DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/81/55

February 27, 1981

To: Members of the Executive Board

From: The Acting Secretary

Subject: Final Minutes of Executive Board Meeting 80/77

The following correction has been made in EBM/80/77 (5/2/80):

Page 9, 2nd full para., last two lines: delete phrase "Any improvement in the situation"

A corrected page is attached.

Att: (1)

Other Distribution;
Department Heads

was to reduce the vulnerability of the budget to inflation, which had resulted from a lack of flexibility in producing revenue and a tendency for expenditure to outpace GDP growth. The limited prospects for a rapid and substantial improvement in the equilibrium of public finances tended to indicate that private savings would have to play a key role in the noninflationary financing of the Development Plan.

Two major weaknesses in the financial system could hamper the efficient promotion and mobilization of savings, Mr. Aulagnon continued. The first was that interest rates remained largely negative, even after the adjustments that had recently taken place. It was clear that further increases were needed, particularly if the prospects for a significant reduction in inflationary pressures were to dim.

The second weakness stemmed from the large proportion of savings deposited in foreign currency accounts, Mr. Aulagnon remarked. While the present rules offered emigrant workers the opportunity not to convert their earnings into national currency and had thus been the primary source of foreign exchange in the recent past, there was little doubt that only a small proportion of such resources had found their way into long-term productive investment.

Any improvement would seem to require a significant adjustment of past financial trends geared to promoting domestic savings and, at the same time, to encouraging emigrant workers to convert their foreign currency holdings into national currency. The authorities could meet both objectives, at least in part, by adopting more realistic rates of remuneration, yet a move in that direction--however desirable--might not be sufficient in view of the magnitude of Egypt's financial needs, which required that significant inflows of medium-term and long-term capital be made available over the next few years if the objectives the authorities were to realize their objectives. In that respect, the confidence of investors in the ability of the authorities to embark upon a program of internal and external adjustment would certainly be a key element in the success of the program. The scope for further cooperation with the Fund should thus be explored as a way of constituting a decisive step toward full rehabilitation of the Egyptian economy.

Mr. Siwatibau commented that he agreed with the analysis and recommended approach in the staff papers and considered that there was an urgent need to contain or reverse the trend in the public sector deficit. The burden of subsidies weighed heavily upon that deficit, and the authorities appeared to recognize that the level of subsidies needed to be reduced over time and that the administration of the system needed to be improved so that the benefits would accrue only to those requiring assistance. However, there was obvious sensitivity about removing benefits that people already enjoyed, so that, while it was desirable to reduce the burden, it would probably be necessary to accept the fact that subsidies would be eased out only gradually. In the meantime, the authorities should be vigilant to see that the growth in recurrent expenditures and capital expenditures did not get out of hand. He agreed with the staff that a reduction in capital expenditures should be a matter of priority and that the focus should be on projects that generated employment and foreign exchange and had a relatively short gestation period.

Efforts to contain the fiscal deficit should also be looked at in light of difficulties on the revenue side, Mr. Siwatibau continued. He agreed with the staff that the tax system should be examined and structured toward enhancing its elasticity, and that it was desirable to adopt ad valorem customs duties rather than the specific ones that existed on many items at present. Moreover, a review should be held of the high level of exemptions from direct taxes, which heavily eroded the tax base. In that connection, he noted that corporate taxes and taxes on personal income generally tended to be elastic with respect to GDP. In many cases, where the exemption levels for personal income taxes were set very low and where a relatively low rate of tax embraced a large number of people in the labor force, the overall yield turned out to be quite high and improved the elasticity of the tax system. He wondered whether the staff had examined the possibility of shifting some of the burden from indirect to direct taxes as a means of enhancing the elasticity of the tax system in Egypt, particularly since the staff had noted that a more elastic tax system would be useful in reversing the trend in the deficit over the medium term.

He welcomed the staff focus on cost/price distortions and their impact on the finances of the public sector, Mr. Siwatibau said; there appeared to be a need for price-setting mechanisms that reflected movements in costs. He supported the program of decontrol, which the authorities had recently espoused, and agreed that decision making with respect to investments and pricing needed to be somewhat more in the hands of the management of the public corporations. He also saw logic in the recommendation by the staff with respect to energy pricing: clearly, if energy prices in Egypt closely reflected prices in the world markets, conservation would result, and the country would be able to increase its exports of petroleum products. Still, he recognized that Egypt's problem in following the staff advice was similar to that in a number of developing countries, namely, balancing what was economically desirable with what was politically feasible.

He supported the staff recommendations on monetary policy--including that regarding interest rate policy--Mr. Siwatibau continued, although he noted that the ability of the authorities to contain the trend in monetary growth was intimately tied to developments in the area of the fiscal deficit.

It was evident from the staff paper that the agricultural sector remained the most important one in Egypt, employing some 40 per cent of the labor force, Mr. Siwatibau observed. Clearly, policy for the