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Minutes of Executive Board Meeting 84/103

10:00 a.m., July 6, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	T. Ramtoolah, Temporary
	G. Ercel, Temporary
B. de Maulde	X. Blandin
	M. Teijeiro
	M. K. Bush
	N. U. Haque, Temporary
	T. Yamashita
J. E. Ismael	
R. K. Joyce	
	J. R. N. Almeida, Temporary
G. Laske	
	N. Coumbis
R. N. Malhotra	
	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	
	R. L. Bernardo, Temporary
G. Salehkhou	
	E. I. M. Mtei
	M. Camara, Temporary
	S. E. Conrado, Temporary
	K. A. Hansen, Temporary
	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
K. S. Friedman, Assistant

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Also Present

R. Barakat, Economic Counsellor, Embassy of Egypt; A. Negm, Deputy Governor, Central Bank of Egypt. African Department: O. B. Makalou, Deputy Director; E. R. Borensztein, S. E. Cronquist, A. B. Diao, C. Enweze, A. Jbili, B. R. H. S. Rajcoomar, M. Sidibe. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; E. J. Zervoudakis. Fiscal Affairs Department: A. M. Abdel-Rahman, J. Diamond. Legal Department: A. O. Liuksila. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; A. K. El Selehdar, Deputy Director; M. Arif, S. H. Hitti, M. E. Massourakis, K. Nashashibi, C. Sassanpour, B. K. Short, E. M. Taha, M. Yaqub. Bureau of Statistics: K. Yao. Advisors to Executive Directors: S. M. Hassan, J.-C. Obame, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: J. Bulloch, M. B. Chatah, M. Eran, V. Govindarajan, D. Hammann, L. Ionescu, H. Kobayashi, M. Lundsager, J. K. Orleans-Lindsay, C. A. Salinas, S. Sornyanyontr, A. Yasseri.

1. CENTRAL AFRICAN REPUBLIC - 1984 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Central African Republic and a proposed decision concluding the 1984 Article XIV consultation, together with a request for a one-year stand-by arrangement in an amount equivalent to SDR 15 million (EBS/84/121, 5/31/84; and Cor. 1, 6/27/84). They also had before them a report on recent economic developments in the Central African Republic (SM/84/138, 6/21/84).

The staff representative from the African Department explained that all the agreed prior actions had been taken, and that negotiations on bilateral debt relief from a major creditor should be concluded soon.

Mr. Tshishimbi made the following statement:

> I wish to express appreciation to the staff for the good set of papers they have produced. My Central African Republic authorities agree broadly with the staff's analysis.
>
> The adjustment effort undertaken by the Government since September 1982 must be seen in the context of the medium-term recovery program adopted by the authorities with a view to promoting and diversifying production and exports and gradually eliminating internal and external disequilibria. In this connection, the authorities have sought and obtained Fund financial support for 1983 and are now requesting a stand-by arrangement for 1984.
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> In 1983, the authorities had hoped to achieve a significant reduction in the deficit of the current account of the balance of payments by curtailing domestic demand, mainly from the public sector. Their action, therefore, was directed at the Government's fiscal position and the financial performance of the parastatals. The authorities adopted measures designed to increase the rate of investment and they emphasized incentives conducive to the attainment of a lasting economic recovery.
>
> More specifically, in the fiscal area the authorities increased the rate of taxes on petroleum products and extended to all salaried nationals the special development tax, which was previously applied only to the civil service. They imposed a wage freeze during the year and undertook to streamline the public administration after a survey of government employment, carried out with technical assistance from the World Bank, had established that the civil service was overstaffed. To improve the overall public sector's financial performance, wages and salaries in the public enterprises were maintained at their 1982 level and their labor force reduced. Electricity tariffs and gasoline prices, as well as the charges applied by the Post

Office and Telecommunications Agency, were also increased. Furthermore, six state enterprises were liquidated. The authorities have concluded negotiations with the World Bank and other foreign creditors on the financing of the integrated rural development project in the cotton zone. They have also initiated the implementation of the Fourth Highway Project, an important infrastructure project for the modernization and maintenance of the road network. In July 1983, the Central African Republic's foreign creditors agreed to reschedule the country's foreign public debt, including arrears, within the framework of the Paris Club, thus contributing about CFAF 7 billion to the financing of the balance of payments deficit that year.

The anticipated results of these measures were unfortunately thwarted by a severe drought that affected the region in 1983, precipitating a decline in overall economic activity. Agricultural output decreased by about 7 percent, with coffee suffering the most. Manufacturing was also affected by the interruption of the electricity supply from the predominantly hydroelectric plants. The transportation system and commercial activity were disrupted. As a result of these developments, real GDP dropped by about 2 percent.

Reflecting the slowdown in economic activity, total budgetary revenue increased only marginally to CFAF 36.2 billion, against a total budgetary expenditure of CFAF 43.2 billion, entailing a deficit of CFAF 7 billion, or about 3 percent of GDP, against a target of 1 percent. As in previous years, the deficit was financed by foreign grants and by debt rescheduling. In addition, the Government borrowed about CFAF 1.6 billion from the banking system. The decline in economic activity was also reflected in the low demand for credit from the private sector, mainly for export crop financing. Overall domestic credit expansion thus remained well below the program target.

Although the external account target could not be attained, the current account deficit declined by 2 percentage points, reflecting an improvement in the terms of trade combined with a moderate increase in exports and a moderate decline in imports. Moreover, an increase in foreign capital inflows contributed to a significant reduction in the overall balance of payments deficit and to a buildup of the net official reserve position. Against this background, the pace of the 1983 adjustment program slowed and the program became inoperative. However, the authorities are determined to continue the stabilization effort during the rest of the recovery period, and to pursue this effort within the framework of a new development plan for the years 1986-90.

The focus of the economic and financial program for 1984, therefore, remains the budget. The main objective is the reduction of the budgetary deficit from 3 percent of GDP to 1.2 percent of GDP. To attain this objective, the Government will improve its revenue performance; it will, in particular, increase the yield from income taxes. In this regard, it is worth noting that the authorities have already implemented the first phase of a tax reform, which was prepared with technical assistance from the Fund. Moreover, the Treasury's share of the marketing surplus on coffee has been increased. In addition, the tax base will be broadened to include unregistered small business enterprises, and the tax administration will be strengthened.

A detailed schedule of payments of the tax proceeds collected by TOCAGES, the petroleum distribution company, including arrears, has been submitted to the Treasury. To achieve the fiscal objective, the Government will also continue its demand-restraining policy. As in 1983, neither a general salary increase nor an upgrading of the salary scale will be granted in 1984. The Government will even borrow the equivalent of one month's wage bill from its civil servants. Employment in the Government will be further restrained through new procedures based on competitive examinations and by limiting to only one third the vacancies to be filled in a given year. New recruitment in 1984, for all categories of government employment, will be subject to a ceiling of 300 units. In order to restrain expenditure on education, competitive examinations have also been introduced for the award of scholarships for secondary and higher education. To reinforce expenditure control, quarterly targets have been set on current expenditure, and the Government has agreed to consult the Fund staff should the overrun exceed 5 percent of the target. Furthermore, a permanent body has been created to monitor and control the public administration restructuring measures.

In the real sector, the authorities will intensify their efforts to stimulate output of agricultural export and food crops. The producer price of cotton has been raised by about 13 percent for the 1984/85 crop season, and efforts to improve the extension service, input supply, and marketing will be continued. With the return to normal weather conditions, domestic food production is expected to increase and thus help reduce the pressure on prices. The restoration of the normal supply of electricity from the hydroelectric plants should contribute to some increase in the output of the manufacturing sector. In a continued effort to improve the financial position of the parastatals, water tariffs have been increased by 30 percent, and electricity rates will also be adjusted upward during the year.

Monetary policy aims at raising credit expansion by 13 percent, in order to accommodate private sector demand for credit, mainly for export crop financing. In the external sector, the authorities aim at further reducing the current account deficit by 3 percentage points of GDP, mainly through an increase in the volume of exports and a reduction in imports.

It is the authorities' view that the past two years have been particularly difficult for their economy. They have shown their courage and resolve in implementing most of the principal policy measures under the 1983 program. They have been encouraged by the progress already made despite the unfavorable weather conditions. They are determined to pursue the adjustment effort in 1984, with a view to restoring domestic and external equilibria in the medium term. To support this effort, the authorities hope that they will benefit from financial assistance from the Fund as well as from donors.

Mr. de Maulde remarked that, following a period of economic mismanagement in the 1970s, the Central African Republic, small and landlocked, had undertaken the difficult task of engineering a recovery just as the world economic recession had begun. The authorities had maintained the adjustment effort in 1983, although the drought in the first half of the year had kept them from meeting the fiscal targets.

The authorities' commitment to adjustment was reflected in the long list of expenditure and revenue measures introduced, Mr. de Maulde continued. General wages had not been increased in 1983, government employment had been reduced by 340 persons, and a special tax on all salaried employees to raise revenues to support the national recovery had resulted in a 5 percent decrease in nominal incomes and a 15 percent drop in real incomes. Furthermore, effective January 1, 1984, recruitment procedures in the civil service had been dramatically changed with the introduction of a competitive entrance examination, and only one third of total vacancies were to have been filled. Introducing such measures at a time of high unemployment and low real wages had obviously been difficult, but if the sizable decline in budgetary receipts owing to the drought had not occurred, the program probably would have remained on track. In any event, the quantitative performance criteria had been observed.

Supply-side measures--including an increase in producer prices--had had substantial success in encouraging agricultural output, especially cotton production, Mr. de Maulde noted, but the producer price for coffee of CFAF 135 per kilogram was still well below the prices in neighboring countries, thereby encouraging unofficial cross-border trade. The price in Cameroon, for instance, was CFAF 397, and the international price was nearly ten times that in the Central African Republic. The staff had mentioned that the official price in the Central African Republic was merely a floor price, and that the actual price was much higher; further comment on the actual price would be helpful.

With the 1984 program, the authorities apparently had strengthened the adjustment effort, Mr. de Maulde commented. For instance, no general civil service wage increase was planned. Indeed, the disposable income of government employees was expected to fall by more than 8 percent in nominal terms as a result of the compulsory contribution to the Government of one month's pay. Moreover, government employment was to be further reduced, the system of competitive examinations was to be extended to scholarships for secondary and higher education, a number of tax measures were expected to raise revenue by some 14 percent, and a further adjustment in the real producer price of cotton should result in additional gains in production. Water and electricity rates also were to be increased, and the authorities intended to transfer three more public enterprises to the private sector.

The projected growth of money should accommodate public and private sector credit without fueling inflation, and he did not agree with the staff that interest rates on deposits would have to be raised, Mr. de Maulde remarked. Lending rates were already positive in real terms, and any further increase in them owing to a rise in deposit rates would probably be counterproductive. It was important to remember that the factors determining savings in a country like the Central African Republic were different from those in industrial countries; for instance, there were no banks outside the capital, Bangui.

Given the strength of the adjustment effort, the proposal to limit the amount of financing under the stand-by arrangement to 50 percent of quota was disappointing, Mr. de Maulde commented. That limit was unfortunately becoming the standard for African countries; over the previous three months, Ivory Coast, Togo, and Sudan had been given the same amounts in relation to quota, and Zambia's access would probably be so limited in the near future. He doubted whether that practice was consistent with the Interim Committee's conclusion in September 1983 that "the amount of access in individual cases should vary with the circumstances of the member."

It was important to bear in mind that the outstanding use of Fund credit by the Central African Republic was the equivalent of only 80 percent of quota, and that the overall balance of payments was expected to be in equilibrium by 1987, Mr. de Maulde remarked. In addition, the debt service ratio was conservatively estimated to peak at 20 percent in 1985 and to decline thereafter. Accordingly, access to Fund resources equivalent to, say, 75 percent of quota--the same level approved in 1983--would be appropriate. He fully supported the proposed program and had hoped that a larger amount of Fund resources would be made available to support it.

Mr. Laske observed that, after a period of mixed economic results, the authorities had undertaken a new effort to tackle the deep-rooted internal and external imbalances. Previous corrective measures under stand-by arrangements had been undermined by exogenous factors and insufficient implementation, and the drought had obviously placed a substantial strain on the budget in 1983.

The program for 1984 seemed to meet the need for comprehensive adjustment, as it included measures affecting prices, the budget, state enterprises, monetary policy, and the external sector, Mr. Laske continued. The series of increases in the prices for cotton and coffee--two of the most important export commodities--were particularly important. The staff had reported the price increases in nominal terms, and a further comment on the real increases and on the relationship between prices in the Central African Republic and its competitors would be helpful.

The fiscal measures to be introduced in 1984 were commendable, Mr. Laske considered. The previous program had been thrown off track mainly by overruns in current expenditure, and careful control of that category in coming years should be given priority.

The authorities intended to intensify their monitoring of the education system, Mr. Laske noted. In the Central African Republic, as in other developing countries, there appeared to be room to improve the system, particularly by ensuring that it met the economic needs of the country, and that its development was consistent with the resources available.

Early and determined action to tighten the public sector wage bill--which accounted for nearly two thirds of current expenditure--was clearly needed, Mr. Laske considered. Any such action should be designed to affect the overall wage level as well as recruiting principles and practices.

The projected increase in the share of capital expenditure in total expenditure was welcome, Mr. Laske remarked. The authorities' close cooperation with the World Bank provided some assurance about the feasibility and profitability of the Government's capital investments.

The measures introduced to increase revenue were also welcome, Mr. Laske said. They were obviously needed to achieve the objective of decreasing the budget deficit to the equivalent of 1.8 percent of GDP.

In the parastatal sector, Mr. Laske noted, the price adjustments and the plans to transfer some enterprises to the public sector were commendable. The valuable information in the staff reports could have been usefully enhanced by a brief assessment of the likely profitability and productivity of public enterprises after the price adjustments, and of the possible effects on the government budget.

The projected increases in credit expansion in 1984 were surprisingly large, Mr. Laske commented. Domestic credit was expected to grow by 13 percent, compared with only 2.7 percent in 1983, and private sector credit in particular was forecast to increase by 12 percent in 1984, compared with 1.6 percent in 1983. The staff had explained the reasons for the substantial credit expansion, but he was worried that it might not be compatible with the effort to restrain consumer prices, which had been rising at an annual rate of 10-15 percent during 1984.

He agreed with the staff that the substantially negative real deposit interest rates were not helping to mobilize domestic savings, Mr. Laske said. As Mr. de Maulde had noted, the conditions affecting savings in developing countries differed from those in developed countries, but a more active interest rate policy could have a beneficial effect on savings in the Central African Republic. The inadequate domestic banking system had apparently also played an important role in the country's poor savings performance.

The external position was expected to remain fragile even after the introduction of the comprehensive adjustment measures, Mr. Laske remarked; a sustainable payments position could not be achieved before 1988. Even though the Fund's holdings of the Central African Republic's currency were not sizable and the amount of the proposed stand-by arrangement was not exceptionally large, Fund involvement in the country could be justified only if the authorities were determined to make a serious adjustment effort over the medium term. The balance of payments projections through 1987 were based on the assumption that the country would benefit from substantial inflows of concessional capital, but they would be forthcoming only if the authorities demonstrated their determination both to press ahead with the required structural adjustments and to maintain prudent financial and fiscal policies. An appropriate fiscal policy would be essential because the country's membership in a regional currency union gave the authorities little or no room for maneuver in the conduct of exchange rate and interest rate policies; the major thrust of the adjustment would have to be in public sector finances. Finally, the proposed decisions were acceptable.

Mr. Mtei commented that the difficult economic situation in the Central African Republic had been aggravated by a severe drought. In 1983, real GDP had declined by more than 2 percent for the fourth consecutive year, while the budget deficit had increased and external payments problems had remained. However, the authorities, recognizing the need for adjustment, had introduced several major measures to contain the deterioration in the economic and financial situation. That the 1983 stand-by arrangement had become inoperative at a time when the authorities had needed to consolidate their adjustment efforts was certainly regrettable.

Some of the policy initiatives had clearly been successful, Mr. Mtei continued. For instance, the pace of public investment had picked up, cotton production had responded favorably to incentives, and the effort to restructure public sector enterprises had been effective. However, the authorities were naturally concerned about the income and employment implications of the adjustment measures, especially as the income level was low, the social security system was not well developed, and there was no reason to hope that the decline in public sector employment could be offset by an increase in private sector employment.

The authorities' continued strong commitment to continue their adjustment effort, the introduction of all the agreed prior actions, and the progress in rescheduling the external debt were encouraging, Mr. Mtei said. The flexible pricing policy and new budgetary measures in 1984 should help to reduce the domestic and external imbalances.

On the fiscal front, Mr. Mtei went on, the tax reform and the measures to contain government expenditure and restructure public corporations were steps in the right direction. One of the authorities' main objectives was to achieve budgetary equilibrium by 1986 and a surplus thereafter. Reducing the fiscal imbalance was important, but he wondered whether an equilibrium or surplus position would be feasible in a country where the Government had to play a leading role in promoting investment and in providing many basic services.

The authorities' intention to accommodate the expected strong private sector demand for credit within the 1984 program ceilings was welcome, Mr. Mtei said. They recognized the possible benefits of a more active interest rate policy, but their ability to introduce major changes in the interest rate structure was limited by the Central African Republic's membership in a regional monetary union.

The targeted reduction in the current account deficit over the medium term could be achieved only if primary product output and weather conditions improved, Mr. Mtei observed. Given the large external debt and the increasing cost of servicing it, the authorities should be encouraged to maintain a cautious external borrowing policy; new nonconcessional loans should be avoided.

He fully agreed with Mr. de Maulde that the proposed access was small in relation to the country's outstanding use of Fund resources, Mr. Mtei concluded. The proposed decisions were acceptable.

Ms. Bush stated that she broadly agreed with the staff appraisal, and supported the proposed decisions. Economic developments in the Central African Republic in 1983 had not been encouraging, owing largely to the drought. The current account and overall fiscal deficits had remained large; while the debt rescheduling in 1983 had relieved much of the pressure on the external payments position, the current account deficit was still unsustainable.

The authorities' commitment to maintaining and strengthening their economic adjustment effort suggested that the 1984 program would be more successful than the previous program, Ms. Bush went on. However, even the relatively optimistic medium-term balance of payments projections in the staff report should indicate to the authorities that there was no room to deviate from the program if they were to restore internal and external equilibrium.

The authorities would have to pay close attention to developments in several areas, Ms. Bush considered. The need for adequate producer incentives--especially flexible pricing--was particularly great, and the recent increase in producer prices and the intention to make further adjustments under the new program were encouraging. She wondered whether those steps would enable farms to operate profitably.

She was pleased that six unprofitable state enterprises had been liquidated in 1983, and that three more were to be transferred to the private sector in 1984, Ms. Bush commented. The authorities' intention under the new five-year plan to encourage small businesses and private sector investment and to limit government intervention to joint ventures with private sector partners was certainly welcome; a comment on the methods they intended to use would be helpful.

The staff had reported that new investments were planned in the textile, cement, and sugar industries, Ms. Bush remarked. She hoped that the industries were in the private sector, in keeping with the authorities' commitment to encourage the economically viable sectors of the economy while avoiding placing a further burden on public finances.

The drain on fiscal resources by state enterprises and the controlled prices were also causes for concern, Ms. Bush said. Inefficient state enterprises, large current expenditures, and slow growth in revenues had already combined to increase the budget deficit to the equivalent of 3 percent of GDP in 1983, compared with the program target of 1 percent, thereby throwing the Fund-supported program off track. She was disappointed that the target for the deficit in 1984--1.2 percent of GDP--while low, exceeded the 1983 target.

Progress had been made in some areas of fiscal adjustment, for instance, the commendable decision to base civil service recruitment on competitive examinations, Ms. Bush commented. However, the progress had generally been slow, and the quarterly ceilings on current expenditures were appropriate. Ideally preparations for the 1985 budget should begin soon, so that preliminary analysis and the establishment of a ceiling on current expenditures for March 1985 could be part of the first review of the 1984 program, rather than of the second review, which would not take place until four months into the new fiscal year.

Monetary policy adjustment was difficult because of the country's membership in the Central African Monetary Union, Ms. Bush remarked, but restraining government borrowing would clearly permit a more adequate expansion of credit to the private sector. The negative real interest rates on deposits were a structural weakness that needed to be addressed. Although the financial sector was not large, positive real rates of return on savings should help to increase the low rate of savings and widen the role of the financial sector in the economy. She wondered whether the interest rates on small deposits could be increased without the concurrence of the other members of the Central African Monetary Union.

She was pleased that the country had no short-term external debt, no restrictions on foreign payments, and a liberal trading system, Ms. Bush said. However, the medium-term balance of payments projections were based on relatively optimistic export assumptions, and financing gaps were nevertheless expected in 1985 and 1986. It would have been preferable to base the projections on conservative assumptions, thereby providing greater certainty that the program would not be thrown off track if developments were less favorable than anticipated.

The authorities' wish to seek debt relief in 1984 on a bilateral basis was appropriate, Ms. Bush considered. However, the Government had failed to make the first installment to the U.S. Government under the relevant 1983 Paris Club agreement. The payment had been due in January 1984, and she hoped that no arrears would remain by the time of the scheduled review under the stand-by arrangement.

Mr. Clark considered that the authorities faced a difficult task in reducing the internal and external imbalances in the economy, and that the proposed stand-by arrangement was well designed to assist them. The recommended access of 50 percent of quota seemed appropriate in the light of the country's balance of payments need, medium-term prospects, and record of previous use of Fund resources. Some of the proposed measures, particularly the fiscal ones, would require great determination by the authorities if they were to be fully implemented. The provision for two reviews and for a slight back-loading of drawings was therefore welcome.

The authorities would have to adhere strictly to the planned expenditure during 1984 to achieve the main targets of halving the overall budget deficit on a commitment basis and of substantially reducing domestic and external arrears, Mr. Clark continued. The fiscal outturn would depend greatly on the evolution of employment and education policies. Experience showed the difficulty in implementing reforms in those areas, and the authorities should be strongly encouraged to introduce the necessary fiscal measures in a timely fashion and to persevere in their implementation. In that connection, the recent creation of a permanent body for streamlining the civil service and the provision of World Bank technical assistance were welcome. He hoped that the inclusion in the program of quarterly limits on current expenditure commitments, and the provision for consultation with the staff if a target was exceeded by more than 5 percent, would work as intended to keep commitments within the budgeted limits.

On the revenue side, Mr. Clark went on, the introduction of the first phase of the tax reform was welcome, but a review of the present system of tax deductions could help to boost revenues. About one fourth of the projected budget deficit for 1984 was to be financed by borrowing from government employees, a novel approach that seemed to pose some risks, although a similar measure--a special levy on public sector salaries--had been used two years previously. He wondered whether all public sector employees would be required to participate in the loan, and what steps would be taken if there was a shortfall in the planned collection.

The authorities should be urged to consider the benefits of a more active interest rate policy in mobilizing domestic resources, Mr. Clark said. A major change in the country's interest rate structure would require a decision by the regional monetary union, but the authorities could introduce some flexibility through the mechanism of margins applied by the commercial banks to the common discount rate. Deposits in absolute terms were small, owing partly to the inadequate banking infrastructure, and partly to the substantially negative real deposit rates. However, he noted that deposits could be made at post offices located throughout the country.

He strongly supported the Government's aim of maintaining appropriate producer prices, Mr. Clark commented. The value of that approach had clearly been demonstrated in the recent expansion of cotton production. Finally, the proposed decisions were satisfactory.

Mr. El-Khouri said that he generally agreed with the staff appraisal. The proposed decisions should be approved. The authorities had made commendable efforts during the previous several years to tackle the deep-rooted imbalances in the economy, but the difficulty in making needed adjustments had been increased by factors beyond their control. As a result, economic activity had continued to decline, the rate of inflation had remained high, and the balance of payments had been under growing pressure.

The authorities' adjustment program was strong and comprehensive, and the emphasis on the resumption of economic growth was fully appropriate in the light of the decline in economic activity over the previous several years, Mr. El-Khouri commented. The increase in the ratio of public investment to GDP and in producer prices for agricultural products, as well as the reform of the public enterprises, should help to increase production and improve the prospects for economic growth, although the growth target could not be achieved unless weather conditions were favorable.

Fiscal policy was appropriately designed to achieve significant reductions in the budget deficit on a commitment basis and in budgetary arrears, Mr. El-Khouri noted. The authorities' efforts to improve the revenue performance, by introducing new tax measures and by reducing tax arrears, and to constrain current spending in 1984 were welcome. The new policies regarding recruitment and scholarships represented a major departure from previous policies. Given the difficulties in controlling current expenditure in the past, the provisions under the new program to ensure that such expenditures would not exceed the target levels were welcome.

The 1984 program targets for growth, inflation, and the balance of payments were appropriate, and the proposed quantitative performance criteria were acceptable, Mr. El-Khouri said. The ceilings on net claims on the Treasury were to be reduced by amounts corresponding to the resources accruing to the Treasury from the exchange rate guarantee scheme. That requirement was appropriate; matching those resources by additional spending would be inflationary.

The staff representative from the African Department remarked that actual producer prices for coffee differed from the official price. The actual prices, which were negotiated between buyers and producers in various areas of the country, were presumably significantly above the official price.

The staff did not have information on real producer prices, because of the absence of good price statistics, the staff representative explained. The authorities had requested technical assistance in formulating a reliable price index. The lack of adequate information was reflected in the relatively brief discussion on inflation in the staff report.

The staff did not have sufficient data to analyze the financial position of all the parastatal enterprises, the staff representative remarked, but the successive increases in the producer price of cotton, together with the decline in production costs, had clearly caused a turnaround in the financial position of SOCADA (Société Centrafricaine de Développement Agricole) in 1982/83.

It was true that the rate of credit expansion forecast in 1984 seemed high compared with 1983, but the drought and subsequent decline in the level of economic activity in 1983 had resulted in a low rate of increase in credit to the private sector in that year, the staff representative said. With the return of normal weather conditions, and the expected increase in agricultural production in 1984, a significant rise in credit to the private sector was likely; in the past, most private sector credit had been in support of crop financing. The credit expansion provided for in the 1984 program seemed adequate.

Public sector employees' contributions to the government budget in 1984 would be compulsory, the staff representative explained. In fact, the authorities planned to pay civil servants 11 rather than 12 months' salary over the coming year.

The question had been raised, the staff representative recalled, whether the preparation for the new budget could not begin earlier than usual. The difficulty in so doing was that all the necessary data were not available until the end of the budget year. However, the staff would discuss the matter with the authorities during the review under the stand-by arrangement. The staff would also ask the authorities to settle the arrears to the United States. The new program provided for the settlement of all arrears outstanding at end-1983 and for the avoidance of arrears in 1984.

The authorities intended to sell some public sector enterprises to the private sector, the staff representative remarked. If buyers could not be found, the authorities would seek private sector participation in the enterprises; if there was no private sector interest, the enterprises would be closed. The authorities had stated their intention not to enlarge the public enterprise sector.

Given the limitations on the banking infrastructure and the low level of income in the country, the authorities believed that an increase in interest rates would not help to mobilize financial savings, the staff representative said. In any event, it was difficult for them to act unilaterally because of the country's membership in the regional monetary union; controls were the preferred policy instrument in the credit area, although they had not been fully effective, mainly because of the substantial increase in nondiscountable credit. The central bank was aware of the problem and was reviewing the credit control measures. The authorities were giving some thought to creating a money market that would enable them to introduce a more active interest rate policy.

A Deputy Director of the Exchange and Trade Relations Department commented that a number of interrelated factors had to be taken into account in considering access for a member country under an arrangement. The balance of payments need was a crucial element, but an assessment of that need had to take into account the strength of the adjustment effort which, to a degree, depended on the period over which adjustment was expected to take place. The Fund's holdings of a country's currency and the significance of the debt service to the Fund in the country's total debt service were also taken into account. The staff included in each report a brief explanation of the factors that had been considered in the proposed amount of an arrangement; the relevant information for the Central African Republic was on pages 29 and 30 of EBS/84/121.

Assessing a country's balance of payments need was not easy, the Deputy Director said, but the relationship between the proposed purchases under a Fund-supported program and the country's overall balance of payments deficit was of considerable relevance. As Table IV in Appendix II to EBS/84/121 showed, the Central African Republic's purchases from the Fund in 1984 and 1985 were slightly larger than the projected overall balance of payments deficits.

It was true that the Fund's holdings of the country's currency were not large, the Deputy Director of the Exchange and Trade Relations Department remarked. However, the adjustment effort in the Central African Republic was likely to be lengthy, and the authorities might well have to make further use of Fund resources. Moreover, the country's debt service to the Fund was projected to rise from about 10 percent of total debt service in 1983 to 34 percent in 1985.

Mr. Tshishimbi said that he was confident that the authorities were determined to implement the new adjustment program. As previous speakers had stressed, there was no room for slippage, and he strongly hoped that, with the return of normal weather conditions, exogenous factors would not adversely affect the authorities' policy efforts.

It had been suggested by Ms. Bush that the target for reducing the budget deficit in 1984 might not be low enough, particularly in comparison with the 1983 target, Mr. Tshishimbi recalled. However, the budgetary performance in 1983 had been influenced by a number of exogenous factors, and the budget deficit had risen to 3 percent of GDP. A substantial effort would be needed to reduce it to 1.2 percent of GDP in 1984.

The authorities probably would not have great difficulty in implementing the planned borrowing from civil servants, Mr. Tshishimbi remarked. The collections under the development tax in 1983 had been substantial; the authorities had retained the tax payments out of civil servants' salaries.

Small and medium-sized enterprises would have an important role to play in the future development of the country, and the authorities clearly wished to encourage them, Mr. Tshishimbi said. They hoped to establish new institutions, for instance, agencies that could guarantee bank credit extended to smaller enterprises. Assistance from the International Finance Corporation might be sought as well.

The authorities had made all the necessary preparations to eliminate arrears, Mr. Tshishimbi remarked, and he was confident that the overdue payments to the United States could be made in the near future.

Mr. de Maulde said that he was pleased that the staff carefully tailored the amount of access to individual cases on the basis of an assessment of a number of interrelated factors. He hoped that, in future, access for particular countries would in fact vary according to circumstances; in the past, the access for individual countries in some groups had been virtually uniform.

The Chairman made the following summing up:

> There was general agreement with the views expressed by the staff. Most Directors prefaced their comments with the observation that, for a number of years, the Central African Republic has experienced a significant decline in economic activity and in per capita incomes, as well as sizable budgetary and external current account deficits and a substantial accumulation of domestic and external arrears. They were impressed, however, with the commitment of the authorities to correct and adopt new policies to restore the basis for domestic growth and external balance.
>
> With respect to the 1983 effort, Directors noted that a number of corrective measures have been implemented as part of the financial program, supported by a one-year stand-by arrangement. However, they stressed that, given the shortfall in government revenue, due mainly to the drought, additional corrective measures would have helped contain the deterioration in the fiscal position. Directors welcomed the Government's resolve to pursue adjustment policies within the context of the three-year (1983-85) recovery program. In this respect, the measures taken regarding recruitment in the civil service and scholarships were considered important steps toward curtailing current spending

and achieving fiscal balance. Directors also noted that the efforts that were begun to rehabilitate public and mixed enterprises through flexible employment and pricing policies, coupled with better management, were in the right direction. Directors observed that the upward adjustment of producer prices, particularly for cotton, has begun to have an encouraging impact on output and exports. This experience with cotton demonstrated the benefits of a more efficient and market-oriented policy. Directors stressed the need for such pricing policies in other productive sectors as well; for example, specific reference was made to pricing policies for coffee.

Directors noted with satisfaction that the economic and financial program for 1984 seeks to reduce the external imbalance through policy measures aimed at expanding supply and restraining domestic demand, especially public consumption. Regarding fiscal policy, Directors underscored the need to achieve fiscal balance by 1986/87, and a surplus thereafter. To that end, they urged the authorities to implement with determination the new policies regarding government employment and scholarships. Directors welcomed the introduction of the first phase of the tax reform, as well as the intention of the authorities to take additional measures to strengthen the tax base and to mobilize domestic resources. In particular, for example, Directors agreed with the staff view on the need to reduce tax deductions as a way of increasing tax revenues.

With respect to supply-oriented measures, Directors welcomed some of the policy steps that were taken, including the real price increases in cotton called for in 1984, and the planned conversion of several public enterprises to private enterprises in 1984. Directors, however, believed that more needed to be done in this area, and they encouraged the authorities to continue their efforts to permit more efficient prices and to improve the operations of the public enterprises, as well as to continue in their efforts to reduce the relative size or number of public enterprises. Directors also welcomed the increase in capital expenditures and, in this connection, the close cooperation with the World Bank.

Regarding credit policies, questions were raised about the large increase in domestic growth planned for 1984, and it was noted that in this connection closer attention will need to be paid to inflation during the year. Directors also emphasized the importance of positive real interest rates in order to induce a higher rate of domestic savings, as well as the need to broaden and deepen the structure of the financial system.

On the external side, Directors emphasized the importance of clearing up arrears.

It is expected that the next Article IV consultation with the Central African Republic will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with the Central African Republic, in light of the 1984 Article IV consultation with the Central African Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that the Central African Republic continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7748-(84/103), adopted
July 6, 1984

Stand-By Arrangement

1. The Government of the Central African Republic has requested a stand-by arrangement for a period of one year from July 6, 1984 in an amount equivalent to SDR 15 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/121, Supplement 2.

3. The Fund waives the limitation in Article V, Section 3(b)(iii), of the Articles of Agreement.

Decision No. 7749-(84/103), adopted
July 6, 1984

2. ARAB REPUBLIC OF EGYPT - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with the Arab Republic of Egypt, together with a proposed decision concluding the 1984 Article XIV consultation (SM/84/119, 5/24/84). They also had before them a report on recent economic developments in the Arab Republic of Egypt (SM/84/136, 6/19/84).

Mr. A. Negm, Deputy Governor, Central Bank of Egypt, and Mr. R. Barakat, Economic Counsellor, Embassy of Egypt, were present.

Mr. Negm made the following statement:

Over the previous decade, Egypt has experienced remarkable economic growth. Credit for this achievement must be given to a number of measures. One of these, the refinement of the Open Door Policy, increased investment. In addition, the increased flexibility in exchange rate policy encouraged a noticeable inflow of workers' remittances. The Five-Year Development Plan clearly redefined the orientation of policies to give priority to industry and agriculture. As a result, the growth of real output was nearly 9 percent a year, while external pressures were minimized and the increase in prices remained moderate. These wide-ranging economic changes took place in a climate of social and political stability, while steps were taken to safeguard the standard of living of low-income families.

More recently, Egypt passed through the international recession without experiencing the shocks felt by so many other developing countries. Despite the adverse effects of falling oil prices, the current account deficit of the balance of payments has been steadily reduced since 1981/82 through a tightening of budget and credit policies, and by rationalizing public sector inputs and stimulating workers' remittances. The Government introduced measures in April 1983 to promote non-oil exports; for instance, it abolished exchange requirements for virtually all commodities that were previously covered at the commercial bank rate.

The benefit of these exchange rate actions, as well as steps to improve marketing and the quality of exports, is already beginning to be felt. Non-oil exports rose by an estimated 20 percent in 1983/84, despite some unfavorable price developments. A further large growth of non-oil exports should occur in the coming several years. In addition, new oil discoveries, enhanced recovery techniques, and stepped-up production of natural gas have improved the prospects for energy production in the period ahead. Moreover, during the first two years of the Five-Year Plan, investment reached a very high level. The shift of resources to industry and agriculture is well under way, as evidenced by the accelerated growth in those two sectors. At the same time, the overall real growth rate has remained high--7 percent.

Early this year, measures were also taken to make the exchange rate used by commercial banks more realistic, to capture more resources from workers' remittances and tourism, and to take steps toward unifying the commercial bank pool and "own" exchange market rates. One of the steps was to finance certain private sector inputs through the commercial banks. As expected, the exchange rate in the own exchange market has remained stable, and the gap between the rates in the commercial bank pool and own exchange markets has narrowed sharply. The Government intends to continue these realistic exchange rate policies.

The growth rate of money and quasi-money has been cut from 44 percent in 1981/82 to 27 percent in 1983 and 22 percent in the 12 months ended March 1984. Important factors in this deceleration have been the reduced recourse to bank financing by the Government, and ceilings imposed by the Central Bank to slow the growth of credit to the private sector. At present, cautious credit policies are being followed, and the deceleration in the growth of the money supply is expected to moderate the rate of inflation. The Banking Law was amended this year to reinforce the Central Bank's control over the banking system.

The recent slump in oil prices and other developments are evidence of the remaining difficulties facing the economy. The Development Plan, which was issued almost two years ago, clearly recognizes the need for relative price adjustments, greater domestic savings, a redirection of investment from the services sector to the commodity-producing sectors, and more exports. The Government remains fully committed to achieving the objectives of the Development Plan.

Under the 1982/83 budget, the fiscal deficit was 18 percent of GDP, compared with 20 percent in 1981/82, and domestic bank financing fell to 12 percent of the money stock, from 28 percent in 1981/82. The 1983/84 budget contains discretionary measures amounting to 4 percent of GDP. Unfortunately, the implementation of some of these measures has had to be delayed. Nevertheless, government borrowing from the banking system in 1983/84 is expected to fall to 10 percent of the money supply.

The Egyptian authorities are aware of the need to tackle the pervasive cost-price distortions and the structural weaknesses in public finance. The recent substantial increase in electricity rates, the largest rise in several years, is an indication of the Government's commitment to bringing domestic energy prices closer to prevailing international prices. Agricultural prices have also been adjusted and remain under review, with the aim of giving producers a fair return. In addition, various ministries and agencies have made a considerable effort to formulate a set of corrective policies to achieve the structural adjustments envisaged in the Development Plan. The intention under the 1984/85 budget, which is being formulated, is to reduce subsidies, slow the growth of government employment, and introduce selective price increases and other measures to raise revenues.

In his recent address opening the People's Assembly, President Mubarak emphasized the importance of economic reform. The new Cabinet, which will take office shortly, will have a stronger mandate to address the difficulties facing the economy. While recognizing the need for firm action, the authorities also intend to implement the necessary measures in a firm and gradual manner that will retain public support for economic policy reform.

Mr. Coumbis noted that in the past two years the Egyptian authorities had made considerable efforts to stimulate activity in agriculture and industry, reduce the rate of inflation, and achieve an overall balance of payments surplus. However, there had been no improvement in public finances; the budget deficit as a percentage of GNP was estimated to increase from 18 percent in 1982/83 to 20 percent in 1983/84.

The need for structural changes was recognized by the authorities, Mr. Coumbis continued, and the targets in the Five-Year Plan (1982/83-1986/87) included an increase in the domestic savings ratio from an average of 16 percent to 19 percent, a reorientation of economic activity toward industry and agriculture, an increase in the ratio of investment to GDP from 24 percent in 1981/82 to 27 percent in 1986/87, and a reduction in the share of net imports from 13 percent of GDP to 4 percent during the same period. However, the Plan did not spell out the policies that needed to be included in the annual government budget to direct the economy toward the fulfillment of the concrete plan targets.

He agreed with the staff appraisal and accepted the proposed decision, Mr. Coumbis said. However, he emphasized the importance of a properly formulated and strictly applied five-year plan in solving the structural problems of the economy. The distortions in the cost-price mechanism in industry, agriculture, interest rates, and exchange rates, and the inelasticities in both government expenditure and government finance were the results of widespread government intervention over two decades and were deeply embedded in the Egyptian economy. It was true that the rapid growth of exchange receipts from oil imports, emigrant remittances, Suez Canal charges, and external assistance had obscured structural weaknesses and had made possible the rapid growth of the economy during the 1970s. However, those external sources of foreign exchange were volatile and could easily be exhausted. They had already slowed in the early 1980s, causing the authorities to take measures to decrease the rate of growth of the economy at a time when the rate of inflation had accelerated almost 20 percent.

To sustain high rates of growth and reduce inflationary pressures, and as the prospects for some of Egypt's major sources of foreign exchange were not favorable, the authorities must make fundamental policy adjustments aimed at correcting the underlying structural problems in the framework of a comprehensive five-year plan.

He agreed with the staff that the adjustment effort should be vigorous enough so that progress in reorienting production and in strengthening the fiscal and external accounts could be made each year, Mr. Coumbis went on. Otherwise, the distortions would grow yearly, and more painful measures would be necessary later. As had been pointed out in the staff report, the period ahead offered the authorities the best opportunity to try to adjust the economy. The world economy was recovering, world inflation was expected to remain low, and the Egyptian economy did not face immediate balance of payments problems.

Ms. Bush remarked that the recent improvements in several areas of the Egyptian economy--particularly the high rate of economic growth and the decline in the current account deficit--were encouraging. The authorities had room to implement the most important policy changes--price adjustments--which should have significant effects on production and consumption. They should be strongly urged to use the present advantageous economic situation to implement some of the needed policy changes rather than wait until structural adjustment could no longer be postponed and would therefore be particularly painful.

The efforts during the previous ten years to make the economy even more open and market-oriented were welcome, Ms. Bush went on. The recently introduced policies to encourage foreign and domestic private investment in the productive sector of the economy were encouraging, but there was still substantial resource misallocation owing to the postponement of adequate pricing adjustments: consumption had been encouraged, while incentives for savings had been reduced; agricultural output had grown by less than 2 percent a year since 1973; farm incomes had been depressed, encouraging migration to the cities; and food imports had increased, draining foreign exchange holdings needed for other imports. The burden of subsidies on the budget had caused large fiscal deficits that had intensified inflation and increased the recourse to foreign borrowing, much of which had been on commercial terms and involved a heavy debt servicing burden.

She was particularly concerned about the estimated LE 700 million budget deficit increase in the previous fiscal year, Ms. Bush commented, and she agreed with the staff that the authorities should give priority to reducing the deficit immediately, especially through cuts in subsidies. Such action was admittedly politically sensitive, but careful preparation of the public could help to defuse the issue. Slowing the growth in expenditures on subsidies by reducing the number of subsidized goods and limiting access to them to low-income groups seemed an appropriate way of tackling the problem. The staff had correctly concluded that wages should be restrained, and that the practice of guaranteeing public sector employment to university graduates and discharged army personnel should be reconsidered. The staff had suggested that some of the measures it had recommended could be included in the 1984/85 budget, and she wondered whether any progress had been made.

Energy price increases could temporarily add to the cost of living of some elements of the population, Ms. Bush commented, but the medium-term benefits in the form of a reduction in cost-price distortions and an increase in government revenues would be of greater significance. The authorities should be urged to accept the staff recommendation for gradually increasing energy prices. They had already raised electricity rates by

30 percent since December 1983. Realistic energy prices should have positive effects on oil exports and the balance of payments as well as on the budget.

Budgetary restraint would ease the pressure on the monetary sector, where credit expansion had decelerated somewhat but was still rapid, Ms. Bush commented. Interest rates on loans and deposits should be raised to positive real levels to encourage the lending to agriculture and manufacturing that had been inhibited by the low interest rates banks were permitted to charge. Higher interest rates on deposits also would encourage saving and reduce consumption. For those reasons, the authorities should be urged to review their interest rate policy.

The need for long-term structural adjustment and the weak control of aggregate demand were reflected in the external accounts, Ms. Bush noted. The current account and overall balance of payments had recently improved, mainly because of increased remittances from abroad, substantial oil export revenues, sizable Suez Canal receipts, and foreign aid inflows. More could be done to achieve a structure of exports and imports that would enable Egypt to maintain a sustainable external position. The medium-term balance of payments projections in the staff report were based in part on a slight increase in workers' remittances. The outlook for the countries hosting Egyptian workers could not be predicted with great confidence, but she was worried that remittances could decline, thereby resulting in an even larger current account deficit than the staff had projected.

Adjustments in the official exchange rate would help to achieve a sustainable improvement in the external current account, Ms. Bush remarked. The increased flexibility in the exchange rate applied to the expanded commercial bank pool was encouraging, and the authorities should be urged to maintain that flexibility in order to reduce the gap between that exchange rate and the free market rate. Unifying the segmented foreign exchange market would be the most effective means of encouraging export growth and diversification, and appropriate credit and interest rate policies would help to sustain the positive balance on the capital account.

Egypt's external debt should be carefully monitored, given the projected increase in debt service, Ms. Bush said. She agreed with the staff that immediate steps should be taken to compile comprehensive debt statistics and to formulate precise guidelines on contracting external debt.

With the recovery in the world economy, the expected continued low rate of world inflation, the absence of immediate balance of payments difficulties in Egypt, and the positive postelection atmosphere in the country, the Government had a unique opportunity to address the crucial need for economic reform, Ms. Bush concluded. The authorities should be urged to act forthwith. Finally, the proposed decision was acceptable.

Mr. Salehkhou noted that page 17 of SM/84/119 and page 69 of SM/84/136 referred to Egypt's overdue loan repayments to the Islamic Republic of Iran. During the previous year he had tried to approach the Egyptian authorities, through the good offices of the Middle Eastern Department, to convince them to discharge those long overdue obligations in a nondiscriminatory fashion. He was pleased to learn from the staff reports of the authorities' willingness to conduct negotiations through the good offices of the Fund. That move precisely coincided with the view of his chair on the best way to handle the overdue obligations, and he looked forward to resolving the issue through such a tripartite meeting.

Mr. Malhotra noted that, through most of the 1970s and the early 1980s, Egypt had made remarkable progress, recording high rates of economic growth with moderate rates of inflation, because of the authorities' good use of the opportunities provided by developments in the oil market and favorable resource flows. There had, however, been certain weaknesses in the pattern of growth, for instance, the increasing role of the services sector at the cost of the commodity-producing sector, although during the previous two years the growth rates of agriculture, mining, and industry had exceeded the growth of the services sector. Moreover, the World Bank had concluded that the Development Plan should help bolster the commodity-producing sector, an outcome that would be most welcome.

The authorities had introduced a variety of fiscal, monetary, and exchange rate measures in 1982, 1983, and 1984 to reduce the fiscal deficit and the inflationary pressures generally, Mr. Malhotra observed. The staff had indicated that the 1983/84 budget was aimed at reinforcing the policy stance of 1982/83, but data for the first half of 1983/84 showed that the budget deficit was expected to be 19.7 percent of GDP, compared with the budget estimate of 16 percent. Moreover, the financing of the fiscal deficit by the banking system as a proportion of GDP was estimated at 7 percent in 1983/84, about the same as in 1982/83. The overall budget deficit was still large, and, while Egypt admittedly had a sizable public sector, the reliance on the banking system to finance the deficit appeared excessive.

The large outflows on account of interest and subsidies were a cause for concern, Mr. Malhotra continued. The decline in outlays on subsidies in previous years had been due mainly to international price developments rather than to policy measures introduced by the authorities. Two important measures were needed to improve the budgetary situation: the dependence on bank borrowing to finance the budget should be reduced, thereby keeping the interest burden on the budget from growing unduly and becoming a serious structural problem; and the large burden of subsidies should be reduced. Subsidies were obviously a sensitive issue, and it was true that, through most of the 1970s, the Government had been able to control inflation by subsidizing foodgrains and other commodities. However, in recent years the rate of inflation had accelerated considerably, from about 10 percent to some 20 percent. Maintaining the standard of living of low-income groups was of course a legitimate objective and had been handled with great skill over the years, but the continuation of large subsidies over several years had resulted in progressively larger budget deficits and in the steep acceleration of inflation.

The authorities should therefore give careful thought to reorienting fiscal policy for the coming years, Mr. Malhotra remarked. He was pleased that they had agreed to consider various measures, one of the most important being higher petroleum product prices. While significant yearly increases in the consumption of petroleum products was typical of developing countries, the Egyptian rate of 12 percent appeared high, probably because of the relatively low petroleum prices.

The authorities had made a substantial effort to contain monetary expansion, Mr. Malhotra considered. The rate of growth of broad money had fallen from 44 percent in 1981/82 to 33 percent in 1982/83, and the rate of increase in net claims on the Government had decelerated from 40 percent in 1981/82 to 16 percent in 1982/83. However, the subsequent accelerated growth of both net claims on the public sector and credit to the private sector was a cause for concern, given the high rate of inflation.

The structure of interest rates, which included a deposit rate of 13 percent, would be appropriate if the average rate of inflation were about 10 percent, Mr. Malhotra considered. The authorities had appropriately given priority to reducing inflation to the rate that had prevailed before 1982; if they could do so, the present interest rates should prove adequate to encourage investment. However, if the rate of inflation continued in the range of 16-20 percent, the interest rate structure would need to be reviewed.

The external current account deficit as a proportion of GDP was estimated to have declined from 6.3 percent in 1982/83 to 3.9 percent in 1983/84, owing mainly to an estimated 23 percent rise in workers' remittances and a 10 percent increase in the value of exports, together with import growth of only 5 percent, Mr. Malhotra commented. The rate of growth of non-oil exports was expected to be as high as 20 percent, which would be a remarkable achievement.

The staff's balance of payments projections for 1984-89 showed some important trends, Mr. Malhotra said. First, net receipts on invisibles were expected to decline by about 9.3 percent because of the expected leveling off of workers' remittances and the continued rise in interest payments on the growing external debt. Second, the trade deficit was projected to increase by 42.3 percent. Third, the capital account balance was not expected to change significantly from the level of 1983/84. Fourth, the debt service ratio would grow considerably, from 28 percent in 1983/84 to 39 percent in 1988/89, assuming that the average interest rate on external debt rose from 5.6 percent in 1983/84 to 7.1 percent in 1988/89. Egypt's debt servicing problem was therefore likely to remain difficult for some years and would have to be watched closely.

The staff had stressed the need to narrow the gap between the commercial bank and free market exchange rates, Mr. Malhotra remarked. During the previous year the authorities had made a commendable initial effort to narrow the exchange rates, but the exchange rate issue was complex, and achievement of a unified rate might well take some time.

The Government had adopted a policy of opening the economy to foreign investment, Mr. Malhotra said. On page 18 of SM/84/136 the staff had noted that "experience with direct foreign investment which has entered Egypt under the provisions of Law No. 43 has been mixed. On the one hand, the companies have been a valuable conduit for new technology. On the other hand, they have not financed as much of their investment from abroad as was originally anticipated but have resorted to local sources instead. By directing much of their production to the domestic market rather than abroad and by relying on the free market to obtain foreign exchange to pay dividends and import inputs, they have unexpectedly proved to be a drain on the foreign exchange market while operating in a protective environment." The staff had also noted that administrative actions had recently been taken to speed up project implementation, stimulate production of commodities rather than services--especially exports--and increase the emphasis on transfers of technology, and that some positive results were already evident. Many other developing countries had had similar experience with their efforts to promote foreign direct investment, and he was pleased that the authorities were attempting to ensure that such investment in Egypt promoted exports, did not prove a drain on foreign exchange resources; and resulted in the transfer of technology.

Vigorous implementation of the Development Plan should help to promote the commodity-producing sector and manufacturing and improve the medium-term balance of payments outlook, Mr. Malhotra remarked. However, productivity and output in agriculture could not be improved without adequate producer prices. Production costs in agriculture had been rising more quickly than prices. While increasing consumer prices in urban areas might be difficult, agricultural producer prices that encouraged increased production would certainly be beneficial in the long run.

Mr. Joyce agreed with the staff that the authorities faced both short-term and structural problems. The Government seemed to be moving in the right direction in setting objectives. For instance, the increased emphasis on agricultural and industrial development to provide a more solid basis for further economic growth, and the recognition of the need to increase domestic savings and to encourage foreign investment, were welcome.

Although the authorities' intentions were good, they had not made a vigorous effort to address the structural weaknesses in the economy, Mr. Joyce went on. There were still widespread cost distortions, resource misallocation, and inefficiencies in production and trade, and the medium-term scenario showed that, without further policy changes, the external position would deteriorate significantly, constraining the country's ability to maintain high rates of economic growth. He hoped that, with the parliamentary elections behind them, the authorities would be in a better position to make a serious effort to implement the staff's policy recommendations.

Much remained to be done, Mr. Joyce commented. For instance, the budget deficit, estimated at nearly 20 percent of GDP in 1983/84, was clearly unsustainable. The ratio of total revenues to GDP was projected to continue its steady decline from 45 percent in 1980/81 to 36.2 percent in 1983/84. The inelasticity of the tax system was an obvious cause for concern, and the staff proposals for enhancing the elasticity of revenues through, for example, implementation of a manufacturing sales tax, certainly warranted consideration.

On the expenditure side, Mr. Joyce continued, subsidies continued to account for nearly 2 percent of total current expenditures. Reducing them was of course politically difficult, but the issue would have to be addressed effectively if the fiscal deficit was to be significantly reduced. At the least, subsidies should be confined to the basic essentials and provided only to low-income groups. The same social objectives could be achieved with less resource misallocation through income-support measures.

Wage moderation was clearly required, Mr. Joyce remarked. The rate of growth public sector wages was estimated at nearly 25 percent in 1983/84. The authorities' intention to consider a freeze on public sector employment was welcome, and he looked forward to new revenue and expenditure measures in the forthcoming budget.

On pricing policy, Mr. Joyce noted that average prices charged by public industrial enterprises had risen by less than 6 percent in 1983 and were expected to increase even more slowly in 1983/84. Domestic oil prices were still just 18 percent of world market prices, and agricultural procurement prices were also well below world levels. More appropriate pricing policies were obviously needed to encourage production, reduce consumption, and make more output available for exports. The authorities' argument that limited price adjustments were a buffer against inflation was valid, but only in the very short term. In the long run, that approach could be maintained only at the cost of continued resource misallocation and lower levels of output and investment that would undermine sustainable economic growth.

A more restrictive monetary policy would help to reduce inflationary pressures, Mr. Joyce considered. Although some progress had recently been made, the rate of growth of liquidity remained unacceptably high. Moreover, interest rates, which were significantly negative in real terms, would have to be increased if savings were to be stimulated. Positive real rates of interest would also lead to a more efficient allocation of capital, and would attract workers' remittances and encourage recipients to convert them into Egyptian pounds.

The exchange rate measures introduced since end-1982, including the removal of the exchange surrender requirement on export receipts effected through the commercial bank pool, were welcome, Mr. Joyce remarked. But the real effective exchange rate was highly overvalued, and the authorities should take further steps toward unifying the exchange markets and introducing a more appropriate exchange rate. At the least, they should draw up a timetable for unifying the exchange rate and should make every effort to adhere to it. Such actions were needed if the balance of payments was to be consistent with the authorities' development objectives.

The external current account deficit was expected to decline to 2 percent of GDP in 1983/84, but to increase in the medium term, and the overall external balance was projected to be in deficit by 1986/87, Mr. Joyce noted. The World Bank staff--whose close working relationship with the Fund in dealing with Egypt was welcome--had probably had those projections in mind in concluding that the authorities' Development Plan would probably be unfinanceable in the absence of significant policy changes.

Egypt still maintained two bilateral payments agreements, Mr. Joyce said. In July 1983 the Executive Board had expressed its hope that they would be terminated as soon as possible, and he hoped that the authorities would be able to act in the near future.

The Government had made significant progress during the previous two years in moving toward more market-oriented policies, Mr. Joyce remarked, but the pace of policy adjustment in some areas seemed insufficient, and a number of fundamental adjustments still had not been made. The authorities seemed more optimistic than the staff about the prospects for the economy and were therefore less inclined to accelerate the pace of adjustment. He hoped that they were correct. If they were not, Egypt would lose valuable time, and the magnitude of the problems facing the economy would increase, thereby requiring more substantial adjustment than at present.

Mr. Laske considered that the Five-Year Development Plan included an important set of objectives, identified appropriate investment priorities, and defined the proper relationship between overall investment and aggregate consumption. The assessments of the Plan by the Fund and the World Bank were essentially identical: the targets could not be met unless major changes were made in nearly all aspects of economic policy. The Fund staff had argued convincingly that, with the completion of the national elections, the authorities had a unique opportunity to reorient their overall approach toward demand management and structural adjustment, and he hoped that they would press ahead with more determination than they had shown hitherto. The staff report gave the impression that the authorities tended to avoid vigorous action and preferred a gradual approach. In some areas--for instance, the long-overdue adjustment of energy prices--the authorities' gradual approach seemed to take a number of years. They should be urged to make a more vigorous effort in the coming period.

The nature of the problems facing the economy was essentially unchanged since the previous discussion on Egypt (EBM/83/112, 7/27/83), Mr. Laske remarked. The balance of payments structure remained weak, despite the increase in foreign exchange receipts from Suez Canal charges, oil exports, and workers' remittances. The upward trend in those receipts might well be temporary, and the staff had projected, on the basis of present policies, a progressive deterioration in both the external current account and the overall balance of payments.

The exchange rate system was still complicated, Mr. Laske continued, and he doubted whether it could genuinely reflect supply and demand conditions. Four different exchange rates were applied to various kinds of transactions; a particularly overvalued rate was applied to most of them, and the least regulated of the exchange rates was applied to minor transactions. The staff's most important policy advice--which he fully endorsed--was to simplify the exchange rate system with a view to eventually unifying the rates. At the least, as an initial step the authorities should unify the free market rate and the recently introduced premium rate for the commercial bank pool. The highly overvalued rate for the central bank pool was obviously causing serious distortions in the prices of commodities, and the authorities should be urged to channel transactions to markets covered by other rates, preferably the free market rate. The sizable appreciation of the real effective exchange rate in recent years underscored the pressing need for a much more flexible exchange rate policy.

The growing disequilibrium in public sector finances had been reflected in the widening of the budget deficit, Mr. Laske noted. Given the Government's large share in overall economic activity, public sector expenditure should be watched closely. The authorities apparently recognized that a strong effort to cut expenditures was needed, but the sizable increases in current expenditure in recent years raised some question about their commitment to that objective. The staff had mentioned several options for increasing the elasticity of the tax system and broadening the tax base, and he urged the authorities to consider their implementation promptly.

The recent slowing of the rate of credit expansion was welcome, but further progress could be made by reducing the public sector deficit, thereby limiting the need for central bank financing, Mr. Laske remarked. The authorities should then be in a position to ensure that adequate credit was available for the private sector. In passing, he noted that the expansion of private sector credit in the past had been somewhat excessive.

One of the problems in conducting monetary policy in Egypt was the ineffective management of bank liquidity and credit expansion, and the authorities should be encouraged to investigate optional ways of improving their performance, Mr. Laske considered. Whatever approach was taken, a more flexible interest rate policy than hitherto should be introduced as soon as possible with a view to establishing positive real interest rates.

The present negative real interest rates over the whole spectrum of maturities were not encouraging the additional domestic savings needed to increase the share of such savings in investment financing.

The serious external problems facing the economy were due directly to the lack of sufficient structural adjustment, Mr. Laske commented. The low energy prices placed a heavy burden on public sector finances and encouraged excessive energy consumption. The low prices for agricultural goods, including imported foodstuffs, had artificially depressed rural incomes which, in turn, had encouraged heavy rural migration. Intensifying the effort to introduce a more rational price structure would help to protect the economically weaker groups in Egypt from excessive hardship. He agreed with Mr. Joyce that price subsidies should be limited to essential goods and should be available only to low-income groups. To be effective, new price measures would have to be fully supported by the authorities, and the social side effects would have to be handled skillfully. Without such measures, the prospects for achieving and maintaining satisfactory economic growth would be seriously limited.

The staff had mentioned the possibility of an adjustment program for Egypt, and presumably Fund resources would be needed to support it, Mr. Laske remarked. He would approach a potential stand-by arrangement for Egypt with an open mind. Given the country's uncertain balance of payments prospects and the deep-seated imbalances in the economy, an intensified adjustment effort was urgently needed to give Egypt a realistic chance of achieving a self-sustaining balance of payments position. Finally, the proposed decision was acceptable.

Mr. de Maulde commented that recent developments in the Egyptian economy had been mixed. On the one hand, the overall budget deficit was large and could well increase to 20 percent of GDP in 1984, while the rate of inflation had accelerated to some 20 percent. On the other hand, GDP growth had been satisfactory--a particularly important development in a country with high rates of unemployment and population growth--and the external current account deficit had fallen from 8 percent of GDP in 1981/82 to 2 percent in 1983/84, while the rate of growth of M-2 had decelerated from 44 per cent in 1981/82 to 27 percent in 1983, although even that rate was still too high.

On balance, Mr. de Maulde went on, the economic situation, although not fully satisfactory, was manageable. Strong demand management could help to tackle the budget deficit and to moderate price pressures in the short run, but he agreed with the staff that pressures would soon re-emerge unless fundamental policy adjustments aimed at correcting the underlying, longer-term structural problems were adopted.

One of the main structural problems was the dependence of the balance of payments on four items that were sensitive to external developments, namely, oil exports, Suez Canal receipts, workers' remittances, and external assistance, Mr. de Maulde said. It could be argued that the world recession and the weakening of the international oil market had negatively affected

Egypt's balance of payments, and that its external position should strengthen as the world recovery broadened. However, it could also be argued, on the basis of the staff's medium-term projections, that the foreign exchange receipts from the four main sources had reached a peak, leaving no room to finance future increases in imports and the growing debt service burden. Given the weak balance of payments structure and the considerable effect on that balance of exogenous factors, the authorities should give a high priority to reviving non-oil exports and to generating the savings needed to support export-oriented investment.

The external debt was the second major structural problem, Mr. de Maulde commented. Debt service was the equivalent of 28 percent of current external receipts and could well reach nearly 40 percent in 1988/89. Precise and firm guidelines on external borrowing were urgently needed, together with appropriate fiscal and monetary policies to generate sufficient internal savings.

A number of deep-rooted structural problems on the supply side also should be tackled in a medium-term perspective, Mr. de Maulde considered. In that connection, the Five-Year Development Plan correctly stressed the need to stimulate agriculture, expand the export base, and generate sufficient domestic savings.

The authorities were to be commended for the measures already introduced to meet the objectives under the Development Plan, but much remained to be done, and the staff had correctly stressed that the adjustment effort had probably been excessively gradual and insufficiently vigorous, Mr. de Maulde remarked. Producer prices, for instance, were of key importance and should be increased to international levels. In addition, the subsidies on consumer goods should be eliminated. The authorities understandably wished to avoid internal disturbances, and the staff's attitude toward reducing subsidies was appropriately flexible. While increases in controlled prices should be gradual, they should certainly be steady. Moreover, further progress should be made in improving the civil service recruitment policy and in increasing the elasticity of the tax system. A firm monetary policy should be maintained, and interest rates should be raised to more realistic levels, in part to improve the allocation of resources. Progessive unification of the exchange system would also make a significant contribution to improving resource allocation.

The authorities seemed well aware of the major problems that would have to be tackled in a medium-term perspective, Mr. de Maulde commented, and the initital steps already taken were encouraging. A steady overall adjustment effort was needed to ensure sufficient employment in the longer run, and the period immediately ahead would be a particularly good one in which to make such an effort, supported by the Fund.

Mr. Suraisry agreed with the staff analysis and accepted the proposed decision. Since 1982/83, the authorities had made a commendable effort to reduce the imbalances and distortions in the economy through fiscal, monetary, and exchange rate policy changes. Additional measures introduced under the 1983/84 budget had already produced positive results, reflecting the authorities' awareness of, and determination to deal with, the problems facing the economy. However, because of the seriousness of the problems, the efforts made thus far would have to be supplemented by the introduction of additional adjustment measures in a more decisive and timely manner than in recent years. In that connection, Mr. Negm's opening statement was encouraging.

The staff and the authorities agreed that the problems facing the economy were serious, but there was some difference of opinion about the speed at which they should be tackled, Mr. Suraisry continued. The staff believed that a comprehensive and strong adjustment program should be adopted as soon as possible, while the authorities considered a gradual approach sufficient. He tended to agree with the staff. The present economic situation in Egypt was manageable, but timely adjustment was clearly needed to deal with the large overall fiscal deficit (estimated at 20 percent of GDP), the high rate of inflation (about 20 percent), and the complicated exchange system. It was important for the authorities to continue the adjustment effort to eliminate the weaknesses in the economy.

The recent emphasis on production and pricing policies of agriculture and industry was particularly important, Mr. Suraisry commented. Timely actions to shift the pattern of production toward the commodity-producing sector were needed, and the measures the authorities had introduced thus far were a step in the right direction. To consolidate the gains from such measures, additional price corrections would be needed; for that purpose, the external environment was relatively favorable, but prices were of course a particularly sensitive issue, and a careful and gradual approach would perhaps be most appropriate.

He agreed with the staff that fiscal policy should be given priority in reducing the overall deficit, Mr. Suraisry said. The room for maneuver was obviously limited, but appropriate measures on both the revenue and expenditure sides could be introduced. The declining trend in revenues as a share of GDP since 1980/81 could not continue without intensifying the problems facing the economy and increasing the difficulty in making the needed adjustments. The authorities' initial response to the staff's suggestions in the fiscal field was encouraging. Their commitment to maintaining a cautious domestic credit policy was also welcome--particularly in the light of the high rate of inflation and large external imbalance--and their steps to strengthen the Central Bank's control over commercial bank operations were commendable.

The exchange system measures introduced since 1982 had been useful, Mr. Suraisry commented. Workers' remittances, for instance, had already responded favorably. However, the existence of three different foreign exchange markets did not contribute to efficient resource allocation and added to the difficulty in managing the exchange system. The authorities should be encouraged to introduce a more flexible system.

The civilian external debt servicing burden was forecast to continue rising until the end of the 1980s; therefore, he agreed with the staff that a cautious debt policy should be maintained, Mr. Suraisry said. A comprehensive approach to bringing the debt burden in line with the country's debt service capacity was required. Close attention should be paid to the structure of foreign debt with a view to avoiding short-term debt on commercial terms as much as possible. Technical assistance provided by the Central Banking Department in the debt area and the authorities' commitment to maintaining prudent borrowing policies were welcome.

He sympathized with the authorities, who believed that the import quotas introduced by some industrial countries were inconsistent with the principle of comparative advantage and would not help the ongoing adjustment efforts in many countries, including Egypt, Mr. Suraisry remarked. He hoped that all barriers to free trade would be eliminated soon. Finally, he wondered whether the Egyptian authorities intended to submit a stabilization program for approval by the Fund.

Mr. Camara observed that Egypt was one of the few developing countries that had been able to make some progress despite the world recession: real economic growth had averaged more than 8 percent over the previous seven years; export earnings had expanded rapidly; and investment had reached 25 percent of GDP in 1981/82. Nevertheless, growth had been concentrated in noncommodity-producing sectors, the fiscal and external positions had remained weak, and inflationary pressures had continued to intensify.

Early adoption of appropriate adjustment measures had inevitably been required to prevent further deterioration in the external and fiscal positions and to improve the pattern of growth, Mr. Camara continued. He was pleased that the authorities had recognized the need for timely adjustment and planned to make additional policy changes. At the same time, given the social and political costs involved, the authorities' wish to adjust gradually, rather than quickly, was understandable.

The emphasis in the Five-Year Development Plan on agriculture and industry reflected the authorities' awareness of the need to address the structural problems facing the economy, Mr. Camara remarked. The recent policy changes aimed at encouraging private sector participation and at increasing the reliance on the price mechanism, as well as the continued efforts to improve the quality of investment, were steps in the right direction.

The authorities' efforts thus far to reduce the fiscal imbalance were welcome, but the budget deficit for 1983/84 was projected at 16 percent of GDP, and further measures clearly would have to be taken, Mr. Camara considered. The effort to reduce the fiscal deficit should be based mainly on correcting the structural problems in the tax system, containing expenditure while changing its composition, and improving the performance of public corporations. Budgetary subsidies would have to be reduced, although that was obviously a sensitive issue. In the circumstances, the authorities would have to balance social and political constraints against the achievement of sustained growth and price stability, which would be difficult in the absence of some strengthening of the Government's financial position.

Although the authorities had slowed the growth of monetary and credit expansion, inflation had recently become a serious problem in Egypt, underscoring the need for a cautious credit policy, Mr. Camara said. In that connection, the authorities were making more effective use of the requirement based on the ratio of loans to deposits, and steps were being taken to strengthen the Central Bank's control over commercial banks' operations. Steps were also needed to help to mobilize private savings and to rationalize bank credit.

The rapid growth of oil export earnings and workers' remittances in recent years had helped Egypt to deal with its external payments problems, Mr. Camara noted. While Egypt did not face severe balance of payments problems at present, the underlying external position remained weak. The authorities had recently introduced policy changes designed to promote non-oil exports and to encourage an increase in the inflow of workers' remittances. A flexible exchange rate policy would also be helpful, although he understood the authorities' wish to take a gradual approach toward the unification of the exchange rates because of the possible effect on prices.

Egypt's external debt and debt servicing burden would have to be closely monitored, Mr. Camara considered, and he hoped that the technical assistance the authorities had requested would be helpful. Their intention to adopt a comprehensive approach to external debt management and to maintain a prudent borrowing policy was welcome.

Mr. Ramtoolah noted that the industrial sector had grown rapidly over the previous seven years, mainly because of the high level of investment. While that development was commendable, the performance of the agricultural sector had been rather disappointing, with an increase in investment not having been commensurate with the rise in population; also, producer prices had not been sufficient to encourage increases in output.

The importance of agriculture in a country like Egypt, where the rate of population growth was relatively high, could not be overstated, Mr. Ramtoolah said. The authorities' awareness of the need to increase agricultural output was reflected in their decision to channel public and bank credit to the agricultural sector on relatively easy terms. Such efforts would have to be supplemented rapidly by other measures if a major expansion of agricultural output was to be achieved. The authorities' wish to adjust producer prices gradually was understandable, given the unfavorable experience with such adjustments in the past, but they should be concerned that, as the staff had noted, Egypt was now spending a significant amount of its foreign exchange earnings on the importation of agricultural products when it used to experience trade surpluses for those products in the past decade." The emphasis in the new Development Plan on increasing investment in agriculture was therefore commendable. In passing, he noted that the increased effort to encourage foreign investors to engage in joint ventures with Egyptian partners, the centralization of responsibility for foreign investment procedures with one ministry, and the rapid appraisal of proposals for projects financed by foreign funds were steps in the right direction.

The fiscal situation was obviously serious, Mr. Ramtoolah remarked. The fiscal deficit could reach 20 percent of GDP in 1983/84, owing in part to the heavy subsidies on agricultural products. While he fully supported the authorities' objective of safeguarding the living standard of low-income groups, they should review the tax system, strengthen the financial performance of public enterprises, introduce a manufacturers' sales tax, and convert most of the remaining specific duties to ad valorem rates. Wage restraint was also clearly needed.

The improvement in the external current account in 1981-84, following an increase in workers' remittances, was welcome, Mr. Ramtoolah remarked. He hoped that, with the relaxation of the foreign exchange constraints, the authorities would be able to unify--at least gradually--the commercial bank pool and free market exchange rates. Their efforts, with the help of the Central Banking Department, to improve the quality and timeliness of debt data and the monitoring of the debt, as well as their intention to maintain a prudent borrowing policy, were welcome.

He hoped that the authorities would accept the staff's advice and undertake a structural adjustment program--possibly under an extended arrangement--as soon as possible, Mr. Ramtoolah concluded. With the recent completion of national elections, a program would be timely.

Mr. Clark noted that Egypt had maintained a rapid rate of economic growth during the world economic recession, but continued growth would be essential to meet the needs of the increasing population; the constraint imposed by the present imbalances on future economic growth was therefore worrying. He agreed with the staff that emphasis should be placed on increasing producer prices to international levels, raising interest rates to mobilize domestic savings, and unifying the exchange rate system.

He was pleased that the authorities recognized the need for structural changes in the economy, Mr. Clark said, and he agreed with the staff that, while the authorities' hesitation to accelerate the pace of adjustment was understandable, any delay would only increase the difficulty in making those adjustments. The authorities should be urged to use the opportunity given by the world recovery to implement the required measures, and he hoped that they would be included in the new budget.

The huge consumer subsidies--equivalent to about 20 percent of GDP--imposed a heavy burden on the budget and created cost-price distortions that adversely affected industrial growth and agricultural production, thereby constraining exports and increasing imports, Mr. Clark remarked. Domestic petroleum prices were a striking example. It was of course politically difficult to increase the prices of basic goods, but the authorities must press ahead with their plans to adjust prices and reduce subsidies, which need not be inconsistent with the objective of safeguarding the standard of living of low-income groups.

If the effort to eliminate price distortions was to be fully effective, a realistic and flexible exchange rate regime would have to be established, Mr. Clark considered. The steps taken toward unifying the exchange rate system were welcome, and the authorities should be urged to make further progress. He agreed with the staff that appropriate flexibility in the exchange rate for the expanded commercial bank pool should be established and then supported by active credit and interest rate policies.

The need for the recommended policy changes was underscored by the external debt projections, Mr. Clark remarked. The debt service of the civilian debt alone was projected to amount to 28 percent of current account receipts in 1984 and 39 percent by 1989. He wondered what the corresponding figures were for the overall debt. That Egypt had fallen behind in its current debt service payments was a cause for concern, and the authorities would be well advised to maintain a cautious approach to contracting further debt.

The current account deficit was expected to triple over the coming five years, Mr. Clark noted, based on the assumption--which could not be taken for granted--that petroleum exports and workers' remittances would steadily rise. The prospects for the external economy were clearly a cause for serious concern and underscored the need for early implementation of the recommended fundamental policy adjustments.

Mr. Teijeiro commented that, despite the commendable growth of real GDP over the previous decade, the Egyptian economy still faced short-term and structural problems. The authorities needed to reduce the underlying inflationary pressures and correct the fundamental budgetary and external imbalances.

The authorities had already introduced a number of corrective measures, but they had not proved sufficient to attain a viable external payments position and to shift domestic activity toward sectors other than services, Mr. Teijeiro remarked. Introducing an appropriate pricing policy seemed to be a first and unavoidable step toward mobilizing resources for the productive sector. More realistic prices in agriculture and industry would provide an incentive to accelerate domestic production which, in turn, would reduce dependence on imports and improve the export performance. It would also improve resource allocation and help to establish the right priorities for investment programs in which both the Government and the private sector might be involved. Prices reflecting the opportunity costs of production would also permit public enterprises to reduce their reliance on government subsidies, thereby contributing to the achievement of a balanced budget.

He agreed with the authorities that the emphasis in fiscal policy should be on achieving an immediate reduction in the overall deficit and on restructuring government finances, Mr. Teijeiro said. They should constrain expenditures by reducing budget subsidies and containing salary adjustments through revised government employment practices. The increase in government employment in recent years had been substantial.

Decelerating the rate of expansion of credit to finance public sector deficits would help to contain inflationary pressures, improve the balance of payments, and enable the authorities to meet the needs of the commodity-producing sector while maintaining a prudent pace of overall credit growth, Mr. Teijeiro considered. Since March 1984, real interest rates on deposits had been negative, and nominal rates had been lower than the expected yield on foreign currency deposits. The authorities should pay attention to the need to maintain competitive positive real interest rates in order to avoid undue pressures on both the market for products and the overall external balance.

The exchange system included three distinct foreign exchange markets, Mr. Teijeiro remarked. While some steps had recently been taken toward the unification of the commercial bank pool and free market rates, the authorities should consider unifying all three markets at a realistic exchange rate to avoid the distortions caused by the separate markets, promote exports effectively, and achieve a sustainable overall external position.

The authorities were to be commended for the improvement in the economic situation, Mr. Teijeiro concluded. He was confident that stronger actions aimed at eliminating the imbalances and structural weaknesses would make a decisive contribution to paving the way for sustainable economic growth. Finally, the proposed decision was acceptable.

The Director of the Middle Eastern Department said that the fiscal year in Egypt began on July 1, but a budget had not been presented because the new Cabinet had not yet been formed. Meanwhile, monthly expenditures were being maintained at the previous year's level.

Discussions on a possible stabilization program had been held in late 1983, the Director commented. However, there had been delays in considering a program for various reasons, including the national elections. The authorities had decided that it would be more appropriate to continue the discussion with the new Cabinet; when it had taken office, the staff intended to visit Egypt again.

The staff had no official information of the size of the military debt service, the Director of the Middle Eastern Department said.

A Deputy Director of the Middle Eastern Department remarked that, in assessing pricing policy, particularly for energy products, it was important to remember that the public sector dominated the economy. Under present policies, public corporations were given little incentive to save energy, and increases in energy prices would have little practical effect unless they were passed on by public corporations to final consumers. Charging higher prices to public corporations alone would merely increase their financing needs, thereby worsening the overall fiscal imbalance. It was also important to bear in mind that the price increases favored by the staff and the World Bank were substantial and would have important implications for both prices and wages. Hence, they should be part of a global policy adjustment effort.

A Deputy Director of the Exchange and Trade Relations Department noted that, on the basis of data that had just become available, the real effective exchange rate of Egypt had appreciated as of May 1984 by 10.5 percent since the previous discussion on Egypt's exchange rate policy in connection with the 1983 Article IV consultation in July 1983. Under the surveillance procedures, a movement in the real effective exchange rate in excess of 10 percent required the issuance of an information notice to the Board. However, since the present meeting provided an opportunity for Directors to comment on Egypt's rate developments and policy, there would be no need to issue a notice.

Mr. Negm remarked that the authorities, with the assistance of the Fund and the World Bank, had been reviewing their policy of gradually increasing petroleum prices. He hoped that recommendations resulting from the review could be implemented as soon as possible. The authorities were also considering whether higher interest rates would attract funds needed to finance investment.

One of the remaining two bilateral payments agreements was to be terminated in 1984, Mr. Negm explained.

The present reserve ratio and ratio of loans to deposits had been established several years previously and had proved to be very tight, Mr. Negm said. The ratios were being reviewed by the Central Bank.

The Acting Chairman made the following summing up:

> There was quite broad support by the Executive Directors for the views expressed in the staff appraisal. While Directors noted that Egypt had maintained a high rate of economic growth despite recent unfavorable international economic developments, they were concerned about the rising rate of inflation in the past two years, the underlying fragility and weakness of the balance of payments, and the severity of the domestic economic imbalances. The staff's medium-term projections for the balance of payments and external debt, although subject to the normal uncertainties, clearly indicated that the balance of payments and external debt situation would weaken in the future in the absence of corrective policies. Thus, Directors expressed concern that the authorities had not taken more advantage of the recent favorable growth and balance of payments developments to tackle the pervasive cost-price distortions and other structural

weaknesses in public finance. All Directors noted the urgent need for the adoption of decisive adjustment policies, consisting of short-term fiscal and credit policies to moderate pressures on the balance of payments and prices, and of fundamental policy adjustments aimed at correcting the underlying longer-term structural problems. In this connection, Executive Directors noted that the emphasis in the current Five-Year Plan on stimulating production in agriculture and industry and on generating more domestic savings was in the right direction. What was needed, however, was vigor in following through on policy adjustments necessary to achieve the domestic and external objectives.

Executive Directors emphasized that producer prices for major crops and prices charged by public entities should be gradually raised to correspond to international market prices. Noting that the present very low level of domestic energy prices encouraged domestic consumption and denied the budget a substantial amount of revenue, Directors stressed the need to adopt a precise schedule for adjusting energy prices to international levels. Also, the issue of consumer subsidies needed to be tackled in a pragmatic and sensitive way in order to reduce the growing burden of the subsidies on the budget. For example, Directors said that the number of subsidized goods should be confined to a few essentials and subsidies could be directed more effectively to low-income groups as total subsidies were reduced.

Directors also were concerned about further deterioration in the overall budget deficit in 1983 and 1984 to a level of about 20 percent of GDP and urged the authorities to achieve an immediate reduction in the 1984/85 budget deficit, to restructure government finances through measures aimed at increasing the elasticity of the tax system, and, more important, to place greater emphasis on slowing the growth of public expenditures. For example, some Directors encouraged the authorities to reconsider the policy of providing guaranteed employment in the public sector to all college graduates and former military personnel.

In the view of most Directors, money and credit growth still exceeded the needs of the economy, and they were concerned about the impact of credit growth on inflation. A slowing of the growth of credit to the public sector would, in the view of Directors, enable the Government to meet the genuine credit needs of the commodity-producing sector within the prudent overall credit growth limits that would be necessary to reduce the rate of inflation over time. Directors also commented that interest rates were negative in real terms, and that interest rate policy should be aimed at costing capital realistically for investment purposes and at encouraging greater savings in assets denominated in Egyptian pounds.

While welcoming the greater realism recently introduced in exchange rate management, Directors urged the authorities to introduce a more comprehensive reform of the exchange system aimed at simplifying and eventually unifying the exchange rate structure, which should then be managed in a way that would maintain a realistic exchange rate level over time.

Directors also agreed with the staff appraisal that great caution needed to be exerted in external debt policy. Many Directors noted the projected sharp rise over the coming years from an already high service ratio of about 28 percent to one of almost 40 percent on that debt which is publicly known. Improvements in the compilation of comprehensive debt statistics are needed, and many Directors emphasized the importance of formulating more precise overall guidelines on the contracting external debt.

In sum, Directors stressed that the postelection period and the more favorable external environment provided an opportunity for the authorities to adopt a comprehensive substantial adjustment effort. Such an adjustment strategy should be devised within a medium-term framework and should include the policies necessary to deal with the structural imbalances as well as the fiscal and credit imbalances. Delays in implementing such policy adjustments, many Directors felt, would result in an intensification of distortions and would make the adjustments more difficult and painful later on.

The next Article IV consultation should be held on the standard 12-month cycle.

The Executive Board then took the following decision:

Decision Concluding 1984 Article XIV Consultation

1. The Fund takes this decision relating to the Arab Republic of Egypt's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Egypt, in the light of the 1984 Article IV consultation with Egypt conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes the recent measures to improve the efficiency of the exchange system. The Fund considers, however, that the system remains complex and believes that further steps should be taken at an early date toward the complete unification

of the existing rates. The Fund hopes that Egypt will terminate the two remaining bilateral payments agreements with Fund members as soon as possible.

Decision No. 7750-(84/103), adopted
July 6, 1984

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/102 (6/29/84) and EBM/84/103 (7/6/84).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/14 are approved. (EBD/84/177, 6/26/84).

Adopted July 2, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/84/111, Supplement 1 (7/2/84), EBAP/84/138 (6/28/84), EBAP/84/140 (7/2/84), and EBAP/84/142 (7/3/84) is approved.

APPROVED: March 5, 1985

LEO VAN HOUTVEN
Secretary