

Egypt – Quiet Progress

While a number of major geo-political events such as the ongoing investigation into Russian meddling of the US elections, saber-rattling by North Korea, Brexit and the more recent Qatar dispute, continue to take-up much of the global media headlines and analysis, Egypt has quietly been making progress on the economic front since it floated the pound and signed up to an IMF program late last year.

Investors Return

One of the first positive effects resulting from the decision to devalue and float the local currency in November last year, was the swift return by offshore investors into Egyptian assets, attracted by a more transparent FX regime and high yield environment in a world where right now every basis point counts. The government has taken advantage of this demand by conducting two international bond issues so far this year, with last month's sale raising US\$3 bio, which was almost double the amount originally targeted, and achieved at better rates than the previous issuance held in January. These hard currency inflows were boosted further by a more than 10% increase in remittances by Egyptian expatriates during the first quarter of 2017, and has helped stabilize the currency as well as providing the Central Bank with an opportunity to replenish its foreign exchange reserves, which had fallen sharply since 2011 but as at the end of last month now stand at a six-year high. It has also led to the removal of most foreign exchange restrictions including the scrapping of the US\$100,000 annual currency transfer limit last week. Freeing up the currency was one of the key conditions demanded by the IMF and this, plus a promise by the government to follow a program of initially painful economic reforms, allowed the fund's board to approve a US\$12 bio three-year loan facility, the first tranche of which has already been released.

Of course the sharp drop in value of the Egyptian Pound has also had a detrimental impact, particularly with regards to inflation, which has soared from an already high 15% in mid-2016 to 32% in April this year, forcing the Central Bank to hike its benchmark rates by 200bp last month. However we believe that most of this inflationary increase, triggered by the currency devaluation, has now been absorbed, and that it will begin to ease during the second half of this year. A hopeful sign that this may have already begun was a reported dip in the annual urban inflation rate to 29.70% in May.

Implementation of Reforms

President Abdel-Fattah al Sisi's administration has had to follow a delicate path in the implementation of its economic reform program, including a reduction in subsidies and the introduction of VAT, in order to keep its promise to the IMF and at the same time try to soften the effect these changes have had on Egypt's large number of poor families. Thus far its tightrope walk has been relatively successful, thanks in part to the patience of Egypt's citizens and some measures aimed at protecting the most vulnerable against the sharp increase in the cost of basic commodities.

Reducing red-tape and boosting the private sector are issues requiring urgent attention if Egypt's economy is to expand and new jobs created. In this regard the government finally ratified the long-awaited 'investment law' recently. This bill includes a number of incentives such as; a 50% tax rebate on investments made in underdeveloped regions, and the restoration of private-sector free-zones which will be exempt from customs excise. However this reform process will be a long-road to traverse and so the risk of reform delays and/or reversal, as well as the potential for a return of social unrest needs to be kept in mind.

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Political Stability

Egypt has experienced severe political and social upheaval since the 2011 revolution; however the current government seems to have managed to stabilize the security situation significantly since it assumed office, and does not appear to face any immediate serious challenge to its legitimacy. However the risk posed by militant groups in the northern Sinai remains, as does the chance of fresh terrorist acts, the latter highlighted most recently by the killing of a number of Coptic Christians in an attack on their convoy near the southern city of Minya last month. On the international front, the clear improvement in relations between Washington and Cairo since the election of Donald Trump, combined with ongoing support from the main GCC states, and closer economic ties with China will help underpin Sisi's administration.

Economy

Tourism, which is one of the country's most important employment and foreign exchange generating sectors, has also been the hardest hit by the years of political unrest and terrorist attacks since 2011. This was highlighted in recent data concerning tourist arrivals, which showed that just 4.8 million visitors travelled to Egypt last year against 14.8 million in 2010. This situation although dire has begun to show some improvement, with the Tourism Promotion Council reporting a 50% increase in arrivals during the first four months of this year compared to 2016, driven by a sharp rise in the number of tourists arriving from Poland, Ukraine, Germany and Italy attracted by bargain packages, as well as Egypt's many renowned tourist attractions. Elsewhere the weaker currency has also helped exports rise by 14% so far this year, particularly when it comes to agricultural products, textiles, construction materials and chemicals, this in turn has supported a further shrinking of the C/A deficit, (although admittedly importers face the opposite challenge). Meanwhile the World Bank is also relatively optimistic on the outlook for the Egyptian economy, as outlined in its recent 'Global Economic Prospects' report which states; "Egypt's growth is expected to remain near 4% in fiscal year 2017 and strengthen in the two years thereafter, supported by the gradual implementation of business climate reforms and improved competitiveness, although high inflation weighs on near-term activity," adding that it forecasts growth of 4.60% in 2018 and 5.30% in 2019 which would be close to the level achieved in 2010.

Local Market Colour

Although liquidity in the local FX market continues to improve, it can still take time for those transactions outside of the repatriation mechanism to be filled, whilst activity within the interbank market remains sporadic. However as mentioned earlier the demand for T-Bills is strong, with foreigners now holding close to US\$9bln worth of this paper, and the attractiveness of Egyptian assets to offshore investors looks set to persist. Thus we are of the opinion that unless there is a major 'risk-off' selloff in global EMFX and equity markets in the near future, then there is potential for the USD/EGP exchange rate to move back below its current 18.00 spot level towards the 16.00 area in the short-term.

| USD/EGP | Ref Rate | 1 month | 2 month | 3 month | 6 month | 9 month | 12 month |
|----------------|----------|-------------|-------------|-------------|-------------|-------------|-------------|
| Spot | 18.10 | | | | | | |
| NDF (Outright) | | 18.20/18.40 | 18.30/18.60 | 18.40/18.70 | 18.90/19.20 | 19.40/19.70 | 19.90/20.20 |
| T-Bill Yields | | | | 20.20% | 20.30% | 20.30% | 20.30% |

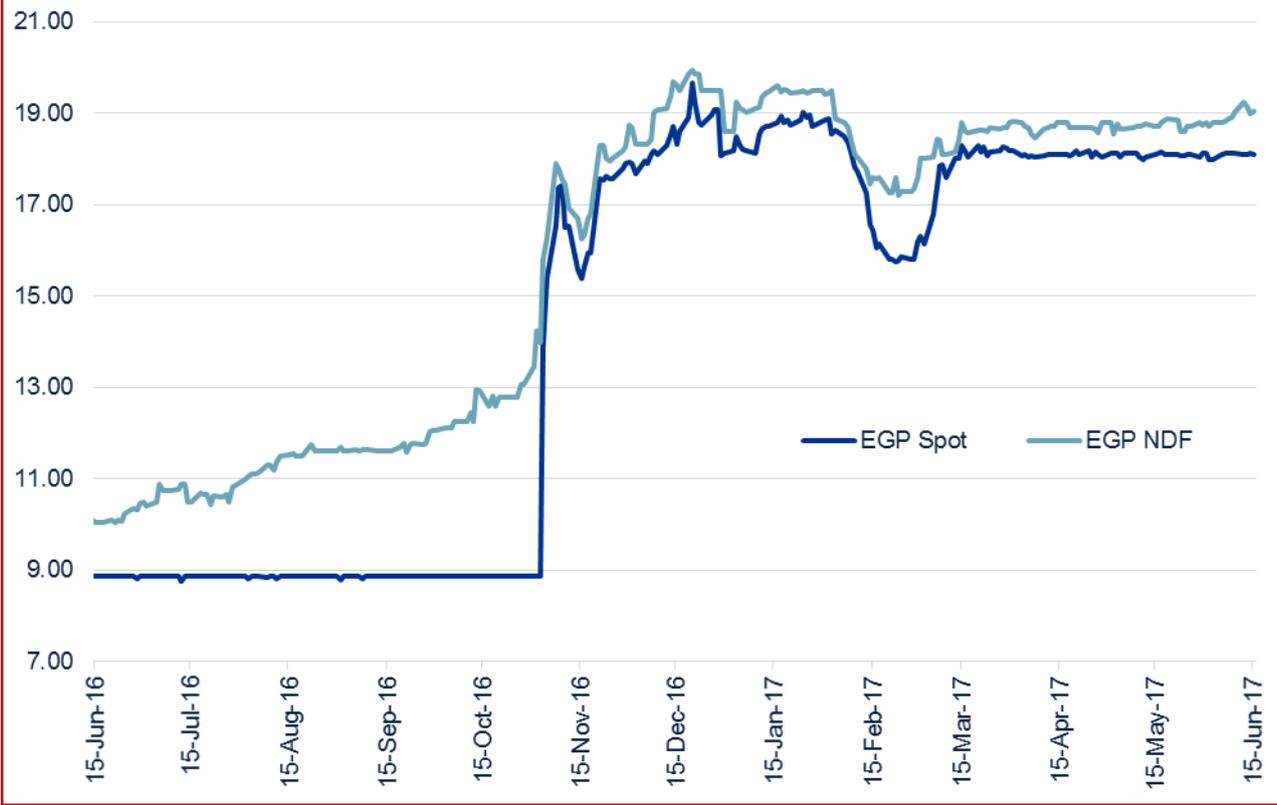
*Indicative levels only as at 16 June 2017

Conclusion

As outlined above we are cautiously optimistic about Egypt's economic recovery in the near term, however there is no doubt that the country still faces a myriad of challenges, and thus the continued implementation of both social and economic reforms will be key in order for this strategically important country to achieve a sustainable and stable long term future.

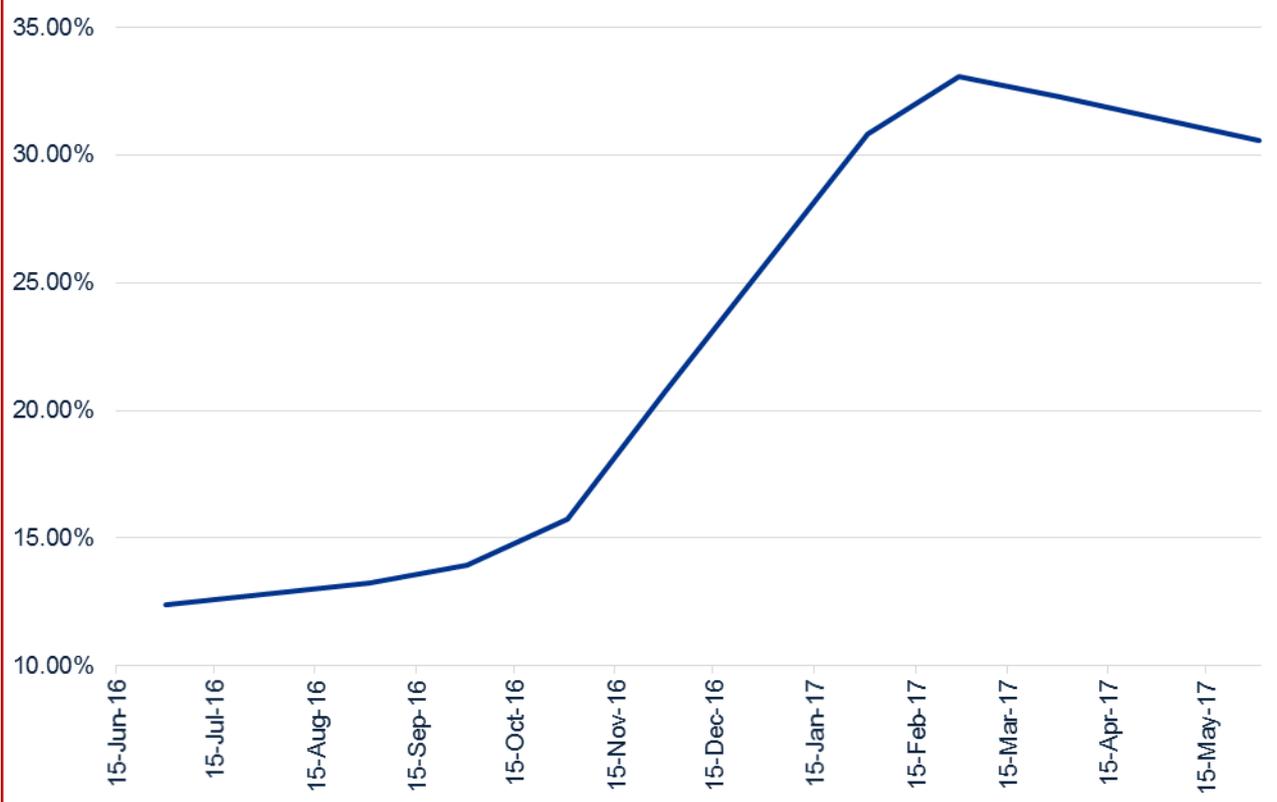
USD/EGP - Spot vs 1Y NDF

Source: Bloomberg/FAB



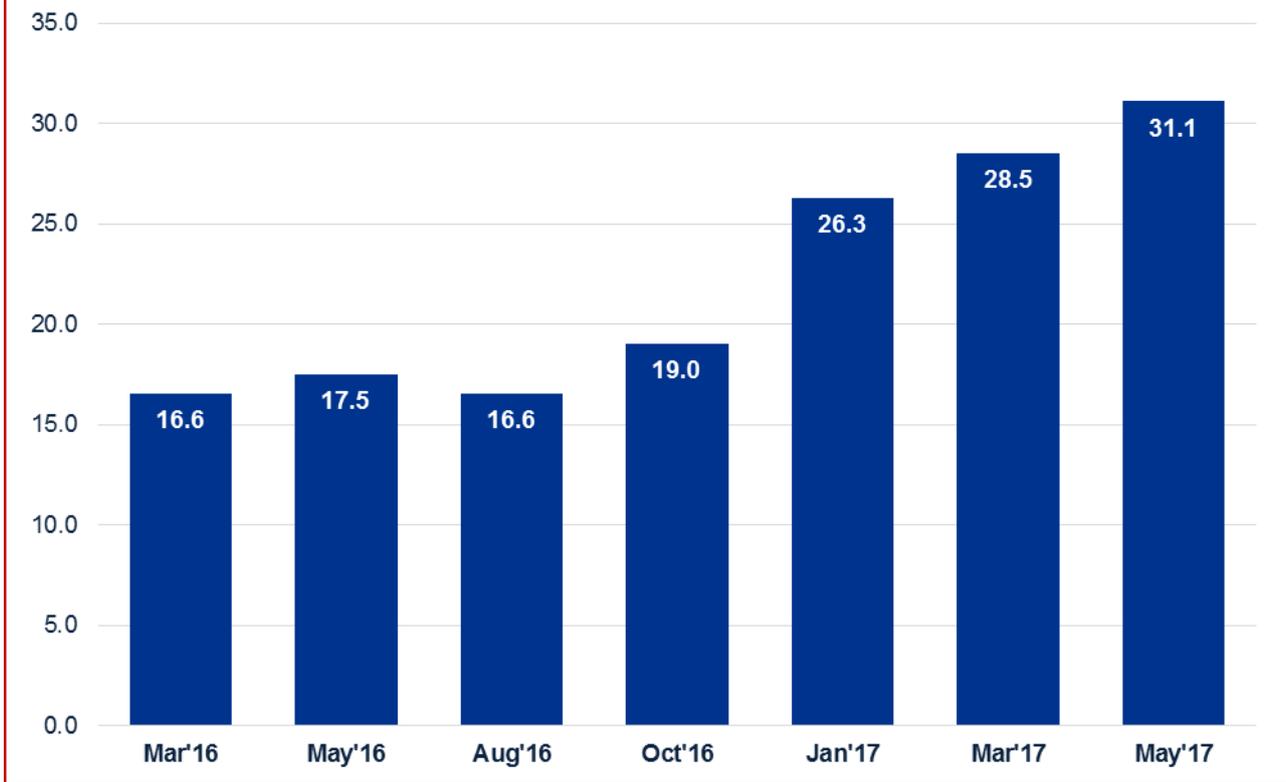
Core Inflation - month-on-month

Source: Bloomberg/FAB



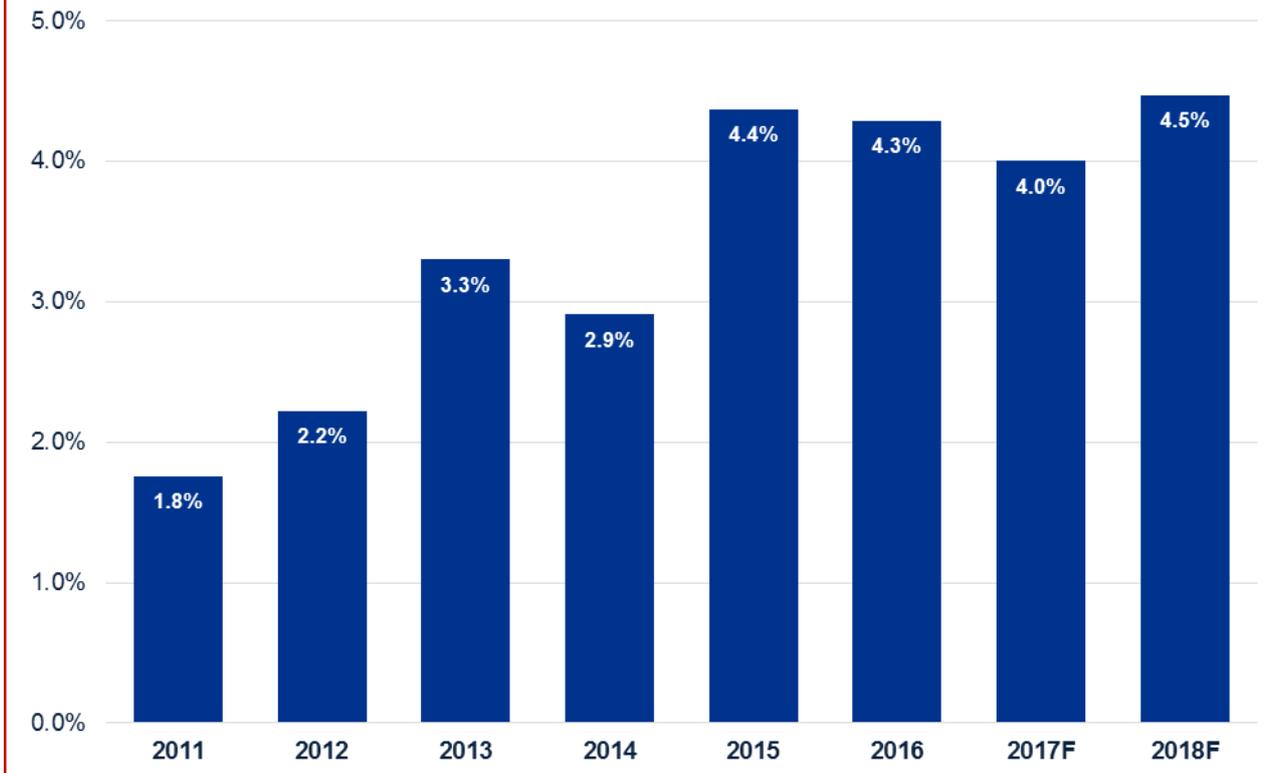
FX Reserves in US\$ Billion

Source: Central Bank of Egypt/FAB



Real GDP Growth (y-o-y % growth)

Source: IMF/WB/FAB



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