



WORLD BANK GROUP
Macroeconomics, Trade & Investment

EGYPT ECONOMIC MONITOR

FROM FLOATING TO THRIVING:
TAKING EGYPT'S EXPORTS TO
NEW LEVELS

July 2019



© 2018 International Bank for Reconstruction and Development / The World Bank

1818 H Street NW, Washington DC 20433

Telephone: +1 202-473-1000

www.worldbank.org

This work is a product of the staff of The World Bank with external contributions. The findings, interpretations, and conclusions expressed in this work do not necessarily reflect the views of The World Bank, its Board of Executive Directors, or the governments they represent.

The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

Rights and Permissions

The material in this work is subject to copyright. Because The World Bank encourages dissemination of its knowledge, this work may be reproduced, in whole or in part, for noncommercial purposes as long as full attribution to this work is given.

Any queries on rights and licenses, including subsidiary rights, should be addressed to World Bank Publications, The World Bank Group, 1818 H Street NW, Washington, DC 20433, USA; fax: 202-522-2625; e-mail: pubrights@worldbank.org.

Photo Credit:

Cover photo: Aerial view container cargo ship, import-export business logistics, and transportation of International by ship in the open sea: © Avigator Fortuner 887/Shutterstock

Internal photo: Aerial top view container ship with crane bridge for load container, logistics import export, shipping or transportation concept background. © Studio concept/Shutterstock

Cover design: Rana Al Gazzaz

PREFACE

The Egypt Economic Monitor is a product of the World Bank's Global Practice for Macroeconomics, Trade and Investment. It provides an update on key economic developments and policies and highlights the key challenges facing the country in the domestic, regional and global context, while assessing possible implications for the economic outlook. It also includes an analytical chapter that explores a special focus area that is of relevance to the country's development. The report is intended for a wide audience, including policy makers, private sector businesses, financial market participants and the community of analysts and professionals engaged on Egypt

This issue was prepared by Hoda Youssef (Senior Economist), Sara Alnashar (Economist), Jala Youssef and Amr Elshawarby (Consultants). The Special Focus chapter was prepared by Hoda Youssef, based on a World Bank Policy Research Working Paper co-authored with Chahir Zaki (Associate Professor, Cairo University). The report was prepared under the guidance of Kevin Carey (Practice Manager), Ibrahim Chowdhury (Program Leader), Sona Varma (Lead Economist) and Marina Wes (Director). Rabah Arezki (Chief Economist) and Ha Nguyen (Economist) provided helpful comments. Raghada Abdelhamied (Team Assistant) provided administrative assistance. Maissa Abdalla (Online Communications Officer) managed the media relations and dissemination.

The findings, interpretations, and conclusions expressed in this Monitor are those of World Bank staff and do not necessarily reflect the views of the Executive Board of the World Bank or the governments they represent.

TABLE OF CONTENTS

Overview.....	7
Chapter One. Recent Economic Developments.....	9
Drivers of growth are shifting from consumption to investment and net exports.....	9
Labor market indicators are yet to reflect a broad-based growth recovery	11
Fiscal reforms are paying off, but important challenges remain.....	12
Inflation receded but remains elevated, with adverse effects on socioeconomic conditions.....	16
External position improved markedly; non-oil exports are yet to catch-up.....	18
Tight monetary conditions and large financing needs have adverse effects on private sector credit...21	
Risks and challenges originate from debt and extra-budgetary activities	23
Economic Outlook.....	24
Annex 1.1 – Main Macroeconomic Indicators.....	27
In Focus. From Floating to Thriving: Taking Egypt’s Exports to New Levels.....	28
Egypt is yet to meet its export potential	29
The production and export landscapes.....	30
Regional integration, a forgotten agenda?.....	32
Explaining the untapped potential.....	33
Non-tariff measures: from legitimate objectives to trade barriers.....	34
Strategic location but limited connectivity.....	36
Three policy areas to unleashing exports potential.....	37
References	41
Annex 2.1 The Gravity Model to Assess Trade Performance.....	42

LIST OF FIGURES

Figure 1. Drivers of GDP growth have changed recently.....	10
Figure 2. Most of the sectors grew at a reasonable pace in FY2018.....	10
Figure 3. Small sectors are the biggest contributors to growth.....	10
Figure 4. Unemployment rate declined, but so did the employment and LFP rates.....	11
Figure 5. Part of the previously unemployed leave the job market.....	11
Figure 6. Fiscal consolidation is on track.....	13
Figure 7. Education and health sectors are yet to benefit from the freed-up resources.....	13
Figure 8. Expenditures on wages compared to peers.....	14
Figure 9. Interest payments are high and increasing.....	14
Figure 10. Savings from energy subsidies are redirected to pensions and fiscal consolidation.....	15
Figure 11. Inflation has receded but remains in the low double-digits.....	17
Figure 12. Energy and utilities price hikes are non-transient shocks.....	17
Figure 13. The BOP has improved, helped by a narrowing CA deficit.....	18
Figure 14. Current account continues to improve in H1-FY2019.....	18
Figure 15. Tourism is picking up but remains below potential.....	18
Figure 16. Oil trade balance runs a surplus in H1- FY2019.....	19
Figure 17. Remittances played an important role in improving the current account.....	19
Figure 18. NIB picked up part of the T-bills dropped by foreign customers.....	20
Figure 19. Oil and gas are the engine of incoming FDI, 2018 (Percentage of GDP).....	20
Figure 20. The Egyptian pound has regained flexibility.....	20
Figure 21. Domestic credit is primarily extended to the public sector (% of total).....	22
Figure 22. Net foreign assets are bouncing back after a steep decline (in EGP billion).....	22
Figure 23. The larger share of debt is domestic but external debt has increased in recent years.....	23
Figure 24. Exports and Trade deficit.....	29
Figure 25. Depreciation and Non-Oil Exports Growth.....	29
Figure 26. Composition of Egyptian exports, FY2018.....	29
Figure 27. Main exports markets.....	30
Figure 28. Egypt's products space, 2016.....	31
Figure 29. Top exporting items and RCAs.....	31
Figure 30. Egypt's exports growth and global demand by product.....	32
Figure 31. Evolution of Tariff Rates, by Sector.....	34
Figure 32. Logistics Performance Index, Egypt.....	37
Figure 33. Capacity for Innovation.....	38
Figure 34. High-Technology Exports.....	38

LIST OF ABBREVIATIONS

AEO	Authorized Economic Operators
BoP	Balance of Payments
BPS	Basis Points
CBE	Central Bank of Egypt
COMESA	Common Market of Eastern and Southern Africa
CPI	Consumer Price Index
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
EGP	Egyptian Pound
EIB	European Investment Bank
EIU	Economist Intelligence Unit
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
GAFTA	Greater Arab Free Trade Area
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GoE	Government of Egypt
GOEIC	General Organization for Export & Import Control
ICA	Investment Climate Assessment
IMF	International Monetary Fund
ITC	International Trade Centre
LFP	Labor Force Participation
LPI	Logistics Performance Index
MIIC	Ministry of Investment and International Cooperation
MoF	Ministry of Finance
MPC	Monetary Policy Committee
NFA	Net Foreign Assets
NIB	National Investment Bank
NIR	Net International Reserves
NSW	National Single Window
NTMs	Non-Tariff Measures
PMI	Purchasing Manager Index
PMR	Product Market Regulations
PPT	Percentage Points
PTA	Preferential Trade Agreements
SEZs	Special Economic Zones
SOEs	State-Owned Enterprises
SPS	Sanitary and Phytosanitary
STCs	Specific Trade Concerns

UEMOA	West African Economic and Monetary Union
UNDESA	United Nations Department of Economic and Social Affairs
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organization

OVERVIEW

Confronted with pervasive macroeconomic imbalances and microeconomic distortions, the Government of Egypt (GOE) started in 2016 to move forward with important reforms to stabilize the economy and restore confidence. At that time, Egypt was facing daunting economic and structural challenges, unsustainable fiscal and external imbalances and a deterring business environment. The severe foreign currency crunch that peaked in late 2016 motivated the GOE to introduce transformative economic reforms to alleviate the longstanding structural constraints to inclusive growth and macroeconomic stability. The flagship reforms of the economic program were (i) the liberalization of the exchange rate to eliminate the large currency overvaluation and foreign exchange shortages; (ii) a fiscal consolidation program that introduced a value-added tax (VAT) and a gradual reduction in energy subsidies and the wage bill, and (iii) major energy sector reforms to address power outages by public and private investment in generation and reestablish Egypt's potential as an oil and gas producer by reducing pricing distortions and arrears. These reforms were complemented by efforts to improve the business climate and attract private investment, starting with legislative reforms and the introduction of new laws on industrial licensing, investment, and insolvency.

Macroeconomic indicators have reacted positively to the stabilization reforms. Most notably, economic growth has accelerated, the parallel market for foreign currency exchange has been contained, external deficits have narrowed, and international reserves have replenished. Public finances are progressing on a more sustainable path, with a firm containment of spending on price subsidies and a narrowing fiscal deficit. The improvement in macroeconomic conditions have also reflected positively on investors' perceptions, with credit rating agencies upgrading their ratings and outlook for Egypt.

Despite their success in stabilizing the macro-fiscal environment and strengthening confidence in the economy, the adopted measures came with adverse socioeconomic effects that were partially mitigated. The highest impact came from the rise in inflation rates driven by the large currency depreciation, which triggered a sharp increase in the cost of living. Whereas vulnerable groups were partially shielded from the impact of inflation through targeted social protection measures, these mitigation measures remain limited in coverage and nature, and leave the middle class struggling to cope with the erosion of real incomes. On the fiscal side, despite the remarkable consolidation efforts, the GOE is still struggling to create the fiscal space necessary to shift towards a human-capital focused policy, where policies and social programs are geared towards a wider concept of social safety nets. This would include productive spending on education, health, social protection and government services, while mobilizing the needed domestic resources through effective and equitable taxation.

As Egyptians look forward to more and better jobs, improved government services and more inclusive economic opportunities, the focus needs to shift towards the next wave of reforms. While macroeconomic stability remains a key pillar for sustained economic improvement, the second generation of reforms should put larger emphasis on leveling the playing field to allow for more private sector participation in the economy, based on fair and transparent rules of competition and economic empowerment. There is also a need for a greater focus on human capital and productivity to better equip the labor force with the necessary skills to engage in economic activity. Reforms in these

important areas are likely to reflect positively on the country's competitiveness and, most importantly, translate into more job creation and better living conditions for the population.

The focus chapter of the Egypt Economic Monitor looks at an important aspect of the economy's competitiveness: export performance and integration into global markets. The large depreciation of local currency was expected to reflect positively on exports performance and reinvigorate the exports-oriented private sector. Yet, the increase in non-oil exports remains modest, thereby suggesting that Egypt could not entirely benefit from such a large depreciation. The focus chapter investigates two questions that may explain this underperformance: (i) to what extent is the structure of domestic production supportive of export-oriented growth? and (ii) what are the key trade and non-trade barriers that prevent the country from unleashing its exports potential? The analysis identifies three main areas where historic lack of reforms has impeded Egypt's ability to fully exploit the recent competitiveness gains from currency depreciation and shift towards an exports-oriented model of growth where exporting firms can flourish and grow. These are the (i) concentration of exports in traditional areas of comparative advantage as opposed to goods that are subject to high global demand; (ii) significant trade (especially non-tariff) barriers; and (iii) connectivity and infrastructure challenges.

CHAPTER ONE

Recent Economic Developments

Drivers of growth are shifting from consumption to investment and net exports.

Macroeconomic indicators have reacted positively to the reforms undertaken by the government of Egypt (GoE). Real GDP grew robustly by 5.3 percent in FY2018 compared to 4.2 percent in the previous year, and an average of 3.5 percent during FY2013-FY2016. Economic growth remained robust in H1-FY2019, reaching 5.4 percent compared to 5.2 percent in the same period of the previous year. The largest contributors to GDP growth in FY2018 were net exports followed by private investment, indicating that the drivers of economic growth are shifting from private consumption, which has historically been the main contributor to GDP growth, even during years of slow economic activity (**FIGURE 1**). Conversely, public consumption and investment contribution to growth is diminishing. The domestic savings rate has thus started to rise once again reaching 6.2 percent of GDP in FY2018 after declining to a fifteen-year low of 1.8 percent in FY2017.

With an influx of capital expenditure to the energy, extractives and real estate sectors, private investment is picking up but remains stifled by the difficult business environment and high interest rates. Private investment improved in FY2018 and became the main driver of total investments in Egypt for the first time since FY2009. Total investments contributed 2.4 percentage points (ppt) to GDP growth in FY2018 (compared to 1.6 the year before), out of which private investments contributed 1.3 ppt compared to 1.1 ppt for public investments. This is explained by

increased capital expenditure in the real estate and natural gas sectors, with the latter being driven by the large natural gas fields discoveries. Other indicators suggest however that non-oil private sector activity continues to be stifled by a challenging business environment. For instance, the purchasing managers' index (PMI), a barometer of private business sentiment, which captures activity in non-oil sectors, contracted for seven months over the first ten months in FY2019. In many cases, the contraction was driven by a decline in output and the fall in non-oil export orders.

Net exports became the largest contributor to GDP growth, helped by competitiveness gains of the depreciated local currency, but the exports base remains narrow and concentrated in extracted gas.

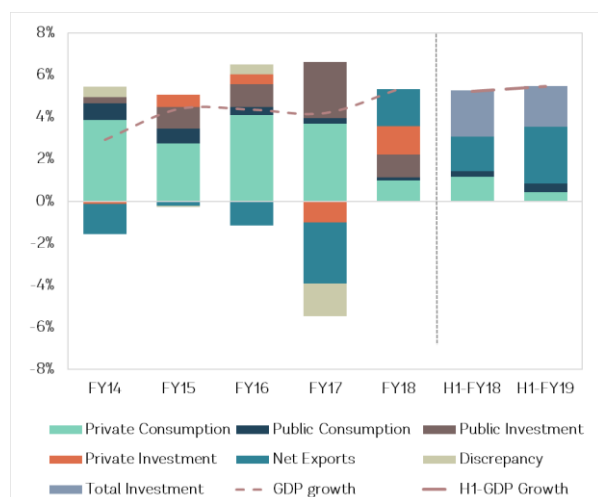
Historically, net exports weighed negatively on growth, a trend that was reversed in FY2018 as they contributed 1.8 ppt to GDP growth (compared to -2.9 ppt in FY2017), largely driven by a boost in exports (particularly gas exports) which outpaced imports growth. Net exports continued to improve in H1-FY2019, contributing 2.7 ppt to GDP compared to 1.6 ppt in H1-FY2018.

Public consumption and investments contributed modestly to growth due to their relative slowdown.

In FY2018, public consumption spending - adjusted by inflation- grew at a modest pace of 1.7 percent (FY2017: 2.5 percent), the lowest growth rate since FY2007. Public investment spending -adjusted by inflation- grew in FY2018 by 12.5 percent in contrast to 41.7 percent in FY2017. Given their relatively lower growth rates and their small weight in GDP, their contribution to growth is relatively modest.

FIGURE 1. Drivers of GDP growth have changed recently

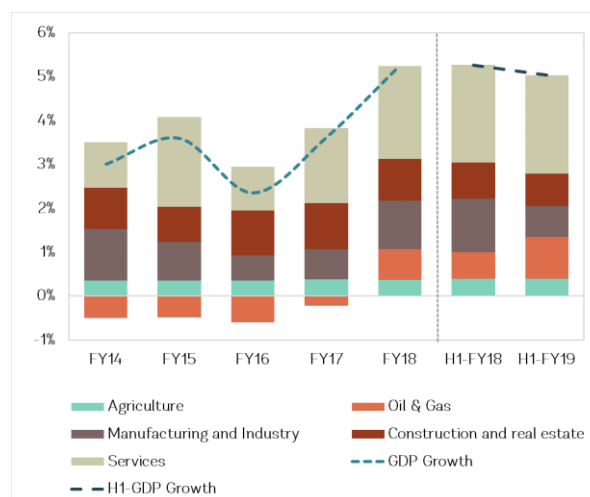
Contributions to GDP, demand side (%)



Note: The breakdown of investment into public and private sectors was not available for H1-FY19 at the time of publishing. Only total investment is displayed for H1-FY18 and H1-FY19. Source: Ministry of Planning¹

FIGURE 2. Most of the sectors grew at a reasonable pace in FY2018

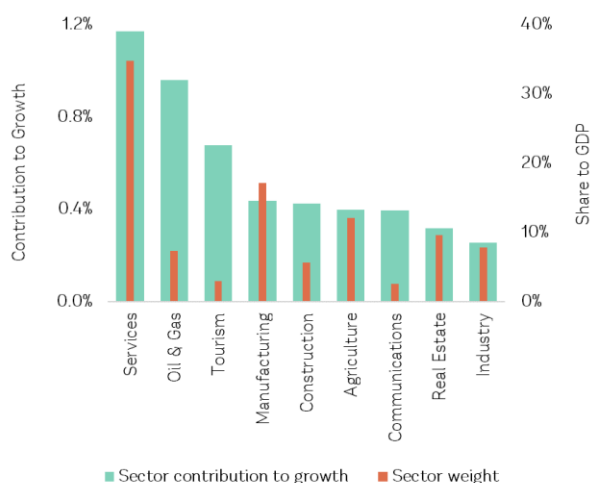
Contributions to GDP, supply side (%)



Source: Ministry of Planning and CBE

On the sectoral side, most of the sectors grew at a reasonable pace in FY2018, but concerns remain over the limited drivers of recovery beyond gas and tourism (FIGURE 2). Sectoral growth has been helped by a favorable exchange rate and gas discoveries. The manufacturing sector was the largest contributor to GDP growth in FY2018 with a 0.8 ppt, but its contribution in H1-FY2019 was more modest, contributing 0.4 ppt to GDP growth (H1 FY2018: 0.9 percent of GDP). The same pattern was observed for the other industrial sectors. Tourism contributed 0.7 ppt to GDP growth in FY2018, up from 0.1 ppt the year before. Construction and real estate activities contributions to growth remained stable in FY2018 at 1 ppt (FY2017: 1 ppt) but have since then decreased to 0.4 and 0.3 ppt each in H1-FY2019, potentially signaling a relative slowdown in the real estate market despite the expansion in large scale construction projects.

FIGURE 3. Small sectors are the biggest contributors to growth



Note: The Services sector includes Suez Canal, wholesale and retail trade, brokerage, insurance, general government, health, education and personal services. Source: Ministry of Planning

¹ Throughout the report, “Ministry of Planning” is used for conciseness. This refers to “Ministry of Planning, Monitoring and Administrative Reform”.

Despite the overall extractives sector doing well, the petroleum sector has been a drag on growth since FY2016. The sector has been suffering a liquidity crunch, notably since the decline in oil-FDI, which was later exacerbated by the foreign exchange shortages of 2016. It has however started to rebound in H1-FY2019, recording a positive albeit small contribution to growth (0.1 ppt). The sluggish pick up in the petroleum sector could be attributed to outstanding stock of arrears owed to foreign oil companies (estimated at US\$1.9 billion in end-June 2018).

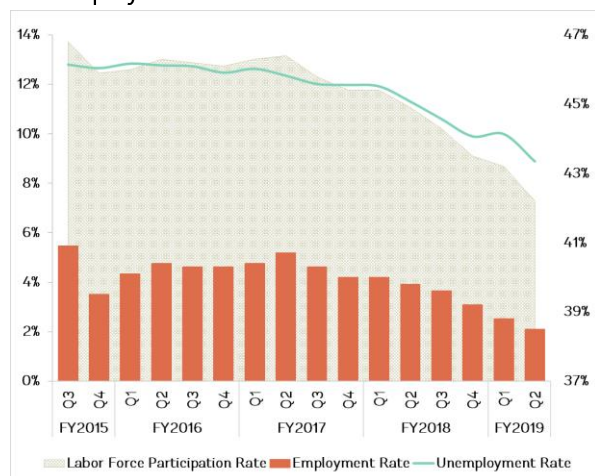
Labor market indicators are yet to reflect a broad-based growth recovery

The unemployment rate declined, but the recent growth recovery does not seem to fully reflect on all labor market outcomes. Unemployment declined to 8.1 percent by Q3-FY2019, compared to 12.6 percent before the beginning of the reforms in Q1-FY2017. This is the lowest unemployment rate since 2011, a decline that should correspond to an equivalent increase in employment rates. Yet, employment rates also fell to 38.5 percent of the population (compared to 40.4 percent in Q1-FY2017), in tandem with a decline in the labor force participation (LFP) to 41.6 percent (compared to 46.3 percent during

the same period) (FIGURE 4). Falling labor force participation is particularly unexpected in a fast growing and young-dominated population like Egypt. A closer look at LFP rates confirms that this declining trend applies to both male and female LFP rates. While the reasons for such a decline in LFP are not clear, possible explanations include seeking employment opportunities abroad, women opting out of the job market, or giving up searching for a job. This declining trend in LFP and employment rates calls for a better understanding of the underlying factors behind the decline in unemployment, and to disentangle the relative weight of these two factors in driving down unemployment. For instance, labor market surveys indicate that out of the 621,000 individuals who are no longer unemployed in Q2-FY2019 compared to a year before, only 474,000 have become employed whereas 147,000 have exited the labor force (FIGURE 5).

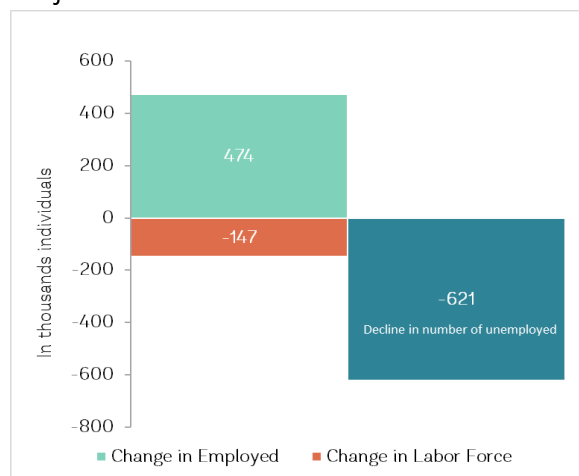
The chronic problem of youth unemployment is particularly challenging, and it is mainly concentrated among those with university education. Around 22 percent of youth (age 15 to 29) are unemployed as of Q2-FY2019 compared to 25 percent in Q2-FY2018. Youth also dominate the unemployed population, as 78.7 percent of unemployed individuals in Q2-FY2019 are between the ages of 15 to 29.

FIGURE 4. Unemployment rate declined, but so did the employment and LFP rates.



Source: CAPMAS – Quarterly Labor Force Surveys

FIGURE 5. Part of the previously unemployed leave the job market



Additionally, 44.6 percent of the total unemployed have a university degree. Although the figures suggest an improvement in youth unemployment, the overall trend becomes unclear in the context of a declining youth labor force participation from 9.4 million in Q2-FY2018 to 7.2 million in Q2-FY2019.

Several reasons may explain the chronic youth unemployment. From the demand side, this suggests that the private sector is not growing fast enough to compensate for the role that was traditionally played by the public sector. From the supply side, anecdotal evidence suggests that the skills of the new entrants to the job market do not necessarily correspond to the type of skills that the private sector needs. Additionally, limited access to finance is hampering the development of entrepreneurship (Barsoum, 2016² and Assaad, 2017)³.

Gender disparity also plays an important role in unemployment in Egypt. Female unemployment has declined to pre-2011 revolution levels, reaching 20 percent in Q2-FY2019. However, this happened in tandem with a decline in female LFP rate, which fell to 16.7 percent in Q2-FY2019 down from an average of 23 percent before 2011. Female LFP in Egypt is one of the lowest rates globally, reflecting several barriers that impede integration of women in the labor market. These include cultural barriers, in addition to a traditional preference for public sector jobs given their favorable work conditions for young women (Barsoum, 2016). It is also argued that oil remittances and a generous pensions system that extends benefits to eligible female survivors including widows, sisters and unmarried daughters might further disincentivize women from joining the labor market.

Fiscal reforms are paying off, but important challenges remain

Egypt is addressing long-standing fiscal imbalances as a cornerstone of its wider economic reform program. Overall fiscal and primary deficits have historically been elevated, averaging 10.0 percent and 3.0 percent of GDP, respectively, in FY2002-17. The peak of the fiscal slippage occurred in FY2013, when the overall and primary deficits reached 12.9 percent and 5.0 percent of GDP, respectively. The fiscal deterioration was mainly driven by a large drop in the revenue-to-GDP ratio, as well as the acceleration of public expenditure, notably in response to heightened social demands, leading to a surge in the public-sector wage bill, subsidies, and social benefits.

Important fiscal reforms on both the expenditure and revenue sides have led to a gradual decline in the fiscal deficit. Between FY2016 and FY2018, the overall fiscal deficit narrowed by around three percentage points to 9.7 percent of GDP, while the deficit in the primary balance improved by 3.6 percentage points—and turned positive during the same period (**FIGURE 6**). The new value-added tax (VAT) regime, introduced in September 2016, boosted tax revenues (**FIGURE 7**), while energy subsidy reforms and measures to rein in the wage bill reduced their share of GDP.

Public expenditure reforms are a main pillar of the fiscal consolidation plan and essential to address both the level and structure of spending. Public expenditure averaged 30.8 percent of GDP in FY2014-17, before gradually declining to 27.8 percent of GDP in FY2018. This is higher than the average of 17.3 percent in lower middle-income countries.

² Barsoum, G. (2016) "Youth Unemployment in Egypt", Global Encyclopedia of Public Administration, Public Policy and Governance.

³ Assaad, R. (2017) "Dynamics of the Egyptian Labor Market", Presentation at the Egyptian Center for Economic Studies (ECES), December 2018.

Expenditures reforms have mostly focused on reducing inefficient and unsustainable expenditure items.

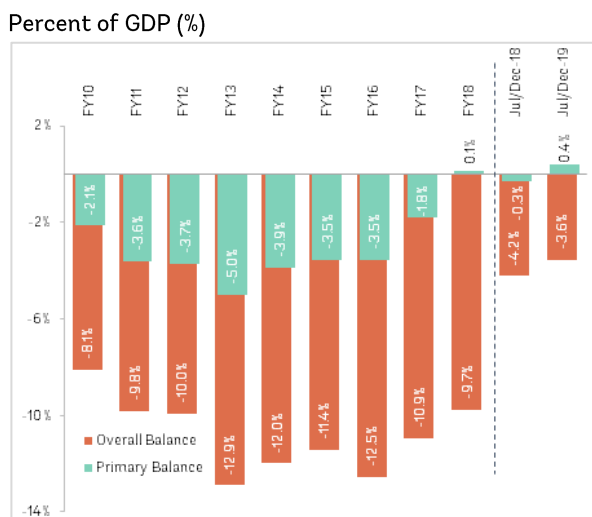
Notably, energy subsidies and public wages had peaked at 6.9 percent of GDP in FY2013 and 8.5 percent of GDP in FY2014, respectively. Multiple increases in fuel prices and electricity tariffs resulted in a decline in energy subsidies to 3.4 percent in FY2018. With the share of fuel declining from 55.0 percent to 37.0 percent of total spending on subsidies between FY2011 and FY2018, the freed-up resources allowed for expanding spending on other social programs, while the rest of savings contributed to fiscal consolidation. This trend continues in FY2020 budget. With the fifth increase in energy prices of July 2019 and the introduction of an indexation mechanism for fuel prices, spending on fuel and electricity subsidies is budgeted to decrease by EGP 35 billion (bn) and EGP 12 bn, respectively (a total of EGP 47 bn). Part of the savings will reflect on higher spending on social welfare contributions (20bn), social housing (4bn), grants and other benefits (3bn), subsidies to industrial zones (2bn), subsidies to rationed goods (1.9bn), social security pension (1bn), while the total spending on subsidies is expected to decrease by EGP 19bn compared to expected levels for FY2019. Other changes in subsidies composition

include a decline in subsidies to farmers and their health insurance by over EGP 0.5 bn. Additionally, spending on health-related subsidies (for example on health insurance for young children's, beneficiaries of social solidarity schemes and the program for treatment at the expense of the State, PTES) seem to gradually decline in favor of the government contribution to the new universal healthcare system. On the contrary, budget contributions to pension funds have been growing, absorbing an expected 20 percent of all subsidies spending in FY2019 compared to only 3 percent in FY2011 (Figure 10).

The education and health sectors have yet to benefit from the freed-up resources.

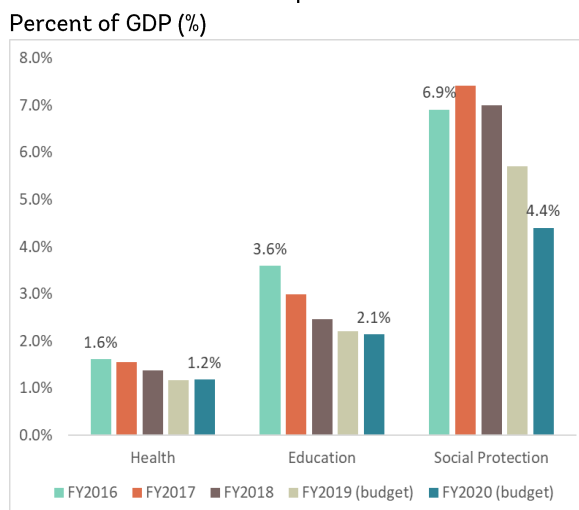
Despite a constitutional mandate to increase spending on education and health to 6.0 percent and 3.0 percent of GDP, respectively, the size of the education sector decreased from 3.6 percent of GDP in FY2016 to 2.5 percent in FY2018 and budgeted at 2.2 percent in FY2019. Similarly, health spending was 1.6 percent of GDP in FY2018—well below its constitutional target. The share of public spending on health and education includes debt servicing for both sectors and the provision of drinking water and sanitation for the health sector.

FIGURE 6. Fiscal consolidation is on track



Source: Ministry of Finance

FIGURE 7. Education and health sectors are yet to benefit from the freed-up resources

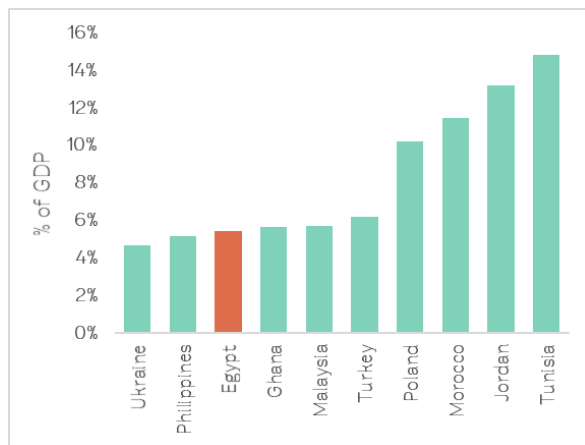


The public sector wage bill has been contained in recent years, but declining real wages may result in recurring wage bill pressures over the medium term. The public-sector wage bill absorbs one-third of total public expenditures and has consistently been the second largest expenditure component. It peaked at 8.5 percent of GDP in FY2015 as a result of an expansion in government employment, before declining to 5.3 percent of GDP in FY2018 (FIGURE 8). The gradual decline in wage expenditure was driven partially by the consolidation of allowances and bonuses into the base pay, while capping wage increases and limiting new hiring. In a context of high inflation, the limited growth in wages has resulted in declining real wages, which may reflect poorly on the incentives of civil servants and adversely affect productivity and public service delivery. As a result, there is a risk that these measures unravel over the medium term and result in recurring wage bill pressures. Undertaking functional reviews to inform structural reforms, as well as institutional reforms that focus on weaknesses in the management of wage and employment processes can help prevent the recurrence of wage bill pressures. The authorities could aim to periodically track and control both the number of government employees and total compensation paid to these employees. These

data can prove helpful to policymakers in determining the source of temporary wage bill pressures. Investment in IT systems to monitor the wage bill can also greatly contribute to improving the management of wage bill spending and enhance service delivery.

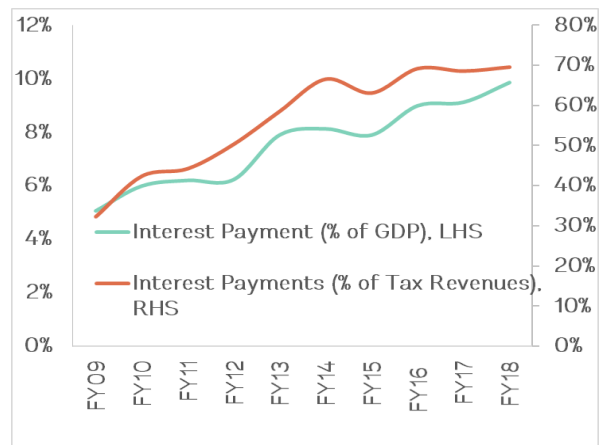
Large interest payments—the budget’s single largest component— exert tremendous pressure on the budget and undermine government efforts to spend on priority areas. Large borrowing needs have led to a rapid increase in interest payments, absorbing 35 percent of total spending in FY2018. This is equivalent to close to 10.0 percent of GDP, absorbing 70.0 percent of tax revenue (FIGURE 9). The surge in interest payments has mainly been driven by the monetary tightening, as the Central Bank of Egypt hiked key policy interest rates by 700 bps between November 2016 and July 2017 to contain inflation pressures. Furthermore, the deterioration in the maturity structure of domestic debt has also contributed to the larger interest burden, as the Ministry of Finance opted for more short-term issuances rather than the long end ones. Reducing interest payments is contingent upon achieving successive primary balance surplus, in tandem with mindful borrowing.

FIGURE 8. Expenditures on wages compared to peers



Note: Figures reflect FY2018 for Egypt, and 2017 or most recently available for peers.
Source: IMF GFS and Ministry of Finance

FIGURE 9. Interest payments are high and increasing



Source: Ministry of Finance

Large public debt ratios weigh on the public budget and have led to rising debt servicing costs. A pick-up in economic growth and a slowdown in domestic borrowing decreased the total public debt to an estimated 97.3 percent of GDP at the end of FY2018, from a peak of 108.0 percent of GDP in FY2017 (a cumulative increase of over 30.0 percentage-points compared to FY2012). The government’s debt has historically been high (averaging 97.0 percent of GDP in FY2002-2017) and driven by primary deficits as well as the episodes of exchange rate depreciations. Around 80.0 percent of debt is domestic. Though the debt ratio is expected to continue on a downward path, significant risks remain in terms of size, composition, contingent liabilities, and policy reversal (see the debt sustainability analysis below).

On the revenues side, higher levels are needed to create fiscal space for growth-enhancing public spending in areas such as infrastructure, healthcare, and education. Tax receipts are the main source of revenue for the GOE, although its tax collection efforts are the lowest among peers. In FY2014-16, tax revenue constituted, on average, 65 percent of government revenues and averaged 12.6 percent of GDP. Following the start of fiscal reforms, tax revenues increased from 13 percent to 14.2 percent of GDP in FY2018, with the increasing trend continuing in H1-FY2019. The increase in tax revenues comes from indirect taxes, which suggests a better enforcement since no changes in VAT tax rates were implemented since 2017. Meanwhile, income taxes revenues have declined compared to FY2016 levels, which calls for using more efficient tools in tax collection through tax administration and policy reforms. More reliable and predictable sources of revenue would help the government transition to medium-term budgeting and avoid a pro-cyclical fiscal policy.

FIGURE 10. Savings from energy subsidies are redirected to pensions and fiscal consolidation

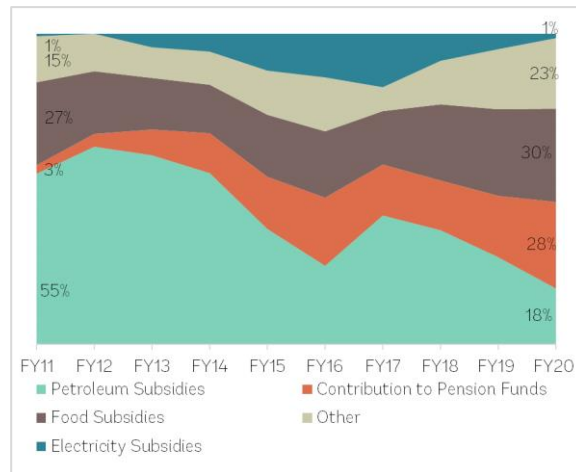
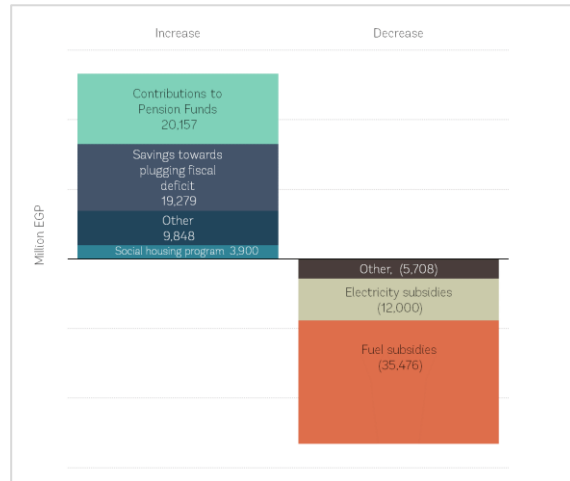
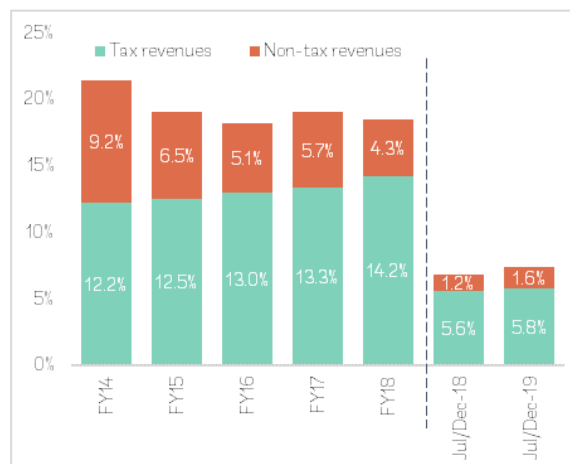


FIGURE 11. Tax revenues are low but improving
Percent of GDP (%)



Source: Ministry of Finance

TABLE 1. Fiscal Summary

(in percent of GDP)	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019 ^e
Total Revenues	19.3	18.3	19.0	21.7	19.1	17.7	19.3	18.5	18.3
Tax Revenues	14.0	12.5	13.6	12.4	12.6	12.7	13.6	14.2	14.3
Non-Tax Revenue	5.3	5.8	5.4	9.3	6.6	5.0	5.8	4.3	4.1
Total Expenditures	29.3	28.4	31.9	33.4	30.2	29.5	30.3	28.0	26.5
Compensation of Employees	7.0	7.4	7.8	8.5	8.2	7.7	6.6	5.4	5.1
Purchases of Goods & Services	1.9	1.6	1.4	1.3	1.3	1.3	1.2	1.2	0.0
Interest Payments	6.2	6.3	8.0	8.2	7.9	8.8	9.3	9.9	0.0
Subsidies, Grants & Social benefits	9.0	9.1	10.7	10.9	8.2	7.3	8.1	7.4	0.0
Other Expenditures	2.3	1.9	1.9	2.0	2.1	2.0	1.8	1.7	1.1
Purchases of Non-Financial assets	2.9	2.2	2.1	2.5	2.5	2.5	3.2	2.5	0.0
Overall Fiscal Deficit	-9.8	-10.1	-13.0	-12.2	-11.5	-12.3	-11.1	-9.7	-8.2
Primary Fiscal Deficit	-3.6	-3.7	-5.0	-3.9	-3.5	-3.5	-1.8	0.1	1.9

Note: e=expected, based on World Bank estimates of GDP in FY2019.

Source: Ministry of Finance.

Inflation receded but remains elevated, with adverse effects on socioeconomic conditions and investment decisions

While necessary, the adopted reform measures carried immediate costs, by fueling inflation and creating economic and social hardship, most notably for the middle class. A record high inflation rate was triggered by the large currency depreciation, which had a widespread impact in a highly imports-dependent economy. The increase in energy prices and the introduction of the VAT have had an additional adverse impact on prices, with inflation reaching a peak of 33 percent in July 2017. Since then, headline inflation has receded significantly but remains in the low double-digits, rising occasionally following energy and utility (electricity and gas) price adjustments or temporary food price shocks (**FIGURE 11**). Headline inflation averaged 21.6 percent during FY2018, declining to 9.4 percent in June 2019. The main driver of inflation is food and beverages which constitutes 40 percent of the CPI basket, the largest contributor to inflation across time. Other important contributors are housing and

utilities prices, and transportation prices. Core inflation on the other hand has averaged 21 percent during the FY2018, declining to 6.4 percent in June 2019.

There seems to be a persistent component in inflation, which causes the effect of price adjustments to last longer. The energy subsidy reform program has involved annual upward revisions of energy and utility prices around the start of every fiscal year since 2014. This induced an increase in the prices of transportation and utilities, driving up inflation as evidenced by a jump in their contributions to inflation around June/July of every fiscal year (**FIGURE 12**). However, these higher contributions to inflation tend to remain elevated throughout the year, possibly pointing to other contributing factors such as inflation expectations and supply side issues

While recent episodes of high inflation were induced by transitory cost, fiscal factors contribute to the persistence of relatively high inflation rates, even in the absence of acute shocks. Recent data show that average headline inflation was below 3 percent in G-7 countries and China and below 5 percent in other MENA countries over the period

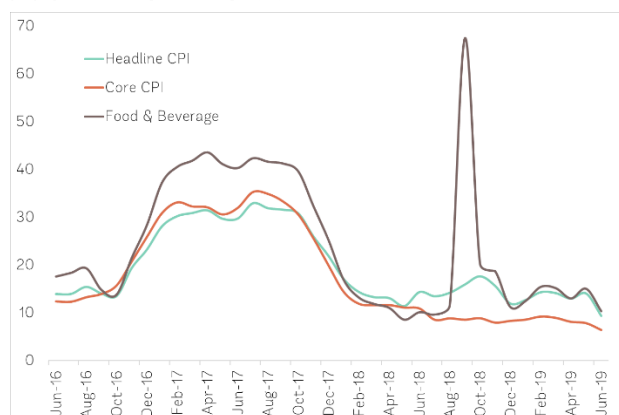
2011-2015, versus an average of 9.4 percent in Egypt over the same period. Beyond the price adjustments and seasonal effects that trigger spikes in inflation, fiscal and accommodating monetary policies have been historically not conducive to price stability. High fiscal deficits and the growing footprint of the Government in the financial sector is reflected in monetary base expansion and sustained inflation. This is evident from the expansion in domestic liquidity that is largely driven by credit extended to government, which also absorbs the largest share of total credit.

Structural factors related to the degree of competition in the economy and the efficiency of goods markets may also explain persistent high inflation in the economy. Despite the significant role of competition in supporting private sector development, its transformational potential for Egypt has not yet been unleashed and the degree of competition in Egyptian markets is still perceived to be weak. Egypt ranks 51st out of 137 countries on the extent of market dominance, 88th on the intensity of local competition and 115th on anti-monopoly policy (Global Competitiveness Report, 2018). Surveys on

operational business risks indicate that Egypt compares well with other MENA countries, but the existence of vested interests and unfair competitive practices remains the highest competition-related risks for companies, thus harming their incentives to invest (EIU, 2017).

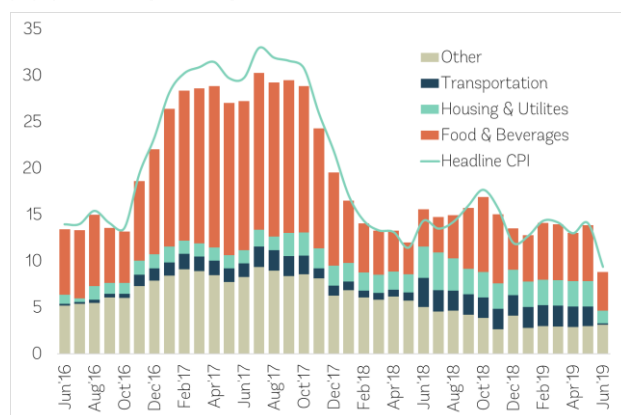
Markets dynamics and prices could benefit from increased competition. Preliminary results from Product Market Regulations (PMR) indicators identify several elements affecting competition, especially those related to the scope of State control and other regulations that limit competition and affect private sector development in key sectors of the economy⁴). State-owned enterprises (SOEs) play a dominant role in key sectors of the economy: among all surveyed countries and 27 screened sectors, Egypt is the only one where the state controls at least one firm in 26 of these sectors, compared to an average of 14 in the PMR data set countries. Out of these, 17 are non-infrastructure sectors typically served by private operators, including manufacture of refined petroleum products, basic metals, fabricated metal products, wholesale trade, and restaurants and hotels.

FIGURE 11. Inflation has receded but remains in the low double-digits, y/y percentage change (%)



Source: Central Bank of Egypt & CAPMAS

FIGURE 12. Energy and utilities price hikes are non-transient shocks y/y percentage change (%)



Source: Central Bank of Egypt & CAPMAS

⁴ Source: Markets and Competition OECD-WBG PMR Indicators for Arab Republic of Egypt, OECD PMR

database and OECD-World Bank Group PMR database for non-OECD countries.

Addressing restricting regulations and practices, in addition to the effective implementation of competition rules and related regulatory instruments, are all necessary to facilitate new firms' entry and operation, and for markets to work better.

High inflation disproportionately hurts the poor and those living on fixed income, and complicate investment decisions. Social protection programs have been stepped up to mitigate the impact on the most vulnerable, for example through the Takaful and Karama cash transfer programs and higher allocations of food subsidies. The GoE has also announced an increase in the civil servants' wages and pensions, to take effect with the start of FY2020 as a mitigating measure that caters more for the middle class. While representing an important step in the social protection agenda, these mitigation measures remain limited, as the erosion of real incomes imposes a socioeconomic hardship and threatens the sustainability of the reforms. Additionally, high inflation complicates investment decision by reducing the predictability of goods and services' cost, price and demand.

External position improved markedly; non-oil exports are yet to catch-up

The balance of payments (BOP) has improved remarkably, helped by a narrowing current account deficit. The overall BOP surplus reached 5.1 percent of GDP in FY2018 compared to -0.6 percent in FY2016 (FIGURE 13). These developments came on the back of improved current account and capital and financial account in FY2018. The current account deficit narrowed markedly in FY2018, reaching 2.4 percent of GDP compared to 6.0 percent in FY2016 (FIGURE 14). The improvement in the current account is largely supported by a strong inflow of private transfers (mainly in the form of workers' remittances), a rebound in tourism revenues and a lower trade deficit supported by contained energy imports as

FIGURE 13. The BOP has improved, helped by a narrowing CA deficit
Percent of GDP (%)

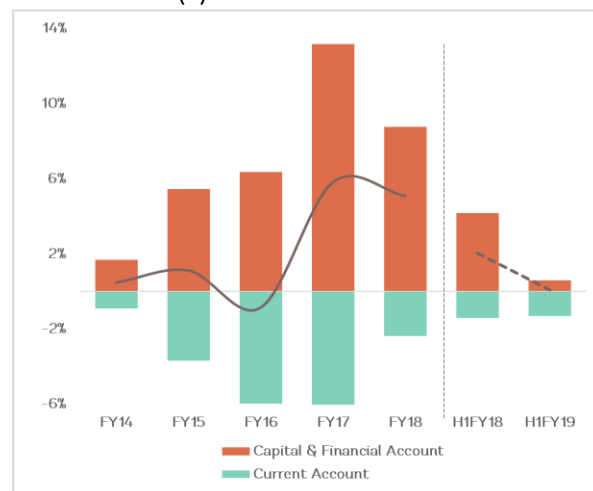


FIGURE 14. Current account continues to improve in H1-FY2019
Percent of GDP (%)

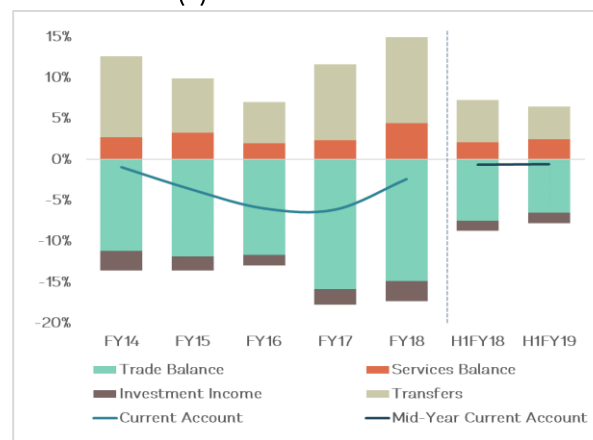
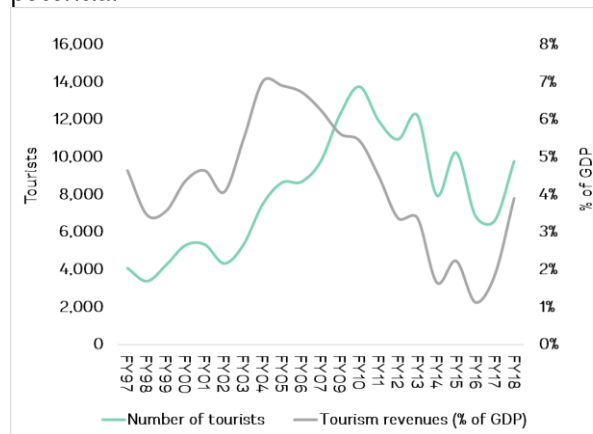
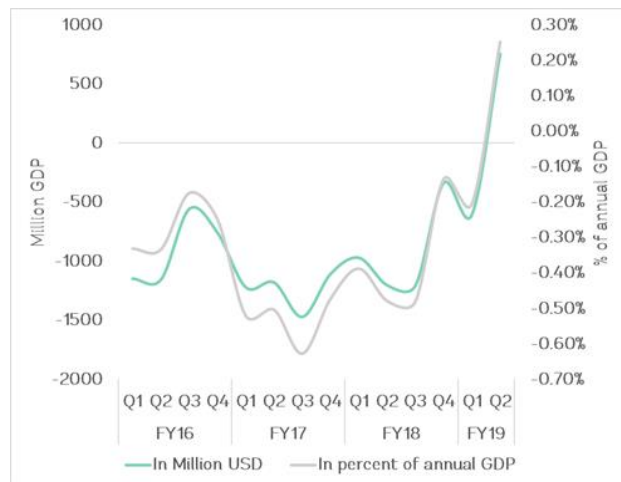


FIGURE 15. Tourism is picking up but remains below potential



Source: Central Bank of Egypt

FIGURE 16. Oil trade balance runs a surplus in H1-FY2019

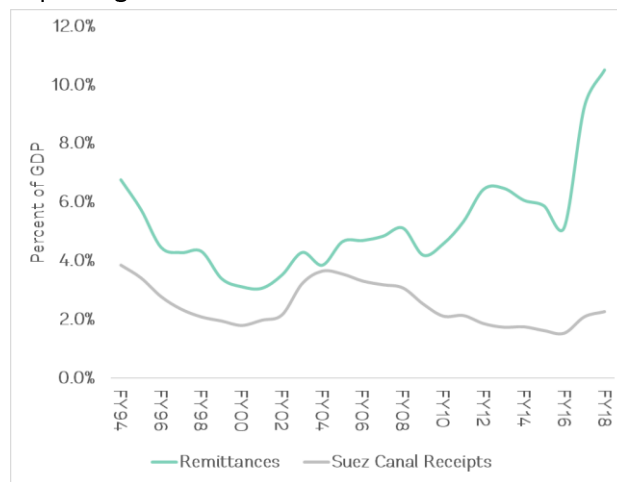


Source: Central Bank of Egypt

offshore gas fields become operational, in addition to lower oil prices. The improving trend has continued in H1-FY2019, as the current account deficit narrowed to 1.3 percent of GDP (compared to 1.4 percent in the first half of the previous year), again supported by improved tourism receipts and a declining trade deficit as the oil trade balance turns positive (FIGURE 16). However, non-oil exports remain weak and workers' remittances have slowed down, suggesting that the FY2018 surge may have been a one-off occurrence related to a wave of returning workers from the Gulf countries that undergo nationalization of jobs programs. Meanwhile, Suez Canal receipts have increased to the highest levels since FY2010.

The trade deficit narrowed, helped by an increase in exports proceeds while import payments remained constrained. Trade deficit declined to 14.8 percent of GDP (down from 15.8 percent in FY2017) with continued improvements during H1-FY2019. This containment of imports is supported by increased natural gas production with the launch of the Zohr gas field and Egypt approaching self-sufficiency, which has also helped the oil trade balance to run a surplus in H1-FY2019 for the first time in more than four years.

FIGURE 17. Remittances played an important role in improving the current account



Non-oil exports proceeds are yet to respond adequately to the magnitude of currency depreciation, as proceeds reached 6.8 percent of GDP in FY2018, only slightly above the 6.4 percent achieved in the previous year.

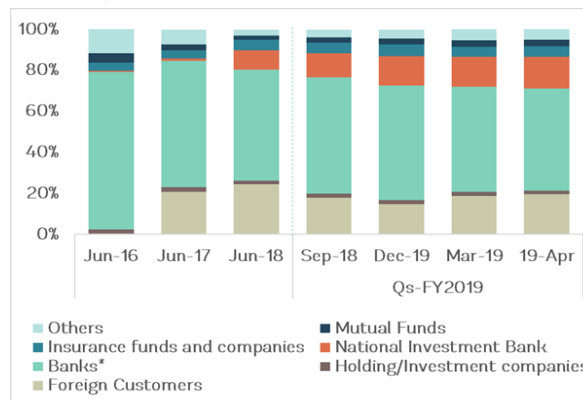
Services are largely contributing to the narrowing of current account deficit, with tourism showing strong signs of recovery. Travel receipts increased to 3.9 percent of GDP in FY2018, compared to 1.9 percent in FY2017. The improving trend has continued in H1-FY2019, as tourism receipts reached 2.3 percent of GDP compared to 2.0 percent in the same period of the previous year. The robust expansion reflects an increase in the number of incoming visitors as well as a longer average stay. Despite the progress however, tourism activity is yet to recover to its pre-2011 levels.

The capital and financial account surplus declined in the aftermath of the emerging markets sell-off in 2018. The surplus declined to 8.8 percent of GDP in FY2018, down from its spike of 13.2 percent of GDP in FY2017 that followed the currency depreciation. Mid-year results show further deterioration in the capital and financial account, with the surplus declining to 0.6 percent of GDP by H1-FY2019, compared to 4.2 percent in the

same period of the previous year. The decline was driven by portfolio outflows following the global emerging markets sell-off, in addition to relatively lower external borrowing. Net portfolio inflows declined to 4.8 percent of GDP in FY2018 and recorded an outflow of 2.0 percent of GDP in H1-FY2019, compared to a surplus of 3.2 percent in the same period of the previous year. Authorities have issued two Eurobonds during the second half of FY2019, including a USD 4 billion issuance in February and a EUR 2 billion in April. The decline in net portfolio inflows also reflected on the foreign participation into treasury bills, which has dropped by USD 6 billion between June and December 2018. The National Investment Bank (NIB) stepped in to pick up part of the T-bills dropped by foreign customers, increasing its share of T-bills ownership from 1 percent in June 2017 to 15 percent by April 2019 (FIGURE 18).

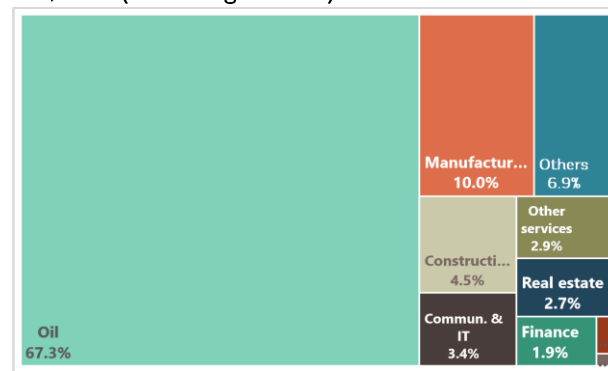
The oil and gas sectors remain the engine of incoming FDI, driven by the expansion in exploration and production agreements with international oil companies. FDI reached 3.1 percent of GDP in FY2018 (equivalent to USD 7.7 billion) compared to 2.1 percent of GDP in FY2016 but slightly lower than the 3.4 percent of the previous year. Despite the decline, Egypt remains the largest FDI recipient in Africa in 2018, followed by South Africa, Congo and Morocco⁵. The decline in FDI inflows has continued in H1-FY2019, equivalent to 1 percent of GDP (USD 2.8 billion) compared to 1.5 percent (USD 3.7 billion) in the first half of FY2018. In FY2018, two thirds of attracted FDI was in oil sector investments, followed by manufacturing with a share of only 10 percent of incoming FDI. Despite the positive effect on the energy sector, this concentration indicates a continuing difficulty to diversify to more labor-intensive sectors.

FIGURE 18. NIB picked up part of the T-bills dropped by foreign customers



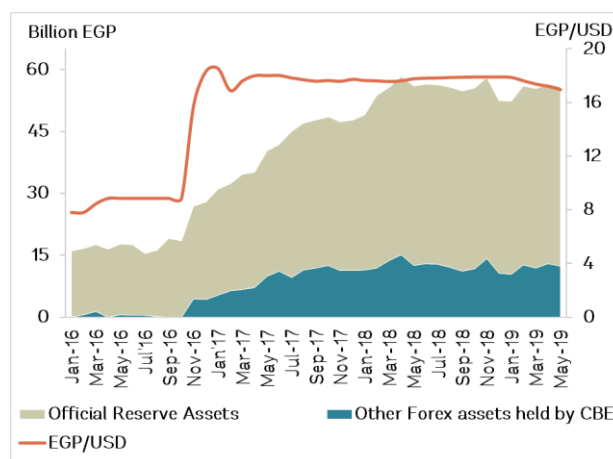
Note: Banks include public, private, foreign branches and specialized banks. Source: Central bank of Egypt

FIGURE 19. Oil and gas are the engine of incoming FDI, 2018 (Percentage of GDP)



Source: Central bank of Egypt

FIGURE 20. The Egyptian pound has regained flexibility



Source: Central bank of Egypt

⁵ World Investment Report, 2019

The GoE had started a range of reforms on investment facilitation including (i) simplified administrative procedures such as the promulgation of an Industrial Permits Act and its executive regulations, aiming to ease procedures for obtaining licenses for industrial establishments; (ii) establishment of new special Economic zones (SEZs) such as the Suez Canal Economic Zone and, most recently, the Golden Triangle Economic Zone; and (iii) investment incentives such as those outlined in the 2017 investment law and its 2019 amendments that encourages expansions of existing investments rather than limiting the incentives to new investments as per the original law. The incentives include corporate tax discounts of 50 percent for projects in designated priority areas and 30 percent for projects in other areas. Notwithstanding these efforts, it is believed that their effectiveness in attracting increased flows of FDI will depend on the overall investment climate, as fiscal and financial incentives cannot on their own compensate for major shortcomings in the general business environment, including cumbersome administrative procedures and high costs, governance issues and lack of transparency as well as the weak competition and lack of a level playing field. This is particularly the case for efficiency-seeking FDI, which Egypt is known to attract. In this regard, there is still room for Egypt to improve. According to the Global Competitiveness Index (GCI), Egypt ranks 94th out of 140 countries in 2018, with the most problematic pillars being institutions (on budget transparency, intellectual property protection, quality of land administration and conflict of interest regulation), macroeconomic stability (on inflation and debt dynamics), labor markets, product markets (on trade tariffs and services trade openness) and labor market (on redundancy costs and adequately educated workforce). Most of the underlying indices making up Egypt's GCI reading show an upward trajectory.

The Egyptian pound has regained flexibility after being steady for around 8 months, which is critical to safeguard competitiveness and help cushion against external shocks. Throughout 2018, the exchange rate averaged EGP/USD 17.79 with fluctuations between a low of EGP/USD 17.62 in February 2018 and a high of EGP/USD 17.91 in December 2018 (**FIGURE 20**). Following the termination of the repatriation mechanism which guaranteed foreign investors' repatriation of dollars against a fee, in December 2018 the Egyptian currency has displayed greater flexibility and has appreciated during the first half of 2019 reaching a rate of EGP/USD 16.97 in July 2019, its strongest level since early 2017. This appreciation contrasts with currencies of most other emerging markets, which have recently suffered amid fears from a slowing global economy and escalation of the US-China trade tensions.

Tight monetary conditions and large financing needs have adverse effects on private sector credit

The CBE has resumed a monetary easing cycle in February 2019, following several months of tightening policy. The CBE had pursued a tightened monetary policy following the liberalization of the exchange rate in 2016 and the subsequent spike in inflation and had raised its policy rate by a cumulative 700 basis points. The easing cycle had then started in February 2018 when the CBE cut its rates by 200 basis points in two consecutive rounds, followed by another cut by 100 basis points. The overnight deposit rate, overnight lending rate, and the rate of the main operation were kept unchanged afterwards at 15.75 percent, 16.75 percent and 16.25 percent, respectively. The discount rate was also cut by 100bp to 16.25 percent. The expected impact on inflation of fuel price and electricity tariff adjustments announced in July 2019 may slow the monetary easing path, as the CBE tries to strike a delicate balance between anchoring inflation expectations and reducing the cost of private sector credit. Recent pressures on

emerging markets might have also led the central bank to delay rate cuts, in an attempt to maintain the attractiveness of Egyptian debt securities to foreign investors.

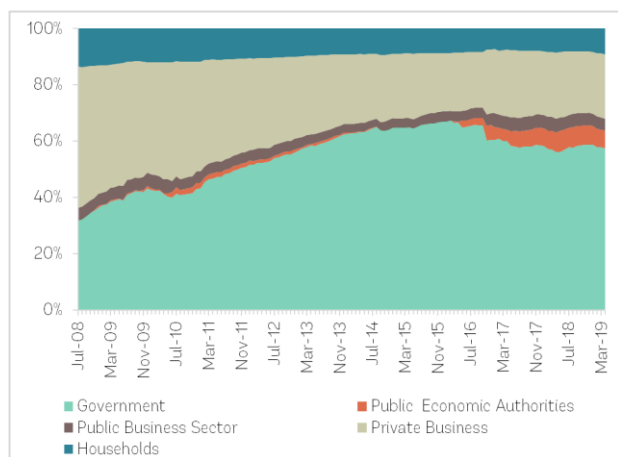
Domestic credit is primarily and increasingly extended to the public sector. Credit to the public sector (including government, public economic authorities and public business sector) absorbs 68 percent of total credit as of April 2019, leaving the private business sector with less than 23 percent of credit (FIGURE 21). Credit to the public sector witnessed a remarkable increase reaching an average of 65 percent of total credit between 2011 and 2018, compared to an average of 42.3 percent during the 2004-2011 period. This compares to a share of 63 percent in Morocco, 66 percent in Tunisia and 80 percent in Jordan. The expansion of credit to public sector in Egypt might be related to the involvement of many government agencies in large infrastructure projects, for which they seek financing from the banking sector. Banks absorb more than half of the outstanding T-bills, providing them with lucrative income in a context of high interest rates. This large exposure to government

securities maintains a long-standing concern over concentration risks and crowding-out of the private sector, especially smaller firms.

Net foreign assets in the overall banking system (CBE and banks) is bouncing back after a steep decline started in May 2018. The emerging markets selloff had triggered a reduction of USD 11.1 bn in commercial banks' net foreign assets between April and December 2018, leading to a net foreign liability position starting in July of the same year. Banks' NFA declined to a record deficit of USD 7.4 billion (EGP 131.5 billion) in November 2018 down from a surplus of USD 3.2 billion (EGP 56 billion) the previous year, before bouncing back to a positive position in April 2019 (FIGURE 22).

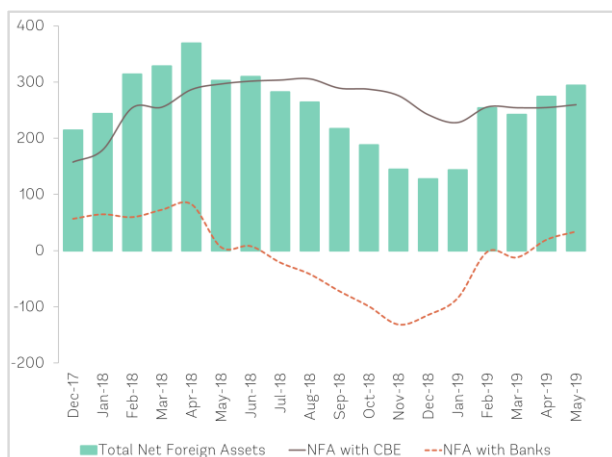
The banking system is financially sound. Non-performing loans have reached a low of 3.9 percent in December 2018, largely thanks to prudent regulations. Banks' capital adequacy ratio continues to improve. Liquidity remains ample, as evidenced by the relatively low loans to deposits ratio, which stood at 47.8 percent in end-December 2018.

FIGURE 21. Domestic credit is primarily extended to the public sector (% of total)



Source: Central Bank of Egypt

FIGURE 22. Net foreign assets are bouncing back after a steep decline (in EGP billion)



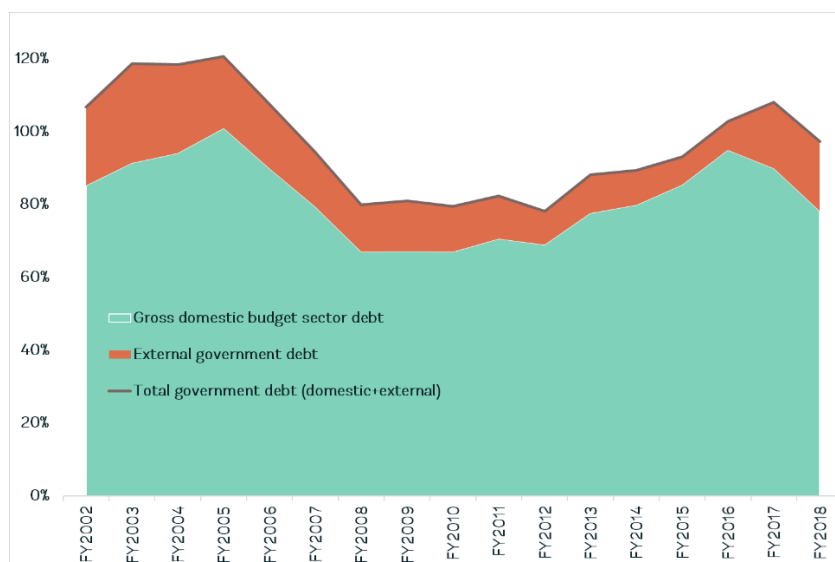
Risks and challenges originate from debt and extra-budgetary activities

Loose fiscal policies have historically contributed to an accumulation of public debt, with increased external debt in recent years. The larger share of government debt is domestic, averaging 85.0 percent of total public debt in FY2002-18. External government debt remained contained at an average of 15.4 percent—equivalent to 15.2 percent of GDP—in the same period but has been increasing in recent years, reaching 19.0 percent of GDP at the end FY2018 (FIGURE 23). The increase in external government debt was due to valuation effects stemming from the large currency depreciation in FY2017, in addition to an increase in external borrowing, including from international bond issuances and International Financial Institutions. Similarly, the GOE's debt is mostly denominated in local currency, but foreign-currency-denominated debt has increased from 12.5 percent of all public debt (domestic and external) at the end of FY2015 to

29.2 percent at the end of FY2018. For external government debt, the US dollar is the dominating currency (forming about two-thirds of total external debt), followed by the Euro (13.9 percent), the Special Drawing Rights (10.2 percent), the Chinese Yuan (3.2 percent), the Kuwaiti dinar (2.8 percent), and the Japanese yen (2.7 percent).

Domestic government debt has a challenging maturity structure, with about half of outstanding debt issued on a short-term basis (less than one year). This maturity structure significantly increases the government's exposure to refinancing risks in case of tighter monetary policy or changes in market sentiment. Conversely, most external public debt has medium- to long-term maturities and is dominated by concessional borrowing from international financing institutions. Hence, one of the GoE's key objectives is to lengthen the maturity structure of the domestic tradable debt, as well as to consolidate a domestic yield curve to reduce the refinancing risk.⁶

FIGURE 23. The larger share of debt is domestic but external debt has increased in recent years



Source: Central Bank of Egypt

⁶ Ministry of Finance, Medium Term Debt Strategy 2019

Egypt's debt-to-GDP ratio is declining but remains high and subject to significant risks. Assuming a gradual pickup in economic growth and a continuation of the fiscal adjustment program, the debt-to-GDP ratio is projected to decline to about 89 percent by end-FY2021. Despite the improved debt outlook, the debt ratio remains high and large contingent liabilities represent additional source of fiscal risk. The envisaged decline over the medium term could be reversed if the projected economic recovery is not sustained and fiscal consolidation efforts lose momentum. A realization of the government's significant contingent liabilities (20.4 percent of GDP as of December 2018) could put additional pressure on public debt. Higher real interest rates due to a tightening of global financial conditions or an abrupt depreciation of the pound may also adversely affect public debt dynamics. The recent publication of a medium-term debt strategy is expected to strengthen the GoE efforts to safeguard sound debt management - which is critical to macroeconomic stability - and inform investors and lenders about the Government's intended policies and plans. By sharing key debt management goals, investors are given higher certainty about market developments, which can reduce risk premiums.

Apart from the elevated level and risky structure of Egypt's government debt, there are challenges pertaining to its management. The institutional setup is also fragmented, as the responsibility of managing government debt is dispersed across the MOF, the CBE, and the Ministry of Investment and International Cooperation (MIIC), with limited formal coordination and communication channels among them.

Important risks remain with regards to extra-budgetary government units and public corporations, considering their complex and non-transparent links to the State budget. Given the non-comprehensiveness of the state budget and as fiscal reforms essentially focus on the budget sector, additional risks originate from public

entities operating outside the budget. State owned enterprises (SOEs) and economic authorities maintain complex financial links with the state budget, either in the form of explicit subsidies or through substantial cross-debts and arrears, which reflect unpaid obligations from public sector entities or from the state. Arrears and cross debts undermine fiscal transparency and make the assessment of the reported fiscal stance more challenging. Additionally, the treasury explicitly guarantees external debts of public sector entities, which exposes the budget to financial risk should these liabilities materialize. These extra-budgetary public entities also undertake significant and increasing levels of off-budget capital spending, which amounts to more than double the on-budget capital spending. In FY2018, off-budget investments - through the broader public sector - are estimated at 6.8 percent of GDP, compared to only 2.4 percent of on-budget spending. While this marked a decline in on-budget investment spending (from an average of 2.6 percent in the five previous years), it also shows a rapid increase in off-budget public investment spending from an average of 3.8 percent of GDP in the same previous five-years period. This off-budget spending affects the allocative efficiency of the country's public spending and undermine a proper oversight to ensure that investments have their intended impact.

Economic Outlook

Real GDP growth is expected to continue rising gradually to reach 6 percent by FY2021, from 5.3 percent in FY2018. Growth during FY2019-FY2021 is expected to be driven by enhanced domestic demand and exports growth. The contribution of private consumption (the largest component of GDP) is expected to have faded somewhat during FY2019, possibly on the back of the eroded real incomes. The recent decisions to raise pensions and civil servants' wages is

expected to help in stimulating private consumption.

Private investment is projected to continue rising, assuming an effective implementation of business climate related reforms. Public investment is also expected to continue growing as planned investment projects are implemented, especially in infrastructure and public works. Exports' growth is projected to rise gradually based on the ongoing rebound in tourism and Suez Canal revenues, as well as a surge in oil exports. This is driven by the uptick in oil prices during FY2019, in addition to the accelerating gas exports including from the recently operationalized Zohr gas field. Nevertheless, Egypt's chronic negative net exports balance may continue to weigh negatively on growth, as exports growth may be diluted by the projected rise in imports (in tandem with the accelerating growth).

Overall fiscal deficit target for FY2019 is conceivable, although reaching a 2 percent primary surplus remains a challenge. The positive fiscal outlook is supported by lower global oil prices relative to the government's initial projection of oil prices at US\$67 per barrel. Preliminary figures for H1-FY2019 (July-December 2018) have improved, with the primary and overall balance reaching +0.4 percent and -3.6 percent of GDP, respectively, compared to a -0.3 percent and -4.2 percent respectively in the same period of the previous year. If fiscal consolidation remains on track, the overall budget deficit and primary surplus are expected to reach 7 percent and 1.8 percent of GDP, by FY2021, respectively, compared to 9.7 percent and 0.1 percent in FY2018. The improved fiscal outturns are expected to be mainly driven by a decline in the expenditure-to-GDP ratio, largely due to the containment of recurrent expenditure items such as interest payments and subsidies, despite the expected increase in public investments. Additionally, the tax-to-GDP ratio is projected to rise slightly in FY2019 and decline thereafter.

Total government debt is expected to decline but external debt-to-GDP ratio is expected to have risen in FY2019 due to the relatively heavier reliance on external financing. Total government debt is projected to decline to 89 percent of GDP in end-FY2021, from 97.3 percent of GDP in end-FY2018. Going forward, external debt is expected to start decreasing as a share of GDP, as the authorities have established a foreign debt committee to overlook any new borrowing, with representations from the Ministries of Planning, Finance, Investment and International Cooperation and representatives from the Central Bank and the Administrative Control Authority. This committee is tasked with managing the overall debt, setting annual ceiling to the external debt, assessing the loans requests of various government entities and liaising with the Ministry of Finance and the Central Bank to avail the government's own financing sources when possible. Interest payments on government debt are expected to be contained – as the debt-to-GDP ratio declines and the maturity structure improves gradually – albeit remaining elevated (projected at above 8 percent of GDP by FY2021). Further acceleration of the downwards debt trajectory is possible if authorities abide by the guidelines issued in the latest Medium-Term Debt Strategy, including the diversification of the debt portfolio and the prolongation of the maturity structure of government debt.

The external accounts are expected to remain favorable over the forecast trajectory. The merchandise trade deficit is expected to continue narrowing on the back of an improving oil trade balance that shall benefit from the increasing gas production, as well as the containment of the oil and gas import bill. The current account deficit is expected to remain around 2.6 percent of GDP throughout the forecast horizon. This is due to the balancing effects of an expected improvement in the services trade surplus (mainly from larger tourism and Suez Canal revenues), whilst private transfers (especially remittances) may decrease. The capital and

financial account is expected to deteriorate somewhat as the external borrowing is gradually phased out. FDI is expected to resume its uptick, after a setback in FY2019, with inflows expected to reach 3 percent of GDP by FY2021, in line with its ratio in FY2018. Portfolio outflows may continue throughout the forecast horizon, but the projected Eurobond issuances over the next three years may help attract portfolio investor resulting in positive net inflows.

Egypt remains vulnerable to global slowdown and regional shocks, and the associated volatility in capital flows. The possible intensification of regional geopolitical tensions and associated regional instability also risks putting upward pressure on global oil prices, hereby exerting pressure on fiscal targets. Finally, the structural reforms agenda that Egypt needs to embrace is complex and interdependent. Any loss of momentum related to fiscal slippages, weak institutional capacity or lack of societal support could adversely impact the above outlook and affect the course of economic transformation that the country needs.

Annex 1.1 – Main Macroeconomic Indicators

	<u>FY2013</u>	<u>FY2014</u>	<u>FY2015</u>	<u>FY2016</u>	<u>FY2017</u>	<u>FY2018</u>	<u>FY2019</u>	<u>FY2020</u>	<u>FY2021</u>
	<u>Actual</u>	<u>Actual</u>	<u>Actual</u>	<u>Actual</u>	<u>Actual</u>	<u>Pre-Actual</u>	<u>Forecast</u>	<u>Forecast</u>	<u>Forecast</u>
Real Sector and Prices									
GDP at Market Prices (EGP Bn)	1,860	2,130	2,444	2,709	3470.0	4,437.4	5,324.9	6,283.4	7,382.9
Real GDP Growth Rate (y/y)	2.2	2.9	4.4	4.3	4.2	5.3	5.5	5.8	6.0
Deflator (y/y)	9.1	11.6	9.9	6.2	23.8	21.4	13.7	11.6	10.8
Population (In Millions)	84.7	86.7	89.0	91.1	93.3	96.1	-	-	-
Unemployment Rate (average)	13.0	13.4	12.9	12.7	12.2	10.9	9.0	8.1	8.0
CPI Annual Inflation Rate (period average)	6.9	10.1	10.9	10.2	23.3	21.6	13.9	12.5	10.7
GDP Per Capita (In USD)	3405.4	3524.8	3700.8	3649.2	2524.2	2611.4	-	-	-
Public Finance (percent of GDP)									
Total Revenues	18.8	21.4	19.0	18.1	19.0	18.5	18.5	18.4	17.0
<i>Tax Revenues</i>	13.5	12.2	12.5	13.0	13.3	14.2	14.3	13.9	13.8
<i>Grants</i>	0.3	4.5	1.0	0.1	0.5	0.1	0.0	0.1	0.1
<i>Other Non-Tax Revenues</i>	5.1	4.7	5.5	5.0	5.2	4.3	4.2	4.4	3.1
Total Expenditures (Excl. NAFA)	31.6	32.9	30.0	30.2	29.7	28.0	27.0	25.8	23.9
<i>Current Expenditures</i>	29.5	30.5	27.5	27.6	26.6	25.6	24.2	22.4	21.2
<i>Capital Expenditures</i>	2.1	2.5	2.5	2.6	3.1	2.5	2.8	3.4	2.7
Net Acquisition of Financial Assets	0.1	0.5	0.5	0.5	0.2	0.2	0.1	0.1	0.1
Overall Budget Balance	-12.9	-12.0	-11.4	-12.5	-10.9	-9.7	-8.6	-7.5	-7.0
Primary Balance	-5.0	-3.9	-3.5	-3.5	-1.8	0.1	1.8	1.8	1.8
Overall Balance Excluding Grants	-13.2	-16.5	-12.5	-12.7	-11.4	-9.8	-8.6	-7.6	-7.1
Gross Domestic Budget Sector Debt	77.5	79.7	85.2	94.9	90.0	78.2	76.9	76.3	77.5
Gross Budget Sector Debt	88.1	89.3	93.1	102.8	108.0	97.3	93.4	90.4	89.3
External Sector (percent of GDP)									
Trade Balance	-10.7	-11.2	-11.7	-11.5	-15.8	-14.9	-12.8	-11.3	-11.2
Current Account Balance	-2.2	-0.9	-3.7	-6.0	-6.1	-2.4	-2.6	-2.6	-2.6
Net Foreign Direct Investment	1.3	1.4	1.9	2.1	3.4	3.1	2.0	2.6	3.0
Capital and Financial Account Balance	3.4	1.7	5.4	6.4	13.2	8.8	2.4	2.3	2.6
Overall Balance of Payments	0.1	0.5	1.1	-0.8	5.8	5.1	-0.3	-0.3	0.0
Net International Reserves (NIR), end of period.									
USD Billion	14.9	16.7	20.1	17.5	31.3	44.3	43.5	42.5	42.6
in months of merchandise imports	3.1	3.3	3.9	3.7	6.4	8.4	7.6	7.2	6.8
External Debt	15.0	15.1	14.6	16.8	41.1	37.2	33.2	29.8	26.7
External Government Debt	10.7	9.7	8.0	8.0	18.1	19.1	16.5	14.1	11.8

Source: Staff calculations based on national sources



From Floating to Thriving: Taking Egypt's Exports to New Levels

After several years of economic and political turmoil, Egypt has embarked on a program of major reforms aimed at redressing macroeconomic imbalances, which have been adversely affecting economic activity, employment, the availability of key commodities and energy supply. A cornerstone of the adopted reforms was the liberalization of the exchange rate to address local currency overvaluation, which has resulted in foreign currency scarcity and loss of competitiveness. Notwithstanding the negative impact on inflation, the resulting depreciation of local currency was expected to reflect positively on exports performance and reinvigorate the exports-oriented private sector. However, the impact on non-oil exports remains modest, thereby suggesting that Egypt could not entirely benefit from such a large depreciation.

This modest response raises questions on the extent to which the structure of domestic production supports an exports-oriented growth. It also suggests the existence of key impediments that prevent the country from unleashing its exports potential, notably those related to non-tariffs barriers to trade.

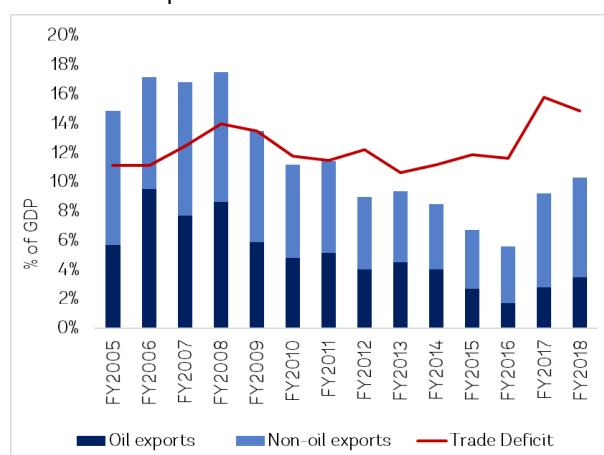
This chapter looks into the structure of Egypt's products space and exports, while trying to identify sectors and markets of untapped potential. It also highlights the key impediments to meeting this potential, notably the role of non-tariff barriers to trade and connectivity challenges. These call for a need to put in place a reforms strategy to alleviate these constraints and allow the country to capitalize on its competitive gains from the currency depreciation and enhance its integration into global markets.

Egypt is yet to meet its export potential

Egypt's exports potential has been historically hampered by several domestic market distortions and multiple barriers. Examples of these distortions include the exchange rate overvaluation and a long history of subsidizing energy that have favored energy-intensive industries and shifted production resources away from labor-intensive and exports-oriented sectors. Together, these have resulted in a weak export performance and a modest regional and global integration. Exports of goods declined from 17 to 5.6 percent of GDP between fiscal years (FY20) 2006 and 2016, before picking up again to reach 10.3 percent of GDP in FY2018. Given the country's high dependence on imports, the weak exports performance has resulted in an average trade deficit of 12 percent of GDP during the same period (FIGURE 24).

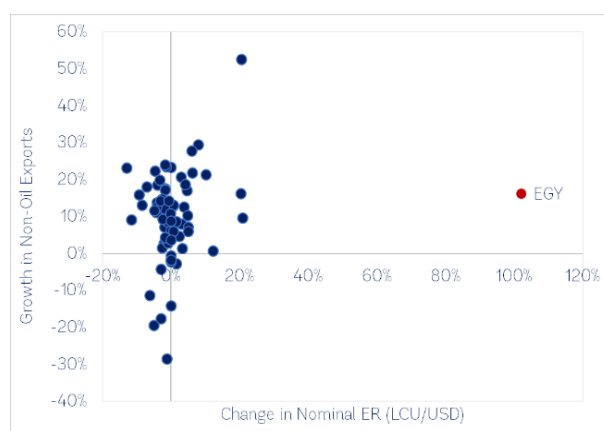
The liberalization of the exchange rate in November 2016 was necessary to correct for the exchange rate misalignment but is not sufficient to guarantee a notable improvement in export performance. FIGURE 25 shows Egypt's non-oil exports response to the currency depreciation in the following year compared to other countries that have witnessed episodes of exchange rate depreciation of different magnitudes. This simple benchmarking exercise clearly shows that other countries have seen their exports reacting more sensibly to more modest currency depreciation, while a significantly larger depreciation in the Egyptian pound was only followed by an export increase of 16 percent in about a year-time. While currency depreciation is expected to boost exports by making the price of domestic products more competitive, this contained response suggests that a rapid and sustained exports growth certainly requires more than a price effect.

FIGURE 24. Exports and Trade deficit



Source: Central Bank of Egypt

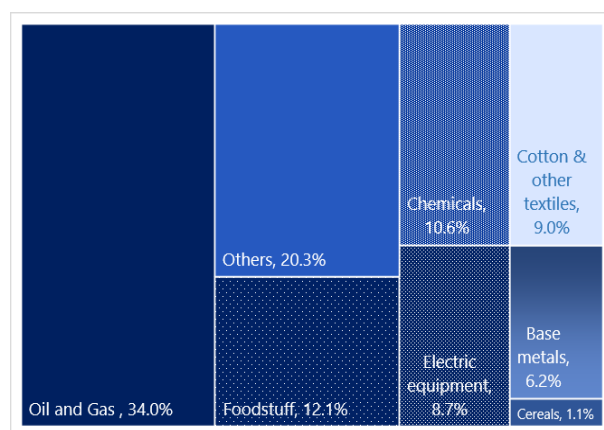
FIGURE 25. Depreciation and Non-Oil Exports Growth



Note: Nominal ER is the official exchange rate, period average. A positive percentage change means that the local currency is depreciating.

Source: World Development Indicators

FIGURE 26. Composition of Egyptian exports, FY2018



Source: Central Bank of Egypt

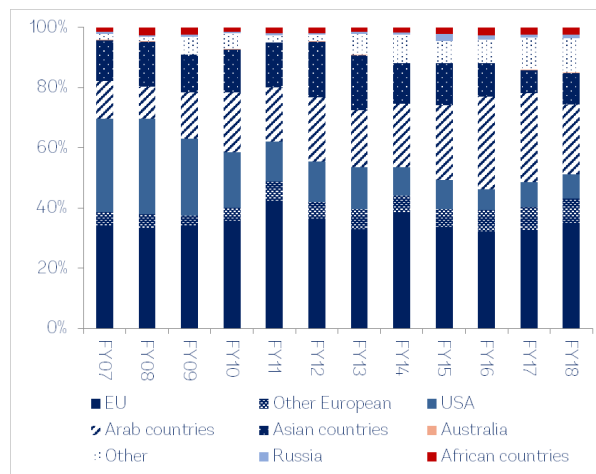
Historical trends also show that improvements in export performance have been short-lived, indicating difficulties in sustaining progress. The late years of 2000s witnessed a remarkable increase in exports, which has then started to deteriorate even before the 2011 economic turmoil. Moreover, when compared to other middle-income countries who started at the same level or below in the early 2000s, Egypt's exports-to-GDP ratio remains much lower.

This reflects a persistent inability to benefit from higher globalization trends, possibly due to the existence of high trade costs, before and at the country's borders. In particular, non-tariff barriers, which cover a diverse set of purposes and take many legal forms, can have economy-wide implications through their effect on the price and quantity of traded products. These barriers may also impose high fixed costs on firms, hereby affecting their ability to become exporters.

The production and export landscapes

To understand why Egypt is not well integrated into global markets, one must look first into the production range as the basis of any trade potential. Egypt's exports have historically been dominated by oil exports, but their weight has gradually declined from half to just over a third of total exports (FIGURE 26). In FY2018, non-oil exports constitute 66 percent of the total. Yet, exports are chiefly concentrated in products that are either traditional or have a low value-added. A long tradition of subsidizing energy prices has also favored the energy-intensive industries and biased the exports structure towards them. Chemicals and base metals on their own constitute 11 percent and 6 percent of the export basket, respectively.

FIGURE 27. Main exports markets

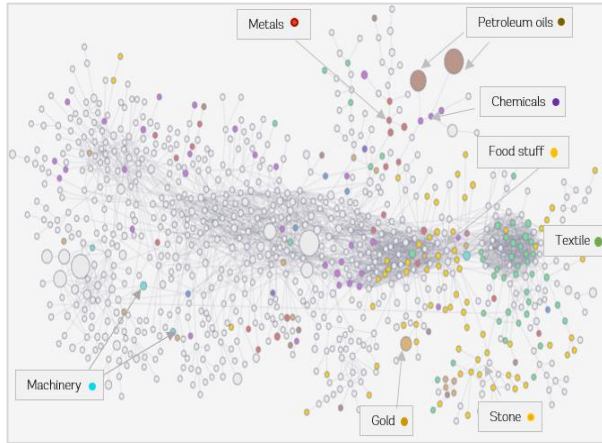


Source: Central Bank of Egypt

The destination for Egypt's exports has gradually shifted away from the USA, but exports remain limited to traditional markets. Throughout the last decade, the European Union (EU) countries have been the most important trading partner and first recipient of Egyptian products. The United States used to be an important recipient of exports, but its weight has gradually declined in recent years in favor of the Arab countries, in particular the United Arab Emirates and Saudi Arabia who received 9.7 percent and 4 percent of exports in FY2018, respectively. Together, the EU and Arab countries receive close to 70 percent of Egypt's exports. Exports to the Africa region remains underdeveloped and have not seen any major increase in the past decade (FIGURE 27).

The product space has also evolved through the years, but the range of exported products remains difficult to expand. The product space visualizes the country's capacity to develop its current production to include related products, given that the required capabilities can be easily redeployed towards the production and export of other comparable products. It also signals the country's capacity to transform its production landscape

FIGURE 28. Egypt’s products space, 2016

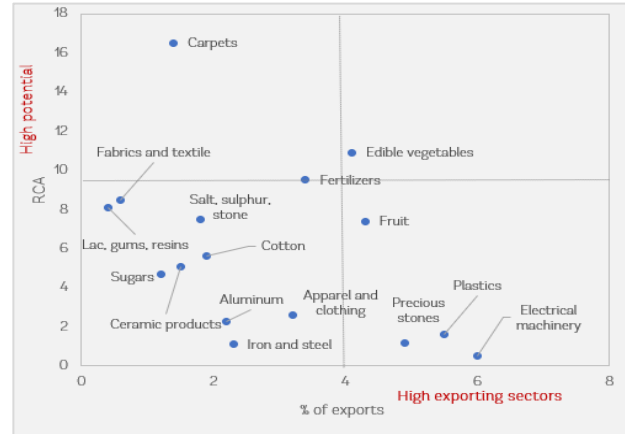


Source: Atlas of Economic Complexity

towards more sophisticated goods.⁷ In Egypt, the product space has become more populated throughout the years, indicating an increase in the number of exported products in which the country has a comparative advantage. Yet, the majority of products in 2016 are situated in the peripheral region, consisting of crude and refined petroleum, precious metals, clusters of agricultural products, textiles and construction material (FIGURE 28). Only a very limited number of products are situated in the rich dense region that reflects more sophisticated goods, which require capabilities that can also be used for producing other goods.

The analysis of Egypt’s exports basket reveals that the largest exported products are not necessarily those in which Egypt has the highest revealed

FIGURE 29. Top exporting items and RCAs



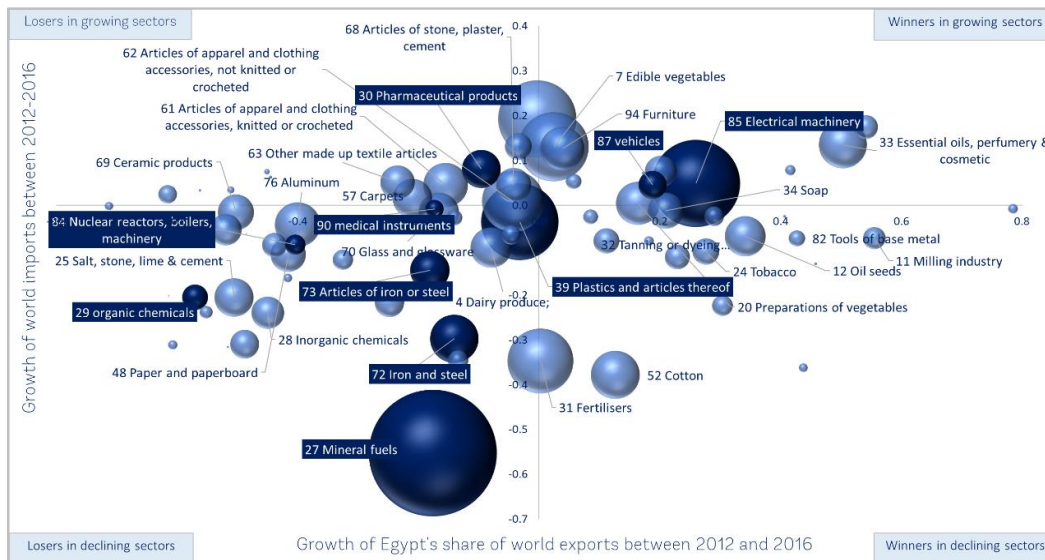
Source: Staff calculations based on UN Comtrade

comparative advantage⁸. For instance, among the products with highest RCA, only edible vegetables and fertilizers have a relatively high share of exports, averaging 4.1 and 3.4 percent respectively on average between 2012 and 2016 (FIGURE 29). At the same time, electrical machinery which is the second largest exported product after mineral fuels has an RCA that is less than one, indicating that Egypt is not an effective exporter of this product. Observing the relatively low weight of products with high RCA in the exports basket highlights the missing opportunities for these promising sectors to further expand into global markets. These include for example carpets, fabrics and textiles and salt, sulphur and stones.

⁷ A country producing many goods in the dense core of the product space will find this expansion a much easier process, whereas a country that specializes in peripheral products will find the shift to more and more sophisticated products more challenging.

⁸ The notion of revealed comparative advantage (RCA) considers a country as an effective exporter of a certain product if the share of this product within the country’s export basket is larger than the share of this product in the global exports market.

FIGURE 30. Egypt's exports growth and global demand by product



Note: Bubbles size reflects products share in Egypt's exports. Darker bubbles represent the top globally traded products. Source: Youssef and Zaki (2019), using Comtrade data.

Only a few products in which Egypt specializes and expands are matching the growth of global demand. A country can accelerate its competitiveness gains if it expands in sectors and products of increasing global demand. Among its top exported products, Egypt's competitiveness is growing in many products that are however subject to lower global demand (FIGURE 30). This is for instance the case for cotton, fertilizers, tobacco and oil seeds, for which Egypt's share in global trade has been growing in the past few years but global demand has been declining. These can be labeled as winners but in losing sectors (lower right quadrant). The country is even losing competitiveness in textiles, cement, aluminum, ceramic and chemicals, as its share of world's trade in these products has declined between 2012-2016. The few products that are subject to accelerating global demand and can be described as winners in growing sectors (upper right quadrant) are few and include electric machinery, essential oils and edible fruits and vegetables. These stylized facts imply a limited ability to achieve substantial increases in Egyptian exports if the exports structure remains concentrated in products that are weakly traded in global markets. They also show that Egypt's

actual trade falls short of the expected levels for several markets and products and suggest that additional factors may be impeding trade.

Regional integration, a forgotten agenda?

While Egypt is a fairly open economy, its regional integration has lagged behind, reflecting limited trade ties to North Africa or the wider MENA and Africa regions. Egypt's openness to trade has average 31.5 percent between FY2008-2018, reaching 34.5 percent in FY2018. The share of exports to the MENA region has increased from 10 to 30 percent between FY2008 and 2017, but retracted to 23 percent in FY2018. Exports to Africa are minimal, averaging 2.2 percent of total exports over the same decade. The same can be said regarding imports, with the share of imports coming from the MENA and Africa regions limited to 20 and 1 percent in FY2018.

Egypt's geographical location has always been acknowledged as one of its major assets, together with its large and diversified economy. This is consistent with economic models of trade that have tried to predict the levels of bilateral trade flows using countries economic size, geographic

distance and a number of other relevant characteristics that typically contribute to trade facilitation. These relevant factors include for example the existence of common borders, languages, legal systems or common currencies.⁹ Comparing the expected levels of trade to the actual ones can shed light on the magnitude of the untapped exports potential, both in terms of products and accessed markets.

Empirical evidence shows that Egypt is not meeting its potential as expected from its different characteristics and those of its commercial partners. In terms of exports markets, the country is under-trading with 63 percent of destinations, with African countries representing half of these destinations. The other half encompasses other small Asian and European countries and American and Pacific islands. At the same time, it is over-trading¹⁰ with around 20 percent of the markets, mainly with the USA, EU countries, China, Japan, Canada and some Asian countries, compared to the expected levels. Only the remainder 10 percent of Egypt's trade partners have an observed level of trade that is in line with the expected level. At the product level, Egypt is under-trading in 53 percent of the products and over-trading in 13 percent, while 32 percent of its products are in line with the expected levels. Surprisingly, some of the under-traded products are among those in which Egypt has a comparative advantage such as textiles, garments, fertilizers, chemicals and wooden products. This suggests that even in these promising sectors, Egypt is not exploiting its full trade potential, which raises questions around other factors that may hinder the development of these exports sectors.

Egypt has signed several preferential trade agreements (PTA), including important ones with

regional trade partners. These are the Greater Arab Free Trade Area (GAFTA), the Agadir Free Trade Agreement (with Tunisia, Jordan and Morocco) and the Common Market of Eastern and Southern Africa (COMESA). Egypt also has some framework agreements that should turn into free trade ones, such as the West African Economic and Monetary Union (UEMOA). These agreements may have helped achieving progress on trade liberalization, yet they were limited to tariff waiving.

A more concerted harmonization of standards and customs procedures, services and regulatory environment, could have contributed to a higher level of intraregional trade. Additionally, the multiplicity of these agreements induces the so-called "spaghetti bowl", creating a counter-productive effect given the resulting discriminatory policies and increased uncertainty on which PTA will apply. Hence, from a policy perspective, trade negotiations should target deeper and more comprehensive trade agreements that address non-tariff measures, harmonization of standards and inclusion of services and investment provisions. This will help Egypt develop regional and global value chains which in turn boosts trade and help small and medium enterprises export (Osnago, Rocha, and Ruta, 2016).

Explaining the untapped potential

Despite significant reforms and liberalization efforts, significant trade barriers prevent the country from fully exploiting its trade potentials and maximizing its gains from trade. This section looks at Egypt's trade policy from the tariffs perspective to assess the country's openness to trade. It also examines several non-tariff measures that are hindering the fast

given their economic size, geographic distance and other relevant characteristics and trade facilitation policies.

⁹ A gravity model is used to analyze the determinants of bilateral trade flows. See Appendix 1 for the model's technical specifications and results.

¹⁰ The concept of over-trading refers to trade flows between two countries exceeding the expected levels

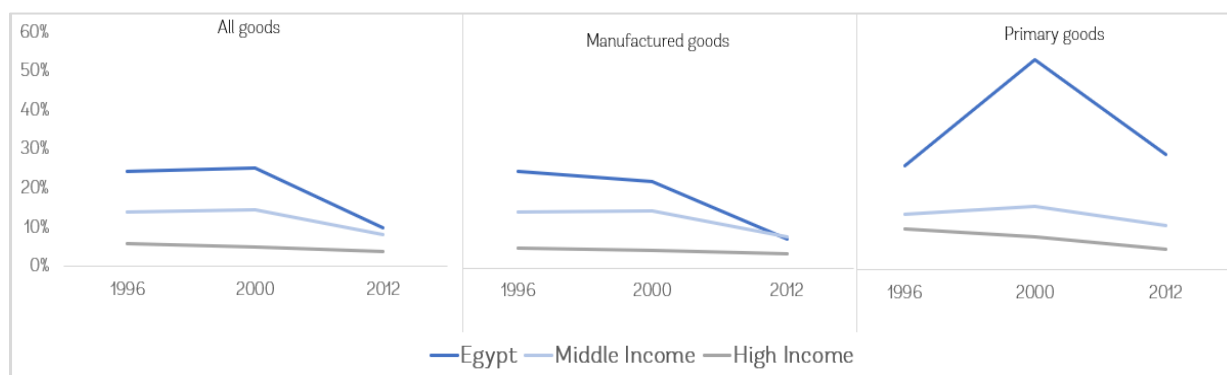
development of exports. These include administrative and technical barriers to trade, as well as other sanitary and phytosanitary (SPS) measures. It also discusses why the country's preferential trade agreements have not yielded the expected results.

Tracing Egypt's tariffs policy over time shows that applied tariffs have dropped significantly over time.

Simple and weighted averages of applied tariffs fell from 24 percent and 16.7 percent to 9.8 percent and 7.4 percent, respectively. Yet, the

primary sector remains more protected, compared to the manufacturing sector which has been significantly liberalized (FIGURE 31). An increasing trend in tariffs for primary goods was initially taking place, with tariffs exceeding 50 percent on average in the late 2000s, before a declining trend takes place afterwards. In comparison to other countries, Egypt's weighted tariffs remain higher than middle-income or high-income countries, with the gap being significantly wide for primary products.

FIGURE 31. Evolution of Tariff Rates, by Sector



Source: Youssef and Zaki, 2019

Non-tariff measures: from legitimate objectives to trade barriers

While non-tariff measures (NTMs) are meant to provide legitimate objectives, they are often used as a protection mechanism for domestic production. Legitimate concerns justifying extra measures at the countries' borders include for example the protection of human, animal or plant health, as well as other technical measures to ensure product quality and safety. Yet, the gradual removal of tariffs to liberalize trade carried a temptation to use non-tariffs measures as a protection mechanism for domestic production from fair competition. By adding an additional non-directly measurable cost, the excessive use of these measures affects the ability and willingness of the private sector to

expand and hinders countries' integration into global markets. It also prevents the benefits of global integration to reflect on consumers' welfare, while many exporting firms - particularly the smaller ones - can exit the exports market because of the ensuing costs. The surviving firms will simply transfer this extra cost to the final price paid by consumers.

Significant trade barriers prevent Egypt from meeting its potential, including administrative, technical and sanitary measures.

While they can vary in their technical and regulatory requirements, a number of NTMs are particularly relevant for Egypt. Identifying the most relevant barriers imposed by trading partners is important to assess their impact on exports and guide future negotiations and arrangements on harmonization and mutual recognition.

An administrative burden results from the lengthy procedures, heavy documentation requirements and costly clearance process for imported and exported goods. From the firms' perspective, customs and trade regulations are identified as a major constraint by 20 percent of the surveyed firms in 2017, (a notable deterioration compared to the 9 percent of 2013), (World Bank, 2016). Egypt also performs poorly on the Trading Across Borders indicator, ranking 171/189 in 2018 (World Bank, 2019) and its score shows a clear deterioration across time, from a peak of 71.1 in 2014 to an all-time low of 42.2 in 2018. This puts Egypt in a bad position especially when compared to MENA and other lower middle-income countries. On the exports side, Egypt managed to gradually reduce the cost to export whereas the inefficiency seems to be more pronounced on the procedures time. On the imports side, the administrative barriers are much higher than comparator countries on both the procedural and cost sides, as lengthy documentation, high fees, unclear customs valuation and technical regulations have been widely reported by

importers. This exerts a negative effect on exports, given the large reliance of domestic production on imported raw material and intermediate inputs.¹¹ These complex restrictions generate extra cost for firms and create uncertainty about access to imported intermediate goods, which limits the ability of domestic firms (notably the smaller ones) to engage in exporting, as evidenced by the low percentage of Egyptian manufacturing firms (8 percent) engaging in exporting activities (EBRD/EIB/WB, 2016)

This administrative burden reflects complicated procedures, as well as other non-trade related concerns. The high number of required documents and procedures, in addition to the lack of clarity in some cases which gives officials a bargaining power in granting clearances. The lack of electronic processing in the customs clearances also contributes to unnecessary delays and gives room for discretionary decisions and corruption (World Bank, 2018). The process is further complicated by the involvement of multiple entities including the customs authority,

TABLE 1. Trading Across Borders, Doing Business Indicators 2018

Indicator	Egypt	MENA	Lower Middle Income	OECD
<i>Time to export</i>				
Documentary compliance (hours)	88	67.9	64	2.4
Border compliance (hours)	48	58	72	12.5
<i>Cost to export</i>				
Documentary compliance (US\$)	100	244.6	140	35.2
Border compliance (US\$)	258	442.4	403	139.1
<i>Time to import</i>				
Documentary compliance (hours)	265	75.5	71	3.4
Border compliance (hours)	240	105.4	99	8.5
<i>Cost to import</i>				
Documentary compliance (US\$)	1,000	269	209	25
Border compliance (US\$)	554	536	503	100.2

Source: World Bank Doing Business Indicators (2019)

¹¹ Recent estimations indicate that 29 percent of inputs of manufacturing firms are of foreign origin. (World Bank, 2016)

the ports authorities, the General Organization for Export & Import Control (GOEIC), security control agencies, among others. Countries may also resort to trade barriers as a way to constrain demand on imported goods and services, thereby influence the exchange rate. This is more likely to happen in countries with de jure floating but de facto managed exchange rate regimes. Yet, while these hurdles can slow down demand for imported goods, they should not be viewed solely through the lens of trade deficits and foreign exchange reserves but rather as a hindrance to firms' competitiveness. In many cases, importing allows firms (including exporting ones) to source equipment and intermediate goods of better quality or lower cost and for two-way traders to acquire global knowledge about new products and processes.

Technical requirements and sanitary and phytosanitary (SPS) measures applied by partner countries are also important obstacles to Egyptian exports. Technical measures refer to those related to assessment of products and production methods' conformity with technical regulations and standards. According to the ITC business survey on non-tariff measures, certification requirements, products registration and testing are the most common types of conformity assessment measures faced by Egyptian exporters, in addition to strict labelling requirements. Regarding SPS measures, major cross-cutting concerns faced by Egyptian exporters between 2016 and 2019 are related to food safety and plant protection (WTO-UNDESA, 2019). They mostly originate from EU Member countries, which are also the most important trade partner for Egypt. In recent years, Egyptian exports to the GCC countries also started to face SPS measures. For instance, between 2012 and 2019, six notifications of SPS measures and Specific Trade Concerns (STCs) were raised by UAE and Saudi Arabia, with Egyptian exports of agriculture and animal products being suspended or banned entry to these markets (WTO, 2019). If repeated, these concerns may result in Egypt

losing its comparative advantages in favor of other competitors. While exporters may be familiar and compliant with the technical requirements imposed by trading partners, they may still face difficulties demonstrating compliance especially in the agriculture and chemicals sectors with regards to tolerance limits for residues and concerns over contamination. Moreover, in addition to the problems faced by exporters due to regulations being too strict to comply with, they may also find compliance difficult because of the related procedural obstacle rather than the regulation itself (ITC, 2016).

Other cumbersome NTMs and quantitative restrictions imposed by Egyptian authorities, compounded by infrastructure challenges, undermine exports growth. Other than those of trading partners, some technical measures implemented by Egyptian authorities cause delays and additional costs. Inspection and certification are particularly burdensome, due to their various procedural problems including delays, arbitrary behavior of inspectors or government officials and inadequately published or not disseminated information. Infrastructure constraints represent additional challenges, including those related to limited or inappropriate storage, cooling and testing facilities. In some cases, exports bans are imposed on certain products that are considered as strategic goods. This has been the case for example regarding the exports of sugar and rice, with the objective of limiting all production to domestic consumption.

Strategic location but limited connectivity

Despite its strong location advantage and proximity to potential markets, Egypt has limited physical connectivity to global markets and weak domestic transport facilities. Maritime, air and land connectivity, together with trade facilitation, are the main pillars of trade connectivity, to which domestic connectivity between various parts of the country and international gateways should be

added as they account for more half of the total time and cost of international supply chains (World Bank, 2015). This is particularly the case vis-à-vis neighboring countries, which offer large opportunities for increasing exports.

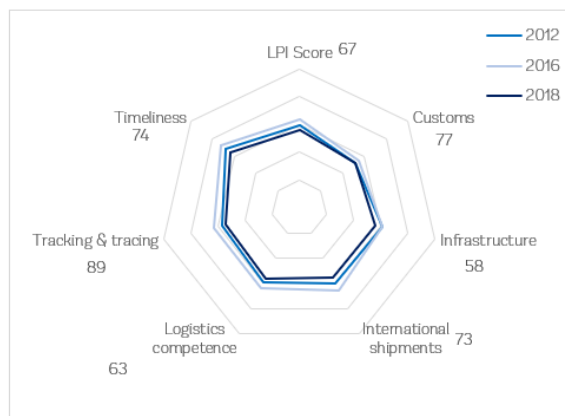
While connectivity on its own cannot not bring about increased trade, both international and domestic connectivity need to be improved to realize the trade opportunities. In Egypt, nearly all the domestic transport of internationally traded goods is undertaken by road transport. National railways are predominantly for passengers and have little participation in the transport of imports or exports, while the opportunity for using (the Nile) River transportation remain largely underutilized (World Bank, 2015). If enhanced and supported with logistical services, these connecting channels can transport goods more efficiently and reduce waste, hereby boosting trade.

Beyond the country’s borders and gateways, logistics processes and institutions may also constrain the free and quick movement of goods. Egypt’s performance on trade logistics puts it at the 67th position globally, out of 160 countries included in the Logistics Performance Index (LPI, 2018). The LPI provides a snapshot of logistics

performance, including information on the time, cost and reliability of import and export supply chains, infrastructure quality, performance of core services, and the friendliness of trade clearance procedures. Among the six components of the LPI, Egypt is lagging the most on customs, tracking and tracing, and on international shipments. Moreover, after having steadily improved in 2016 compared to the previous rounds of assessment, Egypt’s score has deteriorated in 2018 on all components (FIGURE 32).

FIGURE 32. Logistics Performance Index, Egypt

1-5 (best)



Note: Egypt’s 2018 rank between brackets
Source: World Bank, Logistics Performance Index

Three policy areas to unleashing exports potential

The above analysis has identified three main areas where historic lack of reforms has impeded Egypt’s ability to fully exploit the recent competitiveness gains from currency depreciation and shift towards an exports-oriented model of growth where exporting firms

can flourish and grow. These are the (i) concentration of exports in traditional areas of comparative advantage and weak relatedness to globally traded goods; (ii) significant trade (especially non-tariff) barriers; and (iii) connectivity and infrastructure challenges.



Egypt continues to specialize in traditional areas of comparative advantage and limited value-added, as opposed to goods that are subject to high global demand.

For the country to fully exploit its exports potential, increasing exports in established sectors and markets where it has already proven to be internationally competitive seems like a low hanging fruit. Yet, as global demand shifts to new sectors and products, developing new export sectors and expanding the country's access to new markets is equally important.

Beyond the traditional areas that have dominated the exports basket, there is a need to gear the production structure towards products of higher value-added and technology-intensive products of which more developing countries are increasingly becoming exporters. This requires a higher degree of competition in domestic markets, in addition to incentives for firms to upgrade their technological capabilities as well as their production processes and products.

The expansion of global value chains also provides an opportunity for firms to integrate with the global industry chain, and to move up towards high added value stages, which in turn requires more focus on research and development, skills development and technological upgrade. These components remain weak in Egypt's industrial sector compared to other countries, as well as the capacity for innovation compared to other countries (FIGURE 33). This cannot be dissociated from the general business environment in which firms operate, including the lack of incentives for innovation and skill development and the unlevel playing field that limits opportunities for dynamic and innovative firms to flourish and expand in global markets.

FIGURE 33. Capacity for Innovation

1-5 Best

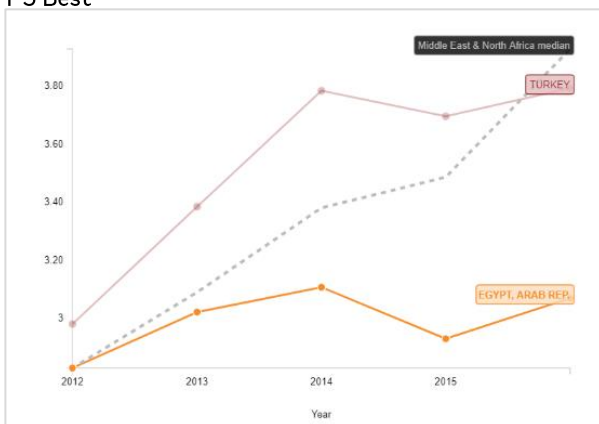
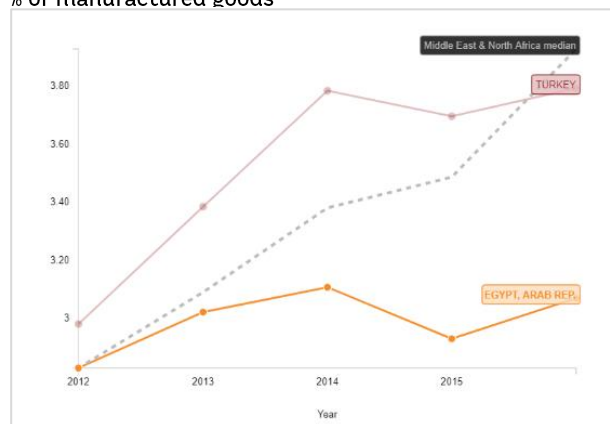


FIGURE 34. High-Technology Exports

% of manufactured goods



Source: World Bank TCdata360

Additionally, a complex business environment also limits the economy's attractiveness for FDI, which remains concentrated in oil and gas while potential investors in non-oil sectors could benefit from Egypt's strategic location in proximity to African, European and Middle Eastern markets. Hence, industrial and

investment policies should encourage business activities that allow for a "technological catching-up", to be complemented and orchestrated with innovation and education policies to avail the skills needed for the catching up process to take place and accelerate (FIGURE 34).



Significant administrative and technical barriers add layers of cost and complexity to trading firms, hereby undermining their ability to engage in trading across borders.

There is an urgent need to ease the regulatory environment around trade activities, notably customs and trade regulations. In this regard, rolling-out the national single window (NSW) system – which allows international traders to submit all documents at one location instead of making separate document submissions to each agency – can contribute substantially to simplifying procedures, reduce the time and cost of trade, and provide more transparency and predictability for traders. Modernized, automated and streamlined customs and logistics procedures through the employment of technology can improve the efficiency of border-control agencies, avoid unnecessary delays in customs release procedures and reduce their adverse effect on prices and consumers' welfare. The introduction of a NSW should also provide better national coordination between relevant authorities, including the customs authority, the ports authorities, GOEIC and other Government agencies involved in cross-border trade. At the regional level, it also allows for better coordination and collaboration between border management agencies through standardized data exchanges and joint risk management. While automation is an important component of a modernized system, it is however important to

stress that the design of the NSW in light of existing legal regulatory framework, processes and procedures is crucial to its success in improving cross-border movement of goods.

Egypt has piloted in the first quarter of 2019 the single-window system at the logistics center of Cairo Airport, and is planning to roll-out the new system in all border agencies by end of FY2020. It is important however to remember that while automation is an important component of the NSW, the preparation and design of any new system is also crucial to its success. This requires a thorough review and harmonization of the legal regulatory framework, and of the existing procedures required to streamline and improve cross-border movement of goods. It also calls for the introduction of a risk-based inspection system - which could be further enhanced if implemented in parallel with the establishment of modern inspection facilities and the introduction of an Authorized Economic Operators (AEO) system, which allows the customs authorities to perform less or no inspections on goods imported or exported through these operators. This is likely to positively affect the trader by reducing the time and financial cost of clearance, as well as to benefit the customs authorities by allowing for a more targeted approach and a better utilization

of their scarce inspection capacity - and. Naturally, this will also entail a substantial focus on improving the human resource capacity and technical capacity of the customs and other relevant authorities.

Given the weight of the technical and sanitary barriers, Egypt should also intensify its efforts to establish quality assurance, sanitary, and phytosanitary inspection programs to comply

with its trading partners' standards and requirements. For example, recent efforts to develop an Egyptian policy on food safety, and on the establishment of a unified Food Safety Authority are very much needed and should be further supported and replicated for other non-food standard-sensitive sectors.



Connectivity, infrastructure and logistics challenges undermine exports growth, as they hinder the movement of goods including across borders and increase product losses from inefficient transportation and storage.

Better connectivity will allow for a more efficient and reliable movement of goods and services, including across borders. In large economies like Egypt, internal distance from borders can add substantial amounts of time and cost. Access to markets, including the cost of transporting goods and transporting key inputs for production or consumption, are function of distance, road quality and other geo-physical barriers (World Bank, 2012). The slow adoption of technology also hinders the international competitiveness of domestic producers.

Enhanced infrastructure and logistics is not only important for the efficient internal movement of goods, it is also key to facilitate exports and reduce losses, especially for perishable products (mostly agricultural exports) that incur substantial waste before reaching external and domestic markets. A better integration of internal markets is also key to attracting FDI.

Enhancing connectivity infrastructure requires an increased focus on three main components: (i) improving connectivity across Egypt, between port locations and consumption and production areas particularly in lagging regions by expanding capacity for rail freight transport, highways, as

well developing the full potential of Nile river transport facilities (World Bank, 2015); (ii) enhancing international connectivity through facilitation of international trade and improved maritime services; and (iii) taking better advantage of the established economic free zones to provide value-adding services.

All three components can be better done by redefining the role of government and public agencies so as to focus primarily on the legal and regulatory framework and to facilitate trade and level the playing field, while enabling private participation and commercial financing in multi-modal freight transport and logistics, including ports, airports, railways and inland waterways (World Bank, 2018).

References

European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and World Bank (2016), "What's holding back the private sector in MENA? Lessons from the Enterprise Survey".

International Trade Center (2016) "Egypt: Company Perspectives. An ITC Series on Non-Tariff Measures".

Osnago, A; N. Rocha, and M. Ruta, (2016), "Deep Trade Agreements and Vertical FDI: The Devil is in the Details", World Bank Policy Research Working Paper No. 7464

World Bank, Doing Business 2019, Training for Reform.

World Bank (2018) "Privilege-Resistant Policies in the Middle East and North Africa. Measurement and Operational Implications", MENA Development report.

World Bank (2018), "Enabling Private Investment and Commercial Financing in Infrastructure".

World Bank (2016), Egypt Enterprise Survey.

World Bank (2015), "Egypt Connectivity Study. A Strategy to improve Egypt's trade connectivity", Report No. ACS12517

World Bank (2012), "Reshaping Egypt's Economic Geography: Domestic Integration as a Development Platform. Technical Background Reports", Report No. 71249 Volume 2.

WTO-UNDESA, ePing database on TBT and SPS. Last consulted May 2019

Youssef, H. and C. Zaki (2019), "From Currency Depreciation to Trade Reform: How to Take Egyptian Exports to New Levels?", World Bank, Working paper WP8809

Annex 2.1 The Gravity Model to Assess Trade Performance¹²

Countries' economic characteristics and geographical distance to trading partners can be used to predict the potential bilateral trade flows and compare the predicted volume to actual trade and estimate the untapped exports potential. A gravity model is used to analyze the determinants of bilateral trade flows, essentially the countries' income level and the geographical distance between them, in addition to other relevant factors such as common borders, common languages, common legal systems, common currencies and common colonial legacies. The model is also used to test the effectiveness of free trade agreements. The basic model for trade between two countries (*i* and *j*) takes the following form:

$$F_{ij} = G * M_i * M_j / D_{ij} \quad (1)$$

where *F* stands for the trade flow, *G* is the constant, *D* stands for the distance and *M* stands for the economic dimensions of the countries *i* and *j* that are being measured. A better understanding of the gravity equation is achieved by using the logarithmic values of all variables. We use the UN Comtrade database for 175 countries including Egypt, with 99 sectors (two-digit HS commodities) for the period 1995 – 2016. Our equation takes the following form:

$$\begin{aligned} \ln X_{ijkt} = & \beta_0 + \beta_1 \ln GDP/cap_{it} + \beta_2 \ln GDP/cap_{jt} + \\ & \beta_3 \ln Dist_{ij} + \beta_4 Contig_{ij} + \beta_5 Comleg_{ij} + \beta_6 Col_{ij} + \\ & \beta_7 ComLang_{ij} + \beta_8 Landlocked + \beta_9 GAFTA_{ijt} + \\ & \beta_{10} Agadir_{ijt} + \beta_{11} EgyptEU_{ijt} + \beta_{12} COMESA_{ijt} + \sigma t + \\ & \sigma j + \varepsilon_{ijkt} \end{aligned} \quad (2)$$

where X_{ijkt} is the bilateral trade flow between Egypt (the exporter) and country *j* (the importer) in year *t* for sector *k*; $\ln GDP/cap_{it}$ and $\ln GDP/cap_{jt}$ are country *i* and *j*'s real gross domestic product per capita in year *t*; $\ln Dist_{ij}$ is the bilateral distance between the two countries, measured as the great circle distance between Cairo and the capital city of its trading

partner, in miles. The distance variable is meant to represent typical trade barriers such as transport costs and time and cultural unfamiliarity. *Contig_{ij}*, *Col_{ij}*, *ComLeg_{ij}*, *ComLang_{ij}* and *Landlocked* are dummy variables that take the value of 1 if the two countries share common borders, had previous colonial links, have common legal origin, have common language, or the destination is landlocked, respectively, as these characteristics are expected to boost trade. We also introduce three variables of trade policy measuring the most important trade agreements for Egypt. Three dummy variables take the value of 1 to capture the association agreement between Egypt and EU countries (changing over time as each EU member joined in different years); *Agadir* a dummy variable that takes the value of 1 for Tunisia, Jordan and Morocco starting 2005, *GAFTA* a dummy variable that takes the value of 1 for GAFTA countries starting 1998 and *COMESA* a dummy variable that takes the value of 1 for COMESA countries.

The predicted level of trade is estimated from the gravity model as the difference between the observed level and the residual of the regression (2) as follows:

$$\ln Xest_{ijkt} = \ln X_{ijkt} - \varepsilon_{ijkt} \quad (3)$$

The observed level of trade is then compared to the estimated level of trade as predicted by the gravity model:

$$Ratio = \ln X_{ijkt} / \ln Xest_{ijkt} \quad (4)$$

Ratios below the value of 1 indicate the country is under-trading with the trading partner, compared to what the economic, geographic and trade agreement characteristics of Egypt and its trading partners would suggest. On the contrary, a ratio that is greater than 1 indicates a bias (or overtrading) towards these markets, beyond the predicted level. A narrow margin around 1 is being considered as very close to 1. Ratios

¹² Extracted from Youssef and Zaki, 2019. For detailed analysis, see the original World Bank Working paper.

below 0.9 are classified as under-trading, while ratios above 1.1 are classified as over-trading.

Results¹³ show that classical gravitational variables have the expected sign and level of significance (see Table A.6 in Appendix 2). Indeed, the income level at destination measured by the GDP/capita of the importer is positively associated to Egypt's exports.¹⁴ Distance is associated to trade negatively, while sharing common borders, common language, common legal origin and colonial links boost trade between Egypt and its trade partners. Additionally, a landlocked destination has a negative impact on Egypt's exports. This is particularly important as most of the African countries are landlocked.

The predicted level of trade (computed based on the gravity model) is then compared to the observed level of trade to determine whether Egypt is meeting its potential as suggested by its own characteristics and those of its commercial partners. Results suggest that Egypt is under-trading with 63 percent of destinations, with African countries representing half of these destinations. The other half encompasses other small Asian and European countries and American and Pacific islands. At the same time, the country is over-trading with around 20 percent of the markets, mainly with the USA, EU countries, China, Japan, Canada and some Asian countries, compared to the expected levels. The remainder 10 percent of Egypt's trade partners has an index close to 1 (from 0.90 to 1.10), pointing out that the observed level of trade is in line with the expected level.

¹³ For detailed results, see Youssef and Zaki, 2019.

¹⁴ The variable capturing Egypt's GDP per capita is dropped when year dummies are introduced as they are perfectly correlated.