in the FY 2019 budget are expected to reach LE 1,424 billion compared to the LE 1,229 billion in FY 2018. Within this context, it is worth mentioning that the overall budget deficit fell by circa 1% over the first five months of the FY 2019 compared to the same period of FY 2018, as total revenues went up by 27.1%, boosted by a 23.1% rise in tax revenues, while total expenditures increased by 16.7% on the back of an 18.3% rise in interest payments and a 19.1% increase in compensation of employees over the same period.

SELECTED PUBLIC FINANCE INDICATORS

LE billion	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Total budget revenues	456.8	465.2	491.5	659.2	805.7
Total budget revenues/GDP	21.7%	19.1%	18.1%	19.0%	18.3%
Total budget expenditures	701.5	733.4	817.8	1,031.9	1,229.1
Total budget expenditures/GDP	33.4%	30.2%	30.2%	29.7%	27.9%
Overall budget deficit	255.4	279.4	339.5	379.6	433.0
Overall budget deficit/GDP	12.2%	11.5%	12.5%	10.9%	9.8%

Sources: Ministry of Finance, Bank Audi's Group Research Department

GOVERNMENT INDEBTEDNESS



Sources: Ministry of Finance, Bank Audi's Group Research Department

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Declining inflation while FX reserves reach new historical high

Amid improved macro fundamentals, stable exchange rate and abated inflation, the Central Bank of Egypt started easing its monetary policy in 2018 after adopting an aggressive monetary tightening since the currency floatation in November 2016. In parallel, the CBE's foreign exchange reserves have been on an upward trend over the year 2018, hitting a new historical high level in December amid rising remittances and touristic receipts that have triggered contractions in the current account deficit.

In details, consumer prices in Egypt subsided in 2018, mainly reflecting monetary tightening as well as large favorable base effects following the devaluation of the Egyptian pound on November 3, 2016. Accordingly, annual headline inflation reached 12.0% in December 2018, falling from 21.9% in December 2017 and a peak level of 33.0% in July 2017. Similarly, the core inflation, which strips out energy and food prices, followed a downward trajectory over the year 2018, reaching 8.3% in December as compared to 19.9% in December 2017, suggesting that underlying inflationary pressures remain contained.

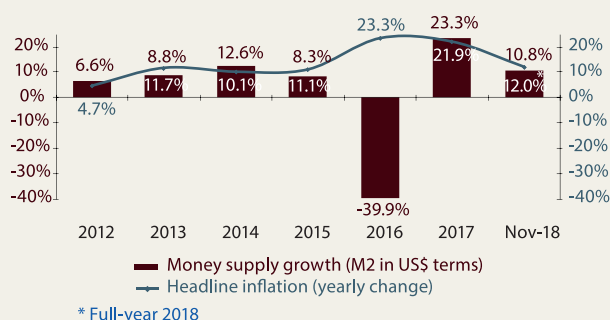
Amid reduced inflationary pressures, the Central Bank of Egypt started at the beginning of the year 2018 easing its tight monetary policy, cutting each of the overnight deposit rate, the overnight lending rate and the rate of CBE's main operation by a total of 200 bps in February and March 2018 to reach 16.75%, 17.75% and 17.25% respectively. Yet, the CBE kept its key policy rates unchanged throughout the year, in consistency with achieving the inflation's outlook and target path.

The Egyptian pound remained widely stable over the year 2018, hovering around LE/US\$ 18 despite a widespread emerging market currency turmoil, mainly supported by an improvement in the country's current account amid a strong growth in tourism activity, remittances inflows and exports. In details, the Egyptian pound closed at LE/US\$ 17.92 at end-December 2018 as compared to LE/US\$ 17.76 at end-December 2017, slightly depreciating by 0.9% against the US dollar. Under these circumstances, it is worth mentioning that the CBE did not intervene on the foreign exchange market over the year 2018.

Supported by a recovery in tourist receipts, strong growth in remittances inflows and international bond sales over the year 2018, the CBE's gross official reserves hit a new record high level of US\$ 42.6 billion at end-December 2018 against US\$ 37.0 billion at end-December 2017, up by a significant 14.9%. Accordingly, the CBE's gross official reserves covered 26.8% of local currency money supply at end-December 2018 and compared to a lower coverage ratio of 26.1% at end-December 2017.

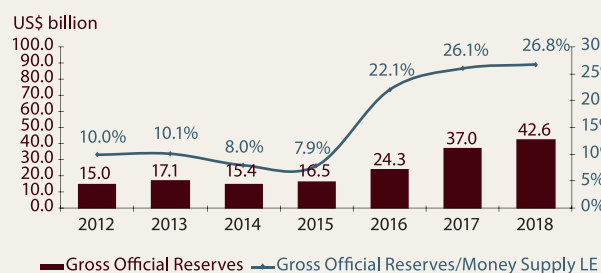
The broader money supply (M2) expanded by a 10.8% in US\$ terms during the first eleven months of 2018, moving up from US\$ 180.3 billion at end-2017 to US\$ 199.9 billion at end-November 2018 amid rising capital inflows. This followed a larger expansion of 23.3% in 2017. Money supply in its narrow sense (M1) widened in US\$ terms by 11.2% during the first eleven months of 2018, following a higher growth of 20.2% in 2017, to reach US\$ 46.2 billion at end-November 2018.

BROAD MONEY AND INFLATION



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

EXCHANGE MARKET INDICATORS



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

Looking forward, the disinflation process is set to continue in the medium term, mainly helped by a weak domestic demand, a significant negative output gap and diminishing risk of supply-side shocks. Within this context, the Central Bank of Egypt set in December 2018 a new inflation target of 9% (± 3 percent) for the fourth quarter of 2020, after meeting the target of 13% (± 3 percent) during the fourth quarter of 2018.

1.4.2. Banking Activity

Strong deposit and lending growth amid a continuously expanding economic activity

Egypt's banking sector witnessed a good year during 2018 on the back of relatively ameliorated domestic conditions and continued healthy economic activity at large. Banks benefited from increased liquidity at hand through deposits to enhance their financial intermediation role and extend new waves of loans to the economy while continuing to lend to the public sector. Measured by the aggregated assets of banks operating in the country, Egypt's banking sector activity grew by 15.9% in local currency terms (+14.9% in US dollar terms) in 11M2018 to reach the equivalent of US\$ 311.3 billion at end-November 2018 as per the latest official figures.

On the funding side, total deposits that account for 67% of total balance sheets and thus constitute the major activity driver of banking activity, contributed the most to total balance sheet growth in the first 11 months of 2018 (56% of total growth). Total deposits at banks in Egypt rose by 13.0% in local currency terms over the covered period to reach the equivalent of US\$ 209.9 billion at end-November 2018.

The rise in deposits is overwhelmingly attributed to the private sector to the extent of 80% while government deposits accounted for 20% of total growth in 11M2018. Among private sector depositors, the household sector, providing banks with stable deposits on the overall, was by far the largest contributor to deposit growth during 2018, followed by the private business sector, both of which have increased their deposits in local currency at a faster pace than those in foreign currencies. As a result, the deposit dollarization ratio reached 22.7% at end-November 2018, against 24.0% at end-2017.

On the asset utilization side of banks' balance sheets, additional funding was primarily used to extend loans to the economy and increase liquidity with the Central Bank (offsetting the decline in placements at banks abroad) while continuing to invest in government debt papers.

At the level of lending, banks operating in Egypt extended new waves of loans to the economy during 2018, with risk appetite ameliorating further and companies' need for funding rising. As a matter of fact, credit facilities extended by banks grew by 21.0% in local currency terms in the first 11 months of 2018 to reach the equivalent of US\$ 98.8 billion at end-November 2018.

Credit facilities extended to the government accounted for 55% of new loans over the covered period (mostly in foreign currencies), leaving 45% to the private sector (in local currency as those in foreign currencies slightly retreated in 11M2018). Retail lending drove new loans in local currency the most, followed by the industrial sector, the services sector and the trade sector in respective order. Egyptian authorities pursued their supportive policies towards the private sector when it comes to lending, as they extended anew their initiative to support the tourism sector and workers in the tourism sector through retail loans until end-December 2019.

Banks are likely to deepen their financial intermediation role in the period ahead, noting that loans to SMEs account for 5%-8% of gross loans, as per Moody's estimates, with the latter adding that new regulations require banks to increase SME lending to 20% of gross loans by 2020, which should further diversify loan books.

At the level of liquidity, banks in general maintain solid liquidity buffers and actively manage their balance sheets to offset interest rate and liquidity risks arising due to sizeable exposure to government debt papers. In the covered period of 2018, liquidity increased on the overall, especially as banks hiked their funds parked at the Central Bank of Egypt. Furthermore, the banking sector's liquidity coverage ratio (LCR) is higher than 150% for both local currency and foreign currencies and thus way above the 90%

regulatory minimum for 2018 that is expected to rise to 100% in 2019. The LCR is particularly high in the local currency where most of banks' investments in government bonds are held, noting that a good chunk of the latter is in short-dated Tbs. In parallel, the net stable funding ratio (NSFR) is also high at 218% on aggregate at end-September 2018 as per latest Central Bank data, more than twice higher than required by the regulator.

At the level of public sector lending and as we noted here above, Egyptian banks are considerably exposed to government securities, leading to high concentration risks for the sector. Last year, banks have further increased their exposure by purchasing additional local currency denominated debt papers, noting that their total securities portfolio rose by 5.6% in 11M2018 mostly due to local currency government papers. Total exposure to the government sector through securities accounted for 30% of total assets at end-November 2018, retreating from 43% at end of FY 2016. Sovereign exposure through government securities nonetheless remains considerable and accounts for nearly five times banks' capital and reserves.

The recent expansion in banks' lending has contributed to a further decline in the non-performing loans to total loans ratio, which reached 4.4% at end-September 2018 against 4.9% at end-December 2017 and close to double-digit levels a few years ago. The decline was also helped by the stricter underwriting standards required by the regulator and the write-off of legacy loans at some banks. In parallel, banks operating in Egypt are well buffered against potential losses, given that non-performing loans are almost fully covered by loan provisions. The provisioning coverage ratio actually reached 98.1% at end-September 2018, almost stable over the covered period. Asset quality metrics of Egyptian banks thus compare quite favorably to regional, emerging market and global benchmarks. Egyptian banks are almost on par with the region's averages for NPL ratio and provisioning coverage ratio while the EM and global averages are in the 7%-8% range for NPL ratio and in the 60%-70% range for the provisioning coverage ratio.

In parallel, banks operating in Egypt have witnessed an improvement in capital ratios in the covered period of 2018. The capital base to risk weighted assets ratio as published by the Central Bank of Egypt reached 16.0% at end-September 2018, against 15.2% at end-December 2017 and levels under the 14% mark a few years ago, thus above minimum requirements and constituting buffers against potential pressures on capital. The bulk of capital is composed of Tier 1 capital given the 13.0% Tier 1 capital to risk weighted assets ratio at end-September 2018 (12.1% at end-December 2017). This happened in the context of the sector regulator's decision to permit banks to include current year profits in the capital adequacy ratio compilation and prohibit all banks from making dividend payments. Regulatory capital requirements have risen in line with Basel III standards, and systemically important banks will see further amendments to regulations during 2019.

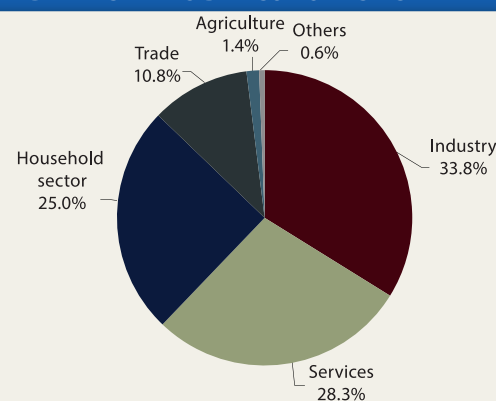
Last but not least, banks' bottom lines have been favored by the positive quantity-effect stemming from healthy lending activity growth, high yields on sovereign debt papers and higher fees and commissions. In the absence of recent consolidated sector data, we resorted to the analysis of figures provided by

BANKING SECTOR INDICATORS

US\$ million	2012	2013	2014	2015	2016	2017	Nov-18
Banking Activity							
Assets	226,556	242,209	275,375	317,393	218,738	271,022	311,269
Deposits	171,486	189,242	218,210	244,484	152,411	187,462	209,896
Credit Facilities	81,248	79,134	88,028	101,073	71,773	82,398	98,812
Capital + Reserves	15,834	16,296	17,174	18,033	13,985	18,082	19,658
Growth rates							
Assets	4.5%	6.9%	13.7%	15.3%	-31.1%	23.9%	14.9%
Deposits	4.6%	10.4%	15.3%	12.0%	-37.7%	23.0%	12.0%
Credit Facilities	0.1%	-2.6%	11.2%	14.8%	-29.0%	14.8%	19.9%
Capital + Reserves	17.0%	2.9%	5.4%	5.0%	-22.4%	29.3%	8.7%

Sources: Central Bank of Egypt, Bank Audi's Group Research Department

BANK CREDIT FACILITIES BY ECONOMIC ACTIVITY*



* As at end-November 2018

Sources: Central Bank of Egypt, Bank Audi's Group Research Department

Moody's –Bureau Van Dijk's Bank Focus. The latter show a 20% increase on a yearly basis of banks' profits after tax in local currency terms in the first nine months of 2018 based on the aggregated figures of 13 banks that issued results over the covered period.

1.4.3. Equity and Bond Markets

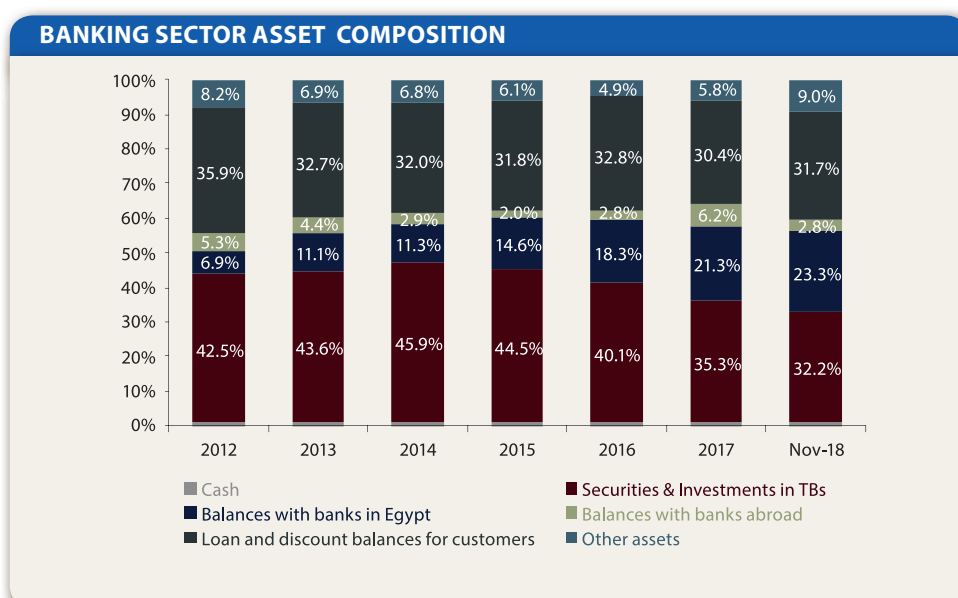
Noticeable price falls in Egyptian capital markets in 2018, tracking wide emerging market sell-off

Egypt's capital markets reversed in 2018 the upward trend that was prevailing over the past couple of years, mainly weighed down by an emerging market sell-off, US Treasuries declines amid a sustained US monetary policy tightening, and lingering fears of a global economic slowdown. As to the cost of insuring debt, Egypt's five-year CDS spreads saw expansions in 2018 following two consecutive years of contractions.

The Egyptian Exchange did not mirror the improvement in the country's macroeconomic conditions over the year 2018, as the fiscal reforms achieved since the November 2016 currency floatation were already discounted in equity prices, while several market-specific factors contributed to dragging down Egyptian equities, including a sustained gradual US monetary policy tightening, a wide sell-off in emerging markets (as reflected by a 16.8% drop in the S&P Emerging Frontier Super Composite Index), lingering US-China trade disputes that have stoked worries about global economic growth, and an increase in average oil prices in 2018 which left a negative spillover effect on the oil-importing country.

The bourse main benchmark index (EGX 30), which is the price index of the 30 most highly capitalized and liquid stocks, closed the year 2018 at 13,036 as compared to 15,019 in 2017, down by 13.2%, despite attractive market valuations, as the Egyptian stocks traded at a P/E of 12.1 times at year-end 2018 as compared to a much higher P/E of 18.8 times at end-2017. The breakdown of the index by sector shows that nine out of 12 sectors registered price falls in 2018 (seven of which posting double-digit price drops). The telecommunications sector led the fall, plunging by 38.8% year-on-year, followed by the construction and material sector (-35.7%), the personal and household products sector (-25.5%), the real estate sector (-21.4%), the healthcare and pharmaceuticals sector (-14.8%), the basic resources sector (-13.6%), the chemicals sector (-13.5%), the food and beverage sector (-8.9%) and the banking sector (-5.1%). In contrast, the travel and leisure sector posted price gains of 26.0%, followed by the industrial goods, services and automobiles sector (+15.3%), and the financial services sector excluding banks (+3.6%).

Alongside an equity price slump, the number of listed companies on the Egyptian Exchange declined from 222 companies at end-2017 to 220 companies at end-2018. This led to a 9.1% contraction in the



Sources: Central Bank of Egypt, Bank Audi's Group Research Department

market capitalization in local currency terms, moving from LE 824.9 billion at end-2017 to LE 749.7 billion at end-2018, which is equivalent to circa LP 75 billion.

The total volume of traded shares dropped from 77,946 million shares in 2017 to 60,771 million shares in 2018. The total number of transactions fell by 10.7%, moving from circa 7.0 million transactions in 2017 to circa 6.3 million transactions in 2018. However, the total trading value rose from LE 332.2 billion in 2017 to LE 358.5 billion in 2018, up by 7.9%. Accordingly, the average monthly trading value increased from LE 27.7 billion in 2017 to LE 29.9 billion in 2018.

Egyptian market players captured 64% of the total value traded in 2018, while foreign investors accounted for the remaining 36%. Individuals captured 56% of activity in 2018, allocated between 50% for Egyptians and 6% for foreigners. Institutional investors accounted for the remaining 44%, and were distributed as 14% for Egyptian institutions and 30% for international institutions, noting that institutional investors were net buyers over the year 2018, recording net inflows of LE 4.5 billion against net inflows of LE 4.6 billion in 2017. Given a yearly increase in total activity and a contraction in the market capitalization, the turnover ratio, measured by total trading value to market capitalization subsequently increased from 40.1% in 2017 to 48.1% in 2018.

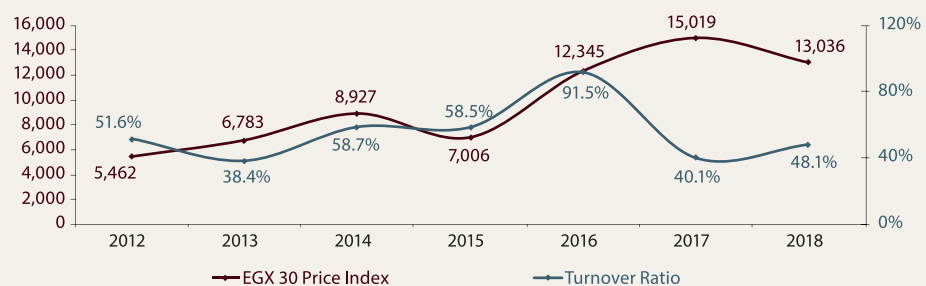
It is worth mentioning that in the aim of improving the country's investment environment, the Egyptian Parliament passed early-2018 a new bankruptcy law, regulating the restructuring, preventive reconciliation and bankruptcy in Egypt. Also, the Ministry of Investment and International Cooperation

CAPITAL MARKETS INDICATORS

	2012	2013	2014	2015	2016	2017	2018
Market capitalization (US\$ billion)	59.0	61.4	69.9	54.9	33.2	46.4	41.8
Total value traded (US\$ million)	30,473	23,555	41,044	32,091	30,389	18,640	20,128
Non-Arab foreign participation as % of total value traded	14.9%	14.3%	9.7%	11.1%	11.5%	17.7%	23.2%
Total volume of traded securities (million)	34,261	29,190	57,230	45,078	68,559	77,946	60,771
Total number of transactions (000s)	6,234	4,790	7,328	4,875	6,008	7,034	6,278
No. of listed companies	213	212	214	221	222	222	220
No. of traded companies	204	204	206	209	209	213	218
% Change in price index (EGX 30)	50.8%	24.2%	31.6%	-21.5%	76.2%	21.7%	-13.2%
P/E ratio (times)	12.4	15.2	20.2	13.6	26.6	18.8	12.1
Dividend yield	8.6%	6.5%	9.3%	7.7%	9.0%	5.7%	6.9%
CDS spreads (bps)	510	605	282	531	450	316	391

Sources: Egypt Stock Exchange, Bank Audi's Group Research Department

STOCK MARKET PERFORMANCE



Sources: Egypt Stock Exchange, Bank Audi's Group Research Department

made some adjustments to the executive regulation in the Corporation Law for the purpose of boosting Egypt's doing business ranking. In the coming period, the Egyptian Exchange's agenda includes issuing rules regarding market makers and short selling operations, updating e-trading platforms, launching a new spot commodity exchange and improving the electronic disclosure system for EGX-listed companies, which is set to enhance the Egyptian stock market's efficiency, liquidity and depth.

In parallel, the Egyptian fixed income market came under downward price pressures in 2018 amid a wave of foreign outflows estimated at circa US\$ 10 billion, mainly tracking a wide sell-off in emerging markets at large (as reflected by a 38% expansion in JP Morgan EMBIG Z-spread), a gradual sustained US monetary policy tightening and a stronger US dollar after the US Federal Reserve lifted its benchmark interest rate four times over the year, while also dragged by concerns about a global economic slowdown amid lingering US-China trade disputes.

That being said, Egyptian sovereigns maturing in 2020, 2022, 2025, 2027, 2040 and 2047 registered price falls ranging between 3.76 pts and 24.54 pts in 2018, along with Z-spreads expansions of 73 bps to 204 bps. Price drops occurred despite credit rating upgrades and changes in outlook by international rating agencies over the year 2018. In fact, Fitch revised in January 2018 the outlook on Egypt's long-term foreign currency Issuer Default Rating to "positive" from "stable" while affirming the IDR at "B", citing significant progress with its reform program. Standard & Poor's raised in May 2018 its long-term foreign and local currency sovereign credit ratings on Egypt to "B" from "B-"; with a "stable" outlook. The upgrade reflects, according to S&P, strengthening GDP growth and rising external foreign exchange reserves, alongside the implementation of reforms. Also, Moody's changed in August 2018 the outlook on Egypt's long-term issuer ratings to "positive" from "stable" and affirmed its "B3" issuer ratings amid continuing structural improvements in the fiscal and current account balances.

Yet, the Egyptian fixed income market started to witness a price recovery in January 2019. US-dollar denominated sovereigns maturing between 2020 and 2048 registered price gains of up to 5.75 pts and Euro-denominated sovereigns maturing in 2026 and 2030 posted price increases of 3.07 pts and 3.90 pts respectively. This was mainly supported by the return of a decent foreign bid to the market as Egypt provided an attractive carry trade opportunity. In fact, the US dollar yield for US-denominated Senior Unsecured fixed rate bonds reached 7.06% at end-2018 as compared to 4.97% at end-2017, and the LE yield for LE-denominated Senior Unsecured fixed rate bonds hit 18.22% at end-2018 as compared to 15.59% at end-2017. Within this context, the Egyptian Finance Minister unveiled recently that foreign holdings of Egyptian Treasury bills and bonds climbed by US\$ 900 million in January 2019.

Regarding new issues, Egypt raised US\$ 6.57 billion in 2018 through the sale of US\$ 1.25 billion five-year notes at a coupon of 5.58%, US\$ 1.25 billion 10-year notes at 6.59%, US\$ 1.5 billion 30-year notes at 7.90%, US\$ 860 million notes maturing in 2026 at 7.125% and US\$ 1.71 billion notes maturing in 2030 at 7.625%. Egypt also raised € 2.0 billion in 2018 through the sale of € 1.0 billion notes maturing in 2026 at a coupon of 4.75% and € 1.0 billion notes maturing in 2030 at 5.625%. Within this context, it is worth mentioning that Egypt mandated banks in January 2019 to manage US dollar-denominated and Euro-denominated bond sales in addition to plans to issue green bonds by the end of fiscal year 2019, which are bonds earmarked to be used for climate and environmental projects. As to the cost of insuring debt, Egypt's five-year CDS spreads expanded by 75 bps in 2018 to reach 391 bps at end-December, before contracting to 369 bps early-February 2019.

In the coming period, the country's solid macro fundamentals and growth outlook, the stable Egyptian pound, the US Federal Reserve's recent decision to be "patient" when making decisions about future monetary policy, the attractive Egyptian yields as they are the highest in emerging markets after Argentina, the attractive market pricing ratios on the equity market, and bets that the Central Bank of Egypt would further cut key interest rates amid eased inflation, all together are set to help attracting demand for Egyptian securities.

2. CONCLUDING REMARKS

Looking ahead, Egypt's growth recovery is likely to be extended throughout the year to come. As several base effects fade (of which the tourism sector), the expansion of gas production and construction should drive the uptrend. Within this context, real growth is forecasted at 5.5% for 2019 and 5.9% for 2020. It is worth noting that Egypt's IMF program remains on track while it is widely expected to be rolled over by end-2019.

At the monetary level, the Central Bank of Egypt is likely to keep rates on hold through the end of the fiscal year in June, while rate cuts are expected in the second half of the year. The Central Bank is seeking to balance the impact of easing inflation with the risks of further currency volatility as the US dollar gains momentum. In parallel, inflation is expected at 14% in 2019 and 10.9% in 2020, with the monetary policy focus being primarily inflation targeting. At the currency level, despite downward pressures on the pound emanating from the relatively higher domestic inflation relative to Egypt's trading partners, developments in the balance of payments should be supportive in the medium term.

At the fiscal level, fiscal policy is increasingly challenged by short term debt maturities. But the economic reform program agreed with the IMF will ensure that progress is made on fiscal consolidation, although business-related reforms would probably proceed slowly. Public finances are likely to be strengthened by rising tax revenue in tandem with higher real GDP growth, while the government should continue to divert spending away from subsidies towards public services such as healthcare and education. Within this context, the fiscal deficit is likely to improve further to 7.9% in 2019 and to 6.5% in 2020, as per the IMF, with debt to GDP subsequently expected to continue to contract over the next couple of years, as per the same source.

At the foreign sector level, the current account will record shrinking deficits over the next couple of years, as export growth outpaces import growth, which will be slowed by rising domestic fuel production. The current account deficit to GDP ratio is likely to decline to 2.4% in 2019 and to 2.2% in 2020, as per the IMF, before moving into surplus by 2021. It is worth mentioning that sources of income such as official transfers, tourism receipts, remittances and Suez Canal earnings are likely to be affected by slower global growth over the next couple of years. The current account deficit will be financed out of the Central Bank's foreign reserves, which will be buttressed by inflows of loans – including Central Bank deposits and FDI.

When assessing the near and medium term outlook of the Egyptian economy, we need to look at key strengths and underlying challenges at the horizon. Among key strengths, we mention the country's large and diversified economy, the wide domestic funding base, the replenished foreign exchange reserves, the broad based recent growth performance and the reversal of growth toward pre-Arab Spring levels, in addition to the prospects of renewed gas exports at large. Among weaknesses, we mention the large government financing needs of 30% to 40% of GDP annually, the relatively high inflation rates, the elevated government funding costs and the security risks and threats in certain areas around the country. Having said that, we believe strengths outpace weaknesses and opportunities outpace threats at the horizon.

To minimize risks and reinforce opportunities, a number of key recommendations emerge. In its recent IMF Article IV Consultation report, the Fund recommended that authorities should monitor risks to the program arising from increased global risk aversion, higher international oil prices, and reform fatigue. In parallel, the CBE should maintain its restrictive monetary policy stance until inflation expectations are well anchored. Finally, preserving and further enhancing exchange rate flexibility is critical to sustain the gains in macroeconomic stabilization, and cushion against external shocks.

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