Egypt: IMF Support Critical

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- We expect the IMF to approve, in the next few weeks, the Egyptian authorities' request for financial assistance, ...
- through a Rapid Financing Instrument (RFI) and a Stand-By Arrangement (SBA).
- This package of financial support would help strengthen confidence in the economy and meet the large financing needs.

Slower growth. The domestic containment measures related to COVID-19, coupled with the global deep recession, are severely affecting the economy. We expect the economy to shift from a growth of 5.4% in the first half of the FY2019/20 (July to December 2019) to a contraction of 2.5% in the second half (January to June 2020). Consequently, headline growth is expected to decline from 5.5% in FY2018/19 to 1.6% in FY2019/20. Manufacturing and services (particularly tourism) are expected to be the sectors more severely impacted.

Weaker external position. Demand and supply shocks related to Covid-19--through lower global trade, tourism, remittances, and tighter global financial conditions--would severely strain the external sector. The sharp decline in exports, tourism, remittance inflows and Suez Canal receipts will widen the current account deficit to 4.1% of GDP in FY2019/20 from 3.5% in 2018/19. The COVID-19 shock has also resulted in a pronounced sudden stop in capital flows to Egypt. Spreads of Egyptian dollar-denominated sovereign bonds were 375 basis points higher by the end of April than in January 2020. Nonresident holding of local currency treasury bills have declined by more than $5 billion in the past two months. Official reserves, excluding gold, dropped by about $5 billion in March, from $41 billion in February, and the decline may have continued last month.

IMF financial support. We expect the IMF to approve the disbursement of $2.8 billion (100% of quota) under the Rapid Financing Instrument (RFI) to address the economic impact of the COVID-19 shock. We also expect the Fund to approve a Stand-by Arrangement (SBA), probably for 2 years and with cumulative access of 200% of quota. The RFI purchase would facilitate increased health spending, a stronger social safety net, and assistance to SMEs to mitigate fallout from the crisis. It would also provide a backstop against the decline in official reserves.

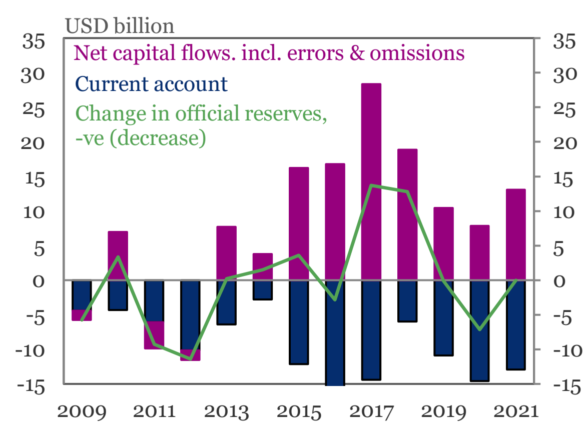
As with the three-year EFF arrangement that expired in November 2019, the size of the SBA would be guided by the country's financing needs, capacity to repay, and track record with use of IMF resources. However, an SBA includes fewer conditions, a shorter repayment period, and less concessional terms than an EFF.

Exhibit 1: External Financing Requirements and Sources
(in billions of dollars, unless otherwise indicated)

	2018/19	2019/20	2020/21	2021/22
Financing requirements	19.8	34.6	32.9	37.1
Current account deficit	10.9	14.6	12.9	13.1
Maturing short-term debt	5.6	9.1	11.5	13.8
Amortization of L-T debt	3.3	10.9	8.5	10.2
Available financing	19.8	34.6	32.9	37.1
FDI net	7.9	6.6	5.8	7.0
Roll-over of ST debt	5.6	9.1	11.5	13.8
Medium & L-T borrowing	13.6	11.8	9.8	10.4
Other net capital flows	-9.4	-5.8	3.9	4.0
ow: portfolio investment	4.1	-2.1	5.3	4.3
IMF	2.0	5.8	1.9	1.9
EFF (ended Nov. 2019)	2.0	2.0	0.0	0.0
RFI (H2 FY2019/20)	0.0	2.8	0.0	0.0
SBA	0.0	1.0	1.9	1.9
Ch. in reserves (- = decrease)	-0.1	-7.1	0.0	0.0
Official reserves, excl. gold	40.3	33.2	33.2	33.2

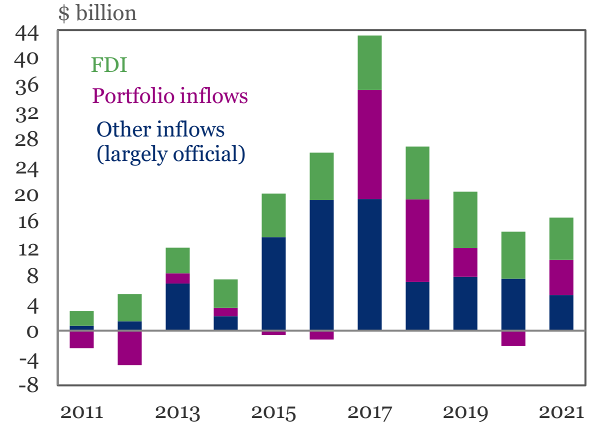
Source: Central Bank of Egypt and IIF estimates and forecasts

Exhibit 2: Inadequate net capital flows and a widening current account deficit will lead to a significant decline in official reserves.



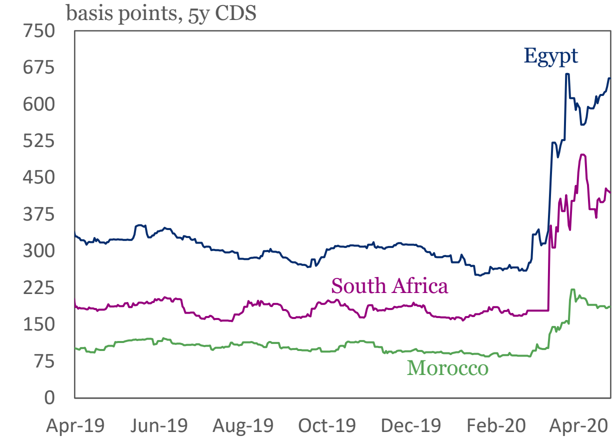
Source: Central Bank of Egypt and IIF estimates and forecasts

Exhibit 3: Non-resident capital flows will decline on the back of portfolio outflows in FY 2019/20.



Source: IIF

Exhibit 4: Spreads of dollar-denominated debt have jumped.



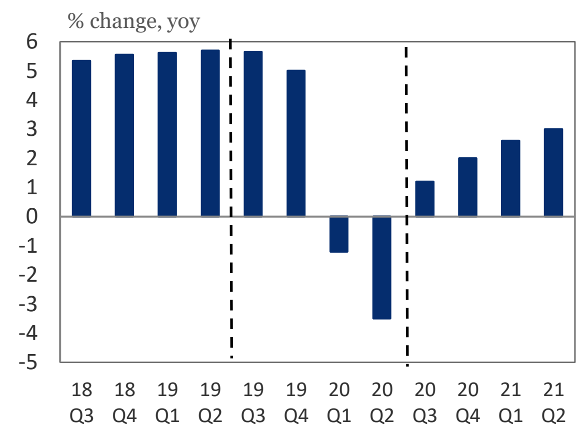
Source: Bloomberg and IIF

Egypt's EFF program (2017-2019) was largely seen as a success story. As the COVID-19 crisis abates, there is need to proceed with a new wave of reforms to support further private sector development and job creation under the requested STB arrangement. In particular, the authorities should aim at reforming public procurement and breaking the iron grip of the state and the army in the economy—to entrench resilience, boost growth potential, and deliver broad-based benefits for all Egyptians.

Monetary easing. To safeguard economic and financial stability, the Central Bank of Egypt (CBE) cut its key policy rates by 300bps in March, the single largest cut in years. The CBE's proactive liquidity and credit-support initiatives (particularly to SMEs) should also shore up activity and safeguard financial stability. We expect monetary policy to ease further, given the fall in CPI inflation and a move toward easing in several emerging and advanced economies. The 12-month headline and core inflation continued falling through March 2020, reaching as low as 5.1% and 1.9%, respectively. The exchange rate of the Egyptian pound has appreciated by about 12% from end-2018 to March 2020.

Fiscal expansion. Despite limited fiscal space and high public debt (around 90% of GDP), the authorities have expanded their social program, with focuses on tackling the health emergency and supporting the most vulnerable. We expect the fiscal deficit in FY 2019/20 (ending June) to widen from 8.0% of GDP in FY2018/19 to 8.5% in FY2019/20 because of lower growth in tax revenues and scaled-up spending. Based on partial information of the draft budget for FY 2020/21, we expect the deficit to narrow to 7.6% of GDP and the primary surplus to increase to 3% of GDP in FY 2020/21. The government intends to increase net debt issuance by 20%. Strong fiscal consolidation will be unavoidable once the Covid-19 crisis abates.

Exhibit 5: Real GDP is expected to contract in the second half of FY2019/2020.



Source: Authorities and IIF through Q4 2019; IIF forecast from Q2 2020 to Q2 2021

Exhibit 6: Main Economic and Financial Indicators

	2017/18	2018/19	2019/20	2020/21
Nominal GDP, $ billion	250.3	302.3	355.6	388.2
Real GDP % change	5.3	5.6	1.5	2.2
Domestic demand	4.4	5.3	1.1	1.5
Exports of goods & serv.	11.5	19.5	-9.4	2.0
Imports of goods & serv.	3.3	11.6	-7.3	-2.0
Headline inflation, ave, %	20.9	13.9	5.7	7.0
Current account, % GDP	-2.4	-3.6	-4.1	-3.3
Official reserves, $ billion	40.4	40.3	33.2	33.2
External debt, % GDP	37.0	36.3	33.7	34.5
Fiscal balance, % GDP	-9.5	-8.0	-8.5	-7.6
Gov't debt, % of GDP	97.5	89.3	91.9	89.4

Source: Authorities through 2018/19; IIF forecast for 2019/20 and 2020/21. Fiscal years July to June.