



National Security Project

Investing in the Revolution:

Economics and the Prospects for Democracy in Egypt

October 2011 | General (ret.) James L. Jones



BIPARTISAN POLICY CENTER



National Security Project

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AUTHORED BY

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The pace and intensity of world events in 2011 have been unrelenting. The spread of political unrest across the Middle East, global financial crises, conflicts and natural disasters have all competed for the attention of policymakers. Achieving the perspective to recognize pivotal moments and seize transformative opportunities can be difficult in the midst of such upheaval. We have joined together to issue these papers to call attention to precisely such an opportunity: the ongoing revolution in Egypt.

The public uprisings that brought Hosni Mubarak's reign to an end could have a greater impact on the political landscape of the Middle East than any other protest in the region to date. What is not yet clear is the nature of the change they will spark. Egypt's revolution is as yet unfinished; it could still lead towards a pluralist and tolerant democracy but, as of this writing, renewed military rule, an Islamist state or rising chaos all seem more likely. If any of these scenarios were to materialize, the implications for Egyptians, the region and U.S. security could be significant.

The ability – and desirability – of the United States to determine the course of events in Egypt is limited. What began as an organic and spontaneous movement should remain that way. Only Egyptians can realize the true potential of their revolution; they deserve latitude to determine their own future. Indeed, affecting political change in any state in flux is a daunting task and we must be humble in our ambitions.

Nevertheless, it is a task we should undertake. It is incumbent upon us to help shape the Egyptian revolution in a positive direction, one that benefits Egyptian and U.S. interests alike. Doing so will require the full spectrum of American power. Egypt is in need of all three pillars of foreign assistance: political reform, economic reform and security. It also needs ideas. As Egyptians decide their future, we should not hesitate to expound the virtues and values of democracy.

We issue a joint introduction to two separate papers to highlight the need for, and importance of, a coordinated strategy toward Egypt. General James Jones writes on the economic problems that underlie Egypt's political turmoil and the steps that policymakers can take to help avert further destabilization. Ambassador James Glassman and Secretary Dan Glickman, together with the Bipartisan Policy Center's (BPC) Strategic Public Diplomacy Task Force, examine the recent history of U.S. public diplomacy efforts in Egypt and draw lessons for how to communicate with the Egyptian public in the post-Mubarak era.

Ambassador
James K. Glassman

Secretary
Dan R. Glickman

General (ret.)
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I. FOREWORD

By Hala Mustafa

The Arab Spring marks the renewal of social, economic, cultural and political contracts between Middle Easterners and our governing and administrative institutions. Changes of volcanic proportions are removing – whether peacefully or by force – the region’s entrenched and despised regimes. The toppling of authoritarians in Tunisia, Egypt and Libya shocked the world. Yet what lies ahead is even more challenging than what has been achieved to date.

Contrary to the clearly defined changes that occurred earlier in Eastern Europe, the direction of change in the Middle East is uncertain. In 1989, there was a shift from collective culture to individualism, from socialism to capitalism, from totalitarian rule to liberal, and pluralistic systems aligned with the universal values of freedom promoted by the West.

Like other states in the region, the direction of Egypt’s domestic and foreign policies, as well as its economic orientation, remain unclear. It is, quite simply, impossible to predict what will come next for the formerly corrupt, crony-capitalist, repressive, intolerant, corporatist and statist country. In the aftermath of the revolution, Egypt is a country divided. Citizens’ understanding of civil liberties, individual rights, Islamism and secularism differ greatly. Economic and constitutional questions – issues defining Egyptian politics and identity – are polarizing the society. These are not new divisions but they were suppressed prior to the Arab Spring and are just now being aired with an intensity proportional to all the years they had been silenced.

At the same time, a deeply rooted – but until recently repressed – populism threatens democratic transformation at all levels of the state and society. Loud voices advocating pan-Arabism and Islamism are drowning out those promoting democracy based on liberal principals. Massive protests against the peace treaty with Israel, growing sectarian tensions and calls for rolling back women’s rights are harbingers of the ill effects of populism on politics in Egypt.

In this new and dynamic political environment, the Muslim Brotherhood has emerged as a force with which to be reckoned. Nearly a year after the uprising, the Brotherhood has yet to articulate a modern agenda for domestic, economic or foreign policy, nor has it described a governing philosophy or explained its stance on individual, political and civil rights. Judging by the Brotherhood’s negative reaction to Turkish Prime Minister Recep Erdogan’s September 2011 declaration in Cairo of his total commitment to secular a state, however, it seems all but assured that Egypt’s Islamists will not fully embrace the basic principles of democratic politics.

Meanwhile, the Brotherhood and its new Freedom and Justice Party are advancing its Islamist agenda and political campaign in coalition with older, established parties like the conservative Wafd and nationalist-socialist Nasserist parties. As a massive voting bloc, this grouping is sure to obtain a considerable number of votes in the upcoming election, enabling it to significantly influence Egypt’s internal and external politics for years to come.

Yet, major ideological differences exist that could split this coalition. To maintain cohesion and electoral support, this coalition will most likely focus on populist economic policies.

Economically, Egypt is still governed by an entrenched, socialist framework. Attempts at reform have been made, beginning in the mid-1970s and continuing under Mubarak. While Egypt did attain considerable economic growth in the last decade, these reforms did not move society towards a successful and sustainable model of economic development. The result, instead, was a distorted capitalism overseen by oligarchs where the rich became richer, the poor became poorer and the middle class deteriorated. Therefore, when Egyptians took the streets on January 25, 2011, "social justice" was the paramount demand.

Now, with Mubarak gone, the extent of his regime's corruption is being exposed. Despite several rounds of privatization, state control over the economy continued under Mubarak and its persistence now threatens the sustainability of Egypt's growth. Much work needs to be done if future governments of Egypt ever hope to meet the demands, and popular expectations, of social justice. This will not be accomplished through statism, but through economic development based on genuine liberalization – meaning strong protection of individual property and minimal state intervention – and this approach must be incorporated into the new constitution.

The trend in Egypt in the coming period will be toward populism tinted with anti-Western sentiment. To succeed in the transition, however, Egypt will need to adopt a sustainable economic model with the support and encouragement of its U.S. and European partners. To be lasting, this economic transformation needs to be comprehensive and paired with similarly far-reaching political change including transparency, rule of law and protection of individual rights. Egypt needs a vision for its future; only such mutually reinforcing changes can wipe away the legacy of oppression and provide a coherent framework that fulfills the promise of our revolution.

Dr. Hala Mustafa is, since 2000, the Editor-in-Chief of the Al-Ahram political quarterly "Democracy" (Al Dimocratiya).

Executive Summary

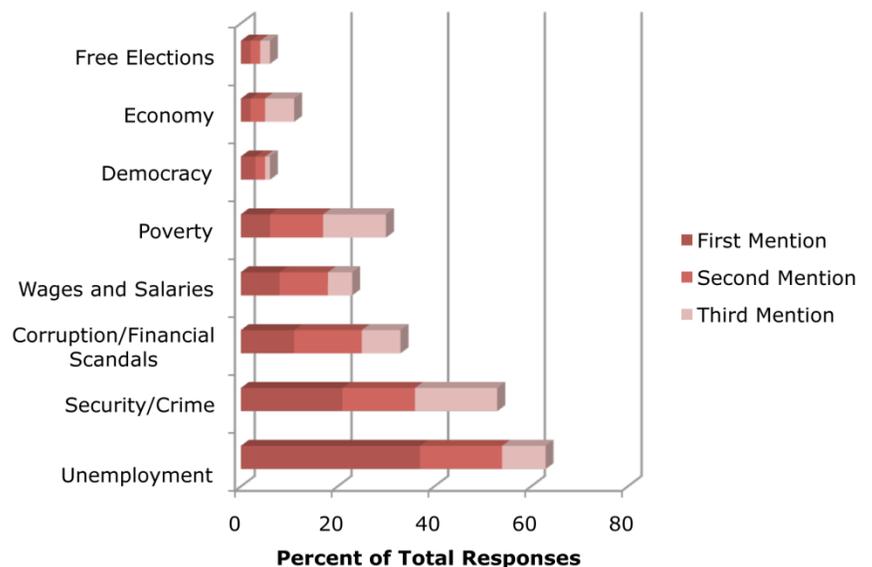
In January 2011, Egyptians, inspired by the success of Tunisians, went to the streets and toppled their own authoritarian regime. After more than 30 years, Hosni Mubarak's deposition was an impressive accomplishment. While the Lotus Revolution was in part driven by Egyptian's desire for democracy, both polling data and anecdotal evidence indicate that economic factors were a primary reason for the uprising.

Indeed, 64 percent of those questioned in an April 2011 poll said that "low living standard/lack of jobs" were the factors that most influenced them to support or participate in the protests that ultimately toppled the regime.¹ Conversely, only 19 percent identified a "lack of democracy and political reform" as the underlying motivation for their mobilization. This corresponds to what we have learned about what makes states stable. As outlined in a previous BPC report, stability rests on three legs: democratic governance, economic development and security.²

Understanding why Egyptians risked life and limb earlier this year to end Mubarak's tenure is critical to getting U.S. policy and assistance to Egypt right.

With 83 million people, Egypt is not only the most populous Arab state but a longstanding column in the U.S. strategic architecture in the Middle East and a regional bellwether. The outcome of Egypt's revolution will have long-lasting repercussions for Egyptians, U.S.-Egyptian relations and the security of the region. Helping smooth Egypt's political transition is a critical task for U.S. foreign policy and one in which economic aid can an important role to play.

Figure 1: What is the single biggest problem facing Egypt as a whole?



Notwithstanding the optimism surrounding much of the Arab Awakening, it is far from certain that the state will ultimately become democratic. Indeed, there is ample reason to be concerned about the direction of politics (and society) in Egypt. Lately, in fact, there has been a disturbing trend in Egypt toward less, not more, freedom related in part to the problematic security situation. To wit, after the Israeli Embassy in Cairo was overrun by demonstrators in September 2011, the Supreme Military Council (SMC) announced the re-imposition of the hated State of Emergency law – giving the government broad power to suppress dissent – that had been abolished after Mubarak’s demise.

Though security may eventually be restored providing an opportunity to move toward a more democratic legal framework, other endemic problems in Egypt will continue to threaten democratic development.

Perhaps the most important factor in determining the trajectory of politics in Egypt will be the economy. This is unsurprising given the increasing desperation of Egypt’s impoverished, a crisis made even more acute by the revolution. Although the Mubarak government initiated economic reforms that led to robust growth in recent years, many of those benefits accrued to a select few in the ruling class, with few jobs or earnings trickling down. What makes the current situation so volatile, however, are the unprecedented skyrocketing expectations that have accompanied the end of the Mubarak era. In the aftermath of the revolution, an astounding 80 percent of Egyptians say they expect their household’s financial situation to improve this year.

These expectations are unlikely to be met anytime in the near future. Rather than improve economies, political unrest tends to disrupt them. Indeed, in the near term, it is possible that Egypt will witness a degree of macroeconomic destabilization. Worse, in the new environment of political competition, there will be little incentive for Egyptian politicians to make the kind of difficult, unpopular economic decisions required to lay the groundwork for future stability. Instead, the trend will almost certainly veer toward populist economic policies that threaten to roll back the few positive economic reforms implemented by the Mubarak regime.

In Washington, the natural if not reflexive response to Egypt’s challenges will be to focus on the state’s impending parliamentary and presidential elections, and the constitution-drafting process. There will be a push for international election monitors and an effort to provide technical assistance to Egyptians as they craft the new legal framework for their state. The goals will be to build democratic institutions in Cairo and ensure free and fair elections.

While these efforts are important, they will be for naught if economic conditions in Egypt do not steadily improve. It is not just a matter of sequencing. If a viable economic

strategy that can deliver long-term economic growth and short-term improvements in the quality of life is not firmly established, Egypt's fledgling and fragile democracy will wilt on the vine. This is what happened in many states of the former Soviet Union and it is not particularly difficult to imagine what might fill the void should efforts at democracy falter in Cairo.

To head off this worst-case scenario, U.S. policy towards Egypt must focus on political reform, security and economic growth. It is incumbent that the Obama administration map out a long-term U.S. commitment to Egypt's economic development. It could take several years to turn around the economy, but the effort should start now. Egypt's combination of high expectations, increased hardship and limited patience suggests that the time for action is short.

Here are six steps that U.S. and European policymakers can take now to invest in a positive outcome for Egypt's revolution:

1. Prioritize Egypt.

Focus now on stemming the deterioration of Egypt's economy and help align it – and by extension its political orientation – with the West. Intensive efforts right now should be made to get Egypt on the right economic trajectory, while Washington's leverage with Cairo, although limited, may be at its peak.

2. Maximize U.S./EU Assistance.

Provide valuable assistance in terms of organizing Egyptian elections and helping the inexperienced and infrastructure-poor liberals organize and compete effectively against their Islamist rivals at the ballot box. The impact of this U.S. aid on the long-term political orientation of Egypt, however, can be maximized by coupling it with assistance from the European Bank for Reconstruction and Development (EBRD). Since 1991, the EBRD has fostered open market economies by boosting the role of the private sector in states transitioning from command economies.

3. Trade (Not Aid).

Washington and Brussels should press forward with signing Free Trade Agreements (FTA) with Cairo. An FTA is a significant gesture of good will that can boost employment and improve the economy in Egypt. Though perhaps politically difficult, by passing an FTA Washington will send a strong signal about its commitment to Egyptians' well-being while doing its part to help prevent Egyptian Islamists from exploiting economic difficulties to take power. Unlike other foreign assistance and in a time of diminished U.S. financial resources, an FTA is budget-neutral and would also create jobs in the

United States.

4. Incentivize Economic Reforms.

It is not a secret that Egypt wants its assistance – financial or otherwise – with no strings attached. Instead, policymakers should press Egypt’s first post-Mubarak elected government to implement what are sure to be unpopular if not painful economic reforms. The United States can condition its assistance, and Egyptians should know this upfront. In our public diplomacy, it is important that we be clear with the Egyptian public about the type of Egypt with whom the U.S. can partner. But we should define it in terms of what kind of country we want to see, not which leader we want to see.

5. Invest in Egypt’s Energy Resources.

Egypt is an important producer and exporter of liquefied natural gas (LNG) and has the largest oil refining capacity in Africa. At the same time, however, electricity consumption surpasses its production capacity and rolling blackouts are common. Reforming and improving the energy sector will be important to Egypt’s economic growth. Washington should work with Egypt to phase out fuel subsidies which are very expensive and promote excessive demand and inefficiency, work with the next Egyptian government to continue development of nuclear energy, and encourage investment in Egypt’s conventional and alternative energy sector.

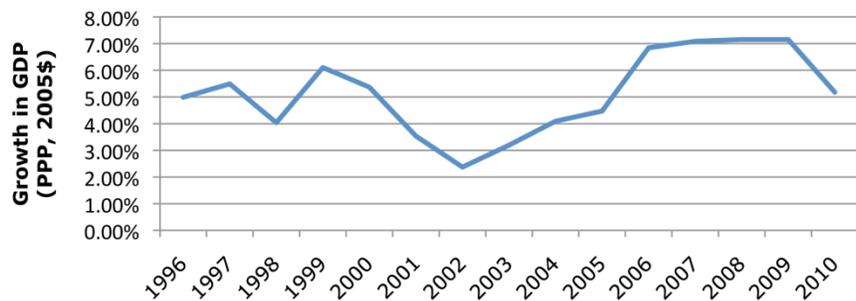
6. Reform the Security Sector.

Post-revolution Egypt has a security problem. Crime is scaring away tourists and would-be investors. Egypt is currently in the process of reconstituting its state security apparatus—an organization that will take the lead in future domestic counterterrorism operations. Washington is not involved but it should be. Egypt would benefit from U.S. training in human rights, transparency, accountability and rule of law, among other topics.

Egypt's Economy

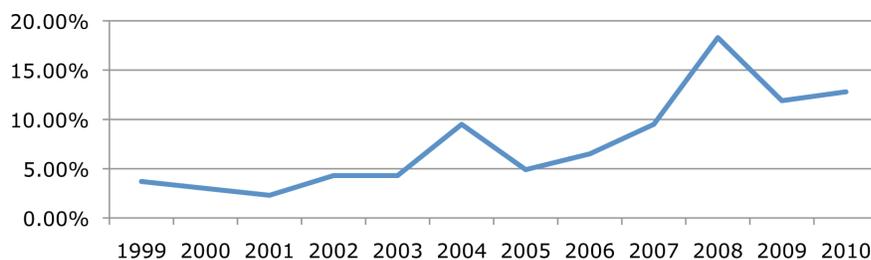
Even before January 2011, the Egyptian economy experienced difficulties. The latest attempts at reform, which began in 2004 with the appointment of Ahmed Nazif as prime minister and the addition of businessmen and technocrats to the cabinet, reduced tariffs, hastened the pace of privatization, restructured the financial sector, increased tax incentives for foreign direct investment (FDI), and sought to make the Egyptian economy more open to spur growth.³ As a result, by 2008 the real growth rate of GDP was as high as 7.2 percent before dipping to 4.2 percent during the global recession of 2009, and FDI reached \$11.6 billion, a five-fold increase from 2004 levels.

Figure 2. GDP Growth Rate



Source: World Bank

Figure 3. Inflation

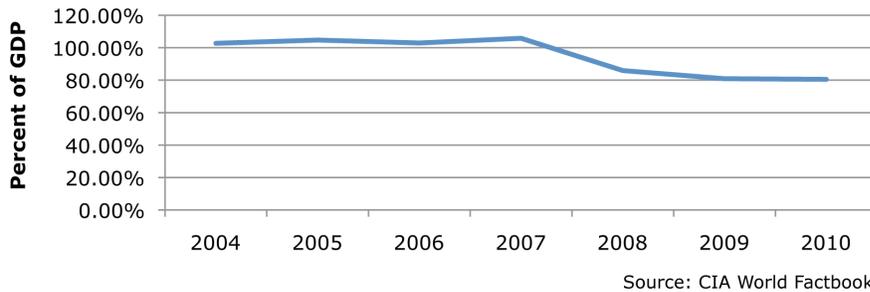


Source: CIA World Factbook

This high growth was a result of the significant liberalization of the Egyptian economy implemented by the Nazif government. The reforms boosted the economic growth rate but this was a

very gradual and partial liberalization, and the fruits of economic growth were connected with corruption and landed disproportionately in the hands of the rich and powerful. On the macroeconomic level, the improvements were dramatic, but there was little trickle down to speak of. As a consequence, in the eyes of many Egyptians, liberalization and privatization were inextricably associated with corruption.

Figure 4. Public Debt



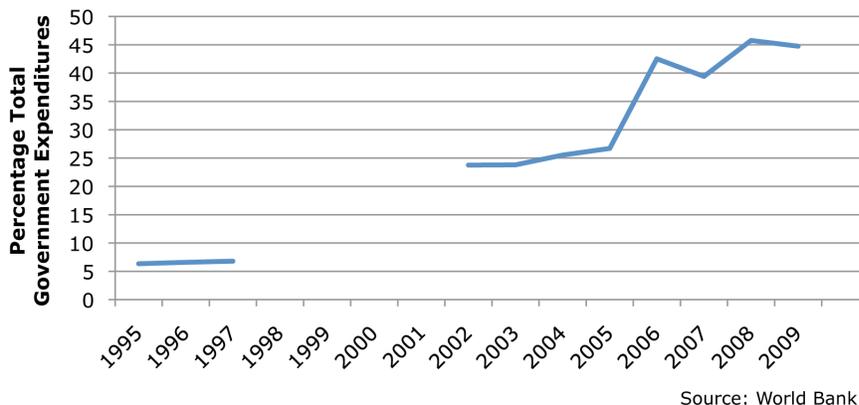
Despite these efforts at liberalization, Egypt's economy was considered only 59.2 percent free in 2011 and ranked 111th out of 180 countries on

the Corruption Perceptions Index as measured by Transparency International in 2009.⁴ In 2008, at the height of Egypt's macroeconomic growth, the World Bank ranked it as only the 126th easiest country with whom to do business out of 178.⁵ More importantly, the reforms did little to improve socioeconomic conditions for most Egyptians or fix the structural problems that have plagued the country's economy.

Notwithstanding significant foreign direct investment and international assistance over the years, unemployment and underemployment have been perennial problems. While per capita GDP leapt from under \$4,000 to nearly \$6,400 in the decade between 2000 and 2010, little of that trickled down to the populace.⁶ With official unemployment consistently hovering around 10 percent and inflation expected to hit 16 percent in 2011 – predominantly driven by rising food and fuel prices – the standard of living for most Egyptians remains low.⁷ According to World Bank estimates, 40 percent of Egyptians live on less than \$2 per day and qualify as poor or near-poor. The situation is even worse among the almost 30 percent of Egypt's population between the ages of 15 and 29. A staggering 25 percent youth unemployment rate compelled the IMF to issue a warning before the revolution, citing a need for an additional 10 million jobs in the nation for stability.⁸ Indeed, some analysts have pointed to this unemployed and disaffected

"youth bulge" as a key dynamic in driving Egypt's revolution.⁹

Figure 5. Cost of Government Subsidies



Egypt is also saddled with harmful and often regressive energy and food subsidy commitments, which amount to some 10 percent of the

annual budget and cost nearly \$10 billion. Of this, nearly four-fifths, or \$9.7 billion, goes to subsidizing the cost of fuel and electricity. The majority of the remainder is spent on food and grain subsidies. These subsidies were designed to offset the political pressures of endemic poverty and unemployment but instead have created perverse incentives that lead to greater corruption, inefficient allocation of resources, food scarcity and fiscal strain. And yet, with Egyptian public debt at almost 80 percent of GDP, the budget for the 2011-2012 fiscal year released by the Ministry of Finance in June 2011 calls for vastly increased spending on subsidies and social security benefits. Such profligate spending is likely to prove unsustainable in the long-term.

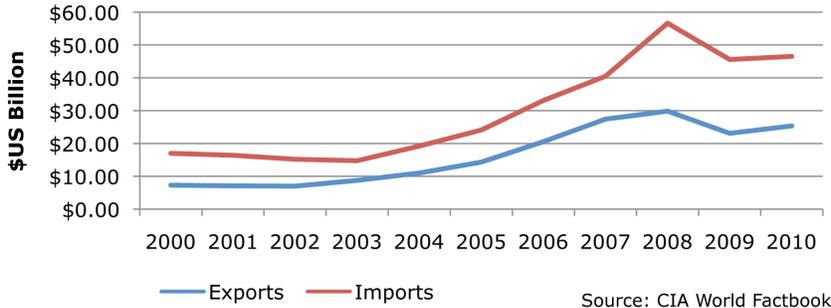
Egypt is caught in a complicated web of economic dilemmas that will be difficult to unravel and solve. First, its economic structure has been distorted by misdirected regulations and peculiarities. For example, although some 40 percent of the population works in agriculture, Egypt ranks among the leading importers of food (as percentage of GDP) and the leading importer of wheat in the world. Food is heavily subsidized, reflecting the Mubarak regime's focus on urban populations over more impoverished rural areas. At the same time, Egyptian industry has been neglected, resulting in minimal manufacturing exports.¹⁰ Instead, the country depends on transit fees generated by the Suez Canal and energy pipelines in addition to tourism, remittances and foreign aid, and investment.

Second, Egypt is caught in an external financial squeeze. Prices of its main imports – food and energy – have risen dramatically in recent years, while in the aftermath of the revolution, tourists have been scared away and foreign direct investment has shifted into capital flight.

Third, Egypt suffers from a domestic financial squeeze, which is a typical outcome of a revolution. Its people hold exaggerated material expectations, manifested in demands for higher wages and social benefits, coupled with a reluctance to pay additional taxes.

The fourth dilemma is ideological. So-called liberals in the former government are discredited and accused of corruption. Meanwhile, the prevailing sentiment is outright populism with a focus on salaries and benefits, stricter government price regulations, and, potentially, nationalization of unjustly (or inappropriately) privatized enterprises. The natural outcome of this mix will be larger budget deficits, loose monetary policy, inflation, devaluation and, in other words, macroeconomic destabilization.

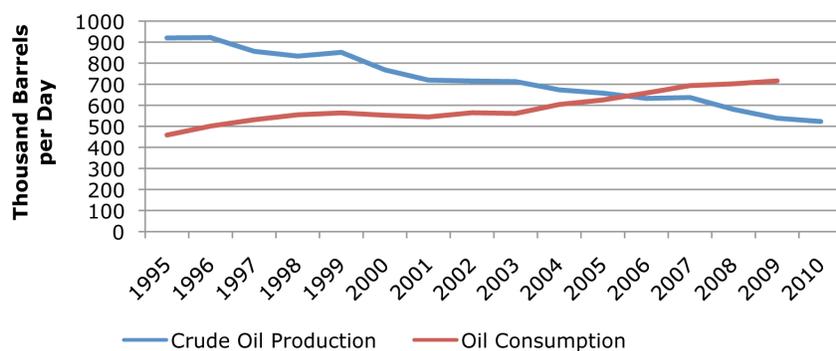
Figure 6. Total Trade



Egypt's Energy Sector

Egypt, unlike some countries in the region, is not a petrostate. It does not have coffers of oil revenues from which it can dole out increased social payments. Its production and proven reserves of oil are mediocre at best, both ranking only 27th largest in the world, respectively.¹¹ In recent years, as production has slumped and consumption spiked, Egypt has, in fact, become a net oil importer. Nevertheless, energy remains an important part of its economy. It is the largest petroleum refiner in Africa, it has emerged as a natural gas exporter, and continues to earn revenue as a critical energy transport hub.

Figure 7. Oil Sector



Source: U.S. Energy Information Administration

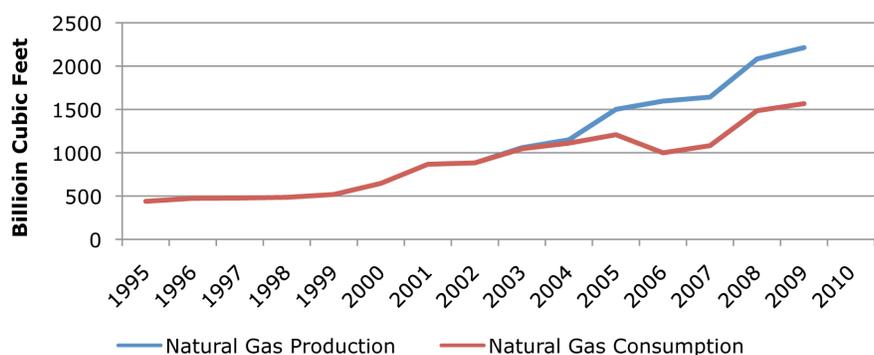
Recent exploration has shown Egypt's proven oil reserves to be slightly higher than previously believed – rising from 3.7 billion barrels in 2009 to 4.4 billion in 2010.¹² This still only represents some three-tenths of one percent of total proven world reserves, however. Despite these

new discoveries, Egypt's total oil production has been on a steady decline since peaking at 933,673 barrels per day (bbl/d) in 1996, reaching a low of about 660,000 bbl/d in 2010.¹³ At the same time, Egypt's consumption of petroleum products has skyrocketed, due in large part to generous energy subsidies from the government, reaching 716,000 bbl/d of petroleum in 2009.¹⁴ Thus, while oil (and fuel) exports totaling \$7.59 billion constituted some 44 percent of Egyptian exports, and almost 15 percent of government revenue in 2009, Egypt imported almost the same amount, \$7.12 billion.¹⁵ As the gap between consumption and production continues to widen, the costs of energy imports are going to mount and place additional strain on the budget. Already, some estimates suggest energy import costs could reach \$90 billion per year by 2020.¹⁶

With the continued decline of oil production, Egypt has focused on building its refining capacity. It already boasts the largest refining sector on the African continent, with 10 refineries and a total refining capacity of 975,000 bbl/d. In the next five years, Egypt plans to bring online another 600,000 bbl/d in refining capacity, with a special focus on

lighter refined petroleum products such as gasoline and diesel rather than heavier products like fuel oil of which Egypt already has a surplus.¹⁷ The Egyptian Refining Company (ERC) is building several new refineries with Citadel Capital, an Egyptian private equity firm, and Essar Group, an Indian industrial conglomerate, but further expansion will require significant additional foreign investment.¹⁸

Figure 8. Natural Gas Sector



Source: U.S. Energy Information Administration

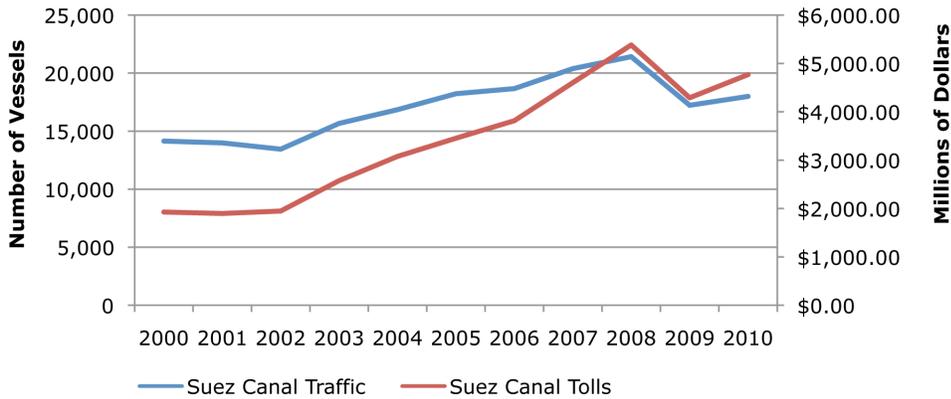
Egypt also has the third largest natural gas reserves in Africa, behind Nigeria and Algeria, amounting to 77 trillion cubic feet (Tcf). Its production of natural gas has more than quadrupled in the last decade, jumping from .518 Tcf in 1999 to over 2.2 Tcf in 2009. While domestic gas consumption has

grown apace, it still only totals 1.6 Tcf, leaving Egypt with natural gas exports of about .650 Tcf. Roughly 70 percent of Egypt’s natural gas exports are shipped as liquefied natural gas (LNG) of which most, some .160 Tcf, headed to the United States and representing 35 percent of the America’s LNG imports. Other recipients of Egyptian LNG include Spain, France, Canada, Mexico and Asia. The remaining 30 percent of Egypt’s natural gas exports are sent, at below-market-level prices, to Lebanon, Jordan and Syria via the Arab Gas Pipeline (AGP), as well as Israel through the Arish-Ashkelon addition to the AGP.¹⁹ The AGP represents a significant energy lifeline for many of these countries; Lebanon has no fossil fuel reserves of its own while Jordan and Israel rely on Egyptian natural gas for some 80 and 40 percent, respectively, of their domestic consumption. Yet Egypt’s natural gas exports have been repeatedly disrupted. A payments dispute pre-dating the revolution has shut down exports to Lebanon while continued attacks on the pipeline – four since the revolution began – have interfered with exports to Israel, which are, as of this writing, suspended.²⁰

Politically, the export of natural gas to Israel is not a winning issue in Egypt and Egypt’s own domestic energy requirements are growing. These factors suggest that Egypt’s days as a natural gas exporter are likely numbered. That said, at present, Egypt’s liquid natural gas (LNG) facility is only operating at half capacity, making it possible that after Israel’s offshore natural gas production comes online, Egypt could profit from processing and transporting the resource.

In addition to its own production and export of energy, Egypt is a crucial hub in the global movement of oil and gas. The Suez Canal – which connects the Red Sea and the Gulf of Suez, and brought Egypt \$4.5 billion in revenue in 2009 – handled almost 2 million bbl/d of petroleum transit in 2010, about 5 percent of total seaborne oil trade. Of the almost 18,000 ships that passed through the Canal last year, about one-quarter were either oil or LNG tankers. For tankers too large to pass through the Canal, such as Very Large Crude Carriers (VLCCs) that carry up to 2 million barrels of oil, the Suez-Mediterranean (SUMED) pipeline provides an alternative transit link. Running from the Red Sea to the Mediterranean, SUMED has a capacity of 2.3 million bbl/d, though it handled only 1.1 million bbl/d in 2010. Traffic through both the Suez Canal and SUMED has dropped sharply since 2008 when it reached 2.4 and 2.1 million bbl/d, respectively, partly as a result of the global economic recession and partly due to increased piracy off the Horn of Africa.

Figure 9. Suez Canal Traffic and Toll Revenue



Source: Suez Canal Authority

Post-Revolution Economic Problems

The Lotus Revolution hit the Egyptian economy hard and its impact continues to reverberate. Ongoing instability in Egypt driven by physical insecurity and continuous demonstrations, among other factors, has spooked investors and tourists alike. At the time of the revolution, the Egyptian stock market dropped precipitously. Not only has the market not recovered, it continues to fall. Indeed, economists forecast that, in 2011, Egypt's growth rate will plummet to about 1.6 percent or less, down from 5.1 percent in 2010.²¹ At the same time, Egypt's once-impressive war chest of foreign reserves has dropped from \$36 billion in January 2011 to \$26 billion in July 2011, with outflows of up to \$1 billion per day at the height of the revolt.²²

As of August 2011, Egypt has remained in a constant state of revolution, with demonstrators filling Tahrir Square and pressing the Supreme Military Council (SMC) to meet their demands. To date, the SMC has acquiesced to nearly all the requests of the protestors. In July, in an effort to placate the crowds, the SMC and the interim government actually shuffled the cabinet, purging it of personnel perceived as tainted by the former regime. The SMC, however, has deep roots in the Egyptian economy, holding over 30 percent of the assets in different sectors and contributing to the military's historical support for a state-controlled regime. It is unclear whether the SMC will continue to defer to the street indefinitely.

The dynamic between protestors, the SMC and Islamists has created an environment of uncertainty that has further shaken investor confidence. Apprehension is related not only to what might occur should the Islamists ultimately come to power – indeed the AK Party improved the Turkish economy – but what kind of policies the next democratically elected Government of Egypt will pursue.

An underlying consensus demand of the revolution (if not the main demand) was "social justice," a concept with a broad range of interpretations and policy implications including, among other things, income redistribution, nationalization of industries and/or increases of subsidies. Given the overwhelming poverty and the higher food prices – according to Government of Egypt statistics, prices have increased one hundred percent on staples since June 2010 – subsidies are a critical safety net.

Egypt's economic woes have reached critical levels. So much so that after July protests in Tahrir Square were held under the banner of "Revolution First," Coptic Pope Baba

Shenouda III suggested it would be more appropriate to rally for "The Poor First." Given this environment and the new populist climate of Egyptian politics, it is unsurprising that the 2011-2012 fiscal year budget contains a sharp rise in subsidy and social security spending. The budget proposed by the Ministry of Finance in June 2011 and approved by the SMC in July raises social spending by one-third, tripling social security benefits, boosting housing benefits by half and increasing subsidies on both basic commodities and energy by 40 percent. Additionally, the government increased salaries of 6 million civil servants by 15 percent. The government also doubled the minimum wage to \$118 per month. The raise has been a long time coming, but it is still insufficient for most. To rein in a deficit projected to reach nearly 11 percent of GDP, the budget increases the top tax rate on companies and individuals and introduces a capital gains tax.²³ Yet despite budget shortfalls, Egypt has turned down a proposed \$3 billion aid package from the IMF, offered with minimal conditions.²⁴

Many economists believe such policies will prove devastating for the state. First, increased private sector salaries will make Egyptian manufacturing even less competitive internationally. Second, and perhaps worse, the raise will increase the budget deficit and fuel the rate of inflation, which already stands at nearly 12 percent.

Adding to the uncertainty surrounding the Egyptian economy is the problematic security environment in Egypt.²⁵ With the crime rate increasing and law enforcement unreliable, Egyptians feel increasingly vulnerable. Not surprisingly, so do foreign and local businesses. Reports in the daily press discussing the looting of private industry's capital assets are becoming more frequent. Given all of these problems, it should come as little surprise that Egypt's capital is fleeing.

Taken together, it appears that Egypt today is standing on the precipice of macroeconomic destabilization. A debt crisis would not be unusual. Indeed, some prominent international economists suggest that macroeconomic crises are "a standard initial outcome of revolutions and democratic breakthroughs."²⁶ While routine, the consequences would be grim. The value of the Egyptian pound – whose exchange rate has long been controlled by the Central Bank – could fluctuate dramatically, producing double exchange rates. Meanwhile, hyperinflation could ensue if the treasury prints more money to stabilize the currency.

Economic Conditions and Democracy

The international community was relatively quick to recognize the impending economic crisis in Egypt. Washington announced a \$2 billion package to prop up the state on May 19, 2011. A week later, from May 26–27, the G8 convened in Deauville, France to discuss, among other issues, a “Partnership for democracy” in support of the Arab Spring. The Partnership focused on two so-called pillars: one, a political process to sustain governance reform and democratic transition and, two, an economic framework to promote “sustainable and inclusive growth.”²⁷

To date, the highest profile aspect of the G8 initiative has been the pledges to Egypt of \$40 billion made by the world’s largest economies. Other offers of assistance have also been impressive: Saudi Arabia and the United Arab Emirates (UAE), for example, made offers of assistance totaling \$4 billion and \$3 billion respectively. Qatar, likewise, vowed to invest \$10 billion in Egypt in the coming years.²⁸ All told, if these obligations are met, the funds will likely suffice to cover the state budget deficit of \$22.5 billion (or 8.6 percent of GDP) this year.

There is a danger that foreign assistance, especially from the Gulf, will be given without adequate conditions and reinforce a counterproductive sentiment that Egypt is entitled to foreign assistance in perpetuity. At least for now, however, the aid serves an important purpose.

In the short term, there is little doubt that Egypt will weather the financial storm. That said, it is exceedingly unlikely there will be macroeconomic improvement in Egypt any time soon. The absence of tangible improvements for the vast majority of Egyptians will pose significant challenges for Cairo. At the most basic level, the government will fall well short of popular expectations. According to survey data, 81 percent of Egyptians polled consider the economy to be either “somewhat” or “very bad,” and 80 percent expect their household’s financial situations to improve this year.²⁹

Beyond popular disappointment, the lack of improvement in economic conditions could also profoundly impact democratic development in post-revolution Egypt. If Egyptians do not perceive that economic policy will eventually lead to some material improvements in their lives, the democratic experiment will likely fail.

The correlation between economic and democratic development is well established. Analysts and academics described this dynamic decades ago. Simply stated, the argument is that establishing a viable economic strategy is critical to the survival of democracy in less affluent countries. When poor countries stagnate, nascent democracies tend to wither on the vine.

While this relationship has never been tested in the Middle East, Eastern Europe provides some examples of the importance of economics.³⁰ In post-Communist Europe, for example, despite intense international attention, Communists emerged as the new oligarchs. No doubt, this was in part attributable to privatization policies implemented after independence. But simultaneous democratization and market reform also undermined national institutions. For Egypt today, like Eastern Europe before it, the challenge will be to run an efficient democratic system immune to both Islamist takeover and a return to control of former regime cronies.³¹ Economics will help determine the outcome of the struggle for Egypt's future.

Test cases from Eastern Europe suggest that a smooth transition from authoritarianism to democracy is far from assured. Poland, for instance, emerged from the collapse of Communism in economic crisis. With the support of the West, Warsaw responded by moving quickly to stem hyperinflation and shift the state-controlled economy to a free market system. Importantly, the state implemented significant structural reforms in the economy under the so-called Balcerowicz Plan. While painful, these reforms established a new and sound framework for economic growth which materialized in a relatively short period of time.

Since then, Poland has demonstrated impressive and sustained GDP growth. During his trip to Europe in May 2011, President Obama cited Poland as a model of democratic transformation for the Middle East.

Of course, Poland had a leg up on most of its former collegial communist satellites. Not only was the state already verging on economic crisis – a status that perhaps paradoxically spurred more immediate and radical measures – Poland had a long history of independence prior to Communism which may have laid the groundwork of a more democratic political culture. Other former members of the Soviet Union were not as fortunate.

Ukraine, for instance, has been less successful in sustaining a flourishing democracy following the collapse of the Soviet Union. At least in part, this appears related to the Ukrainian government's failing to establish any economic strategy at all during the first three years of independence. By the time it had, it was already late and the heavy hand of the state in the economy prevented improvements in Ukrainians' standard of living during the 1990s. The dichotomy between Poland and Ukraine is no doubt related to the

fact that Poland almost immediately adopted timely, radical and comprehensive reforms but it could also be a function of the fact that prior to 1991, Ukraine had only experienced three years of independence.

Importantly, democracy can be sustained not only by quick financial improvement, but by perceived improvements in people's lives. Following the Rose Revolution in Georgia, for example, President Saakashvili focused his efforts on anti-corruption measures, including his famous firing of the entire police force. The move was incredibly popular and resulted in a dramatic increase in confidence in the state and bought the government time to implement deep economic reforms. The economy grew slowly but steadily, and now Georgia is a stable and increasingly prosperous democracy.

Of course, comparisons between Egypt and the former Soviet Union satellite states are imperfect. As noted earlier, the revolution in Egypt occurred for predominately economic reasons. In Eastern Europe, the relationship with the USSR was severed due to a sovereignty agenda. Poles, Georgians and Lithuanians did not go to the streets for increased wages, but for freedom.³²

Notwithstanding the rationales underpinning these rebellions, one thing is clear: revolutions disrupt economies and the Lotus Revolution hit Egypt particularly hard. The uprising suspended one of the state's three critical sources of foreign currency, tourism. One other, expatriate remittances, was dramatically curtailed months later when the revolt started in Libya, forcing hundreds of thousands of Egyptian laborers to return home and join the ranks of the unemployed. (The third, Suez Canal revenues, continues unabated.) It is unclear when these sources of revenue will resume at pre-revolution levels.

Given the extraordinarily difficult economic conditions, the instinct of Egyptian policymakers, perhaps understandably, might be to increase subsidies to diminish the hardship. But this would only delay the road to recovery. Notwithstanding the fact that Egypt's 2012 budget includes higher allocations for both subsidies and government investments, some Egyptian officials understand the importance of a free market economy. In his first statement as Minister of Finance, Hazem El-Beblawi announced that Cairo was "committed to the market economy."

Not only will the free market provide the best opportunity for increasing prosperity in Egypt, it will reduce corruption and balance the more controlling tendencies of a traditionally overbearing and rent-seeking Egyptian state. Ultimately, should Cairo pursue this direction, the economy in Egypt, as well as the lives of average Egyptians, will improve. Regrettably, given the grave economic situation, it is all but guaranteed there will be no macroeconomic improvement this year.

Worse, there are signs that the overwhelming trend toward populism and anti-Americanism could result in an economic turn away from reform and the state's traditional pro-west orientation. The decision of the government in July to reject a \$3 billion IMF loan at extremely favorable terms only highlights how political pressures in the new Egypt could impact decision-making going forward. Along the same lines, a draft bill of rights (known as the Fundamental Principles for the Constitution) published by Egyptian liberals in August 2011 included a guarantee of a "right to work," tasking the state with providing employment opportunities to Egyptians.³³ A similar clause was struck from the 1980 socialist constitution when it was amended in 2007 to gear the economy toward the free market.

The challenge for the government and the SMC, then, will be to deliver something to Egyptians in a relatively short period of time to forestall disillusionment and limit the opportunity for Islamists to discredit democracy and free-market economics. If Cairo fails to provide a sense – either real or perceived – that life is improving, more Egyptians may find themselves looking toward Islam as the solution.

Policy Recommendations

While it sounds more like an election bumper sticker than a policy proscription for dealing with a key Arab ally, the adage “it’s the economy, stupid” applies. Rather than focusing on the current day-to-day political dynamics in Cairo – the November parliamentary elections, for example – the Obama administration should adopt a long view of the challenge. Regardless of what happens in these particular elections, if Egypt does not get its economy right, democracy stands little chance of taking root. This would not bode well for other Middle Eastern states currently in, or heading toward, political transition.

To promote the economic conditions that have the best chance of resulting in a western-oriented democratic Egypt, Washington should, among other things:

1. Prioritize Egypt.

It is by now axiomatic that with 83 million people and a long history of cultural dominance in the Middle East, developments in Egypt will set the tone for the region. In the midst of a war in Libya, an ongoing revolution in Syria, an impending failed state in Yemen, the creation of a new state in Sudan, and unrest in Jordan, it will be difficult to find time in Washington to focus on a relatively peaceful process of transition being overseen by the military in Egypt. Yet the ultimate disposition of Egypt is so important that it demands ongoing senior-level attention in the U.S. government.

After the fall of communism, Washington focused much of its efforts on Poland which was seen as a lynchpin state. In much the same way, the U.S. government should now focus on stemming the deterioration of Egypt’s economy, and writing a strategy to ensure that going forward, Cairo’s economic and, by extension, political orientation remains aligned with the West.

This will be no easy task, for while the United States and the SMC have close and ongoing contact and coordination, emerging civilian political actors are seeking distance from Washington in order to retain their legitimacy. At the same time, in search of votes, politicians will advocate populist – and damaging – economic policies that will further distance U.S. and Egyptian markets. The Obama administration should make intensive efforts right now to put Egypt on the right economic trajectory, while it still retains leverage with Cairo.

2. Maximize U.S./EU Assistance.

Washington can provide valuable assistance in terms of organizing Egyptian elections and helping the inexperienced and infrastructure-poor liberals organize and compete effectively against their Islamist rivals at the ballot box. While valuable, however, this U.S. aid will have less impact on the long-term political orientation of Egypt than the assistance that can be provided now by the European Bank for Reconstruction and Development (EBRD), an institution that since 1991 has fostered open market economies by boosting the role of the private sector in states transitioning from command economies. The EBRD also has expertise in banking reform, privatization, price liberalization and property rights legislation from which Egypt could benefit.

The economic reforms and technical assistance required by Egypt in the coming months and years are exactly what the EBRD specializes in providing. Of course, the IMF, EU and GCC, along with funding from individual Arab states, can play a stabilizing role in the short term. In the long term, however, too much ongoing international financial assistance to Egypt may actually disincentivize economic reforms and aggravate, rather than help, the situation. In fact, Egypt is already turning down funding – \$3 billion in July 2010, for example – from the IMF.

In this context, the Obama administration has pledged to make \$1 billion in Overseas Private Investment Corporation (OPIC) funding available for investments in Egypt. Notwithstanding OPIC's standard political risk insurance, the current climate in Egypt is such that investors are unlikely to hazard the uncertainty. Regrettably, in the near term, OPIC will not soon prove an effective tool for the Egyptian milieu.

3. Trade (Not Aid).

In addition to technical assistance, Washington and the EU should press forward with signing FTAs with Cairo. Egypt has been waiting for decades for an FTA with the United States. It did not occur during the Bush administration largely as an expression of U.S. frustration with the absence of political reform in Cairo (in 2005, then Secretary of State Condoleezza Rice conditioned progress toward an FTA on transparent elections). Instead, Washington offered Cairo Qualified Industrial Zones (QIZs), designated geographic areas in Egypt in which goods produced containing Egyptian and Israeli content enjoy duty-free status in the U.S.

While the QIZs generate \$1 billion per year in revenues, and reportedly provide support for more than 100,000 Egyptians, the advantages of these areas pale in comparison to the potential benefit of an FTA. Jordan is a good example of the impact. In 2001 when the Jordanian parliament ratified the agreement, Jordanian exports to the U.S. were \$229 million. By 2007, they had skyrocketed to \$1.3 billion. This same period saw a

near doubling of Jordan's GDP, from \$8.5 billion to \$16 billion.

Passing an FTA will not be easy. There has long been political opposition to the deal in Congress, based in part on concerns of how the influx of inexpensive Egyptian cotton goods would impact the market for U.S.-produced garments. Another factor to overcome will be congressional skepticism of democratic developments in Cairo. Why, Congress may ask, would Washington provide the benefit of an FTA to a state that may be Islamist, anti-American, or both?

The answer, of course, is that an FTA is a significant gesture of good will that can boost employment and improve the economy in Egypt. By passing an FTA, Washington will be doing its part to help prevent Egypt's Islamists from exploiting economic difficulties to take power. Unlike other foreign assistance, and in a time of diminished U.S. financial resources, an FTA is budget-neutral and could create jobs in the United States. Additional QIZs would also help Egypt.

An FTA would also be important to the EU. Proximity makes Europe a natural trading partner for Egypt and the EU now seems amenable to moving ahead on a deal. The EU already has an FTA (albeit a somewhat flawed one) with Tunisia that, since 1995, has proved to be a real benefit to Tunis. Indeed, if the agreement had been more forward leaning on ending government monopolies and promoting economic competition, it would have been even more advantageous for Tunisia. An agreement along these lines could be a boon for Egypt which is desperate for more jobs and alternative sources of foreign currency.

4. Incentivize Economic Reform.

It is no secret that Egypt wants its assistance – financial or otherwise – with no strings attached. Ever since the peace treaty was sealed with Israel, Egypt's annual \$2 billion earmark has been dispersed like clockwork. With the notable exception of the Bush administration tying the release of \$180 million in aid to the release of dissident and dual U.S.-Egyptian national Saad Eddin Ibrahim from jail, the U.S. government has never assigned a *quid pro quo* for its funds. Cairo and U.S. diplomats have traditionally bristled at the concept of conditionality but now is the time to start.

It would be tempting to link American and other funding to the implementation of a range of democratic processes – making U.S. dollars contingent on Cairo allowing international election monitors, for example. Instead of focusing on political markers, Washington would be well advised to concentrate narrowly on encouraging better economic decision-making in Cairo. In short, this means pressing Egypt's first post-Mubarak elected government to implement what are sure to be unpopular, if not painful, economic reforms. It is important that Egypt move quickly on this front; experience in

post-communist Europe suggests that rapid implementation of reforms has a more positive impact on economic outcomes than a slow reform process.³⁴

Washington and its European partners will have to be aware of Egyptian sensitivities on conditionality. After all, maintaining the aid relationship with Cairo is in U.S. best interests. Not only will it help keep Egypt's western orientation, it can serve as a potential source of leverage and influence with Cairo in the future. In this regard, Egypt's decision to turn down a \$3 billion IMF loan – with an interest rate so low that former Minister of Finance Samir Radwan described it as “remarkable” – in favor of Saudi and Qatari funding, is troublesome.

The declined IMF loan came with almost no strings attached. In the future, however, Egypt would be well placed to be in a more traditional IMF program. Egypt would benefit from the IMF's macroeconomic stabilization experience, helping states in transition to lower inflation and improve their balance of payments and long term growth performance. Of course, in a more traditional program, the concessionary loans would be conditioned on performance criteria. While Cairo would bristle at the constraints, the terms would provide the new government with political cover to make unpopular decisions.

The key for Washington, then, will be to find ways to incentivize difficult economic choices. In the 1990s, the EU offered membership to former communist states, contingent on meeting certain reform benchmarks.³⁵ EU and NATO membership were sufficient motivation as were the billions of Euros in assistance. FTAs with the U.S. and the EU might serve as points of encouragement for Egypt. It will be a challenge for Washington to find additional appropriate sweeteners, but it would be helpful to be able to offer something to Egypt to remain on the difficult course of transition to a free market economy.

Washington has a stake in Egypt's future. It is in our interest that Egypt develops into a state that evinces certain values and adopts certain policies in support of tolerance and peace. The U.S. can condition its assistance, and Egyptians should know this upfront. In our public diplomacy, it is incumbent that we be clear with the Egyptian public about the type of Egypt with whom the United States can partner. But we should define it in terms of what kind of country we want to see, not which leader we do or do not want to see.

5. Invest in Egypt's Energy Resources.

Egypt is an important producer and exporter of liquefied natural gas (LNG) and has the largest oil refining capacity in Africa. At the same time, however, the country's electricity consumption surpasses its production capacity and rolling blackouts are common, particularly in summertime. With domestic demand for oil and LNG increasing, revenues

derived from exports will likely decrease as well. These energy sector problems are, at least in part, homemade: Egypt's government has long subsidized fuel, a policy that in addition to draining state coffers, has the unfortunate consequence of increasing consumption and demand. Cairo can reverse this dynamic by better targeting the regressive subsidies so that Egypt's indigent alone benefit from this government assistance.

In addition to changes in Egypt's subsidy policy, Washington can encourage private sector investment in Egypt's energy sector. More companies exploring for oil and gas in Egypt will likely mean additional finds, which would not only help meet rising domestic consumption, but also generate more revenue for the government.

One of the largest challenges to foreign investment in Egypt, generally speaking, remains corruption and bureaucracy. Moreover, while Egypt is a signatory of various treaties regulating international trade and arbitration, Egyptian courts do not always honor these agreements. Governance and judicial sector reforms aimed at promoting transparency and rule of law will go a long way towards meeting the goals of the revolution, improving the lives of Egyptians and fostering a business climate more conducive to investment.³⁶

There are, however, specific steps that can be taken to promote energy investment. These include working with the Egyptian parliament to change the laws that only allow foreign oil companies to engage in service-, rather than production-sharing contracts with the government. It is precisely such an arrangement that undercut oil investment in much of Iraq.³⁷ By allowing foreign oil companies to sign production-sharing agreements, Egypt can incentivize exploration and development of new oil finds. Additionally, the U.S. government can help spur investment in clean energy, especially wind power, by working with OPIC to provide loans and guarantees for American businesses investing in Egyptian alternative energy ventures.³⁸

6. Reform the Security Sector.

As the repeated destruction of the LNG pipeline suggests, post-revolution Egypt has a security problem. The difficulties go beyond the Sinai. Crime is spiraling in the Nile Valley, scaring away tourists and would-be investors. Neither will return in significant numbers until Egypt is once again perceived to be safe. Criminal activity is on the rise not only because of the newly free environment, but because the police and state security forces were degraded during the course of the revolution. Egypt is currently in the process of reconstituting its state security apparatus – an organization that will take the lead in future domestic counterterrorism operations – and Washington is not involved although it should be.

Security sector reform (SSR) in formerly authoritarian states is critical to ensure democratic development. Egypt would benefit from U.S. training in human rights, transparency, accountability and rule of law, among other topics related to SSR. By helping to rebuild the apparatus, Washington would gain valuable insight into an organization that for decades was opaque. Egypt will no doubt try to resist U.S. involvement, but the administration should push back. During the Mubarak era, the State Security Investigative Service (SSI) was a key part of the government's repressive apparatus. The development of a new organization, along with a new ethos and mission, is too important to leave to chance.

None of these six goals will be easy to implement, especially in the current political climate. But the importance of Egypt – for future of the Middle East and the security of the United States – cannot be overstated. If a viable economic strategy that can deliver long-term economic growth and short-term improvements in the quality of life is not firmly established, Egypt's fledgling and fragile democracy will wilt on the vine. Additionally, it is not particularly difficult to imagine what might fill the void should efforts at democracy falter in Cairo.

To head off this worst-case scenario, U.S. policy towards Egypt must focus on political reform, security stabilization and economic growth. It is incumbent that the administration map out a long-term U.S. commitment to Egypt's economic development. It will take perhaps two or three years to turn the economy around, but the effort should start now. Egypt's combination of high expectations, increased hardship and limited patience suggests that the time for action is short.

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