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Progress towards achieving the International Monetary Fund (IMF) conditions for the \$12 billion extended credit facility is mixed. The Central Bank of Egypt (CBE) does not, as widely expected, devalue the currency. There is continued uncertainty whether it favours a fully-floated currency or a managed floatation. Currency-related commodity shortages result in the government seizing sugar stocks from Edita Food industries and Pepsi Cola Egypt SAE. The government commits to cutting expenditure between 15% and 20% in the current financial year to meet the IMF budget deficit target. IMF approval is also dependent on Egypt securing between \$5 and \$6 billion of additional complementary bilateral financing. However, Egypt has fallen out with key creditor Saudi Arabia.

Central Bank of Egypt fails to devalue currency

Despite investor and market expectations of an imminent currency devaluation, the government remains indecisive over how best to shift to a more flexible exchange-rate system. The prospect of devaluation and exchange rate volatility will continue to deter the investment required to accelerate growth. The **International Monetary Fund (IMF)** has made the requested \$12 billion three-year extended fund facility (EFF) conditional on **Egypt** adopting a more flexible exchange-rate system (see *ARC Briefing Egypt October 2016*). The devaluation has both private sector and political backing. Since the 13% devaluation in March, the Egyptian pound (EGP) has lost 43% of its value.¹ On 26 October, the EGP reached a record low of 16.40 to the **United States (US)** dollar officially, and 16.20 on the parallel market.²

*"This devaluation is much needed, as even following the last one, the pound remained overvalued, a factor putting off investors."*³

President **Abdel Fattah Al-Sisi** (2014- present) met **Central Bank of Egypt (CBE)** governor **Tarek Amer** on 2 October to discuss floating the Egyptian pound.⁴ During the meeting, Sisi called on the CBE to ensure that unspecified "*structural reform measures*" do not harm low-income groups.⁵ Sisi on 26 September, at the opening of a housing project in **Alexandria**, said the government is working to control inflation through increasing the supply of goods "*regardless of the price of dollars*".⁶

Sisi's public political backing for the signaled move to introduce a floating exchange rate may be imminent. However, when the CBE board next convened on 14 October, it did not, as widely expected, devalue the Egyptian pound.⁷ The CBE board had postponed its regular biweekly meeting citing unspecified "*scheduling conflicts*".⁸ However, the meeting passed without a significant announcement. This increased local speculation that it was waiting to confirm it had sufficient foreign reserves (see below) to manage a devaluation.⁹ However, IMF managing director **Christine Lagarde** said on 9

¹ Bloomberg, 26 Oct 2016.

² Al Borsa, 26 Oct 2016.

³ Source, banker, Cairo

⁴ Aswat Masriya, 2 Oct 2016.

⁵ Aswat Masriya, 2 Oct 2016.

⁶ Daily News Egypt, 26 Sept 2016.

⁷ Al Masry Al Youm, 17 Oct 2016.

⁸ Al Mal, 14 Oct 2016.

⁹ Al Mal, 14 Oct 2016.

October that Egypt will need to devalue the currency prior to IMF board approval, increasing the risk of an impasse.¹⁰

“Confidence has decreased since it has emerged that, like in previous years, a tug of war has erupted between the government and the IMF over the terms. The IMF wants the devaluation before they give the next loan installment, while the government wants the money before they move to devalue.”¹¹

Local media has reported that government officials are struggling to balance concerns about price inflation in key commodities with the need to meet IMF conditions.¹² There is reportedly “near paralysis in decision making over the devaluation”.¹³

“But the road to devaluation has been filled with mixed signals from Amer, who makes preemptive statements and doesn’t follow through. Talk to bankers and they will say the same thing about him; he’s on a collision course with the market.”¹⁴

The uncertainty has damaged Amer’s standing with international financial institutions.

“He’s not left a good impression in foreign capitals. He’s deeply unimpressive.”¹⁵

The CBE could either introduce a fully-floated currency or a managed floatation regime backed by foreign reserves.¹⁶ There is increasing speculation that the CBE will not fully float the currency, but instead will implement a gradual devaluation in either November or December.¹⁷ Prime minister **Sherif Ismail** said on 17 October that there will not be a full float of the currency but reiterated the government’s commitment to devaluation.¹⁸ While Ismail was careful to acknowledge that the CBE is politically independent, there is an increasing perception that the CBE’s indecision is the result of political interference.¹⁹

“Devaluation, like the value added tax (VAT), is a necessary step, but these reforms also show the lack of competence within the government. Especially when it comes to the economy. They can’t tell the media that it’s imminent...then nothing. This only fuels uncertainty; meanwhile the dollar is skyrocketing on the black market. This is what happens when economists are not being consulted on how to run an economy.”²⁰

Egypt is about to enter a period of increased political and economic uncertainty.

“The next six months are going to be very telling for Sisi and Egypt. We are watching the government’s reform plans closely, but more importantly the mood of the country. It’s difficult to make predictions [about Egypt] as the situation can change quickly, but this is a crucial time, so we will wait and see.”²¹

Politically, pressure is increasing on the government to devalue the pound to increase domestic production competitiveness and foreign currency access to ease the shortage of imported basic commodities.²² Declining commodity supplies, especially sugar, medicine and oil, and related price hikes resulted in protests in **Matariya** and **Dakahlia Governorates**.²³ The government has

¹⁰ IMF press briefing, 9 Oct 2016.

¹¹ Source, journalist, Cairo

¹² Al Masry Al Youm, 17 Oct 2016.

¹³ Al Masry Al Youm, 17 Oct 2016.

¹⁴ Source, banker, Cairo

¹⁵ Source, business consultant, Cairo

¹⁶ Aswat Masriya, 2 Oct 2016.

¹⁷ Al Masry Al Youm, 17 Oct 2016.

¹⁸ Enterprise, 18 Oct 2016.

¹⁹ Enterprise, 18 Oct 2016.

²⁰ Source, finance journalist, Cairo

²¹ Source, western diplomat, Cairo

²² Al Alam Al Youm, 24 Oct 2016.

²³ www.al-monitor.com

responded by seizing hoarded supplies from the black market and regulating commodity prices at state sales.²⁴ Egypt-based **Edita Food industries** and US-based **PepsiCo Inc** subsidiary **Pepsi Cola Egypt SAE** have both suspended production after the government seized 9,000 tonnes of sugar stocks, which it then sold at subsidised rates.²⁵ The **Federation of Egyptian Industries (FEI)** and the **Egyptian Federation of Chambers of Commerce (EFCC)** have both criticised the seizures of stock.²⁶ Additionally, the military is playing a more active role in the import of basic commodities²⁷ and the CBE has allocated \$1.8 billion to build a six-month stock of strategic goods.²⁸ Prime minister Ismail has also formed a government committee that he will chair, to set profit margins on the sale of basic commodities.²⁹ Both the FEI and the EFCC have described government-set price caps as a breach of the **Investment Law**.³⁰

While this has affected the import of all commodities, sugar is politically sensitive in Egypt due to the popularity of sweet tea. A previously unknown group called **Thawret El Ghalaba** ('Revolution of the Poor') has called for national protests against food shortages and prices on 11 November.³¹ Local media has reported that these shortages have also affected high-end stores with middle and upper class customers.

*"Egyptians are tired. The country is a net importer. Already the currency situation has made it hard to get many goods, especially medicines and for importers the situation couldn't be worse, with the government's new obsession with the black market dealers. There's a sentiment that the government is not doing its job. Egypt's elite have only very recently started to feel the effects of the economic mess, by way that it's starting to affect their ability to use money they have in Egyptian banks abroad. They have started to critique Sisi whom they once supported unwaveringly. For everyone else, not part of the elite, it's been a hard pill to swallow. Inflation and austerity are a dangerous game. And the government, despite all its foibles is acutely aware that their political survival will depend on how the reform process plays out."*³²

The financial sector additionally forecasts increased currency volatility in the short term.³³ Egypt-based investment company **Beltone Financial** has said that, should the CBE introduce a managed-floatation regime, it may then move to a fully-floated regime within two or three weeks.³⁴ According to Beltone Financial, the IMF loan will allow the CBE and state-owned **Banque Misr** to crack down on the parallel market immediately by increasing deposit rates.³⁵ Beltone Financial expects Egypt in this period to raise \$3-5 billion on the Eurobond market, and \$2 billion through a currency swap with **China**, on top of the \$2 billion it secured from **Saudi Arabia** (see below).³⁶ This will all combine to allow the official exchange rate to stabilise at approximately EGP12 to the dollar between mid-November and the end of December.³⁷

Government announces expenditure cuts

The IMF has also made the EFF conditional on Egypt limiting the budget deficit to below 10% of gross domestic product (GDP) in the 2016/2017 fiscal year. The government on 20 October instructed all

²⁴ www.al-monitor.com

²⁵ Al Alam Al Youm, 24 Oct 2016.

²⁶ Al Borsa, 23 Oct 2016.

²⁷ Al Mal, 23 Oct 2016.

²⁸ Reuters, 20 Oct 2016.

²⁹ Enterprise, 24 Oct 2016.

³⁰ Enterprise, 24 Oct 2016.

³¹ www.al-monitor.com

³² Source, political commentator, Cairo

³³ Aswat Masriya, 2 Oct 2016.

³⁴ Aswat Masriya, 2 Oct 2016.

³⁵ Aswat Masriya, 2 Oct 2016.

³⁶ Aswat Masriya, 2 Oct 2016.

³⁷ Aswat Masriya, 2 Oct 2016.

ministries, departments and agencies to cut expenditure between 15% and 20%.³⁸ The move will assuage popular criticism that the government is happy for the population to bear the cost of fiscal austerity as it looks to meet IMF budget deficit targets. Prime minister Sherif Ismail's economic cabinet committee made the recommendation, which will also cover state-owned enterprises.³⁹ The new restrictions will come into force in the current fiscal year. Exemptions to the new expenditure restrictions include salaries, development projects, and investments.⁴⁰ The government has also cut by 50% the number of ministerial representatives in Egyptian embassies.

The finance ministry published data on 18 October showing that the budget deficit has increased 0.3% in the first two months (July – August) of the 2016 fiscal year.⁴¹ While the increase is marginal, it is indicative of the challenges that the government faces in meeting the IMF's conditions for EFF approval. The cumulative budget deficit for the two months accounted for 2.1% of annual GDP. The budget deficit for the first two months reached 68.5 billion Egyptian pounds (EGP) (\$7.72 billion).⁴² Total government revenues increased 0.7% year-on-year to EGP 46.65 billion (\$5.2 billion).⁴³ Tax revenue increased 4.9% year-on-year to EGP 37.9 billion (\$4.3 billion), largely due to a 36% increase in property tax.⁴⁴ However, customs revenues decreased 22% year-on-year to EGP 2.74 billion (\$308m) due to challenges facing importers.⁴⁵ Revenue from non-taxation income, including foreign grants, decreased 14.3% year-on-year to EGP 8.73 billion (\$983m).⁴⁶ Government expenditure increased 3.7% to EGP 114 billion (\$12.8 billion).⁴⁷ A 17% increase in the cost of debt servicing to EGP 41.73 billion (\$4.7 billion) largely offset the benefits of a 21.7% decrease in subsidy payments to EGP 20.87 billion (\$2.4 billion).⁴⁸

The cabinet statement also said the government is considering including ministries' "private funds" in the budget.⁴⁹ The government established the "private funds" to reduce ministries' dependence on the finance ministry, but they have gained a reputation for opacity and are linked to the alleged embezzlement of funds.⁵⁰

The cabinet finance committee also approved:

- A \$900m **China State Construction Engineering Co**-developed phosphate manufacturing complex in **Wadi El Gedid**;
- Allocation of EGP 900m (\$101m) to the **Egyptian Museum**;
- Allocation of EGP 200m (\$22.5m) to housing development in **Luxor**;
- Feasibility study into electric railway connecting new capital with **10th of Ramadan city**.⁵¹

Bilateral relationship with Saudi Arabia deteriorates

The IMF's extended fund facility (EFF) is also conditional on Egypt securing \$5-\$6 billion of additional complementary bilateral financing. A deteriorating bilateral relationship between Egypt and Saudi Arabia, its most important creditor, initially appeared to raise investor concerns that Saudi Arabia is reversing its previous financial backing. The trigger for the recent tension was Egyptian backing for a **Russian-drafted United Nations (UN) Security Council** resolution calling for a truce in **Aleppo**

³⁸ Youm7, 20 Oct 2016.

³⁹ Youm7, 20 Oct 2016.

⁴⁰ Youm7, 20 Oct 2016.

⁴¹ MENA, 18 Oct 2016.

⁴² MENA, 18 Oct 2016.

⁴³ MENA, 18 Oct 2016.

⁴⁴ MENA, 18 Oct 2016.

⁴⁵ MENA, 18 Oct 2016.

⁴⁶ MENA, 18 Oct 2016.

⁴⁷ MENA, 18 Oct 2016.

⁴⁸ MENA, 18 Oct 2016.

⁴⁹ Youm7, 20 Oct 2016.

⁵⁰ Enterprise, 22 Oct 2016.

⁵¹ MENA, 18 Oct 2016.

(Syria) on 7 October.⁵² The resolution failed to pass. Nevertheless, Egyptian backing is indicative of how Egypt has worked to improve ties with Russia to secure the resumption of flights between the two countries following the downing of the **Kogalymavia Ltd (Metrojet)** airliner in October 2015.

“There is disquiet in the Egypt/Saudi relationship, which is making people nervous. Saudi has been for some time Egypt’s benefactor and also guarantor when it comes to securing external funds. But Sisi’s push toward Russia is challenging this established dynamic...When you’re asking everyone for money it becomes harder to maintain old friendships.”⁵³

Egypt is ostensibly neutral over Syria, but on 17 October hosted a Syrian government delegation, led by major general **Ali Mamlouk**, head of the **National Security Bureau**, which met senior intelligence officials.⁵⁴ Saudi Arabia, on the other hand, is seeking the removal of the Syrian president **Bashar al-Assad** (2010- present) administration. There is increasing concern amongst Saudi and western diplomats alike that **Iran** is increasingly influential in Egyptian foreign affairs.⁵⁵ Iranian foreign minister **Mohammad Javad Zarif** reportedly only agreed to attend Syrian talks in **Lausanne (Switzerland)** on 15 October after securing the involvement of Egypt.⁵⁶ Concern about the increasing influence of regional rival Iran, Saudi ambassador to the UN **Abdullah al-Muallami** described Egypt’s support for the Russian resolution as “*painful*”.⁵⁷

Following the UN vote, the Saudi state-owned oil company **Saudi Aramco** suspended for one month deliveries of petroleum products to the **Egyptian General Petroleum Corp (EGPC)** on 10 October.⁵⁸ The deliveries on a long-term concessional credit basis were part of a package of support that King **Salman bin Abdulaziz al-Saud** (2015- present) announced during his visit to Egypt in April. Under the agreement, Aramco is to deliver 700,000 tonnes of petroleum products to Egypt every month over a five-year period. Aramco has confirmed that it remains committed to honouring the contract.⁵⁹ The Egyptian oil ministry says EGPC has tendered fuel shipments from other suppliers to meet the deficit.

There are other sources of tension. The Egyptian government is also waiting for a final ruling about the disputed transfer of the strategic but uninhabited **Tiran** and **Sanafir** islands in the **Red Sea** to Saudi Arabia (see *ARC Briefing Egypt May 2016*). The government has challenged the **Administrative Court** ruling in June that annulled the transfer as a breach of Article 151 of the 2014 constitution, which states that no treaty can involve the concession of land.⁶⁰ The Administrative Court hearing the appeal has adjourned and is only due to reconvene on 8 November.⁶¹ The Sunni Muslim Saudi Arabia has also expected Egypt to provide ground troops in support of military intervention in **Yemen** to combat the Shiite **Houthi** anti-government forces that Saudi Arabia views as proxies of Shiite Iran.⁶² Egypt is apparently concerned about the influence of **al-Islah**, the Yemen-based branch of the **Muslim Brotherhood**, should the Houthi’s influence decline.⁶³ Additionally, Egyptian officials have held meeting with Houthi representatives.⁶⁴

The underlying tension and the UN dispute raised concerns that Saudi Arabia might withhold a pledged \$2 billion deposit from the CBE. However, the CBE confirmed on 14 October that it had received the deposit in September, prior to the UN vote.⁶⁵ Ismail subsequently confirmed on 15

⁵² MENA, 14 Oct 2016.

⁵³ Source, journalist, Cairo

⁵⁴ SANA, 17 Oct 2016.

⁵⁵ Guardian, 18 Oct 2016.

⁵⁶ Guardian, 18 Oct 2016.

⁵⁷ Al Arabiya, 10 Oct 2016

⁵⁸ MENA, 14 Oct 2016.

⁵⁹ Al-Mnatiq, 10 Oct 2016.

⁶⁰ Egyptian Independent, 21 Jun 2016.

⁶¹ www.middleeastmonitor.com

⁶² Source, business consultant, Egypt

⁶³ www.middleeasteye.net

⁶⁴ www.middleeastobserver.org

⁶⁵ Aswat Masriya, 14 Oct 2016.

October that the CBE had included the Saudi deposit in September data that showed foreign reserves had reached \$19.6 billion.⁶⁶

Saudi Arabia is unlikely to suddenly withdraw support for Egypt as it views the country as *“too big to fail”*.⁶⁷ Nevertheless, Egypt’s relatively low foreign reserves – \$19.59 billion at end of September – mean it remains vulnerable to Saudi Arabia demanding a quick settlement of its obligations. The CBE on 14 October published data showing that total foreign debt for the 2015/2016 fiscal year increased \$7.7 billion to reach \$55.7 billion at the end of June 2016.⁶⁸ The CBE noted that foreign debt had increased \$2.3 billion in the fourth quarter alone.⁶⁹ Long-term foreign debt increased \$3.25 billion to reach \$48.74 billion at the end of June 2016.⁷⁰ Short-term debt increased \$4.44 billion to \$7.01 billion.⁷¹ Government debt decreased \$1.2 billion to \$24.4 billion, but this was offset by a \$5.85 billion increase in CBE debts to \$22.1 billion and a \$1.5 billion increase in bank debt to \$3.96 billion.⁷²

Implications

The government now expects IMF board approval for the extended fund financing in late November or December, meaning it will not receive the first tranche of funds until 2017. In the most probable scenario, the CBE will devalue the currency just before the next monetary policy committee convenes on 17 November. The monetary policy committee may then increase its benchmark rates. However, the uncertainty and mixed policy signals surrounding devaluation will increase pressure on the government’s macroeconomic credibility. The raids on the private sector factories are indicative of short-term thinking rather than a coherent plan. The speed with which the government turned to state market regulation to ensure price stability will unnerve investors. The 11 November protests over living costs will increase the risk of limited clashes in urban areas resulting in business disruption.

The government has ring-fenced from planned expenditure cuts national projects that are central to increasing growth and improving Egypt’s operating environment. This reduces the risk of delaying or mothballing key infrastructure projects. The statement may presage government announcements about cuts to popular subsidies, but are unlikely to assuage popular anger over revisions to the subsidy programme.

Egypt’s debt obligations to Saudi Arabia make it likely that it will adopt a more conciliatory stance. However, to avoid future disruptions to aid flows, Egypt may look to develop bilateral relationships with other states, including both traditional partners in the **Gulf** and China.

⁶⁶ MENA, 14 Oct 2016.

⁶⁷ Source, business consultant, Cairo

⁶⁸ Daily News Egypt, 13 Oct 2016.

⁶⁹ Daily News Egypt, 13 Oct 2016.

⁷⁰ Daily News Egypt, 13 Oct 2016.

⁷¹ Daily News Egypt, 13 Oct 2016.

⁷² Daily News Egypt, 13 Oct 2016.

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