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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/1

10:00 a.m., January 7, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
A.D. Ouattara, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	R. Fernandez
	E. Jourcin, Temporary
	C.X. O'Loghlin
	R.J. Singh, Temporary
	U.Y. Tilyayev, Temporary
	W.-D. Donecker
	N. Coumbis
	L. Pinzani, Temporary
D.Z. Guti	J.P. de Morais
	Y. Patel, Temporary
	L.J.F. Erasmus, Temporary
	K. Kask, Temporary
	O.L. Bernal, Temporary
	A.L. Coronel, Temporary
	J. Prader
K. Lissakers	M. Brettschneider, Temporary
A. Mirakhor	M. Daïri
	M.A. Hammoudi, Temporary
	A. Vernikov
	J. Shields
	M.A. Brooke, Temporary
	K.S. Brownlee, Temporary
A.S. Shaalan	G.M. Iradian, Temporary
M.R. Sivaraman	H.B. Disanayaka
G.F. Taylor	
	J. Guzmán-Calafell
	E. Rodríguez, Temporary
	J.P. Leijdekker, Temporary
	A. Barro Chambrier
	S. N'guiamba, Temporary
	D. Fujii, Temporary
	O. Sein, Temporary
Zhang Z.	Qi J., Temporary
	Wang X., Temporary
	O. Otazú, Temporary
	D. Merino, Temporary

A. Mountford, Acting Secretary
D.J. de Vos, Assistant
S. Tenney, Assistant

Cameroon—1997 Article IV Consultation
Staff representatives: M. Katz, AFR; Pujol, PDR

Arab Republic of Egypt—1997 Article IV Consultation; and Stand-By Arrangement—Reviews, Modification and Waiver of Performance Criteria
Staff representatives: Handy, MED; Puckahtikom, PDR

Also Present

IBRD: B. Horton, Africa Regional Office; J.C. Wetter, Middle East and North Africa Regional Office. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director; G.E. Gondwe, Deputy Director; E. Hernández-Cata, Deputy Director; D. Ewenczyk, J. Fajgenbaum, A.J.-P. Feler, D. Ghura, M. Katz, A. Kuijs, S.P. Leite, J. Ntamatungiro. External Relations Department: B.J. Mauprivez. Fiscal Affairs Department: I.C. Lienert, F.S. Mahfouz, A. Schwidrohski. Legal Department: L.E. Nordgaard. Middle Eastern Department: P. Chabrier, Director; P.F. Allum, A. Bisat, R.E. Daumont, S. Eken, H.P.G. Handy, C.E. Lane, K. Nashashibi, L.A. Ricci. Monetary and Exchange Affairs Department: G.R. Iden. Policy Development and Review Department: N.L. Laframboise, J. Mongardini, C. Puckahtikom, J.P. Pujol. Secretary's Department: P. Gotur, N. Hairfield, P.J. Kunzel, B.A. Sarr. Office of the Managing Director: B.V. Christensen, J.A.P. Clément. Advisors to Executive Directors: W.F. Abdelati, M.A. Ahmed, M.H. Elhage, S.S. Farid, P.M. Fremann, A. Giustiniani, C.M. Gonzalez, R.J. Heinbuecher, N. Jadhav, B. Konan, M.F. Melhem, J.-C. Obame, T. Turner-Huggins. Assistants to Executive Directors: A.S. Alosaimi, M. Budington, J. Chelsky, D.A.A. Daco, J.K. Honeyfield, E. Kouprianova, T.-M. Kudiwu, A. Lushin, M.Z. Maatan, W. Merz, I. Moon, T. Presečan, S. Rouai, D. Saha, J. Salleh, T.T. Schneider.

1. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director, Mr. Ouattara, reported on his recent travel to Benin, Ethiopia, and France.

2. CAMEROON—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Cameroon (SM/97/284, 12/11/97; and Cor. 1, 12/29/97). They also had before them a statistical appendix (SM/97/286, 12/16/97).

The staff representative from the African Department reported that, since the issuance of the staff report, the staff had received information confirming that the authorities had met the two structural performance criteria under the program supported by the Enhanced Structural Adjustment Facility, namely, the conclusion of an independent audit of the accounts of SNH, and the completion of a census of tax arrears and the elaboration of a strategy for their clearance. Moreover, the four structural benchmarks for end-December 1997 had also been observed. A staff mission to Cameroon in the first half of February would complete a comprehensive review of performance until end-December 1997. Economic activity had remained buoyant and consumer price inflation amounted to 2.8 percent over the year ending in November 1997.

Mr. Yao and Mr. N'guiamba submitted the following statement:

> The Cameroonian authorities appreciate the strengthening of their working relationship with Fund staff and management, during the design and the implementation of the current ESAF-supported program. They broadly share the staff's views on Cameroon's recent economic developments and medium-term prospects, and wish to express their commitment to the continued implementation of adjustment policies and reforms during the period ahead.
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> Cameroon's economic growth performance, which improved considerably under the 1996/97 staff-monitored program, has remained satisfactory during the first few months of the 1997/98 (July/June) fiscal year, though still below its potential. Indeed, the economic expansion that resulted from the 1994 CFA franc devaluation has continued with the annual rate of real GDP growth stabilizing at around 5 percent since 1995/96. Inflation is also under control. The end of period rate of inflation which was about 10 percent in 1996/97, because of a temporary shortage of foodstuffs associated with political developments in the subregion, has fallen below 3 percent in October and November 1997. The external current account deficit (including official grants) is narrowing and non-oil private capital flows are turning positive after the outflows experienced in recent years. The implementation of adjustment measures was also in line with the requirements of the program during that period. As a result, virtually all end-September benchmarks of the program were observed.
>
> Looking ahead, my Cameroonian authorities intend to pursue their efforts toward the reduction of fiscal and external imbalances. They will also

take actions required to eliminate the existing structural impediments during the medium term and beyond.

In the fiscal area, the results of government efforts have been so far encouraging. The primary budget surplus target was met during the first quarter of the current fiscal year. Total revenue was higher than targeted in the program, reflecting partly the impact of a major tax collection effort that was launched during the last quarter of the 1996/97 fiscal year. The national petroleum company (SNH) has also continued to transfer windfall gains to the budget. In addition, noninterest payment expenditure was contained. As a result of this improvement in the fiscal situation, Cameroon has not only substantially reduced arrears on its external debt, but has also remained current on its debt-service obligations to official bilateral creditors on post-cutoff-date debt and to multilateral creditors.

For the remaining period of the current fiscal year, the authorities are making efforts to achieve the fiscal targets of the first annual ESAF arrangement. While recognizing that the reform of forestry taxation is a key element in their plan to bring about an increase in non-oil revenue, they would like to indicate that they reduced temporarily the rates of forestry taxation in order to end a strike by the forestry industry a few weeks before the recent Presidential election. Despite this reduction, they are confident that the non-oil revenue target of the program can be met with an intensification of the collection of forestry taxes.

Meanwhile, the timing of the application of the tax rates originally assumed in the program is being negotiated with the view to increasing the contribution of the forestry sector to government revenue. Efforts are also being made to further improve tax administration, including the collection of tax arrears. Other revenue measures are aimed at combating fraud, with actions being contemplated against tax delinquents.

On the expenditure side, my authorities intend to enhance transparency and to ensure adherence to spending priorities. To improve their budgetary procedures and public expenditure management, they have already requested an FAD technical assistance mission which is expected to visit Cameroon during the course of this month. The composition of government expenditure will continue to show increases in the relative importance of spending for social services and infrastructure.

On the wage policy, it is important to indicate that total real wages and salaries of government employees have declined significantly in recent years. In order to strengthen public administration and improve the quality of civil service, there will be a gradual introduction of a wage scale and benefits system which will reverse the severe wage compression incurred since 1993, within the limits of the annual wage bill. The settlement of domestic debt arrears is another important expenditure component. In that regard, the government intends to continue to service the securities issued for the pre-1993 domestic payments arrears and the restructuring of the banking system.

In the monetary area, the rehabilitation of the banking system has now been completed. However, a number of actions still need to be taken in order to improve the quality of financial services and restore confidence in the banking system. To achieve an efficient allocation of credit in Cameroon and other member countries of the Banque des Etats de l'Afrique Centrale (BEAC), my authorities strongly support the use of indirect instruments of monetary policy. They also share the view that the independence of the regional banking commission (COBAC) must be strengthened and its prudential requirements observed by all commercial banks. To that end, Cameroon supports COBAC's plan to reinforce its team of bank supervisors by hiring additional inspectors.

On the structural front, many advances have already been made and the authorities intend to continue the implementation of measures aimed at improving the efficiency of the economy. Concerning the reform of the public enterprise sector, considerable progress has been achieved with the privatization of some government-owned units. While contemplating the privatization of other enterprises that are in the pipeline, it is important to indicate that the authorities' objective is not simply to transfer ownership to private interests, but to make the Cameroonian economy more competitive. The government is therefore ready to remove itself from productive activities that could be more efficiently performed by the private sector. Guided by this principle the authorities have now offered the agricultural enterprise (SOCAPALM) and the railway company (REGIFERCAM) for sale.

In the energy sector, transparency concerns are now being addressed more forcefully. To make the operations of SNH more transparent, an audit of its accounts by an independent agency has been completed as envisaged in the program. Actions to liberalize the energy sector are also being taken. In that context, an automatic monthly adjustment mechanism for petroleum prices to reflect changes in international prices has been introduced and the elimination of the national oil refinery's monopoly on the supply of refined products is expected by June 1998. In the transport sector, progress has been made toward the liberalization of maritime transport, with the adoption by the Parliament of the legislation to eliminate all cargo preferences and its recent promulgation into law by the President of the Republic consistent with the program.

Finally, my authorities believe that the recent inclusion of opposition parties into the government creates a favorable environment for a national consensus around the ongoing adjustment efforts. This consensus will provide a new impetus for the implementation of policy and structural measures during the years ahead. They believe, however, that the full success of these efforts will also depend on their ability to mobilize foreign resources. Therefore, it is essential that disbursements from bilateral and multilateral donors take place in a timely manner, in order to cover the financing needs for 1997/98 and the medium term. They look forward to continued close cooperation with the Fund.

Ms. Patel made the following statement:

The Cameroonian authorities' determination in establishing macroeconomic stability through prudent policies supported by appropriate structural reforms is well attested by the substantial progress that has been made over the past few years, in improving economic performance. Implementation of adjustment measures under the Enhanced Structural Adjustment Arrangement approved last year remains broadly in line with the program objectives as reflected by the major macroeconomic and financial indicators. Although below its real potential, GDP growth remains high, inflation has maintained a downward path despite a temporary increase, and both the fiscal and the external current account positions have been further strengthened. Progress in several areas of structural reforms has also been significant, notably the rehabilitation of the banking system.

The adopted economic strategy has proved to be the right approach and now the challenge for the authorities is to stay the course and take advantage of the progress made to intensify the adjustment process, particularly, in the areas of fiscal consolidation and structural reforms. The determination with which the authorities will continue to implement these necessary adjustment measures will help to ensure a more stable macroeconomic environment and enhance the credibility of their efforts, fundamental to encouraging private initiative, from both domestic and foreign investors.

Regarding the fiscal area, notwithstanding the significant improvements made recently, strict adherence to strengthened fiscal discipline is important to ensure the attainment of the medium-term goals as envisaged in the program. The maintenance of sizable primary budgetary surpluses, in part due to large windfall oil revenues, will continue to assist the authorities' efforts to reduce the public debt, and thus reduce the extremely heavy burden of the debt service on the budget, presently amounting to 40 percent of current expenditures. However, due to the variable nature of the oil price in the international markets, it becomes even more important that more emphasis be placed on reinforcing the non-oil tax revenue, especially through increased efficiency of the tax administration and enforcement of tax collection and reducing subsidies. In this regard, we note from Mr. Yao and Mr. N'guiamba's statement, that the authorities not only consider the unavoidable reduction in the taxation of the forestry sector as a temporary measure but are confident that strict collection of the sector's taxes will help to secure the attainment of the revenue target. While the rationalization of the tax system is also an important component of reform in this area, we share the concerns expressed by the staff against an early introduction of a value-added tax (value-added tax) unless the necessary technical and administrative conditions are in place to ensure a smooth transition. Although most of the fiscal consolidation effort will have to rely mainly on enhancing revenue performance, the authorities will need to maintain tight control over expenditure while endeavoring to improve expenditure management through adequate prioritization of outlays. Given the large share of the wages and salaries in the budget, accounting for one-third of the recurrent outlays, tight control of the wage bill is critical for improving the sustainability of the fiscal position. In this respect, while we agree that the measures being taken to remotivate the civil servants are necessary and steps are being taken to reduce the personnel, it appears that the current situation requires further substantive efforts to rationalize the civil service employment, by limiting recruitment and eliminating redundancy.

It is encouraging to note that through the recent economic progress the authorities managed to reverse the decline in per capita income. However, poverty is still widespread and the social indicators remain amongst the worst. Therefore, directing resources toward improving the quality of the basic social services, such as education and health, is paramount and should be accorded priority in spending allocation. Measures to diversify the economy and promoting labor-intensive, small-scale entrepreneurship could assist in creating job opportunities, thus reducing the high unemployment rate and poverty level.

We commend the authorities for their prudent monetary policy that has contributed to maintaining inflation at a low level. Their efforts to finalize the rehabilitation of the banking sector are welcomed and will facilitate the transition to using indirect monetary policy instruments. In this regard, we are encouraged to note from Mr. Yao and Mr. N'guiamba's statement that the authorities intend to move in this direction. Meanwhile, expediting the independence of the regional baking commission (COBAC) and enforcing its prudential requirements would assist in strengthening the efficiency of the banking system.

Notwithstanding the recent debt relief under the Naples terms, external debt remains a heavy burden, both on the budget and on the balance of payments as demonstrated by the respective high debt ratios, and hinders an early return to external viability. Cameroon is a low-income country that has made significant strides to enhance its economic and financial prospects, and to which the traditional mechanisms of debt relief do not seem to provide an exit to its debt overhang. Could the staff indicate how far Cameroon will need to go before the country could be made eligible under the HIPC Initiative?

With these remarks we wish the authorities further success in their adjustment efforts.

Mr. Jourcin made the following statement:

I am gratified to see the progress made so far by Cameroon in implementing the program supported by the Enhanced Structural Adjustment Facility. Performance during the first quarter of 1997/98 was on track, and the prospects for meeting the end-December 1997 performance criteria and benchmarks are relatively good. There can be no doubt that Cameroon is going through a substantial adjustment process, as indicated by the significant results it has achieved since the previous Article IV consultation. While it is true that, given Cameroon's disappointing experience in the past, there no room for any complacency, there is also room for hope.

To summarize, I broadly share the staff view that Cameroon's encouraging progress thus far should be seen only as the beginning of the adjustment process. In the period ahead, it is imperative that the authorities fully confirm their commitment to macroeconomic stabilization and structural reforms. As well, their commendable efforts to normalize Cameroon's relations with the international financial community, and the debt relief granted in October 1997, need to be consolidated by strict observance of the Paris Club agreement. Since I agree with the staff appraisal, I wish to focus my comments on four items.

First, on the fiscal front, Cameroon must continue to increase non-oil revenues in order to meet the program's revenue targets. Despite the difficulties in implementing the forestry tax reform, it is still feasible for the authorities to reach the quantitative targets for non-oil revenues. As necessary, they should consider taking compensatory measures. As for forestry tax reform, I agree with the staff that the sector is currently undertaxed. While it should contribute significantly to increasing non-oil revenue, full implementation of the reform—like the introduction of the value-added tax—needs to be well prepared, and may require some change in its phasing within a tight time frame. Moreover, different phasing of the forestry tax reform should be seen as a means of achieving success, not as an effort to weaken the original reform package.

Second, I wish to emphasize that pursuit of civil service reform should remain a priority of the authorities, as it is a key element necessary to improve the management of the country and to promote good governance. To remotivate civil servants and to improve public administration, further steps are needed as soon as possible to rationalize the salary structure of the civil service.

Third, the public expenditure process remains unsatisfactory, and improvements are needed in all aspects of it. In particular, a strengthening of budgetary control and a better monitoring of expenditure execution are necessary to ensure adherence to spending priorities in favor of social sectors and infrastructure. I welcome the technical assistance that the Fund will provide in 1998 for a review of public expenditure management. Regarding another aspect of public expenditure, I support the staff's recommendation for the authorities to strengthen the performance of the debt-management agency, (CAA), including its management of data.

Fourth, I appreciate the authorities' substantial progress in the financial sector. Indeed, the positive effects of rehabilitation of the domestic banking system are currently being manifested in a gradual return of confidence. Like the staff, I encourage the authorities to help strengthen the independence of the regional banking commission (COBAC) and to ensure that commercial banks comply with prudential regulations.

Mr. Disanayaka made the following statement:

We commend the authorities for maintaining a very satisfactory track record in implementing important reform measures since the commencement of the staff-monitored program, particularly in the second half of fiscal year 1996/97. The authorities were able to make substantial progress in reorganizing the civil service, divesting public enterprises, securitizing domestic arrears, and rehabilitating the domestic banking system. These are admirable achievements, especially considering the country's track record.

Fiscal year 1996/97 also witnessed a strengthening of public finances, assisted in large measure by higher oil prices. Higher oil revenues have been used extensively by the authorities to clear a large portion of the arrears on external, nonreschedulable debt, which total about 5 percent of GDP. Overall economic activity in the country has remained buoyant in 1996/97. Furthermore, with the satisfactory progress in rehabilitating the ailing banking system, confidence appears to have returned to the system, as evidenced by the increased deposits and private sector credit growth. The country's external sector has also strengthened considerably, following strong growth of non-oil exports coupled with an increase in oil prices and exports.

The country's highly satisfactory performance under its previous staff-monitored program has continued into its ESAF-supported program as well. Indeed, Cameroon has been able to meet almost all the benchmarks for the first quarter of 1997/98 and to make substantial progress in meeting performance criteria and benchmarks set for end-December 1997. I am gratified to hear from the staff that the authorities have also met the end-December structural performance criteria. While these favorable trends point to the steady recovery of the economy over the medium term, it is too early to say that the country is fully set on that path; many important areas still require the authorities' urgent attention, if Cameroon is to consolidate its hard-earned achievements and to make further progress. As the staff report has commented lucidly on many of these aspects, I will limit my comments to a few areas that are of particular concern to my chair.

On the fiscal front, we encourage the authorities to complete the census of tax arrears and to formulate a strategy for their collection. While we are gratified to note that the authorities are preparing for the introduction of a value-added tax at the beginning of 1999, we encourage them to strengthen further tax administration and to make the latter better equipped to fight tax evasion. Like the staff, we would also like to see an early reinstatement of forestry taxes, which have been reduced drastically on an ad hoc basis, due to pressures exerted by the forestry industry, and which will result in substantial revenue losses of about 0.2 percent of GDP. We welcome the authorities' steps to improve public expenditure management, and hope that the Fund will be able to extend the technical assistance in the area that is desired by the authorities.

The staff report shows (Appendix IV) that social indicators, particularly on health, education, and income distribution, are unacceptably poor. We therefore encourage the authorities to carry out their plans to strengthen these sectors, and to alleviate poverty, expeditiously. These efforts should go hand in hand with a further deepening of structural reforms that the authorities are embarking upon.

We are encouraged by Cameroon's substantial progress in rehabilitating its banking system. Appendix III of the staff report discusses, inter alia, the measures that the authorities hope to take in the near term toward further strengthening of the system. Table 1 of this appendix shows that, despite the rehabilitation achieved thus far, some of the major banks have yet to meet some key prudential ratios. They have to be encouraged to meet these ratios at an early stage, through closer monitoring. In this connection, we are glad to learn that the government has started reducing its ownership and management of these banks, which will go a long way toward improving the efficiency and competitiveness of the banks. Incidentally, the chart at the bottom of Figure 4 in the staff report shows that there is a substantial margin between deposit and lending rates in the banking system, which has widened further in fiscal year 1996/97. I wonder if the staff would comment on why intermediation costs have risen to such high levels. We welcome the reforms being launched in the insurance sector as well as in the social security fund (CNPS).

We commend the authorities for undertaking bold reforms in the civil service, but note that the salary structure remains too low to attract and retain competent staff. In fact, the present median civil service salary—even after the recent substantial increase—remains at about 60 percent of the level prevailing 12 years ago. A realistic salary structure therefore has to be implemented soon, in tandem with increased revenues and further rationalization of staffing.

We encourage the authorities to proceed rapidly with privatization of the parastatals slated for divestiture, particularly as there are many parastatals that still need to be prepared for their ultimate divestiture. In particular, the authorities have to expedite privatization in the telecommunication and energy sectors.

The authorities have made commendable progress over recent months in reducing arrears on their external debt and in remaining current on obligations falling due. We encourage them to continue their efforts relentlessly, and thereby to regain credibility in international financial markets and to improve their relations with creditors. The authorities should proceed rapidly to conclude bilateral agreements with Paris Club creditors, and reach agreements with non–Paris Club, official and commercial creditors on terms at least comparable to those provided by the Paris Club.

Mr. Rodríguez made the following statement:

I commend the staff for its concise yet informative report, and generally agree with its views. The economic performance of Cameroon has been very satisfactory, with high real growth rates of GDP and declining inflation. Progress in public finances and structural reform, particularly in the areas of banking rehabilitation and privatization, has also been noteworthy. Moreover, the authorities' implementation of their program supported by an Enhanced Structural Adjustment Arrangement has been encouraging. For all of their efforts and accomplishments, the authorities are to be commended.

Poverty in Cameroon remains a cause for serious concern. According to the staff report, it may even have increased over the past decade or so, and is far more pervasive in rural than urban areas. While economic growth should help to alleviate poverty, it is also essential for the authorities to improve health and education, because the latter directly affects poverty, and might, in fact, contribute to growth through positive externalities. Accordingly, it is necessary to increase the share of spending on education and health in the budget. To achieve this, while preserving macroeconomic stability, I urge the authorities to improve their capacity to collect taxes; to reorganize their tax department; eliminate company-specific tax privileges; and to proceed cautiously caution with the planned introduction of the value-added tax.

The originally intended forestry tax has not yet been implemented, and the authorities must reach agreement with the forestry industry to ensure that the tax will be introduced in full, especially because of its environmental impact. From a fiscal point of view, the authorities should adopt compensatory measures to the extent that they are needed, taking into account the fact that revenues from the forestry tax might end up to be higher than envisaged originally under the program because of the rapid expansion of logging activity. Although the latter expansion might be good fiscal news, the implicit further deterioration of the environment that it entails is disappointing, and reinforces my conviction that the forestry tax should be introduced in full.

On the expenditure side, the scheduled technical assistance by the Fiscal Affairs Department is welcome. The strengthening of budgetary control and monitoring of its execution should enhance the effectiveness of public spending, which is particularly important in the case of social programs. In addition, an improved budgetary process may help to shift the allocation of expenditures toward infrastructure, education, and health. Nevertheless, besides requiring the strong commitment of the institutions involved, such changes often require considerable time before they bear fruit.

The reorganization of the civil service has been positive, and the plans to continue rationalizing the pay structure are welcome. As has been the case in many countries, tight fiscal policies over long periods of time often lead to a compression of the wage structure, which is unsustainable in the long run. Besides losing the best public employees and demoralizing the rest, it may even induce questionable practices among public employees in key areas. In the case of Cameroon, according to the staff report, this wage policy may even have contributed to increased poverty. A new wage policy would therefore be desirable, as long as an appropriate incentive structure is adopted and as long as it does not lead to an increased fiscal deficit.

It is encouraging to read in Mr. Yao's and Mr. N'guiamba's statement of the authorities' commitment toward improving the competitiveness of the economy, by relying on private sector initiative. In the energy sector, in particular, the completion of the independent audit of the national oil company and the adoption of an automatic monthly adjustment mechanism for petroleum prices are welcome steps in this direction. Similarly, the offering for sale of the agricultural enterprise and railway company; progress in the liberalization of maritime transport; and the steps to be taken to reduce the production costs of public utilities should serve to enhance growth prospects.

Regarding the financial sector, recent events in Southeast Asia have underscored the need to strengthen prudential regulations and increase transparency in banking operations. Indeed, Cameroon has also had some experience in this area in the past. Accordingly, I encourage the authorities to consolidate their current bank restructuring program, further strengthen the regulatory framework, and curtail political influence in banking operations.

Mr. O'Loghlin made the following statement:

First of all, acknowledgment where acknowledgment is due. Cameroon has delivered on the current program's quantitative and structural benchmarks in the quarter to September. Even if this outcome was strongly supported by the revenue and other impacts of an unanticipated buoyancy of oil prices, it is nonetheless a welcome change from the poor performance which was characteristic under previous arrangements.

I also note that the Cameroon has remained current on emerging debt-service obligations, while apparently overperforming in terms of discharging external debt payment arrears. But while this is heartening at first glance, the longstanding practices of running up arrears and resort to other nonconventional means to finance gaps between expenditures and revenues (like the long-run trend growth in credit taken by government from public enterprises noted in Table 24 of the statistical appendix) is debilitating for the economy, and must be permanently ended.

Since I agree with the general thrust of staff recommendations, and other speakers have well covered the ground in relation to monetary and structural issues, I will confine my remarks to a few points in the public finance area which seem to me to deserve particular emphasis. A quick review of public finance developments indicates that the staff is right to stress that recent performance provides no grounds for complacency. There seem to me to be three critical matters, at least.

First, the revenue base has to be broadened substantially—as is rightly envisaged in the staff's medium-term scenario. This is vital in order to sustain the improvement in the overall public finance balance of the past year, and to support confidence in public management of the economy—and, hence, economic prospects—while strengthening crucial aspects of public services. Why the latter? Indicators of educational and health standards in the Cameroon show a dire need to strengthen the relevant aspects of social provision. Poverty data emphasize the importance of developing, and implementing, the proposed anti-poverty strategy. And the low level of public investment of recent times strongly suggests a need to increase investment in key economic and social infrastructure. Adequate progress in these respects does not seem plausible through a reorientation of priorities within an unchanged level of government spending—hence the necessity to raise the revenue/GDP ratio.

Second, raising the revenue/GDP ratio will require much greater determination on the part of the authorities than is apparent thus far. The improvement in the overall fiscal balance through 1996/97 is scarcely a signal of that stronger determination. It reflected very largely, instead, the ephemeral benefits on the public finances of windfall revenues associated with higher than anticipated oil prices, as is clear from the expectation of a significant drop in oil revenues this fiscal year. Thus, last year saw a disappointing failure to take advantage of renewed economic growth to push up the non-oil revenue/GDP ratio to any worthwhile degree; and the recent row-back on the proposed revisions to the taxation of forest-related activity do not clearly augur greater determination this year. In this context I strongly support the staff's call to the authorities to reinstate the original forest tax reform package rapidly. Improved tax administration is also vital to help ensure that the revenue ratio rises appropriately this budget-year, inter alia by taking steps to seriously combat fraud. The news that the census of tax arrears and a strategy for their collection have been completed is particularly welcome in this context. However, arrears collection—like the windfall gains from the oil sector—can afford temporary relief only; and there are limits to the taxable capacity of forestry.

A third key medium-term requirement, therefore, is to broaden the tax base otherwise. I note that a value-added tax is planned for 1999. Additionally, the significant discrepancies between statutory and effective tax rates, to which the staff refers, suggest that there is significant scope for other base-broadening—to the extent that discrepancies do not reflect either fraud or poor collection otherwise. Perhaps the staff might comment on some of these discrepancies, in order to illustrate the possibilities, and thus enable the Board to encourage the Cameroonian authorities appropriately?

With these remarks, Chairman, I wish Cameroon every success in the future, and hope in particular that the authorities will maintain in the future the degree of program observance of the first quarter of 1997/98.

Mr. Singh made the following statement:

Like other speakers, we welcome Cameroon's recent positive economic developments. During 1996/97, economic activity remained robust, while the inflation rate declined. Public finances were strengthened and a number of structural reforms were carried through. This encouraging performance is, however, partly due to higher than expected oil prices and follows a poor track record under the past four Fund-supported programs. Caution in assessing the situation is therefore warranted, as much still remains to be done.

For instance, non-oil revenue collection should be strengthened, if the 1997/98 target for the overall budget deficit is to be reached and social and infrastructure expenditure increased. Progress in this direction will depend to a great extent on the motivation and the adequate remuneration of civil servants. In this respect, we welcome the authorities' decision to unfreeze promotions.

However, this measure still leaves the median civil servant with a nominal salary about 40 percent lower than what he earned twelve years ago. In addition, wide discrepancies in the salary structure remain between employee categories and between sectors. In such circumstances, it could be feared that civil servants' incentive to undertake undesirable practices will not be reduced and progress in tax collection be limited.

Improvement in non-oil revenue mobilization will be further hampered if certain sectors of the economy are able to negotiate reductions in their rates of taxation. The agreement reached between the authorities and the forestry industry is therefore a worrisome development. Although the authorities view these reductions as only temporary, such ad hoc agreements should be resisted. We would encourage them to reverse this adverse signal by carrying through the original tax reform as soon as possible.

Another area where caution is called for when assessing progress is the financial sector. We welcome the completion of the rehabilitation of the banking system and the gradual return of confidence indicated by the recent strong increase in deposits. Despite these positive developments, however, the sector remains vulnerable.

The authorities still appoint board members in several banks and could easily interfere with business decisions. Moreover, while most banks meet key prudential ratios, these ratios are much more generous than those recommended by the Basle Committee. The observation, therefore, that three banks representing more than 60 percent of total deposits have an exposure to single customers in excess of 75 percent of regulatory capital raises some concern. The staff's comments on this issue would be appreciated.

Experience has shown that the combination of government intervention in the banking sector, lax prudential regulations and limited supervision has to be handled with great care. We would thus join the staff in its recommendations to remove as fast as possible any political interference in banking decisions and to help strengthen the regional supervisory authority. We would also suggest that the COBAC implement fully the recommendations of the Basle Committee as soon possible.

This being said, we encourage the authorities of Cameroon to build on the good performance they have demonstrated during the first quarter of 1997/98 in the implementation of their Fund-supported program and wish them good luck.

Ms. Brettschneider made the following statement:

The quarterly monitoring arrangement under Cameroon's ESAF arrangement in no way detracts from the importance of today's discussion of Cameroon's Article IV consultations. Given the country's history of veering off-track of Fund programs, we need to capitalize on every opportunity to convey to the authorities that the Board is keeping a watchful eye on developments.

Today, much of the news in this initial stage of the program appears to be positive. Growth has rebounded and prospects are good for a continuance of that trend; the budget situation has strengthened considerably, although it is unclear how much of that improvement stems from sound reform or from accommodating world oil prices; arrears on external debt have been reduced; and renewed confidence in the banking sector following rehabilitation efforts has led to a nascent resumption of capital inflows and a stronger balance of payments position.

Having said that, many—if not most—of the problems noted in our previous discussions of Cameroon remain entrenched. In the fiscal area, tax administration continues to be weak and opportunities for fraud remain extensive. The backtracking on the restructuring of forestry taxes in response to pressure from forestry insiders is particularly worrisome, given the multiple negative effects on revenue, governance, and the environment. We join the staff in calling for the immediate reinstatement of the initial forestry tax reform provisions as agreed by parliament and committed to in the letter of intent. The manner in which the backtracking on those commitments took place—with no prior communication with the Fund staff—sends a disturbing signal that the necessary political will to carry out this program may not be assured. The authorities would do well to heed the advice of the World Bank in designing a forestry policy that not only strengthens non-oil revenues, but that also manages this exhaustible resource in a sustainable way.

Strengthening expenditure management is another top priority in the months and years ahead. We welcome the authorities' request for technical assistance in this area. Bold—and politically difficult—steps need to be taken to make the expenditure process a transparent one in order to eliminate opportunities for off-budget transactions and other avenues for corruption. These objectives become even more important in view of the need to redirect spending to social sector priorities. I was particularly struck by Appendix IV of the staff report, which noted that the incidence of poverty has increased over the past decade, with 50 percent of the population now below the poverty line, and that rural/urban discrepancies in social indicators have deteriorated significantly.

The initial response of capital markets and local depositors to Cameroon's bank restructuring efforts has been encouraging, but much more is needed to improve financial intermediation to enable the sector to better support private sector development. Fully eliminating government involvement in the banking sector—the pervasiveness of which is made clear by the fact that the Boards of Directors of four major banks are chaired by government officials—is a prerequisite if a clean break with Cameroon's history of nonperforming loans and other banking sector weaknesses is to be made. Enhanced banking supervision will also be key, and we welcome the authorities' intentions to reinforce its supervision team. Indeed, the broad framework for banking sector reform, as outlined in the appendix to the staff report on these matters, appears to be well placed, and we look forward to continued vigilance on the part of the authorities to follow through with those plans.

The staff's confirmation that the structural performance criteria and benchmarks have been met is encouraging. We welcome the completion of the national oil company audit, and look forward to hearing the results as soon as they become available. As others have noted, liberalization and transparency objectives are especially relevant in the energy sector. We hope privatization of the rubber company and the issuance of additional tenders are indications privatization momentum is finally increasing.

The recent progress on consolidating the civil service is also noteworthy, although it must be kept in mind that departures of civil servants are only now catching up to the pace that had been envisioned a few years ago. We agree that civil service salary increases can only be conditioned on revenue enhancements, further rationalization of the civil service, and, I would add, on improved performance of the civil service in general.

I would close by asking the staff to comment on Cameroon's and the common external tariff (CET) structure of the Central African Custom Union (UDEAC), which is briefly described in footnote 7 on page 11 of the staff report. The CET range of 5 to 30 percent in Cameroon provides excessive protection at a time when the growth prospects of the country, and the region as a whole, hinge on increasing competitiveness. UDEAC's external tariff regime also appears to be much less ambitious than that of the West African Economic and Monetary Union, which has both lower and fewer tariff rates.

Mr. Al-Turki made the following statement:

Cameroon's adjustment and reform effort is broadly on track. Last year, the fiscal and external positions improved and substantial progress in structural reform was made. The economy has also remained responsive with robust growth and a continued drop in the underlying rate of inflation. However, additional macroeconomic and structural improvements are essential to sustain a vigorous recovery.

The continued emphasis on fiscal consolidation is well-placed. Given the planned increase in social and infrastructural spending, a sharp improvement in non-oil revenues is critical for this year's projected surplus. Early action to implement the original forestry tax reform and correct deficiencies in tax collection is therefore essential. On the spending side, the priority for improved management of outlays and further civil service rationalization is welcome.

The authorities are to be commended for the extensive reforms to the banking system. Such reforms have gone a long way toward restoring confidence, as evidenced by last year's rise in net foreign assets and domestic banking deposits. However, further effort is necessary to build on these gains and establish an efficient financial intermediation process. The agreed plan of action outlined in the report is reassuring in that regard.

Enhanced policy credibility has been a major contributor to strengthening the external payments outlook. Early regularization of relations with all creditors will only add to this credibility. In this connection, I welcome the authorities' renewed commitment to clear arrears and to remain current on nonreschedulable external debt.

Regarding structural reform, the program's focus on privatization and further liberalization is appropriate. The extensive ongoing reform of the energy sector is also encouraging. However, in paragraph 26, the staff expresses disappointment over allowing certain deductions to oil producing companies with significant revenue losses to the budget. I will appreciate if the staff elaborates the issues in that regard.

With these comments, I wish the authorities further success.

Mr. Fujii made the following statement:

At the outset, I would like to thank the staff for its intensive work not only on the Article IV Consultation paper, but also on the quarterly report following the Board's request.

It is welcome that the authorities have achieved good economic performance since the approval of the Enhanced Structural Adjustment Arrangement last August. However, as the staff correctly pointed out, this is only the beginning of the adjustment process, and the authorities therefore should make more efforts toward sustained growth and solid external viability. I hope that the authorities will maintain their reform momentum.

I share the thrust of the staff's policy recommendations and will limit my remarks to just a few policies.

On the fiscal front, it is encouraging that the primary balance target for the first quarter of 1997/98 as well as for 1996/97 was met, owing mainly to windfall oil revenues and the containment of noninterest primary expenditures. At the same time, however, I share the staff's disappointment that the authorities were pressured by the forestry sector to weaken the forestry tax reform. The non-oil revenue base remains very weak and it is urgent to establish a stable revenue basis without depending on windfall oil revenues. More important, at the discussion last August, many Executive Directors referred to the authorities' past bad track record. In addition, in order to receive assistance from the international community, including possible debt relief, the authorities need to show a sincere commitment to adjustment. I therefore urge the authorities to reinstate the original package of forestry taxation as soon as possible. Acceleration of preparation for the value-added tax is also important.

Various kinds of structural reform should be implemented to stimulate private sector activity and achieve sustained growth. I would especially note the importance of deepening financial intermediation by eliminating the remaining political interference in banking decisions, as well as accelerating privatization by extending its scope to the public utilities. The implementation of a financial audit of the national oil company by an internationally reputable accounting firm is an important step toward improvement of transparency and efficiency in the energy sector. In light of the importance of transparency in the energy sector, I urge the authorities to implement in a timely manner the programmed reforms, including the introduction of an automatic monthly adjustment mechanism for petroleum prices and the elimination of the national oil refinery's monopoly on the supply of refined products.

With these remarks, I wish the authorities every success.

Mr. O'Loghlin remarked that he wished to clarify his earlier comments by noting that public enterprises had been in a "net due" financial position vis-à-vis the government in 1997, which he expected would continue. Rather than relying on such financing—equivalent to obtaining credit from the public enterprises—the government should have budgeted the sums appropriately. Strictly speaking, it was correct that such nonconventional financing differed from the accumulation of arrears. Nonetheless, he wondered if the staff would comment on a discrepancy between the table on central government financing, indicating that external arrears had increased in the first quarter of the year by CFAF 5 million, and the overall assessment that arrears had fallen.

The staff representative from the African Department remarked that Cameroon had cleared 90 percent of nonreschedulable arrears (or previously deferred arrears under Article III.8.b), which was well ahead of schedule. Only about CFAF 9 billion in arrears remained to be cleared, which the authorities intended to do in early 1998, ahead of schedule. Technically speaking, the authorities had accumulated some reschedulable arrears up until the Paris Club meeting on October 24, 1997, at which time those arrears had been regularized.

Diplomats and some nongovernmental organizations and export-processing zones had been granted legitimate tax exemptions, the staff representative indicated. However, the staff was concerned about some of the unnecessary, ad hoc exemptions that had been granted to private and public enterprises, and in the area of public procurement. The staff hoped that the authorities would deal with all of those exemptions when they introduced the value-added tax.

The program included a gradual elimination of export duties—other than in the forestry sector—the staff representative remarked. The authorities had reduced those duties from 13.5 percent to 10 percent in 1997/98. Cameroon's highest import duty (30 percent) was lower than the maximum rate allowed under UDEAC (35 percent). While there was no formal program or timetable to reduce external tariffs further, informal simulations had been conducted to examine the impact of lower tariffs on revenues, which needed to be kept in mind.

Regarding the question of Cameroon's possible eligibility for the HIPC Initiative, it should be borne in mind that the country's debt to multilateral institutions was only some 17 percent of its total debt, the staff representative pointed out. The vast majority of Cameroon's external debt was owed to bilateral creditors. After debt relief, the ratio of the net present value of external debt to exports was well below 200 percent, while the ratio of government revenues to GDP was 23 percent and should decline subsequently. Cameroon's eligibility for the initiative would be reexamined once the country moved closer to the decision point, and should not be precluded at present.

The spread between the minimum deposit rate and maximum lending rate in Figure 4 of the staff report was not a good measure of the interest rate spread, particularly as both were nonbinding, the staff representative explained. The average cost of funds was about 16 percent, and average return on deposits was higher than the minimum deposit rate depicted in Figure 4.

The prudential ratio of 5 percent required by the regional supervisory authority (COBAC) included the "risks" associated with bank credit to the government, the staff representative said. If one excluded the latter, the prudential ratio was broadly consistent with—or perhaps even more stringent than—the 8 percent ratio required by the Basle Capital Accord. The staff believed that COBAC's requirement of a limit of 75 percent of regulatory capital for exposure to single borrowers, or group of borrowers, was too high, and the staff had urged the authorities to lower it.

Prior to 1990, exploration costs of dry oil wells had not been tax deductible, but since then such costs had been deductible for up to 30 percent of the value of oil production, the staff representative recalled. To the staff's understanding, much of the disputed oil explorations had taken place prior to 1990. The special agreement or "convention" limiting the tax deductibility of dry oil wells had been allowed to expire because of some supposed oversight. The resulting dispute between the government and the foreign oil company had been arbitrated, with the arbitration tribunal ruling that the oil company would be allowed to deduct from taxable income its exploration costs. As a result, the oil company had not paid income tax in 1996/97 on its 1995/96 profits, which had been substantial; and it had paid only CFAF 1.5 billion in taxes in 1997/98 on its 1996/97 profits. An additional problem, which had not yet been resolved, was the issue of whether the pre- or post-devaluation exchange rate should be used in calculating the tax deduction, which was complicated by the fact that exploration costs were denominated in dollars.

Ms. Wang made the following statement:

> The Cameroon authorities are to be commended for their achievements in economic growth, inflation control, and structural reform, especially for their observance of all end-September and December benchmarks under the ESAF-supported program. As I am in broad agreement with the staff appraisal, I will emphasize the following points.
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> The main objectives of Cameroon's medium-term strategy are to place the economy on a sustainable growth path and to restore internal and external viability. In order to achieve these objectives, the authorities' commitment and determination to macroeconomic stabilization and structural reforms are of critical importance. The encouraging developments made so far in implementing the ESAF-supported programs should be seen only as the beginning of the adjustment process, and the authorities are encouraged to maintain and strengthen their commitment and determination for the entire program period.

It is encouraging that some improvement has been made in the conduct of fiscal policy, however, given the significant role that fiscal policy has played in the successful implementation of the program, the weaknesses which remained in both revenue-raising capacity and expenditure management should be taken seriously. Decisive measures should be taken to fight against fraud and improve tax administration, and the increase of revenue should be at least in line with the economic growth rate. In this regard, I agree with the staff that the original forestry tax reform package should be reinstated as soon as possible. In order to lay a solid basis for future growth and development, the spending priorities in favor of social service and infrastructure should be insisted upon, and I am very pleased to learn from Mr. Yao and Mr. N'guiamba that the Fund technical assistance mission, in an effort to enhance the authorities' ability of expenditure management, will visit Cameroon during the course of this month.

Cameroon's external viability cannot be restored with the existence of a heavy external debt burden. In this context, the recent Paris Club agreement to grant Cameroon debt relief is welcome and the authorities are encouraged to progress rapidly toward concluding bilateral agreements with the Paris Club creditors.

With these remarks, I agree with the staff appraisal and wish the authorities greater success in the future.

Mr. Otazú made the following statement:

Since 1994, the performance of the Cameroonian economy has been improving. Per capita growth has been reasonable, inflation is declining, in spite of highly fluctuating trends, non-oil capital flows are turning positive and the fiscal and current account deficits have declined considerably. However, the challenges facing the authorities are many.

As is underscored in the background studies, external competitiveness is key to Cameroonian growth given the economy's relatively high degree of openness. Since more than three quarters of the country's trade is conducted with the industrialized world, the sustainability of growth depends heavily on keeping inflation low and on adequate safeguards for private sector activity, especially private property rights. As a member of the CFA franc zone, Cameroon's monetary policy cannot correct a weak fiscal policy, lack of wage restraint or a weak banking system. I therefore endorse the staff recommendations in those areas, and would like to comment briefly on fiscal policy and banking and structural reforms.

On the fiscal front, while some progress has been made since the realignment in 1994, it is disappointing to see that performance has been faltering in the last years. Noticeable weaknesses remain in both revenue-raising capacity and expenditure management. In addition, although expenditures have been declining as a percentage of GDP since the beginning of the last decade, this trend has been mainly the result of a steady erosion of public investment, which is extremely low (1.4 percent of GDP), and of outlays for basic social services, which are almost nonexistent. This situation itself should be corrected to avert the failure of the program, due to adjustment fatigue and social unrest.

Since the budget is the principal instrument of macroeconomic policy moving in the direction of internal and external balances, the recently enacted legislation to introduce a simple and integral revenue system, which eliminates exceptions on forestry and non-oil revenue services, broadens the tax base and incorporates modern and accessible tax collection techniques, is welcomed. However, these changes should be rapidly implemented. On the expenditure side, it is essential to enhance transparency, to contain and to ensure adherence to spending priorities in favor of basic social spending and infrastructure. If carried out FAD technical advice in the area of budgetary execution could substantially serve to reinvigorate the public finances. To find a rapid solution for domestic debt and payments arrears that represent some 33 percent of total public expenditure, is also imperative for the stability of the current program.

On financial policy, the authorities should take a leading role in applying indirect monetary policy instruments of the BEAC reinforcing the independence of the regional banking commission (COBAC), and ensuring that the prudential requirements are observed by all commercial banks, and incorporated the Base Committee recommendation as soon as possible. The rise in money velocity and the increase in the money demand noted by the staff in Table 8 and paragraph 5 of EBS/97/215 entails contradiction and I would welcome more clarification from the staff. Regarding this issue, I have some doubts if it exists, at present, one appropriate and accurate methodology to measure money demand in Cameroon.

On the structural side, the staff notes that, "the progress made in preparing for the privatization of the agricultural parastatals and the railways company, and calls for an acceleration in such preparations for the remaining parastatals slated for privatization." This is detailed in Mr. Yao's helpful statement. Regrettably, this intention has been expressed since 1996. In this regard, I urge the authorities to adopt a clearer and more realistic stance that includes an acceleration in the privatization and liquidation process during the period of the ESAF Arrangements, which would give the opportunity to take fullest advantage of "the political agreement time," and suggests the need for bold policy initiatives, particularly in the energy and transport sectors, public enterprise reform and transparency.

Considering that the two quantitative performance criteria and a quantitative benchmark are of a technical nature and do not affect the macroeconomic characteristics of the program supported by the ESAF arrangement. I support the request for modification of the three-year and first annual arrangements under the ESAF for Cameroon and I wish the authorities well in their difficult endeavors. But I again express my doubt regarding the sustainability of the program on time. This is in connection with the first question.

Mr. Iradian made the following statement:

Like previous speakers I would like to note the commendable progress in economic management which has certainly been evident in Cameroon during the past two years. Economic growth remained strong, the 12-month inflation rate in October 1997 fell to 2.6 percent, both the external and internal imbalances narrowed, and Cameroon has remained current on its debt-service obligations. These achievements, however, should not lead to any complacency on the part of the authorities. I broadly agree with the thrust of the staff's appraisal and policy recommendation and will limit my remarks to the public sector.

Further fiscal consolidation should rely on revenue enhancement since further meaningful cuts do not appear to be feasible in most expenditure categories, especially in view of the very pressing needs for social outlays and investment in infrastructure to promote higher economic growth. In this respect, I urge the authorities to fight fraud, improve tax administration, and broaden the tax base.

Fiscal discipline, when combined with improving efficiency in the public sector and a diversification of domestic production and exports, would enhance the prospects for sustainable higher rates of economic growth through increased investment and savings. In this regard, we welcome the steps taken to liberalize the energy and transport sectors and encourage the authorities to press ahead with the privatization of the loss making public enterprises. In addition, developing the physical and human infrastructure will enhance Cameroons' growth prospects.

Finally, I would like to raise a question on the size of the public sector in the economy. Table 6, shows that noninterest expenditure of the Central government is currently less than 10 percent of GDP. Table 24 of the statistical appendix also shows that the value added by the public enterprises is estimated at only 3 percent of GDP, and overall these enterprises were profitable in the past three years. Moreover, the size of the public sector employment as a share of the labor force appears to be relatively small. Against this background, I am surprised that the staff is recommending further reduction in the public sector's share in the economy. Staff clarification of this issue would be appreciated.

Mr. Hammoudi made the following statement:

As indicated in Messrs.Yao and N'guiamba's statement, the Cameroonian authorities have achieved encouraging economic progress. Real GDP growth has increased and inflation has decelerated after a burst in June 1997. I note with interest the improvement of the fiscal position, which has been some time the Achilles's heel of Cameroon. Moreover, the external position is strengthening with a decreasing current account deficit. On the structural front, the measures taken by the authorities demonstrate their commitment to the reforms.

Since I am in broad agreement with the authorities' policies and the staff's conclusions, my comments will be brief.

In the fiscal sector, while I welcome the actions taken to render the oil revenues accounting more transparent and to rationalize the expenditures and control the wage policy, the authorities are encouraged to continue strengthening the public finances, with priority to the amelioration of the tax administration and the rehabilitation of the socioeconomic infrastructures, such as the port of Douala that is essential for the country's economic development.

In the monetary sector, the restructuring of the banking sector will certainly improve management and introduce efficiency in this sector. I agree with the staff that implementing indirect monetary instruments, as suggested by the BEAC, will strengthen the resource allocation.

In the structural area, continued reforms are needed to diversify the economy in order to reduce Cameroon's dependency on oil revenues, which international prices are very volatile. In this regard, I welcome the actions already taken by the authorities, however, further developments are needed to restructure and privatize, when it is possible, the public-owned utilities. In this context, the social sector should not be forgotten in all this reform process, in order to alleviate the increasing poverty.

Finally, Cameroon needs financial and technical assistance from the international community in order to succeed in their adjustment efforts. In this respect, the country's eligibility to the HIPC should be considered.

With these remarks, I wish the authorities every success in their endeavors.

Mr. Donecker made the following statement:

As I broadly agree with the thrust of the staff's analysis and recommendations, and concur with most of the remarks of previous speakers—particularly Ms. Brettschneider, and Messrs. Jourcin, O'Loghlin, and Fujii—I will only make a few comments.

In light of Cameroon's unsatisfactory track record with Fund-supported and staff-monitored programs, it is indeed remarkable and commendable that the authorities have met the targets of the current program supported by the Enhanced Structural Adjustment Facility. I certainly also welcome the fact that Cameroon's payment behavior has improved considerably, which has strengthened the confidence of the international donor and creditor community. In this context, I strongly support the staff's recommendation to further enhance those confidence gains by a timely repayment of all nonreschedulable external debt.

I have three areas of concern. First, the authorities must reduce payment arrears, the current account deficit, and make progress in fiscal consolidation which has been facilitated so far by windfall oil profits. As other speakers have stressed, the authorities urgently need to increase non-oil revenues, by taking the measures recommended by staff; this task has been made even more urgent because additional—and necessary—liberalization steps are likely to reduce custom revenues. In this context, as noted by the staff and Mr. Jourcin, the weakening of the forestry tax reform is clearly counterproductive.

Second, public expenditures should be restructured. The needed increase in education and the health expenditures should be financed by expenditure cuts in other areas of the civil service and/or by increased tax revenues.

Third, I encourage the authorities to accelerate the privatization of parastatals. In this connection, I welcome the planned sale of the agricultural enterprise (SOCAPALM) and the railroad company (REGIFERCAM), cited by Mr. Yao. I also welcome the fact that the authorities are implementing an audit of the stated-owned oil company by an international auditing agency. As soon as the results of this audit become available, I hope that the staff will report them to Executive Directors during the Board's country matters discussions.

We agree with the staff that a discussion on whether or not Cameroon is eligible for the HIPC Initiative is premature at this stage. An important condition for eligibility is a sustained track record of successfully implemented Fund-supported programs over a substantial length of time, which Cameroon has yet to do. I wish the authorities much further progress and success in their policies.

Ms. Brownlee made the following statement:

I wish to indicate my support for the general thrust of the staff appraisal. I concur with most of the remarks made by previous speakers, particularly Messrs. Jourcin and Singh, and Ms. Brettschneider. I wish to join Mr. Fujii in thanking the staff for its efforts to institute quarterly monitoring of this program, as requested by the Board in August 1997.

Ms. Pinzani made the following statement:

I will submit my statement for the record, but wish, in the meantime, to join other speakers in commending the authorities for completing their audit of the national oil company and their rehabilitation program for banks. These two measures are needed to put the country on a sustainable growth path, provided, of course, that the reforms proceed smoothly, without interruption.

I agree with Mr. Rodríguez that forestry tax reform is important not only to increase non-oil revenues, but also to deal with environmental concerns.

Private savings are very low, and are projected to decline further in 1998, which the authorities need to make every effort to reverse. They also need to make every effort to improve the conditions for private sector activity, by limiting the scope for ad hoc decision making, rent-seeking, and undesirable preferential treatment of individuals and organizations.

As Cameroon has abundant natural resources and a diversified economic base, I am convinced that, with strong efforts to guarantee good governance and good policy performance, there will be no reason for the economy to lag behind other economies.

The staff representative from the African Department commented that the velocity of money presented in Table 8—based on average GDP over five quarters—had risen, which would indicate decreased confidence in the banking system. However, according to another indicator, bank deposits, confidence had increased in 1996/97 after having declined for years. The velocity/confidence picture was complicated by the fact that two banks had been liquidated (as noted in footnote 3 of Table 2), Banque Méridien-BIAO Cameroun and Crédit Agricole du Cameroun. In the final analysis, if one used end-of-period M2, velocity had declined from 7.9 in 1995/96 to 7.5 in 1996/97, indicating that confidence in the banking system was beginning to increase, reflecting rehabilitation of the system.

In calling for a further reduction in the public sector's share in the economy, the staff had asked specifically for a reduction in the number of parastatals, as compared to the central government, the staff representative indicated. Table 24 of the statistical appendix—which indicated that the value added by the public enterprises was 3 percent of GDP—referred only to a select group of 65 enterprises for which data had been assembled. In fact, there were many more parastatals, which were highly inefficient (as indicated in the appendix of the paper on recent economic developments for the 1996 Article IV consultation). The current program targeted many of those parastatals for privatization or liquidation. Regarding the central government, the staff had noted that its expenditures had been compressed and were distorted, and thus needed to be decompressed and redirected. Accordingly, noninterest expenditures, particularly government investment, would increase, and expenditures would be redirected toward health, education, and maintenance.

Mr. N'guiamba said that he wished to thank Directors for their comments on Cameroon's efforts to strengthen its economic performance. While his authorities would be encouraged that Directors had generally expressed positive views on the measures taken so far, they were aware that much still needed to be done if Cameroon were to sustain a growth rate commensurate with its potential. They recognized that, notwithstanding recent progress in policy implementation, there remained no room for complacency.

Directors had expressed concerns, inter alia, about Cameroon's reliance on oil revenues, and had called for the early reinstatement of the forestry tax, Mr. N'guiamba noted. Negotiations were ongoing about the appropriate timing for reinstatement of the forestry tax, and progress in the area would be reviewed at the time of the forthcoming mission.

The rehabilitation of the banking system has been completed, and the authorities were considering taking further actions to improve the quality of financial services, Mr. N'guiamba added.

The authorities were also making efforts to alleviate poverty, and expected that the ongoing privatization effort would lead to job creation, Mr. N'guiamba remarked.

His authorities agreed that transparency was fundamentally important for improved macroeconomic management, particularly in the financial operations of the government, Mr. N'guiamba continued. They were increasing their efforts to combat tax fraud and would make the granting of concessional tax terms to the forestry sector more transparent, which should help to increase budgetary revenue. Furthermore, they were taking steps to increase the transparency of government expenditure management, and had requested technical assistance from the Fiscal Affairs Department to that end. Cameroon had also taken a number of steps to make the energy sector more transparent, including the recent financial audit of the SNH by an independent agency.

While there was no disagreement between the authorities and the staff on the need to eliminate government involvement in productive activities that could be better performed by the private sector, privatization should not be done with the sole purpose of transferring public ownership to private ownership, nor should it be done if it were to result in the transformation of state monopolies into private monopolies, Mr. N'guiamba remarked. His authorities' goal was to create a competitive environment that would enable private enterprises to supply goods and services to users at the minimum possible cost. By achieving that objective, Cameroon's economy would also increase its international competitiveness. Privatization therefore required thorough study, which could be time consuming.

The authorities strongly believed that a definitive solution to the debt problem of any country should be one enabling the country to service its debt without having to resort to rescheduling, Mr. N'guiamba said. Cameroon hoped to be able to exit as soon as possible from its vicious circle of successive reschedulings. The authorities therefore hoped that more generous debt relief mechanisms would be made available to Cameroon in the not-too-distant future. In the meantime, they welcomed the debt relief granted by the Paris Club in October 1997. They took noted of the goodwill clause in that rescheduling agreement, which stipulated that Cameroon would benefit from a stock of debt reduction if it maintained satisfactory relations with Paris Club members and continued to have an appropriate arrangement with the Fund.

His authorities wished to thank the Board and management for their support of Cameroon's ongoing adjustment effort, Mr. N'guiamba stated. They especially welcomed the cooperative spirit demonstrated by the mission and the staff representative at a critical phase in Cameroon's economic development.

The Acting Chairman commented that, when he had visited Cameroon in January 1997, the country had been holding protracted discussions with the multilateral institutions. He was gratified that so much progress had been achieved in the 12 months since then and wished to commend the authorities and the African Department—especially the staff representative—for their efforts.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They noted the continued buoyancy in economic activity reflected in positive real per capita growth the low inflation rate, and the progress made in strengthening public finances and in implementing key structural reforms under the staff-monitored program for 1996/97. They also noted the efforts made to normalize relations with Cameroon's external creditors. Furthermore,

Directors were encouraged by the good economic performance during the first quarter of 1997/98 under the program supported by the Enhanced Structural Adjustment Facility, but observed that this performance had to be seen only as a beginning of the adjustment process after a period of a poor track record and against the background of the recent favorable oil price developments. Against this background, Directors stressed the importance of strengthened policy implementation to demonstrate a firm and lasting commitment to macroeconomic stabilization and structural reform.

While noting some improvement in the conduct of fiscal policy, Directors emphasized the need to address the significant weaknesses remaining in both revenue-generating capacity and expenditure management. In this regard, they noted the worrisome backtracking on the forestry tax reform included in the program, and urged the authorities to reinstate these taxes as soon as possible. This measure, together with bold actions to improve tax administration and combat fraud, and to prepare adequately for the planned introduction of the value-added tax, would be crucial to broadening the tax base and achieving the revenue target.

On the expenditure side, Directors stressed the need to enhance transparency in government budgetary operations, and ensure adherence to spending priorities in favor of social services and infrastructure. They welcomed the authorities' request for Fund technical assistance on public expenditure management. They also noted that the unfreezing of civil service promotions and merit increases in February 1997 was a first step toward improving staff morale. Noting that civil service reform should be a priority, Directors called on the authorities to decompress the salary structure and rationalize civil service employment to keep the overall wage bill within a reasonable limit.

In the financial sector, Directors noted the completion of the long elusive rehabilitation of the banking system. Moreover, they encouraged the authorities to improve the functioning and soundness of the banking system through removal of the remaining political interference in banking decisions; the active use of indirect monetary instruments; and the strengthening of bank supervision. Several Directors also encouraged the authorities to strengthen the independence of the regional banking commission and ensure that prudential regulations are observed.

Directors stressed the importance of accelerating structural reforms aimed at further reducing the public sector's share in the economy by pressing ahead with privatization and liberalization of the energy and transport sectors, so as to consolidate the gains in external competitiveness and allow Cameroon to achieve its growth potential. In this regard, they underlined the need to enhance transparency in the energy sector and to rehabilitate economic infrastructure.

Directors welcomed the rescheduling agreement reached with the Paris Club in October 1997. They called on the authorities to clear all remaining external payments arrears on nonreschedulable debt, as scheduled, and to remain current on all debt-service payments falling due. Directors urged the authorities to make rapid progress toward concluding bilateral agreements with Paris Club creditors and to reach agreements on similar terms with non–Paris Club official and commercial creditors.

Directors stressed the need to improve further the quality and timeliness of the availability of Cameroon's core data.

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

3. ARAB REPUBLIC OF EGYPT—1997 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT—REVIEWS, MODIFICATION AND WAIVER OF PERFORMANCE CRITERIA

The Executive Directors considered the 1997 Article IV consultation with the Arab Republic of Egypt, the third and fourth reviews under the 24-month Stand-By Arrangement with the Arab Republic of Egypt, and its request for a modification and waiver of performance criteria (EBS/97/238, 12/17/97; and Sup. 1, 1/6/98). They also had before them a background paper on recent economic developments in the Arab Republic of Egypt (SM/97/290, 12/22/97; and Cor. 1, 12/31/97), together with a statistical appendix (SM/97/288, 12/18/97).

Mr. Shaalan made the following statement:

The prudent and sustained Egyptian reform effort launched in 1991 continued into the current fiscal year. Not only do economic indicators, including structural measures, bear witness to the achievements of recent years but more importantly the sea-change in the philosophy underlying the direction of the reform effort has and should continue to contribute to its sustainability. In this context, I would cite three important elements. First, after a long period where the public sector played a dominant role in the economy, the thrust of policy is now directed at creating an environment where the private sector is to assume the pivotal role. This new orientation has been strengthened with the ongoing and accelerated pace of privatization, which, in a unique manner, is supported by the labor unions. Second, the inward orientation of economic policy has given way to a more outward and open economy. Trade barriers have been reduced and investment laws have been both simplified and unified thereby providing a level playing field for all investors. Third, these reforms were made possible by a growing sense of ownership which to no small degree is attributable to the attention the government has accorded to explaining to the public the rationale behind its policies and its objectives. This sense of ownership, in addition to the visible success achieved on several fronts of the reform effort was an important factor in the public and growing investor support for the reform agenda—both necessary prerequisites for success.

The well-written staff report both clearly sets out recent developments in the economy and identifies the challenges policy makers need to address in the period ahead. The authorities are in general agreement with the thrust of the staff analysis and recommendations and wish to take this opportunity to express their gratitude to both management and staff for the unfailing assistance being provided to Egypt. As the staff report points out, the durable macroeconomic performance and the steady pace of structural reforms coupled with a strong well-supervised banking sector, negligible short-term debt, and a strong reserve and balance of payments position, have served the economy well in a period of financial turmoil and have underpinned the achievement of a higher than projected growth rate coupled with a lower than targeted inflation rate over the past year.

The declining role of government in economic activity and the assumption of a greater role for the private sector is clearly reflected in (a) the evolution of the budget, (b) the increasing weight of the private sector in economic activity, in part as a result of the opening up of sectors previously reserved for the public sector, and (c) the pace and scope of privatization which includes key public sector entities being prepared for privatization.

Recent budgetary trends attest to the changed role of the government in economic activity. Total government expenditures have been on a declining trend for the past four years. In the current fiscal year, they are projected to fall to 26 percent of GDP representing a decline of 6 percentage points over the period, with most of the decline taking place in current expenditures—defense outlays, wages, and interest payments. Capital expenditures, at under 6 percent of GDP, are directed at financing basic infrastructure, in line with the redefinition of the government's role in the economy. These developments were accompanied by a strong overall budgetary position where the overall deficit has remained in the vicinity of 1 percent or less for the past four years following years of deficits in the range of 20 percent of GDP immediately prior to launching the current renewed reform effort.

While considerable progress has been made in both opening up sectors for investment, including in particular infrastructure and power generation which were previously exclusively in the domain of the public sector, and in easing and streamlining government regulations, the authorities are fully aware that more needs to be done in further reducing bureaucratic hurdles. To this end, the Ministry of Administrative Reforms is focusing on a comprehensive civil service reform. In this context, a review of government functions is under way to determine the government activities that should be retained, divested or contracted to the private sector.

As envisaged under the two-year reform program, the pace of privatization of nonfinancial public sector enterprises has been accelerated considerably. Over the first year, about one-third of the book value of the targeted enterprises has been divested, while the divestiture of another one-third is expected by end September 1998. This would result in a reduction of the share of the public sector in industrial activity from 38 percent to 13 percent of GDP. In the banking sector, by the end of the two-year program about half of the sector will have been brought under private sector control.

The fiscal consolidation and retrenchment was supported by a prudent monetary policy aimed at limiting monetary aggregates to achieve the inflation target. In view of the lowered growth and inflation assumptions for 1997/98, the central bank quickly moved to targeting a significantly lower liquidity growth. So far, in the current year, capital inflows have been moderate and were comfortably stabilized by the central bank. As the staff notes, the banking sector has been strengthened in a number of respects. At the end of June 1997, international capital adequacy standards have generally been exceeded by a significant margin. The average risk-weighted ratio for the banking system continued to increase and now stands at 10.6 percent. All but three small banks accounting for 2.8 percent of the assets of the banking system, are in compliance—these banks have submitted plans to regulators to restore their capital base. Compliance with other prudential regulations, in particular net open foreign currency positions, liquidity risk ratios, and provisioning against bad loans generally exceeded the minimum required. While admittedly there are problem loans which reflect inherited claims on public sector enterprises, these are being reduced through the use of privatization proceeds.

The authorities attach considerable importance to the attainment of a higher sustained growth rate to create employment opportunities. This would require, in the first instance, increases in national savings and continued determined improvements in the investment environment as indicated earlier. Developments in the past two years bear testimony to the improving investment climate—gross investments increased by 3 percentage points of GDP. National savings which now stand at about 19 percent are targeted to increase by about 3½ percent in the next four years most being generated by the private sector—both the corporate and household sectors. The recent experience of Egypt strongly suggests, and this is corroborated by developments in other developing economies, that private savings do respond positively to the maintenance of a strong macroeconomic posture, as well as continuing with structural and institutional reforms. Privatization, the redefined role of government, including the attention now accorded to addressing bureaucratic impediments as well as the measures under way to deepen the financial and equity markets should permit the achievement of the savings and investment targets. In this context, pension reform is being accorded high priority.

The Egyptian authorities, while encouraged by the success achieved so far, fully realize that continued perseverance in implementing the reform agenda is paramount. Indeed the country faces considerable structural challenges to sustain high investment growth and employment creation. Fortunately, the macro fundamentals are very strong, domestic and international investors are already responding to the intensification of reforms.

In conclusion, the authorities wish to express their gratitude to the Executive Board, management, and staff for their support and guidance.

Mr. Sivaraman made the following statement:

Egypt has done a commendable job in achieving macroeconomic stabilization and moving toward a market-based economy at an impressive pace.

For Egypt, it should be possible to step up the rate of growth beyond what has been achieved in the last four years by aggressively promoting domestic savings which has averaged only 19 percent of GDP compared to 25–28 percent for other developing economies. Another factor which seems to be striking in the case of Egypt is its low level of exports and their excessive concentration on petroleum products. As a percentage of imports, exports have generally been hovering around 32 percent with petroleum exports often accounting for nearly half of total exports. While it is true that the overall balance of payments does not pose any serious problem, income from tourism and investments seems to be more or less stagnant whereas imports seem to be on the uptrend. Egypt will therefore have to concentrate on developing non-oil sector exports so that any shocks in oil prices could be absorbed. The current robust level of reserves at $20.86 billion should not induce complacency as Egypt had higher import cover of reserves in 1993/94 and this has been declining steadily thereafter.

On the capital account side, while there is a robust inflow of foreign investment, a large part of it seems to be in the form of portfolio capital which as experience shows, tends to be volatile.

As per Chart 3, Egypt's real effective exchange rate has gone up by almost 60 percent with nominal exchange rate lagging behind. While the staff has explained that some of it is due to the strength of the US dollar, the extent to which the appreciation of the Egyptian pound has affected its export sector remains unclear. It has been mentioned that Egypt's intervention policy in the exchange market has been guided by the commitments in the letter of intent to counter upward pressure on the pound. To what extent such interventions can take place and whether any other policy changes are required to ensure Egypt's competitiveness need to be examined further. Whether any downward correction of the Egyptian pound would improve competitiveness has also not been analyzed in the staff report.

Inflation, as measured by the consumer price index, has been brought under control, but it seems to be creeping upwards again from a level of 4.8 percent in 1996/97 to anticipated 5.9 in 1997/98. The authorities would have to be vigilant on this front.

The authorities should be commended for their success in containing the budget deficit to a level of 0.9 percent. There has been a marginal increase in tax revenues as a proportion of total central government revenues from about 66 percent in 1993/94 to 70.5 percent in 1996/97. While it is not necessary that every government should be attempting to optimize its tax revenues when it has other elastic sources of revenue, it would be useful to have a tax system which is efficient with a simple legal framework. Revenues from tax sources can always be increased by varying the rates and ensuring coverage. It is not clear as to why the authorities seem to think they should have an open ended system for depreciation while they should limit the tax deductibility of corporates' interest expenses. An open-ended system of depreciation may induce a shift toward capital intensive production which, in the case of Egypt, would not be a welcome measure given the high unemployment rates. An open-ended provision may also induce banks to be lax in the matter of debt recoveries. We would welcome the authorities' decision to eliminate the presumptive withholding tax on noncorporate business income. A presumptive income tax may work in the case of very small trade and business establishments, but would be an invitation for evasion if it is open-ended. It is always better to develop a culture to maintain accounts and file income tax returns rather than going by presumptive incomes. Returns can always be simplified but a legal requirement to file them will infuse discipline in maintaining accounts both to the advantage of the entity filing it and to the state.

It is disheartening to note that income tax is a source of massive litigation in Egypt as has been in the case of India. It would be useful for the Egyptian authorities to contemplate suitable provisions in income tax law for arriving at settlement of disputed cases at different levels of authorities in the tax collecting machinery. In order to avoid potential problems, the law could provide for Benches of two officials who had not dealt with the case to decide on settlement without any further delay. These settled cases could thereafter be subject to independent audit so as to ensure that the settlement has been fair both to the government as well as the party concerned.

We commend the authorities' attempt to systematically move away from administered prices in the energy sector. The sooner these prices are brought in line with the market, the better it would be. It is extraordinarily difficult to remove subsidies in the energy sector and therefore the freeing of administered control over prices of energy products will have to be a steady but a continuous process with a target date to free them completely from control.

We are impressed by the progress made by the authorities in privatizing public enterprises both nonfinancial and financial. Part of the proceeds of privatization could be applied by Egypt to accelerate reduction of the domestic debt which has been showing a declining trend. On the monetary front, the authorities seem to be having a problem only with the inflow of funds from abroad having its impact on reserve money growth and ultimately on broad money. This also has its implications for appreciation of the Egyptian pound. Maybe one of the reasons for a shift from dollar deposits to domestic currency deposits is the increase in confidence level of the public on account of the strong foreign reserve position of the authorities.

Egypt will have to take a number of measures to improve the living standards of its people. Now that a reasonable budget balance has been achieved and the economy is well set to move on a steady growth path, it would be necessary to have a look at the composition of expenditures so as to reallocate them in a manner that would confer the largest benefit to the poorest people. In this context, as Egypt is moving ahead with privatization, conscious efforts are necessary to create an ambience for the private sector to progress rapidly with their investments. Delays at the customs could be substantially reduced by switching over to electronic data interchange facilities with importers and exporters having direct connection to the custom house and the custom house providing electronic cash transfer for payment of any duties. Introduction of such a system would also reduce face to face contact of importers and exporters with the customs officials and enable rapid clearance of goods through the customs which has been pointed out as an irritant.

We understand that Egypt has undertaken a major overhaul of its stock markets which include automated systems, decentralization, creation of trading floors nationwide, providing Internet access to the exchange and new guidelines for brokerage firms. It would be advisable for Egypt to move toward international standards for disclosure, auditing and financial control and also toward scripless trading if this has not been introduced. Authorities could also think in terms of setting up depositories and having a proper regulatory framework for this purpose.

On the whole, we find that Egypt is poised toward advancing quite rapidly on the path of sustained economic growth. The authorities deserve all support and appreciation for their effort. The staff of the Fund also requires to be complimented for maintaining an excellent rapport with the authorities.

We wish them all success.

Mr. Brooke, speaking on behalf of Mr. Shields, made the following statement:

Thanks largely to the authorities' prudent management of the economy, macroeconomic developments in Egypt were positive in fiscal year 1996/97: the fiscal deficit was reduced, output growth increased, inflation fell, and the current account moved back into surplus (albeit a modest one). As a result of these favorable outcomes, there was a sustained capital inflow and the authorities were able to reduce nominal interest rates. Furthermore, helped by Paris Club debt service relief, the external debt to GDP ratio fell by 2.5pp of GDP.

To sustain the impressive outcomes of 1996/97, however, further significant reforms will be needed. I regard the structural issues affecting incentives for private sector development as paramount and fully endorse the staff's views in this area. Additional measures will also be required to prevent the fiscal situation from deteriorating and I would like to comment mainly on this issue.

On the fiscal position as highlighted in the background paper, total revenue is likely to decrease by 3pp of GDP over the next four years, mainly due to lower remittances from the state petroleum company and Suez Canal operations. On the basis of current policies, revenues from other sources are likely to remain broadly stable in relation to GDP over the same period. Hence, containment of the current fiscal position will require either expenditure restraint, new revenue measures, or a combination of the two.

Given this deteriorating revenue trend, the delay in implementing the general sales tax reform is unfortunate. I welcome the authorities' intention to offset the adverse effects of this delay through the introduction of a supplementary package of tax reforms—can the staff confirm that the government has submitted these measures to parliament? In addition to broadening the base of the general sales tax, I feel the authorities should undertake a more comprehensive review of their tax system. In particular, while the intended reforms (involving adoption of an open-ended system for depreciation; introduction of tax deductibility for loan loss provisions; and limitation of corporate tax deductions) are welcome, there are other important issues that need to be addressed.

As can be seen from Table 3 in the background paper, yields from taxes on personal incomes and consumption are particularly low in Egypt. The staff highlights that if the authorities were to raise personal income tax revenues to the average for other countries in the region, the budget would gain 2.7 percent of GDP. Given that Egypt's maximum personal income tax rate isn't significantly below the regional norm, low personal tax revenues (just 0.7 percent of GDP) must reflect either very generous tax allowances and exemptions or widespread nonpayment of taxes. I presume that both factors are significant and would therefore encourage the authorities to implement reforms to streamline the tax system and to improve tax collection methods. Staff comment on this subject would be welcome.

Another reason why the authorities should look to enhance taxes on personal incomes and consumption is that import duties are set to decline in the next few years due to the introduction of tariff reductions connected with the EU Association Agreement. As outlined in the staff report, there remains considerable scope for Egypt to develop a larger merchandise export sector. Unfortunately, the development of international trade is hindered by high tariffs, an extensive system of quality controls, and cumbersome customs procedures. I therefore strongly urge the authorities to reduce the existing nontariff barriers to trade, as well as cutting tariff rates as envisaged under the EU Association Agreement.

Turning to the expenditure side, the main areas where cuts could be realized continue to be reductions in interest payments (relating to reschedulings of non–Paris Club debt) and energy subsidies, plus savings originating from civil service reform. On energy prices, I welcome last August's 13pp increase in the average domestic price of energy products to 88 percent of the world benchmark level. Given this impressive performance, I would like to see the authorities go beyond their commitment under the Stand-By Arrangement and eliminate all energy-price subsidies in full by July 1998. With regard to civil service reform, I welcome the fact that civil service employment was cut by 2 percent in 1996/97 and that a further reduction of the same magnitude is budgeted for 1997/98. However, despite the cut in employment, the aggregate wage bill increased by 9.4 percent last year whereas, in the September 1996 MEP, the government committed itself to limit the increase in the total wage bill to no more than 9 percent. This slippage appears to have come about primarily through high wage settlements (11.6 percent on average, against inflation of 6.2 percent). Whilst increases in wages may be a sensible component of civil service reform, these should be in parallel with much deeper cuts in staff levels and genuine reform of the bureaucracy.

It is also worth noting that the risks to the staff's revenue projections probably lie on the downside at present. Following the recent terrorist attack on tourists at Luxor, there has been a marked reduction in activity and bookings. The key issue for output growth and the budget is the length of time that tourists stay away from Egypt. Given that receipts from tourism were around $3.6bn in 1996/97 (approximately 4.6 percent of GDP), a prolonged slump in the tourist industry could well have a larger impact on GDP growth in 1997/98 than the 0.5 percent assumed by the staff (para. 45).

Regarding structural reform priorities, in addition to the fiscal position, the key challenges facing the authorities continue to be the need to increase the role of the private sector in the economy and to boost investment levels. Progress on privatization has been impressive under the Stand-By Arrangement program and I would encourage the authorities to maintain this momentum during 1998. However, as highlighted in Box 4 of the staff report, much still needs to be done to reduce impediments to private sector development. I agree with the staff on the need for greater transparency of government policies and operations; improvements in the legal framework; and a leaner, pro-business bureaucracy.

Finally, I concur with the staff on the need for the authorities to address the serious deficiencies in their statistical data and I continue to sympathize with the view that moving to a more flexible exchange rate system in the near future would be beneficial.

I can support completion of the current review.

Mr. Al-Tuwaijri made the following statement:

I congratulate the Egyptian authorities for the strong performance of the economy over the past year. Growth accelerated, inflation decelerated, and the balance of payments strengthened. This could not have been achieved without continued implementation of prudent macroeconomic policies and broad-based structural reform.

The challenge facing the authorities at this stage is to sustain the reform effort in order to achieve even higher non-inflationary growth over the medium term. While this task, has been complicated by the recent turmoil in international financial markets, the economic program for 1997/98 is appropriate, and should pave the way for achieving the growth objectives.

The authorities' continued commitment to prudent fiscal policies and their stress on improving the structure of the budget are welcome. Emphasis on rationalizing current spending and the additional measures to simplify the tax system and broaden the tax base are pertinent to promoting an efficient private sector.

Expanding private sector participation in the economy is also dependant on achieving a strong and efficient financial sector. In this regard, the ongoing efforts to privatize a public sector bank and an insurance company as well as the substantial progress toward privatizing joint venture banks are important steps. The authorities are encouraged to expand those efforts and to implement measures to deepen the financial markets along the lines recommended by the staff. Furthermore, with increased deregulation of—and competition in—the financial sector, the importance of improving supervision cannot be overemphasized.

Turning to structural reform in other areas, the emphasis on promoting private sector investment and restructuring public sector enterprises remains crucial. The progress made in privatization and the commitment to broaden this effort are important in that regard. Further regulatory reforms and reductions in bureaucratic hurdles would also encourage private investment. Moreover, the agricultural sector should benefit from the recent decontrolling of rents on agricultural lands.

Turning to the external sector, I agree with staff that Egypt's hard currency policy has served the country well. While this policy has led to a real effective appreciation of the Egyptian pound, it is encouraging that the impact of such appreciation on competitiveness has likely been largely offset by increased productivity. Indeed, non oil export performance is expected to strengthen in 1997/98. The welcome progress in trade reform should further accelerate the trend toward a more efficient and productive domestic economy. However, recent developments in Asia's financial markets underscore the speed with which sentiment could change. Therefore, I am encouraged by the authorities' cognizance of the need to anticipate and respond promptly to changing economic circumstances.

Finally, let me commend staff for the very interesting and informative set of papers.

With these remarks, I support the proposed decision and wish the authorities further success.

Mr. Qi made the following statement:

Recently we have had many consecutive discussions on the financial turmoil in Asia at the Board. It feels like a breath of fresh air to see the sanguine picture in Egypt—one of the emerging markets. The economy keeps growing at a relatively high rate with a steadily declining inflation rate; the fiscal position registers as programmed; monetary indicators are moving in a comfortable way; the balance of payments situation further improves; and the currency stays intact despite the financial turbulence in the Asian emerging markets.

I thank the staff for preparing a very good set of well organized papers, providing us with horizontal comparisons with other relevant economies and plenty of perspective literature. I broadly share the thrust of the staff's appraisal and would like to make a few comments for emphasis.

The Egyptian authorities are to be commended for their strategy in building up confidence in the international community, which, to my mind, is the most important element shielding the country from the serious repercussions of the financial market turbulence and for their prudence in handling both the current and capital account convertibilities which has also contributed to the financial stability in Egypt. Tourism which registered an increase of more than 20 percent in U.S. dollar terms in 1996/97, suffered a sharp decline after the terrorist incidents. This highlights the importance of confidence issues to an emerging market.

The authorities' firm commitment to the adjustment and reform program is the best signal to the market indicating that the country is headed on a healthy and sustainable economic development path, evidenced by the careful observance of both the quantitative and structural criteria under the existing precautionary Stand-By Arrangement. The steps taken by the authorities to increase revenues and contain expenditures are quite effective, curtailing the fiscal deficit for 1996/97 to about 0.9 percent of GDP, with the overall and primary balances being the strongest among similar countries in the region. The current account, including official transfers, recording a surplus, coupled with large capital inflows, has led to the increasing accumulation of foreign exchange reserves. The authorities rightly intervened in the foreign exchange market, offsetting upward pressure on the pound and, in the meantime, sterilized the liquidity impact of this intervention, maintaining the relatively tight monetary policy. Although there are fiscal costs to these operations, they are the costs for winning confidence and therefore worthwhile. It is also very impressive to see that when the financial markets gain strong development momentum, the prudential regulation and banking supervision in Egypt are equally sound, as evidenced by the fact that Egyptian banks are on average well above the Basle minimum standards for capital adequacy.

This being said, the challenges ahead for the authorities, as indicated by the staff in the paper, are still heavy. For a country where poverty is a widespread phenomenon, it is necessary to have a higher economic growth rate. However what I would like to caution is that while promoting investment to support economic growth, the authorities should pay more attention to securing efficient investment, solving economic bottlenecks, and being on high alert against inflationary pressures. It is important to have the public investment focus on infrastructure, health, and education, which can enhance the overall level of economic efficiency and create a conducive environment attracting more private and foreign direct investment. I note that the investment rate in Egypt has been low even compared with the average of the developing countries, but in view of the coming investment boom, it is advisable to optimize the overall investment structure.

The second point I want to make is that the capital inflow increase in Egypt is an encouraging trend, but we should also note that a large portion of the inflows is the volatile portfolio and commercial borrowing. The recent

Asian crisis has taught us a good lesson with regard to this problem. How to make full use of these capital inflows while minimizing the effect of their volatility and uncertainty is an important task for the authorities. I believe the authorities have both the ability and means to achieve their goals in managing these capital inflows and ushering them to appropriate areas. It is encouraging for us to note from both the staff paper and Mr. Shaalan's helpful statement that the authorities are taking measures to attract more foreign direct investment to priority sectors.

Finally, as regards the privatization program in Egypt, I take note from the paper that it is too early to assess the impact of the privatization process. I therefore urge the staff to follow the development in this regard closely, so as to find the best way to enhance economic efficiency.

With these remarks, I support the proposed decision and wish the authorities further success in their future endeavors.

Ms. Lissakers made the following statement:

Egypt continues to perform well under recently difficult circumstances, and it is a pleasure to review the progress of an increasingly steady performer. Despite some bumps delivered to the stock market and some occasional pressure on the exchange rate, macroeconomic management has remained sound over the past year, and the resilience of the economy to external instability and shifting capital flows is promising.

While we continue to have a number of concerns, particularly with regard to the degree of flexibility in the exchange rate and the quality of the business environment, we continue to be optimistic regarding Egypt's medium- and long-term prospects. An important source of this optimism has certainly been the high degree of ownership of the economic reform program shown by the Egyptian authorities and their willingness to take necessary actions. The authorities' continued attention to making their programs and motives understood by the general public also bodes well for the future course of reform.

We are in broad agreement with the staff's analysis of recent developments and its recommendations, and can certainly support completion of the third and fourth reviews. I would like to highlight a few areas where progress will be necessary in order to maintain the forward momentum of Egypt's economy.

Macroeconomic policy certainly continues to be the strong suit of the current administration, and we believe the authorities should be commended for their continued vigilance. Fiscal policy in 1996/97 appears to have been on track, although we were disappointed to see the postponement of the programed extension of the general sales tax to the wholesale and retail levels. We support the staff's proposals to make this a performance criteria for end-June, although we should also certainly follow up the strengthened conditionality with a positive response to the authorities' request for technical assistance in this area. In the meantime, we strongly support the authorities' efforts to fill the revenue gap, particularly the increased attention on accelerating settlement of tax disputes, as noted in Box 1 of the staff report. I would hope that such action is taking place within a larger context of improving tax administration and compliance, an essential element in providing savings to finance future investment.

On the tax issue, I noted Mr. Sivaraman's interesting comments, and I share some of his concerns on the depreciation policy. On the other hand, I think that capping the deductibility of interest rate expenditures for corporations is a very important measure to eliminate what could be an unfortunate incentive for excessive leveraging of corporate debt.

On monetary policy, developments have continued along the same track we saw during the last review, with capital inflows exceeding expectations by modest margins and an associated buildup of foreign exchange reserves to 17 months of import cover. The cost of sterilizing these inflows was probably modest, but the continued pattern of higher than expected inflows highlights the view we have expressed in the past regarding the need for greater flexibility in the exchange rate. This would seem particularly to be the case, as the authorities point out that there is relatively little room for any further fiscal tightening.

We appreciate the staff's interesting work, laid out in the background paper on recent economic developments, on the equilibrium exchange rate. But, notwithstanding the conclusion that the pound may have found its equilibrium point, I cannot but wonder how the staff views the effect of a real effective exchange rate depreciation of 12 percent in the year to September 1997 and the implications for export competitiveness, particularly relative to the efficiency gains that Egypt may show through liberalization, deregulation, and privatization.

The export performance of the non-oil sector, I note, continues to be extremely anemic. We have also noted the rise in imports. I wonder whether the staff is still confident of its assessment of the current account implications of the sharp slowdown in tourism receipts and the recent very sharp drop in oil prices. I would be particularly interested in the oil price issue. I also wonder if Mr. Shaalan has any updated information on the condition of tourism bookings in Egypt and whether there has been any recovery after the very damaging events in November.

On structural reform, the staff has done an excellent job of mapping how far Egypt has come in the past decade, in terms of crucial reforms. Particularly useful, however, is the comparison with other developing countries. It is easy to say that the Egypt of today is a marvel of progress as compared to the Egypt of 10 years ago, but of course the acid test for markets is how Egypt stacks up against the competition. That is how investors will decide where to put their money.

In this light, and notwithstanding the excellent progress made, there are remaining weaknesses that could undercut the gains Egypt has reaped from nearly two decades of effort. On privatization, for example, there is an issue of quality versus quantity. While the authorities have privatized a very substantial number of state firms, with the pace of this process showing a very welcome acceleration in the past two years, attention must be paid to which firms are being privatized and how their management or if their management is changing as a result. Failure to replace management of privatized state firms, as noted in paragraph 23 of the staff report, may limit efficiency gains. Privatization is not just a matter of generating revenue for the state and changing the corporate ownership structure. It is a process of enhancing the efficiency of the economy and generating higher growth and employment.

I would appreciate hearing from the staff a little more on the issue of the quality of privatizations and whether the current approach inhibits the efficiency gains one would expect. On the scope of privatization, the background paper on recent economic developments does a very good job of highlighting how, despite a growing trend toward privatization, the overall share of private sector activity in the economy has actually declined since the late 1980s. This is the kind of big picture data the authorities should take into account in their periodic reviews of which companies should be slated for privatization.

We welcome the steps that have been taken to begin privatization of Egypt telecom, but does the staff have any views on other major activities, such as the port, that should be put on the block? I would also take this opportunity to highlight the importance we attach to the quick privatization of one or more of the state commercial banks. Strengthening the financial sector, as we have seen demonstrated recently, is critical to having a successful reform process. It is our understanding that foreign investors, and probably Egyptian investors, are watching this issue very carefully, and I believe the authorities would do themselves a favor by moving ahead forcefully on this issue as soon as possible.

More broadly on the financial sector, the authorities have made a good start in strengthening supervision and regulation with the introduction of capital adequacy ratios and regulation on loan concentration, for example. It is now important that these rules are enforced. Similarly, while provisioning for the high level of nonperforming loans is conservative, probably rightly so, one has to ask the question of whether it is sufficient to cover the worst case scenario. Also, given that the bulk of nonperforming loans is tied to state enterprises, it would seem to bolster the case for more rapid privatization if the financial system is to remain sound.

I would reiterate our view that the state should be on a clear track toward reducing its presence in the financial sector. I would be interested in any information the staff has about plans for the remaining three state banks.

We have called repeatedly for a more aggressive approach to trade liberalization. We continue to believe that the benefits would outweigh the costs by a large margin. Some steps have been taken, and we join others in welcoming the prospective free trade agreement with the EU. However, we concur with the staff's assessment in the background paper on recent economic developments that deeper trade liberalization would help to spur the higher growth rates that Egypt needs to raise per capita income substantially and reduce unemployment.

A fourth and crucial element of structural reform that must be addressed is the commercial environment. Box 4 of the staff report outlines the kinds of problems that remain, and I will not repeat them here. I would just emphasize the importance of addressing the bureaucratic and regulatory hurdles that continue to thwart investors. Eliminating these obstacles is key to Egypt reaching its full growth potential. We think that the authorities should continue to devote greater attention to this area. I would also ask the staff for more detail regarding the review of government functions mentioned in paragraph 27. We certainly support this effort. We wonder whether there is any input from outside the government, from the private sector, on which activities should be given priority for divestment. Bureaucracies, as we know, are not very good at reforming themselves.

While it is clear that the reform process is headed in the right direction in Egypt and that the economic team and the political leadership are committed to bringing the benefits of integration in the global economy to Egypt, I would strongly urge the Egyptian authorities not to hesitate. I am sure the Egyptian government, like every government in the world, is wondering what the recent events in Asia mean for their own policies. I think when we do a retrospective it will become very clear that one of the weaknesses in the otherwise broad Asian success stories was that they left important pockets of economic activity untouched by reforms. I hope that is a mistake that Egypt will not make.

Finally, just a question of where the Fund and Egypt go from here. The Stand-By Arrangement is due to end in September of this year. Although I can appreciate the authorities' desire to proceed with reforms without a formal Fund program, I would urge them to consider the benefits that a clear and transparent policy framework provided by the Fund can have in facilitating the reform process. Whether or not there is a follow-on arrangement, I certainly hope that the current very close and successful cooperation between the staff and the authorities will continue.

Mr. Donecker made the following statement:

We very much welcome the remarkable further progress the Egyptian authorities have achieved toward internal and external balance and their compliance with the Stand-By Arrangement in the past year. The Stand-By is, therefore, likely to remain a precautionary arrangement. Persistent robust overall growth, which has also allowed for a rise in per capita income, a declining inflation rate at moderate levels, a rather sound budget and external current account situation, a strong external reserve position, and an apparently sufficient degree of immunization against abrupt changes in market sentiment so far, are clear and outstanding rewards for the authorities' commendable implementation of strong stabilization policies and broad-based structural reforms.

Egypt is also a positive example for other member countries that continued adjustment and reform efforts do pay off, not only in the far distant future, and that these efforts do not necessarily have to be accompanied by slow growth or other adverse effects.

The main challenge for the authorities in the period ahead is clearly to sustain their adjustment and structural reform efforts in order to consolidate and extend the ongoing recovery, foster the credibility of the authorities' policies, further strengthen the immunization of the economy against possible internal and external sources of volatility, and thus to provide and to strengthen the conditions for an improvement of living standards and social indicators. The continuation of sound fiscal and monetary policies accompanied by a more flexible exchange rate, structural reforms, well targeted public investments and—as the staff has called it—"enhancing the policy environment" (page 48. para 90) should be the primary ingredients in this endeavor. In this context it seems especially noteworthy that the privatization process has made good progress and that domestic saving rates and in particular private savings are increasing, thereby facilitating the financing of domestic investment.

Overall we can support the thrust of the staff's analysis and recommendations, including the call for more exchange rate flexibility and trade liberalization. We can also support the proposed decision and have only two additional remarks.

First, Egypt fortunately has not been strongly affected by the increased volatility in the international financial markets—probably due to the perception by market participants that the country's fundamentals are sufficiently strong and that its external reserves and debt structure do not give rise to liquidity problems. We certainly do not challenge this assessment. However, given the somewhat high level and probably to a large degree short-term nature of foreign currency deposits with Egyptian banks, one might be concerned about potential risks in this area. Maybe the staff could comment on the size and maturity structure of foreign exchange deposits in comparison to free net international reserves of the banking system. In this context, it seems important to eliminate the implicit exchange rate guarantee in order to avoid setting problematic incentives and to ensure adequate room for maneuver for the central bank in case of increased volatility.

Secondly, on exchange rate policy, I have already expressed our support for the staff's recommendations with respect to more flexibility of the nominal exchange rate. The staff's comprehensive analysis has shown that the recent real appreciation of the Egyptian pound was justified in light of improved fundamentals. However, the adjustment of the real exchange rate was only achieved through higher inflation compared to the anchor currency while the central bank intervened to prevent a nominal appreciation. I, therefore, would like to reiterate our position that such a real appreciation should be achieved through nominal appreciation rather than at the costs of higher inflation. Upward flexibility of the exchange rate could also limit the domestic monetary impact of capital inflows or the respective costs of sterilization.

In concluding we wish the authorities much further success with their adjustment and reform efforts.

Mr. Tilyayev made the following statement:

At the outset, I would like to commend the Egyptian authorities for undertaking "prudent and sustained reform efforts," as it is stated in Mr. Shaalan's comprehensive statement. These reforms have already allowed the authorities to reap some fruits of their hard work. Inflation is kept within single-digit levels and real GDP is expected to grow 5 percent in FY 97/98. In addition, the balance of payments situation is stable and Egypt enjoys a comfortable level of international reserves. Moreover, the external debt position has improved substantially.

I am confident that these positive developments will not induce complacency, and that the authorities realize the need for increased efforts to put the country on a road of sustained economic progress. Since I am in agreement with the thrust of the staff's appraisal and all prior actions were implemented, I support the completion of the third and forth review under the current Stand-By Arrangement. This being said, I would like to confine myself to only a few points just for emphasis.

I concur with the staff who argue in the well-written report that, in the medium term, the authorities should stimulate private investments by eliminating existing impediments and creating a more favorable regulatory environment. Higher investments should create more employment opportunities and will help to alleviate poverty and increase the living standards of the population. I think the World Bank's assistance on this issue should be more crucial.

The public sector still dominates the economy; and calls to accelerate the privatization program therefore seem justified. However, in my view, the authorities should, above all, seek for greater efficiency of the privatization process, rather then trying to hit records on the quantity of companies and financial institutions restructured or sold.

On the capital account, given the portfolio nature of foreign investments and it's extreme volatility, the authorities should use a broader range of instruments and mechanisms to deal with the possible negative effects of such inflows. Improving bank soundness and supervision and further deepening the financial markets are most important in this context.

In conclusion, I would like to wish the Egyptian authorities all the success in the challenges ahead.

Mr. Coumbis made the following statement:

As we said during the second review, the performance of the Egyptian economy continues to be outstanding in the areas connected with GDP growth, rates of inflation, external position, overall fiscal position, the level of foreign debt, and progress in structural reforms. But what is most important, as Mr. Shaalan has put it in his very informative buff, is the substantial change in the philosophy underlying the direction of reforms and the ownership of the program by the authorities and the public. It is clear that sound fundamentals and the intensification of reforms protected the country from the repercussions of the turmoil in Southeast Asia. Since I am in broad agreement with the staff's appraisal and the program is on track, I will limit my intervention to exploring just a few points from the staff report and the background paper in the area of policies and prospects in the medium term.

Poverty is a very acute and serious problem in Egypt. Despite some improvements in income equality and the pickup in real GDP growth in the past few years, social indicators show that there was no serious improvement in the area of poverty during this period. The authorities are fully aware that they should attain as soon as possible a sustainable increase in the rate of growth of the economy and in per capita income in order to ameliorate the poverty situation. In Chapter II of the background paper the staff indicates in two alternative scenarios that in order to increase GDP growth by 5.5–7 percent Egypt has to raise investment by about 8 points of GDP over the next six years. This is not an easy task, taking into account the conditions that have to be fulfilled to satisfy this objective and given that, in the new policy orientation, investment should originate primarily in the private sector. Stable macroeconomic conditions, accelerating structural reforms, and substantial improvement in the institutional and information base are the most important of the necessary conditions.

The staff's view, taking into account recent developments, is that these can all be fulfilled in the next few years. Moreover, international comparisons with other developing countries indicate that the investment and saving ratios in Egypt are much lower than the average for developing countries, and therefore, there is much room for further improvement. My view is that the authorities will finally be able to increase both investment and saving to levels that are necessary to increase per capita income and reduce poverty. However, I think that the road ahead will be very difficult and the time required to succeed in reaching the targets will be long. Therefore, there is no room for complacency and/or for stop-and-go policies in the area of macroeconomic equilibrium and structural reforms.

As we have already said, the substantial increase in private investment necessitates a substantial increase in private savings. Reliance on foreign income from abroad—workers' remittances—or foreign saving, is not wise, unless it is in the form of foreign direct investment: debt creating capital flows from abroad or large current account deficits, as recent experience has demonstrated, are not very reliable sources of financing rapid economic growth in developing countries. It is rather clear that the factors and conditions necessary for increasing private savings are more or less the same as those necessary for increasing private investment, namely a broad range of structural reforms in the areas of privatization and in the institutions of the public sector.

With respect to public saving, I agree with the staff that the most reliable way to increase national saving is through higher public saving. The staff's comparison of Egypt's public saving ratio to that achieved by the newly industrialized Asian economies concluded that there is room for further substantial increases in public saving. Furthermore, a comparison of the ratio of tax revenues to GDP in Egypt and other countries in the region found that there is considerable room for increasing Egypt's tax revenues, and thus the public saving ratio (with respect to GDP). The authorities, using other comparators for the saving ratio, concluded that only a quite limited increase of this ratio was justified.

In its report the staff has extensively used the analytical method of comparing the values of certain economic variables—ratios of public saving, private investment, private saving, tax revenues, etc. to GDP—in Egypt with the same variables in other countries in order to draw certain conclusions regarding these ratios. This method is useful, however, provided that the comparators for a country were chosen very carefully, so as to have meaningful comparisons.

With respect to merchandise exports, I agree with the report's findings that the problem of Egypt's exports is connected with Egypt's general structural problems, high tariffs, important nontariff barriers, burdensome custom clearance procedures, and high charges at airports and harbors. The staff's comparison of Egypt's merchandise exports as a percentage of GDP to the corresponding ratio of a sample of countries of similar size concludes that Egypt's ratio is about one-third that of the sample. At this point, I am going to stress again the problem of the choice of comparators, which in this case is based on the size of the population. I am wondering if this is the right criterion for choosing the comparator countries for the performance of merchandise exports. I agree, however, with both the staff's conclusion that there is room for a further substantial increase of nonoil merchandise exports and their policy recommendations.

With respect to privatization, there is no doubt that the progress made so far is substantial. However, the public sector is still accounting for well over one-third of GDP, which means that the authorities have to intensify their efforts in this area. I was glad to see in the background paper, with respect to the pace of privatization, the recognition by the staff of the dilemma the authorities are usually facing in determining the pricing of public sector assets, as well as with the problems created in certain cases where a privatized public monopoly was simply transformed to a private monopoly, since these factors justify delays in the paced privatization. Finally, on page 22 of the staff report, we read that "in some cases the pace of investment in newly privatized companies is quite modest, which indicates that the management has not been replaced, and this may often be the case in newly privatized companies." I

With respect to the exchange rate, I was happy to see in Chapter IV of the background paper that the real effective exchange rate is no longer the undisputed indicator of overvalued or undervalued exchange rate or of the competitiveness of a country. According to the staff, other factors must be taken into account as well, such as comparative movements of productivity in the country and its trading partners, or comparative changes in other fundamentals, and also a comparison of the real effective exchange rate with the estimated "equilibrium real exchange rate!!" at a certain period of time, which would indicate if the real effective exchange rate for a previous period was overvalued or undervalued. I had the impression that for many reasons we were avoiding the use of the notion of the "equilibrium real exchange rate."

We agree with the staff's conclusion about the completion of third and fourth reviews, and we wish the authorities every success in the extremely difficult task of adjusting their economy successfully.

Mr. Prader made the following statement:

Like others, I am heartened and reassured by the stability of macroeconomic policy and the significant strides in structural reform made by Egypt since it began its Fund-supported adjustment and reform program some 18 months ago. The success of the program—especially high growth, the shift of the economy from a heavily state-controlled system to a system increasingly reliant on the private sector, and the opening of the economy to trade and investment, have exceeded all expectations and broken Egypt's past pattern of derailed Fund programs.

At this stage of the discussion, I have only a few comments and questions. One concerns structural reform. It is regrettable that the schedule of reform was only broadly met and that structural reform fell short of its targets in the important area of the general sales tax reform. Structural reform is also lagging in the area of the privatization of banks. What are the prospects for catching up and eliminating these significant departures from the program?

On the staff's estimate that the economic growth rate will be affected by a mere 0.5 percent by the security-related drop in tourism, I would like to see some further explanation, since I have seen several other, higher estimates of the effects. I recognize that it is difficult to predict when and by how much the confidence of tourists in their personal safety in Egypt will be restored, but the staff may well be underestimating the duration of the loss of confidence due to the terrorist attack in Luxor, as well as the effects on growth of the resulting decline in tourism. I am also interested in the staff's answer to Ms. Lissakers' question about the effect of the decline in oil prices.

On trade liberalization, Egypt is on track and should receive full credit for complying with the program targets. On the other hand, Table 34 of the background paper shows that Egypt still lags behind its regional competitors in terms of the degree of trade liberalization. To that extent, the authorities are not fully realizing their potential for reform. But now that the reform process has worked so well and demonstrated in practice that the economy can be opened up without negative side-effects, the authorities can and should exploit the reform momentum more boldly, surprising both us and the markets with additional trade liberalization even beyond the requirements of the Fund program. Such additional progress on trade integration would definitely expand the economy's choices. Never will it be easier to overcome the resistance of the entrenched interests opposing trade openness than at the present opportune juncture. Maybe Mr. Shaalan could comment on the possibility for further trade reform and on whether there have been any negative effects of trade liberalization which might hold the authorities back from going further.

It is also my view that the Egyptian authorities could now begin working on an independent central bank. This would underpin the new direction of the economy and safeguard the solidity of the reform process. Presently Egypt's central bank does not have sufficient institutional independence nor adequate tools for putting this important concept of independence into practice. I would be interested to learn whether the staff has discussed this essential requirement of a modern market economy with the authorities.

Finally, I take note of the discussion on Egyptian bank soundness in the background paper and a number of statements. It is correct—as Mr. Shaalan points out in his statement—that Egypt has been complying with international standards and norms and has even exceeded international standards for capital adequacy. But an economist from the Interamerican Development Bank has shown, in a paper presented to the American Economic Association, that because of such problems as different accounting standards and inadequate reporting of nonperforming loans, traditional industrial country standards of capital adequacy such as asset quality and liquidity are not good indicators of bank soundness in developing countries—or (to use another, more modern term) emerging markets. The value of these standards for predicting crises and bank vulnerability has turned out to be very low. For developing countries, a better measure of bank soundness seems to be the spread between their loan and deposit rates. I do not imply that Egypt has a bank soundness problem, but only wish to suggest that research into the usefulness of the indicators used for developed market countries should be borne in mind when making judgments about the banking systems of developing countries. In any event, the question of bank soundness in Egypt cannot be considered to be fully answered.

Mr. Taylor made the following statement:

The past year has clearly been another period of good performance. Just about everything under the program has been on track. The macroeconomic indicators are favorable, with solid growth, low inflation, a small external current account deficit, a fiscal deficit under 1 percent, and low external debt. The slippages that have occurred have been, by and large, quite minor.

Nevertheless, as the staff paper notes, the ultimate goal for Egypt is to achieve a higher sustained rate of economic growth. The social indicators on poverty; school enrollment, especially enrollment of females; and the low levels of expenditure on health and education show how far Egypt still has to go and how sustained the effort is going to have to be into the future.

Against that background, I wanted to touch on just three main issues, namely, growth, the fiscal situation down the track, and monetary and exchange rate arrangements. As Mr. Shaalan points out, the response of the economy in the savings area has been encouraging. We are working off a situation not only of low investment and inadequate savings, but also, more important, of low quality in much of the investment stock. The extent of privatization is one thing; the quality of privatization is another thing. It is not only about money; it is actually predominantly about efficiency. In that respect, if there is a question about the quality of privatization, I wonder how inefficient management is able to subsist in new ownership arrangements. Is it because there has been some kind of quasi-monopoly position maintained in which these firms operate? I think there are some more questions that would be worth pursuing in this area.

In the context of the Egyptian situation, it is important to examine how relevant the border protection system is to the future growth potential of the economy. Without repeating the comments put forward by other Directors, it is clear that further progress on tariffs, nontariff impediments, and the administrative system would be helpful in putting downward pressure on prices and in pressing for faster achievement of efficiencies within the domestic economy.

I can associate myself with the comments put forward by Mr. Shields on the fiscal situation, which for the time being seems to be sound. The sources of revenue, by and large, are either flat or declining—in the case of import duties, hopefully, declining. What needs to be done about that? I would advocate placing as much emphasis as possible not on increasing rates or introducing new taxes, but on doing as much as possible to eliminate exemptions and build the administrative capability of the system to collect taxes. While I am not sure about the extent to which that advice applies in the case of Egypt, it certainly applies to several other countries in Asia.

The question of the exchange rate regime inevitably attracts attention. Several Directors have supported introducing more flexibility in the exchange rate. It is important to spell out exactly what is meant by introducing more flexibility, because that can mean different things for different countries. In his opening statement, Mr. Sivaraman pointed out that the effective exchange rate appears to have appreciated by about 60 percent over a period of time. About six months ago I was told that the 40 percent appreciation in the real effective exchange rate of the Philippines could be fully justified. However, that statement is now increasingly coming into question.

The question of exchange rate policy is not simple, and it is not enough simply to advocate more flexibility or some change in the regime. At the same time, however, if a country is faced with a situation that clearly calls for a change in its regime, it does not want to have to implement changes at a time when the banking and exchange system is in crisis. There have been a number of cases in which such changes were forced on countries in a sudden manner, with results approaching disaster. Therefore, it would be advisable at the present stage, as a precautionary measure, to work through the array of administrative and policy issues that would arise if a change in the exchange rate policy became desirable or necessary. The relationship between the exchange rate and exchange rate management and monetary management may need to change quite significantly, and it is likely that the central bank will not have many officials who have experience in a new environment. For example, there have been cases in Asia where officials were not prepared to function effectively in the new policy environment suddenly thrust upon them. That is one area in which I wonder whether Egypt is living just a little bit dangerously.

That question aside, I wonder whether the staff and Mr. Shaalan could comment on the state of development of the monetary policy tools and of banking supervision in Egypt. On the face of it, although there have been some lags, there do not appear to be any immediate problems. But this is not just a question of capital adequacy and provisioning for bad loans. As Mr. Prader pointed out, that is a start, not a finish.

As Mr. Mirakhor suggested, it would be useful to continue the dialogue between the staff and the authorities on the supervisory and regulatory environment in Egypt. I think it is important in a country like Egypt for the staff to shine as bright a light on this area of policy development as possible, drawing on experience elsewhere. Egypt is, after all, a country in transition from an economy that was controlled and effectively owned by the government to one that is presumably to be influenced and guided. Those two kinds of economies are very different, and different policy tools, training, and maybe even different people might be needed in the bureaucracy. As I have indicated on previous occasions, this is no light matter. Such a change in the economic environment requires careful advance preparation and planning.

I welcome the comparative presentation of statistics. The compilation of as good an array of statistics as possible is vital to the effective management of the economy. Therefore, it is urgent for Egypt to press forward in that area.

Finally, I support the staff's recommendations and commend the authorities for the progress made to date.

Mr. Fernandez made the following statement:

I first want to commend the staff for their very clear report and to thank Mr. Shaalan for his helpful statement which gives us some additional background information on his authorities' fundamental policy orientations. I will be brief at this stage of the discussions, as previous speakers or authors of grays have covered the main issues and as I share the thrust of the staff appraisal.

I share other directors' views that macroeconomic developments in Egypt have been very positive and commend the Egyptian authorities for this very good track record. Nevertheless, I would like to comment on four issues. None of these are worrying at the present time, but all deserve careful monitoring.

First, the apparent strong external position and the current account surplus must not hide the fact that imports will increase in the future while non-oil exports remain weak, "anemic" in Ms. Lissakers' words, all in a context in which the staff's assumptions regarding tourism seem quite optimistic.

As Mr. Sivaraman stated in his very interesting statement, the current robust level of reserves should not induce complacency.

Second, the exchange rate policy raises numerous questions. I am of the view that the strength of the pound may be fragile, and that it may handicap the performance and diversification of the export sector alongside structural problems. Therefore, I agree with the staff that increased exchange rate flexibility should be introduced and wonder if it would not be wise to envisage such a move better sooner than later, when the environment seems favorable. I wonder if the staff or Mr. Shaalan could provide further comments on the views of the Egyptian authorities, as referred to in paragraph 84. I will also be interested in hearing the staff's comments on Mr. Taylor's sentiments on this matter.

Third, real interest rates remain high, which is a handicap for a country having enhanced growth as a vital objective. This is necessary to tackle the high unemployment rate.

Fourth, I must say that I find the staff's assumptions regarding the increase in private investment to be extremely ambitious, the ratio to GDP being expected to increase by 6.5 percent over the next five years.

Turning now briefly to structural reforms, I will only make one comment regarding the privatization program, which has achieved impressive progress. Sales to anchor investors, which are in a number of cases the best way to improve corporate performance, remain too rare.

It will also be critical to achieve the planned privatization of a state bank, and the staff's comments would be appreciated on progress being made in this direction. As Ms. Lissakers pointed out, we have to look not only at quantity but also at quality.

Finally, I fully share Mr. Shields' views on the fiscal position and on the necessity to reduce nontariff barriers to trade.

With these comments, I support the proposed decision.

Mr. Guzmán-Calafell made the following statement:

The Egyptian authorities are to be commended for their successful implementation of economic policy during the last years. A prudent macroeconomic policy stance, coupled with ambitious efforts of structural reform, have resulted in a continued strengthening of the rate of GDP growth, a decline in the rate of inflation to moderate levels, a surplus in the current account of the balance of payments, and in general a situation of economic fundamentals that has allowed the country to weather the adverse impact of the turmoil in southeast Asia and of the recent incidents of terrorism. Against this background, and given the overall adherence of the authorities to the measures agreed under the current Stand-By Arrangement, I support the completion of this review.

Clearly, the main challenge for the authorities is to sustain and enhance the progress made thus far. I believe that the policies described in the report are in general consistent with this objective. Thus, I would only like to comment briefly on a few issues which I consider of interest.

Credit to the private sector showed rates of growth above 27 percent in the last couple of years. While the staff is projecting a substantial deceleration in 1997/98, credit to the private sector is still expected to record an increase of 18 percent during the year. This gives rise to two doubts. One is the extent to which this trend is likely to affect the behavior of domestic demand. The other is the potential impact of credit growth on the banking system. As explained in the report and in Mr. Shaalan's very helpful statement, the overall compliance of Egyptian banks with internationally agreed norms is very good, and banks are in general well provisioned. However, the share of nonperforming loans in the total loan portfolio, at 13.4 percent in June 1997, is still high. Although this reflects to a considerable extent inherited bad claims on state-owned enterprises, given the sharp increase in credit to the private sector I am glad to see the authorities' intention to keep the volume of nonperforming loans under close scrutiny.

Exchange rate policy is another area that merits attention. On the one hand, as noted by others, the real exchange rate has appreciated substantially since the early nineties. I agree with the staff that there are reasons to believe that the equilibrium exchange rate has also appreciated. However, it is not clear that the upward trend of the real exchange rate can be fully justified on these grounds. This is not a problem that can easily be solved through more exchange rate flexibility, since the efforts of the authorities have in fact been concentrated on avoiding a nominal appreciation of the pound. In any event, the authorities' intention to keep a watchful eye on external competitiveness is clearly warranted. Regarding the exchange regime, while I concur with the staff that some additional flexibility is warranted, the authorities have a point in saying that the central issue is not the regime per se, but the consistency of policies with that regime. I would add that an open-minded and forward-looking attitude in the design of exchange rate policy to adapt it swiftly to new developments is also crucial in this regard.

The evolution of unemployment in Egypt needs to be followed closely. Box 3 in the report notes that the unemployment rate is estimated from 10 to 22 percent, and consequently that unemployment is a major social problem. In view of the persistence of high rates of unemployment despite the recovery of output, one is led to believe that this is a problem mainly of a structural nature. It is not clear in the report, however, what are the specific sources of unemployment in Egypt and what are the measures that are being implemented to tackle this problem. I believe this is an issue in which additional staff comments are warranted.

Let me turn now to the medium term prospects. I agree with the staff that the fundamental policy challenge is to sustain a high rate of economic growth through increased and more efficient investment and larger national savings. I have three observations in this regard. First, the intention of the authorities to achieve rates of economic growth in the 6.5–7 percent range in the medium term through an increase of one-third in the investment ratio is indeed ambitious and, as noted in the report, quite large compared to what has been achieved in other countries undertaking reforms. However, I note that the staff deems these targets as attainable and it is encouraging that Egypt is making serious efforts to meet them. Second, notwithstanding the important progress made in recent years, and a continued improvement in income distribution, poverty remains a severe problem in Egypt. With this in mind, an increase in the savings rate as that envisaged in the medium term projections is likely to be a difficult task. Third, it is not very realistic to expect that any shortfall in private savings will be compensated by additional public savings. The overall fiscal balance is projected to show only a small deficit in the medium term and, while the authorities must make every effort to ensure that the projected fiscal outcomes are met, at this stage I am not convinced that striving for a stronger fiscal result is warranted. Obviously, if savings do not behave as projected, the authorities will need to weigh the trade-off between achieving the targeted rates of economic growth and the risks linked to current account deficits above those included in the projections.

Finally, on data issues, I welcome the efforts the authorities are making to upgrade national account statistics. The authorities' intention to meet the SDDS as soon as possible, notwithstanding the existence of statistical deficiencies that in the view of the staff hinder economic analysis and policy formulation, is indicative of their determination to solve the problems faced in this area.

With these comments, I congratulate the Egyptian authorities for their remarkable achievements and I wish them continued success.

After adjourning at 1:05 p.m., the meeting reconvened at 2:35 p.m.

Mr. Fujii made the following statement:

I am pleased to see that Egypt's favorable macroeconomic performance has continued. I also commend the authorities for their substantial progress in structural reform and hope they will maintain the present adjustment momentum.

I am concerned, however, that three of the performance criteria for September 1997 were not observed. In addition, the staff indicates that one of these, the performance criterion on external arrears outstanding, is expected not to be observed even in end-December 1997, although this is partly due to the delay of the discussion with non–Paris Club creditors about debt relief. I therefore encourage the authorities to continue the negotiations and eliminate the remaining arrears as soon as possible and observe all performance criteria.

I support the thrust of the staff's policy recommendations and would like to make some comments on some of the policy issues just for emphasis.

Tourism is one of the most important sectors of the Egyptian economy. I therefore share the concern of Ms. Lissakers and Mr. Prader about the negative impact on tourism of the Luxor terrorist incident last year. The staff provides some estimation of this adverse impact on the macroeconomy in the paper, but I would appreciate it if the staff could provide a more detailed explanation on how this incident is expected to affect the macroeconomic prospects, including real GDP growth, fiscal balance, and the current and capital accounts.

On the fiscal front, it is encouraging to see that the fiscal deficit in 1996/97 was reduced as programmed mainly through the containment of expenditures. At the same time, I would note the importance of establishing a stable revenue basis in order to complete fiscal consolidation. In this regard, I am somewhat disappointed at the news that the extension of the GST was postponed, and pleased to note that the program will be correctly modified to include a new structural performance criterion requiring submission of the necessary legislation to the parliament by the end of June 1998.

Given Egypt's relatively low levels of investment and savings, I fully share the staff's view that higher investment and savings are necessary to sustain high growth performance over the medium term. As the staff rightly points out, the private sector is expected to play a central role in boosting investment. In order to facilitate private sector activity, comprehensive structural reforms, including deepening privatization and promoting the soundness of the banking system, should be implemented.

On the external sector, as Mr. Sivaraman notes in his statement, exports as well as foreign direct investment have been on the low side compared with the international standard. The authorities should receive benefits from integration into the global economy by taking various measures such as reducing tariff rates, eliminating nontariff barriers, diversifying the export base, which up to now has mainly been petroleum products, and improving the investment environment.

On the exchange arrangements, with a view to strengthening competitiveness and avoiding turmoil emerging from the short-term capital flows, I support the staff's view that the authorities should consider increasing exchange rate flexibility over time in the context of sound domestic macroeconomic fundamentals and solid external viability. I encourage the authorities to accept the Article VIII obligations as soon as possible.

Finally, I join many previous speakers and encourage the authorities to further pursue a strict macroeconomic policy and structural reform in order to avoid the potential risk of financial crises.

With these remarks, I support the proposed decision and wish the authorities further success in their endeavors.

Mr. Merino made the following statement:

The generally satisfactory compliance with the quantitative performance criteria and structural benchmarks under the current two-year precautionary Stand-By Arrangement demonstrates the authorities' skillful management of fiscal and monetary policies and their strong commitment to structural reform. Economic growth has continued to be robust against the backdrop of judicious stabilization policies, a steadily declining rate of inflation, and a strong external payments position, characterized by a projected small current account deficit, large foreign direct investment and portfolio capital inflows, and a comfortable level of official reserves. Despite the recent incidence of terrorism impacting on tourism, the soundness of Egypt's macroeconomic policies and the momentum of its structural reforms have helped the country to cope with the recent financial turmoil in global capital markets and to lay the basis for strong noninflationary growth.

Since we agree with the thrust of the staff appraisal, and support the completion of these reviews, I will limit my remarks for the current discussion.

The soundness of Egypt's financial sector must remain a priority in order to cope with the risks arising from potentially volatile capital flows. The authorities' efforts to divest public holdings in joint-venture banks and to allow the privatization of public commercial banks and insurance companies, while strengthening prudential regulations and supervision, are welcome. In his helpful opening statement, Mr. Shaalan points out that, on a risk adjustment basis, the average capital adequacy ratio for the banking system was 10.6 percent at the end of June 1997. While this is reassuring, I wonder whether the staff would consider a further increase in the minimum capital adequacy ratio of 8 percent desirable, taking into account, among other factors, the accounting practices, the extent of dollarization in the banking system, and the rapid structural changes in the Egyptian economy.

The staff reports points to the taxation of short-term portfolio flows as a policy option available to the Egyptian authorities to reduce the risks associated with capital inflows. We remain skeptical regarding the effectiveness of the recommendation not only because market participants find ways to circumvent such measures, but also, as important, because they fail to address the risk associated with rapid credit growth in the context of an unfinished agenda of reform in the financial system.

As we have seen recently in other cases, a surge in capital inflows can lead to rapid credit growth that can overwhelm the capacity of domestic financial institutions to allocate such resources efficiently, and to an excessive concentration of external liabilities in the short term. In this regard, have the authorities considered introducing higher reserve requirements in the banking system for prudential reasons if the level of capital inflows becomes excessive?

While the authorities should be commended for their efforts to improve the quality and quantity of financial data reported by banks, they would be well advised to further improve the transparency of the banking system, going beyond the release of aggregate data on key performance ratios.

Reducing the still-high spread between domestic and international rates should also help to alleviate some of the pressure on the exchange rate and reduce the fiscal cost of sterilization. Higher interest rates on pound deposits might have contributed to the fall in the share of deposits in foreign currency by more than half during the past six years. Over the same period, however, the share of foreign currency credit rose from 30 percent to 51 percent. I wonder whether the staff could comment on this trend.

Egypt's hard currency policy has served the country well. We welcome the authorities' intention to keep a watchful eye on external competitiveness. We also welcome the importance attached to structural reforms. Privatization, deregulation, and trade opening can serve to improve productivity in the Egyptian economy. Given Egypt's still-high level of effective protection, however, acceleration in the pace of reforms in these areas is crucial for the continued development of export-oriented activities and long-run export competitiveness. Foreign direct investment can also constitute an effective means to secure productivity gains through the introduction of modern technology and managerial expertise.

Despite the surge in portfolio flows, foreign direct investment increased modestly last year. While such a development can be explained by the stage of the economic cycle and the modalities for privatization, foreign direct investment should be expected to account for a more significant share of total capital inflows. In this connection, opening new areas to foreign participation, improving transparency, and simplifying the regulations governing investment should be encouraged.

In the fiscal area, containing the 1997/98 budget deficit to 0.9 percent of GDP constitutes an ambitious undertaking, given the downward revision of projected revenues. Nevertheless, the authorities should stand ready to respond quickly in the event of adverse developments, particularly by reducing implicit subsidies, by adjusting domestic prices of energy products, and by accelerating income and general sales tax reform.

Finally, sustaining the strong growth of the Egyptian economy is important to underpin popular support for the reform process and for regional stability. It is also needed to consolidate access to the international capital markets. With this come special responsibilities. In this regard, we welcome the authorities' determination to meet the special data dissemination standard as soon as possible.

With these comments, we fully support the proposed decision and wish the Egyptian authorities continued success in their reform efforts.

The staff representative from the Middle Eastern Department said that the staff had held extensive discussions with the Egyptian authorities on both the exchange rate and exchange rate policy. The staff and the authorities agreed that the current exchange rate was not a cause for concern with respect to export competitiveness, although the continued appreciation should be monitored closely. The 10 percent appreciation in 1997 followed the trend in real appreciation that had been taking place over a number of years. The recent nominal appreciation was associated with the peg of the Egyptian pound to the U.S. dollar. Egypt's price performance had fallen into line with that of its main trade partners. The level of wages and business costs in Egypt did not seem to be out of line with competitors, and exporters in Egypt were not complaining about an overvaluation of the pound. However, the recent appreciation did raise questions about how long the trend could continue and about the manageability of the cumulative appreciation, which had amounted to something like 60 percent since 1991.

It should be noted, in a longer perspective, that the upward trend in the exchange rate in the 1990s followed a period in which the exchange rate had depreciated over a number of years, the staff representative stated. In that respect, much of the appreciation over the recent period had simply offset the depreciation of the earlier years. Rather than observing any weakening in the balance of payments, Egypt's external position had remained strong. Thus the recent appreciation may have been a reflection of positive developments in the economy, such as structural reform, improvements in efficiency, and the debt write-off. A recent study by the staff of Egypt's equilibrium exchange rate sought to place these various elements in context, the staff representative noted. That analysis showed that the equilibrium exchange rate had also risen in recent years, and this helped explain why the balance of payments had remained robust over the period.

Exports were rather weak at the present stage, and it was important to bear in mind that the export sector was small, with a very narrow base, in Egypt. However, somewhat faster export growth was projected for 1997/98. The projected import growth, which was higher than that for exports, over the coming period was not a serious cause for concern, the staff representative commented. There were some constraints on import growth arising from quality controls and other restrictions. Those constraints also affected export growth and development. The staff was concerned that structural impediments might also constrain export growth over the medium term. However, the authorities agreed on the need to dismantle structural impediments to trade in the period ahead.

The staff considered that, as a developing country with a liberal exchange rate regime, including freedom of capital movements, that was integrating into the globalized system, Egypt should consider adopting a more flexible exchange rate system, the staff representative continued. At the present stage, there was much less justification than in the past for the nominal exchange rate anchor that had been used to discipline monetary policy. In addition, monetary policy was highly credible.

In the context of the Article IV consultation discussions with Egypt, the staff had urged the authorities to take advantage of the favorable international and domestic environment to introduce greater flexibility into the exchange rate system, the staff representative went on. At that time, however, the authorities had been primarily concerned with the need to ensure that the thrust of their economic policies was consistent with the exchange rate policy presently in place; they considered that, if that were the case, the exchange rate system was a secondary concern. Nevertheless, the authorities were committed to keep the exchange rate policy under review and to adapt it in the event that became necessary.

Developments in emerging markets and the terrorist attacks that had taken place in Egypt in the period since the Article IV consultation discussions had made it more difficult to contemplate changes in the exchange rate system, the staff representative added. The authorities were committed under the program to appropriate exchange rate intervention, and the floor on the net international reserves of the central bank would impose limits on their options in that area. In the event that a change in the exchange rate system became necessary—especially if had to be introduced under pressure—the implementation of changes would likely be facilitated by the firm stance of macroeconomic policies currently in place and by the ongoing program of structural reforms. That observation was consistent with the conclusions of the staff paper on exit strategies. The staff would continue its discussions with the Egyptian authorities on the exchange rate system in the months ahead.

That staff had worked with the authorities in developing estimates on the impact of the recent terrorist attack on the balance of payments, the budget, and on the growth of the economy, the staff representative said. Those estimates were based on a systematic survey of the initial impact the episode had on tourism and the reactions of tour operators. At the time those estimates were developed in November 1997, the impact had been projected to amount to about $500 million in terms of costs to the current account. The impact on the capital account would be much more difficult to estimate. The staff and the authorities expected that the impact on the budget would be negligible. That estimate had been included in the staff's revised budget projections. It was important to bear in mind, however, that those projections were tentative, and they would need to be reviewed. It would be very difficult at the present stage to make a judgment on how quickly the impact of the terrorist attack, in terms of its adverse implications for the economy, would fade. Nevertheless, at the present stage, the staff and the authorities considered that it would likely fade over the course of the current fiscal year.

Although the staff had only fragmentary information on the tourism sector, it was clear that it had suffered significantly as a result of the terrorist attack, the staff representative said. Some companies in European countries had suspended tours in Egypt for the winter season. However, there was some anecdotal evidence that tourists from some other European countries were arriving in Egypt in fairly large numbers to take advantage of the currently reduced costs on hotels. The staff had to the extent possible taken the effects of the terrorist attack into account in the balance of payments projections contained in the staff report.

Oil prices had declined somewhat, the staff representative noted. The most recent *World Economic Outlook* projected that oil prices would be about $2 per barrel lower than assumed in the staff report. While the lower oil prices would have a modest impact on the balance of payments, the staff did not consider it to be a cause for serious concern. Provided there was no further decline in oil prices, the impact of the recent reduction would add the equivalent of about 0.2 percent of GDP to the current account deficit for the current fiscal year. The staff would continue to monitor developments in the current account closely.

With respect to intervention in the foreign exchange market, it was important to note that the market was still quite rudimentary in Egypt, the staff representative commented. A limited number of players (i.e., the central bank and four public commercial banks) dominated the market. Thus, there was a lot of communication between the main players. Clearly, it would be desirable to modernize and deepen the foreign exchange market in Egypt. The authorities had received technical assistance from the Monetary and Exchange Affairs Department in that area. Although the Egyptian authorities had taken some steps to improve the system, the work in that area was still in its early stages. At present, the foreign exchange market was still very narrow, with little or no forward facilities.

Although it normally took some time for the fruits of privatization, in terms of increased efficiency, to become apparent, there were already indications in Egypt that privatized companies were realizing gains in output, profitability, and value added, the staff representative stated. That was particularly true for the companies that had been privatized early on. Also, privatization through employee shareholding accounts had produced very positive results in terms of improved performance. However, the retention by the government of 30–40 percent of the shares in some privatized companies gave it an important—and in many cases a controlling—interest. For that reason, the staff had encouraged the authorities to dispose of its remaining shares in companies that had already been privatized. As an added incentive, the staff had agreed with the authorities to count the divesture of remaining interests in privatized corporations toward the minority privatizations specified in the program, and the authorities had welcomed that option.

As to the period ahead, it should be noted that the privatization program was very broad, encompassing industrial companies, trading companies, hotels, ports, banks, and more recently, the power sector, the staff representative continued. Moreover, the government had recently announced its intention to privatize a portion of the telecommunications sector. Thus, the privatization program currently under way was very ambitious. It was important to note that it was being broadened by the government as public support for the program grew. In that sense, while the pipeline for privatization was already large, it could be expected to continue to grow over the period ahead. It was also important to bear in mind that there were limits to the administrative capacity of the government to push ahead with the program at a rapid pace, and there were limits on market absorption. However, the progress made thus far in Egypt compared favorably with the experience realized in other countries, as shown in the staff report.

Although the delay in the privatization of one of the public commercial banks and insurance companies was something of a disappointment, it was encouraging to note that the required enabling legislation to authorize that privatization was currently before parliament, the staff representative went on. The government was firmly committed to obtaining parliamentary approval of that legislation and to completing the privatization of the public commercial bank and insurance company within six months of the legislation's coming into effect. Moreover, it was hoped that, as that legislation came before parliament and, thus, into the public domain, support for the privatization of financial entities would gain momentum.

While the staff did not wish to press the authorities too hard to spell out their plans for privatizing the remaining public commercial banks and insurance companies, for fear of jeopardizing the privatization of the first ones, it was encouraging to note that the draft-enabling legislation covered all of the public commercial banks and insurance companies, the staff representative added. That suggested that the government had in mind a broader program than the initial steps laid out in the program. Moreover, the draft legislation currently before parliament would allow for foreign participation in Egypt's financial sector.

The government was committed to reducing the size of the civil service by 2 percent per annum, the staff representative said. The most recent information suggested that the authorities were adhering to the timetable for the civil service reform. Thus, the staff's medium-term projections were based on continued reduction in the size of the civil service as a part of the wider effort to streamline bureaucracy in Egypt. A broader program aimed at streamlining the civil service was being designed with assistance from some bilateral donors, including Canada. The work on that broader program was being undertaken in cooperation with all relevant government departments and offices, which had been called upon to present plans for their own restructuring and reorganization. The staff could raise the question of private sector participation in the civil service reform efforts at the time of its next discussions with the Egyptian authorities.

As to the relationship between foreign currency deposits and the free foreign exchange reserves of the commercial banks, it should be noted that foreign currency lending in Egypt was on the rise, the staff representative commented. While foreign currency lending by banks represented an increased share of their total foreign assets, the banks' position remained relatively healthy. Total foreign currency deposits amounted to about $10.7 billion. Over 90 percent of those deposits were in savings, and about 80 percent were backed by the banks' own foreign exchange reserves and deposits at the central bank. In addition, the commercial banks had liquid foreign assets amounting to about $11 billion. Thus, the commercial banks did not appear to be overextended, and the central bank held large amounts of foreign assets.

The staff had held discussions with the authorities on the issue of central bank independence, the staff representative stated. At the present stage, the central bank was under the wing of the Ministry of the Economy, and it was largely dependent on the Ministry of Finance for the securities needed to undertake open-market operations. Central bank independence had also been the subject of technical assistance by the Fund. While the authorities had signaled an interest in moving toward greater independence for the central bank over the medium term, the progress in that direction would take time.

The program supported by the Stand-By Arrangement encompassed a strengthening of the supervisory and regulatory environment of the banking system, the staff representative commented. As the staff report indicated, significant progress had been made in improving banking supervision and in enhancing reporting requirements, and further progress in these areas was envisaged.

The financial soundness of the banking system was adequate, the staff representative noted. In addition, the authorities intended to enhance transparency by requiring banks to publish their accounts in conformity with international accounting standards and by requiring banks to publish aggregate performance indicators beginning in early 1998. While the staff would agree with Directors that developing countries should aim to have minimum capital adequacy ratios above the minimum required by the Basle Committee's *core principles*, it should be noted that the average capital/assets ratio of Egyptian banks, at about 10.3 percent, was well above that minimum. Although the question of raising the minimum capital requirements further had not been taken up with the authorities in previous discussions, the staff would keep that suggestion in mind in forthcoming discussions.

The unemployment problem in Egypt stemmed from many years of sluggish economic growth combined with high rates of growth in the labor force, the staff representative considered. The size of the labor force had been growing at about 3 percent per annum, much faster than the rate of population growth. Another factor behind the current level of unemployment was the transition of the economy from a public sector–led economy to one that was led by the private sector. In such transitions, there was usually some lag between the downsizing of the public sector and the expansion of the private sector. Thus, part of the current unemployment problem in Egypt was transitional. While the labor code was restrictive, it was the staff's understanding that the code was not fully implemented in practice. Thus, it was not believed to be a major contributor to the unemployment problem. The authorities were committed to liberalize the labor market.

Meanwhile, the social fund was performing a useful function in targeting unemployment through public work programs, community development programs, and enterprise development projects as well as through retraining and redeployment, the staff representative continued. Looking ahead, as private sector activity picked up, the growth of the labor force and job creation were likely to move into a more balanced position. Recent indications suggested that new jobs—on a net basis—were being created for the first time in a number of years.

The staff was broadly satisfied with the package of supplementary tax measures that had been submitted to the parliament, the staff representative said. In addition, the authorities had submitted a timetable for the implementation of the measures included in that package. For example, the rationalization of stamp duties had already been enacted. Other measures were expected to be put into effect soon after their approval by parliament, probably before the end of February 1998.

As Directors had noted, the yield of the personal income tax was exceptionally low, at about 0.7 percent of GDP, the staff representative stated. Part of the relatively weak revenue performance could be attributed to the proliferation of deductions and exemptions as well as to weak tax administration. However, one of the main problems with respect to the personal income tax was that different taxes were applied to different sources of income. Thus, portions of income were taxed separately according to different schedules, rather than on an aggregate basis at progressive rates. The complexity of the system also added to the administrative difficulties. The Fund was providing technical assistance to Egypt in the area of taxation, and the staff would continue its discussions with the authorities on further measures to strengthen the revenue system over the medium term.

It was still somewhat premature to address the question of the Fund's relations with Egypt in the post-program period, the staff representative from the Middle Eastern Department commented. As the program supported by the current Stand-By Arrangement would continue to be in place for another seven or eight months, the staff had focused its recent discussions with the authorities on the implementation of the current program. The authorities at the highest level in Egypt were fully committed to the program's completion. At the time of the next mission, the staff planned to begin discussions with the authorities on relations between the Fund and Egypt following the completion of the present program. As the staff and the authorities agreed that the current Stand-By Arrangement marked a particularly positive period for the Egyptian economy, the staff was confident that the Fund's close and cooperative relations with Egypt would continue in the coming years. During its next round of discussions with the authorities, the staff hoped to build on the indications given by the authorities at the recent seminar in Cairo on the range of structural measures that would be needed as Egypt moves into a phase of second-generation reforms. At that time, the staff and the authorities would also consider how best the Fund could assist Egypt in the next fiscal year and beyond.

Mr. Erasmus made the following statement:

The determined efforts of the authorities to achieve a meaningful and durable improvement in economic performance have been rewarded with a large degree of success. Real GDP growth has been raised consistently from less than 1 percent in 1991 to about 5 percent in 1997, without compromising either the internal or external balance of the economy. In fact, throughout this period, the authorities maintained a relatively comfortable balance of payments position and succeeded in reducing inflation sharply from more than 20 percent in 1991 to about 5 percent toward the end of 1997. These results have been predicated on adherence to sound fiscal and monetary policies, as evidenced by the sharp reduction in the overall fiscal deficit and the maintenance of relatively high real interest rates. In addition, the improved performance of the economy has been underpinned by a significant number of structural reforms.

However, despite the improvements that have been made over the past six years, poverty and unemployment remain at relatively high levels. Therefore, we welcome the authorities' commitment to persevere with the efforts to raise the growth performance of the economy through sustained increases in national savings and investment. Succeeding in this challenge, will, however, require not only the maintenance of a stable and predictable macroeconomic environment, but also further substantial progress in the creation of an environment that will elicit a high degree of private sector participation in the economy. I would like to associate myself with the remarks of previous speakers on the exchange rate policy and the need to address factors that are constraining a faster expansion of nontraditional exports.

We agree with the staff that the policy stance for 1997/98 should enable the authorities to secure the progress that has been made in achieving macroeconomic stability. Given the risks underlying the assumptions for the coming year, we also welcome the authorities' stated readiness to adjust these policies if necessary.

With respect to fiscal policy, however, the ratio of revenue to GDP is projected to continue to decline substantially over the coming years. Given the sharp compression of public expenditure that has already taken place over the past few years, the potential impact of a continuation or intensification of internal unrest on the budget, and the less buoyant expectations regarding the traditional revenue sources, we encourage the authorities to give early consideration to a strengthening of Egypt's overall revenue base. In this regard, we agree with the staff that the extension of the general sales tax should be given priority. Early progress in this area will be important to ensure sufficient resources for social expenditures without compromising the progress that has already been made and help improve national savings.

We commend the authorities for the progress that has already been made in the implementation of important reforms as well as for their efforts to build a national consensus for reform, which is essential for the success of the program. However, there is clearly a substantial way to go with privatization. Therefore, we encourage the authorities to intensify and expand the scope of the privatization program. It would also be important to address the administrative and judicial regulations that continue to constrain the participation of the private sector. With these comments, we support the completion of this review and wish the authorities continued success.

Mr. Barro Chambrier made the following statement:

I would like to commend the Egyptian authorities for the progress made in the management of their economy. As a result, economic performance has continued to show significant improvement. In addition, progress has been made in the implementation of some key structural reforms. These positive results have also contributed to boost confidence in the Egyptian economy.

Notwithstanding these commendable outcomes, there are, however, indications that more efforts may be required to sustain the present trends over the medium term and to improve the living standards of the population and to reduce unemployment. In this context, I welcome the authorities' intention to maintain the thrust of their economic and structural adjustment efforts.

Overall, I am in broad agreement with the staff assessment and policy advice and I would like only to make a few comments on the fiscal sector and the structural reforms.

On the fiscal sector, I commend the authorities for their fiscal performance in 1996/97. As for the fiscal year 1997/98, I welcome their resolve to achieve their fiscal objective. On the revenue side, the results registered during the July–September quarter are encouraging, but further efforts will be needed to increase revenue performance in the remaining period of the fiscal year, as well as over the next 4–5 years. While the broadening of the tax system appears necessary, I would appreciate some comments from the staff as regards the importance of the informal sector in the Egyptian economy. I also wonder whether there is some scope of taxing this sector, so as to strengthen the tax base.

On the expenditure side, I would like to encourage the authorities to pursue a prudent wage policy, while accelerating the civil service reform. As saving could be expected from pensions, subsidies and defense outlays, the authorities should continue to monitor expenditure carefully, so as to achieve the fiscal target.

With regard to structural reforms, the authorities have made commendable efforts in promoting the private sector as one of the main engine for growth. However, continued progress is still needed, mainly in the privatization of the public enterprises, civil service reform, tax reform, financial sector reform and trade liberalization, as well as deregulation. As regards financial sector reform, I commend the authorities for the progress achieved, and for the strict application of prudential regulation and banking supervision. However, I would agree with the staff that the pace of privatization of state banks and insurance companies could be increased. Moreover, it would help to reduce the level of nonperforming loans. I would also like to add my support to those who recommend close supervision of banks, especially at a time of financial liberalization.

In conclusion, the Egyptian authorities have achieved much progress toward the goal of macroeconomic stabilization and the creation of an environment conducive to strong private sector development. The challenge facing the authorities is to strengthen their policies, so that the economy can achieve a much higher rate of growth. Resources are still far from being used efficiently and the right policies can help to establish a more dynamic private sector, which can contribute to creating more employment. As noted in Box 4 of the staff report, there are still many impediments to private sector development in Egypt. The regulatory framework and the bureaucracy appear to have been created to slowdown development. Much progress can be achieved in private sector expansion by simplifying the regulatory environment and reducing the bureaucracy.

With these words, let me commend the Egyptian authorities on their performance and also indicate my full support for the proposed decision.

Mrs. Sein made the following statement:

Egypt has made further progress in consolidating its economy in 1996/97 through perseverance with stabilization policy and structural reforms. Despite slight slippage, the Fund program for Egypt remains broadly on track. As I broadly agree with the thrust of the staff assessment of the Egyptian economy as well as the proposed decision, I would like to comment briefly on a number of issues raised in the staff appraisal for emphasis.

As the staff puts it, for the medium term, the fundamental policy challenge facing Egypt is to consolidate and extend the ongoing recovery through higher, more efficient, investment and larger national savings. On the former, Table 2 of the background paper showed that investment by the private sector has increased steadily throughout the past five years while that of the public sector has correspondingly been on a declining trend. While this is good, the aggregate level of investment has remained almost stagnant, except for 1996/97 when there was an increase, but it is still well below the developing country average. In this context, I welcome the authorities' determination to boost investment in the medium term. Furthermore, in line with the downsizing of the government role in the economy, such a task would need to be carried out by the private sector. In doing so, incentives for greater private sector involvement should be clear. Apart from an improved investment climate as a result of the enhanced adjustment and reform program thus far, the authorities, as suggested by the staff, should press ahead with structural reform across a broad front to strengthen the private sector response.

In order to finance a higher level of investment, there is no doubt that savings need to be raised. As mentioned in paragraph 36 and depicted in Figure 6 of the RED, national savings have been in line with investment in the 1990s. While it is noted that since the mid-1970s, net factor income has been a large contributor to investment financing, this part of the national savings is subject to exogenous factors. Therefore, emphasis should be on raising domestic savings. Specifically, efforts should be geared toward balanced or surplus public finance through revenue enhancement or further expenditure cuts or both. As the staff mentioned in paragraph 46 of the staff report, the government financing need for 1997/98 will be met by the banking sector. This nonetheless would be at the expense of a slower bank lending to the private sector, as implied by Chart 2. While further privatization of public sector entities and projects is welcomed, implementation of other structural reforms that would have more longlasting and favorable effect on the public finance and private sector savings, should also be expedited. In this regard, while I share the concern of the staff over the delayed implementation of a broader coverage of the GST to the next fiscal year, I sincerely hope that such slippage would not recur. All necessary steps should be taken to ensure a smooth implementation of the broader GST by June 1998.

On the balance of payments, I share the concern of Mr. Sivaraman in that Egypt should reduce its heavy reliance on oil exports by developing and expanding its non-oil sector exports to cushion against any shock in oil prices. This will not only help narrow the deficit in the goods sector, but could also reduce reliance of the economy on foreign savings in the form of workers' remittances and foreign aid. On the capital account, it is encouraging to note that various measures taken by the authorities so far in stimulating foreign direct investment seems to be paying off in terms of the increase in approved foreign investment projects. I presume that the capital would begin to flow into the economy beginning with the current fiscal year as indicated in the projected figure for foreign direct investment under the program as shown in Table 5 of the staff report, which is significantly higher than the previous year. Perhaps the staff could indicate how much of these inflows would be channeled to the export-oriented sector.

With that note, I wish the Egyptian authorities further success.

Mr. Vernikov made the following statement:

In fiscal year 1996/97 the Egyptian economy made solid progress toward macroeconomic stabilization as has been reflected in decreasing inflation, a sound current account position, and a comfortable level of international reserves. On this ground, further acceleration of economic growth has been achieved and living standards of the population have increased somewhat. As is emphasized in the staff papers, Egypt's performance under the current Stand-By Arrangement remains clearly on track, and the authorities, therefore, should be highly praised for the success of their efforts. At the same time nobody will deny that the country is only at the beginning of the way to a truly market economy and the main reforms still lie ahead. In the remarks that follow I will concentrate on a few major points.

The staff is right to emphasize that the main priority of the Egyptian reform is to support private sector development while diminishing state involvement in economic activity, which currently accounts for well over one-third of GDP. This is the only way to proceed with another challenging task—to raise national savings and investment and on this basis to promote sustained economic growth, increase the employment level and to raise living standards. At the time when a Stand-By Arrangement for Egypt was considered in October 1996, this chair underscored that overregulation of the economy had been the main impediment for creating employment and sustaining a high growth performance. I was encouraged to learn from the staff papers and also from Mr. Shaalan's informative statement that a good deal of work in this area has already been done, especially with regard to privatization and further adjustment of energy prices to the world levels. However, there are still numerous impediments to private sector development in Egypt, and we urge the authorities to eliminate them aggressively. Box 4 of the staff report provides somewhat horrifying evidence in that regard. For example, on average, one month is needed to clear goods through customs, and on average, six years to resolve a commercial dispute in courts. All this can produce a stronger impact on investors than an occasional incidence of terrorism.

The fiscal position of the country remains sound with the budget deficit at less than 1 percent of GDP. I welcome the fact that government expenditures have been on a declining trend for the past four years. Mr. Shaalan rightly notes that such budgetary trends attest to the changed role of the government in economic activity. The staff, in its background paper (see Table 3, p.26), as well as some Directors, indicate a particularly low share of personal income tax in Egypt (0.7 percent of GDP) compared to the regional average of more than 3 percent. In this regard I would like to note that the average regional figure is such mainly due to the inclusion of Israel, where personal income taxes account for nearly 13 percent of GDP. On the other hand, the figure for Egypt is not so different from corresponding figures for, say, Syria or Jordan. Therefore, a low level of personal income taxation should not be seen as an exclusively Egyptian feature.

Among the structural problems, trade liberalization remains a measure of top priority. According to any standards, the level of protection of the domestic economy, both tariff and nontariff, is excessive. This obviously contradicts the authority's intention to make the economy more open internationally and to exploit the opportunities of globalization. Of course, it would be unwise to insist on immediate economic opening, but, on the other hand, persistent protectionism is equally detrimental for economic development. Some moves in the right direction are now being made. Import bans are being replaced by tariffs, although prohibitively high ones initially, and the average effective import tariff is being reduced, even if rather slowly.

The external position of the country looks sound, with the current account being in a modest surplus during the 1996/97 fiscal year. This was obtained from receipts from tourism and high workers' remittances. At the same time, merchandise exports (of which about one-half is petroleum) represent less than 7 percent of GDP and only about one-third of merchandise imports. Under such circumstances, a deterioration of the current account in the future is quite possible, if a relatively stable net service income is accompanied by a rapid expansion of imports, especially if the latter are liberalized. I agree with Mr. Sivaraman that to avoid such a scenario, Egypt will have to concentrate on developing exports, especially in the non-oil sector.

The fixed exchange rate arrangement vis-à-vis the dollar has played an important role as the nominal anchor in the Egyptian economy so far. During the past two years the fixed exchange rate commitment alongside with relatively high interest rates and a stable macroeconomic situation stimulated a rapid inflow of short-term capital into the domestic equity market and local treasury bills, which was reversed in the past several weeks. I would not quite agree with the opinion that Egypt was absolutely unaffected by the recent turmoil in the emerging markets. Nonresidents' holdings of treasury bills, although not very significant in value terms, still decreased by roughly one-half at the very end of 1997. Regarding exchange rate flexibility, I would like to echo Mr. Taylor's question as to what exactly it means in the Egyptian context. Two groups of concerns have been expressed today, namely over the real appreciation of the pound and over presumed inflexibility of the exchange rate. My understanding is that the intervention has been asymmetric, and that it was aimed at preventing excessive appreciation. Should additional flexibility be introduced, it must allow the rate to move either way, which in the event of capital inflows would put upward pressure on the pound. I do not see how these two recommendations are internally consistent.

With these remarks I can comfortably support the proposed decision, and I wish the authorities well in their future endeavors.

Ms. Kask made the following statement:

Given the late stage of the discussion I will be very short and submit my full statement for the record. However, I would like to mention that Egypt has made good progress in stabilizing and reforming the economy in the past couple of years. The authorities' commitment to the program has been strong and I would very much hope that we could see this strong commitment also in the future, as there are remaining big challenges facing the authorities in the areas mentioned by other speakers: fiscal policy, structural reform, privatization, liberalization, deregulation of the economy. Our chair's views concur with Mr. Shields' views on the fiscal issues in his statement and Mrs. Lissakers' and Mr. Prader's comments on the structural area.

I would like to comment mainly on the structural areas. Egypt's success in the medium term will depend strongly on the ability and willingness of the government to carry out strong and widespread public sector reform, together with acceleration in privatization and the promotion of an investorfriendly environment, liberalization of trade policies and enhancing the human capital in the public sector. It seems that the authorities could be stronger in their actions to eliminate the existing restrictions for private sector development and liberalization and more confident in the positive nature of these reforms (if implemented correctly). Despite the possible short-term loss in fiscal revenues that these actions might bring along, the longer term benefits of these reforms in the form of advanced technology and know-how, increasing overall effectiveness of the economy and improving of the living standard of the population, is obvious.

Notwithstanding the progress lately in privatization and divestiture, the state role in the economy has remained very high, maintaining inefficiency in the economy. It is necessary not only to continue the privatization process, but also to broaden and deepen it, as the staff points out, in order for the economy to increase its manufacturing and export potential. The authorities should increase efforts to evaluate the remaining less attractive state enterprises to establish a reasonable price for their privatization, and decide upon other measures necessary to increase incentives for investors to participate in the process.

Reforming other areas of the public sectors is as important. The present situation of long and costly bureaucratic procedures must be tackled soon in order to keep attracting investments. I welcome the authorities' intention to review government functions and urge them to take early actions in order to improve the public sector operations through broad and strong institutional and judicial system reforms. These reforms would help the state to carry out its functions more effectively and through greater transparency, thus giving confidence to the private sector.

Finally, let me underline the need to continue the reduction of trade barriers. Egypt still has one of the highest rates of trade protection in the region. I would be grateful for the staff's comments on the projected average level of tariffs at the end of the program period and about the possibility to accelerate trade liberalization process generally.

Mr. Bernal made the following statement:

We are grateful to the staff for its very useful report on the Egyptian economy. In the context of the current Stand-By Arrangement, Egypt is successfully achieving its comprehensive structural reform program, and the country is moving toward consolidating macroeconomic stability.

The financial program for 1997/98 is anchored in continued prudence in fiscal and monetary policy, and is consistent with a further gradual increase in real GDP growth.

We commend the authorities for deepening the process of strengthening the central bank's capacity for conducting open market operations and other market-based procedures for monetary management.

Also, as the staff and other speakers have mentioned, greater exchange rate flexibility should be considered.

The authorities should consider, as the staff suggests, additional fiscal adjustment that could serve to alleviate potential pressures arising from capital inflows and to crowd in private investment. Fiscal adjustment would also serve to underpin national savings growth.

As Egypt is achieving successfully its structural reform program and moving toward consolidating macroeconomic stability, we strongly support the proposed decisions and wish the authorities continued success in the management of their economy.

The staff representative from the Middle Eastern Department said that the staff had not attempted to estimate the size of the informal sector in Egypt. However, the fact that tax yields were very low, even taking into account the multiplicity of exemptions and exclusions, suggested that the informal sector was very large. The best way to tax that sector would be to streamline and simplify the tax system along the lines recommended by the Fiscal Affairs Department. Some of the recent measures the authorities had submitted to parliament clearly represented a step in that direction. Meanwhile, the planned extension of the general sales tax to the retail sector, which it was hoped would be in place by the time of the new budget, would make an important contribution by expanding the revenue base to include many retailers that had escaped taxation in the past.

The staff did not have any data on the extent to which foreign direct investment was being channeled to the export sector, the staff representative stated. A sectoral breakdown of recent foreign direct investment approvals suggested that about one quarter were earmarked for tourism. About one-half of recent approvals was for foreign direct investment in the manufacturing sector; some of that investment would clearly have an export orientation.

Mr. Shaalan noted that the discussion had been wide-ranging and thought-provoking. He was grateful to Directors for their remarks commending the progress achieved thus far and, more important, for their advice on addressing the challenges ahead. He would convey Directors' comments to his Egyptian authorities promptly.

As the staff had addressed most of the questions raised by Directors for the current discussion, he could limit his comments to only a few points that merited particular emphasis, Mr. Shaalan said.

With respect to the exchange rate policy, it was important to bear in mind that the authorities' operations in the foreign exchange market were asymmetrical to the extent that they focused on preventing further nominal appreciation of the pound, while allowing the exchange rate to depreciate if downward pressures emerged, Mr. Shaalan noted. Given the tight ceiling on the net international reserves of the central bank, the authorities' room for maneuver in that area was clearly limited.

With respect to the analysis of the real effective exchange rate and the sluggish performance of exports over the past year or so, it would be important to avoid over reliance on the real exchange rate as a measure of competitiveness, Mr. Shaalan considered. Recent literature clearly showed that the real exchange rate was not always an appropriate indicator of competitiveness. That was particularly true in the case of Egypt, given the serious impediments to exports arising from bureaucratic hurdles and the high costs of services associated with exports, in particular the costs related to shipping and port facilities. The government was making a concerted effort to remove those impediments. For example, the parliament has recently passed laws authorizing the immediate sale of pubic sector maritime and port services and allowing the private sector to enter into those areas. The government was also putting in place a strategy to address the high costs of services related to exports as part of an overall plan to create an administrative and financial environment that would be more conducive to export growth. Based on the most recent available data, exports appeared to be responding to the government's initiative; non-oil exports were currently projected to increase by about 15 percent in 1998.

Without going into too much detail about the question of arrears, it should be noted that Egypt's arrears to non–Paris Club creditors were minimal, Mr. Shaalan commented. The Egyptian authorities were pursuing appropriate policies to discharge those arrears on terms comparable to those agreed with members of the Paris Club.

As to tourism, the initial impact of the unfortunate terrorist incident, which had shocked the country, had been strong, Mr. Shaalan noted. There had been numerous cancellations of tour operations throughout the winter. However, more recently, there had been some evidence that activity in the tourism sector was beginning to pick up. In that respect, the private sector had taken the initiative of cutting hotel costs sharply. For example, five-star hotels in the Red Sea area were charging only $25 per night. It would be difficult to say how long the impact of the terrorist attack would last. Clearly, the longer the adverse effects of that shock were in place, the more it would affect the balance of payments. However, given the current overall strength of the balance of payments position, the impact of the incident would not likely give rise to problems that could not be addressed by the authorities.

He would agree with Director that the main objective of privatization was not to generate revenue so much as to enhance efficiency, Mr. Shaalan stated. As the staff report noted, the quantitative targets under the privatization program had been met. In addition, privatization receipts had been included in the budget only to the extent that they had been used to reduce the stock of government debt. The authorities had recently informed him that there had been a change in the management of privatized firms, as a result of the requirement that 25–30 percent of privatizations must be directed to institutions that would, then, have a hand in management. As the staff report also noted, the government was being encouraged to sell off its minority shares in companies previously privatized. In that context, four companies had now been passed over entirely to the private sector. Those measures were reflected in the increased profitability of privatized companies. Moreover, it should be noted that the scope of the overall privatization program was very broad, and it was to be further expanded in 1998 to include part of the telecommunications sector.

With respect to trade liberalization, the authorities had met all of the program targets for tariff reductions, Mr. Shaalan noted. Although a number of Directors had suggested that Egypt move faster with respect to liberalization, it was important to bear in mind that the current program of trade liberalization had been announced previously by the government. At the present stage, the authorities considered it very important to fully adhere to that program in order to help build credibility.

It would be very difficult to surmise whether a faster pace of liberalization in the past might have had adverse effects, Mr. Shaalan considered. However, the recent moves taken by the government to eliminate the ban on textile imports had created an uproar within the country. Given the importance of the textile sector as a major manufacturing sector in Egypt, those moves represented a significant achievement. For the future, the pace of trade liberalization would be influenced to a large extent by the prospective Association Agreement with the European Union.

The Egyptian authorities would agree with the comments put forward by Ms. Lissakers on the need to address bureaucratic and regulatory obstacles to growth, Mr. Shaalan commented. Indeed, serious efforts toward that end were currently in train. It should be noted that the Egyptian authorities at the highest level were fully committed not only to seeking parliamentary approval of needed legislation, but also to moving quickly to fully implement the new laws as they came into effect. Against that background, it was also important to bear in mind that it would likely take some time to dismantle the current structure of bureaucracy, which had been built up over many years, in Egypt.

He differed with those speakers who had suggested that the level of real interest rates—which was currently about 3–4 percent—was overly high, Mr. Shaalan stated. Moreover, in the current financial environment, there was a need to use caution in taking any actions to reduce interest rates.

He agreed with Mr. Prader that the traditional indicators used to judge banking sector soundness in industrial countries might not be adequate for other countries, Mr. Shaalan commented. One of the main indicators of banking sector weakness referred to by Mr. Prader was the narrowness of the spread between lending and deposit rates. In that context, it was encouraging to note that the spread between lending and deposit rates in Egypt, at 4–5 percent, was fairly wide. Nevertheless, there was clearly a need for further study on the usefulness of various indicators of banking sector soundness.

With respect to Directors' comments on the social sector, it was pleasing to note that larger expenditures were devoted to education and health in Egypt than to defense, Mr. Shaalan stated. The authorities continued to attach high priority to both of those areas.

The staff and the authorities had not yet discussed the possibility of a follow-up arrangement to the current Stand-By Arrangement, Mr. Shaalan noted. However, the authorities valued the cooperative relationship between Egypt and the Fund. Regardless of whether or not Egypt entered into a new arrangement with the Fund, the authorities considered the maintenance of that cooperative relationship a priority.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the strong progress achieved by the Egyptian economy over the past year, stemming from the implementation of judicious stabilization policies, as well as a broad-based program of structural reforms, and facilitated by the increasingly evident national ownership of the program. They noted that Egypt's strong macroeconomic performance, favorable external reserve position, and reduced debt levels have helped shield its

financial markets and the pound from the potentially more serious repercussions of the recent financial turmoil originating in Southeast Asia.

Directors welcomed the authorities' implementation of prudent macroeconomic policies. Nevertheless, in light of the impact on the economy of recent acts of terrorism as well as the volatility in international capital markets, Directors stressed that continued implementation of strong macroeconomic policies, in conjunction with structural reforms, would be key to fostering a resilient economy in the near term and to the achievement of sustained economic growth, the creation of needed employment opportunities, and the improvement of living standards over the medium term. They welcomed the authorities' readiness to respond quickly in the event of adverse developments, and pointed to the benefits of continued close cooperation with the Fund after the expiration of the present arrangement.

More specifically, Directors affirmed that consolidation and extension of the ongoing recovery would depend on increased national saving and investment, greater private sector participation in the economy, and the further integration of the Egyptian economy into global markets. In this regard, Directors stressed the importance of improving the environment for private sector activity and building investor confidence, particularly through further privatization, implementation of regulatory reforms, reduction of bureaucratic hurdles, and strengthening of the legal framework. Some Directors suggested that intensified efforts to mobilize public sector savings, on a larger scale than currently envisaged, would give greater assurance that the government's bold medium-term targets for increasing national saving and investment would be achieved.

Directors regretted that the authorities had postponed until the June 1998 budget the extension of the general sales tax to the wholesale and retail levels. Noting the expected weakness of several revenue sources, Directors indicated that the planned extension of the sales tax in the 1998 budget would make an important contribution to modernizing the tax system and reinforcing revenues over the medium term. To this end, several Directors also called for efforts to reform and streamline the tax system and to strengthen tax administration.

Noting that the public sector remains dominant in the Egyptian economy, Directors welcomed progress under the privatization program, and stressed the importance of maintaining the momentum of privatization and of broadening its scope in the period ahead. In this connection, they welcomed the recent announcement regarding the early corporatization of the public telecommunications company as a first step toward eventual privatization. Directors also noted the submission to parliament of legislation authorizing divestiture of public sector banks and insurance companies, and urged the early privatization of some of these institutions, as envisaged in the current program. Several Directors also drew attention to the need to put more emphasis on the quality of the privatization process to ensure lasting efficiency gains to the economy.

Directors welcomed the progress achieved in liberalizing external trade. However, several speakers were of the view that there remained considerable scope for further trade liberalization, and they urged an intensification of efforts to eliminate trade restrictions, including nontariff barriers, with a view to enabling Egypt to accelerate its integration into the global economy and more fully realize its growth potential. On exchange rate policy, Directors welcomed the intention of the authorities to monitor external competitiveness, especially given the continued real appreciation of the currency and the slow growth of non-oil exports, and several Directors recommended that consideration be given to increasing the flexibility of the exchange rate. Directors generally were of the view that, given the uncertainties prevailing in a number of emerging market economies, any changes in Egypt's exchange rate policy should be timed carefully. As a complement to exchange rate policy and to facilitate policy responses to fluctuations in capital flows, Directors emphasized the importance of continued efforts on the part of the Egyptian authorities to expand the tools of monetary management and control. Directors noted that Egypt's exchange system was now virtually free of restrictions, and recommended that the authorities consider early acceptance of the obligations of Article VIII of the Fund's Articles of Agreement.

Directors welcomed the authorities' commitment to strong banking supervision and prudential regulation, and underlined the importance of sound financial institutions for overall economic stability. In this connection, Directors urged the authorities to continue to accord high priority to ensuring compliance by the financial institutions with the prudential limits, including those on banks' loan concentration and capital adequacy. They also welcomed the authorities' intention to publish aggregate data on banking performance from early 1998.

Directors welcomed the recent further reductions in implicit subsidies on domestic energy products and the government's intention to complete this process under the current program. Directors also noted the importance of efforts to meet social needs and alleviate poverty, particularly through efficient investment in health and education, and welcomed the intention of the authorities to expand public expenditure in those areas in the period ahead.

Directors underlined the importance of achieving further improvements in the collection and compilation of economic data, and encouraged the authorities to continue their efforts in those areas. They urged the authorities to subscribe to the Special Data Dissemination Standard (SDDS) as soon as possible.

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

The Executive Board took the following decision:

1. The Arab Republic of Egypt has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for

the Arab Republic of Egypt (EBS/96/149, Sup. 2, 10/16/96), as amended, and Appendix I to the Memorandum on Economic Policy attached to the letter from the Minister of Public Sector, Administrative Development, and Environment, the Minister of Finance, and the Governor of the central bank of Egypt, dated September 12, 1996, in order to assess progress under the program and to establish performance criteria for end-March and end-June 1998.

2. The letter dated December 16, 1997 from the Minister for the Public Enterprise Sector, the Minister of Finance, the Minister of Economy, and the Governor of the Central Bank of Egypt, with its attachment, shall be annexed to the Stand-By Arrangement, and the letter dated September 12, 1996, with its attached Memorandum on Economic Policy, shall be read as supplemented and modified by the letter dated December 16, 1997 and its attachment.

3. The Arab Republic of Egypt has requested that the performance criterion specified in paragraph 3(a)(ii) of the Stand-By Arrangement be modified for end-December 1997, that a structural performance criterion be incorporated in the Stand-By Arrangement for June 30, 1998, and that the third and fourth review provided for in paragraph 3(c) of the Stand-By Arrangement and specified in Appendix I attached to the Memorandum on Economic Policy attached to the letter dated September 12, 1996, be consolidated into one review. The Fund approves these requests.

4. Accordingly:

The limit referred to in paragraph 3(a)(ii) for December 31, 1997, and the limits referred to in paragraphs 3(a) and 3(b) for March 31, 1998 and June 30, 1998 of the Stand-By Arrangement shall be as specified in the attachment to the letter dated December 16, 1997.

A new paragraph 3(a)(v) with the following wording shall be included in the Stand-By Arrangement:

"(v) by June 30, 1998, the submission by government to parliament of draft legislation providing for the extension of the general sales tax to the wholesale and retail levels, as specified in paragraph 5 of the letter dated December 16, 1997."

5. The Fund decides that the third and fourth reviews contemplated in paragraph 3(c) of the Stand-By Arrangement and in Appendix I attached to the Memorandum on Economic Policy attached to the letter dated September 12, 1996 have been completed, and that, notwithstanding the nonavailability of data with respect to the performance criteria for December 31, 1997, set forth in paragraphs 3(a)(i) to (iv), and 3(b)(I) and (ii), and the nonobservance of the performance criteria set forth in

paragraph 3(b)(iii) of the Stand-By Arrangement, the Arab Republic of Egypt may proceed to make purchases under the Stand-By Arrangement for up to the equivalent of SDR 223.1 million until February 15, 1998. (EBS/97/238, 12/17/97)

Decision No. 11645-(98/1), adopted
January 7, 1998

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/127 (12/30/97) and EBM/98/1 (1/7/98).

4. COMPENSATORY AND CONTINGENCY FINANCING FACILITY—REVIEW—EXTENSION OF DEADLINE; AND PERIOD OF OPERATION OF CEREAL ELEMENT—EXTENSION

Compensatory and Contingency Financing Facility—Review—Extension of Deadline

Executive Board Decision No. 8955-(88/126), adopted August 23, 1988, as amended, is hereby further amended as follows: paragraph 56, "January 13, 1998" is deleted and replaced with "January 13, 1999." (EBD/97/137, 12/23/97)

Decision No. 11646-(98/1), adopted
January 5, 1998

Compensatory and Contingency Financing Facility—Period of Operation of Cereal Element—Extension

Executive Board Decision No. 8955-(88/126), adopted August 23, 1988, as amended, is hereby further amended as follows: in paragraph 23, "January 13, 1998" is deleted and replaced with "January 13, 1999." (EBD/97/137, 12/23/97)

Decision No. 11647-(98/1), adopted
January 5, 1998

5. ESAF TRUST—RESERVE ACCOUNT—REVIEW

Pursuant to Executive Board Decision No. 10286-(93/23) ESAF, the Fund has reviewed the adequacy of the Reserve Account of the ESAF Trust, and determines that amounts held in the account are sufficient to meet all obligations which could give rise to a payment from the Reserve Account to lenders to the Loan Account of the ESAF Trust in the six months from January 1 to June 30, 1998. (EBS/97/243, 12/22/97)

Decision No. 11648-(98/1), adopted
December 30, 1997

6. PERIODS FOR CONSENT TO AND PAYMENT FOR INCREASES IN QUOTAS UNDER NINTH GENERAL REVIEW—EXTENSION

1. Pursuant to paragraph 4 of the Resolution of the Board of Governors No. 45-2, "Increases in Quotas of Members—Ninth General Review," the Executive Board decides that notices in accordance with paragraph 2 of that Resolution must be received in the Fund before 6:00 p.m., Washington time, on June 30, 1998.

2. Pursuant to paragraph 5 of the Board of Governors Resolution 45-2, the Executive Board decides that each member shall pay to the Fund the increase in its quota under the Ninth Review within 2,057 days after the later of (a) the date on which it notifies the Fund of its consent, or (b) November 11, 1992. (EBD/97/138, 12/23/97)

Decision No. 11649-(98/1), adopted
December 30, 1997

7. PHILIPPINES—EXTENDED ARRANGEMENT—EXTENSION OF COMMITMENT PERIOD

Paragraph 1 of the Extended Arrangement for the Philippines (EBS/94/117, Sup. 2, as amended) shall be partially amended to read: "1. For a period from June 24, 1994 to January 31, 1998, the Philippines . . ." (EBS/97/70, Sup. 3, 12/30/97)

Decision No. 11650-(98/1), adopted
December 31, 1997

8. VIETNAM—DECISION CONCLUDING 1997 ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 1997 Article XIV consultation with Vietnam.

2. Vietnam continues to maintain restrictions on the making of payments and transfers for current international transactions under the transitional arrangements of Article XIV, Section 2, as described in EBD/97/135, Supplement 1. The Fund encourages Vietnam to eliminate these restrictions as soon as circumstances permit. (EBD/97/135, Sup. 1, 12/24/97)

Decision No. 11651-(98/1), adopted
December 31, 1997

9. ADOPTION LEAVE POLICY—AMENDMENT

1. After 10 months of continues service, a staff member, regardless of gender, who adopts a child up to 12 years of age shall be eligible for adoption leave for so much of a period not exceeding eight

calendar weeks as the staff member certifies that he/she is the primary caregiver to that child at the time of the adoption leave, within the maximum of 24 weeks of adoption leave per Fund career.

2. When both parents are employed by the Fund, Fund/Fund couples shall determine the allocation between them of the primary caregiver role during the eight-week adoption leave period for purposes of such certification.

3. The changes set forth herein shall be effective upon the date of the decision. (EBAP/97/124, 12/22/97)

Adopted January 5, 1998

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/199, Supplement 1 (12/29/97) and EBAM/97/202 (12/31/97), and by Assistants to Executive Directors as set forth in EBAM/97/198 (12/23/97) and EBAM/97/201 (12/30/97) is approved.

APPROVAL: October 29, 1998

REINHARD H. MUNZBERG
Secretary