

CHALLENGES OF EGYPT'S ECONOMIC TRANSITION

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NOVEMBER 2011

CARNEGIE MIDDLE EAST CENTER

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Contents

Summary	1
The Economy Since the Revolution	3
Short-Term Responses	5
Investment	5
Institutional and Governance Policies	8
Social Policies	9
Post-Election Responses (Medium-term)	11
Lack of Investment	12
Institutional Weakness	18
Generous but Ineffective Social Policy	23
Conclusion	24
Notes	27
About the Author	31
Carnegie Middle East Center	32

Summary

The Egyptian economy is going through a critical period as the country transitions to democracy. While the shift from authoritarianism is certainly welcome, it has inevitably incited instability unknown to Egypt for the past thirty years. The implementation of economic reform amid this uncertainty is particularly challenging as political demands take precedence. The state attempted several times to revive the Egyptian economy since the *Infitah*, or “open door,” policy initiated by President Anwar Sadat in the mid-1970s. Successive, though unsuccessful, reform programs during the 1990s contributed to the pervasive poverty that served as a central driver of the 2011 Egyptian revolution and persists today. Past experiences can provide useful lessons for what to avoid in the future, even if they are unable to impart what exactly should be done.

A successful transition to democracy can be facilitated by a sound economy and the economic well-being of citizens. Indeed, the transitional government led by the Supreme Council of the Armed Forces (SCAF) that is managing the country until the parliamentary and presidential elections are held is facing tremendous challenges. Yet it has unwisely rushed to fulfill the populist demands of the revolution with little consideration of their long-term effects. While perhaps politically expedient, reactive measures—such as the government’s recent increase in the public-sector minimum wage and the extension of fixed contracts to 450,000 public employees—are nonetheless placing added pressure on an already unsustainable budget deficit. Combined with the maintenance of economically inefficient subsidies, the long-term implications of continued poor economic policymaking will be severe.

The Egyptian economy has been in decline since Hosni Mubarak stepped down in February 2011, in part because of the instability inherent in transitioning states, which in this case was amplified by the global downturn. The effects of the current slowdown are most visible in terms of domestic consumption, direct private investment, and tourism. To reverse these recent trends and to move the economy forward as a whole, the transitional government must prioritize the following in the short term:

- Restore security
- Acknowledge and respond to the reticence of the public sector—both domestic and foreign—with a clear road map that will guarantee investment during this period of volatility

The long-term implications of continued poor economic policymaking will be severe.

- Stop demonizing the private sector and establish new partnerships with independent entrepreneurs
- Adopt a more participatory and transparent approach in the decision-making process
- Ensure the availability of funds for small and medium enterprises by providing guarantees to commercial banks for a limited period of time
- Channel foreign grants and loans for infrastructure and housing projects to the poor and other public utilities

In the medium term after the parliamentary and presidential elections, the government needs to:

- Bolster weak institutions
- Address low levels of investment and limited financial resources
- Correct imbalances between producers and consumers
- Broaden the now limited trickle-down effects of growth that widen the income gap between rich and poor

Addressing these problems and implementing the short- and medium-term measures outlined above will help put the economy back on track and avert the expansion of public expenditure to even further unsustainable levels. Until now, the transitional government has failed to take bold steps in the right direction and has not paid adequate attention to the economic aspects of the transition. Egypt has historically fared poorly in governance indicators such as rule of law, quality of business regulations, and corruption associated with ineffective social spending. The result of the poor ratings is misallocation of resources. Consequently, the government could face the worst-case scenario of continued economic decline and a reversion to authoritarianism.

The Economy Since the Revolution

Economic performance in Egypt has been poor since the revolution began in January 2011; GDP has declined by almost 4 percent and manufacturing by 12 percent. Revenue from tourism has collapsed, putting pressure on the balance of payments, which in turn has sparked a slide in foreign reserves. Official reserves have fallen by \$9 billion during the first half of 2011. It is estimated that Egypt will further face an external financing gap of about \$11 billion in the second half of 2011 and the first half of 2012.

Two recent measures implemented by the transitional government demonstrate that it is merely reacting to populist demands. First, it tolerated allegations of corruption and exaggerated figures to be circulated in the media without response. With such allegations, many businesspeople fear the risk of expropriation because economic liberalization is being equated with corruption.

Second, the transitional government is inflating the budget to appease the demands of the protesters. It has offered fixed-term contracts to 450,000 temporary employees and approved a 15 percent public-sector wage increase that will raise the total pension expenditure. Together, these actions will increase the state's total wage and pension bill by 25 percent.

The most recently drafted budget pledges to increase the minimum wage for public employees from 400 Egyptian pounds (\$70) to 700 Egyptian pounds (\$120).¹ While creating jobs and raising salaries are important to protect the rights of workers, this reactive cycle of demand and commitment is politically as well as economically unsustainable in the long term. Indeed, such actions will have serious long-term implications for the budget and the fiscal stance of the government.

Spending in excess of revenue requires the state to borrow from either domestic or foreign sources. The fiscal 2013 draft budget prepared by the Ministry of Finance estimates that government revenue will total 350.3 billion Egyptian pounds, with 514.4 billion in expenses. In the absence of a parliament, the SCAF approved the budget, cutting expenditures to 491 billion Egyptian pounds.² Until recently, the government has been borrowing from the domestic market. Domestic debt in 2011 registered an increase of 19.6 percent over 2010 in absolute figures and 1.7 percent relative to GDP. External debt increased by 6.9 percent, while its share to GDP has declined because GDP growth surpassed the growth of debt over the same period. Borrowing from the domestic market at a higher rate than that in the international market places an additional burden on the budget and creates the potential for the private sector to be squeezed out from receiving available funds. During

a workshop on July 18, 2011, with the Center for Economic and Financial Research and Studies (CEFRS) at Cairo University, several attendees emphasized the importance of making funds available for the private sector and the potential crowding-out effect. Ahmed Ghoneim, a professor of economics at the university, was critical of domestic borrowing, which in his view would have serious long-term implications. He argued that during this critical time of transition, high lending rates, combined with other numerous restrictions, will tighten liquidity and hinder investment.³

Despite the rising core inflation index, the Central Bank of Egypt has to this point decided to maintain the same monetary policy in place since fiscal 2010. As of the central bank's meeting in June, the most recent at the time

Banks have been reluctant to lend because of the political and economic uncertainty of the transition, and that in turn could exacerbate the problem and lead to further deterioration of the economy.

of this writing, rates remained unchanged for overnight deposits (8.25 percent) and lending rates (9.75 percent). Private-sector entrepreneurs have complained about the high cost of loan financing and their limited ability to secure it. Banks have been reluctant to lend because of the political and economic uncertainty of the transition, and that in turn could exacerbate the problem and lead to further deterioration of the economy. This would place pressure on the transitional government to intervene in the

market to provide alternative sources for funding, which, because of its negative implications for the budget, would not be a desirable option. Moreover, weak performance may encourage patriarchal policies and weaken demand for further political reform. The central bank can create a financial facility window in the short term to ensure that funding is available for independent and creative entrepreneurs.

In light of these recent developments, four possible scenarios could emerge from the interim period, depending on the transitional government's actions:

1. Appeasing the demands of the street in a cyclical and reactive manner will continue, and the budget deficit will rise to increasingly unsustainable levels. Should this occur, economic performance in key sectors would continue to decline and security would deteriorate, exacerbating unemployment, poverty, and, ultimately, the country's stability. Implementation of past patriarchal and authoritarian policies by the transitional government would become increasingly appealing in order to restore order.
2. Some funding will be attracted and secured, but the government will continue to respond to street demands by expanding public expenditures without tackling underlying structural and institutional challenges. Under this scenario, the economy would remain vulnerable with an unsustainable level of public spending and an unreformed economic system that would contribute to a torpid transition to democracy.

3. A coherent macro framework is drafted and the groundwork is laid to deal with immediate demands and to look ahead to possibilities that will address medium-term challenges. Under this scenario, the confidence of banks in the transitional phase and nascent government would be strengthened slowly as political stability is restored.
4. Economic performance improves as a result of measures implemented by the government to regain security and stability without putting together a coherent framework or coordinated action. This scenario would renew private-sector investment activity, and the economy would bounce back. However, lacking a clear framework, a setback would surely occur and the situation would deteriorate; the only question is when.

While the fourth scenario represents the best possible outcome from the perspective of the transitional government, it is unlikely to occur, given recent economic developments and the policies that the government has pursued.

Moreover, implementing dramatic economic reform measures, though the recommended course of action, may prove challenging for a military-led government that has not earned public legitimacy through the democratic process. None of the scenarios is mutually exclusive; the outcome will most likely be a combination of the second and third scenarios. Continued response to popular demands in a measured way would allow the transitional government room to maneuver on its long-term plans to reform the economy. And comprehensive reform can best be achieved by addressing the economy today with a combination of short- and medium-term solutions.

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Short-Term Responses

The challenge in Egypt is how best to introduce short-term policies that can reverse the economic downturn without harming future economic reform based on a more inclusive economic model. Properly thought-out short-term responses will fulfill some of the expectations at the street level while laying foundations for a sound economic future.

Three main policy areas need to be tackled in the short term: investment, institutional and governance policies, and issues related to social policy.

Investment

Reassure the Private Sector About Its Investment

The immediate concerns of the transitional government are to resume growth and to assure the private sector that its interests are safeguarded. The sheer number of criminal inquiries into alleged corruption cases, which currently exceed

6,000, has created a hostile environment for private-sector investment. A perceived risk of expropriation is discouraging both domestic and foreign investors.⁴ Other factors such as taxation, stringent regulations, export and production subsidies, and high transaction costs associated with red tape are also impeding investment. The continuance of tax incentives and production subsidies should be considered, but only for a limited period. The private sector—small-, medium-, and large-scale enterprises alike—should also be actively engaged by the transitional government in its economic policy decisionmaking process. Yet so far, the government's efforts to reassure the private sector have been limited, and investors' anxiety about investing in Egypt therefore remains high.

Stop Crowding Out and Make Funding Available for SMEs

So far, the government has tended to borrow from the domestic market at interest rates higher than those in international markets. Though this is not justified economically, the military council and the transitional government are trying to avoid external borrowing mainly for political reasons. They do not want to be perceived to be pursuing old policies that would burden the country with further external debt, given public sentiments regarding this issue in Egypt. This approach has two implications: It squeezes lending that could be available to the private sector (the crowding-out effect), and it burdens the budget with future obligations. The transitional government should either avoid borrowing except for necessary capital expenditures or turn to the international market to avoid squeezing liquidity and to take advantage of the low interest rates in the external market.

Moreover, the government can establish funds for small and medium enterprises (SMEs) and venture capital based on merit and transparency rules. In the past, similar initiatives failed to achieve intended results, not because the initiatives were wrong in concept, but because of the way they were managed.

According to Egypt's General Authority for Investment and Free Zones, SMEs account for 80 percent of Egypt's domestic economy and 75 percent of the private sector's labor force.⁵ 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. The absence of a clear definition of SMEs by the Central Bank of Egypt means that commercial banks do not use a unified method of classifying and categorizing them. The majority of Egypt's commercial banks treat SMEs as small corporate clients and have no specialized guidelines set for them. Accurate and timely information on the status of the SMEs is also lacking.

These shortcomings, in turn, limit the ability of commercial banks to tailor their products to the needs of the SME market. An effective solution to address such challenges would be the development of a unified method of gathering information that is constantly updated and that strives to eliminate errors in the data.⁶

Some initiatives regarding the SMEs fund have been implemented. For example, as part of its banking reform plan, the central bank has taken measures to exempt commercial banks' deposits for SME loans from the 14 percent reserves requirement ratio. This has provided commercial banks with an incentive to increase the number of loans that target SMEs. Furthermore, according to the central bank's 2010–2011 Economic Review, the central bank and the Egyptian Banking Institute have devised a survey that will attempt to unify the definition of SMEs used by public and private commercial banks. The survey is also intended to gather comprehensive and accurate information about SMEs.

While this is a step in the right direction, the policy should expand out from cities to cover the whole country, particularly in rural areas where unemployment rates are high.

Ease Regulations and Engage the Informal Sector

There is an immediate need to ease the strict regulations that are hindering new investment activity and discouraging business initiatives. Opening a business in Egypt takes six steps, seven days, and a cost equivalent to 6.3 percent of per capita income.⁷ These regulations must be changed immediately if the next generation is to have an opportunity to enter the job market. Entering and exiting the market in Egypt is far more complicated and costly than it is in other countries. Reform measures to facilitate doing business are urgently needed. The cost, time, and procedures required to open a business should all be reduced, and the minimum capital requirement should be trimmed to a symbolic value. In addition, switching to electronic business registration would save time. New laws regulating insolvency and bankruptcy should be enacted to help businesses facing financial difficulties.

The informal sector in Egypt accounts for nearly 40 percent of the economy and operates extra-legally because no improvements have been made in the business environment for decades. Improving the business environment and reducing red tape would encourage those who work in the informal economy to register their business and enjoy the benefits that would come with the formality. This also would widen the tax base and potentially enhance government revenue. As it stands now, workers in this sector typically suffer from poor working conditions, are highly vulnerable to market changes, and receive little immediate benefit from government assistance.

Lead the International Community Toward Egypt's Priorities

International and foreign donors have the potential to play a positive role for Egypt's economy during the interim period, but first the transitional government must articulate its priorities. A difference of opinion recently emerged over where to start and what constitute the most pressing issues. Attempts by

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the U.S. Agency for International Development (USAID) to decide how to allocate its money are clearly being resisted by the transitional government. The situation deteriorated when the Obama administration chastised Egypt's leaders, saying that they were stoking anti-American sentiment,⁸ whereupon Jim Bever, USAID's Egypt country director, abruptly resigned. The Egyptian minister of social solidarity and justice, Gouda Abdel Khaliq, had asserted that the United States was violating Egyptian sovereignty by offering funding to Egyptian associations and civil society organizations. The transitional government now warns such groups against applying for grants from foreign sources. A clarified policy with a clear mandate would help to avoid similar perceptions of disrespect and would help to smooth relations with potential international funders. This has not yet been done, and so stormy relationships will likely persist, to the detriment of the Egyptian economy.

Institutional and Governance Policies

The trust of the Egyptian people in formal institutions must be restored to maintain the social cohesion that characterized the revolution. Moreover, restoring trust will preserve the country's long-term macroeconomic stability.

Adopt a More Participatory Approach to the Decisionmaking Process

The transitional government needs to engage Egypt's new, emerging actors—civil society organizations and various political parties, youth organizations, and the business community—in the decisionmaking process. The business community in particular should be part of a transparent decisionmaking process at this early stage because of its vital role in investment.

Immediately releasing all information related to public spending would be a start. Encouraging open debate about important and sensitive issues such as oversight and evaluation of public spending and official subsidies can facilitate change. Even if concrete measures for transparency, participation, and conciliation are not implemented immediately, a precedent will have been at least been introduced. Up to

this point, however, the transitional government has avoided this path. To the contrary, the means by which it has arrived at its decisions—such as its suggestion of a capital gains tax and the introduction of a progressive tax—are unclear. What the Supreme Council of the Armed Forces has been clear about, however, was its decision to arbitrarily alter expenditures in the fiscal 2012 budget.

Overall, the roles of new and emerging actors are ambiguous. The SCAF, for example, seeks to protect its interests even after returning to the barracks; the military controls an estimated 10 to 15 percent of the economy in areas beyond the military sphere. Moreover, SCAF members have been distancing

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themselves from the public arena and have been ambiguous in the SCAF's intention to "lead from behind."

Enforce Laws... but Do Not Overstate the Extent of Corruption

Certain aspects of the SCAF's management of the transition have contributed to the widespread perception that corruption exists everywhere. Previous policies and their implementation, particularly those regarding economic liberalization, woefully lacked the transparency necessary to prevent the corruption and cronyism that are still pervasive in Egypt today. The SCAF also allowed public attention to be diverted by the media's tireless reporting of unconfirmed figures regarding the alleged exorbitant wealth of Mubarak, his family, and his associates. Under his leadership, Egypt was indeed beset by corruption, and several criminal cases being brought to court deserve appropriate action. Exaggerated attention to these cases, however, creates the absurd illusion that tackling corruption would solve Egypt's economic problems. What economic problems require is economic reform.

Increased transparency and scrutiny on public spending would help to downplay allegations of corruption and redirect focus to more pressing matters. Information sharing and a more transparent budget preparation process would help to map out a new approach toward sound economic governance in the transitional period. Releasing information and debating policies would immediately contribute to creating a new image for Egypt by sending the right message to now skeptical revolutionaries and allowing the transitional government to tackle other important issues. Preparation for the fiscal 2012 budget failed to adopt such a process, however, which left Egyptians and investors with the impression that when it comes to the budget, it's business as usual. Even if transparency were adopted in the budget process, that would not be enough. The government also needs to enforce laws properly through swift action, and that requires an empowered and independent judicial system. Overall, much more can be done at the institutional level without costing the transitional government additional spending. But if ambiguity and hesitance prevail, the desired short-term goals become that much more challenging to achieve.

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Social Policies

Open Debate on Subsidies and Focus on Targeted Groups

Social spending functions as a means for the government to bridge the gap between Egypt's socioeconomic groups. Subsidies as a portion of this spending represent more than 10 percent of GDP, but their effects are failing to reach the poor and marginalized classes who would most benefit from them. The national subsidy program desperately needs restructuring. Total social

spending amounts can reasonably be sustained during the transitional period, but they should at least be rearranged to target those who would gain the most from the subsidies rather than benefit Egypt's upper class as they currently do.⁹

The transitional government should begin this restructuring process by sharing information on the distributional effect of subsidies based on income level. It can distinguish between food subsidies, which are highly sensitive, and fuel subsidies, which are mostly consumed by groups not intended to benefit from the subsidies. Restricting fuel subsidies would be less sensitive politically but would represent a high cost-saving measure on total state spending. Because of the sensitivities of this subject, however, the transitional government has made little effort to pursue subsidy reform. Dealt with appropriately, the utilization of subsidies could produce positive results for those who need them most, as well as for the overall growth of the Egyptian economy.

Coordinate With the Private Sector

The transitional government must coordinate its efforts on social policies with the private sector. The private sector has several initiatives to abide by its Social Corporate Responsibility and would probably accept coordinated efforts in an attempt to build a new image. The government can, for example, advance existing initiatives such as the "1,000 poor villages or towns." This initiative, launched in 2007, aims to improve the status of 1,000 villages by improving the infrastructure of basic education, opening classes to combat illiteracy, offering more jobs, and providing ambulance and postal services. Participating villages were chosen according to a poverty reduction plan drawn up by the Egyptian Ministry of Economic Development and the World Bank. The initiative, which cost more than \$700 million in its first phase, has carried out about 1,400 projects so far.¹⁰ The private sector should be encouraged to take part in this and in other initiatives. This would free up some public resources that the transitional government could allocate to education and health.

Encourage Social Dialogue

So far the transitional government has failed to launch a mechanism through which collective action can be pursued without resorting to strikes or violence. At the beginning of the academic year this fall, severely underpaid private and public school teachers went on strike. Until that day, the transitional government did not take their strike threats seriously. To avoid such work stoppages, the government should initiate a dialogue regarding minimum wage and subsidies and then allow the actors to negotiate among themselves. Dialogue among various stakeholders would establish a sense of decisionmaking as a long-term process, a possibility that was distorted in the past because of political oppression and the weakening of social institutions and labor unions. Comprehensive

dialogue engaging all parties would also comfort private investors who want to avert any surprises during the government transition.

Emphasize the Importance of Education and Health

Although the provision of adequate education and health care is a long-term concern, the transitional government should demonstrate how it intends to tackle weakness in these vital sectors and improve the quality of services. This would require some financial resources that might not be available in the short term. New tools to evaluate performance and reallocate resources, however, would be a welcome change from the practice of the previous government, which virtually ignored such critical issues.

Post-Election Responses (Medium-term)

Post-election responses are related to the medium term, meaning three to five years after the parliamentary and presidential elections are held.¹¹ The elected or future government is trying to achieve a number of objectives. Judging by recent official statements and based on the demands of the Tahrir Square protesters, the main goals of medium-term reforms are to:

- Enhance growth and reduce poverty
- Create decent jobs
- Achieve a more equitable income distribution of registered growth
- Provide incentives to enhance investment
- Maintain and improve infrastructure
- Overcome institutional and governance deficits and promote the rule of law
- Upgrade the education and health sectors
- Revamp social policies to target intended groups

To achieve the desired goals, the elected government must confront significant challenges and determine how to:

- Combat the low investment level and limited availability of financial resources
- Increase productivity of the economy
- Strengthen institutional framework and raise the governance rating
- Implement effective social policies

The means by which the government and other stakeholders such as the private sector can overcome these challenges will affect not only economic growth but also Egypt's progress toward democracy.

Lack of Investment

Facilitate Private-Sector Initiatives and Promote Private–Public Partnership

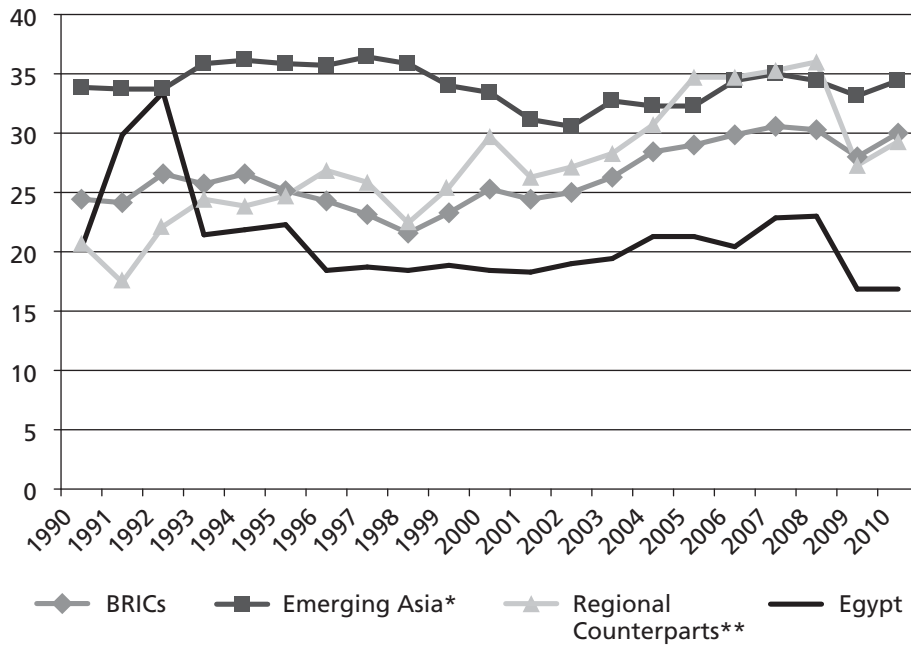
Egypt needs to increase the level of domestic and foreign investment financed and implemented by domestic private investors who have been hesitant and not forthcoming since the revolution. If this aversion continues, the effects on the economy will be devastating and will open the way to the worst-case scenario of an unsustainable budget deficit and a return to authoritarian rule.

To avoid such an outcome, the government should make the facilitation of private investment a top policy priority. A friendly business environment, a coherent political framework, and a stable political environment are imperative. Developing partnership initiatives between the public and the private sectors in areas such as infrastructure and utilities is critical for a clear and transparent governance structure. A number of projects related to infrastructure, such as transportation services and roads to rural areas could be proposed to the private sector. The private sector and the banking sector have the financial and technical resources to undertake such projects, but proper regulations are needed before they can implement such initiatives.

Another source of potential investment is foreign direct investment, which is expected to increase if Egypt's security situation improves and an elected government announces medium-term plans and strategies. Not much progress has yet been made by the transitional government. It has pursued this possibility by securing funding from the African Development Bank and some Gulf Cooperation Council countries. In showing its ability to maneuver both politically and economically, the transitional government refused to accept loans from the International Monetary Fund (IMF) and the World Bank; the IMF in particular was an object of public distrust during the revolution. This is a new behavior and establishes a different relationship between Egypt and the international community; it reflects the ability and desire of the government to decide which of the most important issues should be tackled and under what conditions the government is willing to borrow. Regional development agencies are increasingly playing a prominent role in setting the development agenda for the region.

Historically low investment levels by domestic sources are also contributing to Egypt's current economic problems. The level of domestic savings to GDP averaged 18 to 20 percent of GDP over the period 1990–2010. This is a low rate compared with other countries or regions with which Egypt may try to eventually catch up. The average in the so-called BRIC economies (Brazil, Russia, India, and China), for example, is around 27 percent, and in emerging Asian countries it is even higher, as shown in figure 1. Low savings levels reflect a low ratio of investment to GDP compared with other emerging economies. Figure 2 shows that while this rate exceeded 25 percent in the BRIC countries over the last decade, it averaged just 15 percent in Egypt.

Figure 1. Gross National Savings Levels (% of GDP)

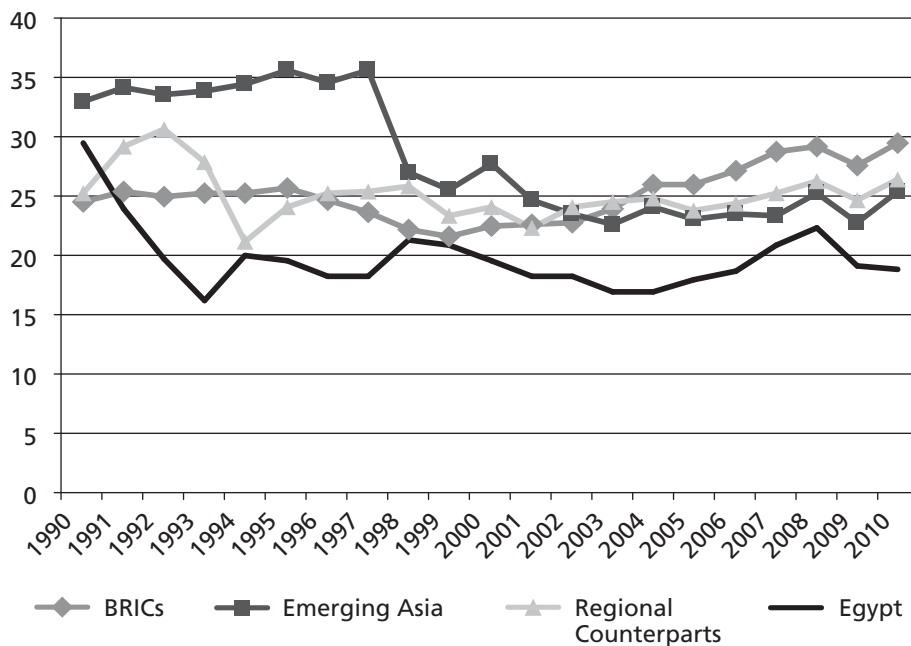


*Emerging Asia includes Indonesia, South Korea, Malaysia, Singapore, Taiwan, and Hong Kong.

**Regional counterparts include Iran, Saudi Arabia, and Turkey.

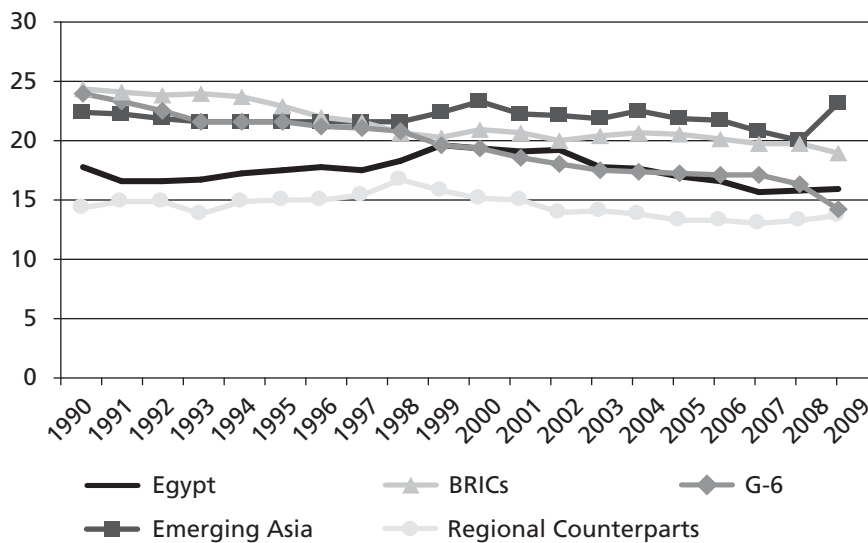
Source: IMF World Economic Outlook Database (2011)

Figure 2. Investment Levels (% of GDP)



Source: IMF World Economic Outlook Database (2011)

Figure 3. Manufacturing Value Added (% of GDP)



Source: IMF World Economic Outlook Database (2011)

A low level of investment reflects a lack of commitment on the investors' side. This has resulted in concentrating investment in "secured sectors" such as construction and financing trade instead of committing resources to manufacturing or more dynamic, innovative sectors. The manufacturing sector's share in Egypt's economy, for example, has been declining since the early 1990s. When measured by the volume of manufacturing value added to GDP, emerging economies outperformed Egypt's economy, particularly since 2000. The gap between these countries and Egypt has been widening, which indicates that development goals cannot be achieved by focusing only on service sector performance. While manufacturing's contribution to the BRICs and Asian countries increased over the past decade, it has continued to decline in Egypt. This comes as no surprise if we consider the combination of low-level investment, the nature of business elitism in Egypt, and indicators related to the political stability and corruption that hinder investment. Figure 3 shows Egypt's declining share of manufacturing value added compared with other economies. Egypt outperformed the regional average, meaning other countries in the region are suffering from the same symptoms as Egypt as a result of deindustrialization.

Clearly, investment levels must increase to at least the same level as other emerging economies if Egypt is to further diversify its economy and create more jobs. Providing quality infrastructure and logistics to access the market would attract investors in sectors such as the agricultural industry in particular, which can be based outside the big cities. So far, any movement in that direction has been limited.

Promote Inclusive Growth

Investment will certainly produce growth, but growth alone provides little benefit to the overall health of the economy without a trickle-down effect. Yet one has to be careful that growth not be compromised for distributional objectives. Welfare concerns can be addressed by focusing on issues related to taxation such as the introduction of a progressive tax system and improving education to increase access of the poor to emerging job opportunities. Inclusive growth means, among other things, making it pro-poor and accompanied by a more equitable distribution of resources. It also has to create productive jobs and contribute to the diversification of the economy. Productive employment is expected to reduce poverty and enhance livelihood and participation. To achieve this, the post-election government should focus on enhancing productivity in the agricultural sector. Egypt has a considerable rural population (58 percent of the total population), and the agricultural sector employs large numbers of workers. Agricultural productivity can be increased by introducing new technology and improving farmers' technical skills through targeted programs. Farmers complain about the lack of funds, access to the market, and huge barriers erected by middlemen. A policy intervention to facilitate market access is extremely important and would serve as an incentive for farmers to expand production. Indonesia, Ghana, and Brazil have managed to double growth in agricultural productivity over the past decade through a combination of policy intervention and investment in research and development. And this was achieved without increasing the number of workers employed in the agricultural sector.

According to Fayza Abounaga, Egypt's minister of planning and international cooperation, inclusive growth requires strengthening interrelations within the "developmental prism"—growth, employment, and social justice. An example of these relations is the necessity of linking nominal wages with productivity on the one hand, and with basic standards of living and general price levels on the other.

Moreover, microfinance could be utilized as one of the engines to promote inclusive growth. A successful example is the Cairo Economic Livelihoods Program, which offers loans to create jobs for women living in the city's most impoverished area. The initiative is built on the premise that local communities can be enabled to handle their own development in a sustainable way. The focus is on the comparative advantage possessed by local communities in the form of producing traditional carpentry, seashell, and other local crafts. Such success stories can be repeated in areas outside Cairo.

In addition to refocusing on agriculture and lifting poorly performing sectors, the post-transition government must ensure the provision of adequate health care and education services. Quality education is particularly important for breaking the intergenerational cycle of poverty by enabling the poor to

become qualified for emerging job opportunities in the sectors that require high levels of skill and are well paid. Inclusive, comprehensive growth is possible with a combination of improved schooling, spurred and secured investment, and a welfare system that targets the poor.

Revisit the Market Structure

There is evidence that markets in Egypt remain highly concentrated, given the prevalence of business elites and their overly comfortable relationship with bureaucrats under the old regime. Regulations were designed to protect the existing market structure with a few producers and traders controlling a major share of the market. Such a market structure ensures high markup, which ultimately exploits poor and middle-class groups.¹² To remedy this insidious problem, the post-election government must restructure the existing market and implement oversight mechanisms to ensure compliance.

Emphasize Formality

It has been estimated that Egypt's informal sector accounts for 40 percent of the country's economy¹³ and 82 percent of all Egyptian enterprises,¹⁴ which are mainly small and micro structures. The bulk of the informal economy is tied to youth entrepreneurship and more specifically to small and micro enterprises. Yet these entities are limited in their ability to access lending, and their growth potential is minimal.

According to the United Nations Development Program's 2010 Human

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Development Report, "Informality continues to be a major concern; young entrepreneurs might operate under the umbrella of the informal economy evading taxes and other constraints, but they are unable to grow due to the lack of access to reasonable sources of finance and fear of regulation and taxation."¹⁵ Despite the "advantages" of the informal sector, such as the absence of taxation and circumvention of government corruption and bureaucracy, the further development of this sector is hardly a viable solution for entrepreneurship in the long term. Given the low returns and increasing vulnerability of informal business, the propagation of the informal sector is the least desirable solution for sustaining the Egyptian economy overall.

In Egypt most of the informal entities are small and mainly operated manually. Any potential growth is hindered by laws and regulations, which offer no incentive for these firms to join the formal economy. If the intention of the government is to encourage such entities to join the formal rank, it should change the incentive scheme. One way is to pursue a gradual approach, such as granting a five-year grace period to the already established informal entities

before they turn into formal entities. During these five years, firms could benefit from financial incentives such as credit facilities and some technical assistance through business incubators that could help nurture small informal entities. Creating a central unit to collect information and provide advice on how to improve productivity would also help these entities.

Today, in order to register any entity in Egypt, new investors have to go through a tedious process that adds roughly 15 percent to the normally estimated cost. On average a newcomer must deal with 25 different official institutions that lack any coordination. Exiting the market is not easy either.

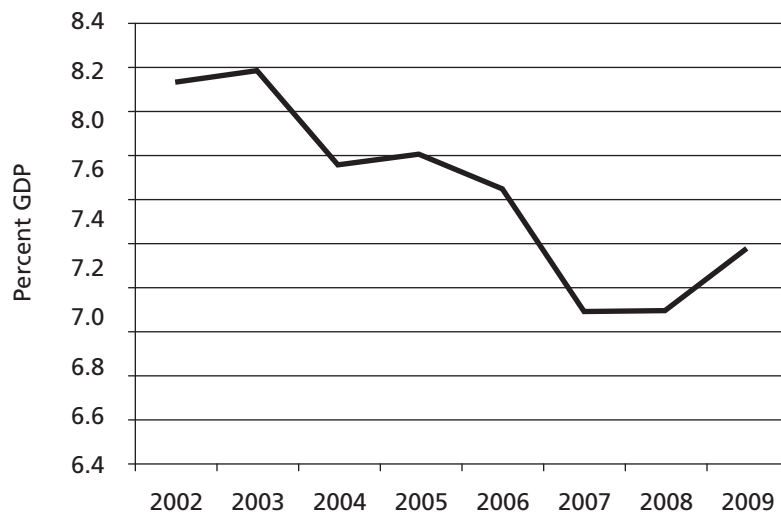
Overall, reducing informality and improving trickle-down effects requires a set of coherent policies that range from public spending to taxation to monetary policy. Several measures have to be undertaken in various domains to make this possible. Restricted access to financing is a pressing issue that must be addressed. As it stands now, less than 4 percent of lending reaches small and medium enterprises. Moreover, the taxation system needs to strike a balance between effective revenue generation and the provision of incentives to attract entrepreneurs to the formal sector via proportional taxation rates. Once again, an essential question is how to reform the educational system to prepare students for the job market. Pairing graduates with job opportunities that complement their skill sets creates supply-demand efficiency in the formal private sector. By encouraging students today to engage in the formal sector and depend on it to secure jobs and better living conditions, trust and reliance in the benefit of formal channels will be progressively realized. This will not happen in the absence of a labor market strategy that provides detailed information about the labor market on both the demand and supply sides.

The taxation system needs to strike a balance between effective revenue generation and the provision of incentives to attract entrepreneurs to the formal sector via proportional taxation rates.

Improve Wages and Productivity and Advocate Flexible Labor Regulations

Improving productivity, which ultimately increases overall employee earnings, is essential to enhancing the competitiveness of the Egyptian economy. This entails building capacity within workers' institutions to better negotiate their wages and benefits. More flexible labor laws and regulations from the employers' perspective should be adopted in tandem. Amending labor codes and empowering employees by facilitating various forms of collective action would help to develop a new order. A flexible labor market also translates into increased competition and productivity.

Yet getting a job in Egypt does not necessarily keep workers above the poverty line. Before the revolution, the minimum wage in the public sector

Figure 4. Employee Compensation

Source: World Bank Development Indicators 2011

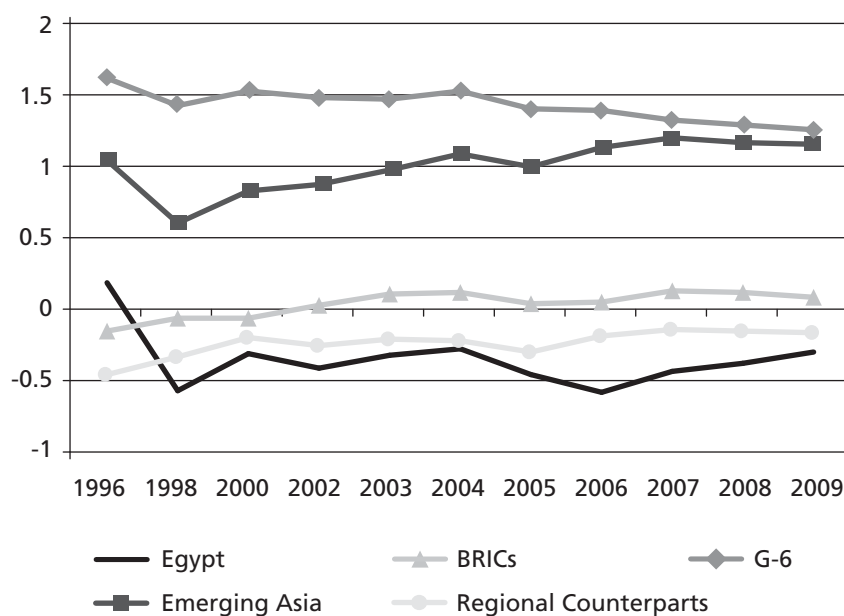
was estimated at \$1.60 per day (\$50 per month¹⁶), which is higher than the international extreme poverty line as defined by the World Bank (\$1.25 per day) but lower than the threshold of \$2. The higher threshold typically allows families to live decently, put aside a little savings, and sometimes acquire access to micro loans. Yet family size in Egypt is estimated to be six persons per household, with the father being the only source of revenue in most cases. Considering the very low rate of women participating in the labor force (23 percent), this simply means that many workers have been living below the poverty line. Poverty in Egypt persists among workers in all sectors—public, private, and informal.

The percentage of wages (compensation to employees) in Egypt relative to total income has declined, suggesting that registered growth has contributed more to profit and taxes. According to World Bank development indicators, the percentage of wages to GDP has decreased from nearly 8.2 percent in 2002 to nearly 7.4 percent in 2009. Figure 4 exhibits such a trend, which suggests that profits and taxes have increased over the same period.

Institutional Weakness

Enforce Laws and Stop Favoring Big Business

The reform process in Egypt under the former regime was characterized by two major features. First, the introduction of laws liberalizing the economy

Figure 5. Government Effectiveness Indicator*

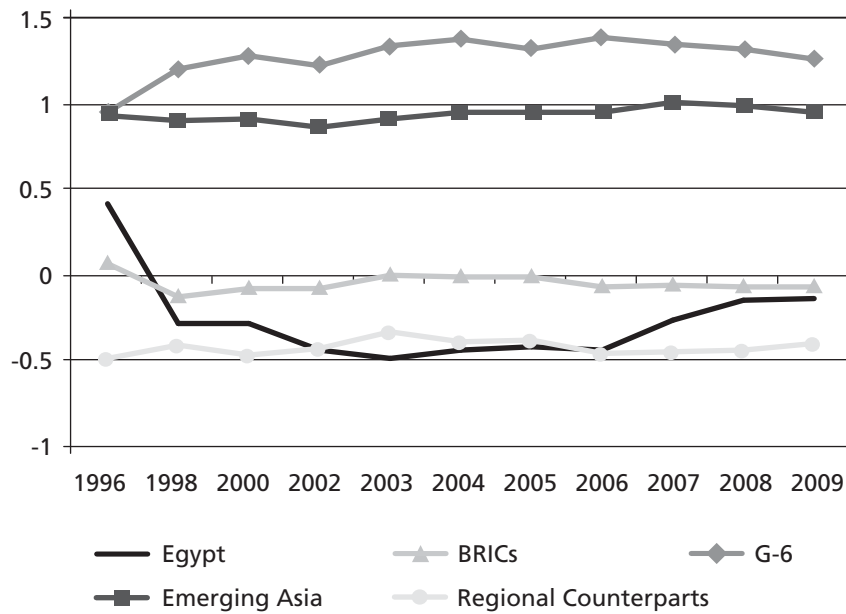
* Indicator is measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes. Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

Source: World Bank Governance Indicators

was accompanied by other legislative changes that increased the already steadfast power of government incumbents. This combination rendered them somewhat untouchable on a constitutional basis. Second, the new laws, amendments, or decrees were not paired with the development of institutional mechanisms for implementation. This deficiency reduced the laws to idealistic statements lacking application. The weakness of enforcing mechanisms was particularly evident in laws regarding competition, trade liberalization, deregulation, and privatization.¹⁷

Egypt ranks poorly on governance indicators compared with other emerging markets. Figure 5 shows Egypt as having one of the worst levels of government effectiveness related to the efficiency of government institutions and their role in socioeconomic development. This ranking must be improved if Egypt is to push ahead with economic reform and achieve its desired goals.

Figure 6. Regulatory Quality Indicator*



*Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private-sector development.

Source: World Bank Governance Indicators

The same situation applies to Egypt's regulatory quality, a trait that is highly developed only in advanced economies such as those of the G6 countries (France, Germany, Italy, Japan, the United Kingdom, and the United States) and emerging Asia. While Egypt fares poorly in this area, as shown in figure 6, much more regulatory efficiency is required for developing economies in general. Egypt's post-election government should work to enhance the independence of the judicial system and to build capacity for ways to deal with market-related issues such as antitrust laws, protection of consumers, intellectual property rights, anti-dumping legislation, and trade policy issues.

Enhance Labor Unions and Consumer Associations

To achieve balance between producers and consumers and between employers and employees, organizational capacity to defend the rights of various organized groups (employees) and scattered groups (consumers) must be enhanced and strengthened. The misuse of power by elites has undermined the role of civil society and institutions and unions that should have taken part in the process of transformation from authoritarian rule. This made the reform process elitist and opaque, with constant allegations of corruption by a public that lacked confidence in the system. Participation by consumer associations, trade and labor unions, and similar institutions was minimal. Sometimes these

groups were even silenced through formal legislation. One law, for instance, significantly weakened unions by placing them under the supervision of the government, leading to labor protests in 2009 and 2010 that paved the way for the 2011 uprisings. Intervention in general and local elections by the security apparatus was standard practice.

The Egyptian Trade Union Federation (ETUF) was dissolved in early August 2011.¹⁸ Since its creation in 1957, the ETUF, along with the 3.5 million workers it represented, was under the control of the regime. It used to be a tool for Mubarak to hold back labor activism by blocking strikes and demonstrations and by forbidding the formation of any other labor unions. With Mubarak's removal, the dismantling of the federation was a given.

Eight months after the fall of Hosni Mubarak, Egypt's newly elected trade unions embarked in September 2011 on their first major challenge to the military. Having its origins in four small unions that organized illegally before the revolution, the newly constituted ETUF is seeking a minimum wage of 1,500 Egyptian pounds a month (£165) and more than three times the barely enforced Mubarak-era lower limit that is still on the statute book.

The core of the movement consists of 22,000 textile workers at the huge Misr Spinning and Weaving Company in the industrial city of Mahalla. They are also seeking a tripling of bonuses and state intervention to increase investment and the supply of raw materials.

The trade union role is expected to resurge in the post-transition environment, giving unions the power and legitimacy to negotiate their terms with employers and allowing them to build their own capacity as an emerging group. In the meantime, a notable number of strikes are taking place in defiance of anti-union laws passed by the transitional government in its first few days in power. Doctors have staged sit-ins at hospitals, seeking pay raises and a trebling of public health spending. Teachers went on strike for the first time since 1951, shutting down thousands of schools. They called for the sacking of the education minister—a remnant of the Mubarak era—and a ninefold rise in pay, among other things. Also, transport workers have partially stalled Cairo's bus fleet in calling for a 200 percent pay increase, while dockworkers stopped work at the key port of Ain Al Sokhna, disrupting Egypt's vital sea links to the Far East. And clearly, the resurgent labor movement appears to be spreading from the public sector to private factories and farms, fueled by the breaking of a barrier of fear that served to curb union activity for decades.¹⁹

Civil society organizations, although maintaining a bold presence in Egypt for the past few decades, should also grow in capacity in order to enforce new laws regulating antitrust and market competition. These existing or newly established organizations would contribute to striking a balance between producers and consumers. They also can help set a limit on the level of exploitive markup practices in some concentrated markets such as cement or steel where a few producers control a large stake in the market and hence are able to set prices.

Engage Stakeholders—Particularly Young People—in the Decisionmaking Process

A new decisionmaking process is a primary factor that could distinguish the post-election regime from the old one. Several stakeholders who had been shut out during the old regime should be involved in the decisionmaking process. Older members of the opposition in addition to the young revolutionary forces are trying to cooperate in order to build new and transparent institutions and create a new image for the country.

On an economic level, the change is significant: Many former business tycoons such as Hussein Salem and Ahmed Ezz, who were symbols of crony capitalism and corruption, have been indicted for embezzlement and squandering public funds.²⁰ Dismantling the elitist system and implementing anti-corruption measures are expected to open opportunities to a new generation of entrepreneurship and a fresh start for the nation's economy. Egypt will become increasingly reliant on its youths, who face huge unemployment challenges and considerable economic obstacles.

Political parties and organizations that represent both employed and unemployed young people, such as the Egypt Youth Party, founded in 2005, or post-revolution groups such as the Coalition of the Youth of the Revolution and the April 6 Youth Movement, are likely to gain prominence. Moreover, young entrepreneur associations will no longer be limited to the traditional class or to representing siblings of the already established business community. Instead, grassroots organizations addressing issues facing new start-ups are likely to emerge. Policymakers can expect to find themselves facing hard questions from precisely those youths who led the revolution.

The private sector should similarly project a new image in this transition and later in the post-election government by pursuing activities through formal, legal channels, and it should commit to Corporate Social Responsibility. It can further articulate a clear policy on social responsibility in order to change its image and show that its interests go beyond profit making. Political parties representing the private sector, such as Naguib Sawiris's Free Egyptian Party,²¹ are expected to be clearer about their mandates and role. Lobbying and protecting their interests will no longer be conducted behind closed doors or via informal routes. To legitimize their work and presence, they are more likely to act publicly with the intention of having political representation in the parliament.

The decisionmaking process in the "new" Egypt can and should be more transparent, open, and participatory. Decisions should no longer be limited to elite groups negotiating with weak, complacent bureaucrats, but rather should be an outcome of a collective dialogue process. These kinds of mechanisms will not fall into place automatically. It will take time for stakeholders to identify how to work collectively and what channels can be pursued in order to lobby for their goals. In Chile and South Africa, countries that experienced regime change, the new political and economic order took years to develop.

One way of beginning this process is through widening the participation of the public in deciding budget priorities. Currently there are several black boxes in Egypt's budget that the public knows little about. Very few know how the government allocates its public expenditures, both sectorally and geographically. Another example is related to setting a minimum wage and resolving labor disputes; at the moment, issues related to wages and benefits are pursued on an ad hoc basis. A formal institution such as an economic and social council can be created and entrusted to open dialogue regarding such explosive issues with the participation of civil society, media, employers, and employees.

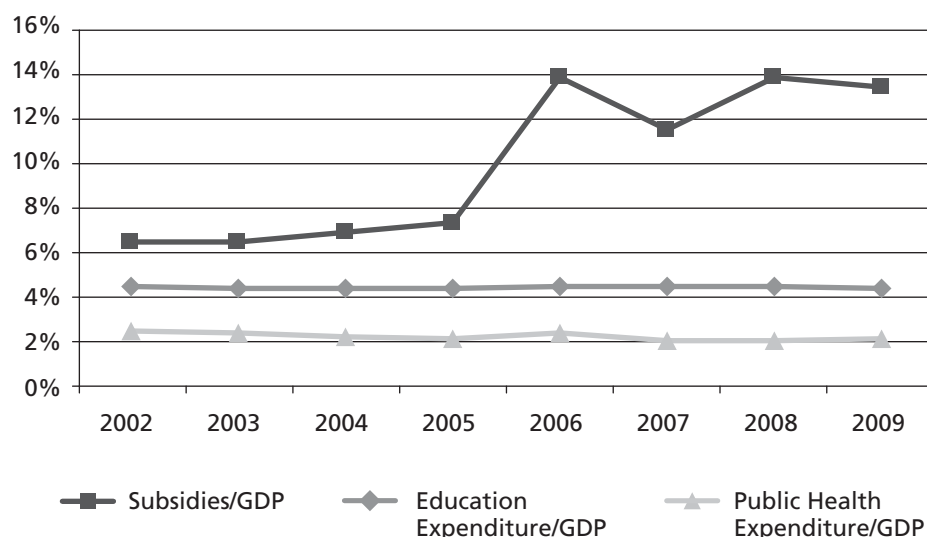
Generous but Ineffective Social Policy

Stop Ineffective Social Spending and Focus on Areas to Help the Poor

There is nearly unanimous agreement among Egyptian economists that the current form of subsidies is unsustainable. Yet no action has been taken to invoke change. The government can start with some gradual steps to revamp this system and ensure that subsidies are reaching the targeted groups. This would improve the efficiency of social spending and could lead to lower dependence on oil and gas revenue. Furthermore, slight changes to subsidy spending could release resources for reform in the education and health sectors. Egypt can benefit from the experiences of other countries, and the international community can provide technical forms of assistance.

Indeed, what is being spent on subsidies in Egypt, as shown in figure 7, exceeds what is being spent on education and health combined. If a new order

Figure 7. Subsidies, Educational Expenditure, and Public Health Expenditure as a Percentage of GDP



is emerging, the government could be expected to allocate more resources to sectors that would contribute to achieving social justice and equity.

Rationalizing subsidies has been avoided. But many advocates suggest that initial steps can be taken in that regard.²²

Taxation Should Be Reviewed

The government needs to rethink its tax policies, but the subject has gained little attention since the revolution and has not been broached. It could in fact be one of the most contentious issues according to Gouda Abdel Khaliq, the minister of social solidarity and justice.²³ Tax reform could establish a new relationship between the business community and government based on a more participatory role for business. Two issues surface in this regard: one related to the potential progressive tax that has been widely avoided in the past, and the second related to the kind of incentives the government would offer to small- and medium-scale enterprises.

The current taxation system is clearly not sufficient to reduce the budget deficit. With no tax on capital gains and with corporate and individual tax rates at a maximum of 20 percent—far below the global average of 25 percent for corporations and 30 percent for individuals—revenue will never match spending. Moreover, the middle class, which should be the engine of economic development, is suffering the most from the progressive rates. The middle class pays an average of 15 percent in individual taxes, while the upper class (those with an income exceeding 40,000 Egyptian pounds a year) pays just 20 percent. In the fiscal 2012 budget, it is suggested that the higher tax bracket be raised to 25 percent for large corporations and wealthy individuals and that a 10 percent capital gains tax be introduced. Apart from the capital gains tax, the SCAF passed the tax increases. Tax evasion is also a considerable problem in Egypt, be it in the informal sector or other areas that have been neglected in the past. Fairness requires imposing taxes on all eligible entities and should be part of a restructuring plan that aims to expand tax pools while at the same time increasing efficiency in public spending.

Conclusion

Looking ahead, Egypt's economic outlook will depend on the government's ability to establish political and social stability. A number of constraints exist, among them the high expectations of the public for the newcomers in the transitional and post-election governments and the short time frame in which to achieve stability; limited resources; and weak institutional capacity. Managing expectations without compromising long-term stability is the most challenging issue that threatens the success of the transition.

The current downward trend in the Egyptian economy must be immediately addressed. The transitional government can begin by regaining the confidence of the private sector and removing barriers for new entrepreneurs. Short-term measures such as production subsidies and limited export facilities could also be implemented during this time of uncertainty in order to boost production and create jobs. The banking sector could assume a more proactive role as well in terms of lending. Coordination by the central bank to avoid repercussions and moral hazard by targeting SMEs based on merit should be among the government's priorities.

Measures taken by Egypt's transitional government have so far failed to send the right message, however, either about its intentions or management of the economy; the SCAF overplayed its role by intervening in the preparation of the fiscal 2012 budget. The transitional government has yet to deliver on simple changes that could have immediate and lasting impact on the economy for the better.

It is not clear which of the scenarios presented here will occur in Egypt. On the one hand, there is a need to reform the bureaucracy, improve its efficiency, and revisit the role of the state to become a facilitator of growth and development. On the other hand, demands are being placed on the state to assume a traditional social and distributive role. The transitional government is trying to balance these two seemingly opposing views. This is no easy task, as the divergent voices raised by citizens in Tahrir Square make clear. A more likely policy prescription: appeasement policies in the short term combined with a coherent plan to deal with medium-term challenges.

Movement to forge a new deal between state and society has been timid, and the transitional government has taken no steps to indicate that a new economic paradigm is emerging. A number of measures can be adopted, such as sharing information and engaging stakeholders, that would not burden the budget and could usher in a new trend in the decisionmaking process. The transitional government has nevertheless failed to take advantage of even such simple, cost-free measures. Moreover, the link between short-term and medium-term outlooks remains weak. While the SCAF is serving as merely a transitional government, abrogation of its responsibility toward the economy threatens the transformation process and, with it, Egypt's long-term potential for democratic consolidation.

The current downward trend in the Egyptian economy must be immediately addressed.

Notes

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The author is grateful to Amanda Kadlec and Joulan Abdul Khalek, research assistants at the Carnegie Middle East Center, for their help in providing insightful comments and editing the first version of this paper.

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