Mona Bedeir
Chief Economist
T +202 3300 5722
mbedeir@egy.primegroup.org

Before the Grand Storm

The current account deficit (CAD) in Q2 FY22 improved on both annual and quarterly basis, thanks to relative improvements in the trade deficit, a rebound in the services balance, and high remittance inflows. CAD contracted by 22% y/y in Q2 FY22 after expanding by 44% y/y in Q1 FY22, leading to a deficit of USD3.8bn. On a quarterly basis, CAD also declined by 5% q/q, but at a slower pace than the 22% q/q fall in Q1 FY22. **The following factors influenced CAD in Q2 FY22:**

(1) **For the first time since Q1 FY21, the trade deficit fell, albeit marginally.** Trade deficit declined by 0.1% y/y on a considerable rise in exports (+78% y/y to USD11.8bn vs. +41% y/y in Q1 FY22). Meanwhile, imports also increased but at a relatively slower pace (+30% y/y vs. +34% y/y in Q1 FY22), although they remain at historic highs of USD22.5bn.

(2) **In Q2 FY22, LNG exports staged its greatest recovery.** The hydrocarbon trade balance improved to a solid surplus of USD2.2bn from a deficit of USD101mn in Q1 FY22. Hydrocarbon exports set a new historical high of USD5bn (vs. USD2.9bn in Q1 FY22) on higher LNG prices and volumes.

(3) **Annual non-hydrocarbon trade deficit growth moderated in Q2 FY22 (+22.6% y/y vs. +26% y/y in Q1 FY22),** owing principally to a 46% y/y increase in non-hydrocarbon exports (vs.+27% y/y in Q1 FY22), reaching USD6.8bn. Meanwhile, imports continued to grow at a substantially high rate, increasing by 30% y/y to USD19.6bn. Non-hydrocarbon trade deficit remained at an all-time high of USD12.8bn, driven mainly by higher global commodity prices.

(4) **Service surplus grew at a slower pace due to an increase in service payments.** Service surplus reached USD2.7bn in Q2 FY22 (vs. USD2.9bn in Q1 FY22 and only USD1mn in Q2 FY21), helped by a strong rebound in the tourism sector, which generated USD3bn (vs. USD2.8bn in Q1 FY22 and only USD987mn in Q2 FY21). Suez Canal revenues remained almost flat q/q but grew 11% y/y to USD1.7bn. Meanwhile, service payment surged by 50% y/y to USD4bn, driven by Egyptians' pent-up demand for travel.

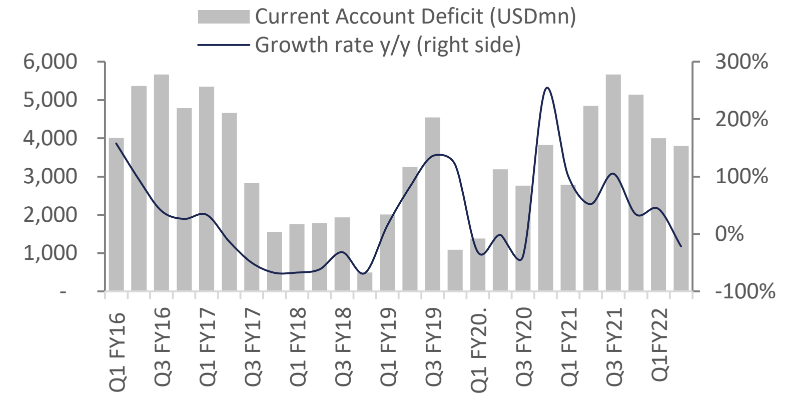
(5) **The deficit in investment income continue to weigh on CAD,** growing by 36% y/y in Q2 FY22 vs. 27% y/y in Q1 FY22, driven by a 48% y/y increase in investment income payments, including earnings of foreign corporates in Egypt and interest payments.

(6) **Remittances slipped in Q2 FY22, in line with our expectations.** Remittances fell by 0.8% y/y to USD7.3bn vs. USD7.5bn in Q2 FY21 and USD8.1bn in Q1 FY22.

(7) **As global tightening circumstances forced FPI to report a net outflow for the first time since Q1 FY21, CAD was financed by net borrowing and other investment.** Net FPI inflows fell further, with a net outflow of USD6bn compared to a net inflow of USD3.6bn in Q1 FY22. Egypt lost USD3.6bn in capital outflows from the T-bills in Q2 FY22, owing to a major shift in the Fed's monetary stance. Meanwhile, FDI declined by 8.7% y/y to USD1.6bn in Q2 FY22 (42% of CAD), after increasing by 4% y/y to USD1.7bn in Q1 FY22.

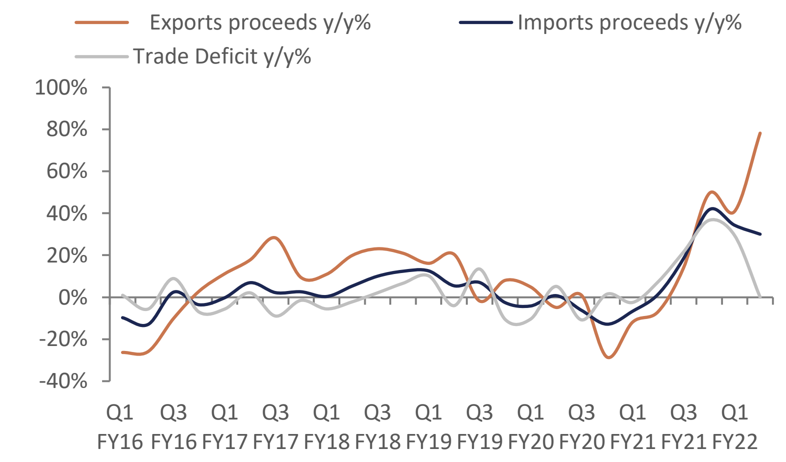
The overall balance of payments (BoP) was in deficit, largely owing to net capital outflows and net errors and omissions (NEO), reflecting the growing pressures on the country's external position, despite the improvement in CAD. Overall, the BoP ran a USD325mn deficit in Q2 FY22 versus a USD311mn surplus in Q1 FY22.

Figure 1: CAD was on the path of improvement before the war



Source: CBE, Prime Research.

Figure 2: LNG exports drives notable exports recovery



Source: CBE, Prime Research.

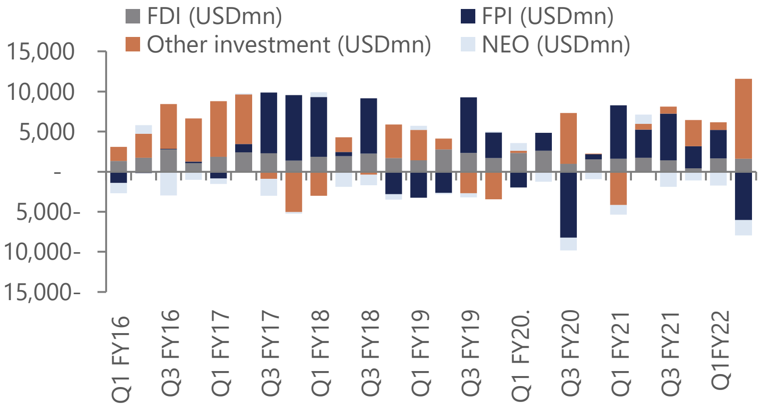
We now have three main takeaways based on what we had expected prior to the Russia-Ukraine war and the performance of BoP in H1 FY22:

(1) **CAD was set to ease to a lower level compared to a year before, but this seems unlikely now.** Prior to the fast acceleration in geopolitical tension and conflict-induced disruptions in global commodity markets, we had forecasted CAD to ease to 3.1% of GDP in FY22, which is equivalent to USD14.2bn. In H1 FY22, CAD was on the path to meet our forecast, having registered USD7.8bn, thanks to a strong recovery in tourism and LNG exports. However, the war has led us to revise our forecast; we now expect CAD to widen to 3.8% of GDP in FY22, amounting to USD16.7bn.

(2) **The effect of the war in Europe started to affect Egypt's external position through three channels (i) trade deficit, (ii) tourism revenues, and (iii) external funding gap. First**, we expect the hydrocarbon trade deficit to improve over the course of FY22, resting on a surge in LNG prices that is set to help the country face the higher cost of imported fuel products. **However, non-hydrocarbon trade deficit will remain the main source of weakness.** It will also be subject to further deterioration despite the CBE's measures to curb imports, due to the higher import bills and the risk of long-lasting global supply disruptions that affect global commodities, especially food imports. The fast depletion of strategic wheat reserves (less than 2.5 months in early April) drove the country to purchase 350,000 tons of wheat last week despite the significantly-higher prices. We estimate the trade deficit will accelerate further in FY22 to 11.6% of GDP, up from the 9% of GDP we had previously anticipated. **Second**, we also revise downward our projection for tourism revenues on the backdrop of an expected slower tourism influx from Russia and Ukraine to reach USD10.6bn by end of FY22. **Third**, Egypt's external funding needs, according to our estimate, are expected to reach USD21.3bn in H2 FY22. The rapid escalation of geopolitical tensions in Eastern Europe, coupled with the drastic shift in global monetary conditions, threaten the country's ability to access funds to finance its external needs. Thus, the March decision to hike interest rates by 100bps and loosen the grip on the EGP was necessary to contain external pressures and safeguard Egypt's external buffers in the event of a more persistent and protracted crisis, given the state of total FX liquidity in the banking sector and significant pressures on the CAD.

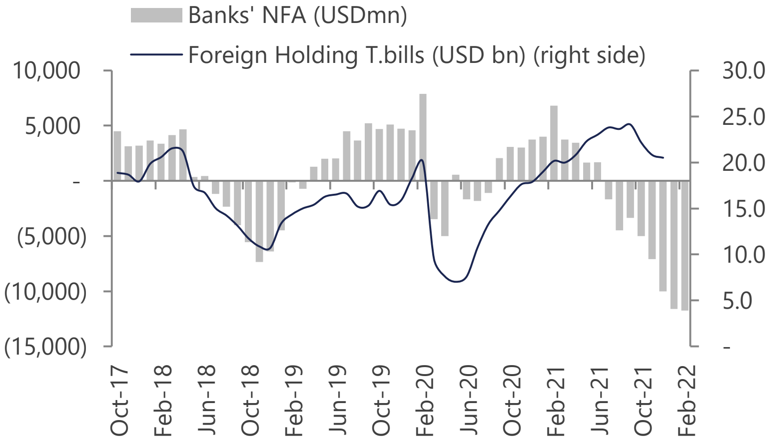
(3) **An IMF deal, in addition to GCC support, should help Egypt meet its funding needs as the outlook for capital inflows is still clouded by the Fed's monetary stance.** We believe an IMF program would help narrow the funding gap by providing a range of USD2-3bn, given the country's current outstanding borrowing from the fund (USD24bn by end of September 2021), making it one of the biggest borrowers from the fund behind Argentina. The latest GCC investment inflows should boost FDIs in FY22 to exceed our early projection of USD8bn, ending the year at USD10bn. **We believe the IMF support and GCC financial inflows will ease investors' concerns about Egypt's external funding gap. However, global tightening conditions will continue to be a major worry, keeping the CBE's monetary stance more hawkish than originally envisaged.**

Figure 3: Financial account on surplus, thanks to borrowing and other investment



Source: CBE.

Figure 4: Even before the geopolitical crisis, capital outflows have been accelerating since Q2 FY22



Source: CBE, Prime Research.

Prime Securities

Shawkat El Maraghy
Managing Director
T +202 3300 5622
SElmaraghy@egy.primegroup.org

Sales

Mohamed Ezzat
Head of Sales & Branches
T +202 3300 5784
MEzzat@egy.primegroup.org

Emad El Safoury
Manager
T +202 3300 5624
EElsafoury@egy.primegroup.org

Mohamed Ashmawy
Head of Institutional Sales
T +202 3300 5612
MAshmawy@egy.primegroup.org

Shawkat Raslan
Heliopolis Branch Manager
T +202 3300 8130
SRaslan@egy.primegroup.org

Amr Alaa CFTe
Team Head –Institutional Desk
T +202 3300 5609
AAlaa@egy.primegroup.org

Nashwa Abuelatta
Alexandria Branch Manager
T +202 3300 5173
NAbuelatta@egy.primegroup.org

Mohamed El Metwaly
Manager
T +202 3300 5610
MElmetwaly@egy.primegroup.org

Research

Amr Hussein Elalfy CFA
Head of Research
T +202 3300 5724
AElalfy@egy.primegroup.org

Head Office

Prime Securities S.A.E.
Regulated by FRA License No. 179.
Member of the Egyptian Exchange.

2 Wadi Elnil St., Liberty Tower, 7th Fl.
Mohandessin, Giza, Egypt
T +202 3300 5700 / 770 / 650 / 649
F +202 3760 7543

Branches

Heliopolis
7 Elhegaz Square
Heliopolis, Cairo, Egypt
T +202 2777 0600
F +202 2777 0604

Alexandria
7 Albert Al Awal St.
Smouha, Alexandria, Egypt
T +202 3300 8170
F +202 3305 4622

Website

www.primeholdingco.com

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