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Arab Republic of Egypt: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Arab Republic of Egypt

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Arab Republic of Egypt, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 6, 2008, with the officials of the Arab Republic of Egypt on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 25, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of December 22, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 22, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for the Arab Republic of Egypt.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ARAB REPUBLIC OF EGYPT

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the
2008 Consultation with the Arab Republic of Egypt

Approved by Lorenzo Pérez and David Marston

November 25, 2008

- **This report is based on discussion held in Cairo during October 22–November 6, 2008**. The staff team comprised Messrs. Thornton (head), Ilahi, and Ariyapruchya, Ms. Dabla-Norris (all MCD), and Ms. Cebotari (FAD). Messrs. Perez and Husain (both MCD), and Mr. Shaalan and Ms. Riad (both OED) participated in the policy discussions.

- **Counterparts**: Discussions were held with Ministers Boutros-Ghali (Finance), Mohieldin (Investment), and Osman (Economic Development), Central Bank Governor El-Okdah, and other government officials and private sector representatives.

- **Context of past surveillance**: Staff have been supportive of the reform program but have urged greater attention to domestic demand pressures to contain inflation, including by having fiscal policy play a larger role than presently envisaged, and more exchange rate flexibility to support monetary policy and deal with external vulnerabilities.

- **Egypt's exchange rate arrangement is a managed float**. On January 2, 2005, Egypt accepted the obligations under Article VIII, sections 2, 3, and 4 of the Articles of Agreement. The exchange system is free of restrictions on the making of payments and transfers for current international transactions.

- **Consultation cycle:** The last Article IV consultation was concluded on November 28, 2007. The staff report was published and Directors' comments can be found at http://www.imf.org/external/pubs/cat/longres.cfm?sk=21507.0 The next Article IV consultation will take place on the standard 12-month cycle.

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EXECUTIVE SUMMARY

A marked slowdown in economic activity is inevitable but the inflation outlook has improved significantly. The international crisis is likely to undermine FDI flows and investor confidence and net exports of goods and services are set to weaken further as key markets shrink and export prices fall. However, with world commodity prices falling and output growth likely to be below potential, the main factors behind this year's inflation surge have been reversed. Growth could fall to 4½-5½ percent this year and next (from a 7 percent average in the last three years), with inflation declining to 8-12 percent over the same period.

The balance of payments has deteriorated and will be vulnerable until the international economy improves. A surge in imports because of buoyant domestic demand and trade liberalization all but eliminated the current account surplus by mid-2008, and a sharp reversal of portfolio flows in August-October 2008 put pressure on central bank reserve assets and the exchange rate. Though the authorities believe that further balance of payments weakness would be consistent with a moderate decline in NIR and some additional exchange rate flexibility, there is the risk of further capital outflows given the global turbulence.

The financial sector has escaped the ravages of the international crisis, so far, and is likely to continue to do so. The relative financial stability reflects the strengthening of balance sheets under the reform program, improved banking supervision, conservative practices with respect to funding, investments, and lending, and the central bank reiterating its existing guarantee of all bank deposits. The main vulnerability would appear to be a deterioration in loan quality in the event of a prolonged slowdown in economic activity, which seems unlikely at present.

The authorities intend to support growth and employment through a modest fiscal stimulus and timely cuts in policy interest rates. A fiscal stimulus of about ½ percent of GDP in 2008/09 will be provided by public infrastructure spending plans, complemented by accelerating PPP's to boost private investment. It would be consistent with the budgeted deficit for the year of 6.9 percent of GDP (as the deficit is on track to fall to below 6½ percent of GDP), a modest increase in the planned medium-term fiscal consolidation path through 2010/11, and with uninterrupted declines in the debt-to-GDP ratio. Judging the timing of an interest rate cut is complicated by the risk that cuts could accentuate recent pressures on central bank reserves and the exchange rate. The central bank should proceed cautiously until balance of payments portfolio flows have stabilized.

Counter-cyclical policies are risky given Egypt's poor initial conditions—large fiscal deficit, high public debt with much of it at short maturity, and high inflation—but staff judge the risk as worth taking in light of the record of reform and fiscal consolidation, the worsened growth prospects, and the still high unemployment. Given the emerging balance of payments weakness and the global crisis, the authorities should manage the exchange rate more flexibly.

The reform program should give priority to restructuring the public finances to support medium-term fiscal consolidation and boosting private investment. This would leave the economy well placed to take advantage of a recovery in the international economy. Important reforms in these areas would include the VAT, subsidy reform, strengthening cash-based social programs, and accelerating the privatization program.

I. Introduction

1. **Economic performance since 2004 generally has been impressive, underpinned by a supportive external environment and the structural reform program** that has included the liberalization of foreign trade, investment, the exchange market, the privatization of state entities, and measures to strengthen bank balance sheets and banking supervision. Annual GDP growth in the post-reform period was more than double the average of the previous decade, driven by large-scale foreign and domestic investment.

2. **With the onset of the global crisis the policy challenges facing the authorities have changed radically**. For most of the period since the last Article IV consultation, the most pressing issue has been to contain inflation when monetary and fiscal policies were constrained by limited exchange rate flexibility, large-scale capital inflows, and the growing cost of fuel and food subsides. By the time of the October-November 2008 consultation mission, inflation appeared to be past its peak and the more urgent challenge was to maintain growth and balance of payments stability in the context of the global financial turmoil and a rapidly deteriorating international economic outlook.

II. Recent Developments

3. **Growth has been strong and the surge in inflation may have come to an end, but the balance of payments has weakened and financial market indicators have deteriorated** (Figure 1).

- Real GDP growth averaged 7 percent in 2005/06-2007/08 and was relatively broad based across manufacturing, hydrocarbons, construction, services, tourism, and agriculture. The main drivers of demand have been private consumption and investment, aided by strong foreign direct investment. Though reports of skilled labor shortages have been widespread, official unemployment has remained stubbornly high at 8½ percent. Inflation reached a peak of 24 percent in August, reflecting a combination of world commodity price developments, changes in administered prices, and pressures from buoyant domestic demand; with the subsequent decline in commodity prices, inflation fell to 20 percent in October.

- Net international reserves were US$35 billion in October 2008, but reserve accumulation has slowed sharply since mid-year. Though exports, remittances, and receipts from tourism and the Suez Canal remained strong, a surge in imports because of buoyant domestic demand and trade liberalization all but eliminated the current account surplus by mid-2008; and in August-October there was an abrupt reversal of portfolio flows as foreigners investors pulled out of the equity and government bond markets. The central bank responded to the portfolio outflows by running down its foreign currency deposits with commercial banks by over US$10 billion from a level of US$11.6 billion at the end of June.[1]

- In the year through mid-November, the stock market fell by about 50 percent and spreads on Egyptian bonds widened by about 175 basis, though these changes were less than the average for emerging market economies. In September, Moody's and Fitch downgraded their investor outlook for Egypt.

4. **Macroeconomic policies struggled to contain domestic demand pressures for much of 2008**:

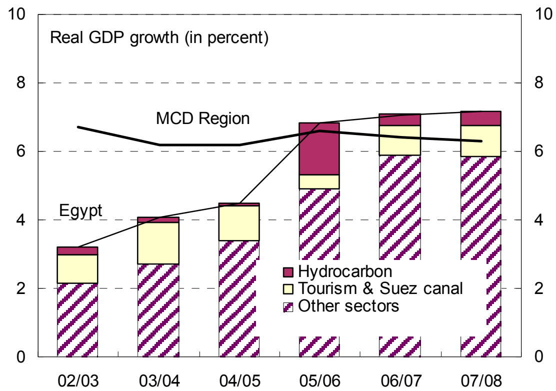
- The limited flexibility of the pound against a weak U.S. dollar and the partial sterilization of capital inflows raised non-U.S. dollar import prices and created the monetary conditions that ignited second-round inflation effects (Box 1). The nominal effective exchange rate appreciated by over 6 percent between January and September 2008, and accelerating inflation appreciated the real effective exchange rate by 21 percent.

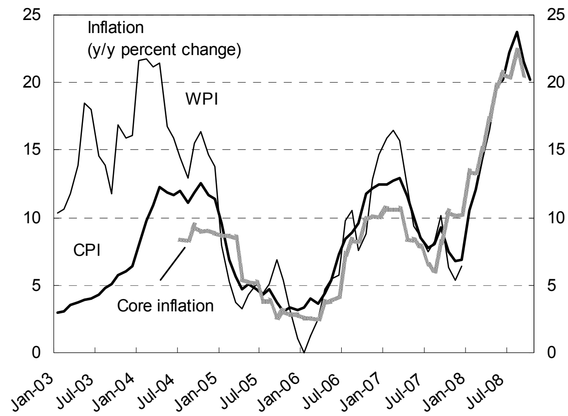
- The central bank increased policy interest rates by 275 bps (to 11½ and 13½ percent) in the first eight months of the year, but market interest rates responded slowly until the abrupt reversal of capital inflows in August-October drained some bank liquidity. The growth of broad money supply, which accelerated sharply under pressure from capital inflows slowed from 24 percent in March to 14 percent in September.

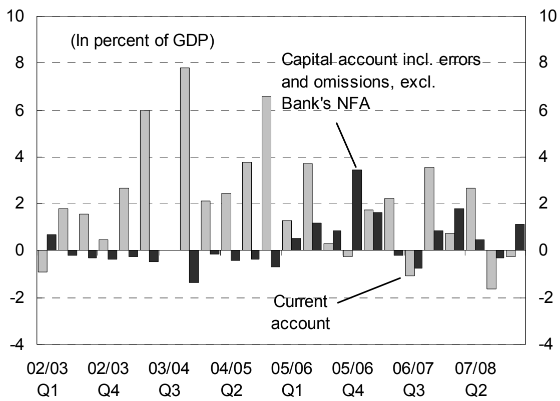
- The central government deficit narrowed to 6.8 percent of GDP in 2007/08, notwithstanding pressures from sharply increased subsidies, but the deficit at the level of the general government widened to 7.8 percent GDP, mainly reflecting increased financial investments by the social insurance fund. The 2008/09 budget left the central government deficit broadly unchanged and included significant increases in pensions, wages, and food subsidies to mitigate adverse social effects of high inflation that were met by a wider income tax base and increases in administered prices of fuels and other products.

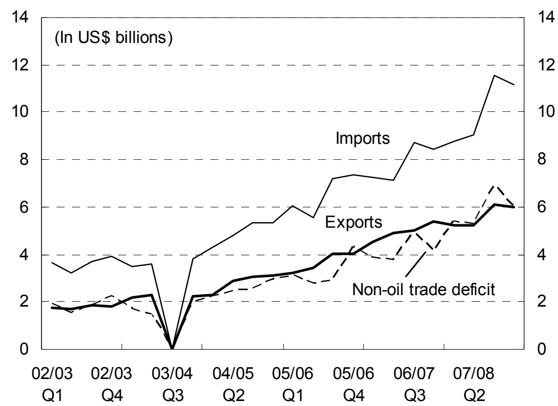
[1] In addition to its net international reserves, the central bank placed substantial foreign currency deposits with commercial banks. These deposits were available to the central bank on a short notice (see CR/07/380).

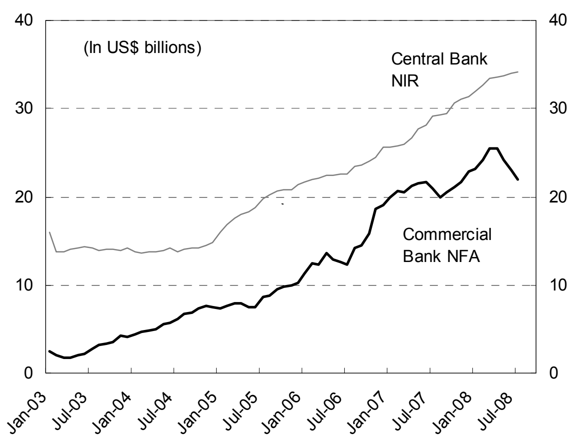
Figure 1. Egypt: Output, Inflation and External Developments











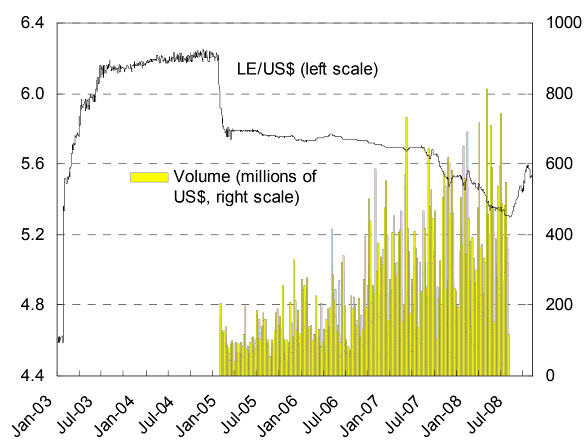
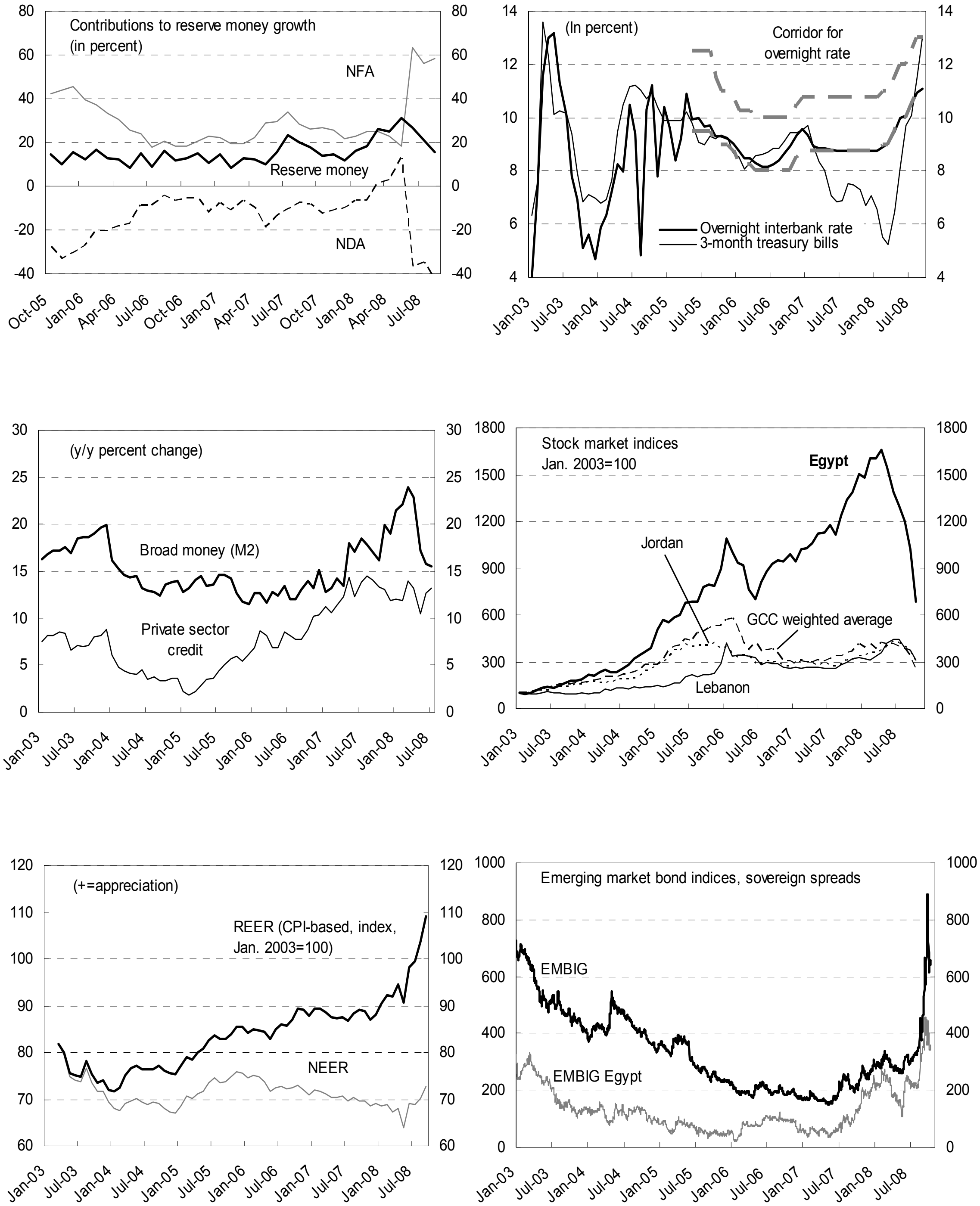


Figure 2. Egypt: Monetary and Financial Indicators



Box 1. Inflation Dynamics in Egypt

The recent surge in inflation through August 2008 reflected a combination of increases in world commodity prices, especially foods, and strong domestic demand. To disentangle the impact on headline inflation of different external and domestic factors, a vector autoregressive model (VAR) was estimated for Egypt and selected countries. This approach captures the underlying interaction of consumer prices with different domestic factors and external commodity food and fuel prices. Based on data for the past decade, changes in world commodity prices explain about 43 percent of the variation in headline inflation in Egypt, with world food prices playing a much larger role than fuel prices (Table 1). This is in line with the high share of food in consumption (44 percent of the basket) and the delayed and incomplete pass-through of international fuel prices. At the same time, domestic demand factors have been significant drivers of inflation pressures in the past. In particular, staff research indicates that shocks to broad money account for over 42 percent of the variation in headline inflation in Egypt.

Table 1. Contribution to Variation in Inflation in Egypt and Selected Countries
(After 24 months; in percent)

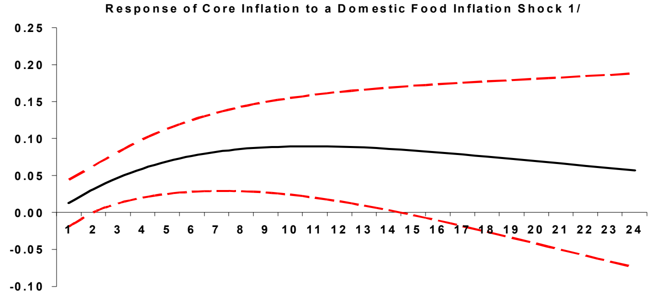
	World food	World fuel	Exchange rate	Money	Inflation inertia
Egypt	**39.8**	**3.3**	**6.8**	**41.9**	**8.1**
Algeria	2.6	22.6	1.2	17.5	56.1
Iran	15.5	7.2	1.1	36.3	40.0
Jordan	42.4	0.3	7.1	9.4	40.8
Kazakhstan	21.7	1.7	1.3	6.6	68.7
Pakistan	62.4	3.7	13.3	2.5	18.0
Syria	8.0	43.0	10.1	4.9	34.0
Tunisia	36.8	2.2	5.4	24.9	30.7

Source: IMF Staff Estimates

1/ The model use monthly data on annual changes in world food and fuel commodity prices (in U.S. dollars); nominal effective exchange rates; broad money; headline inflation, and underlying inflation for the past decade.

The recent commodity price shocks have produced second-round effects on inflation. For example, in a simple VAR model, an initial one percentage point shock to domestic food inflation tends to increase core inflation by around 0.1 percentage points, with fast adjustment, unfolding on average within one year from the original shock and peaking within 10 months. Based on past relationships, this implies that the recent 12-month food price increase of 30 percent in Egypt could lead to a 2.5 percentage point increase in underlying inflation during the following 10 months. However, declining commodity prices and the projected slowdown in domestic demand suggest that headline and underlying inflation should fall relatively quickly.

Response of Core Inflation to a Domestic Food Inflation Shock 1/



Source: IMF staff estimates

1/ Food inflation shock is a one-percentage point increase in domestic food prices. Responses are estimated from impulse response functions in a VAR model using monthly data on annual changes in domestic food and core inflation, nominal effective exchange rates, and broad money (starting 1999m3).

5. **The banking system has largely withstood the global financial crisis**. Information through end-September shows net foreign assets positions of banks and the deposit base have been stable, and the flow of credit to the private sector has continued to grow at the 13-

14 percent annual rate of the previous three years. Nevertheless, to encourage continued confidence in the banking system, the central bank publicly reiterated its guarantee of all bank deposits.

6. **Progress with structural reform has been mixed**: (i) administered prices of fuels and other items were increased sharply, but fuel subsidies continued to grow under pressure from rising international prices; (ii) a property tax reform was approved by the parliament and will be effective in January 2009, but the introduction of the VAT has been delayed until at least late 2008/09; and (iii) the clean up of nonperforming loans of public enterprises continued,[2] but the privatization program suffered a setback in July when bids for state-owned Banque du Caire, the third largest bank, were below the minimum targeted by the government and the auction was cancelled.

III. Policy Discussions

7. **The discussions were dominated by the implications for Egypt of the global financial crisis and the rapidly deteriorating international economic outlook**. As such, they focused on: (i) the extent of the likely slowdown in economic activity in Egypt; (ii) the scope the authorities had for counter-cyclical policies to support growth and employment creation; (iii) the ability of the banking system and the balance of payments to withstand further buffeting from the international crisis; and (iv) areas that could be given greater emphasis in the reform program going forward. The discussions revealed a clear awareness by the authorities of the main challenges and the key risks ahead.

A. The Near-Term Prospects

8. **The authorities viewed a slowdown in Egypt's growth rate as likely, mainly as a result of the global slowdown**. The international crisis is likely to undermine FDI flows and make domestic investors more cautious; and net exports of goods and services looked set to weaken further as key markets shrink and prices fall. The authorities believe that real GDP growth would likely fall to about 5-5½ percent in 2008/09 and further to about 4½-5 percent in 2009/10, before picking up as the recovery of the international economy takes hold.[3]

Text Table 1. Egypt: Macroeconomic Framework

	2007/08	2008/09		2009/10	
		H1	H2	H1	H2
Real GDP growth	7.2	6.2	4.8	4.9	5.1
Inflation 1/	20.2	22.8	14.0	11.0	10.2
External trade balance 2/	-14.4	-6.4	-7.6	-6.3	-7.3
External current account balance 2/	0.5	-0.6	-1.2	-1.9	-1.2
Change in international reserves (increase -) 3/	-5.4	-0.5	0.5	2.5	-0.3
Memorandum item					
Net international reserves 3/	33.8	34.4	33.9	31.4	31.7

1/ End of period.
2/ In percent of GDP.
3/ In billions of U.S. dollars.

[2] The structural reform program includes the use of privatization proceeds to clear the balance sheets of mainly public banks of nonperforming loans.

[3] A slowdown in the Egyptian economy because of global linkages is supported by recent staff research suggesting that a 1 percentage point decline in U.S. baseline growth results in a 0.3-0.5 percentage drop in Egypt baseline growth. Taking account of the projected slowdown in U.S. growth and the importance of foreign (continued)

However, they also believe that there were further downside risks to this projection given the uncertain outlook for the global economy. In contrast, they saw the inflation outlook as having improved markedly, reflecting falling world commodity prices and the weaker Egyptian economy. While the authorities felt it wise to work with a macroeconomic framework in which inflation declined to the 12-14 percent range by mid-2009, and close to single digits in 2009/10, they believed that a faster deceleration was more likely and that inflation could be close to single digits by mid 2009 (see Text Table 1).

9. **Some further weakening of the balance of payments is to be expected until the international economy improves**. Current account revenues from exports, the Suez canal, and tourism are likely to slow or fall; and continuing financial difficulties in developed economies could sustain the recent reversal in portfolio inflows and lead to a drop in FDI. In the authorities' view, the balance of payments pressures could be met comfortably with a modest decline in central bank net international reserves and more flexible exchange rate management through mid-2010.

10. **The authorities judge that the central government deficit could narrow further to just less than 6½ percent of GDP in 2008/09**, mainly reflecting planned measures to boost revenues and some savings on subsidies from import price declines. While such an adjustment would be slower than that envisaged under the medium-term consolidation plan, it suggests that the targeted deficit of 3 percent of GDP by 2010/11 would remain feasible provided planned reforms were put in place, most particularly, the introduction of the VAT later this fiscal year. However, they believed that a more gradual consolidation path was in order given the projected economic slowdown. A near-term macroeconomic framework broadly consistent with these views is discussed below. While Egypt's debt indicators have improved considerably, public debt, the deficit, and annual gross financing needs remain high and impose a heavier burden on government finances than those of similarly rated sovereigns.[4]

B. The Scope for Counter-Cyclical Policies

11. **The authorities believe that they have some room for maneuver to undertake counter-cyclical monetary and fiscal policies to support growth and employment**. They acknowledged that undertaking such policies was risky given the difficulties in assessing potential output in an economy undergoing significant structural change, the uncertainties as to the timing of the recovery of the international economy, and the uncertainties regarding the depth and duration of the recent reversal of portfolio capital inflows.

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contributions to growth in Egypt, the global crisis could reduce Egypt's GDP growth by 1-2 percentage points this year and next.

[4] The interest rate bill—at near 5 percent of GDP—consumes about 17 percent of government revenues, compared to a median of 7 percent among Standard and Poor's BB-rated countries; and annual gross financing needs are over 20 percent of GDP.

12. **The room for maneuver with fiscal policy mainly resulted from the likelihood that the outturn for 2008/09 would be better than budgeted**. They saw a modest fiscal stimulus as appropriate and would keep the fiscal deficit broadly unchanged from 2007/08 and bring forward existing infrastructure spending plans, including an early launch of the PPP program which would also boost private investment. Such a stimulus would be consistent with only a modest alteration to their planned medium-term fiscal consolidation path, raising the planned fiscal deficit target by about ½ percent through 2010/11, and with little impact on the debt-to-GDP ratio (Text Table 2 and Table 6).

Text Table 2. Egypt: Central Government Operations 1/

	2007/08	2008/09		2009/10	2010/11	2011/12
		Baseline	Revised			
Revenue	24.7	25.2	25.2	21.4	20.9	20.6
Expenditure	31.5	31.2	31.8	28.6	28.0	27.3
Of which : investment	3.8	3.0	3.6	3.0	3.1	3.1
Net acquisition of financial assets	0.0	0.2	0.2	0.2	0.2	0.2
Identified measures	...	...	...	1.7	3.9	4.0
Overall balance	-6.8	-6.2	-6.9	-5.8	-3.4	-3.0
Memorandum item:						
Gross debt-to GDP (2008 Article IV)	76.5	69.3	70.0	64.9	59.5	54.9
Gross debt-to GDP (2007 Article IV)	83.1	...	77.5	72.0	65.8	…

1/ In percent of GDP.

13. **The prospect that inflation would decline sharply in the coming months provided room to ease monetary policy**. With key world commodity prices falling and output slipping below potential, both headline and core inflation were likely to fall. The authorities believe that an early and aggressive interest rate cut would likely encourage bank lending and support output and employment, with little harmful impact on the external position and the exchange rate. However, the central bank has opted to proceed with caution given the weakened balance of payments and difficult international environment, and to wait for clearer signs that the economy was slowing and that inflation was firmly on a downward path before starting to lower interest rates.

14. **The authorities agreed that there is no clear indication that the exchange rate is misaligned and the discussion on exchange rate policy was confined to its role in dealing with external shocks (Box 2)**. They recognized the risks of seeking to limit exchange rate flexibility at a time of international crisis and with a weakening balance of payments. However, they viewed the risk of serious balance of payments pressures as low, believing that any weakening could be accommodated with a modest loss of international reserves and some additional exchange rate flexibility. More generally, in managing the exchange rate in the future, they intended to pay greater attention to movements in the euro.

Box 2. Exchange Rate Assessment

Assessment of the level of the REER by a variety of commonly applied methods presents a mixed picture. According to the equilibrium real exchange rate (ERER) methodology, the value of the Egyptian pound evaluated at projected values for 2013 is consistent with the level justified by fundamentals. The macroeconomic balances and external sustainability approaches estimate the Egyptian pound to be overvalued and undervalued, respectively. However, there is considerable uncertainty surrounding the estimates, given the recent structural changes in the economy.

Egypt: Assessment of the Real Effective Exchange Rate

I. End-2007 REER difference against:		II. Macroeconomic balance	III. External sustainability 1/	IV. Equilibrium real exchange rate
10-year average	15-year average	2013 fundamentals		
(Misalignment as percentage deviation from estimated equilibrium, overvaluation (+), undervaluation (-)).				
-19.2	-16.2	8.9	-4.3	-0.3

1/ Provides an estimate of the adjustment needed to stabilize Egypt's net foreign assets (NFA) to GDP ratio at its end-2006 level, using data taken from the CBE. If NFA data are instead taken from the Lane/Milesi-Feretti cross-country database, the resulting estimate is +5.1 percent.

Traditional indicators suggest that Egypt's external competitiveness remains adequate. As of July 2008, the real effective exchange rate (REER) had appreciated by 14 percent relative to end-December 2005, mainly reflecting the recent acceleration in inflation. The external current account has been in surplus, but on a declining trend, during the past seven years, largely on account of import growth related to trade liberalization and robust domestic demand. Exports have grown at double-digit rates in recent years, in tandem with the run-up in commodity prices.

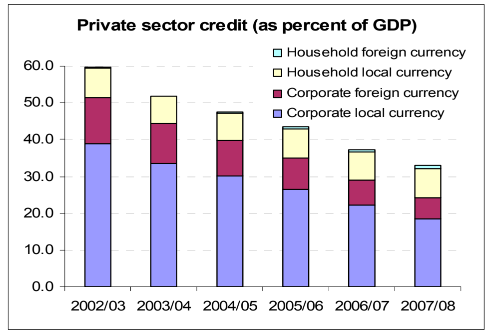
Survey-based indicators of external competitiveness identify several structural impediments to competitiveness. Egypt ranks 77 out of 131 countries in the World Economic Forum's 2008 Global Competitiveness Report, lower than many other emerging market countries, with inefficiencies in government, and inadequate supply of infrastructure and skilled human capital as top impediments. Going forward, removing these structural bottlenecks should be a high priority.

15. **The authorities believed that the banking system would continue to withstand the turmoil in global capital markets**, reflecting the strengthening of balance sheets under the banking reform program, improved banking supervision, conservative practices with respect to funding, investments, and lending (Box 3).[5]

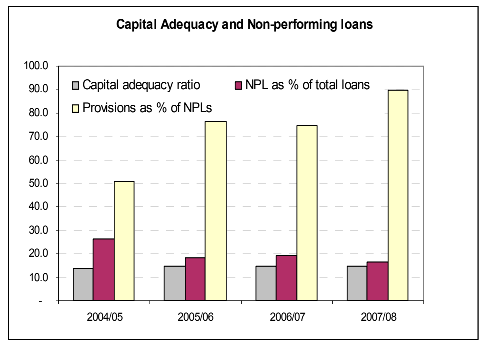
[5] The 2007 FSAP update mission concluded that the main banking system vulnerability was to a worsening in loan quality in the event of a prolonged slowdown in the economy, which seems unlikely at present. It also concluded that the largest banks were resilient to moderate changes in the exchange rate and interest rates, and that the liquidity positions of most banks could withstand a moderate shock to deposits.

Box 3. The Global Turmoil and Egypt's Financial Sector

Egypt's banking system has been able to withstand the recent financial turmoil, reflecting limited direct exposure to structured credit products and low levels of financial integration. Banking system reforms, including a strengthening of bank supervision, restructuring and consolidation, and a cleanup of non-performing loans (NPLs), have contributed to its resilience. The banking system remains healthy, and the presence of ample liquidity has allowed it to successfully absorb shocks emanating from the on-going global financial crisis.

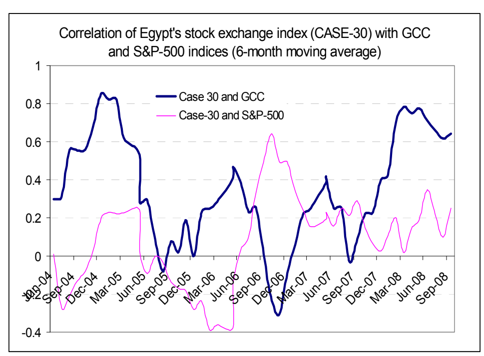


Despite robust economic growth and financial liberalization of recent years, credit growth has been moderate. Credit-to-GDP and loan-to-deposit ratios are low by emerging market standards, and banks' reliance on domestic funding to expand their balance sheets has helped to insulate them from external financing shocks. With the cleanup of NPLs, the banking system remains well capitalized, and provisioning gaps have narrowed.



Notwithstanding the stock market and real estate boom of recent years, the banking system's exposure to these sectors remains small, restricted by strict exposure limits. While foreign bank presence has increased rapidly in recent years, partly on account of privatization, there is no evidence that foreign-owned banks have cut back on lending on account of tightening liquidity conditions in their home markets. Corporate sector dependence on overseas financing is limited, with most corporations relying on retained earnings and credit from domestic financial institutions to fund new investments and working capital.

Equity and fixed income markets could be vulnerable. Foreign investors have retreated from equity and bond markets in recent months, but domestic demand for government paper remains high. While Egypt faces large domestic rollover requirements on public debt, ample liquidity in the banking system suggests the risks may not be high. The stock market, which has been the region's best performer in the past 4 years, has seen increasing equity price volatility, much of it in line with developments in the GCC markets—Egypt's CASE-30 index has become highly correlated with the GCC stock indices as equity market prices have declined sharply since the beginning of this year.



C. Medium-Term Prospects and Structural Reform

16. **Egypt's growth prospects would be enhanced by reforms that support domestic demand and ensure that the economy is well placed to take advantage of the recovery in the international economy**. Following the moderate showdown expected over the next 18 months, growth should return to its more recent historic rate of 6½-7 percent and inflation should moderate. In this context, the reforms with the quickest pay-off are likely to be those that restructure the public finances to support fiscal consolidation, and promote private investment, including by attracting FDI.

17. **Strengthening public finances remains a priority but meeting the revised medium-term fiscal consolidation path will be challenging**. The planned adjustment will require implementation of the full battery of measures being considered by the authorities (in particular, timely passage of the VAT law). Moreover, an adjustment of the magnitude envisaged may not be feasible unless a marked recovery in growth gets underway.

18. **Tax policy and administration reform will support the fiscal adjustment efforts through further broadening of the tax base and strengthening tax administration.** Legislation would be submitted to parliament in 2009/10 to: (i) replace the sales tax with a full-fledged VAT, with an expected yield of about 2 percent of GDP in revenues; (ii) close loopholes in the landmark 2005 income tax legislation and strengthen its anti-avoidance provisions. In tax administration, measures are envisaged to integrate the income tax and sales tax departments, to establish medium and small taxpayer offices in all governorates, and to clear the backlog of tax arrears.

19. **Public expenditure reforms will focus on streamlining the subsidy system, and reforming pension and healthcare systems**. In-kind food subsidies will be gradually replaced with a system of cash transfers, although the capacity to target them adequately will take longer to develop. Pension reforms (to be finalized in the coming months) would involve replacing the current pay-as-you-go defined benefit system with a system based on defined contributions. Healthcare reform—plans for which are at an initial stage—would entail universal coverage, which could pose a significant burden on the budget in the medium-term.

20. **The authorities intend a second round of privatization of state enterprises**. The shares are to be allocated in three ways: (i) a free transfer of shares to the public at large; (ii) retained ownership through holding companies for restructuring and debt settlement; and (iii) investment in a domestic future generations fund. Shares will be allowed to be traded on the stock market. Legislation and the operational framework will be finalized in the coming months, with implementation expected over the next two to three years.

D. Other Issues

21. Further improvements in macroeconomic statistics are needed. Egypt subscribed to the SDDS in January 2005, but data deficiencies persist in many sectors. Formulating

appropriate and timely economic policies requires good data but in Egypt's case, weaknesses in the timeliness, coverage, and reporting of economic and financial statistics continues to constrain informed macroeconomic policymaking and surveillance.

IV. Staff Appraisal

22. **The policy challenges facing the authorities have changed since the last Article IV consultation mission in September 2007**. With inflation appearing to be past its peak, the priority is to maintain growth and balance of payments stability in the context of the global financial turmoil and a rapidly deteriorating international economic outlook. The economic reforms have given the authorities some room for maneuver to undertake counter-cyclical monetary and fiscal policies to support growth and employment in the event that a slowdown in growth materializes, though such policies would not be without risks. Fortunately, with the economy yet to show clear signs of slowdown, there would appear to be some time to balance the risks and to calibrate an appropriately cautious policy response.

23. **Staff believes that the size and composition of the proposed ½ percent of GDP fiscal stimulus in 2008/09 are broadly appropriate**. Accelerating public infrastructure spending would strengthen the weak infrastructure base and help raise potential output. The main risk would appear to stem from adverse market reaction as a result of the still high levels of the fiscal deficit and public debt, the fact that much public debt is of a short maturity, and the credibility of the very back-loaded adjustment effort that is required even to meet the revised fiscal deficit target for 2010/11. However, it is a risk that seems worth taking given the need to absorb a rapidly growing labor force. Moreover, the risks could be mitigated by the authorities' added policy credibility due to their success under the reform program and the progress with fiscal consolidation.

24. **Judging the appropriate timing of a cut in interest rates is complicated by the risk that a rate cut could accentuate pressures on central bank reserves and the exchange rate**. With the initial impact of interest rate cuts much more likely to be on the exchange rate rather than on the demand for credit, there would appear to be room to keep policy rates unchanged until there are clear signs that pressure on the balance of payments has stabilized, and that inflation is firmly on a downward path.

25. **There are particular challenges for managing the exchange rate at a time of international crisis**, when the balance of payments could be weak for an extended period, and when the exchange rate and reserves already have been under some pressure. Staff believes that in judging the balance between reserve losses and exchange rate depreciation to meet any of these pressures, the authorities should allow more exchange rate flexibility; this could also bring some relief to the export sector. More generally, staff welcomes the authorities' intention to pay more attention to the euro in managing the exchange rate in the future. Staff estimates that the Egypt's real exchange rate is broadly in line with fundamentals.

26. **There are reasons to be optimistic that financial intermediation in Egypt will continue largely unimpeded by the international crisis**. The country's financial system is less integrated into the global economy than is the real economy, bank balance sheets have

been strengthened by the reforms, banking practices have been conservative by international standards, and the central bank continues to make good progress with the banking supervision reform agenda.

27. **The authorities are to be commended for their determination to maintain the reform momentum in the difficult circumstances**. That Egypt, so far, has withstood the international crisis better than many other economies, and the fact that it has some room for maneuver to protect output and employment, is in large part because of the achievements under the reform program. Staff believes that the emphasis in the future should be on reforms that support domestic demand and ensure that Egypt is well placed to take advantage of the eventual recovery in the international economy, and that would increase further the authorities' ability to respond to future economic shocks. Reforms that promote private investment, including by continuing to attract FDI, and that restructure the public finances to support fiscal consolidation are likely to be particularly important. In these regards, staff commends the authorities for their plans to broaden the privatization program and urges that priority be given to the early introduction of the VAT, which has the best prospect of yielding the additional revenues needed to improve the public finances and to finance longer-term fiscal structural reforms.

28. **The pressure on Egypt's public finances from fuel and food subsidies underscores the need for subsidy reform**. Staff welcomes the authorities' intention to work with the World Bank to improve the efficiency and targeting of subsidy programs. However, consideration should also be given to introducing automatic adjustment mechanisms for domestic fuel prices, while strengthening cash-based social programs to protect the most vulnerable groups.

29. **Egypt's medium-term outlook is sound**. Staff agrees that modest counter cyclical measures to support growth are appropriate and that authorities' medium-term fiscal deficit target could be relaxed by about ½ percentage point of GDP (to 3½ percent of GDP) in 2010/11. Nonetheless, the authorities need to stand ready to respond flexibly if financing pressures emerge in the balance of payments or in the budget.

30. **The economic and financial statistics provided to the Fund are broadly adequate for surveillance**, but weaknesses in their timeliness, coverage, and reporting continues to constrain informed macroeconomic policymaking and surveillance.

31. It is proposed that the next Article IV consultation with the Arab Republic of Egypt take place on the 12-month cycle

Table 1. Egypt: Selected Macroeconomic Indicators, 2005/06–2009/10 1/

(Quota: SDR 943.7 million)
(Population: 75.5 million; 2007)
(Per capita GDP: US$1,815; 2007)
(Poverty rate: 19.6 percent, 2005)
(Main products and exports: hydrocarbon products, cotton/textiles, iron and steel products, tourism; 2006/07)

	2005/06	2006/07	2007/08	2008/09	2009/10
				Projections	
Output and Prices	(Annual percentage change)				
Real GDP (market price)	6.8	7.1	7.2	5-5½	4½-5
Consumer prices (end of period)	7.2	8.6	20.2	14.0	10.2
Consumer prices (average)	4.2	11.0	11.7	17.1	12.1
Investment and Saving	(In percent of GDP)				
Gross capital formation	18.7	20.9	22.3	21.8	21.5
Gross national saving	19.5	22.3	22.8	20.0	18.4
Public Finances (central government)	(In percent of GDP at market prices)				
Revenue (including grants) 2/ 3/	24.5	24.2	24.7	25.2	21.4
Expenditure 3/ 4/	32.6	31.5	31.5	32.1	27.2
Budget balance	-8.2	-7.3	-6.8	-6.9	-5.8
Primary balance	-2.2	-0.9	-1.2	-1.8	-0.6
Total public debt (net)	79.8	71.4	62.3	58.5	55.1
Monetary Sector	(Annual percentage change)				
Credit to private sector	8.6	12.3	12.6	13.5	13.3
Base money	-5.0	14.7	20.8	12.2	12.4
Broad money (M2)	13.5	17.1	15.8	12.2	12.9
Velocity of broad money	1.1	1.1	1.2	1.3	1.3
Treasury bills (91-day rate, period average, in percent)	8.8	8.7	7.0	...	
External sector	(In percent of GDP, unless otherwise indicated)				
Exports of goods (in U.S. dollar, percentage change)	33.4	19.3	33.3	-15.7	-2.0
Imports of goods (in U.S. dollar, percentage change)	25.8	24.3	39.5	-0.3	4.7
Merchandise trade balance	-11.2	-12.1	-14.4	-14.0	-13.7
Current account excluding official transfers	0.3	0.8	0.0	-2.3	-3.4
Current account including official transfers	0.8	1.4	0.5	-1.8	-3.1
Foreign direct investment	5.6	8.1	7.5	4.0	3.1
Total external debt (in US$ billions)	30.9	30.0	33.9	32.3	31.0
Gross official reserves (in US$ billions)	22.9	28.4	33.8	33.9	31.7
In months of next year imports of goods and services	5.9	5.2	6.4	6.1	5.1
In percent of short-term external debt	529	841	698	657	627
Memorandum items:					
Nominal GDP (in U.S. dollar billions)	107.4	130.3	162.2	198.6	225.4
Unemployment rate (percent)	10.9	8.9	8.8	...	…
Net hydrocarbon exports (in US$ billions)	4.9	6.0	4.9	5.4	5.0
Egyptian pounds per U.S. dollar (period average)	5.8	5.7	5.5	...	...
Real effective exchange rate (pd. average, percentage change)	8.1	4.4	3.0	...	...
Stock market index (CASE 30)	425.7	668.0	811.0	...	...

Sources: Egyptian authorities, World Bank (poverty rate); and Fund staff estimates and projections.

1/ Fiscal year ends June 30.
2/ Authorities' estimates based on revised data and new budget classification adopted in 2006.
3/ Series break in 2005/06, when fuel subsidies were explicitly recorded, and matched by an equivalent notional revenue (from the oil company (EGPC) and its foreign partners) line item.
4/ Includes acquisition of financial assets.

Table 2. Egypt: Summary of Budget Sector Fiscal Operations 2005/06 - 2009/10 1/

	2005/06	2006/07	2007/08	2008/09		2009/10
			Est.	Baseline	Proj.	Proj.
			(In billion of Egyptian pounds)			
Revenue	151.3	180.2	221.4	276.4	276.4	274.8
Tax revenue	97.8	114.3	137.2	172.2	172.2	193.4
Income and property	49.5	60.3	69.1	85.4	85.4	97.0
Goods and services	34.7	39.4	49.7	68.1	68.1	75.9
International trade	9.7	10.4	14.0	15.5	15.5	16.7
Other taxes	3.9	4.2	4.3	3.2	3.2	3.8
Nontax revenue	51.1	62.0	82.7	98.6	98.6	80.0
Grants	2.4	3.9	1.5	5.6	5.6	1.3
Expenditure	207.8	222.0	282.3	342.3	349.3	346.2
Wages	46.7	52.2	62.8	79.0	79.0	90.8
Purchases of goods and services	14.4	17.0	18.5	23.8	23.8	27.9
Interest	36.8	47.7	50.5	54.9	56.0	66.4
Subsidies, grants, and social benefits 2/	68.9	58.4	92.4	125.4	125.4	115.5
Of which: fuel subsidy	41.8	40.1	60.2	52.7	52.7	52.2
food subsidy	9.4	9.4	16.4	22.8	22.8	16.1
Other current expenditure	19.7	21.2	23.9	25.8	25.8	28.7
Investment expenditure	21.2	25.5	34.2	33.3	39.3	38.5
Measures	…	…	…	…	…	-21.7
Cash balance	-56.5	-41.8	-60.9	-65.9	-72.9	-71.4
Net acquisition of financial assets	-6.2	12.9	0.2	2.7	2.7	3.1
Overall fiscal balance	-50.4	-54.7	-61.1	-68.5	-75.6	-74.5
			(In percent of GDP)			
Revenue	24.5	24.2	24.7	25.2	25.2	21.4
Tax revenue	15.8	15.3	15.3	15.7	15.7	15.1
Income and property	8.0	8.1	7.7	7.8	7.8	7.5
Goods and services	5.6	5.3	5.5	6.2	6.2	5.9
International trade	1.6	1.4	1.6	1.4	1.4	1.3
Other	0.6	0.6	0.5	0.3	0.3	0.3
Nontax revenue	8.3	8.3	9.2	9.0	9.0	6.2
Grants	0.4	0.5	0.2	0.5	0.5	0.1
Expenditure	33.6	29.8	31.5	31.2	31.8	26.9
Wages and other remunerations	7.6	7.0	7.0	7.2	7.2	7.1
Purchases of goods and services	2.3	2.3	2.1	2.2	2.2	2.2
Interest	6.0	6.4	5.6	5.0	5.1	5.2
Subsidies, grants, and social benefits 2/	11.2	7.8	10.3	11.4	11.4	9.0
Of which: fuel subsidy	6.8	5.4	6.7	4.8	4.8	4.1
food subsidy	1.5	1.3	1.8	2.1	2.1	1.3
Other current expenditure	3.2	2.8	2.7	2.3	2.3	2.2
Investment expenditure	3.4	3.4	3.8	3.0	3.6	3.0
Measures	…	…	…	…	…	-1.7
Cash balance	-9.2	-5.6	-6.8	-6.0	-6.6	-5.6
Net acquisition of financial assets	-1.0	1.7	0.0	0.2	0.2	0.2
Overall fiscal balance	-8.2	-7.3	-6.8	-6.2	-6.9	-5.8
Discrepancy above and below the line	1.3	0.1	0.0	…	0.0	0.0
Financing	9.5	7.5	6.8	…	6.9	5.8
Net domestic financing	8.8	4.5	4.6	…	8.0	6.4
Net external financing	0.6	0.5	1.3	…	-1.1	-0.6
Other	0.1	2.5	1.0	…	0.0	0.0
Memorandum items:						
Overall balance net of one-off items	-10.4	-8.9	-8.1	-8.6	-9.2	-5.4
Primary balance	-2.2	-0.9	-1.2	-1.2	-1.8	-0.6
Oil revenues 3/	7.8	5.5	6.4	4.4	4.4	3.8
Nonoil revenues	16.7	18.7	18.3	20.7	20.7	17.6
Of which: non-oil tax revenues	12.0	11.9	12.0	13.4	13.4	13.2
Nominal GDP (in billion LE)	617.7	744.8	896.5	1,098.2	1,098.2	1,284.9

Source: Ministry of Finance and Fund staff estimates.
1/ Budget sector comprises central government, local governments, and some public corporations.
The fiscal year begins on July 1st. The data are presented on a cash basis consistent with the GFS 2001 classification.
2/ Beginning in 2005/06, the cost of domestic fuel subsidies and the notional revenues from EGPC are recorded on-budget.
3/ Oil-sector revenue includes corporate income tax receipts from EGPC and foreign partner royalties extraordinary payments, excise taxes on petrol products, and dividends collected from EGPC.

Table 3. Egypt: General Government Fiscal Operations 2005/06 - 2009/10 1/

	2005/06	2006/07	2007/08 Est.	2008/09 Proj.	2009/10 Proj.
	(In billions of Egyptian pounds)				
Total revenue	176.6	206.5	248.8	287.9	315.0
Tax revenue	97.8	114.3	137.2	172.2	193.4
Income and property	49.5	60.3	69.1	85.4	97.0
Goods and services	34.7	39.4	49.7	68.1	75.9
International trade taxes	9.7	10.4	14.0	15.5	16.7
Other taxes	3.9	4.2	4.3	3.2	3.8
Nontax revenue	76.5	88.2	110.1	110.1	120.2
Grants	2.4	3.9	1.5	5.6	1.3
Expenditure	224.3	244.8	305.8	355.1	362.3
Compensation to employees	47.3	52.7	63.5	79.9	91.8
Purchases of goods and services	14.5	17.1	18.8	24.2	28.3
Interest	35.5	39.2	40.9	48.4	58.3
Subsidies, grants and social benefits 2/	86.1	88.7	124.2	137.4	138.1
Of which: fuel subsidy	41.8	40.1	60.2	52.7	52.2
Other current expenditure	19.8	21.6	23.9	25.8	28.7
Investment expenditure	21.2	25.5	34.3	39.4	38.7
Measures	…	…	…	…	-21.7
Cash balance	-47.7	-38.4	-57.0	-67.2	-47.3
Net acquisition of financial assets	8.9	17.8	12.8	16.0	18.1
Overall balance	-56.6	-56.2	-69.7	-83.3	-65.4
	(In percent of GDP)				
Total revenue	28.6	27.7	27.8	26.2	24.5
Tax revenue	15.8	15.3	15.3	15.7	15.1
Income and property	8.0	8.1	7.7	7.8	7.5
Goods and services	5.6	5.3	5.5	6.2	5.9
International trade taxes	1.6	1.4	1.6	1.4	1.3
Other taxes	0.6	0.6	0.5	0.3	0.3
Nontax revenue	12.4	11.8	12.3	10.0	9.4
Grants	0.4	0.5	0.2	0.5	0.1
Expenditure	36.3	32.9	34.1	32.3	28.2
Compensation to employees	7.7	7.1	7.1	7.3	7.1
Purchases of goods and services	2.3	2.3	2.1	2.2	2.2
Interest	5.8	5.3	4.6	4.4	4.5
Subsidies, grants and social benefits 2/	13.9	11.9	13.9	12.5	10.7
Of which: fuel subsidy	6.8	5.4	6.7	4.8	4.1
Other current expenditure	3.2	2.9	2.7	2.4	2.2
Investment expenditure	3.4	3.4	3.8	3.6	3.0
Measures	…	…	…	…	-1.7
Cash balance	-7.7	-5.2	-6.4	-6.1	-3.7
Net acquisition of financial assets	1.4	2.4	1.4	1.5	1.4
Overall balance	-9.2	-7.5	-7.8	-7.6	-5.1
Discrepancy above and below the line	-1.5	-0.1	0.0	0.0	0.0
Financing Sources	7.7	7.5	7.8	7.6	5.1
Net domestic financing	8.3	7.3	4.5	6.9	4.4
Net external financing	0.6	0.5	1.3	0.7	0.7
Other	-1.2	-0.3	2.0	0.0	0.0
Memorandum items:					
Primary fiscal balance	-3.4	-2.3	-3.2	-3.2	-0.6
Oil-related revenue 3/	7.8	5.5	6.4	4.4	3.8
General government gross debt	98.8	87.1	76.5	70.0	64.9
General government net debt	79.8	71.4	62.3	58.5	55.1
Nominal GDP (in billion LE)	617.7	744.8	896.5	1,098.2	1,284.9

Sources: Ministry of Finance and Fund staff estimates.

1/ General government includes the budget sector, the national investment bank (NIB) and social insurance fund. The fiscal year begins in July 1st. The data are presented on a cash basis consistent with the GFS 2001 classification.

2/ Beginning in 2005/06, the cost of domestic fuel subsidies covered by EGPC are recorded on-budget and notional revenues from EGPC are also recorded on-budget.

3/ Oil-sector revenue includes corporate income tax receipts from EGPC and foreign partners, royalties, extraordinary payments, excise taxes on petrol products and dividends collected from EGPC.

Table 4. Egypt: Monetary Survey, 2005/06–2009/10

	2005/06	2006/07	2007/08	2008/09	2009/10
				Projections	
	(End-period, in billions of Egyptian pounds)				
Net foreign assets	133.6	218.8	303.8	240.8	227.9
Central bank (CBE)	129.5	160.2	182.0	171.6	159.2
Commercial banks	72.1	123.3	123.3	70.9	70.3
CBE medium- and long-term liabilities	-3.9	-2.0	-1.6	-1.6	-1.6
Blocked accounts (Rescheduled loans) 1/	-64.0	-62.7	0.0	0.0	0.0
Net domestic assets	426.7	437.4	456.1	611.5	734.3
Net claims on government	175.6	163.7	139.3	226.3	306.3
Claims on public sector companies	32.9	24.4	26.9	26.9	26.9
Claims on private sector companies	292.5	328.5	370.1	420.2	476.0
Net other items	-74.2	-79.4	-80.2	-61.9	-75.0
Broad money (M2)	560.4	656.1	759.9	852.3	962.2
Domestic currency component (M2D)	424.0	502.8	600.6	677.1	769.4
Foreign currency deposits	136.4	153.4	159.3	175.2	192.8
Memorandum items:					
Reserve money 2/	132.4	151.9	183.4	205.8	207.9
Net international reserves	129.5	160.2	182.0	171.6	159.2
Net domestic assets	3.0	-8.3	1.4	34.2	48.7
Of which : sterilization operations	-95.1	-169.9	-182.9		
	(Annual percent change, unless otherwise indicated)				
Broad money					
M2D	13.6	18.6	19.5	12.7	13.6
M2	13.5	17.1	15.8	12.2	12.9
Reserve money 2/	-5.0	14.7	20.8	12.2	12.4
Contribution to Broad Money Growth	13.5	17.1	15.8	12.2	12.9
Net foreign assets	10.6	15.2	13.0	-8.3	-1.5
Net domestic assets	2.8	1.9	2.9	20.5	14.4
Commercial bank credit					
Private sector	8.6	12.3	12.6	13.5	13.3
Government	14.6	-6.7	-14.9	62.5	35.3
Velocity					
M2D/GDP (level)	1.5	1.5	1.5	1.6	1.7
M2/GDP (level)	1.1	1.1	1.2	1.3	1.3
Money multiplier (M2D / reserve money)	3.2	3.3	3.3	3.3	3.3
Foreign currency deposits (in percent of broad money)	24.3	23.4	21.0	20.6	20.0

Sources: Central Bank of Egypt; and IMF staff estimates and projections.

1/ Payments (on original schedule) of public enterprises on debt rescheduled by the Paris Club.
2/ Includes foreign currency deposits of commercial banks at the CBE.

Table 5. Egypt: Balance of Payments, 2005/06–2009/10

	2005/06	2006/07	2007/08	Proj. 2008/09	Proj. 2009/10
	(In billions of U.S. dollars, unless otherwise indicated)				
Current account balance	0.9	1.9	0.9	-3.6	-6.9
Trade balance	-12.0	-15.8	-23.4	-27.9	-30.8
Exports	18.5	22.0	29.4	24.7	24.3
Of which: oil	7.4	7.4	11.5	7.9	7.1
Gas	2.8	2.7	3.0	3.0	3.1
Imports	-30.4	-37.8	-52.8	-52.6	-55.1
Of which: oil	-5.4	-4.1	-9.6	-5.5	-5.2
Services (net)	7.3	10.6	15.0	14.9	14.5
Of which: Tourism receipts	6.4	7.2	10.8	10.1	9.4
Suez canal dues	3.6	4.2	5.2	5.0	5.1
Transfers	5.5	7.1	9.3	9.3	9.4
Official grants	0.6	0.8	1.0	0.8	0.7
Private remittances	5.0	6.3	8.4	8.5	8.7
Capital account	4.6	4.3	6.4	3.7	4.8
Medium- and long-term loans (net)	1.5	-0.6	-1.9	-1.6	-1.3
Drawings	4.2	1.4	0.4	1.1	1.2
Amortization	-2.7	-1.9	-2.3	-2.6	-2.5
FDI	6.0	10.5	12.1	8.0	7.0
Portfolio investment	2.1	3.7	-2.3	-10.6	-1.0
Commercial banks' NFA	-5.0	-9.1	-1.5	7.9	0.1
Errors and omissions (net)	-2.3	-0.7	-1.8	0.0	0.0
Overall balance	3.2	5.5	5.4	0.1	-2.2
Financing	-3.2	-5.5	-5.4	-0.1	2.2
Of which: Net international reserves	-3.2	-5.5	-5.4	-0.1	2.2
Memorandum items:					
Current account (percent of GDP)	0.8	1.4	0.5	-1.8	-3.1
Oil trade balance (percent of GDP)	1.9	2.5	1.2	1.2	0.9
Gross reserves (in U.S. dollar billions, end of period)	22.9	28.4	33.8	33.9	31.7
In months of next year's imports of GNFS	5.9	5.2	6.4	6.1	5.1
GDP (in U.S. dollar billions)	107.4	130.3	162.2	198.6	225.4
External debt 2/	30.9	30.0	33.9	32.3	31.0
External debt service (percent of exports GNFS)	10.0	6.6	5.6	7.2	7.2

Sources: Central Bank of Egypt; IMF staff estimates and projections.

1/ Includes multilateral and bilateral public sector borrowing and private borrowing.
2/ Excludes nonresident holdings of domestic currency-denominated treasury bills.

Table 6. Egypt: Medium-Term Macroeconomic Framework, 2005/06–2012/13

				Projections				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	(In percent of GDP, unless otherwise indicated)							
Growth and prices								
Real GDP (annual percent change)	6.8	7.1	7.2	5.5	5.0	7.0	6.5	6.5
Hydrocarbon production	21.2	6.3	5.2	5.1	4.0	4.5	4.8	5.0
Nonhydrocarbon production	5.8	7.1	7.3	5.5	5.1	7.2	6.7	6.6
CPI inflation (end of period)	7.2	8.6	20.2	14.0	10.2	8.0	7.0	7.0
CPI inflation (average)	4.2	11.0	11.7	17.1	12.1	9.1	7.5	7.0
Savings-investment balance								
Investment	18.7	20.9	22.3	21.8	21.5	23.2	24.2	24.3
Private investment	15.3	17.4	18.4	18.3	18.5	20.1	21.1	21.1
General government investment	3.4	3.4	3.8	3.6	3.0	3.1	3.1	3.1
Savings	19.5	22.3	22.8	20.0	18.4	20.5	22.0	22.0
Private savings	23.8	24.0	25.3	22.6	19.1	19.1	20.3	20.6
General government savings	-4.3	-1.7	-2.5	-2.5	-0.7	1.4	1.6	1.4
Government accounts								
Revenue	24.5	24.2	24.7	25.2	21.4	20.9	20.6	20.1
Expenditure and net acquisition of financial assets	32.6	31.5	31.5	32.1	27.2	24.4	23.6	23.1
Overall fiscal balance (central government)	-8.2	-7.3	-6.8	-6.9	-5.8	-3.4	-3.0	-3.0
Overall fiscal balance (general government)	-9.2	-7.5	-7.8	-7.6	-5.1	-3.0	-2.8	-3.1
Total public debt (net)	79.8	71.4	62.3	58.5	55.1	50.9	47.4	44.6
Balance of payments and external debt								
Non-oil and gas trade balance	-15.7	-16.7	-17.5	-16.8	-15.9	-15.0	-14.7	-14.8
External current account balance	0.8	1.4	0.5	-1.8	-3.1	-2.6	-2.3	-2.3
Foreign direct investment (in US$ billions)	6.0	10.5	12.1	8.0	7.0	9.6	10.3	11.2
Official reserves (in US$ billions)	22.9	28.4	33.8	33.9	31.7	33.7	36.8	39.1
In months of imports	5.9	5.2	6.4	6.1	5.1	4.9	4.9	4.9
External debt (in US$ billion)	30.9	30.0	33.9	32.3	31.0	30.3	30.3	29.1

Sources: Egyptian authorities; and Fund staff estimates and projections.

Table 7. Egypt: Selected Vulnerability Indicators, 2005/06–2009/10

					Projected	
	2002/03	2005/06	2006/07	2007/08	2008/09	2009/2010
Key economic and market indicators						
Real GDP growth (percent)		6.8	7.1	7.2	5.5	5.0
CPI inflation (period average, percent)		4.2	11.0	11.7	17.1	12.1
Short-term interest rate (91-day Treasury bill rate, percent)		8.8	8.7	7.0	...	...
Five-year eurobond spread (basis points, over U.S. Treasury)		68	89	190	...	...
Exchange rate (LE per dollar, end-of-period)		5.8	5.7	5.3	...	...
External sector						
Exchange rate regime		De jure managed float; de facto float since mid-2007				
Current account balance (percent of GDP)		0.8	1.4	0.5	-1.8	-3.1
Net FDI inflows (percent of GDP)		5.6	8.1	7.5	4.0	3.1
Exports of goods and services (percentage change of US$ value, GNFS)		18.1	16.8	38.2	-10.6	-1.6
Real effective exchange rate (1991=100)		108.0	112.8	116.8	...	...
Gross international reserves (GIR) (US$ billions)		22.9	28.4	33.8	33.9	31.7
GIR in percent of debt at remaining maturity 1/		529	841	698	657	627.4
Net international reserves (US$ billions)		22.9	28.4	33.8	33.9	31.7
Total gross external debt in percent of GDP		28.8	23.0	20.9	16.3	13.7
Of which: short-term external debt (original maturity, percent of total)		6.8	5.6	5.1	8.0	8.5
external debt of domestic private sector (percent of total)		6.8	5.6	5.1	8.0	8.5
Total gross external debt in percent of exports of GNFS		93.6	77.8	63.6	67.8	66.1
Gross external financing requirement (US$ billions) 2/		1.8	0.1	1.4	6.3	9.5
Public sector 3/						
General government balance (percent of GDP)		-9.2	-7.5	-7.8	-7.6	-5.1
Primary balance (Central government; percent of GDP)		-2.2	-0.9	-1.2	-1.8	-0.6
Public sector gross debt (percent of GDP)		98.8	87.1	76.5	70.0	64.9
Public sector net debt (percent of GDP)		79.8	71.4	62.3	58.5	55.1
Banking sector 4/						
Capital adequacy ratio (percent)		14.7	14.8	14.9	...	...
NPLs as percent of total loans		18.2	19.3	16.5	...	...
Provisions as percent of NPLs		76.2	74.6	89.9	...	...
Return on average assets (percent)		0.8	0.9	...	...	...
Return on equity (percent)		14.3	15.6	...	...	...
FX deposits (percent of total deposits)		30.1	27.8	26.0	...	...
FX loans (percent of total loans)		27.6	30.9	34.0	...	...
Government debt held by financial sector (percent of total assets)		44.4	44.2	43.8	...	...
Credit to private sector (percent change)		8.6	12.3	12.6	13.5	13.3
Memorandum item:						
Nominal GDP (US$ billions)		107.4	130.3	162.2	198.6	225.4

Sources: Egyptian authorities; and IMF staff estimates and projections.

1/ Debt at remaining maturity is defined as external short-term debt plus maturing medium- and long-term external debt.
2/ Current account deficit plus amortization of external debt.
3/ Public sector covers the general government.
4/ The banking sector includes commercial banks (public and private), business and investment banks, and specialized banks.

Table 8. Egypt: Public Sector Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
1	**Baseline: Public sector debt 1/**	82.4	80.5	79.8	71.4	62.3	**58.6**	**55.4**	**51.5**	**48.2**	**45.5**	**43.1**	**-2.4**
	Of which : foreign-currency denominated	35.6	29.1	26.1	21.8	19.2	17.6	16.4	15.1	14.0	13.1	12.3	
2	Change in public sector debt	-3.5	-1.9	-0.7	-8.4	-9.1	-3.8	-3.2	-3.9	-3.3	-2.8	-2.4	
3	Identified debt-creating flows (4+7+12)	-2.8	-2.1	-1.2	-6.3	-10.2	-3.8	-3.2	-3.9	-3.3	-2.8	-2.4	
4	Primary deficit	2.5	2.7	3.4	2.3	3.2	3.3	0.8	-1.0	-0.8	-0.2	0.2	
5	Revenue and grants	25.6	24.8	28.6	27.7	27.8	28.5	24.5	24.0	23.6	23.0	22.4	
6	Primary (noninterest) expenditure	28.1	27.6	32.0	30.0	31.0	31.7	25.3	23.0	22.8	22.8	22.6	
7	Automatic debt dynamics 2/	-5.4	-4.6	-4.6	-8.6	-8.6	-7.0	-4.0	-3.0	-2.5	-2.5	-2.6	
8	Contribution from interest rate/growth differential 3/	-6.3	-2.5	-4.6	-8.3	-7.5	-7.0	-4.0	-3.0	-2.5	-2.5	-2.6	
9	*Of which:* contribution from real interest rate	-3.3	0.9	0.2	-3.7	-3.2	-4.2	-1.5	0.4	0.4	0.2	0.0	
10	*Of which:* contribution from real GDP growth	-3.0	-3.3	-4.8	-4.7	-4.3	-2.8	-2.5	-3.4	-2.9	-2.7	-2.6	
11	Contribution from exchange rate depreciation 4/	0.9	-2.2	-0.1	-0.2	-1.1	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	-0.2	0.0	0.0	-4.9	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	-0.2	-0.2	-1.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (bank recapitalization, debt retirement with previously unrecognized ac	0.0	0.0	0.2	1.3	-4.8	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	-0.7	0.3	0.6	-2.1	1.2	0.0	0.0	0.0	0.0	0.0	0.0	
	Public sector debt-to-revenue ratio 1/	321.8	324.3	279.2	257.6	224.6	205.9	226.0	214.5	204.6	197.7	192.7	
	Gross financing need 6/	19.7	20.2	22.1	21.4	21.1	21.0	18.4	15.9	15.0	14.4	13.9	
	in billions of U.S. dollars	15.5	18.2	23.7	27.9	34.1	41.8	41.6	40.9	42.9	45.3	48.9	
	Scenario with key variables at their historical averages 7/						**58.6**	**58.7**	**58.8**	**58.9**	**59.2**	**59.3**	**-2.9**
	Scenario with no policy change (constant primary balance) in 2008-2013						**58.6**	**57.4**	**57.5**	**58.0**	**58.1**	**58.5**	**-2.9**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	4.1	4.5	6.8	7.1	7.2	5.5	5.0	7.0	6.5	6.5	6.5	
	Average nominal interest rate on public debt (in percent) 8/	7.7	7.7	8.2	7.9	7.8	8.7	9.1	8.8	8.7	8.5	8.4	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-3.9	1.4	0.8	-4.7	-4.5	-7.5	-2.4	1.3	1.5	1.0	0.4	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.5	7.2	0.3	1.1	6.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	11.7	6.2	7.4	12.6	12.3	16.1	11.4	7.5	7.2	7.6	8.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-0.8	2.3	24.1	0.4	10.6	8.1	-16.3	-2.6	5.4	6.3	5.7	
	Primary deficit	2.5	2.7	3.4	2.3	3.2	3.3	0.8	-1.0	-0.8	-0.2	0.2	

1/ Net debt of general government, including government guaranteed debt. Year t refers to fiscal year t/t+1 (e.g. 2008 is fiscal year 2008/09).

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

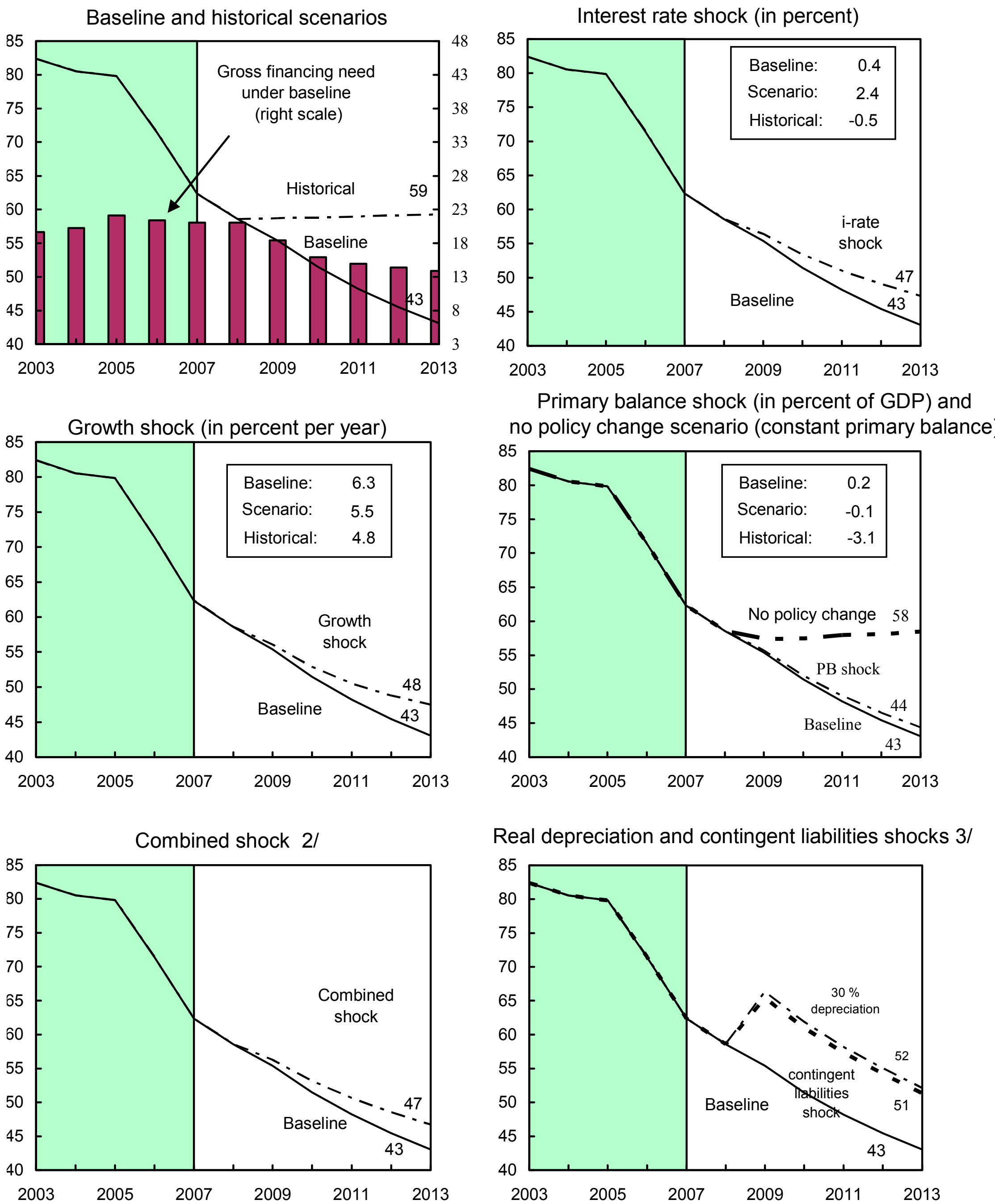
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 3. Egypt: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Egypt: External Debt Sustainability Framework, 2002/03–2012/13

(In percent of GDP, unless otherwise indicated)

	Actual						Projected					
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	
Baseline: External debt	36.1	37.9	32.2	28.8	24.2	18.3	13.7	11.6	10.4	9.1	8.3	Debt-stabilizing non-interest current account 6/
Change in external debt	3.4	1.8	-5.7	-3.5	-4.6	-5.8	-4.6	-2.1	-1.3	-1.3	-0.8	
Identified external debt-creating flows (4+8+9)	-2.9	-6.3	-13.2	-14.5	-18.1	-12.7	-5.2	-3.8	-3.1	-2.5	-1.8	-4.4
Current account deficit, excluding interest payments	-3.2	-5.1	-3.9	-1.4	-1.9	-1.0	0.6	1.2	1.5	2.0	2.3	
Deficit in balance of goods and services	-46.2	-58.6	-64.8	-66.3	-65.2	-73.5	-68.9	-66.1	-66.6	-67.5	-68.2	
Exports	22.1	29.1	31.1	30.7	30.1	33.7	30.8	29.4	29.3	29.5	29.7	
Imports	-24.0	-29.5	-33.7	-35.6	-35.1	-39.9	-38.1	-36.7	-37.3	-38.0	-38.5	
Net nondebt creating capital inflows (negative)	-2.9	-3.1	-5.3	-8.4	-12.0	-7.5	-5.2	-4.7	-4.3	-4.3	-3.9	
Automatic debt dynamics 1/	3.2	1.9	-4.0	-4.7	-4.2	-4.2	-0.6	-0.2	-0.2	-0.2	-0.2	
Contribution from nominal interest rate	0.8	0.8	0.7	0.5	0.5	0.4	0.3	0.5	0.5	0.4	0.4	
Contribution from real GDP growth	-1.1	-1.5	-1.5	-1.8	-1.7	-1.4	-0.9	-0.7	-0.7	-0.6	-0.6	
Contribution from price and exchange rate changes 2/	3.6	2.7	-3.2	-3.4	-2.9	-3.2	...	...	...	...	...	
Residual, including change in gross foreign assets (2 - 3) 3/	6.2	8.1	7.5	11.0	13.4	6.9	0.6	1.7	1.8	1.2	1.0	
External debt-to-exports ratio (in percent)	163.3	130.2	103.6	93.6	80.2	54.5	44.6	39.6	35.4	30.8	28.1	
Gross external financing need (in billions of US dollars) 4/	1.3	-0.1	0.7	3.7	1.7	3.1	6.0	7.8	9.1	11.7	12.4	
in percent of GDP	1.6	-0.2	0.8	3.4	1.3	1.9	3.0	3.3	3.5	4.0	3.9	
Scenario with key variables at their historical averages 5/							16.5	15.2	14.0	12.8	12.1	-5.4
Key macroeconomic assumptions underlying baseline												
Real GDP growth (in percent)	3.2	4.1	4.5	6.8	7.1	7.2	6.0	6.0	6.5	6.8	6.9	
GDP deflator in US dollars (change in percent)	-9.9	-7.0	9.1	11.9	11.3	15.3	21.0	9.7	4.0	4.0	3.3	
Nominal external interest rate (in percent)	2.2	2.0	2.0	2.0	1.9	2.2	2.1	4.3	4.6	4.6	4.8	
Growth of exports of goods and services (US dollar terms, in percent)	14.0	27.5	21.8	18.1	16.8	38.2	17.4	10.9	10.5	11.8	11.0	
Growth of imports of goods and services (US dollar terms, in percent)	0.2	18.8	30.0	26.5	17.6	40.4	22.5	12.2	12.5	13.5	11.7	
Current account balance, excluding interest payments	3.2	5.1	3.9	1.4	1.9	1.0	-0.6	-1.2	-1.5	-2.0	-2.3	
Net non-debt creating capital inflows	2.9	3.1	5.3	8.4	12.0	7.5	5.2	4.7	4.3	4.3	3.9	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and a rising GDP deflator.

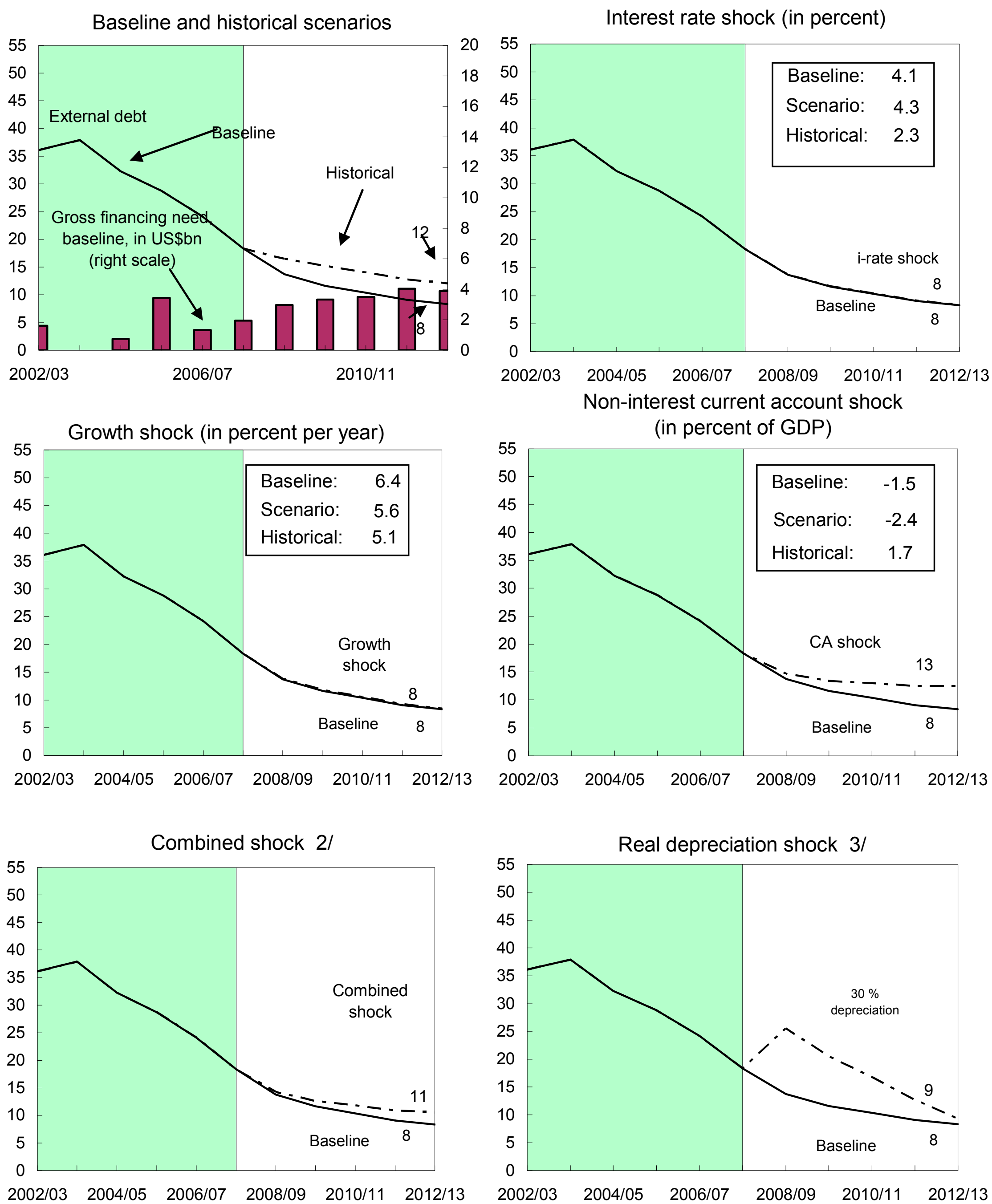
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 4. Egypt: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008/09.

INTERNATIONAL MONETARY FUND

ARAB REPUBLIC OF EGYPT

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Middle East and Central Asia Department
(in consultation with other departments)

November 25, 2008

Contents Page

Appendix I. Egypt: Relations with the Fund

(As of October 31, 2008)

I. **Membership Status**: Joined 12/27/45; Article VIII[6]

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	943.70	100.00
Fund holdings of currency	943.72	100.00

III. **SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	135.92	100.00
Holdings	82.49	60.69

IV. **Outstanding Purchases and Loans:** None

V. **Financial Agreements:**

Type	Approval date	Expiration date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	10/11/96	9/30/98	271.40	0
EFF	9/20/93	9/19/96	400.00	0
Stand-by	5/17/91	5/31/93	234.40	147.20

VI. **Projected Obligations to the Fund:**[7]
(SDR million; based on existing use of resources and present holding of SDRs)

	Forthcoming				
	2008	2009	2010	2011	2012
Charges/interest	0.36	1.03	1.03	1.03	1.03
Total	0.36	1.03	1.03	1.03	1.03

[6] Egypt accepted the obligations of Article VIII, Sections 2, 3, and 4 on January 2, 2005.

[7] The projection of charges and interest assume that overdue principal at the report date (if any) will remain outstanding, but forthcoming obligations will be settled on time.

VII. **Exchange Rate Arrangement** (As of October 31, 2008):

Prior to January 29, 2003, the Egyptian pound was pegged to the dollar, with all foreign exchange transactions taking place within a ±3 percent range around the central rate, which was announced by the Central Bank of Egypt (CBE). Effective January 29, 2003, the Egyptian pound was allowed to float. As a result, the exchange arrangement of Egypt was reclassified to the category "managed float with no pre-announced path for the exchange rate," from the category "pegged exchange rate within horizontal bands." In December 2004, the CBE officially launched the foreign exchange interbank market with no controls on rates, governed by a formal interbank convention on foreign exchange trading. The CBE stands ready to purchase foreign exchange in the interbank market for banks to the extent they exceed prudential limits on net open positions at the prevailing market rate. Effective February 1, 2005, Egypt's exchange rate was reclassified to a conventional peg from a managed float with no predetermined path for the exchange rate. Since July 2007, the de facto exchange arrangement has been akin to a managed float. Egypt maintains a bilateral payment arrangement with Sudan which has been inoperative since the late 1990s.

Egypt maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions; however, Egypt has notified measures to the Fund, pursuant to procedures under Executive Board Decision 144-(52/51), which apply to measures imposed solely for national or international security reasons.

VIII. **Article IV Consultation:**

Consultations with Egypt are on a 12-month cycle. The last Article IV consultation discussions were held in Cairo from August 29-September 12, 2007. The staff report (CR No. 07/380) was discussed by the Executive Board on November 28, 2007. The 2007 Article IV report, and PIN were published on December 13, 2007.

IX. **Financial Sector Assessment Program (FSAP):**

An FSAP Update mission was conducted in May 2007.

X. **Review of Standards and Codes (ROSC):**

FAD	Fiscal module of ROSC	June 2001
MFD	Financial Sector Assessment Program (FSAP)	October 2002
STA	Data ROSC (published on July 21, 2005).	October 2003

XI. **Technical Assistance (2006–08)**

Dept.	Topic	Date
MCM	Inflation targeting (Two resident advisors, in situ for 3 months each)	2007/2008
METAC	Compiling Foreign Direct Investment	January, August 2008
FAD/ METAC	Revenue administration (first of two visits)	
FAD/LEG	Tax policy-Agricultural land tax	March 2006
MFD	Monetary policy expert (last of seven visits)	March 2006
FAD	Tax administration expert (first of four visits)	May 2006
LEG	Article VIII mission	May 2006
METAC	Balance of Payments and IIP	May, August 2006
MFD	TA Assessment on Monetary Operations (inflation targeting)	June 2006
LEG	Forum for compliance officers on AML/CFT	July 2006
FAD	Cash management expert (first of two visits)	August 2006
FAD	Tax administration expert (second of four visits)	August 2006
STA	IIP statistics seminar	September 2006
STA	Government finance statistics	September 2006
FAD	Revenue administration TA evaluation	September 2006
FAD	Fiscal Reporting	September 2006
METAC	Consumer price statistics	Nov 2006, Feb and April 2007
FAD/ METAC	Revenue administration	December 2006
FAD	Tax administration	December 2006
FAD	Macrofiscal advisory	December 2006
FAD	Macrofiscal advisory	February 2007
FAD	Tax administration expert (third of four visits)	March 2007
FAD	Cash administration expert (last of two visits)	March 2007
FAD/ METAC	Follow up mission on treasury single account implementation	March 2007
LEG	National workshop for insurance supervisor (AML/CBT)	April 2007
FAD	Macrofiscal advisory	June 2007
FAD	Tax administration	July 2007
FAD/ METAC	Treasury single account establishment	August 2007

XII. **Resident Representative:**

The Resident Representative’s office in Cairo was closed in September 2008.

Appendix II. Egypt: Relations with the World Bank

1. **Partnership for Development**. In the FY2007–FY2008 period, the Government of Egypt restated its commitment to pursuing the implementation of its national development agenda which key development objectives are to achieve high and sustainable growth by (i) enhancing the role of the private sector in the development process; (ii) focusing the public sector on delivering public goods; and (iii) strengthening the social safety net system. Within this framework, the World Bank Group is operating as part of a broader international effort, together with a number of other donors and financiers. The relationship between Egypt and the World Bank Group has been transformed and markedly improved over the last few years as a result of the progress Egypt has made in implementing reforms and of the successful turnaround of the World Bank Group program outlined in its FY2006-09 Country Assistance Strategy. The WBG has been providing its support through an integrated package of knowledge, advisory services, technical assistance, and financing, in support of Government priorities in given sectors such as Mortgage market development or Education and Skills Development. During that CAS period, the Bank and the government also collaborated on several pieces of analytical work that led to both a better and a shared understanding in such areas a investment climate and financial sector, public expenditure, poverty, pensions and infrastructure. The spirit that marked this collaborative effort bodes well for the future as the shared understanding will continue to feed into policy and project design as well as leads to faster implementation of Bank interventions.

2. **World Bank Country Assistance Strategy**. The current Bank assistance to Egypt is anchored in a Country Assistance Strategy (CAS) initially for the period FY2006–09 which was extended to cover an additional two fiscal years, until end-FY11 in June 2008. In line with the government's development and reform agenda, the current CAS identified and implements interventions that will (i) facilitate private sector development; (ii) enhance the provision of public services; and (iii) promote equity.

3. **IMF-World Bank Collaboration in Specific Areas**. The Bank and IMF continues to collaborate efforts in supporting the Government in the areas of macro-economic framework and management; budget and public expenditure management; public sector reform; and private and financial sector development.

Table 1: Bank-Fund Collaboration in Egypt

Area	Specialized Advice from Fund	Specialized Advice from Bank	Key Instruments
Economic Framework/ Management	Monetary policy, exchange rate, fiscal, and trade policies, economic statistics	Economic growth, economic statistics	IMF: Article IV consultations Bank: Economic work and technical assistance
Budget and Public Expenditure Management	Medium-term budget framework, tax policy and administration, customs, debt management, extra budgetary funds.	Budget management, debt management and statistics and public expenditure management	IMF: Technical assistance Bank: Sector work (PER, CFAA, CPAR) and technical assistance
Public Sector Reform		Civil service reform, anti-corruption agenda, decentralization.	IMF: Technical assistance Bank: Sector work
Private and Financial Sector Development	Banking supervision	Investment climate reforms, financial sector restructuring, mortgage market development	IMF: Bank: Sector work, technical assistance and lending

World Bank/IDA Portfolio

4. As of November 5, 2008,, the Bank had approved 118 projects for Egypt (77 under IBRD including two supplemental financing and 41 under IDA), valued at about US$8.7 billion, of which about US$1.3 billion remain undisbursed. The current IBRD portfolio includes 18 projects with a total commitment of US$2 billion. The sectoral composition of the current portfolio (by value) is as follows: 44 percent for infrastructure, 28 percent for financial and private sector development, 17 percent for agriculture and 11 percent for social sectors.

International Finance Corporation (IFC) Investments.

5. As of November 5, 2008, Egypt is one of the two largest exposure countries for IFC in the MENA region with a total committed portfolio of US$690 million for 34 projects for its own account. Its portfolio includes operations in the financial sector, power, export-oriented manufacturing, ports, oil and gas, metals, agribusiness and IT health. IFC's PEP-MENA TA work in Egypt has also been strongly supported by the government to strengthen financial markets, simplify business start-up procedures, SMEs, corporate governance and providing transaction advice for public-private partnerships (PPPs) in health, education and infrastructure

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Multilateral Investment Guarantee Agency (MIGA) Exposures

6. MIGA's most important contribution to date has been to support and enable investments by an Egyptian telecom company in two telecom projects in Pakistan and Bangladesh, with a combined gross exposure of US$152 million – an example of South-South investment. Requests for MIGA's guarantees with Egypt as a host country are relatively limited for now, since many bilateral agencies provide comparable services.

Bank Group Activities

As of September 3, 2008

(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
IBRD/IDA Lending Operations			
Disbursed	5,468.7	1,954.4	7,422.1
Undisbursed and committed	1.302.5	15.9	1318.4
Number of closed loans/credits = **101**			
Number of ongoing loans/credits = **18**			
Operations Portfolio--Sectoral distribution (less cancellations)			
Infrastructure	849.6	0	849.6
Financial Sector	537.1	0	537.1
Social Sector	75.5	140	215.5
Agriculture	315	15.0	330
Total	**1777.2**	**155**	**1932.2**
IFC Investments			466
MIGA gross exposure (inward)			252

Source: World Bank Group

Appendix III. Egypt: Statistical Issues

1. Data provision has some shortcomings, but is broadly adequate for surveillance. Most shortcomings occur in the areas of the national accounts and external sector statistics. Egypt has subscribed to the Special Data Dissemination Standard (SDDS), and an IMF data ROSC report, based on an October 2003 mission assessing the quality of Egypt's macroeconomic statistics, was published in July 2005.

2. **National accounts:** The National Accounts Department within the Ministry of Planning compiles annual and quarterly national accounts data based on the *1993 System of National Accounts (SNA 1993*). Shortcomings, however, include inconsistency within the dataset (discrepancies between quarterly and annual GDP estimates), inconsistency over time (the base year is often changed without an overlap with the preceding base), and inconsistency with balance of payments statistics. In addition, the October 2003 data ROSC mission found: weaknesses in the source data, limited use of surveys, and lack of an oversight body to provide guidance on the quality of national accounts.

3. **Price statistics:** The Central Agency for Public Mobilization and Statistics (CAPMAS) disseminates a monthly producer price index, bi-monthly CPI data for All Egypt, and monthly CPI data for eight geographic regions (Cairo, Alexandria, Upper Urban, Lower Urban, Canal Cities, and Frontier; and every other month for Upper Rural, Lower Rural).The CPI utilizes expenditure weights derived from a 2004/2005 household expenditure survey.

4. **Balance of Payments (BOP) statistics:** The Central Bank of Egypt (CBE) compiles BOP statistics based on the *Balance of Payments Manual, Fifth Edition (BPM5)*. The 2003 data ROSC mission noted that BOP statistics are affected by source data that do not reasonably approximate an accrual basis, unreliable merchandise trade statistics from customs declarations compelling compilers to estimate using banks' foreign exchange records, limited coverage and classification of foreign exchange transactions, and lack of survey data for direct investment enterprises.

5. **Foreign Direct Investment:** A series of METAC missions to the CBE, beginning in March 2005 have provided advice on the measurement of FDI and the development of an FDI survey and business register. Most recently in August 2008, METAC provided further technical assistance on improving the response rate and data quality of the pilot FDI survey, and could consider additional assistance when the results of a full pilot FDI survey are tabulated.

6. **External debt and the international investment position (IIP).** Egypt reports IIP data for publication in the *International Financial Statistics* (*IFS)* and *Balance of Payments Statistics Yearbook (BOPSY)*. A 2006 STA mission encouraged the authorities to address gaps in the data, to connect stocks with flows, and to improve the reporting system on non-guaranteed debt. The authorities have not yet resolved these issues.

7. **Fiscal data:** The authorities have largely adopted the *Government Finance Statistics Manual 2001 (GSFM 2001)*, with FAD and STA advice. Nonetheless, the consolidation of general government operations (budget sector, National Investment Bank, and Social

Insurance Funds) under this new classification is incomplete for "below-the-line" transactions. Annual government finance statistics based on *GFSM 2001* are reported for publication in the *Government Finance Statistics* (*GFS) Yearbook.* Quarterly data on the budgetary central government are reported for publication in *International Financial Statistics.*

8. **Monetary statistics:** Monthly monetary and financial statistics are comprehensive and reported one month after the reference period. Egypt reports monetary data to STA using the Standardized Report Forms based on the Monetary and Financial Statistics Manual. The data ROSC mission raised the issue of potential overstatement of foreign assets and foreign liabilities of the banking sector, as recorded in the monetary statistics, because an offshore bank located in Egypt is erroneously treated as a nonresident entity.

EGYPT: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of November 13, 2008)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality – Accuracy and reliability[9]
Exchange Rates	real time	real time	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug-08	Sept-08	M	M	M		
Reserve/Base Money	Aug-08	Nov-08	M	M	M	O,O,LO,LO	O,O,O,O,O
Broad Money	Aug-08	Nov-08	M	M	M		
Central Bank Balance Sheet	Jul-08	Oct-08	M	M	M		
Consolidated Balance Sheet of the Banking System	Aug-08	Nov-08	M	M	M		
Interest Rates[2]	real time	real time	D	D	D/I		
Consumer Price Index	Sep-08	Oct-08	M	M	M	O,O,O,O	LNO,LNO,LN, LO,LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2006/ 07	Sep-07	I	I	Q/I	LO,LO,O,O	LO,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q2 FY08	Oct-08	I	I	Q/I		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun-07	Sep-07	I	I	A/Q		
External Current Account Balance	2007	Oct-08	I	I	Q	O,LO,LO,LO	LNO,O,O,O,O
Exports and Imports of Goods and Services	2007	Oct-08	I	I	Q		
GDP/GNP	Q4 2006/ 07	Sep-07	Q	Q	Q	O,O,O,LO	LO,LO,LO,O, LO
Gross External Debt	Q4 2006/ 07	Sep-07	I	I	Q		
International Investment Position [6]	2007	Oct-08	A				

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC (published on July 21, 2005, and based on the findings of the mission that took place during October 7-20, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

Statement by the IMF Staff Representative
December 22, 2008

1. The information below, which has become available following the issuance of the staff report, does not alter the thrust of the staff appraisal.

2. Growth prospects for the remainder of FY2008/09 and for 2009/10 have worsened in the last month in line with the more severe global economic slowdown and the balance of payments is expected to weaken further, with a larger-than-projected decline in net international reserves. The downward revision in world oil prices will likely have a marginal impact on the outlook for the balance of payments as Egypt is a small net exporter of oil. However, the current account deficit is expected to widen further as external demand in major trading partners, tourism and Suez Canal receipts, and the terms of trade weaken, offsetting the impact of weaker domestic demand. Significant downside risks to FDI inflows and the potential for further portfolio outflows could result in a larger-than- projected loss in external reserves.

3. Recent economic data are broadly consistent with staff projections for FY2008/09.

- The economy has begun to show signs of slowing, with GDP growing at 5.8 percent in the first quarter of FY2008/09, compared to 7.2 percent in FY2007/08.

- Inflation pressures continue to ease. Headline consumer inflation ticked down to 20.3 percent in November, while the wholesale PPI declined to 16.9 percent in October.

- Net international reserves declined by some US$600 million during the month of November from US$35 billion in October. The exchange rate depreciated by 4 percent against the U.S. dollar, and appreciated by over 10 percent against the Euro from August to mid-December.

4. More information has become available since the issuance of the staff report on the mass privatization plan. This plan involves the transfer of ownership of up to 155 state-owned companies to its citizens. The shares are to be allocated in the following manner: 60 percent of the shares will be bundled and transferred to citizens who meet the minimum age requirement of 21; 10 percent will be held in a domestic future generations fund and earmarked for social spending; and 30 percent will be retained by government holding companies for debt settlement and restructuring. The plan has the potential to enhance the private sector orientation of the economy, further deepen capital markets, and overcome the negative perception of privatization within Egypt. The plan has limited revenue implications in the near term.

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IMF Executive Board Concludes 2008 Article IV Consultation with the Arab Republic of Egypt

On December 22, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Arab Republic of Egypt.[1]

Background

Economic performance since 2004 generally has been impressive, underpinned by a supportive external environment and the structural reform program that has included the liberalization of foreign trade, investment, and the exchange market, the privatization of state entities, and measures to strengthen bank balance sheets and banking supervision. Annual GDP growth in the post-reform period was more than double the average of the previous decade, driven by large-scale foreign and domestic investment.

With the onset of the global crisis the policy challenges facing the authorities have changed radically. For most of the period since the last Article IV consultation, the most pressing issue has been to contain inflation when monetary and fiscal policies were constrained by limited exchange rate flexibility, large-scale capital inflows, and the growing cost of fuel and food subsides. By the time of the October-November 2008 consultation mission, inflation appeared to be past its peak and the more urgent challenge was to maintain growth and balance of payments stability in the context of the global financial turmoil and a rapidly deteriorating international economic outlook.

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[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.

Real GDP growth averaged 7 percent in 2005/06-2007/08 and was relatively broad based across manufacturing, hydrocarbons, construction, services, tourism, and agriculture. The main drivers of demand have been private consumption and investment, aided by strong foreign direct investment. Though reports of skilled labor shortages have been widespread, official unemployment has remained stubbornly high at 8½ percent. Inflation reached a peak of 24 percent in August, reflecting a combination of world commodity price developments, changes in administered prices, and pressures from buoyant domestic demand; with the subsequent decline in commodity prices, inflation fell to 20 percent in October.

Net international reserves were US$35 billion in September 2008, but reserve accumulation has slowed sharply since mid-year. Though exports, remittances, and receipts from tourism and the Suez Canal remained strong, a surge in imports because of buoyant domestic demand and trade liberalization all but eliminated the current account surplus by mid-2008; and in August-October there was an abrupt reversal of portfolio flows as foreigners investors pulled out of the equity and government bond markets. The central bank responded to the portfolio outflows by running down its foreign currency deposits with commercial banks.

In the year through mid-November, the stock market fell by about 50 percent and spreads on Egyptian bonds widened by about 175 basis, though these falls were less than the average for emerging market economies. In September, Moody's and Fitch downgraded their investor outlook for Egypt.

The limited flexibility of the pound against a weak U.S. dollar and the partial sterilization of capital inflows raised non-U.S. dollar import prices and created the monetary conditions that ignited second-round inflation effects. The nominal effective exchange rate appreciated by over 6 percent between January and September 2008, and accelerating inflation appreciated the real effective exchange rate by 21 percent.

The central bank increased policy interest rates by 275 bps (to 11½ and 13 percent) in the first eight months of the year, but market interest rates responded slowly until the abrupt reversal of capital inflows in August-October drained some bank liquidity. The growth of broad money supply, which accelerated sharply under pressure from capital inflows slowed from 24 percent in March to 14 percent in September.

The central government deficit narrowed to 6.8 percent of GDP in 2007/08, notwithstanding pressures from sharply increased subsidies, but the deficit at the level of the general government widened to 7.8 percent GDP, mainly reflecting increased financial investments by the social insurance fund. The 2008/09 budget left the central government deficit broadly unchanged and included significant increases in pensions, wages, and food subsidies to mitigate adverse social effects of high inflation, to be met by a wider income tax base and increases in administered prices of fuels and other products.

The banking system has largely withstood the global financial crisis. Information through end-September shows net foreign assets positions of banks and the deposit base have been stable, and the flow of credit to the private sector has continued to grow at the 13-14 percent annual rate of the previous three years. Nevertheless, to encourage continued confidence in the banking system, the central bank reiterated its existing guarantee of all bank deposits.

Progress with structural reform has been mixed: (i) administered prices of fuels and other items were increased sharply, but fuel subsidies continued to grow under pressure from rising international prices; (ii) a property tax reform was approved by the parliament and will be effective in January 2009, but the introduction of the VAT has been delayed until at least late 2008/09; and (iii) the clean up of nonperforming loans of public enterprises continued, but the privatization program suffered a setback in July when bids for state-owned Banque du Caire, the third largest bank, were below the minimum targeted by the government and the auction was cancelled.

Executive Board Assessment

Directors commended the Egyptian authorities for their sound macroeconomic management and economic reforms to date. Directors considered that the policy challenges facing the authorities have changed significantly since the onset of the global financial turmoil and the rapid deterioration in the international economic outlook. While the Egyptian economy has withstood the global slowdown relatively well, net exports and foreign direct investment are likely to weaken as external conditions decline further in the months ahead. Under these circumstances, and with inflation past its peak, the priority will be to maintain growth and balance of payments stability. Directors were therefore pleased that Egypt's recent economic reforms have provided the authorities some room for maneuver to cautiously undertake countercyclical policies in the event of an economic slowdown.

Directors supported the authorities' fiscal policy aimed at striking a balance between bolstering short-term activity and ensuring medium-term fiscal sustainability. The size and composition of the proposed fiscal stimulus in 2008/09 to support growth and employment are broadly appropriate. Directors also noted that the envisaged acceleration of public infrastructure spending to address existing bottlenecks will result in only a modest deviation from the planned medium-term consolidation path.

Directors noted that Egypt's medium-term outlook remains sound. They welcomed the authorities' recognition of the particular challenges and uncertainties in the period ahead, and their readiness to act in a timely manner if balance of payments pressures heighten. On the fiscal front, Directors urged the authorities to remain vigilant regarding the challenges posed by the still high levels of the fiscal deficit and public debt, the short-maturity of debt, and the back-loaded adjustment effort required to meet the revised fiscal deficit targets. They considered, however, such challenges to be manageable given the authorities' good record on reform and fiscal consolidation. Notwithstanding the strong record, Directors stressed that, now more than ever, Egypt should persevere with its medium-term fiscal consolidation efforts to reduce the country's vulnerabilities.

Directors welcomed the authorities' intention to move cautiously with policy rates until there are clear signs that the pressure on the balance of payments has stabilized. They noted that judging the timing of an interest rate cut is complicated by the risk that a rate cut could accentuate recent pressures on central bank reserves and the exchange rate. Directors saw scope for the authorities to allow for greater exchange rate flexibility to help deal with pressures on central bank reserves. Directors noted the staff's assessment that the real effective exchange rate of the Egyptian pound is broadly in line with fundamentals.

Directors noted that the banking system has coped well with the recent global financial shocks. This resilience is attributable to the authorities' ongoing banking sector reform efforts—including a strengthening of banking supervision and regulation, a cleanup of nonperforming loans, as well as conservative investment and funding practices. Egypt's healthy bank balance sheets and low level of financial integration suggest that there are good prospects that financial intermediation will not be impeded by the international crisis.

Directors commended the authorities for their determination to maintain the reform momentum in difficult circumstances. They encouraged them to focus on reforms that support domestic demand and promote private investment, so as to ensure that Egypt is well placed to take advantage of the eventual recovery in the international economy. Reforms that restructure the public finances to support fiscal consolidation also deserve priority. Directors attached importance to the early introduction of the VAT, which would have the best prospect of yielding the revenue gains needed for the envisaged medium-term fiscal adjustment. They welcomed recent government efforts to broaden the privatization program.

Directors encouraged the authorities to press further with food and fuel subsidy reforms, and welcomed their intention to improve the efficiency and targeting of food subsidy programs. Consideration should be given to introducing automatic adjustment mechanisms for domestic fuel prices to minimize distortions, while strengthening cash-based social programs to protect vulnerable groups.

Several Directors stressed the importance in the current circumstances of further improving the timeliness of the publication of key macroeconomic data, particularly regarding the balance sheet of the Central Bank of Egypt.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Arab Republic of Egypt: Selected Economic Indicators 1/

	2004/05	2005/06	2006/07	Est. 2007/08	Proj. 2008/09
Real Sector					
Real GDP growth	4.5	6.8	7.1	7.3	5.0-5.5
CPI inflation (12-month change, average)	8.8	4.2	11.0	11.7	17.1
Unemployment rate (in percent)	10.5	10.9	8.9	8.8	…
Public Finances					
Balance of the general government (in percent of GDP)	-8.4	-9.2	-7.5	-7.8	-7.6
Net public debt (in percent of GDP)	80.5	79.8	71.4	62.3	58.5
Money and credit					
Broad money growth (annual rate)	13.6	13.5	17.1	15.8	12.2
Credit to the private sector (annual growth rate)	3.6	8.6	12.3	12.6	13.5
Interest rates on 91-day treasury bills (in percent)	10.2	8.8	8.7	7.0	…
External Sector					
Trade balance (in percent of GDP)	-11.5	-11.2	-12.1	-14.4	-14.0
Current account balance (in percent of GDP)	3.2	0.8	1.4	0.5	-1.8
Reserves (in billions of U.S. dollars)	19.3	22.9	28.4	33.8	33.9
(in months of next year's imports of goods and services)	5.8	5.9	5.2	6.4	6.1
Gross external debt (in percent of GDP)	32.2	28.8	23.0	20.9	16.3
Exchange rates					
Egyptian pounds per U.S. dollar (average)	6.0	5.8	5.7	5.5	...
Real effective exchange rate (average; percent change)	4.2	8.1	4.4	3.0	...

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

Statement by A. Shakour Shaalan, Executive Director for the Arab Republic of Egypt
December 22, 2008

1. Against the backdrop of a rapidly deteriorating global outlook, the focus for this year's consultations was inevitably marked by uncertainty over the fallout from the global financial crisis and its consequences on the Egyptian economy. The last fiscal year witnessed solid economic performance in Egypt, supported by sustained implementation of the economic reform agenda initiated in mid-2004. Growth accelerated further to reach a peak of 7.2 percent in 2007/08, the fiscal deficit continued to narrow for a fourth year in a row, foreign direct investment (FDI) increased to an all time high of over US$12 billion, and a surplus was maintained in both the current account and overall balance of payments. Inflationary pressures, however, increased owing to the surge in international commodity prices, buoyant domestic demand, and administered price increases, but should witness a respite from the recent declines in commodity prices and successive hikes in policy rates.

2. The intensification of global financial strains and the accompanying sharp drop in global economic activity are likely to challenge the outlook for 2008/09 and increase the uncertainty surrounding the outlook thereafter. A deceleration in growth is expected, largely reflecting the negative contribution of net exports as demand in partner countries recedes. Nevertheless, the authorities believe that the build up in growth momentum over the past three years will contribute to a soft landing for the Egyptian economy. Growth is therefore projected to moderate to 5–5½ percent, supported mainly by domestic demand. At the same time, the authorities view the inflation outlook as better than previously envisaged, in light of the improved outlook for international commodity prices and the projected moderation in domestic growth. In the absence of further shocks to the economy, inflation could revert to single digits by mid-2009. Finally, the reversal in portfolio flows in the second half of 2008 was accommodated by a drawdown of foreign assets of the commercial banks. The authorities believe that further pressures on the balance of payments are likely to be limited, and could be mitigated through a modest loss of reserves and additional exchange rate flexibility.

3. On balance, the authorities consider the outlook for 2008/09 as challenging but manageable. However, uncertainty about the depth and duration of the global slowdown constitute downside risks to growth prospects. For this reason, the authorities are devising a set of countercyclical fiscal and monetary policies in support of growth and a soft landing for the economy, while reinforcing its foundations to take advantage of the global recovery later in 2009. The scope for countercyclical policy can be accommodated by the projected stronger outturn on the budget deficit, the improved outlook on inflation, and the strengthened banking sector balance sheets and ample liquidity reflecting progress in banking sector reforms. The authorities agree with staff that undertaking such policies is potentially risky, but consider the risks manageable and worthwhile in terms of payoff for the economy.

Fiscal Policy

4. Despite pressures from sharply increased subsidies, the budget deficit narrowed in 2007/08 to 6.8 percent of GDP. To offset the social impact of the surge in food prices and

inflation, an increase in public wages was granted earlier in May. Importantly, the increase in wages was fully financed through the introduction of politically difficult measures, including increases in administered prices of fuel and related commodities, the elimination of tax exemptions on energy-intensive companies in Free Trade Zones, and increases in excise taxes. Moreover, and while progress in implementing the Value Added Tax (VAT) has been somewhat slower given inflation concerns, the property tax reform was approved and is expected to become effective in January 2009. Barring additional shocks to inflation and if political economy considerations permit, the VAT Law will be submitted to parliament later this year and become effective by mid-2009.

5. The authorities are committed to their medium-term fiscal consolidation path. For 2008/09, the budget deficit is expected to decline further to about 6.2 percent of GDP, reflecting planned revenue enhancing measures, including through invoice reform to reduce tax evasion, as well as savings on the subsidy bill from import price declines. However, in the current circumstances, they consider that a more gradual consolidation path is warranted. Specifically, by targeting a broadly unchanged level of the budget deficit as in 2007/08, there would be a relatively modest fiscal stimulus of about ½ percentage point of GDP through a combination of spending increases and tax cuts. The stimulus would rely principally on accelerating infrastructure investment spending, including by expanding Public-Private Partnerships to promote private investment, in addition to limited measures related to export promotion and tariff reductions on intermediate goods. As noted by staff, the fiscal stimulus would be consistent with only a modest alteration in the planned medium-term consolidation trajectory through 2010/11 and a declining debt-to-GDP ratio over the medium term.

Monetary and Exchange Rate Policies

6. The prospect of a substantial decline in inflation could provide the scope for some easing in monetary policy. The authorities are of the view that caution is warranted going forward regarding the appropriate timing of interest rate cuts. Following six consecutive hikes in policy rates of 275 basis points since early 2008, the central bank left policy rates unchanged at its last meeting in November. However, it also acknowledged the downside risks to domestic growth, and will therefore continue to closely monitor incoming data over the next few months to update its assessment of the domestic growth outlook. The central bank announced its intention to consider a measured easing of monetary policy to forestall an excessive deceleration in economic growth.

7. The authorities believe that the reversal of capital flows during August–October reflects mainly a risk repricing toward emerging market economies as an asset class, and is less related to Egypt-specific factors. As such, and while anticipating some decline in FDI flows and tourism receipts, they consider the risks of further pressures on the balance of payments to be modest, given the strong reserve position. Potential balance of payments pressures could eventually be accommodated through increased exchange rate flexibility and some loss in international reserves, as reported in the staff Supplement.

Financial Sector

8. The financial sector reform agenda further advanced in 2007/08. In the banking sector, progress was achieved in clearing non-performing loans of public enterprises. However, against the background of more difficult global conditions, the privatization of Banque du Caire, Egypt's third largest public bank, was postponed as bidders failed to meet the government target reserve price. Importantly, the private sector credit bureau, established last year, became operational in May, which should help overcome institutional impediments to bank lending and facilitate credit intermediation to small and medium enterprises.

9. The authorities are of the view that domestic financial vulnerabilities are limited. They share staff's assessment that financial intermediation in Egypt is likely to continue broadly unconstrained by the international crisis. The Egyptian banking system has been relatively shielded from the global turbulence, reflecting the pursuit of conservative policies to funding, investments and lending, as well as strengthened balance sheets and enhanced regulatory and banking supervision under the central bank's Banking Sector Reform Program launched in 2004. Domestic banks have virtually no exposure to structured products, rely primarily on domestic deposits for loan expansion, remain well capitalized and enjoy ample liquidity. Additionally, there appeared to be no pressure on foreign-owned banks to restrain lending as a result of tightening liquidity conditions in their home markets. While continued volatility in the equity and fixed income markets could be expected, strict exposure limits have curtailed the banking system's exposure to the stock market and real estate sector. Nevertheless, and to provide additional reassurance to the market, the CBE recently reaffirmed its guarantee of bank deposits. The fundamental requirements for an orderly functioning of the domestic banking sector are therefore well-entrenched in the system.

Structural Reforms

10. Going forward, the authorities agree with staff that strengthening public finances remains a priority, and are committed to the measures on tax policy and administration reform articulated in paragraph 18 of the staff report. They recognize that fulfilling the revised medium-term fiscal consolidation path could be challenging if growth prospects are weaker than projected. In addition, the authorities intend to persevere with subsidy reform efforts, the pace of which will depend on political economy considerations. Specifically, energy price reforms will continue through progressive increases in administered prices, and in-kind food subsidies will be gradually replaced with cash transfers. Pension and health care reforms are also in the pipeline, and efforts are currently underway to assess their fiscal implications and identify potential offsetting measures if needed.

11. The authorities intend to proceed with a second round of privatization of state enterprises, along the lines outlined in the staff report. The scheme is modeled after the Czech and Polish privatization experience, with the objective of ensuring broader public participation in the reform and privatization process. As elaborated in the Supplement, in addition to a free transfer of shares to the public, a portion of the proceeds would be allocated toward a future generations fund. The investments of the fund would be limited to domestic assets, and the returns used to support social investments in health, education, and youth development.

12. Finally, the Egyptian authorities are keenly aware of the challenges and policy risks in the period ahead. They are committed to the pursuit of their reform agenda to achieve a structurally higher growth rate, but the pace would need to take into account changing policy circumstances. The authorities would like to thank staff for a productive consultation based on candid dialogue and well-grounded mutual trust, and express their appreciation for the extensive and highly valuable technical assistance they are receiving from the Fund.