Macroeconomic outlook

Egypt: GDP growth picks up in 1H17; investment boosts foreign reserves

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Overview and outlook

- **Growth improved to 3.6% in FY16/17, and is seen accelerating to 4.5% and 5% in FY17/18 and FY18/19.**
- **Reforms have made significant progress, with a positive impact on activity, on external and fiscal resilience, and on sentiment.**
- **Fiscal deficit narrowed to 11% of GDP in FY16/17; expected to decline to 8.5% in FY17/18 and 7.5% in FY18/19.**
- **Double-digit inflation has been a key concern; inflation seen easing on tighter monetary policy and stable pound.**

The economic recovery strengthened noticeably during the first half of 2017 following the 2016 slowdown. The economy has benefited from strong export growth, a revived tourism sector (albeit from a low base) and a healthy increase in investment. The government's reform program, starting with the November 2016 decision to float the pound, is already having a positive impact on the economy and on sentiment. The IMF's $12 billion loan agreement late in 2016 and the positive first program review in July provided a much-needed boost to investor confidence. As a result, the country's foreign reserves have improved significantly.

Economic activity made a noticeable improvement in 1H17

The economy showed strong signs of improvement during the first half of 2017. Real GDP growth accelerated to 4.1% year-on-year (y/y) and 4.9% in 1Q17 and 2Q17 (Chart 2), respectively. This compares to just 2.3% average growth in 2016. Growth has also been driven largely by the private sector, which grew by 5% y/y in 1Q17. The public sector has also seen growth accelerate but the pace, at 2.4%, remains slower.

Though the Purchasing Managers' Index (PMI) has improved, it has not seen quite the same strength as the national account figures. The index, which rose to 48.9 in August, its best level in nearly two years, remains at levels consistent with GDP growth of only 2-3%. Nonetheless, the index has shown particular strength in exports. New orders and export orders have been improving for months, thanks in part to the cheaper currency.

Economic growth has been driven largely by recoveries in tourism and exports. The latest trade data shows exports rising by 15% y/y in USD terms during the first five months of the year. Tourism also bounced back,

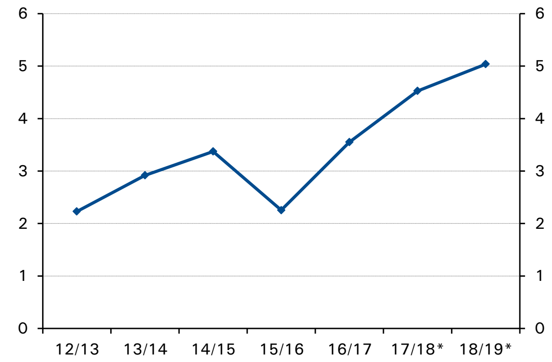
Table 1: Key economic indicators

		FY15/16	FY16/17	FY17/18f	FY18/19f
Nominal GDP	EGP bn	2,708	3,462	4,319	4,954
Nominal GDP	USD bn	326	250	235	263
Real GDP growth	% y/y	2.3	3.6	4.5	5.0
Inflation	% y/y	14.0	30.0	13.0	9.0
Budget balance	% of GDP	-12.1	-10.9	-8.5	-7.5

Source: CBE, MOF, MOP, NBK estimates

Chart 1: Real GDP growth

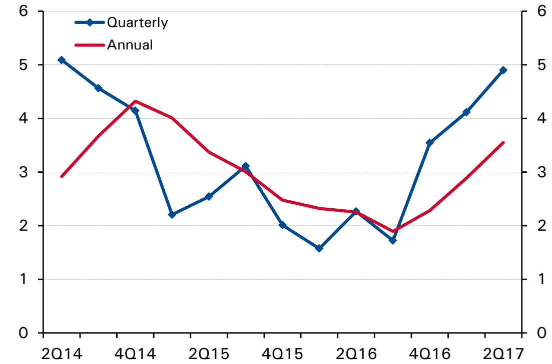
(% y/y)



Source: MOP, TR Eikon, NBK estimates; *estimate/forecast

Chart 2: Quarterly GDP growth

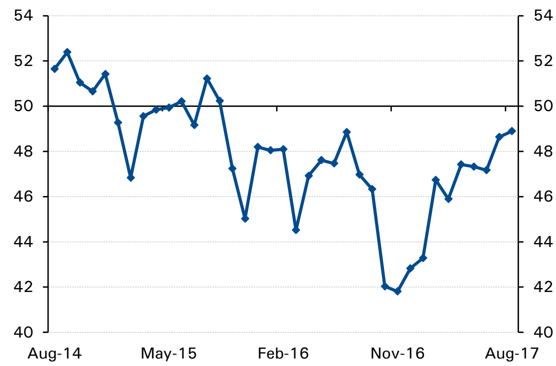
(% y/y)



Source: Ministry of Planning, Thomson Reuters Eikon

Chart 3: Purchasing Managers' Index

(index, seasonally adjusted)



Source: IHS Markit

with the number of visitors to Egypt jumping by 51% y/y during the first five months. This has been reflected in a healthy bounce in the tourism component of the production index, which was up 84% y/y in May 2017. Tourism, which has suffered since the Arab Spring in 2011, remains well below its full potential. The number of visitors to Egypt in 1Q17 was half the 1Q10 level.

The economy is expected to continue to improve during the second half of 2017 and in 2018, despite headwinds from tighter fiscal and monetary stances. After growth of 3.6% in FY16/17, the pace is expected to accelerate to 4.5% and 5% in FY17/18 and FY18/19, respectively (Chart 1). This growth is expected to come from further recovery in the tourism industry, export growth and foreign direct investment.

Progress with reforms has been significant

Toward the end of 2016, the government embarked on an ambitious reform program to reduce its large fiscal deficit and support economic growth and job creation. Fiscal reforms included introducing a VAT in place of a sales tax, reducing state subsidies and bringing wage bill growth under control. These fiscal reforms are well underway and have already had a visible impact on the deficit.

The program also includes structural reforms to boost investment, boost growth and create jobs. Measures include steps to improve the business environment and streamline laws governing investment, industrial registration and insolvency. Progress has already been made in implementing some of these reforms. The government recently approved new regulations overhauling the investment environment in the country. The new law provides broad guarantees and incentives to foreign investors and simplifies the investment process. A new industrial permits law was also recently finalized; the new regulations will simplify the process and reduce waiting times.

Inflation has remained elevated following the floatation of the pound

Some of the reforms have pushed consumer prices higher. Higher import prices following the drop in the value of the pound and increases in subsidized prices have stoked inflation. The introduction of a VAT has also added some pressure to prices. As a result, inflation in consumer prices accelerated to 33% in July 2017 (Chart 4). The rate is expected to remain at those elevated levels throughout most of 2017, before cooling off late in the year and in 2018. We expect inflation to ease to around 22% by the end of 2017 and to 10% by the end of 2018.

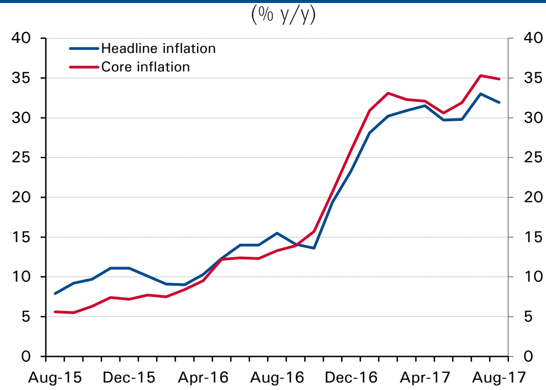
In an effort to fight inflation, the CBE has hiked its policy rates three times since the currency float. The first, in November, saw the central bank lift rates by 300 basis points (bps) at the same time as it moved to de-peg the currency (Chart 11). The CBE had already raised rates by 300 bps in three moves over the previous 12 months. It has since increased rates again in May and July, by 200 bps each time. The bank's overnight deposit and lending rates now stand at 18.75% and 19.75%, respectively. Policy rates are now 10 percentage points higher than they were when the CBE began increasing rates in December 2015.

The fiscal deficit has narrowed as reforms take effect

The fiscal deficit narrowed noticeably in FY16/17 thanks to the implementation of fiscal reforms. Though the full data is not out, according to the president's office the fiscal deficit narrowed to 10.9% of GDP during FY16/17. Ministry of Finance data through May 2017 shows the deficit declining to 10.2% of GDP during the first eleven months of the fiscal year. The primary deficit, which excludes interest payments on

Chart 4: Consumer price inflation

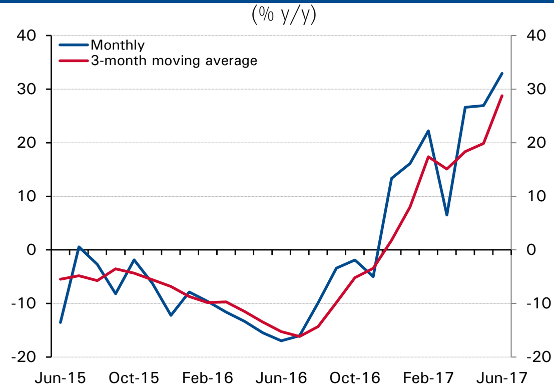
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Eikon

Chart 5: Production index

(% y/y)



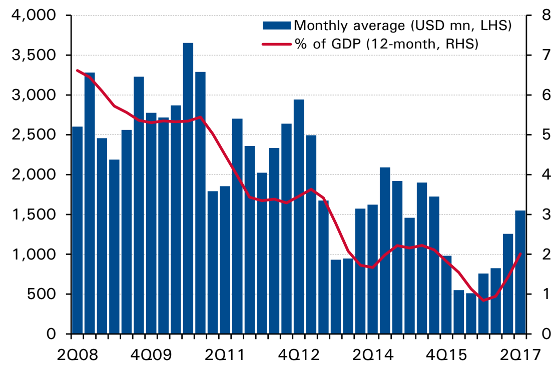
Source: Ministry of Planning, Thomson Reuters Eikon

Chart 6: Tourism

(million nights stayed)

Source: CAPMAS, Thomson Reuters Eikon

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Eikon, press, NBK estimates the debt, narrowed to 1.3% of GDP year-to-date through May 2017, from 3.7% a year ago.

The 2.4 percentage point improvement in the primary deficit came largely from increased control of the wage bill and healthy tax revenue growth. The wage bill grew by just 3% (in nominal terms); this compares to 18% average annual growth during the previous five years. Meanwhile, tax revenues increased by 33% y/y thanks to the new VAT.

This improving trend is expected to continue over the next two years. The deficit should narrow to around 9% and 8% in FY17/18 and FY18/19, respectively. The gains are expected to come from continued measures to reduce the subsidy bill. Higher revenues are also expected to be an important source, especially with the economy recovering, tax collection methods improving and the government increasing the VAT rate from 13% to 14% this fiscal year.

Current account improved in 1Q17 after deficit widened in 2016

The current account deficit shrank to its lowest level in over two years in 1Q17, to $3.5 billion or 7.3% of GDP. The current account benefited from strong export growth, which topped 30% y/y in 1Q17. The quarter also saw tourism receipts and remittances bounce back. At the same time, portfolio inflows skyrocketed following the pound float, providing further support to the external position. Net investment portfolio inflows shot up to $7.6 billion during the quarter, possibly the largest such inflow ever recorded.

In 2Q17, tourism receipts and worker remittances continued to improve, benefiting from the floating of the pound and from improved security conditions. Tourism receipts tripled to $1.5 billion in 2Q17 from a year ago, growing by 17% during the full FY16/17. Despite the improvement, receipts remain well below pre-"Arab Spring" levels. Worker remittances were up 9% y/y in 2Q17 to $4.8 billion.

Foreign reserves have improved significantly since October 2016

Foreign reserves have risen significantly since the decision to float the pound. Reserves shot up past their pre-"Arab Spring" level for the first time in July after adding $4.7 billion in that month alone. They stood at $36.1 billion or an estimated 8.4 months of imports by the end of August 2017, just above their level at the end of 2010 (Chart 13).

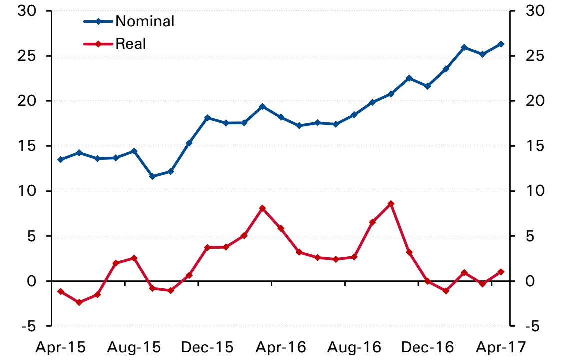
Multilateral commitments, including from the IMF, have been an important source of foreign reserves. However, the more important source has been private investment and other private flows. Higher interest rates after two policy rate hikes have made domestic bonds more attractive. Equities have also drawn investors hoping to profit from the economic recovery.

Egypt has been successfully attracting private investment back to the country as it seen making good progress on fiscal and economic reform promises. Indeed, the IMF completed its first review of progress made in implementing the reform program in July 2017, with the organization issuing a positive overall assessment of the reform program.

Still, there remains much room for investor sentiment to improve further especially with rating agencies holding off on upgrading the country's sovereign credit rating. In August, Moody's affirmed the rating at B3 with a stable outlook despite some expectations that they would decide to upgrade on improving fundamentals. The agency pointed to continued weakness in the country's fiscal position and large financing needs, while noting the "strong" commitment to reforms. The country's sovereign rating by the three major rating agencies remains 4-5 notches below

Chart 8: Private credit in local currency

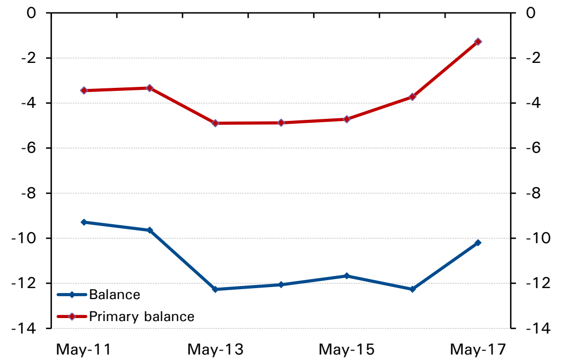
(% y/y)



Source: CBE, Thomson Reuters Eikon, NBK estimates

Chart 9: Fiscal balance

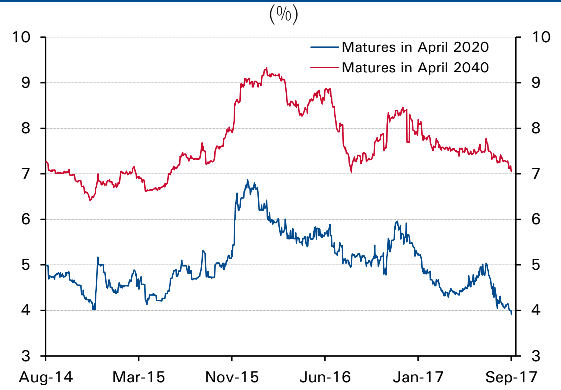
(% of GDP)



Source: Ministry of Finance, NBK estimates

Chart 10: USD sovereign bond yields

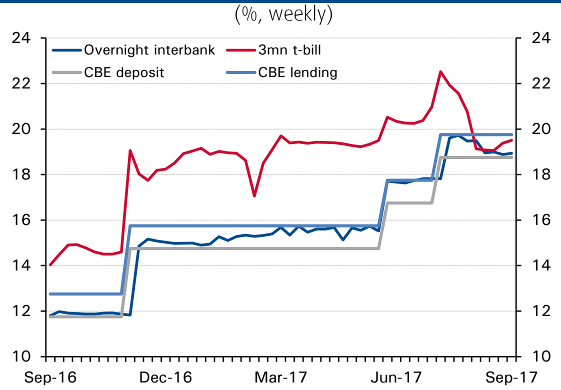
(%)



Source: Thomson Reuters Eikon

Chart 11: Interest rates

(%, weekly)

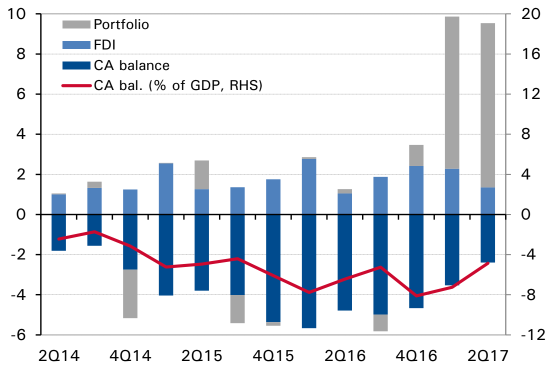


Source: Central Bank of Egypt, Thomson Reuters Eikon where it was in 2010.

Equities rallied since the decision to float the currency

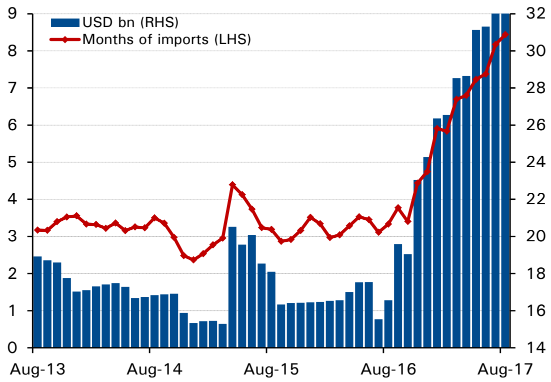
The stock market rallied strongly after the decision to float the pound in November 2016 and continued to perform well during the first half of 2017. The EGX30 index rose 57% in 4Q16 and another 9.3% in 1H17. However, the market has slipped since, losing 2.8% of its value thus far in 3Q17 through the end of August. Despite the rally following the de-pegging of the currency, the gains have not been enough to counter the decline in the EGP; the MSCI total return index valued in USD is still down 19% from its level before the currency float.

Chart 12: Balance of payments



Source: CBE, Thomson Reuters Eikon, NBK estimates

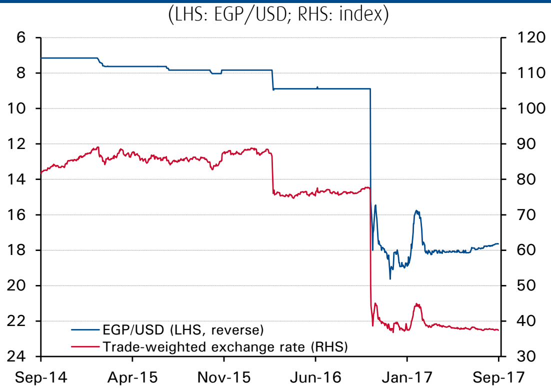
Chart 13: Official reserves



Source: CBE, Thomson Reuters Eikon, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Eikon

Chart 15: Stock exchange

(EGX30, thousand)

Source: Thomson Reuters Eikon

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