A brief history of the Egyptian economic stress cycle

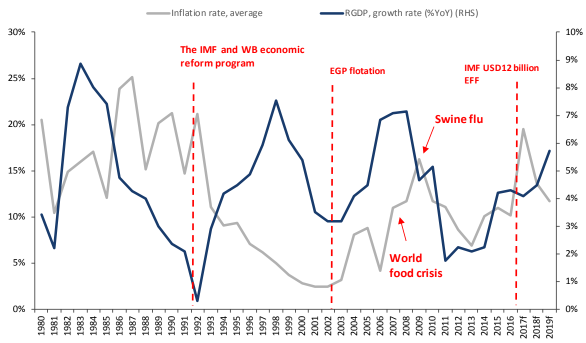
Egyptian Millennials have witnessed two previous major economic reform episodes in 1991/92 and 2002/03. In the former, the Egyptian government resorted to the International Monetary Fund (IMF) and the World Bank (WB) to help rebalance the economy. In the latter, the Central Bank of Egypt (CBE) floated the EGP, while the Ministry of Finance (MoF) undertook broad fiscal reform measures to rebalance the national budget. In both cases, the inflation rate peaked (+20% YoY in FY1991/92 and +8% YoY in FY2002/03), before stabilizing to single digit afterwards. Also, the economic growth rate accelerated following the implementation of the reform measures to c.7% in FY1997/98 and FY2007/08. Recently, the Egyptian economy has been going through almost identical conditions, leading to the implementation of similar economic reform measures with the assistance of the IMF (Chart 1). The key question remains whether these reforms would be sustainable or whether they are just part of a repeated cycle, similar to the aforementioned episodes, which should be expected every decade?

Changing the current structure of the Egyptian economy is the key determinant for the economic performance outlook over the medium/long term

Since the mid-60s, the structure of the Egyptian economy has been changing in one direction: lower share of the agricultural sector, stable industrial sector share and more contribution from the services sector (Chart 3). While this has been partly affected by political destabilizing aspects (i.e. three wars in 1965/67/73 and the post-2011 revolution), economic mismanagement is visible. We highlight two adverse interrelated outcomes over the medium/long term:

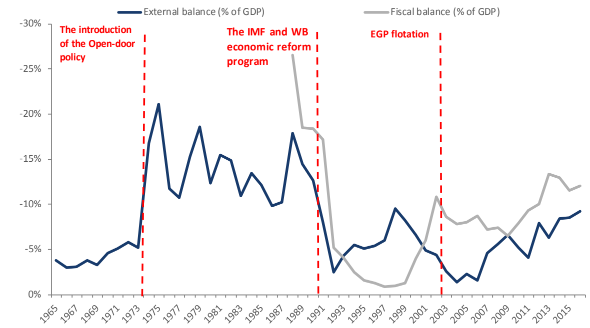
- The persistence of a negative resource gap: The Egyptian key agricultural and industrial trade balances have remained in deficit for decades (i.e. food items, manufactured goods, etc.)
- High vulnerability to external shocks: It is not a coincidence that Egypt's stress cycles starts with a major hit to tourism and Suez Canal revenues (i.e. Luxor in 1997 and Russian plan explosion in 2015). Remittances, which represent a key source of foreign currency in Egypt, are vulnerable to oil price volatility, as the majority of Egyptian diaspora is located in the oil-dependent GCC. In addition, other international commodity price shocks do affect the Egyptian economy (i.e. the World Food and Swine Flu crises in 2007 and 2008 , respectively, led the inflation rate to accelerate significantly in Egypt).

Chart 1| The Egyptian economy has been going through almost identical conditions to the previous reform episodes



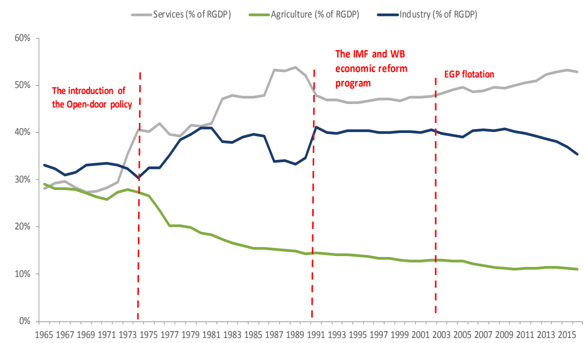
Source: IMF, Pharos research

Chart 2| The recurrence of large fiscal and external imbalances demonstrates a structural rigidity



Source: IMF, Pharos research

Chart 3| Real output sectoral breakdown reveals a diminishing share of the agricultural sector, while a nearly flat industrial sector share over the last 50 years



Source: WorldBank, Pharos research

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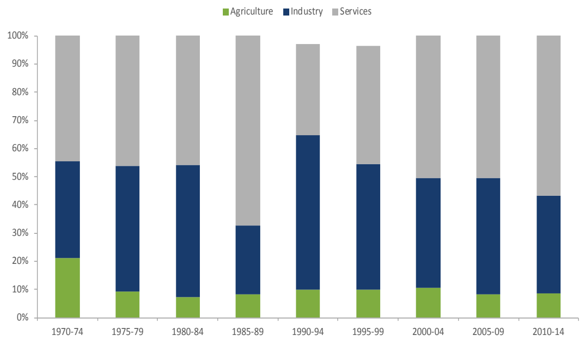
Structural rigidities led to low economic inclusiveness and sustainability over the last 30 years

In a country with a large and a growing population, such structure rigidities led to the emergence of numerous negative consequences:

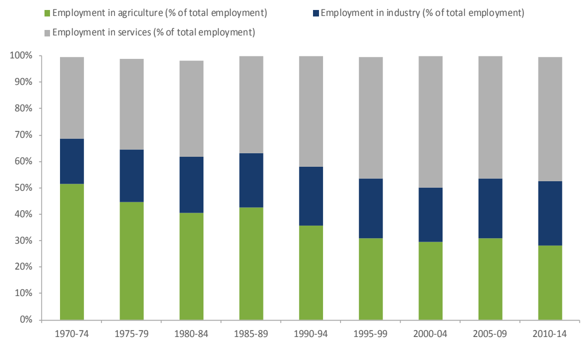
- High income-inequality and low employment rate: Given the fact that 40 - 50% of employment is concentrated in the agricultural and industrial activities, the benefits of economic booms in terms of real wage growth were negatively affected by the low contribution of these sectors (Chart 4 & 5). The search for better job opportunities led to the increase of rural-to-urban migration. This added more pressure on the public infrastructure in the cities, in addition to suppressing the wage growth in the low-skilled service sector as the labor market grows loose.
- Low productivity growth and an unsustainable growth rate: In the long run, it is all about productivity growth. Failing to revamp the industrial and agricultural sectors' real growth, in addition to the concentration of employment in low-skilled labor segments led Egypt's average labor productivity growth to record 0.6% over the last 30 years (versus 4.6% in India and 8.1% in China) (Chart 7). This partly explains the unsustainability of the high real GDP growth rates achieved separately over 1982-85 and 2006-08. We note that Egypt was nearly head-to-head with China in terms of the share of manufactured exports (as % of total exports) in 1986. In 2015, the Egyptian manufactured exported share rose to 52.9% as the Chinese ratio tripled to 94.3% (Chart 8).
- Continued pressure on the exchange rate: The persistence of a current account deficit over decades implies that the EGP exchange rate is defined by foreign investors' willingness to purchase local assets.
- High food inflation rate and price volatility as the declining contribution of the agricultural sector led to supply shortages, bottlenecks, in addition to the impact of imported food items price movements.
- A heavily stressed national fiscal position by the current expenditure: The aforementioned consequences partly explains the government reluctance to introduce various subsidy reform measures as the economic structural rigidities magnified the vulnerability of the low/medium income groups. As a result, the already imbalanced national budget remained heavily pressured by the current expenditure (i.e. wages and subsidies) rather than the much-needed capital expenditure. Hence, the accumulation of public debt remained at unsustainable levels for a long time.

Chart 4| Services possesses the highest share of the real GDP growth



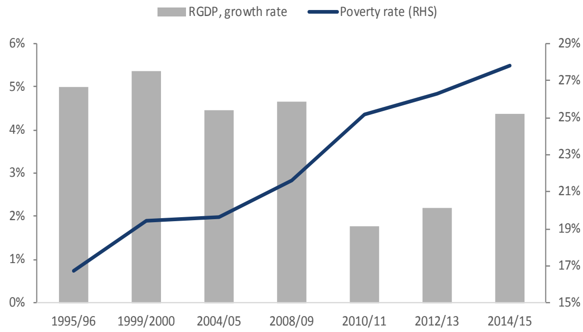
Source: WorldBank, Pharos research

Chart 5| The concentration of employment in both agricultural and industrial sectors, in addition to their low contribution in the real GDP growth, helped reduce inclusiveness



Source: WorldBank, Pharos research

Chart 6| An accelerating poverty rate overtime, despite high economic growth rates, confirms low growth inclusiveness



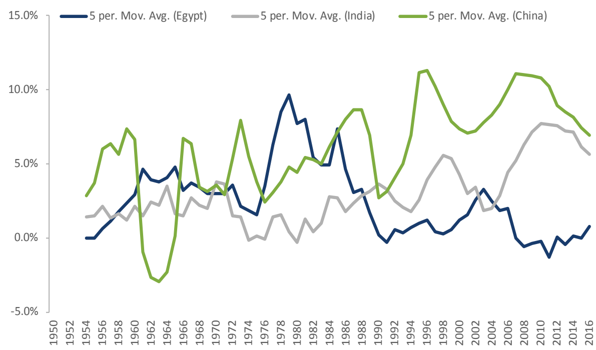
Source: WFP, CAPMAS, Pharos research

The recent efforts to readjust the Egyptian economy structure include the newly introduced civil service law, the investment law and SME's initiative

Under the current economic reform program, we believe that there is a serious attempt to readjust the structure of the economy towards a more sustainable/inclusive growth dynamics over the medium/long term.

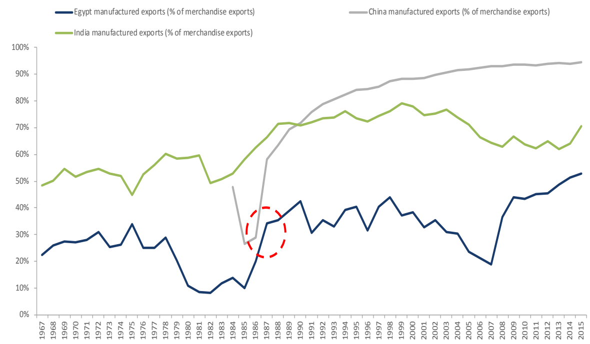
- The Civil Service law: The introduction of such an important bill helps readjust a major fiscal rigidity by capping the public sector wage growth. Over a longer term, it is expected to raise the productivity of the Egyptian public sector at large.
- The Investment law: Attracting more foreign direct investment (FDI) is vital for the Egyptian economy in order to help fund the current account deficit. Moreover, more FDIs in the industrial/agricultural sector will achieve multiple targets, which include lowering the current account deficit due to lower imports and/or higher exports and raising the Egyptian labor productivity due to the technology transfer (i.e. Siemens has agreed to train Egyptian engineers and technicians as part of an accord with the Ministry of Electricity). Hence, the newly introduced investment law stated special incentives for specific industries (i.e. car manufacturing, pharmaceuticals, food products, furniture and other labor-intensive industries). Moreover, the designation of defined incentives to certain geographic locations (i.e. Upper Egypt) will help reduce the income inequality in Egypt.
- The Industrial license act: This is another key bill that is meant to ease the official procedures of establishing industrial facilities in Egypt, which will help raise the contribution of the industrial sector over the medium/long run.
- The Central Bank's SMEs initiative: The CBE initiative includes assigning a preferential low nominal interest rate, in addition to setting a unified well-defined workflow for the SMEs lending. Easing the SMEs access to credit will help raise the economic growth, raise the employment and reduce income inequality in Egypt.

Chart 7| Egypt's average labor productivity growth recorded 0.6% in the last 30 years, which explains the unsustainability of high economic growth rates over the same period



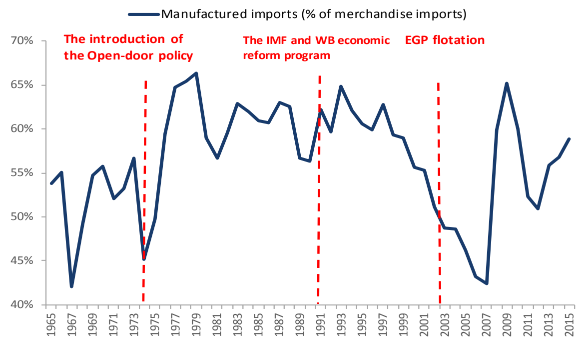
Source: WorldBank, Pharos research

Chart 8| Egypt's manufactured exports (as % of total exports) spread with China recorded c.40% in 2015, versus c.9% in 1986



Source: WorldBank, Pharos research

Chart 9| Egypt's manufactured imports volatility is another evident supporting the need for sustainable structural reforms



Source: WorldBank, Pharos research

As the implementation risk remains a major challenge, more to be done on the agricultural front and on improving the competition in the economy

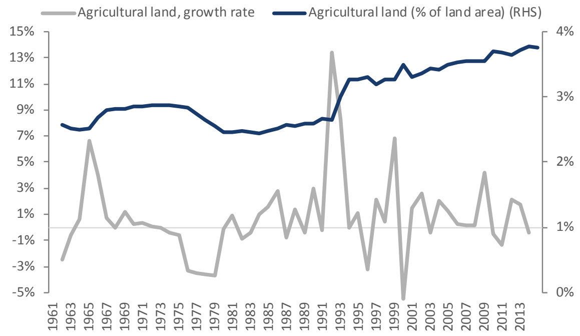
- Given the long history of implementation flaws, the sustainability of efficient implementation of the newly introduced laws remains a key concern. However, we believe that the governmental commitment to a longer term strategy (Egypt Vision 2030) may help reduce such a risk
- The agricultural sector's revival represents another major challenge due to the projected water shortages and the current scarcity of cultivated land (Chart 10). While the details/progress of the 1 million Feddan initiative still are unfolding, we believe that the introduction of a commodity exchange in Egypt should be considered more seriously. On one hand, the commodity exchange will help ease the volatility of agricultural product prices. On the other hand, the consequent improvement in storage capacity and transportation will support the productivity/efficiency of the agricultural sector.
- Another key structural reform necessity would be to further empower the Egyptian competition authority. While we understand the complexity of investigating various sectors on a micro level in an emerging economy, higher competition will help improve the ease of doing business, reduce the supply chain bottlenecks and stabilize the general price level in Egypt over the medium/long term.
- Given the stressed public fiscal position, we believe that public expenditure priority should be given to the more productive infrastructure spending (i.e. Railway, Cairo Metro, etc.)

How can equity investors benefit from all these structural reforms?

A successful economic structural revamp will support the sustainability/inclusiveness of economic growth in Egypt, which in return would be translated into more initial public offerings (IPO), higher trading volumes and a better equity market performance over the medium/long run. For foreign investors, lower vulnerability to external shocks will help reduce the negative impact in case of economic downturn cycles, in addition to presenting Egypt as a more diversified alternative. Furthermore, the aforementioned newly introduced structural reforms support our positive long term stance on the industrial and the banking sector.

Finally, we reiterate that the recently implemented fiscal and monetary reform measures (i.e. energy subsidy reform and the exchange rate liberalization) have set the foundation for rebalancing the economy. Structural reforms are equally important in order to heal the rigidities in the Egyptian economy at large. In our view, an efficient structural reform requires an open/active governmental engagement in order to avoid the previous reform shortcomings.

Chart 10| The scarcity of cultivated land represents a major challenge to the agricultural sector revival



Source: WorldBank, Pharos research

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