



The Economic Situation in Egypt in the Context of Political instability and a Risky Transition

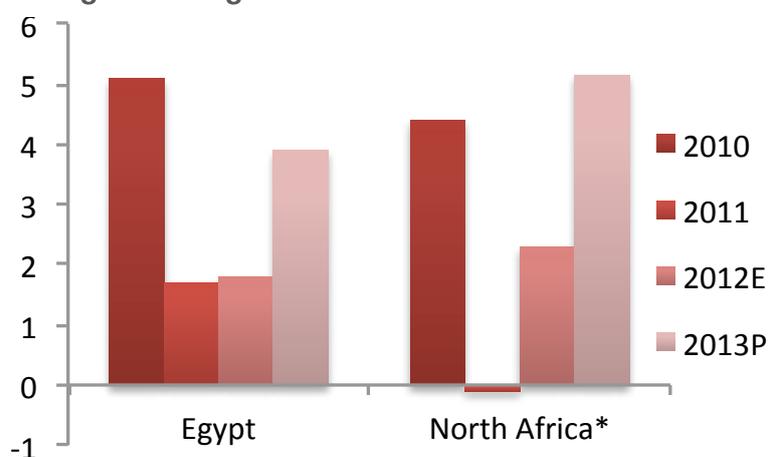
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I- Economic development in Egypt: Background

1. Economic growth: Prospects still uncertain

Despite the political uncertainty, Egypt's economy maintained a growth of 1.8 points in 2012 as compared to 1.7 points in 2011. Activities increased in most of the sectors, though exports shrunk by 0.5 points. Domestic demand was the driving engine of growth as it contributed 5.1 points. Final consumption contributed 3.9% points out of which household consumption alone represents 3.6 points. Gross fixed investment (GFI) added 0.1 point, while GCF contributed 1.2 points. However, external demand contracted this growth by 3.3 points with 2.8 points due to an increase in imports.

Average annual growth rate of GDP in North Africa 2010-2013



Sources: National data (SRO-NA Survey, official websites), IMF, EIU,

*SRO-NA Estimate, P: Projection, E: Estimate

According to the official projection, Egypt was expected to double its growth in 2012/2013 to reach 3.9 points ¹. Although the government has shifted subsidies on 95-Octane petrol in late November, 2012, it has however suspended the introduction of a package of tax increases. However, since the budget adoption, the growth forecast has been revised downward by the Egyptian authorities (2.6%) or by IMF (2%) in April 2013.

Given the weak global demand that negatively affects Egypt's exports and Suez Canal revenue, challenges facing policy makers include mobilizing resources from both concessional loans and from promoting the PPP model to uplift private investment as projected, and implementing a development plan that focuses on both social justice and economic growth.

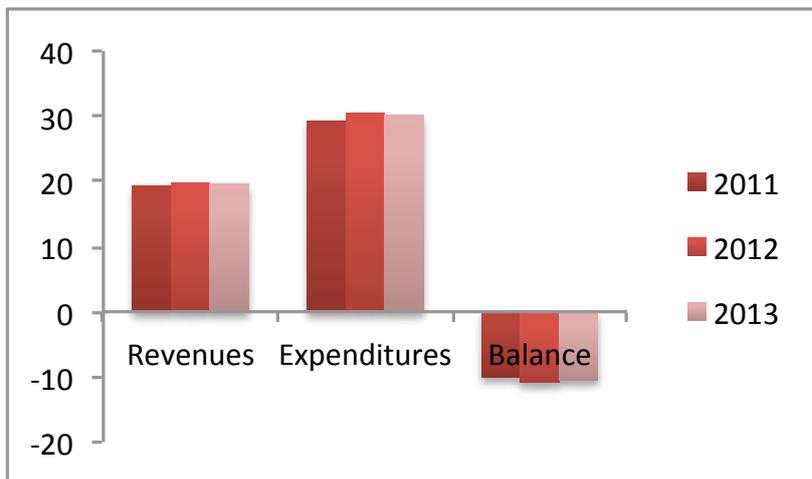
¹ SRO-NA annual survey to Egypt, 2012. The budget for fiscal year 2012/2013 along with the five-year plan target a growth of 4.0 to 4.5 per cent of the GDP.



2. Public finances: support measures continue to weigh

The implementation of the finance law in Egypt shows that since 2010-2011, the deficit continues to be higher than 10% of the GDP. This deficit is the result of a drop in revenues, together with a less significant drop in expenditure. Salary increases in the public sector, from social aid and grants which represent 25% of the total expenditure and 9% of the GDP, combined with the slowdown in economic activity due to the uncertainty created by political tension in the country meant no significant progress could be made on the short term.

Global balances of the Treasuries per country in % of GDP



Sources: (2011) National data, (2012) Country estimate and EIU, (2012)

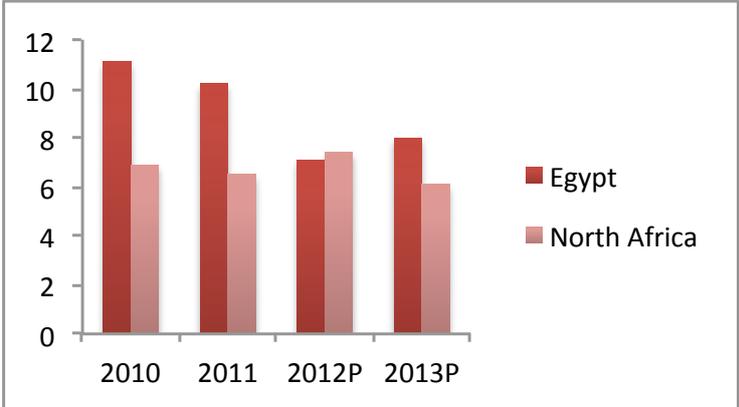
Traditionally, budgetary deficit funding is mainly provided by the local market, but this is proving to be more difficult and expensive, with record high compulsory yields in 2012. In addition to resorting to donations and loans from Saudi-Arabia, Qatar and the Arab Monetary Fund, Egypt turned again to the FMI. Negotiations with the IMF for a loan of 4.8 billion dollars were crucial for the Egyptian authorities as it could facilitate new aids from the World Bank and other international financial institutions and contribute to the restoration of the confidence of economic operators.

Within this context, the government has intended to reduce the deficit by lowering expenditure, mainly by reducing energy grants which currently represent approximately a fifth of the total expenditure. It is also working on increasing income through a series of fiscal reforms, including the implementation of older projects to move from a general tax on sales to the establishment of true value added tax. These reforms, which were announced several times over the two previous budgetary years, could not be implemented because of the ongoing transition. This underlines the problem the government will be facing in order to reach this objective in 2013, because even if the political reforms are in the process of being achieved, there is no consensus on these reforms, which could ensure sustainable stability.

3. Inflation and exchange rates: inflation trends under imported inflationary pressures

Despite the gradual depreciation of the Egyptian pound against the dollar, consumer price inflation in Egypt has reached an average of 7.1% in 2011/2012, compared to 10.2% recorded in the fiscal year 2010/2011. Containing of this inflationary pressure was partially attributed to the decline in food prices, given that Egypt is the major importer of wheat in North Africa, and food prices represent 40% of the index. However, since the end of 2012, as the pound depreciates more rapidly and the global non-oil commodity prices rise, the consumer inflation has gone upward and was projected to average 8% in 2013; and before the July events, the IMF projections for 2014 anticipated a 13.7% average rate.

Annual inflation rates Egypt, 2010-2012

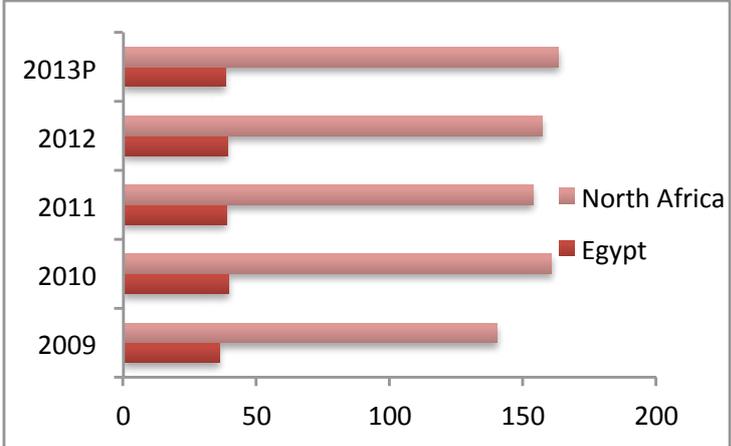


Sources: National data (SRO-NA Survey, official websites), IMF database

4. Investment and foreign trade

Gross fixed investment in Egypt has increased slightly by 1% from \$ 38.6 billion in 2010/2011 to \$ 39 billion in 2011/2012 at current market prices. Total investment has increased from E£ 229.1 billion in 2010/2011 to E£ 236.2 billion 2011/2012. This increase was totally due to private investment increase (from E£141 to E£151.2 billion) ². Renewed activity was around the PPP projects that focus on the role of private investment in economic growth.

Growth of gross fixed investment in Egypt, 2009-2012



Sources: National Data, EIU, IMF

For 2012/2013, the government is targeting a total investment of E£ 276 billion of which E£ 106 billion will be provided by the state, while private investment within the PPP projects is estimated at E£ 170 billion. In 2013, public investment in Egypt is expected to represent the largest spending category of the 2013 budget (About one-third of the exceptional donor grant received in 2012 will be used to increase investment by 50 percent in 2013, mostly in roads, agriculture, and energy projects).

The share of inward FDI in domestic investment: roughly at the same level, although it has increased in absolute volumes

The percentage ratio of gross inward FDI relative to GFI in Egypt was improved significantly as it was expected to reach 31% in 2012, compared to 6.9% in 2011. Given the slight increase in GFI at current market prices in 2012, this improvement of the ratio of FDI to GFI may be attributed to success in attracting the inflow of FDI in 2012, particularly from European investors, despite the political uncertainty.

Foreign trade in Egypt: Partial reduction of the impact of the 2011 political crises

Egypt export sales have declined by 6.5%, and growth was very weak in countries which export no or little petroleum. In general, merchandise imports rose by 7.4% compared to 2011, increasing from 186.6 billion \$EU to 200.5 billion in 2012, due to a robust recovery in Libyan demand (+ 61%) drawn from household consumption and public investments related to the post-conflict reconstruction. For Egypt, demand remained strong on the whole, with growth rates of 5.5%. Food products in particular still hold an important place in the regional demand structure. Egypt remains dependent on imports for up to 55% of its basic food products (wheat, sugar, oils, meat).

The coverage rate of imports by exports remains greatly contrasted. The same ratio continued to drop for Egypt with 44% in 2012, compared to 49% in 2011. The trade balances remained negative. The deficits worsened in relative values by 17.7%, compared to 2011.

Balance of services in Egypt: Progressive recovery of the tourism sector

The service trade increased in 2012 for Egypt (+9%), with balances that are, however, still way below the 2010 levels, in the area of 22.6%. Despite the clear improvement observed, the tourism sector in particular continues to suffer under the effects of the political crises since 2011, and the inherent uncertainties of the political transitions taking place in North Africa.

In Egypt, the inflow of tourists ³ increased to 11.5 million for the 2012 financial year as a whole, i.e. an increase of 17.3% compared to 2011 (9.8 million). This level, however, still remains 21.8% below that of 2010, which has recorded 14.7 million tourists.

5. Social development and employment remain a central issue

Egypt has made progress on human and social development and is on track to achieve the Millennium Development Goals (MDGs). Nevertheless, much remains to be improved and regional gaps are widening. The 2011 UNDP Human Development Index ranked Egypt 113rd out of 182 countries. Extreme poverty and hunger have been curtailed; infant mortality and malnutrition have been halved; life expectancy has risen from 64 to 71 years; and there has been demonstrable improvement in maternal health and the fight against HIV/AIDS. According to World Bank estimates, however, some 22% of Egyptians have incomes lower than USD 2 per day per person, while rural poverty rates reach 44%.

The unemployment situation appears critical in Egypt due to the political and economic uncertainties which have led to a reduction in income from tourism and a lack of visibility among investors, who have either postponed their projects or withdrawn their capital, depriving people of thousands of jobs. This phenomenon has been exacerbated by the intervention of ratings agencies that have, since 2011, reduction in income from tourism and a lack of visibility among investors, who have either postponed their projects or lowered the ratings of the country, thus making access to financing for projects and enterprises more expensive. Between 2009 and 2012, unemployment rate thus went from 9% to 12% in Egypt. If the economic growth in this country is as slow in 2013 as it was in 2012, this will in turn have a negative impact on economic recovery and the social situation.

In post-revolutionary Egypt, the economic and political empowerment of women is uncertain and their status may be deteriorating. Recent political developments in the country demonstrate that it is difficult to guarantee the enforcement of measures to promote gender equity in the current climate. Women's participation in the democratic process remains challenged by the emerging agenda of Islamist political forces. Recent political developments in the country demonstrate that it is difficult to guarantee the enforcement of measures to promote gender equity in the current climate. Women remain marginalised in economic activities: data from Egypt's statistical agency show an unemployment rate of 24% among women during the year of 2012, more than double that of men (9.1%). Although women make up 30% of the professional and technical workforce, only 9% of Egypt's administration and managers were women in 2007



Food security in Egypt, a key element

In Egypt, the contribution of agriculture to overall GDP has averaged 13% and the national grain production satisfies around 60% of the domestic needs in an average year. The sector employs about 28% of the workforce. Livestock breeding is underdeveloped. Egyptian agriculture faces severe natural constraints, including limited water and land resources. The arable land accounts for only 2.6% of the total land area, while water resources are limited to 54 billion m³ per year, the equivalent of the Egypt's quota of the Nile's water. With limited resources and despite high productivity (Egypt is the only one among the countries of North Africa known for 7-8T/ha yields, equivalent to those recorded in "developed countries"), the Egyptian agriculture cannot meet the needs of a large population that increases by 2% per year (84 million inhabitants). The country is the largest importer of wheat in the world with 6-7% of world imports. However, the funding

of cereal imports is limited by the low currency reserves. Poverty is widespread in rural areas. Rural Upper Egypt recorded the highest rates of poverty affecting 51.5% of the population (twice the national average), while the Greater Cairo has the largest number of poor and food-insecure (about 3.5 million people). Monetary poverty affects 21.6% of the population (2009) and it is a major constraint for access to food (households spend about 40% of their monthly income on food).

Pockets of poverty and food insecurity also exist in urban areas, where poverty has increased by almost 40% (from 11% to 15.3%) between 2009 and 2011. In 2011, 17% of Egyptians were food insecure compared to 14% in 2009.

As in all North African countries, Egypt practice generalized price subsidies for basic food products to mitigate the rising international import prices, which increases the budgetary constraints but does not have much impact on the most vulnerable population. The government introduced a universal subsidy for the "baladi" bread with unrestricted quotas and a ration card system for certain eligible households. The system is not well targeted; it covers 68% of the population whilst at the same time excludes 19% of the most vulnerable households. During the 2008 crisis, the cost of food subsidies has increased substantially from 1.25% of GDP in 2007 to 1.7% of GDP in 2008

II- Discussions with IMF and Economic prospects

1- Egypt was to conclude negotiations with IMF before the “new political crisis” (25 June 2013)

After weeks of talks between IMF negotiators and representatives of the Egyptian government in Cairo, and talks of the semi-annual meeting of the IMF and World Bank in Washington D.C, Egypt has reached a preliminary agreement with a team of negotiators for a US\$4.8 billion loan. This preliminary agreement with the technical team was expected to be submitted to the IMF’s executive board for approval.

The situation has changed since the departure of President Morsi from power, as officially there is no formal contact between Egyptian officials and Funding Institutions.

The terms of former draft technical agreement with IMF are no longer valid

According to IMF officials, the Egyptian authorities have developed a national program that seeks to promote economic recovery, address the country’s fiscal and balance of payments deficits, and lay the foundation for rapid job creation and socially balanced growth in the medium term. IMF’s main conditionalities were to remove an important part of subsidies (on oil, bread ...) and increase taxes.

Given the febrile public mood, the task will not be easy. For example, in December 2012, as part of the government’s undertakings to the IMF, President, Mohammed Morsi, announced a raft of tax increases (in 70 products) , but revoked them less than 24 hours later, stating that they would not be introduced unless they are accepted by the people.

Moreover, financial support from some Gulf States will help transition authorities avoid the social risks linked accepting IMF conditionalities. The amount of IMF support is way below the support Egypt has got from Saudi Arabia, Kuwait, UAE (see table).

IMF support versus “Gulf States” support

Thanks to the support received/announced so far, with fewer constraints, Egypt may not feel compelled to rapidly conclude a deal with the IMF. But, IMF funding is a firmer and more explicit condition for further funds from a variety of sources, ranging from the African Development Bank to the European Union – in some cases for up to \$15 billion.

In addition, the Deauville Partnership launched at the 2011 G8 summit which provides US 80 billion assistance to four countries in democratic transition (Egypt, Jordan, Morocco and Tunisia) is related to the IMF negotiations. In fact the IMF plays a central role in the implementation of the partnership, as no significant disbursement is done without an agreement with the IMF on structural reforms.

Moreover, no clear constraints on funding does not mean no dependency on donors/funding countries. Sustainable support is more assistance than bribes. The previous support (10 billion) from Qatar, Libya and Turkey to the Morsi government is a clear signal that some hidden conditions are behind these supports.

These negotiations with IMF are impacted by:

- political instability which is still a challenge, and surely the most important challenge to be dealt with;
- a bad social mood linked to a need to create a clear collective understanding that the level of subsidies in Egypt is unsustainable and the situation is critical; and therefore it is necessary to adopt a gradual approach to remove non-targeted subsidies and still increase taxation level though. Failing to communicate and convince the Egyptian people about the gravity of the economic crisis that is crippling Egypt will not facilitate the recovery but will worsen the economic situation and deepen the negative impact of its social repercussions;
- pressure from bilateral donors that are considered as short term good news to stop rapid degradation of the Egyptian economic situation, but a bad signal that “short term measures” could be more important than structural and unpopular needed reforms.

There is a need to strengthen the perception of the Egyptian transition Authority that the situation would inevitably leave Egypt open to being more dependent on bilateral relations and higher financing/ economical/ political/diplomatic costs.

In term of economic prospects, Egypt faces a problematic combination of rising food prices, unsustainable subsidies with fiscal and balance-of-payments deficits, falling currency reserves, and high political uncertainty. Economic growth before the crisis (2010) was around 5.1%. The 2011 political crisis resulted in a very sharp contraction of the economic growth that fell to 1.7%. The end of the political transition in 2013 was considered to result in a gradual return to growth with an estimated 3.9% growth rate in 2013. The current prospects for the 2013 growth are around 2%. This new political crisis undermines these expectations and we suggest three possible scenarios:

Worsening economic situation scenario with recession risks

- This scenario is related to the current political instability with a long and difficult transition, without strong foreign aid beyond the Gulf States Package;
- It will result in lower performance of the main growth engines, particularly tourism, FDI, remittances, bank services and Suez channel revenues;
- This growth slowdown or possible recession will imply a deterioration of fiscal and balance-of-payments deficits worsening the sustainability of public finance;
- This situations will imply threat to external supplies, with unsustainable subsidies, inflation, that will lead to further social unrests;
- The difficulty of the transition will have an impact on the security situation with the risk of a dramatic deterioration of this situation and a direct impact on economic activity, worsening the economic and social crisis.

Perfusion scenario: with growth rates comparable to 2011 and 2012 rates

- This scenario is based on a growth maintained due to Aid Packages stimulus;
- Beyond the Gulf Package aid, this scenario implies a resumption of negotiations with IMF to allow a rapid and substantive ODA that will allow a recovery of balance-of-payments, and maintain reserve levels and provide support for critical imports;
- It will allow external supplies securization;

- Consequent ODA will stimulate and boost some economic levers, through public demand, and will allow implementing some investment projects through PPP, included in the 5 year development plan;
- However lack of national consensus will imply a long political transition that will impact the economic and social situation of the country;
- Weak, or lack of, political consensus among actors that will not allow deep economic reforms;
- The low or uncertain recovery of the main economic sectors (tourism, FDI, remittances, services, particularly regional finance) will maintain weak social conditions, with consequences on the role and implications of youth in the political instability.

An economic recovery scenario: with growth rates similar to the 2010 rate

- An ideal scenario would be the end of violence with a short political transition, with strong consensus among the different actors. This consensus would be the main leverage to implement sound economic reforms;
- This short transition with national consensus will allow a strong growth recovery due to consequent aid package, with rapid recovery of public finances and balance of payments, and an ambitious program of investment in parallel with reforms. A national consensus will also have a strong impact in reducing uncertainty and will generate significant trust dividends in key sectors from external levers (Tourism, FDI,..) and through internal channels of boosting internal demand.