Egypt at a glance: 2006-07

OVERVIEW
The strong performance of the illegal Muslim Brotherhood in an unusually liberal parliamentary election held in late 2005 puts the Egyptian government in a difficult position. The group's members, standing as independents, won almost 20% of the seats (with 12 still to be settled), including more than half of those they contested—despite the fact that the regime turned to the apparatus of state and to violence to ensure that its own supporters prevailed in later voting. The Brotherhood is likely to focus its efforts initially on winning party status and will therefore probably not prove overly antagonistic towards the government's legislative agenda. The ruling National Democratic Party, in any case, secured around 70% of the seats, ensuring that the government will be able to pass legislation it deems necessary. The government is also likely to press ahead with the programme of economic reform launched by the cabinet of the prime minister, Ahmed Nazif, on its appointment in mid-2004, assessing that strong and sustainable economic growth that raises living standards is the best way to undercut the Islamists. However, there is a risk that the performance of the Islamists—which has revealed the extent of their appeal for the first time—may make the president, Hosni Mubarak, proceed more cautiously with potentially painful reforms, particularly as the Brotherhood, frustrated at the denial of legal status, becomes more assertive.

Key changes from last month
Political outlook
• The Economist Intelligence Unit's political outlook is unchanged.

Economic policy outlook
• Our economic policy forecast is unchanged.

Economic forecast
• We have revised upwards our forecasts for Egypt's fiscal deficit following the release of official data for fiscal 2005 (ended June 30th 2005). We now expect Egypt to post deficits equivalent to 10.4% of GDP and 9.4% of GDP respectively in fiscal 2006 and 2007. We have also revised upwards our forecasts for inflation, which is now expected to rise to 5.5% in 2006.
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Outlook for 2006-07

Political outlook

Domestic politics

In highly energised and unusually free parliamentary election, the outlawed Islamist movement, the Muslim Brotherhood, made major gains, calling into question certainties that have characterised Egyptian politics for decades. With 12 seats still to be settled, Brotherhood members, standing as independents, had won 88, or 20%, of the 444 elected seats (another ten MPs are appointed by the president, Hosni Mubarak), raising the group’s representation fivefold and making it by far the largest opposition force in the People’s Assembly. The legal opposition parties fared poorly, despite efforts to pool resources, winning just nine seats between them. The official candidates of the ruling National Democratic Party (NDP) won 145 seats (33%) before 166 NDP loyalists who had failed to secure the party’s official nomination but had stood successfully as independents rejoined the parliamentary party giving it 69% of the seats—well short of the 87% it held in the previous parliament.

The Brotherhood's performance was remarkable not only for the number of seats it won—eclipsing its level of representation in any previous parliament—but because of its success rate. It fielded only around 160 candidates and therefore won more than half of the seats it contested. This is in part because the group focused on districts where it felt it had the strongest support. Nonetheless, it also avoided antagonising the government by generally not standing against regime stalwarts and would almost certainly have won far more seats had it competed more widely. Moreover, perturbed by the early showing for the Brotherhood, the authorities abandoned their unusually liberal stance as the election progressed, resorting to the apparatus of state and to violence to ensure the success of its preferred candidates. Even though the turnout was only 26%, it is now difficult for the authorities to deny that the Brotherhood commands widespread support.

The Brotherhood's initial aim in parliament is likely to be to win party status. If it achieves this by late 2006 it will be eligible to put forward a candidate for the 2011 presidential election; with party status it will also feel able to field more candidates in the next parliamentary poll, allowing it to extend its influence through democratic channels. There is a small possibility that the regime may acquiesce, assessing that to do so would defuse popular anger and expose the group for lacking workable policies—the Brotherhood’s public proclamations lack detail, centring largely on its catch-all slogan “Islam is the solution”. To dilute the appeal of the Islamists, the government may also ease restrictions on the operations of the legal opposition parties, whose credibility has been badly damaged by years of failure to weaken the state's grip. Far more likely, though, is that the regime will resist granting the Brotherhood party status. Despite recent moves by Mr Mubarak to liberalise the polity—primarily by holding the country's first multi-candidate presidential election—the president's faith in and commitment to the process as an answer to the country's difficulties is highly questionable. Moreover, Mr Mubarak remains deeply mistrustful of the motives...
of the Brotherhood, stating repeatedly that the Islamists support democracy only as a means to win power.

Continued denial of party status for the Brotherhood carries risks. Over the past year the group has demonstrated its ability to mobilise supporters, and its leaders may be tempted to harness this backing to pressurise the government. This could lead to clashes with the security forces, ultimately posing a threat to stability. Another risk is that more dynamic members of the movement may press for a level of assertiveness that its ageing leadership finds uncomfortable, leading to splits, with some taking more direct, radical measures to press for change. However, in the near term at least, it is most likely that the movement will persist, in a united fashion, with its long-established policy of avoiding incurring the wrath of the regime—and the consequent risk that it may be severely repressed.

The near-term risks to the government’s policy agenda are therefore modest. The Brotherhood will be concerned to demonstrate its relevance to its support base and is therefore likely to oppose economic measures that carry a social cost, such as privatisation or rationalisation of subsidies or the bloated civil service. However, to maximise its prospects of winning party status it will probably avoid being overly antagonistic in parliament. In any case, the NDP’s solid majority should ensure the passage of legislation it deems necessary. Over the longer term, however, the risks are greater: the Brotherhood is likely to use parliament as a forum to criticise the government whether it is denied party status (out of frustration) or granted it (as it grows in confidence). Crucial to the government’s prospects for countering the appeal of the group will be its success in reducing economic grievances and maximising the benefits felt by the population of the process of economic reform.

**International relations**

Egypt has welcomed the opportunity to engage in efforts to restart peace talks between Israelis and Palestinians, an opportunity afforded by the tentative improvement in relations between the two sides since the demise of the long-standing Palestinian leader, Yasser Arafat, in November 2004. Egypt attaches great importance to achieving a peaceful outcome to the dispute, which it sees as having the potential to spill over from the immediate conflict. At stake, too, is Egypt’s wider influence in the region, which has historically stemmed from its close ties to the US, in turn based largely on mutual efforts to bring peace between Arabs and Israelis. However, ties with the US have degenerated as the involvement of Egyptians in the September 11th 2001 attacks has prompted unaccustomed scrutiny in the US of Mr Mubarak’s rule, and the Egyptian government has been alarmed by the ideological nature of the regional policies espoused by members of the US administration. Egypt’s relations with Israel have improved, with closer co-ordination over Israel’s withdrawal from the Gaza Strip and strengthening bilateral economic ties. However, the challenges facing peace efforts are immense. There is a strong possibility that unless the US engages fully in the process, trust will quickly ebb and violence will resume.
Economic policy outlook

Policy trends
The sharp deterioration in living standards in the early part of the decade, which stemmed largely from poor economic management under the government of the previous prime minister, Atef Obeid, was an important factor in generating opposition to the government, and will have contributed to the success of the Muslim Brotherhood in the recent parliamentary election. Some younger, more dynamic figures within the ruling establishment are likely to argue that an effective way to counter the Islamists would be to accelerate the programme of economic reform embarked on by the cabinet of the prime minister, Ahmed Nazif, which took office in mid-2004. This, they contend, would achieve more rapid, sustainable economic growth, which would raise living standards and, over the longer term, blunt the appeal of the Islamists. However, this is unlikely to occur, largely because it would imply a degree of social dislocation that the president, whose caution is well-established, would be uncomfortable with, and that the Muslim Brotherhood could readily exploit. Indeed, there is some risk that concerns over bolstering support for the Brotherhood may constrain the process of reform.

Overall, however, it is most likely that the government will persist with its current policy of measured reform, with the goal, in time, of raising the rate of growth and strengthening the capacity of the private sector to absorb the unemployed and thus take the pressure off the public finances. Key measures introduced so far have included sharp reductions in income tax rates and customs duties. The cabinet has also reinvigorated privatisation, launched a process of consolidation in the troubled banking sector, and begun to overhaul commercial legislation and tackle deeply entrenched bureaucratic constraints. There are risks to the cabinet’s approach, however. If commitment to reform flags, economic activity may not strengthen sufficiently—and privatisation might not accelerate enough—to offset revenue shortfalls caused by tax reforms, leaving the public finances in a more precarious state.

Fiscal policy
We have made substantial upward revisions to our projections for the fiscal deficit following the release of government outturn data for fiscal 2005 (July 1st 2004-June 30th 2005) as well as upward revisions to earlier deficits. New data show that the budget (central government) deficit widened markedly in fiscal 2005 to 9.3% of GDP, from 5.9% of GDP. Revenue was close to our estimates, but spending grew far more strongly than expected, driven by a surge in “other” outlays—in other words not wages, interest, defence or capital. It is not clear whether the revisions are the result of changes in methodology or of simple revisions following closer examination of accounts. In any case, the revisions have had a detrimental knock-on effect: we now project that Egypt will register a fiscal deficit equivalent to 10.4% of GDP in fiscal 2006. Customs receipts are likely to grow strongly—following a sharp decline in fiscal 2005 brought about by tariff cuts—as import volumes rise robustly. However, this will be more than offset by a decline in income tax receipts, as corporate and personal income tax rates are lowered sharply. Spending growth is expected to slow, in part as the government strives to rationalise payments on its social safety net (principally
on subsidies) as private-sector activity gradually picks up. Nonetheless, further relatively strong growth in expenditure is forecast, underpinned by large increase in public-sector wages—driven by presidential and parliamentary elections. Spending will also be pushed up by higher interest payments on domestic debt, as the debt stock continues to grow. The deficit is expected to narrow to 9.4% of GDP in fiscal 2007, as tax revenue growth accelerates along with strengthening economic expansion. The pick-up in private-sector activity will also ease government spending pressure.

The historical caution of the government over foreign borrowing makes it likely that the authorities will finance the deficits through local borrowing. This will cause the domestic debt stock, which has risen sharply in recent years, to continue to increase as a percentage of GDP. However, privatisation will accelerate, and part of the proceeds will be used to pay down domestic debt. Provided growth accelerates, the government should be able to meet its commitments and engineer an improvement in the public finances in the medium term.

**Monetary policy**

After years of poorly focused monetary policy, the Central Bank of Egypt (CBE), under the governorship of Farouk al-Okdah—appointed in late 2003—has introduced more coherence into monetary management. Mr Okdah has been more willing to raise interest rates on Treasury bills (kept low for government borrowing purposes) and other savings instruments—albeit not sharply—to counter inflation and support the Egyptian pound. Besides this, in an attempt to bring greater sophistication (and therefore predictability) to monetary policy, and move away from direct intervention, the CBE has introduced a range of new tools to influence monetary conditions and has begun to anchor its monetary policy in targeting inflation. However, the measures are likely to take time to bed down. As well as properly developed instruments, this will require significantly more sophisticated skills on the part of CBE personnel.
**Economic forecast**

### International assumptions summary

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Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

After peaking in 2004, the pace of global economic growth moderated in 2005 and is expected to slow further in 2006, before stabilising in 2007. However, the deceleration will remain modest. World GDP growth is projected to average 4% (measured using purchasing power parity weights) in 2006, slightly down on the 4.4% estimated for 2005 but still a strong rate of expansion compared with much of the 1990s. In 2007 growth is expected to slow further, averaging about 3.9%. The average annual price of the benchmark dated Brent Blend is expected to be little changed in 2006, at US$55/barrel, but is projected to decline to US$46.8/b in 2007.

**Economic growth**

Economic growth is expected to rise to 4.8% in fiscal 2006, from an estimated 4.1% in fiscal 2005. The attacks in Sharm al-Sheikh in July, which killed at least 64 people, are not expected to prove as damaging to tourism as the Luxor attack in 1997—as tourists have become more inured to violence—but they will still constrain expansion in exports of goods and services and, given the key role of the industry as an employer, hold back growth in private consumption to some degree. Nonetheless, growth in private consumption and investment should still pick up, as personal and corporate income tax rates are lowered. Investment will also be supported by increasing confidence, as the government presses ahead with legislative and administrative efforts to improve the business environment and as privatisation accelerates. Growth will be constrained by the declining expansion of government consumption, as private-sector activity picks up and the government makes efforts to rationalise spending. Imports will also continue to rise relatively strongly, holding back overall growth—although the expansion in purchases of capital goods bodes well for the future strength of the economy. In fiscal 2007 growth should accelerate to 5.2%, as business and consumer confidence firms once more and
businesses’ access to finance improves, generating a strong rise in investment and private consumption.

**Inflation**  
We have raised our forecasts for inflation to reflect outturn data that show that month-on-month price growth accelerated in the second half of calendar 2005. As a result, average consumer price inflation in 2006 is now expected to rise, to 5.5%. The increase is largely the consequence of strengthening domestic demand—stimulated by large cuts in income taxes. However, inflation should be constrained by the stability of the Egyptian pound against the US dollar (and other major currencies) as well as by a decline in average world non-oil commodity prices. In addition, the ongoing overhaul of the monetary framework should enable the authorities to control liquidity more effectively. These factors should allow the authorities to hold the average rate of inflation to 4.8% in calendar 2007.

**Exchange rates**  
As a result of strengthening foreign-currency inflows and major improvements in the policy framework, the Egyptian pound strengthened on the official market in late 2004—for the first time since its ten-year peg to the dollar was broken in early 2000—reversing an aggregate depreciation of 45%. Indeed, the situation has improved to the extent that the authorities have sought to prevent the pound appreciating too strongly (and thus undermining export competitiveness) by purchasing hard currency in the market. This has allowed a substantial build-up of foreign reserves since the start of the year, in turn bolstering the authorities’ ability to manage the pound effectively. Overall, we estimate that the pound appreciated to an average of E£5.78:US$1 in 2005, from E£6.20:US$1 in 2004. In 2006 we forecast that the pound will strengthen further, to E£5.72:US$1. This will mark an aggregate real appreciation of about 14% against the euro in 2005-06, but the competitiveness of Egyptian exports will not be much compromised given the extent of the fall in the pound since the start of 2000. In 2007, with confidence in the currency robust, we expect the authorities to manage a depreciation in order to support non-oil exports. However, the decline will be relatively small, with the pound averaging E£5.82:US$1.

**External sector**  
In calendar 2006 the trade deficit will narrow slightly to US$10.2bn, as an acceleration of gas exports will more than offset strong growth in import spending, bolstered by tariff cuts (introduced in late 2004), strengthening economic growth and a further depreciation of the US dollar. The non-merchandise surplus will narrow slightly as a strong recovery in tourism and further growth in inflows of workers’ remittances more than offsets a marked rise in gas-related profit repatriation. Consequently, the current-account surplus should widen slightly to US$2.7bn (2.5% of GDP) from US$2.4bn (2.4% of GDP) in 2005. In 2007 the trade deficit is forecast to widen markedly, as imports continue to rise relatively strongly, outweighing growth in exports, dragged down by a sharp decline in oil prices. This will more than offset a tourism-driven expansion of the non-merchandise surplus, and the current-account surplus is projected to contract to US$1.2bn (1.1% of GDP).
## Forecast summary

(\% unless otherwise indicated)

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<th>2004&lt;sup&gt;a&lt;/sup&gt;</th>
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<sup>a</sup> Actual.  <sup>b</sup> Economist Intelligence Unit estimates.  <sup>c</sup> Economist Intelligence Unit forecasts.  
<sup>d</sup> Recorded official unemployment as a percentage of total labour force.  <sup>e</sup> Ratio based on calendar year GDP; national accounts use fiscal year.