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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/164

10:00 a.m, October 6, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
C. H. Dallara	
J. de Groote	
M. Finaish	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
Huang F.	
J. E. Ismael	
A. Kafka	
T. P. Lankester	M. Foot
H. Lundstrom	
	W. N. Engert, Temporary
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	J. de la Herfan, Temporary
H. Ploix	S. de Forges
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
S. Zecchini	

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

Arab Republic of Egypt: Mahmoud Salah el din Hamed, Minister of Finance; Aly Negm, Governor of the Central Bank of Egypt; Kamal El-Ganzoury, Deputy Prime Minister and Minister of Planning; Atef Ebeid, Minister of Cabinet Affairs. IBRD: A. J. Favilla, Europe, Middle East and North Africa Regional Office. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; M. Guitián, Deputy Director; J. T. Boorman, A. M. Jul, P. M. Keller. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: A. Goorman, C. A. Sisson, M. Z. Yucelik. Legal Department: W. E. Holder, J. K. Oh, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. Kawar, K. Nashashibi, B. K. Short, S. M. Thakur. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. O. Bonvicini, J. P. Pujol. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, A. Bertuch-Samuels, M. B. Chatah, J. Hospedales, A. Ouanes, M. A. Weitz. Assistants to Executive Directors: O. S.-M. Bethel, L. de Montpellier, F. Di Mauro, J. J. Dreizzen, R. Fox, J. M. Jones, O. Isleifsson, M. Lundsager, T. Morita, J. E. Rodríguez, G. Seyler, S. Simonsen, B. Tamami, L. Tornetta, H. van der Burg, B. D. White.

1. MEXICO - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman remarked that on Friday, October 3, and over the weekend, the Fund staff had held discussions with the commercial bank Advisory Committee on Mexico covering certain aspects of the term sheet pertaining to the oil contingency facility. In addition, the Advisory Committee had worked on other elements of the term sheet, including the new money components and those elements involving the World Bank. Negotiations were still under way, and it was not clear precisely when a revised paper would be brought to the Executive Board for consideration. He would keep Directors informed as the discussions progressed.

2. ARAB REPUBLIC OF EGYPT - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered a restricted staff report for the 1986 Article IV consultation with Egypt (EBS/86/186, 8/12/86; and Sup. 1, 9/26/86). They also had before them a background paper on recent economic developments in Egypt (SM/86/215, 8/26/86).

Mahmoud Salah el din Hamed, Minister of Finance of Egypt, and Aly Negm, Governor of the Central Bank of Egypt, were present as the representatives for Egypt. Also present as observers were H. E. Kamal El Ganzoury, Deputy Prime Minister and Minister of Planning, and H. E. Atef Ebeid, Minister of Cabinet Affairs.

The Deputy Director of the Middle Eastern Department made the following statement:

> Discussions have taken place between the Egyptian authorities and the staffs of the Fund and the Bank during the recent Annual Meetings. The Egyptian authorities have presented the World Bank staff with proposed increases for energy prices over the current fiscal year and the next two fiscal years. In the 1986/87 fiscal year, the prices of the major domestic petroleum products, i.e., fuel oil, gas oil, kerosene, diesel oil, and natural gas would be doubled, which would generate more than LE 0.5 billion of new revenue on an annual basis, or 1.2 percent of GDP in 1986/87. Agreement with the Bank has also been reached on commensurate increases in the following two years. The precise timing of the first price adjustment under this scenario is still being discussed with the World Bank staff. The authorities and the World Bank staff have also reached agreement on a three-year program of adjustment of agricultural procurement prices, removal of quota deliveries, and reduction of subsidies on agricultural inputs.

Minister Hamed made the following statement:

> During the previous meeting of the Executive Board on the Article IV consultation with Egypt, the Executive Directors, while welcoming certain corrective measures taken by my Government,

expressed concern over the weakness of the balance of payments position and the need for a comprehensive set of measures to come to grips with the problems facing Egypt.

Since then, Egypt's balance of payments came under increasing pressure as a result of the sharp decline in oil prices, remittances, and tourism. In response to this situation, we have put in place a comprehensive program to address these problems effectively. Many aspects of the program are set out in the staff report. My task today is to elaborate certain measures which are not sufficiently enunciated in the staff report. I also hope to put the program as a whole in a broader perspective.

The period since our last meeting has been far from easy. It certainly was not easy for developing countries that are also oil exporters; they have had to suffer an oil shock comparable to that suffered by the oil importers during the 1970s. Nor was it easy for non-oil developing countries, which have to contend with sagging commodity prices and a sluggish growth, if not an actual decline, in their export earnings.

Egypt has more than its share of the problems besetting its sister countries. As a country for which oil is a major export commodity, it has suffered a considerable loss following the precipitous decline in world oil prices. The loss was not limited to the revenue from oil exports. Workers' remittances and Suez Canal dues--two major sources of foreign exchange earnings--were similarly affected, since both are highly sensitive to developments in the oil market. At the same time, income from tourism experienced a substantial retreat as a result of conditions in our region.

Such is the context in which our adjustment effort has to take place. It is certainly not a happy one. It has aggravated an already difficult economic situation, vastly increased the challenge facing my Government and rendered much more pressing the task of adjustment.

Let me assure you that there is no doubt in our minds about the magnitude of the problem we are facing. Nor is there any doubt about the kind of measures that should be taken for its solution. The adjustment program is designed to achieve the following objectives:

1. To improve the balance of payments position through the establishment of a realistic and unified foreign exchange rate and better performance of the export industries.

2. To reduce the rate of inflation through containing the budget deficit and more effective control over credit expansion.

3. To eliminate price distortions so as to ensure a better allocation of resources and strengthen the incentives at production level.

4. To improve the efficiency of the public sector and create more favorable conditions for the private sector and market-oriented development.

5. To enhance the mobilization of domestic resources and the efficiency of investment.

6. To ensure the equitable distribution in the burden of adjustment. These are the objectives to which my Government is firmly committed. They happen to be in line with the thinking of both the Fund and the Bank. Let us at least get this behind us. There is no difference of views about the basic directions of adjustment and reform. This is not unimportant. It provides a solid basis on which we can build a fruitful and lasting cooperation.

Our adjustment effort addresses the areas of budget deficit, monetary policy, the exchange and trade regimes as well as structural imbalances. These are the areas over which the Executive Directors had expressed concern in our last meeting. Allow me to take them in turn.

A number of public revenue-increasing measures were implemented late last year, in addition to substantial reductions in a number of expenditure items. The Fund staff estimates that these measures reduced the cash deficit in the 1986-87 budget by over 8 percentage points of GDP (page 6 of the staff report). These measures include increases in a number of taxes on such items as cigarettes and luxury goods with an annual yield of some LE 300 million and increases in the prices of gasoline with an annual yield of LE 300 million. These measures, taken for the most part in the second half of 1985-86 and the first month of this fiscal year, resulted in increased revenues while reducing some of the main distortions in the system. In this connection, the latest increases in petroleum prices noted by the staff should also be taken into account. Our customs reform package implemented on August 22 is another example. The change in customs valuation--to which I will come back later--along with the reform of all tariff brackets, is expected to increase customs revenues by about LE 600 million in 1986-87 despite the depressed level of imports. This represents some 6 percent of total revenues or close to 1.5 percent of projected GDP.

To match our efforts on the revenue side, public expenditures are being curtailed and greater efficiency at managing them is being introduced. The following policy changes are cases in point:

1. Termination of the policy of guarantee of employment to all university graduates.

2. Strict limits on public salary and wage increases.

3. Transfer of a number of services performed by the public sector to private entities.

4. Privatization of public enterprises owned by local governments as well as those in the tourism sector.

These and other similar policy changes are allowing us to gain a better grip on public expenditures. Aware that the subsidy bill in the budget was too large, we adopted measures to reduce it and improve its targeting to beneficiaries. The following measures have been implemented:

(a) Reducing the number of subsidized commodities;

(b) reducing the amount of subsidy granted to each commodity; and

(c) relying increasingly on the private sector for the procurement and marketing of a number of previously subsidized goods.

Streamlining the subsidy bill in FY 1985/86 yielded a saving of some LE 360 million, about 14 percent of total subsidies. Other measures and expenditure cuts totaling LE 600 million are to be implemented in FY 1986/87. As a consequence of these measures, the budget deficit is projected to decline to 15 percent of GDP from 23 percent in the previous year.

Cost-price distortions are a major source of inefficiency and waste. This is why the liberalization of the pricing mechanism in the public sector and indeed in the entire economy is being undertaken. In agriculture to date we have increased the procurement prices of all major crops. Rice and cotton prices, for example, were raised by over 30 percent, wheat and sugarcane by close to 10 percent. Additional price increases are contemplated for the next crop year. More fundamentally, we are proceeding toward diminishing the role of government in allocating cropped areas and regulating activities in the agricultural sector. Crops such as maize, fruits, and vegetables were completely decontrolled and government intervention has been confined to cotton and sugarcane and to 50 percent of wheat and rice; and these, as the staff has mentioned, will be decontrolled soon.

Moreover, it is our intention to introduce as soon as possible greater competition in the marketing and distribution of crops as well as in the supply of agricultural inputs which so far have been controlled by the public sector. Subsidies for agricultural inputs will be phased out as crop prices are liberalized and will be allowed to approach their international levels.

The industrial sector is also the subject of great attention in the reform program. Price liberalization has been a major policy goal during the past few years. Last year alone price increases in the public sector enterprises totaled some LE 517 million in increased revenues bringing the total revenues generated through price increases to some LE 1.1 billion over the past two years. The Egyptian authorities, however, plan to go beyond liberalizing pricing mechanisms. Indeed, the coming year will see the introduction of market mechanisms in the management of public sector enterprises. Greater emphasis will be placed on profitability and return on capital in the management of public sector enterprises along with a greater degree of autonomy in decision making.

The same policy of promoting market mechanisms underlies the drive toward confining subsidies to the distribution level and restricting them to a small number of products.

In the area of energy we are proceeding toward reducing the gap between domestic and international prices. Gasoline prices have been increased by some 33 percent last March and again by 25 percent last August. Electricity rates were also increased by some 37 percent last year and are due for a second increase in the coming months. Other petroleum product prices were also increased. Discussions with the World Bank about increases in the prices of fuel oil, natural gas, kerosene, and gas oil are proceeding well and have now yielded an agreement on price realignments.

We realize that monetary expansion has to be curtailed. To this end, we are striving to limit credit expansion to the private and public sectors to levels consistent with our targets for lowering inflationary pressures, maintaining a minimum of real growth, and narrowing the external financing gap. With respect to the public sector, it is expected that the reform measures, by increasing efficiency coupled with price increases, will reduce current deficits and the need for credit from the banking system.

For the time being, our monetary policy relies mainly on quantitative rather than on price rationing through interest rate manipulations. With the containment of inflationary pressures and maintaining interest rates at their present levels, real returns on savings should be positive.

At the center of our reform is the restoration of a viable balance of payments based on free trade flows. To achieve this goal, we have already undertaken or are planning a number of reforms, namely:

1. Liberalization of all import and export flows (undertaken);

2. Implementation of a comprehensive customs reform (undertaken);

3. Unification of all exchange rates into one rate which is both flexible and market determined (begun);

4. Control over the growth of external debt (undertaken); and

5. Reduction in debt service burden through agreements on debt relief (to be initiated shortly after this meeting).

Allow me to say a few words on some of these measures.

Our recently implemented customs reform aims at introducing elements of flexibility and efficiency. The reform raises the exchange rate used for customs valuation to the level of the commercial bank pool rate. In addition to applying an exchange rate close to the scarcity value of foreign exchange, it provides for greater flexibility since the commercial bank pool rate is a variable rate subject to daily setting. Moreover, the number of tariff categories has been greatly reduced and so was the spread between the highest and lowest rates. Simultaneously with tariff reform, measures aiming at liberalizing trade flows were implemented. Thus, exports are no longer subject to any administrative controls. Import licensing and the import rationalization committee were abolished. Interventions in imports is limited to a list of some 210 items. The list was introduced to ease some of the strain on the exchange market and will be reduced as soon as appropriate financing for the balance of payments is secured.

However, the restoration of a viable equilibrium in the balance of payments is contingent upon a fundamental reform of the exchange system.

I should like to elaborate on the exchange reform package that my Government is contemplating at present. Its basic aim is to unify our present system of multiple exchange rates into one market-determined rate. At the outset of the reform all registered commercial banks would be allowed to trade in the free market at the going exchange rate. Next, all transactions carried out at the commercial bank pool exchange rate will be moved to the free market according to a predetermined schedule over a period of 18 months. Finally, the commercial bank pool rate will be managed flexibly and allowed to move in parallel with the free market rate until its final unification.

I believe that our adjustment program is both comprehensive and effective. We intend to seek the assistance of the international financial community to bridge the external financing gap. The Fund will be requested to assist in rescheduling external debt service obligations through multilateral negotiations and in securing additional external assistance from donor countries.

Despite the hardships involved in the adjustment process, we are encouraged by the support and patience of our people and their hope that the reform will lead to sustained growth, control of inflation, and better standards of living. There is little doubt that the support of the international financial community is of crucial importance for the success of our reform program.

Mr. Finaish made the following statement:

There can be no disagreement that Egypt is currently facing a very serious economic situation. The precipitous decline in oil prices this year has had a large negative effect, both direct and indirect, on foreign exchange earnings. The 50 percent drop in oil revenue, which in recent years has accounted for about two thirds of export earnings, combined with the decline in workers' remittances from neighboring oil countries and in income from tourism have resulted in a sharp deterioration in the external position. The import compression associated with the tighter foreign exchange constraint has contributed, in turn, to the slowdown in production and growth, particularly when compared to the remarkably high rates of economic growth in the preceding decade.

Against this background, the need for a major adjustment effort to respond to the new situation is quite obvious, and indeed, urgent. Minister Hamed has stated in his useful presentation that this is fully recognized by the Egyptian authorities, who have outlined in a very clear manner the specific policies which are being followed to achieve the broad objectives of external viability and the restoration of noninflationary growth. In comparing these policies, as outlined by Mr. Hamed, with the staff's own assessment of what is needed, one finds substantial agreement between the staff and the authorities. The differences of view which exist appear to be related more to the pace of implementation of certain policies, namely, exchange and interest rate policies. But the fact that the authorities and staff share a broadly similar view of objectives and policy directions should make it easier for a common assessment of the appropriate timing and pace of specific measures in those areas to be obtained. In trying to reach that common assessment it is important, in our view, to keep two considerations in mind.

First, the distortions and structural weaknesses in the Egyptian economy which the authorities are attempting to correct have evolved over many years and have become so entrenched in the system that the pace of their elimination has to take fully into account their interconnections and be carefully planned to avoid large economic disruptions.

Second, the pace of structural reform, particularly in the areas of pricing and subsidies, will have inevitable implications for income distribution, both actual and perceived. The authorities are clearly mindful of this consideration, and for a good reason. The reaction of the Egyptian public to measures in these areas a few years ago is still well remembered. Thus, it is not surprising that the Egyptian authorities attach particular importance to equity in the distribution of the adjustment burden and to pacing their policies in such a manner that the limits for social and political tolerance are not tested.

I am not suggesting, of course, that the pace of adjustment should be determined on the basis of these considerations alone. Clearly, if medium-term viability of the balance of payments is to be achieved, the pace of policy implementation should be such that this objective is attainable within that time frame. The major challenge in my view is to be able to formulate a medium-term adjustment plan, which, not only in its content but also in its timing, can balance these important considerations.

Since the beginning of this year, and especially over the past few months, the authorities have adopted a wide range of adjustment policies, with a particular emphasis on those areas where the staff considers that adjustment is most needed. Minister Hamed has already outlined to the Board the policy measures taken recently and those which are to be implemented in the near future. He has also explained the authorities' medium-term plans in certain important areas such as exchange rate reform. It is true that more needs to be done, particularly when the economic imbalances are as large as they are in the case of Egypt. The authorities themselves recognize that more needs to be done in the period ahead. At the same time, it is important to give full recognition to the steps already taken in a relatively short period of time.

An example of the seriousness with which the authorities are embarking on their adjustment and reform policy can be seen in the budget outcome expected in the current fiscal year. The fiscal deficit is now projected to drop by 8 percent of GDP from its level last year. What is equally significant is the fact that the measures responsible for the improved fiscal performance are mainly structural in nature and should thus have a beneficial effect on resource allocation in general. We note, in particular, the tariff reform, the termination of employment guarantees to university graduates, the reduction in the number of subsidized commodities, and the cuts in the amounts of subsidies granted to various commodities.

Similarly, major steps have been taken in the area of pricing, which is a central element of the structural reform effort. Most notable in the agricultural sector is the 30 percent increase in the procurement prices of rice and cotton, and the full decontrol of prices in the case of other crops such as maize, fruits, and vegetables. In the industrial sector, the administrative procedures for raising retail prices charged by public enterprises have been simplified; as a result, many prices have been adjusted upward, thus strengthening the financial position of those enterprises. In the energy area, the authorities are steadily moving toward bridging the gap between domestic and international prices. Recent price increases have been quite significant, especially in the case of gasoline and electricity. The collaboration taking place between Egypt and the World Bank regarding the realignment of other energy prices is welcome, and we are pleased to hear from the staff that agreement on this issue has already been reached.

As reported in the supplement to the staff report, an important step toward the simplification of the exchange rate system was taken last July by the elimination of the official commercial bank rate. The authorities have presented a concrete exchange reform plan, which they regard as consistent with the medium-term balance of payments objectives while also providing a reasonble balance between the various considerations which govern the appropriate pace of policy in this area. As Minister Hamed has stated, the aim is to unify the present system of multiple exchange rates into one market-determined rate. However, the authorities feel that the manner in which this objective is achieved can have serious implications for other important objectives that are also being sought, including the lowering of the inflation rate. They feel that the potential price effects of an abrupt exchange rate shift could prove detrimental to the social and political feasibility of further movement on that front. Of course, judgments can differ on the exact magnitude of the price effects of exchange rate changes, and we hope that the staff and the authorities will be able to reach a common view on this matter. It is also relevant to note that the domestic profitability of the production of exportables has already benefited significantly from the increases effected in domestic producer prices, and that the authorities' intention is to continue to adjust these prices as needed.

The same can also be said with respect to the need for interest rate adjustment at this time and its potential effect on investment and economic activity and on the financial sector itself. Another consideration is that there is opposition to charging interest on grounds of religion, which makes increases in interest rates difficult. Given these considerations it is understandable that the authorities feel that increasing interest rates at this time would not be advisable. In any event, the policies being put in place, in particular the tightened budgetary policy, should be helpful in reducing the inflation rate, thus contributing to the attainment of positive real interest rates, something which the authorities too would like to see.

In sum, as Minister Hamed has indicated, the Egyptian authorities have initiated a comprehensive and genuine adjustment and reform policy. The measures taken already are substantial, particularly when seen as part of a medium-term strategy. Of course, the authorities would need to strengthen their policies in the period ahead; and they recognize this. The authorities would certainly prefer an orderly adjustment to a disorderly one. But they fear that a disorderly type of adjustment can equally result from too rapid and disruptive changes in policies as from no change in policies at all. The authorities would expect due flexibility from the Fund in reaching full agreement on a package of adjustment policies that ensures orderly and sustainable progress toward the medium-term economic and financial goals. In the recent case of Mexico, the Fund has shown welcome flexibility in dealing with problems faced by a country as a result of a sharp and unanticipated drop in the earnings from its main export item. In this regard, it may be noted that oil accounts for as large a proportion of Egypt's export earnings as it does in the case of Mexico and that the drop in earnings from it has been equally sharp.

Mr. Nimatallah made the following statement:

Over the past two years, Egypt experienced a serious drop in its foreign exchange earnings, equivalent to an estimated 8 percent of GDP, as a result of a sharp fall in oil revenues, remittances, tourism, and Suez Canal earnings. This, in turn, has unveiled serious, deep-rooted structural weaknesses in the economy and has led to further deterioration in the fiscal position. Thus, the deterioration in the external position of Egypt, including the increase in arrears and the difficulties of debt servicing, has made it clear that short-term corrective policy measures are not sufficient and might even trigger unnecessary social and political unrest.

The authorities are clearly aware of the magnitude of the disequilibrium they face, and they have initiated, since fiscal year 1984/85, a process of policy reforms and adjustment aimed at not only mitigating the impact of the deterioration in the external position, but also at removing structural rigidities in the economy. As indicated in the supplement to the staff report, they have introduced a number of policy changes, notably in the trade system, in pricing, and in the public finance areas in general. These measures are clearly steps in the right direction and are evidence of the resolve of the authorities to effect a durable improvement in the efficiency of the economy and to restore the conditions for a more sustainable growth.

Given Egypt's high population pressure, the low level of per capita income, and the need to increase capacity to service debt obligations, the adjustment process in Egypt needs to ultimately aim for sustainable growth in a climate of financial stability. Clearly, the achievement of such an objective implies that any economic program in Egypt has to be framed in a medium-term context.

It should allow for demand management measures to deal with the pressing internal and external imbalances, as well as for supply-side structural policies. Structural adjustment is needed to create the appropriate environment for economic efficiency. The authorities are aware of this, and they have started the process in that direction. They have started not only the demand management process, but also the structural adjustment process. However, it is important that efforts by the authorities in this growth-oriented adjustment approach be supported by an adequate level of financial assistance and open markets.

Maintaining an appropriate level of investment in the economy will be the key to the success of this approach. In this context, I very much endorse the authorities' present investment strategy. In particular, I encourage them to continue with their efforts to orient public investment outlays toward directly productive projects. The role of investment in sustaining growth depends on maintaining the appropriate investment level and on the appropriate structuring of that investment, particularly in the public sector. While incentives could influence the volume of private sector investment, they may not influence the quality of that investment, at least in the short term. The World Bank has an important role to play in helping the Egyptian authorities design and implement an effective public investment program. However, whatever level and quality of investment is targeted in coordination with the World Bank, the important consideration is to sustain it. Obviously, it is not only financial resources that need to be secured, but also the sustainability in market growth, both domestically and internationally. It is very important to secure the needed financing and the appropriate outlets for such an investment program. The Fund and the Bank are actually trying hard to find the right design of adjustment programs and financing for this kind of commitment to adjustment with growth.

Keeping in mind the commitment for growth, and given the current political and economic conditions in Egypt, it appears that the authorities have specific targets in mind, on different fronts, to be met over a particular timetable. I look forward to seeing soon a program, to be supported by the Fund and the Bank, in order to help the authorities achieve such targets. They obviously are committed to reducing, and eventually eliminating, external and domestic imbalances in the economy. The only word I would add here is to encourage the Fund and the Bank, as well as the authorities, in putting together such a package of policies to pay special attention to the interactions among the policy tools, with a view to maximizing the positive potential effects and minimizing the negative. I can see that the authorities have specific targets in mind for reducing the balance of payments deficit, the fiscal deficit, the promotion of the private sector, as well as reducing inflation. For achieving these targets, I can see several optional tools of policy that are available to the authorities, including the exchange rate, controlling public expenditure, enhancing public revenue, the interest rate, and pricing.

Let me now explore what the authorities have accomplished in realizing these targets and what policy tools they have adopted to reduce the external imbalances. I welcome the recent steps taken to liberalize imports and to simplify the exchange system. I think these are courageous and commendable steps. Further, the authorities have declared their intention to unify the exchange rates in a gradual manner. I am pleased, in particular, to know that the commercial bank rate and the free market rate will be unified within the next 18 months. I, for one, think that the central bank pool may be retained for a slightly longer period, until such time as the authorities feel confident that it can be unified with the free market rate. The important thing is that they persist with their efforts in that direction.

For reducing their fiscal imbalances, the authorities have implemented several steps in the right direction. They have recently increased the number of administered prices, introduced a reform of tariffs, and improved control over expenditures. As a result, the overall fiscal deficit is now expected to be reduced by 8 percentage points of GDP during fiscal year 1986/87. I think this is remarkable, particularly since this improvement will be accompanied by a strengthening of the structure of public finances. I am confident that the authorities will continue this process, as this will certainly strengthen their adjustment in the external sector and will help release needed resources to the private sector. The reason I am confident is that the authorities have demonstrated their commitment by their actions to reduce subsidies, particularly on petroluem products, and eliminate the automatic public employment guarantee, all of which have been burdensome on the budget.

In the private sector, I think the authorities have again demonstrated their commitment to encourage private initiative. It goes without saying that, to sustain economic growth, the private sector should be enabled to take up the slack as the Government reduces its fiscal deficit. But, it should be noted that preparing the private sector for that task is a medium-, or perhaps, a long-term process. The authorities are aware of these two points, and they have again started a far-reaching process of incentives designed to encourage the private sector. In the agricultural sector, for example, they have recently increased the procurement price for cotton and significantly raised the price for rice. In the industrial sector, the authorities have increased the flexibility of the price control mechanism. Of course, liberalizing imports and reforming and simplifying the tariff system are important incentives. Another incentive that was proposed by the staff is the sharp increase in the interest rate. The staff's argument is that this will enhance financing savings and demand for real cash balances in Egyptian pounds. However, as I have stated on previous occasions, I am not certain about the efficacy of such a measure. I am concerned that a higher interest rate might discourage demand for credit by the private sector for investment. I think it is much more important to enhance confidence in the economy by sustaining the type of reforms initiated by the authorities. I am sure that, in time, the appropriate interest rate will emerge. The incentive I would like to see is for the authorities to minimize red tape in the public sector.

In conclusion, the authorities have taken important steps to correct their imbalances and to lay the foundation for durable growth. These steps could form the basis for a Fund-supported program. I therefore encourage the Fund and the authorities to reach an agreement on a stand-by arrangement as soon as possible. I hope also that this agreement will be complemented by an early agreement with the World Bank. I wish the authorities well and success in their efforts.

Mr. de Groote observed that because of its size and political importance in the region, Egypt stood out among the countries that had for a long time hesitated to adopt corrective measures along the lines recommended by the Fund. It was thus particularly important that Egypt now seemed close to an agreement with the Fund; and the consultations were timely. Reaching agreement with the Fund was important for Egypt because the measures already adopted, although significant, did not go far enough to deserve the full support of the international community and might not lead over time to a sufficient correction of the balance of payments deficit. It was also important for the Fund to reach an agreement with Egypt because few cases showed so clearly the perverse effects on income and the external account of a number of policies that constituted what might be called a textbook case of maladjustment. Egypt in particular had suffered from overexpansionary fiscal policies in the past, from important relative price distortions, from heavily protected domestic production--which had led to significant unused capacity--and inefficient production based on high absorption of energy. The exchange rate system was complicated, and the exchange rate was unrealistic. Moreover, interest rates were too low to stimulate savings, and that had led to an increased holding of foreign currencies and a "dollarization" of the economy. Those developments had in turn led to a curtailment of imports, a reduction in the rate of economic growth, and an external debt that had reached unmanageable proportions. Convincing reform measures were called for.

At the center of the Egyptian effort was the reform of the exchange rate system toward a flexible exchange rate and a unification of the different exchange markets, Mr. de Groote continued. Unfortunately, the authorities were facing a dilemma: too rapid a reform risked an increase in inflation, particularly for basic necessities, while too slow a reform could result in leads and lags, perverse expectations from the public, and a loss of credibility for the reform exercise. In the circumstances, an 18-month program might be on the long side, and a 12-month period might have been preferable.

Another factor that argued in favor of a shorter period was related to his understanding that subsidies would be maintained for some time if transactions currently conducted through the central bank market were moved to the free market, Mr. de Groote remarked. The effect on the consumer of the reunification of the two markets would thus be neutralized to a great extent, although it had to be admitted that maintenance of subsidies would not fully cover the amount of the depreciation of the rate. In other words, a buffer existed in the system that would seem to plead for somewhat faster reunification.

He took a rather different view from Mr. Finaish on the question of the liberalization of interest rates, Mr. de Groote commented. As he saw it, it was difficult to have a free exchange market if one did not have a realistic interest rate. Without a realistic interest rate, the dollarization of the economy might increase, and there was the risk of a further and excessive depreciation of the pound. In that respect, he had some difficulty following the argument of the Egyptian authorities against interest rate increases.

Another important aspect of the program was the reshaping of domestic production and the function of market forces, Mr. de Groote said. The Egyptian authorities had certainly taken a number of important measures toward that end. They had also adopted courageous measures on the fiscal side, in particular, by reforming the customs tariff system and increasing the price for petroleum products. On the elimination of budget transfers for the public sector enterprises and the limitation of growth of public sector employment, the authorities had indicated some good intentions; the next step was to establish a time frame within which those intentions would be realized.

The World Bank had put forward a number of suggestions regarding investment in Egypt, Mr. de Groote noted. Strong incentives should certainly be given to the private sector, but he wondered how that could be done without encouraging the repatriation of Egyptian capital held abroad. He had seen little in the Egyptian program or in the Fund staff papers on ways that might be envisaged to attract foreign capital, and he would be interested in staff comment on that point. Would the maintenance of the exchange rate after adjustment at a stable level be regarded as a sufficient element? His own view was that the maintenance of a realistic interest rate at a positive level would be a major determinant in such a reflow of private funds, which was why he believed that interest rate policy in Egypt should be reviewed.

Egypt was an important case that would be watched closely by the international community, Mr. de Groote said, and, in that connection, he hoped the Fund staff would assist the Paris Club in preparing an agreement aimed at alleviating Egypt's debt problems. It was important that Egypt's debt be fully identified; however, it was doubtful that the international community would be able to react quickly enough and with the appropriate amount of financing--given the dimension of the financing gap--unless a clear time frame was established for the various adjustment measures to be implemented. Experience showed that where countries had delayed adjustment, the support of the international community had been slow. The importance of establishing a clear schedule for the implementation of reform measures could not be overstated. It was perhaps also important to adopt a fresh approach to the problems of exchange rate unification and interest rate policy. Given the important effort already undertaken by the Egyptian authorities, he would support the continuation of negotiations currently under way. It was to be hoped that, in the not to distant future, a program could be agreed upon that would cover the immediate and medium-term needs of the country and would justify financial assistance from the Fund.

Mr. Rye made the following statement:

> In last year's discussion of the Article IV consultation with Egypt the Board "expressed serious concern over the extent and severity of (Egypt's) domestic imbalances, the weaknesses of (its) international payments position, and (its) less favorable prospects over the medium term." Since then, Egypt's economic situation has deteriorated further, in large part because the external environment has become more difficult, with lower oil and other commodity prices, a downturn in tourism, and reduced workers' remittances. But failures of domestic policy must carry a share of blame. Although the supplement to the staff report, and the reports we have had this morning from the staff and Minister Hamed, do indicate that in recent months some policy actions representing important first steps have been taken, obviously much more remains to be done.
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> The staff report comprehensively describes the gravity of Egypt's economic plight. Three points bear highlighting. First and foremost, external financing gaps approaching $4 billion a year are projected for the remainder of the decade, and external arrears are already mounting. Second, Egypt's external debt service obligations in 1985/86 are estimated at 53 percent of current account receipts. Going heavily into further debt to cover the financing gaps is not, therefore, a viable longer-term option, although additional financing in the short term, preferably on concessional terms, will obviously be needed. But this financing will be forthcoming only when external viability in the medium term has been reasonably assured. Third, the supply capacity of the economy is being undermined by the pervasiveness of price distortions; and without comprehensive reform, the future growth outlook will be clouded at best.
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> To overcome its difficulties, Egypt clearly needs urgently to implement a comprehensive adjustment program that addresses both present excess demand pressures and--just as important (or more so) from a medium-term standpoint--the need to enhance the supply capacity of the economy. The policy framework outlined in Minister Hamed's statement this morning is welcome in providing a basis for developing such a strategy.

Before focusing on the particular policy actions required, let me make a general point. The Egyptian economy is clearly deteriorating, and it will be turned around only after fundamental adjustment has been undertaken. The Egyptian authorities believe that the pace of reform has to be gradual. I realize that Egypt faces a unique--and in some respects, uniquely difficult--conjunction of economic and political circumstances. The authorities have our sympathy in grappling with these immense problems. But the scale of Egypt's problems is rapidly approaching the monumental, and, in some areas at least, much more forceful action than the authorities seem prepared to envisage will be necessary if the economy is to be turned around.

To be sure, some worthwhile measures have already been taken, measures that will benefit the economy on both the supply and demand sides. The increase in gasoline prices in July to 185 percent of world wholesale levels will improve the fiscal balance as well as reduce energy consumption, although, with energy prices on average still at only 50 percent of the world level, there is considerable scope for further rationalization. It is gratifying to have heard from the staff about the new plans to phase the increase in energy prices to world levels. If I understand them correctly, they represent a sharp improvement over the original intention to phase to world prices over nearly six years, which would have been much too slow an adjustment.

The august reform of the tariff regime will be helpful in raising revenue and improving resource allocation. Also to be welcomed is the authorities' intention to adopt a more flexible pricing policy for publicly provided goods and services; to reduce subsidies and to target them more precisely; and to focus investment mostly on projects already under way that will generate early returns, especially for the balance of payments. In addition to improving structural aspects of the economy, these measures will help lessen the present excessive fiscal burden and improve the parlous finances of the public enterprises. We hope that these good intentions are quickly translated into action.

One area where major changes in pricing and resource allocation are obviously needed is agriculture. As recently as 1974, Egypt was a net exporter of agricultural commodities, to the extent of $300 million. Today, Egypt imports more than 50 percent of its food requirements, and the import bill exceeds $3 billion annually. Of course, world markets in agricultural commodities, including wheat and cotton (crops in which Egypt has a comparative advantage), have been undermined by export subsidies of the major industrial countries. The authorities have, however, compounded these difficulties by holding producer prices below depressed world levels and by maintaining a seriously overvalued exchange rate. The intended liberalization of producer prices and the restoration of a competitive exchange rate will be absolutely crucial elements in any effective adjustment strategy for Egypt.

The staff report indicates that the real effective exchange rate appreciated by 31 percent between August 1981 and May 1986. At a minimum, the Egyptian authorities should be looking to reverse this appreciation. But in all probability, the adjustment should go even further. In this regard, I point to three considerations: first, the CPI used in calculating the real rate probably understates inflation; second, the exchange rate needs to take over some of the burden of import restraint now being carried by more direct and less efficient import controls; and, third, the Egyptian economy, compared with 1981, is now in a much more fragile state. In general, reform of the exchange rate system is needed, including unification of exchange pools and the use of flexible market-oriented rates. The reform package being contemplated by the authorities would seem to be in the right direction. However, I am inclined to agree with Mr. de Groote that more rapid reform would be desirable. But at least what is being contemplated needs to be translated into action.

Of course, all this needs to be supported by effective demand management policies. The revised budget policy for 1986/87 reported in the supplement to the staff report is an encouraging development in this regard. A deficit equivalent to 15 percent of GDP, while still far too high, would be much less damaging than the 23 percent deficit estimated for 1985/86. Unfortunately, however, I feel that the figures understate the gravity of the situation. Overvaluation of the exchange rate and artificially low interest rates are both masking the real extent of the fiscal imbalance. In this context, the authorities' intended pace of reduction of the deficit by 1.5-2 percent of GDP a year appears too slow. It is not clear to me whether at present the authorities are planning to move more quickly in this area, and I would appreciate clarification.

Monetary policy, too, is in need of tightening. A major problem is the low level of Egyptian pound interest rates relative to the rates of return on foreign currency accounts and the difficulties this presents for controlling credit. The regulations introduced in April to address this problem are at best an imperfect solution and will, I fear, quickly lose their effectiveness. I fear also that without a tightening in money and credit policies, inflation, which has been largely suppressed to date, will accelerate sharply.

An increase in interest rates is also called for to attract remittances and financial investments now held abroad. Creditors will be understandably reluctant to provide additional financing when there remain serious questions about the willingness of Egyptian nationals to invest in their own country. Moreover, for capital resources to be allocated efficiently, interest rates must be at least positive in real terms.

In sum, Egypt needs to pursue a comprehensive and forceful adjustment program. This will be far from easy, but the economy is poised on a slippery slope, and it would take very little to push it down to a point where only the most desperate remedies would suffice. Continued pursuit of a strong adjustment program, supported by international financial assistance, would provide a basis for medium-term growth with balance of payments viability. I very much hope that the Egyptian authorities will translate their intentions into firmly scheduled action that will induce adequate official and multilateral support, including support from the Fund. My authorities wish them well in these troubled times.

Mr. Engert made the following statement:

I agree with the analysis and recommendations outlined in the staff reports, and I encourage the Egyptian authorities to pay close attention to the arguments and suggestions presented by the staff. I also welcome Minister Hamed's statement this morning.

As we see in the staff report and background paper, Egypt's relatively high growth rates in the latter half of the 1970s and the early 1980s were largely fortuitous and were not the result of improvements in the productivity and competitiveness of the Egyptian economy. In fact, the Egyptian economy was, and is, beset with structural weaknesses and distortions, which preclude long-lasting prosperity. Furthermore, it would appear that public policy in Egypt is a major contributor to these problems.

The Egyptian authorities recognize the unsustainability of their policies and the growing costs of their policy orientation. Furthermore, they have been compelled by events to react, and commendable steps in the right direction have been taken. As we see in the supplement to the staff report, the import system has been made more efficient, some administered prices have been increased, the structure of the public finances has been strengthened, and the budget deficit has been reduced substantially, although it remains at very high levels and more needs to be done. This morning, Minister Hamed has added to this list of good news.

However, the Government faces a dilemma: individuals' behavior is still predicated on their expectations of subsidies, price controls, protection, fiscal imbalances, and inflation; and individuals will resist the unwinding of arbitrary income transfers. The policy course that is appropriate for the medium and longer term may be characterized in the short run by dislocations, and there is therefore a temptation to minimize the necessary policy adjustments. However, it must be stressed that the alternative to effecting a systematic policy reorientation is ad hoc, piecemeal, and perhaps implicit adjustment path, which is certainly less efficient and more painful and difficult than a systematic and consistent effort.

In terms of a broad policy strategy, in order to minimize the short-run dislocation of implementing the appropriate policy orientation, three elements are necessary. First, the authorities must convince the public of the need for policy changes. I believe that the importance of this is sometimes underestimated. I note in the staff report that the Egyptian authorities are aware of the importance of preparing the public for the consequences of the adjustment effort; this is perhaps a somewhat different point. Second, it is essential that the authorities present and implement a credible and consistent package of policies that are convincing to the public and potential donors. In this connection, while the authorities have taken some appropriate steps in the area of fiscal restraint and greater price flexibility, important structural problems remain, as key prices continue to be distorted, although new steps to be taken have been outlined this morning. Also, in the past, there has tended to be a gap between policy intentions and actual performance. The third element of broad policy strategy should ensure that the short-run effects of adjustment do not fall disproportionately on the poorest members of Egyptian society. This is, I believe, a fundamental requirement that would enhance the probability of successful adjustment.

On more specific policy issues, I agree with the view put forward in the staff report that the key to adjustment in Egypt is the provision of strong incentives for the private sector to encourage investment and production, the repatriation of capital, and foreign direct investment. And, central to this, is a wide-ranging and thorough reform of the pricing system and other controls on productive activity. A clear need exists for reform of agricultural sector policies, where government interference in the pricing and distribution of inputs and production has caused a shift in crops away from those in which Egypt has a competitive advantage--such as cotton and rice--toward those which are relatively less efficiently produced in Egypt. As is described in SM/86/215, the output trends of controlled and uncontrolled crops have differed substantially, with the output trends of the main controlled crops flat, or even declining, despite the rising trends in yields. Also, this has occurred despite the authorities' efforts to offset the effects of their restrictive controls through research and development of higher crop yields and increasing use of agricultural technology. It seems apparent that a more direct and efficient means to secure higher output would be to allow appropriate price signals to operate, rather than trying to offset distortions by additional intrusions. In this connection, it is quite revealing that there have been substantial short-term fluctuations in the output of controlled crops in response to adjustments in procurement prices.

As a result, I welcome the recent increases in agricultural prices, the authorities' intentions to liberalize agricultural production, and the program of agricultural reform mentioned today. However, in this connection, I would welcome staff comment on concrete, systematic measures taken or proposed to deal with agricultural reform. Also, I wonder whether a publicly announced timetable or schedule of reforms, perhaps over a shorter time period than described in the staff report, might not make a useful contribution to the adjustment process.

I welcome the steps recently taken to enhance the flexibility of operations and pricing in the area of public sector enterprises. However, I note from the supplement to the report that the staff feels that price flexibility is still insufficient. I wonder whether the staff could elaborate on this. Also, I would encourage the Egyptian authorities to make certain that sufficient managerial autonomy and responsibility exists to ensure that pricing and operational policies are adequate to cover costs. A potentially promising way to achieve this outcome is to enhance the role of private, competitive producers. In this regard, I am encouraged by the steps taken toward the privatization of the management of public sector companies.

A fundamental and far-reaching distortion affecting the Egyptian economy is the exchange rate system. Here, I will limit my comments mainly to an endorsement of the staff's views and to urging the authorities to move quickly toward a fully unified exchange market, wherein the exchange rate is flexibly determined according to market conditions. This would have to be an integral aspect of remedying Egypt's structural imbalances, and I welcome the authorities' intentions to unify the exchange system, although I, too, would prefer a faster pace of unification than the one proposed.

The negative level of real interest rates is another pervasive distortion in the Egyptian economy, with significant adverse effects. With respect to the economic arguments, I would like to stress that by keeping interest rates below what we might refer to as the market-clearing rate, the fundamental constraint on investment is a lack of savings; increasing the rate toward more remunerative levels can be expected to attract greater savings and investment and to support the external value of the pound as the exchange market is liberalized.

I understand the authorities' reservations about higher interest rates on religious grounds. But, as we have seen in other discussions at the Board, what is important in generating savings and investment is to provide savers with an ex ante expectation of remunerative real returns; whether this is done through the particular institutional framework or risk-sharing arrangement incorporating interest rates is of secondary importance. However, at the present juncture, it is very important that savers be allowed to earn a remunerative real return, and therefore an increase in interest rates under the current institutional setup is warranted.

I have made several suggestions--notably, price deregulation and a market-oriented exchange rate--that could be expected to result in price level adjustments. Under these circumstances then, it is important that adequate control be maintained over the pace of monetary growth. In this connection, I share the concern of the staff regarding the inadequacy of the existing credit control instruments in Egypt. Perhaps the staff or the Egyptian representatives could tell us about the status and/or conclusions of the re-evaluation of credit control instruments referred to on page 19 of the staff report.

Like the staff, I am aware of the social and political implications of economic reform in Egypt. However, as the staff has stressed, delay in the adoption of key reforms will neither reduce the magnitude of the problems nor ease the political difficulties. In fact, I believe that a failure to act quickly and decisively will certainly exacerbate the problems faced by the Egyptian authorities and people. In this connection, I am encouraged by Minister Hamed's statement this morning.

Earlier, I referred to the need to protect the poorest members of Egyptian society from shouldering an undue portion of the short-term effects of adjustment. I believe that a number of the reforms I have mentioned would immediately benefit the poor, especially in rural areas. However, there are additional measures that could be pursued, such as a more effective targeting of subsidies, and/or income assistance. In this connection, I note from SM/86/215 that the subsidy system continues to permit virtually all Egyptian residents unrestricted access to a few subsidized commodities. Also, the establishment of a broadly based ad valorem tax on goods and services would help to direct fiscal adjustment away from the lowest income groups. I would appreciate it if the staff could comment and elaborate on these or other approaches. Fund technical assistance in these areas, and in others, could certainly be helpful. Finally, I support the proposed decision and, in closing, I would like to wish the Egyptian authorities well in facing their challenges.

Mr. Grosche made the following statement:

During recent months, the Egyptian authorities have taken a more active policy stance, thereby responding to a number of the recommendations made by the Executive Board on earlier occasions. The country is moving in the right direction, aiming at bringing the economy back on a satisfactory and financially sound development path.

I am grateful to Minister Hamed for having so clearly presented the measures already taken and still under consideration. The authorities are to be commended, particularly for their attempt to correct a number of prices. Also, the measures initiated in order to improve the financial position and the management of public enterprises are encouraging. Moreover, important steps to simplify and rationalize the exchange and trade system have been introduced; most notably, all administrative controls on exports have been abolished, and a customs and tariff reform has been implemented. And, last but not least, a strong effort has been launched to achieve a significant reduction of the fiscal deficit in FY 1986/87.

The policy reorientation that is demonstrated by these measures is highly welcome. With the staff, I believe that it would be in Egypt's interest to maintain the reform process and to strengthen it in several areas. The authorities would certainly agree with the staff's advice that the adjustment in the price structure needs to be underpinned by cautious and sustained financial policies. Appropriate levels of key macroeconomic prices--notably the exchange and interest rates--will importantly contribute to generating more savings and strong incentives for the production and export of tradable goods. A timely unification of the different exchange pools at a flexible rate will be helpful.

I appreciate the authorities' concern about the political and social implications of moving too fast in the adjustment effort. But the authorities can hardly be satisfied with a medium-term economic situation characterized by stagnant growth, increasing financial imbalances, shortages of consumer goods, and high inflation, especially given the fact that Egypt's population and labor force are rapidly increasing.

No one expects Egypt to overcome its deep-seated problems overnight. As other cases show, the Fund has always been flexible in allowing countries to adjust over a medium-term period. This is reflected in the fact that often several consecutive programs are put in place. And, in formulating the necessary adjustment policies, the Fund will have to continue to take into account the particular political and social circumstances of the case in question. Experience has shown at the same time that it is generally crucial for the success of a program that the essential corrective measures are implemented without undue delay. Achieving visible results at an early stage creates credibility and confidence and can make a significant contribution to the overall acceptability of adjustment efforts.

As regards specific policy items, I have very little to add to the staff's appraisal and to its description of the risks involved for living standards and social stability if present imbalances continue. The authorities have indicated that they agree on many issues and that they intend to move ahead with the reform process. This was confirmed this morning by Minister Hamed. I welcome his statement very much. It is important now that the momentum be maintained and a fair and balanced solution be reached between the Fund staff and Egypt on the elements of a Fund program that pays due regard to the problems of Egypt.

An early and positive outcome should help to foster effective improvement in the conditions for growth and financial stability. A resolution of Egypt's problems is all the more urgent as the external situation is expected to deteriorate further, with the balance of payments financing gap rising to over $3 billion in 1986/87 and the further buildup of external arrears.

In sum, I appreciate and support the endeavors of the Egyptian authorities to restore growth on a sustainable basis and to avoid a further deterioration of living standards. I am convinced that with prudent financial policies, the efficient use of domestic and external resources, and the elimination of structural weaknesses, these objectives can be achieved. A comprehensive adjustment program, aiming at sustained growth, would facilitate the mobilization of financial assistance from the international community, assistance which Egypt urgently needs in the coming years. Finally, I support the proposed decision and wish the authorities well.

Mr. Daliara made the following statement:

I would like to join other Directors in welcoming Minister Hamed and Governor Negm to today's Board meeting and to express my appreciation to them for their presentation of Egypt's economic situation and recent economic initiatives. I would also like to welcome Deputy Prime Minister El Ganzoury and Minister Ebeid to our Board discussion.

I will begin my comments, as did Minister Hamed, by reflecting broadly on developments since last year's Article IV consultation with the Fund. Since that time, Egypt has experienced a sharp drop in exports, due in large part to the decline in oil prices. These and related developments have contributed to a deterioration in the already serious external and internal imbalances in the Egyptian economy. And yet, in spite of these adverse developments over the last year, we approach this year's consultations encouraged about Egypt's economic prospects. For, during this year, the Egyptian authorities have taken significant steps, not only to counter the immediate difficulties relating to oil prices, but to tackle underlying, deep-seated problems in the Egyptian economy. These efforts have not been limited to one area, but have encompassed a number of key aspects of economic policy, including liberalization and simplification of the exchange and trade system, adjustments in prices and improvements in the pricing system, and a strengthening of the public financial position.

We welcome the efforts in these and other areas and commend the authorities for taking these actions in the context of the many difficulties that have developed during the past year.

Perhaps even more important than the specific steps which have been taken, however, is the approach adopted by the authorities, reflecting recognition of the need for a forceful, comprehensive economic program to redress the imbalances and distortions in Egypt's economy and to provide the conditions for sustained economic growth and a viable external position.

The need for such a comprehensive approach is underscored by, among other things, the recent increase in external arrears, when viewed against that background of very low foreign exchange reserves and large external financing gaps projected over the medium term. Such problems can be overcome only if a sound, growth-oriented program is fully developed and put in place, one which can command the support of the international financial community. We encourage the authorities to move expeditiously to put in place all of the elements of such a program, building on the actions already taken. My authorities recognize the serious economic problems which face the Egyptian economy and are determined to support Egypt as it deals with them.

It is important for actions in specific areas to be mutually consistent in both content and timing, so that their effects on the economy positively reinforce one another, leading to stronger, more efficient economic performance. The aim is to ensure that the results are greater than simply the sum of the efforts in individual areas. With liberalization in the exchange rate, domestic pricing, and trade areas working hand in hand, exports of key commodities can be more competitive, scarce commodities can be allocated more efficiently, and strains on the fiscal position can be reduced.

One important area is the exchange and trade system. A number of initial steps have been taken in this area. I shall not enumerate them here, since the staff and Minister Hamed have summarized them for us. We believe they are noteworthy, but clearly additional efforts are needed to restore the long-term competitiveness of the Egyptian economy and to correct distortions. We observed that Egypt has recently discontinued use of one of the exchange rates. While viewing this as an important step toward simplification of the very complex system, I note that very few transactions were passing through this rate, so that the actual effects on economic activity are rather limited.

The Egyptian authorities have indicated that they intend to unify their exchange rates, with the commercial bank pool rate to be moved to the free market rate over a period of 18 months. We welcome the commitment to exchange rate unification, but, like Mr. de Groote, we feel that a more rapid timetable may well be needed to reduce distortions and restore the appropriate incentives to the productive sectors if growth is to be increased, the payments position strengthened, and economic conditions generally improved. In that regard, we are not entirely clear whether this timetable for unification includes the official exchange rate. Further information would be of interest, and we would welcome the views of the staff and Minister Hamed and Governor Negm. In sum, we continue to encourage the authorities to move as quickly as possible to achieve further simplification and unification of the various rates into a flexibly managed system. Without such action, distortions will persist, and the beneficial effects of other policy actions will be minimized.

The problems generated by the complex and inefficient exchange system have, in our view, a very direct link to the performance of the Egyptian economy. For example, the pricing of food imports at the official exchange rate results in artificially low prices of food products, thus inhibiting incentives for Egyptian farmers to expand production of food crops. Not only would such production stimulate employment in the farm sector; it would also improve the payments position, reducing the need for food imports, given Egypt's apparent comparative advantage in production of some of these crops, such as wheat. For these reasons, we believe that stronger efforts, including exchange rate change and reform, are needed to adjust prices in the agricultural sector. Let me add here that in addition to changes in the exchange rate system, attention needs to be given to the distortions that have arisen from the pattern of relative prices in the agricultural sector. Various pricing adjustments appear to have contributed to a drop in production of Egypt's traditional crops, such as wheat, leading Egypt to become a net food importer. We welcome the steps which have been taken to rationalize the agricultural sector and encourage the authorities to move ahead in this area to reduce subsidies, improve the relative price structure and increase competition, consistent with the goals set forth by Minister Hamed this morning. We hope the World Bank could play a helpful role in this process.

An important related area is trade policy, and we welcome the recently implemented reforms that are reducing exemptions and adjusting the system of tariffs. These steps should reduce distortions in the import scheme. The description provided in the supplement appears to indicate that importers will face fewer administrative restrictions, although foreign exchange shortages may continue for some time. In that regard, it is not clear how the recent reforms relate to the restrictions on imports that were intensified last year due to adverse developments in the balance of payments. Perhaps staff could comment.

Turning to monetary policy, I note that some steps have been taken recently to strengthen control over the monetary aggregates. We welcome these efforts, although the pace of reform in the monetary sector may need to be accelerated if financial strengthening is to keep up with and support the structural changes that are under way in the rest of the economy. A very high proportion of money balances is still held in foreign currency deposits, a fact which suggests that deposits denominated in Egyptian pounds are not sufficiently attractive and that stronger efforts are needed to reduce these balances and to encourage additional remittances and savings. Voluntary exchange of foreign currency deposits for Egyptian pound deposits will, in our view, be likely to occur only if additional interest rate actions are taken. We understand the reluctance of the authorities to adjust interest rates; yet inaction could make it all the more difficult for Egypt to achieve the objectives mentioned by Minister Hamed, particularly the objective "to improve the efficiency of the public sector and create more favorable conditions for the private sector and market-oriented development" and "to enhance the mobilization of domestic resources and the efficiency of investment."

On the fiscal effort, large deficits have continued to complicate monetary policy. But significant measures have been introduced in this new fiscal year. We are particularly pleased to see the emphasis on reduced absorption of resources by the Government. The overall deficit is expected to drop to under 15 percent of GDP, and the level of expenditures is budgeted to fall from 53 percent of GDP in 1985/88 to 43.5 percent in 1986/87. While we welcome these adjustments, we feel that a continuation and strengthening of the fiscal effort will be required in the period ahead. Finally, we noted the efforts to improve revenue, but the domestic tax system appears to suffer from a number of weaknesses, and an overall reform effort should be considered. We would welcome any information in this area.

This brings me to the issue of subsidies, which relate the fiscal pressures to the relatively weak supply response of the economy. The determination to reduce subsidies is evident, both in the forceful statement made by Minister Hamed this morning and in the actions which have been taken. A lasting resolution to the budgetary difficulties will require continued, major efforts to reduce subsidies.

Energy subsidies have been substantial and have led to excess consumption of those items whose export is crucial to strengthening the payments position and sustaining a higher level of imports, which could, in turn, help sustain a higher investment and employment ratio. We noted and welcome the recent price adjustments in this area, including those announced this morning. In energy, however, as well as other subsidy areas, further rationalization of prices and reduction of subsidies are required, and we hope the authorities will continue to give increasingly greater attention to this problem.

On one final area related to the budget, namely, public enterprises, I will simply say that while pricing adjustments are critical to strengthening the position of the public enterprises--and we have noted with interest that some steps are being taken to strengthen management--we wonder whether it would not also be useful for the authorities to pursue more actively the possibility of private ownership of certain entities. This area appears to be one that merits additional attention, and we believe that the World Bank could be helpful in suggesting appropriate reforms. Egypt has a rather large and vibrant private sector, which we believe could produce a number of the goods and services now supplied by public entities.

In closing, I would like to make the following points: first, we are heartened by the progress made by the Egyptian authorities in dealing with their economic problems; second, it is clear that the breadth and depth of the problems besetting Egypt's economy call for a broad-based approach under which actions in areas such as exchange rate liberalization and unification, trade liberalization, pricing reforms, and fiscal and monetary restraint can be mutually reinforcing toward greater economic efficiency and vitality; third, in order for this to happen, we encourage the authorities to build on the established momentum to take promptly the additional actions and make the additional commitments needed so that a framework of adjustment and growth can be fully articulated, with initial actions clearly evident; fourth, as the staff suggests in its appraisal, such a program could provide the basis for support from the international financial community, including multilateral and bilateral sources; and, fifth, with such support underpinning steady and determined implementation of an economic program, we believe Egypt can overcome its economic difficulties and establish sustained economic growth and a viable external position. My authorities are fully prepared to support Egypt in traveling down the path of renewed economic growth which they themselves have chosen.

Mr. Polak joined others in welcoming the apparent agreement between Egypt and the Fund on appropriate economic objectives. However, what was needed in addition was agreement on an acceptable time path for their achievement.

The staff paper painted a bleak picture of the Egyptian economy. The recent fall in oil prices, which appeared to have been reflected mainly in a decrease in workers' remittances, had compounded the structural problems of the economy. As had been well documented, those structural problems were mainly the result of inadequate policies, which had led to a distorted price system and a strangulation of private sector initiative, particularly in the agricultural sector. It was striking to note from the staff report that the country that had for a millenium been the breadbasket of the world was currently running a large agricultural trade deficit. As prices increasingly moved away from market-clearing levels and failed to reflect scarcities, the balance of payments would come under increasing pressure. Fundamentally, the Egyptian Government thus far had sought to counter that development by relying on strict administrative controls to stem imports, which in turn had impeded the growth of exports and the growth of real GNP. Egypt was thus witnessing a vicious circle of administrative controls leading to further controls.

At the same time, as further balance of payments pressure developed, external debt and debt servicing rose, Mr. Polak continued. Because of inefficient export growth, and despite the intensification of import controls, external arrears had increased rapidly in recent years. During the 1985 Article IV consultation, he had welcomed the fact that the Egyptian authorities had become increasingly aware that the situation was unsustainable. But the reforms introduced in 1985 had been limited in scope and effectiveness; and some had been rescinded since that time. At present, the authorities were acutely aware of their precarious situation, as had been made clear in Minister Hamed's opening statement. In addition, the supplementary staff paper indicated that some reform measures had recently been taken. Nonetheless, however welcome such measures might be in themselves, the adjustment program as outlined on page 15 of the staff report seemed too limited in scope, given the immense magnitudes of the problems facing Egypt. The envisaged time span for full implementation of some of the measures--particularly those relating to the exchange system and the adjustment of prices of petroleum products--was simply too long, while other measures--for example, those relating to the fiscal situation--were not sufficiently decisive. Moreover, several key measures that over the past year had been recommended by the staff still were only "under consideration" by the authorities. Those included measures relating to interest rates and investment policies.

While it was true, of course, that imbalances that had been developing over a number of years could not be turned around overnight, a gradual implementation of adjustment policies would lead at best to a gradual improvement, Mr. Polak said. In some cases, that might turn out to be no improvement at all, which would make it difficult for the authorities to maintain their commitment to adjustment--and popular support for their effort--over the longer term.

The Fund had a great deal of experience with countries that had, even under Fund programs, taken the gradual route to adjustment, Mr. Polak commented. Those were typically the countries that were currently in arrears to the Fund and in which little or no adjustment had taken place. In passing, it should perhaps be noted that the staff was not being unduly rigid in its approach to the Egyptian adjustment program; indeed, the staff had shown considerable understanding for the position of the Egyptian authorities. Rather than recommending the full unification of the exchange rate system at once, the staff had called for meaningful steps toward that end. Similarly, the staff had not recommended full elimination of consumer subsidies but had called for better targeting of those subsidies to reach the needy segments of the population. Moreover, in its supplementary paper, the staff was apparently satisfied with the reduction in the government budget from 22 percent in 1985 to 15 percent in 1986. While reduction by itself was indeed a welcome step, the deficit would remain considerably above the level originally targeted for 1986 and still implied large monetary financing.

The staff had correctly singled out reform of the price system, including the exchange rate, as the core of any adjustment program, Mr. Polak observed. The authorities should introduce a full unification of the exchange pools at a competitive and flexible rate. As he saw it, the unification should occur immediately or over a very short period. As he had argued in other cases, the simultaneous existence of a controlled official rate and a free market rate carried the built-in risk that the authorities would be tempted to adjust the official rate too slowly as well as the risk of continuing speculation against the official rate. He could not go along with the Egyptian argument that sufficient reserves should be available before effecting unification; if the rate were set at a competitive level, one might expect that foreign exchange would be forthcoming, not only because more remittances could be expected through the new exchange pool, but also because part of the huge dollar holdings in the economy might be exchanged through domestic currency once a more competitive rate was available. It would also be important to pass the new exchange rate on into domestic prices, so that those prices were more in line with world market prices. That was especially true with respect to domestic producer prices for exportable crops, notably cotton and wheat. A speedy increase in fuel prices was also of the essence, and he had noted with pleasure that some progress had recently been made toward eliminating the government subsidy on petroleum products and toward depressing domestic consumption so as to allow more exports.

Pricing reforms must be accompanied by tight financial policies, particularly fiscal policy, Mr. Polak considered. While some progress had been made in reducing the overall budget deficit of the consolidated public sector, the deficit remained unsustainably high at 15 percent of GNP. In passing, he noted from the supplementary paper that the effects of the recent measures were currently estimated to have less of an effect than had been assumed in the earlier paper. Moreover, some of the expected improvement was due to rather uncertain elements such as "better control over expenditures." Expenditure-reducing measures in the form of reduced subsidies and the setting of more appropriate prices by government enterprises were needed. There also seemed to be considerable scope for rationalizing the government bureaucracy, which was swollen by past guarantees of employment. It seemed essential, as a first step, for the authorities to contain the budget deficit at a level that would eliminate recourse to domestic bank borrowing; estimates put that level at approximately 11 percent of GNP.

Remarking on monetary policy, Mr. Polak observed that the staff had rightly stressed the need for more realistic interest rates and a more restrictive policy stance. To achieve those ends would require the elimination of the system of preferential interest rates for various sectors of the economy as well as elimination of the policies that steered credit to particular sectors. He was happy to note that the authorities were apparently considering such a move.

The Egyptian economy was suffering from rigid government controls over key economic variables, Mr. Polak commented. The only way to improve the situation was to allow market forces to play a larger role in the economy, and that would require the Government to show its commitment to adjustment by implementing meaningful and decisive measures. Although the adjustment measures that the authorities were currently comtemplating went in the right direction, they fell considerably short of what was needed. Finally, he had noted earlier the flexibility shown by the staff in respect to various aspects of the program. A word of caution was perhaps in order, lest the staff went too far in the direction of flexibility and entered into an arrangement that was not solidly based. On the matter of flexibility, he had been impressed by the following remarks of the Managing Director at the conclusion of the 1986 Annual Meetings: "...countries can best foster sustained growth by putting in place sound macroeconomic and structural policies and by persevering in their implementation. In a time of sharply changing economic circumstances, some flexibility may be appropriate, but only if that flexibility is consistent with financial stability over the medium term."

Mr. Zecchini made the following statement:

> At the outset, I would like to join other Directors in welcoming the presence of Minister Hamed and Governor Negm in this Board discussion. We welcome in particular the direct exchange of views that it will be possible to have with the authorities, as the Egyptian economy is at a particularly delicate juncture. At present, Egypt is faced with acute balance of payments difficulties, an unfavorable external environment and the need to reorient its policies while coping with a sensitive domestic situation.
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> It is comforting to note that there are important areas of convergence between the Egyptian authorities and the staff on the analysis of the causes of the economic difficulties and on the direction of the required policy changes. The present difficulties are in part the result of the past inward-looking policy stance and of a number of economic rigidities, particularly in the price domain, which have hampered economic development. The unfavorable effects of these policies have been compounded by events beyond the country's control, such as the sharp decrease in oil prices, which negatively affected exports and government receipts, as well as by the drop in workers' remittances and tourism.
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> A comprehensive adjustment effort is therefore warranted and should be centered on important changes and reforms, which should include a liberalization of the pricing system, the unification of exchange markets into one more open to market forces, and a

tightening of financial policies. The effort must be comprehensive to ensure the credibility of the strategy and to restore confidence in the economy, thereby favoring the resumption of fixed investments and capital inflows. Furthermore, only a consistent set of self-reinforcing measures may ensure that the necessary adjustment will eventually be attained. For example, price liberalization would have to be supported by a tightening of financial policies in order to avoid a sharp acceleration of inflation. Moreover, tight financial policies, if they are not supported by supply-side policies, would only reduce domestic demand without favoring the reallocation of resources, which is ultimately necessary to put the Egyptian economy on a healthy growth path.

It should be noted that recently the Egyptian authorities have been implementing some important and commendable adjustment measures to reduce fiscal imbalances, to simplify the exchange rate system, and to adjust relative prices. Furthermore, it should be recognized that their actions are still constrained by internal difficulties. In light of all these considerations, we believe that a program with the Fund represents the best approach for Egypt to proceed toward a comprehensive economic adjustment in combination with appropriate financing of the imbalances while they are being corrected. Of course, the speed of adjustment has to be attuned to the overall circumstances and conditions of the country. However, what is most important is that a realistic program is agreed upon and its implementation is not delayed any further.

It is also clear that the strength and the pace of the adjustment effort will be reflected in the level of access to the Fund's resources. In this respect, an appropriate use of the compensatory financing facility could complement the resources possibly put at the country's disposal under the stand-by agreement. Furthermore, donor countries could ease the inevitable strains and hardships of economic adjustment by providing financing, in addition to the loans of the banks.

Turning to more specific policy issues, I believe that the reform of the pricing system should be given top priority. In particular, it appears necessary to give greater emphasis to market mechanisms in price determination and to bring domestic prices of agricultural and energy products to the levels prevailing in world markets. The social impact of raising the prices of some essential goods could be buffered by a system of limited subsidies, which would allow the maintenance of prices at relatively low levels only for the neediest households. In agriculture, in recent years, pricing policies have discouraged the production of cotton and rice in which Egypt has traditionally had a comparative advantage, while favoring the production of other crops. Since there is a time lag between changes in the relative prices of various crops and their effect on production, it would appear advisable to proceed to a speedy implementation of price reforms in order to promote larger cotton and rice exports. Meanwhile, it is with satisfaction that we heard this morning that the Government is willing to liberalize the prices of cotton, rice, and sugarcane, and that the authorities intend rapidly to introduce greater competition in the marketing of major crops and to reduce input subsidies correspondingly.

Another important area which is pointed out by the staff and in which more ambitious efforts are required relates to energy prices. In this respect, we noted that the adjustments originally envisaged for 1986/87 would bring the domestic prices of petroleum and of fuel oil, respectively, to only 43 percent and 29 percent of world prices. A faster schedule of price increases would seem necessary to increase government receipts while favoring lower domestic consumption and greater export availability of these products. Therefore, we welcome the price measures announced today at the beginning of our discussion.

Exchange rate policy should be viewed as an integral part of pricing policies. In this respect, we welcome the fact that the authorities are aware of the need to unify the exchange system and to adopt a flexible exchange rate policy. However, progress in this area has been slow as yet. Moreover, as can be seen from Chart 8 on page 70a of SM/86/215, in spite of the depreciation which has occurred in the last year, the overall index of the real exchange rate still shows an appreciation compared with the 1979 level. The sharp worsening in Egypt's external environment would instead suggest the need for an exchange rate realignment, including the central bank rate.

With respect to monetary policy, the increase in domestic liquidity which occurred during the year ended in February 1986 does not appear consistent with the aim of reducing inflation. Furthermore, nominal interest rates at 8.5 percent are at markedly negative real levels if compared with an officially projected increase in consumer prices of about 20 percent. Moreover, several preferential interest rates exist. Such an interest rate policy does not seem conducive to a better allocation of financial resources among alternative uses. Furthermore, it discourages capital inflows and favors a shift away from assets denominated in domestic currency toward foreign currency deposits. The latter has already become an obstacle to the effectiveness of monetary policy to the extent that, other conditions being equal, it reduces the authorities' ability to bring the domestic liquidity conditions into line with the authorities' objectives. Increases in interest rates in order to make domestic financial assets competitive vis-à-vis foreign currency-denominated assets are therefore called for.

Finally, I would like to express to the Egyptian authorities the best wishes of my authorities for a successful implementation of the adjustment strategy. We also hope that soon it will be possible to find an adequate solution to Egypt's economic difficulties.

Mrs. Ploix made the following statement:

Like previous speakers, I would like to begin by thanking Minister Hamed, Governor Aly Negm, and their associates for their presence at our meeting today. Their attendance clearly shows the importance the Egyptian authorities attach to the quality of their country's relations with the Fund. I would also like to convey my appreciation to Minister Hamed for the encouraging information he gave us this morning.

Let me say at the outset that we are in general agreement with the thrust of the staff appraisal. It is obvious that the overall situation of the country has become extremely difficult; and the Egyptian authorities clearly agree on this point. This year, the difficult situation is even clearer, since two of the main traditional sources of Egyptian external resources, i.e., oil export receipts and expatriate remittances, have severely declined. Furthermore, this recent aggravation emphasizes a long-term trend.

In past years, the Egyptian authorities have offset this change mainly by import stringency, and more recently by building up external arrears. But as noted by the staff, this curtailment of imports is now so great that it has become a major concern: it has a constricting influence on growth and "exacerbates the growing internal imbalances."

Together with the pre-existing internal imbalances, these developments have made a substantial adjustment policy necessary. Such a policy should be aimed at re-establishing a manageable external payments situation and better prospects for growth.

I am thus pleased to commend the Egyptian authorities for the measures they have taken in the implementation of a comprehensive set of policies. The measures taken in 1985/86 were aimed at reinforcing fiscal restraint and increasing price flexibility. They have been confirmed and supplemented recently by the measures described in the supplement to the staff report.

What I find more revealing is the wide scope of the policies reflected in these measures: the fiscal imbalances are addressed from both the revenue and expenditure sides; the trade system is largely modified, notably through tariff reform; the exchange system was simplified in July, with a view to gradual unification of all foreign exchange markets; and a number of administrative prices have been revised, especially in the energy area. All these decisions demonstrate the firm commitment of the authorities to take action in a comprehensive way and through the use of global instruments to address the tightly linked system of imbalances which endanger the economic outlook.

The wide scope of these actions also highlights the structural problems of the Egyptian economy, and structural reforms must be effected for viable growth to be achieved.

Given the size of the imbalances, and the time needed to correct them, all available forms of assistance must be provided to the Egyptian authorities in order to ensure the success of the measures adopted. I thus welcome, as I did last year, the World Bank involvement in Egypt, particularly its help in designing an appropriate investment program.

The Egyptian authorities are facing a well-known dilemma: either they take a very fast and steep adjustment path, which has obvious advantages but is socially costly; or they take a more gradual approach, based on the fact that, as rightly recalled by the staff in its appraisal, the task of the Egyptian authorities has been made even more difficult because of the falling living standards of the population over the past few years. Whichever way the authorities choose, we consider that there are good prospects for an agreement between Egypt in the Fund. My authorities hope that such an agreement will be reached soon in the interest of both parties. Once a stand-by arrangement is agreed, the way toward a multilateral treatment of the problems of the Egyptian debt will be open.

The Government has shown its determination to implement comprehensive policies; the fact that their actions must take into account social concerns should not lead the international community to delay the necessary support for an effort which my authorities are very pleased to commend and encourage.

Mr. Lankester observed that Egypt's external situation had worsened considerably in the past year. The falloff in receipts from oil, workers' remittances, the Suez Canal, and tourism had exacerbated an already difficult external position and made more urgent than ever the task of adjusting the economy. It was encouraging that the authorities had taken a number of measures recently to strengthen the adjustment effort. The tariff reform, same adjustment of the exchange rate system, lower planned public spending, and higher prices in the public sector, together with more flexible pricing policies, had all been steps in the right direction. Also welcome was the fact that the authorities had begun intensive discussions with the Fund and the World Bank on ways of fitting existing reforms into a comprehensive recovery program. A Fund-supported program was essential if the full benefits of Egypt's adjustment efforts were to be reaped and if relations with external creditors were to be strengthened. The fact that Egypt was once again to be represented in the Executive Board would no doubt help the Fund in its efforts to assist the authorities.

Egypt seemed well on the road to the sort of program that the Fund and the international financial community could support, Mr. Lankester continued. However, he agreed with the staff that policies needed to be strengthened on several fronts, particularly in the area of the exchange rate. While the authorities had taken various measures to support stronger export growth, those did not appear to be an adequate substitute for the more far-reaching reform of the exchange rate system that seemed to be required. The complex system that had existed--and in large part still existed--had introduced considerable distortions into the economy. It was thus encouraging to see from the staff report that the authorities recognized the need to unify the exchange system. They had already eliminated the official commercial bank rate. However, as Mr. Dallara had noted, such a change was a fairly modest one, since only a small proportion of foreign exchange transactions had been carried out at that rate. It was of course a matter for the authorities and Fund management to agree upon the most appropriate timetable for full unification, but he believed that it would be desirable for the authorities to take a very substantial step toward unification--including of the central bank rate--over the next 12 months.

The unification of the exchange rate system would obviously have significant effects upon both the level and the structure of domestic prices, Mr. Lankester remarked. It was important that higher import prices should, to the extent possible, be passed through to domestic consumers and producers if the appropriate incentives were to be given and if resource utilization was to be improved. For example, it should be possible once again to raise domestic wheat production, which had been significantly curtailed in recent years by competition from heavily subsidized imported wheat.

Welcoming the news that the authorities had reached agreement with the World Bank on procurement prices--which were to be adjusted over a three-year period and energy prices which were to be doubled--Mr. Lankester observed that the holding down of prices, at levels far below world market levels had seriously distorted the allocation of resources in the economy and had added to the fiscal problem. He would be interested in hearing the authorities' revised timetable for bringing domestic energy prices fully into line with world prices. In that regard, he did not believe that a lengthy timetable was in the best interests of the Egyptian economy.

Fully accepting that the social and political implications of major changes in the price structure in Egypt could not be ignored, Mr. Lankester said that he could sympathize with the authorities' concern that those effects should be as limited as possible, and it was thus reasonable that the most disadvantaged groups in society should be given some protection. However, in spite of the streamlining of the subsidy system in 1985/86, subsidies at present did not appear to be targeted as closely as they could be on those most in need. Like Mr. Engert, he had noted from page 36 of SM/86/215 that the system permitted virtually all Egyptian residents unrestricted access to various subsidized commodities. It should presumably be possible to target those subsidies more accurately to ensure that the more vulnerable sections of the population were protected.

If the potential impact on the price level of a major exchange rate reform was to be kept under firm control, fiscal and monetary policies in Egypt would need to be adequately restrictive, Mr. Lankester considered. The authorities had taken significant steps toward that end on the fiscal side. The supplement to the staff report suggested that the fiscal position in 1986 would be substantially better than that achieved in 1985. Nonetheless, at 15 percent of GDP, the deficit remained large; and further progress in reducing it would clearly be needed in the years ahead.

The staff had also stressed the need for monetary policies to be tightened as part of an overall adjustment effort, Mr. Lankester commented. That need had been strengthened by the growing dollarization of the economy, which had significantly reduced the effectiveness of the monetary instruments available to the Egyptian authorities. The growing importance of foreign currency holdings within the financial system was itself presumably a reflection, at least in part, of the relatively unattractive terms available on instruments denominated in domestic currency. The extent of the disparity in relative yields was reflected clearly in the staff report, which showed that the returns on domestic currency deposits had lagged significantly behind those on foreign currency deposits. He noted from the supplement to the staff report that the authorities considered the current level of interest rates to be appropriate. As he saw it, higher rates would seem to be a prerequisite for the successful stabilization of the financial system, notwithstanding the difficulties that Minister Hamed and one or two Directors had mentioned in that regard. Like Mr. de Groote, he believed that there was a real risk that, in the absence of higher interest rates, dollarization would continue, with all its implications for the authorities' control over the economy. In sum, the Egyptian authorities faced a very difficult situation resulting in part from the external shocks of the past year. In response to that situation, they had embarked on a package of policies that should improve the outlook for the economy. It was to be hoped that they would be able to reach agreement with the Fund in the near future on a fully articulated program that could form the basis for a stand-by arrangement.

Mr. Vasudevan made the following statement:

> We welcome the discussion of the 1986 Article IV consultation report on the Arab Republic of Egypt, as it provides an opportunity to look at the economic situation of a country that has been working on a program of policy reform in partial response to the play of exogenous factors, such as fall in oil prices.

The staff report gives an admirable array of key elements of the proposed policy reform, among which the emphasis on price decontrol and a greater role for private initiative, as policy objectives constitute a notable departure from past policies. The normal Fund-type policy prescriptions can all be found in the authorities' proposed policy reform: liberalization of administered prices, improved incentives for the agricultural sector, lowering of the share of public investment, reduction in subsidies, increase in domestic prices of petroleum products to world levels within a specified timeframe, containment of wage and salary outlays, control of public investment expenditures, and simplification of the exchange system leading to unification of exchange rates within the next three years.

The staff has welcomed the proposed policy reform but feels that the reform has not been sufficient in its intensity and pervasiveness and has not addressed the question of excessive fiscal deficits and rapid growth of credit. Nor does the reform, according to the staff, address the structural distortions and imbalances in a sufficient manner. The staff does not approve of the authorities' gradual approach to the matter, believing that only a more vigorous and comprehensive policy package will help Egypt gain investor confidence and augment private capital inflows in the medium term. However, honest differences of opinion in this regard were possible; so long as real output growth is maintained at the high level of 8 percent as anticipated in the Five-Year Plan 1982/83 to 1986/87, there should be no apparent problem in pursuing a gradual approach.

The 1985/86 economic performance, on the face of it, is not satisfactory, in that the output growth was lower, prices were higher, fiscal deficits were larger, monetary expansion was higher, and the current account deficit was larger than originally expected. But the authorities have recognized the magnitude of the problem and have taken in recent months a series of welcome measures. As the supplement of September 26 shows, the fundamental tariff reform was implemented in August of this year. Also, a number of prices of public sector enterprises have been increased. Subsidy reductions, wage containment, and investment cuts are in the cards and would all serve to reduce public expenditures. As a result, the 1986/87 budget would, even by the staff's reckoning, show a reduction in overall deficit from 23 percent of GDP in 1985/86 to about 15 percent of GDP in 1986/87. This is a significant fiscal effort for a single year and is worthy of commendation. It is important to recognize that in Egypt's case, one could expect further reductions in fiscal deficits, as price adjustments occur and as tax administration is improved. There is room for maneuverability by price adjustments, especially in respect of energy products.

On the monetary policy front, given the authorities' preference for a gradual reduction in the share of the public sector, and given the fiscal deficit reduction, credit to the public sector could be expected to decelerate in future. The crucial question that would arise would be in relation to the credit extended to the private sector. The April 1986 measures seem to be having some impact in this regard. The question of interest rate increase, which is recommended by the staff on the grounds that interest rates are negative in real terms, would be reviewed as part of the overall review of the structure of interest rates. We would prefer that this matter be left to the authorities, since it is intimately connected with the phenomenon of inflation, the underlying causes of which are not always clear, and would need to be carefully looked into before policy measures are undertaken. After all, as Minister Hamed so perceptively remarked, and as the authorities believe, once inflationary pressures are contained, real returns on savings would turn positive at the present levels of interest rates. It however appears that, after tax adjustment, the long-term deposit rate would be 18-20 percent a year, which would be closer to the average rate of inflation. Table 64 in Appendix II of SM/86/215 gives the impression that the one-year deposit rate, after making the tax adjustment, would be only slightly below the average rate of inflation. We wonder whether this perception is correct. Also, we wonder whether there is any empirical evidence of the relationship between the interest rate and savings in domestic currency and the interest rate and investment activity in the Egyptian economy.

The external payments position of Egypt is worrisome. The gross usable reserves are equivalent to about four weeks of imports. The authorities have recently simplified the exchange rate system by eliminating the official commercial bank rate and by authorizing a higher commercial bank rate. They also intend to unify all foreign exchange markets. We note that measures in this respect are now under study, and we await the outcome of that study with interest. We also note that in August 1986, the authorities replaced the system of approving licenses for imports by a list of prohibited categories. This is a good beginning, especially since it comes about along with the tariff reform.

The medium-term scenarios show external financing gaps in excess of $3 billion during the rest of the current decade. The assumptions given in Appendix III behind the exercise seem to provide a base scenario with which the authorities could usefully work while mapping out their policy framework for the medium term. The exercise shows that the debt service ratio would rise and the financing gaps would go up. The years ahead are going to be difficult, and the authorities therefore need to take adjustment measures that place emphasis on both demand restraint and supply response. The speed of adjustment--a matter on which the staff places considerable stress--will obviously depend on the authorities' perception of the developments in the economy, especially in respect of output and prices. More important, it will depend on how much external assistance the country receives. This aspect has not received much attention in the report. In this connection, and relating to the credibility of the appraisal, it is not enough to merely emphasize that quicker and more vigorous implementation of adjustment measures is crucial; what is important is to work out in some quantifiable terms how quickly the external viability with growth would be achieved if the staff's recommended policies are pursued or, alternatively, if the authorities' stated intentions and policies are pursued. It is clear to us that the direction in which the authorities are moving is in line with the appraisal, and we would urge the authorities to persevere with their current adjustment efforts, intensifying them wherever possible. We wish them well in their endeavors.

Mr. Abdallah made the following statement:

Let me begin by welcoming Minister Hamed to today's discussion, as other Directors who have spoken before me have already done. Also like other Executive Directors, let me say that I am in broad agreement with the staff appraisal and support the proposed decision.

It is clear from the supplementary note and from Minister Hamed's enlightening statement that the Egyptian authorities are now fully cognizant of the seriousness of the situation facing them and have as a result taken a number of comprehensive and fairly drastic measures to deal with it. The broad thrust of Egyptian policy is that of gradualism, but not of a passive kind. A fairer analysis would characterize the policy as accelerated gradualism. The reason for saying this is that a number of measures that were announced to the staff last June were not only implemented but were further intensified in August. For instance, the time frame for unifying the exchange rates of the commercial banks and the free market has been reduced from 36 months to 18 months. Last August, also, further measures were taken to reduce some customs tariffs, change some taxes to an ad valorem basis, and rationalize the structure of taxes to some extent.

It is clear, therefore, that the adjustment program is being speeded up. We have also learned this morning that the Minister and his delegation have just agreed with the World Bank on a three-year program for adjusting procurement prices for agricultural commodities and for raising energy prices to the international level. As a result of this agreement, the World Bank will be able to participate in financing projects in both the energy as well as the agricultural sectors.

While broadly endorsing the policy of gradualism, let me say that there is, to my mind, a more effective way of pursuing it than the one that has been adopted, namely, increasing prices of controlled products and utilities in varying proportions every year for the next three years. Doing so against stagnant growth and falling per capita incomes cannot be very popular. Why not use a different tactic and pick out a strategic sector like energy, for instance, and do a complete price adjustment and finish with it in 1986? The next year the Government could then pick out another area--say, procurement prices for wheat and cotton--and again do a complete adjustment and finish with it, while adjusting prices of other commodities in a gradual fashion. The advantage of this approach is not only to relieve the budget faster; it could also be presented to the public as demonstrating the will to ensure that price increases will not necessarily be a way of life for the rest of the decade.

In his perceptive intervention, Mr. de Groote asked how the authorities intended to attract foreign investment into Egypt in order to enhance the country's growth prospects. In my view, two answers can be given. The first is that Egypt has already signed the Multilateral Insurance Guarantee Agency (MIGA), to which it attaches great importance as a channel for inducing additional private investments into Egypt. Second, substantial amounts of foreign exchange are already in Egypt under arrangements which allow residents to hold foreign currency deposits with domestic institutions. As these funds are already with Egyptian banks, all that is required is to create conditions that will induce their holders to shift them from the banking system into productive enterprises. One possible way is to accelerate the policy of privatization so that existing industrial enterprises may receive the necessary injection of private capital and more dynamic management.

From Appendix IV of the staff report, which deals with statistical issues, it is clear that the most essential data on Egypt are not current. The latest information on national accounts relates to 1984, data on interest rates go back to December 1985, and no precise figures are available on the total of external debt. This failure to produce data on a current basis has nothing to do with deteriorating external circumstances. Egypt has a large reservoir of trained manpower, which has been able to satisfy local needs as well as those of its many Arab neighbors. All that is required, it seems to me, is for the authorities to show real determination to become current with economic data and to recruit the necessary manpower from within. Technical assistance is not necessary. Finally, I wish the Egyptian authorities success in the challenging task which lies ahead.

Mr. de la Herrán made the following statement:

Like others, I would like to thank Minister Hamed and his colleagues for their presence at today's discussion. The main conclusions stemming from the papers presented by the staff are that the economic situation in Egypt has continued to deteriorate and that, unless stronger measures than those envisaged by the authorities are implemented, the country's credibility will suffer and, as a result, the authorities will shortly be confronting financing gaps of considerable magnitude.

Foreign currency availability in Egypt has been traditionally based on three sources: the Suez Canal, workers' remittances, and oil revenues. The existing linkage of these three elements has resulted in a dramatic decline in foreign currency revenues, primarily as a consequence of the drop in oil prices. The rapid reaction of other oil exporting countries to adjust to lower oil prices has not been so firmly followed by Egypt. Instead, a gradual approach has prevailed so far, allowing a greater deterioration than otherwise would have occurred. However, Supplement 1 of September 26 and the very comprehensive statement of Minister Hamed provide some encouraging signs in the sense that they show the progress made in the implementation of urgent measures. This is most welcome, taking into account the difficult economic situation prevailing in Egypt and the need to act with determination. In this context, the tariff reform and the planned actions toward unification of the exchange rates seem to be particularly relevant.

Commenting on more specific subjects, I note that results in 1985/86 in the fiscal area have been somewhat better than envisaged by the staff in its first assessment several months ago, although we are still talking about fiscal deficits on a cash basis representing more than 22 percent of GDP, well above advisable levels. Projections for 1986/87 show an improvement, which should bring the deficit to a level close to 15 percent of GDP. Such improvement, although not enough, certainly constitutes a substantial step forward, even more so given the fact that it will be attained after important measures are implemented, on both the expediture and revenue sides. Particular emphasis should be placed on the tariff reform and pricing policy. Both will underpin the revenue side by adding an estimated 0.9 billion Egyptian pounds from increases in customs duties and higher gasoline prices.

On the expenditure side, prime attention should be devoted to public investment projects. The World Bank in assessing the current situation has recommended a reduction in public investment and the need to shift resources toward quick-yielding projects. Another most interesting recommendation points to the convenience of concentrating investment resources in the energy sector by exploring the possibilities of enlarging the use of natural gas. Chart 3 of the main paper is rather illustrative of the petroleum demand pattern prevailing in Egypt and provides a basis for thinking that some substitution of oil by gas might be beneficial, not only for balance of payments improvement but also for the sake of a more balanced energy policy.

Regarding pricing policy in the public sector, I would like to pinpoint the difficulty in reaching a balance between, on the one hand, progressively eliminating the distortions created by unrealistically low prices for certain goods and subsequent subsidies to producers of such goods and, on the other, the social cost incurred by abrupt price increases of basic products such as bread, fuel, oil, rice, cotton, and so on. Therefore, the actions already taken are highly commendable.

On monetary policy, I would only like to touch upon the question of interest rates. On purely economic grounds, we feel that the current situation seems to call for higher interest rates. The Egyptian economy has a major problem of foreign currency availability; the contribution of positive real interest rates to attract convertible currency might be substantial. However, we can also understand the point raised by the authorities that higher interest rates could hurt investment. If we consider that the World Bank is also in favor of reducing public investment, then the overall investment demand of the economy could be excessively reduced, jeopardizing growth-oriented strategies unless, as Mr. Vasudevan wondered, there is no clear-cut relationship between interest rates and investment in the Egyptian economy. Perhaps some further views from the staff or the authorities could clarify the pros and cons of an increase in interest rates.

The deteriorating trend of the economy has affected with particular strength the balance of payments situation. The authorities' prime challenge lies probably in achieving a viability of the external sector and in finding the means to bridge the financial gaps that, unfortunately, are expected to reach a cumulative amount of $14.7 billion by the end of 1990. Hitherto, the policies implemented have been based on tight import restrictions coexisting with a complicated multiple exchange rate system. In our view, this schedule could have had a favorable effect in the short run, but it is not the policy combination that would lead Egypt to a sustainable balance of payments position. Import restrictions must be replaced by reform in order to improve reallocation of resources and offer better prospects for resuming economic activity.

My final remarks relate to the current relations between Egypt and its creditors and, more specifically, to the intention of the authorities to approach the Paris Club or try some sort of multilateral rescheduling. The reference made by Minister Hamed in his statement on multilateral rescheduling negotiations and requesting Fund assistance for this purpose is most encouraging.

My authorities are of the view that a multilateral rescheduling agreement could provide Egypt with the adequate framework to deal with the problem of the projected financial gaps and, more generally, with the question of controlling the growth of external debt. We would assume that the decision to get involved in multilateral rescheduling would imply a closer relationship with the Fund. We fully share Mr. de Groote's argument in favor of reaching agreement on a stand-by program with the Fund and rescheduling under the Paris Club aegis. In this regard, I would appreciate it if Minister Hamed would be kind enough to give us some further comments on the specific actions planned by the authorities on debt rescheduling and relations with the Fund.

In conclusion, as Mr. Finaish has put it, the main challenge for Egypt now is to design a medium-term plan that in its content and timing enables the authorities to cope with the current imbalances in an effective way. The speed of adjustment is a fundamental issue to be discussed, and at this stage, an excessive gradualism does not seem to be the best alternative for the economy. Finally, let me convey to the Egyptian authorities our best wishes for success in their efforts.

Mr. Salehkhou made the following statement:

It may be recalled that the Central Bank of Egypt has been in substantial arrears to the Islamic Republic of Iran since early 1983 on two sizable and highly concessional government loans. Numerous attempts have since been made to help Egypt settle its overdue financial obligations. After much correspondence through the Fund, Egypt finally proposed, on September 27, 1984, to meet its obligations on a cash-cum-commodity basis. This, as a further concession to Egypt, was agreed by my Iranian authorities in good faith, and as a means to encourage the country to become current in its payments arrears.

After prolonged delays in making a positive move by the Egyptian side on its own proposal, it was decided that an Iranian delegation would visit Cairo to conduct face-to-face negotiations within the framework of the Egyptian proposal. Unfortunately, however, the mission did not succeed, as the delegation was informed in Cairo by the authorities that Egypt was no longer bound by the cash part of the proposed package. This new and totally unexpected position was later confirmed by the Director of the Middle Eastern Department in a memorandum on July 25, 1986. The memorandum reads in part, that "...the Egyptian authorities have advised the Iranian delegation that time or to make any commitments for scheduling any cash payments." My authorities wonder why the Central Bank of Egypt had invited the Iranian mission for the visit to begin with if it felt that it "...was no longer bound by the cash part of the proposal," which the Central Bank of Egypt itself had offered. My authorities were in fact astonished to learn, shortly after the return of the unsuccessful mission, of a public statement by the Egyptian Prime Minister assuring other creditors that "...Egypt was committed to meeting payments of 3.3 billion Egyptian pounds (4.7 billion dollars) in debt and debt servicing this year."

My authorities firmly believe, and have already indicated to the Fund, that the Egyptian behavior lacks good faith and raises serious doubts regarding the authorities' real intention in settling Egypt's overdue financial obligations to Iran. Accordingly, they raise serious objection to the staff's statement on page 25 of SM/86/186 that "...at present, contracts were under way to negotiate an outline of a settlement..." or on page 64 of SM/86/215 that "...discussions...on ways to settle the issue of arrears and the servicing of the obligations...have been under way for sometime." It is clear that Egypt's outright nullification of that country's aforementioned cash-cum-commodity proposal clearly contradicts the staff's above assertion.

Furthermore, while Egypt has not, since early 1983, made any payments to the Islamic Republic of Iran, such has not been the case with respect to its other creditors. The very fact that Egypt is meeting some of the loans on time, as asserted by the staff, inter alia, on page 25 of SM/86/186, is per se evidence of Egypt's discriminatory attitude and behavior. Egypt's other creditors, to whom this country is in arrears, are presumed to have reached certain arrangements and/or understandings according to the staff's recent consultation reports. However, I would like the staff to confirm whether other Egyptian creditors have also been told, as were my Iranian authorities, that Egypt is not "in a position to... make any commitments for scheduling any cash payments." Whether the Islamic Republic of Iran is or is not the only country being discriminated against vis-à-vis other creditors is not relevant as long as Egypt's creditors have not been accorded uniform treatment.

In view of the above, my authorities in the Islamic Republic of Iran are firmly convinced that the Egyptian authorities have not acted in good faith, have resorted to a variety of delaying tactics and, beyond the shadow of a doubt, have discriminated against the Islamic Republic of Iran regarding payments arrears. My authorities therefore wish to request, as they did last year, to have the facts reflected accurately in the relevant staff documents and the proposed decision amended accordingly. Failure to do so, in their view, would implicitly condone such discriminatory behavior, encourage Egypt to continue with its discriminatory treatment as in the past, and encourage other debtors to follow suit.

Like my colleagues who have spoken before me, I recognize the gravity of the economic situation in Egypt and the vitality of external financing needs in pursuing further and more serious adjustment efforts. Accordingly, the Egyptian authorities would be well advised to put aside their political motivations and accord uniform treatment to all creditors. This would primarily be in the best interest of Egypt, as potential donors and the international financial community in general may find it difficult and be reluctant to extend financial assistance to a country with a discriminatory attitude toward creditors.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/163 (9/30/86) and EBM/86/164 (10/6/86).

3. ROMANIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

Paragraph 1 of Executive Board Decision No. 8383-(86/148), adopted September 5, 1986, is amended to read as follows:

> The complaint of the Acting Managing Director dated August 29, 1986 on Romania in EBS/86/205 (8/29/86) is noted. It shall be placed on the agenda of the Executive Board for October 10, 1986. (EBS/86/205, Sup. 3, 9/30/86)

Decision No. 8412-(86/164), adopted
October 1, 1986

4. GUINEA - TECHNICAL ASSISTANCE

In response to a request from the Guinean authorities for technical assistance in the tax field, the Executive Board approves the proposal set forth in EBD/86/263 (9/30/86).

Adopted October 3, 1986

5. KUWAIT - TECHNICAL ASSISTANCE

In response to a request from the Kuwaiti authorities for technical assistance in the budget area, the Executive Board approves the proposal set forth in EBD/86/262 (9/30/86).

Adopted October 3, 1986

6. OMAN - TECHNICAL ASSISTANCE

In response to a request from the Omani authorities for technical assistance to study the performance of the financial sector and to review the existing instruments of central bank policy, the Executive Board approves the proposal set forth in EBD/86/261 (9/30/86).

Adopted October 3, 1986

7. THAILAND - TECHNICAL ASSISTANCE

In response to a request from the Thai authorities for technical assistance in the revenue field, the Executive Board approves the proposal set forth in EBD/86/260 (9/30/86).

Adopted October 3, 1986

8. PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN - TECHNICAL ASSISTANCE

In response to a request from the authorities of the People's Democratic Republic of Yemen for technical assistance to review the tax administration, the Executive Board approves the proposal set forth in EBD/86/264 (9/30/86).

Adopted October 3, 1986

9. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 86/26 and 86/27 are approved. (EBD/86/259, 9/29/86)

Adopted October 3, 1986

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/86/234 (9/30/86) and by Advisors to Executive Directors as set forth in EBAP/86/235 (10/1/86) is approved.

11. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/236 (10/3/86) is approved.

APPROVED: June 11, 1987

LEO VAN HOUTVEN
Secretary