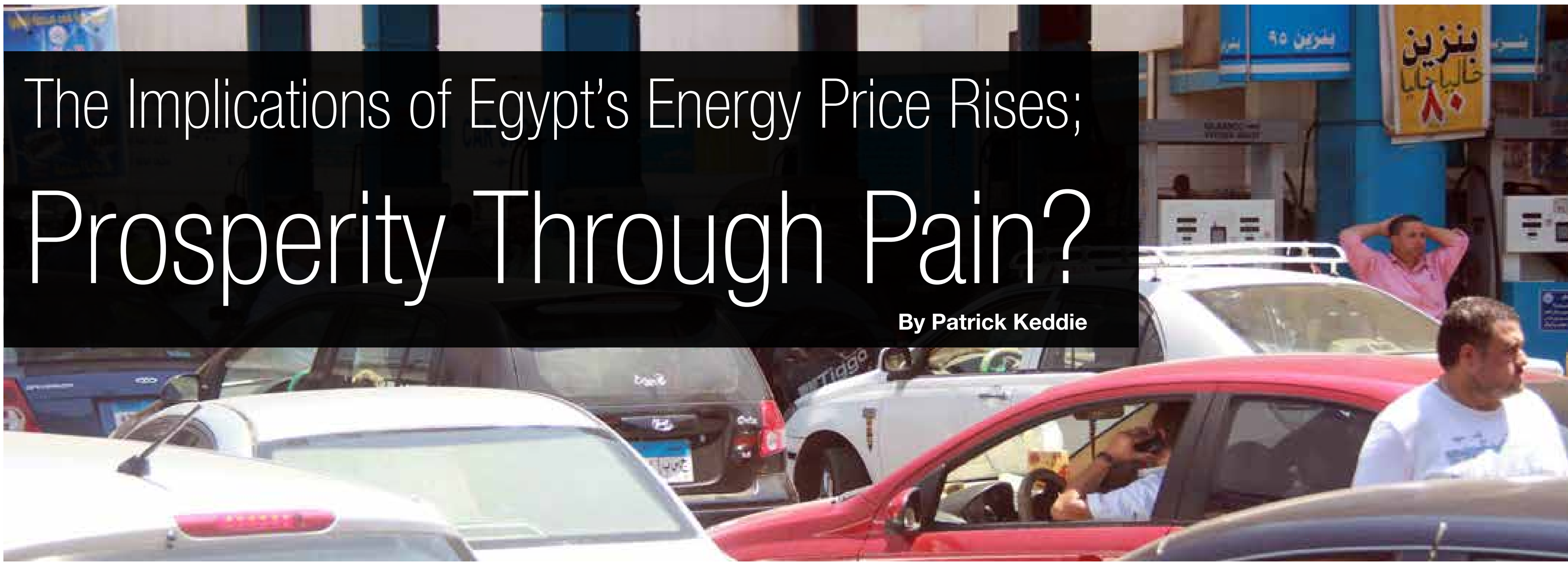

The Implications of Egypt's Energy Price Rises; Prosperity Through Pain?

By Patrick Keddie

Over the course of a few days in early July the Egyptian government announced a range of drastic cuts to energy subsidies.

Natural gas subsidies to several industries are being slashed, increasing prices by 30-75% according to a report by Reuters. Subsidized gasoline and diesel fuel prices will rise by as much as 78%. Electricity prices are set in rise by up to 56% in some pricing tiers.

"[The decisions] needed to be taken now or later, so it is better to confront [the problem] rather than leave the country to drown if we delayed longer than this," said Egypt's President Abdel Fatah El-Sisi, quoted in a Reuters report.

Egypt's spending on energy subsidies has increased substantially over the past decade reaching 22% in of the budget in FY2013 from 9% in FY2002, according to a recent report by the World Bank. The Finance Ministry has said that, without reforms, the budget deficit would have risen to 14.5% in the current fiscal year.

The Finance Ministry has claimed that cuts in energy subsidies could save around 40 billion EGP in the current financial year. Yet the measures are also likely to present challenges for many industries, businesses and ordinary Egyptians.

Natural Gas Price Rises and the Impact on "Competitive Advantage"

The higher natural gas prices are likely to have most impact on certain energy-intensive sectors of the economy as many businesses and industries that have benefited from cheap energy will now have to pay rates that are closer to global prices.

The price of natural gas in the cement sector will increase by a third. The price of natural gas in the iron, steel, aluminum, copper, ceramic, and glass industries will almost double. The cost of gas in the fertilizer, electricity, and petrochemical sectors will also increase.

Many of the affected industries have expressed concern at the measures. Ahmed Abou Hashima, Chief Executive of Egyptian Steel, told Reuters that the measures would strip Egyptian industries of their competitive advantage. Sources in the steel industry said that they were hoping to negotiate with the government to reach an acceptable and gradual price rise to avoid a sharp spike in prices which could deliver a shock to the market.

Cement industry sources, quoted in the International Cement Review, say that the lack of natural gas has already reduced their production capabilities. The latest measures may sharply increase the price of cement, carrying a knock-on effect into other sectors of the economy, such as the construction industry.

The rise in fertilizer prices may indirectly increase costs in agriculture. The rises in other industries may indirectly impact on sectors that are not directly subject to price rises, such as food, textiles, real estate, pharmaceuticals and telecommunications.

"[Changes to] the cuts and subsidies were long overdue and had to be done, and in fact we are only part of the way there—there is still a considerable amount of subsidy that is still being applied," says Ragui Assaad, Professor of Public Affairs at the University of Minnesota. "If you looked at the distribution of where the subsidies were going they were very regressive."

"These industries do clearly have a cost push that will increase the cost of things like agriculture though fertilizers and construction through cement" Assaad concedes, "but there are so many other industries that have not emerged because of the presence of these energy subsidies."

Assaad cites the solar energy industry as an example of a sector which has not emerged because of unfair competition with very low energy and fossil fuel prices. "So I think that this kind of restructuring, although painful in the short run, is actually quite beneficial in the long run and was absolutely necessary from an economic point of view."

Assaad dismisses the argument that industry figures are making about the undermining of their 'competitive advantage.' "Of course it is being undermined" says Assaad, "but they didn't really have a competitive advantage, it was an artificial one that was created by the subsidies."

Justin Dargin, energy expert at the University of Oxford, says that many big businesses and large industrial users are beginning to adapt by becoming more efficient. "They recognize that in order to compete with other global firms, they cannot compete only upon low cost natural gas, but they must compete on better quality and a more efficient industrial process" says Dargin.

Although the attractiveness of the Egyptian industrial sector to international investors will be weakened in some sectors, Dargin believes that "reformation of the energy subsidy framework in Egypt will over the long term make the economy more competitive and business friendly. This is especially true for the energy sector as firms will begin to invest and increase production to meet domestic demand."

However, some of the industries that have benefitted from subsidized gas may also adapt to the price rises by shifting to other more polluting fossil fuels. In April the Egyptian cabinet announced that the cement industry would be allowed to start importing coal for power generation, which is cheaper than natural gas.

Increased Fuel Prices Could Drive Inequity

The rise in gasoline and diesel fuel prices will have an impact on commercial distribution costs, which are likely to be passed on to the consumer. "The head of the Cairo Chamber of Commerce's poultry division said chicken prices will rise by 25% within days because of added transportation costs" reported Bloomberg.

Mini-bus and taxi fares rose by about 13% overnight, according to figures in the state media. 80-octane, favored by many drivers, rose by 78%. Diesel fuel, used in trucks and microbuses, rose by 64%.

In addition to the added pressure on many businesses and industries, analysts worry that the impact of these rises will be felt most acutely by poorer sections of society and that the government has failed to provide them with adequate protection or compensatory measures.

"The only thing that they could have done better is the issue of cash transfers to compensate the poorest groups" argues Assaad. "While they have plans to do that, these plans have not been implemented and are probably too narrow in scope."

Dargin also believes that there may not be adequate safeguards to help mitigate the impact of price increases on the poor. "The reason for this is that Egypt lacks a robust administrative apparatus to be able to moderate any price increase," he says. "Therefore, a phased increase is often best with targeted subsidy reduction that impacts different socio-economic sectors differently."

Egypt's Prime Minister, Ibrahim Mahlab, defended the fuel price increases by arguing that they were a part of the government's "war" on poverty and would help to achieve "justice" in a system that has benefited the wealthy at the expense of the poor. A recent report by the World Bank stated that more than 60% of the fuel subsidies went to the richest quintile of the population while the poorest quintile received only 7% of the subsidies.

Yet it seems likely that the wide ranging impact of these fuel price rises will have a significant secondary impact on a large segment of the population that is already facing economic hardship. Furthermore, if the purchasing power of a large number of people is weakened, this is likely to have a negative impact on many businesses.

Electricity Rises Impact on Ordinary Egyptians

The impact of the government's electricity rises has also provoked debate. The Minister of Electricity said that the electricity price rises were part of a plan to eliminate power subsidies within five years. Energy prices are likely to double over the next five years but the government has announced a new tiered pricing structure that they claim will ease the burden on poorer people.

Yet Yahia Shawkat, Housing and Land Rights Officer at the Egyptian Initiative for Personal Rights, says that the new tiered system is based on unfounded claims about how much electricity is used by the poor. Shawkat says that, contrary to government claims, research shows that energy use for poorest segments of society tends to fall within third and fourth tiers, which are experiencing the highest rate of price increase – between 56% and 39%, whilst the increases for middle and higher earners range from 17% to 25%.

"The rises will affect the poor disproportionately" says Shawkat, adding that poor people will find it hard to cut down on electricity use because they tend to only use the most basic and essential appliances, "whereas in the higher tiers there is a lot that can be cut out and a lot more efficiency can be added in, but since the pricing does not incentivize using less electricity then you're not going to see that."

In addition to making life harder for many struggling Egyptians, a failure to equitably deal with electricity usage will have an impact on the wider economy and government finances in terms of both weakening the buying power of large segments of society, and in limiting the impact of reduced subsidies if overall consumption is not reduced.

The Political Implications

The measures may make the energy sector more efficient and create incentives for investment. They could allow Egypt to greatly reduce its energy import bill in the future. Lifting energy subsidies may also make it easier for Egypt to reach a loan deal with the International Monetary Fund. Money that has been spent on providing energy subsidies could be redirected towards social services. The rebalancing of the economy could provide opportunities for emerging industries, such as solar and wind power.

Yet the measures could also hurt the poorest sections of society, weaken investment attractiveness in some sectors, and provoke some industries to adapt to the changes by shifting to harmful more harmful fuel alternatives.

The government hopes that, while businesses and consumers may have to deal with painful pressures in the short-term, the longer-goal is fiscal sustainability that will provide the conditions for the beleaguered economy to recover.

So far the price rises have not provoked significant political unrest and analysts suggest that Sisi continues to enjoy the backing of many business leaders, yet this could change if the government fails to effectively and fairly manage the short-term pain.

"The political implications will likely be quite significant if the government does not create a new social contract. This would involve making certain that the poor are cushioned from some of the sharpest price increases" argues Dargin. "Sisi will see a sharp reduction in support for his energy policies if he cannot guarantee a social safety net for the poor and consistent supply for the large industrial users."

Patrick Keddie is a British freelance journalist specializing in politics, human rights, and culture in the Middle East.