FOR AGENDA

EBS/87/93

CONFIDENTIAL

April 29, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Arab Republic of Egypt - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is Egypt's request for a stand-by arrangement equivalent to SDR 250 million. Draft decisions appear on page 38.

It is understood that the Executive Director for Egypt will be requesting the Board for a waiver of the circulation period, to enable this subject to be brought to the agenda for discussion on Friday, May 15, 1987.

Mr. Kawar (ext. 7138) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

ARAB REPUBLIC OF EGYPT

Request for Stand-By Arrangement

Prepared by the Middle Eastern Department and the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, Research, and Treasurer's Departments)

Approved by A.S. Shaalan and J.T. Boorman

April 29, 1987

In the attached letter dated February 25, 1987 from the Governor of the Central Bank of Egypt and the Minister of Finance to the Managing Director (Appendix I), the Government of Egypt requests an 18-month stand-by arrangement in the amount of SDR 250 million, equivalent to approximately 54 percent of quota, or 36 percent on an annual basis, in support of a financial program covering the period April 1, 1987 to September 30, 1988. 1/ A Statement on Economic and Financial Policies dated February 24, 1987 and a Technical Memorandum of Understanding dated March 31, 1987 specify intentions by the Government of Egypt and outline policies that will be pursued during the period of the arrangement (Appendix I). Assuming that all planned purchases under the

---

1/ Discussions on the policies of the Government of Egypt during the period of the arrangement and beyond, as well as on technical aspects of policy implementation, were held in Cairo during four staff visits: August 28-September 8, 1986; October 27-November 25, 1986; January 20-February 12, 1987; and March 20-31, 1987; as well as during the visits of Egyptian delegations to Washington during the 1986 Annual Meetings and the April 1987 meetings of the Interim and Development Committees. Staff members participating in one or more of the visits to Cairo included Messrs. Chabrier (Head), Kawar, Short, and Thakur (all of MED); Ms. Jul (ETR); Mr. Sisson (FAD); Ms. Nicholson (Secretary - MED); Mrs. Pahigiannis (Secretary - MED); Ms. Valencia (Secretary - ETR); and Ms. Wright (Secretary - TRE). Mr. Shaalan (MED) participated in some of the discussions as did Messrs. Wall and Chhibber (both of the IBRD). The missions to Cairo were assisted by Mr. Gronlie, the Fund Resident Representative. The Egyptian participants included Prime Ministers Sedki and Loutfi (the latter before November 10, 1986), Deputy Prime Ministers Abdel Meguid (Foreign Affairs) and Ganzouri (Planning), Minister of Finance Razzaz, Ministers of Economy Mostafa and Abou Ali (the latter before November 10, 1986), Minister for Cabinet Affairs and Administrative Development Ebeid, and Governors Hamed and Negm (the latter before November 10, 1986) of the Central Bank.

proposed arrangement are effected, outstanding Fund credit to Egypt would increase to 54 percent of quota at the end of November 1988, the projected expiration date of the arrangement (Table 1).

I. Background

From the mid-1970s through the early 1980s, the Egyptian economy grew rapidly under the stimulus of rising earnings of foreign exchange from petroleum exports, remittances of expatriate Egyptians working in neighboring oil producing countries, Suez Canal dues, tourism, and external aid flows. The increased availability of these foreign exchange resources, which did not result from the productivity and competitiveness of the economy, financed higher private and public expenditure for both consumption and investment, and kept the overall balance of payments in surplus through 1982/83 (fiscal year ending June 30).

During the period, however, the structure of the economy as well as of the balance of payments weakened as a result of domestic economic policies. At the macroeconomic level, the official objective of maintaining minimum living standards for the population through the provision of a wide range of goods and public services at low cost, resulted in the extensive subsidization of the prices of imported foodstuffs and of energy. In turn, it led to the maintenance of a complex exchange and trade system which allowed an effective appreciation of the Egyptian pound, to low nominal rates of interest which encouraged borrowing and discouraged saving, and to expansionary financial policies. 1/ The expansionary financial policies, together with the extensive subsidy system and the overvalued exchange rate, stimulated public sector imports while controls on production and on prices in the agricultural and industrial sectors in an environment of rising domestic costs discouraged the production of tradable goods.

The downward movement of world oil prices after 1981 brought the structural weakness of the balance of payments into the open, in particular the stagnation of non-oil exports and growing imports of essential foodstuffs. However, the external payments position remained manageable owing to the continuation of high levels of aid and access to commercial borrowing abroad; there was also a buildup of arrears to certain creditors. The turnaround in the overall balance of payments in 1983/84 from surplus to a deficit of US$0.4 billion prompted the authorities to adopt a more active policy stance over the ensuing two years. Restraining fiscal actions were taken; the domestic prices of a number of agricultural, industrial, and energy products were raised; the price of bread was doubled; and an attempt at exchange reform was made

1/ Since the late seventies, Egypt's exchange system has comprised a central bank market with multiple fixed rates, a commercial bank market with two fixed rates until recently, and a free market with a floating rate.

which included a small depreciation in the commercial bank exchange rate. However, in relation to the disequilibria of the economy, these actions were limited in extent and in scope. For instance, the overall budget deficit remained at well over 20 percent of GDP in 1984/85 and 1985/86 due to a number of rigidities. Notwithstanding the intensification of import restrictions and the fall in the import prices of a number of commodities (foodstuffs in particular), the current account deficit of the balance of payments widened in both 1984/85 and 1985/86. The shortages of foreign exchange in the official markets led to an acceleration in the accumulation of external payment arrears which rose to US$4.9 billion by June 1986.

The restraints on public capital outlays that were introduced in the 1985/86 budget, together with growing constraints on financing public sector imports, brought about a decline of investment in real terms and a slowdown of the growth of real GDP to an estimated 2 percent in 1985/86, from 4 percent in the previous year; a negative growth rate has been projected by the World Bank for 1986/87. Shortages of imports combined with still expansionary financial policies led to an acceleration in the rate of increase in the consumer price index to 30 percent at the end of 1986. In addition, the free market exchange rate depreciated from LE 1.50 per U.S. dollar in June 1985 to LE 2.10 per U.S. dollar by the first quarter of 1987, a depreciation that would have been even more pronounced had it not been for the intensification of import restrictions and the accumulation of arrears. Despite the depreciation of the free market exchange rate the trade-weighted real effective exchange rate (weighted to include the three main exchange rates) appreciated by 9 percent during the year ended December 1986.

By the end of 1986, Egypt's economy was confronted with severe structural problems: a production structure that was inward-oriented and capital- and energy-intensive; a large and inefficient public sector; and a balance of payments characterized by a narrow export base, heavy dependence on imports, and a mounting debt service burden on an external debt estimated to be in excess of US$40 billion (slightly more than GDP). Financial policies were still excessively expansionary, and the structure of the budget was weak due to the large share of expenditures on wages, pensions, and subsidies and an inelastic revenue base; moreover, while considerably scaled down, public capital spending remained spread over a wide spectrum of projects thus lengthening their gestation and imparting a rising capital/output ratio to the economy. Superimposed upon these structural weaknesses were cyclically adverse developments, in particular oil prices lower than in the early 1980s and weakening growth of world trade. As a result of the expansionary policies and the slower growth of the economy, the accelerating inflation was exacerbating the cost-price distortions. It was in this context that the authorities decided to embark on more far-reaching policies.

Table 1. Egypt: Fund Position During Period of Proposed Arrangement, May 1987-November 1988

	May 31, 1987	1987 July-Sept.	1987 Oct.-Dec.	1988 Jan.-Mar.	1988 Apr.-June	1988 July-Sept.	1988 Oct.-Dec.
	(In millions of SDRs)						
Transactions under tranche policies (net)	116.0	22.3	22.3	22.3	22.3	22.3	22.3
Purchases	116.0	22.3	22.3	22.3	22.3	22.3	22.3
Ordinary resources	116.0	22.3	22.3	22.3	22.3	22.3	22.3
Borrowed resources	--	--	--	--	--	--	--
Repurchases	--	--	--	--	--	--	--
Transactions under special facilities	--	--	--	--	--	--	--
Total Fund credit outstanding (end of period)	134.8	150.8	173.2	189.3	211.6	227.7	250.0
Under tranche policies	116.0	138.3	160.7	183.0	205.3	227.7	250.0
	(As percent of quota)						
Total Fund credit outstanding (end of period)	29.1	32.6	37.4	40.9	45.7	49.2	54.0
Under tranche policies	25.1	29.9	34.7	39.5	44.3	49.2	54.0

Source: IMF Treasurer's Department.

II. The Adjustment Program

Since mid-1986, the staffs of the Fund and the World Bank have discussed with the Egyptian authorities policy corrections that would restore viability in the balance of payments over time and set the proper environment for resumption of growth and more rapid creation of employment opportunities in Egypt now that population growth was of the order of 2.8 percent a year and the possibilities of employment abroad have considerably diminished. The staffs of the two institutions recommended a strategy aimed at addressing the structural weaknesses of the economy through a rapid reduction in cost-price distortions, in particular the introduction of realistic exchange and interest rate levels, increases in energy prices to reach international levels over a short period, adjustments in agricultural and industrial prices, reform of public enterprises in order to improve their efficiency and increase their contribution to budgetary resource mobilization, and adoption of a leaner and better focused public investment program. These supply-side actions were to be accompanied by proper demand restraint through less expansionary fiscal and credit policy. At the same time, the staffs of the two institutions recognized that, in its inital stages, the program of economic reform had to accommodate the provision of basic commodities at affordable prices to lower income groups.

The authorities recognized the importance of correcting distortions by bringing prices to their economic levels and allowing flexibility in their determination afterward. However, they emphasized that the delicate political and social fabric of the country necessitated that adjustment be effected more gradually than recommended by the Fund and Bank staffs. An outline of the authorities' policy proposals was presented at informal meetings of Executive Directors representing Egypt's principal creditors and donors in December 1986 and March 1987. The program was generally considered by Directors as a welcome start on the long road to restoring the health of the Egyptian economy. However, on the basis of the described policy stance, and even with successful implementation of the proposed policies and some reinforcement over the years, the balance of payments was not expected to be viable over the time frame defined by the nature of Fund resources. Given this fact, Fund management decided to pursue a twofold strategy: request from the Egyptian authorities a reinforcement of their policies during the period of the arrangement, and seek assurances from donors and creditors of substantial and adequate financial support over a large number of years. For their part, the Egyptian authorities have responded by proposing to reinforce their policies during the program period. The first review of performance in September 1987 will provide the staff an opportunity to examine the measures which the authorities have taken and plan to take to strengthen their efforts. Major donors and creditors have also provided assurances to the Managing Director about providing the financial assistance being sought over the medium term.

1. General objectives of the adjustment program

In devising their economic reform package, the Egyptian authorities have stressed the following underlying principles: first, the need to achieve and sustain a higher level of real economic growth in order to improve the living standards of Egypt's rapidly growing population and to create sufficient employment opportunities for the new entrants to the labor force and Egyptian workers returning from neighboring oil producing states. The faster growth is to be achieved through increased production of tradable goods and a more efficient utilization of resources; second, increased reliance will be placed on individual incentives and on productivity gains by allowing a greater role for the private sector as well as greater freedom for the interaction of market forces, particularly the use of prices that reflect their true scarcity value.

In quantitative terms, the principal objectives of the program during the remainder of 1986/87 and in 1987/88 are to bring about a recovery of real economic activity to about 2 percent in 1987/88, to reduce the underlying rate of inflation to about 20 percent in 1987/88, to stabilize the current account deficit of the balance of payments at US$4 billion in both 1986/87 and 1987/88 and to improve the net international reserves of the banking system.

The immediate policy actions address both aggregate supply and demand in the economy by starting to adjust the structure of relative prices and incentives on the one hand, and by limiting the injection of liquidity, on the other hand. The stabilization actions are viewed by the Egyptian authorities as preparing the ground for more sustained economic growth, while ensuring through the adoption of appropriate social policies that a minimum safety net is provided to the least advantaged members of the society. Indeed, no change in the prices of basic commodities (including food and rent) is envisaged during the period of the proposed program.

2. Supply-side policies

a. Exchange reform

At present, Egypt has a complex exchange system. The central bank pool handles principal exports (mainly petroleum and cotton), imports of essential commodities (foodstuffs and agricultural inputs), service payments by the Government, most public sector capital transactions, and transactions through bilateral payments agreements. The exchange rate which applies to most transactions through this pool has remained at LE 0.7 per U.S. dollar since January 1979 but recently other exchange rates have been negotiated by aid donors for the conversion of their loans and grants. In addition, a rate of LE 0.39 per U.S. dollar applies to transactions under certain bilateral payments agreements. The commercial bank pool covers mainly a portion of workers' remittances and tourism receipts, public sector exports, imports and capital transactions of the public sector that are not assigned to the central bank pool, and certain private sector exports. Until July 1986, transactions were effected at either the official rate of LE 0.84 per U.S. dollar or the premium rate of about LE 1.35 per U.S. dollar. However, a small step toward simplifying the system was taken in July 1986 with the abolition of the official commercial bank rate of and the shifting of transactions covered by that rate to the premium rate which was then renamed the authorized bank rate. The free market attracts the remaining portion of workers' remittances, tourism receipts, and private sector export receipts, and supplies foreign exchange for all visible and invisible transactions by the private sector.

The Egyptian authorities intend to implement, by May 1, 1987 an exchange reform aimed at unifying the authorized bank rate with the free market rate by June 1988. To achieve this, transactions will be transferred from the commercial bank pool to the free market (or the "market") in three stages and the bank rate will be adjusted periodically so as to progressively reduce the difference between the two rates. 1/ Banks will be authorized to transact in the market from the start of the reform and the exchange rate in the market used by banks (or the "rate") will be determined by a "Chamber" composed of representatives of the banks that will be authorized to operate in this market. At the outset of the reform, the rate will be set at the level prevailing in the free market and subsequent changes will be effected on the basis of supply and demand factors allowing for unusual developments judged to be of a temporary nature. The authorities have indicated their commitment not to intervene in the market and to let the rate be determined realistically. Furthermore, the higher foreign exchange costs to the public sector will be passed through to the final users and will not be absorbed either in part or in total through the budgets of the Central Government or other public sector entities. The programmed unification of the commercial bank pool and the free market will result in about 60 percent of exports of goods and services and 75 percent of imports of goods and services being transacted at the market exchange rate by June 1988. The reform will also contribute significantly to the strengthening of government finances since the authorized bank rate serves as the valuation basis for assessing import duties. Nevertheless, the reform leaves key import and export commodities and capital transactions to be effected at the appreciated central bank rate.

The exchange reform will be continued beyond the period of this program through unification of the central bank rate with the "market" rate. The authorities recognize the important beneficial effects of this move in allowing improved production incentives to farmers, better

---

1/ Approximately 40 percent of transactions now in the commercial bank pool are to be transferred to the market by May 1, 1987, another 40 percent by December 31, 1987 and remaining transactions by June 30, 1988. The adjustment of the bank rate will be done through frequent small steps intended to reduce the difference between the bank rate and the market rate by more or less equal monthly amounts.

resource utilization, and more realistic costing of capital. However, they are equally concerned about the significant price implications of this step for such essential consumption items as bread, sugar, tea, cooking oils, fuel, and textiles since, in their judgment, the effects of the depreciation of the central bank rate should not be offset, even on a temporary basis, through budgetary action, lest this create demands for permanent allocation of budgetary resources to subsidize the prices of the affected commodities. While stressing the need to proceed very carefully in implementing this stage of the unification process, the Egyptian authorities have indicated their commitment to reaching understandings with the Fund, in the course of the first review of performance under the arrangement, on a schedule for the unification of the remaining markets and for devising the appropriate means for alleviating its impact on the living standards of the lower income groups.

The moves to simplify the exchange rate system are not being accompanied at the outset by any reduction in exchange and trade restrictions. The Egyptian authorities judge that, given the uncertainties pertaining to the exchange reform, and the excess demand in the economy, a reduction of restrictions in the initial stages of the reform could result in too rapid a depreciation of the rate outstripping the ability of public sector demanders of foreign exchange to adjust. Moreover, in order to prevent duplication of requests by individual demanders, the authorities are considering requesting a deposit amounting to 50 percent of the value of the letter of credit (L/C) when applying to open the L/C, with the balance to be paid upon the bank's approval of the application. Public sector demand for foreign exchange will also be restrained through the foreign exchange budget, with a committee in charge of smoothing out the demand for foreign exchange by public sector enterprises at the outset of the reform.

b. Pricing and other production incentives

In 1985/86 and 1986/87, the prices of several industrial products sold by public enterprises have been increased, as have been the prices for several agricultural crops procured by public sector marketing agencies, as well as the price of gasoline and electricity tariffs. However, in many instances the adjustments have not kept pace with domestic inflation or with international prices.

For the period ahead, the authorities have indicated their intention to move at a faster pace on the price front in order to improve production incentives and rationalize consumption and, at the same time, change marketing procedures for many publicly provided goods and services, mainly by opening these activities to competition from the private sector.

(i) Agricultural commodities

The Government is preparing to launch a multi-year agricultural sector adjustment program for which it has requested the financial support of the World Bank. The program will focus on removing impediments to enlarged agricultural production, particularly those relating to controls on domestic pricing, international procurement by the Government, area restrictions, and the provision of inputs (e.g., fertilizer, pesticides, etc.).

In 1986, the authorities reduced the official monopoly on trade in various agricultural products (e.g., meat, maize, and milk powder) by opening these up for import by the private sector. Moreover, the pricing of these products for private traders at the retail level has been liberalized through the adoption of the free market exchange rate as the basis for costing imported goods and calculating profit margins. Additionally, as of October 1986, the Government ended the obligation of producers to sell to its agencies certain agricultural commodities, with the exception of cotton and sugar (both of which will continue to be procured 100 percent by official agencies), one half of the rice crop, and small amounts of onions and groundnuts (the latter two being procured from cooperative societies under longstanding arrangements).

For the commodities remaining in the official procurement system (cotton, sugar, and rice), the Government has committed itself to effecting annual adjustments in their official procurement prices that will ensure a sustained increase in production. Since December 1986, the prices for deliveries of crops to be harvested in 1987 have been increased by 26 percent for cotton, 11 percent for sugarcane, and 18 percent for rice (Table 2). While welcome, these adjustments have barely kept pace with inflation after taking into account the input subsidies, so that the implicit taxation of the producers remains high. To ensure better response to market forces, restrictions on cultivated areas will be eliminated for most crops (the exceptions being cotton, rice and sugarcane) although some indicative planning will be retained in order to serve as a basis for calculating needed water release. Furthermore, the Government intends to diminish the attractiveness of domestic meat production, mainly through liberalization of imports, in order to encourage reallocation of agricultural land from fodder to export crops.

The Government also intends to phase out subsidies on agricultural inputs and to encourage greater competition in their supply by separating the input provision activities of the Agricultural Bank from its credit operations and by encouraging a greater private sector participation in the distribution of inputs.

Table 2. Egypt: Official Procurement Prices for Principal Agricultural Commodities, 1985/86-1986/87

(In Egyptian pounds per ton)

	1985/86	1986/87	1986/87 World Prices 1/
Cotton (LE per kantar)	92	116	380 2/
Sugarcane	27	30	45 3/
Rice	165	195	480
Wheat	167	--	300 4/
Horsebeans	355	--	...
Lentils	875	--	1,300
Sesame	958	--	1,250
Groundnuts	480	--	750
Onions	100	--	...

Sources: Ministry of Agriculture and International Financial Statistics.

1/ Landed in Egypt. Evaluated at the free market exchange rate of LE 2.1 per U.S. dollar.
2/ Including the estimated value ot cottonseed.
3/ Derived from the price of refined sugar.
4/ Estimated price for normal commercial sales. Egypt has recently been procuring significant amounts of wheat at lower prices reflecting concessional sales.

(ii) Industrial commodities

In recent years, both the capacity utilization and profitability of public sector enterprises have been adversely affected by restraints on price increases and managements' freedom to organize operations. The Government now recognizes the need to improve the competitiveness and efficiency of domestic production in the manufacturing sector as this sector will have to provide expanded employment opportunities and export earnings over the medium- and long-term. Although a number of product prices have been increased during 1985/86 and 1986/87, operational gains and lessened reliance on budgetary support have been slow in appearing, with many concerns continuing to require budgetary support for investment outlays, in part reflecting past underprovision for maintenance and replacement costs.

In late 1986, the Government commenced discussions with the World Bank on an industrial sector loan intended to support reform of the public manufacturing sector. As part of the policies to be implemented under the reform, the Government and the Bank are presently discussing further liberalization of pricing during a phasing-in period ending in mid-1988 with the objective of reaching a situation where most prices are determined on competitive or on economic efficiency grounds (in cases of insufficient competition). During the phasing-in period, prices would be established on the principle of recovering unit costs (evaluated at normal production capacity) plus a certain profit margin on capital employed but would not exceed the landed import price evaluated at the free market exchange rate plus the nominal tariff. Thereafter, enterprises will be free to adjust their prices without official control, except in those instances where monopolistic conditions are deemed to prevail or where commodities are subject to import controls. However, these ideas have not yet become official policy and dismantling the extensive control practices is likely to be an arduous task. On the other hand, the authorities have indicated that they are committed to improving operating efficiency of industrial public enterprises and ensuring their financial viability, with dependence on government transfers to be retained only for a few products considered to be of overiding social importance.

(iii) Energy products

Over the short run, appropriate energy production and pricing policies are the areas where the greatest gains can be obtained in terms of the balance of payments, budget revenue, and efficient resource allocation. The increase in the domestic production of crude oil, reflecting the official encouragement to foreign oil companies' operations has for many years concealed the cost to the economy of the underpricing of energy products at the levels of both the domestic consumer and producer. Increases in the price of most products, with the notable exception of gasoline, have lagged behind domestic inflation and international prices, thereby encouraging the growth of domestic consumption and the expansion of energy-intensive lines of production, which would not have been financially profitable if the energy input (whether petroleum fuels or electricity) had been appropriately costed.

As part of the objective of improving domestic resource allocation but also in order to restrain the growth of domestic consumption of Egypt's depletable energy resources and to increase budget revenue, the Government has been actively discussing with the World Bank an energy reform program to be supported by a series of sector adjustment loans. As part of this, it has indicated that it will adjust the domestic retail prices of energy products over the coming five years so as to bring them to world levels by 1991/92. The price of gasoline was raised in July 1986 to a level that is currently above world levels. The prices of all other principal products will be increased by an average of about 66 percent and electricity tariffs by 29 percent by May 1, 1987 (Table 3). These adjustments will raise the weighted average domestic price for petroleum products from 29 percent to 35 percent of international prices. Subsequent adjustments are to be agreed upon in the course of reviews of performance and negotiations on future policies keeping in view the objective of reaching world levels by 1991/92. This implies that very large annual increases in domestic energy prices will need to be effected in the ensuing years, even if it is assumed that international prices will rise at a moderate pace and the pound depreciates slowly in the market.

(iv) The level and structure of interest rates

Interest rates on borrowing and lending instruments denominated in Egyptian pounds have been kept low relative to domestic inflation and the yield on foreign currency (including the effects of the depreciation of the pound in the free market). These low levels have acted as a disincentive to holding pound assets while simultaneously encouraging borrowing, especially for speculative purposes which included the conversion of borrowed pounds to foreign currencies.

The Fund staff has repeatedly urged that corrections in both the level and structure of rates be effected promptly in order to discourage certain types of borrowing and to lessen the "dollarization" of the financial system. The Egyptian authorities have decided to postpone raising interest rates in the present circumstances of economic stagnation and resurgence of the influence of religious groups opposed to charging interest. However, as a first step, the structure of lending interest rates will be adjusted not later than May 1, 1987 by increasing the minimum and maximum rates by 1 percentage point on new loans with original maturity of more than one year and up to two years and by an additional percentage point on new loans with an original maturity exceeding two years. Also, the authorities intend to reach understandings with the Fund during the first review of performance under the arrangement on a schedule for adjusting interest rates to levels that are positive in real terms (after allowing for corrections in administered prices) as well as competitive with yields on foreign currency instruments by the end of the arrangement period.

Table 3. Egypt: Prices of Principal Energy Products, 1985/86-1986/87

(In Egyptian pounds per ton)

	1985/86	1986/87 Before May 1	1986/87 After May 1	World Prices 1/
Premium gasoline	350.0	420.0	420.0	349.0
Regular gasoline	280.0	350.0	350.0	318.0
Kerosene	38.0	38.0	63.0	296.0
Gasoil (Solar) 2/	39.0	39.0	65.0	274.0
Fuel oil (Mazout) 2/	17.5	17.5	28.0	201.0
Butane	52.0	52.0	52.0	
Jet fuel	189.1	189.1	189.1	
Asphalt	27.0	27.0	27.0	
Natural gas	20.0	20.0	34.0	

Sources: Data provided by the Egyptian authorities, and *Petroleum Intelligence Weekly*.

1/ Italian ex factory refinery prices at end-February 1987 converted into Egyptian pounds at the present free market exchange rate of LE 2.10 per U.S. dollar.
2/ Weighted average price.

c. The investment program

The increasing resource constraints facing the Egyptian economy, in particular foreign exchange availability, have made it essential to establish realistic investment targets and arrive at appropriate investment priorities that emphasize removal of bottlenecks and supply constraints, and improved maintenance of past investments. The authorities are presently in the final stage of drafting the Second Five-Year Investment Plan covering the period 1987/88-1991/92. Total investment is expected to amount to about LE 46 billion in constant (1986/87) prices or about 6 percent less than the projected implementation level during the current Five-Year Plan (1982/83-1986/87). Within this total, public investment is expected to be about LE 28 billion or 25 percent lower than the implementation level of the current plan and is being programmed to decline from 14 percent of GDP in 1986/87 to about 12 percent of GDP by 1991/92. The Plan is expected to emphasize rehabilitation and completion of ongoing projects by the public sector while leaving the undertaking of new initiatives to the private sector. Within the overall public investment total, a growing proportion is expected to be allocated to the commodity-producing sectors, particularly to the agricultural industrial, and energy sectors.

The World Bank has been invited to render a broad review of the size and composition of the investment program. The preliminary assessment of the mission that visited Cairo in March 1987 was that the overall size of the Plan, and particularly its public sector component, was within the expected resource availability. The Bank staff noted the realism underlying the selection of public sector projects and the drastic cutbacks that had been applied to original departmental requests. They were also reassured concerning the high priority assigned by the authorities for the development of natural gas, the most promising way to expand domestic energy production and, by substituting for refined petroleum products in domestic consumption, to release more petroleum for exports. On the other hand, the Bank staff felt that the costs of some projects included in the Plan were understated because of the use of an appreciated exchange rate as well as reliance on outdated cost estimates, and that the electricity generation program was underfunded. Furthermore, the Bank staff had reservations about proposed investments in land reclamation and in the building of new cities and felt that, although the scale of these investments had been reduced in relation to previous years, they still included activities with low expected returns which should be scaled back further. Additionally, the Bank staff considered that the targets for the economy's growth that are contained in the Plan (an average growth rate of real GDP of 6 percent annually) are overly ambitious and inconsistent with the overall resource constraints. A further set of discussions on these issues between the Egyptian authorities and the World Bank staff is expected to take place in June 1987.

d. Role of the private sector

The Government believes that achievement of its economic objectives requires a greater contribution from the private sector to economic development and expanding the applicability of market forces. In recent years, private sector activity has tended to be directed toward endeavors such as new housing and commercial construction and trade, areas where private capital would not be tied down for long periods and where returns were higher than in the production sectors due mainly to the absence of price controls and availability of cheap credit.

The Second Five-Year Investment Plan is relying on a steadily rising level of private sector investment to about one half of total investment by the final year of the Plan. To encourage increased private sector initiative in the directly productive sectors, the Government has taken steps to liberalize price controls at the retail level and reduce the administrative reviews and delays in approving requests for price increases. Starting in 1986/87, the procedures for sanctioning price increases have been streamlined and approval by the Policies Committee of the Cabinet was speeded up. Administrative procedures for both imports and exports, particularly the completion of customs formalities and the granting of necessary permits and clearances, were lessened. The framework for importation was considerably clarified with the abolition of the administrative restrictions applied by the import rationalization committees and their replacement by a published list of banned items. Additionally, the public sector monopoly on various activities, particularly the marketing of certain agricultural products and inputs, is being ended.

3. Demand management

A key objective of the Egyptian authorities over the immediate period is the alleviation of inflationary pressures, particularly because substantial administrative price increases will be effected. For this reason, but also to reinforce efforts to stem the dollarization of financial assets given the lack of adjustment in deposit interest rate levels, to support the exchange reform, and to improve the balance of payments, the growth of credit to both the Government and the private sector is to be restrained.

a. Fiscal policy

With overall fiscal deficits averaging over 20 percent of GDP during the period 1981/82-1985/86, expansionary fiscal policies have been a major factor exacerbating the economy's external and domestic imbalances. 1/ Notwithstanding the increased availability of external

---

1/ The overall fiscal deficit is defined to include the consolidated deficit of the Central Government, regional and local governments, and the operating balance (after government transfer) the General Authority for Supply Commodities (GASC), the agency responsible for the procurement and distribution of rationed commodities.

resources and the tapping of the considerable financial savings mobilized by the national pension and social insurance system, the largest portion of the overall deficit was financed by domestic bank borrowing which amounted to two thirds of the increase in the domestic component of private sector liquidity during the period. The policies of protecting living standards through price controls on most basic and many other commodities and guaranteeing employment for university graduates, together with the inelasticity of the tax revenue system have contributed to the worsening of the budgetary position. Revenues only grew by about 10 percent per annum (or by less than the inflation during the period), notwithstanding rising foreign exchange earnings from petroleum exports and Suez Canal dues. On the other hand, efforts to limit expenditure growth were impeded by the rapid growth of the wage bill and of subsidies, some of which were financed by foregoing budgetary revenues.

Although the Government did attempt to strengthen its finances and reduce bank borrowing by effecting expenditure controls and revenue measures, the efforts were only partially successful in limiting the growth of the deficit through 1985/86. A more restrictive fiscal stance was adopted in 1986/87 which is projected to stabilize the overall fiscal deficit in nominal terms and to reduce it as a proportion of GDP from 20 percent in 1985/86 to 16 percent. The better budget performance in 1986/87 is being achieved largely through greater control over public outlays, which are projected to increase by only 2 percent. Recurrent expenditures are estimated to increase by 3 percent through a continuation of controls on budgetary disbursements, including limiting the hiring of new government workers to vacancies, no provision for a general wage increase, and sharply lower subsidy costs. Expenses with respect to GASC operations are estimated to decline by one fourth, a drop equivalent to more than 1 percent of GDP, largely due to the decline in international commodity prices, but also to price increases for quantities supplied above the basic ration, better control of inventories, and reduced losses in storage. Investment outlays are expected to decline in nominal terms for another year, falling from 17 percent of GDP in 1985/86 to 14 percent.

On the revenue side, the elasticity of the tax system has been improved by the introduction of the tariff reform in August 1986. However, the earnings from the petroleum sector have been depressed by lower international prices and export volume. Despite strengthened administration of the revenue system, collections from domestic taxes on production and consumption, business profits, and profit transfers from public enterprises have failed to grow at budgeted rates because of stagnation in the domestic economy and continuing financial and managerial difficulties in the public enterprises. As a result, revenues are estimated to increase by only 3 percent from the 1985/86 level. Despite the stabilization of the overall fiscal deficit at LE 7.2 billion (excluding the assumption of past debts of some public enterprises), budgetary recourse to the domestic banking system is estimated to increase to LE 3.6 billion, or 17 percent of the domestic currency component of private sector liquidity at the beginning of the period, partly in reflection of the large drop in net external financing.

The reform program formulated by the Government aims at steady annual reductions in the overall fiscal deficit in relation to GDP to about 4 percent of GDP by 1991/92 with a corresponding decrease in the borrowing by the Government from the domestic banking sector. As such, the 1987/88 budget builds on the progress achieved in 1986/87 and introduces a further tightening in the fiscal stance. The Government intends to limit its recourse to domestic bank borrowing to LE 3.4 billion (15 percent of the domestic currency component of private sector liquidity projected for the beginning of the period). Together with projected external and domestic nonbank borrowing, this will require limiting the overall deficit to LE 7.1 billion, equivalent to 13 percent of projected GDP (Table 4).

To help achieve its fiscal target, the Government proposes to implement a number of measures. On the revenue side, LE 1,400 million in additional resources (equivalent to 3 percent of GDP in 1986/87) will be generated by: (1) adjusting the exchange rate applied for customs duties valuation along the anticipated path in the bank exchange rate (expected to yield LE 800 million); (2) raising the consumption duty levels on both imported and domestically produced cigarettes, converting various consumption duties from a specific to an ad valorem basis, and expanding the coverage of consumption duties which is viewed by the authorities at this stage as a substitute for implementing a broadly based sales tax (yielding LE 300 million); (3) imposing a flat tax on the self employed who have hitherto successfully evaded payment of income taxes (yielding LE 100 million); and (4) increasing profit transfers from the petroleum sector to the Government by the planned adjustment in the retail prices of selected products to be introduced by May 1, 1987 (yielding LE 200 million).

On the expenditure side, the wage bill is budgeted to grow by only the extent of normal bonuses and merit increases, and restraints on hiring will remain in effect. Other recurrent expenditures are to increase by significantly less than the inflation rate, notwithstanding a first-time provision of LE 550 million for interest charges on total rescheduled official debt. Expenditures on food subsidies are being restrained by limiting the volume of deliveries to no more than the previous year's level, thereby containing the increase in nominal outlays for this purpose to the effect of transferring transactions from the commercial bank pool to the free market. In 1987/88, public investment expenditure is estimated at LE 5.6 billion, which would represent a further decrease in nominal terms.

Table 4. Egypt: Summary of Fiscal Developments, 1983/84-1987/88 1/

	1983/84	1984/85	1985/86	Revised Estimate 1986/87	Draft Budget 1987/88
	(In millions of Egyptian pounds)				
Total revenue	10,371	11,311	11,992	12,376	14,047
Central Government	8,193	8,663	9,558	9,953	12,402
Tax	(5,363)	(5,923)	(6,502)	(7,256)	(9,495)
Nontax	(2,830)	(2,740)	(3,056)	(2,697)	(3,062)
Investment self-financing	1,628	2,011	1,731	1,700	689
Other	550	637	703	723	801
Total expenditure (commitments basis)	16,804	18,485	19,818	19,557	21,156
Current, of which,	11,286	11,928	13,461 2/	13,267	15,556
Wages and salaries	(2,620)	(3,158)	(3,440)	(3,765)	(4,115)
Subsidies, of which	(2,875)	(2,747)	(2,766)	(2,194)	(2,454)
Budget transfers to GASC	[1,209]	[1,121]	[1,928]	[1,967]	[1,292]
GASC's net operating deficit (repayment -)	[888]	[742]	[-143]	[-650]	[170]
Investment expenditure	5,518	6,556	6,358	6,290	5,600
Overall deficit	6,433	7,174	7,826 2/	7,181	7,108
External financing (net)	1,052	1,530	1,351	652	172
Domestic (net)	4,606	4,963	6,475	6,529	6,936
Bank 3/	(2,814)	(2,764)	(2,584)	(3,596)	(3,400)
Nonbank	(1,792)	(2,199)	(2,776)	(2,934)	(3,536)
Other 4/	775	681	1,115	--	--
	(As percent of GDP)				
Total revenue	37.2	34.8	33.3	28.1	26.2
Central government tax	19.2	18.2	18.1	16.5	17.7
Central government nontax	10.1	8.4	8.5	6.1	5.7
Total expenditure	60.3	56.8	55.1	44.5	39.5
Current	40.5	36.7	37.4	30.2	29.0
Investment	19.8	20.2	17.7	14.3	10.5
Overall deficit	23.1	22.1	21.7	16.4	13.3
External financing	3.8	4.7	3.8	1.5	0.3
Domestic bank	13.3	10.8	8.0	8.2	6.3
Domestic nonbank	6.4	6.8	7.7	6.7	6.6

Sources: Ministry of Finance and Central Bank of Egypt.

1/ Includes GASC's operating losses and their financing.
2/ Includes LE 605 million representing assumption by the Government of NPE debts.
3/ From monetary accounts. Includes net credit to GASC.
4/ Includes special bonds, errors and omissions, and arrears on external debt servicing obligations. Arrears cannot be identified separately.

The Government's success in achieving its fiscal targets depends crucially on the movement in the commercial bank exchange rate generating the projected customs revenues, and on its success in maintaining expenditure restraints for yet another year. Recognizing that nominal remuneration in the public sector has fallen in real terms and that implementation of the proposed reform program may lead to demands for wage and salary increases above budget allocations, the Government has indicated its commitment to the above fiscal targets by undertaking to fully compensate for any general wage awards by mobilizing sufficient additional resources.

b. Monetary and credit policy 1/

During 1982/83-1984/85 domestic credit expansion, encouraged by low interest rates, was the most important factor for the 22 percent per annum expansion of private sector liquidity (private sector holdings of money and quasi-money in both pounds and foreign currencies). When the private sector's foreign currency deposits are valued at the free market rate (instead of the bank rate of LE 1.34 per U.S. dollar), the growth rate of liquidity increases to 26 percent per annum over the period, with the share of foreign currency deposits in private sector liquidity remaining at 35 percent. During this period, the principal instrument of credit policy was the requirement that individual commercial banks restrict their lending to public sector companies and the private sector to the equivalent of 65 percent of deposits. However, the effectiveness of the instrument was reduced by exemptions from adherence to the ratio and by the injection of reserve money from the Central Bank's financing of the fiscal deficits.

Beginning September 1985, the private sector took greater advantage of the low interest rate on pound loans relative to the yield on foreign currency instruments by borrowing pounds (using foreign currency

---

1/ The evaluation of recent monetary and credit policies is complicated by the buildup of external payments arrears by the Central Bank of Egypt. The problem arises from the fact that public sector pound transfers to the Central Bank in respect of external debt obligations that the Bank has not been able to effect abroad have not been separated and treated as foreign liabilities (as was done by commercial banks), but rather have continued to be treated as deposits of the concerned public sector entity on the balance sheet of the Central Bank. This has understated the expansion of credit to the public sector and overstated the banking system's net foreign assets. In addition, there have been external arrears incurred by the Central Bank itself which have not been reflected in its accounts--thus overstating its net foreign assets. Changes in and growth rates of, net domestic assets, net credit to the public sector, and net credit to the Government are thus understated for periods before 1987. Consequently, data for periods prior to 1987 are not wholly comparable to those after that date.

deposits as security) and converting the proceeds into foreign currency deposits which rose to the equivalent of more than 40 percent of total deposits. In response, the Central Bank issued regulations in April 1986 restricting the use of foreign currency instruments as collateral for pound loans. As a result, the growth of pound credit to the private sector slowed from an annual rate of 30 percent in September 1985-March 1986 to an annual rate of 14 percent in the first half of 1986/87. The behavior of private sector liquidity mainly followed the pattern set by credit to the private sector, with its growth declining from an annual rate of 14 percent in September 1985-March 1986 (24 percent when valued at the free market exchange rate) to an annual rate of 8 percent (12 percent when valued at the free market rate) in the first half of 1986/87 (Table 5).

Several other developments have affected the behavior of monetary and credit aggregates in the recent past. First, largely reflecting the low level of interest rates on pound deposits relative to domestic inflation and the yield on foreign currency instruments, 1/ the private sector's real pound balances have declined since late 1983. Secondly, as the private sector's foreign currency deposits rose during the 1980s, the commercial banks have used some of the proceeds to meet part of the public sector's demand for foreign exchange, with the result that the banks' net liabilities in foreign currencies have grown to almost the equivalent of US$3 billion at present. Finally, the exclusion of the business and investment banks and the specialized banks from the coverage of the loan-to-deposit ratio and other regulations has permitted slippage in credit policy by allowing credit expansion to take place through these banks instead of the commercial banks.

The authorities' credit program for the rest of 1986/87 and 1987/88 recognizes the need to eliminate the excess liquidity in the hands of the private sector. The program has been formulated to take account of (i) a modest recovery of economic activity in 1987/88; (ii) the targeted reduction in the underlying inflation rate during the program period; (iii) a yield differential favoring foreign currency instruments of 10 percentage points in 1986/87 that will be progressively closed over the course of 1987/88; and (iv) an increase in the banking system's net international reserves by US$400 million in both 1986/87 and 1987/88 so

---

1/ Presently, the interest rate on three-month pound time deposits is 8.5 percent per annum, while the rate of inflation is estimated at 30 percent. The yield on foreign currency instruments over the latest 12 months (February 1986-February 1987) was about 16 percent, representing an average return of 6 percent on dollar-denominated assets and the 10 percent depreciation of the Egyptian pound.

as to prevent any further increase in the commercial banks' net foreign currency liabilities and to enable some rebuilding of the Central Bank's net international reserves. 1/

Given these factors, the growth of private sector liquidity is targeted at 9 percent in both 1986/87 and 1987/88. Consistent with this growth, and taking into account balance of payments objectives, the expansion in the banking system's net domestic assets should be limited to 17 percent in 1986/87 and 20 percent in 1987/88. The slightly faster growth in 1987/88 is considered necessary to accommodate some of the increases in administered prices and the rebound in economic activity. In addition, because of the operations of the blocked accounts, credit tightness as regards the public sector during the program will be more than in the previous years for the reasons explained in footnote 1 on page 19.

For the public sector as a whole, the credit program provides for the growth of net credit to be maintained at an annual rate of 21 percent in the second half of 1986/87 before declining to 18 percent in 1987/88. However, in the first quarter of 1987/88, credit to the public sector will rise at an annual rate of 24 percent because of the relatively large amount of government borrowing in that quarter and allowance for the effect of lagged price increases by public sector companies as part of the process of adjusting their prices to reflect changes in costs arising from the exchange reform and other adjustments. Bank financing of the Government is projected at LE 3.6 billion in 1986/87, and at LE 3.4 billion in 1987/88, of which LE 1.2 billion (i.e., 36 percent) will come in the first quarter on account of both seasonal factors and the fact that adjustment of the exchange rate for customs valuation during the year will skew customs revenues toward the end of 1987/88.

Given the increase in public sector borrowing under the program, the onus for tightening credit policy has to fall on the private sector, despite the authorities' objective of promoting private sector activity.

1/ In view of the anticipated rescheduling of the public sector's external debt service, the credit program also provides for the constitution of blocked accounts (which are treated as foreign liabilities); the public sector will transfer into these accounts the pound counterpart due on its external debts, as originally contracted for, from January 1, 1987 so that the relief provided by the rescheduling does not add to domestic liquidity. The credit ceilings established as performance criteria are subject to automatic adjustment for any overpayments or shortfalls in debt sevicing (blocked accounts plus amounts actually effected abroad) in view of the uncertainty about the debt servicing and the extent of relief.

Table 5. Egypt: Monetary Survey and Selected Growth Rates, 1985-88 1/

Stock Outstanding at End of	Actual June 1985	Actual June 1986	Actual Dec. 1986	Projected June 1987	Projected Sept. 1987	Projected June 1988
	(In millions of Egyptian pounds)					
Net foreign assets of which net international reserves	102	804	72	-1,615	-2,390	-5,724
reserves	5,935	7,087	7,505	7,622	7,689	8,158
Net domestic assets	26,777	29,858	31,860	35,015	36,390	42,125
Net claims on public sector	16,358	19,203	21,144	23,229	24,500	27,350
Of which, net claims on Government (including GASC)	(17,532)	(20,116)	(21,656)	(23,636)	(24,850)	(27,050)
Claims on private sector	12,003	14,361	15,353	16,060	16,600	19,200
Other items, net	-1,584	-3,705	-4,637	-4,275	-4,710	-4,425
Private sector liquidity	26,879	30,662	31,933	33,400	34,000	36,400

Percentage Change During	Actual 1985/86	Actual First Half 1986/87	Projected Second Half 1986/87	Projected 1986/87	Projected First Quarter 1987/88	Projected 1987/88
	(In percent per annum)					
Net domestic assets	12	14	21	17	17	20
Net claims on public sector	17	21	21	21	24	18
Net claims on Government	10	16	19	17	22	14
Claims on private sector	20	14	9	12	14	20
Private sector liquidity	14	8	9	9	7	9

Sources: Central Bank of Egypt and Fund staff estimates.

1/ Foreign currency items valued at LE 1.34 = US$1.

By reducing the growth of commercial bank lending to the private sector, the program enables financing of the Government to be shifted to the banks from the Central Bank, thus providing for a reduction in the growth of reseve money. The growth of credit to the private sector is to be reduced from an annual rate of 14 percent in the first half of 1986/87 to an annual rate of 9 percent in the second half (for a rate of 12 percent for the whole year). To achieve this, at the end of March 1987, the Central Bank stipulated limits for each bank's pound loans to the private sector (as well as to public sector companies). For 1987/88, credit to the private sector is programmed to rise by 20 percent but, in the first quarter, due to heavy borrowing by the Government, credit is only to increase at an annual rate of 14 percent, implying a small or possibly no increase in real terms. It is anticipated that the financing constraints imposed on the private sector will encourage it to release inventories (thereby reducing inflationary pressures) and to meet some of its financing needs by converting foreign currency deposits into domestic currency and repatriating capital from abroad (thereby reducing pressure on the exchange rate).

4. Balance of payments

The structure of Egypt's balance of payments has suffered from the distortions that have manifested themselves throughout the economy over the years. Exports of traditional agricultural products have declined in real terms as production of tradables was discouraged by price controls (including the overvalued exchange rates) and cost increases; the non-oil export base is therefore narrow and current account earnings have become heavily dependent on petroleum-related revenues, in the form of exports of crude oil and products and remittances of Egyptian expatriates working in neighboring oil producing countries. This has rendered foreign exchange earnings particularly vulnerable to changes in the world petroleum market. On the payments side, imports of food and consumer goods in particular increased in reflection of the maintenance of an overvalued exchange rate, the relatively large rate of population growth, and the operation of a comprehensive subsidy system. Thus the agricultural export surpluses that had been achieved until the early 1970s turned into large deficits in recent years. Additionally, the growth of external debt has not been accompanied by sufficient gains in production and at the same time has imposed a substantial burden on the balance of payments. As a result, the balance of payments' structure (in particular a level of imports which is four times that of exports) indicates that adjustment will come only slowly, even under favorable external developments.

The underlying weakness in the balance of payments has become more evident since 1985/86 with the emergence of adverse cyclical developments. The deficit in the current account is projected to widen to US$4 billion in 1986/87 mainly as a result of a US$1 billion drop in petroleum exports, to about one half of the previous year's level, reflecting the decline in average export unit values of almost 40 percent (Table 6). Non-oil exports are projected to grow by 7 percent, based largely on an increase in export unit values of manufactured goods; export volumes for all major categories are expected to either stagnate or decline. Imports in U.S. dollar terms are projected to contract further 1986/87 reflecting a 30 percent decline in the international price of wheat, shortages of foreign exchange for public sector imports, and a decline of 6 percent in private sector imports due in part to intensification of import restrictions. The savings from the lower imports, however, will be offset by the deterioration in net service inflows, resulting to a large extent from lower workers' remittances and higher interest payments.

For 1987/88, petroleum export volume is being targeted to increase by 23 percent as a result of policies to restrain the growth of domestic consumption of petroleum products and to encourage production of natural gas and its substitution for refined products in domestic household and industrial use. Cotton export volume is projected to increase by 30 percent as output increases in response to the higher domestic procurement prices, utilization by domestic processors is restrained by higher delivery prices, and the carry-over stock is reduced. The 27 percent increase in export earnings will, however, be more than offset by the recovery in imports needed for the projected modest recovery of economic activity. As a result, the trade deficit is projected to widen further. On the other hand, a small deterioration in net service inflows, as interest payments continue to rise, is expected to be offset by increased receipts from official transfers. Consequently, the current account deficit is expected to remain at roughly the same level as in 1986/87.

Net capital flows, before rescheduling of external debt service, are projected to turn negative in both 1986/87 and 1987/88. This turnaround reflects mainly a sharp drop in the disbursements of suppliers' credits to the public sector on account of the tightening in export cover policies by overseas export guarantee agencies which has already taken place in response to the accumulation of arrears on public sector suppliers' credits. Disbursements on suppliers' credits are projected to drop further in 1987/88, as export agencies are not expected to resume lending or provide guarantees at the same level as in past years until the expected rescheduling agreements under the auspices of the Paris Club are completed. Private capital inflows are projected to drop from US$1.8 billion in 1985/86 to US$1.4 billion in 1986/87, reflecting mainly the trend in remittances, but to recover to their 1985/86 level in 1987/88 on account of direct investment and other private sector foreign exchange inflows, which are projected to expand in response to the recovery in economic activity and the improved investment climate.

Table 6. Egypt: Balance of Payments Summary, 1984/85-1991/92

(In billions of U.S. dollars)

	Actual		Projected					
	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
Trade balance	-6.6	-6.3	-6.8	-7.0	-7.5	-8.0	-8.3	-8.7
Exports, of which	3.9	3.2	2.2	2.8	2.9	3.0	3.2	3.3
Petroleum	(2.6)	(2.0)	(1.0)	(1.4)	(1.5)	(1.5)	(1.5)	(1.6)
Imports, c.i.f.	-10.5	-9.5	-9.0	-9.8	-10.4	-11.0	-11.5	-12.0
Services (net)	3.1	2.2	1.8	1.7	1.9	2.1	2.3	2.6
Receipts	7.5	6.7	6.8	7.0	7.4	7.9	8.5	9.1
Payments, of which	-4.4	-4.5	-4.9	-5.3	-5.5	-5.8	-6.2	-6.5
Interest	(2.6)	(-2.5)	(-2.7)	(-2.9)	(-3.0)	(-3.2)	(-3.3)	(-3.5)
Official transfers	1.1	1.2	1.1	1.2	1.4	1.4	1.4	1.5
Current account	-2.4	-2.9	-3.9	-4.1	-4.2	-4.5	-4.7	-4.7
Capital account	0.2	--	-0.6	-0.8	-0.3	-0.3	-0.5	0.5
Project and commodity loans (net)	0.3	-	-	0.2	0.3	0.2	0.2	0.2
Suppliers' (net)	0.1	-0.2	-0.6	-0.7	--	--	-0.6	0.4
Other (net)	-0.2	0.2 1/	-- 1/	-0.3	-0.1	-0.2	-0.1	-0.1
Balancing items 2/	1.6	1.6	1.3	1.5	1.6	1.8	-1.9	2.0
Errors and omissions	-0.5	0.7	--	--	--	--	--	--
Overall balance	-1.1	-0.6	-3.2	-3.4	-2.9	-3.0	-3.3	-2.2
International reserves (increase -)	-0.1	-0.9	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Unfinanced gap	1.2	1.4	-3.6	-3.8	-3.3	-3.4	-3.7	-2.6
Arrears	1.2	1.4	0.4	-0.7	--	--	--	--
Debt relief 3/	-	-	3.2	3.8	3.3	3.4	3.5	2.1
Exceptional aid	-	-	--	0.7	-	-	0.2	0.5
Memorandum items:								
Total external debt, end of period	...	40.1	44.1	47.5	50.4	53.5	56.6	59.5
Arrears, end of period	3.4	4.9	0.7	--	--	--	--	--
				(In percent)				
Debt service ratio, before rescheduling 4/5/	38.0	51.1	58.7	58.0	55.6	56.0	56.8	47.6
Interest	(22.8)	(25.3)	(29.6)	(29.4)	(29.3)	(29.1)	(28.5)	(27.9)
Principal	(15.2)	(25.8)	(29.1)	(28.6)	(26.3)	(26.9)	(28.3)	(19.7)
Debt service ratio, after rescheduling 4/	38.0	51.1	26.1	19.1	23.5	24.6	26.5	30.8
Interest	(22.8)	(25.3)	(17.1)	(15.4)	(16.8)	(18.3)	(19.4)	(20.1)
Principal	(15.2)	(25.8)	(9.0)	(3.7)	(6.7)	(6.3)	(7.1)	(10.7)

Sources: Central Bank of Egypt, Ministry of Economy, and staff estimates.

1/ Includes US$0.4 billion in 1985/87 and US$0.2 billion in 1986/87 of net repayments of Egyptian lending abroad to finance oil exports.

2/ Mainly private sector foreign exchange inflows used to finance imports, interest and other invisible payments or deposits into the foreign currency accounts held by the private sector with the domestic banking system.

3/ Assumes an 18-month bilateral rescheduling agreement under the auspices of the Paris Club, and four subsequent one-year agreements. The terms of the first debt rescheduling are assumed to be: (a) cut-off date: December 1986; (b) 10 years repayment period, of which 5 years of grace; (c) principal, both on arrears and current obligations, rescheduled at 100 and 90 percent and interest at 90 percent; (d) average interest rate on rescheduled debt: 5 percent. For the following annual rescheduling exercises, the terms of rescheduling would be (a) cut off date: December 1986; (b) 15 years repayment period, of which 7 years of grace, (c) principal rescheduled at 82, 90, 100, and 100 percent and interest at 90 percent; (d) average interest rate on rescheduled debt: 5 percent.

4/ Ratio to exports of goods and services. Interest on total external debt, principal on public sector debt only.

5/ Includes interest on financing the gap; no payment of principal is assumed with regard to closing the gap.

Reflecting these developments, the overall balance of payments deficit--excluding the settlement of arrears outstanding as of end-1986--is projected to widen from US$0.6 billion 1/ in 1985/86 to US$3.2 billion in 1986/87, and to US$3.4 billion in 1987/88. Given the targeted improvement in the net international reserve position of the banking system, the intention to eliminate the arrears outstanding as of December 1986 by June 1988, 2/ and assuming the maintenance of medium- and long-term obligations of the private sector and of short-term debt of the public sector and of the private sector at their respective levels of December 1986, foreign financing equivalent to US$12.3 billion is required for the period of the arrangement.

The foreign financing is expected to become available from: (a) rescheduling by official creditors of arrears on medium- and long-term public sector debt outstanding as of December 1986 (estimated to provide debt relief of about US$5.8 billion); 3/ (b) rescheduling by official creditors of debt service obligations falling due in the period January 1987 to June 1988 on medium- and long-term public sector debt (estimated to provide about US$5.8 billion of debt relief); and (c) US$0.7 billion of new aid disbursements which are expected to come from three sources: first, the conversion of some project aid to commodity/cash aid, for an amount of about US$0.2 billion; second, speeding up of commodity aid disbursements from the existing pipeline and additional aid, particularly food aid, for an amount of about US$0.3 billion; and third, disbursements from World Bank loan commitments that are expected to become available during 1987, including three loans for US$124 million that became effective in February 1987, four loans for US$534 million already signed and that are expected to become effective in April 1987, and an agricultural sector loan (US$175 million) still under negotiation but expected to be available for disbursement by October 1987.

Total external debt, including obligations to the Fund, after rescheduling and new aid, is projected to increase over 1986/87-1987/88 from US$40 billion to US$48 billion, equivalent to five times total exports of goods and services. Debt service, in relation to exports of goods and services before rescheduling is projected to increase from

---

1/ Errors and omissions in 1985/86 amounted to US$700 million compared to a negative US$500 million in 1984/85. This large reversal results in large part from a revaluation of the foreign assets and liabilities of the banks, which overestimates the accumulation of net international reserves of the banking system for 1985/86.

2/ Arrears outstanding as of December 31, 1986 are estimated at about US$6.8 billion, of which US$6.1 billion would be eligible for rescheduling under a Paris Club agreement or on terms similar to those under that agreement.

3/ In March 1987 a preliminary agreement on rescheduling of external debt obligations to the U.S.S.R. was reached. Although some details remain to be worked out, the terms are reported to be 25 years' maturity (of which six years' grace) and no interest charges.

51 percent in 1985/86 to 58 percent in both 1986/87 and 1987/88, with the interest service ratio increasing from 25 percent in 1985/86 to almost 30 percent in 1986/87 and 1987/88 (more than 10 percent of GDP). After rescheduling, the debt service ratio is projected at 26 percent in 1986/87 and 19 percent in 1987/88 with the interest ratio at 17 percent and 15 percent, respectively, (or 7 percent of GDP).

5. Views of the World Bank

In evaluating recent performance and the prospects for Egypt's economy, the World Bank staff consider that many of the country's development constraints are on account of official policies and thus can be eased through appropriate reforms. The rapid economic growth from the mid-1980s resulted from an extraordinary rise in external resource availability, rather than from increased domestic productivity, and, by contributing to the aggravation of distortions in the economy, left future performance vulnerable to a slowdown in the availability of these external resources. Although the external resource position facing Egypt during the remainder of the 1980s is less favorable than in the 1970s, nevertheless, the Bank staff consider that Egypt has substantial potential to revive noninflationary economic growth with a viable balance of payments.

The Bank staff consider that the Government's policy actions since mid-1986 and the commitments embodied in the request for the stand-by arrangement that have been described above represent an important step forward on the long road to correcting Egypt's pervasive distortions. However, the Bank staff regard these policies as only a beginning and in need of considerable intensification in order to help restore the health of the economy, improve Egypt's creditworthiness, and move forward in addressing other long-term issues important for the well-being of the average Egyptian, including reduction in the population growth rate, raising the quality of social services (particularly education), and increasing the availability of housing. In the absence of a strengthening of policies which will help to increase absorptive capacity for development loans and Egypt's creditworthiness, the World Bank is likely to maintain its lending operations in Egypt in a "low mode" of about US$200 million in new commitments annually, whereas with considerably stronger policies, the Bank would increase its annual commitments substantially. At the macro level, the strengthening of policies would be particularly required in the areas of exchange rate and interest rate policies, the reform of public enterprises, and structural improvements in the budget.

6. Overall economic performance during the period of the authorities' program

Given the magnitude and the structural nature of Egypt's economic problems, the gradual policy approach proposed by the authorities together with the absence in the initial phase of the program of some important supportive policies--in particular in the interest rate and pricing areas--will only result in a modest improvement in economic peformance and the balance of payments in the period immediately ahead. This approach, which entails still large budget deficits and maintenance of import restrictions, will result in high pressures on the underlying inflation rate and a less efficient allocation of resources.

In terms of economic activity, implementation of the program is expected to lead to a growth rate of real GDP of about 2 percent in 1987/88, following the decline of about 2 percent estimated for 1986/87. Despite the still depressed investment levels, the rebound in economic activity will be due to a modest recovery in the commodity producing sectors, particularly in industry and petroleum which had been experiencing negative growth in 1986/87 on account of shortages of imported inputs and adverse world market conditions (in the case of petroleum). Also, agricultural output in 1987/88 will benefit from the liberalization measures and the higher procurement prices already in place.

The tighter credit policies since March 1987, the expected improved availability of imports (as a result of the expected alleviation of external financing constraints), and the rebound in domestic production are projected to moderate underlying inflationary pressures and reduce the increase in prices from the average of about 30 percent in 1986/87 to an average of about 20 percent in 1987/88. Given the still high rates of inflation being projected, a reduction in existing price distortions will necessitate an active and flexible pricing policy. However, because of the delay in interest rate action, the past trend of falling real money balances of the private sector is not going to be reversed in the initial stages of the program period, which will lead to somewhat more dollarization of financial assets. At the same time, this expected development and the still large recourse to bank credit by the Government, signify that a large measure of the credit restraint under the program will need to fall on private sector credit, which may postpone the enhanced role envisaged for that sector in the development of the economy.

In the balance of payments area, policies are expected to stabilize the current account deficit in 1987/88 at its level of the previous year, notwithstanding the projected recovery in the exports of oil and cotton. This projected development reflects the high levels of interest payments but also the delayed recovery of workers' remittances and of nontraditional exports, in the case of the latter, which start from a very low base and will have to face strong competition in a climate of slow growth abroad. However, t cause of an expected higher level of imports, it is anticipated that the program will lay the groundwork for faster growth of the economy in following years notwithstanding the low level of public sector investment. In particular, an orderly relationship between Egypt and its creditors will considerably improve the prospects for external financing of Egypt's adjustment effort.

7. Prior actions, quantitative performance criteria, reviews of performance, and phasing of purchases

The Government of Egypt intends to effect by May 1, 1987, the following adjustments in the exchange system, energy prices, and interest rates: (1) to transfer 40 percent of transactions presently effected in the commercial bank pool to the free market and to permit authorized banks to operate in the free market at an exchange rate set by a "Chamber" representing the banks; (2) to increase the domestic selling prices of kerosene, gasoil, diesel, fuel oil, and natural gas by a weighted average 66 percent, and increase the average electricity tariff by 29 percent; and (3) to modify the structure of lending interest rates.

The quantitative performance criteria for the quarters ending June and September 1987, which are summarized in Table 7, cover (1) ceilings on net domestic assets of the banking system, 1/ (2) ceilings on net bank claims on the nonfinancial public sector, 1/ (3) ceilings on net bank claims on the Central Government, local governments, and the GASC, 1/ (4) floors on the net international reserves of the banking system, (5) ceilings on the contracting or guaranteeing by the public sector of short-term external debt, with the exception of trade financing, and (6) ceilings on the contracting or guaranteeing by the public sector (including theCentral Bank and public sector banks) of external debt, maturing in 1-12 years, on nonconcessional terms. Quantitative performance criteria for the period after September 1987 will be agreed during the first review of performance to be completed by November 1987.

1/ The ceilings would be adjusted on the basis of the external debt service actually effected abroad as well as the portion of external debt service transferred to the respective blocked accounts. The mechanism of adjusting the ceilings is as follows: if the sum of the holdings of Egyptian pounds in the blocked account of the public sector and the amount of debt service effected abroad on behalf of the public sector falls below the estimated debt service originally due, the ceilings on the net domestic assets and credit to the public sector for the corresponding end of period dates will be lowered by the amount of the shortfall, and vice versa. Similarly, if the sum of tne holdings of Egyptian pounds in the blocked account of the Government and the amount of debt service effected abroad on behalf of the Government falls below the estimate of debt service originally due, the ceiling on credit to the Government for the corresponding end of period dates will be lowered by the amount of the shortfall, and vice versa.

The nonquantitative performance criteria are: (1) to transfer the second 40 percent of transactions from the commercial bank pool to the free market by end-December 1987; (2) to transfer any remaining transactions from the commercial bank pool to the free market by end-June 1988; (3) to adjust the exchange rate for transactions remaining in the commercial bank pool in a steady manner that leads to unification of the two markets by June 1988; (4) to eliminate all external payments arrears by June 1988, primarily through rescheduling of bilateral debt service obligations; and (5) the standard provisions with regard to multiple currency practices, payment and trade restrictions, and bilateral payments agreements.

Reviews with the Fund are scheduled to be completed by November 30, 1987 and May 31, 1988. These will review progress in achieving the objectives of the program, focusing particularly on the liberalization of prices, budget and credit developments, progress of the exchange reform, and reduction of payments restrictions. In addition, the first review, to be combined with the 1987 Article IV consultation, will:

a. establish quantitative performance criteria for the period of the arrangement after September 1987 which would supersede any indicative targets previously established for that period;

b. reach understandings on a schedule for completing the unification of all exchange markets;

c. reach understandings on ways to bring interest rates on domestic currency deposits and loans to levels that are positive in real terms and competitive with yields on foreign currency instruments during the period of the arrangement;

d. reach understandings on schedules for the prices of energy and electricity and the procurement prices of cotton and rice for the crop year 1987/88. These understandings will take into account the views of the World Bank.

An initial purchase of SDR 116.0 million (Egypt's first credit tranche) will be available upon Fund approval of the arrangement. Further purchases of SDR 22.3 million each (5 percent of quota) will be available no earlier than August 1, 1987; November 1, 1987; February 1, 1988; May 1, 1988; August 1, 1988; and November 1, 1988, respectively, subject to observance of the performance criteria for June 30, 1987; September 30, 1987; December 31, 1987; March 31, 1988; June 30 1988; and September 30, 1988, respectively. Additionally, the third and fifth purchases,will also be subject to completion of the first and second reviews of performance, respectively.

Table 7. Egypt: Quantitative Performance Criteria, 1987

	Actual	Ceilings	
	January	June	September
	Stock at end period (In LE million)		
1. Domestic credit			
Net domestic assets	32,549	35,015	36,390
Net claims on the nonfinancial public sector	21,251	23,250	24,500
Net claims on Central Government, local governments, and GASC	21,676	23,650	24,850
	Stock at end period (In U.S. dollars million)		
2. International reserves			
Net international reserves of the banking system 1/	5,408	5,645	5,695

	1987	
	Jan.-June	Jan.-Sept.
	Change during period (In U.S. dollars million)	
3. External debt 2/		
Up to one year (but excluding trade finance)	200	300
One-twelve years 3/	350	850

	1987	
	Jan.-June	July-Sept.
	(In LE million)	
Memorandum item:		
Estimated debt service originally due during the period by:		
Public sector	2,050 4/	960 4/
Central Government, local governments, and GASC	950 4/	470 4/

Sources: Data provided by the Egyptian authorities and staff estimates.

1/ The banking system consists of the Central Bank, the commercial banks, the business and investment banks, and the specialized banks.

2/ Contracting or guaranteeing by the public sector of external debt on noncessional terms during the period (including the Central Bank and public sector commercial banks).

3/ Excludes four loans from the World Bank which have already been approved by the Bank but not yet made effective by the Egyptian Government, as well as new sectoral loans from the Bank contracted during the period.

4/ If the sum of the holdings of Egyptian pounds in the blocked account of the public sector and the amount of debt service effected abroad by the public sector falls below the estimated debt service originally due, the ceilings on the net domestic assets and credit to the public sector for the corresponding end of period dates will be lowered by the amount of the shortfall, and vice versa. Similarly, if the sum of the holdings of Egyptian pounds in the blocked account of the Government and the amount of debt service effected abroad by Government falls below the estimate of debt service originally due, the ceiling on credit to the Government for the corresponding end of period dates will be lowered by the amount of the shortfall, and vice versa.

III. Medium-Term Balance of Payments Outlook and Capacity to Service Obligations to the Fund

The staff's projections of the balance of payments indicate that on the basis of already indicated policies, Egypt's balance of payments position will remain very weak in the medium term (Table 6). The external financing gap, including the US$400 million a year accumulation of net international reserves, is projected to remain above US$3 billion until 1991/92. Therefore, in addition to continuing reinforcement of policies, further exceptional financing largely in the form of additional reschedulings of bilateral debt but also additional aid in excess of what is considered to be voluntary capital inflows, would be required well beyond the stand-by arrangement period, if Egypt is to remain current in its external obligations.

The balance of payments projections for 1988/89-1991/92 assume the continuation of the policy stance described in the program and prudent domestic financial policies in the period following the expiration of the proposed arrangement. The main assumptions are as follows: there is no erosion of external competitiveness, international oil prices increase at 3 percent a year in U.S dollar terms, while international interest rates would remain at the average 1986/87 levels (see Appendix II). A modest increase in the annual rate of economic growth (3-4 percent a year) has been assumed from 1988/89 onward. On this basis, total exports are projected to rise by 3-4 percent a year in 1988/89-1991/92; the small growth of exports reflects the fact that, given the stable oil production projected over the period, and the growth of domestic energy consumption as a result of the growth of the population and of economic activity,, oil export volumes will be on a downward trend. Tourism receipts are projected to expand at 7 percent a year and workers' remittances at 10 percent a year. Total imports are projected to grow by 5 percent a year; the latter will benefit from the exchange rate and interest rate reforms. Total imports are projected to grow by 5 percent a year on average. As a result, the trade deficit is projected to widen to almost US$9 billion in 1991/92, with the current account deficit remaining at about US$4.5 billion, despite the projected increase for net service receipts. Reflecting the financing of this resource gap and normal capital inflows, the external debt is projected to increase from US$48 billion in June 1988 to US$60 billion by June 1992.

The staff has made a number of alternative scenarios on the basis of changed assumptions. The conclusion is that even with a much reinforced set of policies, the improvement in the current account would be slow because of the specific structure of the balance of payments (large imbalances between imports and non-oil exports, stagnation of oil export volumes, low non-oil export base), the needs of the rapidly growing population, in particular food and other essentials, and above all, the large external debt service obligations. In addition, there is always the inevitable lag between implementation of policies and their impact on the balance of payments due to the numerous rigidities and administrative constraints that exist at present. All the scenarios made by the staff assume that oil production levels will be maintained even though there has been recently a decline in oil exploration; this staff assumption is more optimistic than the preliminary projections of the Five-Year Plan which envisage a decline in domestic oil production. Moreover, the staff projections do not envisage a substantial increase of international food prices and interest rates.

Net capital flows, before rescheduling, are projected to remain negative up to 1990/91, but to become positive in 1991/92, when amortization due on public sector suppliers' credits is projected to drop sharply. Net disbursements of project and commodity loans are projected to remain at about US$200 million a year. Net disbursements on suppliers' credits to the public sector are projected to remain negative up to 1990/91, despite a projected pick-up in disbursements once the orderly settlement of external debt service has taken place, as amortization payments increase steadily throughout the period. Private sector exchange flows other than workers' remittances are projected to grow by about US$100-150 million a year as economic activity rises gradually. Debt service in relation to exports of goods and services, before rescheduling, would remain at 57 percent up to 1990/91, dropping to 48 percent in 1991/92; after rescheduling, the debt service ratio would increase from 24 percent in 1988/89 to 31 percent in 1991/92.

For the period extending beyond the medium-term, tentative balance of payments projections have been attempted. They indicate that the financing gap is projected to decline to about US$2 billion up to 1993/94 but to widen to close to about US$4 billion annually in the 1994/95-1998/99 period, as repayments of principal amounts on external debt obligations rescheduled earlier and on the additional capital inflows required in the 1986/87-1991/92 period come due. Debt service in relation to exports of goods and services would therefore widen from 59 percent in 1992/93 to 74 percent in 1996/97. While these projections are obviously tentative in their nature and their assumptions will have to be revised over time, they nevertheless point to the fragility of the balance of payments, in particular the impact on the external accounts of both the distorted trade accounts and of the external debt overhang. The persistence of financing gaps imply that exceptional financing, including debt relief and additional aid will be required well beyond the period of the requested stand-by arrangement.

IV. Staff Appraisal

For a number of years, the performance of the Egyptian economy has been distorted by insufficient flexibility in prices, exchange rate and interest rate determination; widespread administrative controls; by a weak budget structure; and by expansionary financial policies. As a result, the production of tradables has been held back and an energy and capital-intensive production base has emerged which is also heavily import dependent. Until the early 1980s, the balance of payments benefitted from an extraordinary increase in external resources but these typically did not reflect the productivity and competitiveness of the economy and left it vulnerable to changes in the availability of these resources. By the mid-1980s, the less favorable external environment, in particular the decline in oil prices, and rapid domestic inflation brought into the open the structural weaknesses of the economy. By then, the economy was burdened with large external debt sevicing obligations.

In 1985, the authorities adopted a number of corrective steps, most notably in the budget, pricing, and public investment areas, but these policies were not of a sufficient strength and breadth to cope with the massive imbalances and distortions that were emerging. Despite the decline in the international prices of a number of imported commodities, there was an acute shortage of foreign exchange in the official markets during 1986 which led to a rapid accumulation of external arrears as well as to a reduction of public sector imports with adverse effects on investment, output, and price performance in that year and the first quarter of 1987.

These worsening developments have been viewed with concern by the Egyptian authorities. Since mid-1986, Fund and World Bank staffs have been engaged in a dialogue with the authorities regarding a strategy for adjustment. The staffs of the two institutions have emphasized that the the solution to Egypt's structural problems required the adoption of comprehensive and far-reaching policy actions aimed at correcting the incentive distortions to encourage growth in the tradable sector while restraining aggregate demand. More specifically, the authorities were encouraged to introduce a full exchange market unification in a relatively short period, to adopt realistic exchange and interest rate levels, remove relative price distortions in agriculture and industry and increase consumer prices of energy products toward their international levels, implement management reforms in the public enterprise sector, as well as remove impediments to the private sector's ability to invest, import, and compete freely. In order to reduce inflationary pressures, such policies needed to be supported by a substantial reduction in the budget deficit and tighter credit policies. By improving the production of tradables and employment opportunities, these policies would create the prerequisite for larger inflows of remittances and private investment, and therefore would bring about a more desirable environment for higher growth. However, given the balance of payments' current structure and the large external debt overhang--a significant part of it not associated with productive investment--even with successful and forceful implementation of such policies, it is unlikely that the balance of payments would regain viability before a long number of years.

In response, the authorities have stressed that considerations of domestic political stability precluded the full and immediate implementation of all the measures recommended by the Fund and World Bank staffs. Instead, they have devised a program of economic reform which envisages the phased implementation of policies over a longer time span. On the basis of their policy proposals, they are seeking financial support from the Fund and the World Bank, comprehensive rescheduling of external debt servicing obligations, and increased external aid.

The reform program of the authorities comprises actions in most of the areas recommended by the staff. As such, it represents a considerable improvement over previous attempts at adjustment. The exchange reform envisaged under the program aims at simplifying and partially unifying the complex exchange rate structure over a 14-month period, and at correcting the large overvaluation of the commercial banks' exchange rate. The recent liberalization of delivery quotas and price controls on a number of crops and increases of the procurement prices for cotton, sugar, and rice provide encouragement to agricultural production. The increase in domestic energy prices to be effected by May 1, 1987, and the intention to effect further annual adjustments until prices reach their international level by 1991/92, will raise budget revenues, allocate resources more efficiently and, by slowing the growth of energy consumption, will directly benefit the balance of payments. The public investment program has been scaled down and emphasizes desirable investment priorities. On the demand management front, the steady reduction in the overall budget deficit through expenditure restraint and revenue efforts is welcome and should enable the Government to reduce its domestic bank borrowing. The recent measures tightening credit are essential as they will help contain inflation, support the exchange reform, and, therefore, improve the balance of payments.

The staff has cautioned the authorities that achievement of the objectives of their program requires careful and consistent implementation of policies in four areas: first, fiscal and credit developments should be monitored continuously so that needed corrective policies can be implemented promptly; second, the bank exchange rate in the new market should be maintained at a realistic level; failing this, a new parallel market would emerge and grow, thus defeating the purpose of the exchange reform; third, achievement of the 1987/88 budget deficit targets will necessitate that monthly adjustments in the authorized bank rate--which serves to value imports for customs duty calculation--be effected as planned and that expenditure deviations should be promptly offset by new measures; and, finally, in the credit policy area, the Central Bank needs to ensure that its credit restraint measures apply to all banks without exception and that the creation of reseve money is slowed down.

On the basis of the policies indicated by the authorities and allowing for the effect of exogenous factors, as well as full settlement of all arrears outstanding as of December 31, 1986, an external financing gap of about US$12.3 billion is projected over the period of the proposed arrangement. The staff estimates that about US$11.6 billion can be made available through rescheduling of bilateral debt servicing obligations and that US$0.7 billion of additional financing will be available from acceleration of aid disbursements from existing and new commitments.

In the view of the staff, the authorities' policy proposals are in the right direction. However, a number of important areas including the Central Bank exchange rate, interest rates, and the substantial distortions in domestic prices have not been addressed at the start of the program. Also, given the still large recourse of the public sector to bank credit and the only modest change in the level of interest rates to be introduced on May 1, the onus of the credit tightening falls on the private sector. Forceful adoption of the program will help moderate inflation and arrest the deterioration in the balance of payments. It will also encourage the setting in motion of a donors/creditors' response for substantial relief in the balance of payments; this will allow some resumption of economic growth. It is to be hoped that these positive initial efforts will succeed and that they will give confidence to the authorities to accelerate and broaden their reform effort. In this respect, the staff considers that the proposed program must be seen as a first step in a long process of adjustment.

The Egyptian authorities have already assured the Managing Director of their readiness to accelerate the pace of their reform program at the time of the first review of performance, to be completed by November 30, 1987, in such areas as the exchange reform, interest rates, and pricing policies. Given the importance of the Central Bank rate for trade in agricultural and petroleum products, as well as for government transactions in the balance of payments, a relatively short schedule for full unification of the exchange system would need to be adopted. Also, because of their role in domestic saving mobilization and resource allocation, as well as their direct impact on balance of payments flows, interest rate levels will soon have to be brought to realistic levels. In addition, greater flexibility in all aspects of pricing as well as management reforms in the dominant public sector industries are necessary to improve encourage increased production, rationalize consumption, and improve public finances and the balance of payments. These actions will also have to be supplemented by tight public expenditure controls and measures that increase the elasticity of tax revenue to domestic activity, and by prudent credit policies.

Even with full implementation of the policies under the program and the continuation of normal creditor country support, balance of payments viability is unlikely to be reached over the medium term. Thus, Fund assistance would not be sufficient to deal with the country's balance of payments problem which is of a long-term character. In this particular case, the strategy that is being proposed consists of devising an extended framework for policy adjustment and external financial assistance, where Fund support would be joined to that of the World Bank and the donor/creditor community to bring about the sustained long-term adjustment effort and policy reforms that are required in Egypt to redress the country's structural problems and create the conditions for the viability of the economy over the long haul. In this respect, the assurances received from creditors about their enhanced long-term financial involvement are a key element in this strategy, in part because they will ensure the timely repayment to the Fund.

While the adjustment task is arduous, it is unavoidable, particularly if Egypt wants to maintain the social benefits offered to its rapidly growing population, including the creation of sufficient employment opportunities. The choice is whether external adjustment is to come from inflation, restrictions, and low growth, or from the concerted approach described above that will set in place the conditions for sustained higher growth. In the view of both the Fund and World Bank staff, Egypt has a considerable potential for achieving a sustainable rate of real economic growth in a noninflationary environment and a viable balance of payments position in the long term, provided the right policies are adopted promptly and external assistance in sufficient quantity and of the appropriate type is mobilized. The country has a large domestic market, a relatively diversified industrial base, highly favorable agricultural growing conditions, a surplus of energy resources, a strategic geographical location, and a large skilled labor force. This potential should considerably enhance the chances of success of the collaborative long-term strategy now being envisaged. The proposed stand-by arrangement, which the staff recommends for approval, can be considered as the first installment in that strategy.

Lastly, Egypt maintains restrictions on payments and transfers for current international transactions subject to approval under Article VIII, Section 2 (a) arising from external payments arrears, advance import deposits, and a bilateral payments agreement with a Fund member (Sudan). The multiple currency practice associated with the three-tier exchange market (official, commercial, and free rates) which gives rise to at least seven exchange rates is also subject to approval under Article VIII, Section 3. In the light of Egypt's intentions to unify the authorized bank and the free market rates, to phase out the advance import deposits, and to further liberalize the exchange system, it is proposed that the Fund grant approval for the multiple currency practices and restrictions, other than the bilateral payments agreement, until November 30, 1987 or the completion of the next Article IV consultation, whichever is earlier. The staff also proposes that Egypt be encouraged to eliminate the bilateral payments agreement and other remaining exchange restrictions as soon as possible.

V. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board.

(i) Stand-By Arrangement

1. The Government of the Arab Republic of Egypt has requested a stand-by arrangement in an amount equivalent to SDR 250 million for the period from May __, 1987 to November 30, 1988.

2. The Fund approves the stand-by arrangement set forth in EBS/87/93 .

(ii) Exchange System

As described in EBS/87/93 , Egypt maintains restrictions on payments and transfers for current international transactions evidenced by external payments arrears, advance import deposits, a bilateral payments arrangement, and a multiple currency practice arising from the three-tier exchange market. These measures are subject to approval under Article VIII, Sections 2 and 3. The Fund welcomes the intention of Egypt to unify the bank market and the free market, to eliminate the external payment arrears, and to phase out the advance import deposits. The Fund encourages Egypt to eliminate the remaining exchange restrictions and multiple currency practice as soon as possible. In the meantime, the Fund grants approval for the retention of these restrictions and the multiple currency practice as these may be modified in accordance with paragraph 4(e)(ii) of the stand-by arrangement for Egypt, other than the bilateral payment arrangement, until November 30, 1987, or the completion of the next Article IV consultation, whichever is earlier.

Arab Republic of Egypt--Stand-By Arrangement

Attached hereto is a letter, with annexed Statement on Economic and Financial Policies and attached Technical Memorandum of Understanding, dated February 25, 1987, from the Governor of the Central Bank of Egypt and the Minister of Finance, requesting a stand-by arrangement and setting forth:

(a) the objectives and policies that the authorities of Egypt intend to pursue for the period of this stand-by arrangement;

(b) understandings of the authorities of Egypt with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the Egyptian authorities will pursue for the period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from May 1987 to November 30, 1988, Egypt will have the right to make purchases from the Fund in an amount equivalent to SDR 250 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 116.0 million until August 1, 1987; the equivalent of SDR 138.3 million until November 1, 1987; the equivalent of SDR 160.6 million until February 1, 1988; the equivalent of SDR 182.9 million until May 1, 1988; the equivalent of SDR 205.2 million until August 1, 1988; and the equivalent of SDR 227.5 million until November 1, 1988.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Egyptian currency in the credit tranches beyond 25 percent of quota.

3. Purchases under the stand-by arrangement shall be made from ordinary resources.

4. Egypt will not make purchases under this arrangement that would increase the Fund's holdiongs of Egypt's currency in the credit tranches beyond 25 percent of quota:

(a) during any period before November 1, 1987 in which data at the end of the preceding calendar quarter indicate that

(i) the limit on net domestic assets of the banking system;

(ii) the limit on net claims on the nonfinancial public sector;

(iii) the limit on net claims on the Central Government, local governments, and the General Authority for Supply Commodities;

(iv) the minimum level of the net international reserves of the banking system; and

(v) the limits on new nonconcessional external borrowing contracted, or guaranteed by the public sector, including the Central Bank and the public sector comercial banks;

set forth in Appendices III and IV of the Technical Memorandum of Understanding attached to the letter of February 25, 1987, have not been observed; or

(b) during any period after December 31, 1987 in which the intention to transfer 40 percent of transactions from the commercial bank pool to the free market, as described in paragraph 8 of the Statement on Economic and Financial Policies annexed to the attached letter, is not carried out; or

(c) during any period after June 30, 1988 in which the intentions

(i) to transfer the remaining transactions from the commercial bank pool to the free market, as described in paragraph 8 of the Statement on Economic and Financial Policies annexed to the attached letter,

(ii) to adjust exchange rates for transactions in accordance with paragraph 2 of Appendix I of the Technical Memorandum of Understanding attached to the attached letter, and

(iii) to eliminate all external payments arrears as stated in paragraph 20 of the Statement on Economic and Financial Policies annexed to the attached letter, are not carried out; or

(d) during any period after October 31, 1987 and April 30, 1988, until the first and second review, respectively, contemplated in the attached letter have been completed and understandings on the operation of the exchange market have been reached, and as regards the first review, suitable performance criteria have been established and understandings on interest rate and pricing policies have been reached, or, after such understandings and other performance criteria have been established, while they are not being observed; or

(e) during the entire period of this stand-by arrangement, if Egypt:

(i) imposes or intensifies restrictions on payments and transfers for current international transactions, or

(ii) introduces new or modifies existing multiple currency practices except for the transfer of transactions from the commercial banking pool to the free market, or the unification of the central bank pool rate with the free market rate, or

(iii) concludes bilateral payments agreements that are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Egypt is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Egypt and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Egypt will not make purchases under this arrangement during any period of the arrangement in which Egypt has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

6. Egypt's right to engage in the transactions covered by this stand-by arangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Bdard to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Egypt. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Egypt and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Egypt the Fund agrees to provide them at the time of the purchase.

8. Egypt shall pay a charge for this arrangement in accordance with the decisions of the Fund.

9. (a) Egypt shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement, in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Egypt's balance of payments and reserve position improves.

(b) Any reductions in Egypt's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purchase at the time of the reduction.

10. During the period of the stand-by arrangement, Egypt shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Egypt or of representatives of Egypt to the Fund. Egypt shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Egypt in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with the attached letter of February 25, 1987, Egypt will consult the Fund on the adoption of any measures that may be appropriate, at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Egypt has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Egypt's balance of payments policies.

Mr. Michel Camdessus
Managing Director,
International Monetary Fund,
700 19th Street, N.W.
Washington DC 20431,
USA

Cairo, February 25, 1987

Dear Mr. Camdessus,

The attached Memorandum on Economic and Financial Policies of the Government of Egypt outlines the policies which we will implement to regain growth, preserve stability and restructure our economy. In connection with the adoption of these measures, the Government requests a Stand-by arrangement for 18 months in an amount equivalent to SDR 250 million.

The Egyptian authorities will remain in close contact with the Fund staff on developments and progress in implementing these policies. Egypt will be pleased to invite the Fund to review the country's economic developments and progress in implementing the program, in accordance with the policies of the Fund, not later than November 30, 1987 and May 31, 1988. Egypt will consult with the Fund on the adoption of any measures that may be appropriate in accordance with the policies of the Fund on such consultations.

Sincerely yours,

M. A. El Razzaz
Minister of Finance

M. Salah Eldin Hamed,
Governor
Central Bank of Egypt

Statement by the Government of Egypt on its

Economic and Financial Policies

Background

1. During the 1970s and early 1980s, the Egyptian economy achieved high rates of real growth under the stimulus of a sustained increase in foreign exchange earnings from oil exports, expatriate remittances, Suez Canal traffic, tourism, and foreign aid. Despite the increased foreign exchange earnings, the position of producers in the agricultural and manufacturing sectors was progressively weakened by cost/price distortions and rigidities which inhibited response to changing domestic and external circumstances. Notwithstanding the deterioration in the structure of the balance of payments, the overall payments situation remained manageable through the early 1980s, initially by means of continued growth of receipts from oil exports and subsequently, after oil earnings had peaked, by aid flows and borrowing abroad. By the mid-1980s, however, the external debt service burden had reached significant proportions.

2. Confronted with a weakening balance of payments, the Government of Egypt undertook a substantial number of corrective actions starting in the 1984/85 fiscal year. These included, most importantly, the introduction of greater price flexibility. Nevertheless, the rapid growth of the population along with continuing rigidities in the economy forced the government to maintain financial policies that were relatively expansionary. Despite recourse to administrative controls on imports, the overall payments situation swung from a surplus position, to large overall deficits afterwards which were financed mainly by the accumulation of external payments arrears.

3. In 1985/86 the Government undertook further adjustment measures. Nevertheless the beneficial impact of these measures on the external account was offset by the sharp fall in international oil prices and the decline of workers' remittances and high debt service obligations. In the face of this deterioration, further measures were introduced by the Government in 1986/87 to restrain domestic demand and the growth of imports. These actions included, among others, the containment of public expenditures and an enhanced effort to mobilize budgetary resources; the latter actions consisted of increases in the prices of a number of commodities, the transfer of certain imports from the government to the private sector with their sale at market prices, and several tax measures, the most important of which was a wide-ranging tariff reform in August 1986. Tighter credit policies were also introduced in April 1986. Despite these measures, the balance of payments continued to weaken, giving rise to further accumulation of external payments arrears. By the end of 1986, the domestic economic scene was characterized by balance of payments difficulties which was adversely affecting investment and economic growth as well as putting pressure on prices and the free market exchange rate.

II. Reform Plans

4. To address the current situation and improve the medium-term prospects, the Government of Egypt has decided to reinforce those policy actions that have already been introduced and to introduce further corrective measures on a broad front in the period ahead. The fundamental objective of the present policy package is to make possible over the medium term a sustainable level of economic growth consistent with a manageable balance of payments position and an improved price performance. The present policy package should be seen as a continuation of the process of structural reform which will be pursued in the future. However, because of the structural imbalances of Egypt's external accounts, including the narrow non-oil export base, and the growing burden of external debt servicing, it is expected that the improvement in the current account position of the balance of payments will be spread over a number of years. Consequently, in order to support its adjustment effort, the Government of Egypt is seeking exceptional assistance from the international community during the interim period.

5. For the remainder of 1986/87 and for 1987/88, the objectives of the economic reform program are to bring about a recovery of economic activity, a reduction in the underlying rate of inflation in the consumer price index (exclusive of corrections in administrative prices) from 30 percent in the 12 months to December 1986 to below 20 percent in 1986/87 and further to about 12 percent in 1987/88. As indicated above, because of a number of unfavorable developments, the current account deficit of the balance of payments will increase from 2.9 billion in 1985/86 to US$ 3.6 billion in 1986/87, and the overall balance of payments is projected to be in deficit by US$ 3.4 billion. Despite a projected recovery in oil prices above their 1986/87 average, and the impact of the adjustment policies described below, the external current account deficit is projected to increase to US$ 4.0 billion in 1987/88, with the overall deficit still being of the order of US$ 3.4 billion which cannot be covered by a further reduction in net international reserves. The increase in the current account deficit is due mainly to the higher level of imports necessary to insure a recovery of activity levels as well as the impact of the depreciation of the dollar in world markets on debt service payments.

6. Achievement of the above objectives therefore involves setting in motion a number of policies aimed at increasing the contribution of the private sector to the growth of the economy and enhancing the interaction of market forces. To have the maximum success, these policies will be accompanied by a tighter demand management stance, which will come largely from more restrictive budget and credit policies.

a. Supply policies

7. The Government of Egypt firmly believes that the further improvement in economic prospects and an increase in Egypt's international competitiveness depend on providing adequate incentives for the production of tradeable goods and improving resource allocation. Accordingly, the incentive system is being restructured and public investment streamlined. The policies to be followed in the main areas are described below.

Exchange reform

8. The Government of Egypt is committed to undertake a fundamental exchange reform that aims at simplifying and unifying the present exchange rate structure over time. Banks - Commercial and Business and Investment - currently authorized to operate in Egyptian pounds and foreign currency will be allowed to operate in the free exchange market. Along with the liberalization of the banks' operations, transactions will be transferred from the present commercial bank pool to the free market in three stages according to a predetermined schedule: (a) 40 percent of transactions, including all workers' remittances and tourist receipts, certain agricultural and industrial exports, and selected commodity imports by industrial public sector entities will be transferred by May 1 1987 (b) another 40 percent of transactions of the commercial bank pool will be transferred not later than December 1987; and (c) the remaining transactions would be transferred not later than June 30, 1988. In order to bring about the beneficial effects of this reform, all these measures will not add any additional burden on the public sector budget. Thereafter the rate will be determined competitively in the market.

The government of Egypt is aware that the stabilization program supported by the Fund hinges on the successful implementation of the liberalization of the exchange market. To this end and in order to establish the appropriate administrative environment for the operation of the forces of supply and demand the Government of Egypt has requested the technical assistance of the Fund and the EEC in the field of exchange management.

The informal exchange market in its present structure is characterized by widespread monopolistic practices and is subject to frequent speculative attacks on the Egyptian pound. To reduce its volatility, the Government of Egypt has begun to develop the necessary banking structures and regulations for the proper day to day management of a free foreign currency market within the banking system.

In addition the Government of Egypt requests the short term financial support from the international community, such support will insure the smooth operation of the exchange market in its initial period, which is crucial for the success of the economic reform program.

9. The Government of Egypt will discuss and reach understandings with the Fund, early during the program period, on a schedule for the unification of the central bank pool rate with the free market rate. The impact of the transfers on the Budget and/or on the purchasing power of the lower income groups will be quantified and means for their most efficient management will be established.

Interest rate policy

10. To be successful, the exchange reform has to be a part of a comprehensive package of policies, the key elements of which will be appropriate credit and interest rate policies. As regards interest rate policies the objective of the reform package is to achieve, by the end of the program period, positive real interest rates based on the underlying inflation rate exclusive of administrative price corrections, and competitive yields relative to foreign currency instruments. During the first review of the program understandings will be reached with the Fund on a schedule of interest rate adjustment to meet this objective. Moreover one of the measures being considered which would contribute to the dedollarization of deposits is a premium of 5 percentage points over the going rates, to be applied to domestic currency deposits resulting from foreign currency conversions.

11. The Government of Egypt also recognizes the need to adjust the structure of interest rates, particularly as regards maturity differentials between lending rates. The new term structure, which is under consideration by the board of the Central Bank, will be put in place at the start of the program. In this regard if an economic activity is considered to be in need of additional incentives it will be provided through explicit budgetary subsidies.

Energy policy

12. Concomitant with the objective of improving the allocation of resources domestically but also in the interest of restraining the domestic consumption of Egypt's depletable energy resources, the Government of Egypt intends to adjust the domestic prices of energy products over the next years so as to bring them to world levels by 1991/92. As a first step, electricity tariffs and the prices of the principal petroleum products, will be increased by May 1, 1987.

Agricultural policies

13. Important steps have already been taken to liberalize the procurement prices of agricultural products and terminate the official procurement system hitherto applied to several agricultural commodities. As of end-1986, only five commodities (cotton, rice, sugarcane, onions, and groundnuts) remained in the official procurement system, with the latter two being procured officially solely for the purpose of controlling the quality of such exports. The Government of Egypt intends to effect annual adjustments in the procurement prices of

cotton, rice, and sugarcane that will ensure a sustained production response, adjustments which have been discussed with the World Bank. Already in recent months, the Government increased the sugarcane procurement price by 11 percent and the average cotton price for the 1986/87 crop year by 26 percent. It also will decide on a schedule for the procurement prices of rice during the subsequent two years and on a program for its production and pricing over the period 1986/87-1988/89 by June 30, 1987. In addition, during the program period, the Government intends to: (a) diminish the attractiveness of domestic meat production and thereby encourage the reallocation of agricultural land from fodder to export crops; and (b) starting the phasing out subsidies on agricultural inputs in three equal steps over a three year period.

Pricing and management of public enterprises

14. Over the medium term, Egypt needs to improve the competitiveness and efficiency of domestic production. The large investments made in the public sector are to earn an economic rate of return and contribute to the mobilization of public sector resources. The basic principle in the management of public sector economic enterprises will be to ensure efficiency and financial viability.

The Public Investment Program

15. The Second Five-Year Plan, 1987-1992 is currently in an early stage of formulation. The overall size of the five-year investment program is tentatively estimated to be around LE 42 billion in 1985/86 prices. The share of the private sector is expected to grow to be roughly one-half of total investment. Total investment is projected to remain at about 20% of GDP over the five-year period, with public investment accounting for about 10% of GDP. A growing proportion of total investment is expected to be allocated to the commodity producing sectors, particularly to the agricultural, industry and energy sectors. Priority will be given to the completion of ongoing projects as well as to the rehabilitation of existing capacity. The Government will discuss with the World Bank ~~on~~ the size and composition of the investment program. These discussions will take place within the coming weeks.

The Government places particularly high priority on developing its energy resources to provide for the future growth of the economy and to maintain a surplus for export. Special emphasis will be placed on pursuing an active natural gas development strategy.

b. Demand restraint policies

Budgetary policies

16. A key factor in the financial imbalances in the Egyptian economy during recent years has been the large overall fiscal deficits which averaged 20 percent of GDP. The Government intends to reduce the overall fiscal deficit (calculated as including the financial

requirements of GASC) from about 20 percent in 1985/86 to about 15 percent in 1986/87 and by at least an additional 2 percentage points of GDP annually in subsequent years with the objective of reducing it to the equivalent of 4 percent of GDP by 1991/92. The 1986/87 target is to be achieved through measures that have already been implemented for the most part. In the revenue side, these consist of greater price flexibility in the public enterprise sectors, increases in taxes and various fees, the customs duties reform of August 1986, and the projected adjustment of energy prices in 1987. Also, during the 1986/87 the collections from income taxes and the transfers of profits of public enterprises to the budget are being increased through a more active program to verify profits and entitlements to tax credits. On the expenditure side, the policies have introduced continued the previous restraints on recurring expenditures.

17. The objective for the 1987/88 fiscal year is a further reduction in the overall deficit to at most 13 percent of GDP. The present restraints on various recurrent expenditures and capital outlays will continue in 1987/88 but there will be a need for a salary increase for public sector employees following several years when remunerations decreased significantly in real terms. Revenues will be boosted by planned increase in energy prices, by ongoing reforms in real estate and inheritance taxes, and by the change in the exchange rate used for calculating the import duty base. Of equal importance, the Government intends to increase the elasticity of revenue with respect to domestic economic activity, in particular through broadening the base for consumption taxes, thereby reducing the dependence of the budget on taxes and revenues from foreign transactions. These actions will include the conversion of all remaining specific taxes to an ad valorem basis, the introduction of a broadly based manufacturers sales tax, a revision of all tax exemptions, and improved tax administration and collection procedures.

Monetary policy and credit program

18. Key objectives of financial policy will be to support the exchange reform, improve the balance of payments and reduce the underlying rate of inflation. To help in achieving these objectives, and taking into account the need to rebuild the external reserve position of the banking system, quarterly targets for the expansion of total domestic credit for the total economy, as well as some of its specific components, have been established for the periods ending June 1987 and September 1987 which are presented in the technical annex to this statement. These targets take into account the effects of other policies on the borrowing requirement of the Central Government and the rest of the public sector in light of planned changes in their pricing and operational efficiency. The credit targets for the remainder of the program period will be agreed with the Fund on the occasion of the first review of the program, to be completed by November 15, 1987. The Central Bank will reassess the adequacy of its existing credit control instruments and introduce improvements as needed.

External policies

19. Notwithstanding the policy actions taken to improve the balance of payments, considerable financing requirements will exist in the period of the program, which cannot be covered by a further drawdown ofl reserves. Therefore substantial external assistance including debt relief will be needed. Accordingly, the Government of Egypt intends to request rescheduling of its current external debt service obligations to bilateral creditors falling due during the program period.

20. The expansionary domestic financial policies of recent years coupled with the sharp reduction of foreign exchange availabilities during 1986 have contributed to the accumulation of arrears on external payments obligations. As part of its efforts to improve domestic prospects and to encourage normal capital flows, the Government of Egypt intends to eliminate all outstanding payments arrears by June 30, 1988 and will not incur any new arrears during the period of the stand-by arrangement. It is anticipated that the bulk of existing arrears as of December 1986 could be eliminated through their rescheduling in multilateral fora. The Government of Egypt intends to seek rescheduling on all arrears on the same terms from its creditors.

21. Concomitant with the effort to strengthen the underlying payments position, public external debt management will be carefully monitored. All external debt information will be centralized with the Central Bank of Egypt, and strict guidelines for contracting new non-concessional borrowing by all public sector entities have been put in place. As part of its external debt policies, the Government of Egypt intends to put limits on the contracting of new borrowing on non-concessional terms undertaken by the public sector or guaranteed by the Government.

22. To support the liberalization policies and ensure the regularization of external payments in the medium term, the Government of Egypt has set itself the target of improving the level of net international reserves of the banking system in both 1986/87 and 1987/88 in accordance with quarterly targets set in the attached memorandum. The achievement of these targets will depend crucially on the availability of appropriate external financing as anticipated in the program design.

23. A considerable part of the effort to improve the competitiveness of the economy and allow a faster growth of output involves increased reliance on the price mechanism to provide greater incentives and a liberalization of restraints on economic activity. Wide-ranging actions have already been implemented to increase flexibility in pricing. With the introduction of the 1986 tariff reform, all import licensing requirements have been eliminated and a list of 210 commodity categories, the importation of which is banned, has been introduced. These new procedures have introduced greater clarity in the import regime. Administrative restraints and bottlenecks on exports are being

significantly relaxed. The Government of Egypt intends to continue with this process of liberalization. During the program period, the Government of Egypt does not intend to introduce or modify any multiple currency practices or restrictions on payments and transfers for current international transactions, or impose any new, or intensify, restrictions for balance of payments reasons. Furthermore, in an effort to improve the utilization of the country's resources, it is envisaged that the remaining bilateral payments agreements with Fund members will have their coverage considerably reduced during the period of the stand-by arrangement.

24. The Egyptian government is convinced that structural reforms can only be achieved in an environment which is socially and politically stable. It is seeking an IMF Stand-by arrangement supported by a comprehensive aid package from the international community. Such a package should include the conversion of a higher proportion of ongoing project assistance into commodity and/or cash assistance, as well as special food assistance from Egypt's main donors.

It is the Egyptian government's belief that without a long term comprehensive developmental policy, short term measures will only provide temporary palliatives and the present balance of payments difficulties will only repeat themselves in a few years. Too much emphasis on the short term without due regard to the long term is counterproductive. It is the Egyptian government's hope that the international community led by the Fund and the World Bank will assist Egypt in its endeavors.

* * * *

Mr. Michel Camdessus
Managing Director,
International Monetary Fund,
Washington DC 20431,
USA

Cairo, February 25, 1987

Dear Mr. Camdessus,

We have the pleasure of writing you with reference to paragraph 12 of the statement by the Government of Egypt on its Economic and Financial Policies, attached to the letter dated February 25, 1987. We wish to inform you of the specific actions and policies with regard to future adjustments of domestic energy and electricity prices.

The government of Egypt intends to adjust, by May 1 1987, the prices charged to domestic users, of the petroleum products listed below, to the following levels:

Fuel Oil to LE 28.00 per metric ton,
Kerosene to LE 0.05 per liter,
Gas Oil to LE 0.05 per liter,
Diesel Oil to 0.045 per liter,
Natural Gas to LE 34.00 per metric ton.

Additionally electricity tariffs will be increased by an average of 29 percent over their present levels by May 1, 1987.

The above measures are a first step in our program to reach international levels by 1991/92.

Please accept Mr. Managing Director my highest consideration.

Yours sincerely,

M. A. El Razzaz
Minister of Finance

M. Salah Eldin Hamed
Governor
Central Bank of Egypt

March 31, 1987

Technical Memorandum of Understanding

Under the stand-by arrangement, the Government of Egypt will implement certain policy actions before certain specific dates and during the period of the arrangement. Progress in policy implementation and in the achievement of the objectives of the program will be monitored through quantitative and other indicators (performance criteria) and through periodic reviews of performance by the Fund, which would include the reaching of understandings on future policy actions. Nonobservance of performance criteria or failure to reach understandings during the reviews will interrupt purchases and entail consultations in order to determine the cause of these developments and agree on remedial actions as may prove necessary. The Government of Egypt will report periodically to the Fund on certain economic and financial data (Annex I).

I. Prior Actions

Not later than May 1, 1987 the Government of Egypt will:

a. introduce an exchange reform as described in Appendix I to this memorandum;

b. modify the present structure of interest rates as indicated in Appendix II to this memorandum; and

c. increase the prices of selected petroleum products and electricity tariffs according to the schedule communicated to the Managing Director of the Fund on February 25, 1987.

II. Performance Criteria

1. Credit ceilings

The stock of (a) net domestic assets of the banking system, (b) net credit to the total nonfinancial public sector, and (c) net credit to the Central Government and local governments including the General Authority for Supply Commodities, at end-June 1987 and end-September 1987 will not exceed the limits established in Appendix III to this memorandum. 1/

1/ Credit ceilings and targets for international reserves for the program period after September 1987 will be established on the occasion of the first review of performance under the program to be completed by November 30, 1987.

2. Net international reserves

The net international reserves of the banking system in June 1987 and September 1987 will not fall below the levels indicated in Appendix IV to this memorandum.

3. Arrears on external debt servicing obligations

The level of external arrears has been estimated at about US$6.8 billion at the end of December 1986. The Government of Egypt will eliminate all these arrears and any new arrears incurred after December 1986 by June 30, 1988, primarily through bilateral rescheduling. Furthermore, the Government of Egypt undertakes not to extend less favorable rescheduling terms than those established by the agreed minutes of the multilateral rescheduling forum to any official creditor without that creditor's consent. Moreover, the Government of Egypt will not incur any new arrears during the period of the stand-by arrangement.

4. External borrowing

The contracting of (a) short-term borrowing (maturities of up to one year) by, or with the guarantee of, any public sector entity with the exception of trade financing, and (b) medium- and long-term borrowing (maturities of one year up to 12 years) on nonconcessional terms by, or with the guarantee of, any public sector entity will be limited to the levels indicated in Appendix III, paragraph 2 to this memorandum. For the purposes of this performance criterion, the public sector is defined to include all levels of government (central, regional, and local), all public authorities and enterprises, and all public financial institutions, including the Central Bank and public sector commercial and specialized banks. The concessionality of the borrowing will be determined on the basis of the financing costs (interest charges and other) and repayment terms (grace period and maturity) as established in the above-mentioned Appendix III, paragraph 2, and attached table.

5. Exchange and trade system

In addition to the exchange reform, specified in Appendix I, during the period of the stand-by arrangement, the Government will not:

a. impose or intensify restrictions on payments and transfers for current international transactions, or

b. introduce or modify multiple currency practices, or

c. conclude bilateral payments agreements which are inconsistent with Article VIII of the Fund Articles of Agreement, or

d. impose or intensify import restrictions for balance of payments reasons.

Also, during the period of the stand-by arrangement, the Government will phase out advance import deposits as conditions allow and eliminate any import quotas on the private sector.

6. Other

Any undertakings, reached in the course of the current discussions or reviews of performance, entailing specified actions by defined dates will be deemed as performance criteria requiring that the undertakings be carried out by the dates specified.

III. Reviews

There will be two reviews of performance under the arrangement: (a) the first review is to be initiated in September 1987 and concluded with a discussion by the Fund Executive Board not later than November 30, 1987; and (b) the second review is to be initiated in March 1988 and concluded with a discussion by the Fund Executive Board not later than May 31, 1988.

The first review will

a. focus on budget developments (including pricing policy), progress on exchange reform, and reduction of payments restrictions;

b. establish quantitative performance criteria for the period of the arrangement after September 1987 which would supersede any indicative targets previously established for that period;

c. reach understandings on a schedule for completing the unification of all exchange markets;

d. reach understandings on a schedule for increasing nominal interest rates on domestic currency deposits and loans to levels that are positive in real terms and competitive with yields on foreign currency instruments; and

e. reach understandings on schedules for increasing the prices of energy and electricity and the procurement prices of cotton and rice for the crop year 1988/89. These understandings will be reached in consultation with the World Bank.

The second review will

assess progress in achieving the objectives of the arrangement, with particular focus on budget developments and budget policies for 1988/89, pricing policies, progress on exchange and interest rate reform, and reduction of payments restrictions.

Exchange Reform

The objective of the exchange reform, which will begin May 1, 1987, is to unify the commercial bank rate with the free market rate by June 1988. To achieve this, transactions will be transferred from the commercial bank pool to the new market (or the "market") in three steps and the commercial bank rate will be adjusted so as to reduce the difference between the two rates. Moreover, commercial banks will be authorized to transact in the market from the start. The exchange rate for commercial bank transactions in the market will be determined by a Chamber composed of representatives of the banks that will be authorized to operate in this market.

1. Transfers of transactions from the commercial bank pool to the market

Transactions conducted at present through the commercial bank pool will be transferred to the market in three steps. In the first step, on May 1, 1987, 40 percent of the transactions currently in the commercial bank pool will be transferred to the market. A further 40 percent of these transactions will be transferred by December 31, 1987 and the remaining 20 percent by June 30, 1988.

2. Adjustment of the commercial bank exchange rate

This rate will be adjusted several times during the month in small steps that bring an aggregate monthly movement equivalent to the difference between the two preceding months' moving average of the market rate and the level of the commercial bank rate at the beginning of the month divided by the number of months remaining to June 1988. There will be no discrete adjustment at the onset of the exchange reform.

3. Commercial bank participation in the market

a. Participants in the market

Starting May 1, 1987 all commercial banks authorized at present to carry on business in both foreign and domestic currency will be permitted to operate in the market according to ongoing regulations. The two travel companies (Thomas Cook and American Express) will be allowed to transact in this market.

b. Determination of the exchange rate for commercial bank transactions in the market

The exchange rate in the market will be set by a Chamber of eight members (four representatives of the public sector banks, two from the joint venture banks, and two from the private banks); and two observers, one from the Central Bank of Egypt and one from the Ministry of

Economy. The representatives of the nonpublic sector banks will be rotated every six months.

The Chamber will meet at the end of each business day to fix the rate that will be binding for all bank transactions effected in the market the following business day. Cross rates will be established based on the London exchange market rates at the close of the same business day.

The rate will be set on May 1, 1987 at the level existing in the free market. Thereafter, in setting the rate, the Chamber will use four indicators (supply, demand, working balances of the banks, and assessment of general market trends).

The Structure of Interest Rates on Banks' Domestic Currency Loans

The minimum and maximum interest rates on banks' Egyptian pound loans are presently as follows:

Sector	Minimum/Maximum
	(In percent per annum)
Agriculture and industry	11 - 13
Services	13 - 15
Commerce	16 - no maximum

Effective May 1, 1987 the minimum and maximum interest rates on loans with original maturity of one year and less will remain as at present. The minimum and maximum rates on loans with original maturity of more than one year up to (and including) two years will be 1 percentage point higher. The minimum and maximum rates on loans with original maturity exceeding two years will be an additional 1 percentage point higher.

Limits on the Expansion of Domestic Credit and the Contracting of Foreign Debt

1. Domestic credit

Net domestic assets of the banking system, net claims on the public sector, and net claims on the central and local governments (including the General Authority for Supply Commodities (GASC)), shall not exceed the levels indicated below at end-June 1987 and end-September 1987.

	1987		
	January Actual	June Ceiling	September Ceiling
		(In LE million)	
Net domestic assets	32,549	35,015	36,390
Net claims on the public sector	21,251	23,250	24,500
Net claims on Central Government, local governments, and GASC	21,676	23,650	24,850

The ceilings for June and September have been established on the assumption that the domestic currency counterpart of all external debt service payments that originally fell due in the period January-September 1987 will be placed into a blocked account with the Central Bank of Egypt irrespective of any external rescheduling (see below). Withdrawals from the blocked account may be made only for the domestic currency counterpart of the external debt service actually effected abroad.

The external debt service originally due is estimated at the following levels:

Table 1

	1987 Jan.-June	1987 July-Sept.
	(In LE million)	
a. External debt service by the public sector	2,050	960
b. External debt service by central and local governments (including GASC)	950	470

while the blocked account levels are estimated at:

Table 2

	1987 End-June	1987 End-Sept.
	(In LE million)	
Blocked account level	1,805	2,650
of which:		
Central and local governments (including GASC)	705	1,060

In the event that, at end-June or at end-September, the sum of the holdings in domestic currency in the blocked account for the public sector plus the amount of debt service actually effected in Egyptian pounds by the public sector falls below the amount of the total of external debt originally due (interest and principal) as identified in line (a) of Table 1, above, both the NDA and public sector credit ceilings will be adjusted down by the amount of the shortfall. Likewise, if the sum of holdings in the blocked account for the central and local governments at end-June or end-September, together with the amount of debt service actually effected by the central and local governments falls below the amount of the total external debt originally due (interest and principal) as identified in line (b) of Table 1, above, the central and local governments credit ceiling will be adjusted down by the amount of the shortfall. Conversely, if the sum of the respective blocked accounts and of the external debt service actually made is in excess of the totals specified in Table 1, the affected credit ceiling will be augmented by the amount of the excess.

2. External debt

The contracting or guaranteeing by the public sector of external debt on nonconcessional terms (as defined in the attached table by the World Bank and the OECD) in the maturities, and subject to the coverage indicated below, will not exceed the following amounts during the period January-September 1987:

	1987	
	Jan.-June	Jan.-Sept.
	(In US$ million)	
Nonconcessional external debt contracted by the public sector (including the Central Bank and public commercial and specialized banks) in the maturity of:		
Up to 1 year (but excluding trade finance)	200	300
1 - 12 years 1/	350	850

1/ Excludes four loans from the World Bank which have already been approved by the World Bank but not yet made effective by the Egyptian Government, as well as new sectoral loans from the World Bank contracted during the period.

Minimum Levels of the Net International Reserves of the Banking System

The net international reserves of the banking system shall not fall below the levels indicated below at the end of June and September 1987, respectively.

	1987	
	June	Sept.
	(In US$ million)	
Net international reserves of the banking system	5,645	5,695

Main Features of the Economic Program and the Balance of Payments Projections

A. Principal quantitative targets

The main targets during the fiscal years closest to the period of the arrangement are presented in the Table below:

Table 1. Egypt: Principal Economic Indicators, 1984/85-1987/88

	Actual		Target	
	1984/85	1985/86	1986/87	1987/88
	(Growth in percent)			
Output and prices				
Real GDP	4 1/	2 1/	-2	2
Crude oil production	12	-2	-2	5
Natural gas production	16	33	12	12
Cotton production 2/	--	9	-13	8
CPI - annual average	15	16	30	20
	(As percent of GDP)			
Fiscal performance				
Tax revenues	18	18	17	18
Nontax revenues	8	9	6	6
Other revenues	8	7	6	3
Current expenditures	37	36 3/	30	29
Wages and salaries	(10)	(10)	(9)	(8)
Subsidies	(9)	(8)	(5)	(5)
Capital expenditures	20	18	14	10
Overall deficit	22	20 3/	16	13
External financing	(5)	(4)	(2)	(--)
Domestic Bank financing	(11)	(8)	(8)	(6)
	(Change as percent of liquidity at beginning of period)			
Money and credit				
Private sector liquidity	12	14	9	9
Net domestic assets, of which	19	11	17	21
Net credit to Government	(12)	(10)	(12)	(10)
Net credit to rest of public sector	(1)	(--)	(1)	(2)
Credit to private sector	(8)	(9)	(6)	(9)
Net foreign assets	-7	3	-8	-12
	(Growth in percent)			
Balance of payments				
Exports	-4	-17	-31	26
Oil exports	-2	-21	-53	49
Cotton exports	-21	-14	-2	20
Imports	-2	-9	-6	9
Essential food imports	-12	-7	-22	2
Intermediate goods imports	6	-5	-7	12
Consumer goods imports	3	-10	3	11
Capital goods imports	-9	-16	1	8
Service receipts	-5	-10	--	3
Service payments	7	4	8	6
	(In billion of U.S. dollars)			
Current account deficit	-2.4	-2.9	-4.0	-4.1
Overall deficit	-1.1	-0.6	-3.2	-3.4
External debt at end of period	...	40.1	45.7	49.1
External debt service				
	(Percent of current account receipts)			
Before rescheduling	38	51	59	58
After rescheduling	38	51	26	19

Sources: Data provided by the Egyptian authorities and staff estimates.
1/ Estimated.
2/ Given the lag between harvest and export, the output reported is that of the preceding season which corresponds better with availability for export.
3/ Excluding assumption of NPE debts.

B. Summary of Policies

I. Exchange Reform

1. Commercial as well as business and investment banks to operate in free market. Exchange rate used by banks operating in the free market will reflect market conditions.

2. Transactions to be transferred from commercial bank pool to free market according to following schedule:

   a. Forty percent of transactions including all remittances and tourism receipts, certain agricultural and industrial exports, and selected imports of public sector entities to be transferred by May 1, 1987.

   b. Another 40 percent of transactions to be transferred not later than December 1987.

   c. Remaining transactions to be transferred not later than June 30, 1988.

3. Exchange rate in the existing commercial bank pool to be adjusted frequently along a path that unifies it with the free market by June 1988.

4. Understandings on a schedule for the unification of the central bank pool with the free market to be reached during the first review of performance.

II. Interest Rate Policy

1. Effective May 1, 1987, the minimum and maximum interest rates on loans with original maturity of more than one year up to (and including two years will be increased by 1 percentage point, the minimum and maximum rates on loans with original maturity exceeding two years will be an additional 1 percentage point higher. Any needed sectoral incentives will be provided through explicit budgetary subsidies.

2. Achieve rates that are positive in real terms and competitive with yields on foreign currency and by end of program period. During the first review of performance under the arrangement, understanding will be reached on a schedule of interest rate adjustments to meet this objective.

III. Energy Sector Policies

1. Prices of selected petroleum products and of natural gas will be increased by an average of 66 percent by May 1, 1987. At the same time, electricity tariffs will be increased by an average of 29 percent.

2. Understandings on price increases during 1988/89 to be reached during the first review of performance.

3. Energy prices to be brought to world levels by 1991/92.

IV. Agricultural Sector Policies

1. Procurement prices of principal commodities remaining in the official procurement system (cotton, sugar, and rice) will be adjusted annually by amounts that ensure a sustained production response. Understandings on the procurement prices for cotton and rice during 1988/89 to be reached during the first review of performance.

2. Restrictions on cultivated area to be eliminated.

3. Input subsidies to be phased out in equal steps over a three-year period.

4. Attractiveness of domestic meat production to be diminished in order to encourage the reallocation of agricultural land from fodder crops to export crops.

V. Industrial Sector Policies

Pricing policies and management of public sector enterprises will be reformed so as to ensure efficiency and financial viability.

VI. The Investment Program

1. Total size of LE 46 billion (1986/87 prices) over 1987/88-1991/92.

2. Growing proportion of investment to go to agriculture, industry, and energy. Special emphasis on natural gas development.

3. Priority will be given to completion of ongoing projects and rehabilitation of existing capacity.

VII. Fiscal Policy

1. Reduce fiscal deficit to 13 percent of GDP in 1987/88, while simultaneously limiting government borrowing from the banking system to LE 3.4 billion.

2. Budgetary actions in 1987/88 to include continuing restraints on various current and capital outlays. Revenues to be boosted by increase in energy prices, reform of real estate and inheritance taxes, by changing exchange rate used for calculating the import duty base, converting specific taxes to ad valorem, raising rates and expanding the coverage of consumption duties, introduction of new tax on the self-employed, and improving administration and collection procedures.

3. Further annual reductions to be effected in subsequent years with the objective of reducing the fiscal deficit to the equivalent of 4 percent of GDP by 1991/92.

VIII. Credit Policy

1. Credit targets to be based on need to support exchange reform, reduce underlying rate of inflation, improve balance of payments, and rebuild international reserves.

2. Adequacy of existing credit control instruments to be reassessed and needed improvements to be introduced.

IX. External Sector Policies

1. Eliminate all external arrears by end-June 1988, and prevent their re-emergence.

2. Limit contracting of new debt.

3. Increase international reserves of the banking system in order to stabilize the foreign currency exposure of domestic commercial banks and to rebuild the Central Bank's reserves.

C. Assumptions Underlying Credit Program, 1986/87 and 1987/88

The program has been formulated to take account of (i) a 2 percent decrease in economic activity in 1986/87 and a 2 percent increase in 1987/88; (ii) a yield differential favoring foreign currency deposits of 10 percentage points in 1986/87 which will be gradually closed during 1987/88; (iii) a decline in the real stock of private sector liquidity by 15 percent in 1986/87 and 10 percent in 1987/88; and (iv) an increase in the banking system's net international reserves of US$400 million in both 1986/87 and 1987/88.

D. Assumptions Underlying Balance of Payments Projections, 1986/87-1991/92

	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92
			(Growth in percent)			
1. Trade balance						
Exports						
Petroleum						
Production	-2	5	--	--	--	--
Consumption	1	1	1	1	1	2
Unit value	-37	18	3	3	3	3
Cotton						
Production	-13	8	1	1	6	1
Consumption	-2	-1	2	6	6	2
Unit value	--	-8	6	8	6	10
Other agricultural						
Production	--	1	2	2	2	2
Consumption	--	3	3	3	2	2
Unit value	5	6	3	4	4	4
Manufactured						
Production	-7	-1	2	4	5	6
Consumption	-2	2	2	3	3	4
Unit value	18	10	3	3	3	3
Imports						
Wheat and flour						
Production	1	5	14	5	5	4
Consumption	-3	3	3	3	3	3
Unit value	-30	-11	8	9	5	3
Maize						
Production	--	--	--	--	--	--
Consumption	-2	-2	-2	-2	-2	-2
Unit value	32	18	5	--	-1	3
Edible oils and animal fats						
Production	--	1	2	2	2	2
Consumption	-12	3	3	3	3	3
Unit value	-20	-1	3	8	9	4
Other food						
Produciton	--	1	2	2	2	2
Consumption	3	2	2	2	1	1
Unit value	-2	--	4	4	4	4
Other intermediate goods						
Production	--	-1	2	4	5	6
Consumption	-15	2	3	3	4	4
Unit value	8	5	4	4	4	4
Other consumer goods						
Production	-7	-1	2	4	5	6
Consumption	-15	4	5	6	6	6
Unit value	8	5	4	4	4	4
Capital goods						
Import volume	-20	2	2	3	3	4
Unit value	18	10	3	3	3	3

2. Services
   a. Receipts
      (1) Suez Canal. Receipts projected to increase by about 4 percent annually reflecting a 3 percent growth of world trade and a 1 percent increase in tariffs.
      (2) Workers' remittances. Drop of 9 percent in 1986/87, increase of 6 percent in 1987/88, and increase of 10 pecent a year in the 1988/89-1991/92 period.
      (3) Investment income. An interest rate of 5.5 percent throughout. Earnings base reflects the assumption with regard to gross international reserves.
      (4) Tourism. Increase of 10 percent in 1986/87, and 7 percent annually thereafter.
      (5) Other receipts. A 9 percent increase for 1986/87 (based on half year actuals), a 5 percent drop for 1987/88 (some receipts from petroleum corporations occur every other year), and a 4-5 percent a year increase for 1988/89-1991/92.

   b. Service payments
      (1) Interest. Interest rates range from 4 percent to 9 percent depending on the type of debt.
      (2) Other payments. Increase of 9 percent in 1986/87 (based on half year actuals), 4 percent in 1987/88, and 6.5 percent a year in the period 1988/89-1991/92.

3. Official transfers

   A drop in 1986/87 (based on half-year actuals), increase of US$100 million in 1987/88, increase of US$200 million in 1988/89, constant in 1989/90-1990/91, and an increase of US$100 million in 1991/92.

4. Capital
      (1) Project and commodity loans (net). A US$40 million repayment in 1986/87 and a flow of about US$200 million a year over 1987/88-1991/92.
      (2) Suppliers (net). Repayments through 1990/91 but net disbursements in 1991/92. Based on drawings and estimated repayment reschedule.
      (3) Drawings on supplier's credits. US$700 million average for 1986/87-1987/88, increasing to US$1.1 billion in 1988/89, and to 13 percent of public sector imports from 1989/90 onward.
      (4) Direct investment. US$50 million increase a year.
      (5) Other. Based on amortization schedule for debt other than project and commodity loans and suppliers' credits.

Arab Republic of Egypt - Fund Relations

(As of end-March 1987)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

(a)	Date of membership:	Original member, 1945
(b)	Status:	Article XIV

A. Financial Relations

II. General Department (General Resources Account)

(a)	Quota:	463.4
(b)	Total Fund holdings of Egyptian pounds:	482.2 (104.1 percent of quota)
(c)	Fund credit:	18.8 (4.1 percent of quota)
	Of which: extended Fund facility	18.8 (4.1 percent of quota)
(d)	Reserve tranche position:	--
(e)	Current Operational Budget (maximum use of currency):	--
(f)	Lending to the Fund:	--

III. Current Stand-by or Extended Arrangement and Special Facilities

(a) Current stand-by or extended arrangement: None

(b) Previous stand-by and extended arrangements:

Arrangement	Date	Duration	Amount	Utilization
Stand-by	Apr. 20, 1977	Apr. 19, 1978	125	105
Extended Fund	July 28, 1978	July 27, 1981	600	75

(c) Special facilities: Not used in last 1985-87.

IV. SDR Department

(a)	Net cumulative allocation:	135.92
(b)	Holdings	0.2 (0.1 percent of net cumulative allocation)
(c)	Current Designation Plan:	--

V. Administered Accounts (amounts)

(a) Trust Fund loans
(i) Disbursed: 183.7
(ii) Outstanding: 78.2

(b) SFF Subsidy Account
(i) Donations to Fund: --
(ii) Loans to Fund --
(iii) Payments by Fund: --

VI. Financial Obligations Due to the Fund

	Overdue Financial Obligations Mar. 31, 1987	Principal and Interest Due			
		Apr.-Dec. 1987	1988	1989	1990
Principal	--	28.10	43.84	18.61	5.72
Repurchases	--	6.25	12.50	--	--
Trust Fund repayments	--	21.85	31.34	18.61	5.72
Charges and interest including SDR and Trust Fund (provisional)	--	7.53	9.10	8.52	8.47
Total	--	35.63	52.94	27.13	14.18

B. Nonfinancial Relations

VIII. Exchange Rate Arrangements

The foreign exchange market is divided into three pools. The central bank pool handles exports of petroleum, cotton, and rice; Suez Canal dues; imports of five essential foodstuffs (including wheat), insecticides, and fertilizer; and most capital transactions of the public sector. The commercial bank pool receives receipts from workers' remittances, tourism, and exports not going through the central bank pool while providing foreign exchange for public sector payments not covered by the central bank pool. The free market shares common sources of supply with the commercial bank pool (workers' remittances and tourism), and satisfies the demand by the private sector (both visible and invisible transactions). Transactions in the central bank pool are mainly at the official rate of LE 0.7 = US$1, but transactions under bilateral agreements and certain aid programs are effected at other rates. Since August 1, 1981 the official rate in the commercial bank pool has been set at LE 0.84 = US$1. However, a premium commercial bank exchange rate was introduced in April 1983 to attract workers' remittances to banks. Since then, the commercial banks have been effecting a larger part of their transactions at more depreciated premium rates. At end March 1987, the premium rate was LE 1.38 = US$1 while the rate in the free market was LE 2.1 = US$1. In 1985/86 about 45 percent of current account transactions took place through the central bank pool, 30 percent through the commercial bank pool, and the remainder through the free market pool. A number of bilateral payments agreements (one with a Fund member) remain in force with exchange rates ranging from LE 0.7 = US$1 to LE 0.4 = US$1.

IX. Last Article IV Consultation

Consultations with Egypt are on a standard 12-month cycle. Discussiobns were held by the staff in Cairo during Mary 21June 2, 1986. The Staff Report (EBS/86/186 and Sup. 1) was discussed by the Executive Board on October 6, 1986.

The Executive Board's decision adopted October 6, 1986 was as follows:

1. The Fund takes this decision relating to the Arab Republic of Egypt's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1986 Article XIV consultation with Egypt conducted under Decision No. 5392-(77/63), adopted April 19, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes the intentions of the authorities to liberalize the exchange system and reduce the number of exchange rates. The Fund considers that the system remains complex and believes that steps should be taken at an early date toward the complete unification of the existing rates. The Fund urges Egypt to settle promptly its external payments arrears. The Fund hopes that Egypt will terminate the two remaining bilateral payments agreements with Fund members as soon as possible.

X. Technical Assistance

(a) CBD

1. In September 1983, a CBD mission visited Cairo to review the system for supervising banks and the program for training bank inspectors.

2. A CBD expert has been stationed in Cairo since December 1984 working on the development of a centralized external debt data and management system.

(b) FAD

FAD missions visited Cairo six times in 1984-86 to review the import tariff system and to suggest reforms.

(c) Other

1. Two ETR/MED and one MED technical assistance missions have visited Cairo (in June 1981, November 1982, and November 1984) to review the exchange system and make recommendations for unifying the exchange markets.

2. In March 1983, a STA technical assistance mission visited Cairo to review the methods used to compile monetary statistics.

3. In November 1983 the IMF Institute conducted a seminar in Cairo on Fund policies and Egyptian policy issues.

4. In November 1983 a STA/ETR mission visited Cairo to review balance of payments methodology.

5. In July 1985 and July 1986 a STA mission visited Cairo to facilitate Egyptian participation in the IBS program and to review external debt statistics.

6. In April 1987, Mrs. Jul (ETR) visited Cairo to assist in the preparation of the authorities' request for rescheduling external debt.

XI. Resident Representative/Advisor

The resident representative post that was closed in June 1983 was reopened in July 1986.

World Bank Group Operations

As of December 31, 1986, the World Bank Group had approved 47 loans and 29 credits to Egypt. Total commitments as of that date amounted to US$3,800 million, of which US$2,300 million had been disbursed. About 35 percent went to projects in the industrial sector, while 21 percent was for agriculture, 17 percent for transport and telecommunications, 16 percent for power and energy, and 11 percent for the social services sectors (including education, population, urban development, and water supply and sewerage). In February 1987, three additional loans (Drainage V - US$68 million; Port Said Rehabilitation and Expansion - US$37 million; and Vocational Training - US$19 million) became effective. Four other loans for US$534 million are presently at an advanced stage of ratification and are expected to become effective in April 1987. Discussions are presently taking place concerning sector loans in agriculture, industry, and energy; in addition the Damietta power project (Power IV - US$280 million) is expected to be appraised as soon as the energy price increases planned for May 1 are implemented.

The International Finance Corporation's (IFC) participations and lending commitments for projects in Egypt as of December 31, 1986, totaled about US$116 million. Most of the Corporation's activities have been lending operations. The most important projects financed are a project for an agricultural complex primarily for sugar beet, a building material project in Suez, and a reinforcing bar project at El Dikheila. The IFC has provided technical assistance in the design of incentives to private sector investments and in the development of the capital market. The IFC is considering several other private sector and joint venture projects.

The strategy underlying IBRD activities in Egypt during the 1970s and early 1980s aimed at rehabilitating damaged capacity, improving maintenance practices, eliminating critical deficiencies and bottlenecks to development, and helping the setting up and strengthening of institutions. To achieve these goals, the Bank supported development in a wide spectrum of sectors and served not only as provider of direct financing but also as a catalyst for bilateral and multilateral aid by organizing a Consultative Group for Egypt.

In support of this strategy, the IBRD helped the Government rehabilitate and enlarge the Suez Canal, and assisted in maintaining the productive capacity of the agriculture sector, mainly through a series of projects to install drainage systems in the Nile Delta and Upper Egypt. Bottlenecks in the transportation sector (particularly ports) and in the power sector were also addressed with Bank financing. Attention was also given to the provision of productive inputs, with special emphasis on imported materials and energy. Deficiencies in the areas of cement production, textiles, agricultural productivity, and skilled manpower were eased through projects in the respective subsectors. Private sector activities were fostered through operations aimed at assisting small- and medium-scale industry and through two loans for agro-industries. More recently, export promotion has received increasing support. Most projects included important technical assistance components aimed at strengthening the implementing agencies and other sector institutions. The Eyptian Public Authority for Drainage Projects, the Egyptian Electricity Authority, the Industrial Development Bank, the Suez Canal Authority, and the Export Development Bank are examples of institution-building efforts supported by the Bank in Egypt. Since 1982, the Bank's economic and sector work has concentrated on structural issues, such as trade strategy and investment planning, public sector enterprise reform, etc.

The Bank's current strategy is designed to assist the Government to restore macroeconomic balance through increases in productivity and improvements in investment allocation, resource mobilization, export activities, and employment policies. The sector adjustment loans for the agricultural, industrial, and energy sectors currently under preparation are aimed at realizing the productivity potential which exists in the economy. In addition, projects to overcome critical supply bottlenecks, increase and diversify exports, and foster economic import substitution would be supported. For the longer term, as the stabilization measures become effective and the investment outlook improves, further assistance would be programmed for expanding capacity in the productive sectors. Such lending would also support small and medium industries in the private sector. The Bank's past experience in these sectors is being complemented by substantial economic and sector work to provide effective support to the Government in its economic reform measures.

IBRD and International Development Association (IDA) disbursements in 1984/85 represented 8.3 percent of Egypt's medium- and long-term capital inflow. The Bank and IDA shares of total external debt outstanding and disbursed (excluding military debt) were about 5.2 percent and 4.0 percent, respectively, as of June 30, 1986. It is estimated that in 1986/87, debt service payments to the Bank and IDA will be about 2.9 percent of Egypt's external debt service payments, assuming payment of accumulated arrears to all creditors. The share of debt service payments to Bank and IDA is expected to rise to between 7 percent and 8 percent beyond 1987/88, resulting from rescheduling of bilateral debt service payments. Disbursements had risen US$347 million in 1983/84, as a result of improvements in overall project implementation and of better knowledge of the Bank's disbursement procedures by the Egyptian authorities. There was, however, a decline to US$253 million in 1984/85 and US$217 million in 1985/86, as a result of shortage of local currency allocations, delays in procurement, and inadequate project management. These problems are being addressed through project implementation reviews and increased Bank supervision efforts.

Arab Republic of Egypt: Basic Data

Population (mid-1986)	49.5
Annual rate of population growth	3.0
Per capita GNP (1986 - U.S. dollars)	790

	Estimated			Projected	
	1983/84	1984/85	1985/86	1986/87	1987/88
	(Annual percentage change)				
1. National accounts					
Real GDP at factor cost	5.1	3.6	2.3	-1.8	2.0
Agriculture	2.1	2.0	1.8	--	1.5
Industry and mining	4.5	3.0	1.5	-7.0	--
Petroleum	10.9	8.3	3.8	-5.0	5.0
	Actual			Projected	
	1983/84	1984/85	1985/86	1986/87	1987/88
2. Prices					
CPI	19.7	10.0	19.3	20.0	12.0
	(Annual percentage change)				
3. External sector on the basis of U.S. dollars)					
Exports, f.o.b.	13	-4	-17	-31	26
Oil exports, f.o.b.	(7)	(-2)	(-21)	(-53)	(49)
Imports, c.i.f.	17	-2	-9	-6	9
Suez Canal receipts	2	-8	15	17	8
Tourism	-5	42	-22	81	83
Workers' remittances	24	-11	-15	-11	-13
Current account receipts	12	-5	-12	-10	9
Real effective exchange rate (depreciation -)	15	7	-9	...	...
4. Government budget					
Revenues (excluding foreign grants)	6	9	6	3	14
Total expenditures	12	10	7	-1	8
Wages and salaries	(19)	(21)	(9)	(9)	(9)
Investment 1/	(10)	(19)	(-3)	(-1)	(-11)

1/ Includes investment self-financing by public enterprises.

Arab Republic of Egypt: Basic Data (concluded)

	Actual			Projected	
	1983/84	1984/85	1985/86	1986/87	1987/88
	(Annual percentage change)				
5. Money and credit					
Net domestic assets	22	18	12 1/	17 1/	20 1/
Claims on public sector (net)	22	18	17 1/	21 1/	18 1/
Claims on Government (net)	17	15	10 1/	17 1/	14 1/
Private sector credit	24	23	20 1/	12 1/	20 1/
Private sector liquidity (M2)	20	12	14 1/	9 1/	9 1/
Interest rate (annual rate, three-month deposits, end of period)	8.5	8.5	8.5	8.5	...
	(Percentage change over stock of private sector liquidity at beginning of period)				
6. Net Domestic assets	23	19	11 1/	17 1/	21 1/
Claims on public sector (net)	16	13	11 1/	13 1/	12 1/
Claims on Government (net)	12	10	10 1/	11 1/	10 1/
Claims on private sector	10	8	9 1/	6 1/	9 1/
	(As percent of total expenditure)				
7. Government budget					
Revenue 2/	62	61	61	63	66
Budget deficit (with foreign grants counted as financing--cash basis)	38	39	40	37	34
Domestic financing	(32)	(31)	(33)	(33)	(33)
Domestic bank financing	[22]	[19]	[15]	[18]	[16]
Domestic nonbank financing	[11]	[12]	[14]	[15]	[17]
Foreign financing (including grants)	(6)	(8)	(7)	(3)	(1)

1/ At uniform accounting exchange rate of LE 1.34 = US$1.
2/ Excludes foreign grants.