Understand the cause and effect

Egypt's Complete Economic

Profile from 2011-2017

October 2017

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By: Mahinaz El Baz

Egypt launched a major economic reform program in November 2016 that included floating the exchange rate, fiscal consolidation measures, and reforms to the investment environment. Experts consider the liberalizing of the exchange-rate regime as a milestone towards restoring the competitiveness of the economy and boosting private-sector activity, which had been severely impeded by shortages of foreign currency. Yet, in the short term, the reforms are exacerbating social pressures. Inflation has reached some of the highest recorded rates, according to the World Bank (WB).Despite the side effects of the reforms, the government needed to make serious decisions after the five years of economic fluctuations following the 2011 revolution. The most notable decisions included the floatation of the exchange rate, the reduction of subsidies, the issuance of new taxes, and the increase in interest rates. These decisions were intended to adjust the foreign-exchange market, enhance the investment climate, control the inflation rate, and reduce the balance of payment (BOP) and budget deficits.

Floating Exchange Rate

Egypt had fixed its exchange rate for decades, weakening the economy and creating a parallel exchange market. Since January 2011, Egypt has experienced political, economic, and social instability. The exchange rate of the Egyptian pound (EGP) against the US dollar remained fairly stable despite the turmoil, only depreciating from EGP 5.8/$1 in January 2011 to EGP 6.1/$1 in November 2012, according to the Central Bank of Egypt (CBE). The strain of maintaining the peg, however, led to a sharp decline in Egypt's foreign-exchange reserves, from $36 billion in January 2011 to $15 billion in November 2012, according to Reuters.

Nonetheless, the International Monetary Fund (IMF) reclassified Egypt as having a stabilized exchange rate arrangement in 2012. Trying to stem the massive losses to its foreign-exchange reserves, the CBE announced in December 2012 the adoption of a new system. Under the new system, the CBE auctioned the US dollar, effectively floating the exchange rate. The new currency regime resulted in the depreciation of the EGP against the US dollar, the British pound,

$3.55 B

Highest LNG import bill recorded in FY 2015/2016.

and the euro. The EGP depreciated by 13%, an effect that became visible six months after the adoption of the CBE's tightly managed foreign exchange auctions in December 2012, as per the IMF. Between June 2013 and mid-2014, the official exchange rate has remained stable, creating increasing demand for foreign exchange. This stability is attributable to the financial support of the Gulf countries. Gulf aid permitted the CBE to stabilize the official exchange rate, which depreciated by only 2% against the US dollar during this time period.

In 2013, Egypt received $12 billion in external assistance from Kuwait, Saudi Arabia, and the United Arab Emirates (UAE), greatly easing the pressure on the country's balance of payments and exchange rate, according to Atlantic Council's study on the economic decline of Egypt after the 2011 uprising. With the inflow of foreign funds, the stock market rose sharply. The EGX 30 Index increased by 6% on July 4, 2013, the study notes. The real effective exchange rate had appreciated 18% by the end of November 2014 due to high inflation differentials with trading partners and the appreciation of the US dollar against other major currencies.

In an unexpected move, the CBE raised the weekly auctioned amounts by 25% one month later in December 2014, according to the IMF. The total value of the foreign-exchange auctions offered since December 2012 reached $ 15.4 billion by the end of June 2015, according to a paper titled "Exchange Rate Pass-Through to Inflation in Egypt: A Structural VAR Approach" by Helmy, Fayed, and Hussein.

After years of fixing the exchange rate, the CBE devalued the pound by about 14% in March 2016, willing to move to a more flexible regime. Despite the CBE's decision, the EGP continued to depreciate in the black market in the following weeks, falling to an unprecedented EGP 10 to the US dollar, according to the Atlantic Council's study.

Eight months later, the CBE announced on November 3, 2016, its decision to move, with immediate effect, to a liberalized exchange-rate regime. The move allowed market demand and supply dynamics to provide a reliable and sustainable provision of foreign currencies. It improved foreign currency liquidity while pushing economic activity into formal channels. By the end of December 2016, the EGP had depreciated against all foreign currencies. The weighted average of the US dollar in the Egyptian interbank market at the end of December 2016 was EGP 18.2665, as opposed to the EGP 8.7800 at the end of June 2016, according to the CBE.

The decision to float the EGP has significantly changed the country's short-term economic prospects. The pound depreciated by more than 40% and foreign-currency liquidity has been returning to the banking system—thanks to significantly higher interest rates. About $4 billion has returned to the official banking system and more than $1.3 billion entered the country as portfolio investments, according to a BNP Paribas report.

The effective exchange rate is currently about 28% above its average for the past 15 years, and 29% above its average for the past 10 years, Marwa El Sherif writes in "Exchange Rate Volatility and Central Bank Actions in Egypt: Generalized Autoregressive Conditional Heteroscedasticity Analysis," which was published in the International Journal of Economics and Financial Issues.

Investments

One of the main reasons for floating the exchange rate was to eliminate the parallel exchange market and regain foreign investors' confidence. The credibility of the new exchange rate regime and the 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' report. Moreover, foreigners have returned to the Egyptian debt market, buying more than $3.3 billion of treasuries by mid-March 2017, according to the Ministry of Finance. Egypt issued a $4 billion Eurobond at the end of January 2017 that was three times oversubscribed. As an overall result of the economic reforms, investments in fiscal year (FY) 2016/2017 jumped 27.5% from the previous year, according to a report by the Ministry of Finance.

Total investment as a proportion of gross domestic product (GDP) fell from 21.3% in 2010 to 14.5% in 2015 because of political unrest, according to Atlantic Council's study. It worth noting that Egypt's government began working on a new investment law in 2015 before launching the current economic reforms. The new law attempts to resolve problems with the previous investment legislation, passed in 2005, which aimed to cater to businesses in much the same way. The new investment law makes it easier for investors and businesses to obtain free or subsidized land and protects contracts against challenges from third parties, according to the American Chamber of Commerce in Egypt's study on the legislation.

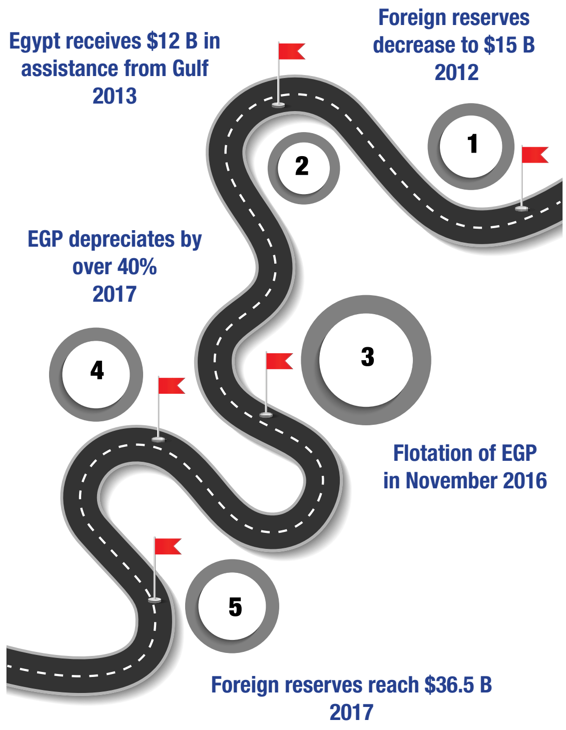
Balance of Payments (BOP)

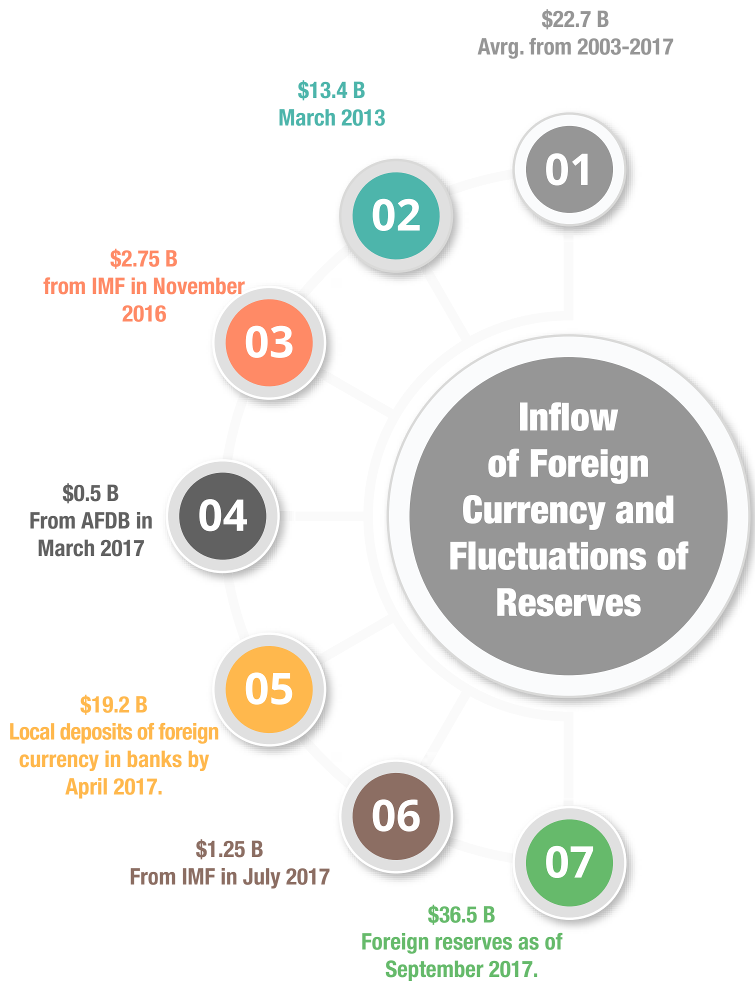
There are three main sources of revenue for Egypt's external accounts: tourism, the Suez Canal, and hydrocarbon exports. These three main revenue sources for Egypt's current account have not changed over the past decade, which makes the external account vulnerable to exogenous factors.

Since 2011, tourism revenues have decreased by more than half. The situation could improve in the short term as some countries lift travel restrictions to Egypt. Greater political risk and the reversal of the oil cycle widened the current account deficit to unsustainable levels, according to CBE. Suez Canal revenue decreased even though capacity recently doubled, according to a recent study by BNP Paribas. This is mainly due to the sharp slowdown in global trade to 1.9% in 2016 from 2.7% in 2015, according to the IMF. Suez Canal revenues are closely linked to the international oil environment.

On the other hand, the drop in oil prices helped improve the current account; in addition, official transfers from the Gulf countries reduced the current account deficit from 5% of GDP in FY2013/2014 to 0.5% in FY 2014/2015, according to CBE. Yet since Egypt is both a hydrocarbon exporter and importer, the gain in terms of the current account balance from the drop in oil prices is modest. It was estimated at about $0.2 billion in FY 2014/2015, which is less than 0.1% of GDP compared to FY 2013/2014.

In the light of static structure of the BOP, the government has taken steps toward diversifying its revenue sources. The economic reforms adopted in 2016 aim to reduce the BOP deficit and create more endogenous sources of revenue. Yet, the reform has had short-term side effects. Faced with higher import costs after the floatation of the exchange rate in November 2016, importers had to choose between maintaining their margins or their market share. One important factor in this decision is the scale of the depreciation. A modest





change is easier to absorb in terms of costs. The depreciation in March 2016, of around 13%, did not result in a significant rise in inflation. After November's floatation—on top of the increase in prices for imported factors of production—most private corporations in the formal sector raised wages by 10-20%, making an increase in selling prices necessary, according to BNP Paribas' report. On the other hand, the positive impact of the reforms is beginning to appear. Egypt's transactions with the external world ran an overall BOP surplus of $ 7.0 billion in the first half of FY 2016/2017, against an overall deficit of $3.4 billion in the same period in FY 2015/2016, according to the CBE.

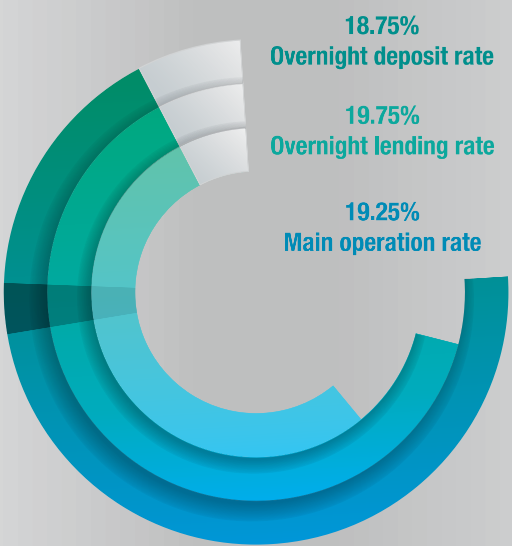
Reserves

Prior to the 2011 revolution, Egypt's international reserves reached $36 billion, but years of political and economic instability caused reserve levels to drop precipitously despite occasional upticks thanks to aid from Gulf allies and multilateral lenders. Government petroleum imports and basic nutritional imports, such as wheat, were the main causes behind the drop in foreign reserves, the CBE noted. Egypt's highest liquefied natural gas (LNG) imports were in FY 2015/2016 and reached around $3.55 billion, an Egyptian General Petroleum Corporation (EGPC) official told Reuters. In addition, political turmoil, decreasing tourism revenues, and low FDI flows—key sources of hard currency—negatively affected international reserves.

International reserves increased slightly to $15.2 billion at end March 2015, the equivalent of 2.4 months of imports of goods and services. This improvement gave the CBE extra room to maneuver. The EGP was gradually depreciated in several moves (i.e decreased by 6% against the US dollar since the end June 2013) and, more recently, the amount offered at hard currency auctions was increased by 25%.

Egypt's government decided to solve the reserves issue by floating the exchange rate. As a result of floating the EGP and sealing a $12 billion deal between the CBE and the IMF in November 2016, reserve levels have been climbing steadily. Egypt has already received two tranches of the IMF loan. The first tranche, of $2.75 billon, was received in November 2016. The second tranche, of $1.25 billion, was received in July 2017 and a $500 million installment of a $1.5 billion loan from the African Development Bank was received in March 2017, according to Reuters. Between November and mid-April, Egyptian banks reportedly pulled in $19.2 billion in foreign-currency deposits, according to Trading Economics. Reserves have increased by 60%, reaching $31.3 billion in June 2017, equivalent to nearly six months worth of goods and services imports, according to BNP Paribas' report.

Interest Rates August 2017



In general, international reserves in Egypt have averaged $22.74469 billion from 2003 until 2017, reaching an all-time high of $36.5 billion in September 2017 and a record low of $13.448 billion in March 2013.

Budget Deficit

Egypt's fiscal imbalance has worsened since the popular uprising in 2011. This has been due to dramatic increases in both non-discretionary expenses—such as wages and salaries due to workers' strikes and demonstrations, appointment of temporary employees, and the application of minimum wage policies—and in subsidies and social benefits. Annual expenditure on current expenses, including wages, subsidies, and social benefits, doubled between FY 2010/2011 and FY 2015/2016, according to Economic Research Forum's Policy Brief No. 23, May 2017.

12%

Average fiscal deficit between 2011 – 2015.

With spending increasing, Egypt's fiscal accounts deteriorated substantially between 2011 and 2015, leading to an average fiscal deficit of nearly 12% of GDP, according to the Atlantic Council's study. This large fiscal deficit and the consequent rise in government debt, which in 2015 amounted to over 88% of GDP, has been due to dramatic increases in both non-discretionary expenses, such as wages and salaries, and in subsidies and social benefits. In addition, the annual cost of variable expenses such as wages, subsidies, and social benefits, dou¬bled between FY 2010/2011 and FY 2015/2016. The budget deficit for FY 2015/2016 was estimated at 11.5% of GDP, according to Ahram Online.

Wage payments and interest on public debt currently account for 43% and 49% of total fiscal revenues, respectively. Maintaining high interest rates and meeting social demands during a period of high inflation will make it hard to control these two expenditures. Despite the implementation of reforms, the primary fiscal balance should remain slightly negative in the medium term (less than 1% of GDP as of 2017/2018), according to BNP Paribas' report. Considering the current challenges and opportunities, public debt should narrow, but will remain at high levels. Estimated at 94% of GDP in 2015/2016, public debt could be trimmed to 87% in 2017/2018, according to BNP Paribas Bank. At the same time, the bank expects that the share of external debt will double to about 20% of total public debt. It worth noting that Egypt's budget deficit for the first nine months of the FY 2016/2017 dipped to 8% of GDP from 9.4% during the same period last year, a draft budget statement showed, according to Reuters.

Furthermore, reducing fiscal deficits and placing public debt on a clearly declining path is an important objective of the reform program, according to the IMF. To accomplish this goal, the government has pursued several key policy measures: the introduction of a value-added tax (VAT), the reduction of energy subsidies, and the optimization of the public sector wage levels. To mitigate the impact of the reforms on the poor, the authorities intend to use part of the fiscal savings to strengthen the social safety net. The planned fiscal consolidation is projected to reduce public debt by almost 10% of GDP by the end of the program.

A. Energy Subsidies Cut

Along with social benefits, subsidies are the biggest ticket item in the budget, exceeding even wages and interest payments. Energy subsidies increased in the FY 2011/2012 budget to around EGP 95 billion, up more than 40% since the FY 2009/2010 budget, according to the World Bank. Despite the importance of urgently reducing energy subsidies, combined energy subsidies increased again, reaching EGP 150 billion in FY 2013/2014, representing around 8.5% of GDP, according to the World Bank. In FY 2014/2015, the government took a major step in reducing subsidies by increasing fuel prices in the FY2014/2015 budget—although they still remained well below international prices.

In order to continue with the budget deficit reduction plan, the government announced a reduction in energy subsidies one day after floating the EGP in November 2016. A second reduction occurred in July 2017. The reduction in energy subsidies was a major factor of consumer inflation. Fuel prices rose to more than 100% higher than they were in 2014 while increases in electricity prices ranged from 29% to 124% higher, depending on the consumption tier, according to BNP Paribas' report.

Prior to the approval of the budget for the FY 2017.2018, the Egyptian state had earlier cut fuel subsidies in a move that will save around EGP 35 billion compared to FY 2016/2017, according to 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, although it has extended the deadline for phasing out electricity subsidies from 2019 to 2021.

B. Tax Reform

The VAT law is part of the government's fiscal-reform program. As part of the program, energy subsidies will be phased out gradually and new taxes will be introduced to reduce the country's ballooning budget deficit. The purpose of the VAT is to improve the efficiency of tax collections and broaden the tax base. In addition, the VAT will reduce the tax burden on

job-creating manufactures and improve Egypt's global competitiveness profile. A 13% VAT was introduced on October 2016, replacing a 10% sales tax. In January 2017, Egypt's government announced that it would increase the VAT to 14% on July 1, 2017. The original plan had called for the 1% increase on October 1, 2017, according to Daily News Egypt. However, the government still faces a large deficit. In addition, the VAT is expected to lead to further price inflation, ranging from 0.5% for low-income Egyptians to 2.3% for the upper classes, stated Amr El Garhy, Egypt's Minister of Finance.

C. Inflation Rates

Inflation rates were highly volatile between 2011 and 2015. In 2011, Egypt experience 11.4% inflation. This rate dropped slightly to 9.04% in March 2012. This inflation, according to IMF data, could have been attributable to the appreciation of the US dollar against the EGP. Moreover, the political and security unrest in Egypt negatively affected commodity supply in local markets. As a result of inefficient policies, the inflation rate increased again in November 2013, reaching 12.94%, which was the highest level since January 2010. This was attributed to government's decision to revise the prices of several regulated items within the Consumer Price Index (CPI) basket, which led to a pickup in the monthly share of most of the CPI sub-groups, especially restaurants and hotels, healthcare, and food and non-alcoholic beverages, according to Helmy, et al.

Public debt is forecasted to decline to 87% in 2017/2018 in comparison to the current 94% recorded in 2015/2016.

Lower prices for some of the commodity groups in the CPI at the beginning of 2014 slightly lowered the inflation rate and it dropped into the single digits again. However, the inflation rate picked up again, reaching 10.13% in December 2014, due to fuel and tobacco price hikes in July 2014. Headline inflation reached 11.3% in June 2015 but afterwards eased to 9.7% in October 2015. In December 2015, the inflation rate increased again, causing the MPC to raise the policy rates by 50 basis points.

The floatation of the Egyptian pound since November 2016 and the introduction of fiscal reforms have significantly increased inflation rates. Annual consumer price inflation has been running at an average of over 30% since January 2017. Furthermore, BNP Paribas' report expects that, in the short term, consumer price inflation is likely to remain elevated. CPI inflation reached 23.7% in FY 2016/2017 and it is expected to be at almost 25% in FY2017/2018. Further subsidy cuts, the persistence of higher import costs, and a possible upturn in domestic demand are all likely to continue driving inflation.

Increasing Interest Rate

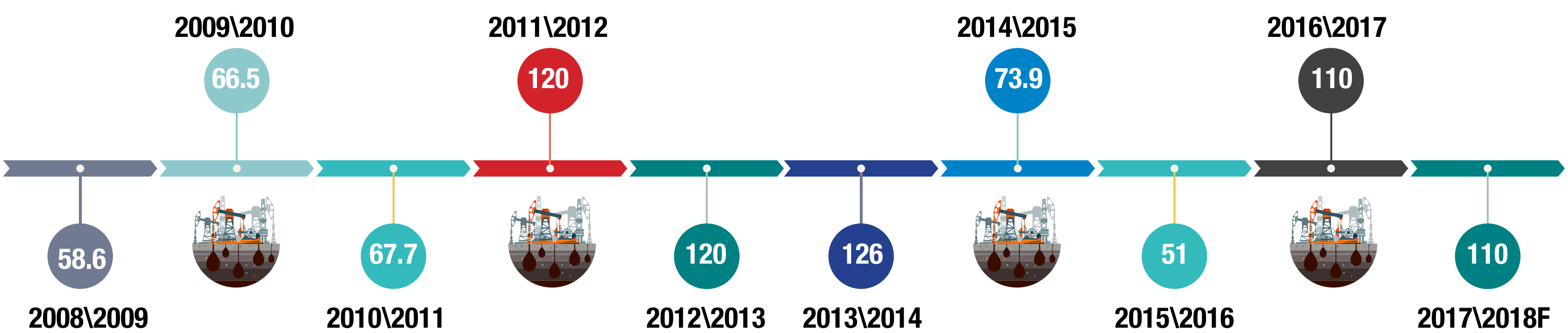
In the light the high inflation rates, the Egyptian government increased interest rates. The CBE raised its main policy interest rates by 300 basis points immediately after the November 2016 flotation decision. In addition, the CBE decided at its August 2017 monetary policy meeting to keep interest rate steady following two rounds of aggressive rate hikes. These hikes, which took place in May and July, were implemented in an attempt to halt the high inflation. The overnight deposit rate was held at 18.75%, the overnight lending rate at 19.75%, and the main operation rate at 19.25%. All decisions were in line with market expectations, according to the CBE. These rates still fall short of previous highs. In October 1991, Egypt's interest rates achieved an all-time high of 21.40%. In contrast, the interest rate was only 8.25% in September 2009, according to Trading Economics Data.

Moving Forward

Economic experts argue that several factors—such as the floatation of the EGP, improvements in foreign-currency liquidity, the accelerated pace of fiscal reforms, and the start-up of production at the Zohr gas field—will have a positive macroeconomic impact. Yet public and external accounts will continue to show deficits in the medium term, and the government will have to deal with growing social pressures during a time of high inflation. Only the return to strong growth through job-rich investments in non-energy sectors will enable the Egyptian economy to pull out of a five-year slump, according to the BNP Paribas report.

Five years of political, economic and social challenges, motivated the Egyptian government to start searching for opportunities and implement a serious economic reform program. While preferring to fix other economic and financial issues gradually, such as reducing subsidies, issuing new taxes, and increasing interest rates, the government dramatically floated the EGP to resolve its currency-flow problems. These economic reforms are meant to improve Egypt's foreign-exchange market, raise the competitiveness of its investment climate, reduce the inflation rate, and control the BOP and budget deficits. While there are more steps to be taken in order to complete the reform program, the government has decided to delay some decisions, such as cutting energy subsidies in FY 2017/2018, to control the high inflation rate and strengthen Egypt's social-security net in order to protect low-income citizens in the short-run.

Value of Subsidies 2008 – 2018



Source: Egypt Oil & Gas

Unit: Billion EGP

Historical Inflation Overview January 2011 – August 2017

Date	General CPI	Core CPI	Price Controlled Goods &Services	Fruits & Vegetables
(YoY percentage change)				
Aug-17	31.916%	34.860%	22.563%	29.892%
Jul-17	32.952%	35.258%	24.456%	32.450%
Jun-17	29.763%	31.947%	17.727%	34.663%
May-17	29.710%	30.571%	17.727%	41.719%
Apr-17	31.464%	32.062%	20.297%	43.948%
Mar-17	30.912%	32.250%	20.297%	39.031%
Feb-17	30.249%	33.100%	18.943%	31.331%
Jan-17	28.138%	30.859%	19.602%	25.829%
Dec-16	23.269%	25.858%	18.733%	16.274%
Nov-16	19.427%	20.731%	18.624%	13.898%
Oct-16	13.563%	15.716%	12.641%	4.619%
Sep-16	14.088%	13.935%	12.701%	16.777%
Aug-16	15.469%	13.252%	10.594%	36.155%
Jul-16	13.999%	12.308%	5.882%	38.383%
Jun-16	13.969%	12.371%	8.137%	33.648%
May-16	12.300%	12.232%	8.137%	19.010%
Apr-16	10.274%	9.512%	5.912%	21.813%
Mar-16	9.015%	8.415%	1.912%	25.439%
Jan-16	10.098%	7.728%	5.626%	34.519%
Dec-15	11.061%	7.235%	8.269%	42.413%
Nov-15	11.079%	7.444%	8.461%	39.841%
Oct-15	9.701%	6.264%	8.430%	31.768%
Sep-15	9.210%	5.548%	10.713%	29.367%
Aug-15	7.880%	5.607%	12.046%	15.407%
Jul-15	8.377%	6.486%	12.458%	13.861%
Jun-15	11.388%	8.067%	19.170%	21.276%
May-15	13.113%	8.139%	19.170%	38.053%
Apr-15	10.964%	7.189%	20.607%	20.518%
Mar-15	11.506%	7.211%	25.341%	17.942%
Feb-15	10.561%	7.147%	22.752%	13.562%
Jan-15	9.658%	7.062%	22.271%	6.728%
Dec-14	10.128%	7.690%	18.348%	13.196%
Nov-14	9.087%	7.809%	16.082%	6.013%
Oct-14	11.836%	8.474%	19.106%	22.244%
Sep-14	11.119%	9.150%	17.178%	14.302%
Aug-14	11.494%	10.072%	16.509%	12.711%
Jul-14	11.042%	9.568%	16.224%	12.400%
Jun-14	8.200%	8.763%	7.005%	6.390%
May-14	8.242%	8.860%	6.060%	7.776%
Apr-14	8.871%	9.113%	4.712%	14.515%

Date	General CPI	Core CPI	Price Controlled Goods &Services	Fruits & Vegetables
(YoY percentage change)				
Mar-14	9.816%	9.903%	5.239%	17.758%
Feb-14	9.765%	9.697%	5.239%	19.010%
Jan-14	11.362%	11.691%	3.400%	24.467%
Dec-13	11.656%	11.912%	6.257%	20.452%
Nov-13	12.972%	11.949%	8.948%	28.347%
Oct-13	10.445%	11.148%	5.212%	14.866%
Sep-13	10.145%	11.155%	8.042%	7.143%
Aug-13	9.745%	8.967%	9.479%	15.546%
Jul-13	10.279%	9.061%	9.183%	21.567%
Jun-13	9.753%	8.560%	8.901%	20.366%
May-13	8.198%	8.036%	9.872%	6.427%
Apr-13	8.112%	7.469%	9.196%	10.795%
Mar-13	7.589%	7.026%	7.570%	11.982%
Feb-13	8.210%	7.677%	8.695%	11.417%
Jan-12	6.274%	5.229%	8.041%	11.037%
Dec-12	4.663%	4.437%	4.953%	5.847%
Nov-12	4.255%	4.200%	4.175%	4.823%
Oct-12	6.701%	4.641%	8.968%	18.203%
Sep-12	6.220%	3.836%	5.862%	24.690%
Aug-12	6.465%	5.336%	3.052%	22.334%
Jul-12	6.392%	6.337%	3.052%	13.718%
Jun-12	7.255%	7.035%	5.007%	13.571%
May-12	8.300%	7.220%	6.751%	19.730%
Apr-12	8.778%	8.364%	8.933%	11.562%
Mar-12	9.027%	8.676%	10.258%	9.368%
Feb-12	9.188%	7.296%	8.764%	27.829%
Jan-12	8.602%	6.865%	8.626%	24.677%
Dec-11	9.550%	7.069%	9.678%	33.545%
Oct-11	7.104%	7.598%	6.364%	4.803%
Sep-11	8.213%	7.948%	8.123%	10.409%
Aug-11	8.486%	6.976%	8.932%	21.159%
Jul-11	10.364%	8.708%	8.932%	29.961%
Jun-11	11.792%	8.937%	12.946%	37.916%
May-11	11.799%	8.814%	11.402%	43.484%
Apr-11	12.077%	8.764%	9.860%	52.004%
Mar-11	11.486%	8.537%	9.630%	47.553%
Feb-11	10.710%	9.506%	9.985%	25.495%
Jan-11	9.068%	7.038%	10.242%	24.218%

Source: Central Agency for Public Mobilization and Statistics (CAPMAS), and CBE calculations.