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EGYPT: PERSISTENT VULNERABILITIES

Pascal Devaux

So far, Egypt's economy has weathered the Covid-19 crisis without any significant worsening of its main macroeconomic indicators. GDP growth has remained positive, and the country's budget and external balances are relatively stable. The macroeconomic stabilisation achieved in previous years and external financial support are the main reasons behind these positive performances. In the short term, the outlook is mixed. The rebound in inflation, if it were to persist, could trigger a cycle of monetary tightening, with negative consequences for public finances. In addition, Egypt's external vulnerability remains significant given structural current account deficits and dependence on portfolio investment flows. More fundamentally, the pace of growth is not sufficient to absorb the growing labour force, fuelling the informal economy. The main solution to these challenges lies in increasing private sector (non-hydrocarbon) investment and productivity, which are two recurrent weaknesses of the Egyptian economy.

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EGYPT: PERSISTENT VULNERABILITIES

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Sustained economic growth, but on fragile foundations

Consumption as a driving force

Since the implementation of macroeconomic reforms in 2017, economic growth has averaged 4.4% per year. In a context of fiscal consolidation and low export competitiveness, Egyptian household consumption and investment have been the main drivers. However, household consumption – which contributes more than 85% of GDP – was constrained in 2018 and 2019 by strong inflationary pressures (at annual average rates of 22% and 13% respectively), which reduced purchasing power. During this period, investment took over thanks to the accelerated transformation of the energy sector with the construction of new hydrocarbon production and electricity generation capacities.

Economic growth has remained strong since the start of the Covid-19 pandemic in 2020 due to moderate restrictions on economic activity, support from public spending and, above all, the recovery in household consumption. Real GDP growth reached 3.6% and 3.3% respectively during fiscal years (FY) 2019/20 and 2020/21[1]. Egypt is the only country in the North Africa/Middle East region that has not experienced a recession during this period. Domestic consumption (public and private) has not recorded a single negative quarter in the last two years. Beyond the structural demographics that traditionally support consumption, the significant fall in inflation (5.6% and 4.5% on average in FY2019/20 and FY 2020/21 respectively) and the growth in household credit led to total GDP growth of 3.6% in FY2019/20 and 3.3% in FY2020/21. On the other hand, investment was the component of growth most affected by the crisis. It contracted by around 26% cumulatively over the period 2020-2021. One major cause of this contraction was the 80% drop in investment in the hydrocarbon sector (around 18% of total investment) against a backdrop of a sharp drop in oil prices in 2020. The contribution of foreign trade to growth was positive in 2020 and then negative in 2021, and it is difficult to identify a clear trend. Revenue from tourism decreased by more than 60% cumulatively over 2020-2021. The sharp increase in gas production since 2018, with the start of production from the Zohr gas field, has reduced energy imports and allowed some of the surplus to be exported. Outside the energy sector, exports are structurally not very dynamic and it is imports, linked to changes in consumption and investment, which determine the net external contribution of non-hydrocarbon sectors.

CONTRIBUTIONS TO GDP GROWTH

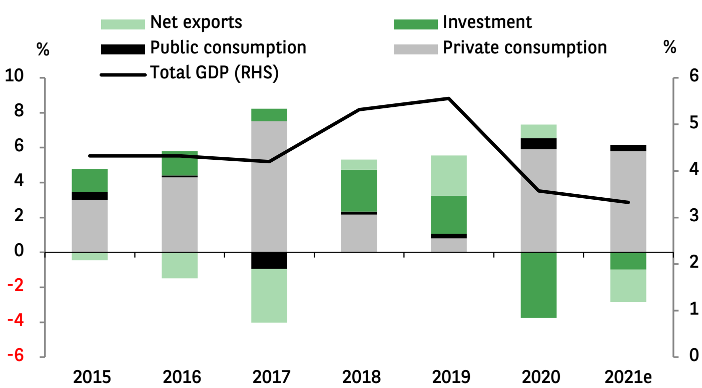

CHART 1 SOURCE: MINISTRY OF PLANNING, BNP PARIBAS

Short-term acceleration expected

In the short term, we expect activity to pick up. Leading economic indicators (electricity consumption, mobility indicator and industrial production index) have bounced back since the second quarter of 2021. The tourism sector is expected to grow with the decrease in pressure linked to the pandemic and the lifting of the ban on tourists from Russia travelling to Egypt. Nevertheless, this increase in visitor numbers will remain gradual given the continuing global threat of the epidemic. Real estate and construction continue to benefit from the implementation of numerous urban and public infrastructure projects. On the demand side, the announced increase in public sector wages and pensions should continue to support household consumption. The rise in energy prices since the beginning of the year and the relatively favourable outlook for producers should stimulate investment spending in the oil sector. Against this backdrop of a recovery in consumption and, to a lesser extent, investment, the rise in imports is expected to dampen the external contribution to GDP growth. Overall, we expect that GDP will grow by 5.5% during FY2021/22. The two main risks to this scenario are an acceleration in inflation, which would weigh on household consumption, and a resurgence of the epidemic, which would jeopardise the recovery of the tourism industry.

Lack of growth drivers in the medium term

In the medium term, the economic outlook is rather favourable, but some weaknesses remain. Household consumption will remain the main driver of growth, although resurgent inflation could slow its progress. The gradual recovery of tourism should directly support employment, while the pace of household lending, which represents only 9% of GDP, should increase with the arrival of non-banking players on this market. The direct contribution of the public sector to

1 Fiscal year n is from July n-1 to June n

REALISED INVESTMENTS, % OF TOTAL

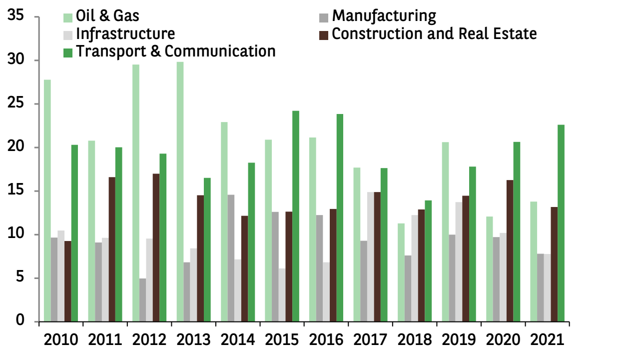

CHART 2 SOURCE: MINISTRY OF PLANNING, BNP PARIBAS

INVESTMENT AS % OF GDP

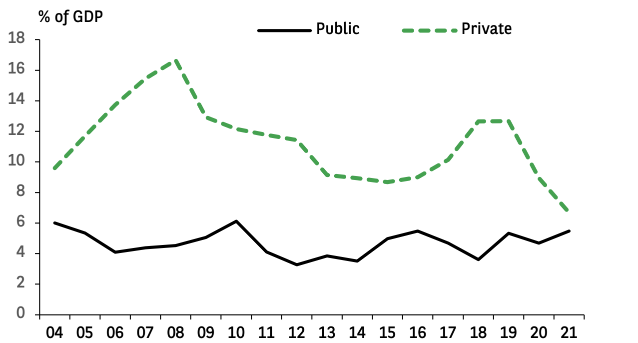

CHART 3 SOURCE: MINISTRY OF PLANNING AND ECONOMIC DEVELOPMENT, BNP PARIBAS

growth could increase with the introduction of more structural policies (health and education). An ongoing policy of major public works should continue to support the construction and real estate sectors, which contribute to around 17% of total GDP, and have continued to grow at a sustained pace during the health crisis.

Nevertheless, the dependence of growth on household consumption is a factor of fragility. Household consumption constituted 87% of GDP in FY2020/21, compared to an average of 73% from 2000-2010. The employment situation remains poor in a context of fiscal consolidation, and job creation in the private sector remains concentrated in the least productive, and therefore least remunerative, sectors. Furthermore, the outlook for investment remains dependent on the energy sector. Hydrocarbon production and power generation have accounted for almost 30% of total investment over the past decade. Although investment in this sector is expected to remain strong in the medium term, particularly with the development of renewable energies and the maintenance of existing production capacities, the level of investment could decline compared to the decade from 2010. The prospects for investment outside the hydrocarbon sector remain very uncertain. Indeed, private sector investment (in nominal terms) as a percentage of GDP has been falling steadily since 2010. From an average of more than 10% of GDP between 2006 and 2010, it has fallen to an average of 6.3% of GDP over the last five years (3.2% during FY2020/21). With regard to foreign direct investment (FDI), this was concentrated in the energy sector until 2019 (over 60% of total FDI).

The challenges of growth in Egypt

It is insufficient to meet the demographic challenge

The job intensity of economic growth is too low to meet the evolving needs of the Egyptian labour market. While the working-age population (aged 15-64) is growing by more than one million people each year, the labour market participation rate (proportion of the working-age population in work) is heading downwards, from 42.8% between 2011 and 2015 to 40.4% on average over the past five years. A growing proportion of the working-age population has either withdrawn from the labour market or (a more likely scenario) is employed in the informal sector. This expansion of the informal sector is confirmed by World Bank[2] data based on social insurance and work contract enrolment rates, which show an increase in the proportion of workers employed in the informal sector between 2016 and 2019. This development is likely to have accelerated in 2020 (a year in which the labour market participation rate fell to 38.5%) and 2021, with the reduction in job opportunities caused by the pandemic. Tourism employs at least 10% of the population, and the drop in visitor numbers certainly amplified this trend towards informal work.

Structural weaknesses in the private sector

The difficulties the Egyptian economy faces in order to generate sustained and sufficiently inclusive growth are linked to low levels of investment (particularly in the private sector) and productivity. This is not new, but these deficiencies have worsened in recent years. The total investment rate has averaged 15% of GDP in real terms over the last ten years, compared to 19% in the previous decade. Not only has this figure been falling over a long period, but it is considerably lower than in equivalent emerging countries, where it has averaged between 25% and 30% of GDP over the last decade (e.g. 28% and 34% in Turkey and Morocco respectively). Private investment is extremely low, and was equivalent to 5% of GDP during FY2019/20 (of which 17% was in the energy sector alone). A number of factors linked to the public sector as a whole may explain this situation: actual interest rates held at a high level to preserve the attractiveness of government debt to international investors, the use of private sector savings to cover the government's significant financing needs, as well as distortions to competition caused by the growing role in the economy of the public sector in the broad sense of the term.

Other more structural factors may also play a significant role. For example, A. Adly[3] has shown that the Egyptian private sector is unbalanced between, on the one hand, large, high-performing companies active in food/agriculture, capital goods or services, some of which are present on the international markets, and on the other, a multitude of very small companies often operating at the edge of the informal sector, which make very limited use of salaried staff. The network of small and medium-sized enterprises (SMEs), which are necessary for economic development, is very underdeveloped. This is what Adly calls "the missing middle". In particular, the author recalls the subcontractor role of these SMEs, which enables the integration of the largest companies into international value chains (in Asia, for

2 World Bank, November 2020: *From crisis to economic transformation: unlocking Egypt's productivity and job-creation potential, Egypt Economic Monitor.*
3 Amr Adly, 2020, *Cleft Capitalism. The social origins of failed market making in Egypt*, Stanford University Press.

example). Yet, it is these SMEs which are in a position to accelerate job creation. According to Adly, difficulties in accessing land and credit explain this underdevelopment of the SME sector. Although these two production factors are ostensibly in good supply (the banking system has a high level of liquidity and land is abundant[4]), the author stresses the lack of intermediary institutions which would allow very small enterprises to access them and thus to develop by integrating into the market.

PRODUCTIVITY AND GROWTH, AVERAGE GROWTH RATE, 2004-2018

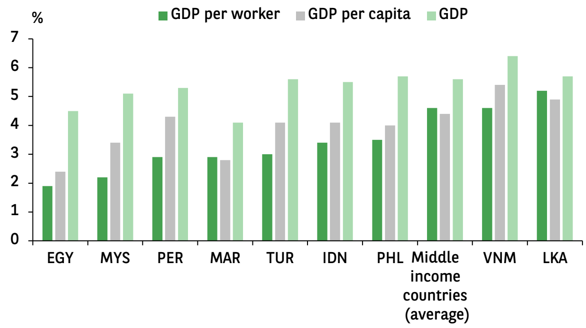

CHART 4 SOURCE: WORLD BANK, BNP PARIBAS

According to the World Bank, productivity growth is one of the lowest among emerging countries in the same category, which limits the potential for job creation. The Egyptian economy tends to specialise in low-productivity sectors such as agriculture (24% of total employment). Sectors such as construction and transport, in which productivity is low, recorded the strongest increase in employment. In addition, the economy is not particularly open to international trade, with exports of goods and services accounting for only 15% of GDP on average since 2016. However, the development of export industries (excluding raw materials) is generally associated with an increase in the productivity of exporting companies. In Egypt, the sectors in which employment growth is strongest belong to the category of non-tradable goods (private sector services and retail trade in particular).

Energy sector

An uncertain outlook for oil

Crude oil production has declined steadily since 2015. Private oil companies have reduced capital spending as oil prices have fallen on international markets. As a result, domestic crude oil and condensate production fell to 0.62 million barrels per day (mbd) in FY2019/20, down from 0.72 mbd in FY2014/15. The onshore production sector is dominated by relatively small companies, and Egyptian production, which is of heavy crude oil, trades at a significant discount compared to benchmark grades of oil. Most of the onshore fields are mature and therefore have a high depletion rate, which implies constant operating and capital expenditure to keep the production level stable. As the financial capacities of small producers are limited, the narrowing of the gap between market prices and the breakeven price leads to a decrease in expenditure and therefore a decrease in production. The recent increase in market prices seems to have boosted spending in the sector, which will help slow the decline in production.

Egypt temporarily became a net oil exporter in 2020 as domestic demand fell during the pandemic. The recent rise in market prices seems to have revived spending in the sector, but this will only slow the decline in production. The country is expected to remain structurally a net importer of crude oil. Conversely, thanks to the introduction of new production units, the country is currently a net exporter of refined petroleum products and could remain so.

OIL MARKET, 000' B/D

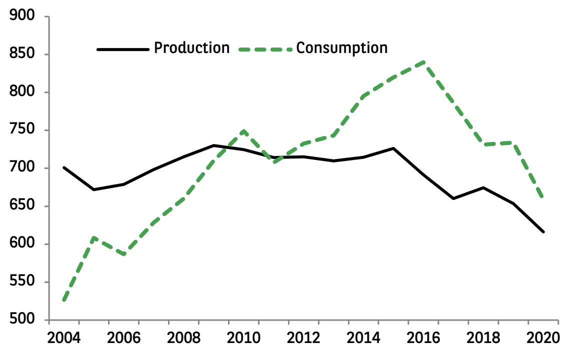

CHART 5 SOURCE: BP, BNP PARIBAS

Increase in gas exports: for how long?

Natural gas has been the main component of Egypt's energy mix since 2018 and the start of production at the Zohr gas field. At present, production capacity exceeds domestic demand, which allowed for an increase in export volumes since the end of 2018. These exports are particularly dependent on market conditions. As a result, they more than halved in 2020 (2.7 bcm compared to 5.9 bcm in 2019) as prices for liquefied natural gas (LNG) dropped on the Asian market, which serves as a benchmark for Egyptian LNG exports. Egyptian LNG sales prices are determined on the spot market (as opposed to long-term supply contracts) and are highly volatile. With activity collapsing in 2020, the market price fell below the Egyptian production cost (around

GAS MARKET, BCF/D

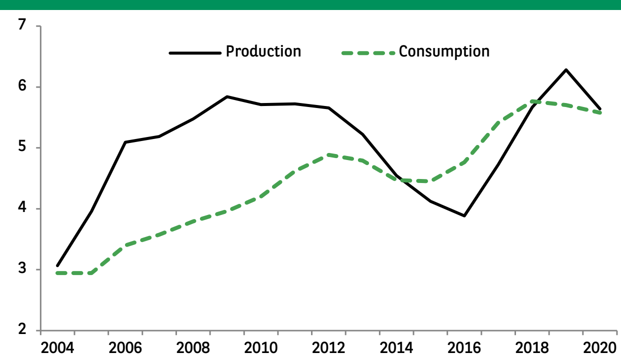

CHART 6 SOURCE: BP, BNP PARIBAS

4 It is estimated that around 96% of the Egyptian population occupies the 5% of the country's territory delineated by the banks and delta of the Nile.

GAS IMPORTS & EXPORTS

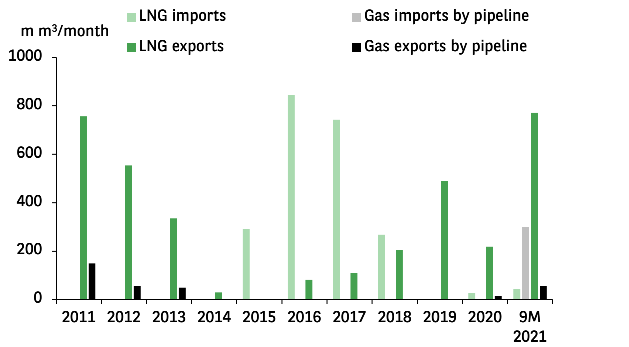

CHART 7 SOURCE: JODI, BNP PARIBAS

CONSUMER PRICE INDEX INFLATION

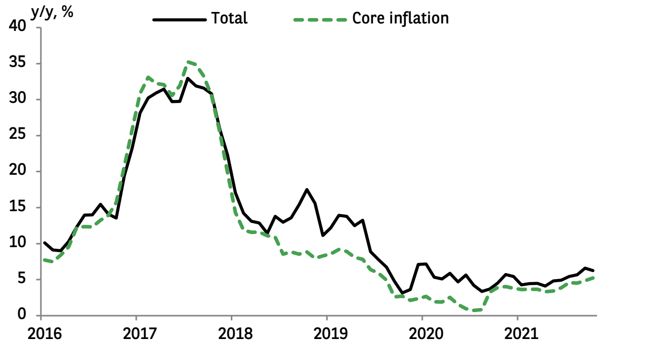

CHART 8 SOURCE: CENTRAL BANK, BNP PARIBAS

USD 5/million British thermal units (mbtu)). The spot price of LNG destined for Asia (over 80% of Egyptian exports) was below USD 4 mbtu between February and October 2020. In this context, EGAS (the state-owned gas market organisation), which has to pay a contractual price of USD 4 mbtu to exporters, has temporarily reduced LNG exports. In 2021, increased Asian demand and the reactivation of the second liquefaction terminal in Damietta has led to a rebound in exports, which in the first seven months of the year were 2.1 times higher than in the whole of 2020. Egypt also exports gas by pipeline (0.19 bcm in 2020), notably to Jordan. However, it should be noted that gas imports, particularly from Israel, by increasing the quantity of exportable gas, partially explain the high level of exports observed since the beginning of the year. Since early 2021, gas imports have been the equivalent of 67% of net exports, compared to 13% for the whole of 2020.

The sustainability of export capacity in the medium term is uncertain. Indeed, while domestic consumption virtually stood still in 2019 and 2020, it is expected to grow in the coming years with increases in the number of households connected to the national gas grid and the petrochemical industry's high demand for natural gas. Moreover, there are no prospects for a significant increase in production capacity at this time.

Moderate rebound in inflation

Consumer price inflation has fallen significantly since 2019, averaging 4.5% in FY2020/21, down from 13.4% in FY2020/19. This decline can be explained by a number of factors: the end of a cycle of subsidy cuts, a lowering of household consumption in 2019 and the stabilisation of food prices, which are traditionally the main driver of inflation. In addition, although energy prices are largely liberalised, fuel prices remain subject to government influence in order to limit their volatility. Inflation of monetary origin (M2 grew by 19% on average in FY2020/21) appears to be limited due to the high level of cash-based transactions.

Since the end of 2020, consumer prices have risen again, against an international backdrop of a spike in food and energy prices and disruption to the supply chains of industrial products. It is currently food, which makes up one third of the price index, which is driving up prices. Core inflation remains contained (up 5.2% year-on-year in October 2021), but has risen steadily over the past six months. It is mainly the core food component, and to a lesser extent education (which is a very seasonal component of inflation), that is driving this

CONSUMER PRICE INDEX, CONTRIBUTIONS

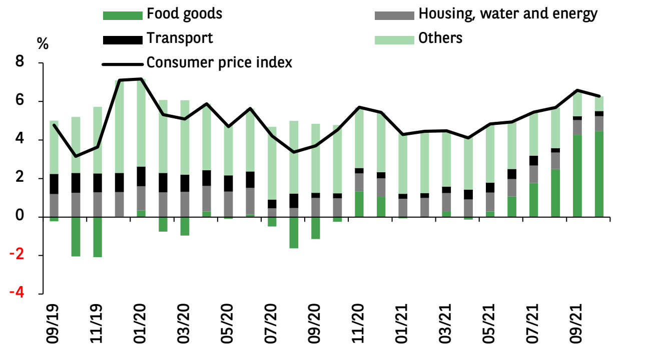

CHART 9 SOURCE: CENTRAL BANK, BNP PARIBAS

CORE INFLATION, CONTRIBUTIONS

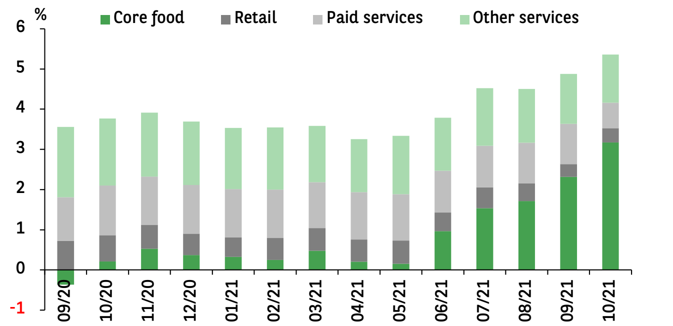

CHART 10 SOURCE: CENTRAL BANK, BNP PARIBAS

core inflation. In the short term, inflation is expected to continue to rise moderately, reaching 9.0% year-on-year at the end of FY2021/22 (+7.3% on average over the year). High commodity prices, a moderate recovery in consumption and, above all, rising production costs should support this increase. Unchanged since March 2020, the price of natural gas for the industrial sector rose by 28% last October and could continue to rise in the short term given the government's willingness to review gas prices more frequently (currently every 6 months). In the short term, inflation forecasts remain contained within the target range set by the central bank (7% +/-2%), but are approaching the upper limit.

A somewhat restrictive monetary policy

Since the outbreak of the pandemic in 2020, the Central Bank of Egypt (CBE) has prioritised support for economic activity over inflation, which officially remains its main objective. The CBE cut its main intervention rates by 400 basis points in 2020. This reduction in policy rates was fully reflected in private sector lending rates but its effectiveness on activity was limited given the low penetration of bank credit. The fact that private sector credit growth has been maintained at a high level since 2019 is notably due to the public policy of subsidised interest rates, which was put in place for certain categories of borrowers (mortgages for the middle classes, tourism, agriculture, industry and construction). Monetary easing ended in 2021 when inflationary pressures worsened.

Furthermore, the CBE carries out open market operations to manage monetary liquidity. Growth in the M2 monetary aggregate has slowed slightly since March 2021, reaching 17.2% in September 2021. The decline in the government's financing need as well as the deterioration in the net international investment position of commercial banks are the main factors behind this slowdown. Despite this, the CBE's open market operations have increased. They accounted for 12.5% of GDP in September 2021 compared with less than 10% of M2 in 2020.

INTEREST RATES

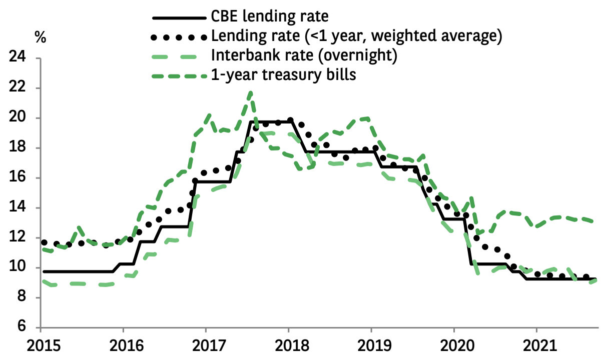

CHART 11 SOURCE: CENTRAL BANK, BNP PARIBAS

MONETARY LIQUIDITY AND COUNTERPARTS (CONTRIBUTIONS)

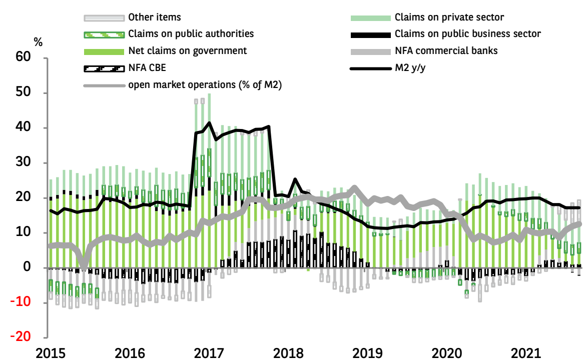

CHART 12 SOURCE: CENTRAL BANK, BNP PARIBAS

SOVEREIGN 10-YEAR REAL INTEREST RATES

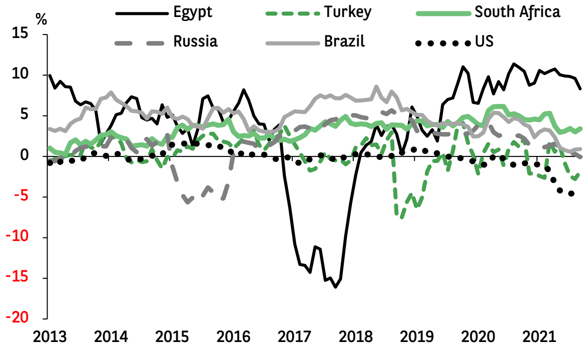

CHART 13 SOURCE: NATIONAL, MACROBOND, BNP PARIBAS

Alongside efforts to control inflation, the policy of high real rates aims to maintain the attractiveness of the public debt market in Egyptian pounds for foreign investors. For the time being, Egyptian debt remains attractive, given the high real rate of return compared to the level of sovereign risk, which remains lower than other sovereign counterparties offering high yield. Nevertheless, portfolio flows are volatile by nature, and the recent past has shown little discrimination by investors when it comes to dealing with global turmoil in financial markets. The halt in rate cuts is justified by the threat of tighter monetary conditions in the US. In the short term, these two factors – an increase in inflationary pressures and international monetary policy tightening – could favour a return to the CBE's policy of raising interest rates.

Public finances: successfully stabilised, but not yet fixed

Fiscal consolidation may slow

Public finances have been improving steadily for the past five years with cuts to some spending (lower subsidies and better wage control). Since FY2019/20, budgetary revenues have been on the rise again thanks to an increase in tax revenues (introduction of new taxes and a widening of the tax base), improved tax collection following the implementation of new tools by the tax authorities (especially the digitalisation of tax operations) and stricter enforcement of tax rules.

The pandemic has had limited consequences for the country's public finances. The budgetary support plan for economic activity was modest and the adjustment continued during this period. The budgetary support package was originally around EGP 100 bn (1.6% of GDP), but the government has reportedly only used part of it. Spending on subsidies continued to decrease as electricity prices rose (equivalent to approximately 0.15% of GDP). At the same time, tax revenues increased by 13% year-on-year during FY2020/21. However, this is the period during which the economy was most affected by the consequences of

SUBSIDIES AND SALARIES

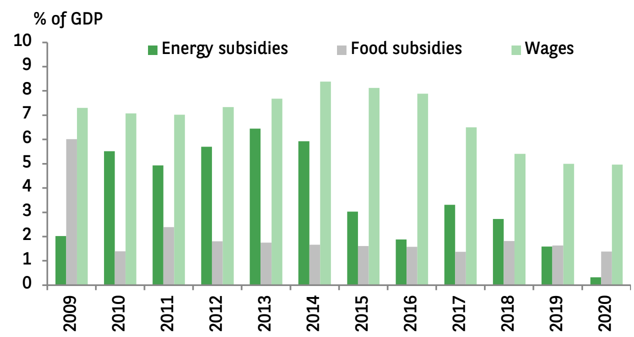

CHART 14 SOURCE: MINISTRY OF FINANCES, BNP PARIBAS

GENERAL GOVERNMENT BUDGET BALANCE

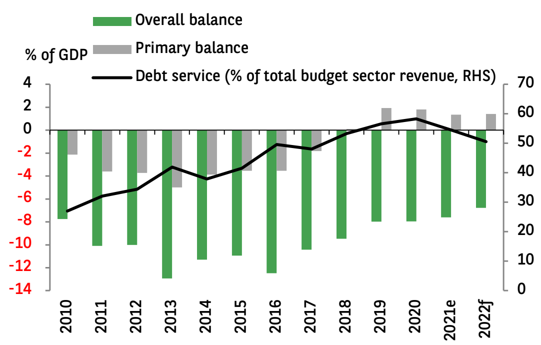

CHART 15 SOURCE: MINISTRY OF FINANCES, BNP PARIBAS

the pandemic, with a one-off tax on wages (1%) and pensions (0.5%) for public sector workers due to generate the equivalent of 0.10-0.15% of GDP in full-year terms.

The primary balance should show a surplus (+1.5% of GDP during FY2020/21). Interest payments on the government's debt are expected to be almost stable in value, but remain very high as a percentage of total budgetary revenues (51% compared with 58% in the previous year). In total, the general government's budget deficit is set to reach 7.4% in FY2020/21.

The budget for FY2021/22 looks to be more expansionary than previous ones, in order to support household purchasing power in particular. The expected 11% increase in the public sector wage bill would lead to a rise in total spending of around 8%. In addition, the focus is on the education and health sectors, indicating a shift in budget priorities after five years of IMF-led consolidation. Nevertheless, the continued pandemic risk could lead the government to postpone some investment spending. In terms of revenue, the economic recovery is expected to increase this by around 12%. In such a scenario, the total budget deficit would fall slightly to 6.8% of GDP.

In the short term, one of the main risks to spending comes from rising commodity prices, which would lead to an increase in subsidy expenditure. Thus, the current increase in wheat prices on the international markets (+13% since the end of June 2021) would have an impact on food subsidies, which account for roughly 6% of total subsidies. The government is considering using hedging instruments to limit the cost to public finances. The consequences of higher energy prices are more difficult to assess. Despite government statements, the automatic fuel price adjustment mechanism (capped at 10% per quarter) does not fully reflect changes in international energy prices. It is difficult to estimate the cost to public finances of higher oil prices, as the incomplete price adjustment could have been beneficial for public finance when global prices were lower than domestic prices during FY2019/20.

Debt servicing remains a strong constraint

Despite the fall in domestic interest rates in 2020 and the expected reduction in the budget deficit, debt servicing will remain very high in the years to come. It is mainly the lengthening of maturities on the local market that will allow a reduction in the annual debt service. The potential for further decline in domestic rates is low in the short term, while the spreads on Eurobonds have widened by circa 150 bps since September 2021. Moreover, international bond issues are voluntarily capped in order to contain the outflow of foreign currency linked to external debt servicing. Diversification of external financing instruments through the issue of *sukuk*[5] and green bonds would remain marginal relative to the total financing need. In the short term, the probability that the CBE will increase rates is fairly high. This is a threat to the debt service reduction process. According to our estimates, it is only from 2023 onwards that the interest burden will return to less than 50% of total budgetary revenues.

Public sector financing and debt: a heavy burden that is difficult to curb

Significant general government financing needs

Even though the budget deficit is steadily declining and the debt dynamic is slowly improving, the government's financing needs remain significant. In addition to the budget deficit, the equivalent of 45 to 50% of GDP in short-term domestic debt matures each year. As a result of these considerable financing requirements and the high proportion of short-term debt, debt servicing is highly sensitive to changes in interest rates. Government debt reached 90% of GDP during FY2019/20

GENERAL GOVERNMENT DEBT

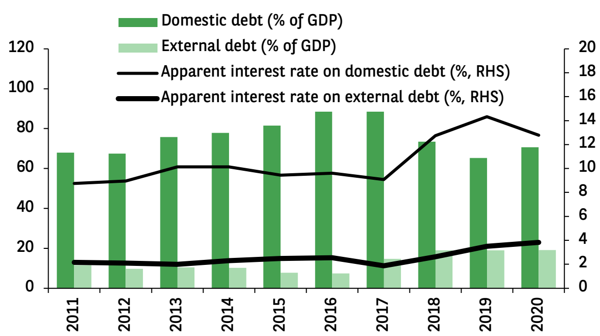

CHART 16 SOURCE: MINISTRY OF FINANCES, BNP PARIBAS

5 Bonds which are compliant with Islamic law

and is expected to peak at 95% of GDP during FY2020/21, before starting to decline from FY2022/23 onwards. Approximately 80% of the total debt is domestic, made up equally of Treasury bills (mainly one year) and medium and long-term Treasury bonds. Eurobonds account for around 36% of the government's external debt (25% in 2017), with the remainder made up of multilateral loans (particularly from the IMF and the World Bank), which offer more favourable lending conditions on average than Eurobonds.

The share of external debt is not expected to increase significantly in the medium term, given the limit imposed on international bond issues and the gradual reduction in IMF financial support. Nevertheless, the government's external debt is significant, standing at 34% of GDP if measured by issue currency (mainly USD), but at 42% of GDP if debt in local currency held by foreign investors is added.

The government's debt profile is improving. The average maturity of debt is increasing but remains relatively short (3.2 years). The average maturity of negotiable debt (around half of domestic debt) is only 1.7 years. With the lengthening of maturities on the local market and international issues, the apparent interest rate6 is on the way down. It was around 9.4% during FY2020/21 compared to 11.9% in FY2018/19 (including 3.6% and 3.5% respectively for external debt) but was 6.5% taking into account the residency criterion, and 11.1% for domestic debt (14.3% in 2019). These attractive yields explain the high proportion of domestic debt held by foreign investors, and have thus contributed to increasing the country's external vulnerability. Interest payments on external debt (according to the residency criterion) are currently equivalent to about 10% of total current account receipts, compared with about 1% in 2015.

Public sector debt and contingent debt

Public debt which is not strictly government debt is not insignificant, but does not appear to be a major source of vulnerability for the public finances. Part of the CBE's foreign currency liabilities is made up of deposits by member states of the Gulf Cooperation Council (GCC), made in order to support the country's foreign currency liquidity. These deposits amount to USD 15 bn (3.9% of GDP in June 2021) and are formally loans. The special status of this external debt (it provides political support, notably) means it is much less subject to enforced repayment than market debt. Indeed, the majority of this debt is rolled over at maturity. Egypt made a repayment to Saudi Arabia in 2020, which then made a further deposit of USD 3 bn in October 2021 and extended the maturity of the existing deposit.

Government-guaranteed debt (including public companies and economic authorities) is the main type of contingent debt. This was estimated to be 18% of GDP during FY2019/20. Public sector companies are active in a wide range of economic sectors. According to the IMF7, if we include public sector companies in the strict sense of the term and companies owned by the army, there are approximately 300 wholly public entities and 645 public-private partnerships. In addition to these companies, there are around 50 economic authorities, which can play a significant macroeconomic role in the transport, energy and housing sectors. Public companies make up around 16% of GDP and 6% of total employment. In general, their profitability is rather low, and the most financially sound companies and economic authorities are those where the government has a monopoly (Suez Canal, hydrocarbons) or has a strong competitive advantage (telecommunications).

6 Defined by interest payments divided by debt stock
7 IMF, July 2021, IMF country report no. 21/163, Article IV, Arab Republic of Egypt

The government wants to accelerate the pace of privatisation, and the Egyptian sovereign wealth fund has announced the sale of some public assets belonging to the army in particular. The amount generated by these operations is limited for the time being and these disposals are not expected to change significantly the government's medium-term solvency.

External accounts: the new Achilles heel?

External accounts are a major source of vulnerability for the Egyptian economy. The reasons for this lie in specific events, such as the consequences of the political situation on the tourism sector, or in more structural trends such as the gradual deterioration of the energy balance. Current account deficits have been recurrent since 2009 and are the result of a drop in some traditional sources of income. Volatile (portfolio flows) or insufficient (Foreign Direct Investment, FDI) capital flows have repeatedly put the country's foreign currency liquidity at risk, necessitating support from international creditors. Despite the apparently satisfactory levels of the CBE's foreign currency reserves, the size of the import bill and the dependence on volatile capital flows have demonstrated that this international support remains essential.

Persistent current account deficits

The current account balance is consistently in deficit, given the high dependence of the Egyptian economy on imports and the low competitiveness of its non-hydrocarbon exports. In this context, the trade deficit is high (on average around 13% of GDP between 2016 and 2020). In general, the current account balance depends on the performance of the three main sources of export income: hydrocarbons (increase in LNG exports, but from a low base, and a structural decline in crude oil exports), tourism and transfers from expatriate workers. LNG exports are an uncertain source of income in the medium term, given the expected changes in consumption and price volatility on the spot market. Tourism is highly dependent on external events such as political tensions or, more recently, a deterioration in the global health situation. More than tourism, private transfers form the basis of current account income (around 30% of total current account receipts) and are relatively stable over time.

The current account deficit remained moderate during FY2019/20 (3.1% of GDP), a consequence of the drop in imports (-6%) and the increase in transfers (+10%). During FY2020/21, the deficit widened to

MAIN CURRENT ACCOUNT RECEIPTS, % OF TOTAL CURRENT RECEIPTS

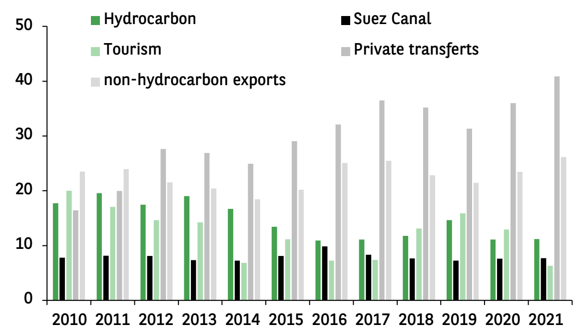

CHART 17
SOURCE: CENTRAL BANK, BNP PARIBAS

CURRENT ACCOUNT BALANCE

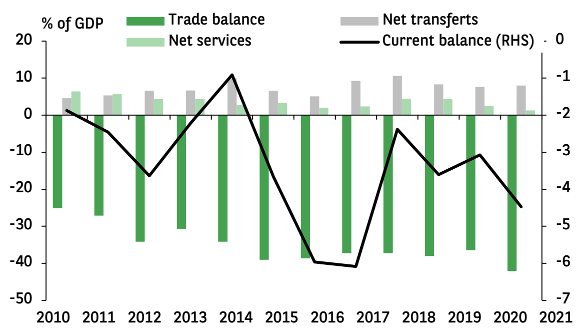

CHART 18 SOURCE: CENTRAL BANK, BNP PARIBAS

NET CAPITAL FLOWS

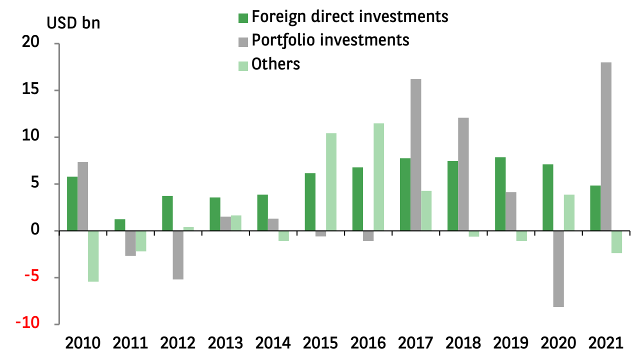

CHART 19 SOURCE: CENTRAL BANK, BNP PARIBAS

4.5% of GDP with the sharp increase in imports (+13%) and the drop in revenue from tourism (-51%). It was the unexpected rise in remittances (+14%), which prevented the current account deficit from exceeding 5% of GDP. Two explanations can be put forward for the dynamism of these remittances in a context of weak economic activity in the Gulf: 1/ Egyptian expatriates who have left Gulf countries (because of lower growth and unfavourable employment policies for non-residents) may have sold their assets before returning to Egypt; 2/ the restrictions on movement brought about by the pandemic may have forced expatriates to use official channels to transfer money, allowing these to be recorded as flows in the balance of payments.

In the short term, the current account deficit is likely to remain above 4% of GDP. A recovery in tourist frequentation is expected to remain gradual, as the risk associated with the pandemic is expected to continue at least during 2022. The rebound in LNG exports will only have a limited effect on the energy balance, given the significant amount of imported gas. The same will be true for oil prices, as the country is a net importer of crude oil but exports refined petroleum products. The main risk lies in the imports, which are driven by the upturn in economic growth and the rise in prices of many non-energy commodities (particularly food). We expect the current account deficit to average 4.5% of GDP in FY2021/22 and FY2022/23.

Foreign currency liquidity is stronger, but vulnerability remains

Foreign currency liquidity has remained satisfactory for several years thanks to bi- and multilateral loans, government issues of Eurobonds and portfolio investment flows, despite low FDI outside the energy sector. The CBE's foreign exchange reserves reached USD 40.6 bn at the end of FY2020/21, equivalent to 6.2 months of imports of goods and services. If Tier 2 reserves are added (the CBE's foreign currency assets not included in the official reserves, and which serve in particular to manage the volatility of portfolio flows), total reserves amounted to USD 50.7 bn, i.e. 7.5 months of imports.

Financial market tensions in March 2020 demonstrated the vulnerability of portfolio investments to market vagaries. During the second quarter of 2020, non-residents' holdings of local currency debt fell by around USD 18 bn to USD 10 bn in June 2020. At the same time, during the first five months of 2020, the CBE's foreign exchange reserves fell by USD 9 bn, while the net international investment position of commercial

EXCHANGE RATE: EGP/USD

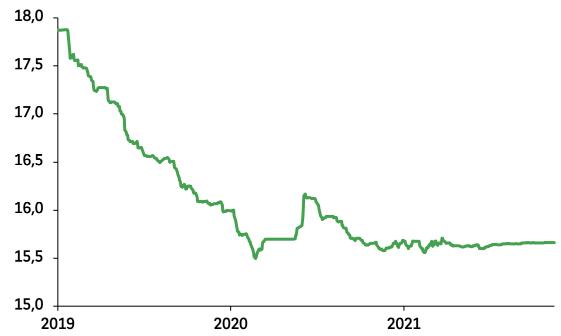

CHART 20 SOURCE: CENTRAL BANK, BNP PARIBAS

CBE FOREIGN EXCHANGE RESERVES AS % OF ST DEBT
(ST DEBT IN FOREIGN CURRENCY + TREASURY BILLS HELD FOREIGN INVESTORS)

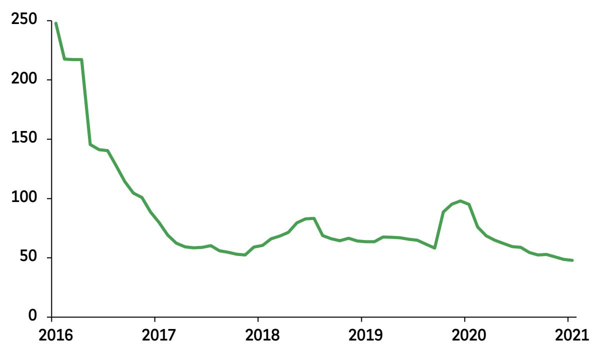

CHART 21 SOURCE: CENTRAL BANK, BNP PARIBAS

banks deteriorated significantly. In addition to the intrinsic volatility of portfolio investments, the CBE's willingness to preserve the stability of the Egyptian pound contributes to the variation of foreign exchange reserves. The coverage of short-term foreign currency debt (the sum of short-term external debt and Treasury bills held by non-residents) by foreign exchange reserves is declining steadily, to 48% in June 2021 compared to 65% at the end of 2019 and 140% at the end of 2016 when there were very few foreign investors in the local debt market.

External financing requirements are substantial

The external financing requirement is significant given the fairly high level of the current account deficit, medium and long-term debt repayments (but there is no «debt wall» in the medium term), and above all the repayment of short-term external debt which accounts for 60% of total repayments according to the IMF. During FY2020/21, total external debt repayment amounted to USD 16 bn, for a total financing requirement of USD 33 bn. This IMF estimate does not take into account deposits made by Gulf countries with the CBE, which are renewed every year. According to our estimates, Egypt's financing requirement (including short-term external debt) will be between USD 25 bn and 30 bn per year until 2025 (around 7% of 2021 GDP).

Despite continued significant external support, as evidenced by Saudi Arabia's recent additional deposit of USD 2 bn with the CBE, the country's dependence on portfolio flows will remain high in the medium term. Indeed, a gradual decline in flows from international institutions can be expected, especially from the IMF, whose support will become more technical than financial. In addition, international sovereign bond issues are expected to remain below USD 10 bn per year. After a low level of 1.3% of GDP in FY2020/21, FDI is expected to rise slowly as foreign investment in the hydrocarbon sector levels off (compared to the peak of USD 10 bn or 3.3% of GDP reached in FY2018/19) but increase very gradually in non-hydrocarbon sectors, to reach a total of 2.5% of GDP in FY2022/23. At the same time, pressure on banks' net foreign assets is expected to continue. According to this scenario, CBE reserves are expected to increase by USD 2.5 bn in FY2021/22 to reach USD 43.3 bn, and remain stable in FY2022/23. This implies a slight deterioration in foreign currency liquidity, since the CBE's foreign exchange reserves would amount to less than 6 months of imports.

Banks exposed to sovereign risk

The Egyptian banking sector is dominated by publicly-owned banks (around half of the sector's total assets). Lending policy is traditionally cautious, which favours banking liquidity, and banks' exposure to the state represents around 40% of total banking assets. The Egyptian economy remains dominated by cash transactions, with household debt accounting for only 9% of GDP. In addition, the government has introduced a policy to encourage increased bank lending to SMEs.

The impact of the pandemic on banking activity and asset quality has been limited for the time being. This is due to the traditionally cautious lending policy, the resilience of economic activity to shocks, and to specific support measures directed towards the most fragile debtors (loans at subsidised rates, the deferral of debt service payments, etc.). Private sector credit has been dynamic since the end of 2019, with an average increase of over 23% in 2020. Household loans (20% of total loans) and government loans (36% of total loans) have been the most dynamic segments of this market since mid-2019. However, the increase in the stock of total net claims on the government (loans and securities) has slowed down significantly over the past year or so (+5% in August 2021 compared with +44% a year earlier) thanks in particular to the improvement in public finances and the use of external financing. Loans to corporates remain the least dynamic segment in the absence of a recovery in productive investment. Despite a deterioration in the economic environment, credit risk remains under control, with the non-performing loans ratio falling from 4.2% in 2019 to 3.5% in June 2021, according to CBE data.

CREDIT TO PRIVATE SECTOR

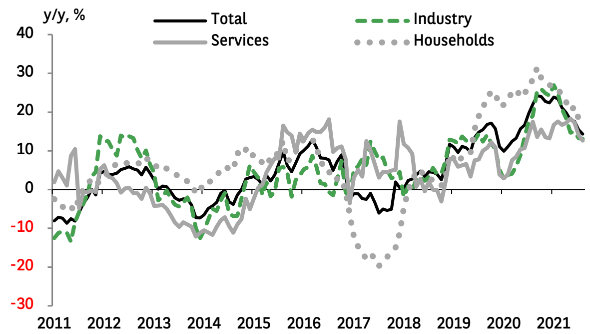

CHART 22 SOURCE: CENTRAL BANK, BNP PARIBAS

COMMERCIAL BANKS' BALANCE SHEET: MAIN ITEMS

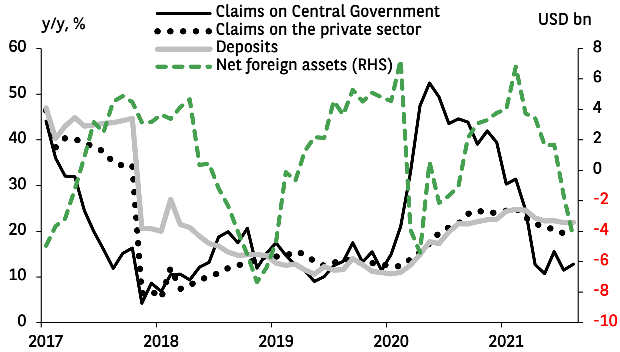

CHART 23 SOURCE: IMF, BNP PARIBAS

NET FOREIGN ASSETS OF THE BANKING SYSTEM AND CARRY TRADE FLOWS

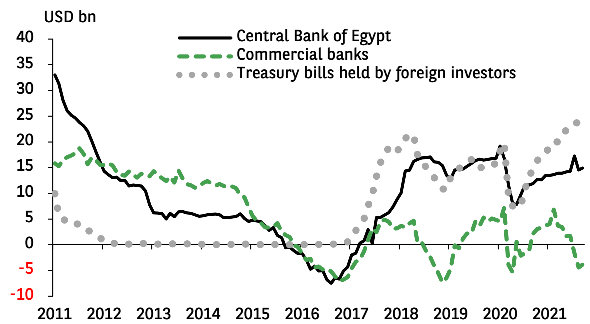

CHART 24 SOURCE: CENTRAL BANK, BNP PARIBAS

In contrast, the net foreign asset (NFA) position of banks has deteriorated significantly since the beginning of the year, from a surplus of USD 6.8 bn in February to a deficit of USD 3.8 bn in September. This situation has not been caused by a strain on banking liquidity, which would require recourse to external resources. Deposits continue to evolve in line with private sector loans, while traditionally the NFA position of banks tends to move in the opposite direction to their claims on the government. Similarly, this deterioration is not in line with previous developments that linked a high level of securities holdings by non-residents with a positive NFA position (the latter selling or swapping currencies with banks to acquire securities in local currency). This deficit is likely to be linked to the widening current account deficit, which reduces the flow of foreign exchange to banks, and could be compensated by CBE intervention.

Conclusion

Since 2016, public finance reform and significant external financial support have helped contain the budget deficit, stabilise public debt and restore foreign currency liquidity. Nevertheless, some macroeconomic imbalances persist, and external support remains essential to cope with exogenous shocks.

The current model of economic development, based essentially on the public sector drive, has enabled infrastructure development to be accelerated and growth to be maintained despite a difficult environment. However, it does not seem capable of reducing certain weaknesses in the Egyptian economy. While sovereign risk now seems to be under control, external vulnerability is increasing. The ways in which this can be reduced are already known. They lie mainly in increasing domestic and foreign private investment, which remains at structurally low levels, and in improving the competitiveness of Egyptian production.

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