ERF Policy Brief

When Macroeconomic Policies Can Address Sustainable Development Goals

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About the authors

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In a nutshell

- *While macroeconomic policies helped the economy stabilize in the short term, development was not mainstreamed within such policies.*
- *Spending priorities need to change by increasing productive spending (on health and education) at the expense of current one.*
- *Exchange rate policy must become more sustainable to reduce the pressure on foreign reserves and boost trade and the competitiveness of the manufacturing sector.*

The work has benefited from the comments of the Technical Experts Editorial Board (TEEB) of the Arab Development Portal (ADP) and from a financial grant provided by the AFESD and ADP partnership. The contents and recommendations do not necessarily reflect the views of the AFESD (on behalf of the Arab Coordination Group) nor the ERF.

Overview of macroeconomic policies in Egypt

Since 2014, the macroeconomy of Egypt was characterized by three main traits. First, while growth in Egypt was positive and relatively resilient in crisis times, exports and investments were weak, growth was primarily driven by capital-intensive sectors that were more productive. Indeed, capital accumulation was the main driving force behind economic growth because of the prevailing employment laws that foster the adoption of capital-intensive production techniques in sectors like mining, cement, iron, and steel. Thus, economic growth was jobless.

Second, the Government of Egypt has been focusing on macroeconomic stabilization to curb inflation, reduce the fiscal deficit and the current account deficit, and increase GDP growth. Thus, the main reforms included sharp reductions in energy subsidies, several currency devaluations of the Egyptian pound, and a freeze in public sector hires. In addition, interest rates were hiking to reduce the potential dollarization of the economy with the currency devaluation and to attract foreign capital.

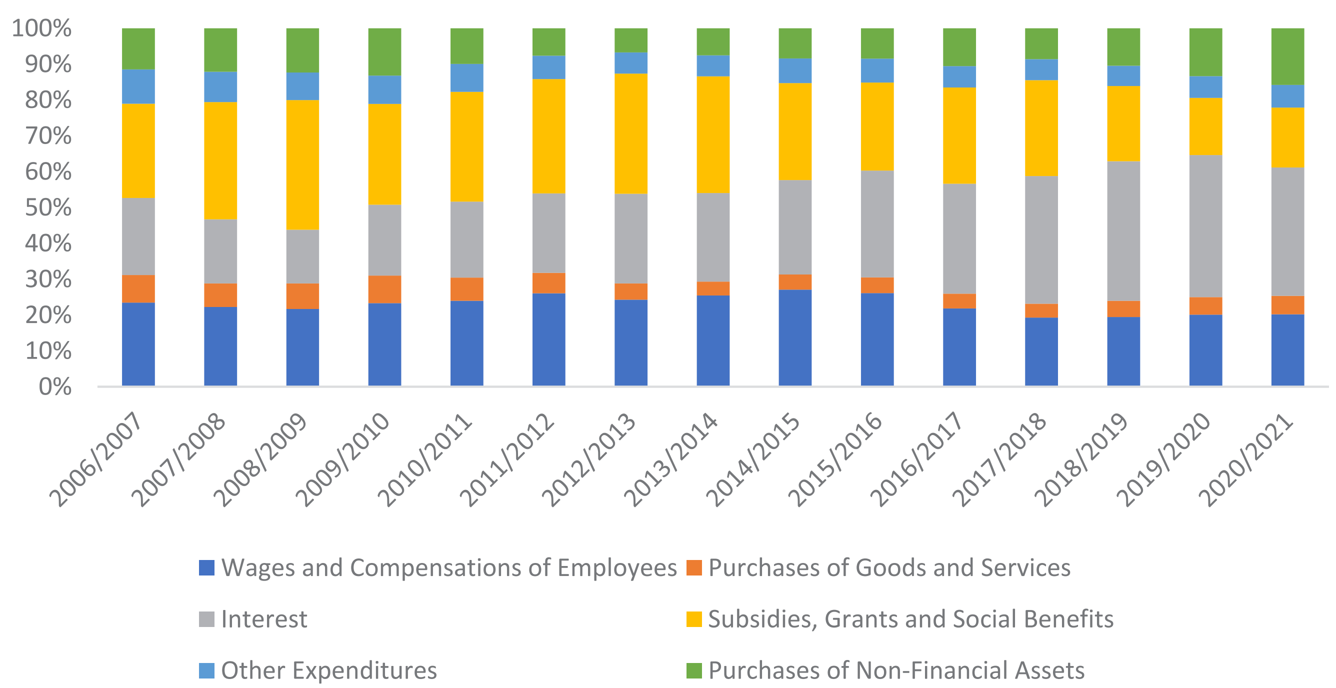
Third, the government heavily relied on the International Monetary Fund's loans and programs. Indeed, in November 2016, it concluded an agreement with the IMF and implemented a reform program. Later, Egypt has obtained a second loan from the IMF under the "Stand-by Arrangement", amounting to 5.2 billion dollars to curb the negative effects of the pandemic. In December 2022, with the war in Ukraine and the large investments in mega-projects, Egypt faced additional pressure and concluded a third loan from the IMF amounting to 3 billion USD with a 46-month arrangement under the Extended Fund Facility (EFF). However, in March 2024, with further pressure implied by the war in Gaza and domestic economic policies, the board of the IMF approved an augmentation of the original program by about 5 billion USD.

Why did Macroeconomic olicies fail to promote sustainable development?

While macroeconomic policies helped the economy stabilize in the short term to a certain extent, development was not mainstreamed within such policies. This is why Egypt's progress in Sustainable Development Goals is rather modest, compared to other economies from the region or belonging to the same income level.

Fiscal policy was mainly characterized by a high share of current spending (around 80% of total spending with the share of wage declining, interest payments increasing, subsidies decreasing and government consumption almost doubled). In contrast, the share productive spending (including purchase of non-financial assets and other expenditure) represents around 20%. As per revenues, the lion share comes from taxes. To finance

Figure 1. Expenditure composition (% of total expenditure)

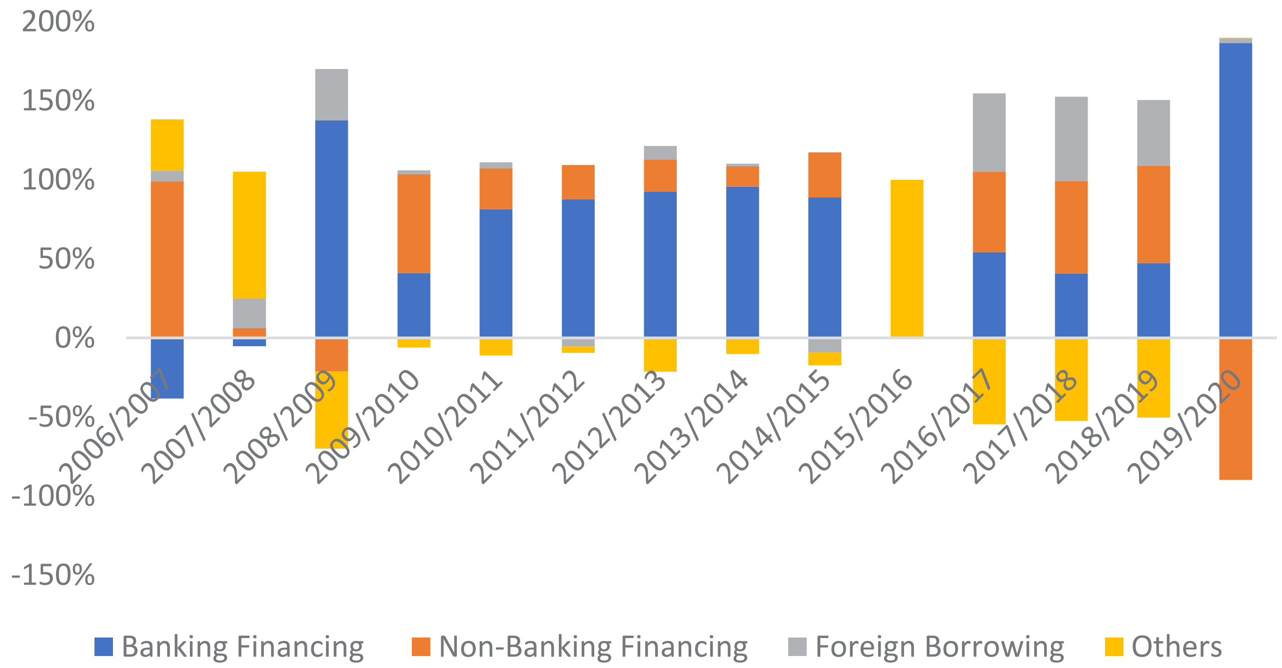


Source: Ministry of Finance, Egypt.

the deficit, the government relied mainly on banking financing with high interest rates (see Figure 2). Finally, while domestic debt was declining, external one was soaring.

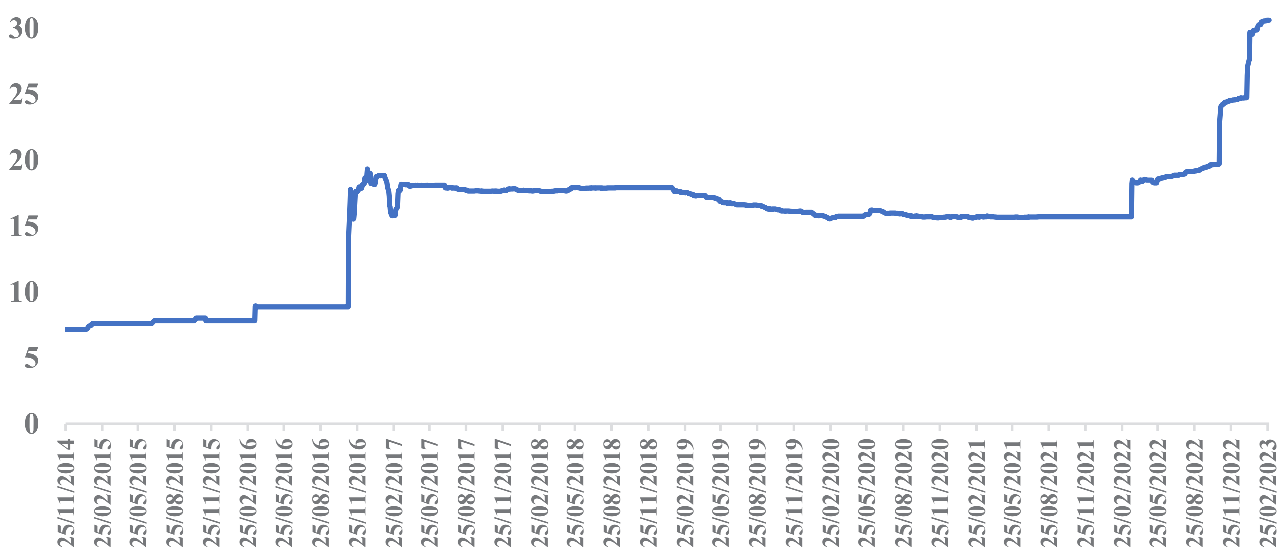
In the same vein, monetary policy was chiefly characterized by a high interest rate, high and volatile inflation rates, and an increase in government lending by the banking system. Generally, despite several currency devaluations, the Egyptian pound was (is) relatively managed by the Central Bank of Egypt (Figure 3). However, while the official objective of the monetary policy in Egypt is to "*achieve price stability by minimizing deviations of inflation from the level considered consistent with price stability (inflation gap) and minimizing volatility of real economic activity with respect to its full capacity utilization (output gap)*", both two objectives have been modestly achieved as growth was high but not inclusive and inflation has been significantly increasing and volatile. Obviously, the main reason behind this is

Figure 2. Financing the deficit (% of total)



Source: Ministry of Finance, Egypt.

Figure 3. Evolution of the exchange rate in Egypt (USD/EGP)



Source: Central Bank of Egypt (CBE).

due to the fact that the overarching objective was to achieve a stable parity between the Egyptian pound and the US dollar at the expense of other macroeconomic aggregates and objectives. In other words, the real sector has been bearing the cost of achieving a stable currency that finished by being devaluated.

This is why macroeconomic policies were not development friendly. A paradigm shift is needed to streamline sustainable development the conception and the implementation of macroeconomic policies.

The way forward

First, several stabilization reforms are needed to reduce the internal and external imbalances. At the fiscal level, growth has been mainly driven by an increasing public spending that led to a surge in Egypt's debt. This is why, in the short term, three reforms are necessary. First, in order to reduce the pressure on foreign currency and reimburse the external debt, the option of restricting imports that are mainly price inelastic goods and intermediate inputs might not be a plausible option. Second, fiscal consolidation is needed to reduce the domestic debt, which will require limiting spending on infrastructure projects. Third, it is important to revisit the spending priorities in order to reduce interest payments and increase spending on education and health (SDG3, SDG4 and SDG6). In other words, it is crucial to reallocate spending from current to productive spending, which will clearly help people get out of poverty (SDG1) and reduce inequality (SDG10).

At the monetary level, the Central Bank of Egypt (CBE) must revisit its policy of increasing interest rates, as it does not reduce inflation (that is supply driven, not demand driven) and of maintaining the exchange rate of the Egyptian pound at unrealistic rates. Indeed, at the exchange rate policy level, the CBE announced several times the adoption of a free-floating exchange rate regime as one of the conditions of the recent IMF loan. Thus, this policy must be more credible and more sustainable to avoid managing an overvaluation of the Egyptian pound and to reduce the burden on foreign exchanges to keep the currency stable. While this is necessary to improve the competitiveness of exports (SDG9), some structural reforms are needed to foster and diversify domestic production and remove administrative and unjustified non-tariff measures that affect exports and therefore production. Finally, a paradigm shift is needed to focus more structural policies that improve the real sector instead of the focus on stabilization per se. Structural and deep reforms are needed to improve the business environment, increase competition, attract FDI in the manufacturing sector, increase exports and thus increase the availability of foreign currency.

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