Egyptian Initiative
for Personal Rights

An Eye on the Debt I

First report on the IMF loan program As of April 2017

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Introduction

This is the first report on the implementation 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 will receive each tranche of the loan after a team of IMF experts confirm that the Egyptian government has complied with the terms of the agreement within the specified timetable.

This independent review seeks to track which measures demanded by the IMF have been implemented by the government and which have not. More basically, it seeks to monitor and analyze the the socioeconomic impact of the program.

A report will be issued to coincide with each visit by the IMF expert team, to give citizens an alternative to the IMF discourse.

This report follows the format of the loan program, as published on the IMF website, addressing the same measures in the same order, to facilitate comparisons between the objectives defined by the IMF, the measures required, and measures actually taken.

As such, this shadow report discusses objectives and policies using the same rubrics as the experts' report submitted to the IMF Executive Board in October 2016:

1. Macroeconomic outlook and risks
2. Monetary and exchange rate policies
3. Fiscal policy and public finance management
4. Energy sector reforms
5. Financial stability
6. Structural reforms for growth and employment

1. Macroeconomic outlook and risks

1.1 Growth

In the first six months of the implementation of the growth policies, the IMF program seems set to fail to meet its growth targets. This is partially due to the government's failure to follow through on some of the agreed-upon measures (see the sections in red on the accompanying matrix) and, more significantly, to the IMF's failure to anticipate the extent to which the currency float would negatively impact growth.

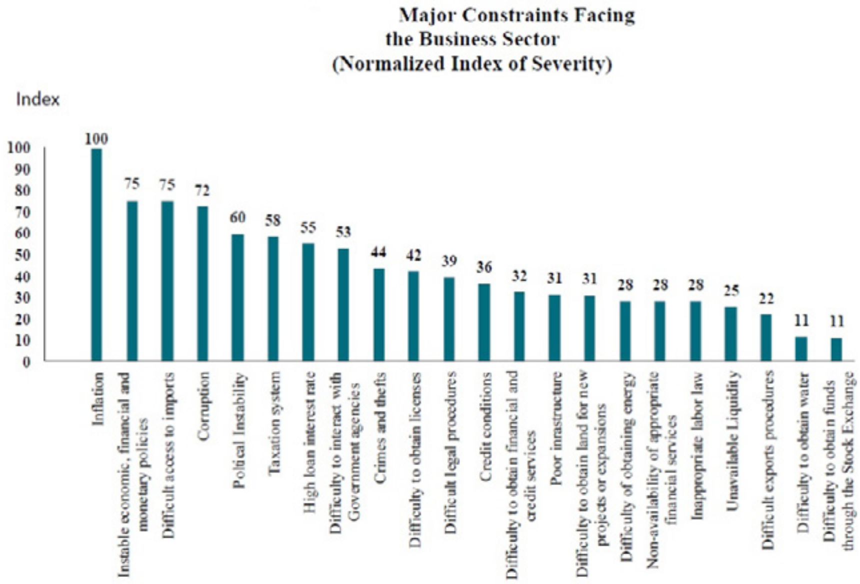
The IMF projected 4-percent growth, an optimistic expectation given that a recession typically accompanies currency floats (Krugman 1976; Frankel 2005).

In fact, many of the risks identified by the IMF came to pass, including: "the difficulties inherent in implementing a strong and wide-ranging reform program," as well as increased public spending, which could undermine the debt sustainability objective, and a failure to tighten monetary policy sufficiently, which could lead to inflationary pressures, the depreciation of the pound, and the loss of foreign currency reserves (IMF program, page 8). There were also the difficulties facing the global and regional economy, which cast their shadow on Egypt.

As a result, the IMF reduced forecasted growth to 3 percent, according to the World Economic Outlook released in April 2017. The Business Barometer issued in March 2017 notes companies' pessimistic projections for production, investment, and employment in the period of January to March 2017.

According to above mentioned report "The lack of optimism persists due to the lack of confidence in the investment climate and the instability of monetary policy. Major firms anticipated very slight growth, a decline in their production, domestic sales, and exports, and continued increases in prices, wages, and the cost of production inputs, although at a lower rate due to slowing inflation in the third quarter. They further expect continued contraction in the size of their investments in the third quarter; small and medium enterprises share these expectations." According to the same report, the industrial sector in particular is witnessing a contraction and slow down since it is most affected by the decision to float the pound. This has reduced production as a result of higher costs and also led to declining domestic sales due to consumers' lower purchasing power. The cost of investment, imported technology, and imported production inputs is also up due to the depreciating value of the local currency. As a result, the industrial sector saw lower growth and employment than other sectors in the second and third quarter of fiscal year 2016/17, following the liberalization of currency prices and higher fuel prices. Investors are thus seeking a stable monetary policy that can rein in and reduce inflation in order to promote economic growth.

The following figure shows impediments to growth as ranked by business owners and managers, according to the same report, in the period of January–March 2017:



Source: Egyptian Center for Economic Studies, March 2017

Comment: The closer to 100 the index reaches, the more companies see the constraint as a major factor; conversely, the closer to 0 the index reaches, the less companies see it as a major factor.

1.2 Privatization

The lack of transparency is the prime feature of the IMF document here. In turn, we do not know if any steps have been taken in this regard as of April 2017.

The IMF program does not mention the privatization of the Bank of Cairo, despite the government's announcement that it is, indeed, part of the program. This highlights the opacity surrounding this significant, socially sensitive topic.

There is a vague reference on page 50 of the IMF document, in the Egyptian government's letter of intent, to promoting competition by "IPO [initial public offering] sales for some public enterprises." But there is no mention of the names of such companies or sectors to which they belong, to enable the public to evaluate why these sectors require more competition and whether privatization in this case and in this way (an IPO) is the ideal method to increase competition.

Ahmed Kouchouk, the deputy finance minister, told the EIPR that the Bank of Cairo is fully ready for an IPO and that at least one company under the Egyptian Petroleum Authority is ready to put shares up for sale. According to Kouchock "There is also the possibility that other shares in one other bank at least may be put up for sale. However, these exceptional revenues are not included in the draft budget because we preferred not to rely on these exceptional revenues. So if the IPO goes forward in the coming fiscal year, it's good, and if it does not happen for some reason, the budget will not be affected. But there is no information about the size of the stakes that will be sold or if employees will be laid off in the companies put on the block".

The EIPR has reservations about the sale of state assets to attract foreign capital (and improve the balance of payments), as such sales are not necessarily followed by the development of the sold companies. It is preferable to attract foreign investment through green field investments. We are also wary of privatization as a means of reducing the budget deficit because it does not address the structural deficit, but is rather a source of exceptional, one-time revenues.

2. Monetary and exchange rate policies

As of April 2017, monetary policy had failed to contain the inflation resulting from the decision to float the Egyptian pound. However, the size of the black market had shrunk and currency prices had stabilized, though at a higher level than projected. The price of the pound had settled at LE18.5/$1 (at the time of writing this report), while the target was set at LE14.5/$1, according to public budget statements for FY2016/17.

Monetary policy in the IMF program through the end of March was based entirely on mitigating the repercussions of the currency liberalization, undertaken in November 2016 (see the attached matrix).

2.1 Inflation

The IMF failed to accurately predict the spike in inflation arising from the currency float. Average inflation in consumer prices was expected to increase to 18 percent, while in fact inflation reached its highest point in 30 years, coming in at 31.7 percent in February 2017 and then 32.2 percent in March 2017.

This forecasting error caused millions of Egyptians to slip below the poverty line, denying them basic needs, most importantly food.

2.2 Interest rates

The program called for raising policy rates by more than 300 basis points concurrent with the float. The government offered deposit auctions at an average interest rate of 17.5 percent, with the goal of controlling the first round of inflationary pressures.

The idea behind the measure was to tighten liquidity in the market, as well as contain investment and private consumption. As local demand slowed, inflation would subside. In short, the move sought to induce a temporary contraction, which influences growth and, in turn, employment.

The interest rate on government debt has hovered at 18 percent since the float.

As a result of the currency float, increased subsidies were directed to government-imported goods, the cost of which had been calculated on the basis of an exchange rate of LE9/$1. As such, the bill for these goods in Egyptian pounds increased, and despite price increases for some of the goods, the subsidy bill in the public budget has exceeded original budget allocations. Government debt payments have also nearly doubled. According to statements from the Finance Ministry, the public debt increased by 15 percent due to the float.

According to Finance Ministry statements, energy subsidies increased because of the float from LE50 billion—the amount assessed in the 2016/17 budget—to LE100 billion, the actual cost of subsidies, in the first eight months of the budget (July 2016 to February 2017).

The EIPR has reservations about the persistent increase in interest rates. This will increase interest payments on domestic public debt, which is now the single largest item of government spending, accounting for approximately 34 percent of all spending. This denies citizens public funds that should be used to improve social services. The spending also goes to well-off Egyptians who possess funds sufficient to invest in treasury bonds. Instead, this cohort should be subject to taxes on their relatively high incomes, rather than be given assistance in increasing their wealth.

In short, the decision to maintain high interest rates is biased to high-income groups and facilitates the accumulation of wealth, even as the inflation resulting from the float has disproportionately harmed lower income groups and impoverished them. Moreover, this prescribed cure has proved ineffective at treating inflation. The proportion of citizens with dealings in the formal banking sector—estimated at 10 percent of the population—has declined.

Finally, monetary policy and measures have led to an economic downturn, which increases unemployment.

2.3 The CBE and improved transparency

The Central Bank of Egypt (CBE) had not complied with IMF terms to publish financial stability reports and monetary policy reports as of April 2017.

The IMF cautions against current policies, whereby currency reserves are invested heedless of best international practices, and it advocates capping reserve allocations maintained abroad at $5.6 billion. The IMF is slated to conduct a comprehensive assessment of these policies before its April–May 2015 meeting. (This report could be delayed until June 2017).

3. Fiscal policy and public finance management

The IMF required the government to implement a value added tax (VAT)—a regressive tax with a negative social impact—as a condition for the loan. It also neglected to reduce energy subsidies received by producers. Finally, the IMF chose as its metric of success deficit reduction across all budget items save interest, including social spending.

3.1 Revenue side

VAT

The government views the VAT as a means of plugging the deficit with no consideration given to its negative distributional impact on lower income groups. Revenues from the VAT increased since its application in November 2016 from LE11–12 billion per month to LE15 billion per month in February 2017. Revenue from the tax on services in the first nine months of current fiscal year increased to LE12.4 billion, compared to LE10 billion last year. Tax revenue on goods reached LE66.5 billion in the same period, compared to LE44 billion in the same period last year (Finance Ministry).

Stamp tax on stock market transactions and acquisitions

On March 21, 2017, the Cabinet approved amendments to this tax and forwarded them to the State Council for its consideration, in preparation for their submission to the parliament; they are expected to be approved in May 2017.

The tax is anticipated to bring in an additional LE1 billion in public revenue, based on a tax of 0.1 percent on all stock market transactions and 0.3 percent on acquisitions of 33 percent or more of any corporate assets.

In the program, the IMF agreed to a three-year delay on the implementation of another, fairer and more lucrative tax—a 10-percent tax on cash dividends and capital gains—and approved the adoption of the stamp tax in late March 2017 instead (p. 56).

The former chair of the Tax Authority, Mustafa Abd al-Qader, said in September 2014 that the capital gains tax of 10 percent was expected to bring in LE10 billion a year.

3.2 Expense side

Wages

In early FY2016/17 the government began cutting the wage bill. It is projected to reach 6.6 percent of GDP at year's end, down from 7.9 percent in FY2015/16; it is expected to fall to 5.6 percent of GDP by 2018/19. The government also promised the IMF to freeze any new hires.

Reduced expenditure on wages is no different from other austerity measures and spending cuts insofar as the policy is to treat all beneficiaries of this spending the same—or more likely, to avoid harm to those who take the lion's share of the budget item and impose austerity on the smaller beneficiaries. This unfair, unsustainable policy further impoverishes lower income groups while also eroding their purchasing power. Whether it is tax policy, lifting subsidies on fuel and electricity, or increasing the price of public services (the metro, for example), the policy pursued makes no distinctions between citizens' divergent levels of income and wealth.

The EIPR believes that social justice required the following:

1. Limiting wage and bonus cuts to senior civil servants.
2. Calculating the cuts after requiring the government to include all special pension funds, which conceal a substantial part of senior employees' income and which would further the fight against corruption and wage disparities within the government sector.
3. Excluding education and health needs from the hiring freeze.

Electricity tariff increase

Electricity tariffs increased by 40 percent with the goal of reducing expenditure by 0.6 percent of GDP in FY2016/17. Annual increases since 2012 have shouldered citizens with a cumulative increase of 160 percent of their electric bills. For the poor, it was a 167-percent increase, including 47 percent in 2016 alone. Middle-income Egyptians saw their bills go up by 190 percent in that period, 52 percent of it in 2016 alone.

The hikes affected two items:

1. An average increase of 33 percent in the consumption bracket tariff across all brackets, though the sharpest increases hit the low and middle consumption brackets, with an increase of 34 and 38 percent in the third and fourth brackets and an increase of 36 and 34 percent in the fifth and sixth brackets, the highest brackets.

2. An increase in the service fee, which affected only three brackets: minor (33-percent increase), low (100-percent increase), and medium (33-percent increase). The high consumption brackets faced no increased service fee.

Cuts to energy subsidies by 0.4 percent of GDP

The government failed to cut the energy subsidy bill due to the impact of the float, although consumers have seen a 30-percent increase in the price of all kinds of fuel.

According financial statements, energy subsidies increased from LE50 billion (the amount allocated in the 2016/17 budget) to LE100 billion (the actual cost of subsidies because of the float) in the first eight months of the budget, from July 2016 to February 2017. This sum does not include subsidies for natural gas for factories. The government sells gas to fuel-intensive industries at $3 on average, inclusive of transportation and liquefaction costs, compared to $3.2 on the global market, which is not inclusive of the aforementioned costs.

Social spending

Under the IMF program, the government is committed to directing 1 percent of GDP (one-third of fiscal savings) to specifically social spending (page 14, IMF program).

It is difficult to evaluate compliance with this commitment, but as of April 2017, several measures have been announced that are likely to increase treatment costs at government hospitals:

1. Privatization of the Takamul hospitals.

2. A change in hospital regulations to fee-based treatment.

The IMF did not seek compliance with constitutional requirements for an increase in expenditure on health, education, and scientific research to a combined 10 percent of GDP. As a result, the draft budget for FY2017/18 flouts this spending requirement for the second year in a row.

3.3 Promoting public finance management

The government did not meet its deadline of January 31, 2017, by which time it was to have prepared a report on all outstanding state guarantees for government and public agency loans, given the significant potential for fiscal crises. According to the IMF program (page 13), the report is designed to strengthen the framework that governs the issuance and monitoring of state guarantees. Apparently, the government will now prepare this report in December 2017 and it will not be published, contrary to the budget transparency requirements laid out in the Government Finance Statistics Manual, published by the IMF in 2015.

The government also did not prepare a fiscal risks statement covering macroeconomic risks, public enterprises, debt, liabilities, and pensions, which was to be completed by March 31, 2017.

Finally, there is no information about the road map for pension reform, which the government is scheduled to develop by June 2017. The government has initiated no public or private debate on the topic.

4. Energy sector reforms

The government has not released its comprehensive plan for energy sector reform, which according to the IMF should include the petroleum, gas, and electricity sectors; the plan was supposed to be ready by March 31, 2017.

Baker and Mackenzie have also not completed the plan to restore financial sustainability to the Egyptian General Petroleum Company (EGPC), which was to have been finalized by March 31, 2017 under the IMF schedule. The plan is in the final stages of development and could include the privatization of several EGPC subsidiaries via IPOs.

The EIPR is especially concerned about the IMF agreeing to exclude fuel-intensive industries from any price increases. We also object to the failure to include natural gas within subsidized fuel types listed in the loan document (and the public budget statements), which the EIPR feels is biased against lower income groups. The decision also works in the interest of those the World Bank calls "persons with political connections," who are the biggest beneficiaries of energy subsidies to the industrial and tourist sectors.

5. Financial stability

There are no measures associated with this rubric until April 2017.

6. Structural reforms for growth and employment

The published program, which only includes measures required during the first half of the program, contains no reforms related to employment save expediting factory licenses.

The parliament approved the new industrial licensing law on March 26, 2017, which the IMF hopes will curb unemployment and promote investment by cutting the time needed to obtain non-hazardous industrial licenses and start operations from an average of 72 to 14 days (p. 15).

Sluggish growth, especially industrial growth that generates jobs, may be exacerbated by the delayed adoption of the new licensing law in industrial zones, which was issued six months after the loan agreement was concluded.

The EIPR believes that the program as a whole lacks measures to support inclusive economic growth and suggests a package of urgent measures to improve the social situation. We recommend these be adopted before the IMF team's second review at the end of 2017:

1. Extend minimum wage protections to the private and informal sectors.
2. Offer tax exemptions for low-income groups.
3. Improve the quality of education and health in government facilities and extend coverage of both.
4. Provide unemployment insurance to people who lose their jobs as a result of sluggish growth resulting from the floating of the pound, tight monetary policies, and reduced government spending.
5. Expedite, within FY2017/18, the extension of cash supports to people below the extreme poverty line, a group estimated in 2015 to consist of four million citizens.

Rubric	Objective	Achieved or not?	Measures required under the program	Were they carried out by govern-ment or CBE?	Economic and social impact according to EIPR	Observations
Growth and risks	Achieve 4 percent growth	No. IMF downgrad-ed projected growth to 3 percent	Adopt new industrial licensing law	Yes	Insufficient. Sluggish growth is attributable to government's failure to follow through on some agreed-upon measures. More importantly, the IMF failed to foresee the full negative impact of the currency float on growth, especially inflation.	
			Privatization	No	Inappropriate remedy to promote inclusive growth	Lack of transparency is the prime feature in the IMF document on this point. Thus we do not know if steps have been tak-en as of April 2017. The IMF program does not mention the privatization of the Bank of Cairo, although the govern-ment has announced it as part of the program.
Mon-etary policy	1. Contain inflationary impact of the float	No. Inflation reached 32 percent in March 2017, compared to IMF projections of just 18 percent	Raise interest rate	Yes. Interest rates were raised more than 300 basis points to 18 percent	1. Increase in absolute number of poor (no official statistics are available and neither the World Bank nor the IMF made projections about the float's impact on poverty) 2. Slower growth due to higher price of inputs and weak demand due to ero-sion of purchasing power	This is the most difficult issue in negotiations between the government and IMF. Talks are underway regarding IMF demand for higher interest rats and fuel prices.
	2. Strength-en CBE transparency policies	No	No financial stability reports or monetary policy reports published as of April 2017	No	The IMF cautions against current policies whereby re-serves are invested heedless of best international stand-ards. It urges the CBE to maintain the current ceiling on reserve allocations abroad ($5.6 billion).	The IMF is sched-uled to undertake comprehensive assessment of these policies before meet-ing of April-May 2017 (the report may be delayed until June 2017).

Fiscal policy	Reduce primary deficit by 0.9 percent of GDP	No		The primary deficit is projected to fall by 1.6 percent of GDP	1. Monetary policy (based on the CBE regulation of interest rates) cannot be separated from fiscal policy (currently based on reducing the budget deficit). The higher the interest rate, the higher interest payments on government debt (which comes to several hundreds of billions annually as it is). 2. Interest on debt increased after the float to more than one-third of general expenditure, compared to one-quarter two years ago. 3. Interest is consuming more than other spending items, such as investments, wages, agricultural subsidies, Upper Egypt development, treatment for the poor and provision of medicines, equipment for hospitals and schools, and other important items of government spending. 4. It is difficult to reduce the deficit with the policies imposed by the IMF. The government and IMF agreed not to use the overall deficit as a measure of reform success, but instead the deficit minus interest, known as the primary deficit. 5. Interest paid to government creditors has increased, meaning the government lost funds it needed to improve services to citizens, while creditors profit.	The IMF measures the success of fiscal policies using the primary budget balance, not the overall deficit because the primary deficit will show the projected movement. This excludes interest payments on debt, which will necessarily increase as a result of monetary policy (higher interest rates).
	1. Increase tax revenues					

	Reduce budget deficit by increasing tax revenue by 1 percent of GDP in 2016/17	No; 0.5 percent-increase only	Implementation of VAT	Yes	Expanded use of regressive consumption taxes instead of progressive taxes and failure to expand the tax base to include the rich and high-income groups; VAT harms low-income groups that spend the greatest share of their meager incomes, while some 67 percent of spending of rich is not subject to taxes. Low-income groups spend 6.4 percent of their annual income on taxes, with a savings rate of 0 percent, or sometimes less, as they spend more than they make on basic needs. Upper-income groups spend 3.34 percent of their income on VAT, saving 25–50 percent of their income.	The IMF required to government to implement the regressive VAT as a condition for the loan. Meanwhile, it neglected reducing energy subsidies received by producers. The measure of success chosen by the IMF is deficit reduction across the board except for interest, but including all categories of social spending.
	Cutting deficit by increasing tax revenues by LE1 billion		Implementation of capital gains tax or stamp tax			Capital gains tax was nixed, continuing the regressive tax policy and in violation of the Egyptian constitution, which stresses need to expand the tax base and adopt a progressive rate to include the highest income groups and increase tax revenue. The capital gains tax was projected to bring in LE10 billion, while the stamp tax is expected to bring in LE1 billion.
	Reduce government spending					

			Implement civil service law and strict employment system in government sector		Contradicting President Abd al-Fattah al-Sisi's pledges, in 2016/17 the government began reducing total government wages, to reach 6.6 percent of GDP by year end, down from 7.9 percent in FY2015/16, and then 5.6 percent at the onset of 2018/19. The government also promised the World Bank to freeze new hires. EIPR believes that social justice required: 1. Limiting wage and bonus cuts to senior civil servants. 2. Calculating the cuts after requiring the government to include all special pension funds, which conceal a large part of senior employees' income. This would also combat corruption and income disparity in the government sector. 3. Excluding education and health needs from the hiring freeze.	
	Reduce spending by 0.6 percent of GDP in FY2016/17		Increase electricity tariffs by 40 percent	Yes	Annual hikes since 2012 have meant that citizens have seen a 160 percent cumulative increase in their electric bills. For poor Egyptians, the increase was 167 percent, and 47 percent in 2016 alone; middle-income groups saw increases of 190 percent, and 52 percent in 2016 alone.	The increase hit two areas: 1. An increase in consumption bracket tariffs, which rose 33 percent on average from the previous year across all brackets. But the highest increases affected the low- and medium-consumption brackets, coming to 34 percent in bracket three, 38 percent in bracket four, 36 percent in bracket five, and 34 percent in bracket six. 2. Increase of the usage fee: this hit only three brackets, minor, low, and medium, by 33 percent, 100 percent, and 33 percent respectively; there was no usage fee increase on the highest consumption brackets.

	Reduce spending by 0.6 percent of GDP in FY2016/17	No, it doubled	Increase price of gasoline and diesel by 35 percent	Yes, in November, as condition for IMF loan	The float cancelled out the impact of the cut to the subsidy bill; fuel subsidies allocated in FY2016/17 increased from LE51.1 billion to LE101.2 billion because of the float.	The subsidy bill as discussed by the IMF and government does not include subsidies for natural gas, diesel, and electricity to fuel-intensive industries or subsidies for diesel, electricity, and butane canisters for the services' sector; it is focused on reducing energy subsidies for household consumers.
			Public finance			
	Better fiscal discipline	Not issued	Report on government guarantees			The report was supposed to be issued by March 31, 2017; it was postponed to December 2017.
	Better fiscal discipline	Not issued	A statement assessing financial risks covering macroeconomic risks, public enterprises, debt, liabilities, and pensions			
			Restructuring			

	Reduce unemployment and encourage investment by shortening non-hazardous industrial licensing from average of 72 days to 14 days		Adopt new licensing law	Yes, the parliament approved the new industrial licensing law on March 15, 2017.	Inadequate measures to reduce unemployment	According to the Business Barometer: "The lack of optimism persists due to the lack of confidence in the investment climate and the instability of monetary policy. Major firms anticipated very slight growth, a decline in their production, domestic sales, and exports, and continued increases in prices, wages, and the cost of production inputs, although at a lower rate due to slowing inflation in the third quarter. They further expect continued contraction in the size of their investments in the third quarter; small and medium enterprises share these expectations."
	Improve efficiency of energy sector; mitigate financial risks of EGPC	Not issued	Integrated plan for restructuring the energy sector and a plan to restore fiscal stability to EGPC	No		Deadline for issuance was March 31, 2017; Baker and Mackenzie are currently working on the report, which should be issued soon.