

ARAB REPUBLIC OF EGYPT

Recent developments

Egypt's nascent recovery faded in FY16, owing to the foreign exchange crunch, a drop in tourism, and an unfavorable external environment. The government seeks to implement measures that will address the ongoing macro-imbalances (especially in the external and fiscal accounts), introduce structural reforms to improve the business environment, and redirect resources towards social programs. This would be supported by a 3-year Extended-Fund Facility (for which a Staff-Level Agreement was reached in August and is pending IMF Board approval).

Egypt's growth was 4.3 percent in 9M-FY16, in line with the previous year, and double the rate during FY11-14, but still below potential. Real growth in Egypt continues to be below potential and is constrained by shortages in hard currency, an overvalued exchange rate, and sluggish growth in Europe (Egypt's main trading partner), as well as the lower international oil prices that adversely impacted the Gulf (primary source of remittances). Additionally, key sectors continued to post negative growth, particularly 'oil and gas extractives' (as the sector suffers from underinvestment and arrears), and 'tourism' (which has deteriorated further since end-October 2015 when Russia and the UK banned travel to Egypt).

Social conditions continue to be a concern. Unemployment remains elevated at 12.5 percent in H2-FY16, with rates higher among the youth and women. Furthermore, the recent spike in inflation (reaching a seven-year high of 15.5 percent in August 2016)—in part due to the March 2016 devaluation—is expected to have increased poverty due to the increase in price of items with high import content, especially food. In June, the government sought to protect the population from the impact of price increases by raising the value of food smart cards from LE15 to LE18 per person (88.6 percent of the population has food smart cards.)

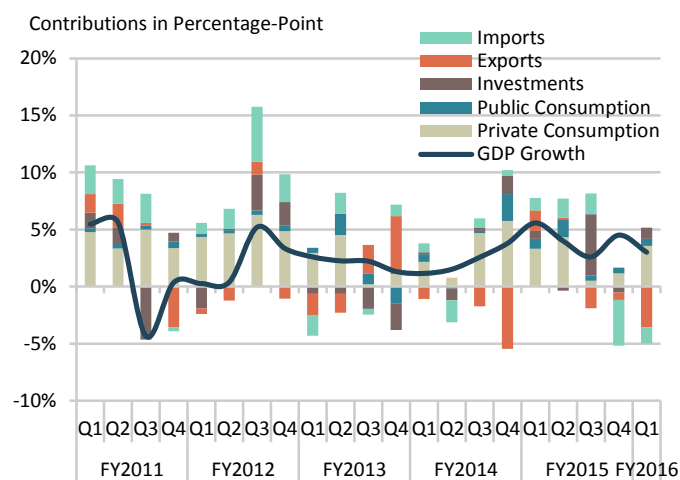
Following delays in the implementation of important fiscal reforms, Egypt is set to

resume its fiscal consolidation plan. In FY16, the fiscal deficit increased to an estimated 12 percent of GDP from 11.5 percent of GDP the year before. Energy subsidy reform announced in early-FY15 was only 'partially' implemented in FY16, along with measures to curb the growth in the civil servants' wages, whereas other key reforms were on hold. Important fiscal reforms are expected in FY17: The government has already raised the electricity tariffs by 35 percent (on average) for households, commercial and industrial users in early-August, and the State budget includes other major fiscal reforms, including introduction of a VAT (approved at end-August 2016) in addition to efforts to raise revenues from existing taxes by improving tax collection.

Meanwhile, the Central Bank of Egypt (CBE) started to tighten monetary policy through key policy rate hikes, but liquidity conditions continue to be loose. The CBE raised its key policy rates twice (by a cumulative 250 basis points, reaching an 8-year high of 12 percent, on average) since the exchange rate was last allowed to depreciate in mid-March, in order to curb the inflationary pressures and alleviate further downward pressure on the currency. However, the parallel exchange rate continued to surge (40 percent weaker than the official rate at end-August), and liquidity growth continued to be strong, driven mainly by the perpetual credit extended to the government.

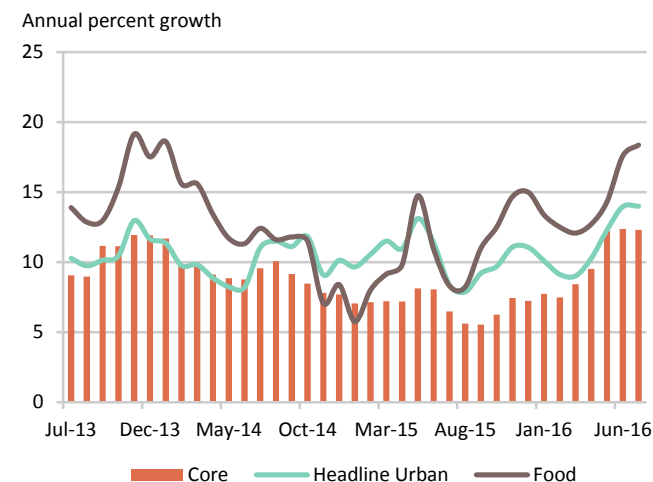
Egypt and the IMF have reached a Staff-Level Agreement on a three-year \$12 billion Extended Fund Facility (EFF). The agreement was signed on August 11, 2016,

FIGURE 1 Arab Republic of Egypt / Real GDP growth, demand-side, FY2011-FY2016



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

FIGURE 2 Arab Republic of Egypt / Inflation rates, July 2013 – July 2016



Sources: Central Bank of Egypt.

and is subject to obtaining adequate financing assurances and approval by the IMF's Executive Board. The government aims to implement reforms on three main fronts: (1) exchange rate liberalization; (2) fiscal consolidation, and (3) structural reforms to boost growth and reduce unemployment. The program also aims to strengthen the social safety nets to better protect the poor and vulnerable groups.

Outlook

GDP is expected to grow by 3.8 percent in FY16, slightly lower than the 4.2 percent growth achieved in FY15, before rebounding gradually thereafter. Growth in FY16 is expected to be entirely driven by domestic demand as consumption remains resilient and public investments crowd-in the private sector. Net exports, on the other hand, continue to be a drag on growth due to the shortages in hard currency and an overvalued real exchange rate. Over the medium term, growth is expected to pick up as economic reforms progress and

key sectors recover.

The fiscal deficit is expected to narrow over the medium term, assuming the government implements the envisaged fiscal consolidation measures. On the external front, Egypt's accounts are likely to worsen in FY16 due to the sharp decline in tourism and lower transfers before recovering slowly afterwards, provided that the CBE continues to ease restrictions on foreign exchange and re-aligns the exchange rate. Current conditions do not appear conducive to significant poverty reduction. While recent efforts to better target food subsidies and to implement the constitutional commitments to increase spending on health and education should help alleviate poverty, higher energy prices and the new VAT could lead to higher inflation in the short term with a negative impact on the poor. The gradual expansion of programs like Takaful and Karama and geographically-targeted programs such as the "Economic Development for Inclusive and Sustainable Growth in Upper Egypt" hold promise for poverty-reduction in the future.

Risks and challenges

The Egyptian economy faces three main challenges: (1) resolving the major macroeconomic imbalances (including exchange rate re-alignment and fiscal consolidation); (2) bringing down the high poverty rate and closing the spatial disparities in health and education outcomes; and (3) jumpstarting growth through implementing structural reforms. Reforms envisaged under the IMF's EFF hold promise to restore macroeconomic stability, but the contractionary and inflationary impacts associated with some measures (such as the energy price adjustments) will have to be mitigated by policies aimed at improving the business environment and strengthening safety nets to better protect the poor. Meanwhile, public expenditure restructuring and governance reforms are crucial to ensure better service-delivery, especially in lagging regions.

TABLE 1 Arab Republic of Egypt / Macro outlook indicators

(annual percent change unless indicated otherwise)

| | 2013 | 2014 | 2015 | 2016 f | 2017 f | 2018 f |
|---|-------|-------|-------|--------|--------|--------|
| Real GDP growth, at constant market prices | 2.1 | 2.2 | 4.2 | 3.8 | 4.0 | 4.2 |
| Private Consumption | 2.8 | 4.1 | 3.6 | 4.0 | 3.0 | 3.0 |
| Government Consumption | 3.9 | 6.6 | 7.0 | 3.5 | 1.1 | 3.7 |
| Gross Fixed Capital Investment | -8.7 | 1.5 | 8.7 | 4.1 | 11.2 | 12.5 |
| Exports, Goods and Services | 5.6 | -11.9 | -0.5 | -5.0 | 5.0 | 6.5 |
| Imports, Goods and Services | 0.5 | 0.2 | 0.4 | -1.0 | 4.0 | 6.5 |
| Real GDP growth, at constant factor prices | 2.1 | 2.2 | 3.1 | 2.8 | 4.0 | 4.3 |
| Agriculture | 3.0 | 3.0 | 3.0 | 3.3 | 3.0 | 3.0 |
| Industry | 0.6 | 1.5 | 1.0 | 1.7 | 3.5 | 4.0 |
| Services | 3.1 | 2.6 | 4.7 | 3.4 | 4.6 | 4.8 |
| Inflation (Consumer Price Index) | 6.9 | 10.1 | 10.9 | 10.2 | 17.0 | 13.0 |
| Current Account Balance (% of GDP) | -2.2 | -0.9 | -3.7 | -5.4 | -5.3 | -4.9 |
| Financial and Capital Account (% of GDP) | 3.4 | 1.7 | 5.4 | 4.7 | 2.4 | 4.8 |
| Fiscal Balance (% of GDP) | -13.0 | -12.2 | -11.5 | -12.1 | -10.0 | -8.9 |

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