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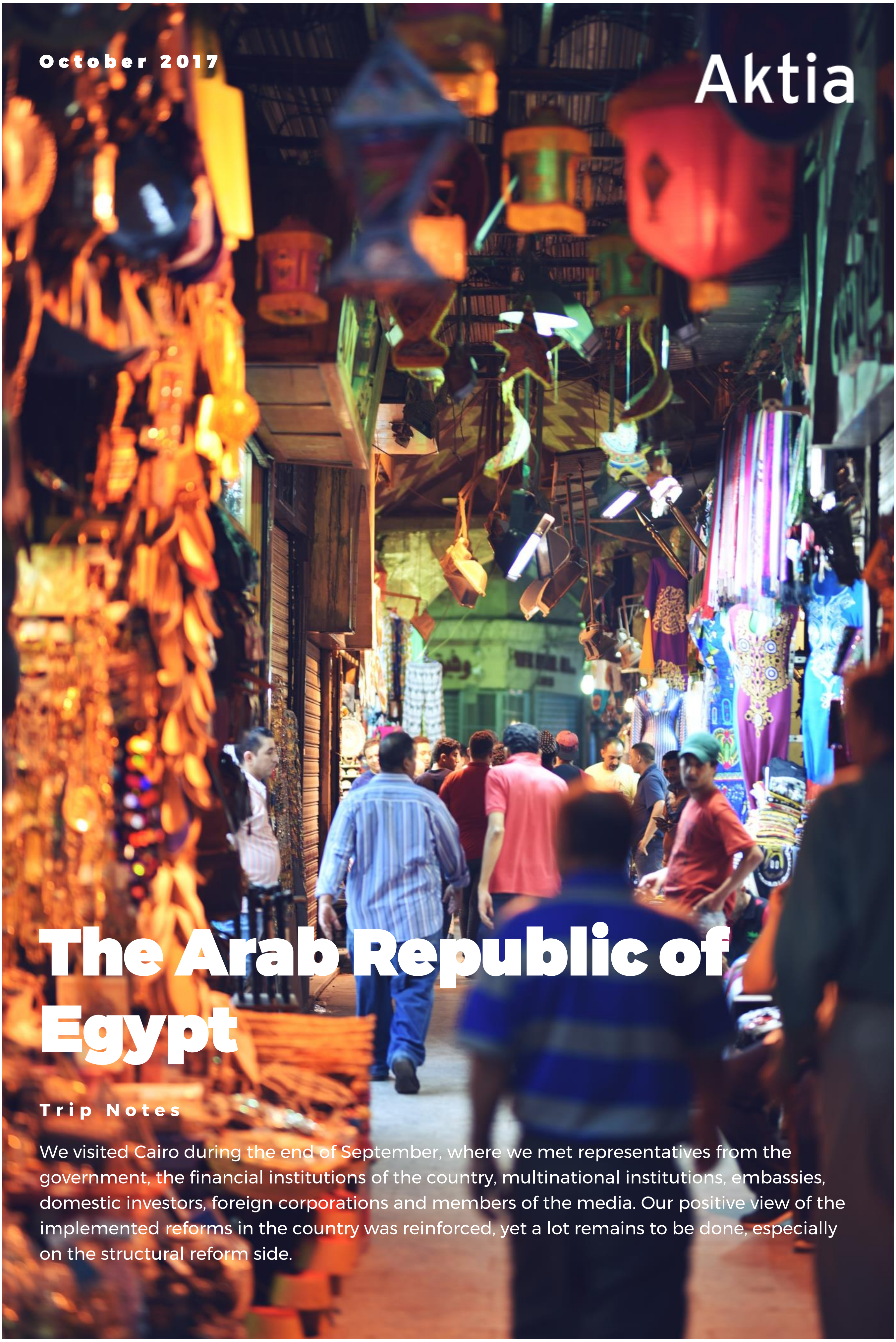
Aktia



The Arab Republic of Egypt

Trip Notes

We visited Cairo during the end of September, where we met representatives from the government, the financial institutions of the country, multinational institutions, embassies, domestic investors, foreign corporations and members of the media. Our positive view of the implemented reforms in the country was reinforced, yet a lot remains to be done, especially on the structural reform side.

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- 13 meetings during two days with a wide range of stakeholders and observers
- The second largest IMF-lending program: success is paramount for all parties
- Positive short-term momentum from successful reforms coupled with need for stability due to upcoming elections in the spring of 2018
- Big question on everyone's lips is whether the authorities can maintain their reform momentum in the mid-term
- Substantial medium-term potential arising from favourable demographics, a beneficial geographic location, natural resource discoveries and a very attractive domestic market.

The Aftermath of the Arab Spring

The long serving president of Egypt, Hosni Mubarak, was overthrown during the revolution of 2011, followed by elections and the short lived government of Mohamed Morsi, who in turn was ousted by a counter-revolution and the eventual coup d'état of the military and election of the current president Abdel Fattah el-Sisi, the former head of the Egyptian Armed Forces, in 2014.

This extended period of uncertainty, coupled with the wider instability in the area in the aftermath of the Arab Spring, exposed the structural weaknesses in the economy. High inflation and a fixed exchange rate resulted in an overvalued currency and a depletion of international reserves. The resulting hard currency shortage, uncertain political and deteriorating security situation caused slowing growth and a decrease in foreign investments and tourism, accentuating the balance of payments problems. Low tax revenue, coupled with high public spending on wages and often inefficient subsidies, led to excessive budget deficits and an high accumulated level of government debt. Egypt has one of the lowest labour participation rates in the world (50 %), 700 000 young Egyptians enter the workforce every year and the below potential GDP growth (potential estimated to be 5-6 % by the IMF) was not helping.

Reforms begin with the support of the IMF

Egypt and the IMF announced a 12 bn USD financial assistance package in the form of an Extended Fund Facility, the second largest IMF lending agreement so far. It seems that the commitment to the program is very high, going to the very top on both sides, a positive signal for the continuation and success of the program. **The first phase** of the program, the macro stabilisation, started with a floatation of the Egyptian pound, leading to a weakening around 50 % against the dollar. This started the path towards a regained external equilibrium and set the ground for a pick-up in growth, as the fx-shortages was seen as the major impediment to doing business. The authorities have addressed the internal imbalances with recurring cuts in electricity and fuel subsidies, both large drags on the government budget (12bn USD deficit from subsidies), coupled with constraints on public salaries.

"The cuts are coupled with simultaneous increases in more efficient social spending targeted at the most exposed segments of society, in the form of direct cash transfers, food subsidies and increased pensions"

The subsidy cuts were perhaps surprisingly front-loaded, e.g. the increase in electricity tariffs during the summer came as a surprise to many, but full cost recovery is targeted over the IMF-program for fuel and within 6-7 years for electricity. The arguably unpopular subsidy cuts are finished for the current fiscal year (July17-June18), well in advance of the upcoming presidential election. Also 1bn USD of efficiency gains will be achieved with the introduction of three new Siemens powered gas plants. The cuts are coupled with simultaneous increases in more efficient social spending targeted at the most exposed segments of society, in the form of direct cash transfers, food subsidies and increased pensions. The revenue side has also been improved, with e.g. the introduction of a new value added tax, which will be broadened in the future. The government has sacrificed a lot of political capital in the course of the reforms, implementing changes that no previous government has been able to do.

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The Need for Structural Reforms

The second phase of the program will be focused more on structural inefficiencies in the economy. The focal point is GDP growth and eventually increasing disposable incomes, important factors for social stability and attracting FDI going forward. The reform program includes increasing access to nurseries and improving the safety of public transport to help women join the labour force along with training programs for youth to generate more inclusive growth. Licensing reforms for industries are streamlined, so that 80 % should be licensed with only a notice, e.g. fire standards are causing a lot of unnecessary red tape at the moment. Bankruptcy, leasing and factoring laws are improved. The government, all the way from Sisi, are really engaged in improving business conditions according to a foreign corporation we spoke to. The next focus of the authorities will be the implementation of all these initiatives, traditionally a stumbling block in the country. Implementation will be particularly challenging after waves of clean-ups in the bureaucracy during consecutive revolutions. The government is still a massive employer, with government wages (ex-military) representing 6,6 % of GDP, however this will naturally decrease as wages are frozen and 150k people leave the payroll naturally each year. We see delays in structural reforms as one of the main risks in the medium-term.

There is plenty of scope for privatisation, but the word is still stigmatised and associated with cronyism in the public perception, after a failed last round of privatisations. That is one of the reasons the authorities plan to only float part of the stakes, instead of full privatisations. If the first IPO's go well, more can be done. The largest financial institutions in the country are government owned and so is the huge vertically integrated Egyptian Electricity Holding Company, serving over 30 mio customers.

Security and Geopolitics in a Volatile Region

The security situation has stabilised, although North Sinai is still precarious; the army has imposed a media blackout and ISIS is still very active in the area, on the mainland they have mostly targeted Coptic churches. There has been no major social unrest so far, people have not returned to the streets, much due to severe revolution fatigue, mainly from the failure in 2011, a clamp down by the government and the jailing or exile of the Muslim Brotherhood's core.

Tourism, a vital sector that has suffered from the security situation, has picked up strongly, although from low levels. The visitors are especially from the Gulf, increasing the spend per night. Egypt sided with the rest of the GCC against Qatar, which was natural due to the amount of Saudis buying properties and vacationing in the country. The last loan to Qatar had been paid off in 2016 and the Saudi government has continued supporting Egypt financially. Egypt also continues to have a good relationship with the US, a large donor and China, a large investor and lender. There is still a travel ban from Russia and partly the UK, traditionally the two most important sources of tourism. There are hopes that a 25 bn USD nuclear deal with Russia would facilitate the lifting of the travel ban.

Growth is Key

Natural gas, construction and strong exports, on the back of the devaluation, have also contributed to growth. PMI's are nevertheless still in contraction, so a lot of the growth is coming from the public sector. The military is heavily involved in especially infrastructure projects, and its growing part in the economy is a worry. The liberalisation and privatisation of the economy will be a litmus test of the structural reforms, sending a signal that Egypt is open for business again. International investors are already returning, with FDI growing strongly again, to around 8 bn USD, at these levels first time since 2008. Half of this was into the energy sector and the rest into food industries, pharma and consumer goods. The authorities hope that more investments would be directed into labour intensive industries, providing jobs for the young population. The GDP growth for Q2 was 4,8 % and the IMF estimate for FY17/18 is 4,5 %.

On the Road to Internal and External Balance

The government targets **a primary surplus** and a 9,3 % deficit overall for this fiscal year. The budget deficit will decrease to 8 % for the next fiscal year according to the authorities. Debt to GDP was 107 % at the end of June and is projected to decrease to 95 % within a year. The government's optimistic growth projections remain a risk to the estimate.

The devaluation supported the **current account** (Q2 deficit halved compared to 2016). The new gas fields will be an important contributor to the current account when online. After that, the largest improvement might be behind, as capex is estimated to pick up with growth (companies mostly borrowing working capital at the moment) and new importing consumer goods companies are moving to Egypt.

"The medium-term prospects for Egypt are supported by a young population, a large domestic market, the widening of the Suez Canal and the planned adjacent economic zones targeted for manufacturing and the newly found large gas deposit"

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Inflation will Moderate Soon

The large devaluation increased inflation due to substantial fx-pass-through. Inflation was simultaneously amplified by the subsidy cuts. Food comprises 40 % of the CPI-basket and most food is transported by truck, so the fuel price increases have an unusually large effect on inflation. YoY inflation was still 31,9 % in August, but it seems to have **peaked during the summer** (Aug MoM +1,1 %), the base effect of the devaluation will fall away in November and the effect of the subsidy cuts will also disappear. Egypt is the single largest importer of wheat and the lower wheat prices also support a lower inflation. The IMF mission chief communicated in September that they expect inflation to fall to slightly above 10 % by the summer of 2018 (World Economic Outlook 2018 average 21,3 %). The target for Q418 by the central bank is 13 ±3 % and their medium-term target for inflation is 8 %. A risk to the outlook is aggressive fiscal tightening through a continuation of faster than expected subsidy cuts, as petrol and electricity prices should still double and diesel triple for full cost recovery. If inflation targets are met, possible unwinding of interest rates might follow, after two hikes in 2017. August inflation was already within the target if the effect of the electricity reform is removed.

Transition from Quantity to Quality of Foreign Flows

Many commentators expect cuts of 400 bps within the next 12 months, also because the current lending rate (19,75 %) is seen as stifling growth. The previous hikes this year have increased portfolio flows into the country and increased the central banks credibility in tampering inflation and reinforced the bank's independence. The central bank's other policy tool is managing liquidity, which it used in October by increasing the minimum reserves commercial banks have to hold at zero interest in the bank. Its other sterilisation operations have been expensive due to the high deposit rates. The liquidity tightening might also increase the possibility of a counterbalancing through a cut in rates.

The central bank's ***repatriation mechanism*** has guaranteed the convertibility of pounds into US dollars for an additional fee of 0,5 % since 2013. This guarantee, one of its kind, has enabled large portfolio flows into the country, increasing reserves substantially, as foreign investors have hedged the convertibility risk in their Egyptian local currency investments. The cost of accumulating reserves in this way has, however, been expensive for the central bank: the additional pounds in the system have been sterilized at local high rates, the dollars remain in the central bank, invested in US T-Bills, instead of making it into the economy through interbank market. Now, that the mechanism seems to have done it's job, it seems evident that it will be revisited, probably by hiking the price of the hedge to 3-5 % or reserving it for longer term investors. Old contracts will most probably be respected though and no changes should apply retrospectively. The hope is that investors will come to the interbank market instead and this would probably make the **pound appreciate**.

The central bank is comfortable with the amount of reserves at the moment, amounting to **eight months of import cover** (36,5 bn USD in September). There is much focus domestically on reserves, due to recent fx-shortages, and therefore the central bank wants to keep a healthy buffer. Reserves are at pre-revolution levels, but include more short-term funds than historically. Foreign investors own a record 30 % of Treasury bills and a shift in foreign sentiment would thus be detrimental. The central bank would like to see a shift in the capital account towards FDI from portfolio flows.

"If you want dollars, you can get them"

The devaluation has eradicated the parallel market for the pound, there are no dollar shortages anymore, backlogs are cleared and the government's dollar arrears have basically been cleared (apart from the oil and gas sector, with around 3 bn USD in arrears). The banking sector has received almost 50 bn USD since the floatation, e.g. through "pillow money" and remittances (20 bn USD yearly), as confidence is returning. Remittances grew 40 % YoY in August. It is in the authorities interest not to let the pound depreciate, causing additional inflation, before the 2018 elections. So there are good arguments for the pound to appreciate in the next sixth months, especially if the repatriation mechanism is amended. A rift in Egypt-GCC relations could pose a risk to this view.

We Remain Very Positive Towards Egypt

The medium-term prospects for the Egyptian economy are supported by factors including a young population (62% under 35 years old), a large domestic market, the widening of the Suez Canal and the planned adjacent economic zones targeted for manufacturing and the large gas deposit found in Egyptian territorial waters in the Mediterranean; the Zohr field.

We maintain our positive view on Egyptian local currency investments, especially the Treasury Bills, which still yield between 18 – 19 %, depending on the maturity and the Egyptian government bonds, yielding around 15 % in five and ten year maturities. All three Aktia's local currency strategies remain strongly invested in Egypt. We are also constructive on the hard currency side, although we've shortened the duration of our investments after very strong year-to-date returns, attractive roll-down in the shorter end and in anticipation of upcoming longer issuance. We look especially forward to the planned euro-denominated issuance in the beginning of 2018.

"There are good arguments for the pound to appreciate in the next sixth months"