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Macroeconomic policy for employment creation in Egypt: Past experience and future prospects

Tariq Haq
Chahir Zaki

Employment
and Labour
Market Policies
Branch

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Preface

The primary goal of the ILO is to work with member States towards achieving full and productive employment and decent work for all. This goal is elaborated in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,¹ which has been widely adopted by the international community. Comprehensive and integrated perspectives to achieve this goal are embedded in the Employment Policy Convention of 1964 (No. 122), the *Global Employment Agenda* (2003) and – in response to the 2008 global economic crisis – the *Global Jobs Pact* (2009) and the conclusions of the *Recurrent Discussion Reports on Employment* (2010 and 2014).

The Employment Policy Department (EMPLOYMENT) is engaged in global advocacy and in supporting member States in placing more and better jobs at the center of economic and social policies and growth and development strategies. Policy research and knowledge generation and dissemination are essential components of the Employment Policy Department's activities. The resulting publications include books, country policy reviews, policy and research briefs, and working papers.²

The *Employment Policy Working Paper* series is designed to disseminate the main findings of research on a broad range of topics undertaken by the branches of the Department. The working papers are intended to encourage the exchange of ideas and to stimulate debate. The views expressed within them are the responsibility of the authors and do not necessarily represent those of the ILO.

Azita Berar Awad
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¹ See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

² See <http://www.ilo.org/employment>

Foreword

Since the early 1990s, the Egyptian economy has undergone several waves of reforms that have shaped its current structure. They laid the foundations for Egypt's move towards a market economy, by liberalizing trade and privatizing many state-owned enterprises. This resulted in reasonably healthy GDP growth; yet decent employment creation remained constrained. The political uprising of 2011 had a significantly negative impact on growth, with severe internal and external imbalances that have endured to the present day. Coupled with Egypt's newfound macroeconomic woes in this period, pre-existing labour market deficiencies have been further exacerbated. In addition to the rise in unemployment, these include a low labour force participation rate, especially for women, high levels of informal employment and underemployment, and a general deterioration in the quality of jobs, including a rise in temporary and non-contractual employment.

In an attempt to address the deteriorating socio-economic conditions, the Government of Egypt has prepared a new national development framework, the Sustainable Development Strategy: Egypt's Vision 2030 ("2030 Strategy"). It seeks to lay the foundations for sustainable growth through macroeconomic stabilisation and the pursuit of a wide array of broader economic, environmental and social targets. Amongst them, it targets reducing the unemployment rate to 5 per cent by 2030. Preliminary estimates show that this would necessitate the creation of some 11.5 million new jobs between now and 2030. Moreover, due attention would also be needed to ensure that the focus on this unemployment target does not detract from the quality of jobs created.

This paper by Tariq Haq and Chahir Zaki seeks to shed light on the nexus between macroeconomic policies and employment in Egypt through three approaches. First, it provides a detailed analysis of each macroeconomic policy area in Egypt and reflects on its relationship with employment creation. Second, an empirical approach is used to provide evidence of the impact of each macroeconomic policy on employment. Finally, on the basis of these analyses, the paper offers a range of pertinent policy recommendations in order to improve employment and labour market conditions in Egypt during its transition.

The main findings show that macroeconomic policies have not directly addressed employment in Egypt in the period under review (1980 to the present day). Yet macroeconomic policies have the potential to increase domestic demand, for local production that is competitive vis-à-vis imports, as well as for labour. This is why, in view of the overwhelming need to provide young Egyptians with decent jobs, a more employment-focused macroeconomic framework should be seriously pursued as Egypt embarks upon implementing the 2030 Strategy.

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Contents

Preface.....	iii
Foreword	v
Acknowledgement.....	vii
1. Introduction.....	1
2. Macroeconomic policies for employment and growth.....	2
2.1. Fiscal policy.....	2
2.2. Monetary policy.....	3
2.3. Exchange rate policy.....	3
3. Analysis of macroeconomic policies in Egypt.....	4
3.1. Breakdown of growth and GDP.....	4
3.2. Fiscal policies	8
3.3. Monetary policy.....	13
3.4. Exchange rate policy.....	15
3.5. Trade policy	19
3.6. Capital account management	21
4. Overview of employment and labour market issues in Egypt	25
5. Employment and macroeconomic policies	29
6. Empirical assessment	32
7. Conclusions and policy recommendations.....	34
Bibliography.....	36
Annex. Egypt: Selected macroeconomic indicators, 2009/10–2015/16.....	39

List of Figures

Figure 1. GDP growth 1990-2013 (per cent).....	4
Figure 2. GDP by demand components (percentage of GDP)	5
Figure 3. GDP by Economic Activity (percentage of GDP).....	6
Figure 4. The 2030 Strategy	8
Figure 5. Domestic lending to the private sector by banks (percentage of GDP)	12

Figure 6. Risk premium on lending (lending rate minus Treasury bill rate, per cent)	12
Figure 7. The evolution of headline inflation in Egypt (per cent).....	13
Figure 8. The correlation between money supply and inflation	14
Figure 9. Distribution of SMEs with reference to dealing with banks (2010)	14
Figure 10. Distribution of SMEs by banking facilities and capital (2010).....	15
Figure 11. Distribution of SMEs by dealing with banks and number of employees (2010).....	15
Figure 12. Evolution of the exchange rate in Egypt (US\$/EGP)	16
Figure 13. Evolution of the real effective exchange rate in Egypt	17
Figure 14. Net international reserves (in million US\$)	18
Figure 15. Share of exports and imports in GDP (per cent).....	19
Figure 16. Net FDI in Egypt.....	22
Figure 17. The evolution of FDI inflows, 1970-2013 (current US\$ BoP)	22
Figure 18. Comparison of KAOPEN index of developing countries across different regions.....	23
Figure 19. The evolution of the KAOPEN index in Egypt (1970-2012)	23
Figure 20. Total FDI in Egypt by economic sector 2011/2012	24
Figure 21. Status in employment (per cent), 2013	26
Figure 22. Employment by Sector (per cent), 2011	27
Figure 23. Output per worker (GDP constant 2005 international \$) (2000=100)	27
Figure 24. Correlation between fiscal deficit and employment	29
Figure 25. Correlation between inflation and employment.....	29
Figure 26. Correlation between investment and employment.....	30
Figure 27. Correlation between exports and employment.....	30
Figure 28. Correlation between FDI and employment.....	31

List of Tables

Table 1. Capital and Labour Share in Total Value-Added (in per cent)	6
Table 2. Contribution to Growth by Factor Accumulation and TFP Growth (in per cent).....	7
Table 3. Summary of Fiscal Operations (in per cent of GDP).....	9
Table 4. Summary of Social Spending (in per cent of GDP).....	9

Table 5. Balance of payments in Egypt as a share of GDP (per cent), FY05-FY13.....	18
Table 6. Tariff rate by sector, 1995-2009	20
Table 7. Export and import procedures, 2015.....	21
Table 8. Key labour market indicators.....	25
Table 9. Empirical Results	33
Table 10. Effect of inflation and fiscal deficit on growth.....	33

List of Boxes

Box 1. Revenue-increasing measures.....	10
Box 2. Measures aimed at rationalizing expenditure.....	11

1. Introduction

The Egyptian economy has undergone several reforms that have shaped its current structure. The first wave of reforms dates back to the early 1990s, when Egypt adopted the Economic Reform and Structural Adjustment Programme (ERSAP) to rectify macro imbalances in the economy. These economic policies were part of the agreement that the Egyptian Government signed with the International Monetary Fund (IMF) and the World Bank. They laid the foundations for Egypt's move towards a market economy, by liberalizing trade and privatizing many state-owned companies. GDP grew at an average rate of almost 4 per cent per annum between 1995 and 2008 (Herrera et al., 2011). Yet, decent employment creation remained constrained. The political uprising of 2011 had a significantly negative impact on growth with severe internal and external imbalances. Over the last four years, annual GDP growth has averaged just 2 per cent. This substantial slowdown has taken its toll on livelihoods. Poverty increased to 26.3 per cent in 2012/13, up from 25 per cent in 2008, while the unemployment rate has risen to over 13 per cent. Fiscal deficits reached 14 per cent of GDP in 2013, and have been chiefly financed domestically, contributing to both a higher level of inflation, at 11 per cent, and the high general government debt that reached some 90.5 per cent of GDP in 2014. At the external level, foreign reserves declined from US\$35 billion (6.8 months of imports) in mid-2010 to US\$15 billion (2.5 months of imports) in December 2014, due to a significant decrease in tourism and a severe capital outflow. Coupled with Egypt's macroeconomic woes, pre-existing labour market deficiencies have been further exacerbated. In addition to the rise in unemployment, these include a low labour force participation rate, especially for women, high levels of informal employment and underemployment, and a general deterioration in the quality of jobs, including a rise in temporary and non-contractual employment. Against this backdrop, according to the IMF Staff Report of its recent consultation under Article IV of the IMF Constitution, the Organization's Executive Board "*stressed that investment should be designed to create jobs in the short term and increase potential growth and exports in the long term*" (IMF, 2015).

This paper tries to shed light on the nexus between macroeconomic policies and employment in Egypt through three approaches. First, it provides a detailed analysis of each macroeconomic policy area in Egypt and reflects on its relationship with employment creation. Second, an empirical approach is used to provide evidence of the impact of each macroeconomic policy on employment. Finally, on the basis of these analyses, the paper offers a range of pertinent policy recommendations in order to improve employment and labour market conditions in Egypt during its transition.

The structure of the paper is as follows. Section 2 sets out a for macroeconomic policy framework for employment and growth. Section 3 provides a comprehensive analysis of different macroeconomic policies (fiscal, monetary, and exchange rate policies, as well as trade and capital account management policies) in Egypt. Section 4 provides an overview of the main employment and labour market issues in Egypt, looking at recent trends and policy objectives. Section 5 analyses the link between macroeconomic policies and employment and poverty outcomes. Section 6 presents an empirical assessment of the impact of these policies on employment in Egypt. Section 7 concludes and provides policy recommendations for the future.

2. Macroeconomic policies for employment and growth

Mainstream macroeconomic policy making has traditionally focused on achieving price stability and curtailing external and internal imbalances. The undeniable importance of stability notwithstanding, an over-reliance on nominal targets that are not rooted in robust evidence has led to a tendency to foster pro-cyclical policies in developing countries, and a propensity to restrict the fiscal/policy space that would be needed to pursue development objectives such as those elaborated in the UN's Millennium Development Goals and in national development frameworks. From an employment perspective, the fundamental problem with a purely conventional approach is that its implicit economic foundations, relying exclusively on market forces for automatic adjustment, could produce market equilibrium at substantially less than full employment. Demand for labour is a derivative of the economic growth process, and there is no space for policy intervention where market equilibrium leads to excess capacity, even though such policy intervention could be critical to expanding productive employment, which in turn would boost economic growth. Evidence over the last decades has shown that many countries that pursued macroeconomic stabilization and structural adjustment without explicitly accommodating development objectives were subsequently plagued by poor growth and insufficient private investment, high unemployment and rising poverty (e.g. Easterly, 2001).

In the light of this, a growing body of literature has emerged on rethinking macroeconomic policy¹. Employment plays a key role in making economic growth conducive to effective poverty reduction. Monetary and fiscal policies must work together to ensure that there are sufficient domestic and external resources available to sustain the core development goals and provide the space for counter-cyclical policies. In addition, capital account and exchange rate policies must be geared towards ensuring that the real exchange rate is not overvalued. Altogether, they ensure that the economic environment is conducive to economic diversification, economic growth and sustainable creation of productive employment opportunities. A macroeconomic framework for employment and growth should take the following elements into consideration.

2.1. Fiscal policy

Fiscal sustainability requires monitoring debts and deficits and, where necessary, setting in place explicit fiscal targets. However, fiscal policy cannot and should not be limited to keeping certain fiscal targets within a boundary. It has a role to play both in reducing economic volatility, as well as in mobilizing resources to support the attainment of development goals. Fiscal sustainability and debt sustainability continue to be important as basic principles, but due attention must be paid to the manner in which balances are achieved. Importantly, attempts should be made to shift from a pro-cyclical to a counter-cyclical fiscal policy stance. The problem with a pro-cyclical fiscal policy is that it can encourage boom-bust cycles and thus diminish the efficiency of public spending. In the short run, making fiscal policy as counter-cyclical as possible, through building up fiscal space during booms and normal periods of economic growth, will allow for fiscal stimulus through enhanced public investment and maintenance of social safety nets during a downturn. Indeed, in the longer run, domestic resources should be mobilized to ensure a social protection floor. They should also be mobilized to provide sustainable support to employment-intensive public investment in infrastructure, Active Labour Market Policies

¹ See, for example, Islam (2003); Epstein (2007 and 2009); Muqtada (2009); Islam and Islam (2014), amongst others.

(ALMPs), as well as health, education and training in order to enhance skills and employability. Where resources come from and the amount allocated to such crucial contributors to growth and employment as infrastructure, health and education are key to the development of a pro-employment macroeconomic framework that is conducive to long-term growth and development.

2.2. Monetary policy

Whilst targeting low and single digit inflation is important for macroeconomic stability and credibility, a pro-employment macroeconomic framework implies that monetary authorities can no longer focus exclusively on the attainment of an inflation target. Monetary policy making should also aim to increase the resilience of the domestic financial system to external shocks, which in turn will also create increased incentives for domestic saving. Moreover, it should also aim to ensure access to credit by SMEs, support development of microfinance institutions and allocate credit to priority sectors and industries using transparent and consistent criteria. Essentially, monetary policymakers will have to bear in mind other policy variables, such as output and employment, and this in turn implies that they should not and cannot continue to operate in isolation from other policymakers. A new macroeconomic framework requires that the interaction between policy tools is taken into account and that monetary policy is articulated with fiscal and exchange rate policies as well. The broader goal is once again long run sustainable growth that is conducive to employment generation and poverty reduction.

2.3. Exchange rate policy

A pro-employment exchange rate policy should be geared towards a stable real exchange rate rule in the medium term in order to predictably influence resource allocation between the traded and non-traded goods sectors. In addition, foreign exchange reserves should be built up to cope with economic volatility (Frenkel, 2004). The pursuit of a stable and competitive real exchange rate also goes hand in hand with a certain degree of exchange rate management. Both a fixed rate regime as well as a clean floating one restricts the ability of the monetary authorities to target the real exchange rate, and in the presence of capital flows, the real exchange rate is exposed to overvaluation. An intermediate exchange rate regime, adjusting the exchange rate within a band, could help to secure a competitive currency as well as absorb exogenous shocks, thereby providing some degree of monetary policy flexibility. As Williamson (2003) points out, maintaining such a pegged floating regime could also provide an anchor for price stability by demonstrating a degree of monetary discipline.

3. Analysis of macroeconomic policies in Egypt

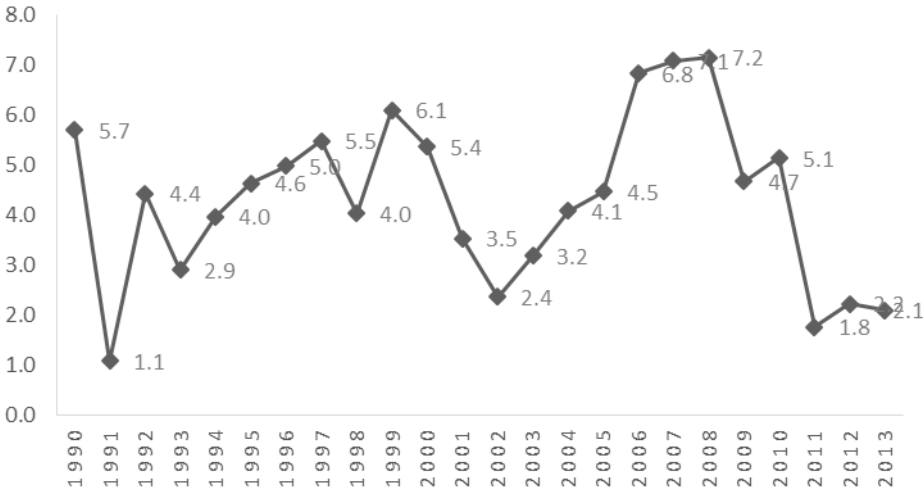
This section explores developments in Egypt’s economic performance and reviews the key macroeconomic policy instruments described in section 2 (above), in addition to assessing the evolution of trade policy and Foreign Direct Investment (FDI), both of which are liable to have an impact on employment.

3.1. Breakdown of growth and GDP

Starting in 2004, the Government of Egypt launched a second wave of reforms on different fronts. These reforms tackled several aspects of the economy such as promoting investment by improving the business environment and enhancing trade performance through trade liberalization and reducing the costs of red tape. This resulted in high levels of GDP growth between 2005 and 2008 (reaching 7.2 per cent in FY08²), as shown in Figure 1.

However, after these boom years, the Egyptian economy was subject to two shocks: the first external and the other internal. Externally, the financial crisis had a negative impact on the Egyptian economy, with growth falling to 4.7 per cent in FY09, down from 7.2 per cent a year earlier. Internally, the popular uprising in January 2011 had a strong negative impact on the economy, as real GDP growth fell from 5.1 per cent in FY10 to 1.8 per cent in FY11, rebounding slightly to 2.2 per cent in FY12. The main sectors that underperformed were manufacturing, construction and building, finance, and communications and information. The impact was greatest during the three months of the revolution itself, January-March 2011, when real GDP growth turned negative, to minus 4.3 per cent. Growth rates recovered in 2013 to a steady .2 per cent, but this nascent recovery in economic activity came on the back of recovery in the construction sector. However, GDP growth continued to be held back by ongoing weaknesses, albeit to a lesser extent, in the manufacturing and tourism sectors.

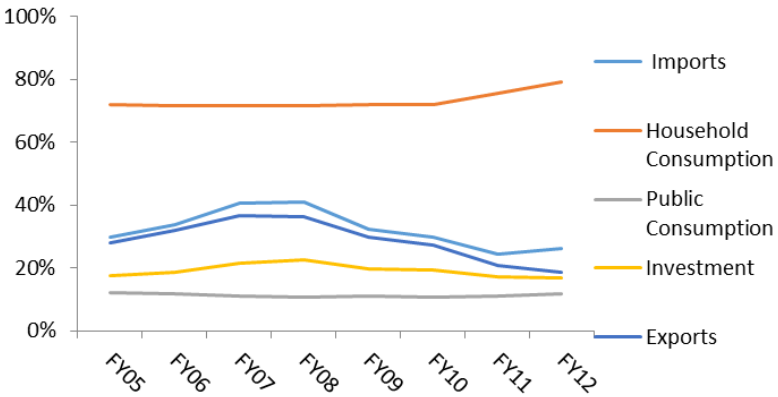
Figure 1. GDP growth 1990-2013 (per cent)



Source: Ministry of Planning data

² Fiscal Year (FY) in Egypt starts in July and ends in June.

Figure 2. GDP by demand components (percentage of GDP)

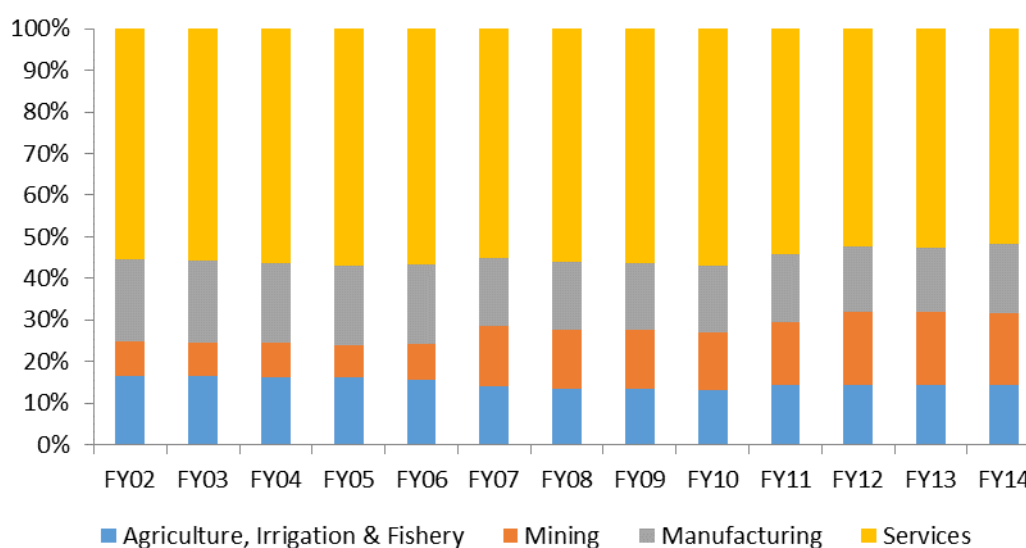


Source: Central Bank of Egypt (2011)

Turning to the breakdown of GDP by type of expenditure, private consumption has the highest share (70 per cent), followed by investment and exports (Figure 2). Whereas growth in the 1990s was driven mainly by consumption, since 2005 growth has been driven mostly by investment and exports (Herrera et al., 2011). The boom in investment can be explained by three main factors. First, starting in 2004, Egypt undertook numerous reforms to improve the investment climate. That is why, in 2008, it was the top reformer in the region and worldwide, greatly improving its position in the global rankings for ease of doing business. Also thanks to these reforms, a surge in foreign direct investment (FDI) characterized the 2005-2008 period. FDI reached US\$17.8 billion in FY08 or 8 per cent of GDP, up from US\$407 million or 0.5 per cent of GDP in FY04. Finally, significant growth in the private sector (more than 60 per cent in FY08, up from 34 per cent in FY91), as a result of the privatization of many state-owned enterprises, boosted investment. Combining all these factors, the share of investment in GDP increased from 17 per cent in FY04 to 22 per cent in FY08. However, given the heightened uncertainty that has faced investors since early 2011, investment levels fell to 17 per cent in FY12. In fact, during the third quarter of FY11 (coinciding with the January 2011 Revolution), investment fell by 31 per cent (year-on-year), contributing by minus6.2 per cent to the decline in GDP during this quarter. The FDI recovery since then has been modest, as will be shown later. Additionally, the growth rate of exports increased significantly from 5 per cent pre-2004 to 24 per cent after. This reflects reforms aimed at promoting private business, reducing red tape for exporters and simplifying trade procedures.

A breakdown of GDP by economic activity shows that the Egyptian economy is heavily dependent on services, whose share in GDP had been constantly increasing to reach 57 per cent in 2010, but declined slightly to 52 per cent in FY14 with the substantial decrease in tourism. By contrast, the share of agriculture, which is a large employer in Egypt, fell from 30 per cent in FY72 to 14 per cent in FY14 (Figure 3).

Figure 3. GDP by Economic Activity (percentage of GDP)



Source: Ministry of Planning

Finally, concerning the breakdown of GDP by factors of production, the social accounting matrices of Egypt show that the share of capital in total value added increased from 57 per cent in FY76 to reach 73 per cent in FY11 (see Table 1). This is in line with the findings of Kheir-El-Din and Moursi (2007), who argue that, between 1960 and 1998, capital accumulation was the main driving force behind economic growth. This was mainly due to the substantial supply of unqualified labour and prevailing employment laws that fostered the adoption of capital-intensive production techniques. Increasing unemployment has resulted from the inability of economic policies in general, and investment policies in particular, to foster high and labour-intensive growth rates. These policies have led to modest investment levels that are biased against labour-intensive growth, which has weakened the economy's ability to create jobs. This is why, observing the breakdown of GDP over the periods 1991-98, 1999-04 and 2005-08 (Table 2), it can be seen that the contribution of physical capital to economic growth has been steadily increasing over the three periods, to the detriment of both human capital and total factor productivity (Herrera et al, 2010).

Table 1. Capital and Labour Share in Total Value-Added (in per cent)

	Capital Share	Labour Share
1975/1976	57.2	42.8
1995/1996	68.1	31.9
1998/1999	67.9	32.1
2000/2001	68.6	31.4
2006/2007	72.7	27.3
2010/2011	72.6	27.4

Source: Constructed by the authors using different SAM

Table 2. Contribution to Growth by Factor Accumulation and TFP Growth (in per cent)

<i>Period average</i>	1991-1998	1999-2004	2005-2008
Human Capital	0.22	3.18	2.32
Physical Capital	1.94	2.42	3.36
TFP	1.79	-1.49	0.7
GDP growth rate	3.9	4.1	6.4

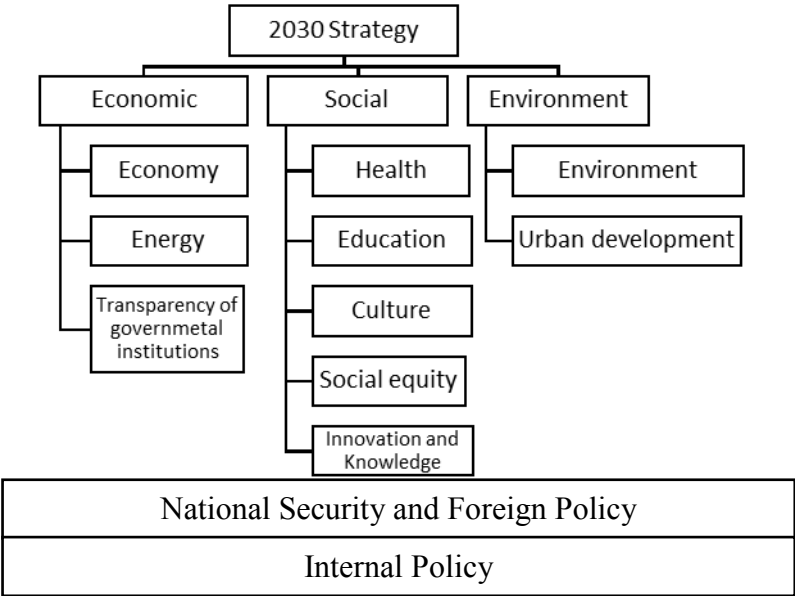
Source: Herrera et al (2010)

The Government of Egypt has initiated the so-called Sustainable Development Strategy: Egypt's Vision 2030 ("2030 Strategy") (see Figure 4). This is a long-term strategy that aims at improving the Egyptian economy on several fronts: economic, social and environmental. At the economic level, the Government plans to reach a sound market economy characterized by sustainable growth (7 per cent on average, with a special focus on services that must represent 70 per cent of GDP by 2030), high levels of competitiveness and diversification, and a significant and influential role in the world economy. At the environmental level, the Government plans to reduce pollution, improve the quality of the environment and extend population surfaces in Egypt. At the social level, the Government plans to improve the quality of social services provided by the State, notably with respect to education and health. It also targets reducing the unemployment rate to 5 per cent by 2030, primarily through a range of programmes geared towards the creation of decent productive jobs, especially for youth. For instance, an investment fund, "AYADY", has been set up. It aims at establishing investment projects in all governorates, contributing to local economic development and creating jobs for thousands of young Egyptians. In addition, training programmes such as the National Training Programme for Rehabilitation and the National Programme for Training for Employment (NPTE) are being promoted to prepare jobseekers for work in the private sector in various fields.³ The target is nonetheless a formidable one: preliminary estimates reveal that as things stand, some 11.5 million new jobs will need to be created between now and 2030 to reach the targeted unemployment rate of 5 per cent – and over 8 million new jobs will need to be created just to maintain the 2014 unemployment rate of 13.2 per cent.⁴ Moreover, in addition to the quantitative dimension of job creation, due attention would also be needed to ensure that the focus on this unemployment target does not detract from the quality of jobs created, or various other relevant indicators of labour market health (or distress) such as productivity, underemployment, vulnerability and informality, as discussed in section 4 below.

³ For further details, see Ministry of Planning (2014).

⁴ Authors' own calculations based on the ILO's Economically Active Population Estimates and Projections for labour force projections until 2030.

Figure 4. The 2030 Strategy



Source: Ministry of Planning (2014)

In terms of future prospects, the Staff Report of the recent IMF Article IV Consultation welcomed the improved economic outlook and supported the authorities’ plans to restore macroeconomic stability (IMF, 2015). Growth is subsequently projected to reach 3.8 per cent in FY15 and 4.3 per cent in FY16 (see Table A.1).

3.2. Fiscal policies

At the fiscal level, Egypt has long been characterized by a structural fiscal deficit. In the wake of the popular uprising, in addition to low growth, the Egyptian economy has sustained even greater fiscal pressures (see Table 3). The budget deficit reached EGP239 billion (or 13.7 per cent of GDP), up from EGP165 in FY13. The Ministry of Finance attributed the widening of the budget deficit to two main factors. First, the significant increase in wages and salaries, which reached EGP143 billion, was due to widespread factional demands (5,232 protests in 2013). Secondly, while subsidies and social benefits increased by 30 per cent between FY12 and FY13, interest payments reached EGP147 billion in FY13, up by 40 per cent over the same period due to higher domestic debt that reached 82.4 per cent in FY13. Third, state revenues remained almost constant with a slight decline in grants.

Table 3. Summary of Fiscal Operations (in per cent of GDP)

	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Revenues	24.2	24.7	27.2	22.2	19.3	19.6	20.0
Taxes	15.3	15.3	15.7	14.1	14.0	13.4	14.3
Grants	0.5	0.2	0.8	0.4	0.2	0.7	0.3
Other Revenues	8.3	9.2	10.7	7.7	5.2	5.6	5.4
Expenditures	29.8	31.5	33.8	30.3	29.3	30.1	33.5
Compensation of employees	7.0	7.0	7.3	7.1	7.0	7.9	8.2
Purchases of Goods And Services	2.3	2.1	2.4	2.3	1.9	1.7	1.5
Interest payments	6.4	5.6	5.1	6.0	6.2	6.7	8.4
Subsidies, Grants, and Social Benefits	7.8	10.3	12.2	8.5	9.0	9.3	11.3
Other Expenditures	2.8	2.7	2.6	2.4	2.3	2.1	2.0
Investments	3.4	3.8	4.2	4.0	2.9	2.3	2.3
Net Acquisition of Financial Assets	1.7	0.0	0.3	0.0	-0.2	-0.0	0.1
Cash Deficit / (Surplus)	-5.6	-6.8	-6.6	-8.1	-10.0	-10.5	-13.6
Overall fiscal balance	-7.3	-6.8	-6.9	-8.1	-9.8	-10.8	-13.7
Primary deficit	-0.9	-1.2	-1.8	-2.1	-3.6	-4	-5.3

Source: Ministry of Finance

A closer look at the structure of social spending most likely to affect the labour market shows that such expenditure is quite modest in the Egyptian economy. Indeed, the share of spending on health and education (which affects a nation's human capital) never exceeded 7 per cent between FY02 and FY12 (Table 4). Furthermore, public investment has also decreased, from 5 per cent in FY02 to 1.9 per cent in FY12. The decrease in this type of spending obviously does have an impact on poverty and inequality in Egypt.

Table 4. Summary of Social Spending (in per cent of GDP)

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Education*	5.4	5.4	5.1	4.8	4.1	3.7	3.7	4.2	4.1	3.8	4.0
Health*	1.6	1.4	1.4	1.3	1.6	1.4	1.5	1.5	1.4	1.5	1.5
Subsidies**	1.6	1.7	2.1	2.6	8.8	7.2	9.4	9.0	7.8	8.1	8.8
Food sub.**	1.2	1.2	1.7	0.0	1.5	1.3	1.8	2.0	1.4	2.4	2.0
Energy sub.**	0.0	0.0	0.0	0.0	6.8	5.4	6.7	6.0	5.5	4.9	6.2
Social Benefits**	2.7	2.8	2.7	2.6	2.0	0.2	0.5	2.8	0.4	0.4	0.6
Public Investment**	4.8	4.5	4.2	3.7	2.9	2.8	3.1	3.3	3.2	2.4	1.9

Sources: * Central Agency for Public Mobilization and Statistics (CAPMAS) (2010, 2011 and 2012)

** Ministry of Finance (2012)

*** World Bank (2015a), World Development Indicators

In July 2014, the Government of Egypt partially removed energy subsidies on all fuel products (other than LPG for needy households) and electricity, to be phased out entirely over the medium term, in order to reduce the fiscal deficit. This decrease can be attributed mainly to the abolition of energy subsidies for energy-intensive sectors, such as those producing petrochemicals, aluminium, ceramics and steel. The energy-intensive sectors account for about 80 per cent of total fuel oil consumption and 15 per cent of total natural gas usage. Both fuel oil and natural gas account for approximately 25 per cent of total energy subsidies. Indeed, beyond its direct impact on the budget by saving some 2 per cent of GDP in FY14/15, Egypt's streamlining of energy subsidies includes redesigning of the country's energy mix, controlling and targeting of subsidized quantities, and improved distribution systems that help to control smuggling. Furthermore, the Government plans to

reduce its deficit to 8.5 per cent of GDP and its debt burden to within 80-85 per cent of GDP, from current levels of 13.7 per cent and 95.5 per cent of GDP, respectively, by the end of FY19. The planned fiscal consolidation programme encompasses measures on both the revenue and expenditure sides of the budget, currently under discussion, to create more fiscal space while enhancing the quality, direction and efficiency of expenditures (see Box 1 for revenue measures and Box 2 for expenditure measures). The fiscal deficit is expected to decline to 11 per cent in FY15 and 8.5 per cent in FY16 as a result of less spending (by continuing reforms of subsidies and of public sector wage-setting and recruitment) and higher revenues (by swiftly enacting a modern VAT).

Box 1. Revenue-increasing measures

- Income Tax: The Income Tax Act has been amended to broaden the tax base to include dividend incomes, capital gains, and residents' foreign earnings. It also added new tax avoidance rules, and increased tax rates by 5 per cent on corporates and individuals earning more than EGP 1 million for a period of three years;
- Real Estate Tax: The new law removed many of the earlier generous tax exemptions, and limited them only to one residential unit with a value of less than EGP 2 million. This is expected to yield 0.4 per cent of GDP in FY14/15; the law requires 50 per cent of the proceeds to be earmarked for the development of rural and slum areas;
- Mines and Quarries Tax: New reforms are being discussed by the Government to generate a higher fiscal yield;
- Telecom Licensing Fees: New measure to yield 0.3 per cent of GDP in FY14/15;
- Higher excise duties on cigarettes and alcoholic beverages;
- Introduction of Value Added Tax (VAT): VAT is expected to be introduced in the second half of FY14/15 and will replace the current General Sales Tax (GST) regime. The new law will be fairer to taxpayers, allowing an immediate full tax refund on capital goods and a broader tax credit system as well as applying a single unified rate, incorporating a high threshold and extending to a wider range of goods and services. The revenue yield from VAT is projected to be 1.6 per cent of GDP on a full year basis;
- Simplified tax regime for small and micro-enterprises: This new regime will be designed not only to bring a wider pool of economic actors into the tax net, but also to encourage them to grow and develop.

The settlement and collection of tax arrears and reduction of tax exemptions will further enhance the revenue effort.

Source: Ministry of Finance (2014)

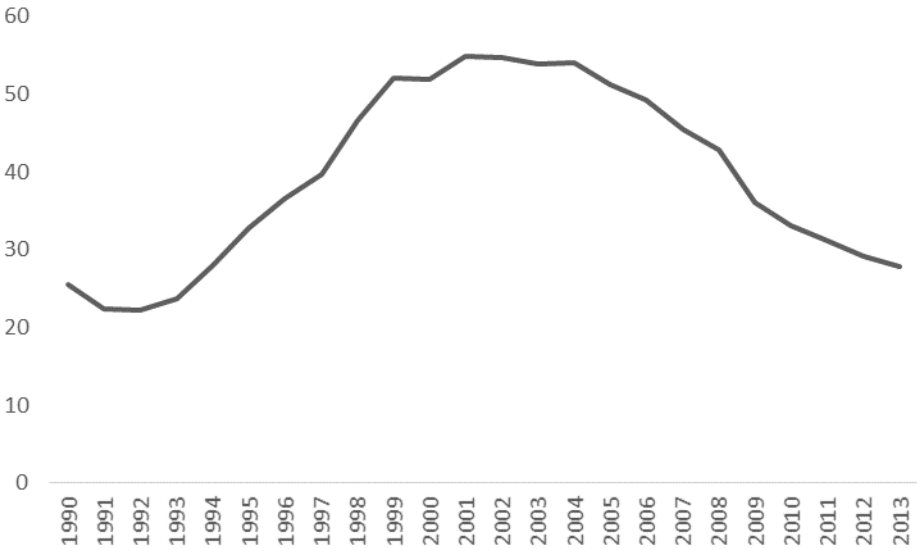
Box 2. Measures aimed at rationalizing expenditure

- Expenditure Measures and Treasury Management Reforms: On the expenditure side, the Egyptian Government's main objective will be to focus on rationalization of energy subsidies and control of wage growth. The Ministry of Finance (MOF) programme also includes the development and enforcement of systems to control and guide cash management, new controls over the government procurement system, and strengthened governance of accounting and other operational and treasury functions. Internal audit systems will be developed and full automation for all payments and collections will be introduced, among other things.
- Social justice will be promoted by targeting the delivery of goods and services to the neediest households, in part by focusing on the geographical distribution of spending and by prioritizing accessibility and quality. According to the Constitution, spending on education, health and scientific research will increase gradually over three years to reach target rates as a percentage of GDP as follows: 3 per cent of spending on health; 6 per cent on education, and 1 per cent on scientific research.
- Energy Subsidies: Reform of energy subsidies will account for the lion's share of the planned fiscal adjustment, with subsidies on all fuel products (other than LPG for needy households) and electricity to be phased out over the medium term. Vulnerable households will be compensated through an expanded cash transfer programme. Ongoing reforms will lead to better capital allocations by removing the incentives that have favoured capital-intensive industry as opposed to labour-intensive activities, thereby generating new jobs. In addition, part of the savings generated by the reform will be redirected to health, education and R&D in line with constitutional requirements and to finance cash transfer programmes;
- Food Subsidies: A new system has been introduced to rationalize the distribution of bread in order to improve its quality of loaves and stabilize the price, target needy households and maintain strategic reserves of wheat. A similar system has been introduced for the ration card system;
- Wage Controls: With effect from the 2014/15 budget, the Act prohibits all government entities from hiring personnel outside the regular system, thereby closing the backdoor used to contract temporary labour; ending existing tax exemption on government employees annual wage increases; and no longer allowing those increases to be consolidated in the basic wage. The Government intends to introduce a new recruitment system which will only accept new recruitment as a given proportion of outgoing personnel.
- Public-Private Partnership (PPP): The Egyptian Government of Egypt is proceeding with a PPP programme to expand private sector participation in infrastructure projects, thereby reducing pressure on the government budget;
- The Government has doubled the appropriation for the cash transfer programme in the FY14/15 budget to double the number of beneficiaries from 1.5 to 3 million families.

Source: Ministry of Finance (2014)

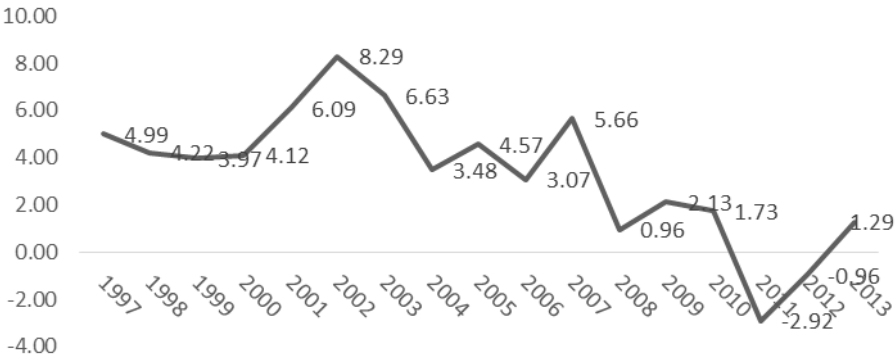
The deficit was financed primarily through local sources, mainly bank subscriptions for Treasury bills. This increased the crowding out effect as bank credit to the Government grew by 35 per cent in July 2012 (year-on-year). The Government's share of total credit increased from 49 per cent in June 2011 to 60 per cent in June 2013, while the private sector's share shrank from 36.2 per cent to 27.5 per cent in 2013 (see Figure 5). Meanwhile, average interest rates on the outstanding stock of T-bills and T-bonds increased to 13.3 per cent by end June 2013, compared to 13 per cent by end June 2012. Thus, the increase in the Treasury bills interest rate made them more attractive and led to a decrease in the risk premium, as shown in Figure 6.

Figure 5. Domestic lending to the private sector by banks (percentage of GDP)



Source: World Bank (2015a), World Development Indicators

Figure 6. Risk premium on lending (lending rate minus Treasury bill rate, per cent)



Source: World Bank (2015a), World Development Indicators

Finally, gross domestic public debt increased by 21 per cent to reach EGP 1,444 billion (82.4 per cent of GDP) by end June 2013, compared to EGP 1,115 billion (73.3 per cent of GDP) at end June 2012. By contrast, Egypt’s external debt increased by 25 per cent by end June 2013 to US\$43.2 billion, up from US\$34.4 billion at end June 2012. The ratio of external debt to GDP increased from 13.2 to 17.3 per cent over the same period.

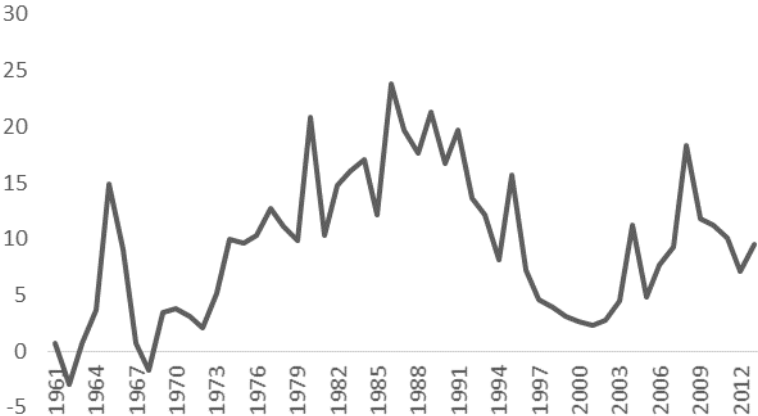
In the 2030 Strategy, the Government plans to attain a fiscal deficit of 5 per cent of GDP and domestic debt of 50 per cent of GDP. As observed above, achieving macroeconomic stability is important, especially where fiscal and debt pressures are clearly impeding the pursuit of growth and employment objectives in the short term. Nonetheless, great care must be taken to ensure that the precise level of the targets set and the means adopted to pursue them are not in themselves detrimental to employment and growth.

3.3. Monetary policy

Before 2003, monetary policy lacked clearly defined specific objectives, either through legislation or otherwise. A Central Banking Act already existed in 1975, but defined general objectives such as the regulation of money and credit policies to achieve broader economic development goals (Abou El-Oyoun, 2003). The adoption of the Economic Reform and Structural Adjustment Programme (ERSAP) in 1991 implicitly entailed the redefinition of monetary policy objectives towards disinflation, even though the Act remained unchanged. It was only with the passing of the Banking Act in 2003 that monetary policy became formally geared towards achieving price stability. *The Central Bank, Banking Sector and Monetary System Act, No. 88 of 2003* “entrusts the Central Bank of Egypt (CBE) with the formulation and implementation of monetary policy, with price stability being the primary and overriding objective. The CBE is committed to achieving, over the medium term, low rates of inflation which it believes are essential for maintaining confidence and for sustaining high rates of investment and economic growth. The Government’s endorsement of the objective of price stability and its commitment to fiscal consolidation is quite important for achieving this objective” (CBE website). However, there is no mention of a numerical objective for inflation. While the Act refrained from citing real objectives (output and employment), CBE reports mention that low inflation must “maintain high rates of investment and economic growth” (CBE, 2004/2005).

Despite the fact that the volatility of inflation measured by its standard deviation decreased from 6.9 before 2003 to 3.8 afterwards and its average from 12.4 to 9.6 over the same period, inflation has been very volatile and remained relatively high because of the lack of transparency and the absence of a numerical objective of the Central Bank (see Figure 7). This, in turn, affected price stability and thus poverty in Egypt. A lax monetary policy is one of the reasons why inflation has been volatile (see Figure 8). Indeed, a more expansionary monetary policy is associated with higher inflation. Yet, it is important to note that, in the 2030 Strategy, inflation is planned to be reduced to between 3 per cent and 5 per cent.⁵ This will help to reduce uncertainty, though again, such nominal targets must be reviewed in the context of growth and employment objectives, the attainment of which may require tolerance of slightly higher levels, overall stability notwithstanding.

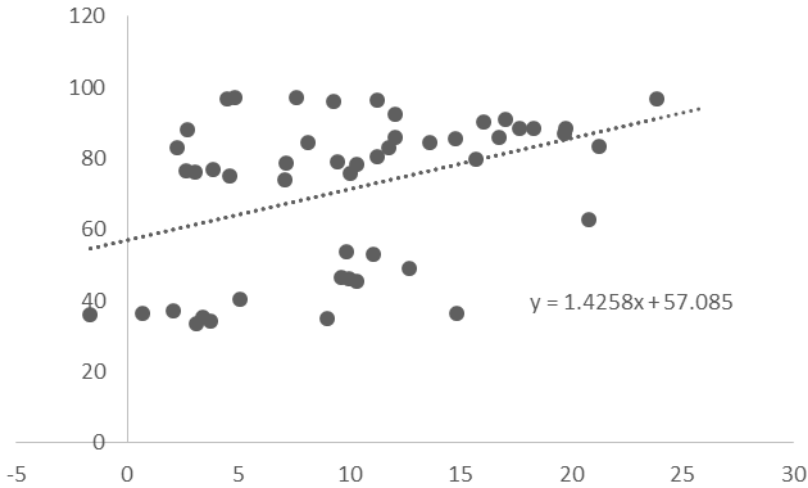
Figure 7. The evolution of headline inflation in Egypt (per cent)



Source: Central Bank of Egypt dataset.

⁵ Such a target of 3 to 5 per cent is in line with standard policy prescriptions for optimal inflation in developing countries. Yet, it is prudent to adopt an evidence-based approach depending on long-run economic growth and inflation trends, import prices, and so on.

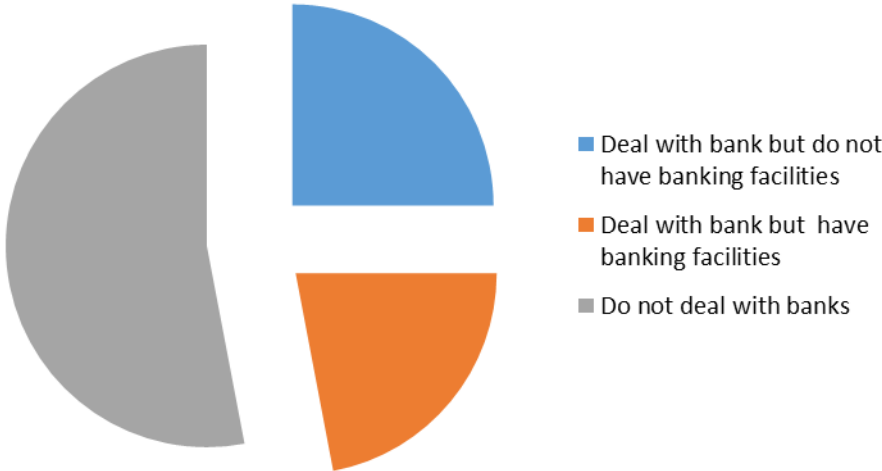
Figure 8. The correlation between money supply and inflation



Source: Constructed by the authors using the World Development Indicators dataset

Another important aspect of monetary policy is financial inclusion, aiming to improve financial services for firms and households, with a special focus on SMEs. Indeed, according to El-Said et al (2014), from the SMEs’ point of view, it is more difficult to obtain financing from banks for several reasons: banks often prefer to extend credit to large corporate clients and related individuals that they consider less risky. From the banks’ point of view, it is less risky to provide loans for larger businesses since they are more stable, less prone to risk, have available records and structured information, are easier to access and are more profitable. SMEs also have other problems such as lack of business documents (registration, licence, and tax records) and reliable financial statements, weak management and lack of business plans. Bearing these characteristics in mind, El-Said et al (2014), using the 2010 SME census, found that only 47 per cent of SMEs in Egypt deal with banks and only 22.4 per cent have access to banking facilities, as shown in Figure 9.

Figure 9. Distribution of SMEs with reference to dealing with banks (2010)

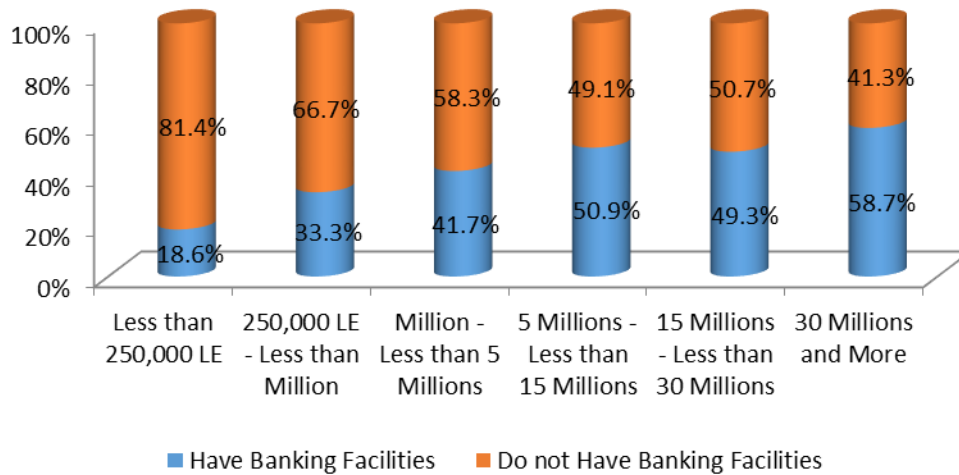


Source: El-Said et al (2014)

It is also obvious that larger SMEs, either in terms of capital (Figure 10) or labour (Figure 11), are more likely to benefit from banking facilities than smaller ones. This

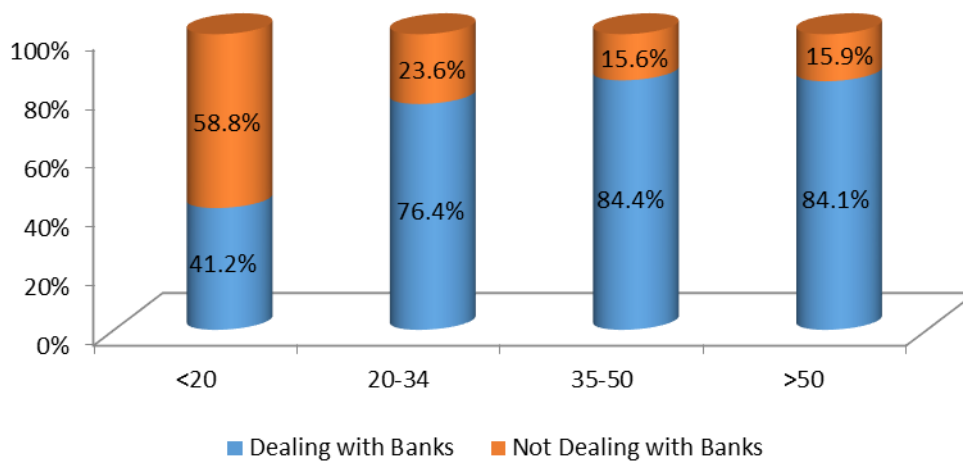
reduces access to finance of new start-ups, which in turn decreases the number of new SMEs and thus the number of jobs that could be generated.

Figure 10. Distribution of SMEs by banking facilities and capital (2010)



Source: El-Said et al (2014)

Figure 11. Distribution of SMEs by dealing with banks and number of employees (2010)



Source: El-Said et al (2014)

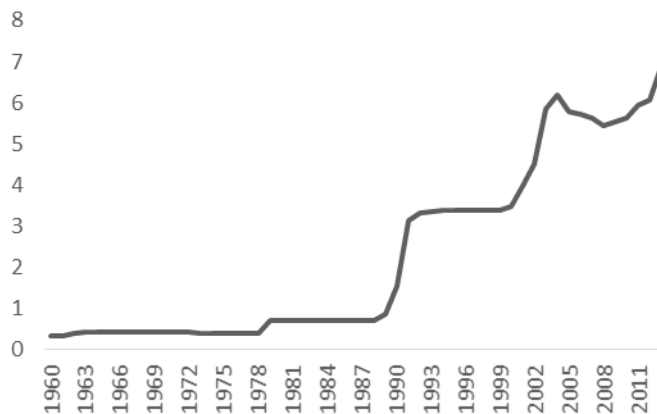
3.4. Exchange rate policy

Figure 12 shows that Egypt maintained a currency peg to the US dollar for over forty years, from the sixties until FY03. As long as Egypt was a closed economy during the period of Gamal Abdel Nasser, it was easy to maintain the peg. Starting from 1970, with greater trade openness and global financial integration, it became more difficult to do so. And with each attempt at openness, Egypt had to introduce more flexibility in its exchange rate system. Since the 1960s, Egypt had a “fixed adjustable peg” to the US dollar,

combined with foreign exchange controls. Efforts to streamline the exchange rate prior to the ERSAP were unsuccessful in unifying the exchange rate system (Abdel Khalek, 2001). By the end of the 1980s, the over-valued exchange rate led to the emergence of an active black market. With the adoption of ERSAP, the multiple exchange rate system was replaced by two exchange markets (a primary restricted market and a secondary free market) which were later merged (Economic Research Forum (ERF) and Institut de la Méditerranée (IM) (2004)), following which the exchange rate stabilized and was maintained within an implicit band around US\$1=LE 3.33. Sterilized intervention was successful and the nominal exchange rate remained stable between 1991 and 2000.

For this reason, the Government announced the abandonment of the exchange rate peg in January 2003. Because the exchange rate was still far from its market-clearing equilibrium, expectations resulted in an immediate fall in the value of the Egyptian pound, as shown in Figure 12 and Figure 13. Despite this decision, consecutive governments adopted several measures to stabilize the exchange rate. The establishment of a foreign exchange interbank market in December 2004 eliminated the parallel foreign exchange market and stabilized the nominal exchange rate starting December 2005. Following these measures, the nominal exchange rate started appreciating in December 2004 and stabilized around LE 5.7/US\$1 until June 2006. Strong capital inflows subsequently helped further boost the pound against the US dollar. The upward trend was mild at first but increasingly strengthened, reflecting increased capital inflows. Consequently, the IMF has reclassified Egypt’s exchange rate regime to a “managed float”.

Figure 12. Evolution of the exchange rate in Egypt (US\$/EGP)



Source: World Bank (2015a), World Development Indicators

However, according to the Staff Report of the IMF Article IV Consultation, a more flexible exchange rate is needed in order to reflect supply and demand for foreign currency and avoid the depletion of foreign reserves that had reached a critical level (with around 3 months’ imports). This would increase the availability of foreign exchange for households and businesses, strengthen competitiveness and attract foreign direct investment. Indeed, the CBE allowed a slight movement of the Egyptian pound, which reached 7.62/US\$1 in May 2015, up from 7.10 in March 2015. The IMF Board of Directors welcomed this recent fluctuation as an important step in the right direction.

Figure 13. Evolution of the real effective exchange rate in Egypt



Source: Darvas (2012)

In the aftermath of the Revolution, Egypt’s external accounts became more fragile for several reasons. First, the current account balance deficit soared to US\$7.9 billion (3.1 per cent of GDP) from US\$2.7 billion (1.2 per cent of GDP) in FY12. This was primarily due to the deterioration in the trade deficit, which increased by 33.2 per cent to reach US\$31.6 billion (12.3 per cent of GDP). The trade deficit in FY12 is explained by a 98 per cent year-on-year increase in petroleum imports, which reached US\$11.7 billion, up from US\$5.9 billion in FY11. In addition, there has been an increase in the imports of raw materials, investment goods and semi-finished products used in the production process. Exports remained almost constant over the two years, as the slight increase in oil exports was offset by a decline in other non-oil exports.

Despite the increased trade deficit, the current account was in equilibrium or surplus before the financial crisis due to strong surpluses in the services and transfers accounts. Following the revolution, net services receipts declined from US\$7.8 billion (3.4 per cent of GDP) in FY11 to US\$5.3 billion (2.1 per cent of GDP) in FY12. This was largely due to a decline in tourism receipts from US\$10.5 in FY11 to US\$9.4 billion in FY12. Service payments also increased by 10 per cent, driven by a surge in investment income and travel payments. However, net transfers receipts surged to US\$18.4 billion in FY12, up from US\$13.1 billion in FY11, thanks to a more than 30 per cent increase in remittances, more than offsetting the fall in net services. In FY13, the trade deficit was greater than the surplus generated by services and transfers, leading to a current account deficit of two per cent.

In addition, given the political instability from which the economy was suffering, Egypt experienced a significant capital outflow, which was very uneven throughout FY11. While the first half of FY11 saw capital inflows of US\$4 billion, the second half witnessed capital outflows of US\$15 billion. On a quarter-by-quarter basis, the January-March 2011 quarter recorded a US\$12 billion capital outflow. For this reason, the capital and financial account, for the first time, registered a deficit, reaching 2 per cent of GDP (see Table 5). This deficit declined slightly to 0.5 per cent of GDP in FY12. However, in FY13, thanks to higher investment (both direct and portfolio), the capital and financial accounts reached the pre-revolution level with a surplus of 4 per cent of GDP.

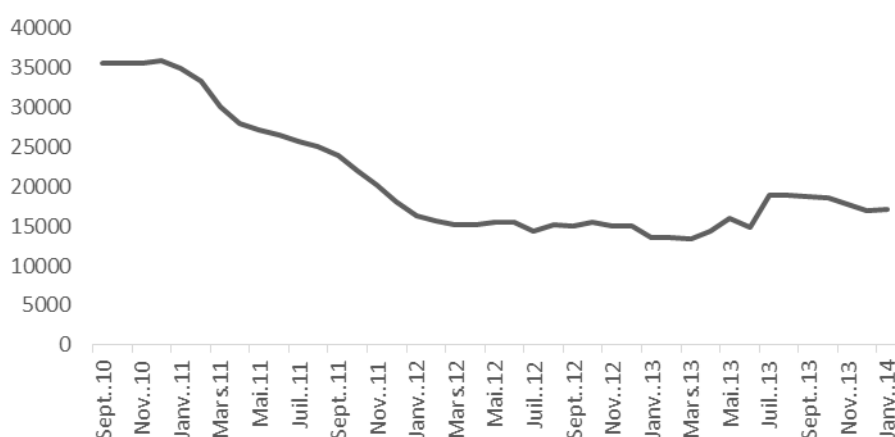
Table 5. Balance of payments in Egypt as a share of GDP (per cent), FY05-FY13

	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Current Account	3	2	2	1	-2	-2	-1	-3	-2
Balance of Goods and Serv.	-3	-4	-4	-5	-7	-7	-7	-10	-9
Trade Balance	-12	-11	-12	-14	-13	-11	-10	-12	-11
Net Services	9	8	9	9	7	5	3	2	2
Transfers	6	5	5	6	4	5	6	7	7
Capital and Financial Account	4	3	1	5	1	4	-2	-0.5	4
Capital account	0	0	0	0	0	0	0	0	0
Financial account	0	3	1	5	1	4	-2	-0.5	4
Net Direct Investment	4	6	8	7	4	3	0.5	1	1
Net Portfolio Investment	2	2	-1	-1	-5	3	-1	-2	1
Other Investments (Net)	-2	-4	-6	-1	2	-2	-1.5	1	2
Overall Balance	5	3	4	3	-2	2	-4	-4.5	0.1
Net International Reserves (end of June), billion US\$	19.3	23	28.6	34.6	31.3	35.2	26.4	15.2	14.9
Exchange Rate (EGP/US\$)	6.01	5.75	5.71	5.51	5.51	5.51	5.95	6.1	6.4

Source: Central Bank of Egypt

Lastly, and implicit in the above changes, international reserves declined rapidly from US\$36 billion in December 2010 to US\$26.4 billion in June 2011, US\$15.5 billion in June 2012 and US\$15.4 billion in January 2015 (equivalent to 2.8 months' projected imports of goods and services). This trend reflects the Central Bank's efforts to defend the Egyptian pound, which lost only around 4 per cent of its value against the dollar between January 2011 and December 2012. Yet, in December 2012, Egypt's Central Bank introduced a new system for buying and selling foreign currency. The system features regular currency auctions, designed to allow the Egyptian pound to float more freely, with its price more closely reflecting supply and demand. The objective was to conserve its foreign reserves, which had fallen to a critical level (see Figure 14). Following these auctions, the Egyptian pound plummeted to an eight-year low against the US dollar, falling to EGP6.70/US\$1 in March 2013. It experienced a further depreciation in early 2015, when the CBE announced that the value of the dollar was now 7.61EGP with a level of foreign reserves of US\$15.4 billion.

Figure 14. Net international reserves (in million US\$)

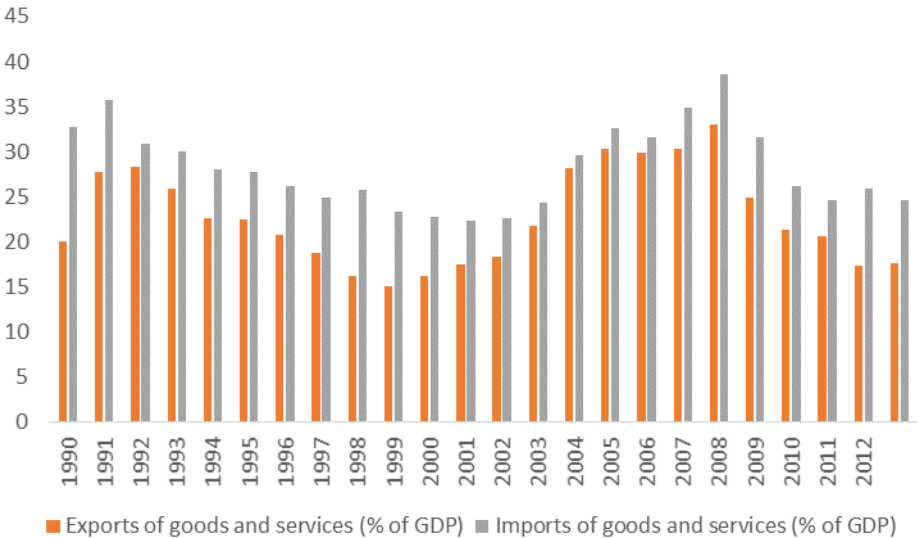


Source: Central Bank of Egypt

3.5. Trade policy

Both exports and imports in Egypt have experienced significant increases since the early 1990s and in a more pronounced way since 2004. On average, exports increased annually by 5 per cent before 2004, compared to 24 per cent after this date, while imports grew by 2 per cent before and 24 per cent after 2004 respectively. Figure 15 depicts the share of exports and imports to GDP between 1990 and 2013. On the other hand, Egypt’s trade balance has been continuously in deficit throughout the period of the study. Imports exceed exports as a result of the increase in the volume of imports that are mainly concentrated in raw materials, investment goods or semi-finished products that are used in the production process. It is worth noting that both exports and imports decreased after the financial crisis and the Revolution, respectively reaching 17 per cent and 24 per cent of GDP in 2013, down from 33 and 38 per cent in 2008.

Figure 15. Share of exports and imports in GDP (per cent)



Source: World Bank (2015a), World Development Indicators

In order to explain the increase in exports and imports, it is important to show how tariffs and other trade barriers have evolved over time. Egypt has significantly liberalized its external trade since 1990. The maximum tariff rate decreased from 110 per cent at the end of the 1980s to 40 per cent at the end of 1990’s. As described by Zaki (2014), in 2004, the Egyptian Government launched the second wave of liberalization. Its objectives were twofold: first, to reduce tariffs and rationalize the tariff structure; and second, to reduce the number of products subject to non-tariff barriers. The number of tariff bands was reduced from 27 tariff brackets to 6, tariff dispersion measured by standard deviation declined from 16.1 in 2000 to 12.7 in 2004 and tariff lines were reduced from 8,000 to 6,000. Both nominal and effective protections have declined in the manufacturing sector from 21.3 per cent to 12.1 per cent and from 23.3 per cent to 14 per cent respectively since the 2004 reform. All those measures should in turn simplify procedures, minimize tariff evasion, and remove possibilities of discretion and corruption (Zaki, 2011). Therefore, the increase in exports and imports can be attributable to these trade reforms. Yet, some sectors, such as the food and tobacco sectors, remain highly protected, due to tariff escalation and non-tariff barriers on the trade side, and due to energy subsidies on the input side. The effective rate of protection (ERP) has decreased from 85.6 per cent in 1999 to 45 per cent in 2009 for private business and from 122.5 per cent to 37 per cent for public enterprises over the same period. In addition, it has been argued that the dispersion of the effective rate of protection fell between 1999 and 2009 from 192 to 57 per cent, but remains higher than the low

dispersion of nominal tariffs due first to tariffs and output subsidies and second to energy subsidies.

Nearly 99 per cent of Egypt's tariff lines are bound at the WTO. Most Favoured Nation (MFN) tariffs on non-agricultural products are generally lower, with an average of 12.8 per cent. Tariffs on agricultural goods remain high, with an average of 66.4 per cent. The higher average on agricultural goods is strongly determined by average tariffs of over 1,000 per cent on beverages and spirits. Table 6 shows both applied and MFN tariff rates.⁶ It is noteworthy that the simple and weighted average of applied tariffs declined significantly,⁷ in particular between 2002 and 2004, from 20.3 per cent and 13.1 per cent respectively from 47.9 per cent and 23.7 per cent. Despite a significant liberalization of the manufacturing sector, the primary sector remains relatively protected given the fact that in 2009, its simple average of MFN tariffs was 41 per cent, compared to 9 per cent for manufacturing. Finally, the difference between applied simple and weighted tariff rates is much larger for the primary sector (37.5 per cent and 6 per cent respectively) than for manufacturing (9.3 per cent and 9.12 per cent respectively). This is due to the fact that some products in the primary sector are subject to high tariffs (such as tobacco and alcohol) whereas their weights in international trade are significantly low.

In the 2030 Strategy, the Egyptian Government plans to increase the contribution of exports to GDP growth to reach 25 per cent, up from an average of 3.5 per cent. This clearly needs measures to facilitate exports, i.e. less bureaucracy and less implicit impediments to trade in order to increase the number of exports, the number of destinations served by the same exporters and the number of products exported by each exporter.

Table 6. Tariff rate by sector, 1995-2009

		1995	1998	2002	2004	2009
Total	Applied simple	24.3	19.65	47.92	20.29	12.56
	Applied weighted	16.65	14.17	23.69	13.1	7.98
	MFN simple	34.65	25.23	61.76	19.94	17.21
	MFN weighted	16.65	14.17	23.69	13.1	8.67
Primary	Applied simple	25.88	23.3	19.06	88.27	37.53
	Applied weighted	7.65	8.86	9.33	18.07	6.18
	MFN simple	52.88	34.79	18.56	41.61	41.05
	MFN weighted	7.65	8.86	9.33	18.07	7.22
Manufacturing	Applied simple	24.02	19.15	50.58	12.96	9.3
	Applied weighted	22.2	17.53	30.71	11.41	9.12
	MFN simple	28.92	22.1	72.79	13.53	9.95
	MFN weighted	22.2	17.53	30.71	11.41	9.63

Source: World Bank, World Development Indicators, 2011

⁶ MFN tariffs are what countries promise to impose on imports from other members of the WTO, unless the country is part of a preferential trade agreement (such as a free trade area or customs union). This means that, in practice, MFN rates are the highest (most restrictive) that WTO members charge one another. An applied tariff rate is the average of effectively applied rates for all products subject to tariffs calculated for all traded goods.

⁷ A weighted mean tariff is the average of tariff rates weighted by the product import shares corresponding to each partner country. A simple mean tariff is the unweighted average of tariff rates for all products subject to tariffs calculated for all traded goods.

Unilateral trade liberalization efforts have been coupled with many bilateral and multilateral free trade agreements (FTAs). On the bilateral front, Egypt has concluded free-trade agreements with the European Union (2004), the members of EFTA (the Republic of Iceland, the Principality of Liechtenstein, the Kingdom of Norway, the Swiss Confederation, 2004), Turkey, and other Arab countries. At the regional level, Egypt has acceded to the Greater Arab Free Trade Area (GAFTA), the Common Market for Eastern and Southern Africa (COMESA) and the Agadir Free Trade Agreement (with Tunisia, Jordan and Morocco). It also has some framework agreements that should turn into free trade ones, such as the agreement with the MERCOSUR countries, as well as one with the West African Economic and Monetary Union (WAEMU). Finally, Egypt also signed a Qualifying Industrial Zones (QIZ) Protocol⁸ in December 2005 with the United States and Israel. All these agreements have contributed to the increase in Egyptian exports and imports since 2004 (Zaki, 2014). Nonetheless, several agreements are not effective or have not generated the expected positive effects.

Despite these liberalization efforts, other impediments to trade still exist, especially administrative barriers. That is why the WTO launched the process of trade facilitation in order to reduce such barriers. In Egypt, certain bureaucratic procedures for exports and imports remain high and costly (Table 7). When compared to MENA or the OECD, it transpires that Egyptian procedures entail the greatest number of documents, which creates a lengthier clearance process for imported and exported goods than is perhaps necessary. Despite this, Egypt's costs of exporting and importing are lower than the OECD or the MENA region. However, there is still much that Egypt can learn from other countries' best practice in trade facilitation.

Table 7. Export and import procedures, 2015

Indicator	Egypt	MENA	OECD
Export documents required (number)	8	6	4
Time to export (days)	12	19.4	10.5
Cost to export (US\$ per container)	625	1,166.3	1,080.3
Import documents required (number)	10	8	4
Time to import (days)	15	23.8	9.6
Cost to import (US\$ per container)	790	1,307	1,100.4

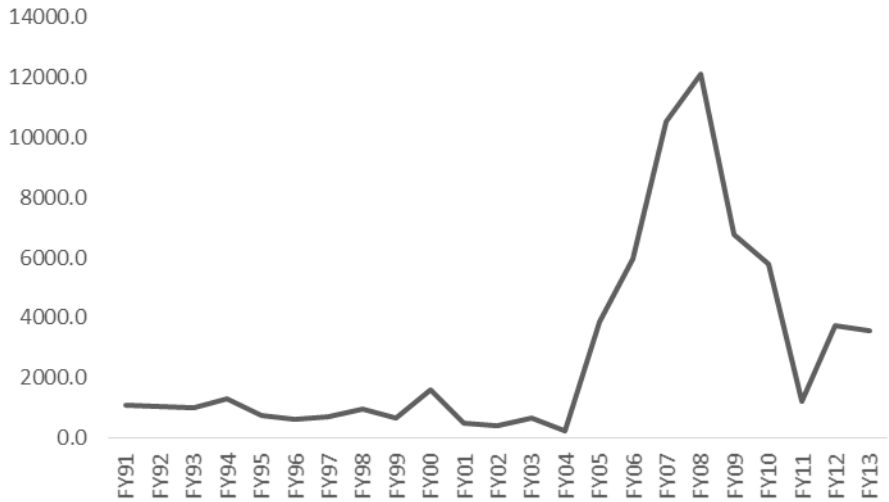
Source: World Bank (2015b), Doing Business Indicators

3.6. Capital account management

FDI in Egypt increased substantially between 2005 and 2008, with the adoption of a series of reforms that attracted FDI from European and Arab investors. Indeed, inflows of FDI had decreased by 62 per cent from the 1990s until 2003. Following the adoption of the reforms, FDI grew 17-fold from 2003 to 2008. Yet, after the financial crisis and the Revolution, FDI fell back by 72 per cent between 2009 and 2013 (see Figure 16).

⁸ Qualifying Industrial Zones (QIZ) are designated geographic areas, within Egypt, that enjoy a duty free status with the United States. Companies located within such zones are granted duty free access to the US markets, provided that they satisfy the agreed upon Israeli component of 10.5%, as per the pre-defined rules of origin.

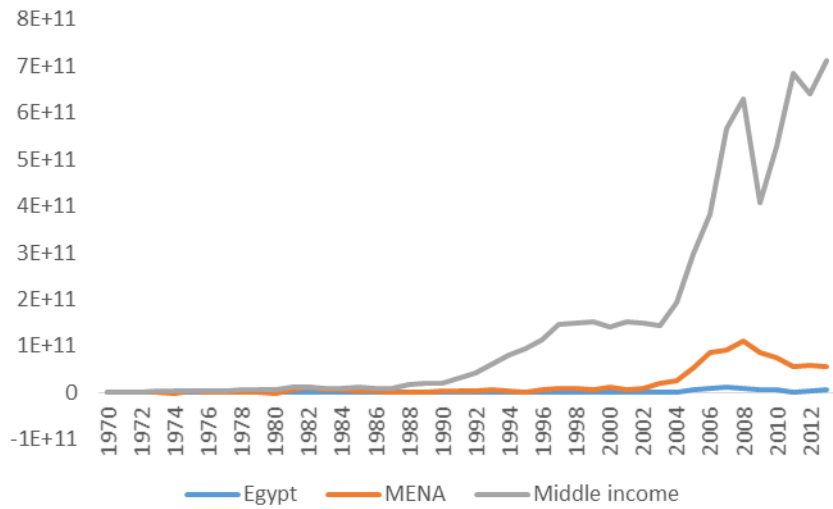
Figure 16. Net FDI in Egypt



Source: Central Bank of Egypt

Nonetheless, as shown in Figure 17, Egypt’s FDI inflows have been consistently lower than those of the MENA region or the middle-income countries despite a significant increase between 1977 and 2013, showing the extent to which Egypt is still not well integrated into the world capital market.

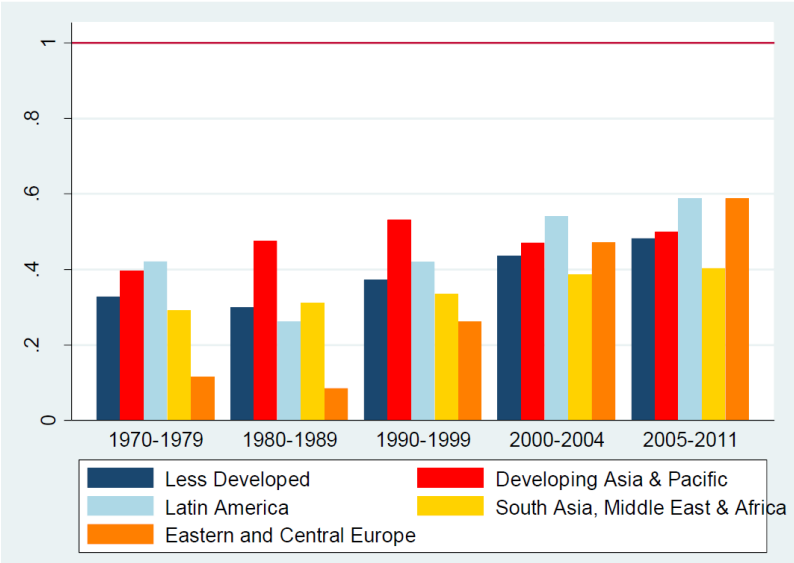
Figure 17. The evolution of FDI inflows, 1970-2013 (current US\$ BoP)



Source: Constructed by the authors using the World Development Indicators

Furthermore, a similar observation can be concluded from the capital account openness (KAOPEN) index developed by Chinn and Ito (2006). This index is a *de jure* measure of financial openness and liberalization using four variables: the presence of multiple exchange rates, restrictions on current account transactions, restrictions on capital account transactions and the degree of openness to trade. The higher the index, the weaker the restrictions on capital movements. The index shows that in general the MENA region is much less integrated in the capital market than other regions (Figure 18).

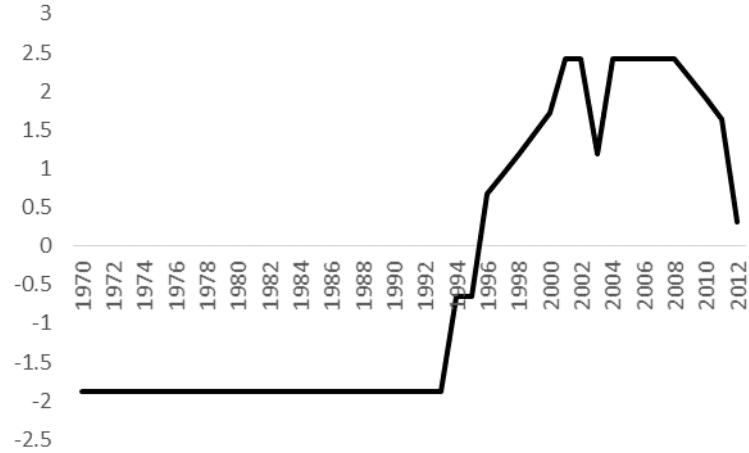
Figure 18. Comparison of KAOPEN index of developing countries across different regions



Source: Chinn and Ito (2006)

In Egypt, a severe decline in financial openness has been experienced (Figure 19) as the index decreased dramatically in recent years, pointing to a reversal of financial integration in the wake of the Revolution.

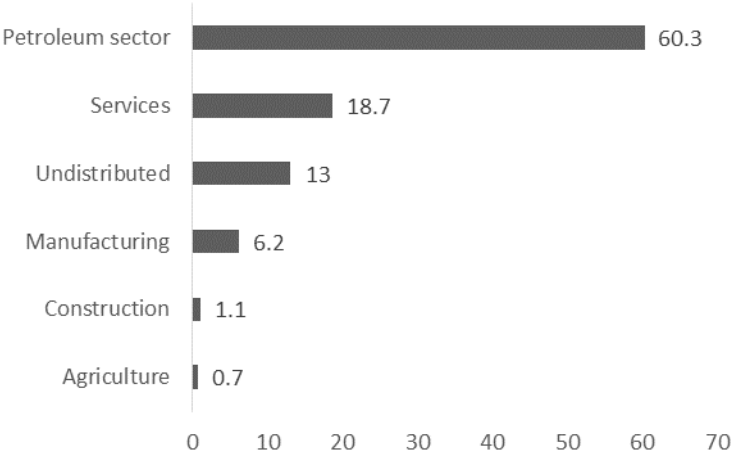
Figure 19. The evolution of the KAOPEN index in Egypt (1970-2012)



Source: Constructed by the authors using the KAOPEN index

Looking at the sectoral distribution of FDI in Egypt, the petroleum sector ranks first, followed by the services sector (Figure 20). This explains why most of the FDI inflows in Egypt did not generate enough jobs. Indeed, extractive industries are primarily capital-intensive rather than labour intensive and their value added is extremely low. For this reason, it is highly recommended to provide more incentives to attract FDI in the manufacturing sector, which is more likely to be conducive to employment generation.

Figure 20. Total FDI in Egypt by economic sector 2011/2012



Source: Central Bank of Egypt (2012)

4. Overview of employment and labour market issues in Egypt

With a working-age population in excess of 55 million, job creation is one of Egypt's most pressing social and economic concerns. Over recent decades, labour demand has singularly failed to keep up with labour supply, even during periods of higher economic growth, such as in the mid-2000s, indicating that the employment content of growth has been inadequate to absorb new labour market entrants. Persistent problems include a lack of jobs for the large cohorts of young people who enter the labour market every year in search of decent and productive employment, as well as particularly poor labour market outcomes for women.

Table 8. Key labour market indicators

Indicator/ Year		2008	2010	2013	2014 Q3	% change 2008-2010	% change 2010-2013
Labour Force ('000)	Total	24651	26180	27623	27655	6.2	5.5
	M	19120	20140	21166	21179	5.3	5.1
	F	5531	6040	6456	6476	9.2	6.9
Employment ('000)	Total	22507	23829	23974	24026	5.9	0.6
	M	18042	19153	19082	19137	6.2	-0.4
	F	4466	4676	4891	4889	4.7	4.6
Unemployment ('000)	Total	2144	2351	3649	3629	9.7	55.2
	M	1078	987	2084	2042	-8.4	111.2
	F	1066	1364	1565	1587	28.0	14.7
Labour Force Participation Rate (%)	Total	47.8	50.2	48.5	51.4	5.0	-3.4
	M	73	75.1	73.4	78	2.9	-2.3
	F	22.8	22.9	22.9	24.3	0.4	0.0
Employment-to-Population Ratio	Total	43.9	44.2	42.9		0.7	-2.9
	M	70	70.5	69.2		0.7	-1.8
	F	18	18.1	16.8		0.6	-7.2
Unemployment Rate (%)	Total	8.7	9	13.2	13.1	3.4	46.7
	M	5.6	4.9	9.9	9.6	-12.5	102.0
	F	19.3	22.6	24.2	24.5	17.1	7.1

Source: CAPMAS, Labour Force Survey, and ILO Key Indicators of the Labour Market, Eighth Edition

Since the January 2011 Revolution, these pre-existing problems have been exacerbated and further compounded by a deterioration in other segments of the labour market. For instance, the labour force participation rate declined from 50.2 per cent in 2010 to 48.5 per cent in 2013, while the overall rate of unemployment grew from 9 per cent to 13.2 per cent over the same period (see Table 8). This has been primarily driven by a more than doubling of the number of unemployed men in the wake of the Revolution, as prolonged periods of unrest and uncertainty have stifled economic activity. Nonetheless, women have continued to experience by far the highest rates of unemployment, rising to 24.2 per cent in 2013, with the rate for young women estimated to be up to three times this figure.

Unemployment affects Egyptians of all educational backgrounds and at all income levels. Young graduates have in recent years been the hardest hit, as they tend to wait for jobs better suited to their acquired skills, resulting in prolonged periods of search in the absence of adequate job creation. However, unemployment itself is only one component of

the labour market distress that Egyptians – and young Egyptians in particular – encounter. High levels of inactivity, underemployment, vulnerability and informality paint an even bleaker picture. Women’s labour force participation was a mere 22.9 per cent in 2013, indicating that over three-quarters of working aged women were absent from the labour market altogether. Of those women who were actually in employment, 46 per cent may be categorized as in vulnerable employment, as either self-employed or contributing family workers (see Figure 21), indicating that job quality is of major concern. Wage and salaried workers are often associated with better wages and working conditions, yet only 6 out of 10 Egyptians (falling to 5 out of 10 Egyptian women) were in wage employment. Increasingly, women and youth entering the labour market have had little choice other than to engage in relatively low-paying work in the informal economy, with limited or no access to social protection.

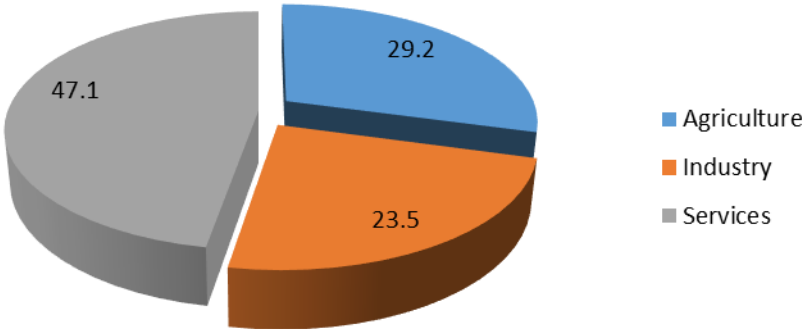
Figure 21. Status in employment (per cent), 2013



Source: CAPMAS, Labour Force Survey, 2013

The sectoral composition of employment is heavily skewed towards services, which accounted for over 47 per cent of jobs in 2011 (see Figure 22). Nearly 30 per cent of employed Egyptians worked in agriculture, while less than a quarter were engaged in industry, the sector ordinarily associated with higher productivity jobs. Moreover, there remains a strong preference for public sector jobs, with the Government being perceived as the employer of first choice and of last resort. Public sector reforms that have promoted privatization have failed to alter this perception, while heavily constrained state budgets have made the sought after government jobs increasingly elusive.

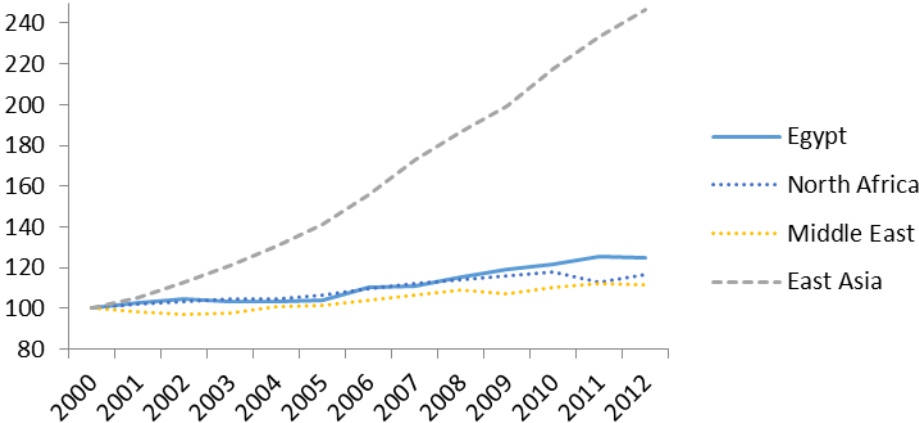
Figure 22. Employment by Sector (per cent), 2011



Source: ILO, Key Indicators of the Labour Market, Eighth Edition

Labour productivity, measured as output per worker, has grown only minimally in Egypt and the MENA region more broadly over recent years, particularly when compared to certain other regions, such as East Asia (see Figure 23). Education and skills mismatches between job seekers and the jobs available certainly play a role, with private sector employers often bemoaning the failure of the formal education and training systems to provide new labour market entrants with the skills required in the workplace. However, other factors such as better working conditions, organizational innovation, investments in infrastructure and a better enabling environment for sustainable enterprises also serve to increase productivity, yet have generally failed to materialize in Egypt. The lack of productivity growth has impeded the space for wage growth, resulting in an overall real wage decline.

Figure 23. Output per worker (GDP constant 2005 international \$) (2000=100)



Source: ILO, Key Indicators of the Labour Market, Eighth Edition

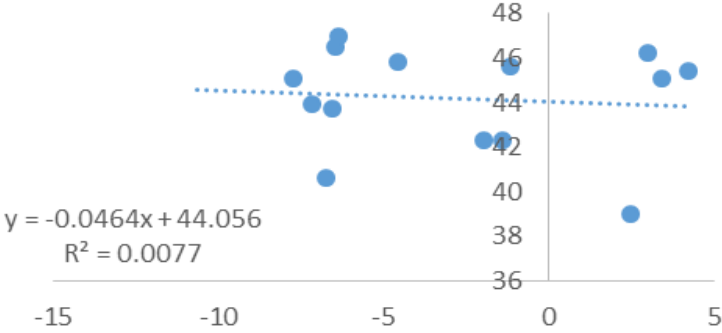
A multitude of policies and programmes have been pursued over the years in an attempt to ease the labour market pressures described above. These have included active labour market policies such as job search assistance, training and retraining, as well as large scale community and public works/job creation programmes and entrepreneurship development schemes, such as those administered by the Social Fund for Development. Passive labour market policies have included the administering of social security schemes including an unemployment benefit, undergoing full legislative reform in 2010, with the new Social Security Act entering into force in 2012. However, there has been a tendency

for such policies and programmes to be implemented in an ad hoc manner, without a clear strategic framework, thereby limiting their effectiveness. Moreover, a wide array of persistent structural and institutional barriers, including ineffective employment services, ill-defined and poorly enforced legislative frameworks, and weak labour market institutions such as collective bargaining in the absence of a credible social dialogue, have hindered the attainment of better labour market outcomes.

5. Employment and macroeconomic policies

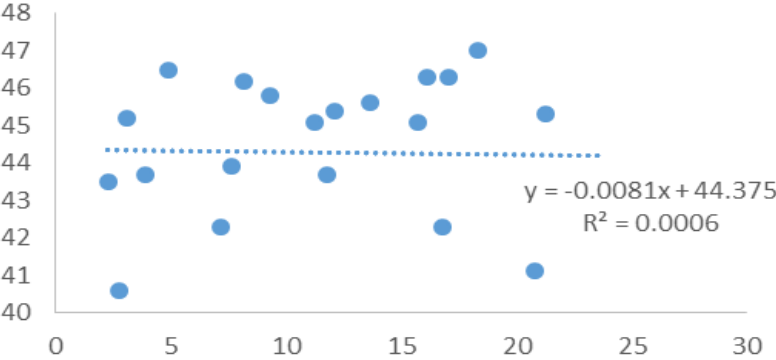
Before presenting the empirical model, it is useful to examine the correlation between different macroeconomic variables and employment. First, Figure 24 shows that the correlation between the fiscal deficit and employment is insignificant. The same observation holds for the nexus between monetary policy (measured by the inflation rate) and employment (see Figure 25). This suggests that neither monetary policy nor fiscal policy have been deployed effectively in promoting growth and employment in Egypt.

Figure 24. Correlation between fiscal deficit and employment



Source: Constructed by the authors using the World Development Indicators

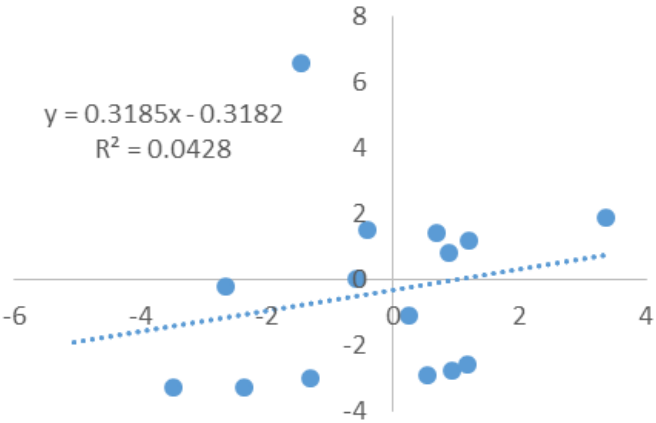
Figure 25. Correlation between inflation and employment



Source: Constructed by the authors using the World Development Indicators

Figure 26 presents an insignificant correlation between investment and employment in Egypt. As mentioned above, this can be attributed to the fact that the increase in the level of unemployment since the early 1990s has been primarily due to the inability of economic policies in general, and investment policies in particular, to achieve high and labour-intensive growth rates, given that the majority of investments have not been labour intensive.

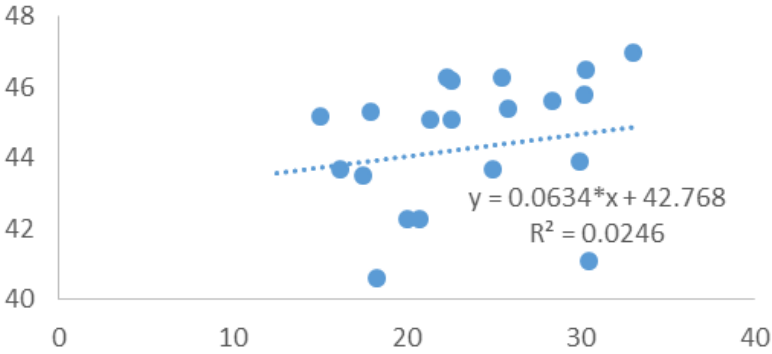
Figure 26. Correlation between investment and employment



Source: Constructed by the authors using the World Development Indicators

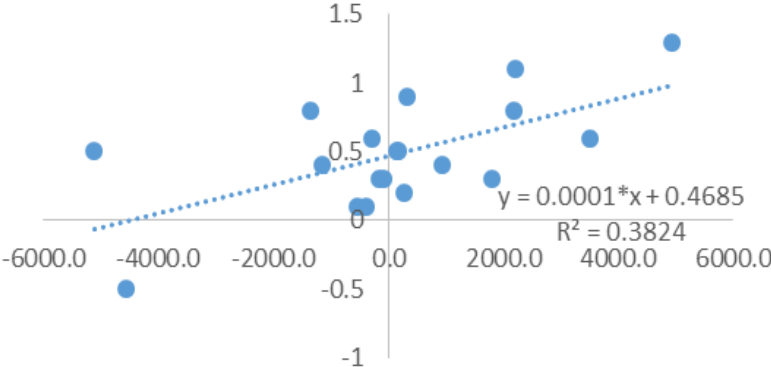
By contrast, Figures 27 and 28 demonstrate that both exports and FDI are positively and significantly correlated to employment. Yet, the correlation is stronger between exports and employment than between FDI and employment. This shows that FDI should be allocated to sectors that can generate more jobs (and that are not capital-intensive), given that most of the FDI inflow in Egypt is directed to the oil sector. From a policy perspective, this result highlights the fact that decision makers must chiefly promote policies aimed at encouraging domestic producers to export and attracting foreign investors in Egypt to labour-intensive sectors in order to reduce unemployment.

Figure 27. Correlation between exports and employment



Source: Constructed by the authors using the World Development Indicators

Figure 28. Correlation between FDI and employment



Source: Constructed by the authors using the World Development Indicators

6. Empirical assessment

In order to test for the effect of different macroeconomic policies on employment, employment has been regressed on different macroeconomic aggregates. Note that in order to make sure that any contemporaneous correlation is minimized and endogeneity eliminated, GDP lagged one year has been used. The following econometric model has been estimated using time series data:

$$\Delta l_t = \alpha + \beta_1 \Delta y_{t-1} + \beta_2 \Delta EXP_t + \beta_3 \Delta INV_t + \beta_4 \Delta DEF_t + \beta_5 \Delta MON_t + \varepsilon_t \quad (1)$$

where l is employment; y is the real GDP growth rate; INV is the ratio of gross fixed capital formation (GFCF or investment) to GDP; EXP stands for the share of exports to GDP; MON measures monetary variables such as inflation or M2 and DEF captures the effect of fiscal deficit on employment; and ε is the discrepancy term.

This model is estimated using annual data (1980-2013), which come from two main sources. GDP data come from the Ministry of Planning in Egypt (previously the Ministry of Economic Development). The remainder of the variables come from the World Development Indicators available on the World Bank website. Exports of goods and services are exports provided to the rest of the world in constant 2000 US dollars. Δy is the growth rate of GDP lagged one year (to eliminate any endogeneity problems). The share of investment to GDP also comes from the World Development Indicators. This equation has been regressed in a first-difference form to control for non-stationarity in the data.⁹

Table 9 presents the empirical results of our regressions. Three groups of regressions have been done. The first includes the whole time series, namely from 1980 to 2012. The second restricts the analysis to males and the third to females. Three main messages emerge from the results.

First, exports had a significant and positive effect on employment over the period 1980 to 2012. This effect is persistent in most of the regressions for total employment, males and females. Table 9 shows that the elasticity of employment with respect to exports is on average 4.5 per cent. Moreover, the effect on the employment of men is greater than that of women. This is in line with the fact that most of the exporting sectors are intensive in low-skilled male labour, such as chemicals and food processing. This is particularly interesting since trade policy can greatly affect employment for both men and women.

Second, it is quite clear that investment does not have an effect on employment over the whole period. This holds when investment is regressed on employment alone and when it is regressed with other variables. This is in line with what Fawzy (2002) found, notably that the increase in the level of unemployment since the early 1990s has been primarily due to the inability of economic policies in general and investment policies in particular to achieve high and labour-intensive growth rates. These policies led to modest investment

⁹ Three tests have been used to test for non-stationarity. First, the Augmented Dickey-Fuller test has been used. Its null hypothesis is that the variable contains a unit root, and the alternative is that the variable was generated by a stationary process. Second, we have used the Philips-Perron test, which uses Newey-West standard errors to account for serial correlation, whereas the augmented Dickey-Fuller test uses additional lags of the first difference variable. Finally, a modified version of the Augmented Dickey-Fuller test has been utilized. It performs a Dickey-Fuller t-test for a unit root in which the series has been transformed by a generalized least-squares regression. The three tests showed that all variables include a unit root. This is why a first difference form has been used in the regressions for all the variables.

levels, which weakened the economy's ability to create jobs, and resulted in investment patterns biased against labour-intensive growth. Moreover, the share of stocks traded or the total value of shares to GDP seem to exert a negative impact on employment, supporting the same conclusion, especially with the volatile hot money coming from Arab investors in boom periods.

Table 9. Empirical Results

	Emp.	Emp	Emp Male	Emp Male	Emp. Fem.	Emp. Fem.
GDP growth	1.948*** (0.239)	1.926*** (0.263)	1.649*** (0.281)	1.632* (0.692)	1.932** (0.510)	1.948** (0.533)
Exp/GDP	0.559*** (0.117)	0.488** (0.133)	0.486*** (0.104)	0.276 (0.228)	0.420** (0.146)	0.419** (0.152)
Inv/GDP	-0.220 (0.172)	-0.329 (0.197)	-0.451* (0.192)	-0.785 (0.499)	-0.0294 (0.332)	-0.0334 (0.211)
Inflation	-0.115 (0.183)		-0.347** (0.105)		-0.00229 (0.224)	
Stock/GDP	-0.328*** (0.0621)	-0.328** (0.0918)	-0.337*** (0.0546)	-0.367** (0.118)	-0.311** (0.100)	-0.321** (0.107)
Deficit/GDP	0.412 (0.272)	0.321 (0.228)	0.340 (0.262)	0.00681 (0.483)	0.580 (0.303)	0.557 (0.392)
M2/GDP		0.0147 (0.250)		0.183 (0.121)		0.0487 (0.269)
R-squared	0.858	0.833	0.923	0.746	0.760	0.762

Robust standard errors in parentheses.

*** p<0.01, ** p<0.05, * p<0.10.

Third, inflation and the fiscal deficit did not have a significant impact on employment over the period under examination. Indeed, both variables have generally been outside the realm of the usual limits called for by the international financial institutions – yet have not significantly affected employment. As shown in Table 10, inflation has had an insignificant impact on growth, suggesting that inflation up to 10 per cent (i.e. above the 2030 Strategy's 3-5 per cent target range) has not adversely affected employment. For this reason, perhaps focus needs to be shifted towards a monetary policy that explicitly supports reallocation of credit to SMEs, which could help towards employment creation in the private sector. In parallel, the fiscal deficit has also not affected employment. Table 10 shows that the fiscal deficit has a slightly negative and statistically significant impact on growth. However, this might be attributed to the fact that most of the public spending is current (notably subsidies, interest payments and wages), which does not help workers improve their human capital, as measured by health, education and other development expenditures. These latter elements of public expenditure are far more likely to stimulate growth and support employment creation.

Table 10. Effect of inflation and fiscal deficit on growth

	GDP growth	GDP growth
Inflation	0.0330 (0.117)	
Deficit/GDP		-0.344* (0.194)
R-squared	0.005	0.203

Robust standard errors in parentheses.

*** p<0.01, ** p<0.05, * p<0.10.

7. Conclusions and policy recommendations

This paper has focused on the nexus between macroeconomic policies and employment. It synthesizes the main facts of the Egyptian economy and analyses the linkages between such policies and employment. At the empirical level, it found that while exports had a significant and positive effect on employment over the period 1980 to 2012, investment did not. Moreover, the share of stocks traded or the total value of shares to GDP seems to have exerted a negative impact on employment. Finally, inflation and the fiscal deficit have not had a significant impact on employment over the period under examination. Therefore, in a nutshell, it may be inferred that macroeconomic policies did not directly address employment in Egypt. Yet macroeconomic policies have the potential to increase domestic demand for local production that is competitive vis-à-vis imports as well as for labour. This is why, from a policy perspective, an efficient macroeconomic framework for employment generation should be seriously pursued, taking into consideration the following elements.

First, in terms of fiscal policy, more efforts should be made to shift from a pro-cyclical to a counter-cyclical fiscal policy stance. In fact, making fiscal policy counter-cyclical, by building up fiscal space during booms and normal periods of economic growth, will allow short-run fiscal stimulus through enhanced public investment and maintenance of social safety nets during downturns. Moreover, in terms of long-run resource mobilization policies, public spending should be allocated first to health, education and training in order to enhance skills and employability, and second to public investment which is labour-intensive.

In terms of investment, more incentives should be provided to entrepreneurs to facilitate a structural transformation of Egypt's economy towards production of high value-added goods and services. Recent trends have seen most investment (including FDI) targeted at either the energy or the real estate sectors, which are neither intensive in labour nor have a significant value added in the economy. Investment policies should be reoriented to attract domestic and foreign investment in order to support economic diversification in a manner conducive to generating decent employment. There is a clear case to be made for increasing investment in high productivity manufacturing industries, in addition to higher end services, where higher quality jobs could reasonably be expected to be found. Investment policy should also aim to give a new lease of life to Egypt's tourism industry, which has been floundering ever since the January 2011 Revolution, as well as to support intensification of agriculture in Egypt's fertile farmland in the Nile Delta and along the river. Investment in research and development and transfer of advanced technologies will also be critical if Egypt is to remain competitive in global markets. In tandem, promotion of an enabling institutional environment, enterprise clusters and value chains should be further pursued.

With regard to monetary policy, even though the monetary authorities should guarantee price stability, they must also ensure a wider and easier access to credit for SMEs and support development of microfinance institutions as part of a broader agenda of financial inclusion. Such measures will support the development of entrepreneurship and employment creation, and consequently reduce poverty and inequality in Egypt.

Concerning exchange rate policy, an intermediate exchange rate regime, adjusting the exchange rate within a band, can be used to reduce exchange rate volatility and attain a stable real exchange rate rule in the medium term, in order to predictably influence resource allocation between the traded and non-traded goods sectors.

In terms of trade policy, given that exports have been shown to have a sizeable impact on employment, Egypt should pursue measures to increase its exports, including through

the conclusion of new trade agreements. Well-designed trade and export promotion measures would boost the access of Egyptian firms to international markets and would allow Egypt to gain from trade by exploiting its comparative advantages and benefiting from economies of scale. Since tariff levels have already significantly declined, more attention should be paid to non-tariff barriers as well as administrative barriers to trade that still hinder exports and therefore production and employment. The sequencing and timing of further trade liberalization is critical because learning capacities are limited. Education and training policies need to meet the specific human capital needs of the labour market, and support economic dynamics by increasing the breadth, diversity and complexity of the social knowledge base and thereby developing social capabilities (Nübler, 2014).

If current trends in the labour market continue, rising unemployment, high shares of informality and vulnerability, low quality jobs and low productivity – particularly among young people – will undermine economic performance and the well-being of the Egyptian population. If these challenges can be overcome, in addition to addressing the inherent discrimination that women face in the labour market, which perpetuates their low level of participation, the position of the Egyptian economy generally will be enhanced, and labour market conditions and living standards will be improved. Addressing these challenges requires a comprehensive approach in which employment-focused macroeconomic, investment and trade policies would be complemented by a range of education, labour market and social protection policies that pay particular attention to institutional reform and supporting the under-served segments of Egyptian society. In view of the interrelation between Egypt's economic and labour market problems and challenges, coordinated efforts of a wide array of stakeholders are needed. Social dialogue can play a critical supporting role not just in the formulation, but also in the implementation of the full policy package, in order to ensure policy coherence, cooperation between the public and private sectors, and improved quality of governance.

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Annex. Egypt: Selected macroeconomic indicators, 2009/10–2015/16

Egypt: Selected macroeconomic indicators, 2009/10–2015/16 1/

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
						Projections
	<i>(Annual percentage change)</i>					
Real GDP (market prices)	1.8	2.2	2.1	2.2	3.8	4.3
Consumer prices (end-of-period)	11.8	7.3	9.8	8.2	11.0	10.5
Consumer prices (period average)	11.1	8.6	6.9	10.1	10.4	10.1
Public finances	<i>(As percentage of GDP at market prices)</i>					
General government ^{2/}						
Revenue and grants	22.0	22.1	23.0	25.0	24.3	23.7
Expenditure (incl. net acquisition of financial assets)	31.8	32.7	37.1	38.6	35.2	32.2
<i>of which</i> : Interest	5.6	5.9	7.7	8.0	7.9	7.5
Overall balance	-9.8	-10.5	-14.1	-13.6	-11.0	-8.5
Overall balance, excl. grants	-10.0	-11.2	-14.4	-17.4	-12.0	-8.6
Primary balance	-4.7	-5.1	-6.6	-6.1	-3.6	-1.4
Gross Debt	76.6	78.9	89.0	90.5	89.8	87.1
External	11.8	9.8	11.4	10.4	11.0	12.2
Domestic	64.8	69.1	77.6	80.1	78.8	74.9
Budget sector ^{3/}						
Revenue and grants	19.3	19.3	20.0	21.8	21.3	20.9
Expenditure (incl. net acquisition of financial assets)	29.2	29.9	33.7	35.7	32.2	29.4
<i>of which</i> : Fuel subsidies	4.9	6.1	6.8	6.3	3.1	1.2
<i>of which</i> : Food subsidies	2.4	1.9	1.9	1.8	1.4	1.3
Overall balance	-9.8	-10.6	-13.7	-13.8	-11.0	-8.5
Overall balance, excl. grants	-10.0	-11.2	-14.0	-17.6	-12.0	-8.6
Primary balance	-3.7	-4.0	-5.3	-5.2	-2.5	-0.4
Monetary sector	<i>(Annual percentage change)</i>					
Credit to the private sector	1.0	7.1	9.8	7.4	11.7	14.9
Reserve money	23.6	5.1	20.4	14.8	16.2	11.2
Broad money (M2)	10.1	8.3	18.4	17.1	15.2	11.8
Treasury bill rate, 3 month (average, as percentage)	10.2	13.4	13.4	11.3	9.5	11.2
External sector	<i>(As percentage of GDP, unless otherwise indicated)</i>					

Exports of goods (in US\$, percentage change)	13.1	-7.1	7.6	-3.2	-14.0	-5.9
Imports of goods (in US\$, percentage change)	10.4	9.5	-2.6	3.7	-1.4	4.7
Merchandise trade balance	-11.5	-13.0	-11.3	-11.8	-11.4	-11.5
Current account	-2.6	-3.9	-2.4	-0.8	-3.4	-4.3
Capital and financial account (incl. errors and omissions)	-1.1	-2.8	2.1	1.6	3.1	3.2
Foreign direct investment (net, in billions of US\$)	1.2	3.7	3.6	3.8	6.9	7.6
External debt ^{4/}	14.8	13.1	15.9	16.1	16.4	17.3
Gross international reserves (in billions of US\$)	26.4	15.2	14.5	16.3	18.7	21.2
In months of next year's imports of goods and services	4.7	2.7	2.5	2.8	3.1	3.2
As percentage of short-term external debt ^{5/}	542.4	308.8	138.1	191.9	116.9	115.2
Memorandum items:						
Nominal GDP (in billions of Egyptian pounds)	1,371.1	1,575.5	1,753.3	1,997.6	2,295.4	2,631.3
Nominal GDP (in billions of US\$)	235.6	262.3	271.4	286.4
GDP per capita (in US\$)	2,930	3,183	3,205	3,304
Unemployment rate (period average, as percentage)	10.4	12.4	13.0	13.4	13.2	12.7
Poverty rate (as percentage)	25.2	n.a.	26.3
Population (in millions)	80.4	82.4	84.7	86.7	88.4	90.2

Sources: Egyptian authorities; IMF staff estimates and projections

1/ Fiscal year ends June 30.

2/ General government includes the budget sector, the National Investment Bank (NIB), and social insurance funds.

3/ Budget sector comprises central government, local governments, and some public corporations.

4/ Includes multilateral and bilateral public sector borrowing, private borrowing and prospective financing (in 2011/12).

5/ Debt at remaining maturity and stock of foreign holding of T-bills.

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