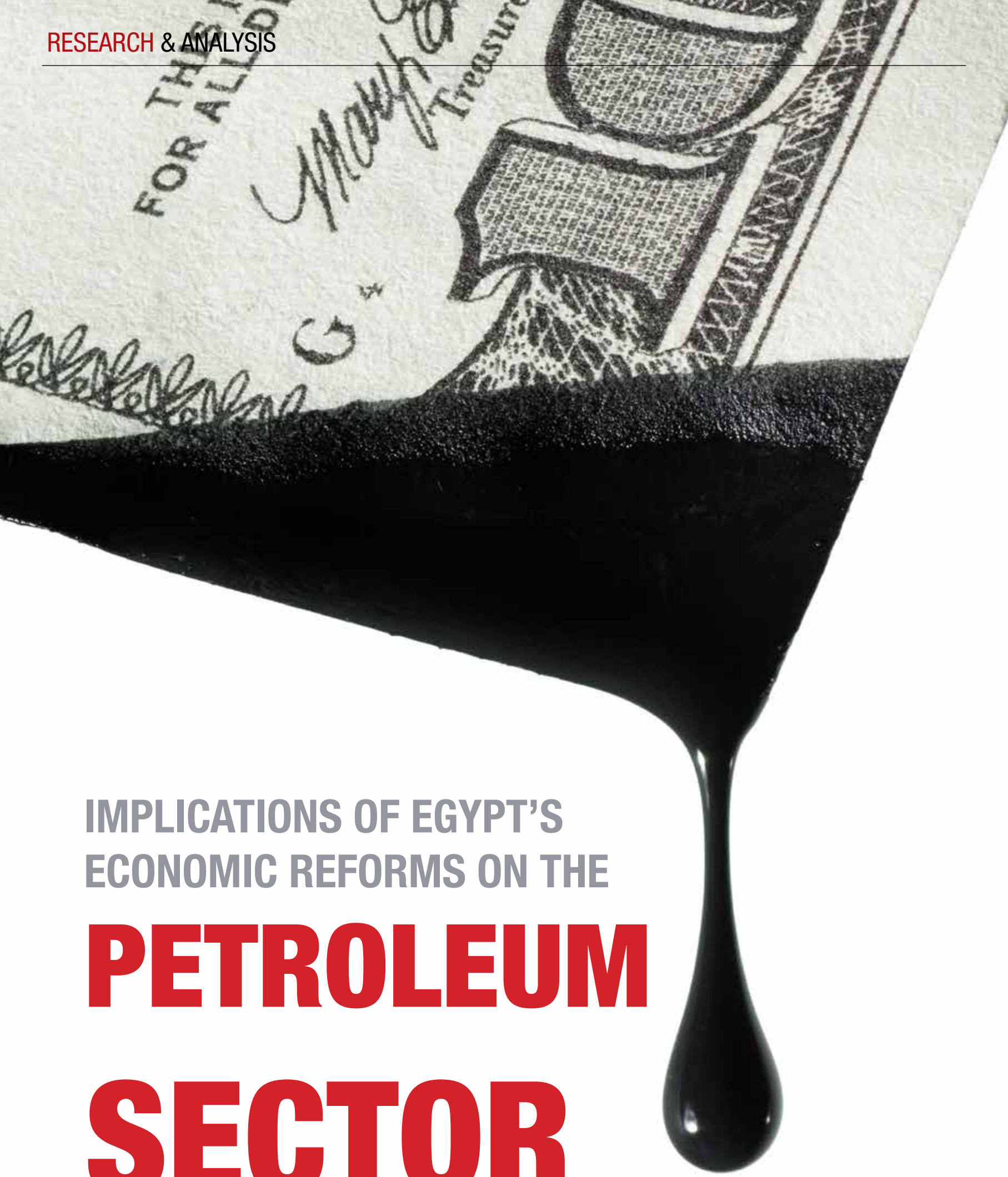

IMPLICATIONS OF EGYPT'S ECONOMIC REFORMS ON THE PETROLEUM SECTOR

By Matthew Hoare, Mahinaz El Baz

The landmark $12 billion loan agreement signed between the International Monetary Fund (IMF) and the Egyptian government in 2016 was conditioned on a set of economic reforms designed to return government debt to sustainable levels and revive the stagnating economy. Following the approval of the loan on November 11, 2016, the IMF said that the reform program would return financial stability and stimulate economic growth across the economy.

The agreement heralds the Egyptian government's ongoing development of a comprehensive reform plan for the energy sector. While the IMF's initial press release is fairly light on sector-specific information, it does highlight plans to address the unsustainability of the Egyptian General Petroleum Company (EGPC)'s finances. Included in this strategy are measures to reduce the state company's debts, improve operational transparency, and introduce efficiency savings.

Now, 20 months on, Egypt Oil & Gas examines the impact of current reforms on the performance of the petroleum sector.

TACKLING THE BUDGET DEFICIT

Right after implementing the reform program, Egypt's budget deficit for fiscal year (FY) 2016/17, which runs from July to June, fell to the lowest level in five years. It stood at 10.9% compared to 12.5% for the previous fiscal year, according to the Ministry of Planning, Monitoring and Administrative Reform (MPMAR).

In early July, the Ministry of Finance announced that Egypt had a primary budget surplus for the first time in 15 years. Finance Minister Mohamed Maait stated that Egypt achieved a 0.2% primary budget surplus, worth EGP 4 million ($223 million) in FY 2017/18. Moreover, it is planned to reduce the total budget deficit to 8.4% of the Gross Domestic Product (GDP) by end of the current FY 2018/19, while achieving a 2% primary surplus. The government recently expected its 2017/18 budget deficit to stand at 9.8%, slightly above the 9.1% it said last year it was targeting in the pre-budget report.

REDUCING EXPENDITURES

Along with social benefits, subsidies are the biggest ticket item in the budget, exceeding even wages and interest payments. In order to continue with the budget deficit reduction plan, Egypt's government decided to move forward with an energy subsidies reduction plan. In FY 2014/15, the government launched an energy subsidies reform program by reducing subsidies and increasing fuel prices in the budget. Since then, the government has committed to periodically increasing the pre-tax cost-recovery ratio on most fuel products in order to achieve 100% in FY 2018/19 and to eliminate electricity subsidies by FY 2020/21, according to the IMF.

In order to successfully reach the goals of the budget deficit reduction plan, the government announced a reduction in energy subsidies one day after floating the Egyptian pound in November 2016. A second reduction occurred in June 2017. Prior to the budget approval for the FY 2017/18, Egypt had earlier cut energy subsidies in a move that will save around EGP 35 billion compared to FY 2016/17, according to the State Information Service. The government has followed through on its plan for a fourth round of electricity subsidy reform, lowering its expenditures on electricity subsidies to EGP 30 billion.

In June, the government announced the third fuel subsidy cut since floating the Egyptian pound in 2016. This was few days after reducing electricity subsidies and raising prices by an average of 26% from July 2017.

The budget of FY 2018/19 has allocated EGP 1.4 trillion of spending. As a result, subsidies on fuel will be cut by around 21%, leaving total spending at around EGP 89 billion in the current budget. Electricity subsidies will witness a tougher cut of around 45%.

MONETARY POLICY

EXCHANGE RATE LIBERALIZATION

On November 3, 2016, the Central Bank of Egypt (CBE) took the radical decision to abolish Egypt's fixed exchange rate system. Now, instead of the central bank determining the exchange rate, the value of the Egyptian pound would be subject to the market dynamics of interbank currency trading. The pound fell sharply against the US dollar from 8.77 pound per dollar to 14.635 pound per dollar on the day of the devaluation, before falling further to 17.417 the following week. The IMF agreement loan – upon which the currency floatation was conditioned – was finalized the following week.

INFLATION

Since the CBE made its initial adjustment to the exchange rate in March 2016, the rate of inflation has fluctuated wildly. Following the initial currency devaluation, the headline Consumer Prices Index (CPI) rate of inflation – which includes more volatile commodities such as food and fuel – jumped from 9% in March to 10.3% in April. Headline inflation continued to rise steadily through the summer of 2016, peaking at 15.5% in August.

The floatation of the pound in November sent headline CPI surged to 19% - up from 13.5% in October – before climbing to 30% by the following February. After peaking at 33% in July 2017, inflation steadily declined to a pre-floatation low of 11.5%. Following government cuts to energy subsidies in the budget of the FY 2018/19, headline CPI jumped by almost 300 basis points to 14.4% in June 2018 – the first increase in 11 months. The CBE said after June's Monetary Policy Committee (MPC) meeting that it expects inflation to fall to single digits by the end of 2018 after the effects of the subsidy cuts dissipate.

INTEREST RATES

Since the first currency devaluation in March 2016, the CBE has followed a tight monetary policy, continuously raising interest rates in an effort to contain the inflationary effects of devaluation. The MPC raised the discount rate by 150 basis points to 11.25% in March 2016; 100 basis points in June 2016; 300 basis points in November 2016; 200 basis points in May 2017; and a further 200 basis points in July 2017 to reach 19.25%. Since inflation started on its downward trajectory in July 2017, the CBE has slightly reduced the discount rate to its current level of 17.25%. The CBE's monetary tightening succeeded in containing the effects of devaluation – albeit only after inflation reached levels not seen since the 1980s.

FOREIGN RESERVES

As a result of sealing the $12 billion deal between the CBE and the IMF, foreign reserves increased by 60%, reaching $31.3 billion in June 2017, according to a BNP Paribas' report. In general, international reserves in Egypt have averaged around $22.7 billion from 2003 until 2017, reaching an all-time high of $37 billion in December 2017 and a record low of $13.4 billion in March 2013, according to the CBE.

During the past 20 months since the floatation of

HIGHLIGHTS

The debts owed to IOCs have now fallen to $1.2 billion, beating 2010's record low of $1.35 billion.

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Egypt's international transactions ran an overall BoP surplus of $13.7 billion in FY 2016/17.

Egypt's Foreign Reserves

Dec 2016 Jun 2018

$24.26 million $44.25 million

82.4% ↑

the pound, increased foreign currency inflows have helped Egypt's foreign reserves to reach record highs. Reserves have almost doubled from $24.26 million in December 2016 to $44.25 million in June 2018, helped by a weaker currency and the first four loan disbursements. Government bond sales have also bolstered reserves - most notably in February 2018 when they jumped by $4.3 billion following a successful $4 billion Eurobond auction.

DOMESTIC AND EXTERNAL DEBTS

While both domestic and external debts have experienced rapid increases this decade, data suggests that the pace of debt accumulation appears to have slowed since the government embarked on its economic reform program.

Data for gross domestic debt shows that debt reached EGP 3.414 trillion from July-December 2017 representing 83.8% of GDP - compared to EGP 3.053 trillion during the same period in 2016, according to the CBE.

External debt data – available until Q2 2017/18 - demonstrates a similar trend. Debts rose from $67.3 million to $82.88 million (a $15.5 million increase) during the IMF period (Q2 2016/17 – Q2 2017/18). In comparison, debts increased by $19.5 million during the year before the IMF agreement (Q2 2015/16 – Q2 2016/17).

Under the IMF program, government debt as a percentage of GDP continued to increase in 2017. According to the fund's latest figures, gross government debt/GDP reached 103.3% in 2017, increasing from 96.8% in 2016.

ARREARS TO IOCS

The exchange rate adjustment, in addition to the increasing foreign reserves have helped in freeing up resources to pay for part of the accumulated arrears to international oil companies (IOCs), which stood at $2.2 billion at the end of January 2018 down from $3.5 billion at the end of 2016, according to the World Bank.

The debts owed to IOCs have now fallen to $1.2 billion, beating 2010's record low of $1.35 billion, according to a press release issued by the Ministry of Petroleum and Mineral Resources. Moreover, Egypt's national oil companies (NOCs) will pay all debts owed to international partners before the end of 2019, Egypt's Minster of Petroleum and Mineral Resources, Tarek El Molla mentioned on many occasions.

TRADE AND INVESTMENT

BALANCE OF PAYMENTS

Egypt's international transactions are depending on three main sources of revenue forming: tourism, the Suez Canal, and hydrocarbon exports. The three sources have not changed over the past decade, which makes the economy increasingly vulnerable to external factors.

In the light of the static structure of Egypt's Balance of Payments (BoP), the government had to take steps toward diversifying and strengthening revenue sources. The economic reform is mainly aiming to reduce the BoP's deficit and create more internal sources of revenues. Yet, the reform has negative effects in the short-run. Faced with higher import costs after floating the exchange rate in November 2016, importers had to choose between maintaining their margins or their market share. One determiner of this choice can be the scale of any depreciation.

A modest change would be easier to absorb in terms of costs, and the first partial depreciation

in March 2016, of around 13%, did not result in a significant rise in inflation. However, after the second depreciation due to November's floatation, on top of the increase in prices for imported factors of production, most private corporates in the formal sector raised wages by 10-20%, making an increase in selling prices necessary, highlighted BNP Paribas's report.

On the other hand, the positive effects of the reform manifested in FY 2016/17 as Egypt's international transactions ran an overall BoP surplus of $13.7 billion. Of this, $12.2 billion were generated between November and June following the CBE's decision to float the currency. This is a large improvement when compared to the overall BoP deficit of $2.8 billion in the previous year. Positive BoP data continued into following fiscal year as well, as the government revealed an overall surplus of $11 billion between July and March in FY 2017/18.

As the current account continued its improvement, with a sharp contraction of 57.5% ($7.2 billion) in its deficit, posting $5.3 billion against $12.5 billion in the same period a year earlier. This improvement was an outcome of the increase in both services balance surplus by 138.2% and net current transfers by 23.2%, and the retreat in trade deficit by 1.3%, according to the CBE.

FOREIGN DIRECT INVESTMENT

Inaugurating the economic reform, the state decided to float the exchange rate to eliminate the parallel exchange market, which helps in getting back foreign investors' confidence. As a result, the credibility of the new exchange rate regime and substantial increase in yields on government securities have attracted more than $10 billion in foreign portfolio investment as of July 2017, compared to virtually zero up until mid-2016, according to BNP Paribas's report.

Furthermore, foreign investors have returned to the Egyptian debt market in FY 2016/17, buying around $13 billion as of the end of June compared to $1 billion the year before, as hikes in interest rates boosted appetite in the country's domestic debt, according to a presidency statement. As an overall result of the economic reform, investments in FY 2016/17 jumped 27.5% from a year earlier, according to the Ministry of Finance's report. Foreign Direct Investment (FDI) in the petroleum sector increased by $1.3 billion to $8.1 billion in FY 2016/17, compared to $6.8 billion in FY 2015/16, according to the Ministry of Petroleum and Mineral Resources.

The latest available data show that total FDI inflows in Egypt recorded around $10.2 billion, while total outflows reached $4.2 billion in July-March FY 2017/18. Accordingly, net FDI in Egypt amounted to $6 billion of inflows, mainly due to the net investment of $3.4 billion in the oil sector, according to the CBE.

Egypt's economic reform program and hydrocarbon modernization strategies are aiming to retain the investor's confidence in the petroleum sector, in addition to unleashing the great potential of the sector. As a direct result, the decreasing debt encouraged IOCs to inject extra FDI, specifically into exploration and production (E&P) activities.

Since providing the petroleum industry's stakeholders with the full picture is our responsibility, Egypt Oil & Gas Research and Analysis is offering a full report covering the implications of the ongoing economic reforms on the petroleum sector. The full report will be available soon. To get your copy please contact Ayman Rady, Egypt Oil & Gas' Business Development Manager:
ayman@egyptoil-gas.com