EGYPT | MACRO NOTE

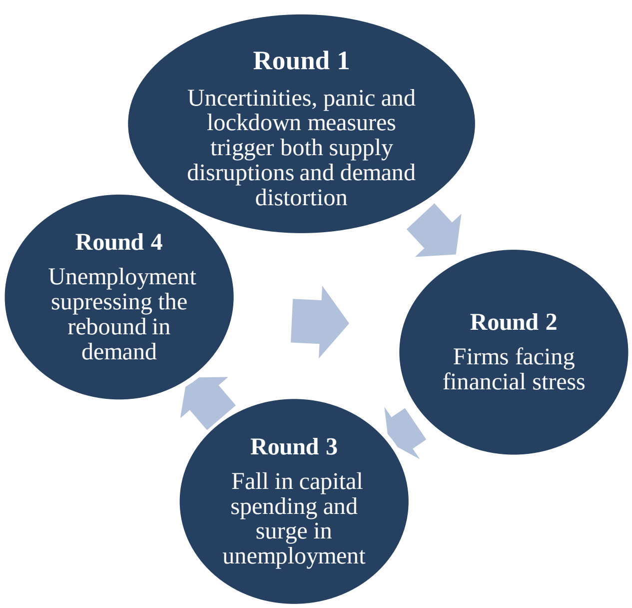
Keeping head above water amid pandemic uncertainties

Monetary measures out of the way; more countercyclical fiscal policy steps in sight

Economic policy makers are faced with a triple whammy, caused by COVID-19, trying to hammer out a formula that would not backfire for three increasingly risky trade-offs. ***First***, the trade-off between flattening the infection curve through isolation and lockdown measures on one hand and the cost of the consequential economic slowdown on the other. ***Second***, the trade-off between providing extensive and effective countercyclical fiscal policy to stimulate growth and the risk of losing the grip over the fiscal deficit and public debt. ***Third***, providing the adequate level of credit to the most hard-hit sectors and the risk of a surge in non-performing loans, which would undermine the banking sector's ability to withstand the storm. Governments around the globe are facing these challenging trade-offs with significant knowledge gap about: (1) the epidemiological characteristics of the virus; (2) the global trajectory of the virus outbreak; (3) the extent of the slump in global economic activities, especially in the Chinese economy which alone represents about 16% of global GDP; and (4) the effectiveness of fiscal stimulus in mitigating the short-term effect on demand, given the absence of historical policy guidance for such unparalleled economic shock. ***Therefore, it would be hard to expect that macroeconomic policies will be easily implemented to balance these trade-offs in a perfect and timely fashion.***

Fiscal stimulus to fill the hole and break the downward spiral. Egypt, like many emerging markets, is falling under pressures have not seen before. The vacuum created by the sudden stop in the global economy is withering external demand and producing huge pressures on those countries' external balances. Moreover, the external financing conditions that faltered on risk-averse mode and capital flights are taking a toll on those countries' ability to meeting funding needs. Over and above, the virus threats to pull the domestic economy into slight contraction in Q4 FY20, for the first time in almost a decade. Furthermore, the trajectory to rebound will be anchored by the effectiveness of macro policies in breaking the chain reaction created by the supply-demand downward spiral.

Figure 1: How the supply-demand downward spiral works



Source: Prime Research.

Supply-demand downward spiral

There are four major dynamics that can determine the trajectory of the fiscal policy of mitigating the short- and long-term impact of the virus upheaval:

1) The level of corporate financial stress.
2) The deterioration in labor market dynamics.
3) The collapse in capital spending.
4) Sequentially, slower rebound in pent-up consumption.

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Leaning on a "whatever it takes" approach, the Egyptian government and the Central Bank of Egypt (CBE) rushed through a raft of new measures to prop up economic growth in the face of the virus turmoil. Following the government's announcement of a fiscal stimulus package of EGP100bn (1.8% of GDP), the CBE announced monetary cum credit measures, including the emergency 300bps rate cut in March 2020, to weather the upheaval caused by the lockdown in response to the pandemic. In Table 1, we can see that most of the fiscal and monetary policy measures are implemented for ***(1) averting the disruptions in the financial markets, (2) allowing the transmission of credit during the economic snarl, (3) ensuring firms have enough cash flows by mitigating financial stress through tax reliefs, and (4) supporting workers in the struggling sectors.***

Table 1: Policy measures in brief

	Fiscal measures	Monetary measures
Financial markets	• Tax on dividends slashed in half. • Stamp tax cuts for both foreign and domestic investors. • Capital gains tax postponed for two years.	• The CBE allocated EGP20bn to support the stock exchange.
Corporates and sectors support	• Export subsidy fund paid EGP1bn in arrears by the end of April. • Lowered energy cost for factories (including natural gas and electricity for medium-, high- and ultra-high voltages) in the industrial sector. • Delayed the payment of property tax due by factories and the tourism sector. • Taxing agricultural lands will be suspended for two years. • Corporate income tax relieved for sectors struggling with the impact of the virus outbreak, i.e. mainly aviation and tourism.	• The CBE reduced the discount interest rate offered under its support programs for factories, mortgage and tourism companies to 8%. • Increased credit limits to finance corporates' working capital. • Postponed all bank loans installments for businesses for a period of six months. • The CBE earmarked an EGP50bn tourism bailout fund for impacted hotels. • The CBE is suspending regulations and black listing against defaulting corporates. • The CBE extended the reach of its EGP100bn industry stimulus initiative to cover all corporates without the eligibility limit on their annual revenues • The CBE expanded its industry stimulus to include agriculture and agricultural production corporates. • The CBE cut interest on soft loans for tourism to 5% from 8%.
Labor market	• A monthly payment of EGP500 to irregular workers for three months. • Emergency aid to employees in the tourism sector.	• The CBE is suspending regulations and black listing against defaulting individuals.
Health sector	• EGP187.6mn of the EGP100bn package was disbursed to the Ministry of Health. • EGP2.25mn was allotted for state-paid healthcare workers.	

Source: Prime Research.

The government has to do whatever it takes to keep corporates afloat to prevent waves of production cutbacks and the ensuing surge in non-performing loans and unemployment. Fiscal policy has more room for mitigation action than the monetary policy at this stage. Fiscal stimulus has the power to put the brakes on the supply-demand downward spiral by boosting demand more directly and quickly than the monetary policy. So far, the proposed fiscal policy measures have focused on three areas:

1) Using a transfer system to mitigate the fall in demand.

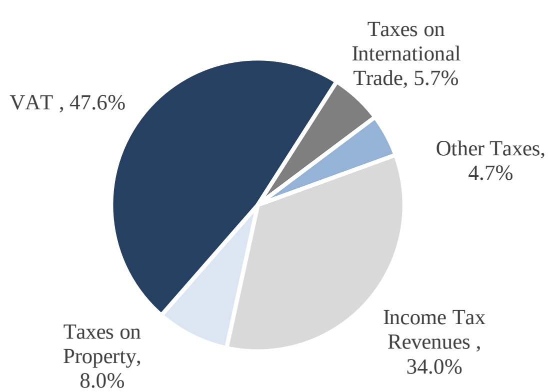
2) Discretionary fiscal measures, mainly for the health sector.

3) Targeted state support for the sectors most hit by the COVID-19 crisis.

However, moving too slow and/or too little is risky, given the uncertainties that still bound any attempt—no matter how calculated—to forecast the extent of the virus-driven economic strain and its duration. Fiscal measures can take a form of preferential tax treatment (tax holiday or tax refund) in a tailored manner and cash injection through bailout plans for front-line sectors. A further energy price cut is still another option on the table, especially for manufacturing industries that are facing deterioration in both export and domestic demand. Meanwhile, expanding public investment is inevitable especially in the health sector.

Does the country have the fiscal capacity to expand its fiscal mitigation measures while maintaining its fiscal deficit within the target of 7.2% in FY20 and 6.3% in FY21? In our view, the answer is no. These targeted numbers are hard to achieve during such unprecedented shock, not only due to the urgent need for fiscal support to boost the domestic economy but also because of the expected fall in government tax revenues on the back of slower economic activities and plummeting corporate profits.

Figure 2: Tax revenues breakdown (FY19, EGP736bn)



Source: Ministry of Finance.

Tax revenues hit by the COVID-19

- The plunge in economic activities will take its toll on VAT taxes which account for almost half of total tax revenues.
- Corporate profits, which account for 30% of total income tax and 9% of total tax revenues, will also suffer, under the pandemic fallout.
- In H1 FY20, tax revenues were almost flat compared to last year as VAT on imported goods and taxes on international trade fell under the pressure of EGP appreciation.

The cost of mitigation measures and weak government revenues driven by the plunge in economic activity could push the deficit to 9.5% in FY20, according to our estimates. ***However, in our view, implementing well-tuned countercyclical measures would help the economy break the spiral of demand-supply disruptions and put the growth on recovery track within a year. The faster the rebound in growth, the quicker the recovery in fiscal revenues, and the more capable the government in putting the public finances back on a more sustainable footing*.**

The IMF support package for technical and financial aid was the next ultimate move as foreign appetite for local debt instruments is currently ebbing and FX revenues are significantly dwindling. As widely expected, Egypt is now in talks with the IMF for further funding arrangement. We estimate that the fund package can reach up to USD6.8bn from two funding programs, Rapid Financing Instruments (RFI) and Standby Agreement (SBA). ***The access to RFI would be used to support the country's balance of payments (BoP), while the SBA should be allocated to finance the growing fiscal needs to combat the effect of the virus upheaval. The IMF support should also help the country to shore up foreign investors' trust and provide technical guidance for effective policies that are essential to forestall worse outcomes of the current crisis.***

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