The Egyptian Economy Post-January 25: Challenges and Prospects

This edition of Policy Viewpoint looks into the developments of the Egyptian economy leading up to the January 25 revolution and highlights the shortcomings that may have contributed to the social discontent. The purpose is to offer a forward-looking and bird’s-eye view strategy to tackle challenges and structural bottlenecks, and to drive reforms and macro policies towards securing a better future for the Egyptian economy. More specifically, the viewpoint starts with an overview of the Egyptian economy to highlight recent achievements and shortcomings. It then takes stock of the near-term economic consequences of the revolution and the challenges ahead with a view to suggesting a menu of macroeconomic and structural policies that should top the list of priorities in the period ahead, deferring more sector-specific recommendations upon further analysis in future editions of policy viewpoint.

Overview

Prior to the outbreak of the revolution, the Egyptian economy was starting to show signs of recovery from the economic slowdown that followed the 2008 global economic crisis. Real GDP growth rate increased from 4.7 percent in 2008/09 to 5.1 percent in 2009/10 (Figure 1). The first two quarters of 2010/11 registered an average growth rate of 5.6 percent, mainly driven by strong performance in the following sectors: tourism (15 percent growth), construction (12.6 percent growth), ICT (10 percent growth), and manufacturing (6 percent growth).

In 2009/10, domestic consumption—which has been historically resilient—was the main driver of growth, constituting 85.9 percent of GDP, providing growth momentum to the sectors that are linked to domestic demand. Sectors that are strongly tied to external transactions improved slightly, compared to the previous year, although they had not fully recovered from the global crisis. Tourism receipts also grew at 12 percent in 2009/10 (US$11.6 billion) after it had declined in the previous year. On the other hand, Suez Canal receipts were still on a declining trend for the second year in a row, hitting a low

Figure 1. Real GDP Growth

Source: International Monetary Fund.
of US$4.5 billion. Other areas that were vulnerable to global turbulences included workers’ remittances, which improved significantly, with an impressive growth rate of 25 percent, reaching US$9.8 billion in 2009/10. FDI inflows continued to decline, reaching US$6.8 billion, almost 50 percent lower than in 2007/08 before the global crisis (Figure 2).

**Figure 2. Foreign Receipts**

![Figure 2. Foreign Receipts](image)

Source: Central Bank of Egypt.

### The Macroeconomy

The conduct of macroeconomic policy in Egypt during 2009/10 had been dictated by the need to mitigate the adverse impact of the global crisis on the domestic economy. Fiscal policy had been expansionary, allowing the overall deficit to rise to 8.1 percent of GDP in 2009/10, more than one percentage point higher than the average in the previous three years. This had been justified as a countercyclical policy to activate the economy, and was driven by higher expenditures due to the stimulus packages that the government implemented in the 2009/10 budget.

Compared to the previous year, domestic public debt registered an increase of 19.6 percent in absolute figures and of 1.7 percent relative to GDP (Figure 3). External debt also increased by 6.9 percent at end of June 2010 to US$33.7 billion.¹ However, relative to GDP, gross external debt had been on a declining trend, reaching 15.9 percent in 2009/10, one percentage point lower than in the previous year. Therefore, Egypt’s external debt position does not constitute an immediate threat to external stability.

![Figure 3. Total Public and External Debt](image)

Source: Central Bank of Egypt.

Monetary policy has held a more neutral stance (Figure 4). Key policy rates were held constant throughout the larger part of 2009/10 to sustain growth momentum, while resorting to non-traditional monetary policy instruments to stem temporary inflationary pressures.

![Figure 4. Policy Rates](image)

Source: Central Bank of Egypt.

While the business climate improved in 2010, the private sector was still challenged by cumbersome bureaucracy and scarcity of skilled labor. Credit extended to the private sector slowed down (Figure 5), crowded out by the relatively higher growth rate of credit extended to the government. Despite ample liquidity of the banking

¹ Contrary to domestic debt, external debt is mostly of long-term maturity that could last through 2030.
system in Egypt, banks seem to favor less risky sovereign lending.

**Figure 5. Credit Indicators**

The balance of payments rebounded to a positive overall balance in 2009/10, notwithstanding the negative current account balance and the deterioration of FDI inflows, both persisting for the second year in a row. The improvement in Egypt’s external sector was mainly due to the recovery of portfolio inflows, boosting the capital and financial accounts.

Despite high growth rates, Egypt has been burdened by dire social conditions. The number of people living in poverty has been on the rise with 21.6 percent of the population living in absolute poverty.\(^2\) Inadequate education seems to be the major culprit behind low earnings and the high unemployment rate.\(^3\) Disparities in economic and social conditions between rich and poor and across rural and urban areas have grown wider, increasing pressure on the most vulnerable groups.

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\(^2\) For indicators of poverty in Egypt, see Kheir-El-Din and El-Laithy (2006) and (2008). Policies to protect the poor and reduce inequality have been articulated in Deininger and Squire (2002), Bourguignon (2005) and Kanbur (2010).

\(^3\) On policies to reform the education system, see Galal (2002) and Ali (2002).

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**Economic Consequences and Challenges Ahead**

The adverse effects of recent events on the economy will undermine the growth performance for the rest of 2010/11. Indeed, the stock market went into a slump and trading was suspended following significant losses that led to a complete shutdown on January 28, after the third day of protests (Figure 6). The main indices of Egypt’s stock exchange, the EGX30 and EGX100, both dropped by 10.5 percent and 14 percent respectively in the last two sessions before the stock market was shut down. During the first days of protesting, several agencies downgraded Egypt’s rating: Moody’s Investors Service cut Egypt’s government bond rating to Ba2 from Ba1; Standard and Poor’s cut the long-term foreign currency debt rating on Egypt to BB, two levels below investment grade and lowered long-term and short-term ratings of local currency bonds to BB+/B from BBB-/A-; Fitch revised the outlook for Egypt to “Negative” from “Stable”. On March 28, operations have resumed in the stock market with modest signs of recovery thus far.

**Figure 6. EGX30 Performance**

Source: Bloomberg.

Disruption of economic activity, security failures, and lingering uncertainty are likely to take a severe toll on growth in the first half of 2011, resulting in a significant downward revision of growth projections in 2010/11. Looming political uncertainty will continue to take its toll on overall economic activity for the rest of 2010/11 as the economic reform agenda and plans of foreign investment will most likely be delayed. However, if political stability is restored, growth could rebound in the next fiscal year.
Other unfavorable effects were manifested in the decrease in domestic demand (which is the largest contributor to GDP). Specifically, private consumption and investment were undermined due to the temporary disruption of economic activity and the prevailing uncertainty. This latter effect may linger till political stability is restored.

Inflation is expected to pick up again in 2010/11 due to possible supply shortages, the depreciation of the Egyptian pound relative to the US dollar and rising international food and energy prices. The monthly core inflation index accelerated in the first half of 2010/11 from 7.1 percent to 9.7 percent, driven by the rising prices of rice, poultry, edible oil and fats (Figure 7).

**Figure 7. International Food and Energy Prices**

Source: Central Bank of Egypt.

Egypt’s external sector is likely to deteriorate in 2010/11 and start to improve again in 2011/12. A significant portion of foreign receipts was lost, mainly owing to the drop in FDI and a surge in capital outflows. As a result, the Egyptian pound weakened relative to the US dollar, reaching EGP 5.967 per US$ on March 27 (See Figure 8).

In addition to a significant drop in trade exports, the services balance received a huge blow as some one million tourists left the country and traffic through Suez Canal slowed down during the early days of the revolution. Coupled with a reduction in remittances in connection to the unrest in neighboring Arab countries and the increase of interest payments on public debt, the current account deficit is expected to widen in 2010/11.

**Figure 8. Exchange Rate Movements**

Source: Oanda.

**Direction of Policies**

On the fiscal front, concerns about inequity and rising pressures for the most vulnerable groups have forced an expansionary fiscal policy in 2010/11 to ameliorate the economic implications of the political unrest and the subsequent uncertainty that has prevailed in Egypt. Thus, the overall budget deficit is expected to widen in 2010/11, compared to the existing budgeted deficit of 7.9 percent.

In response to the protests, a 15 percent increase in wages and pensions was introduced by the government effective April 2011. Moreover, a decision was taken to immediately appoint government employees permanently in their jobs if they have been employed for 3 years or more.

Subsidies may surpass what was originally budgeted on account of more coverage and higher international prices. In 2009/10, the petroleum subsidy alone was estimated at LE 66.5 billion, and represented 5.5 percent of GDP and 18.11 percent of total expenditures (Figure 9). The 2010/11 and 2011/12 budgeted figures for petroleum subsidies were originally set at LE 67.7 billion and LE 87.8 billion, respectively. However, previous plans by the government to phase out subsidies will most likely be stalled, at least under the current interim government, and till the presidential elections is held, following parliamentary elections in September 2011.

On account of the recent measures and commitments, the three largest categories of government spending...
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of subsidies, wages and salaries and interest payments), accounting for 75 percent of total spending (Figure 10), are likely to continue to grow in the next budget. Tax revenues (which constitute more than 60 percent of government revenues) may be undermined by the slowdown of economic activity during the second half of 2010/11 due to the political unrest and associated uncertainty.

A significant increase in spending on subsidies, wages and salaries and compensations for losses, coupled with a reduction in government revenues due to the slowdown, could increase the deficit by 25 percent, compared to budget.

On the monetary front, despite the rising core inflation index, the CBE has decided to keep the policy rates unchanged at 8.25 percent for the overnight deposit rate and 9.75 percent for the overnight lending rate thus far, pursuing the same stable policy since 2009/10. To stem the risk of further depreciation, the Central Bank of Egypt (CBE) affirmed that it guarantees all deposits in the banking system. When commercial banks reopened on February 6 after a one-week closure, the CBE put a ceiling of EGP50,000 on daily cash withdrawals in order to avoid panic that could potentially affect the banking system’s liquidity. Further, the CBE intervened to stem further depreciation of the exchange rate. Following an intervention in the amount of US$1.3 billion and subsequent interventions, the exchange rate of the Egyptian pound reached EGP5.983 per US$ on 31 March, which remains depreciated relative to the pre-crisis level and to the average over the past six years.4

\[\text{Figure 9. Food and Energy Subsidies}\]

![Figure 9. Food and Energy Subsidies](image)

Source: Ministry of Finance.

* Data reflect budget figures after being approved by parliament.

The January 25 revolution has emphasized the importance of associating economic liberalization with both governance reform and efforts to ensure inclusive growth. Since the early 1990s, Egypt has been rapidly integrating into the world economy, orchestrated by the prescriptions of international institutions. While the strategy has paid off in terms of higher growth, the absence of regulatory framework and sound institutions have increased corruption and prevented the trickle-down of economic gains to the broader segments of society.5 Looking ahead, Egypt’s economic outlook in 2010/11 and 2011/12 will depend on the speed of the reform agenda towards achieving political and social stability.

\[\text{Figure 10. Components of Government Spending}\]

![Figure 10. Components of Government Spending](image)

Source: Ministry of Finance.

The Way Forward

The primary objectives for the economy should include poverty alleviation and improving living standards. To that end, the economic agenda should focus on achieving a high and sustained growth rate and addressing social concerns pertaining to high unemployment, the poverty level and deteriorating quality of educational and health

4 To strengthen the foreign exchange position of the central bank and stem depreciation risk, negotiations are in progress to secure concessional lending from international organizations in the amount of US$10 billion towards stabilizing the Egyptian pound.

5 On losses related to corruption and the prospects for reforms, see Tanzi (2006).
services while achieving a more equitable distribution of wealth and earnings.

Fiscal consolidation is vital to the realization of Egypt’s economic and social objectives. Reform efforts have been hampered by significant waste of government resources, reflecting untargeted subsidies and significant rent seeking, resulting in a persistently high deficit and increasing the public debt ratio to GDP. Before the January 25 revolution, the Ministry of Finance had targeted a gradual reduction in the deficit to bring down the overall fiscal deficit from 8.1 percent in 2009/10 to 3.5 percent of GDP and therefore decrease the public debt ratio from 76.7 percent in 2009/10 to 60 percent of GDP by 2015. In the wake of recent developments, it is not clear whether this target can be realistically met.

For 2011/12, additional spending will be needed to meet higher international food and energy prices and a larger wage bill due to ad hoc measures taken in the face of growing labor protests. It is crucial for fiscal sustainability to resume consolidation plans in the near term to reduce the fiscal deficit and concerns about rising public debt.

Adhering to fiscal consolidation is necessary for private-sector led growth. Growing fiscal deficit, which is mostly financed by domestic borrowing, increases the cost of credit and chokes resources that could otherwise be made available to the private sector as banks avoid the risk of private lending. Fiscal consolidation demands prioritizing government spending and mobilizing additional revenues.

On the spending side, the government should cut down on extravagant spending as well as introduce institutional and administrative reforms of public entities to make resources available to address concerns about inequity such as excessive pay of public officials that contributed to deterioration of financial indicators in many public entities.

Over the medium-term, reforms should address the contentious, although necessary, reform of the price subsidies system for food and fuel. The current system involves excessive waste of government resources in the form of untargeted subsidies that are used to subsidize luxury consumption for high income groups. Price subsidies, or an alternative that involves cash or in-kind transfers, should be limited to the vulnerable groups, and savings from the subsidy reform should be used to finance additional spending by the government on education, health, production subsidies and infrastructure.

On the revenue side, there is scope for mobilizing additional revenues by widening the tax base and increasing compliance and fighting corruption and tax evasion. Additional revenues could be mobilized in the short-run by reviewing existing export contracts, particularly for gas, which could amount to added revenues, estimated in billions of dollars. Further analysis of reforming the tax system, including options for flat or progressive taxes, and introducing a revised and more equitable version of the real estate tax, could inform the ongoing debate regarding viable options, taking into consideration Egypt’s track record of revenue collection, international experience and potential adverse effects on economic activity. Tax incentives and production subsidies should be tied to economic priorities in terms of growth, employment and export receipts.

Regarding monetary policy, the rest of 2010/11 will experience higher inflationary pressures owing to the political unrest that resulted in depreciation of the Egyptian pound, in addition to volatile international prices. Going forward, priorities for monetary policy should be focused on inflation targeting to increase competitiveness and contain inflationary expectations. Vigilant monetary policy, including for the exchange rate policy, is necessary to contain the cost of imports and mitigate the risk of supply-side shocks on the economy. Further, regulations should aim at eliminating distortions in marketing and distribution and enforcing surveillance of price gouging and monopolistic practices. In addition, priorities should be established to provide credit to the private sector, particularly in areas that could create more jobs, by providing incentives for credit in the financial sector to small and medium enterprises.

On the structural agenda, it is necessary to address bottlenecks in the labor market towards closing the gap

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6 For details, see Aboulinein, El-Laithy, and Kheir-El-Din (2009). Proposals for reform are outlined in Kandil (2010).

7 For a monetary policy strategy, see Taylor (2005).
between supply and demand, by increasing investment in education and training and gearing efforts towards matching qualifications with available jobs. Rules and laws that increase flexibility in the labor market and, therefore, incentives for formal jobs in the private sector are crucial to the attainment of these objectives.

There has been a recent trend of partnership between the private and public sectors, following new legislation (law no. 67/2010) to form public-private partnerships (PPP). However, in the short-term, this PPP initiative could be challenged by the constraints on the government budget as well as weakened private sector activity, following the January 25 revolution. It is crucial to press ahead with the plan for partnership to reduce pressures on the budget and engage the private sector in infrastructure and capacity building that Egypt badly needs at this stage.

There have been efforts to improve the performance of the public sector, notably these pertaining to state-owned enterprises. Following a peak in 2005/06, the privatization process slowed down during the past four years. Given the recent political unrest, and the evident discontent with the previous government’s approach in handling the transition to a free market economy, the privatization process will most likely be stalled in the near term until stability is restored. Subsequently, a comprehensive strategy should evaluate state-owned enterprises and set a plan to reform or privatize non-performing enterprises, while ensuring transparency and enforcement of the rule of law to avoid previous problems and sustain productive capacity of privatized firms to protect workers’ rights.\(^8\)

**CONCLUDING REMARKS**

Social inequality and inadequate human development coupled with the lack of political reforms have been among the main factors that led to the outbreak of the revolution. Even though the Egyptian economy has made great strides in terms of economic liberalization and growth figures since the early 1990s, reform efforts have been challenged by political stagnation and corruption, depriving the broader segments of the Egyptian society from the fruits of economic growth.

Going forward, priorities should be focused on improving security and pressing ahead with the political reform agenda to lay the foundations for good governance, rule of law, and good institutions that should work to reinforce the strong fundamentals of the Egyptian economy. Economic priorities should be focused on providing more jobs and supporting productive activity that would help vulnerable groups graduate from continued dependency on subsidies, and capitalize on their skills to collect and increase income in line with productivity.

The social agenda in the near term should include rationalizing government spending, including by addressing the need for subsidies’ reform, towards establishing a viable alternative in the medium-term that entails a better targeted scheme that would eliminate waste in spending and establish better equity. In parallel, the agenda should target a reform of the tax system to mobilize additional revenues by widening the tax base and increasing efficiency in tax collection and better compliance.

Social justice requires creating jobs to increase participation by all in the fruits of economic growth and increase wages in line with higher productivity towards achieving higher standards of living. To mobilize additional demand for labor, the government’s support to private sector activity is necessary, including by increasing tax incentives for job creation, providing credit at reduced cost for small and medium enterprises, investing in education and training, and increasing efficiency to close the gap between demand and supply in the labor market. Reforming the pay system should consider variations across sectors, based on economic indicators of growth and value added to align wages with productivity indicators. Further, rules and regulations constraining hiring activity in the private formal sector should be revisited to ease structural bottlenecks and increase incentives for formality.\(^9\)

On the supply side of the labor market, there is a need for a thorough review of the educational system, fields and curricula, to increase the return on education and provide more opportunities for graduates based on the economy’s needs.

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\(^8\) For details, see Nellis (2005).

\(^9\) For concrete proposals, see De Soto (1998).
To conclude, the ongoing political reform agenda, if coupled with a well-defined and forward-looking economic strategy, bodes well for investment in quality institutions, good governance, transparency, rule of law, and fighting bureaucracy and corruption towards boosting investor confidence and securing sustainable and equitable growth to increase the welfare of Egypt’s growing population.

REFERENCES


