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Studying the Effects of Political Risk on FDI Inflows:

The Case of Egypt

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Executive Summary

- Political risk is one of the factors posing the greatest constraints to investment by companies, therefore negatively affecting foreign direct investment (FDI), especially in unstable emerging markets.
- In the case of Egypt, FDI inflows over the period 2010-2014 have followed a pattern influenced by different political risk events happening over that time.
- Sectors behave individually and distinctly, with war, terrorism, and political violence comprising the sources of risk with the highest impact on them.
- The current level of political risk faced by foreign investors in Egypt is very high, as reflected by the results obtained by applying the ICRG methodology.
- High involvement of the military in politics, as well as corruption, terrorism, unemployment, poverty, low democratic accountability and poor quality of bureaucracy are among the sources of risk posing larger threats.
- War, ethnic tensions, civil war/coup threat, and government unity are relatively lower risks for foreign investors.

Introduction

The main aim of this paper is to underscore the importance of performing sound political risk analysis in addition to the regular economic and/or financial assessments executed prior to entering new markets, especially developing ones. In a survey conducted in 2013 by the Economist Intelligence Unit on behalf of MIGA (the Multilateral Investment Guarantee Agency, part of the World Bank Group) among 459 senior executives of multinational enterprises investing in developing countries, political risk was selected as the second-highest factor posing the greatest constraint to investment by the company over the following three years – just surpassed by macroeconomic instability (MIGA, 2014).

This paper is structured in two main parts. The first part will analyze the effects of political risk events in Egypt between 2010 and 2014 on FDI inflows over the same period of time. The second part will provide a snapshot of the current level of political risk in the country through the implementation of the ICRG methodology (PRS Group, 2015). For the purpose of this paper, only the political subcategory of risk has been applied, omitting the financial, economic, and "Type II" forecast.

Finally, studying the trends and interactions between FDI inflows and political risk in the past, as well as the current state of each, will help to forecast how risk will shape foreign investment in Egypt in the near future.

Part I – Political risk and FDI inflows in Egypt, 2010-2014

1.1 Main sources of political risk

The main political risk events that took place in Egypt over the period 2010-2014 can be grouped as follows, according to the classification proposed by the Multilateral Investment Guarantee Agency (MIGA), part of the World Bank Group (MIGA, 2015):

Currency inconvertibility and capital controls

In February 2011, following the ousting of Hosni Mubarak, then-president of Egypt, the Central Bank of Egypt imposed capital controls with a ceiling of USD 100,000 on transfers abroad by individuals for an indefinite period (The Economist Intelligence Unit, 2014). The measure remained in force until January 2014, after which banks were authorized to make one transfer per year per individual of up to the same amount of money. In addition, in 2012

the government imposed a ban on travelers bringing foreign currency into the country or carrying it out in the form of more than USD 10,000 in cash (Matonis, 2012). Capital controls are still in place in 2016.

Furthermore, the effect of such controls on businesses was exacerbated by the authorities' war against a foreign currency black market in an economy thirsty for dollars to pay for its imports (Saleh, 2015). In this regard, one of the measures introduced in 2012 by the Central Bank consisted of a system of auctions to make foreign currency available to commercial banks. In addition, the country has been running annual trade deficits for over a decade, with USD 60.8 billion worth of imports and USD 22 billion worth of exports in 2014, increasing its demand for dollars (The Economist, 2015).

Expropriation

Under President Mubarak, legislation against expropriation was reflected in Article 34 of the Egyptian Constitution of 1971, claiming, "Private ownership is safeguarded and may not be sequestrated except in cases specified in the law and pursuant to a court order. It may not be expropriated except for the public good and against a fair compensation in accordance with the law [ ]". Article 35 provided a similar protection against nationalization, whereas the Investment Law – Article 8 – and the Law on Economic Zones of a Special Nature No. 83 of 2002 also contained safeguards against nationalization and expropriation. As a result, the business climate at the time was favorable to investment and very few cases were sent to international arbitration during that period.

After the 2011 Arab Spring uprising, however, the enforcement of expropriation legislation came under scrutiny. The 2012 constitution and the Constitutional Declaration of 8 July 2013 issued by Interim President Adly Mansour provided new guarantees against direct expropriation and substituted Articles 34 and 35 of the previous constitution. Nonetheless, the revolution was followed by an increased number of expropriation cases, most of them related to privatization or concession projects executed by the former administration (Organization for Economic Cooperation and Development (OECD), 2014). Post-Mubarak governments and third parties reported that several privatization processes had been executed under unfair pricing and thus called for the expropriation of assets in the hands of investors. Since 2011, Egyptian Courts have released at least 11 rulings reversing previously signed contracts. In April 2014, a Decree-Law by the military government on the appeal procedures on state contracts limited the right to challenge a contract to the parties involved in it, preventing third parties from such a privilege.

Table I shows that the number of arbitration cases – most of them related to expropriation – has ballooned since the revolution in 2011: out of the 24 cases involving Egypt since 1989, 14 were filled in the aftermath of 2011. This suggests that expropriation risk was higher during the period 2011-2014.

Table I: Investor-State dispute cases involving Egypt since 1989

Case No.	Claimant(s)	Respondent(s)	Status
ARB/15/47	ArcelorMittal S.A.	Arab Republic of Egypt	Pending
ARB/14/4	Unión Fenosa Gas, S.A.	Arab Republic of Egypt	Pending
ARB/13/37	Utsch M.O.V.E.R.S. International GmbH, Erich Utsch Aktiengesellschaft, and Helmut Jungbluth	Arab Republic of Egypt	Pending
ARB/13/29	Cementos La Union S.A. and Aridos Jativa S.L.U.	Arab Republic of Egypt	Pending
ARB/13/23	ASA International S.p.A.	Arab Republic of Egypt	Pending
ARB/13/4	Ossama Al Sharif	Arab Republic of Egypt	Concluded
ARB/13/5	Ossama Al Sharif	Arab Republic of Egypt	Concluded
ARB/13/3	Ossama Al Sharif	Arab Republic of Egypt	Concluded
ARB/12/15	Veolia Propreté	Arab Republic of Egypt	Pending
ARB/12/11	Ampal-American Israel Corporation and others	Arab Republic of Egypt	Pending
ARB/11/32	Indorama International Finance Limited	Arab Republic of Egypt	Concluded
ARB/11/16	Hussain Sajwani, Damac Park Avenue for Real Estate Development S.A.E., and Damac Gamsha Bay for Development S.A.E.	Arab Republic of Egypt	Concluded
ARB/11/7	National Gas S.A.E.	Arab Republic of Egypt	Concluded
ARB/11/6	Bawabet Al Kuwait Holding Company	Arab Republic of Egypt	Pending
ARB/09/15	H&H Enterprises Investments, Inc.	Arab Republic of Egypt	Pending
ARB/08/18	Malicorp Limited	Arab Republic of Egypt	Concluded
ARB/05/19	Helnan International Hotels A/S	Arab Republic of Egypt	Concluded
ARB/05/15	Waguih Elie George Slag and Clorinda Vecchi	Arab Republic of Egypt	Concluded
ARB/04/13	Jan de Nul N.V. and Dredging International N.V.	Arab Republic of Egypt	Concluded
ARB/03/11	Joy Mining Machinery Limited	Arab Republic of Egypt	Concluded
ARB/03/8	Consortium Groupement L.E.S.I. - - DIPENTA	People's Democratic Republic of Algeria	Concluded
ARB/99/6	Middle East Cement Shipping and Handling Co. S.A.	Arab Republic of Egypt	Concluded
ARB/98/4	Wena Hotels Limited	Arab Republic of Egypt	Concluded
ARB/89/1	Manufacturers Hanover Trust Company	Arab Republic of Egypt and General Authority for Investment and Free Zones	Concluded

Source: ICSID (2015)

War, terrorism, and civil disturbance

Political violence stood out as one of the main risks for foreign investors between 2010 and 2014 in Egypt. The Arab Spring revolution of January 2011 was powerful enough to put an end to the 30-year unchallenged rule of Hosni Mubarak, with a toll of over 800 people killed during the demonstrations (Mungin, 2011). Moreover, in July 2013, and again following days of popular protests and unrest, the country witnessed a military coup d'état, ousting the democratically elected president Morsi after just one year in charge.

Egypt did not just suffer from revolution and insurrection over these years, but also from terrorism. Particularly since the military seized control of the country from the Muslim Brotherhood, followers of the latter and Islamist radicals committed several crimes and bombings; some of them targeted high-ranking government officials. In addition, the Sinai-based armed group Ansar Beit al-Maqdis pledged allegiance to the Islamic State and engaged in an ongoing conflict with the military forces.

Breach of contract

As in the case of expropriation, the number of breach of contract lawsuits against the government of Egypt increased considerably after the 2011 revolution in comparison to previous years' figures. One example involved East Mediterranean Gas (EMG) in 2011, which alleged breaches of contract by the Egyptian government following terrorist attacks that affected EMG's gas pipeline in North Sinai (Reuters, 2011). Another example included Union Fenosa Gas – a joint venture between Spain's Gas Natural and Italy's Eni operating an LNG plant in Damietta – in early 2014 (Vukmanovic, 2014).

1.2 Political risk in Egypt as a reflection of demand for specialized guarantees by foreign investors

Looking at the list of projects that have sought some sort of political risk protection from the World Bank Group's agency, the first fact that is shocking is that of a total of seven – with the oldest one dating back to 1997–, five were processed between 2012 and 2014. Moreover, a second conclusion relates to the economic sectors pursuing protection: oil and gas and manufacturing clearly top the list.

In terms of the sources of political risk that have been most hedged against, war and civil disturbance were included in all contracts except Apache's, which may be explained by the fact that exploration fields in the western desert, where Apache operates, are less exposed

to the effects of political violence. Expropriation is next in the ranking, followed by transfer restriction and breach of contract, respectively.

Table II: Projects contracting MIGA services in Egypt

Company (Investor Country)	Sector	Gross Exposure	Coverage	Date
Egyptian Refining Company (Germany)	Oil and Gas	USD 23,4m	War and Civil Disturbance	July 2014
Elif Global Packaging S.A.E. (Turkey)	Manufacturing	USD 10,2m	Transfer Restriction; Expropriation; War and Civil Disturbance	September 2014
Elif Global Packaging S.A.E. (Turkey)	Manufacturing	USD 26,4m	Transfer Restriction; Expropriation; War and Civil Disturbance	June 2014
Apache Egypt (USA)	Oil and Gas	USD 150m	Expropriation; Breach of Contract	October 2012
Apache Egypt (USA)	Oil and Gas	USD 150m	Re-insurance for OPIC contracts	October 2012
Environmental Service S.A. (Spain)	Solid Waste Management	USD 6,4m	Transfer Restriction; Expropriation; War and Civil Disturbance; Breach of Contract	2005
Heckett MultiServ Bahna S.A.E. (USA)	Manufacturing	USD 2,24m	War and Civil Disturbance	1997

Source: MIGA (2015)

1.3 Analysis of FDI inflows

This section compares the evolution of inward flows and stocks in Egypt to that of the rest of Africa, middle-income developing economies worldwide, and developing economies globally (regardless of their income level).

Table III: FDI: Inward flows and stock, annual, 2009-2014
(USD at current prices and current exchange rates in millions)

Inward FDI - Flows	2009	2010	2011	2012	2013	2014
Egypt	6,712	6,386	-483	6,031	4,192	4,783
Developing economies: Africa	54,379	44,072	47,705	56,435	53,969	53,912
Middle-income developing economies	90,464	94,052	104,459	100,381	101,083	113,851
Developing economies	463,637	579,891	639,135	639,022	670,790	681,387

Inward FDI - Stock	2009	2010	2011	2012	2013	2014
Egypt	66,709	73,095	72,612	78,643	83,114	87,882
Developing economies: Africa	509,506	586,499	599,144	644,147	679,000	709,174
Middle-income developing economies	721,273	861,829	935,472	1,040,877	1,125,551	1,231,630
Developing economies	4,904,737	6,088,657	6,392,829	7,261,542	7,748,172	8,310,055

Source: UNCTAD (2015)

2010

In 2010, FDI inflows in Egypt witnessed a 4.9% reduction in absolute terms compared to the previous year, with a total amount of USD 6.4 billion in new investments coming into the country. Total FDI stock, on the other hand, increased from USD 66.7 billion to USD 73.1 billion, which means that there were no divestments over that period of time.

This slight investment reduction compared to 2009 follows the same trend as is seen in the broader African continent, which experienced a much more severe decline of 19% of its FDI inflows. Yet in that same year, developing economies as a whole enjoyed a 25% increase in their inflows, suggesting a change in investment behavior, with shifting patterns of capital allocation from Africa to other developing regions that were experiencing higher growth rates in the aftermath of the global financial crisis. In fact, according to the UNCTAD, developing economies in America and Asia witnessed FDI inflow increases in their markets in 2010, of 57.73% and 24.11% respectively; with a remarkable 66.86% in South America and an outstanding 127.92% in South-Eastern Asia.

2011

This was without any doubt the worst year for Egypt in terms of inward FDI over the last decade. Its inflows plunged from more than USD 6 billion over the previous years to a negative USD 483 million, which means that investors did not just reduce the amount of money coming in but also brought back home some of the stock they had previously built up. This translated into a 0.7% decline in total FDI stock in a year where the rest of middle-income economies accumulated an additional 8.5% on average.

Political risk arguably had an effect over that period of time: inward FDI inflows to Egypt diminished by 107.6%, whereas in developing economies they increased by 10.2% (8.2% in Africa) with middle-income countries doing so by 11.1%.

2012

Following 2011's strong blow to Egypt's FDI, 2012 was somehow a recovery year, with inflows topping the USD 6 billion pre-revolution levels in absolute terms. In a year in which global investment remained steady in terms of FDI flows to developing economies globally, the African region achieved an 18.3% year-on-year increase, led mainly by its eastern and northern regions. The eastern region witnessed a 41.98% surge in FDI inflows – mainly concentrated in Zambia, Mozambique and Tanzania, with 119.19%, 58.16% and 46.46% respectively; whereas the northern region enjoyed an impressive 127.22% increase – Egypt's recovery was mirrored in other Arab Spring countries such as Libya and Tunisia. Hence, this further supports the claim that 2011's political risk events had a strong negative impact on FDI flows or, in other words, that there is an interdependent relationship between the variables.

2013

In 2013, FDI inflows in Egypt fell to USD 4.2 billion, a 30% decrease from the previous year's value. Taking into consideration that investments remained steady or even increased in the rest of developing economies – as well as in the middle-income range – over the same period of time, this may suggest that increased political risk once again had a chilling effect on the FDI inflows.

2014

Despite a slight recovery – 14.1% of its value in 2013, FDI inflows remained below USD 5 billion in 2014, an overall decline of 25% from its pre-revolution figures. Moreover, the significance of this slight increase drops even further when put into a global context, with middle-income developing economies growing an average of 12.6% over the same period. Hence, data for 2015 will determine whether the country is following a slow but steady growth process or is still affected by its internal turmoil.

1.4 Macro Analysis

As a preliminary conclusion, it can be argued that between 2011 and 2014 (i.e., the years in which such political risks as currency inconvertibility and capital controls, expropriation and breach of contract represented a real threat for foreign investors) inward FDI flows to Egypt remained lower than over the previous years. 2012, however, stands out as a recovery year within this trend. That may be justified by the fact that it was indeed during that year that

social unrest seemed to settle down, protests at Tahrir Square took a break, the country issued its new constitution, and the political system held its first democratic elections. Even though capital controls and expropriation risks were still in place at the time, investors may have seen the light at the end of the tunnel, especially with the decline in political violence.

Civil disturbance, moreover, seems to have had the strongest collateral effects in FDI. It is not without a reason that 2011 and 2013 were the years that witnessed steeper declines in inflows: 107.6% and 30.5%, respectively. These were the years of the social revolution that ousted Hosni Mubarak on the one hand, and the military coup against his successor, Mohamed Morsi, on the other. FDI inflows never recovered to pre-revolution levels however, which may be attributed partly to terrorist attacks over the course of 2014 (see annex for a sectorial breakdown).

On a different note, it is worth mentioning that despite the previously depicted drawbacks, Egypt was able to build up its FDI stocks over time. Hence, the country improved from its USD 73 billion in 2010 to USD 87 billion in 2014, a 20.23% increase. The capital controls in force at the time may provide clues as to the reasons for this increase: they may have acted as a barrier preventing foreign companies from divesting in the country despite the enhanced risk.

Part II – Current level of political risk in Egypt and implications on FDI

The International Country Risk Guide (ICRG) rating system helped assess Egypt's level of political risk in January 2016, when it was used to survey 14 experts who graded 12 components of risk and several subcomponents in different scales weighted according to the model.

The results of the analysis are crystal clear and leave no room for interpretation at a macro level: political risk is currently very high in Egypt. With a country score of 37 on a zero to 100 scale, Egypt without a question falls within the category of very high-risk markets.[1]

Table IV: ICRG methodology results

Political Risk in Egypt	Minimum score	Maximum score	Final score	%	Risk
Government stability	**0**	**12**	**5,86**	**49**	**Very high**
Government unity	0	4	2,29	57	High
Legislative strength	0	4	1,93	48	Very high
Popular support	0	4	1,64	41	Very high
Socioeconomic conditions	**0**	**12**	**3,21**	**27**	**Very high**
Unemployment	0	4	0,93	23	Extreme
Consumer confidence	0	4	1,36	34	Very high
Poverty	0	4	0,93	23	Extreme
Investment profile	**0**	**12**	**4,43**	**37**	**Very high**
Contract viability / Expropriation	0	4	1,64	41	Very high
Profits repatriation	0	4	1,71	43	Very high
Payment delays	0	4	1,07	27	Very high
Internal conflict	**0**	**12**	**4,86**	**41**	**Very high**
Civil war / Coup Threat	0	4	2,57	64	Moderate
Terrorism / Political violence	0	4	0,79	20	Extreme
Civil disorder	0	4	1,50	38	Very high
External conflict	**0**	**12**	**6,29**	**52**	**High**
War	0	4	2,86	72	Low
Cross-border conflict	0	4	2,00	50	High

[1] The ICRG rating system assesses a number of political risk components on scales ranging from zero to three, four, six or 12 (depending on the weighted importance of each factor). The scores can be read as follow: the lower the point total, the higher the risk; and the higher the point total, the lower the risk. Finally, all scores are compiled into a final country composite ranging from zero to 100 – again, with low scores representing high risk.

Political Risk in Egypt	Minimum score	Maximum score	Final score	%	Risk
Foreign pressures	0	4	1,43	36	Very high
Corruption	**0**	**6**	**1,14**	**19**	**Extreme**
Military in politics	**0**	**6**	**0,71**	**12**	**Extreme**
Religious tensions	**0**	**6**	**2,14**	**36**	**Very high**
Law and order	**0**	**6**	**2,08**	**35**	**Very high**
Law	0	3	0,93	31	Very high
Order	0	3	1,15	38	Very high
Ethnic tensions	**0**	**6**	**4,00**	**67**	**Moderate**
Democratic accountability	**0**	**6**	**1,50**	**25**	**Very high**
Bureaucracy quality	**0**	**4**	**1,07**	**27**	**Very high**
Total country score	**0**	**100**	**37,29**	**37**	**Very high**

Source: Original compilation by the author (2016)

While the final total country score is significant, and could easily be compared to those obtained by other countries following the same process – e.g. by a company evaluating and deciding among different markets where to invest abroad, it is also important to analyze how this rating was obtained and how each subcomponent performs individually.

Starting with those **risks that pose a relatively low threat**, the highest score is obtained by **war** with a 2.86 out of 4 – which therefore represents a 72 (low risk) in a homogenized 0 to 100 scale. This comes as no surprise, since the current prospects of an all-out war between Egypt and a third country remain low, especially after the country calmed disputes with its main foe over the 20th century (Israel) in the Camp David Accords of 1979. Moreover, diplomatic relations between both countries have improved considerably since al-Sisi's takeover of the Egyptian presidency, with both countries allied in the fight against the ISIS-affiliated terrorist group Ansar Beit al-Maqdis in northern Sinai (Aronson, 2015).

The second highest score (i.e., lowest risk) in the analysis goes to **ethnic tensions**. Unlike religion, which poses a very high risk due to the ongoing disagreements between the military-backed government and the Muslim Brotherhood, labeled as a terrorist organization, as well as the historic divide between Coptic Christians (10%) and Sunni Muslims (90%) (US Department of State, 2013), ethnicity has never represented a major concern for the country's stability. With 99% of the population considered Egyptian by racial group, Egypt is one of the very few countries in the Middle East enjoying such homogeneity (Central Intelligence Agency, 2015), therefore increasing its stability and reducing risks derived from ethnic tensions. Minorities such as Bedouins, Nubians, Berbers, Greeks, Armenians and other Europeans comprise the remaining 1% of the population (Ennaji, 2014).

After ethnic tensions comes the **risk of civil war** or **coup threat**. With two popular uprisings ousting established regimes in the last five years, it appears stability will finally last for a while – this is, at least, the experts' opinion on the matter. Looking at the sources of internal conflict in the country, foreign investors should thus be more worried about other risks, such as those related with political violence or civil disorder.

The last risk in the group of those posing relatively low threats is **government unity**. It is this unity that currently helps President al-Sisi's government maintain relative stability despite its weak popular support.

On the other hand, there is a group of risks that pose a **potentially extreme threat** to investors in the country. First and foremost, there is the risk of a **high involvement of the military in politics**. The military's involvement in politics automatically reduces democratic accountability in a country, as this form of government has not been elected by its citizens. Moreover, a full-scale military regime may provide stability in the short term – therefore supporting the business environment – but this goes, most certainly so, at the expense of longer-term risks derived from increased corruption in the system and the creation of an armed opposition. In a country where the ruling government came to power through a military coup and whose president is the former commander-in-chief of the armed forces, the average score of 0.71 out of 6 (12%) obtained by this risk appears very straightforward.

The risk of **corruption** comes next, with a final score of 1.14 out of 6, or 19%. As predicted by the ICRG framework, a military government is strongly correlated with corruption practices. In third place comes a component that strongly affects sectors of the economy such as tourism: **terrorism**. Its average score of 0.79 out of 4, or 20%, makes it one of the toughest risks foreign investors will face in 2016.

Furthermore, we find two socioeconomic subcomponents – **unemployment** and **poverty** – tied with a score of 0.93 out of 4, or 23%. According to the World Bank (2015), the percentage of population in Egypt living below the national poverty line accounted for 25.2% in 2010. Nevertheless, the country did not just have a quarter of its population living under poverty conditions, but this figure was also on an upward swing – increasing from 21.6% in 2008. Additionally, unemployment affected 13.2% of the labor force in 2014, following an increasing pattern from 9% in 2010 to 12%, 12.7% and 13.2% in 2011, 2012, and 2013 respectively. Moreover, and given that Egyptian youth represent 23.6% of the total population (around 20.7 million), it is alarming that unemployment among those actively seeking employment from ages 15 to 24 was 42% in 2014 – increasing at a steady pace from 33.9% in 2011.

Last but not least, other components with alarming levels of risk include **democratic accountability** and **bureaucracy quality**, with scores of 25 and 27 respectively on a scale from 0 to 100.

Future implications for FDI

Part I analyses how political risk events affected FDI inflows in the past and Part II assesses the current level of political risk in the country. This information can be used to forecast how risk will shape foreign investment in Egypt in the short term, on a sectoral basis.

Overall, investment in the **petroleum** sector is hard to predict. On the one hand, the political risk assessment is optimistic in the sense that those risks that translated into lower FDI inflows in the past – civil war and coup threat – have obtained moderate risk results in the survey. Nevertheless, other risks that have affected the performance of the sector in the past, such as payment delays or expropriation, are still very high at present. On the other hand, and perhaps more worryingly, we find historically low oil prices. With oil prices hitting an average of USD 30 a barrel in January, this may actually have an impact on foreign E&P investments in 2016 that was not seen when oil prices were higher. As a conclusion, inward FDI attracted by the petroleum sector in 2016 may not be affected by political risk but it could, instead, be affected by other macro trends such as low oil prices. The implementation of the Iran deal in January 2016, with an expected increase in production of 500,000 barrels a day over the subsequent months – which may translate into a supply glut, will not help reverse that situation.

After the political violence starting in 2011 and the subsequent increase in terrorist attacks, Egypt's score currently reflects a high level of risk. This score, which includes the extreme terrorism risk generated after a series of attacks targeting foreigners, will likely reinforce the meteoric fall in FDI flowing to the **tourism** sector. A similar conclusion can be reached regarding the outcome of foreign investment in **real estate**. With a very high risk score among components that have proven to affect FDI inflows in the past, including government stability, socioeconomic conditions, investment profile or internal conflict, the downward pattern of foreign investment in the sector will not shift any time soon.

The sectors of **construction**, **manufacturing**, and **agriculture** were also affected by political risk over the period 2010-2014. Therefore, the very high political risk of 2016 in the country should translate into lower levels of FDI heading to those sectors. The effect, however, should be weaker in construction: given that it was the sector most affected by the uprisings of 2011

and 2013, the current moderate risk of coup threat should in fact be positive, to a certain extent.

But it is not all bad news for Egypt. Following a steady recovery in foreign investment since 2012, the **financial services** sector should continue doing well in 2016. Despite a very high level of risk in the country, the fact that FDI inflows have been growing over the last four years in a context in which risk was at least as high as it is now makes the forecast look positive. A plausible explanation why the sector was first hit in 2011 but has thereafter been growing steadily is that of a change in investor profile. In a country where political risk is the norm and not the exception of late, the risk no longer affects financial markets, since investors are aware of the situation, and the ones attracted to the country are usually those seeking higher yields derived from that enhanced risk.

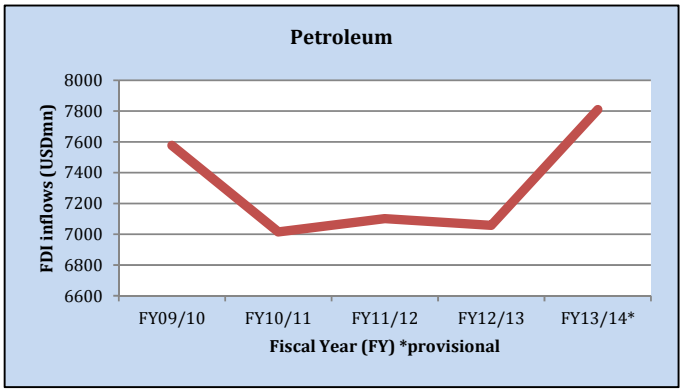
Part III – Conclusions

The main conclusion to be extracted from this paper is that there has been a relation between political events in Egypt and variations in FDI inflows. This states the importance for companies seeking to enter new markets to not just perform economic and financial analyses to assess the attractiveness of a market but also political ones. Moreover, the study also shows that war, terrorism, and political violence are the sources of political risk with the strongest effects on FDI in Egypt over the period between 2010 and 2014. Those effects, however, follow sector-specific patterns.

Secondly, this paper also concludes, through the implementation of the ICRG methodology, that the current level of political risk in Egypt is very high. The high involvement of the military in politics, corruption, terrorism, unemployment, poverty, low democratic accountability and poor quality of bureaucracy are among the sources of risk posing highest threats. On the other hand, war, ethnic tensions, civil war/coup threat, and government unity are relatively lower risks for foreign investors.

Annex: Sectoral breakdown

1. Petroleum



Source: Central Bank of Egypt (2015)

The energy sector has long played a major role in the Egyptian economy, accounting for 15.3% of the country's GDP in the 2013/14 financial year. Moreover, international oil companies dominate the sector with more than 50 operating in the country and conducting around 90% of the exploration activity (Oxford Business Group, 2014). Hence, it comes as no surprise that FDI inflows in the petroleum sector represented an average of 68% of the total received by the country in the period 2010-2014, thus making it the sector attracting the lion's share of foreign investment.

Despite being the sector attracting by far the highest share of FDI to the country, the petroleum industry has witnessed a steadily decreasing trend in foreign investment, from USD 7.5 billion in 2009 to USD 6.6 billion in 2013 (a 12% drop). We cannot assume directly, however, that this is due to political factors, since the energy industry worldwide experienced a drop in demand after the 2009 financial crisis that discouraged investment in new exploration and production (E&P) projects – in fact, global upstream spending was reduced by 12% between 2008 and 2009. However, global E&P investment soon recovered in the following years, which has not been reflected in the evolution of Egypt's FDI inflows.

Table V: Global upstream spending in the oil & gas industry (USD bn)

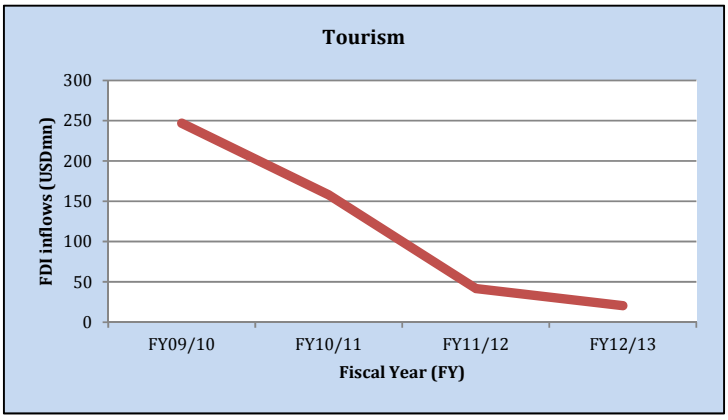
Global upstream spending	2008	% change	2009	% change	2010	% change	2011	% change	2012	% change	2013	% change	2014
Onshore	453	-12.1	398	7.0	426	16.4	496	13.3	562	5.7	594	5.4	626
Offshore	151	-11.3	134	-7.5	124	15.3	143	19.6	171	15.8	198	2.0	202
Total	**604**	-11.9	**532**	3.4	**550**	16.2	**639**	14.7	**733**	8.0	**792**	4.5	**828**

Source: IHS (2015)

A closer look at the evolution of FDI inflows shows that two year-on-year declines over that period took place in 2011 and 2013, following the trend witnessed at a macro level and most

certainly due to the political risk factors analyzed before. On the other hand, that pattern is not followed in 2012, when foreign investments in oil and gas did not show any improvement whatsoever. The most plausible reason may be found in the delay of government payments to energy companies, which started at that time. Several foreign companies – including British BP, Italian Eni and Spanish Repsol – operate through joint ventures with the state-owned Egypt General Petroleum Corp. In 2012, many of them were claiming billions of dollars in overdue payments by the government-related entity. The centrality of that problem came from Egypt's policy to subsidize fuels, which ended up creating a state bill of USD 16 billion a year or about a fifth of the government's entire budget, in a situation that was financially unsustainable (Halime, 2012).

2. Tourism



Source: Central Bank of Egypt (2015)

Once a major contributor to the country's economy, tourism has progressively declined: its share of GDP was 11.3% in 2010 and 1.8% in 2014. The sector as a whole collapsed after the revolution, with revenues from cultural heritage sites falling by 95% since 2011 according to the Ministry of Tourism. The dramatic decrease in the number of tourists – from a record-high 14.7 million in 2010 to 9.9 million in 2014 – has drastically affected the total amount of FDI inflows.

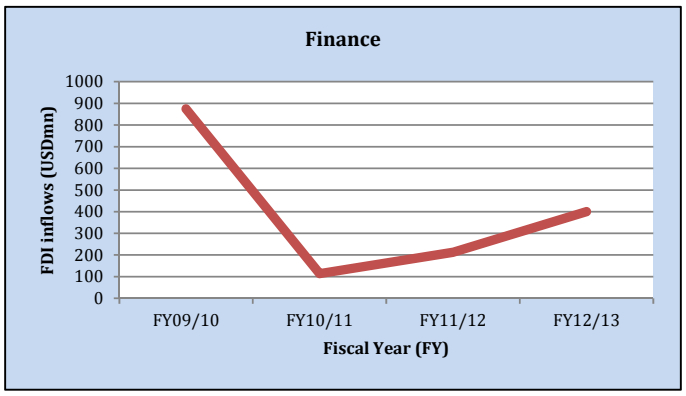
Even when tourism represented an important stake of the country's economy in 2010, the amount of FDI attracted by the sector was relatively low compared to that of others. The main reason may be because tourism is a highly localized industry, with an important role played by the public sector and the main capital investments – hospitality and restoration – made by local businessmen.

Secondly, the effects of political turmoil on the tourism sector are felt progressively and not according to peaks of perceived risk – as seen for instance on a macro level in years 2011 and 2013. This is because tourism is much less resilient to shocks and it takes time to build back confidence in the visitor's mind – as well as in the countries of origin, with most of them advising their citizens against visiting the country after the Arab Spring of 2011.

Thirdly, the sector has not only shrunk significantly in terms of economic output, but it has also been transformed. With travel bans imposed by most Western countries – including the Netherlands, Japan, Belgium, Spain, France, Germany, Italy, Denmark, Ireland and the US – in 2011, which were not lifted in many cases until 2014, the main markets of origin for Egypt's tourism sector are now Eastern European countries: 1.9 million Eastern European tourists arrived in the first half of 2014 (45.1% of the total over that period of time). The main tourist-providers over that same period of time were Russia, the UK, Germany, Ukraine, Italy, Saudi Arabia, Poland and Libya (Oxford Business Group, 2014). Moreover, the Egyptian Tourism Authority has recently been implementing efforts to increase its number of visitors from neighboring Arab countries, with promotional campaigns in the UAE, Saudi Arabia and Kuwait. Diversification efforts are also trying to bring visitors back to the main cultural sites, since most tourists currently choose to remain in the Red Sea resorts of Sharm El Sheikh and Hurghada. One way to do so is by targeting a different tourist profile: new charter flights between Aswan and Shenzhen, Shanghai and Chengdu, starting in February 2015, aim to bring in more visitors from China (El Demerdash, 2015).

Finally, looking at the main sources of political risk, terrorism has recently become the main deterrent of FDI. With the Sinai-based militants increasingly supporting the Islamic State, several attacks have targeted the tourism industry over the course of 2014 and 2015 (Alsharif, 2015). Some examples include the bombing of a tourist bus in Sinai which killed two Koreans and an Egyptian citizen; the episode where Egyptian security forces mistakenly bombed a convoy of Mexican tourists in the western desert, killing 12 people; and the downing of Russian A321 airliner, allegedly through the use of explosives, killing all 224 passengers on board (BBC, 2015).

3. Finance

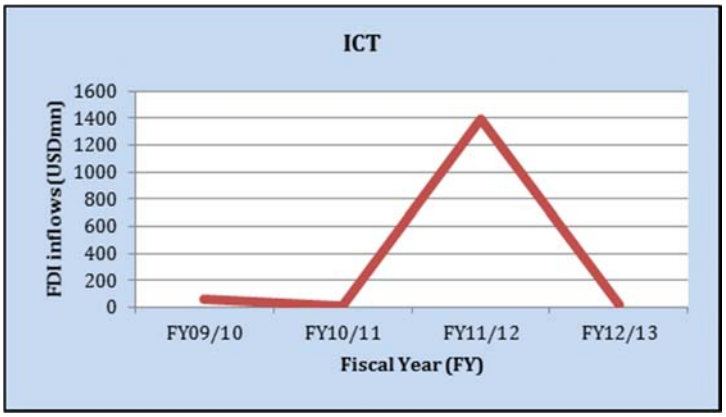


Source: Central Bank of Egypt (2015)

The financial services sector in Egypt seems to be more sensitive to environmental shocks, but also more resilient in terms of recovery time. After suffering a severe 86.9% decrease as a result of 2011's revolution, it quickly bounced back again to positive and steady growth over the three following fiscal years. This recovery, nevertheless, is still far

from reaching its pre-revolution levels of FDI, with total inflows in FY 2012/2013 amounting to USD 401 million – a 252% increase from FY 2010/2011, but still representing just 46% in absolute terms of FY 2009/2010's inflows.

4. ICT

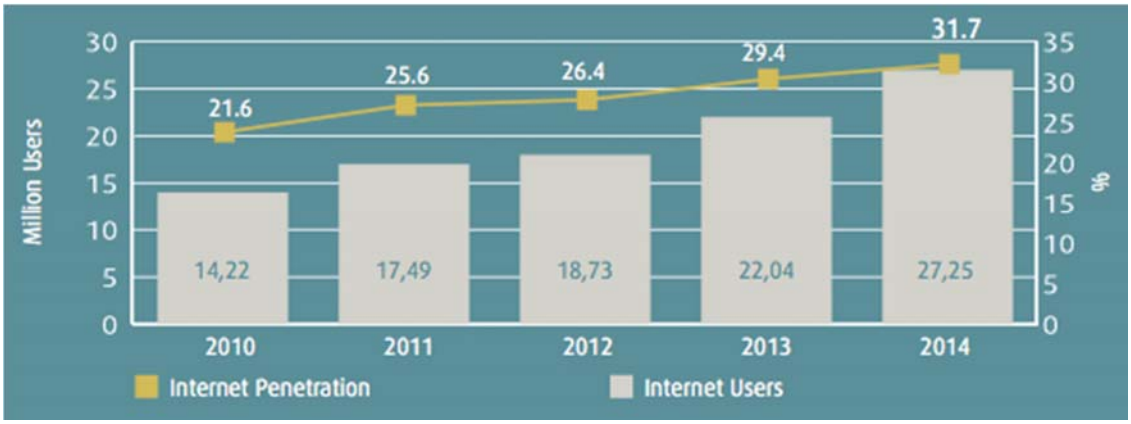


Source: Central Bank of Egypt (2015)

FDI stocks are high in the ICT sector, with UK-based Vodafone owning a 55% stake in Vodafone Egypt and UAE-based Etisalat holding 66% of Etisalat Egypt's shares. However, FDI inflows are strikingly low on a regular basis since those large inflows usually take place as one-off operations. The graph above shows the inflows remaining at an average of USD 30 million in fiscal years 2009/2010, 2010/2011 and 2012/2013, and then suddenly peaking at USD 1.4 billion in FY 2011/2012. This boost in FDI inflows came as a result of a single M&A operation taking place in May 2012, in which France Telecom increased its stake in Mobinil to 94% by acquiring most of the shares previously owned by the company's founder Naguib Sawiris (Carnegy, 2012).

We can therefore conclude that FDI in Egypt's ICT sector has no correlation with and is not affected by political risk. In fact, data by the Ministry of Communications and Information Technology (2015) support that claim by showing a solid evolution in figures such as internet penetration and fixed and mobile lines subscriptions over the period 2010-2014. There was a slight decline in the number of mobile subscriptions in 2014, but this was due to several procedures by the National Telecommunication Regulatory Authority to audit the customers' data, which led to truncation of service for many mobile lines that had no data for its users.

Figure I: Estimated Internet users and Internet penetration in Egypt



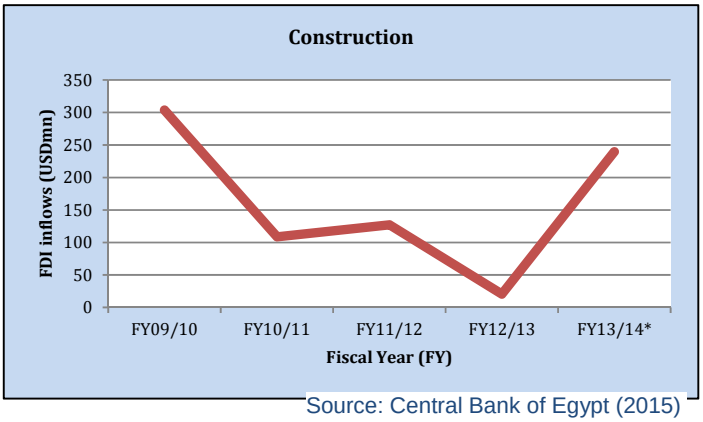
Sources: Ministry of Communications and Information Technology, National Telecom Regulatory Authority (2015)

Figure II: Fixed and mobile line subscriptions in Egypt

Sources: Ministry of Communications and Information Technology, National Telecom Regulatory Authority, Telecom Egypt (2015)

5. Construction

FDI in the construction sector followed a similar pattern to that in petroleum, even though it suffered a sharper downfall after 2011 and a less remarkable recovery. The most recent fiscal year, however, has witnessed a strong comeback, with total

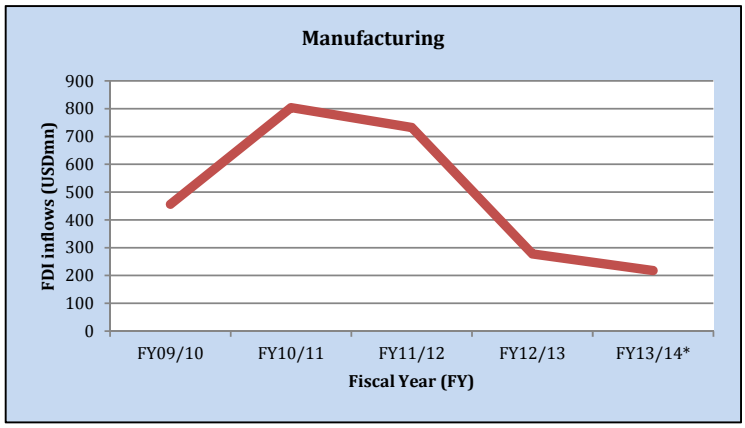


Source: Central Bank of Egypt (2015)

inflows soaring to USD 240 million – an impressive 1,057% year-on-year increase.

With the risk of expropriation and breach of contract remaining more or less constant between 2011 and 2014, it appears that political violence – as in the case of petroleum – had a stronger effect on the construction sector. The main differentiating factor here is that the effect was stronger after the military coup of 2013.

6. Manufacturing

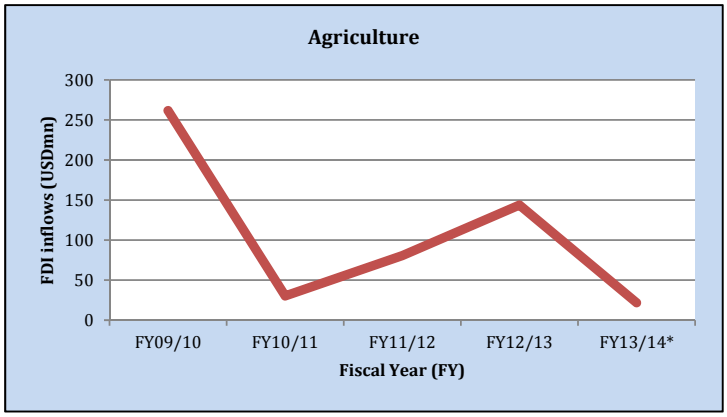


Source: Central Bank of Egypt (2015)

Unlike the sectors analyzed above, manufacturing enjoyed an increase in total FDI inflows in the year following the 2011 revolution. Nonetheless, that strong performance was followed by a steady 73% decrease in the years leading to FY 2013/2014. This pattern may suggest that political turmoil, indeed, affected FDI in the manufacturing sector, but that the collateral effect somehow took a longer time to materialize. In fact, the capital-intensive nature of the manufacturing sector may be a mediating factor, with investments requiring longer set-up time than in services-oriented activities.

As the most populous country in the MENA region and its second biggest economy, it comes as no surprise that the manufacturing industry in Egypt accounted for 15.6% of GDP in FY 2012/2013: the country produces goods for the huge domestic market as well as for export across the world (Oxford Business Group, 2014). Despite a 62% decline in FDI inflows compared to FY 2011/2012, manufacturing grew by 2.3% in FY 2013, revealing that this is a sector strongly driven by local companies.

7 Agriculture



Source: Central Bank of Egypt (2015)

Agriculture, forestry and fishing in Egypt generated 14.5% of GDP in 2013, making it the third-largest contributor to the country's economy, behind oil and gas and manufacturing. Alongside financial services, however, agriculture was one of the most damaged economic sectors after 2011 in terms of inward FDI. Inflows related to agricultural purposes dropped by an alarming 88.4% – from USD 262 million in FY 2009/2010 to USD 30 million in FY 2010/2011. The sector then enjoyed two years of steady recovery, with investment rising to USD 144 million by FY 2012/2013, followed by a second sharp decline in FY 2013/2014 to USD 22 million.

When examining agriculture's share in real GDP growth, we can see how – once adjusted for inflation – its contribution to GDP growth is almost zero every year. The sector's performance is thus clearly strongly correlated with the evolution of prices and the country's broader economic outlook. In other words, when the macro economy of Egypt suffers due to political risk, agriculture suffers too – mainly because of lower domestic demand. Hence, FDI inflows have been indirectly affected by political risk as it has lowered the country's demand for agricultural products.

Table VI: Agricultural sector's share in GDP and real GDP growth rates

Agriculture, irrigation and fishing	FY 09/10	FY 10/11	FY 11/12	FY 12/13	FY 13/14
Growth rate (%)	3,5	2,7	2,9	3,02	3,04
Sector share in real GDP growth (%)	0,5	0,36	0,39	0,44	0,44

Source: Central Bank of Egypt (2015)

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