Quarterly Economic Brief

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Egypt

Economic recovery remains on track despite renewed rise in virus cases

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Highlights

- **Buttressed by continued economic reforms, Egypt's economic recovery from the pandemic remains broadly on track, despite a fresh rise in virus cases lately. GDP growth picked-up to 0.7% y/y in 3Q20, and the PMI activity gauge has returned to pre-pandemic levels.**
- **The public finance position continued to improve with the budget deficit shrinking in the first 7M of FY20/21, while the primary balance remained in small surplus.**
- **The external sector is under pressure as the pandemic ravaged key sources of foreign currency, but the pound has risen.**
- **The CBE continues to cautiously loosen monetary policy to support the economic recovery, as inflation remains low.**

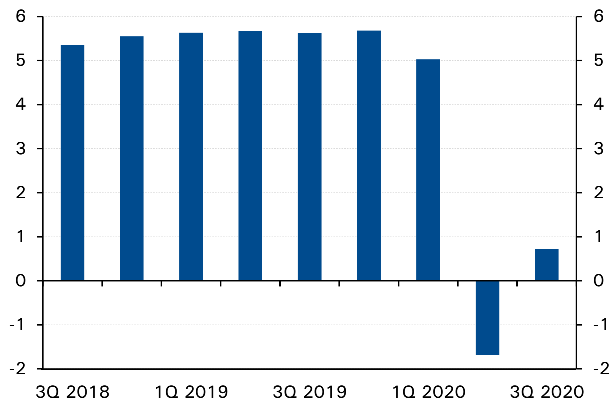
Egypt has managed the COVID-19 crisis quite well, supported by early lockdown policies and public health response, as well as the implementation of important fiscal and monetary measures. This is on top of earlier reform measures that had significantly improved key macro metrics and increased the economy's overall resilience. However, Egypt has recently seen an increase in virus cases that pushed daily infections above 1000 in January, before easing to an average of 600 in February. Still, total infections and deaths at about 178,000 and over 10,000, respectively, since the pandemic began, are below the average recorded both in the MENA region and worldwide. To contain the virus, the government started its coronavirus vaccination campaign on January 24 by inoculating medical workers at quarantine hospitals using the Chinese Sinopharm vaccine, and expanding to use the UK's AstraZeneca and Russia's Sputnik-V soon.

Growth returns to positive territory in 3Q20

The economic reforms that started in earnest in 2017 have made the economy more resilient to shocks. Egypt was one of the few countries that managed to achieve positive economic growth in 2020, reaching 3.6% in FY19/20 (July-June) compared to 5.6% a year earlier. Latest data show that the recovery continued in 3Q20 (Q1 FY20/21) with GDP up 0.7% y/y versus -1.7% a quarter earlier, as lockdown restrictions eased and the economy gradually opened up. This was supported by accommodative fiscal and monetary policies, and the ongoing progress on reforms.

Chart 1: Egypt's quarterly GDP

(y/y, %)



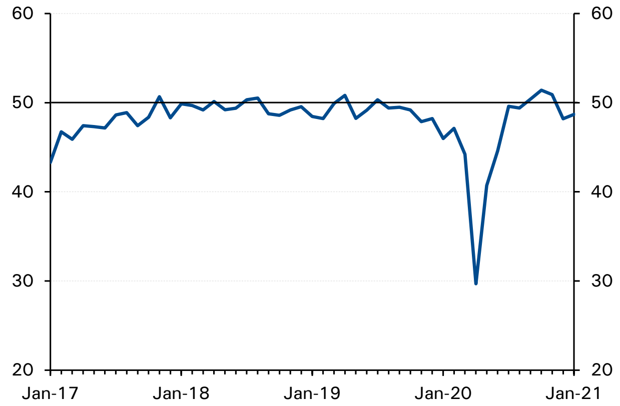
Source: Central Bank of Egypt and NBK estimates

As a good leading economic indicator, the PMI continues to show gradual signs of recovery. The headline index has been on an ascending trend, averaging 50.2 in 4Q20 after 49.8 and 38.3 in 3Q20 and 2Q20 respectively, which may suggest a further pick up in GDP growth in 4Q20. Although the two latest monthly readings fell back to the contraction territory (48.7 in January 2021), this is still a huge improvement from the levels seen at the peak of the pandemic crisis (29.7 in April) and compared to a year ago (46 in January 2020).

This recovery seems to have become more inclusive generating a strong employment response. This is reflected in a continued fall in the unemployment rate to 7.2% in 4Q20 from 9.6% 2Q20, suggesting a return to close to normal business activities.

Chart 2: Egypt's PMI

(Index)



Source: Markit

We expect the economy to improve further in the coming quarters, on hopes for sustainable progress in the vaccination campaign and a faster recovery in the global economy. Growth is projected to reach around 2.8% in FY20/21, and to rebound strongly to about 5% over the medium term, benefitting from the authorities' continued commitment to reforms and renewed IMF support. Still, the economic outlook remains uncertain, as the ongoing increase in coronavirus cases and the potential spread of the new variants could trigger new lockdown measures, affecting economic growth in both Egypt and globally.

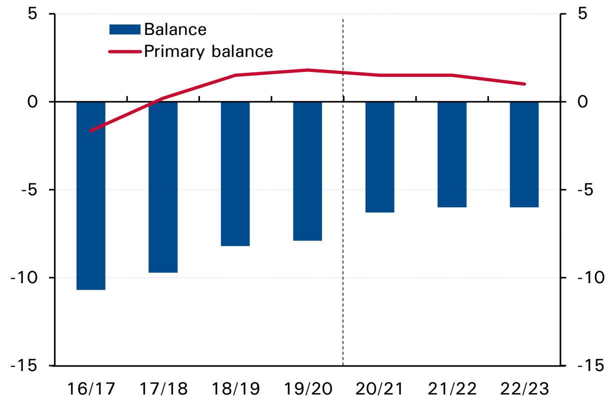
Fiscal performance shows steady improvement

The government has continued its efforts to address its budget deficit through a combination of fiscal measures, including the restructuring and modernization of the tax systems, and subsidy reform. Despite the pandemic, the deficit reached about 4.4% of GDP during the first seven months of the current FY20/21 (July – January), against 4.6% during the same period a year ago. This was the result of good efforts on the revenue side (16% y/y increase) more than offsetting the increase in spending (12.4%) partly needed to deal with, and mitigate the impact of, COVID-19, achieving a primary surplus of $1.2 billion (around 0.5% of GDP).

The government expects the budget deficit to shrink from 7.9% of GDP in FY19/20 to 6.3% in the current fiscal year, thanks partially to a reduction in debt-servicing costs amid government efforts, by changing debt maturities benefiting from lower interest rates. The projected deficit is planned to be financed domestically through EGP denominate treasury bills and bonds as well as foreign borrowing taking advantage of the low global interest rate environment. The latest dollar bond issue of $3.75 billion in three tranches (5, 10, and 40 years) generated a considerable interest reflected in relatively low rates especially for the shorter tenure of 5 years (3.875%, 5.875%, and 7.5%, respectively). The revised budget of FY20/21 expects the public debt-to-GDP ratio to rise slightly to 82.7%(, up from 82.5% in FY19/20) but should decline to 77.5% by the end of June 2022.

Chart 3: Egypt's Fiscal balance

(% of GDP)



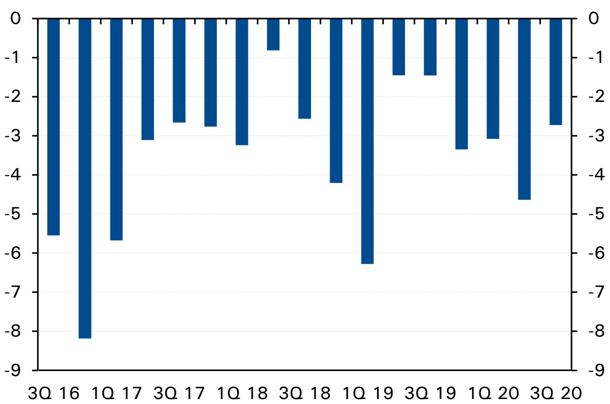
Source: Ministry of Finance, and NBK estimates

External sector still under some pressure

The external current account has been under pressure as some key export sectors have been affected by the pandemic. The deficit widened to $2.8 billion (2.7% of GDP) in the first quarter of FY20/21 (July-September) from $1.4 billion (1.5% of GDP) in the same quarter a year earlier, but improved versus the previous quarter. The tourism sector, which is one of the main sources of foreign exchange, saw a sharp plunge in revenues, to $801 million during the same period from $4.2 billion a year earlier, while net foreign direct investment (FDI) fell 31% y/y to $1.6 billion. On the positive side, remittances from Egyptians working abroad rose 19.6% to $8.0 billion in Q3, motivated likely by the rush to transfer savings amid labor market uncertainty. Looking ahead, the current account deficit could reach 4.0% of GDP in FY20/21, before improving to around 2.5% of GDP in coming years.

Chart 4: Egypt's current account

(% of GDP)

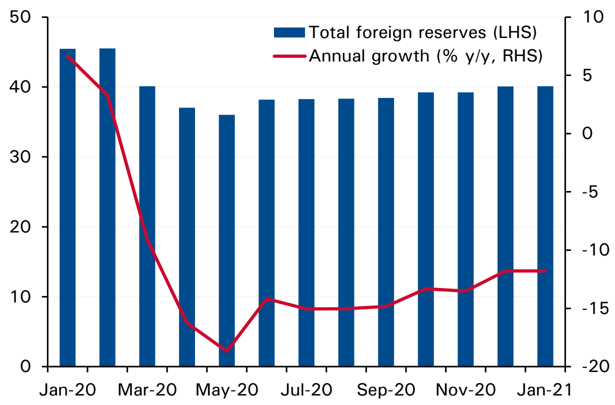


Source: Central Bank of Egypt, and NBK estimates

Despite economic pressures caused by the latest coronavirus wave, foreign reserves continued to improve for eight months in a row. Reserves increased to $40.1 billion in January (about eight months of commodity imports) versus $36 billion last May, its lowest level of the pandemic. The improvement was supported by Egypt's move to secure more financial buffers (IMF support and foreign borrowing) and the recent acceleration of capital inflows.

Chart 5: Egypt's foreign reserves

($ billion)



Source: Central Bank of Egypt

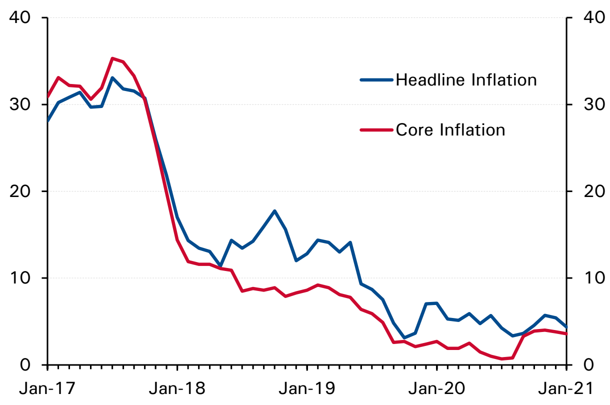
The Egyptian pound has been strengthening against the US dollar supported by macroeconomic fundamentals and capital inflows. The pound appreciated 2% against the US dollar in 2020, and appreciated slightly on so far this year. The US dollar traded at an average of EGP 15.6 in February against EGP 15.7 in January. The currency's appreciation reflects also improved macroeconomic performance, appropriate monetary policy that kept real interest rates relatively high (see below), and increasing confidence due to the continued pace of reforms that has not relented since the floating of the exchange rate and that produced good economic outcomes.

Accommodative monetary policy amid low inflation

Economic reforms have led to macroeconomic stabilization and put Inflation on a downward trend, supported lately by specific government measures aimed at avoiding food shortages. Urban inflation reached 4.3% y/y in January 2021, driven mainly by lower domestic food and beverage prices, which is below the central bank's new 4Q22 target of 7% (±2%). Core inflation also decelerated to 3.6% y/y from 3.8% in December. In the coming months, inflation could increase given the recent rise in commodity and energy prices and the potential pick-up in demand as economic activity recovers. Nevertheless, we expect it to remain broadly under control as the authorities continued their reform efforts and as long as economic fundamentals drive the stability of the exchange rate.

Chart 6: Egypt's inflation

(y/y %)



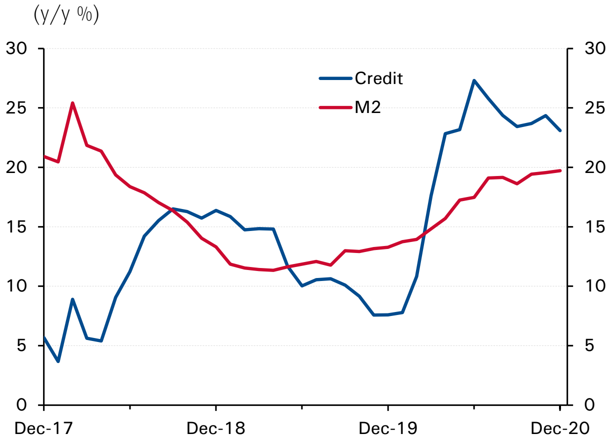
Source: CAPMAS and Central Bank of Egypt

The Central Bank of Egypt (CBE) kept its policy rates unchanged in its first meeting of 2021 (February 4), after cutting its rates by a cumulative 400 basis points in 2020. This no-change decision was likely motivated by the need to maintain high real interest rates compared to other emerging countries, to attract further foreign capital, and avoid any sudden reversals given the volatile global climate. With inflation remains within the target, the CBE will have some room to implement further rate cuts this year (perhaps 100bps) to support the economic recovery and further minimize government debt servicing costs.

Banking sector benefits from stronger credit growth

The banking system has remained healthy with robust credit growth and as authorities provided relief to heavily affected borrowers. In fact, the non-performing loans (NPL) ratio remained low at around 3.4% in 3Q20 (compared to 3.9% and 4.1% in 2Q20 and 1Q20, respectively), while the money supply (M2) increased by 19.7% y/y in December 2020. In addition, domestic credit growth accelerated sharply to 23% in December 2020 from 7.6% a year ago, supported by lower interest rates and in particular, government measures to encourage lending, especially to SMEs and microfinance institutions. The CBE announced recently an increase in the portion of loan portfolios to those institutions (under some relaxed borrowing requirements) to 25%, with the aim to enhance financial inclusion and create jobs for young Egyptians. As such, in the next couple of years, credit growth is expected to remain high, although it could decelerate a bit from its highs (mid-to-high digits) as the boost from the recent credit-boosting measures fades.

Chart 7: Egypt's banking sector



Source: Central Bank of Egypt

Continued reforms needed to sustain strong growth

Egypt has done well in 2020 compared to other emerging markets as reforms proceed apace, supported by the international community. Near term, the downside risks to the outlook mainly come from uncertainty over the recovery in global growth and the success of the vaccination campaign. The recent rise in virus cases, including from new variants, and the imposition of new lockdown measures could weigh heavily on economic activity.

Longer-term, Egypt's economic performance is expected to remain strong as long as the authorities remain committed to forging ahead with reforms, although some risks remain. With macroeconomic stability now well entrenched, achieving higher and sustainable economic growth requires focusing on the country's structural challenges. The private sector needs to play a much bigger role in driving growth, reducing poverty, and creating jobs for a large number of Egyptians entering the labor force. Improving the environment for domestic and foreign private sector investment will reduce dependence on foreign capital, which if continued in the longer term could push the debt to GDP ratio to unsustainable levels, and make the economy more vulnerable to external shocks and capital outflows.

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