EGYPT

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SEMI CONFIDENTIAL

Trip notes

We participated in a three-day investor trip to Cairo to re-assess the economic situation. We met more than 20 representatives from government, central bank, local banks, multinational and domestic corporates, academics, entrepreneurs and political analysts. The trip re-affirmed our positive outlook on the Egyptian economy, whilst highlighted the key challenge of competitiveness in the medium term. Below are our reflections on few selected themes

FX liquidity

The FX market is increasingly liquid and EGP flotation has been a success by the CBE. The BoP is improving rapidly and overseas repatriation is progressing as well. All backlogs have been eliminated and the USD interbank market is growing. IMF objectives in terms of net international reserves (NIR) have been outperformed.

Our interpretation of CBE statements is that the repatriation mechanism can clearly be considered as a key monetary tool. At present, we consider that the repatriation mechanism drives exchange rate movement via reserves accumulation with inflation becoming the cornerstone of CBE's monetary policy. This confirms our view that recent interest rate hikes had two main objectives: *i)* increasing the attractiveness of Egyptian assets and *ii)* meeting IMF requirements. The role of the interest rate as a tool to fight inflation is rather limited. Several possibilities are being studied regarding the evolution of the repatriation mechanism.

There is relative consensus that the EGP will appreciate in 2018. In the medium term, nevertheless, we expect a gradual depreciation in order to preserve Egypt's external competitiveness in a context of high, albeit declining, inflation and uncertain progress in factor productivity. Exports could substantially grow notably through higher foreign investments.

The current EGP spot stability can be partly linked to the prudent behaviour of large local corporates that are waiting for the interest rate easing cycle to begin in order to resume investment.

Economic activity

Consumer demand has been markedly affected by runaway inflation, but food expenditures remain relatively resilient. Consumers have become more price-sensitive and tend to cut non-essential expenditures or trade down their shopping baskets.

From a structural perspective, the main potential drivers of the Egyptian economy are *i)* construction sector linked to the growing urban footprint (driven by rapid population growth), *ii)* low and medium-tech manufacturing and *iii)* agricultural sector (highly labour-intensive).

With regard to export capacity, EGP depreciation will boost exports in 2018-2019, but rapid expansion of the export sector would be constrained by the growing size of the local market.

CPI Inflation

CPI inflation has arguably peaked in 3Q 2017. A further rise in prices could occur in early/mid 2018 with a new round of energy price hikes. The CBE objective is to reduce CPI to single-digit area in the medium term. Inflation has had the greatest impact on mid and mid-upper income households given consumption patterns and the use of private healthcare and education services. The lower-income households are notably exposed via food and transport costs, but they benefit from subsidies for a wide range of goods especially food staples.

Public finance

Fiscal policy is balancing between fiscal consolidation (subsidy cut, VAT) and social safety net measures. Interest rate hikes had the greatest negative impact on government finances but less so on the corporate sector.

The risk of fiscal slippage as a result of upcoming presidential elections (June 2018) is less likely. But that is to be confirmed in view of the upcoming social protection measures.

Deficit financing will remain multi-sourced. A significant part of the GCC debts due in 2018/19 are likely to be rolled over. The objective is to reduce debt service to 25% of total revenues (from 45% currently). The wage bill is expected to decline from 9% to 6% of GDP in the medium term.

The two main risks to fiscal consolidation are commodity price shocks (considered to be unlikely in the coming years) and execution risk of the next rounds of reform.

Banking sector

In the current post-flotation period, corporates' strategy on FX remains uncertain. Corporate loan demand is limited to working capital, while capex lending is muted due to high interest rates. Corporate are not highly leveraged thus making it less sensitive to interest rate hikes. Asset quality has not deteriorated significantly. Corporate profits have declined in some sectors, but most large corporates have flexibility to weather the current difficult period.

A consolidation of the banking sector is needed as smaller banks are not viable in the long term. However, they are not under stress to force consolidation and their risk appetite remains limited.

Financial inclusion is a key theme for both the government and banks. There are ongoing initiatives to capture unbanked households and informal SMEs to improve monetary policy effectiveness and tax collection in the long term.

Energy

The medium-term objective is no longer to be a net gas exporter but to end gas imports by late 2018 and develop Egypt as a gas hub (i.e. mutualisation of regional production capacities in an ecosystem). The gas hub vision is still under discussion with various regional partners (Cyprus, Israel, Jordan). Egypt has a genuine competitive advantage thanks to its two young LNG facilities and given the high cost of building a new one in the East Mediterranean. The key question is not to become a net gas exporter collecting rent but rather a regional center for storage and trading of gas and related energies. The realisation of this vision requires further gas discoveries notably in frontier areas such as West Mediterranean and Red Sea.

The government aims to reach cost recovery in fuel prices within 2-3 years. Liberalisation of the gas market is underway with the possibility for the private sector to supply gas directly to end-users, hence competing with EGAS. EGPC arrears to IOCs amount to USD2.0-2.5bn. While there is no optimal level of arrears, it is critical to keep payments regular and consistent in order to maintain sector momentum.

Tourism

The contribution of the sector to GDP is positive again. In the 2-3Y outlook, the objective is to reach revenues of USD18bn against USD6bn at present.

New Administrative Capital

The government is building a new administrative capital 45KM east of downtown Cairo of which most buildings will be self-financed. The government is betting on a virtuous cycle triggered by relocation of key ministries that can consequently boost the residential footprint. The army is playing a key role in supervising the project. The government is looking to relocate ministers by late 2018, but infrastructure readiness and connectivity to proxy urban centres (Greater Cairo, Suez Canal) are yet to be seen.

Conclusion

We believe that ongoing reforms (monetary and fiscal) have put the Egyptian economy on the right track. Nevertheless, the medium-term prospects are still challenged. High and above-peers population growth creates an enormous need for job creation each year. Structural changes (notably in education and training) are still lacking to meet those needs. The role of the army in the economy is important as a fast-track enabler of development projects during rough political transition, but continuation of that role should maintain a level-playing field.
However, the key open question, in our view, is the future role of the state in Egypt's largely market economy. In conclusion, our positive outlook on the Egyptian economy has been confirmed. The next challenges are execution of remaining reforms as well as achieving a sustained and inclusive economic growth.

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Publisher: Jean Lemierre
Editor: William De Vijlder