



The Egyptian Economy: Short and Medium Term Prospects

June 16, 2011

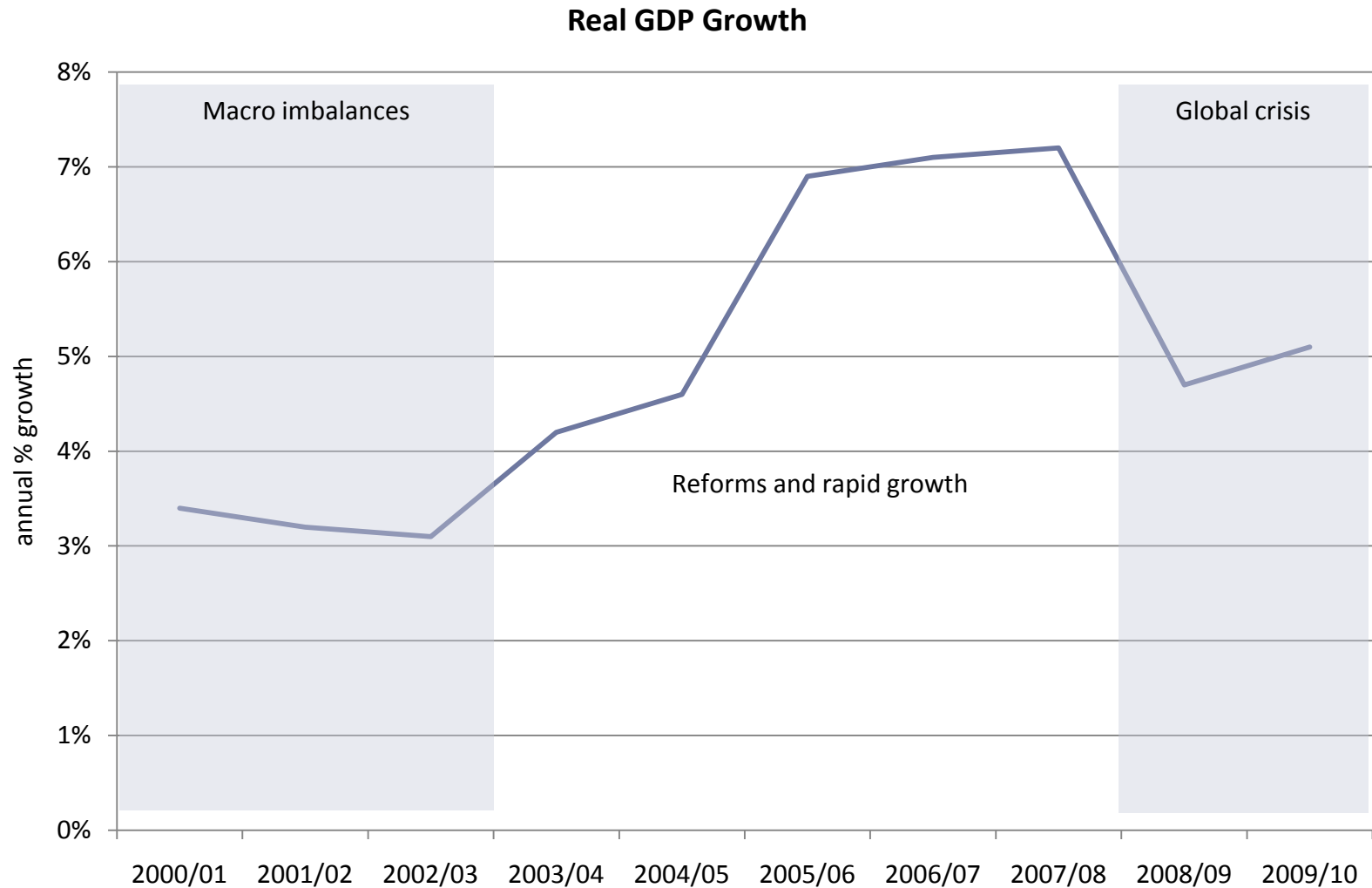
Introduction

- ▶ We aim to look backward into developments in the Egyptian economy leading to the crisis and the shortcomings that may have contributed to the social unrest.
- ▶ Further, we aim to evaluate recent and potential economic losses due to the political upheaval and offer a forward looking strategy to capitalize on ongoing reforms towards securing a better future for the Egyptian economy.

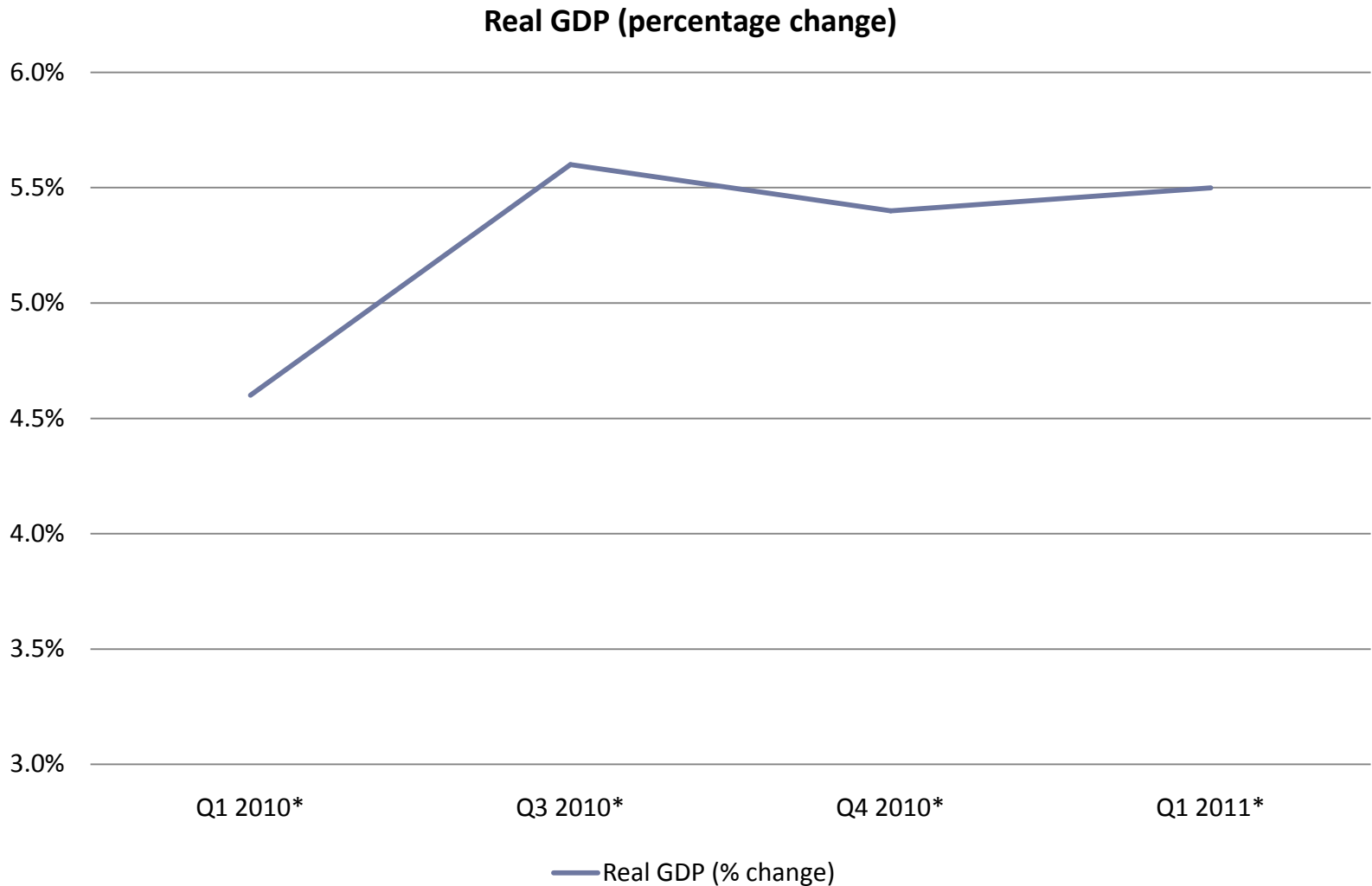


A quick view on the economy before January 25th

- Economic reforms have paid off to energize growth and provided space for policy stimulus during the global crisis



- In 2010, the economy was rebounding well...

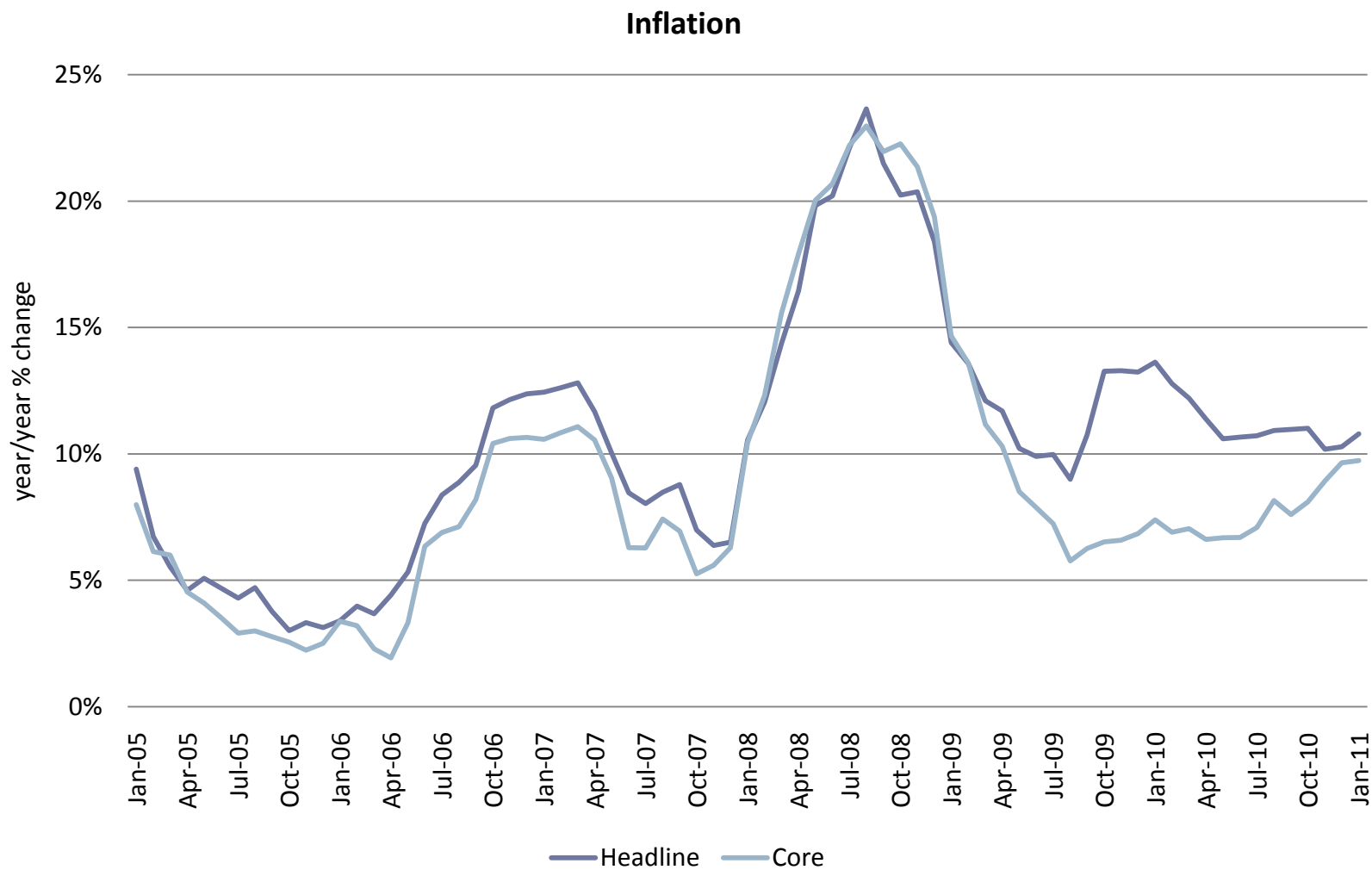


Inflation

- ▶ Annual CPI inflation averaged 11.8 percent in 2009/10.
- ▶ The first half of 2010/11 (July-December) witnessed relative stability in headline inflation rate (year-on-year).
- ▶ Remarkably, however, is the convergence of the core and headline inflation rates.
- ▶ The monthly core inflation index accelerated in the first half of 2010/11 from 7.1 percent to 9.7 percent, driven by the rising prices of rice, poultry, edible oils and fats.



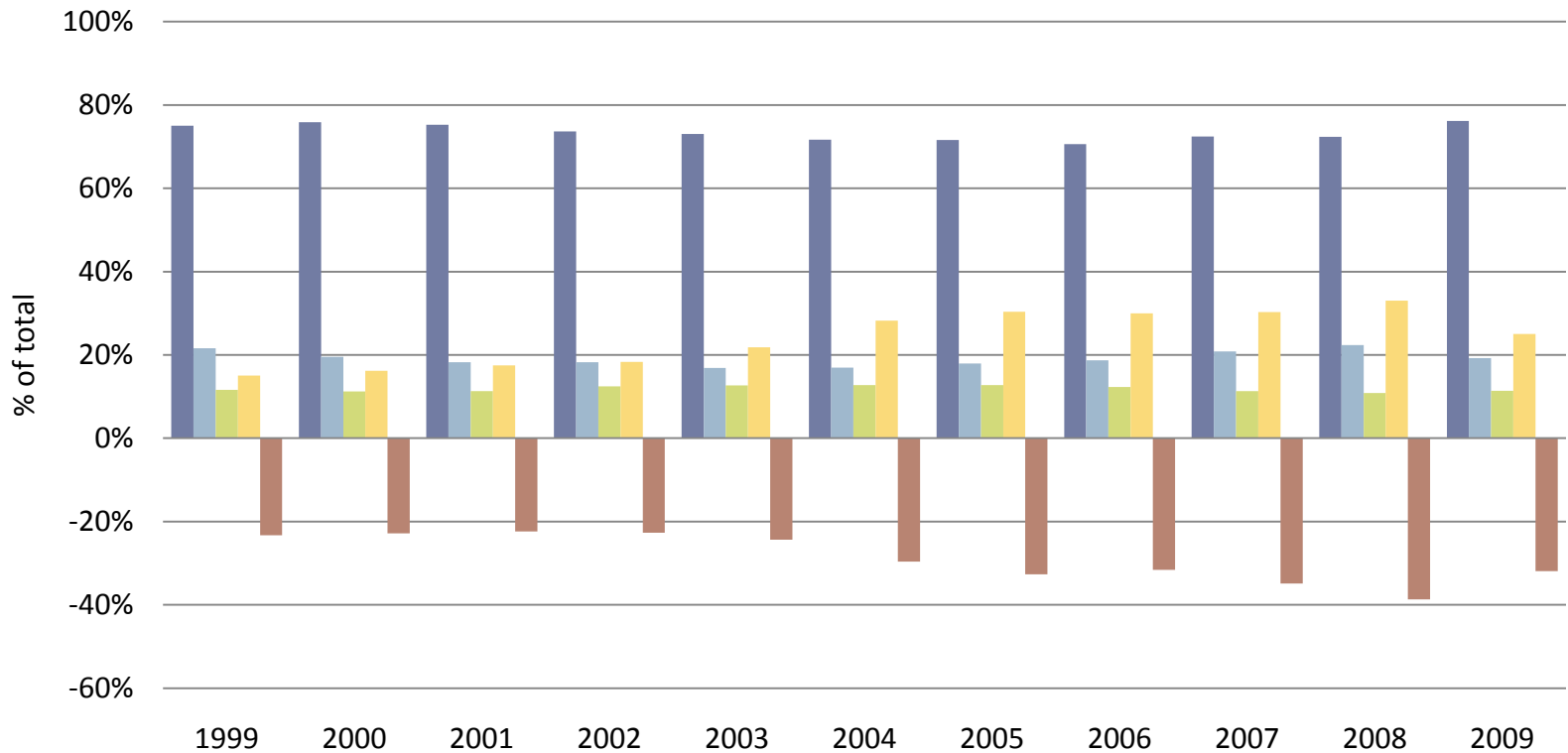
- Core inflation accelerated in the first half of 2010/2011, owing to rising prices of rice, poultry, edible oils and fats



Sources of Growth

• Resilient domestic consumption has been the main driver of growth

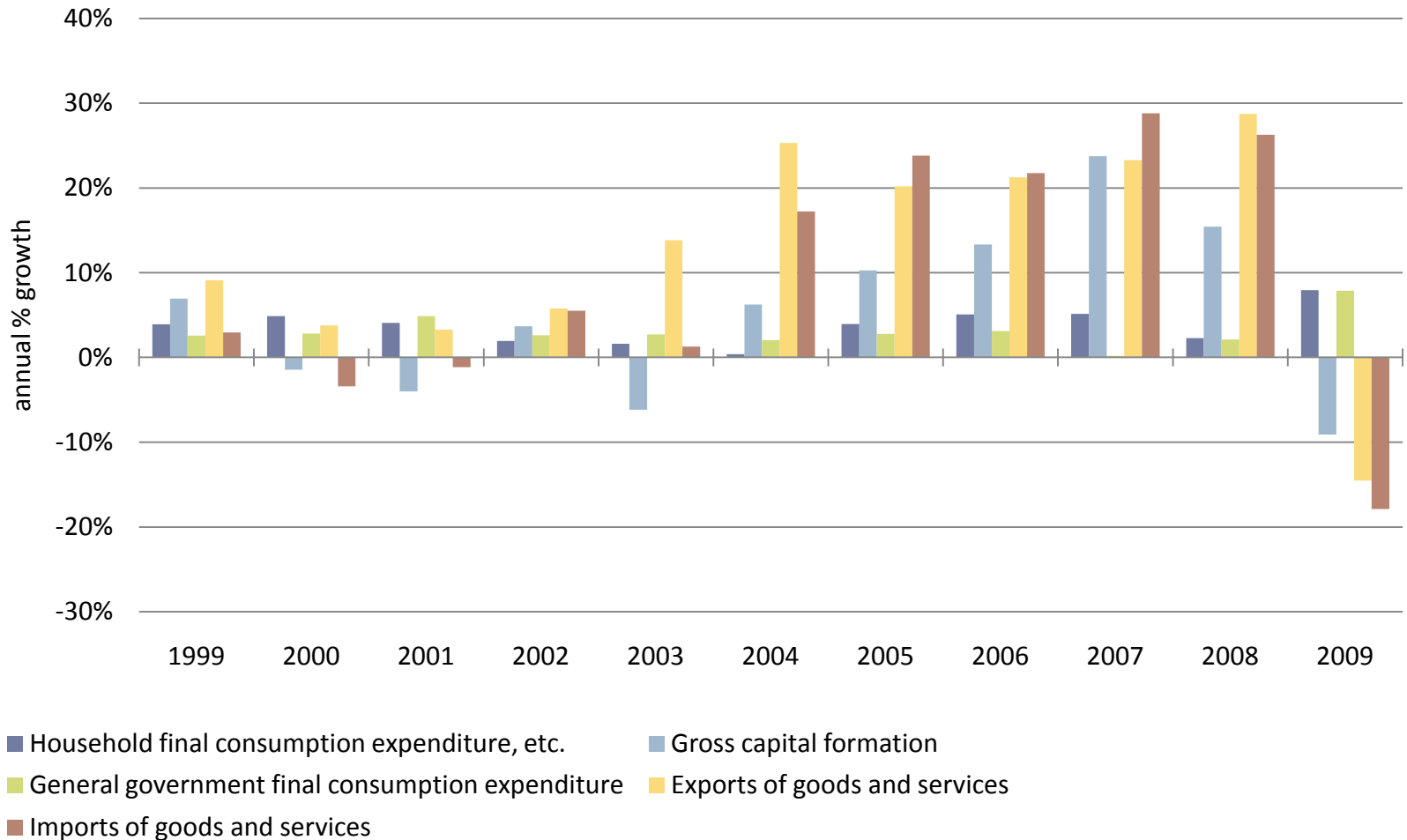
Composition of GDP



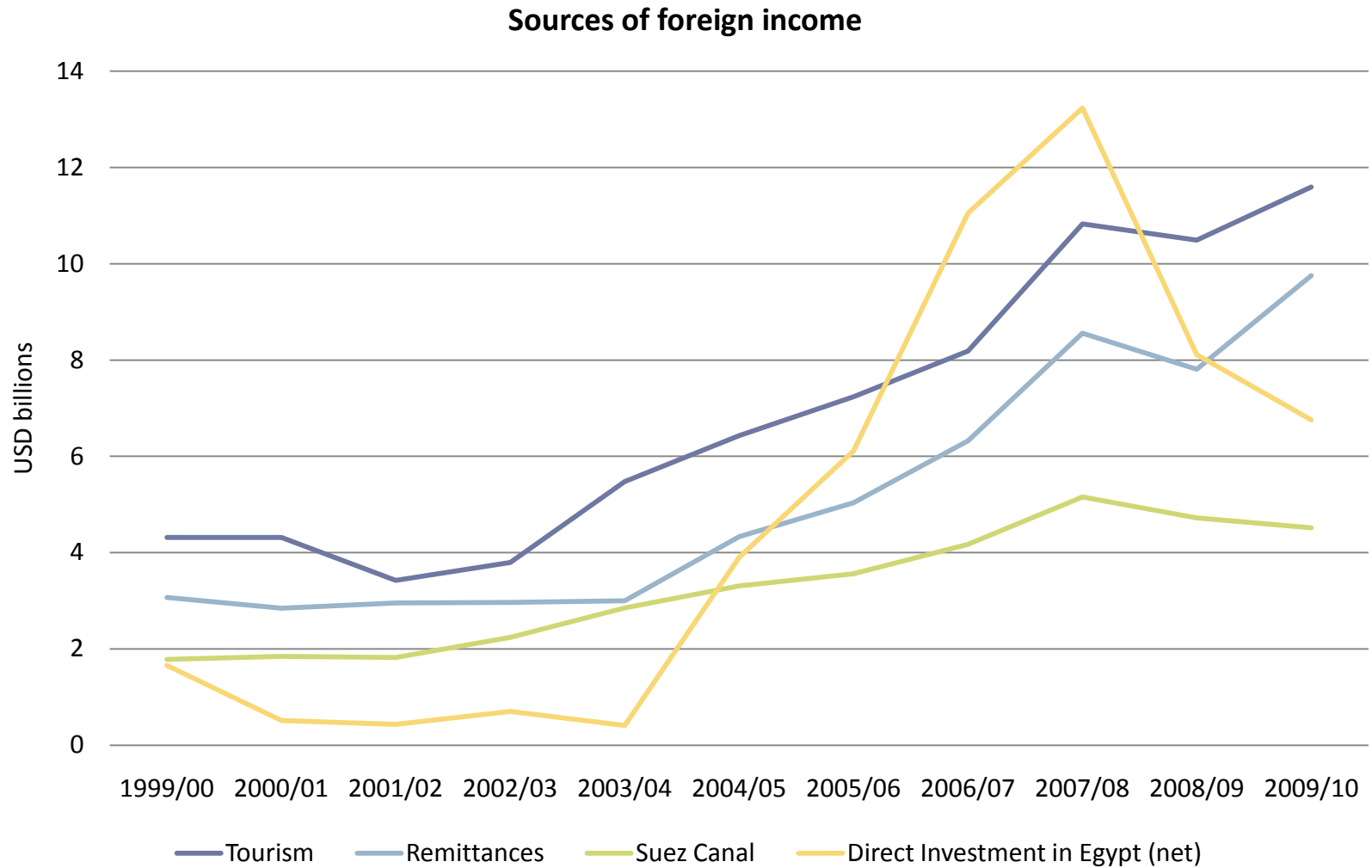
■ Household final consumption expenditure, etc. ■ Gross capital formation
■ General government final consumption expenditure ■ Exports of goods and services
■ Imports of goods and services

- Supported by a pickup in the contributions of investment and exports to growth

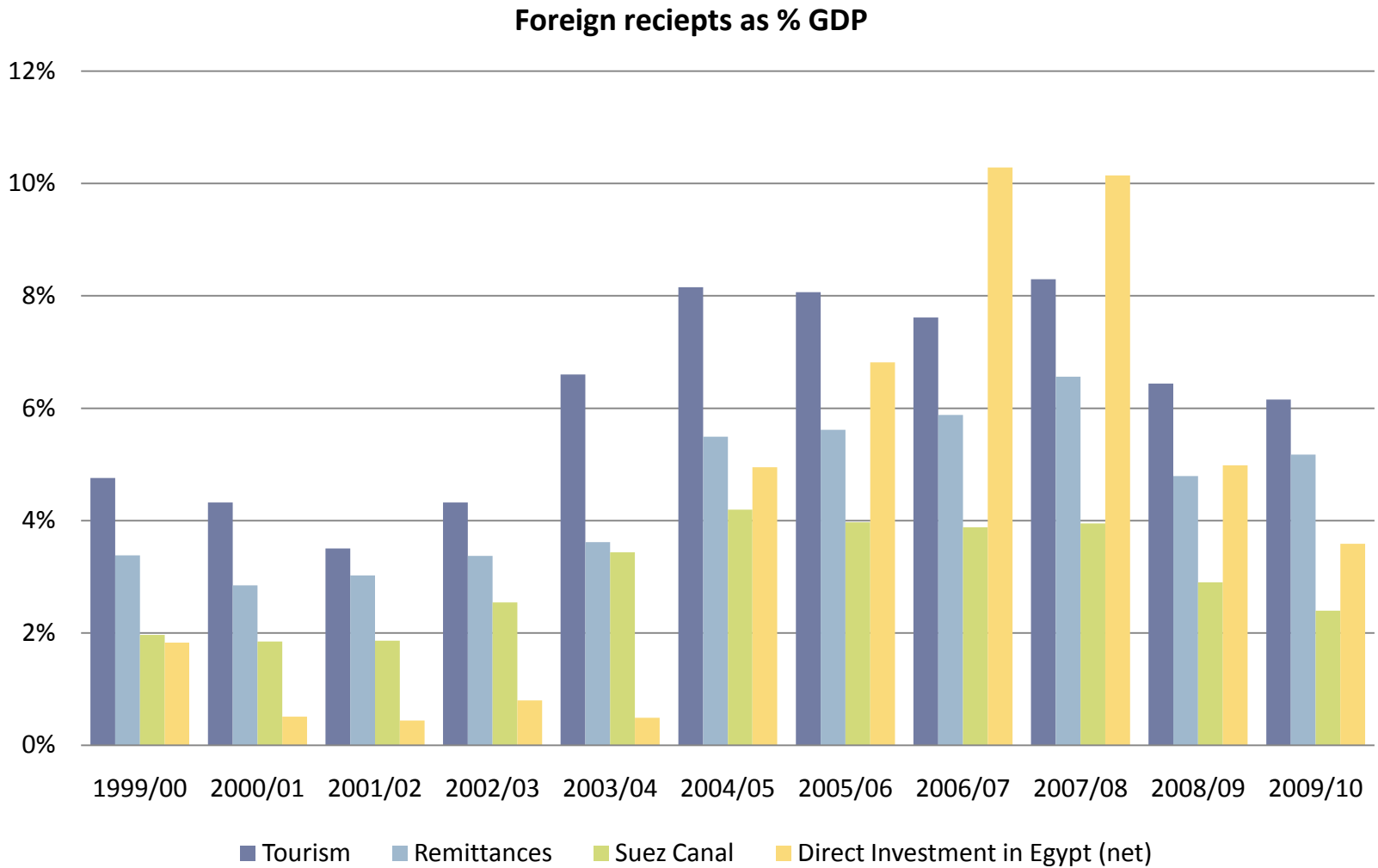
Growth of spending components



- Foreign receipts have been on a rising trend



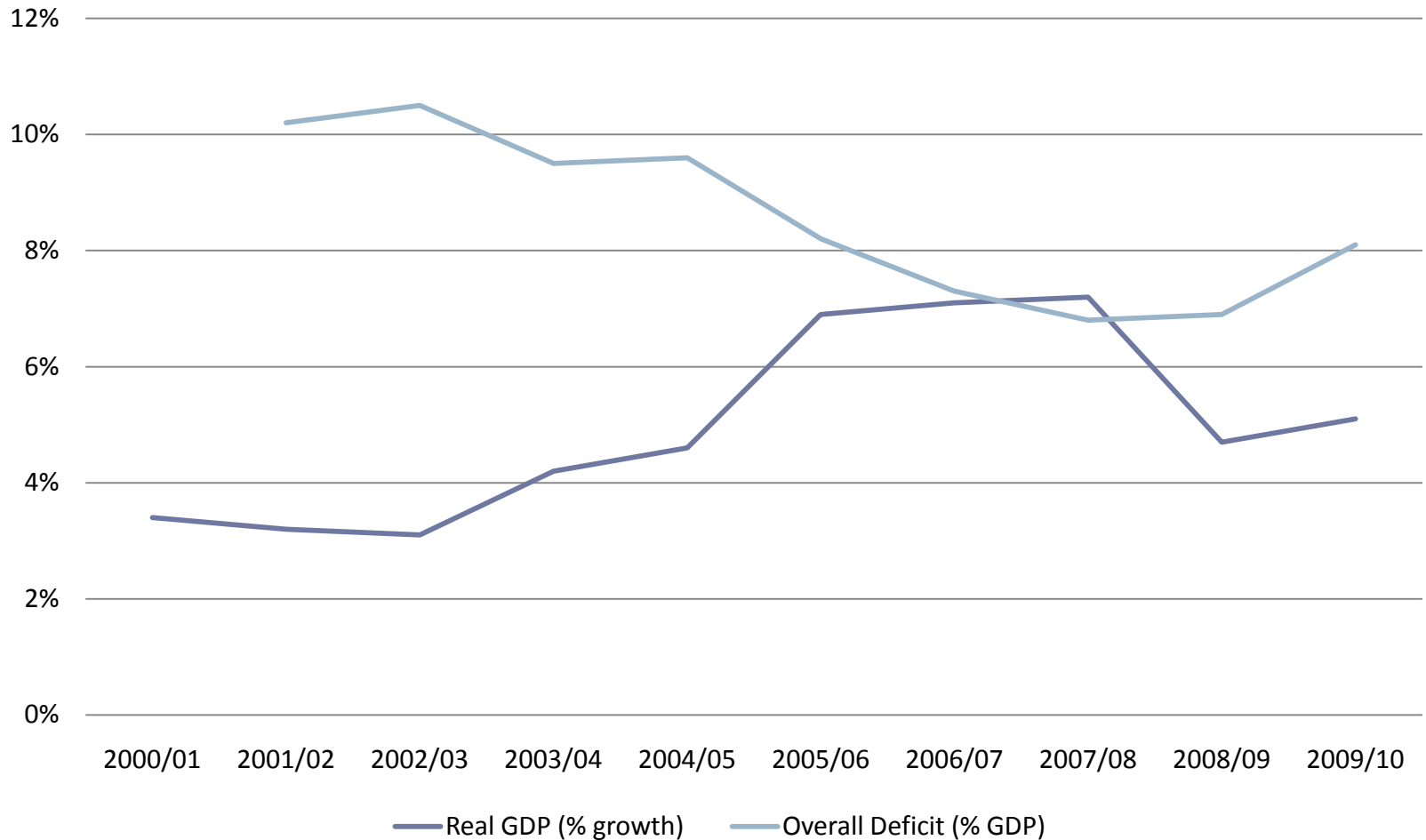
- Foreign receipts have increased relative to GDP over time



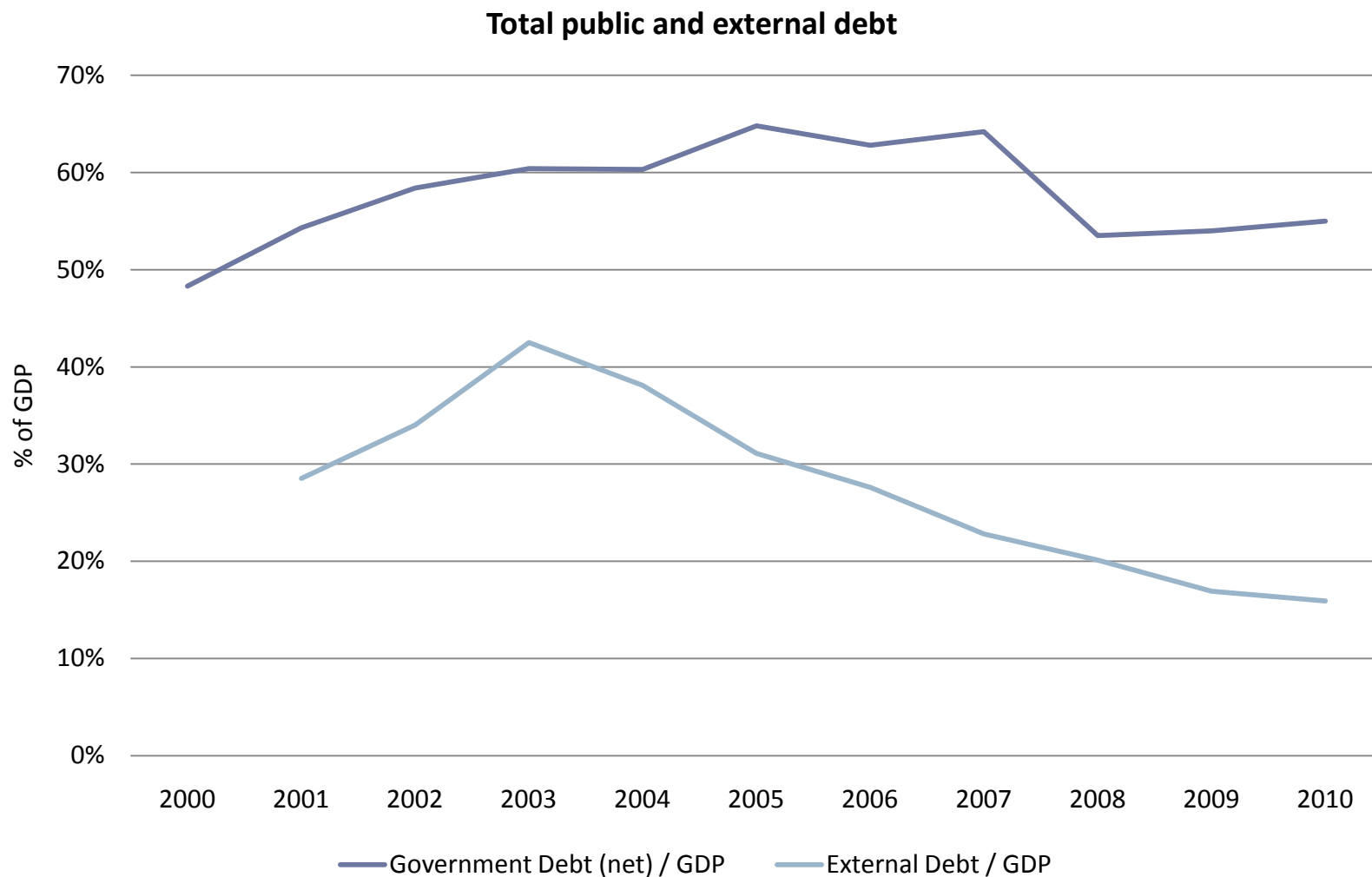
Fiscal Policy

•The deficit widened to provide a necessary stimulus during the downturn

GDP Growth vs. Fiscal Deficit

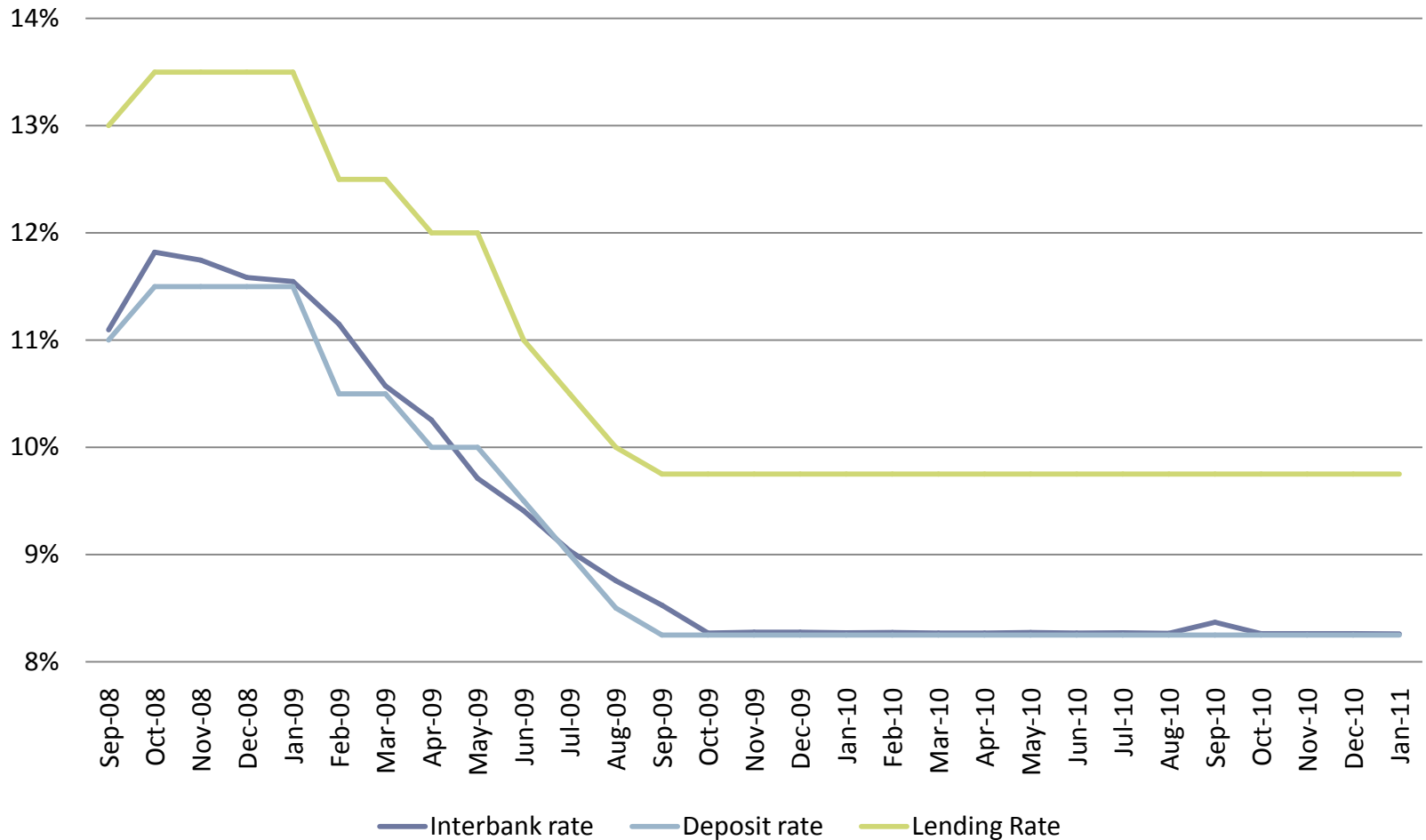


- **Wider fiscal deficit has contributed to a rising public debt ratio, although the external debt has been on a declining path**



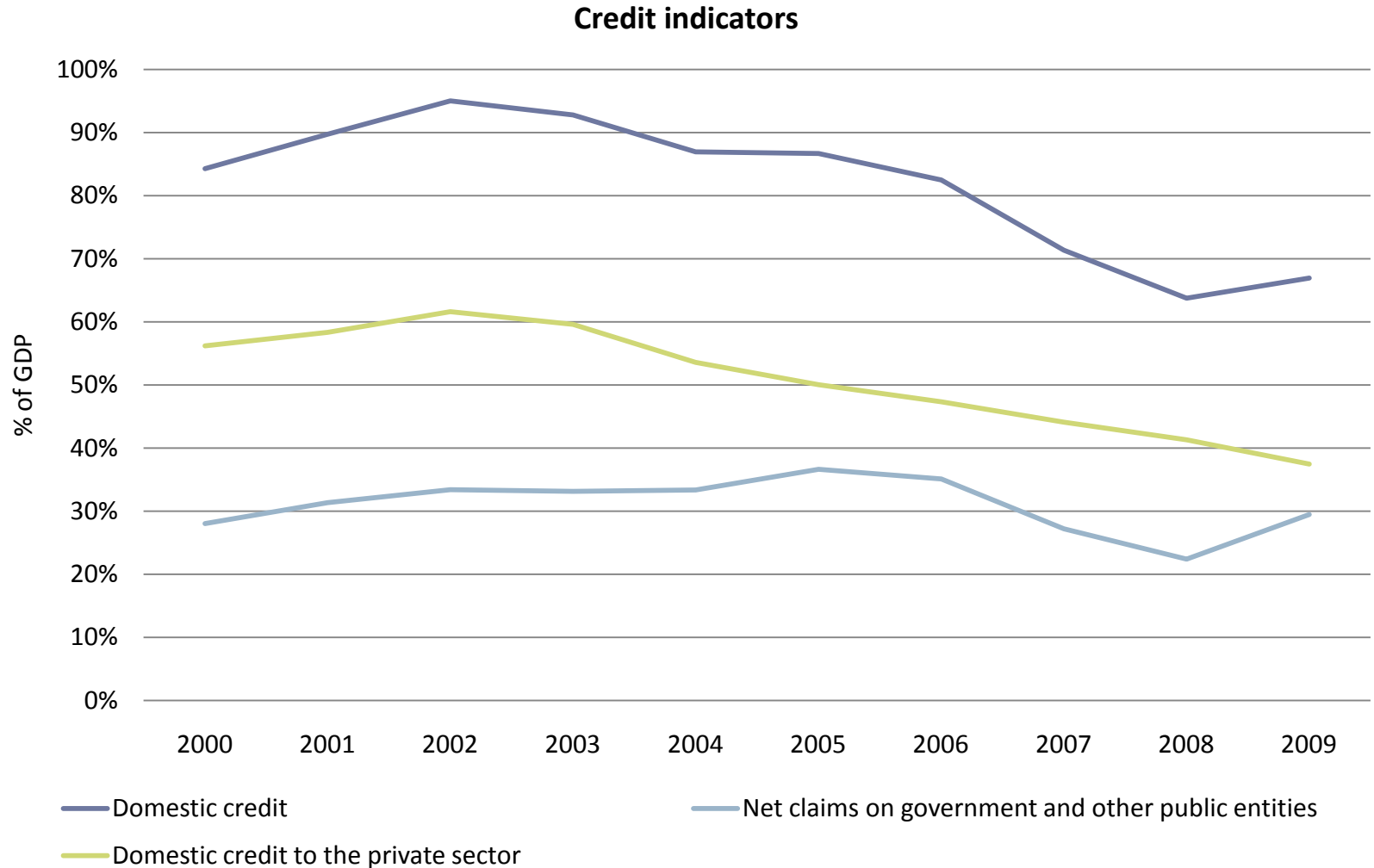
- Monetary policy has been on a neutral stance to sustain growth restoring to non-traditional monetary policy instruments to stem temporary inflationary pressures

Policy rates

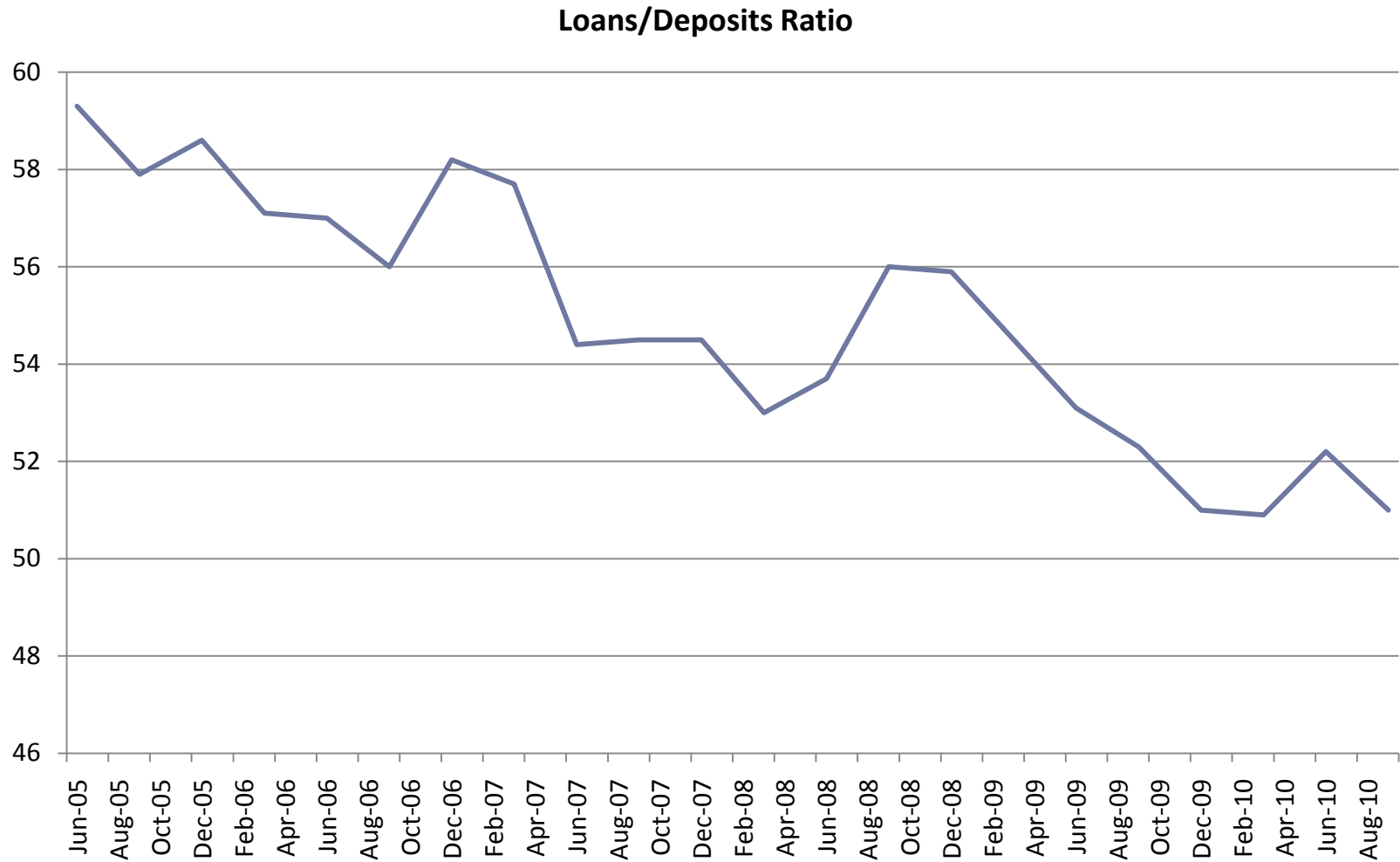


This was coincident with..

- Slowing demand for private credit, coupled with a rebound in government credit



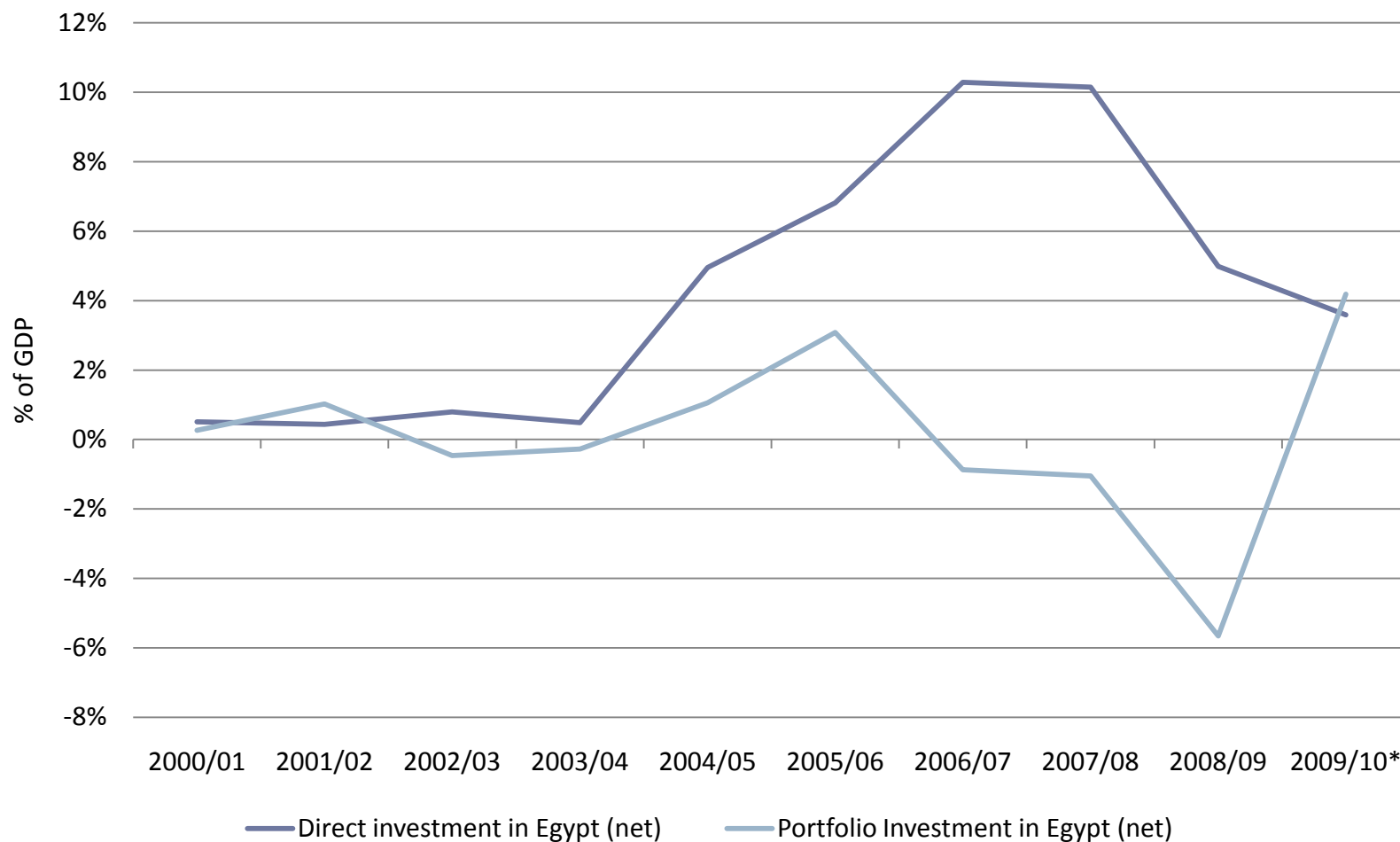
- All this, despite ample liquidity in the banking system



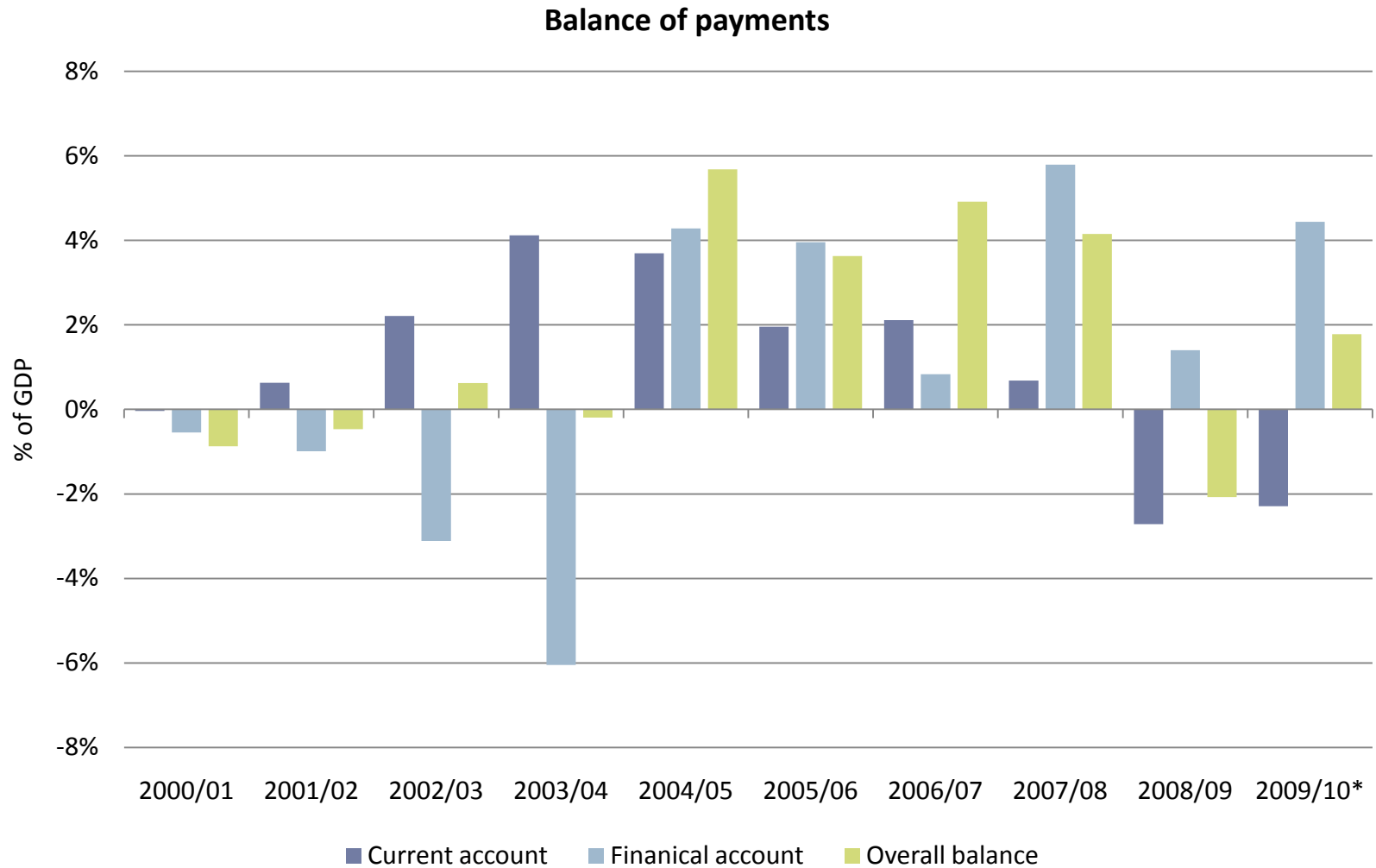
Balance of Payments

- FDI has been slow to recover while portfolio inflows have picked up significantly

Direct investment and portfolio investment

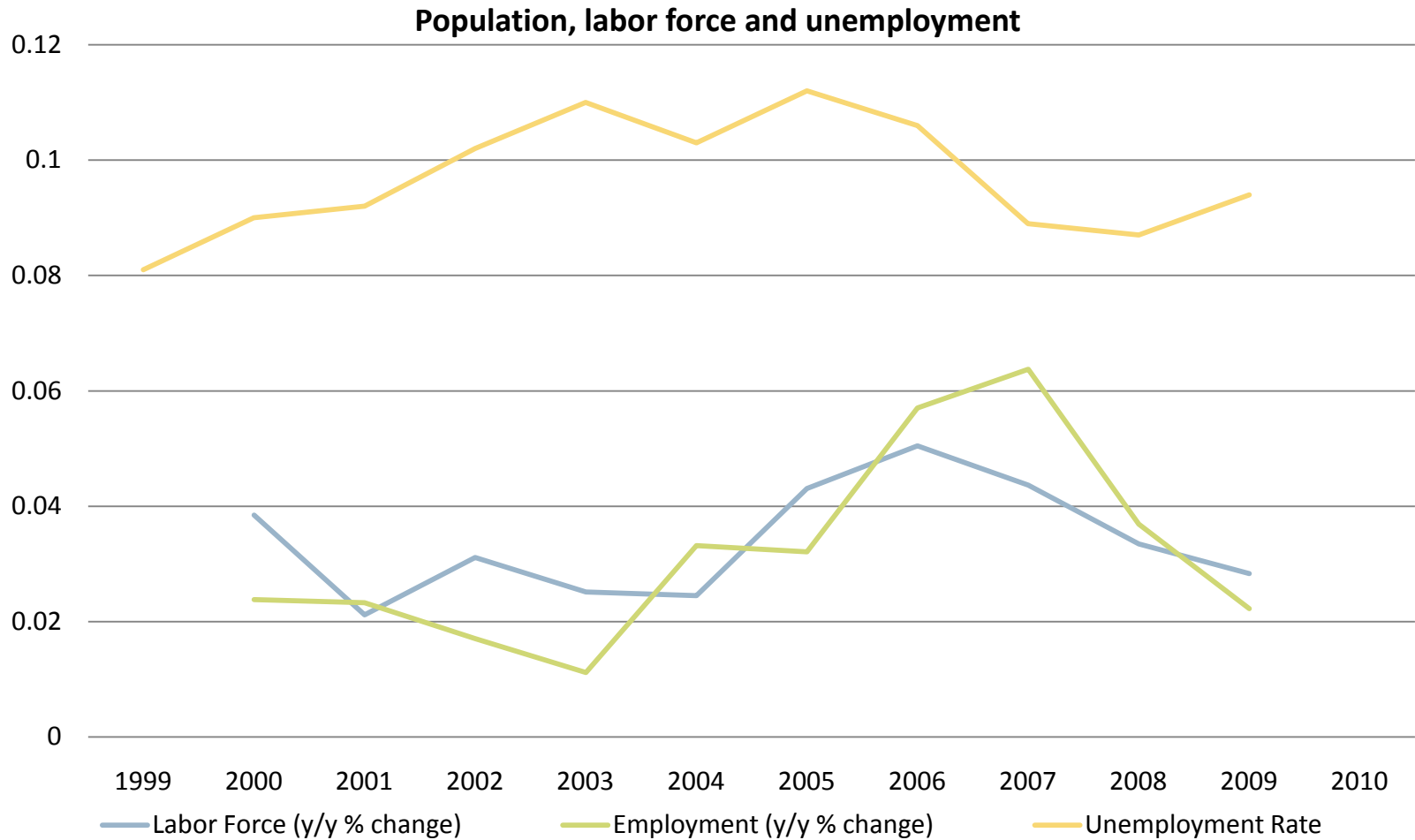


- Robust financial inflows have financed the current account deficit and contributed to build up of foreign reserves



Labor Market and Social Indicators

•Despite high growth rates, inadequate education and labor market structural rigidity have slowed employment growth ...resulting in a high unemployment rate and dire social conditions



- Manifested in high levels of income inequality and extreme poverty

	2000	2005
Poverty headcount ratio at \$2 a day (PPP) (% of population)	19.37	18.46
Income share held by highest 10%	28.34	27.62
Income share held by lowest 10%	3.88	3.85
Income share held by highest 20%	42.1	41.46
Income share held by lowest 20%	8.95	8.96
GINI index	32.76	32.14

Recent Political and Social Unrest and Economic Consequences

- ▶ 2010 was an eventful year for Egypt, ending with very controversial parliamentary election that caused mounting uproar over “legitimacy crisis” and gross allegations of fraud.
- ▶ Egyptians started a nation-wide uprising on January 25 and protests continued over political reform and social inequity, even after the resignation of President Mubarak who had been in power for 30 years.
- ▶ The political upheaval was well received internationally and domestically as the transformation would set the stage for constitutional amendments.
- ▶ The political upheaval and surrounding unrest has had an adverse effect on economic activity, due to the curfew and business closures.



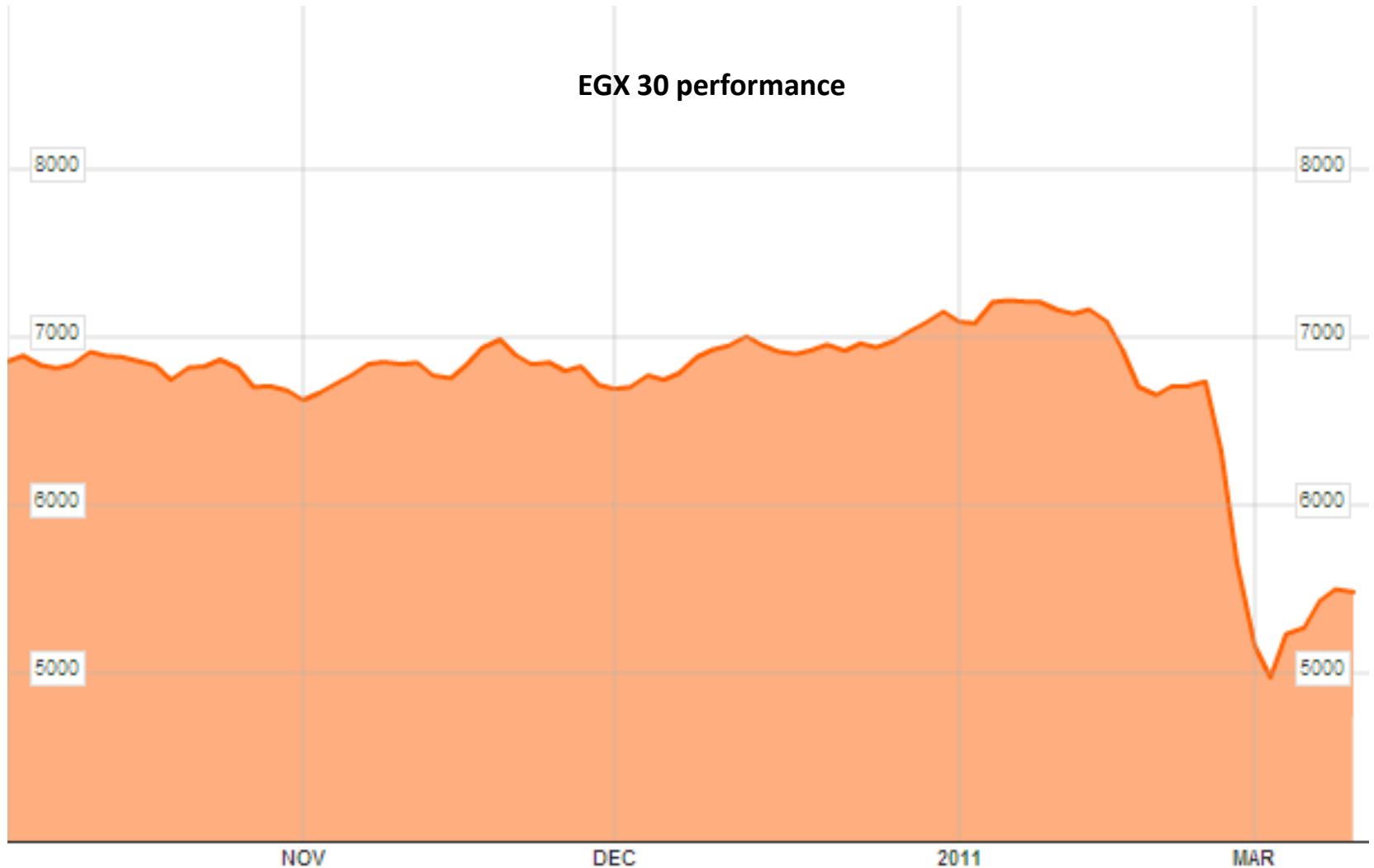
Economic Losses

- ▶ The adverse effects on the economy will undermine growth performance for the rest of 2010/11, estimated to be between 1.7% and 2.5%.
- ▶ The stock market went into a slump and trading was suspended following significant losses that led to a complete shutdown on January 28.
- ▶ The main indices of Egypt's stock exchange, EGX30 and EGX100, both dropped by 10.5 percent and 14 percent.
- ▶ Several agencies downgraded Egypt's rating:
 - ▶ Moody's - Ba1 → Ba2
 - ▶ S&P - BBB-/A- → BB+/B
 - ▶ Fitch - Stable → Negative



- Significant losses in 2011 have offset all the gains of 2010

EGX 30 performance



Disruption of Economic Activity

- ▶ Lingering uncertainty is likely to have severe toll on growth in the first half of 2011.
- ▶ The economic reform agenda and plans of foreign investment will – most likely – be delayed. Foreign investment deteriorated from 6.8 to 2 USD Billion for FY 2010/2011. It is expected to increase to 2.5 USD Billion for FY 2011/2012.
- ▶ However, if political stability is restored, growth could rebound in the next fiscal year such that it is expected to increase from 2.5% to 3.2% for FY 2011/2012.



Impact on Domestic Demand

- ▶ Other unfavorable effects of the political unrest were manifested in the decrease in domestic demand.
- ▶ Private consumption and investment were undermined due to the temporary disruption of economic activity and uncertainty.
- ▶ This latter adverse effect may linger till political stability is restored.

Indicator	Actual 2009/2010	Projected 2010/2011	Budget Proposal 2011/2012
Domestic Investment rate	18.9%	15.4%	14.9%
Domestic savings Rate	14.1%	10.8%	9.6%
Foreign Direct Investment (Billion USD)	6.8	2.0	2.5

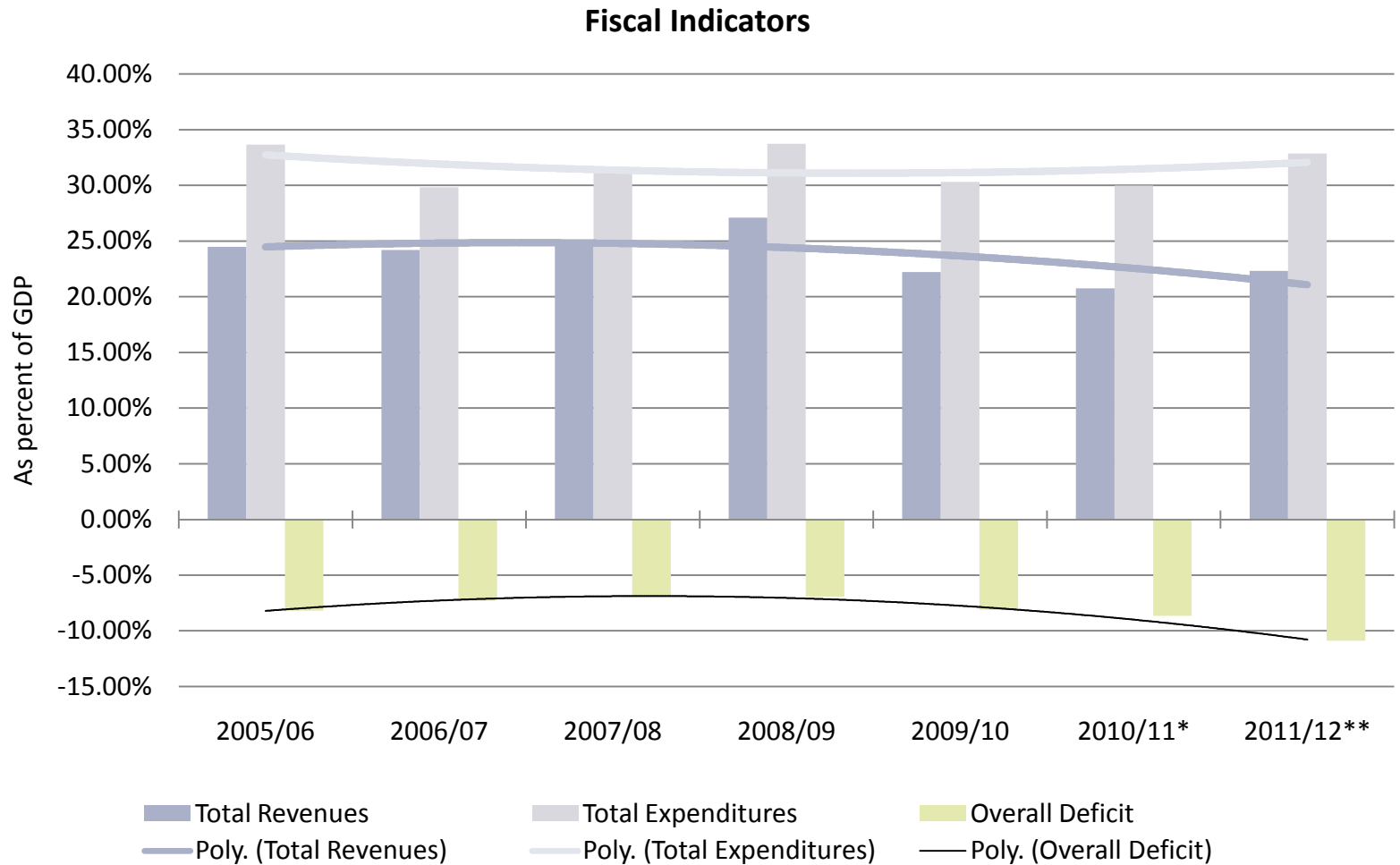


Fiscal Policy Response

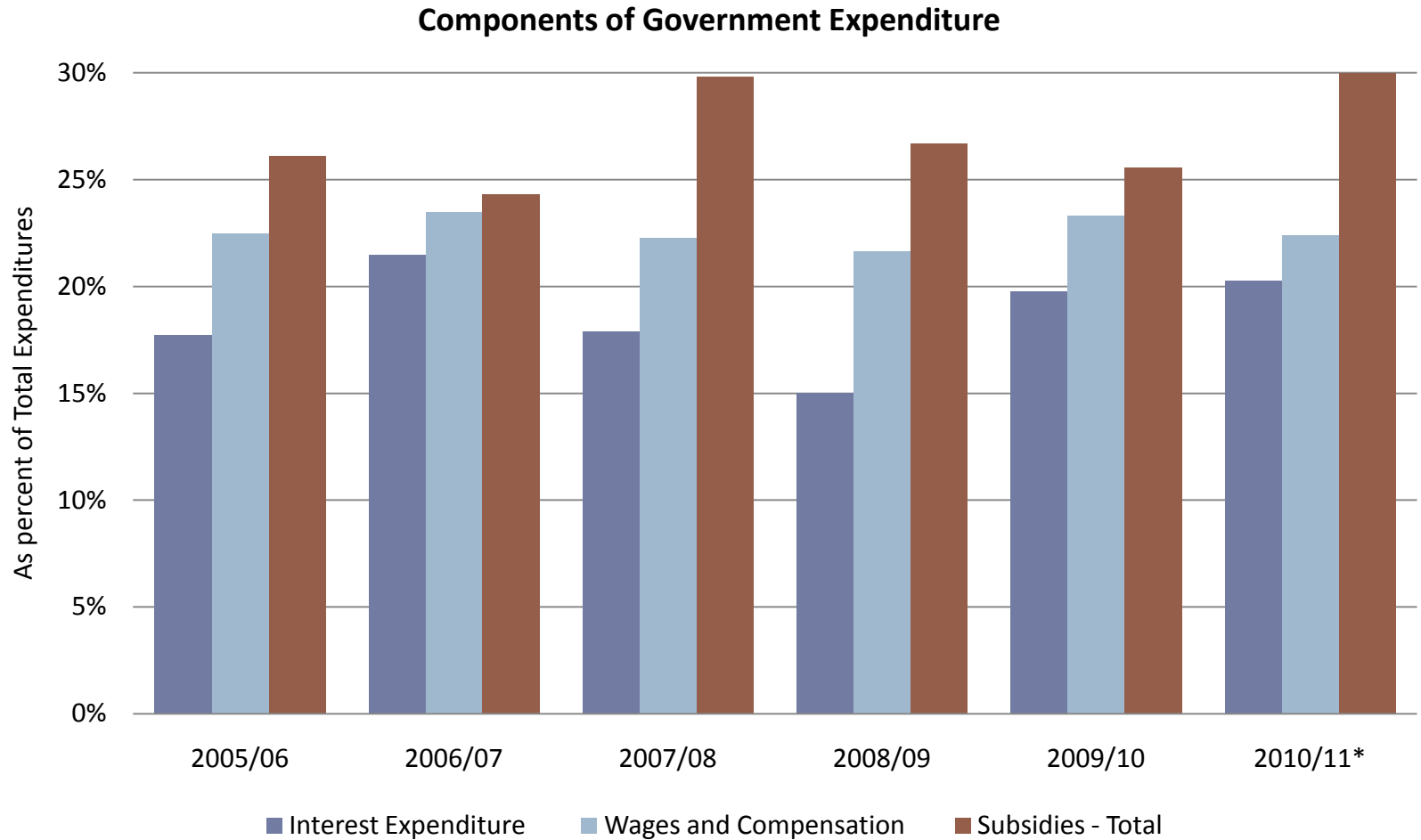
- ▶ Concerns about inequity have forced an expansionary fiscal policy in 2010/11 to ameliorate the economic implications of the political unrest.
- ▶ The overall budget deficit is expected to widen in 2010/11, compared to the budgeted deficit of 7.9 percent.
- ▶ Significant increase in spending on subsidies, wages and salaries and compensations for losses, coupled with significant reduction in revenues due to slowdown, could increase the deficit by 25 percent.

Indicator (As percent of GDP)	Actual 2009/2010	Projected 2010/2011	Budget Proposal 2011/2012
Revenues	22.21%	20.74%	22.31%
Expenditures	30.32%	29.98%	32.86%
Overall Deficit	8.12%	8.64%	10.88%

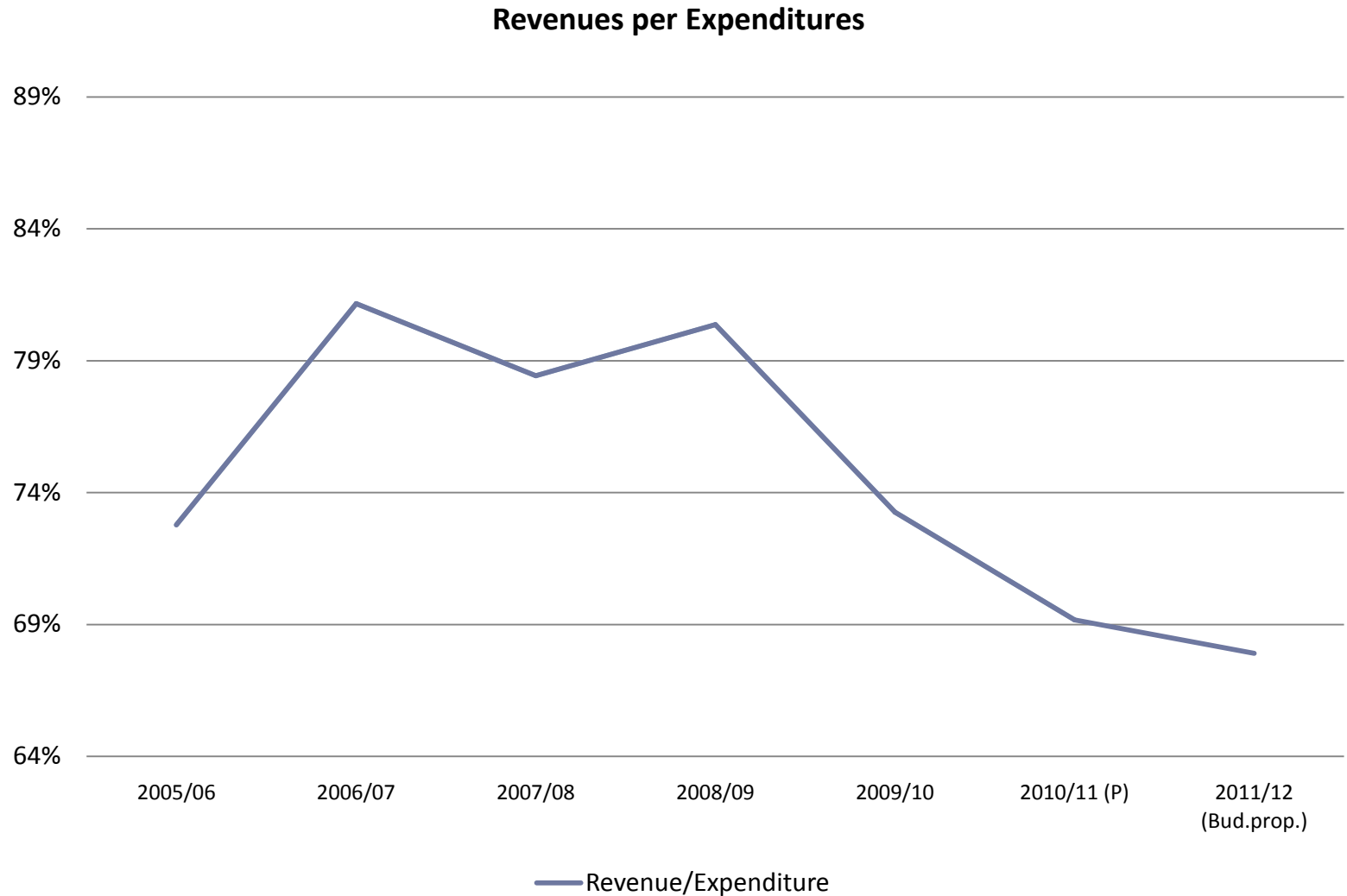
- Following a drive for fiscal consolidation, stimulus and social packages widened the fiscal deficit



- Expenditures on subsidies, wages and salaries, and interest payments have steadily grown, presenting nearly 75% of total spending

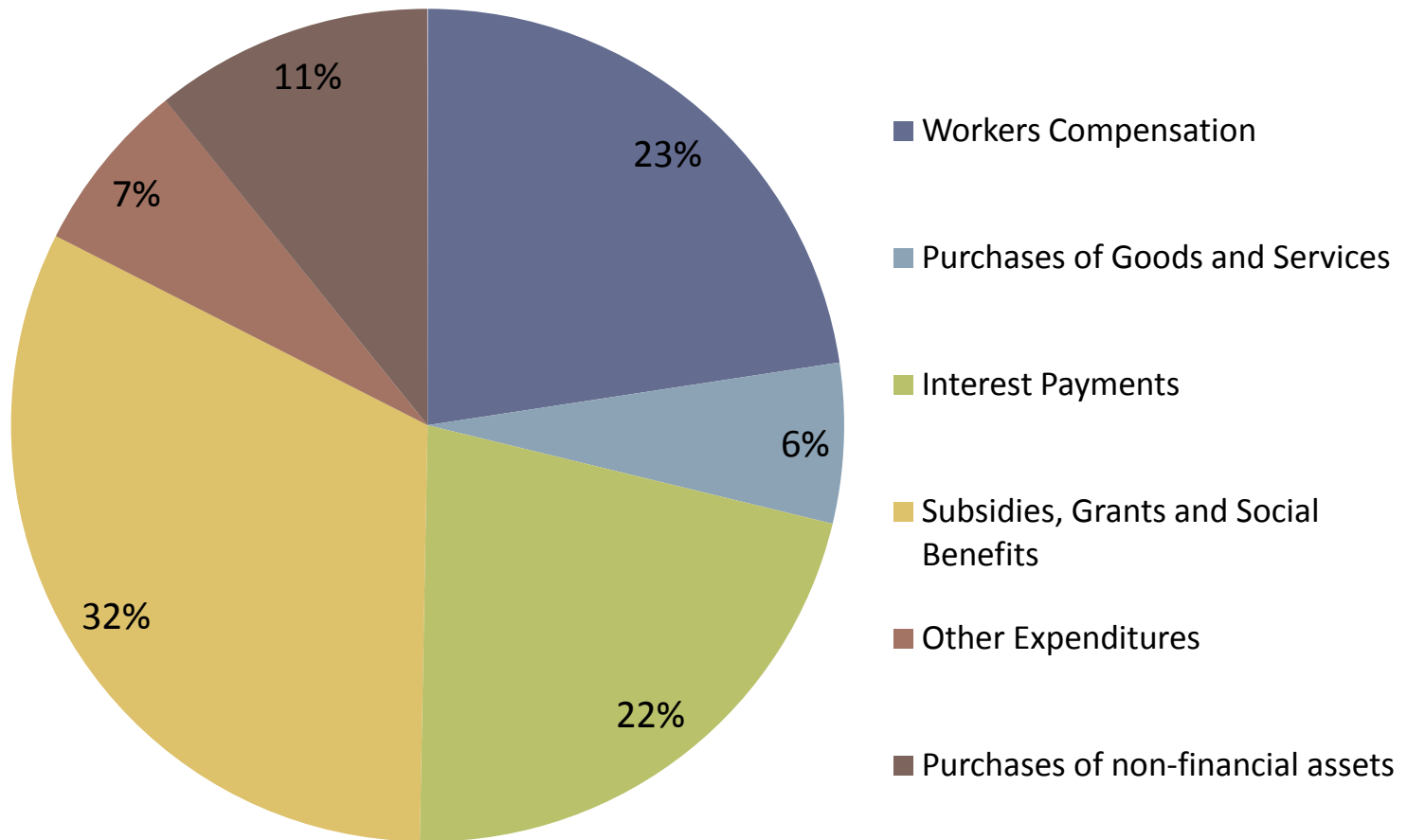


- **Even worse, revenues have shrunk considerably relative to growing expenditures**



- **Current budget does nothing to address these fiscal concerns**

Budget Proposal for FY 2011/2012



- Overall deficit is expected to widen significantly, compared to budget

(LE Million)	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011 -Budget	2010/2011 -Projections	Change	%Change	Budget proposal 2011/2012
Total Revenues	180,215	221,404	282,505	268,114	285,810	279,749	(6,061)	-2.12%	350,300

Total Expenditures	222,029	282,290	351,500	365,987	403,168	424,064	20,896	5.18%	515,887
Wages and Salaries	52,153	62,839	76,147	85,369	95,309	109,605	14,296	15.00%	116,497
Subsidies, Grants and Social benefits	58,442	92,371	127,033	102,974	116,616	118,216	1,600	1.37%	166,223
Other Expenditures							5,000		34,693

Overall Fiscal Deficit	54,697	61,122	98,038	98,038	109,076	136,033	26,957	24.71%	170,800
Overall Deficit/GDP (%)	7.3%	6.8%	6.9%	8.1%	7.9%	10%			10.88%



External Sector

- ▶ Egypt's current account deficit is likely to deteriorate in 2010/11.
- ▶ A significant portion of foreign receipts was lost, owing to lower FDI and higher capital outflow.
- ▶ In addition to significant drop in trade exports and loss of tourism receipts.

Indicator (USD Billion)	Jan-Mar 2009/2010	Jan-Mar 2010/2011
Current Account Deficit	6.6	5.1
Oil Exports	2.1	2.8
Average Quarterly price of Suez Blend	72.5 \$	98.6 \$
Non-Oil Exports	3.4	3.4
Percentage of Non-Oil Exports from Total	62.1	54.6
Foreign Direct Investment	1.7	-0.2

External Sector

- ▶ Reduction in remittances in connection to the unrest in neighboring Arab countries and higher interest payments on public debt will further worsen the deficit.

Indicator (USD Billion)	Jan-Mar 2009/2010	Jan-Mar 2010/2011
Remittances (Total)	2806.8	2828.5
Private remittances	2815.9	2774.5
Official Remittances	-9.1	54
Growth in Tourism in percent	18.8%	-33.0%

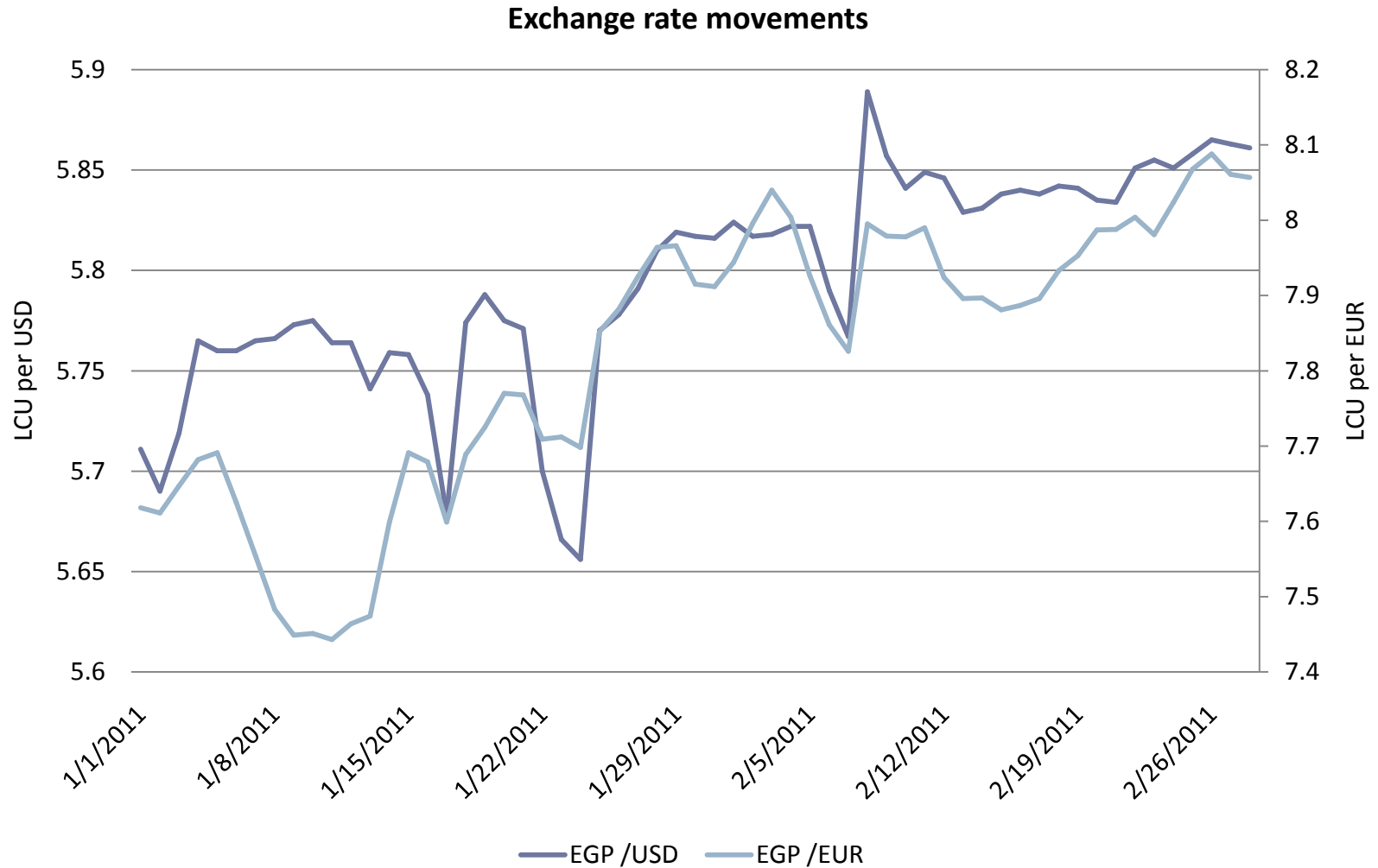


Exchange Rate

- ▶ The loss of foreign receipts and significant outflows weakened the Egyptian pound relative to the US dollar, reaching EGP 5.918 per US\$ as of March 2011.
- ▶ The exchange rate of the pound remains depreciated relative to the pre-crisis level and compared to the average over the past six years.

Exchange rates relative to EGP	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10	Jan-11	Feb-11	Mar-11
USD	5.685	5.681	5.690	5.715	5.744	5.785	5.797	5.884	5.918
GBP	8.771	8.997	8.950	9.140	9.256	9.116	9.081	9.409	9.540
EUR	7.331	7.418	7.498	8.007	7.931	7.718	7.696	7.967	8.265

- Since the beginning of 2011, the EGP has depreciated by nearly five percent, increasing the cost of imports



Monetary Policy Response

- ▶ The Central Bank of Egypt (CBE) affirmed that it guarantees all deposits in the banking system.
- ▶ Further, the CBE put a ceiling of EGP50,000 on daily cash withdrawals to avoid panic that would potentially affect the banking system's liquidity.
- ▶ Further, the CBE intervened to prevent further depreciation of the exchange rate in the amount of US\$1.3 billion.



Sources of Inflationary Pressures

- ▶ Inflation is expected to pick up again in 2010/11.
- ▶ The depreciation of the Egyptian pound relative to the US dollar is likely to increase the cost of imports.
- ▶ Recovery in the global economy is likely to raise international food prices.
- ▶ Lingering political unrest in oil-producing countries has pushed oil prices up.
- ▶ Higher food and fuel prices will increase pressures and deteriorate the fiscal deficit.



Forward Looking Economic Strategy

- ▶ The revolution has emphasized the importance of associating economic liberalization with political reform.
- ▶ Since the early 1990s, Egypt has been rapidly integrating in the world economy.
- ▶ The absence of regulatory framework and sound institutions have increased corruption and prevented the trickle down of the economic gains to wider population.
- ▶ Egypt's economic outlook in 2010/11 and 2011/12 will depend on the speed of the reform agenda towards achieving political and social stability.



Primary Objectives

- ▶ Key priorities are poverty alleviation and improving living standards.
- ▶ The economic agenda should revolve around achieving a high sustained and equitable growth rate.
- ▶ Addressing social concerns demands actions to tackle high unemployment, the poor level and deteriorating quality of educational and health services, and achieving more equitable distribution of wealth and earnings.



Fiscal Priorities

- ▶ Fiscal consolidation is key to the realization of Egypt's economic objectives.
- ▶ Reform efforts have been hampered by significant waste of government resources, reflecting untargeted subsidies, resulting in persistently high deficit and increasing public debt ratio to GDP.
- ▶ Gradual reduction in the deficit is necessary to bring the debt ratio down to 60 percent of GDP.

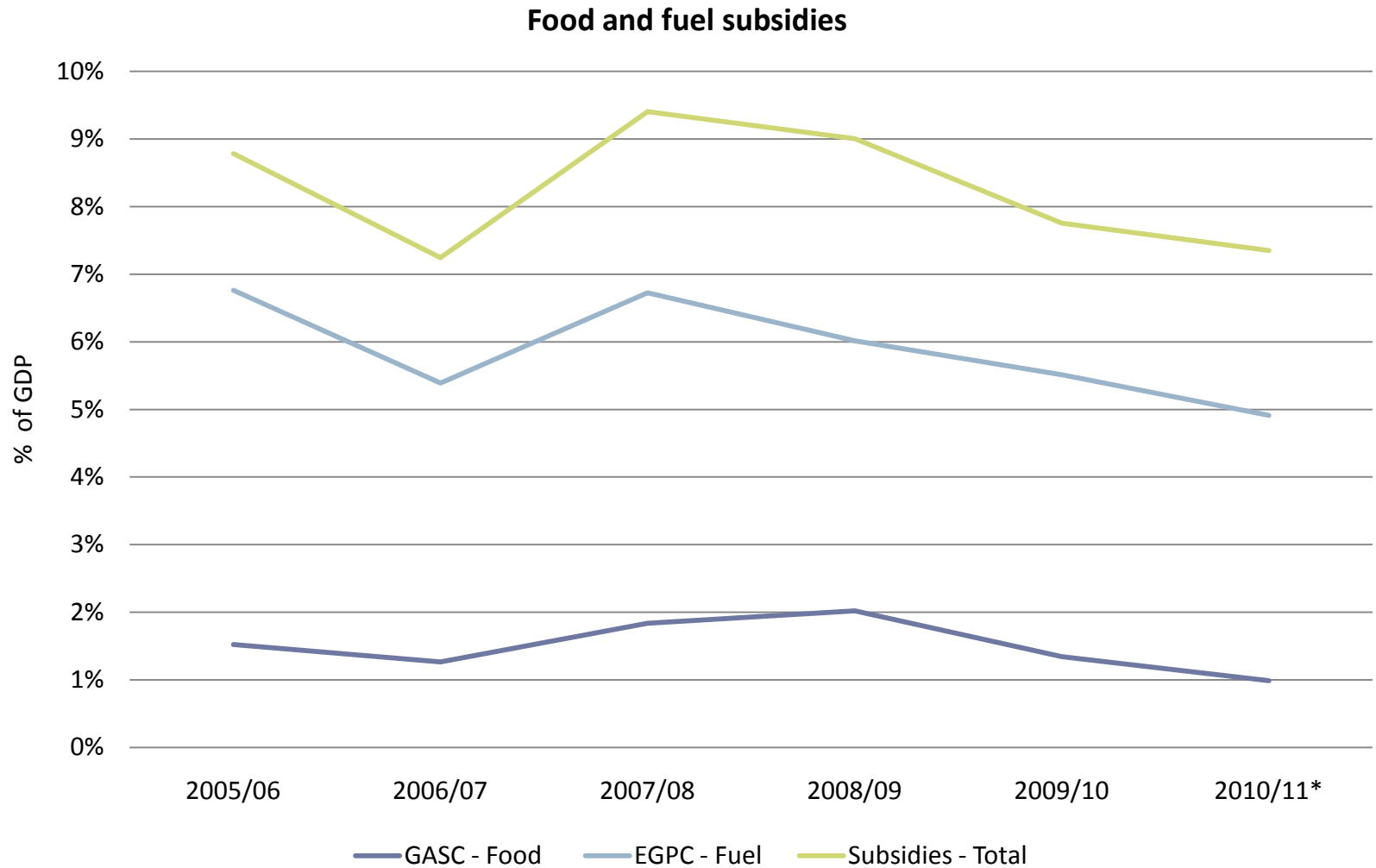


Fiscal Challenges

- ▶ For 2010/11 (and possibly 2011/12) additional spending will be needed:
 - ▶ A 15 percent increase in wages and pensions was stipulated by the government effective April 2011.
 - ▶ A decision was taken to immediately appoint temporary government employees in their jobs.
 - ▶ Subsidies will surpass what was originally budgeted on account of higher international prices.
 - ▶ In 2009/10, the petroleum subsidy alone was estimated at EGP66.5 billion, in contrast to EGP87.8 billion and EGP99 billion in 2010/11 and 2011/12.



- With projected increase in international food and fuel prices, subsidies may rebound to the high level in 2007/2008, exceeding nine percent of GDP

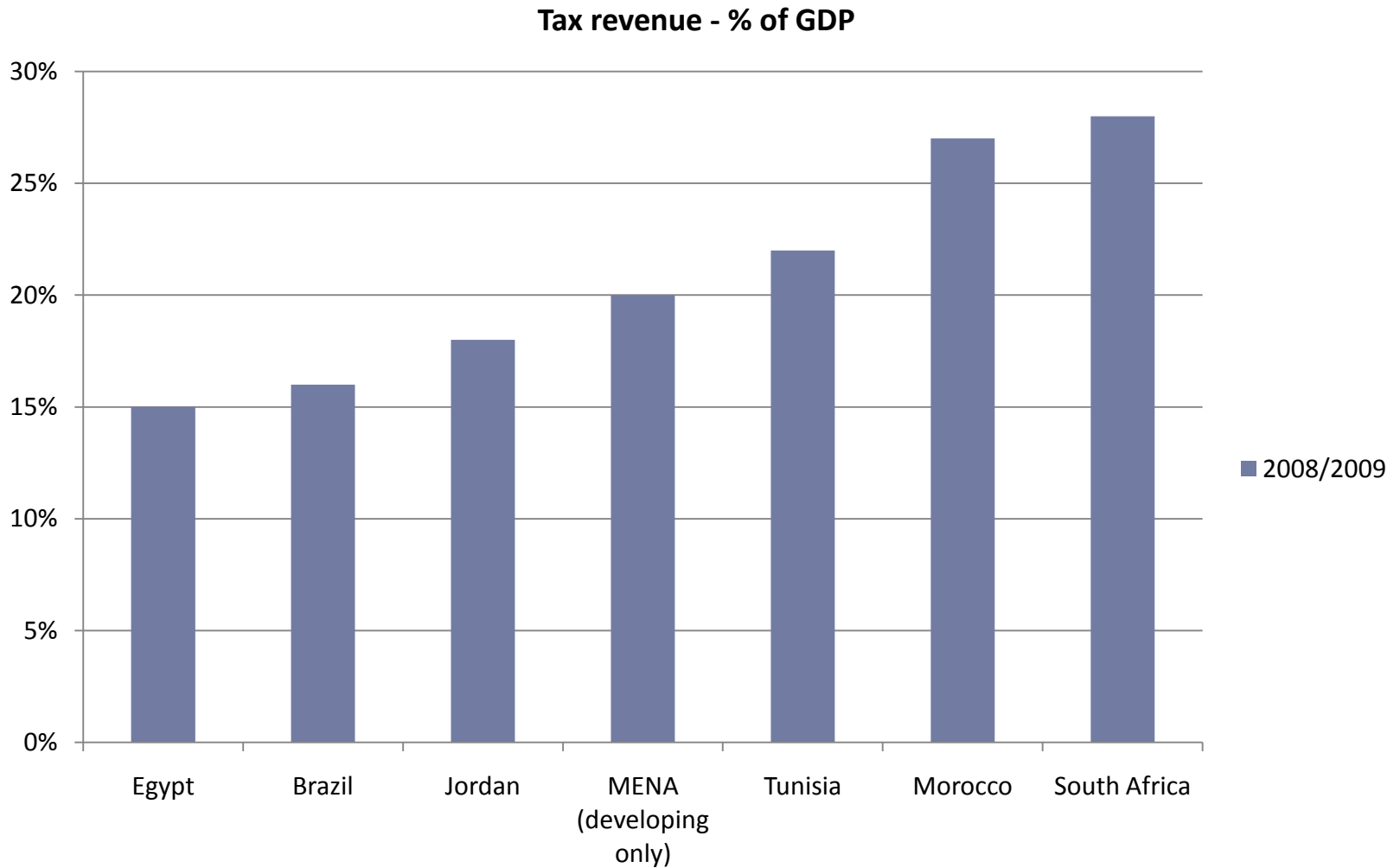


Fiscal Reforms

- ▶ Previous plans by the government to phase out subsidies will most likely be stalled.
- ▶ Tax revenues (which constitute more than 60 percent of government revenues) may be undermined by the slowdown of economic activity during the second half of 2010/11.
- ▶ Fiscal sustainability demands consolidation plans in the near term to reduce the fiscal deficit and concerns about rising public debt.



- Mobilizing additional revenues is key to fiscal consolidation as revenues remain low relative to GDP



Monetary Policy Challenges

- ▶ Despite rising core inflation index in the first half of 2010/11, the CBE decided to keep the policy rates unchanged at 8.25 for the overnight deposit rate and 9.75 percent for the overnight lending rate.
- ▶ The rest of 2010/11 will experience higher inflationary pressures owing to the political unrest and depreciation of the Egyptian pound, in addition to volatile international prices.



Monetary Policy Priorities

- ▶ Priorities should be focused on inflation targeting to increase competitiveness and contain inflationary expectations.
- ▶ Management of the exchange rate policy in line with the underlying fundamentals is necessary to sustain economic growth, contain the inflationary cost of imports and mitigate the risk of supply-side shocks on the economy.
- ▶ Regulations should aim at eliminating distortions in distribution and enforcing surveillance.
- ▶ Priorities should be established to avail credit to the private sector, particularly to SME, and offer tax incentives for business firms that are tied to the employment agenda.



Structural Agenda

- ▶ Efforts to improve the performance of the public sector should continue, notably state-owned enterprises.
- ▶ It is crucial to press ahead with the plan for public/private partnership to reduce pressures on the budget and engage the private sector in infrastructure and capacity building.
- ▶ A comprehensive strategy should evaluate state-owned enterprises and set a plan to reform or privatize non-performing enterprises, while ensuring transparency and enforcement of rule of law to avoid previous problems and sustain productive capacity of privatized firms to protect workers' rights.



Conclusions

- ▶ Social inequality and inadequate human development in Egypt have signified the downside risks attributed to the lack of political reforms alongside the economic reform agenda that the country has embraced.
- ▶ Even though the Egyptian economy has achieved strides in terms of economic liberalization and growth figures, reform efforts have been challenged by political stagnation and corruption, depriving the lower end of the Egyptian society from the fruits of economic growth.



Forward Vision

- ▶ Priorities for the social agenda in the near term should include rationing government spending, including by subsidies' reform, to have a better targeted scheme that would eliminate waste in spending and establish better equity.
- ▶ In parallel, the agenda should target a reform of the tax system to mobilize additional revenues and increase efficiency in tax collection and better compliance.



Medium Term Agenda

- ▶ Availing more jobs in support of productive activity to help vulnerable groups graduate from continued dependency on subsidies.
- ▶ Increasing incentives for job creation and availing more credit to small and medium enterprises.
- ▶ Addressing structural bottlenecks in the labor market towards closing the gap between supply and demand, by increasing investment in education and training and gearing efforts towards matching qualifications with available jobs.



Political and Institutional Reforms

- ▶ Enforcing rules and laws that increase flexibility in the labor market and, therefore, incentives for formal jobs in the private sector.
- ▶ The ongoing political reform agenda bodes well for investment in quality institutions, good governance, transparency, rule of law, and fighting bureaucracy and corruption.
- ▶ Political reforms will reinforce fundamentals towards boosting investors' confidence and securing sustainable and equitable growth to attain higher welfare for Egypt's growing large population.





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April 23, 2011