Arab Republic of Egypt— 2007 Article IV Consultation
Preliminary Conclusions of the IMF Mission[12]

September 12, 2007

Egypt's economy delivered another impressive performance in 2006/07, with high growth generated by reforms and solid macroeconomic management.

1. The Egyptian economy continues to grow rapidly and unemployment is declining. Real GDP growth in 2006/07 is estimated at 7.1 percent, continuing last year's performance. The expansion of the oil and gas sectors slowed from the rapid pace of recent years, but growth in other sectors accelerated, including in agriculture and manufacturing—both labor intensive sectors. The growth spurt since end-2004 has added 2.4 million jobs as of end-March 2007, reducing unemployment from 10.5 percent to 9 percent.

2. Strong growth and rising equity and real estate prices have boosted domestic demand, contributing to strong import growth and a pick-up in underlying inflation. Exports also rose sharply, along with worker remittances, Suez canal receipts, and tourism revenues. With record levels of FDI, the balance of payments recorded a surplus of US$5.3 billion in 2006/07, bringing official reserves to US$30 billion by end-August 2007, equivalent to more than 6 months of imports of goods and services. A spike in inflation over the year through March 2007 was driven largely by the impact of an avian flu outbreak and adjustments in administered fuel prices in 2006; but a rise in core inflation (excluding food and most energy prices) to 10.6 percent (year-on-year) points to some spillovers and demand pressures as well, along with some imported inflation. After peaking at 12.8 percent in March 2007, CPI inflation has gradually receded since, to 8 percent in July, with core inflation down to 6.6 percent.

3. Macroeconomic policies in 2006/07 helped contain demand and inflationary pressures, but were complicated by strong capital inflows.

- **Monetary policy was tightened** once spillover effects of administered price increases became visible in late 2006. Policy interest rates were raised twice. The nominal exchange rate appreciated by 1.1 percent against the U.S. dollar in the year to end-June, with greater flexibility since then. In conjunction with the partial sterilization of external inflows, broad money growth was kept in the 13-15 percent range until April 2007, but subsequently surged to 18 percent as less of the inflows were sterilized and money market funds deposited the proceeds from maturing central bank certificates of deposit with commercial banks.

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[1] These preliminary findings will serve as an input to the Staff Report on the Article IV consultation, which will be submitted to the IMF management in a few weeks. If approved by Fund management, the Staff Report will serve as the basis for the Board discussion of the 2007 Article IV discussion later in the year.
[2] The mission's assessment is based on the data provided by the government.

- **Fiscal imbalances narrowed.** On the basis of preliminary data, the 2006/07 central government deficit is estimated at 7.5 percent of GDP, below the 9 percent average of recent years, largely due to structural improvements including ongoing reforms in the tax area, fuel price adjustments, wage restraint and windfall receipts from a telecom license sale. Excluding windfall receipts and one-off bank restructuring costs, the underlying budget sector deficit fell to 8.5 percent of GDP, an adjustment in 2006/07 of close to 2 percent of GDP from the previous year's underlying deficit, with a broadly similar adjustment for the general government (which includes social security funds and the National Investment Bank, NIB). Combined with privatization receipts and the draw-down of idle cash balances following the consolidation of most government accounts into a Treasury Single Account (TSA), budget borrowing requirements fell dramatically, contributing to the decline in T-bill yields.

4. Structural reforms continued to promote a dynamic private sector driven economy. The privatization of several public enterprises, including public banks and joint ventures, and unused land has helped strengthen the role of the private sector. The reduction of average import tariffs from 9 to 7 percent will benefit consumers and foster exports, and the overhaul of tax administration procedures and practices have started to make tax administration more efficient and taxpayer friendly. Intra-government financing arrangements were streamlined with the elimination of the circular financing between the budget sector, social security funds and the NIB. The recent successful issuance of Egypt's first international local-currency bond should provide a benchmark interest rate, thus helping domestic capital market development.

5. Macroeconomic vulnerabilities are low. The diversified sources of foreign capital (from Europe, the GCC countries and North America) and a still-low share of speculative funds limit the risk of a sudden reversal of capital flows. The vulnerability to any reversal is furthermore limited as little of these inflows have been intermediated through the banking system and the CBE's international reserves are high. Stress testing conducted during the recent joint World Bank/IMF Financial Sector Assessment Program (FSAP) Update highlights that the banking system would be vulnerable mainly to a deterioration of domestic credit quality and much less to exchange and interest rate movements. To date Egypt has weathered the recent turbulences in global financial markets rather well, some pullback in the stock and fixed-income markets notwithstanding.

The task ahead is to sustain high job-creating growth.

6. Sustaining growth in the order of 6-8 percent will require investment to rise to around 26 percent of GDP, and reforms therefore need to continue to tackle constraints on business development, such as inadequate infrastructure, limited access to bank credit by SMEs, red tape, poor public service delivery, and the lack of skilled labor. Continued efforts are also needed to reduce the underpricing of energy, which remains an important distortion that risks attracting investment into sectors where Egypt may not have a long-run comparative advantage, encourages levels of energy consumption that impose high environmental costs, and uses up vast public funds that could be more productively spent, for example on education or infrastructure. Fuel subsidies recorded in the budget amount to 5-6 percent of GDP; however, valuation of domestic oil and gas production at world market prices would put the implicit subsidies substantially higher still. To ensure the domestic and external stability critical for sustaining high growth and investment, continued fiscal adjustment is needed to raise national saving and ensure sustainable public debt dynamics. A further strengthening of the framework for exchange rate and monetary policy will enhance the CBE's ability to smooth cyclical swings and shocks, while keeping inflation low.

7. A strong outlook for 2007/08 and continued favorable external conditions provide a conducive setting for the implementation of the reform agenda. Real GDP is expected to expand by about 7 percent, led by strong growth in investment and consumption. Inflation is projected in the 6-9 percent range as the impact of the 2006 supply shocks dissipate, as long as a prudent monetary policy stance is maintained. Exports and imports are expected to continue growing strongly, and a rising trade deficit will moderate the current account surplus. The overall balance of payments should remain strong though, as Egypt continues to attract FDI and other capital. There are some downside risks to the outlook: tightening global credit markets may contribute to a worsening of the external environment, such as lower global growth and less easy access to international capital markets. Also, reform fatigue may set in as some interest groups are adversely affected and parts of the public are disappointed with the pace at which reform benefits accrue to all strata of society.

Fiscal consolidation is the overarching challenge.

8. Reducing the budget deficit is key to raising national saving and supporting monetary policy in containing inflation and speculative inflows. It is also key to reducing the high level of net public debt (net domestic general government plus public and publicly guaranteed external debt amount to about 70 percent of GDP). The mission welcomes the government's plan to reduce the deficit gradually to 3 percent of GDP by 2010/11, which would put public debt on a firmly declining path. In line with this strategy, the 2007/08 central government budget aims to contain the deficit at 7 percent of GDP. With one-off revenues expected at 0.6 percentage points of GDP, and one-off investments in the railway at 0.2 percent of GDP, achieving this target requires an additional adjustment effort of 1.1 percent of GDP over last year's underlying deficit**.**

9. Achieving the short and medium-term fiscal targets will require policy measures such as continued retrenchment in the wage bill, reform of the sales and property taxes, improvements in the efficiency of cash management and public spending, and further reductions in fuel subsidies. Early action in these areas is needed to deliver the 2007/08 budget target and to enhance the credibility of the reform program, thereby contributing to a strong and swift investor response. The planned phase-out of gas and electricity subsidies for energy intensive industries, if implemented without delay, will contribute sizably toward meeting the medium-term targets. At the same time, efforts should continue to strengthen social safety nets to protect the poorest segments of society. The favorable external environment and continued strong growth provide an opportunity to accelerate fiscal consolidation beyond the pace currently envisaged by the government.

The monetary and exchange rate framework should continue to be strengthened in order to remain effective in containing inflation and smoothing volatility.

10. The authorities' declared monetary and exchange rate policy framework is a managed float and gradual move to inflation targeting. The greater exchange rate flexibility evident in recent weeks is beginning to put in place a crucial element for the success of this approach. Allowing the demand and supply of foreign exchange to play the main role in determining the exchange rate is essential to make monetary policy more effective. In this approach, the CBE should aim at smoothing volatility arising from one-off flows. Greater flexibility could help reduce short-term portfolio inflows by encouraging investors to internalize exchange rate risk, thereby reducing the need for further reserve build-up and costly sterilization, which has severely reduced the CBE's tax and dividend payments to the budget. Any short-term appreciation against the U.S. dollar is unlikely to substantially affect non-hydrocarbon merchandise exports and tourism, given the substantial depreciation of the Egyptian pound in recent years vis-à-vis the euro.

11. In this setting, the CBE's approach of broadly targeting underlying inflation while taking into account monetary aggregates and other indicators remain appropriate. The mission believes that long-run inflation should be anchored at low single digits, and supports the authorities' policy of accommodating one-off effects from administered price adjustments, while aiming to contain spillovers into other prices. With continued gradual subsidy reduction, inflation may persist in the 6-8 percent range for the next few years provided broad money growth is contained at around 15 percent. In the transition to inflation targeting, the mission welcomes the CBE's approach to be guided by a range of indicators of underlying inflationary pressures, as well as monetary aggregates. Clear communication of this approach to the public should help stabilize inflationary expectations.

12. Ongoing financial sector reforms will gradually result in improved financial intermediation, and the mission supports the authorities' plans to push ahead with further reforms. Over the last two years, privatization has put about half of the banking sector into private hands and the government has restructured public banks, paying off nonperforming loans (NPLs) owed by state enterprises, while also fostering resolution of private sector NPLs. The planned financial reform program and restructuring of the state-owned financial institutions in the non-bank sector (e.g., insurance) will enhance mobilization of saving and allocation of capital to the most productive investments. The mission encourages the authorities to build on good progress to date, and continue to improve bank and non-bank supervision along the lines set out in the banking sector program launched in 2004 and in the recent FSAP Update. This would involve rapidly completing the bank recapitalization program, and further improving banking sector data to enhance monitoring and stress testing of the financial sector. Complementary regulatory and judicial reforms—such as setting up specialized economic courts, promoting out-of-court arbitrage and enhancing the role of the private sector-led credit bureau—will also help to improve contract enforcement and creditor protection, thereby addressing key obstacles to bank lending to SMEs.

13. Implementation of the fiscal consolidation and structural reform agenda would help ensure a strong medium-term outlook for Egypt. The mission projects that with continued high growth and rising investment, the current account balance will gradually turn into a deficit of around 2-3 percent of GDP over the medium term, to be financed largely by FDI. This path is consistent with domestic and external stability, and the mission's estimates suggest the actual real exchange rate is broadly in line with its equilibrium level.

14. Efforts to improve macroeconomic statistics need to continue. Egypt subscribed to the SDDS in January 2005, but data improvements in certain areas are urgently needed. The publication of the improved CPI series has been delayed, and progress in implementing a comprehensive foreign investment survey has been slow. Data availability on the production and use of oil and gas needs to be improved, and greater transparency of EGPC's financial situation would help in the rationalization of energy policy. The mission also encourages the authorities to implement the recommendations made in the 2003 data ROSC and improve the overall production of statistics.

We thank the Egyptian authorities for stimulating and productive discussions and for their generous hospitality.