Further reforms in the pipeline; Recovery estimated for FY2017/18

By the end of FY2015/16, the Egyptian economy was under severe distress, recording high budget and current account deficits of 12.2% and 5.6% of GDP, respectively. Moreover, defending the exchange rate against adverse external conditions, where tourism revenues fell 48.8% in FY2015/16 and remittances dropped 13.2% in FY2015/16, led net international reserves to reach a record low level of USD15.5 billion in July 2016 (3.3 month of import cover). In addition, the existence of an active FX parallel market, led the EGP to be traded at more than 30% below the official rate.

Phase I of reform initiated in 1HFY2016/17

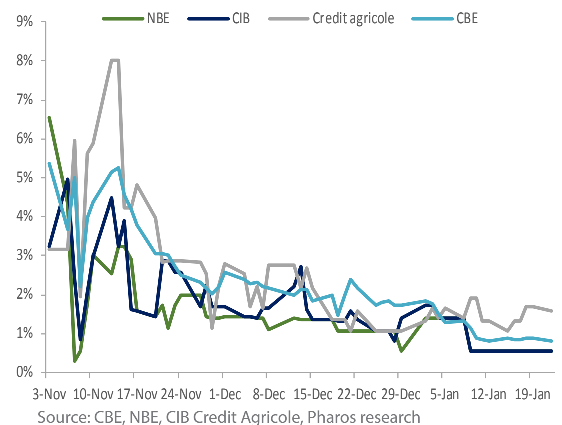
Bearing this brunt, the Egyptian authorities unleashed the first phase of the long-awaited policy reforms in 1HFY2016/17 as a part of a wider programme to restore macroeconomic balances. Reform measures introduced in the first 6 months of the current fiscal year included:

- Introducing the value added tax (VAT) which is meant to expand the tax base
- Approving the Civil Service Law, which would help raise the public sector productivity, in addition to controlling public wage increase (c.26% of budget expenditure)
- Slashing some energy subsidies (electricity in August 2016 and fuel in November 2016)
- Liberating the exchange rate
- Signing a 3-year extended fund facility with the International Monetary Fund (IMF)

Following initial reform measures, the Egyptian economy witnessed positive foreign currency inflows

Two credit rating agencies, Fitch and S&P, upgraded Egypt's outlook from negative to stable. In addition, the CBE governor revealed that USD7.5-8.0 billion flowed into the Egyptian banking system in terms of FCY deposits and USD1.0 billion are estimated to have flown into the Egyptian Stock Market and treasury instruments. Such an inflow was evident through the banks' exchange rate bid-ask spreads, which narrowed significantly following the exchange rate flotation on November 3. Furthermore, the Central Bank net international reserves rose to USD24.3 billion (5.2 months import cover) by the end of December 2016. This positive reaction shows a strong appetite/interest in the Egyptian economy now that it has a more credible reform program. Conservatively, we estimate the exchange rate to settle at around EGP18.20 per USD by the end of FY2016/17, yielding an average exchange rate of EGP15.30 for the fiscal year. At the same time, the urban headline inflation rate rose sharply to 23.3% in December 2016 (core inflation rate was 25.9%), which we had already expected In our Macro Flash note dated 6 November 2016, we estimated "inflation to accelerate to 22 - 25% in the short-term"

Chart 1| Banks' exchange rate bid-ask spreads volatility following the flotation



Source: CBE, NBE, CIB Credit Agricole, Pharos research

Further reforms in the pipeline; recovery estimated for next fiscal year

For the next 6 months, we expect the government to pursue further phases within the reform program. Narrowing the budget deficit, as well as improving the ease of doing business in Egypt are the key issues of this agenda. We summarize the forthcoming steps:

- The approval of the new Investment and Bankruptcy laws, which will help increase domestic investment and attract greater foreign direct investment
- The Ministry of Finance intends to issue a new Tax Law that would enhance the tax payment systems and the tax refund process versus a tax rate rise proposed by Parliament
- The IPOs of public sector companies, which would improve the Egyptian stock market liquidity, attract foreign portfolio investment and raise more revenue for the government. We estimate an initial EGP10 billion in additional revenue from selling a c.20% stake in each of the following four public entities: Banque du Caire, Enppi, AMOC and Sidi Krir
- Rationalizing the food subsidies through updating the smart-card database, which should help decrease the current expenditure levels
- A major energy sector makeover strategy should be developed by March 2017 (EGPC restructuring and energy subsidy reform)
- Focus on social safety and cash transfers
- Higher financial inclusion and an increasing financial penetration ratio (higher access to mortgage and SME financing)
- Tighter risk management within banks and strengthening capital adequacy ratios, in preparation for Basel III implementation.

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Economic growth to reach 3.8% in FY2016/17, then improve to 4.5% in FY2017/18

We estimate the economic growth rate to decline slightly to 3.8% in FY2016/17 before rebounding to 4.5% and 5.7% in FY2017/18 and FY2018/19, respectively. While the household consumption contribution to the real GDP growth is expected to decline in FY2016/17 on lower real personal disposable income, we expect the contribution of private investment to pick up significantly in the following two years. Our assumption is based on three factors:

- The production distortion resulting from foreign currency shortage and restrictions fades away
- Improved private sector access to credit as the government decreases the budget deficit (government utilization of domestic credit averaged 65.3% in FY2015/16 and the private sector debt level is very low at 18.6% of GDP in FY2015/16) and especially with projected rate cuts in FY2017/2018
- Higher foreign direct investment due to investment incentivizing reforms.

Average inflation rate to reach 19.5% in FY2016/17, before decelerating to 13.6% in FY2017/18

While the average inflation rate is expected to reach 19.5% in FY2016/17, we believe it will decelerate to 13.6% and 11.7%, respectively, in FY2017/18 and FY2018/19, respectively, due to:

- The exchange rate pass-through fades out
- The adjusted consumption pattern
- A pick-up in the real GDP growth
- Slow international commodity prices recovery

Accordingly, we expect the CBE to bring down its O/N lending interest rate to 14.25% by the end of FY2017/18 (-150 bps) and 11.50% by the end of FY2018/19 (-275bps).

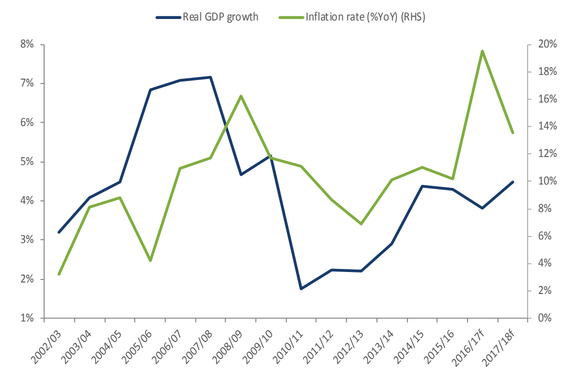
Fiscal deficit to narrow to 10.8% in FY2016/17 and to 9.5% in FY2017/18

We believe that the recent measures should lead the fiscal deficit coming down to 10.8% of GDP in FY2016/17. This level is still above the IMF projection of 10% of GDP, and that is why a second round of fuel price hike is probable in FY2016/17. We note that the government's fiscal reform plan includes four key pillars:

- Energy subsidy phase out (fuel subsidies in three years and electricity subsidies in five years)
- Capping of the public wage growth rate
- Improving the revenue stream through an easy and an efficient tax and customs procedures
- Free-up more resources for cash and food well-targeted subsidies as well as pro-growth/productive capital expenditure

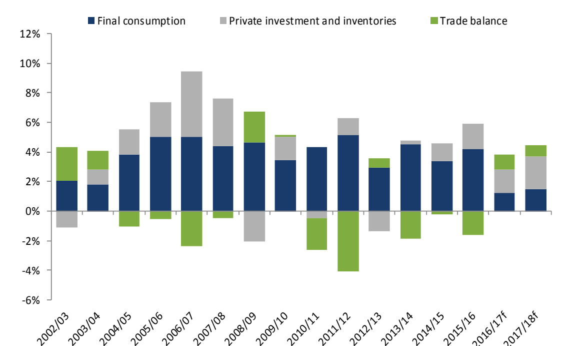
With a major focus on these four reform pillars, we believe that the fiscal deficit should narrow to 9.5% in FY2017/18.

Chart 2| In FY2017/18, we expect economic growth to accelerate to 4.5% and inflation to decelerate to 13.6%



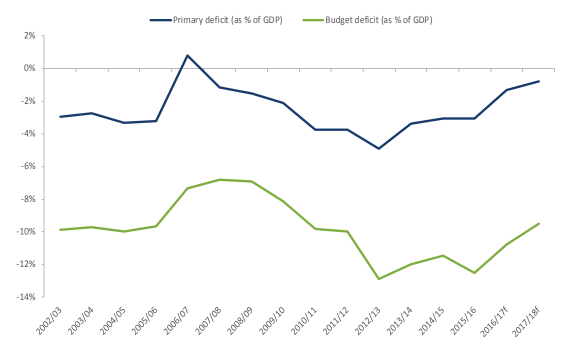
Source: CBE, MoP, Pharos research

Chart 3| We expect the contribution of private investment to pick up significantly in the following two years



Source: MoP, Pharos research

Chart 4| Persistent fiscal reform should narrow the budget deficit to 9.5% in FY2017/18



Source: MoP, Pharos research

Trade balance to improve on EGP flotation, export-incentivizing programs and new gas discoveries

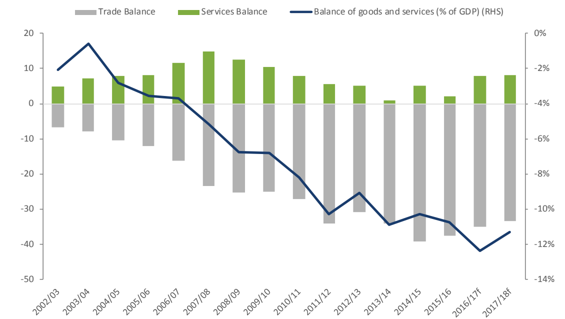
The current structure of Egypt's trade balance manifests that the EGP flotation should not be the only factor in play. We note that c.60% of the total imports include raw material, intermediate and investment goods, while exports contain c.50% of raw and semi-finished goods. Therefore, the impact of international commodity prices on Egypt's trade balance remains significant.

Promoting an export-led growth strategy should be the ideal next step for the Egyptian economy to reap the full benefits of the EGP flotation, which was inevitable. In this context, we note that the newly formulated Investment law provides incentives for import-substitutes, exports and labor intensive investments. On the other hand, we expect the new gas discoveries (i.e. Zohr) to gradually improve the trade balance starting FY2017/18, where it should initially reduce gas imports, with potential exports after FY2020/21.

Current account deficit to decline to USD13.9 billion in FY2016/17 and to USD9.2 billion in FY2017/18

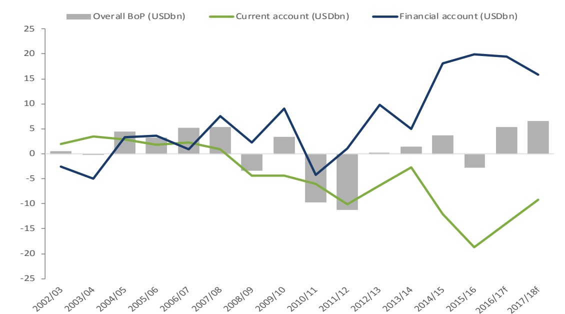
We expect the services surplus to improve in FY2016/17 on a significant decline in imported services, namely travel, following the EGP flotation. Moreover, a Russian decision to resume flights to Egypt looks more likely, according to the Egyptian presidential spokesman. Accordingly, we expect tourism revenues to recover gradually starting FY2016/17. On the other hand, slow global trade growth in addition to a slow oil price recovery will continue to weigh on Suez Canal revenues and remittances in FY2016/17. However, we expect remittances to pick up in FY2017/18 as GCC countries moderately accommodate the new norm of low oil price environment.

Chart 5| Trade balance is expected to improve gradually starting FY2017/18 on new gas discoveries and export-incentivies



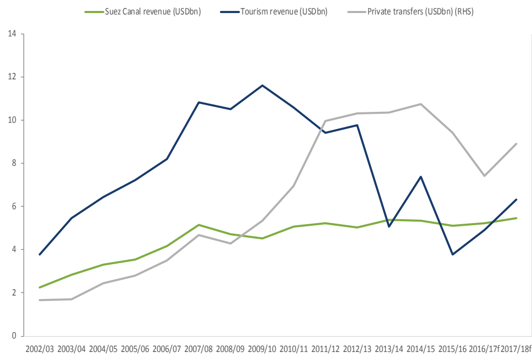
Source: CBE, Pharos research

Chart 6| Current account deficit to reach USD9.2 billion by FY2017/18



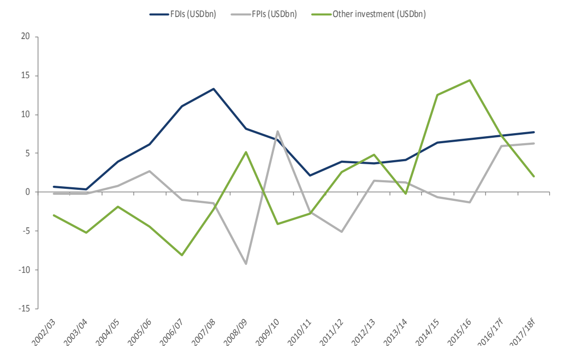
Source: CBE, Pharos research

Chart 7| Tourism revenues and remittances are expected to recover gradually



Source: CBE, Pharos research

Chart 8| A pick-up in foreign direct and portfolio investment is expected starting 2HFY2016/17

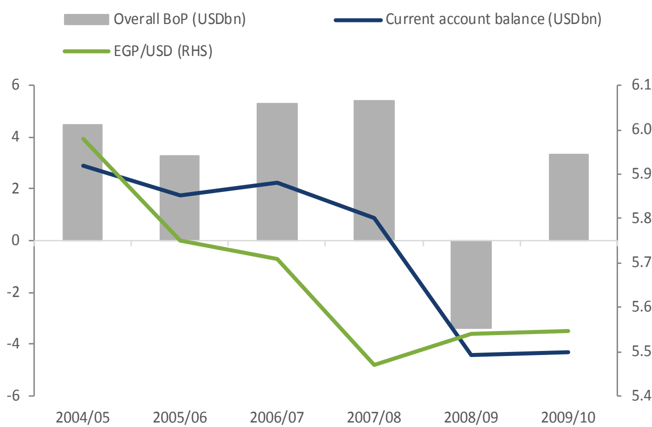


Source: CBE, Pharos research

A possibility for an exchange rate appreciation over the next two years

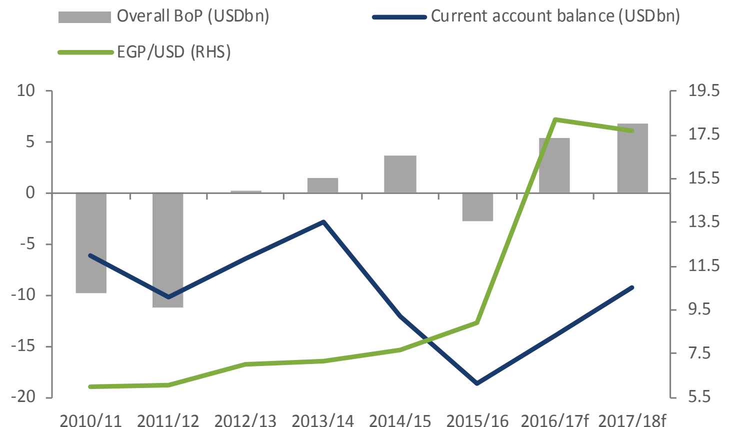
While it is still early to define the Egyptian pound exchange rate future trend, we examined the period when Egypt had applied a relatively flexible exchange rate (FY2004/05-FY2009/10) for some clues. We looked into the current account balance, overall balance of payments and the EGP/USD exchange rate movements over that period. Notably, the EGP appreciated versus the USD from an average of 5.98 per USD in FY2004/05 to an average of EGP5.55 per USD in FY2009/10, despite the fact that the current account balance deteriorated from USD+2.9 billion in FY2004/05 to USD-4.3 billion in FY2009/10. However, the overall balance of payments, which records the accumulation of CBE's NIR, was positive with a sum of USD18.4 billion over that period (NB In FY2008/09, the overall BoP recorded a USD-3.4 billion, which can be explained by the CBE's defense for the currency from the sudden outflows that resulted from the financial crisis). Accordingly, we conclude that as the CBE accumulates NIR reserves, the exchange rate would improve (EGP appreciates), albeit slightly in order not to hurt Egypt's competitiveness. The logic is pretty simple: as a result of strong inflows (foreign direct investment and portfolio investment), the commercial banks' FCY liquidity improves significantly, that the CBE then sterilizes the excess FCY liquidity to build its NIR and to prevent a strong EGP appreciation. Further, the IMF recently-announced staff report forecasts that the CBE's NIR accumulation to be positive from FY2016/17 to FY2020/21 (to reach USD37.6 billion by FY2020/21). Hence, the IMF projects the CBE to "operate on the buy-side" over that period. In line with the aforementioned dynamics, as well as the current exchange rate overshooting, we believe the EGP could strengthen over the next couple of years to reach EGP17.1 per USD by the end of FY2018/19.

Chart 9| Following 2003 EGP flotation, the CBE operated on the buy-side, accumulating NIR reserves. As FCY inflows improved, EGP slightly appreciated



Source: CBE, Pharos research

Chart 10| Starting FY2010/11, the CBE operated on the sell-side, depleting FCY reserves to preserve the exchange rate. Applying, a flexible exchange rate, we expect the CBE to revert back on the buy-side in FY2017/18



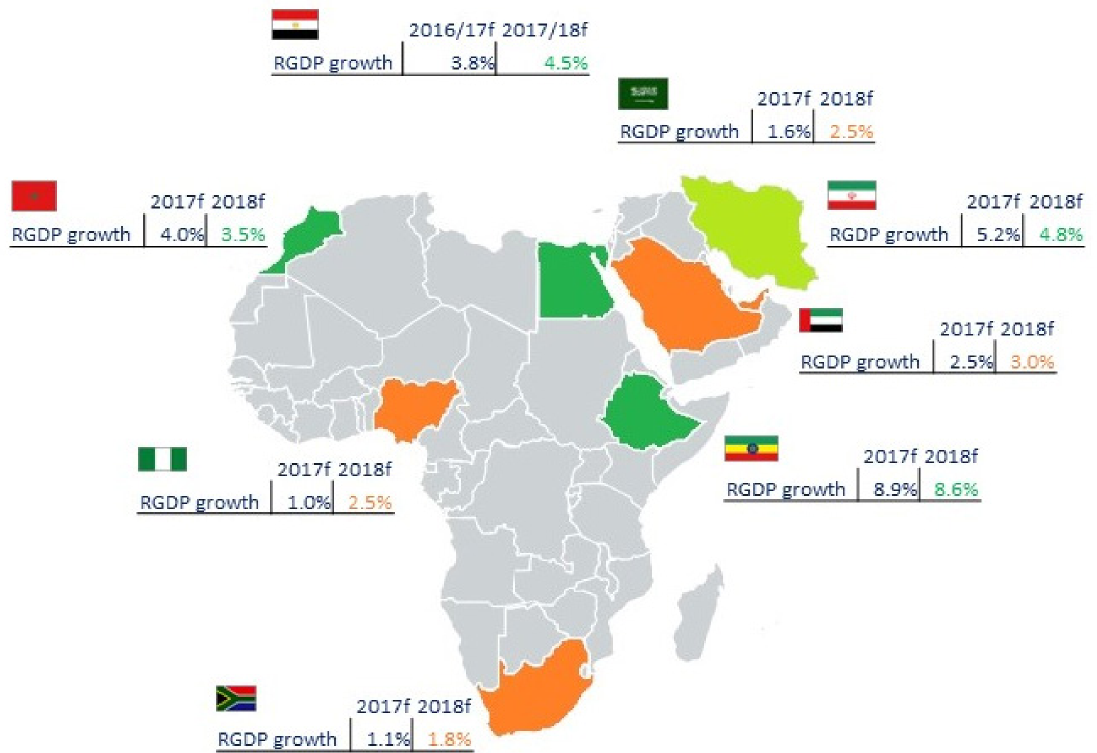
Source: CBE, Pharos research

Three major downside risks to our outlook: policy implementation, political risk, negative external shocks

While settling the general economic reform framework is essential, policy implementation remains a concern in Egypt. Moreover, the Egyptian presidential election in 2018 would be another factor to consider, despite the fact that Egypt has been relatively stable following major social and political turbulence in 2011-2013. Moreover, this also supports the front-loaded economic reform plan initiated in FY2016/17. In the international arena, President Trump's policies toward China, as well as the outcome of the next French and German elections, represent a downside economic risk in 2017. A slower-than expected world economic and trade growth would negatively affect Suez Canal revenues, FDI, PDI, non-petroleum exports and tourism revenues. However, we believe that the CBE's decision to adopt a flexible exchange rate would act as a shock-absorber in case of another negative external shock.

Scanning regional peers' economic performance in the next couple of years provides more depth, adds to the attractiveness of Egypt's economic transformation story

The repercussions of the low oil price environment will continue to weigh on the Gulf Cooperating Council (GCC) member economies, while macroeconomic challenges persist in both South Africa and Nigeria. Moreover, the potential for strong economic growth in Iran faces a major downside risk due to the new administration in the US in addition to the Iranian presidential election in 2017. Furthermore, the size/structure of the Egyptian economy (USD301.5 billion in 2014) offer a positive comparative advantage when compared with both Ethiopia (USD55 billion in 2014) and Morocco (USD109.8 billion in 2014).



Source: World Bank Global Economic Prospects, Pharos research

IMF Staff Report Key Takeaway

- GDP growth is projected to recover to a potential 5-6% over the medium term. Depreciation of the pound should make Egyptian goods and services more competitive and the yields on Egyptian assets more attractive. Investment, including FDI and exports are expected to grow and replace debt-financed consumption as growth picks up.
- The current account deficit is expected to narrow to 3% of GDP by 2018/19. Export recovery is predicated on exploration of new gas fields and competitiveness gains from real depreciation of the pound and growth-friendly reform policies. Import demand will be contained by tighter fiscal and monetary policies, with imports of investment goods financed in part by increasing FDI inflows. The financial account is projected to benefit from increased access to international capital markets. The overall BoP surpluses would rebuild net international reserves.
- The funding gap over the program tenor is about USD35 billion, with about half of the gap resulting from the need to replenish reserves. The government have already secured the full funding for the first year.
- The monetary policy will focus on bringing inflation down to mid-single digits. In 2017/18 and beyond, as inflation declines, interest rates will also come down to permit credit recovery. However, the CBE will be prepared to tighten the monetary stance again should demand pressures reemerge. The CBE will closely monitor banks' excess reserves and rely primarily on indirect policy tools, such as [LCY] deposit auctions and repo/ reverse repo transactions, to achieve its targets, but if warranted may also change reserve requirements.
- Exchange rate liberalization will take time to bear fruit and there will be volatility and uncertainty along the way. Once the foreign exchange market regains confidence and the supply of foreign exchange increases, the CBE will operate mainly on the buy-side, but occasional FX sales might still be needed to prevent excessive short-term exchange rate fluctuations. The CBE is committed to meeting its program objectives, and will consult the Fund on the needed policy adjustments in the event of excessive FX sales (including direct sales to state-owned enterprises and the government).
- The overall deficit is also expected to fall during the program from 12.1% of GDP to 4.7% in FY2020/21. The [VAT] higher tax rate, combined with base broadening and improved compliance will yield an additional 1% of GDP in 2016/17compared to the general sales tax. The authorities are prepared to further adjust fuel prices or take other measures as needed to offset any additional costs in the event of larger than projected depreciation of the pound or higher global oil prices. They have also committed to periodically increasing the pre-tax cost recovery ratio further on most fuel products to achieve 100% in 2018/19and to eliminate electricity subsidies over the next five years. To preserve the fiscal targets, authorities will consider better targeting of food subsidies by improving the current smart card system; and other tax expenditures; and further cutting non-priority expenditures, as needed.
- The Egyptian authorities are developing a comprehensive reform agenda for the energy sector (petroleum, electricity and gas). The objective is to modernize the sector, including by improving the regulatory framework for enabling private investments, strengthening its finances, and promoting competition. An integrated plan for restoring the financial sustainability of the state-owned Egyptian General Petroleum Company (EGPC) will be finalized by March 31, 2017. Meanwhile, the EGPC will gradually reduce existing arrears and not accumulate new net arrears.
- The government is planning a new licensing law [Investment Law], to be adopted by March 2017, which will: streamline industrial licensing for all businesses other than those serving vital public interests.
- The government is also proposing a new Insolvency Law, to be adopted by June 30, 2017, to simplify the time-consuming bankruptcy procedures and to de-criminalize insolvency.
- The government will develop an action plan to rationalize the export-promotion regime and minimize non-tariff barriers to trade; as well as encourage job intermediation schemes and specialized training programs for youth.
- The first review will be based on the performance by December-end 2016. Thereafter, as the macroeconomic situation stabilizes, semiannual reviews should become sufficient. The IMF sets performance criteria on net international reserves, net domestic assets of the CBE, the primary fiscal balance, fuel subsidies, and accumulation of external debt payment arrears, and indicative targets on average reserve money, tax revenues, and EGPC arrears.

Key macroeconomic indicators

	2012/13	2013/14	2014/15	2015/16	2016/17f	2017/18f
Nominal GDP (EGP billion)	1860.4	2130.0	2443.9	2708.3	3359.1	3986.6
Real GDP, growth rate	**2.2%**	**2.9%**	**4.4%**	**4.3%**	**3.8%**	**4.5%**
Inflation rate, average	**6.9%**	**10.1%**	**11.0%**	**10.2%**	**19.5%**	**13.6%**
CBE O/N lending rate, end of period	**10.75%**	**9.25%**	**9.75%**	**12.75%**	**15.75%**	**14.25%**
ToTal revenue (EGP billion)	350.3	456.8	465.2	491.5	687.7	853.1
Total revenue (% of GDP)	18.8%	21.4%	19.0%	18.1%	20.5%	21.4%
Tax revenue (EGP billion)	251.1	260.3	306.0	352.3	499.5	627.5
Tax revenue (% of GDP)	13.5%	12.2%	12.5%	13.0%	14.9%	15.7%
Expenditure (EGP billion)	588.2	701.5	733.4	817.8	1,050.3	1,231.9
Expenditure (% of GDP)	31.6%	32.9%	30.0%	30.2%	31.3%	30.9%
Compensation of employees (EGP billion)	143.0	178.6	198.5	213.7	222.1	266.6
Interest payments (EGP billion)	147.0	173.2	193.0	243.6	317.7	362.6
Subsidies, grants and social benefits (EGP billion)	197.1	228.6	198.6	201.0	254.3	312.7
Primary balance (% of GDP)	**-4.9%**	**-3.4%**	**-3.1%**	**-3.1%**	**-1.3%**	**-0.8%**
Overall fiscal balance (% of GDP)	-12.9%	-12.0%	-11.4%	-12.5%	-10.8%	-9.5%
Current account balance (USD billion)	-6.4	-2.8	-12.1	-18.7	-13.9	-9.2
Current account balance (% of GDP)	**-2.3%**	**-0.9%**	**-3.7%**	**-5.6%**	**-6.3%**	**-4.2%**
Balance of goods and services (USD billion)	-25.7	-33.1	-34.0	-35.5	-27.1	-25.2
Tourism revenue (USD billion)	9.8	5.1	7.4	3.8	4.9	6.3
Suez Canal revenue (USD billion)	5.0	5.4	5.4	5.1	5.2	5.4
Remittances (USD billion)	18.7	18.5	19.3	16.8	13.2	15.9
Net foreign direct investments (USD billion)	3.8	4.2	6.4	6.8	7.3	8.0
Net portfolio investments (USD billion)	1.5	1.2	-0.6	-1.3	6.0	6.3
Net other investments (incl. net borrowing) (USD billion)	4.8	-0.2	12.5	14.4	6.3	1.5
Net international reserves (USD billion)	14.9	16.7	20.1	17.5	23.0	29.5
USD/EGP, end of period	**7.0**	**7.2**	**7.6**	**8.9**	**18.2**	**17.7**
USD/EGP, average rate	**6.6**	**7.0**	**7.4**	**8.2**	**15.3**	**17.9**

Source: MoF, CBE, MoP, Pharos research

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