

CONJONCTURE

April 2019: n°4

Eurozone convergence: Where do things stand today?

The economic convergence of member states lies at the heart of the initial project to create the eurozone, but it has followed a jagged path over the past twenty years. Convergence is a multifaceted concept that covers not only the criteria stipulated in the Maastricht Treaty but also growth dynamics and income dispersion. In the period before the Great Financial Crisis, nominal convergence was relatively complete, but progress towards real convergence was much more mixed. There are several major obstacles to a sustainable convergence within the European Monetary Union, including the lack of eurozone's optimality, possibility of currency devaluations and macroeconomic stabilisation mechanisms.

p.2

Louis Boisset

Egypt: From macroeconomic stabilisation to sustainable growth

Through economic consolidation measures implemented since 2016, Egypt has corrected its macroeconomic imbalances and regained the confidence of international investors. Foreign currency liquidity has returned to satisfying levels, the public account deficit is narrowing, although debt service is maintaining the fiscal deficit at a high level. Inflation is still relatively high but easing. Economic prospects are favourable. So far, the macroeconomic recovery has failed to trigger new momentum capable of accelerating growth and creating jobs. The weight of public sector and a large informal sector reduce the economy's responsiveness to positive macroeconomic signals. Structural reforms are necessary to preserve the achievements of ongoing reforms.

p.8

Pascal Devaux



ECONOMIC RESEARCH DEPARTMENT



BNP PARIBAS

The bank
for a changing
world

Eurozone convergence: where do things stand today?

Louis Boisset

The economic convergence of member states lies at the heart of the initial project to create the eurozone, but it has followed a jagged path over the past twenty years. Convergence is a multifaceted concept that covers not only the criteria stipulated in the Maastricht Treaty but also growth dynamics and income dispersion. In the period before the Great Financial Crisis, nominal convergence was relatively complete, but progress towards real convergence was much more mixed. There are several major obstacles to a sustainable convergence within the European Monetary Union, including the lack of eurozone's optimality, possibility of currency devaluations and macroeconomic stabilisation mechanisms.

The concept of economic convergence covers several different realities. "Nominal" convergence refers to the criteria defined in the Maastricht Treaty in 1993 to prepare for the adoption of the single currency. It covers inflation, long-term interest rates, exchange rates and public debt and deficits. There is another form, called "real" convergence, that refers to the convergence of income levels (notably GDP per capita expressed in terms of purchasing power parity¹), productivity trends and even economic structures (i.e. sector weightings as a share of national value added), but also to economic catching-up phases. Countries that initially had lower income levels must experience faster economic growth than the higher-income countries.

There is a consensus concerning the need for convergence between eurozone member states, notably to facilitate the implementation and transmission of the European Central Bank's monetary policy within the eurozone. Greater synchronisation and less divergent cyclical amplitudes should make it possible to implement a more effective common monetary response, in line with the needs of the majority of countries. Economic convergence thus helps to buffer idiosyncratic shocks. All other factors being the same, the effects of an exogenous shock will be close for countries with similar productive structures. Yet this convergence is not necessarily endogenous to a monetary union. According to authors like Paul Krugman, rather than facilitate the convergence of its member states, an integrated economic and monetary area encourages greater economic specialisation according to comparative advantages. A priori, the convergence of results does not necessarily imply the convergence of economic structures (such as sector weightings within the economy).

Where does eurozone convergence stand today? Since its creation, the eurozone has undergone two distinct phases of convergence. Nominal convergence was a reality even before the creation of the single currency, and it remained between 1999 and the financial crisis of 2008. Real convergence also began during the pre-crisis period, but was much less striking. The post-crisis period revealed structural differences between the member countries and their macroeconomic performances began to diverge.

Prior to the crisis, "nominal" convergence was disruptive

Prior to 1999 and through the 2008 financial crisis, the "nominal" convergence process between eurozone member countries was well established.

Beginning in the mid-1990s, long-term interest rates (10-year government bond yields) converged rapidly between the different economies. Long-term rates fell sharply in the countries with the highest rates, and neared the lower bound represented by German long-term rates. The yield on 10-year Italian government bonds fell by more than 6 points between April 1995 and January 1999. In the peripheral countries², yield spreads with Germany narrowed to nearly zero in 1999, and held there until 2008 (see chart 1). During this period, the risk assessment was the same for all of the EMU member states, and the eurozone seemed to be an entity whose members could not default.

10-year sovereign yield spreads with Germany

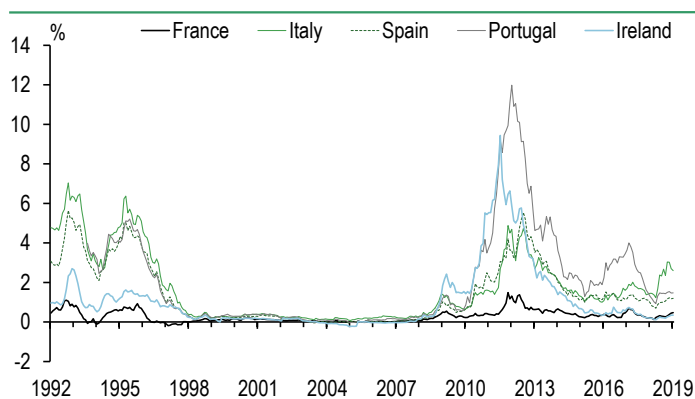


Chart 1

Source: Banque de France

¹ Purchasing power parity (PPP) is used to express a common unit of purchasing power in different currencies, by eliminating price differences between countries.

² For the purposes of this article, the "peripheral" countries are Italy, Spain, Portugal and Greece.



The outbreak of the Great Financial Crisis in 2008-2009 led to the first widening of sovereign spreads. Yet the real rupture occurred during the sovereign debt crisis, when yield spreads rose dramatically between certain member countries. The cost of financing rose sharply in some countries, notably Greece, Portugal and Ireland. Since then, long-term rates have begun to converge again, albeit less so than during the decade leading up to the euro's launch.

Before the creation of the single currency, and in compliance with the Maastricht criteria, inflation rates also converged in a striking manner (see chart 2)³. Yet this convergence came to a halt as of 1999. Inflation differentials, even minor ones, have tended to persist in the first years of Economic and Monetary Union (EMU)⁴. Given the complete convergence of nominal interest rates, countries with structurally higher inflation rates benefited from lower real rates. Low real interest rates may have fuelled credit bubbles and excessive spending, notably in real estate investment. In the end, these tendencies resulted in increasingly sharp current account imbalances (see below).

Standard deviation of annual inflation rates

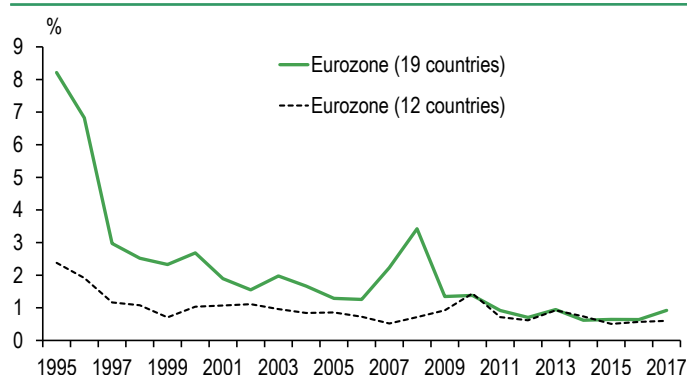


Chart 2

Source: IMF, WEO october 2018

Over time, the persistence of inflation differentials between member countries ended up eroding the price competitiveness of some economies with regard to the eurozone and the rest of the world, as illustrated by fluctuations in real effective exchange rates⁵ (see chart 3).

In Greece and Spain, and to a lesser extent in Portugal and Italy, real effective exchange rates appreciated sharply in the euro's first decade, while their price competitiveness deteriorated relative to their competitors. The "nominal" convergence process was well engaged but insufficiently complete, resulting in macroeconomic imbalances in some eurozone member states that revealed their structural weaknesses.

³ The Maastricht Treaty imposes price stability. For a given member state, the inflation rate must not be more than 1.5 points higher than that of the three member states with the best performances in terms of price stability.

⁴ Between 1999 and 2007, Germany's average annual inflation rate was 1.8%, while the figures for Spain and Greece were virtually twice as high at 3.4%. For some authors, these inflation differentials indicate lagging economic cycles or differences in price determination terms.

⁵ The real effective exchange rate (REER) is the weighted sum of the bilateral exchange rates between trading partners, adjusted for the export price ratio.

Real effective exchange rates (REER)

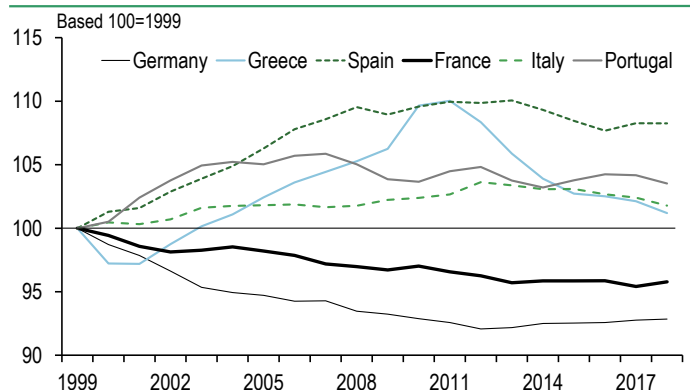


Chart 3

Source: Eurostat

Wealth gaps: no real convergence

During the euro's first decade, the convergence of nominal interest rates stimulated growth in several member economies. In the post-crisis period, however, activity slowed sharply, especially in some of the peripheral countries. Over the period as a whole, the first countries to join the eurozone⁶ did not experience an economic catching-up process. The Baltic countries, which had significantly lower income levels and which joined the euro much later⁷, were virtually the only countries to report a catching-up effect.

Charts 4 and 5 trace the change in the dispersion of GDP per capita from the eurozone average (in purchasing power parity, in euros). To ensure the homogeneity of observation conditions, we narrowed our selection to the initial countries making up the eurozone⁸.

Over the entire period, wealth gaps increased and real convergence does not seem to have occurred. We can nonetheless distinguish between three phases:

- 1) from 1999 to 2008, the dispersion of income levels tended to narrow moderately,
- 2) from the crisis through 2013, income dispersion between member states diverged sharply,
- 3) since then, it seems to be narrowing very slowly again.

⁶ Germany, Belgium, Ireland, Greece, Spain, France, Italy, the Netherlands, Austria, Portugal and Finland

⁷ Estonia joined the eurozone in 2011, Latvia in 2014 and Lithuania in 2015

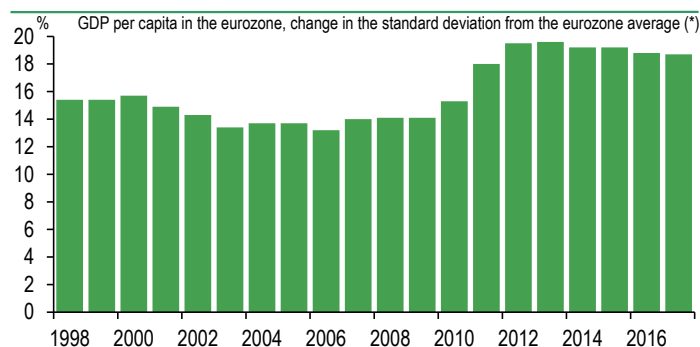
⁸ As of 1999, the first circle comprised Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Portugal and Finland, to which we added Greece, which joined in 2001. Due to the variability in GDP per capita and their sensitivity to exogenous factors (such as changes in international accounting standards), Luxembourg and Ireland were not included in our selection. The standard deviation

is measured as follows: $\sigma = \sqrt{\frac{\sum (x_i - \bar{x})^2}{n}}$, where x_i is GDP per capita in euros (PPP), \bar{x} the weighted average for the eurozone, and n the selection size.



Yet this aggregated approach masks wide national disparities. Member states have followed very different trajectories, especially after the crisis, which contributed to increase wealth gaps within the eurozone (see chart 5).

Wealth gaps have widened since the 2008 crisis

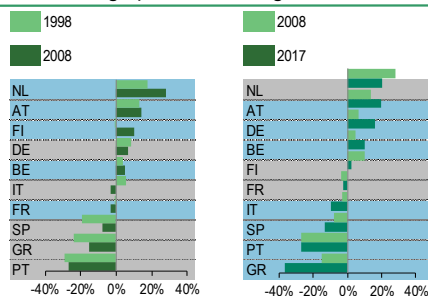


(*) In this table, the eurozone is comprised of Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Portugal, Finland, Greece.

Chart 4

Source: Eurostat

Which countries are converging? Which are diverging? GDP per capita, deviation from the average (area of convergence/area of divergence)



Area of divergence: the mean deviation of the area increases

Area of divergence: the mean deviation of the area decreases

(*) In this table, the eurozone is comprised of Germany (DE), France (FR), Italy (IT), Spain (SP), Netherlands (NL), Belgium (BE), Austria (AT), Portugal (PT), Finland (FI), Greece (GR).

Chart 5

Source: Eurostat

In the euro's first decade, the peripheral countries tended to reduce the wealth gap relative to the eurozone average, albeit using economic models that were hardly sustainable. This was notably the case for Spain, Greece and Portugal. At the same time, these trends were accompanied by the divergence of the northern countries, whose income levels increased faster than the eurozone average. This was notably the case for the Netherlands, Finland and Austria. As to Germany, divergence in real terms did not really occur in the first ten years.

After 2008, these divergences increased sharply. The peripheral countries erased their strong pre-crisis performances, which were fuelled by very low real interest rates and strong credit growth, and generally tended to become more impoverished relative to the eurozone average. Some countries reported a relatively big and sustained increase in the negative output gap, particularly during the sovereign debt crisis (-16% of potential GDP in Greece in 2013, -9% in Spain and

-5% in Italy). Over the same period, in contrast, the northern eurozone members continued to get wealthier, buoyed notably by Germany's dynamic economic momentum, where GDP per capita rose much faster than the eurozone average. France, as is often the case, tended to be in an intermediary position, both before and after the crisis: its wealth gap did not change much relative to the eurozone average.

Why did convergence falter in the post-crisis period?

Several factors explain the lack of convergence since the crisis. Total Factor Productivity (TFP) is one of the keys.

Although productivity gains slowed in most countries, in some of the peripheral economies – where pre-crisis productivity gains were structurally less robust – TFP declined during the post-crisis period (see chart 6). In the initially more productive countries, TFP continued to rise on the whole, albeit at a more subdued pace after the crisis.

Evolution of total factor productivity

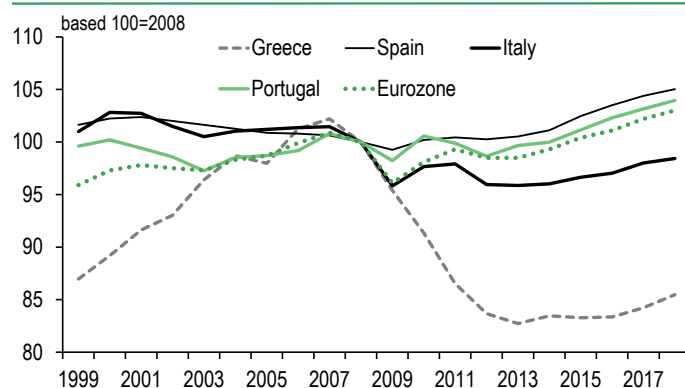


Chart 6

Source: AMECO

Before the crisis, major capital inflows into the lower-income eurozone countries did not trigger a lasting catching-up movement for productivity. Capital inflows into the peripheral economies were comprised essentially of portfolio investment, such as purchases of public debt instruments, and short-term interbank loans, to the detriment of foreign direct investment flows, which tend to be more sustainable and susceptible to boost productivity gains⁹. In some cases, credit booms even managed to hamper productivity gains through the reallocation of labour towards sectors with low productivity¹⁰. This was the case for Spain, where capital allocation was not optimal and largely fuelled a housing bubble. All other factors being the same, the stimulation of domestic demand through strong credit growth in the peripheral countries was also associated with a deterioration in their current accounts during the pre-crisis period (see chart 8 below).

⁹ J.-L. Diaz del Hoyo et al.: *Real convergence in the euro area: a long term perspective*, ECB, December 2017

¹⁰ C. Borio et al.: *Labour reallocation and productivity dynamics: financial causes, real consequences*, BIS Working Papers, December 2015



With the outbreak of the Great Financial Crisis of 2008, and then the sovereign debt crisis of 2011, external financing dried up. The share of inter-bank lending (in the total stock of loans) in the eurozone declined by about 10 points between year-end 2008 and year-end 2018. Essentially cyclical by nature, the already weak productivity gains reported during the expansion years quickly evaporated and turned into losses. The decline in total factor productivity (TFP) was especially sharp in Italy and in Greece, which was also hard hit by a period of drastic fiscal consolidation and a sharp drop-off in investment (the investment rate, all assets combined, dropped from more than 25% of GDP in 2007 to less than 12% in 2014).

Incomplete “nominal” convergence, persistent inflation differentials and credit booms in certain peripheral countries helped aggravate macroeconomic imbalances within the eurozone and interrupted the “real” convergence process.

Internal misalignment

The eurozone never met the criteria for optimality: labour mobility is still rather weak, capital market integration needs to be deepened, the improvement in intra-zone trade relations has not lived up to expectations¹¹ and the convergence of fiscal and budget policies has been snagged by some major obstacles (see below). Moreover, without the option of using currency devaluation as an external adjustment mechanism, other adjustment strategies had to be found. One solution consists of an internal devaluation *via* tight control over unit labour costs (ULC)¹². In this respect, ULC trends within the eurozone indicate a growing gap in terms of cost competitiveness between member countries, especially during the pre-crisis period (see chart 7).

For a long time, Germany went unrivalled. Looking beyond the improvements in non-cost competitiveness and its strategic positioning, since reunification the German economy has focused on wage moderation, thanks notably to the decentralisation of wage negotiations. In the early 2000s, wage moderation was coupled with greater job market flexibility. These trends enabled Germany's manufacturing industry to restore its competitiveness and helped fuel a significant improvement in the current account (+9 points of GDP since 1999, to about 8% in 2017). In the Netherlands, which also reported strong growth and a high current account surplus (more than 10% of GDP in 2017, a 7-point increase compared to 1999), the average increase in ULC was about 2% before the crisis (similar to France), while labour productivity gains were comparable to those in Germany.

During this period, unit labour costs rose sharply in the peripheral countries. In Italy, Portugal and Spain, the pre-crisis increase in ULC was mainly concentrated in the non-tradeable goods and services sectors¹³. As inputs in the production process, ULC growth in the

sheltered sector hindered the competitiveness of sectors exposed to international competition. Different ULC dynamics between eurozone members contributed to the gap between countries with current account deficits and those with current account surpluses (see chart 8). During the euro's first decade, the current account for the eurozone as a whole was generally well balanced, but it rose constantly thereafter, due largely to the impact of Germany's swelling surplus. In the “deficit” countries, in contrast, their current account deficits widened sharply prior to 2008, but narrowed thereafter at a time of sluggish domestic demand.

Unit labor costs

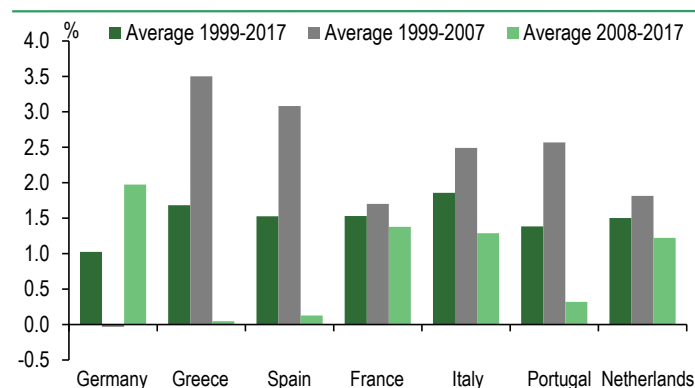


Chart 7

Source: Eurostat

Current account balance

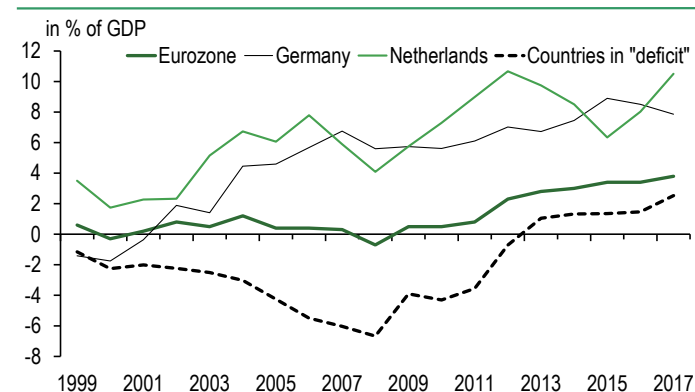


Chart 8

Source: IMF WEO

Interpreting the chart: The “deficit” countries, represented by the black dotted line, are those that have reported a current account deficit on average since 1999. They include Italy, Greece, Spain and Portugal.

Since 2008, wage growth in Germany has tended to be stronger than the eurozone average (German ULC has increased by about 2% on average since the crisis, compared to 1.3% in the eurozone). Other countries experienced abrupt adjustments in their unit labour costs. In Greece and Spain, ULC rose at an average annual rate of more than 3% between 1999 and 2007, but has stagnated ever since. If these new trends persist, they would reduce the gap in cost competitiveness and

¹¹ R. Glick & A. Rose: *The currency union's effect on trade: Redux*, VOX CEPR, June 2015

¹² Unit Labour Costs (ULC) are the ratio between the total wage bill (including employee and employer social welfare contributions) and labour productivity.

¹³ T. Tresselt et al.: *Adjustment in Euro area deficit countries: Progress, challenges, and policies*, IMF Staff Discussion Note, July 2014



could even correct some of the macroeconomic imbalances that have been accumulated within the eurozone.

Much-needed institutional advances

During asymmetric shocks, it is possible to make macroeconomic adjustments, notably *via* the moderation of unit labour costs. Yet these adjustments can have a lasting negative impact on demand. Seen in this light, risk sharing seems to be essential, especially within a monetary union, in order to smooth consumption over time and to improve wellbeing in general. By definition, a common monetary policy limits autonomy at the national level, which implies that risk sharing is necessary to absorb the impact of asymmetric shocks¹⁴. There are several different types of risk sharing mechanisms, which can be either private (*via* the capital markets or credit channels) or public (intergenerational transfers *via* public debt), national or cross border (transfer system between member states).

Unlike the United States, which is a federal republic, the eurozone has experienced very little risk sharing since the creation of EMU, 80% of the shocks affecting a given economy have not been smoothed¹⁵. Risk sharing also tends to weaken during periods of economic hardship. Cross-border lending was hard hit by the 2008 crisis, by the upsurge in risk aversion among economic agents and by greater differentiation between borrower risks.

To strengthen risk-sharing mechanisms within the eurozone, greater capital market integration is needed along with a cross-border credit market that is less sensitive to cyclical downturns. For many observers, the eurozone's brief history has also revealed the need to reinforce institutional convergence.

First steps...

The slow and painful response to the sovereign debt crisis, especially in Greece (whose economy now accounts for only a little over 2% of the eurozone's nominal GDP), highlighted major divergences between the hard-line proponents of "no bailouts" (in compliance with the European treaties) and the partisans of a more interventionist approach. These divergent points of view weakened the eurozone and aggravated tensions in the sovereign bond markets.

The creation of the European Stability Mechanism (ESM), which replaced the European Financial Stability Fund (EFSF)¹⁶, was a first step toward risk sharing. These structures are designed to lend to member states encountering financial difficulties in exchange for "strict conditionality". By stepping in for private lenders in the hardest hit countries, they made it possible to better absorb shocks in the eurozone during the crisis¹⁷. Yet these mechanisms act more as ex-post

emergency measures. Although they are credible tools for fighting negative shocks in the short term, an upstream instrument could absorb part of the shock, which would help limit the negative effects on economic growth and employment.

Since 2012-13, the eurozone has also engaged in banking union with three objectives:

- 1) risk prevention, through a single supervisory mechanism assigned to the European Central Bank (ECB),
- 2) the disassociation of sovereign and banking risks, *via* a single resolution mechanism comprised notably of a single resolution fund financed by the banks themselves, and
- 3) the mutualisation of risks *via* the European bank deposit insurance scheme, which is still incomplete.

Fostering real convergence would require: 1) strengthening the supply conditions of eurozone member countries (especially their competitiveness) to forge a sustainable convergence in terms of productivity and income levels, as discussed above, and 2) to set up mechanisms to limit the lasting negative effects of shocks on GDP and employment. In the rest of this article, we will focus on this second point.

...to be confirmed

The completion of banking union or a capital markets union would be a first step, but this still leaves the risk of capital flight during periods of financial stress. Moreover, the clean-up of macroeconomic and financial fundamentals – which Germany often sees as a precondition for exploring any form of in-depth mutualisation – seems to be a long-term objective, a necessary one but that is not sufficient on its own. As a result, some authors argue that the EMU is still vulnerable¹⁸.

One way to strengthen the eurozone would be to empower it with a supranational fiscal capacity (European Commission, 2017¹⁹). Honed for macroeconomic stabilisation, this counter-cyclical tool would help partially or fully absorb shocks, and would prevent the divergence process from being triggered. It would also favour the implementation of better balanced policy mixes than those observed during the sovereign debt crisis²⁰. A supranational fiscal policy would be even more pertinent today since monetary policy is restricted by very low interest rates.

To be effective, this supranational fiscal capacity would need to be based on a simple mechanism, one that is triggered as soon as the cyclical environment deteriorates. One indicator that could serve as a trigger would be the unemployment rate's deviation from its long-term average²¹. This would be preferable to the output gap (the spread between effective and potential GDP growth), the measurement of

¹⁴ W. De Vijlder: *Risk sharing in the eurozone: which way forward?*, BNP Paribas, Conjoncture, October 2018

¹⁵ ECB, *Risk sharing in the eurozone*, Monthly Bulletin, No. 3 / 2018

¹⁶ The EFSF stopped lending in mid-2012 and was permanently replaced by the ESM, which has much bigger financial clout.

¹⁷ J. Cimadomo et al.: *Private and public risk sharing in the euro area*, ECB, Working Paper Series no. 2148, May 2018

¹⁸ A. Bénassy-Quéré et al.: *Which fiscal union for the euro area?*, French Council of Economic Analysis, February 2016

¹⁹ European Commission: *Reflection Paper on the deepening of the Economic and Monetary Union*, May 2017

²⁰ In 2012 and 2013, the pro-cyclical fiscal policies implemented by certain countries amplified the negative impact of the crisis on activity and employment.

²¹ For this long-term average, several proposals, including one by the IMF, suggest using the simple moving average of the unemployment rate over the past 10 years.



which is regularly the subject of debate and can be called into question *ex-post*.

This fiscal capacity would be mobilised, temporarily and proportionally, in favour of one or more countries hit by an increase in cyclical unemployment following an asymmetric shock, resulting in a deterioration in their fiscal situation (due to a shortfall of revenues and higher social welfare payouts). Such an intervention would also offer the advantage of easing the negative effects of the deterioration of public finances on the bond markets (higher sovereign spreads). It would also limit the *ex-post* activation of the European Stability Mechanism.

The implementation of such a mechanism raises several major issues. Guarantees would also be necessary²². This fiscal mechanism could be financed through annual contributions by each country, which would require the transfer of some national resources to the federal level. The bigger the eurozone's fiscal capacity, the higher the amount of transfers. This also raises the question of whether it would be politically or socially acceptable. In this respect, guarantees would be needed to facilitate the project's implementation. The question of morale hazard also needs to be addressed. How can we guard against the risk of budget overruns at the national level in the presence of this "supranational" insurance mechanism? According to the IMF, net transfers to distressed countries should depend on their compliance with fiscal rules in past years. In case of non-compliance, transfers would not be completely cancelled, but would be digressive instead. This fiscal capacity should not be considered as a permanent mechanism and should not substitute for the sometimes necessary adjustment of national economic policies. When supranational transfers are used too frequently, penalties should be imposed on the delinquent countries (*via* an extra annual contribution, for example).

For the political acceptance and smoothing functioning of this system, eurozone member countries would have to adopt fiscal policies that rebuild fiscal manoeuvring room during cyclical upturns. This would facilitate the dialogue between countries with a structural surplus and those with structural deficits, ensuring the "smooth" functioning of the supranational fiscal capacity.

Crisis after crisis, the EMU has been strengthened through trial by fire. Stabilisation mechanisms have been created that were not part of the original project. The European Central Bank has played a much bigger role by increasing the size of its balance sheet and by directly supervising the main banks *via* a single supervisory mechanism. A capital markets union has been launched. Yet the centrifugal forces that fuelled divergence in the EMU in the past are still operational. European construction still requires special attention, at least in two respects.

Productivity seems to be a core issue. Even before the Great Financial Crisis of 2008, Total Factor Productivity (TFP) between countries varied widely, hampering convergence. Consequently, national policies are needed to raise productivity, which in turn will boost long-term growth potential.

Incomplete institutional advances led to abrupt macroeconomic adjustments that prolonged the crises' negative impact on domestic demand. The eurozone now needs a veritable supranational stabilisation mechanism to make sure that the impact of localised shocks are not amplified and do not widen the gaps between countries.

Completed on 26 April 2019

louis.boisset@bnpparibas.com

²² N. Arnold: *A central fiscal stabilization capacity for the Euro area*. IMF, March 2018



Egypt: From macroeconomic stabilisation to sustainable growth

Pascal Devaux

Through economic consolidation measures implemented since 2016, Egypt has corrected its macroeconomic imbalances and regained the confidence of international investors. Foreign currency liquidity has returned to satisfying levels, the public account deficit is narrowing, although debt service is maintaining the fiscal deficit at a high level. Inflation is still relatively high but easing. Economic prospects are favourable. So far, the macroeconomic recovery has failed to trigger new momentum capable of accelerating growth and creating jobs. The weight of public sector and a large informal sector reduce the economy's responsiveness to positive macroeconomic signals. Structural reforms are necessary to preserve the achievements of ongoing reforms.

Since 2016, economic reform measures and massive external financial support have helped lift the Egyptian economy out of a very tight situation. The most substantial progress was made in terms of external imbalances, while public finances are recovering gradually. Although vulnerabilities persist, the economy is once again poised to enter a new phase of the reform process, one that should stimulate private investment and create jobs. Looking beyond the reduction of macroeconomic imbalances, structural changes will be needed to face up to hard-to-curb demographics and to preserve the economic achievements of the past three years.

External accounts recover

Egypt's foreign currency liquidity is no longer in the alarming zone thanks to the reduction in the current account deficit, financial support from international donor funds and the renewed confidence of foreign investors, who have returned to the local bond market.

Sharp decrease in the current account deficit

The most significant outcome of the reform process initiated in 2016 is the improvement in the external accounts. In 2017/2018¹, the current account deficit narrowed significantly to 2.4% of GDP, down from more than 6% in the previous two years (Chart 1). The main sources of this improvement were the services, revenue and transfer accounts (the so-called invisibles) (Chart 2). Tourist activity rebounded, thanks notably to the depreciation of the Egyptian pound (EGP) and a more stable political environment, and tourism revenues rose to USD 9.8 bn (13% of current account revenues), compared to USD 4.4 bn in 2016/2017 (7% of revenues) (Chart 3). Remittances from expat workers are still a major source of external revenues. They accounted for 35% of revenues in

2017/2018 (USD 26 bn) at a time of rising oil revenues in the Gulf countries, which employ more than 5 million Egyptian expats. High oil prices also bolstered Suez Canal revenues (+15% y/y).

Egypt: current account balance

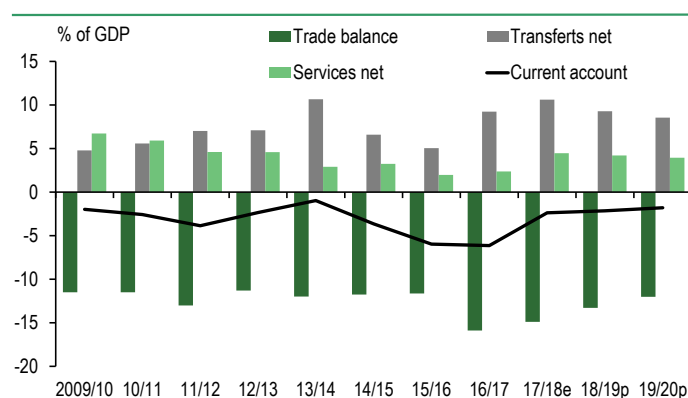


Chart 1

Source: Central Bank of Egypt, BNP Paribas

Egypt: main sources of external revenues

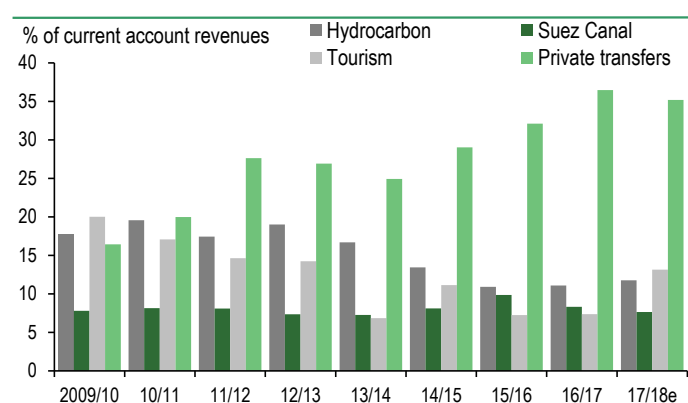


Chart 2

Source: Central Bank of Egypt, BNP Paribas

¹ The fiscal year ends in June.



Egypt: tourism activity (1 year rolling sum, '000)

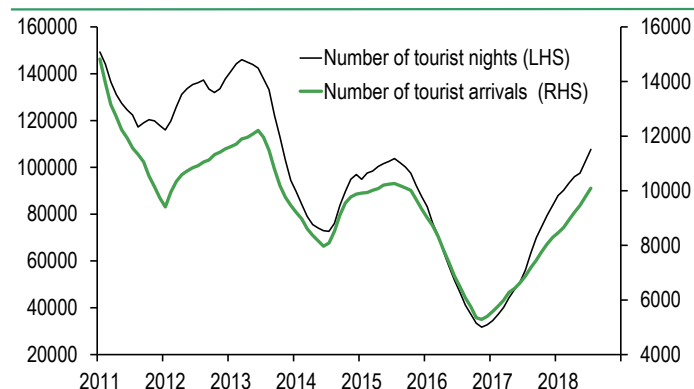


Chart 3

Source: Central Bank of Egypt, BNP Paribas

The results were more mixed for the trade balance than for the “invisible” balance. The hydrocarbon deficit (oil and gas) narrowed to USD 3.7 bn in 2018 from USD 5.4 bn in 2016/2017, thanks to virtually stable imports (+3.9% y/y). This is due to the decline in liquefied natural gas (LNG) imports in volume, and the bigger-than-expected decline in the consumption of petroleum products, a priori due to the cutback in government subsidies, which encouraged more moderate energy consumption. The non-hydrocarbon trade deficit swelled to USD 33 bn from USD 31.8 bn in 2016/2017.

So far, the depreciation of the Egyptian pound has had only a limited impact on exports. On the one hand, winning export market share does not seem to be a priority for the companies (according to EBRD², only 5% of Egyptian companies are exporters). On the other hand, the shortage of investment hurts the competitiveness of exports. All in all, the trade deficit narrowed to 15% of GDP in 2018, which is still near an all-time high (16% of GDP in 2017).

Favourable outlook

Over the next two years, the current account balance should continue to improve, although it should remain in negative territory. The trade deficit should continue to narrow as the country temporarily becomes a net gas exporter. The energy deficit contracted sharply in the first half of 2018/2019 to USD 0.6 bn (vs USD 2.2 bn in the year-earlier period). The start-up of new refining capacity should also reduce imports of oil products. Non-hydrocarbon exports should continue to grow at a moderate pace, while the gradual acceleration in economic growth is expected to boost imports. We also expect private domestic productive investment to recover mildly as of 2020, which should boost capital goods imports.

² EBRD: *Private sector diagnostic. Egypt*. March 2017

At the same time, the tourism sector is expected to become the driving force behind the improvement in the external accounts. Although the strong rebound in 2018 is unlikely to be replicated, activity should pick up and benefit all of Egypt's tourist sites. The expected opening of the Grand Egyptian Museum as of 2020 will also provide the sector with an extra boost. Suez Canal revenues are unlikely to increase significantly at a time when oil prices are expected to be virtually flat.

The current account deficit is expected to narrow to 2.1% of GDP in 2019 and 1.9% of GDP in 2020. Thereafter, it could widen since Egypt is likely to become a net gas importer again in 2020/2021³, and investment growth is likely to fuel imports. There are several risks that could have a negative impact on this scenario, notably a deterioration in the security situation, the application of more restrictive labour policies for expats working in the Gulf countries, and a significant increase in oil prices⁴.

Slowing capital flows

In 2017/2018, portfolio investment flows and new external debt issues covered most of external financing needs (i.e. the current account deficit of USD 6 bn plus USD 2.3 bn in external debt amortisation) (Chart 4). Non-resident investors took advantage of high local interest rates, and counted on the stability of the exchange rate to invest massively in the market for T-bills in the local currency. Net portfolio investment flows slowed to USD 12 bn, from USD 18 bn in 2016/2017.

Egypt: net capital flows

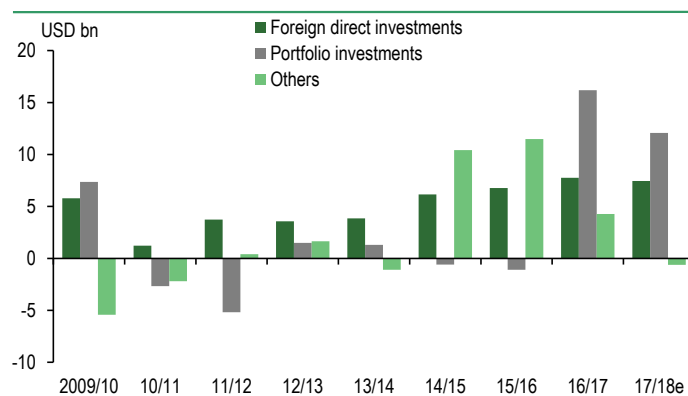


Chart 4

Source: Central Bank of Egypt, BNP Paribas

Similarly, flows of foreign direct investment (FDI) remained strong at USD 7.4 bn, although they are still concentrated in the hydrocarbon sector. Debt flows from bi-lateral and multi-lateral creditors were also high at about USD 10 bn.

³ Only the start-up of new gas fields would enable the country to cover its domestic consumption needs, which are growing rapidly (+14% in 2017).

⁴ Egypt has been a net importer of crude oil since 2009.



The outlook for capital flows is positive in the short term. After the slump in the emerging markets in 2018, the amount of local debt held by non-residents was slashed in half in Egypt. Since early 2019, international investors have returned to the T-Bill market in local currency, and net portfolio investment inflows have become positive again. They are expected to remain positive throughout 2018/2019 and 2019/2020. Even though the gradual decline in interest rates could reduce the yields on Egyptian sovereign debt instruments in the local currency, the risk/return couple will remain favourable thanks to the steady improvement in Egypt's sovereign rating and the appreciation of the Egyptian pound, at least in the short term. As to FDI inflows, we do not foresee a significant upturn outside of the hydrocarbon sector. With the end of the IMF support programme, external debt flows should diminish over the next two years, although they will continue to be supported by Eurobond issues.

Foreign currency liquidity is comfortable in the short term, but vulnerability to portfolio investment flows persists

External liquidity picked up in 2017/2018. The Egyptian Central Bank's official foreign reserves increased by USD 13 bn to a total of more than USD 44 bn, the equivalent of 7.2 months of imports of goods and services (Chart 5). Alongside these official reserves, there are also non-official reserves, also known as Tier 2 reserves, which are reported in a separate account on the central bank's balance sheet. They serve as a safety net in case of a massive flight of non-resident portfolio investment. At the end of 2017/2018, Tier 2 reserves amounted to USD 9 bn, equivalent to 54% of the amount of Treasury bills held by non-residents. Official reserves are expected to continue growing in 2018/2019, to USD 47 bn.

Egypt: Central bank foreign reserves

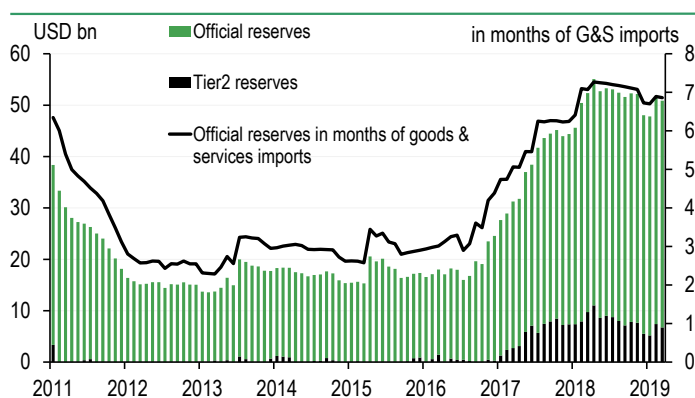


Chart 5

Source: Central Bank of Egypt, BNP Paribas

Yet this improvement in foreign currency liquidity was partially achieved to the detriment of the external position of commercial banks. In 2018, a big part of portfolio investment outflows were supported by the banks. The ending of CBE's repatriation mechanism redirected part of portfolio investment flows from the central bank's balance sheet to that of the commercial banks. Consequently, the banks' net external position deteriorated sharply as of mid-2018 and became negative. Net external liabilities amounted to USD 6.4 bn at the end of 2018. Yet thanks to the reduction in the current account deficit in the first half of 2018/2019 and renewed capital inflows since early 2019, the banks have virtually balanced their net external position since the end of February 2019 (USD -0.13 bn) (Chart 6).

Egypt: banking system net foreign asset and carry trade flows

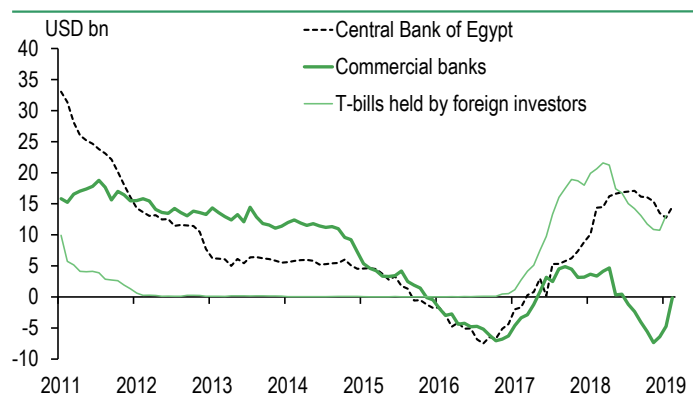


Chart 6

Source: Central Bank of Egypt, BNP Paribas

Moderate external debt

External debt has increased significantly since 2016 with the increase in official bi-lateral and multi-lateral loans, and the government's Eurobond issues (USD 20.5 bn). Yet this is still relatively moderate at 38% of GDP at year-end 2017/2018 (vs 17% in 2015/2016).

At year-end 2017/2018, the government external debt was 19% of GDP and 10.6% of GDP for the central bank (in the form of foreign government deposits). Banks and private companies have low external debt ratios of 2.4% and 5% of GDP, respectively. Government debt benefits from favourable financing conditions: the apparent interest rate on total public external debt⁵ is low, at 1.1% in 2017/2018. The total external debt service (interest and amortisation) accounts for only 7% of current account revenues. This ratio is expected to remain stable over the next two years. As a consequence, external debt is not a source of vulnerability for external liquidity.

In the medium term, the external debt ratio should narrow to 30% of GDP in 2019/2020, assuming the fiscal deficit remains under control.

⁵ External debt interest payment as % of external debt stock



The government has pledged to limit its use of external debt. Moreover, productive investment is not expected to pick up before 2020, and Egyptian companies are traditionally reticent to finance their development through foreign currency debt.

Public finances are gradually improving

Public finances are still the weak point of the Egyptian economy. Despite a sharp reduction in the primary fiscal deficit, the total fiscal deficit remains high due to a debt servicing charge that is difficult to manage.

Towards a primary surplus

Since 2011, political upheavals have disrupted the public finance situation, and the fiscal deficit has soared above 10% of GDP (Chart 7).

Reforms implemented since 2016 have significantly reduced the deficit. The gradual deregulation of energy prices was a key factor, thanks notably to cutback in subsidies (Chart 8). Subsidies averaged 6% of GDP between 2011 and 2014, but were trimmed to 5.3% of GDP in 2018. Concerning fiscal revenues, reform efforts were much more timid. Fiscal revenues amounted to only 14% of GDP. Non-tax revenues, which are mainly comprised of dividends distributed by state-owned companies, are less significant. These dividends are rather volatile due to their dependence on oil prices and Suez Canal activity.

Egypt: general government fiscal balance (% of GDP)

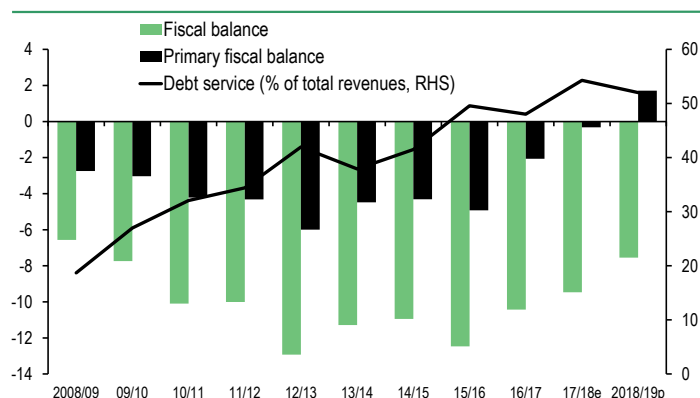


Chart 7 Source: Ministry of Finance, BNP Paribas

Total government revenues have not improved: they amounted to only 20.5% of GDP in 2018, compared to a 2012-2015 average of 22% of GDP. The most notable improvement in government revenues was the increase in the tax on goods and services, which is the easiest way to increase fiscal revenues. It is harder to increase government revenues via income and earnings taxes given the size of the informal sector (at least 40% of GDP) and efforts to attract foreign investment through

lower taxes. It is also difficult politically to increase income taxes at a time of high inflation. All in all, despite stagnant revenues, the reforms significantly improved the primary fiscal balance (excluding interest payment on government debt). For the year 2017/2018, the primary deficit shrank to 0.3% of GDP, compared to an average of 4.3% of GDP for the period 2013-2017.

Over the next two fiscal years, the primary balance is expected to shift into positive territory again, at 1.7% and 3.3% of GDP, respectively, in 2018/2019 and 2019/2020, thanks to ongoing cutbacks in energy subsidies (the next reduction, programmed for 2019, will save EGP 37 bn) and a mild increase in tax revenues. Social expenditures (food subsidies, social transfers and civil servant wages) will increase to offset the decline in disposable household income. Initiated in 2016/2017 and continued in 2017/2018 for a total of 2.4% of GDP, investment efforts will be continued. The 2019/2020 budget proposal calls for investment in healthcare and education to be increased by more than 10%. Future oil price trends are the biggest uncertainty concerning the improvement in the primary balance. Over a given fiscal year, it is estimated that a USD 1 increase in the Brent crude oil prices increases spending by the equivalent of EGP 2.3 bn (about 0.04% of GDP).

Egypt: subsidies & wages

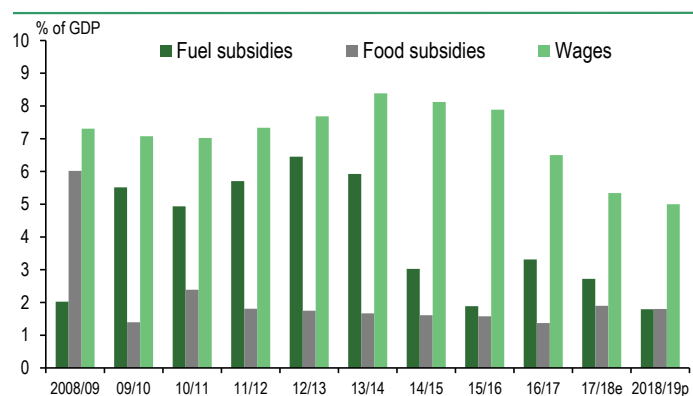


Chart 8 Source: Ministry of Finance, BNP Paribas

Debt service is hard to control

Despite the decline in the primary deficit, the total fiscal deficit will remain high due to swelling interest payment on government debt. As a percentage of GDP, interest payment hit a record high of 9.9% in 2018 and accounted for 54% of total fiscal revenues, by far the highest level among the middle-income emerging market economies. Unsustainable in the medium term, this debt service is notably due to the sharp increase in EGP interest rates after the pound's flotation. Since 2016/2017, the average interest rate on Treasury notes maturing within a year averaged more than 17%, compared to less than 13% in



2015/2016. Debt issues in the international markets have picked up again since 2015 and amounted to USD 20.5 bn. External debt as a share of total government debt rose from 7.4% in 2015/2016 to 21% currently. The average interest rate is 6.9% depending on the maturity. For the moment, the volume of new issues is not high enough to reduce the average interest rate on total government debt.

Egypt: interest rate on 1 year T-bills

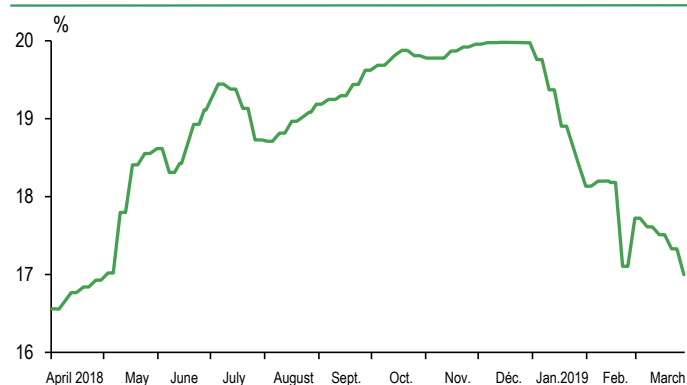


Chart 9

Source: Central Bank of Egypt

Interest rates on domestic debt issues have begun to fall significantly since the beginning of 2019. In the secondary market, interest rates on securities with a maturity of one year have fallen by more than 250 basis points (bp) since the end of 2018 (Chart 9). Falling interest rates will have a small impact on interest payment in the short term, notably due to the very high level of interest rates on issues in the first half of 2018/2019 (which averaged more than 19.5%). All in all, since interest rates are expected to decline very gradually, debt service will remain high in the short term. In the medium term, in contrast, the combination of lower interest rates and longer bond issues on the domestic market⁶ should have a significant impact on debt service. In 2018/2019, we estimate interest payment at the equivalent of 9.3% of GDP and 52% of total fiscal revenues. After levelling off in 2019/2020, it should begin to decline as of 2020/2021, to reach 6.8% of GDP.

Though in decline, the fiscal deficit will remain high. From 9.5% of GDP in 2017/2018, it is expected to narrow to 7.6% in 2018/2019 and 6.3% of GDP in 2019/2020.

High government debt

Cumulative deficits since 2011 have swollen government debt, which rose to 93% of GDP in 2017/2018. With the gradual improvement in the public accounts, the debt ratio should narrow to 87% of GDP in 2020/2021 (Chart 10). Government debt is mostly comprised of local currency instruments with short maturities. At the end of September

⁶ The Finance ministry wants to increase the share of domestic long-term bond issues from 5% to 70% by 2020.

2018, 45% of government debt issued in the local market was comprised of Treasury bills with a maturity of less than a year.

The share of debt denominated in foreign currency was equivalent to about 18% of the total (19% of GDP). About two thirds of the external debt benefited from favourable financing conditions (i.e. concessional loans), and the remainder was comprised of Eurobonds. If we include Treasury bills issued on the local market but denominated in foreign currency, total debt in foreign currency accounted for about 25% of total debt (26% of GDP).

In the medium term, the government's external debt is expected to continue to increase, albeit at a moderate pace. Given the government's commitment to limit Eurobond issues to USD 30 bn by 2022, the government's external debt is likely to reach 21% of GDP in 2020/2021.

Egypt: general government debt

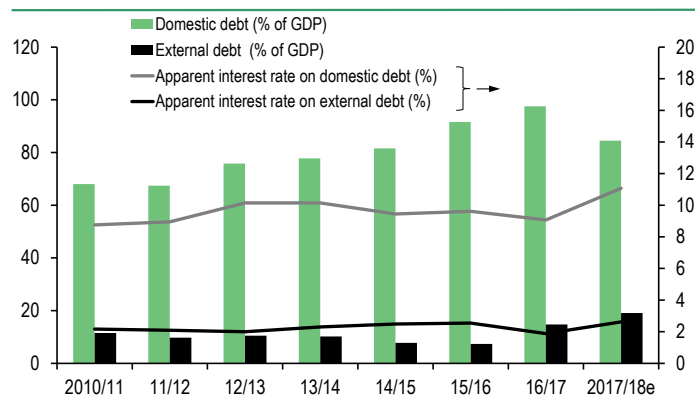


Chart 10

Source: Ministry of Finance, BNP Paribas

No short-term financing risk

After a few temporary difficulties in 2018 caused by an upsurge in risk aversion towards the emerging economies, the financing of the fiscal deficit seems to be assured in the short term.

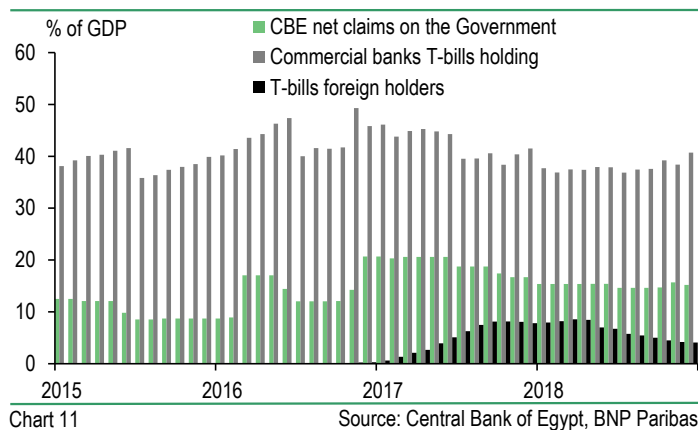
The central bank's holdings of public securities should remain stable, while commercial bank loans to the government should increase by about 15%, in line with the growth of deposits (Chart 11). Non-resident investors returned to the local bond market in January 2019, and this trend is likely to be confirmed in the second half of 2018/2019. Non-resident investors are attracted by the improvement in Egypt's sovereign rating and by the appreciating trend of the Egyptian pound in the short term. Moreover, Eurobond issues will amount to at least USD 6 bn, and the IMF's last pay outs⁷ will total USD 4 bn. There are also other sources of bilateral and multilateral financing. The main risk lies in the volatility of non-resident investors' appetite for Egyptian debt

⁷ USD 2 bn was paid out in February after the conclusion of the fourth review, and another USD 2 bn after the fifth and final review in the first half of 2019.



in the local currency, which depends not only on their appetite to the Egyptian market, but also to the emerging markets in general as an asset class. In case of need, the commercial banks still have abundant excess liquidity, as illustrated by the Central Bank of Egypt's open market operations.

Egypt: government debt holders



Persistent inflationary pressure

After rising sharply on the back of economic reforms, the inflation rate is currently declining. Yet with Egypt's external vulnerability and structural headwinds, inflation will remain high and hard to control.

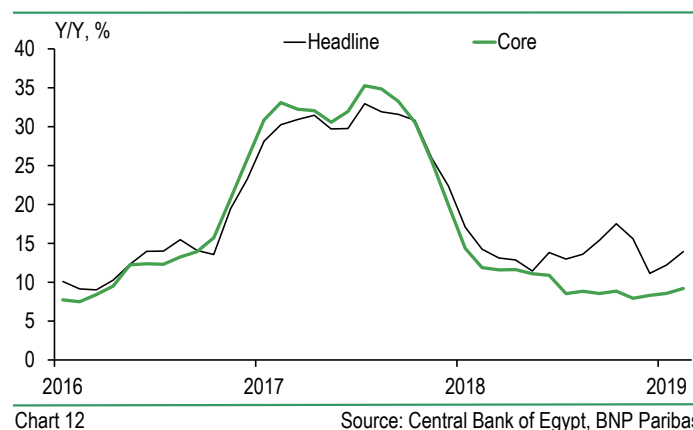
Consumer prices decline gradually

The reforms implemented since the end of 2016 have had a big impact on inflation, which rose sharply in recent years. In addition to structural factors, several short-term factors are also maintaining Egyptian inflation at a high level, including the depreciation of the Egyptian pound, cutbacks in energy subsidies and the upturn in oil prices since 2017.

Yearly average consumer price inflation rose to an all-time high of 30% at year-end 2017. Since then, it has slowed to an average of 21.5% in 2017/2018, from 23.3% the previous year (Chart 12). Since the beginning of 2018, the stabilisation of the Egyptian pound and, to a lesser extent, the end of the monetisation of part of the fiscal deficit, has helped bring down inflation. It is hard to estimate the impact of monetisation of the deficit on inflation. The Central Bank of Egypt has reduced its holdings of public debt instruments (from 25% of M2 money supply in 2016/2017 to 21% in 2017/2018). Since May 2018, the headline and core inflation differential has widened at a time of lower energy subsidies. This points to a favourable trajectory for the core inflation rate, which absorbed the inflationary impact of economic reforms. Food prices are once again a key determinant of rising inflation. Core inflation has held below 10% since the beginning of 2018/2019.

We expect consumer price inflation to average 13.8% in 2018/2019 and 10.7% in 2019/2020. In the medium term, inflation is expected to remain relatively high (average annual rate of 8-10%) due to structural factors, including the rigidities of food supply (transport and marketing), the importance of traditional commerce as opposed to modern retailing, and the vertical integration of certain food producers, which gives them control over retail prices. In the medium term, the Egyptian pound is expected to follow a downward trajectory, a source of imported inflation.

Egypt: CPI inflation



Monetary policy gradually becomes more accommodating

The central bank began easing its monetary policy in 2018. Yet faced with persistently high inflationary pressures, key rates will be lowered very gradually.

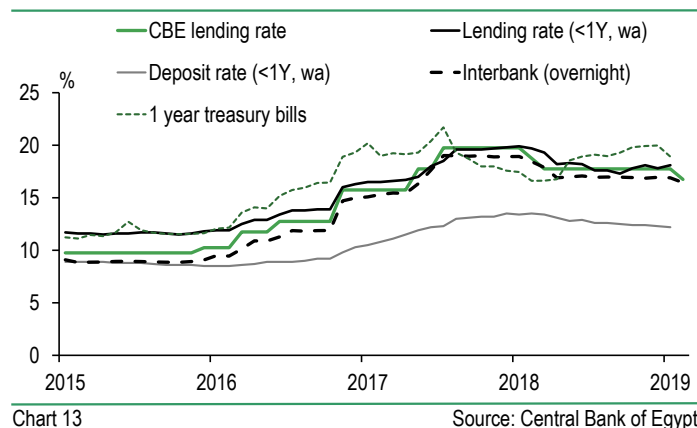
Gradual monetary easing

The central bank is conducting an inflation-targeting monetary policy that aims to bring inflation sustainably below the 10% threshold in the medium term, with a short-term target of 9% (+/-3% by year-end 2020). After the sharp rise in key rates following the pound's flotation, monetary policy was tightened regularly through February 2018 to counter strong inflationary pressures (Chart 13). Higher interest rates curbed private sector investment and drove up interest rates on T-Bills in the local currency. Starting in February 2018, the Central Bank of Egypt began easing financing conditions, with a cumulative 300bp cut in the key rate, to 16.75% at the end of February 2019. The central bank also launched open market operations in the form of deposit facilities for commercial banks, to better control the liquidity in circulation in the country. The amount of these open market operations is still high: the equivalent of 18% of M2 money supply at end-January 2019, down slightly compared to the November figure (23% of M2), but still



significantly higher than before the pound's flotation (less than 10% of M2).

Egypt: interest rates



Currency liberalisation

The central bank does not have an official exchange rate management policy. Since November 2016, the price of EGP is determined by the foreign exchange market, in which the central bank does not intervene. Yet by setting up a repatriation mechanism, the central bank was implicitly able to influence the forex market.

This mechanism, which offers some guarantees to non-resident investors⁸ intervening in the government bond market in the local currency, channelled these investment flows towards the central bank's balance sheet. Despite about USD 10 bn flowing out of the country in 2018 (compared to a maximum of more than USD 20 bn in non-resident portfolio investment stock), the Egyptian pound basically remained stable over the period. The central bank's official foreign reserves also remained stable, while Tier 2 reserves and the net external assets of commercial banks dropped off significantly.

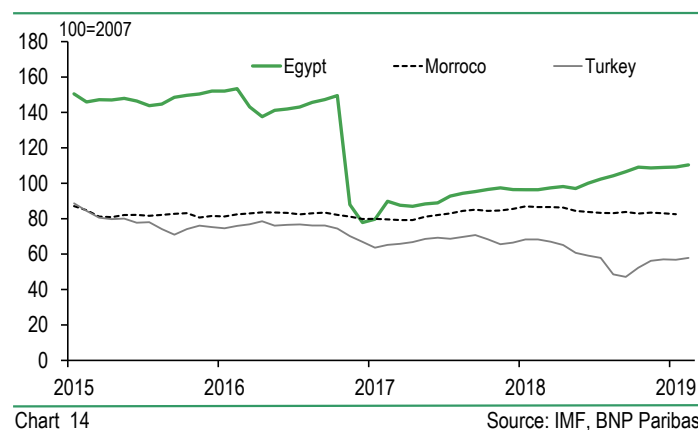
The stabilisation of the exchange rate helped limit imported inflation and reassured foreign investors given the limited possibilities of hedging against currency risk. Both factors were priorities for the economic policy pursued since year-end 2016. At the end of 2018, the central bank halted its repatriation mechanism, and a growing share of foreign currency flows are now fuelling the interbank market in foreign currencies. Given the currently favourable trends in the external accounts, this has resulted in a slight nominal appreciation of the pound. Yet given the depreciation of numerous emerging market currencies since 2017 and Egypt's high inflation rate, the pound's nominal stability

⁸ The availability of foreign currency is guaranteed to foreign investors when they repatriate their funds.

could potentially have a negative impact on the competitiveness of Egyptian exports.

Based on our estimates of the pound's real exchange rate, the country has lost competitiveness against the EUR and the USD. On average (in EUR and USD), the pound's real exchange rate has appreciated by 31% since year-end 2016, while it remained flat in Morocco and depreciated by 32% in Turkey (Chart 14). Even though Egypt is unlikely to become a major merchandise exporting country, certain sectors, notably food and textiles, are very sensitive to price competitiveness. Given this external trade policy challenge, we estimate that the pound appreciation is expected to remain limited.

Real exchange rate against USD



An economic structure unfit for the demographic challenge

Economic growth has been relatively buoyant since 2015, but its capacity to absorb a fast-growing active population is still limited. This is notably due to the social impact of macroeconomic consolidation and the persistence of structural constraints.

Gradual economic recovery

The Egyptian economy entered a recovery phase in 2015, and real GDP growth has averaged 5% over the past three years, compared to an average of 2.6% for the period 2011-2014 (Chart 15). The positive contribution of net exports and the dynamic momentum of infrastructure and energy investment are the driving forces behind this recovery. Private consumption, which accounts for more than 80% of GDP, also made a positive contribution, but it was highly restricted by the impact of economic reforms on household purchasing power (Chart 16).

We expect growth to accelerate in the short term thanks to the steady improvement in household purchasing power as inflation gradually



eases. Investment prospects are still favourable, notably in the energy sector, but on a smaller scale than in recent years (Chart 17). Similarly, infrastructure spending will remain high. In contrast, a significant rebound in investment in non-hydrocarbon manufacturing seems unlikely in the short term. Although high interest rates are hampering a rebound in investment, they are not the biggest constraint.

Egypt: real GDP growth

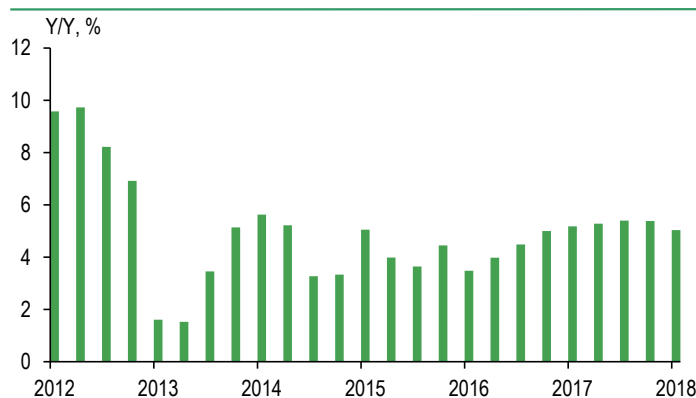


Chart 15

Source: Ministry of Planning, BNP Paribas

Egypt: contributions to real GDP growth (Y/Y, %)

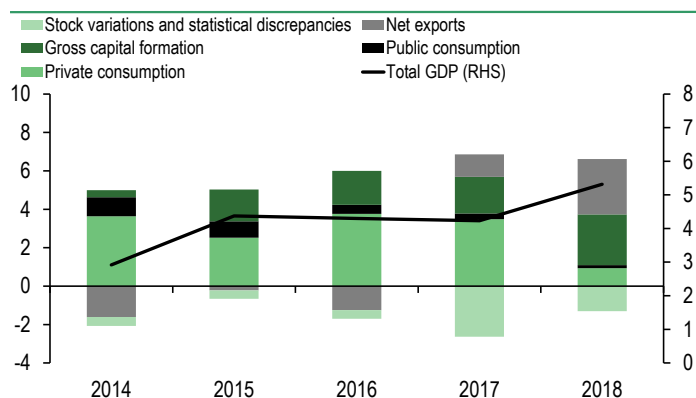


Chart 16

Source: Ministry of Planning, BNP Paribas

Real interest rates reach about 3.5-4%, which is comparable to the levels found in numerous emerging countries. They do not seem to be a major constraint for investment decisions in those countries. Other structural and cyclical factors are curbing investment momentum in the private manufacturing sector. Foreign trade is unlikely to be a growth engine. The increase in hydrocarbon output is a factor that reduces imports, but consumption and investment are highly dependent on imported goods, a trend that is likely to extend into the medium term. Moreover, export momentum is still mild, even though forex trends are rather favourable. Following the sharp depreciation of the pound in the foreign exchange market in 2016/2017, exporters did not significantly adjust their export sales prices in order to win market share. They

preferred to use export gains to offset the decline in margins in the domestic market.

All in all, even in a steadily more buoyant economic environment, growth will not exceed 6% by 2020.

Egypt: implemented investments

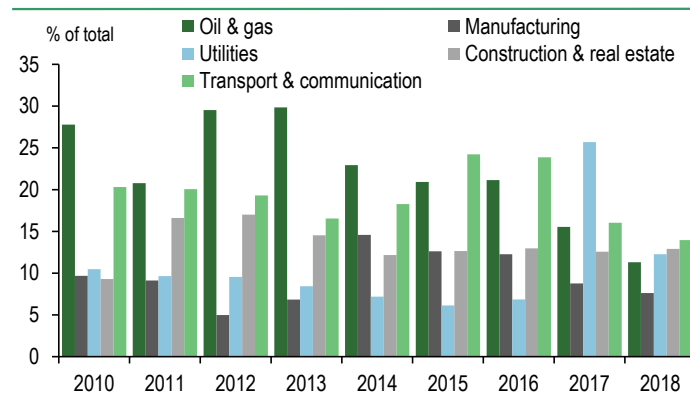


Chart 17

Source: Ministry of Planning, BNP Paribas

Insufficient job creation

Creating sufficient employment is the main challenge facing the Egyptian economy. Based on official figures, the unemployment rate does not really seem to be alarming. It has declined regularly to 8.9% at year-end 2018, from 11.3% the previous year. Yet the employment situation takes on another dimension if we integrate the share of the active population that is underemployed in the informal sector. Current demographic trends make this situation even more difficult.

Egypt has the region's highest population growth rate (about 2.5% a year) with roughly 600,000 new job market entrants each year. In recent years, however, economic growth has not been very job intensive. The main growth engines are in the energy sector, which is not very job rich, and in construction, a source of temporary employment. Companies that invest in the manufacturing sector tend to favour automation, notably in the food and consumer goods sectors. Yet tourism, a job-rich sector, rebounded strongly in 2018, and the government's policy in favour of SMEs could boost the job content of economic growth.

Growth headwinds

Structural factors

A recent study by the Institute of International Finance (IIF)⁹ highlighted Egypt's long-term growth deficit relative to the average for the same category of emerging countries. Over the past thirty years, Egypt's per

⁹ Abed G., Chun J., Markovic B., 2019: *Egypt: good progress to date, but sustainability requires deep, transformational change*, IIF, 20 February 2019.



capita GDP has increased by 50%, compared to a 6-fold increase for the emerging countries as a whole. The government's heavy weight in numerous economic sectors and a very centrally planned economic policy have not favoured the optimum allocation of resources.

Manufacturing value added per capita

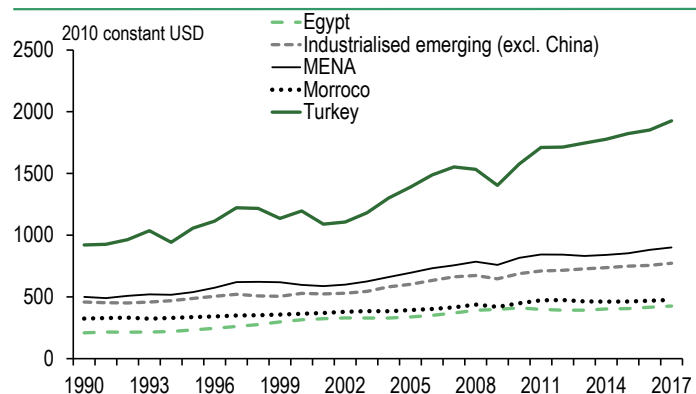


Chart 18

Source: ONUDI

This economic feature is a source of rigidity that favours rent-seeking. There are several obstacles to job-rich economic growth: a shortfall of private productive investment, a low-skilled labour force on average, and insufficient investment in research and development¹⁰. On the whole, Egyptian industry has not advanced much as far as global supply chains are concerned. According to the IIF, over the past 25 years, value added per capita is significantly lower in Egypt compared to the other emerging countries and the regional average (Chart 18).

Recent sector trends are unfavourable

A priori, recent structural changes in the economy do not favour a significant rebound in activity based on productive investment and job creations. The public sector accounts for about 40% of the official economy and a quarter of formal employment. For historical reasons, the public sector plays a very key role in the economy, and recent reforms have not changed this substantially. The public sector, in the broad sense of the term, remains active in numerous sectors, largely exceeding the perimeter of government functions. Access to land also remains tightly controlled. Although the public sector has been a key growth engine driving the economic recovery since 2015, the need to pursue fiscal consolidation reduces its manoeuvring room in the medium term.

The private sector is very heterogeneous. The vast majority of Egyptian companies are small businesses and micro enterprises (97% of the total according to EBRD). They account for 68% of total employment, which is much higher than for the other countries in the region (40% in Jordan and 34% in Turkey). Moreover, large-scale manufacturing companies in

the consumer and capital goods sectors are focused mainly toward the domestic market. This over-representation of small and very small companies tends to curb investment. They are mainly active in the retail sector, which is not very capital intensive and does not require a high skills level.

A large informal sector

The informal sector accounts for between 40% and 50% of the economy. Traditionally, this sector is concentrated in agriculture, retail trade, craft industry and other small industry. Informal businesses require relatively little capital and training. Given the informal sector's economic vulnerability and the heavy dependence of family income on economic activity, producers tend to prefer short returns on investment and to limit high, irreversible fixed capital expenditures.

The deterioration in the broad economic situation of households almost automatically fuels growth by necessity in the informal sector. In a study by the American University of Cairo¹¹ on the motivation of Egyptian entrepreneurs in the formal and informal sectors, the latter are especially driven by the necessity to generate income rather than by the pursuit of economic opportunities. Based on the analysis of a selection of 54 countries, Egypt has the highest proportion of entrepreneurs driven by economic need rather than seeking opportunities. Moreover, this proportion has increased significantly recently. This is due both to fewer job opportunities in the formal sectors (sharp slowdown in public sector hiring and a wait-and-see attitude in the private sector), and to the decline in economic opportunities for entrepreneurs. Ismail *et al* (2019) points out that entrepreneurs driven by necessity tend to develop business in the informal sector with low physical and human capital intensity, and very limited prospects for job creations.

All in all, the recent period of economic uncertainty and reforms eroding disposable household income have favoured the development of economic activities focused towards subsistence, to the detriment of economic opportunities, a source of productive capital accumulation.

A thriving platform economy

Alongside the traditional private/public and formal/informal dichotomies, the platform economy sector has rapidly developed in Egypt over the past few years. The platform economy is based on the formation of networks of individual "entrepreneurs" in a given economic sector, often in the services sector. The urban transport sector has been transformed by a vast, diversified development of the platform economy, ranging from motorized tricycles to bus services. Its development is having a significant impact on employment, although we do not have any precise figures¹² and it is hard to distinguish between net job creations and the

¹⁰ Equivalent to 0.6% of Egypt's GDP, compared to 1.3% in Malaysia and Brazil and 4.3% in South Korea.

¹¹ Ismail A., Tolba A., Barakat S., Meshreki H., 2019: *Global Entrepreneurship Monitor. Egypt national report 2017-2018*, American University of Cairo.

¹² More than 200,000 drivers are now working for the Uber platform.



substitution of informal jobs for employment in the platform economy sector¹³.

The development of a platform economy satisfies two needs: it corrects the shortcomings of Cairo's transport system and provides young graduates an opportunity to enter the job market. In terms of autonomy and flexibility, it is better alternative to the informal sector¹⁴, but it does not provide the labour status or guarantees associated with formal sector employment. Despite its non-negligible impact on employment, the development of a platform economy does not, a priori, generate much productive investment or productivity gains, since it is mainly focused on service activities requiring relatively little capital or skills.

Egypt has entered a new phase in the economic reform process. It is in the process of consolidating its main macroeconomic imbalances: external liquidity has stabilised at an acceptable level, and a fiscal primary surplus should be recorded at the end of the current fiscal year. Short-term prospects are positively oriented. Though narrowing, the imbalances still exist: the hard-to-curb government debt service entails a high fiscal deficit, and the decline in CPI inflation is slower than expected. Moreover the economy is exposed to exogenous factors such as commodity prices and investors' appetite for emerging market risk. Beyond that, the question of job-rich economic growth remains open. Alongside certain very dynamic sectors, notably in new technologies¹⁵, a very large part of the economy is still geared towards rent seeking¹⁶. In recent years, economic policy has been characterised by a blend of old remedies (massive state interventionism) and macroeconomic consolidation. On its own, the later will not suffice to ensure a sustainable, job-rich economic recovery.

Completed on 8 April 2019

pascal.devaux@bnpparibas.com

¹³ In the developed economies, to the contrary, the platform economy can be considered as a shift from formal employment to informal. Van WELSUM D., 2016: *Sharing is caring? Not quite. Some observations about 'the sharing economy'*, World Development Report, World Bank, Background Paper Digital Dividend.

¹⁴ Rizk Nagla, 2017: *A Glimpse into the Sharing Economy: An Analysis of Uber Driver-Partners in Egypt*, (22 February 2017). Available at SSRN: <https://ssrn.com/abstract=2946083>

¹⁵ In 2018, Egypt reported the highest growth in investment in new technology start-ups in the MENA region. The country is the second largest destination for sector investment at the regional level (22%), after the UAE (30%). Magnitt, 2018 MENA Venture, Investment Summary.

¹⁶ Devaux Pascal, March 2015: *Egypt: the need to reform a rent-seeking economy*, Conjoncture, BNP Paribas.



GROUP ECONOMIC RESEARCH

William De Vijlder
Chief Economist

+33 1 55 77 47 31 william.devijlder@bnpparibas.com

ADVANCED ECONOMIES AND STATISTICS

Jean-Luc Proutat

Head – United States, United Kingdom

+33 1 58 16 73 32 jeanluc.proutat@bnpparibas.com

Hélène Baudchon

France – Labour markets

+33 1 58 16 03 63 helene.baudchon@bnpparibas.com

Louis Boisset

European Central Bank watch, Euro area global view, Japan

+33 1 57 43 02 91 louis.boisset@bnpparibas.com

Frédérique Cerisier

Euro area (European governance and public finances), Spain, Portugal

+33 1 43 16 95 52 frederique.cerisier@bnpparibas.com

Catherine Stephan

Nordic countries – World trade – Education, health, social conditions

+33 1 55 77 71 89 catherine.stephan@bnpparibas.com

Raymond Van Der Putten

Germany, Netherlands, Austria, Switzerland – Energy, climate – Long-term projections

+33 1 42 98 53 99 raymond.vanderputten@bnpparibas.com

Tarik Rharrab

Statistics

+33 1 43 16 95 56 tarik.rharrab@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon

Head

+33 1 42 98 56 54 laurent.quignon@bnpparibas.com

Laure Baquero

+ 33 1 43 16 95 50 laure.baquero@bnpparibas.com

Céline Choulet

+33 1 43 16 95 54 celine.choulet@bnpparibas.com

Thomas Humblot

+ 33 1 40 14 30 77 thomas.humblot@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure

Head

+33 1 42 98 79 82 francois.faure@bnpparibas.com

Christine Peltier

Deputy Head – Greater China, Vietnam, other North Asian countries, South Africa

+33 1 42 98 56 27 christine.peltier@bnpparibas.com

Stéphane Alby

Africa (French-speaking countries)

+33 1 42 98 02 04 stephane.alby@bnpparibas.com

Sylvain Bellefontaine

Turkey, Ukraine, Central European countries

+33 1 42 98 26 77 sylvain.bellefontaine@bnpparibas.com

Sara Confalonieri

Africa (Portuguese & English-speaking countries)

+33 1 42 98 43 86 sara.confalonieri@bnpparibas.com

Pascal Devaux

Middle East, Balkan countries

+33 1 43 16 95 51 pascal.devaux@bnpparibas.com

Hélène Drouot

Korea, Thailand, Philippines, Mexico, Andean countries

+33 1 42 98 33 00 helene.drouot@bnpparibas.com

Salim Hammad

Latin America

+33 1 42 98 74 26 salim.hammad@bnpparibas.com

Johanna Melka

India, South Asia, Russia, Kazakhstan, CIS

+33 1 58 16 05 84 johanna.melka@bnpparibas.com

CONTACT MEDIA

Michel Bernardini

+33 1 42 98 05 71 michel.bernardini@bnpparibas.com



BNP PARIBAS

**The bank
for a changing
world**

OUR PUBLICATIONS



CONJUNCTURE

Structural or in news flow, two issues analysed in depth



EMERGING

Analyses and forecasts for a selection of emerging economies



PERSPECTIVES

Analyses and forecasts for the main countries, emerging or developed



ECOFASH

Data releases, major economic events. Our detailed views...



ECOWEEK

Weekly economic news and much more...



ECOTV

In this monthly web TV, our economists make sense of economic news



ECOTV WEEK

What is the main event this week? The answer is in your two minutes of economy

The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. This report does not constitute an offer or solicitation to buy or sell any securities or other investment. It does not constitute investment advice, nor financial research or analysis. Information and opinions contained in the report are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient; they are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. To the fullest extent permitted by law, no BNP Paribas group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report. BNP Paribas SA and its affiliates (collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of any issuer or person mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in any issuer or person mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon. Prices, yields and other similar information included in this report are included for information purposes. Numerous factors will affect market pricing and there is no certainty that transactions could be executed at these prices. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any person mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any person referred to in this report. BNP Paribas may be a party to an agreement with any person relating to the production of this report. BNP Paribas may, to the extent permitted by law, have added upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from or in relation to any person mentioned in this report. Any person mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

BNP Paribas is incorporated in France with limited liability. Registered Office 16 Boulevard des Italiens, 75009 Paris. This report was produced by a BNP Paribas group company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Certain countries within the European Economic Area:

This report has been approved for publication in the United Kingdom by BNP Paribas London Branch. BNP Paribas London Branch is authorised and supervised by the Autorité de Contrôle Prudentiel and authorised and subject to limited regulation by the Financial Services Authority. Details of the extent of our authorisation and regulation by the Financial Services Authority are available from us on request.

This report has been approved for publication in France by BNP Paribas SA. BNP Paribas SA is incorporated in France with Limited Liability and is authorised by the Autorité de Contrôle Prudentiel (ACP) and regulated by the Autorité des Marchés Financiers (AMF). Its head office is 16, boulevard des Italiens 75009 Paris, France.

This report is being distributed in Germany either by BNP Paribas London Branch or by BNP Paribas Niederlassung Frankfurt am Main, a branch of BNP Paribas S.A. whose head office is in Paris, France. BNP Paribas S.A. – Niederlassung Frankfurt am Main, Europa Allee 12, 60327 Frankfurt is authorised and supervised by the Autorité de Contrôle Prudentiel and it is authorised and subject to limited regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority and other principal exchanges. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-U.S. affiliate only when distributed to U.S. persons by BNP Paribas Securities Corp.

Japan: This report is being distributed in Japan by BNP Paribas Securities (Japan) Limited or by a subsidiary or affiliate of BNP Paribas not registered as a financial instruments firm in Japan, to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. BNP Paribas Securities (Japan) Limited is a financial instruments firm registered according to the Financial Instruments and Exchange Law of Japan and a member of the Japan Securities Dealers Association and the Financial Futures Association of Japan. BNP Paribas Securities (Japan) Limited accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited. Some of the foreign securities stated on this report are not disclosed according to the Financial Instruments and Exchange Law of Japan.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is registered as a Licensed Bank under the Banking Ordinance and regulated by the Hong Kong Monetary Authority. BNP Paribas Hong Kong Branch is also a Registered Institution regulated by the Securities and Futures Commission for the conduct of Regulated Activity Types 1, 4 and 6 under the Securities and Futures Ordinance.

Some or all the information reported in this document may already have been published on <https://globalmarkets.bnpparibas.com>

© BNP Paribas (2015). All rights reserved.

YOU WANT TO RECEIVE OUR PUBLICATIONS?

SUBSCRIBE ON OUR WEBSITE
<http://economic-research.bnpparibas.com>

AND

FOLLOW US ON LINKEDIN
<https://www.linkedin.com/showcase/bnp-paribas-economic-research/>
OR TWITTER
https://twitter.com/EtudesEco_BNPP

© BNP Paribas (2015). All rights reserved.
 Prepared by Economic Research – BNP PARIBAS
 Registered Office: 16 boulevard des Italiens – 75009 PARIS
 Tel: +33 (0) 1.42.98.12.34 – www.group.bnpparibas.com
 Publisher: Jean Lemierre. Editor: William De Vijlder



BNP PARIBAS

The bank
for a changing
world