Egypt: Assistance on the horizon

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Fixed Income Research

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Egypt has formally requested assistance from multilateral and bilateral sources, which is likely to be forthcoming. The size and shape of the package is still to be determined.

A formal financing request

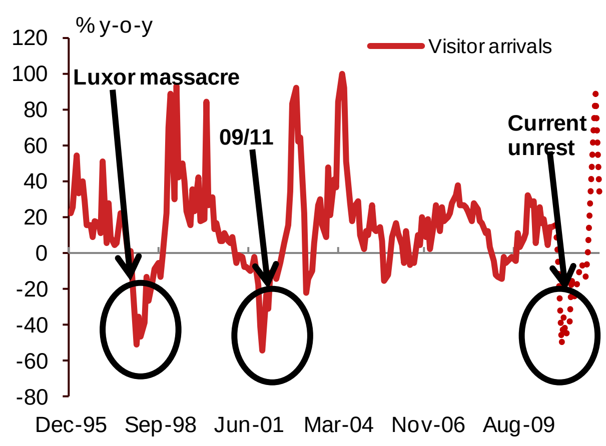
Yesterday, the IMF confirmed that it had received an official loan request from Egypt, in which the authorities indicated an expected financing need of US$10-12bn over the coming year (to June 2012). Along with the Fund, Egypt has reportedly approached other multilateral and bilateral lenders to help meet its expected financing needs, as part of an adjustment program which it has formulated itself. In response to the loan request, the Fund has indicated that it will send a team to Cairo to evaluate needs and discuss any likely conditionality for aid.

This article reflects on the potential effects of slower economic activity, declining tourism revenues, depressed foreign direct investment (FDI) and increased government spending on both external and fiscal accounts and also highlights the expected financing needs arising from upcoming debt rollovers. We then discuss some of the reform areas that are likely to feature in any financial support package, and look at some of the implementation risks. Ultimately, we conclude that while the economic and reform challenges are significant, the political commitment of the international community to support Egypt is strong, which makes the likelihood of reaching agreement high. Nonetheless, keeping to promises made in the program will not be easy, especially in the midst of an historic political transition which has seen the discrediting of former leadership that was supportive of IMF/WB adjustment programs. The current and future political leaders will have a key communications challenge on their hands.

Despite pressure, limited traditional BoP needs for now

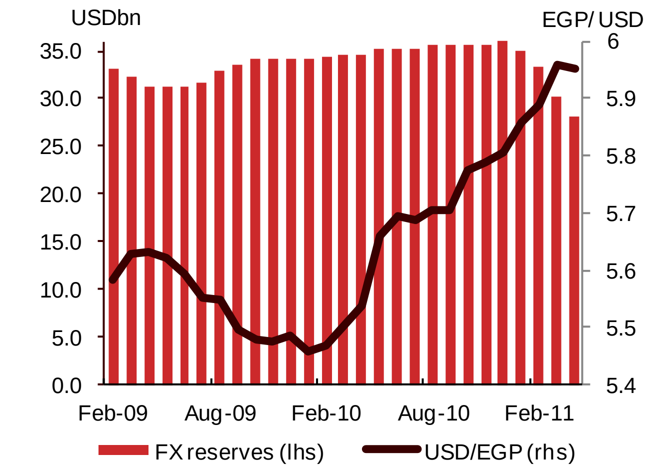
Egypt's external accounts remain under pressure. Declining tourist arrivals have already dented tourism revenues, and they are likely to take some time to recover (Figure1). Looking at past exogenous shocks to the tourist sector like the Luxor attacks in 1997, tourist visits declined by 45% y-o-y in the three months following, resulting in a decline in revenues of approximately 20% in that fiscal year. Applying a similar drop to the current environment would leave arrivals lower by over 3 million people in the next 12 months (compared to the

Figure 1. Visitor arrivals – an historical perspective



Source: CEIC, Nomura Global Economics estimates.

Figure 2. International reserves and exchange rate



Source: Bloomberg, Nomura Economics.

same period last year) and would probably result in a loss of at least US$3bn in revenues, though these figures could be revised upwards, depending on how long the uncertainty lasts. In addition, high global food prices should contribute to a large import bill, while the exodus of Egyptian workers from Libya as a result of unrest there will likely put downward pressure on remittances. Meanwhile, limited prospects for FDI and continued portfolio outflows (though at a slower pace than in Q1) should all contribute to a deterioration of the balance of payments (BoP).

Nonetheless, the buffer of international reserves built by the central bank over the past several years is allowing it to manage outflows in a relatively orderly fashion. Central bank reserves have been drawn down by about US$6bn since the start of the crisis to US$28bn (Figure 2) – still more than six months of imports. A prolonged period of economic stress could lead to more acute BoP pressures, but this will depend to a large extent on political developments in the next 12-24 months.

Short-term fiscal needs are much more acute

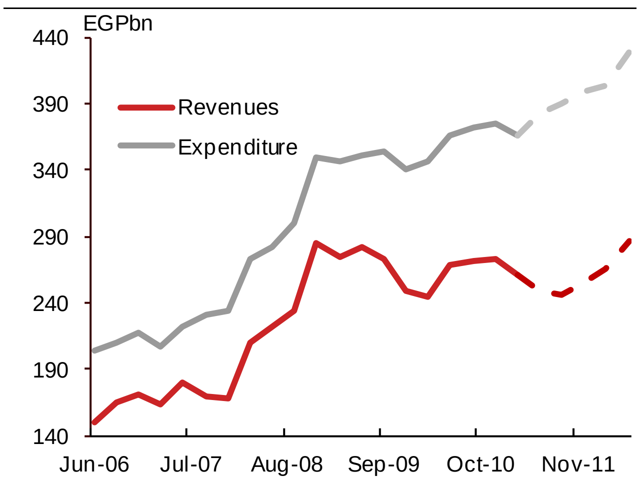
The potential for increased pressure on fiscal accounts is growing, and it is here that any financing package is likely to concentrate. A dramatically weaker economy (we look for just over 1% growth over the next fiscal year, with risks to the downside) is expected to put severe downward pressure on revenues, while post-revolution and pre-election spending demands are already conspiring to push the government to increase expenditure, particularly in light of rising international food and energy prices.

Looking at recent budget results, which provide just an early glance at potential deterioration, we note that revenues already posted a 22% y-o-y decline in January-March (while the revolution did not start until February). This drop was mostly the result of significant losses in tax revenues from income and profits.

For the months ahead, it is worth noting that normally during the Apr-Jun quarter (the last in the fiscal year) some 40% of total revenues are collected. Consequently, the vulnerability of public finances to the still-disruptive environment may be even more acute this year. We assume that revenues collected will remain depressed, which could leave total revenues for the fiscal year at EGP250bn. Over the next fiscal year (2011/12), revenues are expected to pick up slightly as the economy will only gradually recover; we look for total revenues of EGP287bn (Figure 3).

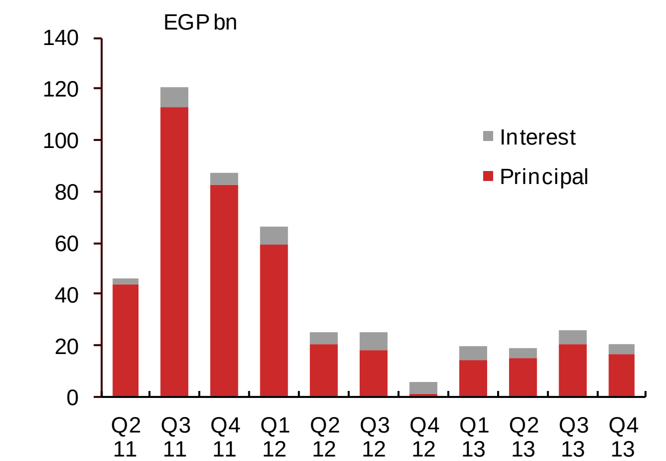
On the expenditure side, after several quarters of limited increases, we expect spending to pick up in the final quarter, leaving total expenditure for the year at EGP391bn and the budget deficit at EGP141bn, or 10.4% of GDP. The period between July 2010 and March

Figure 3. Revenue and expenditure prospects



Source: CEIC, Nomura Global Economics estimates. Note: dotted lines indicate forecasts.

Figure 4. Debt rollover profile



Source: Bloomberg, Nomura Economics.

2011 saw subsidy expenditures of EGP45bn, down some 19% on the EGP55bn spent last year during the same period, although the majority of the decline came in the Jan-Mar period. Spending in this category could increase further in coming quarters. Moreover, recent public sector wage increases are also likely to lead to an increased expenditure bill over time. For the coming fiscal year, we project overall expenditures of EGP430bn.

Egypt's projected financing needs will also incorporate expected rollovers of its debt obligations. Looking at the fiscal year from July 2011, the government has EGP310bn in upcoming obligations that must be met (Figure 4). Putting this together with the projected fiscal deficit would leave financing needs of over 30% of GDP for the fiscal year. Any international lending package would likely aim to help reduce these needs to more manageable levels given the still-challenging environment. Moreover, this should help Egypt's public finances to return to levels which are more in line with its peers with similar credit rating and economic structure (see Figure 5).

Potential sources of finance

It is still early in the assessment of who may contribute to a complete financing package, though at minimum, it would be expected to have an anchor IMF program, as well as some support from the World Bank. Several weeks ago, Finance Minister Samir Radwan indicated that Egypt may seek some US$3-4bn from the IMF and just over US$2bn from the World Bank. In addition to multilateral financing, recent media reports suggest that some bilateral debt relief could also be forthcoming, including possible forgiveness of US$1bn in loans from the US.

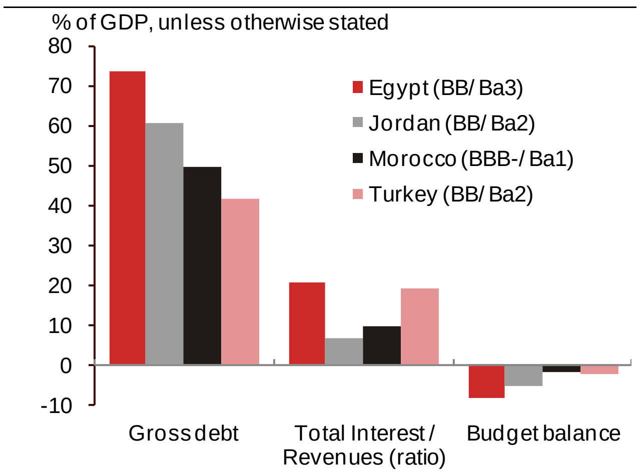
It is possible that international donors and lenders will all ask other countries in the MENA region with ample net foreign assets (such as some of those in the Gulf) to participate in the package, either through loans or through grants. Nonetheless, the potential political challenges around such support – especially given recent efforts to quell protests in some countries – could complicate their ability to provide any meaningful assistance.

Striking a balance with the reform agenda

In order secure any financing package, Egyptian authorities will be asked to commit to a reform program to ensure that fiscal finances are put on a sustainable path, and to meet the longer-term objectives of improving the growth outlook and enhancing prospects for job creation. Egyptian authorities have reportedly put together their own reform program already. In discussions with multilaterals about the conditionality of any loans, we expect the focus to fall on several key areas:

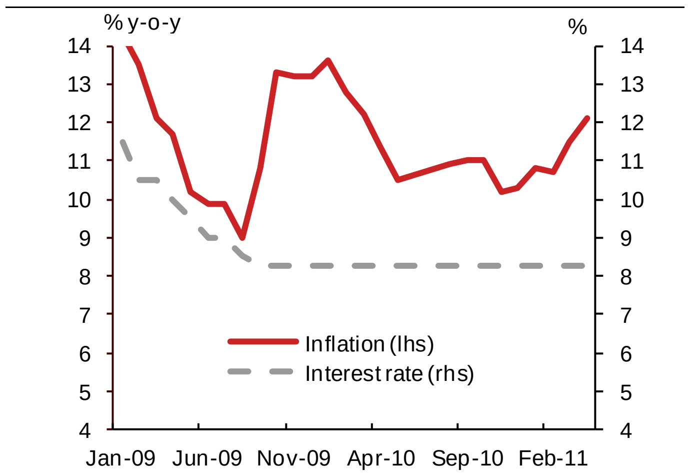
- **Addressing fiscal vulnerabilities**. One of Egypt's most pressing needs is to put its fiscal accounts on a more sustainable path. While it will be difficult to make any major expenditure cuts in the current political environment, there is likely to be a

Figure 5. Fiscal burden comparison



Source: CEIC, Nomura Global Economics

Figure 6. Egypt Inflation



Source: Bloomberg, Nomura Global Economics focus on the need for subsidy reform (to decrease subsidy abuse) and to ensure that support is reaching those most in need. On the revenue side, increasing the tax base will remain an important medium-term goal, but it could be difficult to revive any near-term plans for the already-postponed full-fledged VAT adoption. Nonetheless, the risks of not taking meaningful action are also high. As noted above, financing requirements are growing fast, and if left unaddressed will continue to crowd out the private sector, limit the government's ability to implement counter-cyclical policy in the future, and are likely to put increased pressure on the domestic banking system.

- **Managing inflation expectations.** Recent inflation results have shown the effects of short-term supply disruptions, rising food prices and a weaker exchange rate, as headline CPI inflation accelerated to 12.1% y-o-y, 1.2% m-o-m, in April (see Figure 6). Nonetheless, the central bank has left interest rates on hold, with overnight deposit rate at 8.25% and the lending rate at 9.75%, citing the likely temporary nature of recent price increases, declining core inflation and the potential for the economic slowdown to offset rises in international food prices. Still, the risks that headline pressures spill over into core inflation are rising, particularly given continued demand for wage increases in the wake of the revolution. Moreover, inflation expectations could begin to rise if the central bank holds off on raising interest rates. Over a longer-term horizon, lenders are likely to push for an eventual move toward inflation targeting, though admittedly this may still be several years off.
- **Continued financial sector reforms.** The banking sector has already seen considerable key reform measures under previous programs, so much of the hard work has been done. There will likely be some focus on the need for reforms to improve intermediation and competition, as credit growth has thus far remained subdued. Moreover, lenders will likely stress the need for efforts to provide greater regulatory certainty, including the full implementation of the second phase of the reform program aimed at modernizing prudential oversight.
- **Implementing other longer-term structural reforms.** Many of the structural reforms are likely to be focused on increasing growth potential, improving competitiveness and creating employment (particularly in the private sector). These efforts may include a reinvigoration of the privatization program and increased support for public-private partnership programs. Moreover, pension and healthcare reforms, including moving towards a defined contribution system, could also be on the agenda.

Many of the expected required reforms will likely take time to implement, and as such, should help minimize the near-term stress on any new government. This will be particularly important given the fragile state of the political transition. Nonetheless, it will also be important for the program to maintain credibility if it is to help Egypt gain increased access to international capital markets and diversify its funding sources away from the local banking sector. Finding the right balance between these competing demands will remain an ongoing challenge for the authorities.

Disclosure Appendix A1

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