COUNTRY NOTE: EGYPT

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GlobalEvolution

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We conducted a due diligence trip to Cairo in Sep 24. We arrived around 6 months after the end of a protracted currency crisis. The solution involved coordinated international support, especially from regional partners. The resumption of the Arab-Israeli conflict appears to have focused minds over the importance of Egypt to regional stability. Yet Egypt's too important to fail status arguably contributes to the glacial pace of reforms. The government suggests there is now greater commitment to reducing the economic role of the state (and the army) and promoting the private sector to accelerate growth and resuscitating fragile public finances. Perhaps the litmus tests will be the success of the privatization and market pricing in fuel and energy. The other key test will be the commitment to more market-based policy in both FX and domestic interest rates. The huge depreciation and sharp increase in nominal interest rates in Mar 24 has gone someway to restore short-term currency confidence: ongoing high levels of dollarization suggest Egyptian are still to be convinced.

Stephen Bailey-Smith, Senior Economist

Politics: too important to fail

As the most populus country in the Middle East, Egypt has always been seen as too important for regional security to fall into economic chaos. With the Egyptian economy struggling under the weight of excessive public debt, the latest regional conflict between Israel and its neighbours, proved timely in so much as it focused the international community's mind to come up with an economic package large enough to resuscitate the failing economy.

Although long in the making, the timing of the announcement of the UAE's USD35.0bn purchase of land in Raz El Hekma in late Feb 24 was critical. In combination with a multilateral donor coordinated aid package and better monetary policy, the financial flows were sufficient to improve investor confidence.

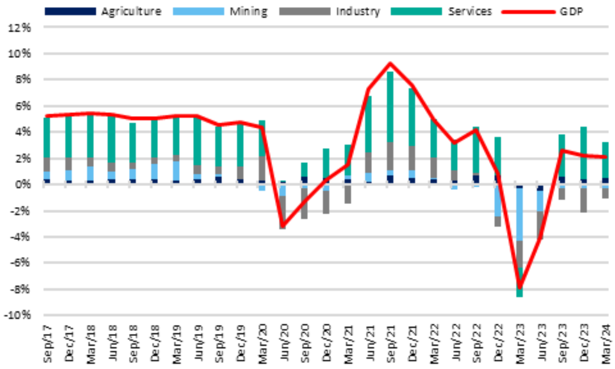
In some ways, the unwavering international and especially the regional community's commitment to keep Egypt afloat may explain the glacial pace of political and economic reform. While the government suggests this time it is different, and they will promote the private sector: proof is in the pudding. Importantly, the quid pro quo for state-sponsored but essentially private sector regional investment appears a more level playing field for foreign investor against local agents including the army, which still dominated much of Egypt's economy.

Economic growth: rebalancing

Real GDP growth has averaged around 4.0% y/y over the last decade. After slowing in 2020 to 1.5% y/y, real GDP growth bounced to 6.7% y/y in 2021 before normalizing to 4.2% in 2022 and declining to 2.9% y/y in 2023. The slowdown was arguably the product of a poor policy response to COVID, which fostered a currency crisis and huge macroeconomic instability.

Action to sort out the mess in early 2024 will foster faster growth further out but has undermined activity in 2024. While allowing a clearing FX market freed up the real economy, it was associated with a sharp tightening in interest rates. On the 6 Mar 24 the Central Bank of Egypt (CBE) raised its policy rates another 600bps to 27.5%. The timing coincided with the end of elections, an augmented IMF sponsored aid package and a huge FDI inflow (USD35.0bn) from UAE for the purchase of land in Ras El-Hekma.
Although fiscal policy is likely to remain tight going forward, we do see stimulus from monetary policy in late 2024 and through 2025. Moreover, the investment flows into the Ras El-Hekma development will likely prove another key growth node, while payment made to the state will be used for FX reserves to help preserve macroeconomic stability. The Gaza insecurity has undermined growth via tourism and more importantly Suez Canal receipts.

GDP growth (y/y): subdued



Source: Haver, Global Evolution

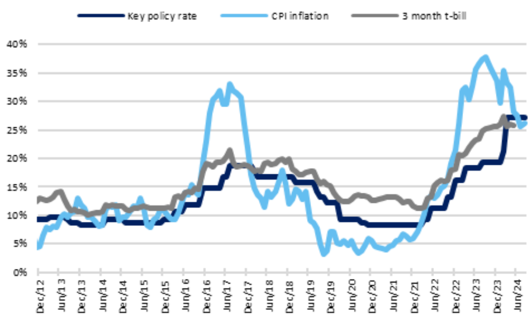
Monetary policy: easing on its way

The inappropriate policy response to COVID left Egypt in macroeconomic crisis with inflation averaging 34.1% y/y between Feb 23 and Apr 24. Ironically, the move in early Mar 24 to depreciate the official currency rate and unify the segmented FX market had limited effect on inflation, suggesting that much of the FX market was transacting in the unofficial market anyway.

The CBE also significantly raised their reference rate 600 bps to 27.25% in Mar 24. Inflation has fallen to 26.2% y/y in Aug 24, while the CBE has left its policy rate on hold, turning the policy rate positive in real terms ex-post for the first time since Feb 22.

Inflation will likely remain sticky through to Feb 25, when base affects will foster a large decline in the y/y rate. Disinflation will be assisted by likely currency stability, fiscal compression and ongoing weak domestic demand but will not be helped by the ongoing removal of energy and fuel subsidies. The CBE see inflation returning to its 7.0% target by late 2026.

Real interest rates: positive again



Source: Haver, Global Evolution

USD/EGP: cobra formation

Source: Bloomberg, Global Evolution

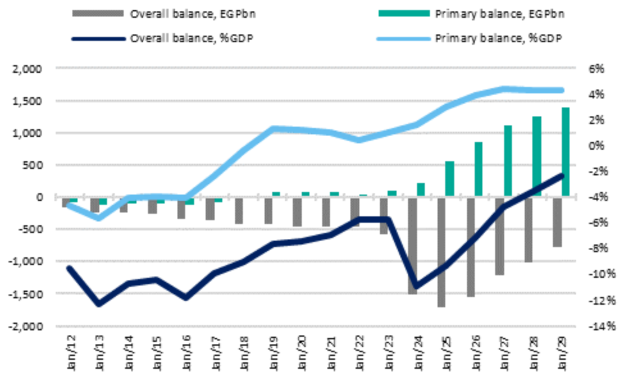
Although a flexible exchange rate is part of the IMF agreement, the CBE still prefers USD/EGP stability and sees USD as a scarce resource to be rationed and saved, albeit there did appear to be a commitment to prevent rationing and segmentation seen in the past.

Fiscal policy: interest-sting

Based on preliminary nominal GDP, the budget deficit for FY24 (ending Jun 24) was 3.6% of GDP with a primary surplus of 6.1% of GDP. This compares to a deficit of 7.8% of GDP and a primary surplus of 1.7% of GDP in FY22/23.

The improvement must be seen in the light of three important factors. First, revenues were elevated by USD12.5bn (3.1% of GDP) of the Raz El-Hekma cash. Second, super high inflation (nominal GDP) gave the government room to reduce expenditure growth relative to revenue growth with less political pain, albeit building latent wage pressures. Third, high T-bill yields and depreciation led to a doubling in interest payments in nominal terms, which used up almost half the government’s spending.

Budget balance: planned trend improvement



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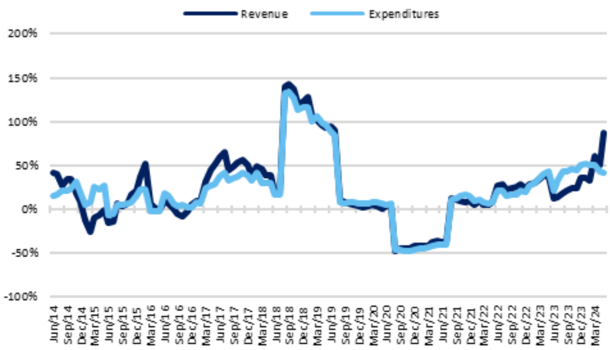
Revenue and expenditure (12m y/y)



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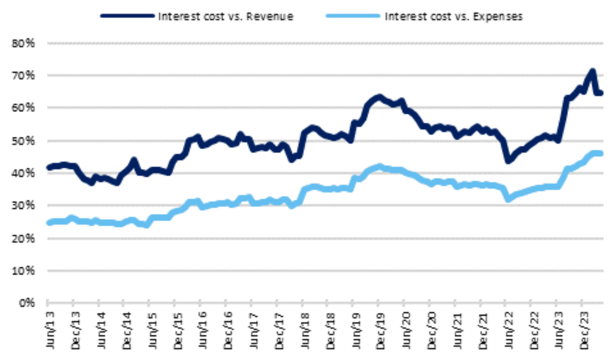
The FY24/25 budget approved by parliament in early Jun 24 targets a primary surplus of 3.5% of GDP, exclusive of divestment proceeds. The budget has revenues increasing 1.0% of GDP, with 0.7% from tax revenues and 0.3% non-tax revenues.

Primary expenditure will be reduced by 0.5% of GDP, not least from reduced subsidies. Divestment proceeds of 1.0% of GDP will be used to reduce public debt. Consolidation of the different government agencies into consolidated public sector accounts is being undertaken to streamline public finances.

Interest cost (12m): the elephant in the room



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Public debt: tricky

Continued fiscal consolidation and primary surpluses will be required to safeguard debt sustainability. Public debt (including the CBE's external debt) was around 120.0% of GDP in 2023: with external debt accounting for 32.0% of GDP.

Even though the sharp devaluation in Mar 24 will take external public debt to around 35.0% of GDP, it is still not the key source of public finance concerns (not least because the majority of it is concessional bilateral or multilateral)

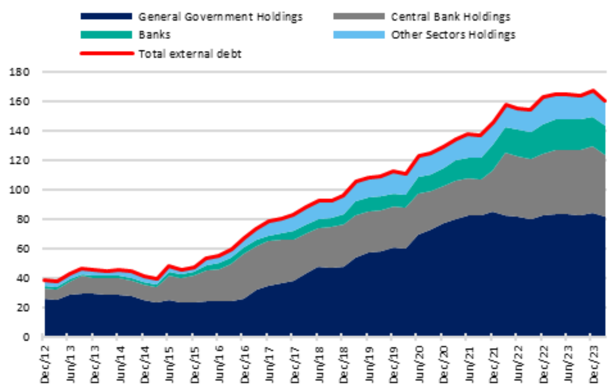
Nevertheless, given recent experience with USD shortages and depreciation elevating servicing costs, the authorities are committed to capping net external public sector borrowing going forward.

Indeed, public external debt fell to USD123.3bn in Q1:24 from USD130.2bn in Q4:23 as the authorities used part of the Raz El-Hekma cash to paydown debt and deposits at the CBE. However, most of the interest costs that used 50.0% of expenditure in FY23/24 went to domestic debt.

Interestingly, of the roughly EGP10.0tr domestic debt some EGP2.2tr is owned by the CBE and is being rolled at policy rate plus 3.0%. A securitization of these instruments into longer low interest-bearing bonds (or zeros) would significantly improve the debt service burden.

Foreign holdings of domestic debt are estimated at around USD16.0bn or around 5.0% of total.

Gross external debt (%GDP):



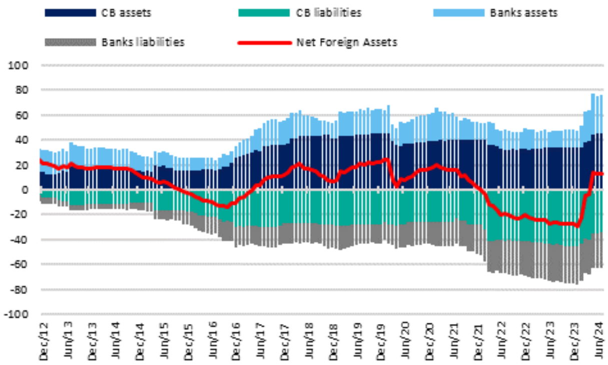
Source: Haver, Global Evolution

Balance of Payments:

The CBE's net FX reserve position was negative USD12.5bn in Jan 24. This has been restored to a positive USD10.0bn by Jun 24. The improvement has been the product of higher rates and sharp EGP depreciation fostering both large FDI and FPI inflows, which were accompanied by significant bilateral and multilateral flows.

The depreciation should also assist the Current Account (CA) that registered a deficit of USD16.5bn in 12m to Mar 24. There has been a sharp improvement in remittances, tourism will benefit from the cheap EGP despite regional insecurity, although Suez receipts look set to struggle due to maritime security threat from Houthi fighters in Yemen.

Net external assets: back in black



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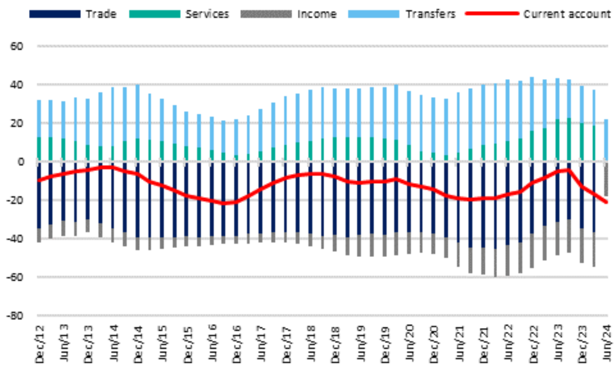
The injection of competitiveness will likely improve the trade balance, assisted by lower public investment spending, low domestic demand and lower oil prices. Yet the opening-up of the FX market led to large outflows of previously trapped corporate dividends and loan repayments.

Dollarization rates have not changed suggesting still weak EGP confidence, despite high and now positive real interest rates. Nevertheless, it is likely that the improvement in the Balance Of Payments (BOP) and reserves accumulation continues in 2024 and through 2025. Raz El-Hekma will likely increase imports from 2026 but will be fully funded and arguably net positive for the BOP.

Current account (4q sum, USDbn): set to improve



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