Reforms help in sustaining growth and dealing with the Pandemic

> Assil EL MAHMAH
Senior Economist
+965 2259 5365
assilelmahmah@nbk.com

Highlights

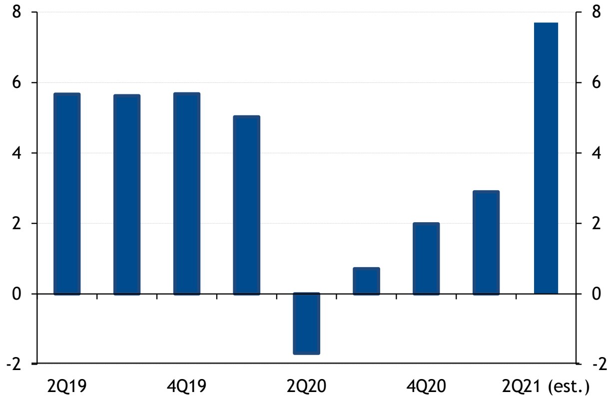
- **Egypt has mitigated the negative impact of the pandemic through health and social spending while keeping an eye on fiscal sustainability.**
- **The fiscal performance is better than expected, with the budget deficit narrowing to 7.4% of GDP in FY20/21 (vs. 8.0% of GDP a year ago).**
- **The current account is still under pressure, but foreign reserves are solid and the pound has remained stable.**
- **With inflation within the Central Bank of Egypt's target range of 7% (±2%), interest rates should remain steady this year.**
- **A potential threat of new virus variants and a slowdown in the global recovery could negatively affect the outlook.**

The Egyptian economy has performed better than expected, despite the Covid spread, thanks to the authorities' effective crisis management. However, the economy remains under pressure due to the uncertainty surrounding the pandemic and the potential emergence of new virus variants. In fact, after declining over much of the summer from a high of around 1200 cases in mid-May, daily infections have again been on the rise after the first case of the Delta Covid-19 variant was detected in July. Total confirmed cases reached about 290,000 and the cumulative number of deaths exceeded 16,000 in August. Still, only about 3.2% of the population has been fully vaccinated, while 7.5 million have had at least one dose. To this effect, the government announced that by October vaccinations would become mandatory for government employees, university students and staff at educational institutions.

Growth continues to accelerate

Buttressed by the ongoing economic reforms, Egypt's economic recovery from the pandemic remains broadly on track. In fact, after averaging 1.9% y/y over the first 9 months of FY20/21 (July-March), real GDP grew by 7.7% in 2Q21 compared with the same period last year when economic activity dropped by 1.7% due to pandemic-related restrictions. For the full fiscal year (July 20 – June 21), real GDP growth reached 3.3% compared to 3.6% in the previous fiscal year, due to weaker economic activity, especially during 1H of FY20/21.

Chart 1: GDP
(y/y, %)



Source: Central Bank of Egypt and NBK estimates

In this context, the unemployment rate dropped slightly to 7.3% in 2Q21 from 7.4% in 4Q20, thanks to the gradual reopening of business activities. This has so far been in line with the goals of the medium-term plan for sustainable development (2018-2022) that aims to lower the unemployment rate to around 7.3% by the end of the current fiscal year, as opposed to the peak of 9.6% recorded in 2Q20. This plan aims also to reduce the population growth rate to about 2% in FY21/22 from 2.56% in 2017 and the poverty rate to 28.5% from 29.7% a year ago.

The PMI edged down to 49.1 in July from 49.9 in June, slightly below the 'no change' 50 mark, but still a huge improvement from the levels seen at the peak of the pandemic crisis (29.7 in April) and above the previous quarter (an average of 48.7 in 2Q21). The slight dip in July's PMI was attributed to ongoing business caution amid continued pandemic-related uncertainty, despite a sharp decline in new virus cases in Egypt through the month. It is worth mentioning that although in principle this signals a contraction in private sector activity, these PMI levels have been consistent with solid GDP growth in the past. Looking ahead, firms remained optimistic about the outlook as the future output index reached 75.6 in July after registering 74.1 in June.

Chart 2: PMI

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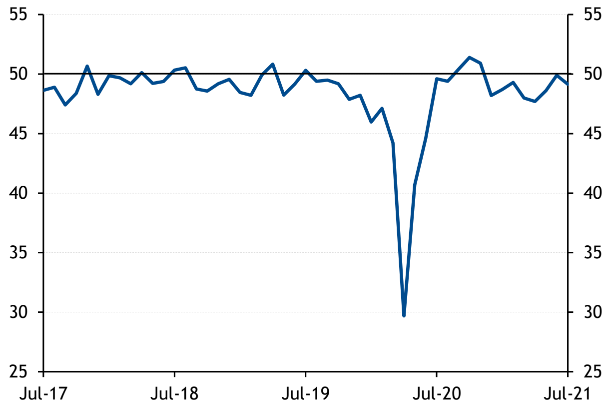


Source: IHS Markit

As restrictions recently eased and vaccine rollout accelerates, we expect the economy to continue its improvement in the coming quarters. Growth could reach about 5% over the medium term, benefitting from the authorities' continued commitment to reforms, absent any potential threat from new virus variants or a global economic setback.

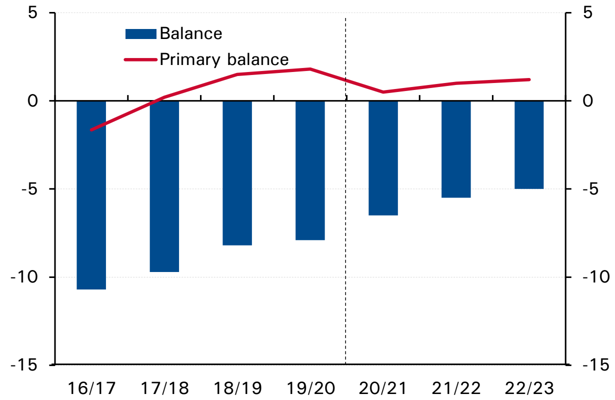
Fiscal position has improved more than expected

The fiscal position improved due to reduced subsidies and better public debt management. The government achieved a primary surplus (i.e. before interest payment) of 1.4% of GDP in FY20/21, higher than the 0.9% official target and the 1% expected by the IMF. This reflects a rise in revenues by 12% y/y, outpacing the increase in spending, which increased by 9%. As a result, the budget deficit declined to 7.4% of GDP in FY20/21 from 8% a year ago and from the government's initial target of 7.8%. One main contributing factor was the cut in debt-servicing costs to 36% of total expenditures during FY20/21 compared to 40% a year ago, benefitting from the change in debt maturities and lower interest rates. Indeed, the government succeeded in extending the life of the debt from less than 1.3 years before June 2017 to 3.45 years in June 2021.

Like other countries, Egypt's debt increased during the pandemic, from 84.0% to 90.6% of GDP in FY20/21 due to the unexpected surge in spending on health care. Unlike most other countries, however, the debt to GDP ratio declined from its pre-pandemic peak of 108% in FY16/17. Looking ahead, Egypt's debt-to-GDP ratio should decline to about 80% by the end of June 2022, as the government maintains its commitment to fiscal reforms and as the economy continues to grow. The overall budget deficit could narrow to 7% of GDP before dropping to about 6.5% in FY22/23, while still allowing sufficient public spending to support economic activity.

Chart 3: Fiscal balance

(% of GDP)



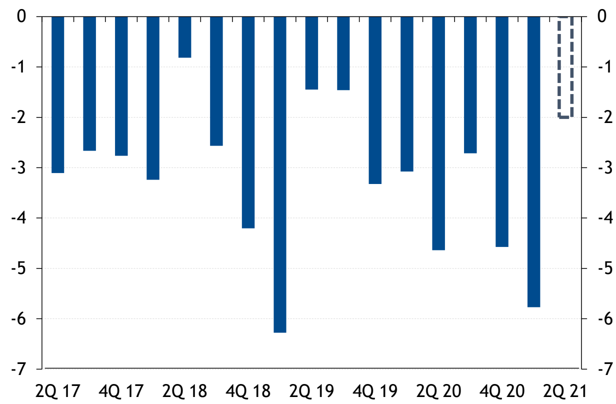
Source: Ministry of Finance, and NBK estimates

External sector is struggling as tourism revenue collapses

The pandemic and the restrictions on international travel have hit the tourism sector hard, leading to a larger current account deficit. The deficit almost doubled in the first nine months of FY20/21 (July – March), mainly on the back of a drop in tourism revenues (to $3.1 billion from $9.6 billion a year ago).

Chart 4: Current account balance

(% of GDP)



Source: Central Bank of Egypt, and NBK estimates

However, improvements in net foreign direct investment (FDI), remittances, and Suez Canal revenues are helping the overall balance of payments. FDI rose by 47.3% y/y in 1Q21, with a 21.7% y/y inflow to the non-oil sector. Remittances from Egyptians working abroad also continued their upward trend, increasing by 13% to $28.5 billion during the first 11 months of FY20/21 (July-May). Revenues from Egypt's Suez Canal also picked up 11.2% y/y in 8 months (Jan. - Aug.) to $3.88 billion, as the number of ships crossing rose by about 15%. The current account deficit could reach 4% of GDP in FY20/21, before improving to around 2.5% of GDP in coming years, as the fallout from the pandemic fades.

The recent acceleration of capital inflows, IMF support and foreign borrowing have more than compensated for the increase in the current account deficit, leading to an increase in net foreign reserves. These increased to $40.6 billion in July, more than $4 billion over the pandemic trough of $36 billion in May 2020. Foreign reserves are expected to increase further, as Egypt will receive a foreign currency boost equivalent to $2.8 billion through the IMF's new SDR allocation, in addition to issuing sukuk in 1H22.

The gradual recovery of Egypt's external position has helped the Egyptian pound to remain broadly stable against the US dollar at an average of EGP15.7/US$1 this year. This stability reflects overall improved macroeconomic performance, relatively high interest rates, which have maintained the currency's attractiveness, and confidence surrounding reforms.

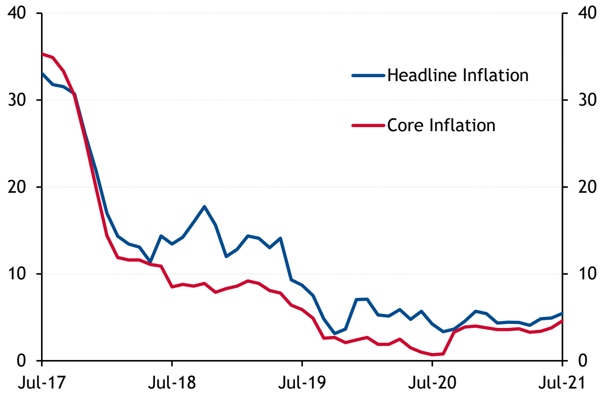
Inflation remains low despite its recent acceleration

Following recent hikes in electricity tariffs and cigarette prices as well as the continued increase in food costs, consumer prices rose at their fastest pace since last December. Urban inflation accelerated to 5.4% in July from an average of 4.6% y/y in 2Q21, with food and beverages costs—the largest single component of the inflation basket—accelerating by 4.8% y/y from 3.4% in June. (Chart 5.) Core inflation, which strips out volatile items, increased to 4.6% y/y from 3.8% in June.

In the coming months, inflation is expected to rise as the late-July increase in fuel prices will likely trickle down to other items and likely be visible in next quarter's headline figure. The recent announcement of a potential rise in prices for subsidized bread could also push inflation higher, although there have been no official estimates yet of the new costs.

Chart 5: Inflation*

(y/y %)



Source: CAPMAS and Central Bank of Egypt * For urban areas

In this context, the Central Bank of Egypt (CBE) kept its policy rates unchanged at its last meeting in August at relatively high levels (8.25-9.25%) for the sixth time in a row. With inflation still within its target of 7% (±2%), the CBE will not likely take any action this year. There is also no obvious need to raise rates at this time, given that growth is strong, global interest rates are likely to increase and the need to maintain a relatively attractive real interest rate (difference between the nominal interest rate and the inflation rate) to attract capital inflows.

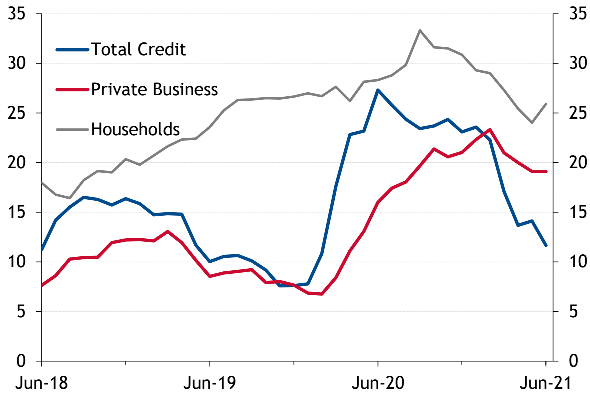
Banking sector remains resilient despite pandemic

The banking system continues to improve its liquidity position and boost depositor confidence, helped by the central bank's appropriate response during the pandemic. In fact, the non-performing loans ratio remained relatively low at 3.5% in 1Q21 compared to 3.6% in 4Q20 and 4.1% in 1Q20.

Besides authorities' efforts to provide affordable loans to heavily-affected SMEs, the CBE has launched an EGP 100 billion ($6.4 billion) mortgage finance initiative, targeting the low and middle-income homebuyers, with payment in installments over a period of up to 30 years and a low-interest rate of not more than 3%. Domestic credit continued to record double-digit growth in June at 11.6%, although it has decelerated from its highs as the boost from some previous government measures to encourage lending during the pandemic starts to fade. (Chart 6.) Looking ahead, credit growth is expected to remain solid, supported by the gradual economic recovery and by the clear guidance provided by a stable and consistent monetary policy.

Chart 6: Bank credit

(y/y %)



Source: Central Bank of Egypt

Remaining challenges require continuous efforts

Egypt has succeeded in laying the foundations of a more resilient and balanced economy that has been able to manage the spread of Covid-19 without halting macroeconomic and structural reforms or significantly affecting growth. However, the uncertainty over the global economic recovery and potential new waves of virus cases are the main risks to the outlook in the near term. Meanwhile, high public debt and large gross financing needs are considered the main factors that could leave Egypt vulnerable to external shocks in the medium and long terms. In the meantime, the government should continue with structural reforms to empower the private sector to play a much bigger role in driving growth, reducing poverty, and creating durable jobs.

Table 1: Key economic data

	FY14/15	FY15/16	FY16/17	FY17/18	FY18/19	FY19/20	Estimates/forecasts FY20/21	FY21/22
Nominal GDP ($ billion)	331.6	331.8	235	251	300	328	352	390
Real GDP (% growth)	3.4	2.3	4.2	5.3	5.6	3.6	3.3	5
Budget balance (% of GDP)	-10.8	-12.2	-10.9	-9.8	-8.2	-7.9	-7	-6.5
Primary balance (% of GDP)	-3.0	-3.1	-1.8	0.1	2	1.8	0.5	1
Current account balance (% of GDP)	-3.8	-6.0	-6.1	-2.4	-3.6	-3.1	-3.7	-2.9
Inflation (% y/y, FY average)	11.0	10.2	23.5	20.8	13.9	5.7	4.5	5.8
Public Debt (% of GDP)	85.0	102.8	108	97.3	90.2	82.5	83	80
Unemployment (%)	12.9	12.5	11.8	9.9	7.9	8.3	7.3	7.1

Source: Central Agency for Public Mobilization and Statistics (CAPMAS), Ministry of Finance, Central Bank of Egypt, NBK estimates.

Table 2: Monthly economic data

	Nov-21	Dec-21	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21
Credit Growth (% y/y)	24.4	23.1	23.6	22.3	17.1	13.7	14.1	11.6
Money supply (M2) growth (% y/y)	19.6	19.7	19.8	20	20	19.1	18.1	18.1
Urban Inflation (% y/y)	5.7	5.4	4.4	4.5	4.4	4.1	4.8	4.9
Core Inflation (% y/y)	4	3.8	3.6	3.6	3.7	3.3	3.4	3.8
Discount Rate (%)	8.75	8.75	8.75	8.75	8.75	8.75	8.75	8.75
Overnight lending rate (%)	9.25	9.25	9.25	9.25	9.25	9.25	9.25	9.25
Overnight deposit rate (%)	8.25	8.25	8.25	8.25	8.25	8.25	8.25	8.25
Exchange rate (USD/ EGP, average)	16.66	15.69	15.7	15.69	15.7	15.69	15.69	15.7

Source: Central Agency for Public Mobilization and Statistics (CAPMAS), Ministry of Finance, Central Bank of Egypt, NBK estimates.

Table 3: Quarterly economic data

	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21
GDP growth (% y/y)	5.6	5.7	5	-1.7	0.7	2	2.9	7.7
Current account balance (% of GDP)	-1.5	-3.3	-3.1	-4.6	-2.7	-4.6	-5.8	…
Unemployment rate (%)	7.8	8	7.7	9.6	7.3	7.2	7.4	7.3

Source: Central Agency for Public Mobilization and Statistics (CAPMAS), Ministry of Finance, Central Bank of Egypt, NBK estimates.

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353