EMEA

JUNTA INCORPORATED

Marcus Chenevix

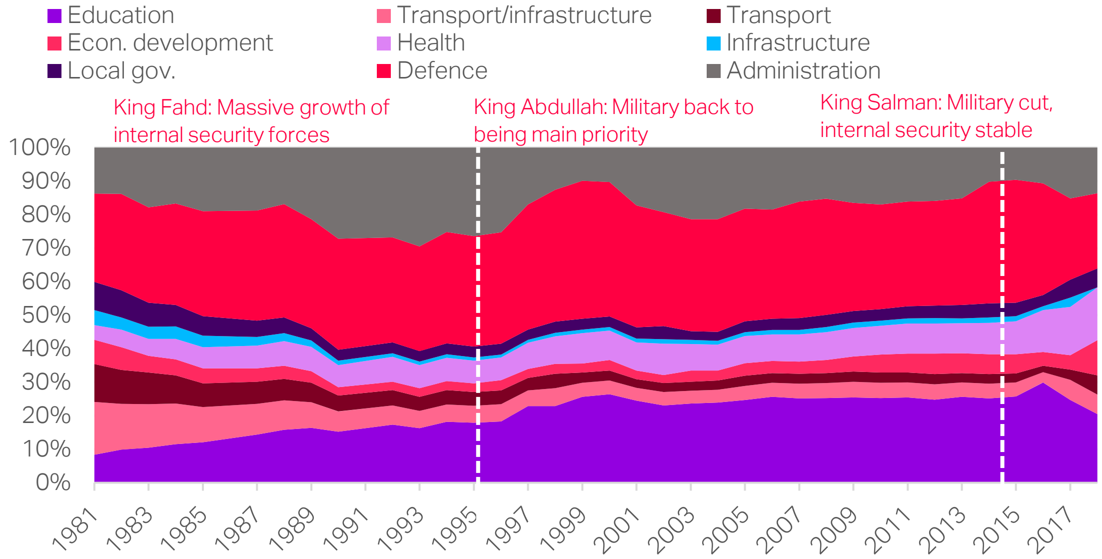
Across the Middle East, the military is back – including as a major economic player. With Military Inc. on the march, we examine the far-reaching consequences for companies and markets – and implications for investors – through case studies of Egypt and KSA.

- **Post-Arab Spring, military power is growing across the MENA region – economically as well as politically.**
- **In Egypt 10-20% of GDP has fallen under military control, making the military the country's largest "company".**
- **Other countries in the region are heading down the same road – most importantly, Saudi Arabia.**
- **Investors in these economies face a stark choice: travel with the military or aim for sectors – such as TMT or food retailing – that are not the object of its predatory appetites. We advise the latter.**

This publication is part of our EM service. Click here for more details.

Power shifts in Saudi Arabia

Budgetary sectors as proportions of overall spending



Source: SAMA, TS Lombard

The fall and rise of the military economy

2011 proved positive for the power and wealth of the officer class

The military was prime-mover in the post-independence Middle East. Through the 1950s and 60s the continuous reality of military coups (see chart below) allowed militaries to shape regional economies. Sometimes they did this through the direct seizure of government, and sometimes through their coup-supported veto power over policy.

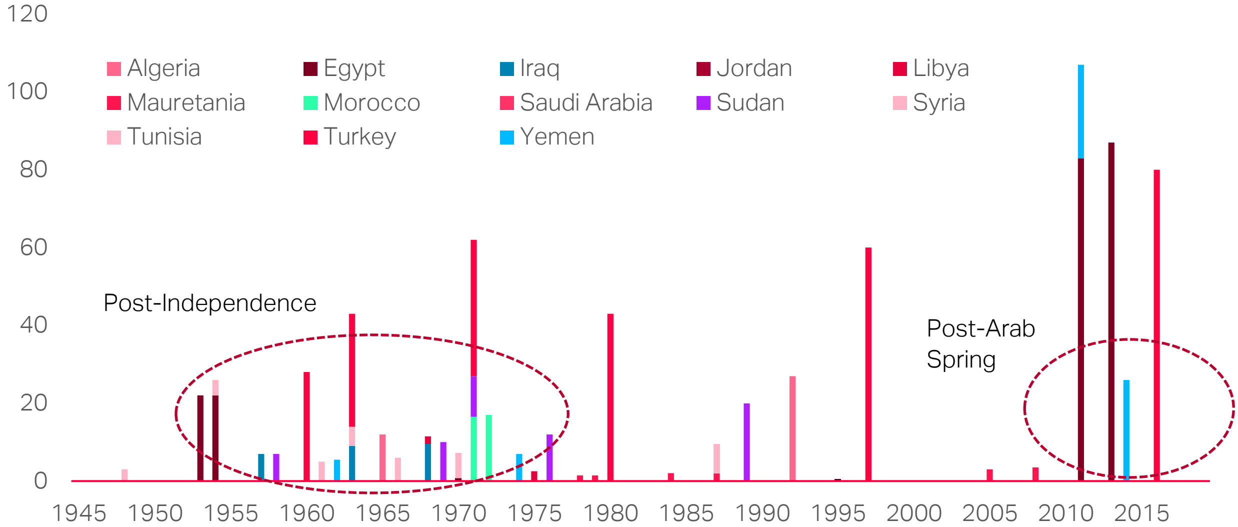
In the 1970's military power began to fade region-wide. After 1973, the political dynamic began to shift. Militaries across the region became increasingly alienated from Presidents and Kings, who relied more and more on police and security services as their enforcers, seeing the military as unreliable and threatening. Government by or for the military had meanwhile become less suited to managing economies as the development agenda matured from the initial focus on building infrastructure and other construction to the more complex challenges of private sector expansion and consumerism.

By the end of the Iran/Iraq war in 1988, defence budgets were in decline across the region and military officers found their interests being subordinated to the ascendancy of expanded police states answering to politically alien presidencies. At the same time, first Egypt, followed by Jordan and Syria, began to engage in far-reaching programs of modernization involving a shift away from statist models to a more mixed economy. This process had the often intentional side-effect of further reducing the power of the military, which up to that point had been absorbing 20-40% of government spending in major Arab economies. Starved of funds, lacking a clear role, and continually purged of potential coup-plotters by the police state, the military became increasingly neglected and marginal in most Middle Eastern countries.

In 2011, this all changed as the failure of police states across the region opened the way for the military to regain power. It turned out that the police states of the Arab World were also not particularly good at the 'complex stage' of development. In 2011, mass unemployment, rising poverty rates and a prevalent feeling of exclusion led to popular revolts region-wide. In Bahrain, Yemen, Syria, Libya, Egypt and Tunisia police states imploded, leading to direct military

Return of the Coup

Coups and major attempted coups by country and population (mn people, LHS)



Sources: UN Population Fund, Nazih Ayubi.

intervention both for and against incumbent regimes. In these destabilized countries the military was able to renegotiate a new deal for itself – with control of the economy as a key bargaining point. Even in relatively unaffected states such as Saudi Arabia, the UAE and Jordan, governments have felt an increasing reliance on the once neglected military – sometimes out of a desire to shore up regime/military links and avoid a coup, and sometimes because the military is seen as a useful pro-regime force to blunt domestic opposition.

Opening the "black box" of the military economy

Military economic involvement is often wrongly regarded as too opaque to be understood. A core thesis of this note it that it is perfectly possible to analyse the extent and nature of military penetration of economic sectors to which investors are also exposed. Even allowing for the difficulty of precise measurement, we can have a good idea of:

- The rate of expansion of military involvement in the economy
- The sectors and companies that are military-controlled
- Which macro-economic policies militaries favour, and the reforms that they block
- The systemic consequences of military penetration of product and service markets

We focus our analysis on two cases of expanding military economic power: Egypt, which is an extreme and chronic case; and Saudi Arabia, which is in the early stages of military outgrowth.

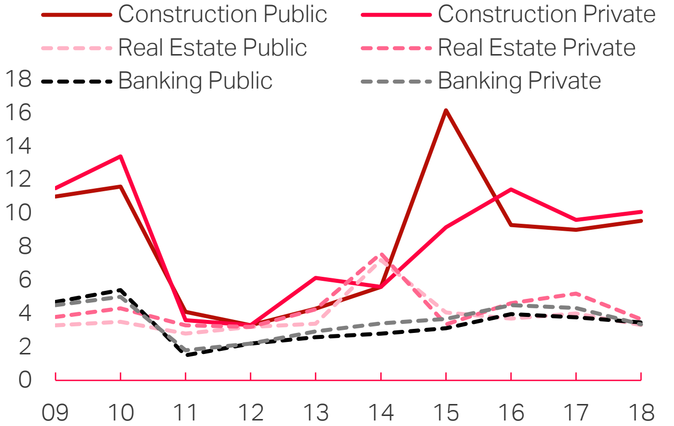
Egypt: Fully developed junta-nomics

The dark side of the boom

In the years since the June 2013 coup, Egypt has returned to growth and Egyptian equities have outperformed EM indices. Following the 2013 military takeover, Egypt's economy has begun a recovery. Partly this has been the result of external factors: a rise in Suez Canal receipts, a major natural gas discovery, and generally benign conditions for EM economies living beyond their means. But the key driver has been the government's domestic policies underpinned by a US$12 billion IMF facility. The conditionality for this IMF financing has included FX liberalisation, deregulation and interest rate stabilisation; with it the Egyptian pound has been stabilized, fending off a liquidity crisis. The IMF now claims that Egypt can look forward to a period of sustained growth. They are likely to be dissapointed.

Building for the sake of building

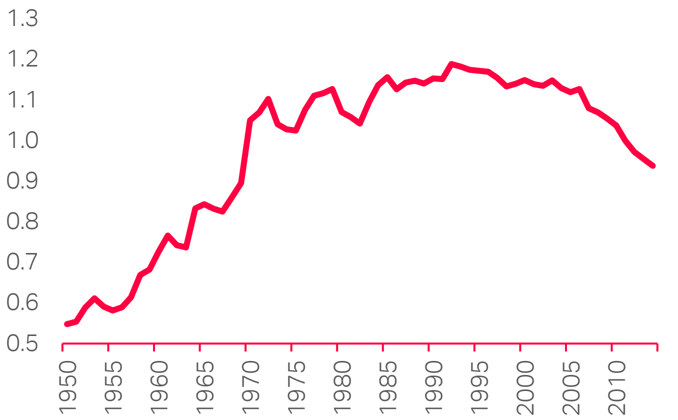
Sectoral GDP growth (% yoy, constant EGP)



Source: Central Bank of Egypt

Productivity of capital is falling

Total Factor Productivity Index (2011=1)



Source: FRED

Under the surface of the recovery, something strange is happening: a mushrooming of overcapacity. Closer inspection of sectoral growth reveals an anomaly: construction sector growth has been incredibly rapid, but without any accompanying growth surge in either real estate trade or lending (see chart above). This disjointed sectoral growth pattern points to overcapacity. Other parts of the economy make even less sense. In 2017, Egyptian cement companies had production capacity of 79 million tons per year, supplying a market that demanded only 53 million tons; and yet in the same year, the cement sector added another 13 million tons of new capacity.

The productivity of Egyptian capital is falling fast. Total factor productivity in Egypt has been declining sharply since 2011, despite (admittedly slow) growth in labour productivity, implying much lower productivity of capital. We believe that outside of the food sector, which is recovering for its own reasons, the recovery in Egypt is not what it seems, and at the heart of the problem is the peculiar commercial role of the Egyptian military.

Military incorporated

With its complete lack of oversight and near unlimited mandate, the Egyptian army can be understood as a kind of heavily-armed holding company. The chief beneficiaries of this company are senior officers, with junior officers hoping for reward in the future. The Egyptian army maintains an almost complete separation between officers, of whom there are around 80,000, and non-commissioned ranks, who number around 700,000 (counting internal security units), meaning the lower ranks function mostly as cheap labour. They are not shareholders.

In the 60s and 70s the "company's" positioning revolved around the state: it accounted for a huge share of the state budget, around 40% of all spending, and had control of a portfolio of state-owned industries. However, towards the end of the 1980s, the military's share of the state budget was cut heavily, falling from 19% of GDP in 1980 to 12% in 1990, and then down to 2.5% by 2000. At the same time the value of the military's control over aging state industries began to decline, with the state companies increasingly outcompeted by a new brand of private corporation run by Mubarak's handpicked class of oligarchs.

Clearly, the military needed to diversify the portfolio. In order to make up for the lost budgetary revenue military officers began to get involved for the first time in an impressive variety of businesses: farms, car plants, general manufacturing, quarries, hotels and housing projects – all using conscripts as cheap labour. Mubarak allowed this, seeing it as a way to keep the military busy and far from politics, in any case, he felt could always count on his oligarchs and his police state to stop the officers' activities from getting out of control.

Now, two coups later, the military is supreme, and twenty years of business-building turns out to have become a habit. The desire to grow the portfolio was likely a large part of why the military pushed Mubarak out in 2011, and ousted Morsi in 2013 – both leaders were seen as a threat to the military's commercial holdings. Since former army chief President Sisi took over, accompanied by a coterie of former military colleagues, Military Inc. has run rampant. Three main corporate subsidiaries define the military takeover of the Egyptian economy:

1. **The Armed Forces Land Projects Authority (AFLPA):** Since 2015, the Egyptian military, via AFLPA, a wholly military owned institution, has had the power to declare any area of land to be a national security asset and then to sell this land to investors if it chooses. The AFLPA is even empowered to form joint stock companies using the land. Whilst the military has always had a high level of control over land usage, it has never

previously been so well positioned to monetize its control over land. In this context it is hardly surprising that Egypt's developers are reporting suddenly sky-high land prices.

2. **Administrative Capital for Urban Development (ACUD):** In case the military had not already made enough money from the land sales involved in the new capital project, it has also been handed the brief for infrastructure construction in the new city – a project worth US$45 billion if official numbers are to be believed. The body that awarded the military the contract was ACUD, which is itself 51% military owned. ACUD not only controls all tenders and land sales for the new capital project, but will also inherit *all vacated government property in central Cairo*. The army is taking over much of the country's prime urban real estate, mostly for free.

3. **The National Service Projects Authority (NSPA):** Alongside these spectacular land grabs, the military has been growing its more conventional holdings. Via the NSPA, a wholly owned subsidiary company, the Egyptian military has moved into almost every sector of the economy, from food to mining. In cement, for example, NSPA has gone from being a bit player with 6% of supply under its control in 2014, to controlling 20% of supply today. Trusted sources tell us that the NSPA, along with hundreds of other, more indirectly owned, companies now employ close to 500,000 people.

We estimate the extent of the Egyptian economy now under military control in the range 10-20% of GDP. This range may be conservative as it assumes the Suez Canal and the entire petroleum sector to be outside of military control – something that many local experts would dispute. At a recent conference on the Egyptian military, one speaker put the proportion of military control at 40 percent of GDP. The military is easily Egypt's largest commercial corporation.

With such huge holdings, it is unsurprising that the military has a major influence on macroeconomic policy. Over the last five years, President Sisi's economic policies have not always been easy to explain. On the one hand they appear expansionist and populist: digging a new Suez Canal, building a new capital, ramping up defence budgets and introducing a 10% capital gains tax. On the other hand, they seem orthodox and austere: floating the Egyptian pound, slashing fuel subsidies and raising utility prices. The policy mix makes a lot more sense when you see that Sisi's chief constituency is Military Incorporated. Land development and construction are the military's chief revenue raisers and these mega projects are tailor made for the military's immense pool of cheap labour. Military officers are tax exempt and the new capital gains tax could help to hobble their rivals. Similarly, in the case of subsidies, the officer class operate on a wholly different set of subsidies. In their perspective, slashing fuel subsidies for the general population simply frees up more money to be spent on expanding the defence budget.

Both popular demands and economic stability are taking a back seat to military interests. It is impossible to know what bargain President Sisi has made with his former colleagues in the military when he ascended to the presidency. But we do know that they are his critical political constituency and in order to protect their interests the Egyptian economy is going to remain heavily regulated, largely state controlled and without consistent institutional governance. As for the Egyptian people; they are going to have a lot to protest about in the coming years.

Saudi Arabia: The Process Begins

MBS and his military

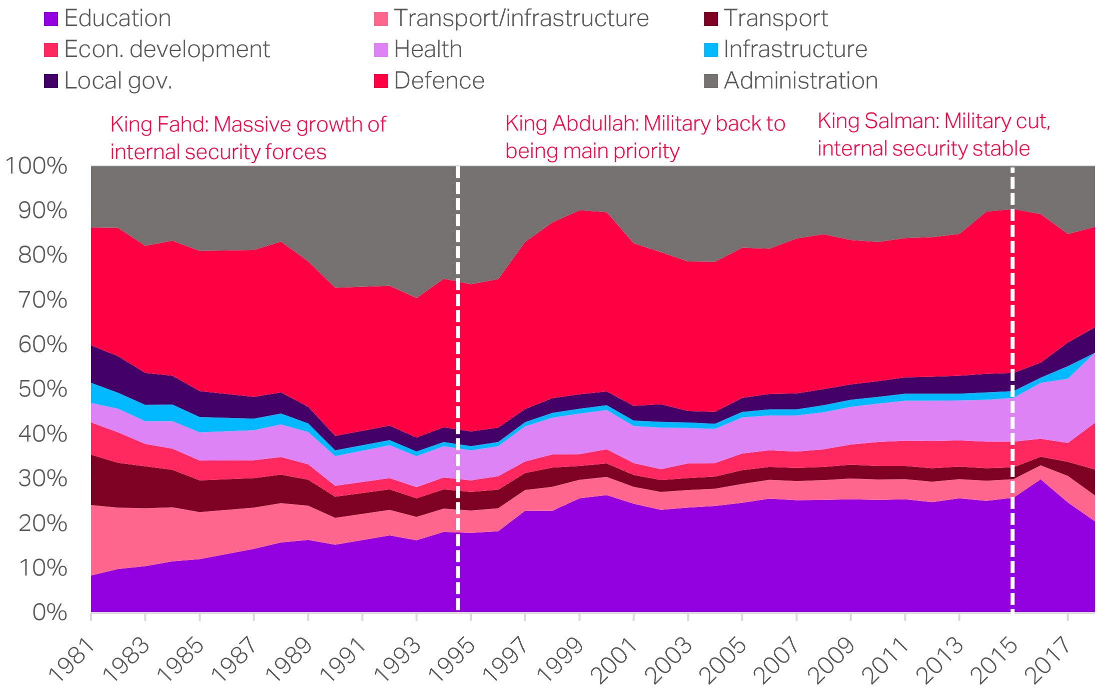
Egypt is an extreme case, but the role of the military deserves attention across the region. From Iran to Algeria, the role of the military in regional economies is growing. The pivotal role of army officers in suppressing or reinforcing the Arab Spring has greatly upgraded the political status of military officers, who have used this status to expand their economic reach across increasingly liberalised markets. Once military officers become entrenched in commerce economies, they become much less amenable to democratic change or institutional reform. They subvert macroeconomic policy, shut out competition and retard the development of capital markets, the transparency of which they resent. They have little interest in raising productivity and enthusiastically generate overcapacity – knowing that competing civilian-owned capacity can always be crushed if necessary.

What then of Saudi Arabia, the region's most important market? Something significant is clearly happening in Saudi Arabian civil-military relations. The Kingdom's *de facto* ruler, Crown Prince Muhammad Bin Salman ("MBS") has located the nexus of his power in the Ministry of Defence, with key aides such as Ahmed al-Assiri (of late Khashoggi related infamy) coming straight out of the Saudi officer corps. When the time came for MBS to crush the power of the oligarchs in the 2017 Ritz-Carlton Purge, it was the military he turned to as his enforcers.

This political reliance is curiously at odds with fiscal picture. No Saudi administration in the past 30 years has devoted a lower portion of the budget to the military. Despite his war in Yemen, and his use of the military as a power centre, MBS has not been generous to his officers in terms of budgetary allocations. In fact, he has been relatively much more generous to the internal security forces (categorised under "administration" costs in the chart below). This despite the fact that the internal security forces have much more divided loyalties.

Power shifts in Saudi Arabia

Budgetary sectors as proportions of overall spending



Source: SAMA, TS Lombard

MBS is rewarding his soldiers in some other way. Two possibilities spring to mind, one is that MBS has reduced military spending by moving some of it off the books. This would not be particularly hard. As an example of fiscal opacity, drawdowns from SAMA's foreign reserves never tally with the official state budget. The other possibility is that Vision 2030's focus on building a domestic defence industry is at least partly intended as a giveaway to military officers.

This is exactly how the process of military expansion began in Egypt. The NSPA, that body that now manufactures everything from cement to macaroni, began as an attempt by the Egyptian government to onshore defence production. The decision to build a domestic defence industry was the fist step in building Military Incorporated. Saudi officers know how the Egyptian army works, MBS knows that he will need to keep the military busy when they eventually return from Yemen. This could well hasten Saudi Arabia's progress in emulating the Egyptian model.

Investment Conclusion

Investing in a fully militarised economy like Egypt implies choosing between two strategies. There are areas of the economy that military officers do not seem to understand and tend to avoid. For example, whilst military officers like agricultural projects, they spurn the marketing and trading side of the food industry. Similarly, the military penchant for 'hard' infrastructure does appear to extend to telecoms and IT. In the Egyptian case, these are sectors to which investors can get exposure with a reasonable prospect of avoiding threats to property rights from the military or returns on investment being undermined by the rigging of markets in favour of military-owned competitors. Alternately, an investor may decide that in a military ruled economy, the best idea is to go with the flow and invest in real estate, cement, steel and construction, knowing that these are markets that the military is shaping the economy to suit.

Overall, we would advise option 1: avoidance. The problem with attempting to piggy-back on military favoured sectors is that military officers have no care for overcapacity. They will keep building new capacity regardless of demand, relying on punishing privately-owned sources of supply should the market need to be rebalanced.

Region-wide, the rise of the military poses a long-term challenge to political and economic stability. The rise of the military as a corporation is the result of repeated attempts at economic liberalisation without political reform. In an autocratic, unaccountable and non-inclusive state the market economy is more at the mercy of the military with every step towards privatisation and liberalisation. Although for now Saudi Arabia lags Egypt in the militarization of the economy, it is moving in that direction: oligarchs have been purged, a defence industry is being built, and a series of mega-projects planned. Investors in Saudi equities should watch where PIF money is invested internally, and what sort of management comes in to run companies seized in last year's purge. Evidence of military-linked management would be a strong argument for avoiding not only the companies concerned but also other companies in the same industry sectors.