Helpdesk Research Report: IFIs, economic reform and inclusive growth in Egypt

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Query: Why did post-2004 IFI-supported economic reform programmes in Egypt fail to deliver inclusive growth?

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1. Overview

In 2004 Egypt began to implement bold economic reforms, supported by its main donors and the International Finance Institutions (IFIs), including the World Bank Group (particularly the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC)), the African Development Bank, the European Investment Bank, the European Union (EU), bilateral agencies, the Gulf countries, Japan, the UN agencies, and United States Agency for International Development (USAID) (World Bank 2010). The reforms contributed to a rapid acceleration of growth, making it one of the Middle East and North Africa’s fastest-growing economies. In 2007/08 this growth peaked at 7.2%. Significant sectors of the economy saw expansion including energy, construction, and telecommunications. Between 2004 and 2007, 2.4 million jobs were created and unemployment dropped from 10.5% to 9%. Exports and imports also rose sharply, along with Suez Canal receipts, and tourism revenues. Government reforms led to a friendlier investment climate, yielding a strong private sector response, and the World Bank regularly ranked Egypt as a top reformer in its Doing Business report (World Bank 2010; Enders 2008; IMF 2007).
This economic growth, however, did not result in inclusive growth. In this context, inclusive growth is understood as broad-based growth across sectors, inclusive of a large part of the country’s workforce. It is also associated with participation and benefit-sharing; the distribution of both wealth and welfare; the availability and distribution of economic opportunities among the population; and lasting poverty reduction (World Bank 2009, IPC-IG 2011). In Egypt growth was uneven and unemployment remained high among particular groups, especially youth. In 2006, well over 80% of the unemployed were under the age of 29, and 82% of the unemployed had never worked before (UNDP, 2010; 2010b). Women also continued to be excluded from the benefits of economic development. Further, from 2000 to 2008 poverty (as measured by the poverty headcount ratio) increased from 16.7% to 22%. There were also disparities between different regions; for instance, in 2005, the poverty rate in Rural Upper Egypt was almost 40%, compared to 14.5% in Lower Egypt and only 5.7% in urban areas (UNDP 2010).

This paper considers the nature of Egypt’s economic reforms after 2004 and their limitations in terms of providing for inclusive growth. The reform programmes included (Enders 2008; Nasr 2008; IMF 2007):

- key **structural reforms**, including the modernisation of fiscal accounts in the areas of trade, taxes, and subsidies, to improve the climate for business creation and investment
- **macroeconomic policies**, including a strengthened monetary policy, underpinned by greater exchange rate flexibility
- **financial sector reform**, including reforming the banking sector, restructuring the insurance sector, deepening capital markets, developing a well-functioning mortgage market, and activating other non-bank financial institutions and services
- the **privatisation** of nationally-owned companies.

A number of reasons are put forward for the reform programmes’ failure to deliver inclusive growth:

- **Problems within the labour market, particularly persistent unemployment**: Growth was largely located in sectors with the least employment opportunities. Low wages, and a mismatch between the skills capacity and demand contributed to limited income distribution and high unemployment among certain segments of the population, including rural inhabitants, youth and college graduates.

- **Cronyism**: This was considered an endemic problem, whereby among other actions, the ruling National Democratic Party (NDP) protected monopolies through legislation and awarded contracts to personal contacts, ensuring that the profits of privatisation did not broadly benefit the people (Schenker, email communication).

- **Subsidies**: Although energy and food subsidies were important for low-wage earners, in addition to contributing to the public debt, subsidies encouraged inefficient industries that Egypt would otherwise not have had a comparative advantage in, and diverted funds from programmes that would have more effectively targeted vulnerable segments of the population (Schenker 2011).
- **Lack of democratic space:** Economic liberalisation was not accompanied by political liberalisation, and Egypt made little progress in areas such as the rule of law, quality of government services, human rights practices, and political participation (Dunne, email communication).

- **Insufficient attention to dynamic sectors:** While economic reform streamlined practices for large businesses, the informal sector, which employs an estimated 9.6 million people, continued to face operational constraints, including difficulties obtaining credit, tenure rights and licenses (de Soto 2011).

Before the change in regime in February 2011, President Mubarak’s government and its donors had begun to implement measures aimed at addressing these constraints. For instance, presidential elections were held for the first time in 2005. Economic reform support by donors began to incorporate social development assistance, particularly around employment creation. Some subsidies were also reduced. These proved, however, too little too late. Recommendations from programme evaluations, as well as research on the issue provide suggestions for assuring inclusive growth occurs alongside economic growth. These include:

- socio-economic development that improves poor people’s living conditions
- sustained job creation, particularly among the youth and the educated
- appropriate education and skills training for the Egyptian economy
- the removal of subsidies, in favour of targeted assistance programmes aimed at the poorest people
- the promotion of small and micro-business development
- support for democratic processes, good governance and political reform.

## 2. Economic reforms: nature, management and outcomes

**Reform summary**

The direction of economic policies in Egypt changed sharply in 2004 with the appointment of a pro-reform cabinet led by the Prime Minister Nazif (IMF 2005). The new economic team moved aggressively to reform key areas such as trade, taxes, and subsidies, and launched plans to restructure the financial system, privatise most state companies, modernise the fiscal accounts, and strengthen monetary policy (IMF 2005). The Egyptian government received the full support of its donors and the IFIs.

The Financial Sector Reform Programme was launched in September 2004. It rested on five pillars: reforming the banking sector, restructuring the insurance sector, deepening capital markets, developing a well-functioning mortgage market, and activating other non-bank financial institutions and services. The programme aimed at improving the soundness of the financial sector and promoting an enabling environment for an efficient and competitive financial system that served Egypt’s development and growth objectives (Nasr 2008).

Structural reforms sought to create a better business climate. They included (Enders 2008):
A well-functioning foreign exchange market was established, which lifted formal and informal restrictions on access to foreign exchange that had hampered business in Egypt.

In two rounds of reductions, the weighted average import tariff was cut to about 6.9% by 2007, accelerating integration with the global economy.

Personal and corporate income tax rates were slashed, and tax administration modernised.

Business regulations were streamlined to speed up customs clearance and facilitate registration of new businesses and property.

A wide range of productive assets, including joint-venture banks and the fourth-largest state bank, were privatised.

Governance and financial soundness of state banks and banking supervision were strengthened in the context of broader, ongoing financial sector reforms. These reforms also modernised the insurance sector and capital markets.

The following sub-sections details specific economic reform collaborations between the Egyptian government and some of its donors/funders: the IBRD, the EU, the IMF and USAID.

**IBRD and IFC (World Bank Group)**
Beginning in 2004, IBRD’s support to the Egyptian government’s reforms centred on improving the business climate across a broad range of policy areas (trade, finance and taxation) and enhancing the provision of public services such as basic infrastructure and education (World Bank 2010). In 2007, the World Bank’s loan portfolio in Egypt totalled some US$1 billion (EC 2007).

IBRD provided support through an integrated package of knowledge and advisory services, technical assistance and financing, in support of government priorities in specific sectors. These included benchmarking exercises to inform and stimulate policy debates and influence reforms. Information sharing between other developing countries and development practitioners in Egypt helped the government define the ‘how to’ of implementation for key reforms. Particular efforts were made to deliver knowledge services in the social sectors where the government was reluctant to borrow, and IBRD supported the authorities through lending and knowledge advice in a wide number of sectors.

Through policy support, analytical work, technical assistance, advisory services, IBRD lending and IFC investment, the World Bank worked closely with government ministries and other development partners to support:

- **Country-wide Skills Development Projects**, which trained 22,000 workers in 800 Egyptian enterprises; funding of over US$3 billion between 2005-2010 for four investment projects in the energy sector, to expand power-generation capacity.

- **Public services and infrastructure development**, including boosting airport capacity to 14 million passengers per year from 9.5 million, since 2003 and fostering private sector involvement in airport management. IFC also supported a public-private partnership for the water and road sectors and helped preparations for the restructuring of the national railways.
• **Financial sector reform**, in particular increasing private ownership in the banking and insurance sectors, developing the mortgage market, and growing small and medium-size enterprise banking. The African Development Bank, European Union, International Monetary Fund, and USAID were also active in providing support in the financial sector, with a Financial Sector Donors Group, chaired by the World Bank, meeting monthly at the World Bank’s Cairo Office.

• **Trade reform**, providing assistance to strengthen value chains in selected sectors, and to develop a global trade finance programme; supporting local banks, and designing reforms for the business environment; and supporting the development of a framework for public-private partnerships.

The World Bank’s activities were not limited to economic support, however. It also supported environmental programmes for pollution abatement and provided substantial technical and analytical assistance (including fee-based services) in the areas of agriculture (rural development and irrigation); education (policy dialogue around curriculum); equity promotion (social protection and safety nets, including pensions reform); health (policy reform and financing private sector-managed health facilities). It also coordinated with other agencies, such as jointly funding an Early Childhood Education Enhancement Project with CIDA and WFP (World Bank 2010).

**European Union**

EU assistance to Egypt is articulated in its Egypt Country Strategy Papers. For the period after 2004, this encompasses the 2000-2006 strategy, and the 2007-2013 strategy. The 2000 strategy focused on three priority areas: a) promoting effective implementation of the Association Agreement (which forms the legal basis governing relations between Egypt and the EU), primarily by assisting Egyptian enterprises and institutions to meet the challenge of increasingly competitive internal and external markets; b) supporting the process of economic transition from an inefficient command economy to an efficient and liberalised free market economy able to support sustainable growth and create employment; and c) supporting stability and sustainable and balanced socio-economic development to match economic liberalisation with social and political reform, good governance, the rule of law, constructive involvement of civil society and protection of the environment (EC 2007: 15).

The European Investment Bank (EIB) provided financing in Egypt, mainly for energy, transport and environmental projects and for small and medium-sized enterprises. Under the 2000-2006 mandate, the EIB provided more than €1 862 million. EIB loans supported projects in the fields of energy (power generation, natural gas storage and processing, and bulk transmission), transport (civil aviation) and the environment (wastewater collection, treatment and drainage).

Other processes included the MEDA Programme, which supports the economic transition of Mediterranean non-member countries and the establishment of a Euro-Mediterranean free trade area by promoting economic and social reforms for the modernisation of enterprises and the development of the private sector. MEDA regional cooperation included activities on governance and public administration reform, the environment, justice and home affairs; political and economic research; South-South economic cooperation, statistics, transport; and energy;
maritime safety; modernisation of higher education; information society; and the protection of cultural heritage and co-operation in the field of youth. Support was also provided under thematic budget lines such as the European Initiative for Democracy and Human Rights (EIDHR: €5 million), and NGO budget lines (€5.4 million) (EC 2007).

While all three of the 2000 strategy’s priority areas focused on economic transition, the 2007 strategy indicated a shift, allocated €558 million to support a) political reform and good governance; b) competitiveness and productivity of the economy; and c) socio-economic sustainability of the development process. It recognised that while substantial progress had been made in economic reform since 2004, social reform had lagged behind (EC 2007).

From 2007, the implementation of the European Neighbourhood Policy (ENP) reinforced co-operation spanning a wider spectrum of the fields of co-operation (EuropeAid). It worked towards the development of political institutions based on the values enshrined in the 2001 Association Agreement, including democracy, the rule of law and human rights; regional stability; cooperation on justice and home affairs; and economic and social reforms that would create new opportunities for development and modernisation, for further liberalisation of trade, and for gradual participation in the internal market (EC 2007).

**IMF**
The IMF’s priority areas in Egypt were monetary policy, fiscal reform and privatisation. In January 2005, Egypt subscribed to the IMF’s Special Data Dissemination Standard (SDDS) and accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF’s Articles of Agreement (IMF 2005). These set out legal obligations which effectively promote the free convertibility of members’ currencies for payments and transfers for current international transactions. This includes prohibitions from imposing exchange restrictions (restrictions on the making of payments and transfers for current international Transaction) and engaging in discriminatory currency arrangements.

With help from the IMF, Egypt’s budgets were presented in line with international standards. Between July 2004 and March 2005 seventeen non-financial companies were privatised. This helped the Government to make substantial progress on its comprehensive five-year plan for restructuring the financial sector, including the sale of its stakes in joint venture banks, consolidation of the sector through mergers, privatisation of one of the four large state banks and progress with the reform of the non-bank financial sector, which helped exchange rate stability and improved the investment environment. All this contributed to inward foreign direct investment reaching €3.3 billion in the 2004/2005 fiscal year (EC 2007).

**USA (USAID)**
While not an IFI, the USA is Egypt’s largest single donor (EC 2007). In addition to military assistance (the majority of its support) and support for economic growth, USAID priorities include education, environmental protection and infrastructure. USAID also manages programmes on health, democracy and good governance. The USAID mid-term review for fiscal years 2000-2009 called for significantly increased efforts on education as well as on democracy and governance, slightly higher funding for health and population issues and slightly lower funding for economic
growth, while increasing the focus of the economic growth programme (trade enhancement, customs and financial sector reform) (EC 2007).

Outcomes
Egypt’s attempts at economic reform were largely successful: Egypt posted a real gross domestic product (GDP) growth of 7.1% in 2007 and 7.2% in 2008. In the face of the global financial crisis, it still managed a 4.7% rate of GDP growth in 2009. The reforms introduced made the Egyptian economy attractive for foreign direct assistance (FDI), which increased from $2.2 billion in 2004 to $11.6 billion in 2007 (Schenker 2011). The share of private investment increased to 15% from 8%. Import tariffs were reduced to a weighted average of 6.9%, putting Egypt at the lower end of the international trade tariff scale. The tax system was rationalised, and there was an improvement in tax administration that saw the number of taxpayers rise to 2.5 million in 2006 from 1.7 million in 2004 (World Bank 2010).

However, Marotta et al (2011) estimate that that 55% of Egyptians experienced poverty or near-poverty between 2005 and 2008. Further, according to an authoritative 2009 report published by the Board of Trustees of the General Authority for Investment and Free Zones in Egypt, the benefits of economic expansion failed to trickle down to the poor, creating a growing gap between the very rich and everyone else (referenced in Schenker 2011). Despite improvements in living conditions, wealth did not lead to equity: the richest 10% of the population account for 27.6% of the income of the country, while the poorest 20% survive on 8.9% of the national income.\footnote{World Bank, World Development Indicators database, http://data.worldbank.org/country/egypt-arab-republic} Indeed, it is estimated that 18.9% of the population was living on less than $1 per day in 2008 (World Bank, 2008, cited in Alquézar, Panzica and Popova 2009).

3. Factors accounting for the lack of inclusive growth

Several factors have been identified as contributing to the lack of inclusive growth. These include:

**Problems within the labour market, particularly persistent unemployment**

According to the 2009 Board of Trustees of the General Authority for Investment and Free Zones in Egypt report (cited in Schenker 2011) sources of growth were located primarily in sectors with the least employment. Egypt’s largest employment sector – agriculture – experienced little if any growth in recent years.

35% of the labour force works in the informal sector, which has the lowest salaries. Further, 44% of the labour force is illiterate or semi-illiterate, and those with high school educations – 28% of workers – have the highest rate of unemployment in the country, at 33%, compared to 10% across Egypt.

College graduates and youth have among the highest rates of unemployment. Many researchers have pointed to the problem of a lack of synergy between education and economic
opportunity in Egypt, critiquing the quality and relevance of education (see for instance, GSDRC 2007). This is due mostly to the lack of practical training in skills needed by employers. Universities have some way to go to adapt their curricula to the needs of the labour market, in terms of both the nature of the training provided and of the level of skills required (EC 2007). Also, the private sector has not been able to compensate for the slowdown in public-sector hiring of graduates and is unable to absorb the explosive growth of new technical secondary graduates forecast for the years ahead who will be seeking work in industry and agriculture.

Egypt has also struggled to create jobs to gainfully employ its labour force, and conservative reports suggest that underemployment affects some 7.5% of the working population, depressing wages and slowing the economy, proving to be a major source of discontent, particularly among the educated. The formal sector is also hindered by high non-wage labour costs and expensive firing rules (IMF 2007). Women are also 2.5 to 4 times as likely to be unemployed as men (EC 2007; UNDP 2010).

Finally, distribution of income is limited: 40% of the lowest wage earners earn just 15% of the salaries. Geographically, more than 75% of the poor are concentrated in Upper Egypt and the Nile Delta, both relatively low-growth areas. Generally, jobs that are available in Egypt do not pay very much, and the minimum wage in Egypt has stagnated since 1984, perceived as particularly problematic in the face of increasing public sector salaries. Given rising commodity prices, the relative buying power for all Egyptians has declined considerably, effectively lowering the standard of living for a wide segment of the population.

Cronyism
Dunne and Revkin (2011) state, ‘unfortunately the NDP’s brand of economic reform also included a generous dose of cronyism and corruption, including allocation of state lands for private development, concessionary loans for the ruling elite, and sweetheart deals on privatized state industries for regime figures... Meanwhile, ordinary Egyptian citizens were facing high unemployment and rising prices on basic commodities, and were becoming increasingly aware of a painful disparity in the distribution of the material benefits of economic reform’.

According to Arvind Subramanian, a former IMF resident representative in Cairo, Egypt’s biggest economic challenge is its reliance on rents, which he defines as wealth derived from historical and geographical legacies rather than job-generating economic growth. Included among these are the Suez Canal, which generates some $5 billion a year in fees; aid received in exchange for peace with Israel; the pyramids and other antiquities that draw tourists, and even remittances, which are the result not of Egyptian success but of failure that forces its citizens to seek work abroad. He argues that this political economy needs to be broken in order for a sustainable economic development to take place, and replaced with a flourishing private sector and a vibrant entrepreneurial class (MacDonald 2011).

Subsidies
Egypt’s significant subsidies, particularly of the food and energy sectors, contributed to high public debt, which is 74% of GDP (Dadush and Dunne 2011). According to Schenker (email communication), ‘Economic reform programmes never truly made headway into subsidy reform, which are a significant drag on the economy. Aside from some pilot programs with direct cash
subsidies, very little was done. Subsidies account for 10% of the budget, but they are regressive in nature, particularly the fuel subsidy. Roughly 80% of the 56 billion Egyptian pounds (LE) in subsidies – or $9.7 billion – offsets the cost of energy (i.e., fuel and electricity). As a result, fuel costs in Egypt are lower than those in Saudi Arabia. While impoverished Egyptians depend on low energy costs to heat and cool their homes and fuel their automobiles, the subsidies also have a negative impact on the economy above and beyond adding to the deficit.

Government food subsidies amounting to $3 billion a year, or nearly 5% of the budget, are no less problematic. Egyptians – nearly 40% of whom live on less than $2 per day – have come to depend on government food assistance, especially for wheat products. Egypt has long been unable to meet its demand for wheat domestically, and today the commodity accounts for 5% of the country’s total imports. Indeed, Egypt is the world’s top wheat importer, bringing in about 7 million tons per year (Schenker 2011).

While subsidies appear beneficial to poorer segments of Egyptian society, they divert funds from targeted transfers and social protection programmes, which would benefit those who are most in need of such programmes.

**Lack of democratic space**

While many of the macroeconomic reforms have some positive effects, the economic benefits of such policies often take years, even decades to trickle down. Dunne (email communication) asserts that this may have been given the chance to happen, had the Mubarak government been wise enough to carry out improvements, however gradual, in other areas such as the rule of law, quality of government services, human rights practices, and political participation. However, they did not, and the population ran out of patience. The rigged parliamentary elections of 2010, the ‘emergency’ repressive measures that lasted for decades, and the absence of freedom to speak and assemble robbed Egyptians of their sense of dignity (Dunne et al 2011).

Schenker (2011) asserts that dissatisfaction with authoritarian government – and especially with Hosni Mubarak – rather than economic grievances, served as the chief mobilising factor in Egypt’s January demonstrations (although he also states that the economy provided a basis around which to animate popular discontent).

**Prohibitive legal institutions**

According to some estimates, Egypt’s underground economy is the nation's biggest employer. While economic reform simplified rules for large and medium enterprises, small and micro-enterprises continued to operate in difficult environments. De Soto (2011), citing research conducted by the Institute for Liberty and Democracy in 2004, states that the legal private sector employed 6.8 million people and the public sector employed 5.9 million, while 9.6 million people worked in the extralegal sector. While this sector has the potential to boost employment, its entrepreneurs are constrained as they lack access to the business organisational forms that would enable them to grow the way legal enterprises do. This makes it difficult for them to obtain credit to grow, enter into contracts and benefit from economies of scale. The procedures for legalising such businesses are extremely complex, making it difficult to obtain legal title to assets and real estate. Laws are burdensome and discriminatory. For instance, the research found that to open a small bakery would take more than 500 days, and that to get legal title to a vacant
piece of land would take more than 10 years of dealing with red tape. To do business in Egypt, an aspiring poor entrepreneur would have to deal with 56 government agencies and repetitive government inspections (de Soto, 2011).

4. Lessons and Recommendations

The descriptions of IFI engagement in section 2 above indicates that in mid-term reviews of their assistance programmes since 2004, Egypt's donors had begun to realise that their focus on economic reform needed to be supplemented with support to social sectors and democratic reform. Their recommendations also reflect the shortcomings of the programme highlighted in section 3 and have become of immediate importance in the wake of the Arab Spring.

In 2005, a World Bank report suggested that that the long-run potential payoff from shifting resources out of subsidies and into a substantially strengthened and expanded assistance programme could be significant for poor people. Social safety nets could instead be strengthened, including through the expansion of the cash-assistance programme, greater use of geographic targeting, and the introduction of a workfare programme that provide temporary jobs for the able-bodied poor (World Bank 2005).

The World Bank (2010) also recognised that ‘while social indicators have improved dramatically over the last decade, poverty remains high at about 20% of the population’, and emphasised the need to expand the economic reform programme to include programmes that aimed at translating the recent strong macroeconomic performance into improved living conditions for those below and around the poverty line. The EU 2007 Strategy Paper also indicated a shift in priority areas away from enterprise development and capital markets towards political reform, good governance, and socio-economic development.

These concerns were also reflected in the Egyptian Government’s policy strategy documents, particularly in the context of increasing labour supply and improving labour supply through better education. A key aspect of this was a national technical and vocational education and training policy (EC 2007).

The IMF acknowledged in 2008 that with Egypt's labour force growing rapidly, sustained growth that produced jobs would be essential. This would require sustained higher investment. Among its recommendations were structural reforms that would continue to tackle constraints on small business development, such as inadequate infrastructure, red tape, poor public service delivery, and the scarcity of skilled labour. Further, access to finance, particularly for smaller firms was essential. Complementary regulatory and judicial reforms – such as setting up specialised economic courts and enhancing the role of the private sector-led credit bureau – would also help improve contract enforcement and creditor protection. These were all considered steps that would facilitate bank lending to smaller enterprises.

Regional experts also emphasise improving trade association agreements currently in place between Egypt and the European Union, and negotiating a free trade agreement with the USA,
as they assert that ‘none of the current arrangements are sufficient to incentivize the economic policies needed to support sound growth and political transitions’ (Dadush and Dunne 2011: 138).

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6. Further information

Experts consulted
Michele Dunne, Hariri Center at the Atlantic Council
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