

The Sovereign Debt Crisis in EU and MENA: Mechanisms and Challenges

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Abstract

The European Union has been struggling with a crisis over the enormous debts faced by its weakest economies, such as Greece and Portugal, or those most battered by the global recession, like Spain and Ireland as a major consequence of the global financial crisis 2008. This led to a crisis of confidence as well as the widening of bond yield spreads and risk insurance on credit default swaps between these countries and other EU members, most importantly Germany.

The exact reasons for the deficits and the large debt levels differ between countries; in Greece's case, it is mainly the result of poor tax collection; in Ireland's, it is a consequence of having to support their banking system and in most of them, there has been a consumption and property boom made possible by the single European market and fuelled by the low interest rates that came with euro membership.

Due to global recession and Arab spring in MENA region, south Mediterranean countries such as Egypt face high debt levels as its public debt is 90% on February 2011 and expected to be higher by the end of the year which will require efficient tools to deal with the debt crisis.

This study seeks an analysis of the core causes, features and remedy tools of the European sovereign debt crisis. It investigates the financial and economic consequences of the debt crisis on their economies. This study investigates the responses by EU member state governments and the EU level institutions to the current sovereign debt crisis. The aim is to understand the nature of the crisis, the European response to it and its impact on the development process. The researcher intends to study various literatures as well as to examine the relevant theories of financial crisis and sustainable development. Finally, the lessons learnt from the European debt crisis will be applied on the MENA region in general with special reference to Egypt.

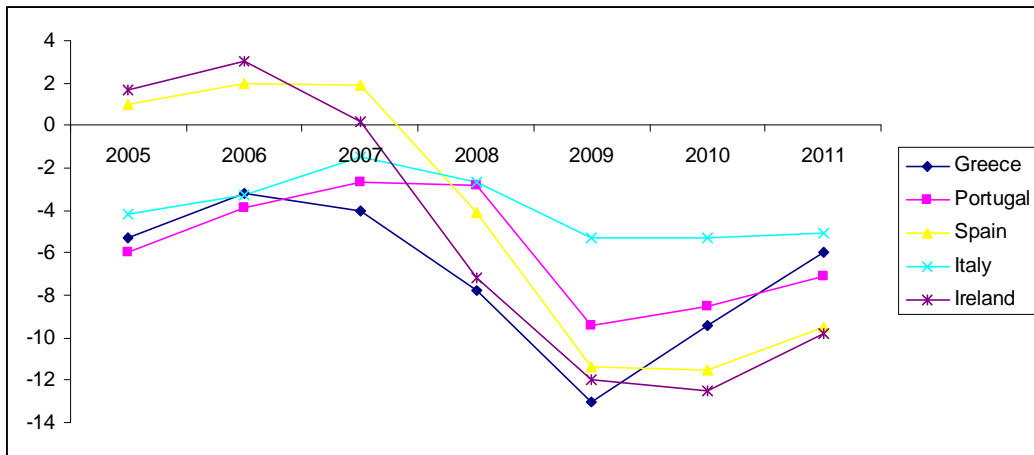
Key Words

Debt Crisis - Financial Crisis - Growth and Stability Pact - Fiscal Policy - Monetary Policy.

Introduction

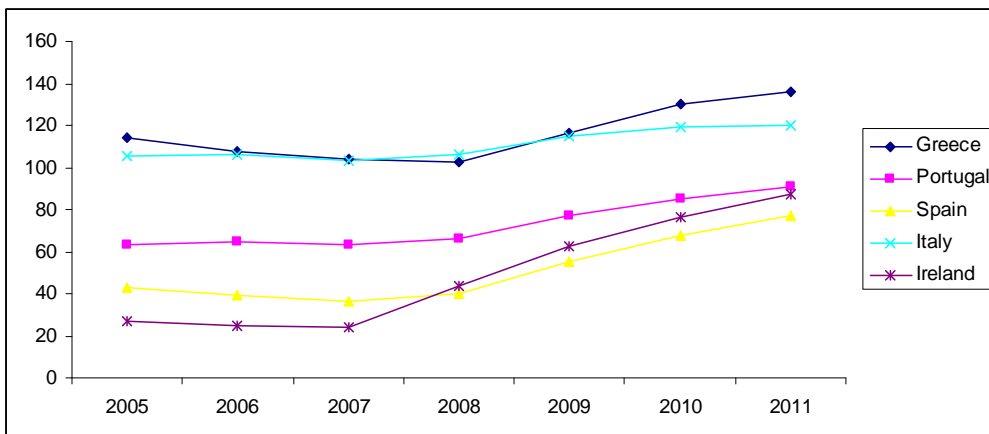
The European sovereign debt crisis has renewed the interest in European integration and the Euro by policy makers, central bankers and researchers alike. Although concerns about the future of the common European currency never completely ceased, the crisis has caused an unprecedented challenge to the Euro and has called into question the homogeneity of European countries on which the success of the monetary union is built. Consequently, the crisis is not just a financial crisis, but also a crisis of confidence in the strength of the monetary union.

Figure 1
Government Budget, % of GDP



Source: IMF (2011).

Figure 2
Public Debt, % of GDP



Source: IMF (2011).

I. Greece Debt Crisis

I.1 Causes

I.1.1. Global Recession

The global financial crisis that erupted in August 2007, following the collapse of the U.S. sub-prime mortgage market, initially had huge impact on Greek financial markets. The global recession resulting from the financial crisis put strain on many governments' budgets, including Greece's, as spending increased and tax revenues weakened (Jackson, 2010). Tourism and the shipping industry have been the Greek economy's strongest sectors which are declined hugely due to the global financial crisis.

I.1.2. Increasing Budget Deficit and Public Debt

During the period 2001-2009 the Greek economy was marked by growing, unsustainable fiscal and external imbalances. Since the adoption of the euro in 2001 till 2008, Greece's reported budget deficits averaged 5% per year, compared to a Eurozone average of 2% (World Economic Outlook, 2009). In 2009, Greece's budget deficit is estimated to have been more than 13% of GDP.

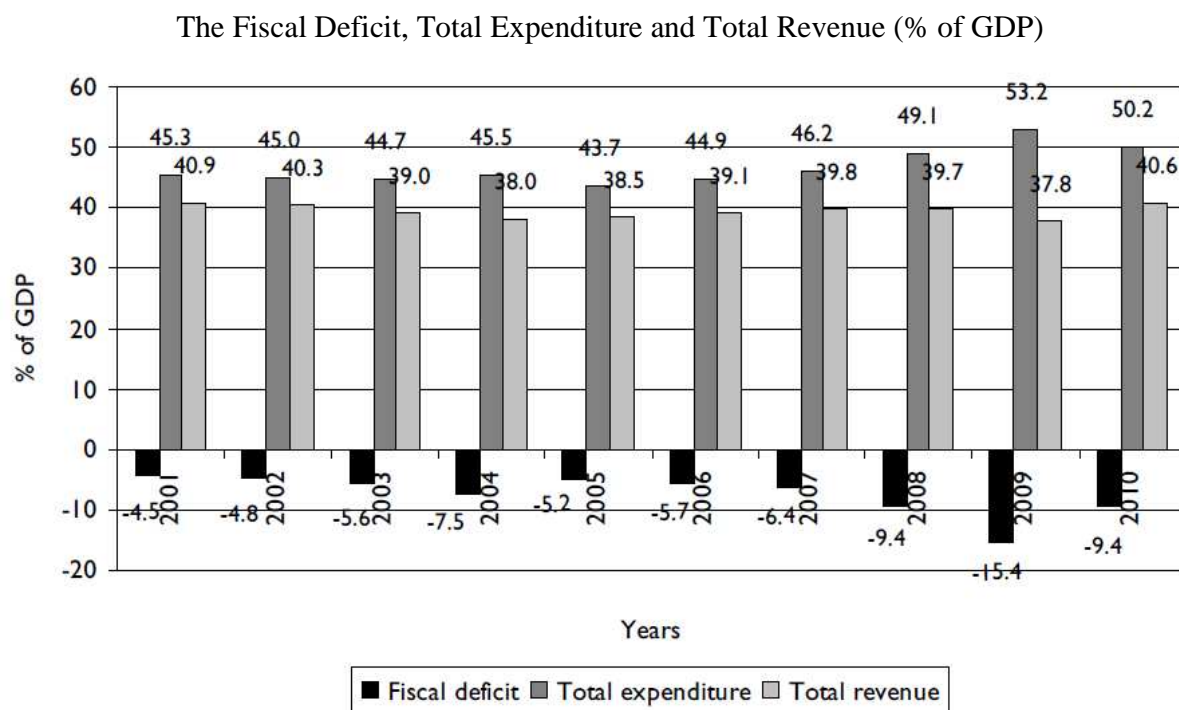
Greece funded these twin deficits by borrowing in international capital markets, leaving it with a chronically high external debt 116% of GDP in 2009 (Economist Intelligence Unit, 2010). Both Greece's budget deficit and external debt level are well above those permitted by the rules governing the EU's Economic and Monetary Union (EMU), commonly referred to as the Maastricht Treaty, calls for budget deficit ceilings of 3% of GDP and external debt ceilings of 60% of GDP. Greece is not alone, however, in exceeding these limits. Of the 27 EU member states, 25 exceed these limits (Europa, 2010).

In October 2009, Prime Minister George Papandreou, revised the estimate of the government budget deficit for 2009, nearly doubling the existing estimate of 6.7% of GDP to 12.7% of GDP (Oxford Economics, 2010).

Over the past six years, however, while central government expenditures increased by 87%, revenues grew by only 31%, leading to budget deficits well above the EU's agreed-upon threshold of 3% (Greek Ministry of Finance, 2010). The Greek government faces government

budget and current account deficits that it can no longer finance by borrowing from international capital markets.

Figure 3



Source: European Commission, Excessive Debt Procedure Notification.

I.1.2.1 Tax Evasion

Weak revenue collection has also contributed to Greece's budget deficits. Many economists identify tax evasion and Greece's unrecorded economy as key factors behind the deficits. Observers offer a variety of explanations for the prevalence of tax evasion in Greece, including high levels of taxation and a complex tax code, excessive regulation, and inefficiency in the public sector. Some studies have valued the informal economy in Greece at between 25%-30% of GDP (Economist Intelligence Unit, 2010).

I.1.2.2 Government Spending

Fiscal policy was pro-cyclical throughout the period 2001 through 2009, with deficits consistently exceeding the Stability and Growth Pact's limit of 3 per cent of GDP by wide margins. Expansionary fiscal policy was mainly expenditure-driven, leading to a rise in the share of government spending (to over 50 per cent of GDP in 2009, from about 45 per cent in 2001).

The government debt-to-GDP ratio remained near 100 per cent throughout the period 2001 through 2009. Between 2001 and 2007, Greece's GDP grew at an average annual rate of 4.3%, compared to a Eurozone average of 3.1% (World Economic Outlook, 2009). High economic growth rates were driven primarily by increases in private consumption (largely fueled by easier access to credit) and public investment financed by the EU and the central government. Spending on public administration as a percentage of total public expenditure in Greece was higher than in any other OECD member in 2004, with no evidence that the quantity or quality of the services are superior (OECD, 2007).

This trend has continued. Greek government expenditures in 2009 accounted for 50% of GDP, with 75% of (non-interest) public spending going to wages and social benefits (IMF, 2010).

Successive Greek governments have taken steps to modernize and consolidate the public administration. However, observers continue to cite overstaffing and poor productivity in the public sector as an impediment to improved economic performance.

Greece considered one of Europe's most generous pension systems. Greece's replacement rate of 70%-80% of wages (plus any benefits from supplementary schemes) is high, and entitlement to a full pension requires only 35 years of contributions, compared to 40 in many other countries (OECD, 2009). Absent reform, total Greek public pension payments are expected to increase from 11.5% of GDP in 2005 to 24% of GDP in 2050.

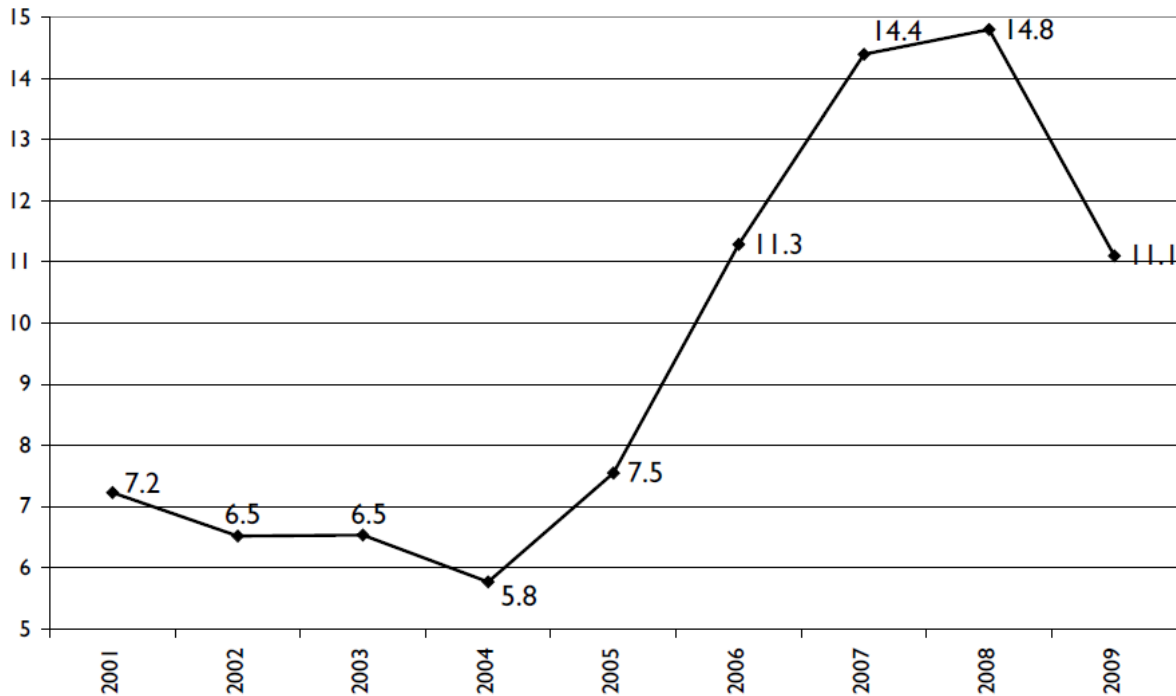
I.1.3. Current Account Deficit

Since the adoption of the euro in 2001 till 2008, Greece's reported current account deficits averaged 9% per year, compared to a Eurozone average of 1% (World Economic Outlook, 2009).

Many attribute the budget and current account deficits to the high spending of successive Greek governments (Economist, 2010).

Since the adoption of the euro in 2001 till 2008, Greek exports to its major trading partners grew at 3.8% per year, only half the rate of those countries' imports from other trading partners (Oxford Economics, 2010).

Figure 4
Greece: Current Account Deficit



Source: Bank of Greece

I.1.4. Misreporting the Statistics

Misreporting of official economic statistics to keep within the monetary union guidelines, the government of Greece (like many other governments in the Euro zone) had misreported the country's official economic statistics.

In the beginning of 2010, it was discovered that Greece had paid Goldman Sachs and other banks hundreds of millions of dollars in fees since 2001 for arranging transactions that hid the actual level of borrowing. The purpose of these deals made by several subsequent Greek governments was to enable them to continue spending while hiding the actual deficit from the EU. The emphasis on the Greek case has tended to overshadow similar serious irregularities, usage of derivatives and "massaging" of statistics (to cope with monetary union guidelines) that have also been observed in cases of other EU countries; however Greece was the most publicized case.

I.2 Consequences

I.2.1. Credit Ratings

In November 2009, the three major credit rating agencies downgraded the Greek bonds. In late April 2010, the spread between Greek and German 10-year bonds reached a record high of 650 basis points (Becatoros and Eddy, 2010). In April 2010, Moody's, downgraded Greece's bond rating by one notch. On April 27, 2010 S&P's, downgraded Greek bonds to "junk" status.

I.2.2. Investor Confidence

Allegations that Greek governments had falsified statistics and attempted to obscure debt levels through complex financial instruments also contributed to a drop in investor confidence (Hope, Peel, and Barber, 2009). Before the crisis, Greek 10-year bond yields were 10 to 40 basis points above German 10-year bonds. With the crisis, this spread increased to 400 basis points in January 2010, which was at the time a record high (Reuters, 2010). High bond spreads indicate declining investor confidence in the Greek economy.

I.2.3. Contagion Effect

The threat of Greece's crisis spreading to other Eurozone countries remained. Bond spreads for several other European countries spiked.

I.2.4. Euro Depreciation

The euro started to depreciate rapidly in response to the Greece debt crisis and the contagion effect to other vulnerable European countries.

I.2.5. High Interest Rate

With the eruption of the Greek financial crisis in late 2009, however, interest rates have shot upward, with the 10-year government bond yield increasing to almost 12 per cent at the end of 2010. Spreads on 10-year sovereigns widened from about 130 basis points in October 2009 to around 900 basis points one year later. Despite increasing nervousness surrounding Greece's economy, the Greek government was able to successfully sell €8 billion (\$10.2 billion) in bonds at the end of January 2010, €5 billion (\$6.4 billion) at the end of March 2010, and €1.56 billion (\$1.99 billion) in mid-April 2010, albeit at high interest rates (Mollenkamp and Bryan-Low, 2010).

I.3 Remedy Tools

I.3.1. Fiscal Austerity Measures

In exchange for financial assistance, Greece submitted a three year plan aimed at cutting its budget deficit from 13.6% of GDP in 2009 to below 3% of GDP in 2014.

On the spending side, most of the cuts focus on the civil service. They include a reduction or freeze on all civil service pensions, wages, and bonuses and a civil servant hiring freeze in 2010 with a 5:1 retirement/recruitment ratio for new public sector hires from 2011.

On the revenue side, the government has raised the average value-added tax rate from 19% to 23% and increased taxes on fuel, tobacco, liquor, and luxury products, among other things. The government hopes to raise revenues equivalent to 1.8% of GDP through strengthened tax collection and higher contribution requirements for tax evaders.

I.3.2. Structural Reform

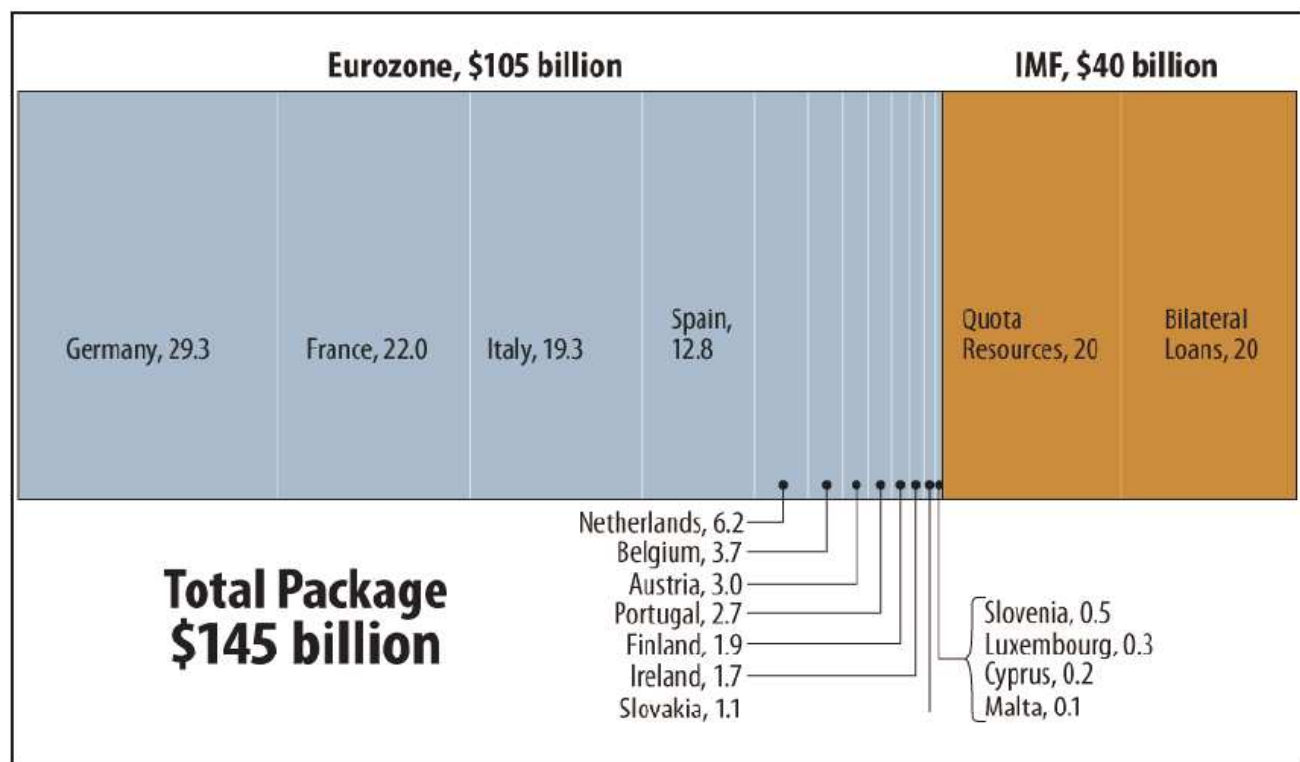
Enhancing the competitiveness of Greek industries through increasing productivity, significantly cut wages, and increase savings. Further, increasing Greek exports through investment in areas where the country has a comparative advantage.

I.3.3. Eurozone/IMF Financial Assistance

early May 2010 between the Greek government and the International Monetary Fund, the European Central Bank, and the European Commission, for a three-year, €110 billion adjustment loan under which the Greek government committed to lower its fiscal deficit to 8.1 per cent of GDP in 2010 and to below 3.0 per cent in 2014.

On May 2, 2010, the Eurozone members and International Monetary Fund (IMF) endorsed a historic €110 billion (about \$145 billion) financial package for Greece in an effort to avoid a Greek default and to stem contagion of Greece's crisis to other European countries, particularly Portugal, Spain, Ireland, and Italy. On May 9, 2010, the European Union (EU) announced an additional €500 billion (about \$636 billion) in financial assistance that could be made available to assist vulnerable European countries.

Figure 5:
Euro-Zone/ IMF Financial Assistance Package for Greece (US\$ Billions)



Source: IMF (2010).

I.3.4. Kick out of Euro-Zone

Greece could simply get out of the Eurozone and devalue its currency till it restructure its economy and then join again the Eurozone. Greece represents only 2.5% from EU GDP so it could be rescued easily as the consequences of Greece default would result in high transaction costs.

I.3.5. Default

The exposure of U.S. banks is estimated at \$16.6 billion (BIS, 2009). But the cost of default would be really high as it will depreciate the euro dramatically and results in loss of confidence to many investors. What is also clear is that drastic measures such as abandoning the euro will inevitably remain the topic of much theoretical speculation even if this has little practical consideration - the risks far exceed the likely benefits and the legal implications are severe.

II. Egyptian Economy Post 25 January

II.1 Causes

II.1.1 Political Turmoil

Egypt has been on the brink of social and political turmoil for the past few years, with evident signs of mounting frustration among citizens, mainly due to the severe socio-economic conditions, constraints on liberties and an uncertain political outlook.

The grievances that led to the revolution of 25th January were chiefly political, but old economic grievances played a role as well. The rigged parliamentary elections of 2010, the 'emergency' repressive measures that lasted for decades, and the absence of freedom to speak and assemble robbed Egyptians of their sense of dignity. At the same time, Egyptians blamed their government for high rates of poverty, youth unemployment, corruption, illiteracy, and deep divisions between rich and poor.

Inspired by the Tunisian revolution, Egyptians started a large-scale uprising on 25th January 2011 and after 18 days of protests; former president Hosni Mubarak stepped down, bringing to an end his 30-year rule as Egypt's President. Power was delegated to the Supreme Council of the Armed Forces, which became responsible for conducting the affairs of the State and leading the transitional period according to a constitutional declaration issued on 30 March, until the parliamentary and presidential elections are held towards the end of 2011.

Former president Mubarak's son Gamal reformed and privatized the system in order to build his own corporate empire, As the old regime reformed and privatized the system for their own good not for the sake of the society, now Mubarak and his reform-minded son are out of the picture and Egypt has a budget deficit and a government debt load that are teetering on the edge of sustainability (Ramadan, 2011).

II.1.2 Arab Spring

The current revaluations that happen in the middle east that would result on recession, higher unemployment, higher budget deficit, increasing debt levels, lower growth rates, lower investment, lower work remiattance and declining stock market on the short term. But on the long term it would result in higher economic growth rate and higher welfare.

II.1.3 Corruption

Egypt's international corruption for 2010 score 3.1 comparing to corruption in Egypt 2007 score 2.9 And Egypt's rank 98 for 2010 comparing to 2007 recorded 105. Corruption can increase the cost of conducting business or reduce revenue.

	2007		2010	
	Rank	Score	Rank	Score
Egypt	105	2.9	98	3.1

The popular backlash against the cronyism and corruption of the Mubarak era has prompted a wave of criminal inquiries into business deals conducted during this period; by mid-April, as many as 6,000 probes into corruption cases had been launched, according to Egypt's military leadership. The pace of new corruption investigations seems to be slowing, but there is still fear in the business community of a witch hunt. This is enormously destabilizing. These politically motivated trials increase the perceived risk of expropriation and discourage both domestic and foreign investors. As is the case in all revolutions, popular expectations of immediate change are likely to be unfulfilled. In a poll carried out in April by the International Republican Institute (IRI), an overwhelming majority (80 per cent) of Egyptians expected the financial situation of their households to improve over the course of the next year, with 32 per cent thinking that it would be "much better" than at the present time. A similar surge in optimism regarding the country's future was reported by the Gallup survey conducted in early April. If these expectations are not met, the sense of economic crisis could foster support for authoritarian populists, radical Islamist politicians, or a reversion to military rule.

The absence of economic efficiency in Egypt has been reflected in recent international competitiveness reports. The figures of the Ministry of Economic Development show a rise in real estate investment in the five-year plan at the expense of industry and agriculture. In addition, according to the quarterly report published by the Ministry of Industry and Trade and the indicators noted in the World Bank's annual World Development Report, industrialization in Egypt is declining.

II.1.4 Global Recession

The Global recession due to the global financial crisis and the European sovereign debt crisis which result in lower international trade.

II.1.5 Increasing Budget Deficit and Public Debt

Government budget deficit has widened in FY 2009/2010 to record EGP 98 billion compared to EGP 71.8 billion during 2008/2009, representing 8.1% of GDP up from 6.9% in the previous year. The increase in the budget deficit resulted from the government's strategy, which aimed at increasing total expenditures in order to stimulate demand in the economy facing the negative impacts of the global financial crisis, coupled with a decline in public revenues and a significant surge in interest payments on the government debts.

Moreover, recent data for July- May of the FY 2010/2011 showed that the overall deficit to GDP ratio increased by 1% to record 8.2%, reaching EGP 112.6 billion compared to EGP 86.8 billion during July- May of the FY 2009/2010 (Ministry of Finance, 2011).

A sharp increase in the budget deficit is expected to be witnessed during the last months of the current FY 2010/2011 and the next year, as per the Ministry of Finance, last actual figures reveal that the budget deficit recorded 6% of GDP during the 8-months period (July-February 2010/2011) and according to the Minister's estimates the deficit is to widen to reach 8.5% by the end of the year, which conveys a significant deterioration in the last four months of the year (March-June 2011) where deficit is expected to reach 13.6% of GDP. A gradual decline is forecasted thereafter to reach 7.4% of GDP by FY 2014/2015.

The mentioned surge in budget deficit is estimated to result from the negative short-term economic impacts of the revolution, reducing the budget revenues, through the decline in business activity and consumers' spending, which will in turn weaken the government's tax generation mainly in terms of corporate income taxes as well as indirect sales taxes.

During FY 2009/2010 the budget deficit amounting to EGP 98 bn, was heavily financed through domestic sources, covering EGP 95.5bn, represented mainly in T-bills, whereas external financing recorded EGP 2.5bn. Total Public Debt to GDP stood at 80%.

Egypt's gross domestic debt in 2010 recorded LE 888.66 billion representing 73.6% of GDP, compared to LE 755.30 billion in the previous year 2009 representing 72.5% of GDP (Central Bank of Egypt, 2011).

It is noteworthy that the realized increase in domestic public debt was due to an increase in accumulated debt of the general government and the increase in total outstanding debt of economic authorities. Meanwhile Egypt external debt shows resilience despite a slight deterioration. External debt increased in 2010 recording US \$ 33.69 billion representing 15.9% of

GDP compared to US \$31.53 billion in 2009 representing 16.9% of GDP (Central Bank of Egypt, 2011).

After the 25th revolution Central Auditing Agency (CAA) Chairman Gawdat El-Malt announced that Egypt net domestic debt reached LE 888 billion, and the total net domestic and foreign debt reached LE 1080 billion representing 89.5% of GDP (Michaletos, 2011). It is expected that by the end of this year Egypt's public debt will represent 120% of GDP, as debt will be the major source to finance the increased government spending and widening budget deficit (Michaletos, 2011) .

II.1.5.1 Revenues

Total revenues and grants decreased by 5.1% during FY 2009/2010, registering EGP 268.1 billion compared to EGP 282.5 billion during FY 2008/2009. Revenues decreased due to lower non-tax revenues by 18.2% offsetting the 4.5% increase in tax revenues. During July-May 2010/2011 total revenues increased by 4% registering EGP 200.8 billion compared to EGP 193 billion during the same period last year. This increase is due to the 12% increase in tax revenues, which offsets the decrease of 14.7% in non-tax revenues (Ministry of Finance, 2011).

With tourism now being on a downward curve, with thousands of Egyptians having returned from Libya and with Tunisian, Yemeni and Libyan markets being closed to Egyptian exports, the need is pressing to compensate the losses suffered during the days of uprising.

II.1.5.1 Government Spending

Total expenditures increased by 4.1% during FY 2009/2010, registering EGP 366 billion compared to EGP 351.5 billion during FY 2008/2009. This increase is due to number of factors; (1) 37% increase in interest payment on external & domestic debt to reach EGP 72.3bn (representing 20% of total expenditures, which is the highest ratio recorded over the last five years). (2) 12.1% increase in employee wages & compensations to reach EGP 85.4bn during FY 2009/2010 (24% of expenditures) compared to EGP 76.1 bn. (3) Purchase of non-financial assets increased by 11.3% to reach EGP 48.4 bn compared to EGP 43.4 bn last year. (4) Purchase of goods & services increased by 12% to reach EGP 28.1bn during FY 2009/2010 (Ministry of Finance, 2011).

Total expenditures increased during the period July-May 2010/ 2011 by 12.7%, recording EGP 315.1 bn compared to EGP 279.7 bn during the same period last year. This increase comes with the expansion growth in all spending chapters except for purchases of goods & services, and purchase of non-financial assets that have decreased by 12.6% and 19.5% to reach EGP 17.1 bn and EGP 29 bn respectively during July-May 2010/ 2011. Compensation of employees has increased by 13.8% to reach EGP 79.9 bn compared to EGP 70.2 bn during July-May 2009/ 2010. Interest payments increased by 15.4% recording EGP 72.7 bn during July-May 2010/ 2011 compared to EGP 63 bn during the same period last year. Expenditures and subsidies, grants and social benefits increased by 7.3 & 36% to reach EGP 26.8 & 89.7 bn compared to EGP 25 & 66 bn respectively during July-May 2009/ 2010 (Ministry of Finance, 2011).

An additional EGP 10 bn allocated for subsidizing strategic food commodities during the current year 2010/2011, backed by the surge in commodity prices amid the global food price hikes. This will exert pressure over the government's subsidy bill (a depreciating currency will definitely add more pressure). A 15% social incentive offered by the government will increase wages and compensations effective as of April 2011 (Ministry of Finance, 2011).

Untargeted subsidies, particularly for fuels, constitute a large portion of the overall government spending, and the deficit problem cannot be solved without tackling these policies. The subsidies are a wasteful and inefficient method of helping poorer Egyptians. Most of their benefits are accrued to the middle classes and the well-off. A 2005 World Bank study found that a better-off Egyptian received twice the amount in subsidies as a poorer Egyptian citizen. The government subsidizes the fuel sold to the factories to produce products which eventually sold in the international prices not subsidy prices, and thus increasing government expenditures due this corruption.

II.1.6 Current Account Deterioration

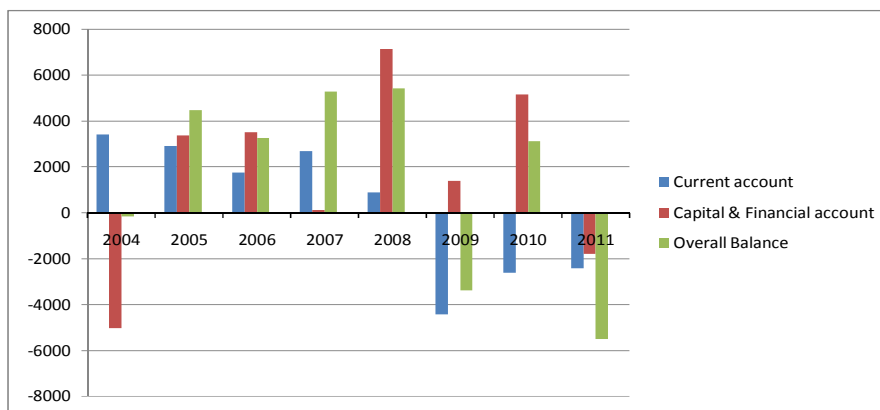
BOP recorded an overall deficit of USD 5.5 bn during July – March 2010/2011 compared to a surplus of USD 3.1 bn during the same period last year. The recorded deficit comes as a result of the capital & financial accounting accruing an outflow of USD 1.8 bn versus an inflow of USD 5.2 bn during July – march 2009/2010 in addition to the outflow of USD 2.4 bn in the current account. In the meantime net errors and omissions recorded a net outflow of USD 1.3 bn during the first nine months of 2010/2011, compared to a net inflow of USD 0.5 bn during the

corresponding period of the previous year. Current account deficit is expected to widen during FY 2010/2011 to reach 5.7% of GDP, down from 1.4% recorded in FY 2009/2010.

A growing trade deficit is estimated, particularly over the short term period, backed by Egypt's declining output and forced growing imports, in addition to rising consumer goods prices due to a slowdown in production.

Figure 6:

Egypt's Balance of Payment 2004-2011 (in US\$ Millions)



Source: Central Bank of Egypt (2011).

II.2 Consequences

II.2.1 Loss of Confidence

Due to political instability investors are now hesitant to put money in Egypt, there is lack of knowledge about where the revolution will go next and so there is uncertainty of where the business environment will go next" investors like to have predictability and this is one hindrance in Egypt for many investors".

II.2.2 Credit Ratings

Standard & Poor's downgraded its ratings for Egypt, with a <BB/B> for long- and short-term foreign currency ratings and a <BB+/B> for long- and short-term local currency ratings and removing the long-term ratings from its Credit-Watch. S&P also affirmed the <3> recovery rating on Egypt's senior unsecured foreign currency sovereign debt, indicating a recovery range of

between 50% and 70% in a debt restructuring or default scenario. At the same time, it maintained Egypt's Transfer and Convertibility Assessment at <BB+>. The outlook on Egypt's long-term ratings is negative.

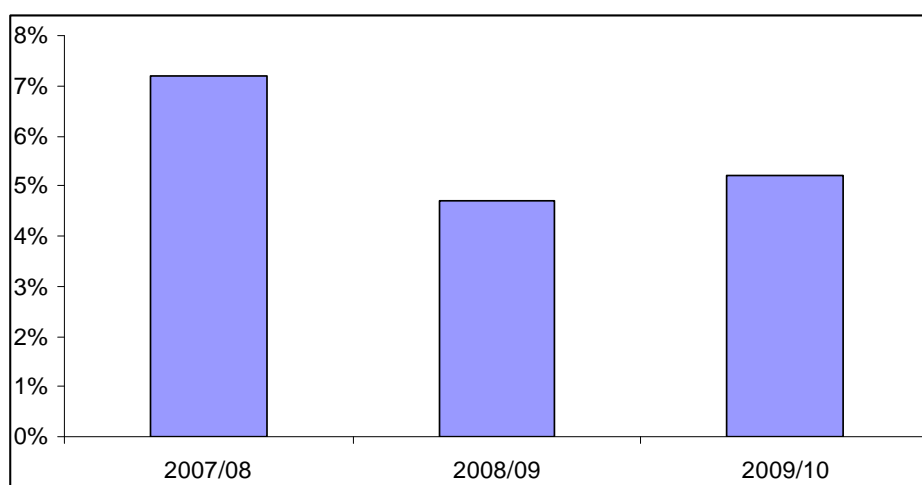
Moody's downgraded Egypt's sovereign debt rating by one notch to «Ba3» and said it may downgrade it further if foreign reserves fall or the political situation deteriorates. The downgrade was based on concerns that new government, after the ousting of Hosni Mubarak on February 11th, 2011, would not be stable and effective and the effect any instability might have on the country's fiscal position and economic performance (Alloway, 2011).

II.2.3 Growth Rate

While it is early to assess the long-term impact that the recent events will have on economic growth, data for the third quarter of the current fiscal year recorded a negative growth rate of 4.2%, compared to an average growth rate of 5.5% during the preceding two quarters due to the significant decline in tourism, other manufacturing industry, and the construction sector (Ministry of Finance, 2011).

GDP (market prices) growth for July-march 2011 decelerated to 2.3%, compared to 5.0% realized growth in the first 9 months of last year. The realized growth comes as a result of the strong GDP performance during the first 2 quarters of the current FY which overcame the negative growth in the third quarter (Ministry of Finance, 2011).

Figure 7
Real Growth Rate 2008-2010



Source: Ministry of Finance (2011).

The restoration of political stability and effective reform system are essential if the Egyptian economy is to return to solid growth that benefits the population as a whole. In order to alleviate poverty and improve living standards, the priority has to be a high and sustainable growth rate while addressing social concerns such as unemployment, income distribution and the poor level and quality of education and health services.

II.2.4 Inflation

According to the Central Bank of Egypt, the expected slowdown in economic growth could largely offset the upside risks on inflation from the rising international food prices. Hence, the Monetary Policy Committee (MPC) decided in its meeting held on March 10, 2011, to keep the overnight deposit rate and overnight lending rate unchanged at 8.25% and 9.75%, respectively. The discount rate was also kept unchanged at 8.5 %.

In a move towards keeping short-term interest rates under control providing liquidity to banks, the Central Bank of Egypt decided on March 10, 2011 to launch regular repurchasing agreements (repo) as part of its monetary policy operational framework every Tuesday starting March 22nd. The 7-day repo will be the main monetary policy instrument with a fixed rate determined by the MPC.

The CBE's decision to keep its rates unchanged was also driven by the motive of stimulating investments to enhance economic growth rates during the coming period. However, as a result of the expected rise in inflation rate during 2011, we expect the CBE to increase its rates to reach an average of 10.7% in 2011 as a mean for targeting inflation (Central Bank of Egypt, 2011).

The inflation rates was Increased affected partly by the increase in wages and salaries, without a corresponding increase in production, in addition to the expected increase in global prices of food and oil as well as weaker local currency.

II.2.5 Foreign Direct Investment

Egypt ranked first among North African countries and second in the African Continent as an attractor of FDI, according to the World Investment Report 2010 by the United Nations Conference on Trade and Development (UNCTAD). Then FDI started to gradually decline after the global financial crises took place in late 2008, where it declined by 39% & 17% in 2008/09

and 2009/10 respectively. Net FDI inflows decreased from USD 13.2bn in FY 2007/08, to reach USD 8.1bn in FY 2008/09, and further declined to record USD 6.8bn in FY 2009/10.

Net FDI inflows constituted 3.2% of GDP in FY 2009/10, down from 4.5% in FY 2008/09. In FY 2007/08 net FDI inflows represented 8.5% of GDP. Net FDI decelerated during July-march 2010/2011 recording a net inflow of USD 2.1bn, 51.8% lower than the USD 4.3 bn recorded in the first nine months. In the short run, a delay in Greenfield projects, yet, no shutdowns are expected to occur. Meanwhile, the existing projects will, in our view, continue their operations normally. However, with new government efforts, more investments, especially from the Middle East, will flow into the economy in the medium and long term (Ministry of Finance, 2011).

II.2.6 Tourism

Tourism sector, which accounted for 53% of total receipts in H1 2010/11, has witnessed a sharp decline compared to a deficit of USD 2.6 bn during the same period of the previous fiscal year (Central Bank of Egypt, 2011).

In FY 2009/10, revenues from tourism reached USD 11.6bn, surging 10.5% y-o-y, compared to USD 10.5bn in FY 2008/09. Despite that tourism income grew at a CAGR of 13% during the last 5 years, it represented 5.6% of GDP in FY 2009/10 compared to 7.2% in FY 2005/06.

During February 2011, whereas, the number of tourists visiting Egypt dropped by 80% during the same month. The report also pointed out that tourist facilities were consequently forced to dismiss temporary staff and decrease salaries for permanent workers, resulting in a total loss in income of EGP 70mn. During the period July – April (2010/2011) revenues from tourism reached USD 8.7 bn (Ministry of Finance, 2011).

The Red Sea Tourism Department confirmed receiving only 59,000 tourists during February 2011, plummeting 80% y-o-y, compared to 309,000 tourists in the comparative period. The declining number of guests clearly reflects the occupancy rates of hotels and resorts that reached 0-20% during and after the Egyptian revolution, where fears of insecure environment prevented tourists from spending their holidays in Egypt.

II.2.7 Suez Canal

Suez Canal revenues are expected to remain stable, representing 60% of transportation receipts. Although marking a decline of 6.7% m-o-m, Suez Canal Revenues reported USD 388.7mn in February 2011, marking an increase of 16.3% y-o-y (Central Bank of Egypt, 2011).

The Suez Canal Authority (SCA) reported revenues of USD 388.7mn for February 2011, marking a decline of 6.7% m-o-m, compared to USD 416mn recorded in January 2011 and increasing by 16.3% y-o-y as compared to February 2010. The Suez Canal revenues decreased by 17.3% during 2010/2011 (March – July) compared to 2009/2010.

The Suez Canal is a major gatekeeper of global trade, carrying 8% of the world's ship traffic in 2009. The other alternative for the Suez Canal for ships and vessels to reach Europe and parts of North America is to transit around the southern tip of Africa which is a longer and more dangerous route with strong seasonal storms (Ministry of Finance, 2011).

II.2.8 Stock Market Slump

After a suspension that lasted for 7 weeks, EGX resumed trading on March 23rd 2011, where the Prime Minister Essam Sharaf tasked Mr. Mohamed Abdel Salam, chairman of Misr for Central Clearing, Depository and Registry (MCDR), to oversee EGX for the next six months, after former bourse chairman Khaled Serry Siam resigned. The Egyptian Financial Supervisory Authority (EFSA) initiated several exceptional measures regarding trading at EGX, where such procedures will gradually be removed during the first two weeks of April 2011. EGX-30 lost 21.17% of its value to settle at 5,300.06pts on April 14th 2011, down from 6,723.17pts recorded on January 24th 2011 right before the revolution.

The EGX- 30 index decreased by 1026 points during may 2011, reaching 5523 compared to 6549 during may 2010. It is worth noting that the EGX- 30 index increased for the first time since the events of January 25th by 519 points compared to last month. Similarly, Market capitalization declined over the previous year by 3.7% in may 2011 to LE 410 bn (29.8% of GDP) such negative developments are expected in light of the recent events Egypt witnessed since 25th of January 2011 (Ministry of Finance, 2011).

II.2.9 Egyptian Pound Depreciation

Despite fears over a significant weakening in the EGP against the USD, during the early days of the revolution, and especially in the period of banks' closure, which resulted in increased speculation, the CBE managed to maintain the EGP/USD rate at reasonable rates, of around EGP 5.9/USD reaching its highest interbank rate of EGP 5.97 post the Egyptian Revolution. Weighted average USD interbank rate grew from EGP 5.59 in FY 2008/09 to EGP 5.69 in 2009/10. Over the medium term, withdrawals from NIRs are unavoidable, and hence a weakening EGP is expected. It is estimated that EGP/USD will reach 6.1 during FY 2011, and will hike in FY 2012 to amount to 6.2 (Central Bank of Egypt, 2011).

II.2.10 Unemployment

Registered unemployment reached 10.6% in November 2009, the highest level since March 2005, and is expected to increase in 2010 and 2011. As of October 2009, 27.5% of young people (aged 15-24) in Greece were unemployed.

II.2.11 Net International Reserve

Net International Reserve (NIR) lost USD 5 bn in the period from January to March 2011. NIR amounted to USD 30.1 bn in March 2011, dropping 9.6% m-o-m, compared to USD 33.32bn recorded in February 2011, which is the largest decline since 2007. The Egyptian government has been exposed to pressure in order to cover its rising imports of strategic commodities, deteriorating tourism revenues and weak Egyptian remittances. Moreover, at the end of July 2011 NIR reached US \$ 25706 mn compared to June 2011 NIR amounted to USD 26569 mn lost USD 863 mn. And lost USD 9301 mn since January as it recorded USD 35007 mn dropping roughly 26.6% since the revolution (Central Bank of Egypt, 2011).

II.3 Remedy Tools

II.3.1 Political Stability

The primary step to stop economic deterioration is to restore security & political stability, in order to encourage investors to invest in Egypt and increase production and exports and solve unemployment problem.

II.3.1 Financing Current Deficit

Financing the current budget deficit through issuing treasury bonds, getting grants especially from U.S. and Saudi Arabia and finally getting international loans from IMF.

II.3.1 Economic Structural Reform

Reforming fuel subsidies is more urgent and politically more feasible than acting on the much smaller but highly sensitive food subsidies. The transitional government recognized this by making some small cuts to fuel subsidies in the revised budget passed in June. These changes will curb butane gas subsidies to non-residential users and extend the natural gas grid to some butane-consuming factories such as brick making facilities. The savings from such measures will be about \$580 million (LE 3.5 billion) over the coming year. The cuts are only a very small step in the right direction, however. In the revised 2011/2012 budget, \$16.8 billion (LE 100.5 billion) – over 20 per cent of total government expenditure and 6 per cent of GDP – is allocated to fuel and electricity subsidies, while \$9.6 billion (LE 57.2 billion) goes to all other subsidies and grants, of which food subsidies constitute only a small fraction, according to the Egyptian Center for Economic Studies (ECES). In the fiscal year 2010/2011, for example, the total cost of food subsidies amounted to \$2.3 billion (LE 13.5 billion).

Applying the ministry of finance propositions of a restructuring in wages and tax schemes to ensure more equality among the society and reduce the gap between income classes, there are increased expectations for the following measures to take place; the government may raise the minimum wage (this can be accompanied as well by a wage ceiling in the government sector). In addition a progressive tax system might be adopted instead of the current flat rate system. Finally, the ministry of Finance is currently studying amending the real estate tax law, to remove real estate units, which are acquired for usage from the tax base.

Replacing regressive subsidies with a system of supports explicitly targeted at the poor can correct this distortion and may also prove politically appealing. Egyptian policymakers could learn from the examples of other countries – including Jordan (1991-1999), Mexico (1997) or India (1997) – which successfully replaced untargeted subsidies with alternative programs designed to alleviate poverty. Certainly such a step would be consistent with the desire for greater social justice, an important theme of the revolution. Reformers should note that different fuel subsidies impact poverty differently. The World Bank report found that eliminating petrol and natural-gas subsidies would have only a very small impact on the poor, increasing the incidence of poverty by 0.15 per cent. In contrast, the elimination of the liquefied petroleum gas subsidy altogether would raise the incidence of poverty by 4.4 per cent. The same study concluded that if subsidies are phased out gradually, and if their elimination is accompanied by a strengthened social safety net, the increase in poverty can be completely offset.

Conclusion

Greece nowadays has to pay dearly for the misguided growth model which has prevailed in the past. This model, together with the credibility gained from euro entry, may have allowed Greece to narrow the gap with EU standards of living but it has proved to be as unsustainable as the old model of persistent devaluations. For far too long, the Greek public sector has acted as a bailout mechanism and benefactor of last resort to the economy at large, allowing the country to avoid the necessary private sector adjustments and the move towards more balanced growth – effectively a speed limit set by the natural pace of export expansion.

Domestic demand will be affected by the lower productivity, higher prices, higher unemployment, strikes and curfews. However, the economic outlook will improve in the medium term, due to gradual decline of categorical demands and strikes, and more stable political circumstances, where the new constitution will be completed by 2012. This will promote investments and improve the economic conditions, which will lead to higher productivity and consumption. According to EIU, the growth in FY 2011/2012 will record 4.9% and will then increase gradually to reach 6.4% by FY 2014/2015.

Egypt's economy is capable of resuming fairly rapid growth, but for this growth to be sustained, far-reaching economic reforms are needed. Some of these reforms cannot and should not wait. If properly explained and executed, they could also attract popular support, including among Egypt's poor. In fact, the reforms adopted during the last years of Mubarak's rule were achieving good results. The country made considerable progress in attracting domestic and foreign investment, improving its business environment, reducing the public debt load, and generating growth. In spite of the progress achieved, the public sector remains highly inefficient, corrupt, and heavy-handed in its interventions. As a result, some 82 per cent of private businesses are run informally.

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