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**Conclusions of the Staff Visit**

In our discussions with representatives of the Egyptian government and the private sector we have taken the opportunity to bring ourselves up-to-date on recent developments and to review economic prospects. The medium-term prospects for the economy remain very positive, supported by good progress under the reform program. However, we believe that there are some pressing near-term challenges for economic policy. The main conclusions of our visit are as follows:

- **The reform program has strengthened the economy**: (i) economic growth is broad based and robust and unemployment has declined, with reports of skilled labor shortages in several sectors; (ii) financial market indicators are strong, with equity prices at record levels and spreads on Egyptian eurobonds below the average for emerging market economies; (iii) investor confidence has resulted in large capital inflows, mainly of FDI, which have more than offset the deterioration in the current account balance resulting from buoyant domestic demand and trade liberalization; (iv) international reserves are substantial and reserve cover is comfortable; and (v) the path of the public debt-to-GDP ratio is firmly downward-sloping. There is every reason to be confident that the planned deepening of reforms will sustain the improvement in economic performance.

- **However, successful reform has given rise to several new policy challenges**. In particular, important judgments need to be made with respect to: (i) the appropriate pace of fiscal consolidation in the presence of large increases in world prices of basic foods and fuels; (ii) the best means of maintaining monetary discipline in the presence of large capital inflows; and (iii) assessing and responding to underlying inflation when prices of imports and some administered items have risen sharply and domestic demand is robust. There is also the challenge of ensuring that the gains from reform are dispersed broadly across the population and in a timely manner in order to garner support for a deepening of the reform effort.

- **A more difficult international environment has also complicated policy making**. Demand in the United States and European export markets appears likely to slow as growth rates in those economies dip, and there is little certainty that pressures from world commodity prices will ease significantly in the near future given still strong demand in major emerging market economies, or that international financial market conditions will be less volatile.

- **The most pressing challenge is to contain the surge in inflation**, which is undermining the reform program, encouraging restrictive export practices, and slowing the pace of poverty reduction. The 12-month headline rate of inflation (12.1 percent in February) is some 50 percent higher than projected at the time of the Article IV discussion, with prices of both tradables and nontradables rising sharply. During the Article IV consultation discussions, we suggested to accommodate price increases from subsidy reductions but to tighten monetary policy in response to inflation stemming from robust demand, and that, to be effective, the tightening of monetary policy would need to be accompanied by greater exchange rate flexibility. We believe that advice remains appropriate but action is now more urgent given the need for subsidy reduction to bring the medium-term fiscal strategy back on track, and to avoid second-round inflationary effects.

- **Monetary policy continues to be hampered by limited exchange rate flexibility in the presence of large capital inflows**. After appreciating by 2½ percent during August-October, the LE/US$ exchange rate has remained within a +/- 1 percent band around a central rate of LE/US$5.50, with capital inflows only partially sterilized. As a result, the banking system remains very liquid and broad money supply continues to grow rapidly, reaching 22 percent in February (year-on-year). These monetary conditions may already have ignited second-round inflation effects from increases in import and administered prices. The recent increases in central bank policy rates were steps in the right direction; however, they have not materially impacted the financial system liquidity, which would be best facilitated by some accompanying appreciation of the Egyptian pound. Some real appreciation appears to be inevitable in the presence of sustained large capital inflows and structural reform, and the reform strategy and poverty reduction would be best served if this were to take place through an appreciation of the nominal exchange rate rather than as the result of an inflation rate well in excess of that in Egypt's major trading partners.

- **The postponement of further fiscal consolidation until 2009/2010 will increase the burden on monetary policy to contain inflation**. Sticking to the original path of deficit reduction would ease the pressure on domestic demand and on the exchange rate to appreciate. The projected level of subsidies this year and next is a particular cause for concern. While we understand the need to move cautiously with food subsidies, fuel subsidies are rising at an alarming rate and are likely to reach 6.6 percent of GDP this year—1.1 percentage points of GDP higher than projected during the Article IV consultation—with little reduction budgeted for 2008/09. We recommend reconsidering the level of the fuel subsidy for 2008/09 and being cautious with respect to increasing wages and other recurrent expenditures so as to bring the path of fiscal consolidation closer to that originally intended, create fiscal space for more growth-enhancing public expenditures and better targeted poverty assistance, and to give more room for maneuver in the event of unforeseen developments.

- **The difficulty in containing spending, and the pending social security and health reforms, make it more urgent to move ahead with tax reform**. The adoption of the delayed VAT is particularly important. At the same time, the reform agenda could be broadened to include programs to mitigate the adverse impact of subsidy reduction on the most vulnerable groups through better targeted social assistance. It is also crucial for medium term fiscal stability to adequately cost the proposed social security and health reforms before deciding on the models that are going to be adopted.

Though we have focused on the task of short-run stabilization, we of course recognize the impressive progress that continues to be made under the reform program more generally. Indeed, that progress has placed Egypt in a much stronger position to carry out the task than otherwise would have been the case. We hope to have an opportunity to review these issues with you further during the forthcoming IMF Spring Meetings, and look forward to our discussing a broader policy agenda during the 2008 Article IV consultation later this year.