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Research Report

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Built on Sand: Egypt's Questionable Strategy for Growth and Development

Stephan Roll and Matthias Sailer

The Egypt Economic Development Conference staged at the Red Sea resort of Sharm el-Sheikh from 13 to 15 March will showcase the country's investment potential. Cairo hopes to prove it has started a turnaround after four years of political and economic turmoil. In fact a recovery is not even on the horizon. Foreign capital will be crucial for the mega-projects the Sisi administration is relying upon to stimulate growth. But the flow of direct investment is as uncertain as the development approach itself is questionable. With economic stagnation and an ensuing deterioration of living conditions foreseeable, protests are liable to flare up again. Germany and the European Union should prepare for further destabilisation in the Arab world's most populous nation.

Cairo hopes that the Egypt Economic Development Conference will produce a massive influx of foreign capital. In recent months the regime has issued a steady stream of positive economic news, asserting that accelerating growth, falling unemployment and rising foreign direct investment demonstrate the efficacy of its economic course. The leadership around President Abdel Fatah al-Sisi received backing from the International Monetary Fund, whose February 2015 Staff Report notes a series of concerns but concludes that the regime's economic reforms are initiating a turnaround.

How Bad Have Things Got?

These positive claims obscure the true extent of Egypt's economic crisis, and above all the

consequences for its population of 87 million. In fact economic growth more or less stopped during the political upheaval of 2011 and has barely recovered since. Between 2011 and 2013 annual GDP growth struggled to keep pace with population growth. For the current fiscal year ending in June, Cairo has announced GDP will rise by more than 4 percent – but that puts per capita growth at about 2 percent and as such only slightly higher than the figures for highly developed industrial economies. This is nowhere near enough to absorb the annual influx of up to 800,000 young people entering the Egyptian labour market. That, it is estimated, would require annual growth of at least 6 or 7 percent. And even higher long-term growth rates would be required to bring down the high rate of un-

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employment, which is currently estimated at almost 40 percent among young people (aged 15–24).

Unemployment, low-quality jobs and ongoing inflation in combination have led to a dramatic increase in poverty. In the 2012–13 fiscal year the national poverty rate (in relation to a poverty line of slightly less than €40/month) exceeded 26 percent, having increased by almost five percentage points within only four years. Here again, young Egyptians are affected particularly badly: in 2013–14 the official statistical agency put the proportion of young people living below or only just above the poverty line at almost 52 percent. These figures are all the more alarming if one considers the state's lack of resources to increase social spending.

With the economic crisis comes a budget squeeze whose end – contrary to government predictions. – is nowhere in sight. State debt has risen by more than 11 percent since 2011 to hit an estimated 94 percent of GDP (2014). And the budget deficit has stayed in double figures, peaking at an estimated 13.7 percent in the 2012–13 budget year. A further rise has only been averted by at least \$23 billion worth of aid, loans and oil shipments from Saudi Arabia, Kuwait and the United Arab Emirates. Without that assistance from the Gulf, Egypt would already have gone bankrupt. Cairo has announced its intention to reduce its budget deficit to 10 percent in the present budget year by means of tax increases and massive cuts in energy subsidies. But while subsidies on fuel and electricity were indeed scaled back in summer 2014 – leading to price increases of up to 70 percent – the move made conspicuously little impact on the budget figures released in March. The opacity of the state budget makes it virtually impossible to forecast the medium- and long-term effect of such measures. The IMF expects further cuts in subsidies to follow, but given the foreseeable unpopularity of such a move it is by no means certain.

State Mega-Projects on Empty Coffers

Despite his empty treasury, Sisi is relying on gigantic development projects to revive the economy. Alongside one million homes, multiple energy ventures (including Egypt's first nuclear reactor), and several large-scale regional development projects (such as building a new seat of government near Cairo), the Suez Canal expansion is the centrepiece of state planning. The construction of the New Suez Canal permitting vessels to pass in both directions simultaneously is scheduled for completion by August 2015. While the Sisi regime celebrates the project as a blow for the national cause, question marks over its cost-benefit calculations recur in similar form in other mega-projects still in the planning phase. The government's forecast of traffic doubling and revenues rising by about 150 percent by 2023 is not credible. For the number of vessels passing through depends on numerous other factors apart from the capacity of the channel, not least global economic trends. It is also questionable whether construction of the second channel will actually generate sustainable trickle-down effects. The project is extremely labour-intensive – but only during the construction phase. And even there the employment effects are unclear, because the military will contribute its own personnel in the construction process. But the central problem is the immense cost of construction, probably far exceeding \$8 billion. Rather than tapping external funding such as loans from international donor organisations, which would probably have offered much more favourable conditions but demanded considerably greater transparency, the government is relying on purely domestic financing. Repayment of principal and interest on the investment certificates, which supposedly preserve the national character of the venture, will burden the state budget with liabilities of up to \$13 billion over the coming five years. Issuance of the certificates is also likely to exacerbate the credit squeeze in the Egyptian banking sector, because a not

inconsiderable proportion (probably more than 40 percent) have been bought using existing deposits, thus withdrawing liquidity from the banks. Application of this funding model to other development projects is therefore highly unrealistic.

Direct Investment as Solution?

To fund further mega-projects the Sisi administration is therefore relying instead on foreign capital. At the investment conference in March it intends to invite foreign businesses to participate financially in about thirty major development projects. More broadly, the government also hopes to enhance the country's fundamentally attractiveness for foreign investors, principally through a new investment law designed to accelerate administrative procedures and strengthen legal certainty. But legislative reforms alone will not solve Egypt's structural economic problems, such as the very low quality of education, weak innovation capacity and labour market inefficiency. Moreover, the government does nothing to eliminate endemic corruption and state mismanagement. That would demand first and foremost a comprehensive and transparent pursuit of Mubarak-era corruption cases. In fact, many of these lawsuits have instead been dropped in recent months or ended in opaque settlements. Legal changes instituted in 2014 place enormous obstacles in the way of challenging contracts between state agencies and investors and will make it almost impossible for NGOs to fight state corruption.

Altogether the current efforts of the Sisi administration to attract foreign direct investment are strongly reminiscent of the latter years of the Mubarak era. Between 2004 and 2007 Egypt was able to increase the inflow of foreign capital almost tenfold through partial reform of the legal framework, tax incentives and the distribution of cheap building land. Net inward investment in 2007 was almost 9 percent of GDP (almost four times the 2013 figure), and in response economic growth rose to more

than 7 percent. The World Bank's *Doing Business Report* even praised Egypt as "top reformer in 2006/07". However, the investment boom had no positive effects on general living conditions. On the contrary, the national poverty rate jumped two percentage points between 2005 and 2008 alone.

Criticism of the new investment strategy is therefore also heard from Egyptian civil society circles. In a study published in February 2015, the Egyptian Centre for Economic and Social Rights states that treating the flow of direct investment as a goal in itself rather than as a means to combat poverty, unemployment and underdevelopment means that the country attracts only investments that pay quick returns but create little in the way of sustainable employment. Examples it names include the construction of shopping malls and housing for Egypt's elites by firms from the Gulf states, as well as direct investment in the Egyptian gas and oil sector. Such projects, it says, contribute little to industrialisation or to knowledge and technology transfer.

Besides that, these legislative amendments are of only secondary importance for the decisions of longer-term investors, for whom the general state of the Egyptian judiciary is likely to carry greater weight. In recent months Egyptian courts have attracted attention primarily for overtly political mass death sentences with no pretence of observing due process, raising doubts about the legal wisdom of investing in Egypt. But most of all the current security situation is likely to influence investment decisions. Politically motivated violence has increased since the military took power, with almost daily attacks on security forces, energy and transport infrastructure, and increasingly also foreign companies, which are accused of supporting the regime.

Conclusion: No Stabilisation in Sight

At best the upcoming investment conference might generate short-term growth stimuli. But it will not initiate any sustain-

able economic transformation. The Sisi administration's growth strategy leaves too many structural problems untouched, including rampant corruption, nepotism and legal uncertainty. Any trickle-down effects will be small, and dissatisfaction will grow in large parts of the population. To preserve its power the regime will have to step up repression, with further negative repercussions on economic development. The probability of a progressive destabilisation of the most populous state on the Mediterranean is thus high.

Germany and the European Union should therefore refrain from supporting the development strategy of the Sisi administration until it undertakes recognisable steps to improve governance. The precondition for this is an end to the current comprehensive political clampdown on the actors that could promote good governance – the critical press, civil society and the political opposition. Furthermore, excessive persecution of the Muslim Brotherhood in particular accelerates the radicalisation of hitherto moderate actors, as already reflected in rising politically motivated violence, with dramatic economic consequences too. A reintegration of the Brotherhood into the political process would therefore appear imperative for Egypt's stabilisation and economic development. On that point, Germany and the European Union should also explore the position of the new Saudi leadership. Recent weeks have seen repeated signs of a cautious shift in the Kingdom's otherwise hostile position towards the Brotherhood. As one of Egypt's largest benefactors, Riyadh would be in a position to persuade Cairo to adapt its strategy.

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