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## BROOKINGS

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# EGYPT'S IMF PROGRAM: ASSESSING THE POLITICAL ECONOMY CHALLENGES

BESSMA MOMANI<sup>1</sup>

On November 11, 2016, the International Monetary Fund (IMF) and Egypt signed a \$12 billion loan agreement with the aim of “addressing macroeconomic vulnerabilities and promoting inclusive growth and job creation.”<sup>2</sup> Prior to the IMF program, these vulnerabilities included an overvalued exchange rate (and the corresponding rise of a parallel, or black market, exchange rate); foreign exchange scarcity, which severely undermined private sector activity; a dramatic drop in foreign exchange reserves; large fiscal deficits; and a high level of public debt.

Accordingly, key features of the IMF’s three-year Extended Fund Facility (EFF) program have included the liberalization of the exchange rate regime (i.e. floating the Egyptian pound), fiscal consolidation to lower budget expenditures, tax increases, deep structural reforms, and lifting business regulations to spur economic growth. The EFF program was also expected to secure an additional \$3 billion from the World Bank, \$1.5 billion from the African Development Bank, and \$6 billion from bilateral donors.

While the program has technical merits, critical political challenges to its implementation remain, and thus it may fall well short of its goal to lay a foundation that can help transform the Egyptian economy. Lack of investor confidence in President Abdel-Fattah el-Sissi’s government may also upend the IMF-Egypt agreement.

This policy briefing assesses major elements of the IMF-Egypt program by drawing on interviews with key stakeholders.<sup>3</sup> It argues that Egypt must enact key structural reforms in order to meet the goals of strengthening the business climate, attracting investment, and increasing employment, in particular among youth and women. Following a discussion of Egypt-IMF relations, the briefing offers suggestions for how Egypt can more effectively achieve these goals and deal with the political economy issues that threaten to undermine the program’s economic strategy.

## BACKGROUND TO EGYPT-IMF RELATIONSHIP

Leading up to the 2008 international financial crisis and the 2011 Egyptian revolution, Egypt undertook significant structural reforms to facilitate economic growth. Although these reforms had some significant success in increasing economic growth, the government failed to tackle head-on the issues of poverty, high unemployment (especially among women and youth), inequality, and corruption. Such issues were among the main factors behind opposition to the Hosni Mubarak government in 2011. Following the Egyptian revolution, political and regional developments continued to undermine Egypt’s economy. With fewer tourists and less income from the Suez Canal (due to the stagnating global economy), economic growth slowed.

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<sup>2</sup> International Monetary Fund (IMF), “Arab Republic of Egypt: 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,” Country Report No. 17/17, January 2017, 7, <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>.

<sup>3</sup> The author conducted interviews with IMF and World Bank staff, private sector analysts, business people, and poverty activists, most of whom preferred to remain anonymous. The interviews took place in Cairo, Aswan, and Luxor in Egypt and Washington, D.C. in the United States in 2016 and 2017.

Moreover, the government increased public debt to fund its expenditures, but failed to address underlying structural challenges, thus leading to the build-up of macroeconomic imbalances.

As the political climate worsened after the January 25, 2011 revolution, Egypt's long-standing structural challenges—including high public debt, poorly targeted subsidies, a growing public sector wage bill, over-reliance on food imports, and an overvalued currency—pushed the country to consider an IMF loan agreement. Egypt previously relied on external benefactors, namely Saudi Arabia, the United Arab Emirates (UAE), and Kuwait, to finance its budgetary shortfalls and provide liquidity support to the Central Bank of Egypt (CBE). Saudi Arabia contributed nearly \$25 billion to the Egyptian economy between 2013 and 2016.<sup>4</sup> But the Gulf States could not be expected to prop-up Egypt's economy indefinitely without structural reforms.

By mid-2016, as an acute foreign exchange shortage began crippling Egypt's economy, particularly the manufacturing sector, Cairo formally sought an IMF agreement. Yet, as a precondition to securing IMF approval, Egypt needed to raise \$6 billion in external funds, which it did thanks to financial support from the UAE, China, and the G7. Notably, Saudi Arabia, though it had previously supported Egypt, did not contribute to these funds due its disagreement with statements made by President el-Sissi in support of Syria's President Bashar al-Assad.<sup>5</sup>

The three-year \$12 billion IMF loan to Egypt was packaged with a reform agenda that focused on three key areas: monetary, fiscal, and structural reforms. Monetarily, Egypt was to transition to a flexible exchange-rate regime (in which market forces would determine the exchange rate) and contain inflation. Most significantly, this entailed floating the Egyptian pound (EGP). Fiscally, the country was to reduce public debt by cutting fuel subsidies while expanding spending on vulnerable groups like youth and women. Structurally, Egypt was to streamline industrial licensing, provide financing to small and medium-sized enterprises (SMEs), decriminalize insolvency, and simplify bankruptcy laws (see Table 1).<sup>6</sup> At the insistence of Managing Director Christine Lagarde, the IMF agreement included measures to support women and children through increased funding for daycares and school meals, combined with policies aimed at making public transportation safer and more accessible for women.<sup>7</sup>

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<sup>4</sup> "Shifting Sands: As Egypt Quarrels with Saudi Arabia, It Is Finding New Friends," *The Economist*, November 25, 2016, <https://www.economist.com/news/middle-east-and-africa/21710912-series-incidents-has-disrupted-relationship-between-arab-worlds>.

<sup>5</sup> Nour Youssef and Diaa Hadid, "'We Don't Owe Anyone': Egypt Jousts With Its Chief Benefactor, Saudi Arabia," *The New York Times*, November 1, 2016, <http://www.nytimes.com/2016/11/02/world/middleeast/egypt-saudi-arabia.html>.

<sup>6</sup> "Online Press Briefing on the Release of the Staff Report on Egypt's Request for and IMF Extended Fund Facility," IMF, January 18, 2016, <http://www.imf.org/en/News/Articles/2017/01/18/tr01182017-Transcript-Online-press-briefing-on-the-release-of-release-of-the-Staff-Report-on-Egypt>; IMF, "Arab Republic of Egypt: Request for Extended Arrangement."

<sup>7</sup> IMF staff member, interview with author, Washington, D.C., April 2017.

Table 1: Conditions of IMF's 2016 Loan to Egypt

	Economic issues	IMF 2016 Extended Fund Facility Conditionality	What Egypt implemented
<b>Monetary</b>	Shortage of foreign exchange and low reserves	Exchange rate liberalization	Introduced a market-determined exchanged rate system
		Limit increases in the money supply	
	Fixed exchange rates	Contain inflation and bring down to mid-single digits over medium term	
<b>Fiscal</b>	High government deficit and public debt	Strengthen government revenues	Parliament passed the valued-added tax (VAT)
		Energy subsidy reform: cuts in fuel	Energy prices raised in November 2017 and June 2017
		Control the public sector wage bill	
	Strengthening social protection programs	Food subsidies to expand the coverage of Takaful and Karama	The government cut food subsidies
		Increase social spending amounting to about 1 percent of GDP	
		Vocational training for youth	
		Cover subsidized transportation for children, infant formula, and children's medicines	Government rolled out its program and increase for spending
		Set up free school meals	
<b>Structural</b>	Low growth (2.5) and high unemployment (12.7)	Streamline industrial licensing system	Legislation on investment law ratified
		Facilitate access to finance for small and medium-sized enterprises	
		Reform bankruptcy law	
		Make it easier for women to go into the workforce by increasing public nurseries	
		Improve safety of public transportation	

It is important to recall that “Egypt’s economic and developmental ills did not begin after the revolution; they accumulated over previous decades and in fact contributed to the circumstances that brought about the revolution and its demands.”<sup>8</sup> The IMF-Egypt program that is examined in this policy briefing, moreover, is just the latest round in the institution’s dealings with Egypt. These have long focused, in particular, on policies aimed at reducing inflation, controlling debt, and encouraging investment and liberalization, as evidenced by IMF structural adjustment policies starting in the 1980s. According to Mohamadieh:

Statistics from 1996 to 2009 illustrate the consequences of these policies.

During these years, annual real economic growth ranged between 2.8 and 6.4 percent in Egypt, but productivity only grew between 0.3 and 3.7 percent on average. The labor force stagnated at around 44 percent of the active population, mainly due to the low participation of women. Unemployment remained close to 10 percent, with much higher rates among women and youth. ... Thus, while Egypt’s economy appeared to grow, inequalities and poverty were increasing.<sup>9</sup>

The parallels between past and present IMF policies in Egypt are evident: they emphasize the pursuit of economic growth while overlooking (and hence exacerbating) the pressing political

<sup>8</sup> Kinda Mohamadieh, “Egypt & the IMF: Conditions as Usual,” Middle East Institute, June 27, 2013, <http://www.mei.edu/content/egypt-imf-conditions-usual>.

<sup>9</sup> Ibid.

economy challenges involved in its pursuit. Egypt may well fall into the same trap again if it does not make key structural reforms to mitigate the constraints and concerns that threaten the successful implementation of the EFF.

## POLITICAL ECONOMY CHALLENGES AHEAD

Despite its aim to right Egypt's macroeconomic imbalances, the IMF-Egypt program nonetheless sidelines political economy issues and alienates important socio-political groups. This will likely undermine the program's ability to meet key objectives. Shokr, for example, argues that Egypt's policies will have varying effects on different segments of society:

[L]arge sections of Egypt's variegated middle class will suffer economically, at least in the short term, under the current austerity policies; and those policies benefiting people in the middle and upper classes who are connected to the Egyptian military and its economic activities will accelerate tendencies toward the militarization of the government and its social base.<sup>10</sup>

The El-Sissi government has also silenced opposition voices by jailing activists and members of the Muslim Brotherhood, thus weakening resistance to EFF measures introduced so far, including the floating of the pound.<sup>11</sup> Moreover, the government has blocked over 100 media websites and restricted nongovernmental organizations from activities such as the publication of opinion polls, further curtailing public discussion of government

decisions. With this in mind, the following sections discuss key political economy factors that continue to challenge the effectiveness of the Egypt-IMF agreement.

## *MONETARY REFORMS: THE POUND FLOATS AND INFLATION SURGES*

Before Egypt floated its pound in November 2016, black market activity had surged after decades of relative dormancy. Black market exchange rates had become far more favorable than those at banks. Consequently, individuals and companies with hard currency turned to the black market or held out in anticipation of a possible devaluation. This led to dollar shortages across the country.

In response, the Egyptian government limited dollar transfers abroad, which caused hoarding and a further rise in black market rates. More troublingly, Egyptians working abroad avoided formal banking structures for remittance transfers to their home country because these banks had exchange rates that were far less lucrative than the black market or hawala systems (peer-to-peer transfer of money based on trust).

The IMF saw liberalizing Egypt's exchange-rate regime as key to offsetting these emergent problems, and it did help. Indeed, in the long term, devaluation can also address fiscal imbalances, if managed properly. Egyptian workers' remittances reached \$8 billion in the second quarter of 2017, up by 13 percent.<sup>12</sup> Moreover, as of March 2017, remittances were still rising, bankers were reporting that the

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<sup>10</sup> Ahmad Shokr, "Sisi's Egypt: Building Political Legitimacy amidst Economic Crises," Crown Center for Middle East Studies, Middle East Brief 106, February 2017, 6, <https://pdfs.semanticscholar.org/122b/a2c2862db6011021fec2b3571b4507b96677.pdf>.

<sup>11</sup> Joshua Hammer, "How Egypt's Activists Became 'Generation Jail,'" *New York Times Magazine*, March 15, 2017, <https://www.nytimes.com/2017/03/14/magazine/how-egypts-activists-became-generation-jail.html>.

<sup>12</sup> IMF, "Arab Republic of Egypt: First Review Under the Extended Arrangement Under the Extended Fund Facility and Requests for Waivers for Nonobservance and Applicability of Performance Criteria-Press Release; Staff Report; and Statement by the Executive Director for the Arab Republic of Egypt," Country Report No. 17/290, September 2017, 47, <https://www.imf.org/en/Publications/CR/Issues/2017/09/26/Arab-Republic-of-Egypt-First-Review-Under-the-Extended-Arrangement-Under-the-Extended-Fund-45273>.



currency black market had all but disappeared, and banks were enjoying improved dollar liquidity.<sup>13</sup>

However, inflation, which had fluctuated within a range of 8-15 percent between 2011 and 2016, rose to 22 percent in December 2016. Periods of high inflation are generally expected to accompany devaluations. But the EGP depreciated even more than the IMF had anticipated, possibly in part because of “the Fund’s public statements about an awaited devaluation in the days preceding the float.”<sup>14</sup> Inflation in Egypt remained above 30 percent for much of 2017, “causing deep public concern and hardship.”<sup>15</sup>

To be sure, devaluation has increased the prices of basic consumer goods, including sugar, oil, baby formula, and rice.<sup>16</sup> This, in turn, has caused hoarding of goods and profiteering by unscrupulous vendors. Egypt also remains highly dependent on imported input goods that go into the production of local drugs. With devaluation, medicine prices—some of which are necessary to treat chronic diseases—have risen substantially.<sup>17</sup>

Finally, the EFF emphasized that the liberalization of Egypt’s foreign exchange system would spur investment and exports.<sup>18</sup> Foreign financial and direct investment have risen since the floating of the pound.<sup>19</sup> However, investors still want to see better management of

Egypt’s overall economy. Measures to increase transparency and strengthen Egypt’s public financial management—including efforts to bring investment practices into conformity with international best practices—face obstacles. They may be hampered by the el-Sissi government’s chronic lack of accountability in its spending of public funds, and the persistence of rampant cronyism, which continues to plague the Egyptian political system. Moreover, potential investors are concerned that Egypt’s domestic debt remains at around 95 percent of GDP and its budget deficit in the fiscal year that ended in June 2016 was 12.2 percent of GDP.<sup>20</sup>

#### *FISCAL REFORMS: REVAMPING SUBSIDIES AND ADDING TAXES*

The IMF program aims to address Egypt’s budgetary deficit by reducing government spending, including on subsidies, and boosting revenues. So far, the government has implemented cuts to fuel subsidies in an effort to comply with EFF terms to decrease spending, with the result that in June 2017 fuel prices increased by up to 50 percent.<sup>21</sup> Cuts to fuel subsidies, it was argued, were also needed as they did little to benefit the poor.<sup>22</sup> However, this only seems to have exacerbated the burdens of average Egyptians—many, for example, struggle to manage such a huge increase in fuel prices at a time when the cost of living has risen significantly due to devaluation.<sup>23</sup>

<sup>13</sup> Heba Saleh, “Egypt Attracts Foreign Investment as Currency Falls,” *Financial Times*, March 22, 2017, <https://www.ft.com/content/083a15cc-e248-11e6-9645-c9357a75844a>.

<sup>14</sup> IMF, “Arab Republic of Egypt: First Review,” 4.

<sup>15</sup> *Ibid.*, 1.

<sup>16</sup> Diaa Hadid and Nour Youssef, “Sweet-Toothed Egypt Endures a Sugar Crisis: ‘People Are Going to Snap,’” *The New York Times*, October 20, 2016, <https://www.nytimes.com/2016/10/21/world/middleeast/egypt-sugar-shortage.html>.

<sup>17</sup> Mohamed Hamama, “Egypt’s Health Sector in the Shadow of Devaluation: All Roads Lead to Ruin,” *Mada Masr*, March 24, 2017, <http://www.madamasr.com/en/2017/03/24/feature/politics/egypts-health-sector-in-the-shadow-of-devaluation-all-roads-lead-to-ruin/>.

<sup>18</sup> IMF, “Arab Republic of Egypt: Request for Extended Arrangement,” 3.

<sup>19</sup> Ahmed Feteha, “Egypt Foreign Reserves Surge to Record as Confidence Returns,” *Bloomberg*, August 1, 2017, <https://www.bloomberg.com/news/articles/2017-08-01/egypt-s-net-foreign-reserves-surge-to-record-high-in-july>.

<sup>20</sup> Saleh, “Egypt Attracts Foreign Investment.”

<sup>21</sup> Abdelrahman Adel and Amina Ismail, “Egypt Raises Fuel Prices by up to 50 Percent under IMF Deal,” *Reuters*, June 29, 2017, <https://www.reuters.com/article/egypt-economy-idUSL8N1JQ1G5>.

<sup>22</sup> Samir, “IMF Approves \$12bn Load,” 2016.

<sup>23</sup> Ruth Michaelson, “‘We Want Bread’: Subsidy Cut Sparks Protests Across Egypt,” *The Guardian*, March 8, 2017, <https://www.theguardian.com/world/2017/mar/08/egypt-protests-we-want-bread-subsidy-cut>; Adel and Ismail, “Egypt Raises Fuel Prices.”

Another focus is on improving how Egypt's subsidies are allocated, including through changes to the country's smart card system. Smart cards were introduced in 2014 to help regulate subsidized goods and services, and eliminate corruption in their purchase and distribution.<sup>24</sup> However, though the smart card program is a step in the right direction to help ensure that subsidies reach Egypt's most disadvantaged, interviews with civil society groups in southern Egypt have revealed that many poor, illiterate, and undocumented Egyptians are not able to apply for smart cards.<sup>25</sup> As Egypt has an illiteracy rate of 25 percent and perhaps as many as 7 million unregistered nationals, it is little wonder that "77 percent of the top spending bracket have smart cards entitling them to subsidized goods, while 82 percent of the poor do not benefit from Egypt's social insurance program."<sup>26</sup> The smart card system also continues to be plagued by corruption and fraud.<sup>27</sup>

Moreover, under the IMF plan, smart card holders were granted an increased subsidy of 21 EGP per person (up from 12), but this hardly covered the inflated prices of essential goods.<sup>28</sup> Increases were enacted again in June 2017 to 50 EGP. However, inflation has remained high at around 30 percent, even after declining from its July 2017 peak, thus limiting the benefits stemming from subsidy increases to smart card holders.<sup>29</sup> The Egyptian government has

distributed "gold cards" in its most impoverished areas to those without or on waiting lists for smart cards, but allowances were slashed in March 2017, sparking protests in the poorest parts of Egypt. In response, the government increased quota allowances to gold card suppliers.<sup>30</sup>

In order to help ease the adjustment process brought on by EFF reform, "[a]bout 1 percent of GDP in fiscal savings will be directed to additional food subsidies, cash transfers to the elderly and low-income families, and other targeted social programs," including, for example, subsidies for children's medicine.<sup>31</sup> The government also plans to expand key social safety net programs, including *Takaful* and *Karama*, which have been established in 2015 and will be expanded by 200,000 households in 2017/18.<sup>32</sup> Again, however, it remains to be seen whether such measures will be able to mitigate the adverse impacts of Egypt's high inflation, particularly given Egypt's comparatively low social spending and the El-Sissi government's lack of accountability.

In addition to curtailing overall spending on subsidies, Egypt also reduced public sector expenditures under the IMF agreement in August 2016. Due to wage bill reforms, the public sector wage bill has seen a consistent annual decline as a percent of GDP from 8.1 in 2014/15 to 5.3 in 2017/18.<sup>33</sup> However, reforms

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<sup>24</sup> Eric Knecht, "Baking Bad: Egypt's Dirty Wheat Problem," Reuters, March 15, 2016, <http://www.reuters.com/investigates/special-report/egypt-wheat-corruption/>.

<sup>25</sup> Poverty activists, interviews with author, Luxor and Aswan, Egypt, December 2016.

<sup>26</sup> "The Unregistered," *Al Jazeera*, April 16, 2014, <http://www.aljazeera.com/programmes/aljazeeraworld/2014/03/unregistered-2014331115431285389.html>; Beesan Kassab, "Household Survey Highlights Rise in Poverty, Inequality in Egypt," *Mada Masr*, July 27, 2016, <https://www.madamasr.com/en/2016/07/27/news/economy/household-survey-highlights-rise-in-poverty-inequality-in-egypt/>.

<sup>27</sup> Knecht, "Baking Bad," 2016.

<sup>28</sup> Chris Jarvis, "Protecting the Vulnerable during Egypt's Economic Reform," Montada (blog), IMF, January 18, 2017, <https://blog-montada.imf.org/?p=4648>.

<sup>29</sup> Nadine Awadalla, "Egypt Inflation Dips in August From Record Highs," Reuters, September 10, 2017, <https://www.reuters.com/article/us-egypt-economy-inflation-int/egypt-inflation-dips-in-august-from-record-highs-idUSKCN1BL0S9?il%3D0>.

<sup>30</sup> Neil Ketchly and Thoraya El-Rayyes, "On the Breadline in Sisi's Egypt," Middle East Research and Information Project, March 29, 2017, <http://www.merip.org/mero/mero032917>.

<sup>31</sup> IMF, "Arab Republic of Egypt: Request for Extended Arrangement," 4, 13.

<sup>32</sup> IMF, "Arab Republic of Egypt: First Review," 11.

<sup>33</sup> IMF, "Arab Republic of Egypt: First Review," 2.

to reduce the wage bill were already enacted as part of the 1991 IMF loan agreement, casting doubt on the effectiveness of these latest cuts.

Meanwhile, to increase revenue, the government introduced a value-added tax (VAT) and new fees, in addition to selling telecom licenses and land.<sup>34</sup> The VAT charged 13 percent on most goods and services in FY 2016/2017, and is to be increased to 14 percent in 2017/18. Such policies largely ignore the plight of Egypt's poor. According to a Cairo University statistics professor, Heba al-Laithy, for example, the VAT policy will likely increase the percentage of Egypt's population that is poor (living on less than \$26 per month) from 27.8 percent in 2015 to at least 35 percent.<sup>35</sup> Notably, this comes after Egypt reduced the tax rate for its top income bracket from 25 percent to 22.5 percent in 2015 — a tax break for the richest Egyptians.<sup>36</sup>

#### STRUCTURAL REFORMS AND INCLUSIVE GROWTH

The 2016 IMF program also made changes to business regulations with the intention of attracting foreign investment and helping smaller firms scale up. Before this, starting a business in Egypt was complicated, involving lots of regulations and administrative red tape. Those arrangements squeezed out smaller enterprises and protected larger industrialists, allowing more entry points for corruption at different ministries.<sup>37</sup> A new investment law—another precondition of the IMF loan—minimized

those regulations, but it continues to provide free or highly discounted land for certain projects, which contributes to government corruption and cronyism.<sup>38</sup>

The IMF program's improved bankruptcy laws, currently under review in Egypt's parliament, would simplify bankruptcy and liquidation procedures, and should make it easier for investors to come to the country—as will easing the conditions on industrial licensing.<sup>39</sup> Still, there are doubts that these reforms will be sufficient to attract foreign investment. Three private sector experts interviewed for this brief, for example, believed IMF projections for foreign investment were too optimistic.<sup>40</sup>

According to bankers, foreign investors are concerned about “execution risk.” While IMF monitoring of Egypt's adherence to its economic reform program may inspire confidence in the government's commitment, some still fear that social pressures arising from high inflation, the cap on public sector wages, and subsidy cuts could cause the authorities to let up on reforms.<sup>41</sup> One analyst said IMF monitoring makes Egypt's reforms more credible, but there is some concern that barriers to reform are chiefly political.<sup>42</sup>

Similarly, interviewees believed that IMF projections of 5-6 percent GDP growth in the medium term were too ambitious. Domestically, access to credit remains an issue.<sup>43</sup> While foreign

<sup>34</sup> IMF, “Arab Republic of Egypt: Request for Extended Arrangement,” 56.

<sup>35</sup> Osman El Sharnoubi, “IMF Loan in Hand, Where will the Promised LE25 Bn in Social Spending Be Allocated?” *Mada Masr*, February 23, 2017, <https://www.madamasr.com/en/2017/02/23/feature/economy/imf-loan-in-hand-where-will-the-promised-le25-bn-in-social-spending-be-allocated/>.

<sup>36</sup> “Egypt Enacts Income Tax Cuts, Formally Suspends Capital Gains Tax,” *Mada Masr*, August 24, 2015, <https://www.madamasr.com/en/2015/08/24/news/economy/egypt-enacts-income-tax-cuts-formally-suspends-capital-gains-tax/>.

<sup>37</sup> IMF staff member, interview.

<sup>38</sup> Waad Ahmed, “Investment Between 2 IMF Loans: An Unchanged Philosophy and Challenges to Governance,” *Mada Masr*, March 2, 2017, <http://www.madamasr.com/en/2017/03/02/feature/economy/investment-between-2-imf-loans-an-unchanged-philosophy-amid-challenges-to-governance/>.

<sup>39</sup> IMF staff member, interview.

<sup>40</sup> Private sector analysts, phone interviews with author, Washington, D.C., April 2017.

<sup>41</sup> Saleh, “Egypt Attracts Foreign Investment.”<sup>42</sup> Private sector analysts, interview.

<sup>43</sup> World Bank staff member, interview with author, Washington, D.C., April 2017.

companies have capital, domestic companies remain dependent on local agencies that suffer from Egypt's lack of regulatory transparency, corruption, heavy-handed management of economic concerns, and continuing market inefficiencies, all of which are likely to impede investment and growth.<sup>44</sup>

There continues, in particular, to be investor concern regarding existing agreements between the government and private investors (power purchase agreements, or PPAs). Investors worry that in disputes with local authorities the Egyptian legal system will not be impartial. Egypt's lack of checks and balances became most evident after the April 2017 decision to give the president the authority to appoint heads of judicial bodies, thus further eroding investor confidence in Egypt's judiciary. Consequently, a number of foreign investors who had entered PPAs are leaving Egypt.<sup>45</sup>

More broadly, some investors' hesitation is declining. In May 2017, Egypt sold a higher than anticipated number of Eurobonds (\$3 billion) to North America and Europe, and at lower interest rates than was garnered a few months earlier, which suggests the lessening apprehension of foreign investors.<sup>46</sup> However, as Rachel Ziemba, Managing Director at Roubini Global Economics noted in April, "Egypt's IMF program and devaluation were [a] necessary but insufficient condition to return investor confidence."<sup>47</sup>

Aside from attracting investment, the IMF program seeks to address Egypt's low growth and high unemployment by providing specialized job training programs for youth as well as measures to increase women's participation in the labor force.<sup>48</sup> Numerous studies have demonstrated the economic benefits of having more women enter the labor force, particularly in the Middle East and North Africa (MENA) region, which has the lowest rates of female employment in the formal sector.<sup>49</sup> Yet, a 2013 U.N.-commissioned study found that 86.5 percent of Egyptian women surveyed felt unsafe using public transportation, which remains a key barrier to realizing their full economic potential.<sup>50</sup> EFF measures to enhance safety on public transportation and to provide more public nurseries should help more women enter and remain in the workforce. However, only \$14 million of the \$12 billion IMF loan will be allocated to improving such infrastructure for Egyptian women, a figure that seems unlikely to significantly improve current conditions.

#### *THE WELL-ARMED ELEPHANT IN THE ROOM*

There is one major aspect of Egypt's economy that the IMF program does not address, but will be crucial going forward: the role of the military. Military involvement in the economy was initially undertaken to fill the absence of private investment in Egypt; yet the institution continues to encroach upon the country's economic sectors, and has been cited as another area of concern among investors.<sup>51</sup>

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<sup>44</sup> Saleh, "Egypt Attracts Foreign Investment."

<sup>45</sup> Lin Noueihed and Ola Noureldin, "Egypt's Solar Power Upset Clouds Outlook for Foreign Investors," Reuters, August 4, 2016, <http://www.reuters.com/article/egypt-economy-solar-idUSL8N1AL593>.

<sup>46</sup> Ahmed Aboulenein, "Egypt Eurobond Sale to Cover FY 2017-18 Financing Needs," Reuters, May 24, 2017, <https://www.reuters.com/article/egypt-eurobonds-minister-idUSL8N1IQ6FM>.

<sup>47</sup> Rachel Ziemba (managing director at Roubini Global Economics), interview with author, April 22, 2017, Washington, D.C.

<sup>48</sup> IMF, "Arab Republic of Egypt: Request for Extended Arrangement," 4.

<sup>49</sup> Bessma Momani, "Equality and the Economy: Why the Arab World Should Employ More Women," Brookings Doha Center, Policy Briefing, December 2016, <https://www.brookings.edu/research/equality-and-the-economy-why-the-arab-world-should-employ-more-women/>.

<sup>50</sup> "From Play-Acting to Real-Life Action: A Journey to End Harassment on Public Transit in Egypt," UN Women, February 27, 2013, <http://www.unwomen.org/en/news/stories/2013/2/from-play-acting-to-real-life-action>; Momani, "Equality and the Economy," 2016.

<sup>51</sup> Several Egyptian business people, interviews with author, Cairo, December 2016; IMF staff member, interview.

In 2012, Major General Mahmoud Nasr said that the military's share of Egypt's budget was 4.2 percent and that its enterprises earned \$198 million per year.<sup>52</sup> But this significantly underestimates the scale of the military's involvement in Egypt's economy. As verifiable data is difficult to come by, analysts estimate that the military accounts for anywhere from 5 to 40 percent of Egypt's GDP.<sup>53</sup> As Zeinab Abul-Magd notes:

The Egyptian military owns business enterprises that are in almost every sector and produce an extremely wide area of services and goods. It runs hotels, sea resorts, and apartment buildings along with lavish villas. It owns cement, steel, jeep, fertilizer, home appliances, pasta, and other factories; runs gas stations; and constructs toll highways.<sup>54</sup>

The military's role is not only large, but privileged. In December 2015, President El-Sissi issued a decree "permitting the military to form companies or partnerships for land ownership with local or foreign investors, [and] giving the Armed Forces a share of the revenue when the company is sold and enabling them to retain ownership of the land."<sup>55</sup> Meanwhile, another law exempts nearly 600 military businesses from real estate taxes.<sup>56</sup> Military-run businesses have also received subsidized loans through state-owned banks, distorting market forces.<sup>57</sup>

For many, including potential investors, the array of businesses run by the military is particularly disconcerting. Cairo-based business people noted that domestic investors are not willing to pursue capital expansion when generals might

compete with private enterprises.<sup>58</sup> After all, in a corruption-riddled country, competing with the military comes with major risks.

## POLICY RECOMMENDATIONS

The following recommended policies would help ensure the successful implementation of the IMF-Egypt Program and mitigate some of its negative consequences. This may require Egypt to further coordinate with the World Bank and other aid agencies to help address some of the political economy challenges noted above.

### *INCREASE TRANSPARENCY—EVEN FOR THE MILITARY*

The fact that many Egyptians continue to question where and how the billions of dollars received from Gulf backers since 2013 has been allocated highlights the lack of transparency and accountability of government spending in Egypt. The government has spent a great deal on megaprojects, such as Suez Canal development, that appear to serve political goals, including projections of grandeur, more than economic ones. The government therefore needs to improve the transparency of public expenditures and explain their economic benefits to instill greater public and investor confidence in the government and the IMF program.

In addition, the Egyptian military's purchase of private assets remains a deterrent to domestic and foreign investment, as "the private sector... fears it will not be able to compete with such a powerful and politically-connected institution."<sup>59</sup> Such interventions in the private sector—particularly when they do not clearly relate to military need or expertise—create market distortions. An

<sup>52</sup> Shana Marshall, "The Egyptian Armed Forces and the Remaking of an Economic Empire," Carnegie Middle East Center, April 15, 2015, <http://carnegie-mec.org/2015/04/15/egyptian-armed-forces-and-remaking-of-economic-empire/i736>.

<sup>53</sup> Mohamed Hamama, "Sisi Says Military Economy is 1.5% of Egypt's GDP, But How Accurate Is This?" *Mada Masr* November 2, 2016, <https://www.madammasr.com/en/2016/11/02/feature/economy/sisi-says-military-economy-is-1-5-of-egypts-gdp-but-how-accurate-is-this/>; Author is thankful to discussions with Yezid Sayigh at Carnegie Endowment for International Peace on clarifying this point. Sayigh has a forthcoming paper on Egypt's military that will elucidate this data.

<sup>54</sup> Zeinab Abul-Magd, "Egypt's Military Business: The Need for Change," Middle East Institute, November 19, 2015, <http://www.mei.edu/content/map/egypt%E2%80%99s-military-business-need-change>.

<sup>55</sup> Hamama, "Sisi Says Military Economy."

<sup>56</sup> Zeinab Abul-Magd, "Egypt's Military Business."

<sup>57</sup> Marshall, "The Egyptian Armed Forces."

<sup>58</sup> Several Egyptian business people, interviews; IMF staff member, interview.

<sup>59</sup> Saleh, "Egypt Attracts Foreign Investment."



overall lack of political and legal oversight of the military's economic activities can also lead to increased investor disquiet. For example, audits of military enterprises are performed internally. Moreover, concerns over the military's selective implementation of IMF program conditions persist, in particular the cutting of public spending on basic goods while expanding the military's dominance of key economic sectors, including agriculture, construction, and pharmaceuticals.<sup>60</sup>

Egypt needs laws and political mechanisms in place to ensure a more equitable balance between economic and military institutions. For example, the government should establish an external committee to oversee the military's economic role. Otherwise, instilling investor confidence in Egypt beyond the current, somewhat improved level, may prove difficult.

#### *PROGRESSIVE TAXATION*

Income taxes are difficult to collect in a predominantly cash-based society with a large informal sector. Egypt, however, can increase tax revenue and help address income inequality through introducing forms of taxation that have progressive effects—where the tax rate increases along with earnings or wealth. These can include taxes on property, capital gains, and luxury items.

Egypt introduced a 10 percent capital gains tax on listed shares on the stock market in 2014, but halted it in May 2015. The IMF pressed Egypt to reinstate the tax, citing the potential for strong revenue growth over the long term.<sup>61</sup> Official estimates projected that the tax would

bring in a minimum of 4 billion EGP per year.<sup>62</sup> However, in June 2017, the el-Sissi government extended the suspension of the capital gains tax, and instead imposed a stamp duty, that taxes each stock exchange transaction.<sup>63</sup>

Egypt also lacks administrative capacities regarding property registration, which thwarts efforts to collect property taxes and capital gains taxes on real estate profits. This is important as real estate holdings are a major component of wealth in the Middle East. IMF technical assistance could assist Egypt in finding more effective ways of collecting property taxes. The example of Greece, which was also under an IMF agreement and had high rates of tax avoidance, could be helpful.

#### *INCREASE SOCIAL PROTECTION OF POOR*

According to the IMF's first review of the EFF program, "energy subsidy reform, wage restraint, and the new VAT have all contributed to reducing the fiscal deficit and helped free up space for social spending to support the poor." Yet, the IMF review also recognizes that these measures will not be enough to protect vulnerable groups as Egypt moves forward with its reform program.<sup>64</sup>

Cuts to food subsidies, moreover, have proven problematic. Bread riots, which erupted in March 2017 in Alexandria, Giza, Kafr el-Sheikh, and Minya, echo those of January 1977, when, seeking to follow IMF advice, Egypt similarly reduced food subsidies.<sup>65</sup> The unrest underscores the need for Egyptian authorities to more clearly communicate to citizens the reasoning, purpose, and benefits of such measures, particularly when

<sup>60</sup> Zeinab Abul-Magd, "Egypt's Coming Revolt of the Poor," *Foreign Policy*, March 31, 2017, <http://foreignpolicy.com/2017/03/31/egypts-coming-revolt-of-the-poor/>.

<sup>61</sup> IMF, "Arab Republic of Egypt: Request for Extended Arrangement," 56.

<sup>62</sup> Doaa Farid, "Egypt: Lost Revenues – How Egypt Botched Implementation of Its Capital Gains Tax Law," *AllAfrica*, December 26, 2016, <http://allafrica.com/stories/201612270484.html>.

<sup>63</sup> "Egypt President Ratifies Capital Gains Tax Freeze Extension, Approves Stamp Duty," Reuters, June 22, 2017, <https://www.reuters.com/article/us-egypt-economy-tax/egypt-president-ratifies-capital-gains-tax-freeze-extension-approves-stamp-duty-idUSKBN19D2DM>.

<sup>64</sup> *Ibid.*

<sup>65</sup> Abul-Magd, "Egypt's Coming Revolt."

dealing with staples of such social and cultural importance as bread.<sup>66</sup>

With this in mind, and to better support Egypt's poorest families, the authorities intend "to expand cash transfer programs and increase semi-cash allowances under the food subsidy program."<sup>67</sup> However, the Egyptian government should also focus on increasing quotas and allowances to gold card holders in the most impoverished areas. Moreover, it should increase fines and revoke vendor permits for those who abuse the food subsidy system. Addressing the source of this abuse without making cuts to the subsidy system is imperative to ensure the most vulnerable Egyptians are protected.

Vulnerable Egyptians' access to much-needed prescription drugs is also a key cause for concern throughout the country. The prices of medicines increased significantly due to devaluation of the pound. A national strategy to effectively mitigate this negative impact of the EFF program is required to prevent Egypt's poor from undue suffering.

#### *INVEST IN WOMEN TO INCREASE ECONOMIC GROWTH*

The IMF program's focus on increasing women's participation in the labor force could raise the living standards of many women and encourage growth in the Egyptian economy. Yet, the total invested into social protections for women—funds to improve public facilities, such as nurseries, to allow women to actively seek jobs, for example—pales in comparison to the total IMF program: just 250 million EGP in 2016/2017 and 500 million EGP in 2017/2018.<sup>68</sup> The funds allocated for things like

improving the quality of childcare and access to safe public transportation only amount to 0.2 percent of GDP, and are low compared to total investments.<sup>69</sup>

Moreover, underlying problems that remain unaddressed will likely impede any progress made under current EFF provisions to invest in women. These issues include a lack of legal definitions of sexual harassment, a corresponding lack of data on reported assaults, and lack of training for police and prosecutors in dealing with sexual assault cases.<sup>70</sup> Investing in these structural problems should thus be a top government priority.

#### **CONCLUSION**

The IMF's three-year Extended Fund Facility program in Egypt will provide an infusion of much-needed funds to help the country deal with some of its macroeconomic issues. However, despite the program's technical merits, political economy challenges remain which cannot be ignored. As it stands, the program will likely not achieve the economic growth it promises, and will do little to address the poverty, inequality, and corruption that continue to lay a heavy burden on Egypt.

The policy recommendations above are necessary in order to help Egypt mitigate the adverse consequences embedded within the IMF-Egypt program. Such reforms will not be easy: government red tape, the suppression of oppositional voices, and a persisting lack of transparency in policy decisions will continue to hinder efforts to improve Egypt's struggling economy.

<sup>66</sup> Michaelson, "We Want Bread."

<sup>67</sup> IMF, "Arab Republic of Egypt: First Review," 17.

<sup>68</sup> IMF, "Arab Republic of Egypt: First Review," 13.

<sup>69</sup> Ibid., 52.

<sup>70</sup> Nazra for Feminist Studies, New Woman Foundation and Uprising of Women in the Arab World, "Egypt: Keeping Women Out – Sexual Violence Against Women in the Public Sphere," International Federation for Human Rights (FIDH), Report No. 630a, April 16, 2014 [http://nazra.org/sites/nazra/files/attachments/joint\\_report\\_sexual\\_violence\\_egypt\\_en.pdf](http://nazra.org/sites/nazra/files/attachments/joint_report_sexual_violence_egypt_en.pdf).

Enacting these recommended policies will therefore require a deep commitment by stakeholders to making critical changes to Egypt's current social and political environment.



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