Economic Update

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Egypt outlook

Growth outlook solid as government pushes on with reforms

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Highlights

- Economic growth should remain at a robust 5% as the government presses on with its reform agenda.
- The cheaper pound has seen exports grow strongly and tourism continue to recover, while unemployment has fallen.
- Inflation has come down to a still-high 11% but could rise in 2H18 following fresh subsidy cuts.
- The prospect of higher inflation has seen the central bank pause in its interest rate cutting cycle.
- The fiscal deficit should narrow to below 9% of GDP in FY18/19 amid further revenue measures and spending restraint.
- The current account deficit widened in 1Q18, but the external position overall is much stronger thanks to capital inflows.

The economy has continued to recover from the crisis of late 2016, which saw the currency devalued and a three-year IMF support package worth $12 billion predicated on a package of macroeconomic policies and structural reforms. Following the re-election of President Sisi for a second four-year term in April 2018, the government looks set to press ahead with the reform agenda, which aims at cutting subsidies, reducing the still-large fiscal deficit, while boosting long-run growth and job creation. Although the economy faces a number of long-term challenges including persistently high inflation and unemployment, poverty and low levels of investment, near-term prospects remain bright, with growth supported by the more competitive currency, recovering tourism, falling domestic interest rates and more orthodox policymaking than in pre-crisis years.

Growth to remain robust at close to 5%

GDP growth came in strong in the second half of 2017 (1H FY2017/18), averaging 5.2% y/y. This compares to growth of 3.6% in FY2016/17 and 2.3% a year earlier. Growth in 2H17 was boosted by a strong pick-up in both exports and investment, while growth in the private sector outpaced that in the public sector, at a healthy 5.4%. Reflecting the improving conditions, unemployment fell to 10.5% in 1Q18 from 12% a year earlier, its lowest in eight years.

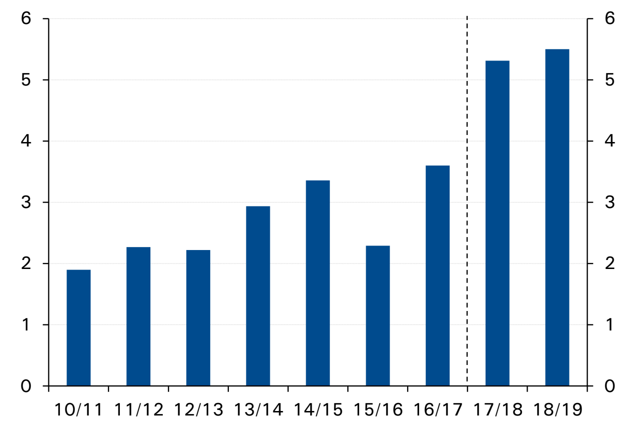
The Purchasing Managers Index (PMI) has confirmed the pick-up in activity seen over the past year, averaging close to 50 in January-May (+8% y/y) and peaking above the 50 mark in April for only the second time since 2015. Strength has been seen in both the output and new orders components. The export orders component has eased back to around 50, having recovered strongly last year, but remains well above the low of just 36 recorded before the currency float.

Table 1: Key economic indicators

		FY16/17	FY17/18f	FY18/19f	FY19/20f
Nominal GDP	EGP bn	3,470	4,387	5,089	5,853
Nominal GDP	USD bn	251	248	288	331
Real GDP	% y/y	3.6	5.3	5.0	5.0
Inflation	% y/y	23.5	20.6	10.0	9.0
Budget balance	% of GDP	-10.9	-10.0	-8.5	-7.0

Source: Official sources, NBK estimates

Chart 1: Real GDP



Source: Thomson Reuters Datastream / NBK

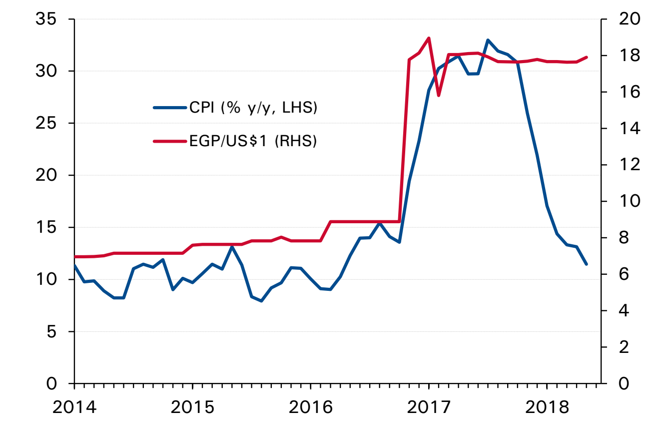
Growth is also supported by improved trade, which has been helped by a more competitive pound. Export receipts were up strongly at 14% y/y in the first four months of 2018, though slightly off the 20%+ rate recorded at the end of last year. Tourism numbers have also strengthened, with arrivals up 54% y/y in 4Q17, albeit remaining well below pre-"Arab Spring" levels.

Based upon improved policy-setting, the more competitive currency, rising tourism, falling inflation and interest rates (see below) and progress on reforms, we expect growth to remain solid over the short-to-medium term, at around 5% in both FY2017/18 and FY2018/19. Growth will also benefit from a rise in natural gas output including from the offshore Zohr gas field, where production could reach 2.7 billion cubic feet per day by end-2019 and add 2% to the level of GDP.

Inflation has returned to more moderate levels

Inflation surged in the months following the currency float in November 2016, with higher import prices, domestic supply shortages, subsidy cuts and the introduction of (and then increase in) VAT pushing it to a peak of 33% in July 2017. (Chart 2.) It has since come down sharply, thanks in part to the fading impact of the currency depreciation but also tighter monetary policy by the central bank (CBE). The inflation rate had fallen to 11.5% y/y in May 2018 (core 11.1% y/y) – still high but a level similar to its average in the years before the currency float.

Chart 2: Consumer price inflation and the exch. rate



Source: Thomson Reuters Datastream

Recent fresh cuts in utility subsidies are expected to push inflation back up over coming months, before it resumes its downward path in the autumn. We expect inflation to average 21% in FY2017/18, falling to 10% in FY2018/19. The decline in inflation has given the central bank space to cut interest rates by 200 bps in the first half of 2018, leaving its overnight deposit and lending rates at 16.75% and 17.75%, respectively, though it held off from further cuts at its policy meeting in June. The CBE is targeting inflation at 13% +/- 3% in 4Q18 and falling to single digits thereafter. It views the main upside risks to this outlook as rising oil prices, demand-side pressures and the inflationary impact of fiscal reforms and is seen maintaining a cautious approach to policy loosening going forward.

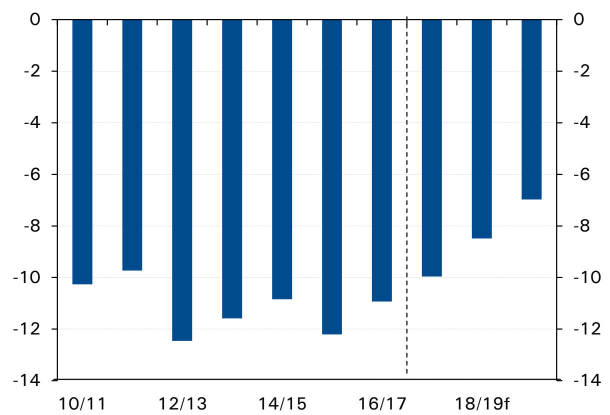
Budget deficit narrowing gradually, but still large

The government has made good headway implementing the fiscal reforms agreed under the IMF program and, as a result, the fiscal balance has seen some improvement. VAT was introduced in September 2016 at 13% then raised to 14% in July 2017; electricity and fuel prices have risen multiple times – the latter four times since 2014 with subsidies due to be eliminated by end-2019; and excise duties were raised on tobacco last year. There has also been more stringent control of the wage bill and improvements in revenue collection.

The budget deficit narrowed to 10.9% of GDP in FY2016/17 from 12.2% a year earlier, and figures for the first eight months of FY2017/18 point to further improvement. Spending was up 29% y/y in July-February on higher interest payments and social payouts, but revenues rose a stronger 39% y/y, reflecting increases in tax revenues. Despite an increase in expenditures, including on wages and pensions to compensate for some of the impact of lifting subsides, the official budget for FY2018/19 still targets a deficit of 8.4% of GDP as revenues are expected to increase as well. Given recent trends, strong economic growth and the apparent commitment to reform, we think this target is achievable.

Chart 3: Fiscal balance

(% of GDP)



Source: Thomson Reuters Datastream / NBK

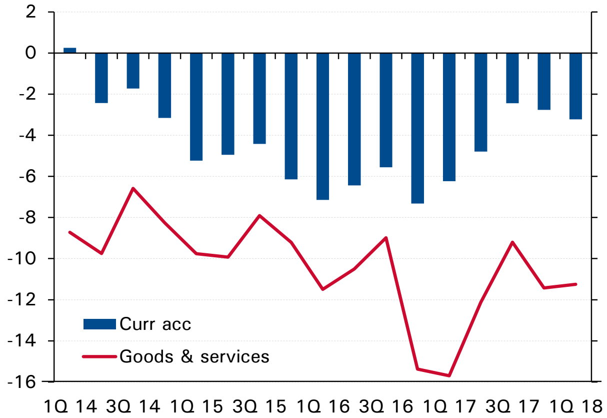
The improved picture is also reflected in better financing conditions. Yields on the government's short and long-term domestic debt – the bulk of total debt – have declined this year due to lower policy rates and inflation, but the 10-year yield remained high at 15% in May. Yields on external debt however have risen alongside international rates. Public debt rose to around 100% of GDP in 2017, but given high inflation and the narrowing fiscal deficit, is forecast to decline to around 90% of GDP by 2019. However, the government's credit rating has barely improved at well below investment grade (Moody's at B3; S&P the exception, having upgraded to B from B- in May), with rating agencies waiting to see further progress on reducing the deficit given still large funding needs and the potential for reform fatigue.

Current account still in deficit, but reserves stronger

The current account deficit widened to 3.2% of GDP, or $1.9 billion in 1Q18 from 2.8% in 4Q17 and a three-year low of 2.4% in 3Q17. (Chart 4.) But this is still well below the 7.3% of GDP peak recorded in 4Q16 just after the currency float. The widening in 1Q18 was due to a rise in the deficit on investment income, which has climbed in the past two years helped by rising interest payments and dividend payments from Egypt-based international oil companies. The goods and services deficit meanwhile narrowed slightly to 11.2% of GDP on strong growth in exports. Transfer payments stood at a very large surplus of 10.8% of GDP and was more than double its levels of two years ago due to the impact of the cheaper pound on remittance payments from overseas – traditionally an important source of support for the external position.

Chart 4: Current account balance

(% GDP)



Source: Thomson Reuters Datastream / NBK

Meanwhile the overall balance of payments swung further into surplus in 1Q18 at 9.0% of GDP, or $5.4 billion, its best figure since 2005. Key to the improvement have been rising capital inflows notably portfolio investment, at $6.9 billion in 1Q18. Investors have taken advantage of higher domestic interest rates and the cheaper currency, and foreigners now hold nearly one-third of all treasury bills outstanding versus almost none before the currency float. The improvement has also resulted in a sharp recovery in the central bank's foreign reserves, which rose to $44 billion in May 2018, up 42% y/y and from a low of $16 billion nearly two years earlier. (Chart 5.)

The government has received a $2 billion installment from the IMF in July at the completion of the third review under the program, taking the total received to $8 billion so far and boosting reserves further.

Chart 5: International reserves

($ billion)

Source: Thomson Reuters Datastream

Equity market sees further gains in 2018

The main stock market index jumped nearly 50% in the two months after the currency float, then followed this with a further 22% rally in 2017. (Chart 6.) In the first half of 2018, the index has outperformed most regional markets, rose 9%, helped by strong economic growth prospects, the more stable external climate, lower domestic interest rates and positive news on financial support from the IMF. However, this increase has not been enough to keep pace with the decline in the pound's value, and the index is still below November 2016 levels in US dollar terms.

Chart 6: EGX 30 stock market index

(index)

Source: Thomson Reuters Datastream

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