

# Macro Forum insights and perspectives

April 2017



# Welcome

In this issue, we are privileged to be able to report on a recent interview with the Governor of the Central Bank of Egypt. Our team in Cairo has proven able through the years to identify profitable and interesting investment opportunities in both our private equity and energy businesses, and with the recent flotation of the Egyptian Pound, the interview reveals a new sense of optimism that the course of reform is now well-set. In addition, we come back to the question of why investors should continue to allocate to growth markets, notwithstanding strong relative performance in the developed markets over the last few years. Finally, we reflect on the warming in the relationship between China and the new administration in the US, and question whether the pre-election rhetoric will translate into aggressive trade policy now that President Trump is in the White House.



**Andrew Newington**  
COO,  
London



**Ali Mazanderani**  
Financial Services,  
London



**Bruno Moraes**  
Energy,  
Brazil



**Pratik Jain**  
Financial Services,  
India



**Stuart Jackson**  
Knowledge & Information,  
London



**Sherif Elkholy**  
Consumer,  
Egypt



**Max Lin**  
Consumer,  
China



**Janet van Niekerk**  
Knowledge & Information,  
South Africa



**Hilaire Dongmo**  
Real Estate,  
London



**John Thompson**  
IDG,  
London



**Nicolas Escallon**  
Energy,  
Mexico

# Egypt's Economic Reforms: An in-depth interview with the Governor of Egypt's Central Bank

Sherif Elkholy

Consumer, Egypt

selkholy@act.is



**Sherif Elkholy: Mr. Governor, when you were appointed as the Governor of the Central Bank in 2015 there was already significant distortions and illiquidity in Egypt's currency market. How did the decision to float the Egyptian Pound (LE) in November last year come about and what was the thought process underlying it?**

**H.E. Mr. Tarek Amer:** It was clear to me since the beginning that the fixed exchange rate regime was unsustainable. This was evident from the emergence of parallel foreign exchange markets as well as the deterioration of the external balance of goods and services in a way that was hardly financeable given weak appetite for foreign investment in Egypt at the time. While external factors outside the CBE's control contributed to the deterioration—such as the drop in tourism—an adjustment mechanism was necessary to re-balance supply and demand of foreign currency to restore an orderly functioning foreign exchange market, attract foreign investors, and improve inflows and liquidity. In March 2016, the CBE decided to devalue the Egyptian pound by 13% in order to quell the distortions that had emerged in the domestic foreign currency market. However, this was not enough, for we realized that in order to set the Egyptian economy on a sustainable path we had to develop a comprehensive, all-encompassing economic program. Reform is a belief, and a conviction above everything else. As such, the CBE and the Government embarked on developing a truly multi-faceted program aimed at addressing macroeconomic vulnerabilities while promoting inclusive growth and job creation. Significant policy adjustments were needed in order to restore confidence in the Egyptian economy such as fiscal consolidation and ensuring public debt sustainability. At the heart of these policy adjustments was the decision to liberalize the foreign exchange regime. This enormous shift was aimed at improving Egypt's competitiveness and allowing for the deepening of foreign currency liquidity while streamlining activity into the formal channels.

**SE: Is the flotation of the LE achieving its desired impact on economic and investment activity and is the CBE determined to uphold its position on letting the exchange rate be freely determined by the forces of supply and demand?**

**HETA:** We believe that an open market with a liberal exchange rate is the optimal solution for providing a sustainable path for Egypt's economic stability, and, for this reason, we remain committed to the steps we have taken. In fact, there is a strong political will at the highest level in the country to see these reforms through, and without that strong political will the reform program wouldn't have been implemented. The results of the liberalization have already started to positively reflect on the recent indicators of economic and investment activities. But first let me summarize what the program is about; Egypt's economic reform program is supported by the USD12bn three-year extended fund facility ("EFF") Agreement with the IMF. The program aims at accomplishing 4 main keystones:

1. Rectifying the macroeconomic imbalances with strong fiscal conditions, better monetary policy conditions, and eliminating FX distortions;
2. Anchoring the structural reforms in sound microeconomic policies that provide a social safety net through channelling more resources into pro-poor social programs;
3. Promoting inclusive growth through creating new job opportunities and raising exports; and
4. Closing the financing gap by improving the profile and build-up of the country's foreign reserves.

There has been some progress in each area over the second quarter of the fiscal year ("FY") 2016/17. Progress on keystones 1 and 4 has perhaps been the most pronounced as we have started to see signs of external sector rebalancing. For example, during the period of October-December 2016, the overall balance of payments surplus jumped to US\$ 5.1 billion (from US\$ 1.9 billion in July-September 2016), confirming early signs of external adjustment post the decision to liberalize the exchange rate market in November 2016. The current account registered its first improvement on an annual basis since Q1 FY 2014/15,

and the capital and financial account registered a net inflow of US\$ 10.5 billion (vs. US\$ 4.5 billion in the same period for the previous year). The current account improvements were mainly driven by a gradual recovery in exports, and a recovery in workers' remittances which started to be channelled through the formal banking market following the liberalization. Net inflows from tourism also recovered for the first time since Q2 2015/16.

More recently, the following signs continue to provide reassurances that Egypt is now on the right track following the reforms. In January 2017 non-oil exports rose by 34.3% year-on-year, workers' remittances increased by 23.0% year-on-year, and tourism revenues rose by 73.4% year-on-year. Foreign exchange shortages that used to hinder economic activity have been eliminated, making Egypt more competitive. Investors' appetite for various Egyptian asset classes witnessed a marked improvement, and this has directly contributed to the rebuilding of Egypt's foreign currency reserves. Egypt's gross foreign reserves figure amounted to LE 26.5 billion in February 2017, the highest figure since June 2011. So yes, I am very proud of what has been achieved so far!

**SE: How does the liberalization of the LE fit into Egypt's overall comprehensive economic reform program?**

**HETA:** As I said earlier, we are on a journey of comprehensive economic reform. To do that, we had to change mindsets and break legacy policy taboos. The overall objective of Egypt's economic reform agenda is to return to sustainability and the new exchange rate regime is in line with this overall objective. Before the reform program, Egypt's current account deficit had risen to 5.9 percent of GDP during FY 2015/16 and was hardly financeable under the old exchange rate regime, resulting in one-sided exchange rate movements and expectations as well as constant cost-push pressures on inflation. Starting our comprehensive reform plan quickly changed that environment and it put the reputation and the credibility of the Egyptian economy back on track.

On the other hand, the new exchange rate regime and the associated strong depreciation of the Egyptian pound against trading partner currencies is only expected to conduct temporary cost-push pressures on inflation, subsequently

enabling low and stable inflation over the medium term in line with the CBE's mandate, in addition to gains in terms of sustainability and a lower current account deficit as a percent of GDP. Indeed, monthly inflation during February 2017 dropped to 2.6 percent after averaging 4.0 percent in the preceding three months, suggesting diminishing cost-push pressures and confirming the short-term nature of the inflationary shock. Given the recent level shift of the consumer price index, annual inflation is expected to drop when favourable base effects kick-in, supported by monetary policy actions and receding monthly inflation rates.

**SE: Since the liberalization of the FX regime, the stock market has reacted very positively, with a strong recovery in foreign investors' participation. We have also seen strong appetite for Egypt's USD 4bn multi-tranche international bond issuance which was over 3x oversubscribed. Do you feel that the flexible exchange rate environment is directly paving the way for the reduction of Egypt's risk premiums and recovery of FDI?**

**HETA:** Yes indeed. The liberalized exchange rate regime ignited more demand for various Egyptian asset classes by foreign investors and partly contributed to the rebuilding of Egypt's foreign currency reserves. Egypt's risk premiums have tightened since the liberalization. As of now Egypt's 5 year CDS spread stands at 3.32%, down from 4.75% before the liberalization of the foreign exchange regime. This strongly indicates an improvement in the risk sentiment towards Egypt. Also, yields on Egypt's Eurobonds have tightened across all maturities since the liberalization due to an improvement in

the sentiment and the recovery of foreign investors' appetite for Egypt.

On the topic of foreign direct investment... foreign investment on the EGX, which was on a negative trend before the liberalization, switched to show a net positive purchase position of US\$ 395 million from October-December 2016 (against net sales of US\$ 134.8 million in the corresponding period a year earlier). The EGX 30 index increased by 53% since November 2016, surpassing most emerging markets indices over the same period. Foreign investments in Egyptian treasury bills switched to reflect a net inflow, recording net purchases of US\$ 631.7 million (against net sales of US\$ 10.3 million in the corresponding period the previous year).

**SE: In light of the ongoing reforms and the improving macro picture for Egypt, what can you say to foreign investors who are seeking comfort on their ability to freely repatriate profits out of Egypt as a precondition to increasing their investments in the country?**

**HETA:** I would say the following... this country has always had huge potential; it just needed the correct policies to unlock that potential and turn it into real opportunities. The President has made it clear that we are committed to our reform program and to unlocking Egypt's potential. This strong political will should provide clear reassurances to investors. Foreign exchange shortages and restrictions that used to hinder economic activity have been eliminated post the liberalization as banks became in a solid position to accommodate new demand for foreign currency and equally important to address backlogs of dividends and trade, amongst others. For example, portfolio investors' backlog that had reached US\$

416 million before the liberalization of the exchange rate was cleared swiftly post 3 November 2016. Foreign companies and portfolio investors are now freely repatriating their profits. Moreover, foreign currency liquidity has substantially improved since the liberalization and our foreign exchange interbank market is now showing persistent signs of a deeper and more liquid market, allowing banks as mentioned above to cater to demand for foreign currency from different market participants such as importers, portfolio investors, and foreign direct investors.

In addition, Egypt's ability to tap international markets improved markedly as evidenced by the successful issuance of its Eurobonds during the first quarter of 2017. Investors' appetite has strongly recovered as witnessed by the oversubscription and pricing of our bond issuance as well as the huge inflows into our local equity and fixed income markets. This recovery in investor sentiment is also evidenced by the surge of capital inflows into the country and the increase in banks' resources; our international reserves have increased creating a virtuous cycle of increased confidence in our economy and in our foreign currency market. The parallel market has also been eliminated. So in summary, Egypt has been and will always be fully committed to meeting its obligations, and now the Egyptian economy has turned a corner and the market should be fundamentally more attractive for investors. We will see these reforms through!

**SE: Your Excellency, on behalf of Actis thank you very much for your time and for your invaluable insights.**

**HETA:** You are very welcome; I wish you continued success in Egypt.



# Why invest in the Growth Markets?

Andrew Newington

COO, London

[anewington@act.is](mailto:anewington@act.is)



The urban myth would have you believe that investment in growth markets is inherently and unavoidably high risk, involving as it does a need to assess and price in the impact of political instability, macro-economic volatility and exposure to FX movements where the underlying investment is not hard currency denominated. Indeed, when we look at data from Hamilton Lane and others, we can see that their broadly defined group of Emerging Market GPs have in general under-performed their developed market peers over the fund vintages since the global financial crisis in 2008. However, as we look at the relative attraction of our markets today, we see a different picture developing, and one which suggests that the rear-view mirror is no longer the right tool for investors to use in deciding on how best to allocate capital.

The picture is dominated by two foreground elements. Firstly, the relative risk no longer favours developed markets in the same way as it has historically. Why is this? One reason of course is the significantly greater political risk we see in the US, Europe and developed Asia. Previous articles in this publication have reflected on the impact of President Trump on global economic growth prospects, but it seems undeniable that the continuation of the populist movement that brought him to power risks unleashing a powerful backlash in developed market economies as the reality of isolationism bites in the form of increased inflation and a worsening balance of trade. In addition, the factors that have driven asset price inflation (and the performance of alternative assets) in developed markets – supply of capital and demand for assets, yield curve compression and increased risk tolerance – all seem to be at or close to their peak.

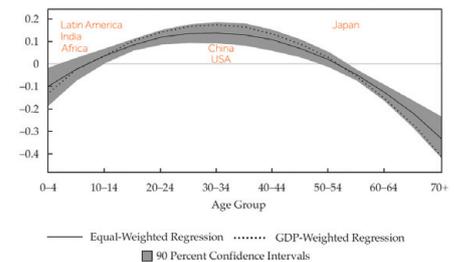
Secondly, the developed world appears to be stuck in perpetual low growth, already almost 10 years down the path established by Japan. Sustained loose monetary and fiscal policy do not appear to have stimulated anything other than growth in asset prices and the concentration of wealth in the hands of the few, and yet no developed economy seems able to wean themselves off the drug of easy money and focus on what we would argue are the only two sustainable drivers of growth in an economy – **population** and **productivity**. And it is this simple truth that we would suggest requires that investors put aside their rear-view mirror as they consider their asset allocation decisions.

In growth markets, both population and productivity are driving sustained growth. Of course, there will continue to be bumps in the road, particularly as the less mature democracies occasionally stumble, but the correlation between positive

demographics and economic growth are evident. Recent research has shown conclusively that the rate of growth in GDP is highly correlated to the average age of the population, peaking when this reaches 30-35.

## GDP Growth and Demographic Shares

Implied regression coefficient



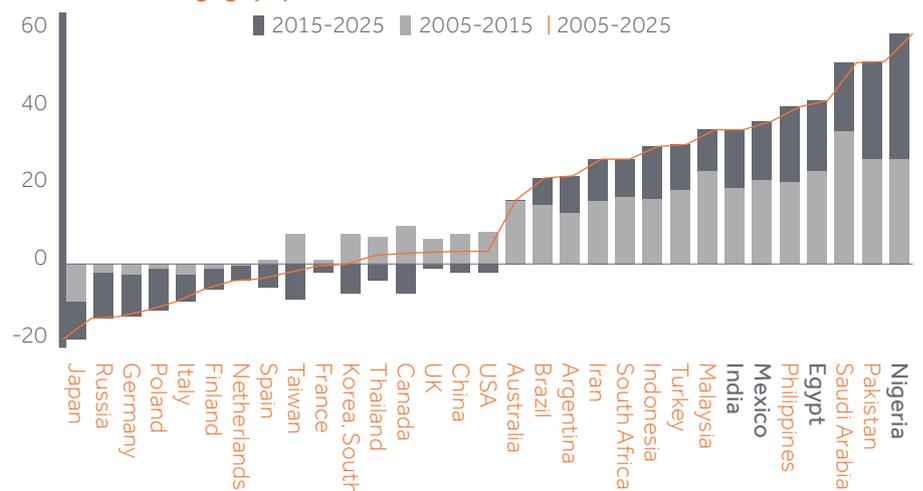
Source: Arnott and Chaves, "Demographic Changes, Financial Markets, and the Economy". *FAJ*, Vol 68(1), 2012

Regional labelling added by Actis.

## A growing working age population

So are our growth markets really younger? The evidence confirms this, with UN data placing Nigeria, Egypt, India and Mexico at the upper end of forecast growth in the population of working age. This stands in stark contrast to the forecasts for the EU and Japan, and this is before taking into account the impact of post-populist reductions in net immigration.

## Growth in working age population



Source: UN Population Division; The Conference Board

## Productivity is also improving

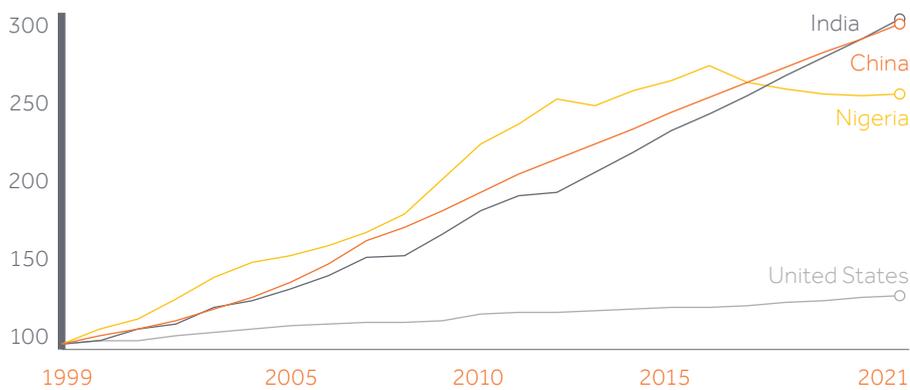
Turning then to productivity, long the factor on which the US has relied in retaining its crown as the world's largest economy. Again, the evidence shows us that productivity is demonstrably greater in economies with growing populations, and particularly those where the average age of the population is low. This seems intuitive, as once populations start to age to the point where the elderly outnumber the working population, as we are seeing in Japan, the ability to replace

lost economic output must necessarily impact GDP growth, even where there is significant investment in infrastructure and automation. When you then remove or limit immigration, a significant source of historical population and productivity growth in the US, and you do so for political reasons, you place a further burden on the existing working population and you remove from your armoury the one socio-economic weapon that can reverse the trend.

Finally, many of our markets have historically been net exporters of human capital, but with the tide turning in the developed world, we anticipate that a global diaspora could easily contribute to their relative competitive advantage, by bringing skills and an influx of investment back home. This is also not something that is going to impact dramatically on growth in the next few years, but it contributes to the sustainability of the growth we are already seeing, and potentially to an acceleration in the development of an affluent middle class, one of the key themes that growth market investors like ourselves have sought to invest behind.

So pulling these themes together, what we observe is that the monetary factors that have stimulated developed market out-performance post-global financial crisis appear to have peaked, whilst the two drivers of long term sustainable growth are notable by their absence. In contrast, the growth markets have not seen significant benefits from accommodative economic policy, but are poised for strong and sustained growth, particularly on a relative basis.

## Productivity growth (1999-2021)



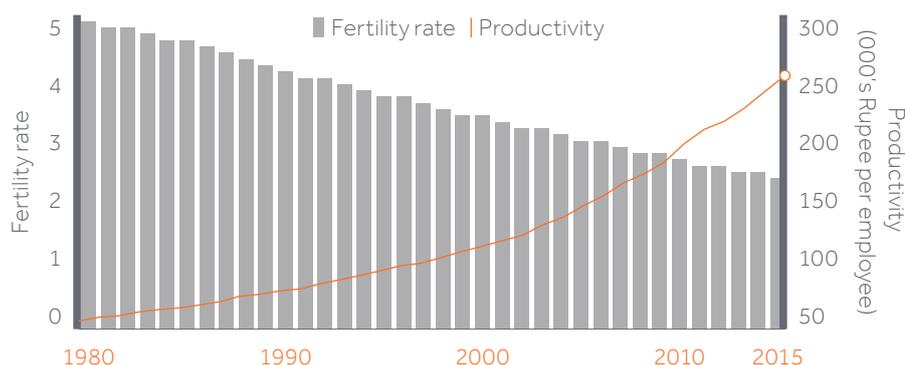
Source: Oxford Economics

## Correlation between fertility and productivity

The data also demonstrates that fertility rates and productivity are correlated, and that once fertility starts to decline, observed productivity increases, and in all growth markets outside Africa, this trend is evident in the historic data. As and when the benefits of better female education, improved access to healthcare and reduced infant mortality start to come

through in Sub-Saharan Africa, we would expect to see productivity improve as it has in the rest of the world. Perhaps not tomorrow, but with the continued and unflinching support of committed donors and responsible investors in the region, we see these improvements starting to bear fruit locally.

## India - Fertility rate vs productivity (1980-2015)



Source: World Bank; Oxford Economics





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故事

# China's role as leader of growth markets:

## Impact post US election

Max Lin

Consumer, China

[mlin@act.is](mailto:mlin@act.is)



### Challenges and opportunities

Over the past three decades, China has been one of the two largest contributors to global growth and has been the standout performer from our growth markets. It has been one of the chief beneficiaries of globalization. China surpassed the US as the world's largest trading nation in 2013, with a trade surplus against the US alone standing at US\$347 billion in 2016, about 3% of China GDP or 2% of US GDP.

There has been considerable concern within the Chinese government since the November 2016 US elections, that the Trump Administration will be taking an aggressive policy stance with respect to Sino-US relations, and particularly towards Sino-US trade. However, recent developments, including a visit to Beijing by US Secretary of State, Rex Tillerson, and the meeting between President Trump and Chairman Xi in April, seems to have reassured the Chinese that the new Administration is coming back to the normal post-election realization that working with China to solve problems is more productive.

On the other hand, a lot of Chinese saw the recent settlement of the investigation of ZTE, coming soon after the inauguration of the Trump Administration, as a strong signal of the toughening of US attitude towards trade. ZTE, China's second largest telecom equipment maker, was accused by US authorities of violating American laws on selling US technology to Iran. While the investigation of ZTE was initiated by the Obama Administration, the settlement and its USD900 mn fine came in early March 2017.

While we think a full on trade war between US and China is unlikely, a more protectionist approach to trade, such as more aggressive imposition of anti-dumping and anti-subsidy charges against certain goods from China, is still possible and could bring significant challenges to China's economic growth in the near term.

As China faces pressure of excess capacity in many of its export-oriented sectors, slowdown of exports to the US will negatively impact economic growth and employment in China. While the Chinese government has been implementing further domestic reforms over the past 18 months with focus on structural reforms on the supply side, with the new US administration, there is renewed urgency on the part of the Chinese government to shift its economic growth drivers. At the recently concluded annual session of the People's Congress, Premier Li reaffirmed the Chinese government's economic policies to boost domestic consumption and explore new external demand, while seeking to maintain currency stability within a reasonable range.

A key policy initiative to increase domestic consumption for the Chinese government has been increasing urbanization and that urbanization drive has received renewed urgency. As of today, China's urbanization ratio is 54%, still much lower than developed countries. The Chinese government is accelerating policies that encourage urbanization with a targeted urbanization ratio of 60% by 2020, driving demand for urban infrastructure and services, the underlying drivers for consumption upgrade and increasing demand for quality education and health care services.

While there are challenges on Chinese exports, the Chinese government sees the rising protectionism from the US actually providing a historical opportunity for China to take on more global responsibility and a leadership role to promote international

trade and globalisation, such as its ambitious "One Belt, One Road" initiative for the emerging markets.

Unlike US and other developed markets, many countries in the "One Belt, One Road" regions, including Southeast Asia, Central Asia, Middle East, Eastern Europe and Africa still have significant demand for domestic infrastructure. The overwhelming responses from over a hundred countries to the China-led Asian Infrastructure Bank is a perfect example. However, "One Belt, One Road" is not just about infrastructure projects. It helps deepen economic ties between China and other emerging markets in many sectors such as consumer, healthcare and industrials where we make most of our investments in China. For example, some of our medical devices portfolio companies in China are entering new overseas markets with high-quality value-for-money products, where Chinese government investment is helping some "One Belt, One Road" countries build new hospitals. There is also increasing Chinese interest in acquiring our portfolio companies located in those countries, as they look to diversify away from developed markets following the recent imposition of new overseas investment restrictions.

A successful "One Belt, One Road" initiative will drive external demand for Chinese goods and services, and support economic development and promote trade for countries in these regions. Whether these benefits will be realized to their full potential depends on how successful stakeholders are in navigating the political, social and economic challenges along the way. The important task for China, therefore, should be to carefully consider the interests of its partners, and guide and help other countries to take advantage of and share benefits from world trade and globalization. China certainly does not want to be seen to promote "China first".

# actis



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**[www.act.is](http://www.act.is)**

For more information, please contact:

Stuart Jackson

+44 (0) 207 234 5154

[sjackson@act.is](mailto:sjackson@act.is)



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