How the IMF's 'conditions' stop economic growth: the case of Egypt

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The following is an abridged form of the policy paper "Egypt's Aid Experience, 1974-83," submitted to the Schiller Institute for its Nov. 24-25 international conference in Washington, D.C. by Prof. Gouda Abdel-Khalek, Cairo University, Cairo, Egypt. Footnotes have been omitted from this version but may be obtained from EIR *on request.*

I. Introduction

Many policy makers and planners in developing countries believe that *the more resources the better*. This is echoed in the terms of reference and recommendations of the now famous Pearson and Brandt Commissions. Thus, in 1968 the recommendations of the Pearson Commission report read:

> 1) Each developed country should increase its resource transfers to developing countries to a minimum of 1 per cent of its Gross National Product as rapidly as possible, and in no case later than 1975.
>
> 2) Each developed country should increase its commitments of official development assistance to the level necessary for net disbursements to reach 0.70 per cent of its Gross National Product by 1975 or shortly thereafter, but in no case later than 1980.

Twelve years later, in 1980, the Brandt Commission report reads:

> There must be a substantial increase in the transfer of resources to the developing countries. . . .
>
> The flow of official development finance should be enlarged by:
>
> 1) An international system of universal revenue mobilization, based on a sliding scale related to national income. . . .
>
> 2) The adoption of timetables to increase Official Development Assistance from industrialized countries to the level of 0.7 per cent of GNP by 1985, and to one per cent before the end of the century.
>
> 3) Introduction of automatic revenue transfers through international levies on some of the following: international trade, arms production or exports; international travel; the global commons, especially seabed minerals.

The plea for increasing the flow of official development assistance (for brevity, we shall henceforth call it "aid") from developed to developing countries was a key element in the declaration of the New International Economic Order (NIEO). Such significant developing countries as India and Egypt have made external borrowing a cornerstone of their national development plans. The logic underlying this orientation is both straightforward and, at least seemingly, appealing: More resources will enable the developing country to increase the rate of investment and hence raise the growth rate of its economy.

But such logic is not as sound as it looks. The tenet that the more resources the better is based on a fundamental implicit *ceteris paribus* assumption. Such assumption is highly doubtful when a developing country relies heavily on foreign "aid" to finance its development effort. In such case, factors relevant to development other than investment will change in a way not conducive to development.

In this paper we make a case against heavy reliance on foreign aid. Such a case will be based on Egypt's experience during the last decade. The analysis will be organized in four additional parts. Part II will outline the analytical logic of the case against foreign aid. In part III we shall examine the extent of Egypt's reliance on such aid. Part IV documents and analyzes the strings attached to aid received by Egypt in order to provide empirical evidence to back up the theoretical arguments of part II. The final part V draws the lessons and pertinent issues from Egypt's experience.

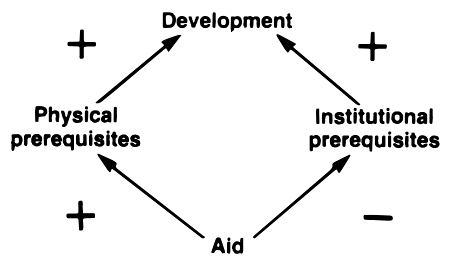
II. Aid and the developing economy: partnership in development or bonds of dependency?

The relationship of aid to development has been at the heart of the discussion of development theory and policy throughout the postwar period. Most of the emphasis in the discussion was placed, however, on the gap-filling function of aid. The now famous two-gap model is reminiscent of this. It is crucial to realize that the assumption of *ceteris paribus* is indispensable for the two-gap model to provide justification for increasing the aid flows to developing countries.

Here we drop the *ceteris paribus* assumption. If aid flows on a significantly large scale, *other things cannot remain constant*. In order to expound this point, we have to define development first. For the sake of the argument of this paper, and in line with recent trends in development thinking, development is here perceived as a process of comprehensive social change that releases latent energies for creative behavior.

Development thus defined implies emancipating both the individual and the societal will, not just raising the rate of economic growth. Self-reliance as a negation of the state of dependency becomes a basic element of development. This is why over-reliance on foreign aid becomes inhibiting to development. We may use the schematic illustration (**Figure 1**) to make this point.

Figure 1



Aid eventually affects development through two intermediate links. The first link embodies the physical prerequisites of development, basically capital formation, and the second embodies institutional prerequisites—mainly the country's system for decision-making and setting national priorities. It is self-evidently clear that both the physical and the institutional prerequisites affect development in a positive way. It is also assumed that aid affects the first type of prerequisites positively and the second negatively.

That aid improves the situation with regard to availability of factors of production (basically capital) needs no emphasis. It does not mean relieving all physical constraints, but at least it does not make some more binding. In this respect more aid means more physical prerequisites and hence more development. This analysis has so frequently been propagated that it seems widely accepted.

It is the aid-institutional prerequisites link that has often been overlooked, and needs clarification. One could think of many elements to go under this catch-all expression. Most important among these are the ability to set national priorities and to decide autonomously on allocation of resources and pricing in both commodity and factor markets. It is with regard to such elements that the effect of heavy reliance on foreign aid may not be beneficial. The country receiving aid may find itself subject to conditions put by the donor that are costly to meet but difficult to reject.

However, in the current international setting, aid is usually linked to sanctions of the politics of the receiving country. Such sanctions are usually placed by the IMF, the aid consortia, or consultative groups.

Under such circumstances, it becomes open to question whether aid is—on balance—of real benefit to the receiving country.

III. Extent of Egypt's aid dependence

It may be said that, generally speaking, there has been an increasing trend in Egypt to finance development through foreign resources. Such a trend may be ascertained by referring to **Figure 2.**

Figure 2

Extent of reliance on foreign resources 1960/61-62

Period	Annual average foreign borrowing (millions of $)	Percentage of investment	Percentage of imports
1960/61-1964-65	129.2	38.1	38.2
1965/66-1969/70	104.5	27.4	25.1
1970/71-1975	516.6	80.0	64.1
1978-1982	487.0	70.1	—
1960/61-1982	309.3	53.9	42.5

Sources: Gouda Abdel-Khalek, "Development, self-reliance and equity: queries raised by the Egyptian experience of heavy reliance on foreign aid," in *Economic Development and Social Justice*. Proceedings of the Fourth Egyptian Economists' Conference (Cairo: Société Egyptienne d'Economie Politique, de Statistique et de Legislation, 1981).

It may be concluded from the data in the table that the extent of dependence on foreign financing (basically foreign aid) has been on the rise. There is evidence for more recent years of *an intention* to lower such dependence. Thus, in Egypt's current five-year plan (1982/83-1986/87), one reads a specific guideline to lower the proportion of foreign finance significantly over the plan horizon. Actual performance does not, however, show a significant improvement on that score.

Compelling as it may look, *aggregate* evidence does not really tell the whole story. For the last decade, Egypt has grown heavily dependent on one country, the United States of America, for economic and military assistance. American annual economic aid flow to Egypt has risen from a negligible amount in 1974 to over one billion dollars in recent years. Over the decade 1974-83, total commitments by the U.S. Agency for International Development (USAID) totalled \$8.518 billion. Disbursement amounted to \$5.991 billion. Perhaps even more significant, the U.S. provides Egypt with a significant proportion of its wheat consumption. Thus, in 1980 total wheat consumption in Egypt was 4,471 thousand tons and wheat imports from the U.S. amounted to 1,035 thousand tons, in addition to 389 thousand tons of wheat flour. This makes Egypt very heavily dependent on the U.S. for basic staple food supplies.

All this raises the issue of effective independence in setting national priorities. So long as those priorities as seen by the Egyptian government are in line with American perceptions, there is no problem. But in the more likely circumstances of diverging views between the two sides of the aid relation, stress, and even tension develops. We may reach the breaking point and aid is cut, slowing down the pace of national programs. The experience of Egypt in the mid-sixties should not go unnoticed. But before the breaking point, the relation has to continue. It will only do so if the receiving party submits to conditions set by the donor. It is our contention that Egypt has been subjected to very stringent non-financial conditions of aid from both bilateral and multilateral sources. This is the political toll of economic "assistance," as will be shown in the next part of the paper.

IV. Non-financial conditions of foreign aid

There are various mechanisms through which heavy dependence on foreign aid may affect national priorities with regard to socio-economic development. Such mechanisms are due to the nature of the very *conditions* which are the *sine qua non* of the aid received. Before dealing with the conditions of aid, by the various donors, it is important to stress that they do complement each other in a reinforcing pattern. We shall naturally start with the conditions of the IMF.

A. **IMF conditions:** IMF conditions are embodied in the *stabilization programs* that are usually spelled out in a *letter of intent*. That letter is a document issued by the country suffering balance of payments problems to the director of the IMF detailing its intentions regarding measures in various policy areas such as the exchange rate, budget deficit, subsidies, inflation, trade policy, pricing of domestic goods, etc. . . . It is well known that national governments do not produce letters of intent on their own initiative. Extensive and often protracted bargaining and discussion between the Fund staff and representations of the government of the country concerned usually result in a draft of the letter. The document represents a *commitment* by the government of the country concerned to implement the set of measures which make up the stabilization program.

On the basis of this document, the IMF signs a stabilization agreement with the member country.

The government of Egypt has issued several letters of intent to the IMF; most significant perhaps is that of June 10, 1978. It was the basis of a stabilization agreement whereby Egypt was to receive SDR 600 million (U.S. \$720 million) of Fund support over three years. In return, the government of Egypt committed itself to a program of economic reform. Since IMF approval of the country's policies is a prerequisite for getting aid from any source, it is relevant to the discussion of non-financial conditions of aid to dwell on the main elements of the program. There are two parts: one outlining *structural reform* and the other specifying certain measures for the first year of the program.

1) *Structural reform:* There are four basic components of the suggested reform: eliminating cost-price distortions in the economy, encouraging agriculture, reducing subsidies, and giving public-sector projects the power to hire and fire.

First. With regard to elimination of cost-price distortions, the program stipulates transferring the power of pricing products from the cabinet to the management boards of industrial public-sector companies. Moreover, prices of industrial products of public-sector companies are to be periodically revised to reflect increased costs. The ultimate goal is to place the operations of public-sector companies on a commercial basis, and to relegate subsidy giving to the government budget. Reform of the public sector in Egypt has been the subject of debate and discussion for a long time. The issues at hand are so intricate and involved that a piecemeal approach may only exacerbate the problems. Specifically, raising the prices of industrial sector products coupled with import liberalization will put the national industries in unequal competition with foreign industry in the domestic market.

Second. With regard to agriculture, the program of structural reform stresses vertical expansion as a means for utilizing the great potential in this sector. This includes improving drainage and irrigation, developing agricultural extension services, revising agricultural pricing policy, and rationalizing the distribution system for agricultural inputs. Although one cannot belittle the import of agriculture for any genuine development effort in Egypt, property relations cannot be taken as given with emphasis placed only on the means proposed in the reform package.

Third. As for subsidies, the program of structural reform entails reducing the growth rate of subsidy expenditure much below the growth rate of aggregate current government expenditure. Such measures would definitely have negative redistributive effects, since it would raise the prices of staple food items without a matching increase in the incomes of the socio-economic groups affected.

Finally. The program of structural reform suggests giving government departments and public-sector companies the authority of hiring according to their needs. This means that large numbers of fresh university graduates will not find employment. The program does not suggest any measures to compensate for this blocking of employment opportunities.

These are the basic elements of structural reform included in the letter of intent. They amount to redefining national priorities and in particular re-instating market forces both as the allocative and distributive mechanism.

2) *Policy measures in different areas:* The measures suggested in the letter of intent reflect the usual IMF package: restrictive fiscal and monetary policies and exchange-rate adjustment. These measures have been analyzed in detail before. It is significant to draw the implication for Egypt's development. The IMF package reshapes the system of priorities in the Egyptian economy. It gives preference to agriculture over industry, the private sector over the public sector, the foreign enterprise over the national enterprise, and commercial activities over productive activities. All this reflects a fundamental economic and social philosophy which we think is inimical to any genuine development. It can only be expected to distort the economy and further its dependence on the outside world. This is no surprise, since a combination of neo-classical and monetarist medicine is prescribed for a structural illness.

B. **Consultative Group conditions:** The Consultative Group is a euphemism for the creditors' cartel or the association of aid donors. The Egypt Consultative Group was composed of countries, regional, and international organizations concerned with providing aid to Egypt. It held its first meeting in May 1977.

The preparations for the meeting, and the discussions and negotiations that took place during the meeting are very enlightening with regard to the institutional set-up for, and the non-financial conditions associated with, aid-giving. Hence the impact on what we termed "institutional prerequisites" for development.

The head of the Egyptian delegation to the meeting (the three Deputy Prime Ministers for Financial and Economic Affairs) reported to the conference regarding the economic conditions in Egypt, the problems facing the country, and policies suggested to deal with these problems. The policies represented the elements of an economic reform package included in a letter of intent issued to the IMF in March 1977. It included:

- balancing the government budget as much as possible;
- attempting to close the deficit in the foreign exchange budget;
- undertaking some internal economic reforms such as reforming the tax system and the tariff system;
- making necessary changes in the Housing Act to allow raising rents such as to increase investors' expected return;
- amending the law for Investing Arab and Foreign Capital to eliminate ambiguities in its articles.

The IMF Executive Director for Middle East Operations addressed the conference, declaring that the Fund has endorsed Egypt's economic reform package, and pointing in a carrot-and-stick fashion that *if Egypt implemented this package, this will be a justification for receiving new facilities.* It is interesting to observe that the above package is an honest application of the IMF *recipe,* which involves liberalizing trade and payments, currency devaluation, adopting contractionary monetary and fiscal policy, and encouraging private investment.

The Egyptian delegation was quizzed by members of the Consultative Group with regard to: Egypt's plan for social and economic development and its priorities with respect to industry and agriculture; its plan to deal with the population problem; education policy; external borrowing policy; foreign-exchange policy; and the role of the private and public sectors. It is blatantly obvious that such matters transcend discussions of socio-economic policies, and go to the heart of the socio-economic system itself.

Under the pressure by the members of the Consultative Group, the head of the Egyptian delegation announced that Egypt, in the context of the open-door policy, has taken several measures to encourage the private sector. They include amending the law for Investing Arab and Foreign Capital (Law 43 for 1974); breaking public-sector monopoly of foreign trade; activating the stock exchange; reducing government intervention in commodity pricing, and raising interest on savings in addition to granting tax exemption to interest income.

The above provides concrete evidence to the pressures placed by aid donors collectively and in concert. Although it may be the subject matter of various analyses, we shall only concern ourselves with its impact on the institutional framework for development. The upshot of all these pressures is simply to reduce the role of the state in economic affairs to the barest minimum. Correspondingly, the role of the private sector within a dominantly market set-up will rise. One may then legitimately pose the question as to the kind of development that is achievable under these conditions. More resources through foreign aid may thus mean more investment. But that does not automatically mean more development; for development to be in a developing country, there must be a big role for the state.

The contribution of the Keynesian revolution of almost half a century with regard to the role of the state in economic affairs is deliberately ignored by aid donors. In place of it, they reach out to a neo-classical and monetarist theoretical framework. It is not proven beyond any doubt that the latter is better than the former. In fact, in view of the dearth of entrepreneurial talent and the large disparity between social and private cost and benefits in developing countries, a good case may be made for a larger role of government and planning vis-à-vis the private sector and market forces.

C. **Project-loan conditions:** The "macro-conditions" analyzed above are supported by "micro-conditions," or conditions on the project level. Although there has been a lot of discussion and analysis of conditions in the context of "tying practices," the non-financial conditions with bearing on the institutional prerequisites of development have been largely ignored.

Loan agreements signed between Egypt and various lenders contain several main conditions. We shall focus on non-financial conditions of aid by examining two examples of American aid to Egypt just as illustrative examples.

1) *The Qattamiah Cement Project Agreement*: The loan agreement for this project stipulates that the United States Agency for International Development (USAID) provide a loan for $95 million to the government of Egypt (GOE) to finance a cement project in Qattamiah by the Suez Cement Company. The most significant non-financial conditions for this loan are:

- The GOE provides for the project no less than $35.1 million and LE (Egyptian pound) 46.5 million.
- The borrower (GOE) relends $58.5 million out of the loan to the Suez Cement Company, with the balance ($36.5 million) given as a grant.
- Selling at least 20% of the stock of the Suez Cement Company to the private sector, with foreign currency sales of at least $4.6 million.
- Raising the price of locally produced cement, and consulting periodically with USAID for cement pricing.
- Submitting a detailed plan for cement distribution in Egypt to USAID covering the period 1980-85.

An examination of these conditions clearly indicates that they are inhibiting to development. For although the project increases capital formation and hence productive capacity, it involves raising prices of cement and interfering with national priorities. Cement is a vital commodity for investment and any control of either its allocation or price means, in the planning jargon, controlling a national parameter. In addition, raising cement prices will have negative distributive effects since the cost of housing for the low-income groups will rise as a result. Moreover, the implementation of the loan agreement amounts to de facto denationalization of public-sector enterprises. It is here that the "micro-condition" has macro-implications.

2) *Loan for the Rationalization of Industrial Sector and Reduction of Environmental Effects*: This is an agreement signed (in August 1978) by the Egyptian Ministry of Industry (MOI) as borrower and USAID as lender. According to the agreement, MOI receives a loan of $46.445 million. This was later supplemented by a grant of $7.5 million. Both the loan and the grant were aimed at raising the institutional capacity of the MOI to manage resource allocation in the industrial sector. The most pertinent non-financial conditions are:

- The borrower is to provide matching funds of not less than LE 21 million for the loan and not less than LE 21.5 for the grant.
- The borrower agrees to adopt a long-term policy to abolish subsidies which stand in the way of developing the industrial sector. The borrower also agrees to meet with USAID officers from time to time to discuss the progress in implementing the said policy, and to consider USAID remarks as part of a continuous exchange to develop the industrial sector.
- The loan and the grant are to be exempted from any taxes or duties, and also any contractor to be financed therefrom or any purchase of goods to be financed therefrom are to be exempted from taxes or duties.

Perhaps the most significant condition is that of abolishing subsidies for the industrial sector. It is to be noted that the IMF has also put the same condition to Egypt. In fact, if not coupled with other measures to support the Egyptian industrial sector, abolishing subsidies will have detrimental effects: raising the prices of industrial products hence causing a contraction in industrial activity, and exposing public industrial enterprises to outside competition. This may snowball to endanger *employment* in the industrial sector. Thus both the consumers and the workers may be harmed because of these conditions. Moreover, continuous consultation with USAID means that Egypt does not effectively act as a sovereign country. The considerations of equity, of having a national industry and or acting as a truly sovereign entity, are all sacrificed at a price of some $50 million. This is a very bad deal indeed.

V. Concluding remarks

In the foregoing analysis we have shown that when a country depends heavily on foreign assistance, it is bound to accept conditions that frustrate its national efforts for development. We argue that was Egypt's experience since the mid-seventies. Egypt based its development effort on the belief that investment is the determinant of growth and that domestic resources are insufficient. It is interesting to observe that Egypt has continued to tread this path, despite evidence from recent studies that it is sector institutional factors, not material factors, that restrain development.

We have also shown that although foreign funds obtained by Egypt may have *augmented resources* available for development, they have at the same time undermined its capacity to set its own priorities and to chart its own development path. The outcome of the conditions mentioned above is to further integrate Egypt's economy in the current international division of labor. This is reminiscent of Egypt's experience since the second half of the 19th century.

Perhaps the most important lesson that may be drawn from Egypt's experience of excessive reliance on foreign aid is that self-reliance may be an alternative development strategy worthy of consideration. But beyond this point is a theme for another paper.