INSS Insight No. 454, August 8, 2013

Egypt's Economic Options: The Need for an Outward Strategy

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The Egyptian economy, currently in dire straits, is vital to the country's stability, and stability in Egypt is a central interest of Israel. While in the long term, future governments can adopt and implement policies to improve Egypt's economy, the short term impact of the recent political revolution exacerbates the current conditions. Adopting an outward strategy and reconnecting the Egyptian economy with the global economy is the only way to encourage growth and build a long term sustainable recovery.

The reality speaks for itself. Political instability, fiscal deficits (13 percent of GDP), and shortage of foreign exchange reserves limit the spending ability of the Egyptian government. The spending power is critical in an economic environment where fuel and food (mainly bread) subsidies are an important pillar of the economy. Recent aid packages from the Gulf states provide some breathing space for the next six months, but it is unclear what will follow. Egypt's labor market is weak, unemployment is 13 percent, including among one third of the young people, and wages are low. Food prices have risen 50 percent since 2010, and services in the public sector are poor.

This reality puts much pressure on the government to focus on internal economic policies and provide subsidies and employment opportunities. However, neglecting the external front may not bring Egypt to economic independence. The new interim government, with its strong regulatory and economic background, can pursue several tracks within an outward strategy, which can provide more sustainable growth. Egypt's low growth rate, around 2 percent for 2012, is one of the factors behind the high unemployment rate, and sustainable growth can address this crisis.

First, the government must strategically increase foreign direct investment (FDI) in the country. The United Nations Conference on Trade and Development (UNCTAD) 2013 Investment Report from June 2013 shows a modest increase in 2012 in North Africa and the Levant, with Egypt receiving in absolute terms the largest share due to its large GDP. Yet Egypt's inward FDI is shrinking quickly due to political and economic instability. The inward FDI in the nine months to March 2013 was $1.4 billion, compared to annual

levels of $10 billion a few years ago. According to many studies, higher FDI will provide jobs, increase salaries, and strengthen stability.

Several initiatives can help increase inward FDI. The interim government should signal the market that it will not adopt game-changing policies that may be reversed by the next permanent government. Foreign investors seek stability, and another six months of inconsistency is not helpful. In addition, the ongoing political instability calls for improving the political risk insurance market. Egypt is desperately looking to finance sizable energy projects designed to reduce its power shortage. Many of these projects can be insured against political risk by multinational institutions, such as the Multilateral Investment Guarantee Agency. Securing an IMF loan can improve the relationships between Egypt and many multilateral institutions and increase the volume of political risk insurance policies with lower premium rates.

Furthermore, the rule of law principle and regulatory clarity and stability are important components of any FDI framework. Denouncing international agreements may send a signal that Egypt cannot promise foreign investors the commercial environment they seek. While a regulatory stabilization clause is common in international agreements in developing markets, the government can and should do more to protect investor interests. Egypt's decision to suspend its agreement to supply gas to East Mediterranean Gas, which supplied gas to the Israel Electric Corporation, may present a risk to other state-to-state financial agreements and energy deals. While in Israel the market follows this story from a geopolitical view, for most investors it is a case study of the ability to meet commercial terms and contractual obligations. Similarly, Egypt should avoid discriminatory actions against foreign investors, or the perception thereof, as in the recent alleged tax evasion cases.

The second track for Egypt is to change the international trade bias that traditionally – and naturally – has favored the Gulf states. In light of its unique nexus with the Gulf, Egypt's current trade map does not reflect recent changes in the global economy. The government, for example, can open commercial offices in new and less traditional markets.

Third, bilateral trade and investment agreements have been quite instrumental in building sustainable trade and investment relations around the world. Egypt can continue to negotiate these agreements, making sure that the new agreements open Egypt to new markets. The proposed Egypt-China Free Trade Agreement, which also includes an investment chapter, is a case in point. The parties negotiated the agreement in 2012 but the process is not moving forward. The government should expedite the negotiations process in 2013 since many of its competitors in competitive products already have such agreements in place. While some analysts question the effectiveness of trade and

investment agreements, the cumulative effect of these agreements on the economy as a whole and the region is significant.

These agreements should follow macro economic trends. Egypt-China bilateral trade, for example, sees a year-on-year increase of 18.8 percent and reached nearly $7 billion in 2010. Egypt is China's fifth largest trade partner in Africa, and Chinese cumulative investment in Egypt reached $335 million.

Fourth, the government needs to educate the street better on the role of the IMF and other multilateral institutions in the Egyptian economy. The perception that the IMF conditionality will lead to unnecessary structural reforms should be replaced by conveying the role of IMF financing in stabilizing markets, inducing other institutions to finance the Egyptian government (such as the European Union), and providing legitimacy for internal economic policies. The proposed IMF loans will force Egypt to address its fiscal crisis seriously by reducing local spending and subsidies, a move that would require a shift in public opinion.

Fifth, Egypt should leverage the large sovereign funds in the Arab world and convince them to increase their asset allocation to the region's private companies in general, and Egypt's companies in particular. The current situation whereby these funds invest globally and leave some of its neighbors behind is not sustainable. Recent improvements in the Egyptian stock market are promising. Aid packages provided by the Gulf states should be replaced by direct Greenfield investments. The International Finance Corporation's shift toward direct investments in developing markets by private funds, which are financed partially by sovereign governments, can be a role model.

Finally, Egypt should reorient the national economic dialogue from a culture of aid to a culture of regional and global economic integration. Indeed, the IMF loans and the US and EU civil and military aid are critical to Egypt's operations, and Israel, which has an interest in Egypt's economic and political stability, should continue to support foreign aid of this sort from its allies in the US and Europe. Yet this aid should not become a goal in and of itself, and prompt the neglect of private sector initiatives. The coming months are critical. For instance, Egypt needs to roll over about $5 billion in dollar-dominated Treasury bills matured by the end of 2013. Adopting long term strategies that look externally and not internally will help Egypt to position itself better to deal with the serious challenges in the months ahead.

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