ATLANTIC COUNCIL
IDEAS. INFLUENCE. IMPACT.

ISSUEBRIEF

Mohsin Khan
Svetlana Milbert

RAFIK HARIRI CENTER FOR THE MIDDLE EAST

Economic Policies in Egypt: Populism or Reforms?

The Arab Spring that swept the Middle East last year dramatically altered the political landscape of the region for the better with the overthrow of autocratic regimes. But it also generated considerable uncertainty over the future of economic policies and economic reforms in the Arab world. Will the political transition triggered by the Arab Spring lead to a continuation of the market-oriented economic reforms that most Arab countries had embarked upon over the past two decades, or will more populist regimes emerge that will undo these reforms and adopt economic policies that cater primarily to the immediate demands of the restive public?

Unlike the Central and Eastern European transition countries, the Arab countries do not have the European Union economic model to which they can aspire, so there is a distinct possibility that the Arab countries could seek their own economic model. And it is not clear at all at this stage what type of economic policies the countries will adopt.

The explosive combination of popular unrest against undemocratic governments, corruption, high unemployment, and soaring world food and fuel prices all created the conditions for the uprising. They also create the conditions for a new economic reality.

It is well accepted that what happens in Egypt is a leading indicator of economic developments in the whole Middle East. With a quarter of the population and the largest non-oil GDP of any of its states, Egypt in many respects defines the Arab region. During the last decade it also undertook an active program of macroeconomic reforms under the deposed President Hosni Mubarak, but the benefits failed to trickle down to the poorest Egyptians and are commonly associated with the cronyism of the old regime. Yet many in Egypt, particularly in the business sector, believe that more such reforms relating to taxation, banking, trade, and business regulations will be necessary in order to improve the climate for the domestic and international investment needed to generate employment.

Will the economic policies and reforms undertaken during the Mubarak years be discarded and replaced by more populist economic policies involving greater government intervention in the economy, which would then be imitated by other countries in the region? If so, how can the international community create incentives for the new Egyptian government to keep on the reform path?

The 2004—2010 Economic Reforms

Egypt made a slow transition from a relatively closed to an open economy starting in 1991 within the context of an IMF stabilization and structural adjustment program.

Rafik Hariri Center for the Middle East

The Rafik Hariri Center for the Middle East at the Atlantic Council studies political transitions and economic conditions in Arab countries and recommends US and European policies to encourage constructive change.

Mohsin Khan is a senior fellow at the Atlantic Council's Rafik Hariri Center for the Middle East. **Svetlana Milbert** is assistant director at the Atlantic Council's Rafik Hariri Center for the Middle East.

Former Prime Minister Ahmed Nazif launched an ambitious economic reform program in mid-2004, with his internationally acclaimed economic team of Minister of Finance Youssef Boutros-Ghali, Minister of Foreign Trade Rachid Rachid, and Minister of Investment Mahmoud Mohieldin, all of whom were close associates of Gamal Mubarak, the former president's son, who at the time was being positioned to succeed as president. The underlying goal of the reform program was to remove binding constraints to growth by restructuring the public and financial sectors, streamlining business regulations, enhancing trade liberalization, and privatizing state-owned enterprises and joint venture banks[1]. Essentially the Egyptian government signed on to the so-called Washington Consensus, a term coined by John Williamson of the Peterson Institute for International Economics to describe a set of economic reforms that countries should undertake if they wished to stabilize their economies and generate sustained economic growth[2].

As a result of these reform efforts, coupled with a favorable external environment, Egypt's economic growth increased from 4.5 percent in 2004 to 7.2 percent in 2008 and Egypt was described as an "emerging success story" by the International Monetary Fund (IMF) and listed among the top performers in the World Bank's 2010 Doing Business Report. Egypt also managed to withstand the impact of the global recession and grew at an average rate of 5 percent during 2008 to 2010. With rising exports, workers' remittances from overseas, tourism revenues, Suez Canal receipts, and large inflows of foreign direct investment and portfolio capital, foreign currency reserves increased from $14.8 billion in 2004 to $36 billion in 2010.

Social indicators also saw improvements. Over the period of 1991 to 2011, child mortality rates fell from eighty-one deaths per thousand to twenty-one; the average years of schooling rose from 3 years to 6.4 years; and life expectancy went from 63 years to 73 years[3]. Furthermore, World Bank data shows that strong growth between 2005 and 2009 led to a 14 percent decline in the proportion of the population living below the national poverty line of $2 a day.

Still, higher growth did not yield greater economic opportunities for large segments of Egypt's population. While overall growth generated 2.5 million jobs, this was barely enough to keep ahead of increases in the labor force, so the impact on job creation was only modest; the official unemployment rate only declined from 10.5 percent in 2004 to less than 9 percent in 2010. Small and medium enterprises (SMEs) continued to face difficulties in accessing credit and unemployment remained high due to skills mismatches in the labor market and a fast-growing, educated and young labor force. Therefore, despite some promising macroeconomic statistics, Egypt is still riddled with open unemployment and underemployment, and has a large informal sector that some argue is about half the size of total Egyptian GDP[4].

While Egypt has done much on the reform front there is still a long unfinished agenda needed to make the country truly a market-oriented economy. Further reforms include[5]:

- Reducing existing subsidies, which amount to about 10 percent of GDP, among the highest in developing countries.
- Reducing government employment, which still accounts for almost 25 percent of total employment of 24 million.
- Advancing the privatization process to further reduce the number of state-owned enterprises and banks
- Assisting the SMEs in obtaining bank credit to expand and create jobs.

1 See Klaus Enders, "Egypt—Searching for Binding Constraints on Growth," IMF Working Paper WP/07/57, March 2007.
2 John Williamson, "What Washington Means by Policy Reform," in J. Williamson (ed.), Latin American Readjustment: How Much Has Happened, Washington, DC: Peterson Institute for International Economics, 1989.
3 These numbers are discussed by Jane Kinninmont, "Bread, Dignity and Social Justice: The Political Economy of Egypt's Transition", MENAP BP 2012/01, Chatham House, April 2012.
4 While estimates of the informal economy vary, the midpoint of the estimates is about 50 percent. See, for example: International Monetary Fund http://www.imf.org/external/pubs/ft/reo/2011/mcd/eng/pdf/oilimporters.pdf; Steven Viney http://www.egyptindependent.com/news/informal-economy-presents-challenges-also-opportunities.
5 See Klaus Enders, "Egypt: Reforms Trigger Economic Growth," International Monetary Fund Survey, February 13, 2008.

Economic Developments since the Revolution

The Supreme Council of the Armed Forced (SCAF) led by Field Marshal Mohamed Hussein Tantawi, which assumed powers as the transitional government after the overthrow of President Mubarak on February 11, 2011, avoided making any significant economic changes. Under the SCAF-led government, Prime Minister Essam Sharaf (in power from March 3, 2011 to November 12, 2011) drew up a plan to increase taxes and reduce subsidies, indicating that austerity measures were necessary. But there was no follow through as his government was replaced and the successive government of Kamal Ganzouri postponed any major economic measures until after the upcoming elections.

During the transitional period, the economy worsened considerably. In 2011, growth fell to 1.8 percent, inflation remained around 11 percent, and official unemployment rate was at its highest in 10 years reaching over 12 percent. The fiscal deficit increased to 8.6 percent of GDP, as the SCAF-led transitional government continued to finance populist measures, such as increasing subsidies and public wages, and financed these expenditures by borrowing from domestic banks. The external current account deficit rose to nearly $5 billion (over 2 percent of GDP) as the trade account worsened and tourism collapsed. Capital also fled the country and foreign direct investment dried up. The result was a drastic fall in international reserves from $36 billion in December 2010 to $14.4 billion in July 2012, back at the same level as in 2004[6]. Consequently, the three major international credit rating agencies—Moody's, Fitch, and Standard & Poor's—downgraded Egypt's sovereign credit rating.

The New Economic Strategy

The Egyptian economy continues to struggle in the wake of the post-Arab Spring government of President Mohammed Morsi, elected in the country's first democratic presidential election in June 2012. Political issues have received priority and economic policies have not been given the required attention. Now that a new cabinet is in place it will have to propose a plan to revive the economy as Egypt continues to face external financing pressures. It is estimated that Egypt will require some $22 billion in financing for fiscal year 2012-13. In the absence of a clear economic program, it is also projected the economy may only grow as much as 1.5-2.0 percent in 2012 and thus it will require a renewed emphasis on economic reforms to raise the growth rate to levels sufficient to absorb the large and growing labor force.

Morsi's campaign speeches did not suggest a radical departure from the policies and programs advocated by more secular groups, although he did emphasize expanding social services, microloan programs, subsidies for lower-income households, "fair" wages, and health insurance for all workers. Consistent with the interests of the generally middle class political base of the Freedom and Justice Party (FJP) formed by the Muslim Brotherhood, Morsi has said he is committed to private enterprise and to liberalizing Egypt's economy. He has expressed his support for the Brotherhood's Nahda (Renaissance) project which stresses lowering unemployment, promoting economic and social justice, improving living standards, and supporting the SMEs and agricultural sectors. These general goals still need to be translated into a coherent economic plan.

Morsi's economic platform outlined specific indicators he would achieve if elected president. These include: reducing unemployment to 7 percent by 2016; cutting inflation from double-digit rates to half the long-term GDP growth rate; reducing the public sector debt by 15 percent; and lowering the fiscal deficit to around 6 percent of GDP. Furthermore, Morsi has said his government will offer interest-free loans to farmers and pledged to increase investment to 30 percent of GDP from its current level of about 20 percent. What economic policies would be followed to achieve these ambitions was not specified. Furthermore, how the increases in expenditures would be financed was left unclear, although it was assumed that friendly Arab neighbors, notably the Gulf oil producers, would provide sufficient loans and grants to meet Egypt's budgetary needs and expanded commitments.

6 In fact, the situation was sufficiently grim that the SCAF itself had to lend the Central Bank of Egypt (CBE) $1 billion in December 2011 to boost foreign reserves.

Since becoming president, Morsi has traveled to Saudi Arabia, China, Europe, and the United States and put a special emphasis on his desire to attract foreign investors back to Egypt. Still, the signs are there that the new government will be subject to populist pressures. The Egyptian uprising was at least as much about economic issues as political ones, so politicians will have to respond to the economic demands of the population. Heading the list of grievances is unemployment and the rising food and fuel prices.

How can the new government address these issues in the short run so as to keep the people from coming back into Tahrir Square? Creating jobs has to be the first priority. But these cannot be generated out of thin air. Improving the education system to eliminate the skills mismatch between the types of college graduates produced by universities and the demands of the private sector is a long run proposition. Promoting private businesses through infrastructure development and further reduction and elimination of regulations so that they will hire more workers is similarly something that cannot be done overnight. The only way to reduce unemployment in the short run would be through expanding government employment, thereby reversing the shrinking of the government that has been going on over the last few years. It is also very likely that these public employment schemes will result in a permanent increase in the government workforce. This increase in government employment has already started with some 400,000 jobs being created by the Ganzouri government.

The other major issue to tackle is cutting subsidies, which accounted for 10 percent of GDP and 27 percent of government expenditures in 2011. Fuel subsidies alone make up 48 percent of the total subsidies bill. Food subsidies must also be addressed because they distort the agricultural system and increase the budget deficit. Egypt continues to import wheat and is susceptible to volatile commodity prices reflected in food inflation that averaged nearly 19 percent in 2010-11. In the budget for 2012-13, the transitional government proposed reducing fuel subsidies by 25 percent (primarily subsidies provided to commercial enterprises) and increasing food subsidies by 8 percent over the previous year.

From the list of incomplete reforms there is a high probability that energy subsidies may be reduced, but food subsidies will be increased further. Nevertheless, total subsidies will continue to take up a large proportion of the budget. Privatization of state assets, which in the minds of many Egyptians is synonymous with corruption, will assuredly stop and there may even be strong political pressures to re-nationalize some of the companies that were bought by individuals close to the Mubarak regime.

Other economic reforms also face varying degrees of risk of reversal. If Egypt faces serious balance of payments difficulties, import tariffs could be raised and capital and exchange controls could be introduced, particularly the exchange rate is kept unchanged. In fact, some exchange controls have already been announced as a temporary measure by the Central Bank of Egypt (CBE) to contain the loss of international reserves. On the fiscal front, it is possible that corporate and personal income taxes for high-income earners will be increased[7]. Furthermore, since the FJP's base is small businessmen, it can be expected that the government will press the CBE to lower lending rates, which currently are well above 20 percent.[8] The availability and cost of credit is a major constraint in the expansion of SMEs. With inflation still high, a fragile balance of payments position, and large government borrowing requirements, the only way to achieve lower lending rates is to either subsidize bank borrowings by SMEs or by controls on bank lending rates. It is plausible to assume that the state-owned banks will be pressured to lend more to SMEs.

In sum, if the Egyptian government gives in to populist pressures, Egypt may look quite different from the Egypt of today. This would be unfortunate, as the reforms were hard to achieve and their abandonment would have serious long-term development consequences for the country.

---

7 Although in recent press reports President Morsi has said there would be no tax increases.

8 Egyptian banks have an obvious preference to lend to the government given the average yield on treasury bills is near 16 percent. Currently commercial banks' holdings of central government Treasury bills and bonds are about 56 percent of total banking system assets.

Role of the International Community

If implemented as described, the new Egyptian economic policies will require substantial external financing. Neither the US nor Europe is willing or able to provide such financing. Even the Gulf countries, which are currently flush with oil revenues, have shown reluctance to step in without assurances that Egypt has an acceptable economic plan that does not turn back the clock. So what can the international community do to create incentives for the new government to keep on the general reform path, while allowing for some elements of more populist policies catering to the demands of the protesters? The short answer is to encourage the Egyptian government to sign on to an IMF program as soon as possible[9].

An IMF program finally seems to be in the cards (after some premature announcements over the last couple of months by Finance Minister Momtaz El-Saeed that an agreement was close at hand). An IMF team visited Cairo on August 22 at the request of Egyptian authorities. Managing Director Christine Lagarde of the IMF also participated in the meetings with the new government, presumably to demonstrate the IMF's willingness to negotiate a program[10]. Discussions reportedly center around $4.8 billion or higher in financing to ease the adjustment, while at the same time providing a macroeconomic framework to reduce inflation and ease balance of payment pressures.

So what should the IMF and the Egyptian government be looking for in it the new program? Clearly, as discussed before, the economic picture in Egypt had steadily worsened since the fall of the Mubarak regime. Virtually all macroeconomic indicators—growth, employment, the external current account balance, foreign direct investment, the fiscal position—point to an economy in considerable distress. With international reserves reaching a low of $14 billion, down from over $36 billion at the end of 2010, a currency crisis is in the making absent large scale external financing. Some funding has come from Saudi Arabia ($1 billion) and some is expected shortly from Qatar ($2 billion). But the external financing gap is around $22 billion if a buildup in international reserves by $5-6 billion is factored in. Thus, Egypt needs much more external financing and many donors and investors are understandably waiting on the sidelines for a clear signal that Egypt's new government has got its economic act together[11].

An IMF program will provide Egyptians and the international community evidence that the Egyptian government is putting its economic house in order. In the new program with Egypt, the IMF should give the highest priority to two issues. First, rationalizing the very costly subsidies scheme in Egypt. Replacing the subsidies scheme with a more targeted system directed at the truly needy, possibly through direct cash transfers or coupons, is essential to ensure long-term fiscal sustainability. Second, the CBE has to let the exchange rate move in response to market pressures. The cost of keeping the Egyptian pound relatively stable since the beginning of 2011 has been over $20 billion loss of foreign exchange reserves. The IMF has to insist on this condition and press the CBE to allow the currency to depreciate, even though Morsi and the Minister of Finance are reportedly against any devaluation. Governor Farouk El Okday of the CBE has stated that the exchange rate would be determined by market forces, which could allow for depreciation without overt CBE action[12].

What is in it for Egypt? Certainly an IMF program that endorses the Egyptian government's economic plan will go a long way towards persuading foreign investors to return to Egypt and convincing donors to provide the financing they promised. The IMF loan will itself help fill the financing

9 Other incentives include debt relief (see John Williamson and Mohsin Khan, "Debt Relief for Egypt?" Washington, D.C.: Peterson Institute for International Economics, 2011), and trade agreements (see Meredith Broadband, "The Role of FTA Negotiations in the Future of US-Egypt Relations," Washington, D.C: Center for Strategic and International Studies, 2011).

10 For a discussion of the IMF Managing Director's visit to Cairo, see Mohsin Khan, "Lagarde to Visit Egypt: Is an IMF Program in the Offing?" Washington, D.C.: Atlantic Council, August 15, 2012.

11 For example, the EU has promised 500 million euros when an IMF program is in place.

12 While the CBE maintains that it has followed a policy of "managed floating" since 2004, this is difficult to reconcile with the facts. Between 2004 and end-2010, the exchange rate appreciated by only 5.5 percent while international reserves rose by $21 billion. And since January 2011 to date, international reserves fell by over $20 billion and yet the Egyptian pound only depreciated by 3.5 percent with respect to the US dollar. It therefore remains to be seen how ready the CBE will be in allowing demand and supply factors to determine the rate. The track record is not too promising.

gap and at a very low interest rate of around 1.1 percent[13]. Finally, it will also send a positive message to domestic businessmen and investors that the government is serious in delivering on its commitments to macroeconomic stability and structural reforms.

Egypt has been the leader in MENA and what it does is frequently followed by other countries in the region. Thus, naturally there is interest and concern about the economic policies that post-Mubarak Egypt will adopt. Will Egypt be a statist, closed and tightly-regulated economy that is unfriendly to business, or a market-oriented economy integrated with the world? With the help of the international community, it could be the latter. The details of the Egyptian economic plan should become clearer as it begins negotiations with the IMF, as both sides have stated that the IMF program will be based on a homegrown program developed by the Egyptian government[14]. The challenge will be to balance the short-term populist measures the government has promised to take while keeping on a clear long-term economic reform path.

OCTOBER 2012

13 This is the IMF's current basic rate for loans of up to 300 percent of a country's quota. Egypt's quota is about $1.6 billion, so 300 percent of quota amounts to $4.8 billion, which is exactly what the Egyptian government has requested from the IMF. Larger loans have a surcharge of 200 basis points on the amounts in excess of 300 percent of quota.

14 See Mohsin Khan and Svetlana Milbert, "Egypt: To Have or Not to Have and IMF Program? " Washington, DC: Atlantic Council, June 19, 2012. Washington, D.C.: Atlantic Council, August 15, 2012.

The Atlantic Council's Board of Directors

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

1101 15th Street, NW, Washington, DC 20005
(202) 463-7226, www.acus.org