NATIONAL BANK OF GREECE

Economic Analysis Division
Emerging Markets Analysis

Special Issue

Special Issue: Egypt

“Egypt’s way out of the crisis is through additional economic adjustment and reforms to unlock its significant growth potential”

NBG - Economic Analysis Division

Emerging Markets Analysis

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May 2023

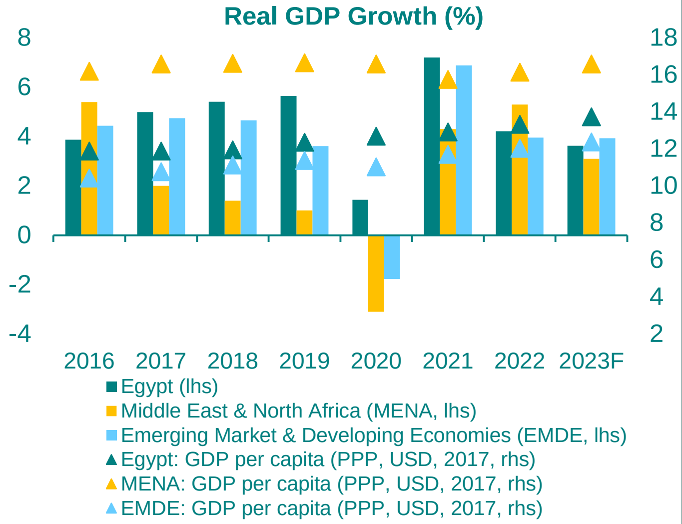
The Egyptian economy before the pandemic and the Russia-Ukraine conflict

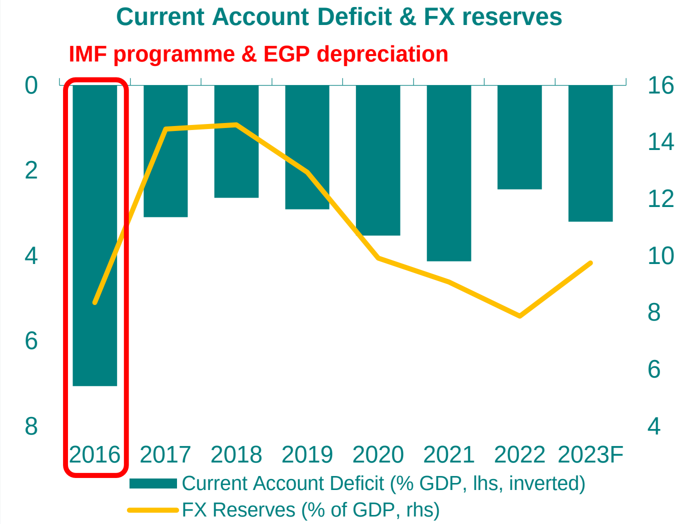
The fallout from the double shock and the subsequent global monetary tightening led Egypt to the IMF

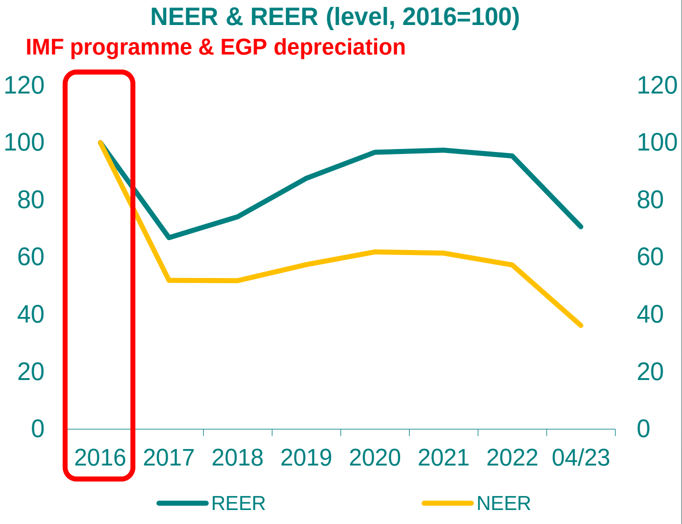
Outlook

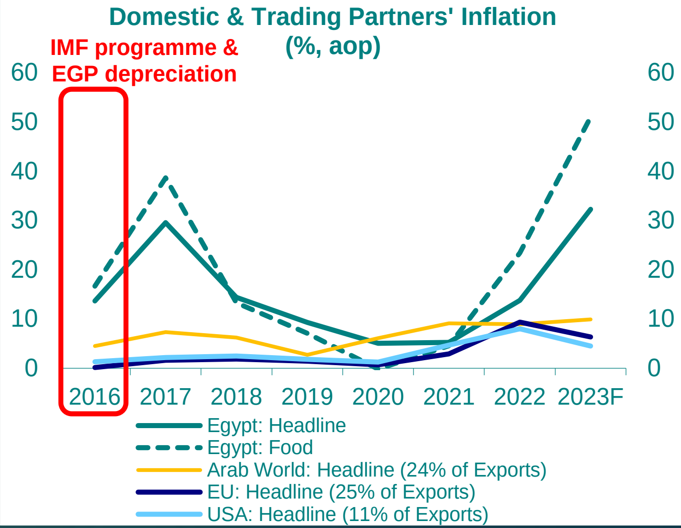
"Egypt was one of the fastest growing emerging markets prior to the double shock, yet lagging behind its peers in terms of convergence and competitiveness"

- ✓ Egypt's solid macroeconomic performance prior to the shocks of the pandemic and the Russia-Ukraine conflict was underpinned by the critical reforms carried out under the auspices of the IMF in 2016-19 (including the floating of the Egyptian Pound, EGP, and fiscal consolidation), which promoted a more inclusive growth model, while helping to correct external and domestic imbalances
- ✓ Following the sharp depreciation of the EGP (by c. 50%) in 2016, a substantial external rebalancing took place, bringing Egypt's external position broadly in line with economic fundamentals, mainly by stimulating exports of non-oil goods and tourism services. At the same time, the exploitation of the Zohr gas field helped Egypt to close its energy deficit
- ✓ Still, non-energy exports remained significantly lower than those of Egypt's peers, suggesting persistent structural imbalances (stemming, *inter alia*, from tariff & non-tariff barriers, the legacy of inward-oriented policies and the prominent role of the state), with the trade deficit exceeding 10% of GDP, among the highest in the emerging markets sphere, despite persistent under-investment
- ✓ Nevertheless, authorities' bias towards FX stability, mainly with a view to containing inflation, quickly eroded the competitiveness gains derived from the weaker EGP, inhibiting a drop in import spending
- ✓ Indeed, although headline inflation was brought down in the years prior to the pandemic, it continued to surpass that of Egypt's main trade partners, mainly reflecting the impact of an accommodative domestic monetary policy and structurally high food inflation









Sources: CBE, IMF, WB, Reuters, Bloomberg & NBG estimates

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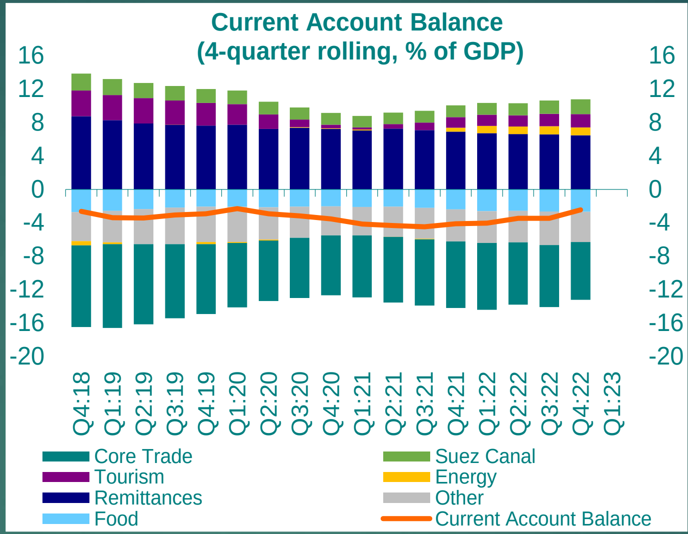
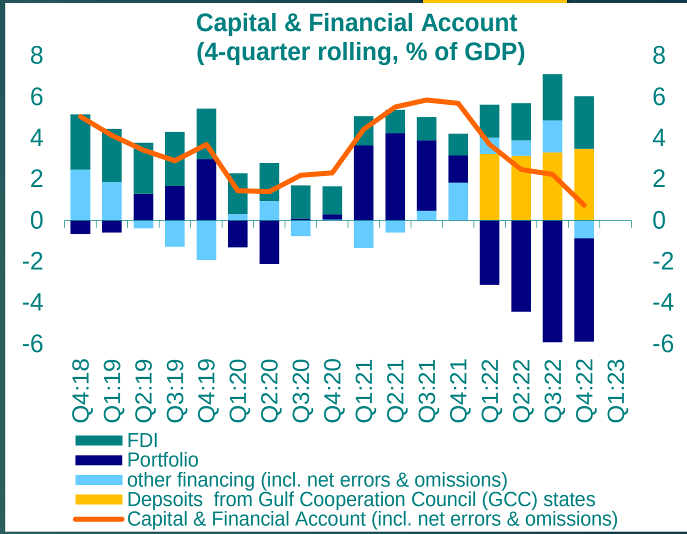
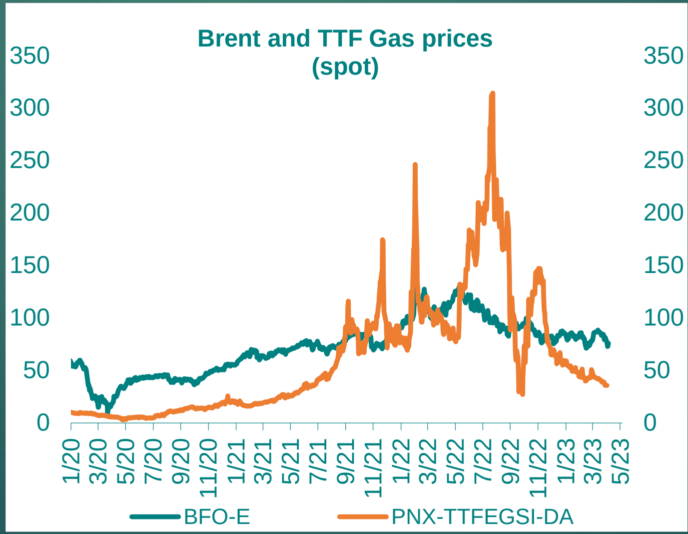
The fallout from the double shock and the subsequent global monetary tightening led Egypt to the IMF

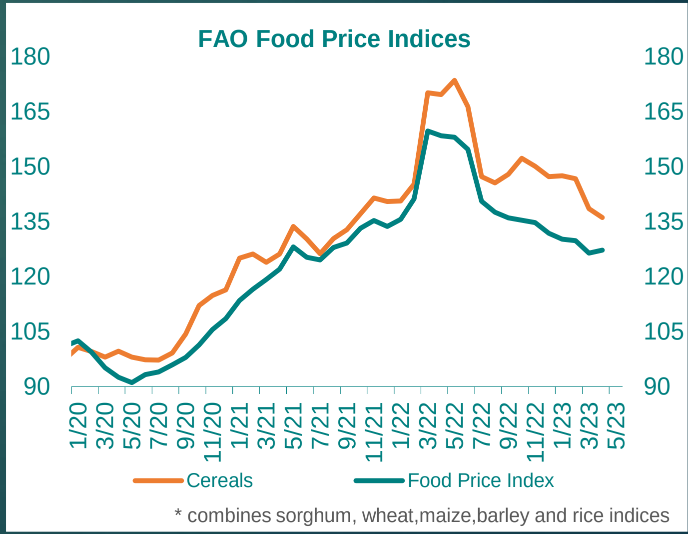
"External pressures in the aftermath of the double shock and tightening global financing conditions eroded the buffers Egypt had built …"

- ✓ In the wake of the double shock of the pandemic and the Russia-Ukraine conflict and the subsequent global monetary tightening, Egypt has been faced with an abrupt worsening in external imbalances, reflecting a (modest) widening in the current account deficit (CAD), on the one hand, and a sharp deterioration in external financing conditions, on the other hand
- ✓ Specifically, the jump in global food prices has put significant pressure on the trade deficit, due to the country's reliance on imports to cover its basic food needs (note that Egypt is the largest wheat importer globally)
- ✓ Weaker tourism inflows (due to the poor epidemiological situation during the pandemic, initially, and reduced arrivals from Russia and Ukraine -- together accounting for a sizeable 30% of tourist arrivals -- later), along with decreased Suez Canal receipts (due to weaker global growth and disruptions in global supply chains) and lower remittances have also weighed on the CAD
- ✓ The CAD would have been larger, had Egypt not benefited from higher global gas prices. Still, the energy trade surplus covers slightly more than ⅓rd of the food trade deficit
- ✓ The import restrictions imposed in the beginning of 2022 (see below) have also helped in containing the trade deficit
- ✓ At the same time, there has been a sizeable capital flight from Egypt (and other emerging markets), reflecting increased risk aversion worldwide, following the outbreak of COVID-19, in the first place, and the subsequent dramatic policy turn by global central banks to tame surging inflation







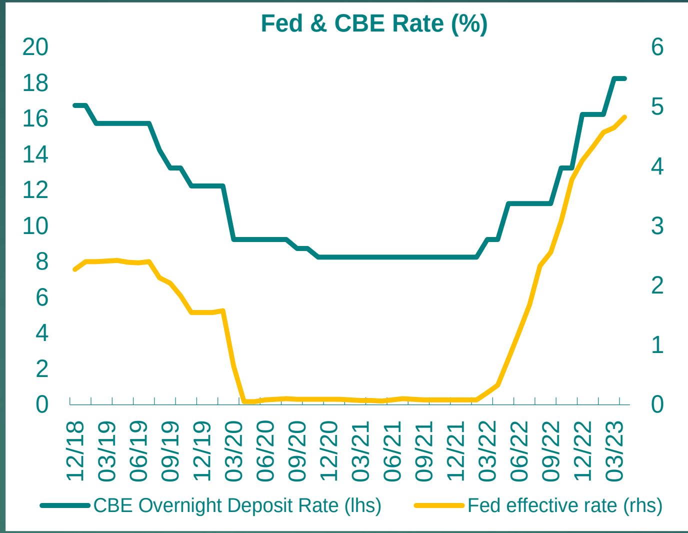


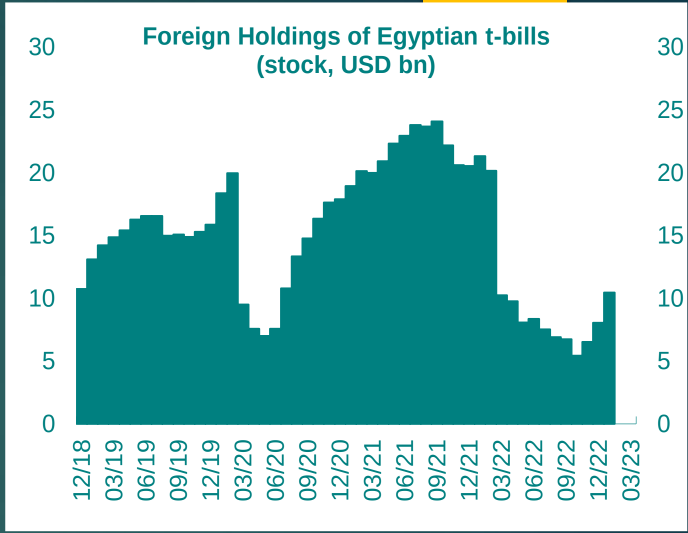
Sources: CBE & NBG estimates

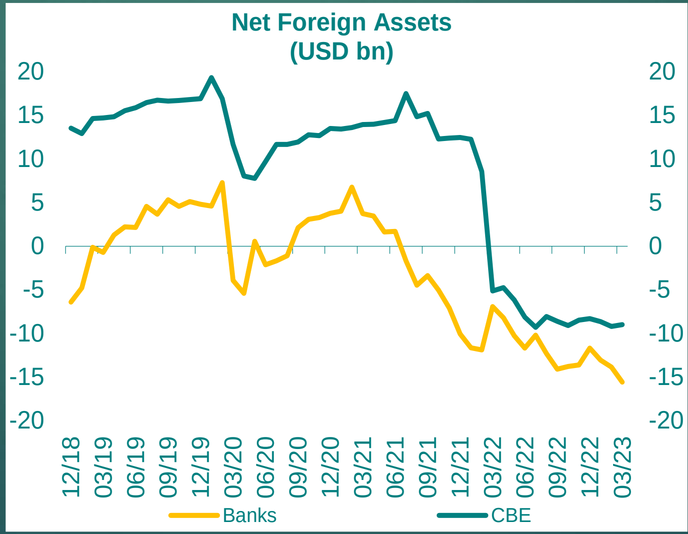
The fallout from the double shock and the subsequent global monetary tightening led Egypt to the IMF

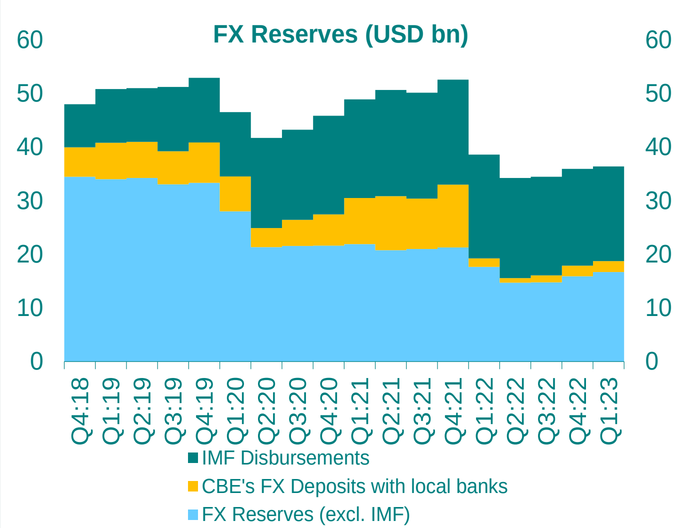
"… forcing authorities to break the EGP's peg with the USD…"

- ✓ Against the backdrop of widening external imbalances, Egyptian authorities' bias towards a stable exchange rate boded ill for financial stability, eroding market's confidence in the economy, despite the Central Bank of Egypt's (CBE) tightening moves
- ✓ Portfolio investment which has traditionally been a key source of FX funding, deteriorated sharply, with foreign holdings of T-bills dropping abruptly, highlighting the risks associated with the "hot money" policy Egypt was pursuing
- ✓ Note that Egypt's FX needs would have been much larger without the significant non-market funding support received from the Gulf Cooperation Council (GCC) countries (amounting to c. USD 16bn since early-2022)
- ✓ As a result, and despite the rapid unwinding of Egyptian banks' net foreign assets, FX reserves depleted rapidly (eventually falling to a 5-year low of c. USD 33.0bn in mid-2022 -- or a mere USD 14.5bn adjusted for IMF disbursements -- equivalent to 4 months of GNFS imports, having slightly increased since then), testing the CBE's capacity to maintain the EGP's *de-facto* peg with the USD. The latter eventually broke in March 2022
- ✓ Over the next few months, and amid an abrupt tightening in external financing conditions, authorities resorted to "*quasi*" capital controls measures (including the imposition of import restrictions) to contain FX demand and stem depreciation pressures, which would fuel further the already elevated inflation
- ✓ Despite these measures, the EGP remained on a depreciating trend, with debt yields and CDS spreads surging to default levels, at the same time









Sources: CBE, Reuters & NBG estimates

"…and eventually resort to the IMF"

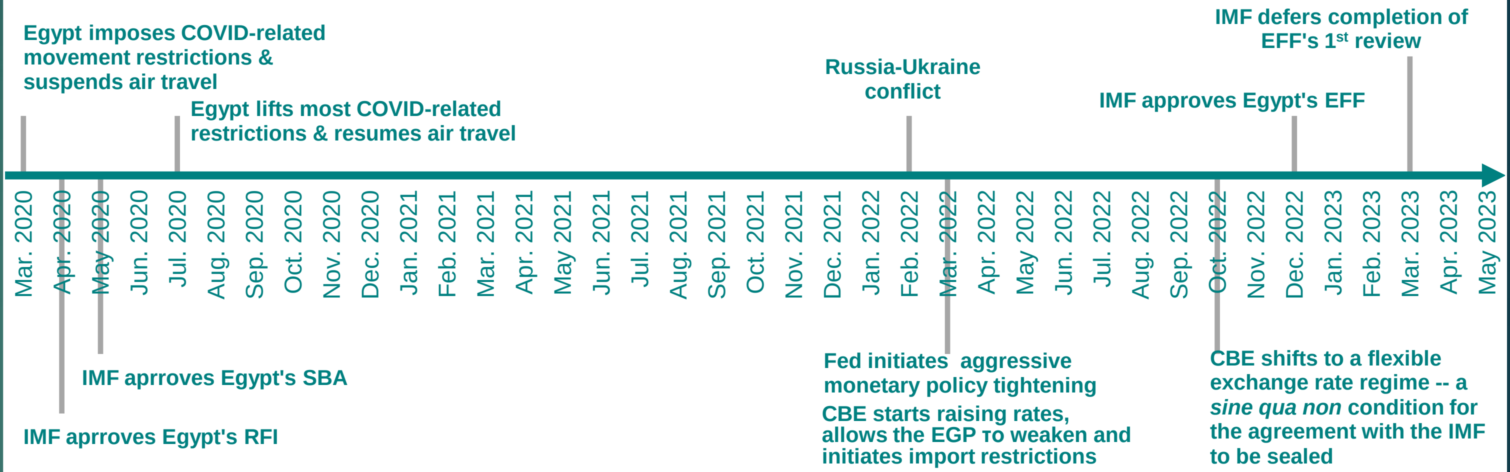
- ✓ Against this challenging backdrop, Egypt was forced to resort to the IMF in December '22, sealing a 46-month USD 3bn Extended Fund Facility Arrangement (EFF)
- ✓ Given Egypt's large outstanding obligations with the IMF (exceeding both the cumulative and annual access limits, with the country currently being the Fund's 2nd largest borrower after Argentina), the funding amount secured covers just a small part of its external financing gap (see below)
- ✓ Under the agreement and as part of its adjustment programme to escape the crisis and increase the economy's resilience, domestic authorities committed to proceed with:

a. "*a permanent shift to a flexible exchange rate regime*" and an effective inflation-targeting monetary policy;

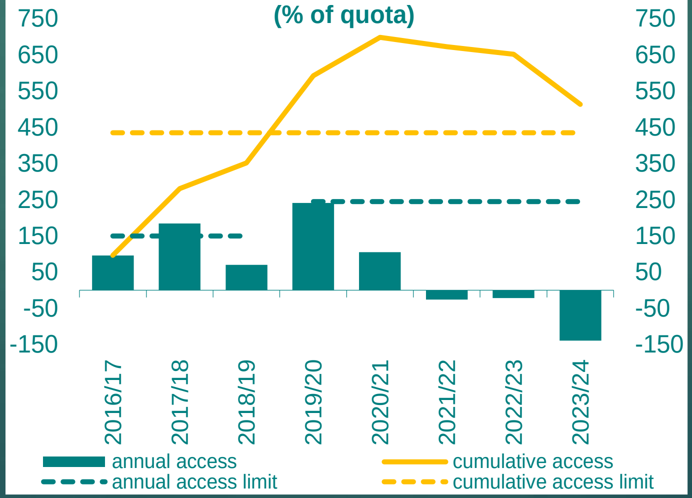
b. further fiscal consolidation to put the public-debt-to-GDP ratio on a sustainable downward trend; and

c. reforms aiming at reducing the public sector's large footprint on the economy. In this context, authorities agreed to privatize 32 state-owned enterprises (SOEs) by March '24 and level the playing field across all agents by removing trade barriers and enhancing transparency and governance in the public sector

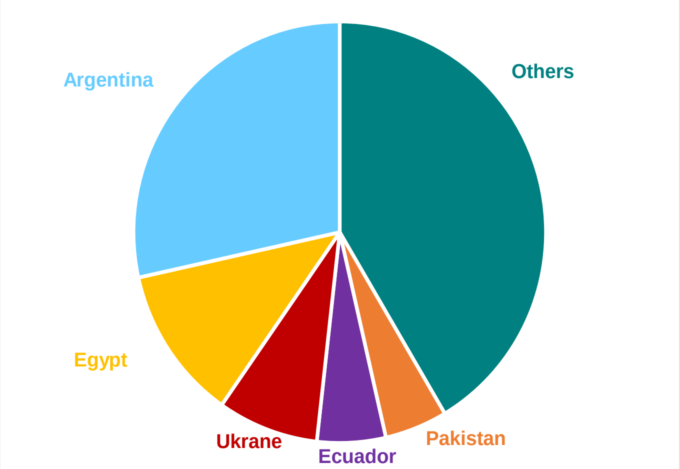
Timeline of events leading up to IMF EFF (2020-2023)



Access to IMF Funding (% of quota)



Total IMF Credit Outstanding



Sources: CBE, IMF, Reuters & NBG estimates

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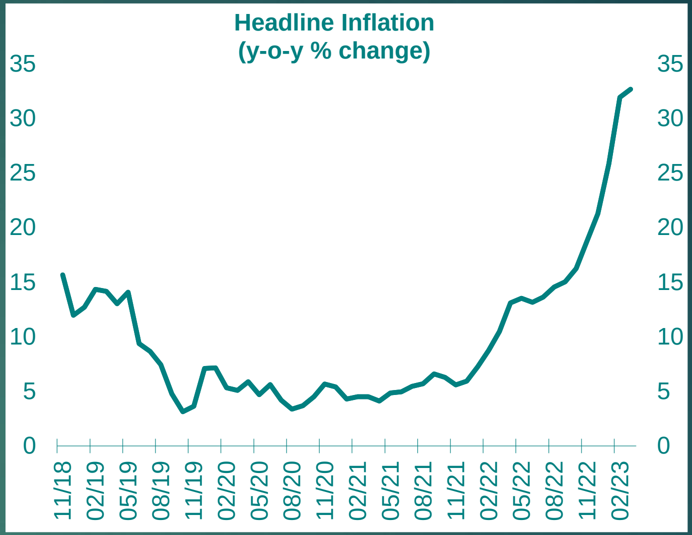
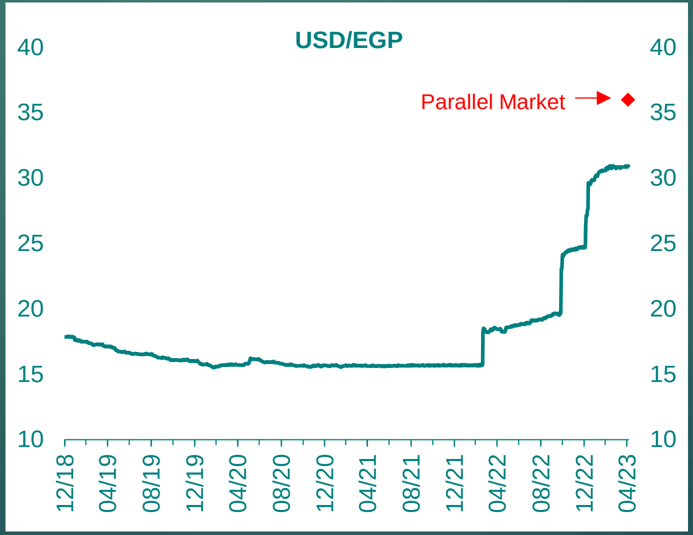
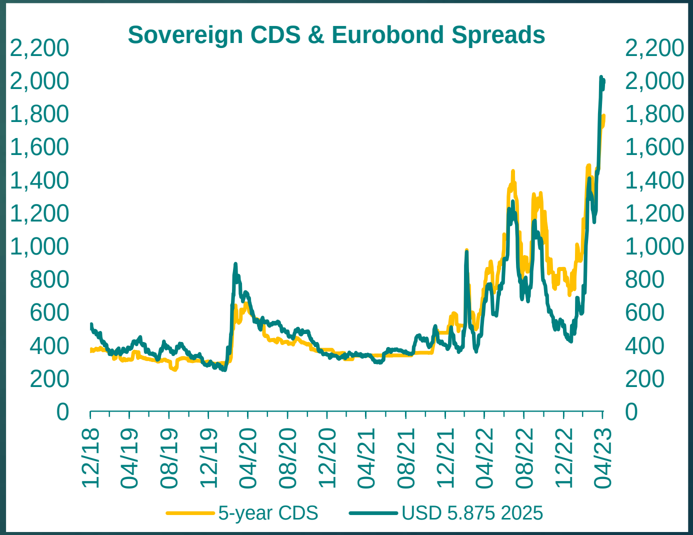
- ✓ Since announcing the shift in FX policy, the EGP has depreciated by another 20% against the USD, bringing cumulative losses since March '22 to 50%, among the largest witnessed globally
- ✓ Still, the EGP appears not to be freely floating, with the current regime mostly looking like a "crawling peg"
- ✓ In fact, underlying depreciation pressures on the currency remain strong, as suggested by the EGP currently trading at a discount of more than 15% to the official exchange rate on the parallel market, due, *inter alia*, to agents hoarding FX, amid heightened uncertainty
- ✓ Highlighting the USD shortage, there reportedly is a significant (yet smaller than a few months ago) backlog of imports waiting to be cleared, despite the revocation of a requirement for importers to secure letters of a credit
- ✓ The key factor behind authorities' reluctance to allow the EGP to weaken is the impact that latter would incur on already high inflation. Inflation has been rising since early-2022, hitting a high of 32.7% y-o-y in March '23, driven by the weaker EGP and higher global food prices
- ✓ Worryingly, in a higher for longer inflation and, thus, interest rate environment, public finances would also deteriorate, due to higher interest payments (with the latter making up around $^{1}/_{3}$rd of total budget spending, equivalent to c. 7.0% of GDP), implying the need for a larger and more painful adjustment, which could undermine social cohesion (see below)
- ✓ All said, limited transition to a flexible FX regime, together with slow progress with other structural reforms, including privatizations, which have been stalled, amid adverse market conditions, has led the IMF to delay its 1st review keeping market volatility high (as suggested by CDS and Eurobond spreads nearly doubling from the levels seen prior to Egypt's agreement with the IMF)

"Slow reform drive keeps uncertainty heightened and fuels market volatility"







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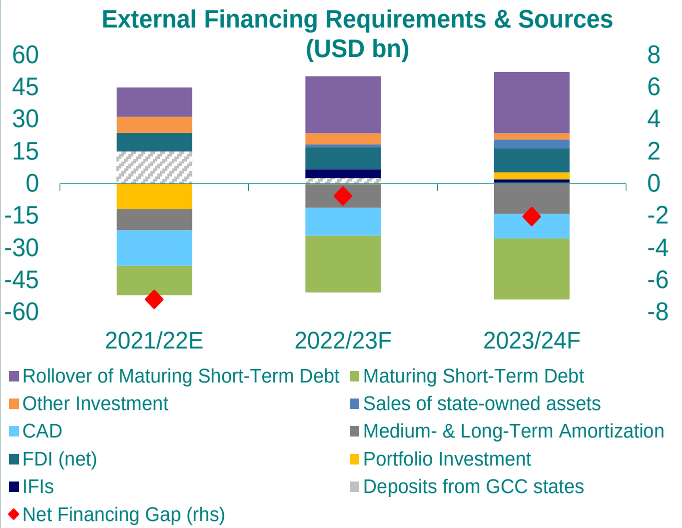
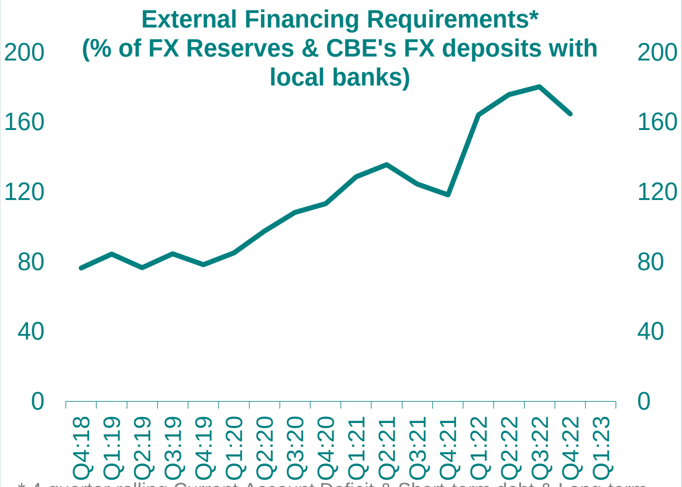
> "The near-term outlook for the EGP remains bleak, due to high external financing needs …"

- ✓ Total external financing needs, covering the CAD and external debt repayments, are projected at a sizeable USD 50.7bn (or 13.1% of GDP) in the fiscal year ending June 30, 2023, and USD 54.1bn in 2024 (14.6% of GDP), among the largest worldwide, exceeding FX reserves
- ✓ Financing inflows from the IMF and other IFIs should cover just a small portion of external financing needs
- ✓ Under more conservative, and we believe, realistic assumptions for FDI (including privatization proceeds) than the official ones, there remains a significant external financing gap to be covered
- ✓ Worryingly, other available financing sources remain limited and expensive, amid tightening global financing conditions, on the one hand, and increasing uncertainty over the actual pace of Egypt's economic and financial rebalancing, on the other hand
- ✓ Against this backdrop, we expect a critical part of the remaining external financing gap to be covered by GCC countries and other parties (either in the form of deposits with the CBE or bilateral loans). Although there are increasing signs of departure from GCC's traditional policy of almost unconditional support to Egypt, we still believe that they would act as "lenders of last resort", although we recognize that risks are skewed to the downside
- ✓ Still, there remains an external financing gap to be covered (estimated at c. USD 0.5bn and USD 2.0bn in FY:22/23 and FY:23/24, respectively), suggesting that further EGP depreciation is in the pipeline



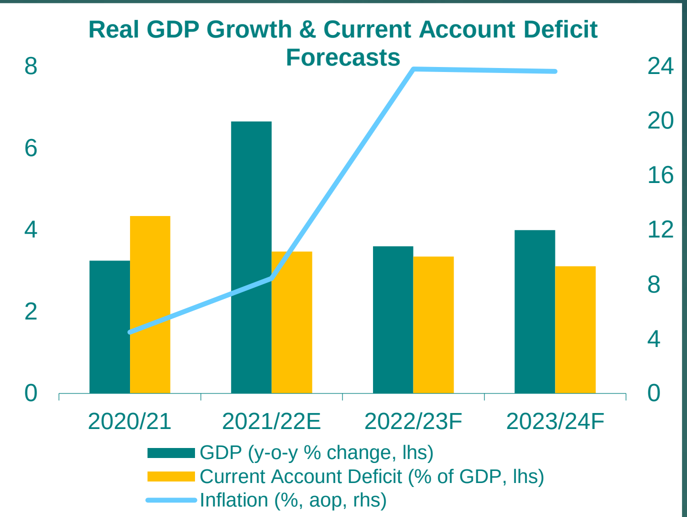


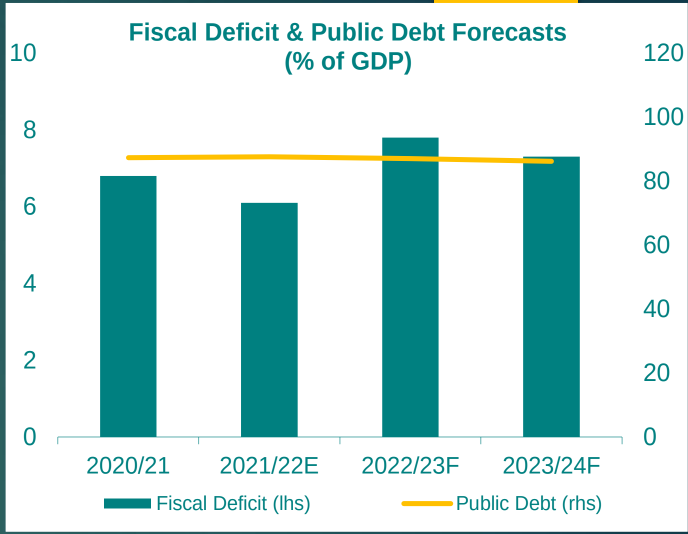
* 4-quarter rolling Current Account Deficit & Short-term debt & Long-term debt maturing over next 4 quarters

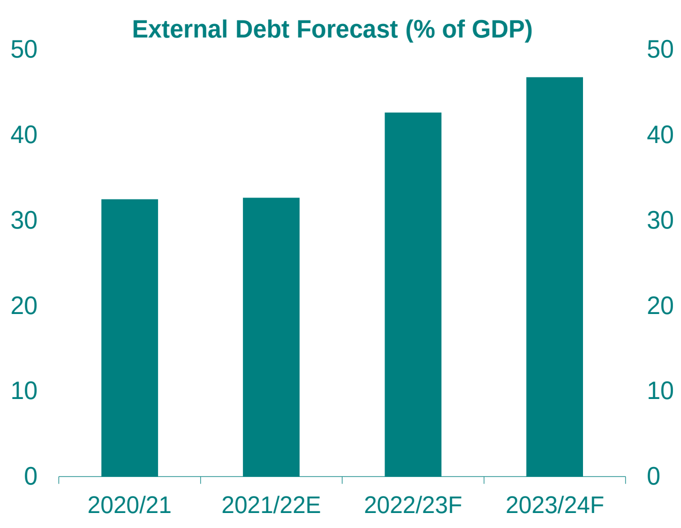
Sources: CBE, IMF & NBG estimates

"… still, Egypt should avoid a full-blown balance of payments crisis …"

- ✓ As a result, we project the EGP weakening by a further 15% against the USD by June '24 to reach 36.0 (implying a c. 40% depreciation of the EGP in REER terms since the beginning of 2022), with Egypt avoiding, however, a full-blown balance of payments crisis
- ✓ Against this backdrop, we expect the CBE to maintain its tightening bias. Besides cooling down domestic demand and anchoring inflation expectations (albeit with limited effectiveness, due to the very low lending penetration rate -- 27% of GDP), high interest rates should lure foreign investors to Egypt's debt market, helping to close the external financing gap
- ✓ All said, we see GDP growth moderating to 3.6% in FY:22/23, reflecting, *inter alia*, poor economic sentiment and the impact of disruptions in domestic supply chains caused by FX shortage. Assuming successful implementation of economic reforms, GDP growth should firm to 4.0% in FY:23/24, slightly below its long-term potential
- ✓ Importantly, the small share of FX liabilities in total public debt stock and high nominal GDP growth mean that the gross public debt-to-GDP ratio is set to remain at current -- yet elevated -- levels over the forecast period, despite large budget deficits (with lower public investment largely offsetting higher social spending)
- ✓ Similarly, albeit affecting external debt, the weaker EGP should not threaten its sustainability, in view of the latter's small size (32.7% of GDP in June 2022, well below that of Egypt's peers)



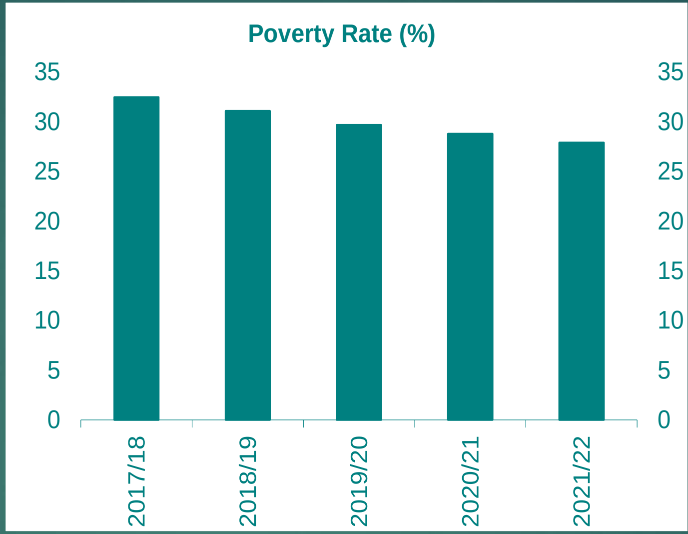


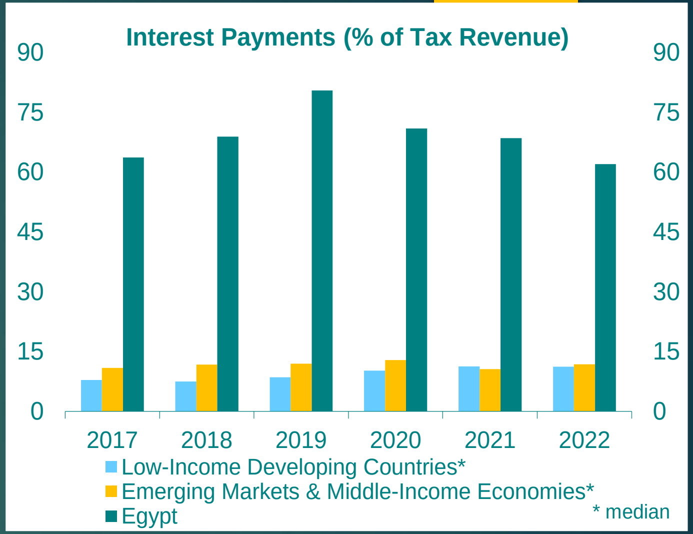


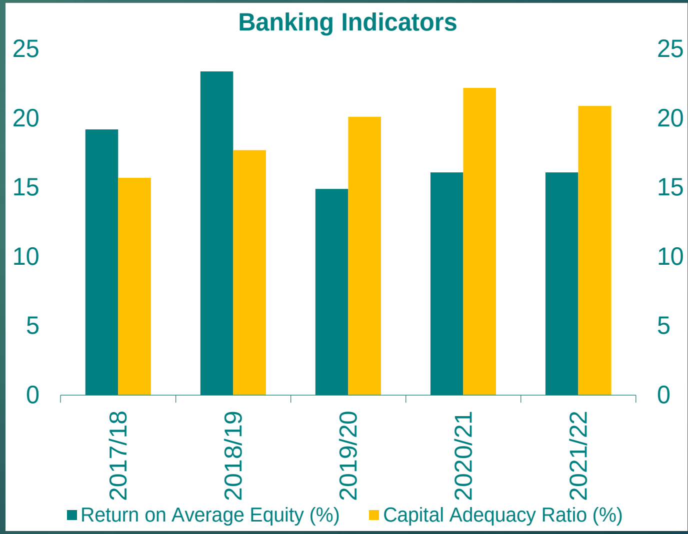
Sources: CAPMAS, CBE, Ministry of Finance & NBG estimates

“… however, risks are tilted to the downside, reflecting a fragile social environment, high public debt and the banking sector’s significant exposure to the latter”

- ✓ Amid a highly fragile social environment, risks to the economic outlook are clearly tilted to the downside, mainly due to the need to proceed with difficult -- yet necessary -- policy adjustments, which need time to implement and deliver results. Note that c. $^{1}/_{3}$rd of the country’s over 100mn population falls below the poverty line. To this end, it is important that authorities strengthen social safety nets, while maintaining fiscal prudence
- ✓ Indeed, the growing share of budget revenue committed to interest payments could put public debt’s sustainability at risk, in view of the latter’s already high level
- ✓ Worryingly, tighter financing conditions could stress financial stability, in view of the strong sovereign-bank nexus (with banks holding 60% of public debt, equivalent to c. 40% of their assets). At the same time, rising interest rates and the weaker EGP cannot but stress the private sector’s debt repayment capacity (with the low NPL ratio – currently standing at 3.4% -- offering, however, a favourable starting point). Encouragingly, private banks’ high regulatory capital buffers and strong internal capital generation capacity should provide some cushion to these risks
- ✓ Other downside risks stem from the ongoing crisis in neighbouring Sudan, which has been already resulted into a significant influx of refugees, and a potential escalation of tensions with Ethiopia over the Grand Renaissance Dam, the building of which risks draining river Nile







Sources: CAPMAS, CBE, IMF & NBG estimates

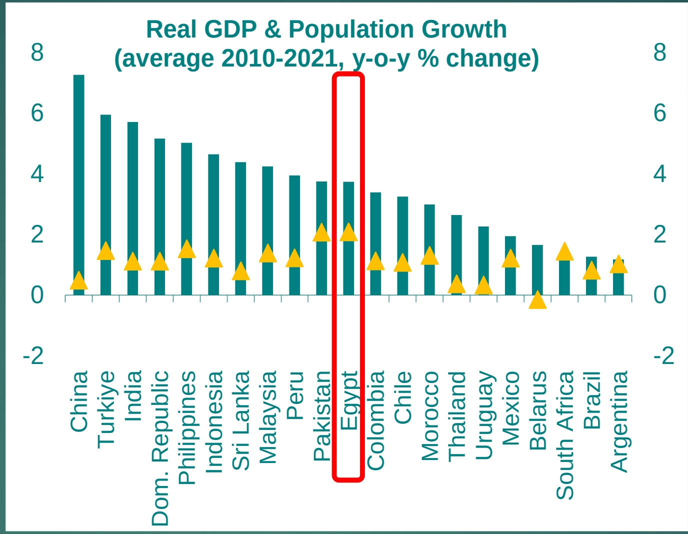
- Looking further ahead, the challenge for the authorities is to unlock the economy's potential for higher growth, stemming, *inter alia*, by its large domestic market, with a young and growing population, and its particularly advantageous location between Middle East and African markets. The latter, together with still low labour costs and the country's strong energy position (with abundant gas reserves and a surplus in power production, offering an important potential for higher RES production and exports), could provide Egypt a significant competitive advantage, especially in the current context of the energy crisis and reorientating global value chains
- In this regard, authorities' efforts should mainly focus on:

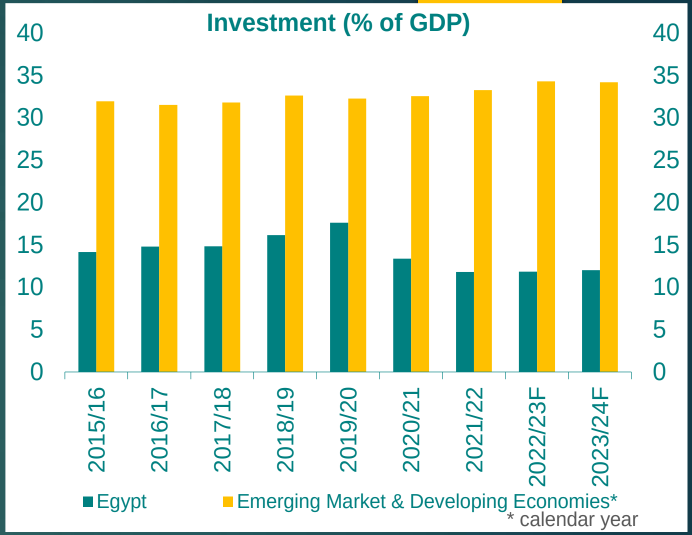
a. reducing the crowding out of the private sector from the public sector (with the latter accounting for c. 30% of GDP, while employing almost 2 times more workers than the official private sector), while putting emphasis on the expansion of non-energy activities, mainly through targeted investment initiatives (note that investment in the sector currently account for a mere $^1/_3$rd of total investment, well below Egypt's peers) and reforms aiming at improving the subpar business environment; and

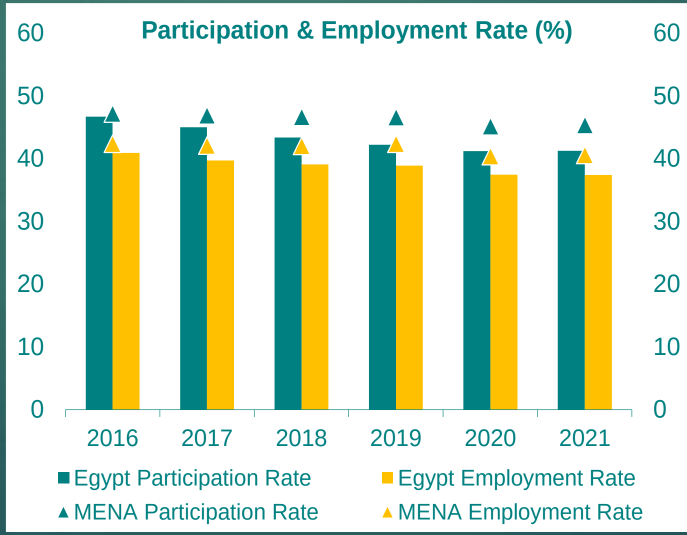
b. increasing labour force participation and employment (especially for young people and women who are under-represented in the labour market), through, *inter alia*, educational reforms and activation policies

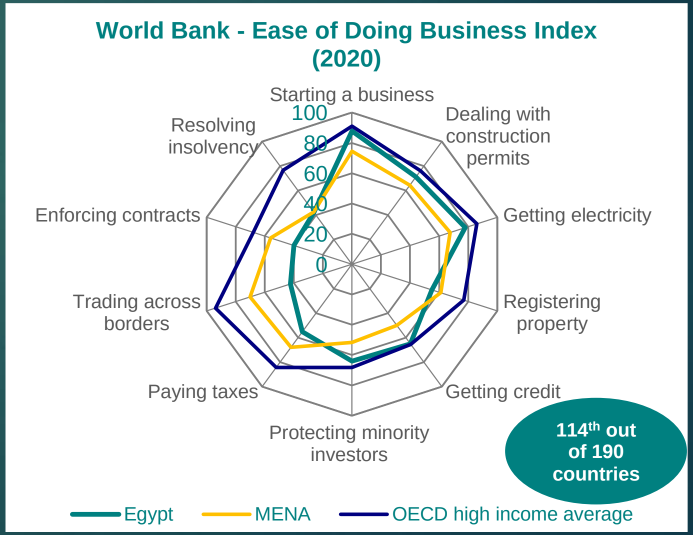
- All said, shifting to a more inclusive and sustainable growth model, relying on investment and exports, should also help to narrow external imbalances, leading, *inter alia*, to external financing inflows of higher quality
- Such an economic growth model would also help to reduce poverty, providing, in turn, relief to fiscal accounts. Measures tackling the very large informal economy (accounting for c. ½ of actual employment) could also help to this end

"Egypt has strong upside potential for growth"









Sources: CBE, IMF, WB & NBG estimates

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