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International Macroeconomic Theory in Current Events
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Case study: The Political Economy of Egypt's currency crisis

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I. Introduction

In early 2011, massive popular uprisings across Egypt precipitated the fall of long-time ruler Husni Mubarak's regime, after more than 30 years of semi-authoritarian rule. More than just a call for a transition to democratic governance, the widespread social mobilization signaled a revolt against the regime's corruption and crony-capitalism, and decades of growing socio-economic inequalities in a country where as much as 40% of the 85 million population lives under the poverty line, and a high percentage of an overwhelmingly young population is unemployed.[1]

However, more than two years after January 2011, the prospects of achieving sustainable and inclusive economic development in Egypt are very low. In fact, the country's current short- to medium-term

[1] Awad, Marwa and Stamp, David. *Analysis: Egypt is in for trouble with or without the IMF.* Reuters online. March 5th, 2013.

economic outlook is in many ways far worse than it was before. The chronic socio-political unrest and instability have caused significant macroeconomic disruption (contraction in national growth rates, as well both trade and financial capital flows) and placed unprecedented levels of pressure on an already structurally very weak Egyptian economy. Meanwhile, the country has yet to undertake any form of deep and meaningful structural economic reform. As a result, many observers fear that the country's economy may be facing very serious short-term risks, particularly due to the likelihood of a balance of payment's crisis which could have far-reaching social and economic implications.

II. The Egyptian economy pre-2011: strong macroeconomic indicators despite underlying structural weaknesses

Throughout most of the decade preceding 2011, the Egyptian economy was faring well in terms of macroeconomic indicators. The country's central bank had steadily built up its official foreign exchange reserves, reaching a peak of US$ 36 billion in December 2010 (see graph 1). This accumulation of reserves was probably facilitated by years of relatively strong economic growth (ranging between 4.7% and 7.2% from 2004 to 2010[2]), high levels of tourism (i.e. exports) and a very significant rise in inflows of foreign direct investments, from about US$ 20 billion in 2003 up to more than $70 billion in 2010 (see graph 2). Throughout this period, given the country's consistent growth, presumed political stability and rising official reserves, the Central Bank of Egypt (CBE) likely did not face too many difficulties maintaining the unofficial peg of its currency, which remained constant between 5.5 and 6 Egyptian pounds per US dollar (see graph 3).

It is important to note, however, that beneath the veneer of macro-level growth and stability, the Egyptian economy suffered from serious structural weaknesses and distributive inequities resulting from decades of political manipulation and economic mismanagement. The stability and growth resulting from neoliberal economic restructuring programs implemented in the 1990's (privatization, trade and financial liberalization, reduced state support programs) had primarily served to enrich an increasingly powerful, corrupt and oligopolistic elite, while further marginalizing a larger and larger share of poor Egyptians. The political acquiescence of the growing number of destitute and vulnerable Egyptians was ensured via a system of subsidies on basic staple goods such as fuel and wheat, or patronage via massive public sector employment (an estimated 5.4 million government employees)[3]. Over the decades, the subsidies and salaries had come to represent a tremendous weight on government expenditures, due to a combination of demographic growth, dropping domestic oil production (Egypt became a net importer of oil in 2007 and is major importer of food) and rising global oil and food prices. For instance, by 2005 the Egyptian General Petroleum Corporation (the government body managing oil production and distribution and subsidies) had begun operating at a loss and therefore rapidly accumulating significant debt to finance itself (possibly as much as US$ 60 billion by 2011)[4].

III. The Egyptian economy post-2011: from systemic shock to balance of payments crisis

The socio-political turmoil that shook Egypt in early 2011 dealt a systemic shock to the Egyptian economy and led to an economic contraction that caused sharp drop in the demand for Egyptian currency through several channels. In a very clear break with the positive trends of the preceding period, GDP

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[2] International Monetary Fund, World Economic Outlook Database, October 2012
[3] Shokr, Ahmed. "Reflections of two revolutions". Middle East Research and Information Project (MERIP) 265. Winter 2012
[4] Ibid.

growth dropped from 5.1% in 2010 to 1.8% in 2011[5], flows of foreign direct investment into the Egyptian economy actually dropped by 0.7% in 2011 after an average annual growth of 20% from 2004 to 2010[6], and a sharp drop in tourism not only hurt one of the nation's primary economic activities, but also importantly corresponded to a reduction in exports. Since 2011, fears of potential default have risen as international credit rating agencies have subjected Egypt to a series of downgrades, the most recent of which occurred on "on December 24 to B- from Standard & Poor's – six notches below investment grade and the same rating as Greece."[7] The loss of investor confidence has led to rises in interest rates, causing higher debt-financing costs for government that borrows heavily to pay for excessive public expenditures. Private banks are also forced to raise interest rates on savings deposits - most recently in February 2013 as many of Egypt's largest banks raised their interest rates by as much as 2%.[8]

Egypt has therefore simultaneously faced a worsening current account deficit (from 2% of GDP in 2010 to 2.6%, or US$ 6 billion, in 2011, and to an estimated 3.4% in 2012[9]) and important capital outflows (drop in investment). The significance of this sequence of events is evident when we look at the current account identity between savings (S), investment (I), and the current account (CA): S-I = CA. Given that savings have probably not increased, the concomitant drop in investment (I) and trade balance (CA) are highly problematic. As Krugman, Obstfeld and Melitz write:

> A balance of payments crisis results because the country's official exchange reserves may be the only ready means it has to pay off foreign short-term debts. By running down its official reserves, the government can cushion aggregate demand by reducing the size of the current account surplus needed to meet creditors' demands for repayment. But the loss of its reserves leaves the government unable to peg the exchange rate any longer.[10]

Indeed, it is exactly this scenario that has played out in Egypt. Graph 1 shows how steeply the Central Bank's foreign reserves have fallen between January 2011 and early 2013, by as much as 60%. This drop primarily reflects the necessity to help the government finance the country's current account deficit in the face of economic contraction and capital outflows (as explained above), but also the necessity to defend the unofficial peg of the Egyptian pound from devaluation pressures (as explained below).

The combination of all economic factors over the past two years has caused a sudden drop in the demand for Egyptian pound, which should have led to a depreciation of this currency if it had actually been allowed to float freely. However, the CBE has intervened in the money market by selling foreign currency (US dollars) reserves to offset excess supply of Egyptian pound and therefore prevent a sudden devaluation of the pound (see graph below).

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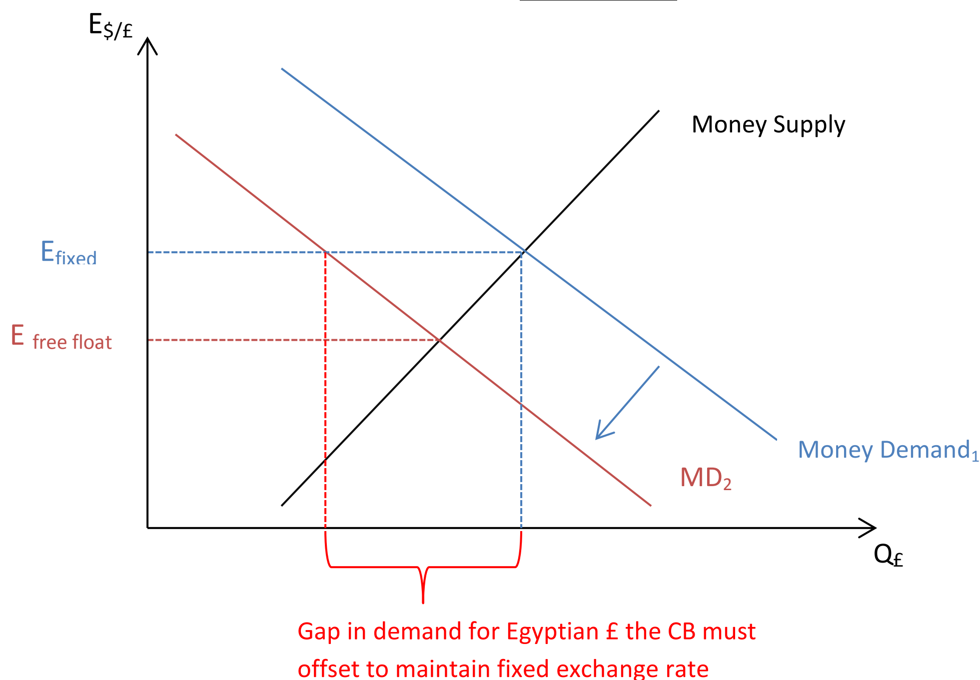
[5] International Monetary Fund, World Economic Outlook Database, October 2012
[6] UNCTAD
[7] Bowman, Andrew. *Egypt's currency slides as central bank attempts managed devaluation*. Financial Times, beyondbrics. January 3rd, 2013
[8] Daily News Egypt. *National Bank of Egypt follows in Bank Misr footsteps, raises interest rates on platinum by 2%.* February 5th, 2013.
[9] International Monetary Fund, World Economic Outlook Database, October 2012
[10] Krugman, Obstfeld, Melitz. *International Economics, Theory and Policy*. Ninth Edition, 2012. (658-659)

Diagram. Central Bank intervention to maintain fixed exchange rate following negative demand shock



Theoretically, allowing the currency to devaluate would have made domestic exports more competitive, improved the current account and therefore led to a rise in national output. Moreover, had the Central Bank decided to fix the exchange rate at a new, lower level, it could actually have increased its foreign currency reserves because the rise in output would have led to a subsequent rise in the demand for Egyptian currency, in which case the Central Bank would have had to sell Egyptian pounds in exchange for US dollars in order to maintain the new peg and prevent a re-appreciation.[11]

Why, then, has the CBE defended the Egyptian pound's exchange rate? For many developing countries facing balance of payments crises in the past (notably during the Asian financial crisis of 1997-1998), a sharp depreciation of the domestic currency was a major threat due to high levels of exposure to external debt denominated in foreign currency. However, according to the Financial Times, this risk is not as prevalent in Egypt[12]. Instead the Egyptian Central Bank's intervention was most probably motivated by the political and structural factors mentioned earlier: a sharp devaluation of the Egyptian pound would immediately have made foreign goods much more expensive, a very risky development in light of the country's significant reliance on imports (inflationary pressures), and the government's already

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[11] This sequence of events occurred, for example, during Brazil's balance of payments crisis in 1998 and 1999. See pp. 510-511 in Krugman, Obstfeld, Melitz. *International Economics, Theory and Policy*. Ninth Edition, 2012.
[12] Bowman, Andrew. *Egypt's currency slides as central bank attempts managed devaluation.* Financial Times, beyondbrics. January 3rd, 2013

substantial expenditures on subsidies (some suggest more than $16 bn per year[13], while the Petroleum Minister has cited energy subsidies alone could soon surpass $17.8bn per year[14]).

The pressures on the CBE to let its currency devaluate have been rising rapidly in recent months. The central bank is now nearing the complete depletion of its foreign reserves: while these stood at about US$ 15 billion in January 2013, much of this amount was either in gold (about US$ 4 bn) or securities that "if touched would signal the country's bankruptcy."[15] As of March 2013, the Financial Times writes that "Egypt's foreign reserves have reached $13.5bn – below the critical level for three months of imports (...)."[16] Due to the absence of effective economic reform or of any improvements in the national economy over the past two years, markets and speculators are becoming increasingly certain that the CBE will not be able to maintain the peg. The market's expectations of a future depreciation of the Egyptian pound leads to a higher expected return on foreign currency deposits (in terms of Egyptian pounds) and therefore creates additional pressures for devaluation. The rising excess demand for foreign currency assets increases the amount of foreign reserves the central bank needs to sell to maintain the fixed exchange rate.

IV. External financial support and the politics of economic reform

In light of the continuing degradation of the country's economic situation, the Egyptian government has been engaged in negotiations with international inter-governmental and financial institutions for the provision of loans that would prevent a complete depletion of foreign reserves and economic collapse. The most prominent of these negotiation processes has been with the International Monetary Fund, for a loan of US$ 4.8bn. However, because access to the IMF loan is dependent on Egypt's adoption of strict economic structural reforms, it is believed that a successful outcome for these negotiations would boost confidence in the Egyptian economy and could "unlock up to $9.5bn of additional finance from other external sources."[17] However, successive Egyptian governments (first military rule from February 2011 and then civilian rule by the highly contested Muslim Brotherhood since parliamentary and presidential elections starting early 2012) have suffered from a severe lack of legitimacy and been very reluctant to actually implement economic reforms that would come at great costs for different elements of the Egyptian population.

The reforms, in very simplified terms, would either need to increase government revenues (most likely through increased taxation) or restructure public finances so as to cut government expenditures. Raising taxes is clearly not a popular policy option, and likely not the most efficient alternative in a country where a significant share of the economy is informal. Some have suggested more progressive taxation (targeting the rich specifically), such as a one-time wealth tax, but such a policy would also threaten politically-powerful interest groups.

On the expenditure cuts side, the most prominent area of reform is the government's subsidies (mainly fuel and wheat). However, implementing subsidy cuts would also be extremely problematic primarily for

[13] Al-Ahram filmed discussion with Masood Ahmed, director of the IMF for the Middle East and West Asia. March 2012 (link accessed March 2013).
[14] Awad, Marwa and Stamp, David. *Analysis: Egypt is in for trouble with or without the IMF.* Reuters online. March 5th, 2013.
[15] Mahmud Salem, aka Sandmonkey. Blog entry (in english), '*The Powers that be.'* December 24, 2012. Accessed March 2013 (http://www.sandmonkey.org/)
[16] Saleh, Heba and Khalaf, Roula. *Egypt eyes crisis finance as bid for $4.8bn IMF loan hits difficulty*. Financial Times print edition (page 1). March 11, 2013.
[17] Ibid.

two reasons. First of all, a very large portion of the subsidies actively profit Egypt's richer classes or support the economy through reduced production costs – this is especially true for fuel/gasoline subsidies that offer huge advantages to capital-intensive producers. IMF regional director Masood Ahmed explains that 90% of gasoline subsidies go to the top 20% of households in Egypt.[18].Higher energy prices[19] would therefore have high short-term economic costs for industrial production, a possibility which is sure to incite strong resistance from powerful and politically-connected interest groups. Moreover, the rising prices on basic necessities resulting from subsidy cuts would also have a direct and disproportionate impact on the millions of poor and economically-vulnerable households, for whom food and energy costs represent a greater share of total expenditures. To reduce subsidies would therefor most probably cause new rounds of social turmoil.

V. Conclusion

As our analysis has shown, the Egyptian economy is facing a very dire and increasingly urgent set of macroeconomic problems. As the process of capital flight continues, a total depletion of the Central Bank of Egypt's foreign reserves would come at dramatic economic and social costs, but even before then a complete loss of confidence in the Egyptian pound would lead to 'dollarisation' as all investors tried to switch to other currencies, or a run on Egyptian banks.

Over the recent years, Egyptian authorities have failed to react to rapidly rising costs from the convergence of a deep social and political crisis and a legacy of severe structural weaknesses from decades of political and economic mismanagement. Powerful political factors prevented the decisive and rapid adoption of the reforms that might have allowed the adjustments needed to avoid today's impending crisis. Today it seems the country has no easy or cost-free way out, though one might hope that gradual reforms might still be able to avoid complete collapse or mitigate the depth and length of the crisis. The Central Bank of Egypt has begun to gradually devaluate its currency since early 2013 (see graph 3) – a necessary move welcomed as a first step in the right direction.[20] Similarly, negotiations with international lenders could hopefully lead to gradual and progressive structural reforms (incremental tax increases or subsidy cuts, with mechanisms designed to target the more wealthy and support the poorer classes). However, similar structural reform packages in the past have had a very dismal track-record in terms of avoiding the tremendous social costs that are to be expected, and this makes the prospect of improved living conditions for the Egyptian population in the short- to medium-term (in terms of inclusive economic development and socio-political stability) very unlikely.

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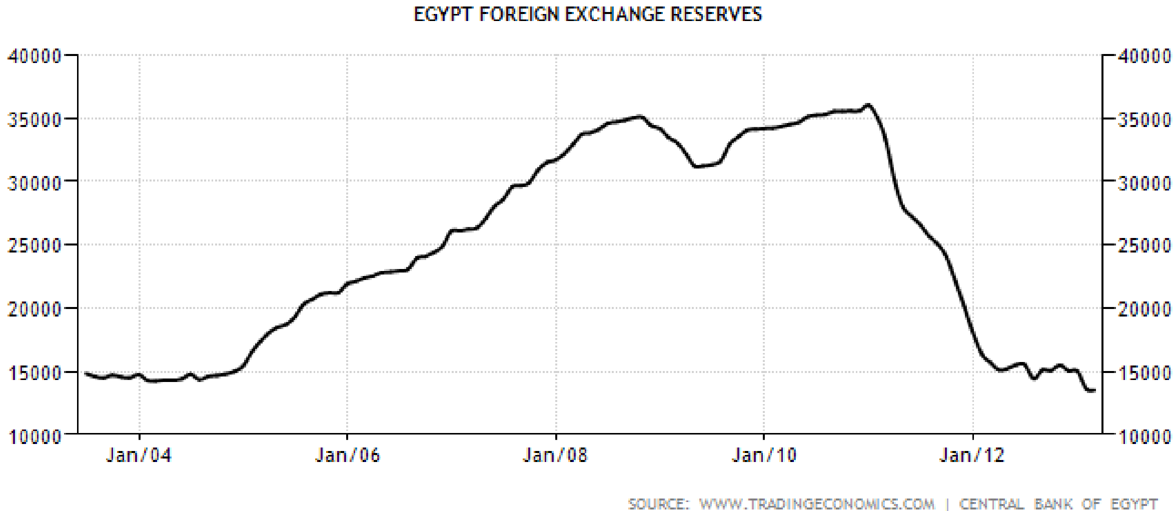
[18] Al-Ahram filmed discussion with Masood Ahmed, director of the IMF for the Middle East and West Asia. March 2012 (link accessed March 2013).

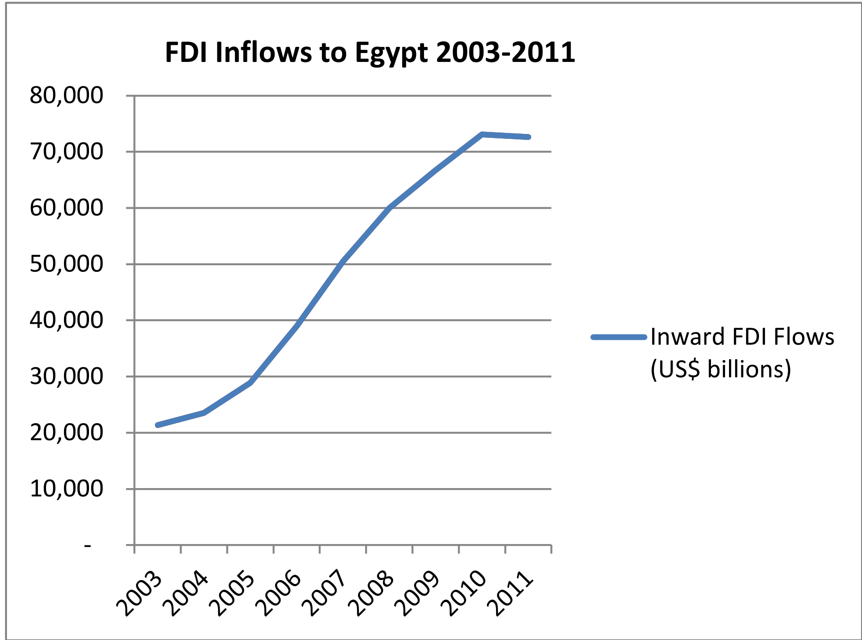
[19] Reuters reports that: "According to projections compiled for the IMF, the commonly used 90 octane gasoline would leap to 5.71 Egyptian pounds ($0.85) a liter from 1.75, and diesel would go up to 5.21 pounds from 1.10." Awad, Marwa and Stamp, David. *Analysis: Egypt is in for trouble with or without the IMF.* Reuters online. March 5th, 2013.

[20] Bowman, Andrew. *Egypt's currency slides as central bank attempts managed devaluation*. Financial Times, beyondbrics. January 3rd, 2013

Graph 1



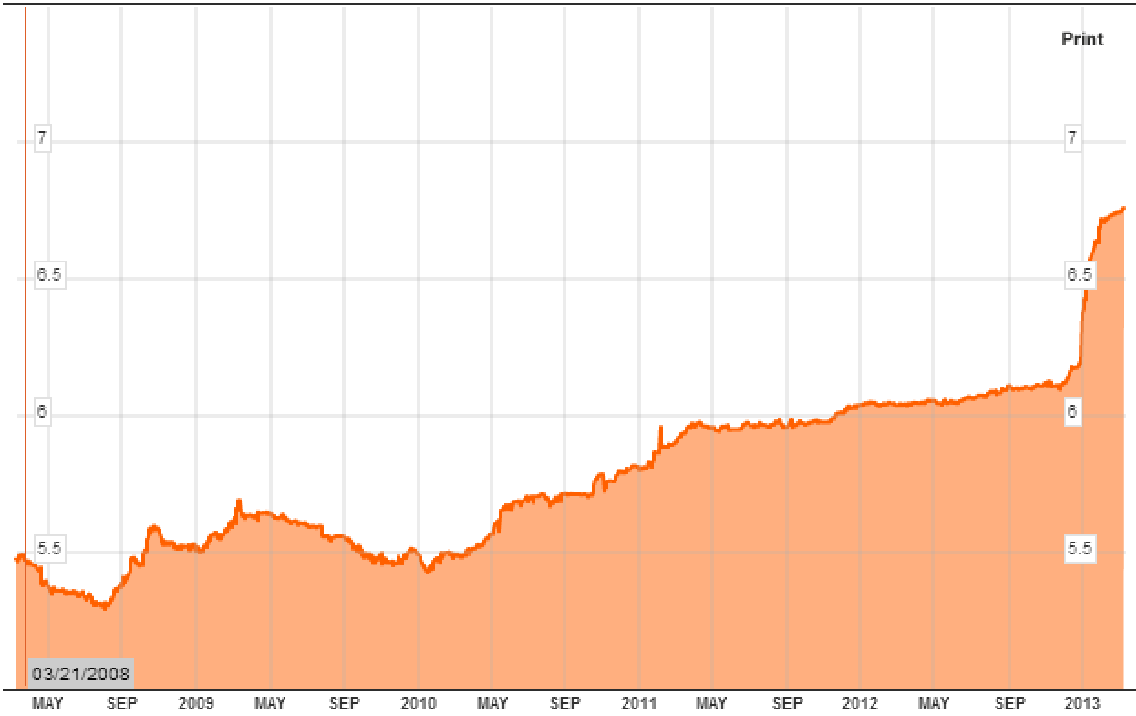
Graph 2



Source: UNCTAD

Graph 3

US Dollar – Egyptian Pound exchange rate (2008-2013)



Source: Bloomberg.com