Rebalancing the Egyptian Economy
Reform in Action

November 6, 2016

Resetting Egypt's economic equation

Last week, Egypt unleashed broad fiscal, monetary and structural measures aiming at reviving the economy:

- First, the Supreme Investment Council approved a number of incentives, of which was the extension of capital gains tax suspension, in order to help attract more foreign direct and portfolio investment
- Second, the Central Bank of Egypt (CBE) announced the long-awaited liberalisation of the foreign exchange rate
- Third, the government raised petroleum products' price-at-pump, in a move to cut fuel subsidies and subsequently reduce the soaring budget deficit

The big picture – Widening 'saving-investment' and 'production-absorption' gaps

Before moving into the implications of the aforementioned measures, we believe it is important to recall the big picture. We remind our clients about the answer to the most frequently asked question over the weekend: Why was introducing these measures so inevitable? The Egyptian economy suffers two widening gaps:

(1) The gap between the country's production of goods and services and the level of absorption (total demand in the economy), which stood at c.8% of GDP in FY2015/16. Such a high level of demand that is not in line with the country's production capacity raises inflationary pressures and worsens an already frail external position

(2) The gap between national savings (public and private) and investment, which must be covered by foreign funds, recorded 5.4% of GDP in FY2015/16. Low public savings reflect a wide government deficit that is also inflationary by definition. On the other hand, small private savings indicate weak financial inclusion and a high consumption level.

Fiscal discipline and monetary tightening are needed to close those gaps

Restoring the macroeconomic balance requires reducing the current high absorption level, raising production capacity and cutting the budget deficit. Since adding production capacity takes time to become operational, the faster readjustment had to be on the demand side. That is the reason why fiscal discipline and monetary tightening were inevitable.

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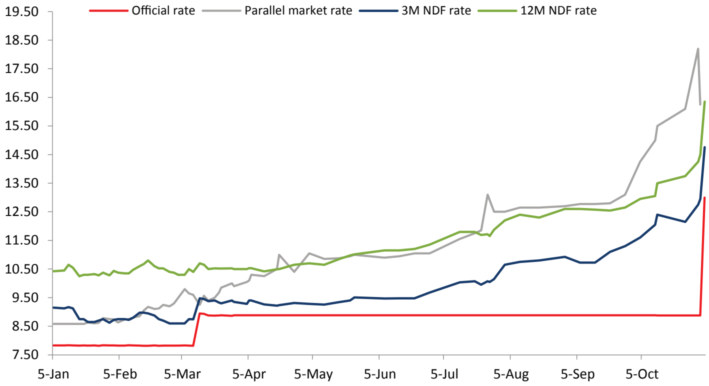
The CBE initiated an EGP float just as the speculative bubble burst in the parallel market, 3 month NDFs recorded EGP12.95/USD the night before the FX liberation

We stated in our previous research publications that a full flotation is better from a macroeconomic perspective, but a managed float would be more appropriate politically. Having chosen the former, the CBE sends a positive signal of credibility and independence. Moreover, the timing of the CBE's highly anticipated FX move has been appropriate, since it coincided with the burst of a speculative attack in the parallel currency market. Last week, the EGP exchange rate versus the USD recorded EGP16.25 on the parallel market against EGP18.20 the week before. Hence, the CBE was right to consider such an opportunity to narrow the FX exchange rate gap (Chart 1). We note that the CBE set the starting EGP exchange rate at EGP13.00, which supports our favourite FX market value gauge as the 3-month NDFs recorded EGP12.95 versus the USD on the day before float. Henceforth, the CBE announced that the exchange rate will be decided through the interbank. In that context, monitoring the 3-month NDFs versus reported exchange rates will show the efficiency of the market-driven exchange rate.

Chart 1 Exchange Rate Fluctutations



Source: Bloomberg, Reuters, CBE, Pharos Research

Super rate hike in tandem with the float

In accordance with the FX move, the CBE raised its two standing facilities' interest rates by 300 basis points. We believe that such a hike was much needed in order to support the local currency by easing dollarisation, attracting foreign funds and most importantly anchoring inflation expectations. In reaction to the FX liberalization, in addition to fuel subsidy cuts, inflation expectations are high whilst wage growth expectations remain low/flat. As a result, people would rush to consume more now in order to hedge against weaker purchasing power in the future, which in turn adds to current inflationary pressure. Accordingly, the interest rate hike is meant to offset the aforementioned behaviour by making savings more attractive than consumption.

Inflation dynamics and reaction to the recent fiscal and monetary measures

Noting inflation, we define four major inflation determinants in Egypt:

(1) demand-pull

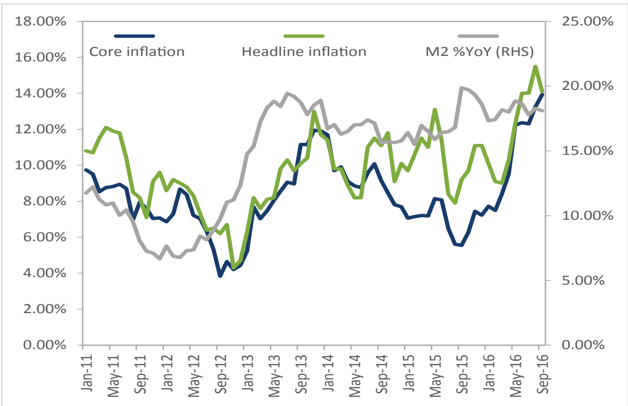
(2) cost-push; which is related to key commodity price shocks

(3) exchange rate pass-through effect

(4) domestic market inefficiencies

We believe that demand-pull inflation is a major contributor to the dynamics of the current inflation in Egypt (2011-2016) (Chart 2). Excessive deficit monetisation led to a higher rate of money creation (measured by the monetary aggregates) that exceeds the domestic production rate in Egypt. Then, more money chasing fewer goods fueled inflationary pressure. On the other hand, low international commodity prices, in addition to a nearly fixed exchange rate eased cost-push and the pass-through impact on inflation. Following the recent fiscal and monetary measures, we believe that inflation will come under two-sided sequels. First, the implementation of a flexible exchange rate, in addition to raising fuel prices, will add more inflationary pressure in the short run. Second, a lower disposable income will lead all economic agents to readjust their consumption pattern, which will ease inflationary pressures over the medium term.

Chart 2 Demand-pull inflation is a major contributor to the current inflation



Source: CBE, Pharos Research

Short-term inflationary pressure to peak within 3 months' time, to fade over 12 months

While a wide segment of market participants are already dealing with the parallel market rates, we believe that the official exchange rate pass-through will peak in three months' time. Similarly, we estimate the price reaction to the fuel subsidy cut to peak within three months. We also refer to the previous round of fuel subsidy reform that took place in July 2014. Back then, headline inflation rose from 8.76% in June 2014 to 11.84% in October 2014 before decelerating to 9.09% in November 2014 (which also included a notable base effect). Accordingly, we estimate inflation to accelerate to 21.6-25% in the short-term and to average around 16-18.5% in FY2016/17.

FX liberalisation, interest rate hike and fuel subsidy cut: Triple impact on the budget deficit

Updating our initial budget deficit projection, we estimate the FX liberalisation decision to add EGP51.8 billion in terms of fuel and food subsidies. Moreover, the interest rate hike by 300 basis points is estimated to add another EGP25.1 billion in additional interest expense. However, we estimate the government's fuel subsidy cut decision to save EGP22 billion. Accordingly, the budget deficit adjusted for all three decisions is expected to settle around 11.5% of the GDP in FY2016/17 (Table 1). This means that the government will definitely need to increase revenues and/or rationalise more expenditure in order to meet the budget projected deficit of 9.8% of GDP. In that context, we note that the Minister of Planning announced that the government is currently updating the food subsidy ration-cards database in order to exclude non-eligible members. Moreover, the Egyptian Prime Minister signaled a potential increase for the price of underground tickets. Finally, the Parliament is studying an increase in the income tax brackets, where the highest income groups (earning EGP500,000 per annum or more) would be subject to a 30% tax rate, rather than 22.5%.

FY2016/17 Budget assumptions:	Oil (USD per barrel)	Avg.Exchange Rate (EGP/USD)	Fuel Subsidies (EGP Bn)	Food Subsidies (EGP Bn)	Interest payment	Nominal GDP (EGPbn)	Projected Deficit (EGPbn)	Projected Deficit (% of GDP)
MoF initial assmptions	40.0	9.0	35.0	41.1	292.5	3,247	319.5	9.8%
Adjusted MoF initial assmptions before fuel subsidy cut*	48.9	13.6	77.5	50.4	317.7	3,247	396.4	12.2%
Adjusted MoF initial assmptions after fuel subsidy cut	48.9	13.6	55.5	50.4	317.7	3,247	374.4	11.5%

Source: Ministry of Finance, Bloomberg, Pharos estimate

* The adjustments include: (1) exchange rate liberalisation, (2) oil price, (3) interest rate 300 basis points hike

Egypt to sign the Yuan currency swap and unlock the IMF funding within weeks

The CBE Governor noted that the currency swap agreement with China should be signed within 10 days. Following the implementation of a flexible exchange rate regime and the cut in fuel subsidy, Egypt is ready to unlock the USD12 billion financing facility from the IMF. Hence, we expect the approval of the loan and the disbursement of the first tranche (USD2.5 billion) within the next few weeks. The aforementioned inflows, in addition to a USD2-3 billion international bond issuance will support the net international reserves, which could potentially surpass USD25 billion by the year end.

We welcome last week's long-awaited reform measures since they establish a solid ground for rebalancing the Egyptian economy and we still expect further reform on both the fiscal and the structural fronts. As a primary positive reaction, the yields on Egypt's US-denominated bonds dropped significantly on Thursday.

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