Arab Republic of Egypt—2008 Article IV Consultation
Preliminary Conclusions of the IMF Mission
November 6, 2008

Introduction

1. Economic performance since 2004 has been impressive, underpinned by the structural reform program that has included tax reform and fiscal consolidation, 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. The reforms have raised Egypt's potential output and provided more room for maneuver with respect to macroeconomic policies.

2. The policy challenges facing the authorities have changed since the last Article IV consultation mission in September 2007 and even since the interim Fund staff visit in March-April 2008. At the time of the latter, the most pressing issue was 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. Now, inflation appears to be past its peak and the more urgent challenges are to maintain growth and balance of payments stability in the context of the global financial turmoil and a rapidly deteriorating international economic outlook. The achievements under the authorities' economic reform program have increased the prospect that these challenges can be met successfully.

3. With these challenges in mind, our discussions with government officials and private sector representatives aimed at trying to clarify: (i) the extent of the likely slowdown in economic activity; (ii) the scope for counter-cyclical policies to support growth and employment creation; (iii) the ability of the banking system and the balance of payments to withstand further buffeting from the international crisis; and (iv) areas that could be given greater emphasis in the reform program going forward.

4. The discussions with the Egyptian authorities on these issues revealed a clear awareness on their part of the main challenges and the key risks ahead. In our discussions with private sector representatives, we found a broad consensus among them on the near-term economic and financial prospects and risks.

Recent Developments and Near-Term Prospects

5. A slowdown in economic activity would appear to be inevitable given the increased global integration of Egypt's real economy. Prior to the international crisis, the economy looked set to record another strong performance in 2008/09, with growth likely to have been close to 7 percent, the annual average of the previous three years. However, the international crisis is likely to undermine FDI flows and make domestic investors more cautious; private consumption is under pressure from an inflation-related squeeze on real incomes, and net exports of goods and services are set to weaken further as key markets shrink and prices fall. As a result, real GDP growth is likely to slow over the next 12-18 months, before picking up as the recovery of the international economy takes hold.

6. While the prospects for growth may have dimmed, the inflation outlook has improved markedly. The surge in inflation this year (to 24 percent in August 2008) reflected a combination of world commodity price developments, changes in administered prices, and pressures from buoyant domestic demand. However, exchange rate policy also contributed to the surge because of the limited flexibility of the pound against a weak U.S. dollar and the partial sterilization of capital inflows, which raised non-U.S. dollar import prices and created the monetary conditions that ignited second-round inflation effects. The impact of the international crisis has been to reverse many of these causal factors: falling world commodity prices and the slower growth of the Egyptian economy should reduce pressures on headline and core inflation; and a reversal of net balance of payments inflows should tighten bank liquidity and increase the effectiveness of central bank policy interest rates. Our assessment is that the recent fall in inflation will continue, with the rate likely to decline to 12-14 percent by mid-2009 and further to 8-10 percent by mid-2010.

7. The balance of payments has weakened and will remain vulnerable until the international economy improves. Though exports, remittances, and receipts from tourism and the Suez Canal have 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 the sharp reversal of portfolio flows during August-October 2008 put pressure on central bank reserve assets and the exchange rate. Looking ahead, the external current account deficit seems set to widen through 2009/10 as exports decline sharply; and while still high by historical standards, FDI inflows are unlikely to be sufficient to prevent a moderate decline in central bank net international reserves. Moreover, there is the risk of further capital outflows in the near term given the ongoing turbulence in the global financial markets.

8. The central government finances have continued to improve notwithstanding a much more difficult international situation than envisaged at the time of the last Article IV consultation. The deficit outturn for 2007/08 of 6.8 percent of GDP was better than budgeted, despite pressures from sharply increased subsidies, and the authorities judge that the deficit could narrow further to just less than 6½ percent of GDP in 2008/09, reflecting savings on subsidies because of import price declines and planned measures to boost revenues. While such an adjustment would not be quite as fast as that envisaged under the medium-term consolidation plan, it suggests that the targeted deficit of 3 percent of GDP by 2010/11 would remain feasible provided planned reforms are put in place, most particularly the introduction of the VAT later this fiscal year. However, a somewhat more gradual consolidation path now looks to be in order given the projected economic slowdown.

9. The financial sector, so far, has escaped the ravages of the international crisis, reflecting the strengthening of balance sheets under the banking reform program, improved banking supervision, conservative practices with respect to funding, investments, and lending, and the recent statement by the Central Bank that it guaranteed the deposits of all banks. The deposit base has been stable and there has been no

interruption to the flow of credit to the private sector. As domestic liquidity conditions tighten somewhat in response to portfolio outflows and increased purchases of government securities (as banks take up the slack left by foreign investors), some repatriation of banks' overseas assets seems likely, which would give some relief to the balance of payments.

The Scope for Counter-Cyclical Policies

10. The recent economic reforms have given the authorities some room for maneuver to undertake counter-cyclical monetary and fiscal policies to support growth and employment in the event that a slowdown in growth materializes. Nonetheless, undertaking such policies is likely to be fraught with risk given the difficulties in assessing potential output in an economy undergoing significant structural change and the uncertainties as to the timing of the recovery of the international economy. Moreover, there are considerable uncertainties regarding the depth and duration of the recent reversal of capital flows. With these caveats in mind, our assessment is that the projected slowdown in GDP growth is likely to take output below its potential, which would leave some scope for a modest policy stimulus to assist the economy through 2009, when international developments should be more favorable.

11. There should be room for a fiscal stimulus of about ½ percent of GDP in 2008/09, which could be achieved by foregoing the additional adjustment projected on present policies and keeping the fiscal deficit broadly unchanged from 2007/08. The weak public infrastructure base and the contribution that such expenditures could make to increasing potential output, suggest that the stimulus should emphasize the acceleration of existing infrastructure spending plans, while avoiding increases in recurrent expenditure. A stimulus of this magnitude would be consistent with only a modest alteration to the authorities' proposed medium-term fiscal consolidation path, raising the planned fiscal deficit by about ½ percent through 2010/11, and with uninterrupted declines in the debt-to-GDP ratio. A revised adjustment path, even of this limited magnitude, is not without risk given the still high levels of the fiscal deficit and public debt, the fact that much public debt is of a short-maturity, and the loss for the present of a foreign investor base. However, it is a risk that seems worth taking given the added policy credibility due to the successes under the reform program and the progress with fiscal consolidation.

12. Judging the timing of a monetary stimulus is complicated by the risk that a cut in interest rates could accentuate pressures on central bank reserves and the exchange rate. With the initial impact of interest rate cuts much more likely to be on the exchange rate rather than on the demand for credit, there would appear to be room to keep policy rates

unchanged until there are clear signs that pressure on the balance of payments has stabilized.

13. There are particular challenges for managing the exchange rate at a time of international crisis, when the balance of payments could be weak for an extended period, and when the exchange rate and reserves already have been under some pressure. These uncertainties suggest that the balance between reserve losses and exchange rate depreciation to meet any of these pressures should give greater emphasis to allowing more exchange rate flexibility; this could also bring some relief to the export sector.

14. Fortunately, with the economy yet to show clear signs of slowdown there would appear to be some time to balance the many risks and to calibrate an appropriately cautious policy response.

Banking Sector Stability

15. There are reasons to be optimistic that financial intermediation will continue largely unimpeded by the international crisis. There is little bank dependence on foreign credit lines; loan-to-deposit ratios are low; banks have little exposure to fluctuations in the prices of equities and other investments; there are virtually no structured credit and derivative products; foreign currency loans are mainly funded from domestic foreign currency deposits and made to entities with foreign currency revenues; and there are strict limits on mortgage lending.

16. The 2007 FSAP update mission concluded that the largest banks were resilient to moderate changes in the exchange rate, that most banks could withstand moderate changes in interest rates and shock to deposits. The main vulnerability would appear to be to a worsening in loan quality in the event of a prolonged slowdown in the economy or deterioration in lending practices, which seems unlikely at present. Nonetheless, the severity of the crisis underscores the urgency for the central bank to continue the good progress with the banking supervision reform agenda, including with respect to strengthening banks' risk management systems, implementing risk-based supervision, and improving the collection and analysis of banking and financial sector indicators.

Maintaining the Reform Momentum

17. That Egypt, so far, has withstood the international crisis better than many other economies, and the fact that it has some room for maneuver to protect output and employment, is in large part because of the achievements under the reform program. This underscores the need to maintain the momentum of reform.

18. The emphasis should be on reforms that support domestic demand in the more difficult international climate, ensure that Egypt is well placed to take advantage of the eventual recovery in the international economy, and that would increase further the authorities' ability to respond to economic shocks. Though there is a broad agenda, the reforms with the quickest pay-off in these respects are likely to be those that restructure the public finances to support fiscal consolidation, and support private investment, including by continuing to attract FDI. For example:

• Early introduction of the VAT, which has the best prospect of yielding the additional revenues needed to improve the public finances and to finance longer-term fiscal structural reforms.
• Subsidy reform, including through better targeting, and the introduction of automatic adjustment mechanisms for domestic administered prices.
• Strengthening cash-based social programs for more effective protection of the most vulnerable groups, particularly in the context of subsidy reform.

• Accelerating preparations for the privatization of state entities to be able to take early advantage of the recovery in the international economy.

19. The need to create greater room for maneuver with fiscal policy also underscores the need for the planned health and social security reforms to be properly costed and sequenced to be consistent with the medium-term fiscal consolidation path.

20. Finally, though there have been improvements in the timeliness, coverage, and reporting of economic and financial statistics, weakness in these areas continue to constrain informed macroeconomic policymaking and surveillance.

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21. Our discussions with the Egyptian authorities have been open, frank, and stimulating, and we thank them for again providing such generous hospitality to the mission.