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

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



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

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, and in many cases have reached the trough. Yet, the economy is still surviving. This is mainly due to the unprecedented support of some of Arab Gulf countries, whose unconditional aid has helped to mitigate the deteriorating economic conditions.

The economic challenges facing Egypt have been 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 these challenges. In fact, the challenges that the Egyptian economy has been facing have deep roots in its socio-political-economic context, which this paper aims to explain. The revolution and its aftermath have brought to the forefront challenges which have always been mitigated by short-term solutions that never dealt seriously with their roots. Moreover, 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 Egypt is expected to 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 regime in power up to the 25 of January 2011 was able to keep the macroeconomic balances under control. Over the period 2004-2010 the Egyptian economy was just doing perfect, with growth rates exceeding 7% in some years, the budget deficit was in the range of 8-10% and was heavily controlled, the balance of payments had been turned into a surplus, and foreign exchange reserves were increasing. Moreover, foreign direct investment (FDI) had 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 considered as the “top reformer” in 2006/2007 by *Doing Business Report (2008)*, for improving in 5 of the 10 areas assessed by the Report.¹ Yet, this good economic performance was not reflected in improvements in 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 25 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 (LE120 per capita per month).² The situation had not changed much since the early 1990s, where at that time 24% of the population fell below the national poverty line.³ Yet, according to World Bank (2009),⁴ the 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 slowdown in growth rates, a significant increase in unemployment rates, and the unstable political situation (table 1). According to data issued by the Central Agency for Public Mobilization and Statistics (CAPMAS), Egypt's poverty increased to encompass 25.2 % of the population in 2010/2011 compared to 21.6% in 2008/2009. “Extreme” poverty had decreased to 4.8% of the population in 2010/2011 from 6.1% in 2008/2009. These figures are calculated according to the poverty line in Egypt, which is estimated at LE256 per person per month, or LE8.5 per day, while the “extreme” poverty line is calculated at LE171.5 per person per month or LE5.7 per day.⁵

¹ World Bank (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).

⁴ World Bank (2009).

⁵ Central Agency for Public Mobilization and Statistics (CAPMAS), (2012).

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 25 of January revolution pointed out the need of paying attention to the 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 were exacerbated, where the conflict between achieving social goals and economic objectives became so intense, and in fact none of the challenges have been solved. The macroeconomic indicators have been deteriorating in the aftermath of the revolution and it is clearly that it has negatively affected the economy as has been revealed by the deteriorating economic indicators (slowdown of the economy where the growth rate went down from 5.9% in 2009/2010 to 1.9% in 2010/2011 (CBE, 2011)⁶ (table 2), unemployment reaching higher and alarming rates (figure 1), and the decline in net FDI inflows 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).

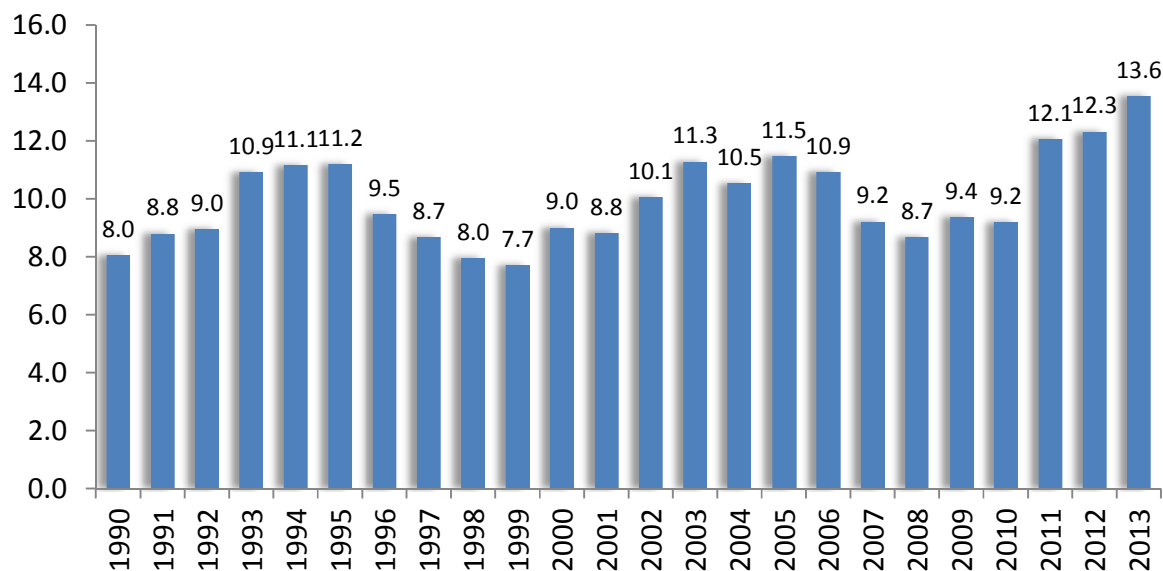
Table 2: Selected Economic Indicators for Egypt over the Period 2008-2011

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>

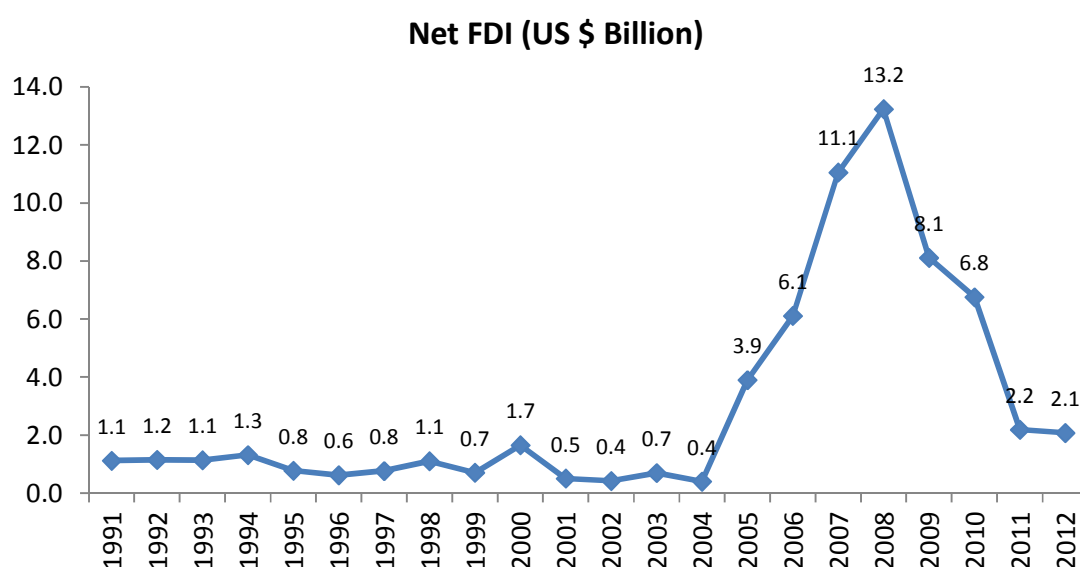
⁶ Central Bank of Egypt Annual Report 2010/2011 (2011).

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>

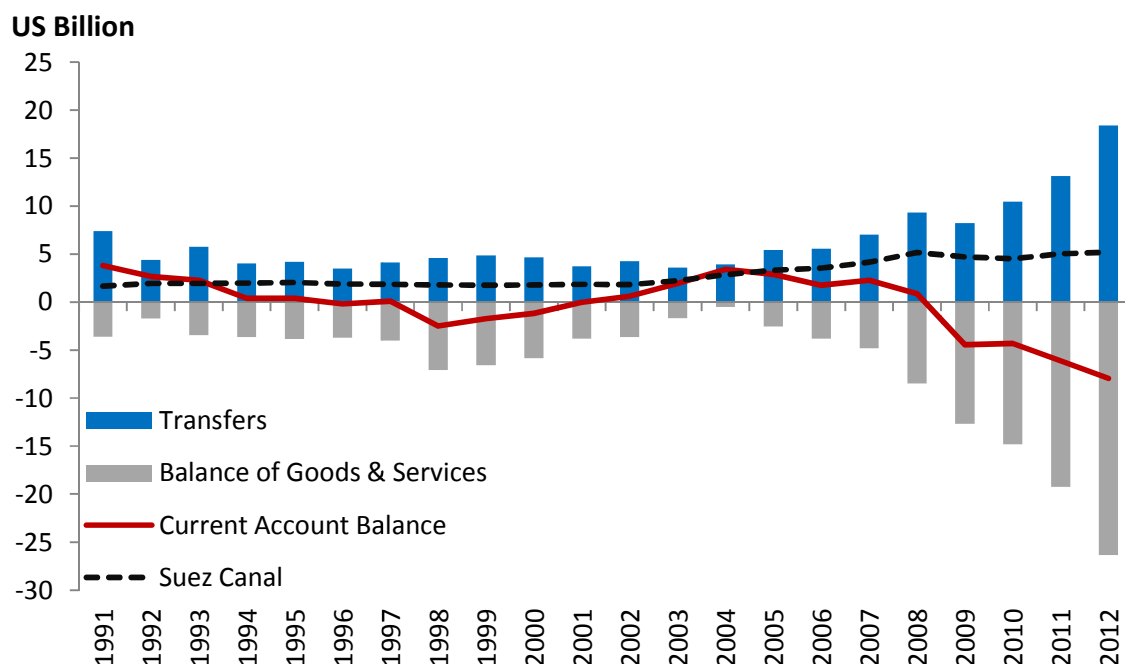
Figure 2: Foreign Direct Investment



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 the 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 the 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 as a result of its declining credit worthiness. Due to this situation, the interest rate on treasury bills increased by almost 2 percentage points making it more burdensome for the government to borrow. The government's 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, the 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.

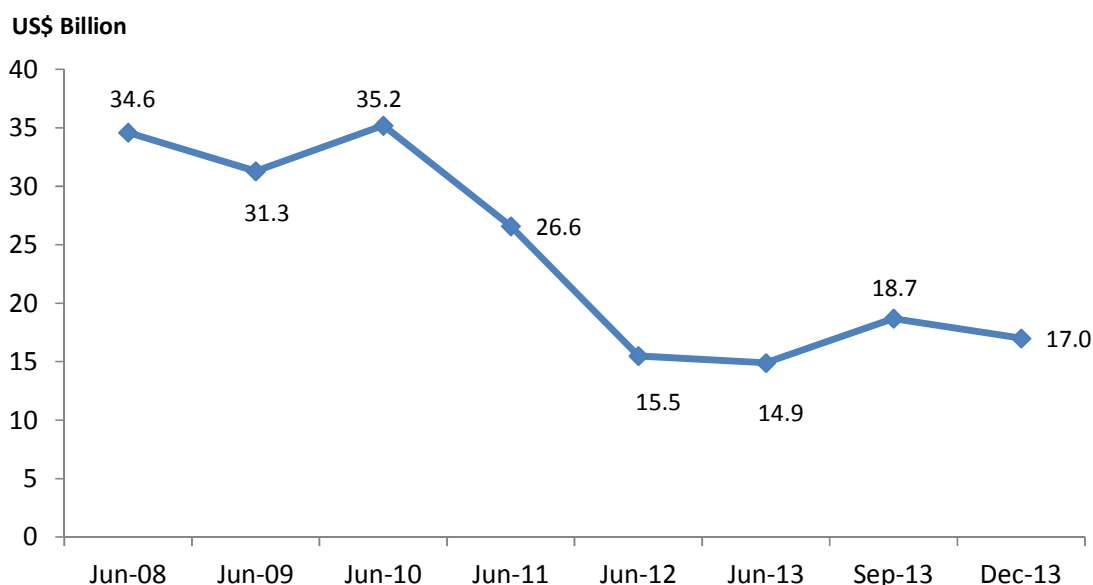
Figure 3: Balance of Payments



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.

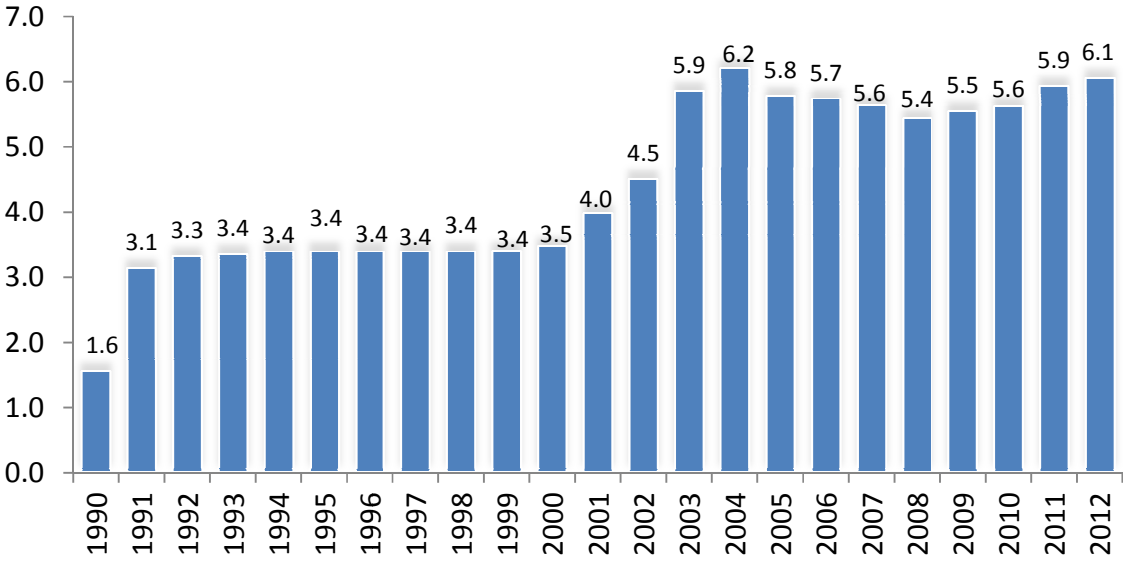
http://cbe.org.eg/CBE_Bulletin/2014/Bulletin_2014_1_Jan/30_19_Gross_and_Net_International_Reserves_with_CBE.pdf

The balance of payments problems hinge mainly on declining foreign exchange receipts from tourism, exports and, FDI. Other sources of foreign exchange as remittances and Suez Canal revenues which 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 shown in figure 5. Currently, there is a small black market premium which does not exceed 5%, signalling 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)



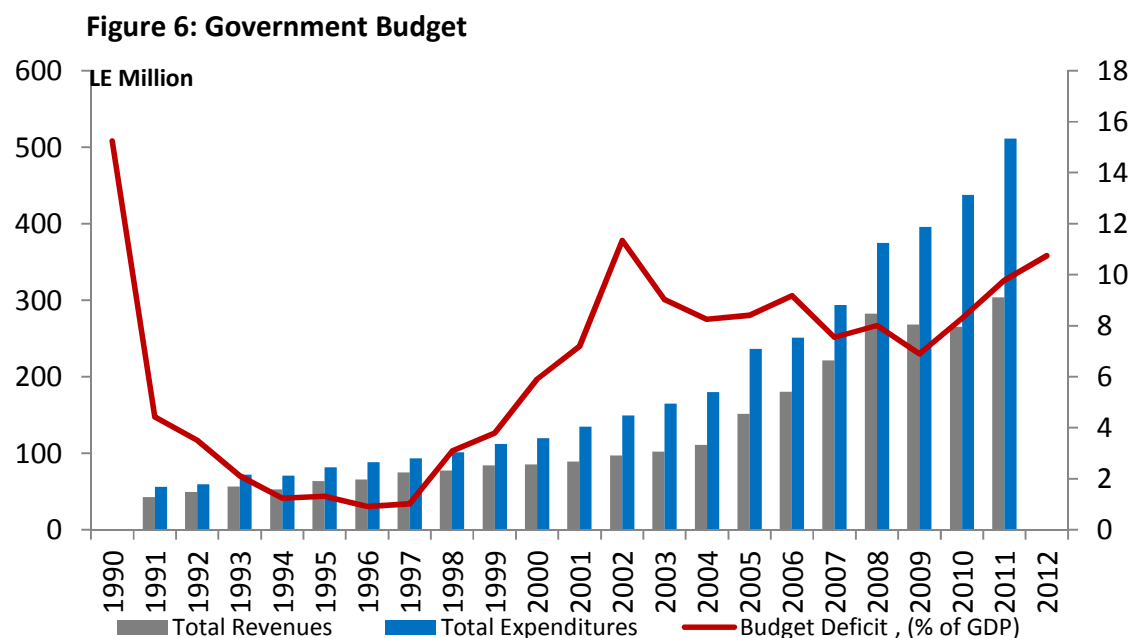
Source: Central Bank of Egypt, Research and Publications, Time Series, <http://www.cbe.org.eg/English/Economic+Research/Time+Series/>

The deteriorating economic conditions have exacerbated the unemployment problem with official figures stating the unemployment level having reached 13%. Despite the relatively high figure we believe it is underestimated due to the absorption of the informal sector and government of 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: the reform of subsidies and unemployment.

Subsidies seem to be the major challenge that all governing regimes in Egypt have failed to tackle. In fact, subsidies have always represented the symbol of the social contract between the governing regime and the population. Any attempt to reform subsidies was always a major concern, and none of the preceding regimes in the last 60 years was able to implement serious reform measures. Rather, a piecemeal approach (often manipulated in one way or another) was always used when it became 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, inefficiencies 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).



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 (%)

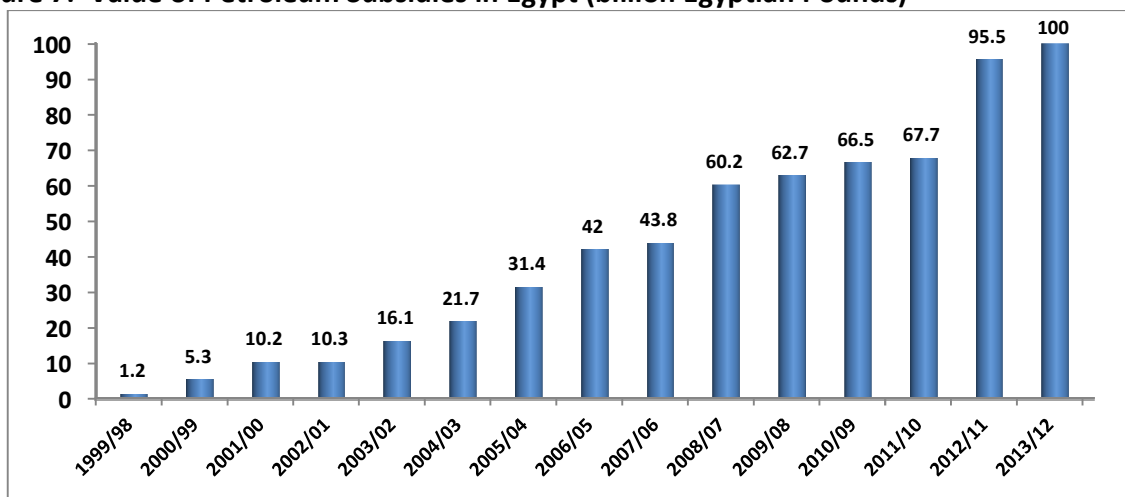
	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013
• Compensations of Employees	22.5	23.5	22.3	21.7	23.3	24.0	26.1	24.3
Salaries and wages	18.1	19.1	18.1	17.8	19.2	19.5	21.2	20.1
• Purchases of Goods and Services	6.9	7.7	6.5	7.1	7.7	6.5	5.7	4.5
• Interests	17.7	21.5	17.9	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	10.2	11.5	12.1	12.4	13.2	9.9	7.6	6.7
• Assets (Investments)								

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 LE 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 LE1.2 billion in 1998/1999 to LE100 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.

As for unemployment, its rate increased significantly in 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 first quarter (January-March) of 2013.⁸ There are 800,000 new entrants to the labor market annually and for enough jobs to be created for them a growth rate of 6.5-7% per year for at least two decades is required (Ikram, 2006).⁹ However due to inefficient educational and employment policies, among other macroeconomic deficiencies, this huge labor force has not been effectively used. In the last two decades the growth was driven by specific sectors including telecommunications, financial services and real estate which has not been necessarily employment enhancing. Manufacturing sectors with high value added did not play an effective role in enhancing growth. Government policies have

⁸ Central Agency for Public Mobilization and Statistics (CAPMAS), (2013).

⁹ Ikram, Khalid (2006).



failed to deal with the structural problems of the economy, and so unemployment remained chronic. The concentration of the unemployment among youth is another major challenge (22% for age bracket 25-29 and 44% for age bracket 20-24 are out of work)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 of the problem remained unresolved. In the aftermath of the Arab uprising the problem has worsened and the average rate of unemployment rose to 13% up from an average of 9.9% for the decade before 2011.

Moreover, youth employment does not improve when young people climb up the ladder of skills and education since it has been hitting all skill levels. Even highly skilled young workers have been facing severe challenges in getting a job at their level of competence and they have been either forced into the informal economy, or to migrate, or else prefer not to join the labour market.¹¹


The negative consequences of the unemployment problem in terms of proliferation of the informal sector and its correlation with higher poverty rates has led to socio-economic and political repercussions, especially in light of the old social contract which confirmed that creating jobs is a main role for the stabilization of governing regimes. So much so that in the last few years, rising unemployment has been associated with protests whose number have increased dramatically. In 2008 Egypt witnessed around 323 protests and strikes, spanning a wide social spectrum. It is worth noting that most of these protests came from within blue collar circles.¹² Such protests revealed the anger of the unemployed as well as the employed out of a sense of insecurity and/or in support for higher wages. This signalled the breakdown of the old social contract, and the inability of the governing regimes to respond adequately 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 deteriorating level of education, the mismatch between educational 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 the wrong incentives encouraging energy and capital intensive industries, rather than labour intensive ones.

¹⁰ African Development Bank (ADB) (2013).

¹¹ International Labour Organization (ILO), (2013).

¹² AL-Ahram Weekly (2009).



There are other several challenges that are related to the main two challenges of subsidies and unemployment and which account for the chronic deficits in the last three decades, namely the *budget deficit* which reached about 17.2% of GDP in 1990/1991, 10.2% in 2001/2002 and 10.7% in 2011/2012¹³ and overall *balance of payments* 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 respectively.¹⁴ Moreover, the domestic component of the overall national debt remains a major concern and it has represented on average 83.5% of the total debt (*external and domestic*) by the end of December 2012.¹⁵

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 which was made worse by the wasteful food subsidy system. 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 increase in the external debt is a new challenge that appeared in the period following the Presidential elections of 2012 when it rose sharply 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 2012,¹⁶ 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 from the 1990s onwards has failed to create sufficient jobs to match the rapid increase in the labour force of 2.7% per year. The proliferation of the informal sector has created another type of political and social problem to the government. The current predominance of the informal sector gives the 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 proportions in Egypt representing on average 34.9% between 1999 and 2006/2007.¹⁷ The inflated public sector has also acted as an outlet for reducing the official unemployment rates, but in fact this has a case of disguising unemployment.

¹³ Central Bank of Egypt (2013a).

¹⁴ Central Bank of Egypt (2013b).

¹⁵ This figure is calculated by dividing the gross domestic debt by total debt (external and domestic), **Source:** Central Bank of Egypt (2013c).

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

¹⁷ Schneider, Friedrich; Andreas Buehn and Claudio E. Montenegro, (2010).

Section Two: Explaining the Roots of Economic Challenges:


The picture given that the pre-revolution regime was actually 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. Problems were proliferating below the surface before the 25th of January revolution. These problems were not new, but they 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 clear 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 also been a major culprit for causing the economic problems. The model was established by relying heavily on 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 in return for stability and security.¹⁸ In 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 the “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 from the 1960s have provided untargeted subsidies for the population. The subsidies encompassed food as well as energy. In the early stages of the 1960s and throughout the 1970s, these untargeted subsidies could have been tolerated due to the relatively limited size of the population and the relative closed nature of Egypt, 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 concerning the efficiency of the 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 the social safety nets out of fear of 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 governing regimes to undertake their necessary economic reform measures while ensuring that there would be no social unrest.

¹⁸ For a similar argument see Amin et. al (2012).




However, in time the cost of subsidies increased dramatically in most, if not all of them. Fuel subsidies amounted to around LE95.5 billion in 2011/12, compared to LE60.2 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 an 84 percent increase over the same period, rising from LE16.4 billion to LE30.3 billion. This implies that fuel and food subsidies represented more than 20 percent and 6 percent of total budget expenditure in 2011/12,¹⁹ 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 for example the number of beds in hospitals per thousand persons or expenditure on health. Such indicators have been misleading, for whereas 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 but it carried with it the seeds of petty corruption, which increased significantly, signaling at the same time the huge inefficiency of the social public services provided by the government and pre-announcing the breakup 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 the start of economic reforms in the 1990s. By time, the inefficiency of the social safety net intensified and the resources devoted to the 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 an inefficient social safety net.

Lack of Institutions Necessary to Govern the Market

The governing regimes neglected the necessity of establishing the right institutions to govern the market (e.g. competition and consumer protection laws), or in some cases introduced weak laws which remained on the shelf with no enforcement or discretionary enforcement. In fact, the economic reform program adopted in the 1990s did not focus on this important aspect, and the emphasis was on economic policies as explained above. Subsequently, a new variable emerged, namely the desire of the governing dictators to be succeeded by their family members. To achieve this, 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 the lack of clear rules on conflict of interest implied a wrong marriage between political power and capital. This led to the phenomena of crony capitalism and nepotism, and ultimately led to

¹⁹ Ministry of Finance, Egypt.



delay the establishment of the institutions to govern the markets or to the establishment of such agencies which only existed on paper and had no impact at all on the market. The income gaps widened dramatically in which although not well captured by formal indicators, led to an increase in the overall feeling of *relative* poverty among the public.²⁰

The end result of these 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 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 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 enhances the growth of sectors with high propensity of generating employment, and an effective formal social safety net is needed to be designed and implemented. The agriculture sector is the largest contributor to employment in the economy (absorbing one third of labour force), but has remained weak in generating higher value added.

Enhancing forward and backward linkages: The nature of the new drivers of growth (as in the case of 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 labour productivity and the backward and forward linkages 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 a system of subsidies, especially on food and energy products, has been heavily criticized of being inefficient and of lacking 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 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 elites in the country.



Enabling the private sector: The private sector remains unequipped for the task of enabling the business environment to improve and in turn help businesses to become the the main engine of growth. In fact, the size of the private sector as a percentage of GDP increased over time. However, the existing indicators show that the business environment suffers from a number of problems that prevent it from acting as a catalyst of growth and development. Problems include the lack of efficient public services, red tape and 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, but the efficiency of these needs to be increased


Enhancing the role of SMEs and strengthening the forward and backward linkages with the sectors that enjoy high growth rate but are not necessarily labour intensive. SMEs which account for 80% of Egypt's domestic economy and 75% of the private sector's labour force are another unutilized driver of growth.²¹ Such huge production capacity is suffering from red tape, high transaction costs and bureaucracy which have driven SMEs into the informal sector. Moreover, SMEs have not been integrated in the value chain and they do not interact with large enterprises. SMEs cannot be dealt with as one entity as they need to be differentiated by sector. SMEs are in need of a holistic approach, as well as 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 output.²² 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 their 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 the adoption of liberal policies starting in the 1970s. The size of the 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

²¹ Saif, Ibrahim (2011).

²² Ibid.




between income levels, and a lack of justice.²³ 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 Egyptian society. The day to day incidents have shown huge divergences and clear segmentation among Egyptians, an issue that was neither visible to that extent before the revolution nor was expected to be to that extreme after the revolution. The 25th of January revolution was triggered by explicit and implicit economic factors. The failure of the old regime to provide a decent living 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 youth. Young people started asking for "bread", "freedom", and "social equity". Those three important aspects of a decent 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's demands. Such goals are translated on the ground in the form of job creation, 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 their place in the new parliament? 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 these problems, political turbulence, and weak economic management by 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 an environment which is more conducive to business growth. The large vacuum left by crowding out the large private sector players will have to be filled and filled quickly. The new regime, in the light of the worsening economic conditions, might be forced to revert to obtaining funding and enhancing production through other means, either foreign (Arab finance) or domestic (depending on the military), but

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>



not necessarily in a more efficient way. A recent study (Saif and Ghoneim, 2013)²⁴ identified that the private sector in Egypt is facing several problems in its ability to function. Among the problems that Saif and Ghoneim (2013) identified there 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 are very knowledgeable on how to deal with business community problems.

Keeping aside the ideological political debates of the 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 by different names. In other words, the transitional period that Egypt is passing through has proven to be extremely difficult and is causing severe economic hardships.

Finally, it is unlikely that there will emerge 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 of embarking on any type of major market-oriented change that attempts to leapfrog state of affairs to a newer one. 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 ideals; it is rather a matter of fear from social and/or political unrest that may result 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. The wish list that is often mentioned includes very lofty objectives such as a high sustainable growth rate, increasing GDP per capita, reform of subsidies, etc. But how to achieve such objectives has not been clearly identified. To conclude, Egypt's economic challenges and problems are well known. Remedies are also clearly identified, but what is lacking is the political economy context that enables the governing regime to start the reforms. Given the political economy context Egypt is passing through right now, it is not expected that a big bang approach to reform will be 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 and to support them, which is so far, is still non-existent.

²⁴ Ghoneim, Ahmed F. and Ibrahim Saif (2013).

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