

Egypt's Economic Crisis: How to Help Cairo Help Itself

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Brief Analysis

Because Egypt's economic crisis has political roots, international donors cannot save the country by themselves. But they can use the IMF negotiations to help Cairo recognize that a turnaround will require not just economic reform, but more inclusive government and political reconciliation.

Just as Washington is contending with a spreading civil war in Syria and trying to head off a conflict with Iran, U.S. policymakers find themselves worrying about yet another looming contingency: economic collapse in Egypt. As Secretary of State John Kerry stated during his recent visit to Cairo, "It is important, even urgent, that the Egyptian economy gets stronger." The United States and its allies have several options for addressing this concern, but each requires a fuller understanding of the country's economic problems and how the Egyptian government has responded thus far.

IMMINENT COLLAPSE?

Since the January 2011 revolution, Egypt has been gripped by deepening stagflation: economic growth in the last three months of 2012 was a mere 2.2 percent according to official data, while inflation rose in February 2013 to an annualized rate of 8.7 percent, its highest level since 2010. This combination has placed mounting pressure on ordinary Egyptians, who face rising prices for basic goods (e.g., food, medicine) and increasing unemployment, which rose to 13 percent in the last quarter of 2012, up from 9.8 percent during the same period of 2010 -- which translates to an additional 850,000 jobless people.

These problems are largely driven by two factors. First and foremost is political instability, which has spurred capital flight and harmed domestic businesses. Second is the lack of flexibility in Cairo's fiscal and monetary policies, particularly its mounting budget deficits (a result of large food and fuel subsidies) and its efforts to defend the Egyptian pound against devaluation.

Political instability following the revolution, which has yet to abate, drove a massive outflow of foreign direct

investment and portfolio investment; according to Egypt's Central Bank, these losses totaled \$418.1 million and \$3.3 billion, respectively, in the second half of 2011. This in turn encouraged Egyptians to convert their deposits into dollars and move money abroad, exacerbating the pressure on the pound.

The capital outflows have been accompanied by a sharp decline in tourism, another important source of foreign exchange. Egypt's Tourism Ministry has reported a "loss" of \$2.5 billion in tourism revenue since January 2011 compared to typical pre-revolution levels, and the World Economic Forum recently -- and devastatingly -- ranked the country as one of the world's most dangerous destinations for tourists. These developments decreased demand for the pound, the value of which has declined from about 5.8 to the dollar in 2010 to a record low of 6.78 today (and reportedly 7.3 on the black market).

Eager to avoid an increase in the prices of key imports priced in dollars, the Central Bank moved to defend the pound's value, resulting in a staggering decline in Egypt's foreign exchange reserves from almost \$37 billion before the revolution to about \$13.5 billion today. Furthermore, about half of these reserves are in the form of gold, which is essentially illiquid because it is deposited in Egypt. This means that available reserves are sufficient to cover just over a month's worth of imports, which is critical given Egypt's need to purchase fuel and wheat on global markets and service its external debts.

Meanwhile, the government's post-revolution budget deficit and debt have increased at an accelerating rate as the pound's diminishing value and high global commodity prices drove up Cairo's subsidy bill (which accounts for at least 27 percent of all government spending). This was accompanied by increased spending on social benefits, a key demand of the revolution. Overall, subsidy and social benefit spending rose 49 percent from July 2012 to January 2013 compared to the same period the previous year; the budget deficit rose by 36 percent to \$17.7 billion that period and is projected to increase to \$27-34 billion by July. With Egypt's international credit rating repeatedly downgraded, the government has been forced to finance these enormous deficits by relying almost exclusively on domestic debt, which last year rose \$34 billion to reach \$184 billion, or almost 70 percent of gross domestic product. This has increased domestic borrowing costs, potentially crowding out private-sector borrowing that is vital to renewed economic growth.

Taken together, these developments paint a dire picture for Egyptians, especially if the government runs short of the foreign exchange required for food and fuel imports, resulting in shortages. According to Egypt's Ministry of Industry and Foreign Trade, food products represent about 17 percent of the country's imports, and oil products about 18 percent. From 2011 to 2012, these imports increased at least 10 and 28 percent, respectively. Egypt's wheat supply is reportedly already under pressure, reduced from six months' stock to three. The alternative -- ending the Central Bank's defense of the pound -- could mean a sharp drop in the currency's value, significant inflation, and even more pressure on the budget and the banks. Either way, Egypt faces the possibility of significant economic hardship and further social unrest.

For its part, the Egyptian government appears to be banking on a third scenario -- muddling through. President Muhammad Morsi's current policy amounts to reducing food and fuel imports, though not to crisis levels, while counting on stopgap assistance from friendly countries to prevent the Central Bank's foreign exchange reserves from reaching critical levels. Yet this policy cannot be sustained indefinitely; public anxiety about the pound is accelerating dollarization of deposits, and upcoming debt payments could combine with other factors to trigger a deeper crisis (similar to the \$650 million Paris Club payment Cairo made in January, which caused a sharp drop in reserves).

IMF TO THE RESCUE?

As it looks for a way out of this dilemma, the Morsi government appears to have pinned its hopes on two external

sources of capital. The first is money supposedly held abroad by former officials of the Mubarak government. Yet Egypt's finance minister recently announced that less than \$15 million in such funds had been recovered to date, despite domestic media reports that billions were available for recovery. The final return on these efforts will likely be disappointing due to international legal challenges. Moreover, the sometimes capricious-seeming pursuit of such funds has hurt the local business environment and may well deter domestic and foreign investors. A recent example is the sharp drop in the Egyptian stock market, which followed the imposition of travel bans against members of the wealthy Sawiris family. Whatever modest short-term gains the recovery efforts yield, the seemingly politicized prosecutions of businessmen will likely undermine the country's recovery.

Cairo is also pursuing a stand-by agreement with the International Monetary Fund amounting to \$4.8 billion, along with several billion in additional aid from the United States, Europe, and elsewhere that is dependent on an IMF deal. Egypt and the IMF reportedly reached a tentative agreement in late 2012 on a reform plan, but Cairo reneged on mandatory tax increases within hours of announcing them, nullifying the agreement. Although many observers expected the IMF to soften its terms -- whether because Egypt is "too big to fail," or in response to pressure from the Obama administration, which has strongly backed Morsi -- the agency has held fast. The IMF and other donors are undoubtedly cognizant that giving Egypt money under the current circumstances would -- like the \$5 billion or more already provided by Qatar and the \$2 billion Libya sent recently -- merely extend the time it takes for Cairo to exhaust its foreign reserves, without addressing the country's underlying economic problems.

IMF or other major international aid is unlikely to flow to Egypt until the Morsi government does three things:

1. Put forward a credible reform plan that tackles the foremost economic challenges, namely, replacing costly, regressive subsidies with targeted social spending, boosting tax revenues, allowing the pound to move more freely, and improving the business and investment environment, including for foreigners.
2. Spend political capital to secure broad support for the reform plan and build consensus around the economic way forward. Given the fractious state of Egyptian politics, this will likely require Morsi to address the opposition's other primary grievances, particularly the flawed new constitution adopted over the objections of non-Islamist parties.
3. Enhance the government's capacity to implement the reform plan by drawing on talent outside the Muslim Brotherhood's ideological circle for key ministerial positions, something Morsi has thus far been reluctant to do.

The latter two steps in particular would represent a sea change, since the Brotherhood currently appears more eager to fight ideological battles than promote political reconciliation and advance national interests.

With parliamentary elections looming, Morsi will not be eager to undertake this difficult work, as it would likely harm the Brotherhood's electoral fortunes. In fact, the group seems to view its projected electoral victory as a substitute for hard-won political consensus. Brotherhood leaders may therefore try to muddle through economically until then. Given the extended timeline for elections, however, Morsi may not be able to stave off crisis for that long. And even if he does, the international community's three prerequisites for aid will likely remain in force after the vote.

Assuming the Brotherhood is capable of skirting the immediate political danger of enacting painful reforms before the election, many question whether it can transform its broader approach to governing sufficiently to satisfy international donors and investors. In particular, this would mean forsaking economic populism, appointing technocrats rather than ideologues, and winning over non-Islamists rather than steamrolling them.

Finally, even if external assistance is forthcoming, it can only serve as a bridge until private-sector capital flows resume and Egyptians themselves begin to reinvest in the economy. Due to the nonstop turmoil that has gripped the country in recent months, simply securing an IMF agreement is unlikely to persuade private investors, much less tourists, to return. That will require an extended period of quiet and political stability, which could be an eventual

but not immediate byproduct of the process outlined above.

IMPLICATIONS FOR U.S. POLICY

Given the scale of Egypt's economic challenges, the \$190 million in budgetary support that Secretary Kerry announced during his visit was purely symbolic. In fact, it may do more harm than good -- in addition to breaking international solidarity over withholding aid until an IMF agreement is reached, the pledge may have reinforced Morsi's view that U.S. support will come regardless of the Brotherhood's approach to economic policy and governing. The U.S. interest is not simply in purchasing goodwill with the current government, but in ensuring that Egypt avoids economic collapse -- with its attendant risk of deeper unrest -- and hews to a path of democratic development and economic recovery.

Yet efforts to impose conditions on U.S. aid to Egypt are complicated by the fact that bilateral funding alone provides little meaningful leverage given the size of Cairo's external financing needs. If Egypt's budget deficit grows as projected, even the \$3 billion in total annual aid -- including military assistance -- traditionally provided by Washington will represent only about 10 percent of Cairo's fiscal gap. Successful aid conditionality requires that Egypt see the conditions as less costly than forgoing the aid altogether -- assuming that Washington's goal is for the conditions to be met and the aid to be disbursed, rather than simply using the conditions to send a message with the expectation that they will not be met, meaning the aid will be withheld.

This leaves Washington with two viable options for conditioning economic aid to Egypt (military aid is a separate question). First, it could impose "easy" conditions or no conditions at all, so that Cairo receives the funds regardless -- essentially, the current approach. As noted above, whatever small measure of goodwill this approach buys in the short term pales in comparison to the lost opportunity to help stabilize the country and shape the Brotherhood's approach to governance.

The alternative is to unify all international donors behind a common set of conditions, most notably an IMF agreement. This approach has the benefit of giving Washington far more leverage, since the total foreign aid at stake could amount to \$15 billion or more. In addition, the conditions imposed would enjoy strong support internationally and, to some extent, in Egypt.

The Obama administration should use this leverage and its strong ties with the Egyptian government to achieve the broad, positive effects inherent in Cairo meeting the terms of an IMF agreement. This does not mean restricting itself to economic conditionality. Rather, it means convincing Morsi to make a broad set of vital but painful decisions (credible economic reform, political reconciliation, and capacity-building in key ministries) needed to secure international aid -- preferably before the parliamentary elections, but if necessary after them. If other conditions are added, Washington must make the diplomatic effort to gain international support for them so that Morsi does not believe he can simply ignore U.S. demands.

The administration can further increase its leverage by convincing regional allies to pledge assistance contingent on Cairo taking the above steps. These allies have the capacity to provide aid but are wary of the Brotherhood. Washington should convince them that their interests would be better served by offering conditional assistance as an incentive for the Brotherhood to change its approach to governance; the alternative is potential economic collapse in Egypt, with its attendant consequences for regional stability.

Some have criticized this sort of approach as "letting Egypt fail." Yet it is not within Washington or the IMF's ability to singlehandedly prevent Egypt from failing. The best the United States can do is help the Morsi government help itself -- or, if Cairo proves unwilling, to gird itself for the consequences of a deeper economic crisis in Egypt.

Michael Singh is managing director of The Washington Institute. ❖

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