Egypt's economic development: What's and Why's

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Egypt possesses an abundance of resources—a strategic location, oil and gas deposits, fertile agriculture, myriads of tourist attractions, a long tradition of learning, a hard-working labor force, and an extensive diaspora that regularly remits large amounts of funds to Egypt. And yet the country's economic performance seems to lag well behind that of many less well-endowed countries and even fails to meet many of Egypt's own requirements. Is this indeed the case? If so, why? And what should policymakers do to rectify the situation?

These are the questions I have most frequently been asked in an association of more than 40 years with the Egyptian economy. In attempting an answer, I have drawn on the discussion and data in my new book, *The Political Economy of Reforms in Egypt: Issues and Policymaking since 1952* (AUC Press, 2018).

What should be the primary goals for Egypt's economic managers?

My premise is that a government's prime responsibility is to improve the condition of the people and, especially in view of Egypt's history, to reduce the country's vulnerability to external pressure. A key element in a better life is a higher income, because it enables persons to obtain command over goods and services that help them to live a life they value, while a key element in warding off external pressures is a reduction in Egypt's dependence on foreign savings. In operational terms, therefore, one might say that the primary task for Egypt's economic managers is to expand the country's real GDP (the value of its production of goods and services adjusted for price changes) while restricting the deficit on its external accounts to a manageable level. Moreover, in the interests of political harmony, there must be a socially acceptable distribution of this GDP.

Most incomes are earned through employment. Given the rapid increase in Egypt's population and labor force, creating a sufficient number of jobs requires rapid increases in the GDP. Egypt's demographic dynamics permit no alternative. Every two years Egypt adds a New Zealand or Ireland to its population; every three, a Denmark or Finland; every four, an Israel or Switzerland; and every five, a Sweden or Portugal. And while it adds the population, it does not add the capital assets, the technical knowledge, the institutions, and the governance of these countries.

How has the economy performed in relation to its requirements, and how does this compare with the experience of high-performing countries?

How fast must Egypt's GDP grow in order to provide jobs to all the entrants into the labor force? Estimates suggest that a one percentage point increase in Egypt's GDP growth rate produces an increase of roughly one-half percentage point in the employment rate. Egypt's labor force is increasing at about 3.5 percent a year; thus the GDP would have to grow at around 6.5–7.0 percent a year in real terms for the next few decades. Indeed, to reduce the backlog of unemployment and underemployment, GDP growth would have to be toward the higher end of the range, and possibly even higher. The fast-growing countries of East Asia, such as Korea, China, Japan, Taiwan, Malaysia, Hong Kong, and Singapore averaged real GDP growth rates of 8.5–9.0 percent for such periods.

As against this, Egypt's real GDP growth over the 50-year period 1965 to 2016 averaged about 4.7 percent a year. The difference is stark: a dollar growing at 4.7 percent a year becomes $9.9 after 50 years, while one dollar growing at 9 percent a year becomes $74.4 in the same period.

Why did Egypt's growth rate fall so short of the East Asian countries?

Broadly speaking, GDP growth results from increased inputs of capital (investment in machinery and equipment) and labor, and improvements in "total factor productivity," (TFP), i.e., the efficiency with which capital and labor are combined in use. The short answer is that Egypt's growth fell well behind the East Asian countries because it both invested much less than them and because its TFP increased much more slowly.

If Egypt's real GDP is to grow at 7 percent a year, international experience suggests that the country would have to invest at least 30 percent of GDP. The East Asian countries cited earlier regularly maintained ratios of investment to GDP of around 35 percent, while the rate for China frequently exceeded 40 percent. *As against this, between 1965 and 2016 Egypt's investment rate averaged barely 20 percent.*

The other major source of growth is a sustained improvement in TFP. *In the 50 years from 1965, TFP growth contributed probably less than 10 percent to the growth of Egypt's GDP*; in the East Asian countries the contribution was around 25 percent, and even higher in China. The inadequacy of Egypt's investment was not compensated for by productivity increases. Egypt's growth depended upon adding additional inputs of capital and labor and not on innovation—on perspiration rather than inspiration, as the Nobel laureate Paul Krugman put it in a similar context.

What about the other main objective, namely, to lessen the country's reliance on foreign savings? This requires reducing the gap between the country's own savings and its investment, and the gap between its foreign exchange earnings and expenditures (i.e., the deficit on the current account of the balance of payments).

If the investment rate is to be 30 percent of GDP, then savings will likely have to be of the order of at least 25 percent. *As against this, between 1965 and 2016, Egypt's domestic savings rate averaged only 13.5 percent.* The picture is a little better than appears at first sight, because Egypt's national savings (the savings by Egyptians world-wide) are higher than its domestic savings (the savings generated within the borders of Egypt); however, on any measure, the gap remains very wide. A major contributor to the low rate of savings was the yawning gap between the government's revenues and expenditures—*over the period 1965 to 2016, the budget deficit averaged 11.3 percent of GDP* and its monetization, i.e., financing it by printing money, was an important driver of the country's inflation rate.

The self-reliance objective would also require the gap on the current account to be restricted to perhaps no more than 5 percent of GDP; in fact, *between 1965 and 2016 Egypt's current account deficit averaged 8.2 percent of GDP.* As a percentage of GDP, imports of goods and services during this 50-year period averaged 28.8 percent, compared with 20.6 percent for exports.

Why has the Egyptian economy underperformed compared with several East Asian countries?

The question of economic policymaking has been extensively examined by scholars. The studies offer different nuances, but their underlying message is rooted in a political-economy approach that places a premium on regime-survival, and views policy outcomes as resulting principally from a struggle between coalitions of opposing economic interests. The discussion highlights three issues that are critical for Egypt, and could be paraphrased as follows.

First, Egyptian regimes have felt vulnerable because they lacked the legitimacy of a democratic election. The basic political-economy element in their survival strategy was to placate the population by offering an abundance of consumer and other subsidies (at times even cigarettes and dessert [*halawa*] were subsidized); free education and health care; guaranteed employment; controlled rents for housing; redistribution of landholdings; regular increases in bonuses, industrial wages, and government salaries; ceilings on interest rates that in the face of rising inflation often created negative real rates, subsidized investment for a very large and generally not very efficient public sector, and so on. The result was that real public consumption expenditure increased at an annual rate of 4.4 percent between 1965 and 2016—almost twice the rate of population growth. The regimes also could not risk antagonizing the population by increasing taxes—the 16 percent ratio of tax revenue to GDP in 2016 was virtually the same as in 1965. The combination of high public consumption expenditure and tepid domestic resource mobilization resulted in a shortage of funds for investment, as well as for education, training, and research, with predictable consequences for GDP growth.

Regimes attempted to mobilize much of their resources from economic rents (unearned incomes) whose burden for the most part fell on foreigners. Egypt's experience since 1965 is replete with episodes of massive inflows of external funds and reschedulings and forgiveness of foreign debt. However, "the kindness of strangers" is subject to whims, has limits, and generally comes with a political price-tag.

Second, Egypt's development strategy was based on import-substitution and involved a wide-ranging system of protection against imports. This raised the price of imported items in the Egyptian market, and thus made it more profitable for Egyptian producers of the same or similar items to divert their production to the home market than to sell them abroad. But "a tax on imports is a tax on exports," as the Nobel laureate Robert Mundell reminded his Cairo audience in 2003. The overvalued foreign exchange rate provided further inducements to importers at the cost of exporters. The coalition of importers evidently held much greater political sway than that of exporters, and the wide range of measures that pandered to importers' interests implanted a substantial anti-export bias in Egypt's policy structure.

Third, Egypt's foreign policy initiatives from 1952 to 1974 inflicted substantial costs. Egypt had projected itself as the leader of the Arabs; a leader of the Muslim world; a leader of Africa; a leader of the "nonaligned" group of countries; champion of Palestinian rights; supporter of Algerian resistance to French rule; and a bulwark of the Third World against the West. It had been involved in wars with Israel in 1948, 1956, 1967, and 1973, plus a "war of attrition" (March 1969 to August 1970) and a war in Yemen against Saudi Arabia from 1962 to 1967, and in hostilities against Libya in 1977. All these severely depleted Egypt's economic, financial, and human capital. Of course, Egypt had the right to choose any foreign policy it deemed to be in its interest or to which it felt morally committed. However, choices have consequences, and antagonizing the world's principal sources of capital, food, and trade cost Egypt their support.

In sum*, one might say that Egypt's failure to perform to its economic potential resulted chiefly from internal political pressures to maintain increases in public consumption while not mobilizing sufficient revenues from domestic sources and, until 1974, foreign policy overstretch. The regimes' political-economy strategy favored groups that prioritized consumption over savings and imports over exports. These factors held down domestic savings and investment and created large external and budgetary deficits, requiring continual recourse to foreign savings.*

What should Egypt's policymakers do?

In order to make the best use of its physical and human assets, and especially because a number of immediately required reforms (e.g., to the exchange rate and subsidies) have already been undertaken, Egypt has increasingly to move toward "second generation" reforms. These are measures that impact on laws, institutions, the structure of incentives, the regularization of property rights, and other matters that go to improving governance.

Egypt must start as soon as possible on these reforms, because they are both necessary and also take time. Thus, for example, second-stage reforms generally require a reform of the bureaucracy. This is seldom easy and could be particularly difficult in Egypt. More than one-fourth of the country's labor force is employed in various parts of the government—in 2016 there was one government employee for every thirteen citizens (even this figure excludes the Armed Forces)—and is set in its attitudes and methods of working. The reforms might also require creating entirely new institutions or politically empowering existing ones, such as regulatory agencies that would actually restrain monopolistic or oligopolistic behavior by firms. They would also require fundamental improvements in the functioning of the commercial judicial system to speed up judgments and to reduce the case burden on judges. And measures would also have to be put in place to ensure that judicial decisions were implemented promptly. The system of education and training will also have to undergo changes to equip its graduates with skills that match the demands of the market.

This blog post only scratches the surface of a subject that is vitally important for Egypt and its friends; the issues are discussed in much greater detail in my recent book. The road ahead may be difficult, but traversing it is well within the capacity of Egyptians. It will, however, require a united and concerted effort by policymakers, intellectuals, workers, students, and others. My long experience with Egypt convinces me that Egyptians are a gifted and resilient people who are up to any challenge that confronts them.
