Country Report

EGYPT

Summary

A wave of protests of relatively loosely organized youth groups with support of Islamist and civil organizations forced an end to the 30+ years of Mubarak rule. In February the ever-present military took power by appointing an interim civil government, which made it very clear -right from the start- to be willing to honor all existing international financial and diplomatic obligations. Parliamentary and presidential elections plus a referendum on a potentially controversial new constitution are announced for the coming nine months.

Egypt's economic outlook for 2011 is uncertain, but the worst fears of a total collapse are highly unlikely to materialize. GDP growth for 2011 will be lower (but remains positive), while inflation, fiscal and current account deficits will be higher than in previous years. Moderately optimistic consensus projections made just a few months ago, were all adjusted downward, but assume that the economy will in the end weather it through. Egypt's financial system is in the favorable position of having built up large financial reserves in the past decade as a first line of defense.

Things to watch:

- FX reserves of central and commercial banks
- Election processes and outcomes

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EGYPT

National facts	
Type of government	Republic
Capital	Cairo
Surface area (thousand sq km)	997
Population (millions)	84.6
Main languages	Arab (100%)
Main religions	Muslim/Sunnite (90%) Coptic/Christian (10%)
Head of State (president)	vacant
Head of Government (PM)	Essam Sharaf
Monetary unit	EGP (Egyptian pound)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	217	0.35
Nominal GDP at PPP	500	0.67
Export value of goods and service:	45	0.24
IMF quotum (in mln SDR)	944	0.43
Economic structure	*2010*	*5-year av.*
Real GDP growth	5.1	6.0
Agriculture (% of GDP)	14	14
Industry (% of GDP)	38	37
Services (% of GDP)	48	49
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2570	26
Nominal GDP per head at PPP	5907	51
Real GDP per head	1487	19

Social and governance indicators	rank / total
Human Development Index (rank)	101 / 169
Ease of doing business (rank)	94 / 183
Economic freedom index (rank)	96 / 179
Corruption perceptions index (rank)	98 / 178
Press freedom index (rank)	127 / 178
Gini index (income distribution)	32
Population below $1.25 per day (PPP)	2%

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	7	US	11
Italy	7	China	9
Spain	6	Germany	8
India	6	Italy	6

Main export products (%)	*2010*
Crude petroleum & -products	51
Finished goods (incl textiles)	38
Semi finished products	8
Iron & steel	3
Main import products (%)	
Semi-finished goods	38
Capital goods	24
Consumer goods	20
Petroleum & products	11
Openness of the economy	
Export value of G&S (% of GDP)	21
Import value of G&S (% of GDP)	26
Inward FDI (% of GDP)	2.6

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Egypt is for 97% barren territory, with most economic activity taking place in the highly fertile and irrigated Nile valley. Along the Nile river, which is the only perennial water source, the high and fast growing population density is now around 2500 inhabitants fast per square km. Some 90% of the 85 million Egyptians live on a territory with the size of the Netherlands (17m inhabitants). This represents an enormous burden on the environment and the quality of life. Not so much land itself, but the access to fresh water is the major issue: natural fresh water resources are non-existent apart from the Nile. By an international treaty dating from colonial times, Egypt has the first rights over all Nile waters, to the frustration of thirsty Sudan and Ethiopia, where the water largely originates. Annually some 1,000 cubic m of fresh water per capita is extracted, three to six times as much as in similarly arid neighboring North Africa, Israel and Jordan. Most of the withdrawn water is used by agriculture (source of 13% of GDP, but using 86% of water available) on just 3% of total territory. Water shortages are likely to worsen and a long-term material restraint on social and economic development.

The energy sector (oil and gas) accounts for some 6% of GDP. Oil production more or less equals domestic consumption, but a third of the gas production is exported, enough to dominate Egypt's merchandise exports with a 50% share. On a global scale Egypt is not an energy power of any importance, although the current –but temporary- regional geopolitical impact of its gas exports to

Israel, Jordan, Syria and Lebanon since 2008 is substantial. Proven oil and gas reserves suffice for 16 and 35 years of current annual output respectively.

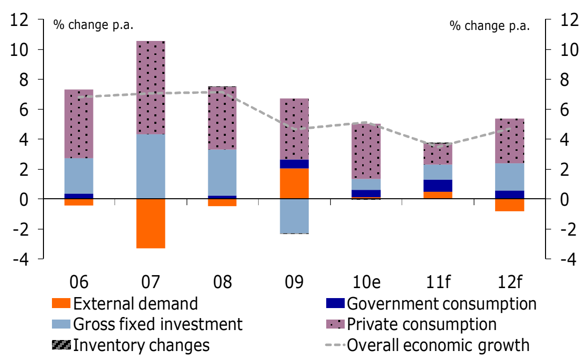
After a national revolution ousted the British-backed monarch in 1952, Egypt's economy for decades was highly centralized. Opening-up started in 1980, under former president Mubarak. The economic authorities pursued -with general international praise from 2004 to 2008- strong pro-market policies to attract foreign investment and spur GDP growth. But in recent years of global financial crisis, growth of the non-energy export-led sectors (some energy intensive manufacturing and tourism) fell, as did Suez Canal revenues (which account for 2% of GDP).

Despite the high level of average annual economic growth over the past decade (5%), living conditions for the average Egyptian have remained poor as high population growth (2% p.a.) eroded much of the progress. Currently, still a high proportion of Egyptians live in poverty (20% by national definition) and 2% even on less than USD 1,25 a day (internationally comparable).

Short-term GDP growth prospects of for 2011 are at 4% much lower than in the previous years. Early 2011, political tensions rose and caused economic and logistic disruptions, which caused negative q-o-q GDP growth in the first quarter of 2011. In particular the process to and outcomes of the crucial presidential, parliamentary elections plus a referendum on a new constitution are causes of uncertainty till the end of the year. As a result it is now projected that for 2011 as a whole, private consumption, investment and other exports are likely to remain subdued. But not all is bad or negative: tourism revenues (6% of GDP and 20% of export earnings in 2009) will be down, although -apparently- not as badly as initially feared. Also, energy-related and Suez Canal revenues are hardly or not affected, and real government consumption (food and energy subsidies and public sector wages) will increase by 7.5% in response to the recent food and energy prices and political unrest. These latter spending categories will partially compensate the slowdown of domestic private consumption and investment.

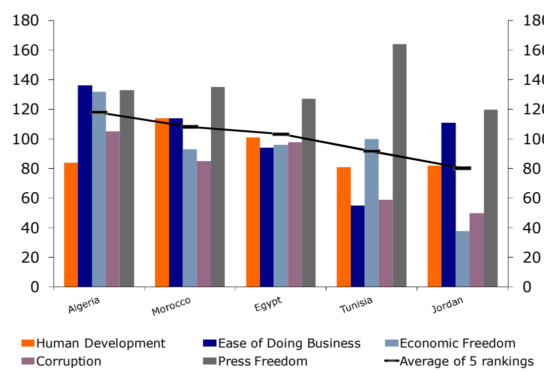
Estimates of overall GDP growth in 2011 made by respected sources differ widely (from 1.3% to 5.5% for 2011), but a net economic contraction (i.e. a shrinking economy) is not one of the noted outcomes. In our baseline scenario, growth will decelerate to 4% at most, with substantial downward risk as political uncertainty may negatively impact household and business spending for some time. But for 2012, a modest recovery to 5% growth, assuming at least some restoration of political stability, is projected. This growth rate is still below the level of 6-7% needed to absorb the influx of young entrants to the labor market and reduce the high unemployment levels to be estimated to climb to at least 10% (official data, excluding high hidden unemployment).

Chart 1: Growth performance



Source: EIU

Chart 2: Social and governance indicators



Source: EIU

Over the past decade financial sector policies were aimed at (i) consolidating smaller banks into larger ones, privatization and restructuring of state-owned banks; (ii) reducing non-performing loans (NPLs, which are successfully down from 22% of total loans in 2004 to 14% by mid-2010; over 95% of NPLs is now provisioned for) and (iii) improving supervision. All this has resulted in more solid banks (with on average and by national standards 15% capital adequacy) and much better provisioned banks. The number of banks dropped from 61 in 2004 to 39 currently, although they remain geared to service the government and large companies. Only 13% of small enterprises (that employ 75% of Egypt's workforce) actually have access to bank finance. Also, there is now ample liquidity in the banking system: the private sector loans-to-deposit ratio is structurally at around 60 percent, the remainder largely invested in liquid government bonds. The decline in economic growth in 2011 as a result of lower exports and tourism revenue will impact banks' profitability and likely lead to higher NPLs.

Political and social situation

The informal coalition of protest groups that took to the streets and succeeded to unleash a relatively bloodless change of power in early February 2011 can be described as non-ideological, secular and liberal. This loose opposition proved organisationally weak, divided and lacked charismatic leadership. It was the military that dealt the final non-violent blow to president Mubarak -in power for over three decades- and his government. Ever since independence from the UK in 1952, the army has played a strong role in actual politics, albeit often off-screen. Also this February, the smooth change of power was de facto ultimately arranged through a 'slow motion military coup' with tacit support from the international community. Many ministers -including the few known to support economic liberalization- were replaced, with the interim government focusing on political and economic stabilization, rather than risking another backlash by pushing for economic changes.

On March 22nd, that is within six weeks after the revolution, the amended 'old' constitution was overwhelmingly approved by 77% of the voters (60% in the cities and 90% in rural areas), although the overall voter turnout was just 40%. The military and the Muslim Brotherhood endorsed the text, while leaders of the (mostly urban) protest groups advised negatively as the proposed amendments did not address their demands for stronger 'countervailing' powers for parliament against presidential hegemony. Also the Christian Coptic community (often victim of religious animosity but still 10% of the population) was largely against, since article 2 of the constitution, qualifying Islamic law as the most important source of legislation, was not removed. Although the present constitution is only temporary, it will impact who is elected -and how- in the elections later in 2011. These representatives in turn will have a major say in the drafting of a new final constitution.

The (interim) military government promised to lift the 30 year emergency legislation before the early parliamentary elections. The removal of the ban on religious political parties is good news for the political wing of the overall moderately Islamist Muslim Brotherhood, which is in the process of forming the Freedom and Justice Party from its gamma of social organizations. Whatever the election outcome, the dominance of remnants of the now-dissolved National Democratic Party (NDP) of former ruling autocrat Mubarak will be diluted. At the same time, civil society and pluralism could suffer as the new and still loosely organized non Islamic opposition groups lack time to formally register and compete as a political force. For many observers and opposition leaders this all amounts to a return of 'Mubarakism without Mubarak', where the 'ancien regime' is replaced by a 'national unity' alliance of the Muslim Brotherhood, some technocratic remnants of the NDP and the ever-present army. The more liberal secular protest groups will be more or less sidelined in the formal political process.

The recent changes amount to a partial revolution at best, without much of an ideological re-orientation toward political Islamism, nationalism or other ideology. Neither is there much evidence of anti-business, anti-capitalist or anti-western sentiments. Surprisingly to many, even the hugely unpopular 'cold peace' with Israel remains unchallenged. Whatever the outcome of the events in the coming months, the consensus among political analysts is that the hard-line Islamist tendencies are unlikely to materialize, although some more explicit Islamic elements may well enter politics. This should follow the semi-secular Turkish example, rather than the theocratic Iranian model. Also broad consensus on free markets and opening up of the economy will guide the -as ever slow- Egyptian pace of structural economic policies. The new leadership will likely focus on restoring political stability, rather than changing the economy.

However historic, dramatic and spectacular the political changes may be, improvements of the underlying social-economic situation as measured by development indicators will lag behind demands and naive expectations of many of those participating in the events. Large segments of urban society will unavoidably be disappointed by the new political environment as it may not immediately deliver any betterment of material life. Chart 2 presents some social and governance indicators of Egypt and its surrounding countries, reflecting pre-revolutionary rankings, that are thus unlikely to change in the short-term.

Given the Egyptian army's continuingly leading role in actual political decision making and decades of close ties of the army with the US (a large provider of the military budget and training), the relationships with the US and the West in general are unlikely to suffer very much. Although small radical Islamist groups remain, there was also hardly expression of anti-western and anti-Israel sentiments during the protests. Relations with surrounding Arab states are good, but the interim government is quiet on relationships with the Libya's maverick leader Ghadaffi. The interim authorities have announced that Egypt will continue to respect all existing international agreements, including the peace treaty with Israel in 1979. Also here, the consensus among political analysts is that even with the Muslim Brotherhood's rise to power, the widely detested accord with Israel will not be addressed immediately. But support for and co-operation with Israel in isolating Islamist groups – a shared enemy- in occupied territories will not be as automatic as under Mubarak's rule.

Economic policy

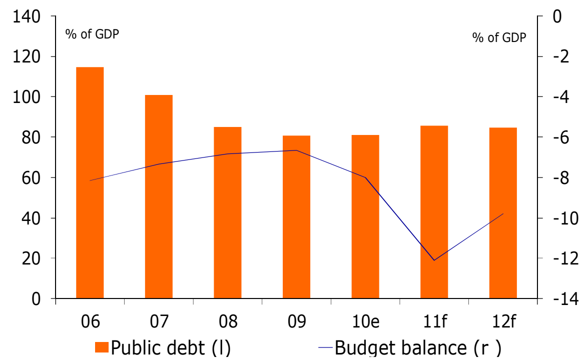
Since the late 1990s, the government has shown a commitment to economic liberalization and speeding up the privatization of state assets, while at the same time improving the business climate to attract foreign investment. The last Mubarak cabinet pursued liberal economic policies, resulting in a period of strong, investment-led, economic growth and achieved real economic growth of up to 9%. But, with the ministers most closely identified with economic reforms no longer their positions, the interim government is likely to put reforms on hold, concentrating on the more urgent task of ensuring the delivery of essential goods and services to the population.

The budget deficit may increase to 12% of GDP. Government revenues are expected to be lower than budgeted in 2011 given the expected lower economic activity and by another postponement of the introduction of the unpopular VAT. But revenues from the oil and gas sector, a major component of total tax income, will remain high, as this sector was hardly affected by the political unrest and prices are up. On the fiscal spending side, wage increases to placate the large number of public-sector workers, increased food and energy subsidies (in 2010: 25% of total expenditures) and higher interest costs (23% of expenditures) on public debt will lead to a much higher current spending by the government in 2011. In addition, there will also be pressure on the government of whatever make-up to compensate for the unrest-related absence of private sector investment.

The ousted pro-market Minister of Finance was a strong advocate of fiscal restraint and gained respect for years of decreasing fiscal deficits and public debt/GDP ratios (see chart 3), contributing to better sovereign and country risk ratings. Just before the unrest broke out, a 3.5% deficit was

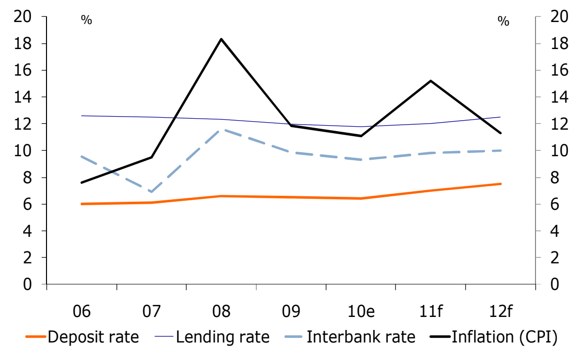
targeted in 2014, down from almost 10% in 2004. With a deficit in 2011 of up to 12% of GDP, the public debt/GDP ratio will -in our baseline scenario- increase to 86% in 2011. Thanks to high inflation (2011: 15%), this is a modest reversal of a speedy downward trend, which started in 2005, when the ratio amounted to 131% of GDP.
Almost all (90%) of government debt is held domestically and -given the ample liquidity of the banking system- financing has in the past not posed problems. Nevertheless, by mid-April the authorities were sounding the IMF and WB for soft loans to finance their expected 2010/11 deficit, indicating that the authorities feel the need to diversify their creditor base and reduce upward pressure on the domestic interest rates.

Chart 3: Fiscal position



Source: EIU

Chart 4: Interest rates and inflation



Source: EIU

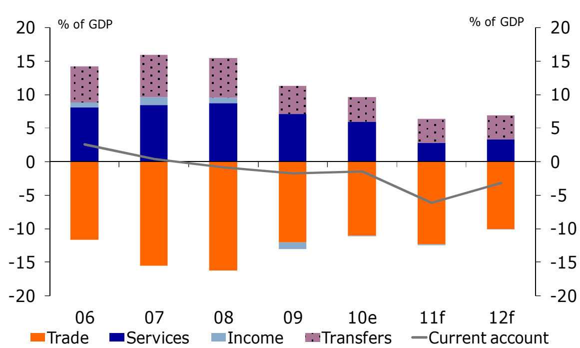
Consumer price inflation has been high in recent years, reaching 18% in 2008, and is again increasing owing to higher global commodity prices and the political turbulences of early 2011. Not increased demand, but supply shortages and logistical distribution problems drove up food prices. As interest rate hikes or other monetary policy measures are irrelevant as a remedy in such circumstances, the policy interest rates are projected to remain stable (see chart 4). Consumer price inflation is set to increase in 2011 to 15% from its already high level of 11% in 2010.
Recent events also put the Egyptian pound (EGP) under strong downward pressure against the US dollar, as its value decreased by 5% in the first three months of 2011. The central bank used some of its ample reserves to defend the currency, which proved partially successful in dampening EGP's depreciation. However, with the prospect of falling foreign exchange reserves (see below), costly interventions will remain modest and a further depreciation of around a 10% for 2011 as a whole is projected. This should also mitigate at least partly the effect of high domestic inflation on the external prices of non-oil exportable goods (i.a. textiles) and services (tourism), which is helpful in keeping the large trade deficit somewhat in check.

Balance of Payments

Egypt has for long been a rather closed economy with merchandise exports at only 10% of GDP. With imports of goods structurally higher at 20% or more of GDP, this implies a trade deficit of 10% to 15% of GDP (see chart 5). Since 2008, the country has become a major exporter of natural gas via pipelines to only a narrow range of neighboring economies. Together with very modest income from oil sales, natural gas exports account for 50% of all merchandise exports. Some diversification of the export mix, to energy intensive products like cement, iron, fertilizers and other petrochemicals is underway, but structural quality problems hamper the export performance of these products, causing the export product diversification to remain narrow. On the import side,

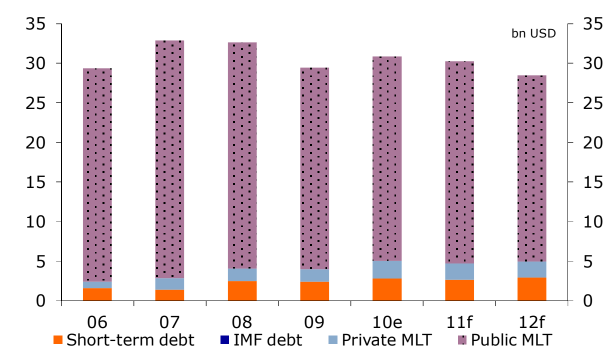
industry and development related goods (60%) dominate, with consumer goods accounting for only 20% of import value, which is all appropriate to a developing country.
Egypt is a member of the World Trade Organization and concluded an Association Agreement with the EU. This facilitates access to the EU markets, but also obliges the authorities to phase out tariffs on imports by 2015. A free-trade bilateral agreement with the US is in the making since the early 1990s, but the US still considers Egypt's economy too much dominated by the state and Egypt's "Military Inc.", which is estimated to own as much as 40 % of the nation's economy. Existing bilateral US-Egypt tariff reductions can still unilaterally be withdrawn. Although a member of African and Middle Eastern trade bodies, these markets are not significant yet as bilateral trade is still low: the quality of Egypt' s output cannot compete on the demanding Arab markets and black Africa's markets too small to make an impact.
The large structural trade deficit is partly compensated by surpluses on services balance, where revenues are derived from tourism (expected to be down in 2011 and 2012) and the Suez Canal transit fees (likely to remain unaffected by the turmoil). The services surplus in 2011 is projected to be substantially reduced to just 3% of GDP, against 10% in 2008. Of little help to restore balance of payment equilibrium are the expected transfers of Egyptians working abroad. These may lower to 3% of GDP in 2011, half the level of 2007 and 2008, when the Gulf state economies were still booming. Helped by low average interest paid on external debt (2% to 3% on principal), the county's income balance is reported to be more or less in equilibrium, despite the negative net investment position of the economy (-16% of GDP).

Chart 5: Current Account composition



Source: EIU

Chart 6: Composition of external debt

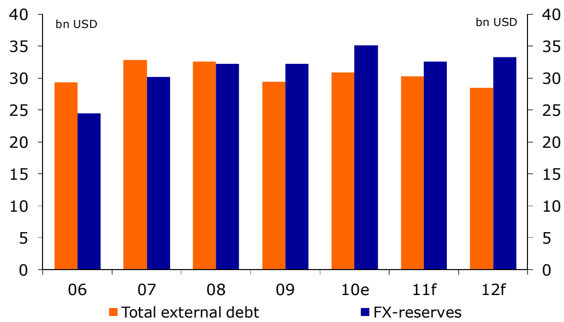


Source: EIU

The overall effect of these developments is a worsening of the current account from an -on average- near equilibrium in the past five years to a projected deficit of 6% in 2011. Provided political near-stability is maintained, tourist should return in higher numbers and the current account balance may improve in 2012, when the deficit may be reduced to 3% of GDP.
The current account deficits have until recently largely been financed by direct investments, with debt inflows and portfolio investments playing a minor role. For 2011 capital inflows will most likely decline compared with recent years as investor confidence is down due to the political instability. Also, with domestic interest rates hardly changing, the value of the pound declined. The Central Bank resorted to modest selling of foreign reserves early in 2011 to support the Egyptian Pound. The risk of imposition of controls on access to foreign exchange for capital account purposes (thus other than paying for imports) has increased, but all depends on the maintenance of commercial banks' and official FX reserves. Such currency restrictions will affect the inflow of dollar transfers from expatriate Egyptians into their homeland's banking system. Foreign currency inflows may

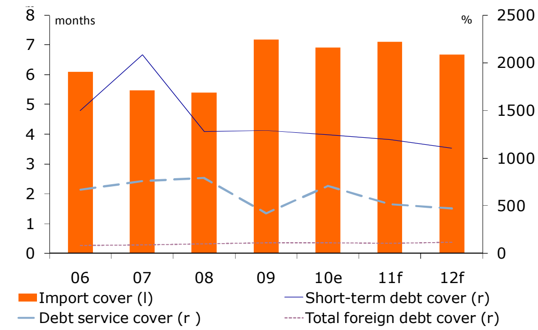
increasingly be diverted via non-bank channels (that is paper dollars smuggled in) to a re-emerging black market, rather than be stored in the banking system and add to their FX reserves. Late 2010, before the unrest erupted, the solid (although far from dynamic), financial system was adequately buffered by high local and foreign currency reserves. These amounted to almost USD 33bn and USD 19bn by the end of 2010. By the end of the first quarter of 2011 the central bank's FX reserves had declined modestly to just over USD30bn, a decline of 9%, but still at 6 months of imports. Thus, as far as data is currently available, these two sources of foreign reserves seem to have held up relatively well and the recent return to relative stability offers positive prospects.

Chart 7: External debt and official FX reserves



Source: EIU

Chart 8: External liquidity indicators



Source: EIU

External position

Reflecting the large net inflows of direct investment over the past decade amounting to USD 48bn, total international liabilities have increased from USD 56bn in 2004 (earliest data available) to USD 102bn by the end of 2009, while total external debt remained almost stable at around USD 30bn (see chart 7). The official FX reserves exceed since 2009 the external debt, where virtually all debt is public entity or government guaranteed. When including the stocks of inward and outward direct investment and commercial banks assets and liabilities, Egypt's very moderate net liabilities position amounted to around 20% of GDP over the years 2004-2009 for which data is available.

Medium and long term debt carries on average low interest rates of around 2.5% only and their effective maturities are comfortably long at 15 years. As a result, annual debt service has been at an acceptable level of only 6% to a moderate 14% of export revenues over the past years. Short-term debt is less than 10% of total and growing in line with total foreign trade values, also indicating a stable situation.

Creditors are mostly other governments and multilateral organizations. Foreign private sector creditors provide only 10-15% of total medium and long term debt, but are likely to dominate in the short term (trade-related) external finance. Minimal arrears totaling USD 3m only were reported in 2004 and 2005, but resolved in 2006.

Chart 8 shows the stability of macroeconomic liquidity ratios at reasonably favorable levels. In particular the central bank's FX reserves position is an important indicator. At the end of 2010 they equaled almost 7 months of import, excluding the net foreign assets held by commercial banks (USD 19bn by the end of 2010), which would add another 3 months to the 'import cover' ratio.

EGYPT

Egypt, Nominal GDP in bn USD	107.9	132.2	164.8	187.3	217.4	232.3	264.2
Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	6.8	7.1	7.2	4.7	5.1	4.1	4.9
Consumer prices (average % change pa)	7.6	9.5	18.3	11.8	11.1	15.2	11.3
Current account balance (% of GDP)	2.5	0.4	-0.8	-1.7	-1.5	-6.1	-3.2
Total foreign exchange reserves (mln USD)	24462	30188	32216	32253	35114	32540	33260
Economic growth							
GDP (% real change pa)	6.8	7.1	7.2	4.7	5.1	4.1	4.9
Gross fixed investment (% real change pa)	13.8	23.7	14.8	-10.2	3.9	7.5	12.0
Private consumption (% real change pa)	6.4	8.8	5.7	5.7	5.1	1.9	4.2
Government consumption (% real change pa)	3.1	0.2	2.1	5.6	4.5	7.5	5.7
Exports of G&S (% real change pa)	21.2	20.2	28.8	-14.5	-3.0	1.4	4.8
Imports of G&S (% real change pa)	21.7	30.5	26.3	-17.9	-3.2	-1.3	8.3
Economic policy							
Budget balance (% of GDP)	-8.2	-7.3	-6.8	-6.6	-8.0	-12.1	-9.8
Public debt (% of GDP)	115	101	85	81	81	86	85
Money market interest rate (%)	9.5	6.9	11.6	9.8	9.3	9.8	10.0
M2 growth (% change pa)	15	19	10	10	22	16	20
Consumer prices (average % change pa)	7.6	9.5	18.3	11.8	11.1	15.2	11.3
Exchange rate LCU to USD (average)	5.7	5.6	5.4	5.5	5.6	6.1	6.2
Recorded unemployment (%)	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Balance of payments (mln USD)							
Current account balance	2731	501	-1331	-3195	-3229	-14180	-8410
Trade balance	-12558	-20494	-26774	-22475	-23901	-28580	-26580
Export value of goods	20546	24455	29849	23089	23614	22260	23620
Import value of goods	33104	44949	56623	45564	47514	50830	50200
Services balance	8689	11195	14312	13242	12898	6430	8850
Income balance	831	1478	1373	-1922	-150	-390	-160
Transfer balance	5770	8322	9758	7960	7924	8350	9490
Net direct investment flows	9895	10913	7575	6141	5077	3780	4510
Net portfolio investment flows	-700	-4217	-7650	1832	-3486	-2720	-1620
Net debt flows	-526	1434	475	-2886	1717	-290	-1260
Other capital flows (negative is flight)	-7207	-2838	3406	-1808	2451	10730	7400
Change in international reserves	4193	5793	2475	84	2531	-2670	620
External position (mln USD)							
Total foreign debt	29351	32830	32616	29456	30841	30260	28440
Short-term debt	1633	1450	2519	2499	2823	2730	3020
Total debt service due, incl. short-term debt	3653	3973	4080	7706	4965	6300	7080
Total foreign exchange reserves	24462	30188	32216	32253	35114	32540	33260
International investment position	-10810	-8364	-27028	-29739	n.a.	n.a.	n.a.
Total assets	61559	76365	67351	72701	n.a.	n.a.	n.a.
Total liabilities	72369	84729	94379	102439	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-11.6	-15.5	-16.2	-12.0	-11.0	-12.3	-10.1
Current account balance (% of GDP)	2.5	0.4	-0.8	-1.7	-1.5	-6.1	-3.2
Inward FDI (% of GDP)	9.3	8.8	5.8	3.6	2.6	1.9	2.0
Foreign debt (% of GDP)	27	25	20	16	14	13	11
Foreign debt (% of XGSIT)	65	58	48	55	56	63	53
International investment position (% of GDP)	-10.0	-6.3	-16.4	-15.9	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	8	7	6	14	9	13	13
Interest service ratio incl. arrears (% of XGSIT)	2	2	1	1	1	1	1
FX-reserves import cover (months)	6.1	5.5	5.4	7.2	6.9	7.1	6.7
FX-reserves debt service cover (%)	670	760	790	419	707	517	470
Liquidity ratio	176	175	173	161	171	153	161

Source: EIU