Back for more: Egypt has seen a return to economic progress

EGYPT'S REFORMS START TO PAY OFF

President Abdel Fattah el-Sisi has pushed through business-friendly reforms that would have been unthinkable in Egypt a few years ago, including cutting fuel subsidies. The results have been impressive, bringing praise from the IMF. So is the optimism prevailing in the country justified? James King *reports.*

In 1977, the then-president of Egypt, Anwar Sadat, lifted state subsidies on a range of basic foodstuffs. Under a policy of 'Infitah', or openness, the reforms were introduced as part of a wider programme of economic liberalisation. The result was catastrophic; cities across the country erupted in riots in what became known as 'the Bread Intifada'. Nearly 80 people were killed and hundreds were injured in the ensuing violence. In the intervening years, no Egyptian government has dared to tackle the country's subsidy regime – until now.

Since being sworn into office in 2014, current president Abdel Fattah el-Sisi has embarked on one of the most striking economic reform programmes anywhere in the world. The president, whose reputation is akin to that of a demanding chief executive, has shaken the foundations of the Egyptian economy in his pursuit of a more business-friendly market. The end goal is Vision 2030 and the attainment of a balanced, competitive and diversified economic model.

BOLD REFORMS

To get there, Mr Sisi's government has enacted what, historically, were deeply unpopular policies. "Hydrocarbon subsidies and the exchange rate peg were among the 'taboo' reforms that no one thought the government would touch. It was incredibly bold of the government to address these issues," says Karim Awad, chief executive of EFG Hermes, a financial services group headquartered in Cairo.

The fuel subsidy bill has, for instance, fallen from 5.9% of gross domestic product (GDP) in 2013/14 to an expected 2.4% in 2017/18, following a government programme to tackle the broader subsidy regime. But the authorities have not stopped there. Since Mr Sisi's inauguration, advances have been seen in almost every area of the country's economic framework. New legislation has cut bureaucracy for Egyptian businesses and infrastructure spending is transforming Egypt's physical landscape, while the introduction of value-added tax will contribute to an expected fiscal surplus in 2017/18.

"I think what we have seen over the past couple of years has been, quite honestly, revolutionary in terms of the extent of the reforms," says Mr Awad.

This sentiment is echoed across Egypt's financial sector. "The government has been bold enough to take seemingly unpopular decisions; subsidies reforms and the currency flotation redressed an earlier stalemate that stalked the economy," says Hassan Abdalla, chief executive of Arab African International Bank (AAIB).

BETTER COMMUNICATION

So why is the government now able to make these changes where its predecessors could not? Mr Awad attributes this to popular support, as well as the administration's efforts to explain to the public the need for these changes.

"I think the government realises that its popularity is strong enough to take these kinds of actions. It has also communicated the need to reform to the population very well. Today, people are expecting further changes to hydrocarbon and electricity subsidies in the second half of 2018. It's no longer a surprise," he says.

Nevertheless, Mr Sisi's government has its critics. For all of its progress on economic reform, the same cannot be said for its commitment to political liberalisation. Many opponents point to changes to the country's anti-terror and security legislation, which they have labelled as 'draconian'. In the build up to its presidential election, scheduled for March 26 to March 28, some major opposition campaigns withdrew from the race, claiming they were subject to intimidation. The president now faces one opponent who is himself, according to various sources, a Sisi supporter.

IMPROVED SECURITY

But the administration does have some political achievements under its belt. For one, the president's meritocratic approach to cabinet appointments included six women as of mid-March 2018 – for the first time in Egypt's history. In addition, Cairo's private sector leaders tend to agree that the security situation is improving, particularly in the Sinai, where local populations are aligning against extremist groups in the area.

"The security situation has improved and this is a big achievement. We are getting back to normal," says Hisham Ezz Al-Arab, chairman of Commercial International Bank (CIB), Egypt's largest private bank.

For now, however, the economy is clearly the government's focus. And its crowning achievement to date has been the free float of the Egyptian pound, which was executed in November 2016. "The free float of the Egyptian pound has probably been the most impressive reform so far," says Mr Awad. "Before this happened, international investors would talk to us and acknowledge the economy's strong fundamentals but few would be willing to take the currency risk associated with Egypt, which was huge."

The benefits for Egypt's economy have been profound. Bankers in Cairo are seeing rising production and consumption of domestic goods and services, employment is increasing in tandem and all the right numbers are emerging at the macroeconomic level.

"Previously, the currency was overvalued; [the result was] that many businesses found imports cheaper than local production. They flooded the country with imports because they were coming in at half the price," says Yasser Hassan, managing director of the National Bank of Kuwait in Egypt. "The negative and very serious consequence of that was that local production continued to shrink and the unemployment rate went up. The current monetary policy has put Egypt on the right track to remedy these problems."

SHORT-TERM INFLATION HIKE

But these benefits have also come with serious but short-term drawbacks for ordinary Egyptians. Inflation skyrocketed in the aftermath of the pound's flotation, as well as the lifting of key subsidies, with consumer price inflation reaching as high as 35% midway through 2017. This has hit Egyptian consumers, particularly the middle class, hard, reflecting their extensive obligations from school fees to the use of private vehicles. Nevertheless, the inflation story has hit every strata of society.

Encouragingly, inflation is now on a downward trajectory. In January 2018 annual urban consumer price inflation dipped to 17%, while core inflation fell to about 14% (from 19% in January 2017). Renaissance Capital, an emerging markets investment bank, expects inflation to hit between 11% and 12% by the middle of 2018, though further subsidy reductions may keep it somewhere around this level for a while longer.

But the net gains from the pound's flotation have been significant. For one, foreign currency liquidity has improved dramatically. Egypt faced a dearth of hard currency following the political upheaval of 2011 as tourists and investors limited their exposure to the country. It was also subject to a fixed exchange rate (E£8.8 to the dollar) that did not reflect the market value of the pound. This contributed to a multi-billion-dollar backlog of foreign currency requests from foreign entities and importers operating »

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THE GOVERNMENT HAS BEEN BOLD ENOUGH TO TAKE SEEMINGLY UNPOPULAR DECISIONS; SUBSIDIES REFORMS AND THE CURRENCY FLOTATION REDRESSED AN EARLIER STALEMATE THAT STALKED THE ECONOMY

Hassan Abdalla

in the country, which has since been cleared.

Improving dollar liquidity in the system is also opening up new opportunities for foreign investment. "I believe that the economy is now open for foreign direct investment [FDI] after several years during which the gate of investment – the foreign exchange market – was closed," says AAIB's Mr Abdalla.

LOCAL AND FOREIGN INVESTMENT

In May 2017, the Egyptian parliament approved the passage of the 'new investment law'. Designed to promote additional FDI, the law grants investors new rights and protections, including residency permits for the duration of their investments in Egypt and the right to repatriate profits and receive international financial assistance without restriction. Similar efforts are being made to improve the domestic operating environment for Egyptian companies.

"What is really promising is that the government of Egypt is not only addressing foreign investment, but local direct investment as well. It is also trying to give local businessmen a better business environment," says Mr Abdalla.

Indeed, the administration appears to be getting the basics of the domestic business environment right. These include substantial investments in key infrastructure, including transport networks, and the wholesale reform of the electricity sector. In previous years, both of these components were something of a hit-and-miss affair.

In 2014, for example, Egypt saw power demand peak at 27,000 megawatts, almost 20% above total capacity, according to research from HSBC. Under these conditions, power outages were common for households and businesses alike. But the current administration is completely revamping the country's energy sector by encouraging local and foreign investment, introducing a liberalised regulatory regime, diversifying the energy mix and investing in new power generation facilities.

AMBITIONS FOR ENERGY

The results have been outstanding. According to a number of sources, Egypt is expected to double its generation output by the end of 2018. "What the Ministry of Electricity has achieved is historic. It has transformed the market over the past three years. Now Egypt can even export electricity. And the government is not satisfied with the progress it has achieved. Complacency hasn't set in. The government is currently building the Benban Solar Park, soon to be the biggest solar installation in the world," says Mr Ezz Al-Arab at CIB.

In a boost for Egypt's plans to become a regional energy hub the country's offshore Zohr gas field, the largest hydrocarbon discovery in the Mediterranean, began production in December 2017. With daily production goals of 760 million cubic metres by the end of 2019, production from the Zohr field will go beyond meeting domestic demand and could potentially position Egypt as an exporter of natural gas. This comes as a private sector deal between Israeli and Egyptian companies, signed in early 2018, will see about 64 billion cubic metres of Israeli natural gas supplied to Egypt over the next 10 years.

Various projects are under way to fulfil Egypt's regional energy ambitions, including hydrocarbon tanker refuelling stations, petroleum storage facilities and pipeline infrastructure. The country has two underused gas liquefaction plants that could export new gas as it arrives into the country. And, at a time of growing tensions between Russia and the EU, this could be fortuitous.

IMF RECOGNITION

All of this bodes well for Egypt's future. Confidence is growing among Egypt's business community as the reform programme opens up new opportunities for development. GDP growth has picked up from 3.5% in 2015/16 to an expected 4.8% in 2017/18 before strengthening to 6% over the medium term, according to the International Monetary Fund (IMF). Little wonder then that IMF managing director Christine Lagarde singled out Egypt as a positive example of economic reform in comments made at the World Government Summit in February.

Nevertheless, it may still take some time for the success of Egypt's reform story to reach a wider audience. "When Egypt last executed a major devaluation in 2003, it took a while before real FDI started coming into the country. It takes time for investor awareness to develop and the same will be true under the current reform programme. But to hear the IMF talking positively about the country will certainly help," says Mr Awad.

Egypt's economy is clearly on the right track and the government has a credible plan in place to improve it further. Though the real benefits of this reform may not be felt for a number of years, the authorities are at least making the kind of hard choices now that will benefit the country in decades to come.

"When you sit down after four years and you look at what has been achieved, it is quite significant. I am comfortably optimistic about the coming few years," says Mr Ezz Al-Arab. TB

Commercial International Bank, the largest private lender in Egypt, has seen impressive increases in its net income

A VISION OF HOPE

Egypt's banks are throwing their weight behind extending financial inclusion to small and micro businesses, as well as the country's wider population as part of the national Vision 2030 strategy, helped by changes to the bankruptcy system and hopes of lower interest rates. James King reports.

Egypt's banks have long played an outsized role within the country's economy. Through the country's most difficult years, from the financial crisis to the political turmoil of the recent past, the strength of Egypt's banking sector has been a constant source of stability. And this role is unlikely to diminish.

Today, in many ways, the country's banks help underpin the wholesale transformation of the market in which they operate. As Egypt marches towards the goal of a balanced and diversified economy under the government's Vision 2030 strategy, its lenders are greasing the wheels of commerce and private enterprise to help it get there.

Banks are also offering profoundly important solutions to the challenge of extending financial services to a market of nearly 100 million people. And they are doing all of this, and more, in a swiftly evolving regulatory environment. Encouragingly, the sector as a whole is shouldering these challenges from a position of strength; capital and liquidity ratios are strong, while profitability and asset quality ratios are generally sound.

> INFLATION IS COMING DOWN. SO WE NEED RATES TO MOVE ABOUT ANOTHER 400 BPS SO CREDIT CAN START TO FLOW MORE EASILY
> *Hisham Ezz Al-Arab*

GOOD NEWS ON PROFITS

The good news is that profitability is expected to remain robust over the medium term. EFG Hermes, a local financial services group, expects the sector's return on equity to average about 26% between 2018 and 2020. This follows a strong performance by most of the country's largest banks in 2017, despite market headwinds including high inflation and a 700 basis points (bps) increase to corridor rates.

Commercial International Bank, the largest private lender in Egypt, saw its full-year net income increase by 25% over the periods with a return on average assets of 2.69% and a return on average equity of 32.5%. Meanwhile, during financial year 2016/17, state-owned National Bank of Egypt – the oldest »

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Karim Awad

and largest bank in the country – saw net profits increase by 8% to E£13.4bn ($760m).

Many foreign-owned lenders have also posted strong growth in recent times. National Bank of Kuwait Egypt (NBK Egypt), for instance, saw its full-year standalone net profit increase from E£848.9m to E£1.5bn in 2017. This comes as Egypt continues to attract buy-ins from banks in the wider region. Al Ahli Bank of Kuwait, for example, completed the acquisition of Piraeus Bank's country unit in November 2015, while in late 2016 Morocco's Attijariwafa Bank completed the acquisition of Barclays' Egyptian business.

Nevertheless, bankers in Egypt are hoping to see an easing of monetary policy in 2018 to support credit growth in the economy. "Lower interest rates are needed now and this will happen naturally. Inflation is coming down. So we need rates to move about another 400 bps so credit can start to flow more easily," says Hisham Ezz Al-Arab, chairman of Commercial International Bank.

In February, the Central Bank of Egypt (CBE) cut rates by 100bps to 17.75%. Most observers expect a measured process of easing to continue throughout 2018. "Our research division expects to see a further 300bps reduction over the remainder of the year. If that does happen then the stock market should rally as all companies with leverage on their balance sheet will see an [aggregate] 400bps fall in the cost of financing that debt," says Karim Awad, chief executive of EFG Hermes.

LEGAL CHANGES

Meanwhile, several regulatory and legislative changes are also easing the business environment for Egyptian banks. In January 2018, the country's parliament passed its first ever bankruptcy law, a legislative move expected to spur additional foreign and domestic investment.

For Egypt's banks, the new law will offer new ways to deal with troubled companies by making loan workouts faster and more flexible, according to research from rating agency Moody's. It will also speed up the liquidation of non-viable companies. Indeed, the new law will help Egyptian banks deal with problem loans more effectively than under the previous bankruptcy system, which dealt with them in the courts on a case-by-case basis.

The Egyptian parliament also passed amended capital markets legislation in February 2018. Among other things, this introduces futures trading, a commodities exchange, a reduction to listing fees and changes to help facilitate sukuk issuance. It is expected to boost Egyptian banks' debt capital markets business over the long term.

CATERING FOR SMALL BUSINESSES

Beyond these legislative changes, the Egyptian Financial Regulatory Authority launched the country's first movable collateral registry in March 2018. According to Moody's, this will help banks to make credit decisions and augment their capacity to secure movable collateral including, but not limited to, clients' machinery and crops. The launch of this registry is a huge step forward in addressing the funding needs of Egypt's small and medium-sized enterprises (SMEs), which often rely on movable collateral when engaging with financial institutions.

To help improve SMEs' access to credit, the CBE has enacted a requirement that involves the country's lenders allocating 20% of their loan portfolios to this segment by 2020. In addition, banks must keep interest rates to 5% for loans to entities that have revenues of between E£1m and E£20m. With SMEs accounting for about 85% of Egypt's gross domestic product and 75% of employment, the measures are an urgent, if problematic, example of regulatory intervention in the economy.

"SMEs are hard to bank. It is a different model but we have put a model in place to service [them]. NBK Egypt is one of the most active banks [in the country] for SMEs. It is part of our strategy that coincides well with the push the regulator is putting on this front," says Yasser Hassan, managing director of NBK Egypt.

According to research from the Oxford Business Group, the central bank has allowed lenders to finance SME loans from their non-interest bearing regulatory reserves. In addition, the CBE launched a new microfinance initiative in May 2017, in an effort to direct about E£30bn to more than 10 million recipients over the next four years.

Under the scheme, eight Egyptian banks will offer subsidised funding to accredited microfinance companies, institutions and non-government organisations working in the financial inclusion area. The programme will be incorporated under the existing SME lending framework, meaning that funds allocated under the initiative will go towards banks' SME lending targets.

FINANCIAL INCLUSION

The government has been pushing hard in recent years to address issues around financial inclusion since banking sector penetration sits at about 30% in a population that is close to 100 million. If much of this grey economy

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Yasser Hassan

can be formalised in the coming years, the impact on the banking sector – and by extension the economy – would be profound.

To address the financial inclusion agenda, some banks and financial institutions have recently launched microfinance ventures. Arab African International Bank (AAIB), for instance, has partnered with the Sanad Fund for micro and small enterprises, part of Germany's KfW Development Bank, to launch a microfinance unit known as Sandah.

"Financial inclusion is a major twist in the evolution of the Egyptian financial industry," says Hassan Abdalla, chief executive of AAIB.

Securing external expertise is an approach that has also been adopted by EFG Hermes. "We opted to acquire an existing microfinance outfit, Tanmeyah, because of its unique level of expertise and business model that we could not have built in house. Tanmeyah has a workforce of more than 2000 with a branch network of 150-plus locations and more than 160,000 clients. Its focus is activity-based lending to micro, small and medium-sized enterprises. I believe that despite its current status as Egypt's largest private sector microfinance provider, it has just scratched the surface," says Mr Awad.

Nevertheless, a number of hurdles lie in the way of the government meeting its ambitious financial inclusion goals. These relate primarily to the logistics of providing such a large market with formal financial services, as well as the regulatory dimensions that are underpinning its growth.

"We are interacting with the government and civil society to expedite financial inclusion. But there has to be a regulatory shift that will permit digital rather than paper archiving of documentation, for example, if the country's financial inclusion goals are going to be met," says Mr Ezz Al-Arab at Commercial International Bank.

Commercial International Bank is turning to technology, among other measures, to extend financial services to the wider population. This includes the rollout of digital products services, such as its smart wallet proposition, and updated versions of its mobile and online banking platforms. "We have revamped our internet banking and mobile application to make them more user friendly. We are trying to get more customers to use those channels," says Mr Ezz Al-Arab.

ANALYSING THE DATA

Commercial International Bank is taking a market lead on the use of data. "Data analytics will play an important role in the bank's future. And we are building the necessary data infrastructure to figure out how we can extract value [from existing operations] and how can we develop new business in the future," adds Mr Ezz Al-Arab.

The bank is one of the early adopters of artificial intelligence in Egypt's banking market and is employing the technology in its credit assessments. "One of the models we are developing is an artificial intelligence model for early warning signals covering credit stress. We are trying to use historical data to build a model that automatically alerts the bank when a credit file is under stress, rather than using a credit officer to go through all the paperwork," says Mr Ezz Al-Arab.

Innovation and ambition have long been at the heart of Egypt's leading banks. And beyond digital innovation, these traits are manifesting themselves through the Mostadam initiative. Originally conceived by AAIB, Mostadam is a platform for promoting sustainable finance in Egypt.

"Not long after the 2008 financial crisis we came to understand that banking needs to go beyond the mere making of profit," says Mr Abdalla. "Mostadam is an Arabic word derived from sustainability. It's a platform that aims to align the financial industry with the dimensions inherent in the sustainability concept: the environment, society and governance."

According to AAIB, the initiative has provided capacity-building programmes that have benefited 60% of the Egyptian financial industry. "We have ambitions to turn Mostadam into a global movement, starting from Egypt. The whole idea is to train and develop a new generation of bankers who understand that their industry is not just about numbers but also about value," says Mr Abdalla.

OPTIMISM PREVAILS

Looking ahead, Egypt's banks are bullish about their prospects in an economy that is in the throes of a genuine transformation. Armed with innovative new products and services, as well as a commensurate level of ambition, Egyptian lenders are gearing up for a new growth trajectory over the longer term.

This includes the financing of some of the world's most impressive mega-projects, including the Benban Solar Park, soon to be the largest solar installation anywhere in the world. Occupying a 37-square-kilometre plot near Aswan, the project will generate about 1650 megawatts of electricity when it is completed in 2019.

Such developments will drive Egypt toward the next chapter in its history, a history in which, as always, the country's banks will be playing a vital role. TB

HALA EL SAID

Egypt's minister of planning and administrative reform talks to James King about government strategies to cut unemployment through greater private sector involvement and the decentralisation of investment to the governorates.

WE ARE READY FOR THE PRIVATE SECTOR, BOTH IN TERMS OF PHYSICAL INFRASTRUCTURE AND IN TERMS OF OUR LEGISLATIVE REFORMS ***Hala El Said***

Q How would you characterise Egypt's economic development today?

A The economy is moving on an upward trajectory. We are aiming to achieve gross domestic product [GDP] growth of 5.8% in the fiscal year 2018/19, before hitting 6.2% and 6.6% in 2019/20 and 2020/21, respectively. In addition, the government has launched a four-year medium-term development plan, which covers the period from 2018 to 2022. By the end of this period we are hoping to achieve GDP growth of 7%.

What's more important than the growth rate is the constituent components of the country's growth. In the past, our growth was driven by consumption rather than investment. Now our growth is coming from investment. What is also important is where this growth is coming from; every sector of the Egyptian economy is today adding value.

Q What steps are the government taking to tackle unemployment?

A In 2014, the unemployment rate was at 13%. Now it is 11.3%, so the unemployment numbers are heading in the right direction. But, of course, it is not enough. We are targeting an unemployment rate of 8% by the end of the four-year medium-term plan.

To do this we are aiming to create 850,000 to 900,000 jobs every year. The number of Egyptian graduates every year is between 650,000 to 750,000, so we need to absorb these graduates while addressing the numbers of the existing unemployed.

Q Are these targets for job creation realistic?

A Over the past year, about 850,000 jobs have been created in the economy – so it's realistic based on what we have achieved over this timeframe. I know a lot of this employment is, at the moment, coming from mega-projects and public investment. But these investments are vital because Egypt has suffered from a lack of investment in its infrastructure in previous years. The country needed a big boost; that's why a lot of funds have been provided to develop the country's infrastructure and pave the way for the private sector to grow.

Today we are ready for the private sector, both in terms of physical infrastructure and in terms of our legislative reforms. Once the private sector begins to invest and expand off the back of our infrastructure investments, it will be able to generate a significant number of jobs. Looking ahead, the extractive industries will be important in terms of job creation, as will agribusiness and petrochemicals, among many other sectors.

Q What will the passing of the unified planning law mean for Egypt's development?

A I believe that real development happens from the bottom up. It happens at the level of the governorate and not from the central administration. This law ensures that a big portion of investment goes through the regional governorates and [caters to] their needs.

Previously, a minister would say that investment was needed in this location or that location. These decisions weren't being driven by the governorate. So we have to give the governorates independence in determining what they need and what their priorities are.

But moving to decentralisation is not easy; if the governorates don't have the capacity or calibre to handle increased resources it will be difficult. So we are moving gradually towards decentralisation.

This year I am increasing the flow of funds to Egypt's governorates and these funds are targeting development gaps based on various human development indicators, including population and unemployment rates, the density of schools and so on. I am trying to close the development gaps in some of the governorates to improve their economic and social situation.

We are also enhancing the capacity of the civil servants working in the governorates. This is being done in order for them to start understanding financial issues and to learn how to design a development strategy. TB