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# IMF Executive Board Concludes 2008 Article IV Consultation with the Arab Republic of Egypt

On December 22, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Arab Republic of Egypt.[1]

## Background

Economic performance since 2004 generally has been impressive, underpinned by a supportive external environment and the structural reform program that has included the liberalization of foreign trade, investment, and the exchange market, the privatization of state entities, and measures to strengthen bank balance sheets and banking supervision. Annual GDP growth in the post-reform period was more than double the average of the previous decade, driven by large-scale foreign and domestic investment.

With the onset of the global crisis the policy challenges facing the authorities have changed radically. For most of the period since the last Article IV consultation, the most pressing issue has been to contain inflation when monetary and fiscal policies were constrained by limited exchange rate flexibility, large-scale capital inflows, and the growing cost of fuel and food subsides. By the time of the October-November 2008 consultation mission, inflation appeared to be past its peak and the more urgent challenge was to maintain growth and balance of payments stability in the context of the global financial turmoil and a rapidly deteriorating international economic outlook.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Real GDP growth averaged 7 percent in 2005/06-2007/08 and was relatively broad based across manufacturing, hydrocarbons, construction, services, tourism, and agriculture. The main drivers of demand have been private consumption and investment, aided by strong foreign direct investment. Though reports of skilled labor shortages have been widespread, official unemployment has remained stubbornly high at 8½ percent. Inflation reached a peak of 24 percent in August, reflecting a combination of world commodity price developments, changes in administered prices, and pressures from buoyant domestic demand; with the subsequent decline in commodity prices, inflation fell to 20 percent in October.

Net international reserves were US$35 billion in September 2008, but reserve accumulation has slowed sharply since mid-year. Though exports, remittances, and receipts from tourism and the Suez Canal remained strong, a surge in imports because of buoyant domestic demand and trade liberalization all but eliminated the current account surplus by mid-2008; and in August-October there was an abrupt reversal of portfolio flows as foreigners investors pulled out of the equity and government bond markets. The central bank responded to the portfolio outflows by running down its foreign currency deposits with commercial banks.

In the year through mid-November, the stock market fell by about 50 percent and spreads on Egyptian bonds widened by about 175 basis, though these falls were less than the average for emerging market economies. In September, Moody's and Fitch downgraded their investor outlook for Egypt.

The limited flexibility of the pound against a weak U.S. dollar and the partial sterilization of capital inflows raised non-U.S. dollar import prices and created the monetary conditions that ignited second-round inflation effects. The nominal effective exchange rate appreciated by over 6 percent between January and September 2008, and accelerating inflation appreciated the real effective exchange rate by 21 percent.

The central bank increased policy interest rates by 275 bps (to 11½ and 13 percent) in the first eight months of the year, but market interest rates responded slowly until the abrupt reversal of capital inflows in August-October drained some bank liquidity. The growth of broad money supply, which accelerated sharply under pressure from capital inflows slowed from 24 percent in March to 14 percent in September.

The central government deficit narrowed to 6.8 percent of GDP in 2007/08, notwithstanding pressures from sharply increased subsidies, but the deficit at the level of the general government widened to 7.8 percent GDP, mainly reflecting increased financial investments by the social insurance fund. The 2008/09 budget left the central government deficit broadly unchanged and included significant increases in pensions, wages, and food subsidies to mitigate adverse social effects of high inflation, to be met by a wider income tax base and increases in administered prices of fuels and other products.

The banking system has largely withstood the global financial crisis. Information through end-September shows net foreign assets positions of banks and the deposit base have been stable, and the flow of credit to the private sector has continued to grow at the 13-14 percent annual rate of the previous three years. Nevertheless, to encourage continued confidence in the banking system, the central bank reiterated its existing guarantee of all bank deposits.

Progress with structural reform has been mixed: (i) administered prices of fuels and other items were increased sharply, but fuel subsidies continued to grow under pressure from rising international prices; (ii) a property tax reform was approved by the parliament and will be effective in January 2009, but the introduction of the VAT has been delayed until at least late 2008/09; and (iii) the clean up of nonperforming loans of public enterprises continued, but the privatization program suffered a setback in July when bids for state-owned Banque du Caire, the third largest bank, were below the minimum targeted by the government and the auction was cancelled.

**Executive Board Assessment**

Directors commended the Egyptian authorities for their sound macroeconomic management and economic reforms to date. Directors considered that the policy challenges facing the authorities have changed significantly since the onset of the global financial turmoil and the rapid deterioration in the international economic outlook. While the Egyptian economy has withstood the global slowdown relatively well, net exports and foreign direct investment are likely to weaken as external conditions decline further in the months ahead. Under these circumstances, and with inflation past its peak, the priority will be to maintain growth and balance of payments stability. Directors were therefore pleased that Egypt's recent economic reforms have provided the authorities some room for maneuver to cautiously undertake countercyclical policies in the event of an economic slowdown.

Directors supported the authorities' fiscal policy aimed at striking a balance between bolstering short-term activity and ensuring medium-term fiscal sustainability. The size and composition of the proposed fiscal stimulus in 2008/09 to support growth and employment are broadly appropriate. Directors also noted that the envisaged acceleration of public infrastructure spending to address existing bottlenecks will result in only a modest deviation from the planned medium-term consolidation path.

Directors noted that Egypt's medium-term outlook remains sound. They welcomed the authorities' recognition of the particular challenges and uncertainties in the period ahead, and their readiness to act in a timely manner if balance of payments pressures heighten. On the fiscal front, Directors urged the authorities to remain vigilant regarding the challenges posed by the still high levels of the fiscal deficit and public debt, the short-maturity of debt, and the back-loaded adjustment effort required to meet the revised fiscal deficit targets. They considered, however, such challenges to be manageable given the authorities' good record on reform and fiscal consolidation. Notwithstanding the strong record, Directors stressed that, now more than ever, Egypt should persevere with its medium-term fiscal consolidation efforts to reduce the country's vulnerabilities.

Directors welcomed the authorities' intention to move cautiously with policy rates until there are clear signs that the pressure on the balance of payments has stabilized. They noted that judging the timing of an interest rate cut is complicated by the risk that a rate cut could accentuate recent pressures on central bank reserves and the exchange rate. Directors saw scope for the authorities to allow for greater exchange rate flexibility to help deal with pressures on central bank reserves. Directors noted the staff's assessment that the real effective exchange rate of the Egyptian pound is broadly in line with fundamentals.

Directors noted that the banking system has coped well with the recent global financial shocks. This resilience is attributable to the authorities' ongoing banking sector reform efforts—including a strengthening of banking supervision and regulation, a cleanup of nonperforming loans, as well as conservative investment and funding practices. Egypt's healthy bank balance sheets and low level of financial integration suggest that there are good prospects that financial intermediation will not be impeded by the international crisis.

Directors commended the authorities for their determination to maintain the reform momentum in difficult circumstances. They encouraged them to focus on reforms that support domestic demand and promote private investment, so as to ensure that Egypt is well placed to take advantage of the eventual recovery in the international economy. Reforms that restructure the public finances to support fiscal consolidation also deserve priority. Directors attached importance to the early introduction of the VAT, which would have the best prospect of yielding the revenue gains needed for the envisaged medium-term fiscal adjustment. They welcomed recent government efforts to broaden the privatization program.

Directors encouraged the authorities to press further with food and fuel subsidy reforms, and welcomed their intention to improve the efficiency and targeting of food subsidy programs. Consideration should be given to introducing automatic adjustment mechanisms for domestic fuel prices to minimize distortions, while strengthening cash-based social programs to protect vulnerable groups.

Several Directors stressed the importance in the current circumstances of further improving the timeliness of the publication of key macroeconomic data, particularly regarding the balance sheet of the Central Bank of Egypt.

Arab Republic of Egypt: Selected Economic Indicators 1/

| | 2004/05 | 2005/06 | 2006/07 | Est. 2007/08 | Proj. 2008/09 |
|---|---|---|---|---|---|
| Real Sector | | | | | |
| Real GDP growth | 4.5 | 6.8 | 7.1 | 7.3 | 5.0-5.5 |
| CPI inflation (12-month change, average) | 8.8 | 4.2 | 11.0 | 11.7 | 17.1 |
| Unemployment rate (in percent) | 10.5 | 10.9 | 8.9 | 8.8 | … |
| Public Finances | | | | | |
| Balance of the general government (in percent of GDP) | -8.4 | -9.2 | -7.5 | -7.8 | -7.6 |
| Net public debt (in percent of GDP) | 80.5 | 79.8 | 71.4 | 62.3 | 58.5 |
| Money and credit | | | | | |
| Broad money growth (annual rate) | 13.6 | 13.5 | 17.1 | 15.8 | 12.2 |
| Credit to the private sector (annual growth rate) | 3.6 | 8.6 | 12.3 | 12.6 | 13.5 |
| Interest rates on 91-day treasury bills (in percent) | 10.2 | 8.8 | 8.7 | 7.0 | … |
| External Sector | | | | | |
| Trade balance (in percent of GDP) | -11.5 | -11.2 | -12.1 | -14.4 | -14.0 |
| Current account balance (in percent of GDP) | 3.2 | 0.8 | 1.4 | 0.5 | -1.8 |
| Reserves (in billions of U.S. dollars) | 19.3 | 22.9 | 28.4 | 33.8 | 33.9 |
| (in months of next year's imports of goods and services) | 5.8 | 5.9 | 5.2 | 6.4 | 6.1 |
| Gross external debt (in percent of GDP) | 32.2 | 28.8 | 23.0 | 20.9 | 16.3 |
| Exchange rates | | | | | |
| Egyptian pounds per U.S. dollar (average) | 6.0 | 5.8 | 5.7 | 5.5 | ... |
| Real effective exchange rate (average; percent change) | 4.2 | 8.1 | 4.4 | 3.0 | ... |

Sources: Egyptian authorities; and IMF staff estimates.
1/ Egyptian fiscal year ends June 30.