Egypt: impressive economic transition with strings attached

Pascal Devaux

Egypt is implementing an ambitious programme of economic reforms. Macroeconomic imbalances are being reduced thanks to the pound flotation and some progress in fiscal reforms. Nevertheless, households' purchasing power is affected by a sharp rise in consumer prices, and the hike in interest rates is a threat for public finances.

After five years of sluggish growth and swelling fiscal and external deficits, the Egyptian economy has undergone major changes over the past two years. Three factors have helped the economy return to brighter prospects. First, the decision to float the Egyptian pound lifted a major constraint on activity and foreign-currency liquidity, which had fallen to alarmingly low levels. Second, major fiscal reforms were implemented with the support of international donor funds, checking the deterioration in public finances. Third, the accelerated development of natural gas resources is expected to trigger a significant reduction in the trade deficit and ensure the country's energy supply. Yet these economic adjustments have been very costly, both for the local population, due to record-high price increases, and for debtors – and above all the state – due to higher interest rates. Although reforms have created positive momentum for correcting macroeconomic imbalances, the size of the adjustments could become a source of greater vulnerability.

Floating the pound: a successful reform

In November 2016, the decision to float the Egyptian pound ended several months of tensions in the currency markets, which had fostered numerous restrictions on trade (blocking imports) and financial transactions (restricting international bank transactions), and encouraged the development of a parallel currency market. The floating of the Egyptian pound (which has depreciated by 50%) coincided with a significant increase in domestic interest rates and a 3-year USD 5.4 billion loan from the International Monetary Fund (IMF).

Net improvement in the banking system's foreign-currency liquidity

Floating the pound, international financial support, and the acceleration of public finance reforms restored confidence in the country's economic policy and triggered a massive inflow of foreign currency into the banking system. These included currency transfers previously outside of the official banking system, and foreign capital inflows. Resident capital flows were estimated at more than USD 20 bn in the eight months since the pound was floated.

Exchange rate: EGP/USD

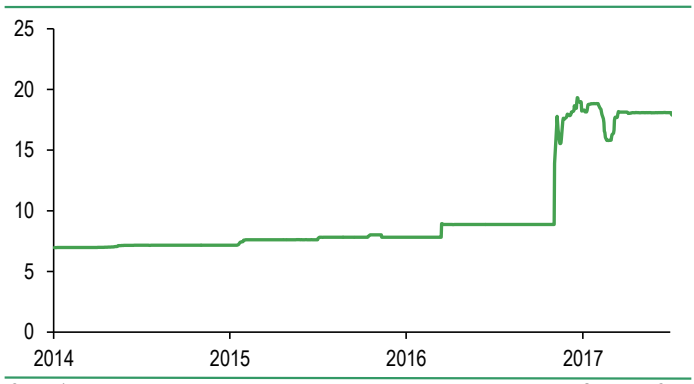


Chart 1 Source : CBE

International capital flows

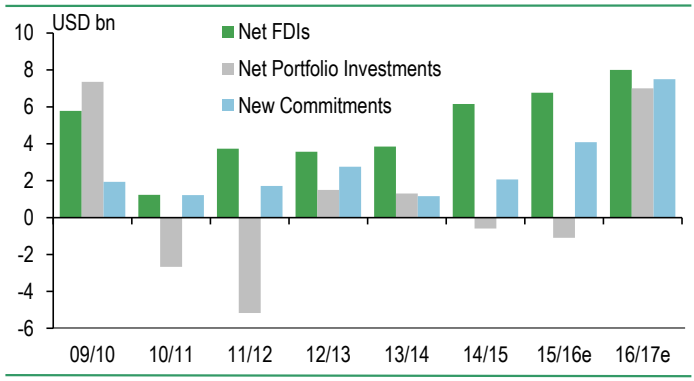


Chart 2 Sources: CBE, IMF, BNP Paribas

Non-resident capital inflows were also substantial, estimated at about USD 27 bn over the same period. In addition to the IMF's USD 2.7 bn pay out as part of its Extended Fund Facility, there was also about USD 3 bn in support from other multilateral donor funds (World Bank), and USD 7 bn from two government bond issues on international markets. Moreover, high yields on government bonds and renewed

confidence in the currency market attracted about USD 10 bn in portfolio investment.

A little under USD 1 bn was invested in the Cairo stock exchange. Lastly, remittances have been sustained (USD 4.5-5 bn per quarter). All in all, about USD 57 bn has flowed into the Egyptian banking system since the decision to float the pound (equivalent to about 35% of M2 money supply at March 2017). A direct consequence of this inflow of foreign currencies was a significant improvement in the Central Bank of Egypt's foreign reserves. At the end of June 2017[1], CBE foreign reserves amounted to USD 31.3 bn, equivalent to 5.7 months of goods and services imports, compared to the alarming level of USD 15.5 bn, or only 2.9 months of imports, 11 months earlier.

CBE Forex reserves

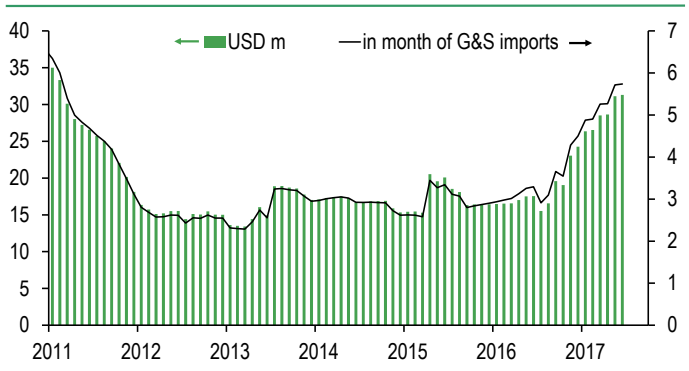


Chart 3 Sources: CBE, BNP Paribas

Reduction in external imbalances

More significantly, the net external debt of the entire banking system (CBE and commercial banks) narrowed sharply. Faced with a persistently high current account deficit and insufficient capital inflows, the banking system had to take on debt to cover part of the Egyptian market's hard currency needs. At the end of October 2016, the CBE's net external debt (comprised notably of deposits from the Gulf countries) hit a record high of more than USD 6.7 bn. In December 2016, the net external debt of banks reached a similar amount. By May 2017, the net external position of the CBE and the commercial banks had swung back into positive territory, at about USD 2.3 bn and USD 0.9 bn, respectively.

Once foreign currency liquidity had returned to much more comfortable levels, the restrictions on currency transactions were gradually lifted. Moreover, with the rebuilding of the CBE's foreign reserves, the national oil company EGPC is in the process of repaying its arrears to international energy companies, which have been reduced to USD 2.3 bn from about USD 3.5 bn at year-end 2016 (national estimates).

Despite higher oil prices in H2 2016, the current account balance improved. Yet this improvement is mainly due to a surge in private transfers, due notably to the renewed confidence of non-resident Egyptians in the domestic currency market. These flows are expected to return to normal in the short term. For the moment, the pound's depreciation has not had a notable impact on the trade balance. Although imports are declining due to higher costs, exports have not yet benefited from the improved competitiveness of the exchange rate.

Banking system net foreign assets

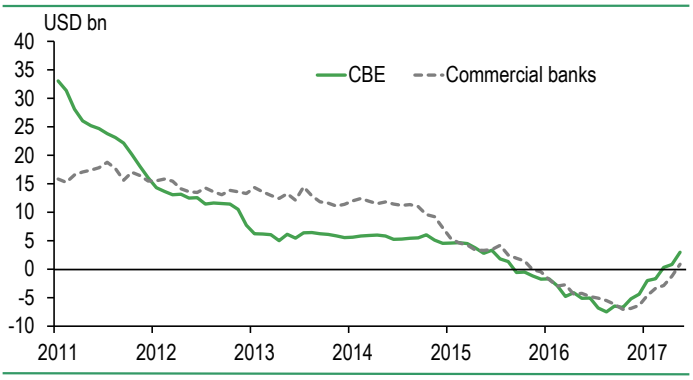


Chart 4 Sources: CBE, BNP Paribas

Claims on private sector as % of deposits

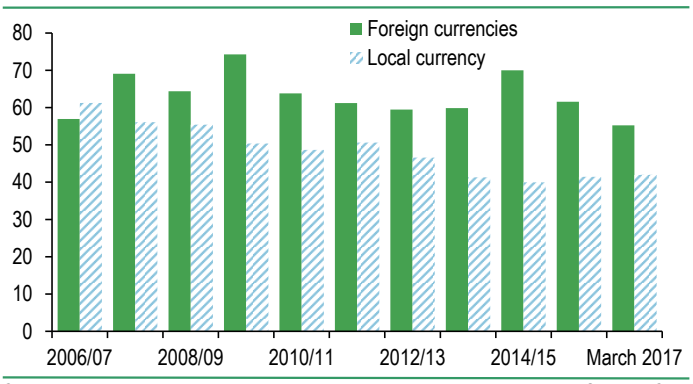


Chart 5 Source: CBE

Improvement in public finances remains constrained

Fiscal reform acceleration

Since 2011/12, public finances have deteriorated sharply. The fiscal deficit has swollen to an average of 12% of GDP over the period 2011/12-2015/16, compared to a 7.7% average during the five previous years. This deterioration is mainly due to the hard-to-curb and high current expenditures. In 2015/16, the public sector wage bill and subsidies (energy and food) amounted to 28% of fiscal revenues each,

[1] Fiscal year ends in June

while debt service also absorbed about 30% of revenues. Significant efforts have been made to clean up public finances since 2015/16. In keeping with the IMF support programme, these efforts were accelerated in 2016/17.

External accounts

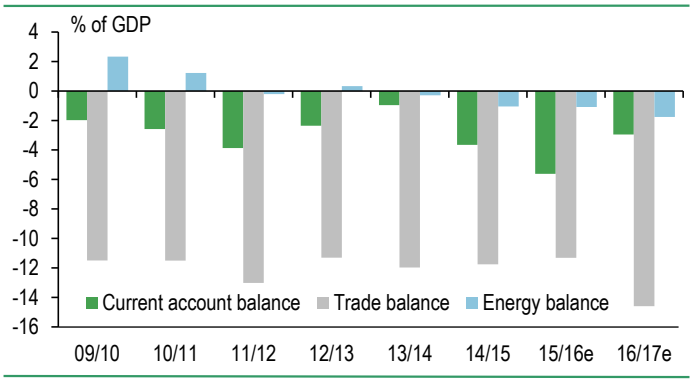


Chart 6 Sources: CBE, BNP Paribas

The main measures include the introduction of a value-added tax, currently at 14% (which replaces the previous 10% tax on goods), and cut in energy subsidies. Although these measures should help reduce the fiscal deficit in the medium term, their impact on the budget is limited for the moment. The currency effect combined with higher oil prices in international markets has increased the energy bill, doubling the amount of energy subsidies relative to the initial budget proposal. The amount of subsidies will continue to be extremely vulnerable to external factors, given the spread between consumer energy prices and market prices (currently estimated at 65%). Moreover, the need to increase social measures to offset the impact of higher prices is another factor driving up public spending. In terms of revenues, however, the introduction of VAT as of Q2 2016/17 helped boost fiscal inflows, which increased by about 30%. The increase in the total wage bill remained mild (+4%). The primary fiscal deficit has improved significantly in 2016/17. We estimate that narrowed by the equivalent of 1 point of GDP to 2.7% of GDP.

The primary deficit is shrinking

In fiscal year 2017/18, the government expects these trends to continue: higher fiscal revenues, a mild increase in the total wage bill and an increase in social expenditures and subsidies, due in part to the increase in some social transfers. The decline in energy subsidies, which took effect in early July for fuel (prices rose by about 40%) should continue with the rise in electricity prices. These measures should help reduce the primary deficit, which we estimate at 1.3% of GDP in fiscal year 2017/18. However, the government's target of reducing the total deficit below 10% of GDP seems to be optimistic. Debt service is expected to rise sharply, which would call this target into question.

Debt servicing is hard to control, increasing the vulnerability of public finances

The very high cost of servicing public debt is a major reason for the increase in fiscal deficits. As a percentage of fiscal spending, debt service reached nearly 50% in 2015/16. The deficit is essentially financed on the domestic market, with high interest rates and short maturities. Since November 2016, despite the growing use of international financing in foreign currencies to contain the cost of financing, the sharp rise in domestic interest rates should drive up the apparent interest rate on the public debt.

Fiscal balance

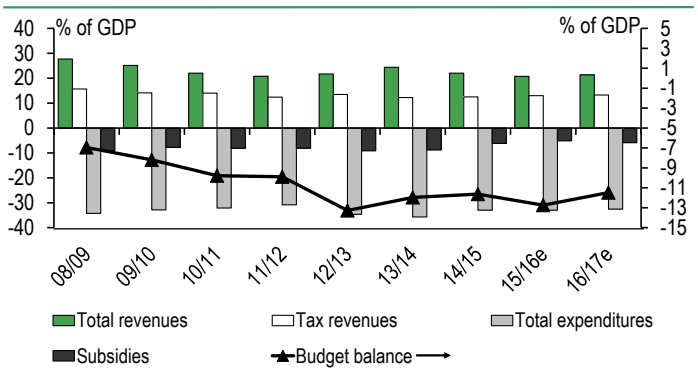


Chart 7 Sources: MoF, IMF, BNP Paribas

General government debt

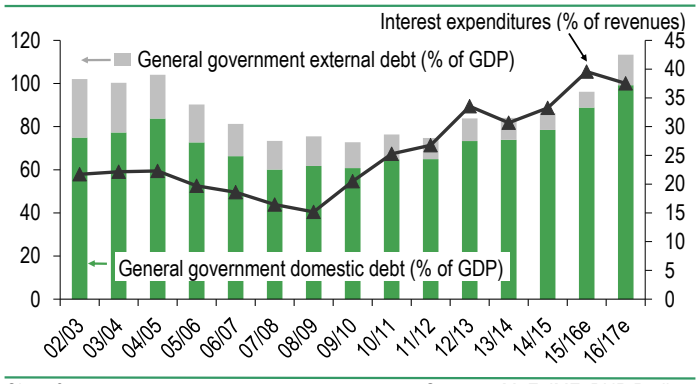


Chart 8 Sources: MoF, IMF, BNP Paribas

Since September 2016, the CBE's key rate has increased by 885 basis points (bp) to 19.25%. Interest rates were raised for two reasons: to combat inflationary pressures, and above all, to continue improving foreign currency liquidity in the banking system, by attracting currency still outside of the official banking system into bank deposits offering higher remuneration.

The latest 200 bp key rate increase, which caught numerous analysts by surprise, is only a temporary measure according to the CBE. Yet such a steep increase in the cost of debt threatens the goal of fiscal consolidation. Even though the CBE's key rate increase is not carried over in full to the yield on government securities, it sharply increases the cost of domestic debt for the government.

As a result, the interest rate on 3-month treasury bonds has increased from 15% in October 2016 to 22.5% during the latest auction on 9 July. Given that the government is expected to resort less to international financing this year (about USD 4-5 bn), a 200 bp interest rate hike increases the government's interest charge over a full year by about EGP 40 bn (1% of expected GDP in 2017/18). However, the net cost of interest rate hike for public finance will be lower. We have to take into account the various maturities of the debt portfolio and the fiscal income provided by the activity on the debt market. In 2015/16, the tax on T-bills and bonds' payable interest yielded EGP 23 bn.

Under these conditions, it will be difficult for the government to meet its target of reducing the fiscal deficit below 10% of GDP. We are forecasting a slight decline in the deficit, to 10.2% of GDP in FY 2017/18.

5Y Sovereign CDS

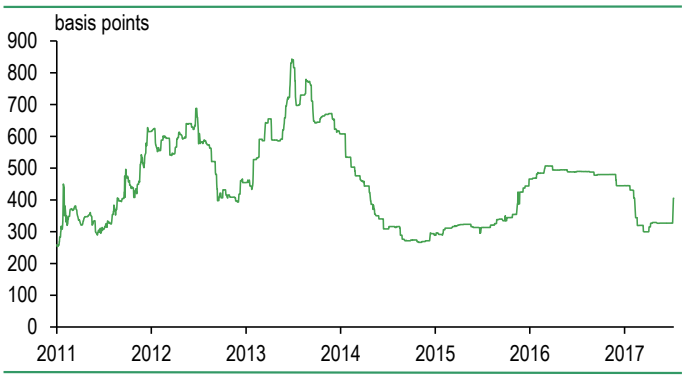


Chart 9 Source: Thomson Reuters

Interest rates

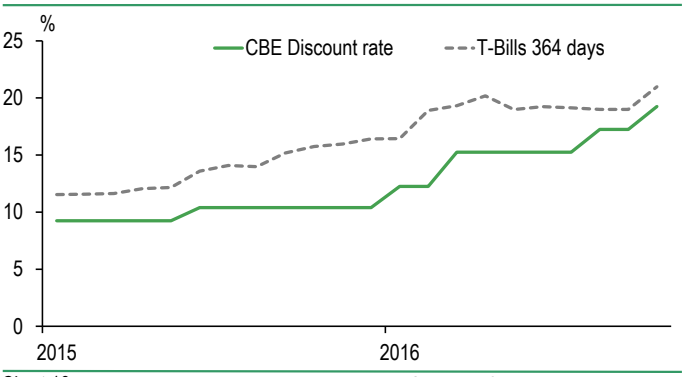


Chart 10 Sources: CBE, MoF, BNP Paribas

Public debt is expected to level off

Government debt has swollen to a high level (97% of GDP in 2015/16 according to the IMF). The majority is comprised of bonds issued on the domestic market with rather short maturities. The IMF loan and two bond issues in 2017 (USD 7 bn) have helped increase the percentage denominated in foreign currency, which currently accounts for about 15% of total debt. In fiscal year 2017/18, given the expected sharp increase in nominal GDP, we forecast debt to reach 94% of GDP, after peaking at an estimated 113% of GDP in 2016/17. The privatisation of some state-owned companies could further reduce the country's debt. The state-owned company Enppi is expected to float part of its capital in the short term. The government expects to raise USD 150 m, which would only have a marginal impact on public debt.

The energy sector outlook has markedly improved

The energy sector is crucial for macroeconomic stability. It contributes to fiscal and external balances and is a factor driving economic activity.

Some difficult times

Egypt's energy sector boomed in the early 2000s, driven by strong domestic demand and Liquefied Natural Gas (LNG) exports. Gas production increased more than three-fold to 6bcf/d between 1999 and 2009. Since 2010, however, sharp macroeconomic deterioration and structural natural resource trends have pushed the sector into difficulties. The first hit was the decline in offshore Mediterranean gas production as a result of reservoir maturity and stalled investments. The production of four of Egypt's major offshore gas fields started to decline in 2012 as they had been discovered and developed at the same time in the mid-1990s. The second hit was the accumulation of Egyptian General Petroleum Corporation (EGPC) arrears to upstream investors peaking at USD 6.3 bn in 2012 (2% of GDP) as a result of mounting fiscal deficits and deteriorating external liquidity during the political transition. The third hit came from the decline in crude prices in 2014-15, thereby discouraging foreign investment especially in high-risk deepwater exploration.

Egypt became a net gas importer in FY 2015/16 with a hydrocarbon external deficit of USD 3.6bn compared with a surplus of USD 5.1 bn in FY 2009/10. During that period, the current account deficit was largely driven more by the negative hydrocarbon balance than by the decline in tourism. Real economic activity was also impacted as households and energy-intensive industries suffered from occasional fuel and power shortages.

Energy balance

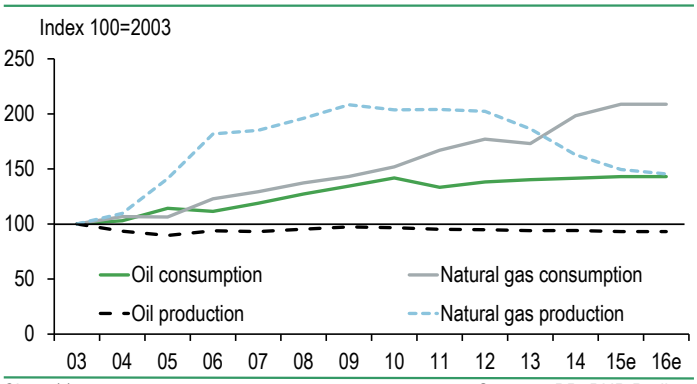


Chart 11 Sources: BP, BNP Paribas

Major East-Med discoveries

In the short term, the government secured concessional fuel supply agreements with GCC sovereigns and launched LNG imports fulfilling around 25% of domestic demand. In the medium term, the government repriced gas offtake from new blocks by 40-120% and upwards to incentivise production and auctioned large exploration acreage at competitive terms to accelerate reserve replacement. On the financial side, the government allowed some onshore producers to increase exports in order to decelerate the build-up of arrears. That, combined with a series of material payments to targeted E&P operators, has indeed halved EGPC arrears to USD 3.5 bn (Dec 2016). However, outstanding receivables continue to be a major constraint for new E&P investments primarily in gassy portfolios.

The turning point was the discovery of the Zohr jumbo gasfield (Eni) in August 2015. This gasfield, with its recoverable reserves of 22tcf, has not only replenished Egypt's total gas resources by one third, but has also been fast-tracked to start production in H2 2017. Egypt is currently replenishing most of its gas production with new discoveries and is likely to achieve self-sufficiency by 2019. These new discoveries are comprised of two large offshore projects, Zohr and West Nile Delta (BP), in addition to the smaller Noroos (Eni) and Atoll (BP) fields that should jointly produce around 5bcf/d at plateau representing 1.1x Egypt's current total gas production.

More investments are needed

The first and foremost constraint is large domestic demand that caps the gas surplus available for export. The prime consumer of gas is electricity generation, which burns 60-65% of Egypt's gas output. Gas consumption is dependent on both structural trends in demand and availability of energy for end-users. While gas consumption markedly rose during the first half of the 2000s (+12% CAGR in 2000-05), it has been almost stable since 2011 given shortages (+1% CAGR in 2011-15). The key factor driving electricity consumption is population growth because two-thirds of power output is consumed by residential and commercial customers. Population growth (+2.2% annual average in 2000-15) is one of the highest in the MENA region, a trend that is likely to last beyond the medium term due to Egypt's youth boom (one-third of total population is under 14). Another source of gas demand is gas-intensive industry (steel, fertilizers), which is expected to return to full utilisation in step with the economic recovery. Here, Egypt has to choose between exporting surplus gas in either LNG in order to accumulate fx reserves or industrial forms in a way that maximises factors of economic development such as employment and industrial integration.

Pursuant to demand management, Egypt is challenged to manage gas supply. Some producing legacy gasfields suffer from high rates of decline in production (12% annual average). While the four key offshore discoveries are being fast-tracked, they have varying production plateaus ranging from 11-18 years (Atoll, Zohr) to much shorter 3-5 years (Noroos, West Nile Delta). Replacing declining offshore production necessitates further exploration investments to proactively sustain Western Desert production that should start naturally declining in 2-3 years, albeit at smoother rate.

Under the conservative assumption that gas consumption will grow by 4% per annum on average in the medium term and a production to peak in 2021 and decline afterwards, Egypt's capacity to export gas may not last beyond 2022. Even if such production forecasts are considered conservative, we believe that Egypt can sustain gas exportation only if further discoveries are made and subsequently developed. That is partly achievable if EGPC arrears are repaid on a regular basis to provide the needed certainty for private E&P investments.

CPI inflation is very high

CPI inflation is structurally high. Average inflation reached 10% on average during 2005-15. This is mainly due to several constraints on supply chains, to vulnerability to commodity prices (Egypt is the first world wheat importer) and exchange rate.

Exchange rate movements are crucial

There is significant exchange rate pass-through to inflation. Analysis of the period from 2003 to 2015 by faculty members of Cairo University and the CBE[2] showed that relatively little of this happens through a direct effect on the price of imported goods; more significant transmission occurs through an indirect effect via the increase in the prices of semi-finished goods and commodities, which feeds through into production prices and then consumer prices. This mechanism is particularly due to the existence of few sizeable domestic manufacturers across consumer goods segments. According to the authors, this transmission is not immediate, and persists over a two-year period. Moreover, the level of transmission is considered as incomplete, due to the existence of numerous goods for which prices are controlled.

[2] Omneia Helmy, Mona Fayed, Kholoud Hussein, 2017, *Exchange rate Pass-through to Inflation in Egypt: A Structural VAR Approach*, 37th Annual meeting of the Middle East Economic Association.

From November 2016, the increase in consumer prices has been incremental rather than immediate, but it has been substantial. The scale of the EGP depreciation is clearly a decisive factor. After the pound was allowed to float in 2003, its depreciation relative to the USD was fairly modest (13% after one year, and 25% after twenty months), whereas it immediately fell 50% following the decision to let it float in November 2016.

In addition, the level of transmission has varied since 2003 due to more structural factors. The share of imports in GDP is currently much higher at 21% compared to 14% in 2003 in real terms. We can also assume that over the medium term this figure will be higher, given the tight restrictions on the availability of foreign currencies that hampered importers over the quarters preceding the EGP liberalisation in November 2016.

Another factor affecting the degree of transmission is the reaction of companies to the currency depreciation. Schematically, faced with higher import costs they need to choose between maintaining their margins or their market share. One determiner of this choice can be the scale of any depreciation. A modest change would be easier to absorb in terms of costs, and the depreciation in March 2016, of around 13%, did not result in a significant rise in inflation. After the depreciation in November 2016, on top of the increase in prices for imported factors of production, most private corporates in the formal sector raised wages (by 10-20%), making an increase in selling prices necessary. Another more structural factor influencing inflation relates to market organisation, and specifically the level of competition in the consumer goods sector.

Contributions to CPI inflation

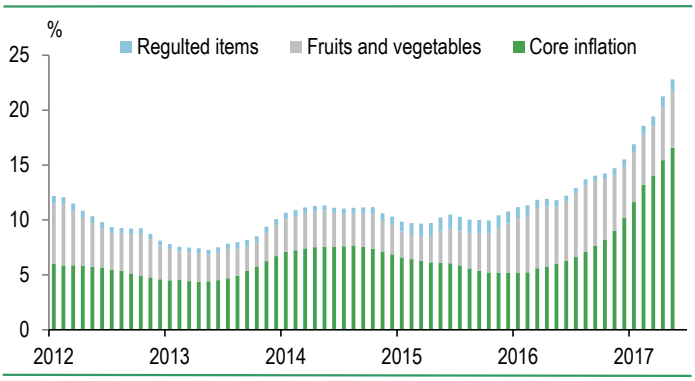


Chart 12 Sources: CBE, BNP Paribas

Limited competition in the consumer retail market

We believe that limited competition in the consumer goods market, and specifically food retail, is a major driver of inflation. Food is a crucial item as it represents circa 34% of average household expenditure as well as 31% of the inflation basket (excluding seasonally-fluctuating fruits and vegetables). It appears that control over distribution channels (up to and including a certain level of integration) is a key determining factor for producers in setting their pricing strategies. Companies may have direct control over part of their distribution channels and/or be mainly distributing through traditional circuits (local shops) in which they have higher control over selling prices. The modern retail sector (e.g. super- and hypermarkets) is expanding rapidly as demonstrated by recent entry of major regional supermarkets to Egypt [3]. However producers tend to favour traditional distribution channels. Their products are present in supermarkets, but there is a real desire to limit the share that this represents, in order to protect pricing power. This strategy is made possible due to relatively low competition in the domestic market. According to the latest World Economic Forum report on global competitiveness, Egypt ranks 112th (out of 138) in terms of the efficiency of the market for goods and 127th on the "intensity of domestic competition" sub-component. In a certain number of markets for consumer goods, particularly food, local producers hold the bulk of market share and the role of multinationals remains fairly marginal. Following the EGP depreciation there is anecdotal evidence that some price hikes in certain consumer good categories may have gone beyond covering the rising cost of intermediate imported goods allowing producers to make up lost ground after several years of relative price stability. Limited competition in the consumer retail market may also explain the persistence of high inflation over a long period, even when production capacity is not fully utilised. The expansion of modern supermarkets in Egypt may therefore promote competition and relieve inflation, but also threaten producer margins.

Trends in fiscal policy

In H2 2016, the reduction in energy subsidies was another important factor of consumer inflation. Petrol prices were more than 100% higher than in 2014, whilst increases in electricity prices ranged from 29% to 124% depending on the consumption tier. The monetisation of the budget deficit, by expanding the money supply, may be inflationary, but this factor does not appear decisive. This monetisation [4] was fairly substantial in 2015 but was reduced in 2016. In more general terms, we are not seeing an uncontrolled expansion of money supply. The M2 aggregate as a percentage of GDP rose only slightly – from 76% to 80% – between late 2014 and March 2017.

In the short term, consumer price inflation is likely to remain elevated. CPI inflation reached 23.7% in FY2016/17 and almost 25% is expected in FY2017/18. Further subsidy cuts, the persistence of imported inflation and a possible upturn in domestic demand are all likely to continue driving inflation. Higher energy and farm product prices on international markets should also be considered, although oil price recovery is likely to be subdued in the medium term. The resources available to the government and the CBE to tackle inflation are currently limited. The effectiveness of the interest rate lever is limited by the low adult bankability ratio (less than 15%), whilst, up to now, the CBE's exchange rate policy focuses on building up forex reserves in order to protect against possible tensions. The recent EGP appreciation could signal a change in this policy.

[3] In 2013-2016, leading MENA supermarket groups entered Egypt such as Lulu, Panda, Al Othaim and BIM in addition to the expansion of existing foreign players such as Carrefour and Spinney's.

[4] CBE gross claims on the government reached 70% of GDP in 2015/16 against 52% in 2012/13. They currently reach 66% of GDP

Recovery to be confirmed

Investment and exports fuel growth

In a restrictive fiscal environment, economic activity in the second half of fiscal year 2016/17 was driven by the positive dynamics created by economic reforms. According to the government, real GDP growth is expected to reach about 4% in 2016/17, compared to the previous year's performance of 4.3%. One growth engine was investment, bolstered notably by foreign investment in the energy sector, and by a very buoyant construction sector. Private consumption, the main growth engine, remained rather resilient, even though it was curbed by high inflation.

This momentum is expected to be confirmed in the short term, albeit without fuelling a real acceleration in activity. Although the impact of inflation on the disposable income of low income households can be partially offset by social welfare transfers, it severely erodes the purchasing power of the middle class. This category of the population is a big spender on imported consumer goods (such as cars), but also on education and healthcare services in the private sector, the costs of which are rising rapidly. This means they will have to hedge their purchases, which could end up having a negative impact on the overall level of consumption.

As to investment, sharply higher interest rates will scale back the investment decisions of national companies, at least in the short term. For the moment, the increase in foreign direct investment is still concentrated in the energy sector. Excluding the energy sector, non-resident investment decisions are generally made by companies that are already present in the Egyptian market, and many foreign companies are taking a wait-and-see approach. An increase in public investment, which is one of the government's priorities, could provide additional support. Investment expenditure accounts for only about 10% of total fiscal spending, or 3.5% of GDP. Lastly, the net export contribution could provide non-negligible support for activity in 2017/18. Non-oil sector exports should regain competitiveness, but above all, imports are likely to contract for three reasons: 1) the unfavourable currency effect, 2) government restrictions on importers, and 3) the start-up of production at natural gas fields, which should reduce hydrocarbon imports. All in all, we expect growth to accelerate to more than 5% in the medium term.

Mixed medium-term prospects

Yet, looking beyond short-term trends and the rebound in growth since 2011, there are reasons to doubt the Egyptian economy's capacity to reach sustainable growth strong enough to create sufficient jobs and to reduce the role of the informal sector. According to the International Institute of Finance (IIF)[5], Egypt's potential growth rate has been declining for the past ten years, to 3.5% presently, from 4.4% over the period 2007-10. This decline can be attributed to both the slowdown in investment (even though it has picked up as a share of GDP since 2014) and the significant decline in total factor productivity. Reforms to the business climate are currently underway, including a new investment law, and major capital expenditures have been made, notably in infrastructure and energy production. Even so, some key factors for boosting productivity, such as improving employability through spending on education, seem to be missing, at least for the moment, from the economic reform programme.

Contributions to real GDP growth

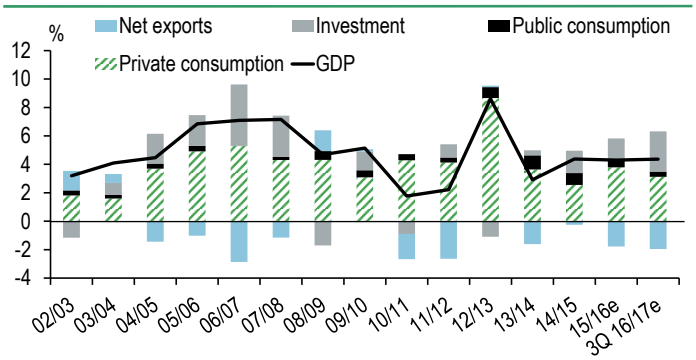


Chart 13 Sources: Ministry of Planning, BNP Paribas

What are the main vulnerabilities?

The year 2017 is a transition year for the Egyptian economy. Through major economic reforms, the authorities are aiming to foster a sustained recovery in a stabilised macroeconomic environment. Three factors threaten this scenario: persistent political risks, the difficult coordination of economic policy, and international market fluctuations.

Political tensions

Egypt, like the Middle East region as a whole, is plagued by political tensions. The tourism sector has virtually collapsed since 2011. The number of tourists has plunged from 15 million a year in 2010 to 5.4 million in 2016. We can see a timid recovery in this sector (+11% at an annualised rate in Q3 2016/17), thanks notably to the reopening of certain air routes. Some routes have not reopened yet (Russia, for example), and the development of new tourism business (China) is a very gradual process.

For the moment, the political crisis between the Gulf States (Egypt is a partner in the coalition behind the Qatar embargo) is having only a limited impact on the Egyptian economy. Yet the crisis represents a potential economic risk given Egypt's strong presence in Qatar (about 250,000 Egyptians work in Qatar, mainly in skilled jobs). Tighter sanctions could trigger retaliation from Qatar. Yet the relative dependence of the two economies limits such an outcome: Qatar is present in certain key sectors of the Egyptian economy (industry,

[5] G. Iradian, Y. Yakhshilikov, B. Markovic, 2017, Egypt research note. "Major adjustment is underway", IIF.

banking), and needs Egypt's skilled workforce to keep parts of its economy running smoothly.

The right balance for economic policy is difficult to find

Over the course of fiscal year 2017/18, it will be no easy task to coordinate short-term monetary policy goals (boosting bank liquidity and reducing inflation) with medium-term fiscal reforms. The fiscal situation is still fragile, and a sharp increase in CBE interest rates could have a very negative impact on debt service, and in turn on the dynamics of consolidating public finances in the medium term. For the moment, foreign investors are attracted by higher yields on government securities. But 2018 is an election year, which tends to encourage the easing of fiscal consolidation, as can be seen in numerous countries under similar circumstances. It will be important to monitor the duration of monetary tightening, which a priori should be only temporary.

Tourism activity

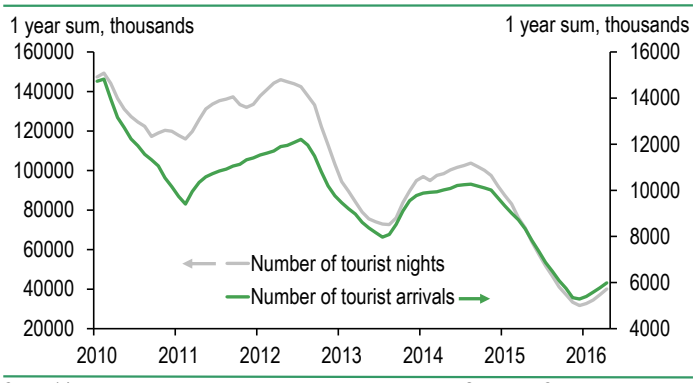


Chart 14 Sources: CBE, BNP Paribas

Vulnerability to international markets is changing

Egypt's vulnerability to fluctuations in global hydrocarbon prices has ebbed due to the big increase in natural gas production and investments in electrical power generation, which has improved its energy efficiency. Moreover, the reduction in energy subsidies, with the goal of recovering costs in the medium term, will reduce the vulnerability of public finances to oil price fluctuations.

Yet, floating the pound and raising interest rates expose external accounts to the volatility of international capital flows. Currently, Egypt is the second most attractive country for carry trade operations, after Argentina. These flows could become more volatile if the pound continues to appreciate in the quarters ahead, or if interest rates begin to decline.

Conclusion

Faced with an increasingly alarming macroeconomic situation, the Egyptian authorities have opted to launch massive, rapid reforms with the support of the international financial community. The first goals have been met: to restore the country's foreign-currency liquidity and reverse the deterioration of public finances. Yet other imbalances have emerged: in an economy with a low level of bank penetration, the massive increase in interest rates did not bring down inflation, but increased the cost of servicing the public debt.

During this transition year, there is a risk that too many incompatible reforms will be launched all at once. The key is to strike the right balance between monetary policy goals and fiscal reform targets. For the Egyptian economy, the way out of this delicate situation is to return to sustainable, diversified growth. This can only be achieved through the combination of strong household consumption and accelerated productive investment.

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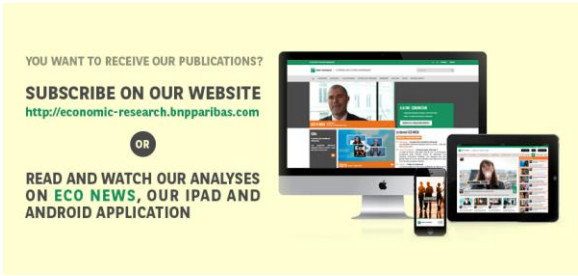
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