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Stability returns, new government can build reform momentum

- **Economic growth slowed to 2.2% in Q3 FY23/24 from 2.3% in Q2 but PMI levels, real credit growth, and cooling inflation signal that activity may have bottomed out.**
- **The current account deficit as expected deteriorated tremendously in 9M FY23/24 on lower gas production and falling remittances. However, we should see a narrower deficit in FY24/25.**
- **We see scope for sovereign credit rating upgrades on the back of a sustained flexible exchange rate regime, banking system NFAs moving back to positive territory, and post-election political stability.**
- **The new government can embark on major business reforms to ensure sustained FX inflows and that the economy can thrive beyond the one-off impact of the Ras El Hekma deal.**

It did not take long for the Egyptian authorities to capitalize on the economic reforms that took place in March, with the appointment in July of a new cabinet welcomed locally and regionally and injecting fresh optimism for the first time in years. We see in particular scope for greater coherence on economic policy with three key economy-focused ministries (Finance, Investment and the newly-merged Planning, Economic Development & International Cooperation) headed by a young generation (aged 50 on average) of officials with backgrounds in international institutions such as the IMF and World Bank helping to drive policy forward, albeit based on a medium-term plan that we are yet to see.

Meanwhile, the economy has started to show early signs of recovery with inflation cooling, growth indicators ticking up, the currency stable and the external finances correcting sharply. Likely subsidy cuts over coming months should not disrupt the trend of lower inflation, providing space for interest rates to fall from September.

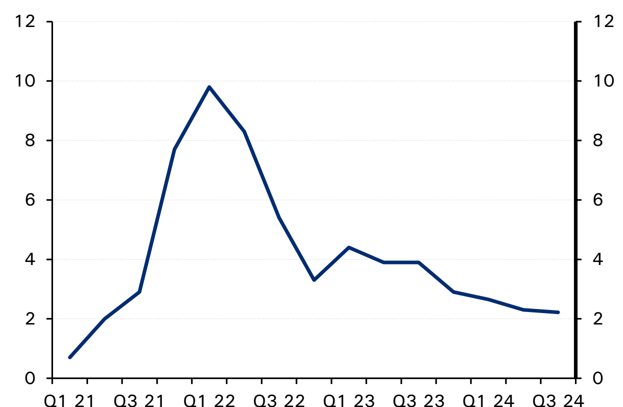
Major economic challenges still lie ahead. Egypt is now emerging from its crisis stage thanks to critical one-off policy moves and deals including the currency devaluation and mega-investment from the UAE in Ras El Hekma that helped secure large capital inflows. Markets, investors and rating agencies will now be looking at what comes next – and in particular for the government to embark on the second stage of the reform process relating to enhancing the business environment and strong communication of the new agenda.

Growth may have bottomed out in Jan-Mar

Latest data show economic growth continuing its downward path, slowing for the fifth consecutive quarter to 2.2% y/y in Q3 FY23/24 (Jan-Mar 2024) from 2.3% in the previous quarter. We expect Q4 growth to come in close to 2.5% with the full year at 2.4% versus 3.5% the previous year.

Chart 1: GDP

(% y/y)



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

The period January to March 2024 was possibly the toughest on both businesses and households as it saw

Economic Research Group
T: (+965) 2259 5500, econ@nbk.com, © 2024 NBK

extreme volatility in the EGP on the parallel market, where it reached as low as EGP70/$1 on (versus the EGP31/$1 official rate) before the government devalued the pound in early March. This along with an 8% cumulative interest rate hike during the quarter took a toll on businesses and retail. Detailed data has not yet been released, but we expect a slowdown in consumption due to eroded purchasing power (inflation peaked at 35.7% in February) and major shortages of goods that affected both the manufacturing and the services sectors.

Supporting this view, the PMI activity gauge picked up in April-June to 48.5 versus 47.6 the previous quarter and ended the year at 49.6, close to the 50 neutral level which we expect to be surpassed in the coming months. This was the highest level for the PMI since September 2021. Several sub-indicators already exceeded the 50 mark including the employment, future output, and new export orders indices. In our opinion, this reflects the improvement in overall macro stability including lower inflation, the stable exchange rate, and better availability of foreign currency. We expect further improvement in the coming period as inflation falls further and interest rates start to fall. We forecast growth accelerating in the coming year (FY24/25) to 3.5-4.0%.

Current account deficit widens on lower gas production

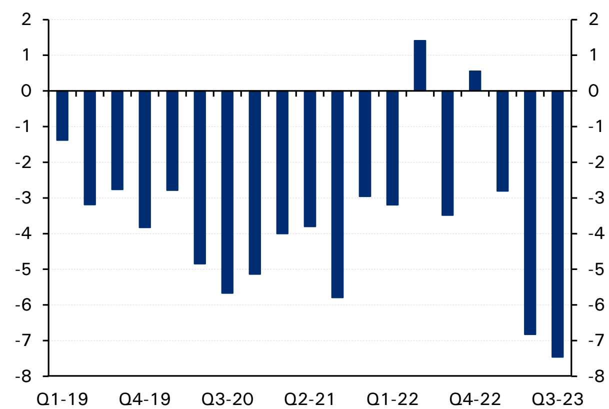
The current account deficit widened in 9M FY23/24 (July to March) to $17.1bn from $5.3bn in the same period in FY22/23 mainly on the back of a significant drop in Egypt's natural gas production, which pushed the oil trade balance into a $5.1bn deficit. On the other hand, the non-oil trade deficit improved by $1.5bn to $23.7bn mainly on the back of a 3% drop in imports due to import restrictions. Remittances from Egyptians living abroad also slowed to $14.5bn (-17% y/y). On a positive note, tourism revenues remained strong, growing by 5.3% y/y even amid all the regional tensions.

The situation was positive on the capital account front as the EGP devaluation in March allowed for the release of the $15bn first tranche of the Ras El Hekma deal along with significant inflows from carry trade investments. This was reflected in FDI reaching $23.7bn (from $7.9bn) and a net inflow of $14.6bn in portfolio investments (versus a net outflow of $3.4bn). The overall balance of payments saw a surplus of $4.1bn (from a $0.3bn deficit).

We expect the current account deficit to shrink in the final quarter of FY23/24 (April-June) to around $1-2bn (from $8.2bn in Q3) on the back of a rise in tourism receipts and recovery in remittances. On a full-year basis, the deficit could be $19-21bn, the largest deficit in Egypt's history, but should correct once again in FY24/25 to $10bn as a 10-15% import recovery is offset by a higher remittances, continued strong tourism receipts, and the maintenance of a more flexible exchange rate that keeps the pound in line with its fair value. We see limited scope for a natural gas production recovery over the coming 2 years.

Chart 2: Current account balance

($, bn)



Source: Central Bank of Egypt, NBK estimates Note: quarters are for fiscal year

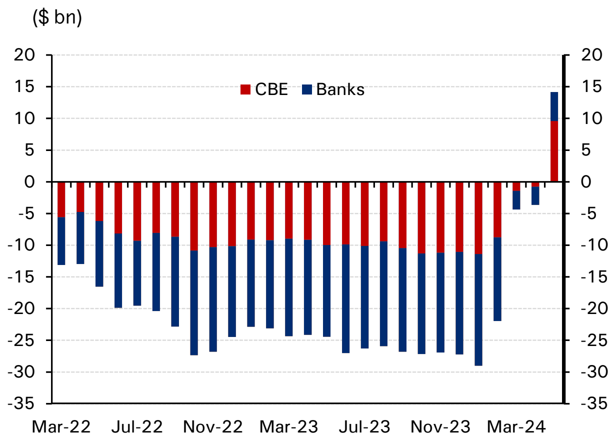
A credit rating upgrade could be on the way

The authorities received the final tranche of the Ras El Hekma investment deal from the UAE in May worth $14bn (and $11bn in the form of UAE deposits to be converted into EGP) pushing FX reserves to an all-time high of $46.3bn as of June 2024. Net foreign assets at banks (both central and commercial banks) has turned into a positive position of $14bn as of May, from a negative position of -$3.7bn in April. The authorities clearly delivered on their promise to utilize majority of the Ras El Hekma proceeds to rebuild FX buffers, however we think that that improvement is now mostly behind us. Our outlook of BoP dynamics shows that it will be difficult to sustain ongoing rises in foreign reserves due to a net cumulative financing gap of $10bn over the coming 2 years until the end of FY25/26. Additionally, we see no official urge for even higher foreign reserves as they are already more than satisfactory covering close to 7 months of imports.

Yields on Egypt's 5yr-Eurobond have maintained their compression from the past months standing at 9.5% as of mid-July from 15% pre-devaluation in February, while 5-yr CDS levels (a measure of default risk) have narrowed to around 570bps from 1100 bps and above. The risk compression could be followed soon by upgrades to Egypt's credit rating from the current B-/Caa1 by at least

two notches to B+/B2 by S&P and Moody's. Key factors needed to earn this upgrade have been ticked, including sustaining a more flexible EGP exchange rate, strong external support, and a significant improvement in the NFA position.

Chart 3: Net foreign assets at banks



Source: Central Bank of Egypt, NBK estimates

Energy subsidy cuts should not hinder inflation slowdown

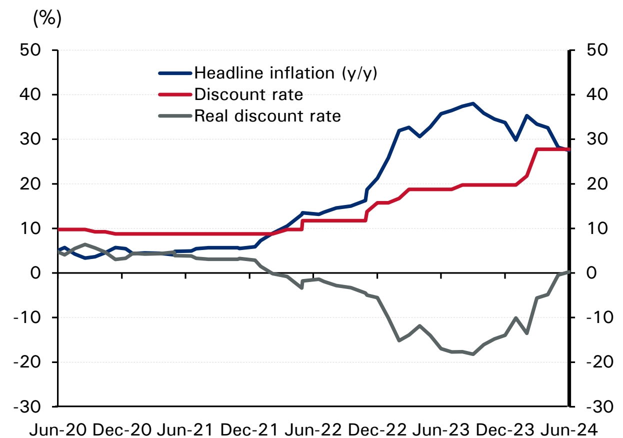
Inflation has continued its clear downward trend over the past quarter, averaging 29.4% y/y in Q2 (CY) down from 34.0% in Q1 as the EGP devaluation impact fades and smoother FX availability allows for improved supply of goods. Average monthly price rises have slowed sharply to 0.7% m/m for Q2 from 4.7% for Q1. In early June, the government cut bread subsidies resulting in a 300% increase in the price of a loaf from EGP0.05 to EGP0.20. This added around 1.2% to June's CPI which rose 1.6% overall as subsidized bread represents less than 0.5% of the CPI basket. Next in line could be changes in fixed/subsidized electricity and fuel prices, though we expect the inflation impact to be limited (fuel and electricity represent around 4% of the CPI basket and a 20% increase adds about 0.8% to the CPI).

We expect inflation to average 25% in H2 (July to December) of 2024 down from 31% in the first half with a strong possibility that inflation ends the year below 24%. We forecast inflation to average 19% for FY24/25 (much lower than previously on the back of softer than expected inflation post-March devaluation) down from 34% in FY23/24. We continue to wait for the CBE to amend the inflation target timeline to Q4 25 (from Q4 24); a target of around 10% would be met based on current dynamics, in our view.

CBE to cut rates in H2

The central bank kept rates unchanged throughout Q2 (April to June) at 27.75% on the discount rate, while average 1-year treasury bills have dropped by 2% since March to 26%, which implies that markets are looking at 1-2% in rate cuts in the coming period. As inflation has decelerated over the past months (27.5% as of June), real interest rates have turned positive for the first time since January 2022. As inflation falls further through 2024, we expect the CBE to commence the monetary easing cycle in the coming period starting potentially in September, with cuts of a cumulative 400 bps rate cuts by year-end.

Chart 4: Real and nominal policy interest rates



Source: Central Bank of Egypt, NBK estimates

Private business credit boosted by currency effect

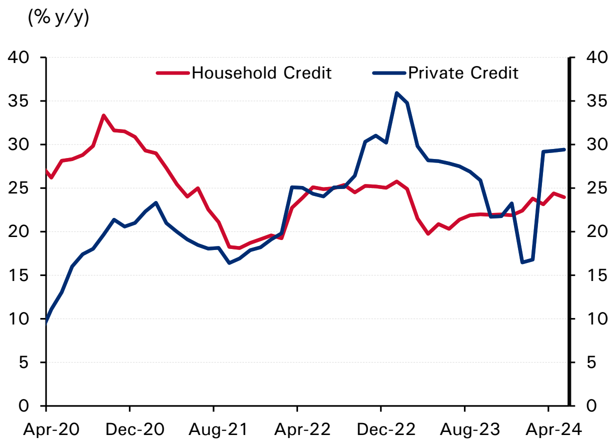
The latest available data for bank credit are as of May, so capture the initial impact of the early March rate hike and other policy changes that took place in the March to May period. Credit to private businesses showed strong growth of 29% y/y for the 3 months to May from 18.8% for the previous 3 months. However, adjusting for the March EGP devaluation, credit would have grown by 16.8%.

Household credit growth remained in strong growth territory but unlike business credit there was no strong adjustment to the devaluation with growth at 24% y/y in the 3 months to May versus 23% for the previous 3 months. On a real-terms basis, credit to private firms recorded -2% y/y, improving hugely from -14% for the period Dec 23 – Feb 24. As for households, it stood at -7.2%, improving from -10.3%.

The improvement in real credit growth in both the private and household segments are early signs of economic recovery and proof of the heavy burden on economic activity well before the official devaluation took place in March. As inflation cools in the coming period so will credit growth in EGP terms but possible interest rate cuts

in FY24/25 should encourage firms to take on longer-term loans targeted towards CAPEX, not only OPEX spending. We expect credit to grow by 25% in FY24/25 down from 31.5% in FY23/24, but it will grow on a real basis by +6% from -2%.

Chart 5: Bank credit by sector



Source: Central Bank of Egypt, NBK estimates

Ras El Hekma deal a game-changer for fiscal dynamics

The government utilized 50% of the Ras El Hekma deal proceeds ($12bn once UAE bank deposits – which was not 'fresh' money – are excluded/EGP580bn) to reduce the fiscal deficit evident in the July-May FY23/24 deficit which came in at 3.6% of GDP (versus 7.7% without the Ras El Hekma proceeds) and a ballooning primary balance of 5.9% (1.7% ex Ras El Hekma). We expect a deficit of 4% of GDP and a primary balance of 6.2% of GDP for the full year. In FY24/25, we expect a normalized deficit close to 8.0% (7.3% for the government target), mainly on the absence of another big one-off revenue boost in FY24/25 (at least for now). The government is allocating EGP154bn for the energy subsidy which entails a 20% price hike (gasoline, diesel, and butane cylinders) in each quarter in FY24/25. However, we think the government might opt to go for a lower price hike (10-15%) which means the final subsidy could be in the range of EGP210bn, adding EGP60bn (0.6%) to the fiscal deficit.

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	2.4	4.0
External Indicators					
Current account balance ($bn)	-18.4	-16.6	-4.7	-20	-10
Current account balance (% of GDP)	-4.4	-3.6	-1.6	-6.3	-2.5
Gross official reserves ($bn)	39.4	31.5	34.8	43	-
Fiscal Indicators					
Fiscal deficit (% of GDP)	7.1	6.1	6.0	4.0	8.0
Primary balance (% of GDP)	1.4	1.1	1.5	6.2	2.5
Monetary Indicators					
Inflation (period average, %)	4.5	8.4	24.1	33.50	19.00
Interest rates (end of period,(%)	8.2	11.7	19.7	27.75	17.75
Exchange rate (EGP per USD, end of period)	15.6	16.2	25.8	48.6	-

Source: Central Bank of Egypt, Bloomberg, NBK estimates

Head Office

Kuwait
National Bank of Kuwait SAKP
Shuhada Street,
Sharq Area, NBK Tower
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2222 2011
Fax: +965 2229 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
34h Floor, NBK Tower
Shuhada'a street, Sharq Area
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

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