Cross-Country Emerging Markets Analysis

Economic Watch

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Economic Analysis

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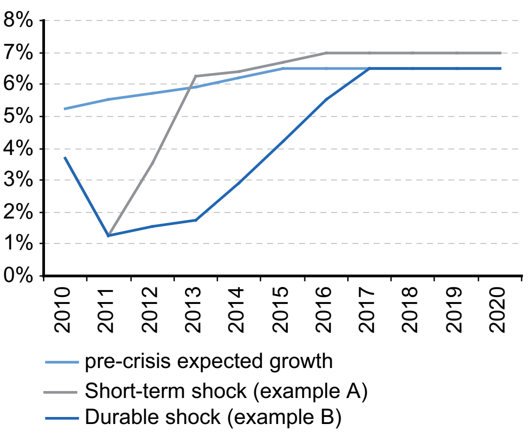
Can Egypt continue to be an EAGLE?

Recent political events could alter growth expectations

- **Prior to the crisis, Egypt was the only African EAGLE,** expected to deliver the eighth largest contribution to global growth between 2010 and 2020.
- **The revolution in Egypt is leaving a dent over the economy.** Financial markets endured a significant and almost immediate penalization. The real side is expected to follow suit, although with greater uncertainty.
- **In order for Egypt to fall out of EAGLEs,** the economy would have to stagnate for more than two years.
- **Falling out of the Nest,** on the contrary, would require a much stronger or longer negative shock. This seems highly unlikely.
- **Despite the above, political transition is also an opportunity for the economy.** Hence, we would advise against a premature endorsement of reduced growth scenarios in the new political context.
- **Given the uncertainty that surrounds the current context in Egypt,** and in light of the dynamic character of our EAGLE aggregate, we stress our commitment to regularly update its composition.

Chart 1

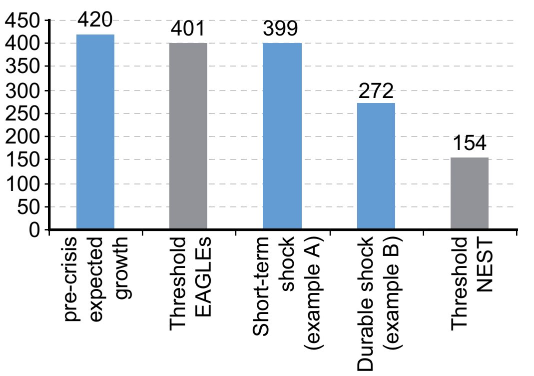
Egypt: Alternative GDP Growth Paths (%)



Source: BBVA Research

Chart 2

Levels of incremental demand (PPP USD Bln; 2010-2020)



Source: BBVA Research

Can Egypt continue to be an EAGLE?

The wave of social unrest that began in Tunisia last December has become, barely three months after, the most important agent for political change in MENA countries since decolonization. With two regimes already toppled, another one engulfed in civil strife, and several others threatened by relentless demonstrations, it is unclear when or where the process will end.

Egypt has been one of the countries most affected by these winds of change. Even though the ousting of Hosni Mubarak has been the swiftest regime change so far in the region, the country is entering the same uncertain path that affects other regional peers. With this in mind, and aware of the changes that a process of this magnitude might bring over economic growth, we feel compelled to assess the circumstances that could expel Egypt from our EAGLEs aggregate.

The African EAGLE

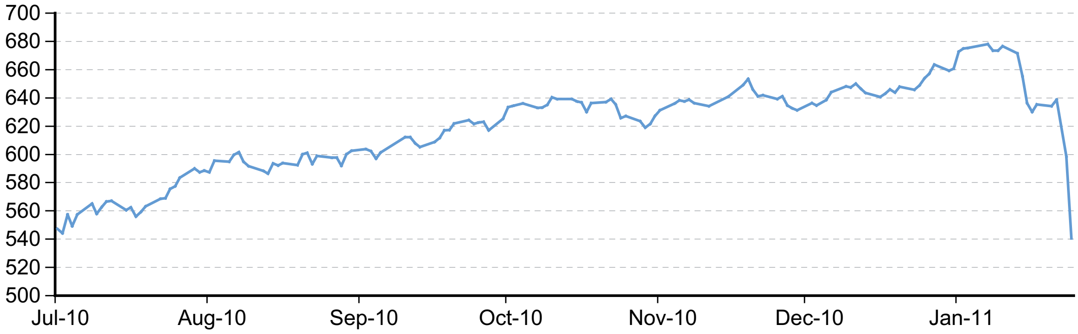
As a brief reminder the reader, the concept of EAGLEs includes all the emerging markets whose contribution to global growth is expected to be larger than that of the average G6 economy (ie. the G7 excluding the US) in the next ten years. Characterizing Egypt as an EAGLE rested on the fact that its GDP growth during this period is expected to deliver the eighth largest contribution to global growth. In this fashion, Egypt is the only African country to satisfy the criteria for membership, even though other countries in the region, notably South Africa, had been regularly portrayed as the “key” emerging market in the region. Against this convention, our forecasts encompass a more dynamic future growth in Egypt, so much that it would enable the country to surpass South Africa and become the largest economy in the continent by 2013. A population pyramid highly beneficial to growth, or a well-diversified export base, are some of the factors that support the superior performance of Egypt compared to other African nations.

At the time we unveiled the group of EAGLEs, we warned that Egypt’s situation was not easy: it has an uncomfortably high level of public debt and fiscal deficit, and a relatively high and volatile inflation. Thus political stability was a concern even before the hostilities, in light of the fraudulent 2010 elections, the immediacy of Mubarak’s succession, or the inter-faith conflict that ravages the country from time to time. The current crisis has obviously raised political risk even further, as well as the chances for a correction on the expected GDP growth path.

Impact over economic variables

Financial variables have received a significant correction: The National Stock Exchange (Hermes) lost 20% from January 10th to 27th, and it has remained closed afterwards. The CDS has also been severely penalized, with a maximum increment of 250 bps on January 28th, later sustaining lower increments. The Egyptian pound has not endured such a drastic correction, around 2%, partly because it is tightly managed by the Central Bank, and especially because of market activity has been severely restrained since the turmoil began.

Chart 3
Hermes Stock Market Index



Source: Bloomberg

With financial markets in a state of paralysis, the real side of the economy has also been a source of concerns, particularly with regards to potential disruptions of the Suez Canal, and most notably Tourism. While the canal traffic has not been interrupted, the Tourism industry is expected to suffer a significant dent, particularly given that the height of the turmoil took place during the peak season.

How much to become a “fallen angel”?

Notwithstanding the uncertainty that surrounds any GDP growth path designed in this unstable political environment, we aim in this section to illustrate the conditions that could depose Egypt from its EAGLE status. The growth assumptions embedded in our original, pre-crisis analysis, expected Egypt to add 420 USD billion of incremental demand[1] between 2010 and 2020. Compared to this, the average of the G6 ex-USA (i.e., the threshold that defines EAGLE membership) would contribute 401 USD billion during the same period.

With the previous numbers as a reference, we can illustrate the kind of growth paths that would displace Egypt from EAGLEs. First, we portray a relatively benign scenario (example A) that would concentrate a significant negative shock to GDP (4 pp lower) only in 2011, to be followed by a lower correction in 2012, but then followed by a rapid return to trend growth that would deliver a marginally superior GDP growth in the post crisis scenario (0.5 pp each year). This growth forecast would barely reach the minimum incremental demand for Egypt to retain its EAGLE status (i.e., around 400 billion USD).

More contractive scenarios, consequently, would leave Egypt out of EAGLEs. This would be the case of a more problematic transition that inhibits GDP growth for longer, as example B illustrates: in this scenario, GDP receives a 4 pp negative shock that remains until 2013, to gradually converge to the original growth path by 2017. As we stated, a contraction of this magnitude would leave Egypt out of EAGLEs, with an incremental demand of 270 USD billion. Even in this scenario, Egypt would remain firmly within the Nest[2], given that the threshold for this group is significantly lower, 154 USD billion. Other versions of this type of acute shocks, for instance through a contraction that is more uniformly distributed throughout the forecast horizon, would essentially deliver similar consequences.

In all, the conclusion we tend to convey from this alternative scenarios is clear: the possibility for Egypt to fall out of EAGLEs is significant in a tumultuous scenario like the one the country is facing. Falling out of Nest, on the other hand, would require a shock that could only arise if the political transition process deteriorates to the extent of collapsing the economy (e.g., civil war).

In any event, we would advise against a quick endorsement to scenarios that portray such strong contractions in activity. Not only because Egypt, like Tunisia, seems to be transitioning to a peaceful transition that is quickly reducing the probability of such gloomy scenarios. But also because of the elusive record of the research on democratization and growth, a link that has been profusely investigated by the political economy literature, without shedding much light over its sign or causality[3].

A simple glance at the effect of democratization over growth illustrates the previous ambivalence. To do so, we rely on the Polity IV Project, one of the most exhaustive and comprehensive databases on political transition. We take this source to single out those transition events that ended up in more democratic regimes[4]. Thus, we compute the pre and post-transition economic growth through their averages of annual GDP growth[5]. On a subsequent and final step, we compute the same averages for world GDP, and subtract them from the national averages. This sort of “filtered” GDP growth aims to disregard the influence of the global economic cycle.

1: Absolute change in GDP levels between 2010 and 2020, measured in PPP terms.
2: The Nest is an EAGLE “watchlist”, composed of the countries (currently 12) that could get the EAGLEs status if their growth prospects for the next 10 years improve.
3: The positive link between democratization and growth has many facets in the literature, ranging from reductions in capital market imperfections (Galor and Zeira, 1993) or the ability to deal better with adverse economic shocks (Rodrik 1999). Examples of papers finding a negative relationship tend to emphasize deleterious growth effects via fiscal policy. This line of thought is exemplified by the Public Choice school (Buchanan and Tullock, 1962), as well as papers based on the median voter problem (Alesina and Rodrik, 1994; Persson and Tabellini, 1994.
4: The database includes a variable (regtran) that allows singling out those cases where there is a substantive, normative change in political authority towards democratization.
5: Specifically, we take the 9 years before and after the year when the transition begins (t0), with this one excluded from the computation of averages. For the sake of providing an illustration relevant to the current events, we only regime change events that happened on or after 1989.

Table 1 shows the results of comparing both values, which confirm a rough equality between countries where growth improves after the regime change happens, and countries where it worsens. Overall, we find that the average change in “filtered” GDP between pre and post-transition periods is 1.9 pp, with the median being slightly lower (1.0 pp). Thus, 48% of the countries experience an increase in this “filtered” GDP growth of at least 1 pp compared to pre-transition times. 41% of the cases maintain relatively similar growth rates between both periods (i.e., between -1 and +1 pp of difference), while only 11% experience a substantial drop (greater than 1 pp) in post-transition GDP growth.

The previous exercise gives evidence of a hypothesis we would like to highlight in this note: the idea that democratization processes, as turbulent as they might be, offer a window of opportunity for the economic outlook of the transiting country. This obviously depends on the extent to which political transition goes beyond the establishment of procedural democracies void of content; but when these process are accompanied by institutional improvements, from strengthening the rule of law, to controlling corruption more efficiently, or reducing bureaucratic hurdles, we could expect positive externalities over entrepreneurial activity, and ultimately over investment.

Finally, we would like to remind the reader of a key advantage of our EAGLEs group, and one that gains relevance in the current context. Namely, the fact that it is a dynamic concept, allowing for changes on its composition as countries change. This is a clear advantage over other aggregates (CIVETs, NEXT-11) where country membership is fixed. In all, and with Egypt currently at the crossroads of widely different growth paths, we remain committed to regularly update our group of EAGLEs, making any changes on its composition if necessary.

Table 1

Democratization and Growth

Average growth change in the post-transition period	1.9
Median growth change in the post-transition period	1.0
% of cases where growth improves more than 1 pp	48
% of cases where growth is between -1 and 1 pp	41
% of cases where growth is lower than -1 pp	11
Sample of transition events	46

Note: GDP growth change is net of global growth, to eliminate the influence of the global economic cycle.
Source: BBVA Research; Polity IV Project

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