



بنك الإمارات دبي الوطني
Emirates NBD

Egypt Quarterly

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Egypt Quarterly

- **Growth outlook:** We maintain our Egyptian real GDP growth forecast of 5.5% this fiscal year, rising to 6.1% in FY 2019/20. Government investment and economic rebalancing will continue to be the engines of economic growth over the coming quarters, while private consumption and private sector activity will remain under pressure.
- **Fiscal policy:** Despite the windfall from the development of its offshore gas fields, Egypt's fiscal balance will remain under significant pressure over the coming quarters, and a balanced budget will remain a distant prospect.
- **Balance of payments:** The Central Bank of Egypt (CBE) has released full-year balance of payments data for 2017/18 (July-June). The data shows an ongoing improvement in Egypt's external position as a surplus of USD 12.8bn over the year led foreign reserves to rise to record levels of USD 44.26bn in June. Notably, the current account deficit declined by 58.6% y/y, and stood at -2.5% of GDP according to our estimates, compared to -6.5% the previous year. In 2018/19 we project that the deficit will narrow further, to -2.0%, aided by declining energy imports and ongoing growth in visitor numbers.
- **Monetary policy:** As was widely expected, the Central Bank of Egypt (CBE) kept its benchmark interest rates on hold on September 27, marking the fourth consecutive meeting at which the MPC has taken no action. This keeps the overnight deposit and the overnight lending at 16.75% and 17.75% respectively. The monetary easing with which the year began (two cuts of 100bps each in February and March) has been put on hold as reform-related price pressures and wider concerns over emerging market volatility have outweighed the need to boost domestic private sector activity and curtail escalating government debt servicing costs.
- **Egyptian pound:** We maintain our view that the Egyptian pound will remain fairly stable over the coming quarters, with some slight weakness through next year. We forecast an end-2018 level of EGP 18.00/USD, which would imply a modest depreciation from the EGP 17.91/USD at which it's currently trading in the spot market. In 2019, we project a further depreciation to EGP 18.25/USD by year-end.

Egypt Real GDP growth, % y/y



Source: Haver Analytics, Emirates NBD Research

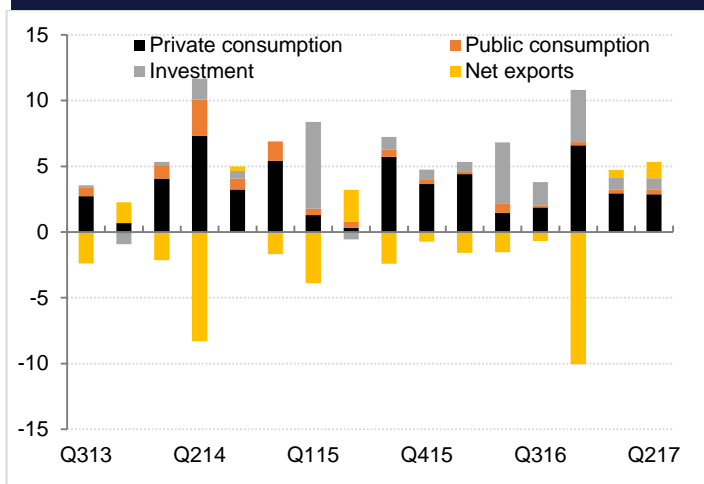
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Growth Outlook

We maintain our Egyptian real GDP growth forecast of 5.5% this fiscal year, rising to 6.1% in FY 2019/20. Government investment and economic rebalancing will continue to be the engines of economic growth over the coming quarters, while private consumption and private sector activity will remain under pressure. Although this compares favourably to the 5.3% last year, and even more so to the 3.6% averaged over the eight years since 2011, this would nevertheless likely disappoint the Egyptian government. Indeed, the government has a bullish expectation of growth in the region of 7.5%-8.0% by 2021/22, a projection we find overly bullish. Nevertheless, we expect that conditions will improve, and a more positive environment for private consumption in the next fiscal year, alongside a positive outlook for tourism and the offshore gas sector, will support the pick-up in growth we expect.

Real GDP growth by component, % point



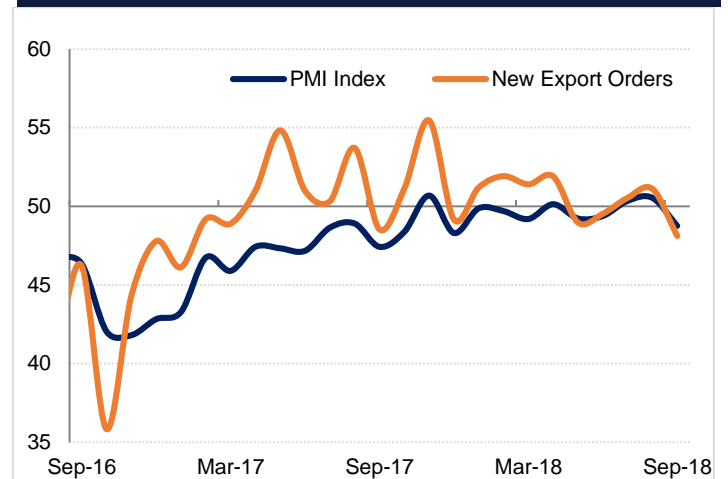
Source: Haver Analytics, Emirates NBD Research

The primary factor behind our more bearish outlook this year is the poor outlook for private consumption, which remains the primary constituent of GDP. Inflation ticked up to 16.0% in September, while wages remain stagnant and unemployment high – though this has fallen to 9.9% in Q2. With interest rates now more likely to remain elevated over the next several quarters owing to global monetary tightening and EM aversion, household spending will be further held back by a reluctance to borrow.

Recent PMI results for Egypt suggest that this environment continues to weigh on private sector firms. The Emirates NBD Purchasing Managers' Index (PMI) for Egypt fell to 48.7 in September, compared to 50.5 in August. This represents a return to contractionary territory following the two consecutive months of expansion recorded previously, indicating that there is still some weakness in the private sector's recovery. Output registered just 47.8 – the lowest level in 2018 – as respondents identified unfavourable market conditions and 18% of firms saw a decline compared to the previous month. New orders also fell to a 2018 low, at 47.7 compared to 50.8 in August, with new export orders only moderately less weak at 48.1. 17.3% of firms saw orders fall, though

this was mitigated somewhat by 12.7% of respondents enjoying stronger demand. The contraction in new orders will weigh on future output, indicating that the private sector will remain under pressure.

Purchasing managers' index



Source: IHS Markit, Emirates NBD Research

Firms continue to contend with rising price pressures, in part driven by the ongoing subsidy reform programme which has seen fuel and utilities costs rise significantly for businesses since the start of the new fiscal year in July. Purchase costs recorded 63.0, a three-month low but still indicating fairly strong price growth. Owing to a higher cost of living, staff costs also exerted pressure at 53.2, and while firms passed on some of these costs to customers – output prices were 52.2 – margins will have remained under pressure. This is reflected in a neutral employment index at 50.0, indicating a stagnation in job numbers following the series-high of 51.7 seen in August.

Conditions will improve

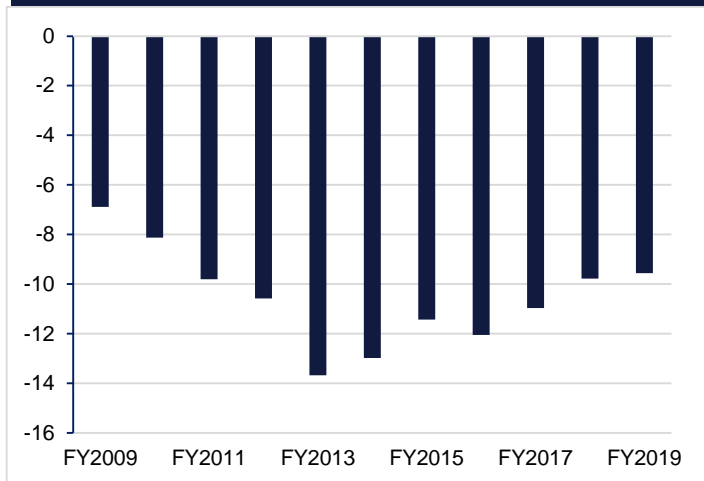
However, while the environment remains difficult at present, we do expect an improvement. Inflation should stabilise, enabling the central bank to resume its rate-cutting cycle next year, which would bolster both household consumption and private sector investment. The above-50.0 readings achieved in the PMI in recent months suggests that the sector is already strengthening, even if these gains have not yet been consistent. One sector which we expect to do well is tourism, where visitor numbers have already enjoyed rapid growth, and will likely continue to expand as the increased competitiveness of the cheaper Egyptian pound since 2016 is now matched by greater security and political stability. Should the UK and Russia resume direct flights to the Red Sea resorts, then the expansion could be rapid.

Offshore gas is another bright spot, and has been attracting the bulk of FDI into Egypt in recent years. Eni's Zohr gas field launched at the close of 2017, and has already ramped up production to such a degree that the authorities have ceased ordering new imports of LNG, which will bolster the net exports component of GDP. There are further fields under development which should also support investment and net exports, as will plans to develop into a regional hub for natural gas, servicing fields owned by Israel and Cyprus.

Fiscal Policy

Despite the windfall from the development of its offshore gas fields, Egypt's fiscal balance will remain under significant pressure over the coming quarters, and a balanced budget will remain a distant prospect. While recording the first primary surplus in a decade in fiscal 2017/18 is testament to the progress made by the authorities in their reform programme to date, higher oil prices and persistently high borrowing costs will preclude a more effective drawdown of the deficit. As local debt will remain more expensive than foreseen by the budget, increased reliance on external debt is likely. We forecast that Egypt's budget balance will be equivalent to -9.2% of GDP in 2018/19 (ending June 2019), compared to -9.8% of GDP last year. This would miss the government's target of -8.4%.

Fiscal balance, % GDP



Source: Haver Analytics, Emirates NBD Research

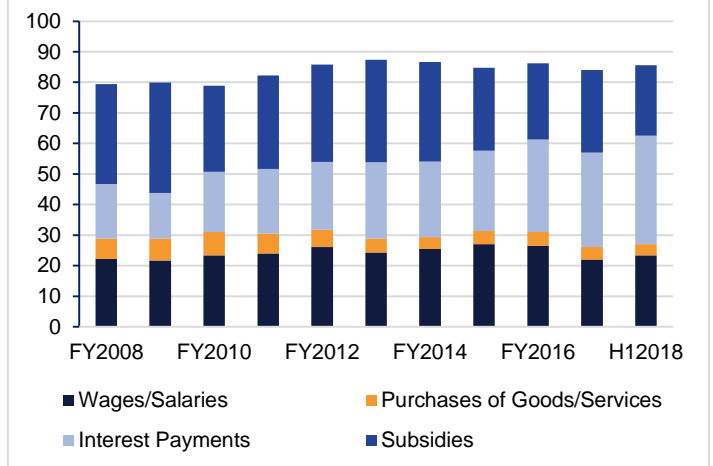
There has been significant progress made on fiscal consolidation since the IMF-sponsored reform programme was entered into in late 2016, and we expect that the primary balance will remain in positive territory. This will be driven by ongoing subsidy reform (new cuts were introduced at the start of the fiscal year) and higher tax revenues. Further, the offshore gas windfall will also help boost coffers; Egypt has just announced self-sufficiency in natural gas following the launch of the Zohr gas field in December last year, and received its last LNG delivery in September.

However, higher oil prices than previously anticipated will prevent a greater primary surplus as the government still has subsidy obligations which are hit by a rise in Brent. The fiscal plan had budgeted for Brent crude prices between USD 65/b and USD 67/b, but the average over the fiscal year so far has been USD 77/b, with a period of closes over USD 80/b. We project an average of USD 73/b over 2019, which would place a significant strain on government spending.

While the government aim remains to remove subsidies on all oil products save butane by the end of the fiscal year, until this is done, higher oil prices will continue to exert pressure on government finances. Equally, political considerations may lead to a delay in this

target given that inflation has already begun to tick back up in recent months. This also has implications for the central bank's policy direction, with any significant loosening of monetary policy likely off the cards.

Expenditure, % of total



Source: Haver Analytics, Emirates NBD Research

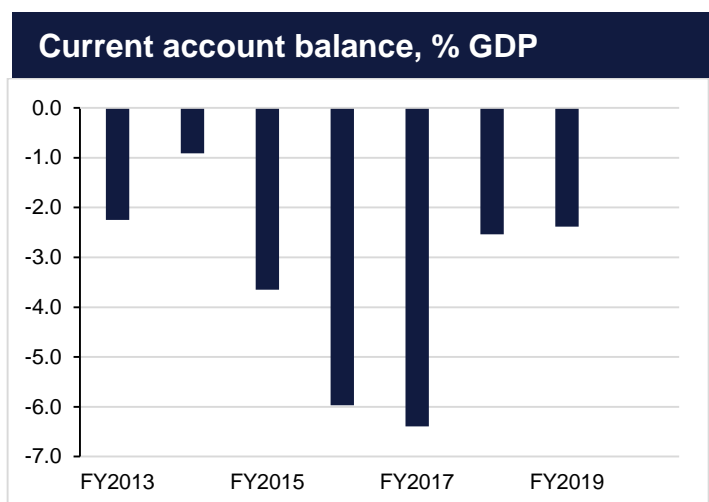
Given that we expect that interest rates will remain high over the coming year (see our section on Monetary Policy), Egypt's debt servicing costs will remain elevated, and this will weigh on the headline budget figures. Debt servicing accounted for over a third of expenditure last year, and as progress continues to be made in cutting subsidy expenditure (24% last year down from 34% in 2012/13), we expect that this will rise further, to 45% this year. As with the oil price, external macroeconomic developments will weigh on Egypt's progress, as global monetary tightening and greater EM aversion has meant that yields on Egypt's local debt have remained higher than anticipated. The 2018/19 spending plan reportedly budgeted for interest rates on government debt securities to average 14.7%, down from the 18.5% budgeted in last year's plan. Any one percentage point higher than this will increase the debt servicing bill by EGP 4-5bn according to the MoF, meaning that its prediction of EGP 541bn of debt servicing this year is unlikely to be met.

The frustration of the authorities with the failure to cut rates has been shown by the cancellation of successive five- and 10-year treasury bond auctions through September and October, stating: 'The required return rates were not within logical limits and did not reflect the good economic and financial performance or the improvement of Egypt's credit rating, but were affected by the risks associated with the emerging markets.' As such, we expect that there will be a renewed drive to issue external debt over the coming months. While this increases currency risk, the pound is likely to remain fairly stable, and the rates on offer are potentially far lower than on local debt. According to reports, Egypt is preparing to issue as much as USD 20bn in foreign currency debt up until 2022. Government officials participated in a non-deal roadshow in Asia in October, and alongside dollar-denominated Eurobonds, there is also interest in (yen-denominated) Samurai bonds and (yuan-denominated) Panda bonds, and international bonds issued in local currency.

Balance of Payments

The Central Bank of Egypt (CBE) has released full-year balance of payments data for 2017/18 (July-June). The data shows an ongoing improvement in Egypt's external position as a surplus of USD 12.8bn over the year led foreign reserves to rise to record levels of USD 44.26bn in June. Notably, the current account deficit declined by 58.6% y/y, and stood at -2.5% of GDP according to our estimates, compared to -6.5% the previous year. In 2018/19 we project that the deficit will narrow further, to -2.0%, aided by declining energy imports and ongoing growth in visitor numbers.

expected to strengthen next year, these will likely continue to expand, although ongoing 'Saudisation' efforts in Saudi Arabia do pose a modest risk.

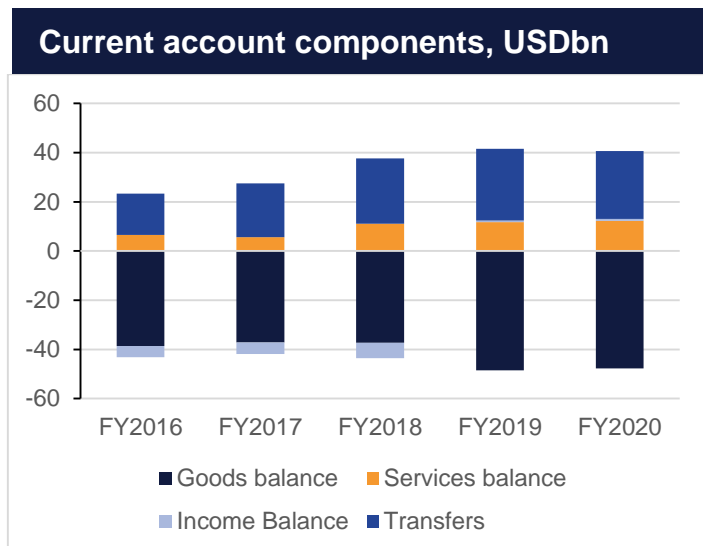


Source: Haver Analytics, Emirates NBD Research

The narrowing current account deficit has been a positive for Egypt's macroeconomic stability, contributing to the EGP's resilience through recent EM turmoil, as compared to other emerging markets where the trajectory has been in the opposite direction. That being said, the CBE data shows that foreign direct investment has continued to lag, and with portfolio investment likely to decline over the year, a failure to boost other streams of dollar inflows will weigh on consolidation efforts. The pace of reserves accumulation has already slowed considerably since April, suggesting that the balance of payments surplus has been negligible in recent months.

Services outperform

The IMF reform programme entered into by Egypt in late 2016 progressed in a textbook fashion last year, as the sharp currency devaluation implemented as a condition of the deal served to constrain imports while making exports more competitive. This was most evident in the services account, where a boom in visitor numbers, enticed by improving security and a more competitive currency, saw travel receipts climb 123.8% y/y. Stronger world trade contributed to 15.4% growth in Suez Canal revenues, and services receipts overall climbed 39.5%. On the other side of the equation, services payments expanded only 5.9%. Travel payments declined 10.5%, following the 33.0% decline recorded the previous year, as Egyptians' ability to spend abroad continues to be constrained by the weaker pound. The cheaper pound, combined with improving conditions in the GCC, has also contributed to greater inflows of remittances. These rose 21.0% y/y, and with growth in the Gulf

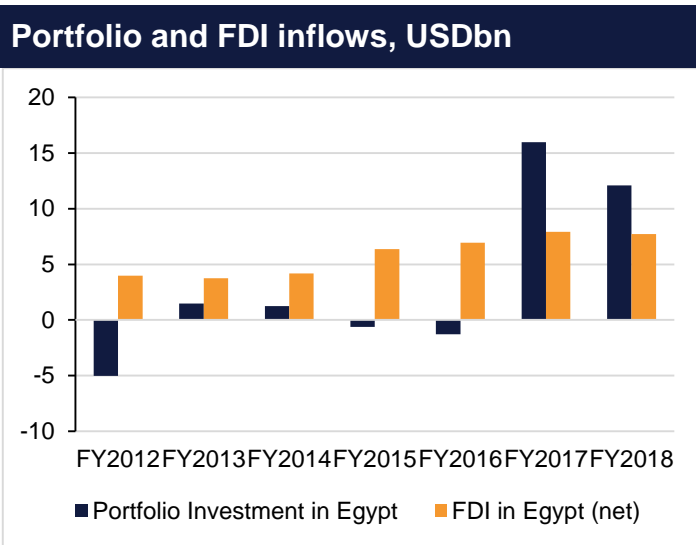


Source: Haver Analytics, Emirates NBD Research

The effect of the currency depreciation on the trade account has been more muted, and the deficit remained static at USD 37.3bn, the same as the previous year. The fairly sticky nature of Egypt's imports and limited success in import substitution to now has seen imports climb over the past two years. Higher oil prices have also led to a greater import bill. Equally, capacity constraints and fairly sluggish FDI inflows have held back growth in Egyptian exports other than petroleum. That said, although the authorities may have expected more robust growth, other exports have expanded by 16.2% and 12.7% in 2016/17 and 2017/18 respectively, compared to an average decline of 2.6% per annum over the previous five years. Petroleum exports grew by 33.1% last year.

Portfolio inflows under pressure

One of the biggest stories in Egypt's balance of payments over the past two years has been the startling uptick in portfolio inflows enjoyed since the currency devaluation and subsequent 700 cumulative basis points of hikes to the benchmark interest rates and commensurate rise in treasury bill yields. The removal of capital controls also contributed to the recovery which saw portfolio investment climb from negative USD1.3bn in 2015/16 to USD 16.0bn in 2016/17 and USD 12.1bn last year. However, with rising EM aversion since May, this story has begun to unravel. Foreign ownership of treasury bills has declined from USD 21.6bn in March to just USD 14.2bn in August. Much of this entered into Egypt through the repatriation mechanism and so was not reflected in official BoP figures or reserves, and as such the effect of its departure on the EGP has been marginal. Nevertheless, there was a USD 2.9bn outflow of portfolio investment from Egypt recorded in the financial account in Q4 2017/18.



Source: Haver Analytics, Emirates NBD Research

In light of this, the need to boost FDI and other revenue streams will become increasingly important. Net FDI was USD 7.7bn last year, down from USD 7.9bn the previous year, and the bulk of this continues to go into the oil and gas sector (USD 4.5bn), meaning that the development of other growth and employment generating private sector industries has lagged. The improving macroeconomic fundamentals and new investment and bankruptcy laws should aid in this going forward, which will also be positive for ongoing sustainable growth and economic development.

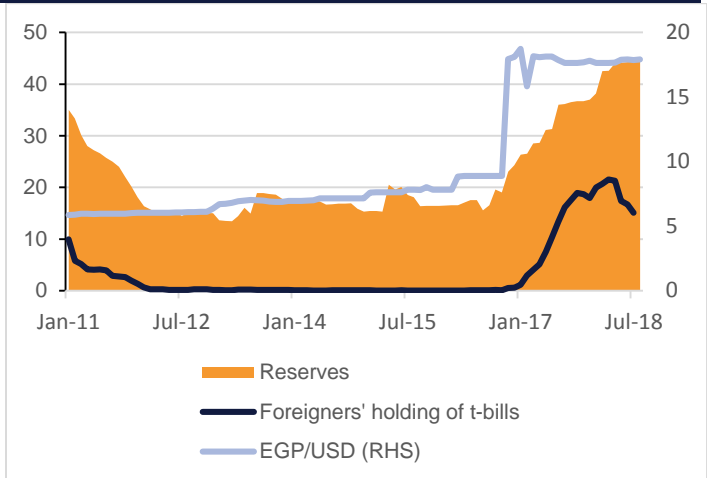
Gas sector a bright spot

A major bright spot in Egypt's balance of payments dynamics is the development of its offshore gas sector, and according to petroleum minister Tarek el-Molla, Egypt has now ceased imports of LNG following a delivery received in September. The launch of the Zohr gas field in December has seen Egypt's production of natural gas rise to 6.6bn cubic feet per day in September, negating the need to import, and saving USD 250mn a month according to Molla's previous estimates. Egypt aims to become a regional gas hub, servicing volumes from Israeli offshore gas fields, alongside still others belonging to Egypt yet to come online, and this will further boost dollar inflows through associated tariffs.

Monetary Policy

As was widely expected, the Central Bank of Egypt (CBE) kept its benchmark interest rates on hold on September 27, marking the fourth consecutive meeting at which the MPC has taken no action. This keeps the overnight deposit and the overnight lending at 16.75% and 17.75% respectively. The monetary easing with which the year began (two cuts of 100bps each in February and March) has been put on hold as reform-related price pressures and wider concerns over emerging market volatility have outweighed the need to boost domestic private sector activity and curtail escalating government debt servicing costs. While we had earlier expected at least one more cut in 2018, changing global dynamics have made this unlikely, and we now anticipate that the CBE will hold rates through the end of the year. In 2019 we expect 200bps of cuts.

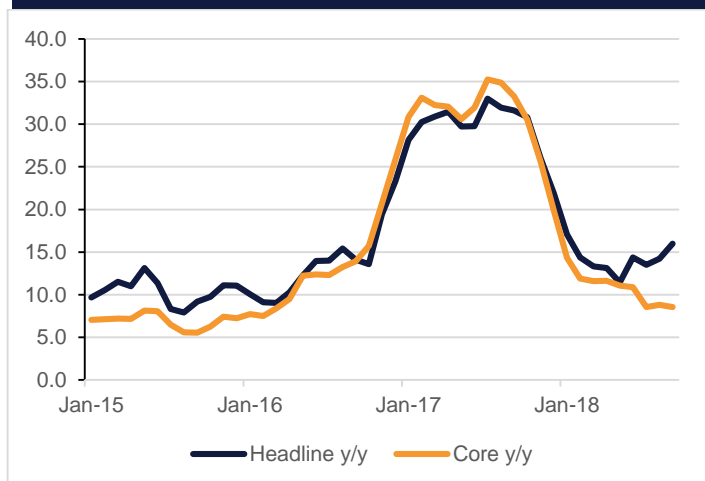
Reserve holdings, USD bn



Source: Haver Analytics, Bloomberg, Emirates NBD Research

As EM aversion has risen since May, led by Argentina and Turkey but subsequently affecting markets all over the world, there has been a marked decline in foreign ownership of t-bills in Egypt, from a peak of USD 21.6bn in March to USD 14.2bn in August. Egypt's fundamentals have been relatively unscathed by this departure, with the EGP seeing only marginal declines over the period, especially compared to other EM currencies. Having entered through the repatriation mechanism, much of the money was kept separate from the headline reserves in a special vehicle. Given it had marginal upside effect on the pound on coming in, its effect on leaving will likewise be muted. Nevertheless, the CBE will likely be wary of cutting too much too soon, thus prompting an even more rapid flight of this hot money out of the country. Although the CBE's communique pointed out that the 'pass-through to domestic inflation from developments in emerging market economies remained contained due to stabilization and structural policies', the global developments of the past several months were likely in mind as the rate decision was taken.

Inflation, % y/y

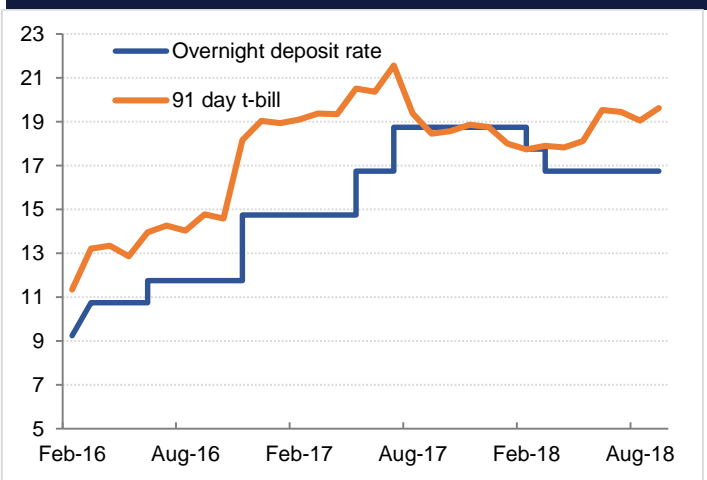


Source: Haver Analytics, Emirates NBD Research

Although comparative currency stability has led inflation to fall far from a peak of 33.0% in mid-2017, the latest raft of subsidy cuts initiated at the start of the fiscal year has seen price growth tick up once more over the past several months, from 11.4% in May to 16.0% at the latest print in September. This puts inflation at the upper ceiling of the central bank's target range of 13.0% \pm 3, and it is unlikely to take any meaningful leg lower over the coming months, especially if the fuel indexation mechanism is introduced by year-end as planned. With Brent futures closing above USD 80/b for the first time since 2014 in recent months, a more reflexive pricing structure will feed through to increased costs at the pump. This provides incentive for the bank to continue holding the benchmark rates static given the squeeze on real rates higher inflation would mean.

Aside from the domestic pressures, the CBE will also be cognizant of the global context, where tightening monetary policy in developed markets is leading to increased pressure on emerging economies, especially net oil importers with high debt loads. The FOMC made its third hike of 2018 in September, with one more expected this year, and other major central banks are hiking rates or cutting back on asset purchases.

Interest rates, %

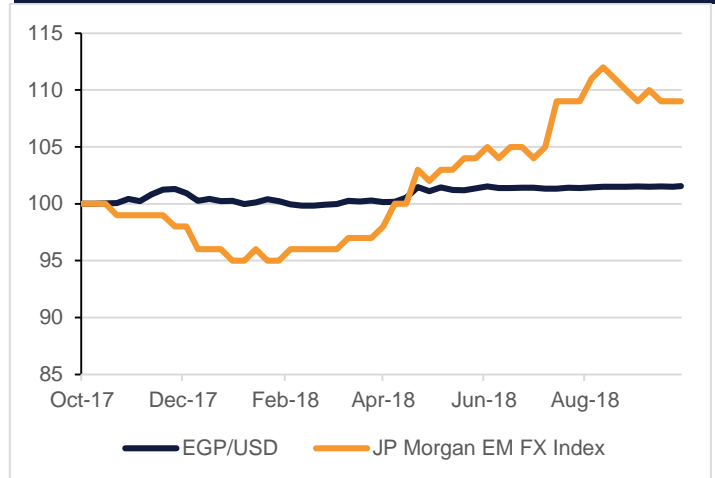


Source: Haver Analytics, Emirates NBD Research

Egyptian Pound

We maintain our view that the Egyptian pound will remain fairly stable over the coming quarters, with some slight weakness through next year. We forecast an end-2018 level of EGP 18.00/USD, which would imply a modest depreciation from the EGP 17.91/USD at which it's currently trading in the spot market. In 2019, we project a further depreciation to EGP 18.25/USD by year-end. The view is largely neutral, but given the Central Bank's preference for a competitive currency, ongoing EM aversion and further rate hikes to come in the US, what risks there are are weighted to the downside.

EGP, EM FX, rebased 12 months



Source: Bloomberg, JP Morgan, Emirates NBD Research

That being said, while the pound has proven resilient in 2018, we believe that US tightening and dollar strength will prompt a modest depreciation in 2019, especially as the CBE begins to cut rates once more. Further pressure will come from a persistent current account deficit. While this will be fairly slight as compared to recent years, elevated oil prices will be a drain on dollars. A modicum of higher volatility in the pound is also likely as greater availability of dollars has seen international investors increasingly turn away from the repatriation mechanism. The CBE has looked to accelerate this process through introducing a 1.0% entrance fee for using the mechanism in December 2017. Bloomberg reported in March that as much as 30% of debt-related foreign currency trades had begun going through the open market.

EGP/USD exchange rate



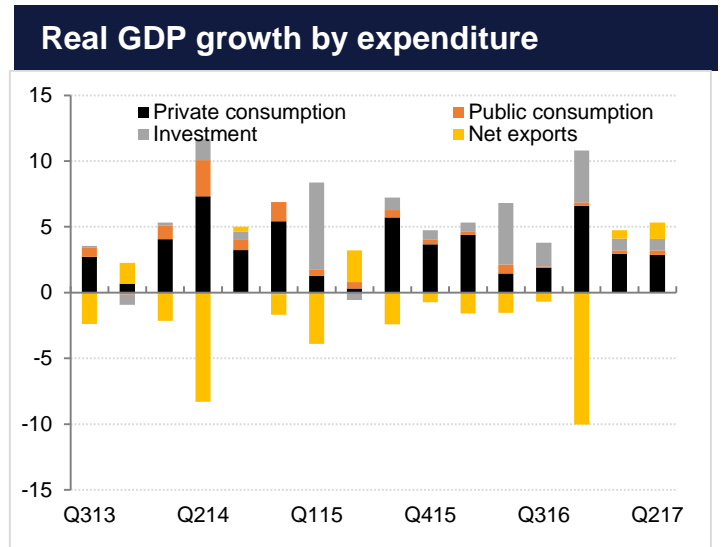
Source: Bloomberg, Emirates NBD Research

While there was a limited sell-off of the Egyptian pound through the EM volatility seen since May, this was as nothing when compared to many other emerging economy currencies, and especially as compared to Argentina and Turkey. By contrast to these countries, Egypt is seen as on the right trajectory, with ongoing economic reforms contributing to an effective rebalancing and narrowing of the twin deficits. We expect that this will continue to insulate Egypt from some of the general EM weakness, as will its relative political stability. A number of other major EMs, including South Africa, Nigeria, Turkey and Brazil have elections approaching which could prompt renewed uncertainty.

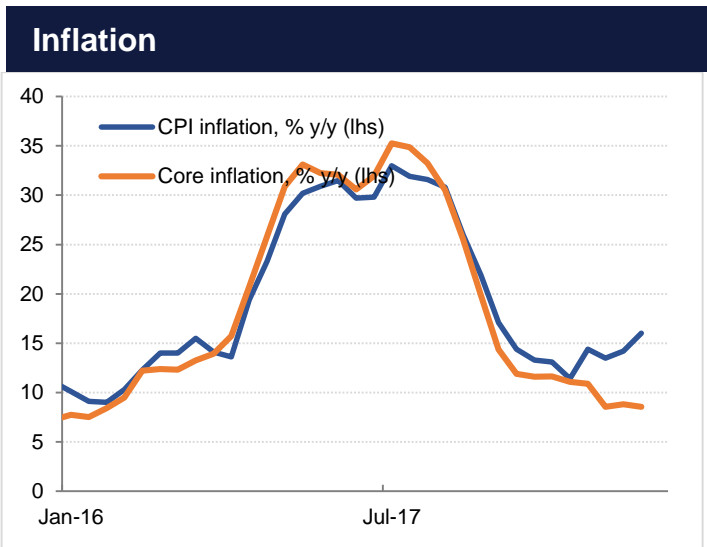
That is not to say that Egypt was entirely unaffected by the EM aversion which began in May; foreign ownership of treasury bills declined from USD 21.6bn in March to just USD 14.2bn in August. However, given that much of this entered via the repatriation mechanism and was thus recorded separately from headline reserves, it was met while maintaining FX reserves at record figures (USD 44.6bn in September) and with minimal impact on the currency. Egypt's stability, persistently high yields on local debt, and perceived currency stability, is reportedly enticing foreign buyers back into Egyptian treasury bills, and this will further support the pound henceforth. Another support will come from the pause in the central bank's rate cutting cycle, which we expect to remain on hold into 2019 as the CBE has proceeded with particular caution so far.



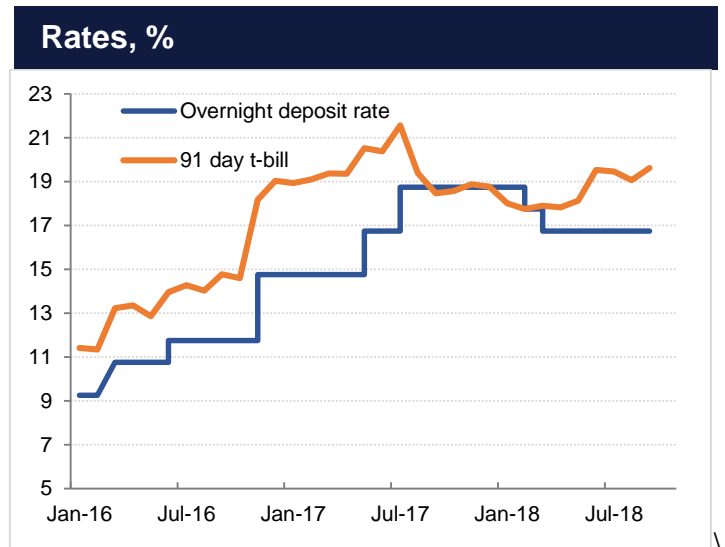
Source: Haver Analytics, Emirates NBD Research



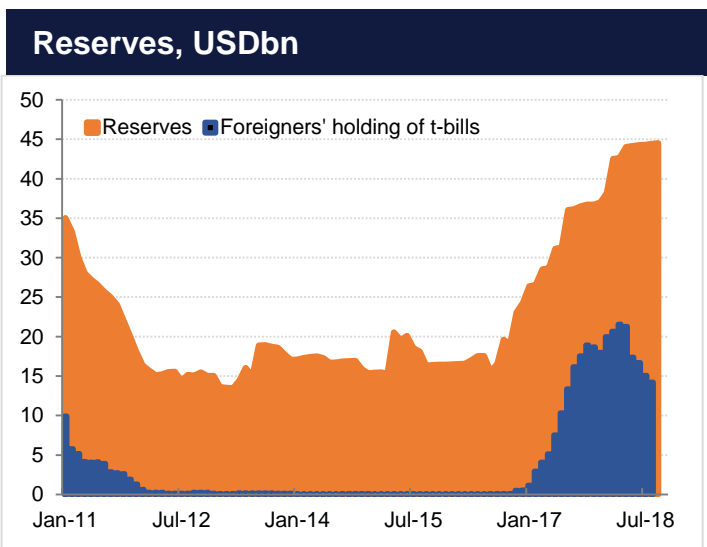
Source: Haver Analytics, Emirates NBD Research



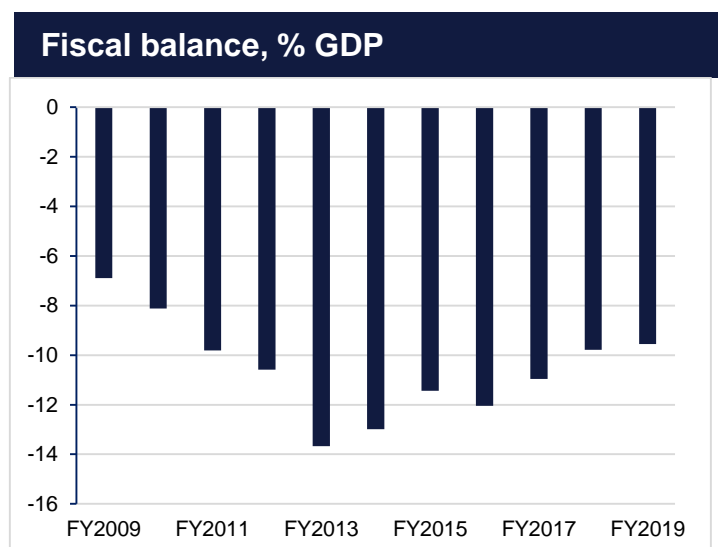
Source: Haver Analytics, Emirates NBD Research



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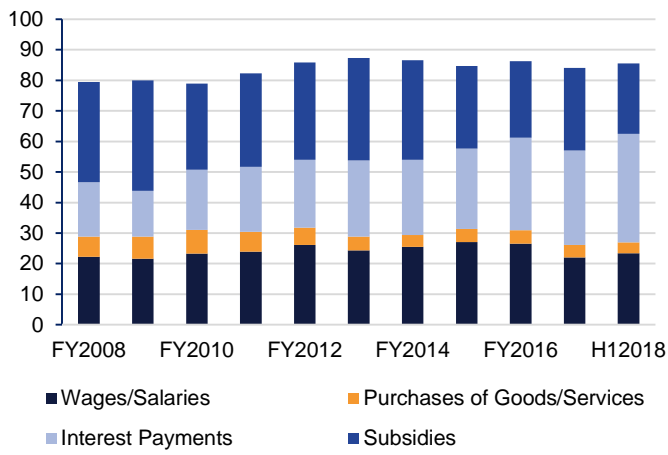


Source: Haver Analytics, Emirates NBD Research



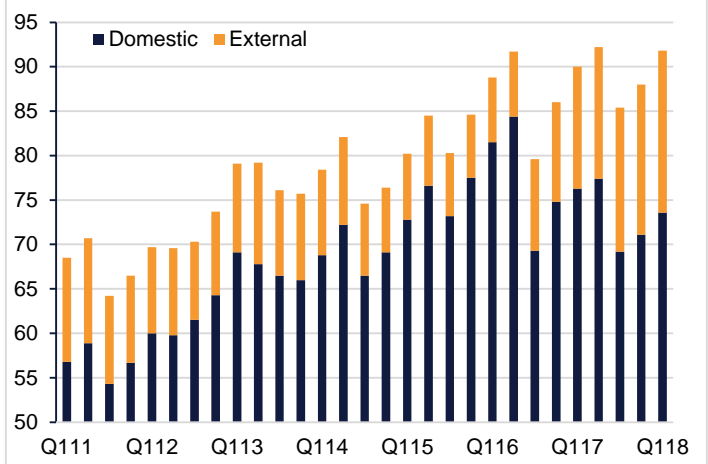
Source: Haver Analytics, Emirates NBD Research

Expenditure, % of total



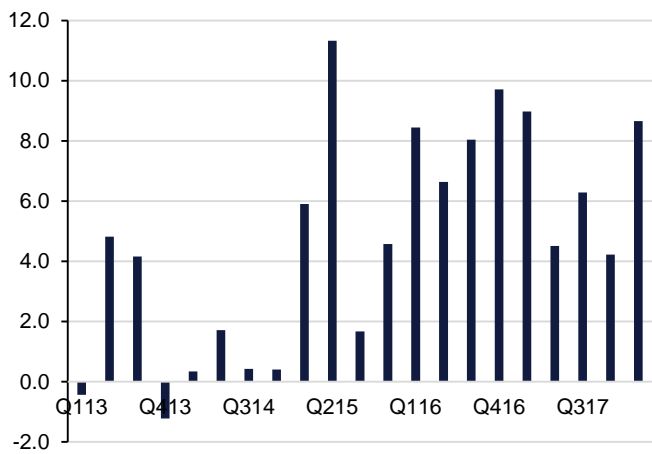
Source: Haver Analytics, Emirates NBD Research

Government debt, % GDP



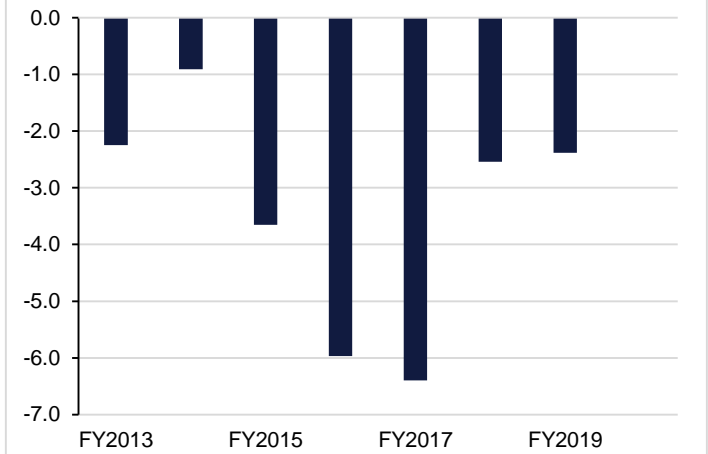
Source: Haver Analytics, Emirates NBD Research

Net FDI, USDbn



Source: Haver Analytics, Emirates NBD Research

Current account, % GDP



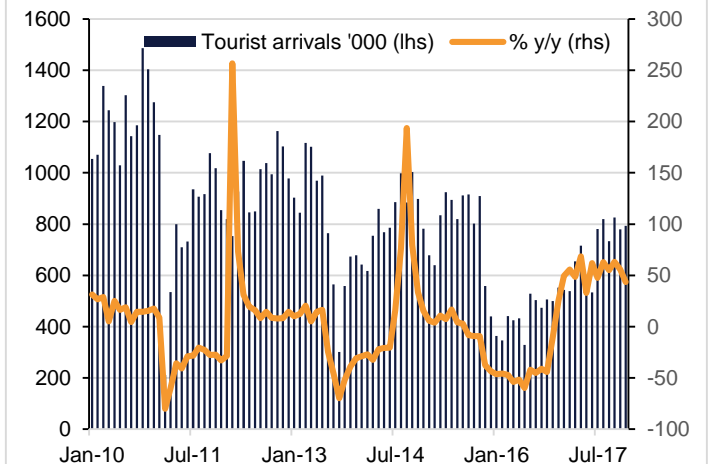
Source: Haver Analytics, Emirates NBD Research

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 | 4227.6 | 5016.2 |
| Nominal GDP (USD bn) | 332.6 | 332.4 | 223.0 | 236.5 | 276.8 |
| GDP per capita (USD) | 3635 | 3554 | 2333 | 2421 | 2773 |
| | | | | | |
| Real GDP Growth (% y/y)* | 4.4 | 4.3 | 4.2 | 5.3 | 5.5 |
| | | | | | |
| Monetary Indicators (% y/y) | | | | | |
| M2 | 16.4 | 18.6 | 39.3 | 20.3 | 17.5 |
| CPI (average) | 10.4 | 13.7 | 29.6 | 15.0 | 12.0 |
| | | | | | |
| External Accounts (USD bn)* | | | | | |
| Exports | 22.2 | 18.7 | 21.7 | 25.8 | 28.4 |
| Imports | 61.3 | 57.4 | 59.0 | 63.1 | 77.0 |
| Trade Balance | -39.1 | -38.7 | -37.3 | -37.3 | -48.6 |
| % of GDP | -11.7 | -11.6 | -16.7 | -15.8 | -17.5 |
| Current Account Balance | -10.1 | -6.4 | -2.8 | -6.0 | -7.0 |
| % of GDP | -3.7 | -6.0 | -6.4 | -2.5 | -2.4 |
| Reserves | 20.0 | 17.6 | 31.3 | 44.3 | 42.0 |
| | | | | | |
| Public Finances* | | | | | |
| Revenue (EGP bn) | 465241 | 491488 | 659184 | 768940 | 838440 |
| Expenditure (EGP bn) | 733350 | 804704 | 1025109 | 1182965 | 1318262 |
| Balance | -279430 | -326355 | -372758 | -414026 | -479822 |
| % of GDP | -11.43 | -12.05 | -10.96 | -9.79 | -9.57 |
| Central Government Domestic Debt (EGP mn) | 1871332 | 2285644 | 2685898 | 3500000 | 4000000 |
| % of GDP | 76.6 | 84.4 | 79.0 | 82.8 | 79.7 |
| Total debt, % GDP | 94.5 | 104 | 105.9 | 94.3 | 91.5 |

Source: Haver Analytics, Emirates NBD Research. *Fiscal

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