Macroeconomic outlook

Egypt: Progress on painful reforms bears fruit; growth begins to recover

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Overview and outlook

- **Growth should improve to 3% in FY16/17, before it accelerates to 4% and 5% in FY17/18 and FY18/19.**
- **The floating of the pound alleviated foreign currency shortages, but GDP growth recovery has been gradual.**
- **Fiscal deficit to narrow to 11% of GDP in FY16/17 and to 8-9% in FY17/18 and FY18/19 as fiscal reform stays the course.**
- **Double-digit inflation should ease in late 2017, and further in 2018, as monetary policy tightens, stabilizing the pound.**

Egypt's economy has been in recovery mode following a considerable slowdown in 2016. A currency shortage that crimped activity last year was relieved with the decision to float the currency and the launch of a comprehensive reform program. A number of fiscal reforms implemented in 2016 are already having a positive impact on the deficit. A $12 billion IMF loan agreement also helped inject a degree of confidence among investors. As a result, the country's foreign reserves have improved significantly over the last seven months.

With reforms expected to see fiscal and monetary policy tighten, growth will be largely driven by foreign investment, exports and tourism, all supported by a more competitive currency and by the prospect of an improved operating environment. This is already being felt, with exports and tourism improving in 4Q16 and 1Q17. Foreign investment is also up, in part benefiting from large pledges by multilateral institutions.

The key risk to the outlook is a lack of progress on reforms, though it has been relatively good so far. Indeed, the IMF recently provided a positive assessment as it approved the disbursement of the second tranche of its loan agreement. The IMF felt that the authorities had taken important measures that are likely to "place public debt on a declining path to sustainable levels". The latest fiscal figures also indicate that progress is being made.

Egypt's decision to join its GCC allies in cutting ties with Qatar is not likely to have a material impact on the Egyptian economy. Over 250,000 Egyptians living in Qatar have not been asked to leave, though they account for just 4-5% of remittances. While Qatar provided over 60% of Egypt's LNG imports in 2016, these shipments have not been halted during the crisis. Meanwhile, authorities in Egypt indicated that private

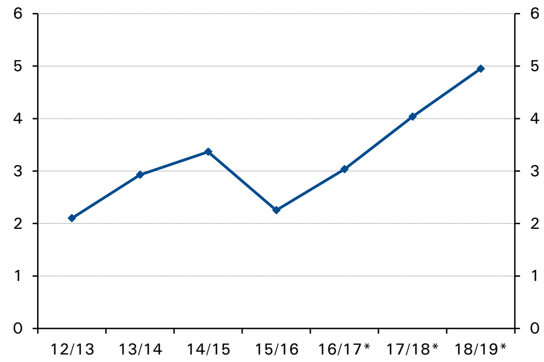
Table 1: Key economic indicators

		FY15/16	FY16/17f	FY17/18f	FY18/19f
Nominal GDP	EGP bn	2,708	3,421	4,185	4,796
Nominal GDP	USD bn	326	236	226	253
Real GDP growth	% y/y	2.3	3.0	4.0	5.0
Inflation	% y/y	14.0	30.0	11.0	9.0
Budget balance	% of GDP	-12.1	-10.5	-8.8	-7.7

Source: CBE, MOF, MOP, NBK estimates

Chart 1: Real GDP growth

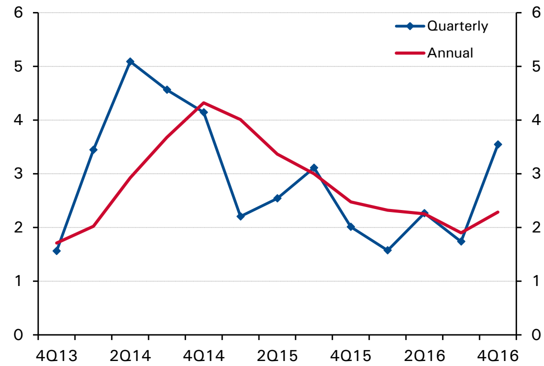
(% y/y)



Source: MOP, TR Datastream, NBK estimates; *estimate/forecast

Chart 2: Quarterly GDP growth

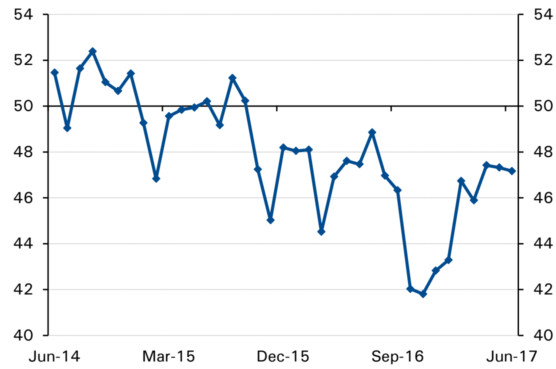
(% y/y)



Source: Ministry of Planning, Thomson Reuters Datastream

Chart 3: Purchasing Managers' Index

(index, seasonally adjusted)



Source: Markit

Qatari investments will not be affected, though Qatar accounts for only 1-2% of FDI inflows.

Economy showed signs of bouncing back in 4Q16 and 1Q17

After slowing significantly during 2016, economic growth began bouncing back late in the year. Real GDP growth rose to 3.5% year-on-year (y/y) in 4Q16 (Chart 2), compared to average growth below 2% during the first nine months of 2016. The improvement came largely from the manufacturing sector, which grew 6.4% y/y in 4Q16. Growth in other sectors remained weak.

GDP growth appeared to improve further in 1Q17. The quarter saw a much awaited rebound in tourism. The number of tourist arrivals rose to a monthly average of 580,000 during the first three months of 2017 (Chart 6). While this figure is well below potential, it is up 49% y/y. The improvement is reflected in a healthy bounce in the tourism component of the production index, which was up 81% y/y in March.

The sector continues to be weighed down by security concerns following the downing of a Russian commercial airline in October 2015 by terrorists. Indeed, a number of European countries maintain travel restrictions to the country as a result. Tourism, which has suffered since the Arab Spring in 2011, remains well below its full potential. Arrivals in 1Q17 were half their 1Q10 level.

Markit's Purchasing Managers' Index (PMI) also indicated growth may be returning, though by that measure the recovery appears to be relatively weak. The index rose from a low of 42 in November 2016 to 47 in June (Chart 3). Despite the improvement in the index, it remains at levels consistent with GDP growth of only 2%. Nonetheless, the index does indicate particular strength in exports; the new export orders component rose to a survey-high of 54.8 in May.

The economy is expected to continue to improve in 2017, despite headwinds from tighter fiscal and monetary stances. Growth in FY16/17 is expected to have averaged 3.0%, up from 2.3% the previous fiscal year. The pace is expected to accelerate to 4% and 5% in FY17/18 and FY18/19, respectively (Chart 1).

Reform agenda boosts optimism and the long-term outlook

In January, the IMF published details of the reform program that was the basis of a $12 billion loan approved in November 2016. It includes a number of fiscal reforms, including a VAT, cutting subsidies and reducing wage bill growth. The program also seeks deep structural reform to boost job creation, foreign investment and exports, including steps to improve the business environment with new laws governing investment, industrial registration and insolvency. Liberalizing the external account is also a key part of the program, including floating the currency and doing away with capital controls imposed since 2011.

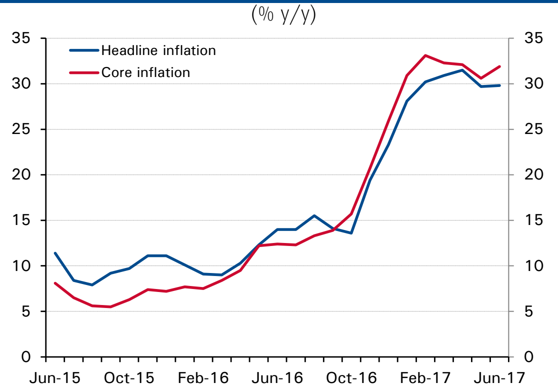
Many of these reforms have already been implemented. Indeed, floating the currency was one of the conditions of the IMF loan agreement and was seen as necessary to address the large external imbalances. The 50% decline in the value of the pound improved Egypt's competitiveness, which in turn helped boost non-oil exports by more than 29% y/y in 4Q16. The pound has since been relatively stable at around 18 EGP to the USD.

Inflation has remained elevated following floatation of the pound

However, the large decline in the value of the EGP has fueled inflation, as the higher price of imported goods pushes domestic prices higher.

Chart 4: Consumer price inflation

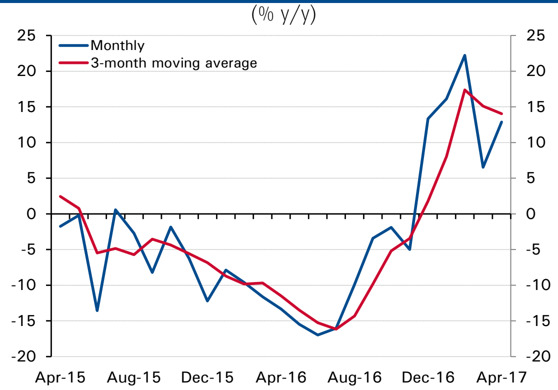
(% y/y)



Source: Central Bank of Egypt, Thomson Reuters Datastream

Chart 5: Production index

(% y/y)



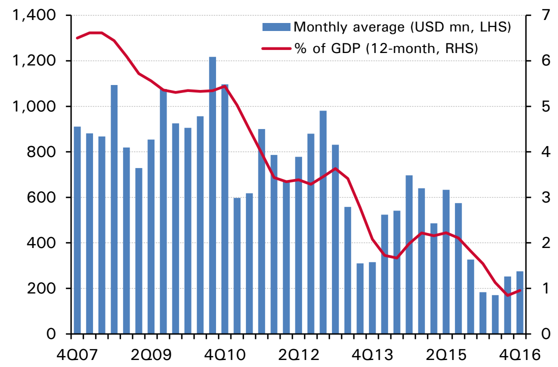
Source: Ministry of Planning, Thomson Reuters Datastream

Chart 6: Tourism

(million nights stayed)

Source: CAPMAS, Thomson Reuters Datastream

Chart 7: Tourism receipts



Source: CBE, Thomson Reuters Datastream, NBK estimates

Inflation accelerated to 30% by June 2017 (Chart 4). The rate is expected to remain at those elevated levels throughout most of 2017, before cooling off in late 2017 and easing further in 2018. We expect inflation to ease to around 20% by the end of 2017 and to 10% by the end of 2018.

Policy rates have been hiked twice in an effort to quell inflation

In an effort to fight inflation, the CBE hiked its policy rates three times since the currency float. The first time, in November, the central bank lifted rates by 300 basis points (bps) (Chart 11). Authorities had already raised rates by 300 bps in three moves over the previous 12 months. The CBE increased rates again in May and July, by 200 bps each time.

Fiscal deficit has narrowed as reforms begin to take effect

The key priority for the government has been addressing the large fiscal deficit, which is a key source of imbalance for the economy. Some progress has already been made in that regard. The government replaced its sales tax with a value-added tax (VAT) in 2016. There have also been efforts to control the wage bill and to reduce government subsidies. A financial stamp tax was also introduced, though its fiscal impact is expected to be limited.

The impact of these measures on the fiscal picture has already been felt. The deficit narrowed during the first nine months of FY16/17 through March 2017 to 11% of GDP. The improvement, around 1.1 percentage points, came largely from increased control of the wage bill and healthy tax revenue growth. Tax revenues increased by 27% y/y thanks to the new VAT. During this period, the primary deficit (excluding interest payments) more than halved to 1.5% of GDP.

This improving trend is expected to continue over the next two years. The deficit should narrow to around 10% of GDP in FY16/17 from around 12% the prior year (Chart 9), and further to around 9% and 8% in FY17/18 and FY18/19, respectively.

Government taps international debt market

In an effort to reduce reliance on domestic financing of the deficit, the government has tapped international markets. The government raised $4 billion in USD bonds in January, an issuance that was more than 3.5 times oversubscribed. Pricing also came in more favorably than anticipated. The debt sale, which was Africa's largest ever, included 5-year, 10-year and 30-year tranches. Another $3 billion was raised in May with similar maturities. Once again, appetite for the issuance was strong, with the size double what the government had targeted initially.

Current account improved in 1Q17 after deficit widened in 2016

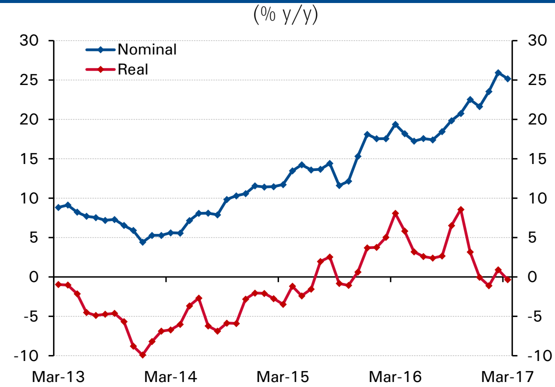
The current account deteriorated in 2016 largely as a result of the collapse in tourism and lower remittances, but has since improved in 1Q17. Tourism receipts were more than halved to $2.6 billion, as tourists stayed away following the bombing of a Russian passenger airplane. Meanwhile, remittances fell by 9% to $16 billion; an unfavorable official exchange rate had seen overseas workers increasingly use unofficial channels to repatriate their savings, which hurt remittances.

These negative trends, both of which we expect will begin to abate in 2017, were countered by more positive trends in the goods balance. The trade deficit actually narrowed by 5% thanks to strong export growth. Non-oil exports received a strong boost in 2016, increasing by 17% to $14.5 billion. At the same time, import growth was flat in part thanks to a 17% drop in the oil import bill.

Egypt continued to benefit from healthy levels of foreign direct

Chart 8: Private credit in local currency

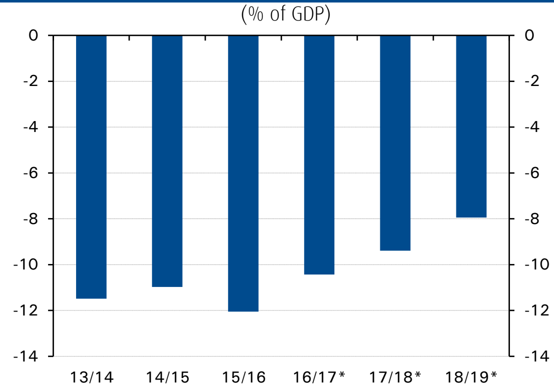
(% y/y)



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 9: Fiscal balance

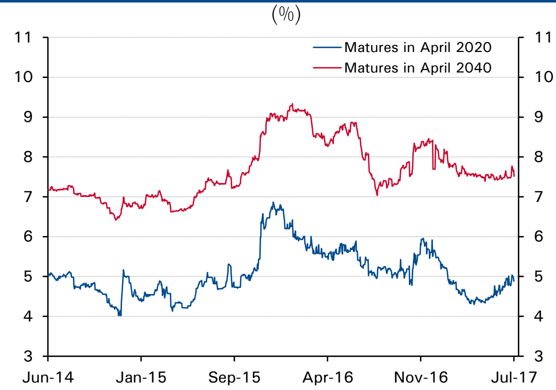
(% of GDP)



Source: MOF, TR Datastream, NBK estimates, *estimate/forecast

Chart 10: USD sovereign bond yields

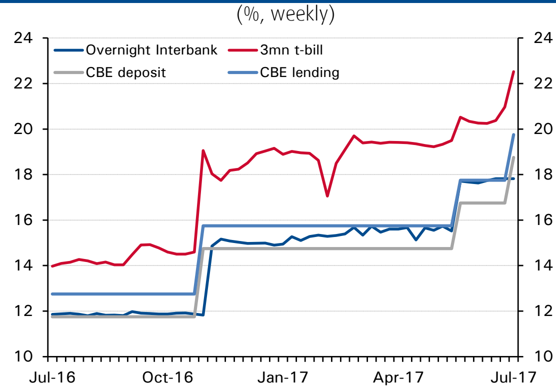
(%)



Source: Thomson Reuters Datastream

Chart 11: Interest rates

(%, weekly)



Source: Central Bank of Egypt, Thomson Reuters Datastream investment (FDI), which continued to provide support to the balance of payments (Chart 12). FDI rose by 17% in 2016 and accounted for around 2.9% of GDP. FDI in 4Q16 alone saw a healthy jump to an annualized 4.2% of GDP, recording one of the best quarters in more than six years.

The balance of payments saw trends improve strongly in 1Q17; the current account deficit shrank to its lowest level in over two years (to $3.5 billion or 7.3% of GDP) and portfolio inflows skyrocketed, as the decline in the pound made Egypt an attractive destination (Chart X). The current account continued to benefit from strong export growth, which topped 30% y/y in 1Q17. The quarter also saw tourism receipts and remittances bounce back. Meanwhile, net investment portfolio inflows shot up to $7.6 billion during the quarter, possibly the largest such inflow ever recorded.

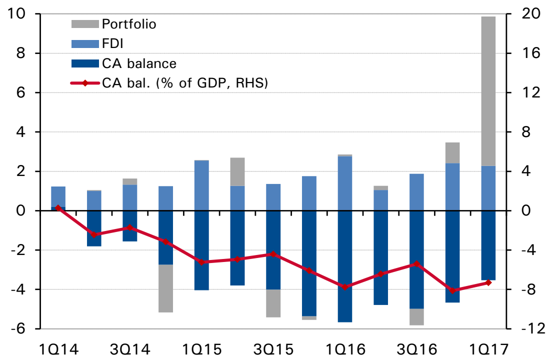
Foreign reserves have improved significantly since October 2016

Foreign reserves have risen significantly since the decision to float the pound. CBE reserves rose to their highest level in over six years in May to $31.1 billion or an estimated 7.7 months of imports (Chart 13). This is more than 60% higher than their level on the eve of the decision and before the IMF finalized its $12 billion loan to Egypt. The decision to float the currency relieved much of the pressure on reserves; these also benefited from inflows from a number of multi-lateral organizations, including the IMF.

Equities rallied since the decision to float the currency

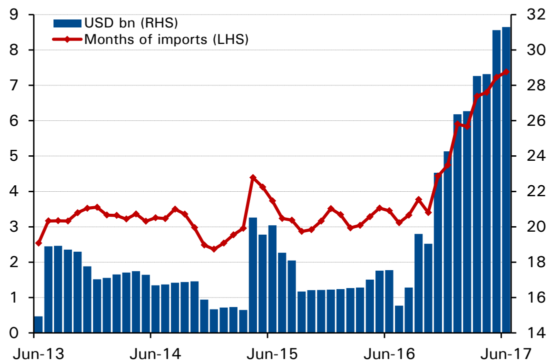
The stock market has outperformed most markets since October 2016. The EGX30 index was up 10.9% thus far in 2017 through 12 July. This followed a gain of 57% in 4Q16, with most of that taking place in November. Despite the rally, gains have not been enough to counter the drop in the currency; the MSCI total return index in USD remains down by 16% from its level before the currency float.

Chart 12: Balance of payments



Source: CBE, Thomson Reuters Datastream, NBK estimates

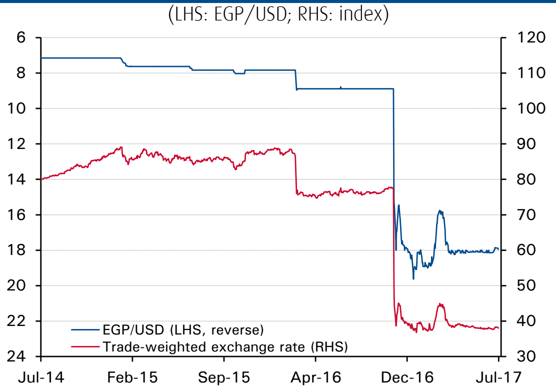
Chart 13: Official reserves



Source: CBE, Thomson Reuters Datastream, NBK estimates

Chart 14: Exchange rate

(LHS: EGP/USD; RHS: index)



Source: JP Morgan, Thomson Reuters Datastream

Chart 15: Stock exchange

(EGX30, thousand)

Source: Thomson Reuters Datastream

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