EGYPT

Highlights

- **Growth decelerated in the first half of fiscal year 2015-16.** While private consumption and investment remained resilient, a contraction in exports of nearly 11 per cent drove a slow-down in the first half of 2015-16. Foreign exchange shortages have also hurt economic activity, particularly in the manufacturing sector.
- **Structural reforms have continued, albeit at a slower pace.** A long-awaited VAT bill was recently approved with minor amendments and a new civil service law has been passed, albeit with significant amendments. However, tariff and non-tariff barriers to trade have risen as the authorities have tried to mitigate balance-of-payments pressures.
- **Some initiatives have been taken to expand access to finance.** A new regime for pledging movable assets has been introduced; the central bank has launched a scheme to target higher lending to small and medium-sized enterprises (SMEs) by banks; and a new insolvency law is currently being drafted to address some of the deficiencies of the existing framework.

Key priorities for 2017

- **Restoring macroeconomic stabilisation will boost investor confidence.** The top priorities are improving the functioning of the foreign exchange market and undertaking credible fiscal consolidation to ensure the sustainability of public debt.
- **Advancing structural reforms is needed to enhance the business climate.** In the short term, priorities include modernising the insolvency framework; streamlining industrial licensing procedures; and improving the transparency, accountability and competitiveness of the public procurement process.
- **The authorities have started addressing challenges in the water sector.** Increased investment in water and wastewater infrastructure – including through public-private partnerships (PPPs) – can reduce leakages, improve water quality and result in more efficient pumping. In addition, introducing incentives to control costs in state-owned holding companies and resource efficiency legislation can help address these issues.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	2.2	2.1	2.2	4.2	3.8
Inflation (average)	8.6	6.9	10.1	11.0	18.0
Government balance/GDP	-10.0	-13.4	-12.1	-11.7	-12.0
Current account balance/GDP	-3.7	-2.2	-0.9	-3.6	n.a.
Net FDI/GDP [neg. sign = inflows]	-1.4	-1.3	-1.4	-1.9	n.a.
External debt/GDP	12.5	16.4	15.6	14.9	n.a.
Gross reserves/GDP	5.6	5.2	5.5	6.1	n.a.
Credit to private sector/GDP	28.1	26.9	26.4	26.8	n.a.

NOTE: All figures are for the fiscal year July-June, except gross reserves and private sector credit.

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Macroeconomic performance

Economic activity picked up slightly in the first three quarters of 2015-16. GDP growth reached 4.2 per cent in 2014-15 thanks to policy reforms, financial support from Gulf countries and a more stable political situation, and ticked up to 4.3 per cent year-on-year in the first three quarters of 2015-16. Private consumption continued to be the primary driver of growth and investment remained resilient. However, a fall of nearly 20 per cent in exports in real terms meant that net export performance remains a significant drag on growth. Unemployment is on a downwards trend but nevertheless remains elevated at 12.5 per cent as of the second quarter of 2016.

External imbalances have widened and international reserves declined to a critical level. The current account deficit widened to 5.6 per cent of GDP in the first three quarters of 2015-16, compared with 3.4 per cent of GDP in the same period a year earlier. This development has been primarily driven by a fall in transfers into the country, with both official transfers and remittances falling by nearly 1 per cent of GDP over that time horizon. The balance of services has also weakened as a result of a fall in tourism receipts (amid security concerns and flight bans) and declining Suez Canal earnings amid slowing global trade. Meanwhile, foreign direct investment (FDI) inflows have improved only slightly, to 2.3 per cent of GDP. As a result, international reserves fell below the critical threshold of three months' worth of imports.

Despite a recent exchange rate devaluation, foreign exchange shortages continue. Declining foreign exchange receipts combined with the central bank's measures to clamp down on the parallel foreign exchange market have led to significant foreign exchange shortages, which adversely impact on the private sector's ability to import, plan and repatriate profits. A 13 per cent devaluation of the Egyptian pound in March 2016 was accompanied by statements that the central bank would be adopting a more flexible exchange rate policy. This should increase the availability of foreign exchange, support competitiveness and attract foreign investment, but will increase inflationary pressures (inflation stood at 14 per cent in September 2016 – well above its SEMED peers). Nevertheless, the Egyptian pound has continued to weaken on the parallel foreign exchange market.

Despite a modest improvement in the government balance, fiscal pressures persist and public debt is rising. The fiscal deficit stood at 11.7 per cent of GDP in 2014-15 – down from 12.1 per cent in the previous year. The improvement was driven by significant reductions to subsidy spending, helped also by a modest reduction in public wage spending and a slight increase in tax revenues as a share of GDP. However, the deficit remains wide and grant receipts in particular are under pressure, falling from 4.6 per cent of GDP in 2013-14 to 1.0 per cent of GDP in 2014-15. In the first three quarters of 2015-16, grant receipts continued to fall, to 0.2 per cent of GDP. As a result of wide deficits, public debt has risen to over 90 per cent of GDP. The majority of this debt remains domestically held, with external debt at around 15 per cent of GDP.

A staff-level agreement has been reached with the IMF for a US$ 12 billion three-year Extended Fund Facility, subject to IMF Executive Board approval. IMF funding will help cover part of Egypt's total external financing gap, which is estimated at US$ 35 billion over the next three years, thus helping to cushion foreign reserves. The programme's primary aims are to improve the functioning of foreign exchange markets; bring down the budget deficit and public debt levels; and raise growth through supporting the government's reform efforts to improve the business environment, deepen labour markets, simplify regulations and promote competition. Strengthening the social safety net to protect the vulnerable during the process of adjustment is a cornerstone of the programme.

Economic activity is expected to pick up next year. Growth is expected to rise from an anticipated 3.8 per cent in 2015-16 to 4.0 per cent in 2016-17, assisted by improved competitiveness. Domestic and regional security risks present a downside risk to the forecast.

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Major structural reform developments

A number of initiatives have aimed to tackle the obstacles to accessing finance. The recent Law No. 115 of 2015, introduced in November 2015, aims to address deficiencies in the legal framework governing security by creating a new regime for pledging a wide range of movable assets and centralising security registration. These amendments should ease collateral requirements for SMEs in particular, although it remains to be seen how and when the law will be implemented. In addition, in January 2016 the Central Bank of Egypt (CBE) launched a scheme whereby banks are obliged to provide E£ 200 billion in loans to SMEs over a period of four years at a 5 per cent interest rate, offsetting the amount they lend against obligatory reserves at the central bank. Banks are also requested to allocate 20 per cent of their portfolio to SMEs. However, this is likely to be an infeasible target for most commercial privately owned banks, and there are concerns about a potential weakening of banks' asset quality given the high credit risks of SMEs. As of mid-2016, a new insolvency law was being drafted which would modernise the legal framework for dealing with bankruptcies. At the moment, there are no real means to effectively reorganise a viable business or to swiftly liquidate a failed one.

The CBE has issued new rules to limit concentration and retail lending risks in the banking system. Under the new rules, introduced in January 2016, the single borrower limit has been reduced from 20 per cent to 15 per cent of a bank's Tier 1 capital and the limit for lending to a single borrower (and related borrowers) has been reduced to 20 per cent from 25 per cent. Limits relating to retail lending (which accounts for 50 to 60 per cent of the lending portfolio of many banks) have also been introduced in the form of maximum loan-to-income ratios. The maximum monthly cost of servicing mortgages has been set at 40 per cent of monthly income, while the cap for non-mortgage retail loans has been set at 35 per cent.

Fiscal structural reforms are ongoing, albeit with delays. On the revenue side, the long-planned introduction of a modern, broad-based value-added tax (VAT) to replace general sales tax was finally approved in August 2016, with minor amendments. The new tax, which came into effect in September, is estimated to raise revenue of 1.0 to 1.1 per cent of GDP. On the expenditure side, while major subsidy reforms have been enacted, several factors have complicated other structural reforms to reduce the deficit. Debt service payments are on the rise and concerns over inflation have led to revisions of the schedule for electricity tariff rises, stretching the deadline for the phasing out of subsidies to 2020 instead of 2019. Moreover, the deficit needs to be brought down while simultaneously increasing growth-enhancing expenditure on health and education, in line with constitutional commitments. Notably, however, a Civil Service Law that overhauls public sector compensation was finally approved in July 2016 after initially being rejected by parliament in February and undergoing significant amendments, including raising the cap on annual salary increases for civil servants.

The authorities have announced plans to offer shares in state-owned assets in the financial and energy sectors. In March 2016, the CBE governor announced that Egypt will offer a 40 per cent stake in Arab African International Bank and a 20 per cent stake in Banque du Caire on the Egyptian Stock Exchange by the end of the year. The authorities are also planning to offer shares on the stock market in five part state-owned energy companies: Middle East Oil Refinery (MIDOR); Ethylene Derivatives Company (Ethydco); Sidi Kerir Petrochemical Company (Sidpec); Alexandria Mineral Oils Company (AMOC) and Misr Fertiliser Production Company (Mopco). These listings are also expected to be made by the end of the year. The announced offerings are significant because they mark a change in recent government policy – no state-owned companies have been listed on the exchange since 2005.

Barriers to trade have been rising. In February 2016, tariff rates on imported luxury goods (such as pet food, kitchen appliances and textiles) in the 10 to 30 per cent range were increased to levels of 20 to 40 per cent. Additional registration requirements for importers were also introduced, as part of the government's plans to cut import spending by a quarter in this fiscal year to mitigate balance-of-payments pressures.