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# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 86/165

3:00 p.m., October 6, 1986

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | J. K. Orleans-Lindsay, Temporary |
| C. H. Dallara | M. K. Bush |
| J. de Groote | |
| M. Finaish | |
| | T. Morita, Temporary |
| G. Grosche | |
| Huang F. | |
| J. E. Ismael | |
| | J. Hospedales, Temporary |
| T. P. Lankester | M. Foot |
| | O. Isleifsson, Temporary |
| | W. N. Engert, Temporary |
| | A. Abdallah |
| | M. A. Weitz, Temporary |
| Y. A. Nimatallah | J. E. Suraisry |
| | J. de la Herrân, Temporary |
| H. Ploix | |
| J. J. Polak | |
| C. R. Rye | |
| G. Salehkhou | |
| | A. Vasudevan, Temporary |
| | L. Tornetta, Temporary |

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; 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: J. T. Boorman, A. M. Jul, P. M. Keller. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: A. Goorman, M. Z. Yucelik. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; S. Kawar, K. Nashashibi, B. K. Short, S. M. Thakur. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, A. Ouanes. Assistants to Executive Directors: A. Bertuch-Samuels, G. Ercel, R. Fox, J. M. Jones, M. Lundsager, J. E. Rodríguez, B. Tamami, H. van der Burg, B. D. White.

1. ARAB REBUBLIC OF EGYPT - 1986 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/86/164, 10/6/86) their consideration of the restricted staff report for the 1986 Article IV consultation with Egypt (EBM/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, were present as the representatives for Egypt.

The Deputy Director of the Middle Eastern Department, responding to comments and questions by Executive Directors at EBM/86/164, observed that the staff continued to feel that the policy steps taken by the Egyptian authorities, particularly in the energy and agricultural pricing areas, were positive but were not sufficient to guarantee balance of payments viability over the medium term in the absence of action in other policy areas. Basically, the measures that the authorities had adopted did not provide as much impetus for growth in the period ahead, particularly in tradables, as was desirable. Additional policy measures must be implemented in the areas of pricing, the exchange rate, and interest rates; appropriate investment priorities must also be established.

The Executive Board had two issues to consider, the Deputy Director continued. The first was whether it felt that the steps taken thus far were sufficient to bring about balance of payments viability in the medium term; the second was whether the additional steps currently under discussion with the authorities should be implemented gradually or up front at the beginning of the program. In coming to a conclusion on that latter question, the Board must make a judgment about the likely success of the additional policies being considered; and account must be taken of the desire of the authorities to shield some segments of the population from the adverse impact of price increases that would result if the policies were implemented. As noted by Mr. Polak, the staff had shown, and was prepared to continue to show, flexibility in many of the policy areas as well as in the timing of implementation of some policies, in particular exchange rate and pricing areas.

Two policy areas had dominated the discussion at EBM/86/164, the Deputy Director recalled. The first was exchange rate reform; the second was related to interest rates, which formed part of the broader area of pricing policy. On the issue of exchange rate reform, there was no difference of view between the Egyptian authorities and the staff on what the reform should accomplish (i.e., full unification and flexibility in the rate); nor was there any difference of view on the importance of exchange rate policy as part of the policy mix. The staff had reviewed the policy proposals of the authorities in the exchange area and believed that, by comparison with previous proposals, the authorities were also showing greater flexibility. However, in assessing the viability of exchange rate reform, certain principles must be accepted. First, if one agreed with a gradual approach which should not be too long in order to maintain the impetus, it was important from the very beginning of the reform to move those transactions that were most price sensitive to the more depreciated rate. Second, the administration of the system should be simplified and made transparent to all the participants in the market during the transition period until full unification was achieved. Third, for its success, the reform should be supported by measures in other policy areas, in particular interest rate and credit policy.

There was also some difference of view between the staff and the authorities on the role of the interest rate as an economic tool; the lengthy difference lengthy concerned the timing for making interest rates positive in real terms, the Deputy Director commented. In addition to the points made by the staff in its report on the impact of interest rate changes, other considerations should be taken into account when addressing the role of interest rate policy in Egypt. Excluding oil transactions, the balance of payments was dominated by capital and transfer movements, which took place on the basis of yields or potential yields. To the extent that the Egyptian authorities did not use the interest rate instrument from the beginning in order to encourage the holding of domestic assets (the alternative being foreign assets or imports) they must be prepared--in order to achieve their balance of payments objectives--to accept a rapid depreciation of the exchange rate in the parallel market which might lead them to reconsider the exchange reform. And it was not clear whether such a depreciation would have a positive impact on other sectors of the economy. Another point to be kept in mind was the fact that no empirical evidence existed in Egypt on the relationship between the interest rate and the level of investment and savings. However, it was important in constructing a financial program to be able to predict fairly accurately the velocity of M2 in domestic currency. For a given balance of payments objective, the success or failure in turning around a velocity trend could have quite different implications for the construction of a credit program. In other words, unless the recent accelerating trend in velocity was reversed, then one had to contain the growth of net domestic credit to the amounts of domestic liquidity which the public wanted to hold. That would therefore mean, under the circumstances, a substantial reduction in credit expansion which, given the current budget posture, would have to fall on private sector credit; that would appear to be counter to the stated objective of the authorities to encourage the private sector. A third consideration relating to the interest rate debate in Egypt was the growth of the population and the number of new entrants into the labor market at a time when economic conditions abroad made it difficult to absorb the surplus labor. Since it was important to provide positive signals to private investors, a policy under which employment was a major consideration behind investment would seem to dictate somewhat more flexible interest rate policy. Moreover, a more flexible policy would give the Central Bank additional instruments in its arsenal of credit policy instruments including the potential for creating efficient money and capital market operations of the sort that did not exist at present. An appropriate interest and exchange rate policy would help that policy objective. More generally, in addition to appropriate levels of interest rates to encourage capital inflows, domestic savings and efficient use of capital, what was needed was to create an appropriate policy environment that would give the population confidence that Egypt's economic problems were being firmly tackled, a confidence that was essential in order to encourage private sector activity and investment.

In response to those Directors who had questioned whether there was sufficient price flexibility at present in Egypt, the Deputy Director observed that the pace of adjustment in prices was in his view still slow, and pricing of a number of products had not yet been decontrolled. The World Bank had recently completed a study of public enterprises in Egypt and had recommended, inter alia, that for those units operating in a competitive environment, prices should be determined by supply and demand considerations. For the tradables, the price should be raised as rapidly as possible to international levels at the appropriate exchange rate.

The matter of subsidies had been discussed at great length with the authorities and the focus had been on two basic issues, the Deputy Director noted. The first was the openendedness of the system. The staff had suggested the use of an income test for access to subsidized products, and the authorities were looking into that and a number of other possibilities to ensure that the benefits of subsidies were directed to those most in need. For example, some months earlier, the idea had been advanced that the consumption of electricity might be used as a proxy for an income test. The second issue was the transparency of the subsidies. The staff believed that making policy instruments play a role for which they had not been designed was not particularly efficient. A number of products in Egypt were being subsidized through the exchange rate; the staff felt that the subsidies should become transparent through the budget and that the exchange rate should play its more traditional role.

In response to a question by Mr. Dallara on the implications of the trade reform, the Deputy Director observed that in 1984/85, imports--particularly to the private sector--had been guided through the licensing system; and to the extent that there was restrictiveness in the system, it was difficult for the staff to make an accurate assessment of the implications of the reform. The staff believed that the reform had introduced additional restrictiveness. However, it was important to note that in his presentation, Minister Hamed had indicated that the list of products had been introduced to ease the strain on the exchange market and that the list would be reduced as soon as the appropriate financing for the balance of payments had been secured.

In the area of tax reform, the authorities had already taken an important step in the area of import duties, the Deputy Director said; but a number of weaknesses remained on the revenue side of the budget, which depended excessively on international transactions of the sort that had proved extremely volatile of late. Also, there was a lack of elasticity in a number of taxes, reflecting in part weaknesses in administration and collection. A strong effort had been made to improve tax administration in 1985, particularly in the area of income and profit taxation, but more remained to be done. There was also some inelasticity in the consumption tax, as a number of rates were specific. The authorities had held discussions with experts in the Fund's Fiscal Affairs Department, and a Fund mission from that department was to visit Cairo at the beginning of 1987 to assess the progress in the implementation of the tariff reform, with a view to correcting any anomalies that might be found. Another objective of that mission would be to look at the possibility of introducing a sales tax or changing consumption taxes to an ad valorem basis. Of course, the revenue side of the budget could be enhanced through greater price flexibility as well.

Responding to a query on the status of improvements of monetary policy instruments, the Deputy Director observed that, fundamentally, three courses of action were available. The first was to improve the functioning of the loan/deposit ratio; the second was to improve the structure of interest rates; and the third was to use other instruments. The use of the loan/deposit ratio was being reviewed by the Central Bank. The improvement of the structure of interest rates--as distinct from their level--raised two issues. First, at the short end of the market, the cost of deposits provided sufficient profit to the banks to give credit to the priority sectors of industry and agriculture; at the longer end of the market, however, given the 25 percent reserve requirement, the cost of some deposits did not appear to provide sufficient profitability to the banks when they made credits to the priority sectors. A second issue was that, while deposit rates varied according to maturity, lending rates were fixed irrespective of maturity. As to the use of other monetary policy instruments, the staff would like to review with the authorities the possibility of introducing an active money market or capital market policy.

A number of comments had been made on the beneficial impact of increasing energy prices, the Deputy Director recalled. Such increases, as were being discussed with the World Bank, would give clear signal to the private and public sectors that energy was not a cheap resource and that, in planning for investment, projects should be selected with that notion in mind. In addition to pricing policy in the energy area, another issue that required consideration was the need to embark on plant upgrading and modernization of some projects that were large energy users. Two examples could be cited: in the public sector 15-20 percent of the energy used was consumed by a single fertilizer company, an upgrading of which would provide a welcome saving in energy; also, the World Bank had estimated that more efficient gas-based techniques in the production of ammonia would reduce the production cost per ton from $800 to $115.

Elaborating on those specific steps that the authorities had taken in the agricultural sector and on those being recommended by the staff, the Deputy Director noted that, basically, the aim was to liberalize the marketing of agricultural crops and inputs as well as their prices and the authorities were moving toward that goal. Removal of quotas on planting and delivery was proceeding according to plan.

Finally, in assessing prospects for Egypt and chances of success of an adjustment program, one had to mention a number of positive factors, the Deputy Director remarked. Unlike many other developing countries, Egypt had a number of important assets: a large domestic market (50 million), a strategic geographic location, a well-qualified labor force, a diversified industrial base, and extremely fertile land with ideal agro-climatic conditions. Egypt was an energy surplus country with diversified sources of foreign exchange, ranging from tourism to oil to remittances. Furthermore, as far as he could gather from the Board discussion, Egypt could expect a continuation of aid from a large number of willing and sympathic creditors. The staff would visit Cairo at the end of the month to continue its discussions with the authorities, and it was to be hoped that any remaining differences between the authorities and the staff could be bridged at that time.

The staff representative from the Exchange and Trade Relations Department, responding to Mr. Salehkhou's remarks concerning certain obligations of Egypt to Iran, said that it was the staff's understanding that Egypt fully accepted its obligations to Iran and that, consequently, the amounts due under its obligations were treated as arrears. Insofar as those arrears arose from exchange restrictions, the staff report advised the Executive Board to continue with nonapproval of those restrictions, and the decision read that the authorities should be encouraged promptly to eliminate the arrears.

It was his experience that, in cases where arrears emerged, they frequently did so in disorderly fashion, the staff representative continued. Countries employed various criteria for deciding which obligations would be financed and to what extent they would be financed as the arrears emerged in the early stages of external financing difficulties. It became clear how such obligations could be settled in a more orderly fashion only once the process was set in motion by which the arrears could be directly addressed by the debtor, usually in cooperation with a multilateral forum of its creditor. The Fund's role in the case in question was three-pronged: the staff had been discussing with the authorities a program of economic adjustment and reform that would allow an orderly reduction of arrears and servicing of obligations falling due; the staff had encouraged the Egyptian authorities in those discussions to approach their creditors in a multilateral forum as a way of ensuring that the creditors had an opportunity to press for comparability of treatment and to determine what would be acceptable to them; and the staff had used the good offices of the Fund in arranging for the two parties in the debate to get together. Most recently, during the course of the 1986 Annual Meetings, the staff had met with the Iranian authorities, who had asked that the staff convey certain messages to the Egyptian authorities aimed at restarting discussions on the arrears issue. That request was being carried out.

Mr. Salehkhou asked whether the implication of the staff representative's statement was that the imposition of restrictions and the exercise of discrimination by Egypt was none of the Fund's business or that such practices were approved by the Fund.

The staff representative from the Exchange and Trade Relations Department replied that, insofar as the arrears resulted from restrictions, the staff was recommending to the Executive Board that those restrictions not be approved. It was doing so, in part, because there was no plan by the authorities at present to reduce those arrears in an orderly fashion. In such matters, the staff acted on the guidance of the Board, most recently provided in the 1984 discussion of a paper on disputes and the settlement of arrears. At that time, the Board had advised the staff to exercise great caution in reaching conclusions about matters such as discrimination in the repayment of arrears or the settlement of outstanding obligations, emphasizing that, ultimately, the judgment on that matter rested with the creditors. For such a judgment to be made, a standard was required, and there was no standard as yet in the case in question, insofar as the creditors as a group had not been approached by the Egyptian authorities, and a process for the orderly reduction of arrears--against which some other process could be judged--had not yet been set in motion. Without such a standard, the staff had no precise knowledge of the relationship between every creditor and the Egyptian authorities and was thus hesitant to make a judgment about whether discrimination was taking place.

Mr. Salehkhou stated that he was not asking for a judgment by the Fund. It was clear from page 25 of the staff report that for certain Arab countries' deposits with the Central Bank of Egypt "an arrangement existed whereby these deposits were renewed as they matured; in the case of one country, there were claims and counterclaims. With regard to the loans from the Gulf Organization for the Development of Egypt, there was an arrangement for interest to be capitalized." It was also noted that for other loans, "payments were being made on time." It was only with respect to the Islamic Republic of Iran that the process of reduction of arrears, from the moment those arrears had begun to accumulate, had been limited merely to contacts or discussion.

He had also asked the staff to confirm whether any other creditor had been told that Egypt was not "in a position to...make any commitments for scheduling any cash payments." That amounted to a flat refusal and did not call for any judgment. There had been cases in the past where countries had refused payment, and their behavior had been reflected in staff reports. He had asked for similar treatment with regard to Egypt in he staff report in 1985; perhaps because he had not pursued his request for a correction of the 1985 report, that request had not been acted upon. His authorities had hoped that continuing discussions with the Egyptian authorities would lead somewhere, but he had seen no positive moves after three years. And yet the staff was continuing to insist that discussions were taking place.

The staff representative from the Exchange and Trade Relations Department noted that at the time the staff report had been under preparation, the staff had been given to understand that discussions had been taking place in Cairo between an Iranian mission and the Egyptian authorities and the staff had made reference to those discussions in its report. Similarly, the staff had been given indications during the week of the

Annual Meetings that the Iranian authorities wanted the Fund staff to convey messages to the Egyptian authorities. That desire implied some willingness to continue discussions, and the Fund staff had conveyed those messages to the Egyptian authorities. He was not in a position to know whether or not the Egyptian authorities had made similar statements about their arrears to any other creditors. Even if they had, it was clear that an indication that the authorities were not in a position at a given time to make a cash payment or commitment could be interpreted in various ways.

Mr. Salehkhou recalled that he had been present at the meeting between his authorities and the Fund staff and did not recall that his authorities had at any time asked for a continuation of discussions with the Egyptian authorities. Recalling that Egypt had made a proposal in 1984 for clearing the arrears and had then nullified that proposal, his authorities had only asked about the intentions of the Egyptians, why they had been discriminating against Iran and how they were planning to meet their obligations. There had been no request for continuation of discussions and no mention of any future contact.

It seemed that the case of discrimination was clearly established, because the Egyptians had flatly refused to make any cash payments to Iran or even to commit themselves to make such payments in future, Mr. Salehkhou continued. At the same time, Egypt was promising to pay other creditors the equivalent of $4.7 billion within the current year. He would appreciate hearing more particularly how other creditors were being treated.

The staff representative from the Exchange and Trade Relations Department agreed, first, that there had indeed been no request by the Iranian authorities for "discussion" with the Egyptian authorities. However, the Iranian authorities had asked the Fund staff to "communicate" with the Egyptian authorities, and he presumed that a reply was expected.

On the question of discrimination, the staff had not conducted a study of Egypt's relations with its creditors, the staff representative continued. However, it was clear that in most cases, a disorderly process of arrears reduction emerged as, in a crisis situation of short foreign exchange, a debtor country chose the obligations it would finance; and the criteria for those choices were established by the country itself. In the process of resolving its difficulties and putting into place a more orderly process for the clearance of arrears and the settling of financial obligations, the authorities of member countries were encouraged to employ a mulilateral framework so that creditors could express their wishes and so that comparability of treatment could be afforded to the creditors. There had been cases under financial programs with the Fund where, as an undertaking or an understanding, it had been agreed that arrears would be worked down in a certain fashion. There even had been one stand-by arrangement under which it had been made a performance criterion that arrears be reduced in what had been an agreed fashion.

Mr. Salehkhou remarked that, in the absence of any outside information, he relied mainly on the staff reports; the staff report before the Board classified all Egypt's creditors, and it was clear that no other creditor had been treated in the same way as the Islamic Republic of Iran. In particular, following a description of some of Egypt's debts, it was noted on page 24 that "they (the Egyptian authorities) intended to clear these as well as other external payments arrears as quickly as the position of the Central Bank pool would allow." Yet the Egyptian authorities had flatly refused either to pay or even to commit to make payment to the Islamic Republic of Iran. With all the other countries classified as Egypt's creditors, certain arrangements or understandings had been reached. And, indeed, he knew of no other country that was complaining of discrimination. It was only his country with which the Egyptians had, since 1983, limited themselves to discussing the matter of arrears. Again, in those circumstances, he did not see how the Fund needed to make a judgment on what was a clear case of discrimination.

The staff representative from the Exchange and Trade Relations Department noted that, as guided by the Executive Board in the paper on disputes involving financial obligations, the staff could offer the good offices of the Fund only when the two parties to the dispute agreed that the Fund could act in such a fashion; and he believed that the guidance of the Board had been followed in the case in question. The staff had been arranging for messages to be conveyed from one party to the other, and in one instance the result had been a mission from one country to the other and discussions between the two sides. As far as he knew, the staff's efforts had been appreciated by both parties.

Mr. Salehkhou said that he would appreciate no more references to the paper on the role of the Fund in the settlement of disputes. There was no dispute; it was understood that the Egyptian side accepted its obligations. Besides, guidelines given in the paper to which the staff had referred should certainly not be considered over and above the Articles of Agreement or the Rules and decisions of the institution. If the Fund accepted the case of discrimination, he had no more to say on the matter.

The Acting Chairman observed that the staff had been working with both sides in the hope of making some arrangement to deal with Egypt's arrears to Iran. The staff's contacts with the Egyptian authorities did not suggest that there was unwillingness on their part to communicate, work with, or develop an arrangement with Iran that would enable them to repay, and it was on that basis--rather than on the basis of evidence of the sort mentioned by Mr. Salehkhou--that the staff must respond to the Egyptian authorities. It was of course clear that Egypt was faced generally with difficult payments problems and that it had accumulated large arrears; but the staff had decided not to make the judgment that the Egyptian authorities were acting in a discriminatory manner, because the staff would then have to make similar judgments in other cases where countries were suddenly faced with external financing problems at a time of accumulating financial obligations, some of which were overdue. The staff advised all countries in arrears that the obligations should be settled as quickly as possible and in a nondiscriminatory way; and he would reaffirm that view in his summing up of the day's discussion.

Mr. Salehkhou, thanking the Acting Chairman for his remarks, indicated that his authorities regretted having had to make public the issue of Egypt's arrears to Iran. He believed that the only side to be blamed for such action was the Egyptian side. As he had noted earlier, he was not asking the Fund to make a judgment in the case but only to recognize the facts, which showed that Egypt had indeed discriminated against Iran. However, if management wished, and if a judgment was required, he could produce statements from the Fund to the effect that Egypt had indeed discriminated against Iran. He would leave it to the management to decide what the Fund could or could not do to resolve the issue, but he would caution against the setting of a bad precedent.

Minister Hamed agreed with those who had recognized that the only difference of view between the Egyptian authorities and the Fund staff was related to the appropriate pace of adjustment over time. In the circumstances, it might be helpful if he explained in some detail what Egypt was doing and why it had chosen to move at a particular pace. First, Egypt was committed to the program of economic reform embarked upon after discussions with the Fund and the World Bank in late May 1986. Egypt was committed to liberalization in all areas and to restructuring the economy in order to improve the allocation of resources and promote economic growth. Second, Egypt was committed to restructure revenues in order to provide greater flexibility and to encourage savings to finance the investment program. Third, Egypt was committed to privatization in order to revitalize production in the economy. A number of measures toward those ends had already been adopted as part of what was clearly a comprehensive program. Measures had been taken to liberalize prices of goods produced by the public sector, and a great many price increases had been effected over the past two years and during the first part of 1986. In that respect, he saw the pace of reform as relatively rapid.

In the budget area, as well, Egypt was doing more than earlier expected on the basis of a recognition of the need to reduce the budget deficit, Minister Hamed continued. Of course, the projected reduction from 23 percent to 15 percent of GDP was no reason for complacency; and an effort would be made to reduce the budget deficit even further through the adoption of measures that would increase the elasticity of revenue. Also, an effort was under way to reduce the rate of growth of expenditure. The problem of subsidies was being tackled in a realistic manner, in part through a reduction in the number of commodities subsidized by the Government and partly through a reduction in the size of the subsidies themselves. Furthermore, an effort was being made to distinquish between those who needed the subsidies and those who did not, a distinction based on general income tax liability. However, thought was being given to increasing the number of people ineligible for the subsidies, and other methods of distinquishing among people were being explored, including the possible use of electricity consumption as a substitute for, or supplement to, the income test.

Prices were being increased with a view to moving more toward international price levels, but it took some time to introduce liberalization where rigidities had existed for a long period, Mr. Hamed remarked. The aim was to correct all the anomalies in the economy over a three-year period, which he felt was a pace that would not lead to political and social instability of the sort that the region could ill afford.

Tax reform, having been initiated some two years previously, was continuing, Minister Hamed observed. Exemptions from income tax were relatively widespread. The exemptions had been established as a means of attracting investment, and the World Bank had been asked to undertake a study to see whether or not the exemptions were out of line and whether a change would give the tax system greater flexibility. Over the past two years, Egypt had increased the administrative capacity of the tax system, which had lead to an increase in revenue of some LE 300 million.

Under the comprehensive program of reform, Egypt was also moving toward improving the management and pricing policy of the state enterprises, Minister Hamed said. The aim was to reduce the burden on the budget by making public sector enterprises accountable for a certain rate of return on their capital, inter alia, by bringing in private managers. Improvement in the financial status of the public enterprises would reduce the burden they placed on the budget.

In response to queries about the best way to attract investment in Egypt, Minister Hamed observed that pricing policy and interest rate policy were only two of many areas that should be taken into account. Egypt was looking toward political and social stability of the sort that would provide the right climate for investment. Also, with the liberalization of the exchange rate, more workers' remittances would be used for domestic investment. Finally, energy prices had been and were being increased more toward market prices. The measures he had described, taken together, represented a comprehensive attack on the problems of the Egyptian economy.

Mr. Negm made the following statement:

> There are some four major areas where questions have been raised: the speed of exchange rate unification; interest rate increases; credit policy tools; and multilateral rescheduling of foreign debt.
>
> There are now three exchange rates prevailing in Egypt, and we propose to unify them over a specified time path. The commercial bank rate and the free market rate are to be unified over an 18-month period, while, as some Directors pointed out, the unification of the Central Bank rate could take longer. This

action on our part must be taken in the context of other measures that are now in place and that have served to increase prices. An acceleration of the time schedule for unfication could have a cumulative effect on price increases that we feel will increase the burden on the low-income groups, which represent the vast majority of the population.

On the unification of the official rate, it must be recalled that one of Egypt's main objectives is to improve the incentives for the agricultural sector. We have reached agreement with the World Bank on a three-year program of adjustment of agricultural procurement prices.

On interest rates, the present level in the prevailing structure is not in our view low. One must keep in mind that the gross return on deposits is about 18 percent, while price increases are currently running about 19 percent. Please note that I said "price increases"; the underlying inflation rate is low because of administered price increases referred to in Minister Hamed's statement.

We must be aware of the adverse impact that any increase in interest rates could have on the level of economic activity--which is depressed at present--and on the health of the banking system. Many Directors have pointed to the relationship between interest rates and the dollarization of the Egyptian economy. The increasing dollarization is not related to interest rates alone; there is the more important question of confidence in the economy, which is what we are trying to build up now. However, we are ready to review interest rate policy in the next few months as the results of our program begin to be felt.

On credit policy, I note that in addition to the use of normal central bank tools, the Central Bank of Egypt took steps last April to prohibit Egyptian pound credit to the private sector secured by foreign currency deposits which reduced the growth of such credit in the last quarter of 1985/86. We have also issued instructions that credits should be directed to recognized purposes. We continue to monitor the credit situation carefully, with a view to slowing credit growth yet maintaining a flow commensurate with the legitimate needs of the economy.

In response to the question raised about multilateral debt rescheduling, I note that we are working closely with the Fund to reach an accurate estimation of the financing gaps that lie ahead. We fully agree that the support of the international community will play an important part in closing these gaps.

Finally, I assure you that the matter raised by Mr. Salehkhou will have our careful attention, and I believe that the two countries will be able to reach an understanding on the issue. It should perhaps be noted that Egypt had invited the Iranian delegation to Cairo for that purpose, but the mission had delayed its arrival until June 1986.

Mr. Salehkhou said that he was uncertain whether some of the points raised by Mr. Negm were accurate. His recollection was that difficulties had initially been encountered in reaching agreement on the dates of the Iranian mission to Egypt and that, subsequently, delays had been experienced in obtaining entry visas into the country. When the mission had finally arrived, it had been told that no cash payments would be made. The authorities who had met with the mission had then produced a totally different list of commodities for payment. And the list of commodities offered, even if it had proved acceptable to the Iranian authorities, had been comprised of items the supply of which could not have been guaranteed. The delegation had then been left in a vacuum with no indication of with whom it was to meet and what to discuss. Mr. Negm might recall that he himself had refused to receive the head of the delegation to hear grievances. For a week the delegation had wasted its time and had then left empty handed. Now it was being suggested by Mr. Negm that the delays and the failure to reach agreement were the fault of the Iranian mission. In concluding, he noted that the list of grievances--which had been sent by telex to Mr. Negm--could be provided to the Board if management so wished.

The Acting Chairman observed that, in the circumstances, it might be best if the staff and management took advantage of Mr. Negm's presence in Washington over the next few days and attempted to bridge the differences that apparently still existed between Egypt and the Islamic Republic of Iran on the question of arrears.

The Acting Chairman then made the following summing up:

Directors expressed broad support for the thrust of the views set forth in the staff appraisal in the report for the 1986 Article IV consultation with the Arab Republic of Egypt. Directors noted, with many of them recalling earlier Article IV discussions, that Egypt's internal imbalances and external payments position had been deteriorating for a number of years under the impact of large fiscal deficits, expansionary monetary policies, severe relative price distortions, and trade and exchange restrictions. These difficulties had recently been intensified by the sharp slowdown in Egypt's main sources of foreign exchange, including workers' remittances. Directors noted that, recognizing the gravity of the situation confronting them, the authorities had begun taking significant corrective measures. In that context, they warmly welcomed the statement of Minister Hamed at today's Executive Board meeting, which showed a wide measure of agreement regarding the need for, the thrust of, and the objectives of a comprehensive adjustment program. Directors believed that the staff's analysis together with the Minister's statement could form the basis for the elaboration of a broad-based program of demand management and structural reform, including a fully articulated timetable for the implementation of the measures that are urgently needed to restore external viability and encourage sustainable growth in the medium term. While some Directors expressed their agreement with the authorities' contemplated timetable for policy actions, most Directors stressed that this timetable was too gradual and needed to be accelerated significantly if Egypt was to avoid further deterioration in the economy and was to attract the support of the international financial community.

Directors commended the authorities' recent efforts to contain public expenditure and implement revenue raising measures--such as the tariff reform--and thereby reduce the fiscal deficit from 23 percent of GDP in 1985/86 to 15 percent of projected GDP in 1986/87, while at the same time improving the structure of the budget. The authorities were urged to implement budget restraint without any slippage. Directors expressed the view that the improved budget position formed a good basis upon which a comprehensive adjustment program could be built. However, Directors emphasized the need for additional measures over a broad front--including exchange rates, interest rates, pricing, monetary and credit policies--and the proper setting of priorities in the public investment program.

Directors stressed the importance of continuing to make flexible price adjustments to remove relative price distortions in order to encourage a vigorous supply response, particularly in the agricultural sector. Directors also stressed the vital importance of adequate and speedy adjustments in energy prices in order to limit the growth of domestic energy consumption, improve the budget and the export performance, and to attain a better allocation of resources. They noted that in spite of the recent price increases, energy prices remained well below world market levels.

In this regard, Directors welcomed the progress made between the Egyptian authorities and the World Bank in their discussions on the size of and the timetable for increases in petroleum product and agricultural producer prices, and in reduction of subsidies on agricultural inputs over the next three years. Directors welcomed the steps toward privatization of public enterprises as well as the managerial and financial reform of these enterprises, with a view to improving their efficiency. Greater price flexibility was seen to be an integral part of that reform. Directors, noting that the recommended price adjustments would have an adverse impact on the living standards of the poorer section of the population, recommended that ways be found to shield the low-income earners.

A number of Directors stressed that a further sharp reduction in the budget deficit was called for in the near future, at least to a level that would obviate the need for domestic bank financing, as was envisaged in the original 1986/87 budget. In particular, it was noted that greater transparency of subsidies would facilitate financial management. Furthermore, there was a need to introduce further fiscal measures to increase elasticity of revenue and reduce the reliance of budget revenue on foreign transactions which had introduced an element of volatility in such receipts. Directors stressed that the recent decline in public investment spending in real terms and the projected financing constraints called for a critical review of investment priorities, along the lines recommended by the World Bank.

On the exchange system, Directors welcomed the elimination of one of the official exchange rates. However, the continuing overvaluation of the central bank and commercial bank rates perpetuated the bias against the tradable goods sector and aggravated the pressures on the balance of payments. Directors urged a speedy unification of all exchange markets into one rate, to be then managed in a flexible manner. While some Directors agreed with the authorities' path and timing of exchange rate unification, most Directors believed that the proposed time frame for unification could be shortened significantly. Directors also expressed concern over the accumulation of large external payments arrears and called for progress in their elimination in a nondiscriminatory manner.

Directors emphasized that underpinning the exchange, pricing, and fiscal measures should be tight credit and monetary policies. While a few Directors agreed with the authorities' approach to interest rates, the weight of the views expressed on this issue in the Board today was to urge the authorities to raise interest rates promptly to positive levels in real terms in order to encourage savings, to promote the efficient allocation of investment resources, and above all to encourage the holding of assets in Egyptian pounds and the repatriation of Egyptian capital from abroad and thus stem the increased dollarization of the economy. Also, Directors encouraged the authorities to review the structure of interest rates as well as the efficiency of the current credit control instruments.

Finally, Directors underlined their awareness of the complexity of the tasks facing the Egyptian authorities. Sympathy was expressed with respect to the difficult social and political problems faced by the people of Egypt. The precipitous decline in the world price of oil since late 1985 and its adverse impact on the labor importing countries of the region had added to the precariousness of Egypt's external position. However, it was noted that favorable developments in these external factors in the preceding period had not been accompanied by an improvement in the basic structure and productive base of the Egyptian economy. Thus, Directors felt that because of the underlying imbalances and misallocation of resources in the economy and the unlikely prospects for a sharp reversal in the external environment in the near future, a comprehensive and timely approach to adjustment was called for, and they encouraged the authorities to pursue their recent commendable efforts toward this end with vigor and urgency. Directors encouraged the authorities to submit a program--fully articulated as regards its substance and timetable--that could be supported by the use of Fund resources and that would attract other needed assistance from the international financial community, including rescheduling of external public debt, in order to close the large financing gaps that had been forecast. In this connection, Directors believed that the World Bank would need to play a major role in providing policy analysis and advice as well as financial support.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the Arab Republic of Egypt's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1986 Article XIV consultation with Egypt, in the light of the 1986 Article IV consultation with Egypt conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

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

Decision No. 8415-(86/165), adopted
October 6, 1986

APPROVED: June 11, 1987

LEO VAN HOUTVEN
Secretary