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The Director of Central Intelligence  
Washington, D.C. 20505

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National Intelligence Council

05 MAR 1986

MEMORANDUM FOR: Ambassador Morton I. Abramowitz  
Director of Intelligence and Research  
Department of State

SUBJECT: Prognosis for Egypt

*Mort -*

1. Attached you will find the paper on Egypt you requested in your 3 February letter for Allen Wallis. It is an in-house-paper--at Wallis' request and has not been coordinated by the Community. Last week's riots underscore the paper's pessimism about the regime's ability to address its problems effectively and the possible immediacy of a crisis.

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3. We hope this paper is helpful to Allen Wallis and others who are formulating economic and aid policies for Egypt through what may prove to be a very difficult period. The paper is important enough to be seen by other key members of the policy community and has been distributed accordingly.

*RMG*

Robert M. Gates  
Chairman

Attachment:  
As stated

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EGYPT: Prospects for the Mubarak Regime

3 March 1986

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KEY JUDGMENTS

Egypt's rapidly deteriorating economic situation could bring the Mubarak regime's viability into question during 1986.

Under present circumstances we see little prospect that this trend will be arrested in any major way. Mubarak's position has been so weakened by numerous issues that the requisite will and political capability is lacking to take the major remedial economic steps necessary, e.g., restructuring the economy to reduce subsidies, rationalize exchange rates, and control imports.

Ultimately, Mubarak will be pressured into negotiating a standby agreement with the IMF and rescheduling the official debt.

- If he adequately prepares public opinion in advance, the political reaction to the IMF agreement need not in itself precipitate an unmanageable situation.
- But if the only economic adjustments made are superficial, then all that will have been bought is a little time until Egypt's external debt troubles and its relations with creditors threatens even its ability to import food and other essentials.

Conversely, if Mubarak has not adequately prepared public opinion for new IMF strictures, the likelihood will rise of civil disorder and sharp reactions against both his regime and his pro-US policies. In such circumstances, Mubarak could easily miscalculate and lose control of events, particularly if the police and military balked at forcibly suppressing popular disturbances.

Furthermore, the present economic difficulties are only part of Mubarak's serious troubles. They follow a series of dramatic political setbacks -- in particular, the Achille Lauro incident, the Malta hijacking, Israel's raid on Tunis, and the February police riots -- which have undercut his influence and left him vulnerable to an increasingly hostile opposition.

It is this greatly weakened political position which renders unlikely the major remedial shifts in economic policy which Mubarak should take, whether on his own initiative or formalized in an IMF-supported standby program. Substantial political risks would be involved for him:

- The public debate on the economy centers around the well-being of Egyptians, not the debt crisis.

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- The mass of Egypt's low- and middle-income urban population already see their economic status eroding.
- IMF-imposed austerity measures would be portrayed by the opposition as a loss of sovereignty.
- A reduction in subsidies and sudden price hikes in basic commodities almost certainly would lead to widespread rioting.

We believe Mubarak will push hard for debt relief and expanded financial assistance from the US and will interpret any perceived footdragging by Washington as a sign of growing indifference to Egypt's plight. Although he is unlikely to jeopardize existing US aid flows by downgrading ties with Washington or totally abandoning the Camp David accords, public opinion may force him to cool relations with Tel Aviv even further and distance Cairo from US policies in the region.

- In a prolonged period of general disorder we expect that Mubarak would reverse the most egregious austerity measures. If disorder continued and Mubarak seemed unable to govern, senior officers would probably require him to step down. Similarly, if Mubarak dies or resigns we would expect the military to supervise the transition of power since Mubarak has not appointed a successor. If the military proved as incapable as Mubarak in addressing the nation's economic woes, the prospects of a takeover by more radical elements increases.

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## DISCUSSION

The Setting

Adverse economic and political circumstances place extreme pressure on the Mubarak regime and could bring its viability into question during 1986. Egypt's ability to meet both import requirements and external debt obligations is deteriorating rapidly. Its balance of payments position will likely become unmanageable during 1986 without some combination of significant increases in external assistance, debt rescheduling, and large cuts in import growth. These difficult choices come at a time when Mubarak is in a particularly bad position for addressing them.

Economic Prospects. Egypt's major sources of foreign earnings are in decline with falling oil revenues presenting the most serious and immediate concern. Next to worker remittances, oil revenues represent the single greatest source of foreign exchange earnings. 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. Petroleum sales still accounted, however for about 60 percent of Egypt's commodity exports and 20 percent of its foreign exchange earnings.

Even before the latest steep decline in world oil prices, Egypt's petroleum revenue outlook was poor. Production much beyond current levels of between 900,000 b/d and 960,000 b/d is unlikely, according to knowledgeable oil industry sources. Meanwhile, domestic oil consumption has been increasing at a rate of 10-13 percent over the past several years, cutting ever deeper into the exportable surplus.

These negative trends have now been reinforced by the precipitous slide in world oil prices. If the average price per barrel for the year falls to \$20, Egypt will lose about \$650 million in hard currency oil revenues. If, as some analysts now believe, prices fall even further, to say \$15 per barrel, Egypt could lose \$1.15 billion annually.

Foreign earnings losses at even the more "moderate" \$20 per barrel level will strike Egyptian government finances particularly hard in the coming months as the full magnitude of the price cuts begins to be felt. Cairo has already experienced serious difficulties in servicing its international debt obligations, now estimated at about \$3.7 billion annually. Lengthening delays in repayment, a large debt burden, and declining earnings potential have effectively excluded Egypt from negotiating further medium-to-long term commercial loans. Financial sources have also reported that Egyptian borrowers are experiencing increasing difficulties in obtaining short-term credits.

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Other major sources of foreign exchange--in particular, remittances and tourism--are unlikely to compensate for the loss of oil earnings during the current year. The economic downturn in the oil economics of the Persian Gulf--the area employing most of Egypt's overseas workers--has already begun to affect expatriate remittances, which totaled 2.8 billion in 1985. While we discount alarmist projections that assume large-scale layoffs of Egyptian workers, we believe it is possible that some layoffs will occur and that reductions in pay and benefits are likely for many more. Accordingly, a major increase in remittance earnings is unlikely during 1986, and these earnings may even fall.

Similarly, tourist earnings which provided over \$400 million in hard currency last year will probably decline. Publicity surrounding the recent spate of terrorist hijackings in the Middle East has led tourists, particularly US citizens, to avoid what is seen as an increasingly dangerous region to visit. Bookings at major Cairo hotels reportedly have slumped badly in the past few months and are unlikely to pick up sufficiently during the year to provide for any growth in earnings. With the possible exception of cotton sales, we can detect no measurable component of foreign earnings that will experience significant growth over the current year--certainly none that will make up for the acute loss of oil earnings.

The Political Scene. An unprecedented rash of political setbacks has put Mubarak on the defensive and seriously undermined his ability to cope with Egypt's economic crunch. Cairo's mismanagement of several recent crises have eroded Mubarak's political credibility and left him vulnerable to an increasingly hostile opposition. These crises include:

- The Achille Lauro incident.
- The hijacking of an Egyptian airliner to Malta.
- Border tensions with Libya in which Mubarak appeared to vacillate.
- The February police riots.

We do not believe that opposition to Mubarak is strong enough to topple him, but it is growing and causing him serious concern. Last October, opposition elements were openly backing the government against the US and Israel in displays of national unity. Subsequent crises--in particular the suicide in January of an Egyptian policeman convicted of killing seven Israelis in the Sinai--have led responsible opposition leaders to exploit public emotions by publicly challenging government policy. There is the continuing possibility that this type of event, beyond Mubarak's control, could precipitate a major crisis that further discredits him.

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Mubarak's political troubles are compounded by deepening paralysis within the Egyptian government that is largely of his own making. His insistence on maintaining personal control of economic decisionmaking continues to discourage initiative at the Cabinet level. At the same time, Egypt's Prime Minister Lufti--a prominent economist and Mubarak's personal choice for the position--has proved totally incapable of controlling Cabinet infighting and implementing coherent policies.

Because of his direct role in recent decisions and growing participation in day-to-day administration, Mubarak increasingly is being blamed personally for government drift and incompetence. The public debate centers on the economic well-being of Egyptians and Mubarak has been unable to rally national support for a general economic belt-tightening.

Opposition responses to tough government reforms would range from condemnation by those on the religious right and socialist left of Egypt's political spectrum to criticism by those in the center. Muslim fundamentalists--both "moderate" Muslim Brothers and extremists among low-income Egyptians--would denounce the measures as those of a corrupt regime failing in its welfare duties to "the faithful." Socialists--while far less able than religious factions to mobilize anti-regime sentiment--would portray the decision as capitulation to Western capitalist pressure. Criticism by moderately well-off Egyptians in the large New Wafd party would initially be more restrained but would increase if outside forces were perceived as dictating Cairo's policy.

Effective economic solutions will entail political choices that any government would be reluctant to make, but Mubarak's shaky political position would make certain aspects of an austerity program doubly dangerous. An increase in food prices in 1977 immediately caused widespread rioting that required military force--and a return to the old prices--to restore order. We believe that a similar increase today would prove even more destabilizing in the likely event public discontent were fueled by well-organized Islamic fundamentalists seeking a weapon against the regime. Furthermore, police riots last month have weakened Egypt's internal security forces and have seriously damaged Mubarak's position.

Mubarak's growing personal sense of vulnerability also will complicate economic decisionmaking. Mubarak is especially sensitive about policies that focus popular discontent on his leadership--a predisposition reenforced by having witnessed Sadat's assassination at close range. If Mubarak cannot take refuge in inaction or stopgap solutions--his usual preference--he will seek to rally support for his position by placing as much blame as possible on external actors such as the US or oil prices for Egypt's situation before undertaking more far-reaching policies. He has already begun to prepare public opinion for hard times in recent public statements about the world's soft oil market.

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Policy Options

We believe Cairo will continue to explore various policy options designed to contain its payments deficits and avoid crippling import cuts. In developing these options Mubarak will consider some combination of the following:

- Self-initiated acceleration of reform. Until now, the Egyptian government has strenuously resisted this option. Current plans envision a five to seven year period for the elimination of most subsidies. This pace will yield few dividends in the near term, but Egyptian policymakers fear that a speedup in reform entails many political risks with no immediate economic benefits. They are aware that economic policy adjustments would initially involve large jumps in living costs and perhaps displacement of workers, and they lack confidence in their ability to survive politically during such a period.

The shock of substantially lower oil prices and its obvious implications for Egypt's economic outlook could provide the government with a pretext for proceeding with a more vigorous reform program. The greatest drawback of the current piecemeal approach to reform has been, we believe, its very gradualism. By delaying needed price adjustments, or by stretching them out into increments acceptable to the general public, a sense of urgency has been lost and much of the shock value of reform dissipated. The stark reality of plummeting oil prices, given wide play by the Egyptian media, could, however, be portrayed by the regime as an event beyond its control that forces harsh, but necessary, austerity measures.

We believe there is a high probability that the Mubarak regime will accelerate reform but we doubt it will take the form of a coherent, integrated program. More than likely, given Mubarak's excessively cautious approach and the fragmentation of economic decisionmaking within the current government, reform will remain piecemeal. Certain commodities will be subjected to substantial price hikes, while others, including probably bread, will be left relatively untouched. Some measures, including harsh import controls may, if selectively implemented to fall disproportionately on the private sector, throttle economic activity and do more harm than good. In any case, it is unlikely that unilateral reform, alone, at this late stage will provide sufficient relief to extricate Egypt from its economic crisis.

- 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

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unofficial political links with most Arab states, but its estrangement from mainstream Arab politics is an impediment 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. The Gulf Arab states are in the midst of their own financial crisis because of falling oil revenues and would not be inclined to provide the additional aid Egypt will require. Even if they were, it would probably be at the price of deemphasizing the Camp David accords. This would jeopardize current US assistance levels of about \$2.3 billion annually and probably leave Cairo no better off than before.

Garnering 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.

- Debt rescheduling. We estimate Egypt's external debt at \$37 billion. Annual servicing obligations on this indebtedness will probably total about \$3.7 billion during 1986. This huge debt burden clouds the immediate financial outlook more than any other factor. Hence, rescheduling, of these payments represents an attractive alternative for the Egyptian Government.

Rescheduling of public-sector debt--including US Foreign Military Sales obligations which Cairo believes can be easily restructured--is traditionally contingent upon having an IMF-supported economic adjustment program in place.<sup>1</sup> For Egypt, an IMF standby agreement would entail adherence to strict

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<sup>1</sup> The IMF and IBRD are prepared to offer a substantial assistance package including over \$1 billion in financial aid and a Paris Club rescheduling of bilateral debt if Egypt agrees to a structural adjustment program. Before such a program could begin, Cairo would probably have to implement some of the reforms specified in its FY 85/86 Budget including additional energy price increases, customs revaluation, and movement toward exchange rate unification. It is not clear whether the IMF/IBRD would insist that all such reforms be enacted before aid is disbursed, or if movement on exchange rate unification together with general agreement on a timetable for other reforms, would suffice. Much will depend on the IMF/IBRD's assessment of the resolve the government demonstrates before a program is agreed upon--highlighting the importance of a serious dialogue beginning as soon as possible.

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financial and monetary guidelines, including much more rigorous subsidy reforms and more rapid movement toward a unified exchange rate. It is such adjustments that would force substantial increases in consumer prices and probably provoke political unrest.

The Mubarak government has in the past expressed great sensitivity to the appearance of foreign control over the country's economic policies. Egypt's leaders continually remind US officials that they have not forgotten the IMF supported austerity program in 1977, which they blame for having caused widespread riots. Furthermore, we believe the government fears that Islamic fundamentalists could take advantage of an embittered and disillusioned population who would vent its opposition to economic austerity by turning to radical Islamic fundamentalism.

Nevertheless, in the absence of large increases in aid, Cairo probably will be forced into some form of rescheduling during the current year. For purposes of analysis we have reduced the likely options available to the Egyptians into two possible scenarios. These are:

- Unilateral action. Cairo could decide to go it alone as some third world countries already have done and limit debt payments without an agreement with creditors. Such a move could involve a unilaterally imposed debt moratorium, a freeze on principal repayments, or a decision to repay only those creditors Cairo believes are likely to provide fresh funds. This approach avoids any association with foreigners dictating the country's economic policies and, accordingly, is more politically palatable than an IMF program. Such actions, however, probably would result in a drastic reduction or cutoff of shortterm credit lines, an event that would slow imports to a trickle given Egypt's low foreign exchange reserves. Moreover, a unilateral action would discredit the Egyptians and make subsequent dealings with the IMF extremely difficult should the regime decide to approach the Fund at a later date. For these reasons, we doubt the Mubarak regime would opt for such a solution to its economic problems.
- IMF Standby Agreement. More likely, Egypt will negotiate a standby agreement with the IMF and pursue a Paris Club rescheduling of official debt. A rescheduling of commercial bank debt, however which accounts for more than half of Egypt's total debt would be a lengthy process and would be derailed if Cairo were to fall out of compliance with its IMF program.

An agreement with the IMF need not precipitate an adverse political reaction, at least not initially, if the Egyptian

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government prepares public opinion and the IMF is especially lenient on preconditions. Most of the painful price adjustments would need to be postponed until well after the first disbursement of financial assistance. Cairo over the next several months could use the media to dramatize the seriousness of the economic situation, stressing how events beyond the government's control (i.e., the fall in oil prices) require drastic changes in economic policy.

An even more sophisticated approach would involve prior consultations between Cairo and the IMF designed to quietly reach an agreement in principle on an economic adjustment program. Mubarak then could publicly announce Egypt was adopting "independent" austerity program without any foreign interference or infringement on Egyptian sovereignty. The IMF subsequently could endorse the "homegrown" Egyptian economic prescriptions and invite Cairo to formalize the program into a standby agreement.

The IMF-standby scenario could be complicated by several factors:

- Even if a smooth transition into a standby agreement occurs, it merely postpones the inevitable price hikes that would be a part of any IMF agreement. At this later date, however, the Egyptian skill at procrastination would probably lead to stretched-out price adjustments as the pace of the price hikes becomes a source of protracted haggling between the government and the Fund.
- The Egyptian government could bungle the preparation for an IMF program. If the current drift in policymaking authority within the cabinet continues, a troublefree progression to a Fund program is unlikely. Communication between the government and the Fund and, for that matter, between the government and the populace likely will become garbled and may break down. The worst possible approach Cairo could take, in our estimation, would be to try to slip into an IMF-supported program without any public preparation or announcement. Given its poor track record on implementing prior economic policy changes, such a move is a distinct possibility. Under these circumstances the likelihood of political reaction and civil disorder become far greater.
- Perhaps most seriously, Egypt may make only a superficial commitment to economic adjustment merely to win an IMF standby and Paris rescheduling. While this would provide a modicum of financial relief this year, it would exacerbate both Egypt's external debt troubles and its relations with creditors in the following years.

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General Disorder/Coup Scenarios

Mubarak will likely encounter some disorder no matter what strategy he adopts. Most urban Egyptians already need two sources of income just to afford goods at current prices, and they would see a large jump in living costs as intolerable. A substantial price hike in basic commodities bread, flour, rice, and cooking oil, for example would lead to widespread riots.

Even if Mubarak avoided price hikes in basic commodities, other austerity measures perceived to hurt the lower and middle class might prompt them to make common cause with Islamic fundamentalist and leftist forces to challenge government policies. Furthermore, external acts perceived as anti-Arabs such as an Israeli raid on a PLO camp would further aggravate passions, and possibly instill commitment within some fundamentalist groups to assassinate the president.

Mubarak will almost certainly adopt a more anti-US posture to get ahead of public opinion in the likely event unrest takes on the theme that Washington has not done enough to aid Egypt. His reading of mass sentiment, however, will determine how anti-US he becomes. Blaming the US for Egypt's troubles would bolster his leadership position by diverting public attention from his policies.

Even if Mubarak rescinded austerity measures, he still could find himself in a situation beyond his control. It is possible that demonstrations would not abate. Bloody suppression of the rioters by police forces would further embitter the populace.

Mubarak cannot rely on the Interior Ministry's security forces. The majority of the conscripted troops that make up the bulk of the police forces are poorly educated Moslems who have grown up in deeply religious homes and would likely crumble in confrontations with mobs.

The February police riots accentuate Mubarak's dependence on the military. Instead of the ultimate guarantor of security, the Army must now be reckoned as the power holding things together. The Army itself is suspect in certain scenarios. Conscript personnel might find themselves in sympathy with the disgruntled population and refuse orders to suppress popular disturbances. If large-scale disorder prompted rebellion in the armed forces, it would almost certainly bring down the Mubarak regime.

Mubarak Dies or Resigns. Egypt has demonstrated that its political institutions are flexible enough to accommodate drastic leadership changes--as evidenced by Nasir's death and Sadat's assassination. If Mubarak were to die or resign before his tenure ended in 1987, the Constitution stipulates the Speaker of the People's Assembly would become the interim president in the absence of a vice president. Within 60 days, a new president would have to be nominated by a two-thirds vote of the People's Assembly, and then approved by a majority of the electorate.

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An orderly succession is likely, but a contentious one is possible, especially during a period of turmoil. In those circumstances, the military would strongly influence and probably supervise the transition, presenting a military leader as candidate for president.

Senior Officers Take Control. The current senior officers could intervene in domestic politics if massive public disorder threatened a breakdown of law and order. If the Interior Ministry's security forces became so hard pressed that they were on the verge of collapse, the military would move to restore order.

If general disorder continued, a martial law decree would be issued and constitutional rights suspended. This collapse of civilian authority would seriously discredit the regime and leave the military in de facto control of the government but possibly with Mubarak remaining at the head. If the populace were to blame Mubarak personally for Egypt's policy failures, however, the military would ask him to step down. Under these circumstances, we believe he would probably resign, rather than be forced out of office. The senior officers most likely would name the defense minister president.

Senior officers would distance themselves somewhat from Mubarak's policies, but they would not abandon the peace process or ties with Washington altogether. The regime would not want to risk another war with Israel or jeopardize the US sponsored modernization programs for Egypt's armed forces. Bitter experiences with the Soviets in the 1970s have underscored the difficulties of replacing one arms supplier with another, and senior officers would avoid a repetition.

Instead, anti-US sentiment could prompt demands for cutbacks in AID projects that are visible and, in some cases, controversial. Senior officers could also demand reductions in US official personnel as well as contractors and researchers. A massive expulsion of Americans, however, would be unlikely.

The senior officers are not likely to have political agendas at variance with Mubarak's and, therefore, would find it difficult to provide forwardlooking, reformminded leadership. They would soon find themselves stymied by the same hard choices that precipitated Mubarak's fall. The likely failure of such a regime to solve Egypt's problems could set the stage for a more radical alternative.

Radical Nationalists Seize Power--the worst case for the short term. A period of political paralysis, economic stagnation, and dependence on foreign assistance could force the overthrow of a regime set up by senior officers. The leaders in such a coup would likely be younger generals or colonels whose ideology blends radical Arab nationalism with Islamic fundamentalism. Their popular appeal would reside in their ability to evoke a recall of the Nasir era and to exploit xenophobic sentiments

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brought on by bitter disappointment in Western and especially US patronage. Although we do not expect this scenario to unfold within the next year, Mubarak's near term attempts to grapple with Egypt's economic distress sets events in motion that directly affects this possibility.

A radical nationalist regime of this type would have to seize power by force, but, if successful, would probably gain the acquiescence of the rank-and-file military. The mass of Egyptians would probably accept severe belt-tightening under such a regime as long as all segments of society were forced to make sacrifices.

The regime would seek to break perceived Western economic domination and look for alternative sources of financial support. This could begin with a renunciation of the Camp David accords to attract assistance from wealthier Arab states and a full return to the Arab fold. The regime would also make friendly overtures to the Soviet Union, Iran, and Libya to strengthen Egypt's nonaligned credentials. The regime would be unlikely, however, to initiate any hostile gestures toward Israel, allowing instead the perpetuation of a "cold peace."

#### Implications for the United States

As Mubarak begins to grapple with Egypt's burgeoning economic crisis, he will continue to seek debt relief and expanded financial assistance from the United States, and may make this a more visible, public, and contentious issue despite repeated warnings from US officials that the prospects for such aid are poor. Egyptian officials will push hard for FMS debt rescheduling. We do not believe that they sufficiently understand that FMS debt relief can only realistically be addressed within the context of Paris Club rescheduling. Accordingly the government will continue to push hard for bilateral accommodation on military debt.

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 altered economic outlook resulting from falling oil prices. 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 such direct assistance, Cairo will probably also ask the United States to use its influence within the IMF to grant assistance to Egypt on the most lenient terms possible. The Egyptian government

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will be looking for minimal preconditions before a first tranche of aid is released and sufficient flexibility on the timing and degree of price adjustments required.

The longer Egypt's economic crisis continues, the more Egyptians will opt to blame Washington for their plight. A major economic policy shift will intensify the growing Egyptian opposition to Mubarak's close ties to the US and Israel. Many Egyptians have come to view US assistance as an insulting bribe for Cairo's "good" behavior toward Israel, yet at the same time they have been disappointed that US largess flowing from the Camp David accords has failed to improve Egypt's lot. Although Mubarak is unlikely to jeopardize existing US aid by downgrading ties to Washington or abandoning Camp David, public opinion may force him to cool relations with Tel Aviv and distance himself from arrangements increasingly perceived as affronts to Egypt's prestige.

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EGYPT: Prospects for the Mubarak Regime

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