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The Political Side of Egypt's Economic Ordeal

ANONYMOUSLY

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The Political Side of Egypt's Economic Ordeal

by Anonymous

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Preface to the Series Policy Brief Egypt

The Egyptian economy is in continuous decline. To a significant extent, this crisis is a result of the ways in which the current rulers have secured their power and avoided social unrest. Their structural crisis of legitimacy and the closure of nearly all channels of collective interest representation prevent any substantial reform. Economic policy, including the implementation of the recent agreement with the IMF, will therefore be limited to the management of misery unless the current rulers accept the need for more participation in policy formulation. The EU and Germany should encourage and support steps towards an upgrading of Egyptian industry as part of a strategy for bottom-up import substitution.

On November 3, 2016, and without any prior warning, the Egyptian government officially floated the national currency, following through with a key demand of the International Monetary Fund (IMF). Perhaps more immediately, it also responded to pressure from the black market, where the Egyptian pound had plunged to a record low of 18 to the dollar, less than half of the official rate. Prices for imported goods have since surged, adding to the inflationary pressures created by the slashing of subsidies and new consumer taxes. Within less than a year, a large part of the Egyptian population has seen half of its real purchase power wiped out.

How did we come to this?

Egypt has been witnessing problems with its managed-floated currency system as early as late 2012. Since 2003/2004, the stability of the exchange rate system depended on the capacity of the Central Bank to accumulate large foreign reserves that would cover 9 or 10 months of annual imports. The Central Bank could use these reserves to meet demand for dollars needed to pay for import goods, and could hence effectively defend the value of the pound. For a net importer of food and fuel like Egypt, managing the exchange rate was important to control inflation and especially the price of basic staples. Earlier experience – such as the massive bread riots in 1977 – had shown the destabilizing potential of sudden price hikes amidst rampant urban poverty.

Following the 2011 revolution and the political turmoil that ensued, growth rates decreased considerably and foreign reserves dwindled as Egypt suffered from capital flight and a dramatic drop in foreign direct investment and the tourism sector. Between 2011 and 2012, the Central Bank used its reserves to defend the value of the pound by financing the imports of basic foods and fuels by state agencies. By December 2012, foreign reserves had contracted from 35 billion dollars in January 2011 to 15 billion. This diminished the capacity of the Central Bank to meet the demand for dollars. However, an unprecedented, largely politically motivated expansion in foreign credit and aid, primarily in the form of long-term deposits at the Central Bank, kept the system afloat artificially. By the time Mohamed Mursi was toppled in July 2013, Egypt had already received around 8 billion dollars, mostly from Qatar, and to a lesser extent Turkey, who were keen on helping the rule of the Muslim Brotherhood succeed. The 2013 coup abruptly terminated these special relations (much of the Qatari deposits and loans were in fact repaid), to be replaced by even larger support from Saudi Arabia, the UAE and to a lesser extent Kuwait. All told, between 2011 and 2016, Egypt received an impressive total of 29 billion dollars in aid, cheap credit, long-term deposits at the Central Bank and free oil and gas shipments.[1]

The absence of an economic vision from the side of the leadership, and reluctance to rein in spending, however meant that the opportunity offered by these unprecedented inflows was lost. As long as support from the GCC was coming in, it could have served to mitigate the contractionary impacts of austerity, and facilitate the implementation of reforms to address long-standing structural weaknesses in Egypt's finances. Mindful of the instability that may have come with rising prices and layoffs of state employees, and keen to build up support for the new, military-backed regime, the new leadership instead chose to use these funds to *avoid* reforms. Thus, negotiations with the IMF were put on ice, and the holes in

1 Abdelatif Sobh: Dramatic report on foreign exchange from the Central Bank, 5 August 2016, available at www.parlmany.com/News/7/111119/أخطر-تقرير-للبنك-المركزى-عن-النقد-الأجنبى (Arabic), accessed 8 February 2017.

the government's budget and the balance of payment were plugged with the cheap money coming in from the Gulf.

What was the government's strategy? Surely they could not have expected that the Gulf's generosity would last forever?

The Egyptian government's bet was to achieve a massive increase of foreign direct investment (FDI). Once the security situation appeared to stabilize, the Sharm El-Sheikh conference held in March 2015 was meant to re-introduce Egypt as an attractive destination for foreign capital, not least through large-scale projects such as a special development zone along the Suez Canal, or the building of a new administrative capital east of Cairo. If successful, this strategy could have generated growth and employment and improved the balance of payments. Down the line, it could have compensated for some of the adverse effects of austerity measures, and generated fiscal breathing space that would have allowed for gradual reforms rather than drastic cuts.

Yet, for reasons that were partly out of government control, the bet on FDI fell through. Globally, the world economy went into yet another cycle of recession. The Eurozone, Egypt's largest trade partner, was still reeling from its debt crisis. Oil prices collapsed in late 2014, limiting the capacity of the Gulf countries to inject politically motivated investment, and deterring energy companies – traditionally the largest sources of FDI in Egypt – from expanding their engagement in the country. Lower prices of oil affected Egypt's foreign currency earnings in additional ways: It also meant stagnant remittances sent by those working in the oil-rich GCC countries, and less income from oil and gas, which still account for around 40 percent of total Egyptian exports.

In October 2015, the tourism sector received yet another catastrophic blow when a Russian Airplane out of Sharm El-Sheikh was downed by what was believed to be an attack by radical Jihadists. Other security incidents – such as the kidnapping and beheading of an engineer working for a French oil services company in August 2015, or the recent bombing of the main Coptic cathedral complex in Cairo in December 2016, continue to deter investors and tourists alike. Some particularly bad choices – such as defending an artificially high exchange rate for the pound over months – further contributed to the mess. When the support from the Gulf Cooperation Council (GCC) was halted, for political or economic reasons or both, Egypt's economical conundrum was back to square one, and the government had no option left but to return to the IMF. On November 11, 2016, the fund approved the Egyptian application for a loan of 12 billion dollars.

Where do we go from here?

With the IMF conditionality, the government has now been forced to introduce extremely unpopular austerity measures within less than two months. Fuel subsidies were cut raising local energy prices by around 25–30 percent. The new Value Added Tax (VAT) was introduced at 13 percent, up from the 10 percent consumption tax it replaced, and is slated to go up to 14 percent in 2017. The devaluation of the pound further drives up prices in import-dependent sectors, with ripple effects into the rest of the economy. These measures are bound to depress demand and hence growth while driving up inflation (a combination that economists refer to as «stagflation»), at least in the short- to medium-term, i.e. the coming year or two. Things will get much worse before they get better, if they improve at all given the extent to which the situation depends on the health of the international economy, but also on the treatment of longer-term political and security risks for tourism and investment to come back.

The IMF is now effectively in charge of Egypt's fiscal and monetary policy. The government negotiated a detailed program for fiscal and monetary restructuring in the coming four to five years. The commitments set in this program will shape public policy through the period to come in return for sustained funding. The content of the conditionality and the general reform program is not new by any means. It has been tried in tens of countries throughout the last four decades, to extremely divergent effects. In some cases, austerity measures combined with the liberalization of exchange rates, managed to stabilize macroeconomic indicators and to relaunch the economy after a period of slowdown, like for instance in Turkey in the aftermath of the 2001 financial crisis. Conversely, the IMF reform packages proved disastrous in a few Asian cases following the meltdown of 1997, in Russia in 1998 and most certainly in Argentina in 2000/2001. The variance can be explained in terms of the many external factors that IMF economists often choose to ignore while modeling reforms and projecting their economic outcome: for instance, the general state of the global economy, the structure and competitiveness of a country's export sector, the economic conditions in export markets and political long-term (un)certainty. For instance, countries with robust economic structures may use depreciated currency values to expand their exports whereas countries with weak exporting sector could hardly benefit from such measures.

Will the IMF deal save Egypt's economy?

Macroeconomic indicators (e.g. exchange and interest rates, budget deficit and public debt ratio to GDP) are likely to improve in the coming two to three years, albeit at the cost of a deeper recession. The extreme depreciation of the Egyptian pound versus the dollar since November 2016 is already causing a downturn in the demand for imported goods and hence, reduces the deficit in the balance of payments. By effectively eliminating the black market, the floatation has also channeled dollars back into the official banking system and reduced transaction costs. This should send positive signals to foreign investors and creditors as well as to Egyptian expats. However, medium-term recovery will depend on much more than just sound macroeconomic indicators. Some crucial factors lie completely out of the control of the Egyptian government. The most important factors are as follows:

First: Egyptian agricultural and manufacturing exports will only be able to take advantage of the depreciated pound (which reduces local cost, and makes it possible to sell at competitive prices) if the global economy recovers within the coming two years. This however largely hinges on the fate of the Eurozone and the EU, in addition to potential disruptions in international trade if the new American administration were to adopt protectionist policies.

Second: Egypt's complex dependency on oil and gas makes it extremely difficult to assess whether lower energy prices would have a net positive or negative impact on the economy as a whole. Since imports of (processed) oil products outstrip the value of Egypt's (raw) oil and gas exports,[2] low energy prices will reduce the import bill and hence the trade deficit. Yet lower energy prices are also likely to deter foreign investment in the field and restrain remittances from expatriates and investors from the GCC economies. This equation may turn clearly negative in the coming few years when Egypt's newly discovered gas fields in the Mediterranean start producing, but fail to realize the expected earnings.

Third: While the currency devaluation has turned Egypt into a bargain destination for tourists, a full recovery of the sector remains conditioned by the future security situation, in particularly on the Sinai Peninsula, but also in the region at large. Continued instability in the countries surrounding Egypt will continue to deter tourists even if the security situation in the country itself improves significantly.

Fourth: there is a long-term source of political uncertainty, which stems from the failure to institutionalize Egypt's ruling regime, and from its low capacity to extend channels of interest aggregation and representation within the existing authoritarian framework. Big decisions affecting the livelihood of millions have been taken lately in an authoritative and un-participatory way. Austerity measures and other inflation-inducing decisions affect workers, civil servants and the urban poor and middle classes. The lack of coordination and communication may ignite protest or acts of resistance and may hence lead to partial or total policy reversals.[3]

If we add to these contingent factors other structural features of the economy that are not likely to undergo transformation in the coming two or three years, the IMF reform pack-

2 Amr Adly, Egypt's Oil Dependency and Political Discontent, Carnegie Middle East Center, 2 August 2016, available at http://carnegie-mec.org/2016/08/02/egypt-s-oil-dependency-and-political-discontent-pub-64224, accessed 8 February 2017.

3 For a more detailed analysis see: Amr Adly, Egypt's Regime Faces an Authoritarian Catch-22, Carnegie Middle East Center, 21 July 2016, available at http://carnegie-mec.org/2016/07/21/egypt-s-regime-faces-authoritarian-catch-22-pub-64135, accessed 9 February 2017.

age may actually be a recipe for deeper problems for Egypt, at least in the short-term. The IMF's plan aims to build up foreign reserves through a massive foreign debt accumulation in the coming three years. Already, foreign public debt has reached 60 billion dollars in the first quarter of 2017 as compared to 46 billions in the first quarter of 2016.[4] Additionally, Egypt is to receive 12 billion dollars from the IMF. It has already raised 6 billion dollars in bonds on international markets. The total amount of foreign loans is expected to stand at 21 billion dollars in new debt by 2019/2020, on top of the already standing 52 billion dollars in external debt.[5] Unless the economy, and in particular the sectors that generate foreign currency earnings, show strong signs of recovery, Egypt may not be able to service the external debts it has been amassing. That would constitute an effective case of state bankruptcy.

Debt-driven growth has worked in cases like post-2001 Turkey. However, Turkey had already managed to create a vibrant export sector in the 1980s and 1990s, made up primarily of manufactured goods, which generated sufficient earnings to service the debt once liquidity was injected into the economy. Egypt, on the other hand, failed to develop an equally vibrant export sector despite several rounds of economic restructuring since 1990. The country's export earnings remain dependent on low-value added raw materials, primarily oil, together with energy-intensive industries like cement, fertilizers and iron and steel. Given these structural restraints that are not likely to change in the medium-term, there may be serious concerns about Egypt's solvency in the near future.

Will the crisis cause unrest, or even another revolution?

While economic hardship and political instability are definitely linked, there is no mechanical or automatic relationship between them. Actual as well as perceived hardship will likely increase discontent and put the legitimacy of the ruling regime in question. Whether this translates into actual protests and unrest depends on the ability to act collectively, which in turn is conditioned by structural, institutional and cultural factors.

The current situation in Egypt does not threaten any immediate or dramatic challenge to the incumbent leadership or to the state as the custodian of public order. Heightened re-

4 Al-Shourouq: The Central Bank: Foreign debt to reach 60 billion during the first quarter of the fiscal year, 5 January 2017, available at: www.shorouknews.com/news/view.aspx?cdate=05012017&id=74e3a90b-0962-4fcf-a071-a770a80f2853 (Arabic), accessed 9 February 2017.

5 Central Bank of Egypt, External position of the Egyptian economy 2015–16, available at www.cbe.org.eg/en/EconomicResearch/Publications/Pages/ExternalPosition.aspx?year=2015/2016), accessed 9 February 2017.

pression of virtually all opposition groups and even independent individuals, together with the subjugation of independent media and the effective suppression of all types of protests, be it in the form of demonstrations or labor strikes and sit-ins, will make it extremely difficult to express discontent through a coherent political discourse of contention.

On the other hand, a general disenchantment with politics following the June 30th uprising and the subsequent coup has rendered many ordinary citizens, especially the middle classes, wary of instability and any challenges to state authority. This wariness is amplified by the frequent terrorist attacks, the ongoing insurgency in the Sinai and the continuing civil strife in neighboring Libya, Syria and Iraq. Thus, discontent may assume the form of disconnected and apolitical contentious action, such as riots, localized strikes or demonstrations that target individual measures and policies rather than threaten the regime as a whole.

The regime has hitherto capitalized on the intense repression it employed over the last three years to pass unpopular policies while minimizing the occurrence of public protest, at least in the short-term. On November 11, 2016, calls for mass protests went unheeded, despite the massive price hikes caused by the currency floating and the subsidy cuts a few days earlier, and dissatisfaction with the government and the president, which is reportedly on the rise among the populace. This underlines that the ability (or not) to undertake collective action may be far more relevant than factors such as material degradation or disillusionment with the leadership.

Economic measures were passed autonomously of any institutionalized interest representation, be it by labor or business. While it is true that the business sector has largely been spared the adverse effects, this comes as part of the IMF conditionality, and of the government's strategy to attract foreign direct investment. It does not reflect a direct influence of economic actors on the government, or a strategic alliance between big business and the regime. As a matter of fact, big business has mostly lost the once dense informal networks it had within state institutions before the 2011 revolution. The current regime does not prefer giving a political role to big businessmen. With few exceptions, it rather depends on the military and its vast formal and informal economy to implement public works. This is already proving to be an obstacle for economic recovery, given the importance of the business elite in attracting foreign capital, as well as reviving key sectors like manufactured exports and tourism.

The autonomy of the current regime from broader societal groups and constituencies may come in handy in the short-term in order to impose unpopular measures. This would put Egypt in a league with cases of bureaucratic authoritarianism such as Pinochet's Chile (1973–1990), where state repression would be employed to abet (re-)distributional ends, like the dismantling of welfare structures and pro-market reforms. Yet the lack of institutionalized interest representation for social and economic actors is liable to cause major policy reversals in the medium-term. It may also increase longer-term political risks of uncertainty and upheaval. This is especially the case if the impact on state-dependent middle classes, which constitute the very core support base of the regime since 2013, is considered.

Who really carries the cost?

Contrary to the government's rhetoric that focuses on extending compensatory measures to the urban poor, the hammer will fall hardest on state-dependent middle classes. Just as in many developing countries, the urban poor barely consume beyond the basics. Around 60 percent of their income is spent on subsidized food items, which will not be touched by the IMF deal. However, subsidized items are limited eventually and do not include a broad array of items that are consumed by a majority of Egyptians like vegetables and sugar. According to CAPMAS, the official annual inflation rate in December 2016 stood at 24.3 percent. The rate of inflation was 10.2 percent for cereals and bread and 6.9 percent for dairy products and eggs.[6]

Transportation cost is also bound to increase, despite the fact that prices for the Cairo metro, the most important means of commute for the capital's working poor, have remained unchanged through two rounds of fuel subsidy reduction in 2014 and 2016. The effect of higher energy prices will still be felt given the strong presence of privately-owned transportation means, especially microbuses and motor rickshaws. This is also the case with the recent increases in electricity bills.

The problem will however be with what Asef Bayat once called the «poor middle classes» in reference to educated social strata who however face trouble to access jobs that would allow them to earn a living and reproduce their social status. Like in many other Arab countries with large public sectors, in Egypt these people were primarily absorbed by the state bureaucracy as low-paid civil servants. These stand for almost one third of the total labor force and around half of the wage laborers.[7] These state-dependent middle classes consume beyond the basics, but their ability to do so hinges on the state's ability to pay for wages, or for untargeted subsidies. Subsidized fuel and energy, for instance, benefit the middle class rather than the poor, who can't afford cars, air conditioners or washing machines in the first place.

State employees were at the core of the labor protest movement against Mubarak in the years that preceded the 2011 revolution, reportedly accounting for nearly two thirds of all protests between 2004 and 2014.[8] With that in mind, the subsequent post-uprising

6 Heba Hossam, The Central Statistic Authority reports an inflation rate of 24,3 for the month of December, available at www.youm7.com/story/2017/1/10/التعبئة-والإحصاء-يعلن-ارتفاع-معدل-التضخم-السنوى-لـ-24-3/3048233, accessed 9 February 2017.

7 Al-Masri Al-Youm, The Central Statistic Authority reports that the number of employees in the public sector has reached 5,752 Mio., 17 August 2014, available at www.almasryalyoum.com/news/details/503133, accessed 9 February 2017.

8 Fatima Ramadan & Amr Adly, Low-Cost Authoritarianism: The Egyptian Regime and Labor Movement Since 2013, Carnegie Middle East Center, available at: http://carnegie-mec.org/2015/09/17/low-cost-authoritarianism-egyptian-regime-and-labor-movement-since-2013-pub-61321, accessed 9 February 2017.

governments kept raising sector wages beyond the annual rate of inflation. Civil servants where thus shielded from the inflationary pressures experienced in other sectors. Conversely, the recent austerity measures hit this segment with full force. Moreover, their job security may be at stake by an impending restructuring and downsizing of the bureaucracy. Over and above, the government has committed to the IMF that wage increases in the public sector will remain below inflation rates. In one sentence, if Egypt has to reduce consumption as the main route towards financial re-stabilization, it will be at the expense of this fragile middle class. This is politically consequential, for it means moving against the very base that has supported state authoritarianism in Egypt since the 1950s. It also constitutes a reversal on those steps that allowed for social stabilization in the aftermath of the 2011 revolution.

One of the potential political consequences then is the re-emergence of labor protest in the bureaucracy and state enterprises over the coming months. It is not clear how the regime will deal with them. Under Mubarak and afterwards, the state preferred appeasement over repression, by offering side-payments in order to avoid politicization and keep contention restricted to labor issues. This time around, such concessions would jeopardize compliance with the IMF commitments. The open question remains whether the IMF may choose to turn a blind eye on such a breach (perhaps motivated by the perceived gravity of the political consequences) or rather, force the government to deliver, leaving repression as the only option.

Recommendations: What is to be done?

Egypt is a pivotal country in the Southern Mediterranean and the Middle East and North Africa. It may be too big to fail, but state failure may still occur in the absence of decisive action. It also has plenty of potential to realize, which has been held back by a long legacy of failed governance and unproductive state-society relations. Is there anything that can be done for Egypt? A short and direct answer would be, yes there is. The following five points include general recommendations about medium-to long-term measures that the Egyptian government could take or should be aided with:

- Egypt needs a less orthodox reform approach. Getting macroeconomic indicators right may be a necessary but by no means sufficient condition for economic development. In the past, there has been a prioritization of financial indicators and numerical growth, at the expense of more structural illnesses related to Egypt's development model. This exacerbated unemployment and underemployment and unequal access to income and to opportunities, which were the root causes that led to the 2011 uprisings. A development model that supports future social and political stability should include the real economy i.e. sectors that produce actual goods and services and create jobs rather than speculation in real-estate and inflows of hot money.

- Egypt's financial problems are rooted in the way its economy has been related to the world economy since the 1970s. Imports have constantly outpaced exports at an average of two to one. While expatriate remittances and earnings from services (e.g., the Suez Canal revenue, tourism) have often covered this gap, these sources have proven to be volatile, and conditioned by factors that are beyond the government's control. The same applies to foreign direct investment. Boosting export earnings for manufactured goods, in turn, would require a coherent strategic effort to improve competitiveness which, while desirable, can only bear fruit in the long term – and only if it coincides with a cycle of international growth. Meanwhile, as much as 41 percent on average of total imports are made up of semi-finished goods that are used as production inputs for final goods. Many of these are of a low-technology content that can be supplied by Egyptian producers through the deepening of industry and the creation of backward linkages with feeding industries and services. In other words, rather than the «two fetishes of the Washington consensus» – attracting FDI and expanding exports – Egypt should bank on a reform package that focuses on import-substituting manufacturing, which can save foreign currency and create jobs at comparatively low levels of investment. This should not, however, lead to the creation of inefficient and uncompetitive local industries behind a shield of protection, as it did in the past. Rather, the point is to use the effective protection furnished by the current surge in the prices of imported goods to encourage and support Egyptian producers to step into the gap and build up production lines that can compete with imports once the macro-economic situation improves and imports become available again.
- One of the main challenges to such an industrialization strategy will be institutional coordination between the state bodies in charge of designing and implementing industrial and trade policies and the private sector. Even though Egypt has a rather poor record in state-private sector coordination, these problems can be overcome. One option may be to revitalize the Industrial Modernization Center (IMC), established in 2004 in partnership between the state, the private sector and the European Commission with the purpose of modernizing Egypt's base of manufacturing enterprises, especially small and medium-sized ones. The Center managed to create a database of more than 21 thousand firms. It delivered services for the managerial and technical upgrading of many. There were also efforts to use the database in order to create backward and forward linkages that may link big business with small and medium-sized enterprises in a way through which technology could be transferred and markets could be accessed, including exports. While the IMC still exists it was considerably sidelined after the 2011 revolution amidst the turmoil and the disruption in the informal ties between state and business that had underpinned its work during the Mubarak era.
- The current IMF-sponsored plan for recovery may prove counter-productive for longer-term development and stability in Egypt. Giving priority to foreign direct investments has led to a renewed focus on oil and natural gas extraction, especially in the light of newly discovered gas fields in the Mediterranean. However, given the

volatility of energy prices and the constant growth of Egypt's own consumption, it is unlikely that investment in this field can address the fiscal deficit in the long term. Instead, it threatens to divert attention away from higher value-added and more sustainable sectors like services and manufacturing that can generate badly-needed jobs. It may also further undermine investment in renewables, where Egypt has enormous potentials. Diversification of Egypt's energy sources is already an area of cooperation with the Europeans, especially Germany, and it should continue. Focus should shift however to include institution-building in the realm of energy strategy development and implementation instead of just concentrating all efforts on technical aid and policy design.

- The last recommendation is more political than economic. Egypt has a clear political authority signified by the president and the presidential office more generally. It however hardly has a political regime defined as institutionalized rules and channels for practicing power, interest aggregation and representation and conflict mediation between different societal groups. Attracting investment, regenerating growth and even macroeconomic stability all hinge on establishing reliable mechanisms for such mediation, which will go a long way to address political uncertainty. This can be achieved through the better institutionalization of the current regime, which in turn cannot happen without relative liberalization and more tolerance towards dissent in the political as well as the public spheres.

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Anonymous. In order to protect the identity of the author, the Heinrich-Böll-Stiftung has chosen to publish the paper without naming the author.

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