NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/122

10:00 a.m., August 7, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
	H. G. Schneider
B. de Maulde	
	M. B. Chatah, Temporary
H. Fujino	
	B. Goos
J. E. Ismael	Jaafar A.
R. K. Joyce	
	J. Hospedales, Temporary
H. Lundstrom	H. Fugmann
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
	J. de la Herrán, Temporary
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	
	T. A. Clark
S. Zecchini	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

S. Hamed, Minister of Economy and Finance of Egypt; Aly Negm, Governor of the Central Bank of Egypt; A. H. Ali, Commercial Minister, Embassy of Egypt. IBRD: S. Moini, Europe, Middle East and North Africa Regional Office. Central Banking Department: C. Lindgren. Exchange and Trade Relations Department: J. T. Boorman, Y. Boutros-Ghali, P. J. Quirk. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: C. A. Sisson. Legal Department: J. V. Surr. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; F. Drees, M. A. El-Erian, S. H. Hitti, B. A. Karamali, K. Nashashibi, B. K. Short, S. M. Thakur, G. Tomasson, A. Yahie, M. Zavadjil. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, D. Hammann, G. W. K. Pickering, A. Steinberg, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: R. Fox, V. Govindarajan, O. Isleifsson, A. R. Ismael, Z. b. Ismail, H. Kobayashi, M. Lundsager, K. Murakami, J. K. Orleans-Lindsay, J. E. Rodríguez, C. A. Salinas, M. Sarenac, L. Tornetta, A. Yasseri.

1. ARAB REPUBLIC OF EGYPT - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with the Arab Republic of Egypt together with a proposed decision concluding the 1985 Article XIV consultation (SM/85/177, 6/24/85; and Sup. 1, 8/5/85). They also had before them a report on recent economic developments in Egypt (SM/85/198, 7/10/85).

Also present were Mr. Salah Hamed, Minister of Finance of Egypt; Mr. Aly Negm, Governor of the Central Bank of Egypt; and Mr. Abdel Halim Ali, Commercial Minister, Embassy of Egypt in Washington, D.C.

The Acting Chairman expressed his regret that there had been a leak to the press of the staff report on Egypt. The Fund attached considerable importance to the confidentiality of its relationship with member countries and therefore the disclosure gave cause for concern.

Mr. Hamed said that the present discussion was taking place at a time when the international economic and financial environment was characterized by serious difficulties. Although world inflation had subsided and recovery had proceeded as expected, and many difficulties continued to pose serious challenges to governments and international institutions. Rising protectionism, continuing high real interest rates, and misalignment and volatility of exchange rates threatened the world trading and monetary system and greatly complicated the adjustment process. In the case of Egypt, the recent decline in oil prices and in the inflow of workers' remittances had rendered more difficult the task of economic and financial management. The gradual transformation of the Egyptian economy from a system of controls to a more liberal environment was a long and difficult process. The authorities were committed to that course, over which they had already traveled a long distance.

During their discussion of the 1984 Article IV consultation on July 6, 1984 (EBM/84/103), Executive Directors had expressed concern that the balance of payments and external debt positions would weaken in the absence of a comprehensive adjustment effort formulated within a medium-term framework, Mr. Hamed recalled. It was felt that efforts should be directed at structural as well as financial imbalances in three broad areas: distortion in relative prices, fiscal and monetary policies, and management of the external sector. In all three areas significant progress had been made since the previous discussion.

With respect to distortion in relative prices, Mr. Hamed continued, the authorities agreed with the Fund and World Bank on the impact of pricing policies on the Egyptian economy. The need for realigning domestic prices with international levels was recognized, and the authorities were not oblivious to the waste involved in the present situation, nor did they underestimate the detrimental impact on incentives and resource allocation. For the past three years, the Government had been actively pursuing a policy to rectify the situation. In 1984, procurement prices of cotton, rice, and sugarcane had been raised by 20-30 percent. For industrial products, prices had been allowed to move to levels that would ensure a reasonable rate of return on investment. Public sector companies had been authorized to charge prices in line with costs. Those changes had served to strengthen producers' incentives and to reduce somewhat the gap between domestic and international prices. As a side effect, the changes had generated additional revenue equivalent to LE 534 million in fiscal year 1984/85, equivalent to 9 percent of the gross sales of the industrial sector.

The same policy had been applied to consumer goods as well as to public services with the aim of both bringing prices and tariffs more in line with costs and reducing the burden of subsidies, Mr. Hamed said. Thus, by effectively raising the price of bread, the amount of subsidies had been reduced by LE 300 million in 1984/85--a decision that had been politically difficult but that was proof of the authorities' resolve in the pricing area. Prices and tariffs had also been raised for many consumer products and public services, including meat, poultry, edible oils, sugar, and rice, as well as transportation, telecommunications, water, and electricity. That process would continue in the current fiscal year.

In the energy sector, which was particularly important in view of its impact on export potential, the authorities were applying a two-track policy, Mr. Hamed explained. The first was through significant and successive price adjustments, as in the case of electricity tariffs as well as gasoline and other petroleum product prices. The second was through the implementation of conservation policies involving the substitution of natural gas, which was relatively abundant, for other forms of energy. The authorities were mindful of their commitment to adjust energy prices gradually toward international levels and to eliminate waste in the use of scarce resources.

Changes in relative prices raised the question of investment priorities, Mr. Hamed noted. The staff report stressed the need to refine priorities in public investment so that only the most essential and quickest-yielding projects would be carried through in the next few years. The authorities' policy was basically in line with that view. The current five-year plan recognized the crucial role of the productive sector. In industry, priority was being given to completing projects in the major import-substitution industries, such as cement, steel, and fertilizers. Greater attention was being given to the development of tourism potential, the fuller utilization of existing capacity, and the promotion of export-oriented industries. In that context, the Export Development Bank and the Tourism Development Council had recently been established.

In line with government policy of attaining economic growth with stability, various fiscal policy measures had been taken to reduce the budget deficit, Mr. Hamed commented. During 1984/85, better tax collection--totaling LE 250 million--increased receipts from customs duties following a reduction in the scope of exemptions--LE 700 million--and higher transfers to the Treasury from the Petroleum Corporation as a result of the rise in the prices of oil products--LE 700 million--had improved the revenue picture. The 1985/86 budget contained further measures that would increase revenue by LE 1.6 billion. On the expenditure side, subsidies were reduced by about LE 600 million. Moreover, tighter controls were exerted on the growth of public expenditure through a cut in current expenses by 15 percent and the elimination of guaranteed employment of graduates in public service. As a consequence, the budget deficit was projected to be reduced from LE 5.4 billion in 1984/85 to LE 4.9 billion in 1985/86, and domestic bank financing from LE 1.2 billion to LE 0.9 billion.

The growth rate of money supply had been steadily reduced from 44 percent in 1981/82 to 17 percent in the 12 months ended March 1985, Mr. Hamed continued. Monetary and credit policies had been successful in decelerating the rate of monetary expansion, thereby assisting in containing inflationary pressures. Indeed, the rate of increase in the consumer price index had declined from 20 percent a year to a range of 12-14 percent in the first half of 1985. Those developments, together with the recent declines in interest rates on dollar deposits, had served to narrow the gap between the rate of returns on savings in local and foreign currencies. In that context, it should be noted that in Egypt interest on deposits was exempt from income tax, the rate of which amounted to about 40 percent. Thus, an average interest rate of about 13 percent was equivalent to a pretax rate of about 21.6 percent, which was significantly higher than the current inflation rate. It should also be noted that interest was a cost, and an increase could be a barrier to investment.

The authorities were aware of shortcomings in the foreign exchange system, Mr. Hamed said. They agreed with the staff that the ultimate objective was unification of the various exchange rates into a flexible rate reflecting market conditions. Indeed, even though the problem was complex, developments as of April 1985 indicated that the authorities were moving in the right direction. The gap between the free market rate and the commercial bank rate had been reduced; there was currently greater flexibility in determining the premium; and finally, more products were being imported at more realistic exchange rates. The situation was being closely monitored with a view to moving toward the ultimate goal.

With respect to external debt, the staff report referred to three issues: improvement in statistical coverage, resolution of external payments arrears, and greater caution in contracting additional external debt, Mr. Hamed remarked. He was pleased to announce that progress had been made on all three fronts. Fund assistance was being provided to help to improve the efficiency of statistical coverage. The matter of payments arrears was receiving the most careful attention. As to the contraction of new external debt, a committee, with membership consisting of Ministers and the Governor of the Central Bank, had recently been established. The approval of the committee must henceforth be obtained prior to the contraction of any new debt; furthermore, new borrowing would be limited, as a matter of policy, to essential external finance requirements. The committee would centralize all external debt operations in a single body within the Central Bank and would supervise the computerization of the data base.

The external debt figures mentioned in the staff report were higher than those calculated by the Egyptian officials, Mr. Hamed added. As those figures remained to be verified, the authorities would have preferred to delay their publication. In addition, his Government had been dismayed by the recent leak to the press of the Fund's report on Egypt. Such leaks could damage a country's creditworthiness; they would only serve to reduce the good cooperation Egypt had had with the Fund, and make it more difficult to carry out economic reform. He therefore urged the Fund to take all possible steps to prevent a recurrence of such incidents.

During the ten-year period 1975-84, the Egyptian economy had been able to achieve a rate of growth averaging about 7.6 percent a year in real terms, Mr. Hamed observed. Such a rate of growth was among the highest for developing countries and was exceeded by only a few countries. Even if that rate had perhaps slowed down during the past two years, Egypt's performance was nevertheless remarkable during a period of great difficulties and turbulence in the world economy. Apparently, concern about the performance of the Egyptian economy was related more to its prospects than to the past.

The staff projected a serious deterioration over the medium term, with the financing gap jumping from $1 billion in 1984/85 to $2.6 billion in 1985/86, Mr. Hamed continued. In the years 1986/87-1989/90, the staff projected financing gaps averaging $3 billion a year. In his view, those projections were highly questionable. His authorities realized, of course, the uncertainties surrounding oil prices and workers' remittances, but the decline in those receipts could be compensated by other income. The staff projections were based on rather pessimistic assumptions with respect to export and import growth, capital flows, and the growth of external debt. It was of course possible to envisage a combination of adverse circumstances for every variable, but such a likelihood was remote. However, due account should be taken of recent policies on export promotion and on import substitution of major items such as cement, steel, fertilizers, and edible oils. Account should also be taken of oil and gas exploration, energy conservation, tourism development, price adjustments, and control over debt growth. When those developments were taken into account, the projected financing gap appeared exaggerated.

The authorities were not complacent about past performance or about prospects, Mr. Hamed commented; they believed that there was certainly a wide scope for improvement. But the adjustment effort during the past three years had not been insignificant. The staff report stated that:

> Less favorable external developments for Egypt's main sources of foreign exchange brought the balance of payments under pressure

> in 1983/84. This, in turn, increased awareness of the authorities that the structural weaknesses of the economy had to be resolutely tackled. As a result, greater flexibility has been introduced in pricing policy at both producer and consumer levels, electricity tariffs and the prices of several petroleum products have been raised within the context of an energy policy which is being formulated. At the same time, the least expensive loaf of bread has gradually been replaced by an improved loaf at twice the price.... Efforts have also been made to increase budget revenue and contain public expenditure and, since 1984 greater realism has been introduced in exchange rate policy through flexibility in the premium exchange rate. The authorities should be commended for these new policies that represent a substantial turnaround from the rigid pricing policies of the past.

The Egyptian authorities appreciated that fair and balanced assessment by the staff; they would have been more appreciative if it had been reflected in the staff appraisal. Unfortunately, it was not. According to the staff, that adjustment effort was not enough; it had been limited in scope and not sufficiently coordinated with other policy areas. However, the effort would have received a more favorable appraisal if sufficient weight had been given to the great social and political constraints with which the policymakers were faced and that were too well known to warrant elaboration. It sufficed to say that political stability and social equity, both real and perceived, were the sine qua non of sustained adjustment.

Mr. de Maulde stated that one of the features of the staff report he appreciated most was the concrete evidence it gave of close and integrated cooperation with the World Bank. Such evidence was to be found, in particular, in the description in the staff report of the policy discussion on production, investment, and prices, as well as in Appendix V, in which the Bank's views and programs concerning Egypt were spelled out. That joint approach appeared particularly warranted in the present case where supply-side problems were at least as acute as those on the demand side.

Egypt's overall situation had become extremely difficult, as acknowledged by the authorities, Mr. de Maulde remarked. To date, the economy had been shored up by receipts from oil exports, remittances from expatriate workers, and considerable amounts of foreign aid. But at the same time, the development of productive capacity had slowed down and become unbalanced through the various distortions maintained by inappropriate pricing policies, an overvaluated and complex exchange regime, inadequate investment strategies, and excessive bureaucracy. The situation in the agricultural sector had become even worse than in the rest of the economy. Furthermore, in spite of the importance of foreign aid, Egypt had been unable to avoid a growing external debt, which currently amounted to approximately 100 percent of its GNP. As a result, the country was facing two different possible crises: external arrears had already begun to accumulate and in the medium term, a gap would grow between the increase in population and the poor performances of the productive sector.

The various measures implemented by the authorities in recent months went in the right direction and demonstrated that they had become conscious of the acuteness of the present situation, Mr. de Maulde remarked. Nevertheless, the measures appeared well below what would be needed to reverse the course of events. In particular, it was hard to imagine how the balance of payments gap, forecast by the staff to reach some $3 billion, could be closed under the present policies. Although that forecast was disputed by the authorities, it was acceptable to him as a working hypothesis, as it was always wiser to err on the safe side. He therefore supported the staff's recommendation that a major comprehensive adjustment effort was urgently needed, combining the restoration of basic financial equilibria with forward-looking measures aimed at rehabilitating the supply side of the economy.

Priority should clearly be given to increasing non-oil export receipts, Mr. de Maulde stated. That action would call for an active exchange rate policy, in addition to phasing out the current multiple exchange rate practices; it also implied decisive action in the field of prices, with particular emphasis on agricultural products.

Over the medium term, Mr. de Maulde continued, the International Finance Corporation (IFC) could play an important role in helping Egypt to redirect its efforts toward the productive sector. Egypt had a comparative advantage in labor-intensive industries; the IFC could help to catalyze investment in that sector. He wondered if a comment could be made by the World Bank representative to describe current IFC investment projects in Egypt.

The indication in the staff report that "at the request of the Egyptian authorities, initial discussions were conducted on a program of adjustment that could be supported by use of Fund resources" was welcome, Mr. de Maulde said. Such a program was overdue, and he looked forward to its finalization and approval by the Board in the near future. The World Bank's associated financing would add to its effectiveness.

Finally, Appendix IV of the staff report had described the inadequacy of existing statistical data in Egypt, Mr. de Maulde concluded; a determined effort in that field was a precondition for the success of future policies.

Mr. Dallara recalled that during the Board's discussion of the 1984 Article IV consultation with Egypt, several beneficial external developments had been noted. Unfortunately, many of those developments had proved to be temporary, and the balance of payments position and prospects had deteriorated, as shown most clearly by the emergence of an estimated

$1 billion in external arrears. The projected balance of payments financing gap for fiscal year 1985/86 of $2.6 billion was cause for serious concern.

In recognition of the worsening external situation and of the need to address internal imbalances and distortions, the authorities had taken a number of positive measures during the past two years, Mr. Dallara remarked. He had paid particular attention to the comment by Mr. Hamed that he fully agreed with the staff's assessment of the adverse effects of past pricing policies and the importance of removing price distortions if a basis were to be established for medium-term growth.

The measures that had been taken by the Egyptian authorities were welcome, Mr. Dallara said. Those steps would provide the basis for an adjustment program and, as the Minister had stated, "had not been insignificant." He noted in particular the various price increases for petroleum and agricultural products, bread, industrial goods, and electricity; the privatization of bus service in Cairo; the abolition of employment guarantees for college graduates--a problem in a number of member countries that was not easy to deal with; and efforts, though not particularly successful at present, at exchange rate reform. Notwithstanding those and other measures, both the short-term and medium-term outlooks, particularly for Egypt's balance of payments, were not encouraging.

The medium-term projections provided by the staff were cause for serious concern, Mr. Dallara commented. They suggested that in the absence of a more accelerated comprehensive adjustment program, a balance of payments financing gap of the order of $4 billion could emerge by the end of the decade. Mr. Hamed had commented that the Egyptian authorities did not fully share the pessimism implied in those projections as they did not fully take account of current and prospective policy changes. In that connection, he asked the staff to explain why it had stated in Section IV on medium-term prospects that the medium-term scenario was based on the present pace of policy implementation while, in Appendix III, it was stated that "the basic scenario assumes that the present stance of policies, including the adoption of the measures proposed in the 1985/86 budget, is maintained."

While he appreciated the difficulties of projecting not only various economic assumptions but also the policy steps that could be taken in the future, it was unclear whether additional policy steps beyond those embodied in the 1985/86 budget--for example, additional pricing steps--had been incorporated into the medium-term scenario, Mr. Dallara went on. The authorities had indicated a progression of policy measures that extended into that time period and could have some bearing on the difference of views expressed by Mr. Hamed with regard to the medium-term projections. Mr. Hamed had noted, in particular, prospects for domestic production of various products--cement, steel, and fertilizers--that would reduce import needs, a strategy that emphasized import substitution and not necessarily export promotion. He wondered whether that was the basic strategy of the authorities at the present stage, what the staff's view was, and whether the Egyptian economy was perceived as having a comparative advantage in each of those products.

On the medium-term outlook, Mr. Dallara continued, even after adjusting downward by 30 percent the projected financing gap for 1989/90 given in Table 5 of the staff report to take account of the points made by Mr. Hamed, there remained a serious financing gap and an unsustainable external position. The measures outlined and currently contemplated were not commensurate with the magnitude of the problem facing the Egyptian economy. He agreed with the staff that in light of the payments difficulties, more far-reaching measures covering all policy areas and sustained over a number of years should be implemented. Mr. Hamed had acknowledged that there was wide scope for improvement, and he agreed.

The prices of many important products remained significantly subsidized, Mr. Dallara commented. The authorities had indicated that they would continue to adjust prices, a welcome commitment since many remained substantially below international levels. The inadequacy of agricultural producer prices, in spite of the changes that had been made, was indicated, for example, by the large reversal of the agricultural trade balance of Egypt from surpluses averaging about $300 million in the early 1970s to deficits averaging over $2 billion in the present decade. Enhanced domestic agricultural production, stimulated by more market-determined pricing measures, could help significantly to reduce the projected medium-term financing gap.

Increased producer prices should be accompanied by more rationally determined domestic demand, implying adjustment in retail prices as well, Mr. Dallara added. While he understood the associated difficulties and the need in certain areas to move with caution, he nevertheless strongly urged the authorities to continue to accelerate where possible the measures they had begun to take during the past year. Without those price adjustments, consumers in Egypt would continue their historic pattern of consumption, which had not contributed to an efficient use of Egypt's productive base or externally provided resources.

Pricing adjustments were also clearly necessary for fiscal reasons, Mr. Dallara remarked. Even if the deficit, excluding grants, were about 15 percent of GDP in 1984/85, as projected by the authorities, it remained too high. The staff had expressed concern regarding the attainability of that fiscal projection and the current year's target as well. According to the staff report, direct government subsidies to producers and consumers were estimated at 7 percent of GDP in 1984 while implicit subsidies on petroleum equaled about 13 percent of GDP. A lasting resolution of the fiscal problem would require reductions in expenditures relating to subsidies. The Egyptian authorities were legitimately concerned about the impact on the cost of living of potential price changes, and thus had been reluctant to increase certain producer and consumer prices rapidly. Nevertheless, without improved producer incentives, and given the restraints increasingly affecting the economy through the external position, shortages could easily materialize in the future--a development that clearly could have not only short-term but medium-term adverse effects on living standards.

The projected increase in the wage bill for 1984/85 of only 9 percent was a positive step, and strict adherence to that target would be especially welcome, given the concern about the fiscal situation, Mr. Dallara commented. As the inflation rate was expected to amount to 12-13 percent, the wage bill implied some containment of fiscal sector employment, and he would appreciate further information on that point. The measures described in Supplement 1 to the staff report emphasized revenue enhancement, notably through better implementation of the tariff system. While improved efficiency in the operation of the revenue system would be welcome, a much more extensive effort should be made to contain expenditure, as revenues still exceeded 30 percent of GDP, although they had fallen significantly in the past few years.

He wondered whether the authorities were planning broad reforms in the public enterprise sector, Mr. Dallara said, and whether the World Bank study on the sector would include recommendations for divestiture and privatization of viable enterprises.

He agreed with the staff that an increase in interest rates on deposits in local currency could be helpful, Mr. Dallara stated. Otherwise, monetary management would remain difficult, given the large amounts of foreign currency deposits currently held by Egyptian residents.

The balance of payments situation in the medium term argued most strongly for the adoption of a broadly based adjustment program, Mr. Dallara observed. Some of the inflows over the past few years, including workers' remittances, could not be counted on for ever, and actions at the present stage would help to avoid an extremely dire payments position in the late 1980s.

Exchange rate adjustment was important, Mr. Dallara considered; with the free market rate still far above the official and the commercial bank rates, either adjustment of the two rates or transfer of more items from the official market to the commercial bank pool, and from there to the free market, was urgently required to attain the necessary eventual unification.

The authorities had been disappointed that direct investment in Egypt had generally led to production for the domestic market rather than for export, Mr. Dallara noted. Such a development was related both to the inappropriate exchange rate structure in the economy that had limited profitability in the export sector and to pricing considerations.

In sum, Mr. Dallara concluded, Egypt's deeply rooted structural problems required a far-reaching and comprehensive adjustment effort if the considerable vitality and potential of the economy were to be realized. The authorities had taken a number of important and commendable steps in recent years in that direction; but since they had been put into effect, the external environment had worsened, and the distortions resulting from earlier policies were clearly evident in the economy. For those reasons, additional measures should be taken by the authorities as soon as possible, so that orderly and sustained adjustment could take place to support continued growth and to move the economy toward a viable medium-term payments position. Finally, he supported the proposed decision.

Mr. Ismael said that he was in general agreement with the staff appraisal and supported the proposed decision. The authorities were to be commended for introducing flexible policies to tackle the structural weaknesses of the economy, a substantial turnaround from the rigid pricing policies of the past. However, the economy was still beset with widespread cost distortions, resource misallocations, and inefficiencies in production and trade; and unless further policy changes were forthcoming, the medium-term external position would deteriorate significantly, constraining the country's ability to maintain high rates of economic growth. Much remained to be done, and he hoped that a vigorous effort would be made to implement the staff's policy recommendations.

The various adjustments made in the procurement prices of a number of crops in 1984/85 were also commendable, Mr. Ismael continued. The removal of relative price distortions was a key element in the adjustment effort if resource allocation was to be improved and the budgetary burden reduced. The authorities' commitment to flexibility in 1985/86 was welcome, but he agreed with the staff that the authorities' approach of raising prices through product differentiation and market segmentation was too gradual to redress distortions quickly enough to halt the deterioration in the budget and balance of payments in the absence of other substantial measures. Thus, a more pragmatic approach needed to be adopted to alleviate the effects of subsidies on the budget and to reduce their distorting impact on production and saving while improving the targeting of subsidies to the lower-income families by limiting them to a few essentials.

It was disappointing that fiscal policy had remained expansionary despite measures taken to raise revenues, increase administered prices, and constrain public expenditures, Mr. Ismael commented. A substantial reduction in the fiscal deficit was necessary; various measures had been introduced by the authorities, but offers were needed to ensure a lasting improvement in the structure of public finances and bring the fiscal position under control. There was a need to introduce greater elasticity in government revenues, and the staff's recommendations to convert specific excises to ad valorem taxes and to introduce a broadly based manufacturers' sales tax merited consideration by the authorities. He welcomed the information that the staff's recommendations concerning customs duties and exemptions had been implemented, resulting in an increase of LE 700 million in customs receipts. On the expenditure side, in addition to reducing subsidies for nonessentials, it would be desirable to slow down the growth of public sector employment, to limit all government spending to the amounts initially allocated in the budget, and to reinforce expenditure-control procedures. He was pleased to note that the authorities were carefully examining the recommendations of the World Bank staff on investment strategy and that they planned to examine the World Bank report on the management of public sector enterprises, which was expected to be ready at the end of the year.

The high rate of credit expansion to the Government and the public sector was cause for concern, Mr. Ismael remarked, and should be reduced significantly to avoid worsening considerably the balance of payments position and inflationary pressures. Implementation of the staff's recommendation to increase interest rates on deposits and loans to positive real levels so as to increase savings, shift liquidity preferences toward domestic currency, allocate credit efficiently, and support the exchange rate was long overdue. It was encouraging that interest rate policy was under active review by the authorities.

The projected deterioration in the 1984/85 current account and the overall balance of payments, after having improved in the past three years, was also cause for concern, Mr. Ismael noted. The staff's medium-term projections portrayed a serious deterioration in the balance of payments, with a financing gap of $2.6 billion in 1985/86 and $3 billion a year on average in the period 1986/87-1989/90. To close the external financing gaps, the authorities would need not only to adopt promptly a strong adjustment package that would be sustained over the years but also to rely on the cooperative and active participation of Egypt's donors and external creditors.

It was disappointing that the exchange reform introduced in January 1985 had had to be rescinded in April, Mr. Ismael commented. That action reflected not only the overvalued exchange rates but also the complexity of the exchange rate system. He therefore endorsed the staff's recommendation to fully unify the various exchange rates into a single and flexible exchange rate, coupled with a reduction of exchange and trade restrictions, as the most effective way to reduce the existing inefficiencies in the exchange system. The authorities should draw up a timetable for unifying the exchange rates and adhere to that schedule.

Given the size of its outstanding debt and its servicing burden, Egypt must exert the utmost caution before contracting additional debt, Mr. Ismael concluded.

Mr. Goos noted that while there were significant differences of view between the Egyptian authorities and the staff on Egypt's economic prospects and some other issues, he was inclined to agree with the thrust of the staff's assessment of Egypt's economic situation, as well as with the staff's recommendations. He also supported the proposed decision.

The staff report provided ample evidence that recent policies had led the country into serious economic problems, which threatened to become unmanageable unless there was a comprehensive reorientation of the present policy stance, Mr. Goos stated. Although such a reorientation was already taking place to some extent, as indicated by the more active fiscal and pricing policies introduced in 1984/85, the measures taken fell considerably short of requirements, as illustrated by the fact that the main concerns and recommendations in the staff reports were virtually identical with the views expressed by the Board during the discussion of the 1984 Article IV consultation. Furthermore, the unsustainability of the present policy stance was demonstrated by the disquieting outlook of the medium-term scenario and by Appendix V describing the World Bank view of the Egyptian economy. The authorities did not share the assessment underlying the scenario, but he advocated erring on the safe side as the appropriate course of action in the circumstances of Egypt.

It was disappointing that the authorities remained reluctant to adopt the main policy reforms urged by the staff, in particular those affecting interest rate and exchange rate policies, Mr. Goos commented. His concerns in that regard had not been completely assuaged by the Minister's statement. The authorities, to be sure, intended to review their policies in important areas, and some of the staff's recommendations were apparently under active consideration. However, the deteriorating economic situation required an immediate and decisive stabilization effort. Any delay, or recourse to further regulatory measures such as the "rationalization of imports," would worsen the situation and increase the eventual adjustment burden.

The authorities had introduced courageous and imaginative steps to reduce domestic price distortions and subsidies, Mr. Goos noted, and he welcomed their intention to move further in that direction. However, he wondered whether a quicker pace of adjustment of consumer and procurement prices would not be more appropriate. On the basis of current plans, and in line with the recommendations of the World Bank, it would take eight years to adjust prices of petroleum products to world market levels. He asked the staff or the World Bank representative to explain the rationale for such a slow pace of adjustment and how it was consistent with the urgent need for corrective action. The staff had noted that "pricing measures as well as the substitution of natural gas for petroleum products were, over the short term, the most promising measure to increase export receipts." In view of the difficult balance of payments situation, the authorities should take such measures with the shortest possible delay, especially in view of the staff's more general assessment that the response of the external accounts to policy action was likely to be slow. Pricing policies were a particularly sensitive subject, given the country's painful experience in that area, and he appreciated the authorities' concerns about the impact of pricing measures on the purchasing power of the poor and possible public resistance to such measures. He welcomed the staff's explicit attention to that issue in the paper and supported its position of insisting on the removal of relative price distortions as a key element of adjustment while proposing "better targeting of subsidies and limiting them to a few essentials."

The possible use of Fund resources had been mentioned in the staff report, Mr. Goos observed. The staff had rightly stressed the urgent need for an adjustment effort that would give donors, creditors, and foreign investors confidence that the structural weaknesses of the balance of payments were being successfully tackled. Clearly, the Fund must also be confident in that respect as a prerequisite for engaging in a credit arrangement. Inasmuch as the present policy stance did not appear to meet that requirement, the Fund should insist on the adoption of policies along the lines of the staff appraisal and on clear indications that concrete steps would be taken before considering a request for a stand-by arrangement. Another prerequisite, of course, would be the elimination of current external payments arrears, consistent with the Fund's established policies.

Mr. Alfidja remarked that Egypt's economic growth during the past few years had been remarkable. Substantial foreign exchange inflows in the form of oil export receipts, Suez Canal dues, workers' remittances, and foreign aid had contributed to such a performance. Unfortunately, in 1983/84, the decline in those inflows had brought to light the vulnerability of the external position, with the balance of payments experiencing increasing pressure. Against that background, the measures implemented since 1982/83 to deal with the economic and financial problems that had emerged were welcome.

The authorities had shown flexibility by raising the prices of several items at producer and consumer levels, Mr. Alfidja noted. The price of an important basic food item--bread--had been gradually raised and the quality improved. The authorities were to be commended for taking those courageous steps.

It was encouraging that the 1985/86 budget aimed at a further reduction in the overall deficit through revenue-raising and expenditure-containment measures, Mr. Alfidja observed. In view of the declining share of government revenue relative to GDP, there seemed to be some room for a further increase in revenue. He endorsed the staff recommendation urging the authorities to introduce greater elasticity in government revenue, and he welcomed the review of the tariff structure being undertaken with Fund technical assistance. He wondered whether that review, as well as the staff's recommended tax changes, would be reflected in the 1986/87 budget. There were positive indications that the authorities were moving in the right direction to restrain the rate of growth of expenditure as evidenced by the reduction in capital outlays and some subsidies. Such restraint, together with tighter expenditure control procedures, would help to achieve a fiscal position that relied less on credit from the banking system.

The Egyptian authorities had made welcome attempts to improve the efficiency of the exchange system, Mr. Alfidja remarked. The recent reinforcement of the Export Promotion Center and the establishment of an Export Development Bank in close collaboration with the World Bank testified to the authorities' resolve to strengthen the external position through export promotion and ultimately to minimize the need for exchange restrictions. The authorities' intention to correct the shortcomings of the present exchange system was welcome.

The authorities should pay particular attention to the improvement of data on external debt, Mr. Alfidja urged. A timetable for an orderly settlement of external payments arrears would indicate to creditors and donors that serious steps were being taken to tackle the external debt situation.

The pace of adjustment in Egypt might appear to be rather slow, Mr. Alfidja commented, and the unfortunate impression might have been created that the authorities were not showing sufficient commitment to stronger measures in the context of a comprehensive adjustment program. But it was appropriate to weigh such criticism carefully in the light of the Egyptian authorities' past experience with policies calling for the speedy restructuring of relative prices and the reduction or elimination of food subsidies. Recent experience in other African countries, where rapid economic and financial changes had led to serious social and political consequences, were no doubt guiding the Egyptian authorities to move cautiously and gradually. Their present stance was understandable, as they needed to win the confidence and understanding of the people before they could proceed further.

Mr. Nimatallah said that he was in broad agreement with the staff appraisal and supported the proposed decision. Egypt's economy had suffered from large and widespread structural weaknesses that had been made more serious by the downturn in external revenues--particularly in workers' remittances and Suez Canal revenues. Recognizing those difficulties, the authorities had taken commendable corrective steps. They had embarked on a set of firm adjustment measures, including in 1984 the reduction of price rigidities. In the public sector industries, for example, prices had been raised by an average of 9 percent; that action had started a process of improving resource allocation and reducing the burden on the budget. Increases of 20-30 percent in procurement prices for major crops had resulted in a larger cultivated area for those crops. It was also encouraging that electricity rates and petroleum-product prices had been raised in the past fiscal year, with further increases planned for 1985/86. However, more active pricing policies were needed in the period ahead. He therefore encouraged the authorities to continue their efforts to reduce price rigidities. That policy should be combined with measures to reduce the rigidities in government procedures so as to encourage private business and new investment.

The authorities must recognize that the fiscal deficit was large and structural in nature, Mr. Nimatallah stated, and there was an urgent need to reduce that deficit. Measures had been taken in 1984/85 to reduce the deficit relative to GDP, and additional steps would be taken in 1985/86 to cut both the size of the deficit and its financing by domestic banks. While those intensified efforts to reduce were welcome, it would be prudent for the authorities to design contingency measures that could be implemented in case the reduction in the budget deficit was not fully realized.

Fiscal restraint should be complemented by more determined steps to control credit, Mr. Nimatallah continued. The authorities had managed to slow the growth of bank credit to the public sector, and thereby the growth of money, from 44 percent in 1981/82 to 20 percent a year at present. That development should help to contain inflationary pressures, strengthen the Egyptian pound, and encourage savings. However, more action was needed to reduce complexities in monetary management aimed at gaining better control of inflation.

The Egyptian authorities' commitment to the unification of the exchange rate system was welcome, Mr. Nimatallah said. A more flexible exchange rate policy would help economic management and increase the efficiency of resource allocation. He looked forward to further progress toward exchange rate unification.

The Egyptian economy suffered from persistent structural weaknesses, Mr. Nimatallah concluded. The authorities had made commendable efforts to reduce those imbalances and had made a good start toward tackling Egypt's economic and financial problems, but a formidable task remained, and greater efforts were needed.

Mr. Clark observed that the Egyptian authorities had taken a number of corrective measures over the past year in the broad direction indicated by the Fund during previous Article IV consultations. The measures, although somewhat limited in scope, included action in some important and sensitive areas, notably the reduction in certain consumer subsidies and the increase in domestic oil and agricultural producer prices. That action was welcome, especially as it represented a departure from the rigid pricing policies of the past. However, those measures could only be regarded as a first step, in terms of the needs of both individual sectors--domestic prices for oil and agricultural products remained substantially below world levels--and the economy as a whole, in its current serious and deteriorating situation. He therefore strongly encouraged the authorities to intensify their efforts, especially if the outcome described in the staff's medium-term scenario, which seemed all too plausible, was to be avoided.

The staff appraisal listed the further policy actions judged necessary, including in the short term the simplification of the exchange system, increases in interest rates, and a tightening of credit policy, Mr. Clark continued; in the longer term, the introduction of more appropriate relative prices and an improvement in the fiscal position were called for. His authorities joined the World Bank in judging that program appropriate.

The rescinding of the January 1985 exchange rate system reforms was disappointing, Mr. Clark remarked, and the recent appreciation of the commercial bank premium exchange rate was also cause for regret. Given the reduction in the differential between that rate and the free market rate to less than 10 percent, and given the authorities' more active policy to introduce a greater realism to the premium rate, any move would have been expected to narrow rather than widen the differential. The weakening of the U.S. dollar might have been one factor underlying the adjustment. He wondered whether the staff or Mr. Hamed could provide further information. Meanwhile, radical simplification of the exchange system--for example, the elimination of controlled rates in both the commercial bank and central bank pools--would await the results of two detailed official studies. While policy in that area needed to be carefully analyzed and prepared, he wondered whether the staff could elaborate on any new aspects that had arisen since previous Article IV consultations that would be covered in those studies.

An improvement in competitiveness would be a much more efficient way of discouraging imports than the present preference for direct controls, Mr. Clark commented. Moreover, a more competitive exchange rate should also help to restore incentives and to encourage the growth of non-oil exports. He doubted whether exports would be greatly encouraged by a strengthening of the Export Promotion Center, which might increase the administrative burden on industry.

In contrast to the reduced deficit projected in the budget by the Egyptian authorities for 1985/86, the staff expected that the deficit would widen or, at best, hold steady, Mr. Clark observed. He wondered whether the staff still held the same view. In any event, there seemed to be a need for much firmer action on fiscal policy. Although the social and political constraints were well known, without such action the situation could deteriorate seriously and perhaps irretrievably.

There had been overreliance on trade taxes, Mr. Clark continued, and urgent measures were needed to broaden the tax base and to increase the elasticity of the tax system. The expenditure restraint of 1984/85 had been confined to subsidies, while other current spending, including wages and salaries, had risen by over 16 percent. The limitation of subsidies was an important achievement, but the difficulty of making progress in that area merely reinforced the importance of achieving restraint elsewhere, particularly in public sector wages. In that respect, the relatively modest increase in the public sector wage bill budgeted for 1985/86 was welcome.

The World Bank had urged a refining of public capital expenditure priorities, Mr. Clark noted. After a fall in 1984/85, capital spending was budgeted to increase in 1985/86. He invited the staff to comment on the magnitude of the economies that would follow if the Bank's recommendations, described in the staff report, were to be implemented in full.

Shortcomings in the quality of data hampered analysis of the economic situation, Mr. Clark said. There were particular problems concerning the data for the public enterprises, whose poor profitability had been a factor behind the large fiscal deficits of recent years, and for external debt. He could therefore support any request for further technical assistance in that area.

In sum, Mr. Clark concluded, while he recognized the constraints facing the Egyptian authorities, they nevertheless urgently needed to consider further action in a number of areas, especially prices and the exchange rate. The authorities should take that action promptly so as to realize the Egyptian economy's considerable potential.

Mr. Fujino commented that the economy of Egypt had experienced high real growth averaging 8.5 percent since the mid-1970s, which, by international standards, was a remarkable achievement. That high growth had been supported by the favorable turn of events accompanying the substantial increase in oil prices. The export of oil had increased nearly sevenfold, to $2.7 billion, in 1975-80, and remittances from workers in the neighboring oil producing countries had also recorded a corresponding sevenfold increase, to $2.7 billion, during the same period. Those favorable external developments should have provided the Egyptian economy with a timely opportunity to broaden and diversify the productive base of the economy. However, expansion had been concentrated more on various services sectors than on industry and agriculture, which had lagged behind the development of other sectors. The focus of investment seemed to have been directed toward capital-intensive industrial investment in the public sector, as well as infrastructure, commerce, and housing, resulting in a relatively poor performance in terms of profitability.

From a longer-run viewpoint, Mr. Fujino continued, replenishment of the infrastructure in a developing economy was an essential condition for the efficient and profitable operation of industry, and, if adequately programmed, it would have a highly beneficial impact on the economy. For example, the dredging and expansion of the Suez Canal, completed in late 1980, had directly contributed to the larger volume of cargo and the increase in revenue, in terms of foreign exchange, from $100 million in 1975 to close to $1 billion a year recently.

Egypt's failure to fully avail itself of the opportunity provided by favorable external developments was manifesting itself in high overall fiscal deficits and a substantial deterioration of the balance of payments, Mr. Fujino remarked. Faced with that situation, the authorities were actively implementing measures toward economic reform.

The difficulties facing the Egyptian economy called to mind the hardships experienced during the Japanese reconstruction period, Mr. Fujino said. To pull through the present difficult stage, drastic measures, such as those carried out by the Japanese authorities, would be important, particularly in the following areas: curtailment of expenditures, with strong emphasis on phasing out subsidies to the extent possible; introduction of broad-based revenue-increasing measures; appropriate incentives to raise productivity and induce private initiatives; and simplification of the exchange system and liberalization of trade restrictions. The magnitude of the imbalances called for extensive and drastic measures; however, he recognized that the adjustment period could be longer because of the difficulties involved.

The official estimate of an overall budget deficit of 14.9 percent of GDP was substantial by any standard, Mr. Fujino noted. The staff had stated that there was even a likelihood that that estimate was too low. The reduction of expenditure on subsidies by 13 percent was a welcome development, although part of that decline might have been accounted for by a rundown of inventories. The increase in current expenditure on goods and services of about 22 percent was high under the circumstances, and it would be important to contain current expenditure, including wages and salaries. In that respect, the moderate increase in the public sector wage bill in the 1985/86 budget was welcome. Subsidies and transfers to finance losses of public enterprises, which had amounted to 9.6 percent of GDP, were the other components of the budget to be covered under the program of expenditure cuts. There were also implicit subsidies, for example, in the form of the appreciated official exchange rate for imports. Suich subsidization was not only the source of huge budget deficits but created distortions in the economy. A decisive approach would be required to effect a meaningful cut in those expenditure items, although with care to avoid serious social impact.

The trend of budget revenue seemed to be weak and inelastic, and action would be essential to make the revenue structure more broadly based, Mr. Fujino added. He welcomed the increase in customs receipts by 30 percent and the indication that the authorities would consider the suggested changes in the tax structure; it was hoped that the outcome of such consideration would be constructive.

The staff had provided an enlightening medium-term scenario of supply-side measures up to 1990, which demonstrated the need for the Egyptian economy to enlarge its internationally competitive export-oriented industry, Mr. Fujino observed. That sector would also be the key to improving external imbalances and reducing reliance on imported foodstuffs.

Pricing policy was the basis for all those improvements, Mr. Fujino continued. Appropriate price incentives would encourage productivity in agriculture and industry. He welcomed the progress that was taking place; the recommendations of the World Bank on investment priority and strategy were the starting point, and close collaboration with the Bank would be very important. He was reassured by the authorities' comment that the recommendations were being carefully examined, but he emphasized that early action was crucial.

The current account deficit was projected to reach $1.8 billion, or 3.7 percent of GDP, during the current fiscal year, and the overall balance would record a deficit of $1.2 billion, Mr. Fujino noted. Furthermore, the current account deficit would continue to increase, according to the staff's medium-term scenario. The staff stated correctly that the analysis of the country's balance of payments indicated a slow response of the external account to policy action. The complicated foreign exchange system--although reforms were taking place--together with large subsidies and transfers constituted an obstacle to sustained improvement of the structure of the economy and external imbalances. Comprehensive policy action would also be needed to streamline the exchange system and trade restrictions. The domestic and external imbalances facing the Egyptian economy were enormous. Timely policy action that would decisively tackle the problems was urgently needed. Finally, he was in general agreement with the thrust of the staff paper and supported the proposed decision.

Mr. Nebbia remarked that in spite of the commendable growth of real GDP over the previous decade, the Egyptian economy continued to face short-term and structural problems that called for prompt reduction of underlying inflationary pressures and for substantial correction of the budgetary and external imbalances. The corrective measures that had been introduced by the authorities--particularly regarding pricing policies and public finances--were welcome. But if a viable external position was to be achieved, and a shift in domestic activity toward the non-oil tradable goods sector was to materialize, further steps would have to be taken.

As had been stated during the discussion for the 1984 Article IV consultation with Egypt, an appropriate pricing policy seemed to be the first, unavoidable step that must be taken toward mobilizing resources for the productive sector, Mr. Nebbia suggested. During the past year, flexibility had replaced the rigidity in pricing policies. Increases of 20-30 percent in the prices of major crops, such as rice, sugarcane, and cotton, with the positive result of an increase in cultivated areas, and the adjustment of public sector companies' prices to reflect the cost of production were welcome, as was the liberalization of the prices of industrial products. The larger the scope of the authorities' new approach, the greater would be the improvement in the resource allocation process, providing incentives to increase domestic production, reduce excessive dependency on imports, and improve export performance. Prices reflecting the opportunity cost of production would also permit public enterprises to reduce their reliance on government subsidies and in some cases to increase their profits, which in turn would contribute to the achievement of a balanced budget. The proposed increase in petroleum prices represented a positive step toward that goal.

Nevertheless, additional and far-reaching measures should be adopted promptly to reduce the sizable budget deficit Mr. Nebbia continued. The level of subsidization was unduly high, accounting for some 25 percent of total current expenditure. The substantial growth in public sector employment in the past five years, at a compound annual rate of close to 6.5 percent, was not only a major cause of fiscal deterioration but also the inevitable outcome of the lack of incentives to sectors other than services. Reducing budget subsidies and restraining salary adjustments through revised government employment practices remained crucial to constrain expenditures.

On the revenue side, the removal of relative price distortions would improve the position of public sector enterprises by allowing them to generate reasonable amounts of savings that could either be transferred to the Central Government or channeled toward priority investments in the productive sector, Mr. Nebbia remarked. At the same time, a shift of economic activities over the medium term toward sectors other than services would also contribute, together with additional tax measures, to the improvement of the elasticity of government revenue.

The steps already taken by the authorities in pricing and fiscal policies were in line with the achievement of a more sustainable budget position and an improved process of resource allocation, Mr. Nebbia observed. But the scope of the adjustment must be widened to cover other policy areas, although he recognized the social and political implications of Egypt's experiences in the past.

The deceleration of the rate of credit expansion to finance public deficits would help to improve the balance of payments position, to contain inflationary pressures, and to meet the needs of the private sector, while maintaining a prudent pace of overall credit growth, Mr. Nebbia continued. The slowdown in total credit expansion in the past three years, although insufficient to deal appropriately with existing imbalances, was welcome. He encouraged the Egyptian authorities to persevere in pursuing tighter financial policies to slow down the growth of aggregate demand and to restrain underlying inflationary pressures. Nevertheless, it was disappointing that interest rates had remained negative in real terms for the past two or three years and that nominal rates had been lower than the expected yield on foreign currency deposits since March 1984. He agreed with the staff that the authorities would be well advised to maintain competitive positive real interest rates so as to mobilize effectively domestic resources, thus avoiding undue pressures on both the market for products and the overall external balance.

He endorsed the staff's view that a full unification of the various exchange rates into a single and flexible exchange rate reflecting market forces would eliminate existing inefficiencies in the system and would be fully in line with the overall effort to eliminate price distortions in the economy, Mr. Nebbia said. However, there were implications for the prices of basic commodities imported under the central bank pool and for the budget.

The prospects for the external economy, in particular the external debt projections and the expected further deterioration on current account, were clearly cause for serious concern, Mr. Nebbia observed. To a large extent, those prospects underscored the need for prompt implementation of the recommended fundamental policy adjustments. Nonetheless, stronger actions aimed at redressing current imbalances and structural weaknesses would make a decisive contribution to the achievement of sustainable economic growth. Finally, he supported the proposed decision.

Mr. Abdallah said that he was in broad agreement with the staff analysis and appraisal. There was no doubt that during the past decade Egypt had received substantial inflows of capital from various sources, including earnings from petroleum exports and the Suez Canal. There was also no doubt that while the economy had experienced impressive real growth of over 7 percent a year, in the same period the balance of payments had undergone progressive structural deterioration, which had not been attended to by the authorities. Because of a combination of adverse factors, the Egyptian economy was in a critical state at present. Firm action needed to be taken in several areas in a persistent and coordinated fashion.

The government budget constituted a dominant share of total expenditure in the economy, amounting to 58 percent of GDP in 1983/84 and 50.3 percent in 1984/85, Mr. Abdallah noted. The fiscal deficit--at 19.5 percent of GDP in 1983/84 and 18.4 percent 1984/85--was a permanent feature of the government budget. Current expenditure for wages and salaries on the one hand and subsidies on the other competed for primacy of place in the allocation of funds: in 1982/83 and 1983/84, subsidies had received a larger allocation than wages and salaries, while under the 1984/85 budget a larger share had gone to personal emoluments.

For over four decades, the Egyptian authorities had concentrated resources on protecting the consumer, particularly on the poorest people who constituted the overwhelming majority of the population, Mr. Abdallah commented. That policy encompassed a long, mixed list of controlled prices, for items ranging from essential supplies--like wheat and sugar--to gasoline and aviation fuel. In addition, the staff had provided an extensive list of commodities subject to centralized price control by the Ministry of Industry.

The deficits of all the parastatal enterprises that manufactured controlled commodities or imported controlled goods for domestic distribution were ultimately borne by the Central Government, Mr. Abdallah continued. The total deficit was financed partly by foreign borrowing but predominantly by domestic sources, with the banking system contributing a significant share. The fiscal operations of the Government, through its unrelenting resort to deficit financing, had had detrimental effects in several areas of the economy. The external debt had risen to an unsustainable level; the current account had registered substantial deficits; inflationary pressures had intensified--and would have been much higher if the Egyptian currency had not appreciated so noticeably--and the production of tradables had declined. The measures that had already been taken by the authorities to reduce the fiscal imbalance were welcome, but additional steps were required as soon as possible. The Egyptian people must also be exposed to the full rigors and discipline of international trade, like the rest of the developing world, in order to compete.

The staff's medium-term scenario indicated that for the rest of the decade Egypt would be facing a rising deficit in its external sector that would require financing on a substantial scale, Mr. Abdallah noted. To secure the required assistance on terms and conditions that would enable the country to push through the structural reforms that must be undertaken, it would be necessary to work out with the Fund and the World Bank a strong and comprehensive adjustment program that would be implemented with consistency and determination over several years.

The first requirement in any meaningful adjustment program was a major reform of the present complex and unwieldy foreign exchange system, Mr. Abdallah added. The three-tier exchange arrangement was the principal instrument in the promotion of distortions in relative prices within the economy and the consequent misallocation of resources. The only rationale the arrangementf was that the exchange system was another mechanism for maintaining the pervasive policy of subsidies outside the formal structure of the budget. By importing wheat at the central bank rate, the parastatal responsible for that commodity could acquire the grain more cheaply from foreign sources than from Egyptian farmers. As a consequence, wheat production in Egypt was falling while imports were rising. In addition, by paying cotton producers on the basis of the highly appreciated Egyptian currency, the profit was so reduced that not much incentive was left to increase production. As a consequence, cotton production had fallen. Rice producers had experienced the same fate. Egypt's potential for increased production of exportable goods, should be exploited fully.

One good reason to reform the unwieldy exchange system was the competitive aggressiveness of the free market, which had become highly sophisticated and could not be brought under effective control, Mr. Abdallah remarked. The only viable solution was unification of the foreign exchange market, as recommended by the staff. The authorities had no other alternative because they had decided some years previously to allow Egyptian residents to open foreign currency accounts in local banks. Those accounts had grown over the years, and both the interest and the capital were payable in the foreign exchange in which the account had been opened. Allowing those accounts in a country that still availed itself of the provisions of Article XIV was a bold innovation that entailed certain risks. Some of those risks had already emerged during the past 6-12 months: nationalized banks had used the foreign currency to finance parastatals' imports and had no means of replacing it other than by recourse to the government, which was also short of hard currency. Foreign currency deposits had therefore become a ready source of funds for transacting business in the free market. Their existence created an incentive for traders as well as individuals to become involved in foreign currency transactions outside the banking system. There was no way that the "administered" exchange rate could compete with the prices prevailing in the free market. Therefore, the free trader should be invited into a liberalized official market that responded increasingly to forces of supply and demand. Finally, he supported the proposed decision.

Mr. Zecchini remarked that he was in general agreement with the staff appraisal and its policy recommendations. Egypt was facing a very serious and, in some respects, deteriorating economic situation. Major imbalances were being registered on the fiscal front and in the balance of payments. However, the authorities had adopted some measures to redress the situation. Steps to reduce the public deficit and introduce greater price flexibility through adjustments in producer and consumer prices were welcome. Nevertheless, those measures had fallen short of what was required to promote sustainable and balanced growth in the economy. A gradual approach did not seem adequate; on the contrary, a more effective and comprehensive adjustment program was called for. He encouraged the authorities to tighten considerably domestic demand policies and to proceed further in the direction of increasing price flexibility and simplifying the exchange rate system. A two-stage policy approach, as suggested by the staff, was not necessary; instead, a contemporaneous implementation of exchange rate and demand measures would be preferable, as the control of domestic absorption was a necessary complement to exchange rate reform if a lasting improvement in external competitiveness was to be attained.

A sizable reduction in the public deficit was needed, Mr. Zecchini continued. The positive results that had been obtained by the authorities in reducing expenditures from 60.5 percent of GDP in 1982/83 to about 51 percent of GDP in 1984/85 had been offset by a disappointing revenue performance. In the past three years, public revenue had decreased from 41.2 percent of GDP to approximately 33.2 percent, and that outcome had only been related in part to decreasing oil revenues. Therefore, while continuing expenditure restraint was called for, a major effort would have to be made to change the structure of the tax system by increasing the share of direct taxation and broadening the tax base. In that respect, an excessive reliance on customs duties, as contemplated in the 1985/86 budget, did not seem to be the best solution. On the expenditure side, the maintenance of investment projects in priority areas, as suggested by the staff of the World Bank, appeared indispensable in order to strengthen the country's external position in the medium term.

Monetary policy had not been as strict as called for by the large imbalances of the economy, Mr. Zecchini observed. Credit to the public and private sectors had increased briskly, at an annual pace of about 21 percent between March 1984 and March 1985, and interest rates had remained unsatisfactory in real terms. A tightening of monetary policy would therefore seem warranted.

With regard to the pricing system, government procurement policies had had an important impact on agricultural production and the use of land for alternative crops, Mr. Zecchini stated. Tables 3 and 22 of the report on recent economic developments illustrated that the profitability of cotton, wheat, rice, and sugarcane had been relatively low and that production, as well as the area planted with those crops, had decreased in the past years. Producer prices for those products had been between one third and one half of international prices. Since those were important export crops, procurement price policies had had a negative impact on the country's external position. To counter those results, a better structure of production should be sought through flexible procurement policies.

Both the level of the exchange rate and the segmentation of the exchange rate system, together with a number of restrictions on trade, had hampered adjustments in the balance of payments, Mr. Zecchini remarked. The commercial bank exchange rate had been appreciated in July 1985, thereby increasing its differential with respect to the free market rate. The staff's medium-term scenario indicated that in the absence of immediate adjustment measures, the balance of payments was expected to deteriorate markedly in the coming years. Therefore, early action in the exchange rate system was needed along with tightened management of domestic demand.

He encouraged the Egyptian authorities to pursue strongly their initiative to enter into a program of adjustment, supported by Fund resources, to put the economy on a sustainable economic growth track, Mr. Zecchini concluded.

Mr. Sengupta noted that Egypt had experienced relatively high growth rates of about 8.5 percent a year in the period 1975-1982/83 and that the authorities estimated that the rate of growth in the past two years had been only slightly lower--8 percent--which represented a remarkable achievement. During that period, the authorities had been able to undertake important development programs, aided especially by large oil export receipts, Suez Canal dues, workers' remittances, foreign borrowing, and aid. However, since 1983, less favorable external developments had contributed to a fall in receipts from those sources, resulting in severe strain in Egypt's balance of payments. The budget deficit had increased, to about 18-20 percent of GDP, and inflation was relatively high, about 20 percent in 1984, although the consumer price index appeared to have declined in the first few months of 1985. Debt and the debt service burden had grown rapidly, with a debt service ratio as a percentage of current account receipts of about 35 percent, and external arrears appeared to be accumulating.

The actions taken recently by the authorities clearly indicated their awareness of the need for urgent structural reform to ensure balance of payments viability in the longer term, Mr. Sengupta commented. The staff was aware of the authorities' position, and he urged that the proposed decision reflect that view. A number of changes had been made in 1984 in pricing policy, including increases in electricity tariffs, in the prices of several petroleum products, and in the procurement prices of agricultural products. Efforts had also been made to restrain budget expenditures and to increase revenues. As a result, it was expected that the overall budget deficit would be reduced from about 20 percent of GDP to 15 percent in 1984/85. The rise in expenditures had been confined to about 2 percent. Because of price adjustments and other factors, subsidies were expected to fall by about 13 percent.

With regard to monetary policy, Mr. Sengupta continued, growth of total bank credit had slowed from 22 percent in 1983/84 to about 19 percent in January 1985, reflecting lower credit requirements of the Government and the public sector, while credit to the private sector continued to expand at about 24 percent. The authorities had also shown flexibility in their exchange rate policy, although they had had to increase import restrictions to ensure that the already high external debt did not increase further.

The staff had recommended a two-stage approach to tackle the severe balance of payments problems, Mr. Sengupta said: first, the simplification of the exchange system, including a realistic exchange rate policy with tighter credit controls and a substantial increase in interest rates; and second, the introduction of a comprehensive economic program combining strong demand management measures and structural policies in the light of the 1985/86 budget. Evidently, the authorities were contemplating the implementation of a number of measures in that direction. As far as investment priorities were concerned, they agreed with the staff that public investment should be directed to the most essential and quickest yielding projects in the coming years, and they were carefully studying the recommendations of the World Bank with a view to their implementation. The suggestions of the World Bank appeared to cover almost all areas of investment, and it might be necessary for the authorities to fix priorities, given the resources constraint.

The intention of the authorities to maintain price flexibility was welcome, Mr. Sengupta stated. The price increases included in the 1985/86 draft budget were indicative of their determination. The announced increases covered several commodities, including foodstuffs, charges on public services, and petroleum products. The authorities' intention to continue price increases under the strategy of "unannounced" prices and "improved" products further showed the seriousness with which they were approaching the problem. However, it would be undesirable to increase the prices of those products, especially food items, too steeply; that action could result in hardship to a large number of consumers. Therefore, the cautious approach of the authorities was commendable. Petroleum products, however, was an area where the authorities clearly realized that they would benefit by raising prices, which were at present quite low by international standards. In addition, the authorities were examining the issue of further reductions of subsidies.

A number of measures had been indicated by the authorities to reduce the fiscal deficit in the 1985/86 budget, Mr. Sengupta noted. Those steps went in the right direction to bring about the needed reduction in expenditures and improvement in revenues. The staff seemed to consider that the overall deficit of LE 4.9 billion projected by the authorities might not be realized; however, even at the level projected by the staff, the deficit as a percentage of GDP would be lower, by about 20 percent, than in previous years. There was no doubt that an improvement in revenue elasticities would be needed, and the authorities should study the staff's suggestions. He welcomed the indication that they were considering a review of tariffs with the Fund's technical assistance.

Monetary expansion had been contained, Mr. Sengupta stated; broad money growth had fallen from 44 percent in 1981 to about 20 percent in 1984. However, with continuing balance of payments and inflationary pressures, continued vigilance in that area would be needed. The staff had recommended substantial increases in interest rates. While an appropriate increase would be useful, it was necessary to ensure that such increases did not hinder investment or affect the finances of the public sector. In addition, if the authorities continued their strong policies to combat inflation, and if the average rate of inflation continued to be lower than the deposit rate, there might not be a case for large increases in nominal interest rates. Nevertheless, the authorities should avoid large increases in net foreign currency liabilities so as to avoid increased vulnerability due to sudden withdrawals.

Egypt had maintained a multiple exchange rate system for some time, Mr. Sengupta remarked. The Fund staff had argued for a complete unification of the commercial bank premium rate and the free market rate, with the central bank rate ultimately being moved to that unified rate. The active exchange rate policy followed by the authorities was commendable; they had accepted the goal of exchange rate unification and were moving in that direction. But he agreed with them that unification of the commercial bank and free market rates needed to be done in stages; thus the steps indicated by the authorities appeared appropriate, and the Fund should respect their preference for a cautious approach.

Multiple exchange rates might make sense in countries where the industrial sector was less developed and where there was low mobility of resources, Mr. Sengupta commented. Of course, it was necessary to have only one price for foreign exchange, but effective prices of exports and imports were relevant for resource allocation. Those prices could be influenced by appropriate taxes and subsidies or, when administered flexibly, by differential exchange rates. When market prices could not give the right signals, government intervention to ensure appropriate resource allocation was necessary, and depending upon the elasticities and the feasibility of appropriate tax-subsidy measures, a temporary multiple exchange rate practice might have to be accepted to achieve the diversification of exports and the production structure. So long as the Egyptian authorities were taking steps in the right direction, those efforts should be commended. In addition, there was a need to proceed cautiously in order to avoid undue shocks to the domestic economy.

The tentative medium-term outlook for the balance of payments portrayed a serious deterioration, with financing gaps averaging $3 billion a year in the next five years, Mr. Sengupta remarked. Given the structure of the existing balance of payments--the small share of non-oil exports, difficulty in compressing imports beyond a certain level, heavy dependence on workers' remittances and Suez Canal receipts, and a high debt and debt service burden--action to bring about necessary changes would inevitably be slow to take effect. The comprehensive set of policies in the development plan needed to be implemented urgently. An examination of the medium-term balance of payments outlook showed that petroleum, with its uncertain price, accounted for one third of exports. A rapid increase in non-oil exports would require structural changes, and a too rapid increase in primary exports might affect the terms of trade adversely. Efforts in the medium term would have to concentrate on import substitution, and he fully endorsed Mr. Hamed's emphasis on such a policy, which need not encourage inefficiency but could benefit the balance of payments and promote rapid industrialization.

The authorities had clearly exhibited their determination to tackle the problems facing them and therefore deserved to be supported, Mr. Sengupta said. In that effort, international institutions--especially the Fund and the World Bank--aid donors, and creditors would need to play an important role. Given the nature of the problem, the Fund should consider an extended arrangement for Egypt. If the external environment continued to be hostile, Egypt might also need debt restructuring. The World Bank should continue to support Egypt, both through structural lending and through other long-term development lending for projects and programs.

Mr. Wang remarked that during the past ten years Egypt had achieved a high rate of economic growth attributable to the rapid increase of foreign exchange inflows from oil revenue, nontrade earnings, and capital transfers. However, since the decline in oil prices in 1982-83, the external environment had worsened, holding back domestic economic activities. Investment, output, and employment had slowed down considerably, and the balance of payments position had also faced a serious deterioration. To reverse the situation, the Egyptian authorities had adopted a more active policy stance in 1984/85 and had implemented some commendable measures, inter alia practicing greater flexibility in pricing and exchange rate arrangements, reducing the fiscal and current account deficits, and introducing a tight monetary policy, with positive results in many important areas.

Further adjustment measures covering all policy areas had been proposed for 1985/86, Mr. Wang continued. Those measures should be placed in a medium-term framework and include policies necessary to deal with structural imbalances as well as fiscal and external imbalances. Considering the substantial size of the external financing gap, continued cooperation and active participation by Egypt's donors and external creditors were indispensable.

He welcomed the negotiations that had been undertaken on an adjustment program to be supported by the use of Fund resources, and hoped that they could be concluded at an early date, Mr. Wang noted. He supported the view that undue delay in implementing effective adjustment policies would make the envisaged comprehensive adjustment more difficult, alhough caution should also be exerted, especially in light of the social and political implications.

Mr. Joyce commented that in the past few years Egypt had made significant progress, despite adverse economic circumstances, and had initiated important adjustments. Admittedly, it was unfortunate that more had not been done when Egypt's circumstances had been more promising. The outlook for Egypt remained serious, especially in the medium term. The authorities would need to persevere in their adjustment efforts, which must address not only the financial problems facing Egypt at present but also the significant structural problems persisting in the economy. The rub of the problem was the speed with which fundamental changes had to be made; the changes being made were neither comprehensive nor decisive enough in current circumstances. The authorities referred to a gradual transformation of the economy in a long and difficult process; he agreed that structural problems could not be solved overnight, but adjustment could not be delayed. The medium-term forecast for the balance of payments and the financing gaps projected by the staff to exist through the rest of the decade, in the absence of further policy changes, left the authorities with little option. Attempts to delay the adjustment process by seeking additional financing from abroad would only force adjustment that would have to be sharper, more abrupt, and more costly in social and economic terms.

He appreciated the concerns of the authorities about the need to command continued public support, Mr. Joyce said. It was important to ensure that the burden of adjustment did not fall unduly on the poor and the weak. Therefore, a pragmatic approach was called for. He broadly agreed with the recommendations of the staff and the comments by other speakers, especially with respect to pricing and exchange rate policies.

His authorities would welcome a comprehensive adjustment program supported by Fund resources, especially if it were developed in close cooperation with the World Bank and bilateral donors to ensure that adequate policy changes were made, the right investment priorities were established, and sufficient financing was available, Mr. Joyce said. However, the final decision as to the appropriateness of the program would rest with the Egyptian authorities; he urged them to give the matter close consideration, particularly in light of the comments made at the present meeting. The proposed decision expressed the hope--as had previous decisions concluding Article XIV consultations with Egypt--that Egypt would terminate the two remaining bilateral payments agreements with Fund members as soon as possible. He asked the Egyptian representatives or the staff whether any progress had been made toward their elimination.

Mr. Romuáldez said that he agreed fully with the staff appraisal and policy recommendations. Discussions were continuing on a program of adjustment, and he looked forward to its consideration by the Board. That program must be decisive, strong, comprehensive, and designed to address the requirements of both demand management and structural adjustment. A World Bank role was of the essence, not so much in project as in sectoral development, particularly export development, and perhaps in the context of a structural adjustment loan.

He urged the authorities to resist a gradual adjustment, a temptation engendered by significant aid flows, Mr. Romuáldez continued. The experience of the past fiscal year and the medium-term prospects would indicate that less than decisive adjustment efforts were usually nullified by the momentum toward deterioration when structural and broadly based weaknesses were present in the economy. Indeed, the "unique opportunity" for adjustment afforded by favorable circumstances in Egypt noted by Directors at the time of previous Article IV consultations might have been lost, and adjustment might have to be made under more difficult circumstances. During those consultation discussions, Directors had noted that the current five-year plan showed that the authorities were moving in the right direction but that they needed to follow through rigorously on policy adjustments to achieve their objectives.

In the recent period, the authorities had attempted some adjustment, by introducing greater price flexibility, taking steps to reduce the overall budget deficit through revenue measures and expenditure cuts, and trying to set lower limits for bank credit expansion, Mr. Romuáldez commented. Like other speakers, he joined the staff in taking a cautious view of the authorities' estimates of overall and bank-financed deficits, which seemed low in light of an expected decline in revenues, with lower import levels, slower domestic economic activity, and less favorable oil markets abroad, and of an expected increase in subsidies. The external payments arrears that had emerged might also contribute to the underestimation of deficits on a commitment basis.

He welcomed the authorities' serious consideration of staff recommendations for some sectors of the economy, Mr. Romuáldez said, including the need to refine priorities in public investment, introduce greater price flexibility, and reduce or even eliminate subsidies to producers and consumers. He encouraged the authorities to be decisive and adequately responsive to the exigencies of the situation in each sector.

The authorities' efforts in the fiscal sector must be two-pronged, Mr. Romuáldez stated. Steps must be taken to address the more immediate problem of the fiscal deficit for 1985/86, given the likelihood of shortfalls in expected revenues and continuing high subsidy requirements. At the same time, more lasting improvements should be made, for example, by slowing the growth of public sector employment, which had been increasing at an average annual rate of 7 percent in the past four years; by reinforcing expenditure control procedures; and by introducing greater elasticity in government revenues, through converting specific excise taxes to ad valorem taxes, reducing customs exemptions, and valuing imports for customs purposes at the actual exchange rate and not the central bank rate. In addition, it was important that public enterprises be managed on the basis of firm commercial principles.

As in other sectors of the economy, Mr. Romuáldez went on, monetary policy must give meaningful and decisive signals away from expansion. He urged the authorities to re-examine credit and control instruments in light of staff criticism that substantial slippages still occurred in spite of measures already taken. He welcomed the authorities' active review of their interest rate policy. Interest rates needed to be raised in order to stimulate savings, shift liquidity preferences toward domestic currency, allocate credit more efficiently, and support the exchange rate. The growing vulnerability of commercial banks, given the rising level of their net foreign currency liabilities, was also significant.

The authorities would do well to begin moving decisively toward full unification of the commercial bank and free market exchange rates, and ultimately toward the inclusion of the central bank rate in that unification, Mr. Romuâldez said.

He was concerned that an accurate appraisal of the size of Egypt's external debt was not possible at a time when greater caution in contracting new debt had to be exercised, given present estimates of the size of existing debt and the rise in the debt service burden, Mr. Romuâldez commented. Therefore, Mr. Hamed's statement that the problems were being tackled and that progress toward their resolution was being made was welcome. External payments arrears needed to be settled, and bilateral payments agreements between Egypt and two Fund members should be terminated.

The urgency remained for Egypt to adopt a medium-term program of adjustment that was strong and comprehensive, Mr. Romuâldez concluded. Delay could only intensify the momentum of deterioration. Finally, he supported the proposed decision.

Mr. Polak observed that in recent years, consultations with Egypt had left a thoroughly disappointing impression. Against that background, the present discussion provided some rays of hope. As the staff appraisal indicated, the authorities had shown greater flexibility in pricing and subsidy policies, introduced greater realism in exchange rate policy, and made efforts to tackle the budget. Mr. Hamed's statement underlining the convergence that was taking place between the views of the Egyptian authorities and the Fund was most welcome.

Those developments gave grounds for some satisfaction, but it remained a matter of renewed disappointment to see how far they still fell short of what was needed to pull Egypt fully out of the policy morass in which it had been mired for years, Mr. Polak continued. The fundamental problems of Egypt--relating to land, population, and shortage of real capital--were too grave to have been made even more difficult by what were essentially man-made problems: price distortions, multiple and unrealistic exchange rates, and large subsidies, which had contributed to huge budget deficits and also caused a large balance of payments deficit. It was cause for regret that the authorities had not shown the readiness to take the incisive action that would be needed to make an integrated Fund program possible--the more so as the program approach of the staff seemed modest and realistic. The staff had acknowledged that "a viable improvement in the balance of payments can only be envisaged in a medium-term context." On the most sensitive issue--subsidies--the staff had shown itself to be far from dogmatic in proposing "a pragmatic approach... including better targeting of subsidies and limiting them to a few essentials."

A pricing policy was called for that recognized that prices in Egypt could not remain divorced from those on the international market without undermining the growth of Egypt's natural export crops and undercutting exports of petroleum, Mr. Polak stated. A unitary exchange rate policy that promoted exports, appropriately fostered the domestic production of tradables, and avoided speculation and favoritism was also necessary. The authorities should design a budget with less expenditure on subsidies--explicit and implicit--slower growth in public employment, and a more appropriate revenue system. A thorough program based on those principles would bring striking benefits to Egypt.

Mr. Salehkhou said that he wished to clarify a reference in the report on recent economic developments to Egypt's long overdue financial obligations to the Islamic Republic of Iran. The report stated that Egypt did not at present service its debt to the Islamic Republic of Iran and then went on to state that "in the case of the Islamic Republic of Iran, discussions between the authorities of Egypt and the Islamic Republic of Iran on ways to settle the issue of arrears on the servicing of obligations relating to two loans to Egypt have been under way for some time." That statement was not strictly accurate as the use of the word "discussions" implied meaningful mutual negotiations in which both sides usually responded to each other's points of contention. In the present case, the Egyptian authorities had resorted to prolonged delays in responding to offers that had been based completely on their own proposals. In addition, almost three years had elapsed since Egypt had first failed to service its debt obligations to the Islamic Republic of Iran.

Such lengthy delays should be specifically referred to in the relevant section of the report on recent economic developments, Mr. Salehkhou stated. In fact, the staff mentioned such delays in the case of Egypt's obligations to a number of other bilateral creditors, including the Berne Union members. Furthermore, according to the existing Paris Club procedures, a time limit was set during which the debtor was required to reach an agreement with bilateral creditors, and that time limit was also enforced by the Fund.

The Executive Board discussion of the role of the Fund in the settlement of disputes between members relating to external financial obligations (EBM/84/98 and EBM/84/99, 6/22/84) had clearly defined the important role of the staff in tracing the records of each financial obligation to verify its conformity to the existing rules and provisions, Mr. Salehkhou said. The Fund's Annual Report on Exchange Arrangements and Exchange Restrictions, 1985, stated that "policies and practices followed by the Fund with respect to its direct interest in members' overdue financial obligations stemming from the Fund's jurisdiction under Article VIII and Article XIV of the Fund's Articles of Agreement have been affirmed...and members are obliged to provide the information the Fund requires to make such a determination at the time that the nonpayments occur."

In a spirit of cooperation and to endorse the calls by many speakers that donors should cooperate with Egypt in helping to alleviate its external problems, his country, in addition to having originally extended the loans on highly concessional terms, had also agreed to accept as part of the settlement the purchase of commodities as requested by Egypt, Mr. Salehkhou concluded.

Mr. Fugmann stated that he supported the staff appraisal and the proposed decision.

Mr. de la Herrán said that he supported the proposed decision. He commended the authorities for their efforts, which were reflected in the measures described by Mr. Hamed. The four main revenue sources in Egypt--oil exports, workers' remittances, Suez Canal dues, and foreign aid--had suffered great deterioration over the past years. As a consequence, the country was currently facing a serious economic and financial situation. The magnitude of the problem was reflected in the staff report, which described a delicate situation and medium-term prospects that showed no substantial signs of improvement. On the contrary, the scenarios indicated that stronger adjustment measures should be implemented promptly to avoid a rapid worsening of the situation.

The large divergence between the staff and the authorities in their projections about the envisaged fiscal deficit was worrisome, Mr. de la Herrán commented. Furthermore, the expenditure side of the 1984/85 budget included a combination of investment and current outlays that clearly favored the latter, including an expected decline of 5 percent in investment and an increase of 6 percent in current outlays. In addition, some components of current expenditure--for example, wages and salaries--had been officially projected to grow sharply. He urged the authorities to apply a more restrictive expenditure policy along the lines of that already initiated in the 1985/86 budget, which contained cuts in current expenses of 15 percent. Corrective action must also be takend to reduce subsidies, perhaps gradually to avoid abrupt price changes. In 1985/86 subsidies were expected to remain at the same level as in the 1984/85 budget; that trend must be reversed, starting with the elimination of subsidies to nonessential consumer goods.

Economic development had followed an inappropriate pattern in Egypt, and the measures recently adopted by the authorities to attain a more flexible pricing policy were welcome, Mr. de la Herrán said. That action would exert a positive influence on the pattern of production, mainly in the agricultural sector. The staff recommendation of an upward revision of prices for energy, as well as for agricultural inputs, seemed urgent in order to continue the process of making prices more flexible. A good complement to that pricing policy was the World Bank strategy recommending priorities in public investment. Fund-Bank collaboration in that field would be welcome as it would help to correct supply-side policy and re-establish an economic development pattern more in line with Egypt's prospects and resources.

The most serious imbalance in the Egyptian economy at present existed in the external sector, which also presented the greatest constraint to the implementation of needed economic policy, Mr. de la Herrán observed. The good performance of the external sector during the 1970s was not likely to be repeated in the near future. On the contrary, any improvement in the external account should be based on proper domestic adjustment, as external factors were not expected to play a favorable role in solving the problems of the large current account deficit, external debt, and emerging arrears. Exchange rate policy should be an essential instrument in reducing those external imbalances, but the current exchange rate system was too complex to be used efficiently. The multiple exchange rate system was deeply rooted in the Egyptian economy, and understandable uncertainties would surround its sudden elimination. Nevertheless, he supported the staff recommendation to unify the various prevailing exchange rates. Fortunately, the authorities agreed on the need for the full unification and had already taken some measures that would benefit the external situation and build up a rational system biased more toward the promotion of non-oil exports.

The Egyptian authorities must implement a durable adjustment policy, taking into account the fact that no rapid responses should be expected and that only perseverance in reducing structural imbalances would permit improvements in the external sector, Mr. de la Herrán concluded. Meanwhile, cautious debt management should remain a priority.

The Deputy Director of the Middle Eastern Department suggested that the staff's medium-term projections could be described more as a working hypothesis than as predictions. Those projections had been made three months previously, in April 1985, when some of the details of the 1985/86 budget and recent developments in the oil markets had not been known. He agreed with the Egyptian representatives that the measures that had been taken in the 1985/86 budget, and those that were proposed for implementation, could possibly result in some reductions in the financing gap. Nevertheless, there was an important qualification: the projections had been made on the basis of oil price developments, as described in the April 1985 World Economic Outlook. However, Egypt's average export price for oil since those projections were made had been $1.75 a barrel lower than projected, so that some of the improvement resulting from policy measures would be offset by less favorable external developments. In any case, as the staff report indicated, even if a strong adjustment effort were undertaken by the authorities, there was little possibility of achieving a dramatic improvement in the balance of payments in the short term. The improvement had to be seen in a medium-term context. The scenario assumed that the growth rate in the economy would be maintained at about 4-5 percent a year in real terms. Obviously, if that growth rate were not maintained and the financing were not obtained, the external gap would be somewhat lower, but the reduction would most likely come through increased restrictions in the import system with adverse consequences for investment and growth in the future. The projections had benefited from substantial World Bank assistance; the Fund staff had made its projections at the macroeconomic level, while the World Bank had assisted through sectoral projections. Thus, the projections should be seen as a basic scenario that was fully endorsed by the World Bank staff.

With regard to the 1985/86 budget, the Deputy Director continued, the procedures announced by Mr. Hamed to improve tax collection and administration, as well as to achieve greater price flexibility and to cover higher costs through price adjustments in some areas, were positive measures. However, uncertainty in oil price developments might indicate some reduction in revenue from the Petroleum Corporation, a downward adjustment of imports, and consequently a decrease in import revenues. While the staff views on the 1985/86 budget remained unchanged, that was not to say that some reduction in the overall balance of payments deficit would not occur.

A question was asked about the magnitude of the savings that could be obtained on the investment budget if the Egyptian authorities adopted the recommendations of the World Bank, the Deputy Director recalled. The main concern of the World Bank and the Fund staff had been the fall by over 20 percent in real investment since the start of the plan because of inadequate domestic savings generation. The investment momentum was therefore losing strength simply because the budget over the past several years had not generated sufficient revenues. Given the domestic and financial constraints, it was therefore important to improve the efficiency of investment at the lower levels. The World Bank had recommended a delay in some projects, notably in the construction of new cities and the reclamation of land, which represented only about 10 percent of the investment budget, or LE 500 million, on an annual basis. The World Bank, however, had recommended an orientation within the budgeted investment limits toward quick-yielding projects, such as faster development of gas production, completion of the cement plant, and rehabilitation of irrigation and drainage facilities. If those measures were adopted, they would allow a speeding up of the rate of growth, better balance of payments prospects, and an improvement in the budget.

The World Bank was currently preparing a report on the management of public enterprises, and discussions were ongoing in Egypt, the Deputy Director remarked. The Fund was providing technical assistance in the form of recommendations on external tariffs; a mission had visited Egypt at end-1984 and another one was planned for October 1985. Tariff rationalization was particularly important because of its budgetary and balance of payments implications. For example, the exchange rate could not be discussed without giving due regard to effective protection and tariff rates. It had been found that tariffs at present were providing excessive protection to some sectors in which Egypt had little comparative advantage, while they did not provide adequate protection for those sectors where Egypt had a comparative advantage--for example, food processing. Moreover, widespread tariff exemptions had weakened the budget revenue elasticity. Specific recommendations were therefore being proposed to the Egyptian authorities.

Because of the low income level of a large majority of the population, the staff agreed with the authorities that a reduction in subsidies on basic food items and other essentials could only be gradual, the Deputy Director observed. But there was little justification to continue to subsidize such items as gasoline, frozen meat, and electricity, which did not qualify as basic necessities. The granting of subsidies should be made on the basis of an income test, and it was encouraging that the authorities would soon initiate distribution of low-cost bread in some areas only. Subsidies, both explicit and implicit, should be clearly identified in the budget. Finally, other policy instruments such as the exchange rate should not be used for the purpose of income distribution; the use of an appreciated official rate for importation of basic commodities penalized the export sector and prevented the achievement of the balance of payments objective.

The 40 percent increase in petroleum prices announced by the authorities was in line with the adjustment proposed by the World Bank to bring petroleum prices to their international level within eight years, the Deputy Director said. The Fund staff subscribed to that adjustment, provided that measures in other policy areas were reinforcing and brought about the necessary adjustment of the balance of payments toward medium-term viability. Both the World Bank and the Fund placed considerable stress on the substantial adjustments of petroleum prices and the faster development of natural gas resources in Egypt that would free petroleum for exports. Indeed, the staff's sensitivity analysis illustrated that a reduction in the domestic consumption of petroleum products of 1 percent from the high average growth rates of over 10 percent in recent years would generate additional export revenue of over $150 million. The greatest prospects for relief of the pressure on the balance of payments were to be derived from an active pricing policy in the energy sector, which was therefore a key element in bringing about a viable balance of payments.

The staff had advocated a two-stage approach to adjustment when it had visited Cairo in April 1985, the Deputy Director stated, because the staff had realized that it would take some time for the authorities to devise the comprehensive package of structural measures needed by the economy. Over the very short term, however, the fastest way to improve foreign exchange resources was through greater inflows of remittances from workers abroad. Two policies were required to meet that objective: first, the exchange rate offered by the commercial banks had to be able to compete with a highly sophisticated free market; therefore, unification of the commercial bank and free market rates was recommended. Second, ideally the proceeds in local currency of those foreign currency remittances should not be spent--because that would in turn result in a higher demand for imports--but should be invested in financial savings in order to relieve the pressure on the balance of payments; therefore, the staff had emphasized higher interest rates as well as realistic exchange rate policies as a stopgap approach until a strong and mutually reinforcing policy package could be put in place.

The staff had been discussing with the authorities for some time a adjustment package that would bring the balance of payments to viability over the medium term, the Deputy Director noted. First, it had been emphasized that the strength of the adjustment effort should be such that the balance of payments would be financeable over the medium term, with little additional, or only exceptional, financing. Second, the adjustment measures under such a program should be capable of dealing with structural problems relating to pricing, the budget, investment, and the labor market; balance of payments adjustment through additional import restrictions would be self-defeating. Third, the measures under the adjustment policy should be reinforcing. For example, because the exchange reform of January 1985 had not been accompanied by measures in the budget, credit, or interest rate areas, it had not been effective. Fourth, the adjustment process would have to be continued and strengthened over the years in view of the size of the present and projected imbalances.

Before the staff could start negotiations for an adjustment program in which it had confidence, better statistics were needed in several key areas such as external debt and public finance, the Deputy Director of the Middle Eastern Department concluded. Fund technical assistance was being provided in the external debt area through the posting of a Central Banking Department expert in Cairo for one year until December 1985.

The staff representative from the Exchange and Trade Relations Department noted that Egypt's two existing bilateral arrangements were with Sudan and China. Available information on those long-standing arrangements indicated that at the end of 1984, one was in surplus and the other in deficit. Although the staff had no specific indications of the current status or plans for those arrangements, it would, of course, encourage the authorities to work toward their elimination.

The staff believed that unification of the exchange rates on an appropriate timetable would remove many of the disincentives inherent in the current system, the staff representative said. Unification would be important not only for Egyptian exporters but also for all domestic producers—both public and private--engaged in import substitution. The maintenance of the current multiple currency practices inhibited the necessary adjustment in the economy.

The staff representative from the World Bank noted that the International Finance Corporation was proposing to expand its activities in Egypt significantly, aiming at two or three operations a year in an amount of $50 billion, or more than double the program of the past few years. The IFC intended to concentrate on the agricultural industry with perhaps some investment in energy development.

With the support of the Government, the Bank was undertaking a study of public sector enterprises, the staff representative went on. The study would focus mainly on the financial interrelationships between the enterprises and the Government, and as such would not cover such issues as privatization, at least not in the first phase of the study.

The program of energy policy reform recommended to the Government by the Bank, two years previously, had covered a period of ten years, the staff representative from the World Bank recalled. That period of price adjustment was essentially a matter of judgment. The judgment of the Government and the World Bank was that bringing domestic energy prices into line with international prices would call for significant adjustment accompanied by a large investment in conservation methods and in industrial processes. It would be counterproductive to move too quickly without allowing time for the industrial sector, which was currently the major consumer of energy, to make that adjustment.

The Executive Directors agreed to resume 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/85/121 (8/5/85) and EBM/85/122 (8/7/85).

2. ECUADOR - EXCHANGE SYSTEM

The approval under Executive Board Decision No. 7927-(85/39), adopted March 11, 1985, for the retention by Ecuador of the multiple currency practice arising from the multiple rate system, the exchange restrictions involved in the minimum financing or barter requirement for imports, and the exchange restriction corresponding to external payments arrears is extended until the completion of the 1985 Article IV consultation with Ecuador or September 30, 1985, whichever is earlier. (EBD/85/202, 8/1/85)

Decision No. 8043-(85/122), adopted
August 6, 1985

3. MEXICO - TECHNICAL ASSISTANCE

In response to a request from the Mexican authorities for technical assistance to undertake a comprehensive survey of the direct taxes levied by the Federal Government, the Executive Board approves the proposal set forth in EBD/85/200 (7/31/85).

Adopted August 6, 1985

4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/85/154, Sup. 2, 8/5/85) on the canvass of votes of the Governors on Resolution No. 40-1, with respect to remuneration of Executive Directors and their Alternates, approved by the Executive Board (EBM/85/99, 6/21/85) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes		434,361
Total negative votes		237,496
Total votes cast		671,857
Abstentions recorded	183,312	
Other replies	1,641	
Total replies		856,810
Votes of members that did not reply		73,208
Total votes of members		930,018

Decision No. 8044-(85/122), adopted
August 5, 1985

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/160 and 84/161 are approved. (EBD/85/199, 7/30/85)

Adopted August 5, 1985

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and Advisors to Executive Directors as set forth in EBAP/85/204 (8/2/85) and by an Assistant to Executive Director as set forth in EBAP/85/206 (8/2/85) is approved.

APPROVED: May 6, 1986

LEO VAN HOUTVEN
Secretary