Medium-Term Macroeconomic Policy Framework

FY 2014/15 – FY 2018/19

The Government of Egypt is pursuing a five-year macro-economic policy framework which will deliver:

- sustainable real GDP growth of 6 per cent by the end of the forecast period;
- a faster pace of job creation in order to bring the unemployment rate below double digits;
- inflation within the Central Bank of Egypt's comfort zone;
- higher rates of domestic investment;
- improved export performance;
- greater efficiency in government spending in parallel with a planned reduction of the fiscal deficit to 8-9 per cent of GDP and the government debt to within a range of 80-85 per cent of GDP;
- the development and betterment of the country's human resources.

These are realistic and achievable targets which will be supported by the GoE's commitment to sound macroeconomic policies, in particular a concerted drive to achieve fiscal sustainability. The magnitude of the government's budget deficit (12.6% of GDP in FY 2013/14) reflects long-standing structural challenges that have been exacerbated by the difficult political transition of the past three years, with the resulting cyclical factors playing an instrumental role in widening the deficit as well as pushing the government debt to GDP ratio up to 97 per cent. Moreover, the government's increasing financing needs contribute to inflationary pressures, distort the incentives of the banking system, crowd out the private sector and constrain government expenditure in productive areas due to the large debt service burden.

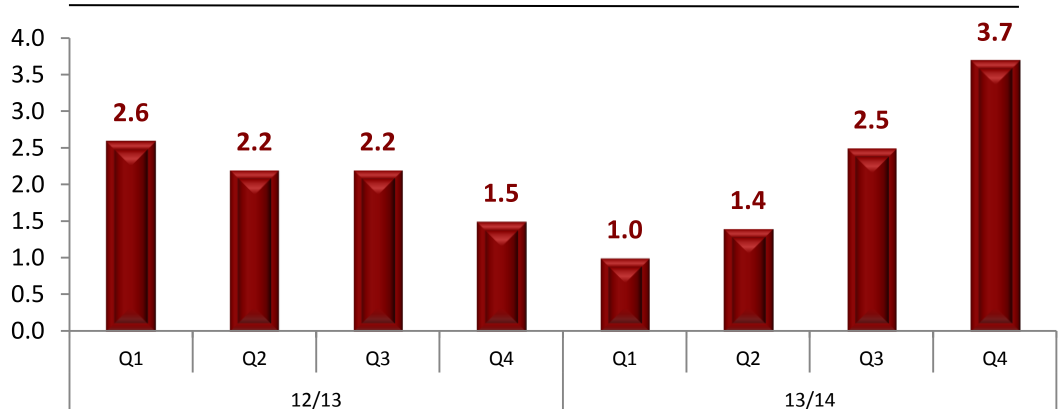
Fiscal consolidation aimed at putting the public debt onto a sustainable trajectory while concurrently improving the quality and direction of government spending will serve as the essential cornerstone on which the GoE will build a platform for higher and better quality growth. Any new spending commitment undertaken by the GoE will be rigorously subjected to a review of its economic and social merits, and planned fiscal reforms will focus on rationalizing existing expenditures. Current expenditures will be streamlined and constrained to allow more room to shift spending to sectors that will enhance the economy's productive capacity and to better targeted social programs.

An overarching principle governing the GoE's medium- and longer-term policies and programs concerns the goal of achieving social justice in tandem with higher, sustainable, and more inclusive growth. This will entail the redirection of part of the savings achieved through the fiscal consolidation measures to health, education and the strengthening of social safety nets. Although this approach will necessarily slow down the pace of fiscal adjustment vis-à-vis what could otherwise be obtained, it will ensure a more equitable distribution of both the costs and benefits of the adjustment as well as secure public support for the required reforms. In seeking to deliver a material improvement in the quality of life of Egyptian citizens, the GoE will thus safeguard the momentum and durability of reforms.

Growth, inflation and unemployment outlook

Growth in FY 2013/2014 reached 2.2 per cent, almost the same as in the preceding fiscal year. This headline performance obscures an important improvement in the overall growth trend over the course of the just ended fiscal year as political stability and internal security improved, bolstering market confidence. As the chart below shows, growth in Q1 2013/14 of only 1.0 per cent (yoy) rose to 3.6 per cent (yoy) by Q4 2013/14. While base effects had some influence on the growth outcome over the final quarter of FY 2013/14, it is clear that an economic recovery is underway. Since May 2014, the industrial and manufacturing production indices have picked up at a robust pace. Additional signs of confidence include the growing foreign purchases of government debt since the beginning of this calendar year; the strong upturn in the benchmark stock market index (EGX70), which has gained 40 per cent this year; and the significant decline in the country's 5-years CDS to less than 275 bps from some 900 bps about a year ago.

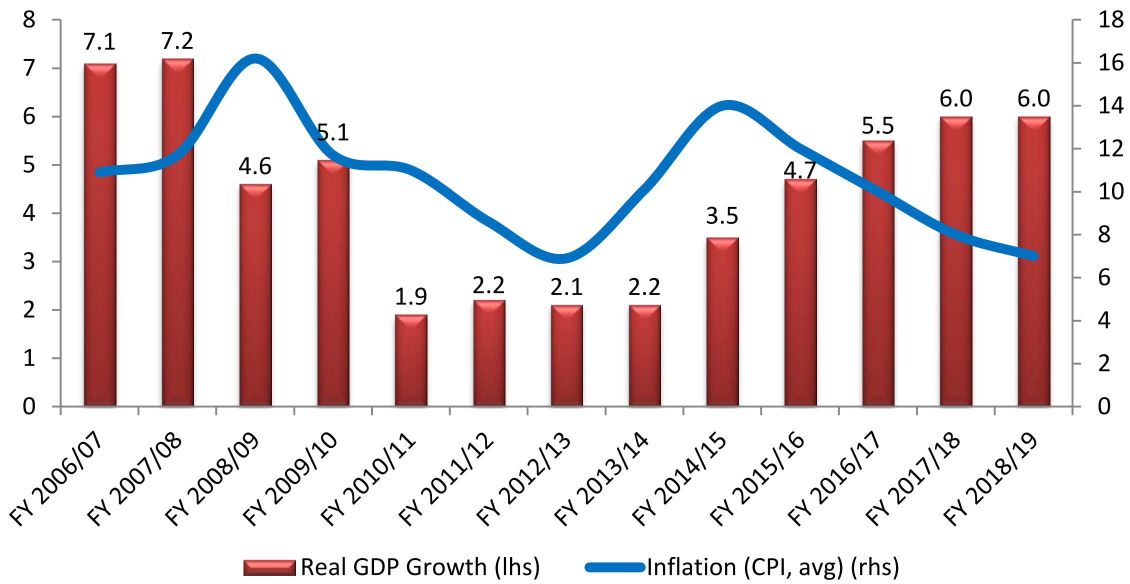
Real GDP Growth Rate (%): Quarterly data from FY12/13 through FY13/14



Source: MoP

In light of these recent developments, the GoE's projection of 3.5 per cent growth in FY 2014/15 should be seen as realistic, if not conservative. The government expects that investment will emerge as the key driver of growth in the current fiscal year, with the private sector beginning to take on a leading role even as the public sector continues to invest in major infrastructure projects (including the first phase of the Suez Canal development project, low-cost housing units, new roads, and the expansion and upgrading of utilities). Over the forecast period, growth is projected to climb steadily and to reach 6 per cent in FY 2017/18 (before the end of the forecast period) as private sector investment rises to 15 per cent of GDP, where it stood prior to the 2008 global financial crisis. The inflation rate will gradually fall within the CBE's single digit comfort zone, as prudent monetary policies are maintained and supply-side bottlenecks (energy, transport, and distribution) are addressed.

Real GDP Growth and Inflation: Historical and Projected



One of the GoE's key priorities is to enhance the business environment in order to attract and retain both domestic and foreign investment. To this end, the government has introduced amendments to the competition and anti-monopoly laws. It has also removed legal hurdles and will soon introduce a new uniform investment law to further streamline the path for foreign investment. Reducing the regulatory burden, streamlining processes, clarifying land use and ownership issues, creating a level playing field, establishing and enforcing the rule of law and minimizing bureaucratic impediments will be important not only to attract more investments, but also to create incentives for the large informal sector to enter the formal sector. This is particularly important to catalyze the role of the small- and medium-sized enterprises as the country's engines of job creation.

Fiscal reforms, objectives and projections

The GoE will reduce its deficit to 8.5 per cent of GDP and its debt burden to within 80-85% of GDP, from current levels of 12.6 per cent and 97 per cent of GDP, respectively, by the end of the five-year forecast period. The planned fiscal consolidation program encompasses measures on both the revenue and expenditure sides of the budget that will create more fiscal room while enhancing the quality, direction and efficiency of expenditures. By restraining and rationalizing current expenditures, the GoE will refocus spending on infrastructure, health, education and other sectors that will bolster the country's economic potential.

Revenue Measures

The guiding objectives underlying the GoE's tax reforms are to broaden the tax base and increase tax buoyancy, to develop a tax system in conformance with international standards and improve tax progressivity, to incentivize the informal sector to join the formal sector, and to curtail tax evasion. Specific policies include the following:

- Income Tax: The Income Tax Law has been amended to broaden the tax base through taxing dividend incomes, capital gains, and residents' incomes attained abroad. It also added new anti- tax avoidance rules, and increased tax rates by 5 per cent on corporates and individuals earning more than EGP 1 million for a period of three years;
- Real Estate Tax: The new law streamlined earlier generous tax exemptions, limiting them to only one residential unit with a value less than EGP 2 million. The law is expected to yield 0.4% of GDP in FY 2014/15, and requires the redirection of 50 per cent of the proceeds for the development of rural and slum areas;
- Mines and Quarries Tax: New reforms are being discussed by the government to generate a higher fiscal yield;
- Telecom Licensing Fees: New measure to yield 0.3 per cent of GDP in FY 2014/15;
- Higher excises taxes on cigarettes and alcoholic beverages;
- Introduction of VAT: The VAT is expected to be implemented in the second half of FY 2014/15 and will replace the current GST regime. The new law will be fairer to taxpayers, allowing an immediate full tax refund on capital goods and a broader tax credit system as well as applying a single unified rate, incorporating a high threshold and extending to a wider range of goods and services. The revenue yield from the VAT is projected to be 1.6 per cent of GDP on a full year basis;
- Simplified tax regime for Small and Micro-Enterprises: This new regime will be designed to not only bring a wider pool of economic actors into the tax net, but also to incentivize them to grow and develop.
- The settlement and collection of tax arrears and reduction of tax exemptions will further enhance the revenue effort.

Expenditure Measures and Treasury Management Reforms

On the expenditure side, the GoE's main objective will be to focus on energy subsidy rationalization and control over wage bill growth. MOF program also includes the development and enforcement of systems to control and guide cash management, new controls over the government procurement system, and the strengthening of governance over accounting and other operational and treasury functions. Internal audit systems will be developed, and full automation for all payments and collections will be introduced, among other initiatives.

Social justice will be promoted by targeting the delivery of goods and services to the neediest households, in part by focusing on the geographical distribution of spending and by prioritizing accessibility and quality. According to the Constitution, spending on education, health and scientific research will increase gradually over three years to reach target rates as a percentage of GDP as follows: 3 per cent of spending on health; 6 per cent on education, and 1 per cent on scientific research.

Specific reform measures include:

- Energy Subsidies: Reform of energy subsidies will account for the lion's share of the planned fiscal adjustment, with subsidies on all fuel products (other than LPG for needy households) and electricity to be phased out over the medium-term. Vulnerable households will be compensated through an expanded cash transfer program. Beyond its direct positive impact on the budget (savings ~2 per cent of GDP in FY 2014/15), the energy subsidies reform plan includes price movements, redesigning Egypt's energy mix, controlling and targeting subsidized quantities, and improving distribution systems to help control smuggling. Ongoing reforms will lead to better capital allocations by removing the incentives that have favored capital-intensive industry vis-à-vis labor intensive activities, in turn generating new jobs. In addition, part of the savings generated by the reform will be redirected to health, education and R&D in line with constitutional requirements and to finance cash transfer programs;
- Food Subsidies: A new system has been introduced to rationalize the distribution of bread in order to increase the quality of loaves, stabilize the price, target needy households and maintain strategic reserves of wheat. A similar system has been introduced for the rationed cards system;
- Wage Bill Controls: Starting with the 2014/15 budget, the Law prohibits all government entities from hiring personnel outside the regular system, thereby closing the backdoors used to contract temporary labor on other than the wage chapter; the law also brought an end to the existing tax exemption on government employees' annual wage increases and stopped allowing those increases to become part of the base wage. The government intends to introduce a new hiring system which will only accept new recruitments as a fraction of outgoing personnel.
- Public-Private Partnership: The GoE is proceeding with a PPP program to expand the participation of the private sector in infrastructure projects, thereby reducing pressure on the government budget;
- The GoE has doubled the appropriation for the cash transfer program in the FY 2014/15 budget to expand the number of beneficiaries from 1.5 to 3 million families.