Egypt will struggle to service high-interest loans

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Egypt's latest budget shows the government is turning to higher-interest rate financing mechanisms


An employee counts Egyptian pounds at a foreign exchange office in central Cairo, Egypt, March 20 (Reuters/Mohamed Abd El Ghany)

On June 30, President Abdel Fattah el-Sisi approved Egypt's budget for the 2019/20 fiscal year (FY), which started on July 1. The budget assumes 6.0% GDP growth and a 7.2% deficit, compared to 5.6% growth and an 8.4% deficit for the previous fiscal year. However, these numbers are distorted through a number of mechanisms.

What next

Egypt is finding it harder to secure loans at reasonable rates from international financial institutions (IFIs) and Gulf Cooperation Council (GCC) allies. The government is already turning to higher-interest rate financing mechanisms, including issuing bonds. Capital inflows in the form of 'hot' money will grow, as Egypt struggles to service heavy debt obligations, increasing volatility. Low- and middle-income Egyptians will bear the greater part of the burden through reduced subsidies, increased income and value-added taxes, and degraded quality of basic social services such as health and education.

Subsidiary Impacts

- Investors in the short-to-medium term will continue to reap high profits from Egypt's government bonds.
- Egypt is steadily accumulating debt, but the government's fiscal policy suggests plans to stabilise this.
- The private sector will find it ever more difficult to compete with military-led enterprises, which enjoy special privileges.
- The military's role in the economy is a subject of speculation, but is thought to be growing.
- Military spending does not factor into public expenditure, casting doubt on the accuracy of the state budget.

Analysis

Most revenue for the new fiscal year is to come from taxes -- a weight disproportionately born by low- and middle-income tax-payers. Value-added tax (VAT) is to account for a 32% of public revenues (21 billion dollars) in the new fiscal year, a rise of 2.6 billion dollars from the the projected numbers of fiscal year 2018/19 (see EGYPT: Wage rises will increase economic disparities - May 21, 2019).

Income tax is to bring in another 3.3 billion dollars, up from 2.3 billion. Meanwhile, revenues from capital gains tax are only expected to amount to 60 million dollars, with wealth and real estate taxes bringing in a mere 38 million.

Egypt will have to pay 32.6 billion dollars in interest this fiscal year, which will account for a full 36% of expenditures. Full debt servicing will amount to some 54.1 billion dollars, including the 21.5 billion dollars of principal repayments not accounted for in the deficit.

This leaves little cash for spending on social goods. Only 4.2 billion and 7.6 billion dollars are earmarked for health and education respectively, for a population of some 100 million. And a mere 177 million dollars is allocated towards environmental protection in a country with one of the world's most polluted cities, Cairo.

These numbers are well below their levels before the currency flotation in November 2016, with 5.6

billion dollars, 12.4 billion dollars and 274 million dollars spent on health, education and environmental protection, respectively, in the 2015/16 fiscal year.

Increasingly expensive debt

Egypt's 12-billion-dollar agreement with the IMF in 2016 opened the door to tens of billions of dollars in loans at discounted rates from various IFIs. The country also received substantial grants and low-interest loans from GCC allies, especially Saudi Arabia, the United Arab Emirates (UAE) and Kuwait, prior to the IMF deal.

However, Egypt is now having to turn to higher-interest rate borrowing to fund the deficit and settle debt repayments. As of December 2018, debt levels stood at 339 billion dollars (242 billion and 97 billion in domestic and foreign debt, respectively), according to Egypt's Central Bank.

The government has already rescheduled debts in exchange for paying a higher interest rate, including 6.6 billion dollars owed to Saudi Arabia originally set to mature this year.

> Sisi is looking to China to finance his mega-projects

As financing from traditional allies dries up, the government has looked east to finance its mega-projects. Since Sisi assumed the presidency in 2014, debt held by China jumped from only 338 million dollars in 2015, to some 6.5 billion dollars by the end of September 2018 (see EGYPT/CHINA: Deals will help army more than economy - March 19, 2019). Interest rates for a number of the loans remain undisclosed.

In February, Egypt issued 4 billion dollars in international bonds, with maturities ranging from five to 30 years, and yields between 6.2% and 8.7%. By comparison, similar maturity periods on loans from the IMF and GCC countries averaged yields of 2.7%.

The new budget calls for the issuance of another 4 billion dollars in international bonds for the current fiscal year, and Finance Minister Mohamed Maait says the number may reach as high as 7 billion dollars.

On the local debt market, the government plans to issue a staggering 41.5 billion dollars in treasury bills (T-bills) and bonds, compared to 28.7 billion in FY 2018/19. As of April, yields on 91-day T-bills stood at 17.49%. Yields on local debt had earlier exceeded 20%.

The sale of T-bills, with maturities between three and twelve months, is increasing volatility in Egypt's financial portfolio. During the first quarter of FY 2018/19, Egypt experienced a 3.2-billion-dollar net outflow of financial investments -- a dramatic drop from the net inflow of 7.5 billion dollars during the previous fiscal year's first quarter. This dive was primarily caused by foreign investors selling back their T-bills.

Meanwhile, the more stable foreign direct investment (FDI) inflow has been unimpressive and is dominated by the extractive industries. The oil sector accounted for 71% of the 1.1 billion dollars in net FDI inflows in the first quarter of FY 2018/19. The real estate sector followed, representing 8.3% of FDI inflows.

Fiscal sustainability risks

One of the main drivers of recent GDP growth has been government spending -- largely in the form of infrastructure projects initiated by the military and financed by debt. Much of this spending is funded by debt for investments that do not yield future economic returns, exacerbating the trend of high current growth leading to an ever-increasing financial burden down the road.

Oxford Analytica

Military infrastructure projects are inflating GDP growth

The spending that is boosting GDP now will soon transform into a burden, when the debt matures and the state must pay back the loans, with interest. Sisi's prestige projects are not likely to generate sustainable future revenues, as would spending on support for agriculture or non-extractive industries.

The 8-billion-dollar military-led expansion of the Suez Canal completed in 2015 has yet to demonstrate the promised increase in profits. In March 2015, the Suez Canal chairman said revenues were expected to surge from 5 billion dollars to 13 billion by 2023. However, two years after the inauguration of the expanded canal, revenues hovered at 5.7 billion dollars for FY 2017/18, and the first quarter of FY 2018/19 recorded only a slight improvement of 1.44 billion dollars.

Meanwhile, the then investment minister, Ashraf Salman, said the surrounding developments of the Suez Canal Zone mega-project, also led by the military, would boost FDI to reach 15 billion dollars by FY 2018/19. Yet net FDI inflows for the first quarter of that fiscal year totalled only 1.1 billion dollars.

The billions of dollars spent on military equipment are also widening the fiscal deficit. Over 2014-18, Egypt became the world's third-largest arms importer. It purchased more than 8.5 billion dollars in arms from Europe and Russia during 2013-17, to say nothing of the 1.3 billion dollars in US aid earmarked for the purchase of US military equipment (see EGYPT: Arms purchases will boost regional image - March 29, 2019).