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POLICY MEMO

EGYPT, THE IMF AND EUROPEAN ECONOMIC ASSISTANCE

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SUMMARY

Egypt is in the grip of dual crises that are fuelling dangerous discontent. First, it faces contentious parliamentary elections amid a mounting challenge to the legitimacy of post-Mubarak institutions. Second, in order to secure a $4.8 billion loan from the International Monetary Fund, it must implement austerity measures and broad structural reforms. The IMF loan would provide temporary fiscal relief and unlock billions in additional aid, which European, US, and other donors have made conditional on Cairo adopting the Fund's terms. However, the political risks attached to enforcing the austerity programme leave an increasingly fragile Egyptian government reluctant to sign on.

This memo argues that it is shortsighted for the European Union and key member states to withhold all of the $6.5 billion in economic support they have earmarked for Egypt until the IMF accord is signed. Europe should not wait for Cairo to agree on the long-term structural reform demanded by the IMF before helping Egypt address the growing crisis of unemployment, which threatens to fuel renewed social turbulence. Instead, even before terms are agreed between Cairo and the IMF over long-term macro-economic policy, European donors should immediately commit funds to grassroots training and vocational skills programmes to help tackle unemployment.

Egypt is in the grip of profound economic and political crises, each of which reinforces the other and imperils the prospects for long-term social stability, growth, and development. The International Monetary Fund (IMF) has made a $4.8 billion loan conditional on reforms that it believes are essential in order to create sustainable growth in Egypt. But the government in Cairo is reluctant to implement these reforms, which would have a negative short-term impact on the living standards of many millions of Egyptians. The toxic political atmosphere is endangering prospects of achieving the political consensus over economic reform that the IMF believes is essential to the programme's success. The inflationary impact of the growing balance-of-payments deficit threatens a new season of social outrage on the streets.

The IMF loan is central to Egypt's immediate economic prospects, not only because of the likely impact of the loan itself but also because a number of other donors and investors have made their own commitments conditional on Cairo's adoption of the IMF's terms. Egypt's adoption of the IMF reform package is thus the trigger for releasing an estimated $12 billion in contingent loans. An IMF loan agreement would also be viewed in international capital markets as a signal that Egypt is finally on track to narrow its budget deficit and implement key reforms, easing the uncertainty that has restrained foreign investors from returning to Egypt. But the long-term structural reform envisaged under the loan agreement is not a panacea for the problems facing the country and will not solve the immediate crisis of stubbornly high youth unemployment.

In mid-March, the IMF recognised the danger of delaying assistance until the reform programme had been agreed and offered Egypt a temporary loan facility of $750 million to help it cope with a currency and budget crisis. IMF officials have argued that, while Egypt urgently needs ambitious reforms to tackle its economic problems, it should nonetheless be assisted with a bridging loan while the terms of the full programme are being negotiated.[1] But this emergency loan is likely to have had similar restructuring conditions as the original larger loan. Thus the Egyptian government – which has already been offered $13 billion in immediate loans and grants from Qatar, Turkey, Saudi Arabia, and Libya have already offered $13 billion in immediate loans and grants, dwarfing the stopgap package from the IMF – has thus far rejected it. Rather than "quick fixes", Planning Minister Ashraf al-Araby said that Egypt needed "broad structural measures" to tackle its budget deficit.[2]

A deepening economic crisis

The deep structural weaknesses in the Egyptian economy that had set the tinder for the 2011 uprising that led to the ouster of President Hosni Mubarak have been exacerbated amid the ensuing political turmoil since then. Most alarming is Egypt's burgeoning youth unemployment. According official figures, 13 percent of Egyptians are unemployed, of whom 74 percent are aged between of 15 and 29, and some believe the real number of those who are unemployed is much higher.[3] Eight out of ten university graduates are unable to find work.[4]

Meanwhile, revenues from tourism – a key source of Egypt's foreign exchange income for decades – are down by more than a fifth since the start of the revolution, while foreign direct investment has fallen by 56 percent amid the uncertainty of the post-Mubarak period.[5] The central bank recently warned that Egypt's foreign reserves had fallen to "critical levels" despite a cash infusion from Qatar and currency-control measures – a situation with potentially volatile social consequences in a country that imports much of its food, including about 60 per cent of its staple grain, wheat.[6] $15 billion typically covers three months' imports. But foreign currency reserves now stand at little more than a third of the $36 billion that Egypt held immediately before the 2011 uprising. Although the government has depleted its own reserves and used some of the assistance from Qatar to defend the currency, the value of the Egyptian pound is likely to continue to fall. Because of this, as well as rising global food prices, Egypt's inflation rate – currently 8.2 percent – is likely to rise.

Without an IMF agreement, pressure on the Egyptian pound is likely to grow. Analysts at Capital Economics say "there is a real risk of a more disorderly devaluation, whereby the pound could plunge by up to 50 percent in a matter of weeks".[7] This could spur inflation and a banking crisis, as well as a precipitous fall in asset prices, while dramatically impairing Egypt's ability to import wheat and fuel for citizens. Such a sharp increase in the economic pain suffered by the poorest Egyptians would risk new turmoil on the streets and could even create a revolutionary situation reminiscent of the riots sparked by rising bread prices in the Mubarak era during the 1980s and 1990s and against the government of President Anwar el-Sadat in 1977.

Until now, the government has staved off more dramatic economic deterioration through loans from the Muslim Brotherhood's political allies elsewhere in the region. In January, Qatar loaned Egypt $2 billion and opened an additional $500 million line of credit, having deposited $2 billion in the country's coffers last August.[8] Gas-rich Qatar then threw Egypt another $3 billion lifeline in April, also promising to extend gas supplies to the country this summer as needed.[9] The total $8 billion in loans, grants, and deposits from Qatar suggest that the Egyptian government may be giving in more to the opposition's demands as continued financial support from Doha could further delay an IMF agreement, which comes with a plan that secular and liberal groups say they have not seen.

Meanwhile, Turkey has agreed to lend Egypt $2 billion, while Libya has committed to provide Egypt with the equivalent of one million barrels of crude oil per month and is also considering offering Egypt financial aid.[10] To ease fuel shortages, the Egyptian government has said that it plans to import four million barrels of oil from Iraq every month, which could be at preferential rates.[11] While such emergency measures may not solve Egypt's long-term economic problems, the political risks attached to embracing the IMF's terms may tempt the government to extend its reliance on supportive governments with deeper pockets.

When Egypt first requested an amount of $3.2 billion from the IMF in May 2011 politicians and international donors viewed it as an emergency cash injection to buffer an economy damaged by the uprising. Egypt's political

1 Marwa Awad and Yasmine Saleh, "Egypt studies IMF bridging loan as crisis deepens", Reuters, 11 March 2013, available at http://www.reuters.com/article/2013/03/11/egypt-economy-idUSL6N0C3B8Z20130311.
2 Asma al-Sharif, "Egypt does not need IMF bridging funding - minister", Reuters, 10 March 2013, available at http://www.reuters.com/article/2013/03/10/egypt-imf-idUSL6N0C243J20130310.
3 Central Agency for Public Mobilization and Statistics, "Labor Force, Employment & Unemployment in Egypt", 16 February 2013, available at http://www.capmas.gov.eg/pepo/LabourForce/sdds_lb2_e2.pdf.
4 Nada Badawi, "CAPMAS: Unemployment reaches 3.4 million", *Daily News Egypt*, 4 March 2013, available at http://www.dailynewsegypt.com/2013/03/04/capmas-unemployment-reaches-3-5-million/.
5 Monthly Statistical Bulletin, Central Bank of Egypt, February 2013, available at http://www.cbe.org.eg/English/Economic+Research/Publications/Monthly+Statistical+Bulletin/Feb+2013+Statistical+Bulletin.htm.
6 Aya Batrawy, "Egypt's central bank: reserves at 'critical' level", Associated Press, 29 December 2012, available at http://news.yahoo.com/egypts-central-bank-reserves-critical-level-164608124.html.
7 William Jackson, "How far and how quickly will the Egyptian pound fall?", Capital Economics, Middle East Economics Update, 8 January 2013, available at https://www.capitaleconomics.com/middle-east-north-africa-economics/middle-east-economic-updates/how-far-and-how-quickly-will-the-egyptian-pound-fall.html.
8 "Qatar says boosting aid to Egypt by extra $2.5bn", Reuters, 8 January 2013, available at http://www.reuters.com/article/2013/01/08/egypt-qatar-idUSL5E9C878S20130108.
9 Regan Doherty and Maggie Fick, "Qatar throws Egypt $3 billion lifeline amid IMF loan talks", Reuters, 10 April 2012, available at http://uk.reuters.com/article/2013/04/10/uk-egypt-qatar-talks-idUKBRE9390B920130410.
10 Asma al-Sharif and Regan Doherty, "Egypt to import Libya oil, pay down energy debt", Reuters, 27 March 2013, available at http://www.reuters.com/article/2013/03/27/egypt-oil-payments-idUSL5N0CJ14G20130327.
11 Jessica Donati and Julia Payne, "Egypt cuts back on oil imports", Reuters, 5 March 2013, available at http://www.reuters.com/article/2013/03/05/egypt-gasoil-idUSL6N0BXEZV20130305.

turmoil has already delayed the adoption of the IMF loan terms by almost two years, and it had been widely assumed that an agreement would be postponed at least until after the legislative elections had been concluded in the summer. However, a successful court challenge has forced President Morsi to delay the election, which is now expected to be held in October. According to the new timetable, a parliament should be formed by the end of the year, but recent history suggests that it could be delayed further. Meanwhile, the loan has grown not only in size but also come to epitomise the challenges of reforming a creaking, public-sector leaning economy amid growing political polarisation.

Points of contention

Mindful of the social context in Egypt, the IMF has sought to taper its reform demands to ease their impact on the poor, for example by demanding changes to the rules governing subsidies to ensure that they benefit only the neediest Egyptians. Still, the IMF reform package will impose a heavy burden, and the loan agreement's political risk is exacerbated by the fact that the IMF has become associated, in the eyes of many Egyptians, with the cronyism and kleptocracy of the Mubarak era. (A small business elite connected to President Mubarak's son, Gamal, had been the prime beneficiaries of the massive privatisation of state-owned enterprises undertaken at the IMF's behest in the 1990s.)

The Muslim Brotherhood believes that the loan agreement represents the country's best chance for economic recovery. But the negative perceptions of the IMF in Egypt – and the fact that the majority of working Egyptians saw little benefit, and in many cases grew poorer, after previous rounds of privatisation, deregulation, and trade liberalisation – have created fertile ground for those opposition groups denouncing the current package as "bondage and slavery" claiming it will force Egypt "to sell the pyramids". At the same time, the military is also opposed to IMF-mandated privatisation because it threatens its massive role in the civilian economy. Some of the points of contention over the IMF plan are specific to Egypt's post-Mubarak political environment, while others are based on the long-term structure of the country's economy.

Islamist objections

The anti-usury prescriptions of Islamic sharia law could be invoked as a potential rallying point for Islamist opposition to the loan. The largest bloc of Egyptian voters backed Islamist parties in the last legislative election, giving added significance to the sensitivities of this constituency. Although the Morsi government shares many of the free-market economic assumptions of the IMF, the need to fend off the challenge of the more conservative Salafis competing for the same voter base has prompted it to insist that the 1.1 percent interest rate on the loan is sharia-compliant. Muslim Brotherhood economists have characterised the interest that would be paid on the loan as "administrative fees".[12] But others question or contest that claim and MPs from the Salafist Nour Party requested that the agreement be referred for a religious ruling to al-Azhar, the 1,000-year-old Islamic university and mosque mandated by the Egyptian constitution to vet legislation for sharia compliance.[13]

Opposition to public sector cuts

Although the government concurs with the IMF that scaling back public spending will have to include cuts to the state payroll, widespread dependence on public sector employment creates countervailing political pressures. While job growth in the private sector is slow, Egypt's public sector has six million employees whose salaries consume one quarter of the state's budget. But as IMF adviser Magda Kandil noted in an August 2012 brief, attempts to cut the size of the public sector have "torn at the fabric of the middle class. Young college-educated Egyptians can no longer be sure of getting civil service jobs in an era of privatisation and greater budget discipline."[14] If anything, the government is now under pressure to spend more, not less.

Unwillingness to cut energy subsidies

Egypt has a system of subsidies for commodities such as petroleum and flour that is hugely expensive and works very poorly. In particular, it spends about 20 percent of its national budget on keeping down fuel prices for the general public even though it pays out more to support wealthier households whose fuel consumption is higher than in needier ones. The public debt is further swelled by the fact that, because of Egypt's declining domestic output and the sporadic disruption caused by strikes, a growing portion of the subsidised petrol and natural gas is imported. However, the Morsi government is unlikely to tempt fate by altering the fuel subsidy status quo amid the uncertainty over the election. In February, Egypt's oil minister Osama Kamel announced a delay of up to three months in implementing a new system of rationing subsidised fuel – a move initially set for April as part of IMF-mandated austerity measures.[15]

Inability to collect taxes

The Egyptian state's inability to expand tax revenues was highlighted on the eve of the constitutional referendum in December when the Morsi government announced a package of sharp tax hikes on items ranging from cigarettes and mobile phone calls to electricity bills and real estate but was forced to back down within hours in the face of a concerted public outcry. The ruling party has signalled that it favours progressive taxation and raising the tax burden on corporations and wealthier Egyptians, but the risk of capital flight and scaring away already jittery investors makes any

12 Author interview with Ashraf Serry, an economist and Steering Committee Member at the Muslim Brotherhood's Renaissance Project team, 16 January 2013.
13 Salafi MPs consider EU loan as usury", MSN Arabia, 11 February 2013, available at http://arabia.msn.com/news/middle-east/1295526/salafi-mps-consider-loan-usury/.
14 Magda Kandil, "The Egyptian Economy in Retrospect and Future Prospects", Egyptian Center for Economic Studies, Number 32, August 2012, available at http://www.eces.org.eg/publications/View_Pub.asp?p_id=9&p_detail_id=324&logout=1.
15 Asma al-Sharif, "Egypt to Delay Fuel Subsidy Rationing", Reuters, 12 February 2013, available at http://www.zawya.com/story/Egypt_to_delay_fuel_subsidy_rationing-TR20130212nL5N0BCCL82/.

short-term movement in this direction unlikely. Even if tax rates were raised, questions remain over the government's capacity to collect the resulting revenues. Analysts estimate that Egypt will require extensive technical assistance to improve tax collection and implement other reforms mandated by the IMF. But President Morsi has so far been reluctant to make use of technical expertise from outside of Muslim Brotherhood circles.

The lack of a clear economic vision

Putting the Egyptian economy on course for sustainable development requires political buy-in broad enough to inoculate the reform programme from the country's ongoing political turmoil. This is a difficult ask in a polity as divided as Egypt's, but it might be more achievable with greater transparency and public discussion of the government's plans. Morsi's administration has had a poor track record in this respect, while the opposition has also shown little inclination to engage. The public was poorly informed on proposed tax and subsidy reforms, while the government has failed to communicate a broader economic vision and the concomitant investment strategy to boost employment and GDP.

As a result of these points of contention, further negotiations will be required to bridge the gap between the IMF's reform expectations and the changes the Egyptians are willing to make. Although parliament is not required to approve the agreement, the IMF has repeatedly urged Egyptians to secure broad public acceptance of its terms – an unlikely prospect in the current political environment. Senior European diplomats are working with the IMF and have brought opposition members of parliament into the negotiations in order to hash out an economic plan that is supported by a broad consensus of public opinion. In January, IMF Managing Director Christine Lagarde said that the IMF needed a "commitment of the political authorities that can actually endorse the programme, own it, and propose it to the population as theirs".[16]

However, "owning" the programme is particularly politically dangerous in a pre-election moment. In fact, elements of the opposition, from Salafist Islamists to left and centre-left secular parties, are already campaigning directly against the loan (while pro-Western opposition figures such as former Foreign Minister Amr Moussa and former International Atomic Energy Agency Director-General Mohammed el-Baradei, who now heads the new Constitution Party, have called for a national consensus in support of it). For example, the Nasserite socialist Hamdeen Sabahi, who speaks for a segment of the Egyptian public that is deeply suspicious of free markets, has insisted that the loan would be unnecessary if the country weaned itself from Western economic orthodoxy and imposed steep annual taxes on the rich, including a one-time 20 percent tax on the wealth of anyone owning more than about $17 million. He also advocates expanding Egypt's public sector to create more jobs for the poor.[17]

Thus, while the Morsi government may be desperate to secure the IMF loan and is committed to making far-reaching market-oriented reforms, adopting the IMF's terms and the consequent economic pain for millions of Egyptians presents a substantial political risk that the government has been unsurprisingly reluctant to take at a time when its legitimacy is being challenged on the streets by its opponents, election results notwithstanding. Indeed, it was the febrile political atmosphere surrounding last December's constitutional referendum that prompted President Morsi to postpone signing the IMF loan agreement and delay or renege on tax reforms and cuts to energy subsidies and other public spending programmes previously agreed on in negotiations with the IMF.

Although a number of Western and international donors remain insistent that Cairo adopt the IMF package before releasing their own funds earmarked for Egypt, some fear the consequences of waiting until the government finds the political strength to risk implementing an austerity programme. During a visit to Cairo in early March, US Secretary of State John Kerry said that Washington would release $190 million of a pledged $450 million in budget support to Egypt following an assurance by President Morsi that he plans to "complete the IMF process".[18] At the same time, Kerry urged Egypt's political class to put aside its differences and adopt the IMF's terms, exhorting political parties to "come together around the economic choices and to find some common ground."

What Europe should do

European officials have said that they stand ready to help Egypt's economic transition with technical assistance, soft loans, and aid. A range of European investors and donors have already pledged a total of $6.5 billion to Egypt, including $590 million for the period 2011-2013 already made available from the European Union, an additional $1.3 billion from the EU in macro-financial assistance, concessional loans, and grants, potential lending of up to $2.2 billion for 2012 and 2013 from the European Investment Bank, and up to $1.3 billion a year for the next two years from the European Bank for Reconstruction and Development.[19] But aside from about $900 million of this, most is conditional on the IMF loan being signed. Meanwhile, easy money from Saudi Arabia and especially Qatar artificially cushions the Egyptian government and enables it to delay the implementation of comprehensive economic reform. Thus, waiting for adoption of the IMF terms before disbursing funds effectively leaves Europe on

16 Joe Bavier, "Egypt must convince people of need for IMF - Lagarde", Reuters, 8 January 2013, available at http://www.reuters.com/article/2013/01/08/us-egypt-economy-imf-idUSBRE9070FD20130108.

17 David Kirkpatrick, "First Fighting Islamists, Now The Free Market", New York Times, 25 December 2012, available at http://www.nytimes.com/2012/12/26/world/middleeast/egypts-hamdeen-sabahy-vs-islamists-and-free-markets.html?_r=0.

18 "U.S. to give Egypt budget aid after assurance on IMF: Kerry", Reuters, 3 March 2013, available at http://www.reuters.com/article/2013/03/03/us-egypt-usa-kerry-idUSBRE9220AK20130303.

19 "EU-Egypt Task Force Fact Sheet", European Union, 14 November 2012, available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/EN/foraff/133513.pdf.

the sidelines when it could be playing a more immediate and constructive role in Egypt. Nor would a collapse of the Egyptian economy or further political instability be in the European interest.

Europe's proportional over-representation in the IMF's decision-making structures could allow it to play a positive role in achieving a reform agreement between the IMF and the Egyptian government, particularly since European officials are aware of the danger of over-burdening Egypt's fragile polity with additional reform demands. But it could also make a more direct impact on the overall political, economic, and social situation in Egypt by taking a staggered approach to aid that would alleviate pressure on balancing the budget once the IMF loan deal is signed. In this way, Europe would be able to complement and support the broader reform project while helping to prevent the economy from sliding into a zone from which accessing outside assistance would require even tougher and more politically risky conditionality. It should immediately release part of its funding package, which had initially been directed at supporting immediate infrastructure improvement and youth employment schemes.

The EU should reassess its mechanism of conditionality, which is based on the principle of "more for more" and "less for less" that has guided European support of the transitions in North Africa.[20] Disbursements could be predicated only on the stated condition that Egypt maintains its democratic goals. Thus the EU should withhold aid only if Egypt's government breaks fundamental democratic principles by, for example, preventing free and fair elections. In light of the current economic and political climate, the European Parliament's resolution that would withhold funds if Egypt's government fails to carry out significant steps to abide by human and democratic rights and the rule of law should define "significant" to ensure that funds are only held back if red lines are breached.[21]

Europe's priority in Egypt should be investing in young people, both by targeting partnerships with large companies and by promoting investment in the job-creation engine of Egypt's manufacturing sector. It is a tragedy that the private sector struggles to find qualified employees even though more young Egyptians than ever are looking for work.[22] Graduate jobs at large transnational companies typically require applicants to apply business and management skills lacking in graduates of Egypt's tertiary education system. The long-term solution to this problem lies in overhauling and reforming Egypt's education sector, but European donors could have an immediate positive impact by finding and supporting private-sector partners on the ground that are able to plug the short-term gap in on-the-job vocational training and business skills among young Egyptians.

According to a senior EU diplomat in Cairo, the EU will sign two programmes under the ongoing national European Neighbourhood Policy that "respond directly to this problem".[23] An emergency $90 million employment grant, to be signed in the next month, will create 90,000 jobs in basic infrastructural works while an additional $64 million for a technical and vocational skills programme, to be signed later this year, will benefit many thousands of young job seekers in the construction, industry, and especially the tourism sectors. The funding for these initiatives will be provided "quite apart from the IMF package and budget support, which is a mix of grants and loans and linked to systemic reforms". The World Bank has also disbursed $200 million to fund Egypt's small and medium enterprises though the Social Development Fund, with a special focus on rural Egypt.

This promising development exemplifies the awareness that Europe can and should move quickly to support Egypt's economy even before the IMF package is agreed, through aid and on-the-ground assistance. It should serve as a model for EU member states to develop their own programmes of targeted assistance, delinked from the conditionality of the larger IMF and other assistance, to help build Egypt's capacity in education, energy, tourism, and infrastructure. Europe should also aim to support Egypt's floundering manufacturing sector. A recent Egyptian report estimated that over 4,500 factories have shut down since the revolution at a cost to the economy of thousands of jobs, while many that remain open are plagued by power cuts, strikes, poor security, and difficulty in securing loans in credit markets as a result of their government's shaky credit.[24] A little cash and a lot of technical expertise could have a significant positive impact on reversing this trend.

Egypt's political situation prevents the Morsi government from embracing a comprehensive reform programme as demanded by the IMF at this point in time. Essential measures such as overhauling subsidies and raising the sales tax are a difficult sell to an already over-burdened population, many of whom have lost income and jobs over the past two years. The IMF loan effectively asks Egypt's political class, despite its profound schisms, to achieve consensus over a programme of economic reform that will bring short-term pain to millions of Egyptians. Advocates insist that the reform package offers the best prospect for sustainable development that raises living standards; many Egyptians, including major players in the political arena, believe it demands that ordinary Egyptians shoulder the burden of a set of changes that will bring them little benefit.

Conditioning European financial assistance to the Egyptian government on the adoption of an austerity programme will likely exacerbate political turmoil and place Egypt in a Catch-22 situation: lenders require political stability before releasing loans and aid; but political stability requires loans

20 See Anthony Dworkin, "The Struggle for Pluralism after the North African Revolutions", European Council on Foreign Relations, March 2013, available at http://ecfr.eu/page/-/ECFR74_PLURALISM_REPORT.pdf.
21 "No aid to Egypt without democracy, human rights: EU Parliament", Ahram Online, 15 March 2013, available at: http://english.ahram.org.eg/News/66924.aspx.
22 Moataz al-Alfi, "Jobs for the Young and Restless", McKinsey on Society, January 2013, available at http://voices.mckinseyonsociety.com/youth-unemployment-egypt-solutions/.
23 All quotations in this section are from a background interview in March 2013 with a senior EU diplomat in Cairo, conducted by the author.
24 Asma al-Sharif, "Factories struggle in Egypt as costs, risks rise", Reuters, 27 February 2013, available at http://www.reuters.com/article/2013/02/27/egypt-industry-idUSL6N0BKDRW20130227.

and aid to create jobs and inclusive growth. European lenders should therefore offer Egypt grants and loans targeted at increasing employment even before the IMF loan is signed. The IMF loan is geared toward fixing long-term structural flaws in Egypt's economy. But the nation's most pressing problem – stubbornly high youth unemployment – needs immediate solutions, which Europe is well placed to provide through soft loans and aid focused on job creation. Reforming and revitalising Egypt's economy is vital to the prospects for a successful democratic transition – a project in which Europe also has a stake.

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