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"Flash-in-the-Pan" Development in Egypt?

IMF-backed Economic Recovery Stymied by Absence of Structural Reforms and Massive Human Rights Violations

Stephan Roll

In November 2016, Egypt agreed a comprehensive aid programme with the International Monetary Fund (IMF). Its stated objective was to stabilize the country's macroeconomic situation within three years and put it on track for inclusive economic growth. At the half-way stage, hardly any structural reforms have been implemented despite a short-term macroeconomic stabilization resulting from the conditions put in place. Rather, the increasingly influential military has prevented the emergence of a functioning market economy. This has been compounded by the disastrous human rights record of the government under President Abdel Fattah el-Sisi, which has also had a negative impact on Egypt's economic development. Germany played a key role in the IMF agreement being concluded. The German government should, therefore, work to ensure the IMF produces a critical assessment of the reforms that have taken place so far. It should also link its willingness to support future aid packages with improving the human rights situation and strengthening civil society.

In July 2016, Egypt was forced to send a request for assistance to the IMF. In the months that followed, they negotiated a three-year reform programme. The individual measures announced in the programme show how dramatic the situation was for the Egyptian government in the summer of 2016. In the past, the Egyptians had roundly rejected calls by international donors for comprehensive subsidy reductions, tax increases and a freeing up of the exchange rate. This time, the country's insolvency was so palpable that the political leadership under President Sisi had no alternative but to agree to the corresponding commitments. The country's borrowing requirement to implement the programme was estimated at 35 billion US dollars. The IMF agreed to provide 12 billion US dollars in loans under extended fund facilities. In order to obtain this money, Egypt needed to raise the remaining amount through negotiations with other financial institutions and major donor countries, notably Germany. The phased disbursement of the IMF loan in a total of six tranches was linked to positive half-yearly evaluations by the Fund.

Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Conditionalities take effect

In its interim reports to date, the IMF has painted a very positive picture of how the announced reforms are being implemented. In fact, Cairo has essentially already implemented the agreed monetary and fiscal policies which have helped achieve some economic stabilization in Egypt. For example, the depreciation of the Egyptian pound as part of exchange rate liberalization in November 2016 contributed significantly to a decline in the current account deficit to 0.8% of GDP in the fourth quarter of 2017 (from 1.8% of GDP over the same period in the previous year) and to increased foreign exchange availability. In addition, the central bank's foreign exchange reserves increased significantly (from 17.55 billion US dollars in July 2016 to 44.26 billion US dollars in June 2018). The budget deficit was reduced further by cutting energy subsidies by much more than 40 percent in some cases and introducing sales tax at a rate of 14 percent. For the first time in years, the budget deficit could amount to less than ten percent of GDP in the current financial year (2015/16: 12.5 percent of GDP). This would even allow the budget to show a small primary surplus (budget surplus, excluding debt service costs).

As a consequence of macroeconomic stabilization, Egypt can now refinance itself on the international capital market again. Above all, however, it has paved the way for more exports, a revival of tourism and stronger — albeit mostly state — investment activity. As a result, economic growth will increase by more than one percentage point to an expected 5.2% (budget year 2017/2018).

But there is also a downside to the current reform policy. Egypt's debt burden has continued to increase since the programme began and is expected to reach well over 100 percent of GDP by the end of 2017. According to figures from the Egyptian central bank, more than 40 percent of government revenue had to be spent on servicing debt in the first half of 2017/18, which severely narrows the scope for investment, for example.

Above all, however, the life situation of most Egyptians has deteriorated dramatically in the course of the reforms. The cut in subsidies and price increases following exchange rate liberalization led to a drastic increase in inflation to over 30 percent at times. Due to the higher prices, well over 35 percent of the population is now believed to live below the national poverty line (45 US dollars per month). There can, therefore, be no talk of inclusive growth so far. In response to this worrying development, the Egyptian government refers to the reduction in unemployment from 12.5 percent (2016) to 10.6 percent (first quarter of 2018). However, it seems questionable whether these figures are meaningful. It is striking that, according to official government figures, the proportion of working population to total population is less than one third — an extremely low value by international standards, which suggests a significantly higher level of unemployment.

Insufficient structural reform

The worsening living conditions caused by the reforms are all the more serious because it is by no means clear that this is only a short period of economic hardship and that, in the long term, the population will benefit from the course being taken. For the current economic recovery to be more than a flash in the pan, comprehensive structural reforms are needed. These are referred to in the programme itself as "crucial" for success. However, the catalogue of structural reforms agreed with the IMF appears rather arbitrary. By themselves, measures such as streamlining industrial licensing procedures, drafting new bankruptcy legislation or improving public transport safety may be important issues. But, as long as the institutional and regulatory framework of the Egyptian economy is not fundamentally reformed, they are unlikely to have any effect. Deficiencies such as the complete lack of transparency with which the government plans and implements contentious infrastructure projects, for example establishing a new capital city or constructing the country's first nuclear power plant are not mentioned in the IMF agreement, nor are endemic corruption and dysfunctional market surveillance institutions. The expansion of the military within the economy was also not mentioned. This phenomenon, in particular, has clearly become more relevant since 2013 and is counteracting the development of a functioning market economy. The military is involved in numerous civil sectors such as construction, food production and energy. It benefits not only from preferential treatment in public procurement, but also from tax privileges and cheap labour. This puts private entrepreneurship at a clear disadvantage, which can also be seen in statistical surveys, such as the purchasing manager index of banking group *Emirates NBD*. According to the index, economic activity in the private sector (with the exception of the energy sector) has tended to decline since the beginning of the reforms.

Police state as a barrier to growth

It is important not to ignore the excessive police state repression under President Sisi when evaluating the current economic reforms in Egypt because this, too, will counteract any sustainable economic development. Egypt can only develop its full potential as a tourist destination or investment location if it achieves lasting political stability. Notably, the current upturn in tourism has only been possible due to falling prices caused by the tense security situation. Foreign direct investment actually declined in the last quarter of 2017, with no improvement on the horizon. The routine use of massive police violence against sections of the population promotes social polarization. The security forces repeatedly carry out enforced disappearances. Human Rights Watch reports document the systematic use of torture. It is estimated that more than 60,000 political prisoners are living in overcrowded detention centres considered breeding grounds for Islamist radicalization.

State repression is by no means only directed against political opponents, but also against the entire non-governmental civil society. There are hardly any human rights activists who have not been either arrested or at least charged. In addition, there are comprehensive restrictions on press freedom. Journalists cannot report freely, critical television channels and online media are blocked. In 2017, Egypt ranked 161 out of 180 in the World Press Freedom Index produced by Reporters Without Borders. As a result, the regime is suppressing those very actors who advocate the fight against corruption, state transparency and the establishment of procedures based on the rule of law.

Implications for Germany's policy on Egypt

Germany played a major role in the IMF agreement being concluded with Egypt. It was not so much the weight of the German vote on the IMF Board of Directors that was so significant, it was more that Egypt was relying on Germany's help to organize the additional funding needed for the IMF loan. Previously, Germany was Egypt's largest single creditor by far within the Paris Club with loans of 4.6 billion US dollars in 2016. In 2017, total loans and government guarantees came to the princely sum of 6.5 billion US dollars. Germany was, therefore, the second largest creditor nation behind Saudi Arabia (around 8 billion US dollars in central bank deposits). Nonetheless, Germany offered further loans (250 million US dollars in 2016 and the same amount in 2017) — a very important signal for other donors, including European countries such as France and the UK. Against the backdrop of the refugee crisis, however, the German government considered support for the reform programme primarily as an opportunity to encourage Egypt to close its Mediterranean Sea border to irregular migration, while negotiating the programme and reviewing it were left entirely to the IMF.

The results of the programme so far show that this approach was not very effective in promoting sustainable economic development. However, such economic development is essential from a German and European point of view. If the most densely populated Mediterranean country with a population of around 100 million were to collapse, it would have unforeseeable consequences for Europe from growing migratory pressure and a rising terrorist threat. Therefore, two conclusions for German politics from this precarious situation should be drawn: Firstly, the German government should make its own assessment of the economic reforms and strongly urge the IMF to explicitly identify obvious problems, such as the expansion of the military within the economy. For the IMF to not even mention key obstacles to reform in its reports is evidence of a dangerous misperception of developments in Egypt. This paints a distorted picture of the country, as occurred all too often in analyses by international financial institutions before 2011 — including the IMF. Identifying reform deficits is all the more urgent as the two outstanding loan tranches could be used as leverage to demand tangible progress from the Egyptian government, at least in some areas.

Secondly, Germany should, together with its European partners where possible, address the question of how to respond to future requests for support from the Egyptian government. Given the Egyptian government's dramatic debt burden and failure to set a course for greater, sustainable economic growth, it is unlikely that the country will be able to manage without further external assistance once the current IMF-backed reform programme has ended. However, renewed support after 2019 only makes sense if it also benefits the population. This requires conditionalities that not only have a greater impact on effecting structural reform than has been the case to date, but also on improving the human rights situation and strengthening civil society. Urging international donor institutions to include appropriate conditions in their programmes does not appear to be working. The IMF, in particular, does not consider the enforcement of human rights a part of its mandate. However, Germany, as the most important creditor among Paris Club nations, will have significant influence on such programmes being agreed. The German government can, therefore, link its approval with ancillary agreements. It should use this leverage to promote the development of a political framework that will enable economic development for the benefit of the Egyptian people.

Dr. Stephan Roll is Deputy Head of the Middle East and Africa Division at SWP.

SWP
Stiftung Wissenschaft und
Politik
German Institute for
International and
Security Affairs

Ludwigkirchplatz 3 — 4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

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