Macroeconomic outlook

Egypt: Painful reforms and IMF loan should support gradual recovery

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Overview and outlook

- **Growth is expected to be steady at 2.5% in FY16/17 before it starts to improve again to 4% and 5% in FY17/18 and FY18/19.**
- **Decision to float the pound should alleviate foreign currency shortage that crimped activity, but growth will depend on foreign investment.**
- **Fiscal deficit to narrow to 10% of GDP in FY16/17 and to 6-7.5% in FY16/17 and FY17/18 if fiscal reform stays the course.**
- **Double-digit inflation should ease in 2017 and further in 2018 as monetary policy tightens, helping stabilize the pound.**

The economy slowed considerably in 2016 when a currency shortage worsened and tourism failed to recover from a collapse amid heightened security concerns. But by the end of the year, the authorities were doing the right things to help push growth back towards its potential. The government took steps to restart much needed reform, including floating the currency, hiking fuel prices, and introducing a value-added tax (VAT), as it sought to clinch a $12 billion IMF loan agreement. Once approved, the deal unlocked further funding and investment which, it is hoped, will propel the economy back towards healthy growth of 4-5% in the medium term.

The reforms being implemented are expected to see Egypt's fiscal and monetary policy tighten significantly in 2017. This will no doubt put pressure on growth, though we expect this pressure will be more than offset by an increase in foreign investment, exports and tourism. The large depreciation in the pound, following its floating, should boost the competitiveness of Egypt's exports and tourism sector. The cheaper pound will also encourage foreign investors to return, supported by the government's promise to implement much needed reforms and by large multilateral investors' pledges to increase FDI to the country.

Of course, whenever major reforms are promised there are risks that authorities will fail to deliver. Indeed, the authorities will be tempted to limit the tightening of fiscal and monetary policy to minimize the short-term economic and social pain, which could be severe. However, the massive fiscal and investment support currently pledged to Egypt by the IMF and others is largely conditional on the progress of reforms. Any slippage could hold up those funds, reduce growth and put renewed pressure on the pound; it would also hurt sentiment among private

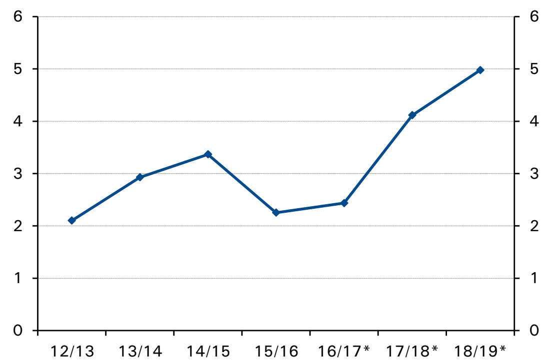
Table 1: Key economic indicators

		FY15/16	FY16/17f	FY17/18f	FY18/19f
Nominal GDP	EGP bn	2,708	3,147	3,612	4,094
Nominal GDP	USD bn	326	221	195	216
Real GDP growth	% y/y	2.3	2.5	4.0	5.0
Inflation	% y/y	14.0	18.0	10.0	8.0
Budget balance	% of GDP	-11.0	-10.0	-7.5	-6.0

Source: CBE, MOF, MOP, NBK estimates

Chart 1: Real GDP growth

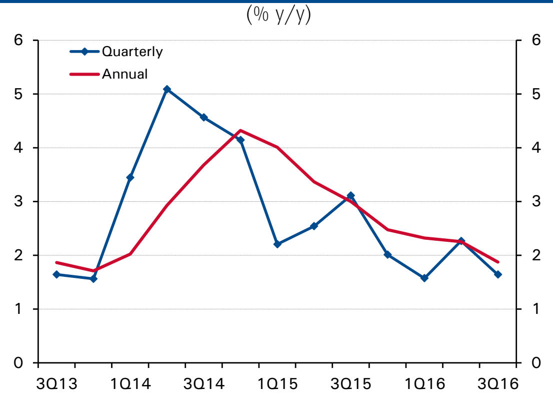
(% y/y)



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

Chart 2: Quarterly GDP growth

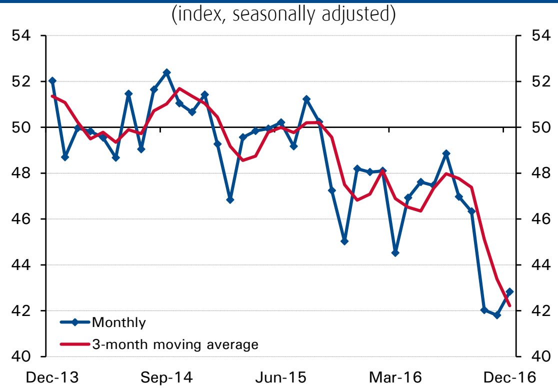
(% y/y)



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index

(index, seasonally adjusted)



Source: Markit

investors. It is thus critical that the government be seen to be moving decisively to reduce the sizeable fiscal deficit, even if the reduction is gradual. This would in turn reduce the need for domestic deficit financing and thus allow monetary policy to tighten and help stabilize the pound.

Economy slowed in 2016 on FX shortage and collapse in tourism

Economic growth is expected to have slowed significantly during 2016 following a more modest slowdown in 2015. Real GDP growth slowed to 1.6% year-on-year (y/y) in 3Q16 (Chart 2), down from average growth of 3% the year before. All indications are growth has remained subdued since. The economy should improve gradually in 2017 following the floatation of the currency, which should help competitiveness and business sentiment. Growth in FY16/17 will still come in at a relatively weak 2.5% before accelerating to 4% and 5% in FY17/18 and FY18/19, respectively (Chart 1).

Growth had been deteriorating gradually since the middle of 2015 and into 2016. The Ministry of Planning's production index had been in decline for most of that period. In October 2016, the index was down by 4.9% y/y (Chart 5). The slump came mostly from a decline in tourism and the related transportation sector, as well as construction. We should expect production to start improving in 2017, after the liberalization of the exchange rate and the approval of the IMF loan agreement. The production index will also benefit from a basis effect as the 4Q15 collapse in tourism fades.

Markit's Purchasing Managers' Index (PMI) has also reflected the weak growth, staying below 50 for over a year since late 2015 (Chart 3). The index averaged 46 during 2016, a level consistent with GDP growth below 2%. The December PMI figure remained depressed at 42.8, indicating activity had yet to benefit from the pound's free floatation and from the approval of the IMF loan agreement.

Tourism remained weak in 2016 on security concerns

Tourism has been a key source of slowdown over the last year. The tragic terrorist attack in October 2015 that downed a Russian plane shortly after takeoff in Sharm El-Sheikh had a devastating effect on the tourist industry. The attack came at a time when Egyptian tourism was struggling to recover from years of political instability and security threats. September 2016 data show that tourist numbers had yet to recover. The number of visitors was off by 41% y/y, and the number of "nights stayed" was 45% lower y/y (Chart 6).

Currency float sees capital controls scrapped and pound down 50%

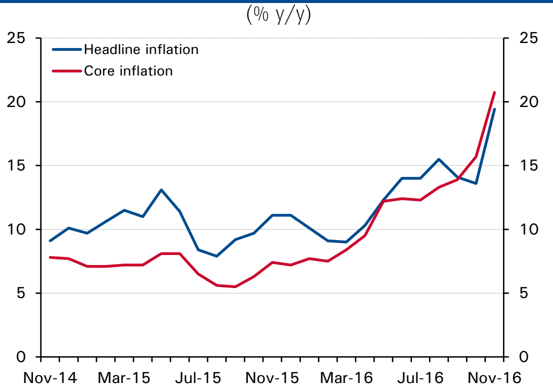
In November, Egypt chose to float its currency, after a 6-year struggle to maintain a peg to the US dollar. Capital controls, in place in various forms since 2011, and more strictly since early 2013, were gradually scrapped, and the Central Bank of Egypt (CBE) finally allowed banks to trade the currency freely starting 3 November. The Egyptian pound (EGP) has declined by over 50% against the dollar since, to settle at around 18.2 EGP/USD by early January (Chart 14); it was down by 57% in 2016.

Inflation jumped following pound floatation and fuel price hike

The floating of the pound was followed by a 30-50% increase in controlled fuel prices. The move helped cushion the impact of the pound's depreciation on the budget; but it also added to the rise in consumer prices. Inflation was already on the rise in 2016, having accelerated to around 14% by October 2016 (Chart 4). In November it jumped to 19.4% and is expected to remain at those levels through most of 2017, before cooling off in late 2017 and easing further in 2018.

Chart 4: Consumer price inflation

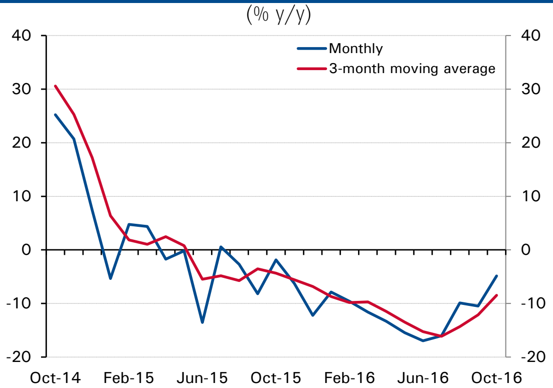
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

(% y/y)



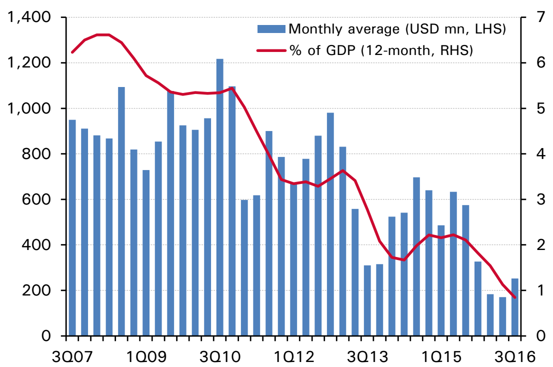
Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism

(million nights stayed)

Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, NBK estimates

The CBE also moved to hike policy rates in November, in an effort to quell inflation and support the newly floated pound. The CBE increased rates by 300 basis points (bps), raising the CBE deposit and lending rates to 14.75% and 15.75%, respectively (Chart 11). The central bank had already raised rates by 300 bps in three moves over the previous 12 months. The CBE is likely to maintain a tighter monetary policy in the months ahead just as the government moves ahead with the tighter fiscal stance promised in its reform agenda.

Tighter fiscal stance is key to the government agenda and outlook

Egypt's fiscal deficit remains relatively large and a key source of imbalance for the economy. In its effort to kick-start reforms and gain approval for the IMF loan agreement, the government pledged to bring the deficit under control. In this effort, the government fast tracked legislation for a value-added tax (VAT) in August 2016. Other efforts include reining in spending by controlling the wage bill and reducing government subsidies. These reforms should help reduce the deficit to around 10% of GDP in FY16/17 from around 12% the prior year (Chart 9). Further improvements in the deficit to around 8% and 6% of GDP are expected in FY17/18 and FY18/19, respectively.

Pressure on domestic financing to diminish

In recent years, the government has largely resorted to domestic debt issuance to finance its deficit and most of this debt has been absorbed by banks. This has come at a cost of crowding-out lending to the private sector and of boosting money supply. Over the last six years, claims to the government have risen, from 25% of assets to 56% in August 2016. By contrast, lending to the private sector dipped below 25% of bank assets.

The pressure on domestic financing is likely to diminish in the medium term, as the government reduces the deficit and relies more on international funding. Some of the financing will come from over $20 billion in funding pledged by various multilateral institutions and states. Debt markets will also play an important role, with Egypt planning to issue $3-5 billion in international bonds in the near future.

The positive news of the IMF loan deal has helped ease Egypt's sovereign yields. Egypt's USD 2040 bond yielded 8.5% in mid-December (Chart 10). While the spread to the 20-year US Treasury bond was mostly unchanged at around 540 bps from just before the IMF deal's approval, this was well below spreads in excess of 600 bps seen prior to the approval of the IMF deal.

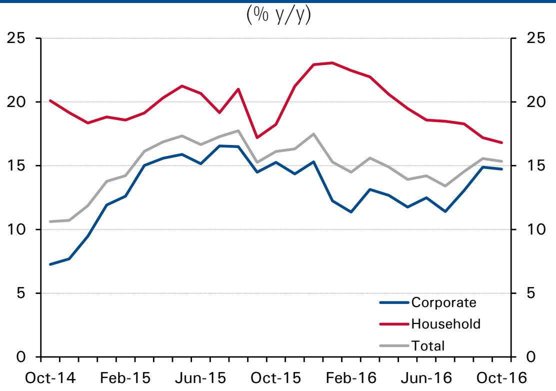
Current account deficit widened in 2016

The current account deteriorated further in 2016, with the deficit widening to $9.7 billion during the first half of the year. The 12-month trailing deficit rose to 5.8% of GDP compared to 3.7% a year before. The deterioration was due largely to a collapse in tourism revenues, and declines in worker remittances and foreign grants. By contrast, the trade deficit narrowed by 13% thanks largely to a drop in imports. Foreign direct investment (FDI) also continued to provide support (Chart 12), accounting for around 2.1% of GDP during the 12 months through 2Q16.

Foreign reserves saw a notable improvement towards the end of 2016 as Egypt agreed to an IMF-supported economic reform program and began implementation. The $12 billion IMF loan agreement, which was approved in November, was supplemented by a number of additional bilateral and multilateral pledges. This has helped push reserves to $23.1 billion by the end of November 2016, equivalent to 4.5 months of

Chart 8: Private credit

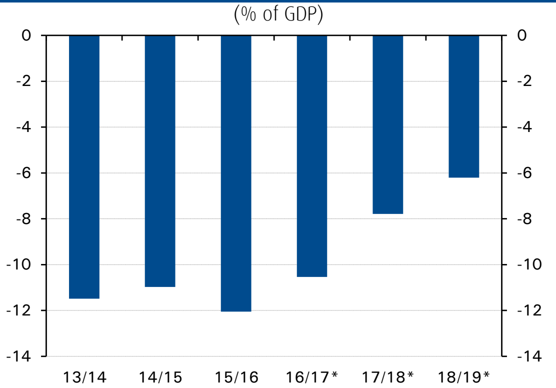
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 9: Fiscal balance

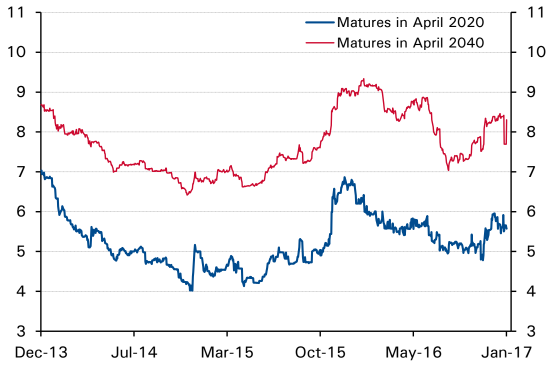
(% of GDP)



Source: MOF, TR Datastream, NBK estimates, *estimate/forecast

Chart 10: USD sovereign bond yields

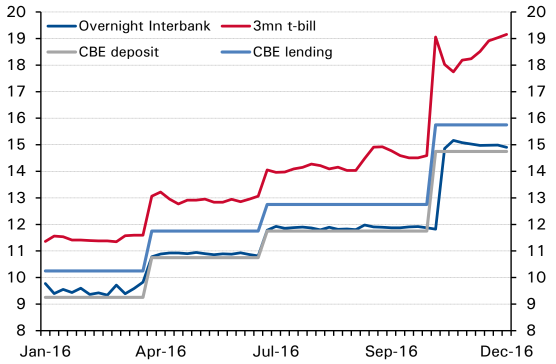
(%)



Source: Thomson Reuters Datastream

Chart 11: Interest rates

(%, weekly)



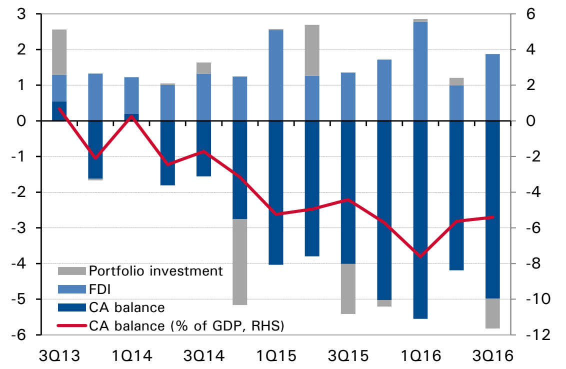
Source: Central Bank of Egypt, Thomson Reuters Datastream imports and the highest figure in over five years (Chart 13).

The decision to float the currency in early November should help relieve much of the pressure on reserves. With the CBE no longer supporting the EGP, the depletion of reserves should be reduced significantly. The currency has already fallen by more than 50%; tighter fiscal and monetary policy going forward should help stabilize the pound, as inflation is brought down and foreign investment returns to the country.

Equities market has outperformed region in 2016

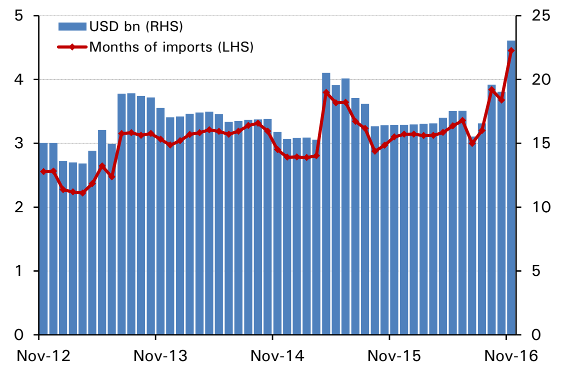
The stock market outperformed the MENA region in 2016, especially after the decision to float the currency. The market first rallied in March following a devaluation; it rose strongly again after the pound fell by more than 50% in November 2016 in the wake of the currency's floating. The EGX30 index was up 76% during 2016 (Chart 15); still, the market has not kept up with the drop in the currency, with the MSCI total return USD index off by 11%.

Chart 12: Balance of payments



Source: Central Bank of Egypt, Thomson Reuters Datastream

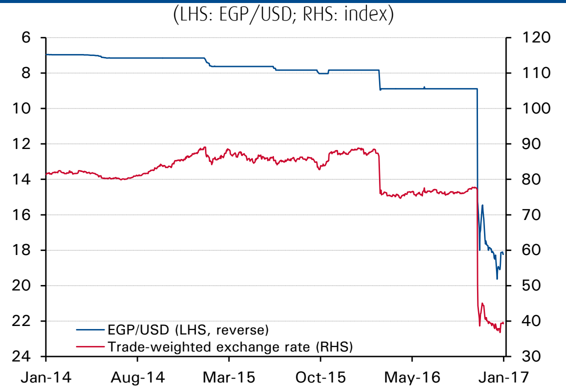
Chart 13: Official reserves



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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