Quarterly Economic Brief

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Egypt

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Growth remains solid; the pandemic clouds the outlook

Highlights

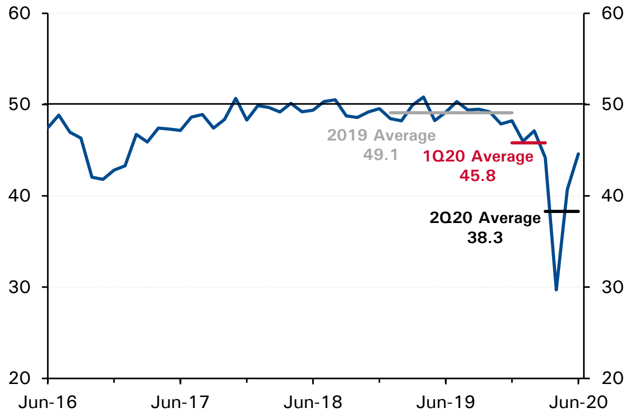
- **Economic growth moderated in 1Q20 and is expected to fall further in 2Q20 as the impact of the pandemic containment measures that were introduced in March take hold.**
- **Pandemic-related expenses and increased public investment will weigh on the public finances with the budget deficit for FY20/21 expected to rise above its target.**
- **The external current account deficit widened as the pandemic ravaged some of Egypt's main sources of foreign currency.**
- **The central bank kept interest rates unchanged at its last three meetings amid slowing inflation.**

Lockdown measures weigh on economic activity

With more than 85,000 confirmed cases (as of July 16), the government took preventive measures to stem the spread of the Covid-19 pandemic, including closing airports and imposing movement restrictions and a curfew, among others. It adopted a stimulus package of EGP 100 billion ($6.3 billion) to mitigate the impact of the pandemic. However, as many sectors were hit hard, economic growth moderated in 1Q20 compared to recent trends, as containment measures were imposed later in the quarter (in March). GDP grew by 5.0% y/y in 1Q20 (3Q of FY19/20) down from 5.6% in 4Q19. This is below the government's expectation of 5.9% but remains fairly solid compared to the contractions experienced in many other countries around the world.

Chart 1: Egypt's PMI

(Index)



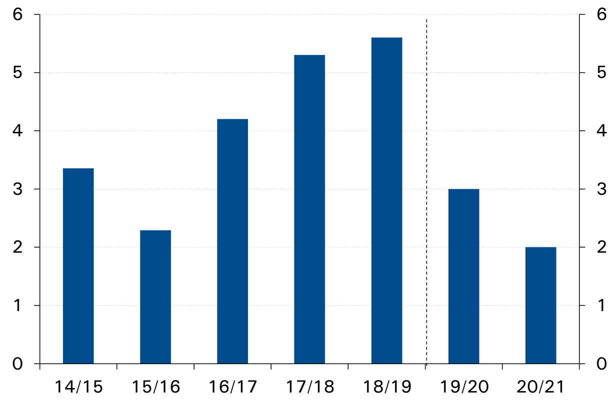
Source: Markit

Growth in the second quarter is likely to drop further as the impact of the restrictions take hold. This is already confirmed by the sharp decline of Egypt's PMI to a historic low of 29.7 in April. Although the index improved to 40.7 in May and 44.6 in June as lockdown measures eased, the average 38.3 for 2Q20 is still far below the 2019 average of 49.1, indicating a significant drop in private sector activity.

As a result, we expect growth to slow sharply to around 3% in FY19/20 (ended in June) from 5.6% in FY18/19. For FY20/21, we forecast growth to dip below 2%, since many sectors such as tourism, aviation, transportation and shipment will remain under severe strain, especially if the pandemic crisis continues in the second half of the year. With lower growth, the unemployment rate is expected to increase, after falling to 7.7% in 1Q20, compared to 8.0% in 4Q19 and 8.1% in the same period last year.

Chart 2: Egypt's economic growth

(y/y, %)



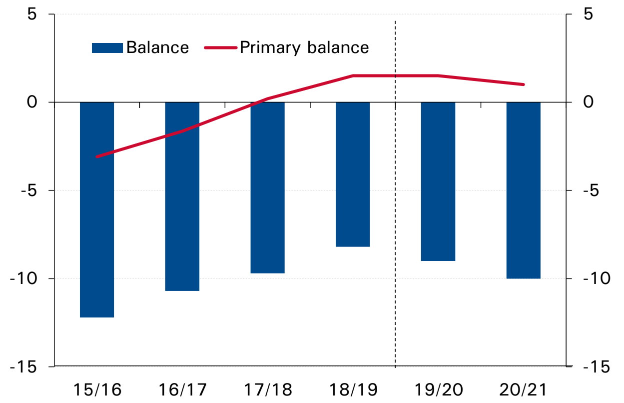
Source: Central Bank of Egypt, IMF, and NBK estimates

Fiscal position to worsen

Fiscal performance significantly improved during the first half of FY19/20, with the budget deficit declining to less than 4% of GDP. However, the lower revenues coupled with an unexpected increase in spending on health care and other social services, and the economic stimulus measures would worsen the fiscal position. The government expected the deficit to increase to around 8% of GDP in FY19/20, but this would still be narrower than the 8.4% deficit recorded in 2018/19.

Chart 3: Egypt's Fiscal balance

(% of GDP)



Source: Ministry of Finance, and NBK estimates

For FY20/21, Egypt approved the largest budget in the country's history, at EGP 2.2 trillion ($137 billion), reflecting mainly the increase in spending on public investment and social services, mainly health and education. In view of the current crisis, the budget deficit will likely increase to 7.8% of GDP in FY20/21 according to government estimates, against April's estimation of 6.2% and a pre-pandemic target of 5%. The draft budget aimed at reducing the public debt-to-GDP ratio from an estimated 85% in FY19/20 to 82.7% and 77.5% in this fiscal year and next, respectively. However, we believe that these targets are no longer achievable, especially if the pandemic lasts much longer.

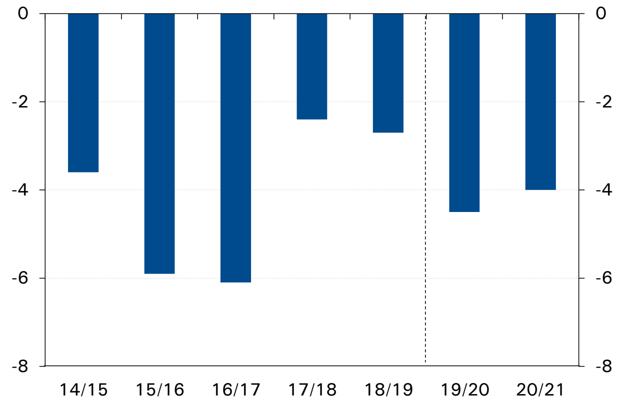
The external sector is under pressure

The external current account will widen as the pandemic ravaged some of Egypt's main sources of foreign currency. Revenues from the Suez Canal fell by $32.1 million to $5.72 billion during FY19/20, due mainly to a drop in revenue by 9.6% y/y in May alone given the slowdown of international trade. Egypt's tourism industry is expected to lose at least 62% of its revenue in 2020, according to the Egyptian National Planning Institute. Remittances have been also threatened by the crisis, given that thousands of Egyptians working abroad have returned home or lost their jobs.

All these factors in addition to some capital flight as investors sought safe havens following the outbreak of the coronavirus have pushed foreign reserves down from a record of $45.5 billion in February to $36.0 billion in May, before bouncing back to reach $38.2 billion in June.

Chart 4: Egypt's current account

(% of GDP)

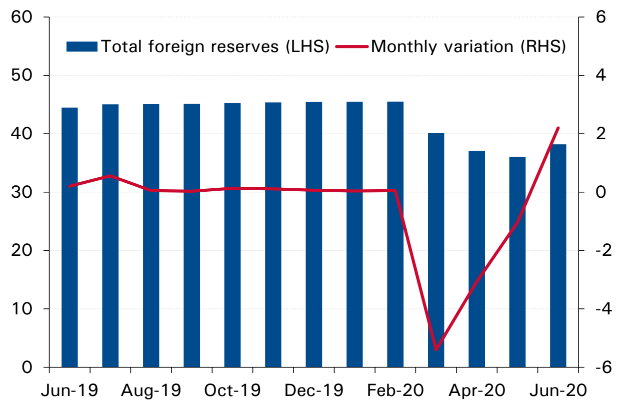


Source: Central Bank of Egypt, and NBK estimates

The worsening of the overall balance of payments explains Egypt's move to secure more financial buffers amid global uncertainty. In May, Egypt sold a $5 billion Eurobond in Its largest-ever issuance, which was more than four times oversubscribed, with total bids of $22 billion. Also, Egypt received from the IMF $2.8 billion in financing under the Rapid Financing Instrument to deal with the fallout from the pandemic, and negotiated a new 12-month IMF Stand-By Agreement worth $5.2 billion with $2 billion to be paid immediately and the remainder will be in two tranches of $1.6 billion within a year. The IMF agreements could catalyze some additional external support. These financial resources may not be sufficient to meet the balance of payments and budget financing needs, and Egypt could issue more bonds in 2020 and secure more loans from other sources.

Chart 5: Egypt's foreign reserves

(KD billion)



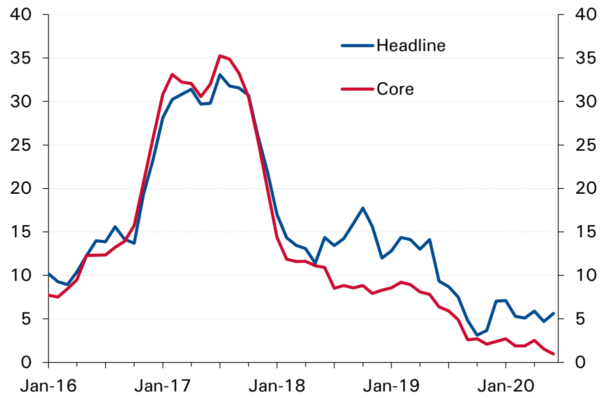
Source: Central Bank of Egypt

Inflation remains broadly within the central bank target

The urban inflation rate increased to 5.6% y/y in June from 4.7% in May, its lowest figure since last November. This was mainly due to a high demand for specific products related to the pandemic. Annual core inflation continued its deceleration, reaching a historic low of about 1% in June, down from 1.5% in May. However, inflation is expected to accelerate in the second half of the year, given the recent increase in electricity tariffs and the potential pick-up in demand as restrictions are eased.

Chart 6: Egypt's inflation

(y/y %)



Source: Central Bank of Egypt

Since inflation remains broadly consistent with the target of 9% (±3 percentage points), the Central Bank of Egypt (CBE) kept interest rates unchanged at its last three meetings after cutting them by 3 percentage points at an unscheduled meeting in March, as a part of precautionary measures to curb the effect of the virus outbreak. We expect the CBE to remain prudent and move cautiously in the months to come to avoid an acceleration of capital outflows.

Challenges remain in a highly uncertain outlook

Egypt faces some challenges that were compounded by the coronavirus. The restrictions and lockdown measures to stem the outbreak of the virus, and the additional spending to reduce its impact will disrupt the efforts that have been made over the past few years to achieve macroeconomic stability. The scale and longevity of the pandemic remain highly uncertain, casting doubt on the outlook. It is hoped that this will be temporary and the country will resume its reform efforts and put growth on an upward trajectory toward a fast and steep recovery. Once the pandemic is contained, attention needs to focus on redressing any emerging macroeconomic imbalances and tackling the many structural issues that the country faces, chief among them improving the business environment and making the private sector the primary driver of economic growth. Stronger and inclusive growth is highly needed to reduce poverty, which is still rampant, and create employment for the young Egyptians entering into the labor force in large numbers.

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