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# Egypt:

## Economy

July 2016



# EGYPT

## SUMMARY

### **Tourism faces fresh blow as France launches crash crime case**

The crash of an Egyptian airliner into the Mediterranean Sea on route from Paris to Cairo in May 2016 looks certain to deliver another devastating blow to the country's fragile tourist industry. In June 2016 French investigators opened a manslaughter investigation into the crash of EgyptAir flight MS804 over the Mediterranean Sea on its way from Paris to Cairo with the loss of 66 passengers and crew. The French authorities will return the recover black box recorder to Cairo and are still working on the cockpit voice recorder. Although the cause of the disaster is still not known the rising speculation of a terrorist attack will deter travellers. Tourist arrivals collapsed following the downing of a Russian jet over Sinai in October 2015 when Russia, an important source of tourists, cancelled all flights to and from Egypt until it was satisfied that security had been improved. Bookings by tourists to the Red Sea resort of Sharm El-Sheikh tumbled: according to reports, 80%-90% of bookings were cancelled while almost half the tourists had left the resort. Tourist arrivals into Egypt in the year to May 2016, the latest month for which official figures are available, were down 46% on the same period in 2015. May was the seventh straight month that tourism had declined. Tourism arrivals were already at their lowest levels for a decade before the crash, which threatens to deliver a knockout blow to the industry.

### **Egypt hikes rates to rein in inflation**

The Egyptian central bank moved decisively to rein in inflation, defend the currency and ease a dollar shortage in June 2016. It ordered a 100 basis point rise in interest rates to 11.75%. It was the second major rate rise within four months. In March it announced a sharp 150 basis point hike in interest rates to 10.75% along with a steep devaluation of the currency from EGP7.7301 to the US dollar to EGP8.78. In June one US dollar was buying EGP10.9 on the black market slightly stronger than the EGP11.0 seen at the end of May. The continued spread between the pegged and street exchange rates is causing concern for the Egyptian authorities. In June the government announced prison sentences for traders selling foreign currency outside the official exchange rate, marking an escalation in the central bank's crackdown on a black market it says destabilises the country's currency.

### **Egypt looks for next AfDB loan tranche as deficit rises**

In June 2016 Egypt's international cooperation minister, Sahar Nasr, renewed calls to the African Development Bank (AfDB) to hand over the second tranche of their over \$1.5bn loan to Egypt before September. The AfDB handed Egypt the first batch to support Egypt's budget, which also amounted to approximately \$500m, in January. The call came after official figures showed that the budget deficit widened to 9.8% of GDP in the first 10 months of the financial year, thanks to rising public sector wages and welfare costs caused. The deficit compared with 9.5% for the same period a year earlier, the finance ministry said in June 2016. The government expects the budget deficit for the fiscal year 2015/2016 to be between 11.0%-11.5%, while it aims to reduce the deficit to 9.9% in the upcoming fiscal year ending June 30 2017. The government announced in December 2015 it would look to bring the budget deficit down below 10% within the next two fiscal years.

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The country needs an estimated \$17bn in foreign currency to cover its external financing needs — the sum of its current account balance and maturing external debt — over the next 12 months. The debt/GDP ratio was around double its peers' median, at an estimated 93.7% at end of the 2014/15 fiscal year and is only expected to fall by around five percentage points by the end of the 2016/17 year. Domestic banks, including the central bank, account for the bulk of deficit financing.

## Economics forecasts

Subject Descriptor	Units	2014	2015	2016	2017	2018	2019
GDP, constant prices	% change	2.2	4.2	4.3	4.3	4.5	4.8
GDP, current prices	US dollars	301.4	330.8	n/a	n/a	n/a	n/a
GDP per capita, current prices	US dollars	3,476	3,740	n/a	n/a	n/a	n/a
Total investment	%, GDP	13.6	14.0	15.7	16.6	17.3	19.0
Inflation, average consumer prices	% change	10.1	11.0	9.6	9.5	9.0	7.5
Volume of imports of goods and services	% change	7.2	12.1	21.3	6.0	0.0	4.0
Volume of imports of goods	% change	5.1	14.0	15.9	6.5	0.8	4.3
Volume of exports of goods and services	% change	-11.8	14.0	-1.7	7.6	9/0	7.9
Volume of exports of goods	% change	-7.8	1.8	0.3	0.9	22.5	16.2
Unemployment rate	%, total labour force	13.4	12.9	13.0	12.4	11.7	10.7
Population	Millions	86.7	88.4	89.3	92.0	93.8	95.7
General government structural balance	%, potential GDP	-12.5	-11.5	-11.1	-9.8	-10.0	-9.5
General government gross debt	%, GDP	86.0	87.7	89.3	88.8	88.4	88.4
Current account balance	%, GDP	-0.8	-3.7	-5.3	-5.3	-4.0	-3.5

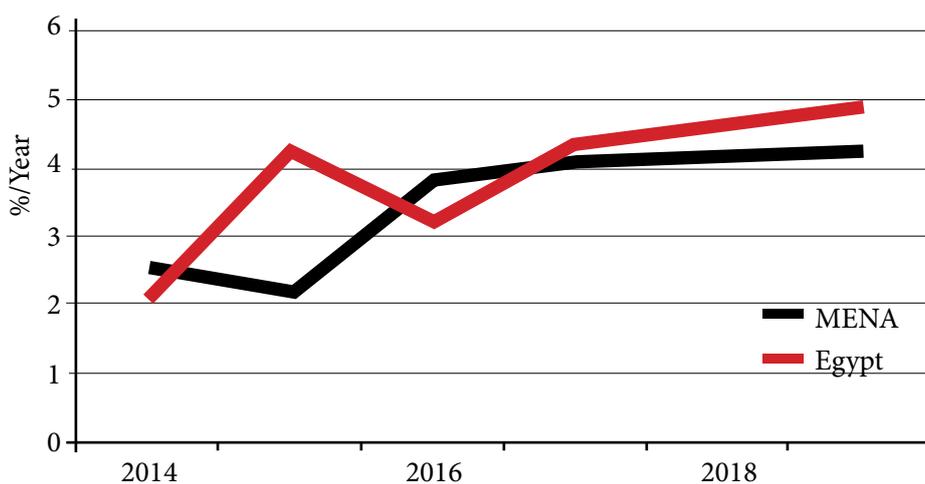
Source: IMF

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## Plane crash adds to downside pressures on economy ...

Egypt appears on course for an economic slowdown in 2016 after ending 2015 with a robust outturn of 3.5% for the year. The economy probably ended the 2015/16 financial year that closed on 30 June with 3.3% annual growth, down from 4.2% in the previous year, according to new forecasts from the World Bank. The first quarter of FY15/16 witnessed subdued growth (of 3%, from 5.6% a year earlier), mainly due to foreign exchange shortages that stifled production. The latest activity data on tourism, industrial production and remittances have pointed to weak growth in the first quarter of the 2016 calendar year (the third quarter of FY15/16). The crash of the EgyptAir flight MS804 in May 2016 threatens to deliver another blow to the tourism industry. The Government cut its forecast for growth in the 2015/16 year in February 2016. The revision by the Finance Minister Hany Kadry Dimian to a range of 4%-4.25% from 5.5% already appears to have been overtaken by events. Dimian blamed the downing of a Russian passenger jet in 2015, saying that the crash had had an impact on tourism. In April 2016 the International Monetary Fund cut its growth forecasts for 2016 to 3.3% from 4.3% six months earlier but trimmed the forecasts for 2017-2018 by 20 basis points (0.2%) to 4.3% and 4.5%, respectively. In August 2015 Egypt opened a major expansion of the Suez Canal, which deepens the main channel and provides ships with a 35km waterway parallel to it. Although Suez Canal revenues fell in 2015 to \$5.17bn from \$5.46bn in 2014, there have been signs of a pick up. Revenues reached \$1.239bn in the first quarter of 2016, up slightly from \$1.236bn in the same period last year. The number of ships passing the canal grew by 10.5% while net tonnage grew 3.5%.

## GDP Growth



Source: International Monetary Fund, World Economic Outlook database, April 2016

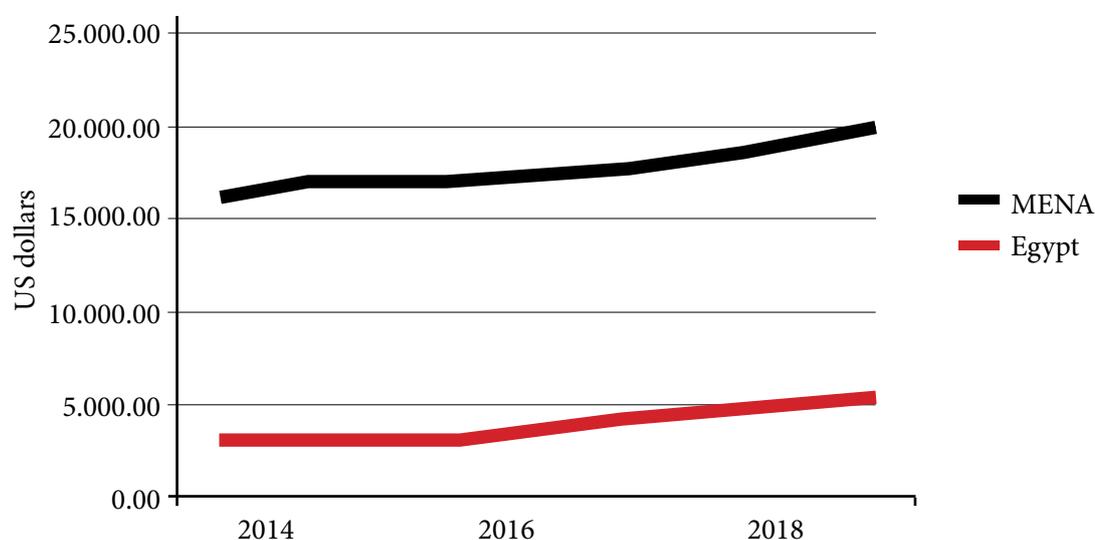
## ...as weak pound and tourism drop saps business activity

Business conditions worsened for the eighth straight month, confirming that the non-oil sectors of the economy had begun the new calendar year in much the same way that they ended 2015. The private sector contracted in May 2016 according to the snapshot index of business managers that recorded a figure of 47.6, a slight recovery from 46.9 in April, on an index where any number below 50 indicates negative growth.

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On the positive side the rates of contraction in output, new business and employment all eased over the month although each of the declines remained strong relative to its long-run trend. But contributors cited generally subdued market conditions as well as the impact of currency depreciation for contributing to high prices and liquidity shortages, both of which dampened demand. The economy is also suffering the impacts of the downing in late October 2015 of a Russian airplane and the crash of the EgyptAir flight MS804. Bookings by tourists to the Red Sea resort of Sharm El-Sheikh have tumbled. According to reports, 80%-90% of bookings have been cancelled while almost half the tourists had left the resort. The downturn in tourism continued in April with the number of tourist arrivals falling by 54% with a year earlier — the month before the latest crash — due to the virtual disappearance of Russian travellers. The number of tourist nights spent in the country tumbled by 67.4% y/y to 2.5m in March mainly due to a 99.2% y/y plunge in tourist nights spent by Russians. The May 2016 crash of the EgyptAir plan from Paris to Cairo will likely hit tourism revenues further. On the positive side the economy received a boost from the Egypt Energy Investment Summit in February 2016 that brought together leading power developers, investors and technology providers. Sherif Oteifa, advisor to the Minister of Investment, has said Egypt will attract direct foreign investments of \$1bn in the renewable energy sector during the current year. Meanwhile GDP per capita looks certain to continue to lag the region (Chart 2).

## GDP per capita, current prices



Source: International Monetary Fund, World Economic Outlook database, April 2016

## Evidence points to terrorist attack on MS804

French investigators have opened a manslaughter investigation into the crash of EgyptAir flight MS804 over the Mediterranean Sea on its way from Paris to Cairo with the loss of 66 passengers and crew from a dozen countries have put the international spotlight back on Egypt's security situation. The flight data recorder — the so-called black box — of the plane that crashed in May has been successfully repaired and will be returned to Cairo for analysis of its contents, The plane's cockpit voice recorder is still being worked on.

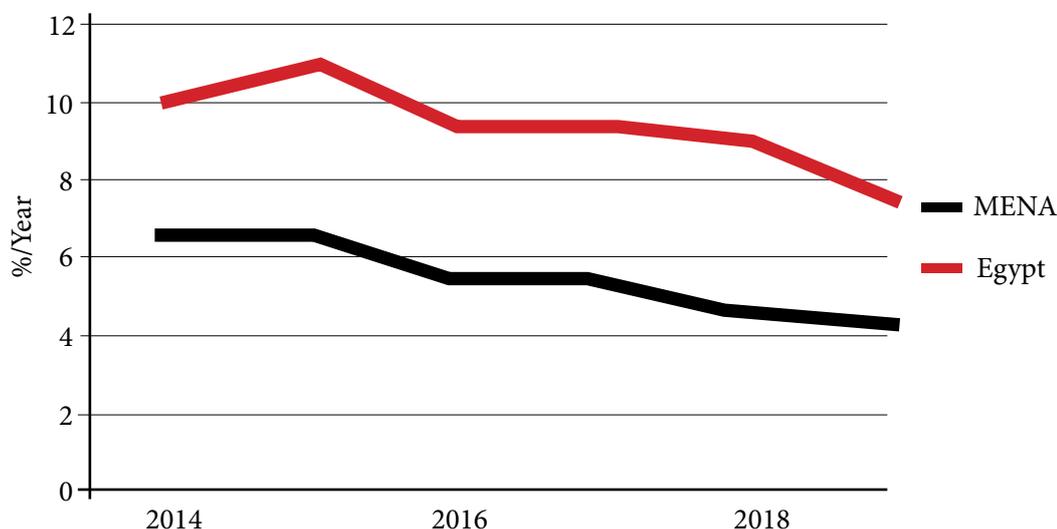
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Although it has not been established whether the cause was terrorism, the disaster has triggered concern over the vulnerability of Egypt's security systems. On the domestic front, President Abdel Fattah el-Sisi addressed parliament in February 2016 for the first time since it had reconvened. The first session of parliament since Egypt's last legislative session was dissolved in June 2012 took place in January 2016 after elections held between October and December. There are concerns that the legislative body will have few powers and willingness to control Sisi. His speech came a day after a rare large-scale public protest took place against the Egyptian authorities. Thousands of doctors demonstrated in Cairo in a rare protest over allegations of police impunity after two doctors were claimed to have been assaulted in a hospital in the city the previous month. The new legislature is unlikely to have a smooth ride. Unlike the previous parliament where Islamists won the biggest bloc with the then-ruling Muslim Brotherhood group emerging as the dominant group, this parliament does not have a majority bloc, a clear opposition force or a ruling party. The turnout in the poll was low. As few as one in four voters took part in the two phases of the poll, which were carried out in October and December 2015.

## Inflation jumps ahead of 100bp rate hike...

Inflation rose sharply in May 2016 as the impact of the previous month's devaluation of the pound began to feed through to economic activity. The headline consumer price index hit a seven-year high of 12.3% in May 2016, up from 10.3% in the previous month and less than 9% earlier in 2016. On a monthly basis inflation accelerated by 3.1% between April and May compared with 1.3% in the previous month. This reflected regulated price adjustments which contributed by 0.4 percentage points, supply shocks such as the increase in rice prices which contributed by 0.5 percentage points, seasonal effects of the holy month of Ramadan, and a lagged pass-through effect from the March 2016 exchange rate adjustment. The International Monetary Fund expects the inflation rate to slow gently to 7.5% by 2019 (Chart 3). The central bank responded to the latest jump in inflation with a 100 basis point rise in the benchmark rate to 11.75% following the 150 basis point rise it ordered in March to support the 13% devaluation of the pound.

### CPI Inflation

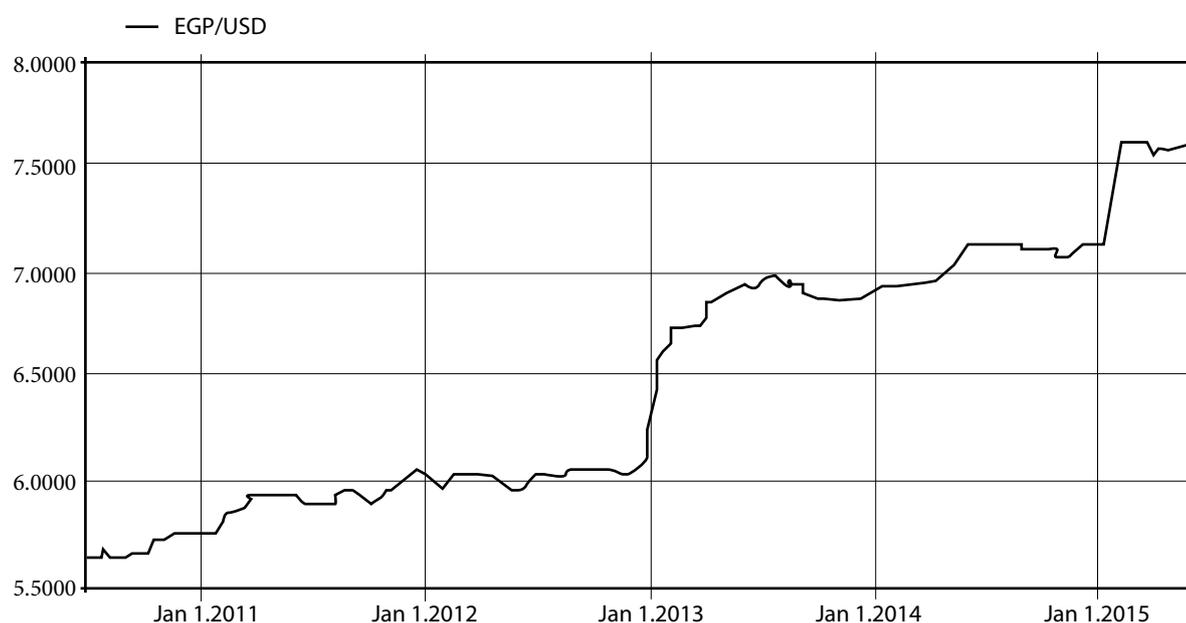


Source: International Monetary Fund, World Economic Outlook database, April 2016

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## ...as unofficial trading points to further devaluations

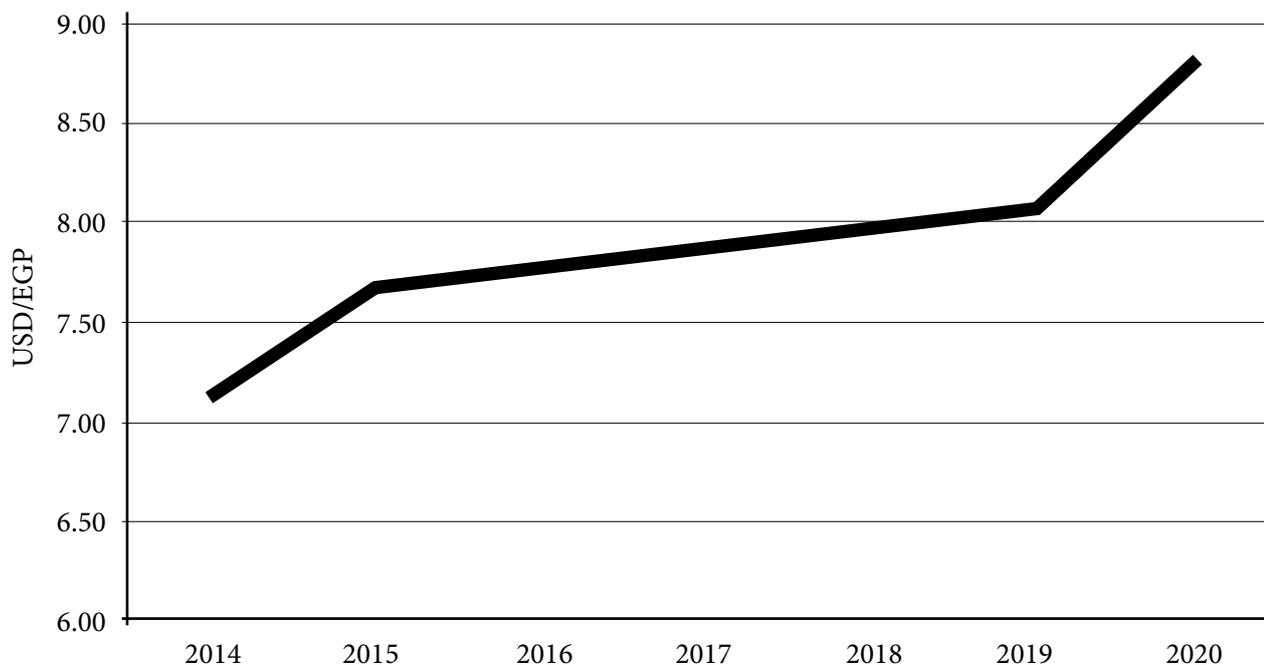
The continued spread between the pegged and street exchange rates is causing concern for the Egyptian authorities. In June 2016 one US dollar was buying EGP10.9 on the black market slightly stronger than the EGP11.0 seen at the end of May but still more than EGP2 above the pegged rate of EGP8.78 (Chart 4). In June the government announced prison sentences for traders selling foreign currency outside the official exchange rate, marking an escalation in the central bank's crackdown on a black market it says destabilises the country's currency. According to media reports, foreign exchange houses are hoarding dollars in the belief that the central bank will weaken the currency again. However the Governor of the central bank, Tarek Amer, has denied that any devaluation is imminent. The initial euphoria on the stock market has faded with the EGX 30 equity falling around 7.8% in the month to late June and down 18.9% in the year to the same point. Egypt had faced growing pressure to devalue the pound since it started rationing dollars to keep the currency artificially strong at the EGP7.7301 fix. Devaluation to EGP8.78 had appeared inevitable because of the shortage of foreign exchange and the weakness of the export sector. The pound is likely to continue to depreciate according to the latest forecasts by the Economist Intelligence Unit for nooz.com that indicated that the pound would end 2016 at EGP9.56 to the pound and then weaken by another 43% to EGP13.64 by 2021 (Chart 5).



Source: : [www.oanda.com/currency/historical-rates/](http://www.oanda.com/currency/historical-rates/)

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## Exchange rate forecast



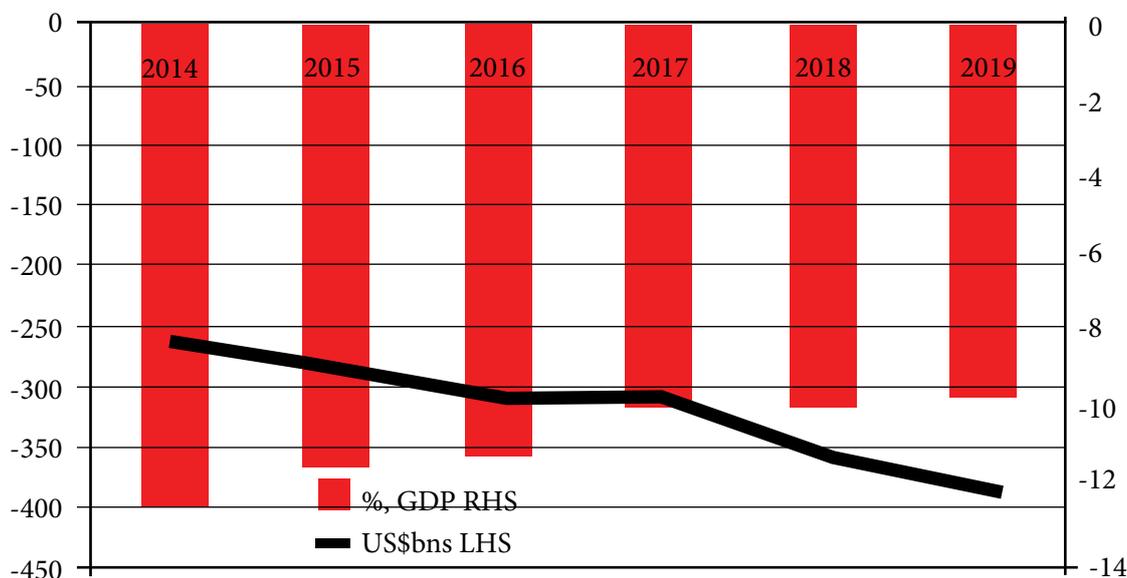
Source: EIU

## VAT in sight, as deficit and debt are still high...

Egypt's budget deficit widened to 9.8% of GDP in the first 10 months of the financial year, thanks to rising public sector wages and welfare costs caused. The deficit compared with 9.5% for the same period a year earlier, the finance ministry said in June 2016. In its monthly report for May, the ministry said the deficit stood at EGP273bn (\$30.7bn) between July 2015 and April 2016, compared with EGP231bn in the same period a year ago. The government expects the budget deficit for the fiscal year 2015/2016 that ended in June 2016 to be between 11.0%-11.5%, while it aims to reduce the deficit to 9.9% in the upcoming fiscal year ending June 30 2017. This was down from the 12.2% recorded for the 2013/2014 fiscal year, and 13.7% in the 2012/2013 year. The government announced in December 2015 it would look to bring the budget deficit down below 10% within the next two fiscal years. The budget for that year will be the first to be reviewed by parliament in five years. In order to achieve this it has pledged reforms that include recalibrating subsidies and capping public sector salary growth. Egypt is set to continue to reduce energy subsidies as part of a strategy to reduce its budget deficit. Egypt's cabinet has referred the most recent version of the draft law to the State Council for review prior to resending it back to the parliament. It could generate as much as EGP30bn (\$3.38bn) in additional annual fiscal revenues. The launch date will be 1 January 2017. It is hoped that will stimulate growth as well as make the tax regime more user friendly. Moody's, the rating agency, expects the shortfall to narrow to around 9.3% by 2016. This is in line with the IMF's forecasts of a narrowing from 11.5% to 9.5% of GDP by 2019 (Chart 6). In December 2015 Fitch Ratings affirmed Egypt's sovereign rating at B with a stable outlook, saying that deficit reduction and stronger nominal GDP growth are forecast to put the debt/GDP ratio on a downward trend, ending a multi-year deterioration.

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## Government Budget Balance



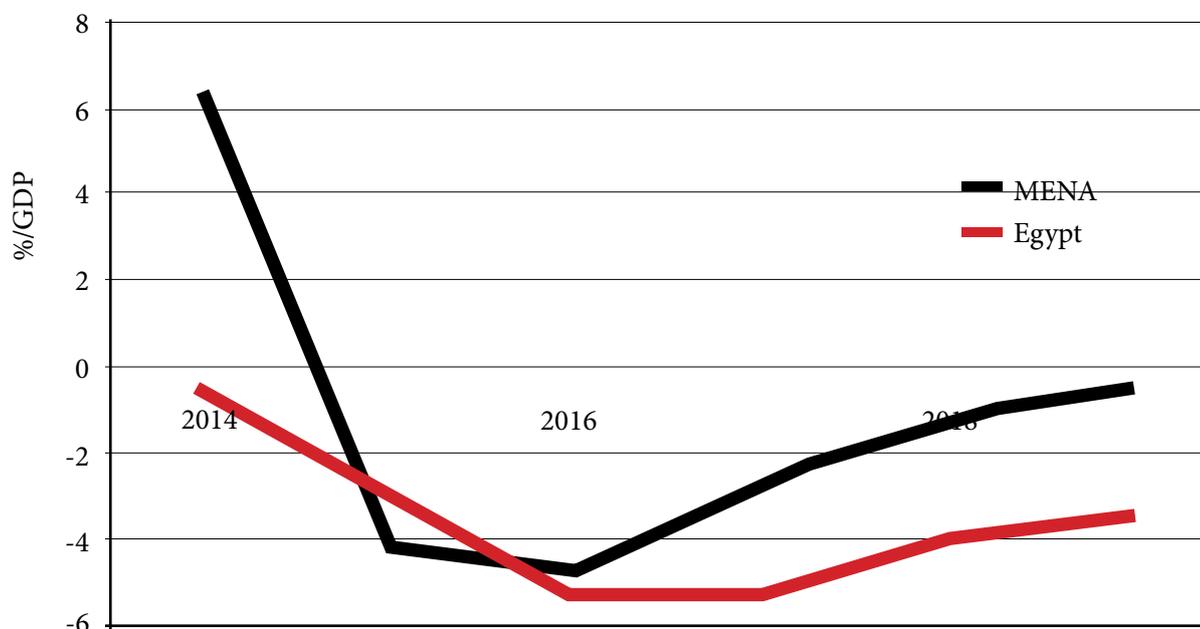
Source: International Monetary Fund, World Economic Outlook database, April 2016

### ...and current account balance is in deficit...

The scale of Egypt's external deficit was highlighted by official figures showing that the current account had soared in the first half of the new fiscal year — the six months to December. The deficit more than doubled to \$8.9bn from \$4.3bn a year earlier, the central bank said. Goods exports declined 26% year-on-year, Suez Canal revenues by 7% in dollar terms, while current transfers declined 30%, and personal remittances fell 12%. The outlook is likely to worsen over the first half of the 2016/17 year as figures in late April 2016 showed that tourism revenue down 66% in the first quarter of 2016. Egypt received just \$500m in tourism revenue in the three months to March, down from \$1.5bn a year earlier. Moody's, the ratings agency, said it estimated that the deficit reached a record 5.8% of GDP in the fourth quarter of calendar year 2015, up from 3.1% a year earlier. This reflects a sizable structural trade deficit, a drop in the services surplus and a sharp decline in net transfer receipts. While the worsening of the position was mainly due to a 17.5% drop in tourism revenues the figures did not include the impact of the Sharm el Sheikh crash in late October 2015 whose impact on tourism dominates the fourth quarter data. The country is suffering from a shortage of foreign exchange thanks to declines in foreign investment and tourism receipts. Official reserves have declined from \$36bn before the 2011 uprising to \$17.5bn at the end of May 2016. The government has said it hopes to tap the international bond market before the end of the fiscal year, market conditions permitting. So far Egypt has been able to finance the deficit thanks to its return to international capital markets that was marked by the successful issue of a \$1.5bn Euro-bond. Egypt is borrowing \$3bn from the World Bank and \$1.5bn from the African Development Bank (AfDB) to support the general budget. The first \$1bn tranche of World Bank money is aimed to help the country carry out key economic reforms. In June 2016 Egypt's international cooperation minister, Sahar Nasr, renewed calls to the African Development Bank (AfDB) to hand over the second half of the next \$500m tranche of its promised \$1.5bn loan to Egypt before next September.

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## Current Account Balance



Source: International Monetary Fund, World Economic Outlook database, April 2016

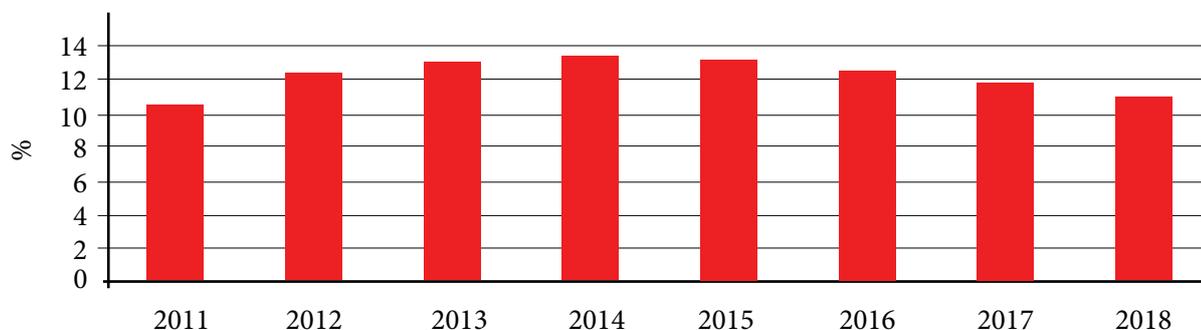
The AfDB handed Egypt the first batch of the loans to support Egypt’s budget, which also amounted to approximately \$500m, last January. Nevertheless the current account deficit is expected to be maintained (Chart 7).

### ...while the unemployment rate is high

The jobless rate fell in the first quarter of 2016 albeit to still high levels, official figures showed in May 2016. The unemployment rate for the 15-64 age range fell to 12.7% in the three months to March, compared with 12.8% in the fourth quarter of 2015, according to the Central Agency for Public Mobilisation and Statistics. Unemployment among the 15-29 age range reached 27.3% while more than a third of those (36.1%) had completed secondary or university education. The rate for the male youth was 21%, but was 46.8% for women in the same age range. The unemployment rate averaged 10.74% between 1993 and 2015, hitting an all-time high of 13.4% in the third quarter of 2013, since when a rebound in economic growth had led to a rise in employment (Chart 8). Egypt’s labour force added 333,000 new jobs over the fourth quarter to reach 28.3 million. President Abdel Fatah al-Sisi has pledged to reduce joblessness to 10% over the next five years — a target that will require much higher levels of economic growth than are currently forecast. The highest levels of joblessness are found among youth. The poverty rate rose to 26.3% in the 2012/13 fiscal year, with the IMF estimating another 20% of the population to be close to the poverty line. The government has taken action to create jobs and reduce unemployment but further rises in the jobless rate could add to social unrest.

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## Unemployment



Source: International Monetary Fund, World Economic Outlook database, April 2016

## Medium term outlook is cautiously upbeat...

The economy faces a period of low growth in the face a number of political and economic challenges. While the main cause is the impact on confidence and business activity following the crashes of two planes carrying tourists in December 2015 and May 2016, there are signs that the slowdown is driven by wider factors. The sustained low price of oil prices will continue to hurt the oil sector while the manufacturing sector is expected to continue on a downward trend. The 13% devaluation of the pound should make manufacturing more competitive but has contributed to high prices and liquidity shortages, both of which dampened demand. It should lead to a removal of the foreign exchange restrictions, which would allow firms to import intermediate goods and services. The large hikes in interest rates will add to borrowing costs for households and businesses although it should succeed in keeping inflation under control. However the medium-term outlook is more positive, reflected in the maintenance of the growth outlook by the IMF. The positive outlook is also based on signs that the government's reforms to the export industry are beginning to pay dividends. ENI, the Italian group, has begun production at a gas field in the Nile delta while supplies from the giant Zohr gas field in the Egyptian sector of the Mediterranean Sea should come on stream in 2017. The total gas in place is around 850bn cubic metres, which would double Egypt's reserves. In an update on the first annual assessment of the economy that it had carried out in November 2014 after a four-year hiatus, the IMF said there had been many "positive developments" in the previous 10 months. Decisions announced made at the February 2016 Egypt Energy Investment Summit, the opening of the parallel Suez Canal and the major gas find in Egyptian waters boded well for the country's outlook in the medium term. However all these forecasts were made before the shooting down of the Russian plane over Sinai which will have pronounced short-term negative effects.

## ...but both economic and political risks remain

The overall outlook is uncertain and Egypt faces a number of downside risks. In the immediate term the key risk is the implications of the latest air disaster. If the May 2016 does, as seems extremely likely, turn out to be a terrorist incident, that will highlight the ongoing security risk posed to Egypt and to travellers.

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Even if terrorism were ruled out the general climate of fear would still deter tourists. It builds on the impact of the downing of the Russian jet over Sinai has raised fears that IS terrorists are operating with impunity within the country and that the country's airport security is easily compromised. This was compounded by the killing of 13 police officers in the city of El-Arish in March 2016 that was claimed by IS. These fears are likely to affect tourism over both the short- and medium-terms unless the government can convince foreign governments that they have tightened security and eliminated IS cells. It will also dampen household confidence and may affect consumer spending. Tourism makes up 6% of Egypt's GDP and supports around 1.3 million jobs. The loss of export earnings from tourism will hit the country's current account deficit and put the shrinking official reserves under further pressure. Deterioration in the political situation in the Middle East and continued tensions between Russia and the West over Syria could lead to a slowdown in global trade that would affect Suez Canal revenues. On the domestic front, the decision to take over two Red Sea islands, long viewed as Egyptian, to Saudi Arabia under a secretly negotiated border agreement has triggered protests. Public calls for the downfall of the regime and condemnation by usually loyal newspaper al-Watan indicate that feelings are running high. On the domestic front the low turnout in the national elections combined by signing of increasing authoritarian behaviour by the government has stirred concerns of a repeat of the 2011 Arab Spring revolution. Weakening in the reform programme could deter investment. Perceptions that the parliament is simply rubber-stamping al-Sisi's decrees could foment dissent among citizens that are already dealing with 13% unemployment. The protests in February and April 2016 are a sign that people are more willing to raise their voices. The downgrade of the economic growth forecast by the government in February 2016 is the first real sign of the economic impact of the Sinai plane crash. However there is potential for growth to surprise on the upside both from continued successful implementation of the reform agenda. Hikes to domestic energy prices will add to inflation, which is already running at a seven-year high despite 250 basis points of interest rate hikes. There is speculation of a further devaluation in the exchange rate in the light of the EGP2 gap between the official and market rates.