EGYPT

LOOKING FOR A BALANCED MONETARY POLICY

The Egyptian economy has performed pretty well in the face of the pandemic. Activity has been bolstered by major public investment projects, whilst inflation has fallen well below the central bank's target. The fiscal and current account deficits are likely to increase, but international support and access to capital markets at favourable conditions have contributed to a macroeconomic stabilisation. The continuation of a high policy rate at the central bank has helped keep the Egyptian market attractive to international investors. Thanks to injections of liquidity, lending remains strong, although this increases the exposure of banks to sovereign debt and credit risk in an increasingly uncertain environment.

ACTIVITY BOLSTERED BY PUBLIC SECTOR INVESTMENT

Economic activity remained strong during the 2020 fiscal year, despite lockdown measures. GDP grew by 3.5% in real terms. This was significantly slower than the 5.6% posted in 2019, but ahead of most analysts' estimates. In reality only the final quarter of the fiscal year (Q2 2020) was affected by public health restrictions. Over the first three quarters GDP grew by an average of 5% year-on-year. Construction activity was only marginally affected by restrictions on travel, and public infrastructure projects (transport, new cities) continued pretty much as normal. Lastly, strong demographic growth (at more than 2% per year) is a significant base for economic growth.

The outlook for 2021 is relatively positive and growth could increase slightly (3.8% estimated). On the health front, the Covid-19 epidemic is currently fairly well controlled according to official figures. As a result, most restrictions have been relaxed (only those relating to places of worship remain in force), allowing a recovery in the market services sector. In addition, the government introduced measures to support household purchasing power. However, against a background of rising rate of unemployment (9.6% in Q2 2020, the highest level for two years) and falling disposable income for a large part of the population, it seems unlikely that household consumption will grow significantly this year. Instead it will be public spending, particularly on mega-projects, which will continue to drive GDP growth.

A SIGNIFICANT FALL IN INFLATION

Consumer price inflation has been falling steadily since the beginning of the year, due mainly to lower food prices, which makes up 40% of the index. Food prices fell month-on-month for the third consecutive month in August and are down by an average of 0.4% over the past twelve months. It is far from certain that these lower food prices will last and thus allow Egypt to reduce inflation significantly over the coming years. In part, the fall in consumer prices has been the result of the slowing of economic growth. In addition, government intervention has given it higher control over food product trade and prices. It is not certain that this policy will be sustainable over the medium term.

We estimate that annual inflation is likely to hit a yearly average of 4.6% in December 2020, well below the Central Bank of Egypt's target of 9% +/-3%, and then drop to 4.0% on average for the fiscal year 2021.

THE POLICY RATE IS STILL AT A HIGH LEVEL

Under circumstances that would seem to favour monetary easing, the CBE has a gradual approach and prefers to maintain its policy rate at a high level (8.75%) for the time being. There are three arguments for this policy. First, after the 300 basis point cut in March, further cuts would have limited effects on economic activity. Although most of the health restrictions that limited economic activity have been lifted, the prospects for recovery remain uncertain, which is not encouraging corporates to invest.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	5.3	5.6	3.5	3.8
Inflation (CPI, year average, %)	21.5	13.4	5.6	4.0
Central. Gov. balance / GDP (%)	-9.5	-8.0	-8.7	-9.2
Central. Gov. debt / GDP (%)	93	89	86	89
Current account balance / GDP (%)	-2.4	-3.6	-3.8	-4.1
External debt / GDP (%)	37	34	33	35
Forex reserves (USD bn)	44	44	38	38
Forex reserves, in months of imports	7.2	6.9	6.2	6.2
Exchange rate USDEGP (year end)	17.9	16.7	16.1	16.0

TABLE 1

(1): Fiscal year from July 1st of year n to June 30th of year n+1
e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

CONSUMER PRICE INFLATION (%)

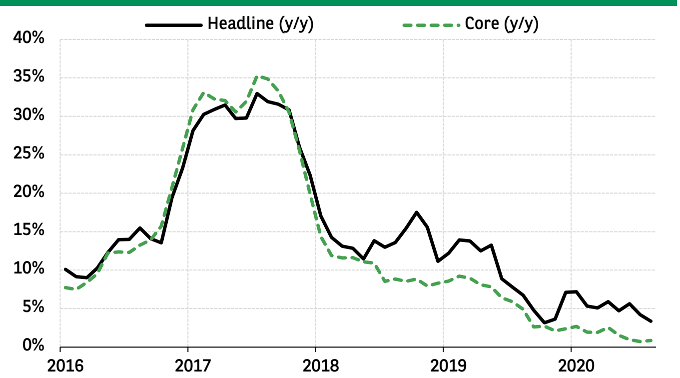

CHART 1

SOURCE: GENERAL AUTHORITY FOR STATISTICS, BNP PARIBAS

Secondly, the spectacular fall in inflation is still fragile. The fall in food prices is linked to factors that are likely to change, whilst the ending of regulated energy prices makes these much more sensitive than before to market prices. Thirdly, the financial shock in 2020 and the global recession that has followed have confirmed the continuing vulnerability of the country's external accounts, and the need to maintain an interest rate policy that will attract foreign investors who are active in the local currency debt market.

With tourism collapsing and expectations of a worsening of the current account deficit, foreign investors fled the Egyptian markets in March. The value of TBills held by non-residents fell by USD 12.7 billion to USD 7 billion over the three months to May. International liquidity has been restored thanks to the financial support of the IMF for a total of USD 8 billion and the issue of USD5 billion in sovereign debt on the international markets. In July foreign portfolio inflows recovered and TBills held by non-residents reached more than USD 10 billion. The current level of interest rates gives the Egyptian market a significant advantage in terms of the risk-reward balance, and contributes to the stability, or even slight strengthening of the currency, providing further incentive for carry trade positions.

CONTRIBUTIONS TO MONEY SUPPLY GROWTH (%)

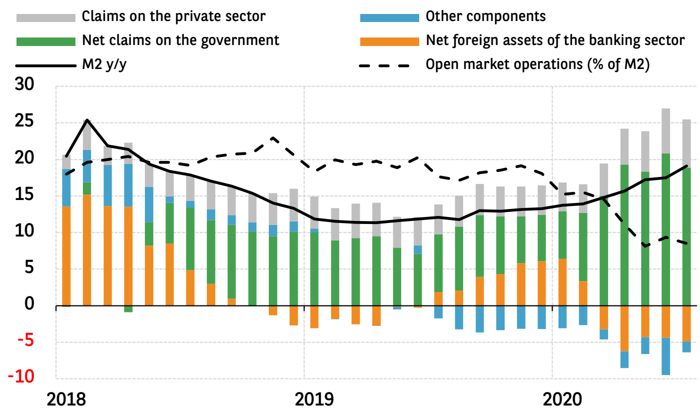

CHART 2

SOURCE: CBE, BNP PARIBAS

INJECTION OF ADDITIONAL LIQUIDITY INTO THE ECONOMY

In parallel with high interest rates, the CBE has injected liquidity into the economy through open market operations. These operations have been used on a massive scale since the end of 2016 in order to limit the expansion of money supply and its possible inflationary consequences. Since the beginning of this year, the value of open market operations has reduced significantly, dropping from an average of 20% of M2 in 2018 and 2019 to 8.5% in July 2020. This additional liquidity has mainly been used to finance government debt, which has contributed on average a 19% increase in M2 since April 2020 (against 5.8% for the private sector). This increase in liquidity has not had inflationary consequences due to the slowing of economic growth and the attractiveness of certificates of deposit offered by public banks (50% of bank assets) in order to discourage the dollarisation of deposits.

EXPANSION OF LENDING TO HOUSEHOLDS AND GROWING BANK EXPOSURE TO SOVEREIGN DEBT

The changes seen in money supply are mirrored in the exposure of banks to sovereign debt. Claims on the government represented 42% of total claims in May 2020 (from 32% a year earlier). Banks' exposure to sovereign debt has returned to its level at the end of 2016, when foreign investors were absent from the government local debt market. However, maintaining interest rates at a sufficiently attractive level for foreign investors could contribute to freeing up liquidity for the private sector.

The acceleration of claims on the private sector is noteworthy (up 20% y/y in June 2020), although it remains slower than growth in claims on the government (49%). In the first half of 2020, the increase in lending to companies mainly concerned short-term loans and was boosted by the policy of loans at subsidised rates introduced by the CBE in 2019, the rate on which was cut from 10% to 8%. Although lending to companies has grown since the beginning of the year (18% y/y to May 2020), it has been lending to households (30% of private sector credit) that has seen the most significant growth (up 30%). Egyptian banks are known for their cautious lending policies, and household borrowing is conditional on a regular source of income.

This said, the growth in lending to households will need to be watched closely given the deterioration of the economic situation. Against a background of rising poverty recorded by the World Bank since 2016, the gradual withdrawal of the subsidy policy has resulted in a reduction in purchasing power for a large section of the middle class. The current economic slowdown and negative outlook for tourism does not suggest an improvement in the short term.

For the time being, the quality of bank assets in the private sector has remained stable. According to the bank results published for the first half, the non-performing loan rate was 3.8% in Q2 2020, from 3.9% in Q1 2019 (4.5% in September 2019 for the banking system as a whole according to the IMF). At the same time, banks have made sizeable increases in provisions to take account of tougher economic conditions. However, the moratorium on interest payments on bank loans to all borrowers has made a significant contribution to stabilising the quality of banks' asset portfolio. The ending of the moratorium in September 2020 will reveal borrowers' real financial positions and could affect the quality of bank loan books.

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