



Egypt: a giant with (financial) feet of clay

by José Luengo-Cabrera

Five years after the political upheaval that ended with the ousting of strongman Hosni Mubarak, Egypt's path to economic recovery remains fragile. Despite the high hopes for an economic rebound following the election of President Sisi in July 2014, pervasive insecurity and adverse economic conditions have raised the risk of a currency crisis.

With the largest revenue-generating sectors faltering and its foreign exchange (FX) reserves dwindling, the Egyptian economy will continue to muddle through and could worsen if aid from the Gulf wanes. Amid rising inflation and shortages of basic goods, the living conditions of an economically stressed and insecure citizenry could deteriorate further. As a result, the bouts of labour strikes and protests seen in 2015 could intensify – with the current clampdown on political dissidence and restrictions on civil rights adding fuel to the fire. Moreover, the recent murder of an Italian student who was in Egypt researching trade unions and labour rights has heightened (already widespread) concerns about the human rights situation of the country.

The past five years are an indication of the troubles facing Cairo should it fail to address the concerns of a politically disgruntled population plagued by mounting economic hardships.

Tarnished hopes

After coming to power, President Sisi carried out a series of much-needed economic reforms – notably the slashing of fuel subsidies and the approval of investment-

friendly laws. He was praised for keeping the Egyptian economy afloat, even if temporarily and in large part thanks to over \$24 billion in financial aid provided by Saudi Arabia, Kuwait and the United Arab Emirates since 2013. The March 2015 economic conference in Sharm el-Sheikh was hailed as a success after securing sums of up to \$60 billion in investments, loans and grants – destined primarily for the energy and real-estate sectors.

In addition, the recent discovery of the Zohr underwater gas basin (which potentially holds 30 trillion cubic feet of gas) means Egypt could become energy self-sufficient by 2019. This would not only eliminate the need to import fuel from abroad but also allow Egypt to position itself as the biggest gas exporter in the Mediterranean.

Although this generated optimism, the economy remains highly vulnerable to the jitters of risk-averse investors and increasingly frightened tourists. Market uncertainty and heightened security concerns have caused foreign direct investment (FDI) to stagnate, reducing the availability of capital for domestic and multinational companies already struggling with infrastructural bottlenecks and widespread electricity outages.

Tourism, a sector which accounts for 11% of GDP, is currently in the doldrums. Following the downing of a Russian airliner over the Sinai desert last October, tourist arrivals dropped by 38% (y/y) in November alone. The suspension of flights from Russia, Turkey and the UK was estimated to cost \$280 million in lost

revenues per month and the terrorist attacks claimed by the Islamic State of Iraq and the Levant (ISIL) in the Red Sea resort of Hurgada and Cairo this January are expected to cause further shortfalls.

Meanwhile, Suez Canal revenues fell by 7% (y/y) in the second half of 2015; largely as a result of the Chinese-driven global trade slowdown that has reduced the traffic of transiting vessels. The consequent widening of Egypt's fiscal and current account deficits are symptomatic of the economy's reduced capacity to generate and attract revenue, stripping the government of the required financial firepower to weather recurrent shocks.

Economic penuries

Being heavily dependent on the purchase of imported primary and intermediate goods, the manufacturing sector has been contracting as FX shortages have forced local businesses to either defer or suspend production. In addition, the heavy reliance on 'megaprojects' – like building a new capital city – to boost the economy will prove ephemeral and devoid of trickle-down effects, particularly as the Egyptian armed forces have taken control of the major commercial ventures, leaving little space for the involvement of non-military domestic companies.

Meanwhile, heavy borrowing by the state to finance the \$9 billion Suez Canal expansion and other grand schemes has crowded-out private sector credit, especially for cash-strapped small and medium enterprises (SMEs). Although President Sisi ordered the Central Bank of Egypt (CBE) to inject \$25 billion from the banking sector into SMEs in early January, it is likely to be a one-off as state coffers are depleted and monetising the economy will stoke inflation further above the 11.1% (y/y) level recorded last December.

With the prevalence of macroeconomic and security risks, the sharp drop in FX revenue has exposed the economy to a currency crisis. This has forced the CBE to maintain capital restrictions in order to forestall the devaluating pressures emanating from a currency sell-off. But the CBE may be forced to devalue the Egyptian pound in order to boost exports and reduce the current account deficit. This may, however, prove politically costly as an ensuing price surge will place a significant burden on low- and middle-income households already affected by double-digit unemployment (12.8%).

Without further external financial aid, Egypt's balance of payments will come under serious strain and shortages of essential imported goods could intensify. The fact that the General Authority for the Supply of Commodities (GASC) was ordered last October to

begin supplying wheat to the private sector and import other foodstuffs to keep prices in check is an indication of the severity of the situation.

Simmering tensions

Moves by the Egyptian authorities to secure financing from multilateral institutions like the World Bank and the African Development Bank showcase Cairo's desperate need for cash. This comes at a time when financial aid from Gulf countries will be less forthcoming as plummeting oil prices will force them to cut back on politically motivated spending. In spite of Saudi King Salman's announcement of a further \$8 billion in investment for Egypt last December, Cairo's unsatisfactory economic performance – as well as its support for Russia's intervention in Syria – risks seeing it fail to secure further funding from Riyadh. Unless new financial packages are upped, they will remain insufficient to avert a currency crisis down the line. At present, the state needs more resources to cover its \$60 billion annual import bill while at the same time attempting to cut down on expenditure, notably on the bloated public service payroll.

But with over 1,117 labour protests staged throughout 2015 (averaging 93 protests per month) in 26 out of 27 governorates, public sector unions have been demanding higher wages and social allowances to cushion the erosion of purchasing power resulting from rising inflation. The rejection by the recently elected parliament of Sisi's controversial civil service law – designed to slow wage increases and trim bonuses in the public sector – demonstrates the degree of political aversion towards upsetting powerful unions.

As evidenced by the limited demonstrations on 25 January (marking the fifth anniversary of the Egyptian uprising), the heavy-handed security forces have succeeded in containing protests and stopped unrest from spreading. But simmering tensions and anger remain over corruption and government attempts to slash public sector jobs at a time when private sector opportunities are scant.

With GDP growth projected to remain below 5% (y/y) in 2016, the economy will be unable to absorb the 800,000 annual influx of young people into the job market. Amid high youth unemployment (28.3%), the degree of joblessness combined with surges in the price of basic goods is a toxic mix that risks sparking social unrest. The situation will be exacerbated by the restriction of channels to express political discontent and abuses perpetrated by security forces. Egypt is facing a tough year ahead.

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