ARAB REPUBLIC OF EGYPT

Macroeconomic conditions are showing signs of stabilization following the liberalization of the exchange rate. Important fiscal reforms are underway, with energy subsidy cuts and containment of the wage bill contributing to fiscal consolidation. However, inflation has spiked to record high levels with negative implications on social conditions. The Central Bank of Egypt (CBE) has tightened monetary policy and the Government has increased spending on social protection to mitigate the impact on living conditions.

Recent developments

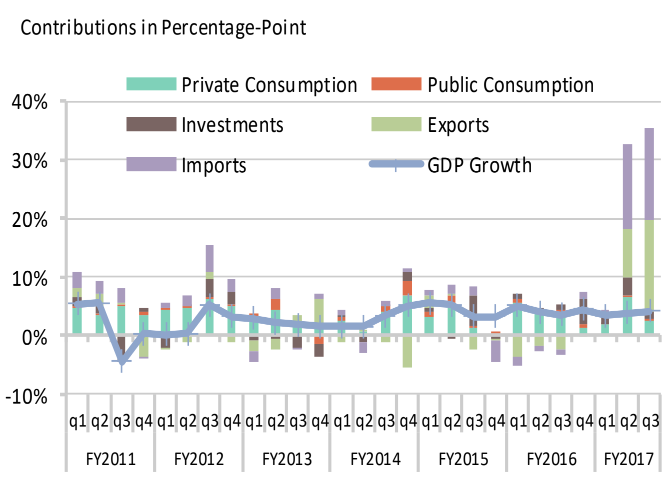
Egypt's economy is estimated to have grown at 4.1 percent in FY2016/17 (July/June), slightly lower than the 4.3 percent real growth achieved in the previous year. Following two quarters of slowdown in growth, economic activity is picking up, driven primarily by the resilient private and (to a lesser extent) public consumption, as well as by an uptick in investments with net exports contributing positively for the first time in two years, albeit still marginally.

The liberalization of the exchange rate in November 2016 has eased shortages in foreign currency, eliminated the parallel market and kick-started an improvement in Egypt's external accounts. The Balance of Payments (BoP) achieved a US$13.7 billion surplus (5.8 percent of the year's projected GDP); 90 percent of which was realized only following the November exchange rate floatation. This compares to a BoP deficit of US$2.8 billion (-0.8 percent of GDP) a year earlier,[1] with the large improvement in FY2016/17 resulting from a narrowing current account deficit (albeit in absolute terms only), and a surge in capital and financial inflows. The current account deficit fell to US$15.6 billion in FY2016/17 from US$19.8 billion a year earlier, due to higher oil and non-oil exports, contained imports, an uptick in tourism and remittances. The capital and financial account jumped to US$29 billion in FY2016/17, from US$21.2 billion due to increased external borrowing as well as the rise in net FDI (reaching 3.3 percent of projected GDP, from 2.1 percent a year earlier) as well as a surge in portfolio inflows that were encouraged by Egypt's improved outlook and attractive returns on EGP-denominated assets. The exchange rate adjustment has helped in freeing up resources to pay part of the accumulated arrears to international oil companies, which currently stand at US$2.3 billion in end-June 2017 down from US$3.5 billion in end-2016. Net international reserves spiked to a record level of US$36 billion (7.5 months of merchandise imports) in end-August 2017, compared to US$19 billion in end-October 2016.

Egypt has also embarked on an ambitious fiscal consolidation program, notably through cuts in energy subsidies, containment of the wage bill and implementation of the VAT. These fiscal reforms have helped avail resources to scale up social spending whilst achieving a fiscal consolidation in the magnitude of 1.7 percent of GDP resulting in a projected fiscal deficit of 10.9 percent of GDP in FY2016/17.

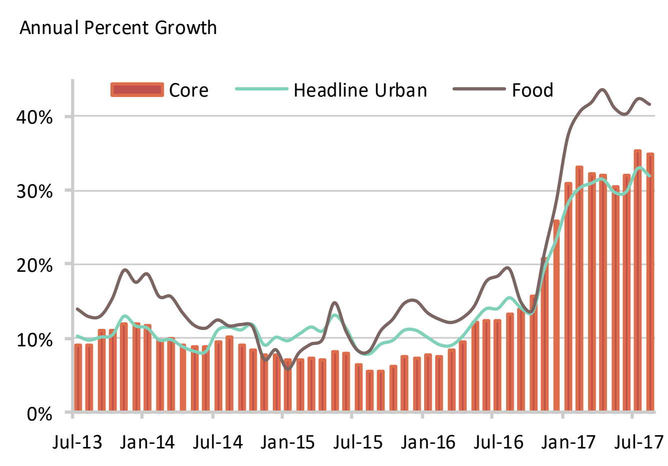
However, inflation continues to be a major concern, spiking to a record high of 33 percent in July 2017, before receding somewhat to 31.9 percent in August. The sharp currency depreciation, along with the introduction of the VAT (followed by the increase of 1 percentage-point in its rate), the two rounds of hikes in energy prices, in addition to non-competitive practices in domestic markets have all exerted upward pressure on domestic prices. Notwithstanding the CBE's efforts to tighten monetary policy (cumulative policy rate hikes worth 700 basis points

FIGURE 1 Arab Republic of Egypt / Real GDP Growth, demand-side, FY2011-17



Source: Authors' calculations based on Ministry of Planning data.

FIGURE 2 Arab Republic of Egypt / Inflation rates, July 2013-July 2017



Source: Central Bank of Egypt.

between November 2016 and June 2017), real interest rates remain negative.

The acceleration of inflation is weighing on social conditions, with the impact affecting both the middle-class and low income groups. While unemployment has started to decline, it remains elevated at around 12 percent in FY2016-17 (compared to 12.7 percent a year earlier), and continues to be higher among the youth and the educated. Social protection measures were scaled up to mitigate the impact of the recent inflation spike. These include the expansion in amount and coverage of the cash transfer programs (*Takaful* and *Karama*), an increase in the allotment in food smartcards from EGP 21 to EGP 50 per person per month, in addition to higher income tax threshold, lower income taxes and an exceptional cost of living bonus for state workers.

Outlook

As Egypt sustains the momentum of reforms, economic activity is expected to improve, and imbalances are projected to narrow further through the elimination of distortions in foreign currency markets and the government's commitment to fiscal consolidation. If properly implemented, the recently adopted industrial licensing law and further improvement in the regulatory framework are expected to improve the business climate and foster growth over the medium term.

The economy is forecast to grow by 4.5 percent in FY2017/18 driven by a resilient private consumption, albeit partially diluted by high inflation over the short term. As Egypt sustains the momentum of reforms, further pick-up in investment and a recovery in merchandise exports and tourism are expected to contribute positively to growth. The operationalization of new gas fields is set to boost the extractives sector and improve fiscal and external balances.

The budget deficit is expected to decrease to 8.8 percent of GDP by FY2017/18, supported by energy subsidies reform and increase in tax revenues. The current account deficit is expected to narrow to 4.6 percent of GDP in FY2017/18.

Poverty could decrease in part through the strengthened social protection measures embedded in the approved budget for FY2017/18, including the increased allocations for food smartcards and for cash transfer programs.

Risks and challenges

Policy slippage and delays in real sector reforms may jeopardize the restoration of macroeconomic balances. Egypt's total government debt to GDP ratio was 102.8 percent in end-FY2015/16, and is expected to increase further in FY2016/17 with the sharp depreciation and increased foreign borrowing. Thus, any slowdown/reversal in fiscal reform efforts or slowdown in growth can undermine debt sustainability. High inflation, i f persistent, can warrant monetary tightening and challenge economic growth.

Additionally, regional and domestic security risks can exert an adverse impact on the recovery of foreign investments, tour-ism and remittances, all considered im-portant sources of government revenues and foreign exchange resources.

TABLE 2 Arab Republic of Egypt / Macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	2.9	4.4	4.3	4.2	4.5	5.3
Private Consumption	4.4	3.1	4.6	2.2	3.1	4.0
Government Consumption	8.4	7.0	3.9	0.8	1.1	1.6
Gross Fixed Capital Investment	1.5	13.8	12.0	8.2	10.1	10.9
Exports, Goods and Services	-11.9	-0.6	-14.5	3.2	5.4	7.6
Imports, Goods and Services	0.2	0.6	-1.9	-3.0	1.6	3.8
Real GDP growth, at constant factor prices	2.9	3.4	2.3	4.2	4.5	5.3
Agriculture	3.0	3.1	3.1	3.0	3.0	3.0
Industry	1.5	1.1	0.2	1.9	3.6	4.5
Services	3.9	5.0	3.7	6.0	5.4	6.3
Inflation (Consumer Price Index)	10.1	10.9	10.2	23.3	22.1	14.0
Current Account Balance (% of GDP)	-0.9	-3.7	-6.0	-6.6	-4.6	-3.9
Fiscal Balance (% of GDP)	-12.0	-11.4	-12.5	-10.8	-8.8	-7.1
	..	16.1	15.0	15.1	14.6	14.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.

It is worth noting that the current account deficit to GDP ratio has actually increased to 6.6 percent, from 6 percent a year earlier. The deterioration is due to the sharp drop in the US$-denominated GDP following the exchange rate depreciation.

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