Economic Update
19 December 2017

Macroeconomic outlook

Egypt: Economy continues to recover as reforms boost sentiment and exports

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Overview and outlook

- **Growth is set to continue to improve to 4.7% in FY17/18, and to 5% and 5.5% in FY18/19 and FY19/20.**
- **There has been significant progress on reforms, with a positive impact on external flows, fiscal resilience, and activity.**
- **The fiscal deficit is set to narrow further in the coming years, after declining to under 11% of GDP in FY16/17.**
- **Double-digit inflation is set to ease as the central bank has kept policy rates high and the pound has been stable.**

Economic activity continued to bounce back in 3Q17 after showing a healthy recovery during the first half of 2017. The economy has generally benefited from the floating of the pound, which has helped renew optimism and made the economy more competitive. Other fiscal and structural reforms have also made significant progress. As a result, the economy has benefited from strong export growth, a recovery in tourism and higher investment. The country's foreign reserves have also improved significantly, returning to levels not seen since before the political unrest in 2011.

Growth is set to accelerate to 5.5% by FY19/20

The economy continued to see robust growth in 3Q17, as real GDP growth accelerated to 5.2% year-on-year (y/y) (Chart 2). This compares to just 2.3% average growth in 2016. The private sector has been a key source of growth, expanding by 5% y/y in 1Q17, according to the most recent data available, while the public sector grew by just 2.4% y/y.

The Purchasing Managers' Index (PMI) continued to improve in 4Q17, suggesting further acceleration in GDP growth. The index rose to 50.7 in November, its best level in over two years. Exports have been particularly strong in the PMI data, with the new export orders component rising to 55.5. The latest trade data also shows exports (in US dollar terms) up 14% y/y in 3Q17. The drop in the value of the pound after last year's currency float has clearly made exports more competitive.

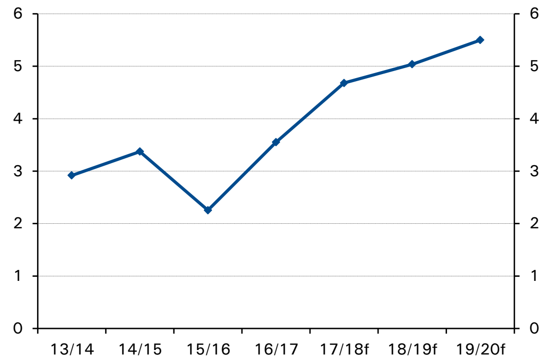
The improving growth has also been supported by a recovery in tourism. The number of visitors to Egypt jumped by 55% y/y in 3Q17. The tourism component of the production index rose by 15% y/y in 2Q17. Despite the improvement, the potential for growth in the sector remains massive,

Table 1: Key economic indicators

		FY16/17	FY17/18f	FY18/19f	FY19/20f
Nominal GDP	EGP bn	3,481	4,366	5,028	5,771
Nominal GDP	USD bn	251	237	267	299
Real GDP growth	% y/y	3.6	4.7	5.0	5.5
Inflation (average)	% y/y	30.0	14.0	10.0	9.0
Budget balance	% of GDP	-10.9	-8.5	-7.5	-6.5

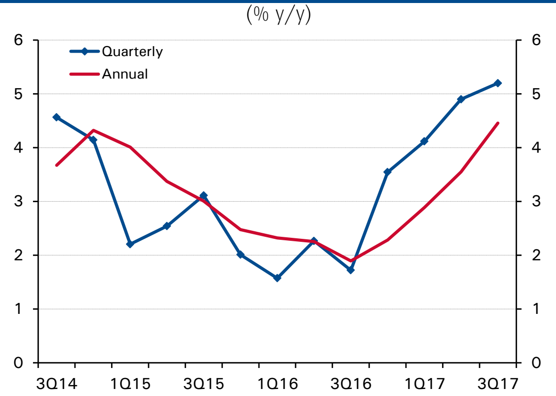
Source: CBE, MOF, MOP, NBK estimates

Chart 1: Real GDP growth
(% y/y)



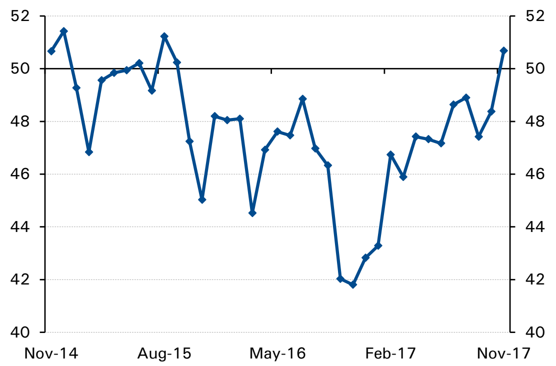
Source: MOP, Thomson Reuters Datastream, NBK estimates

Chart 2: Quarterly GDP growth
(% y/y)



Source: MOP, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index
(index, seasonally adjusted)



Source: IHS Markit

with tourism still well below pre-2011 levels. The political unrest and the heightened threat of terror attacks have continued to put significant pressure on the sector. The number of visitors to Egypt in 1Q17 remains 36% below the 3Q10 level.

The economy is expected to continue to improve in the years ahead. While we see growth cooling slightly in the coming quarters as some base effects fade, average growth in FY17/18 is still expected to improve to 4.7% from the prior year's 3.6%. Beyond that, growth is seen accelerating to 5% and 5.5% in FY18/19 and FY19/20, respectively (Chart 1). The economy will continue to face some headwinds from tighter fiscal and monetary stances in the coming 2-3 years, but this is expected to be countered by strong investment activity, export growth and a recovery in tourism.

Fiscal deficit narrowing as reforms take effect

The government has been undertaking an ambitious reform program including tackling its large fiscal deficit. Last year, the existing sales tax was replaced by a value-added tax (VAT), which promised to increase tax revenues by up to 1% of GDP. The government also cut subsidies, raising the retail price of fuel and electricity and water. Fiscal reform also included an effort to bring wage bill growth under control.

The results have already born fruit, though some fiscal targets were missed due to the significant increase in oil prices. The fiscal deficit declined to 10.9% of GDP in FY16/17 from 12.1% the prior fiscal year. 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 the debt, narrowed to 1.3% of GDP year-to-date through May 2017, from 3.7% a year ago.

Increased control of the wage bill and healthy tax revenue growth from the VAT were responsible for most of the improvement in the primary deficit. Indeed, the wage bill grew by just 3% (in nominal terms); this compares to 18% average annual growth during the previous five years. As a result, total spending fell to 25.3% of GDP to-date in FY16/17, its lowest level in six years. At the same time, tax revenues grew by 33% y/y, which helped push total revenues to 15.1% of GDP.

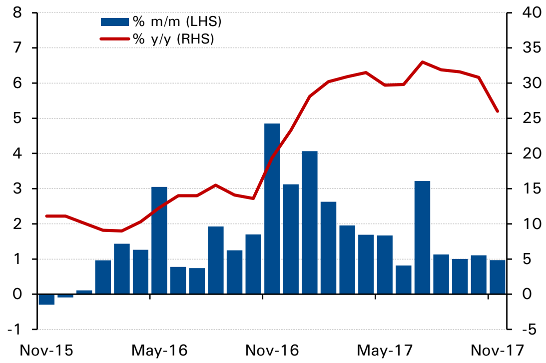
We expect this improving trend to continue in the coming two fiscal years as spending is brought under control and the government improves revenue collection. The deficit should narrow to 8.5% for the full FY17/18 before improving further to 7.5% and 6.5% in the following two fiscal years. The gains are expected to come from continued measures to reduce the subsidy bill. Higher revenues are also expected to be an important source, as tax collection methods improve and the government's hiking of the VAT rate from 13% to 14% this fiscal year is felt.

Structural reforms also moved forward in 2017

The reform agenda also includes structural reforms to boost investment, growth and job creation. Measures include steps to improve the business environment and streamline laws governing investment, industrial registration and insolvency. Significant progress has already been made in implementing these. New regulations overhauling the investment environment were enacted during 2017. The new law provides broad guarantees and incentives to foreign investors and simplifies the investment process. The year also saw the passing of a new industrial permits law, which will streamline the process and reduce waiting times.

Chart 4: Consumer price inflation

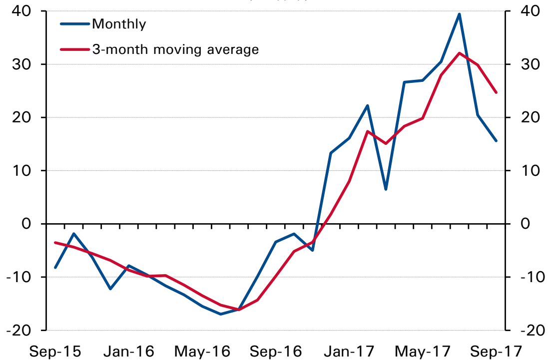
(%)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

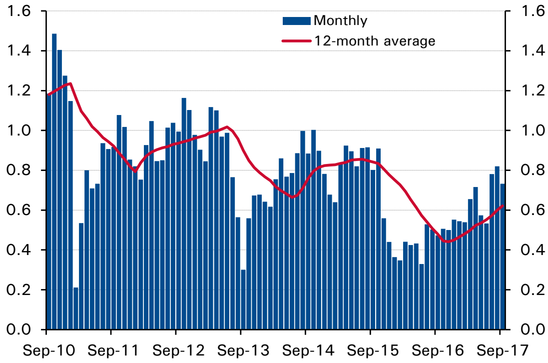
(% y/y)



Source: MOP, Thomson Reuters Datastream

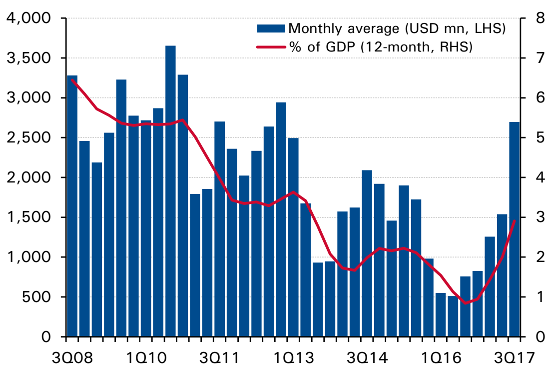
Chart 6: Tourism

(million visitors)



Source: CAPMAS

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, press, NBK estimates

Elevated inflation is set to ease with tough CBE approach

Last year's floating of the currency, cuts in subsidies and the introduction of the VAT all contributed to higher inflation over the last year. CBE policy rate hikes have helped bring inflation under control, though it remains relatively elevated. Inflation stood at 31% y/y in October, though monthly price growth continued to ease (Chart 4). The rate is expected to end 2017 at around 23% before easing further to 10% by the end of 2018 and 8% by the end of 2019.

The central bank's policy rates have remained elevated in an effort to combat the high level of inflation. Three hikes since the currency float have seen rates rise by 700 basis points over the last twelve months. The bank's overnight deposit and lending rates now stand at 18.75% and 19.75%, respectively (Chart 11). Expectations are for the central bank to begin cutting rates in the coming months, as soon as the CBE is convinced that inflation has come under control.

Current account improved in 1Q17 after the deficit widened in 2016

The current account deficit shrank to its lowest level in nearly three years in 2Q17, to $2.4 billion or 4.8% of GDP. The current account benefited from strong export growth, which topped 7.4% y/y in 2Q17. The quarter also saw strong growth in tourism receipts and remittances.

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 10% y/y in 2Q17 to $4.8 billion.

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 $8.2 billion during the quarter, possibly the largest such inflow ever recorded. This came on the heels of a $7.6 billion net inflow in 1Q17.

Foreign reserves are holding at improved levels

As a result, foreign reserves have risen significantly. By July, reserves had shot up past their pre-"Arab Spring" level for the first time. Since then, reserves have been largely steady, coming in at $36.7 billion or an estimated 8.1 months of imports at the end of November 2017 (Chart 13).

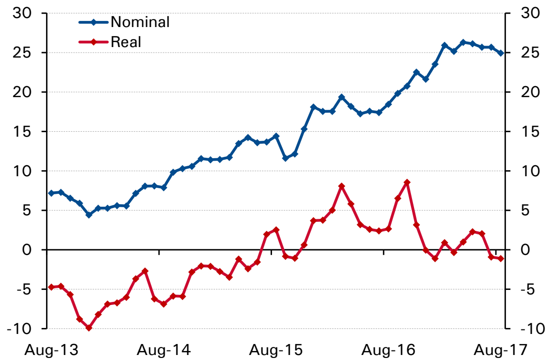
The strong recovery in foreign reserves over the last year has seen the CBE remove restrictions imposed on foreign currency activity after 2011. The CBE recently scrapped caps on deposits and withdrawals by importers. It also imposed a 1% entry charge for use of the CBE repatriation mechanism by foreign investors, presumably in an effort to discourage its use and possibly with an eye toward eventually phasing it out entirely.

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 have made domestic bonds more attractive while equities have drawn investors hoping to profit from the economic recovery.

Despite the improved outlook and investment sentiment, rating agencies have yet to upgrade the country's sovereign credit rating to reflect that. Moody's affirmed the sovereign rating at B3 with a stable outlook in August. The agency pointed to continued weakness in the country's fiscal

Chart 8: Private credit in local currency

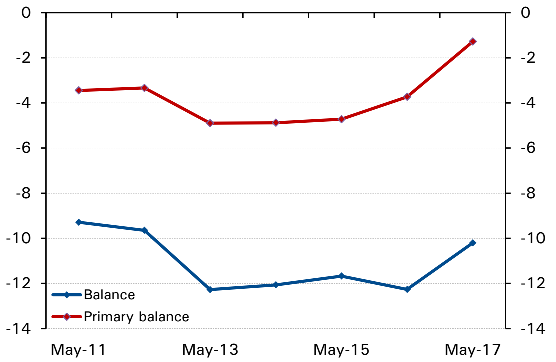
(% y/y)



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 9: Fiscal balance

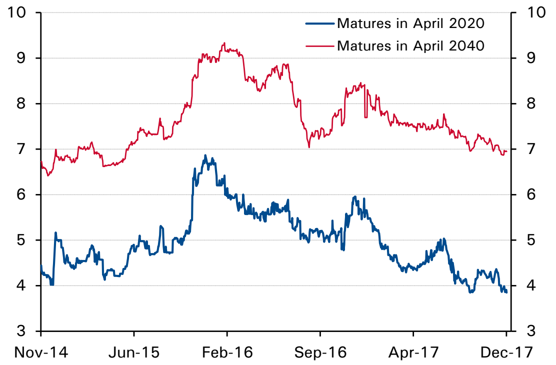
(% of GDP)



Source: Ministry of Finance, NBK estimates

Chart 10: USD sovereign bond yields

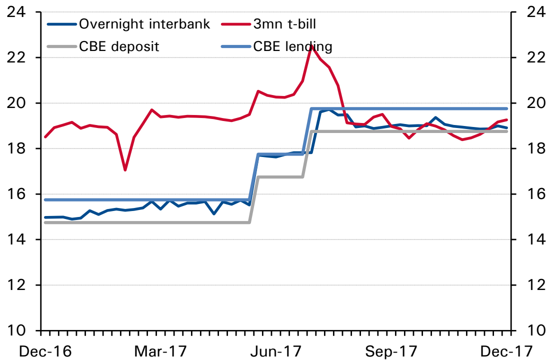
(%)



Source: Thomson Reuters Datastream

Chart 11: Interest rates

(%, weekly)

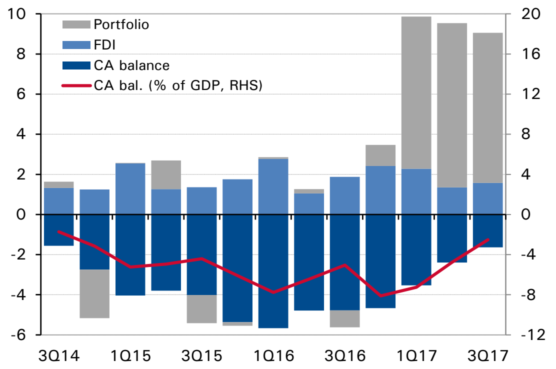


Source: Central Bank of Egypt, Thomson Reuters Datastream position and large financing needs, while noting the "strong" commitment to reforms. The country's sovereign rating by the three major rating agencies remains 4-5 notches below 2010. Indeed, 2018 might be the year when rating agencies begin to take a more positive view as risks recede and the economic reforms picks up pace.

Equities continued to do well on the positive outlook

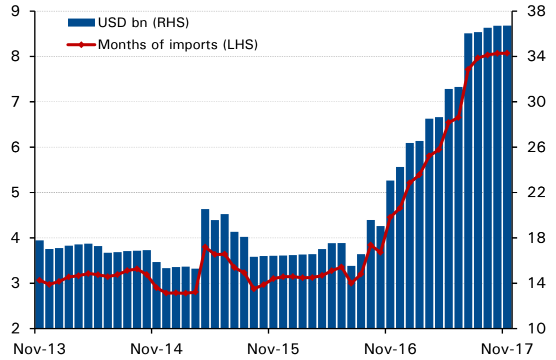
After seeing a strong rally in the wake pound float, equities continued to do well in 2017. The EGX30 was up 17% year-to-date through 5 December. However, despite the strong 72% rise in the EGX30 index to-date following the currency float, the gains have not been enough to counter the decline in the pound. The index valued in US dollars is down 15% to-date from the end of October 2016.

Chart 12: Balance of payments



Source: CBE, Thomson Reuters Datastream, NBK estimates

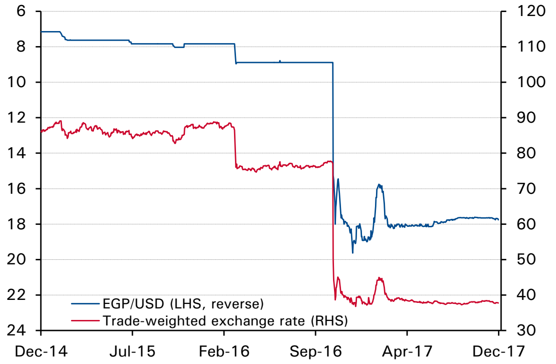
Chart 13: Official reserves



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30, thousand)

Source: Thomson Reuters Datastream

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