Egypt Macroeconomic Reform

February 2018

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES ON LAST PAGE OF THIS PRESENTATION

Executive summary

- *On November 3 the Central Bank of Egypt liberalized the Egyptian pound exchange rate. This marked the beginning of an ambitious and a far reaching reform program underwritten by* **a USD12 billion Extended Fund Facility (EFF) by the International Monetary Fund (IMF)***.*
- *The program aims at restoring macroeconomic balances in an economy devastated by five years of political instability and mismanagement.*
- *The EFF program is centered around the reduction of the budget deficit, restoring sustainable financing of the balance of payments, reducing inflation and restoring growth.*
- *These goals imply a number of budgetary measures of expenditure reduction and revenue increase. Concurrently monetary conditions will remain significantly tight, intended to control inflation, the financing gap of the balance of payments and the exchange rate depreciation.*
- *The Egyptian national budget suffers from a number of structural rigidities that limit the amount of expenditure reduction to measures – such as the elimination of subsidies – requiring therefore a phased approach over time. Accordingly, we expect a lengthy fiscal consolidation process.*
- *In the context of the tight monetary conditions interest rates on government paper and for the rest of the economy are also likely to start loosening soon. Average EGP-denominated T-bills yields continued to fall since July 2017 and it fell to 18.64% in January 2018 for the 3-month T-bills and 18.63% for the 6-month T-bills.*
- *At present, the Egyptian pound is undervalued as a consequence of the flotation on 3/11/16. We do not expect this to unwind in the short run.*
- *Simultaneously as the financing outlook of the balance of payments improves with easier international borrowing, the loans from the IMF, the World Bank, the African Development Bank and the European Investment Bank; as well as a slow recovery of FDI, the exchange rate in the free market should stabilize around the current level.*

Macroeconomic Reform in Action

- *Bearing the brunt of high twin deficits, 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*

Phase I

Value Added Tax	Civil Service Law	Slash Energy Subsidies	Exchange Rate Liberalization	IMF 3-year extended fund facility
• Expand tax base	• Control public sector wage increase • Raise the public sector's productivity	• Electricity tariff hike (August 2016/July 2017) • Fuel price hike (November 2016/ July 2017)	• Unify exchange rates • Improve FX liquidity in the banking system	• Boost the confidence in the economy over the horizon of the programme and beyond

- *The government applied further reform measures to help reduce the budget deficit, as well as improving the ease of doing business in Egypt*

Phase II

New Investment and Bankruptcy Law	New Tax Law	IPOs of public sector companies	Rationalizing the food subsidies	Energy sector makeover
• Increase domestic investment • Attract greater foreign direct investment	• Enhance the tax payment systems and the tax refund process versus a tax rate rise proposed by Parliament	• Improve the Egyptian stock market liquidity • Attract foreign portfolio investment • Raise more revenue for the government	• Updating the smart-card database should help decrease the current expenditure levels	• A major energy sector makeover strategy is underway, which includes EGPC restructuring and further energy subsidy reform

Growth and Inflation Dynamics| Private investments to drive real GDP growth to 5.7% as inflation rate decelerates to 12.9% in FY2018/19

Our assumption is based on <u>three factors</u>:

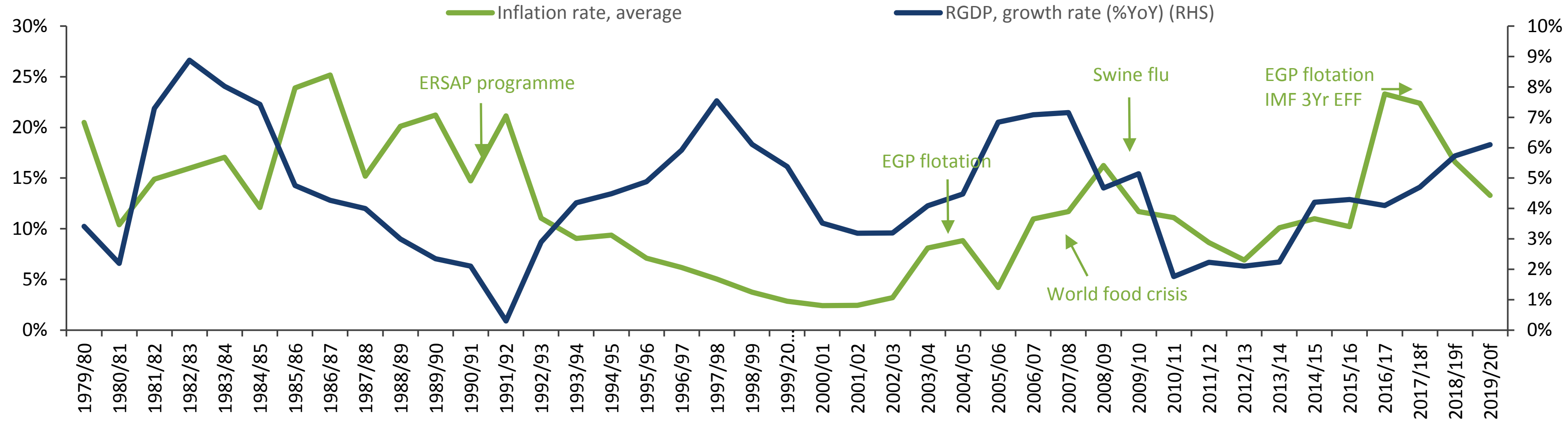
- *The production distortion resulting from foreign currency shortage and restrictions fades away*
- *Improved private sector access to credit as the government decreases the budget deficit and diversifies funding resources*
- *Higher foreign direct investment due to investment incentivizing reforms*

The average inflation rate will decelerate from 27% in 2Q FY2017/18 to 15.3% YoY in 3Q FY2017/18, and 12.60% YoY in 4Q FY2017/18, due to:

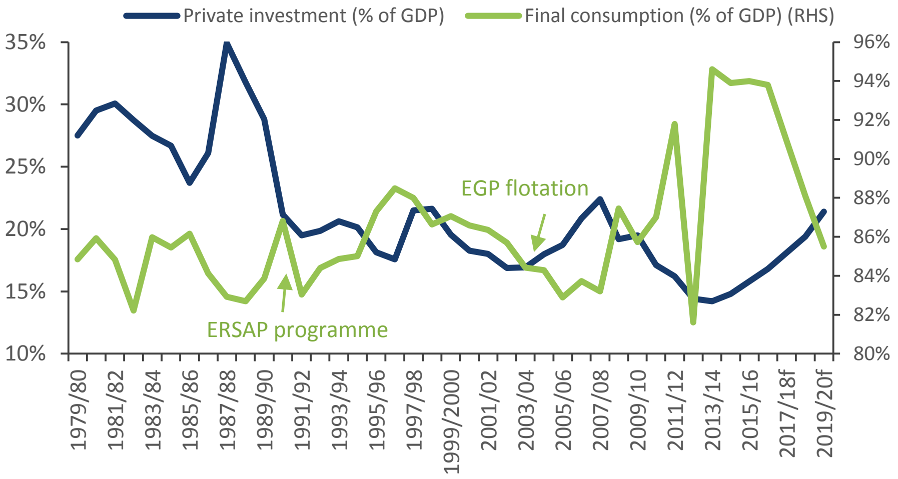
- *The exchange rate pass-through effect fades out*
- *The adjusted consumption pattern*
- *A pick-up in the real GDP growth*
- *Slow international commodity prices recovery*
- *Narrower fiscal deficit*
- *Base year effect*

Accordingly, the CBE will bring down its O/N lending interest rate to 16.75% by the end of FY2017/18 and 14.25% by the end of FY2018/19.

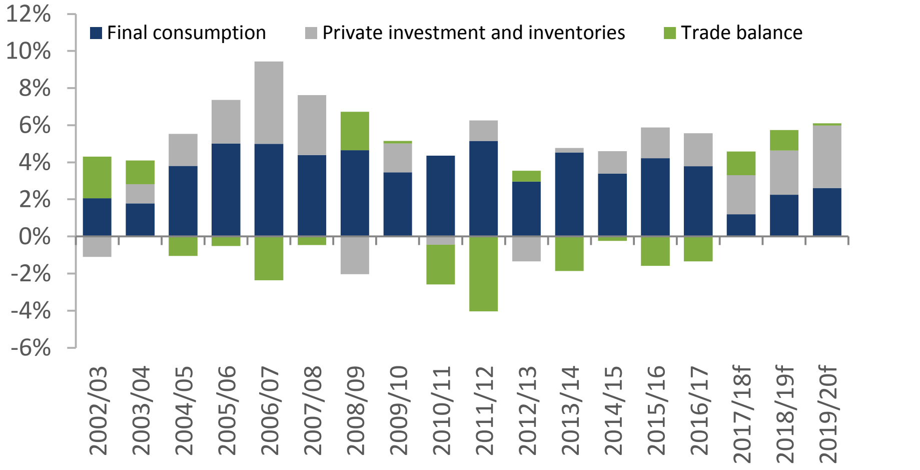
We estimate the economic growth rate to increase slightly to 4.7% in FY2017/18 and then to 5.7% and 6.1% in FY2018/19 and FY2019/20, respectively



Household consumption growth to decline on a lower real personal disposable income



Private investments' contribution to real GDP growth rate to pick up significantly

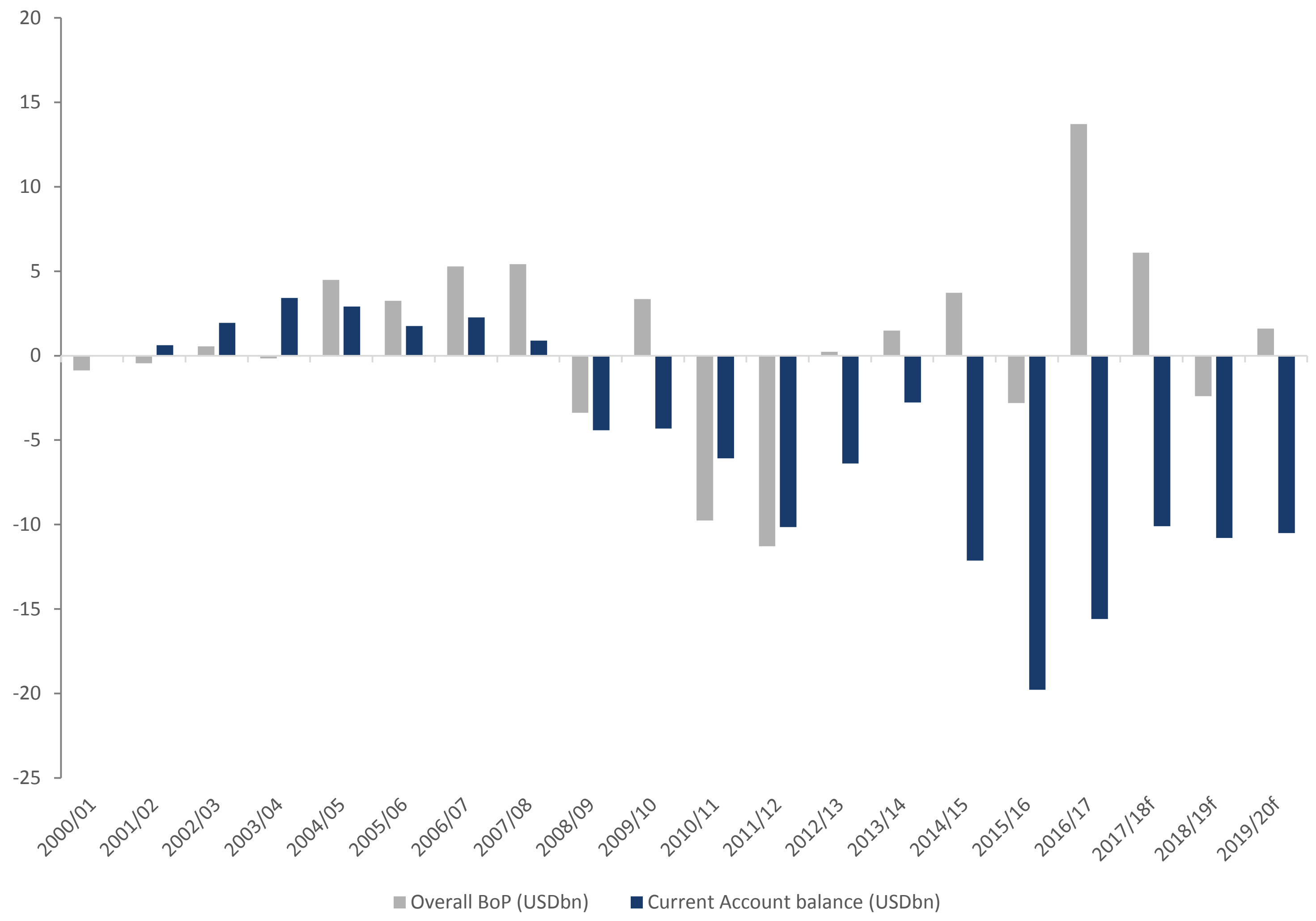


Current account deficit to narrow to 3.2% of GDP (USD9 billion) in FY2018/19

In 4Q FY2016/17, the fundamental BoP indicator continued to show strong inflows following the economic reform measures implementation, which implies an improved foreign currency liquidity.

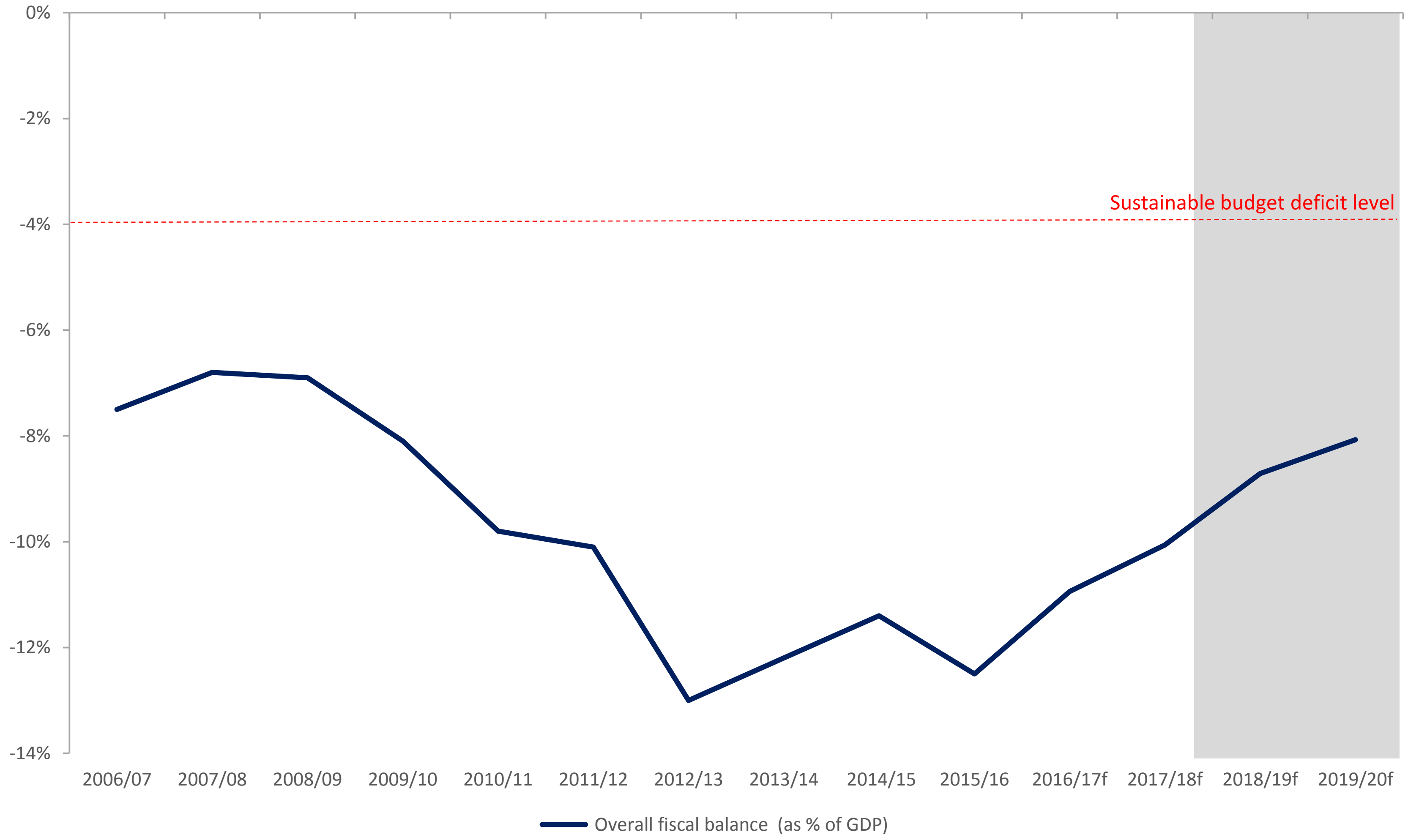
- *A narrower non-oil trade deficit by 15.4% YoY, mainly due to a 11.0% YoY decline in the non-petroleum imports in 4Q FY2016/17*
- *Tourism revenue rose significantly from USD0.5 billion in 4Q FY2015/16 to USD1.5 billion in 4Q FY2016/17*
- *Travel payments continued to decline from USD1.2 billion in 4Q FY2015/16 to USD0.6 billion in 4Q FY2016/17*
- *Remittances of Egyptians working abroad rose from USD4.4 billion in 4Q FY2015/16 to USD4.8 billion in 4Q FY2016/17, which implies that the funds continued to fly back through the formal channels.*
- *The cumulative net direct investments went up 14.5% YoY from USD6.9 billion FY2015/16 to USD7.9 billion in FY2016/17.*

External position to improve on lower current account deficit and more sustainable financial account inflows



Egypt Macroeconomic Reform; Budget deficit

A lengthy fiscal consolidation is expected

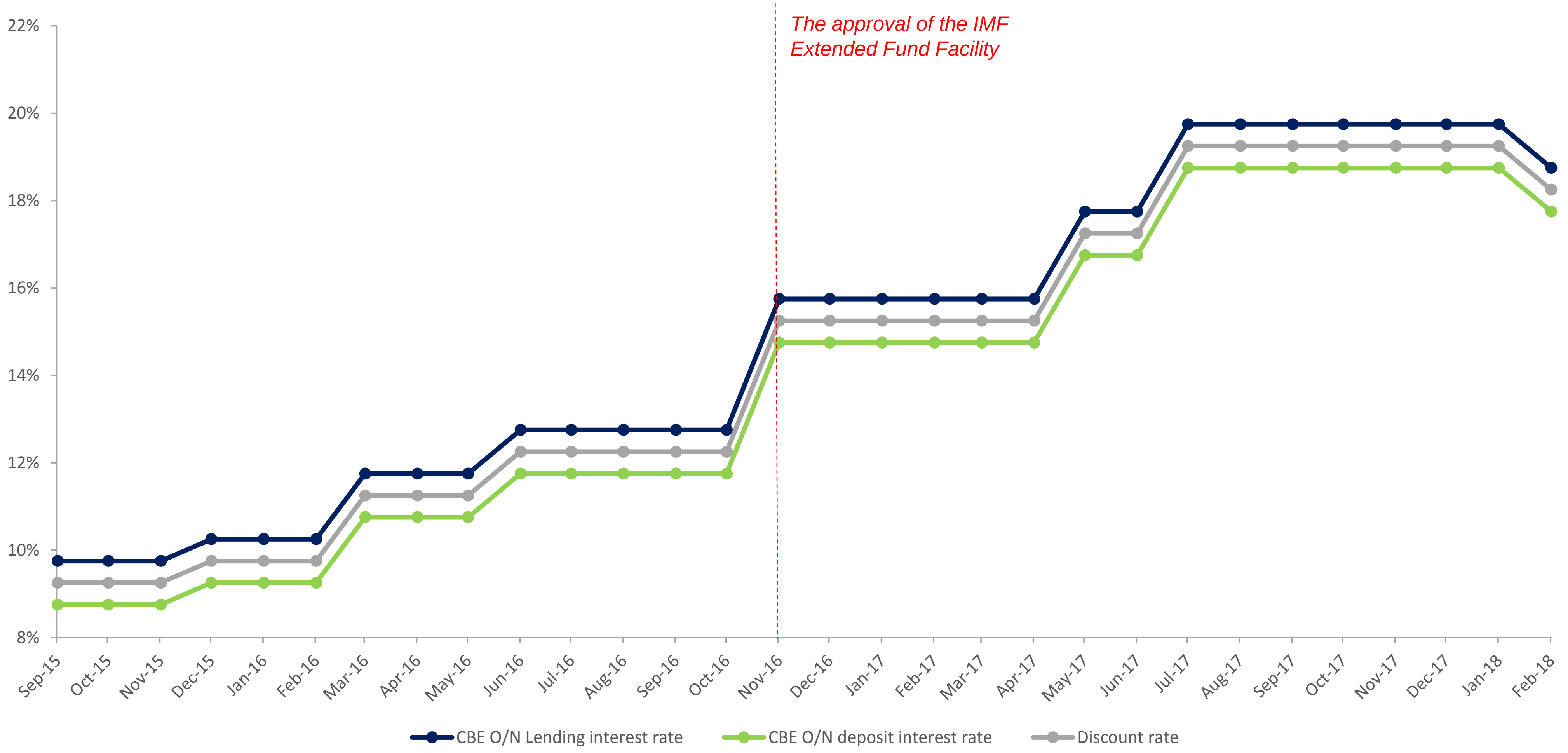


Source: Ministry of Finance

- **Despite the significant effort by the government, structural rigidities in the national budget will make fiscal consolidation a lengthy process**
- **The Balance of Payments (BoP) gaps are likely to be resolved in the near future from a more sustainable resources, leading to a stable exchange rate**
- **Meanwhile, fiscal pressures will continue on the domestic credit**
- **Tight monetary conditions with the attendant high interest rate environment will start loosen in 2018 once the inflation deceleration is stabilized**

Egypt Macroeconomic Reform; Policy rates trend

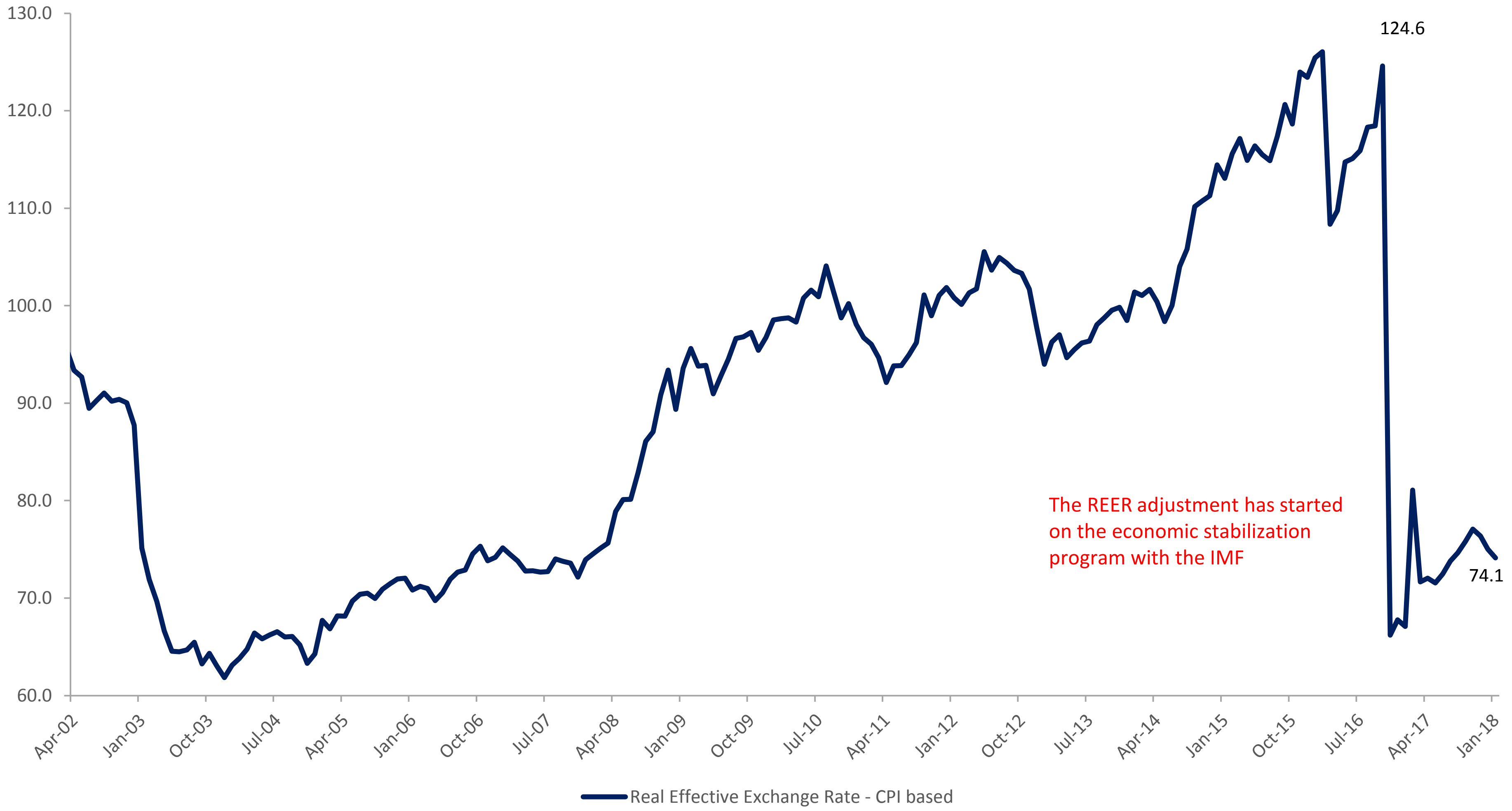
The CBE policy interest rates suggest loosening monetary conditions



Source: Central Bank of Egypt

Egypt Macroeconomic Reform; Exchange rate

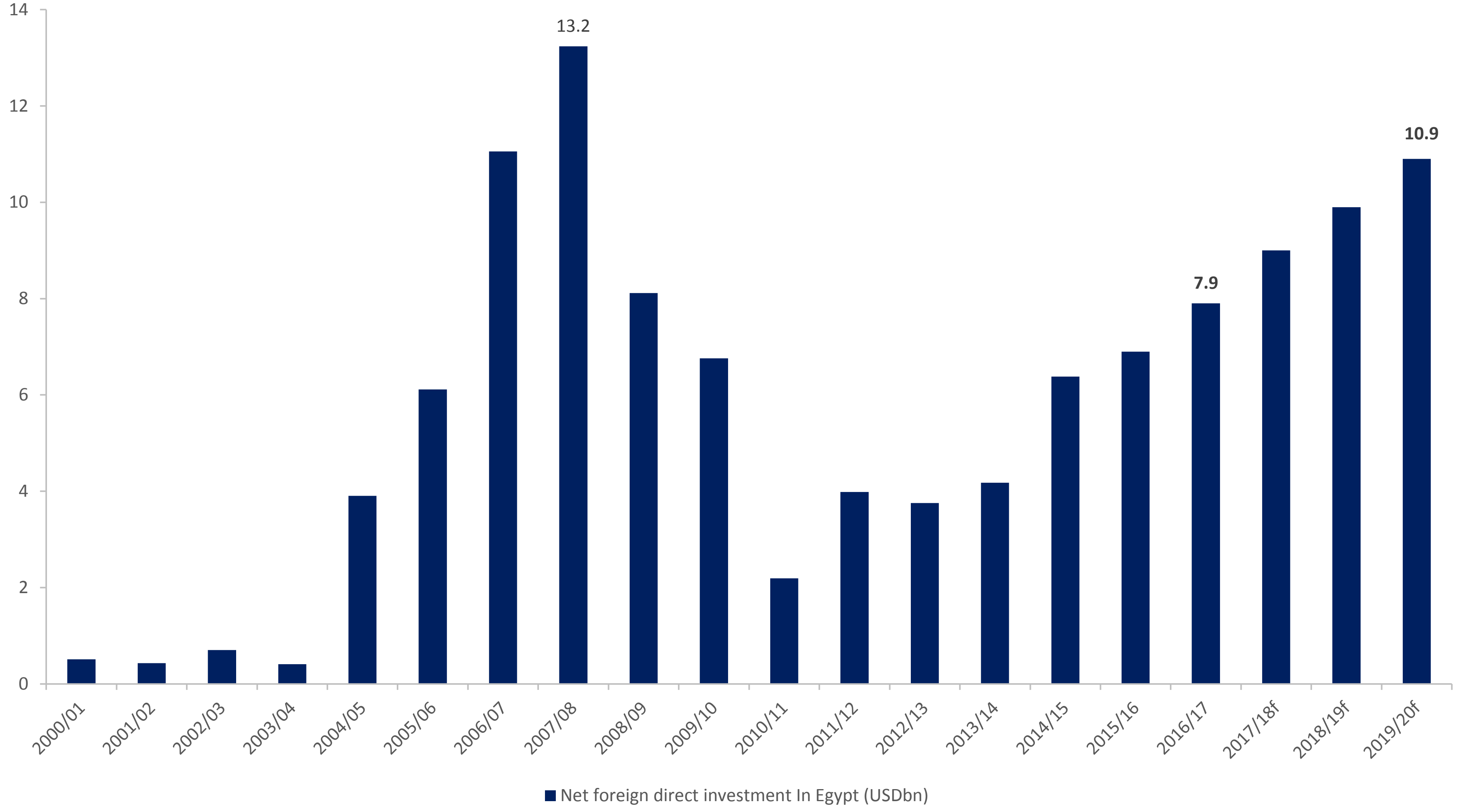
The significant adjustment in the real effective exchange rate (REER) signals that the EGP exchange rate is likely to remain undervalued over the next two years



Source: Bloomberg

Egypt Macroeconomic Reform; Foreign Direct Investment

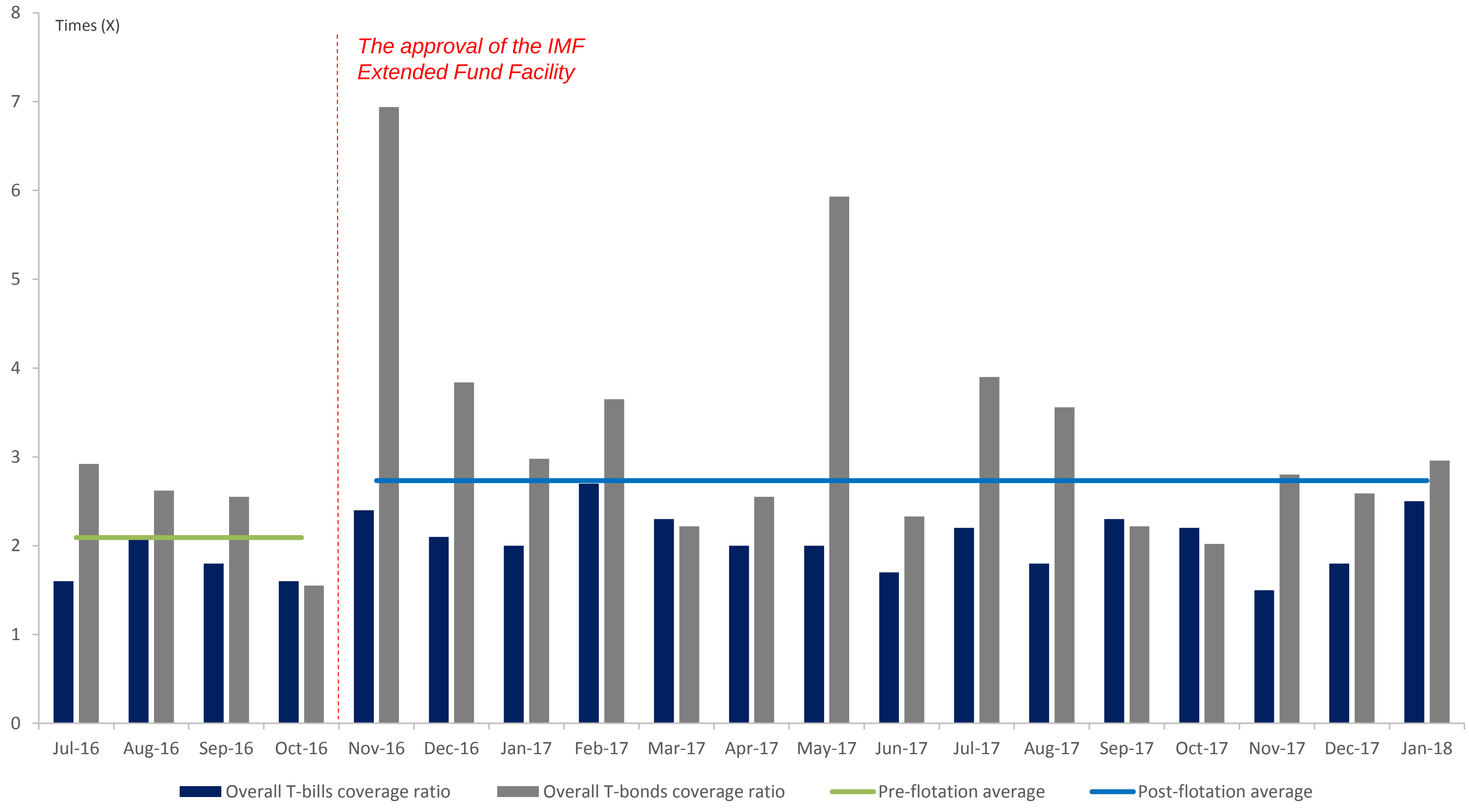
FDI is expected to pick-up post flotation, boosting GDP growth and easing economic conditions over the medium term



Source: Central Bank of Egypt

Egypt Macroeconomic Reform; Demand for Egyptian T-Bills and T-Bonds

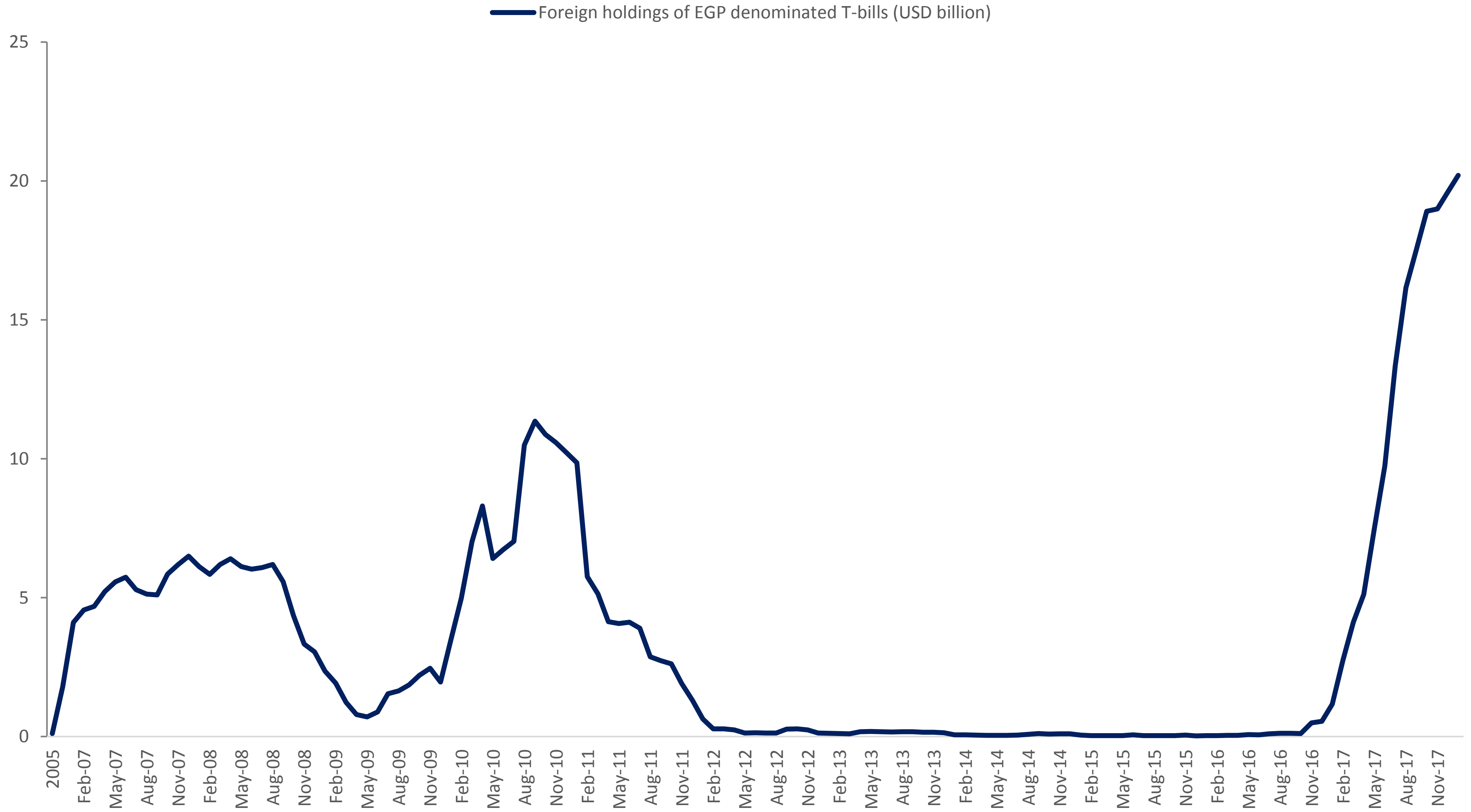
The demand on short term government financial paper rose after the CBE's decision to liberalize the EGP exchange rate



Source: Central Bank of Egypt, Pharos Research

Egypt Macroeconomic Reform; Foreign capital inflow into T-bills

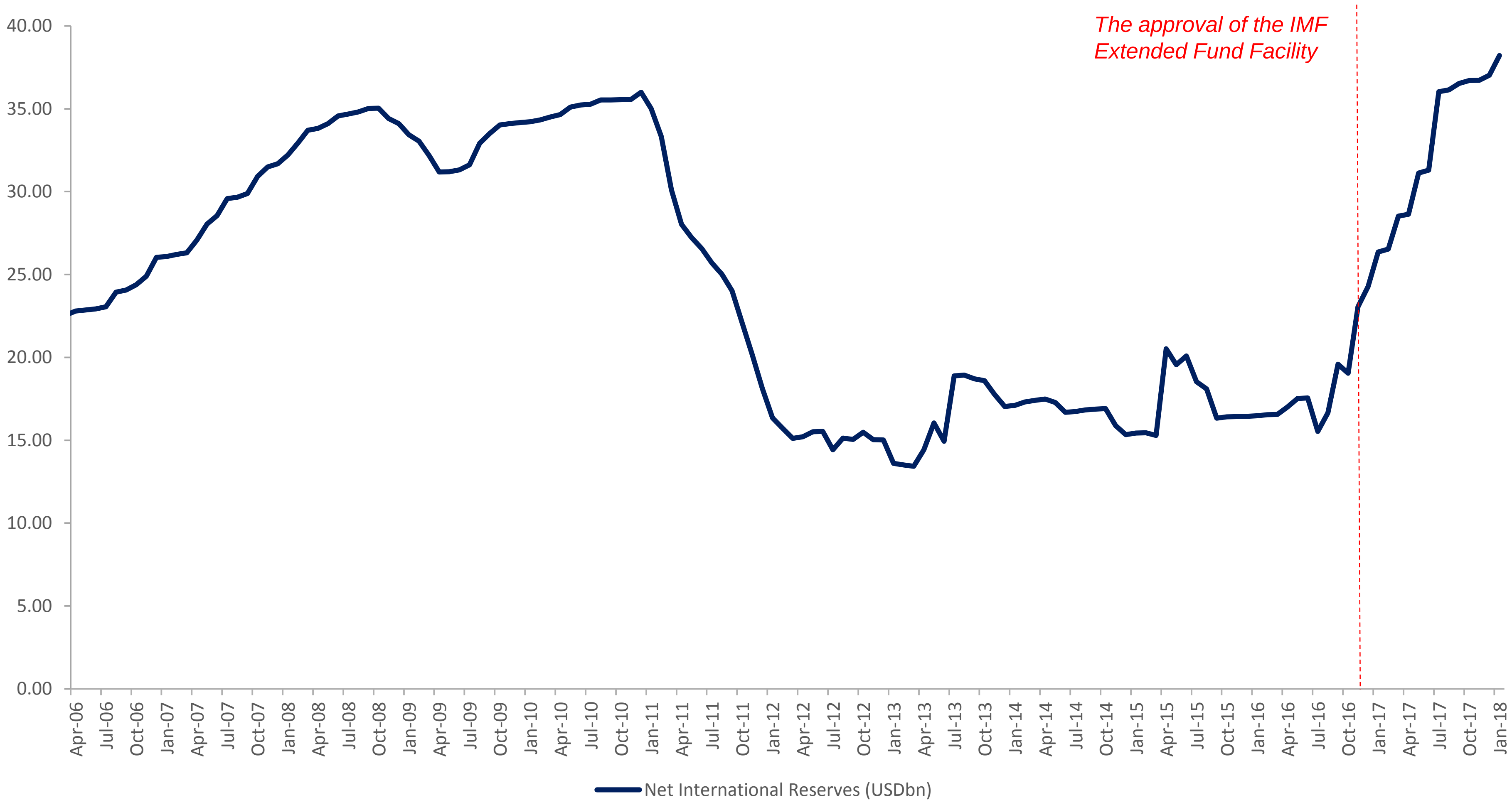
The present reform measures helped restore the financial environment that managed to attract close to USD 20.2 billion in government financial papers by the end of January 2018.



Source: Central Bank of Egypt, Ministry of Finance

Egypt Macroeconomic Reform; Net International Reserves

Net foreign reserves reached the highest level since 2005, recording USD38.21 billion



Source: Central Bank of Egypt

Egypt Macroeconomic Reform

Key macroeconomic indicators	2013/14	2014/15	2015/16	2016/17	2017/18f	2018/19f	2019/2020f
Nominal GDP (EGP billion)	2130.0	2443.9	2708.3	3475.9	4335.7	5144.8	6042.6
Nominal GDP (USD billion)	305.4	332.2	332.3	233.3	240.3	276.2	304.5
Real GDP, growth rate	2.9%	4.4%	4.3%	4.1%	4.7%	5.7%	6.1%
CPI inflation rate, average	10.1%	11.0%	10.2%	23.3%	22.4%	16.6%	13.3%
Tax revenues (as % of GDP)	12.2%	12.5%	13.0%	13.4%	13.9%	13.8%	13.9%
Total expenditure (as % of GDP)	32.9%	30.0%	30.2%	29.7%	29.1%	27.7%	27.2%
Primary fiscal balance (% of GDP)	-3.9%	-3.5%	-3.5%	-1.8%	-1.0%	0.3%	0.9%
Overall fiscal balance (% of GDP)	-12.0%	-11.4%	-12.5%	-10.9%	-10.1%	-8.7%	-8.1%
O/N deposit rate, (end of period)	8.30%	8.80%	11.80%	17.75%	17.25%	15.50%	13.50%
Broad money, growth rate	17.0%	16.4%	18.6%	39.4%	14.8%	22.3%	15.5%
Current account balance (% of GDP)	-3.7%	-5.6%	-5.3%	-6.6%	-4.1%	-3.9%	-3.5%
Overall balance of payments (% of GDP)	0.5%	1.1%	-0.8%	5.9%	2.6%	-0.9%	0.5%
Net international reserves (USD billion)	16.7	20.1	17.5	31.3	37.5	35.1	36.7
USD/EGP, average rate	7.0	7.4	8.2	14.9	17.5	18.6	19.8

Source: Ministry of Finance, Central Bank of Egypt, Pharos Research

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