

Egypt Macro View

Has Morsi taken control? Is that good for markets?

- Egyptian President Mohamed Morsi has removed top military brass (including SCAF leader Field Marshal Tantawi), and has reclaimed executive powers.
- Signs of collusion/accommodation with next generation of military leadership implies reduced SCAF-MB tensions going forward in our view.
- But Morsi's consolidation of power will probably alarm anti-brotherhood elements in Egyptian society. We expect ongoing confrontations in the political scene, but are also wary of potential further capital flight.
- Overall, we are marginally more bullish on the prospect that Egypt may avoid a disorderly currency devaluation, but do note the risks remain elevated, especially given the \$1.1bn FX reserve burn in July.
- We still expect that economic growth will remain sluggish and fiscal pressures will continue to build. However, we also note that the consolidation of the President's executive powers and the likely easing of tensions with the SCAF do provide a stronger platform for economic policy going forward.

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Has Morsi taken control? Is that good for markets?

On Sunday, Egyptian president Morsi has ostensibly made a bid to consolidate power by forcing into retirement Field Marshall Hussein Tantawi, 76, defense minister, head of SCAF, and de facto leader during transition, along with other top brass including the Chief of Staff, the head of the Navy and the head of the Air Force. All have been forced into semi-retirement, with comfortable post military roles and various honours.

At the same time, Morsi also repealed a constitutional declaration issued in June which gave the military a host of executive and legislative rights in the absence of parliament.

We believe it is likely that these developments were the result of a deal struck between certain elements within the military leadership and the presidency. Indeed, Reuters (August 13) reported that a SCAF member said the decisions were taken in consultation with the military leadership. In our view, Morsi's political capital was on the rise after censuring the security establishment for their failure last week in the Sinai, where 16 servicemen were killed by terrorists. This was also a damaging embarrassment for the military top brass. It was in this context that we believe a deal would have been struck to hand the reins of military leadership to the next generation of Generals, lead by General Abdel-Fattah El-Sissi, 57, who replaces Tantawi as defense minister. We believe part of this deal would have included revoking the constitutional decree.

In short, we interpret the most recent developments as an alignment of interests between younger but powerful elements within the military and the MB, resulting in an internal regime change within the military. We do not believe that Morsi could or would have acted without the support from within the military.

So has Morsi taken charge?

Yes and no. Morsi's hand has been strengthened significantly. Apart from establishing a more symbiotic relationship with SCAF where interests are better aligned (at least for now), his reclaiming of executive powers significantly bolsters his position. Indeed, in the absence of parliament, which was dissolved earlier in the Summer, Morsi has near-supreme control in the near term, including the right to appoint a constituent assembly to redraft the constitution should the current assembly be dissolved. In this sense, Morsi has very much taken charge.

That said, the big unknown is the extent to which the military will continue to act as a check on Morsi's powers. We do not believe that the military, despite personnel changes at the top and a more amicable relationship with the presidency, have accepted to be totally subservient to a civilian government. We believe the old lines are very likely to be in place: the military will not accept civilian oversight in its economic affairs, and will strive to preserve its extensive political powers, particularly in the field of foreign policy. In this sense, Morsi has taken charge only up to certain point, one determined by the ongoing position of the military as a central pillar of Egyptian government.

What does this all mean for political stability?

We believe that the good news is that tensions between SCAF and the government should now ease significantly. The deal struck implies agreement on the relative roles of the executive and the military, at least for the time being. However, there are a couple of downside possible consequences.

First, Egypt's anti-Islamist (secular and minority) groupings are harbouring grave concerns regarding the consolidation of powers in the hands of an Islamist president. The traditional thinking among more sanguine seculars was that it didn't really matter that an Islamist was president, so long as the military was there to keep any Islamist tendencies in check. Now, this belief is less secure. Insofar as secular liberals enjoy a disproportionate amount of the country's wealth, concerns may surface regarding further possible capital outflows. However, we believe this is unlikely to be triggered in the absence of "anti-secular" policies put forward by the Muslim Brotherhood or Morsi. But the benefit of the doubt is diminishing rapidly. Very likely will be a rise in tensions between Islamist and anti-Islamist elements, which will make for a continued fractious and disunited political scene going forward.

Second, the new co-habitation deal between the executive and military could come under threat during the constitutional redrafting process, something the executive does not have total control over. This could cause animosity between the SCAF and the executive to resurface, leading to further political instability.

What does this mean for the economy?

Our immediate reaction is that this is potentially good news for the near-term economic outlook, in our view. The consolidation of power within the presidency should provide a stronger platform for economic policy, which may also be good news for an IMF deal. Already, Qatar's \$2bn deposit with the Central Bank of Egypt may have helped push out the likelihood of a balance of payments crisis, and a disorderly sharp devaluation of the pound – an easing of SCAF-MB tensions could help bolster confidence and promote further investment and capital inflows.

That said, any negative anti-secular policies will likely antagonize anti-Islamist elements of society (as discussed earlier) and could destabilise the economy. The \$1.1bn fall in FX reserves in July, which was largely due to the repayment of an external bond during the month, illustrates that the external situation remains very precarious indeed. Growing unease among Egypt's secular/minority groupings could add to the pressures on that front.

Moreover, the near-term drivers remain relatively weak, given the state of the global economy and the myriad social/economic challenges the country faces. We believe it is unrealistic to expect Egypt to return to its former growth trajectory in the near term in the absence of a prolonged period of economic reform coupled with sustained political stability. This will, by definition, take time to establish.

Finally, we hold to our view that the public finances are likely to remain weak given the spending pressures that exist and the less than buoyant economic outlook. The government will thus need to improve its long-term financing options should it wish to avoid negative policies in our view, such as monetising the debt or crowding out private sector borrowing from banks (see [Egypt Macro View - Can The Banking Sector Finance The Sovereign?](#) August 7).

Appendix A-1

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