EGYPT

Highlights

- **Growth has slowed amid rising inflation but the fiscal deficit has narrowed.** Fiscal reforms are anchored within a new IMF programme, and the current account deficit has remained broadly unchanged.
- **Reform progress in the past year was significant.** The exchange rate was liberalised and limits on foreign currency transfers scrapped; value-added tax (VAT) was introduced and the rate increased; several rounds of fuel, electricity and subsidy reforms were implemented; and there was progress on the industrial licensing, natural gas industry, investment and bankruptcy laws.
- **Foreign investment has increased amid rising confidence.** The approval of the IMF programme in November 2016 and the completion of the first review in July 2017, coupled with the strong reform momentum, have led to higher foreign direct and portfolio investments, increased remittances, and a heightened foreign appetite for domestic debt instruments and Eurobond issuances.

Key priorities for 2018

- **Continued fiscal consolidation, along with higher capital and social spending, is a priority.** The increase in VAT, continued energy subsidy reforms and wage restraint will reduce public debt over time and provide fiscal space for a strong social component to ease the burden of adjustment on the poor and vulnerable.
- **An immediate priority is to reduce inflation.** Inflation has reached record high levels in 2017 as a result of the currency depreciation following the liberalisation, VAT increases and subsidy cuts. As the currency starts stabilising and inflation expectations are guided by the central bank, inflation should ease.
- **Implementing and enacting executive regulations of approved laws should continue.** Legislative reforms to strengthen the business climate, attract investments, support private sector development, and promote growth are critical and should focus on, among other things, the investment law's executive regulations and investment map.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.3	2.9	4.4	4.3	4.1
Inflation (average)	6.9	10.1	11.0	10.2	23.5
Government balance/GDP	-12.9	-12.0	-11.4	-12.5	-10.9
Current account balance/GDP	-2.2	-0.9	-3.6	-6.0	-5.8
Net FDI/GDP [neg. sign = inflows]	-1.3	-1.4	-1.9	-2.1	-3.7
External debt/GDP	15.0	15.1	14.4	16.6	n.a.
Gross reserves/GDP	n.a.	5.5	6.1	9.0	n.a.
Credit to private sector/GDP	n.a.	25.4	25.7	25.6	n.a.

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Macroeconomic performance

Economic growth slowed and inflation sharply accelerated. Growth declined to 4.1 per cent in the fiscal year 2016-17, compared with 4.3 per cent the previous fiscal year. Meanwhile, private consumption continued to be the primary driver of growth despite eroded purchasing power as a result of inflation, and investment remained resilient. Net export performance picked up in the last two quarters following the liberalisation of the exchange rate, after being a significant drag on growth in the first two quarters. Unemployment decreased but remains elevated at 12.0 per cent in the second quarter of 2017 and youth unemployment is at 26.7 per cent. Inflation has risen, reaching 31.6 per cent year-on-year in September 2017, after having reached 33.0 per cent year-on-year in July 2017, its highest level in decades, fuelled by a new round of subsidy cuts implemented in late June.

The fiscal position improved but the deficit remains high. The fiscal deficit is estimated to have fallen to 10.9 per cent of GDP in the 2016-17 fiscal year, the lowest level in five years, down from 12.5 per cent of GDP in the previous fiscal year. The narrowing in deficit was driven by a contained wage bill and cuts in subsidies, coupled with a continued strong tax performance, especially with the introduction of value-added tax, despite increases in interest payments. The government also cleared its payment arrears to international oil companies in August 2017 from a peak of US$ 6.4 billion in 2012, which encouraged investment in the energy sector. Meanwhile, gross public debt rose to 98.4 per cent of GDP from 93.8 per cent in the previous fiscal year, with the ratio of external debt to total debt doubling to 21.8 per cent as a result of disbursements from the IMF and Eurobond issuances.

The external position remained broadly unchanged. The current account deficit increased in the third quarter of the 2016-17 fiscal year to 7.2 per cent of GDP compared with 7.0 per cent in the corresponding period the previous year, as the increase in exports and current transfers was offset by the increase in imports. The current account deficit is estimated to have declined marginally from 6.0 per cent to 5.8 per cent of GDP in 2016-17.

A new IMF programme is in place, boosting investor confidence. The programme is a three-year Extended Fund Facility of US$ 12 billion and was signed in November 2016. It was accompanied by an immediate liberalisation of the exchange rate. The first review of the programme was successfully completed in July 2017 and, coupled with strong reform momentum, boosted investor confidence. Foreign direct investment (FDI) in Egypt increased by 12.1 per cent year-on-year in the first three quarters of 2016-17, reaching 5.3 per cent of GDP compared with 3.7 per cent in the corresponding period of the previous fiscal year. Egypt attracted close to US$ 10 billion of foreign investment in domestic debt instruments in 2016-17 compared with US$ 1.1 billion the previous fiscal year. Remittances from Egyptians working abroad have also increased. International reserves have rebounded to pre-2011 levels, reaching a record high of US$ 36.5 billion in September 2017, and covering 6.1 months of imports, up from a critically low level of 3.1 months in June 2016.

Economic growth will pick up to 4.5 per cent in 2017-18, with the composition changing. High inflation will continue to adversely affect private consumption, but exports are expected to rise further. Construction will continue to be the main driver of growth, with various low-income housing projects and the construction of the new capital city. Growing confidence in the availability of foreign exchange and continued reform efforts should boost business sentiment and attract foreign investors, but significant downside risks remain, associated mainly with the adverse effect of high inflation on private sector consumption and investment, both domestic and foreign, and on competitiveness.

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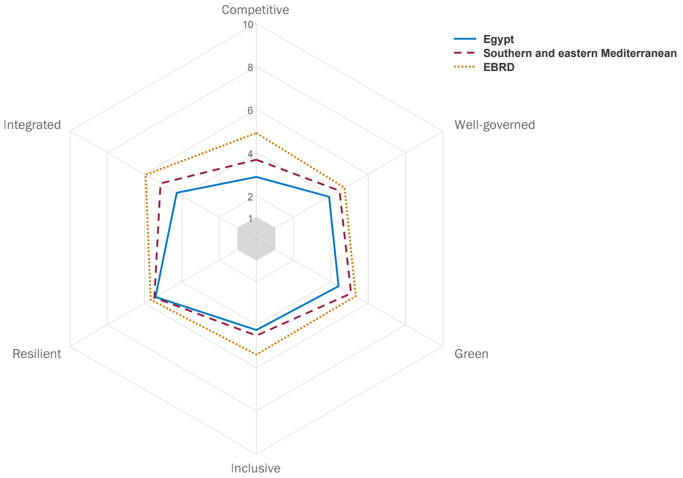
Assessment of transition qualities (1-10)



Major structural reform developments

The central bank has implemented several bold reforms. To reduce inflation and absorb excess liquidity, the central bank increased its policy interest rate three times since November 2016; 300 basis points in November followed by 200 basis points each in May and July 2017. Inflation reached record high levels, posing a risk to macroeconomic stability and hurting the poor. The liberalisation of the exchange rate regime in November 2016 was a critical step towards restoring confidence in the economy and eliminating foreign exchange shortages. Moreover, in June 2017, the central bank scrapped limits on currency transfers abroad, signalling the easing of the foreign currency shortage, which had strangled the economy and eroded international reserves and was a major concern for foreign investors who were unable to repatriate profits.

Reforms in the energy market have advanced. The government performed several rounds of fuel and electricity subsidy reforms, the latest of which were in June 2017, where the prices of diesel and 80-octane petrol increased by 55.0 per cent, 92-octane went up by 43.0 per cent, and 95-octane rose by 5.6 per cent. The price of a canister of liquefied petroleum gas was doubled, but it remains the most heavily subsidised energy product. Moreover, the act deregulating the natural gas industry was issued and published in August 2017. The act opens the door for private sector participation in importing and trading natural gas, a move that could help end supply shortages which have hampered businesses. It also transforms the state from the monopoly manager of the distribution network into a regulator, by setting up a natural gas regulatory authority charged with licensing and devising a plan to open the gas market to competition. The strategy to settle outstanding arrears to international oil companies has already contributed to major investment pledges by two British companies, BP and BG Group, as well as Eni of Italy, which operates the Zohr gas field, the largest discovered field in the Mediterranean, potentially large enough to meet Egypt's entire domestic needs for a decade and allow for the resumption of natural gas exports.

Value-added tax (VAT) and a stamp tax on capital market transactions have been introduced. The VAT came into force in September 2016 at a rate of 13 per cent. The rate was increased in July 2017 to 14 per cent, strengthening fiscal consolidation. In the same month the authorities also introduced a new stamp tax on capital market transactions. This is a 0.125 per cent levy imposed on both sides of any capital market transaction that gradually rises to 0.175 per cent by its third year.

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A new investment law has been approved. Parliament approved the new law in May 2017, and the cabinet signed off on the executive regulations in August 2017. The new law will ease the process of establishing companies and obtaining licences considerably but does not resolve some of the difficulties facing investors in land acquisition procedures. As a result, although the law is an improvement on earlier versions, it is likely to undergo future revisions. Moreover, weak institutional capacity and the influence of powerful interest groups within government may pose implementation risks.

Procedures to establish a business are being simplified. A new industrial licensing law was approved by parliament in March 2017 and signed by the president in May, followed by the announcement of the executive regulations in August. The new law aims to combat bureaucracy and reduce the waiting time for new projects. Investors have long complained of lengthy processes for obtaining approvals, with Egypt ranked 128th in the World Bank's *Doing Business 2018* report, partly because of difficulties obtaining permits and licences. With the new law the waiting period for 80 per cent of industries will be reduced to one week or less, while the remaining 20 per cent, deemed more critical due to their higher risks to health, environment, safety or security, will require about one month.

Social protection measures are under way. Resolutions to protect the most vulnerable groups were announced by the president in June 2017. The main measures are: (i) increase the monetary support per capita on ration cards by 140 per cent; (ii) increase the insurance pensions by 15 per cent for 10 million pensioners; (iii) increase the value of monetary support to the 8 million beneficiaries of the two targeted social safety net cash transfer programmes which provide monthly income called *Takaful* ("solidarity" – an incentive-based system related to school attendance and making use of maternal and child health care services) and *Karama* ("dignity" – targeting the poor, the elderly and people with severe disabilities who are unable to work); (iv) approve a periodic bonus for those addressed by the Civil Service Law of 7 per cent and approve an exceptional inflation premium of 7 per cent; (v) approve a periodic bonus for those who are not addressed by the Civil Service Law of 10 per cent and an exceptional inflation premium of 10 per cent; and (vi) stop the tax on agricultural land for three years to ease the tax burden on the sector. Moreover, the school meals programme for children, which provides a daily meal and aims to address malnutrition among children in poor families and decrease the numbers of those students dropping out, has been expanded to include all public schools.

Meanwhile, some important reforms are delayed. The authorities have announced plans to offer shares in state-owned assets in the financial and energy sectors to promote competition but implementation has been delayed. The new bankruptcy law, approved by the cabinet in January 2017, is yet to be passed by parliament at the start of its autumn legislative term.