Egypt: a case of bad timing

A clash between the ruling military council and the Muslim Brotherhood, last weekend, threatens Egypt's fragile economic and political stability, as it could delay a much-needed IMF deal. Thus, although fears of renewed political chaos should not be exaggerated, the potential economic implications are worrisome.

Last weekend, the Muslim Brotherhood (MB) openly clashed with Egypt's ruling military council (SCAF). The timing of the clash is less than ideal, as Egypt just started its negotiations with the IMF over a much-needed USD 3.2bn credit facility. The clash was triggered by a statement issued by the MB that called into question the SCAF's willingness to hand over power and accused it of planning to rig the upcoming presidential election, this May to June. Among others, the MB demands that, as a sign of good faith, the SCAF fires the current government ahead of the presidential elections, to replace it with the democratically elected parliament. Instead, the SCAF responded by threatening to return to the country's long history of repressing the MB.

It represents the first tear in an already fragile power sharing arrangement between the SCAF and the MB, which came about after the MB won the parliamentary elections in January (2012). The arrangement is largely a manifestation of the mutual understanding that open conflict would not be beneficial to either party. Nonetheless, a deep-seated distrust between the SCAF and the MB remains and will continue to rise its ugly head every once in a while. While the MB fears the SCAF will maintain its firm grip on political and economic power, the SCAF holds that the MB is attempting to create an Islamic constitution. Adding further tension is the fact that the only presidential candidate that was endorsed by both sides removed himself from the race, just this week.

Still, it seems very likely that a new power sharing agreement will be reached, as both sides simply have too much to lose. While the SCAF holds the military resources to repress the MB and block the presidential elections, the MB enjoys considerable support from the Egyptian population and, even though it is currently at odds with the youth groups that started the revolution, it would likely be able to mobilize the masses. As such, the failure to reach an agreement could potentially throw the country into another episode of widespread chaos, if not violence.

In addition to the political impact, renewed unrest would further aggravate the country's economic problems. Since the revolution, foreign investors have pulled out of the country, while tourists continue to stay away. As a result, foreign exchange reserves fell sharply, from USD 22bn last October, to USD 15.7bn now. Furthermore, increased public spending and reduced tax income resulted in an expected budget deficit of nearly 10% of GDP in 2011, which further adds to an already high public debt level of 86% of GDP. All in all, it is estimated that Egypt requires roughly USD 11bn in the next two years to prevent a devaluation of the Egyptian pound, or even a full-blown economic crisis. Further unrest would only increase this number and thus the risk of crisis. Such political and economic turmoil would not benefit either side and a return to the cold war-type arrangement, in which both parties reluctantly agree to co-exist and not attack, is thus believed the most likely outcome.

But, although this would certainly constitute the most rational outcome, we do worry that, since neither side has any real political experience, a tactical mistake (such as witnessed last weekend) could quickly unravel this fragile balance. In addition, the upheaval will likely delay IMF talks, as the IMF requires both sides to fully endorse its conditions, before extending the credit facility. Obtaining the credit facility is a

Anouk Ruhaak

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crucial first step in convincing investors to return to Egypt and will therefore proof vital for any effort to strengthen FX reserves. Any delays in negotiating the facility would thus jeopardize Egypt's delicate economic stability.

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Rabobank Economic Research Department

	Tel.	E-mail:
Chief economist	+31 30 21	
Wim Boonstra	66617	W.W.Boonstra@rn.rabobank.nl
International Economic Research		
Allard Bruinshoofd*	63272	W.A.Bruinshoofd@rn.rabobank.nl
Macro		
Shahin Kamalodin	31106	S.A.Kamalodin@rn.rabobank.nl
Tim Legierse	62677	T.Legierse@rn.rabobank.nl
Michiel Verduijn	30522	M.P.Verduijn@rn.rabobank.nl
Country Risk		
Erwin Blaauw	62648	E.R.Blaauw@rn.rabobank.nl
Fabian Briegel	64053	F.Briegel@rn.rabobank.nl
Jeroen van IJzerloo*	62406	J.IJzerloo@rn.rabobank.nl
Herwin Loman	31105	H.Loman@rn.rabobank.nl
Reintje Maasdam	31403	R.Maasdam@rn.rabobank.nl
Ashwin Matabadal	61601	A.R.K.Matabadal@rn.rabobank.nl
Reinier Meijer	31568	R.Meijer@rn.rabobank.nl
Anouk Ruhaak	64860	A.N.Ruhaak@rn.rabobank.nl
National Economic Research		
Hans Stegeman*	31407	H.W.Stegeman@rn.rabobank.nl
Macro		
Ruth van de Belt	60143	R.Belt@rn.rabobank.nl
Maarten van der Molen	64214	M.T.Molen@rn.rabobank.nl
Danijela Piljic	31104	D.Piljic@rn.rabobank.nl
Anke Struijs	31408	A.C.A.Struijs@rn.rabobank.nl
Theo Smid	67599	T.H.Smid@rn.rabobank.nl
Paul de Vries	30172	Vries.P@rn.rabobank.nl
Regional		
Rogier Aalders	31393	R.Aalders@rn.rabobank.nl
Cynthia Briesen	31411	C.C.Briesen@rn.rabobank.nl
Frits Oevering	64439	F.J.Oevering@rn.rabobank.nl
Anouk Smeltink-Mensen	66404	A.H.H.M.Smeltink@rn.rabobank.nl
Willem van der Velden*	62478	W.Velden@rn.rabobank.nl
Financial Sector Research		
Yvette Jörissen	64931	Y.M.Jorissen@rn.rabobank.nl
Dick Scherjon	31405	D.P.Scherjon@rn.rabobank.nl
August Sjauw-Koen-Fa	31406	A.R.Sjauw@rn.rabobank.nl
Nicole Smolders	79108	N.M.P.Smolders@rn.rabobank.nl
Leontine Treur	67084	L.Treur@rn.rabobank.nl
Bouke de Vries*	61195	Y.B.Vries@rn.rabobank.nl

**Head*