Economic reform early success is promising; key challenges remain

Highlights

- The Egyptian government recently adopted an ambitious economic reform program to address macroeconomic vulnerabilities and promote inclusive growth and job creation.
- The stabilization program focuses on reducing the budget deficit through gradual subsidies cut, tax reform, and floating the exchange rate, and on structural reforms to boost private sector investment and growth.
- Egypt’s early success is promising but continues to face a host of economic challenges and vulnerabilities.

Egypt has great potential, including an abundant labor force, a well-diversified economic base and an important geographic location that provides easy access to vital foreign markets. Yet, economic development was constrained by the legacy of a large role for the state in economic activity, weak governance and inward-oriented economic policies. This prevented Egypt from taking full advantage of the opportunities provided by globalization that helped lift living standards among many of its peers. To reverse these trends, the Egyptian economy has undergone major changes over the past couple of years, in the context of an ambitious economic reform program. Much progress has been made under the program, which ushers in a new era with great opportunities, but Egypt continues to face a host of economic challenges and vulnerabilities.

Legacy of Egypt’s Development Model

For decades, the Egyptian economy was characterized by its dependence on government subsidies and by a large public sector workforce, leaving little fiscal room for policies that would boost private sector activity and economic development. The dominant role of the state made government spending the primary driver of economic growth, which led to weak productivity growth and slow job creation.

Egypt’s growth in the last two decades has been insufficient to improve living standards and reduce poverty. Growth averaged 4.2% over 1990-2017, reaching an all-time high of 7.5% in 1997/98, but GDP per capita growth was modest at around 1.9%. The labor force stagnated at around 44% of the active population and the unemployment rate remained close to 10%, with much higher rates among women and the youth. Thus, while Egypt’s economy appeared to grow, inequalities and poverty were increasing. According to the World Bank, the national poverty rate has been creeping up, reaching 27.8% in 2015, compared to 26.3% in 2012 and 19.6% in 2004.

Chart 1: Egypt’s economic growth
(Average growth, %)

Due to a combination of political instability since 2011 and poor economic management, economic conditions deteriorated resulting in severe macroeconomic imbalances. GDP growth slowed to 3.3% during 2011-17, the exchange rate became overvalued, foreign exchange reserves dropped substantially, and fiscal deficits and public debt increased to record highs. These problems were also a manifestation of the weak economic governance over the past decades.

The economic reform program

Faced with dire economic conditions, the Egyptian government recognized the seriousness of the situation and adopted in late...
2016 an ambitious and politically difficult economic reform program, supported by $12 billion loan from the IMF, with the aim of addressing macroeconomic vulnerabilities and promoting inclusive growth and job creation. The program involved mainly a gradual phasing out of state subsidies, a tax reform and the flotation of the Egyptian Pound (EGP). Besides recalibrating the economy, the difficult measures undertaken aim to attract foreign direct investment and to demonstrate to Egypt’s regional and international partners that the government is very much committed to the success of the adjustment program.

Subsidy reforms

Subsidies served as a key policy tool and a social safety net to support low-income households and maintain political stability. However, the subsidies were not well targeted, benefiting all regardless of their income and wealth and imposing a heavy burden on public finances. Rising international oil prices and growing domestic demand for energy products led to a dramatic increase in energy subsidies, reaching 22% of total government spending in 2011/12, compared with 9% a decade earlier.

With fuel subsidies being a major contributor to the increasing budget deficit, energy subsidy reform was a strategic priority for the government. In fact, Egypt started reforming its subsidy system slowly in 2012 by increasing gasoline prices and raising electricity prices in 2013. These reforms were not sufficient to reduce the fiscal deficit to a sustainable level. Therefore, the government adopted deeper reforms of public expenditure in July 2014, with the goal of reducing fuel subsidies to 0.5% of GDP by 2019 from 7% in 2013, through periodic rises of fuel and electricity prices. These price hikes, combined with lower global oil prices, have helped the Egyptian government lower spending on subsidies. More recently, energy and domestic water tariffs were increased by up to 50% in August 2017. Moreover, the government tightened eligibility rules for food subsidy cards, and at the same time increased rations for remaining subsidy cardholders, in an effort to cushion the most vulnerable against soaring prices. However, the government partially reversed an earlier decision to lower subsidies on bread in March 2017, given that bread is a key food staple that directly affects millions of people.

In this context, it is possible to improve further the targeting of subsidies through the use of biometric data. India provides a good example. Like Egypt, India which has large population and high poverty rate was able to strengthen its social safety net and reduce inefficiency and corruption by adopting biometric data as a form of identification, and by creating a payment architecture based on the ID system to channel direct subsidies and benefits.

Tax reforms:

To reduce the large fiscal deficits and the debt-to-GDP ratio, the government had to resort not only to cutting spending but also to raising revenue. To this end, the government introduced a 14% value-added tax (replacing the 10% general sales tax) and a tax administration reform aimed at increasing tax revenues. While these steps are significant, the current tax system is still complex with multiple tax rates and tariffs, creating an uneven playing field. Egypt’s tax revenue is under 13% of GDP in 2016, which is still much lower than the average of its peers.

Egypt could still create more fiscal space through tax policy reforms and better tax administration, to invest in infrastructure, health, and education, as well as to build a sustainable social safety net.

Floating the currency:

The floating of the EGP in November 2016 entailed about 50% depreciation, but was a critical step in resolving the shortage of foreign exchange and improving the economy competitiveness. This decision ended several months of tensions in the currency markets, which had fostered numerous restrictions on trade and financial transactions, and encouraged the development of a parallel exchange market. Moreover, it helped to narrow the current account deficit, with exports slightly increasing and imports moderating. There have also been improvements in foreign capital flows, as well as an increase in remittances and sharp increase in the number of tourists. However, the floating of the exchange rate combined with subsidies cut and tax reform pushed inflation to as high as 33% in July 2017. The impact of these measures started to wane and inflation started to come down although it edged up to 16% in September 2018 (from 14%) mainly on account of higher energy prices.
Main achievements

After several years of sluggish growth and weak economic performance, the Egyptian economy is showing signs of recovery, with growth reaching 5.3% in the fiscal year 2017/18, the fastest pace in a decade. Growth was supported mainly by a strong pick-up in government investment spending, an improved regulatory environment, an expansion of investment in the gas sector and a recovery in the tourism sector. As a result, unemployment rate fell to 9.9% in 2Q18 from 12% a year earlier, its lowest in eight years.

In fiscal year 2018/19, despite higher oil prices and the recent decrease in appetite for emerging-market assets, economic growth is expected to increase further to reach about 5.5%. Egypt’s government is targeting a growth rate of 7.8%-8% by 2022, according to its economic reform program.

The tourism sector, a main driver of economic growth, staged a strong rebound thanks mainly to EGP float that made the country a relatively cheap destination for foreign visitors. Tourism revenues rose by 77% in the first half of 2018 to around $4.8 billion compared with the same period last year, due to an increase in the number of tourists by 41% to about 5 million during the same period. In addition, remittances from Egyptian expats increased by about $4.6 billion (21.1%) during fiscal year 2017/2018, reaching a new record of about $26.5 billion compared to $21.9 billion in the previous fiscal year.

The external sector has also gained considerable strength since the depreciation of the EGP, supported by some export growth due to improved competitiveness as well as lower imports. The current account deficit in fiscal year 2017/18 narrowed by 58.6% to $6 billion, falling to 2.5% of GDP from 6.1% of GDP ($14 billion) a year ago. The current account is projected to narrow further to about 2% of GDP in 2018/19. Larger capital inflows helped improve the overall balance of payments, which registered a surplus of more than $13 billion over the past couple of years.

FDI inflows were strong at $7.7 billion (3.2% of GDP) in the fiscal year 2017/18, driven by hydrocarbon investments, while portfolio investment declined recently, as emerging markets witnessed capital flight with some countries experiencing currency crisis (Turkey and Argentina).
Opportunities and challenges

Given the success of the reforms, Egypt’s future looks brighter. There is now a growing interest in Egypt as an investment destination by regional and foreign investors who are looking to benefit from its vast potential, including strategic location, an abundant labor force and more generally low cost of doing business. The diversified economic base provides opportunities for everyone and in different sectors:

- **Investment in the gas sector is promising.** Egypt has been successful in appealing to foreign investors and in creating partnerships with many international and regional partners in the oil and gas sectors.
- **Real estate is another area that could generate a lot of interest**, especially when other regional markets are either saturated or unstable (Dubai and Turkey for example).
- **Tourism sector is particularly appealing and is expected to flourish** after the improvement in the security situation and the floating of the exchange rate, which makes Egypt’s cheaper for tourists. In this context, many investment opportunities exist in related sectors such as hotels, infrastructures, food industry, among others.
- **There is also a great potential for investment in the financial sector.** In view of the limited financial inclusion and the large segment of the population that remains unbanked, banking and financial services could expand exponentially in the coming years to respond to market demand. And relatedly, financial technology needs to be enhanced further and built on some progress that Egypt has made in this area especially in mobile technology.

While opportunities abound and the outlook is promising as the reform process proceeds in measured steps, more work is needed on structural issues and on maintaining macroeconomic stability as Egypt faces a host of economic risks and structural challenges going forward.

- **Sensitivity to external shocks:** In the last decades, Egypt has opened its markets to foreign investments and international trade. This openness should serve Egypt well as the country becomes well integrated with the global economy and would benefit from trade, technology and know-how transfer, and inflows of capital. However, with these benefits come some risks especially when domestic conditions are not improved to the point where such risks could be mitigated.
- **Oil price:** An increase in oil prices would weaken the current account and increase the fuel subsidy bill, thereby undermining fiscal consolidation and debt reduction. Higher oil prices would also add to inflationary pressure if fully absorbed by prices at the fuel pumps, and affect...
consumption and consequently growth. To preserve the fiscal targets, a larger adjustment in oil prices would be required, putting more pressure not only on the most vulnerable groups but also on middle-income groups and this may lessen support for the reform program.

- **Interest rates:** Egypt is currently facing a higher cost of borrowing as investors’ appetite for emerging markets debt is waning, especially after the recent crises in Turkey and Argentina. With global interest rates on the rise and capital seeking safe haven in developed countries, a deceleration of capital inflows would put pressure on the central bank’s international reserves and potentially on the exchange rate. One other factor affecting the rate of interest is inflation. With higher inflation investors will demand higher return on their investment, rendering the reduction of the budget deficit more challenging. Recent experience has shown that with an inflation rate of 14%, investors required about 19% interest on their investment, leading the authorities to cancel a number of government bond auctions.

- **Policy Dilemma:** In that context, Egypt is facing a difficult dilemma. On one hand, it needs to maintain high interest rates to attract foreign capital to serve its financing needs in foreign currencies. But on the other hand, it wants to reduce the cost of borrowing to encourage investment and boost economic growth, as well as reduce debt service to reach the budget deficit target. Balancing these two objectives would require skillful management of economic policies going forward. The increase in global interest rates is an exogenous factor that is outside the control of the authorities and therefore efforts should focus on reducing the country’s risks by maintaining fiscal discipline and more importantly by adopting strong structural reforms such improving the business environment so as to lower the interest rate risk premium.

- **Heavy dependence on foreign capital:** Given Egypt’s strong dependence on foreign capital, any shift in investors’ behavior and sentiment would have an adverse impact on Egypt. Thus, the current emerging market currency crisis has reduced investors’ interest and led to a decline in capital flows even in the presence of IMF support and the improvement of credit rating. While a contagion effect cannot be ruled out completely, having strong macroeconomic conditions and macroeconomic stability would reduce the economy’s vulnerability to external shocks. The countries that were affected the most during this period were those with weaker economic fundamentals.

- **Low private consumption:** Domestic consumption is typically the largest contributor to economic growth and an important factor in attracting foreign direct investment in consumer-related sectors. Restoring macroeconomic stability including through some austerity measures has undoubtedly affected consumption of the middle and low income groups. With a very low average income, ($2785 in 2017), it may take some time for reforms to raise income to a level where consumer spending will increase.

- **Reform fatigue:** Achieving good economic outcome in the short term is one thing but maintaining the momentum for the longer haul is another. The more time it takes for reform and austerity measures to show positive results on the ground, the more likely for reform fatigue will set in mainly because of less popular and political support for the reforms. Opposition by vested interest groups would affect the reforms goals and weaken credibility. This could be accompanied by continued pressures to increase spending on wages and expand social programs beyond what is budgeted, undermining fiscal goals and thereby hurting the prospects for investment and growth. In case global or regional conditions worsen, more austerity measures will be needed, increasing the likelihood of policy reversal.

**Structural vulnerabilities**

Beside the risks outlined above, there are some deep-seated vulnerabilities that are mainly of structural nature that need to be addressed to promote inclusive economic growth and put the country on a sustainable path. True, these structural issues will take a long time to resolve but if delayed, or worse, not done, they could derail the macroeconomic stabilization that is taking place and set backward the reform process.

**Business environment**

The Egyptian authorities already took several measures and issued new laws to enhance investment climate. Foreign direct investment inflows reached $10.2 billion during the first nine months of the fiscal year 17/18 (July-march), but there is room for raising FDIs to much higher levels by improving regulations and preserving a conducive macroeconomic environment.

According to the 2019 World Bank Doing Business report, Egypt has improved eight places (to 120th from 128th in the previous report). This is a positive development but of course there is more room for improvement. The authorities need to address reported lack of transparency, excessive bureaucracy and perception of corruption as they represent major deterrents to investment.

International Firms need to know what the rules of the game are, and require some assurance that those rules will not change once they have invested. Foreign investors need to understand the practical implications of rules governing their investment, in terms of the conditions to fulfill, the procedures for a public review and the appeals process in the event of a
dispute. Improving transparency and having clear regulations could help ensure healthy investment climate in order to attract local and foreign investors.

Financial sector reform

The banking system in Egypt is in good shape and remains liquid and profitable. However, financial inclusion is weak compared to other emerging markets, with little access to banking and financial services by a large segment of the population. According to the Central Bank of Egypt, only 32% of the population has bank accounts and 80% of transactions are in cash. Improving financial inclusion and developing financial technology is critical. While some progress has been made in mobile banking, much more is needed to bring in more people into the financial sector, which is paramount objectives for Egypt. Financial sector development is also important for SMEs as it would lead to lower cost, higher efficiency and more jobs.

The prominent role of the state

Efforts should concentrate on balancing the roles of the private and public sector, where the latter should focus more on providing the physical and social infrastructures that would allow the private sector to be the main engine of growth.

The state still owns a large number of public enterprises in multiple sectors, such as energy, banking, manufacturing, agriculture, transport, tourism, and services. This large and privileged role of the state marginalizes and weakens the private sector, limits the fiscal space for productive investments and imposes large public outlays. In this context, the government’s plan to privatize public commercial entities should proceed apace to allow the private sector to increase its share in the economy. Many countries have taken measures to end government monopolies and empower the private sector with positive impact on growth (e.g. Indonesia and Malaysia are good examples).

Rapidly growing population and high youth unemployment

Egypt’s current population is estimated at approximately 97 million people, 33 % of whom are under the age of 14. According to UN projections, Egypt’s population will reach 150 million by 2050, and around 200 million and by 2100. As the population grows, Egyptian urban centers will struggle to provide services such as housing, sanitation, health care, and education, given that the population is concentrated in only 8% of the territory.

Rapid population growth represents both a challenge and an opportunity. It is an opportunity as it could support strong growth if the private sector is able to generate sufficient employment for new entrants (estimated at 750,000 each year) into the labor force. But it is also a tremendous challenge as it will require high growth rates, as well as improving living standards and lifting more people out of poverty.

Although Egypt does not have the kind of labor market rigidities that afflict other countries but it suffers mainly from skills mismatch between modern job requirements and the qualifications of job seekers.

To sustain macroeconomic stability, boost long-term economic growth and create jobs for the growing population and particularly the youth, it is of utmost importance to improve the education system. This latter remains somewhat antiquated as it has not adapted sufficiently to modern world changes, producing graduates that are not equipped to deal with the demand in the labor market.

Increasing spending on education should not be spared as long as there is a concrete and viable plan with specific objectives and well defined time line. Other countries’ experiences demonstrate the importance of education for growth and employment (Mexico and Malaysia invested heavily in education and created millions of jobs in the process).

The potential impact of GCC labor nationalization on Egypt

GCC countries are going through labor nationalization programs with a view to create more jobs for nationals and rely less on foreign labor.

There is a large number of Egyptians working in the GCC countries in different fields and professions. While the impact of the nationalization programs has not been felt yet by Egypt, in the medium and long term, the potential return of millions of Egyptians from GCC countries and the expected decline in opportunities for young Egyptian graduates to migrate to the Gulf region will put pressure on the authorities to create more jobs.

Moreover, a reduction in the number of Egyptians working in the Gulf will deprive Egypt from much needed foreign capital through remittances, which could worsen the external current account and the overall balance of payments.

**Chart 8: unemployment rate**

(%, by Gender)

Source: International Labor Organization
Inequality of economic opportunities

Even with relatively high levels of economic growth over the past decades, living conditions for the average Egyptian remain poor. According to Crédit Agricole, the richest 1% of Egyptians owned half of the wealth in 2014, up from one-third in 2000, an inequality gap that may grow even further if not addressed. Despite government’s efforts to protect the most vulnerable people against soaring prices, the 50% depreciation of the EGP, the deep cuts in fuel and electricity subsidies, and the new value-added tax, decreased the purchasing power of poorer Egyptians and affected significantly the consumption behavior of middle class households. This growing inequality could choke reforms’ gains, and inevitably create much resentment and unrest if left unattended.

Conclusion

Egypt’s economic reform program is timely, bold, and ambitious reflecting the authorities’ determination to address macroeconomic imbalances, promote inclusive economic growth and create jobs for the large number of Egyptian entering the labor force. To this end, the government took a number of strong and painful measures including floating the exchange rate, cutting down subsidies, and improving overall fiscal position and reducing public debt, while protecting the most vulnerable groups. IMF’s three-year IMF program is providing technical and financial support for authorities’ program. The significant progress made in a short time won the praise of all and ushers in a new era for Egypt.

The outlook for Egypt looks promising, but there remain a number of risks and challenges, which could reverse the recent trends in the medium and long term if not addressed. Some of the macroeconomic risks include exposure to external shocks, higher oil prices, higher interest rates, and low consumption, among others. There is a pressing needed to address important structural challenges related to the need to reduce the role of government in the economy, contain the rate of population growth, improve the education system, as well as make the business environment more conducive to investment. These are indeed a tall order but are critical for success.

The experiences of some countries that have undertaken economic reform efforts similar to those adopted in Egypt, show that it is not easy to maintain the pace of reform and macroeconomic stability for the long haul unless the benefits of reforms trickle down to benefit most citizens. To sustain economic reform momentum in the medium term, policy priorities should aim to raise potential output and promote inclusive growth to create jobs for Egypt’s young and growing population.

This will require a quantum leap in the private sector’s role to become the primary engine of growth, while the state should focus more on providing a stable macroeconomic environment, a healthy business climate and efficient physical and social infrastructures. In parallel, the government will need to focus on strengthening social protection, which is very important to shield the most vulnerable groups from the adverse impact of the reform measures to ensure continued support for much needed reforms.