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The roots of economic challenges facing Egypt in the aftermath of the 25th revolution

by **Ahmed Farouk Ghoneim** (University of Cairo)



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by Ahmed Farouk Ghoneim*

Introduction

Since the 25th of January, 2011 revolution the Egyptian economy has been suffering on all fronts. Almost all the economic indicators have been pointing towards a deteriorating situation, that in many cases have reached the trough. Yet, the economy is still surviving, even if all indicators have been pointing towards a near collapse. This is mainly due to the unprecedented support of some of Arab Gulf countries, whom their unconditional support has helped to mitigate the deteriorating economic conditions.

The economic challenges facing in Egypt have exacerbated after the 25th of January revolution mainly because of the deteriorating political and security conditions which have interrupted the functioning of the economy. Yet, this is not to say that revolution has caused such challenges. In fact the challenges that the Egyptian economy has been facing have deep roots in the socio-political-economic context, which this paper aims at explaining. The revolution and its aftermath have brought to the forefront such challenges which have been always mitigated by short term solutions that never dealt seriously with the roots. In addition, the revolution has brought additional problems associated with the macroeconomic imbalances. As a result, the challenges became more complex especially in light of the need to balance the social and economic aspects.

The paper proceeds as follows; in section one we pinpoint the main challenges faced by Egypt where we identify the symptoms and causes of such challenges. In section two we discuss the roots of such challenges. Finally, we conclude and provide our understanding of how is it expected that Egypt will face its challenges in the near future

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Section One: Challenges Facing the Egyptian Economy

Despite the deeply rooted economic problems, the former 25th of January regime was able to keep the macroeconomic balances under control. Over the period 2004-2010 the Egyptian economy has just been doing perfect where growth rate exceeded in some years the 7%, budget deficit was in the range of 8-10% and was heavily controlled, balance of payments was turned into a surplus, and foreign exchange reserves were increasing. Moreover, foreign direct investment (FDI) has reached unprecedented levels (13 billion US\$). In fact, Egypt was appraised by international organizations for its remarkable good economic performance, which according to their standards has been improving over time. For example, Egypt, was accounted for as the “top reformer” in 2006/2007 by *Doing Business Report (2008)*, for improving in 5 of the 10 areas studied by Doing Business¹. Yet, such good economic performance was not reflected in improving the socio economic indicators, where the level of poverty remained high and income distribution did not improve. In other words, the governing regime before the 25th of January revolution focused mainly on the economic aspects while leaving the social aspect relatively untouched. Poverty in Egypt has remained high and vulnerable to changes in GDP growth rates. By February 2009, it was estimated that almost 21% of the population (approximately 13.5 million) was below the national poverty line (120 LE per capita per month)². The situation did not change much since the early 1990s where at that time 24% of the population fell below the national poverty line³, yet, according to World Bank (2009)⁴, poverty situation improved in 2008 compared to 2004/2005 as reflected in the incidence of poverty whereas the poverty gap slightly increased as well as the severity of poverty. In the aftermath of the 25th of January revolution, poverty levels have increased significantly, mainly due to the dramatic slow-down in growth rates, significant increase in unemployment rates, and unstable political situation (table 1). According to the Central Agency for Public Mobilization and Statistics (CAPMAS) data Egypt's poverty increased to encompass 25.2 % of the population in 2010/2011 compared to 21.6% in 2008/2009, also “extreme” poverty had decreased to 4.8% of the population in 2010/2011 from 6.1% in 2008/2009. These figures are according to the poverty line in Egypt, which is estimated at LE 256 per person per month, or LE8.5 per day, while the "extreme" poverty line is calculated at LE 171.5 pounds per person per month or LE5.7 per day⁵.

¹ World Bank (2008), *Doing Business 2008*, The World Bank, Washington D.C., Available online at: <http://www.doingbusiness.org/reports/global-reports/doing-business-2008/>

² World Bank (2009) puts the figure of poor in Egypt at 28 million people in 2005 representing 40% of the population. World Bank (2009) considers 13.6 million (19.6%) in absolute poverty or ultra-poverty (spending than the minimum to cover their basic food requirements or less than LE 1423 per year per capita) and 14.5 million (21%) in near poverty (spending between LE 1424 and 1854 per year per capita).

³ UNDP (2010), ‘Egypt Human Development Report 2010’, Available at: <http://www.undp.org/Portals/0/NHDR%202010%20english.pdf>.

⁴ World Bank (2009), ‘Economic Growth, Inequality, and Poverty: Social Mobility in Egypt between 2005 and 2008’, Report No. 48093, Washington D.C.: World Bank.

⁵ Central Agency for Public Mobilization and Statistics (CAPMAS), News, Press Release, 2012, available at: <http://capmas.gov.eg/pepo/281.pdf>

Table 1: Poverty Rate in Different Years

	2000	2005	2008	2009	2011
Poverty headcount ratio at national poverty line (% of population)	16.7	19.6	-	21.6	25.2

Source: World Bank, World Development Indicators, 2014, available online at:

<http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators>

The 25th of January revolution pointed out the need to pay attention to social dimension which was neglected to a large extent by the former regime. The slogan of the revolution has been “bread, freedom, and social justice”. Hence, the different regimes that followed after the revolution have leaned towards achieving the social goals, in many cases at the expense of the economic stability. As a result, the challenges exacerbated, where the conflict between achieving social goals and economic objectives became so tensed, and in fact none of the challenges have been solved. The macroeconomic indicators have been deteriorating where the aftermath of the revolution has clearly negatively affected the economy as has been revealed by the deteriorating economic indicators (slowdown of the economy where growth rate went down from 5.9% in 2009/2010 to 1.9% in 2010/2011 (CBE, 2011)⁶ (table 2), unemployment reached higher alarming rates (figure 1), and net FDI inflows went down from 6.6 billion US \$ in 2009/2010 to 2.2 billion US \$ in 2010/2011 with a negative growth rate of 67% (figure 2).

Table 2: Selected Economic Indicators for Egypt over the Period 2008-2011

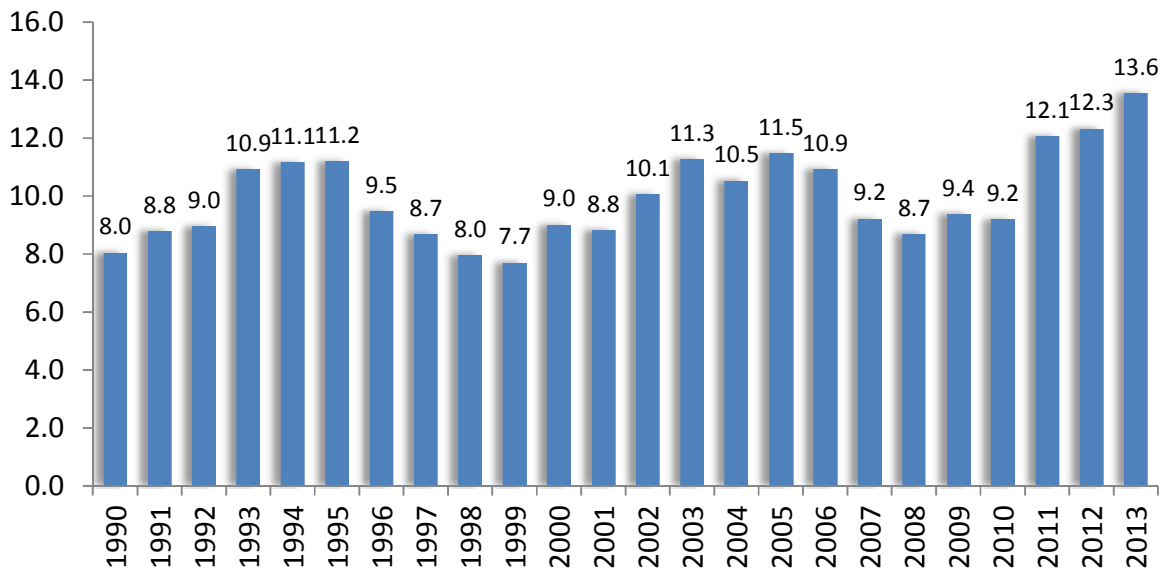
Indicator	Egypt			
	2008	2009	2010	2011
GDP growth (annual %)	7.2	4.7	5.1	1.8
Current account balance (% of GDP)	-0.9	-1.8	-2.1	-2.4
Total reserves in months of imports	6.0	7.4	6.7	3.3
Total Unemployment (% of total labor force)	8.7	9.4	9.0	12
State Budget Cash Deficit (% of GDP)	-6.4	-6.6	-7.7	-10.1
Total reserves (% of total external debt)	102.5	99.8	101.7	53.2
Inflation, consumer prices (annual %)	18.3	11.8	11.3	10.1

Source: World Bank, World Development Indicators, available online at:

<http://databank.worldbank.org/data/views/variableSelection/selectvariables.aspx?source=world-development-indicators>

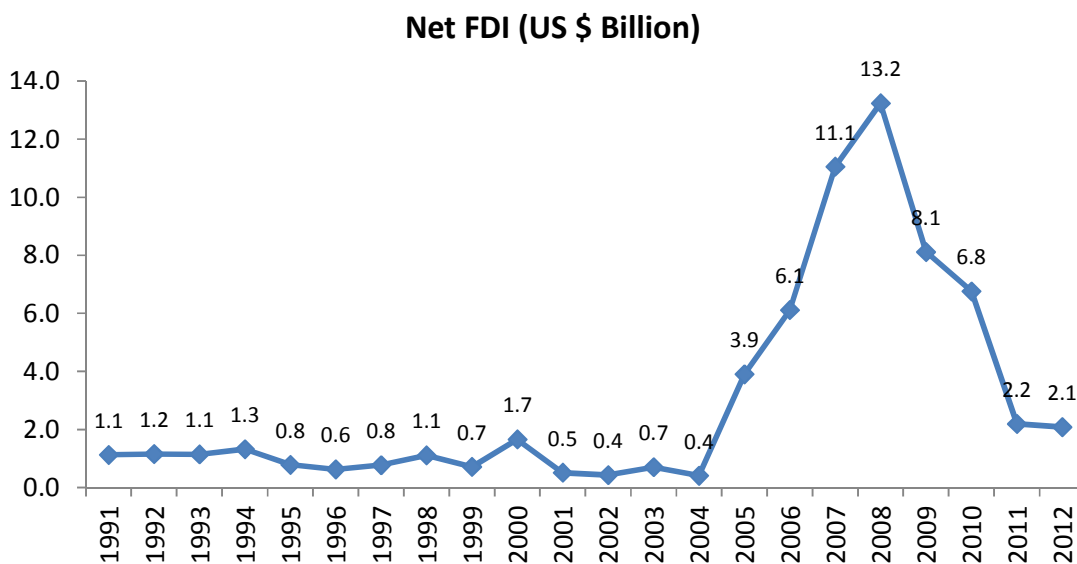
⁶ CBE Annual Report (2010/2011), <http://www.cbe.org.eg/public/AnnualRepot2011.pdf>

Figure 1: Unemployment Rate (%)



Source: International Monetary Fund (IMF), World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.asp>

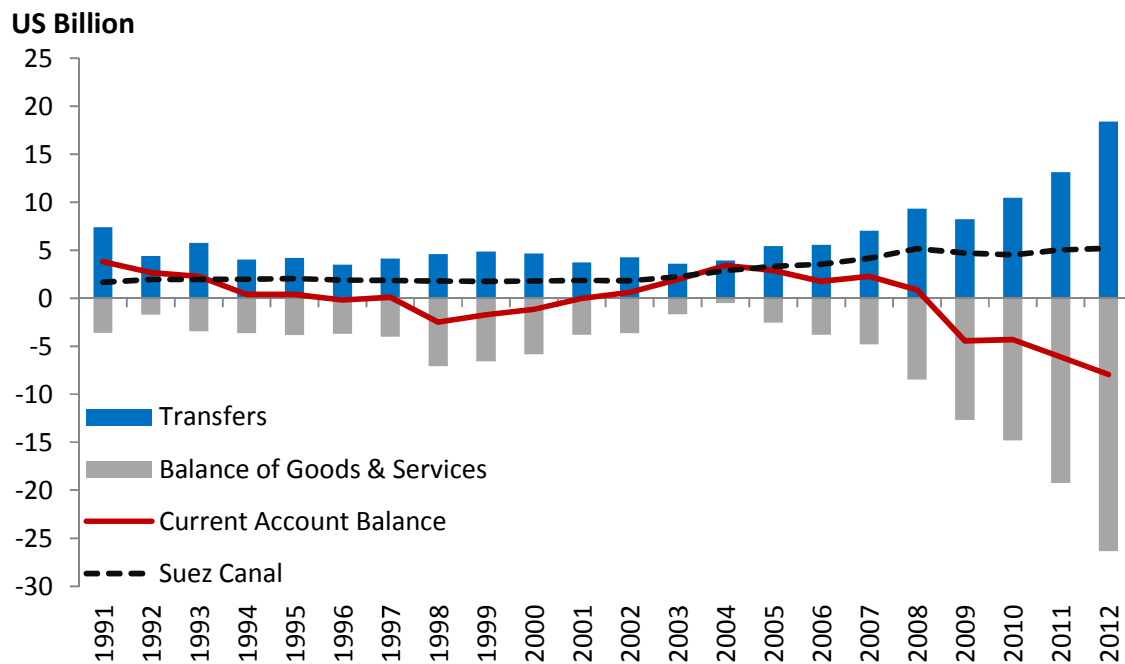
Figure 2: Foreign Direct Investment



Source: Central Bank of Egypt, Research and Publications, Time Series, <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

The 2010/2011 deficit in balance of payments reached unprecedented heights scoring 9.8 billion US \$ (4.1% of GDP) compared to a surplus of 3.4 billion US \$ (1.5% of GDP) in 2009/2010, whereas international reserves slipped down from 36 billion US dollars in January 2011 (covering more than 8 month of imports) to 16 billion US dollars in January 2012 (covering less than 4 months of imports) (see figures 3 and 4). Tourism receipts declined significantly and prospects for the future are worrisome due to worsening security situation. The credit rating for Egypt by major rating agencies has deteriorated several times since the beginning of the revolution causing additional problems with the ability of Egypt to borrow from abroad and its credit worthiness. As a result, the interest rate on treasury bills increased by almost 2 percentage points making it more burdensome for the government to borrow. The government overall⁷ budget deficit reached high records of 142 billion Egyptian pounds (23 billion US \$), representing around 10% of GDP, and not including foreign and domestic debt service which reached 99 billion US \$. The budget deficit soared to almost 14% of GDP, foreign reserves have been declining significantly, black market in foreign exchange appeared despite devaluation taking place, balance of payments turned from surplus to deficit, etc. The economic outlook is extremely gloomy. Figures 1 and 2 show how the budget deficit and balance of payments have deteriorated significantly.

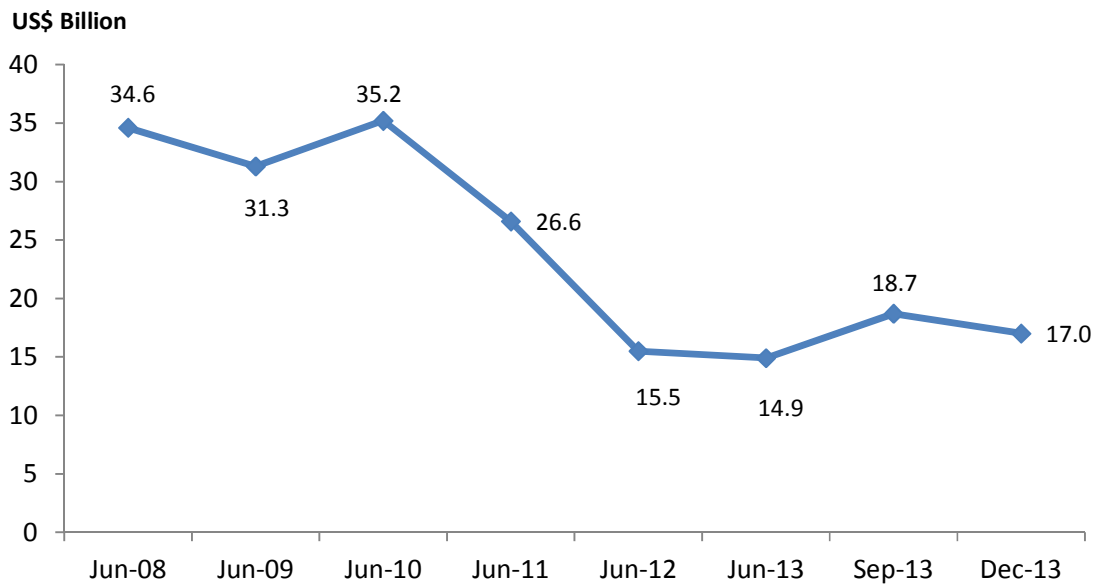
Figure 3: Balance of Payments



Source: Central Bank of Egypt, Research and Publications, Time Series, <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

⁷ Revenues less expenditures, plus net acquisition of financial assets

Figure 4: Net International Reserves



Source: Central Bank of Egypt, Publications, Statistical Bulletin, January 2014.

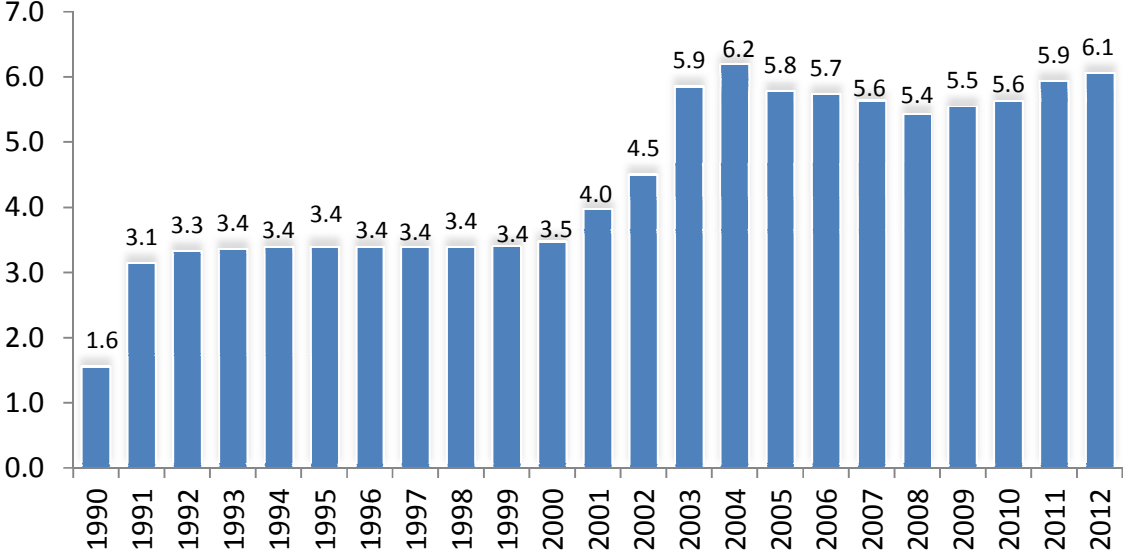
http://cbe.org.eg/CBE_Bulletin/2014/Bulletin_2014_1_Jan/30_19_Gross_and_Net_International_Reserves_with_CBE.pdf

The balance of payments problems hinge mainly on declining foreign exchange receipts of tourism, exports and, FDI. Other sources of foreign exchange as remittances and Suez Canal revenues have maintained their levels and even increased in some instances, yet the relative scarcity of foreign exchange has had a negative impact on the exchange rate (figure 5). However, the devaluation that took place in December 2012 was not substantial as show in figure 5. Currently, there is a small black market premium which does not exceed 5%, signaling that the Central Bank, so far, is in control of managing the exchange rate, mainly with the support of the Gulf countries which reached around 17 billion US\$ in the period of July 1st 2013 till May 1st, 2014.



Figure 5: Exchange Rate

Official exchange rate (Egyptian Pound per US\$, period average)



Source: Central Bank of Egypt, Research and Publications, Time Series, <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

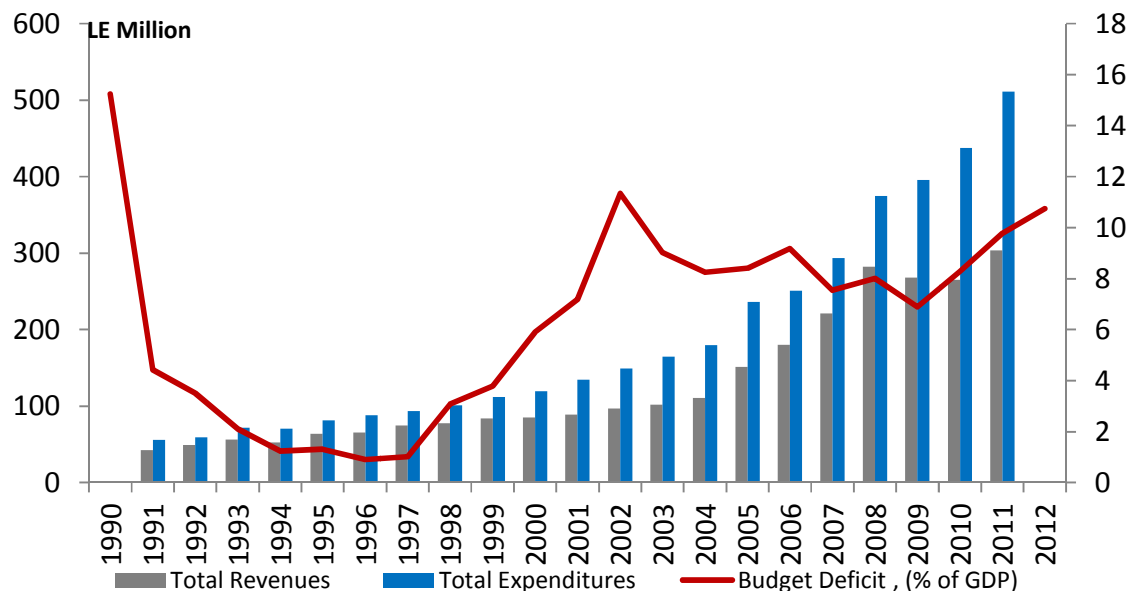
The deteriorating economic conditions have exacerbated the unemployment problem with official figures stating the unemployment level to have reached 13%. Despite the relatively high figure we believe it is underestimated due to the absorption of the informal sector and government for additional waves of job seekers after the 25th of January revolution.

The two major economic challenges faced by the Egyptian economy (before and after the revolution) remain two: subsidies reform and unemployment.

Subsidies seem to be the major challenge that any governing regime in Egypt has failed to tackle. In fact, subsidies have always represented the symbol of the social contract between the governing regime and the population. Any trial to reform subsidies was always a major concern, and none of the preceding regimes for the last 60 years was able to implement serious reform measures. Rather, a piecemeal approach (often manipulated in a way or another) was always used if it was really urgent and pressing to undertake adjustments to the subsidies system. Otherwise, and as long as the system can be sustained, even if at extremely high economic cost full of inefficiency and waste of resources, no reform took place.

The main cause behind the budget deficit deterioration (figure 6) has been the soaring expenditure on increasing public wages (as a response to the demonstrations) and energy subsidies (table 3).

Figure 6: Government Budget



Source: Ministry of Finance, State's General Budget Final Accounts,
<http://www.mof.gov.eg/English/Pages/FinalAccountsData.aspx>

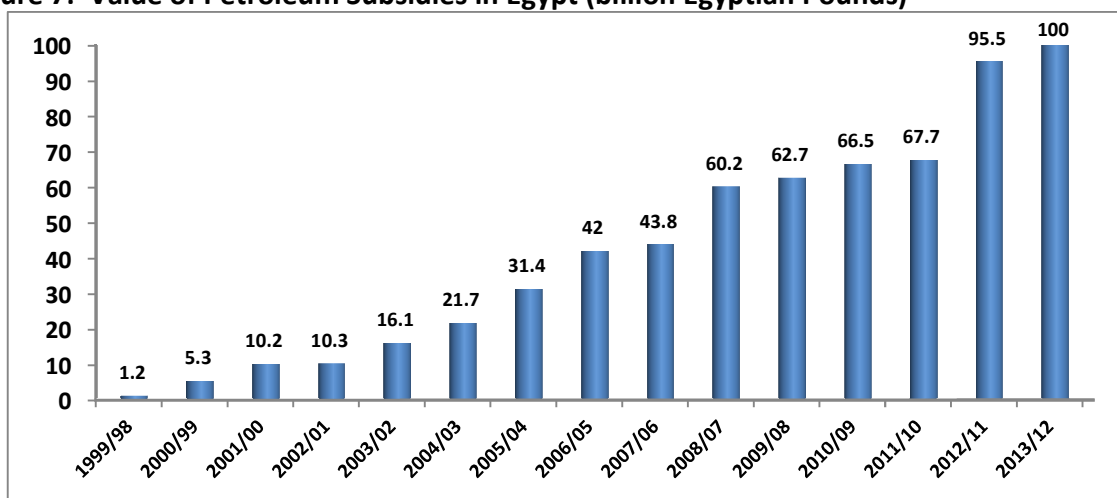
Table 3: Distribution of Government Expenditures (%)

	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013
• Compensations of Employees	22.5	23.5	22.3	21.7	23.3	24.0	26.1	24.3
Salaries and wages	18.1	19.1	18.1	17.8	19.2	19.5	21.2	20.1
• Purchases of Goods and Services	6.9	7.7	6.5	7.1	7.7	6.5	5.7	4.5
• Interests	17.7	21.5	17.9	15.0	19.8	21.2	22.2	25.0
• Subsidies, Grants and Social Benefits	33.2	26.3	32.7	36.1	28.1	30.6	31.9	33.5
Subsidies	26.1	24.3	29.8	26.7	25.6	27.7	28.7	29.0
To Petroleum	20.1	18.1	21.3	17.8	18.2	16.8	20.3	20.4
Grants	1.0	1.2	1.4	1.2	1.2	1.3	1.1	0.9
Social Benefits	5.9	0.7	1.4	8.2	1.2	1.5	2.0	3.5
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
• Other Expenditures	9.5	9.6	8.5	7.7	7.9	7.8	6.5	5.9
• Purchases of Non-Financial Assets (Investments)	10.2	11.5	12.1	12.4	13.2	9.9	7.6	6.7

Source: Calculated using data from Central Bank of Egypt, Research and Publications, Time Series, <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

Energy subsidies comprise a significant share of government expenditure in Egypt. In 2012/2013, petroleum subsidies reached L.E 100 billion (US\$14.3 billion), constituting 5.6% of GDP, 17% of total government expenditure, and 25.4% of total government revenues. Petroleum subsidies increased from L.E 1.2 billion in 1998/1999 to LE 100 billion in the 2012/2013 (figure 7) :

Figure 7: Value of Petroleum Subsidies in Egypt (billion Egyptian Pounds)




Source: Ministry of Finance, Closing Accounts of State Budget, Several Years.

The unemployment rate in Egypt increased significantly over the 1990s. The high average unemployment rate continued to prevail in the 2000s. Moreover, unemployment rates increased further after the revolution. The highest unemployment rates have been concentrated among youth as well as females. Egypt enjoys a *large and young labor force* which reached about 27.2 million by end of the 1st quarter (January-march) for year 2013⁸. There are 800,000 new entrants to the labor market on yearly basis) requiring at least a rate of growth of 6.5-7% on annual basis for at least two decades (Ikram, 2006)⁹. However due to inefficient educational and employment policies, among other macroeconomic policies such huge labor force has not been effectively used. In the last two decades the growth was driven by specific sectors including telecommunications, financial, real estate sectors which have not been necessarily employment enhancing. Manufacturing sectors with high value added did not play an effective role in enhancing growth. The governmental policies adopted failed to deal with the structural problems of the Egyptian economy, where unemployment remained chronic. The concentration of the unemployment among youth is another major challenge (22% for age

⁸ Central Agency for Public Mobilization and Statistics (CAPMAS) (2013) labor force survey results, Press Release, Webpage: http://www.capmas.gov.eg/pepo/403_e.pdf

⁹ Ikram, Khalid (2006), *The Egyptian Economy, 1952-2000: Performance, policies, and issues*, London and New York: Routledge



bracket 25-29 and 44% for age bracket 20-24)¹⁰ implying that this important driver of growth has not been utilized and has acted a burden rather than an opportunity. Public sector employment, and informal sector helped to alleviate the features of the problem, yet the core remained un-tackled. The aftermath of the Arab uprising has led to exacerbate the unemployment problem where the average rate of unemployment rose to 13% up from an average of 9.9% for the decade before 2011.

Moreover, youth unemployment does not improve by climbing up the ladder of skills and education and has been hitting all skill levels. Even highly skilled young workers have been facing severe challenges in getting a job at their competence level and have been either forced into the informal economy, migrating, or preferring not to join the labour market¹¹.

The negative consequences of the unemployment problem in terms of proliferation of the informal sector and being correlated with higher poverty rates implied socio-economic and political repercussions, especially in light of the old social contract that confirmed that creating jobs is a main role for the governing regimes. As a result, and especially in the last few years protests increased dramatically. In 2008 Egypt has witnessed around 323 protests and strikes, which spanned a wide social spectrum. It is worth noting that most of these protests came from within blue collar circles¹². Such protests revealed the anger of the unemployed as well as the employed but not feeling secure and/or asking for wage raises signaling the breaking of the old social contract, and the inability of the governing regimes in responding to the needs of their population.

In fact the unemployment problem in Egypt has a number of causes on both the supply and demand sides. On the supply side, the major problems are associated with the deteriorated level of education, the mismatch between education systems outcomes and labour market requirements, and the inflexible labour market policies and regulations. On the demand side, the investment and industrial policies adopted were not geared to create job opportunities, and this is highly associated with the inefficient energy subsidy scheme which created wrong incentives encouraging energy and capital intensive industries, rather than labor intensive ones. There are other several challenges that are related to the main two challenges and include the two chronic deficits in the last three decades, namely *budget deficit* which reached about 17.2%

¹⁰ African Development Bank (ADB) (2013), Egypt Economic Quarterly Review, Volume 3, April 2013, Egypt Country Office, Webpage: <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Egypt%20Economic%20Quarterly%20Review%20-%20Volume%203%20-%20April%202013.pdf>

¹¹ International Labour Organization (ILO) (2013), Global Employment Trends 2013: Recovering from a Second Job Dips, ILO, Geneva, Webpage: http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_202326.pdf

¹² AL-Ahram Weekly, "Seasons of protest: 2008: When demonstrations and strikes became the norm", Issue No. 928, January 2009, Available online at: <http://weekly.ahram.org.eg/2009/928/eg6.htm> .

of GDP in 1990/1991, 10.2% in 2001/2002 and 10.7% in 2011/2012¹³ and overall *balance of payment* deficit which was about 0.9 billion dollars in 2000/2001 reaching 11.3 billion dollars in 2011/2012 representing 0.9% and 4.4% of GDP in the previously mentioned years respectively¹⁴. Moreover, the domestic component of the overall national debt remains a major concern where it has represented on average 83.5% of the total *external and domestic debt* by end of December 2012¹⁵.

In the mid 2000s the macroeconomic policies adopted aimed mainly at restoring the macroeconomic imbalances. Yet, the inability to tackle the inefficient energy subsidy system led to worsening fiscal situation. Moreover, the inefficient food subsidy system has also added to the fiscal problems. The economic developments following the aftermath of the 25th of January revolution have been significant. The balance of payments turned from a surplus of 3.4 billion US \$ in the fiscal year 2009/2010 to a deficit of 9.8 billion US \$ in 2010/2011. The rise of the external debt is a new challenge that appeared in the period following the Presidential elections of 2012 where external debt rose sharply in this year to reach around 40 billion US \$ in December, 2012. However, in relative terms the external debt remained in the range of 13.8% of GDP by end of December 2012¹⁶ which is considered an acceptable range. Yet, the domestic debt has been increasing significantly.

The improvement of the *socio economic situation* has also remained a major challenge. As explained above the growth performance of the Egyptian economy in the 1990s onwards has failed to create sufficient jobs to match the rapid increase in the labor force of 2.7% per year. The proliferation of the informal sector has created another type of political and social problems to the government. The current predominance of the informal sector gives a wrong impression on the improvement of employment prospects, where in reality the jobs remain unproductive and do not have a positive impact on economic growth. Based on recent estimates, the informal economy has reached remarkable proportion in Egypt representing on average 34.9% between 1999 and 2006/2007¹⁷. The inflated public sector has also acted as an outlet for reducing the official unemployment rates, but in fact has been hiding disguised unemployment.

¹³ Central Bank of Egypt (2013), Time Series Data, New Budget Data, Economic Research Sector, Webpage: <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

¹⁴ Central Bank of Egypt (2013), Time Series Data, Balance of Payment and External Debt, Economic Research Sector, Webpage: <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

¹⁵ This figure is calculated by dividing the gross domestic debt by total debt (external and domestic), **Source:** Central Bank of Egypt (2013), Monthly Statistical Bulletin, June 2013, Webpage: <http://www.cbe.org.eg/English/Economic+Research/Publications/Monthly+Statistical+Bulletin/June+2013+Statistical+Bulletin.htm>

¹⁶ Central Bank of Egypt (2013), op.cit.

¹⁷ Schneider, Friedrich; Andreas Buehn and Claudio E. Montenegro (2010), "Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007", Policy Research Working Paper 5356, The World Bank, Development Research Group, Poverty and Inequality Team & Europe and Central Asia Region, Human Development Economics Unit, July 2010 Webpage: http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2010/10/14/000158349_20101014160704/Rendered/PDF/WPS5356.pdf

Section Two: Explaining the Roots of Economic Challenges:

Achieving decent growth rates, accumulating foreign reserves, lessening budget deficits, turning balance of payments from deficits to surpluses, and controlling inflation did not tell the full story of success of the pre 25th of January 2001 regime. Problems below the surface were proliferating before the 25th of January revolution. Such problems have not been new, but were either neglected or overlooked by both the governing regime as well as the international community. We can identify three main problems in this regard, namely unemployment; lack of or inefficient social safety net; and anti-competitive behavior mixed with vivid elements of crony capitalism. From a political economy perspective the three problems are to a large extent interrelated. Moreover, the developmental model adopted by Egypt since the 1960s has been also a major culprit for causing the economic problems. A model was established by relying heavily on the government intervention in the economy with social contracts established between the governing autocratic regimes and the society where the government is responsible for making jobs, subsidized food, and cheap fuel available in return of stability and security¹⁸. By time, and starting the 1990s when the economic situation worsened, there was a need for economic reform, which was implemented jointly with the International Monetary Fund (IMF) and the World Bank. The reform program was based on “Washington Consensus” type of prescription and the governing regime started to undertake measures to liberalize the economy. But such measures failed to allow the private sector to become an engine of growth due to the inheritance of bureaucracy, rent seeking activities and the old social contract. Egypt started to suffer from several structural problems associated with the inefficiency of its economy, lack of diversification, and inability to create the type of growth that ensures employment generation. As a result, unemployment rates started to increase significantly and other economic problems started to intensify.

Below we highlight a number of aspects that explain the aforementioned challenges

Inefficient Social Safety Nets

The governing regimes starting the 1960s have provided untargeted subsidies for the population. The subsidies encompassed food as well as energy. At early times in the 1960s and the 1970s such untargeted subsidies could have been tolerated due to the relatively limited size of the population and the relative closed nature of Egypt at that time which enabled the regime to be shielded from exogenous shocks. With the adoption of the economic reform programs in the 1990s the focus of the regimes turned to economic aspects, whereas the social considerations were left behind. International organizations have devoted more attention to getting macroeconomic balances right, while issues of efficiency of social safety net were not high on the agenda. The governing regime has focused also on macroeconomic indicators and avoided any kind of substantial reform of their social safety nets fearing from the negative political and social repercussions. The informal sector acted as a substitute for the formal social safety net that should have been provided by the governing regimes. This allowed the

¹⁸ For a similar argument see Amin et. al (2012), *After The Spring: Economic Transitions in the Arab World*, New York: Oxford University Press.

governing regimes to undertake their necessary economic reform measures while ensuring that there will be no social unrest.


However, by time the bill of subsidies increased dramatically in most, if not all of these countries. Fuel subsidies amounted to around L.E 95.5 billion in 2011/12, compared to L.E 60.2 billion in 2007/08, recording more than 58.6 percent increase (Ministry of Finance, Final Accounts). The same has been true in the case of food subsidies which recorded more than 84 percent increase over the same period, rising from L.E 16.4 billion to L.E 30.3 billion. This implies that fuel and food subsidies represented more than 20 percent and 6 percent of total budget expenditure in 2011/12¹⁹, which started to affect negatively the fiscal balance. The quality of public services started to deteriorate dramatically, an issue which has not been easily captured by data published as number of beds in hospitals per thousand persons or expenditure on health. Such indicators have been misleading where as the number of beds might have been within the acceptable international norms, the quality aspect was never captured. The same is true for the public expenditure on health and education, where such figures do not reveal the expenditure outlays, which in many cases have been channeled to finance administrative staff and not technical staff or investments. The proliferation of the informal sector acted again as a substitute here and it carried with it as well the seeds for petty corruption, which increased significantly, signaling huge inefficiency of the social public services provided by the government and announcing the breaking of the old social contract.

Hence the inefficiency of the social safety net which was not an important issue till the 1990s started to become a major problem after embarking on economic reforms in the 1990s. By time, the inefficiency of the social safety net intensified and the resources devoted to provision of public social services did not help to improve the quality of such services or reach the needy people. The informal sector and petty corruption provided a substitute for such inefficient social safety net.

Lack of Institutions Necessary to Govern the Market

The governing regimes neglected the necessity of establishing the right institutions that govern the market (e.g. competition and consumer protection laws), or introduced weak laws which remained on shelf with no enforcement or discretionary one. In fact, the economic reform program adopted in the 1990s did not focus on this important aspect, where the emphasis has been on economic policies as explained above. By time, a new variable emerged, namely the desire of the governing dictators to be succeeded by their family members. In response the governing regimes increased their dubious ties with the certain elements of the private sector to act as a strong lobby for them remaining in power. This led to conflict of interest and grand corruption, but served to sustain the necessary political support for the regimes (by creating beneficiaries from the succession procedure). Major private sector players started to hold legislative and executive positions, which in a country suffering from clear rules on conflict of interest implied wrong marriage between political power and capital. This led to the

¹⁹ Ministry of Finance, Final Accounts, Various Years, Webpage:
http://www.mof.gov.eg/Arabic/عناوين%20رئيسيه/Pages/hessab_khetamy.aspx



phenomena of crony capitalism and nepotism, and ultimately led to delay of establishing the institutions or having them only on paper. The income gaps widened dramatically in which although not highly captured by formal indicators, the overall feeling of *relative poverty*²⁰ increased among the public.

The end result of those economic problems was an increasing loss of trust in the regimes among different segments of the population and discontent that the old social contract was no longer respected, especially in light of the high unemployment rates among the youth. A mixture of anger about the political, economic, and social conditions triggered by the domino effect of developments in other Arab countries, together with an inability to handle the protests and demonstrations then ultimately led to the revolution and fall of the regime.


What Needs to be Done: Prospects for the Future

Ensuring a long term positive correlation between growth and employment requires reforms in a number of sectors, and coordination among several policies. There is a need for major reforms in the educational system, employment policy and institutional infrastructure to ensure that economic growth yields positive impact on employment, unemployment, and poverty. There is a need for better coordination among different macroeconomic policies and sectoral policies. Investment policy needs to be tailored in a way that enhance growth of sectors with high propensity of generating employment, and a well effective formal social safety net is needed to be designed and implemented. Agriculture sector is the largest contributor to employment in the economy (absorbing one third of labor force), but has remained weak in generating higher value added.

Enhancing forward and backward linkages: The nature of the new drivers of growth (as the telecommunications sector), being capital intensive, cannot be altered. However, this does not imply that they cannot play a role in enhancing employment. In fact their role in increasing labor productivity and the backward and forward linkages they attain with other sectors of the economy should be used in a way to enhance employment in sectors that are labor intensive.

Rationalization of the generous subsidy system: Generous *subsidies* have also played an important role in acting as a social safety net. In fact such system of subsidies, especially on food and energy products, has been heavily criticized of being inefficient and lack targeting (in 1992, 86% of the population continued to benefit from subsidy programs). The generous subsidy system played an important role especially in light of the declining real wages phenomenon that affected all sectors of the economy in the 1990s. Yet the generous subsidies are being yet rationed due to the high burden they impose on the government budget. Improving the *status of vulnerable groups* requires devoting special programs for them within the framework of the social safety net.

²⁰ By relative poverty we mean the feeling of the general public that there is a wide gap between their incomes and the incomes of specific elite in the country.



Enabling the private sector: Private sector remains unequipped with the enabling business environment that help it to act as the main engine of growth. In fact, the size of the private sector as percentage of GDP increased over time. However, the existing indicators show that business environment remains suffering from a number of problems that prevent it from acting as a catalyst of growth and development. Problems include lack of efficient public services, to red tape measures, to rent seeking activities. *Credit to private sector needs to be enhanced* and its existing schemes should be reformed, Moreover, crucial institutional pillars of a market economy were lately introduced including the competition law in 2005 and consumer protection law in 2006.

Enhancing the role of SMEs and strengthening the forward and backward linkages with the sectors that enjoy high growth rate but are not necessarily labor intensive. SMEs which account for 80 % of Egypt's domestic economy and 75% of the private sector's labor force are another unutilized driver of growth²¹. Such huge production capacity remains suffering from red tape measures, high transaction costs and bureaucracy which have derived SMEs into the informal sector. Moreover, the SMEs have not been integrated in the value chain where they do not interact with large enterprises. SMEs cannot be dealt with as one entity as their needs differ by sector. SMEs are in need of a holistic vision, but as well sectoral policies. Moreover, SMEs should be further enhanced to undertake their role in creating productive employment. Despite their significant contribution to Egypt's economy, SMEs receive only 10 percent of available banking finance, making it difficult to increase their productivity and output²². In this regard, there is an urgent need to *upgrade the labor skills and enhance productivity* through tailored training programs that respond to the need of the market. This requires the adoption of demand and supply side policies including labor, investment, industrial, and trade policies.


The question that then follows is to what extent are such ills of economics and governance likely to be solved in the near future?

The old regimes might have achieved sound macroeconomic indicators, yet in reality it had several pitfalls. Some have blamed the failure due to adoption of market system, whereas in reality the regime did not opt for one. On the contrary, the failure is due to its inability to implement a proper free market system and prepare well to benefit from integration. As shown by Ikram (2006) the size of the public sector to GDP remained extremely high despite the announcement of adoption of liberal policies starting the 1970s where the size of public sector to GDP reached 50% in the 1980s. A market system implies by default a larger role for the government on two fronts, namely social safety net, and proper, well-enforced regulations that govern the market (strong institutions). In both cases, there was a clear government failure in creating an efficient social safety net as well establishing a transparent well enforced regulatory system that governs the market. The end result was corruption, widening gaps between income

²¹ Saif, Ibrahim (2011), "Challenges of Egypt's Economic Transition", The Carnegie Papers, Issue 28, Carnegie Middle East Center, November 2011,

Webpage: <http://xa.yimg.com/kq/groups/21555389/1517237933/name/Egypt+Econ+Transition+2011.pdf>

²² Saif, Ibrahim (2011), op.cit.




levels, and lack of justice²³. But this is not because of adoption of free market system and integration in the world economy, rather it is because of the government which failed to set the needed pre-conditions for a market economy and integration in the world economy to function properly.

Egypt is at crossroads, not only from a political point of view, but also on economic and social grounds. The 25th of January revolution and its aftermath have shocked the Egyptian society. The day to day incidents have shown huge divergence and clear segmentation among the Egyptians, an issue that was neither revealed to that extent before the revolution nor was expected to be to that extreme after the revolution. The 25th of January revolution embedded explicitly and implicitly economic reasons. The failure of the old regime in providing a descent life for the majority of the population, while at the same time supporting the corrupt elite, led to extremely high levels of dissatisfaction among the population, and especially the youth. The youth went out asking for "bread", "freedom", and "social equity". Those three important aspects of a descent life were not provided by the old regime. Hence, it is expected that any political power or party, regardless of its economic ideology or religious roots, will need to highlight such aspects in its election program in order to fulfill the revolution demands. Such aspects are translated on the ground in the form of creation of jobs, fighting corruption, overcoming unemployment, and ensuring social equity.

However, on the ground, there is still a need to create a vision on how the economic system should look like? What are the main features of it given the wide variety of ideological and religious groups competing for the parliament's membership. Such a crucial aspect of the future of Egypt has been largely neglected by the political powers, yet it is expected to gain attention in the remaining phase of the transitional period and afterwards.

Bearing in mind the factors discussed above such as the problem of the social contract, the model of development adopted, as well as the worsening economic indicators in the last two years, it seems unlikely that the economic conditions will change in the near future. In fact, and because of the structural nature of such problems, political turbulence, and weak economic management from the current governing regimes economic problems are likely to be further intensified. The governance challenges are also unlikely to be drastically changed. The only change likely to happen is the removal of the old private sector tycoons who were heavily engaged with the old regime. But this does not necessarily imply a more conducive business environment. The large vacuum left by crowding out the large private sector players will have to be filled and filled quickly. The new regimes, in light of worsening economic conditions, might be forced to revert to something similar, either foreign or domestic, but not necessarily

²³ As argued on the Economist blog "*Earlier attempts to strengthen private businesses by pursuing those policies were in practice half-hearted or skewed towards well-connected insiders, tainting the whole process of reform.*" See <http://www.economist.com/blogs/freeexchange/2012/02/economic-reform>



more efficient. A recent study (Saif and Ghoneim, 2013)²⁴ identified that the private sector in Egypt is having several problems in its ability to function. Among the problems that Saif and Ghoneim (2013) identified has been the lack of political and economic vision, deteriorating security status, inability to determine how policy making and decisions are being made in the new regime, frequent change of cabinets, and change of several senior government officials who have been aware of how to deal with business community problems.

Keeping aside the ideological political debates between different parties, what alternative do we have from an economic point of view? The answer is a modified free market system, that builds on the past but fixes its problems associated with market failure and ad hoc liberal decisions. Advocates of a new system (and they are many) argue that the free market system of the old regime is the culprit for all Egyptian ills and call for more government involvement. But they never identified what is meant by that, putting in mind that free market advocates also argue for more government involvement. Sometimes they refer to more involvement of the government in production of goods and services (to balance the monopolistic and oligopolistic abuse of power by private players), and sometimes they call for better regulations. The scene is not clear, and it seems that all are aiming at the same thing but calling it differently. In other words, the transitional period that Egypt is passing by has proven to be extremely difficult that is causing severe economic hardships.

Finally, it is unlikely that there will be a clear economic system that is able to characterize Egypt's economic regime. The socialist elements rooted in the economic system are likely to remain for a while. Any regime that governs will be extra cautious with embarking on any type of major market oriented leapfrog. Moreover, the sensitivity of the transitional period and the period that will follow to social unrest will imply continuing with high levels of public spending that is not sustainable from an economic point of view. Hence, what is expected is a piece meal market oriented reform to avoid social and political unrest. This does not imply that there is a tendency to invoke socialist ideas, it is rather a matter of fear from social and/or political unrest if major reforms are undertaken. This has been reflected in the initiatives announced by the government over the last three years where such initiatives focused on objectives without identifying means. This remain close to a wish list of mentioning issues like high sustainable growth rate, increasing GDP per capita, reform of subsidies, etc. But how to achieve such objectives was not clearly identified. To conclude, Egypt's economic challenges and problems are well known. Remedies are also clearly identified, but what lacks is the conducive political economy context that enables the governing regime to start the reforms. Given the political economy context Egypt is passing by right now, it is unexpected that a big bang approach of reform is adopted, it is rather likely to remain a piece meal approach. To be able to achieve significant economic reforms there is a need for building the socio political constituency to undertake the reforms, which is so far still not there.

²⁴ Ghoneim, Ahmed F. and Ibrahim Saif (2013), "The Private Sector in Post Revolution Egypt", Carnegie Middle East Center, available at http://carnegieendowment.org/files/egypt_private_sector1.pdf