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Statement by Mr. Shaalan on the Arab Republic of Egypt
Executive Board Meeting
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An Overview

In most respects, the staff's recommendations in the current Article IV consultation report are those that have guided policy orientation in Egypt in the recent past. However, admittedly, the timing of the introduction of some of the reforms has been slower than the staff had anticipated. This was in part due to exogenous factors. Over the last few years, the Egyptian economy has suffered from the impact of both the global slowdown and the well-known heightened tensions in the region. The adverse impact of these exogenous influences was, however, contained by the pursuit of generally sound policies and continued progress in the implementation of certain reforms. It should also be noted that the aforementioned tensions in the region have, understandably, delayed the implementation of certain planned key reforms.

In the past fiscal year, the consolidated deficit of the general government was maintained at about 2.5 percent of GDP in 2002/03; monetary policy was eased during the second half of the year to mitigate the adverse impact of the external environment on growth, and the exchange rate was allowed to depreciate almost 50 percent. As a result of this responsive policy mix, the growth rate remained at about 3 percent, inflation was maintained at a relatively low level, and foreign exchange reserves coverage continued to be comfortable.

Improving economic conditions have continued into 2003/04. The GDP growth is estimated at 3.7 percent and is projected to accelerate further in the medium term. The significant exchange rate depreciation has continued to strengthen the exports of goods and services in a substantial manner. As the recovery became evident and inflationary pressures emerged, the authorities began to tighten financial policies in the first half of the fiscal year, and have maintained the stance since then in order to facilitate a move to a more flexible exchange rate. In the meantime, structural reform efforts were focused on strengthening the banking sector, and enhancing the business environment to promote both private domestic and foreign investment, which have been depressed for the past two years.

Fiscal Policy

Total revenue of the consolidated general government has been increasing steadily in relation to GDP since 2001/02. This increase was not only due to the pound's depreciation

and consequent price increases, but also to the efforts over the last few years to strengthen tax and customs administration under a program for which Fund assistance was provided. At the same time, all expenditure items have been controlled, with only a modest increase over the last few years, largely on account of higher domestic interest payments. As a result, the consolidated government deficit declined marginally to 2.3 percent of GDP in 2003/04. While this decline in the overall deficit may appear modest, it is well to note that the primary surplus increased by about 1/2 percent of GDP compared to 2002/03 and 1 percent of GDP compared to 2001/02. This was achieved in an environment of subdued economic activity.

Notwithstanding the fiscal consolidation of the last few years, the public debt continued to grow as a result of the currency depreciation and extra-budgetary borrowing activities. The latter is in part related to regularization of investment expenditures of previous years and suppliers' credit. There is an ongoing effort to identify and monitor these expenditures and to bring them under the control of the Ministry of Finance. While this work is still in progress, the gross public sector borrowing requirement has been an improving trend, having declined from 8.5 percent in 2000/01 to 6.9 percent of GDP in 2003/04. The public debt continues to be mostly of long-term maturity and in domestic currency, reflecting the authorities' prudent liability management approach.

The government is determined to stabilize the debt ratio in 2004/05 and put it on a declining trajectory over the medium term. In addition to strengthening the control of extra-budgetary borrowing, a number of fiscal measures are being implemented, targeting a reduction in the consolidated general government deficit to close to 1 percent of GDP in 2004/05. Given the compression of the primary expenditure over the past few years, the fiscal effort is mostly based on a strong revenue package amounting to 2 percent of GDP and comprising of increases in energy prices and various taxes and fees, and a further strengthening of tax administration. Petroleum products' prices are already being adjusted, and the Peoples' Assembly has approved the budget for 2004/05. Expenditure will continue to be restrained, with primary spending projected to grow by only 0.2 percent of GDP. The authorities intend to extend these reforms over the medium term, including by further energy price adjustments, conversion of the GST to a VAT, additional increases in various taxes and fees, and a further strengthening of expenditure control. The adjustment scenario in the report reflects these measures, which were described to staff in detail during the mission but had not been legislated at that time. Technical assistance in some of these areas from the Fund and other sources are underway.

Monetary, Exchange Rate, and External Sector Issues

It is well to examine the current exchange rate system in perspective. For a number of years prior to 1999, the Egyptian pound was pegged to the U.S. dollar. The system worked well with the help of the supportive financial policies. As some pressures on the pound associated to a degree with the Luxor terrorist incident emerged, the monetary authorities re-pegged the rate at a depreciated level on the recommendation of the Fund. This was followed by the introduction of a number of currency bands. After the introduction of each of those bands, a parallel market emerged but the gap between the official bank rate and the parallel market rate virtually disappeared by January 2003 and exchange markets were liquid.

At that time, it appeared that the timing to introduce the float was propitious, and significantly it was not prompted or forced by any pressures emanating from markets, the authorities decided to float the rate. To the surprise of observers, including myself, the rate immediately depreciated and a parallel market emerged as the banks chose not to engage in a race for depreciation with what they believed to be a rate emanating from speculative activity.

A new governor and board of directors of the central bank were appointed at the end of last year. Since then, monetary policy has been further tightened, a new law has restricted government borrowing from the central bank, a self-regulatory foreign exchange interbank market convention is being established and is expected to be fully operative in several weeks, and the monetary policy framework and instruments are being enhanced with the help of technical assistance from the Fund. Confidence has been strengthening and the exchange rate spread between the banks and the black market narrowed considerably and now stands at about 4 percent. Both the waiting period to execute outstanding requests to purchase foreign exchange and the total size of these requests have declined substantially, with the latter being reduced to less than US$200 million, they were all made by public sector entities. All private sector requests have been satisfied. The authorities are determined to increase the flexibility of the exchange rate in the very near future once the preparatory work currently underway has been completed, in order to maximize chances of the success of the new regime.

As staff analysis illustrates, Egypt's balance of payments continues to show resilience. The current account has been strengthening substantially and the outlook for exports and tourism is favorable. The capital account deficit is projected to decline substantially in 2004/05 and to turn to a small surplus over the medium term. The staff's rigorous external vulnerability analysis shows a favorable external debt sustainability with a declining medium-term path for the external debt-to-GDP ratio in the baseline scenario. There are no significant liquidity or solvency risks.

Banking Sector and Public Enterprise Issues

The central bank has continued to strengthen prudential supervision in line with the recommendations of the 2002 FSAP. While recorded NPL's have shown some increase this, in part, reflects the more accurate reporting. To address this issue, measures have been taken to facilitate the recovery of collateral and to improve the management of public sector banks. Also, a scheme to address public sector debt has been completed and will be implemented in the next 2-3 months. Given this new environment, the growth of bank credit to the private sector has started to recover with the pick up in economic activity and the recent increase in banks' willingness to take calculated credit risks after a period of excessive caution, which was partly due to increased accountability and strict enforcement of penalties for violating prudential regulations and lending procedures.

After privatizing most of the profitable public enterprises, the authorities' attention has shifted to the less successful ones. Progress in divesting the assets of these enterprises or restructuring them in preparation for privatization is inherently less visible than the early easier phase of privatization. This should not detract from the important effort in this area.

The debt of these enterprises will also be restructured over the next months. The restructuring program will be financed by receipts from the remaining profitable enterprises as well as ongoing asset divesture. While the details of the scheme have not been finalized yet, the authorities are determined to avoid any delays in the divesture program or a deterioration in the incentives system that governs the operations of these enterprises. Progress in this area will prepare the ground for an ambitious privatization plan for 2004/06, which involves 111 of the remaining 178 public enterprises.

Other Structural Reforms

The authorities are fully aware that macrostability, by itself, is not sufficient to enhance durable growth to absorb the new entrants to the labor force. To this end, important initiatives have been launched to reduce the administrative burdens and enhance the business environment in order to promote investment and employment. A new investment law is near completion, one-stop investment offices are being established in the governorates, and the management of ports is being improved. Customs tariffs on a number of goods have been reduced in line with WTO commitments, while fees and specific tariffs on other imports have been converted to ad valorem rates. The Association Agreement with the European Union became effective earlier this year, and other trade agreements are being negotiated.

Finally, the Egyptian authorities are determined to continue their reform efforts with a view to maintain stability and growth. They would like to express their appreciation for the technical assistance they are receiving from the Fund in support of their reform efforts, and thank management and staff for a most useful consultation. They look forward to continued close collaboration with the Fund in the period ahead.