Steve Weisman: With the Middle East in turmoil over the Israeli confrontation with Hamas in Gaza, an overlooked aspect of the political and economic situation in the region is the fact that the International Monetary Fund (IMF) is in negotiations with Egypt over a multibillion dollar bailout. Arvind Subramanian, senior fellow at the Peterson Institute, lived in Cairo in the late 1990s and was the IMF’s senior representative there in negotiating with the Egyptian government on terms of financial rescue. He is here with me, Steve Weisman, to talk about this highly significant aspect of the Middle East crisis.

Arvind, first, explain the fundamentals. Egypt needs a loan because its finances are a disaster. What is the IMF offering?

Arvind Subramanian: I think this is really a classic IMF intervention situation because Egypt is running out of foreign exchange reserves, growth has slowed down, tourism has declined, and because of all the instability. Growth has declined, the revenues have declined, so the fiscal situation is bad. Inflation is picking up, so it’s kind of a classic case of a country on the verge of macroeconomic crisis. And hence, the IMF has stepped in.

It’s going to offer a fairly large sum of money -- $4.8 billion dollars, it’s reported -- and in return, it’s going to ask Egypt to do all the things that the IMF always asks a country to do, which is to get its fiscal house in order; increase taxes, reduce the budget deficit, get rid of subsidies so that it can bring down inflation, do other things that will boost growth, and then get Egypt back on some kind of path toward recovery.

Steve Weisman: Meanwhile the United States and perhaps other benefactors of the IMF in Europe are seeking Egyptian help to defuse the crisis in Gaza. The IMF, as I understand it, is not permitted to bring political issues into the discussion. But how could they not enter into this situation?

Arvind Subramanian: Yes, Steve, you’re absolutely right. I think formally and overtly, no IMF program can lay down political conditions as a prerequisite for a loan, or indeed as an ex post criterion to keep monitoring and keep meeting. However, these things do not take place in the political vacuum. It must have been the case that the U.S. and Europe, wanting Egyptian help in the Middle East and Gaza, must have had discussions, kind of loosely linking economic aid via the IMF, which they of course control, to some kind of Egyptian help in the Middle East.

I would be very surprised if there weren’t such a link drawn by the benefactors, because Steve, the history of the IMF has always been replete overtly with no political conditions, but in reality lots of political conditions.
Steve Weisman: For example, can you think of some cases where that’s come into play?

Arvind Subramanian: I think for example, the irony in all of this is of course that in the ‘80s and ‘90s when Egypt was borrowing from the IMF, we always knew that the IMF would be very soft on Egypt because it was an ally of the U.S. and was on good terms with Israel. So in many ways, it’s been, if anything, fairly true of Egypt in the past because it’s been an ally. Whenever it’s got into trouble, it’s got a lot of money; it’s got soft conditions and so on, so I think this just happens all the time. I mean, I can give you many examples.

Steve Weisman: News reports out of Cairo suggest that there has been a preliminary agreement with a technical team for this loan. How does this compare with past discussions that you were involved in in the ‘90s?

Arvind Subramanian: I think in this case, because the country is in such bad shape macro-economically, a lot of the focus is on providing the money to cushion the short term and then getting the government revenues back on track.

The one thing that does strike me about this package, if this were to hold true, is that the IMF has not asked for the currency, the Egyptian pound, to be devalued and that’s very significant. It’s very significant because nearly most cases of adjustment out of external crises and fiscal crises require devaluation to the exchange and because that restores competitiveness, that boosts exports. That’s one of the ways in which growth takes off.

Steve Weisman: Boost exports and curbs imports or raises the cost of imports—

Arvind Subramanian: Exactly.

Steve Weisman: Which is the rub here.

Arvind Subramanian: Because that’s the rub, because it’s going to reduce imports, I think therefore the IMF provides the money to cushion that and to allow it to import.

Steve Weisman: But it raises the cost of food.

Arvind Subramanian: In fact, that’s the reason why the IMF is not asking for a devaluation, because I think historically, one of the most sensitive issues between Egypt and the IMF has been the question of food subsidies, which relates to the exchange rate, because if you devalue a currency, food prices go up.

Or alternatively, to prevent food prices from going up, the government has to give huge subsidies and Egypt can’t afford the subsidies now because its fiscal situation is very bad. So the way they’re trying to square the circle is by saying, “OK, we don’t force you to devalue your currency,” which is going to be politically dynamite in Egypt, “but we will give you a lot of money to cushion against the fact that you need the money to import the food.” And so it’s kind of a difficult juggling act.

After all, this is the same issue that is the case of Greece, Latvia, etc., how much do you do through internal devaluation -- i.e., keep the exchange where it is and have austerity, and how much do you use the exchange rate as an instrument to regain competitiveness and get growth
and recovery back on track? So I would say this is a necessary political concession to avoid ev-
erything from blowing up, because this is such a controversial and touchy issue in Egypt.

Steve Weisman: Having spent time in Egypt, put yourself in the frame of mind for President [Moham-
med] Morsi of Egypt. He is of the Muslim Brotherhood, he’s just taken office, he’s under a huge political pressure to side with Hamas and the Palestinians. But on the other hand he is just dependent on the West for this help. What do you think is going through his mind?

Arvind Subramanian: He must be in an awful bind. You know, on the one hand all of what they stand for and their political instincts, I think, go towards helping their Palestinian brothers. But I think the economics goes completely the other way, because I think ultimately the government has to probably think that this political instability, the regional insecurity and the security situation is one cause also of the economic problems in Egypt itself, because tourism is down, etc.

So I think the way they square this is by saying, “OK, if we can do whatever we can to settle things politically that also helps us.” And the reward for doing so is in the interim, we get all this money to cushion us against what could otherwise turn out to be a really explosive and ugly situation. Because I think as it is, the whole Arab uprising, at least in Egypt, is in part due to decades of economic stagnation and economic disaffection, especially for the youth. So I think if the economic situation doesn’t turn around, it’s bad news for whoever is in power in Egypt.

Steve Weisman: Arvind, thanks very much.

Arvind Subramanian: Thanks, Steve.