# ARAB REPUBLIC OF EGYPT—2010 ARTICLE IV CONSULTATION MISSION CONCLUDING STATEMENT

## CAIRO, FEBRUARY 16, 2010

1. ***Egypt's economy has been resilient to the crisis.*** Financial contagion was contained by limited direct exposure to structured products and low levels of financial integration with world financial markets. Sustained and wide-ranging reforms since 2004 had reduced fiscal, monetary, and external vulnerabilities, and improved the investment climate. These bolstered the economy's durability and provided breathing space for appropriate policy responses.

- ***Financial market conditions have eased since the initial downturn.*** A sharp outflow of capital took place in the second half of 2008, as foreign investors pulled out of equity and government debt markets. Investors' confidence in Egypt and appetite for risk have improved since March 2009, and the stock market reversed course, capital inflows resumed, and official international reserves have been rising.

- ***Economic performance was better than expected, although headline inflation remains elevated.*** Growth fell only to 4.7 percent in FY2008/09 on the strength of consumption spending, and production in the construction, communications, and trade sectors. The first half of FY2009/10 provides further evidence of a pickup in growth and external demand. After falling rapidly from 24 percent, headline inflation has risen above 13 percent in recent months, although much of the impetus appears to be idiosyncratic. Core inflation remains within the central bank's informal comfort zone.

2. ***Prompt fiscal and monetary responses helped cushion the impact of the post-Lehman slowdown.*** Additional infrastructure expenditures—some off-budget—provided a targeted and temporary stimulus. Also helping to limit the slowdown, interest rates were cut sharply. The rapid capital outflow in late 2008 was met mostly with a drawdown in official reserves and the Central Bank of Egypt's (CBE's) foreign currency deposits with commercial banks, limiting the impact on the Egyptian pound and real economy.

3. ***As the recovery gains strength, the focus of policies can shift back toward fiscal consolidation and other growth-oriented reforms.*** With growth expected to reach 5 percent in FY2009/10 and 5.5 percent in FY2010/11, the need for further stimulus is waning.

**Fiscal Policy**

4. ***The FY2009/10 budget is appropriately supportive, but budget execution should give regard to the pace at which activity rebounds.*** The government's FY2009/10 fiscal deficit target of 8.4 percent of GDP is expected to be met on the strength of careful fiscal management. If revenues perform better than expected as a result of strengthening activity, it would be prudent to save these. While the large government

borrowing requirement represents a potential risk, financing should be available without undue stress. Development of markets for longer-term government debt is under way. The authorities could also consider diversifying toward additional foreign financing. These steps can help lengthen the average maturity of the debt, reduce financing costs, and lessen pressures on the banking system to finance the budget.

5. ***The authorities' objective of reducing the fiscal deficit to about 3 percent by FY2014/15 is critical to achieving private sector-led growth and reducing vulnerabilities.*** Reducing the overall deficit by about 5 percent of GDP over the next five years is feasible, based on the experience of other countries, and would lead to a further 15 percentage point decline in the debt-to-GDP ratio. Such adjustment will be crucial to maintain investor confidence, preserve macroeconomic stability, and create scope for future countercyclical fiscal policy. Anchoring the strategy in reforms to increase the low tax revenue-to-GDP ratio and the efficiency of public spending will help durably address Egypt's main fiscal vulnerabilities. Priorities include adopting as early as possible a full-fledged VAT, complementing energy subsidy reform with better-targeted transfers to the most needy, and containing the fiscal cost of the pension and health reforms.

6. ***The mission advises that the FY2010/11 budget targets a narrowing of the deficit compared to this year.*** A tightening of 1½–2 percent of GDP would provide an upfront signal to investors that progress toward the medium term objective is well under way, encouraging a more rapid private sector response to boost FDI and growth. While adopting major reforms could be challenging with the approaching elections—as evidenced by the delays in the property tax—the mission encourages the authorities to continue taking measures such as strengthening tax compliance and reducing the cost of subsidy abuse, and also to resist pressures for additional spending.

**Monetary Policy**

7. ***While 12–month inflation is expected to decline in the coming months, the CBE should stand ready to tighten monetary conditions if inflation does not abate.*** As inflation ceased declining and output growth picked up, the recent decisions to keep rates stable were appropriate. Increases in headline inflation have been driven largely by fruit and vegetable prices. Such pressures are likely to be mostly idiosyncratic and not demand-induced. But persistently high headline inflation risks generating inflationary momentum through its effect on expectations. Bringing down inflation toward partner country levels should remain a key objective for the coming years. The mission welcomes progress in strengthening the monetary policy framework. The new core inflation measure and publishing the planned monetary policy reports will allow a better understanding of the CBE's monetary policy decisions, and help improve its effectiveness.

8. ***Capital inflows, if continued, will complicate monetary policy-making.*** As the CBE has done in the past, sterilized intervention is the first option for hot money inflows, although this is expensive and unlikely to be effective if inflows persist. The CBE should also continue to allow greater exchange rate variability to limit one-way bets. Egypt's real effective exchange rate is estimated to be slightly more appreciated than equilibrium, although these estimates are subject to uncertainties. The possibility that capital inflows

could exert longer-lasting pressures for real appreciation reinforces the need for fiscal adjustment and productivity-enhancing reforms.

**Reforms for Sustained Growth**

9. ***Continuing the reform momentum and reducing fiscal vulnerabilities remain the key medium-term challenges.*** Rapid growth is crucial to tackling poverty and the high level of unemployment. In this context, reinvigorating the structural reform agenda should help raise productivity and reinforce Egypt's competitiveness.

- ***Prioritizing reforms that promote macroeconomic stability and improve the investment climate will support the resumption of foreign direct investment.*** As noted, the planned fiscal adjustment and tax reforms are an important element of generating confidence, improving the business environment, and ensuring space for the private sector. Resumption of privatization and development of public-private partnerships will help mobilize private sector financing and know-how. Contingent liabilities associated with PPPs, however, should be monitored closely.

- ***Reinforcing financial soundness and promoting financial sector deepening will help mobilize savings needed to finance private sector-led growth.*** The stability of the financial sector during and since the crisis is a testament to reforms since 2004. The mission supports the continuation of reform efforts with the CBE's Phase II agenda. Introducing Basel II standards and supporting financial sector development will help facilitate intermediation of savings and increase private sector access to credit. The mission supports plans to adopt additional prudential measures to contain vulnerabilities that will arise with greater integration with the global economy and the introduction of new asset classes. Close coordination between the new nonbank supervisory authority and CBE will be a priority, and consideration should be given to introducing forward-looking risk management and developing global standards on liquidity and leverage.

- ***Strengthening data quality and transparency will help improve the policy debate and business environment, and enhance Fund surveillance.*** The need for greater transparency and higher frequency data was underscored by the global financial crisis, and enhancements would help ensure that data availability is on par with other emerging markets. In particular, there is a need for more robust CPI and GDP deflators, and for publishing higher-frequency aggregate financial soundness indicators (as planned), and encouraging banks to make available detailed performance and soundness indicators.

*The IMF mission team expresses its appreciation to the Egyptian authorities for the productive discussions and their warm hospitality.*