

## Economics

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# Middle East Macro View

## Looking the Deauville declaration in the mouth

- The G8 declaration on the Arab Springs on 27 May reflected disagreement among the G8 countries on how and whether to provide support to the budding 'democracies' of the Arab spring, in our view. The suggestion that \$20bn could be available from multilaterals subject to strict conditions is, in our view, an inducement for transitioning countries to encourage them to stay the straight and narrow, politically and economically.
- We believe that, if disbursed, the \$20bn mentioned in the G8 declaration, in addition to the further \$20bn potentially being made available from the likes of the IMF, Saudi and Qatar, could have a material impact on the economic situation in Egypt and Tunisia, but will do little to shore up public finances. The lack of appetite for direct budgetary support raises serious questions about how these countries, especially Egypt, will manage their financing gap over the coming years.
- We also think it unlikely that the full \$40bn variously pledged will make its way to Cairo and Tunis because the political and economic conditionality associated with the assistance is likely to prove difficult for the two countries to meet.
- Aside from the fact that it is still far from certain to what extent the political systems in Egypt and Tunisia will transition toward western-style democracies in the near term, there are also major uncertainties as to the nature of any post-transition regimes and, in particular, their policies towards the west. That the west and the multilaterals they control would be able and willing to provide material economic assistance to countries drifting towards a state of greater hostility towards them seems unlikely, and, in our view, increases uncertainty with respect to whether this assistance would indeed materialise.
- We also think the economic conditionality of the financial assistance will be difficult to meet. We believe the market based reforms of the previous regimes were an integral element in sowing the seeds of unrest that later removed them from power. This being the case, we believe it is unlikely that any future government will be tempted to replicate these reform efforts going forward, nor would the populations be appreciative of their imposition by foreign multilaterals
- We believe that it is more likely that financial assistance will come from fellow Arab countries, with the GCC states keen to stabilise Egypt, the heart of the Arab world, and to limit the spread of Iranian influence in the region.

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# Looking the Deauville declaration in the mouth

Despite the positive media headlines, we note the G8 declaration on the Arab Springs on 27 May didn't offer any confirmed financial support to the budding 'democracies' of Egypt and Tunisia. Instead, the declaration contains the conditional suggestion that, "...multilateral development banks could provide over \$20bn... for Egypt and Tunisia for 2011-2013 in support of suitable reform efforts." Moreover, most of the multilateral financing that makes up this \$20bn was announced in the weeks prior to the Deauville summit (see figure 1).

Figure 1. What makes up the \$20bn Deauville "pledge"?

Multilateral	Pledge
World Bank	\$6bn
European Investment Bank	\$5bn
European Bank for Reconstruction and Development	\$3.6bn
Islamic Development Bank	\$2bn
African Development Bank	\$3.4bn*
*CIRA Estimate	

Source: Bloomberg, Reuters, AFP, Citi Investment Research and Analysis

**We believe the declaration reflects divides among the G8 camp over how and whether to provide financial support to 'democratising' Arab countries.** The host, France, was evidently keen to provide direct assistance, declaring \$1.4bn in bilateral soft-loans to North Africa in the coming years. Canada, on the other hand, dismissed suggestions of direct assistance, preferring to leave the burden of economic support entirely to the multilaterals in which the G8 countries are heavily invested. The United States urged the G8 to follow its own example, having offered Egypt a measure of relief on its foreign debt by allowing the country to redirect repayments on \$1bn of outstanding debt towards pre-agreed domestic investment. The United States had also previously announced \$1bn in sovereign guarantees to help Egypt tap international markets, and increase lending to the private sector in Egypt through its Overseas Private Investment Corporation (OPIC). The UK offered £110mn, and we are not aware of any further significant bilateral G8 assistance.

**Sizeable pledges have also been made by non-G8 countries and by the IMF.** Qatar has said it will provide up to \$10bn to Egypt in the form of direct investment in the country, including the building of two new ports in Alexandria and Port Said. Saudi Arabia has pledged \$4bn in long term loans and grants. Finally, IMF support may be forthcoming to help bridge financing gaps. In parallel to the Deauville declaration, the IMF announced its readiness to provide up to \$35bn in financing to the MENA region as a whole.

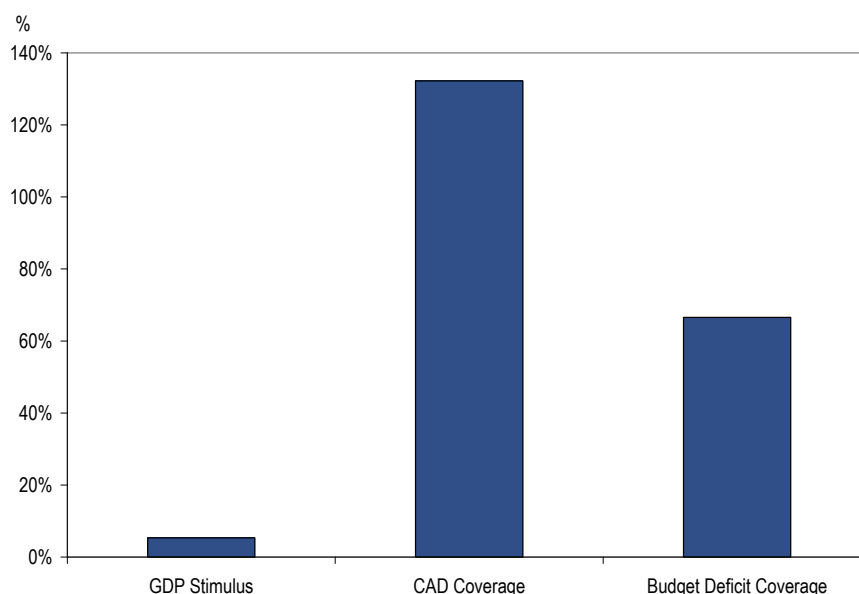
**Taken together, we calculate that the total amount of support that could potentially be made available to Egypt and Tunisia in the coming 3 years is around \$40bn.**

## Little appetite for budgetary support

**\$40bn in financial support could potentially have a material impact on the economic situation in Egypt and Tunisia, but would do little to shore up public finances, in our view.** According to our calculations, it represents over 5% of the two countries' combined annual GDP in 2011-2013, and would more than cover the combined projected cumulative current account deficit for this period. We believe this represents a healthy economic stimulus and would ensure the inflow of much

needed foreign currency, helping these countries avoid a balance of payments crisis. However, although in theory the sum would also cover two-thirds of the combined projected budget deficit for this period, the vast majority of the funds would not be deployed for the purposes of direct budgetary support, and would instead focus on lending to the private sector and for specific projects. We believe this raises questions as to how Egypt, and to a lesser extent, Tunisia will manage their government financing gaps going forward, even if the sort of financial support announced in Deauville is forthcoming.

**Figure 2. The \$40bn pledged by multilaterals, the IMF and individual countries would be material to Egypt and Tunisia's economies**

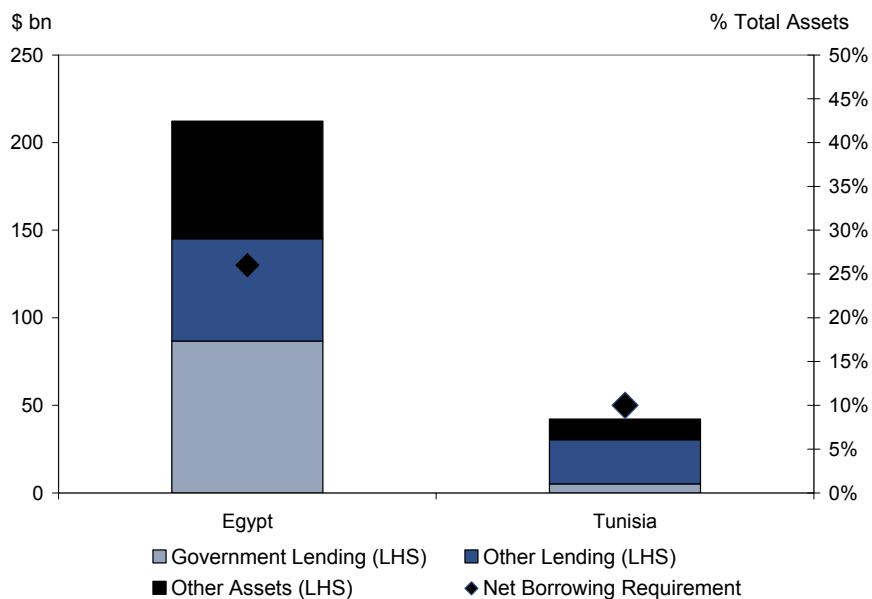


Source: IMF WEO, Haver Analytics, Citi Investment Research and Analysis

**The domestic banking sector has the capacity to support government deficits, in our view, but only at the cost of significant crowding out of the private sector.** We project a cumulative gross financing requirement of almost \$200bn for the Egyptian government during 2011-2013, while the number for the Tunisian government is a more modest \$19bn (Figure 3). For each, this includes debt falling due, with a roll-over ratio assumed at one-third of total debt. Assuming, however, that there is no question that existing debt holders (mainly local banks) continue to rollover debt, the net borrowing requirement for each government is \$56bn and \$4.3bn respectively and becomes the relevant financing measure. Figure 3 shows that for Egypt, such a net borrowing requirement represents 26% of total current bank assets. If banks were to finance the deficit in its entirety, this would increase their holdings of government debt from 41% of total assets today, to almost 61% of total assets by end-2013.<sup>1</sup> While the good news is that the banking sector has the capacity to absorb this, the bad news is that it can only do so at the expense of lending to the private sector, which would have a detrimental impact on economic growth.

<sup>1</sup> Assumes total banking sector assets growth of 10% per year

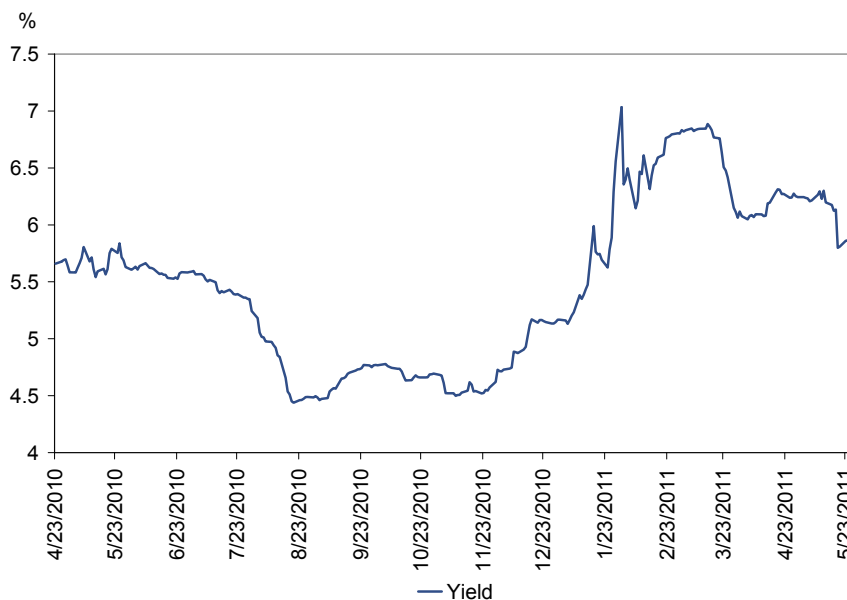
Figure 3. Banking Sector assets are already skewed towards government lending in Egypt



Source: IMF WEO, Haver Analytics, Citi Investment Research and Analysis

**International capital markets may be another option for these countries to raise finances, but it is unlikely that the amounts raised would cover a significant portion of the financing gap.** Egypt is seeking to raise \$1bn through a new Eurobond issue in 2011. According to statements by the Finance Minister Samir Radwan, this will be done with the US guarantee mentioned earlier, similar to the \$1.25bn September 2005 issue which received a AAA rating (ISIN US038461AC32). Tunisia, too, could benefit from such guarantees, particularly from the French government. However, it is unlikely that either of these countries could borrow at attractive rates in international markets off their own bats in the near term, given the ongoing political and economic uncertainties facing these countries. Yields on Egyptian external debt today stand at 150bp, 200bp higher than their pre-crisis levels, and a glut of Egyptian international paper could push these even higher, in our view (see Figure 4). Thus, the quantum of issuance is likely to remain limited by the guarantees provided, which we estimate would be insufficient to make a dent in the overall borrowing requirements of these two countries.

Figure 4. Yields on Egyptian external bonds have risen sharply



Source: Bloomberg, Citi Investment Research and Analysis

**In short, we think the amount of budgetary support pledged to the Egyptian and Tunisian governments, given their large financing requirements in the coming three years, raises questions on how the gap will be filled.** We believe this will be the key challenge, especially for Egypt, during the transition period, despite headline pledges of support.

### Conditions will also be tough to meet

**We also consider it unlikely that the actual sum of international financing will come to the full \$40-odd billion described above.** The Deauville declaration announced a partnership between the G8 countries and the transitioning Arab democracies in which context the \$20bn of multilateral financing would take place. According to the declaration:

*This Partnership is based on two pillars: a political process to support the democratic transition and foster governance reforms, notably the fight against corruption and the strengthening of the institutions needed to ensure transparency and accountable government; and an economic framework for sustainable and inclusive growth. It is designed to support Partnership Countries in the economic and social reforms that they will undertake, particularly to create jobs and enshrine the fair rule of law, while ensuring that economic stability underpins the challenge of transition to stable democracies.*

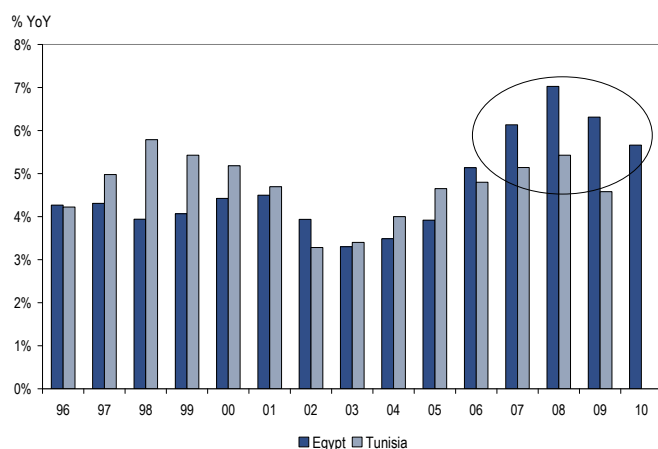
Language in US President Obama's speech on the Middle East earlier in May echoed the notion that financial support would be contingent on these countries maintaining their path towards democracy, and at the same time embracing private-sector based market reforms to stabilise their economies. So how realistic is this?

**Aside from the fact that it is still far from certain to what extent the political systems in Egypt and Tunisia will transition toward western-style democracies in the near term, there are also major uncertainties as to the**

**nature of any post-transition regimes and, in particular, their policies towards the west.** In Egypt, in particular, there has been a strong popular anti-western, anti-Israeli undertone throughout the unrest and transition period to date. Since the removal of Mubarak, Egypt's political orientation has become markedly less aligned with US and western interests. A tentative rapprochement with Iran seems underway, and relations with Israel appear strained over a gas-contract dispute and the recent decision to re-open the Rafah border crossing into Gaza. The Muslim Brotherhood and some potential presidential candidates have called for a review of the Camp David peace agreement between Egypt and Israel. Egypt also played a key role in the reconciliation of Hamas and Fatah in the Palestinian territories, an important step in the run up to the Palestinian bid for statehood at the UN in September. These developments are the bi-product of greater pluralism in Egyptian politics insofar as they echo sentiment on the street, as demonstrated by the assault on the Israeli embassy in Cairo on May 15, which was repelled by Egyptian security forces. They also reflect the growing influence of the Islamists, who have re-organised themselves and seem poised to make significant gains in any pluralist regime. That the west and the multilaterals they control would be able and willing to provide material economic assistance to countries transitioning towards a state of greater hostility towards them seems, in our view, unlikely, and increases uncertainties with respect to whether this assistance would indeed materialise.

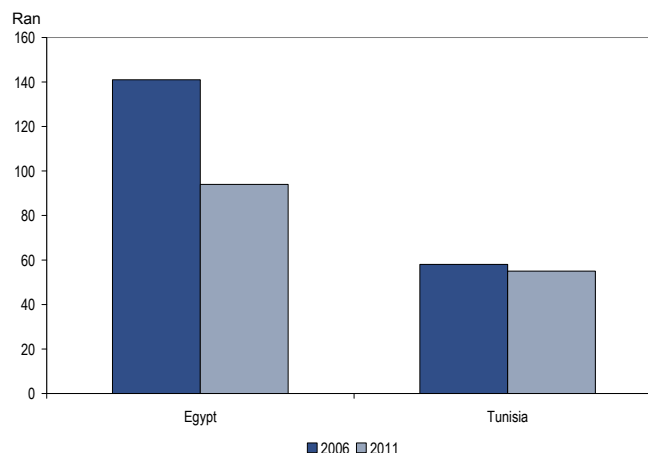
**We also think the economic conditionality of the financial assistance will be difficult to meet.** The premise set out both in the G8 declaration and Obama's speech appears to be that private sector oriented market reforms will bolster economic growth and create jobs, hence improving social stability. This will apparently safeguard political transition and prevent it from being hijacked by Islamists. We believe that this premise is flawed. Before the Arab Spring began, Egypt and, to a lesser extent, Tunisia were seeing a remarkable surge in economic growth achieved on the back of private sector oriented market reforms (figure 5). This was at a time when global economic growth had fallen sharply. The World Bank's Doing Business Report in 2010 stated that "Colombia and Egypt have been top global reformers in four of the past seven years", and Egypt's place in the rankings surged during that time (Figure 6). It appears such reforms were not met by the people with the kind of gratitude and appreciation that the government may have been hoping for. On the contrary, we believe the economic policies of the previous regimes were an integral element in sowing the seeds of unrest that later removed them from power. This being the case, we believe it is highly unlikely that any future government will be tempted to replicate these reform efforts going forward, nor would the populations be well disposed to their imposition by foreign multilaterals.

Figure 5. Growth was higher in the run up to the Arab spring than it had been in years



Source: Haver Analytics, Citi Investment Research and Analysis

Figure 6. Reforms had won recognition from the World Bank Doing Business Report



Source: Citi Investment Research and Analysis

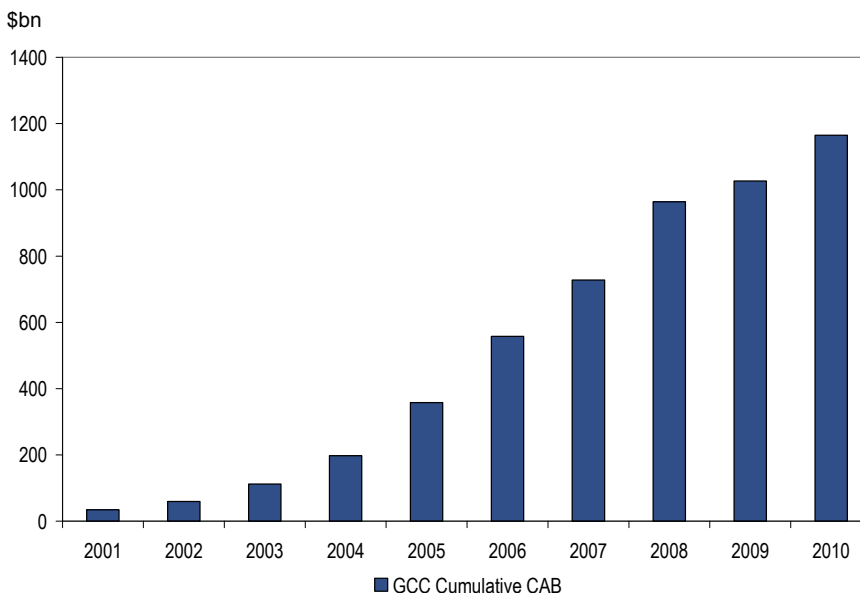
**Rather, as we have argued in the past, we expect populism to define economic policy in the medium term, with the emphasis being placed on reducing unemployment and improving wealth distribution.** In our view, this is most quickly and easily achieved through policies such as greater public sector hiring, higher wages, and increased subsidies, all of which have been implemented already. We believe that the risk of more populist policies, such as increased corporate taxes, protectionism, and even nationalisation of certain industries, is ever present, and will make it very difficult for these countries to meet the economic conditionality set out in any potential multilateral lending.

**In this context, we view the G8 declaration and pledges of western assistance as an attempt to offer an inducement to transitioning countries to encourage them to stay the straight and narrow, politically and economically.** Insofar as there is a risk that these countries will drift towards a foreign policy that is more hostile towards the west, and a domestic policy grounded in populism, we consider that the total amount of assistance that will reach Cairo and Tunis may be significantly smaller than that pledged.

## Go East

**Saudi Arabia and Qatar have pledged around \$15bn to Egypt over the coming years.** The GCC oil exporters can afford to be more generous when it comes to extending assistance than the cash-strapped industrialised countries. The GCC cumulative current account surplus over the past decade was almost \$1.2 trillion, 20 times the projected financing gap for Egypt and Tunisia during 2011-2013. The possibility of establishing a Middle East Development Bank has also been formally raised by Qatar.

Figure 7. High oil prices have left GCC countries awash with liquidity



Source: Haver Analytics, Citi Investment Research and Analysis

**The conditionality on loans from fellow Arab states is likely to be less stringent than that on western funding.** This is not to say that wealthy Arab states will act purely out of a sense of philanthropy. Egypt's place at the centre of Arab politics is well established, and Egypt is widely seen as a weathervane for the region as a whole. Instability in Egypt is viewed as a threat to all Arab countries. Moreover, the GCC states are seeking to prevent Iran from gaining any further influence in the region, and are thus keen to extend their own influence over all Arab countries at a time when US influence appears to be ebbing.

## Conclusion

**The G8 declaration on the Arab Springs on 27 May reflected disagreement among the G8 countries on how and whether to provide support to the budding democracies of the Arab spring, in our view.** We believe that the suggestion that \$20bn could be available from multilaterals subject to strict conditions amounts to an inducement to transitioning countries to encourage them to stay the straight and narrow, politically and economically.

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## Appendix A-1

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