Egypt: Poised for Sustained Growth?

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In early 1996, Egypt embarked on the second phase of an intensified adjustment and reform effort aimed at placing the economy on a higher growth path to raise living standards and accelerate Egypt’s integration into the world economy. This effort has begun to pay off in the form of higher investment and growth, and sizable international capital inflows. How did the economic turnaround begin and what does the future hold for Egypt?

The first phase

By the late 1980s, Egypt was beset by chronic macroeconomic problems. Inflation exceeded 20 percent; the current account was in deficit to the tune of 8 percent of GDP; large external arrears had accumulated; and confidence in the economy, reflected in rising dollar holdings, had ebbed (Charts 1 and 2). Underlying these imbalances were chronically large fiscal deficits (averaging more than 15 percent of GDP) and a loose monetary policy.

In 1990–91, the government initiated a bold stabilization effort, supported by an IMF Stand-By Arrangement, that focused on slashing the fiscal deficit to 2 percent of GDP in two years. Coupled with prudent monetary and exchange rate policies and debt relief, this effort dramatically improved Egypt’s economic situation. The stabilization program was complemented by measures to liberalize interest rates and exchange markets and to decontrol prices, as well as by the introduction of a general sales tax. Confidence in the economy improved as inflation declined to 7 percent in 1996; the current account moved into surplus; and international reserves burgeoned from $3 billion at the end of 1990 to $17 billion by the end of 1996.

The growth challenge

Notwithstanding these successes, Egypt still faced challenges stemming from the lackluster performance of the real economy. Although growth picked up as stabilization took hold, it was not strong enough to generate substantial gains in per capita income or to make a dent in rising unemployment. And investment, at 17 percent of GDP in 1995, was below the average for developing countries (26 percent of GDP) and for the fast-growing Asian countries (31 percent of GDP) (Chart 3). This state of affairs was inevitable in an economy that had acquired all the trappings of statism: a dominant and inefficient public sector cosseted by high trade barriers that encouraged inefficient import substitution at the expense of exportable production, price controls, and multiple exchange rates.

To meet these challenges, the structural reform effort was deepened in 1996, supported by a two-year IMF Stand-By Arrangement. The goal is to move the economy onto a high growth path, create about half a million jobs annually, and more closely integrate the economy into world markets. The new program targets a medium-term growth rate of about 7 percent, which is predicated on a sharp rise in

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investment and domestic saving. Realizing faster growth will depend on making the economy more efficient through privatization of the nonfinancial public sector, trade liberalization, reform of the financial sector, fiscal reform, and deregulation.

Structural reforms

Privatization has figured prominently in the structural reform effort. The government divested its majority stake in 42 enterprises and a large hotel, as well as a minority stake in 11 other enterprises, which together account for about 25 percent of the industrial public sector, or 6 percent of GDP. In the area of trade liberalization, all quantitative import restrictions (except those scheduled for dismantling under the Uruguay Round) were eliminated, and the maximum tariff was reduced from 70 percent to 50 percent, with comparable reductions in tariffs above 30 percent. As for deregulation, the government decontrolled rents; liberalized investment procedures; and passed a new investment law reaffirming basic guarantees for investors and unifying and rationalizing the framework for investment incentives. The principle of greater private sector participation in infrastructure—including power, telecommunications, roads, and airports—was established.

The private sector’s role in finance is being enhanced by the divestiture of the government’s majority stake in all but three joint venture banks and all joint venture insurance companies. Preparations are under way for the privatization of a commercial bank and an insurance company. Privatization is being complemented by strengthened bank supervision; and banks are being required to comply with international standards for reporting, accounting, and disclosure.

As for fiscal reform, the government is extending the general sales tax to wholesale and retail transactions. Important steps toward rationalizing the corporate income tax, including the reduction of exemptions, are being considered. On the expenditure side, the civil service has been reduced by 2 percent, despite expanded employment in health and education.

Early results

There are indications of an early investor response to the reforms, a pickup in economic activity, and a surge in international confidence in Egypt. Investment approvals for both foreign and domestic investors have jumped (Chart 4). If these approvals get translated into actual expenditures, Egypt will have begun to lay the foundation for higher growth. Activity has rebounded—real GDP is estimated to have risen by 5 percent in 1996, owing to rapid growth in industry, tourism, and services, and savings are expected to rise by almost 2 percentage points, to 19 percent of GDP, in 1997.

Following the acceleration of structural reforms, the agreement with the IMF, and the investment-grade rating accorded by Standard and Poor’s rating agency, international perceptions of the risk-adjusted return on Egyptian assets have improved considerably. A surge in private portfolio inflows of about $1.5 billion (from negligible levels the previous year) is expected in 1997. Partly reflecting this foreign demand, the share price index of the Egyptian stock market doubled between June 1996 and February 1997.

The challenges ahead

Although Egypt’s financial turnaround since 1990 has been impressive, the challenges ahead remain formidable. A key one will be to implement the reforms steadfastly and to intensify them as needed. To take one example, following the successful privatization of profitable enterprises, the restructuring or liquidation of unprofitable firms, which still account for the bulk of the public enterprise sector, will need to be addressed. Tariffs remain high and bureaucratic obstacles continue to hobble trade and investment. Furthermore, given the sharp decline in Egypt’s openness over the last decade, improvements in economy-wide competitiveness will be imperative if export-oriented growth is to be realized.

Steps will need to be taken to ensure that the fruits of growth are widely shared. This will require a major effort in social policy, in particular in health and education, and in providing safety nets for the most vulnerable groups. The transitional costs of reform should be properly managed.

Finally, Egypt will have to manage the “risks of success” that stem from a surge in capital inflows. As the experience of other developing countries has shown, these flows can pose difficult challenges for macroeconomic policy and for domestic financial institutions.

Egypt has embarked on a home-grown reform program aimed at achieving sustained growth and expanding employment. The government’s commitment to reform, growing popular support for it, the program’s endorsement by the international financial community and the resulting discipline, as well as the reforms’ early successes, presage steady implementation.

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