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Egypt's Economic Crisis: Policy Options and Implications

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An Intelligence Assessment

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January 1986
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Egypt's Economic Crisis: Policy Options and Implications [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office of Near Eastern and South Asian Analysis. It was coordinated with the Directorate of Operations. [redacted] 25X1 25X1

Comments and queries are welcome and may be directed to the Chief, Arab-Israeli Division, NESA, [redacted] 25X1

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Egypt's Economic Crisis: Policy Options and Implications 25X1

Key Judgments

Information available as of 16 December 1985 was used in this report.

Egypt's capacity to meet its external financial obligations is deteriorating. Its balance-of-payments position will become untenable without a combination of major cuts in import growth, debt rescheduling, and significant increases in external assistance. 25X1

Deep import cuts will throttle economic growth and severely limit economic opportunities for a rapidly expanding and frustrated population. Resentment within the lower and middle classes over declining living standards would probably swell the political opposition, including the ranks of Islamic fundamentalists, and could ultimately destabilize the country. 25X1

The Mubarak regime's approach to reform has not produced significant improvement in Egypt's economic prospects. Cairo's incremental and excessively cautious approach provides little incentive for consumers, producers, and investors to shift gears and adopt new modes of behavior that might result in increased productivity and investment. Even if Cairo were to moderately accelerate the pace of economic reform, unsustainable balance-of-payments deficits would still occur. 25X1

The present government is unlikely to push for sweeping reform, despite lipservice to the contrary, because it believes that major restructuring of the current system of price supports, subsidies, and government controls would produce political instability. Egypt's leadership probably assumes that the strong US commitment to supporting a moderate regime in Cairo will guarantee major increases in financial assistance from the United States, lowering the pressure on Cairo to undertake politically risky reforms. 25X1

Even if Egypt succeeds in holding import growth to a rate that covers little more than the normal increase in population, the government will require annually an additional $1 billion in cash grants by 1987. Multilateral rescheduling under IMF auspices would mitigate this problem but would require Egyptian adherence to strict monetary and fiscal guidelines that would increase the risk of political upheaval. Cairo will probably be forced into an IMF standby agreement by 1987 at the latest unless the United States quadruples its balance-of-payments support. 25X1

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Higher levels of US aid would ease Egypt's external payments constraints, but they would provide few additional political benefits to the United States. Balance-of-payments support would be largely invisible to the Egyptian public and would be unlikely to engender greater support for ties to the United States. Opposition political groups already voice criticism of Egypt's dependence on the United States. If US assistance continues to grow while living standards stagnate or decline, the United States will be singled out with greater frequency as the cause, not the cure, for Egypt's economic woes. 25X1

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Egypt's Economic Crisis: Policy Options and Implications [redacted] 25X1

During the late 1970s and early 1980s Egypt enjoyed a period of rapid economic growth and improved foreign payments balances. These developments were spurred by large inflows of foreign assistance (especially from the United States), sharply rising foreign earnings from oil and worker remittances, and policies that stimulated the private sector. As a consequence, the Egyptian Government could provide extensive and, from a budgetary perspective, costly consumer subsidies and price controls to shelter low- and middle-income consumers. [redacted]

This era of rising prosperity has ended, and Egypt's policymakers are confronted with daunting problems and rapidly narrowing policy options. Economic growth, [redacted] has slowed, and the already bad foreign payments situation threatens to reach unmanageable proportions over the next several years. Efforts by Cairo to address its payments deficits are likely to require painful cuts in consumption. The government's ability to manage such an adjustment will be tested to its fullest because rapid population growth, grossly inadequate housing and services, and lack of meaningful employment opportunities already stretch the fabric of the social order. [redacted]

Recent Developments

During the past year Egypt's economy exhibited few signs of long-term health. Weak world oil prices, confusing exchange rate policies, and, despite some reforms, inappropriate internal pricing contributed to a marked deterioration in the country's balance of payments. We estimate that Egypt's foreign payments swung from a modest $200 million surplus in the fiscal year ending 30 June 1984 to a projected $1.3 billion deficit during FY 1985. [redacted]

Egypt earned about $2.2 billion from oil sales in 1985, down 15 percent from the previous calendar year. Declining petroleum revenues stemmed largely from the sluggish world oil market, which depressed prices and held exports to 250,000 barrels per day (b/d). Petroleum sales still accounted, however, for about 60 percent of Egypt's commodity exports and 20 percent of its foreign exchange earnings. [redacted]

Remittance earnings from 2-3 million Egyptian workers abroad also dipped, [redacted], by an estimated 28 percent over the previous year. Much of the drop in remittances, Egypt's single largest source of foreign exchange, is, we believe, attributable to the government's poorly conceived attempt to reform the complex, multitiered exchange rate system. Adopted in January 1985, the latest reforms attempted to alter the free market for foreign exchange by severely restricting transactions in this market and establishing a flexible bank rate of exchange that would be controlled by the government. Uncertainty about the new system, amplified by repeated government reinterpretations of the rules, caused foreign currency inflows to drop. Moreover, Cairo's reluctance to allow significant flexibility in the bank rate permitted the spread between the government rate and free market rate to grow and thus provided even less incentive for foreign currency holders to convert their funds within the commercial bank system. [redacted]

In April 1985 the government repealed most of the new foreign exchange rules, legalizing free market transactions but maintaining the flexible bank rate. [redacted] the flow of hard currency through the commercial bank system remained sluggish, causing arrearages in foreign currency payment obligations to grow. By September abnormally heavy purchases of dollars by both private- and public-sector institutions sparked a further dramatic depreciation of the free market rate and provoked a minor economic crisis. The free market rate has subsequently appreciated as a result of market forces, averting at least temporarily a major financial crisis and postponing the need for intervention by the government. Nevertheless, the basic structural weaknesses of the multitiered exchange rate system remain intact. [redacted]

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Table 1
Egypt: Estimated Balance of Payments, 1985-90

Billion US $

	1985	1986	1987	1988	1989	1990
Current account balance	−1.9	−2.0	−3.4	−3.8	−4.1	−4.4
Trade balance	−6.4	−6.7	−7.4	−8.0	−8.6	−9.2
Exports (f.o.b.)	3.7	3.9	3.7	3.7	3.7	3.7
Oil	2.2	2.3	2.0	1.8	1.6	1.4
Nonoil	1.5	1.6	1.7	1.9	2.1	2.3
Imports	−10.1	−10.6	−11.1	−11.7	−12.3	−12.9
Service balance	3.6	3.3	3.1	3.3	3.6	3.9
Receipts	7.4	7.3	7.3	7.7	8.2	8.7
Remittances	2.8	2.7	2.6	2.7	2.9	3.0
Suez Canal earnings	0.9	0.9	0.9	1.0	1.1	1.2
Tourism	0.4	0.4	0.4	0.5	0.6	0.7
Other	3.3	3.3	3.4	3.5	3.6	3.8
Payments	−3.8	−4.0	−4.2	−4.4	−4.6	−4.8
Official transfers	0.9	1.4	0.9	0.9	0.9	0.9
Capital account	0.6	1.2	1.3	1.2	1.0	0.9
Overall balance	−1.3	−0.8	−2.1	−2.6	−3.1	−3.5

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In line with its foreign exchange reforms, Cairo has pushed a restrictive import allocation policy that has also contributed to lower growth rates. [redacted] a government-administered import system based on lists of commodities banned from importation cut deeply during early 1985 into private-sector imports. It did little to stem the tide of public-sector purchases. General dissatisfaction with the system's cumbersome procedures and its negative impact on private-sector growth have led to its suspension. [redacted] a new system based on graduated custom fees is now under development. [redacted]

Policy Changes to Date

Cairo's efforts to address the serious economic distortions caused by the complex system of subsidies and fixed prices have accelerated within the past year. In our judgment, these reforms are too piecemeal and gradual to have had substantial impact on economic performance. Nevertheless, from the perspective of Egyptian policymakers, sensitive to the political ramifications of increasing consumer prices, reform efforts are viewed with a considerable sense of accomplishment, according to US Embassy reporting. [redacted]

Pricing changes to date encompass three broad areas: food subsidies, energy, and agricultural procurement prices. Food subsidies, the most politically sensitive component, have undergone the least change. The government has doubled the price of flour and introduced a 2-piaster bread loaf to replace the previous 1-piaster loaf. Nevertheless, this bread—priced at slightly over 1 cent a loaf—is heavily subsidized and, even for Egyptians, so cheap and abundant that Western observers have reported its use as fodder for livestock. [redacted]

The Mubarak regime's sensitivity regarding food issues was most recently demonstrated by its stand on produce pricing. After an abortive attempt to decontrol vegetable prices in May 1985, Cairo resorted to a voluntary system of price restraints to quell growing consumer dissatisfaction. This failed to produce price levels acceptable to the general public, and in October Prime Minister Lotfy announced the resumption of compulsory pricing. The rapid resort to controlled prices, in our view, demonstrates the regime's weak commitment to economic liberalization. [redacted]

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Egyptian Exchange Rates

Egypt has a complicated multiple exchange rate system. The most important rates include:

- Official exchange rate of LE 0.70 = $1.00. *This rate, last changed in January 1979, is used for public-sector earnings—such as petroleum exports and Suez Canal receipts—and for government imports of basic commodities and other approved transactions. The official rate essentially is an accounting rate for foreign transactions within the Egyptian Government.*

- Official flexible rate or "bank rate" currently at LE 1.35 = $1.00. *This rate, established in January 1985, is designed to enable Egypt's public-sector banks to be more competitive with the free market in the purchase of worker remittances and tourist dollars. Largely replacing the official "incentive rate," the new rate was billed as a flexible rate and was to be adjusted weekly to correspond to changes in the free market rate. In practice, the government has allowed very little flexibility, and the spread between this rate and the free market rate remains too large to attract most remittance earnings.*

- Free market rate, currently at LE 1.80 = $1.00. *The free market rate varies daily, and transactions are made through private traders. Workers abroad and tourists provide most of the foreign exchange. This market has increasingly been used by public-sector firms and banks because of inadequate foreign exchange in official channels. During late summer 1985 large-scale official demand for dollars was at least partly responsible for pushing the free market rate to a temporary high approaching LE 2.00 = $1.00.*

Price increases in the energy sector have been more rapid, but the contribution to reform is, in our view, questionable. The government raised gasoline prices by over 30 percent during 1985; the cost of regular gasoline following this price hike (converted at the free market rate) is still, however, only about 48 cents per gallon. Electricity prices were also increased last July between 10.5 and 60 percent. The smallest increase went to low-use residential customers, the highest to large commercial users. Despite this jump, domestic energy prices remain comparatively low, less than 25 percent of world levels and well below energy price levels in most non-oil-developing countries. 25X1

Procurement prices have also been subjected to considerable revision during the past year. The prices the government pays to producers of cotton, rice, sugarcane, and wheat were increased by 20 to 30 percent during the fiscal year ending June 1985. Our analysis of price differentials indicates that procurement prices for wheat have reached about three-fourths of world price levels, a price trend that, if continued, could stimulate greater wheat production in the future. Nevertheless, most procurement prices, including cotton and rice, remain substantially below international levels and provide Egyptian farmers with little incentive to expand production. 25X1

Economic Prospects, 1986-90

We expect the decline in oil revenues to continue through the end of the decade. Production, according to oil company estimates, will increase from a current level of about 900,000 b/d to over 960,000 b/d by mid-1986 and to over 1 million b/d by early 1987. It will probably stabilize at this level for at least the next two to three years before beginning to decline. Despite such gains, the combination of a weak world oil market and rapid growth of domestic consumption will almost certainly continue to depress earnings. 25X1

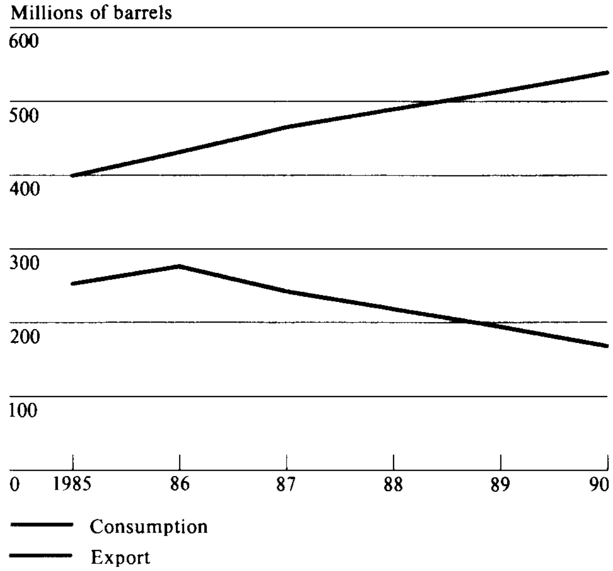
Domestic oil consumption has been increasing at a rate of 10 to 13 percent over the past several years, stimulated by Egypt's artificially low prices for energy and by government policies that have deliberately 25X1

Egypt's Troubled Agricultural Sector

A newly straightened and deepened mesqa (private irrigation ditch) in El-Minya Governorate

Egypt's agricultural production has been distorted by low government procurement prices, which provide little incentive for farmers to expand acreage of controlled crops such as wheat, rice, and cotton. Instead, many farmers have switched to growing forage crops, such as corn and clover, which are not regulated by the government and accordingly provide higher profit margins. Meanwhile, Egypt's food deficit grows. Egypt imports over half of its food needs at a cost of more than $2.5 billion annually.

Figure 1
Egypt: Oil Consumption and Export Projections, 1985-90



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encouraged greater use of electricity. This fast pace of domestic oil use will be slowed somewhat by the introduction of planned energy price increases in 1986, probably in the range of 20 to 30 percent, and by government plans to use 70 percent more gas by 1990.

Even with these developments, we believe that Egypt will have difficulty effecting significant reductions in domestic oil consumption in the near term. The projected rate of price increases for energy does not appear sufficient to produce the large shifts in consumption required. Our analysis leads us to believe that, at best, Cairo will slow growth of oil consumption to 8 percent per year in 1986 and 1987 and to 5 percent per year in 1988-90. Even these cuts, assuming they occur, will be insufficient to stem a reduction in oil available for export. Oil revenues will continue to decline.

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Remittances from workers abroad, the other major contributor to Egypt's foreign earnings, are likely to grow only marginally over the remainder of the decade. Although documentation is sketchy, the economic downturn in the oil economies of the Persian Gulf—the area employing most of Egypt's overseas workers—has probably already begun to affect expatriate earnings. We believe, however, that alarmist projections that assume large-scale layoffs of Egyptian workers over the next several years are unrealistic. Much of the Egyptian work force in the Gulf consists of skilled workers whose ethnic and religious compatibility and willingness to work at lower wages

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Oil Price Assumptions

Our projections in figure 1 are based on the premise that oil prices will decline only moderately over the next five years. This assumption could be overturned by the results of the December 1985 OPEC meeting in Geneva. If OPEC countries attempt to capture a larger market share, oil prices may, according to knowledgeable oil analysts, drop to the $20 per barrel level. A price decline of this magnitude would have disastrous implications for Egyptian revenue earnings and would entail the loss of about $700 million in hard currency during 1986 alone. [redacted]

than Western expatriates will probably ensure their continued employment. Nevertheless, we assume that some layoffs will occur, especially among less skilled workers, and that reductions in pay and benefits are likely for many more. [redacted]

Egypt's other traditional foreign exchange earners are unlikely to provide significant growth in foreign earnings. Suez Canal revenues have stabilized at just under $1 billion during the past few years and show few signs of expansion during the balance of the decade. Growth will remain constrained largely by sluggish economic activity in the Gulf region. [redacted]

Tourist revenues recently have sunk, according to US Embassy sources, and prospects over the next several years do not appear bright. The Egyptian tourist industry, outside a few luxury hotels in Cairo, is plagued with inadequate infrastructure and notoriously poor service, characteristics that do not encourage return visits. According to recent press reports, publicity surrounding terrorist hijackings in the Middle East also has influenced tourists, particularly US citizens, to avoid what is seen as an increasingly dangerous region to visit. [redacted]

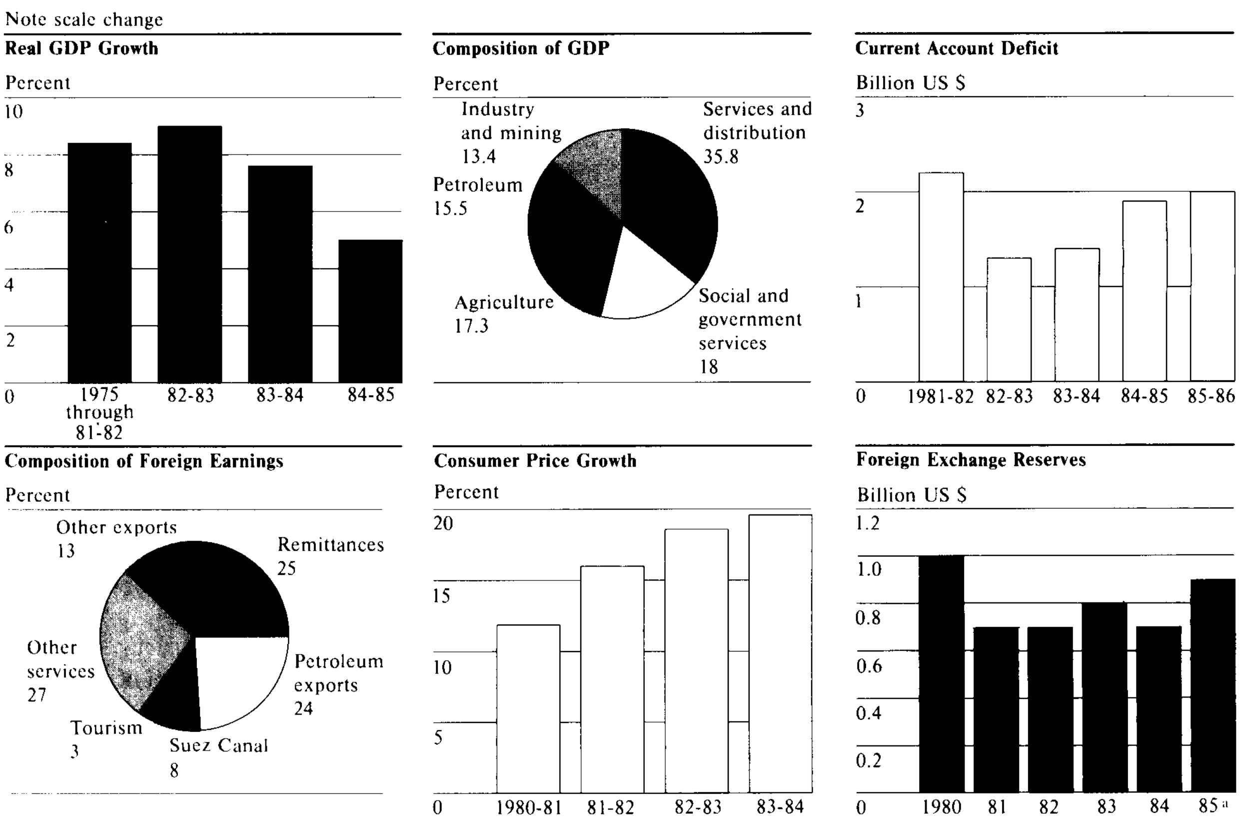
Recent increases in procurement prices for cotton may stimulate production and exports, but not enough to make a significant difference in overall foreign exchange earnings. Export earnings from cotton during FY 1985 were about $500 million, or roughly one-third of total nonoil exports. [redacted] 25X1

Other nonoil exports are unlikely to fare as well. [redacted] textiles 25X1 will face severe international competition and protectionist policies abroad. Industrial exports are widely regarded in financial circles as largely uncompetitive and likely to remain so for some time. Egyptian industry is dominated by public-sector enterprises whose low productivity, orientation to the home market, and dependence on government pricing policies make them poor vehicles for export expansion. [redacted] 25X1

Given the bleak prospects for most of Egypt's traditional foreign currency earners and the unlikely development over the next several years of new sources of 25X1 revenue, we believe that Egypt's balance-of-payments position will become untenable without a combination of major cuts in import growth and significant increases in external assistance. We have assumed for purposes of analysis that the government will be willing and able to limit import growth to 5 percent per year over the balance of the decade. Even with 25X1 such moderation, Egypt will experience an unsustainable deterioration in its foreign payments position. [redacted] 25X1

Economic growth, including the creation of new jobs for Egypt's burgeoning population, would be among the first casualties of import cuts. Although subject to significant swings, imports have risen over the past 25X1 several years at an average annual rate of 10 percent. If the government implements draconian import restrictions, it most likely will, given its inclination to maintain subsidies and price supports, protect public-sector imports at the expense of the private sector and also cut capital spending. Such measures will throttle growth, which has already slipped, [redacted] 25X1 [redacted] from an average 8.5 percent between 1975 and 25X1 1983 to no more than 5 percent in 1985. With population growth of 2.7 percent annually and urban growth of 3.5 percent, [redacted] 25X1 the Mubarak regime can ill afford to deal with the 25X1 social and political consequences of a stagnant economy. [redacted] 25X1

Figure 2
Egypt: Economic Indicators



[a] Estimated foreign exchange reserves.

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Policy Options

Cairo will continue to explore various policy options to help reduce its payments deficits and avoid crippling import cuts. These alternatives include:

- *External financial assistance other than from the United States.* Although Egypt will look first to the United States, it may also explore the possibility of other bilateral financing, particularly from the oil-rich Arab states. Egypt maintains active political links to most Arab states, but the lack of full diplomatic relations with most and Egypt's absence from the Arab League—the forum that approved many large aid flows in the past—are impediments to new official aid flows. We do not regard the prospects for significant funding from such sources as a viable alternative—even assuming a major political reorientation by the Egyptian Government.[1] 25X1

[1] Since the peace treaty with Israel, Cairo's official financial relationships with other Arab states have been limited primarily to the sale of military supplies to Iraq. Funds obtained from such transactions, which appear, according to US Embassy sources, to be declining in volume, are retained by the Egyptian military for its own use and do not go into the government's foreign exchange reserve for civilian needs. 25X1

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The Gulf Arab states are in the midst of their own financial crisis because of falling oil revenues and would not be inclined, we believe, to provide the additional aid Egypt will require. Moreover, de-emphasis of the Camp David accords would jeopardize current US assistance levels of about $2.3 billion annually and leave Cairo no better, and possibly worse off, than before. Finally, financial assistance from Libya or the Soviet Union would probably require an even more fundamental political reorientation by the Egyptian Government and would not, in our judgment, provide anywhere near the level of funding Egypt would lose by abandoning its relationship with the United States. [redacted]

- *Debt Rescheduling.* On the basis of US Embassy reporting [redacted] we estimate Egypt's external debt at $31 billion. Annual servicing obligations on this indebtedness have reached $3.6 billion—nearly one-third of current account receipts. Hence, rescheduling, involving deferral of all or part of these payments, represents an attractive alternative for the Egyptian Government. [redacted]

The most likely candidates for debt deferral from the Egyptian perspective are military debts, particularly US and French loans, which together total almost $7 billion. The French Government, according to the US Embassy, has already granted a grace period of up to two years on repayment of at least a portion of the $3 billion owed it. Cairo will undoubtedly press for similar, or better, rescheduling terms from the United States on FMS debt obligations. Mubarak probably views FMS rescheduling as a highly promising debt relief alternative, given his perception that the United States attaches high importance to the US-Egyptian security relationship. [redacted]

Rescheduling of public-sector nonmilitary debt is a far more complex problem and may involve political costs that the Egyptian Government is unwilling to bear. Current civilian debts, [redacted] include over $16 billion in long- and medium-term obligations and short-term liabilities of over $7 billion. A large debt burden, declining earnings potential, and lengthening delays in repayment have effectively excluded Cairo from negotiating further medium-to-long-term commercial loans. [redacted]

Table 2
Egypt: Estimated Foreign Debt, December 1985

	Billion US $
Civilian	
Medium- and long-term	16.5
Short-term	7.5
Military	7.0
Of which:	
US FMS debt	3.7
Total	31.0

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The Mubarak government's only viable option with regard to civilian debt relief appears to be multilateral rescheduling of long- and medium-term liabilities under IMF auspices. An IMF standby agreement would entail considerable cost. In exchange for lines of credit and extended repayment terms on bank-syndicated and bilateral loans, Egypt would have to adhere to strict financial and monetary guidelines, including much more rigorous subsidy reforms and more rapid movement toward a unified exchange rate. Such adjustments, however, would almost certainly force substantial increases in consumer prices and probably provoke political unrest. [redacted] 25X1

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The Mubarak government is highly sensitive to the appearance of foreign control over the country's economic policies and to the political fallout that could result from acceptance of an IMF-supported reform package. Egypt's leaders continually remind US officials that they have not forgotten the IMF-induced austerity program in 1977, which they blame for having caused widespread riots. Furthermore, we believe the government fears that an embittered and disillusioned population will vent its opposition to economic austerity by turning to radical Islamic fundamentalism. [redacted]

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Nevertheless, in the absence of large increases in US aid, Cairo probably cannot delay much beyond 1987 the introduction of an IMF standby agreement. A Fund program, while onerous and politically dangerous, would provide the government with some means of deflecting criticism from itself. It and an accompanying rescheduling agreement would also provide immediate economic relief. Moreover, given recent experiences in IMF standby agreements, the positive benefit of rescheduling would remain intact even if Egypt, at a later date, fell out of compliance with the IMF program.

- *Accelerated Reform.* From an economic perspective, a substantial self-initiated acceleration of economic reform is the most effective option available to Egypt. It is also about as palatable as an IMF standby agreement, from Cairo's political viewpoint. Current plans envision a five-to-seven-year period for the elimination of most subsidies, a pace that will yield few dividends in the near term. To Egyptian policymakers, however, a speedup in reform over the next one to two years entails too many political risks with no tangible economic benefits. Public statements by Egyptian leaders suggest that accelerated price increases, reform of the bloated bureaucracy, divestment of inefficient public-sector industries, and exchange rate unification are recognized as inherently important goals. These officials also believe, according to private conversations with US officials, that such adjustments would initially entail large and politically unacceptable jumps in living costs and displacement of workers before there is any visible improvement in the economy.

We believe that the Mubarak government lacks confidence in its ability to survive during such a period of economic adjustment. US Embassy analysis supports our belief that the mass of Egypt's low- and middle-income urban population already see their economic status eroding and would regard a rapid reduction in subsidies as intolerable. Moreover, a strong consensus within Egyptian society holds the government responsible for providing affordable goods and services to the public. These attitudes act as powerful constraints to any accelerated reform effort.

The greatest drawback to the Egyptian Government's piecemeal approach to reform is, economically speaking, its very gradualism. By delaying needed price adjustments or by stretching them out into increments acceptable to the general public, a sense of urgency is lost and much of the shock value of reform is dissipated. Cairo's excessively cautious approach to reform provides little incentive for consumers, producers, and investors to shift gears and adopt new modes of behavior that might result in increased productivity and investment. Instead, it is business as usual for most Egyptians, despite the burden of price hikes. 25X1
Finally, by not providing incentives (for example, higher wages, increased access to consumer goods) and by attempting to slip price increases through in a furtive manner, the regime confirms in the minds of most Egyptians that reform can only be injurious to their long-term economic well-being. 25X1

Implications for the United States, 1986-90

Cairo will almost certainly expand its efforts to obtain greater balance-of-payments support from the United States. The dim prospects of aid from other sources and the unattractiveness of an IMF standby agreement or greatly accelerated, self-initiated economic reform leave no other feasible alternative, from the Mubarak government's perspective. Egyptian officials are likely to argue that, despite tensions flowing from the Achille Lauro affair, their country remains the United States' most supportive friend in the Middle East and an indispensable partner in the search for regional peace. 25X1

We believe that Egypt will push hard for FMS debt rescheduling. The $3.7 billion in military debt obliga- 25X1
tions owed to the United States will require annual payments of about $550 million over the next several years. The Egyptians are $470 million in arrears on these payments and are constantly pushing up against the one-year arrearage limit that could trigger a Brooke amendment cutoff in all US assistance. Cairo has requested debt relief in past meetings with US officials and will almost certainly press harder for forgiveness, or substantial rescheduling, during the next year. Egypt's special military relationship with the United States and shared concerns over the role of the Soviets, Libyans, and Iranians in the Middle East 25X1
will undoubtedly be cited by Cairo as justification for FMS relief. 25X1

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Why Inflation Is So Low in Egypt

Normally, countries with large balance-of-payments and budget deficits would face inflation rates in the 50- to 200-percent annual range. The low inflation rate in Egypt, officially 20 percent in 1984, results from the fact that a large share of consumption, probably 50 to 70 percent, is subsidized in one form or another. Further, the prices of most goods measured in the consumer price index are controlled by the government. A better picture of the underlying rate of inflation may be obtained by looking at subindexes for categories of goods and services that are more exposed to market influences. For example, the subindex for services increased by 34 percent in 1984.

While domestic inflation is held to a minimum by subsidies and controlled prices, international inflation is deflected by the exchange rate system. These policies combine to lay the costs of inflation on the government and not directly on the people.

The Mubarak government also will strongly argue for conversion of more Economic Support Funding (ESF) into cash transfers, as well as an increase in total ESF, which currently is $815 million annually. During the current US fiscal year about $300 million of ESF has been allocated by the United States for balance-of-payments support; the remainder is distributed as project assistance through USAID. Cairo will probably attempt to persuade US officials to convert more project assistance into grants, citing as justification the cash grant status of all ESF under US assistance to Israel. The Egyptians have long maintained that the United States promised aid parity with Israel. Egyptian officials may also cite growing political and social tensions caused by the large US presence in Egypt and argue the desirability of lowering the US profile by channeling more project assistance directly into Egyptian hands.

In addition to regular ESF, Egypt is receiving from the United States $500 million in supplemental grant assistance—all of which will be disbursed during the current Egyptian fiscal year. Our analysis of Egypt's 1985/86 budget suggests that Cairo has already incorporated this amount into the capital transfer and investment portions of its budget, leading us to believe that the Egyptians assume this supposedly one-time funding, or the equivalent in new ESF, will be made available to them on an annual basis after 1986. 25X1

Given current financial trends, Egypt could require, in the absence of an IMF standby program and a rescheduling agreement, an additional $1 billion in balance-of-payments support by 1987. This would necessitate a roughly fourfold hike in US aid designated solely for payments support and, in the absence of any general aid increases, would require converting most current US assistance, military and civilian, into cash grants. An IMF-supported standby program for 25X1
Egypt undoubtedly would ameliorate to some extent the need for greater direct financing but would probably entail additional costs for the United States in the form of supporting the IMF program and deferring loan obligations. 25X1
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We believe that the Mubarak government will not accept an IMF adjustment program, at least not on the IMF's usually strict terms, until it is convinced that the United States will not provide the large increases in assistance that would be required to meet external payments. Depending upon the US response, we see two possible scenarios evolving over the next one to two years:

Scenario A—The United States limits additional financial support. Under this scenario, Egypt would probably be forced to accept an IMF program. Cairo may view US unwillingness to extend additional support as a repudiation of the special relationship it believes it has established with Washington. Accordingly, US-Egyptian political and strategic relations would suffer. We do not believe, however, that Cairo would renounce its adherence to the Camp David accords unless it was convinced that other donors would replace the United States, a prospect we regard 25X1
as unlikely. 25X1

An IMF-supervised adjustment program and the specter of foreigners dictating Egyptian economic policies would give opposition groups a potent issue against President Mubarak. The accelerated level of economic reforms, including subsidy reductions and price increases, would fuel additional discontent within Egypt's lower and middle classes and possibly lead to an explosive political situation. The government might be able to deflect some criticism from itself and assign blame to the IMF and the United States. It would require, however, a rare combination of political resolve, skillfully crafted economic policies, and deft public relations handling for the Mubarak regime to survive unscathed. 25X1

Less likely, Cairo could decide to act unilaterally like Peru and consign only a fixed amount of its foreign exchange earnings—for example, 10 percent—to repayment of foreign debt. Unilateral rescheduling would provide the Egyptian Government with a more politically palatable alternative to an IMF program and would also give the government the flexibility to fashion its own adjustment program—providing it had the will to do so. A cutoff of short-term lines of credit, however, would make trade financing extremely difficult for Egypt, given its low foreign exchange holdings. Most bilateral creditors, including the United States, would react with displeasure to unilateral rescheduling but would probably refrain, for political reasons, from an aid cutoff. The short-term benefits of going it alone would be quickly dissipated if the regime did not quickly accelerate the rate of economic reform. 25X1

Scenario B—The United States provides significant new levels of financial support. Higher levels of US aid would probably delay Egyptian acceptance of an IMF-supported adjustment program. It also would, judging from Cairo's policy initiatives over the past several years, lead to only modest acceleration in the government's gradualist approach to economic reform. The fundamental structural weaknesses of the Egyptian economy would remain, to be addressed at a later date when corrective measures may entail even harsher adjustments. 25X1

Greatly expanded aid levels would do little more than preserve the political status quo. Additional balance-of-payments support would appear largely invisible to the Egyptian public and would not promote greater support for ties to the United States. Moreover, opposition political groups already criticize Egypt's dependence on US aid. In the event that Egyptian living standards continued to stagnate or decline, the United States would probably be singled out more frequently as the cause for Egypt's economic woes. Cairo might then find itself under greater pressure to be less cooperative in its dealings with the United States, despite larger US aid commitments. 25X1