I.3 .. THE DOMESTIC ECONOMY: CHALLENGES AND OPPORTUNITIES AHEAD

Positive outlook for economic growth
As discussed in previous issues, there is no evidence that macroeconomic imbalances will emerge in 2005 or 2006. Moreover, the decisive and challenging initiatives taken by the Economic Cabinet of July 2004[11] are generating a mutually reinforcing growth momentum that promises higher growth for the Egyptian economy. The data analyzed in this report provide evidence that the economy is indeed benefiting from the reforms undertaken. Trade and tax developments, monetary policy reforms, exchange rate liberalization, aggressive privatization and the commitment to restructure the banking system have all raised optimism and restored confidence in the economy. There is faster growth, lower inflation, and a robust external position reflected in a falling external debt and debt service ratio. Foreign direct investment flows have surged and the CBE has built up its net international reserves to record levels. In response to the reforms, investment demand has picked up, while consumption demand, particularly private consumption, has led the strong economic growth. Prospects for the economy appear more favorable than at the beginning of the millennium.

Challenges to sustaining the growth momentum
Increasing growth and employment on a sustained basis is the biggest priority for policy makers.
But there could be downside risks to this growth potential. There exist a number of tests that the economy could face, and which would require proactive and efficient policy responsiveness.

The principal challenge in the near-term will be to ensure that economic policy facilitates the necessary adjustments to consumption and investment that arise from the bold trade, fiscal and financial sector reforms being undertaken. This task remains a fundamental objective of the Government in the near-term, particularly in light of the continued rapid rise and volatility in the world price of oil that could cause global current account imbalances and thus financial difficulties for both vulnerable emerging economies and poor oil-importing countries. Higher oil prices could also mean slower global growth. In this respect, Fitch recently commented that the policy framework of the Egyptian government has improved substantially, which has benefited economic performance.[12]

The Government has thus started a process to adjust monetary policies to ensure exchange rate flexibility and to mitigate the effects of (i) imported inflation (should such inflation arise), and (ii) slower global growth (should slower growth materialize, reducing external demand for Egyptian goods). In addition, bold fiscal adjustment (further tax and pensions reform) as well as vigorous structural reforms (including privatization, financial sector reforms and improvements in the investment climate) are underway.

As noted in **Section I.1: Overview of the Economy: Recent Trends**, the strong increase in external demand in 2004 has stimulated economic growth in 2005 and 2006, particularly domestic demand. Pro-active measures are directed towards the steady stimulation of all components of domestic demand in order to trigger the necessary multiplier effects on the other demand factors These measures include the recent increase in civil service salaries and the approval of the new Income Tax Law in June 2005. The increase in civil service salaries has an immediate effect to increase the purchasing power of this large group of wage earners. In doing so, it provides immediate social welfare benefits directly to the recipients and, later, downstream through its multiplier effect. It directly addresses the key Government goal of improved social equity and supports widespread participation in the benefits of the economic reform program.

The new Income Tax Law which became effective in July 2005 also stimulates domestic demand. The reduced tax rates leave more resources at the disposal of the individual taxpayers for both consumption and investment. Taxpayers, particularly at the corporate level, also realize additional benefits from the reduction of compliance costs arising from the streamlining of procedures. In addition, the overall improvement in net profits opens new private sector investment opportunities which previously appeared unattractive. Over the longer term, the Government will continue to modernize its tax institutions so that a strong bond of mutual respect and professionalism develops between the citizens and these institutions.

In addition, there are two risks that relate to the trade deficit and the domestic industry. One risk is that a robust growth in imports in response to lower tariffs and a stronger Egyptian pound could increase pressures on the trade deficit. However the services surplus should remain unaffected and should more than make up for any pressures on the trade balance, keeping the current account in surplus. The appreciation of the pound by 8 percent should not have a significant impact on either tourism or the Suez Canal

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[11] *The same economic team was sworn in on December 31, 2005 for a new term.*
[12] *Even then, the Egyptian tourism industry has shown significant buoyancy in the face of incidents that occurred in Taba and Sharm el-Sheikh in 2004/2005, and more recently in Dahab last April.*

receipts, both of which tend to be more influenced by geopolitical developments.[13] European tourists represent the majority of tourists arriving in Egypt, and continue to benefit from a strong Euro. Suez Canal earnings will actually benefit from higher oil prices. Hence, the diversity of foreign exchange income in the current account provides resilience to external shocks.[14] **(See Section II: Egyptian Economy Watch, Figure II.20.)**

As for the risk to the domestic industry, it would be temporary. Tariffs on raw materials, production inputs and semi-processed goods were reduced by more than 50 percent in many cases, and slashed by as much as 80 percent in other cases. Tariffs on other inputs were completely eliminated.[15] These reductions will serve to increase the competitiveness of Egyptian products in the global markets over the medium term, thus serving to lower the trade deficit. Thus, all policy reforms that improve the investment environment and reduce the cost of trade through across the board tariff reductions or through preferential trade agreements remain a top priority of the Government.

A second challenge is the cost of tax reforms to the budget. The implemented reductions in tax rates and customs duties carry short-term costs in terms of lower revenues. Despite the risk of initial losses of the fiscal reforms, these measures have proven to be revenue neutral in the short term, as we saw in **Section I: Overview of the Egyptian Economy,** and **Section II: Egyptian Economy Watch, Figures II:8&9.** As economic growth expands fiscal capacity, it is expected that the budget deficit will be lower.[16] Despite the 50 percent tax cuts implemented in July 2005, total tax revenues during the first three quarters of the year have already grown by 17 percent in comparison to 13 percent in 2004/2005. The growth rate however still lags behind the 20 percent increase witnessed in 2003/2004. A large proportion of the increase in growth derives from corporate taxes which contribute 7.9 percent to this growth, followed by sales tax at 5.5 percent. Because tax paid by corporations constitutes an overwhelming share of total tax revenues, increased economic activity in response to the reforms was reflected in increased corporate tax payments despite the rate cuts. It must be noted that very few countries (only three Eastern European countries, Ireland and Mauritius) have undergone such a comprehensive and deep tax transformation. In these countries tax reforms had no negative impact on FDI flows, manufacturing exports and manufacturing value added, even in the short term.[17]

Compared with previous years individual tax payments contributed 2.5 percent to the growth in total tax receipts in 2003/2004. This contribution declined to 1.8 percent in 2004/2005 and further declined to less than 1 percent during the first three quarters of 2005/2006. The widening of the tax base (the lower tax rates mean more inclusion of taxpayers and less evasion) has positive implications for tax revenues in the immediate to medium term. The drop in tax receipts could thus be recouped by a widening of "taxable capacity.".

With respect to customs duties, after negative performance following the cut in tariff rates, taxes on international trade contributed 2.6 percent of the growth in customs duties between July-March 2005/2006, compared to a negative contribution of 2.2 percent in 2004/2005 and only 1.7 percent in 2003/2004. There is scope for further increasing customs proceeds in the medium term as the economy and investment demand pick up. Export led growth will be stimulated because the tariff reductions will reduce the costs of importing essential raw materials and intermediate and capital goods used in the exportables industry, thus reducing the cost of investment and consumption. This is expected to support domestic investment, production and stronger growth. The growth in the domestic industry in response to an increase in exports and economic expansion would in turn create many job opportunities.

In the medium term, these reform measures should also start a virtuous circle of stimuli to the economy. The planned transformation of the tax authority, which will include greater automation leading to a less discretionary application of the rules, would raise additional income while the tax rate is reduced at the same time. Economic activity will be further reinforced in response to the rapid pace of current reforms and increased confidence in government policy. The budget will also be bolstered by complementary efforts by the Ministry of Finance to manage public expenditure more efficiently.

In the short run, some of these short term costs can be absorbed without jeopardizing the budget. According to Fitch Ratings, "Egypt's debt dynamics benefit from strong nominal GDP growth ..., so the Government can incur a slightly higher deficit without jeopardizing the debt/GDP ratio."[18] The acceleration of privatization could also provide supplementary budget support in the immediate term.

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13 Fitch Ratings. May 2006. Arab Republic of Egypt: International Credit Analysis.

14 Even then, the Egyptian tourism industry has shown significant buoyancy in the face of incidents that occurred in Taba and Sharm el-Sheikh in 2004/2005. Although these two incidents happened at season peaks, occupancy in the two resorts rapidly recovered.

15 Fitch Ratings. December 15, 2004. Fitch Revises Egypt's Outlook to Stable. Press Release.

16 For a discussion of why the 2005/2006 deficit appears slightly larger please refer to **Section I.1: Overview of the Economy: Recent Trends** and **Appendix C: Economic News.**

17 UNCTAD (United Nations Conference on Trade and Development). April 2005. Note on Country Experiences with Tax Harmonization.

18 Fitch Ratings. December 15, 2004. Fitch Revises Egypt's Outlook to Stable. Press Release.

Nevertheless a third and important challenge relates to fiscal consolidation. The Ministry of Finance is preparing a multi-year fiscal consolidation package aimed at bringing down the budget deficit in the medium term. This plan will serve to support the impact of strong economic growth on revenue dynamics discussed above. Some of these measures include (i) adopting a more efficient subsidy system that better targets the underprivileged; (ii) reforming the sales tax into a value added tax with a broader base, a single rate and a higher threshold; (iii) introducing a presumptive tax for small businesses; (iv) broadening the base and streamlining rates for property tax and stamp taxes; (v) introducing a treasury single account to help improve cash management; (vi) improving debt management ; (vii) launching private pubic partnerships to finance public investments in schools and hospitals; and (viii) reforming the pensions system by reducing transaction costs and establishing a fully funded contributory system for new entrants.

The Egyptian Government has introduced significant changes in the past 18 months. These reforms are now proving instrumental in increasing the ability of the Egyptian economy to withstand exogenous shocks, and to weather the developments in the global economy. Equally important, the continued political will to introduce new reforms will help to maintain the momentum for continued economic liberalization and strengthening of the macroeconomy, including improving the fiscal and public debt profiles. Egypt thus stands to benefit from improved economic fundamentals that will boost domestic demand, ensure that the momentum of growth remains solid, and thus increase the resilience of the economy to negative global developments. In March these fundamentals were tested when the Gulf stock markets declined causing a fall in the Egyptian market. The Egyptian stock market has largely recovered since then as we saw in **Section II: Egyptian Economy Watch**, indicating that the economy is well equipped with fundamentals that put it on the path to sustainable development. These fundamentals include an improved business environment with reduced bureaucracy, an improvement in companies' access to infrastructure and financing,[19] and a rapid and successful privatization program since July 2004 as is discussed in Appendix C: Recent Economic News.

Rapid and comprehensive economic transformation has become an integral part of the vocabulary of the Economic Team of the July 2004 Cabinet which was sworn in for a second term on December 31, 2005.[20] There is growing support for the announced policy changes, and the renewed credibility of the Economic Team bodes well for positive economic effects. The Economic Team will continue to show the way ahead by clarifying the future policy agenda and continuing to pursue and set in motion complementary, dynamic and constantly adapting reforms.

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[19] Business Monitor International, Daily Brief on Middle East and Africa: *Egypt Reform Outlook Still Promising*. March 22, 2006.

[20] See **Appendix C: Economic News.**