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Egypt's Economy after the Elections

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In the ten months since Husni Mubarak was ousted as president, Egypt has moved from elation to despair and near chaos. The political future of the country is clouded and that is bad for its much weakened economy. The outcome of the elections is increasingly clear: Islamist parties have taken the lead and will play a major role in Egypt's political future if not in government. The uncertainty is due to the complex and prolonged procedures of the elections and the great unknown: Will the army allow a government to be formed by parties that have a parliamentary majority. Will it give such a government real authority? Other uncertainties relate to the role of the interim government that Gamal Kanzouri has formed at the request of the Supreme Council of the Armed Forces (SCAF) and the role of the president, due to be elected in 2012.

Egyptians are worried: a recent opinion poll quoted by the Cairo daily, *Al Ahram*, states that most Egyptians are more concerned about worsening economic conditions than they are about the political situation. Their primary concerns are rapidly rising prices, unemployment, lack of security in the streets, low wages, and poverty. They are right to be concerned as the economic situation is indeed bleak.

The economy has deteriorated dramatically and the International Monetary Fund expects it to grow by only 1.5 percent in 2011, compared to an annual average of 5.5 percent in the last seven years of Mubarak's rule. Even this forecast may prove overly optimistic. The population is growing by about 1.7 percent a year; if the economy does not grow by the same rate, living standards will decline.

The economy has stumbled because tourist revenues, which used to account for over 10 percent of national income, have collapsed. Foreign investment, which reached $8.1 billion in 2008-9, has also ceased. Not only has foreign investment in Egypt dried up, but foreigners and Egyptians have taken funds out of the country. In an attempt to prevent the exchange rate falling, the Central Bank of Egypt (CBE) has bought Egyptian pounds (LE) and sold foreign currency. As a result, its foreign exchange reserves fell by 44 percent during the year to November 2011. Foreigners held LE 59 billion of Egyptian Treasury bills at the end of 2010 and now hold LE17 billion. As a result of the fall in their attractiveness, yields on 90-day bills have risen from 9.3 percent in October 2010 to 12.4 percent in October 2011. In November, Standard and Poor's cut Egypt's long-term foreign sovereign credit rating one level to B+, four levels below investment grade, after clashes broke out between protesters and security forces. Moody's has done the same. The financial deterioration could bring even more severe problems: it is estimated that the country has six months' wheat reserves while those of cooking oil, sugar and rice will last three months. What happens after depends on the availability of foreign exchange. Egypt’s benchmark stock index has fallen by 45 percent this year, and the government is paying almost 15 percent to borrow on domestic markets. This has pushed up the rate of interest that has to be paid by the private sector, those discouraging investment.

The transitional government led by the SCAF faces huge challenges. It has responded to the populist demands of the revolution with little consideration for their long-term effects. The government’s recent decision to increase minimum wage in the public-sector and to extend fixed contracts to 450,000 temporary public sector employees put massive pressure on a budget that already has a large deficit. In October, Egypt approved a new monthly minimum wage of LE700 ($117) for the private sector, which takes effect in January 2012. These measures, combined with large-scale and economically inefficient subsidies, are threats to economic stability.

At the end of November, the Central Bank of Egypt increased interest rates. After two years of unchanged rates, it decided to raise the overnight deposit rate by one percent to 9.25 percent while raising the overnight lending rate and the seven-day repo (repurchase agreement) rate by half a percentage point to 10.25 percent and 9.75 percent, respectively. The discount rate was also raised by one percent to 9.5 percent. The bank attributed the need to hike rates to the need to prevent rising inflation resulting from the re-emergence of local supply bottlenecks and distortions in the economy. It also cited the risks to national income due to political factors at home, the Euro crisis and its possible effects on other regions as well as weaker than anticipated growth rates in advanced economies. Higher interest rates may encourage savers to keep funds in the domestic currency but will discourage investment by making borrowing more expensive.

In April, the then finance minister stated that the budget deficit would rise to 9.1 percent in the current financial year 2011-2012, from 8.5 percent in 2010-2011 and, if all demands are met, the deficit might exceed 10 percent of GDP. These figures now look low. The problems facing the Egyptian economy have been exacerbated by the global downturn that is expected to deepen in 2012.

The task of restoring the economy will be hard for a number of reasons. First, despite the fact that the economy grew under Mubarak, socio-economic conditions for most Egyptians remained dire. (**See Iqtisadi, May 2011.**) Second, the economy has lost a year's growth and that means higher unemployment. The Egyptian labor force is growing even faster than the population. Every year some 1.5 million enter the labor market; 250,000 quit mainly because of retirement and so the net addition is about 1.25 million job seekers. If they do not find jobs, then unemployment rises.

Underlying these short term problems are deeper, structural ones. The most important structural issue is the weakness of the manufacturing sector. Manufacturing was central in the industrial revolution that began in Britain, spread to Europe and the United States in the nineteenth century, and then to other parts of the world in the twentieth century. Egypt, like other Arab countries, has a relatively small manufacturing sector and this has limited the creation of well-paid jobs. The informal sector, which consists of individual traders and very small workshops, accounts for 30 percent of GDP and employs 40 percent of the labor force. Productivity and earnings are low, but this is the sector that absorbs most of the huge numbers of young people entering the labor market each year.

The Finance Ministry and CBE have resorted to borrowing from the domestic market to meet financing needs by issuing government securities and treasury bills — an expensive option with one-year notes offering a 14.9 percent interest rate. The IMF loan is understood to be much cheaper, with a pay-back interest rate of around three percent, and has few conditions attached.

At the end of November, it was reported that Egypt would reopen discussions with the IMF for a US$3.2 billion stand-by credit facility that it had rejected in June. According to then finance minister, Egypt will have to borrow from overseas to help finance the budget deficit, as it will no longer be able to depend on domestic borrowing. He said that discussions with the IMF will probably be over the same amount that it had initially turned down.

The reforms Egypt agreed upon with the IMF in the summer included a revised budget for the fiscal year 2011-2012, which began on July 1. Expenditure in the new budget was to focus on human capital and social investment, as well as labor-intensive public works to generate job-intensive growth.

Egypt's budget deficit has widened in recent months, owing to extra spending measures taken by the government as a result of the protests. This deficit was to be financed in part through foreign grants and loans from bilateral and multilateral development partners, including the IMF. This strategy ensures that sufficient domestic resources remain available for credit to the private sector, and helps reduce borrowing costs and lengthen the maturity profile of the public debt. The budget also included a number of tax reforms designed to generate resources for social spending and enhance fairness through a moderate increase in the progressivity of the tax system. In addition, measures were promised to strengthen tax administration and improve compliance. The government's plan envisaged a number of structural reforms, including the transition to a VAT-like consumption tax and reform of the highly inequitable and costly system of subsidies, which are needed to improve the efficiency of public spending and help reduce the fiscal deficit. The deal was, however, rejected by the SCAF, which feared a public backlash against IMF conditions.

The IMF-backed plan was originally intended to be launched within 6-8 months, but following the November resignation of the Sharaf government, it is no longer clear when it will be implemented. If none of the measures come into effect, the finance ministry forecasts a deficit of 10.5-11.5 percent of GDP in fiscal year 2011-12 (July-June) and 12-12.5 percent of GDP in 2012-13 with a fiscal financing requirement of about $32.5 billion and $52.8 billion, respectively. Under this scenario, the ministry also assumes an US$8.5 billion external financing requirement over the next 18 months. If the reforms agreed with the IMF go ahead, the finance ministry forecasts a deficit of 10-10.5 percent of GDP in 2011-12 and 9.5-10.5 percent of GDP in 2012-13. This scenario would entail a lower financing requirement of $30 billion in the first year and $30 billion in the second.

What needs to be done? In the short term Egypt needs funds to plug the massive hole in the budget. This will have to come from borrowing at home and/or abroad. Secondly, it needs security: law and order have collapsed and Egypt's military rulers have failed to provide one of the country's most basic requirements. Finally, the economy needs restructuring. Economic growth experienced under Mubarak was narrowly-based and it created a limited number of jobs in manufacturing, which is the leading sector in industrialization. Growth was partly based on increased gas production, but even this did not prevent the emergence of larger budget deficits, rising public debt, and inflation. Investment, including foreign investment, in manufacturing, agriculture, and other productive sectors needs to be encouraged. The pattern of ownership needs reform to break-up the public-private oligarchies that thrived under Mubarak so as to generate more equality of earnings and ownership. How these are to be achieved in the current political climate is hard to see. What are the prospects? Much depends on political developments. One commentator was quoted as saying that the Arab world "is in a state of panic…rulers are afraid of their people, the elite are afraid of the poor, the middle class is afraid of the lower class and the common people." Fear, insecurity and instability are the enemies of reform.

For the previous issue of Iqtisadi, Press here.