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STRENGTHENING TRANSATLANTIC COOPERATION

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Summary: Last year Egypt recorded a growth rate far better than other major countries in the MENA region: +4.7 percent against +1 percent of Iran, +0.2 percent of Saudi Arabia and -5 percent of Turkey.

This good performance has not prevented, however, the rise in unemployment. In order to decisively reduce its substantial social problems, and strengthen its regional role, Egypt needs an extended period of high economic growth, which in turn requires deepening the economic reforms launched in 2004. The negative effects of the international crisis, together with the 2010-2011 elections, hamper this process and cloud the outlook.

The United States and the European Union, whose policies toward Egypt today tend to be complementary, may converge in their support for economic reforms.

1744 R Street NW
Washington, DC 20009
T 1 202 745 3950
F 1 202 265 1662
E info@gmfus.org

Egypt After the Crisis: Resilience and New Challenges

by Franco Zallio[1]

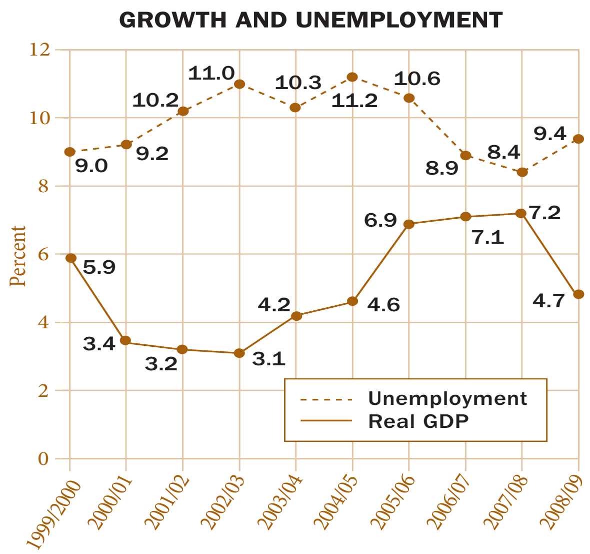
The Egyptian economy has weathered the international economic crisis relatively well. The financial contagion was very limited thanks to both old vices—such as the limited integration with world financial markets, and the backwardness of local financial instruments—and new virtues: economic reforms launched in 2004 have consolidated and strengthened the banking system. The accumulation of international reserves—which more than doubled after 2004—allowed Egypt to cope with the massive outflow of portfolio investment that took place in the second half of 2008.

In a more difficult, but still positive, way Egypt has faced the spillovers of the international crisis on foreign exchange receipts and, consequently, on the real economy. Oil price decline has decreased oil exports, the fall of international trade has reduced non-oil exports and Suez Canal revenues. Recession in industrial countries and the sharp economic slowdown in the Gulf have cut tourism receipts as well as remittances and foreign direct investments.

Relatively solid public finances[2] allowed for an expansionary fiscal policy and, in particular, a sharp increase in public investments that together with domestic consumption have supported economic growth. In FY2008/2009,[3] growth was 4.7 percent, down from previous years (see Graph 1), but definitely positive given the global context.

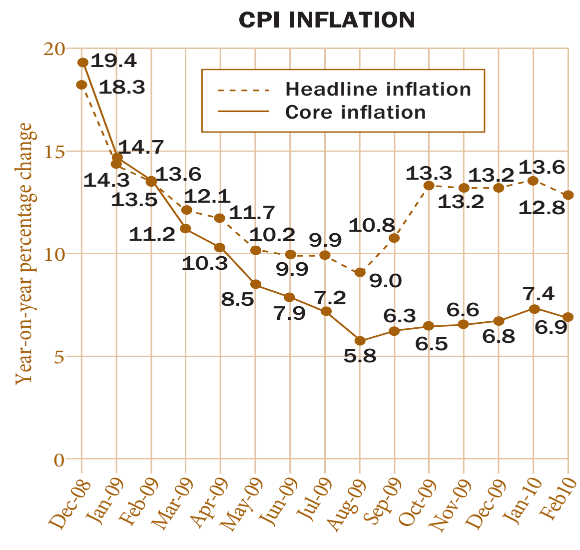
Growth is expected to accelerate in FY2009/2010, reaching 5.5 percent according to official sources. The negative effects of the crisis are, in fact, declining. In the second half of 2009, tourism receipts were growing again, and so were portfolio investments, thus fuelling international reserves. Furthermore, since the beginning of 2010, Suez Canal revenues have been increasing. Nevertheless, exports, remittances, and foreign direct investments have not yet displayed any sign of recovery. Consequently, economic growth still remains largely dependent on expansionary monetary and fiscal policies.

[1] Franco Zallio is senior consultant to Paralleli, and has published extensively on issues related to the economics and international relations of the Mediterranean and the Middle East. The views expressed in this brief are those of the author and do not necessarily represent the views of the German Marshall Fund of the United States.
[2] By the end of June 2008 public debt was equal to 76 percent of GDP, a sharp decrease compared to the 113 percent of three years earlier.
[3] Egyptian statistics are based on fiscal years beginning July 1.



Source: Ministry of Economic Development.

Graph 1



Source: CAPMAS and Central Bank of Egypt.

Graph 2

Egypt's new challenges

However, expansionary policies have their limitations. In FY2009/2010, the public deficit may exceed budget targets (8.4 percent of GDP), despite some infrastructure investments having been kept off-budget. To avoid a public debt crisis, the current deficit will have to be rebalanced, perhaps sooner than scheduled by the government, which had already decided to postpone the FY2014/2015 reduction of the deficit to 3 percent of GDP. Deficit containment measures—both the tax system review and energy subsidy reform—are likely to be postponed in view of the forthcoming elections.[4] Plans for a new property tax have already been delayed.

Furthermore, expansionary monetary policy risks are stoking inflation, which in 2008 generated severe social tensions. After a rapid decline, compared to its peak in August 2008 (at 23.6 percent), inflation is accelerating again, and since last October it has stabilized around 13 percent. As Graph 2 shows, core inflation[5] is lower, a modest consolation since it excludes goods of particular relevance for the population. Moreover, rising inflation can be reinforced through its effect on expectations.

Today, the main economic challenge facing Egypt does not concern its macroeconomic equilibrium, but rather inadequate economic growth, which is insufficient to improve its deep social problems. Higher growth rates are necessary to extend the benefits of economic reform to the whole population, reducing unemployment and poverty.

According to the—notoriously underestimated—official statistics, in FY2008/2009 unemployment grew again after a three-year decline (see Graph 1) and is now approaching 10 percent.[6] In the Egyptian context, characterized by rapid labor force growth and structural economic weaknesses, a 7 percent growth rate, as it was recorded in FY2005/2006-2007/2008, is needed for an extended period in order to significantly reduce poverty and unemployment. For this goal, expansionary policies alone are insufficient. Structural measures, related to a deepening of economic reforms and to human capital formation, are needed.

Greater liberalization of services will be especially important. The topic is politically controversial, touching upon areas where the intertwining of politics and economics is particularly strong, and where it is feared that liberalization might produce nega-

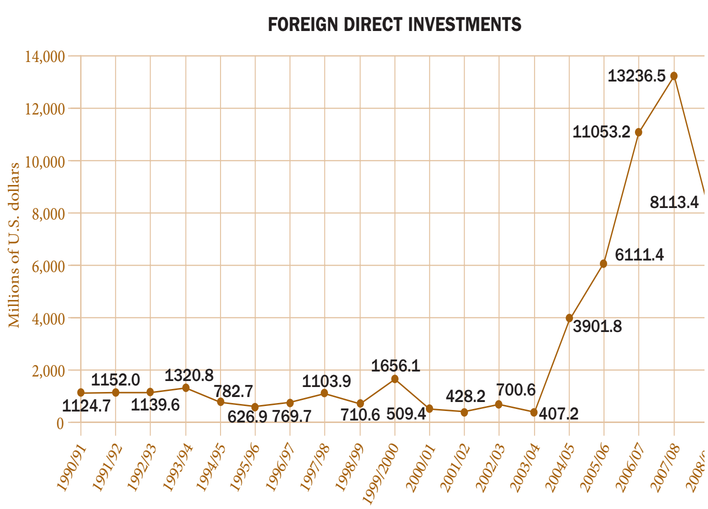
[4] In 2010, parliamentary elections will be held (the upper House in June, and in November the most important, that is the lower House), while in September 2011 Presidential elections will take place.

[5] This is computed by the Central Bank excluding fruits and vegetables, whose prices are very volatile, as well as regulated items such as energy products.

[6] The increase in unemployment is partially a direct result of the international crisis. The Dubai crisis, along with the economic difficulties of other Gulf monarchies, forced tens of thousands of Egyptians working in the region to return home.

tive effects on employment and consumer prices. Furthermore, the international economic crisis has accentuated criticisms and suspicions regarding liberalizations. Nevertheless, liberalization of services offers great potential for economic development. For example, according to a World Bank study, "removing barriers to trade in transport services would reduce export costs to the European Union by 10 percent and import costs from the European Union by 16 percent. These efficiency gains could imply up to 1 percentage point of additional output growth per year."[7] Even bank services would benefit from a new opening. After some improvements, banking sector reform is progressing slowly, and privatizations are frozen after the *Banque du Caire* sale was halted in 2008. Facing international crisis, the banking system has been resilient and liquidity remains ample, but intermediation of savings and private sector access to credit need to grow, given the traditional focus of the banking sector on financing large enterprises and the public sector.

Greater liberalization of services would also revive direct foreign investments. The decline of which, already visible in FY2008/2009 (see Graph 3), accelerated during July—December 2009



Source: Central Bank of Egypt

Graph 3

(US$2.6 billion against 4.0 billion of the same period of the previous year). In fact, the crisis has reduced only temporarily Egypt's attractiveness for foreign investors.[8] Ultimately, Egyptian attractiveness has increased relative to other emerging economies that have been hit more seriously by the crisis in terms of economic growth, financial stability and the macroeconomic equilibrium.

Egypt's attractiveness for outsourcing activities in the service sector, where it could exploit the wide knowledge of English, has been highlighted by several studies. The deepening of reforms in the service sector would further expand this attractiveness and allow Egypt to better exploit its favorable geographical position to strengthen its role in regional transport and communications.

Nevertheless, like fiscal consolidation measures, the deepening of reforms is hostage to the upcoming elections, albeit no one expects surprises from the parliamentary elections.[9] The obsessive discussion about Hosni Mubarak's succession—in the scenario he would not run for a sixth term in 2011, when he will be 83—represents a sign of frustration more than a hope for renewal.[10]

A transatlantic approach?

Egypt's challenges cannot, thus, simply be reduced to the identity of candidates in the presidential election of 2011. The main challenges seem to flow primarily from the regional and socio-economic context. After a prolonged decline, Egypt needs to boost its regional role. Some positive signals are emerging: the co-presidency of the newly born Union for the Mediterranean that Egypt assumed—along with France—in July 2008; the choice of Cairo as the location for Obama's June 2009 speech to the Islamic world; Egyptian participation in the G8 summit in L'Aquila, albeit in an undefined position,[11] as well as the subsequent French and Italian proposal to institutionalize the L'Aquila summit in a "G14," which Egypt would join. On balance, however, the emergence of the G20 as the main forum for international

[7] World Bank, *Egypt and the Global Economic Crisis: A Preliminary Assessment of Macroeconomic Impact and Response*, Volume I: Main Report, August 16, 2009, p. 14.

[8] LSE Outsourcing Unit, *Beyond BRIC. Offshoring in non-BRIC countries: Egypt—A New Growth Market,* January 2009, http://www.outsourcingunit.org/publications/BeyondBRIC_interactive.pdf; Commonwealth Business Council-Cybermedia India, *Outsourcing To Africa. A Relative Ranking of 15 Country Locations*, February 2009, http://www.cbcglobal.org/CBC_Pages/LibraryDetails.aspx?LID=398; A. T. Kearney, *The Shifting Geography of Offshoring—The 2009,* A.T. Kearney Global Services Location IndexTM, 2009.

[9] After the success in the 2005 elections, when they obtained 88 of the 454 available lower House seats, the Muslim Brotherhood were subject to a strong repression that weakened them. Several internal divisions emerged that lead, last January, the conservative wing (which shows little interest in the parliamentary game) to play a dominant role in the election of the new supreme guide of the movement. The small secular opposition parties are very weak, often close to irrelevance.

[10] The return home of Mohamed El-Baradei—former Director General of the International Atomic Energy Agency—has triggered again the debate on future Presidential candidates, which sees on top of the list Gamal Mubarak, the son of the President, who has been for years threading a net of alliances straddling from the business community to minorities. For example, in July 2009 the Coptic patriarch Shenuda III went as far as saying during a TV interview that "most Egyptians love Gamal Mubarak and would vote for him before any other candidate." This intervention raised several critiques among the Coptic community.

[11] As stated by the summary of the Italian Presidency, "from July 9th [the G8 leaders] were joined by Brazil, China, India, Mexico, and South Africa, establishing a structured and continued dialogue on a broad range of global issues. Egypt was also invited to participate in the meeting."

economic cooperation has reduced the role of Egypt, which is not a member of the G20 (to which only one Mediterranean non-EU member belongs, namely Turkey, as well as only one Arab State, Saudi Arabia). The regional and socio-economic challenges are deeply intertwined. A scenario whereby Egypt—thanks to strong economic growth—could finally succeed in diminishing its severe social problems, would also allow it to gain a greater role in international economic governance.

In the context of Egypt's challenges and opportunities, the United States and the European Union have clear common interests, together with the potential for playing a major role in shaping future prospects. Notwithstanding the rapid expansion of the last years in trade relations between Egypt, China, and other Asian countries, the European Union and the United States still account for more than half of Egypt's foreign trade. According to Egyptian statistics, in FY2008/2009 trade with the European Union was equal to 36.3 percent of Egypt's total trade, while that with the United States represented 18.4 percent of its overall trade. These trade relations have also greatly benefited from the Egyptian economic reforms, and have recorded significant growth rates.[12] Despite the foreign direct investment boom from Gulf countries of the last years (which is now declining after the Dubai crisis), American and European investors continue to play a key role.

Even more significantly, American and European policies toward Egypt tend to be complementary. Competitive tensions, which emerged in the last decade, have been overcome. The tensions were particularly evident when the Bush administration launched an ambitious bilateral Free Trade Agreements (FTA) program, in reaction to the proliferation of bilateral FTAs by Europe and Asia. Out of this program, in 2003, the U.S.-Middle East Free Trade Initiative was launched. At the time, this was perceived to be in competition with the Euro-Mediterranean FTA launched in Barcelona in 1995. The obstacles that both European and American initiatives met have subsequently reduced competitive tensions. The American project has essentially stalled after an initial number of agreements (with Bahrain and Morocco in 2004, and with Oman in 2006; previous administrations had already concluded free trade agreements with Israel and Jordan).

Egyptian free trade negotiations stalled in 2003, in part for economic reasons (the then U.S. Trade Representative, Robert Zoellick, criticized the Egyptian authorities for not implementing the necessary measures),[13] and in part for lack of Egyptian support during a dispute between the United States and the European Union at the World Trade Organization on GMOs.[14] In 2004-2005, U.S. pressure for an opening of the Egyptian political system (especially in preparation of the 2005 parliamentary elections) put an end to attempts to revive negotiations.

Yet bilateral trade did not suffer. In 2004, the United States extended to Egypt the same special terms previously granted to Jordan in support of joint industrial activities with Israel. These terms were applicable to the so-called Qualifying Industrial Zones (QIZ); special zones whose products can enter the American market duty-free as long as they respect the relevant rules of origins. In the Egyptian case, this implies a minimum of 35 percent local content, of which at least 11.7 percent should be Egyptian content, and 10.5 percent Israeli content. The QIZ have been a remarkable success. In 2008, exports to the United States of goods produced in Egyptian QIZ totalled US$874 million, more than three times the 2005 level. However, the QIZ—while supporting an Egyptian textile industry[15] that was suffering the impact of the end of the Multifibre agreement—have not played any role in deepening the economic reforms that would have been supported by a free trade agreement.

A recent study on U.S.-Egypt economic relations[16] assumes that an FTA is not a practical option in the near term given the impact of the international economic crisis and the continuing divisions in U.S. trade policy. It goes on to suggest a series of measures including the expansion of the QIZ to areas other than textiles, a bilateral agreement on trade in services focused on transport, construction, electricity, information and communication; technical assistance in customs, ports and intellectual property; infrastructure projects and human capital formation that could be funded by the Millennium Challenge Corporation.

These proposals are largely complementary with the evolution of EU trade policy toward Egypt. Even the European FTA

[12] According to U.S. statistics, in 2009 exports to Egypt were equal to US$5,258 million (against 2,607 million in 2003), while imports from Egypt were 2,058 million (against 1,143 million in 2003). According to EU statistics, in 2008 exports to Egypt were €12,743 million (against 6,346 million of 2003), and the imports from Egypt were 8,234 million (against 3,577 million in 2003).

[13] "We know that Egypt is the traditional heart of the Arab world. We know the population. We know the opportunity. But what's important for Egyptians to recognize is that this is not just going to be handed to them on a plate by foreign ministers because Egypt is a big and important country. It's going to require some work," Zoellick Q&A Following Speech to World Economic Forum, Dead Sea, Jordan, June 23, 2003.

[14] "U.S. beats Egypt with trade stick" and "U.S. retaliation against Egypt hits trade plans," *Financial Times*, June 29, 2003.

[15] Textile products represent around 90 percent of QIZ output.

[16] Barbara Kotschwar and Jeffrey J. Schott, *Reengaging Egypt: Options for U.S.-Egypt Economic Relations,* Peter G. Peterson Institute for International Economics, January 2010.

[17] The Euro-Mediterranean association agreement with Egypt, whose negotiations were launched back in 1994, was signed in June 2001, and it entered into force only in June 2004. The agreement provides for a 15-year transitory phase before the free trade comes fully into force, a free trade in any case limited to industrial products.

project faced strong difficulties and was subject to long delays. The deepening of economic relations with the EU has long been hostage to Egyptian reluctance to undertake economic reforms. Egypt is, thus, one of the last Mediterranean countries to start tariff dismantling.[17] Egypt will complete this process only by 2019, lagging well behind the 2010 target for completion of a Euro-Mediterranean FTA.

It was only after the revival of Egyptian economic reforms in 2004 that cooperation with the European Union has intensified. The FTA had finally entered into force, and in the subsequent years further negotiations were launched to deepen and extend it to other products. In 2008, negotiations were concluded for further liberalization of bilateral trade in agricultural and processed agricultural products, as well as fish and fishery products. Also in 2008, bilateral negotiations on the liberalization of trade in services and the right of establishment were launched.[18] In December 2008, the European Union and Egypt signed a Memorandum of Understanding (MOU) on a strategic partnership in energy. Egypt is the sixth largest supplier of gas of the European Union, besides being a modest oil producer.

In April 2009, the EU-Egypt Association Council endorsed the Egyptian proposal to negotiate a deepening of relations with the EU, which could partially follow the model of the advanced status that Morocco negotiated with the European Union in 2008, and which led to the first Morocco-EU summit in Barcelona in March 2010. Finally, in the coming years, European aid will concentrate on supporting reform of the transport and energy sectors, as well as supporting trade facilitation measures and human capital formation.

These issues broadly correspond to the proposals for strengthening economic relations between the United States and Egypt. Today, as economic reforms are slowed down by the upcoming Egyptian elections and the continued fallout from the international economic crisis, the United States and the European Union could align their policies toward Egypt in favor of greater economic openness, to ease Egypt's serious social problems and to strengthen its regional potential.

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Paralleli's mandate is to contribute to the creation of a Euro-Mediterranean area of freedom and of economic and social development. The institute acts at the local, national, and international level with the aim of meeting the needs of the North-West region of Italy concerning its relations with the other sides of the Mediterranean Sea. The activities of the Institute fall within the process of Euro-Mediterranean partnership initiated by the European Union with the 1995 Barcelona Process and currently undergoing a major relaunch through the "Union for the Mediterranean," since July 2008. Paralleli intends to contribute to the reinforcement of political relations, economic cooperation, cultural exchange, and human flows between the European and the South-East Mediterranean countries. Its main objective is to promote dialogue at cultural, social, and political level between the societies of the Mediterranean countries, with the aim of encouraging and improving economic relations between them, with a particular focus on the dimension of sustainability and co-development. For this reason, the institute has decided: to involve civil society in the development of Euro-Mediterranean relations; to create and to support networking in the Mediterranean area; and to increase the value of research in order to suggest truly effective policies to local, national, and international actors.

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[18] Commission of the European Communities, *Implementation of the European Neighbourhood Policy in 2008. Progress Report Egypt*, SEC(2009) 523/2, Brussels, 23/04/2009.