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The Good News from Egypt – and the Bad

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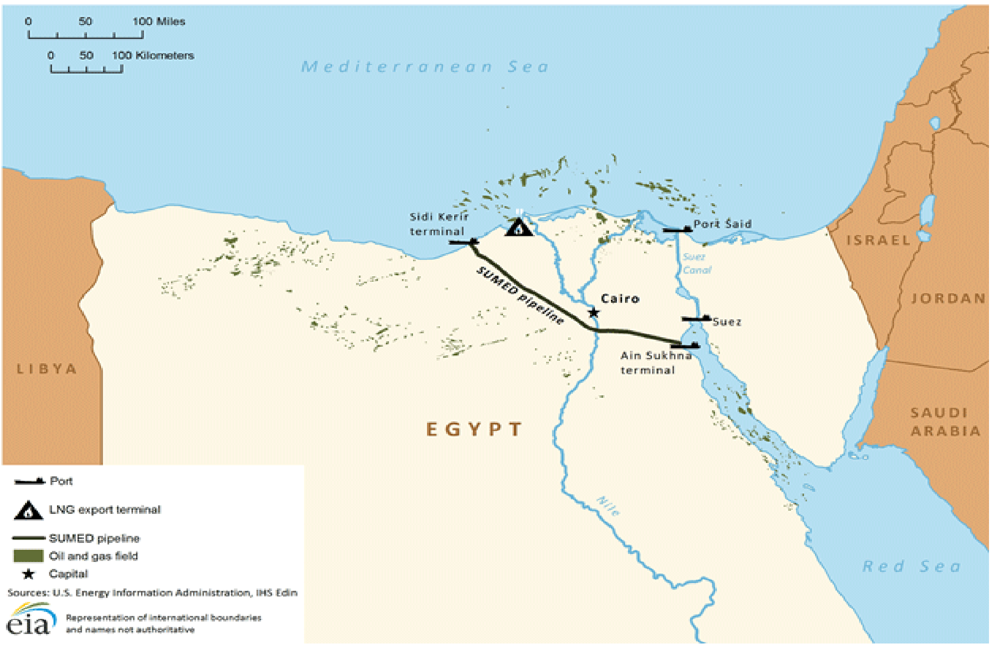
At the beginning of August 2015, President ʿAbd al-Fattah al-Sisi inaugurated the expansion of the Suez Canal project. It added 35 kilometers (km) of new channels to the existing canal, forming a parallel side channel running about one-third the length of the existing canal. An additional 35km of the original canal were dredged to make way for larger ships. The Suez Canal Authority claims that the expansion will lower waiting times for ships and will more than double annual revenues to $13.2 billion by 2023. That increase would reportedly require a nine percent annual increase in the volume global trade, although between 2005 and 2013, international trade grew by an annual average rate of only three percent. The canal has immense political as well as economic significance for Egypt, as a brief look at its history will show.



When it opened, the Suez Canal was only 25 feet deep, 72 feet wide at the bottom, and 200 to 300 feet wide at the surface. As a result, fewer than 500 ships navigated it in its first full year of operation. Major improvements began in 1876, however, and the canal soon grew into the one of the world's most heavily traveled shipping lanes. In 1875, Great Britain became the largest shareholder in the Suez Canal Company when it bought the stock from the Ottoman governor of Egypt. In 1882, Britain invaded Egypt, beginning a long occupation of the country that lasted until the Anglo-Egyptian treaty of 1936 made Egypt virtually independent, but with Britain reserving rights over the canal.

After World War II, Egypt pressed for evacuation of British troops from the Suez Canal Zone, and in July 1956 President Gamal ʿAbdel Nasser nationalized the canal, hoping to charge tolls that would cover the cost of constructing the Aswan Dam on the Nile. Israel invaded the Sinai in late October 1956, and British and French troops landed in early November, occupying the Canal Zone. Under pressure from the U.S. and the U.S.S.R., Britain and France withdrew in December, and Israeli forces departed in March 1957. That month, Egypt took control of the canal and reopened it to commercial shipping.

Ten years later, Egypt shut down the canal again during the Six Day War and Israel's occupation of the Sinai Peninsula. For the next eight years, the Suez Canal became the front line between the Egyptian and Israeli armies. In 1975, Egyptian President Anwar al-Sadat reopened the Suez Canal as a goodwill gesture after peace talks with Israel. In recent years, a daily average of 50 ships have navigated the canal, carrying more than $300 million tons of goods a year.

Parts of the canal were, however, too narrow for two-way traffic and so the canal authorities arranged for ships to take turns passing in convoys heading in alternate directions. For many years, Egypt has been trying to reduce the bottlenecks. Three side channels were created in 1955 and another three in 1980. And in recent years, Egypt has implemented dredging projects to deepen the canal to accommodate ever-larger cargo ships passing through the canal.

The expansion plan, ordered by President Sisi in 2014, yielded two major economic achievements. The first was that the project was completed in one year, a third of the time that experts said it would take. The second is that it was domestically financed: Egyptians bought nearly $9 billion in special investment certificates paying 12 percent interest to fund the project. In addition, the government plans to turn the canal zone into a giant logistical, ship-servicing, and manufacturing hub.

The president issues a decree designating the Suez Canal area a special economic zone, stating that the law regulating operations in the zone now applies to the area, which extends over 460 square kilometers. Work on the Suez Canal Area Development Project (SCADP) can now begin, as the legal framework has been agreed to by the government.

Egypt's aim is to attract investment to the area on which it is pinning hopes to spur economic growth and job creation. The area includes six ports, East Port Said, West Port Said, Ain al-Sukhna, al-Arish, al-Tor and Adabya, and other areas such as the Technology Valley in Ismaʿilia and other industrial and logistical zones around the three canal cities of Suez, Ismaʿilia, and Port Said. Legal changes provide a simplified tax and customs regime, one of the main hurdles facing investment in Egypt. They will also exempt exports from all forms of tax and include a very flexible dispute-settlement plan.

Also in August, Eni SpA, the Italian oil and gas company, announced that that it made a massive natural-gas discovery about 130 kilometers off the Mediterranean coast of Egypt. The gas finding, estimated at about 30 trillion cubic feet (tcf) or 5.5 billion barrels of oil equivalent, is enough to supply Egypt for decades. This represents a 50 percent increase in Egypt's reserves, compared with those estimated by BP at the end of 2014. Egypt will use most of the gas for domestic consumption, exporting any excess using a liquefied natural gas plant that Eni has at Damietta, not far from the field.

Eni has been prospecting for oil and gas in Egypt for over 60 years and is the biggest Western producer there. It will use existing facilities, including offshore platforms near the new find, to keep the development costs relatively low. A subsea well also will be used to limit costs.

Drilling is expected to begin early in 2016, with production likely to start in 2017. Eni, through an Egyptian subsidiary, has complete control of the exploration and will have a 50 percent stake in the production, with the rest held by Egyptian state oil and gas companies: the Egyptian General Petroleum Corporation and the Egyptian Natural Gas Holding Company.

This discovery comes after years of turmoil Egypt, which had once been a gas exporter, and had become an importer over the past few years after production failed to keep pace with the growth of domestic demand. The new gas find could help Egypt, which is dealing with its worst energy crisis in decades, meet most of its domestic gas demand. It may also have implications for neighboring Israel, which is looking to export its own deposits to Egypt and Jordan. The Leviathan natural gas field off the coast of Israel, with between 16 and 22 tcf of reserves, was the largest discovery in the Mediterranean before this Egyptian gas field was found.

Egypt faces three related crises: a shortage of electricity, a shortage of gas, and a fiscal crisis. The gas crisis resulted from the combination of fast-growing demand, government subsidies, and underinvestment in new gas production. Low prices for producers dating back to the Mubarak era have been a disincentive to produce. The electricity crisis is also the result of growing demand with subsidized prices. Shortages of electricity, gas, and petrol helped to undermine Morsi's rule and a solution is therefore one of Sisi's highest priorities. The fiscal crisis is partly the result of the state’s enormous subsidy burden. In 2013/14 fuel subsidies accounted for 6.3 percent of government spending. Following the subsidy cuts announced last summer, this is planned to fall to 3.1 percent in 2015/16. Further the scale of the state oil company’s debts mean that it cannot reimburse international oil and gas companies for their costs, causing some of them to cut investment.

The government has increased prices for domestic gas production, as in the deal with BP and RWE of Germany to develop the large West Nile Delta Project. This is in line with the government’s liberalization policy that resulted in subsidy cuts for consumers. Liquefied natural gas imports have finally begun after many delays with Egypt benefiting from sharp falls in the price of the fuel. Two more import terminals are planned and large users are to be able to procure their gas directly. Gas supplies from Cyprus have been discussed, and would be less politically sensitive than a deal with Israel. Israeli gas could be chilled for re-export from Egypt's idle LNG (Liquefied Natural Gas) export plants.

LNG, chemical, fertilizer, and cement plants require reliable gas feedstock (inputs) sources. In recent years, these have been reduced to preserve supplies for power plants, easing the problems of domestic consumers while damaging the economy and raising unemployment.

The Egypt Economic Development Conference held in Sharm al-Sheikh in March 2015 resulted in Siemens closing a massive deal to supply gas turbines and wind power to Egypt. Nearly five gigawatts (GW) of renewable energy, including solar power, are under consideration, compared to current total generating capacity of 31GW. Another 13GW will be needed by 2019. The falling price of renewable energy will help, but to pay for these plans, Egypt needs to bring more private capital into the electricity sector and to raise prices to cover costs.

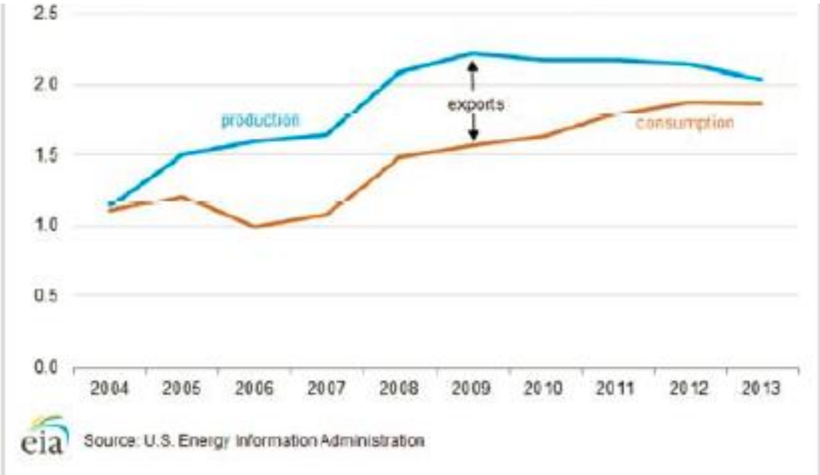
A rationing scheme is being introduced for petrol and diesel, but the proposed allowances are so high that most motorists will pay the subsidized rate. Lower oil prices have helped Egypt, but petrol prices remain about half of what they are in the United States.

The challenge is to secure universal energy access at affordable prices for the poor, while providing incentives (i.e., prices that cover costs) for productive sectors of the economy, and reducing the huge fiscal burden of subsidies on the government.

The new gas field may be capable of producing 2.5 to 3 billion cubic feet per day, which would cover most, though not all, of Egypt's energy gap. (See Table 1) Although this find probably rules out the need for gas imports from Israel, Egypt is unlikely to become a significant exporter unless more is discovered. The then oil minister and now prime minister, Sherif Ismail said that discussions to buy gas from Israel would continue despite the Eni finding.

Table 1

Natural Gas production and consumption (trillion cubic feet)



Despite the good news that came in August, the outlook for Egypt's economy is far from optimistic. The war against terrorism continues throughout the country and the underlying problems remain. Suez Canal tolls and gas revenues are both forms of rental income. Egypt relies heavily on rents to maintain its balance of payments and boost its national income. The increase in Suez Canal tolls and gas revenues will help improve Egypt's finances and this is of crucial political importance because it will allow the government to become much more independent of foreign aid donors. Whether the rent will be used in a way that tackles Egypt's economic problems is less clear.

According to a recent paper issued by the Economic Research Forum in Cairo: Economic growth in Egypt during the high growth period of 2000 to 2010, while comparable to other countries with similar income levels, failed to significantly reduce unemployment, lower poverty levels, or raise overall productivity. Egypt did not experience a reallocation of excess labor towards modern, productive sectors similar to what occurred in Southeast Asia and other emerging markets. While there is large potential for productivity gains in the Egyptian economy, limited openness to foreign trade, little diversification of exports, and a lack of access to finance prevented the structural shift of its labor force towards manufacturing and private services. Egypt remained locked in what has been called a “low value trap.”

The IMF has analyzed Egypt's economic problems in similar terms. Microeconomic distortions are the result of energy subsidies that remain high. These generate a bias in favor of capital and energy-intensive industries and divert resources, including foreign investment towards these sectors at the expense of more efficient or labor-intensive industries. Inefficient labor markets push firms and workers into the informal sector. Weak governance, perceived corruption, and poor enforcement of contracts are constraints on foreign companies doing business in Egypt.

The public sector in Egypt is huge, accounting for 39 percent of formal GDP in 2013/14. Despite privatization over the past decade, the state still controls the majority of assets in the banking and insurance sectors. It is an important player in telecoms and transportation, and it is dominant in oil and gas, refining, and electricity. Low average levels of human capital, as evidenced by poor health and education indicators and the poor infrastructure – especially roads and electricity – also negatively affect productivity. Education is underfunded and does not prepare young people for productive employment. Because public health services are inadequate, health standards and human capital formation also suffer. The poor transportation infrastructure results in traffic congestion, distribution bottlenecks, and electricity, fuel, and water shortages.

The expansion of the Suez Canal and the new gas finding offer Egypt a financial breathing space. The key issue is whether new government revenues can be used to improve the economy. This will require structural changes that will impinge on the privileges of powerful groups in the economy. The danger is that these revenues may, in fact, reduce the incentives for change.

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