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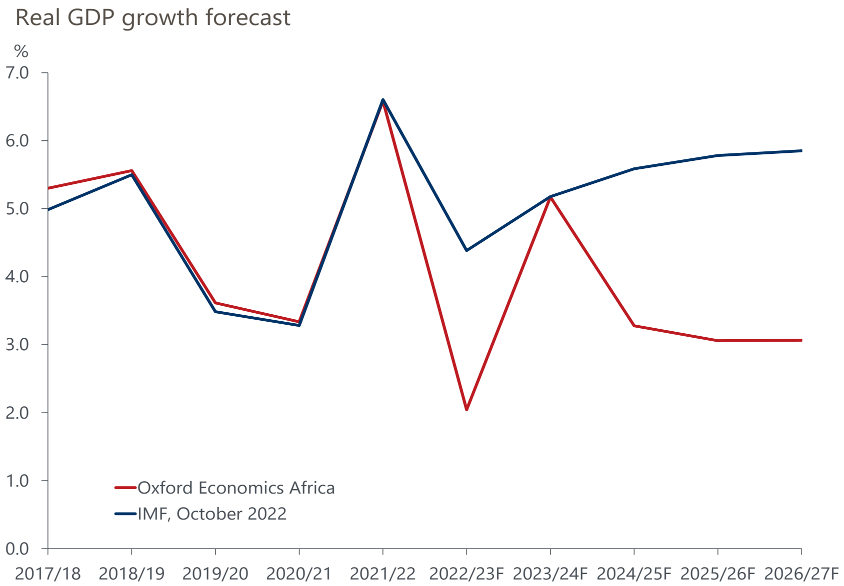
Research Briefing | Egypt

Will another IMF loan solve Egypt's problems?

- **Egyptian authorities met with IMF staff on the sidelines of the IMF and the World Bank annual meetings held in Washington over October 10 - 16 to discuss the soon-to-be-announced economic reform package. A statement released by IMF Spokesperson, Gerry Rice, notes that the Egyptian authorities had held "*very productive in-person discussions*" and a Staff-Level Agreement is expected to be reached "*very soon*". The loan would be the fourth engagement with the multilateral institution since 2016, potentially taking the funds borrowed to over $20bn, begging the question of whether another IMF loan will really solve Egypt's economic problems? Our conclusion: it will help, but it is not the cure. Political will to stick with the reform agenda, which has been lacking following previous IMF commitments, is needed.**
- **The latest press release from the IMF gives an idea of the key policy areas expected to be on the reform agenda, and not much has changed. Fiscal consolidation, safeguarding public debt sustainability, currency flexibility, enhancing the private sector, reducing the role of the state in the economy, et cetera – we've heard it all before. Progress has been made in some of these areas, but it has been very slow in others.**
- **Too often we have seen a pickup in enthusiasm towards the reform agenda in the run-up to IMF deals, followed by a loss in momentum thereafter. If the Egyptian authorities really want to solve their economic woes, they need to remain committed to the reform agenda, regardless of whether an IMF deal is in the picture or not.**
- **Another IMF deal will certainly give renewed impetus to the reform agenda, which is essential for restoring investor confidence and opening the floodgates for loans from other creditors. It will also give the external position a much-needed boost, but it will not plug Egypt's huge external financing shortfall, which is estimated at around $40bn this year.**

Chart 1: Our forecast for medium-term real GDP growth is much weaker than the IMF's



Sources: Oxford Economics Africa, IMF World Economic Outlook

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The areas of policy reform

The [recent IMF statement] notes that IMF staff and Egyptian authorities had made "*substantial progress on all policies*" during the negotiations. These policy areas include:

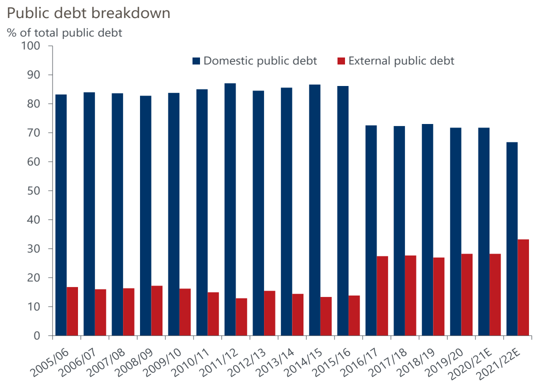
- **A continued path of fiscal consolidation:** This will safeguard public debt sustainability and ensure a steady decline of the debt-to-GDP ratio over the medium term.
- **Other fiscal and related structural policies:** Expanding the social safety net for the most vulnerable, improving the budget composition and enhancing fiscal transparency.
- **Monetary and exchange rate policies:** These policies will anchor inflation expectations, improve monetary policy transmission, improve the functioning of the foreign exchange market, and bolster Egypt's external resilience.
- **A comprehensive structural reform agenda**: These reforms will focus on enhancing the competitiveness of the economy, reducing the role of the state in the economy, levelling the playing field for the private sector, improving the business climate, and fostering the transition towards a greener economy.

These reform areas are not new and have been a key feature of the previous deals signed with the IMF since 2016. Below, we examine the progress made in these reform areas over the years, as well as what we can expect from a policy perspective going forward.

Safeguarding public debt sustainability

Since 2016, when Egypt entered a three-year Extended Fund Facility (EFF) economic programme with the IMF, it has made strides in cementing its pathway to fiscal consolidation. The fiscal deficit narrowed by 4.6 ppts to 7.4% of GDP over the 2015/16 FY - 2020/21 FY period, thanks to measures, such as slashing energy subsidies, modernising the VAT system, and simplifying the business tax regime. The implementation of a Medium-Term Tax Revenue Strategy, which seeks to improve tax policy and administration, is also ongoing. Progress has also been made on reducing public debt as a percentage of GDP: Gross government debt (which includes domestic public debt and external public debt) gradually declined to 96% of GDP in 2019/20 FY, from 110% of GDP in 2015/16 FY. Around 72% of this is public domestic debt (debt owed to creditors inside the country), while the remaining 28% of this is external public debt (debt owed to creditors outside the country).

Chart 2: Public domestic debt accounts for the majority of gross government debt



Sources: MOF, CBE & Oxford Economics Africa

That said, the IMF's ex-post evaluation of the 2020 Stand-By Arrangement (SBA), published in June 2022, highlights that while Egypt's public debt was viewed as sustainable for the duration of the SBA, the Fund acknowledges that there is high uncertainty around the baseline forecasts, and that it had increased its medium-term projections for public debt compared to the initial SBA request in 2020. The latter baseline saw the public debt-to-GDP ratio increasing to between 87% and 93% over the programme period before declining to a range of between 75% and 80% by 2026. The downside risks to this baseline have, however, materialised since the onset of the Russia-Ukraine war, which has exposed Egypt's vulnerability to external shocks and changes in emerging market (EM) sentiment. A faster-than-expected path towards monetary policy normalisation by advanced economies, coupled with tighter financial conditions, has seen Egypt experiencing $22bn in foreign outflows since the start of the war. This together with an inflated import bill (against the backdrop of elevated global commodity prices) has exacerbated the drawdown on foreign reserves and raised concerns around Egypt's ability to service upcoming external public debt commitments – which has resulted in Egyptian authorities seeking more external public debt.

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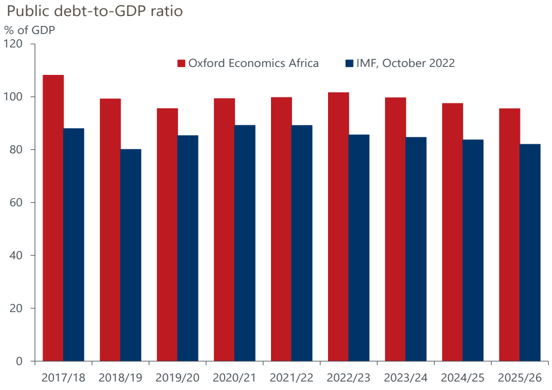
Chart 3: Public debt-to-GDP ratio is unlikely to fall below 80% by 2026



Sources: Oxford Economics Africa, IMF World Economic Outlook

Although we expect the public debt-to-GDP ratio to follow a downward path over the medium term, our forecasts suggest that it is unlikely that the ratio will fall below 80% of GDP by 2026. Rather, we see this figure coming in closer to 95%. This reflects our weaker medium-term real GDP growth forecast compared with the IMF, but also a slight difference in our definition of external public debt (we include the CBE's external debt stock, which includes Gulf deposits to the central bank).

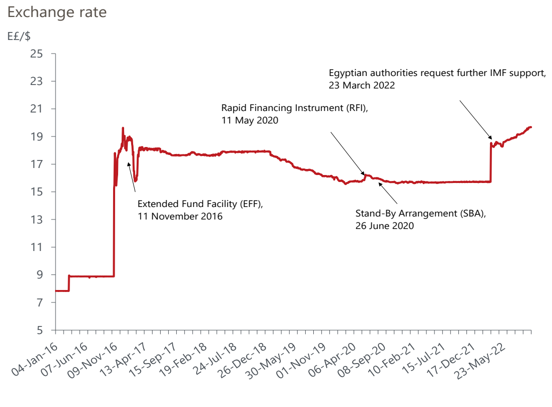
Against a backdrop of slowing medium-term real GDP growth and robust government demand for foreign debt, we think that fiscal consolidation reforms aimed at freeing up fiscal space for government spending, while increasing revenues, will be crucial for reducing the public debt burden. Meanwhile, structural reforms which promote the private sector will also be essential for boosting economic growth and placing the debt-to-GDP ratio on a downward path.

We expect these to be at the centre of the soon-to-be-announced IMF programme. The Medium-Term Debt Strategy, which was adopted by the Ministry of Finance in 2021 and outlines Egypt's debt strategy for 2020/21 FY through 2023/24 FY, will also provide the foundation for debt-related reforms. Under this strategy, Egypt has successfully lengthened its debt maturity profile, while other planned measures include diversifying funding and assessing & minimising the risks of state-owned enterprises (SOEs) and capital projects.

"Drip" depreciation or an abrupt devaluation?

Finance Minister Mohamed Maait noted on October 13 that Egypt is "*ready to make the Egyptian pound exchange rate flexible, if necessary*", especially against the backdrop of ongoing dollar strength. We are certain that we will continue to see a weaker Egyptian pound-dollar exchange rate in coming months. The question is more whether the CBE will continue with the slow and gradual depreciation seen since the March devaluation – what some analysts have termed a drip depreciation – or whether we can expect another abrupt devaluation. If past IMF deals are anything to go by, we could possibly see another devaluation of the currency upon the announcement of a new programme. Devaluations have typically followed IMF deals, followed by a shift back towards currency intervention thereafter. This approach threatens to damage investor trust in the local currency unit. However, we hope the CBE's commitment towards long-run exchange rate flexibility will be stronger under the leadership of the new central bank governor, Hassan Abdalla. He is viewed as having a more progressive voice on exchange rate policy than his predecessor Mr Tarek Amer.

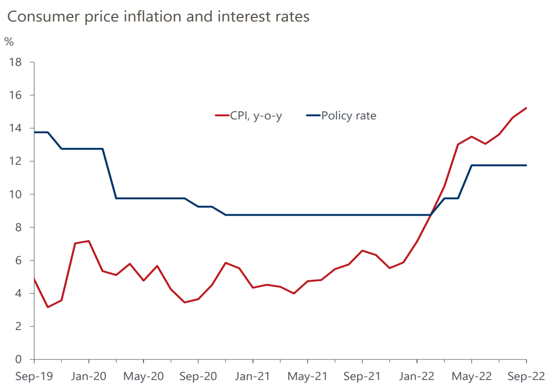
Chart 4: IMF deals are typically associated with increased currency flexibility, followed by intervention



Sources: Oxford Economics/Haver Analytics

If the CBE opts for a drip depreciation, the bank may have a hard time anchoring medium-term inflation expectations, as the passthrough effects of a weaker currency on imported inflation may be dragged out for longer. However, a gradual depreciation post-IMF deal could also signal that the Egyptian authorities may be shifting away from past tendencies to initially accommodate IMF demands (through devaluations) and then backtrack on them at a later stage. A slow but planned shift towards currency flexibility would also limit an initial price shock associated with an abrupt devaluation, and thus reduce immediate risks to social stability.

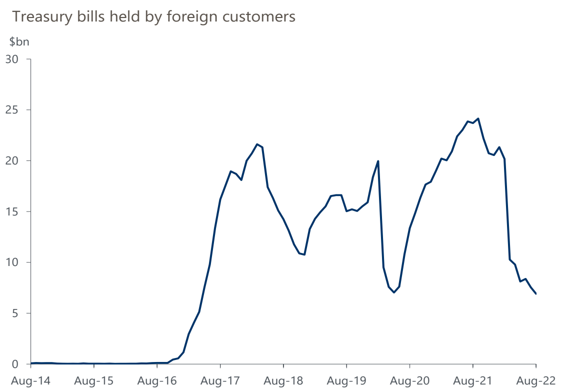
Chart 5: Real interest rates in negative territory



Source: CBE

A backdrop dulled by weak EM sentiment and negative real interest rates also suggests that a devaluation is unlikely to trigger a sudden reversal in capital outflows. This strengthens the case for a drip depreciation amid rising inflation. That said, a devaluation should, in theory, boost export competitiveness and improve the external buffer (i.e., addressing dollar shortages that are driving inflation in the first place). Therefore, the IMF might prefer a significant adjustment in the exchange rate upon approval of the loan – though this is not our baseline.

Chart 6: Foreign demand for Egyptian assets has plummeted since March

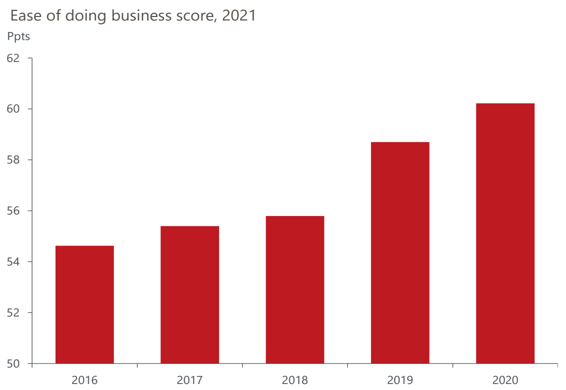


Source: CBE

Promoting the private sector

Increasing private sector-led growth and participation was also a key reform point laid out in the 2016 programme. To achieve this, authorities implemented several reforms to the business climate as demonstrated by an improvement in Egypt's score in the World Bank's Ease of Doing Business index: a 5.6 pts improvement to 60.2 pts over the 2016-20 period. This stems largely from progress made in terms of making it easier to start a business, get electricity, obtain access to credit, and pay taxes. That said, Egypt still ranked 114th out of 200 countries on the index in 2020, indicating that there is still much work to be done.

Chart 7: Business climate has improved, but work still needs to be done



Source: World Bank, where 100 = best score

The state (and the military) maintains a large degree of control over the economy, and the successes of the government's Initial Public Offering (IPO) programme have been limited so far. The five-year IPO programme, which intended to offer shares in state-owned companies in the financial services, oil & gas, petrochemical, and real estate sectors, was announced back in 2016. In 2018, the names of 23 SOEs that would go under IPOs were announced. Following two IPOs in 2019, the plan was postponed due to disruptions to global markets caused by the Covid-19 pandemic. This crushed hopes of at least 14 companies going public in 2020. The plan made a slow comeback in 2021, with two IPOs, one technical listing, and one stake sale as part of the state privatisation programme.

In May 2022, it was also announced that plans to list at least six government companies on the stock exchange by June 2022 would be delayed for another three to four months following the onset of the Russia-Ukraine war, which sent global financial markets into disarray. In that same month, the government announced that it intended to attract around $40bn in investment over the next four years by withdrawing from certain sectors and increasing the private sector's share of overall investment to 65% from 30% currently.

We initially had our doubts around this plan, largely because we have heard these promises before, but the progress on this front makes us more hopeful. In September, it was revealed that the Egyptian Exchange (EGX) is in "*advanced talks*" with five or six private companies wishing to list on the exchange. Minister of Planning Hala El-said also noted that a pre-IPO fund had been established to restructure state-owned assets and prepare them for stake sale. The government plans to transfer up to $6bn in assets to this fund in coming months. The pre-IPO fund is not only preparing company shares for sale on the EGX though. It is also selling shares to strategic investors, mainly Gulf sovereign funds & investors, prior to their listing on the EGX, in what is termed "*bloc sales*".

While the exit of the government from core economic sectors is key for boosting private sector growth, we have some concerns around the way in which this agenda is being pursued. By selecting investors through privately negotiated transactions, the government may be selecting buyers, especially in Gulf countries, with whom it has political connections. This raises issues around transparency, and whether the SOEs are being sold to the most efficient private sector buyer. This also places the future financial viability of these companies – many of which will no longer benefit from state resources for the first time – into question, which might have implications for employees.

There is also abundant evidence suggesting that privatisations of state-owned companies often tend to be under-priced. Dewenter & Malatesta (1997) note that "*political objectives suggest that government officials have stronger incentives to under-price IPOs and they do to a greater degree*". Whether selling shares at discount, building support for a broader programme of privatisation, or seeking to benefit indirectly from under-priced shares and allocating them to political allies, the incentives are bountiful.

Lastly, speaking to the government's broader plan of attracting foreign direct investment (FDI) into the private sector, through for example, foreign acquisitions of private companies, we would caution against the risk of "*fire sales, adverse selection and leverage*". These are three concepts which the IMF warns against in a piece which questions whether FDI is always beneficial for developing countries:

FDI is not only a transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms – that is, it is a corporate governance mechanism. The transfer of control may not always benefit the host country because of the circumstances under which it occurs, problems of adverse selection, or excessive leverage.

Political will is the cure

Most of the structural reform areas highlighted in the IMF's recent statement have been on the agenda for many years. While progress has been made in some areas, it has been frustratingly slow in others. Nonetheless, the finalisation of the upcoming deal will give renewed impetus to these reform points. It also signals that the Egyptian authorities are still open to a liberal shift in economic policy, which is crucial for restoring investor confidence. This could serve as a gateway for more funding from other creditors. A decent financial package will also give the external position a much-needed boost. That said, some media sources have suggested that the package under negotiation will range between $3bn and $6bn, which will not go very far in covering the external financing shortfall that is estimated at around $40bn this year. We would, however, caution Egyptian authorities against relying solely on IMF deals as a signal of their commitment to policy reform. **This will be their fourth engagement with the multilateral institution since 2016, and certainly not the first time that public debt sustainability, exchange rate flexibility and privatisation have made it onto the agenda.** To really solve Egypt's economic woes, the Egyptian authorities need to prove that they are committed to pursuing these reforms, regardless of whether an IMF loan is in the picture or not. Too often we have seen these reforms fall off the radar during the good times – when portfolio inflows are soaring, and FX reserves are surging. Those would have been the best times to push forward the reform agenda. Now, times are tough, not only for the Egyptians but for the rest of the globe as well, meaning that Egyptian authorities have lost bargaining power and the stakes are higher.