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The Egyptian Center for Economic Studies

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PM:

"We will reduce the level of public debt to a figure Egypt has not seen in 50 years—and within four years, we will be in a completely different place."

Introduction:

Over a year ago, Mr. Hassan Heikal proposed the idea of eliminating government debt through what he called the "Grand Swap." At that time, the Egyptian Center for Economic Studies (ECES) wrote an opinion piece on this matter but decided not to publish it, opting instead to circulate it among limited circles of specialists. The reason for not publishing it then—and still—is the Center's conviction that there is no need to circulate a proposal that is fundamentally flawed from a scientific standpoint, as discussing it only fuels confusion and may mislead non-specialists who could be attracted by the superficial appeal of the proposal without a clear understanding of its deep and potentially serious consequences. However, around two weeks ago Prime Minister Madbouly promised significant debt reduction without elaborating on how this would be achieved. This led to the revival of Hassan Heikal's proposal, at least as one of the suggestions on this matter as well as to discussions on social media and press interviews between proponents and opponents.

At this point, ECES found that publishing the aforementioned opinion piece has become a national responsibility, aimed at correcting misconceptions and presenting a comprehensive analysis of all aspects of the proposal, as well as relevant international experiences. In what follows, this edition presents the analysis along with some concluding remarks.

Link

(Special Issue)

Hassan Heikal's Proposal:

Mr. Heikal proposed to offload government domestic debt of EGP 8 trillion to the Central Bank, through the implementation of what he termed the Grand Swap. This involves the Government selling companies, lands and banks equivalent to the total amount of domestic debt to a new fund to be established by the Central Bank. This automatically leads to lifting the burden of paying interest in the state's general budget by about EGP 3 trillion. Heikal cited what happened in Greece 12 years ago when the European Central Bank intervened to buy all bank debts.

This commentary comprises three parts. The first relates to the pillars of the proposal and key reservations about it. The second relates to the experiences of countries that implemented similar proposals. The third discusses the suitability of the proposal to the Egyptian context and the seriousness of its repercussions on more than one level.

I. Reservations regarding the pillars of the proposal

- The proposal is based on the idea of barter, the creation of a new fund, and the addition of a new role to the central bank that breaks from its traditional role. There is a problem with every pillar. Barter is an old commercial concept that has fallen out of use—despite its apparent simplicity—because of the inherent difficulty in fairly valuing the items being exchanged.. Despite the difference in what is being exchanged in the case of the above proposal, determining the fair value of companies and lands in a way that allows a proper exchange is extremely difficult. Several questions follow as to who will carry out this evaluation? Also, will the Central Bank be pressured into accepting unfair evaluations due to political considerations to end the domestic debt problem?
- There is no greater evidence of the difficulty of this procedure as a whole than the fact that all sales of state-owned companies have been delayed in recent years due to the difficulty of assessing the value of these companies. In the event of conducting the swap domestically, the proposal assumes smooth dealings since both entities are affiliated with the State. This would take Egypt back to the severe institutional failure it suffered prior to the 90s, when financial dealings between public companies and banks were

conducted openly and with no controls. Conducting the swap in such a manner represents a drastic step backward, and is extremely serious at the macroeconomic level.

- In addition to the above, there is the second pillar of the proposal, which is the creation of a new fund. The State has taken a reformist approach for several years to abolish the funds due to their lack of transparency, and their creation of financial spending avenues away from financial oversight. In other words, this pillar also means a serious step backward.
- As for the third pillar, which is the involvement of the Central Bank in real estate transactions in lands and companies on a very large scale. This is not the role of a central bank The banking sector already struggles with managing land and company assets acquired involuntarily as collateral from firms and individuals who default on their obligations. So, one can imagine the size of the problem of dealing in State assets, especially in light of their size, their age in many cases, and the difficulty of evaluating them as previously mentioned. More importantly, this is not the role of a central bank anywhere in the world, and attempts to drag the central bank into a new and currently very troubled area is yet another institutional problem. This raises a question: If these assets are easily marketable, why doesn't the

government sell them itself and then repay the debts? That is instead of shifting the debt burden onto banks and replacing a transparent and clearly valued mechanism—such as treasury bills—with a mechanism lacking transparency. This would compromise the banking sector after Egypt succeeded over the years in improving its performance and bringing it closer to internationally accepted standards?

II. Experiences of countries that implemented similar proposals

- Mr. Hassan Heikal cited the case of Greece in 2010, overlooking the fact that the latter proposal relates to the intervention of the European Central Bank. In this case, the European Central Bank is an entity external to Greece. This means that the proposal was implemented through an external entity that bore the burden of debts. It was not a transfer of debts from one entity to another within the same country. It is a completely different proposal, and it is inaccurate, even deceptive, to refer to it as a successful example, as if the circumstances were similar and the players were the same players as in the Egyptian case.

- Scientific research has mentioned cases in which similar operations were implemented in certain countries at different times, such as Brazil in the 70s and 80s, and Argentina in 2001. These experiences were never referred to as sound solutions to the debt problem. These attempts mostly failed over the long run, even if they achieved a temporary reduction in debt. In fact, the implementation of similar policies in Brazil and Argentina in terms of transferring assets with the aim of improving the financial situation has led to opposite results. In the case of Argentina, the government failed to implement real structural reforms after using assets as collateral, which led to the persistence of the debt crisis and failure to achieve any clear economic benefits. In Brazil, similar policies led to higher inflation and debt accumulation as a result of poor asset management.

III. How suitable is the proposal for the Egyptian case?

- The proposal in the Egyptian case may seem attractive to some because it eliminates the burden of domestic debt, and even opens the door to taking on new debt and continuing the same policies that drove Egypt into a vicious cycle of debt—the source of Egypt's economic woes. However, this disposal is illusory because the debt remains as is locally, and is only transferred to another entity. It is strange that there is no clear and quick opposing stand from the Central Bank, which indicates the extent of the pressure and lack of transparency that will certainly be associated with this proposal if implemented on the ground.

- The second serious point is that Egypt is currently implementing a strict program with the IMF, at the heart of which lies the achievement of more governance and institutional reform. So, how can a proposal be presented in a way that makes the Central Bank act as if it were one of the government bodies, which will no doubt serve a fatal blow to the independence of the Central Bank, coupled with the lack of transparency referred to more than once above.
- Public banks and the central bank are still in their early stages of recovery from the serious decline in reserves due to government pressure on the central bank to finance large national projects. It is well known that a significant portion of this burden has affected depositors' funds, and banks currently need more capital to remedy their positions. So, how can they be dragged into a proposal of this kind? And what will Egypt's international image be with this policy recklessness? Is what the country is already facing not enough? Finally, at this critical juncture in Egypt's economic history, and amid public anxiety about policy changes, this new proposal - if implemented - would open the door to increased public concern about rising inflation, and more

seriously, concern for depositors' funds at banks, fearing they might be used to complete the swap, something Egypt's current conditions cannot afford at all. Even if this does not happen in reality, the mere fear of it is enough to cause political and social instability.

- This proposal is completely invalid, both scientifically and practically. All proposals that have been floated in an attempt to control domestic debt and direct local resources to government bodies, so that they are better used for the public good, cannot be achieved unless a full pooling of the budgets of all these bodies with the Ministry of Finance is achieved beforehand. This way Egypt can have one pool as is the case in other countries, which in itself is an institutional reform required for longer-term reform.
- The fundamental principle is to adopt an integrated debt management strategy as part of the State’s economic policy, not as a separate issue, along with implementing an integrated institutional reform that addresses the root causes of the problem. This begins with thoroughly studying policies before adopting them, consolidating the finances of all State bodies under the Ministry of Finance, reducing the number of ministries, and radically improving governance.

Conclusion:

Despite the need to address the issue of debt, there is a significant risk in implementing Mr. Hassan Heikal's proposal, either wholly or partially. The fundamental principle should be to tackle the debt problem at its source, namely at the point where decisions to resort to borrowing are made.. This is the institutional reform that ECES has repeatedly called for, and is the only way to break free from the cycle of debt and improve the modest performance of the Egyptian economy, even as traditional growth indicators improve and even if such improvements are praised by the IMF.

In addition, the idea of creating space for spending on health and education as support for the proposal to reduce debt quickly in unconventional and ill-considered ways is a problem in itself. This is because the basic principle is that education and health should be at the core of spending items, and they should have a priority that surpasses other projects. Human capital is the pillar of all successful economies, and it is still a fundamental weakness in Egypt.

We urge the Prime Minister to quickly present the approach the government intends to adopt regarding debt reduction, so that talk about Mr. Hassan Heikal's scientifically and practically unsound proposal, as explained, will cease. We hope no forced asset swap will be imposed on any entity—beyond the accepted standards of swapping assets for any debt.

This is because achieving any temporary gain in reducing the current debt is not commensurate with the price that the Egyptian economy will pay in terms of the collapse of its institutions. What is proposed is nothing more than swapping debt between local entities to improve appearance with no new external flow of resources, with complete destruction of the banking sector and other related entities. It is preferable that the government seek to maximize investment in its assets and use the proceeds to pay off debts, instead of placing the burden of debt on other entities. Again, this is in the event that Mr. Hassan Heikal's flawed proposal is even put forth in the first place.