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Egypt: Sadat's Economic Options

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Egypt: Sadat's Economic Options

Egyptian President Anwar Sadat faces economic problems that could eventually figure in the search for peace in the Middle East. New short-term difficulties have been added to the long-term problems of chronic trade deficits and crushing foreign debt. These difficulties include a rise in the prospective current account deficit to almost US $400 million in 1973, even after counting Khartoum subsidies of some $250 million. The rise in the deficit stems from increased expenditures for wheat, decreased earnings from oil, and the suspension of Libya's ad hoc aid, which covered as much as $200 million of Egypt's annual deficits.

Sadat has several options, none entirely palatable. He can:

- Muddle through – e.g., draw down unexpended credits, seek further credits from international lending agencies, cut imports further, and default on current bills and debt service payments. These measures, however, could deprive Egypt of its remaining credit hopes, lower living standards, and cut back employment opportunities for the restless urban population.

- Seek additional aid from the USSR. The Soviets might defer or extend debt repayment to ease Sadat's immediate financial problem, but they distrust Sadat and are wary of adding to the huge debt owed by the Egyptians on past military and economic aid. In any case, they have never supplied substantial amounts of hard currency to any LDC.

- Embrace the oil-rich Libyans in the hope of assuring both immediate ad hoc aid and longer term economic security. This option probably would require Cairo to adopt a more radical stance toward Israel.

- Endeavor to exact financial aid from the United States and other Western countries by agreeing to more forthcoming settlement terms with Israel. If such a move were made, all remaining Libyan financial support – including Libya's annual $59 million Khartoum subsidy – would cease. Egypt also might lose $191 million annually in Khartoum subsidies from other Arab states.

Note: Comments and queries regarding this publication are welcomed. They may be directed to [redacted] 25X1

DISCUSSION

Weak Inheritance

1. The economy inherited by Egyptian President Anwar Sadat in 1970 was riddled with fundamental weaknesses. Land for agriculture was inadequate to feed Egypt's poor and rapidly growing population. Mineral resources to support industrial production were in short supply. A chronic balance-of-payments deficit was making the economy increasingly dependent on foreign financial assistance. Little breathing space was available, because roll-over agreements on debt repayments had already been negotiated with most of Egypt's creditors.

2. Economic planners in the 1960s had banked heavily on the expansion of primary production to increase export earnings and on the development of domestic industry to replace imported manufactures. Their expectations were disappointed. Although the Aswan High Dam, completed in 1970, resulted in the more effective use of the Nile's water, the extent of reclaimable land proved exaggerated. On much of the best land, high output levels have already been achieved, and further gains in yields are running into diminishing returns. The savings expected from the expansion of consumer industries were largely offset by new requirements for imported raw materials and intermediate goods. Explorations for oil failed to turn up appreciable new reserves.

Large Trade Deficits

3. Under the Nasir regime, improvident economic policies, costly military programs, and foreign adventures in Yemen and elsewhere had turned a small international trade surplus into a sizable deficit. By the end of 1966, Egypt's gold reserves had been reduced to less than $100 million and foreign exchange reserves had been drawn down to $156 million from $750 million in 1952. Non-military debt alone was some $2 billion, equal in amount to more than one-third of gross national product (GNP).

4. After the 1967 war with Israel, the trade deficit was reduced (see Table 1). Consumer imports were restricted, and a drop in investment meant smaller imports of capital goods. Export earnings, on the other hand, were boosted by a partial recovery of petroleum exports and bumper harvests of cotton in 1969 and 1970. Nevertheless, these gains in the merchandise account were more than offset by losses of foreign exchange earnings from the Suez Canal and tourism. Closure of the canal deprived Egypt of more than $200 million annually in revenues, and tourist earnings suffered an initial cut of nearly 25%. Industrial production facilities in the

Table 1

Egypt: Balance of Payments, Pre-War and Post-War[1]

	FY 1967	FY 1968	FY 1969	FY 1970
				Million US $
Merchandise trade balance	-346	-307	-176	-288
Exports, f.o.b.	607	583	707	800
Imports, c.i.f.	-953	-890	-883	-1,088
Services (net)	164	-49	-59	-81
Receipts	402	134	154	171
Suez Canal dues	219	....	....	....
Tourism and other services	183	134	154	171
Payments (including interest on debt)	-239	-184	-214	-252
Unrequited transfers (net)	69	192	288	320
Balance on current account	**-113**	**-164**	**52**	**-49**
Non-monetary capital	158	48	-33	43
Drawings on medium-term and long-term loans	230	128	176	249
Repayments on medium-term and long-term loans	-126	-134	-244	-267
Other capital (net)	54	55	34	61
Net errors and omissions	6	-8	7	-6
Balance of payments	**51**	**-124**	**26**	**-12**
Monetary movements[2]	-51	124	-26	12
Allocation of SDR's	....	....	....	25
Use of fund credit	-12	10	-21	-16
Foreign exchange	-121	80	-6	16
Payments agreements	22	29	-2	-17
Other	60	5	3	4

1. Fiscal years ending 30 June of designated year. Because of rounding, components may not add to the totals shown.
2. A negative entry denotes a balance-of-payments surplus, a positive entry a deficit.

once-thriving canal zone area were damaged or destroyed and production dislocated, depriving Egypt of assets that had accounted for 7% of GNP.

5. Egypt's foreign exchange losses from the 1967 war prompted regular annual Arab subsidies of at least $250 million. Because foreign exchange reserves and net foreign capital inflows from both the Eastern and Western countries were reduced to a minimum (in 1969 there was a net outflow), even this substantial aid was insufficient, and the chronic current account deficit had to be covered by ad hoc aid from friendly

Arab countries. Since 1967 the Arab world has paid out close to $2 billion in annual subsidies and other aid to keep Egypt afloat financially.

The Economy in 1967-72

6. Whereas the postwar Egyptian economy required substantial foreign assistance, it showed more resilience than most observers had expected. In spite of damage to industrial plant in the canal zone, industrial output was increased, largely through use of excess capacity. Favorable growing conditions resulted in a bumper cotton crop in the fall of 1969, followed by an even larger crop in 1970. A steady influx of luxury-hungry Soviet technicians and their families stimulated the demand for Egyptian consumer goods. The buildup of military installations provided employment and markets for domestic industries, particularly the construction industry, which had experienced a downturn with the completion of basic work on the Aswan Dam. Egypt's real GNP increased as follows:

Egypt: Box-Score of Gross National Product
1967-72[1]

1967: Down 1% because of war and lack of foreign exchange to buy industrial raw materials and replacement parts.

1968: Up 2% primarily because of increased support from other Arab states, which enabled industry to work at a higher rate.

1969: Up 6% because of continued Arab support, accelerated defense building, and below-average damage from agricultural pests.

1970: Up 5% because of increases in industrial activity, construction of military facilities, and Arab support.

1971: Up 3%-4% as industrial and military expansion and Arab support started to level off.

1972: Little or no expansion as agricultural output declined slightly, military activity slowed further, and a drop in Arab aid created import bottlenecks in the industrial sector.

1. Because Egyptian data are fragmentary and are presented on a fiscal year basis, the GNP percentages above should be regarded as rough orders of magnitude.

Economic Planning

7. Egyptian leaders have attempted four economic plans in little more than a decade and have discarded three of them. The First Five-Year Plan, launched in fiscal year (FY) 1961,[1] achieved moderate success. Many of the plan projects were completed, and the basic goal – a rise in per capita income – was achieved for several years. The Second Five-Year Plan, begun in FY 1966, was doomed from the start because certain preliminary steps, such as the renovation of the transportation system and the expansion of intermediate goods production, had not been completed during the First Plan. An interim Three-Year Plan fell victim to the June 1967 war, which caused a switch to extraordinary wartime planning. The Third Five-Year Plan, drawn up to start in FY 1970, was postponed a year by the Nasir regime and was abandoned when Sadat came to power in September 1970.

8. Soon after taking over, Sadat announced his basic aims for the economy to be an increase in national income of 100% in 10 years, an average annual growth of 7%, a rate never previously sustained by Egypt. In the first years under Sadat, real growth of GNP actually averaged roughly 2% per year. The recently announced Ten-Year Plan (1973-82) purports to be a format for accelerating this growth rate through injections of state investment of $19 billion over the plan period. The plan earmarks considerable investment for the petroleum industry, apparently on the optimistic assumption that new discoveries of oil and gas will provide much of the additional foreign exchange needed to support the plan. Prospects are remote that Egypt can find enough foreign exchange from other sources.

Prospects for 1973

9. Sadat faces dreary prospects on the economic front in 1973 – a sharply rising bill for imported food, reduced assistance from the USSR and Arab states, and a lack of vigor in the industrial sector.

10. The worldwide shortage of foodgrains is having a marked impact on Egypt's 1973 payments deficit. With the vast majority of Egypt's 35 million people squeezed into the narrow Nile Valley and with much of the best acreage devoted to cotton and other non-grain crops, agriculture can furnish little wheat for urban consumption. The minimum import requirement for wheat in 1973 will be on the order of 3 million metric tons. Although some price protection will be afforded by existing long-term supply agreements, the rise in wheat prices of some $40 to $50 a ton will be a main factor in raising Egypt's wheat bill by some $100 million in 1973. This rise in wheat prices is not likely to cause a shift of appreciable

1. Through FY 1972, Egypt's fiscal year ran from 1 July to 30 June of the stated year. Fiscal years now coincide with calendar years.

acreage to wheat, at least in the short-run, because a rearrangement of water control is necessary in a switch, and wheat is a more land-intensive crop than most other Egyptian crops.

11. Falling petroleum output also will widen the trade deficit. In the once highly productive El Morgan field in the Gulf of Suez, a decline in pressure has reduced output by almost 200,000 barrels per day since 1970. Output in older fields also is falling. Total output in calendar year 1973 may not exceed 200,000 barrels per day, compared with 245,000 barrels per day in FY 1972. This decline will deprive the Egyptian General Petroleum Company, owner or joint owner of most operations, of about $40 million in export earnings in 1973. The current account deficit for 1973 is likely to be almost $400 million (see Table 2).

Table 2

Egypt: Balance-of-Payments Summary[1]

Million US $

	FY 1971	FY 1972	FY 1973[2]
Current account[3]	-216	-244	-394
Capital account	Negl.	Negl.	34
Of which West German aid:	....	....	34
Balance	-216	-244	-360
Financing			
Bilateral clearing balances	60	80	100
Ad hoc balance-of-payments support[4]	146	153	15
Other (including reserve drawdown)	10	11	245

1. Through FY 1972, Egypt's fiscal year ran from 1 July to 30 June. Fiscal years now coincide with calendar years. Thus the second part of calendar year 1972 is not accounted for in the table.
2. Estimated.
3. Including Khartoum subsidy payments from Arab states of from $250 million to $281 million annually.

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12. Prospects for Arab aid also are poorer than in the recent past. In 1970-71 Libya provided about $150 million annually in direct balance-of-payments support in addition to a $59 million annual Khartoum subsidy.[2] Since 1971, however, Qadhafi has been reluctant to give untied

2. As the result of an Arab summit meeting at Khartoum in the aftermath of the Six-Day War, rich Arab nations agreed to transfer substantial sums annually to Egypt to make up for losses in foreign exchange.

funds to any client state. [redacted] 25X1

13. The precarious financial situation suggests that some trimming of imports will be needed in 1973. Because little room exists for additional cuts in imports of luxury consumer goods and because cuts in imports of food or fertilizer could only worsen Sadat's political position, the effect of a reduction of imports will be felt most acutely in manufacturing. Most manufactures depend to some extent on imports of raw materials and equipment. A cut in imports for industry, together with the large annual additions to the labor force, means an inevitable rise in unemployment or underemployment in the cities.

14. In the short term, Sadat may try to muddle through with his economic problems, drawing down available credits not yet expended, seeking further credits from international lending agencies, cutting imports here and there, and defaulting on current bills and debt service payments. The US agreement, which requires a net outflow of at least $15 million annually, would be a prime candidate for default.[3] Such temporary measures might backfire quickly, depriving Egypt of its remaining credit hopes, lowering living standards, and cutting back job opportunities, particularly in the cities. Eventually, economic deterioration and the consequent erosion of Sadat's political position could force a harder look at other economic options.

Economic Options in the Longer Term

15. Sadat has to appraise his long-term economic options under at least two alternative assumptions: (a) a continuation of the **status quo** of "no war, no peace", and (b) a settlement with Israel that would provide for at least partial return of the Sinai and opening of the Suez Canal. The economic implications for Egypt of the two assumptions vary widely in major respects but share a common theme of continued heavy reliance on outside resources.

No War, No Peace

16. Under current conditions of "no war, no peace," the basic economic problem to be faced by Egypt's socialist government is covering a current account deficit that will total more than $1 billion over the next 5 years even in the absence of large inflows of capital goods. Expected

3. Until this year, payments to the United States were kept current, unlike those on agreements with any other major Western creditor.

gains in exports over the next several years probably will no more than cover increasing requirements for imported foods, other essential consumer goods, and industrial inputs. Imports of capital goods necessary to sustain investment activity must continue to be financed with additional foreign loans or grants. In 1971-72, investment of about 12% of GNP[4] yielded a growth rate at best equal to population growth -- about 3%. The current account deficit was more than $200 million in those years. The deficit almost certainly cannot be reduced below this level for several years without further reducing present austere consumption standards or the already low rate of economic growth.

17. Adequate credits to cover this future deficit may not be available, even though some possible lines of credit exist. Substantial credits already extended by Eastern Europe remain unused. West Germany has proved to be fairly generous and has recently provided a rollover agreement and additional credits. Several smaller Western nations such as Sweden and Australia have extended small trade credits recently. Finally, the multinational lending institutions such as the IBRD and UN Development Program could extend additional aid. Grants may be forthcoming from the newly rich Persian Gulf states. Egyptian sabre rattling may even bring forth untied cash or joint venture proposals from traditional Arab donors -- Kuwait, Saudi Arabia, and Libya. Nevertheless, only $750 million in net credit is clearly in sight over the next 5 years (see Table 3). Because most of this amount is project aid, it will not actually become available until projects are selected and construction is begun.

18. Sadat has sought to fill the prospective balance-of-payments gap by seeking private foreign capital investment and by encouraging the repatriation of funds banked by Egyptians abroad. The Arab International Bank was set up by Sadat in 1970 to marshal private funds; a large number of investment guarantees have been provided. Thus far, however, only a few investment projects have been approved in the private sector. Implementation probably will continue to lag because revitalizing the private sector runs counter to deep socialist currents and poses difficult political questions. Furthermore, the amount of capital offered will be reduced by the impatience of entrepreneurs with the tortuous process of approval and with the continuing threat of renewed hostilities. In any event, the encouragement of private investment is a long-term policy that will not relieve Egypt's short-term economic stringencies.

19. Sadat may consider asking the USSR to finance some or all of the prospective payments deficit, but the USSR cannot be expected to rush

4. If the population of a less developed country is growing at 3%, the investment of 12% of its GNP normally provides for little momentum in economic development.

Table 3

Egypt: Foreign Account Financing at Alternative Levels of GNP Growth 1973-77

	GNP Growth of 3%-4.5%		GNP Growth of 6.5%-7.5%[1]
		Million US $	
Cumulative current account deficit	1,250		2,250
Foreseeable financing (net)		750	
Eastern Europe		350	
IBRD		100	
West Germany		100	
Other Western countries		100	
Bilateral trade credits		100	
To be financed	500		1,500

1. Based on information available on the new Ten-Year Plan.

to Egypt's rescue as it did in the 1950s and 1960s when the West refused to finance the Aswan High Dam and when the United States cut off commodity aid. Moscow might agree to defer or extend Egypt's debt repayments to ease immediate financial problems. Moscow is reluctant, however, to accept further increments in Egypt's already gigantic debt, which, including military obligations, now totals $1.5 billion. Moreover, the USSR is not interested in bailing out Sadat, a man Moscow now distrusts and would like to see replaced.

20. Sadat may still be counting on the option of union with Libya, which remains scheduled for September 1973. With its $3 billion in reserves and $1.5 billion in annual revenues from oil, Libya offers to Egypt a degree of financial security unobtainable elsewhere.[5]

21. If economic conditions deteriorate in 1973 to the extent that Sadat's political position is threatened, Cairo can be expected to intensify its efforts to obtain additional Libyan or other Arab aid for Egypt's short-term and long-term interests. The other Arab countries – which are

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rapidly becoming loaded with oil money -- are capable of underwriting Egypt's economic future indefinitely. Libya might be ready to do so, especially if a more radical approach to Israel can be exacted as an interim **quid pro quo**. The magnitude of the long-term financial assurances needed by Egypt is uncertain, but more than $1 billion would be required over the next five years to assure constant per capita incomes and to offset settlement risks. To underwrite a settlement with Israel and the Ten-Year Plan, which is doomed without a sponsor, would cost $2 billion over the 5-year period.

Western Aid in Exchange for Settlement with Israel

22. Sadat might seek to ease his economic difficulties by exacting promises of financial assistance from the United States and other Western countries in exchange for an agreement to more forthcoming settlement terms with Israel. In the event of a settlement with Israel, the impact on Egypt's economy would depend on a number of factors. (For a detailed discussion, see the Appendix.) Chief among these is the attitude of Egypt's Arab benefactors who are formally committed to provide subsidies only until the "consequences of the aggression are removed." Timing also will be important. Even under the best of circumstances, however, a settlement cannot free Sadat completely from dependence on others.

23. In the case of a settlement in the near term, the immediate cost of covering Egypt's current account deficit could be small. Conceivably, much of the deficit could be covered by gains in revenues once the Suez Canal was reopened, together with rapid drawdowns of existing foreign credits and the continued receipt of annual subsidy payments from Saudi Arabia and Kuwait. If the latter subsidy payments were discontinued in the wake of the peace settlement, Egypt would require additional foreign assistance of at least $191 million to cover the annual deficit. Egypt would no doubt like to enter into a settlement with some guarantees of foreign assistance to rebuild the economy and to provide for an increase in the rate of GNP growth. Such guarantees could cost an additional $100 million in foreign assistance. If settlement is delayed, the annual costs of covering Egypt's deficit would go up because revenues from Sinai oil and from the Suez Canal probably will decline over the years.

APPENDIX

THE ECONOMIC EFFECTS OF SETTLEMENT

An immediate settlement that would return all or part of the Sinai and lead to reopening of the Suez Canal probably would be favorable for Egypt's economy, even though it would almost certainly cause Qadhafi to cut off the $59 million annual subsidy. In the short run, this loss would be more than offset by oil output regained from the Sinai fields, valued at about $95 million a year at current production rates. Net earnings of some $110 million a year could be expected once the Suez Canal is opened. The restoration of these two sources of revenue would reduce Egypt's prospective balance-of-payments gap by $146 million, even without Libyan aid. Potential gains, however, would not offset the loss of other Arab aid. If Kuwait and Saudi Arabia curtail their subsidies, the payments gap would be increased by at least $45 million annually (see the table).

Egypt: The Financial Impact of Peace in 1974

	Million US $
Egyptian gains	205
Net canal revenues[1]	110
Increased oil income	95
Loss of Arab aid	
Libya	59
Kuwait and Saudi Arabia	191
Net impact under alternate assumptions	
Libyan aid cut off	+146
All Khartoum aid cut off	-45

1. Gross revenues are estimated to be $120 million annually, assuming no decline over the years. Clearing costs of $40 million are prorated over four years and excluded from the cumulative total.

The longer a settlement is delayed, the less favorable will be the economic impact. After almost 6 years of rapid Israeli exploitation, considerable doubt exists concerning the size of remaining oil reserves in the Sinai. Most observers agree that output has reached maximum levels and that production probably will decline to zero over the next decade. The prospective net gain to Egypt from the canal also will decrease with increased use of larger tankers that cannot transit the canal and as costs for renovating the canal increase.

Regardless of the timing of a settlement, the indirect benefits should be sizable over the long run. Peace would facilitate development of the tourist industry, Egypt's most promising growth sector. The Sadat regime, unlike the Nasir regime, might be willing to devote official energies released by peace to the task of streamlining Egypt's state bureaucracy and reducing internal obstacles to economic progress. If Egypt opts for development of a strong private sector, peace would be especially beneficial. As has been demonstrated by the prolonged negotiations on the Sumed pipeline,* the threat of hostilities can seriously complicate the search for private capital no matter how profitable the venture may otherwise appear.

The economic benefits of a demobilization would be far less than commonly supposed. External accounts would be practically unaffected because the foreign exchange costs of defense have normally been covered by foreign grants and loans. The loans must be repaid whether or not demobilization occurs. As for internal benefits, a reduction of the defense budget would not necessarily release substantial resources for state investment. The defense budget has increased 220% since the war.** Until the cease-fire was arranged in 1970, actual defense expenditures undoubtedly increased. Subsequent increases in the defense budget can be attributed mainly to absorption of welfare state functions by the military sector. Thus the largest categories of defense expenditure – payment and maintenance of troops and pensions to survivors and evacuees – almost certainly would be transferred to other current accounts to be disbursed as civilian salaries, doles, and subsidies. In sum, the obstacles to a successful self-sustaining program of economic development would not be removed by a reduction in the use of resources for defense.

* The proposed Sumed pipeline would carry oil from the Gulf of Suez to a point on the Mediterranean coast near Alexandria. Demands by potential investors for firm repayment guarantees have prolonged financial negotiations for several years.

** From $394 million in FY 1967 to $1.26 billion (including the unbudgeted post-war Emergency Fund) in FY 1972. The total real per capita current budget (including defense) has risen only 18%.