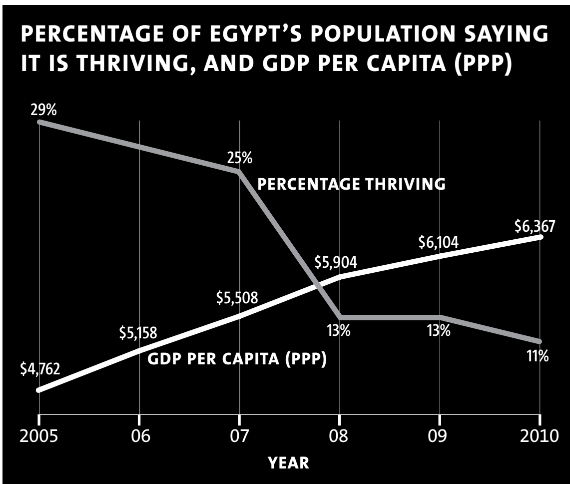
First, Confront

Discontent

Setting Priorities for Egypt’s Economy

BY HAFEZ GHANEM

The Arab Spring — more specifically, the Egyptian Spring — is not a season that will gracefully morph into a golden summer. Building a robust civil society will take time, and there will probably be setbacks along the way. But one thing we can say for certain: Egypt's new government needs to start showing economic results soon.



PERCENTAGE OF EGYPT'S POPULATION SAYING IT IS THRIVING, AND GDP PER CAPITA (PPP)

SOURCE: International Monetary Fund

And in view of the country's limited institutional and financial resources, it needs to focus on achieving a small number of priority objectives. I believe that macroeconomic stabilization, along with the cultivation of entrepreneurship, should be at the top of the list.

SETTING PRIORITIES

The revolution that began in Tahrir Square in January 2011 brought down the old autocratic regime, weakened the influence of the military and led to free elections. The next steps are likely to be tortuous, though, as citizens of a country with no historical memory of democracy and with deep cultural schisms decide where they want to go. Hence the importance of easing one core source of friction by getting the economy back on a growth track.

That's right: *back* on track. The economy improved markedly during the last decade of Mubarak's rule – especially after 2004, when the government accelerated privatization and deregulation. GDP growth was in the 5-7 percent range, even during the global financial crisis. But as the figure to the left shows, the number of people responding positively to the question of whether they were thriving fell from 29 percent in 2005 to 11 percent in 2010.

There are at least two possible explanations for this divergence between economic growth and perceptions of well-being. The first is purely political: discontent may have been mainly due to an increased sense of injustice and a feeling that corruption and cronyism were on the rise, coupled with tightening political controls and increasing police brutality. Proponents of this view point to the fact that the initial protests were led by middle-class youth, most of whom were relatively well educated and had good jobs.

The second explanation is economic. It can be argued that Egypt's middle class, and especially its lower-middle class, was hurt by economic reforms that reduced its access to government jobs and increased the cost of living. Despite the economic growth (and unlike the situation in successful developing countries like Brazil and China) the proportion of the

HAFEZ GHANEM is a senior fellow in the Brookings Institution's global economy and development program, and the leader of its Arab economies project.

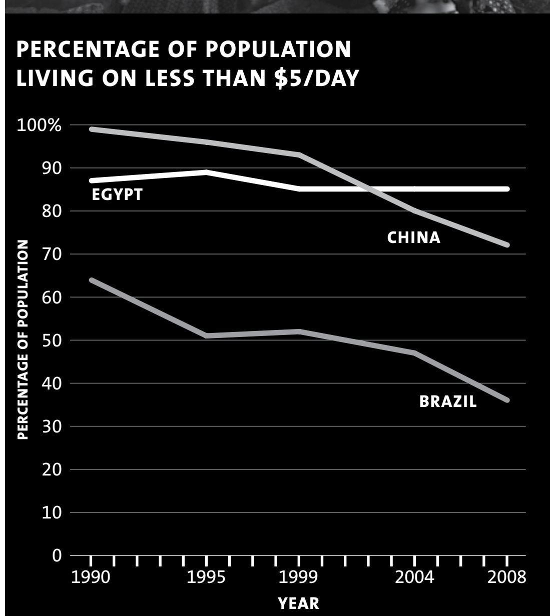
Egyptian population living on less than $5 a day in purchasing-power terms stagnated at around 85 percent. Those households saw the benefits of rapid growth accruing almost exclusively to those better off, which may have led to their alienation and willingness to confront the forces of repression.

The motto of the Egyptian revolution is "bread, freedom and social justice." Hence, while disagreeing about the relative importance of the factors that led to the revolution, most political observers agree that the current government needs to start delivering on the promise of a better life (bread). The problem, of course, is that much needs to be done to spur balanced growth, but the Egyptian government has very limited institutional capacity or financial resources to manage that. I believe, then, that the government should focus in the short term on a limited number of issues, using three selection criteria: level of urgency, ability to mobilize broad political support and contribution to the goals of the revolution.

In my view, that makes the first priority the stabilization of the economy by reducing the government deficit and increasing foreign currency reserves. This is critical, as there is a serious risk of a crisis that has been averted so far only through aid from Saudi Arabia, Qatar and the Islamic Development Bank. But stabilization is the metaphoric equivalent of choosing spinach instead of french fries. It will not increase the government's popularity, because it is all about saying "no." Hence, it is especially important to develop a program that protects the vulnerable in the process.

Stabilization must be accompanied by measures to expand output and to provide hope for a better future, especially for youth. Therefore, the second priority should be a concerted effort to support young entrepreneurs and small-scale enterprises. Shifting from a system of crony capitalism, which favored large, established enterprises, to one that focuses on opening markets to small businesses and creating opportunities for the young would garner broad-based political support and contribute to the goal of inclusive growth. What's more, it would make the belt-tightening that will be required for macrostabilization more palatable.

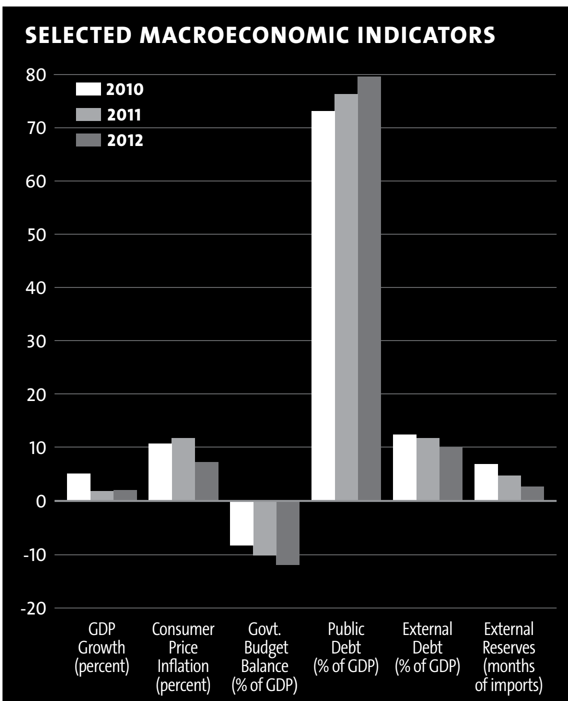
© KHALIL HAMRA/AP/CORBIS



SOURCE: World Bank

STEADY SHE MUST GO

As should have been expected, the initial impact of the revolution on Egypt's economy was quite negative. Investment (both foreign and domestic) fell sharply, tourism came to a standstill and capital fled the country. GDP growth fell from more than 5 percent in 2010 to less than 2 percent in 2011 while officially measured unemployment rose from about 9 percent to more than 12 percent. The government deficit, which was already high before the revolution, ballooned to 10 percent of GDP in 2011 and nearly 12 percent in 2012. Accordingly, the public debt rose to nearly 80 percent of GDP last year.



SOURCE: IMF

Since foreign debt is only about 10 percent of GDP (down from 12.4 percent in 2010), the huge increase in government borrowing must have come from the domestic banking system. Indeed, the government has been paying about 16 percent interest on its short-term treasury bills, sucking liquidity from the financial system and making it far more expensive for the private sector to acquire credit.

Meanwhile, government reserves of foreign currency, which stood at $36 billion in 2010 (covering about seven months of imports), fell to $15 billion in 2012. During the summer of 2012, Egyptians started feeling the first pains of a financial squeeze in the form of fuel shortages and electricity blackouts. The governments of Saudi Arabia and Qatar, along with the Jeddah-based Islamic Development Bank, intervened to help avoid further deterioration. The Saudis deposited $1 billion with the Central Bank of Egypt and bought treasury bills for another $500 million. The Islamic Development Bank provided a $1 billion loan to pay for food and fuel imports, while Qatar announced that it would deposit $2 billion in an account with the Central Bank of Egypt.

These loans amounted to a Band-Aid; the Egyptian government decided to seek IMF support for a coherent macrostabilization program. IMF missions have been visiting Cairo to help prepare the plan, which may be completed before this article is published. An agreement with the IMF (assuming there is one) will provide Egypt with access to increased external financing from the IMF, as well as from other multilateral and government donors who are inclined to tie their support to an IMF accord on a credible macroframework. By the same token, an IMF agreement would provide an encouraging signal to private foreign and domestic investors, who have largely watched the revolution from the cheap seats.

However, reaching agreement is not an easy process, because it will probably require decisions on the politically sensitive issue of

Tempers flare over fuel shortages in Cairo.

fuel subsidies and the level at which the currency-exchange rate is defended through central bank intervention. Reaching an agreement with the IMF, moreover, would not be the end of the story; implementing the program is likely to be quite difficult, given the country's political ferment.

Fuel Subsidies

The Egyptian government spends 6 to 7 percent of GDP on fuel subsidies and some 2 percent of GDP on food subsidies. Combined, they are roughly equal to the entire sum that the government (including health and education ministries) pays in wages, and more than double the amount the government invests in infrastructure.

The fuel subsidies, by the way, are not just budget-busters; they have distorted the market economy by encouraging overconsumption of energy. According to World Bank consultants, the energy intensity of the Egyptian economy – that is, energy use per unit of productive output – is two-and-one-half to three times higher than the average for advanced countries. The World Bank also argues that the fuel subsidies are highly regressive in nature, as 57 percent of the benefits go to the richest two-fifths of the population. Hence, to be credible, a macrostabilization program would need to include a reduction in fuel subsidies, probably as a step toward their elimination over the medium term.

TOP: AFP/GETTY IMAGES. BOTTOM: EPA/STR.

Buildings collapse in Cairo, linked to poor construction and corrupt regulation.

© SAMI WAHIB /AP/CORBIS

Reducing fuel subsidies will need to be carried out carefully. The fact that 57 percent of the subsidy goes to the richest two-fifths can be misinterpreted; the vast majority of this group lives on just $4 to $10 a day (Indeed, only about 2.5 percent of Egyptians live on more than $10 a day.) So the most of this top two-fifths can probably be classified as middle class, but certainly not as rich.

Moreover, the 57 percent figure implies that 43 percent of the subsidy in fact benefits people who live on less than $4 a day. Notwithstanding the regressive nature of the subsidy, then, it seems clear that reducing or eliminating it will hurt the middle class and the poor, and therefore will be politically difficult to implement.

This is not a new problem. When President Anwar El-Sadat tried reducing subsidies in the late 1970s (also within the context of an IMF-supported stabilization program), mobs took to the streets and he was forced to reverse the decision.

In 2011, Nigeria tried eliminating fuel subsidies. But faced with massive protests, the government was compelled to restore them in part. And just months ago, Jordan was hit by street riots after attempting to raise prices at the pump. On the other hand, some developing countries (including Ghana and India) have succeeded in reducing energy subsidies, and Egypt can draw some lessons from their experiences. Maria Vagliasidi, an economist at the World Bank, studied 20 developing countries and found that they managed to reduce the average cost of energy subsidies in their budgets from 1.8 percent of GDP in 2004 to 1.3 percent in 2010 – and that this, in turn, led to both a reduction in energy intensity and an increase in energy efficiency.

Programs that have succeeded in paring energy subsidies have usually included two features: compensatory measures to help the most vulnerable, and a strong communications strategy to convince the public of the benefits. In Indonesia, President Megawati Sukarnoputri tried to put energy price reforms into effect in 2003, but was faced with stiff opposition and had to roll back the program. Three years later, President Susilo Bambang Yudhoyono tried again, starting with a public-information campaign that clearly identified the benefits of the reform and the ways the needy would be protected from harm. He was able to reduce subsidies without much opposition.

Ghana, for its part, launched a study of fuel subsidies in 2004. The study's steering committee included a variety of stakeholders (government officials, academics, company representatives and others). In 2005, the government used the committee's report to launch an information effort complete with a description of the social-mitigation measures, and was subsequently able to increase fuel prices by 50 percent without violent blowback.

Exchange Rates

As in most countries, the currency-exchange rate in Egypt is a political variable. Most macrostabilization programs supported by the IMF include a devaluation of the national currency to enhance competitiveness, improve the balance of payments and rebuild international reserves. However, many countries try to avoid devaluations because they lead to an increase in the price of imports, raising the cost of living. Thus, in a country like Egypt that is highly dependent on food imports, the poor could be hurt by a devaluation. Note, moreover, that a devaluation of the Egyptian pound would raise the domestic price of fuel and make a reduction in fuel subsidies more difficult politically.

Is the Egyptian pound overvalued by objective criteria? In the table, note first that inflation was much higher in Egypt than in the United States between 2004 and 2010 (just before the revolution): the Egyptian consumer price index rose five times as fast as its American counterpart. But in that period, the Egyptian pound actually appreciated: in 2004, a dollar would buy 6.2 pounds; six years later it would fetch just 5.6 pounds. As a result, one measure of the "real" exchange rate of the pound versus the dollar (that is, the exchange rate adjusted for relative rates of inflation in the two currencies) appreciated by a whopping 42 percent.

EVOLUTION OF EGYPT'S EXCHANGE RATE AGAINST THE DOLLAR

	2004	2010	2011	2012Q2
Egypt CPI	95.4	173.1	190.5	203.2
USA CPI	96.7	111.7	115.2	117.7
LE/$ exchange rate	6.2	5.8	5.9	6.0
Nominal exchange rate index	107.2	97.3	102.7	104.3
Real exchange rate index	108.8	62.7	62.1	60.4

SOURCE: IMF and author's calculations

The Egyptian pound did depreciate in nominal terms after the revolution, going from 5.6 to the dollar in 2010 to 6.0 to the dollar in the second quarter of 2012. However, this depreciation was not enough to offset the inflation differential between the two countries, and so the "real" exchange rate actually appreciated by an additional 3.7 percent.

In a 2010 report, the IMF concluded that the pound "appears somewhat overvalued under each of the standard metrics." If the real exchange rate was overvalued when economic growth was strong and the country had external reserves covering seven months of imports, it is probably safe to assume that today

© ALEX MAJOLI/MAGNUM PHOTOS

it is even more overvalued. A competitive real exchange rate, it's worth remembering, is also important for attracting foreign investment – something that Egypt particularly needs now.

To be sure, devaluation is not the only way to deal with the problem of an overvalued real exchange rate. An economy can regain international competitiveness through deflationary policies that drive domestic inflation below inflation in countries buying its exports. However, as the current depression in Greece demonstrates, such "internal devaluation" would be even more painful than a nominal devaluation.

SMALL IS BEAUTIFUL

Thanks to decades of high birth rates, the Egyptian labor force has been expanding at a fierce pace for a generation. Currently, about 850,000 young people enter the labor market annually. The Egyptian public sector used to provide jobs to large numbers of them – particularly those with college degrees. But that changed with the economic reforms of the last decade, which were aimed at controlling spending and reducing waste in the public sector. And given the high fiscal deficit (as well as lingering overemployment in the public sector) the government is unlikely to absorb many new graduates in the future. As a result, it has become increasingly hard for young people to find jobs, and young people with a high school education or more represent about 95 percent of the formally unemployed.

The problem is particularly acute for young women, who are nearly four times more likely to be unemployed than young men. Of the youths who do find jobs, only 28 percent find formal-sector jobs – 18 percent in government and 10 percent in private business. The remainder end up working off the books in micro- and small businesses (MSEs).

In view of its large contribution to job creation, it seems reasonable to focus on developing the MSE sector and expanding the opportunities available for youth both as entrepreneurs and workers. However, not everybody agrees with this logic. Some argue that large enterprises provide better pay and offer more security – hence provide better quality jobs. Moreover, they point out that because the survival rate for MSEs is low, they do not offer as many jobs on a net basis as the gross data suggest.

It's true that Egyptian MSEs are mostly low-productivity family businesses providing simple services to the household sector. The average amount of capital per worker in these businesses is only $2,000 and almost two-thirds of the employees are related to the owners or managers.

Consider, too, the critics say, that about 60 percent of MSEs are small retailers and wholesalers selling food, clothes, furniture, plastics and building materials. Another 30 percent provide services, including transportation, local shipping, laundry, cafes, restaurants and hotels. That leaves only 10 percent in higher-productivity activities, including food processing, wood and furniture, ceramics, building materials and some electrical and engineering workshops. And less than three MSEs in a thousand sell to export markets – which are a potent source of mobility in Asian emerging economies.

This does not mean that government should abandon the MSE sector and maintain past policies that favored large enterprises (in many cases, those with close ties to the political establishment). However, it does suggest that the government should focus on raising the competitiveness of the MSEs and enhance their ties to national and international markets.

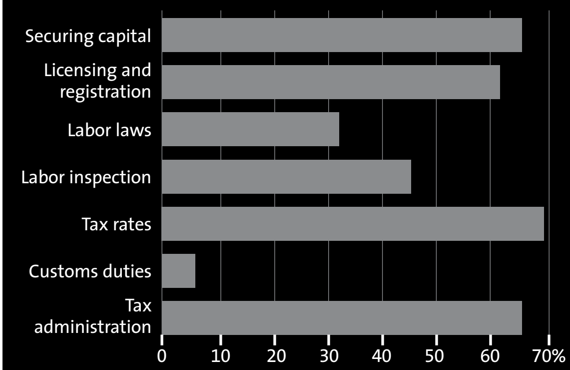
Finding jobs in MSEs for the educated young people who simply increase the ranks of those earning $2 to $4 per day would not solve Egypt's social problems. The objective should be to encourage the modernization of the sector so that it can provide better living standards for young entrepreneurs and decent jobs for new entrants to the labor market. Such a strategy would need to operate at two levels, both changing the institutional framework that inhibits start-ups and intervening in favor of MSEs.

It has become increasingly hard for young people to find jobs. The problem is particularly acute for young women, who are nearly four times more likely to be unemployed than young men.

The table on page 34 shows the result of a survey of small-business owners asked to identify the main constraints facing their firms. The No. 1 obstacle appears to be taxation – tax rates as well as the inefficiency (corruption?) of the tax administration. More than 60 percent of the entrepreneurs also complained about regulations concerning business registration and licensing.

Reducing the taxation and regulation of MSEs would send a strong positive signal to

PERCENTAGE OF ENTREPRENEURS SAYING THE ISSUE IS A MAJOR CONSTRAINT



the market. It is important to emphasize, however, that simply posting new laws and regulatory reforms would be insufficient. Government has to make sure that they are implemented, which often requires changes in the way the civil service is organized (and the inclination of civil servants to demand illicit side payment to do their jobs).

Between 2004 and 2010, the Mubarak administration implemented a variety of measures to simplify procedures. As a result, the World Bank gave Egypt higher marks in its doing-business reports. However, a comparison of small entrepreneurs' responses to survey questions in 2003 and 2011 shows virtually no change in the level of frustration with government. A possible explanation: large, well-connected firms were able to benefit from the improved environment, while for MSEs it was business as usual.

About 60 percent of small-business owners identified access to capital as a key constraint. In fact, only about 5 percent of them said they had any way to raise capital from the formal financial sector. Most rely on personal savings and support from family and friends. Hence, an expansion of existing government programs to provide financing to small entrepreneurs – perhaps with a special focus on young entrepreneurs – seems to be warranted.

Financing alone is not enough. Small businesses need support to improve access to technology and to larger, more competitive markets. There is even a need for training in basic business skills, as the education system is largely geared to producing more government bureaucrats. Moreover, given the paucity of institutional support for delivering services, it is hard to imagine that government alone would do a decent job. Building a modern entrepreneurial class will require partnerships with the private sector and civil society.

* * *

As noted above, Mubarak implemented sweeping economic reforms after 2004. And, in some ways, the results were impressive. The economy grew rapidly and all macroeconomic indicators were positive. Indeed, the people who designed those reforms argue that if they had been given more time, the benefits would have trickled down to the middle class and the poor.

Macrostability is a prerequisite for any economic plan to have a prayer of success. But forcing down more of the traditional medicine on which the Mubarak economy thrived – privatization and liberalization without due attention to social issues – is untenable politically. That's why I favor a new approach that prioritizes small-business development and encourages youth entrepreneurship, even if it is not the most direct path to higher productivity and rapid growth.

Are Egyptians up to the challenge of building a prosperous economy that offers opportunity to the have-nots? I'm betting they are, provided policymakers manage to walk the narrow line between what works and what is politically possible.