Egyptian Initiative
for Personal Rights

Eye on Debt III:

The Third report on the IMF loan program for the third review period, November 2017-May 2018

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Executive Summary

This is the third report in the series "Eye on Debt." It assesses the measures specified by the International Monetary Fund during the third review covering the period from November 2017 to May 2018. The report also tracks the steps taken by the government during this period and assesses what they have achieved.

"*On June 29, 2018, the Executive Board of the International Monetary Fund (IMF) completed the third review of Egypt's economic reform program supported by an arrangement under the Extended Fund Facility (EFF). The completion of the review allows the authorities to draw the equivalent of SDR 1,432.76 million (about US$ 2.02 billion), bringing total purchases to SDR 5,731.05 million (about US$ 8.06 billion).*"[1]

Eye on Debt III evaluates the economic and social impact of these measures, based primarily on economic literature and previous international experiences, in the absence of official data.

In the period reviewed by the report, the IMF program imposed 14 measures on the Egyptian government, including two measures with a positive socio-economic impact and eight measures with a negative impact on citizens and economic development more broadly. Examples of the latter include continuing with the implementation of a contractionary monetary policy and cutting budget deficit through inequitable adjustment for fiscal policy. **The government implemented only four out of the 14 measures, all of which have a negative socio-economic impact.**

The IMF also overlooked **three measures** pertaining to transparency of information and data that were mandated for in the original agreement and which the government did not implement in any of the reviews. These are the regular publishing of the monetary policy report, the financial stability report and medium-term fiscal strategy paper. The IMF report of the third review report did not mention that the government has not implemented these measures.

In addition to this analysis, much economic data covering the first fiscal year 2017/2018 of the implementation of the IMF program has became available, and so Eye on Debt III discusses selected topics in more detail and focus. **These are the economic risks of the program and economic growth that was achieved; the extent to which this growth is equitable and sustainable; and the contradictions between the monetary policy and fiscal policy laid out by the IMF.**

The report assesses the economic and social impact of the economic adjustment program, agreed upon by the Egyptian government and the International Monetary Fund as a condition for Egypt's receipt of $12-billion loan under the Extended Fund Facility, to be disbursed in six tranches. Egypt receives each tranche after a team of IMF experts confirm that Egyptian government has complied with the agreed upon measures within the specified timeframe. This independent review also seeks to track which measures demanded by the IMF have been implemented by the government and which have not.

1- IMF (July 2, 2018), "Egypt: IMF Executive Board Completes Third Review under the Extended Fund Facility." https://www.imf.org/en/News/Articles/2018/07/02/pr18271-egypt-board-completes-3rd-review-under-eff

Part One: Selected topics

1. Risks of the government economic program

An assessment of the IMF, WB and credit agencies reports[2]

The coming few years contain disconcerting challenges. Several documents released by the creditors and credit agencies consider Egypt to be one of the most risky countries. Some refer to "the great ambition of the reforms," while others to the unfavorable conditions in the global economy, and some even warn of the high cost of foreign debt. Decision makers are in an unenviable position, citizens have expectations of improved living conditions while these continue to worse.

Some of these risks have already begun to unfold, but given that Egypt is receiving unprecedented support from major states, neighboring countries and international financial institutions, this may aid in mitigating the risks.

These risks highlight that despite the past three years of austerity, in the process of economic reform, the Egyptian economy remains weak.

These risks also show that the improvement in indicators does not necessary translate to an improvement in conditions, so long as the real economy remains fragile, and its growth is unevenly distributed.

This analysis attempts to narrate and dissect the main risks the Egyptian economy is expected to face in the medium term. This is done through an examination of several documents released by the World Bank and the International Monetary Fund with regards to the loans Egypt has received, as well as research papers issued by credit agency, Moody's. We then go on to offer recommendations to mitigate the possible impact of these risks.

a. Globalization drawbacks: Dollar, interest rates and petroleum

The rise in the dollar and international interest rates are pressuring the value of the Egyptian pound. The rise in international oil prices, which have hit record levels, is also augmenting the risks associated with Egypt's reform program.

The US economy recovered faster than other advanced countries from the 2008 crash over the past few years up to 2017. This is largely due to a process of printing money known as "quantitative easing," as the federal reserve bought large quantities of debt securities from major developing economies, and cut interest rates to near zero during this period. The European Central Bank then followed suit, but European recovery remains slower than in the United States.

With recovery, the US monetary authority began raising interest rates, and reducing its foreign debt

2- This analysis is an update to a previously published article by the same author: Salma Hussein (July 2018), "Risks of the government economic program," Democracy magazine, Issue 71, Al-Ahram, Cairo [Arabic].

portfolio, allowing the value of the dollar compared to other currencies to rise.[3] This in turn constitutes a pressure on developing countries that had used the period when the dollar was weak and interest rates in the US were low, in order to increase their dependence on external debt to finance domestic growth. Egypt was one of these countries.[4]

The circumstances have now changed, and today the changes resulting from external factors in the financial variables have become a source of high risks. Mohamed el-Erian gives Argentina[5] as an example. Argentina raised the interest rate most recently to 40 percent, in order to avoid the risk of an exodus of foreign investors, particularly from buyers of government debt securities. "Externally driven changes in financial variables have thus become a source of serious risk, especially in countries, like Argentina, with a history of economic mismanagement, large current account deficits, other financial imbalances, and a habit of pursuing too many objectives with too few instruments." Erian went on to warn of the risk of contagion among emerging markets and particularly those with structural problems.

According to the International Monetary Fund, reducing stimulus measures through monetary policy in the United States and Europe will lead to raising interest rates globally and to an increase in time period for debt repayment, as well as a stronger dollar and euro.

Moody's predicted that

"By 2021, we forecast that the US Federal Reserve will raise its policy rate to 3.25% and the European Central Bank to 1.0%. Global financing conditions will also tighten as the Federal Reserve gradually shrinks its balance sheet"[6]. All of this would raise the interest rate on external loans. Moody's then goes on to explain that measures taken to phase out the economic stimulus program through monetary policy in the United States and Europe would lead to a global rise in interest rates and debt repayment periods, as well as strengthening the dollar and euro.

During April- May 2018, several developing countries have been exposed to higher interest rates and a low supply of international financing leading to a pressure on their local currencies compared to the dollar. Capital flow also slowed down. This comes at a time when these countries are already struggling from high deficits in their budgets and from inflated government debt, thus leaving them with little room for maneuver to combat what the international credit agency Moody's report described as "exchange rate shock."

The International Monetary Fund puts the risk of tightening global financial conditions as high in the short term for Egypt.[7]

3- Mohamed el-Erian (May, 14, 2018), "Managing the Risks of a Rising Dollar," Project Syndicate.
https://www.project-syndicate.org/commentary/us-dollar-appreciation-risks-policy-response-by-mohamed-a--el-erian-2018-05

4- Finance Ministry (2016), "Debt Strategy for the medium term" [Arabic].

5- Mohamed el-Erian (2018), "Managing the Risks of a Rising Dollar," Project Syndicate.

6- Elisa Parisi-Capone and Michael Higgins (2018), "Sector in Depth: Weakest MENA and APAC Sovereigns Would be Most Sensitive to an Interest Rate Shock", Moody's Investors Service.
https://www.moodys.com/research/Moodys-Weakest-APAC-and-MENA-sovereigns-amongst-most-exposed-to--PR_383668

7- IMF (January 22, 2018), "Arab Republic of Egypt: 2017 Article IV Consultation, Second Review Under the Extended Arrangement Under the Extended Fund Facility, and Request for Modification of Performance Criteria-Press Release; Staff Report; and Statement by the Executive Director for the Arab Republic of Egypt," International Monetary Fund, Washington, D.C.
http://www.imf.org/en/Publications/CR/Issues/2018/01/22/Arab-Republic-of-Egypt-2017-Article-IV-Consultation-Second-Review-Under-the-Extended-45568

The IMF also warned in its second review released in January 2018 that "unexpected tightening of global financial conditions could weaken the market appetite for the Egyptian Eurobonds and could lead to reversal of portfolio flows." This is what happened in the following months according to the IMF's third review, published in July 2018 (p.13). "External risks have increased in recent months, with a shift to capital outflows as tightening global financial conditions have contributed to a pullback by investors from emerging markets."

According to Reuters, $5 billion worth of government debt securities exited the Egyptian market between April and July 2018.[8]

On the sovereign debt front, according to Moody's[9], there are four Arab countries in the list of the 10 countries most likely to be affected by the global financial tightening. Egypt is the second most impacted country, along with Lebanon, Bahrain and Jordan. "all of which have large fiscal

exposures due to high debt ratios, low debt affordability, and high rollover risk".[10] Thus, these countries are exposed to a high impact on their budget deficits.

In Middle East and North Africa, these include Lebanon, Egypt (B3 stable) , Bahrain and Jordan (B1 stable),

The IMF summarizes possible risks by looking at the Debt Sustainability Analysis using the metrics of debt level, gross financing needs and debt profile[11]

Table 1: Egypt Public DSA Risk Assessment (Heat Map)

Debt level*	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs**	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile***	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

**The cell is highlighted in green if debt burden benchmark of 70 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.*

8- Reuters (July 12, 2018), "As foreign investors exit emerging markets, Egypt treasury yields hit 1-year highs." https://af.reuters.com/article/egyptNews/idAFL8N1U84F7

9- Elisa Parisi-Capone and Michael Higgins (2018), "Sector in Depth: Weakest MENA and APAC Sovereigns Would be Most Sensitive to an Interest Rate Shock", Moody's Investors Service, a previously mentioned reference.

10- Debt rollover is a term that refers to the act of borrowing by the state in order to pay off older debts (interests and principle). Often the new loan is from the same creditor but with different conditions and interest rate.

11- IMF (12, July 2018), p.37, "Arab Republic of Egypt: Third Review Under the Extended Arrangement Under the Extended Fund Facility, and Requests for a Waiver of Nonobservance of a Performance Criterion and for Modification of a Performance Criterion-Press Release; Staff Report; and Statement by the Executive Director for the Arab Republic of Egypt," International Monetary Fund, Washington, D.C. https://www.imf.org/en/Publications/CR/Issues/2018/07/12/Arab-Republic-of-Egypt-Third-Review-Under-the-Extended-Arrangement-Under-the-Extended-Fund-46061

***The cell is highlighted in green if gross financing needs benchmark of 15 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.*

****The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are:*

*200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.***

External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

***** The cells in white indicate information is unavailable*

Source: IMF, July 2018, p.37.

In terms of possible challenges, the IMF adds the continuing economic slowdown in the short and medium term in the countries most important to Egypt's exports, such as European countries and major frontier economies which are expected with a 30 percent probability to suffer from resource misallocation and policy missteps which would exacerbate the impact of declining productivity and potential growth.[12]

b. Free exchange rate: The IMF's remedy that hurts Egyptians

Moody's bets that Egypt is in a better position than other countries because it has been pursuing an exchange rate policy since the end of 2016, which strengthens the dollar against the Egyptian pound allowing Egyptian debt securities to remain attractive to foreign investors. the shock of a stronger dollar will nevertheless impact Egypt's economy. The Egyptian public debt risk metric shows that the exchange rate shock is one of the probable risks.[13]

For its part, the IMF warns against moving away from the free exchange rate policy and against lowering interest rates pointing to the impact this could have on the pound. This remains the IMF's position in the face of the possible crisis even if it comes at the expense of augmenting public debt and a higher than planned budget deficit.[14]

The possibilities remain open: Will Egypt be able to attract debt and foreign capital in the form of high growth, job creation and rising exports to compensate for the fall in the value of the pound? Or are difficult years similar to 2017 and 2018 likely to recur?

There are other external risks threatening the success of the Egyptian government's plan, such as the rise in international oil prices, which would "weaken the current account and increase the fuel subsidy bill, thereby undermining fiscal consolidation and debt reduction," according to the IMF. We have already seen how a stronger dollar impacted the budget deficit, as Egypt is a net importer of petroleum products. In FY 2017/2018, the energy subsidy bill increased to LE121 billion compared to a planned

12- IMF (2018), Second Review, p.9-47.

13- IMF (2018), Third Review, p.37.

14- IMF (2018), Third Review, p.47.

LE108 billion despite a fall in consumption and higher energy prices.[15]

While the state budget bill for FY 2018/2019, assumed a price of $60-64 for a barrel of oil, current global oil prices have exceeded $80 per barrel. Every dollar increase in the price of an oil barrel leads to the rise of energy subsidy allocations by LE3-4 billion.[16]

The IMF predicts in its main scenario of the risks facing the loan agreement that the inflation rate will reach 21.5 percent during 2018 due to these factors.

c. Regional Security

The IMF predicts that any deterioration in security, divisions, or turmoil in the region, Asia or Europe could lead to economic and social turbulence and to disruption of the emerging recovery in the tourism sector.[17] The World Bank points out that there are several conflicts in Egypt's vicinity and states that Egypt's stability is an essential requirement for the region's stability, as well as sustainable and inclusive growth in the region. "Any risk for instability in Egypt has enormous implications for MENA, Europe and the wider global community."[18]

Internal risks: Vested interests obstacles and social anger

Some of the measures taken by the government come into conflict with the interests of influential actors. They also have inflationary repercussions, which have a negative impact on social satisfaction.

The World Bank document on the education sector refers to ongoing high risks of governance.[19] The World Bank fears what it calls the large ambition of the current reform. As several laws are being issued to weaken monopolies, and to reduce the cost of red tape transactions. According to the WB, what remains is to be seen is the extent of the resistance that the implementation of these laws will face.[20]

The second IMF review of the the loan agreement claims that "corruption is perceived as high and widespread."[21] Perceptions-based corruption indices are higher in Egypt compared to most of its regional peers and other emerging market economies. "In this vein, the perception of corruption might have mitigated to some extent the impact of past reforms on growth, although it would be difficult to estimate the precise effect."[22] The second review report also adds that "opposition by vested interests would weaken the program's hard-won credibility," (p.9) without explaining who these vested interests are. The first loan agreement document identified one of these vested interests as energy intensive com-

15- IMF (2018), Third Review, p.9.

16- Enterprise daily bulletin, (20 May 2018), Cairo. https://enterprise.press

17- IMF (2018), Third Review, p.47.

18- World Bank (2015), IBRD Program Document for a Proposed Loan to Egypt, Report no. 100978-EG, P. 52, World Bank, Washington.
http://documents.worldbank.org/curated/en/630471468186542188/pdf/100978-PGD-P157704-R2015-0233-1-Box393255B-OUO-9.pdf

19- World Bank (2018), IBRD Program Document for a Proposed Loan to Egypt, p.52.

20- World Bank (2018), IBRD Program Document for a Proposed Loan to Egypt, p.52.

21- IMF (2018), Second Review, p.18.

22- IMF (2018), Second Review, p.13.

panies, as both the IMF and WB refer to their possible opposition to the reduction of energy subsidies.[23]

Energy intensive companies have great political influence through their positions in the semi-formal Federation of Industries and through their members in the Parliament.[24] They have succeeded in avoiding any hike in energy prices for their companies since 2014, when energy prices increased on some industries, albeit at lower rates than households.[25] A study conducted by a World Bank researcher in 2016 found that the household sector receives only 20 percent from the government energy subsidy allocations, while companies and the private sector receive 80 percent of the subsidy bill.[26] According to the Finance Ministry, the subsidy bill for 2017 was LE80 billion, and according to the IMF third review, this has increased to more than LE100 billion.

e. The risk of cutting social spending

The IMF warns against responding to social pressure in the short and medium term through wage increases and higher social spending allocations due to their impact on public debt as a percentage of GDP. At the same time, the IMF warns against a premature cut in indicative interest rates,[27] which is expected to rise in 2018 in alignment with the aforementioned external risks. This measure would help sustain the attractiveness of government debt securities to foreign investors (external debt hidden in the form of domestic debt that has reached $25 billion since the flotation of the pound).[28]

Raising the interest rate above the current level would undermine the government's target for reducing public debt as a percentage of GDP, however, as well as raise debt service and subsequently the budget deficit. This in turn increases pressure on the government to cut wages and social spending further.

The World Bank reports that the risk of social turmoil remains because its causes continue to be present. These include the absence of efficient social security nets and schemes at the national level, in addition to the lack of formal job opportunities, high unemployment, widespread temporary work among Egyptian youth, as well as the exclusion of the poor. All of these factors need time to see im-

23- IMF (January 18, 2017), p.12-18, "Request for Extended Arrangement Under the Extended Fund Facility-Press Release; Staff Report; and Statement by the Executive Director for the Arab Republic of Egypt", International Monetary Fund, Washington DC.
http://www.imf.org/en/Publications/CR/Issues/2017/01/18/Arab-Republic-of-Egypt-Request-for-Extended-Arrangement-Under-the-Extended-Fund-Facility-44534

24- For more on politically connected businessmen, see:
Abdelhamid Mekawy, Osama Diab and Salma Hussein (April 2018), "Veils of secrecy: assessing the IFC's role in enhancing tax and ownership transparency in development projects," Egyptian Initiative for Personal Rights, Cairo
https://eipr.org/sites/default/files/reports/pdf/veils_of_secrecy.pdf and Ishac Diwan, Philip Keefer, Marc Schiffbauer (July 2015), "Pyramid Capitalism: Political Connections, Regulation, and Firm Productivity in Egypt," Policy Research Working Paper, No. 7354. World Bank, Washington, DC. https://openknowledge.worldbank.org/handle/10986/22236

25- Al-Borsa newspaper (February 22, 2017), "Al Swedy: No increases in energy prices to industries in the coming period" [Arabic]. https://alborsanews.com/2017/02/22/981329 See also: Reuters (2014), "Egypt cuts natural gas subsidies to factories" https://ara.reuters.com/article/businessNews/idARAKBN0F91WQ20140704

26- Peter Griffin, Thomas Laursen and James Robertson (2016), "Egypt Guiding Reform of Energy Subsidies Long-Term," Policy Research Working Paper no. 7571, The World Bank Group, Washington.
http://documents.worldbank.org/curated/en/310781467988953360/Egypt-guiding-reform-of-energy-subsidies-long-term

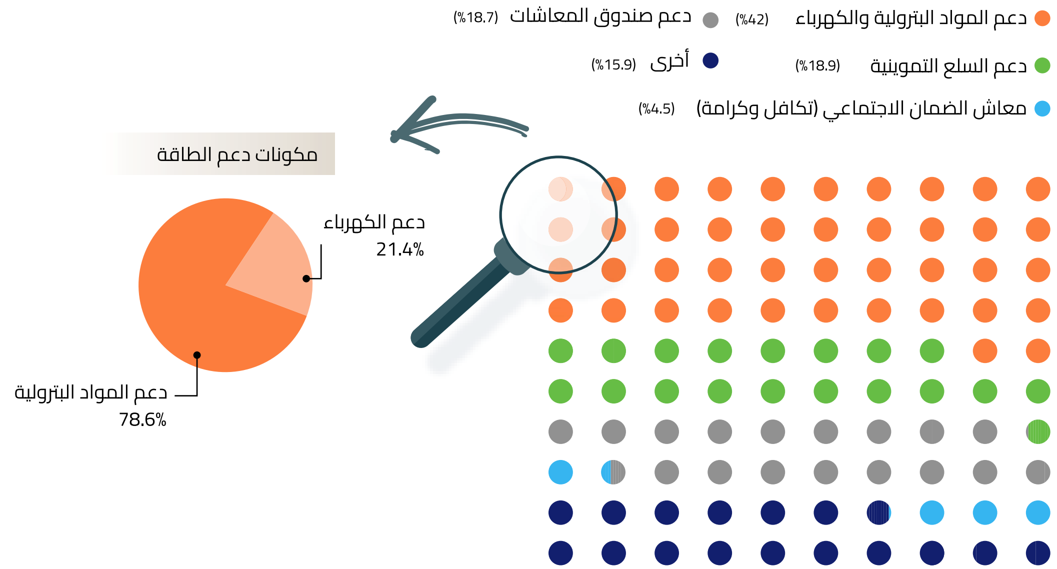
27- IMF, ibid.

28- Ahmed Shams Eddin (2018), "Dollar and petroleum rise and a double challenge for Egypt" [Arabic]. https://www.almasryalyoum.com/news/details/1291885 provement through the policies that the government adopts and implements، according to the WB.[29]

This occurs at a time when Egypt has one of the lowest social spending levels as a percentage of GDP compared to countries in the Middle East, West Asia and Africa. Its social spending is not even half the average for the Middle East, which is 1 percent of GDP.[30]

Figure 1: A comparison between subsidies allocated to social solidarity schemes and subsidies allocated to energy in FY 2017/2018

Source: Finance Ministry, budget bill for FY 2017/2018.



Orange: Subsidies on petroleum products and electricity (42%)
Green: Subsidies on supply commodities (18.9%)
Blue: Social solidarity subsidies (Solidarity and Dignity - Takaful and Karama) (4.5%)
Gray: Subsidies on pensions fund (18.7%)
Navy blue: Others (15.9%)

Pie Chart:
Distribution of energy subsidies
Electricity subsidies 21.4%
Petroleum products subsidies 78.6%

The blue dots show the small size of cash subsidies allocated to the poor, at the forefront of which is the Takaful and Karama (Solidarity and Dignity) scheme that targets poor families and those with disabilities. The size of cash subsidies is small when compared to the orange dots representing the energy subsidies which are paid mostly to companies not households.

29- World Bank (2018), Supporting Egypt Education Reform Project, p.53.

30- World Bank (2018), p.19 "The State of Social Safety Nets," World Bank Group, Washington, D.C. http://hdl.handle.net/10986/29115

f. Recommendations

Reform does not have to be at the expense of the lower classes, nor of essential social services such as education and health. A period of crisis allows for taking measures that impact the upper classes, so that the burden of reform is equitably distributed.

i. Revenues

1. Adjust the tax structure to increase government revenues in order to mitigate the expected negative impact on the state budget and public debt. Here, taxes on wealth can play a role in raising revenues, without having an impact on economic activity. Within this context comes the implementation of the real estate tax and resumption of capital gains tax while widening its reach to include land and real estate as well as mergers and acquisitions. In addition to imposing an annual tax on unused real estate units.
2. Widen the reach of income taxation while increasing its progressivity, such as the stock market capital gains tax, eliminating the various tax exemptions provided by the government to different types of investors, and in particular free zones.
3. The World Bank recommends preparing plans to accelerate the reform of tax administration, in order to assure that the success of tax reforms (real estate tax, capital gains tax, mining sector taxes). The government can also encourage tax payment commitment by improving public services.[31]
4. Accelerate the implementation of the IMF's medium-term recommendation to create fiscal space, so that it begins this current year, in order to mitigate the social impact of global and domestic risks. "Egypt needs to create fiscal space for its significant spending needs. The spending priorities include upgrading infrastructure, investing in health and education, and building a sustainable social safety net. Egypt could create more fiscal space through tax policy reforms and better tax administration. Egypt's tax revenue is under 13 percent of GDP, which is low by international standards. The current tax system is complex with multiple tax rates and tariffs, creating an uneven playing field."[32] Replace financing from international capital markets through which the government issues Eurobonds with long-term soft loans that have long grace periods from international financial institutions and international and regional development funds. Increase the ratio of grants to loans.

ii) Expenditure

1. Include special funds (extra-budgetary funds) within the state budget or at least publish their budgets, and lower the wages paid to senior government employees, whether from the state budget or from these special funds.

2. Increase prices of energy allocated to energy intensive factories to reduce the subsidy bill, and curb the impact on inflation. It is possible to reduce the subsidy bill without burdening the household sector. Some 70 percent of all energy allocated to the industrial sector, is consumed by no more than 100 factories,[33] and overall energy intensive companies (transportation, construction , tourism and industry) consume 80 percent of the total energy subsidy bill.[34]

31- World Bank (2018), Supporting Egypt Education Reform Project, p.52.

32- IMF (2018), Second Review, p. 19.

33- Reuters (2014), "Egypt: Energy price hikes for some factories" [Arabic].

34- Peter Griffin, Thomas B. Laursen and James W. Robertson (2016), p.5.

3. Restructure public debt by negotiating with state-owned Egyptian banks, in order to prolong the debt repayment tenor and reduce the average interest rate, in order to cut down on the debt service burden, which has become the largest spending item in the budget at more than 35 percent of annual government expenditure.

4. Widen the umbrella of minimum wage and social insurance to include the private sector, so that youth seek appropriate jobs in this sector.

2. Economic growth serves neither the poor nor sustainability

a. An overview of economic growth in Egypt

According to both Egyptian government figures[35] and IMF experts, the accelerating growth rate is one of the main accomplishments of the recent period. This section seeks to look into the quality of this growth, in terms of sustainability in the medium and long term, the impact on jobs creation and job quality, and finally in relation to development more broadly. This will be done through the analysis of data of FY 2017/2018 and examination of projections for the coming years.

It is not sufficient to look at the increase in the growth rate alone as an indicator of improvement in economic performance. In order to assess the extent to which this notable growth can serve economic and developmental goals and raise the population's living standards, the consequences of this growth as well as the nature of the drivers of growth must be fully considered. In its third review published in July 2018, the IMF identifies the main drivers of growth as tourism, construction, and natural gas finds.[36]

To assess economic growth rate in Egypt, we can begin by discussing two topics: the pattern of capital accumulation that dominates the production process, and total investment.

Capital deepening has been the main driver of growth in Egypt since the 1990s and until the present, as opposed to capital widening, according to the IMF's second review.[37] Capital deepening refers to the increase in capital for each worker, such as the increase in the use of technology, and as such capital deepening is associated with increasing the productivity of workers while maintaining the same number of workers. Capital widening, on the other hand, refers to reaching a positive equilibrium of capital to each worker, which means equally increasing capital and the size of the labor force, which is associated with an expansion of investment rather than a deepening of the productive process alone. While developing the productive process is of course crucial, working on both paths simultaneously is the appropriate way to absorb population increase which results in a widening labor force. Additionally, the Solow model for growth shows that the domination of capital deepening as a pattern of accumulation ultimately leads to a fall in growth rates.

Capital deepening dominates driving economic growth in Egypt, and is responsible for 80 percent of per capita GDP growth in the 1990s and beginning of the new millenium.[38] The IMF referred to this

35- Youm7 newspaper, (May 6, 2018), "Planning Minister participates today in conference on inclusive growth and job creation" [Arabic].

36- IMF (2018), Third Review, p.43.

37- IMF (2018), Second Review, p.5.

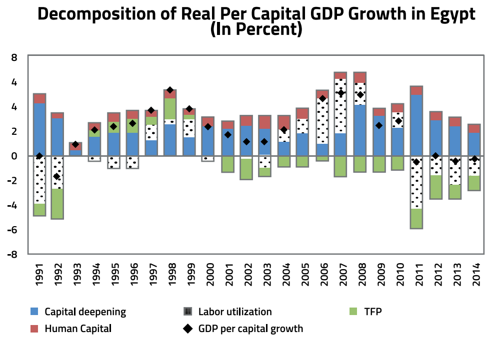
38- IMF (2018), Second Review, p.5.

issue in its second review. Egyptians then suffered from unemployment rates that hit 10 percent since the beginning of the new millenium and until 2010, after which unemployment rates peaked at 13.4 percent.[39] In the meantime, this is not reflected in the ratio of total investments of GDP which has stood at 15 percent for the past 15 years. This rate is around half that in the MENA region where the rates vary between 26 percent to 33 percent.[40] The ratio of private investment in Egypt from 2000 to 2016 has been on average 11.4 percent of GDP, which is 7 percent lower than in the MENA region.

FDI plunged to 2.3 percent of GDP in the period from 2014 to 2017,[41] compared to around 4.3 percent in the period from 2000 to 2010.

Around 75 percent of total FDI goes to extraction industries that are capital intensive and require little labor and to the real estate sector, which provides temporary jobs that end with the completion of construction and do not usually maintain basic labor rights.[42]

Figures 2 and 3: Unemployment rates in Egypt and decomposition of real per capita GDP growth



Source: Dabla-Norris et al., 2013

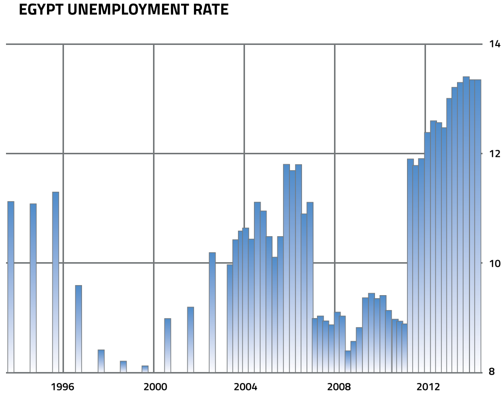


Figure 2 depicts the surge in unemployment rates in Egypt at the beginning of the millenium as a result of the inability of the growth to utilize labor, while Figure 3 shows how capital deepening largely contributed to growth in the 1990s until the present compared to a minimal contribution to labor utilization which in recent years became a negative contribution.

It is estimated that around 3.5 million Egyptians will join the labor market in the coming five years. Around 60 percent of Egyptians are of working age and around 700,000 people join them each year.[43]

The general picture of the distribution of growth and the slight drop in unemployment rates to 12.6 percent in the period from July to September 2016 compared to 11.9 percent in the period from July to September 2017[44] show that despite the improvement, growth remains unable to serve the goals of development, from education, health and other public services to integrating Egyptians into the labor market.

39- IMF (2018), Second Review, p.4.

40- IMF (2018), Second Review, p.5.

41- IMF (2018), Second Review, p.5.

42- Al-Mal newspaper (September 15, 2016), "Day laborers life is unstable," [Arabic].

43- IMF (2018), Second Review, p.4

44- Finance Ministry (January 2018), Financial Monthly.

b. Which sectors drive growth? How is this significant?

The previous fiscal year that began on July 2017 and ended on June 2018 is the first full fiscal year covered by the reform program that the government is implementing in partnership with and under the supervision of the IMF. During this year, the Egyptian economy achieved its highest growth rate since 2011 despite the contractionary monetary policy and the fiscal adjustment. This may be because of the exceptional leaps in the petroleum, gas and construction sectors. Using the available data for FY 2017/2018, we can discuss growth drivers through a thorough examination of the first quarter, which reflects the pattern of growth in the following quarters.

The real GDP increased to LE850.5 billion in the first quarter (July-September 2017) compared to LE808.8 billion in the same period a year earlier, at a growth rate of 5.2 percent; and compared to LE505 billion in the same quarter of the previous year at a growth rate of 4.8 percent. The main contributors to real GDP growth include extraction, manufacturing, construction, real estate and tourism sectors.

The extractive sector contributed the most in to GDP growth followed by tourism, construction, and Suez Canal. All of the sectors that saw growth are volatile sectors that depend on external conditions and are capital intensive, which explains the minimal reduction in unemployment rate.

The extractive industries sector registered an annual growth rate of 8.7 percent compared to a contraction in the quarter from April to June 2017 when the sector recorded negative 4.1 percent. This growth is the outcome of the surge in natural gas extraction, an issue that is exceptional due to the new discoveries in the Mediterranean.

The following quarter (July-September 2017) saw the growth rate decrease in some sectors compared to the previous quarter. The Suez Canal grew by 5.8 percent and the construction sector grew by 9.1 percent, which is one of the sectors that utilizes labor though only for the length of a project.

On the other hand, **the social services contribution to GDP growth fell, due to the unchanged growth in the healthcare sector, the slight increase in the education sector and sharp decrease in other services.**

The growth rate of social services slowed from 3.3 percent in the quarter from July to September 2016 to 3.1 percent in the quarter from July to September 2017, due to the unchanged growth in the healthcare sector which remained at 3 percent and slight increase in the education sector from 3 percent to 3.2 percent and the slower growth in other services from 4.6 percent to 3.1 percent.[45]

When comparing to the quarter from April to June, we find that education sector slowed from 5.5 percent and healthcare sector slowed from 5.4 percent and other services slowed from 6.5 percent.

It is estimated that around 3.5 million Egyptians will join the labor market in the coming five years. Around 60 percent of Egyptians are of working age and around 700,000 people join them each year.[46]

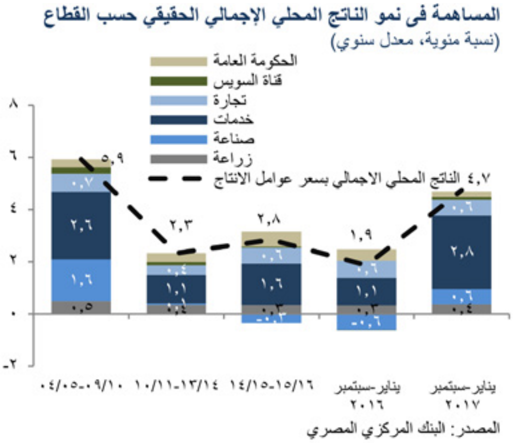
Notably, the unemployment rate dropped to 11.9 percent due to the fall in the workforce (Figure 4), reflecting that some working age people stopped looking for work, after losing hope of finding a job (often females). This indicates that the fall in the unemployment rate can be attributed to reasons other than economic recovery.

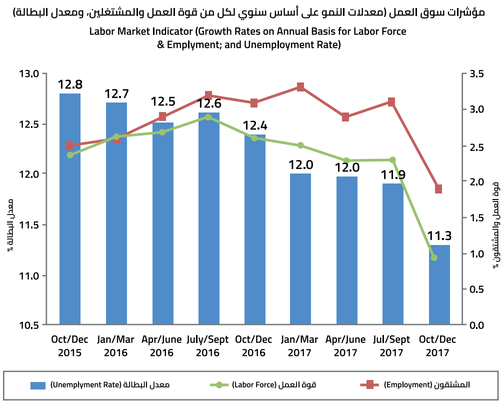
45- Central Bank of Egypt (February 2018), monthly statistical bulletin, issue no. 251.

46- IMF (2018), Second Review, p.4

Figure 5 shows the reduction of the contribution of the agricultural and industrial sectors to economic. Those sectors are the most labor intensive, and are the largest contributors to positive growth.

Figures 4 and 5: Labor market and growth indicators





Sectoral contribution to real GDP growth

Top-down:

Public government

Suez Canal

Trade

Services

Industry

Agriculture

GDP at factor cost (constant prices)

Vertical axis: Last two columns from left to right

January - September 2016

January to September 2017

It should be noted here that raising the allocations of government investment is not necessarily a good idea, because the point is in the priorities of this investment, which was not allocated to the agriculture, health, education, water and sanitation sectors. For example, total implemented investments were around LE150 billion in the quarter from July to September 2017, at a growth rate of 53 percent compared to the same quarter a year earlier. The private sector implemented 52.1 percent of these investments, and followed by the government sector and public companies at 6.5 percent and economic authorities at 4.2 percent.[47]

The size of growth then in the period between the current and previous fiscal years is LE52 billion, of which national projects acquired LE38 billion, while investment in agriculture, irrigation, and land reclamation was only LE700 million. Investment in healthcare services increased also by only LE700 million, all of which from the private sector, indicating that this investment did not benefit the lower

47- Central Bank of Egypt (February 2018).

classes who depend on government healthcare services. The government healthcare services fell over the quarters mentioned above from LE1.15 billion to LE889 million. In the meantime, investment in education increased by around LE2.387 billion, half of which was directed toward private sector education. Investment in water services also increased by around LE551 million and investment in sanitation by around LE619 million.[48]

Figure 6 in section c cites the Central Bank of Egypt data showing that **the petroleum sector (and gas) continues to be the largest contributor to capital inflows to Egypt, while green field direct investment continues to decrease.**

c. Growth in a post-devaluation year

Official data shows that growth indicators have increased, but there is much evidence calling the significance of these figures into question, as demonstrated in this section.

Growth continued to follow the same path for the whole of FY 2017/2018, according to the growth indicators announced by the minister of planning on 26 July 2018. Around 76 percent of GDP growth drivers in the fourth quarter of FY 2017/2018 came from the extractive industries sector at 17.6 percent, the construction sector at 10.9 percent, the manufacturing sector at 9.9 percent, wholesale and retail sector at 8.7 percent, followed by real estate activities at 7.4 percent and agriculture at 6.3 percent.[49]

According to the planning minister these sectors contributed to GDP growth by 77 percent for the whole of FY 2017/2018. For the year, the extractive sector contributed 15.8 percent followed by the manufacturing sector at 12.2 percent, the construction sector at 10.3 percent, wholesale and retail at 9.6 percent, real estate activities at 7 percent and agriculture sector at 6.8 percent.[50]

On the level of sectoral growth, these same sectors were able to achieve positive growth rates in the fourth quarter of the fiscal year 2017/2018, and in the whole fiscal year. The Suez Canal sector grew by 10.7 percent in the fourth quarter, and by 10.2 percent in the whole fiscal year, followed by the construction sector with a rate of 9.1 percent in the fourth quarter and 9.5 percent in the whole year. The telecommunications sector saw growth at 9 percent in the last quarter of 2017/2018 and 9.4 percent over the whole year, while the private sector in the extractive industries grew by 8.5 percent in the fourth quarter and 8.6 percent in the whole year.[51]

Foreign Direct Investment (FDI) followed the same unsustainable path. The monthly statistical bulletin issued by the Central Bank of Egypt — available data covers the first three quarters of FY 2017/2018 — shows that net FDI in the period from July 2017 until the end of March 2018 reached around $6 billion, a drop of $500 million from the same period the previous year earlier,[52] and with an increase of 84.2 percent in the implemented investments in the petroleum sector in the first three months.[53]

48- Central Bank of Egypt (February 2018).

49- Planning Ministry (July 2018), "Planning Minister announces economic growth indicators for FY 2017/2018, and fourth quarter indicators for the same year" [Arabic] http://related.mpmar.gov.eg/Media/newsdetails/4510

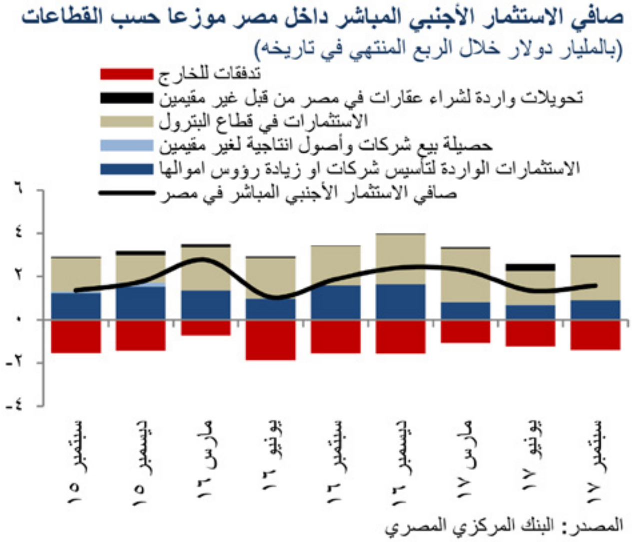
50- Planning Ministry (2018), Planning Minister announces economic growth indicators for FY 2017/2018.

51- Planning Ministry (2018), Planning Minister announces economic growth indicators for FY 2017/2018.

52- Central Bank of Egypt (June 2018), monthly statistical bulletin. June, 2018.

53- Planning Ministry (2018), Planning Minister announces economic growth indicators for FY 2017/2018.

Figure 6: Foreign Direct Investment (FDI)



Net FDI in Egypt by sectors
(in billion dollars at the end of each quarter)

Top-down:

Outflows

Remittances received for the purchase of real estate in Egypt

Investments in the petroleum sector

Proceeds From Selling companies and productive assets to non-residents

Greenfield investments

Net FDI in Egypt

Vertical axis: Left to Right

September 15

December 15

March 16

June 16

September 16

December 16

March 17

June 17

September 17

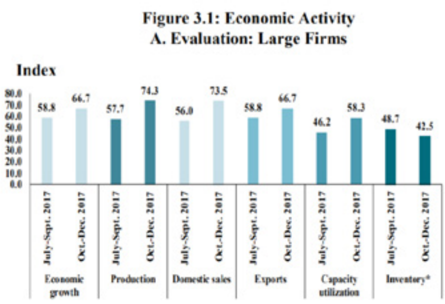
Small and medium enterprises and micro-enterprises contribute around 70 percent to job creation in the non-agricultural private sector, and yet these companies face significant challenges undermining their ability to expand (al-Mahdy and Nawar 2014, IMF second review report, p.8). The Egyptian growth model has not succeeded over the past two decades, although speculations based on this model contine. Its failure is manifested in its inability to create jobs or attract investment to labor intensive industries.

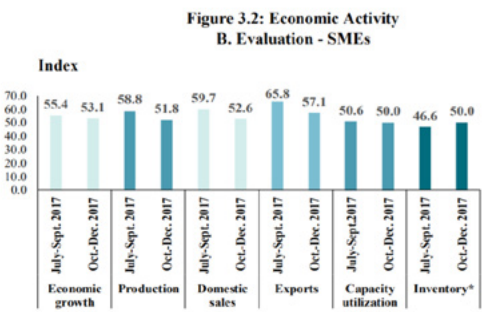
According to the Business Barometer survey of companies' performance, in the fourth quarter of 2017 (October-December) there was an improvement in the business barometer index in terms of economic activities for large companies while the indices for small and medium enterprises remained unchanged. According to the survey,[54*] this discrepancy in performance is explained by the ability of large companies to adjust to the consequences of economic measures more easily than SMEs.[55]

On the level of economic activity, large companies reported an increase in domestic sales and exports allowing them to raise production and subsequently raise production capacity rates. This was reflected positively in the economic growth indicators in the first quarter of FY 2017/2018, which is consistent with official statements. But the quarter saw a **rise in inventory** which reflects the companies' concerns over a change in the exchange rate or trade policy. The performance of SMEs was less positive. In the meantime, employment indicators remained unchanged for all company sizes.[56]

In the first two quarters of 2018 (January-March and April-June) the projections for production indicators and domestic sales and exports and other production capacity indicators, were positive. The financial services sector recorded the best projections, followed by the communications and tourism sectors, then the constructions sector and lastly the manufacturing and transportation sectors. In the actual performance report for the first quarter of 2018 (January-March), the survey results show that the performance evaluation for sales, exports, the use of production capacity, and employment through the quarter continue to reflect improvement in the performance of large companies that is better than the last quarter of 2017. Overall, the improvement in the performance of SMEs was less than that of large companies, as well as less than recorded in the last quarter of 2017.[57]

Figures 7 and 8: Performance evaluation for SMEs and large companies according to the Business Barometer survey





54- The Business Barometer survey quarterly evaluates a sample of 120 companies. The barometer reflects the perspective of the business community with regards to economic growth and the operational results of the companies in terms of production, domestic sales, exports, inventory, production capacity utilization, prices, wages, employment and investment. The report analyzes the results of a sample survey of firms that cover manufacturing (50 percent), financial services (13 percent), construction (12 percent), transportation (10 percent), tourism (9 percent) and telecommunications (7 percent). The survey is conducted on a number of micro, small, medium and large firms as defined by the Central Bank of Egypt.

55- Egyptian Center for Economic Studies (March 2018), Business Barometer Index, Issue 46.

56- Egyptian Center for Economic Studies (March 2018).

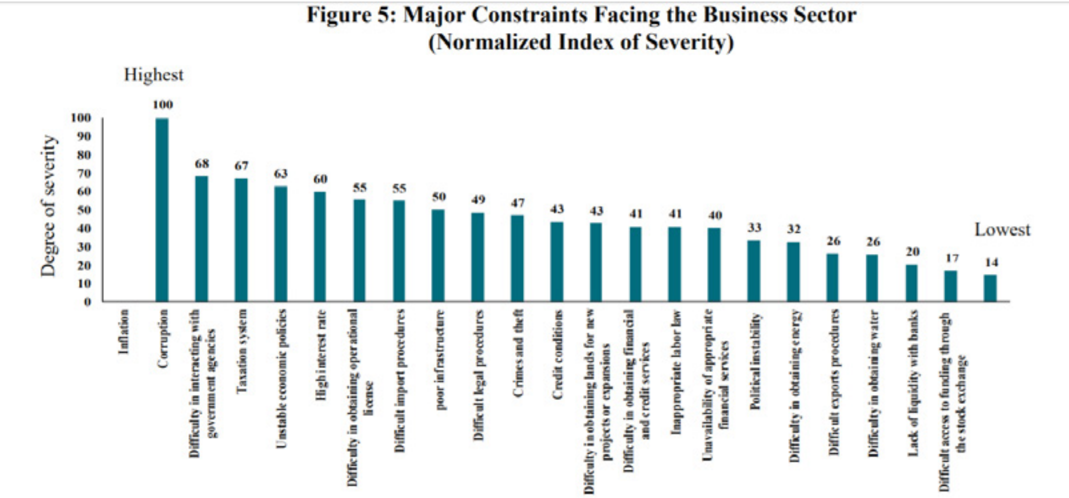
57- Egyptian Center for Economic Studies (July 2018), Business Barometer Index, Issue 47.

In the meantime, the most recent release of the Egypt PMI survey in July 2018,[58] shows that the non-oil private sector is deteriorating and the index in general remained in contraction due to the fall in production, which resulted in a general relapse in commercial dealings at the end of the second quarter (April-June). The evidence gathered shows that weak demand is one of the causes of the contraction in commercial activity. The non-oil private sector also noted that new employment was still declining in June, and that liquidity remains low.

The companies surveyed for the PMI index noted inflationary pressures in June. The companies also noted that the purchasing prices and costs of employment were driven by the increase in the total prices of production input amid an increase in the prices of raw material and living costs. In response to the increase in costs, the companies raised the average sales prices in June.[59]

Despite the noticeable improvement in the growth rate and in several macroeconomic indicators, the fruits of this growth are not reflected in the indicators that reflect a direct improvement in the living standards of citizens, such as employment, spending on public services, education and health. The analysis presented in this paper shows that the issues of inequality and absence of inclusive growth in Egypt are a matter of policies and priorities. The Egyptian Economic Reform program, supervised by the IMF, focuses its attention on the improvement of Egypt's external image and does not lead to fair growth.

Figure 9: Main challenges faced by businesses according to the Business Barometer survey



According to the Business Barometer survey for the period from January to March 2018, inflation and corruption are the main concerns and obstacles that impact business expansion.

58- The seasonally adjusted Emirates NBD Egypt Purchasing Managers' Index™ (PMI) is a composite indicator designed to give an accurate overview of operating conditions in the non-oil private sector economy.
Emirates NBD Egypt Purchasing Managers' Index™ (PMI), 3 July 2018, Cairo.
https://www.markiteconomics.com/Public/Release/PressReleases?language=en

59- Emirates NBD Egypt Purchasing Managers' Index™ (PMI) (2018).

3. The contradiction between monetary policy and fiscal policy targets

The purpose of this analysis is to clarify the contradiction inherent in the IMF program being implemented by Egypt since November 2016. The fiscal consolidation objective contradicts the the monetary policy mandated by the program. This section analyses the reasons for this contradiction, before turning to an analysis of the socio-economic impact that arises and which is not considered by the IMF. The section ends with a proposal for an alternative monetary policy.

In exchange for an Extended Fund Facility worth $12 billion over 3 years, ending in June 2019, the IMF imposed the following two pre-condition on Egypt:

- Complete liberalization of the exchange rate
- Hiking interest rates on the Egyptian pound, to absorb some of the inflationary impact of liberalizing the exchange rate (IMF, 2016, p.9).

These two conditions were in contrast to what Egypt's government had planned, which was to implement more gradual flexibility to the exchange rate, according to the plan that the World Bank had agreed to the prior year, in coordination with the IMF, when the World Bank approved a $3 billion loan to Egypt (WB, 2015, p.9-12).

These two pre-conditions had a negative impact on attaining fiscal consolidation, which is one of the main objectives of the IMF agreement. They also had a negative impact on developmental objectives and equality of income and in opportunity.

a. Indicators between aspirations and reality

Figures 10 and 11 (below) show the development in in interest payments on government debt and in total budget deficit, before and after implementing the IMF program.

There are a few remarks arising from observation of each of the colors in Figures 10 and 11:

1. The IMF's projections, which are based on its program objectives, are always optimistic. Thus, the projections are revised upwards after the implementation begins. Notice how the yellow line, the most of recent of the IMF projections, ends higher than the blue, orange and gray lines.

   In Figure 10, notice how the deficit ended in year 2016/17 at a higher level than all the projections. Hence, it is expected that when the actual data for FYs 2017/18 and 2018/19 becomes available, the trajectory of the gray line would go higher than is current level.

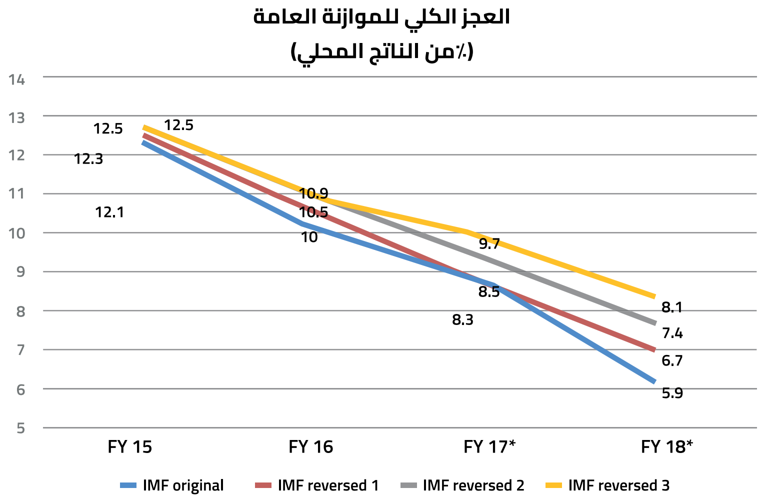
   In Figure 11, projections for interest payments on debt are usually higher than each revised projection. It is expected that in both FYs 2017/18 and 2018/19, the actual figures would be higher than the projections.

2. When the results of a certain recommendation prove to be unsatisfactory, the IMF does not revise the recommended policies. If the interest rate is shown to be an unsuitable tool for Egypt's context, and the negative consequences of hiking interest rates are always more than projected, the IMF would not recommend any change in policy, but rather would recommending the continued use of the same tool.

3. Notice the gray line in figure 11, the situation was better before starting the IMF program. This is the case although fiscal year 2015/2016 was the year the Egyptian economic crisis, this is why Egypt resorted to the WB and then the IMF. Yet this year remains much better than the years thatfollowed.[60]

4. The IMF experts look at the interest rate merely as a monetary policy tool, without looking at the wider economic/political analysis or at the social and distributional impact. As such the government pledges, "As inflationary pressures subside, we will consider a measured easing of the monetary stance. This will allow a reduction in interest rates and will support credit growth. However, should inflationary pressures emerge, the CBE will stand ready to delay the easing or tighten the monetary stance as needed."[61]

Figure 10: The missed projections for total budget deficit



Blue: IMF original projection as described in the agreement

Orange: The revised projection as described in the first review

Gray: The revised projection as described in the second review

Yellow: The revised projection as described in the third review

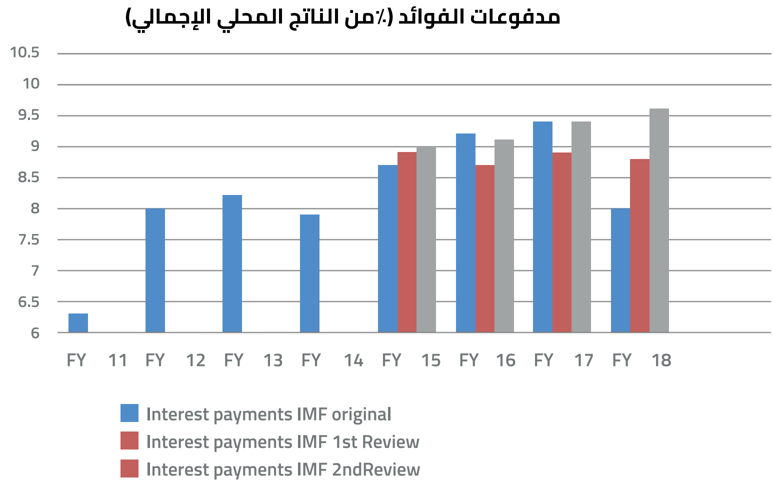
Source: IMF first, second and third reviews

*FY 2017/18. 2018/19 are projected figures. It is expected that the actual values will be higher.

60- Interest payments are not the only indicator that deteriorated since the start of the IMF program. There are several goals set out in the IMF program that were not attained. These indicators were better prior to the implementation of the program (in year 2015/2016, the year of the Egyptian economic crisis), such as the size of subsidies allocated to energy, government wages that had fallen significantly compared to international rates, and other indicators, most notably inflation. This summary refers to some of them.

61- From the letter of intent submitted by the Egyptian government to the IMF. The text was published in the Second Review, p.16.

Figure 11: The missed projections for interest payments on public debt



Blue: Original Projection as seen in the IMF agreement

Orange: Revised projection as seen in the first review

Gray: Revised projection as seen in the second review

Source: IMF first and second review reports

*FY 2017/18. 2018/19 are projected figures. It is expected that the actual values will be higher.

The figures in the following section highlight the negative impact of the pound flotation and raising the interest rate on cutting the budget deficit target.

b. The impact of pound flotation on the state budget

"Every LE1 decrease in the value of the pound to the dollar, contributes a net burden of LE3 billion to the primary deficit."[62] This is due to the subsidy allocated to the goods imported by the government (mainly petroleum products and foodstuff).

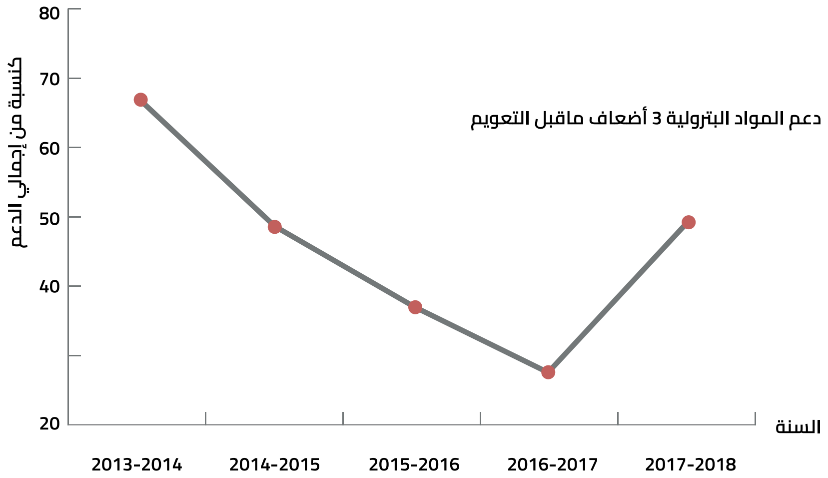
Accordingly, the petroleum products subsidy increased from LE51 billion in FY 2015/2016 to LE115 billion the year after.[63]

Figure 12 shows that the fuel subsidy bill decreased gradually before the flotation (mostly due to the plunge in international prices), and then multiplied as a result of the flotation (FY 2017/2018).

62- Finance Ministry, State Budget 2018/2019, p.52. The main influence on total deficit (i.e. if we add interest to external debt).

63- Finance Ministry (December 2017), p.28, Mid-year review. The government floated the pound in November 2016, i.e. four months after the beginning of the fiscal year on July 1, 2016.

Figure 12: Fuel subsidies as a percent of total subsidies



Source: EIPR calculations based on Finance Ministry data

The depreciation of the pound to the dollar also led to higher public debt payments. The public debt itself also exceeded projections during the first year of implementation of the IMF program, as shown in Table 2.

Table 2: Size of debt in budget sector, comparison between first and second reviews by IMF staff staff.

	LE billion	Percentage of GDP
Debt (First review)	3.623	104.5
Debt (Second review)	3.773	108.5

Source: IMF, January 2018, p.8

Finally, **an increase in domestic debt means that reducing the deficit is no more than a formality, as the government resorted to raising the debt in order for the deficit to appear smaller.**

c. The impact of interest rate hike on the state budget

The IMF imposed an increase on the interest rate of 300 basis points alongside the flotation of the pound.[64] The following year, the interest rate was raised twice consecutively by a total of 400 basis points.[65]

This led to a rise in the cost of government borrowing. The already limited fiscal space for other government spending was thus further tightened. The state budget deficit (as a percentage of GDP) then exceeded the original target, set in the first review, by 4 percentage points.[66] This followed the increase in the debt service bill by 0.5 percent of GDP as a result of the hike in the interest rate.[67]

64- IMF (2016), loan document, p.9.

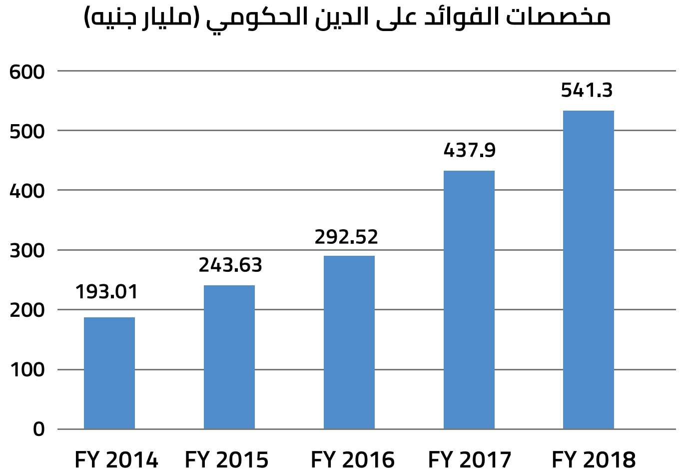
65- IMF (2018), Second Review, p.8.

66- IMF (2018), Second Review, p.8.

67- IMF (2018), Second Review, p.8.

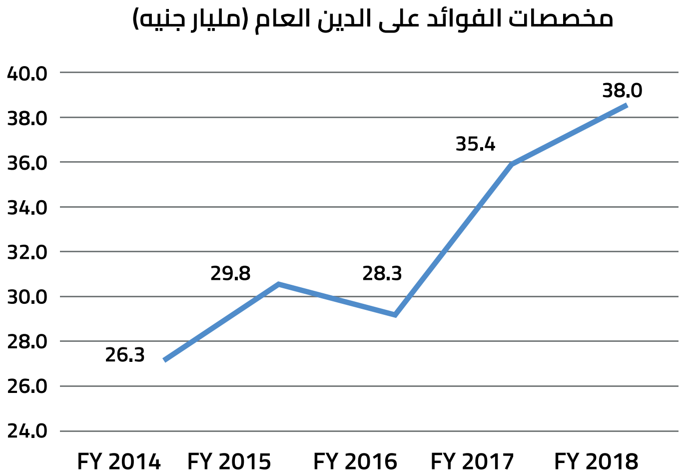
"The higher than expected interest rates pushed the overall deficit beyond targets, in spite of considerable off-setting measures."[68]

Figure 13: Public debt service allocations (LEbillion)



Source: Finance Ministry

Figure 14: Public debt service payments as a percentage of total expenditure



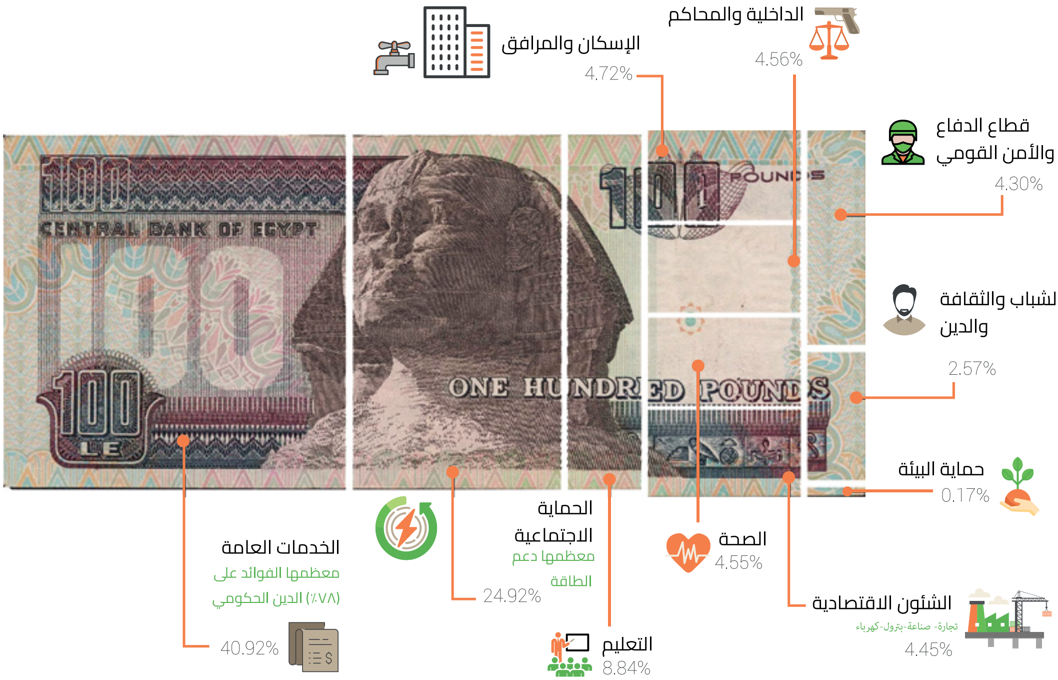
Source: Finance Ministry

Figures 13 and 14 show how **the public debt service payments doubled compared to before the IMF program was implemented, reaching 40 percent of public spending.**

Figure 15 demonstrates how the other sectors of the budget saw their share of public spending decrease as compared to the public services sector (80 percent of which is interest payments).

68- IMF (2018), Second Review, p.4.

Figure 15: The functional categorization of expenditures (FY 2017/2018)



Source: Finance Ministry data

Breakdown of the budget (FY 2017/2018)

40.92% refers to Public Service expenditures (most of which (78%) goes to government debt).

24.92% refers to Social Security expenditures (most of which goes to energy subsidies).

8.84% refers to Education expenditures.

4.72% refers to Housing and Utilities expenditures.

4.56% refers to Ministry of Interior and Judiciary expenditures.

4.55% refers to Health expenditures.

4.45% refers to Economic Affairs expenditure.

4.30% refers to Ministry of Defence expenditures.

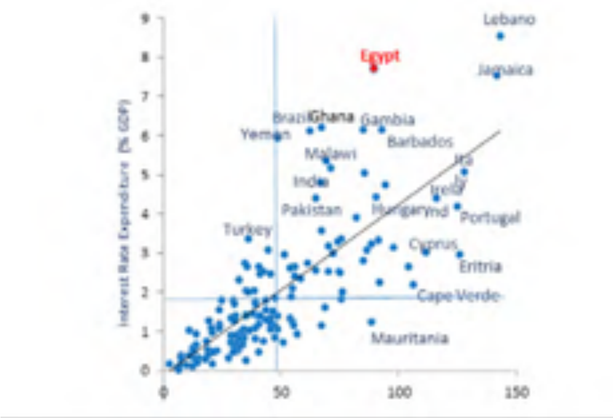
2.57% refers to Youth, Culture and Religion expenditures.

0.17% refers to Environmental Protection expenditures.

Notably, this increase in interest on public debt occurred despite the fact that Egypt was already one of the countries with the highest public debt burden, according to World Bank data for year 2015, that is before the implementation of the IMF program began (Figure 16).

It would have been preferable to study the causes of an increase in interest payments to mitigate the rise in interest payments rather than further burdening the state budget.[69]

Figure 16: International comparison between interest payments and size of public debt (both as a percentage of GDP)



Source: World Bank, unpublished, 2015

d. Social and distributional impact of raising the interest rate

i. Targeting primary deficit and the crowding-out effect

The IMF chose the primary deficit indicator as a measure of fiscal consolidation. The primary deficit is defined as the difference between total revenues and total expenditure (after deducting interest payments).

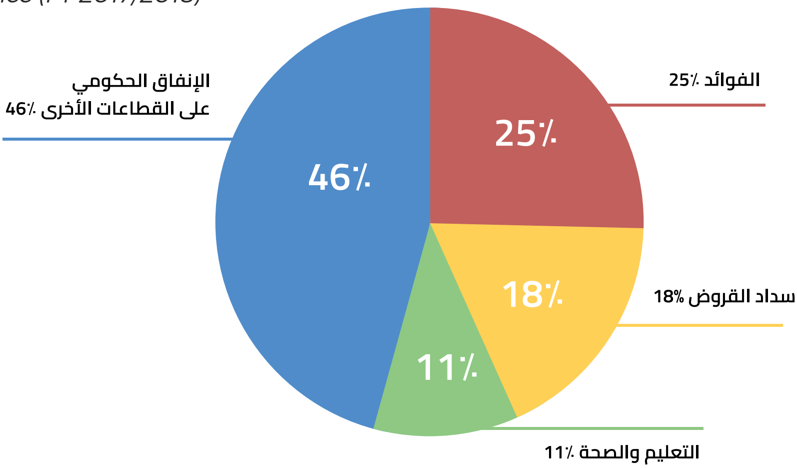
The program aims to cut the primary deficit by four percentage points of the GDP over the coming two years. "This would be achieved by reducing wages and energy subsidies, raising revenues through VAT, excises and stamp duty on government services."[70] These measures are socially unjust and inequitable in general, and in relation to how they are implemented.

As an outcome of using this indicator, the government reduces all other spending clauses in order to be able to meet its interest payments obligations. Subsequently, what is referred to as the crowding-out effect occurs, primarily influencing social services in particular education and health, as shown in Figure 17.

69- The IMF staff have not conducted any study on the reasons for the raise of the interest rate in Egypt compared to similar countries with similar public debt. Hence, in the absence of detailed public data on the holders of Egyptian public debt securities, and in light of the concentration of wealth within 1 percent of the population, including those referred to by the World Bank as politically connected investors, it is likely that this rise in the interest rate will be accompanied by a concentration of these securities with fewer of public and private banks, and a deepening of crony capitalism. There is a need for more study on the ownership of public debt and its relationship to the interest rate, in order to eliminate any effect of the abduction of the "public debt" by a handful of influential people, who seek massive earnings through this concentration.

70- IMF (2018), Second Review, p.48.

Figure 17: Crowding-out effect: Share of health and education of total expenditure, compared to debt service (FY 2017/2018)



Source: Finance Ministry and calculations by EIPR

Blue (46%) refers to Other Expenditures.

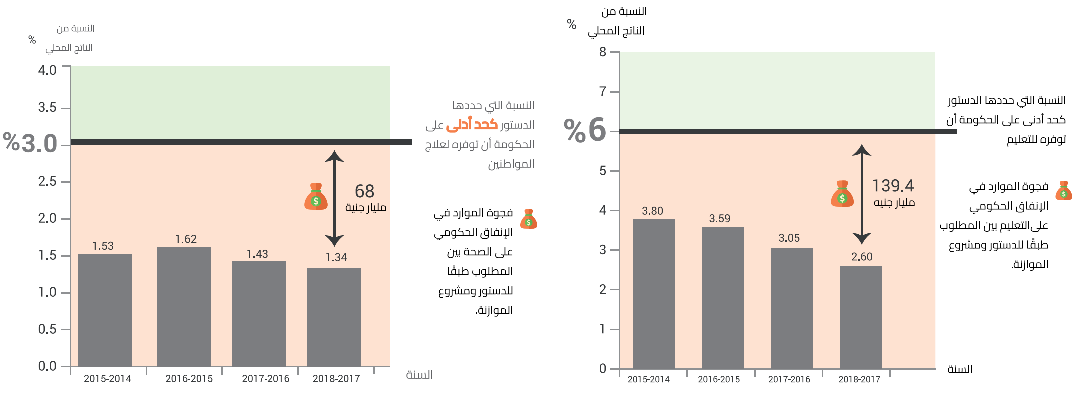
Red (25%) refers to Debt Services.

Yellow (18%) refers to Debt Installments.

Green (11%) refers to Health and Education.

The allocations for debt service hit LE400 billion, which is double the amount required for government spending on basic education, university education and health combined to meet the minimum constitutional mandate. The percentage of spending on both health and education is also far less than their historical levels in Egypt and below the global average (Figure 18).

Figure 18: Egypt falls behind the minimum constitutional mandate for spending on health and education



Source: Finance Ministry data, World Bank, EIPR calculations

On the left: The gap between the constitutionally mandated rate (3% of GDP) and the actual rate of public expenditure on health (1.34% of GDP).

On the right: The gap between the constitutionally mandated rate (6% of GDP) and the actual rate of public expenditure on Education (2.60% of GDP).

ii. Distributional impact from hiking the interest rate

Raising interest rates results in redistributing income in the interest of the upper classes. As explained by Thomas Piketty in his book *Capital in the Twenty First Century* (2014), instead of having the wealthiest pay taxes in order to reduce the budget deficit, the wealthiest loan the government to finance the budget deficit in exchange for interest payments, thereby increasing their income and wealth.

The government is the biggest borrower from Egyptian banks. Accordingly, every 1 percent increase in the interest rate is equivalent to an additional LE16-20 billion of interest payments on public debt, according to calculations by investment bank, Multiples Group.[71] These interests are not paid to entrepreneurial activities, and not on merit, but rather are are paid to those who have surplus, that is banks and people with savings. This results in a deepening of inequality in wealth and in income.

Egypt is ranks the third highest in the world in terms of wealth inequality.[72] Egypt also suffers from large-scale income inequality, when measured by the Gini coefficient, at 0.54. Additionally, the share of the top decile bracket out of Gross National Income is 49 percent.[73]

e. Inflation and its impact on poverty

Inflation rates increased as a result of the pound depreciation, and the IMF proposed an interest rate hike to absorb the impact of inflation.

There is an expected negative impact of the surge in the rate inflation throughout the past two years on poverty rates in Egypt. It is expected that inflation will continue to increase in the current year 2018. The IMF estimates that the rate of inflation will hit 21 percent,[74] despite estimating back in 2016 that there would be only a one-off cycle, after which inflation would ease and fall back into single digits.[75]

The IMF explains the surge in the rate of inflation as a result of three factors:[76]

- Depreciation of the pound
- Hike in fuel and electricity prices
- Imposing VAT, raising its rate and excises

Another factor, not cited by the IMF, is the expansion of the budget deficit.

Despite these socially tough measures, neither the IMF, World Bank nor the Egyptian government has conducted a compound impact assessment on poverty.

71- Omar ElShenety (May 4, 2017), "How not to decrease inflation", Omar ElSheneity official page. http://www.omarshenety.com/2017/05/how-not-to-decrease-inflation.html
The researcher double checked this figure through an interview with the deputy finance minister, Ahmed Kouchouk (2017)

72- Credit Suisse (2017), Credit Suisse Wealth Databook, Credit Suisse Research Institute.
https://www.credit-suisse.com/corporate/en/research/research-institute/global-wealth-report.html

73- Facundo Alvaredo, Lydia Assouad and Thomas Piketty (2017), "Measuring Inequality in the Middle East 2016-١٩٩٠: The World's Most Unequal Region?" WID working paper no. 2017/15, WID.World, Paris.
http://wid.world/document/alvaredoassouadpiketty-middleeast-widworldwp201715/

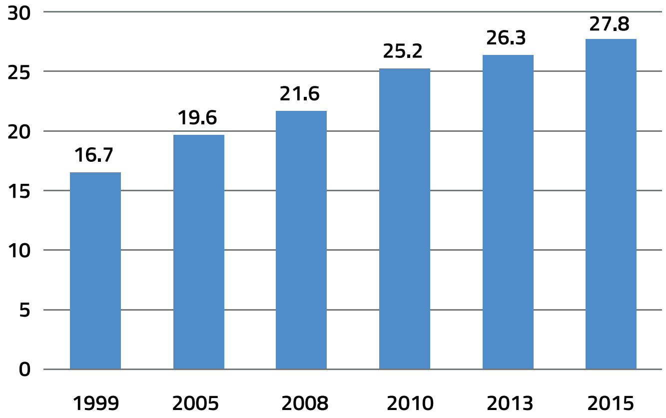
74- IMF (2018), Third Review, p.48.

75- IMF (2017), Loan agreement, p. 8.

76- IMF (2017), Loan agreement, p. 8

An unpublished government study estimates that poverty rates are likely to have increased in 2017 to 35 percent of the total Egyptian population (compared to 27.5 percent in 2015). The study assesses the impact of raising electricity prices and imposing VAT and assumed that wages and salaries remained unchanged, as well as assuming inflation rates hit only 15 percent. Based on these assumptions, the study found that the poverty rate would reach 35 percent.[77]

Figure 19: The increase in official poverty rate



This analysis shows the impact of depending on monetary policy alone, especially raising interest rates to achieve contraction as a temporary measure to curb the inflation rate which was a response to the depreciation of the pound, and hiking fuel and energy prices. Notably, the Egyptian government is expected to impose another round of price hikes **while the IMF notes that there are increasing risks that the Egyptian pound will weaken.[78]**

Proposed alternative:

Achieving the same impact on inflation through tax policy.

Increasing taxes results in reducing the budget deficit, and subsequently inflation. A tax rate hike must be drafted with caution, however, in order to curb rent activity only without having a negative impact on growth and on job creation. This can be done by:

- Imposing progressive income taxation, in particular on income generated through rent activity (investment in government securities, sale of land and real estate, and profits generated by the sale of companies or large stakes in companies). This would discourage demand among the upper classes for imported goods (one of the main sources of price increases).
- Imposing taxes on unused wealth such as closed real estate units or land and on sources of wealth, possession of which entails no risk, such as inheritance, or generous gifts from parents to their sons and daughters (such as apartments or dowries).

77- Safia Mounir, Al-Shorouk newspaper (2016), "Heba al-Laithy CAPMAS consultant: The fall in the standards of education is one of the major factors linked to poverty in Egypt." [Arabic]
https://www.shorouknews.com/news/view.aspx?cdate=12122016&id=7b103c03-872a-4902-a38f-c1fc70d9bb2e

78- IMF (2018), Third Review, p.37.

The impact of these taxes on growth is positive, as it re-allocates wealth from low value added investment (real estate and financial investment) to high value added production. It also has a positive impact on combating inequality and redistributing wealth and subsequently re-enforcing social stability.

In summary, the alternative is to reduce the budget deficit and inflation through taxation of the wealthy, who currently own government debt, instead of increasing their wealth along with the deficit and inflation by having the state borrow from the wealthy.

Part Two: Table for assessing the measures agreed upon with the IMF during third review

1. Overview and risks

Factor	IMF evaluation
1. Global rise in interest rates and strengthening US$ compared to other currencies The IMF also warned in its second review released in January 2018 that "unexpected tightening of global financial conditions could weaken the market appetite for the Egyptian Eurobonds and could lead to reversal of portfolio flows." This is what happened in the following months according to the IMF's third review, published in July 2018 (p.13). "External risks have increased in recent months, with a shift to capital outflows as tightening global financial conditions have contributed to a pullback by investors from emerging markets." According to Reuters, $5 billion worth of government debt securities exited the Egyptian market in the past few months.	The IMF argues for maintaining a free exchange rate, that is: further weakening of the Egyptian pound to the dollar, and an increase in inflation and slower growth. "The healthy level of foreign reserves and flexible exchange rate leaves Egypt well positioned to manage any acceleration in outflows, but this reinforces the importance of a sound macroeconomic framework and consistent policy implementation." (IMF, July 2018, p.15). In an analysis of the sustainability of external debt, the IMF points to large possibilities for the Egyptian economy to be exposed to an exchange rate shock.
2. Increase in global oil prices	Another increase in global oil prices would pressure the state budget further, and would demand further hikes in fuel prices in order to cover cost of production (p.2).
3. Deterioration of security situation and "fatigue" resulting from reform	"A deterioration of the security situation would disrupt the emerging recovery in tourism. In addition, adjustment fatigue may weaken reform momentum. These risks are mitigated by the authorities' record of sound macroeconomies policies and strong program implementation" (p.1).

4. Corruption and weak governance	Corruption is perceived as high and widespread. Perceptions-based corruption indices show high levels of perceived corruption in Egypt compared to most of its regional peers and other emerging market economies. Literature suggests that a reduction in the perception of corruption could have very strong economic effects. The staff report of the second review mentions that opposition to reforms "by vested interests would weaken the program's hard-won credibility" (p.9), without explaining who these vested interests are.

EIPR Assessment

1. Return to managed exchange rate regime. Replace financing from international capital markets through which the government issues Eurobonds with long-term soft loans that have long grace periods from international financial institutions and international and regional development funds. Increase the ratio of international grants to loans.

2. Accelerate the implementation of the IMF's medium-term recommendation made in its second review to create fiscal space, so that it begins this current year, in order to mitigate the social impact of global and domestic risks. The recommendation highlighted here is the creation of more fiscal space through measures such as tax reforms and the upgrading of the tax administration, as tax revenues in Egypt are around 13 percent of GDP, which is low according to international standards.

3. EIPR is critical of the cost recovery target that ends up burdening households with the surge in international oil prices. It is preferable to replace the fuel subsidies allocated to energy intensive companies and factories with fuel subsidies allocations to labor and technology intensive businesses. It is important to note that the lack of data on energy subsidies remains a major obstacle to an assessment of the energy subsidy elimination policy adopted by the government under the supervision of the IMF.

4. The IMF does not criticize the fragility of growth driven by a recovery in the tourism sector which is a volatile sector with high exposure to external shocks. The IMF also undermines the social anger resulting from the loan agreement program and does not offer alternatives to mitigate that social anger. Meanwhile the World Bank refers to the risk of social turmoil because its causes continue to be present, and identifies these as the absence of efficient social solidarity nets and schemes at the national level, in addition to the lack of formal job opportunities, high unemployment, widespread temporary work among Egyptian youth, as well as the exclusion of the poor. All of these factors need time to see improvement through the policies that the government adopts and implements (World Bank 2018, p.53).

The IMF program does not have sufficient measures to combat corruption and weak governance. It has never raised an objection to the Egyptian government's failure to meet the mandated transparency guidelines since the program began, and up until the end of the third review.

2. Macro indicators

	Required measure	Timeframe	Was it achieved?	Are the IMF tools adequate?
Growth and job creation	Achieve growth rate of 4.8 percent	FY 2017/2018	Yes	No
Inflation	Reduce inflation to single digits	FY 2017/2018	No. Inflation rate is projected to reach 21.5 percent in 2018	No

Social impact

Despite achieving a growth rate of 5.2 percent, exceeding the IMF projection, this growth is unable to serve the development goals of education, health and other public services, and the integration of Egyptians into the labor market. The main drivers of growth are tourism, construction, new gas fields discoveries, which are all rent economy sectors that do not contribute to sustainable growth nor absorb new labor market entrants, while growth in social services sectors such as education and health is slowing down.

Remarks and alternatives

The EIPR is critical of the prolonged retreat in investment spending on basic public services and believes that it is important for the state to further support and encourage SMEs to enable them to expand their contribution to economic growth. Tt is also important for the government to lead growth by encouraging the private sector to invest in productive industries.

Monetary Policy

Required measure	Timeframe	Was it achieved?	Are the IMF tools adequate?
Continuing with the contractionary monetary policy to curb inflationary pressures1	Years 2017 and 2018	Yes	No
A new CBE law to improve legislative framework	June 30, 2018	No, it was postponed on December 31, 2017 then again to September 30, 2018	Unclear
Lowering CBE hard currency deposits at Egyptian banks abroad to less than $4 billion	December 31, 2017	Yes	No
Lowering CBE hard currency deposits at Egyptian banks abroad to less than $3 billion	June 30, 2018	No	No

Socio-economic impact

Hiking the interest rate is often done to curb inflationary pressures driven by demand and not those driven by supply. In the case of Egypt, the CBE said it raised the interest rate in order to curb the inflationary repercussions of the austerity measures (supply side) which were implemented simultaneously, and hence this tool was not very effective.[79]

The IMF imposed an increase on the interest rate of 300 basis points alongside the flotation of the pound. The following year, the interest rate was raised twice consecutively by a total of 400 basis points. This led to a rise in the cost of government borrowing. The already limited fiscal space for other government spending was thus further tightened. The state budget deficit (as a percentage of GDP) then exceeded the original target, set in the first review, by 4 percentage points. This followed the increase in the debt service bill by 0.5 percent of GDP as a result of the hike in the interest rate.

79- Mada Masr (April 28, 2017), "A disconnect of interest: The social injustice hidden in the Egypt's monetary policy" https://madamasr.com/en/2017/04/28/feature/economy/a-disconnect-of-interest-the-social-injustice-hidden-in-egypts-monetary-policy/

Because of all of the above, inflationary pressures arising from the budget deficit have increased, which leads to higher poverty rates (neither the government nor the World Bank have updated poverty estimates in Egypt). In addition, there is also the crowding out effect in public spending (interest payments replacing spending on education, health, utilities and public services). Finally, interest payments are given as a form of profit to those with savings and investment, and commercial banks, which adds to the wealth of the rich and increases inequality.

With regard to the IMF's requirement to decrease the CBE's hard currency deposits in Egyptian banks outside of the country, the second Eye on Debt report noted while this measure is appropriate to promote transparency, it represents the elimination of one method of defense of the pound against speculation on the dollar, without providing reasons. This could lead to the return of the black market and the weakening of the pound, which would in turn raise inflation with particular impact on the poorest. It is preferable to keep the dollar deposits, and if possible, to even increase their value while announcing that value.

Remarks and alternatives

The growth analysis in this Eye on Debt report shows that the high interest rates on debt is one of the main obstacles to the expansion of large and medium companies and to increasing investments. In addition to its impact on the state budget at the expense of basic public services, the rise in the interest rate contributes to rising cost of investment and subsequently to companies' inability to meet their economic targets and expand their activities, which ultimately influences the utilization of new entrants to the labor force and negatively impacts efforts to lower unemployments rates.

While media reports show that the first hike in the interest rate by 3 percent in November 2016 was expected, the following hikes in May and July 2017 by 2 percent each were controversial, while inflation continued to accelerate to record levels.[80] It is believed that the latter hikes were meant to compensate creditors for their losses because of inflation.[81] While inflation rates slowed after the end of the base year and also because the former inflation levels were not driven by demand, EIPR concludes that it is necessary to gradually lower the high interest rate and end the contractionary phase to enable growth, in particular the growth of medium and large enterprises that depend on borrowing.

80- Mada Masr (March 29, 2018), "The ups and downs of Egypt's interest rates: What does the central bank want?" https://madamasr.com/en/2018/03/29/feature/economy/the-ups-and-downs-of-egypts-interest-rates-what-does-the-central-bank-want/

81- Mada Masr (2017), A disconnect of interest

3. Fiscal policy

Required measure	Timeframe	Was it attained?	Are the IMF tools adequate?
1. Develop a system to evaluate and decide on new guarantees for government companies and agencies and set a plan to limit new guarantees based on a government report on guarantees and the accumulation of this debt.	June 2018	No	Yes
2. Reduce public debt through fiscal consolidation.	June 2018	No	No
3. Allocate LE500 million, in addition to the previous allocation of LE500 million, to improve the availability of public nurseries for 0 to 4-year old children and other facilities that can enhance the ability of women to actively seek jobs.	June 2018	No	Yes
Fiscal indicators			
4. Primary deficit	June 2018	No	No
5. Total state budget deficit		No	No
6. Energy subsidies		No	No
7. Liberalize energy prices for households and link it to global prices.	June 2018	No	No

Remarks and alternatives

1. The government guarantees report on accumulated debt is very important for improving public debt administration, because it monitors all accumulated loans covering all government agencies that do not appear in the state budget (electricity companies, Suez Canal, the Egyptian General Petroleum Corporation etc). These government entities borrow with a government guarantee (i.e. the government is responsible for repaying the debt if a debtor entity defaults). The government guarantees report was supposed to be published within six months of the signing of the agreement between Egypt and the IMF, but it has not been published. The third review by the IMF staff did not mention whether the government has prepared this report or not. There has not been any announcement with regards to the issue of government guarantees.

2. The aim was to reduce public debt to 91.3 percent of GDP, but that aim was amended to 92.4 percent for FY 2017/2018. Judging by the previous year, it is unlikely that this revised objective will be attained. According to the IMF's second review, public debt increased to 108.5 percent of GDP instead of the projected 104.5 percent. The IMF warns that in the short and medium term "pressures to increase spending on wages, or expand social programs beyond what is budgeted," would constitute a risk to fiscal consolidation and reduction of public debt to GDP.
   But raising the interest rate (on government debt) above current levels would hinder attaining the objective of reducing public debt as a percentage of GDP, and it would also widen the interest on the domestic debt bill and subsequently the state budget deficit. This increases the pressure on the government to implement more austerity and reduce other wages and social protection, as well as services provided to citizens. This comes at a time when Egypt already has one of the lowest social spending to GDP ratio in the Middle East, west Asia and Africa. This ratio is below the Middle East average (1 percent of GDP), (WB, 2018, p.19).

3. The government has not allocated any money towards building nurseries as seen in the government statement and the budget released on the Finance Ministry website.

4. The government attained all the quantitative objectives with the exception of the primary surplus (below target by LE0.1 billion). The government also missed the repayment of oil arrears target by $200 million. The primary deficit[82] is one of the indicators measuring the sustainability of the public debt (i.e. the government's ability to repay its debts), but it is unsuitable alone as a measure of the adequacy of a country's fiscal policy. The government failed to attain a fiscal surplus of 0.2 percent of GDP.

5. The IMF revised its projection for the state budget to 9.8 percent of GDP up from 9.2 percent due to the rise in the debt service payments bill (IMF, July 2018, p.9).
   The IMF has also failed in its projection as seen in the second review by 4 basis points, due to the increase in the debt service bill by 0.5 percent of GDP as a result of the hike in the interest rate. "The higher than expected interest rates pushed the overall deficit beyond targets, in spite of considerable off-setting measures." (IMF, January 2018, p. 4).

6. The government raised fuel prices by 44 percent on average, after the third review, which increased the cost recovery ratio to 73 percent for Octane, Diesel, Kerosene and Mazot (IMF, July 2018, p.10). The energy subsidy bill increased to LE120.9 billion, above the planned LE108 billion (IMF, July 2018, p.22).

7. The prime minister approved setting energy prices for households through a pricing formula that reflects changes in global oil prices, the exchange rate and size of imports. This formula is drafted under the supervision of the IMF (IMF, July 2018, p.58). It was agreed with the IMF to postpone its implementation until December 2018. The implementation of similar formulas resulted in popular protests in Tunisia and Jordan over the past two years. The governments subsequently suspended the implementation of some of measures mandated by the IMF.

82- Primary deficit/surplus: The difference between revenues and expenditure after deducting interest payments on public debt. This is a necessary but insufficient indicator on the sustainability of public debt. The primary deficit occurs in countries that do not collect enough tax revenues to cover its large expenditure that is often allocated to defense, roads and schools (IMF, 2013). For more on the state budget deficits and historic backgrounds, see: Paolo Mauro, Rafael Romeu, Ariel Binder and Asad Zaman (2013), «A Modern History of Fiscal Prudence and Profligacy,» IMF Working Paper No. 13/5, International Monetary Fund, Washington, DC.
http://www.imf.org/external/np/fad/histdb/

The EIPR is critical of the implementation of this formula on households while the private sector are exempted from a similar formula. The government of former President Hosni Mubarak had negotiated at the beginning of the millennium with the private and public sectors to gradually lift energy subsidies on industries, and made a distinction between energy intensive and non-energy intensive industries. This was never implemented, however. It is known that the energy subsidies allocated to households represents only 20 percent of total energy subsidies. Accordingly, the liberalization of energy subsidies for households will have a minimal impact on the energy subsidy bill, while also having a massive negative impact on the real income and living standards of citizens.

On the other hand, the IMF does not acknowledge that natural gas is subsidized by the government. This is inaccurate and socially unjust. More than 90 percent of natural gas is used in generating electricity allocated to industries and in operating energy intensive factories. Thus, it is a hidden subsidy allocated to specific industries and leads to the distortion of allocations to energy andinvestments.

4. Privatization and Structural adjustment

	IMF Assessment	**EIPR Assessment**
Sovereign fund	The government in agreement with the IMF aims to privatize several State Owned Enterprises (SOEs) whether through IPOs or raising capital,[84] while neither the program nor the following staff reports have mentioned the sovereign fund despite its importance. Some economists have warned that this move represents the large-scale privatization and land and natural resource sales without transparency or any clear regulatory framework. This is because the fund has the right to privatize used and unused public assets that are owned by the state but the returns would be collected by the fund.[84]	Despite the ambiguity around the reasons for establishing the fund, and the lack of clarity around the assets that will be managed by the fund and its beneficiaries, EIPR asserts that it is important to follow the 10 principles of transparency of sovereign funds, as developed by the Sovereign Wealth Fund Institute. The principles cover the reasons for establishing such a fund, the source of wealth, the government stake and the beneficiary owners, in addition to publishing an annual report detailing the fund's activities.[85]

83- Finance Ministry (March 18, 2018), "Implementing ambitious IPOs by the government to finance Egyptian companies" [Arabic]
http://www.mof.gov.eg/Arabic/MOFNews/Press/Pages/news-a-18-3-18.aspx

84- Ahmed Sayed El-Naggar (July 23, 2018), "The Egyptian Sovereign Fund: A gate to privatization, foreigners hegemony and unregulated borrowing," Kateb website. [Arabic]

85- Sovereign Wealth Fund Institute, Transparency Index, https://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/

Egyptian General Petroleum Corporation (EGPC)	The government has noted in various program reports including the third review (p.50-1) that it is restructuring the EGPC by offering a minimal stake to the private sector. The privatization program announced by the government in March 2018, includes five companies in the petroleum and refining sector, namely ENPPI, EDC, MIDOR, ASORC and AMOC.[86] The ministry plans to restructure either through IPOs or raising capital on the stock exchange.	A report by AmCham notes that in September 2014, the government announced an investment plan worth $12.5 billion over six years that aims to add 1.7 million barrels per day to Egypt's production capacity. MIDOR would receive $1.4 billion to increase its refining capacity from 100,000 barrels per day to 160,000. According to the head of MIDOR, a consortium including Credit Agricole, CDP Italy and BNP Paribas has already agreed to finance the expansion to the tune of $1.2 billion. This brings the private sector contributions up to 85 percent of the financing needs for the expansion, as opposed to the initial expectations that the private sector would contribute 60 percent of financing needs.6
Reviewing the industrial land allocation system	The IMF notes in the third review that the difficulty of accessing industrial land remains one of the major obstacles to the growth of private investments in Egypt and this is because of corruption and speculation and absence of transparency in the land allocation system. Notably, a government working group was supposed to be created at the end of June 2018 to draft a reform plan for the land allocation system and its general rules which is due be published on March 31, 2019.[88]	Facilitating starting private investments especially SMEs is necessary in order to overcome high unemployment rates and to boost growth. SMEs and micro enterprises contribute 70 percent to the total job creation in the non-agriculture private sector.[87]

86- Finance Ministry, (2018), Implementing ambitious IPOs

87- American Chamber of Commerce in Egypt (November 2016), "Oil: From upstream to downstream."
https://www.amcham.org.eg/publications/industry-insight/issue/4/Oil-From-Upstream-to-Downstream

88- IMF (July 2018), Third Review, p.11.

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10- IMF (January 2018), 2017 Article IV Consultation, Second Review Under the Extended Arrangement Under the Extended Fund Facility, International Monetary Fund, Washington. http://www.imf.org/en/Publications/CR/Issues/2018/01/22/Arab-Republic-of-Egypt-2017-Article-IV-Consultation-Second-Review-Under-the-Extended-45568

11- IMF (July 2018), Third Review Under the Extended Fund Facility, International Monetary Fund, Washington. https://www.imf.org/en/Publications/CR/Issues/2018/07/12/Arab-Republic-of-Egypt-Third-Review-Under-the-Extended-Arrangement-Under-the-Extended-Fund-46061

12- Omar ElSheneity (2017), "How not to decrease inflation", Omar ElSheneity official page. http://www.omarshenety.com/2017/05/how-not-to-decrease-inflation.html

13- World Bank (2015), IBRD Program Document for a Proposed Loan to Egypt, Report no. 100978-EG, World Bank, Washington. http://documents.worldbank.org/curated/en/630471468186542188/pdf/100978-PGD-P157704-R2015-0233-1-Box393255B-OUO-9.pdf