The IMF and Egypt: off to a good start, but still a long way to go

In November 2016, Egypt signed a historic agreement with the International Monetary Fund (IMF) under which it committed to implement a raft of economic reforms in exchange for $12 billion to be disbursed over three years. The agreement also served as a signal from the IMF to the international financial community that President Sisi's government is on the right track and should be given financial help to implement its economic agenda.

As the first anniversary of the agreement approaches, *Arab Banker*'s Editor, Andrew Cunningham, assesses the state of the Egyptian economy and the role that Egypt's banks are playing in supporting the government and the local economy.

The IMF's Extended Fund Facility (EFF) is worth $12 bn over three years. The first disbursement, of $2.75 bn, occurred immediately after the Fund's Board of Directors approved the deal. The second disbursement, of $1.25 bn, was approved after a staff visit to Cairo in May this year, at the end of which the IMF staff commented that the programme was "off to a good start".

Remaining funds are due to be disbursed in instalments of approximately $2 bn every six months, subject to a review by the Fund of Egypt's compliance with its performance criteria. The final disbursement and review are due to take place in March 2019.

The IMF's funds account for only about one third of the $35 bn funding gap which the IMF believes Egypt will face over the life of its three-year facility. Nearly half of this funding gap occurred during the financial year 2016/2017, which ended on 30 June 2017.

Table 1 shows the extent to which Egypt has been dependent on other donors to cover its funding gap. Of the Gulf States, only the UAE provided cash support. China's currency swap dwarfed the support provided by other G20 economies.

During the second and third years of the IMF facility, reliance on other donors will reduce, with the Fund's disbursements of $4 bn per year covering about half of the funding gap.

Of course, the IMF's money comes at a price. Egypt has committed to a set of significant economic reforms, the success of which will be measured against performance criteria and benchmarks.

The planned economic reforms fall into three areas:

- Exchange rate, money and financial sector
- Fiscal policy, social protection and public financial management
- Structural reforms and inclusive growth

The most significant step taken so far is the liberalisation of the exchange rate. On 3 November, the Central Bank of Egypt (CBE) liberalised the exchange rate, which promptly fell from around $1=LE8.8 to around $1=LE16. This 100% devaluation was greater than the authorities had been expecting (they had been anticipating a rate of around $1=LE13) and is by far the most significant devaluation to have occurred in recent Egyptian history. Over the last 30 years the exchange rate has progressively weakened, but there has never been a sudden devaluation of this magnitude.

The devaluation led quickly to an increase in domestic prices. Urban inflation rose to around 30% in early 2017 and remained at that level through the summer. This was the highest level of inflation since Egypt's economic crises of the mid-1980s. Food prices rose by more than 40%, year on year, in the weeks ahead of Ramadan, when food demand peaks

Table 1: Financing the funding gap

After taking account of the revenue effects of policy measures agreed with the IMF, Egypt will face a funding gap of $35 bn over the three years of the IMF programme. Of this, $16.3 bn occurred in 2016/17. The Egyptian government planned to fill the gap as shown below.

	$mn
IMF EFF Facility	4,000
World Bank	1,000
World Bank (second tranch of existing facility)	1,000
Afreximbank, rolling over existing loan	3,200
African Development Bank	500
Eurobond issue	950
Local banks repo transaction	1,350
UAE	1,000
China, currency swap	2,700
Germany	250
United Kingdom	150
France	150
Japan	50
Total	16,300

Source: Government of Egypt, Memorandum of Economic and Financial Policies

Table 2: Egyptian Government Budget, 2015/16: preliminary outcome

	Billion Egyptian pounds
Revenues and grants	487.9
tax revenue	339.4
non-tax revenue	144.3
Expenditures	810.2
Wages	212.0
Interest on debt	241.5
Subsidies/social benefits	201.1
Deficit*	322.3
Financing by local banks	341.3

Figures do not take account of acquistion of financial assets or external debt repayment
Source: IMF

(because of larger than usual consumption after people have broken their fast). Inflation had been running at around 12% during the three years prior to the devaluation.

The devaluation also had an effect on banks, most of which had been allowing customers to open 'uncovered' letters of credit (LCs) for imports. When the exchange rate fell, the cost of the uncovered portion of the LCs doubled. Banks have been working with their customers to resolve the problem, giving them more time to settle, but it is expected that banks will show losses on their LCs when they publish their June 2017 financial statements.

Egypt took significant steps to address its budget deficit in the weeks before the IMF agreement was signed. Parliament passed the VAT law at the end of August 2016, providing for an initial rate of 13%, rising to 14% during the current financial year, which began on 1 July. VAT replaces the previous sales tax, which stood at 10%, and is believed to be easier to collect and fairer. The government is expecting that VAT will generate about $3 bn more than the sales tax every year.

Electricity prices were increased by 40% in July 2016 and gasoline and diesel prices were increased by 35% in early November. The Egyptian government has committed to eliminating energy subsidies altogether by the end of 2021.

The IMF programme projects that tax revenues will increase by 2.5% of GDP over its three-year term, while primary expenditure will be reduced by 3.5% due to the reduction of subsidies and the containment of the public sector wage bill. (The automatic indexation of public sector bonuses and allowances has already been abolished.) These measures will be offset by additional food subsidies and cash transfers that target the elderly and low income families, and some other social measures such as increasing the number of children who are eligible for free school meals. These offsetting programmes will cost about 1% of GDP.

The scale of the fiscal task facing the Egyptian government can be seen in Table 2, which shows the preliminary figures for the Egyptian Government Budget in 2015/16, which ended on 30 June 2016. Revenues of LE487.9 bn compared to expenditure of LE810.2 bn. Public sector wages, interest on debt, and subsidies each account for about a quarter of total expenditure.

Table 2 also shows the extent to which the government is reliant on local banks to fund its budget deficit.

Egyptian banks are already providing the government with considerable financial support. Table 3 shows that their purchases of government Treasury Bills accounted for 40% of their assets at the end of 2016, down from around 45% in previous years, as a result of the November devaluation. (The devaluation increased the local currency value of foreign currency loans to the private sector, but did not affect the value of Treasury Bills, which are denominated in local currency.)

Banks' holdings of Treasury Bills increased by 44% in 2016 and direct lending to the government doubled.

It is easy to see why banks want to invest in Treasury Bills. Table 4 shows that the spread between 1–3 month deposits and the interest rates on 91-day Treasury Bills has

"The Egyptian banking system has been transformed over the last ten years as a result of the privatisation of many of the small banks in which the Egyptian government used to hold a commanding share."

Photo by MOHAMED OSAMA on Unsplash

Table 3: Aggregate balance sheet of Egyptian commercial banks

Million Egyptian pounds	Dec-16	Dec-15	Dec-14	Dec-13	Dec-12
Treasury bills	1,591	1,106	904	735	613
Placements with banks in Egypt	723	364	222	186	100
Loans to government	296	101	47	42	35
Loans to private sector	1,004	691	582	509	482
Assets	3,962	2,485	1,968	1,684	1,441
Deposits	2,754	1,909	1,555	1,312	1,088
Capital and reserves	253	141	123	113	101
Ratios (%)					
Treasury bills % assets	40.2	44.5	45.9	43.6	42.5
Total loans % assets	32.8	31.9	32.0	32.7	35.9
Total loans % deposits	47.2	41.5	40.5	42.0	47.5
Capital and reserves % assets	6.4	5.7	6.2	6.7	7.0
Capital % risk-adjusted assets	14.1	14.5	13.9	13.7	14.9
Exchange rate $1=Egyptian pounds	*18.2*	*7.8*	*7.1*	*6.9*	*6.1*

Source for data: Central Bank of Egypt
Source for exchange rate: Oanda.com

Table 4: Local currency interest rates: T-Bills and bank deposits

	End December 2016	End June 2016	End June 2015	End June 2014	End June 2013	End June 2012
91-day government bills	19.0	14.0	11.7	10.6	14.2	14.8
1–3 month deposits	10.3	7.5	6.8	6.7	8.0	7.7

Source: Central Bank of Egypt

been widening, reaching nearly 9% at the end of 2016. The attractions of earning such a spread on apparently risk-free assets that carry a low risk weight for capital calculation are irresistible.

Although the amount that banks invest in Treasury Bills has consistently exceeded the amount that they have lent to the private sector in recent years, private sector credit has been increasing. The Central Bank of Egypt is also spearheading efforts to force banks to lend more to small- and medium-sized enterprises.

The Egyptian banking system has been transformed over the last ten years as a result of the privatisation of many of the small banks in which the Egyptian government used to hold a commanding share. Many of these small banks have been bought by well-capitalised and efficient banks from the GCC and Lebanon. Table 5 summarises the most prominent of these transactions.

As a result of this injection of capital and management expertise into the smaller banks, the Egyptian banking system as a whole is much stronger and more efficient than in the past. Yet in terms of resources – either to buy government bonds or make loans to local businesses – it is still the big five banks that matter, and in particular the big two: National Bank of Egypt and Banque Misr. The deposits held by these two are as great as those of all other Egyptian banks combined.

However, the IMF's endorsement of Egypt's economic plans has reopened the door to international debt financing. The government raised $4 bn in January and was planning a further issue as *Arab Banker* was going to press.

Egypt has not always had a good relationship with the IMF. Former President Mubarak once referred to the Fund as a 'quack doctor' when he didn't want to implement the remedies it was proposing for Egypt's economic ills at the time. The Fund is pleased with Egypt's progress during the first year of the current facility, but we should certainly expect some robust discussions and disagreements as the programme moves into its second year. ■

Table 5: Major purchases of Egyptian banks by foreign buyers

2005	Lebanon's BLOM Bank buys Misr Romanian Bank
2006	Ahli United Bank of Bahrain buys into Delta Bank; Lebanon's Bank Audi buys Cairo Far East Bank, Abu Dhabi's Union National Bank buys Alexandria Commercial and Maritime Bank
2007	Abu Dhabi Islamic Bank buys National Bank of Development
2012	Emirates NBD buys BNP Paribas' operations in Egypt
2013	Qatar National Bank buys National Société Générale Bank
2015	Al Ahli Bank of Kuwait buys the Egyptian operations of Pireaus Bank of Greece
2016	Morocco's Attijariwafa Bank buys Barclays' operations in Egypt