# Egypt Economic Outlook

**Macro Fiscal Policy Unit**

**Ministry of Finance**

**Cairo, Egypt**

**September 2008**

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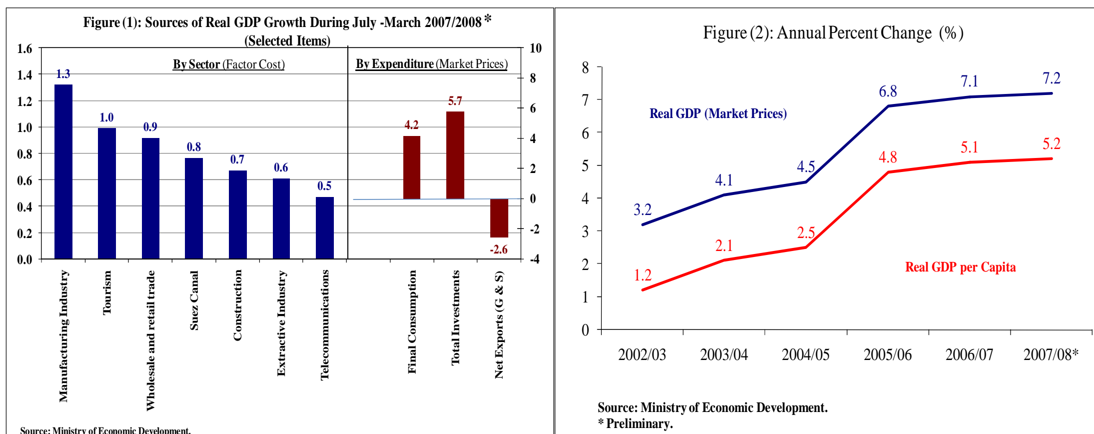
# EGYPT ECONOMIC OUTLOOK

## Robust Growth Outlook

The Egyptian economy achieved real growth of 7.2% during FY 2007/08, close to its level in 2006/07, but up from the 4.1% achieved just half a decade ago in 2003/04. Real GDP per capita income also increased by 5.2% in 2007/08, compared to just 1.2% half a decade ago. Signs of increased productivity in the Egyptian economy are also noted. Unemployment continued declining to less than 8.4% in last quarter of 2007/08 from 8.9% in 2006/07, and down from 11.1% in 2003/04. As identified by a recent IMF mission to Cairo, such growth is *"broad based and robust"*, with investments leading this economic wave starting FY 2005/06. The economy is also gaining momentum and diversity. The accumulation of a strong and advanced capital base, as reflected in the breakdown of FDI and structure of commodity imports and exports, reflect a major structural change in the drivers of economic growth in Egypt, and signal for sustained economic and exports growth over the medium and long term.

As such, the government is committed to progress on its far reaching institutional and structural reforms agenda, and implement policies that pursue sustained economic growth of average 7 percent over the coming years, while achieving fiscal consolidation and preserving social stability.




*Breakdown for 2007/08 full year not available

**Fiscal Consolidation Program: Minor Reengineering, while Still on Track**

Without jeopardizing political and social stability, fiscal reforms are on track. The government reiterates its commitment to reducing the budget deficit to some 3% of GDP by end of FY 2010/11 despite challenging international financial and economic conditions, unfavorable developments in the international commodity prices (food, basic inputs, and energy), and the ensuing necessary domestic wage adjustments and increased subsidies outlays. Such fiscal target was clearly emphasized in the Fiscal Policy Speech addressed by the Minister of Finance during the discussions of the 2008/09 budget in the Parliament. They were also reflected in the 2007/08 preliminary budget outcomes which reveal an improved overall deficit of 6.8% of GDP compared to 7.5% of GDP a year earlier, and a budget target of 6.9% of GDP. This improvement was achieved in contrast to deteriorations witnessed in the budget results for several economies in consequence to those pressures.

Tax policies will continue to support economic activity, improved business environment, and serve as an effective vehicle for better income redistribution across the various social groups. Tax buoyancy is improving too, and is expected to further progress with planned reforms in the sales tax area, besides limited amendments to the income tax code aimed at reducing tax planning and further promoting taxpayers compliance. Recently, the Parliament approved a new Real Estate Tax Law. This new law is believed to have significant potential for large and sustainable revenue windfalls over the medium and long term. Customs reforms are progressing, and will continue playing a pivotal role in promoting Egypt's foreign trade; a main bloc in the country's growth framework. Further, public treasury functions are advancing, and will help reduce the cost of government funds, while promoting financial sector development.

**The International Price Shock**

Like other small open economies, Egypt was hard hit with the ongoing wave of unprecedented world price increases of food, energy, and other primary goods. As described by many observers, such a wave is nearly unmatched in terms of its magnitude, length, and nature; hitting both supply and demand sides simultaneously, while further fueled by declining global growth prospects, significant turbulences in

major world economic centers and financial markets, and large speculations in commodities futures markets.

The impact of the recent price shock was most significant on the middle and lower income groups in the Egyptian society. On average, Egyptians spend some 45 percent of their incomes on food items; reaching some 60 percent for the lowest quintile. This brought the budget under hard pressures and required additional resources to alleviate the impact of such price shock on the most vulnerable social groups and to preserve social and economic stability.

As such, the Egyptian Parliament endorsed Law number 114/2008 with the objective of enacting sustainable revenue measures to offset the additional budgetary outlays associated with higher spending on wages, pensions, and food subsidies in excess to what was originally proposed in the government's 2008/09 draft budget. A total bill of 14.4 billion pounds was passed on May 5th, 2008, with a reduction in energy subsidies (LE 7.5 billion)[1], an increase in sales tax on cigarettes (LE 1.3 billion), higher fees on vehicle licensing (LE 1.1 billion), higher fees for the use of cement raw materials (LE 1 billion), and elimination of selected income tax exemptions (LE 3.5 billion).

This bill will raise renewable resources to finance the additional costs associated with adjusting the government employees base-wage scheme (some 5.9 million employees)[2], paying higher pensions, as well as disbursing additional amounts of rice, sugar, and edible oil through the rationed cards system. President Hosni Mubarak announced an increase of 30% to the basic pay for all government employees effective May 2008[3]. In addition, an adjustment to the minimum *incentives payment*s directed to local government employees (3.4 million employees) was enacted to raise the minimum take home salary of the lowest paid government employees [4] . Monthly

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1 It is noteworthy that the government has taken several measures to reduce energy subsides during the past few years. The last move was in September 2007, with the Prime Minister decree 1914/2007 which doubled fuel oil prices, and adjusted the price of natural gas for energy intensive industries to international levels over three phases ending 2009.

2 Includes employees in the government sector, and economic authorities.

3 On average, basic pay represents 25-33 percent of the total take home salary.

4 It is unlikely however for the *private sector* to witness similar wage increases for two reasons: *first*, the private sector has already gone through major wage adjustments over the past 12-15 months, which therefore makes any likely increases relatively smaller; and *second*, the 30% increase to the government employees' basic pay is not compulsory to the private sector. In this regard, the Ministry of

pensions were also increased by 20% (with maximum LE 100). The total budgetary cost for wages and pensions adjustments are estimated at LE 2.1 billion in 2007/08 (0.2% of GDP), and at LE 12.8 billion in 2008/09 (1.3% of GDP), whereas additional food subsidy costs are estimated at LE 0.2 billion in 2007/2008, and LE 1.6 billion for 2008/09 (some 0.16 percent of GDP). Thus, the introduced social package will be budget neutral (or may possibly reveal some net revenues) and will not change the government's originally presented deficit target. It therefore sustains the announced medium-term fiscal consolidation program, while maintaining an adequate social and economic balance, and sets a good reference case for policy-makers in response to such pressures.

**Table (1): Fiscal Implications of Increased Wages, Pensions, and Subsidies Bills**

| Additional Cost | 2007/08 | 2008/09 | Financing Sources | 2007/08 | 2008/09 |
|---|---|---|---|---|---|
| Increasing monthly take home salary by 30% of base wage | 1.1 | 6.2 | Reducing energy subsidies and increasing sales tax on petroleum products | 1.3 | 7.5 |
| Increasing maximum rewards for local government employees to 75 | 0.4 | 3.0 | Increasing sales tax on cigarettes | 0.2 | 1.3 |
| Disbursing additional quantities of rice, edible. oil, and sugar on 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** |

* Recent revisions suggest that the above programs may reveal higher revenues than originally anticipated.

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Labor and Migration assured private entities to decide on the proper wage increase according to their own circumstances.

**Fiscal Balances for FY 2007/08 and 2008/09 are set on a Stabilizing Mode**

**2007/08 Preliminary Outturns**

Preliminary results for FY 2007/08 reflect continued improvements in the main fiscal indicators. The overall deficit for 2007/08 dropped further to 6.8% of GDP down from 7.5% of GDP in 2006/07, and compared to 6.9% as targeted in the year's original budget. The primary deficit was close to its previous year's level at 1.0% of GDP, but down from 3.5% just three years ago. This improvement occurred despite increased social-related outlays which took place in 2007/08 as mentioned, and also in spite of larger exceptional revenues windfalls realized during 2006/07 compared to 2007/08[5]. Nevertheless, excluding such exceptional flows from both years' outcomes, the *underlying deficit* for 2007/08 records an improvement of some one percentage point of GDP compared to 2006/07 outturns. (Figure-3) [6].

Meanwhile, debt indicators improved significantly. Total *gross* debt of the budget sector entities[7] was reported at 82% of GDP as of end June 2008; about 14 percentage points lower than its ratio a year earlier, and some 38 percentage points below its ratio in 2004/05 at 121% of GDP. Total *net* debt also declined by some 12 percentage

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[5] 2006/07 witnessed large exceptional receipts from the sales of the third mobile license. Those stand at nearly double the one-off receipts recorded in 2007/08 from the sales of cement and steel licenses and permits to use 3G technologies in mobile phones. Meanwhile, both years' budgets were burdened with necessary exceptional outlays, mostly related to the restructuring of main public entities, including Egypt Railways.

[6] In related developments, the general government budget recorded an overall deficit of 7.7% of GDP, similar to its level in 2006/07, yet, lower than the deficit achieved in 2005/06 at 9.2% of GDP . The cash deficit which excludes net expenses primarily related to portfolio management decisions was reported at 6.5%, close to its average during the past five years.(Figure-4). Meanwhile, total gross debt to GDP for the general government declined in 2007/08 to some 72% of GDP compared to some 82% in 2006/07, whereas the total net debt to GDP declined by some 8 percentage points to 58% of GDP. (Figure-4).

The General Government is a broader consolidation level of the budget. It consolidates the financial operations of the budget sector entities (central government, local governments and services authorities), National Investment Bank (NIB), and Social Insurance Funds (SIF).

It is noteworthy that the general government deficit may depart significantly from the budget sector deficit outturns. This is primarily explained by the investment decisions that may be taken by NIB and SIF related to managing their portfolios, which are independent from the fundamental budget operations of the government budget. NIB and SIF acquisition of financial assets from non-budget sector entities, or NIB lending activities to such entities, are recorded as outlays on the general government books, and therefore widen its deficit compared to the budget sector outcomes. The sales of financial assets by either entity, or reimbursements to NIB will have an opposite impact on the general government deficit.

[7] Domestic and foreign debt.

points during the last year to 68% of GDP, and down from 92% of GDP in 2004/05. This occurred on the back of improved revenues, lower effective borrowing needs (as percent of GDP), and implementation of a recent agreement between MOF and CBE to integrate the Paris Club 1991 blocked account in domestic debt calculations[8]. (Figure-3).

Building on such advancing economic performance, ongoing structural reforms, and improved taxpayers compliance, total revenues increased by more than 21% in 2007/08 over the previous year's receipts to LE 219 billion (25% of GDP). Total tax revenues increased by one-fifth to LE 137 billion (15.8% of GDP). Income tax receipts increased by 14.6% to some LE 67 billion, in light of higher corporate tax receipts which increased by 13.5% to LE 16 billion. It is noteworthy that excluding a one-off tax settlement which took place in 2006/07, corporate tax receipts report a notable increase of 45% during 2007/08.[9] Tax receipts on salaries increased by 11.5% to some LE 7 billion in light of higher wages and improved reporting. In addition, taxes on goods and services increased by 27% to some LE 50 billion (5.7% of GDP), due to higher economic activity and recent reforms in the stamp duties area. Further, taxes on international trade increased by 35% to some LE 14 billion (1.6% of GDP). Lastly, non-tax revenues increased by 29% to slightly higher than LE 80 billion (9.2% of GDP), counting primarily on higher dividends from Suez Canal and EGPC.

On Expenditures, preliminary results for FY 2007/08 reveal a year-on-year increase in total expenditures by some 25% (LE 55.4 Billion) to some LE 277 billion (32% of GDP). As mentioned above, this went in tandem with adjusting the base-wage structure of government employees and increased allocations to subsidies and social benefits programs to shield the poorer segments of the society from the negative global spillovers and to ensure social stability. As such, the total wage bill increased over the original budgeted figures by LE 1.4 Billion (0.16% of GDP) to some LE 62 billion (7.1% of GDP). Nevertheless, wages - as a percent of GDP - were successfully put on a declining trend over the past few years; falling from 8.1% of GDP in FY 2001/02 to 7.1% in FY2007/08.

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[8]According to this agreement, MOF retired outstanding government debt with CBE with total value of LE 39 billion.

[9] The corporate sector in this analysis excludes economic authorities such as Suez Canal Authority, EGPC, and others.

Subsidies, grants and social benefits, increased over last year's outcomes by 58% to some LE 92 billion (10.6% of GDP), and by 3% of GDP over the original 2007/08 budget estimates to account for higher international energy and food prices as well as increased pensions benefits[10]. Despite 2007/08 energy subsidies increases by some 50% over previous year's allocations, it is important to note that a large content of the fuel subsidies bill is offset by higher tax and dividends receipts from EGPC; making such burden more affordable by the budget[11]. Similar to the case in wages, total subsidies to GDP declined from 8.8% of GDP in 2005/06 to 7.4% of GDP in 2006/07, and would have been expected to further decline in 2007/08 had it not been adjusted for the negative global spillovers and higher energy prices.

Interest payments on debt declined by 0.7 percentage points to 5.8% of GDP; down from 6.5% of GDP in 2006/07. Government investments and other spending outlays increased by 26% and 9% respectively, to stand at LE 32 billion (3.7% of GDP) and LE 23 billion (2.7% of GDP). Finally, the government contained spending on purchases of goods and services close to FY 2006/07 outcomes at LE 17.4 billion, growing by only 2.3% year on year.

## 2008/09 Targets

The overall budget deficit is set to stabilize in the new fiscal year 2008/09 at 6.9 percent of GDP, close to the preliminary outturns in 2007/08 [12]. The primary deficit is expected to increase to 1.7% of GDP. Expected reforms in the sales tax law will give a notable thrust to government revenues in the neighborhood of 2 percentage points of GDP annually, and thus reducing the overall deficit by the same extent[13]. Tax buoyancy will also improve in light of awaited amendments into the income tax law that will help improve tax compliance.

[10] Subsidies stand at LE 84.2 billion (9.7% of GDP).

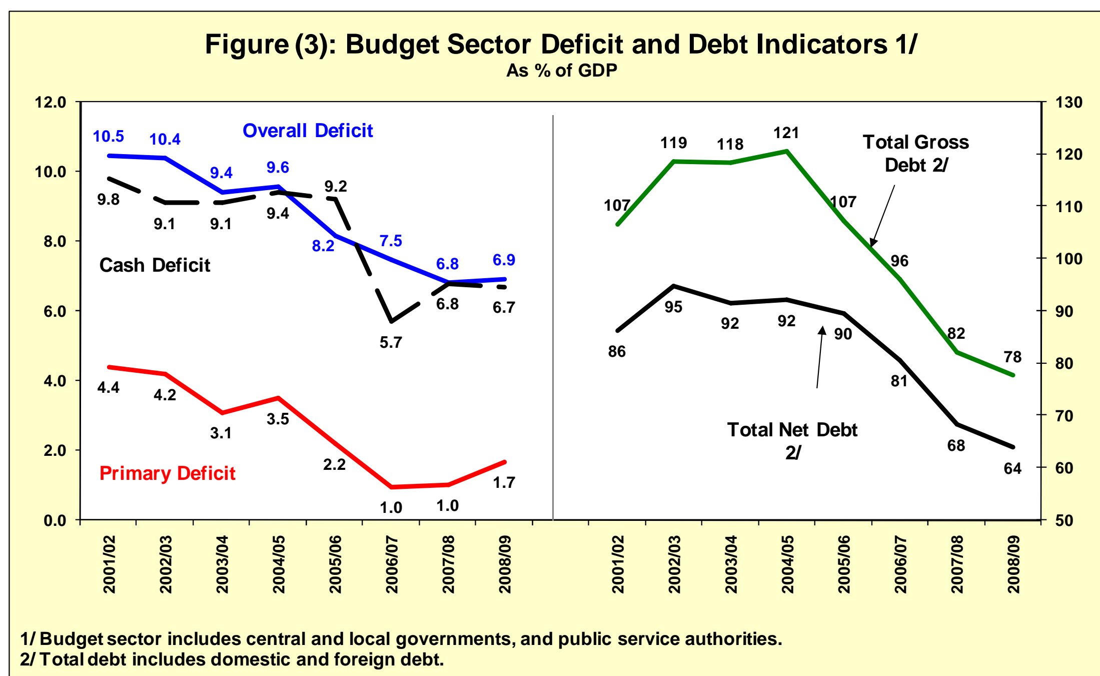
[11] EGPC stands for the Egyptian General Petroleum Corporation.

[12] The budget approved by the Parliament is valued as a *"baseline budget"* as it excludes any expected additional receipts from measures still in the pipelines such as sales tax reform, the new property income tax (which was ratified by parliament after the draft budget was presented), or proposed amendments to the income tax law (aiming towards reducing tax avoidance and improving its buoyancy).

[13] The New sales tax law is expected to become effective in late FY 2008/09 or beginning of FY 2009/10.

Meanwhile, the overall debt is expected to continue improving, with total gross debt of the budget entities estimated to decline to some 78% of GDP compared to 82% for FY 2007/08 preliminary results, and down from 121% of GDP in FY 2004/05 as mentioned.

Total revenues are expected to increase by some 27% to LE 277 billion (27.5% of GDP), on the back of further improved tax revenues, higher dividends and taxes from the oil sector and Suez Canal, and a financial settlement with the social insurance funds with an equivalent reflection to this value on the expenditures side. Total expenditures will also increase by 24% to LE 344 billion (34.1% of GDP), due primarily to the above mentioned financial settlement between the budget and the social insurance funds, increased subsidies, and higher wage adjustments to alleviate the burden of the recent international developments on the most vulnerable social groups. As mentioned in the previous section, the increase in wages, pension benefits and subsidies outlays are deficit neutral. (Table-2)



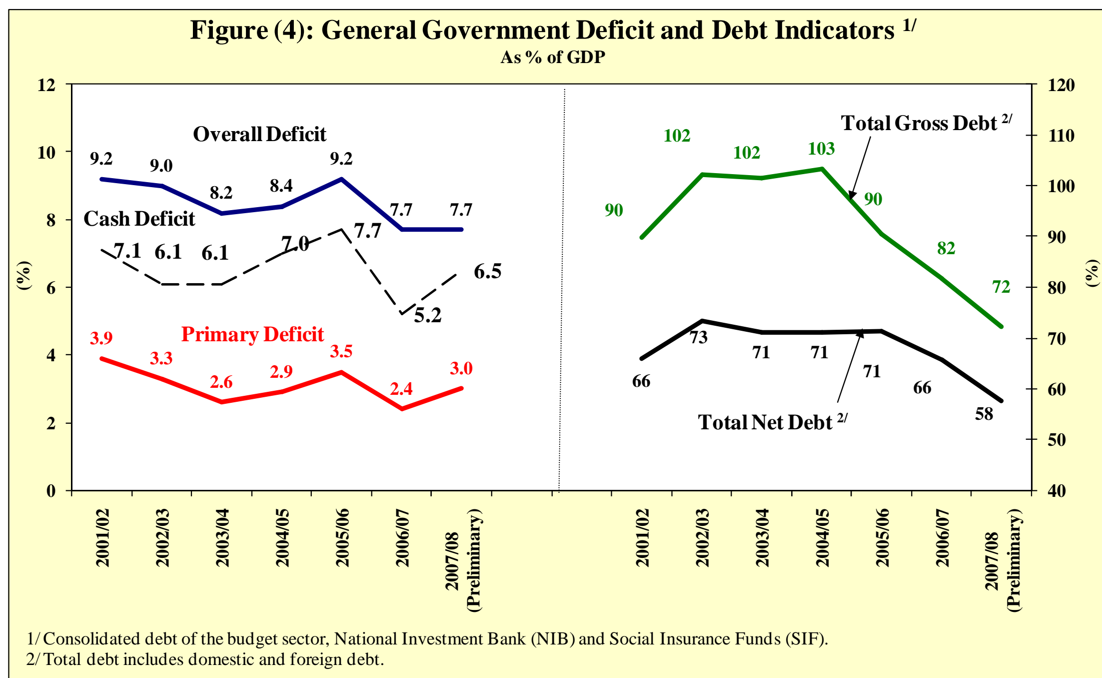



**Table (2): Summary of Government Fiscal Operations For FY 2007/2008 In Light of the Application Of Law No. 114 Of 2008, and for FY 2008/09**

In LE Millions

| | 2006/2007 | 2007/2008 | | 2008/2009 | |
|---|---|---|---|---|---|
| | ACTUAL | Approved Budget | Preliminary Actual Outturns | Approved Budget Figures | Annual Percent change * |
| **Total Revenues and Grants** | **180,215** | **187,239** | **218,500** | **276,795** | **27%** |
| Tax Revenues | 114,326 | 120,824 | 137,378 | 166,569 | 21% |
| Grants | 3,886 | 3,166 | 971 | 5,557 | 472% |
| Other Revenues | 62,003 | 63,249 | 80,151 | 104,669 | 31% |
| **Total Expenditures** | **222,029** | **244,061** | **277,432** | **343,913** | **24%** |
| Wages and Salaries | 52,153 | 60,344 | 62,062 | 79,039 | 27% |
| Purchases of Goods and Services | 17,028 | 16,945 | 17,416 | 23,833 | 37% |
| Interest Payments | 47,700 | 51,979 | 50,395 | 52,930 | 5% |
| Subsidies, Grants and Social benefits | 58,442 | 64,280 | 92,276 | 134,062 | 45% |
| Other Expenditures | 21,208 | 22,864 | 23,188 | 25,788 | 11% |
| Investments | 25,498 | 27,650 | 32,095 | 28,261 | -12% |
| **Cash Deficit** | **41,815** | **56,823** | **58,933** | **67,118** | **14%** |
| **Net Acquisition of Financial assets** | **12,883** | **1,946** | **302** | **2,674** | **--** |
| **Overall Deficit** | **54,697** | **58,769** | **59,234** | **69,792** | **18%** |
| **GDP** | **731,202** | **846,800** | **870,000** | **1,008,000** | **16%** |
| **Cash Deficit In Percent of GDP** | **5.7%** | **6.7%** | **6.8%** | **6.7%** | **--** |
| **Overall Deficit In Percent of GDP** | **7.5%** | **6.9%** | **6.8%** | **6.9%** | **--** |

*** FY 2008/09 budget over FY 2007/08 preliminary actual.**
**-- Not applicable.**

## Monetary and Banking Sectors

Meanwhile, monetary and banking policies are on track. The CBE continues on strengthening its monetary policy management framework and banking supervision capacity, while progressing simultaneously towards building necessary fundamentals for applying a formal inflation targeting scheme when appropriate. With stable macroeconomic policies, liberalized foreign exchange system, increasingly active and deepening inter-bank market, declining budget deficit, and advancing financial sector, monetary policy is gaining greater flexibility, while most of the main blocs needed for implementing inflation targeting are advancing.

The ongoing major financial restructuring of the banking system, lead by a significant cut in public sector companies' non-performing loans (by more than two thirds), privatization of public stakes in joint ventures and increased competition in the banking sector (helped by internationally sound new entrants), and enhanced confidence, led to a revival in banking intermediation after years of lingering. Credit growth to the private sector during the year ending June 2008 increased by 12.6 percent[14], up from 4.5 percent in June 2004 for instance. This comes at a time when public sector companies' non-performing loans were being settled with their main bank debtors. Meanwhile, net foreign assets of the banking sector increased by 39% for the twelve month period ending June 2008 to US$57 billion (35% of GDP), whereas dollarization in broad money continued declining to 20.8 % in June 2008, down from 23% a year earlier and 28.4% in June 2004.

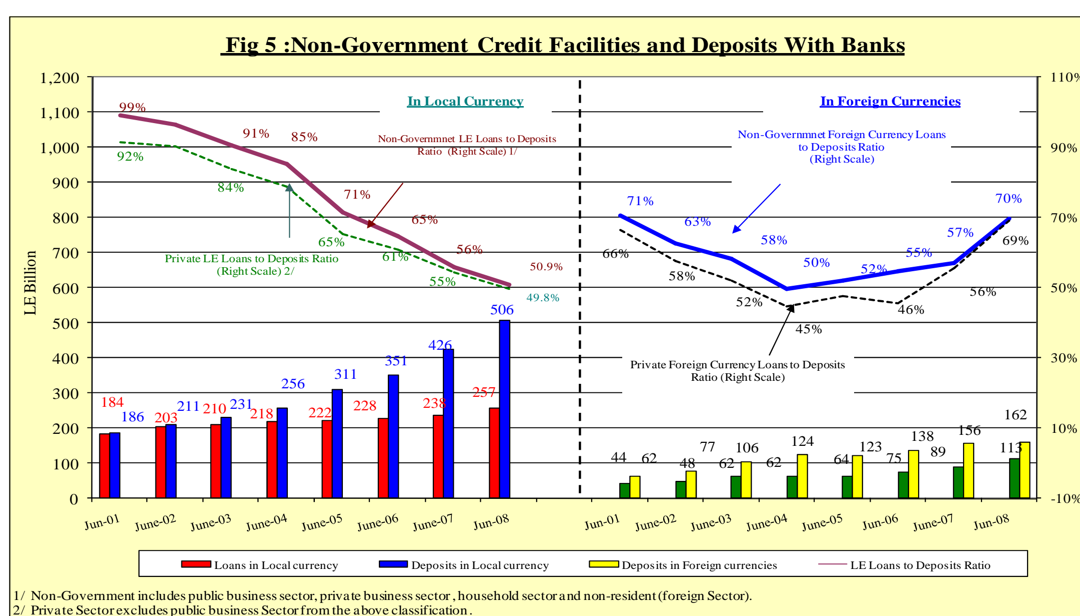



Fig 5 :Non-Government Credit Facilities and Deposits With Banks

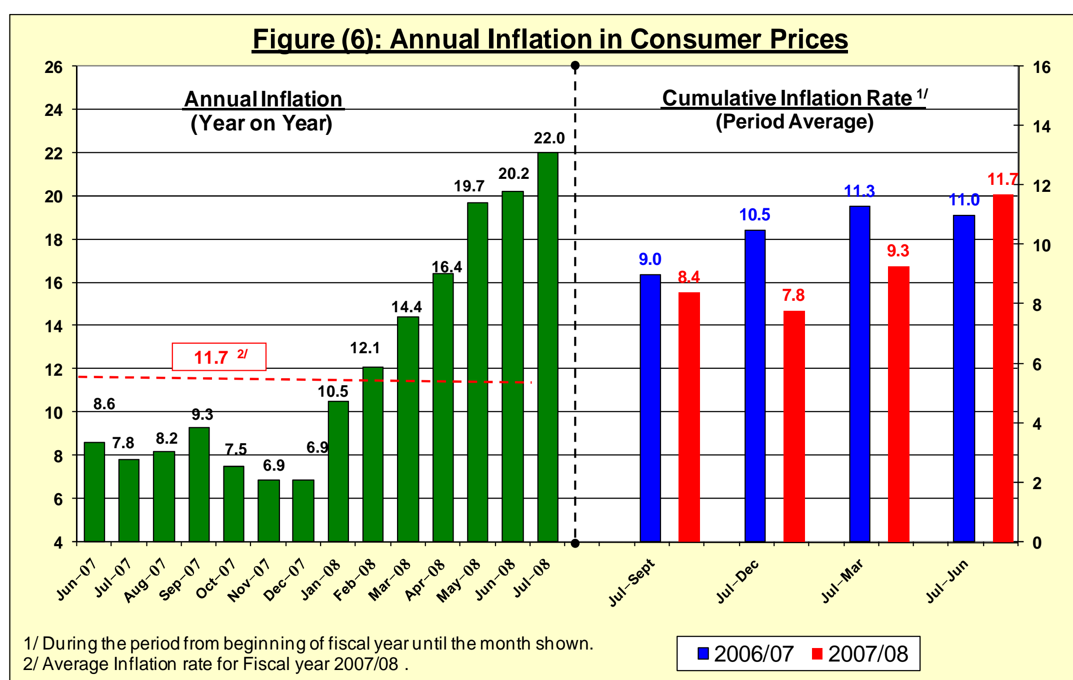
1/ Non-Government includes public business sector, private business sector, household sector and non-resident (foreign Sector).
2/ Private Sector excludes public business Sector from the above classification.

[14] And nearly 13 percent on average for the twelve months to June 2008.

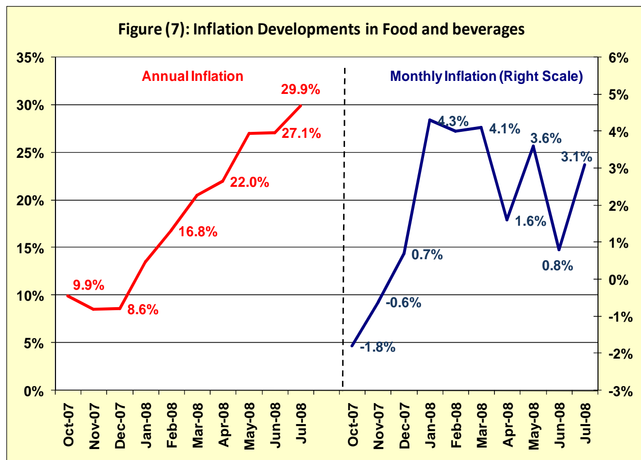
## Inflation Pressures are Mostly Transitional and Policy Response Stands Firm

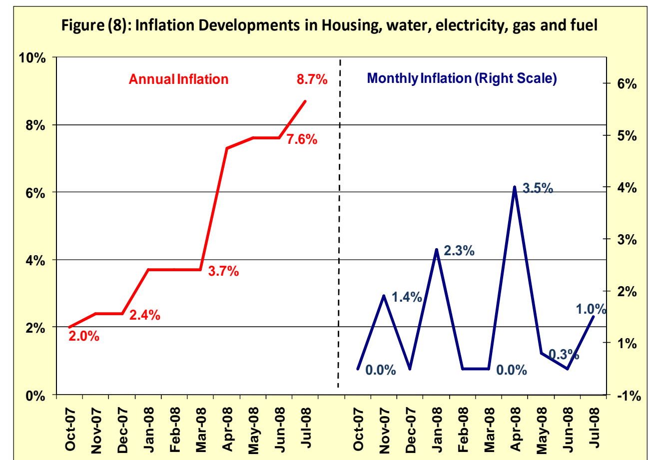
Average annual inflation for FY 2007/08 recorded 11.7%, where it is mostly reflected in domestic price increases of energy, basic food items, and primary goods. This compares to an average inflation of 11% a year earlier.[15] Although the current inflationary episode is mostly imported and of cost-push origins, CBE is taking necessary measures to address possible domestic demand-driven inflation.

The government closely monitors the drivers of domestic inflation, and is aware that the current inflationary wave, regardless of its origins, represents a main challenge to the country's economic progress and policy stance. As the case with earlier successfully dealt with double-digit inflation episodes during this decade, the government reiterates its commitment to address such challenge within economically and socially viable policies to bring inflation rates down. Such policies include: advancing structural reforms on all fronts aiming to further improve the business environment, domestic market dynamics, and promote sustainable growth of average 7% over the medium term; continuing fiscal consolidation to bring the overall deficit down to some 3% of GDP by year 2010/11; as well as enhancing the utilization of the fiscal and tax tools as effective vehicles to achieve better income redistribution amongst the different social groups.




[15] Egypt's average inflation over the past three fiscal years is some 8.7%.

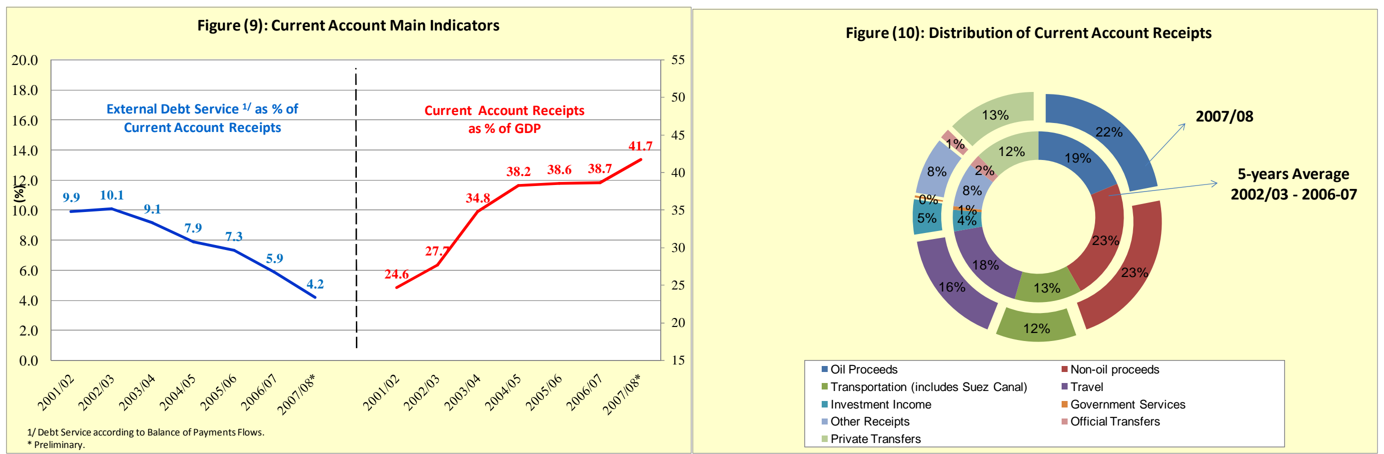



## Diversified and Vibrant External Sector

Egypt's external position is robust as indicated by a healthy and strong growth of exports of goods and services as well as large foreign direct investments (FDI) inflows, mostly in Greenfield areas. The overall balance of payments maintained a surplus of some 3.4% of GDP during FY 2007/08, with net FDI recording US$ 13.2 billion, up from US$ 11 billion in 2006/07 and more than double its level in 2005/06. The current account remained in a small surplus of 0.6% of GDP, compared to an average of 2.7% of GDP over the period 2002/03-2006/07, in light of increasing imports volumes and fueled by higher international prices[16]. Non-oil exports increased by 25% to slightly less than US$15 billion, and remain the country's largest source of foreign exchange current flows, recording some 23% of total current account receipts, followed by hydrocarbon exports (22%) and tourism (16%). Such structural change in Egypt's sources of foreign exchange from past trends; which were mostly dominated by oil exports, Suez Canal receipts, and later, tourism, affirms higher diversity and sustainability of the external sector.

[16] It is worth mentioning that the increase in imports over the past few years is consistent with increased investments ratios, building of a modern capital base, and accelerating growth. Statistics show that imports of capital and intermediate inputs stand for the major bulk of Egypt's imports reaching 70% of total imports.




Meanwhile, total external debt as percent of GDP continued declining to less than 22% of GDP in March 2008, whereas net international reserves increased by more than one-fifth to US$ 34.6 billion in June 2008 (21% of GDP); covering 7.9 months of commodity imports. Last but not least, total external debt service stands at only slightly higher than 4% of the country's current accounts receipts in 2007/08, down from some 10% of current receipts half a decade ago.

## In Conclusion

The Egyptian economy is expected to safeguard its growth momentum over the medium-term in light of improved institutions and higher resilience to external shocks. Real GDP growth is anticipated to average some 7% while progressing on widening its coverage of greater segments of the population and broader geographical areas. Egypt's strong external position, advancing fiscal consolidation, increasing investments, coupled with highly determined structural reforms agenda makes such sustained growth scenario quite plausible, while realizing fiscal sustainability and safeguarding social stability. Further, the healthy diversity in the economy's growth drivers, including manufacturing, construction, trade and services, telecommunication, tourism, and other sectors, contribute significantly to such outlook.

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