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Egypt Macro View

Are lower oil prices good for Egypt?

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- As oil prices trend sharply downwards, our first concern has naturally been the oil-exporters of the region, mainly the Gulf countries and Iraq, for whom lower oil prices present clear fiscal and economic challenges. But there may be a silver lining for the region: if lower oil prices are bad for the oil exporters, then they are surely good for oil importers such as Lebanon, Jordan and Egypt. Right? Wrong.

- A narrow analysis of the government budget and trade balance would suggest a marginally positive effect from lower oil prices. Indeed, driven by the impact on the subsidy bill, we calculate that a $10 per barrel fall in the price of Brent translates into a narrowing of the budget deficit by 0.7% of GDP. At current prices (around $85) this implies a net narrowing in the deficit relative to budget of around 1.4% of GDP.

- Turning to the trade balance, we find that Egypt's oil exports (including oil-related Suez Canal revenues) and imports are roughly equal; implying that an oil price move will have no significant effect on the overall trade balance, as both exports and imports will rise and fall in tandem.

- Thus far, it would be tempting to conclude that with a positive effect on the budget and a neutral impact on trade, a fall in oil prices is on balance good for Egypt. However, this ignores other indirect factors that could have a negative effect on both public finances and the balance of payments (BoP).

- On the public finances side, our main concern is with respect to the contingent liabilities accruing at the state oil company EGPC. EGPC is responsible for settling arrears with IOCs (currently standing at around $6bn) and has recently been mandated to pay future for future LNG imports, according to local press reports (the Egyptian paper *Daily News*, August 23). To cover these costs, EGPC debt has been rising sharply, and lower oil prices put further pressure on the company's finances. We believe that it is likely that the government will have to step in to support EGPC and/or take a greater share of the procurement bill onto the budget, raising oil-related expenditures and potentially more than compensating for any on-balance sheet gains from falling oil prices.

- On the external side, lower oil prices bring into question the extent of future support to the BoP coming from the Gulf, be this from workers' remittances, government aid, FDI or tourism. Remittances and aid, in particular, have been critical in helping Egypt avert a BoP crisis in recent years, while much hope is pinned on the resurgence of FDI going forward. In our view, lower oil prices likely jeopardise these supporting factors, resulting in our assessment of the impact on the BoP as being probably negative.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Are lower oil prices good for Egypt?

As oil prices trend sharply downwards, our first concern has naturally been the oil-exporters of the region, mainly the Gulf countries and Iraq, for whom lower oil prices present clear fiscal and economic challenges (see Middle East Macro Monthly - Twin peaks in peril: The threat to the GCC from falling oil prices, September 30). But in the logical spirit of economic symmetry, it is tempting to see a silver lining for the region: what is bad for the oil exporters is surely good for oil importers such as Lebanon, Jordan and Egypt. Right?

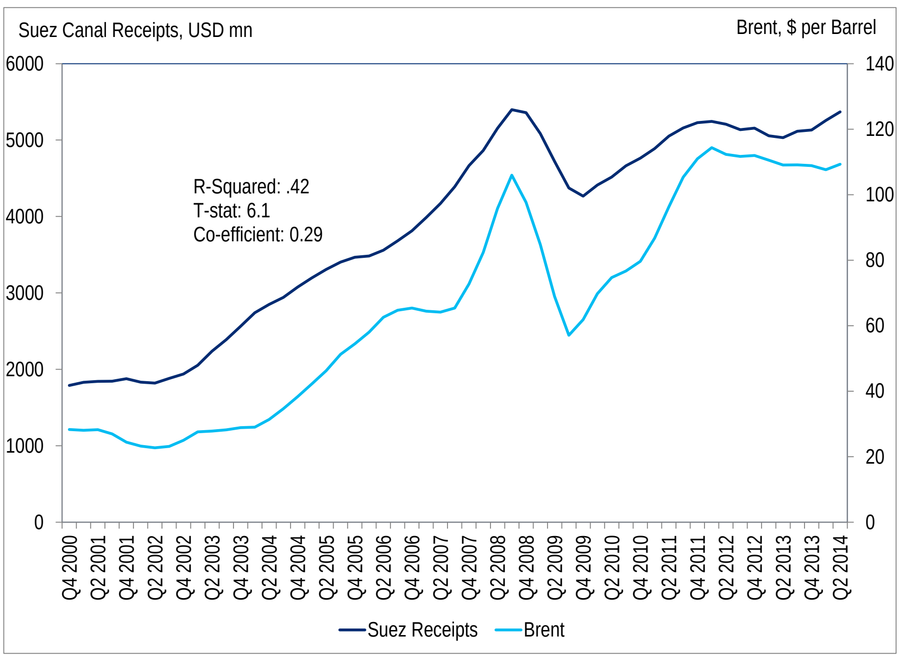
In this note we examine whether this logical symmetry holds and find that sadly, it does not. Even though the direct impact of lower oil prices on Egypt's public finances and trade balance is marginally positive, the indirect impact, coming from rising government contingent liabilities and a potential reduction in support from the oil-rich Gulf in a low oil price environment, probably outweighs this.

Impact on the public purse

Oil prices directly impact the Egyptian budget through both the revenue channel and the expenditure channel. But the vagaries of the Egyptian budgeting process potentially mask other routes by which oil prices movements can harm or benefit the public purse. Most notably, the extent to which the central government pushes responsibility of certain oil-related expenditures onto the state oil company, and the contingent liabilities this creates, should also be taken into account.

There are two channels through which lower oil prices will reduce budgetary revenues. The first is direct oil revenues: we estimate these to have been around 5% of GDP (with oil prices at an average of $105 per barrel) in FY 2013/2014. Assuming these revenues decline in proportion to the oil price, we therefore calculate that a $10 per barrel fall in the price of Brent translates into a roughly 0.5% of GDP decline in Egyptian government revenues.

Figure 1. Suez Canal receipts are highly sensitive to the oil price



Source: Haver Analytics, Citi Research

The second channel is through their impact on Suez Canal receipts. These are particularly sensitive to oil prices, as Figure 1 shows, as oil tankers make up a large proportion of ships going through the canal, and fees are charged in proportion to the value of the freight being carried. In the absence of a detailed breakdown of fees, we are forced to estimate the sensitivity of Suez Canal revenues to oil prices using a simple regression on quarterly data beginning in 2000. The results confirm a strong correlation between the Brent oil price and Suez Canal revenues, with changes in the former explaining almost half of the changes in the latter. The regression tells us that a 1% change in the price of oil results in a 0.3% change in Suez Canal receipts. This implies that a $10 per barrel fall in the price of Brent translates into a roughly 3% fall in Suez Canal revenues. With Suez Canal Receipts contributing a little under 2% of GDP to revenues, this implies that a $10 fall in the oil price will result in a loss of revenues of around 0.1%, bringing the combined estimated loss of direct budgetary revenues (including the fall in direct oil receipts) to 0.6%.

That said, falling oil prices clearly save the Egyptian government money in the form of reduced subsidies. The Egyptian government has for the current fiscal year budgeted to procure almost EGP220bn ($31bn) in petroleum products domestically and externally, and expects to recoup around half of that cost through domestic sales (Fig 2).[1] This represents a subsidy of almost EGP110bn ($15bn). A reduction in the procurement costs proportionate to a decline by $10 per barrel in the price of Brent would therefore translate into direct estimated savings to the Egyptian government of 1.3% of GDP.

Figure 2. Total budgeted subsidies for current fiscal year represent 6.2% of GDP

	Cost	Revenue	Subsidy	% Total	% GDP
Butane Gas	20236	1120	19116	18%	1.1%
Petrol	34482	14335	20147	19%	1.1%
Kerosene	79	26	53	0%	0.0%
Diesel	70024	25120	44904	41%	2.6%
Fuel oil	44891	28860	16031	15%	0.9%
Natural gas*	50148	42032	8116	7%	0.5%
Total	219860	111493	108367	100%	6.2%

Source: Budget Financial Statement 2014/2015, Citi Research

*Natural gas figure taken from the 2013/2014 budget as was not included in current subsidy budget

This implies that the net benefit to the Egyptian budget from a $10 per barrel fall in the oil price is equivalent to around 0.7% of GDP (1.3% savings minus the loss of 0.6% in oil revenues). At current oil prices of around $85 per barrel, this implies a narrowing of the deficit (relative to budget) of around 1.4% of GDP, all else equal.

But all else is not equal, and the off-balance sheet impact of the fall in oil prices must be considered to assess the impact on overall public finances. Here, the main issue is the opaque relationship between the state oil company, Egyptian General Petroleum Corporation (EGPC), and the central government. EGPC has acted as a fiscal safety-valve in recent years as the Egyptian government has built arrears to international oil companies, currently standing at around $6bn, and has parked these on EGPC's balance sheet. This has led to a decline in production as foreign partners have all but halted investment, which has put further pressure on EGPC revenues and capacity to pay. The vicious cycle has led to rising debt at EGPC,

[1] Details available in the Budget Financial Statement 2014-2015, only in Arabic at: http://www.mof.gov.eg/MOFGallerySource/Arabic/budget2014-2015/Financial_statement14-15.pdf

some of which has been guaranteed by future oil revenues, further reducing expected earnings. Most recently, the Egyptian government has also passed on the responsibility of paying for expected LNG shipments from Qatar and elsewhere to EGPC, a move that has led to Ministry of Petroleum officials arguing that the government is putting EGPC finances in jeopardy (Egypt's *Daily News*, August 23).

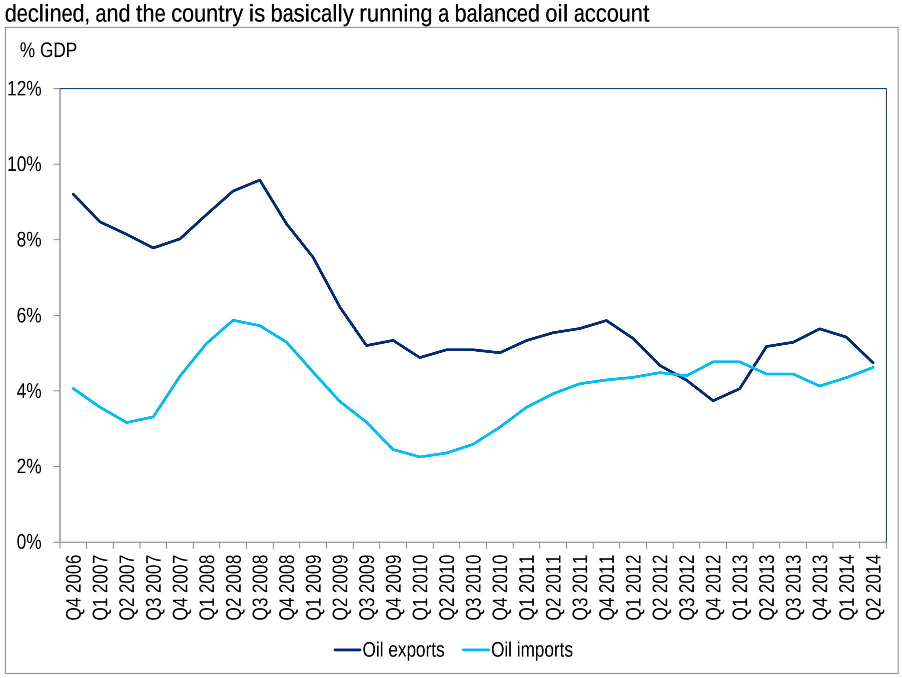
And so the recent decline in oil prices, which will further squeeze EGPC revenues and exacerbate an already precarious financial position of the state-owned company, will potentially have broader negative repercussions for public finances, although these are not captured by a simple balance sheet analysis. We believe that it is likely that the government will have to step-in to support EGPC and/or take a greater share of the procurement bill onto the budget, raising oil-related expenditures and potentially more than compensating for any on-balance sheet gains from falling oil prices.

Impact on external balances

As with public finances, there is a simple analysis of the direct impact of oil prices on the trade balance, as well as a more nuanced view regarding the indirect impact on the overall balance of payments, which is at least as important.

Egypt's net oil export position (including oil-related Suez Canal revenues) has been declining in recent years as local demand has outstripped production growth, reducing total exports. Today, the country's oil trade is roughly balanced, with oil exports (including oil-related Suez Canal revenues) and imports each accounting for around 4% of GDP (Fig 3). This means that an oil price move (assuming it has an equal effect on selling and buying prices) will have no significant effect on the overall oil balance and trade balance as both exports and imports will fall in tandem.

Figure 3. Egypt's net petroleum exports (including oil-related Suez Canal revenues) have declined, and the country is basically running a balanced oil account

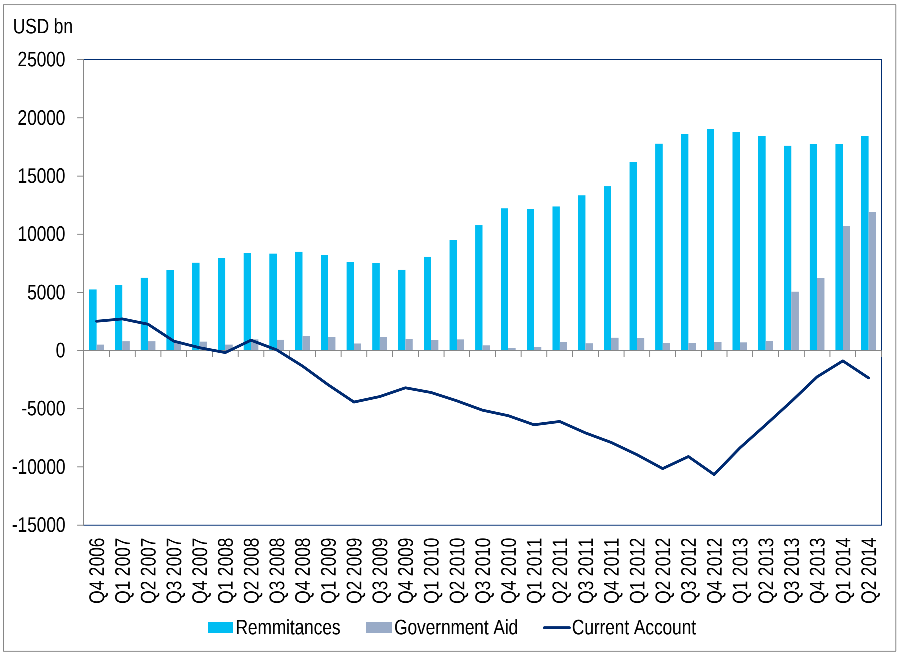


Source: Haver Analytics, Citi Research

But to conclude that Egypt's external position is neutral regarding the price of oil would not be entirely correct, in our view. This is because there are other highly significant sources of external financing that are potentially jeopardised by falling oil prices.

Perhaps somewhat counter-intuitively, the high oil price environment of the past decade has brought benefits to the region's oil importers as the Gulf countries have risen in prominence as a source of remittances of workers abroad, foreign government aid, investment and tourism. In 2011, the IMF published empirical analysis that supports the hypothesis that "…the price of oil, through its impact on external income and in turn on capital accumulation, is one of the main long-run drivers of real output in Jordan."[2] Jordan, we note, is a country with no oil resources and a complete dependence on oil and gas imports for domestic energy needs. More recently, the positive effects of abundant oil wealth in the Gulf are most vividly demonstrated in the billions of dollars that the Gulf countries have pumped into Egypt, Jordan and Lebanon to prop up these economies in the face of serious domestic political and economic challenges.

Figure 4. Workers' remittances and government aid have risen considerably in recent years, helping Egypt to contain its widening underlying current account deficit



Source: Haver Analytics, Citi Research

In Egypt's case, workers' remittances[3] and official foreign aid from the oil-rich Gulf have been instrumental in propping up the country's external balances and reserves, and probably preventing an all-out balance of payments crisis in the wake of the 2011 revolution and the ensuing political and economic instability (Fig 4). Remittances have risen roughly threefold since the start of the decade, and stood at $18.5bn (6% of GDP) in the year to end-June 2014. Government grants (mainly from the Gulf) have ballooned to almost $13bn during that period. This latter number does not include deposits from Gulf countries into the Central Bank of Egypt to prop up reserves.

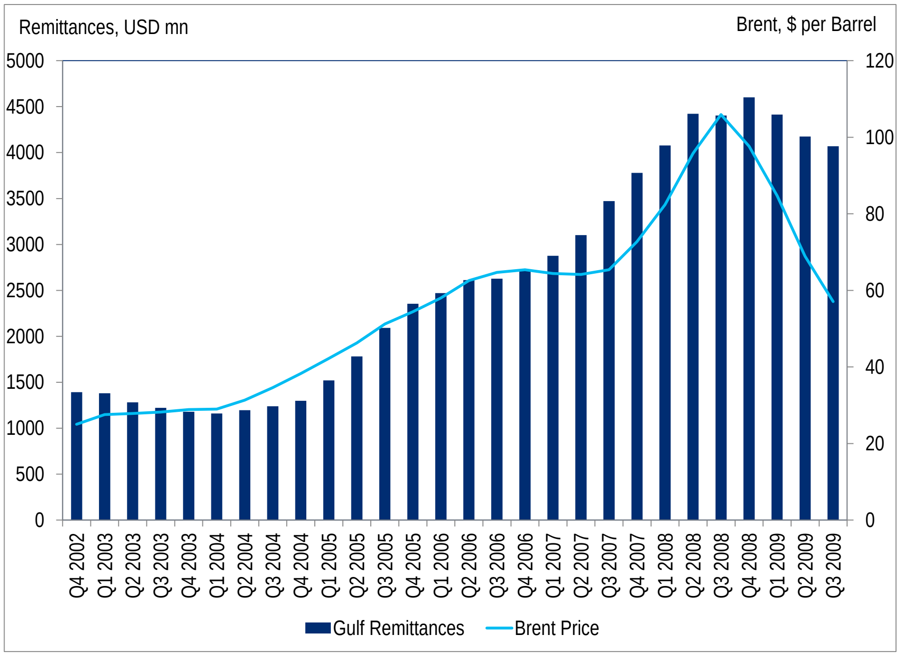
Are these inflows at risk in a low-oil price environment? We believe they may be.

[2] Mohaddes, Kamiar and M Raissi, 2011, "Oil Prices, External Income, and Growth: Lessons from Jordan", *IMF Working Paper*, WP/11/291

[3] The last geographical breakdown we have of remittances we have is from 2009, which shows that over 50% of total remittances originated from workers in Gulf countries. This number was growing, and Gulf countries accounted for the vast majority of remittance growth.

Remittances, in particular, appear highly correlated to the oil price (Fig 5). Throughout the early part of the 2000s, rising oil prices fuelled considerable growth in Gulf economies and in public spending. Egyptian school teachers, health workers, construction workers and professionals flocked to Kuwait, Saudi Arabia and the UAE, in particular, to cash in on the boom. In 2008/2009, the Gulf economies took a hit as the Brent oil price tumbled from over $140 per barrel to under $40 per barrel in a matter of weeks. The real estate bubble in Dubai collapsed, insolvent investment companies in Kuwait shook the financial system, and the global economic downturn put a dampener on domestic growth prospects. This all translated into a drop-off in remittances in absolute terms of close to $1bn in 2009.

Figure 5. Remittances from Egyptian workers in the Gulf appears correlated to the oil price



Source: Haver Analytics, Citi Research

We do not expect the recent fall in oil prices to result in the sort of economic sudden stop that we saw in 2009 (see Middle East Macro View - Twin peaks in peril: The threat to the GCC from falling oil prices, October 1). However, in a low oil price environment, we expect growth in Gulf jobs and salaries to slow and to result in a stagnation of remittances in absolute terms. This would mean declining remittances in %GDP terms, and therefore declining support to the current account. Moreover, low oil prices are likely to accelerate efforts by GCC governments to reduce dependence on foreign labour (e.g. the Nitiqat programme in Saudi), putting further downward pressure on remittances from the Gulf.

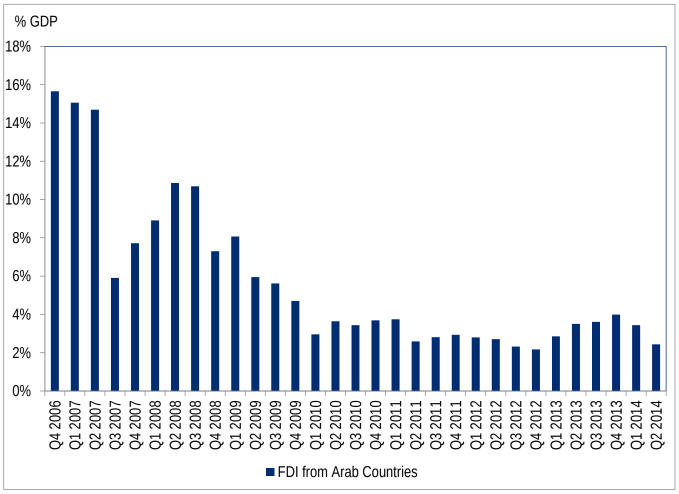
We are more sanguine with respect to the prospects for continued government aid from the Gulf in a low oil price environment. We consider this aid to be motivated by wider geopolitical calculations, and the willingness/ability of Gulf governments to prop up the Egyptian government is unlikely, in our view, to be very sensitive to oil revenues, at least in the near- to medium-term. That said, our expectations of further government aid are not high. Rather, we believe the strategy going forward is to gradually replace official aid with FDI from the Gulf, a main driver of the forthcoming Egyptian Economic/Investor Forum, tentatively scheduled for early in 2015.

This leads us to the question of whether FDI will be negatively impacted by the falling price of oil. On the one hand, we would argue that FDI has already fallen off a cliff: FDI from Arab countries collapsed in the wake of the 2008/2009 global economic downturn and fall in oil prices, and has not recovered due the political instability that has gripped Egypt since early 2011. FDI is thus unlikely to have any further negative impact on the balance of payments.

On the other hand, as mentioned above, FDI from the Gulf is one of the key pillars upon which Egypt plans to build its economic recovery going forward. The Egyptian Economic/Investor Forum is being touted by the government as a landmark event that will see in excess of $20bn in FDI pledges, mainly from the Gulf (see Middle East Macro Monthly - Trip notes from Cairo, July 4). Whether a low oil price environment will have a bearing on Gulf FDI appetite remains to be seen, but we would consider risks to be on the downside.

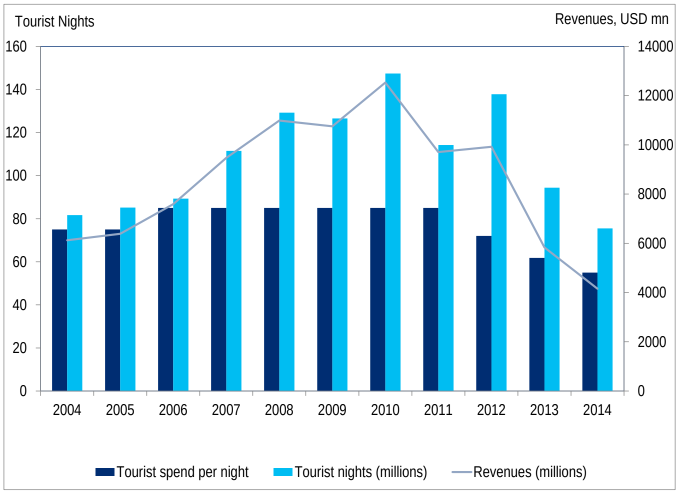
Finally, our thoughts, on tourism. In our view, Gulf tourism remains a relatively small segment of the overall Egyptian tourism market, which has in any case declined significantly in recent years as a result of the country's political instability. Low oil prices may imperil future Gulf tourist numbers, but the trend has been negative anyway and the incremental downside is unlikely to be large, in our view. Nor is a turn-around in the tourism industry a central part of our projections for Egypt: we continue to believe that the tourism industry will remain depressed until the security situation stabilises, particularly with respect to domestic terrorism, and that this is unlikely in the near- to medium-term.

Figure 6. FDI from the Gulf has never really recovered from the global economic downturn



Source: Haver Analytics, Citi Research

Figure 7. Tourism revenues have fallen off sharply in the wake of political instability



Source: Haver Analytics, Citi Research

Appendix A-1

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