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Electronic version

URL: <https://journals.openedition.org/ema/3727>

DOI: 10.4000/ema.3727

ISSN: 2090-7273

Publisher

CEDEJ - Centre d'études et de documentation économiques juridiques et sociales

Printed version

Date of publication: 15 October 2017

Number of pages: 99-124

ISBN: 2-905838-95-7

ISSN: 1110-5097

Electronic reference

Chahir Zaki, "An overview of Structural Imbalances in Egypt", *Égypte/Monde arabe* [Online], 16 | 2017, Online since 15 October 2019, connection on 07 July 2022. URL: <http://journals.openedition.org/ema/3727> ; DOI: <https://doi.org/10.4000/ema.3727>

AN OVERVIEW OF STRUCTURAL IMBALANCES IN EGYPT

ABSTRACT

The Egyptian economy has been negatively affected by the political instability that the country has witnessed since 2011. Indeed, this instability showed the extent to which the Egyptian economy suffers from several structural imbalances that first amplified the negative effects of the revolution and then delayed its recovery. This paper analyzes both internal and external structural imbalances that characterize the Egyptian economy and presents a roadmap for future reforms. Egypt is suffering from three primary levels of internal imbalance: the sectoral level (a declining industrial sector with a low level of competitiveness), the fiscal level (between revenues and spending, current vs. productive spending), and the monetary level (non-transparent monetary policy). Externally, two structural imbalances can be identified, namely a high level of imported intermediate inputs leading to a chronic trade deficit and FDI concentrated in low-value-added. It is argued that the main reasons for such imbalances are inefficient political and economic institutions.

INTRODUCTION

In early 1990, Egypt implemented an economic reform and structural adjustment program with the World Bank and International Monetary Fund. This program tried to rectify macroeconomic imbalances by enhancing the role of the market and privatizing state-owned firms. Starting in 2004, the Egyptian government launched a second wave of reforms on various fronts. These reforms tackled several aspects of the economy, including promoting investment by improving the business environment and enhancing trade performance through

trade liberalization and reducing red tape. This resulted in high levels of GDP growth between 2005 and 2008 (reaching 7.2% in FY2007/08¹).

However, the Egyptian economy was subject to two shocks that had negative implications for the economy. First, the financial crisis caused growth to fall to 4.7% in FY2008/09. Second, the popular uprising in January 2011 caused real GDP growth to fall from 5.1% in FY10 to 1.8% in FY11. It is worth noting that the quarter during which real GDP growth fell the furthest was during the revolution (January/March 2011), when it dropped to -4.3%. Growth rates remained constant in 2013 and 2014 at 2.2%. Thanks to more public investment, growth doubled to reach 4.2% in 2015. Nonetheless, GDP growth continued to be slowed by ongoing weaknesses in the manufacturing and tourism sectors. Hence, the underlying cause of the current crisis lies in real economic imbalances, exacerbated by the recent development to which they gave rise (or hid, for a time). Such internal and external shocks showed to what extent the Egyptian economy suffers from several structural imbalances that first amplified the negative effects of the revolution and then delayed its recovery.

Those imbalances are observable at the external and internal levels. Internally, fiscal imbalances are related to the structure of spending and revenues and the disequilibrium between them. Moreover, sectoral imbalance involves sectoral dislocation between different economic activities. Monetary imbalances show how monetary policies failed to maintain low inflation rates. Externally, structural imbalances are related to the structure of imports, the exchange policy and the sectoral allocation of foreign direct investment (FDI).

This paper makes three contributions. First, it analyzes both internal and external structural imbalances that characterize the Egyptian economy. Second, it attempts to show how such imbalances reduced the potential GDP of Egypt and consequently delayed its recovery. Finally, it argues that such imbalances are primarily caused by inefficient political and economic institutions and provides a roadmap for future reforms.

The paper is organized as follows. Section 2 presents internal imbalances, including monetary, fiscal and sectoral imbalances. Section 3 presents external ones, with a special focus on FDI, import structure and exchange rate policy. Section 4 attempts to explain these imbalances using a political economy approach. Section 5 offers a conclusion.

1. Fiscal Year (FY) in Egypt starts in July and ends in June.

INTERNAL IMBALANCES

Sectoral Imbalances

Disaggregating GDP by economic activity shows that the Egyptian economy heavily depends on services. Previously, services had comprised an increasing share of GDP, reaching 57% in 2010. However, this share fell slightly to 52% in FY14, due to the significant decline in tourism. Meanwhile, the share comprised by agriculture has fallen consistently, from 30% in FY72 to 14% in FY14 (Figure 1).

Figure 1. GDP by Economic Activity (by percentage of GDP)

Source: Ministry of Planning

Furthermore, the manufacturing sector share has remained relatively low, not exceeding 30%. Indeed, this sector has faced several problems that affected its competitiveness (especially institutional barriers as it is shown in Figure 2). Indeed, Figure 2 shows that Egypt (compared to other comparable economies, such as Tunisia, Morocco, Jordan, Lebanon, Brazil, Poland and Turkey) is suffering from a lack of rule of law, low protection of property rights, a lack of market competition and the relative absence of anti-monopoly practices and laws.

Figure 2. Institutional Barriers

Source: Source: Rule of Law, Market-based competition and Anti-monopoly policy indices come from Bertelsmann Transformation Index. A greater value of the index shows a better performance of the country (from 1 to 10). Property rights and Transparency of government policymaking come from the Global Competitiveness Index. A greater value of the index shows a better performance of the country (from 1 to 10).

Moreover, the innovative capacity in Egypt is relatively low, which in turn affects its competitiveness (Figure 3) and increases its specialization in traditional exports. Indeed, Figure 4 shows that Egypt has a low share of medium- and high-tech activities in its industrial sector.

Figure 3. Capacity for Innovation

Source: Competitive Industrial Performance

Figure 4. Share of medium- and high-tech activities

Source: *Competitive Industrial Performance*

A number of other problems affect the industrial sector in southern-Mediterranean countries (Altunberg, 2011). First, there are strong rent-seeking activities, which are not constrained by effective checks and balances. This leads to the misallocation of funds, political capture and the creation of perverse incentives for investors and bureaucrats. Second, few countries have policy think tanks that are likely to review policy experiments and inform policymaking. This suggests that a number of industrial strategies are not evidence-based. Third, industrial policies are generally not well-coordinated with other related policies, such as those related to Small and Medium Enterprises (SME), investment promotion, trade, or science and technology. Fourth, the business community is highly fragmented. Production systems in all of the countries in our sample are fragmented along different lines (micro/small vs. large firms; state-owned or -related (military or party-affiliated) vs. private enterprises; national and foreign-funded; ethnic minority-owned and other domestic firms). Such fragmentation decreases inter-firm specialization and obstructs factor mobility between groups of firms, as well as knowledge spillovers from efficient to less-efficient firms. All these problems lead the industrial sector to comprise a small share of GDP, contributing products that are not labor intensive and are low-value-added. This is why Egypt's social accounting matrices show that the share of capital in the total value added increased from 57% in FY76 to 73% in FY11 (see Table 1). This is in line with the findings of Kheir-El-Din and Moursi (2007), who argue that between 1960 and 1998 capital accumulation was the main driving force behind economic growth. This was mainly due to the substantial supply of unqualified labor and prevailing employment laws that fostered the adoption of capital-intensive production techniques. These policies have led to modest investment levels that are biased against labor-intensive growth, which have weakened the economy's ability to create jobs.

Table 1. Capital and Labour Shares of Total Value Added (percentage)

	Capital Share	Labour Share
1975/1976	57.2	42.8
1995/1996	68.1	31.9
1998/1999	67.9	32.1
2000/2001	68.6	31.4
2006/2007	72.7	27.3
2010/2011	72.6	27.4

Source: Constructed by the authors using different SAM

This is why in order to resolve sectoral imbalances, it is crucial to increase both the share and the competitiveness of the industrial sector in order to boost its production, exports and employment.

Fiscal Imbalances

At the fiscal level, Egypt has long been characterized by a structural fiscal deficit. In the wake of the popular uprising, the Egyptian economy experienced low growth, as well as a higher fiscal deficit (see Table 2) for two reasons: the significant increase in wages and salaries after the revolution and the increase in interest payments (8.8% of GDP in FY16) due to a higher domestic debt (up to 85.8% of GDP in FY16 from 70.5% in FY11). Moreover, state revenues remained almost constant. This is why, despite the subsidies reforms that reduced energy subsidies in July 2014 and November 2016,² the overall fiscal deficit widened to 12.3% in FY16, up from 11.5% a year before and 9.5% before the revolution.

2. In July 2014, the Government of Egypt partially removed energy subsidies on all fuel products (except LPG for needy households) and electricity, to be phased out entirely over the medium-term, in order to reduce the fiscal deficit. This decrease is mainly explained by the elimination of energy subsidies to energy-intensive sectors, such as those producing petrochemicals, aluminum, ceramic and steel. Energy intensive sectors are responsible for around 80% of total fuel oil consumption and 15% of total natural gas usage. Both fuel oil and natural gas account for approximately 25% of total energy subsidies. In November 2016, the government announced a second decrease in subsidies before signing the International Monetary Fund loan.

Table 2. Summary of Fiscal Operations (in percent of GDP)

	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Total revenues	19.3	18.3	19	21.7	19.1	17.7	20.6
Tax revenues	14	12.5	13.6	12.4	12.6	12.7	13.3
Non-tax revenues	5.3	5.8	5.4	9.3	6.6	5	7.3
Total expenditure	29.3	28.4	31.9	33.4	30.2	29.5	30
Compensation of employees	7	7.4	7.8	8.5	8.2	7.7	7
Interest payments	6.2	6.3	8	8.2	7.9	8.8	9
Primary deficit	3.6	3.8	5	3.9	3.6	3.6	0.8
Cash deficit	10	10.1	12.9	11.6	11	11.8	9.4
Overall deficit	9.8	10.1	13	12.2	11.5	12.3	9.8

Source: Ministry of Finance

Note: Figures for 2016/17 are preliminary.

A closer look at the structure of social spending reveals the fiscal imbalances from which Egypt is suffering. Indeed, social expenditure is quite modest; the share of spending on health and education (which affect human capital) never exceeded 7% between FY02 and FY12 (Table 3). Furthermore, public investment decreased from 5% in FY02 to 1.9% in FY12. The decrease in these types of spending obviously has an impact on medium- and long-term growth. Indeed, most public spending is allocated to current expenditure (wages, subsidies and interest payments), while a minor part is allocated to productive expenditure (education, health and infrastructure).

Table 3. Summary of Social Spending (percentage of GDP)

	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Education*	4.8	4.1	3.7	3.7	4.2	4.1	3.8	4.0
Health*	1.3	1.6	1.4	1.5	1.5	1.4	1.5	1.5
Subsidies**	2.6	8.8	7.2	9.4	9.0	7.8	8.1	8.8
Food sub.**	0.0	1.5	1.3	1.8	2.0	1.4	2.4	2.0
Energy sub.**	0.0	6.8	5.4	6.7	6.0	5.5	4.9	6.2
Social Benefits**	2.6	2.0	0.2	0.5	2.8	0.4	0.4	0.6
Public Investment**	3.7	2.9	2.8	3.1	3.3	3.2	2.4	1.9

Sources: *CAPMAS (2010, 2011 and 2012)

** Ministry of Finance (2012)

The deficit was primarily financed through local sources, and particularly through bank subscriptions for treasury bills. This increased the crowding out effect as net claims on the government increased at the expense of credit to the private sector, in order to finance the increasing budget deficit (Figure 5). This evolution also shows how fiscal imbalances have had negative consequences on growth determinants in the medium- and long-term.

Figure 5. Net claims on the government are crowding out private sector credit

Source: Ministry of Finance, the Financial Monthly, various issues.

To attract savings, interest rates on government bills and bonds have increased to an average of 14% in 2014. Consequently, the outstanding stock of treasury bills (TBs) has increased substantially over the period from 2002-2014, as shown in Figure 6.

Figure 6. Outstanding stock of Treasury Bills (TBs) (LE billion)

Source: Ministry of Finance, the Financial Monthly, various issues.

As the interest rate on treasury bills (TBs) increased, they became more attractive, which led to a decrease in the risk premium (the difference between the real lending rate and the real treasury bill rate), as Figure 7 shows.

Figure 7. Risk Premium (percentage)

Source: Ministry of Finance, *the Financial Monthly*, various issues.

Monetary Imbalances

Monetary policy in Egypt suffers from two main problems. First, it lacks clearly defined objectives, either legislative or otherwise. When the Banking Law was issued in 2003, monetary policy became formally geared towards achieving price stability. “Law No. 88 of 2003 of the “Central Bank, Banking Sector and Monetary System” entrusts the Central Bank of Egypt (CBE) with the formulation and implementation of monetary policy, with price stability being the primary and overriding objective. The CBE is committed to achieving, over the medium term, low rates of inflation, which it believes are essential for maintaining confidence and for sustaining high rates of investment and economic growth. The Government’s endorsement of the objective of price stability and its commitment to fiscal consolidation is quite important for achieving this objective” (CBE website). Yet, there is no mention of a numerical target for inflation. While the law refrained from citing real objectives (output and employment), CBE reports mention that low inflation must “maintain high rates of investment and economic growth” (CBE, 2004/2005).

Second, the Central Bank of Egypt provides neither operational transparency (by publishing regular reports with the expected inflation), nor numerical transparency (since it does not have numerical inflation targets). This is why monetary policy remains uncertain and expectations are not concrete. Hence, a more independent and transparent, and thus credible, Central Bank will help to solidify expectations and consequently make monetary policy more effective in achieving its goals.

Two points are worth mentioning. First, a lax monetary policy is one of the reasons why inflation has been volatile (see Figure 8). Indeed, a more expansionary monetary policy is associated with higher inflation.

Figure 8. The Correlation between Money Supply and Inflation

Source: Constructed by the authors using the World Development Indicators

Second, domestic inflation is still highly affected by changes to the dollar exchange rate. Indeed, in November 2016, the CBE announced its decision to move, with immediate effect, to a liberalized exchange rate regime in order to address distortions in the domestic foreign currency market. At the end of 2016, the Egyptian pound was floated against the US dollar to reach EGP 13 per USD. By early 2017, the exchange rate reached 18 EGP per USD (Figure 9) leading inflation rates (Figure 10) to soar, reaching over 25% in December 2016, the highest level in almost 12 years. In addition, the Central Bank raised interest rates by 300 basis points on the day it floated the pound. High inflation levels will definitely put pressure on households in a country where around 27% of people are living under the national poverty line.

Figure 9. Exchange Rate Developments

Source: The Central Bank of Egypt

Figure 10. Inflation Rate Development

Source: The Central Bank of Egypt

In a nutshell, Egypt is suffering from three main internal imbalances: at the sectoral level (a declining industrial sector with a low level of competitiveness), the fiscal level (between revenues and spending, current vs. productive spending), and at the monetary level (non-transparent monetary policy).

EXTERNAL IMBALANCES

Export and Import Structures

In the aftermath of the revolution, Egypt's external accounts became more fragile for three main reasons. First, the current account balance deficit increased to \$7.9 billion (3.1% of GDP) from \$2.7 billion (1.2% of GDP) in FY12. This was primarily due to the rise in the trade deficit, which increased by 33.2% due to more imports and fewer exports. It is worth noting that around 75% of Egyptian imports are raw materials, intermediate inputs, investment goods or fuel. This is why, with the Egyptian pound devaluation, the potential increase in exports might be offset by more costly and imports that cannot be reduced.

Figure 11. Import Structure
Source: The Central Bank of Egypt.

Yet, despite the increased trade deficit, the current account was in equilibrium or surplus before the financial crisis due to strong surpluses in the services (mainly tourism) and transfer accounts. Following the revolution, net service receipts fell by 30%, down to \$7370.4 million, due to a decline in tourism receipts. Net transfer receipts also fell in FY15 due to lower oil prices. In FY15, the trade deficit was greater than the surplus generated by services and transfers, leading to a current account deficit (-3.7%).

Second, Egypt experienced a significant capital outflow of both portfolio and FDI, which were uneven throughout FY11. For this reason, the capital and financial account registered a deficit, which equaled 2% of GDP (see Table 4).

This deficit declined slightly but the surplus increased in FY15 thanks to more net borrowing from the rest of the world.

Table 4. Balance of Payments in Egypt as a Share of GDP (percentage), FY10-FY15

	FY10	FY11	FY12	FY13	FY14	FY15
Balance of Current Account	-2.0%	-2.6%	-3.7%	-2.2%	-0.9%	-3.7%
Trade Balance	-11.5%	-11.5%	-12.4%	-10.7%	-11.3%	-11.8%
Services Balance	6.7%	5.9%	4.4%	4.4%	2.7%	3.2%
Investment Income Balance (net)	-2.0%	-2.6%	-2.3%	-2.6%	-2.4%	-1.7%
Transfers	4.8%	5.6%	6.7%	6.7%	10.1%	6.6%
Capital & Financial Account	4.1%	-1.8%	0.4%	3.4%	1.7%	5.4%
Capital Account	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%
Financial Account	4.1%	-1.8%	0.4%	3.4%	1.7%	5.5%
Direct Investment In Egypt (net)	3.1%	0.9%	1.4%	1.3%	1.4%	1.9%
Portfolio Investment in Egypt (net)	3.6%	-1.1%	-1.8%	0.5%	0.4%	-0.2%
Other Investment (net)	-1.9%	-1.2%	0.9%	1.7%	-0.1%	3.8%
Overall Balance	1.5%	-4.1%	-4.1%	0.1%	0.5%	1.1%
Change in CBE reserve assets	-3355.7	9753.9	11278.4	-237	-1478.6	-3724.9

Source: Central Bank of Egypt

Note: For the change in CBE reserves, a negative sign means an increase

As a consequence, international reserves declined from \$36 billion in December 2010 to \$26.4 billion in June 2011, \$15.5 billion in June 2012 and \$15.4 billion in January 2015. This is chiefly attributed to the Central Bank's efforts to defend the Egyptian pound. In December 2012, Egypt's central bank introduced a new system for buying and selling foreign currency through currency auctions and the Egyptian pound decreased to reach EGP6.70/\$1 in March 2013. It experienced a further depreciation in early 2015, when the CBE announced that the value of the dollar was 7.61EGP. Finally, while the dollar reached an official rate of EGP 8.88, on the parallel market it reached EGP 18.

Finally, an important aspect of the trade policy is that of trade barriers. Indeed, in order to boost exports and imports, Egypt has signed several trade agreements and reduced its tariffs. However, despite these liberalization efforts, other impediments to trade still exist, especially administrative barriers that remain high and costly. Procedures entail a high number of documents, which creates a lengthier clearance process for imported and exported goods (see Table 5).

Table 5. Export and Import Procedures, 2015

Indicator	Egypt	MENA	OECD
Documents to export (number)	8	6	4
Time to export (days)	12	19.4	10.5
Cost to export (USD per container)	625	1,166.3	1,080.3
Documents to import (number)	10	8	4
Time to import (days)	15	23.8	9.6
Cost to import (USD per container)	790	1,307	1,100.4

Source: World Bank (2015b), *Doing Business Indicators*

FDI Drawbacks

FDI in Egypt increased between 2005 and 2008 after Egypt adopted a series of reforms that attracted FDI from European and Arab investors. Therefore, FDI multiplied 17-fold from 2003 to 2008. Yet, due to the financial crisis and the revolution, FDI declined by 72% between 2009 and 2015 (see Figure 12). In looking at the sectoral distribution of FDI in Egypt, the petroleum sector ranks first, followed by the services sector (Figure 13). This explains why the FDI inflow in Egypt did not generate enough jobs. Indeed, extractive industries are primarily capital intensive rather than labor intensive and their value added is extremely low.

Figure 12. Net FDI in Egypt (% GDP)

Source: Central Bank of Egypt.

Figure 13. Total FDI in Egypt by Economic Sector 2011/2012

Source: Central Bank of Egypt (2012)

Hence, external structural imbalances can be summarized as follows: a high level of imported intermediate inputs leading to a chronic trade deficit and FDI concentrated in low-value-added sectors.

A POLITICAL ECONOMY EXPLANATION

The most important cause of these imbalances in Egypt is institutional deficiency. Indeed, according to Acemoglu and Robinson (2008), modeling institutions include economic institutions, political power and political institutions. First, economic institutions matter for economic growth because they shape the incentives of key economic actors in society. Particularly, they affect investments in physical and human capital, as well as technology and the organization of production. However, since institutions have an influence on the distribution of economic gains, not all individuals and groups prefer the same set of economic institutions. Consequently, a conflict of interest arises among various groups and individuals over the choice of economic institutions, and the political power of the different groups becomes the deciding factor. Finally, political institutions determine the constraints on and the incentives of the key actors in the political sphere. These institutions may vary depending on the form of government, democracy versus dictatorship or autocracy, and the extent of constraints on politicians and political elite. Therefore, as is shown in Figure 14, economic performance depends chiefly on political institutions that shape *de jure* political power and on the distribution of resources that determine *de facto*

political power. Both of them determine economic and political institutions that affect economic performance. This is why bad economic performance (manifested by structural imbalances) results from inefficient institutions.

Figure 14. The link between Economic Performance and Institutions
Source: Acemoglu and Robinson (2008).

Although institutions matter for the economy to function well, it is difficult to measure some of their aspects. The literature focuses on the frequency of coups and revolutions as a proxy for government stability (Barro, 1991), the size of the black market and the percentage of national income in “contract intensive” activities as proxies for the effectiveness of economic institutions (Clague et al.1996), the risk of nationalization, the prevalence of corruption, and the efficiency of dispute resolution procedures (Knack and Keefer, 1995).

A host of indicators shows that Egypt is low-ranked compared to its peer economies in the region. Indeed, the Index of Economic Freedom³ (IEF) shows that most of the 15 MENA countries graded are “moderately free” or “mostly unfree,” with Iran and Algeria considered to be “repressed.” Egypt is “mostly unfree,” as are Yemen, Tunisia, and Lebanon. By contrast, Bahrain, the Emirates, Qatar, and Israel are “mostly free” (Table 6a). A closer look into the components of the IEF (Tables 6b) shows that most of the indicators are “moderately free,” such as government spending, business freedom and monetary freedom. The only indicator that is “free” is fiscal freedom, while trade is “mostly free.” At the bottom, both labor freedom and investment freedom are “mostly unfree,” followed by property rights corruption and financial freedom, which

3. In the Index of Economic Freedom, the Heritage Foundation evaluates countries in four broad policy areas that affect economic freedom: rule of law, government size, regulatory efficiency, and market openness. There are 10 specific categories: property rights, freedom from corruption, fiscal freedom, government spending, business freedom, labor freedom, monetary freedom, trade freedom, investment freedom, and financial freedom. Scores in these categories are averaged to create an overall score. Based on an average score, each of 178 countries graded in the 2015 Index is classified as “free” (i.e., combined scores of 80 or higher); “mostly free” (70-79.9); “moderately free” (60-69.9); “mostly unfree” (50-59.9); or “repressed” (under 50).

are “repressed.” This shows that Egypt’s world rank (124) is lower than other countries such as Tunisia (107), Lebanon (94), Morocco (89) and Jordan (38).

Table 6a. 2015 IEF for Selected MENA countries

	World Rank	Region Rank	2015 Score	Change in Yearly Score from 2014
Iran	171	15	41.8	1.5
Algeria	157	14	48.9	-1.9
Yemen	133	13	53.7	-1.8
Egypt	124	12	55.2	2.3
Tunisia	107	11	57.7	0.4
Lebanon	94	10	59.3	-0.1
Morocco	89	9	60.1	1.8
Saudi Arabia	77	8	62.1	-0.1
Kuwait	74	7	62.5	0.2
Oman	56	6	66.7	-0.7
Jordan	38	5	69.3	0.1
Israel	33	4	70.5	2.1
Qatar	32	3	70.8	-0.4
UAE	25	2	72.4	1.0
Bahrain	18	1	73.4	-1.7

Source: 2015 Index of Economic Freedom, the Heritage Foundation.

Note: Countries (total of 178 countries graded) are classified as “free” for an IEF score of 80 or higher, “mostly free” for an IEF score between 70 and 79.9, “moderately free” between 60 and 69.9, “mostly unfree” between 50 and 59.9 or “repressed” for an IEF score under 50.

UAE refers to the United Arab Emirates.

Tables 6b. Performance in Aspects of Economic Freedom Entering the Composition of the IEF 2015 for Selected MENA Countries

	Property Rights	Freedom from Corruption	Fiscal Freedom	Government Spending	Business Freedom	Labor Freedom
Algeria	30.0	36.0	80.0	38.7	66.6	50.5
Bahrain	60.0	48.0	99.9	73.1	72.5	83.1
Egypt	20.0	32.0	85.8	68.0	65.4	53.6
Iran	10.0	25.0	81.2	93.0	57.0	51.3
Iraq	N/A	16.0	N/A	43.8	57.7	74.4
Israel	75.0	61.0	61.9	47.8	72.4	67.1
Jordan	60.0	45.0	93.7	70.7	59.1	74.4
Kuwait	45.0	43.0	97.7	61.1	58.6	64.2
Lebanon	20.0	28.0	91.3	70.6	54.7	60.7
Libya	10.0	15.0	95.0	37.5	46.8	66.7
Morocco	40.0	37.0	70.9	61.0	68.8	33.4
Oman	55.0	47.0	98.5	44.2	68.4	76.1
Qatar	70.0	68.0	99.7	71.9	70.5	71.2
Saudi-Ar.	40.0	46.0	99.7	61.9	65.8	72.7
Syria	10.0	17.0	N/A	N/A	57.3	49.1
Tunisia	40.0	41.0	74.3	70.8	81.2	69.1
UAE	55.0	69.0	99.5	85.8	74.7	83.8
Yemen	30.0	18.0	91.5	59.9	54.0	57.1

	Monetary Freedom	Trade Freedom	Investment Freedom	Financial Freedom
Algeria	71.2	60.8	25.0	30.0
Bahrain	74.2	78.6	65.0	80.0
Egypt	67.4	70.0	50.0	40.0
Iran	48.7	41.4	0.0	10.0
Iraq	73.6	N/A	N/A	N/A
Israel	81.6	88.6	80.0	70.0
Jordan	80.6	79.6	70.0	60.0
Kuwait	74.0	76.2	55.0	50.0
Lebanon	72.0	75.8	60.0	60.0
Libya	71.4	80.0	5.0	20.0
Morocco	81.9	78.2	70.0	60.0
Oman	76.2	76.8	65.0	60.0
Qatar	79.7	81.8	45.0	50.0
Saudi-Ar.	68.4	76.4	40.0	50.0
Syria	N/A	N/A	0.0	20.0
Tunisia	74.8	61.2	35.0	30.0
UAE	83.8	82.4	40.0	50.0
Yemen	68.5	77.6	50.0	30.0

Source: 2015 Index of Economic Freedom, the Heritage Foundation.

Note: UAE refers to the United Arab Emirates.

Moreover, data from the Worldwide Governance Indicators⁴ (WGI) shows that Egypt, which was initially an “average” performer (Figure 15), dropped drastically in the percentile ranking between 1996 and 2013, losing 20 to 25 points in each indicator. This holds for control of corruption (with a percentile rank of 32.5), government effectiveness (19.6), rule of law (34.1), voice and accountability (18.1), regulatory quality (26.3) and political stability (7.1). By contrast, the United Arab Emirates, Qatar, Malta, and Israel are the region’s top performers in “Control of Corruption,” “Government Effectiveness,” “Regulatory Quality,” and “Rule of Law,” holding percentile ranks of 70 and above. The only countries ranked below Egypt overall are Iran, Syria, Yemen, Libya and Palestine.

Figures 15. Worldwide Governance Indicators for MENA Countries in Percentile Rank, 2013

(a) Control of Corruption

(b) Government Effectiveness

4. See annexe

(c) Political Stability and Absence of Violence/Terrorism

(d) Regulatory Quality

(e) Rule of Law

(f) Voice and Accountability

Source: World Governance Indicators, the World Bank.

Note: Percentile rank indicates the country's rank among all countries covered by the aggregate indicator, with 0 corresponding to lowest rank, and 100 to highest rank. Percentile ranks have been adjusted to correct for changes over time in the composition of the countries covered by the WGI.

A similar conclusion can also be drawn from the Global Competitiveness Index,⁵ (GCI) as Egypt is ranked between 100 and 130 among 144 countries. Indeed, when it is compared to Jordan, it is quite clear that the indices that have a particularly low rank are property rights, intellectual property protection, diversion of public funds, public trust in politicians, wastefulness of government spending, efficiency of legal framework in settling disputes, reliability of police services, strength of auditing and reporting standards, efficacy of corporate boards and protection of minority shareholders' interests (Figure 16).

5. The Global Competitiveness Index has been used since 2005 by the World Economic Forum as a comprehensive tool that measures the microeconomic and macroeconomic foundations of national competitiveness. It is a weighted average of many different components, each measuring a different aspect of competitiveness grouped into 12 pillars: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation.

Figure 16. Rank of GCI Institutional Indicators, 2014-2015

Source: *The Global Competitiveness Report 2014-2015*, World Economic Forum.

Note: Indicators are derived from the World Economic Forum's annual Executive Opinion Survey. Indicators not derived from the Survey are identified by an asterisk (*). The value included in the table is the country's rank among the 144 economies included in the Index.

CONCLUSION AND FUTURE REFORMS

The Egyptian economy has been negatively affected by the political instability that the country has witnessed since 2011. Indeed, this instability showed the extent to which the Egyptian economy suffers from several structural imbalances that first amplified the negative effects of the revolution and then delayed its recovery. This paper analyzes both internal and external structural imbalances that characterize the Egyptian economy and presents a roadmap for future reforms. Egypt is suffering from three primary levels of internal imbalance: the sectoral level (a declining industrial sector with a low level of competitiveness), the fiscal level (between revenues and spending, current vs. productive spending), and the monetary level (non-transparent monetary

policy). Externally, two structural imbalances can be identified, namely a high level of imported intermediate inputs leading to a chronic trade deficit and FDI concentrated in low-value-added sectors.

To reduce such imbalances, more efficient institutions are necessary. First, as a general rule, independence and accountability are important determinants of good institutions. Second, as institutions are the societal “rules of the game,” or the humanly-devised constraints that shape human interaction, investing in education generally leads to better outcomes, better choices and therefore better rules (Acemoglu and Robinson, 2008).

In terms of reforms, the government should adopt three main principles while implementing future reforms. The first principle is coordination. Different policies should be coordinated to guarantee that they are pushing the economy in the right direction. The second one is transparency. The more transparent the government, the more understandable its decisions are to the public, and thus the easier it is to control expectations. The third one is gradualism. Decisions should be implemented in a gradual way, so as to avoid strong shocks that negatively impact the poor. For instance, even though liberalizing the exchange rate and reducing energy subsidies were necessary decisions for the health of the Egyptian economy, it would have been better to implement these reforms in a more gradual fashion.

More specifically, for each structural imbalance, some recommendations can be made as follows. At the fiscal level, as the Egyptian government has already started to reduce energy subsidies and implement new taxes, it is important to generate more revenues and allocate higher amounts to education and health, as they are important determinants of growth in the medium- and short-term. In addition, the question of safety nets (such as *Takaful and Karama*) will be central, as more subsidies are expected to be phased-out. Indeed, the *Takaful and Karama* program is being developed as a targeted national social safety net program, aimed at protecting the poor through income support. It is expected to increase its coverage during 2017 to reduce the negative effects of the adjustment program that Egypt has started to implement with the IMF.

At the sectoral level, to promote industry, incentives are an important determinant of industrial sector performance. As argued by El Haddad (2016), incentives should be performance-based, finite, pre-announced and enforced, along with constant independent monitoring and evaluation. Second, improving administrative procedures and reducing bureaucracy and red tape will increase incentives for producers. Third, as also suggested by El Haddad (2016), it is crucial to improve the economy’s competitive environment and accentuate equality of opportunity between all market players (including public, private, foreign firms and the army). Fourth, it is necessary to cultivate an educated workforce and improve matching between the education system and labour market requirements.

At the monetary policy level, institutional reforms are necessary to lower inflation. Indeed, several studies showed that central bank independence was negatively correlated with average inflation among developed economies. Central bank independence must be based on the idea that the central bank has

its own objectives, but must also take into account the government's objectives when deciding on policy. More transparency will also lead to more credibility and more anchored expectations and thus lower inflation.

At the external level, export promotion is the only way to reduce imbalances. Indeed, more facilitation for exports is needed, i.e. less bureaucracy and fewer implicit impediments to trade in order to increase the number of exports, the number of destinations served by the same exporters and the number of products exported by each exporter.

Finally, while promoting FDI, the government should attract it to the manufacturing sector in order to generate a higher value added and create more jobs. In fact, job creation has been dominated by low-productivity sectors in most MENA economies, and especially Egypt, while the employment shares of the manufacturing and services sectors have remained relatively low (EBRD, 2013). A transfer of resources to more productive and higher value-added sectors will be an important determinant of sustainable and labor-intensive growth, which will help attract more FDI to sectors with strong job-creation potential

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ANNEXE

The World Bank's Worldwide Governance Indicators consist of six composite indicators covering broad dimensions of governance in over 200 countries since 1996: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. These indicators are based on several hundred variables obtained from 31 different data sources, capturing governance

perceptions as reported by survey respondents, non-governmental organizations, commercial business information providers, and public sector organizations worldwide. Control of Corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as “capture” of the state by elites and private interests. Government Effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies. Political Stability and Absence of Violence/Terrorism captures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically motivated violence and terrorism. Regulatory Quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Voice and Accountability captures perceptions of the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and freedom of media.