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Huge international financing deals trigger long-awaited policy reforms

- **Egypt's economy witnessed an eventful first quarter of 2024 as the authorities delivered some long-awaited policy moves, devaluing the currency and raising interest rates significantly.**
- **A key trigger was the mega investment deal with the UAE over the Ras El Hekma area, providing for an expanded FCY buffer. This was followed subsequently by new financing deals with the IMF and others.**
- **We expect growth to be hit near-term as the economy absorbs the policy shocks. However, these were needed to restore macro stability and investor confidence. Key external risk metrics have improved.**
- **We see growth potentially rebounding in FY24/25 as inflation and interest rates come down and assuming that the government commits to the reforms.**

Egypt finally embarked on long-awaited macroeconomic reforms in March, devaluing the currency and raising interest rates sharply. The bold moves came soon after the government managed to secure a major FX buffer via a $35 billion mega-investment deal with the UAE over the Ras Al Hekma area. Since then, the string of positive news has continued with the IMF approving an expanded loan of $8bn (from $3bn), the World Bank approving a new loan of $6bn, and the EU providing $8bn of loans and investments. The combined agreements have diminished market fears of a credit event for Egypt, with external risk metrics improving reflecting a more positive outlook among investors.

In the near term, the economy will inevitably face more headwinds as the devaluation keeps inflation and interest rates high and household and business spending compressed. But the following few months will also be important for Egypt to regain financial and macro stability and restore market confidence, laying the foundation for a sustainable economic recovery in 2025.

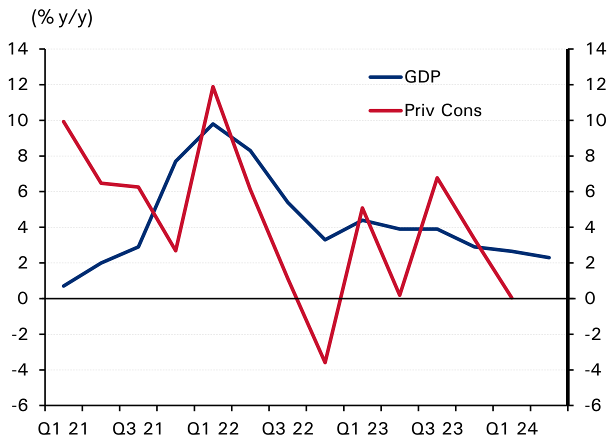
We believe that for economic growth to reach levels of 6%+ on a sustained basis, the government will need to commit to and make progress on other key structural reforms, including limiting public investments (from both government and quasi-government entities), and giving more space for the private sector to drive growth. A good start could include the appointment of more technocrats in any forthcoming cabinet reshuffle, following the start of President Sisi's third term in office in April that will last until 2030.

Growth at lowest levels in the past 3 years

Economic growth, as expected, has continued its downward path in FY23/24 (ending June 2024) with growth decelerating sharply to 2.5% in H1 compared to 4.2% for H1 the previous year. Growth for the full year FY23/24 could come in close to 2.5%, which is lower than both the government's forecast of 3.5% and our initial forecast of 3% as well.

Elevated costs, import restrictions and general uncertainty continued at a strong rate into FY23/24, taking a toll on private consumption. The available breakdown up to Q1 FY23/24 show private consumption flat at 0% y/y versus 3.3% in the previous quarter, though the high base from the same quarter in the previous year (growth was at 5%) played a role. The biggest contributor to growth in the quarter was net exports, which recorded a positive balance of EGP5bn versus EGP-70bn a year earlier. However, import restrictions were the main driver of this change, and once imports start to recover in the coming period, the positive net export balance will likely fade away. Government consumption grew by 11% y/y while investments contracted by 16%.

Chart 1: GDP and private consumption



Source: Ministry of Planning, NBK estimates
Note: Quarters are for the fiscal year, so Q1 24 = Q1 FY23/24

Reflecting the tough macro-economic conditions, the PMI activity indicator dropped in Q3 (Jan-Mar 2024) to 47.6 versus 48.2 for Q2 thus remaining significantly below the 50 'no change' level with firms reporting weak sales, difficulties sourcing raw materials from abroad and rapid price rises. Looking ahead, businesses should start getting access to FX allowing for a smoother import process and an improved production cycle – though the anticipated recovery in orders and demand could take a few months as inflation is expected to remain high in the near term following the currency devaluation.

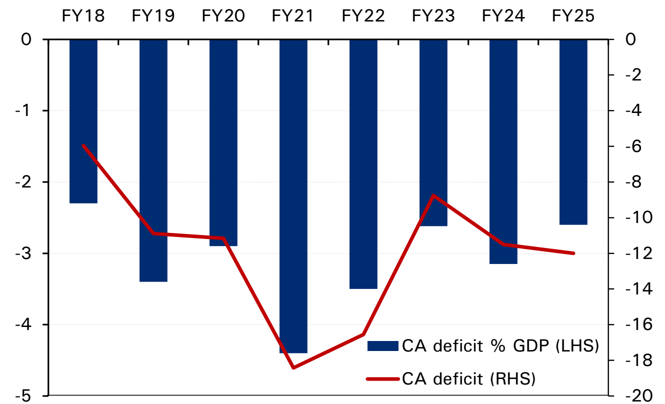
In our opinion, growth should bottom out this year at around 2.5-3.0% with elevated price pressures and the rise in interest rates keeping demand subdued. But as some of these pressures fade, growth will start recovering next year (FY24/25) towards 3.5-4.0%.

Current account deficit narrows as imports drop

The goods trade deficit narrowed by $1.2bn in Q1 FY23/24 to $8bn (1.9% of GDP), mainly driven by a 15% y/y drop in imports. Meanwhile, the services surplus widened by 28% to $5.2bn on the back of higher tourism and Suez Canal revenues during that period (Suez Canal disruptions only started more recently). Overall, the current account deficit narrowed by 12% y/y to stand at $2.8bn in the quarter. We expect similar trends through Q2 and Q3 with FX pressures limiting remittance and portfolio inflows into the LCY debt market, as well as exports. We expect the current account deficit to end the full year at $11.5bn (3.2% of GDP).

For FY24/25, we forecast the current account deficit to remain within a similar range at $12bn (2.6% of GDP). We expect imports to pick up by 15-20% but the impact on the deficit to be offset by a strong recovery in remittances, continued strong tourism proceeds, and the maintenance of a more flexible exchange rate that keeps the pound in line with its fair value.

Chart 2: Current account balance



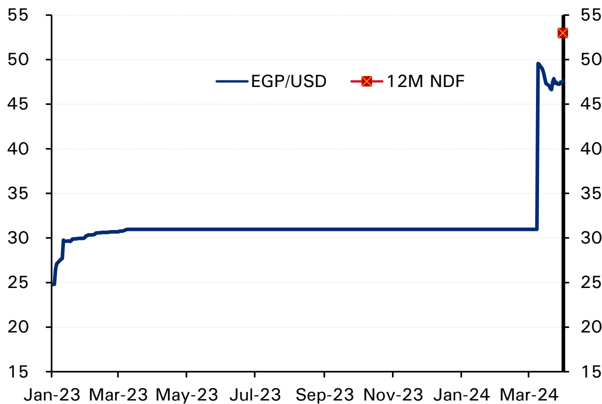
Source: Central Bank of Egypt, NBK estimates

External finances to improve significantly

More broadly, the external financing picture for the next 2-3 years has been transformed positively by the policy changes and financing agreements made in recent weeks. The latter are worth a combined $59bn ($48bn excluding the UAE deposits at the CBE which have been converted into FDI) over the coming years (until FY25/26), with the majority skewed towards the current year. The Ras El Hekma deal with the UAE ($35bn) is due to be delivered in the current fiscal year with $22bn already delivered and the remainder in May 2024. The rest of the agreements – from World Bank, IMF and EU – will be disbursed over the coming 3 years ($7-8bn a year on average). As well as financing regular trade flows, this will be used to remove the import backlog, pay down dues to international energy firms, reduce net foreign liabilities in the banking system, pay off any maturing external debt and potentially lift official reserves.

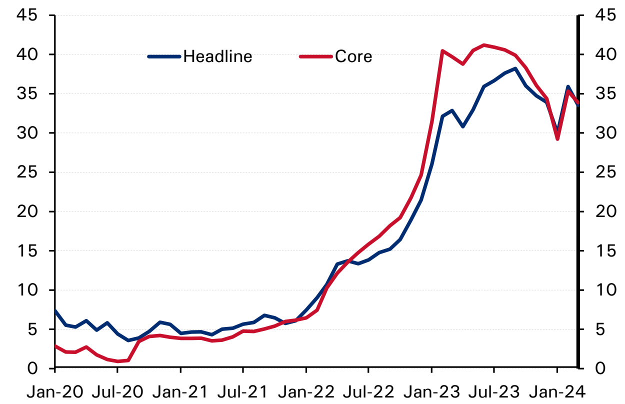
Given the above, we project a net cumulative financing gap of $10bn over the coming 2 years until the end of FY25/26. This gap could be covered through Eurobond issuance at a pace of $3-4bn per year, in addition to possible debt restructuring, over and above the agreed loans, from some of the multilateral institutions such as the World Bank, IMF, and others. An additional upside could be strong portfolio inflows linked to the carry trade given high domestic interest rates.

Chart 3: Egyptian pound exchange rate



Source: Central Bank of Egypt, NBK estimates

Chart 4: CPI inflation



Source: Central Bank of Egypt, NBK estimates

Financial markets and rating agencies have applauded the developments. Yields on Egypt's 5yr-Eurobond have fallen significantly to below 10% from 15% in February and 5-yr CDS levels (a measure of default risk) improved to around 550bps from 1100 bps and above. The 12M currency forward rate is currently trading at EGP54/$, 12% weaker than the official rate. Moody's & S&P have upgraded Egypt credit outlook to positive from negative and stable, respectively. Finally, investors poured a net total of $12.5bn into LCY debt and now represent 25% of the total versus 9% in February and remittances have risen up since the exchange rate unification.

Inflation to remain above 35% for most of the year

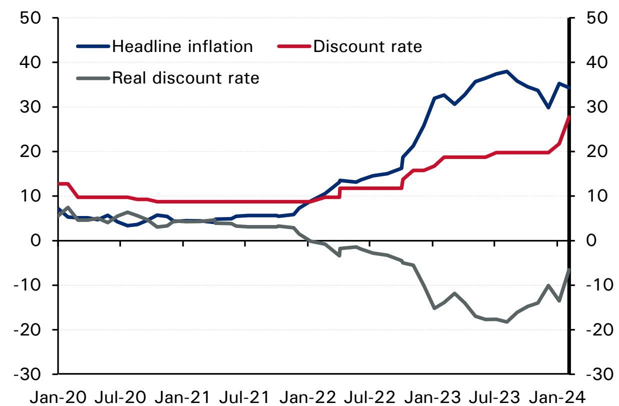
Inflation slowed to 33.3% y/y in March after jumping to 35.3% (and 11% m/m) in February. February's spike was likely due to the extreme weakness of the EGP in the parallel market to all-time highs of EGP70/$, which was subsequently reversed following the devaluation in March given improved dollar availability. Inflation averaged 4.9% m/m during January-March, significantly higher than 1.2% m/m in the previous quarter.

We saw in March the first-round effects of the EGP devaluation but second-round effects could persist for 2-3 months (April-June). These would include further product repricing by companies and higher utility prices (petroleum, electricity). This in addition to an unfavorable base effect from last year could cause inflation to head back towards 40% in the current quarter, before starting to decelerate from July and ending the year below 35%. This will still be far from the central bank's target set for Q4 2024 (CY) of 7% +/-2% which we expect to be revised.

Policy rates are close to peak but could rise further

The central bank hiked policy rates by a total of 8% during Q1 CY2024 (2% in February then 6% in March) taking the discount rate to 27.75, while average 1-year treasury bill yields reached an all-time high of 32% in the first week of March, before dropping back to 25.5% on huge demand for LCY debt from foreign investors. The 6% policy rate hike exceeded expectations but was not enough to offer a positive real yield in the short term. Real yields – using the discount rate – stood at -6% in March and will remain negative though improve towards the end of the year.

Chart 5: Real and nominal policy interest rates



Source: Central Bank of Egypt, NBK estimates

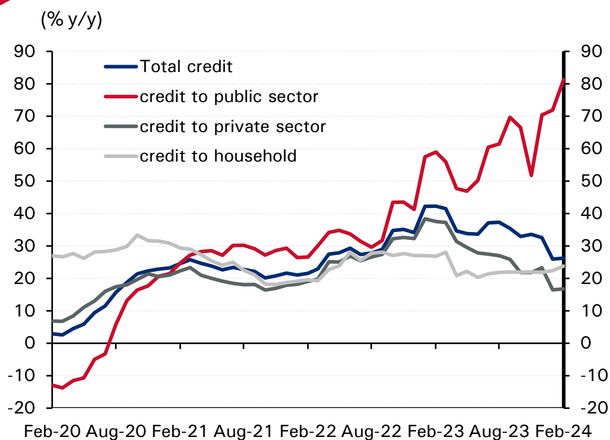
As we expect inflation to remain high in the coming months, we do not rule out the possibility that the CBE might raise policy rates again even though the magnitude of the hike would be significantly smaller (1-2%) than the previous one. However, as the devaluation pass through fades and inflationary pressures show signs of easing, we think that the bank may have a window to cut rates by the end of this year.

Private credit growth slows but public credit expands

The latest available data for credit are as of February 2024, and thus not reflecting the impact of the March rate hike and other policy changes. Credit to the private sector slowed significantly to 16.8% y/y from a 2023 peak of 35% in February 2023. Household credit growth held up better at 24% y/y versus 25% y/y in February 2023. On a real-terms basis, credit to both private sector businesses (-18%) and households (-11%) were both heavily negative.

Meanwhile, despite the high interest expense and the tough macro-economic conditions, public sector credit growth continued to surprise, expanding by 80% y/y in February, a continued rally from a low of 41% y/y in May. This was also a strong 44% y/y on a real-terms basis. Public credit growth expanded by 14% q/q for the 3 months to February up from 8.5% q/q for the 3 months to November of last year.

Chart 6: Bank credit by sector



Source: Central Bank of Egypt, NBK estimates

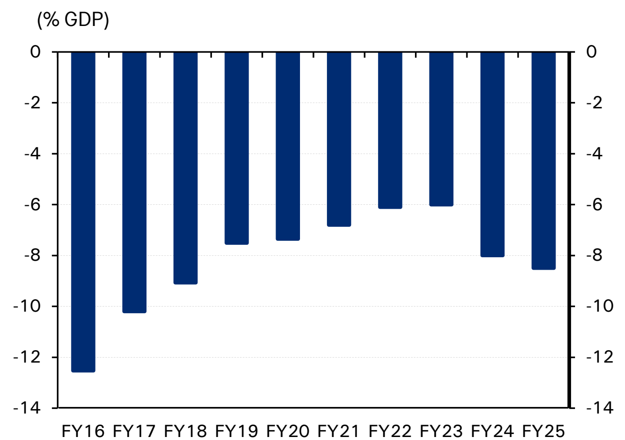
Fiscal deficit widens amid rising interest costs

The Ministry of Finance released fiscal data for the first 8 months (July-February) of FY23/24 showing the deficit widening significantly to 6.6% of GDP from 5.0% a year earlier. This suggests to us that the full-year deficit will come in at around 8-8.5% of GDP, higher than the budgeted forecast of 7%. However, the primary surplus (i.e. excluding debt interest payments) improved to 1.4% of GDP from 0.4% a year earlier. We expect a primary surplus of 2.2% of GDP for the full-year, only slightly short of the government's budgeted figure of 2.5%.

Revenues increased by 35% y/y to EGP1.08tn in the first 8 months, while spending surged by 52% to EGP2.0tn, leaving a deficit of EGP0.9tn. The rise in expenses came mainly on the back of a 100% increase in interest costs as treasury yields averaged 26.5% versus 13.2% a year earlier.

The budget for FY24/25 projects a deficit of 7.٢% of GDP (EGP1.4tn) and a primary surplus of 3.5% of GDP. Spending is expected at EGP6.4tn and revenues at EGP5.05tn. We expect the subsidy bill to increase by 32% and interest expenses by 38%, leading to a rise of 36% in spending for this year.

Chart 7: Fiscal deficit



Source: Ministry of Finance, NBK estimates

Table 1: Forecast Table

	FY20/21	FY21/22	FY22/23	FY23/24	FY24/25
Real Indicators					
Nominal GDP (EGPbn)	6,663	7,940	10,337	13,810	16,656
Real GDP (%)	3.3	6.7	3.8	2.5	3.5
Unemployment rate (%)	7.4	7.6	7.8	7.8	7.6
Population (mn)	104	108	110	112	114
External Indicators					
Trade Balance ($bn)	(42.1)	(43.4)	(31.1)	(32.0)	(41.0)
Trade Balance (% of GDP)	(9.9)	(9.0)	(7.5)	(8.3)	(11.5)
Current account balance ($bn)	(18.4)	(16.6)	(4.7)	(11.2)	(12.0)
Current account balance (% of GDP)	(4.4)	(3.6)	(1.6)	(3.15)	(2.6)
Gross official reserves ($bn)	39.4	31.5	34.8	-	-
Fiscal Indicators					
Fiscal deficit (% of GDP)	7.1	6.1	6.0	8.0	8.5
Primary balance (% of GDP)	1.4	1.1	1.5	2.2	2.5
Debt (% of GDP)	89.9	92.1	89.3	86.2	84.5
Monetary Indicators					
Inflation (period average, %)	4.5	8.4	24.1	36.0	25.0
Interest rates (end of period,(%)	8.2	11.7	19.7	27.75	17.75
Exchange rate (EGP per USD)	15.6	16.2	25.8	48.6*	-

Source: Central Bank of Egypt, Bloomberg, NBK estimates *As of mid-April 2024

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