The United States as 'International Broker': Egypt's Ailing Economy and Opportunities for Support

by **Mustansir Barma**

SUMMARY

Egypt is facing extreme economic decline, as a result of both the political instability Egypt has experienced since its revolution, as well as the legacy of flawed economic policies during the Mubarak era.

While external financing may be important to alleviating short-term crises, Egypt's economic troubles can only be addressed sustainably through meaningful reforms.

The unwillingness of the Morsi government to implement economic reform in the current political environment, combined with the unreliability of external financing, has resulted in policy paralysis.

Debates in Washington have focused excessively on direct foreign assistance to Egypt, and the United States should broaden its approach to leverage other policy tools to bolster Egypt's economy.

This should include leveraging its relationship with states in the region to structure their support to Egypt with reform rather than dependence in mind and exploring a debt-for-commodities option to relieve Egypt's debt burden while also addressing impending wheat shortages.

In some circles in Washington, frustration with the trajectory of Egypt's political transition–coupled with fears of Islamists rising to power and a desire to cut foreign aid due to domestic budgetary constraints–threatens to result in diminished U.S. engagement with Egypt and a withdrawal of support for its fragile transition. Uncertainty regarding Egypt's future has caused delays in the delivery of U.S. foreign aid to Egypt and spurred calls for maintaining a strategic "pause" in such aid moving forward. Likewise, U.S. and other foreign investors remain reticent to become involved in Egypt during its fragile and tumultuous transition.

But Egypt's economy is bleeding. State revenues cover only 60 percent of expenditures, leaving a gaping hole in the government budget. In the second half of 2012, $5 billion worth of investment fled Egypt. Workers' strikes are projected to result in $15 billion in economic losses this fiscal year–around 5 percent of Egypt' gross domestic product (GDP). Over the past two years, foreign reserves have plummeted 60 percent, the currency has lost 15 percent of its value against the dollar, and inflation has been close to double digits. Energy shortages are expected to continue and will exacerbate power cuts in the summer, a season when tourism tends to retreat even in the best of times, leaving more Egyptians out of work in a sector devastated by the country's ongoing turbulence. Unemployment hovers around 13 percent (up from 9 percent in 2010), and is double that level for youth. Egypt's economy is veering toward a potential collapse that would send shockwaves across the region, to the United States, and beyond.

The cost of inaction is high, and Washington cannot afford to remain on the sidelines, especially with political and economic success in Egypt so deeply intertwined. The nation's economy cannot recover without real political progress in its transition toward a stable, democratic government, and any progress toward political stability cannot be sustained without a reversal of the current economic decline.

The U.S. government should increase efforts to work with political actors on all sides to advance Egypt's democratic transition, and at the same time take assertive steps to help revive Egypt's economy. Although economic aid cannot easily be expanded due to domestic budget constraints, the U.S. administration has many other tools at its disposal, and it must be bolder and more creative in its efforts to bolster Egypt's economy.

DETERIORATING FINANCES

Reform programs in the last decade of the Mubarak era generated impressive rates of economic growth, but little improvement in the economic conditions of the vast majority. Anchored in a private sector-led open economy, Prime Minister Ahmed Nazif's reforms saw economic growth rates climb above 7 percent in the 2000's and net foreign direct investment (FDI) reach a peak of $13.2 billion. However, an underlying problem was the failure of growth to trickle down, with only an elite few benefitting and the gains not shared by other segments of society. The fact that the poor remained poor meant that the private sector had failed to provide social justice, and the government had to step in to provide a social safety net. This was largely done through a subsidies program that ballooned in cost a hundredfold in the last 15 years. Energy products accounted for three-quarters of total subsidies in the last budget; and prices to consumers have remained flat while international prices have risen exponentially. Unable to cope with the rapid rise in domestic demand, Egypt flipped last year to become a net energy importer.

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Job creation was another major concern under Mubarak, whose civil service grew to a bloated 6 million employees, roughly one-quarter of Egypt's labor force. This was a legacy of President Gamal Abdel Nasser's socialist period; Egypt never shook off the notion that the government was responsible for job provision. The civil service burden saw skyrocketing wage bills for the government; in order to finance the rising costs of subsidies and wages, the government was forced to borrow. High interest rates of 13 percent in the domestic market meant that the government was soon caught in a vicious circle of paying for debt servicing - a system that continues to today. As a result of these unchecked policies, government expenditures on subsidies, wages, and interest payments each account for around one-quarter of the budget in the current fiscal year. Budgets have been far off target since the revolution, with the budget deficit for fiscal year 2012-13 projected to be 50 percent higher than what was initially planned. As an illustration, the energy subsidies bill was budgeted at $10 billion but will end up around $17 billion, due largely to delays in liberalizing prices of products such as gasoline.

The proposed budget for fiscal year 2013-14, while more realistic, is no cause for optimism. The deficit is expected to reach $30 billion – around 50 percent higher than the initially budgeted amount for the fiscal year 2012-13. Despite initial objectives to bring next year's budget deficit down to 7 percent of GDP, the proposed figures imply a deficit of 9.5 percent. Projected government expenditures are set to go up 30 percent, and analysts see revenue estimates as exaggerated. The trifecta of subsidies, interest payments, and wages will again collectively account for three-quarters of government expenses.

Driven the government's increasing desperation to preserve what it could of the economy, the Central Bank embarked on a two-year attempt to prop up Egypt's currency that ultimately failed. Consequently, foreign currency reserves have plummeted by more than half since the pre-revolution peak of $36 billion in November 2010. At the levels of the first few months of 2013, hovering around $13-15 billion, Egypt is under the critical threshold level recommended by the IMF, as the country cannot cover three months of imports. The end of

2012 marked a managed devaluation of the Egyptian pound through regular currency auctions held by the Central Bank. In the first four months of 2013, the Egyptian pound slid from 6.1 to the U.S. dollar to 6.9. As Egypt is a net importer, the deteriorating exchange rate adversely affected prices, causing further inflationary pressures. Goods such as pharmaceutical products have seen steep price increases because drugs are either imported directly or the raw materials for local manufacturing are imported.

MUDDLING THROUGH CHANGE

Given the budget deficit and loss in reserves, the need to plug these gaps is apparent. Simply stated, the Egyptian government is faced with two main options for doing so – reform or seek external financing. Unfortunately, reforms have not been pursued and external financing has been erratic and unreliable. Economic decisions over the last two years have been incoherent insofar as policy impacts were not thought through in a holistic manner. As a result, many policies were inconsistently applied or subsequently withdrawn. For example, in April 2011, then-Minister of Labor Ahmed El Borai issued Ministerial Decree No. 90/2011 that clamped down on the conditions of hiring foreign workers. After a few months of investor confusion and delays in issuing work permits, the legislation was forgotten. In August 2011 then-Minister of Tourism Mounir Abdel Nour announced that visas for tourists would have to be obtained at embassies abroad rather than on arrival in Egypt. After an immediate backlash from the tourism industry, which had already seen drops in hotel occupancy from 80 percent to 15 percent, the plans were cancelled the next working day. In December 2012, heavy fuel oil prices to energy-intensive industries were suddenly increased 2.3 times, without warning. When the major cement companies said they would be forced to shut down plants and lay off workers, the government decided to postpone this decision. Flip-flops like these have occurred virtually on a monthly basis since the 2011 uprising.

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On top of the fact that many of these decisions would have served to dampen private sector activity, the uncertainty itself has done much harm to investment. Net FDI in the two fiscal years since the revolution stood at \$2.1-\$2.2 billion, down three-fold from the fiscal year prior to the revolution and six-fold since the FDI peak five years ago.

The most famous series of U-turns relate to the long-awaited IMF support package. In June 2011, the transitional government celebrated a \$3.2 billion IMF loan that would give Egypt a lifeline. Not even a week later, then-Minister of International Cooperation Fayza Aboul Naga rebuked the very idea of taking an IMF loan. Faced with criticism of an unelected government burdening future generations with foreign debt, IMF talks were put off. Discussions resurfaced a few times over the course of the next year, but the most serious headway was made after newly elected President Mohamed Morsi put the IMF loan back on the agenda. The loan size was increased to \$4.8 billion, and Prime Minister Hesham Qandil’s government formulated an economic reform program upon which the loan would be contingent. In some ways, these planned reforms were more valuable than the loan itself – ultimately the loan size will not even cover one month of Egypt’s imports bill, not to mention the fact that the loan would be delivered in tranches. A letter of intent was signed with the IMF in November 2012. On December 9, then-Finance Minister Momtaz Al Saeed announced a broad range of tax increases according to the government's program. The same day, Morsi canceled the tax proposal, and less than a month later Al Saeed lost his job in a Cabinet shakeup. At Egypt's request, the IMF deferred making a final decision on the loan (scheduled for the IMF's December 19 board meeting) while the government sought to gain political consensus on a reform path.

Today, as the need for tandem economic and political reform has become even more pressing, no authority is willing to make any decisions. Officials do not want to expose themselves to any potential legal proceedings. Even Prime Minister Qandil was slapped with a one-year deferred prison term by an administrative court in April 2013 for failing to execute a renationalization decision (though it is unclear if this sentence will be implemented). Given the policy delays, businesses are facing difficulties acquiring various operating permits and have stalled. Meanwhile, investors have no confidence that a decision made today would hold tomorrow. Adding to the decision-making paralysis are the Cabinet reshuffles that have taken place periodically since the uprising in 2011, the most recent of which occurred in May 2013. These have been carried out to try to win broad political mandate, but changes have largely been cosmetic. Reform does not have to be equated with austerity. Measures to promote investment and focus on labor-intensive industries do not necessarily have to be immediately met with unpopular decisions of tax increases and subsidies cuts. While measures that reform the tax structure and better target of subsidies must eventually be implemented, these need not be the first phase.

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Without meaningful reform, an IMF agreement may not take place until after parliamentary elections, which are not expected to take place until October (though no date has been set). Meanwhile, some of Egypt's neighbors have been coming to the rescue. Qatar, Libya, and Turkey have been recent supporters through a mix of grants and loans in the form of Central Bank deposits. While the funding provides some much-needed replenishment of foreign reserves to pay for critical imports such as wheat and pharmaceuticals, ultimately these injections are little more than stopgap measures to buy time. Unfortunately, they do little to push Egypt down the path to reform. Additionally, it is risky to rely on lifelines that might be cut at any time. The United Arab Emirates, Kuwait, and Iraq, for example, were supportive in the early days of Egypt's revolution, but have been silent recently. An April government visit to Russia to solicit funds also received a cool response.

Ultimately, no amount of foreign support will match the positive effects of a successfully implemented economic reform plan. Soon after Qatar agreed to give Egypt an additional $3 billion in deposits in April 2013, the IMF delegation left Egypt following inconclusive talks, adding further delays to implementing reform. The other problem with this type of support is that Egypt is amassing foreign debt. While Egypt's foreign debt-to-GDP ratio of 13 to 15 percent in the last few years is not of great concern in and of itself, Egypt might be concerned with the exertion of soft power by its supporters. For example, Qatar has a stated intention of investing $18 billion in Egypt over the coming years, some of which will be through corporate acquisitions. Therefore, Qatar may persuade Egypt not to tax corporate transactions – a topic that has been on and off the table – thus further derailing reform.

Sporadic financing from Egypt's neighbors and allies, generous as they may be, will not have the same impact as a plan to address Egypt's problems for the long term. While Egypt alone must control its destiny by drawing up an economic program accepted by a wide range of political forces, the United States does have a role to play in the areas of promoting reform, coordinating international support, and promoting trade and investment – all of which will bring in revenues to plug the hole in Egypt's budget deficit and boost foreign currency reserves.

POLICY RECOMMENDATIONS

The United States has struggled to react to Egypt's transition. Rather than focusing solely on the mechanisms of direct assistance, the United States should take a broader approach. This should include bolder steps to reinvigorate trade and investment and the use of its influence on the global stage to effect change. This should be done with mutual interests in mind – Egypt, as mentioned, needs reform and outside support; the United States wants to reassert its standing in the Middle East, reaffirm ties with its strongest regional ally, and boost trade and investment between the two countries. In this setting, Washington should:

- ***Use its influence to help mobilize pledged international support and Egypt's economic reform program.*** Recognizing that the United States is grappling with its own fiscal constraints, Washington can still play a pivotal role by using its clout with international financial institutions to reach conclusion on loan agreements. The IMF loan, in particular, will have the effect of kick-starting Egypt's much-needed economic reform program, and have a secondary effect of unlocking roughly another $14 billion pledged by Europe and Egypt's neighbors. In addition, the United States can give a stamp of approval, perhaps through loan guarantees, in order to raise investor confidence regarding the credibility of reforms.

- ***Institute a regular and structured 'Strategic Economic Dialogue' focusing on trade and investment promotion.*** The United States can initiate a high-level bilateral forum to make headway on economic issues. The administration has rightly recognized that the positive effects of trade and investment can outweigh the impact of aid. The United States is Egypt's strongest trade partner with more than $8 billion in two-way trade. Still, the U.S. has been losing its share over the last few years, as other countries and regional blocs are taking advantage of trade agreements, such as the E.U.-Egypt Association Agreement. Further expansion of the Qualifying Industrial Zones – areas that allow tariff-free exports to the United States after fulfilling certain conditions – can boost Egypt's manufacturing and agricultural sectors through export promotion. Taking the bold step of expressing support for re-engaging in free trade agreement talks would signal a vote of confidence in Egypt. Dialogue can also work towards supporting Egypt's potential to be a regional hub for manufacturing, assembly, and re-export, capitalizing on the country's geostrategic position. This will have the positive effect of reinvigorating investment, and the Egyptian government can in turn implement domestic policies to support labor-intensive industries to tackle unemployment.

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The Project on Middle East Democracy is a nonpartisan, nonprofit organization dedicated to examining how genuine democracies can develop in the Middle East and how the U.S. can best support that process. Through dialogue, research, and advocacy, we work to strengthen the constituency for U.S. policies that peacefully support democratic reform in the Middle East.

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- ***Relieve all of Egypt's $2.7 billion in debt owed to the United States.*** Although Egypt incurred most of its debt more than two decades ago and has since already repaid the principal several times over, the remaining debt is a significant burden on Egypt's beleaguered economy. Since a pure write-down of the debt would not be politically palatable in the United States, the U.S. administration should explore creative options for debt relief such as debt-for-commodities (e.g. wheat shipments that will help alleviate growing food security concerns).

- ***Continue regular assistance programs and consider faster expansion.*** The United States has committed to providing Egypt with annual economic assistance of $250 million through the U.S. Agency for International Development and approximately $1 billion in bilateral debt relief. During Secretary Kerry's March 2013 visit to Cairo, he released $190 million of these funds for budget support, following progress on IMF loan talks. (A further $260 million will be released after signing the IMF loan.) A further $60 million has been obligated towards the creation of a U.S.-Egypt Enterprise Fund to support small- and medium-sized enterprises. Washington should continue to support such assistance programs to Egypt, and avoid any delays in doing so. The administration's stated goal is to increase the enterprise fund to $300 million in coming years; Congress should work to expedite this. Other programming can be targeted towards vocational training to address joblessness and technical assistance for subsidies retargeting, budget transparency, labor market reform, and the like.

- ***Encourage Egypt's neighbors to support Egypt responsibly.*** The Egyptian government is unlikely to proceed with serious economic reform if handouts from regional countries continue on an unsystematic basis, and such funding spurts might create false friends and dependency. Washington should leverage its relationship with Gulf and Mediterranean states to coordinate support with the objective of promoting Egypt's own economic reform program.

- ***Promote participatory budgeting.*** A proven success in various parts of the world, participatory budgeting engages a marginalized populace and provides citizens a voice in determining which programs their tax payments support. Local communities have a say in how resources are spent, and in turn, governments become more accountable and transparency increases. The International Budget Partnership has found that Egypt's budget transparency has actually decreased significantly since the revolution; participatory budgeting would be a step toward countering this trend.

- ***Work with other arms of government and private organizations to support Egypt's economy.*** Government agencies such as the Overseas Private Investment Corporation (OPIC) are helping Egypt's entrepreneurs through a partnership with regional private equity group Abraaj Capital, signed in September 2012. Congress should support expansion of such partnerships. The U.S Export Import Bank should continue in its assistance to Egypt's economic recovery by supporting letters of credit issued by Egyptian financial institutions. Washington should continue to support Chambers of Commerce in organizing trade delegations and business missions between the United States and Egypt.