Arab NGO Network for Development
شبكة المنظمات العربية غير الحكومية للتنمية

The Inequities of the International Monetary Fund Program in Egypt:

How Monetary Policy Conflict with the Fiscal Policies Objectives

Policy Brief

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The Inequities of the International Monetary Fund Program in Egypt:

How Monetary Policy Conflict with the Fiscal Policies Objectives

Policy Brief

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The purpose of this brief is to clarify the contradictions in the International Monetary Fund (IMF) program implemented by Egypt since November 2016, wherein the objective of fiscal consolidation is in conflict with the monetary policy prescribed by the program. The brief analyzes the causes of this contradiction and then explains its social and economic effects which the IMF fails to take into account, concluding with presenting an alternative to that harmful monetary policy.

Introduction

The Egyptian government presented an “economic reform” program to the IMF in 2016, with a view to obtaining an Extended Credit Facility(ECF) of USD 12 billion over three years, ending in June 2019. The IMF imposed two requirements on Egypt as a precondition to obtaining the loan:

- Full liberalization of the exchange rate;
- Raising the interest rate on the Egyptian Pound to absorb some of the effects of liberalization of the exchange rate (IMF, 2016, p. 9).

These two requirements were contrary to what the Egyptian government had planned, which was more gradual flexibilization of the exchange market. This is according to the plan accepted by the World Bank the previous year, in coordination with the IMF, when it agreed to lend to Egypt USD 3 billion (The World Bank, 2015, p. 19-20).

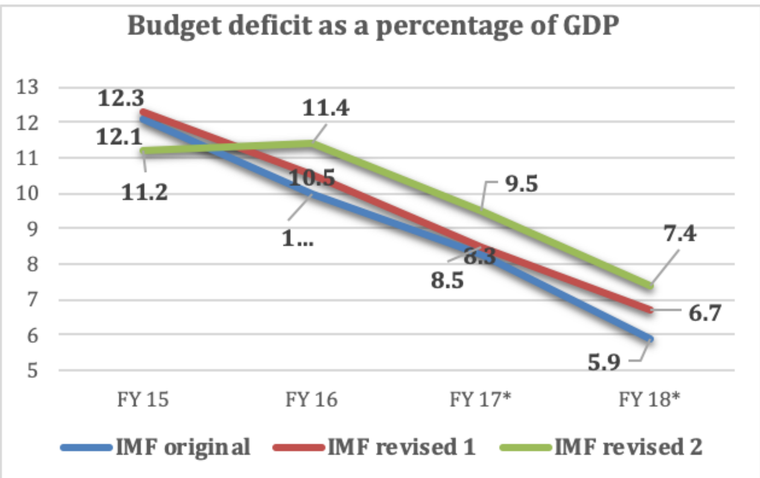
Those two requirements have had a negative impact on the reaching the objective of public fiscal consolidation, a stated objective of the agreement with IMF. They have also had negative impacts on achieving development goals, equality of income and opportunity.

Indicators between aspirations and reality

Figures 1 and 2 show the evolution in both interest payments on government debt and total deficit before and after the implementation of the IMF program.

There are several notes to be drawn from tracing the three lines, blue, red and gray:

Figure 1: False projections for total budget deficit

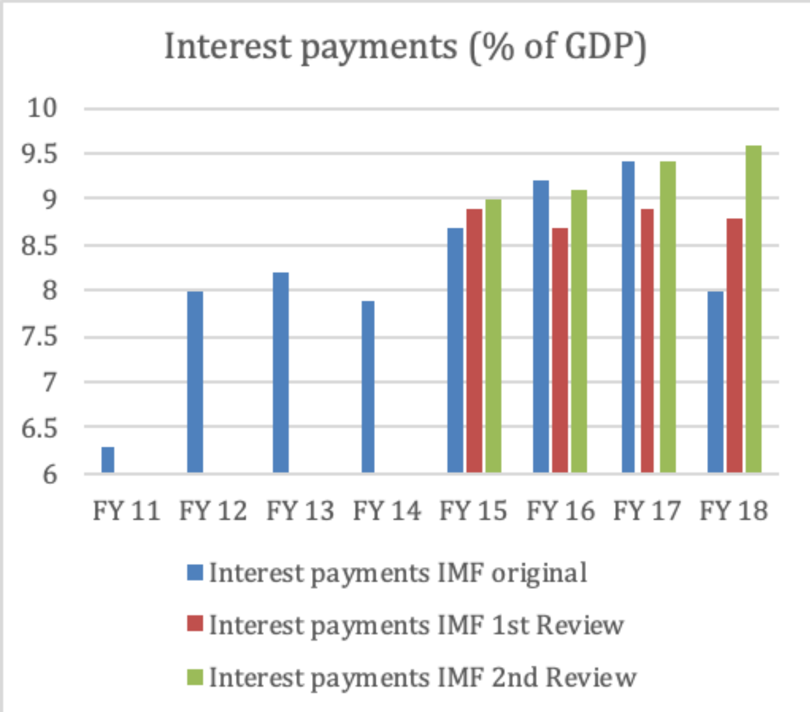


Blue: Original forecast as stated in the IMF's program
Red: Adjustment according to the 1st review
Gray: Adjustment according to the 2nd review

Source: IMF Program, first and second reviews reports.

* The two fiscal years 2017 and 2018 are projected values. Actual values are expected to rise.

Figure 2: False projections for interest payments on public debt



Blue: Original forecast as stated in the IMF's program
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Gray: Adjustment according to the 2nd review

Source: IMF Program, first and second reviews reports.

* The two fiscal years 2017 and 2018 are projected values. Actual values are expected to rise.

1. That the Fund was always over-optimistic about the objectives set by its program, which it subsequently upwardly it upwards once implementation began. Note how the gray line level ended above the blue and red lines.

Note in Figure 1 how the deficit ended in 2016-17 effectively exceeding all projections. It is therefore expected when the actual data are announced for the fiscal years 2017-2018 that the gray line rises above its current level.

Moreover, as shown in Figure 2, projections for interest payments on debt also often ended up higher from one review to another. The two years 2017 and 2018 are expected to end with higher effective levels than projected.

2. If a recommendation proves to have produced unsatisfactory results, the IMF does not review

the policies it recommends. If the interest rate is not appropriate for the Egyptian situation, and the disadvantages of raising it outweighs the projected, the IMF will not recommend changing the tool, but to continue raising interest rates (IMF, 2016, p. 9 and 11).

3. Note in the gray line how the situation was better before the beginning of the implementation of the program. The fiscal year 2015 was a year of crisis for the Egyptian economy, which was why Egypt resorted to the World Bank and then the IMF. But it remains much better compared to the subsequent years.[1]

4. The Fund's experts view the interest rate as a mere instrument of monetary policy, without considering the broader political economic analysis or the social and distributional impacts of that policy. As such, the government pledges:

"If inflationary pressures recede, we will introduce a thoughtful monetary easing. This would allow for lower interest rates and allow for credit growth. But if inflationary pressures emerge, the central bank will be willing to delay the easing or impose further monetary tightening (Letter of intent, second review, p. 65)."

The impact of the floating Egyptian pound and raising interest rate

The following figures look at both the floating of the Egyptian pound against the dollar and the raising of the interest rate, and how they negatively affected the objective of reducing the budget deficit:

1- The impact of floating the Egyptian pound on the public budget:

"Every pound falling against the dollar imposes a net burden of 3 billion pounds on the initial balance" (Financial statement 2018-19, p. 52),[2] which is due to subsidies for goods imported by the Government (mainly petroleum and food items).

Accordingly, the bill for subsidizing petroleum products has inc

reased from 51 billion Egyptian pound in 2015-16 to 115 billion in the following year[3] (Ministry of Finance, December 2017, p. 28).

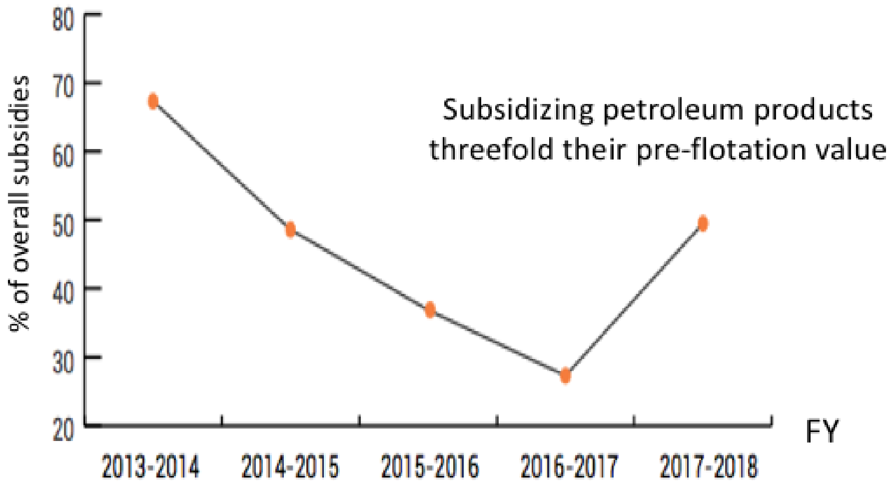
Figure 3 shows how the fuel subsidy bill gradually decreased before the flotation (most of the decrease owes to lower global oil prices) and how this bill doubled as a result of flotation.

1 Interest payments are not the only indicator that has deteriorated following the implementation of the Fund's program. A large number of the objectives of the Fund program that has not been achieved, and whose indicators had been better before (in 2015-16, The general crisis of the Egyptian economy), such as the volume of energy-targeted subsidies, and government wages that have fallen significantly below global rates, and many others, most notably inflation. This brief refers to some of these indicators.

2 The effect is greater on the total deficit (i.e. if we add interest to external debt).

3 The government floated the Egyptian pound in November 2016, four months after the start of the fiscal year on 1 July 2016.

Figure 3: Petroleum subsidies as a percentage of total subsidies



Source: Ministry of Finance data, Egyptian Initiative for Personal Rights (EIPR) calculation.

The rise of the dollar exchange rate against the Egyptian pound has led to an increase in public debt payments. Public debt also increased by more than expected in 2016, as shown in Table 1.

Table 1: The size of debt in the budget sector, a comparison between the first and second reviews of the Fund's experts

	Billion Egyptian pound	of GDP %
(Debt (first review	3,623	104.5
(Debt (second review	3,773	108.5

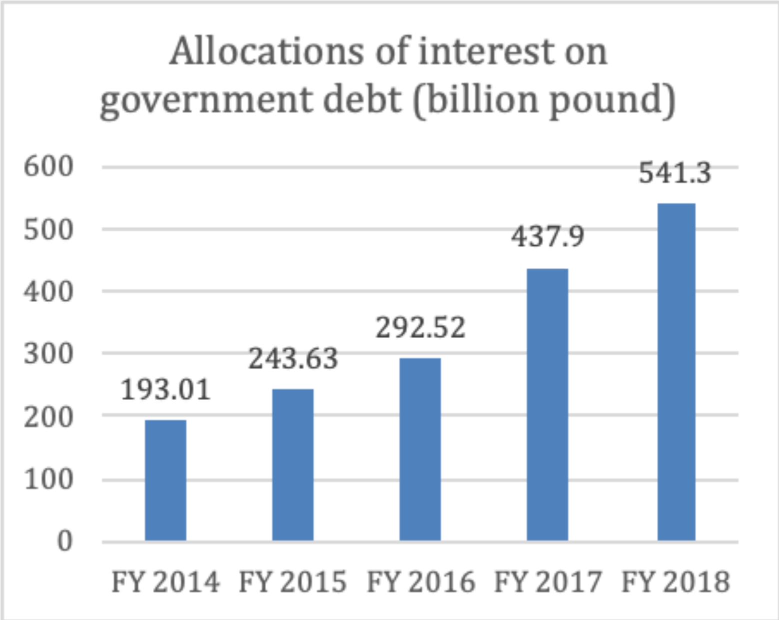
Source: IMF, 2018, p. 8.

2- The impact of increasing the interest rate on the general budget

The IMF imposed an increase in the interest rate of 300 base points in conjunction with the floating of the Egyptian pound (IMF, 2016, p. 9). Then in the following year, it was increased twice in a row at a total of 400 base points (IMF, 2018, p.8).

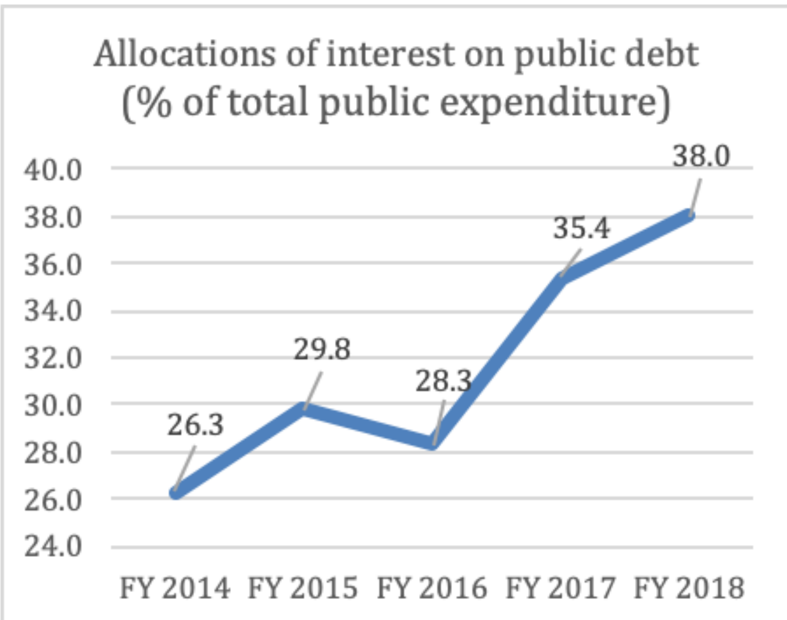
This has led to higher government borrowing costs, which meant further shrinking of the fiscal space – already limited – for other government spending. The general budget deficit (as a percentage of GDP) has also increased by 4 percentage points from what was initially aimed for following the first review (IMF, 2018, p.8). In fact, the rise in the interest rate led to a rise in the interest bill of the governmental debt by 0.5% of GDP (ibid.). “The higher than expected interest rates pushed the overall deficit beyond targets, in spite of considerable off-setting measures” (IMF, 2018, p. 4).

Figure 4: Allocations of interests on public debt (in billion Egyptian pound)



Source: Ministry of Finance.

Figure 5: Interest payments on public debt as a percentage of overall expenditure

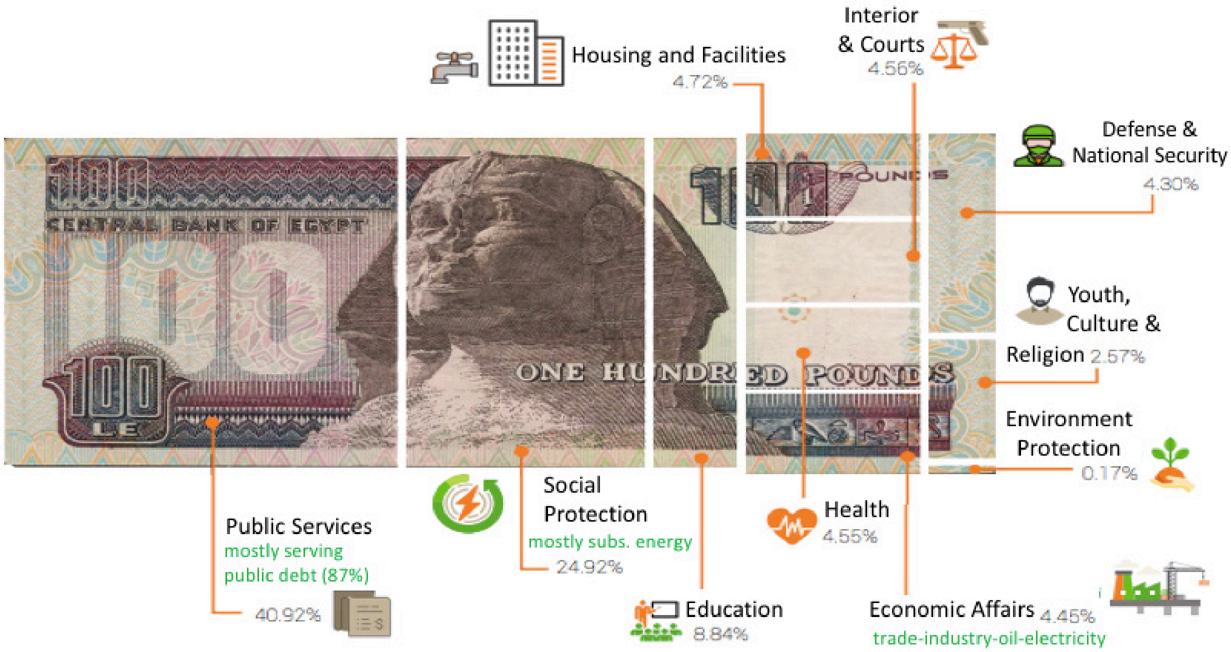


Source: Ministry of Finance.

Figures 4 and 5 show how interest payments on the public debt doubled, compared to figures before the implementation of the IMF program. This has taken up an increasing share of government spending that reached nearly 40% of public spending.

Figure 6 shows how the relative shares of other sectors have diminished, compared to the public services sector (80% of which account for interest payments).

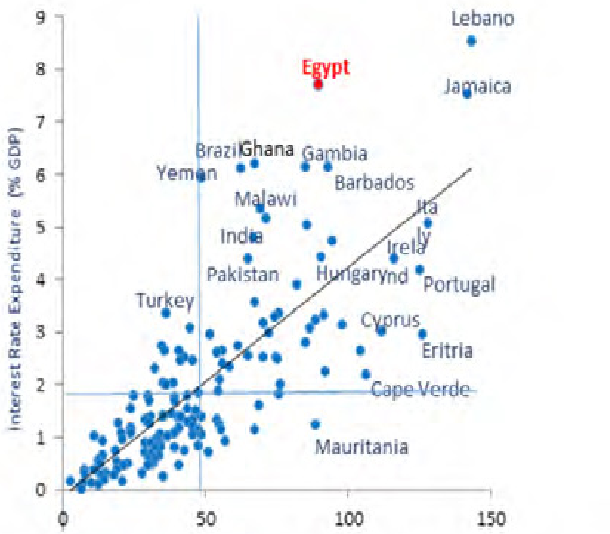
Figure 6: government expenditure by function (FY 2017-18)



Source: Ministry of Finance data.

It should be noted that the increase in interests on public debt was implemented despite the fact that Egypt is already suffering from one of the highest levels of public debt burden, according to World Bank data for 2015, that is, before the implementation of the IMF program (Figure 7). It would have been more feasible to examine the causes for the rise in interest payments, in order to remedy them and cast off some additional burden of the general budget.[4]

Figure 7: An international comparison between interest payments and the volume of public debt (both as a percentage of



GDP)

Source: World Bank, unpublished data, 2015.

4 IMF experts have not conducted a study to analyze the causes behind Egypt experiencing higher interest rates than other countries with the same volume of public debt. Hence, in the absence of any detailed data declaring the holders of Egyptian public debt securities, and in light of the concentration of wealth in the hands of the top 1% of the population, particularly in the hands of the what the World Bank calls "the politically connected" investors, it is likely that the increase is due the concentration of those securities in a few public and private banks, as well as the crony capitalism. There is a need for more studies on the ownership of the public debt and its relationship with the higher interest rates in order to rule out any trace of "hijacking" the public debt by an influential minority seeking to obtain extraordinary rents as a result of said concentration.

3- Social and distributional impacts of interest rate increase

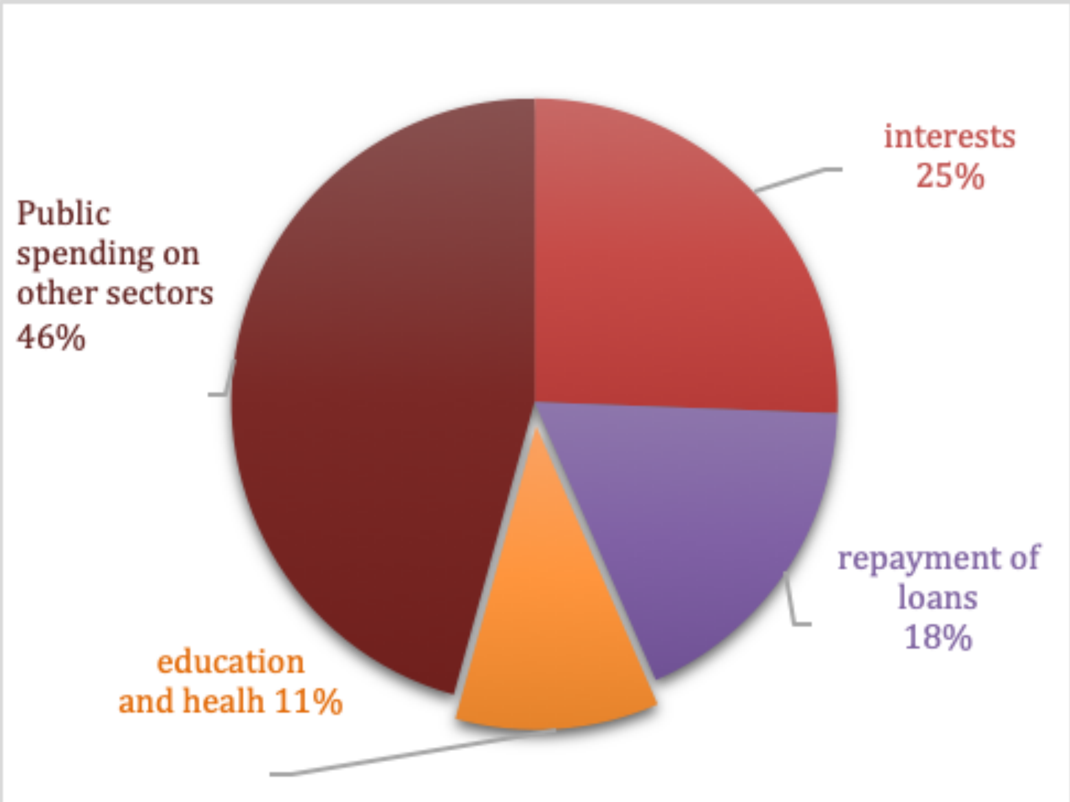
Targeting initial deficit and crowding-out effect

The IMF chose the primary deficit indicator as a measure of fiscal consolidation. The primary deficit is defined as overall revenues minus overall expenditures (excluding interest payments).

The program aims to reduce the primary deficit by four percentage points relative to GDP over the next two years. This is achieved "by the declining wage and energy subsidy bill, and higher revenue from VAT receipts, excises and fees on government services" (IMF, 2018, p. 48). All of these measures, and judging by their application, are socially unjust.

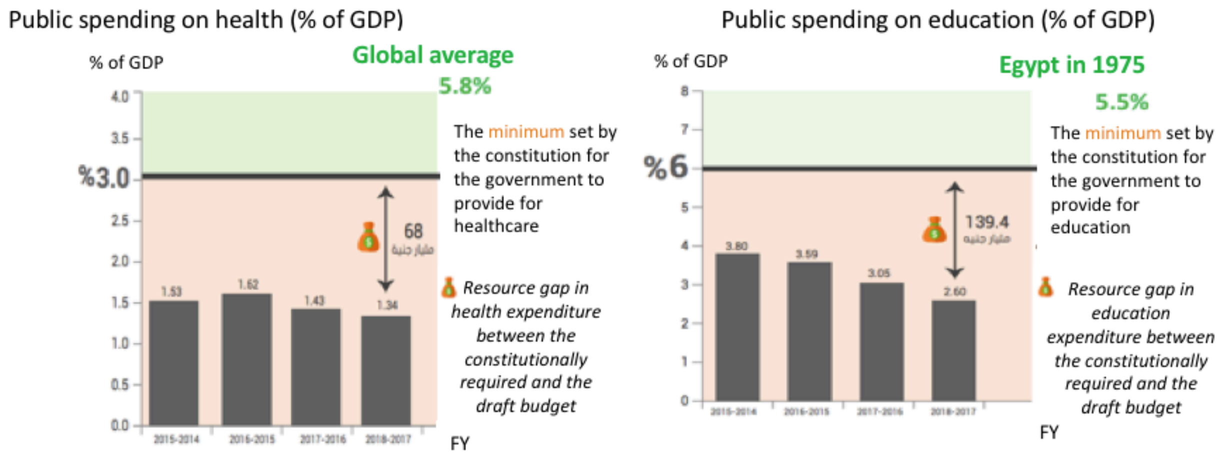
The choice of these measures would end up with the government reducing all other items so that it could meet interest payments. This results in what is known as the crowding-out effect, whereby the first sectors to be affected are social services, especially education and health, as illustrated by the Figure 8.

Figure 8: Crowding-out effect: the health and education share of overall public expenditure, compared to debt service (2017-18)



The value of the interests on debt is 400 billion Egyptian Pounds, that is double the necessary amount for the government spending on pre-university education, university education and health – all combined – to reach the minimum stipulated by the constitution. In addition, expenditure rates are moving away from their historical levels and also from the global average (Figure 9).

Figure 9: Egypt is moving away from the constitutional minimum spending on education and health



Source: Ministry of Finance, World Bank, EIPR accounts.

Distributional impact of high interest rate

Higher interest rates result in a redistribution of income favoring the wealthiest. In his book “Capital in the Twenty-First Century”, Thomas Piketty (2013) explains how, instead of the rich paying taxes and thereby reducing the budget deficit, the rich lend the government in return for rents with which they increase their incomes and accumulate more wealth.

The government is the largest borrower from Egyptian banks. Therefore, according to the calculations of the investment bank Multiples Group[5] each 1% increase in the interest rate is equivalent to additional 16-20 billion Egyptian Pounds in interest payments on public debt. These rents are not generated through entrepreneurship, nor by merit, yet, they flow to whoever has surpluses – banks and savings owners, leading to further deepening of inequality in wealth and in income.

Egypt ranks third in terms of highest inequality in wealth in the world (Credit Suisse, 2017). It also suffers from significant inequality in income, with the Gini coefficient estimated at 0.54 (Facundo et al., 2017), wherein the share of the top 10% amounts to 49% of GNI (Facundo et al., ibid.).

Inflation and impact on poverty

There is an expected negative impact on poverty rates in Egypt due to high inflation during the last two years. Inflation is expected to continue rising this year of 2018, as the IMF projects it to reach 21% (IMF, 2018, p. 48), although it had expected in 2016 one-off cycle of floating-induced high inflation that would soon drop from the double-digits to single-digit level (IMF, 2016, p. 8).

5 Omar ElSheneity (2017), “How not to decrease inflation,” ElSheneity’s official website: http://www.omarshenety.com/2017/05/how-not-to-decrease-inflation.html

The IMF explains the rise in inflation by the interaction of three factors (IMF, 2016, p. 8):

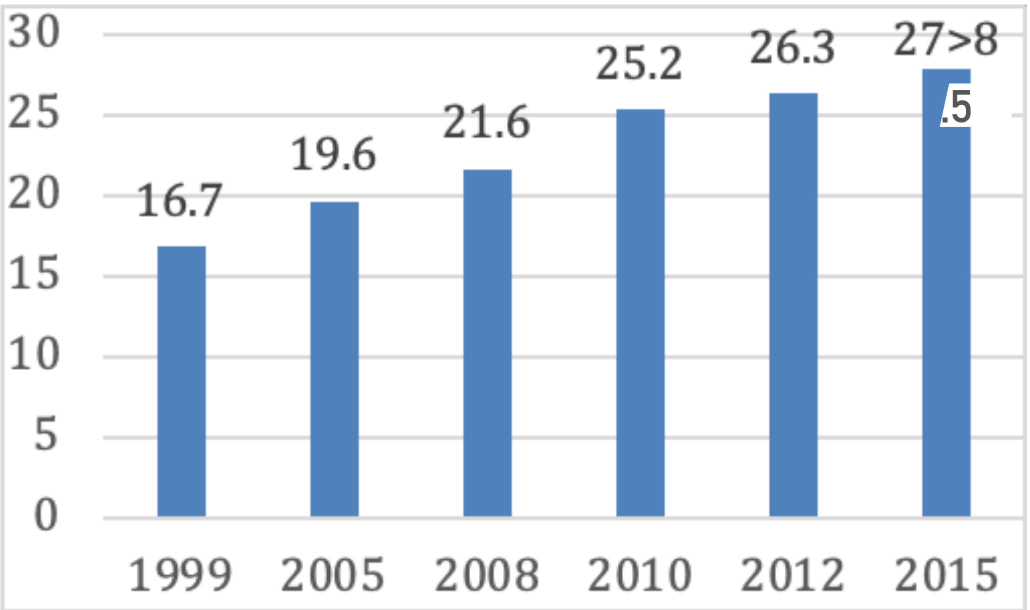
- Depreciation of the Egyptian pound
- Raising the prices of fuel and electricity
- Imposing VAT and increasing its rate and increasing excises.

These are in addition to a fourth factor (not mentioned by the IMF) which is the increase in the budget deficit.

Despite these socially harsh measures, neither the World Bank and the IMF nor the Egyptian government has assessed the compound impact of these factors on poverty.

An unpublished official study has estimated that poverty rates are expected to increase to cover 35% of the Egyptian population (compared to 27.5% in 2015). Assuming that the salaries stay fixed, the study assessed the impact of the decisions to raise electricity prices and to impose VAT, and with prices rising by only 15% and not more, it found that the proportion of the poor will reach 35% (Al Shorouk, 2016).

Figure 10: Rising official poverty rate



Alternatives

These policy brief shows the effects of relying exclusively on monetary policy. This was especially striking with the policy raising the interest rate to achieve a deflationary effect as a temporary measure to reduce the inflation rate resulting from the depreciation of the local currency and the increase in electricity and fuel prices.

It should be noted that the Egyptian government is in the process of a new cycle of increase, and that there are high risks due to further potential fall in the value of the Egyptian pound (IMF, 2018).

The proposed alternative is to achieve the same effect of reducing inflation through fiscal (taxation) policy.

The increase in taxes reduces the budget deficit, and therefore inflation. That increase however must be carefully designed as to only limit rent-seeking activity without affecting growth and job creation, which can be achieved by:

- The imposition of progressive taxes on higher incomes, especially those generated through rents (investment in government debt securities, sale of land and real estate, profits resulting from the sale of all companies or large shares of them). This would discourage the demands by the wealthy who are more likely to consume imported goods (the most significant sources of price increases).

- Taxation of unexploited wealth such as closed property or plots of land, or wealth that was not generated through risk-taking or effort, such as those passed on through inheritance, or the generous gifts granted by the wealthy to their children (such as apartments and dowry at marriage).

The impact of such taxes on growth is positive, because they redirect wealth from low-value-added investment behaviors (real estate and financial investment) to productive investment with higher value added. They also have a positive impact on the fight against inequality and enhance the redistribution of wealth, thereby strengthening social stability.

In short, the alternative is to collect taxes – and then reduce the deficit and inflation – from the pockets of those who currently own the government debt, instead of increasing their wealth – and deficit, and inflation – by requiring the state to borrow from them.

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