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Identifying the Repercussions of Recent Political Upheavals on the Macroeconomic Policies in Egypt since 2011

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Abstract: The political incidents that took place in Egypt since the January 2011 revolution had their fair share of negativities on the Egyptian economy. Almost all industries of the Egyptian economy were profoundly thumped by the rising political upheaval and the dismal outlook prevailed during the transitional period. Monetary and fiscal policies stood victimized in a stationary halt, with monetary policy torn between stagnant GDP progress, soaring inflation and depreciating domestic currency relative to the U.S. dollar. On the other hand, fiscal policies were under their substantial share of pressure due to increasing socially-driven spending, weakening public revenues, rising fiscal deficits, dwindling foreign currency reserves, and debt stock. This study aims at highlighting the repercussions of the recent political events upon the fiscal and the monetary sides of the economy as well as identifying how fiscal and monetary policies were managed during the transition period. The research concludes its course with an assessment of the overall challenges that faced the country, and recommendations that could help overcome them.

Key words: monetary policy; fiscal policy; fiscal deficit; inflation; stagnant GDP
JEL codes: E00, E52, E62

1. Introduction

Before the political changes began taking shape, Egypt's economy was strong in many respects. The economy was growing at a fairly rapid pace, averaging 5% a year between 2000 and 2010 (CBE, 2012). Starting in 2004, the government pursued wide-ranging structural reforms, including tariff reductions, privatization of state-owned enterprises, and reductions in regulation of the private sector, among other policy measures. These reforms aimed to improve the business environment and make Egypt's economy more competitive. The 2008 World Bank "Doing Business" report ranked Egypt as the top worldwide economic reformer. In general, reforms helped attract foreign capital, and foreign direct investments (FDI) in Egypt surged from 1.2% of GDP in 2000 to 9.3% of GDP in 2006. The global financial crisis of 2008-2009 had limited impact on Egypt's economy, due to low exposure to the types of structured financial products at the heart of the financial crisis and the government's accommodating fiscal and monetary policies following the onset of the crisis.

Behind strong growth and capital inflows during the 2000s, however, Egypt's economy faced a number of

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vulnerabilities. Average Egyptians saw little immediate benefit from the economic reforms praised by outside observers and investors. Growth had done little to lower persistently high unemployment, which averaged 9.9% during the 2000s (and was reportedly much higher among youth), or substantially reduce poverty. Fifteen percent of the population, or about one in seven Egyptians, were living on less than $2 per day in 2008. The government was also running relatively large budget deficits, averaging 8.2% of GDP between 2002 and 2010 (Abu Hatab, 2009). In its 2010 annual review of Egypt's economy, the IMF cautioned about the need for fiscal consolidation and recommended a value-added tax (VAT), energy subsidy reform, and measures to contain the fiscal cost of pension and health reforms. Persistent budget deficits also left public debt at 73% of GDP in 2010, above the 60% threshold that some economists believe is stable and conducive to growth. The IMF also warned about the need to continue reform "momentum" to further improve the business environment and build the private sector. Finally, inflation had steadily increased through the decade, from 2.8% in 2000 to 11.7% in 2008 (IMF, 2013).

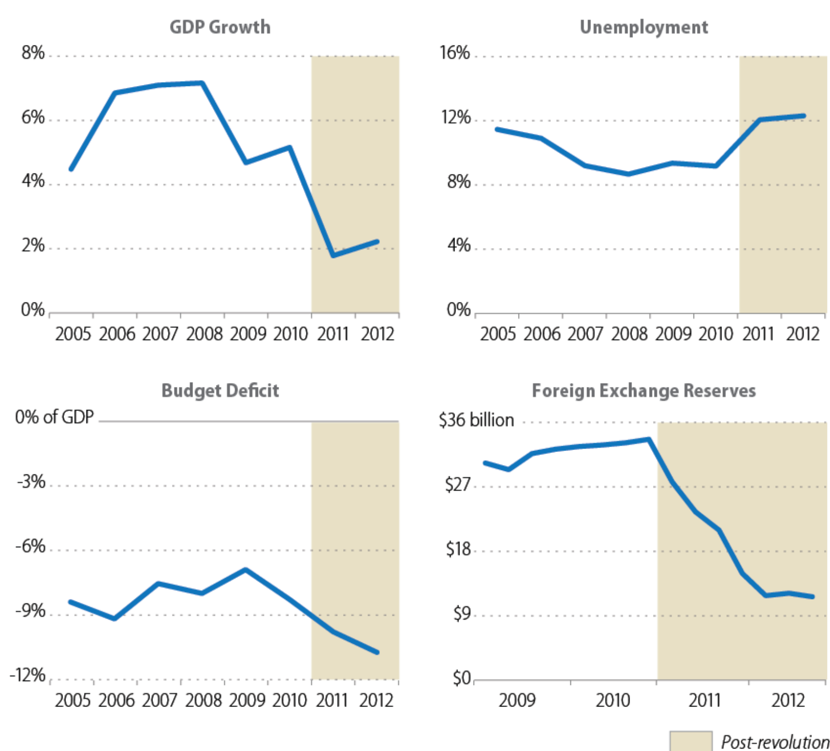

Figure 1 Economic Indicators Pre- and Post-revolution

Source: IMF, World Economic Outlook, April 2013; IMF, International Financial Statistics, 2013.

The objectives of this research paper are twofold: The first objective is to identify the impact of the political up-rise on the overall macroeconomic environment in Egypt, and how the country's main macroeconomic indicators responded accordingly. The second objective is to assess and critically review how the fiscal and monetary policies were administered to cautiously handle the impact of such reverberations.

This research consists of five parts beside an introduction and conclusion. The second part depicts the Literature Review, which briefly introduces the main theories and contributions of different schools of thought, which represent the evolution of macroeconomic policies in the contemporary world, and particularly in Egypt. The third part is addressed to the Egyptian Monetary Policy prior to the 2011 Revolution, with a demonstration of how its main instruments and tools were administered. The fourth section consequently deals with the Monetary

Policy in Egypt post the up-rise. Proceeding part four, a similar descriptive analysis of that of the Monetary policy will be provided for the Fiscal policy, while discussing the main impediments faced by the Egyptian Public authorities and governmental institutions. Finally, an illustration of some recommendations will follow, in addition to a concluding statement. The time horizon of this research begins with the era between 2000 to 2010, while a descriptive analysis of the revolution's aftermath covers the time span between 2011 to 2015.

Emphasis will be placed on three specific policy areas that Egypt has struggled with since 2011. These three policy areas are (1) the general misallocation of fiscal expenditure-reduction rather than revenue-creation; (2) the manipulation and use of subsidies in Egypt to appease the populous instead of fostering employment generation; (3) the failure to adequately promote employment-intensive investment.

2. Literature Review

Macroeconomic theories provide extensive analyses and views in a variety of forms. Some of which are grouped according to time periods and others to schools of thought. A few of the most commonly cited theories are the Classical theory and Keynesian Model theory. The Classical School relied on Adam Smith's masterpiece "An Inquiry into the Nature and Causes of the Wealth of Nations", popularly known as "The Wealth of Nations" for short, published in 1776. Smith called for minimum, if not absolute absence of government intervention, and the spread of free Trade and competition. He urged for no government alteration nor impediment of the latter. As a result, Smith's classical era witnessed the absence of the Monetary Policy's control over prices and inflation (Mabruk, 2012).

On the other hand, David Hume (1711-1776), the famous Scottish Philosopher and thinker, was given prominent credit for his elucidation of monetary theory, in particular his clear exposition of the price-specie-flow mechanism. His theory relied on free market operations where a rapidly self-correcting force at work equilibrates balance of payments and price levels, while preventing inflation from going too far. Hume's principles worked in line with the Quantity Theory of Money introduced by the Monetarists. He supported the notion that any surplus of exports would be associated with an increase in gold and silver imports, as a result of increasing money supply, inflation occurs. According to Hume, the only way to constrain inflation would be through decreasing exports (Mabruk, 2012).

While the classical economists supported the rules of "Say's Law" — that prevailing supply tends to generate its own demand if operating below potential input and the production possibility frontier — Keynesians believed that the low aggregate demand levels during economic recessions inevitably lead to wasted production, employment opportunities, and thereby fiscal deficits. Under the Keynesian school of thought, government intervention was indispensable. John Maynard Keynes himself believed that fiscal policy had substantial and sufficient control over aggregate demand, ridiculing and diminishing that of monetary policy. His main criticism towards the latter was related to the liquidity trap that depicts a situation where interest rates fail to drop below a certain level no matter how high money supply rises. When an economy enters this zone, or the liquidity trap, the monetary policy's conventional tools become ineffective; giving the floor to fiscal policy instruments to stimulate economic activity (Al Asrag, 2003).

In conflict with the Keynesian school and theory, the Monetarists Anna Schwartz and Milton Friedman in their book Monetary History of the U.S. 1876-1960, which was published in 1971, claimed that the reasons behind the great depression of the 1930s were related to the ineffectiveness and malfunctioning of the fiscal

policies used during that era. The Monetarists' argument stated that the depression was created as a result of a substantial contraction in money supply rather than the lack of investment, and that post war inflation records soared due to an expansion in the money supply. These arguments explained the failure of fiscal policies to reduce inflation and ignite economic growth in the 1970s. Milton and Schwartz's statements urged Central Banks to control inflation by manipulating, or rather efficiently managing the money supply of loanable funds, and thereby setting appropriate interest rates to stimulate investment and economic activity. The Monetarists' remarkable contribution, however, emerged with the novelty of the quantity theory of money which was first introduced in 1848. This theory explained that the correlation between money supply and the price level was directly positive.

According to the traditional Keynesian school, interest rate channels presented in the IS-LM model were summarized in the following sequential equation of monetary tightening proposed by the latter (Mabruk, 2012);

$$MS \downarrow, i \uparrow, I \downarrow, Y \downarrow$$

MS; being the money supply, if decreased, will consequently raise (i) interest rates; put pressure on (I) investments, and eventually a drop in (Y) output will be inevitable.

There has been a growing trend of granting independence to monetary authorities and central banks with the aim of achieving price stability to avoid inflationary pressures. These trends, to say the least, were based on the notion that "an independent monetary authority can effectively achieve a country's desirable target path of inflation" (Abdel-Haleim, 2014). This notion coincides with the classical economic theories that advocate that the attainment of two policy goals requires more than one policy instrument. This eventually leads to the materialization of a new policy environment where the sole dependence on either fiscal or monetary policy is inadequate to achieve the desired amalgam of sustainable growth and stable prices. Needless to say that the integration of monetary and fiscal policy is regarded as one of the fundamental — but also of the most complicated — relationships in economic theory (AbdelLatif, 1990).

Unfortunately, each policy with its set of operating tools, could succeed in accomplishing a particular macroeconomic objective, yet at the same time impede the attainment of other desired targets, imposing a pressure to effectively and shrewdly coordinate between the two.

3. Egypt's Monetary Policy Prior to 2011

The monetary policy is used to affect the money supply in any economy, through open market operations, domestic interest rates, reserve requirements and other tools. Specifically, there are three channels through which monetary policy has its effects upon the economy; the interest rate channel, the exchange rate channel and the credit channel. The interest rate channel reflects the effects of monetary policy upon the economy through changes in real interest rates (changes in real interest rates affect investment and hence production and prices) (Handy, 2001). The exchange rate channel refers to the outcomes of monetary policy upon the economy via real exchange rate changes (changes in real exchange rate alters the relative prices of exports and imports and hence amount of net exports and aggregate demand) (Hassan, 2003). The credit channel on the other hand, reflects the effect of monetary policy through adjusting supply and demand for credit (Emam, 2012).

It is known that the primary monetary tools and instruments require cautious and shrewd management on behalf of the central bank. The main objective of a country's central bank is to achieve price stability. The Central Bank of Egypt (CBE) is no exception. In fact, law no. 88 of 2003 of the "Central Bank, Banking Sector and Monetary System" in Egypt explicitly entrusted the CBE with the formulation and implementation of monetary

policy, with price stability being the primary objective (CBE, 2010). Furthermore, in 2004 the monetary policy in Egypt witnessed remarkable advancements as the Central Bank adopted serious roles to develop its monetary framework with the intention to implement inflation targeting (IT) over the medium term. Such steps included measures to facilitate the move towards a more modernized banking sector (Abd El Ghaffar, 2007). Among these measures were the launch of the comprehensive banking sector reform program which involved the privatization of banks, restructuring of Non-Performing Loans (NPLs), liberalization of foreign exchange and money markets, as well as the release of the banking law No. 88, mentioned earlier, that granted the CBE instrument independence and strengthened its supervisory power. In such an environment, it is essential to understand how the CBE conducts is monetary policy and how it adjusts its monetary policy instruments in response to past, current and future macroeconomic and inflationary developments (Al-Mashat, 2008).

Prior to the 2011 revolution, the main challenges faced by the Egyptian Central Bank and its monetary policy were to curb a rising double digit inflation rate and managing a deteriorating domestic currency that was failing and losing purchasing power relative to the dollar (Korayem, 1997). Taking into consideration that Egypt is a highly importing country, the depreciating domestic pound was only aggravating the situation, and pushing it towards dangerous alerts. Putting more pressure on consumers' disposable income and purchasing power, rising imports were a critical challenge to be faced (Azzi, 2015).

Interest rates and credit channels were also under extensive scrutiny. Implementing an effective monetary regime requires abstruse understanding of how this channel works, to be able to presage the magnitude of the effect that interest rates have on inflation. According to a vast literature on industrial, emerging, transitional and developing economics, interest rate channels played a crucial role in transmitting monetary changes to households (HH) and firms through competitive banking system, but the degree of the pass through of this channel varies across countries, according to the efficiency of the banking system (Mabruk, 2012).

4. Egypt's Monetary Policy after the 2011 Revolution

Egypt as a society and Egypt as an economy suffered dramatically after the revolutionary up-rise of 2011. The monetary condition was no exception. The year 2011 was marked by an acute drop in the reserves of hard currencies and soaring double digit inflation figures were both speculated and real (Abdel-Haleim, 2014). Controlling inflation remained a key challenge all through the years after the revolution to date. Rising food prices, higher fuel costs and the reduction in fuel subsidies all contributed to the aggravated situation of domestic inflation and a weakening Egyptian pound[1]. To make matters worse, supply shortages due to poor logistics and storage capacities, and a decline in imports due to low reserves all imposed pressure on domestic production. The rising prices have impacted lower income households more than the richer segments of the population (Hosny, 2014).

4.1 Small and Medium Enterprises (SMEs)

Following the political instability in 2011, it was the least to expect a remarkable drop in the confidence level towards the Egyptian pound. Egyptians had a drive to get rid of their domestic currency in favor of the U.S. dollar and a massive wave of dollarization emerged. In June 2012, domestic dollar dollarization rose to 20.7% as opposed to 17.2% in the year before. Consequently, Egypt witnessed a 6% rate of depreciation arriving at an

[1] After 2010/11, the world wide drop in oil and food prices reversed this situation and proceeding research work by several economists suggested taking advantage of the situation and reviving the domestic export industry.

exchange rate of 6 pounds for the dollar by December 2012 (IMF, 2010).

The central Bank of Egypt (CBE) relied on a number of tools during the aftermath of the revolution. An important aspect of the monetary policy adjustments adopted then was financial inclusion, aiming to improve financial services for firms and households, with a special focus on Small and Medium Enterprises (SMEs). Indeed, from the SMEs' point of view, it was more difficult to obtain financing from banks for several reasons: banks often preferred to extend credit to large corporate clients and related individuals that they considered less risky (Metwaly, 2011). From the banks' point of view, it was less risky to provide loans for larger businesses since they were more stable, less prone to risk, have available records and structured information, were easier to access and more profitable (Ministry of Finance, 2012). SMEs also had other problems such as lack of business documents (registration, license, and tax records) and reliable financial statements, weak management and lack of business plans. Bearing these characteristics in mind, the 2010 SME census, found that only 47 percent of SMEs in Egypt dealt with banks and only 22.4 percent had access to banking facilities. As a result, The Central Bank of Egypt (CBE) announced a plan to provide EGP 200bn to 350,000 small and medium enterprises (SME) over the next four years, according to a statement released by the CBE in January 2016. The CBE directed banks to increase the percentage of loans allocated to this sector to 20% of their total loans portfolio. The CBE explained that the banks will apply this rate in return for being allowed to deduct the value of the funds they will grant to these projects from the value of their obligatory reserves at the CBE (Bakta, 2015).

The CBE explained that supporting 350,000 SMEs will create approximately 4 million jobs the course of approximately four years. It also highlighted the importance of providing information to venture capitalists and investors, and facilitating their access to banks, in addition to providing the needed training for small businesses in order to increase their chances of success (Ministry of Planning, 2014).

4.2 Open Market Operations (OMOs)/Repurchasing Agreements

After the revolution in 2011, the CBE used OMOs to pump liquidity into the domestic market. Reacting to the political changes in Egypt in the second half of FY 2010/2011, which cast their shadow over the level of economic activity and the performance of financial markets, and eventually over the available liquidity in the market, the Monetary Policy Committee (MPC) (in its meeting dated 10 March, 2011) decided to launch weekly repo operations on a regular basis under the operational framework of the CBE monetary policy, with a maturity of one week and an interest rate to be set by the MPC in each meeting (Cobham, 2015). The aim was to provide adequate liquidity for banks that may face potential pressures on their liquidity position. The Committee set an interest rate of 9.25 percent per annum on repos, and the rate remained in effect till the end of June 201. Later, on 24 November, the MPC increased the 7-day repos to 9.75 percent. As an outcome of the repo operations, net open market operations (absorption and injection) revealed liquidity-injecting operations of LE 14.5 billion at end of June 2011. The action bore fruit in the first half of FY 2012/2013, as the domestic market witnessed a noticeable decline in the average liquidity deficit from LE 26.7 billion at end of June 2012 (as repo agreements registered an average figure of LE 33.1 billion and overnight deposits LE 6.4 billion), to as low as LE 0.2 billion at end of Dec. (as repo agreements averaged LE 10.2 billion, while overnight deposits averaged LE 10.0 billion).

4.3 Interest Rates

With rising inflationary pressures, the central bank's Monetary Policy Committee based its decisions accordingly. In its three meetings between the period from July to Oct. 2011, the MPC decided to keep the CBE's key interest rates (the overnight deposit and lending rates) unchanged at 8.25 percent and 9.75 percent per annum, in order. The lending and discount rate was also maintained at 8.50 percent as before, and the repo rate at 9.25 percent

per annum. However, by November 2011, the MPC decided to raise the overnight deposit rate to 9.25 percent and the-23-overnight lending rate to 10.25 percent. The lending and discount rates were also raised. The CBE's justification for such moves were based on the notion that potential inflation was to be predicted and hence, raising these key policy rates would have set back its effect. Another justification claimed that there was a desire to boost domestic currency deposits and combat the ever rising wave of dollarization.

4.4 Net International Reserves (NIR)

Amid the extraordinary events witnessed in the second half of the year, net international reserves at the CBE shrank by about US$ 8.6 billion or 24.6 percent, to end the year at US$ 26.6 billion, against US$ 36.0 billion at end of Dec. 2010 and US$ 35.2 billion at end of June 2010 (the decline in Jan./June 2011 was by about US$ 9.4 billion or 26.2 percent). Withdrawals from NIRs were mainly to make up for the departure of many foreign investors from the market in the second half of the year. Notwithstanding their contraction, NIRs covered 6.3 months of merchandise imports at end of June 2011. Unfortunately, in the years to follow, NIRs continued to decline further, standing at US$ 18.1 billion at end of December, thereby covering 3.7 months.

Despite the gloomy situation regarding the country's NIR, the CBE and its MPC continued to portray a positive picture. In spite of their efforts, the actual reality stated facts differently. The sharp decline in Egypt's NIR reached unprecedented figures by the end of FY2015, plunging below the threatening $15 billion range. This decline imposed profound pressure on the CBE to consider yet another devaluation of the Egyptian pound. Economists claimed that Egypt's monetary situation was destined to enter dangerous zones with such figure.

To make matters worse, the deterioration of security measures–on the other hand–did not serve the tourism industry much good either. Being one of the primary generators of foreign currency to the country, the inflows from the sector just continued to diminish substantially. Furthermore, excessive and redundant imports of luxury goods and unimportant products contributed negatively to the dwindling reserves of the country, forcing its trade balance to inevitable deficits.

Noting that despite the cancelation of the IMF loan Egypt negotiated with the latter in 2013 (a loan worth $4.8 billion), speculations emerged in January 2016 of a new agreement discussed on the table.

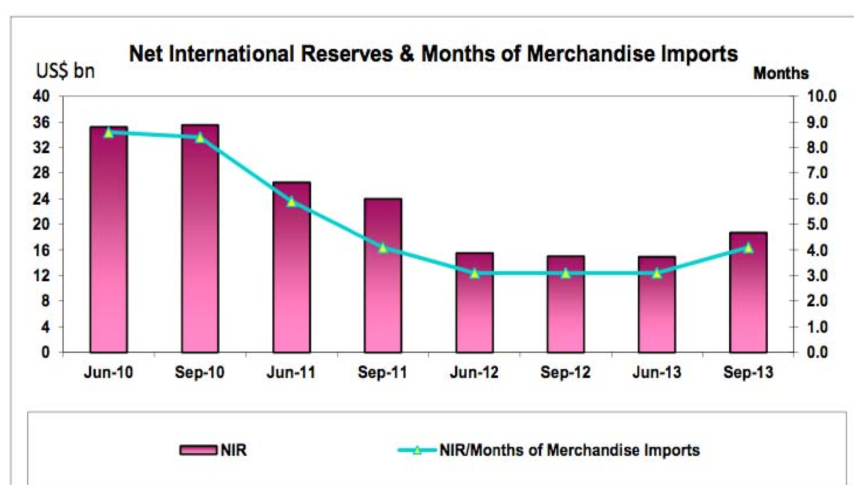

Figure 2 Net National Reserves/Months of Merchandise Imports FY 2013-2014

Source: Economic Review Report, Vol. 54, FY2013-2014

By the end of 2015, the CBE's primary agenda focused on raising the availability of dollar-based deposits to

fight its appreciation against the pound. According to its new governor appointed in October 2015, new dollar-based deposits called "Beladi" raised numerous controversial opinions among economists. The exaggerated interest rate granted to these deposits was never witnessed before in any emerging, yet alone developed economy. Channeled through three national banks only, these deposits are currently seen by some critics as a temporary painkiller to the eroding monetary situation that will only aggravate Egypt's external debt, rather than raise foreign currency reserves.

4.5 Foreign Exchange Market

According to the Central Bank of Egypt, its monetary policy committee believed that its management of the foreign exchange market through the dollar interbank system was successful (Bakta, 2015). With reference to the MPC, the new mechanism proved highly effective in cushioning the market against any drastic volatility, especially after large investments had abandoned the country and tourism revenues had plunged. The dollar interbank system helped soothe investors' fears against any imminent fluctuations in foreign exchange rates. Over the first nine months of 2011/2012, the volume of trade in the Forex market scaled down by US$ 16.3 billion or 36.9 percent, posting US$ 27.85 billion. Public banks' sales and purchases accounted for 14.6 percent and 4.1 percent, respectively, of the total volume of transactions. On the other hand, sales of private sector banks constituted 85.4 percent and purchases 95.9 percent. The volume of trade in the interbank market — since its inception at the end of 2004 up to the end of March 2012 — grew by 12.9 percent, standing at US$ 328.9 billion (against US$ 291.3 billion at the end of March 2011).

By the end of 2012, the CBE launched a new mechanism to support the foreign exchange interbank market. Via this mechanism, the CBE offered periodic Foreign Exchange auctions for banks to buy and sell US dollars. The aim of this mechanism was to regulate the forex market and preserve NIRs, after reaching critical levels. In addition, the CBE issued a number of decisions conducive to bolstering the confidence of market participants (Egyptians and foreigners). In 2013, the CBE issued a decision, allowing Egyptian persons, who transfer their savings from their accounts abroad to banks in Egypt, to retransfer the same amount abroad. Also in 2013, the CBE decided to reactivate the repatriation mechanism of foreign investor funds, in addition to developing and expanding this mechanism to cover treasury bills and bonds, in addition to the stocks listed on the Egyptian Exchange.

By March 2015, the US dollar exchange rate recorded LE 7.53, with a drop of 5.2 percent in the value of the Egyptian pound during July/March 2014/2015. This decrease came as a result of the CBE's gradual increase of the US dollar exchange rate vis-à-vis the Egyptian pound in periodic FX auctions held for banks, with the aim of eradicating the parallel market (the black market) and curbing dollar speculations. Moreover, the CBE set daily and monthly maximum limits for foreign currency cash deposits. The measure aimed at stopping companies from buying large amounts of dollars from the black market and then depositing them briefly in banks in order to open letters of credit for imports. Since the CBE imposed restrictions on hard-currency sales to the market at the end of 2012, the black market had flourished. The clampdown on cash deposits came after the CBE allowed the 5.2% depreciation of the Egyptian mentioned above. By devaluing the official rate, the CBE wanted the supply of hard currency in the banking system to increase, thereby enabling importers to finance their transactions without having to resort to the black market. The combination of devaluation and curbing the black market was also a way to raise the volume of remittances from Egyptians working abroad.

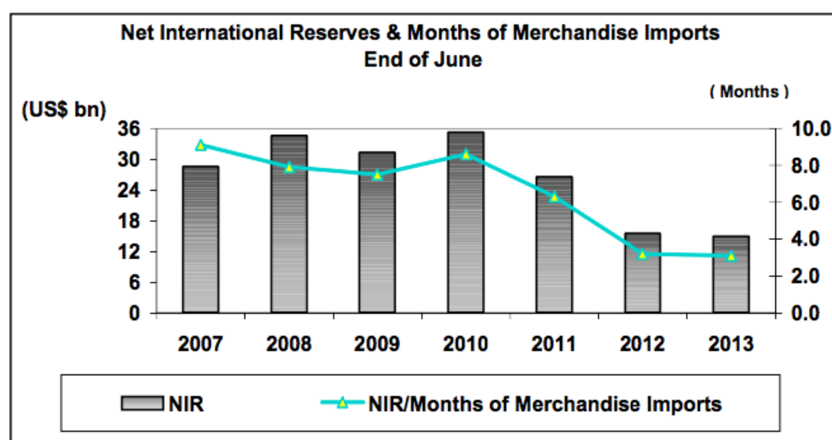

Figure 3 Net National Reserves/Months of Merchandise Imports FY 2012-2013

Source: Economic Review Report, vol.53, FY2012-2013

4.6 Domestic Liquidity (M2)

Domestic liquidity (M2) consists of currency in circulation outside the banking system and non-government deposits at banks (in both local and foreign currencies). In July/December 2014/2015, domestic liquidity grew by LE 89.9 billion or 5.9 percent, against LE 91.6 billion and 7.1 percent in the same period a year earlier.

The pickup in domestic liquidity during that period was reflected on the growth in money supply and quasi-money[2]. In figures, money supply rose by LE 35.2 billion or 8.6 percent (compared with LE 29.5 billion and 8.6 percent in the previous corresponding period), reaching LE 445.7 billion at end of December 2014. The increase in money supply was a combined result of the pickup in both currency in circulation outside the banking system by LE 6.3 billion or 2.3 percent, and local currency demand deposits at banks by some LE 28.9 billion or 20.7 percent (due to the rise in all sectors' deposits).

Quasi-money rose by LE 54.7 billion or 4.9 percent during the same period (against LE 62.1 billion and 6.5 percent during the corresponding period a year earlier), to register LE 1160.8 billion at end of December 2014. Such a rise reflected the growth in LE time and saving deposits and the retreat in foreign currency deposits. Specifically, LE time and saving deposits surged by LE 58.3 billion or 6.7 percent (against LE 69.1 billion and 9.5 percent), reaching LE 928.3 billion, thereby constituting 80.0 percent of quasi-money and 57.8 percent of total domestic liquidity at end of December 2014. The increase in LE time and saving deposits came as a result of the rise in the deposits of the household sector by LE 29.4 billion or 3.8 percent to post LE 806.0 billion at end of December 2014. The increase was also contributed by the private business sector whose deposits grew by LE 26.0 billion or 34.5 percent to LE 101.6 billion and the public business sector whose deposits augmented by LE 2.9 billion or 16.4 percent to LE 20.7 billion.

On the other hand, foreign currency deposits moved down by LE 3.6 billion worth or 1.5 percent (against LE 7.0 billion worth or 3.1 percent), to stand at LE 232.5 billion worth. These deposits constituted 17.5 percent of total deposits at banks (dollarization rate) at end of December 2014 (against 19.0 percent at end of June 2014).

The increase in domestic credit during the period between 2011-2015 was an outcome of the following developments:

Net credit to the government by the banking system surged by LE 81.6 billion or 7.8 percent during the

[2] Quasi Money is a term used in economics to describe highly liquid assets that can easily be converted into cash.

period under review (against a rise of LE 120.0 billion and 15.0 percent in the corresponding period a year earlier), bringing its balance to LE 1126.8 billion or 64.8 percent of total credit at end of December 2014. The surge was attributed, on the one hand, to the rise in banks' holdings of government securities and TBs by LE 138.7 billion, and in loans to the government by LE 40.7 billion. On the other hand, government deposits at the banking system stepped up by LE 97.8 billion (of which LE 55.5 billion were economic authorities' deposits due to the proceeds of Suez Canal certificates). The increase in net claims on the government was traceable to the fact that the government resorted to banks and the CBE to finance part of the budget deficit during the reporting period. According to the Ministry of Finance data for the period July/Dec. 2014, the CBE financed LE 36.7 billion of that deficit, while banks funded LE 46.3 billion.

Credit to the public business sector expanded by LE 13.2 billion or 28.9 percent (against LE 0.8 billion and 1.9 percent), bringing its balance to LE 58.6 billion at end of December 2014. Credit to the household sector surged by LE 12.9 billion or 8.9 percent (against LE 5.7 billion and 4.5 percent) to LE 158.2 billion at end of December 2014. Credit extended by banks to the private business sector mounted by LE 6.9 billion or 1.8 percent (against a decline of LE 7.9 billion and 2.1 percent), posting LE 396.2 billion and representing 22.8 percent of total domestic credit at end of December 2014.

5. Egypt's Fiscal Policy Prior to 2011

Egypt's Economic Reform and Structural Adjustment Program (ERSAP) which began in the early 1990s had a focused agenda aiming at stabilizing the economy at all costs. The program, in short, aimed at administering its tools to attract as much FDIs as possible, promote the country's export industry by providing credit facilities to it, boost the private sector and support a massive wave of privatization, level out Egypt's balance sheet, and last but not least, raise the efficiency of the public sector (Moursi, 2007). Regarding the attraction of foreign direct investments, the Egyptian government introduced protection laws against nationalization to foreign investors, granted tax exemption schemes, provided payment facilities on custom duties, protected Egyptian entrepreneurs and the private sector in general, and supported partnerships and joint ventures among the latter (Nasser, 1997). It is worth noting that the main feature of the ERSAP era was the pegged/fixed exchange rate regime that, despite its unrealistic market value of the pound, had a main objective of creating a stable investment environment where a thriving economy could emerge (Ugo, 2001). At that time, the IMF requested a 20-30% devaluation of the Egyptian pound, but the CBE declined the request, in fear of uncontrollable inflation rates.

The main advantage of the ERSAP was its capability of cutting budget deficits substantially reaching a mere 2-3% of GDP in 1994-1995 (Nasser, 1997). The program achieved that cut via two measures; the revenue-generating measure and the expenditure-decrease measure. With respect to government revenue-generators, the Egyptian government resorted to introducing new tax legislations on income and sales activities. Excise taxes were also surged and prices of energy experienced the same change. Together with higher prices of public enterprise production, the Egyptian government was able to increase its revenue-generating sources to curb its budget deficits (WB Report, 2005).

On the other hand, the expenditure side measures included restrains on the public wage bill, sacrificing public investments and government spending, and reducing subsidies to reach 1% of GDP (Kandil, 2010). These measures were also geared not only to switch spending schemes away from soaring deficits and towards more income generating outlets, but also to raise domestic output levels and reduce the gap between actual and potential

GDP. It was expected in the short run period after implementing these measures that resource allocation would be administered in a more efficient manner by eliminating the distortions caused by the overvalued exchange rate, excessive subsidies that could be otherwise forgone, and taxes (Helmy, 2008).

With all these measures and tactics placed in the ERSAP basket, the Egyptian government expected to witness certain results in the long run. These long run outcomes pertained to reviving the investment environment; particularly among the private sector; attracting FDIs and transfers of technology form the west; investments in capacity building programs; and hikes in productivity and total production figures. Not to exclude of course balancing out budget deficits and promoting export activities to increase foreign currency reserves.

It is worth noting that Egypt was granted a substantial debt relief privilege after the Gulf war in 1990-91 which helped the government achieve its goals in cutting budget deficits. Together with the tight fiscal policy the government implemented, records reflected a favorable picture on Egypt's current and capital accounts. FDIs (including deposits in Egyptian banks) rose from $135.6 million in 1990-1991 to reach $520.2 million in 1993-1994. The current account deficit which was $634 million in 1989/90 turned to a surplus reaching $4.5 billion in 1992-1993. These results, if anything, reflected a strong and prompt response of demand and supply to the currency devaluation and tight policy measures.

However, the positive impact was over shadowed by negativities. In a quick attempt to assess the influence of the tight fiscal policy measures adopted by the ERSAP up to the late 1990s, some main indicators could be referred to. These indicators include: domestic savings, investments, the growth rate of GDP, and last but not least, income per capita growth rate.

(1) Gross domestic savings averaged 9.1% of GDP between 1988-1991 while gross domestic investment during the same period averaged 21.9% of GDP. This indicated an average saving-investment gap of 12.8% of GDP.

(2) Gross domestic investment decreased from 23.3% in 1988-1991 to 20.4%. This was attributed to the fall in public investment which represented three quarters of gross domestic investment and which fall by approximately 7% in the early 1990s[3].

(3) The third indicator was the growth rate of GDP. Based on the downward push the program had on investment; the impact on GDP growth rate was no different. Hence the drop came at no surprise reflecting a 0.3% and 0.5% growth rate in the years 1990-1992, respectively.

(4) Regarding the income per capita, the growth rate witnessed in Egypt was dismal. In the two years preceding the program of reform, the annual per capita income growth rate was zero, compared to 0.5% in 1988.

Moving away from the ERSAP era of the 1990s, the 2000s period witnessed its own share of fiscal reforms and adjustments. In the span between 2001 to 2005, fiscal deficits in the government's budget were substantial, resting at 9.6% of GDP in 2004-2005. The investment climate was weak and the percentage of the latter to GDP stood at a mere 17%. These two factors drove the government towards a tax reform program in 2005 to mobilize additional revenue and promote economic activity. The objectives were more or less the same as those of the ERSAP scheme, yet the tactics differed slightly.

The tax reform implemented in 2005 aimed at: widening the tax base, boosting tax revenues, improving the

[3] ERSAP was expected to have a negative impact on investment in the short run for two reasons; the first being the tight monetary policies of raising interest rates and reducing domestic credit, and the second being the tight fiscal policy of cutting down government expenditure. This was expected to have a significant negative impact on total investment, since government investment represented the largest share in total domestic investment.

business environment, smoothing out tax administrative procedures, encouraging transparency and accountability, and of course, ultimately, promoting Egypt's economic competitiveness and presence in the international arena (Helmy, 2008). To achieve the desired objectives, it was crucial for the plunging tax rates to trigger and stimulate more investments in domestic projects, particularly those of a developmental nature (Haq, 2015). With less tax evasion, the government was hopeful to widen its tax base towards higher tax revenues. By 2005-2006, the new tax program reflected a 2% rise of tax revenues as percentage of GDP, consequently reducing the budget deficit accordingly. The reforms also paid-off to energize private investment and economic growth.

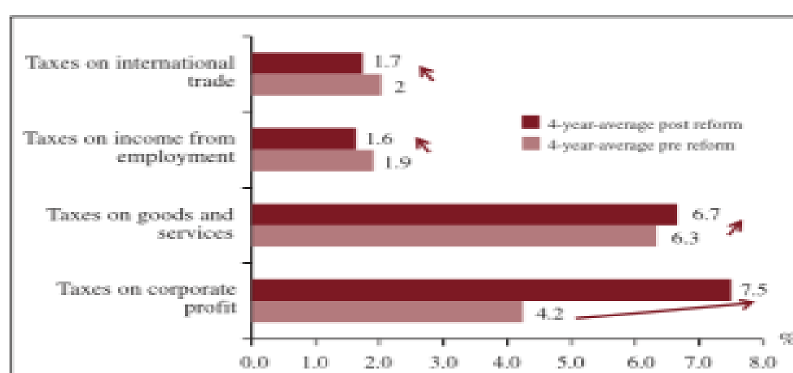

Figure 4 Taxes as Percentage of GDP: 4-Year Average Pre- and Post Reforms

Source: Ministry of Finance. *Monthly Financial Bulletin*.

Along the same lines, FDI increased relative to GDP post the 2005 tax reform. Consumption also fell relative to GDP, showing higher savings post-reform.

It is worth noting that generating more tax revenues does not necessarily entail a change in the tax rate. On the contrary, it may only require reducing the high rate of tax evasion and modernizing tax-administration tools–such as the average tax payment time payers go through to finalize their tax payments. Together with eliminating the previously mentioned faults in the tax system, such as the prominent social injustice Egypt faced in allocation of tax revenues, Egypt could have smoothly paved it's a way to truly widen its tax base and enlarge its tax revenues, while sustaining them.

Equally important was the controversial issue concerning the government's subsidies expenses. During the early 2000s, government subsidies were literally choking-off the scarce government revenues in the form of benefits delivered to those who did not really need them.

6. Egypt's Fiscal Policy after the 2011 Revolution

According to the Economic Review Report of 2012 (The World Bank), Egypt's economic position was described as "precarious". By the end of FY2011, the overall budget deficit stood at LE113.1 billion; up by LE19.1 billion OR BY 20.3%. The government sought several ways to raise revenues to finance the deficit; some of which depended highly on tax receipts and external grants. For example, government revenues came mainly from tax collections after the application of the law that granted incentives to taxpayers when settling their arrears. On the other hand, external grants rose by LE8.4 billion.

Meanwhile, public spending was not being merciful on the government's budget. The latter stood at 19.8% of GDP with a rise of LE71 billion or 29.6%. Accounting for 64% of this increase were oil subsidies which jumped

by LE45.5 billion to satisfy the higher market for oil products (Bagnied, 2013). Local and external interest payments also rose by LE17.2 billion, swallowing about 40% of total revenues. To intensify the dismal situation, the wage bill showed an increase of 30% that further ate away from total revenues as well. To make matters worse, investment fell by approximately LE5.2 billion or 22%, and the initial budget of FY2013 predicted a growth rate of a moderate 3% (Bakta, 2015).

Basically, during the first eighteen months after the revolution, Egypt's public finance conditions came under substantial pressure with the escalating political and social instabilities weakening the growth of revenues. By the end of 2012, the budget deficit widened and fiscal imbalances exacerbated. Egypt's rigid public spending scheme did not allow for great flexibility either. It was mainly geared towards achieving social welfare through a bloated wage bill and an inflated subsidy-program that constituted more than 50% from total expenditures[4].

During the course of the four years that followed the January 2011 revolution, the new government adopted an expansionary fiscal policy to encourage economic growth through incentives to promote productive investment, while rationalizing both the subsidy policy and the revenue collection mechanism to widen the tax base and reduce the budget deficit to 11% by the end of 2014/15 (Azzi, 2015). The main objective behind such expansionary measures was to transfer expenditure away from redundant and ineffective subsidies to development projects — ones that would certainly contribute to employment opportunities — and public consumption and investment. At the same time, serious reforms were implemented in the tax system and public-sector wages. As part of this policy stance, in June 2014 energy subsidies were cut by around 40%.

According to the IMF, Egypt's fiscal program included a gradual removal of subsidies on an incremental basis during a span of five years, ending in 2018. Value added taxes (VATs) were also imposed.

After large budget shortfalls in FY 2011/12 and 2012/13, the fiscal deficit narrowed to reach 12.8% of GDP in 2013/14, compared to 13.7% the previous year. This is due to exceptional financial assistance from the GCC countries and the drawing down of government deposits at the CBE. Yet those were non-sustainable flows that imposed a risk of increasing the fiscal deficit in the long run.

To enhance fiscal revenues, the government increased taxes on some unnecessary products, such as cigarettes and alcohol by around 50% and 200%, respectively. It also raised income taxes by 5% on those earning more than EGP 1 million per year, and started a new 10% capital-gains tax on stock-market transactions, dividends cash distributions and profits resulting from investment in foreign securities.

Acknowledging the social pressures for more focus on lower income households, a presidential decree was issued amending the Real Estate Law No. 196/2008 and called for granting tax exemptions to units owned by people with middle or low incomes. The amendment also exempted the owners of units used in non-housing purposes from taxes if the net annual rental value is less than EGP 1,200. The minister of finance at the time announced his intentions to allocate about a quarter of real-estate tax revenues to remote governorates in support of project implementation, while another quarter will be used for the development of slum areas. The minister also announced that the remaining 50% of tax earnings will be devoted to education, health and insurance systems and development projects in remote governorates.

In mid 2014, the ratio of gross public debt to GDP increased to 97%, compared to 94% a year previously. This increase was mainly due to the use of domestic short-term debt that the government resorted to finance its

[4] Subsidies and wages accelerated significantly in 2011 by 19.6% and 12.8%, respectively. Unfavorable increases in global food prices together with the depreciation of the domestic currency added more pressure to the subsidy bill.

financial shortages. While Egypt was not a frequent bond issuer[5], its government resorted to issuing US Dollar dominated T-Bills, selling Diaspora bonds to expatriates, and received substantial foreign aid packages from international institutions and Gulf countries, which put weight on the country's external debt bill. By June 2014, external debt rose to USD 46.1 billion (16.4% of GDP) from USD 43.2 billion (17.3% of GDP) over the same period in the previous year. Medium- and long-term debt constituted 92.1% of the total external debt.

7. Conclusion and Recommendations

The government's widening budget deficit after the revolution, made the latter resort to countercyclical fiscal policy measures to stimulate the economy. Yet, what was also required, was a comprehensive reform agenda to correct the structural imbalances in the economy, rather than short term solutions. This comprehensive reform agenda should encompass poverty alleviation, improving living standards, and avoid further social up-rises that could otherwise distract the government from adhering to the reform agenda.

Sound macroeconomic policies in general, good governance and a business-friendly environment provide the basis for growth-potential strategies. They are, however, all the more important for the development of a true emerging economy such as Egypt, since only a transparent and accountable governance system and an efficient business climate can support the creation and absorption of innovative ideas in the private sector.

Shortcomings in the overall government structure have oppressed the efforts of some key economic growth attempts initiated by several administrations in Egypt during the five-year period after the revolution. However, the ongoing transitions now stand fertile to nurture the opportunities that could thrive and revive the economic situation in the country. At the institutional level, the adherence, endorsement, and execution of the rule of law is critical for productivity-driven growth.

From the monetary perspective, the recent devaluation of the Egyptian pound relative to the dollar could only render itself futile if accompanied by productivity enhancement and competitiveness. A devalued currency is meant to boost export production, raise competitiveness in the world market, and generate foreign currency inflows from international trade. Unless competence and world demand exists for Egyptian made product, this currency devaluation will only bring upon Egyptians unbearable inflation pressures. It is true that the CBE has raised interest rates on Egyptian pound-based bank deposits in the early months of 2016; mainly to offset the inevitable inflation dooming because of the devaluation; yet so far the balance the Bank was hoping for has not yet been achieved.

On the fiscal policy front, the government has strived to cut down on its unnecessary expenses on luxury imports; yet more effort and focus is needed to foster employment-generating projects that will put the government's savings into good use. Together with subsidy cuts and tax reforms, rising unemployment could very well trigger another social upheaval; if not shrewdly attended to via labor-intensive projects.

Furthermore, Egypt needs to dwell on its current factor endowments and invest in capacity building programs from its budget. Agriculture-project development is now necessary to both, absorb the pool of unemployed labor, and raise Egypt's production potential to its maximum point on its production possibilities frontier. Cutting down on imported inputs and employing more of domestically produced raw materials will certainly help in narrowing down the gap between the government's fiscal revenues and expenses. Last but not least, safety and security measures need to assure and ensure the stability of both domestic and foreign investors. Without the latter, the

[5] The last internationally traded bond was issued in 2010 and had low liquidity.

sustainability of FDIs, foreign capital inflows, tourism, and others will certainly be a challenge.

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