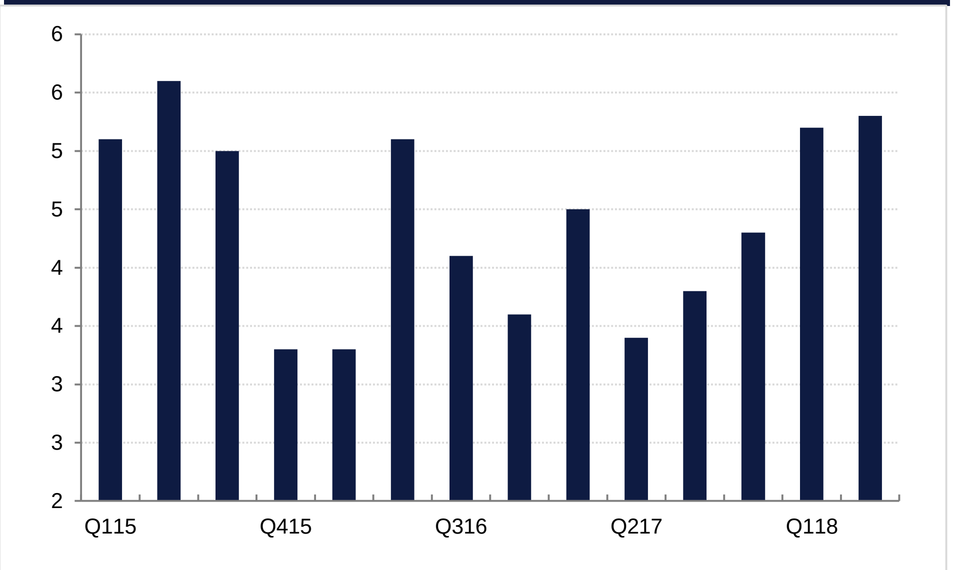
Emirates NBD

Egypt Quarterly

- **Growth outlook:** The Egyptian economy continues to improve. Real GDP growth has strengthened over the past four consecutive quarters, climbing to 5.3% y/y in Q2 2017/18, and we expect that the expansion will remain robust, forecasting an annual 5.2% this year, and 5.5% in 2018/19 (compared to an average of just 3.3% over the previous seven years).
- **Fiscal policy:** The budget outlined for fiscal 2018/19 shows a commitment by the Egyptian government to economic reform and steadily reducing the budget deficit, but this process will be slow nonetheless. We forecast that the shortfall will be equivalent to 8.5% of GDP, compared to a projected 9.5% this year.
- **Balance of payments** Egypt's current account deficit has narrowed significantly on the back of its recent economic reforms, and its currency float in particular. According to the most recent data from the CBE, Egypt's current account deficit narrowed to just USD 1.8bn in Q2 2017/18, compared to USD 4.7bn in the same period a year earlier.
- **Monetary policy:** The Central Bank of Egypt (CBE) enacted the second of what we expect will be a total of four 100bps cuts to its benchmark interest rates on March 29, taking the overnight lending rate to 17.75% and the overnight deposit rate to 16.75%.
- **Egyptian pound:** We anticipate that the Egyptian pound will remain fairly stable over the remainder of 2018, appreciating modestly from its current levels of EGP 17.7219/USD to around EGP 17.0000/USD by year-end.

Real GDP growth, % y/y



Source: Haver Analytics, Emirates NBD Research

Egypt
Quarterly
24 April 2018

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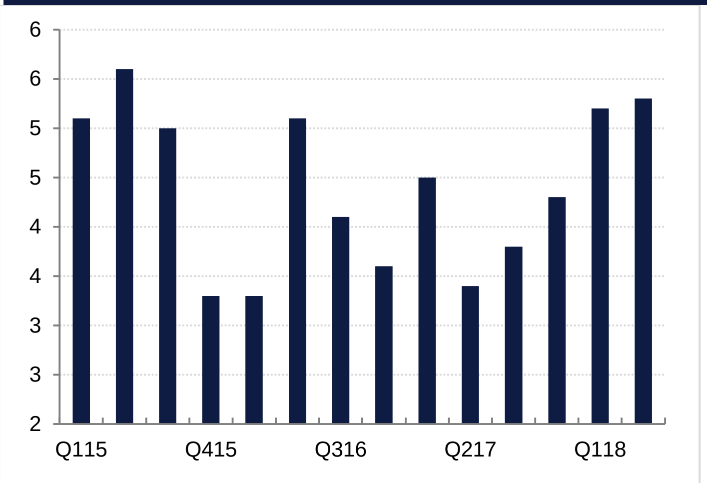
Content

Growth Outlook

The Egyptian economy continues to improve. Real GDP growth has strengthened over the past four consecutive quarters, climbing to 5.3% y/y in Q2 2017/18, and we expect that the expansion will remain robust, forecasting an annual 5.2% this year, and 5.5% in 2018/19 (compared to an average of just 3.3% over the previous seven years). The country's IMF-sponsored reform programme is progressing as planned, and with much of the short-term pain now in the base, Egypt is set to reap the rewards.

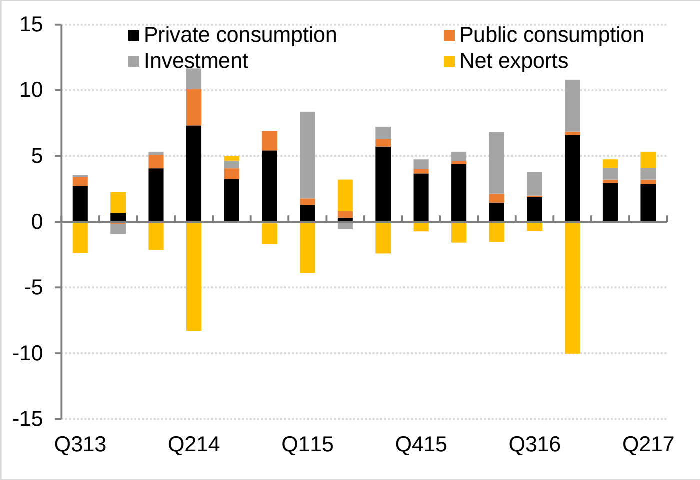
Real GDP growth, % y/y



Source: Haver Analytics, Emirates NBD Research

The re-election of President Abdel Fattah el-Sisi in March will be seen as a mandate for ongoing economic reform, meaning that the authorities will continue to work towards improving the country's fundamentals, as well as maintaining growth levels. Egypt's GDP data for the past two quarters demonstrates the effect that the reforms enacted under its IMF-sponsored programme since November 2016 have had on the economy already; not only has growth been given a boost, but the drivers of that growth have changed as well. The reforms have been wide-ranging, entailing subsidy cuts, tax hikes, and the removal of capital controls, but it was the removal of the Egyptian pound's peg to the dollar which has had the most marked effect. The sharp sell-off of the currency has boosted exports while curbing imports, and net exports has had a positive effect on Egypt's real GDP growth over the past two quarters, for the first time since Q3 2013/14.

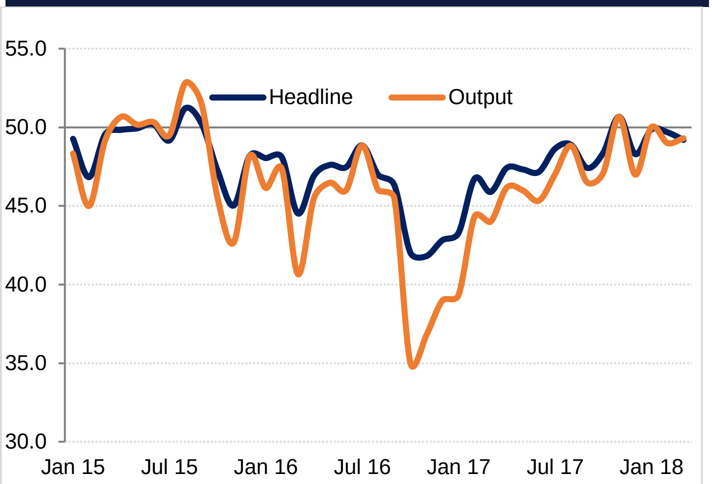
Real GDP growth by component, pp



Source: Haver Analytics, Emirates NBD Research

What the authorities are looking to ensure now is that growth will continue apace, and not only from a rebalancing of the external position, but from greater private consumption and investment also – a more productive growth generator. The Central Bank of Egypt (CBE) has noted in its monetary policy statements that government demand and external rebalancing have driven the growth recovery to date, while private domestic demand has lagged. The fact that the Emirates NBD Egypt Purchasing Managers' Index (PMI) has remained largely in contractionary territory (just) also suggests that the private sector has not yet started meaningfully contributing to the growth story.

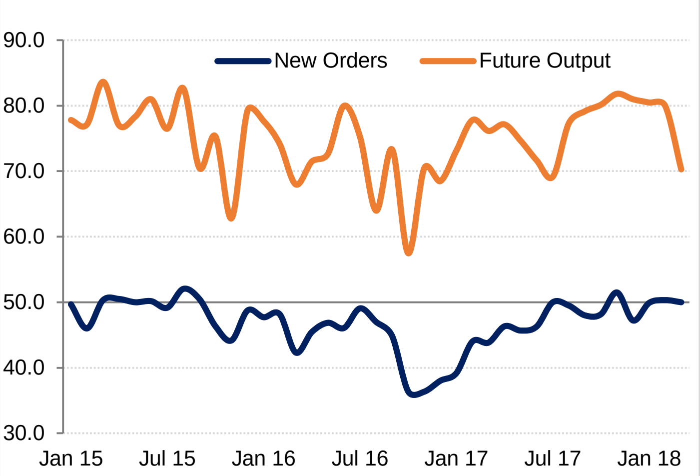
Emirates NBD Egypt PMI



Source: IHS Markit, Emirates NBD Research

We expect that this will change, and that the private sector will begin to perform more strongly as there are a number of positive factors at play in Egypt in 2018. The PMI data supports this expectation, with new orders, new export orders, and optimism around future output all positive.

Emirates NBD Egypt PMI



Source: IHS Markit, Emirates NBD Research

- Falling inflation and easing monetary policy will support greater household spending and private sector expansion – although further subsidy cuts will offset some of this and households will remain under pressure.

- The reinstatement of direct flights between Moscow and Cairo in April bodes well for further easing on flight restrictions to Egypt. This would give the tourism sector a significant boost, further to the strong growth it is already enjoying (tourist arrivals were up 53.6% y/y in 2017). Tourism minister Rania al-Mashat announced plans to reform the tourism sector in April, in a bid to encourage greater investment.

- We expect that ongoing political stability after the peaceful conclusion of March elections will encourage increased investment, both domestic and from overseas. Incumbent President Abdel Fattah el-Sisi has returned for a second term with 97% of the vote on 41% turnout. Ongoing reforms will also entice greater FDI.

- Ratings agencies Fitch and S&P have both upgraded the outlook on their ratings for Egypt to positive in the past six months.

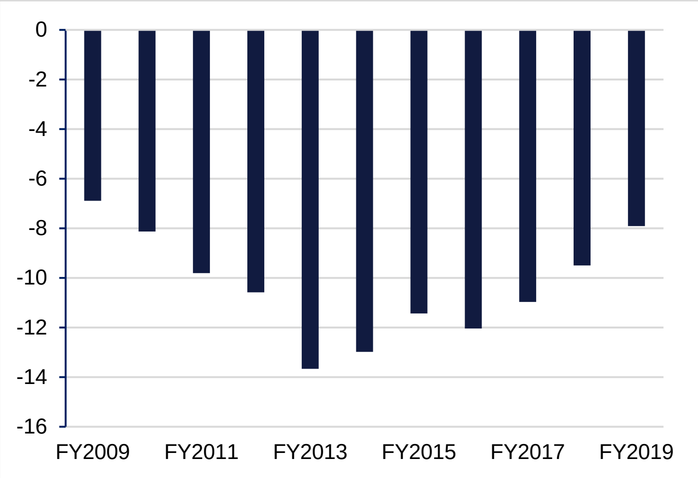
- Egypt's major new offshore gas fields like Zohr will bring a number of benefits to the Egyptian economy. Initial production at Zohr will be 350mn cubic feet per day, rising to 1bn in June and 2.7bn by the end of next year. This will be bolstered by the North Alexandria and Nooros fields once launched. Plans to make Egypt a regional energy hub are also positive for growth. Petroleum minister Tarek el-Molla said in April that Egypt was looking for USD 10bn of investment into the oil & gas sector in 2018/19 which would mark a 25% increase y/y.

With all of that being said, the real challenge will begin beyond the next two years. The 'stroke of a pen' reforms have been done, and Egypt is enjoying the fruits of these, but in many ways the harder part of the reform process is yet to come. This would entail a fundamental overhaul of the Egyptian economy and encourage greater private sector participation in key industries. The IMF has highlighted this as a concern in its reports, stating in its second review that 'Egypt's reform efforts should aim to improve allocation of resources in the economy and enhance the business climate for private sector development.'

Fiscal Policy

The budget outlined for fiscal 2018/19 shows a commitment by the Egyptian government to economic reform and steadily reducing the budget deficit, but this process will be slow nonetheless. We forecast that the shortfall will be equivalent to -8.5% of GDP, compared to a projected -9.5% this year. While still wide, this marks an improvement on the -11.0% recorded last year, and the recent peak of -13.7% in 2012/13. Fiscal consolidation efforts under the auspices of the IMF programme have been two-pronged, entailing tax hikes (higher VAT rates for instance) on one hand and subsidy cuts on the other.

Fiscal balance, % GDP

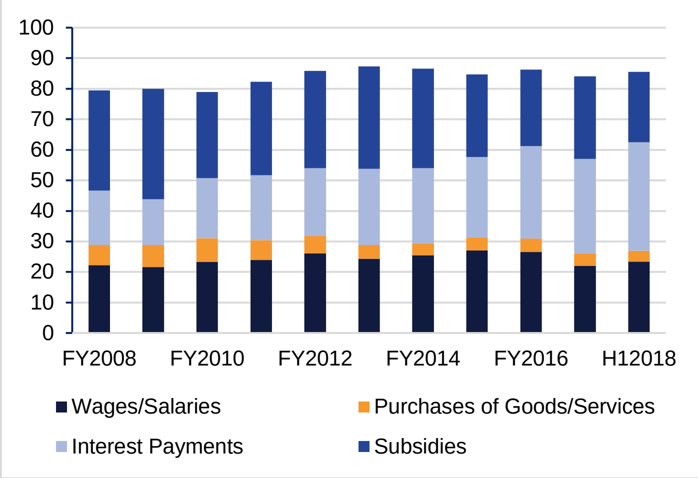


Source: Haver Analytics, Emirates NBD Research

The need to reduce the government's subsidy programme has been highlighted by the rise in global oil prices seen at the start of 2018 forcing the government to adjust its deficit target for this year upwards. As such, the government's plans to further cut subsidy support for fuel and electricity next year will give it greater control over its finances in future. The draft budget revealed in March shows plans to cut fuel subsidies by 26.3% to EGP 89bn and electricity subsidies by 46.7% to EGP 16bn. Cuts to subsidies last year saw fuel prices rise by 50%, and electricity by 42%, exacerbating inflationary pressures, and these cuts will have a similar effect. However, the draft budget seeks to protect the poorest in society from the worst of this, through a planned 5% rise in food subsidies.

Subsidy payments as a proportion of expenditure fell to just 23% in the first half of the current fiscal year, compared to as much as 34% in recent years, and we expect that it will continue to decline. However, it should be noted that debt servicing costs as a percentage of expenditure have risen over the same period. This will prevent a more rapid drawdown of the fiscal deficit than might otherwise have happened, but a strategy of increasing the share of external debt in the total debt load should lower borrowing costs, and should also reduce crowding out of the private sector in the domestic market. Egypt has successfully issued Eurobonds of USD 4bn in February and EUR 2bn in April.

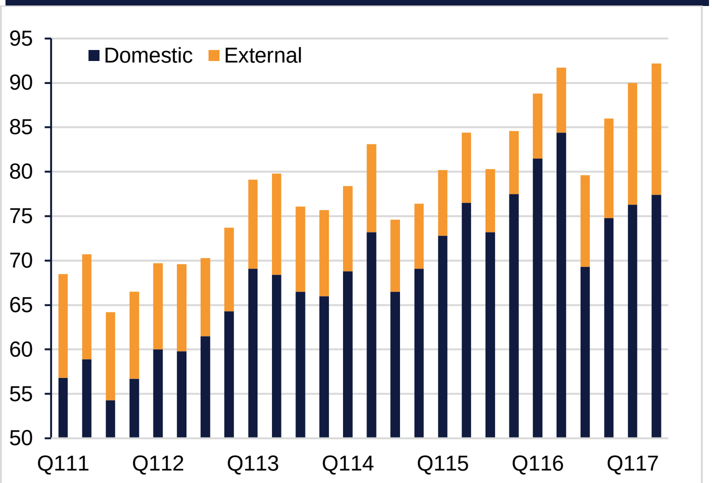
Expenditure, % of total



Source: Haver Analytics, Emirates NBD Research

Crucially, government plans to privatise a number of state assets will help prevent a more rapid escalation of public debt, which stands at nearly 100% of GDP. The government's IPO programme looks to sell off 23 of Egypt's state-run companies on the stock exchange. While plans to achieve all of this within the next two and a half years are probably overambitious given the size of the Egyptian market, successful listings of the companies will be an important source of revenue until the books can be balanced.

Government debt, % GDP

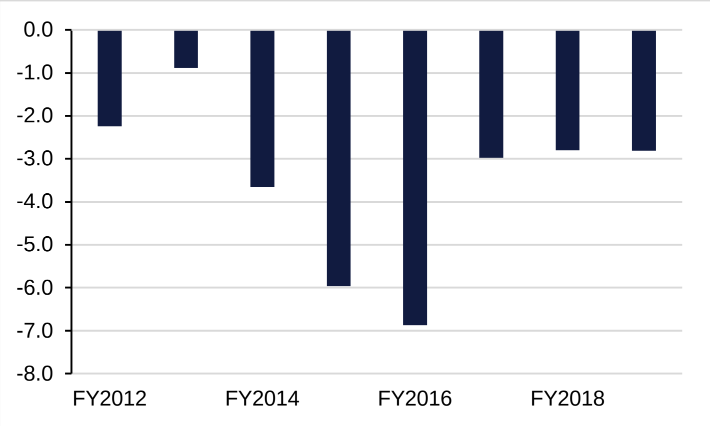


Source: Haver Analytics, Emirates NBD Research

Balance of Payments

Egypt's current account deficit has narrowed significantly on the back of its recent economic reforms, and its currency float in particular. According to the most recent data from the CBE, Egypt's current account deficit narrowed to -USD 1.8bn in Q2 2017/18, compared to -USD 4.7bn in the same period a year earlier. We forecast that it will stand equivalent to -3.0% of GDP in 2017/18 and -2.8% in 2018/19 (compared to -6.0% and -6.9% the two previous years). The more competitive currency should continue to boost exports receipts, remittances and investment inflows, while at the same time constraining imports.

Current account balance, % GDP

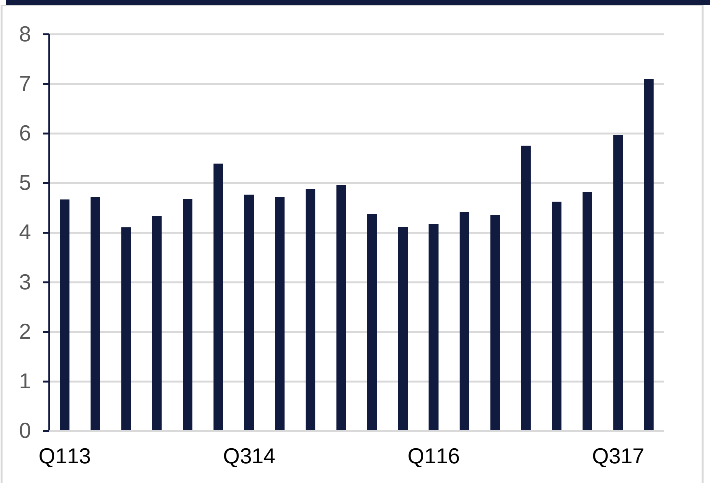


Source: Haver Analytics, Emirates NBD Research

Both goods and services exports have climbed fairly consistently q/q over the past five periods, contributing to the far narrower deficit. Services receipts in particular have enjoyed rapid growth (up 78% y/y in Q2), buoyed by strong growth in travel receipts (up 176.3%) as visitor numbers rose by 53.6%%. We expect that this trend will continue as tourists look to take advantage of the more competitive currency and increased political stability. The reinstatement of direct flights between Moscow and Cairo in April bodes well for visitor numbers, especially if it proves a precursor to direct flights running between Russia and the UK, and Egypt's Red Sea resorts once more. Another positive comes from the development of Egypt's offshore gas sector, which will soon make it self-sufficient in terms of natural gas, with even a surplus to export down the line.

Although goods imports are fairly sticky, and higher oil prices will boost the cost of fuel imports in the coming months, growth has been far slower on the imports side than that seen in exports. Services payments have also expanded at a much slower pace, in part due to travel payments abroad having halved since prior to the currency float as Egyptians have seen the cost of travelling rise as the currency depreciated. On the other side of this, remittances have risen sharply as those abroad look to take advantage of the cheaper pound. Remittances, which have always been one of the most important sources of foreign exchange in Egypt, came to USD 7.1bn in Q2, compared to USD 4.4bn prior to the float. With the GCC states set to grow more strongly in 2018, the prospects for even greater remittances are positive.

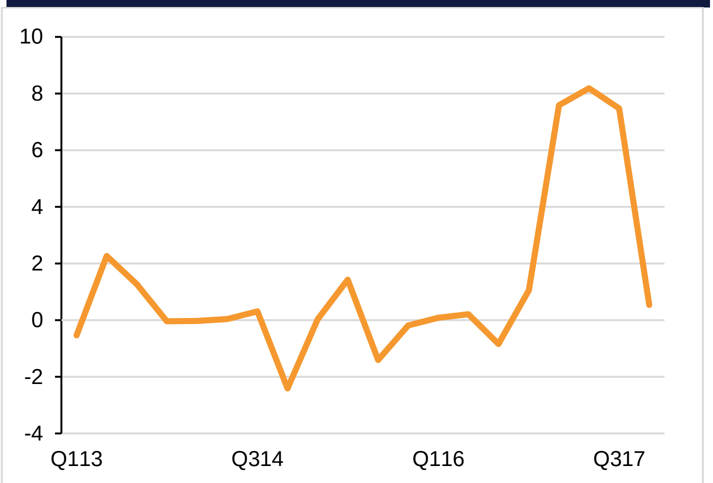
Remittances, USDbn



Source: Haver Analytics, Emirates NBD Research

One potential source of weakness in Egypt's balance of payments arose in Q4, when the rapid portfolio inflows seen over previous quarters slowed markedly. Over the previous three periods, portfolio inflows averaged USD 7.8bn, but this slowed to just USD 540.7mn in the three months ended December 2017. This is reflected in the foreign ownership of treasury bills, which declined (moderately) over those months. With the central bank cutting rates, and yields on Egyptian treasury bills falling, their relative attractiveness has waned and the rapid inflows seen at the start of last year are unlikely to be repeated.

Portfolio inflows, USDbn



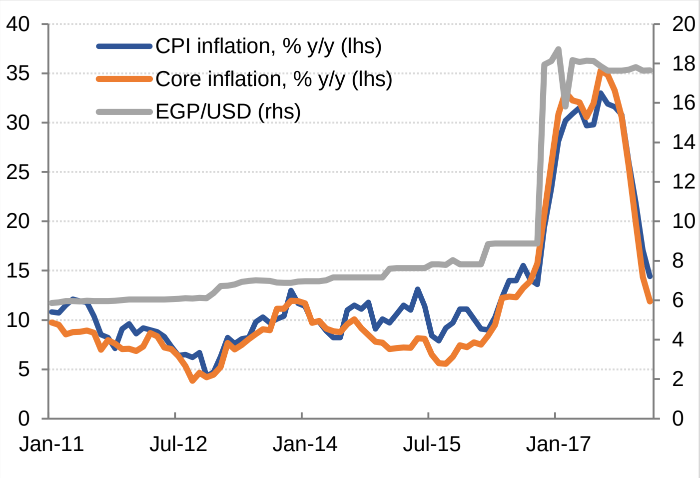
Source: Haver Analytics, Emirates NBD Research

All the same, we do not expect a rapid departure of foreigners from Egypt's capital markets, especially as the EGX is on a bullish uptrend with a busy pipeline of IPOs. We also expect that FDI inflows will begin to make a bigger impact on the overall balance of payments this year.

Monetary Policy

The Central Bank of Egypt (CBE) enacted the second of what we believe will be a total of four 100bps cuts to its benchmark interest rates on March 29, taking the overnight lending rate to 17.75% and the overnight deposit rate to 16.75%. This followed the first rate cut of this easing cycle which was implemented in mid-February. The CBE was forced to implement a cumulative 700bps of hikes as Egypt embarked on its IMF-sponsored reform programme in late 2016, as the removal of the Egyptian pound's peg to the dollar, alongside a number of tax hikes and subsidy cuts, led to inflation rising to a peak of 33.0% in July.

Inflation & EGP



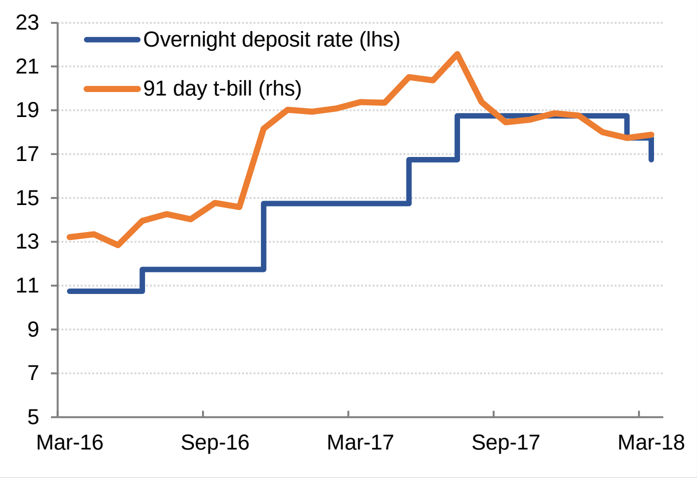
Source: Haver Analytics, Emirates NBD Research

With the pound's 2016 depreciation now in the base, inflation has come down to 13.3% at the latest print in March, which has enabled the CBE to begin cutting rates. However, we do not expect that these cuts will be rapid even as the bank looks to stimulate the private sector demand which has lagged to date in Egypt's economic recovery, as a number of factors continue to argue for fairly tight monetary policy. We expect two further 100bps cuts in 2018, both in the second half of the year most likely.

The primary reason for this caution is that there remain significant inflationary pressures that will prevent a continued sharp decline in inflation over the coming months. With the pound's depreciation in the base, the pace of the decline has already slowed, and the headline inflation figure dropped just 1.1 percentage points in the latest reading. Further subsidy cuts are due in the new fiscal year starting July, and these will slow the decline even more - the government aims to cut spending on fuel subsidies by 26.3% and on electricity subsidies by 46.7% in its new budget.

The CBE's March communiqué said that it will be watching the 'timing and magnitude of potential subsidy-reform measures' closely, and also cited higher oil prices as a potential source of inflationary pressure. In light of this, the IMF will be supportive of continued high interest rates in Egypt, which will be another factor behind cautious cuts.

Rates, %



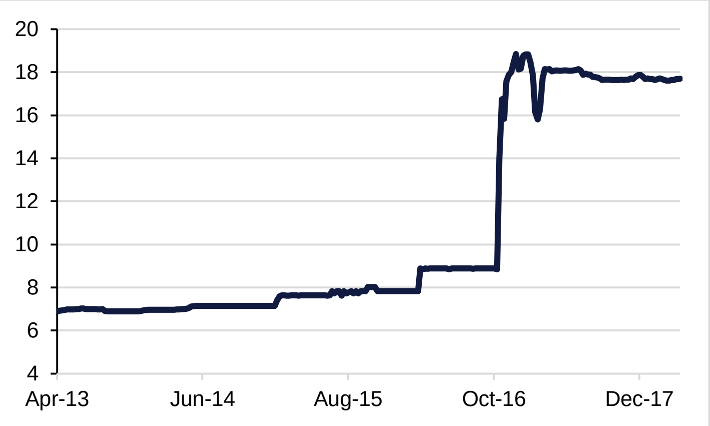
Source: Haver Analytics, Emirates NBD Research

Another salient factor is that the CBE will be cognizant of the risk of prompting capital flight of the billions of dollars of portfolio inflows Egypt has enjoyed over the past 18 months, especially in light of global monetary tightening. The very high interest rates made Egyptian domestic debt attractive to international investors, especially as the country loosened its capital controls. Foreign ownership of treasury bills rose from USD 0.1bn in October 2016, to USD 18.9bn at its peak in October. Lower yields have already contributed to this figure falling for the first time since the currency float over the past several months, falling to USD 18.0bn in December (last available data), and the CBE will be wary of hastening this decline through over-eager rate cuts .

Egyptian Pound

We anticipate that the Egyptian pound will remain fairly stable over the remainder of 2018, appreciating modestly from its current levels of EGP 17.7219/USD to around EGP 17.0000/USD by year-end. The risks to this forecast are moderately towards the downside, but we certainly do not envisage any sell-off the like of which was seen in 2016, even as the CBE embarks on its rate-cutting cycle.

EGP/USD

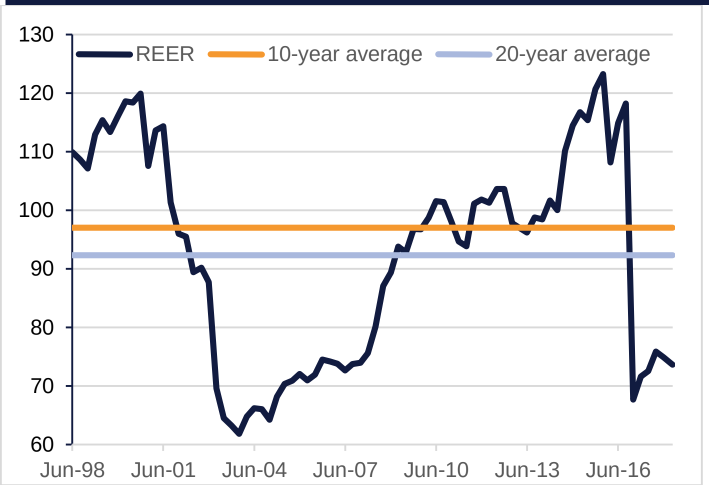


Source: Bloomberg, Emirates NBD Research

Despite the monetary easing cycle embarked upon by the CBE in February, we do not anticipate a rush of hot money out of Egypt prompting a crisis and collapse of the pound for a number of reasons. First, international reserves stood at a record USD 42.6bn in March, with a further USD 13.7bn of other foreign currency assets not recorded in the official reserves figure, giving the bank substantial fire power. Second, we also anticipate that other inflows will begin to pick up even as foreign investment into treasury bills slows. This will take the form of both greater FDI and also portfolio inflows into equities, with the EGX on a bullish uptrend and a number of IPOs in the pipeline – Egyptian Exchange Governor Mohamed Farid said in December that net purchases by foreign investors had been EGP 13bn since the exchange rate liberalisation in November 2016. Finally, the CBE's likely cautious approach will prevent too much profit taking by foreign investors in any case, especially as the greater political stability in Egypt will in part mitigate the lower yields on offer.

The argument that the pound will strengthen is in large part predicated on the fact that its sell-off in 2016 was somewhat overdone, taking both the Egyptian authorities and the IMF by surprise, especially given the effect it then had on inflation. Greater political stability, a far narrower current account deficit, and improving fiscal fundamentals all point towards a modest appreciation. Indeed, on a real effective exchange rate basis, the pound is trading far off both its 10- and 20-year averages. While previous devaluations – that enacted in March 2016, for instance – had only a limited effect on Egypt's REER, it can be seen in the graph below how much of an impact the removal of the pound's peg had in late 2016.

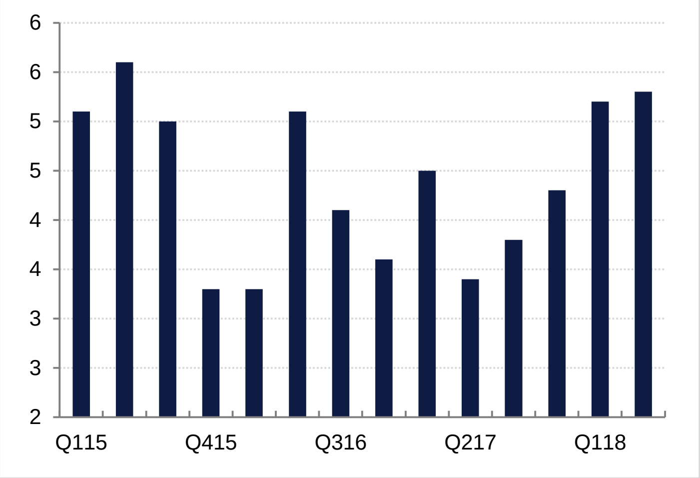
EGP REER



Source: Bloomberg, JP Morgan, Emirates NBD Research

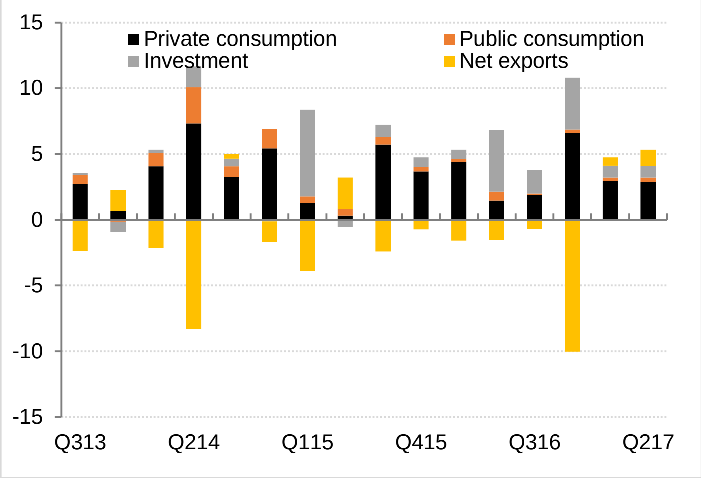
That being said, the central bank has made clear its preference for a 'competitive' currency, and the 2018/19 budget assumed an exchange rate of EGP 17.2500/USD, which will limit any upside potential.

Real GDP growth, % y/y



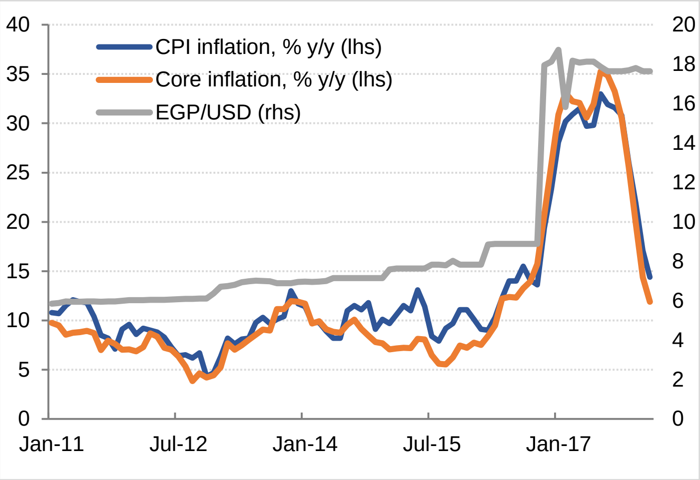
Source: Haver Analytics, Emirates NBD Research

Real GDP growth by expenditure



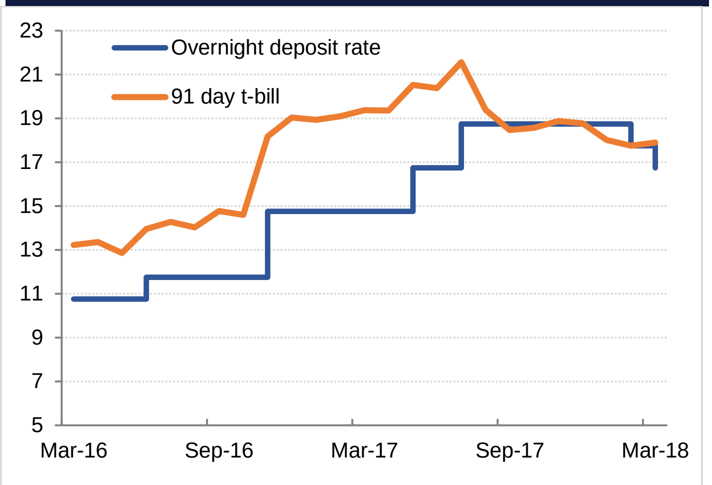
Source: Haver Analytics, Emirates NBD Research

Inflation



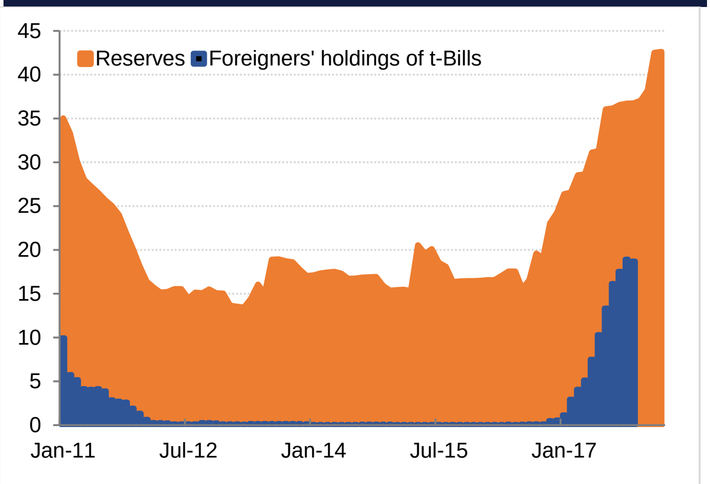
Source: Haver Analytics, Emirates NBD Research

Rates, %



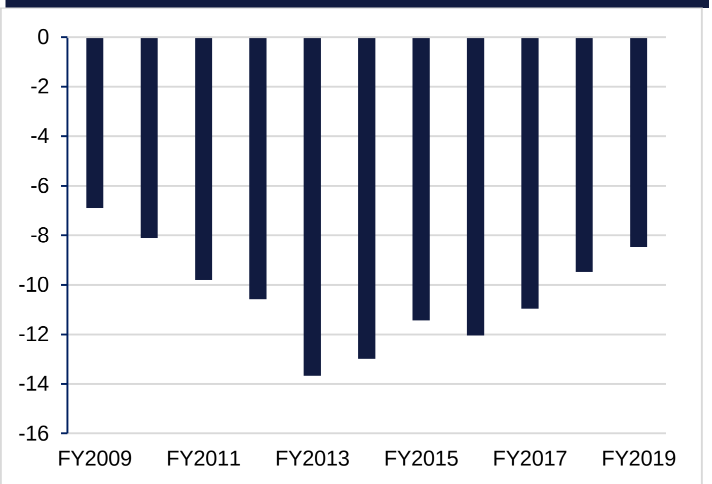
Source: Haver Analytics, Emirates NBD Research

Reserves, USDbn



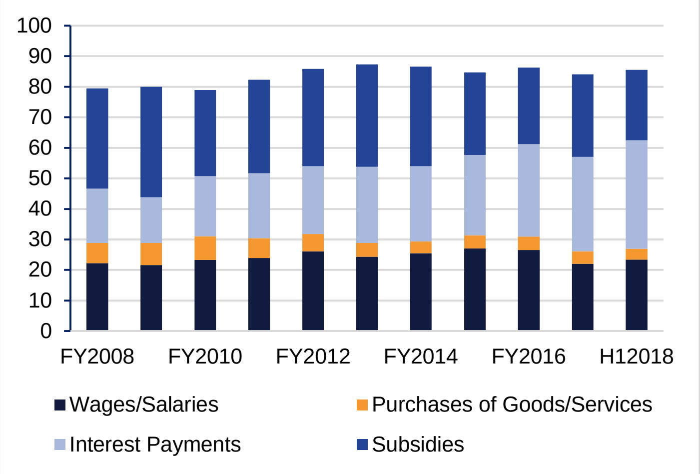
Source: Haver Analytics, Emirates NBD Research

Fiscal balance, % GDP



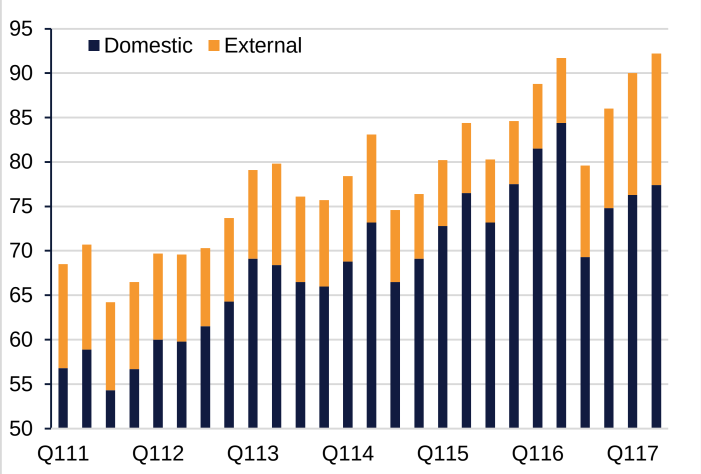
Source: Haver Analytics, Emirates NBD Research

Expenditure, % of total



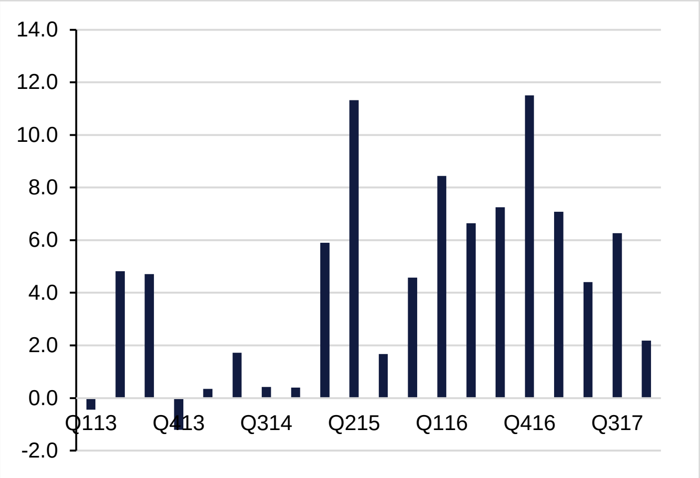
Source: Haver Analytics, Emirates NBD Research

Government debt, % GDP



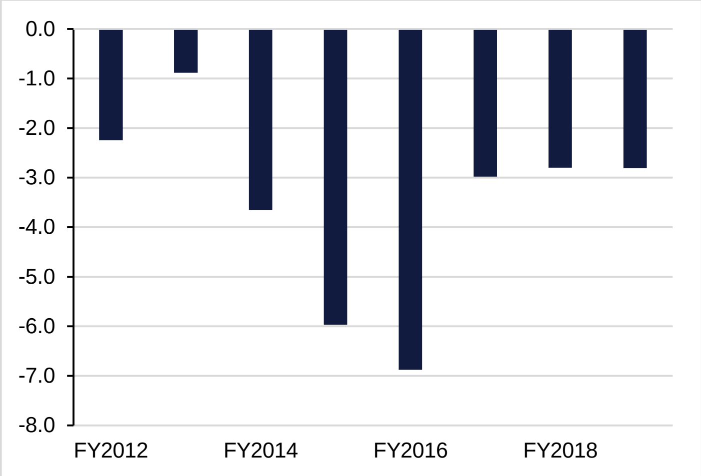
Source: Haver Analytics, Emirates NBD Research

Net FDI, USDbn



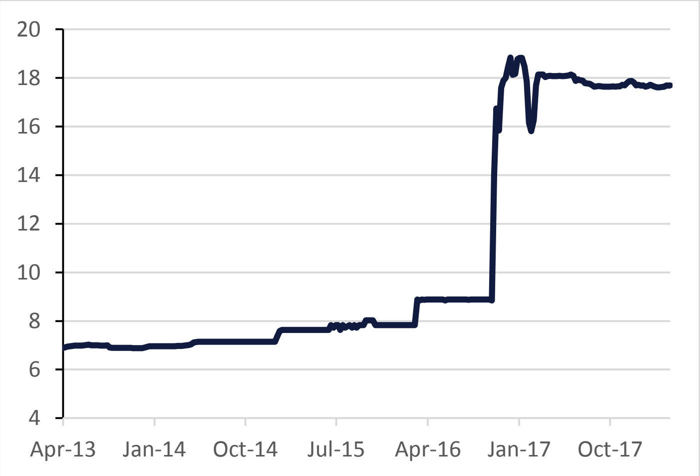
Source: Haver Analytics, Emirates NBD Research

Current account, % GDP



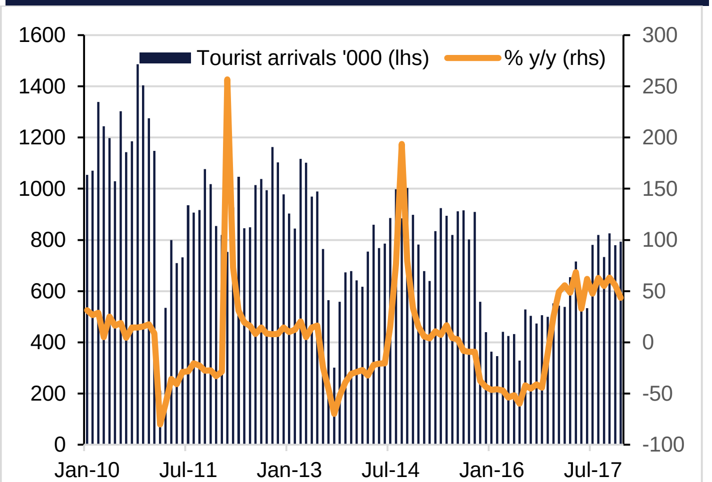
Source: Haver Analytics, Emirates NBD Research

EGP/USD



Source: Bloomberg, Emirates NBD Research

Tourist arrivals



Source: Haver Analytics, Emirates NBD Research

Key Economic Forecasts: Egypt

National Income*	2015	2016	2017	2018f	2019f
Nominal GDP (EGP bn)	2443.9	2709.4	3399.6	4223.7	5011.6
Nominal GDP (USD bn)	332.6	332.4	189.9	243.1	290.5
GDP per capita (USD)	3635	3554	1987	2489	2910
Real GDP Growth (% y/y)*	4.4	4.3	4.2	5.2	5.5
Monetary Indicators (% y/y)					
M2	16.4	18.6	39.3	20.2	17.5
CPI (average)	10.4	13.7	29.6	15.0	12.0
External Accounts (USD bn)*					
Exports	-39.1	-38.7	-36.6	-38.3	-39.6
Imports	13.4	13.0	15.1	17.4	19.2
Trade Balance	-52.4	-51.7	-51.7	-55.7	-58.8
% of GDP	-15.8	-15.6	-27.2	-22.9	-20.2
Current Account Balance	-12.1	-19.8	-15.3	-9.2	-9.2
% of GDP	-3.7	-6.0	-6.9	-3.9	-3.1
Reserves	20.0	17.6	31.3	44.0	42.0
Public Finances*					
Revenue (EGP bn)	-38029	-40035	-24451	-22241	-25016
Expenditure (EGP bn)	733350	804704	1025109	1167135	1246473
Balance	-279430	-326355	-372758	-400337	-425268
% of GDP	-11.43	-12.05	-10.96	-9.48	-8.49
Central Government Debt (EGP mn)	1871332	2285644	2685898	3500000	4000000
% of GDP	76.6	84.4	79.0	82.9	79.8

*Source: Haver Analytics, Emirates NBD Research. *Fiscal*

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