

ISSUER IN-DEPTH

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Government of Egypt

FAQ on the sustainability of economic and fiscal improvements amid persistently high financing needs

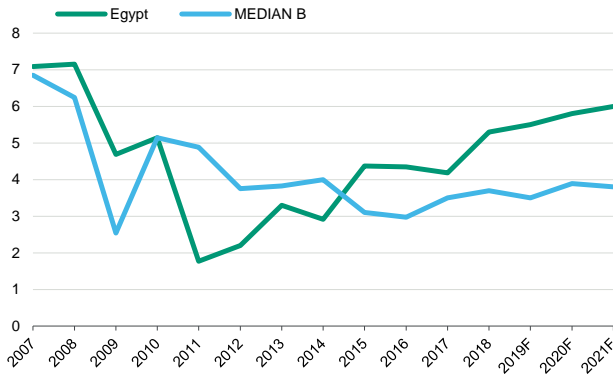
The macroeconomic and fiscal reforms the [Government of Egypt \(B2 stable\)](#) has implemented in the run-up to and under the umbrella of its three-year Extended Fund Facility (EFF) with the IMF since November 2016 have helped move the economy toward a higher trend growth path and strengthened its shock-absorption capacity. In this report, we answer questions about the credit implications of the implemented and planned reforms, the risk of reform reversal, as well as credit risks arising from the sovereign's sizeable borrowing requirements.

- » **Does Moody's expect the economy will sustain higher-trend growth?** Continued progress on reforms observed over the past three years and improvements in the private sector's access to credit underpin our expectations of a return to 5.5% GDP growth in 2019 and further acceleration to 6% by 2021. Longer-term, Egypt's potential growth will hinge on reforms that foster absorption of large numbers of new labour market entrants over the next decade in light of the public sector's balance sheet constraints. Long-standing vested interests in the public sector are likely to slow these efforts.
- » **Does Moody's expect the government will sustain fiscal discipline after the IMF program ends this year?** The completion of reforms to energy subsidies envisaged under the EFF together with earlier reductions in the wage bill to an expected 5% of GDP from 8.5% in 2013 underpin our expectations of a return to a general government primary surplus in fiscal 2019.¹ In particular, the extension of the consumer price indexation formula to most fuel types--supported by the adopted oil price hedging mechanism as backstop against oil price spikes--will shield the fiscal trajectory from oil price shocks and allow the fiscal deficit to decline in line with a gradually diminishing interest bill. The changes in the structure of government spending towards more focused support to lower-income households and toward investment will help strengthen the resilience of the government's fiscal position to economic and financial shocks.
- » **How resilient is Egypt's credit profile to liquidity risks and capital market outflows?** Annual gross financing needs worth 30%-40% of GDP over the next few years – driven by the high interest bill in the 8%-9% of GDP range and the low average maturity of the debt stock of about three years – are a key source of liquidity risk for the sovereign that will continue to weigh on Egypt's credit profile. Although sharp capital outflows in the second half of 2018 and the consequent widening in spreads highlight the sensitivity of Egypt's debt costs to shifts in foreign investor demand, this period also underscores the shock-absorption capacity of domestic financial sector and its role as a primary funding source for the government during times of stress.

Q1: Does Moody's expect the economy will be able to sustain higher-trend growth?

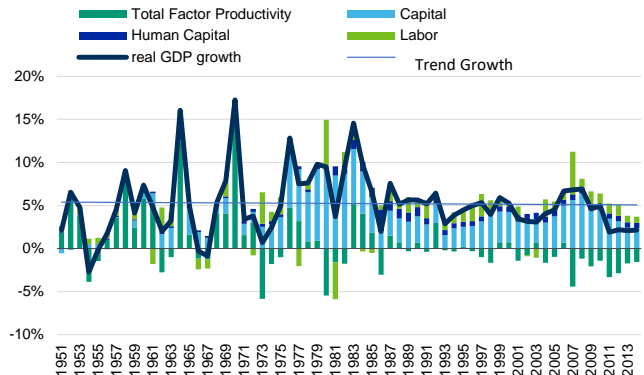
We expect a return to 5.5% GDP growth for 2019 and further convergence to 6% by 2021. These forecasts are based on the assumption that the government will build on the initial boost in price competitiveness from the decision to float the pound in late 2016 by progressing with the macroeconomic reforms observed over the past three years. This should provide a boost to exports and investment. Our growth forecast is above the median for B-rated sovereigns and is in line with Egypt's long-term trend growth (see Exhibits 1 and 2).

Exhibit 1
We project Egypt's growth will outperform B-rated peers... (% change)



Source: Moody's Investors Service

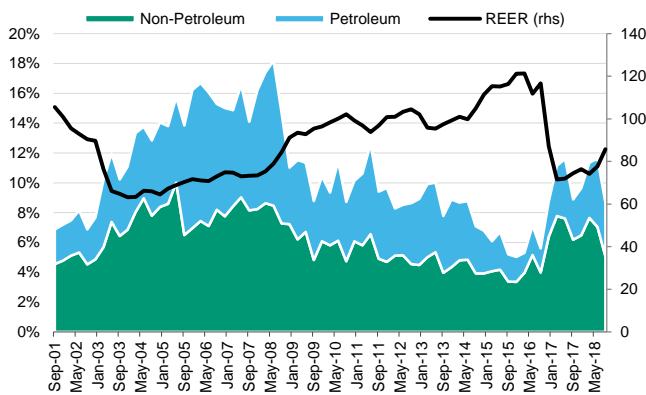
Exhibit 2
...and to return to its long-term growth potential (growth contributions, percentage points)



Source: Penn World Tables, Moody's Investors Service

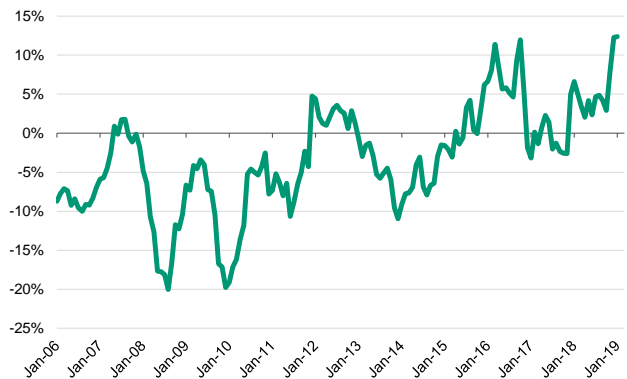
The business environment reforms the government embarked on under the three-year \$12 billion Extended Fund Facility (EFF) with the IMF are aimed at shifting the economy's orientation to a more efficient and inclusive private sector-led growth model in light of the public sector's balance sheet constraints. Improved price competitiveness vis-à-vis trading partners and the private sector's renewed access to credit after years of being crowded out by the government set the stage for broader-based growth driven by both domestic and external demand, including via higher non-hydrocarbon exports (see Exhibits 3 and 4).

Exhibit 3
Improved relative price competitiveness should boost non-petroleum exports... (petroleum and non-petroleum exports/GDP, %; Real effective exchange rate, 2010 = 100)



Source: JPMorgan, Haver Analytics, Moody's Investors Service

Exhibit 4
...while the private business sector's renewed access to credit will support domestic demand (real lending to the private business sector, % change, y/y)

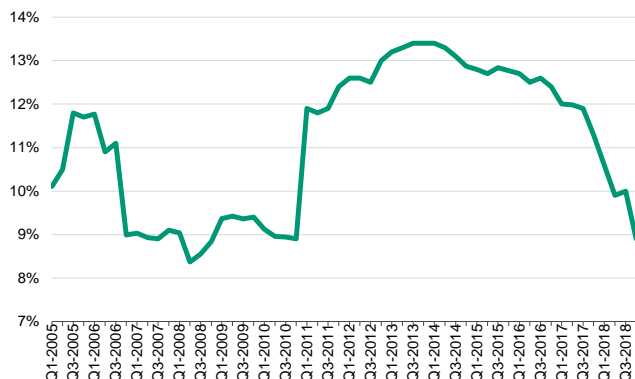


Calculated as nominal lending to private business sector minus urban CPI (both in %, y/y)
Source: Haver Analytics, Moody's Investors Service

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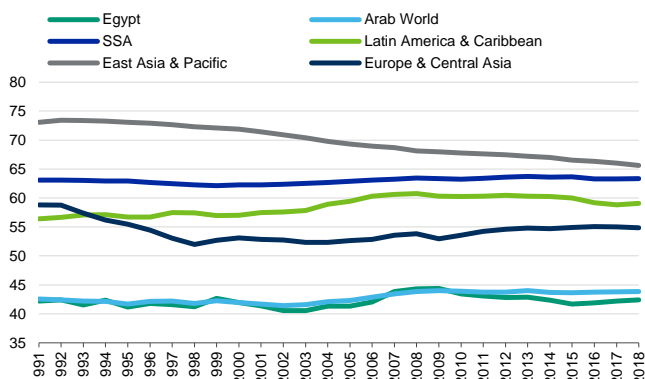
Over the longer term, more inclusive growth will depend on a rise in the employment rate (especially among females) to absorb the large number of new labour market entrants in light of Egypt's comparatively high fertility rate and the higher than average share of youth unemployment, especially among graduates (see Exhibits 5 and 6).

Exhibit 5
The unemployment rate has dropped to multiyear lows...
 (% of labor force)



Source: CAPMAS, Haver Analytics, Moody's Investors Service

Exhibit 6
... but the overall employment rate is low compared to global peers
 (employment to population ratio, 15+, %, excl. high income countries)

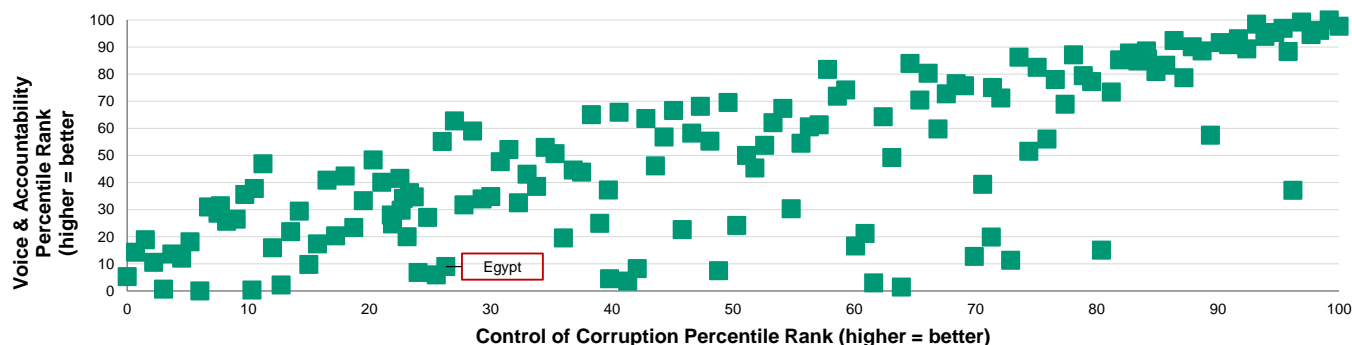


Source: World Bank Development Indicators

Higher labour participation rates that support social stability in the future will hinge on further liberalization in markets that have traditionally been protected by long-standing vested interests in the public sector. The structural reforms implemented under the EFF are geared toward strengthening competition, improving governance and limiting the scope for corruption, while reducing the role of the state. These are fundamental changes in the economic fabric the results of which will only become apparent over time.

In the short term, we estimate that the likelihood of renewed social instability and/or reform reversal is low given improved economic prospects and in light of the high costs of social upheaval already incurred after 2011. However, Egypt's low ranking for "Voice & Accountability" and "Control of Corruption", which can be seen as proxies for or related to wider trust in institutions and the ease at which firms can enter and exit the market, inform our assessment that a threat to social instability remains a constraint on potential growth in the medium to long term (see Exhibit 7).

Exhibit 7
Low "Voice & Accountability" and "Control of Corruption" scores in international comparisons highlight political event risks in the absence of pervasive economic reforms
 (percentile rank across all Moody's-rated sovereigns, 2017)



Source: World Bank Worldwide Governance Indicators

Q2: Does Moody's expect the government will sustain fiscal discipline after the IMF program ends this year?

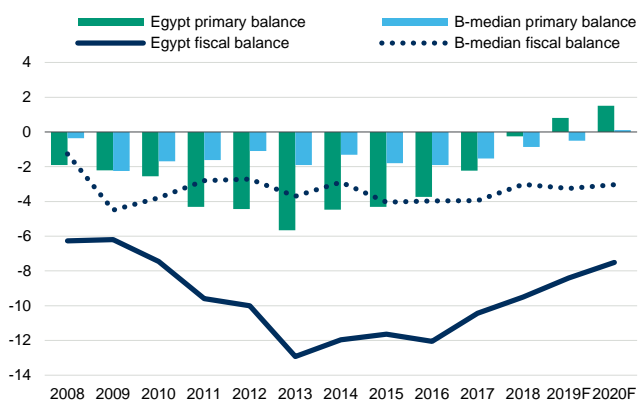
Renewed international capital market volatility that results in significant outflows and in higher borrowing costs and/or a renewed surge in oil prices that delays the completion of fuel subsidy reform represent the main risks to continued fiscal consolidation. Over time, the changes in the structure of government spending towards more focused support to lower-income households and toward investment will help strengthen the resilience of the government's fiscal position to economic and financial shocks.

Both types of shock materialized during the second half of 2018 and the adopted measures to safeguard fiscal discipline during that period--including cutbacks of other non-priority spending, adoption of a financial hedge against oil price spikes starting this year, as well as the availability of domestic funding sources to offset the impact on demand for government debt of capital outflows--inform our expectation that fiscal discipline will be maintained after the expiration of the IMF program later this year. According to recent statements by finance minister Mohamed Maait, the government is also discussing a non-financial follow-up program with the IMF in a technical or policy support capacity after the program ends in June.²

We expect the general government primary balance surplus to increase gradually in the next few years, towards 2% of GDP by fiscal 2022, from 0.8% in fiscal 2019 and a 5.6% deficit in fiscal 2013, supported primarily by spending reductions. After reducing the wage bill to a budgeted 5% of GDP in fiscal 2019 from 8.5% in 2013, spending efficiencies will primarily be achieved via permanent reductions in the energy subsidy bill in favour of targeted transfers, and expected reductions in the interest bill in line with improved inflation expectations and a falling debt burden (see Exhibits 8 and 9). On the revenue side, the implementation of the value added tax (VAT) legislation which was adopted in 2016 with a standard rate of 13% and which was subsequently increased to 14% in 2017, contributed to improved revenue collection by about 1.5-2 percentage points of GDP since inception. Looking forward, the government will focus on improved revenue collection and administration.

Exhibit 8

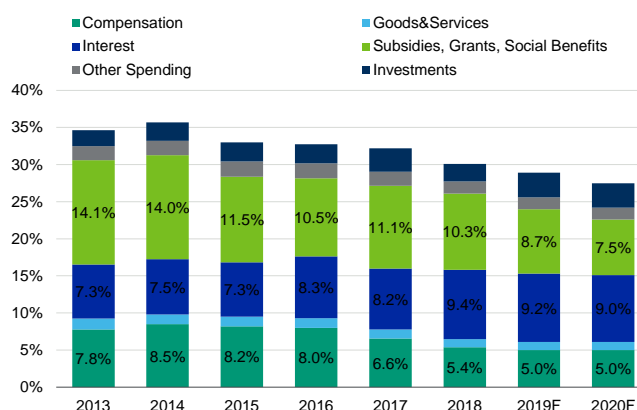
Our expectation of a further improvement in primary balances...
(general government, % of GDP)



Source: Egypt Ministry of Finance, Haver Analytics, Moody's Investors Service

Exhibit 9

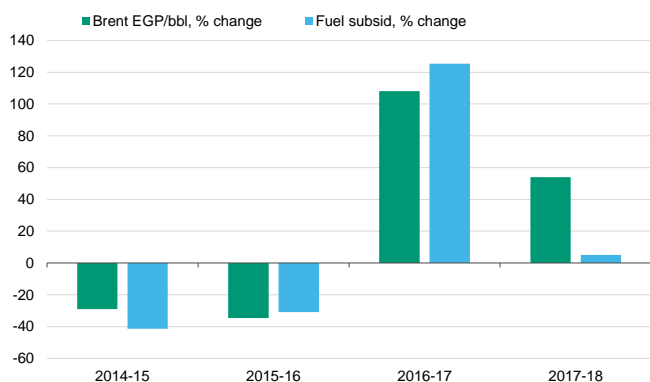
...is supported by contained wage and energy subsidy bills and, in the future, a falling interest bill
(% of GDP)



Source: Ministry of Finance, Haver Analytics, Moody's Investors Service

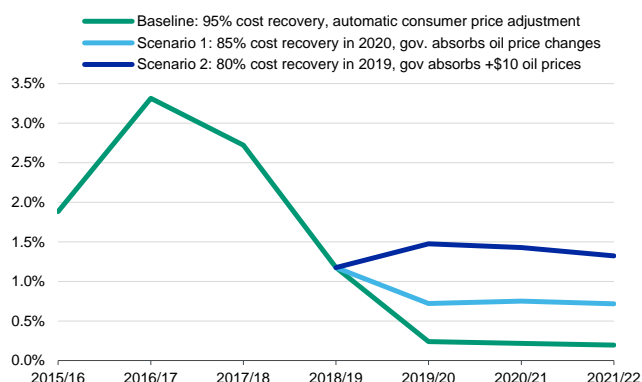
As agreed with the IMF, the application of the automatic fuel price indexation mechanism to most fuel types (except for cooking gas and fuel oil used for electricity generation that authorities project will switch to non-subsidized natural gas starting fiscal 2020) once full cost recovery has been established at the end of fiscal 2019 from the current 85-90%, will be crucial in persistently reducing Egypt's fiscal exposure to international oil price volatility. Exhibit 10 highlights the break in correlation between international oil prices and fuel subsidy spending from fiscal 2018 onwards. Exhibit 11 outlines our estimates of the fiscal savings under different fuel subsidy policy scenarios. The government also remains committed to eliminating electricity subsidies by establishing cost efficient tariffs by the end of fiscal 2022.

Exhibit 10
Reform results in reduced oil price/subsidy bill correlation
 (% change, in local currency terms)



Source: Moody's Investors Service

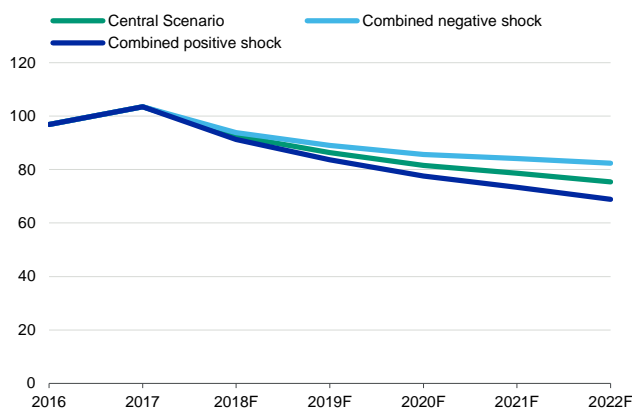
Exhibit 11
Fuel subsidy spending will be broadly eliminated starting fiscal 2020 in baseline
 (% of GDP)



Baseline oil price forecast: \$50-70 range, with \$65 for 2019, then converging to midpoint
 Source: Moody's Investors Service

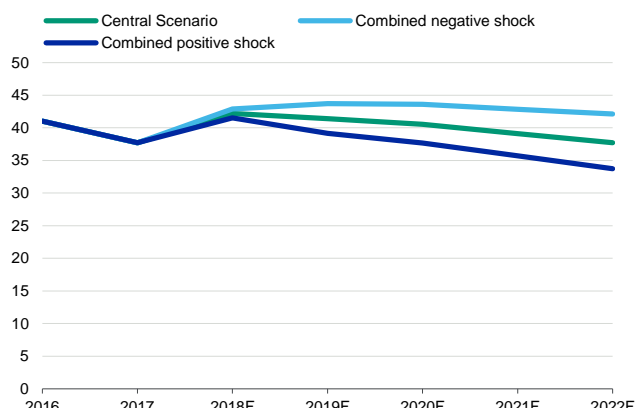
Under our central scenario of subsidy reform completion, the general government debt/GDP ratio will continue to decline to below 80% in fiscal 2021. Even in a scenario of less favourable economic and financing conditions (weaker growth, slower fiscal consolidation, higher interest rates and a weaker currency), the debt ratio remains on a declining path and debt affordability remains unchanged at current levels. Under the same shock assumptions, debt affordability as measured by interest/revenue would remain broadly unchanged at the current levels, although very weak compared to other sovereigns internationally.

Exhibit 12
Declining debt/GDP trend is resistant to negative shocks...
 (debt/GDP, %)



Combined positive/negative shock scenario adds/subtracts 0.25 standard deviation of long-term growth (+/-0.8%), fiscal (+/-0.4% of GDP), interest (+/-0.3%), FX (+/-1.5%) trends to our baseline assumptions
 Source: Moody's Investors Service

Exhibit 13
... while debt affordability would at least not deteriorate
 (interest/revenue, %)



Combined positive/negative shock scenario adds/subtracts 0.25 standard deviation of long-term growth (+/-0.8%), fiscal (+/-0.4% of GDP), interest (+/-0.3%), FX (+/-1.5%) trends to our baseline assumptions
 Source: Moody's Investors Service

Q3: How resilient is Egypt's credit profile to liquidity risks and capital market outflows?

Egypt's high interest bill at about 9% of GDP and the short average maturity of its domestic debt stock (two to three years) result in annual gross financing needs worth 30%-40% of GDP over the next few years (see Exhibit 14). These elevated financing requirements expose the government to shocks in borrowing costs which would rapidly feed adverse debt dynamics, a key source of government liquidity risk.

The capital outflows experienced by many emerging markets in the second half of 2018 amounted to a period of stress that highlights the sensitivity of Egypt's debt costs to shifts in foreign investor demand, but also underscores the shock-absorption capacity of the domestic financial sector and its role as a primary funding source for the government. Overall, Egypt's deep and stable domestic funding base in its large banking sector with an established track record of financing support to the government supports our assessment that Egypt's credit profile is less vulnerable to external financing shocks than the fiscal metrics alone would suggest.

Exhibit 14

Egypt's gross borrowing requirements remain high because of high T-bill rollovers (% of GDP)

	2018	2019F	2020F	2021F
Financing Needs	12%	11%	10%	9%
Fiscal deficit	9.5%	8.4%	7.5%	6.8%
External amortization	3%	3%	2%	2%
Financing Sources	13%	13%	9%	8%
External financing sources	3%	3%	2%	2%
Domestic new financing sources	9%	10%	7%	6%
<i>New T-bills</i>	8%	7%	4%	3%
<i>T-Bonds</i>	2%	3%	3%	3%
T-bill rollover (n-1)	19%	24%	25%	26%
Gross Borrowing Requirements	31%	35%	34%	34%

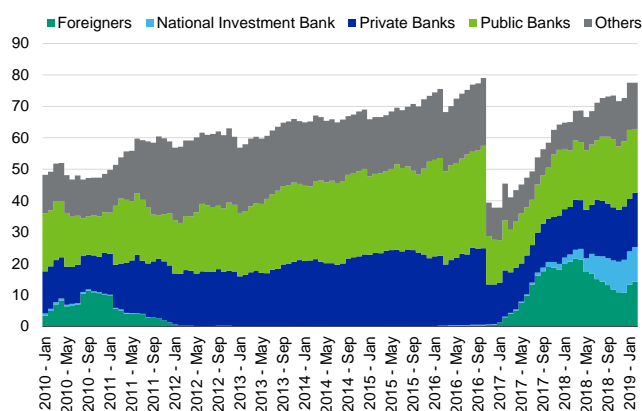
Source: Ministry of Finance, Moody's Investors Service

Between April and December 2018, capital outflows amounted to over \$10 billion (about 4% of GDP), reflected in a fall in non-resident T-bill holdings to about 15% of the total from 30% during that period. Exhibit 15 highlights the role of the National Investment Bank (NIB), the development bank established in 1980, in absorbing outflows from non-residents via the issuance of investment certificates which are an instrument for the non-bank sector to gain exposure to the high-yielding T-bill market. While borrowing costs increased significantly during that period (see Exhibit 16), financial stability was maintained, with the exchange rate and foreign exchange reserves remaining broadly stable.

We believe the period of very tight domestic financing conditions and low foreign exchange reserve buffers in the run-up to the flotation in late 2016 represented the domestic financial system's close to maximum government funding capacity in case foreign investors would completely withdraw from the domestic T-bill market. Since then, gross financing requirements have declined from over 50% of GDP in June 2016, and foreign exchange reserves have increased to six months of import cover from 2.5 months.

Exhibit 15

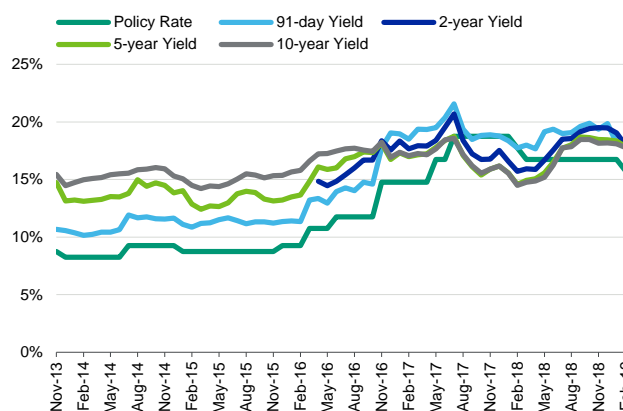
Domestic financial system has absorbed recent capital outflows... (T-bills by holder, billion \$)



Source: Haver Analytics, Moody's Investors Service

Exhibit 16

...although borrowing costs have increased significantly (%)



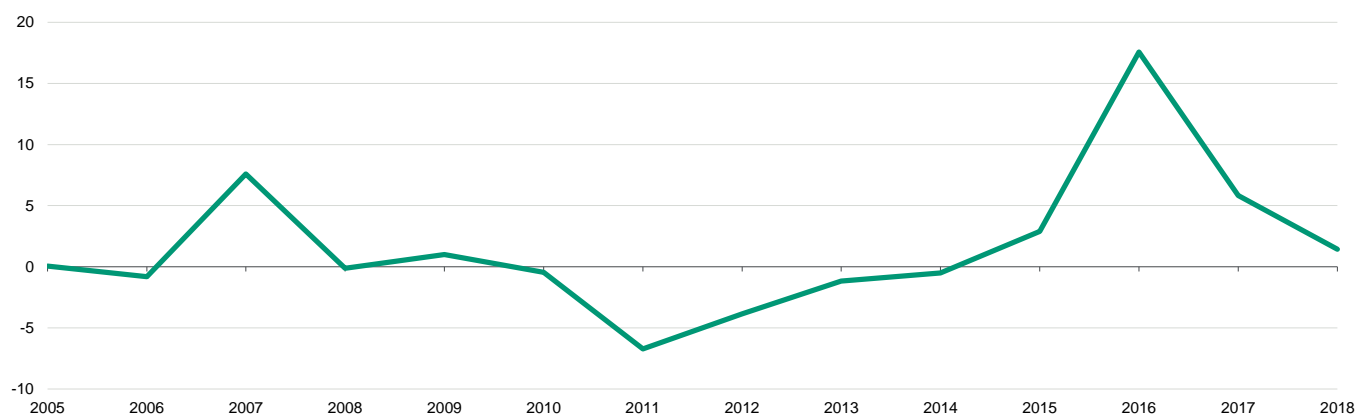
Source: Haver Analytics, Moody's Investors Service

From a flow perspective, we expect that annual bank deposit growth will continue to provide funding to domestic banks for them to finance the government's deficits, in line with the past track record (see Exhibit 17). Reliable access to domestic banks' funding capacity supports the government's liquidity position even in times of constrained access to external financing.

In addition, the renewed foreign investor participation in the domestic T-bill market will increasingly allow banks to extend credit to the private business sector instead of focusing mainly on investing in government securities as reflected in a loan to deposit ratio at below 48% as of January 2019. The government is actively encouraging this reorientation by phasing out a tax loophole in the accounting of income from T-bill holdings that tilted the playing field toward investments in government securities.

Exhibit 17

Annual change in bank deposits provides funding to banks to finance the government's fiscal deficit (difference in % of GDP)



Note that the uptick in 2016/2017 includes valuation effects from the currency flotation

Source: Haver Analytics, Moody's Investors Service

Moody's related publications

- » **Credit Opinion:** [Government of Egypt – B2 Stable: Update following rating upgrade, outlook stable](#), 17 April 2019
- » **Issuer Comment:** [Government of Egypt: Egypt's fiscal 2020 budget points to continued fiscal consolidation, a credit positive](#), 3 April 2019
- » **Sector In-depth:** [Sovereigns - Africa and Middle East: Domestic banking constraints intensify liquidity risks as global markets tighten](#), January 2019
- » **Sector In-depth:** [Weakest APAC and MENA sovereigns amongst most exposed to interest rate shock](#), May 2018
- » **Outlook:** [Sovereigns -- Levant & North Africa: 2019 outlook stable, but global headwinds and slowing reforms point to downside risks](#), 22 January 2019
- » **Methodology:** [Sovereign Bond Ratings](#), 27 November 2018

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

¹ In central government terms, a primary surplus of 0.2% of GDP was recorded in fiscal 2018 and is projected to reach 2% by fiscal 2019. General government includes the budget sector, the National Investment Bank (NIB), and social insurance funds.

² [Egypt Eyes First Panda, Samurai, Sukuk Issuances](#), April 11, 2019, Bloomberg.

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