Egypt

SEB GROUP COUNTRY RISK ANALYSIS **December 27, 2018**

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The steady implementation of economic reforms has contributed to lifting economic growth and improving external balances. Meanwhile, the political situation has stabilised.

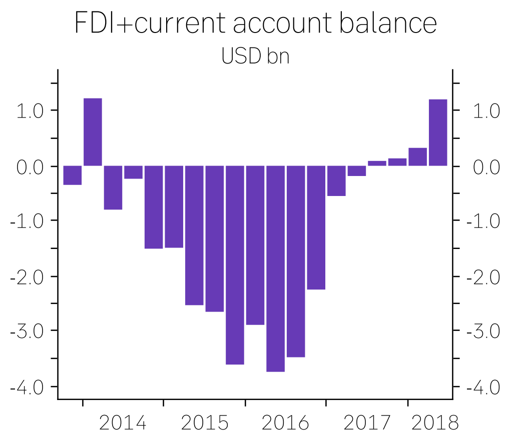
Country Risk Analysis

Recent economic developments

GDP growth accelerates. The economic recovery continues driven largely by household spending and large state-led investment projects. Real GDP growth was 5.3% in the fiscal year ending in June 2018. This compares with 4.2% in the previous year. Following the floating and depreciation of currency in 2017, inflation soared to an average of nearly 30%. In 2018, it is likely to average about half that rate, despite occasional spikes related to energy price hikes. The unemployment rate has edged down from high levels but employment is not rising.

External balances gradually improving. The twin deficits that have been plaguing Egypt for many years has both been on a decline since the start of the IMF programme in late 2016. Starting with the external position, it continued to improve in the past year helped by the sharp devaluation of the currency and a rebound in tourism. In FY 2017/18 the current account deficit narrowed to 2.4% of GDP from 6.1% the year before. We see the deficit averaging 2.5% in 2018.

Remittances rose in the past year, attracted by the more favourable exchange rate. At the same time, foreign direct investment (FDI), mainly going into the oil and gas sector, edged down slightly but has financed the current account in the past quarters. Portfolio flows have been extensive following the devaluation, helped also by the removal of capital controls. This summer's cooling emerging market sentiment led to a reversal of flows but it did not materially impact the exchange rate or FX reserves as it did in several other emerging markets.



Source: Central Bank of Egypt

New gas fields support the balance of payment. The development of the country's off-shore gas sector is contributing to improving the balance of payments. In late 2018, the country reportedly reached a production level that made them self-sufficient. It is expected that Egypt becomes a net exporter again in 2019. Several new gas fields are under development and the authorities plan to make the country a regional gas hub, servicing also production from Israeli offshore gas fields.

International reserves have stabilised at more comfortable levels. Since embarking on the IMF programme, the central bank has roughly tripled its FX reserves, reaching new record highs. Despite an increasingly favourable external position, reserves have largely stabilised since early 2018. At about USD 44 bn, they are equivalent to about 6 months' of imports, and easily cover outstanding short-term debt. Most forecasts point to reserves staying broadly at these levels in the near-term.

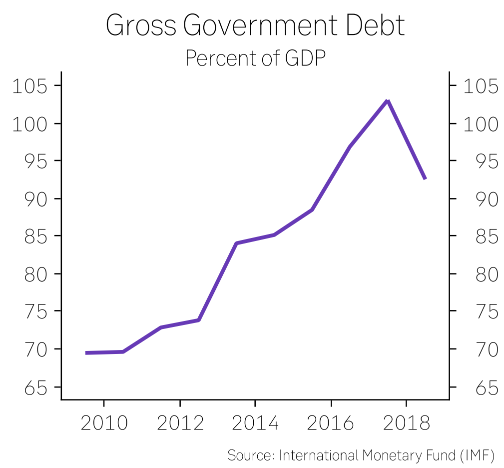
External debt is moderate and mostly on concessional terms. Rapid growth produced a decline in external debt/GDP in the past year despite a continued rise in nominal debt. A debt ratio around 35% of GDP is broadly in line with that of peers. A significant share of debt is on concessional terms owed to multilaterals or in the form of deposits from GCC countries.

Economic policies

Fiscal consolidation challenges in light of rigid budget structures. Significant progress has been made in consolidating public finances since the start of the IMF programme in 2016. For the first time in a decade, the government produced a primary budget surplus in the fiscal year ending in June 2018. A key ingredient has been a reduction in energy subsidies and reforms of public sector wages. The government aims to eliminate subsidies on all oil products (except butane) during the current fiscal year. In the meantime, lower than previously expected oil prices eases the fiscal pressures.

A standing challenge, however, is the fact that expenditures on wages, social benefits and interest rate payments, stand for roughly 80% of total spending. The wage share has been decreasing under the IMF programme but interest rate costs remain high. Servicing these payments has previously been facilitated by negative real interest rates on domestic debt. With inflation declining, and new debt (Eurobonds and securities bought by the central bank at rising interest rates) issued during 2018 this could make interest payments increasingly challenging. High interest rate costs contributed to a headline budget deficit of -9.8% of GDP in the past fiscal year. For the current fiscal year, the government sees a decline to -8.4% which is viewed as optimistic by most observers.

Government debt likely to have peaked. Running significant primary deficits since 2011 financed by borrowing heavily resulted in a steadily rising government debt to levels clearly above that of risk class peers. However, following the improvement on the primary budget balance in the past year, the debt ratio shrank to about 92% of GDP in mid-2018. Average maturity of debt is relatively short making the economy very sensitive to higher borrowing costs. The IMF programme sees a continued gradual decline in the debt ratio over the next couple of years.



Monetary policy: Interest rates remain elevated. The central bank is gradually moving towards an inflation targeting framework with the end-2018 target of 13%+-3%. As inflation fell in early 2018, the bank found room to cut interest rates twice to

17.25%. The gradual up-tick in inflation since then has led to a pause in the cutting cycle leaving real interest rates in the economy at fairly elevated levels. With global interest rates on the rise, this should imply that debt servicing costs for Egypt should remain high in the near-term.

Rating agency raised its sovereign rating. One of the major credit rating agencies upgraded their sovereign rating in 2018 while the other two settled for upping their rating outlook to positive. The agencies mainly cited higher economic growth and strengthening external balances.

Banking sector largely sound. Most aggregate financial soundness indicators for the banking sector remain at reasonably comfortable levels despite the upheaval from the devaluation. The IMF recently gave the banking sector a clean sheet, noting that it remains profitable, liquid and adequately capitalised. Banks are strongly tied to the government since more than 30% of aggregate assets are invested in government securities. The share, however, has declined over the past two years.

Political stability but social tensions are brewing. Government efficiency has improved under president Sisi. His re-election in early 2018 should bode for political stability and continued implementation of economic reforms. At the same time, Sisi has centralised all powers to his personal tight inner circle. An increasingly authoritarian government and the silencing of critics are generating rising discontent and social unrest. Meanwhile the army has been expanding its role.

Security threats mainly in Northern Sinai. Although there have been some small-scale attacks on police and military forces in urban areas, the main security threats, often clashes between security forces and militant groups affiliated with ISIS, are contained to Norther Sinai and the Western areas. This is far from tourism areas.

Outlook

High growth and fiscal consolidation expected to reduce government debt. The near-term growth outlook appears favourable as the recovery in the tourism sector and rising natural gas production is expected to generate GDP growth of around 5.5%. Looking further ahead, the government believes that growth could reach 7.5-8% in 2021/2022, a forecast which we think is overly optimistic. Our house forecasters Oxford Economics expect growth to stay at around 5.5%. We assume continued implementation of the IMF programme. This should pave the way for a gradual reduction of the twin deficits. The authorities aim at achieving a primary budget surplus of 2 percent of GDP in the near-term. Even a slightly less ambitious outcome would reduce the government debt to around 75% of GDP in the medium term.

We expect that terrorist groups operating mainly in Sinai will keep security risk elevated for some time. At the same time, we assume that the government and state security will be able to prevent any major destabilisation of the country.

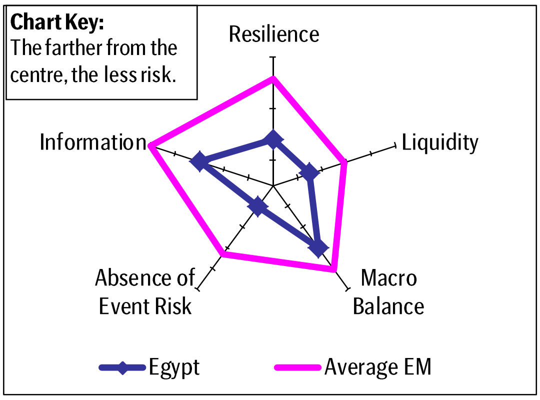
Risks related to social discontent. Although inflation is declining, it is still eroding much purchasing power of the low income part of the population. This together with double-digit youth unemployment rates could easily generate deeper social unrest. Social discontent could, in turn, trigger a reversal of the fiscal consolidation or a slowdown in the pace of economic reform.

Security risks remain. Another important risk naturally relates to the security environment turning more challenging. It is, for example, easy to envisage how regionally related terrorist activities take a larger toll on the tourism industry and foreign investments.

External risks to growth from oil prices and reduced trade. External risks include mainly a higher than expected oil price which would put pressure on government finances. Another risk would be a worsening of global emerging market sentiment or tighter than expected global financial conditions in general could lead to capital outflows.

Egypt: Risk Profile

Key figures	2019
Population (mn.)	91.8
GDP/capita (USD)	2602
Real GDP (% chg)	5.4
Inflation (%)	11.6
Curr.Acc. Balance (% of GDP)	-2.4
Reserves/imports (months)	5.6
Budget balance (% of GDP)	-8.4
Government debt (% of GDP)	84



External ratings:
Fitch: B / Pos
Moody's: B3 / Pos
S&P: B / Stable

Peers:
Bangladesh
Tunisia
Cyprus

Graph: Egypt's risk profile is weaker than the average for all emerging market countries, particularly regarding resilience and event risk, which increased following the revolution in 2011.

Egypt: Key Economic Indicators

Macroeconomic*	2014	2015	2016	2017	2018	2019	2020	2021
GDP real (chg)	2.9%	4.4%	4.3%	4.2%	5.3%	5.4%	5.5%	5.4%
GDP (bn USD)	300.9	317.8	270.1	191.8	234.0	263.1	279.7	279.7
GDP/capita (USD)	3 277	3 388	2 825	1 968	2 357	2 602	2 717	2 673
Investments/GDP	12%	12%	12%	12%	13%	14%	16%	17%
Trade/GDP (%)	37%	35%	33%	63%	67%	66%	67%	72%
Money & Prices								
CPI inflation (%)	10%	10%	14%	30%	14%	12%	10%	10%
Interest rates	11.0%	11.2%	14.3%	19.4%	18.5%	16.3%	15.7%	15.4%
Exchange Rate (USD)	7.1	7.7	10.0	17.8	17.8	18.1	18.2	18.6
Government Finances*								
Budget balance/GDP	-11.5%	-11.4%	-12.0%	-10.7%	-9.8%	-8.4%	-7.6%	-6.4%
Govt debt/GDP	89%	97%	103%	92%	86%	84%	81%	78%
Balance of Payments (USD bn)								
Current account	-6.0	-17.2	-19.9	-8.9	-6.7	-7.6	-8.2	-9.0
(share of GDP)	-1.8%	-5.3%	-6.7%	-3.9%	-2.5%	-2.4%	-2.3%	-2.2%
Export of goods	41.8	41.8	35.5	66.1	86.9	95.8	104.2	112.6
Imports of goods	68.7	69.4	53.8	55.6	71.0	77.1	82.0	87.7
Other current acct flows	21.0	10.3	-1.6	-19.4	-22.6	-26.2	-30.4	-33.9
Net FDI	4.4	6.7	7.9	7.2	7.3	7.5	7.7	7.8
External Debt & Liquidity (USD bn)								
Reserves	12.0	13.3	20.9	33.2	41.3	45.4	47.5	49.3
In months of next year's imports	2.1	3.0	4.5	5.6	6.4	6.7	6.5	6.3
Gross external debt (% of GDP)	14	15	25	43	42	40	41	45
Gross External Debt	41.8	48.5	67.2	82.9	97.3	105.8	115.4	125.5
o/w short term debt	2.5	2.9	4.1	5.0	5.9	6.4	7.0	7.6
Oil price (Brent)	$99	$52	$44	$54	$71	$61	$66	$67

** Fiscal year (July 1 - June 30).*

Source: OEF (Oxford Economic Forecasting), IMF and Fitch.

Rating history (eoy)				
Fitch	B	B	B	B
Moody's	Caa1	B3	B3	B3
S&P	B-	B-	B-	B-

Type of government: Government heavily influenced by the military

Next elections: Parliamentary - 2019 or 2020. Presidential - 2022

Other:

Latest PC deal: 1991

Recent IMF programmes: 2016, three-year Extended Fund Facility of USD 12 bn.