STABILITY AND INSTABILITY IN EGYPT: A CLOSER LOOK AT RECENT EGYPTIAN GROWTH

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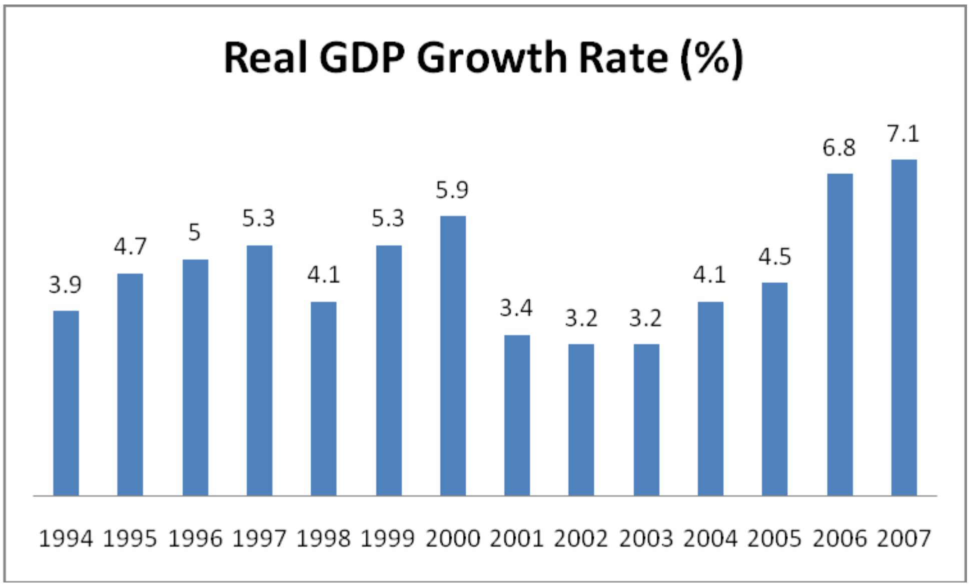
The IMF’s *Regional Economic Outlook* for the Middle East and Central Asia published in October 2007, before the revelation of the full depth of the global financial crisis, described Egypt in a 2-page box (pp. 32-33) as ‘an emerging success story’. The report described the Egyptian ‘success story’ as follows: ‘Following years of weak growth and rising unemployment, reforms launched in 2004 triggered a growth spurt, with Egypt’s economy growing by nearly 7 percent annually in the last two years—stronger than many regional peers.’ Thus, the impulse of success, according to the IMF report, came from reforms launched in 2004 that were ‘geared to encouraging the private sector to become the engine of job-creating growth’.

The Egyptian ‘success story’

The ‘success story’ was described in the IMF report in idyllic terms creating the impression that Egypt was joining other ‘emerging’ economies (hence the title of the box): broad-based growth including agriculture and manufacturing; beginning of decline in chronically high unemployment; robust stock market performance; surge in tourism revenues and remittances; strong capital inflows, mostly in foreign direct investment. We will take here a closer look at these aspects and other indicators of the state of Egypt’s economy and then discuss the reasons lying behind the ‘success story’ in order to assess its durability and Egypt’s overall economic stability.

The relatively robust performance of the Egyptian economy in very recent years is an indisputable fact. According to Egyptian official figures of the Ministry of Economic Development (MOED), the real GDP annual growth rate rose from 3.2% in the fiscal year 2002/03 to 4.1% in 2003/04 and 4.5% in 2004/05, and then sharply to 6.8% in 2005/06 and 7.1% in 2006/07, the highest rate in recent years. This performance was repeated in 2007/08 with a real growth rate of 7.2%, according to latest Central Bank figures. Even though these figures remain below those of countries like China and even India, they look all the more impressive that they were preceded by a particularly poor performance in the first three years of the new century and a weak performance on average during most of the last two decades (Chart 1). In 1999/2000 however, the real GDP growth rate came close to 6%. Moreover, the 7% rate was defined as a medium-term target as late back as 1996 in a structural reform agenda supported by an IMF Stand-By Arrangement—it has thus been reached only 10 years later.



The surge in real growth was broad based indeed: according to Egyptian official figures, the major contribution to the 7.1% of 2006/07 was the manufacturing industries sector (18.9% relative weight, i.e. 18.9% of the 7.1% real GDP growth), followed by the agricultural sector (15.5%). Traditional 'rentier' sectors contributed little to the surge: Petroleum and mining (8.9%) came after the two next sectors of trade and government, contributing slightly more than financial services, and although Suez Canal revenues grew by close to 15% during the same year, their relative weight is modest (3.3%).

Egypt's demographic increase rate, important as it is, was offset by the economic growth rate with therefore a substantial per capita real GDP growth rate. According to the UN Economic and Social Commission for Western Asia (ESCWA), Egypt's per capita growth rate reached 5% in 2005, 5.2% in 2006 and 5.4% in 2007. This led in turn to a growth in employment, offsetting and bypassing the growth of the labour force: 3% (600'000 jobs created) against 2.3% in 2006/07—pushing the unemployment rate to 9.1% (2 million unemployed) down from 9.5% in 2005/06, according to governmental figures. However, one must bear in mind, on the one hand, that the official unemployment rate was as 'low' as 7% in 1996 and that it exceeded 10% only in 2001, reached 11% in 2003 and then declined to 10.3% in 2004.

On the other hand, notwithstanding unofficial estimates that put unemployment figures at several percentage points higher than official figures—up to double—it is well known that the latter are only for people counted officially as job-seekers. They exclude those considered to have a 'job' in a country where the proportion of informal labour amounting in reality to disguised unemployment—not to mention underemployment, gender-related or other—is particularly high. Thus, according to the official sources themselves, more than one half of the 1.1 million jobs created in 2005-2007, i.e. 550'000 were provided through 'self-employment'.

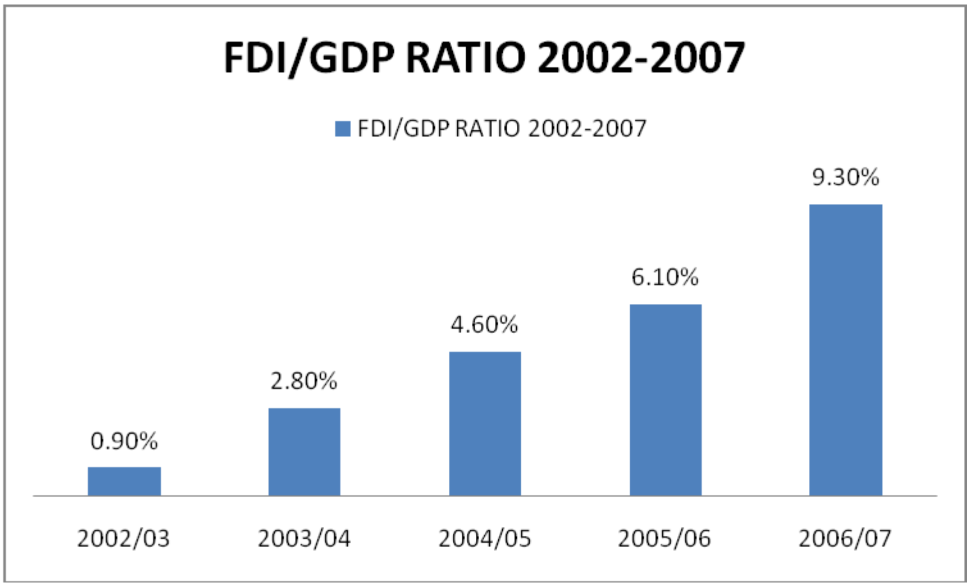
When it comes to the financial sector, Egypt has experienced in previous years in a way a foretaste of the global crisis. Credit excesses in the late 1990s led to the accumulation of 'nonperforming loans' in a banking sector that is dominated by the state, along with insurance companies. Governmental requirements arising from the scope of the fiscal deficit further complicated the picture, leading to problems with regard to private sector lending. The government bailed out public sector companies through a new wave of privatisation, using privatisation receipts to that effect. As a result, the majority of Egypt's banking sector is now privately owned for the first time since the sweeping nationalisations of the late 1950s under Gamal Abdel-Nasser. The insurance sector and the pension system are also increasingly privatised.

This aspect of the 2004 reforms naturally boosted the stock market, which saw a marked increase of 170% in transactions value in 2006/07, leading to an increase of about 60% in market capitalization value of companies traded on the Stock Exchange, with a ratio of 88% to GDP. Along with the privatisation of the financial sector, this was stimulated by initial public offerings (IPOs) with the sale of a number of companies in the field of communications and information technology to local private businesses as well as international buyers.

Tourism too showed a strong performance in 2006/07, in spite of the turbulence affecting the region, with Israel waging two wars in the summer of 2006, one of them against the Gaza Strip located in the north-east of the Sinai Peninsula, where most Egyptian touristic resorts are located. The number of tourists during 2006/07 increased by 13%, reaching 9.8 million compared to 8.7 million in the previous year. Tourist nights increased at the same rate during the same period from 85.1 million to 96.3 million nights, while tourism revenues grew slightly slower by 11%. It is worth noting that the overwhelming majority of tourists visiting Egypt are European—73% in 2006/07—Arabs (Middle East) accounting for only 14% in the same year, down from 19% the year before. American tourists represent only 4% of all visitors.

Remittances from Egyptian workers abroad kept growing in recent years, reaching a peak in 2006/07 with close to US$ 6.3 billion, representing an absolute increase of US$ 1.3 billion with a growth rate of 26% compared to 2005/06 (when they grew by 14% compared to the previous year). This surge in remittances was the main factor behind the amazing 63% increase in the balance of payment surplus in 2006/07, reaching US$ 5.3 billion with an increase of about US$ 2 billion compared to the previous year.

Capital inflows in the form of Foreign Direct Investment also surged. There has been a steady increase year after year in FDI flows to Egypt since the turn of the century. Whereas FDI inflow amounted to US$ 0.7 billion in 2002/03, it raised to US$ 2.1 billion in 2003/04, 3.9 billion in 2004/05 and 6.1 billion in 2005/06. In 2006/07, the total amount leaped to US$ 11.1 billion, representing an 82% increase bringing Egypt to the rank of second FDI recipient in Africa after South Africa. Accordingly, the ratio of FDI to GDP increased tremendously during the same period, as shown by Chart 2.



Behind the 'success story'

The Social and Economic Development Report for the year 2006/07, published by the Egyptian MOED, attributes the surge in FDI to the 2004 reform, according to the same logic found in the IMF report quoted above: 'This increase [in FDI] is due to several factors, of which the most important are:(i) the notable improvement in the investment climate; (ii) the strong commitment to good governance practices emphasizing transparency, accountability and information disclosure; and (iii) the pursuance of stable and stimulating economic policies.'

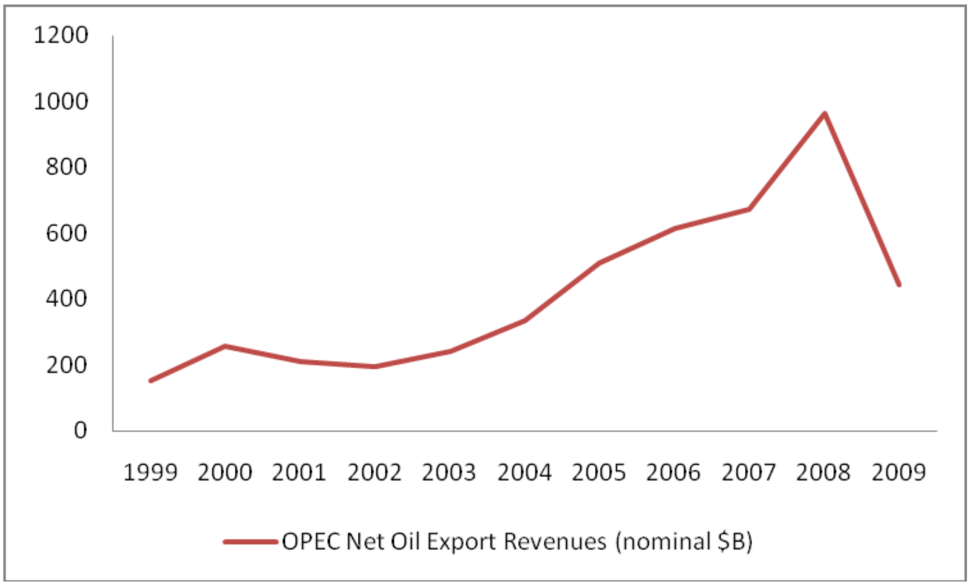
Although it cannot be disputed that the better the conditions made for foreign investors, the more foreign investment a country can attract, the above explanation of the continuous and increased surge in FDI over recent years begs two questions. On the one hand, where do FDI flowing into Egypt come from, and on the second hand, why did FDI inflows and remittances from Egyptians abroad leap in 2006/07 specifically? These two questions lead us to examine the source of FDI through a 'supply-side' lens in contrast with the exclusive focus on the conditions in the demanding country that underlies the explanation put forward by both the IMF and the Egyptian government.

The clue to the source of FDI flowing into Egypt can be found by looking at the distribution by nationality of investors in the Egyptian economy. While Egypt's Central bank figures show a very slight increase in the net stock of FDI of US origin from US$ 4.5 billion in 2005/06 to 4.7 billion in 2006/07 and an important increase of European FDI from US$ 2.9 billion to 4.1 billion, the leap in Arab net FDI stock has been impressive during the same period, soaring from US$ 0.5 billion in 2005/06 to 3.3 billion in 2006/07.

MOED figures show unambiguously that the surge in 2006/07 originated in Arab capital pouring into Egypt. Thus the relative share of Arab investors in total investments almost doubled from 13% in 2005/06 to 25% in 2006/07 while the share of non-Arab foreigners shrunk dramatically from 25% to 11% during the same period, with the share of Egyptians hardly increasing (from 62% to 64%). This very peculiar type of surge in FDI poorly fits the explanation attributing it primarily to the improvement in the investment climate in Egypt.

If this were the case indeed, there would be no reason why the Arab/non-Arab ratio would shift so dramatically in the span of one year, all the less that Egypt has consistently taken all sorts of measures over the last quarter of century in order to attract Arab capital from oil-rich Gulf monarchies. In fact, due to the harsh global competition between recipient countries, one could even expect non-Arab capital to be more sensitive to the improvement in investment conditions than Arab capital for which Egypt offers comparative advantages in belonging to the same language and culture, in addition to proximity.

The parallel sharp increase in remittances from Egyptians abroad is related to the same Arab-related cause since, in 2004 already, 45% of these remittances came from Arab countries, the next major source being North America with 32%—while nothing happened in 2007 in North America that would explain a surge in remittances. The Arab-related reason is, of course, the surge in Arab oil revenues: as is well known, starting from 1999, oil exporters have enjoyed a steady and unprecedented rising slope in the nominal price of oil and therefore in their nominal oil revenues.



For the richest Arab oil exporting countries, members of the Gulf Cooperation Council (GCC), this meant that their gross oil export revenues doubled with the curve at its steepest between 2004 and 2007—soaring from US$ 191.1 billion to US$ 381.9 billion according to figures computed by ESCWA. This has meant for all Arab major oil exporters a parallel, very sharp increase in their current-account balance during the same period. With lower than average rates of investment to GDP, the GCC countries accumulated huge surpluses that translated in soaring capital outflows. Before the peak of 2007/08, GCC capital outflows during the five years from 2002 to 2006 were estimated at US$ 530 billion by the Institute of International Finance. The bulk of these outflows, i.e. US$ 300 billion went to the USA, according to the same source, with only US$ 60 billion going to Arab countries. This amount is enough nevertheless to produce a real impact on the main recipient countries, among which Egypt is a key beneficiary.

The oil windfall explains why there was a surge of FDI into Egypt in contrast with previous years at least as much as any reforms implemented in the country in the meanwhile. As stated by ESCWA in its survey for 2007-2008:

'The surpluses on current account have been swelled by significant inflows of FDI, representing a significant new phenomenon for [Middle East Arab] countries, which generally missed out on FDI inflows during the previous global boom of 1996-7. FDI increased rapidly in Egypt after 2003 as financial liberalisation and privatisation encouraged Mergers and Acquisitions. During 2005-6 FDI in Egypt accelerated as funds came from the Gulf countries.'

Arab capital is attracted to Egypt by the usual mix of real estate, tourism and initial public offerings (IPOs), while the government tries to incite it to diversify into mainstream industries. This is well illustrated by the following excerpt from a report published in the April 2008 issue of the London-based monthly magazine *The Middle East*:

'"Gulf investors find Egypt an attractive investment destination for several reasons", the UK-based Oxford Business Group said in January. "As an Arabic-speaking Muslim country, it has a linguistic bond and cultural similarities with its neighbours. Egypt's large population," the Group noted, "is another draw. Although its economy is growing very quickly ... prices of assets and labour are still relatively low compared to those in the Gulf states." Speaking during a visit to Kuwait in January, Egypt's minister for investment, Mahmoud Mohieldin, said: "Investors are welcome to invest in a wide range of industries, including health, textiles, chemicals and automotive parts, as well as infrastructure. The opening of a new stock exchange later this year to handle the shares of small and medium-sized enterprises," he added, "would broaden the opportunities for firms, funds and individuals to invest in Egypt."'

However, capital flows into Egypt did not deviate from the general regional pattern of search for immediately profitable investment outlets. In 2006/07, 28% of FDI were still going to the relatively small Egyptian petroleum sector, which attracted almost two thirds of FDI (65%) only two years before in 2004/05. On the other hand, 25% of FDI were attracted by privatisation proceeds in 2006/07 compared with 11% two years before. This left nevertheless a plurality of 47% of FDI going into industry, tourism, real estate, finance, and services in 2006/07. An examination of growth rates by sectors in 2007/08, according to the latest Central Bank figures, shows that the most important growth was achieved in restaurants & hotels (24.3%), followed by the Suez Canal (18%), construction (14.8%) and communication (14.2%).

The key role played by Arab capital inflows in Egypt's 'success story' mean that the story is highly dependent on foreign scriptwriting, which is in turn highly dependent on the oil market and the state of GCC economies. Still, this cannot be seen in and by itself as a factor of instability or insecurity with regard to Egypt's economic future, since projections show important capital outflows from GCC countries under all oil-price scenarios. Thus, a recent study by the McKinsey Global Institute titled 'The Coming Oil Windfall in the Gulf' estimates that even in the unlikely case of a price of oil as low as US$ 30 per barrel, capital outflows from the GCC will reach US$ 1 billion in 2014, while they would reach 3 billion with US$ 100 per barrel.

A major weakness of the Egyptian economy is the deficit of its trade balance, despite Egypt being a producer and even a net exporter of oil—a fact that represents a huge advantage compared to oil-importing countries, especially for the period under consideration characterised by skyrocketing oil prices. Despite a boom in its non-oil exports in 2006/07 leaping to US$ 11.9 billion, i.e. 54% of all exports and 12% of GDP, from US$ 8.2 billion the year before, i.e. 44% of exports and 9.5% of GDP, with hydrocarbon exports remaining at the same amount level of close to US$ 10 billion, Egypt's trade deficit increased by about 30% from US$ 12 billion in 2005/06 to 15.7 billion in 2006/07, as Egypt's imports increased from US$ 30.5 billion to 37.7 billion.

However, the bulk of commodity imports were in raw material, intermediate commodities and investment commodities, some of which used by export industries, a fact which point to the possibility of this being a transitional stage towards improving the trade balance, mainly by means of further export increase rather than import reduction through import-substitution. On the other hand, this increase in imports is certainly due to some extent to the increase in their cost per constant volume due to the global rise in the price of some commodities, especially food. This significant and growing trade deficit has been offset by the factors examined above, i.e. FDI, remittances and tourism, which were decisive in producing an increase in Egypt's current account surplus from US$ 1.75 billion in 2005/06 to 2.8 billion in 2006/07.

Factors of instability jeopardising Egypt's economic future

Egypt's main problem is the ability to attract continuously the capital inflow that it needs badly in order to sustain growth and a structural trade deficit. Whereas purely economic factors can be seen as warranting a certain degree of optimism in this respect, it is Egypt's perceived and actual *social and political instability* that is by far the major factor imperilling the country's future. In recent years, the overflow of surplus oil income from GCC countries, spilling over into the region in general and Egypt in particular for lack of sufficient safe outlets in Western economies, was able to offset a major scourge of Egypt's economy and other economies in the region: capital flight. As the 2007-2008 survey by ESCWA put it:

'Liberalisation of the economic environment in Egypt ... preceded significant capital flight in 2000-2004. And yet, as the oil boom took hold, more flows of FDI from the Gulf countries have been directed to Egypt and other diversified ESCWA economies in the period after 2004. In contrast, for more diversified ESCWA economies, such as Egypt and Syria, capital flight probably reflects perceptions of internal stability in the face of political uncertainty, rapidly growing populations, persistent poverty and mediocre economic performance. Finally, capital flight across the region is primarily influenced by political instability across the Middle East. ... For Egypt, Syria and Jordan, and even for Lebanon except for 2003, capital flight was prevalent during 2000-2004. However, as the effects of the oil boom began to emerge, the figures at least for Egypt for 2005-6 are likely to be very different. FDI from Gulf countries has increased substantially, thus reversing capital flight.'

According to ESCWA's estimation, capital flight from Egypt increased tremendously in the first years of the new oil boom, from a net inflow of US$ 381 million in 2000, reflecting a degree of confidence in the local currency, to a net outflow of 3.7 billion in 2004. The surge in FDI pouring into Egypt has certainly offset and probably reversed the capital flight, as the slight appreciation of the Egyptian pound's value indicated with its exchange rate declining from LE 5.75 per dollar in July 2006 to LE 5.70 per dollar in July 2007. This trend continued with the exchange rate down to LE 5.55 per dollar in January 2009. It remains to be seen whether this is only temporary, the key determinants in this respect being those enumerated by ESCWA, especially political uncertainty, rapidly growing populations, and persistent poverty. As the same survey commented:

'Although Egypt is a positive recipient of FDI for more than two decades and, since 2003, significant inward FDI has taken place, above all, from the Gulf countries, the picture remains unclear. After 25 years of five to six percent real GDP growth on average, a 15 percent rise in the price of bread led to mass riots and exposed the fragility of the development process. Upon closer examination, it was found that income inequality, measured over the same period, was rising. The net result is that an inequitable and narrowly based path of growth was experienced.'

Indeed, this state of things is aggravated by a soaring inflation, resulting from the increase in demand created by massive capital inflows as well as from the rising cost of imports, with the Egyptian urban CPI jumping very suddenly from under 10% in 2007 to over 20% in 2008, as reflected in the latest figures provided by the Central Bank. The natural outcome of this increase was vividly illustrated by this Associated Press report dated 10 June 2008:

'A government official says inflation in Egypt soared to 21.1 percent in May, as rising prices drive up the country's food costs. The official Middle East News Agency quoted the head of the Mobilization and Statistics Organization as saying Tuesday that inflation in rural areas increased even higher to 22.9 percent in May. ...On Saturday, thousands of demonstrators fought with police after a protest over flour rations in a town on Egypt's Mediterranean coast. In the last two months, 11 people have died in clashes while standing in line to buy subsidized bread.'

The inflation rate kept soaring, reaching an annual 23.6% in August 2008, the fastest pace since 1992, putting pressure on the Central Bank to increase interest rates for a sixth time in the same year. The CPI urban index remained above 20% thereafter. The very fact that the country experienced accelerated growth since 2005/06, even before the surge in the inflation rate, led, from 2006 on, to the biggest wave of workers strikes that Egypt has ever seen since the 1950s, with over 200 instances of labour unrest in 2006 alone. The strike wave continued to gather momentum in 2007 and 2008 with repeated strikes, riots and clashes between strikers and demonstrators, and police forces.

After three people were killed in riots on 6 and 7 April 2007 in the Northern textile town of Mahalla El-Kobra, part of a series of protests against high food prices, privatisation of state enterprises and firings, Egypt's parliament approved tax increases on 5 May for items including fuel and cigarettes, and boosted taxes on vehicles to fund a 30% pay raise for state workers. This move did not succeed in abating the wave of struggles, which reached another peak in September 2007 with the weeklong strike by 27,000 employees at the Misr Spinning and Weaving Factory in the same industrial city of Mahalla El-Kobra.

Then, in 2008, as the same factory was planning again to be the leading force of a nationwide day of action on 6 April against rising prices and low wages, police forces occupied it the night before the strike, leading to clashes and dozens of injuries, while security forces cracked down on protesters throughout the country arresting more than 100 persons. Even university professors went on strike in March 2008 with 2000 of them staging a one-day strike over the country.

This extremely tense situation is aggravated by the increasing uncertainty about Egyptian president Hosni Mubarak's succession. Born in 1928, the president has been ruling Egypt since the assassination of his predecessor Anwar El Sadat in October 1981. Moreover, it is a well-known fact that the strongest opposition force in Egypt is the Islamic fundamentalist Muslim Brotherhood, an organisation whose Palestinian branch, Hamas, was at the centre of intense national sympathy during the violent Israeli onslaught in December 2008-January 2009.

These hugely important facts point to an increasingly high risk factor jeopardising the future of Egypt's economy. Egypt's prospects are marred by such a high degree of social and political instability that the 'success story' trumpeted by the IMF and the World Bank sounds like a very light-hearted tune indeed. The very fact that this was about a country where close to 44% of the population live with less than US$ 2 a day, according to UNDP figures, should have been a sufficient reason for more sober evaluations. Rather than an unmitigated 'success story', Egypt's situation should rather be seen as quite worrying indeed.

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