Egypt Response to the Global Crises

Ministry of Finance

Macro Fiscal Policy Unit
Cairo, Egypt

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1. Background

During the past few years, the Egyptian economy has seen the culmination of more than 15 years of relentless reform efforts. The reform program dates back to the 1990s when Egypt embarked on an Economic Reform and Structural Adjustment program (ERSAP) aimed at stabilizing the economy and promoting economic growth. The program has helped a noticeable improvement in several economic fundamentals including the increase in growth to 5.9% in 1999/2000 compared to 1.9% in 1991/92. On the backdrop of several external and domestic shocks, the reforms were interrupted, however resuming strongly since 2004 giving birth to a new trajectory of sustained and better diversified growth in the Egyptian economy.

The overarching objective of reform has been to maintain high levels of equitable growth and sustainable development. Growth rates accelerated to an average of 7% in the past three years, up from an average of 3.9% in the preceding three years, whereas unemployment was brought down to 8.4% by the end of 2007/08 from 11.2% in 2004/2005. More importantly, the reform program succeeded in diversifying the growth drivers away from the traditional naturally-endowed sectors such as oil and Suez Canal to more sustainable sources, where manufacturing, trade, and telecommunications known for their relatively high value added, have been the primary engines for growth. Foreign direct investment peaked to a record of US$ 13.2 billion or 8.1% of GDP in 2007/08 up from US$ 407 million or 0.5% in 2003/2004, with the bulk of funds going to non-oil green field investments, helping the renovation of the capital base, boosting future growth potential and driving investment ratios up to 22.3% of GDP in 2007/08 up from 16.9% in 2003/2004. The fiscal consolidation program has successfully set the overall fiscal deficit on a downward trend reaching 6.8% in FY 2007/08 down from a peak of 9.6% in 2004/05.

However, during the course of reform, emerging global turbulences such as the notable hike in world food and energy prices (2007-2008) followed by the global financial turmoil (2008 to present) increasingly challenged the ability of economic policy to deliver on its objective. In reaction to such crises, there emerged a need for tuning economic policy to mitigate its adverse effects on both the economic and the social sides. In response to the first shock, the government passed a LE 14 billion deficit-neutral package in May 2008 stipulating several tax reforms (ceasing some tax holidays, and increasing sales tax on cigarettes and some oil products). Revenue from such measures were used to finance major adjustments in basic civil wages of some 5.8 million government employees and increase the supply of basic staples on ration cards used by more than 11 million families. The package was concomitant with the general direction taken by the government to carry out the fiscal consolidation, respond flexibly to ensuing challenges, and help that the fruits of growth are reaped at all income levels.

Faced with the second challenge, the global financial turmoil, the government was also prompted to respond quickly by introducing a fiscal stimulus package worth of 1.5% of GDP in accelerated implementation of infrastructure and utility projects to help preserve growth momentum. This note highlights the impact of the two crises on the Egyptian economy and the main features of the policy responses enacted by the Egyptian government.

2. Policy Response to the First Crises: The International Price Shocks

Like other small open economies, Egypt was hard hit with the unprecedented hike in the prices of food, energy, and other primary goods witnessed in 2007-2008. The impact of the price shock was most pronounced on the middle and lower income groups of the Egyptian society, who spend on average some 45 percent of their incomes on food items; reaching some 60 percent for the lowest quintile. This brought economic policy under hard pressures and necessitated a quick response to alleviate the impact of the shock on the most vulnerable social groups in order to preserve social and economic stability.

As such, the Egyptian Parliament endorsed Law number 114/2008 with the objective of cushioning the effect of the crisis on the lower income groups while securing sustainable finances to such measures taken to maintain fiscal sustainability. A total bill of LE 14.4 billion was passed on May 5th, 2008, with a reduction in energy subsidies, higher sales tax on cigarettes, higher fees on vehicle, higher fees for the use of cement raw materials, and elimination of selected income tax exemptions.

This bill was intended to raise sustainable resources to finance the additional costs associated with adjusting the government employees base-wage scheme (some 5.8 million employees), raising the minimum wage of the lowest paid government employees, paying higher pensions, as well as disbursing additional amounts of rice, sugar, and edible oil through the rationed cards system. In this regard, the social package introduced was fiscally neutral and has thus helped maintain an adequate social and economic balance, setting a good reference case for policy-makers in response to such pressures. Details of the package are highlighted in table (1).

Table 1: Policy measures taken in response to the global price shocks

Additional Cost	2007/08	2008/09	Financing Sources	2007/08	2008/09
Increasing monthly take home base wage by 30% of salary	1.1	6.2	Reducing energy subsidies and increasing sales tax on petroleum products	1.3	7.5
Increasing maximum rewards for to 75 local government employees	0.4	3.0	Increasing sales tax on cigarettes	0.2	1.3
Disbursing additional quantities of . sugar on rice, edible oil, and rationed cards	0.2	1.6	Increasing vehicle licensing and registration fees	0.2	1.1
Increasing monthly pensions by 20% with maximum LE 100	0.6	3.6	Increasing fees on quarries	0.2	1.0
Increasing Energy subsidies	4.0		Seizing tax-exemptions on power intensive industries in Free Zones	0.1	0.6
			Seizing tax-exemptions on T-bills interest income	0.1	1.0
			Seizing tax exemptions on profits of educational institutions		0.9
			Seizing forward carry-over of loses		1
			Higher tax receipts and dividends from EGPC	2.7	0
			Other	1.5	
Total Additional Uses	**6.3**	**14.4**	**Total Additional Sources**	**6.3**	**14.4**

3. Policy Response to the Second Crisis: The Global Financial Crisis

By mid 2008, the hike in global prices had coincided with the first round of the global financial crisis, featuring a dual challenge of a price hike fueling domestic inflation and a slump in global demand undermining growth and triggering a resurgence of unemployment in Egypt. Thanks to sound prudential regulations and strong banking sector supervision and early reforms, the Egyptian economy was immune to the first round effects of the rapid collapse of global financial markets. However, by time second round effects of the global financial turmoil had already begun to spillover into the real economy, prompting the government to react by designing a rescue package aimed at preserving demand, together with other specific measures targeting to help those sectors directly affected by the crisis[1].

The onset of the global financial crises faced the Egyptian economy with significant challenges to its recent growth trajectory. Dwindling foreign demand has entailed a slowdown in exports of goods and services and consequently on economic growth momentum and a rise in the unemployment rate. Waning current account receipts (from exports of goods and services as well as remittances) coupled with receding foreign investment flows have also rendered the balance of payments in deficit for the first time in five years. Table 3 at the end of this note illustrates developments in Egypt's main macroeconomic indicators.

Meanwhile, pressures on the budget will be increasing on the backdrop of declining tax receipts and the need to increase some spending programs to help stimulate the domestic economy. In this regard, 2009/10 budget reveals an expected increase in the overall deficit to 8.4% of GDP.

It is noteworthy, however, that structural and macro-prudential reforms enacted during the past few years in the fiscal, monetary, banking, business environment and

[1] Annex-2 at the end of this note presents main measures taken to help alleviate the impact of the crisis on some sectors.

other areas contributed to the improvement of the resilience of the Egyptian economy in face of the crisis.

3.1. The Fiscal Stimulus Package

In spite of a relatively buoyant growth momentum that kept domestic economic growth rates floating above world average, quarterly Y-o-Y growth rates declined for the fourth quarter in a row in Q2 of FY 2008/09 recording 4.1% down from 7.6% a year earlier. Accordingly, the government introduced its "first" fiscal stimulus package of some LE 15.5 billion (1.5% of GDP) in 2008/09, mostly to finance accelerated investments in public utilities. Though the additional outlays were formally ratified by Parliament in March of 2009, several projects under the package were already off the ground in September 2008 financed through budgeted contingencies.

The provision of such a package helped serve a dual purpose; on one hand, it helped stimulate domestic demand and precluded a sharp decline in economic activity, and on the other, it accelerated the execution of several crucial infrastructure projects with high social value such as drinking water, sewage and roads. These projects will also help the recovery of the domestic economy once global demand rebounds.

It is worth noting that although additional spending on the fiscal stimulus package was not included in the original FY 2008/09, overall budget deficit is not expected to deviate significantly from budgeted targets (at 6.9% of GDP) due to expected savings in some expenditure items (wages) and improved revenue items[2]. Meanwhile, Gross budget sector debt is expected to maintain its level around 81% of GDP by the end of FY 2008/09 and 2009/10, close to its level in FY 2007/08 despite the fact that the Central Bank of Egypt (CBE) has reclassified part of the external debt worth US$ 4.3 billion into government debt in September 2008. It is worth mentioning that the 2009/10 budget includes some LE 5.5-6 billion that can be marked as part of a *"second stimulus package"*. Those include some 2.5 – 3 billion in accelerated or

[2] Including higher than budgeted taxes on goods and services receipts, and other non-recurrent revenues.

additional investment expenditures that go beyond the normal increases in the annual investments budget. Most of those extra outlays are directed to finance investment projects, in addition to allocations for exports promotion and internal markets development programs, besides the completion of the one-year sales tax rebate on capital goods that was launched as part of the first stimulus package. Preliminary sustainability indicators also suggest the possibility of injecting further stimulus should the global outlook remains to be grim, without impacting medium-term fiscal and debt sustainability.

Table 2: Breakdown of the Fiscal Stimulus Package

Overall Stimulus Package	**15,532**
I. Investment Expenditure	**10,832**
I.I For General Budget Sector	
- Potable Water and Sewage projects	7,030
- Building roads and bridges	1,000
- Domestic development projects in various governorates	1,000
- Building basic health care centers	400
- Building schools	150
- others	652
Total investment in the budget sector	**10,232**
I.II For Economic Authorities	
-Improving the efficiency of railways	400
- Executing infrastructure projects for the development of East Port-Saed sea port	50
- Improving the capacity of Red Sea ports	150
Total investment in economic authorities	**600**
II. Current Expenditure (Transfers/Subsidies)	**2,700**
- Increasing competitiveness of Egyptian exports	2100
- Supporting industrial zones in the Delta	400
- Supporting logistic areas for internal trade	200
III. Reductions in Customs Duties and Sales Tax	**2,000**
- Reducing custom duties on some industrial inputs and capital goods	1,500
- Temporary lift of sales tax on capital goods	500*

*Another 500 of foregone sales tax on capital goods are estimated to take place during FY 2009/10.

3.2. Monetary Stimulus

At the onset of the crises, the CBE has affirmed that it continues to guarantee all deposits in the banking sector. Though this is formally promulgated by law, this move came to prevent possible panics or runs on deposits. In addition to this step, a monetary stimulus package was designed to supplement the abovementioned fiscal stimulus.

Meanwhile, the rapidly changing global economic landscape has painted a mixed picture about the required policy action. First, the global inflationary wave during 2007/08 signaled that monetary policy would maintain a non-expansionary stance to avoid pressures stemming from possible demand driven inflation. As such, the Central Bank increased the overnight deposit and lending rates for its corridor system by 275 basis points over six successive times. Later, as inflationary pressures subsided, and as pressures from the current global financial turmoil filtered into the domestic economy, CBE resorted to cutting the corridor spread rates by 250 basis points over three consecutive Monitory Policy Committee (MPC) meetings from February to May 2009, narrowing down the corridor by 50 basis points during the last meeting[3]. CBE cited the decline in inflation on the back of a sharp decline in international commodity prices, softening in growth momentum as external demand dwindles, and grim outlook shed by the global financial turmoil as the drivers behind it recent policy rates cuts. The CBE also reiterated that it will continue to take the necessary measures to cushion the effect of the global crises on the domestic economy provided that this does not conflict with its primary objective of price stability. It is worth noting that annual headline CPI inflation continued to decline in May 2009, reaching 10.2% and recording a cumulative drop of 13.4 percentage points since its peak in August 2008.

Further, CBE board decided to exempt banks' deposits, equivalent to the size of the loans extended to finance Small and Medium Enterprises (SME) from the 14% legal reserve requirements. Facilitating finance to SMEs, known for their labor-intensive nature, is intended to help economic activity and employment. The package also

[3] During the last MPC meeting the overnight deposit rate was cut by 50 bps to 9.5 percent while the overnight lending rate was cut by 100 bps to 11 percent. Accordingly, the width of the corridor has been narrowed from 2 percent to 1.5 percent.

included banning corporate sector investment in financial instruments of more than 3-year maturity to encourage private sector to reinvest their residuals.

It is worth noting that, in addition to the measures taken by the CBE, Egypt's two largest state-owned banks are set to launch a LE 10 billion initiative of retail banking to stimulate private household consumption. Such funds will be allocated to the finance of personal loans, car loans, and purchase of durable goods.

4. Outstanding Challenges and The Way Ahead

Albeit the Egyptian economy demonstrates relative resilience to the global crises as compared to other developing and emerging economies, the prolonged slowdown in global demand and volatility in some basic commodity prices remain to constitute a threat to economic growth and employment. According to recent IMF World Economic Outlook figures, world output and trade are forecasted to shrink in 2009 by 1.3% and 11% respectively. Having external demand and foreign investment playing an important role in spurring domestic growth in the past few years, this grim outlook of the global economy does not come without its own challenges to the domestic economy. Weakening exports of goods and services and foreign direct investment is likely to hold back economic growth, and interrupt record rates achieved in the past three years. Meanwhile, Government stimulus policies are anticipated to prevent sharp drawbacks in economic activity.

The government is nevertheless committed to carrying ahead its reform program set in motion since 2004. The rapidly deteriorating global economic conditions are expected to affect the pace of reform; however, it does not undermine the commitment to the reform program. Given its improved economic and institutional fundamentals, the Egyptian economy is expected to maintain resilience in face of the crises.

Annex 1: Egypt Main Economic Indicators

	2003/04	2004/05	2005/06	2006/07	2007/08	Q1 2008/09	Q2 2008/09	Q3 2008/09
Real Sector								
Annual % Change [1]								
Real GDP	4.10%	4.50%	6.80%	7.14%	7.16%	5.81%	4.11%	4.30%
Nominal GDP	16.2%	11.0%	14.7%	20.6%	20.4%	25.7%	14.0%	13.6%
Consumption	14.5%	10.8%	13.9%	20.6%	20.4%	27.0%	19.9%	15.4%
Investment	16.6%	17.8%	19.5%	34.2%	28.5%	29.3%	5.9%	9.3%
Exports	50.5%	19.3%	18.2%	16.6%	30.4%	23.0%	-13.6%	-26.8%
Imports	41.1%	22.3%	18.6%	24.5%	34.1%	28.2%	-0.5%	-20.1%
% of GDP								
Consumption	84.4%	84.3%	83.7%	83.7%	83.8%	90.4%	89.0%	82.3%
Investment	16.9%	18.0%	18.7%	20.9%	22.3%	15.8%	21.4%	22.4%
Exports	28.2%	30.3%	31.3%	30.2%	32.8%	29.0%	24.2%	22.3%
Imports	29.6%	32.6%	33.7%	34.8%	38.8%	39.0%	34.6%	27.4%
Prices								
Inflation Rate (CPI, annual average)	10.3%	11.4%	4.2%	11.0%	11.7%	22.4%	19.6%	13.3%
Exchage Rate LE/US$	6.16	6.01	5.75	5.71	5.50	5.35	5.52	5.57
Discount Rate (end of period)	8.4%	10.1%	8.8%	8.7%	7.0%	6.9%	7.4%	7.1%
T-bills Rate (91 days)	7.7%	7.6%	5.9%	6.1%	6.5%	10.9%	11.7%	11.1%
3-Months Deposits (end of Period)	8.2%	9.5%	8.6%	8.8%	10.3%	5.3%	5.5%	5.6%
External Sector (% of GDP)								
Current Account Balance [2]	4.3%	3.2%	1.6%	1.7%	0.5%	-0.5%	-0.8%	-0.5%
FDI [2]	0.5%	4.4%	5.7%	8.5%	8.1%	0.9%	1.3%	0.6%
Overall Balance of Payments [2]	-0.2%	5.0%	3.0%	4.0%	3.3%	0.2%	-0.5%	-1.0%
Total Reserves (US$ billion)	14.78	19.30	22.93	28.56	34.57	35.02	34.11	32.18
Reserves (in month of commodity imports)	9.7	9.6	9.0	8.9	7.9	6.9	7.8	9.2
Fiscal Sector (% of GDP)								
Overall Fiscal Balance[2]	-9.4%	-9.6%	-8.2%	-7.3%	-6.8%	-2.2%	-3.5%	-5.4%
Primary Balance[2]	-3.1%	-3.5%	-2.2%	-0.9%	-1.2%	1.2%	-1.2%	-1.5%
Gross Budget Sector Debt (domestic and foreign)	118.3%	120.6%	107.4%	94.3%	79.7%	75.1%	77.1%	79.7%

1) In nominal terms unless otherwise stated.
2) Quarterly figures in percent of full year estimated GDP.

Annex 2: Other Sectoral Measures in light of the crises

In addition to the abovementioned measures, several targeted programs have been designed to cushion the effect of the crises on the most exposed sectors. This includes the following:

TRADE

- Reducing tariffs on specific capital goods and production components that have no local substitutes.
- Increasing finance to export programs by 50% in order to allow 1,300 companies to continue benefiting from 25 programs that provide 875 job opportunities.
- Reducing participation fees for specialized international fairs and exhibitions by 50%, in addition to doubling the number of participating companies.

TOURISM

- Rescheduling of outstanding debt and providing various loan facilities to projects in the tourism sector.
- Intensifying joint marketing campaigns with international travel agencies
- Concentrating marketing efforts towards emerging economies with high potential.
- Supporting charter flights programs.
- Enhancing efforts aimed at introducing low-cost carriers to the Egyptian market.

MANUFACTURING SECTOR

- Waving sales tax on machinery, equipment and capital goods for one year. starting January 2009.
- Postponing the payment of 75% of industrial land installments due to the government for one year.
- Fixing natural gas and energy prices for all operating plants till the end of 2009, and rescheduling of energy connection fees over three years.
- Enhancing services provided by the Industrial Training Council, the Industrial Technology Centers and the Industrial Modernization Center by reducing contributions by benefiting companies to 50%, so as to better serve 11,500 companies staffed with around one million insured workers.
- Increasing subsidies to services provided by technological centers to various industries.
- Decentralizing the process of issuing industrial and operating licenses to the boards of the Industrial Zones at governorate level, and streamlining the required procedures for the renewal of industrial registration.
- Providing the required approvals for all new non-energy-intensive industrial projects in one day.