IMF Executive Board Concludes 2005 Article IV Consultation with the Arab Republic of Egypt

On May 18, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Arab Republic of Egypt.[1]

Background

The direction of economic policies in Egypt changed sharply in 2004 with the appointment of a pro-reform cabinet led by Prime Minister Nazif. The new economic team moved aggressively on key structural reforms in the areas of trade, taxes, and subsidies, and launched plans to restructure the financial system, privatize most state companies, modernize the fiscal accounts, and strengthen monetary policy. Thus far, the authorities have sold their stake in 17 nonfinancial companies and two financial entities. In January 2005, Egypt subscribed to the IMF's Special Data Dissemination Standard (SDDS) and accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

The economic recovery gained steam in 2004. Driven by strong growth in exports of goods and services, real GDP advanced by 4.8 percent in the first half of 2004/05 (July-December). Confidence has rebounded, as reflected in the surge in the stock market and the recent appreciation in the pound. Egypt made the transition to a unified, flexible exchange rate regime in December 2004 with the establishment of a formal interbank market for foreign exchange and the elimination of the surrender requirement. Favorable trends in the balance of payments have contributed to the orderly functioning of the market since its inception.

Egypt's external position has strengthened further. All foreign exchange generating activities exhibited robust growth during 2004. The surplus in the external current account rose to 4.4 percent of GDP in 2003/04, and is expected to be slightly higher in 2004/05. This strength reflects improved competitiveness stemming from the real depreciation of the pound since 2001, as well as other external factors, such as higher oil prices and higher Suez Canal traffic. Strong current account flows enabled banks to strengthen their net foreign asset position; the Central Bank of Egypt (CBE) also took advantage of market conditions to build up its reserve position. Total external debt remained stable at about US$29 billion (31 percent of GDP) at end-2004.

Monetary policy was tightened in 2004, but not by enough to contain inflation at single digit rates. Annual CPI inflation (12-month rate) stayed close to 12 percent for most of the year. With nominal interest rates remaining in the 10-13 percent range, real interest rates were close to, or below, zero throughout 2004. Recently released data shows a decline in consumer and wholesale prices in the first two months of 2005, bringing 12-month rates of inflation into single digits.

Total government borrowing in 2003/04 was 6.6 percent of GDP, due in part to the deficit of the general government, which was 2.5 percent of GDP (unchanged from 2002/03). As in previous years, however, most of the borrowing (4.1 percent of GDP) was related to other debt-creating operations of the government captured in the official financing data but not included in the published measure of the deficit. Over half of those operations were related to transactions of the National Investment Bank (NIB). Gross public debt reached a peak of 112 percent of GDP in June 2004, but government deposits with banks grew at a faster pace, reaching 46 percent of GDP by end-2003/04. Net public debt was LE 312 billion in June 2004 (65.7 percent of GDP). The cost and maturity structure of government debt, and the implied vulnerabilities, have not deteriorated.

The credit excesses of the late-1990s have continued to weigh heavily on banks, hindering their ability to contribute to the recovery. Bank credit to the private sector declined again in real terms in 2004, and most of the recent expansion in banks' domestic claims has been to the government. Nonperforming loans rose to over 25 percent of total loans in September 2004, compared to 20 percent in June 2003.

In the period ahead, external conditions are expected to remain favorable, and the recovery is likely to firm. Preliminary data suggest a continuation of recent trends in government borrowing in 2004/05. This outlook implies a small increase in the general government deficit on account of lower customs and nontax revenues, and no change in the level of other debt-creating operations. Net public debt is expected to rise to LE 350 billion by June 2005. Presidential elections by direct popular vote are scheduled for September 2005.

Executive Board Assessment

Directors welcomed the clear change in the direction of economic policies in Egypt since the 2004 consultation. They commended the authorities on their comprehensive economic reform program and the impressive achievements to date. Directors welcomed the priority being attached to modernizing the public sector and to reducing government interference in market mechanisms. They welcomed the decisive measures taken in the areas of customs tariffs, taxes, and subsidies, the ambitious programs of privatization and financial sector reform, and the improvements in transparency. Directors considered that these policy achievements have increased market confidence. They also noted the strengthening of the externally-driven recovery, as well as the positive developments in the foreign exchange market and the recent good news on the inflation front.

Notwithstanding the substantial progress attained since mid-2004, Directors noted that the challenges ahead to build a dynamic, private sector-driven economy in Egypt remain considerable. They noted that output growth remains below the minimum required to absorb labor force growth, the financial sector is weak, and government borrowing and debt are still high, while acknowledging that the structure of Egypt's public debt makes it less vulnerable to exchange rate and interest rate shocks. Directors encouraged the authorities to sustain the current pace of structural reform while pursuing fiscal consolidation and a prudent monetary policy. These policies would help bring about the robust responses of private investment and output growth that are needed to reduce unemployment and poverty. Directors were encouraged by the authorities' awareness of these challenges and their commitment to implement the reforms necessary to address them.

Directors congratulated the authorities on the successful unification of the exchange rate. In particular, they applauded the disappearance of the parallel market premium, which has removed a serious distortion from the economy, and the launching of the interbank market for foreign exchange. Directors also welcomed Egypt's acceptance of the obligations of Article VIII, Sections 2, 3 and 4. They noted that a market-determined, flexible exchange rate would be beneficial for foreign investment, increase the economy's resilience to shocks, and improve macroeconomic management. Directors welcomed the authorities' commitment to continue to let the exchange rate be determined by market forces and to tolerate short-term fluctuations in the rate.

Directors recognized that the Central Bank of Egypt (CBE) has continued work to strengthen the monetary policy framework over the past year. They encouraged the CBE to intensify these efforts, and to continue developing a cohesive and credible monetary policy framework that effectively anchors inflation expectations in the context of a flexible exchange rate, and that relies on a proactive interest rate policy. In this context, the importance of strengthening central bank independence was stressed. Many Directors also pointed to the shortcomings with the price indices in Egypt and highlighted the difficulties these posed for assessing the monetary policy stance and for improving monetary policy formulation. Directors therefore urged the authorities to intensify efforts to produce more reliable price statistics.

While the conduct of monetary policy has improved during 2004, Directors were of the view that, in the near term, monetary policy needs to be more forward-looking and provide better guidance to the market, including with a well-understood nominal anchor. In this regard, a number of Directors encouraged the central bank to communicate more clearly its short-term monetary policy strategy, including by making periodic announcements about the general direction of monetary policy. These actions would also enhance the credibility and transparency of the central bank and help anchor inflationary expectations while the monetary policy framework is being strengthened. Directors therefore welcomed the central bank's intention to improve its communications policy. They underscored that monetary policy should continue to focus on achieving low inflation, and encouraged the authorities to remain vigilant with a view to adapting monetary conditions as necessary.

Directors welcomed the authorities' focus on fiscal reform in their overall policy agenda. In particular, they praised the decisive actions taken during 2004 in the areas of tariff reform, income tax reform, and subsidies, and welcomed the plans being developed to increase the transparency of subsidies and improve tax administration. Directors also welcomed the ongoing efforts to modernize Egypt's budget and improve treasury cash management. Directors agreed that the latter reforms were necessary conditions for an efficient control of government expenditure and would improve the measurement of the fiscal balance. However, most Directors noted that these reforms by themselves would not result in lower government spending or borrowing unless supplemented with concrete expenditure-reducing measures, such as pruning subsidies and the government wage bill.

Directors emphasized that implementing a multi-year strategy of fiscal consolidation that lowers total government borrowing and places public debt on a firmly declining path would be crucial for achieving a robust response from private investment and growth. Directors also noted that the fiscal costs of the financial sector reform, which can be significant, further strengthen the case for sizable medium-term fiscal consolidation. They therefore welcomed the authorities' commitment to set ambitious deficit-reduction targets using a multi-year framework. However, as the official deficit accounts for only a fraction of total government borrowing, a few Directors suggested setting specific targets on government borrowing to ensure that government debt follows a declining path.

Directors indicated that effective control over all government spending is necessary to design an efficient fiscal consolidation strategy. Many Directors also attached importance to reducing offbudget outlays and integrating them into the budget. In this regard, they noted that bringing the investment budget under the full control of the Ministry of Finance would strengthen control over government spending over the medium term. Directors encouraged the authorities to make the necessary institutional changes, including those affecting the National Investment Bank, a priority of Egypt's public sector reform.

Directors commended the progress made in strengthening the macroeconomic database during 2004 and praised Egypt's subscription to the Special Data Dissemination Standard (SDDS). Directors were pleased to learn that the authorities are turning their attention to improving the quality of statistics, noting that the country's economic data continue to suffer from a number of deficiencies. Directors encouraged the authorities to improve coordination among agencies and to implement the methodological improvements suggested in the 2003 Data ROSC. In this connection, they noted that priority should be given to improving the fiscal accounts, price statistics, and the balance of payments.

Directors strongly endorsed the financial sector reform and privatization programs launched by the government, which focus on strengthening the banking system through consolidation and privatization of small joint venture and public sector banks; restructuring of public sector banks, including through recapitalization; and resolution of the problem of non-performing loans. They were encouraged that the process encompasses key goalposts with defined target dates, and encouraged the authorities to implement the program fully and to adhere to the envisaged time frame. Directors supported the authorities' efforts to obtain a diagnosis of the financial position of state banks, noting that an estimate of their potential recapitalization needs would be critical for the success of the program and efficient fiscal consolidation.

Directors welcomed the relaunching of Egypt's privatization program. They noted that the sales finalized since late 2004 and the public listing of companies up for sale in 2005 attested to the government's commitment to the program. Directors encouraged the authorities to closely adhere to their targets, and to incorporate the proceeds expected from the divestitures in a medium-term fiscal framework. Directors welcomed the authorities' decision to channel all privatization proceeds through the Ministry of Finance, and to allocate the bulk of the proceeds to retiring government debt.

Directors applauded the September 2004 reform of Egypt's tariff regime, and encouraged the authorities to consider further cuts in import tariffs as well as streamlining the exemptions and duty relief schemes not addressed by last year's reform. More generally, Directors encouraged the authorities to continue forging ahead with structural reforms that create employment opportunities and help alleviate poverty, including reforms to labor market legislation.

Directors noted that external vulnerability is low, and that the medium-term outlook for Egypt's balance of payments remains favorable. They were of the view that the ongoing development of Egypt's tourism potential and vast gas resources bodes well for Egypt's balance of payments over the medium term. Several Directors pointed to weaknesses in the official estimates of Egypt's balance of payments, noting that those weaknesses affect the authorities' ability to assess cyclical macroeconomic conditions and to undertake timely policy responses. Directors welcomed the authorities' resolve to address these issues.

Directors welcomed the increase in the transparency of economic policies in Egypt. They took note of the authorities' intentions to make further progress in the area of transparency.

Arab Republic of Egypt: Selected Economic Indicators 1/

	2001/02	2002/03	2003/04	Proj. 2004/05	Proj. 2005/06
Real Sector					
Real GDP growth	3.2	3.1	4.1	4.8	5.0
CPI inflation (12-month change, average)	2.4	3.2	8.1	9.6	8.0
Unemployment rate (in percent)	10.2	11.0	10.7	10.4	10.1
Public Finances					
Balance of the general government (in percent of GDP)	-2.5	-2.4	-2.5	-3.1	-2.9
Other debt creating operations (in percent of GDP)	-5.4	-4.7	-4.1	-4.0	-4.0
Net public debt (in percent of GDP)	61.9	65.9	65.7	63.7	63.9
Money and credit					
Broad money growth (annual rate)	15.3	17.3	13.2	13.2	16.3
Net claims on government sector (annual growth rate)	25.5	24.2	20.3	17.6	16.1
Credit to the private sector (annual growth rate)	7.9	1.6	3.9	3.9	4.2
Interest rates on 91-day treasury bills (in percent)	7.8	8.3	8.4	...	...
External Sector					
Trade balance (in percent of GDP)	-8.6	-8.1	-10.2	-9.9	-9.0
Current account balance (in percent of GDP)	0.6	1.9	3.4	4.2	3.5
Reserves (in billions of U.S. dollars)	14.1	14.8	14.8	17.2	19.9
(in months of imports of goods and services)	8.7	9.1	7.6	7.2	7.6
Gross external debt (in percent of GDP)	32.8	35.3	37.6	31.3	29.0
Exchange rates					
Egyptian pounds per U.S. dollar (average)	4.33	5.13	6.16	...	...
Real effective exchange rate (average; percent change)	-13.0	-20.1	-21.6	...	...

Sources: Egyptian authorities; and IMF Staff estimates.
1/ Egyptian fiscal year ends June 30.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.