NATIONAL BANK OF GREECE

Economic Analysis Division
Emerging Markets Analysis

Special Issue

Special Issue: Egypt

"Despite vulnerabilities, Egypt should avoid a full-blown balance of payments crisis"

NBG - Economic Analysis Division

Emerging Markets Analysis

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Egypt in the pre-COVID-19 era

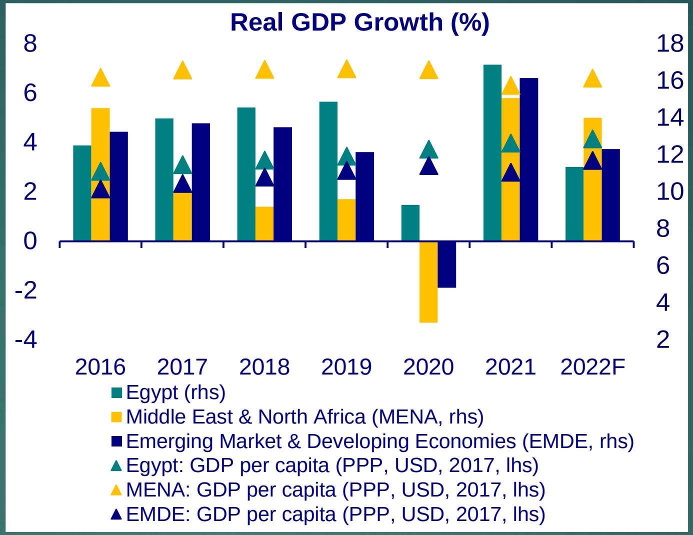
Egypt under the strain of COVID-19 & the Russia-Ukraine conflict

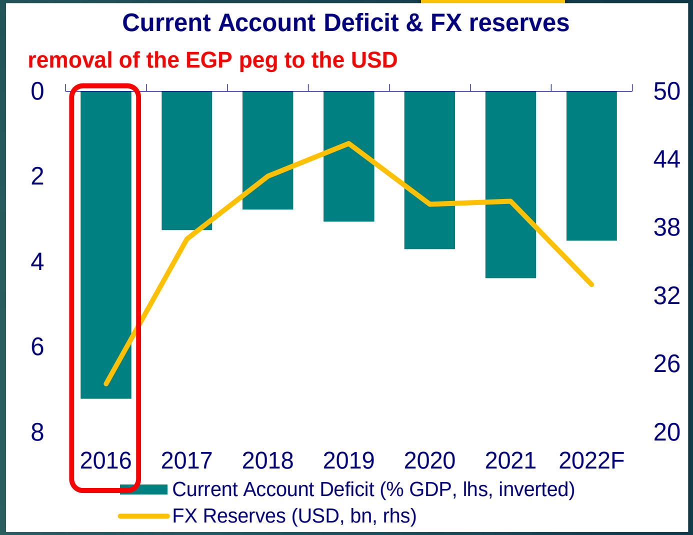
Outlook

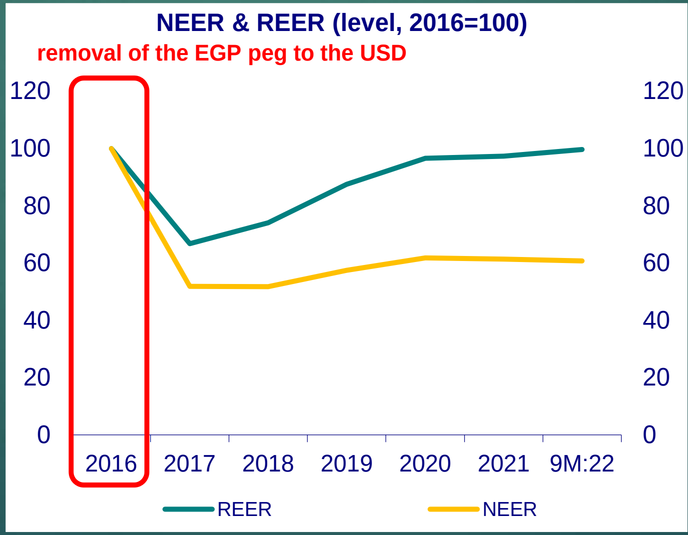
Egypt in the pre-COVID-19 era

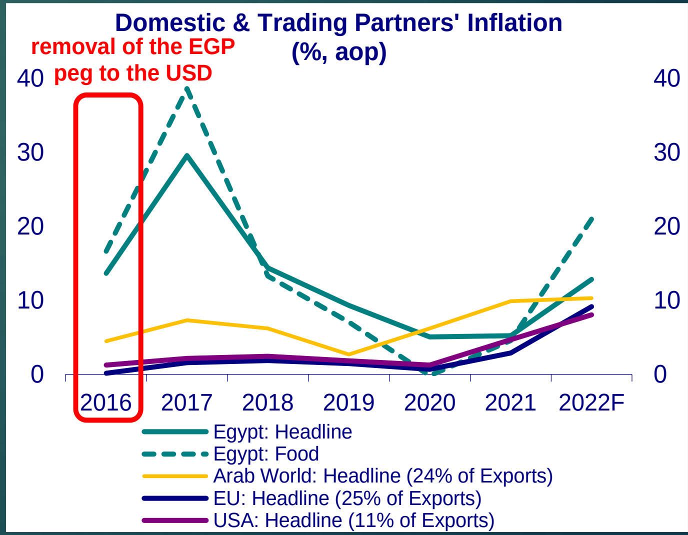
"Egypt was one of the fastest growing emerging markets in pre-COVID-19 times, yet lagging behind its peers"

- ✓ A key factor behind Egypt's solid macroeconomic performance prior to the pandemic were the critical reforms carried out under the auspices of the IMF in 2016-19 (incl. the floating of the Egyptian Pound, EGP, and efficient implementation of fiscal consolidation measures), which promoted a more inclusive growth model, while helping to correct external and domestic imbalances
- ✓ In this context, Egypt's growth structure started to shift from consumption towards exports and investment, with non-tradable sector, however, still dominating economic activity
- ✓ At the same time, following the sharp depreciation of the EGP (by c. 50%) in 2016, a substantial external adjustment 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 (initiated at end-2018) 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)
- ✓ Nevertheless, authorities' bias towards FX stability, mainly with a view to containing inflationary pressures, quickly eroded the competitiveness gains derived from the 2016 EGP depreciation
- ✓ 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, reflecting the impact of an accommodative domestic monetary policy as well as of structurally high food inflation (accounting for c. 45% of variations in headline inflation). The latter is mainly attributed to deficiencies in the domestic agricultural sector (including low yields, limited storage capacity and poor transport links)









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

Egypt in the pre-COVID-19 era

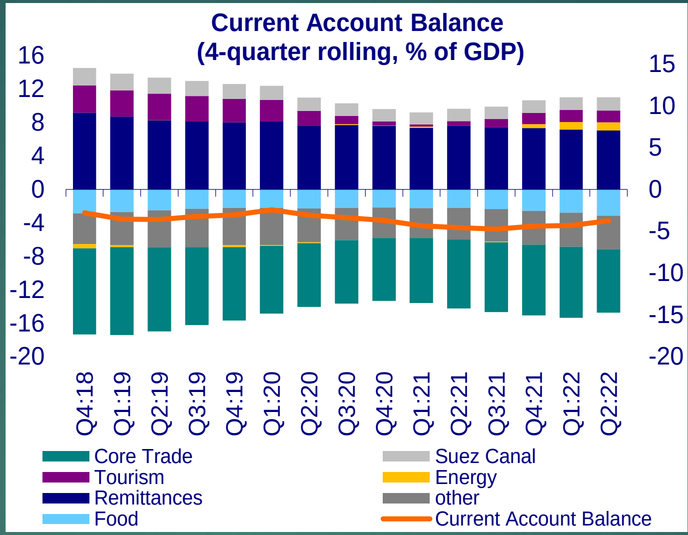
Egypt under the strain of COVID-19 & the Russia-Ukraine conflict

Outlook

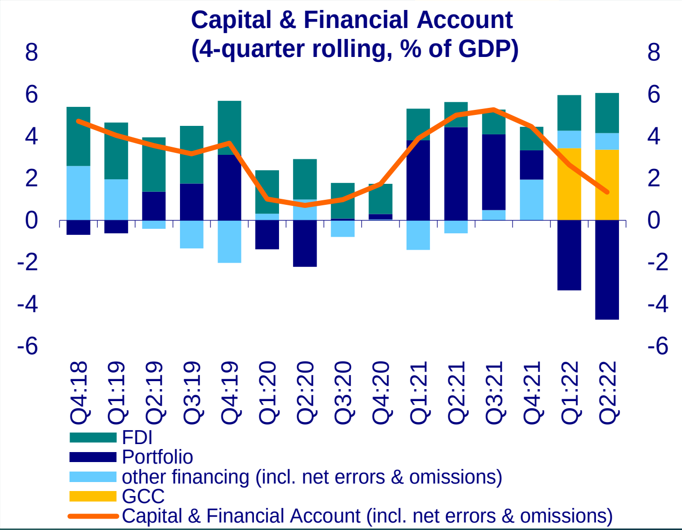
"External pressures in the aftermath of COVID-19 and the Russia-Ukraine conflict eroded the buffers Egypt had built …"

- ✓ In the wake of COVID-19 outbreak and the subsequent Russia-Ukraine conflict, Egypt has been faced with an abrupt worsening of external imbalances, reflecting a widening current account deficit (CAD), on the one hand, and deteriorating financing conditions, on the other hand
- ✓ Specifically, the sharp drop in tourism inflows along with decreases in Suez Canal receipts and remittances (mainly from workers in Gulf countries) took a significant toll on the current account deficit during the pandemic
- ✓ More recently, the jump in global food prices, in the aftermath of the Russia-Ukraine conflict, has put additional pressure on external accounts, due to the country's reliance on imports to cover its basic food needs (note that Egypt is the largest global wheat importer). The plunge in arrivals from Russia and Ukraine (combined accounting for a sizeable 30% of total arrivals) has also added weighed on the CAD. The latter would have been larger, had Egypt -- in its capacity as a being a net exporter of natural gas -- not benefited from the hike in global gas prices. Still, the implied energy trade surplus covered less than ⅓rd of the food trade deficit
- ✓ At the same time, there has been a sizeable capital flight (mainly in the form of portfolio withdrawals, with portfolio investment having traditionally been a key source of FX funding) from Egypt (and other EMs), reflecting increased risk aversion worldwide, following the outbreak of COVID-19, in the first place, and the subsequent commodity-driven inflationary shock caused by the Russia-Ukraine conflict and the associated hawkish turn by central banks globally

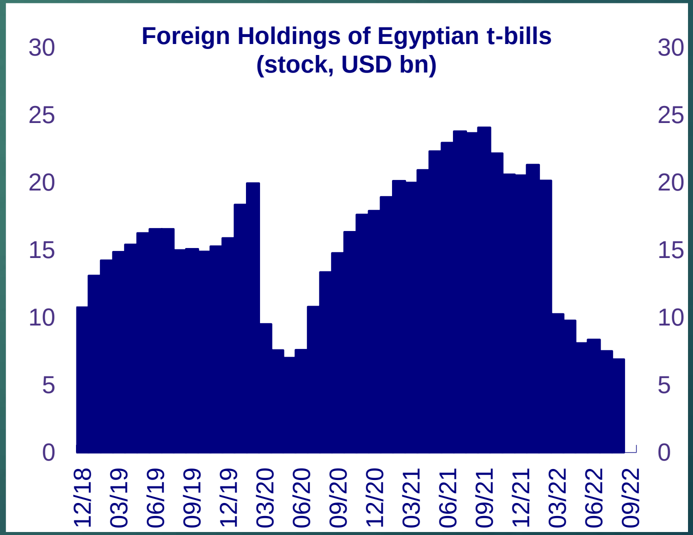
Current Account Balance (4-quarter rolling, % of GDP)



Capital & Financial Account (4-quarter rolling, % of GDP)



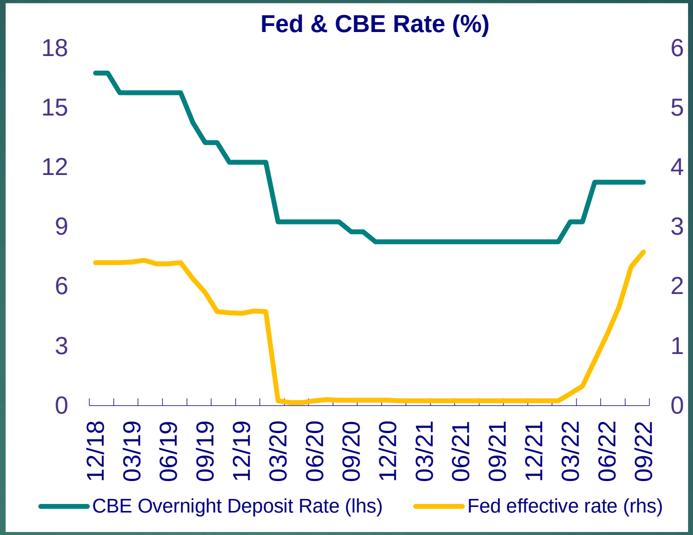
Foreign Holdings of Egyptian t-bills (stock, USD bn)

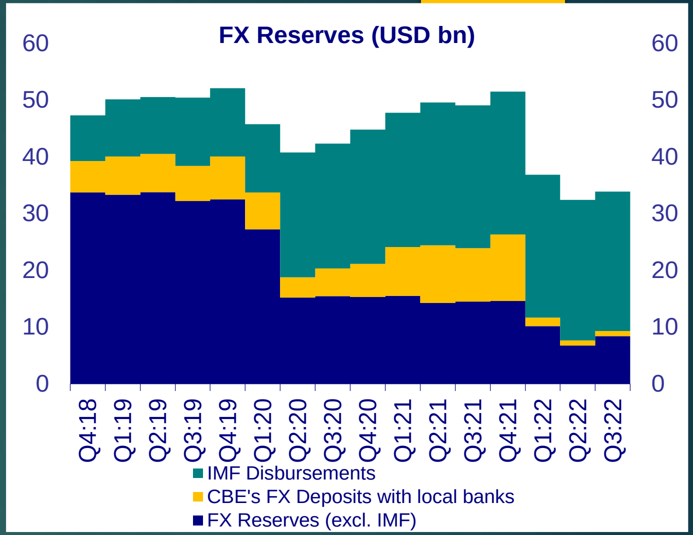


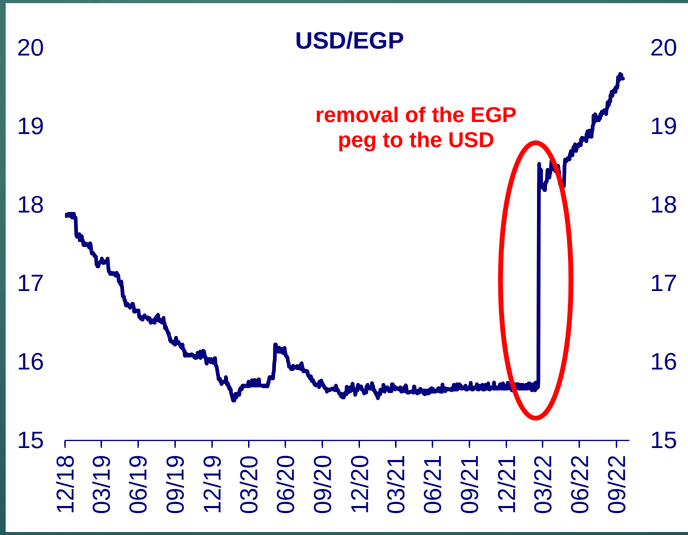
Sources: CBE & NBG estimates

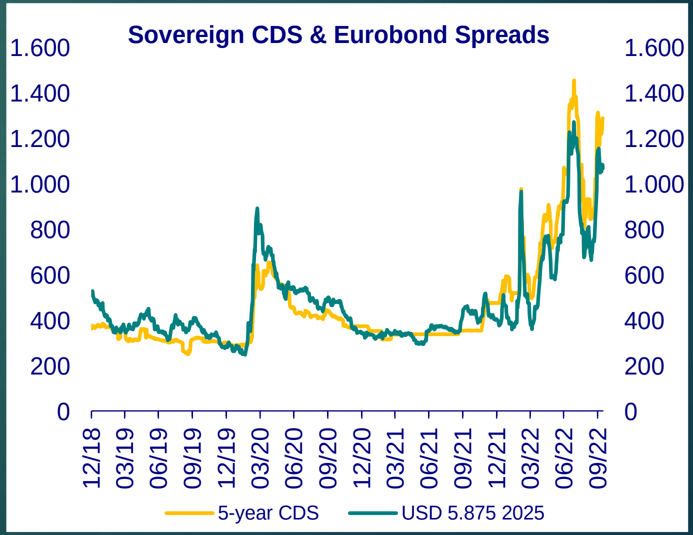
"… forcing the CBE to break the EGP's peg with the USD"

- ✓ Market concerns over Egypt's widening external financing gap and the lack of a decisive policy response (with the CBE having raised its key rate by 300 bps between March and May and then opting for indirect policy tightening, through, *inter alia*, hikes in banks' reserve requirements) exacerbated further external financing pressures
- ✓ Besides strong downside risks to economic growth, a key factor behind the CBE's reluctance to hike rates further has been its bid to keep public debt servicing costs subdued (with the latter making up around $^{1}/_{3}{}^{rd}$ of total budget spending or c. 9.0% of GDP)
- ✓ Note that Egypt's FX needs would have been much larger without the significant non-market financing support received from the Gulf Cooperation Council (GCC) countries (amounting to c. USD 15bn in FY:21/22)
- ✓ Against this backdrop, FX reserves have depleted rapidly over the past 2 years (hitting a 5-year low of USD 33.2bn in September -- or a mere USD 8.6bn adjusted for IMF disbursements), testing the CBE's capacity to maintain the EGP's *de-facto* peg with the USD. The latter eventually broke in March 2022, with the CBE allowing the EGP to depreciate by 15.0% against the USD. Pressures on the currency have not eased since then, widening the currency's y-t-d losses to 20.0%
- ✓ Note that authorities' tight control over the FX market, through the imposition, *inter alia*, of import restrictions since March, has allowed the EGP to depreciate at a controlled pace. At the same time, Eurobond spreads and sovereign CDS have surged to record-high levels









Sources: CBE, Reuters & NBG estimates

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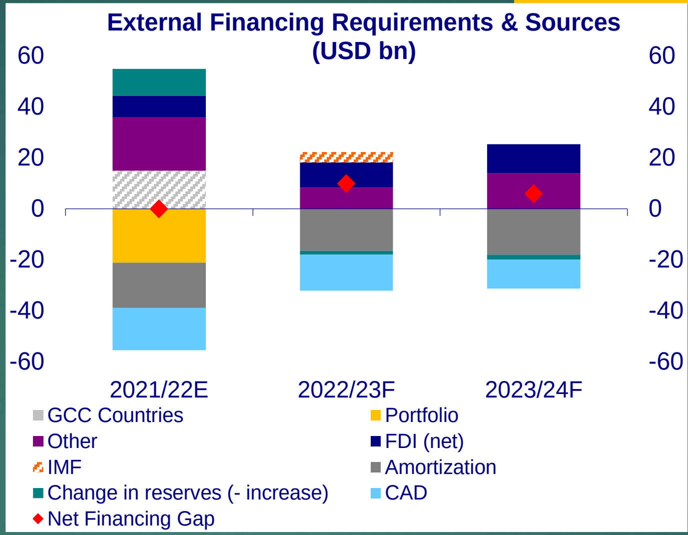
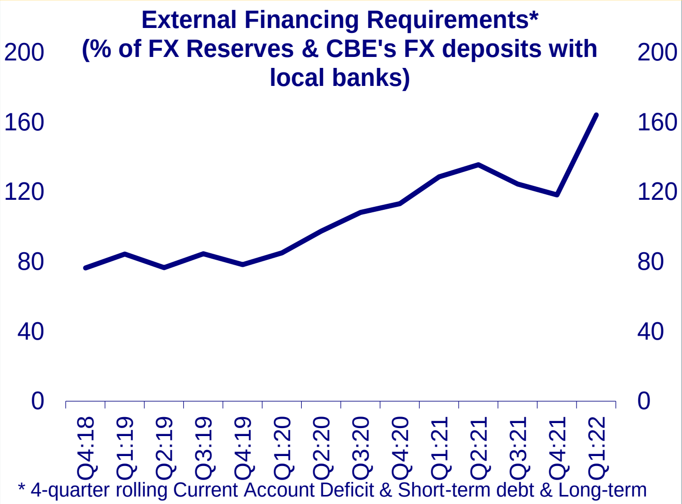
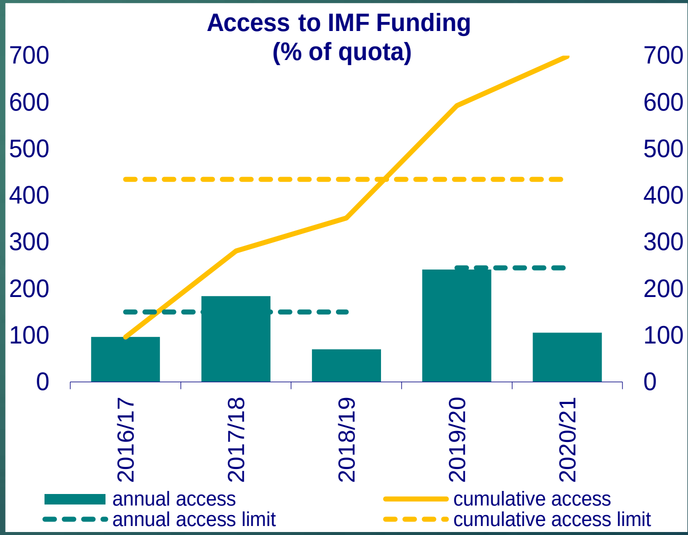
"EGP depreciation should bear most of the burden of the necessary external adjustment…"

- ✓ Total external financing needs to cover the CAD and the external debt repayments looming ahead are projected at a sizeable USD 34.0bn (equivalent to 7.9% of GDP, among the highest worldwide) through June 2023 (i.e. the end of Egypt's fiscal year), exceeding the current level of FX reserves
- ✓ Worryingly, available financing sources remain limited, despite continuing support from GCC countries. Indeed, amid heightened uncertainty and tightening global financing conditions, private FX financing flows are unlikely to revive soon, especially in the absence of a bold policy response by domestic authorities
- ✓ The implied, still sizeable FX financing gap (estimated at c. USD 10.0bn in FY:22/23) suggests that a further depreciation of the EGP is in the pipeline
- ✓ Part of this gap is due to be covered by the IMF, with related negotiations having begun since March and a staff-level agreement between the two sides being reportedly on the cards
- ✓ In any case, the IMF is likely to cover just a small portion of this gap (with latest reports pointing to a loan facility worth up to USD 4.0bn), given Egypt's large outstanding obligations, exceeding (both the cumulative and annual) access limits, with the country currently being the Fund's 2nd largest borrower after Argentina
- ✓ Note that FX flexibility is considered a *sine qua non* condition for a new agreement with the IMF to be sealed
- ✓ In this context, monetary policy is also expected to tighten, facilitating the ongoing external adjustment, while helping to tame inflation





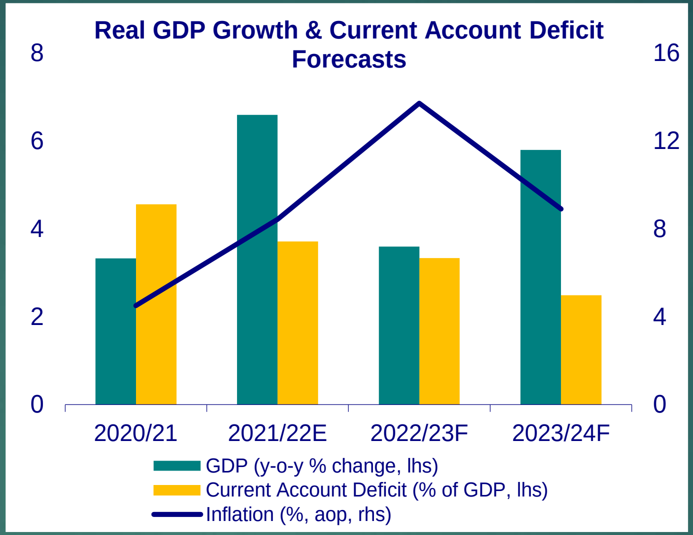
* 4-quarter rolling Current Account Deficit & Short-term debt & Long-term debt maturing over next 4 quarters

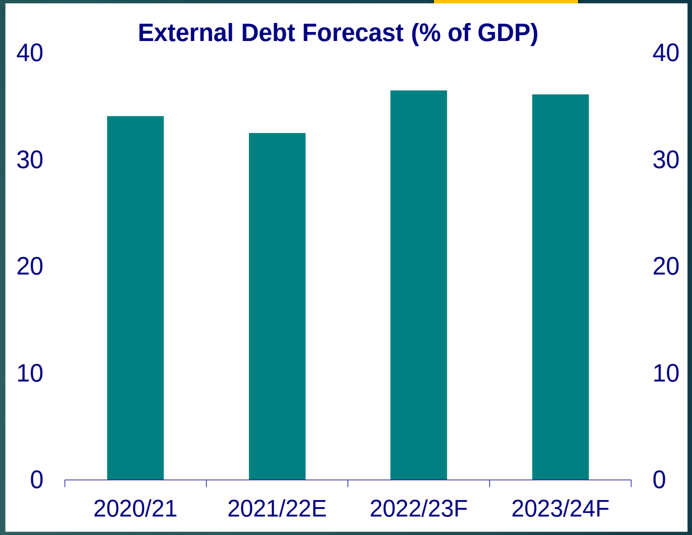


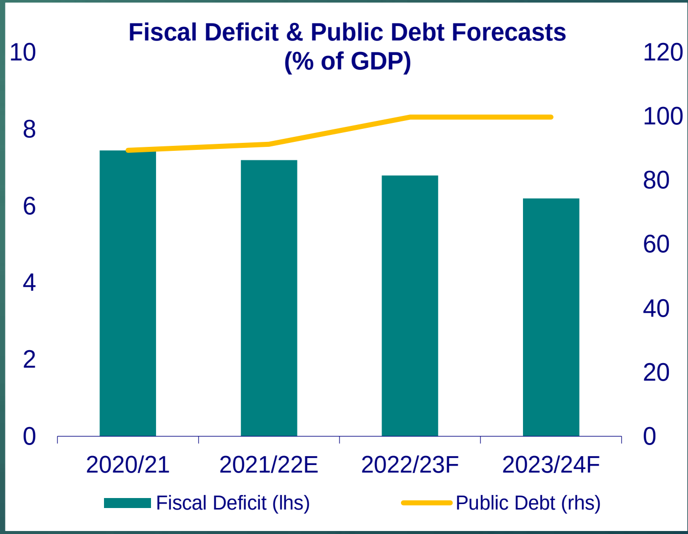
Sources: CBE, IMF & NBG estimates

“…helping Egypt to avoid a full-blown balance of payments crisis”

- ✓ Under our baseline scenario, we project the EGP weakening by a further 8.0% against the USD by mid-2023 to reach 21.5 (implying a c. 10% depreciation of the EGP in REER terms since the beginning of 2022), with Egypt avoiding, however, a full-blown balance of payments crisis
- ✓ Worryingly, the depreciation of the EGP comes against an unfavourable backdrop, fueling further the already elevated inflation, and thus weighing on economic growth
- ✓ Importantly, the weaker EGP should not threaten external debt sustainability, in view of the latter's small size (standing at 32.5% of GDP in June 2022, well below that of Egypt's peers)
- ✓ On the contrary, the weaker EGP should push the already elevated gross public debt even higher, close to the alarming rate of 100% of GDP. To safeguard public debt sustainability, it is essential for Egypt to embark on a continued fiscal consolidation path
- ✓ Assuming some easing in global price pressures next year, economic growth is due to rebound and the current account start narrowing
- ✓ Looking further ahead, the economy is expected to embark on a more sustainable growth path, with Egypt's long-term potential growth rate estimated at c. 4.0%
- ✓ At the same time, Egypt should be able to rebuild its FX reserves, strengthening the economy's resilience to external shocks





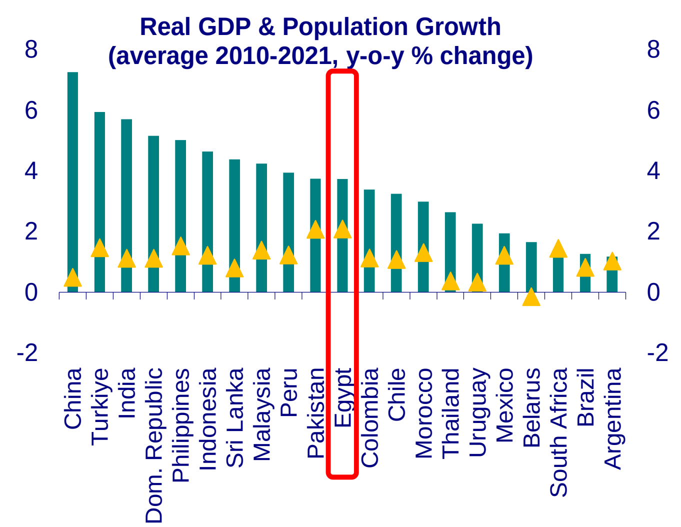


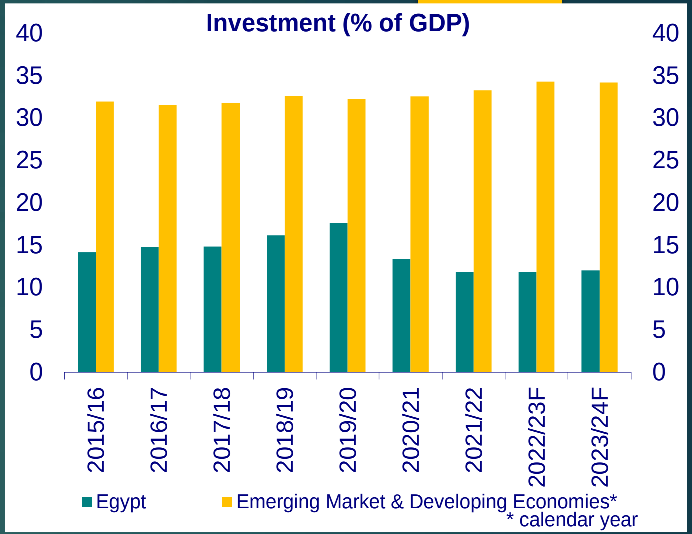
Sources: NBG estimates

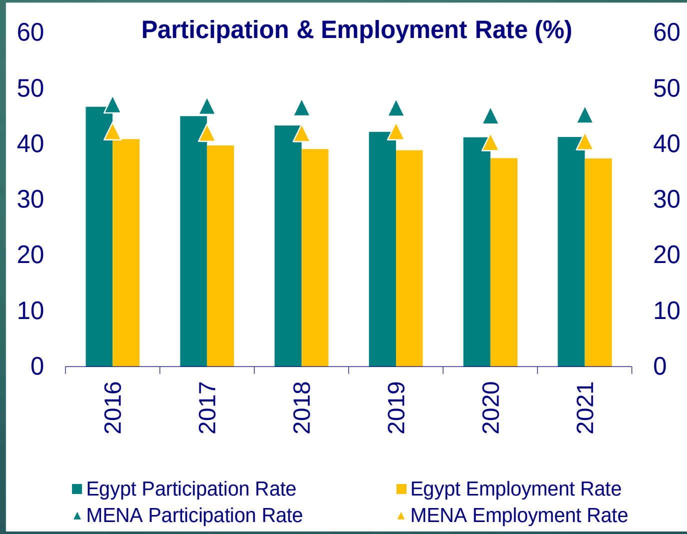
Outlook

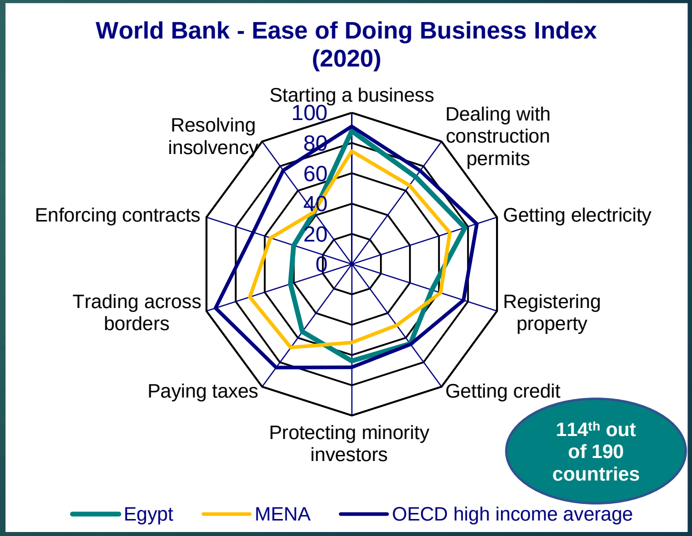
- ✓ Looking further ahead, the challenge for the authorities is to unlock the economy's potential for higher growth, stemming, *inter alia*, by its large domestic market, with a young and growing population, and its particularly advantageous location between Middle East and African markets. The latter, together with still low labour costs and the country's strong energy position (with abundant gas reserves and a surplus in power production), could offer 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:
  - 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
  - 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, including stronger FDI inflows
- ✓ Such an economic growth model would also help to reduce poverty (with c. ⅓rd of population currently living below the official poverty line), 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

Disclosures

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