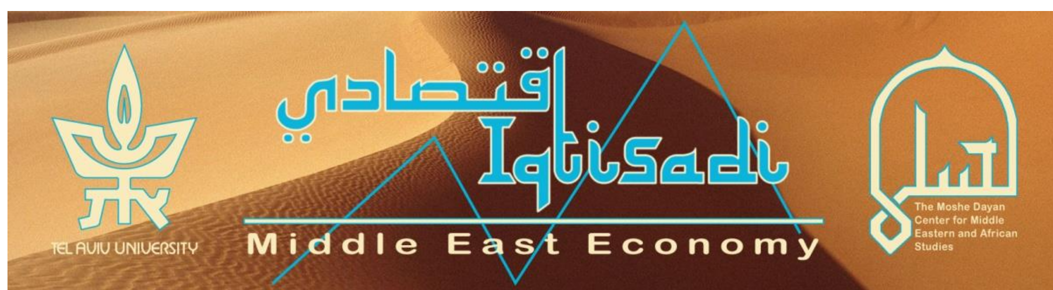

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The Egyptian Economy: The Plot Thickens

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In recent years, Egypt's shortage of foreign currency has resulted in a lack of basic goods such as fuel and food. As the demand for foreign currency exceeded the supply on official markets, the premium on the parallel market rose and a dual system evolved. Currency devaluations in 2015 and early 2016 did not solve the problem.

In November 2016, the Central Bank of Egypt (CBE) devalued the Egyptian pound again, this time by 32.5 percent against the US dollar. Unlike previous occasions, the rate was then left to float without intervention from the central bank. The market was now to determine the rate of exchange, signifying a major change of policy. In the month following the devaluation, the value of the Egyptian pound fell further and the devaluation reached 50 percent.

As a result, a rapid acceleration of inflation replaced pressures in the foreign exchange market as the most immediate problem. Behind both problems were the underlying problems of an extremely inefficient economy, widespread poverty, and demographic growth that swamped the labor market.

The November 2016 devaluation was part of a deal agreed with the International Monetary Fund (IMF). In November 2016, the IMF approved a three-year extended arrangement under the Extended Fund Facility (EFF) for Egypt for approximately $12 billion, to support the authorities' economic reform program. In the words of the Fund, "The EFF-supported program will help Egypt restore macroeconomic stability

and promote inclusive growth. Policies supported by the program aim to correct external imbalances and restore competitiveness, place the budget deficit and public debt on a declining path, boost growth and create jobs while protecting vulnerable groups." Some $2.75 billion was made available immediately and the remainder will be made available over the duration of the program, subject to review.

The policy agreed on by Egypt and the IMF was based on a significant policy adjustment, including the liberalization of the foreign exchange system. This was designed to eliminate foreign exchange shortages, as well as encourage investment and exports. Monetary policy would be used to contain inflation. Fiscal policy would be tightened to help reduce the public debt and at the same time social safety nets would be strengthened by increasing spending on food subsidies and cash transfers to the poor. Structural reform would be implemented to promote higher and inclusive growth designed to generate jobs for young people and women. In addition, Egypt would look for other sources of external financing to fund the fiscal and balance of payments deficits.

In the financial year that ended in June 2015, the Central Bank of Egypt devalued the Egyptian pound by five percent and raised interest rates to reduce inflation. Spending in the state budget was cut through subsidy cuts, tax increases, and civil service reforms. Fuel and electricity prices were increased as subsidies fell, and a plan for phasing out these subsidies was proposed. As a result, the subsidy bill fell by nearly three percent of GDP and the budget deficit fell from over 13 percent of GDP in 2013/14 to 11.5 percent in 2014/15.

In 2015/16, the pace of reform slowed. Although income tax rates were cut, the introduction of a capital gains tax was postponed and parliamentary consideration of VAT was delayed until 2016/17. Planned fuel price increases were not implemented, but total subsidies fell by the equivalent of 1.1 percent of GDP, because of lower world oil prices. Government debt reached almost 95 percent of GDP, 20 percent higher than in 2011/12 and so interest payments increased by 0.9 percent of GDP. The 2015/16 budget deficit therefore widened to 12.1 percent of GDP, compared to a planned 8.9 percent.

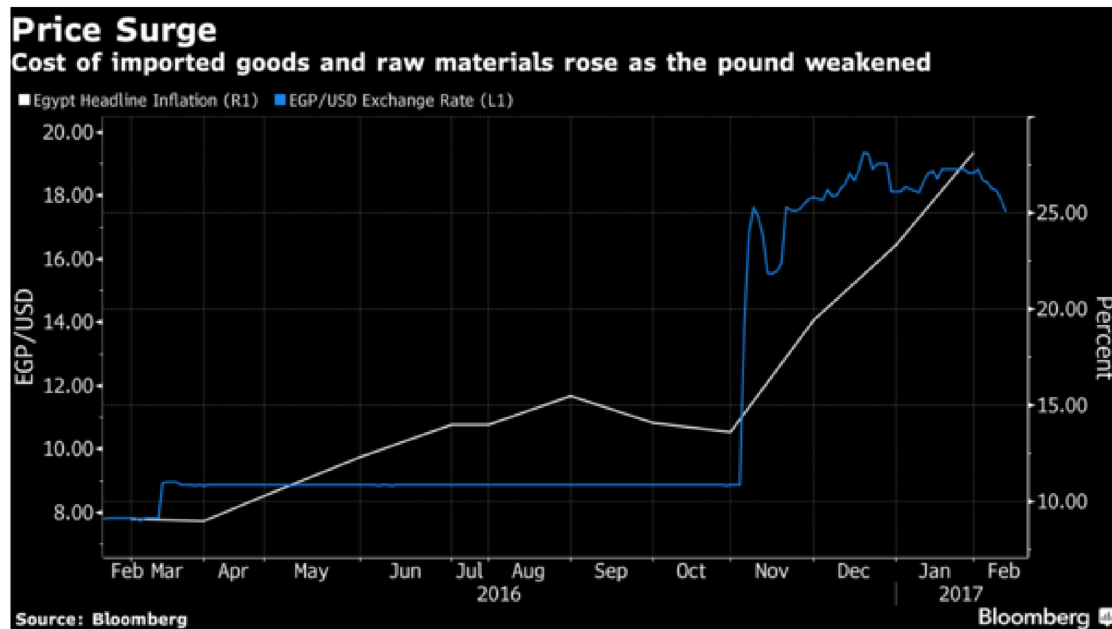
As a result, growth slowed and inflation accelerated. Economic growth in 2015/16 (the year to June 30, 2016) was estimated at 3.8 percent compared with 4.2 percent the previous year. Foreign exchange shortages and the overvalued currency hampered manufacturing industry and tourism revenues were badly affected by security concerns and the disruption of flights, following the terrorist bombing of a passenger plane over Sinai Peninsula in October 2015. Inflationary pressures intensified in the second half of the year, with inflation rising from about nine percent in early 2016 to almost 14 percent in September. The deficit on current account of the balance of payments further widened from 3.7 percent of GDP in 2014/15 to an estimated 5.5 percent of GDP in 2015/16, while the balance of goods and services deteriorated by about one percent of GDP. In June 2016, gross international reserves stood at $17.1 billion, equivalent to only 3.1 months of prospective imports.

In March 2016, the official exchange rate of the pound against the U.S. dollar was devalued by 13 percent. Nevertheless, strong pressures on the exchange rate and reserves continued, and equilibrium in the market was not restored. By the end of September the parallel market premium widened to more than 30 percent, and the official exchange rate was estimated to be overvalued by about 25 percent in real effective terms, while foreign exchange shortages continued.

The main immediate effect was to increase the cost of imports including a wide range of goods that consumers and the economy as a whole rely on. This pushed up the cost of living and accelerated inflation. In January 2016 prices were 7.7 percent higher than a year earlier; by June they were rising by 12.3 percent and in December by 25.9 percent. In January 2017, the rate had reached 30.9 percent, the highest rate for thirty years. “This is causing distress and people are adjusting to inflation by reducing their consumption of basic items, not luxury items, and that is disastrous for the future,” said Ehab al-Desouki, head of the Economy Department of the Sadat Academy in Cairo. The poor are squeezed, and the middle class is being impoverished.

Further aid from the IMF depends on implementation of plans agreed with the IMF, including subsidy cuts. Egypt is due for a review by the International Monetary Fund (IMF) to make sure its reforms are on track to receive the second tranche of the $12 billion Extended Fund Facility. The minister of electricity recently told the House of

Representatives that the cost of electricity subsidies had more than doubled to LE65 billion (about $3.6 billion) because of the floatation of the pound and the increase in oil prices.



Source: [Bloomberg]

The pressure for the November 2016 devaluation arose because of Egypt's chronic shortage of foreign currency. This was due to the fact that imports exceeded exports and the balance had to be met by borrowing, as shown in Table 1. The table indicates how large imports have been compared with exports and how little Egypt has to sell abroad. Oil accounted for an average of 42 percent of exports of goods in 2011/12-2015/16. It fell sharply in 2014/5-2015/16 because of the fall in international oil prices but non-oil exports also declined. Non-oil exports are dominated by chemicals.

Although it is an oil producer, Egypt has to import a range of oil products, the result of inefficiency in its refining system. The service balance was in surplus but as a result of the weakness of the tourism sector since the outbreak of the Arab Spring, it has been small. Transfers have covered much of the balance but private remittances from millions of Egyptians working abroad have shrunk. This was because the labor market in Libya largely collapsed as conflict raged there and because the over-valued exchange rate of the Egyptian pound discouraged transfers into the banks. With the exception of 2013/14, official transfers were small, as were deposits by Gulf

Cooperation Council (GCC) member states to the Egyptian banking system. The latter were part of the capital account that could be used to finance the current account deficit. The figures in Table 1 suggest that between 2011/12 and 2015/16 aid from the GCC in the form of grants and deposits totaled only $13.5 billion, with over half received in 2013/14. This suggests that external aid will not solve Egypt's problems.

Table 1
The Balance of Payments, 2011/12-2015/16
(Percent of GDP)

	2011/12	2012/13	2013/14	2014/15	2015/16 Preliminary
Current account	-3.7	-2.2	-0.8	-3.7	-5.5
Goods balance	-11.3	-10.8	-11.2	-11.7	-11. 2
Services balance	2.0	1.8	0.3	1.4	0.6
Exports	9.1	9.5	8.7	6.7	5.5
- Oil	4.1	4.6	4.1	2.6	1.7
- Other	5.0	4.9	4.5	4.0	3.8
Imports	20.4	20.2	19.8	18.4	16.5
- Oil	4.3	4.2	4.4	3.7	2.7
- Other	16.2	16.0	15.4	14.7	13.8
Transfers	6.7	6.7	10.1	6.6	5.0
- Official grants	0.2	0.3	4.0	0.8	0.0
- Private remittances	6.4	6.5	6.1	5.8	4.9
Short term deposits from GCC countries in capital account	0.4	1.9	3.3	1.8	0.8

Source: IMF. Arab Republic of Egypt. Country Report number 17/17

Egypt suffers from long-term structural problems of high unemployment, low labor force participation, and an unfavorable business environment. Poverty has increased sharply in recent years: in 2015, 25 million people, or 27.8 percent of the population, lived below the poverty line compared with 17.5 million, or 21.6 percent in 2009.

The population is growing by 1.88 percent a year according to the UN and by 2.4 percent a year, according to the official statistical agency CAMPAS. In mid-2016 the population resident in Egypt was estimated at 91 million. This means that the annual addition to the population is between 1.7 million and 2.2 million people.

This in itself is a huge burden on the economy but the structure of the population presents another challenge. The Egyptian population, like that in the Middle East as a whole, is very young. As a result large numbers of young people enter the labor market each year. Although the growth rate of the labor market entrance group has slowed, the number of young people looking for work remains large. The economy, with its long standing bias towards using capital rather than labor, cannot absorb them all and those with education and skills suffer higher unemployment than those that do not.