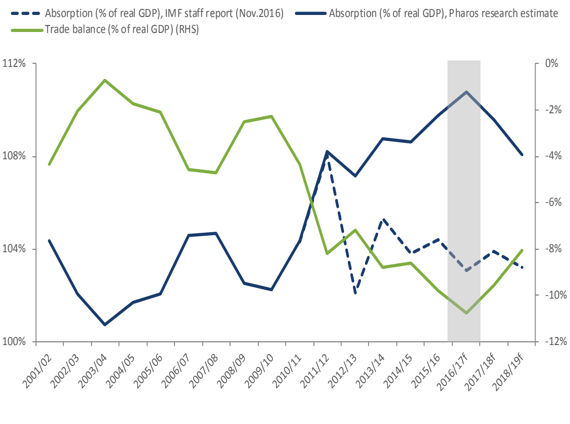
## Revisiting the big picture: The Egyptian economic agents have been spending beyond the economy's means over the last six years

Starting with the diagnosis of the Egyptian economic malaise, Egypt has been spending beyond the sustainable level over the last six years. The level of absorption (real aggregate demand), which is measured by adding the final consumption to the gross capital formation in the economy, exceeded the domestic production by an average of 8.5% over 2011-2016. This extensive spending pattern was supported by a high budget deficit and an artificial fixed exchange rate, which made imports cheaper than local production. Hence, the real trade balance deteriorated from -4.3% in FY2010/11 to -9.8% in FY2015/16 (Chart 1). **Given the fact that the production capacity is fixed in the short run, the proper solution is to curb the domestic absorption (spending) growth to meet the level of domestic supply.** In that context, the Egyptian government initiated a wide economic reform program aimed at reducing the budget deficit, in addition to liberalizing the exchange rate to reflect the fundamentals of the economy.

Chart 1| Domestic demand growth was expected to ease in FY2016/17

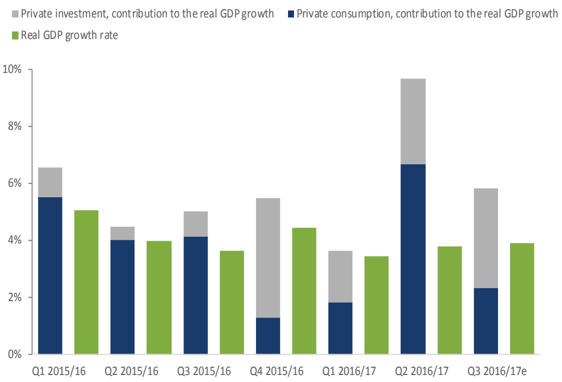



Source: Ministry of Planning, Pharos research

## The expected outcome would have been a slower absorption growth, but the recent data showed that the domestic demand remained higher than expected

In the short run, implementing tight fiscal policy (i.e. higher taxes and lower fuel/electricity subsidies), in addition to a tight monetary policy (i.e. positive real interest rates and less liquidity in the system) was warranted to ease the spending growth momentum. Meanwhile, it would also help to tackle the demand-side inflationary reaction to the aforementioned reform measures. **We note that the IMF staff report, which was published in November 2016, expected the real absorption growth to halve from 4.5% in FY2015/16 to 2.4% in FY2016/17. However, the recent data published by the Central Bank of Egypt (CBE) and the Ministry of Planning suggested a differently.** The real GDP growth rose slightly from 3.4% in 1Q FY2016/17 to 3.9% in 3Q FY2016/17. The real absorption growth rate rose from an average of 5.3% in 3-quarters FY2015/16 to 6.1% in 3-quarters FY2016/17 (Chart 2). Moreover, the local currency loans continued to grow at a normal pace despite a stable contribution from the net claims on the government. This has been partly supported by an increase in the local currency loans to the private and public enterprises post the exchange rate liberalization (Chart 3). This has been also in line with our real interest rate flashnote, which was published earlier this month, that the short-term borrowing cost had been attractive.

Chart 2| The real absorption growth remained unexpectedly high




Source: Ministry of Planning, Pharos research

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## Three possible explanations: the wage/price spiral, the behavioural reaction to the reform measures and the weak interest rate transmission mechanism in Egypt

We believe that there are three possible explanations for the faster than expected absorption growth:

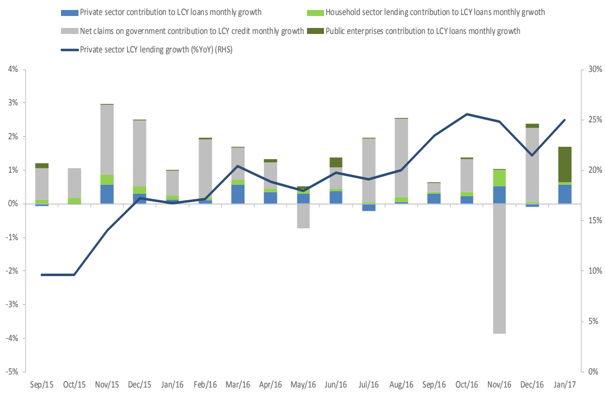
- The wage adjustment in the private sector helped minimize the decline in the disposable income following the implementation of the first phase of the economic reform measures.
- The behavioural reaction to such a shock fueled demand growth, despite the increase in the local currency deposit level.
- In 2005, the CBE introduced the policy rate corridor as Egypt moved towards adopting inflation targeting as its nominal anchor. Under the new monetary policy framework, the CBE would manage the liquidity mainly through the overnight policy interest rates. As the change in short-term interest rate goes through the economy, it would affect economic agents' (households, corporates, etc.) saving/spending decisions guiding the inflation rate towards the desired level over the medium term. However, the low level of financial inclusion implied a less efficient transmission mechanism. One reason, in our view, was the fact that Egypt has had zero or negative real interest rates over a long period (Chart 4). Accordingly, economic agents traditionally resort to real estate and/or pile up durable goods and gold to store value rather than the saving accounts. In other words, Egyptian economic agents spend more in order to hedge high inflation expectations. This would explain the high domestic demand despite the decline in disposable income.

Such a slower than expected readjustment mechanism suggested that the initial nominal interest rate hike was not high enough and required a further monetary policy reaction, in addition to further fiscal tightness.

## The persistence of an attractive positive real interest rates will help change the saving/spending pattern in Egypt

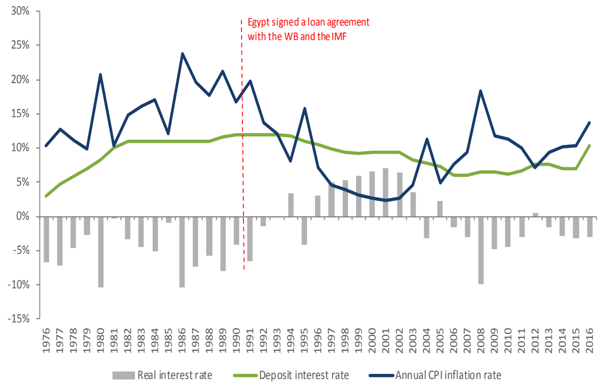
Given the fact that Egypt is a cash economy, a change in the saving/spending pattern in the Egyptian economy requires the persistence of a real interest rates, in addition to attractive nominal interest rates to counter the "money illusion". Here is where we see the possibility of a nominal interest rate hike over the short-term. On one side, this will eventually help strengthen the financial inclusion and the monetary policy transmission mechanism. On the other hand, the small size of indebted companies/personnel relative to the GDP, in addition to the preferential low nominal lending rates provided to some sectors imply a small negative impact on the broader economy.

Chart 3| Private sector local currency loan growth maintained growth pace




Source: Central Bank of Egypt, Pharos research

Chart 4| The persistence of negative real interest rate over a long time helped channel savings away from banks




Source: WorldBank, Pharos research

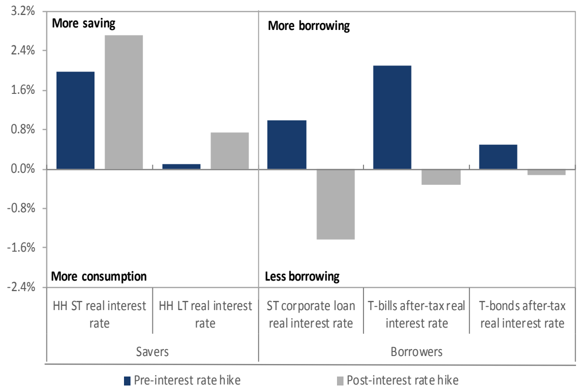
## The post +200bps real interest rate structure makes borrowing more expensive and saving more attractive

We re-calculated the real interest rate across the economy using our CPI inflation forecast. We also assumed no change on the certificates of deposit (CDs) nominal interest rate. Following the recent nominal interest rate hike, households enjoys a better positive real interest rate. On the other hand, the real interest rate has turned positive for short and long term borrowings (Chart 5). Spending is now less attractive for various economic agents, which , in principal, fits in the broader macroeconomic strategy to curb absorption. One valid question remains whether this would be enough to alter the aforementioned Egyptian saving/spending given the expected fuel price hike.

## The negative impact on the budget deficit would be mitigated via further fiscal discipline, external borrowing and foreign EGP-denominated treasuries purchasing activity

Following the successful international bond issuance in January 2017, the Minister of Finance, Amr El-Garhy, expected another round of international bond issuance to take place by the year-end. However, Egypt tapped the international debt market last week for an extra USD3 billion. Changing the original plan, in our view, was supported by three factors. First, taking the advantage of the current positive perception of the Egyptian macroeconomic transformation story by foreign investors. Second, moving before the expected Federal Reserve interest rate hike in June. Third, we cannot ignore the aforementioned domestic developments, which would signal a coordination with the CBE. The Ministery of Finance plans to minimize the high domestic borrowing cost by diversifying the source of funding, in addition to the already planned fiscal reform measures (i.e. electricity/fuel subsidy cuts). Furthermore, we note that foreign investors' EGP-denominated treasuries purchasing activity will also help maintain a reasonable cost of borrowing for the government (hint: more demand tends to push yields lower/ cap yields increase).

Chart 5| The real interest rate structure implies more savings and less borrowing




* (+ve) indicates gains, (-ve) indicates losses

** We assume no CDs interest rate change

Source: Central Bank of Egypt, Pharos research

In a brief, the short term framework of rebalancing the economy implies a slower domestic demand growth in order to be consistent with the local production growth. The persistence of a high resource gap would continue to pressure the exchange rate and the inflation rate. The recent move by the CBE, which was also supported by the IMF, was due to the new economic developments on the ground. While we acknowledge that curbing the current high inflation rate requires additional structural measures, but tighter monetary and fiscal policies remain crucial over the short run. Therefore, we should not rule out the possibility of another nominal interest rate increase over the short run. If our analysis proves to be right, consumption will come under pressure due to further fiscal and monetary tightening, in addition to a slower wage adjustment. This would initially prevail until 2Q FY2017/18, where we expect the inflation rate to decelerate leading the nominal interest rate downwards. In that context, we advise our clients to keep an eye on the disinflation pace, the local currency borrowings growth, in addition to June's Monetary Policy and the IMF staff reports for more color regarding the short run direction of the monetary policy in Egypt.

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