Macroeconomic outlook

Egypt: recovery gains pace as fiscal reforms are implemented

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Overview and outlook

- **Growth prospects appear to be improving, with the pace seen reaching 3.5% in FY14/15 and 4.5% in FY15/16; the recovery is driven by the improved political outlook and return of investor confidence.**
- **New government addresses key risk head-on as fiscal reforms move ahead with the implementation of fuel price hikes in June; as a result, inflation will accelerate this fiscal year before easing again in FY15/16.**
- **The external position is stable following a managed depreciation in 2Q14 which helped relieve pressure on the EGP and undermine the unofficial exchange market.**

The Egyptian economy has shown the best signs yet that it is accelerating above 2%-growth for the first time in over three years, supported by a more stable political environment and improving confidence. The recent inauguration of the popular new president, Abdel Fattah el-Sisi, was the most credible attempt yet to re-establish political stability. Though tourism remains weak, other sectors such as manufacturing and construction have driven growth in recent months. Meanwhile, the country's external position has stabilized thanks to support from Egypt's GCC allies and the improving outlook.

Business confidence is likely to receive another positive boost on the heels of the government's most recent decision to prioritize fiscal reforms, which saw their most significant development in years when fuel price hikes were implemented in June. The hikes, one of the first moves by the new president, will reduce Egypt's massive fuel subsidies, shrink the deficit and support Egypt's long term sustainability. With inflation expected to rise in the near-term as a result, the central bank has already responded by lifting policy rates.

Despite the improved outlook for growth, the country continues to face significant risks which could derail the recovery. A large fiscal deficit and a relatively high public debt continue to present the government with a challenge as it seeks to achieve a stable and sustainable macroeconomic environment. Unemployment levels remain elevated and are unlikely to begin falling before a year or two. Nevertheless, Egypt appears to be making good progress and, despite the risks, many factors point to a robust albeit gradual recovery ahead.

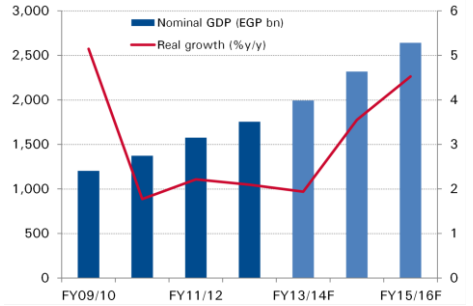
Table 1: Macroeconomic forecasts

		Year			
		FY12/13	FY13/14E	FY14/15F	FY15/16F
Nominal GDP	EGP bn	1,753	1,994	2,265	2,573
Real GDP growth	% y/y	2.1	2.0	3.5	4.5
Inflation	% y/y	9.8	8.2	12.0	10.0
Budget balance	% GDP	-13.6	-12.3	-10.6	-10.0

Source: Central Bank of Egypt, Ministry of Finance, Ministry of Planning, NBK estimates

Chart 1: GDP

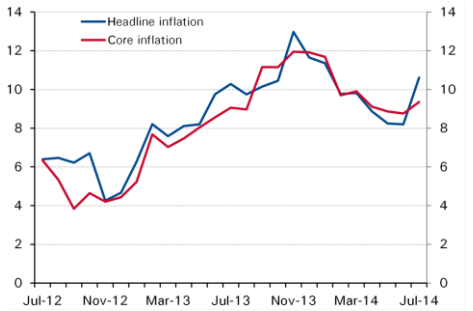
(% y/y)



Source: Ministry of Planning, NBK estimates

Chart 2: Consumer price inflation

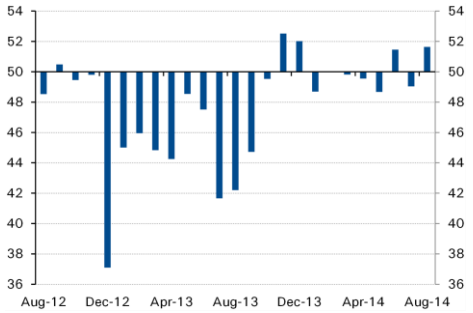
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 3: Purchasing managers' index

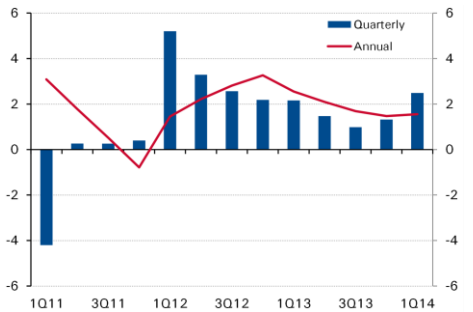
(index, seasonally adjusted)



Source: Markit

Chart 4: Real GDP

(% y/y)



Source: Ministry of Planning, Thomson Reuters Datastream

Economic activity has been picking up

Economic growth has been accelerating in recent months, with real GDP recording quarterly year-on-year (y/y) growth of 2.5% in 1Q14, up from just 1.3% in 4Q13. In the second quarter, the Ministry of Planning's production index through June implied y/y GDP growth above 3% during the quarter.

Credit growth has also been accelerating during the first half of 2014, with y/y growth reaching 7.4% in June. While Markit's Purchasing Managers Index (PMI) has not consistently sustained levels above 50, it too has shown improvement from recent lows and recorded a new 2014 high in August, coming in at 51.6.

As a result of the more positive figures, we expect real GDP growth in FY14/15 to pick up to 3.5%, following estimated growth of 2% in FY13/14. In addition to continued strength in manufacturing and construction, FY14/15 should benefit from a recovery in the tourist industry from a low base last year. FY15/16 is expected to see further acceleration to 4.5% as the recovery takes hold.

Tourism and natural gas production main sources of GDP weakness

The sectors seeing the most robust growth have been manufacturing, construction, and trade. The manufacturing sector, which accounts for 16% of GDP and includes oil refining, saw growth accelerate to 6.9% in 1Q14. Construction, which has maintained relatively stronger growth, grew by 12% in real terms y/y through 1Q14. The domestic trade sector, with an 11% share of the economy, saw growth gain pace to 5.2% in 1Q14.

These sectors countered significant weakness in tourism, which continues to suffer from the political and security conditions in the country. A year after the popular protest that led to the toppling of President Mursi in June 2013, tourist numbers are down by 23% while the number of tourist nights spent is 15% lower than a year ago. This has principally been felt in the restaurant and hotel sector which shrank by 28% y/y in real terms in 1Q14.

Natural gas has been another source of weakness, with natural gas output shrinking significantly. GDP in the natural gas sector dropped by 12% y/y following several quarters of decline. The decrease in natural gas production is the result of a number of factors that have disrupted investment in the sector, not allowing new developments to replace declining production in aging fields. According to the Ministry of Planning, the output in the sector was down 9% y/y in May, following a 2.4% y/y decline a year before.

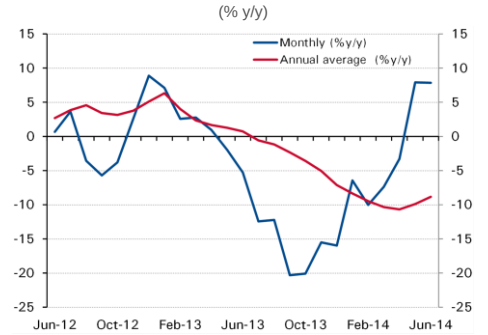
Unemployment remains elevated despite pick up in employment

Employment growth has improved in recent quarters. In 1Q14, employment levels surpassed pre-2011 levels for the first time. In 2Q14 employment continued to increase, with the net increase in the number of jobs during the 12 months ending in June 2014 reaching 328,000. This compares to an increase of 93,000 during the same period a year before. Despite a small decline in the 2Q14, the unemployment rate remains elevated at 13.3%, representing one of the key challenges facing the current government.

Credit growth bounces back

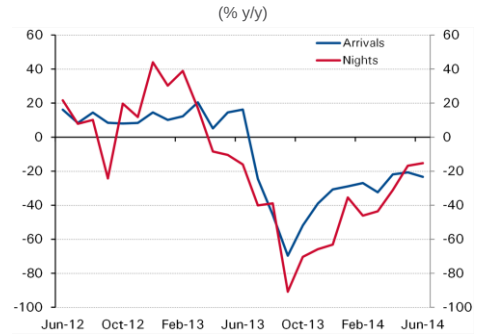
Credit growth also confirmed a pick-up in activity, with growth in the first half of 2014 accelerating to an annualized pace 16% following a 0.8% annualized decline in 2H13. The y/y increase in private credit remains more modest at 7.4%, but is rapidly gaining pace. We expect growth to continue to accelerate in the coming months, further supporting the recovery in real economic growth.

Chart 5: Production index



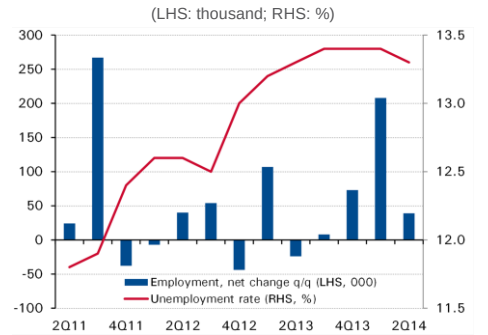
Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism



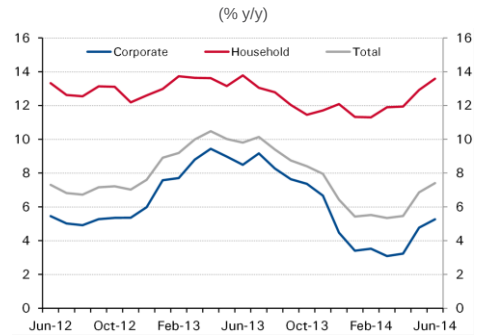
Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Employment



Source: Thomson Reuters Datastream

Chart 8: Credit growth



Source: Central Bank of Egypt, Thomson Reuters Datastream

Move to cut subsidies addresses high fiscal deficit

Egypt's fiscal deficit remains high and containing it is a top priority of the new government. The deficit stood at 11% of GDP at the end of May 2014. While it has come off a high of 13.6% of GDP a year ago, this was largely due to GCC grants. Indeed, without the additional reported grants of around $6.5 billion, the deficit in May would have stood at 13.3% of GDP.

Last June, in its most significant effort to date, the government sought to reduce subsidies by hiking fuel prices. Prices of a number of popular fuels rose by 64-78%. The government also announced a five-year plan to lift electricity prices. These increases are expected to save the government EGP 44 billion in FY14/15. According to the latest figures for FY13/14, the government's total subsidy bill amounted to 7.3% of GDP. The latest move could, if government targets are achieved, help trim that to around 5%, cutting around two percentage points off the budget deficit in the process. The government is planning additional fiscal reforms in the coming months, including the introduction of value-added-tax (VAT) in 1Q15.

Sovereign yields decline as risks recede

The recent reform measures will help keep Egypt's sovereign yields and risk of default down in the coming period. The improved economic outlook and increased political stability has already resulted in a decline in market yields on USD denominated sovereign debt. Yields on Egypt's USD bonds due in 2020 and 2040 have fallen to their lowest levels since 2010, reaching 5% and 7.2%, respectively. The price of the country's credit default swap (CDS) has also been on a declining trend, dropping to its lowest level in three years.

Domestic rates also fell over the last year as policy rates were cut and helped to control the government's cost of servicing its debt. However, the Central Bank of Egypt raised rates in July to help control inflation following the recent hike in fuel prices. As a result, yields on government bills have risen in recent weeks.

Inflation was down before recent fuel price hikes

Inflation had been on the decline in the last few months, easing to 8.2% in June, down from 12% at the end of 2013. However, the June hike in fuel prices has caused inflation to rise again and is likely to keep inflation elevated throughout FY14/15. Inflation rose to 10.6% y/y in July, following the price hike, though core inflation was lower at 9.4% y/y having been somewhat less affected by the rise in fuel prices.

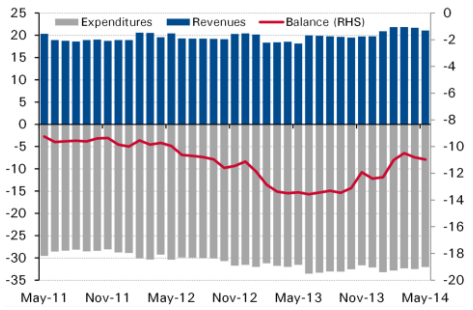
External pressures recede, EGP stable

One of the positive trends seen over the last 18 months has been the narrowing of Egypt's current account deficit. The deficit, which had peaked at 3.9% in 2012, shrank to 0.7% by the end of 1Q14 on a 12-month trailing basis. While the introduction of capital controls and the managed devaluation of the currency in 2013 and 2014 helped reduce the deficit, most of the decline was due to over $10 billion in "official transfers", most of it from GCC allies. A decline in non-oil imports has also been helpful. While private remittances improved in 2012, they have since been mostly stable.

The country's capital and financial account has also improved notably from lows reached in 2011. Foreign direct investment (FDI) improved more quickly and reached 2.3% of GDP during the 12 months ending in March 2014, though FDI levels remain well below highs seen in 2008, when they topped 8% of GDP. Net portfolio inflows have also recovered, to reach 1.2% of GDP in March, though they have far from recouped the outflows recorded post-2011.

Chart 9: Fiscal balance

(% of GDP, 12-month trailing)



Source: Ministry of Finance, Thomson Reuters Datastream

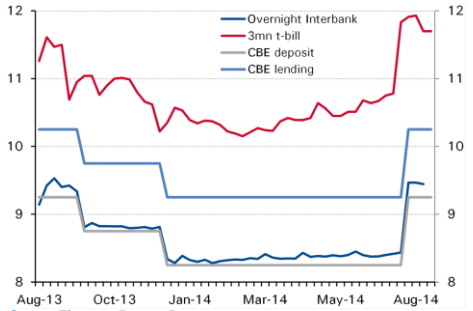
Chart 10: USD sovereign bond yields

(%)

Source: Thomson Reuters Datastream

Chart 11: Key rates

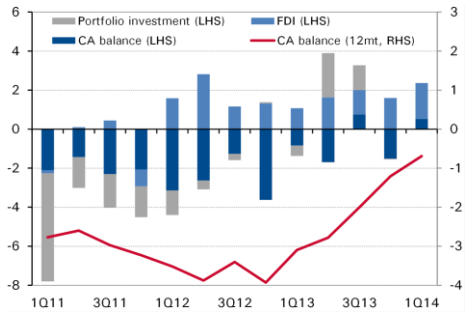
(%, weekly)



Source: Thomson Reuters Datastream

Chart 12: Balance of payments

(LHS: USD billion; RHS: % of GDP)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Meanwhile, official support, capital controls, and a decline in the value of pound have helped stabilize central bank foreign reserves, which stood at $16.7 billion in July 2014, or 3.6 months of imports. While the level has stabilized, it remains well below where it stood before 2011. Reserves should increase to more comfortable levels as the economic recovery takes hold and foreign investment returns in the coming year or so.

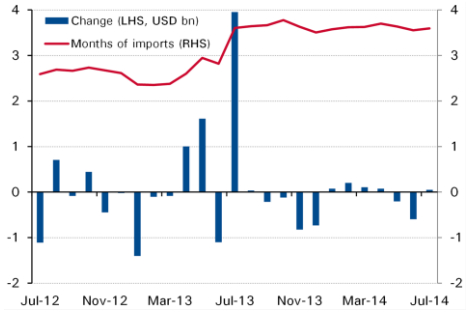
Reduced external pressures have helped the Egyptian pound (EGP) stabilize in recent months, thanks in large part to the central bank's careful management. The currency has been allowed to depreciate at times of pressure to help avoid a crisis and to ensure the current account deficit does not widen, but also to keep a lid on the unofficial rate paid for the pound. The EGP/USD now stands at around 7.15. The black market premium remains quite limited at around 3.5%, less than half its size at the end of 2013.

Equity market has maintained a strong performance

Egypt's stock market has been one of the best performers in the region, gaining over 100% since the market bottomed out in late June 2013. The market's benchmark EGX30 index rose to 9387, surpassing its pre-2011 high by 36%. For dollar investors, the gain in equity prices from the pre-2011 peak was a more modest 10% as a result of the decline in the value of EGP.

Chart 13: International reserves

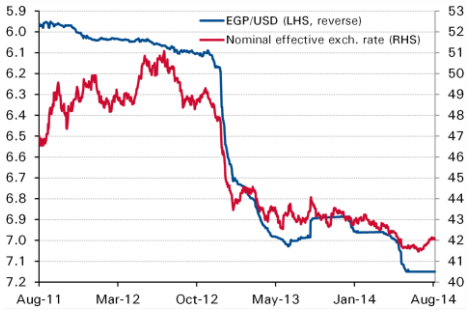
(LHS: USD billion; RHS: months of imports)



Source: Central Bank of Egypt, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30)

Source: Thomson Reuters Datastream

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