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Egypt's Economy: The Agony Continues

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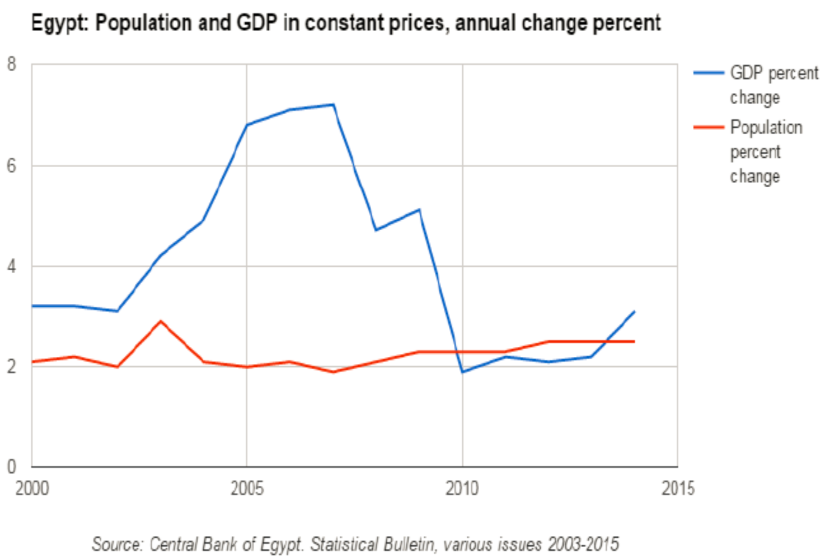
With the expansion of the Suez Canal in August 2015, and the discovery of large reserves of natural gas in the Egyptian Mediterranean, there was a wave of optimism about the Egyptian economy (See: "The Good News from Egypt – and the Bad," *Iqtisadi*, September 25, 2015). This has dissipated and the economic indicators look bad. Tourism has been badly affected by terrorism, including the downing of a Russian plane over the Sinai in November 2015. National income per capita may well have fallen as a result of the acceleration of population growth and a weak economy: unemployment has increased as has inflation (See Figure 1). Why has demographic growth accelerated and what has happened to the Egyptian economy?

Figure 1



Between 2010 and 2015, Egypt's population increased by an average annual rate of 2.2 percent, compared with an average annual of 1.8 percent between 2005 and 2010. This acceleration resulted in the population increasing each year by about 300,000 *more* in 2010-15 than in 2005-2010. The annual increase in 2005 was about 1.4 million and by 2010 it was 1.8 million; the rise of 432,000 was due to the acceleration of the growth rate and the larger population base. A UN forecast suggests population growth rates will decelerate, but by 2050 the population will exceed 151 million, and by the end of the century it will exceed 200 million. It should be noted that between 5 and 6 million Egyptians live abroad, and they are included in the data.

Why, after decelerating for years, did the demographic clock speed up? There are several explanations. The first is the collapse of population control policies during the final period of Hosni Mubarak's rule and during Mohammed Morsi's year in office. The second is what has been called the "demographic echo": the increase in the number of women of childbearing age. Finally, there has been an increase in fertility rates; the result has been more women having more children.

Population control policies were relatively successful during the 1980s and 1990s, and the result was a decline in the growth rate. During the final years of Hosni Mubarak's rule they ceased to be a priority and even fell off the agenda, especially in the chaos that followed Mubarak's removal in 2011. When Mohammed Morsi, of the Muslim Brotherhood, was elected president in 2012, negligence became official policy. Morsi's government publicly declared that population control was not a government concern.

The National Population Council was founded in 1985 with support from the US Agency for International Development (AID). The NPC was responsible for national population policy and included the ministers of planning, social affairs, health, education, information, and international cooperation, as well as public figures with relevant experience.

According to its head, Hala Youssef, the Council did not function during Morsi's year in office, although his predecessors also bore responsibility for the weakening of the population policy. According to the Ministry of Health, contraceptive use by married women aged 15 to 49 years rose rapidly in the 1980s, and, in 1992, the overall use rate was 47 percent, almost twice the rate reported in the 1980 Egypt Fertility Survey (24 percent). The use rate continued to rise—although at a more moderate rate—reaching 60 percent at the time of the 2003 survey. The rate peaked in 2008 at 60.3 percent and fell to 58.5 percent in 2014.

The second factor that effected the demographic surge was an increase in the number of women of child-bearing age. In 1980, there were 10.2 million women aged between 15 and 49 years; in 1995, there were 14.4 million and in 2014, there were 22 million. Between 1995 and 2014, the total population increased by 44 percent while that of women of child-bearing age rose by almost 53 percent.

The third factor was the increase in fertility.[*] Why has this occurred? One reason is that the age of marriage has fallen. This may have been made possible by changes in the housing market that made it possible for young couples to get married. The second factor was the fall in the number of jobs available for women in the public sector. This was part of the slow liberalization of the economy that shifted the burden of employment from the public to the private sector. In 1991, 33 percent of 25 to 29 year old men were employed in the public sector and by 2012 that had fallen to 14 percent. In 1991, 15 to 16 percent of females were employed in the public sector and in 2012 it was only 10 percent.

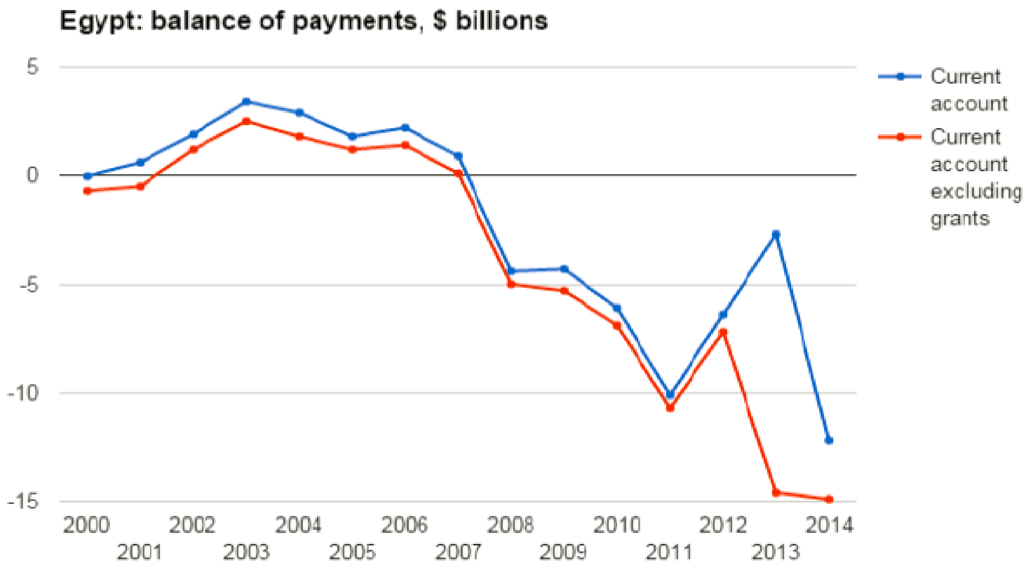
Against this background of increasing population pressure, the economy has slowed, resulting in higher unemployment. According to official sources, the number of unemployed increased from 2.55 million (10.3 percent of the labor force) in 2004 to 3.6 million (13 percent) in 2014. It should be noted that Egypt has a low labor force participation rate of about 32 percent, and if more people looked for work the unemployment rate would have been even higher. Unemployment increased because economic growth was weak. Figure 1 shows that the economy needed to grow by at least 2.2 percent a year just to prevent national income per capita from falling. This has

[*] Fertility is defined as the number of births per woman during her lifetime. A more refined definition is age specific: how many births within a certain number of years. The birthrate reflects fertility rates and the number of women of child-bearing age.

not happened in recent years. Since 2010 economic growth has averaged about two percent a year.

As shown in Figure 2, slow economic growth has not prevented a deterioration of the balance of payments. Slow economic growth is often accompanied by lower imports and this permits the balance of payments to strengthen but this did not happen because exports were so weak. The deficit on the current account of the balance of payments reached a low (of $12 billion in 2014/15, compared with $2.2 billion in 2013/14 and an annual average of $7.5 billion in 2010/11-2012/13). The most recent figures show a further worsening: from a deficit of $4.3 billion in July-December 2014 to $8.9 billion in July-December 2015. This was partly due to lower revenues for oil exports as a result of the fall in international oil prices.

<u>Figure 2</u>



Source: Central Bank of Egypt. Statistical Bulletin, various issues 2003-2015

Figure 3 shows the sharp decline in foreign reserves since 2010, a fall in foreign investment since 2007, and a rise in foreign debt. Aid from the Gulf States has partially replenished the foreign reserves, enabling Egypt to import vital commodities. The increase in the foreign debt means that the volume of interest payments goes up and this weighs on the balance of payments. The increase in foreign investment in Egypt between 2002 and 2007 was one of former President Hosni Mubarak's successes, but it was based on political stability that no longer prevails.

Figure 3

In 2012/13-2014/15 the fiscal (government) deficit averaged almost 13 percent of GDP. This meant that there was a very large gap between government expenditure and revenue that was funded by borrowing. In June 2011, 49 percent of domestic credit was taken by the government. In June 2014, this had increased to 53 percent and by March 2016 it had reached 67 percent. This meant that a decreasing share was available to the private sector and that the cost of credit increased, a disincentive for private investment.

Despite the recession that usually dampens inflation, Egypt suffers from rising prices. At the end of June 2016, The Central Bank of Egypt (CBE) raised interest rates by one percent to reduce in the inflation that had hit a seven-year high in May.

The bank raised the overnight deposit rate from 10.75 per cent to 11.75 per cent, its highest level in over a decade, and increased the overnight lending rate from 11.75 per cent to 12.75 per cent, its highest level since 2008. These are rates that influence the cost of borrowing throughout the economy. The annual inflation rate rose to 12.3 per cent in May 2016 from 10.27 per cent in April, the highest monthly rate since July 2014. The core annual inflation rate, which excludes volatile prices such as fruit and vegetables, jumped to 12.23 per cent in May 2016 compared with 9.5 per cent in April. This was the highest rate since 2009. The acceleration of inflation was due to supply shocks such as the increase in rice prices, the seasonal effects of Ramadan, and a delayed effect from the devaluation of the Egyptian pound in March that increased the cost of imports.

In March 2016, the CBE devalued the Egyptian pound by 14 percent to LE 8.78 per US dollar and raised interest rates by 150 basis points days later to control inflation. Devaluation was made necessary by the shortage of foreign exchange, the result of the weakness of the balance of payments. The devaluation did not solve Egypt's financial problems. The shortage of foreign exchange (dollars and euros) means that there is a black market in which the dollar is higher in value than the official rate of exchange. Inflation remains high, partly because of the March devaluation, and is one of the factors leading to hesitation about implementing another devaluation.

According to the World Bank, the fiscal position improved following subsidy cuts in the fiscal year 2014/2015, but the reform momentum faded in 2015/2016. The budget deficit was reduced in 2014/15 due to the reduction of energy subsidies, measures to increase revenues, and the fall in international oil prices. This was achieved at the same time that the government only modestly increased allocations for health, education, and the infrastructure. The pace of reform has slowed since then, as the energy subsidy reform program was only partially implemented, and the ratification of the value added tax and mining laws have been delayed.

The 2016/17 budget was approved by parliament at the end of June. It projects total expenditure of Egyptian pounds (EGP) 936 billion (about $105 billion) and revenues of EGP 631 billion ($71 billion). The projected budget deficit is equal to 9.9 percent of GDP, lower than the actual deficit in recent years. The budget includes subsidies of EGP 130.1 billion ($14.7 billion), of which EGP 46.3 billion ($5.2 billion) is for a food and farmers. The 2016/17 subsidy bill is planned to be 14 percent lower than in 2015/16. If implemented this would raise prices, reduce purchasing power, and accelerate inflation.

From the fiscal year 2016-2017, the constitution obliges the government to allocate the equivalent of four percent of GDP to education, two percent to higher education, three percent to healthcare, and one per cent to scientific research. According to opposition parties, the 2016/17 allocations for healthcare, education, and scientific research in the budget are far too low.

The failure to allocate sufficient funds for education and health reflects the large and unaccounted amounts allocated to the military and the very weak revenue base. In 2009/10, taxes accounted for only 14.1 percent of GDP while spending accounted for 30.3 percent. In 2013/14, the share of taxation had fallen to 12.4 percent while spending remained almost constant at 30.5 percent.

Without a major change in the tax system, the government will not be able to finance vital investments in education, health, and the country's infrastructure. More effective taxation will, however, be resisted by those who will be liable to pay.