November 10, 1986

OPTIONS FOR THE U.S. AS EGYPT'S TIME OF RECKONING NEARS

INTRODUCTION

America's foremost friend in the Arab world is in increasing difficulty. Confronting Egypt is a festering economic crisis that threatens to shatter that nation's fragile social peace and alter its political orientation. For too many years Cairo has postponed sorely needed structural economic reforms by drawing on the financial bonanza of its Camp David "peace dividends" (the Sinai oilfields, Western aid, and tourism) and by tapping into the Persian Gulf oil boom through the remittances of over two million expatriate workers. But with the decline of oil prices, tens of thousands of Egyptian workers have returned from abroad, depriving Cairo of much of the foreign exchange it needs to finance its $37 billion foreign debt and chronic balance-of-trade deficit.

By late this year or early next, Egypt's time of reckoning will arrive. The country's foreign currency reserves will be exhausted. If it cannot borrow new funds, Egypt will be confronted with the stark choice of defaulting on its foreign debt or risking political turmoil by cutting imports.

Hosni Mubarak, who became Egyptian President after Anwar Sadat was assassinated in 1981, has appealed to the United States and other Western nations to ease Egypt's cash crisis by helping it make up a foreign exchange shortfall of up to $5 billion in the coming year. Though the U.S. is giving Egypt $2.5 billion aid this year, Cairo seeks more next year, plus greater flexibility in the form of cash grants and cooperation in renegotiating the terms of outstanding loans. Washington can help ameliorate Egypt's short-term financial crisis. Only Cairo, however, can solve Egypt's long-term economic problems.

The Mubarak government has made half-hearted efforts at piecemeal reform but has been reluctant to overhaul the flawed core of Egypt's archaic socialist economy--the labyrinthine bureaucracy that administers the lumbering public sector and consumer subsidies. The government has borrowed heavily from abroad to maintain the costly subsidy system to forestall social turbulence and coopt political opposition. Yet Egypt's deteriorating economy, increasingly burdensome debt, and growing dependence on the West have fueled Islamic fundamentalism and raised the risks of a radical fundamentalist backlash. Such a convulsion not only might sweep away Egypt's experiment with democracy but could destabilize the Middle East by unraveling the U.S.-engineered Camp David agreements.

To assure the survival of a stable, pro-Western Egypt, the U.S. must help Egypt to cushion its poor while undertaking the kind of radical overhaul of its economy that will offer Egyptians hope for the future. Washington should ease Egypt's immediate cash crisis--but only if Cairo makes a long-term commitment to restructure its economy to promote growth and productivity and reduce waste. U.S. aid will be wasted unless Egypt puts its house in order.

The U.S. should encourage Egypt to:

- Bolster the private sector by reducing bureaucratic red tape, artificial foreign exchange rates, and obstructive licensing procedures.

- Gradually eliminate price controls and move toward a free market economy.

- Trim consumer subsidies that distort economic behavior, limiting them to those consumers with a genuine need for state assistance.

- Replace Egypt's import substitution orientation with an export orientation by developing labor intensive industries in which Egypt has a competitive advantage.

- Privatize state-run enterprises to prevent the huge public sector from choking out infant private sector enterprises.

- Encourage private investment by Egyptian and foreign investors by giving potential investors concrete assurances against future nationalizations.

EGYPT'S ECONOMIC TROUBLES

Egyptian Prime Minister Ali Lutfi concisely defined Egypt's economic problem as "consuming more than we produce, importing more than we export and spending more than we receive."[1] Cairo's economic difficulties are to a large degree a legacy of Gamal Abdul Nasser, who headed Egypt from 1952 to 1970. His socialist policies bred overcentralization, inefficiency, waste, and corruption. The nationalization of foreign-owned enterprises in 1956 deprived Egypt of foreign investment, while nationalization of domestic enterprises after 1960 spurred capital flight and an exodus of talented managers and other professionals. A cumbersome bureaucracy grew to oversee a swollen public sector plagued by obsolescent equipment, low productivity, and lack of competition. For political reasons, Nasser directed trade to favor the Soviet bloc and erected tariff barriers and other import restrictions on western trade. Finally, Nasser's belligerence provoked the 1967 Arab-Israeli war, which left Israeli forces in possession of the Sinai, depriving Egypt of revenues from the Suez Canal and Sinai oil fields.

Anwar Sadat, who became President after Nasser's death, sought to revive the failing statist economy by unleashing the private sector. He launched his Infitah (Open Door) policy in 1974 to open Egypt to Western trade, technology, and investment. Central to his vision was the hope of combining Arab oil money, Western know-how, and Egyptian labor to modernize the moribund economy. Egypt reduced the bureaucratic impediments to growth in the private sector and liberalized the tax and tariff systems to encourage foreign economic participation.

Infitah successfully lured large capital inflows into the country but failed to harness them productively. In a major retreat from the policy's intent, Law 32 of 1977 altered the professed goal of liberalization from export encouragement to import substitution. Much of the foreign investment flowed into financial services, tourist enterprises, and real estate rather than productive investments in industry and agriculture. Though Egypt's gross domestic product (GDP) grew at an impressive annual rate of over 9 percent from 1974 to 1981, this was not accompanied by real economic development. Instead an outburst of consumerism enriched traders who channeled profits into speculative investments or shifted money abroad. Sadat was criticized

1. Financial Times (London), June 4, 1986, p. 21.

for transforming Egypt "from a planned market economy into a supermarket economy."[2]

When Hosni Mubarak came to power, in 1981, he inherited a mixed economy in which a dominant public sector coexisted uneasily with a small but increasingly vibrant private sector. Sadat's Infitah had created a schizoid economic system with independent capitalist and collectivist subsystems functioning in an unintegrated manner. Despite the failure of Nasser's socialism to maintain economic growth and the inability of Sadat's liberalization to provide development with growth, President Mubarak has retained both with minor variations. Consequently, Egypt has been hobbled by chronic balance-of-payment deficits and a deepening dependence on Western aid.

THE IMMEDIATE CRISIS

The Egyptian economy has been buffeted by exogenous factors beyond Cairo's control. Egypt has been one of the countries hardest hit by falling oil prices. Egyptian oil export revenues this year are expected to plummet 50 percent or $1.1 billion from 1985.[3] More important, remittances from the 2.7 million Egyptians working in the oil rich Arab states,[4] which already had slumped from $4 billion in 1984 to $3.7 billion in 1985, are expected to fall by another $1 billion this year.[5] As Persian Gulf states strive to export the brunt of the oil recession by expelling foreign workers, Egypt will lose an important safety valve that defused social tensions and gave poor Egyptians hope for a better standard of living.

Tourism also has fallen. Here the culprit is terrorism. Airplane hijackings and the Achille Lauro incident have discouraged travel to the Middle East. The 1985 massacre of Israeli tourists on a Sinai beach by a deranged Egyptian policeman and the bloody February 1986 uprising of Egypt's riot police have raised anxiety over the safety of tourists in Egypt. As a result, revenues from tourism, estimated at almost $1 billion last year, could be

---

2. Mohammed Heikal, Autumn of Fury (London: Deutsch, 1983), p. 86.

3. The Wall Street Journal, June 23, 1986, p. 24.

4. In 1985, there were an estimated 1.25 million Egyptians in Iraq, 800,000 in Saudi Arabia, 300,00 in Libya, 200,000 in Kuwait, and 150,000 in the United Arab Emirates. Quarterly Economic Review: Egypt, 1985 Annual Supplement, Economist Intelligence Unit, London, p. 9.

5. The Wall Street Journal, February 27, 1986.

halved. By one estimate, total foreign exchange earnings will shrink from $9.6 billion in 1985 to $6.6 billion in 1986.[6]

Even before its sources of foreign exchange began to dry up, Egypt was burdened with a crushing debt service ratio--35 percent of current account inflows immediately flow out again to pay the interest on the foreign debt. Egypt's national debt is estimated to be $37 billion,[7] with $6.8 billion owed to the U.S., its single largest creditor. The International Monetary Fund (IMF) estimates that Egypt's debt repayment obligation will be $3.7 billion this year,[8] up from $3.3 billion in 1985.

In addition to servicing the national debt, Cairo must finance a trade deficit that grew from approximately $6 billion in Egyptian fiscal year 1984/1985 (ending June 30) to $7 billion in 1985/1986.[9] To finance this gap without reneging on its foreign debt obligations, Egypt must make up a projected shortfall of up to $5 billion in 1986/1987.[10] If it cannot do so, Cairo will have to choose between slashing imports or defaulting on its foreign debt. The first option might spark an uprising by poor Egyptians dependent on subsidized food imports; the second would vitiate prospects of securing future loans.

To escape this dilemma, the Mubarak regime is lobbying Western governments to step up economic aid and ease the terms of debt repayment. This May, Cairo appealed to the seven nations attending the economic summit in Tokyo to establish a $30 billion Middle East development fund to assist states hurt by the oil glut. Egypt entered negotiations with the IMF for a $1 billion standby loan and hopes for up to $800 million from the World Bank. In July President Mubarak toured West Germany, France, Britain, and Italy in search of more aid and requested European help in convincing the IMF to make a loan without requiring Egypt to pare its budget deficit by cutting subsidies.[11] A steady stream of Egyptian officials have visited Washington seeking assistance in scraping up enough cash to avoid the clutches of the IMF. High on their list is the reduction of interest rates on the $4.5 billion Egypt has borrowed from the U.S. for

---

6. Paul Jabber, "Egypt's Crisis, America's Dilemma," Foreign Affairs, Summer 1986, p. 961.

7. The Wall Street Journal, November 4, 1986, p. 38.

8. The New York Times, August 23, 1986.

9. Middle East Economic Digest, Special Report: Egypt, June 1986, p. 8.

10. Financial Times (London), June 4, 1986, p. 21.

11. The Wall Street Journal, July 30, 1986.

military purchases. Cairo also wants Washington to boost the cash grant portion of the U.S. aid program. In FY 1985, $115 million of the $2.48 billion U.S. aid program was disbursed in the form of a cash grant.

Egyptians have grown addicted to massive consumer subsidies that have drained the government treasury and warped economic activity. Subsidies on food, clothing, and energy cost the state $7 billion per year, soaking up about one third of the national budget.[12] A loaf of bread costs the government four times as much to produce as it is sold for, and until recently gasoline cost less than bottled water. Such artificially low prices ease the immediate plight of the urban poor but distort the economy and create tremendous waste. Egyptian farmers, for instance, are known to feed subsidized bread to livestock because it is cheaper than animal feed. Because heavily subsidized government flour depresses domestic wheat prices, locally grown wheat is sometimes more valuable as a source of straw for making bricks than as a source of food.[13] More than one-third of domestic crops is estimated to be lost through sloppy handling.[14] Practices such as these make Egypt the world's foremost per capita consumer of grain. Since 75 percent of the grain Egypt consumes is imported from abroad, Egypt is forced to go deeper into debt to underwrite grain imports that it does not really need.

In effect, Cairo is mortgaging its future to sustain wasteful current consumption patterns. The existing system of price controls is an economically suicidal act. Although consumption subsidies contribute to political stability in the short run by easing the plight of the urban poor, in the long run such subsidies threaten Egypt's political stability by sapping the vitality of the economy. In the long run, the urban poor will have to bear an even heavier burden.

THE NEED FOR ECONOMIC REFORM

Mubarak's first speech after assuming power recognized that his government's success would depend on its economic record. He initially distanced himself from the excesses of Sadat's economic scheme by mounting an anticorruption drive against businessmen who had exploited political ties to cash in on Infitah. Mubarak called for a

---

12. The Washington Post, June 26, 1986, p. A36.

13. Marvin Weinbaum, "Dependent Development and U.S. Economic Aid to Egypt", International Journal of Middle Eastern Studies, May 1986, p. 122.

14. The New York Times, August 23, 1986.

shift from Sadat's "consumptive open door," which encouraged luxury imports, banking, and real estate speculation, toward a "productive open door" to promote domestic industry and agriculture. He endorsed the concept of "guided capitalism," in which the state sets goals and coordinates the different sectors of a mixed economy.

Mubarak's cautious pragmatism has been soothing after the political pyrotechnics of the Sadat era. But while Mubarak reversed Sadat's 1981 crackdown in the political sphere, he failed to follow through on long overdue economic reforms. A decent and honest man, Mubarak lacks the personal charisma and decisiveness that Egyptian political culture extolls. A sense of drift has pervaded economic policy making, as the government has tried to defer hard choices by propping up the faltering economy with foreign assistance.

Cairo has tinkered with marginal reforms but has not come to grips with the heart of its problem--the subsidy system that skews economic behavior by distorting price signals. A patchwork of ad hoc price hikes has been fashioned, often by stealth, to defuse opposition. Example: The price and size of a subsidized loaf of bread were doubled, then the size and quality gradually were reduced, while the price remained at the higher level. Cautious attempts to trim subsidies, however, provoked riots by industrial workers near Alexandria in October 1984, inducing the government to roll back some of its belt-tightening decrees.

Further austerity measures were shelved for several months, but Egypt's deepening economic malaise prompted Mubarak to appoint Ali Lutfi, an advocate of reform, as Prime Minister in September 1985. A former finance minister, Lutfi recognized the burden posed by subsidies but also realized that the government could not cancel the subsidies outright, thereby abruptly abandoning the implicit social contract that Nasser had extended to Egypt's poor. Lutfi proposed that subsidies be reduced gradually over five years, while the salaries of the poor, many of whom held low-paying government jobs, were raised.[15] He also called for the strengthening of the private sector to boost exports and domestic food production.

Lutfi has not been able to carry out his reforms, however, because of divisions in the cabinet. He is a technocrat without a political base, whereas other cabinet ministers seem determined to protect their public sector constituencies. The government gingerly has introduced reforms that expand the role of the private sector, such as Decree 121 early this year that allowed private firms to import and market foods previously reserved for state-run enterprises. This April, the cabinet approved a draft budget that included modest cost-cutting and revenue-raising measures. The

---

15. The Wall Street Journal, October 9, 1985, p. 36.

government claims that the new budget scales back subsidies by almost 15 percent, but since Egypt frequently overspends its budget, such savings probably will be elusive.

This June, the Egyptian finance and planning ministers came to Washington with further proposals for cutting subsidies, streamlining the state bureaucracy, and raising energy prices. The Reagan Administration is pressing for a more detailed program of pricing reforms on tighter deadlines. Cairo appears to be moving in the right direction, but hesitantly, for fear that wrenching austerity measures will ignite discontent, which Muslim fundamentalist extremists are poised to exploit.

THE SPECTER OF ISLAMIC FUNDAMENTALISM

The Egyptian government must face as well the growing challenge of Moslem fundamentalists, who seek to remold Egyptian society along Islamic lines through the establishment of Islamic law (sharia). The Moslem Brotherhood, outlawed since a 1954 assassination attempt on Nasser, exerts a deepening influence on Egyptian political parties and the state bureaucracy. Radical fundamentalists in loosely organized Islamic associations--the gamaat Islamiya--have seized control of student unions and faculty clubs. Unlike the Moslem Brotherhood, which currently sees the Egyptian parliament as a legitimate means of reforming society, many members of the gamaat Islamiya seek revolutionary change through violence. Although Islamic radicals probably number no more than 10,000 activists, they form an underground network that continues to gain strength.

Islamic fundamentalists in Egypt as elsewhere in the Islamic world rail against adoption of Western values, secularism, materialism, and corruption. In Egypt's case, the fundamentalists include the Camp David peace treaty and dependence on the West. They advocate a return to an idealized form of Islam, which they claim will remedy Egypt's social, economic, and political problems. Their ranks are fed by the steady influx of rural migrants into the cities and by Egypt's educated youth, disillusioned with their bleak economic future. The rise of fundamentalism reflects a widespread popular yearning for reassurance and stability in a rapidly changing society. In a crisis, such yearnings for simple answers to Egypt's formidable problems could be manipulated by Islamic radicals and channeled into an attack on the government.

In the early 1970s, President Sadat tacitly encouraged fundamentalists to counterbalance Egyptian leftists, but cracked down on them in his last months in power. Mubarak, who was standing beside Sadat when Sadat was assassinated by radical Moslem fundamentalists in 1981, has continued cracking down on the radicals while trying to establish a dialogue with moderate fundamentalists. This has avoided the pitfall of pushing disaffected Egyptians into the arms of Moslem extremists, but there is a danger that the government's tolerance could be mistaken for weakness.

Egypt is not Iran. There is little chance that an Iranian-style Islamic revolution will topple the government. Unlike Iran's Shah Muhammed Reza Pahlevi, Mubarak is respected by his people as an honest leader who abhors corruption. Unlike Iran, whose independent Shiite clergy was troubled theologically by the legitimacy of secular authority, Egypt is a predominantly Sunni (orthodox) Moslem nation, whose top religious leadership is supported by the state. Egypt's fundamentalist opposition is divided, and there is no charismatic figure on the horizon such as Iran's Ayatollah Khomeini to unify splinter groups. There also is a large Coptic Christian minority in Egypt, which poses a countervailing force to the Moslem militants.

Nevertheless, Moslem fundamentalism continues to make inroads, particularly among the young. And the Egyptian army, long the backbone of the state, has not remained immune. If fundamentalists come to power in Egypt, it is likely to be through the army, rather than against it.

EGYPT'S CHALLENGE TO THE REAGAN ADMINISTRATION

Cairo has made strong political and strategic arguments that it deserves special consideration and help to avert a financial crisis. Egypt is the most populous Arab state; it sits astride the land route between two continents and controls the Suez Canal linking the oil-rich Persian Gulf to the West. Egypt buttresses U.S. defense policy through strategic cooperation that enhances American ability to respond to a Persian Gulf crisis, and it contributes to U.S. Middle East diplomacy by supporting the expansion of the Camp David accords. Finally, Egypt is an embryonic democracy that faces the internal challenge of radical Islamic fundamentalism. For all these reasons Egypt merits U.S. help.

Washington must address Egypt's long-term economic problems, not just its short-term cash crisis. A U.S. cash transfusion would bleed rapidly through the twin hemorrhages of Egypt's trade and budget deficits. It only would postpone economic collapse unless Egypt instituted sweeping reforms.

Egypt's impending cash crisis is a symptom, not a cause, of its long-term economic predicament. To be sure, Washington should help Cairo relieve this symptom, but it should do so with the intention of administering a final cure. Washington has poured $20.3 billion in assistance into Egypt since 1974, yet Egypt remains in economic distress. A case can be made that aid even might be counterproductive if it sedates Cairo's sense of urgency in undertaking reforms.

Washington's help in easing Cairo's cash crisis should be linked to an Egyptian commitment to overhauling its economy. Only internal reforms, not external aid, can resolve Egypt's difficulties. At best, U.S. aid can provide a cushion to ease the transition to a system in which market forces stimulate growth, enhance productivity, and reduce waste.

Short-Term Assistance

U.S. aid to Egypt in fiscal year 1985 totaled $2.48 billion including a $250 million emergency grant pushed through Congress in conjunction with emergency aid to Israel. The Egyptians seek aid parity with Israel, particularly in receiving more of their aid in the form of cash grants. While federal budget constraints prevent the Reagan Administration from even considering more aid to Egypt, a greater share of current aid could be given as cash grants rather than project aid. This would give Egypt more flexibility in spending the U.S. funds. The Reagan Administration should make it clear to Cairo, however, that this restructured U.S. aid depends on Egyptian commitment to basic economic reforms.

Egypt has requested relief from the interest rates that it pays on its $4.55 billion military loans from the U.S. Accumulated from 1977 to 1984 under the Foreign Military Sales (FMS) program, this debt carries interest rates of 12 to 14 percent reflecting the high interest rates of those years. These FMS loans are repayable over 30 years, with the first ten years constituting a grace period in which only interest is paid. Although the FMS program has been operated on an all-grant basis since 1985, Egypt owes $555 million in 1986 to cover interest and a 4 percent penalty on overdue payments. Egypt chronically has missed deadlines on repayment and is in danger of triggering the Brooke Amendment, which requires all U.S. aid to be frozen to any aid recipient in arrears for twelve months or more.

Washington has resisted renegotiating Egypt's FMS debt because doing so would open a Pandora's box of problems. There are more than $18 billion of outstanding FMS loans to various countries. A renegotiation of Egypt's loans would lead other borrowers to seek similar treatment. Another option would be to refinance Egypt's FMS debts through commercial banks. This would lower Cairo's debt burden by taking advantage of today's lower interest rates. Bankers Trust reportedly is leading discussions about lending Egypt the money to pay off its FMS loans. But any such deal probably would be contingent on U.S. government loan guarantees. This creates enormous problems because it would invite pressures for U.S. government loan guarantees of huge Third World debts to U.S. banks. If no other solution is possible, it would be preferable to renegotiate Egypt's FMS loans rather than give loan guarantees. The scale of any debt relief plan should be calibrated to match the scope of Egypt's implementation of economic reform.

Another possibility for resolving Egypt's overall foreign debt problem would be a debt/equity swap. Egypt could, in effect, sell public sector enterprises to foreign creditors, who would accept a share of ownership in newly privatized firms in return for retiring Egypt's debt. Debt/equity swaps are an increasingly promising means of dealing with Third World debt. Although Egypt may be sensitive about comparisons to the 1875 British purchase of Egyptian shares in the Suez Canal, this option merits consideration.

Long-Term Policy

U.S. assistance will be wasted unless Egypt puts its house in order by making structural economic reforms:

- Egypt should move toward a free market economy to improve its balance of trade and spark economic growth. Domestic prices must be realigned more closely to world prices to minimize waste and enhance efficiency. Price controls on agricultural products should be lifted to give farmers maximum incentive to raise production.

- Egypt should limit consumer subsidies to those with a genuine need for them. The U.S., moreover, should press Egypt to follow through on Prime Minister Lutfi's goal of raising salaries and cutting subsidies gradually.

- Egypt should move from a strategy of import substitution to an export orientation by developing labor intensive industries in which it has a comparative economic advantage. The recent establishment of a General Motors automobile assembly plant is an important test case that could become the wave of the future. The government should bolster the private sector by privatizing public sector enterprises and streamlining bureaucratic procedures.

- Investment should be encouraged by giving potential investors concrete assurances against future nationalizations. Because of Nasser's nationalizations, Egyptian investors, for good reason, have neglected long-term capital investment in favor of quick capital gains. By constructing a free market economy, Cairo can tap into billions of dollars of savings that Egyptians have hidden from the government.

- Washington could purchase Egyptian oil for use in the Strategic Petroleum Reserve whenever possible, as it also is doing for hard-pressed Mexico. The U.S. also should urge its European allies to substitute Egyptian oil for Libyan oil.

- Washington should reduce the visibility of its official presence in Egypt. The U.S. Embassy in Cairo is now the largest American embassy anywhere. A high American profile is a too convenient lightning rod for Muslim fundamentalists and further strains bilateral Egyptian-American relations.

- Washington must encourage Japan and Western Europe to increase aid to Egypt. Japan and Western Europe should further reward Egypt for making peace with Israel. Extensive Japanese and West European dependence on Middle Eastern oil makes their economic stake in Middle East stability equal to, if not greater than, that of the U.S.

- The U.S. must work to broaden the Camp David accords to include responsible Palestinians and receptive Arab states. This not only will reduce Egyptian fundamentalists' ability to exploit the issue of a "separate peace" with Israel, but will maximize Egypt's opportunity to play a stabilizing regional role.

CONCLUSION

Because a significant boost in U.S. aid is precluded by Gramm-Rudman constraints on the federal budget, Washington cannot unilaterally rescue Egypt. But actually this is a blessing. A U.S. bailout would only postpone Egypt's economic collapse unless it were accompanied by a radical overhaul of Egypt's sluggish socialist economy.

Washington can help ameliorate Egypt's short-term cash crisis, but only Cairo can resolve Egypt's long-term economic predicament. The U.S. should offer help in reducing Egypt's debt burden but should tie its aid to an Egyptian commitment to undertaking genuine economic reforms.

James A. Phillips
Senior Policy Analyst