

# A Crisis of Confidence

by [David Schenker \(/experts/david-schenker\)](/experts/david-schenker)

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## ABOUT THE AUTHORS



[David Schenker \(/experts/david-schenker\)](/experts/david-schenker)

David Schenker is the Taube Senior Fellow at The Washington Institute and director of the Program on Arab Politics. He is the former Assistant Secretary of State for Near Eastern Affairs.



## Articles & Testimony

From failing European economies to staggering murder rates in Central America, there's no shortage of crises on the agenda as the International Monetary Fund holds its annual spring meeting in Washington this week. Of all the problems within the IMF's purview, however, the ongoing economic deterioration in Egypt may be the most acute. Compared to the problems in Europe, the Egyptian economic meltdown is relatively inconsequential, yet the regional implications could be profound. While not specifically on the agenda, the crisis in Egypt may very well overshadow the conference.

The attention is well warranted. With 83 million people, the Suez Canal, and a peace treaty with Israel, stability in Egypt matters. Recognizing this, the IMF has spent the past year trying to cajole a financially struggling Egypt to accept a \$3 billion loan. Despite the best of intentions, though, the loan program is at most a stopgap measure.

The situation in Egypt is increasingly dire. Political uncertainty and an absence of physical security have scared away tourists and investors alike as local capital has taken flight. With unemployment and inflation up, consumer confidence is down and the mood is dour. In March, 88 percent of those polled said they were pessimistic about Egypt's economic prospects -- an astounding increase from 11 percent just a month earlier in February.

News on the macroeconomic front is little better. Since the February 2011 revolution, the state's foreign reserves have dwindled from \$36 billion to less than \$15 billion and are falling at a rate of \$600 million a month. Cairo has been using its reserves to defend the pound, but a continued drop in reserves will result in currency devaluation or hyperinflation, a devastating prospect for a state where more than 40 percent of the population lives on less than \$2 a day.

Short on cash and with precious few sources of revenue, Cairo is borrowing from domestic banks at interest rates in excess of 15 percent to help cover its \$23 billion budget deficit. It also borrowed \$1 billion from the Egyptian military. The military-appointed transitional government has also been looking abroad for assistance. Regional donors include Saudi Arabia, which has delivered about a billion dollars, and says it will honor its pledge to donate another \$2.75 billion.

As for Western institutional lenders, Egyptian populism and politics have made their money all but untouchable. Shortly after the uprising, the interim Egyptian government gave in to anti-American sentiments -- 70 percent of

Egyptians say they no longer want U.S. assistance -- and declined a \$3 billion IMF loan. More recently, the FJP declared its opposition to an IMF loan so long as the transitional government remains in power. This has served as an effective veto on IMF action, since the fund requires "broad political support" for its loans.

After the presidential elections this summer and the seating of a new -- presumably Islamist -- government, the FJP has hinted that it will relent and drop its opposition to the loan. But this alone will not solve the state's economic woes. Going forward, the key will be to restore domestic and international confidence in the Egyptian economy, no mean feat given the volatile political environment.

Consider the Egyptian stock market, which lost half its value in 2011. In early 2012, the FJP reached a modus vivendi with the military's ruling Supreme Council of the Armed Forces (SCAF) and stocks rebounded. But rising Islamist-SCAF tensions have reversed this trend. The day after the FJP nominated a presidential candidate, the EGX 30 stock index dropped almost four percent.

Of equal concern to foreign investors, as well the tourism industry, are the social changes the Islamists say they intend to effect. One concern is a potential ban on bikinis and alcohol that would permanently cripple Western tourism in the Sinai. But the FJP and their ultra-conservative Salafist cousins -- who control 27 percent of parliament -- have a broader legislative agenda that includes instituting sharia and the penalties associated with it -- like cutting the hands of recidivist thieves -- lifting the legal ban on female genital mutilation, and mandating that Muslim women wear hijabs.

Despite these potentially damaging social policies, the Muslim Brotherhood has been continuously reassuring skeptics of its commitment to a free market economy. Months ago, Hassan Malik, one of the organization's chief local financiers and policy advisors, said it in the most impolitic way possible. The economic policies of the Mubarak regime, he said, "were on the right track, but were marred by rampant corruption and nepotism."

Since then, the Muslim Brotherhood has issued a detailed economic program that could easily pass for European-style capitalism -- including trade protectionism -- and FJP parliamentarians have visited the Egyptian bourse. More recently, earlier this month, Malik founded the Egyptian Business Development Association, an NGO dedicated to attracting foreign investment and encouraging local entrepreneurs. While these sentiments may be reassuring, it's unclear if they'll be sufficient, particularly when senior leaders of the organization, like erstwhile presidential candidate Khairat al-Shater, suggest that there will be "social constraints" on the private sector in the "Islamic system."

It's possible that the Muslim Brotherhood will delay, for pragmatic purposes, the implementation of sharia legislation until the economy rebounds. It's also conceivable that investors will ignore oppressive social legislation and invest if the regulatory environment is sound. After all, Egypt offers investors a large, young workforce, as well as a growing consumer class that, last year, enticed Procter & Gamble to build a \$1.5 billion diaper factory just outside of Cairo.

Still, continued uncertainty and insecurity may keep investors away. While there is little the Muslim Brotherhood and the FJP can do about the insecurity, Islamist missteps could exacerbate economic difficulties. Should the Islamists move too fast in pursuing their theocratic agenda; bait the military into a confrontation; provoke the ire of the remaining secular and/or Christian minority; or sour the West with intolerance at home, Egypt will remain in a state of revolution, allowing neither a return to political normalcy nor economic stability.

The Muslim Brotherhood has a lot to prove in Egypt. But Washington also has a lot invested in the success of the Islamists. Indeed, on March 3, State Department spokeswoman Victoria Nuland said the United States was "committed to ensuring Egypt's economic and financial stability." No doubt, the prospect of Egypt as a failed state is unappealing. Yet it's not exactly clear what the administration's commitment entails -- or whether the obligation will

endure implementation of illiberal and repressive legislation in Cairo. Washington is not likely to bail Egypt out indefinitely.

While neither American -- nor IMF -- funding will determine the trajectory of Egypt, this week's IMF meetings do present an opportunity to encourage Egypt toward a more pragmatic path. The mandate of the IMF is not governance, but economic growth and alleviating poverty. Nonetheless, Washington and its European allies should emphasize to Egypt -- and the Islamists who will soon govern -- the inverse relationship between radicalism and foreign direct investment. At the same time, Egypt should be encouraged to commit to economic reform, and to lay out a clear vision of where the economy is headed.

With a supermajority in parliament, it will be tempting for the Muslim Brotherhood and its Salafist fellow travelers to prioritize the legislating of a hard-line Islamist domestic social agenda. But progress on this front will have a cost -- both at home and abroad. Should Egypt's Islamists not behave responsibly, prospects for stability and economic recovery will remain remote.

*David Schenker is the Aufzien fellow and director of the [Program on Arab Politics at The Washington Institute](https://www.washingtoninstitute.org/about/research-programs/program-on-arab-politics/) (<https://www.washingtoninstitute.org/about/research-programs/program-on-arab-politics/>). ❖*

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