INTERNATIONAL MONETARY FUND

Arab Republic of Egypt—2006 Article IV Consultation

Preliminary Conclusions of the IMF Mission[1]

April 17, 2006

1. Discussions for the IMF's 2006 Article IV consultation with the Arab Republic of Egypt were held in Cairo from April 3 16, 2006. The mission's assessment of macroeconomic conditions and policies is summarized in this concluding statement, which draws on meetings with government officials and private sector representatives. The team is grateful to the Egyptian authorities and other counterparts for their generous cooperation and hospitality.

2. Investor confidence in the direction of economic policy in Egypt remains bullish, buoyed by the success of the reform program at improving macroeconomic performance while tackling some of the structural impediments to higher growth. This is a welcome break from the past, and Egypt's economic prospects are the brighter for it. However, unemployment remains high, and the public is growing impatient for the "trickle down" impact. Building on achievements so far, the second stage of reforms will pose greater challenges to the authorities in terms of policy trade-offs and the need to ensure sufficient socio-political consensus.

I. Recent Economic Developments and Outlook

3. The government's skillful management of the economy has strongly enhanced macroeconomic stability and contributed to favorable economic developments. While the external sector remains an important engine of growth, construction and services are also expanding at a healthy rate. After real GDP growth of 5.9 percent in the first half of 2005/06, recent trends in industrial production and the weakening impulse from gas production suggest a slightly slower, but still robust pace of 5.6 percent for the year as a whole and for 2006/07.

4. While tourism, Suez Canal traffic, workers remittances and gas exports continue to expand, non-oil export growth has tapered off following two years of very strong growth. With non-oil imports continuing to grow rapidly, the current account surplus is forecast to narrow to 2.2 percent of GDP in 2005/06 from 3.3 percent of GDP in 2004/05. The overall balance of payments has been buoyed by a surge in foreign investment (currently running at an annual rate of 6.5 percent of GDP), which has helped to fuel an increase in the country's foreign asset position over the past 15 months, both at the central bank (US$7 billion) and in the banking system (US$5 billion). Egypt's external debt is manageable at about 30 percent of GDP and external vulnerabilities remain low.

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[1] This represents the views of the mission team, not of the IMF, and these views may evolve as the staff assessment presented in the staff report on the Arab Republic of Egypt is produced.

Notwithstanding strong import growth, staff analysis indicates that the balance of payments outlook will remain comfortable over the medium term, with the current account balance declining steadily while non-debt-creating capital inflows continue apace.

5. Since the conclusion of the last Article IV consultation, the central bank has succeeded in lowering CPI inflation from over 17 percent to 4 percent. Since May 2005, the CBE has cut its deposit rate and lending rate by 250 and 350 basis points, respectively. Real interest rates have turned positive for the first time in several years. Excess liquidity in the money market has kept the overnight interbank rate near the floor deposit rate. Credit to the private sector remains weak, but has recently shown positive real growth, while net claims on the government have been constant since mid-2005. The main source of money creation has been NFA growth. Growth of broad money aggregates since mid-2005 at rates well above recent historical averages is attributed mostly to a shift in money demand related to increased confidence in the Egyptian pound. The interbank foreign exchange market continues to function smoothly with the LE/US$ exchange rate remaining very stable.

6. The authorities have made progress at strengthening the tax regime and producing a comprehensive set of consolidated general government accounts under a modern system of budget classification. The government borrowing needs, however, remain high at around 9 percent of GDP. For 2005/06, the fiscal outcome may improve somewhat from 2004/05 due to exceptional revenues related to payment of tax arrears from the state-owned oil company (EGPC) and from the sale of part of Egypt Telecom. On the other hand, there were transitional losses associated with the full year impact of the income tax reform, and lower current tax payments from the oil company due to the sharp increase in domestic fuel subsidies. Net government debt in June 2005 was LE 352 billion (65.6 percent of GDP) and is projected to rise to LE 402 billion by June 2006 (67.5 percent of GDP).

7. In the area of financial sector reform and privatization, the authorities have delivered impressive results that, in some respects, surpass their original objectives. Of particular note are the divestment of joint venture banks and the CBE-led drive to restructure nearly half of the stock of private sector non-performing loans (NPLs). Capital market regulation is well advanced in adopting best practices, and the stock market is enforcing higher standards of corporate governance. In addition, the authorities have made progress in reducing the bureaucratic obstacles to private investment and business licensing and registration.

II. Key Policy Issues

8. Reducing unemployment and raising per capita incomes are the overriding policy challenges in Egypt. To realize meaningful gains in these areas, the authorities agreed with the mission that the economy will need to grow by at least 6 7 percent, and investment will need to reach 24 25 percent of GDP at a minimum, well above recent levels of around 18 percent. Moreover, employment creation will have to come from private sector growth, which has been held back by distortions in energy prices, weaknesses in financial intermediation, bureaucratic/governance barriers to business development, and a high level of unproductive government spending. While the policy

choices are more difficult at this stage of reform, favorable economic conditions, both domestically and in the regional and international context, make the timing ripe for tackling tough decisions.

A. Fiscal Policy

9. The ministry of finance prepared a full set of consolidated general government accounts under the GFSM 2001 budget classification and has made progress towards reconciling public debt and financing data. This has increased the transparency and consistency of the fiscal accounts, and will serve as the starting point for fiscal policy formulation going forward. *The mission encourages the authorities to keep the momentum of reform going in order to complete unfinished business in the following areas*: (i) bringing the coverage of the fiscal accounts "above the line" and "below the line" into harmony and fully reconciling financing flows with debt stocks; (ii) moving, as much as feasible, to a full cash basis; (iii) implementing recommendations left by the mission and the outstanding recommendations of the October 2005 FAD mission; and (iv) reviewing the accounting treatment of the blocked accounts (deposits at the central bank earmarked for payments in respect of the Paris Club debt restructuring) and the associated revaluation adjustments.

10. The mission also took note of other fiscal reforms being pursued by the authorities, namely, efforts to continue strengthening the tax structure and revenue administration by enacting a new income tax law, and work to integrate domestic tax administration and move towards taxpayer segmentation, beginning with large taxpayers. These efforts have been rewarded with a revenue yield this year that is, so far, greater than anticipated owing to an increase in the number of tax filings, and to an increase in the average return.

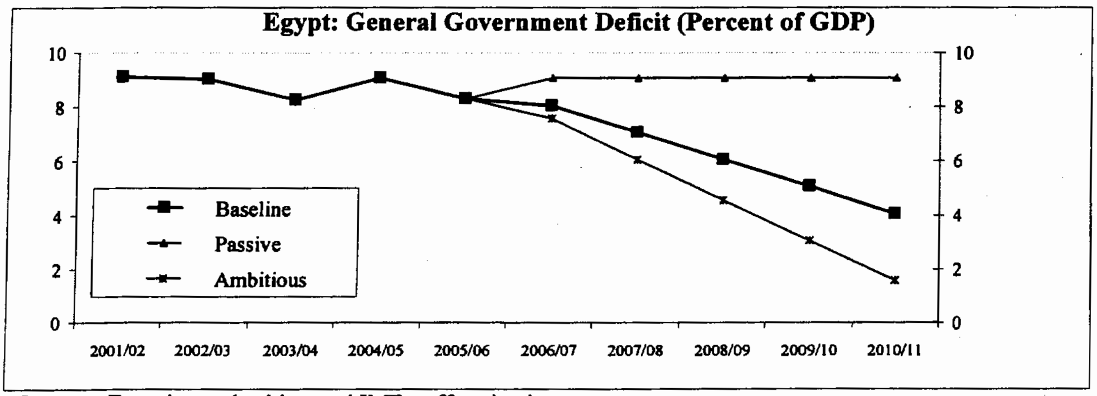
11. The mission welcomed the government's fiscal plans, which represent a very positive shift in fiscal policy. With the general government deficit at roughly 9 percent of GDP, and with net and gross public debt over 65 percent and 108 percent of GDP respectively, and rising, the authorities agreed with the mission that the fiscal deficit and government borrowing were excessive and unsustainable. The authorities outlined a multi-year fiscal consolidation package aimed at bringing the deficit down by 1 percent of GDP every year for five years. This would reduce the general government deficit to around 4 percent by 2010/11.

12. The government's consolidation plan includes measures—to be phased in starting in 2006 that will generate, in 2006/07 and beyond, gains from the expenditure, revenue, and administrative sides. These include: (i) reforming domestic fuel subsidies by targeting them more effectively on the poor and providing incentives to switch to natural gas; (ii) streamlining and improving the product targeting of food subsidies; (iii) instituting wage and employment measures designed to contain the wage bill; (iv) reforming the GST into a unified VAT with a broader base; (v) reforming the property tax and stamp taxes; (vi) introducing a Treasury Single Account (TSA); (vii) reorganizing the institutional layout whereby funds flowing between the budget, the NIB, and the SIF are rationalized; (viii) tightening operating flows with state enterprises to increase the control and transparency of expenditure; (ix) automating wage payments; (x) improving debt

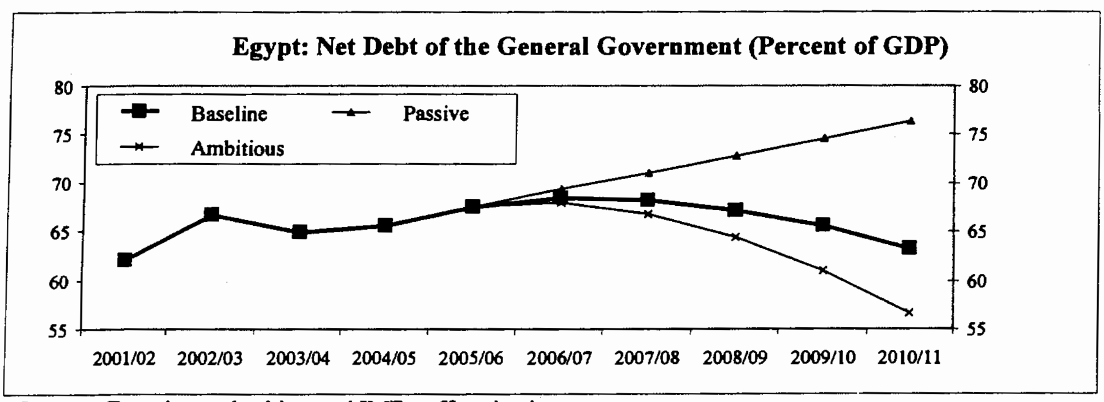
management; and (xi) launching public private partnerships (PPPs) for capital spending, particularly for schools and health clinics.

13. While the government expects these measures to reduce the deficit by about 1 percent of GDP per year over five years, *the mission cautioned about a number of additional challenges on the horizon:* (i) pension reform will have to be designed in a way that minimizes any transition costs; and (ii) the cost of banking sector restructuring may have implications for the fiscal position, depending on the costs relative to total privatization receipts. In addition, the 2005/06 inflows related to the payment of tax arrears by EGPC, and the sale of shares in Egypt Telecom, are not likely to be repeated in future. The one-off nature of these inflows imply the need for an underlying adjustment equivalent to 2 3 percent of GDP in 2006/07 to meet the 1 percent of GDP consolidation target.

14. Preliminary analysis by staff of the medium-term outlook suggests that the amount of fiscal adjustment under consideration ("*Baseline*" scenario) would place public debt on declining path, bringing net public debt to about 63 percent of GDP by 2011. Under this scenario, increased government savings and structural reforms would gradually boost investment, and growth would accelerate to 6.5 percent by 2010/11. *The mission believes that a more ambitious adjustment goal would be desirable, and encourages the government to consider an annual fiscal consolidation of 1.5 percent of GDP per year ("Ambitious" scenario), or more.*



Sources: Egyptian authorities; and IMF staff projections.



Sources: Egyptian authorities; and IMF staff projections.

15. In the mission's view, the consolidation program should involve a comprehensive approach designed to produce an efficient and equitable fiscal policy with well targeted, pro-poor spending. *In particular, the two priority areas in need of urgent reform are subsidies and the wage bill.* On the latter, the team is encouraged by plans to submit to parliament later in 2006 a more comprehensive, medium-term reform of the civil service aimed at improving the efficiency of government and streamlining the administration. *The authorities concurred with the mission that PPPs need to be designed very carefully, with close attention paid to the supporting legal and institutional framework underpinning contracts, in order to avoid the difficulties encountered by several countries that have implemented PPPs.*

16. The mission encourages the government to communicate to the public its multi-year fiscal consolidation strategy, outlining the benefits in terms growth, employment and poverty reduction, and the risks of not moving in that direction. This could help to build ownership and support for the reform program, and manage expectations. Credible policy commitments may also bring early benefits in capital markets.

B. Monetary and Exchange Rate Policy

17. The mission shares the CBE's view that the current stance of monetary policy can be seen as broadly neutral, *but cautions against further interest rate reductions until liquidity growth decelerates to more comfortable levels, particularly since the "portfolio shift" appears to have run its course.* The mission pointed to the higher rate of growth in broad money, particularly the domestic currency component (M2D), which expanded at annual rates of 20 percent (y/y) in the second half of 2005, well above the historical average. While M2D growth has started to decelerate, it remains above the CBE's indicative target zone. However, CBE officials do not expect inflationary consequences from this growth because of: (i) a portfolio shift during this period that translated into a structural increase in money demand; (ii) more confidence in their reading of underlying inflation; and (iii) the fact that central bank rate cuts have not been fully transmitted to bank lending rates. That being said, the mission recommends a slightly tighter indicative target for M2D growth of 10 12 percent in order to contain underlying inflation to 5 6 percent. The CBE will also have to monitor carefully the implications of the large government deficit, which has been financed mostly from external sources over the last eight months. The deficit could eventually need financing from the domestic banking system, which could put further pressure on monetary aggregates.

18. Despite the strong external position, the nominal LE/$ exchange rate has remained stable over the past 12 months. The interbank foreign exchange market is operating smoothly, although trading volumes remain modest compared to total foreign exchange flows. The CBE undertakes transactions outside the market on behalf of the government (e.g., converting Suez canal proceeds), and also acts to clear the market, if necessary, on a daily basis. While the CBE transacts at the prevailing market rate, these actions appear to influence the price setting behavior of market participants. The authorities are satisfied with this arrangement, and with the stability and level of the LE/$ exchange rate. They are concerned about the effect of a nominal appreciation on external competitiveness, pointing to stagnation in the growth of non-oil exports during the second half of 2005,

and the implications for the government's ambitious expansion plan for the tourism sector. Movements in other currencies (mostly the Euro) suggest that the nominal effective exchange rate has appreciated by about 15 percent. The mission concurs with the CBE that the trade balance is likely to decline as growth expands, which would eventually put downward pressure on the currency.

19. The CBE re-affirmed to staff that, while the IT framework is being developed, the CBE is following a transitional approach relying on indicative money growth targets as well as inflation. However, the present exchange rate policy seems to be sending a conflicting signal about the CBE's policy objective. The mission found a widespread perception among market participants that the central bank is targeting the exchange rate. Until recently, this approach may also have encouraged one way bets by foreign investors, as indicated by a significant increase in foreign holdings of treasuries between July 2005 and March 2006. Finally, stability in the exchange rate discourages the development of risk management methods and instruments. Given the regional and global risks on the horizon (avian flu, regional security-related uncertainties, global imbalances), the mission believes that Egypt would be better served if market participants developed the skills and instruments to cope with exchange rate uncertainty.

20. *In the mission's view, the CBE should reconsider how it engages in the market so as to permit the supply and demand of foreign exchange to play a greater role in determining the exchange rate,* while smoothing the effects of one-off capital flows related to, for example, privatization and the placement of sovereign bonds. A greater degree of exchange rate flexibility on the margins would introduce some uncertainty that could help discourage one way bets, slow down the accumulation of reserves, and help bring M2D growth rates down to the indicative target range. This could create room for further interest rate cuts, and would encourage the development of hedging instruments, which are important for deepening the foreign exchange market and its ability to absorb shocks. Maintaining a stable nominal exchange rate while accumulating NFA may require higher interest rates to effectively sterilize balance of payments surpluses, could encourage more "hot money" inflows, and may not be sustainable.

21. The CBE has been working over the past year to modernize monetary policy formulation and operations. Staff congratulates the authorities for implementing the corridor for the interbank overnight rate; enhancing communications with the publication of a monetary policy statement and releases following regular Monetary Policy Committee meetings; reorganizing the structure of the CBE; expanding research and forecasting capacities; and developing other prerequisites (including core inflation measures) to move, over time, to the stated goal of adopting a formal inflation-targeting (IT) framework. The mission supports the CBE's goal of moving to formal IT. While work is proceeding to improve price statistics and research, and to meet other prerequisites required for an IT framework, the monetary authorities should accelerate the institutional reforms necessary for IT, namely revisiting the composition of the MPC, preparing legislation prohibiting monetary financing of fiscal deficits, and further enhancing communication on monetary policy with the public.

22. The mission urges the authorities to intensify efforts to develop a secondary market in government bonds. An obstacle to development of the market has been a traditional buy-and-hold approach taken in the primary market. In addition, the tax-free treatment of interest on government securities appears to be undermining the development of capital markets in view of the effective yield advantage they provide.

C. Financial Sector Reform and Privatization

23. The mission commends the government's achievements in the area of financial sector reform. Of particular note are the divestment of joint venture banks, the impending sale of Bank of Alexandria (BoA), and the CBE-led arbitration approach to restructuring private sector NPLs, of which almost half have been restructured. The successful restructuring of the BoA highlights the useful influence that the goal of privatization can have on the process of bank modernization and restructuring. Work to strengthen the insurance sector, including through privatization, is moving ahead. In addition, supervision of the banking and insurance sectors, and the capital markets is being strengthened, with the authorities aiming to bring supervision practices and industry standards into compliance with international best practices.

24. The mission welcomes the plans to restructure and recapitalize the remaining large state banks on a parallel track over the next two–three years. Completion of the audits of these banks, and their independent analysis, is essential for further progress. However, at the end of the government's current reform program, close to half of the banking system will remain under state ownership, implying a drag on economic growth, and raising concerns about a level playing field between public and private sector banks.

25. During the first nine months of 2005/06, the government privatized 20 entities for a total of LE 14.3 billion (this includes land transactions worth LE 0.6 billion). The assets sold include a 20 percent stake in Egypt Telecom and the state's share in seven joint venture banks. While there is a vast list of potential assets to sell over the medium term, at present there are already 97 entities listed for sale by the government, comprising 42 companies (or stakes in companies) and 55 joint ventures. The results and near-term plans demonstrate the government's commitment to reducing the role of the state in the productive sectors of the economy. The mission fully supports the divestment program, and encourages the government to step up efforts to explain to the public the rationale for the privatization program, and the distribution and use of the proceeds.

D. Structural Reforms

26. While well below WTO bindings, the actual average tariff rate in Egypt is still high compared to other high growth emerging markets. The authorities indicated that they are contemplating further tariff reductions to build on the gains achieved in September 2004, when the government restructured and lowered tariff rates. The mission welcomes these intentions, and encourages the authorities to streamline the extensive system of exemptions and duty relief schemes that were not addressed by the 2004 reform.

27. While the government's comprehensive reform agenda should lead to higher employment creation, cross country comparisons indicate that Egypt's labor market regulations lack flexibility. The mission encourages the authorities to consider modernizing labor market legislation in order to complement the incentives for private

investment and private sector employment that are being implemented with the other reforms underway.

28. Business surveys in Egypt and abroad point to the heavy burden of bureaucracy and regulation as a major impediment to the promotion of private investment and small business expansion. The government has recently submitted draft legislation for specialized economic courts to parliament to improve the judicial framework underlying business contracts. This approach is based on previous positive experiences reforming institutions by developing improved processes on a parallel track. In addition, disputes between private sector operators and the government are increasingly being resolved by a dedicated ministerial committee. The staff encourages the authorities to continue the ongoing efforts to streamline regulatory and legal procedures.

III. Data and Other Issues

29. The government has addressed a significant shortcoming in data reporting with the preparation for the mission of a comprehensive set of general government accounts. Further efforts are needed to improve the legal and institutional framework for the production of economic statistics, and to increase inter-agency cooperation. More specifically, work is needed to improve statistics on prices, balance of payments, real indicators of economic activity, and the fiscal accounts. With regard to the CPI, concerns focus in particular on the quality of price coverage and sampling, and on the level of cooperation between CAPMAS and the CBE.

30. The mission is grateful to the authorities for their assistance and cooperation with the staff's review of Egypt's exchange regulations and practices under the obligations of Article VIII. The staff expects to complete the review at the time of the Executive Board meeting on the 2006 Article IV consultation with Egypt.

31. The mission welcomes the authorities' intention to publish the 2006 Article IV staff report.