Egypt

Growth accelerates despite ongoing pandemic pressures, reform challenges

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Highlights

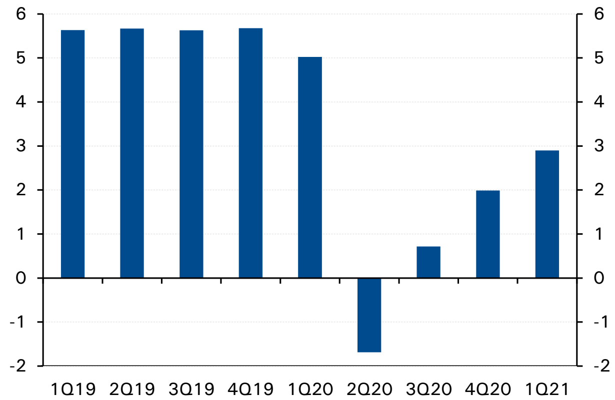
- **Egypt's economic recovery from the pandemic remains broadly on track, with GDP growth rising to 2.9% in 1Q21 and summer prospects improved by a lifting of various virus-related restrictions from June.**
- **Despite Covid pressures, the fiscal deficit may narrow in FY20/21 with the primary balance remaining in a small surplus.**
- **The external sector has been hit by the pandemic, but foreign reserves are solid and the pound has remained very stable.**
- **Inflation remains below the central bank's target range although the window for an interest rate cut may be narrowing.**

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 derailing growth or halting structural reforms. Still, the economy remains under pressure due to Covid. A third wave of infections in 2Q21 saw daily cases above 1,000 starting late April, before easing from mid-May after restrictions to curb the virus's spread were reintroduced on May 6. Total confirmed cases reached about 280,000 and deaths over 16,000 by the end of June. To accelerate the vaccination campaign, the government signed an agreement with China to manufacture the Sinovac vaccine locally, and aims to vaccinate 40% of its population by the end of 2021 (3.4 million people had been vaccinated by June). To boost the tourism sector over the crucial summer period, restrictions were lifted on June 1, including on the early closure of shops and restaurants, while the vaccination of workers in hotels in Southern Sinai and the Red Sea provinces was completed to encourage both domestic and foreign tourists.

GDP growth has continued to accelerate

Helped by an easing in lockdown restrictions from January, the gradual reopening of business activities pushed economic growth to 2.9% y/y in Q3 of FY20/21 (Jan-March) from 2% a quarter earlier. (Chart 1.) This was supported by government efforts to alleviate the pandemic's impact on key sectors and to boost domestic demand by raising wages and supporting vulnerable households. Over the first 9 months of FY20/21 (July-March), GDP growth averaged 1.9% y/y compared to about 5.4% in the same period a year earlier. Several sectors managed to maintain their growth trajectory, including wholesale & retail trade, industry, agriculture and real estate, representing more than half of the economy. However, the tourism sector that represents 11.3% of GDP remained badly affected by the pandemic.

Chart 1: GDP
(y/y, %)



Source: Central Bank of Egypt and NBK estimates

In this context, the unemployment rate edged up to 7.4% in 1Q21 from 7.2% in 4Q20, on the back of the second wave of the coronavirus pandemic. However, this rate is below the peak of 9.6% recorded in 2Q20 and even the 2019 average of 7.9%, suggesting a return to close to normal in some business areas.

The PMI also continues to show signs of normalization, although is off its highs. (Chart 2.) The headline index recorded a huge improvement from the levels seen at the peak of the pandemic crisis, averaging 48.7 in 1Q21 versus 38.3 in 2Q20. While the index remains in sub-50 contraction territory, this level of the index has historically been consistent with solid GDP growth. Figures for Q2 so far look a touch softer, perhaps affected by the virus restrictions imposed in May. However, firms are optimistic about the outlook as the future output index reached 79.1 in May, its highest level since February 2018.

Chart 2: PMI

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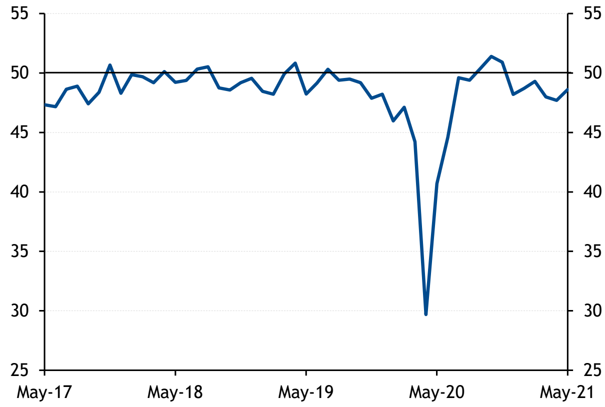
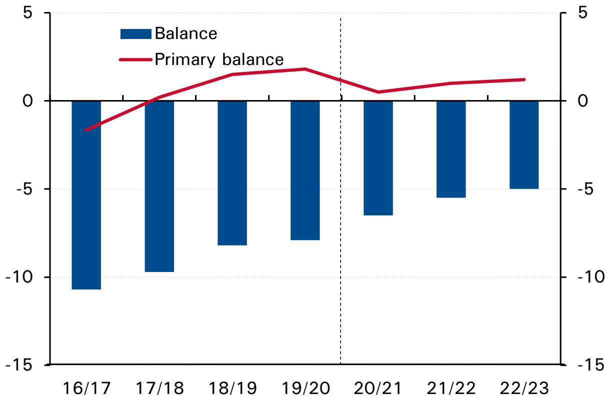


Source: IHS Markit

Chart 3: Fiscal balance

(% of GDP)



Source: Ministry of Finance, and NBK estimates

With virus cases starting to dip, restrictions recently eased and vaccine rollout picking up, we expect the economy to continue its improvement in the coming quarters. Growth is forecast at 2.5% in FY20/21, rebounding strongly to about 5% over the medium term, benefitting from the authorities' continued commitment to reforms. However, the still unknown path of the pandemic and in particular the threat of new virus variants remains a serious risk to the outlook for the coming year both in Egypt and globally.

Fiscal reforms on the right path

The government has continued to address its public finance challenges through a combination of measures such as reducing energy subsidies and directing the savings to priority areas. In fact, the government achieved a primary surplus (i.e. before interest is paid) of 0.4% of GDP during the first nine months of FY20/21 (July-March), despite an increase in spending needed to mitigate the impact of Covid-19. Amid government efforts to reduce debt-servicing costs by changing debt maturities to benefit from lower interest rates, the total 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.

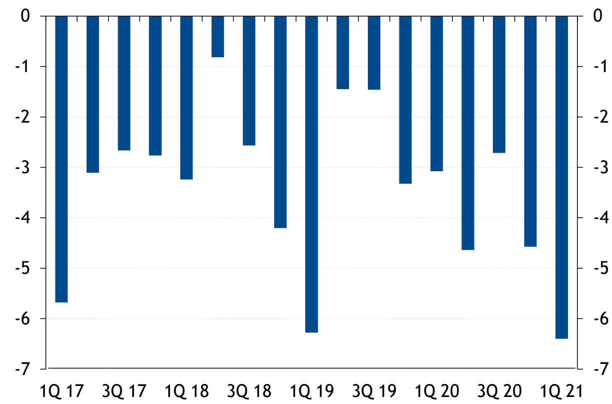
The government is targeting a decrease in the deficit to 6.5% of GDP in FY21/22, 5.3% in FY22/23, and 4.6% in FY23/24, thanks to a medium-term strategy to reduce the burden of debt servicing and create additional financial space for the budget to support economic activity. The public debt-to-GDP ratio is expected to rise slightly to 83% in FY20/21 up from 82.5% in FY19/20, but should decline to about 80% by the end of June 2022. (Chart 3). These targets seem reasonable and close to our forecasts as long as the government maintains its commitment to reforms in the areas of economic growth and fiscal sustainability.

External sector began to recover but still under pressure

The current account balance has widened a little since the start of the pandemic, with some key sectors still in bad shape. The deficit reached $5.7 billion (6.4% of NBK estimated GDP) in 1Q21 from $2.8 billion (3.1% of GDP) in the previous year. (Chart 4.) The tourism sector, which is one of the main sources of foreign exchange, saw its revenues drop by 67.5% over the first nine months of FY20/21 to $3.1 billion, as the pandemic sharply reduced international travel. The trade deficit also widened by 12.7% to $30.7 billion in July-March, amid a rise in imports of equipment related to Covid and an increase in commodity prices.

Chart 4: Current account balance

(% of GDP)



Source: Central Bank of Egypt, and NBK estimates

On the positive side, net foreign direct investment began to recover during 2H FY20/21, with net inflows of $1.4 billion in 1Q21 compared to $970 million in 1Q20. Remittances from Egyptians working abroad also continued an upward trend, increasing by 8.5% to $23.4 billion in July-March compared to $21.5 billion a year ago. 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, as pandemic fallout fades.

As the pandemic affected foreign reserves, the authorities were able to secure additional financial buffers in the form of IMF support, foreign borrowing and the recent acceleration of capital inflows. Indeed, net foreign reserves increased by around $125 million in May to $40.5 billion, and were up more than $4 billion versus the pandemic trough of $36 billion in May 2020. Foreign reserves are expected to rise as Egypt received in June the third tranche worth $1.6 billion of the IMF's $5.2 billion stand-by agreement program.

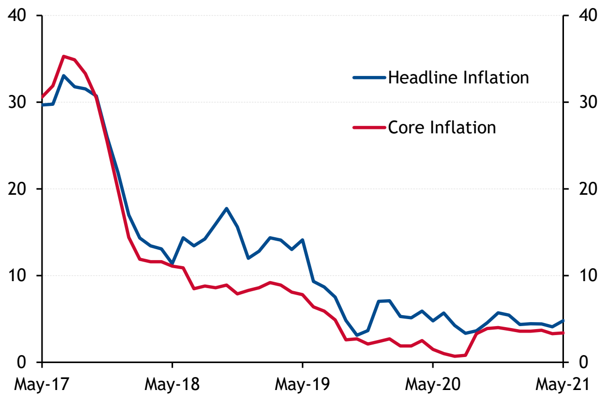
After appreciating against the US dollar in 2020, the pound has been broadly stable in 1H21 and has traded at an average of EGP15.7/US$1 so far this year. This stability against the backdrop of the pandemic reflects overall improved macroeconomic performance, relatively high interest rates which have maintained the currency's attractiveness, and confidence surrounding reforms. The steady pound has also reinforced the improved economic climate by supporting the investment environment and contributing to reduced inflationary pressures versus earlier years (see below).

Stable monetary policy amid low inflation

From an average of 4.4% y/y in 1Q21, inflation picked up to 4.8% in May, the highest since December. (Chart 5.) This was attributed to an increase in food and beverage prices amid Ramadan and the Eid al-Fitr celebration. In the coming months, inflation could increase given rising commodity prices, scheduled electricity tariff hikes and the potential pick-up in demand as economic activity recovers. Still, it is expected to remain much lower than the double-digit rates recorded in 2019 and before, reflecting both improved policy setting and greater exchange rate stability following earlier currency liberalization measures.

Chart 5: Inflation*

(y/y %)



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

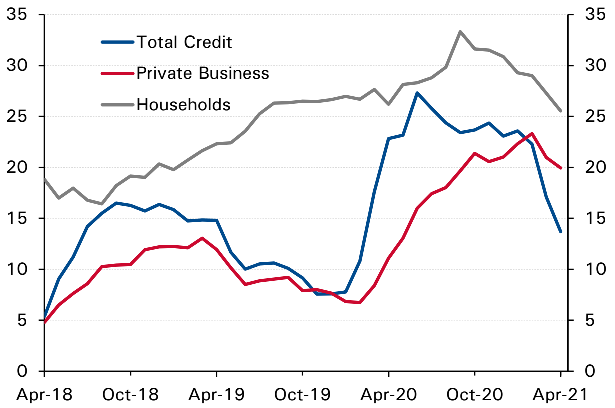
With inflation remaining below the target of 7% (±2%), the Central Bank of Egypt (CBE) has kept its policy rates unchanged at relatively high levels (8.25-9.25%) since its meeting last December, helping to keep local assets attractive for international buyers. While the CBE may still have some room for loosening policy this year (perhaps 50bps) to support the economic recovery and reduce the government's debt-servicing costs, the window for interest rate cuts may be narrowing as central banks elsewhere including the US Fed start to consider tighter policy.

Healthy banking sector supported by solid credit growth

The banking system has remained relatively resilient, helped by a sound initial liquidity position and appropriate response by the central bank. In fact, the non-performing loans ratio remained low at 3.6% in 4Q20 compared to 4.2% in 4Q19. In addition, domestic credit continued to record double-digit growth at 14.1%, although it has decelerated from its highs as the boost from government measures to encourage lending started to fade. (Chart 6.) Looking ahead, credit growth is expected to remain solid supported by the economic recovery, accommodative monetary policy (although rates are high by international standards), ongoing economic reforms and authorities' efforts to provide relief to heavily affected SMEs, especially in the tourism sector.

Chart 6: Bank credit

(y/y %)



Source: Central Bank of Egypt

Economy improving, reforms to help sustain strong growth

Although still facing severe challenges related to the pandemic, the economy seems to have stabilized and is improving. The uncertainty over the recovery in global growth and potential new waves of virus cases are the main risks to the outlook in the near term, while the central bank will remain vigilant to the risks to inflation from rising oil and food prices at a global level. Meanwhile, the ongoing fiscal and economic reforms if sustained will present strong medium-term growth prospects for Egypt, benefitting from lower domestic interest rates that will put the debt ratio on a downward path. It will also be crucial to focus on structural challenges, allowing the private sector to play a much bigger role in driving growth, reducing poverty, and creating jobs for a large number of Egyptians entering the labor force.

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	303	331	354	386
Real GDP (% growth)	3.4	2.3	4.2	5.3	5.6	3.6	2.5	5.0
Budget balance (% of GDP)	-10.8	-12.2	-10.9	-9.8	-8.2	-7.9	-7.0	-6.5
Primary balance (% of GDP)	-3.0	-3.1	-1.8	0.1	2.0	1.8	0.5	1.0
Current account balance (% of GDP)	-3.8	-6.0	-6.1	-2.4	-3.6	-3.1	-4.0	-2.9
Inflation (% y/y, FY average)	11.0	10.2	23.5	20.8	13.9	5.7	4.5	5.2
Public Debt (% of GDP)	85.0	102.8	108	97.3	90.2	82.5	83.0	80.0
Unemployment (%)	12.9	12.5	11.8	9.9	7.9	8.0	8.0	7.5

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

Table 2: Monthly economic data

	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	April-21	May-21
Credit Growth (% y/y)	23.7	24.4	23.1	23.6	22.3	17.1	13.7	...
Money supply (M2) growth (% y/y)	19.4	19.6	19.7	19.8	20.0	20.0	19.1	...
Urban Inflation (% y/y)	4.6	5.7	5.4	4.4	4.5	4.4	4.1	4.8
Core Inflation (% y/y)	3.9	4.0	3.8	3.6	3.6	3.7	3.3	3.4
Discount Rate (%)	9.25	8.75	8.75	8.75	8.75	8.75	8.75	8.75
Overnight lending rate (%)	9.75	9.25	9.25	9.25	9.25	9.25	9.25	9.25
Overnight deposit rate (%)	8.75	8.25	8.25	8.25	8.25	8.25	8.25	8.25
Exchange rate (EGP/USD, average)	15.70	16.66	15.69	15.70	15.69	15.70	15.69	15.69

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

Table 3: Quarterly economic data

	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21
GDP growth (% y/y)	5.7	5.6	5.7	5.0	-1.7	0.7	2.0	2.9
Current account balance (% of GDP)	-1.4	-1.5	-3.3	-3.1	-4.6	-2.7	-4.6	-6.4
Unemployment rate (%)	7.5	7.8	8	7.7	9.6	7.3	7.2	7.4

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

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