Fiscal position, not only monetary policy, is another corner stone of the IMF agreement

Egypt awaits this month the IMF board approval on a three year USD12 billion financial support package. While all eyes have been on monetary policy and the movement in exchange rate, we believe another corner stone of the IMF agreement is bringing down the budget deficit as a percentage to GDP down to single digit. Consequently, it is time to spot more light on the Egyptian 'fiscal puzzle' and which factors come in play to determine the success of achieving such target. Now, the USD12 billion question is: How will Egypt be on track to restore macroeconomic balances rather than roll over economic distress?

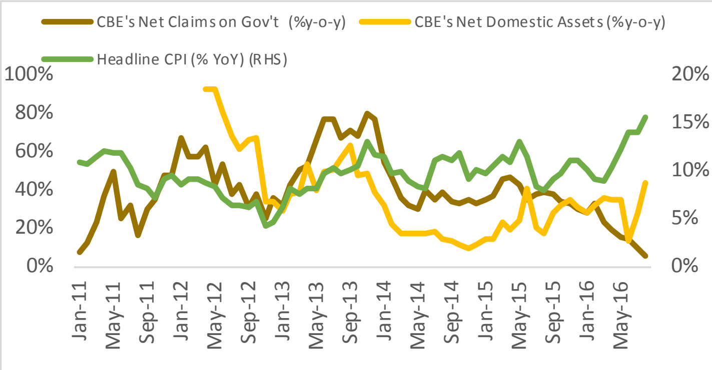
Monetizing the deficit fueled absorption and pressured external position

Following 2011, the government started monetizing its deficit directly through the central bank as the budget deficit widened sharply from 8.1% of GDP in FY2009/10 to 13% of GDP in FY2012/13. Deploying the printing machine resulted in more money chasing slow-growing domestic production. In addition, with limited growth in productivity, the end result was a combination of soaring inflation and higher pressure on the country's dwindling external position (Figures 1 & 2). Add to those the politically-driven decision to defend the local currency versus the USD, which made things even worse.

The exchange rate and oil price assumptions within the budget are crucial corner stones

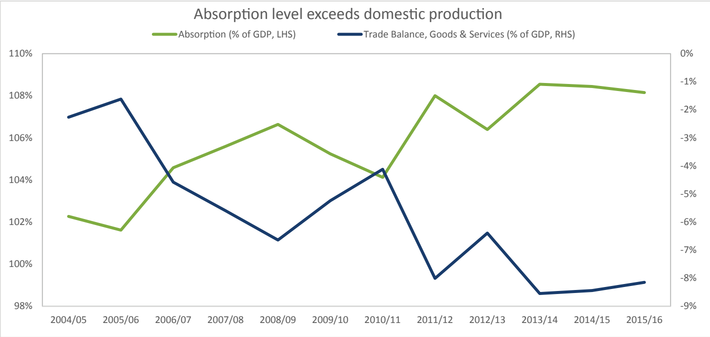
In terms of sustainability, we believe that fixing the fiscal imbalances should go hand in hand with the exchange rate policy. Revisiting the government budget assumptions of FY2016/17 is crucial in order to extrapolate Egypt's macroeconomic outlook. According to the Ministry of Finance, the exchange rate and oil price assumptions play a leading role in determining the deficit. Every USD1.00 increase in price of petroleum based products would raise energy subsidies by EGP1.9 billion and would raise revenue from EGPC by EGP0.4 billion, creating a net increase in budget deficit of EGP1.5 billion. Every EGP0.10 weakness for the EGP/USD exchange rate would raise energy subsidies by EGP0.8 billion and reduce EGPC revenue by EGP0.3 billion, resulting in a net increase of EGP1.1 billion in the budget deficit.

Figure 1: Inflation has been directly affected by deficit monetization



Source: Central Bank of Egypt, Pharos Research

Figure 2: Absorption level exceeds domestic production



Source: Ministry of Planning, Pharos Research

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Back in July 2016, the Ministry of Finance had set its budget for FY2016/17 on an oil price assumption of USD40.00 per barrel and an average exchange rate at EGP9.00 per USD, which when both were adjusted for USD51.57 and EGP11.08/USD, respectively, the end result is a fiscal deficit that is EGP40.2 billion wider than budgeted. We also estimate that the implementation of a more flexible exchange rate would increase the food subsidy bill by EGP7.7 billion more than budgeted. This lead us to the conclusion that the target budget deficit of 9.8% has a high probability of hitting more than 11% (Table 1). For that not to happen, the government needs to adjust revenues and expenses in a way that would generate a net budget savings of EGP47.9 billion, to stay in line with the aforementioned target.

	Oil (USD per barrel)	Avg. Exchange Rate (EGP/USD)	Fuel Subsidies (EGP Bn)	Food Subsidies (EGP Bn)	Nominal GDP (EGP Bn)	Projected Deficit (EGP Bn)	Projected Deficit (% of GDP)
MoF initial assumptions	40.0	9.0	35.0	41.1	3,247	319.5	9.8%
Pharos Research Estimates	51.6	11.1	75.2	48.8	3,247	367.4	11.3%

Source: Ministry of Finance, Bloomberg, Pharos estimate

Three substantial clues in focus: Energy subsidy, tax reforms, and civil service law

1) **Energy subsidy reform:** In FY2016/17, the government allocates EGP62.4 billion for energy subsidies (fuel and electricity). While the plan to trim electricity subsidies is in place, albeit rather slowly, we expect the government to proceed with another fuel subsidy cut. Cutting energy subsidies further will help sustain the targeted spending on that item, despite oil prices being higher than the USD40.00 per barrel budgeted by the government early this year. In addition, it should encourage more private investments in such a vital sector. Further, the government needs to shift spending from energy subsidies to cash transfers/social safety net.

2) **Tax reforms:** The government intends to raise tax revenue from 12.6% of GDP in FY2014/15 to 18.5% of GDP in FY2021/22. Having a large informal sector, the broad-line is to widen the tax base rather than just raise the tax rate. The implementation of the value-added tax (VAT) is supposed to tackle a large portion of that issue (Chart 3). We note that the structure of the recently applied VAT is similar to the General Sales Tax (GST). The key point was adding more services to the base (GST included only 17 services). Due to a larger-than-expected exemption list, we estimate goods and services tax revenue to record EGP161.8 billion (4.98% of GDP) rather than the budgeted EGP201.2 billion (6.2% of GDP) in FY2016/17.

3) **Cash transfers, the social safety net and the civil service law:** In order to reduce the impact of high inflation and currency adjustment on low income groups, the government continues improving the social safety net, which is another crucial dimension for the success of the IMF program. The allocated budget for cash transfer programs (e.g. Takaful and Karama) rose from EGP7.5 billion to EGP11.2bn in FY2016/17. On the other hand, we note that the civil service law is designed to control the current wage expenditure surge through linking wage increases to productivity. While such an important structural reform will help raise efficiency within the public sector, it induces another source of cash outflow in the short-run due to incentive pays for early retirement programs, and might result in good-caliber-migration from the public to the private sector.

Due to debt service burdens, the primary, rather than overall, deficit in focus over the next three years

Given the magnitude of interest payments and with projections pointing to higher policy rates, watching the primary deficit is crucial. A diminishing primary deficit will gradually slowdown public debt growth rate and the consequent debt servicing burden. Moreover, a primary surplus should provide the government with enough funds to reverse the public debt curve trend over the medium term (Chart 4). That's why we believe that the IMF deal includes a primary surplus target by the end of the 3-year program. Every 1% increase in interest rate adds EGP12.57 billion of interest expense, and with the expected rise in policy rates by another 200bps, and with the external debt to be raised over the next 2 quarters, the rise in interest expense should hover around EGP25.7 billion, above the government's estimated expense.

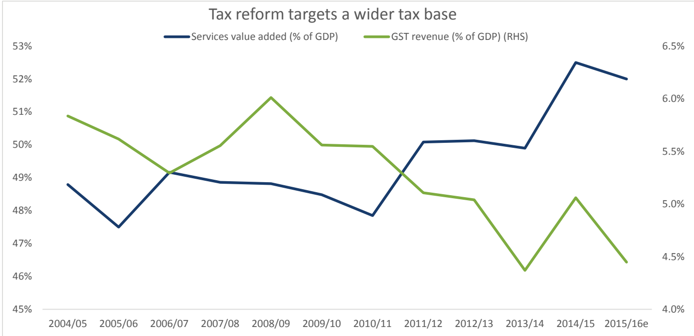
Let us not forget the denominator and another key factor in the equation: Nominal GDP

It is notable that the MOF is building its assumption on a nominal GDP figure of EGP3.2 trillion, which implies a c.17% nominal GDP growth, from an estimated EGP2.8 trillion estimated to be recorded by FY15/16. We believe that the figure is quite achievable, especially with a high deflator, in addition to c.3.2% real GDP growth, much lower than the government's projected real GDP growth of 5.2%.

Rationalizing current expenditure should create room for higher capital expenditure

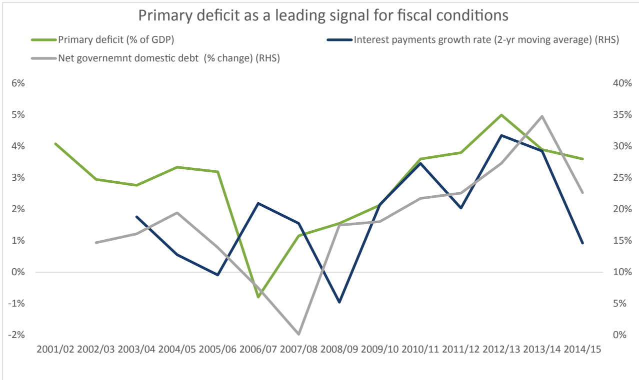
In conclusion, the optimal outcome of the aforementioned 'fiscal puzzle' reorder implies a more efficient allocation to current expenditure in order to create more room for capital expenditure. At the end of the day, focus on the county's ailing infrastructure should attract more investments and raise productivity over the medium to long terms. This way, the Egyptian economy will be able to secure more sustainable and inclusive growth.

Figure 3| Tax reforms targets a wider tax base



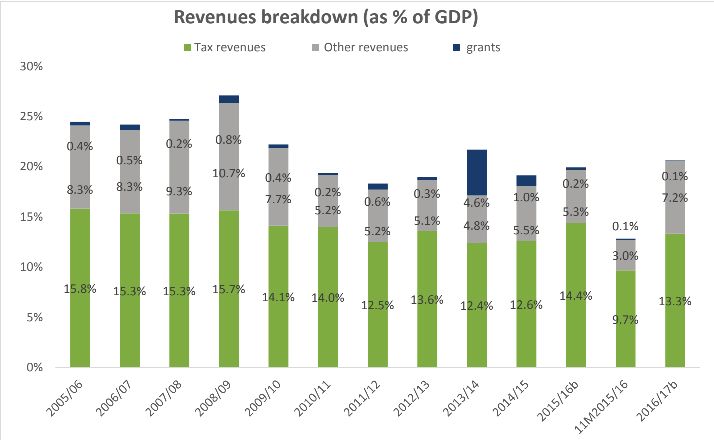
Source: Ministry of Finance, World Bank, Pharos Research

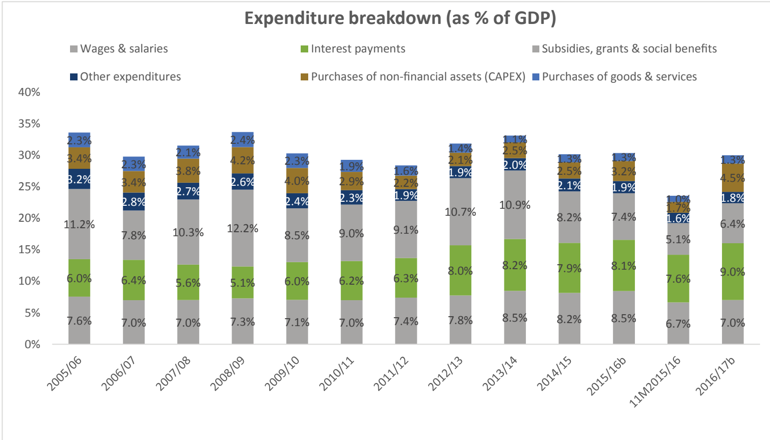
Figure 4| Primary fiscal deficit is first area of attack

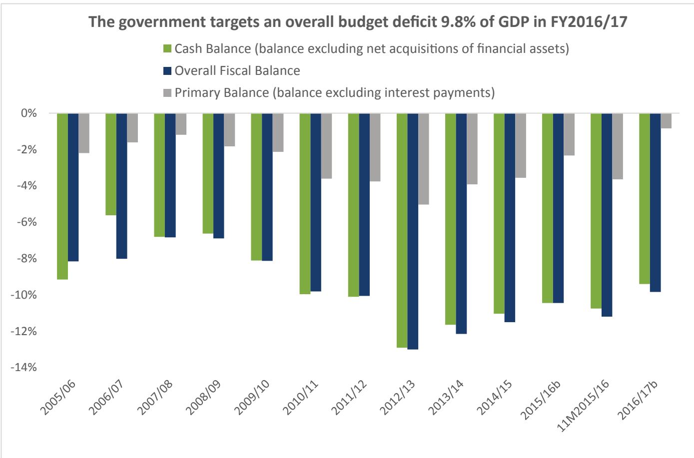


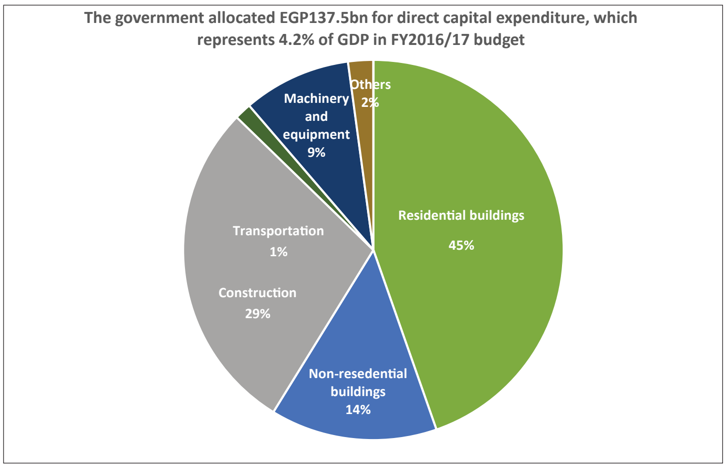
Source: Ministry of Finance, Pharos Research

Fiscal Stance At a Glance









Source: Ministry of Planning, Ministry of Finance, Pharos Research

Key Budget Items (EGP Billion)	2005 /06	2006 /07	2007 /08	2008 /09	2009 /10	2010 /11	2011 /12	2012 /13	2013 /14	2014 /15	2015 /16b	2015 /16*	2016 /17b
Total Revenues and Grants	151	180	221	283	268	265	304	350	457	465	565	357	670
Tax revenues	98	114	137	163	170	192	207	251	260	306	408	269	433
Grants	2	4	1	8	4	2	10	5	96	25	7	3	2
Other revenues	51	62	83	111	93	71	86	94	100	134	150	85	234
Total Expenditures	208	222	282	351	366	402	471	588	702	733	861	655	975
Wages & salaries	47	52	63	76	85	96	123	143	179	198	240	185	229
Purchases of goods & services	14	17	18	25	28	26	27	27	22	31	36	27	42
Interest payments	37	48	51	53	72	85	104	147	173	193	230	210	293
Subsidies, grants & social benefits	69	58	92	127	103	123	150	197	229	199	210	140	206
Other expenditures	20	21	24	27	29	31	31	35	41	50	55	46	58
Purchases of non-financial assets (CAPEX)	21	25	34	43	48	40	36	40	53	62	90	48	147
Cash Balance (Balance excluding net acquisitions of financial assets)	(57)	(42)	(61)	(69)	(98)	(137)	(167)	(238)	(245)	(268)	(296)	(298)	(305)
Net Acquisition of Financial assets	(6)	18	0	3	0	(2)	(1)	2	11	11	-	13	14
Overall Fiscal Balance	(50)	(60)	(61)	(72)	(98)	(134)	(167)	(240)	(255)	(279)	(296)	(311)	(319)
Primary Balance (Balance excluding interest payments)	(14)	(12)	(11)	(19)	(26)	(49)	(62)	(93)	(82)	(86)	(66)	(101)	(27)
Nominal GDP (at market price)	618	745	895	1,042	1,207	1,371	1,657	1,844	2,102	2,430	2,833	2,777	3,247

* Figures are for 11 months only.

Key Budget Items (% of GDP)	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16b	2015/16*	2016/17b
Total Revenues and Grants	24.5%	24.2%	24.8%	27.1%	22.2%	19.3%	18.3%	19.0%	21.7%	19.1%	19.9%	12.8%	20.6%
Tax revenues	15.8%	15.3%	15.3%	15.7%	14.1%	14.0%	12.5%	13.6%	12.4%	12.6%	14.4%	9.7%	13.3%
grants	0.4%	0.5%	0.2%	0.8%	0.4%	0.2%	0.6%	0.3%	4.6%	1.0%	0.2%	0.1%	0.1%
Other revenues	8.3%	8.3%	9.3%	10.7%	7.7%	5.2%	5.2%	5.1%	4.8%	5.5%	5.3%	3.0%	7.2%
Total Expenditures	33.6%	29.8%	31.6%	33.7%	30.3%	29.3%	28.4%	31.9%	33.4%	30.2%	30.4%	23.6%	30.0%
Wages & salaries	7.6%	7.0%	7.0%	7.3%	7.1%	7.0%	7.4%	7.8%	8.5%	8.2%	8.5%	6.7%	7.0%
Purchases of goods & services	2.3%	2.3%	2.1%	2.4%	2.3%	1.9%	1.6%	1.4%	1.1%	1.3%	1.3%	1.0%	1.3%
Interest payments	6.0%	6.4%	5.6%	5.1%	6.0%	6.2%	6.3%	8.0%	8.2%	7.9%	8.1%	7.6%	9.0%
Subsidies, grants & social benefits	11.2%	7.8%	10.3%	12.2%	8.5%	9.0%	9.1%	10.7%	10.9%	8.2%	7.4%	5.1%	6.4%
Other expenditures	3.2%	2.8%	2.7%	2.6%	2.4%	2.3%	1.9%	1.9%	2.0%	2.1%	1.9%	1.6%	1.8%
Purchases of non-financial assets (CAPEX)	3.4%	3.4%	3.8%	4.2%	4.0%	2.9%	2.2%	2.1%	2.5%	2.5%	3.2%	1.7%	4.5%
Cash Balance (balance excluding net acquisitions of financial assets)	-9.2%	-5.6%	-6.8%	-6.6%	-8.1%	-10.0%	-10.1%	-12.9%	-11.6%	-11.0%	-10.4%	-10.7%	-9.4%
Net Acquisition of Financial assets	-1.0%	2.4%	0.0%	0.3%	0.0%	-0.2%	0.0%	0.1%	0.5%	0.5%	0.0%	0.5%	0.4%
Overall Fiscal Balance	-8.2%	-8.0%	-6.8%	-6.9%	-8.1%	-9.8%	-10.1%	-13.0%	-12.2%	-11.5%	-10.4%	-11.2%	-9.8%
Primary Balance (balance excluding interest payments)	-2.2%	-1.6%	-1.2%	-1.8%	-2.1%	-3.6%	-3.8%	-5.0%	-3.9%	-3.6%	-2.3%	-3.6%	-0.8%

* Figures are for 11 months only.

Source: Ministry of Finance, Ministry of Planning

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