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Egypt: Political Transition vs. Economic Challenges?

By Marek Dabrowski

The revolutionary events of January and February 2011, following similar developments in Tunisia, opened the door for democratic transition in Egypt. This has yet to happen and the road to a stable and sustainable democracy will be long and full of challenges. In the case of Egypt, political transition does not need to be accompanied by fundamental economic changes of the sort which took place in former communist countries during the 1990s. Unlike the communist bloc economies, the Egyptian economy is mostly private and market driven, a result of the implementation of economic reforms during the previous ten years. However, the macroeconomic environment post-revolution has become increasingly worrying as a result of past fiscal and monetary imbalances, revolution-induced shocks and unstable politics. This inability to address pressing economic challenges may hurt the nascent and fragile Egyptian democracy. On the other hand, prolonged transition may not help to build a political consensus around the most urgent economic decisions[1].

TABLE 1: EGYPT: BASIC MACROECONOMIC INDICATORS, 2002-2010

Variable	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP growth in %	3.2	3.2	4.1	4.5	6.8	7.1	7.2	4.7	5.1
Inflation, eop, in %	2.7	4.0	11.7	4.7	7.2	8.6	20.2	10.0	10.7
Unemployment rate, % of labor force	10.1	11.3	10.5	11.5	10.9	9.2	8.9	9.4	9.2
GG net lending/borrowing, % of GDP	-9.2	-9.0	-8.3	-8.4	-9.2	-7.5	-7.8	-6.9	-8.3
GG gross debt, % of GDP	100.9	114.8	112.9	112.8	98.8	87.1	74.7	75.6	73.8
Current account balance, % of GDP	0.7	2.4	4.3	3.2	1.6	2.1	0.5	-2.3	-2.0

Source: IMF World Economic Outlook, April 2011

The Economic Legacy of the Past

Egypt is the most populous country in the Middle East and North Africa region (83 million people). According to the Atlas method (2009) it is a lower-middle-income country with a GNP per capita of USD 2,070. Moreover, since the mid 1980's its economic performance has not been particularly impressive: for most of this period the growth rate rarely exceeded 3-4%, compared to population growth between 2 and 3% until the early 1990s and slightly below 2% since then.

In fact, Egypt experienced only short episodes of higher growth, one of them between 2005 and 2008, just before the global financial crisis (see Table 1). At that period Egypt benefited from the global economic boom, i.e., from record-high oil prices (part of the oil wealth accumulated in the Gulf region was spent and invested in Egypt), intensification of world trade (revenues from the Suez Canal), increasing external demand for its manufacturing production and tourist services.

High growth rates also resulted from economic reforms initiated in the 2000s. The government of Prime Minister Ahmed Nazif (2004-2011) conducted a large-scale privatization program, decreased the regulatory burden, and opened Egypt to external trade and investments. These reforms helped to overcome the legacy of so-called Arab socialism during the 1960s and 1970s, i.e. an inward oriented import-substitution strategy based on the substantial role of public ownership, central planning and heavy government regulation.

Egypt's increasing trade openness has been underpinned by the EU-Egypt Association Agreement which entered into force in 2004 and was further deepened in 2009 within agriculture, processed agriculture and fishery products. It has been supplemented by free trade agreements with EFTA

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countries and Turkey, and the Agadir Agreement which established a free trade zone between Morocco, Tunisia, Jordan and Egypt. Egypt also belongs to the Greater Arab Free Trade Agreement (GAFTA) involving all Arab countries as well as the Common Market for Eastern and Southern Africa (COMESA). Furthermore, it benefits from the Qualified Industrial Zones program as a part of the US-Israel FTA. All these trade liberalization initiatives came into effect in the 2000s.

In spite of the negative demand shock and liquidity squeeze generated by the global financial crisis, the Egyptian economy managed to continue growing in 2009-2010 at a rate close to 5%.

Social tensions

Like many other developing countries Egypt faces various social challenges such as high unemployment (especially among young people and women), a large informal sector, poverty (more than 20% of the population live below the national poverty line), income inequality (Gini coefficient over 0.3), poor education and high rates of illiteracy (over 40% among the female population). The latter is of fundamental importance for the country's future. Without a radical overhaul of its education system the prospects of economic growth, job creation, reducing poverty and inequality, and enhancing international competitiveness will remain seriously constrained.

Fiscal Imbalances, Inflation and Unsolved Subsidy Problems

Unfortunately, the impressive growth record of the second half of the 2000s was overshadowed by the chronic large fiscal deficit (at the range of 7-9% of GDP) and high inflation (20.2% in 2008 and ca. 10% in 2009-2010).

The fiscal deficit originates from large energy and food subsidies (6% and 2% of GDP respectively in the fiscal year 2008/2009). Apart from huge fiscal costs, subsidies distort both production costs and consumption patterns, thus creating fertile ground for corruption and misuse of public funds. They do relatively little to help poor people (especially in the case of energy subsidies). Instead, they should be replaced by targeted cash benefits to the most vulnerable populations. Both fundamental flaws of the subsidy system as well as the advantages of the alternative have been recognized by both economists and policymakers for years if not decades. However, the memory of the popular revolt, which took place in January 1977 after President Muhammad Anwar al-Sadat had reduced bread subsidies made subsequent governments highly reluctant to undertake these reforms.

In turn, inflation which accelerated in the second half of the 2000s had its roots both in partial monetization of the fiscal deficit and in pegging the Egyptian pound to the weakening US dollar. Double-digit inflation had a negative impact on the living standards of the most vulnerable socio-economic groups, adding to the described social problems.

Revolution-related Shocks

The revolution in Egypt, and elsewhere in the region, generated several adverse economic shocks. First, it reduced the number of foreign tourists visiting Egypt. Second, the civil war in Libya forced a large number of Egyptian migrant workers to come back home. This not only had a negative effect on remittance inflows but also the domestic labor market. Third, increasing instability in Yemen and the African Horn reduced transportation traffic in the Red Sea and Suez Canal. Fourth, foreign portfolio investors fled from both the Egyptian T-bill market and the stock exchange. Fifth, internal insecurity hurt many manufacturing and service activities and halted further investments.

Revolution has triggered a wave of social demands related to higher wages, pensions, improved employment opportunities, etc. Both the Supreme Council of the Armed Forces (SCAF) and the transition government of Prime Minister Essam Sharaf consider Egypt's social and political stability as their top priority. Therefore, they have succumbed, at least partly, to these demands. Examples of such decisions include increasing the minimal wage as well as the number of permanent employees in the public sector, even though it adds to the already excessive and inefficient government sector.

However, social and political pressures go beyond just rapid improvement in the country's living standards. The corrupt record of the Mubarak regime (confirmed by Egypt's 98th ranking in the Transparency International Corruption Perception Index 2010) provoked a popular backlash against privatization and, sometimes, against economic liberalization. On top of these populist sentiments there are a lot of ownership claims in respect to previous privatization and real estate transactions.

In addition, there is a growing atmosphere of witch hunting against not only senior officials of the previous government but also those who benefited from various privatization and investment deals in the past. All this deteriorates the business and investment climate, thereby creating widespread uncertainty with regards to property rights and making the government reluctant to

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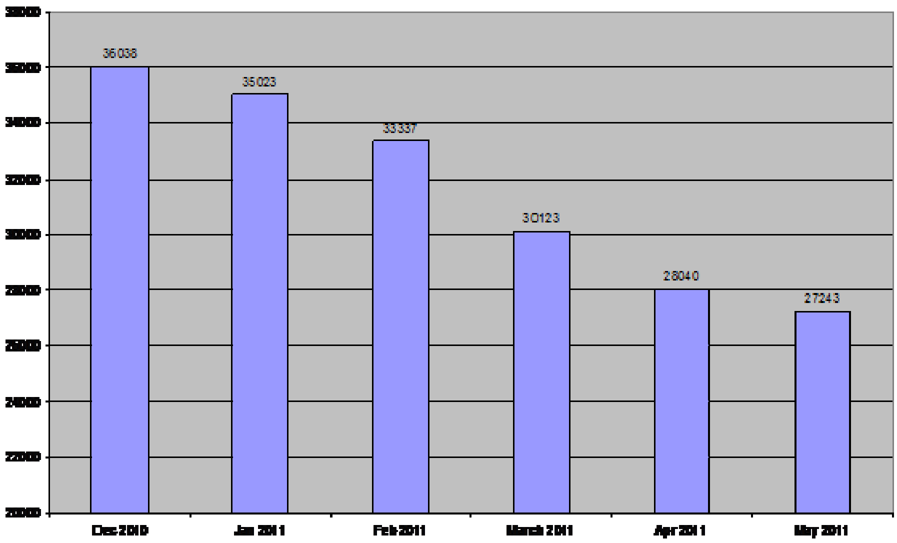
initiate new investment or privatization projects.

How to Avoid Macroeconomic Crisis?

As a result of these numerous shocks, Egypt's macroeconomic situation has deteriorated rapidly. The rate of economic growth in 2011 will not exceed 1% (best case scenario), the lowest since the early 1990s. This will inevitably affect unemployment and poverty rates although current estimates of these variables are not available. The fiscal deficit is widening rapidly and is expected to reach 11% of GDP in fiscal year 2011/2012. The same goes for the gross public debt (one of the highest in the developing world) which, under persistent large budget deficits, could be kept under control only as long as rapid economic growth continues.

The combination of the current and capital account shocks brought down the international reserves of the Central Bank of Egypt (CBE) from USD 36,038 million at the end of 2010 to USD 27,243 million at the end of May 2011 (see Figure 1). However, the decrease in the CBE's net foreign assets has been fully sterilized by an increase in net credit to the government, which indicates the possibility of a further decline in reserves.

FIGURE 1: EGYPT: GROSS INTERNATIONAL RESERVES IN USD MILLIONS



Source: http://www.cbe.org.eg/sdds_excel/InternationalReserves.htm

To close the financing gap the Government of Egypt requested a Stand-by loan of USD 3 billion from the IMF along with additional World Bank budget-support lending and bilateral aid. However, this may not be enough to avoid a balance-of-payments and fiscal crisis, especially, if the first stage of political transitions (upcoming parliamentary and presidential elections) takes longer than originally expected.

Some politically difficult fiscal adjustment measures (reducing or removing subsidies) seem to be unavoidable if the economy is to come back on the road to sustainable growth. The same concerns resuming privatization, trade liberalization, reform of education and other social services, starting decentralization and civil service reforms and many other structural and institutional measures. All of them require a stable government with democratic legitimacy and firm backing of a parliamentary majority.

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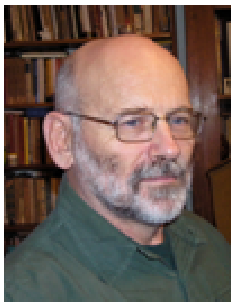
However, the chances of forming such a government soon look quite unlikely today. The timetable set just after President Mubarak's resignation by the SCAF (parliamentary election in September, presidential election in December 2011) is questionable. The increasing number of newly created political parties suggests more time is needed to adequately prepare for parliamentary elections. Many of them are putting pressure to adopt the new Constitution prior to elections. Not going into details of this debate one can only express concern that longer periods of political transition associated with uncertainty regarding its ultimate outcome serves neither the economy nor Egypt's young democracy.



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