July 2006
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Arab Republic of Egypt: 2006 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 2006 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 5, 2006, 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 June 15, 2006. 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 June 30, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 5, 2006 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

ARAB REPUBLIC OF EGYPT

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with the Arab Republic of Egypt

Approved by Lorenzo Pérez and Carlo Cottarelli

June 15, 2006

- Discussions for the 2006 Article IV consultation were held in Cairo from April 3-16, 2006. The team comprised Mr. Enders (head), Ms. Laframboise, Mr. Moriyama, Mr. Rabanal (all MCD), Mr. Almekinders (PDR), Ms. Guin-Siu and Mr. Mattina (both FAD), Mr. Roger (MFD), and Ms. Gruber (STA consultant), and was supported by Mr. Sassanpour (Senior Resident Representative). Mr. Khan (MCD), and Mr. Shaalan and Ms. Riad (both OED) participated in the policy discussions.

- The mission met with Ministers Boutros-Ghali (Finance), Mohieldin (Investment), and Osman (Planning), Central Bank Governor El-Okdah, and other government officials and private sector representatives. A press statement was released at the conclusion of the mission (http://www.imf. org/external/np/sec/pr/2006/pr0674.htm).

- The last Article IV consultation was concluded on May 18, 2005. Directors' comments may be found at http://www.imf.org/external/np/sec/pn/2005/pn0572.htm.

- Egypt accepted the obligations of Article VIII, Sections 2, 3, and 4, on January 2, 2005. Staff is in the process of undertaking the review of Egypt's foreign exchange system in connection with this acceptance.

Contents Page

EXECUTIVE SUMMARY

Economic Developments

- Bold and wide-ranging reforms, supportive macroeconomic policies, and a favorable external environment have contributed to macroeconomic stability and higher growth and employment. While the external sector remains an important engine of growth, the economic expansion has become more broad-based. The balance of payments has been bolstered by capital inflows. Foreign debt and external vulnerabilities remain low.

- Significant progress in the government's reform program has taken Egypt further along the road to a full market economy. The privatization program has gained momentum, the restructuring of state-owned banks is progressing, and trade reforms are continuing. The authorities continue to strengthen monetary policy operations and have implemented a number of important reforms in the fiscal area, including implementing a major income tax reform and improving revenue administration.

- Inflation fell sharply in 2005 and real interest rates turned positive. The transparency of public finances has improved considerably with the preparation of a revised set of fiscal accounts. However, public debt is high and the fiscal deficit remains large; the expected improvement in 2005/06 largely reflects exceptional revenues.

Policy Issues

- Generating sustained economic growth, and thereby creating jobs, is the overriding policy objective in Egypt. Private sector investment will need to play a key role in this regard. To reduce unemployment, the economy will need to grow at sustained rates of at least 6 percent, for which investment will have to reach about 25 percent of GDP.

- The authorities outlined a multi-year fiscal consolidation package aimed at bringing the deficit down by at least 1 percent of GDP annually for five years. This fiscal adjustment is welcome, although more ambitious targets would more decisively reverse debt dynamics in the coming years. The regulatory environment needs to be further liberalized and the financial sector strengthened to accelerate private sector development and job creation.

- The current stance of monetary policy is broadly neutral, and additional interest rate reductions should wait until liquidity growth decelerates. In the run-up to the planned adoption of formal inflation targeting, the authorities should further enhance central bank operational autonomy and strengthen policy formulation.

- Egypt has adopted a managed float exchange rate regime since 2004, although de facto the Egyptian pound has remained very stable vis-à-vis the U.S. dollar over the last 15 months. There is scope to enhance the role of market forces in determining the exchange rate; however, for competitiveness reasons, the central bank could continue to lean against exchange rate appreciation driven by transitional capital inflows (e.g., privatization) until ongoing structural reforms translate into tangible productivity gains.

I. Introduction

1. **Economic conditions in Egypt are favorable and the economic reform program is moving forward.** A new cabinet led by Prime Minister Ahmed Nazif, first appointed in 2004, was reappointed in December 2005 following parliamentary elections. The economic team was also reinstated, reaffirming the government's commitment to economic reform. The election resulted in a parliamentary majority for the ruling National Democratic Party, with members of the Muslim Brotherhood—who ran as independents—winning about 20 percent of the seats in parliament.

2. **The government's reform program since 2004 has been addressing most of the areas regarded as critical in recent Article IV consultations, often involving Fund technical assistance.** During 2005, the authorities made substantial progress in the areas of tax reform, public finance management, monetary policy, privatization, and financial sector restructuring. However, the Fund has stressed the need for ambitious fiscal adjustment, which the authorities recognize and accept.

3. **Investor confidence in the direction of economic policy remains high**. The reform progress achieved to date has raised and improved Egypt's profile in international capital markets. Foreign direct investment and inward portfolio flows have risen sharply. Economic growth has accelerated and the balance of payments remains robust. Intermittent security incidents add some downside risk to the economic outlook, but their impact so far has been relatively minor and short-lived.

4. **Increasing growth on a sustained basis is the biggest priority for policymakers**. In this regard, the government is moving ahead with the next phase of reforms intended to address the structural impediments to higher growth and job creation, notably, large fiscal deficits, unproductive public expenditure, red tape, deficiencies in financial intermediation, and labor market rigidities. These reforms pose difficult socio-political challenges, and will require broad political consensus to implement.

5. **While the authorities face a broad range of policy challenges and have developed a comprehensive reform agenda to tackle them, the Article IV discussions focused on** the elements of a macroeconomic policy mix that would best support the authorities' main policy objectives. Specifically, staff discussed with the authorities: (i) a multi-year fiscal consolidation plan; (ii) the monetary policy stance and strategy appropriate for maintaining inflation in low single-digits; (iii) exchange rate policy; and (iv) progress in financial sector reform.

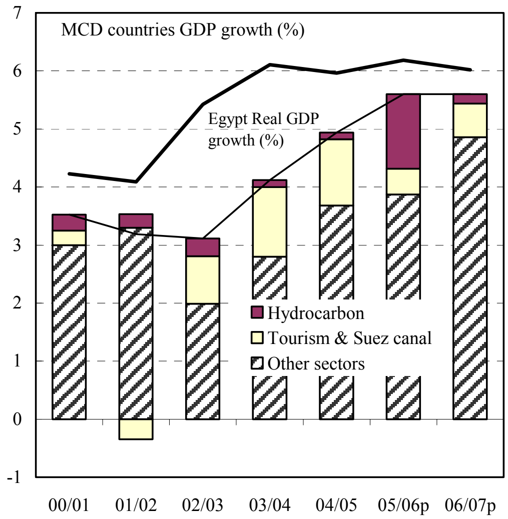
II. Recent Economic Developments and Outlook

6. Recent economic developments are chronicled in charts on the following pages.[1] The

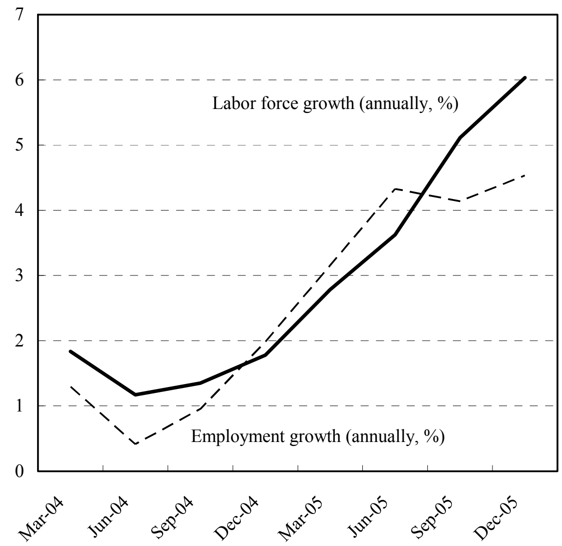
[1] All charts are based on data from the Egyptian authorities (www.capmas.gov.eg for employment) and IMF staff estimates or projections, unless noted otherwise; stock market data are from Bloomberg.

external sector remains an important engine of growth, but the expansion has become more broad-based, with construction and services now increasing at a healthy rate. Privatization in 2005/06 (fiscal year ending June 30) has exceeded expectations (Box 1), and reforms in the fiscal area have prepared the groundwork for fiscal consolidation going forward.

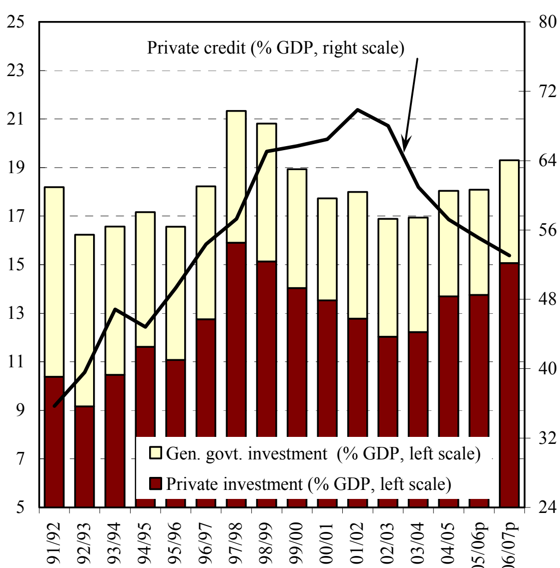
After a slowdown from 2000-03, economic growth has been rising towards regional average rates.



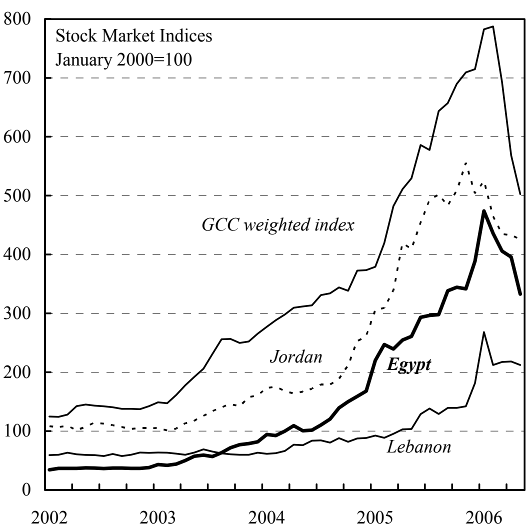
Employment has expanded with output, but not by as much as the labor force, which increased rapidly in 2005.



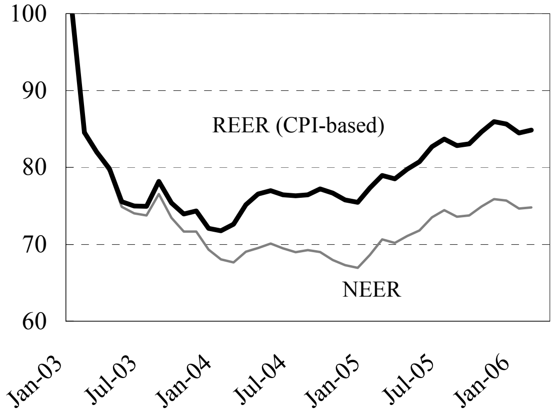
After a recovery in the late 1990s, credit and investment remain weak.



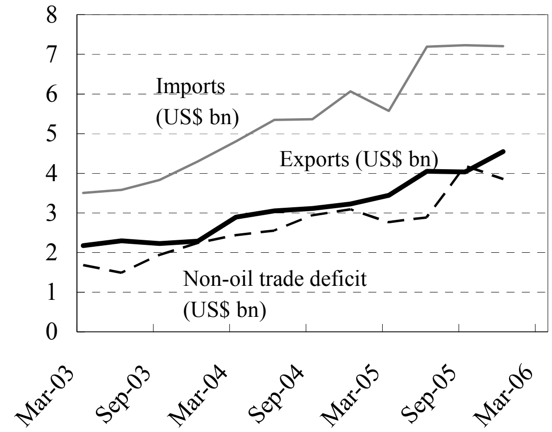
Confidence in economic policy contributed to a bull stock market. The regional correction in 2006 has affected Egypt, but less severely than in other countries.



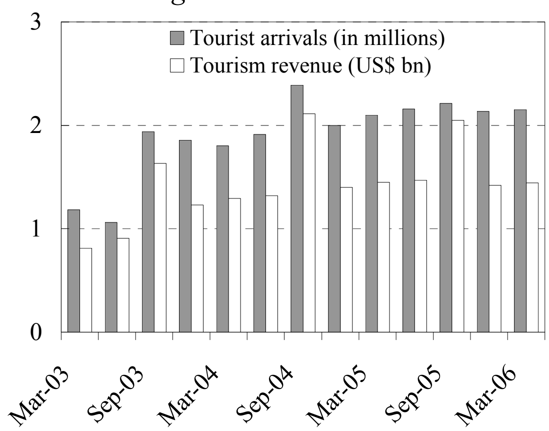
The real exchange rate began appreciating in January 2004....



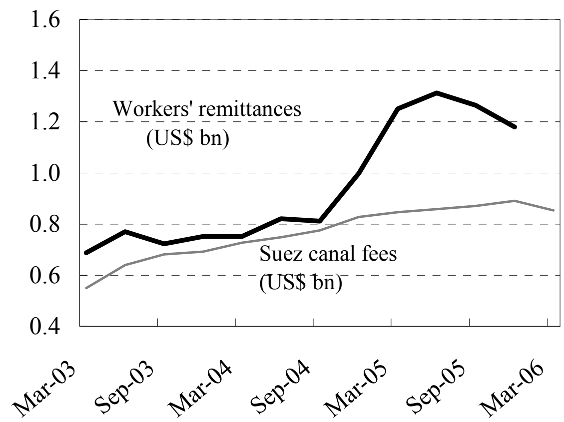
... and the trade deficit has widened.



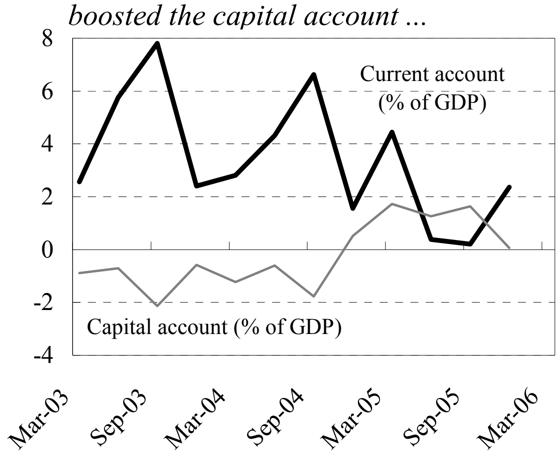
But service receipts remain strong, including tourism ....



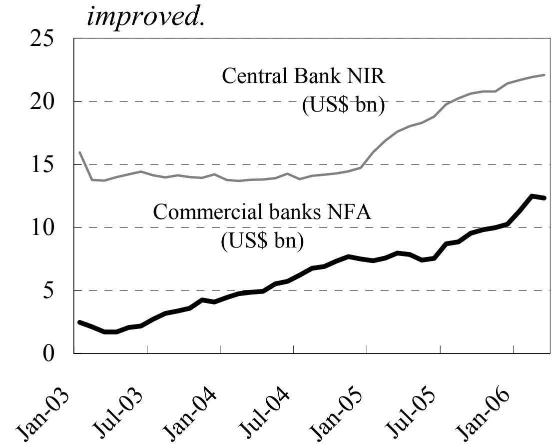
... and worker remittances from the Gulf have risen with the oil boom.



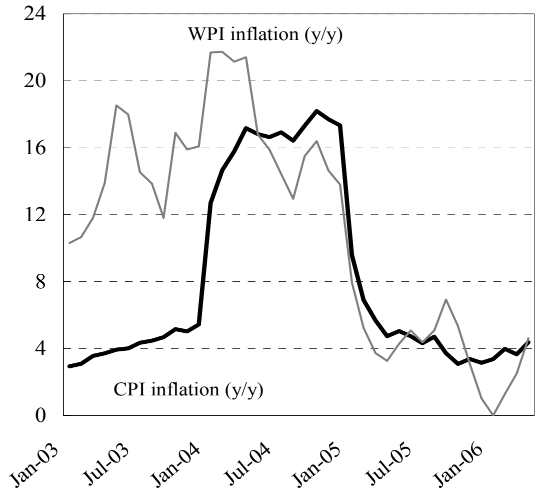
As large capital inflows and FDI have boosted the capital account ...



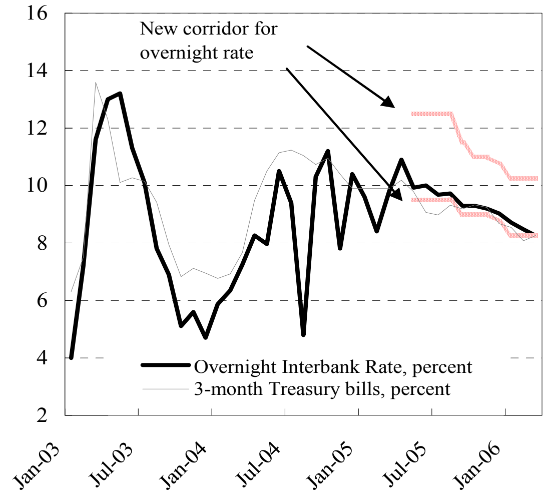
... the country's NFA position has improved.



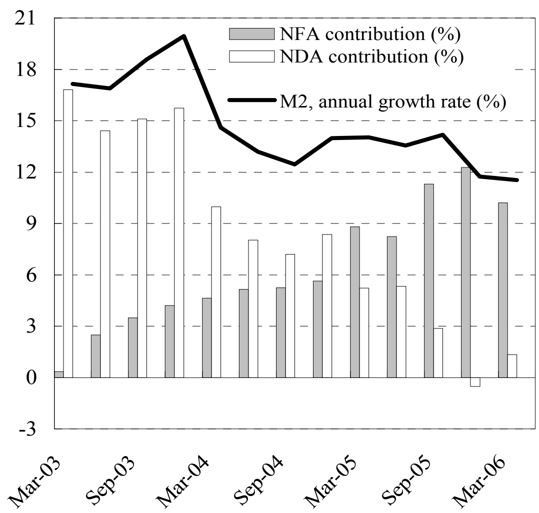
Inflation fell sharply in 2005 and ...



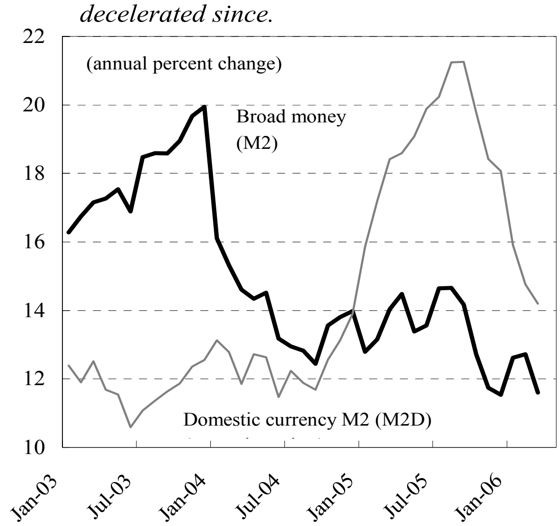
... the CBE lowered interest rates; the overnight rate stayed near the corridor floor.



NFA has been the main source of broad money (M2) growth since early 2005.



M2D surged in 2005, but has decelerated since.



7. **Notwithstanding the continued economic recovery, labor force growth exceeded employment growth in 2005.** The official unemployment rate peaked in September 2005 near 12 percent, before falling slightly in December. The labor market is characterized by an excess supply of labor, particularly among the youth, a serious mismatch between the skills required and those furnished by the public education system, and significant restrictions on hiring and firing. However, in investor and business surveys, labor market constraints are typically not perceived as the main obstacles to doing business.

8. **Inflation during 2005 fell sharply from the high levels of 2004.** The high inflation rate in 2004 appears to have reflected lagged pass-through pressures from the large nominal depreciation of the pound and lax monetary policy during 2003. The subsequent stabilization

of the exchange rate and the tightening of monetary conditions led to a fairly sharp decline in inflation in 2005.[2]

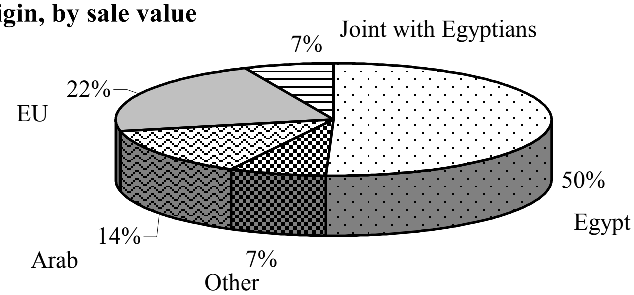
Box 1. Privatization in Egypt

Asset sales in 2005/06 have surpassed expectations and have attracted international investors. In the first nine months of 2005/06, 49 state assets were sold for a total of US$2.5 billion, including seven joint venture banks and 20 percent of the government's stake in Egypt Telecom. As of April 2006, 97 entities were listed for sale by the government comprising 42 companies (or stakes in companies) and 55 joint ventures (www.investment.gov.eg).

Asset Sales: July 2005-March 2006	Sales	US$ billion
Assets sold	49	2.47
100% of government share sold	34	0.16
< 100% of government share sold	15	2.30
Joint ventures	13	1.30
Share offers	7	1.05
Land transactions	29	0.11

Source: Ministry of Investment

Buyer origin, by sale value



The proceeds are being allocated to the original owners (line ministries, public holding companies, the Treasury) and are being used mostly to restructure remaining state enterprises; in 2004/05, about 20 percent of the proceeds went to the Treasury. About 5 percent of the proceeds help finance employee compensation packages at entities being privatized. Employees not retained are compensated, retrained, or shifted to "sister" entities under the same state holding company.

According to the Ministry of Investment, the performance of privatized companies has been good. Specifically, about 70 percent of the privatized companies surveyed had increased sales and profits, 90 percent had raised salaries or increased staff, and nearly 80 percent had strengthened their balance sheets.

[2] Shortcomings in the CPI data (such as a large share of subsidized products, and an underweighting of services) complicate the assessment of inflation developments.

9. **The authorities implemented a range of structural reforms in the fiscal area in 2005.** On the revenue side, the government reduced and streamlined corporate and individual income taxes, moved to self-assessment procedures, and established a large taxpayer center (Box 2). On the expenditure side, the budget for 2005/06 made explicit for the first time the large fuel subsidy provided by the state-owned oil company, Egyptian General Petroleum Corporation (EGPC). While not involving cash payments through the budget (the cash impact is reflected in foregone tax/dividend payments by EGPC), this has contributed to a wider public debate on subsidies.

Box 2. Reforms in Tax Policy and Revenue Administration

As part of an ongoing overhaul of the tax regime supported by Fund technical assistance, the authorities:

- Adopted a new customs tariff in 2004 that simplified the tariff structure and reduced the weighted average tariff rate from 14 to 9 percent, and the unweighted average from 27 to 20 percent.

- Passed a new income tax law in mid-2005 that reduced the top marginal tax rates on income and profits from 32 to 20 percent for individuals and from 40 to 20 percent for corporations and partnerships (EGPC, the Suez Canal authority, and the central bank were left at 40 percent). The reform increased the exemption threshold, provided for more generous depreciation allowances, broadened the tax base by eliminating deductions, and provided for the phasing out of tax holidays while grandfathering current beneficiaries.

- Began modernizing tax administration with (i) the successful introduction of self-assessment, (ii) the creation of a Large Taxpayer Office in 2005, and (iii) preparation for integration of the Income Tax and Sales Tax Departments with the appointment of a single tax commissioner.

10. Another accomplishment was the preparation in 2006 of a set of consolidated fiscal accounts under the GFSM 2001 budget classification. This has increased the transparency and consistency of the fiscal accounts. The authorities are in the process of addressing a number of remaining issues, notably, fully harmonizing the coverage of the fiscal accounts "above" and "below the line" and reconciling financing flows with debt stocks (Table 3).

11. **Historical data revisions and the reclassification of accounts revealed a weaker fiscal position in recent years than what had been depicted earlier (Table 4).** In the process of migrating to the new budget classification (NBC) in 2005, the authorities made significant revisions to the historical series, and also reclassified some operations as above-the-line items (an adjustment Fund staff made to get the *augmented fiscal balance* presented in recent Article IV staff reports based on the old budget classification). These revisions, starting in 2001/02, resulted in a large upward adjustment of the previous deficit estimates for 2001/02-03/04. Adoption of the NBC and the move to a cash basis explain a smaller part of the upward revision in the deficit estimates.

12. **Under the NBC-based fiscal accounts, the consolidated general government deficit in 2005/06 is projected at 8.3 percent of GDP**, down from 9.1 percent of GDP in 2004/05. The improvement reflects exceptional receipts related to: (i) the partial sale of Egypt Telecom (0.8 percent of GDP), and (ii) the payment of tax arrears by EGPC

(1.2 percent of GDP).[3] The latter was financed by incurring an external liability of US$1.55 billion secured by a forward sale of oil. Revenue losses from the income tax reform (involving steep rate cuts) in 2005 are estimated at 1 percent of GDP. These losses are expected to be short-lived because the tax reform should broaden the base, lead to greater compliance (there is already some evidence of a surge in tax filings), and eventually generate a higher yield. Domestic fuel subsidies are set to increase by 2.6 percent of GDP to 6.9 percent of GDP.

III. KEY ISSUES AND VIEWS OF THE AUTHORITIES

Overview and reform objectives

13. **In order to lower unemployment,** the government agreed with staff that the economy will need to grow on a sustained basis by at least 6–7 percent, and that total investment will need to reach about 25 percent of GDP, well above recent levels of around 18 percent of GDP. In the authorities' view, the main constraints to private investment and higher growth are inefficiencies in financial intermediation and bureaucratic barriers to business development. The high level of unproductive government spending (i.e., subsidies) and distortions in relative prices, particularly energy prices, have also hindered growth.

Macro framework and balance of payments outlook

14. **The discussions were framed in a macroeconomic scenario based on moderate fiscal adjustment (*baseline* scenario discussed below) and continued structural reforms.** Under this scenario, staff expects increased government savings and the supply impulse driven by structural reforms to gradually raise productivity and boost private investment as a share of GDP to 20 percent by 2011 (Table 5), along with a small increase in government investment to 5 percent of GDP.[4] Real GDP growth is projected to increase over time to 6.5 percent by 2010/11, and structural unemployment to be reduced by about 2 percentage points over the period. The external current account would move from a surplus of 2 percent of GDP in 2005/06 to a deficit of 2 percent of GDP by 2011, financed largely by non-debt-creating capital inflows. Egypt's external debt is expected to decline gradually over the medium term, even in the face of external shocks (Tables 8 and 9), and external vulnerabilities will remain low.

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[3] These are recorded under the GFSM 2001 framework as receipts "above the line."

[4] The average investment ratio from 1980 to 2000 was 24 percent of GDP, but investment fell sharply from 2000-2004 during the economic slowdown. The projected increase in investment is driven by fiscal consolidation (total savings as a share of GDP is assumed to rise by 2 percentage points), and by other growth-enchancing structural reforms.

Fiscal Policy

15. **The authorities outlined a range of measures aimed at bringing the deficit down by at least 1 percent of GDP annually for five years**. The plan involves the following mix of measures—to be phased in gradually starting in 2006/07:

i) reforming domestic fuel subsidies by targeting them more effectively on the poor and providing incentives to switch to natural gas;

ii) streamlining and improving the product targeting of food subsidies;

iii) instituting wage and employment measures designed to contain the wage bill, including a partial hiring freeze and measures to slow wage drift; the authorities plan to submit to parliament in 2006 a comprehensive reform of the civil service expected to contribute to fiscal consolidation;

iv) reforming the GST into a unified VAT with a broader base, a single rate, and a higher threshold, with a presumptive tax regime for small businesses;

v) broadening the base and streamlining rates for the property tax and stamp taxes;

vi) introducing a Treasury Single Account (TSA) to help improve cash management and increase control over off-budget resources kept by budget entities in the banking system;

vii) reorganizing the institutional layout and streamlining the flow of funds between the budget, the National Investment Bank (NIB), and the Social Insurance Funds (SIFs);

viii) tightening controls on operating flows with state enterprises to increase the transparency and control of expenditures;

ix) improving debt management; and

x) launching public private partnerships (PPPs) to finance the provision of much-needed public investment, particularly for schools and health clinics.

16. **Possible sources of fiscal pressure in the coming years include pension reform and bank restructuring**. A public pension reform plan is currently being formulated with assistance from the World Bank, and could have sizeable transition costs, depending on the final design. The main features of the plan comprise closing the current system to new entrants, establishing a fully funded contributory system for new entrants, and adding a

Box 3. Subsidies in Egypt

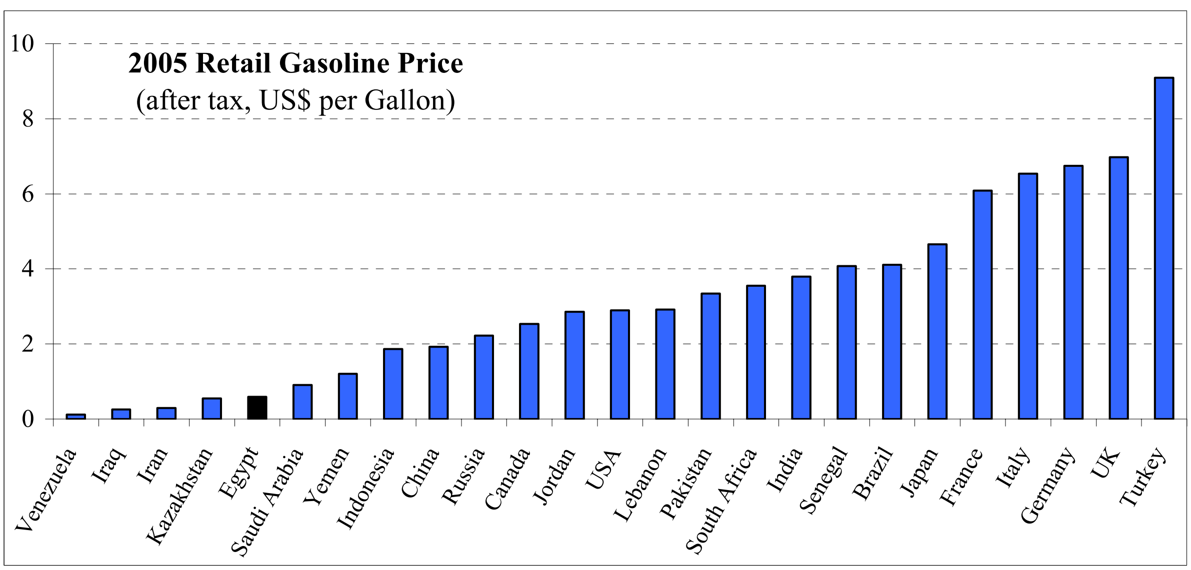
Public spending on subsidies has increased dramatically in recent years and now far exceeds outlays on education and health. While subsidies have been motivated by social concerns, preliminary data indicate that the share of the population living below the poverty line (headcount ratio) has nevertheless increased since 2000.

Social Spending	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	Prel. 2004/05	Proj. 2005/06
				(in percent of GDP)				
Social Spending	12.9	13.5	15.8	16.5	17.9	18.5	18.4	19.4
Subsidies	3.1	3.5	4.8	4.9	6.1	7.7	7.4	9.6
of which : Fuel	1.1	1.6	2.8	2.7	3.9	5.0	4.3	6.9
of which : Food	...	...	0.9	1.1	1.0	1.7	2.1	1.6
Health and education	6.3	6.3	6.8	7.1	7.3	6.6	6.4	5.6
Other	3.4	3.7	4.2	4.5	4.4	4.1	4.5	4.2
Poverty rate *(in percent of pop.)*	...	16.7	...	...	...	...	19.6	...

Source: Ministry of Finance, World Bank (for poverty), and Fund staff estimates.

The benefits are not well targeted. Recent studies (World Bank, USAID, World Food Program) show that fuel subsidies benefit mostly the production sector, as households account directly for less than 20 percent of energy consumption. The richest quintile of households reaps 93 percent of the gasoline subsidy and 65 percent of the natural gas subsidy, while many poor households do not have access to the required food ration cards. A recent World Bank simulation estimated that the poverty headcount ratio would drop by 6.1 points to 13.5 percent if subsidies were reduced by 50 percent and the savings allocated to households as cash transfers.

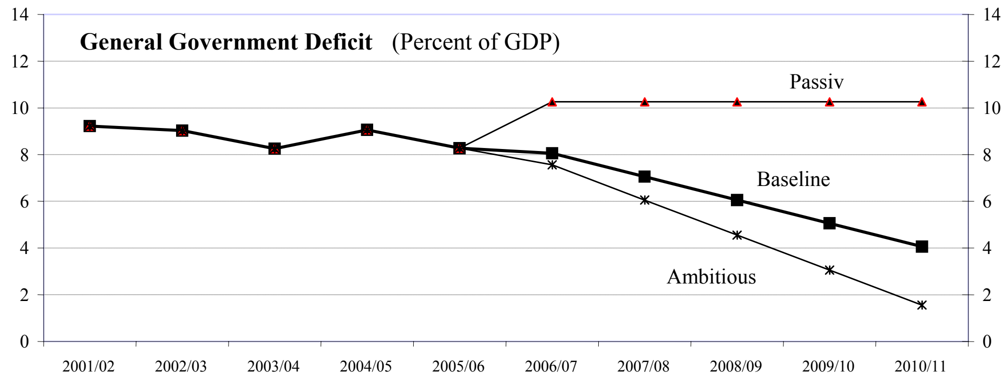
Subsidies have contributed to a misallocation of resources. Retail prices of petroleum products are among the lowest in the world. By increasing the profitability of fuel-intensive sectors, investments are likely to be channeled into activities with sub-optimal social returns. Per unit of output, Egypt's energy use in 2000 was close to that of the United States, and CO_2 emissions were among the highest in the world (*WDI 2000*).

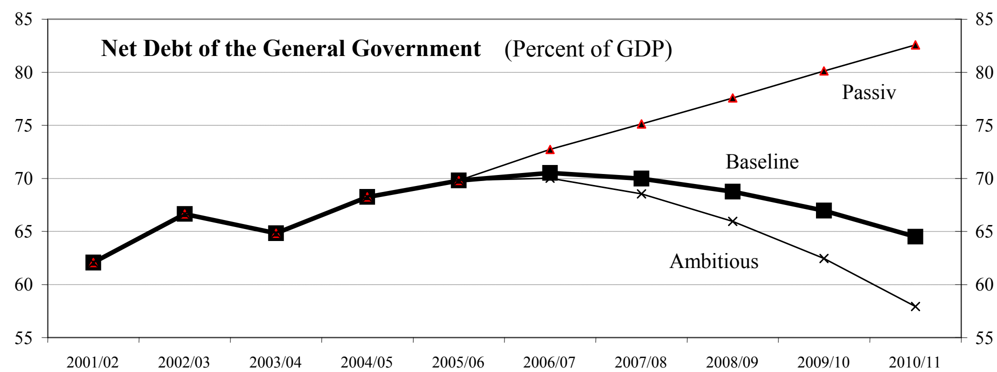


noncontributory minimum pension plan (integrating various existing schemes). As for bank restructuring, the authorities intend to finance the rest of their restructuring program with privatization proceeds. If privatization progresses at the current pace, proceeds should cover bank recapitalization costs over time.

17. **In the absence of any reform measures, and assuming one-off receipts are not repeated, the general government deficit would reach about 10 percent of GDP in 2006/07 ("*passive*" scenario, below).** While the central government budget for 2006/07 approved by parliament did not include any of the new measures specified above, the authorities plan to start phasing them in this year, particularly the fuel subsidy reform, which would translate into higher cash tax payments from EGPC (up to several percentage points of GDP); the GST/VAT reform, which would, depending on the unified rate chosen, yield a half year impact of at least 0.5 percent of GDP; and further measures, such as the TSA (0.5 percent of GDP from savings on interest payments) and better expenditure control. Based on these indications from the authorities—i.e., adjustment equivalent to about 2 percent of GDP— during 2006/07, staff estimate that the general government deficit could be reduced to 8.1 percent of GDP.

18. **Outlook:** Under the "*baseline*" scenario (deficit 8.1 percent of GDP in 2006/07 and a 1 percent of GDP annual adjustment thereafter), net public debt would decline after five years to 65 percent of GDP—the June 2004 level. A gradual decline in the debt/GDP ratio would still occur under various shocks (Table 7). A more ambitious adjustment path ("*ambitious*" scenario) of an additional 0.5 percent adjustment of GDP annually would lower debt to 58 percent of GDP by June 2011. If the underlying deficit were maintained at 10 percent of GDP ("*passive*" scenario), public debt would continue rising along recent trends and reach 83 percent of GDP in 2011. It is important to note, however, that the investor base, structure, and composition of Egypt's domestic public debt stock help to limit near-term vulnerabilities normally associated with debt levels of this magnitude (see Country Report No. 05/177, Staff Report, Box 1).





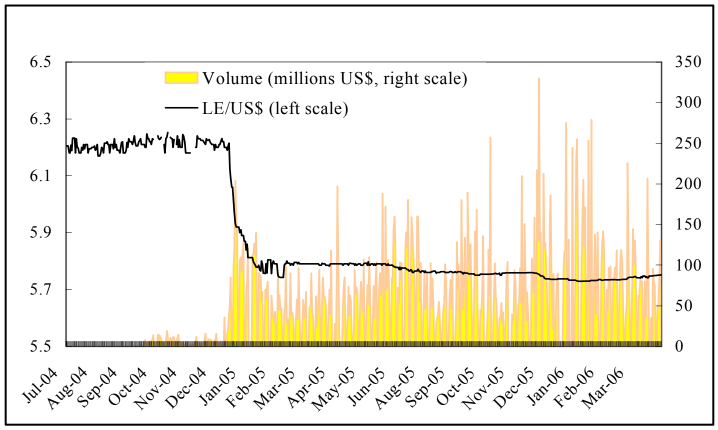
Monetary and Exchange Rate Policy

19. **The CBE is modernizing monetary policy formulation and operations, and confirmed its plans to adopt a formal inflation targeting (IT) framework over the medium-term.** In this context, the CBE has established a corridor for the interbank overnight rate and significantly enhanced communications with the publication of a monetary policy statement and releases following regular Monetary Policy Committee meetings. The central bank is also developing its macroeconomic analysis and forecasting capacity.

20. **In the transition to inflation targeting, the CBE has adopted a monetary policy framework relying on broad indicative guidance from monetary aggregates and various inflation measures in the context of a managed float.** The authorities attributed the decline in inflation through March 2006 to the secular decline of broad money (M2) growth since early 2004 and the appreciation and subsequent stability of the LE/US$ exchange rate during 2005. In their view, the surge in 2005 in the growth of domestic currency broad money (M2D) above indicative “target” zones of around 12–13 percent was caused by portfolio shifts related to increased confidence in the Egyptian pound, with no inflationary consequences. The CBE considers the current stance of monetary policy to be broadly consistent with stabilizing inflation at current low levels of 4–6 percent, assuming money demand continues to grow somewhat faster than GDP. However, it stands ready to tighten

policies should signs of inflationary pressures re-emerge. The authorities expressed concern about continued weak credit growth. This can be explained by the fact that central bank rate cuts have not been fully passed through to bank lending rates, commercial banks remain overly cautious following the bad loan build-up of earlier years, and commercial banks have preferred alternative assets (government securities, foreign assets) with more favorable risk/return characteristics.

21. **The interbank foreign exchange market is operating smoothly and market participants expressed satisfaction with its efficient functioning.** In the context of the recent large balance of payments surpluses, the CBE has used the abundance of foreign exchange liquidity over the past year as an opportunity to strengthen its international reserve position, both through purchases outside the market on behalf of the government (e.g., converting Suez Canal proceeds), and by buying on the market to help banks respect regulatory limits on open positions. These actions by the CBE have influenced the LE/$ exchange rate, keeping it in a narrow range (LE/US$5.72–5.78) over the past 15 months, implying a *de facto* peg during that period.



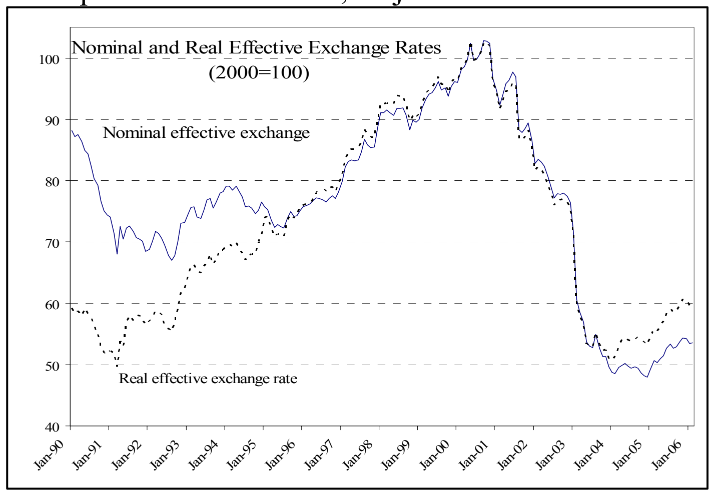
22. **While reaffirming their commitment to a managed float, the authorities expressed concern about the effect of a nominal appreciation, driven in part by temporary capital inflows, on competitiveness.** They pointed in particular to stagnation in the growth of non-oil exports during the second half of 2005 and to the importance of supporting the tourism sector. Going forward, the CBE believes that the trade deficit is likely to widen as growth rises, while portfolio inflows should weaken as interest rate differentials narrow; both developments should put downward pressure on the currency.

Non-oil Merchandise Exports

	US $ billion	In percent of total world imports	In percent of GDP
1996	2.4	0.044	3.5
1997	2.8	0.049	3.7
1998	3.4	0.062	4.1
1999	3.6	0.063	3.8
2000	4.5	0.068	4.1
2001	4.7	0.073	4.7
2002	4.8	0.072	5.4
2003	5.4	0.070	6.2
2004	7.5	0.079	8.3
2005	8.6	0.079	9.5

Sources: Central Bank of Egypt and DOTS

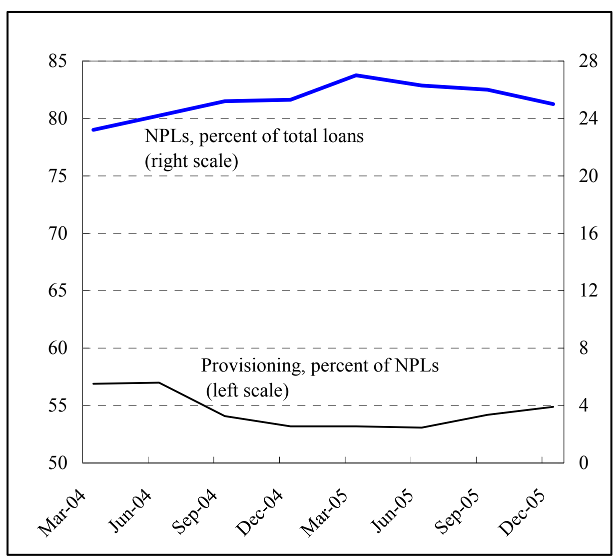
23. The slow-down in growth and the decline in reserves suggest that the Egyptian pound was substantially overvalued in 2000. The large depreciation that occurred between 2001 and 2004 appears to have broadly restored equilibrium. However, major structural breaks and data shortcomings (notably regarding the CPI series and data on unit labor costs) impede a more quantitative appraisal of Egypt's competitiveness. The string of current account surpluses after 2000 could suggest an undervalued exchange rate, although the surplus has dropped sharply in 2005/06 and is forecasted to turn into a deficit by 2008, while the real exchange rate has been appreciating since 2004.



Financial sector restructuring

24. **The authorities have achieved significant progress in strengthening the banking sector.** The government sold its stake in most joint venture banks, thereby transferring nearly 20 percent of the banking system (measured by deposits) from *de facto* public control to the private sector. The sale of Bank of Alexandria (BoA) is on track to be completed in late 2006. The authorities are merging two of the remaining three state banks, and intend to restructure and recapitalize the resulting two state banks over the next three years. While the current reform would still leave more than 40 percent of the banking system (based on current shares in deposits) under state ownership by 2008, the authorities expect this share to decline rapidly, given the much faster growth in private sector banks.

25. **The soundness of the financial sector has been improving.** Capital adequacy ratios have been rising since 2001, the rates of return on assets and on capital have trended upwards, and nonperforming loans (NPLs) recently started to decline as a share of total loans (Table 11). Workout units in the state banks, supported by CBE-led arbitration, have restructured about one half of outstanding private sector NPLs. All public sector NPLs of BoA were settled in cash in early 2006, and the planned clearance of public sector NPLs of other state banks should further improve the NPL/loan and

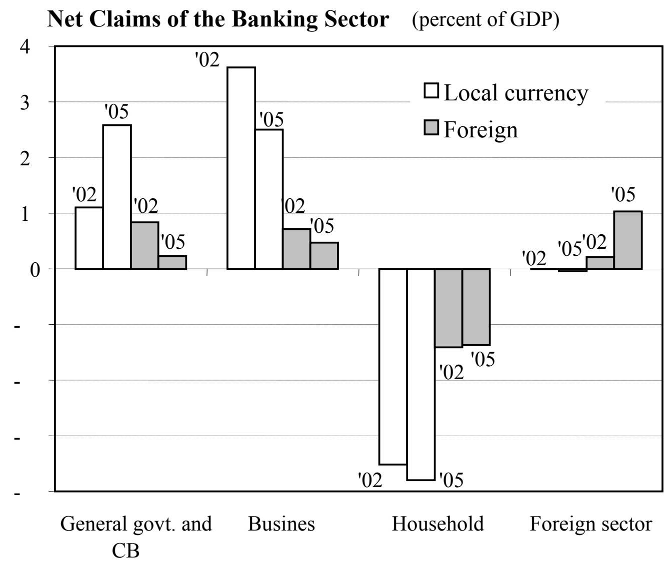


provisioning/NPL ratios. Exposure of the banking system to exchange rate risk remains low, although sustained large exposure to the public sector will be incompatible with a vibrant growth-enhancing financial system (Box 4).

Box 4. Balance Sheet Analysis of the Banking Sector

From 2002 to 2005, the banking sector (excluding the CBE) has more than doubled its net exposure in local currency to the government sector (including the CBE), from 10 to 25 percent of GDP, while sharply reducing net claims on the business sector. Net exposure to the government surpassed that to businesses at end-2005.

The increase in claims on the government arises from past large fiscal deficits and an increase in deposits with the CBE, which reflects the recent strong NFA growth. Declining exposure to the private sector is due in part to the recent loan portfolio clean-up and to the portfolio choices of banks in favor of government securities and central bank deposits over corporate loans. This is likely to have reduced credit and interest maturity risks in the banking sector.

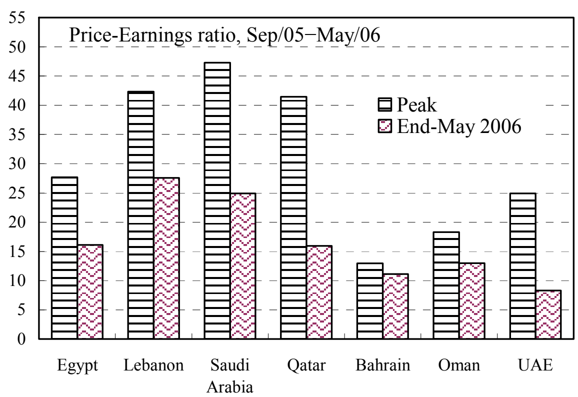


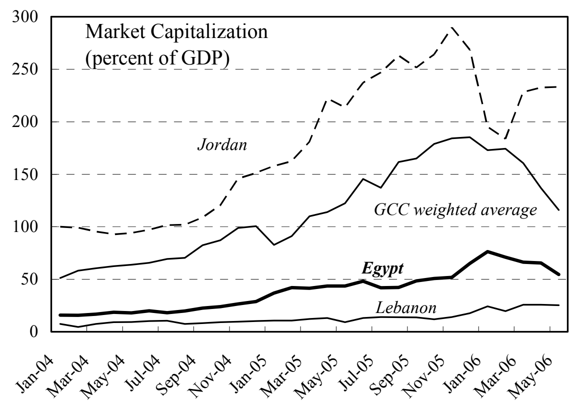
However, stagnating credit to business may amplify macro volatility because it reduces the financial sector's ability to efficiently reallocate financial resources across firms. This would be more critical during bad times when profitable firms experiencing temporary cash shortages might face financing constraints. More generally, sustained large government borrowing can harm the depth and quality of financial development, as banks have lesser incentives to improve efficiency.

Net foreign currency-denominated claims on the government and business sectors have declined since 2002, while claims on the rest of the world (mainly deposits with correspondents) increased from about US$4 billion at end-2002 to US$13 billion in early 2006. Banks' net open positions are not large, and the aggregate net open position is negligible, implying a low overall foreign exchange risk. The decline in foreign currency exposure to entities with revenues mostly in local currency (government and local businesses) has further reduced exchange rate risk.

26. **Egypt's stock market was one of the top performers in 2005.** The bull market, which started in late 2003, was driven by increased confidence in economic policies, but was also fueled by ample domestic and regional liquidity related to the oil boom. The market experienced a sharp correction in early 2006, falling by 33 percent between the January peak and late May. However, this was less than most Gulf markets, mainly because the rise in valuations in Egypt in 2005 was much less than experienced in the Gulf (or during the 2000 dotcom bubble in the United States). The price/earnings ratio hit 27 in January, before falling

to 15 in May. The correction has so far had little visible impact on the economy, in part because market capitalization is still relatively low, and trading is concentrated in a few big stocks. The value of the biggest five (ten) companies account for 62 percent (80) percent of the market. While information on the makeup of the investor base is limited, the correction was reportedly driven more by retail investors who entered the market in 2005. Anecdotal evidence suggests that potential risks to the banking system as a result of margin lending to retail investors is likely to be limited, consistent with the observed weak credit growth.





27. **Outside the banking sector, state-owned insurance companies are also being restructured, with a view to privatization.** Capital market regulation is well advanced in adopting best practices, and the stock market is enforcing higher standards of corporate governance. The authorities are also in the process of bringing supervision in banking and insurance into compliance with international best practices. However, the tax-free treatment of interest on government securities appears to be undermining the development of broader capital markets, and the secondary market in government securities remains small. The authorities are interested in an FSAP update in 2007 to assess progress in the financial restructuring program and take stock of the changes wrought by the recent reforms.

Other structural reforms and data issues

28. **The authorities are contemplating further tariff reductions** to build on the gains achieved in September 2004, when the government restructured and lowered tariff rates by 7 percentage points to 20 percent (unweighted average). These are still considerably higher than the current average of 11.2 percent for countries in the Middle-East and Central Asia. Egypt's weighted average tariff rate is 9 percent.

29. **The government recently submitted draft legislation to parliament to establish specialized economic courts**. These are designed to reduce red tape and to improve the judicial framework underlying business contracts. This approach is based on previous positive experiences reforming institutions by developing improved processes on a parallel track. In addition, disputes between private sector operators and the government are increasingly being resolved by a ministerial committee.

30. **The authorities are giving data quality problems greater attention.** A high level inter-ministerial committee has been established to address weaknesses in statistics, notably the CPI and FDI data, where shortcomings include the quality of coverage and sampling and limited cooperation between the relevant agencies.

31. **A high-level ministerial committee has been established to coordinate Egypt's response to the avian flu threat.** Avian flu has so far affected only the poultry sector and the authorities have not prepared a specific program for the financial sector. They do not expect the avian flu to pose a problem for the functioning of the financial system. However, they expressed interest in understanding the best-practice measures being developed elsewhere and plan to participate in international seminars for bank supervisors on the topic.

IV. Staff Appraisal

32. **The staff essentially concurs with the authorities' economic objectives and policy priorities.** Under the authorities' strategy, fixed investment will need to rise considerably, and private sector growth will need to drive employment creation. Staff welcomes the authorities' decision to place fiscal consolidation at the center of Egypt's macroeconomic policy agenda, which will imply difficult policy choices and require strong efforts at consensus building. However, favorable global economic conditions make the timing ripe for tackling tough issues, which will have long-term positive effects on the economy. Staff appreciates the authorities' active participation in elaborating a technical assistance strategy that ties TA priorities closely to the government's reform agenda, and will help guide the Fund's technical assistance to Egypt over the coming years.

33. **Fiscal consolidation is central to achieving the authorities' growth objectives.** In this regard, absent the "one-time receipts" of 2 percent of GDP, the general government fiscal deficit in 2005/06 would rise. Public debt needs to be put on a firmly declining path to ensure macroeconomic stability over the long run, reduce uncertainty for investors, and avoid debt overhang effects. In addition, growing public debt, which already limits the authorities' budget flexibility, will further squeeze their ability to use countercyclical fiscal policy to cope with exogenous shocks. Finally, a large share of government spending is unproductive and has encouraged a misallocation of resources, with fuel subsidies being the most obvious example.

34. **The government's multi-year fiscal consolidation plan is welcome.** However, a more ambitious medium-term fiscal adjustment, on the order of 1.5 percent of GDP annually over five years, would more decisively reverse the debt dynamics in the coming years. Even then, debt levels would remain high for many years, particularly relative to other high-growth emerging markets. The fiscal consolidation program should be based on a comprehensive and appropriately prioritized strategy, and should be centered on subsidy reduction and early introduction of a modern VAT. Medium-term expenditure rationalization should be guided by the relative efficiency of major spending categories in terms of performance outcomes, rather than relying on ad hoc or across-the-board cuts. Social assistance should be targeted more directly at low-income households.

35. **For 2006/07, the budget approved by parliament needs to be complemented by specific fiscal measures.** The measures outlined by the authorities look promising, and if fully implemented, could produce the desired adjustment. Since several of the measures require legislative action, staff urges prompt action to introduce the relevant laws to parliament and press for early adoption in order to contain the general government deficit for 2006/07 to 8 percent of GDP.

36. **The authorities plan to rely partly on public private partnerships (PPPs) for financing much needed public investment, particularly in the social sectors.** Staff believe that public investment should primarily be financed with resources freed up by cuts in inefficient current spending (e.g., subsidies). Use of PPPs would require that close attention be paid to the supporting legal and institutional framework underpinning contracts. Any contingencies arising from PPPs should be recorded explicitly in the budget in the interests of fiscal prudence and transparency. Similarly, staff encourages the authorities to carefully assess and contain any transitional fiscal costs from the planned pension reform.

37. **The current stance of monetary policy appears appropriate for sustaining current low levels of inflation.** Thus, additional interest rate reductions should wait until liquidity growth decelerates further and low inflation becomes firmly entrenched. The authorities need to monitor closely the rate of growth in broad money, and specifically domestic currency broad money. The large government deficit, financed in recent months mostly from nonbank sources, may eventually need more financing from the domestic banking system, which could put further pressure on monetary aggregates or crowd out private credit. Staff supports the CBE's goal of moving to formal inflation targeting (IT), and recommends accelerating the reforms needed to support central bank operational autonomy and strengthen policy formulation. These include: revisiting the composition of the Monetary Policy Committee to ensure greater independence, preparing legislation prohibiting monetary financing of fiscal deficits, building up CBE forecasting and analytical capabilities, and further enhancing communication on monetary policy with the public.

38. **Staff estimate that the real appreciation since 2004 reflects the appreciation of Egypt's equilibrium real exchange rate** stemming from (i) a large improvement in the country's net external position and (ii) a surge in both the volume and the U.S. dollar value of proven hydrocarbon reserves. However, looking forward, it is doubtful that the non-oil export and tourism sectors could sustain a further real appreciation of the pound without losing market share. In the context of the ongoing gradual weakening of external balances, there may thus be a good case for the central bank to occasionally lean against nominal appreciation driven by transitional capital inflows (e.g. privatization receipts) until ongoing structural reforms translate into tangible productivity gains.

39. **The CBE could, at the same time, allow market forces greater play in exchange rate developments.** This would help discourage one way bets and encourage the development of risk management instruments, and more generally help in deepening the foreign exchange market. Furthermore, greater flexibility would be required if the CBE

moved to a formal IT framework, and allowing some fluctuations in the rate would be helpful in getting the public accustomed to movements in the exchange rate.

40. **The successful restructuring of the BoA highlights the useful influence that the goal of privatization can have on the process of bank modernization and reform.** Completion of the audits of the remaining state banks, and their independent analysis, is essential for further progress in banking restructuring. Even at the end of the current financial reform program (2008), however, a large share of the banking system would remain under state ownership, raising concerns about the efficiency of financial intermediation and about a level playing field between public and private banks.

41. **The results of the privatization program and near-term plans demonstrate the government's commitment to reducing the role of the state in the productive sectors of the economy.** Staff welcomes efforts to secure sustained support for the privatization program through the wide dissemination of relevant information on the distribution and use of the proceeds.

42. **Further efforts are needed to improve the legal and institutional framework for the production of economic statistics and to increase inter-agency cooperation.** This is necessary to support the work needed to improve statistics on prices, balance of payments, real indicators of economic activity, and the fiscal accounts.

43. **The mission welcomes the government's intentions to consider further tariff reductions.** The system of exemptions and duty relief schemes not addressed by the 2004 reform should be phased out.

44. The ongoing review of Egypt's exchange system, in connection with Egypt's acceptance of the obligations under Article VIII, is expected to be concluded by the time of the 2006 Article IV consultation Executive Board meeting.

45. 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, 2001/02–2006/07 1/

Population (2005): 70.5 million; Per capita GDP (2005): $1,320

					Projections	
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
National accounts	(annual percentage change, unless otherwise indicated)					
Nominal GDP at market prices (in LE billions)	378.9	417.5	485.3	536.6	595.2	665.1
Nominal GDP (in US$ billions)	87.5	81.4	78.8	89.5	103.5	111.8
Real GDP	3.2	3.1	4.1	4.9	5.6	5.6
CPI inflation (average)	2.4	3.2	10.3	11.4	4.1	5.5
CPI inflation (end-of-period)	2.7	4.0	16.6	4.7	5.0	6.0
Unemployment rate (percent) 6/	9.4	10.5	11.1	10.5	11.7	...
Poverty headcount index (percent of population)	18.4	...	...	19.6	...	...
Oil and gas sector						
Total oil and gas exports (in US$ billions)	2.4	3.2	3.9	5.3	9.8	11.0
Average Egyptian oil export price (in US$/barrel)	20.1	25.6	27.5	39.1	54.5	63.0
Crude oil production (in millions of barrels/day)	0.70	0.70	0.68	0.64	0.62	0.61
Investment and savings	(in percent of GDP at market prices)					
Investment	18.0	16.9	16.9	18.0	18.1	19.3
Gross national savings	18.7	19.3	21.3	21.3	20.1	20.5
Savings/investment balance	0.7	2.4	4.3	3.3	2.0	1.2
General government operations						
Revenue and grants 2/ 3/	25.4	26.2	25.6	24.8	31.7	30.7
Expenditures 2/ 3/	32.5	32.2	31.6	31.8	38.8	36.7
Net Acquisition of Financial Assets 2/	2.1	3.0	2.2	2.0	1.1	2.0
Balance 2/ 4/	-9.2	-9.0	-8.3	-9.1	-8.3	-8.1
Identified financing	7.0	8.2	6.4	8.5	...	...
Statistical discrepancy	2.2	0.8	1.8	0.6	...	...
Net public debt	62.1	66.6	64.8	68.2	69.8	70.5
Monetary sector	(annual percentage change, unless otherwise indicated)					
Broad money (M2)	15.6	16.9	13.2	13.6	13.8	14.7
Net foreign assets (contribution to M2 growth)	-0.4	2.5	5.1	8.2	11.6	5.7
Net domestic assets (contribution to M2 growth)	16.0	14.4	8.0	5.3	2.2	8.9
Domestic currency component (M2D)	13.0	10.6	11.5	19.9	15.3	...
Velocity of broad money	1.15	1.09	1.12	1.09	1.06	...
Credit to private sector	11.0	7.3	4.1	3.8	6.8	7.7
Treasury bills (91-day rate, period average) 5/	7.8	8.3	8.4	10.2	8.8	...
Stock market index (Local currency, end of period) 5/	57.2	82.2	135.7	449.7	572.7	...
External sector	(in billions of U.S. dollars, unless otherwise indicated)					
Exports of goods and nonfactor services	15.8	18.0	22.9	28.0	32.9	36.2
Of which: non-oil goods	4.7	5.0	6.5	8.5	8.7	9.7
Imports of goods and nonfactor services	19.5	19.6	23.3	30.2	37.0	40.9
Current account balance	0.6	1.9	3.4	2.9	2.1	1.4
In percent of GDP	0.7	2.4	4.3	3.3	2.0	1.2
Capital account balance	2.5	0.8	-1.7	2.1	1.7	1.8
Overall Balance	-0.5	0.5	-0.2	4.5	3.8	3.2
External debt	28.7	29.4	29.9	28.9	31.3	29.5
In percent of GDP	32.8	36.1	37.9	32.4	30.3	26.4
External debt service (as a percent of exports of GNFS)	13.2	12.4	10.9	9.7	8.6	11.0
Gross official reserves	14.1	14.8	14.8	19.3	23.1	26.3
In months of imports (of GNFS)	8.7	9.1	7.6	7.7	7.5	7.7
Memorandum items:						
Nominal effective exchange rate (1991=100, period average)	120.6	96.1	71.4	70.2	...	...
Real effective exchange rate (1991=100, period average)	153.1	122.2	95.8	99.8	...	...
Exchange rate (LE/US$; average) 5/	4.33	5.13	6.16	6.00	5.75	...

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

1/ Fiscal year ends June 30.

2/ Authorities' estimates based on revised source data and new budget classification. New series are not comparable to those in last staff report (Country Report No. 05/177).

3/ There is a series break in 2005/06, when notional recording of fuel subsidies was made explicit in budget expenditures. The counterpart is a larger notional payment by the oil company (EGPC) by an equivalent amount (see footnote 3 of Table 3).

4/ As calculated by the MOF, but adjusted by: (i) including the repayment of past arrears as a capital spending item (purchase of nonfinancial assets), and (ii) eliminating the creation of arrears from the financing side, as well as from capital spending.

5/ For 2005/06, averages refer to July 05-May 06 period; for stock market, index as of April 2006.

6/ For 2005/06, unemployment rate as of December 2005.

Table 2. Egypt: Monetary Survey, 2001/02–2006/07

	2001/02	2002/03	2003/04	2004/05	Projections 2005/06	2006/07
	(end-period stocks, in billions of Egyptian pounds)					
Net foreign assets	17.4	25.5	45.3	81.1	138.3	170.5
Net international reserves	69.4	99.4	123.7	152.4	204.4	229.9
Central bank	61.9	86.3	88.3	108.7	130.5	136.6
Other banks	7.5	13.1	35.4	43.6	73.9	93.3
CBE medium- and long-term liabilities	-4.2	-5.7	-6.1	-5.8	-5.7	-6.0
Blocked accounts (Rescheduled loans)	-47.8	-68.1	-72.3	-65.5	-60.3	-53.3
Net domestic assets	311.3	358.7	389.6	412.7	423.8	474.1
Net claims on government sector	88.7	95.8	118.7	153.2	162.6	187.6
Claims on public sector companies	31.1	35.0	35.6	37.4	36.4	40.3
Claims on private sector companies	233.5	248.9	260.1	269.5	291.2	312.6
Net other items	-42.0	-21.0	-24.8	-47.3	-66.4	-66.4
Broad money (M2)	328.7	384.3	434.9	493.9	562.2	644.6
Domestic currency component (M2D)	252.6	279.3	311.4	373.3	430.4	...
Foreign currency component	76.2	105.0	123.6	120.6	131.8	...
Memorandum items:						
Summary central bank balance sheet						
Reserve money 1/ 2/	73.8	83.0	93.4	105.9	123.1	142.4
Net international reserves	61.9	86.3	88.3	108.7	130.5	136.6
Net domestic assets	110.0	98.3	127.4	151.7	155.7	174.2
	(annual percent change, unless otherwise indicated)					
Broad money (M2)	15.6	16.9	13.2	13.6	13.8	14.7
Broad Money - Domestic currency component (M2D) 3/	13.0	10.6	11.5	19.9	15.3	...
Reserve money	5.4	12.4	12.6	13.4	16.2	15.7
Money multiplier (ratio) 4/	3.4	3.4	3.3	3.5	3.5	3.5
Contribution to Broad Money Growth	15.6	16.9	13.2	13.6	13.8	14.7
NFA component	-0.4	2.5	5.1	8.2	11.6	5.7
NDA component	16.0	14.4	8.0	5.3	2.2	8.9
Private sector credit	11.0	7.3	4.1	3.8	6.8	7.7
Net claims to the government and GASC 5/	22.0	22.7	25.8	26.0	5.9	17.3
Domestic currency velocity (ratio)	1.5	1.5	1.6	1.4	1.4	...
M2 velocity (ratio)	1.2	1.1	1.1	1.1	1.1	1.0
Dollarization ratio 6/	23.2	27.3	28.4	24.4	23.4	...

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

1/ Excludes deposit auctions.

2/ Excludes reserve requirements on foreign currency deposits.

3/ Broad money less foreign currency deposits.

4/ Ratio of broad money (domestic currency component) to reserve money.

5/ Excludes valuation effects.

6/ Foreign currency deposits over broad money.

Table 3. Egypt: Summary of the General Government Operations, 2001/02-2006/07 1/

				Prel.	Proj.	
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
			(in percent of GDP)			
Revenue	25.4	26.2	25.6	24.8	31.7	30.7
Tax revenue	13.4	13.3	13.8	14.1	14.1	14.6
Income taxes 2/	5.2	5.0	5.6	5.9	5.9	5.9
Goods and services	5.5	5.5	5.5	5.9	5.9	6.4
International trade	1.9	2.0	1.9	1.4	1.4	1.4
Other	0.8	0.9	0.9	0.9	0.9	0.9
Grants	1.1	0.8	1.0	0.5	0.5	0.5
Other revenue 3/	10.8	12.0	10.7	10.2	17.0	15.5
Expenditure	32.5	32.2	31.6	31.8	38.8	36.7
Wages and other Remunerations	8.1	8.2	7.8	7.8	7.8	7.7
Purchases of Goods And Services	2.3	2.1	1.9	2.4	2.4	2.3
Interests	5.4	5.7	5.7	5.6	5.7	5.5
Subsidies, Grants, and Social Benefits 3/	7.0	7.0	7.2	7.7	14.6	13.1
Other Expenditures	4.4	4.4	4.3	4.1	4.1	4.0
Purchase of Non Financial Assets (Investments)	5.2	4.9	4.7	4.3	4.3	4.2
Net Acquisition of Financial Assets 4/	2.1	3.0	2.2	2.0	1.1	2.0
Overall General Government Balance	-9.2	-9.0	-8.3	-9.1	-8.3	-8.1
Statistical discrepancy	2.2	0.8	1.8	0.6	...	...
Financing	7.0	8.2	6.4	8.5	8.3	8.1
External and domestic	5.8	4.6	6.2	8.7	...	...
Domestic financing	5.7	5.6	7.1	9.4	...	...
External financing 5/	0.1	-1.0	-0.8	-0.8	...	...
Arrears repayment	-1.5	-0.7	-0.6	-0.5	...	...
Arrears creation	1.5	1.2	0.5	0.8	...	...
Revaluation adjustments 6/	1.2	3.1	0.3	-0.7	...	...
Privatization receipts	0.1	0.0	0.0	0.2	...	...
Memo items:						
Primary balance	-3.9	-3.3	-2.6	-3.5	-2.6	-2.6
Cash balance 7/	-7.1	-6.0	-6.0	-7.0	-7.1	-6.0
Gross public debt 8/	97.7	111.4	109.9	112.5	...	...
Net public debt 9/	62.1	66.6	64.8	68.2	69.8	70.5

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

1/ General government comprises the budget sector, National Investment Bank (NIB), and the Social Insurance Funds (SIF).
2/ In 2005/06, includes a 1.2 percent of GDP payment of tax arrears by EGPC .
3/ From 2005/06, fuel subsidies are explicitly recorded as a notional expenditure item. An equivalent amount is recorded as notional revenues from EGPC and foreign partners under "other revenue".
4/ In 2005/06, includes a 0.8 percent of GDP inflow due to the partial sale of Egypt Telecom.
5/ Fund staff estimates, derived from changes in the stock of gross external debt.
6/ Refers to adjustments to the net financing flows denominated in foreign currency related to exchange rate movements.
7/ Refers to revenue minus expenditure (approximation of net lending/borrowing under GFSM-2001).
8/ Refers to the general government debt, including government guaranteed external debt.
9/ Gross debt minus deposits with banks. Deposits include the 'blocked accounts" on rescheduled Paris Club debt held at the CBE.

Table 4. Egypt: Comparison of Old Budget Classification (OBC) and New Budget Classification (NBC) 1/
General Government Operations, 2001/02-2003/04

	2001/02	2002/03	2003/04	2001/02	2002/03	2003/04
	(LE million)			*(in percent of GDP)*		
Total Revenue and Grants						
OBC	104,042	115,551	130,202	27.5	27.7	26.8
NBC	96,088	109,235	124,128	25.4	26.2	25.6
of which:						
Tax revenues						
OBC	51,726	57,486	64,793	13.7	13.8	13.4
NBC	50,801	55,708	67,147	13.4	13.3	13.8
Other revenues, excluding grants						
OBC	48,603	55,111	61,997	6.2	6.2	6.5
NBC	41,022	50,238	51,922	6.1	7.3	6.1
Total expenditure 2/						
OBC	113,665	125,497	141,949	30.0	30.1	29.2
NBC	131,017	146,910	164,185	34.6	35.2	33.8
of which:						
Wages and salaries						
OBC	28,500	31,859	36,290	7.5	7.6	7.5
NBC	30,817	34,150	37,631	8.1	8.2	7.8
Subsidies and transfers						
OBC	24,069	26,242	30,004	6.4	6.3	6.2
NBC	26,545	29,273	34,880	7.0	7.0	7.2
Other expenditure, including defense						
OBC	10,218	11,215	12,400	2.7	2.7	2.6
NBC	16,861	18,354	21,066	4.4	4.4	4.3
Capital Expenditure (Investment)						
OBC	15,267	16,560	18,322	4.0	4.0	3.8
NBC	19,809	20,276	22,867	5.2	4.9	4.7
General government balance						
OBC	-9,623	-9,946	-11,747	-2.5	-2.4	-2.4
NBC	-34,928	-37,675	-40,058	-9.2	-9.0	-8.3
IMF Staff "Augmented fiscal balance" 3/	-30,121	-29,462	-31,317	-7.9	-7.1	-6.5
Nominal GDP (mill LE)	378,900	417,500	485,300			

Sources: Egyptian authorities; and IMF staff estimates.

1/ New budget classification (NBC) is based on GFSM 2001.

2/ Includes net lending in the old budget classification (OBC), and net acquisition of financial assets in the NBC series.

3/ Augmented fiscal balance as presented in 2005 Article IV Staff report (Country Report No. 05/177). These estimates were based on the OBC, adjusted for financing operations that had been recorded officially "below the line".

Table 5. Egypt: Medium-Term Macroeconomic Framework, 2001/02–2010/11

					Baseline Projections					
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	(in percent of GDP, unless otherwise indicated)									
Real GDP (annual percent change)	3.2	3.1	4.1	4.9	5.6	5.6	5.8	6.0	6.3	6.5
CPI inflation (average, annual percent change)	2.4	3.2	10.3	11.4	4.1	5.5	5.8	5.3	4.5	4.0
Investment	18.0	16.9	16.9	18.0	18.1	19.3	20.5	21.7	22.8	24.1
Private investment	12.8	12.0	12.2	13.7	13.8	15.1	16.2	17.3	18.3	19.5
General government investment	5.2	4.9	4.7	4.3	4.3	4.2	4.3	4.4	4.5	4.6
Saving	18.7	19.3	21.3	21.3	20.1	20.5	20.9	21.3	21.7	22.1
External current account balance	0.7	2.4	4.3	3.3	2.0	1.2	0.4	-0.4	-1.1	-2.0
Overall fiscal balance (general government)	-9.2	-9.0	-8.3	-9.1	-8.3	-8.1	-7.1	-6.1	-5.1	-4.1

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

Table 6. Egypt: Public Sector Debt Sustainability Framework, 2001/02-2010/11
(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	**Debt-stabilizing primary balance 10/**
Baseline: Net public debt 1/	62.1	66.6	64.8	68.2	**69.8**	**70.5**	**70.0**	**68.7**	**67.0**	**64.5**	**-3.1**
o/w foreign-currency denominated	22.3	27.6	23.8	18.2	24.4	24.7	24.5	24.1	23.4	22.6	
Change in public sector debt	8.2	4.6	-1.8	3.4	1.6	0.7	-0.5	-1.2	-1.8	-2.5	
Identified debt-creating flows (4+7+12)	8.0	7.4	-2.7	-1.1	-0.7	-0.9	-1.9	-2.9	-3.8	-4.7	
Primary deficit	3.9	3.3	2.6	3.5	2.6	2.5	1.6	0.7	-0.2	-1.1	
Revenue and grants	25.4	26.2	25.6	24.8	31.7	32.2	32.7	32.7	32.7	32.7	
Primary (noninterest) expenditure	29.2	29.5	28.2	28.3	34.3	34.7	34.3	33.4	32.5	31.6	
Automatic debt dynamics 2/	4.3	4.0	-5.3	-4.4	-3.3	-3.3	-3.5	-3.6	-3.6	-3.6	
Contribution from interest rate/growth differential 3/	0.6	-2.1	-5.9	-2.9	-3.3	-3.3	-3.5	-3.6	-3.6	-3.6	
Of which contribution from real interest rate	2.2	-0.4	-3.5	0.0	0.2	0.2	0.1	0.2	0.3	0.3	
Of which contribution from real GDP growth	-1.6	-1.8	-2.4	-2.9	-3.4	-3.5	-3.6	-3.8	-3.9	-3.9	
Contribution from exchange rate depreciation 4/	3.7	6.2	0.6	-1.5	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	0.0	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative) 5/	-0.1	0.0	0.0	-0.2	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	
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	
Other (specify, e.g. bank recapitalization) 5/	0.0	0.0	0.0	0.0	0.4	0.4	0.4	0.4	0.4	0.4	
Residual, including asset changes (2-3) 6/	0.2	-2.8	0.9	4.5	2.2	1.6	1.4	1.7	2.1	2.3	
Public sector debt-to-revenue ratio 1/	244.7	254.7	253.4	275.0	220.2	219.0	214.0	210.2	204.8	197.3	
Gross financing need 7/	20.5	24.6	24.4	25.4	25.4	26.4	24.3	23.2	21.9	20.5	
in billions of U.S. dollars	17.9	20.0	19.2	22.7	26.3	29.5	29.4	30.4	31.1	31.6	
Scenario with key variables at their historical averages 8/					**69.8**	**71.9**	**73.7**	**75.8**	**78.3**	**81.0**	**-2.8**
Scenario with no policy change (constant primary balance) in 2005-2010					**69.8**	**73.3**	**75.2**	**77.5**	**80.5**	**83.9**	**-1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	3.2	3.1	4.1	4.9	5.6	5.6	5.8	6.0	6.3	6.5	
Average nominal interest rate on public debt (in percent) 9/	6.8	6.4	5.9	5.6	5.6	6.4	6.5	5.9	5.2	4.8	
Average real interest rate (nominal rate minus change in GDP deflato	4.4	-0.5	-5.7	0.2	0.6	0.6	0.6	0.6	0.7	0.8	
Nominal appreciation (increase in US dollar value of local currency,	-16.9	-22.9	-2.5	7.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.4	6.9	11.6	5.4	5.0	5.8	5.9	5.3	4.5	4.0	
Growth of real primary spending (deflated by GDP deflator, in percei	0.0	4.1	-0.6	5.4	28.0	6.8	4.6	3.2	3.4	3.5	
Primary deficit	3.9	3.3	2.6	3.5	2.6	2.5	1.6	0.7	-0.2	-1.1	

Sources: IMF staff estimates and projections.

1/ Refers to the general government, including government guaranteed debt.

2/ Derived as $[(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 ae(1+r).

5/ The projections are purely illustrative as the level of future privatization receipts accrueing to the budget is highly uncertain and bank recapitalization requirements are yet to be finalized, but reflect the authorities' intention to finance recapitalization outlays with privatization receipts.

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

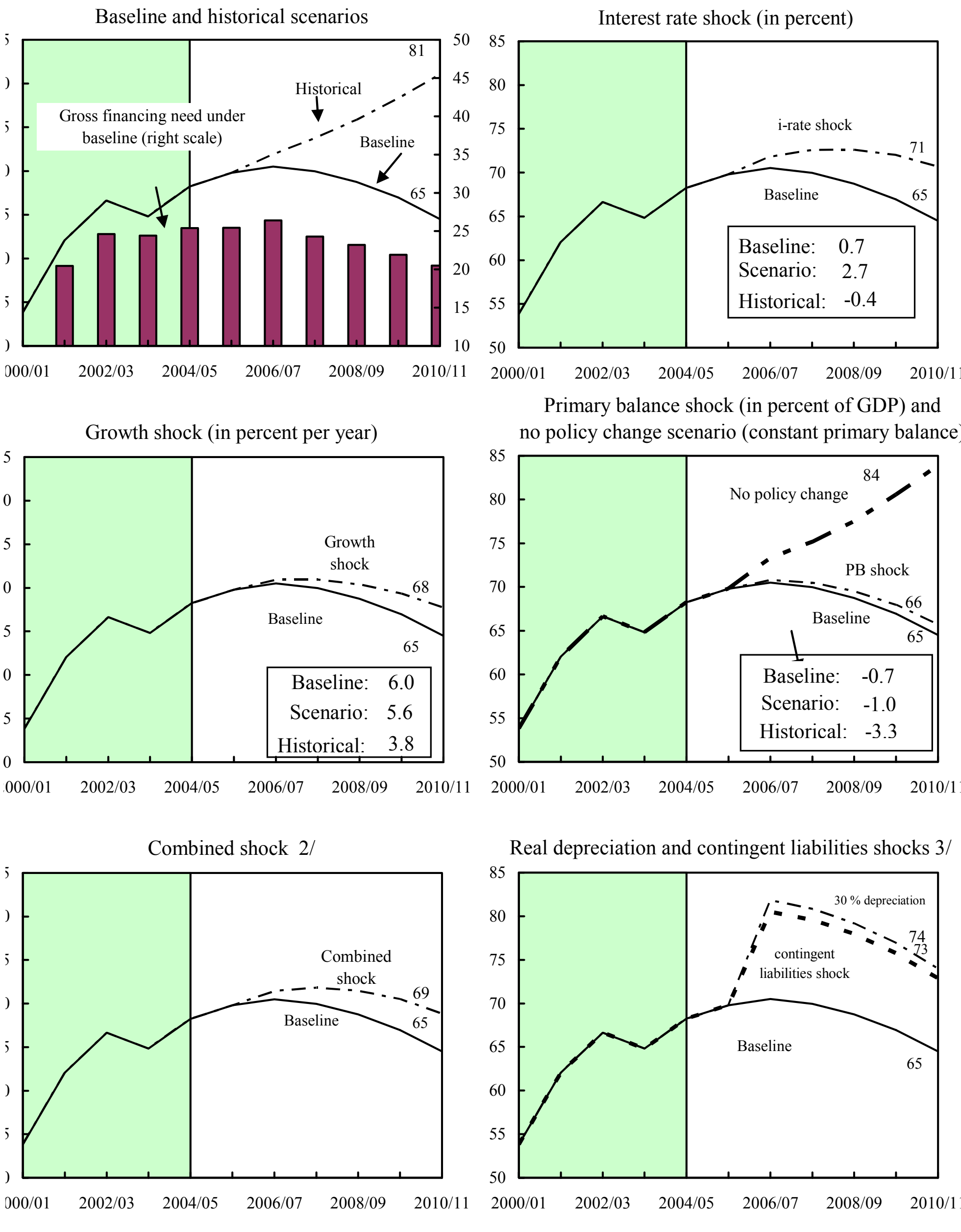
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

10/ 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.

Table 7. Egypt: Public Debt Sustainability - Bound Tests 1/
(Public debt in percent of GDP)



Sources: *IMF staff estimates and projections.*

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. The four-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 2006, 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 8. Egypt: Medium-Term Balance of Payments, 2001/02–2010/11

					Baseline Projections					
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	(billions of U.S. dollars, unless otherwise indicated)									
Current Account Balance	0.6	1.9	3.4	2.9	2.1	1.4	0.5	-0.5	-1.6	-3.1
Trade balance	-7.5	-6.6	-7.8	-10.4	-10.9	-12.1	-13.7	-15.6	-17.4	-19.6
Exports	7.1	8.2	10.5	13.8	18.5	20.8	21.4	21.8	22.3	23.0
Of which: oil	2.4	3.2	3.9	5.0	7.1	7.8	7.3	6.7	6.2	5.8
Gas	0.0	0.0	0.0	0.3	2.7	3.3	3.4	3.5	3.5	3.5
Imports	-14.6	-14.8	-18.3	-24.2	-29.4	-32.8	-35.1	-37.4	-39.7	-42.7
Of which: oil	-2.5	-2.3	-2.6	-4.0	-5.6	-6.8	-7.1	-7.2	-7.5	-7.7
Services (net)	3.9	4.9	7.3	7.8	6.9	7.2	7.8	8.3	8.9	9.3
Receipts	9.6	10.4	13.0	15.0	16.0	17.4	18.6	19.8	21.1	22.4
Of which: Tourism	3.4	3.8	5.5	6.4	6.4	6.9	7.4	7.9	8.4	9.0
Suez canal dues	1.8	2.2	2.8	3.3	3.5	3.7	3.9	4.1	4.3	4.6
Investment income	0.9	0.6	0.5	0.9	1.7	2.0	2.1	2.3	2.4	2.5
Payments	5.7	5.5	5.7	7.2	9.2	10.2	10.8	11.5	12.2	13.1
Interest payments	0.7	0.6	0.6	0.6	0.6	0.8	0.8	0.7	0.7	0.8
Profit remittances	0.2	0.1	0.1	0.6	1.0	1.3	1.4	1.5	1.7	1.8
Travel payments	1.2	1.4	1.3	1.4	1.7	1.8	2.0	2.2	2.4	2.6
Transfers	4.3	3.6	3.9	5.4	6.1	6.2	6.5	6.7	7.0	7.2
Official grants	1.1	0.7	0.9	1.1	0.8	0.8	0.7	0.7	0.6	0.6
Private remittances	3.1	2.9	3.0	4.4	5.2	5.5	5.8	6.1	6.4	6.7
Capital Account	2.5	0.8	-1.7	2.1	1.7	1.8	2.5	2.4	3.5	3.3
Medium and long term loans (net)	0.2	-0.9	-0.6	-1.3	2.4	-1.8	-0.6	-0.6	-0.6	-0.7
Drawings	1.6	0.7	1.3	0.8	4.6	1.4	1.5	1.5	1.6	1.6
Government market borrowing	1.0	0.0	0.0	0.0	2.8	0.5	0.5	0.5	0.5	0.5
Other 1/	0.6	0.7	1.3	0.8	1.8	0.9	1.0	1.0	1.1	1.1
Amortization	-1.4	-1.6	-1.9	-2.1	-2.2	-3.2	-2.0	-2.1	-2.2	-2.3
FDI 2/	2.5	2.8	2.6	3.9	5.6	4.0	3.5	3.5	3.5	3.5
Portfolio investment	0.0	-0.4	-0.1	1.4	-0.1	0.6	0.6	0.6	0.6	0.5
Commercial banks' NFA	-0.2	-0.6	-3.5	-1.8	-5.3	-1.0	-1.0	-1.0	0.0	0.0
Other (including short-term capital) 3/	0.0	0.0	0.0	0.0	-0.8	0.0	0.0	0.0	0.0	0.0
Errors and Omissions (net)	-3.6	-2.2	-1.9	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-0.5	0.5	-0.2	4.5	3.8	3.2	3.0	1.9	1.9	0.2
Of which: net international reserves	0.5	-0.5	0.2	-4.5	-3.8	-3.2	-3.0	-1.9	-1.9	-0.2
Memorandum items:										
Current account (percent of GDP)	0.7	2.4	4.3	3.3	2.0	1.2	0.4	-0.4	-1.1	-2.0
Trade balance (percent of GDP)	-8.6	-8.1	-9.9	-11.6	-10.5	-10.8	-11.4	-11.9	-12.3	-12.7
Gross reserves (in US$ billions, end of period)	14.1	14.8	14.8	19.3	23.1	26.3	29.3	31.2	33.1	33.3
In months of imports of GNFS	8.7	9.1	7.6	7.7	7.5	7.7	8.1	8.1	8.0	7.5
GDP (in US$ billions)	87.5	81.4	78.8	89.5	103.5	111.8	121.0	130.9	141.9	154.3
External debt (in US$ billions) 4/	28.7	29.4	29.9	28.9	31.3	29.5	29.0	28.4	27.7	27.0
External debt service (percent of exports GNFS)	13.2	12.4	10.9	9.7	8.6	11.0	7.4	7.3	7.1	7.1

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

1/ Includes multilateral and bilateral public sector borrowing and private borrowing.

2/ Data before 2004/05 are the CBE data on non-oil FDI augmented by estimates of FDI in the oil and gas sector derived from EGPC annual reports.

3/ In addition to the revisions to the FDI data (see footnote 2), IMF staff make three other adjustments to the official balance of payments data. First, the CBE estimates record the difference between a headcount-based estimate of tourism-related inflows and the estimates obtained from the International Transactions Recording System as an outflow in the capital account. The Staff estimates here record only the flows based on direct estimates of tourist arrivals with the errors and omissions line offsetting any upward bias implicit in these estimates.

Second, because of large discrepancies between the annual flows of net short-term suppliers credits and changes in end-of-period stocks in the official data, net flows of short-term suppliers credits are not identified here and are instead absorbed in errors and omissions. Third, unlike in the official data, and in order to preserve symmetry with unrecorded capital outflows on account of currency substitution in earlier years, reverse currency substitution in 2004/05 is not recorded under other capital inflows, but instead reflected in errors and omissions.

4/ The official data on external debt do not include non-resident holdings of domestic currency-denominated Treasury Bills (about US$1.6 billion at end-2005). BIS data for non-bank private sector external debt suggest that the official data on external debt underestimate the former by US$1.3 billion and the latter by more than US$3 billion.

Table 9. Egypt: External Debt Sustainability Framework, 2000/01-2010/11

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	**Debt stabilizing curr. acc. 6/**
1 **Baseline: External debt**	27.8	32.8	36.1	37.9	32.4	**30.3**	**26.4**	**24.0**	**21.7**	**19.5**	**17.5**	
2 Change in external debt	-0.2	4.9	3.4	1.8	-5.6	-2.0	-3.9	-2.5	-2.3	-2.1	-2.0	
3 Identified external debt-creating flows (4+8+9)	-1.3	0.3	0.6	-11.6	-13.2	-9.2	-7.2	-5.5	-4.3	-3.3	-2.0	
4 Current account deficit, excluding interest payments	-0.7	-1.5	-3.2	-5.1	-3.9	-2.6	-2.0	-1.0	-0.2	0.6	1.5	**-3.8**
5 Deficit in balance of goods and services	-6.1	-6.9	-9.7	-12.2	-10.9	-10.8	-10.2	-9.3	-8.5	-7.8	-7.0	
6 Exports	17.7	18.1	22.1	29.1	31.2	31.8	32.3	31.2	30.0	28.9	27.8	
7 Imports	11.6	11.1	12.4	16.9	20.3	21.1	22.1	21.9	21.5	21.1	20.9	
8 Net non-debt creating capital inflows (negative)	-3.0	-2.9	-2.9	-3.0	-5.2	-5.6	-4.4	-3.7	-3.4	-3.1	-2.8	
9 Automatic debt dynamics 1/	2.4	4.7	6.6	-3.6	-4.0	-1.0	-0.9	-0.8	-0.8	-0.7	-0.7	
10 Contribution from nominal interest rate	0.8	0.8	0.8	0.6	0.6	0.6	0.7	0.6	0.6	0.5	0.5	
11 Contribution from real GDP growth	-1.0	-1.0	-1.2	-1.3	-1.6	-1.6	-1.6	-1.4	-1.3	-1.3	-1.2	
12 Contribution from price and exchange rate changes 2/	2.6	4.9	7.0	-2.9	-3.1	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.1	4.6	2.8	13.4	7.6	7.2	3.3	3.0	2.0	1.1	0.0	
External debt-to-exports ratio (in percent)	156.9	181.4	163.3	130.2	103.6	95.2	81.7	76.7	72.2	67.7	63.0	
Gross external financing need (in billions of US dollars) 4/	2.7	2.5	1.3	-0.1	0.7	2.0	3.6	3.4	4.5	5.6	7.2	
in percent of GDP	2.8	2.8	1.6	-0.2	0.8	2.0	3.3	2.8	3.4	4.0	4.7	
Scenario with key variables at their historical averages 5/						**30.3**	**30.3**	**29.8**	**28.3**	**25.9**	**22.1**	**-2.8**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.5	3.2	3.1	4.1	4.9	5.6	5.6	5.8	6.0	6.3	6.5	
GDP deflator in US dollars (change in percent)	-8.6	-14.9	-17.6	8.8	8.8	9.3	2.5	2.3	2.1	2.0	2.1	
Nominal external interest rate (in percent)	2.6	2.6	2.2	2.0	2.0	2.0	2.5	2.6	2.6	2.6	2.8	
Growth of exports (US dollar terms, in percent)	5.9	-6.6	14.0	27.5	21.8	17.7	9.9	4.5	4.1	4.3	4.8	
Growth of imports (US dollar terms, in percent)	-14.3	-12.3	3.5	32.2	36.4	19.8	13.6	7.1	6.4	6.3	7.4	
Current account balance, excluding interest payments	0.7	1.5	3.2	5.1	3.9	2.6	2.0	1.0	0.2	-0.6	-1.5	
Net non-debt creating capital inflows	3.0	2.9	2.9	3.0	5.2	5.6	4.4	3.7	3.4	3.1	2.8	

Sources: IMF staff estimates and projections.

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

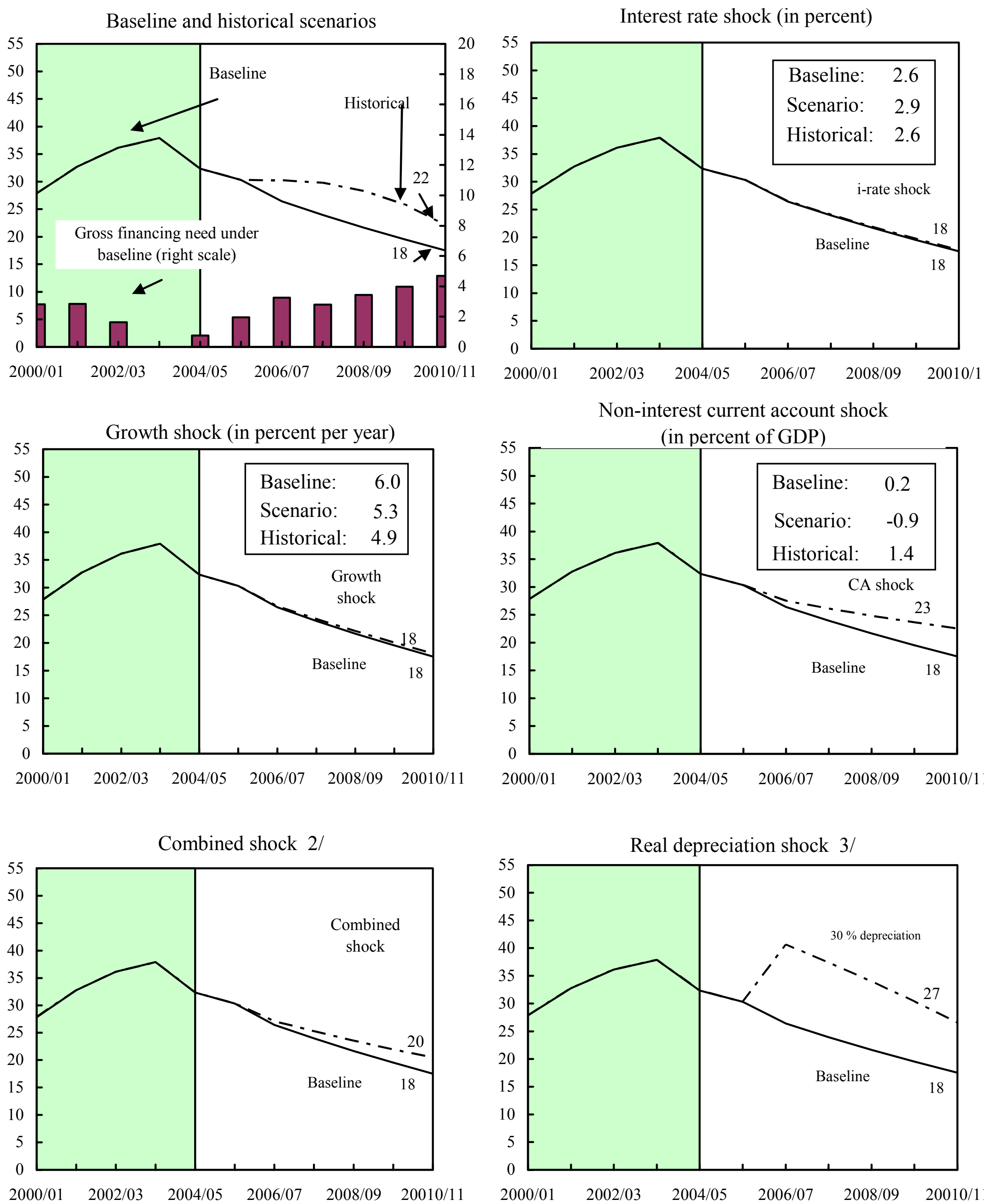
3/ For projection, line includes the impact of price and exchange rate changes.

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 non-interest current account and non-debt 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 non-debt inflows in percent of GDP) remain at their levels of the last projection year.

10. Egypt: External Debt Sustainability - Bound Tests 1/
(external debt in percent of GDP)



Sources: IMF staff estimates and projections.

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 2006/07.

Table 11. Egypt: Selected Vulnerability Indicators, 2001/02–2005/06

	2001/02	2002/03	2003/04	2004/05	Proj. 2005/06
Key Economic and Market Indicators					
Real GDP growth (percent)	3.2	3.1	4.1	4.9	5.6
CPI inflation (period average, percent)	2.4	3.2	10.3	11.4	4.1
Short-term interest rate (91-day Treasury bill rate, percent)	7.8	8.3	8.4	10.2	8.8
5-year Eurobond spread (basis points, over U.S. Treasury)	266	208	123	95	...
Exchange rate (LE per dollar, end-of-period)	4.65	6.03	6.19	5.77	...
External Sector					
Exchange rate regime	Unified flexible exchange rate since December 2004				
Current account balance (percent of GDP)	0.7	2.4	4.3	3.3	2.0
Net FDI inflows (percent of GDP)	2.9	3.4	3.2	4.3	5.4
Exports (percentage change of US$ value, GNFS)	-6.6	14.0	27.5	21.8	17.7
Real effective exchange rate (1991=100)	153.1	122.2	95.8	99.8	...
Gross international reserves (GIR) (US$ billions)	14.1	14.8	14.8	19.3	23.1
GIR in percent of debt at remaining maturity 1/	464	498	437	486	563
GIR in percent of debt at remaining maturity and banks' FX deposits 1/	72.7	72.9	63.4	77.7	85.5
Net international reserves (US$ billions)	14.0	14.8	14.8	19.3	23.1
Total gross external debt in percent of GDP	32.8	36.1	37.9	32.4	30.3
Of which: short-term external debt (original maturity, percent of total)	5.8	4.6	4.9	6.4	5.9
external debt of domestic private sector (percent of total)	6.0	4.9	4.7	6.3	7.1
Total gross external debt in percent of exports of GNFS	181.4	163.3	130.2	103.6	95.2
Gross external financing requirement (US$ billions) 2/	0.8	-0.3	-1.5	-0.8	0.2
Public Sector 3/					
General government balance (percent of GDP)	-9.2	-9.0	-8.3	-9.1	-8.3
Primary balance (percent of GDP)	-3.9	-3.3	-2.6	-3.5	-2.6
Public sector gross debt (percent of GDP)	97.7	111.4	109.9	112.5	...
Public sector net debt (percent of GDP)	62.1	66.6	64.8	68.2	69.8
Financial Sector 4/ 5/					
Capital adequacy ratio (percent)	9.9	11.0	11.1	13.8	14.5
NPLs as percent of total loans	16.9	20.2	24.2	26.3	25.0
Provisions as percent of NPLs	67.5	62.3	57.0	53.1	54.9
Return on average assets (percent)	0.7	0.5	0.5	0.6	0.6
Return on equity (percent)	12.4	8.9	9.8	10.6	10.7
FX deposits (percent of total deposits)	26.2	30.7	32.4	28.5	28.0
FX loans (percent of total loans)	23.1	26.1	27.1	27.2	26.1
Government debt held by financial sector (percent of total assets)	38.2	40.4	43.8	45.2	42.8
Credit to private sector (percent change)	11.0	7.3	4.1	3.8	6.8
Memorandum item:					
Nominal GDP (US$ billions)	87.5	81.4	78.8	89.5	103.5

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 financial sector includes commercial banks (public and private), business and investment banks, and specialized banks.

5/ Projections for 2005/06 reflect the actual value as of December 2005.

Egypt: Fund Relations
(As of April 30, 2006)

I. **Membership Status**: Joined 12/27/45[5]

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	75.06	55.22

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	0.00
EFF	9/20/93	9/19/96	400.00	0.00
Stand-by	5/17/91	5/31/93	234.40	147.20

VI. **Projected Obligations to the Fund:**[6]
(SDR million; based on existing use of resources and present holding of SDRs)

	Forthcoming				
	2006	2007	2008	2009	2010
Charges/interest	1.59	2.14	2.15	2.14	2.14
Total	1.59	2.14	2.15	2.14	2.14

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

[6] 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 March 31, 2006):

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 preannounced 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. Since early 2005, the LE/US$ rate has fluctuated in a narrow range, akin to a de facto peg. Egypt maintains an inoperative bilateral payments arrangement with Sudan. A joint LEG/MFD team is reviewing the foreign exchange system in connection with Egypt’s acceptance of the obligations of Article VIII in 2005.

VIII. **Article IV Consultation:**

Consultations with Egypt are on a 12-month cycle. The last Article IV consultation discussions were held in Cairo from February 2-16, 2005. The staff report (Country Report No. 05/177) was discussed by the Executive Board on May 18, 2005. The 2005 Article IV report, PIN, and Selected Issues Papers were published on June 7, 2005.

IX. **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

X. **Technical Assistance (2004-2006)**

Dept.	**Topic**	**Date**
FAD	Income tax reform	January 2004
MFD	Needs assessment mission I	February 2004
MFD	Needs assessment II on monetary operations, payments systems and banking supervision	April 2004
MFD	Banking Reform	May 2004
FAD	Budget system reforms, classification	August 2004
LEG	Income tax legislation reform	August 2004
MFD	Monetary Policy Expert (first of six visits)	August 2004
MFD	Reassessment of CBE TA needs	October 2004
FAD	Budget classification (follow-up)	October 2004
MFD	Monetary Policy Expert (second of six visits)	October 2004
LEG	Income tax legislation reform (follow-up)	November 2004
FAD	Income tax reform (follow-up)	November 2004
FAD	Revenue Administration, tax and customs administration and modernization	December 2004
FAD	Treasury Single Account; Macro fiscal unit	January 200 5

MFD	Monetary Policy Expert (third of six visits)	February 2005
METAC	Bank restructuring and Supervision	February 2005
MFD	Bank restructuring	February 2005
METAC	Needs assessment on statistics (multisector)	February 2005
FAD	Resident macro fiscal advisor (start date)	March 2005
FAD	Revenue administration	March 2005
METAC	Revenue administration.	March 2005
METAC	Foreign Direct Investment Statistics	March/April 2005
FAD	Revenue Administration Advisor	May 2005
MFD	Monetary Policy Expert (fourth of six visits)	May 2005
FAD	GST reform; taxation system for small taxpayers	May/June 2005
STA/METAC	Producer Price Index—assistance to CAPMAS	July 2005
LEG	Tax legislation	July 2005
MFD	Monetary Policy Expert (fifth and sixth of seven visits)	August 2005
FAD	Revenue Administration Advisor	August 2005
FAD/STA	Budget classification, fiscal reporting framework	October 2005
MFD	Resident expert at CBE: monetary operations (start date)	October 2005
LEG	Tax Legislation—follow up	October 2005
FAD	Revenue Administration Advisor	November 2005
FAD	Real Estate Tax	November 2005
MFD	Monetary Policy Expert (sixth of seven visits)	November 2005
FAD	Tax Administration	December 2005
FAD/METAC	Revenue administration (first of two visits)	February 2006
FAD/LEG	Tax policy-Agricultural land tax	March 2006
MFD	Monetary policy expert (last of seven visits)	March 2006
FAD	Revenue Administration	May 2006
LEG/MFD	Article VIII review	May 2006

XI. **Resident Representative:**

Cyrus Sassanpour has been Senior Resident Representative in Cairo since September 2004.

Egypt: Relations with the World Bank

1. **Partnership for Development**. Key development objectives of the government of Egypt as expressed in its development plan are to achieve high and sustainable growth by enhancing the role of the private sector in the development process; focusing the public sector on delivering public goods; and strengthening the social safety net system. Within the context of a lending program (outlined in the Country Assistance Strategy of FY2002-2004) which was modest in relation to the size and importance of the country, the Bank assisted the government in addressing its development challenges. 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 as poverty trends, gender achievements and education sector needs. The spirit that marked this collaborative effort bodes well for the future as the shared understanding feeds 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) for the period FY2006–09, which the Board of Directors endorsed on June 16, 2005. 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 will continue to collaborate efforts in supporting the government in the areas of: macroeconomic framework and management; budget and public expenditure management; public sector reform; and private and financial sector development.

IBRD/IDA Portfolio

4. As of February 28, 2006, the Bank had approved 112 projects for Egypt, valued at about $5.34 billion (excluding grants and cancellations), of which about $4.7 billion have been disbursed, and about US$879.9 million remain undisbursed. The current portfolio has 15 active projects with commitment value of about US$1.3 billion. The sectoral composition of the current portfolio (by value) is as follows: 25 percent for infrastructure, 29 percent for agriculture, 15 percent for education, 7 percent for health, 4 percent for social protection, and 20 percent for power.

International Finance Corporation (IFC) Investments

5. Currently (as at February 28, 2006), Egypt is one of IFC's two largest exposure countries in the MNA Region with a portfolio of $287 million invested in 22 companies in the financial sector, power, export-oriented manufacturing, ports, oil and gas, metals, agribusiness and IT. IFC's PEP-MENA TA work in Egypt has also been strongly supported by the government including business start-up simplification, SME access to finance and

management training, microfinance, a corporate governance project and training of women entrepreneurs.

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 (Investment Climate Assessment); technical assistance and lending

Multilateral Investment Guarantee Agency (MIGA) Exposures

6. As of February 28, 2006, MIGA has one active project in the urban waste management sector in Cairo (covered in FY05) which is facing a potential claim from the insured investor, Urbaser SA of Spain. MIGA's gross exposure in the project is US$ 6.4 million. The claim is in arbitration, after negotiations between the investor and the Cairo Governorate failed.

Bank Group Activities
As of February 28, 2006
(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
IBRD/IDA Lending Operations			
Disbursed	2,987.8	1,726.3	4,714.08
Undisbursed and committed	779.9	100.0	879.9
Number of closed loans/credits = **97**			
Number of ongoing loans/credits = **15**			
Ongoing operations 1/			
Agriculture	296.7	93.3	390.0
Education	75.5	125.0	200.5
Health, Nutrition & Population	0.0	90.0	90.0
Social Protection	0.0	50.0	50.0
Infrastructure	335.0	0.0	335.0
Power	259.6	0.0	259.6
Total	**966.8**	**358.3**	**1325.1**
IFC Investments 2/			287.0
MIGA (gross exposure)			6.4

Source: World Bank Group.
1/ Original commitments less cancellations.
2/ Loans plus equity, disbursed portfolio, February 28, 2006.

Egypt: Statistical Issues

Economic and financial statistics provided to the fund are broadly adequate for surveillance purposes. A data ROSC was conducted in October 2003, and published in July 2005, assessing the quality of Egypt's macroeconomic statistics and recommending improvements. Egypt subscribed to the SDDS in January 2005. Remaining SDDS issues include the timeliness of the labor market data on employment and unemployment, and the timeliness and periodicity of the labor market data for wages/earnings and data for central government operations.

National accounts. National accounts data are compiled on an annual fiscal year basis and a quarterly basis by the National Accounts Department within the Ministry of Planning in current and constant prices, using the 1993 System of National Accounts (*SNA 1993*). The data have a number of shortcomings, including inconsistencies with balance of payments statistics and the absence of a reliable series on GDP and its uses at constant prices (the base year is often changed without an overlap for the series with different base). The problem is exacerbated by the absence of a reliable system of current indicators of economic activity. The authorities requested Fund's technical assistance in this area. Accordingly, an STA consultant joined the 2001 Article IV mission and provided concrete recommendations in the compilation and dissemination of high frequency real sector data. Since January 2002, the authorities have initiated the collection of a monthly index of industrial production, which was first published in April 2003. The October 2003 data ROSC mission found that work still needs to be done to improve national accounts statistics, including the need for a more critical review of source statistics. There are no periodic user surveys or an oversight body to provide guidance on the quality of national accounts.

- **Price statistics.** An updated CPI with new weights based on a 1999–2000 household expenditure survey was first published in April 2004. The October 2003 ROSC found that various constraints, including inadequate computer resources, have curtailed much needed innovations in the CPI, and the index may not be accurate. There are concerns regarding the quality of price statistics, and lack of systematic reviews to identify shortcomings; price statistics are revised without providing explanation, most recently in August 2005. The authorities have upgraded computer equipment and are developing a comprehensive price database, in cooperation with donors. In this regard, there are plans to further improve the CPI and to replace the wholesale price index with a producer price index and to improve the external trade price indices (the latter are unreliable and available only annually). The authorities are currently involved in projects to improve the CPI and to complete development of the PPI with technical assistance from METAC in close cooperation with the STA. These actions are complemented by a training program in price statistics to be delivered by the U.S. BLS.

- **Balance of Payments (BOP) statistics.** The BOP statistics, compiled by the Central Bank of Egypt (CBE) and reported to the Fund, have been revised with Fund technical assistance in accordance with the fifth edition of the *Balance of Payments Manual* (*BMP5*).

Although the national presentation is less detailed than in *BPM5*, data are provided to international organizations using *BPM5* format. The October 2003 ROSC noted that Egypt's balance of payments statistics face problems with source data. Because merchandise trade statistics based on customs declarations have serious problems, BOP compilers rely on banks' foreign exchange records for exports and imports of goods; however, the coverage and classification of foreign exchange transactions are deteriorating following exchange liberalization, and source data do not reasonably approximate the accrual basis. Another key shortcoming is the lack of coverage of direct investment enterprises. The CBE is working with other agencies to improve both customs and direct investment statistics. A December 2004 STA mission noted that the CBE has started to disseminate quarterly BOP data and provide detailed sources and methods on the CBE website on the basis of *BPM5*, and a committee has been established to coordinate work on direct investment data.

- **METAC external sector statistics related missions in 2005.** A METAC mission in March 2005 provided technical assistance in measuring foreign direct investment (FDI) to the Central Bank of Egypt (CBE), the Ministry of Investment (MOI), and the General Administration for Investment and Free Zones (GAFI). The METAC expert made several recommendations, including proposing a benchmark FDI survey of 500 to 600 FDI enterprises to collect data on the stocks and flows associated with FDI. The mission concluded that the GAFI, with its resources and capability of its staff, can conduct the survey. Further, based on discussions with the CBE, MOI, GAFI, the Ministry of Petroleum, the Central Agency for Public Mobilization and Statistics, the Capital Market Authority, and the American Chamber of Commerce, recommendations were made to the CBE to revise the balance of payments data related to direct investment, services receipts, income payments, other foreign investments in Egypt, and other sectors' assets abroad. These recommendations were consistent with the data ROSC mission's recommendations. Subsequently, the CBE incorporated petroleum investment data into the balance of payments for the third and fourth quarters of 2004 and first quarter of 2005.

- **External debt and the international investment position (IIP).** A STA mission in December 2004 found that the authorities had made progress in the compilation of the IIP, and determined that the IIP compiled for end-2003 met the SDDS prescriptions. Similarly, data on external debt now meets SDDS requirements. The authorities are drawing on advice from Fund staff and other outside advisers to design a strategy for strengthening the reporting system on nonguaranteed debt.

- **Fiscal data**. Egypt does not report fiscal data for publication in the *International Financial Statistics* (*IFS*); annual data were last reported for 2003 for the *Government Finance Statistics* (*GFS) Yearbook.* Some of the requirements of the *Government Finance Statistics Manual 2001* have been met. The authorities have adopted a new budget classification (NBC) based on the *GFSM 2001*, with FAD and STA advice. The consolidation of general government operations (budget sector, National Investment Bank, and Social Insurance Funds) under this new classification has yet to be finalized, and has been applied only to "above-the-line" transactions. In addition, there have been large revisions to fiscal data for 2001/02-2004/05, and the authorities do not plan to report fiscal data under the NBC prior to 2001/02. Other areas that have been the subject of recent STA TA have been the reconciliation of fiscal and monetary accounts and improving the definition and measurement of public debt.

• **Monetary statistics**. The statistics are comprehensive and reported regularly. However, the 2003 data ROSC mission raised the issue of potential overstatement of foreign assets and 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. The authorities have begun providing monetary date to STA using the new Standardized Report Forms.

EGYPT: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of May 24, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Mar-06	April 2006 time	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jan-06	Feb-06	M	M	M		
Reserve/Base Money	Feb-06	4/27/06	M	M	M	O,O,LO,LO	O,O,O,O,O
Broad Money	Feb-06	4/27/06	M	M	M		
Central Bank Balance Sheet	Feb-06	4/27/06	M	M	M		
Consolidated Balance Sheet of the Banking System	Feb-06	4/27/06	M	M	M		
Interest Rates[2]	Jan-06	4/26/06	D	D	D/I		
Consumer Price Index	Mar-06	May-06	M	M	M	O,O,O,O	LNO,LNO,LNO,LO,LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2 2005/06	Feb-06	I	I	Q/I	LO,LO,O,O	LO,O,O,O,O,O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Q2 2005/06	Feb-06	I	I	Q/I		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun-05	Dec-05	I	I	A/Q		
External Current Account Balance	Q1 2005/06	Dec-05	I	I	Q	O,LO,LO,LO	LNO,O,O,O,O
Exports and Imports of Goods and Services	Q1 2005/06	Dec-05	I	I	Q		
GDP/GNP	Q1 2005/06	Dec-05	Q	Q	Q	O,O,O,LO	LO,LO,LO,O,LO
Gross External Debt	Q1 2005/06	Dec-05	I	I	Q		

[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] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] 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).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/75
FOR IMMEDIATE RELEASE
July 11, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with the Arab Republic of Egypt

On June 23, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Arab Republic of Egypt.[1]

Background

Over the last two years, Egypt has accelerated reforms aimed at tackling impediments to higher growth and employment creation. Implementation of a broad range of reforms aimed at modernizing government and boosting private sector activity, and a favorable external environment, have contributed to macroeconomic stability.

Growth accelerated to 5.7 percent in the first half of 2005/06. While the external sector remains an important engine of growth, the expansion has become more broad-based, with construction and services now increasing at a healthy rate. Employment is rising, but continued high unemployment points to the need to further boost private investment and growth.

Inflation fell sharply during 2005, and real interest rates turned positive for the first time in years. Headline CPI inflation declined from 17 percent (y/y) to 4 percent (y/y) over the 15 months through end-April 2006. The Central Bank of Egypt (CBE) introduced a corridor for the overnight interbank rate in May 2005 that has reduced the volatility of short-term rates. With inflation declining, the CBE started easing monetary policy in mid-2005. Money

[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.

aggregates expanded rapidly in 2005, but have decelerated in 2006. Lower policy rates have not been fully passed through to bank lending rates, and growth of credit to the private sector remains weak.

The interbank foreign exchange market launched in late-2004 is functioning well, with banks free to buy and sell foreign exchange at market determined rates. In a context of ample dollar liquidity from large balance of payments surpluses, the CBE has been buying large amounts of foreign exchange, in part to strengthen international reserves. As a result, the Egyptian pound-U.S. dollar exchange rate has been virtually unchanged since early 2005, while the growth in the net foreign assets of the banking system was the main source of money creation in 2005.

The balance of payments and external positions remain comfortable. International reserves have increased from US$15 billion to US$22.5 billion (7½ months of imports) over the 15 months through end-March 2006. With non-oil imports growing rapidly, and non-oil exports stagnating, the current account surplus has started to narrow. However, the country's net foreign asset position, both at the central bank and in the banking system, is being bolstered by capital inflows, mostly nondebt creating. The external debt-to-GDP ratio, currently at 30 percent of GDP, is projected to decline in the coming years, reflecting prudent external borrowing.

The authorities implemented a range of reforms in the fiscal area in 2005. On the revenue side, the government reduced and streamlined corporate and individual income taxes, moved to self-assessment procedures, and established a large taxpayer center. While expected to lose revenue in the short run, the reforms have reportedly triggered greater tax compliance and filing. On the expenditure side, a new budget classification in line with the IMF's Government Finance Statistics Manual (GFSM-2001) has been adopted. This has improved fiscal transparency considerably. For instance, the budget for 2005/06 made explicit for the first time the large fuel subsidy provided through the state owned Egyptian General Petroleum Corporation (EGPC).

The consolidated general government deficit is projected at 8.3 percent of GDP in 2005/06, down from 9.1 percent of GDP in 2004/05. The fiscal position in 2005/06 has benefited from exceptional revenues arising from a payment of tax arrears by EGPC and the sale of 20 percent of Egypt Telecom. Net public debt is projected to rise by about 1.6 percentage points in 2005/06 to 69.8 percent of GDP by June 2006. The authorities are in the process of preparing a package of measures aimed at reducing the deficit in the following years by at least 1 percent of GDP per year, including streamlining of subsidies, introduction of a full fledged VAT, and reduction in the growth of the wage bill.

Significant progress in the structural reform program of the government has taken Egypt further along the road to a market economy. The privatization program is gaining momentum. Regulatory and supervisory standards in the capital markets, insurance industry, and the banking sector are being strengthened. The restructuring of state-owned banks is progressing, including the sale of joint venture banks, and restructuring and settlement of nonperforming loans. The privatization of the fourth-largest state bank (Bank of Alexandria) is expected to be completed in 2006. Egypt's stock market was the strongest performer in the region in 2005.

Executive Board Assessment

Directors noted in particular the impressive decline in inflation, while the economic recovery further accelerated and had become more broad based. This was supported by strong achievements in privatization and financial sector reform, which had greatly increased market confidence. They also commended the authorities' strong efforts to put in place structural reforms in the fiscal area that have improved the transparency and efficiency of budget preparation and control. Looking ahead, Directors noted that important challenges remain to enable Egypt to raise economic growth on a sustained basis and lower unemployment, pointing in particular to the high government borrowing and debt levels, and the shallow financial intermediation and bureaucratic barriers to private sector activity.

Directors expressed concern about the large fiscal deficit and therefore welcomed the authorities' medium-term plan to reduce it by at least 1 percent of GDP per year. However, they encouraged them to consider a more ambitious pace of adjustment to reverse more decisively the debt dynamics, secure macroeconomic stability over time, and increase investor confidence and the economy's resilience to exogenous shocks. Directors urged the authorities to swiftly implement measures to ensure the envisaged fiscal adjustment, noting in particular the urgent need to reduce fuel subsidies and target them better.

Directors commended the efforts of the Central Bank of Egypt to modernize monetary policy formulation and operations and agreed that the current stance of monetary policy appears to be broadly consistent with stabilizing inflation at current levels. They nonetheless cautioned that any additional interest rate reductions should wait until liquidity growth decelerates further and low inflation becomes firmly entrenched, and noted that financing of the government should be strictly limited.

Directors recommended accelerating the reforms needed to support central bank operational autonomy and strengthen policy formulation, with a view to moving to a formal inflation targeting framework over the medium term. However, they cautioned that this would also require greater exchange rate flexibility.

Directors noted the smooth operation of the interbank foreign exchange market. However, they favored allowing market forces to play a greater role in determining the exchange rate, which will also foster the development of risk management instruments. They considered that stepping up the pace of structural reforms would be well suited to counter the effect of exchange rate appreciation by enhancing productivity and the competitiveness of the economy.

Directors welcomed the achievements in the area of financial sector reform, including the sale of many joint venture banks and the pending sale of Bank of Alexandria. They encouraged the authorities to develop a clear medium-term plan for the privatization of the remaining major state banks. Directors also welcomed the resolution of a large amount of private sector nonperforming loans and noted the improvements in capital market regulation and efforts to bring supervision in banking and insurance into compliance with international best practices. Directors agreed with the authorities that a Financial Sector Assessment Program update in 2007 would be a useful tool to assess progress in the financial restructuring program and identify possible areas of weakness.

Directors were encouraged by the government's intention to reduce barriers to private sector activity through a further liberalization of the trade regime, a reduction of red tape, and the improvement of the legal framework for business activities. They also pointed to the need to further enhance the flexibility of the labor market and improve education and training to help reduce skill mismatches.

Directors welcomed the establishment of the inter-ministerial committee to address weaknesses in statistics, notably the CPI and FDI data. They urged the authorities to attach high priority to strengthening the legal and institutional framework for the production of economic statistics and to increase inter-agency cooperation.

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. The Staff Report for the 2006 Article IV Consultation with the Arab Republic of Egypt is also available.

Arab Republic of Egypt: Selected Economic Indicators 1/

	2002/03	2003/04	2004/05	Proj. 2005/06	Proj. 2006/07
Real Sector					
Real GDP growth	3.1	4.1	4.9	5.6	5.6
CPI inflation (12-month change, average)	3.2	10.3	11.4	4.1	5.5
Unemployment rate (in percent)	10.5	11.1	10.5	...	...
Public Finances					
Balance of the general government (in percent of GDP)	-9.0	-8.3	-9.1	-8.3	-8.1
Net public debt (in percent of GDP)	66.6	64.8	68.2	69.8	70.5
Money and credit					
Broad money growth (annual rate)	16.9	13.2	13.6	13.8	14.7
Net claims on government sector (annual growth rate)	22.7	25.8	26.0	5.9	17.3
Credit to the private sector (annual growth rate)	7.3	4.1	3.8	6.8	7.7
Interest rates on 91-day treasury bills (in percent)	8.3	8.4	10.2	8.8	...
External Sector					
Trade balance (in percent of GDP)	-8.1	-9.9	-11.6	-10.5	-10.8
Current account balance (in percent of GDP)	2.4	4.3	3.3	2.0	1.2
Reserves (in billions of U.S. dollars)	14.8	14.8	19.3	23.1	26.3
(in months of imports of goods and services)	9.1	7.6	7.7	7.5	7.7
Gross external debt (in percent of GDP)	36.1	37.9	32.4	30.3	26.4
Exchange rates					
Egyptian pounds per U.S. dollar (average)	5.13	6.16	6.00	5.75	...
Real effective exchange rate (average; percent change)	-20.1	-21.6	4.2	...	...

Sources: Egyptian authorities; and IMF staff estimates.

1/ Egyptian fiscal year ends June 30.

Statement by the IMF Staff Representative
July 5, 2006

1. The following information has become available since the issuance of the staff report on June 15, 2006. It does not change the thrust of the staff appraisal.

2. Inflation (as measured by the CPI) accelerated in May to 5.4 percent (y/y), from 4.4 percent in April, mainly due to higher food and telecommunication prices. M2 growth in the year through April 2006 remained virtually unchanged from previous months at 12.8 percent. Available balance of payments data through March 2006 confirm the weakening of the current account compared to last year. The accumulation of net international reserves slowed to US$66 million in May, from a monthly average of US$226 million during January-April.

3. The stock market correction deepened somewhat; as of June 29, the broad CASE 30 index was down 25 percent for the year and 41 percent from the peak in early 2006. The EMBI spread for Egypt widened to 94 basis points (June 28), from 58 basis points at end-2005. Staff's views on the likely economic impact of these developments have not changed.

4. Parliament passed a general accounting law establishing the legal basis for the introduction of a treasury single account (TSA). The TSA will be operational for flow transactions by October 2006; existing government deposits will be integrated over 2-3 years.

5. In June 2006, the World Bank Board approved a Financial Sector Development Loan of US$0.5 billion in support of Egypt's financial sector reform.

6. Since March 31, 2006, another 10 state assets were sold under Egypt's privatization program, of which half were land sales and the other half stakes in firms. This brings the number of asset sales in 2005/06 to 59, for a total of US$ 2.6 billion.

7. Staff has concluded the review of Egypt's exchange system in connection with Egypt's acceptance (January 2, 2005) of the obligations under Article VIII, sections 2, 3 and 4 of the Articles of Agreement. On the basis of the information provided by the government and in discussions with market participants, staff concludes that Egypt maintains an exchange system that is free of exchange restrictions and multiple currency practices on the making of payments and transfers for current international transactions. Staff also welcomes the issuance of Decree No. 40 of 2006 issued by the CBE on June 8, 2006 which provides for intra day adjustments of the CBE's exchange rates used for official transactions outside the interbank foreign exchange market.

Statement by Shakour Shaalan, Executive Director for the Arab Republic of Egypt
July 5, 2006

1. In many respects, economic developments in Egypt since last year's consultation attest to the authorities' vigorous implementation of a bold and far-reaching reform agenda introduced since mid-2004. The range of measures instituted so far, in particular the fiscal and financial sector reforms, are successfully tackling deep-seated structural impediments and injecting dynamism into the economy. In addition to important tax policy and administrative reforms, tariff rates were substantially reduced, privatization of state assets was accelerated, and measurable progress was accomplished in the divestiture of state ownership in the banking sector. Improvements in the monetary policy framework continue to be implemented, building up toward a formal inflation targeting regime in the medium-term, and coordination between fiscal and monetary policies is being strengthened, contributing to improved economic management. The impulse from these reforms was reflected in a solid economic growth in 2004/05, amidst an environment of modest inflation and stable market-determined exchange rate. The expansion was supported by a strong external sector, and with the reforms currently underway, is expected to accelerate further in 2005/06 and become even broader-based. Market sentiment remains strong, reflected in the upward revision of the long-term outlook from negative to stable last year by credit rating agencies, the continued tight spreads on sovereign debt, and the surge in equity and foreign direct investment flows.

2. The authorities are well aware of the ground they still need to cover to generate growth rates of 6-7 percent and the required increase in investment levels to attain this goal. They also recognize, however, that the next generation of structural reforms are inherently more difficult to implement, and will therefore need to be mindful of political economy considerations and calibrated so as to ensure broad public consensus for their implementation. In the period ahead, the reform effort will focus on fiscal consolidation to reduce the high levels of deficit and remove economic distortions induced by subsidies, persevering with financial sector reforms to enhance financial intermediation in support of higher investment, and strengthening of the business climate to promote corporate activity. Indeed, 2006/07 could well mark a turning point for the Egyptian economy, with the benefits of the recently implemented fiscal and structural reforms fully coming to fruition and laying the foundation for a stronger expansion going forward.

Fiscal Policy and Reforms

3. Fiscal consolidation remains a major pillar of the reform program. Measures to this end have also focused on improving the structure and transparency of the budget, as well as strengthening public expenditure management. An important accomplishment in this regard, with Fund technical assistance, is the preparation of a set of consolidated fiscal accounts for the 2005/06 budget using the GFSM 2001 classification. Under the new standard, many budget lines were reclassified, including operations that were previously treated 'below the line', and for the first time, the indirect petroleum subsidies provided by the state-owned oil company were rendered explicit. Although the reclassification process revealed a weaker fiscal position,

the increased transparency and consistency that it brings to the budget will allow stronger control over resources and expenditures. At 9.1 percent of GDP in 2004/05, the fiscal deficit is admittedly large and unsustainable. While projected to decline to 8.3 percent in 2005/06, the improvement in the fiscal position largely reflects the exceptional revenues from the partial privatization of Egypt Telecom, and the settlement of tax arrears by the national oil company, which have more than offset the initial losses from the income tax reforms.

4. The authorities are fully committed to lowering the budget deficit by at least one percentage point annually over the coming five years, effectively halving the deficit by 2011, through a range of well-identified and detailed measures to be gradually phased in beginning 2006/07. On the revenue side, the recent reforms to the income tax law have begun to bear fruit, with preliminary estimates showing higher revenue intake, reflecting an increased number of taxpayers (due to reduced tax evasion) and larger average per-tax receipts (due to stronger economic activity). In addition, efforts are underway to broaden the tax base and improve tax buoyancy, by transforming the GST into a unified VAT with a single rate and streamlining of property and stamp taxes, and reinforce expenditure control through the institution of a Treasury Single Account (TSA).

5. Revenue measures would be complemented by decisive action on the expenditure side. Measures on this front focus on rationalizing the wage bill through reforms that would slow the drift in wages, and on streamlining the subsidy bill, particularly the fuel subsidies, which are poorly targeted. The authorities recognize that this basket of expenditure reforms is politically sensitive and would require broad public consensus for successful implementation. As such, while the non-inclusion of the adjustment measures in the 2006/07 budget was motivated by political economy considerations, a targeted fuel price increase is contemplated, along with the streamlining of the food subsidy bill. Progress with subsidy reforms, however, would need to coincide with measures to strengthen the social safety net and institute adequate compensatory schemes. In this respect, the authorities are planning to expand coverage of the social safety net and improve its targeting of low-income households through a means-tested system.

6. The authorities are in agreement with staff on the importance of fiscal adjustment to firmly reduce government debt and create the fiscal space for growth-enhancing investments. It is important to note, however, that the ‘baseline’ scenario of a one percent adjustment per year up to 2011 reflects the authorities’ conservative estimate of the impact of the ongoing and contemplated reform measures. Should the envisaged full package of measures outlined by staff be introduced, the adjustment could very well approximate the 1.5 percent predicated in the ‘ambitious’ scenario. In fact, accounting for the absence of exceptional revenues in 2006/07, the projected deficit of 8.1 percent implies an even larger adjustment effort compared to 2005/06. Nonetheless, and as staff point out, even in the baseline scenario, the level of external debt would pursue a declining trajectory still in the face of shocks. Moreover, the structure of the domestic public debt, with its longer term maturity and its investor base, mitigates any potential vulnerabilities.

Monetary, Exchange Rate, and External Sector Issues

7. The authorities are committed to a monetary policy framework that promotes price stability, and are intent on adopting a formal inflation targeting framework once the requisite institutional and analytical infrastructures are in place. In the meantime, monetary policy formulation continues to improve, underpinned by a more proactive interest rate policy, to render it more forward-looking and provide better guidance to the market. In this connection, the Central Bank of Egypt (CBE) launched an interest rate corridor in June 2005, with the overnight interbank rate as the operational target. With the width narrowed from 300 bps at inception to 200 bps in October 2005, the corridor has been effective in significantly reducing interest volatility and guiding market expectations. Predictability and transparency of monetary policy have improved, with interest rate decisions being determined by the Monetary Policy Committee (MPC), which meets regularly every six weeks. These meetings are followed by a monetary policy statement communicated to the public. Moreover, the CBE liquidity management toolkit was expanded with the issuance of its own securities (CBE notes) in August 2005.

8. Monetary policy throughout 2005 and early 2006 remained attuned to developments in indicative monetary aggregates and inflation indicators, as well as developments in credit growth. With inflation stabilizing at around 4-5 percent, in part induced by the appreciation of the exchange rate, real interest rates turned highly positive. Partly reflecting concerns over the sluggish growth in private sector credit, the CBE lowered its policy rates successively until April 2006. These rates, however, were not immediately reflected in bank lending rates, where spreads remained high and credit growth timid. This may suggest an excessively cautious lending stance by commercial banks following the credit excesses of the late 1990s, which is expected to be mitigated by the wide-ranging structural reforms currently ongoing in the banking sector. In the last MPC meeting in May 2006, interest rates were left unchanged, with the CBE adopting a vigilant stance regarding the course of key indicative targets.

9. Since its introduction in December 2004, the interbank foreign exchange market has been operating smoothly and efficiently, without any intervention from the CBE. Reflecting increased confidence in CBE’s management, as well as significant capital inflows, the Egyptian pound appreciated against the US dollar by over 7 percent in 2005, following a period of overshooting in the previous year, and stabilized within a narrow range. With the sizable surpluses on the balance of payments, the CBE further bolstered its reserve position, which has risen to US$23 billion (equivalent to more than seven months of imports). However, it is important to underscore that the CBE is not seeking to stabilize the rate. In large measure, the apparent stability reflects the underlying structure of the market, where traditionally Suez Canal and hydrocarbon foreign exchange receipts are transacted outside of the market, whereas excesses in banks are mopped up by the CBE to help them conform with regulatory ceilings on their open positions. Moreover, the authorities have indicated their willingness to tolerate fluctuations in the exchange rate, provided these are induced by fundamentals and not by one-time factors, such as portfolio shifts related to increased confidence in the domestic currency, and volatile capital flows associated with activity in asset markets. As underscored by staff, tempering exchange rate fluctuations of a temporary nature is a legitimate policy

concern to help protect the exportable sectors, until the structural shifts currently underway in the economy take hold. Going forward, upward pressure on the exchange rate is likely to dissipate, as the accelerated growth erodes the surplus on the current account, and the compressed interest rate differentials soothe portfolio flows.

Financial Sector Reforms

10. Perhaps one of the most significant achievements in 2005 relates to the financial sector in general, and the banking sector in particular. The cornerstone of the Financial Sector Reform Program, to be implemented over 2005-08, rests on a major public sector restructuring in the banking and non-banking sectors. The program aims to build a more competitive financial sector, able in the medium-term to provide modern and efficient financial intermediation, including by strengthening the enabling environment for resource mobilization to support greater corporate activity. The program continues to be on track, and in some cases, even ahead of schedule. In the banking sector, consolidation has advanced with the number of banks reduced from 57 in 2004 to 43, through 7 merger operations involving 14 banks. The plan is to further reduce the number of banks to 34 by end-2007. In addition, shares in 12 of 17 shareholdings of state-owned banks in joint-venture banks have been divested, representing 94 percent of total market value in joint-venture ownership. The privatization of Bank of Alexandria (Egypt’s fourth largest bank with 7 percent of system deposits) is almost complete, with the invitation for expression of interest published in the international press in March 2006. More importantly, the authorities recognize that the resolution of the large stock of non-performing loans (NPL) would considerably strengthen the system’s capacity for financial intermediation. In this respect, settlement agreements representing 46 percent of private sector NPL have been reached, and a scheme to deal with state-owned enterprises NPL was outlined, with defined resources from privatization proceeds earmarked to this effect.

Privatization and Structural Reform Issues

11. The government has considerably stepped up the pace of its privatization program. Since the adoption of the Asset Management Program (AMP) by the Ministry of Investment in July 2004, state ownership in 77 assets was transferred to the private sector. Of these, 49 transactions took place between July 2005 and March 2006 alone, yielding proceeds of US$2.5 billion that are well in excess of those recorded in the preceding five years combined. The pick up in privatization involved a series of IPOs which were positively received by the markets, and contributed to an increased diversification of the investor base. In December 2005, the IPO for Egypt Telecom was launched on the Cairo Stock and London Stock Exchanges, offering 20 percent of the state’s stake in the landline operator. Ten percent of the stake was made available to institutional investors and was 45 times oversubscribed, while the remaining 10 percent was offered to small investors and witnessed a three-fold oversubscription. The Egypt Telecom IPO is the largest for the Middle East and North Africa region to be listed on an international exchange in 2005. Other important privatization transactions in the pipeline include the sale of the state’s stake in one of its major oil refineries, Middle East for Oil Refinement (MEDOR), expected within year-end. As also noted by staff, the allocation of the

privatization proceeds is transparent, with a good portion being retained by line and functional ministries to restructure remaining enterprises.

12. The government is actively pursuing reforms to strengthen the business climate, by addressing the bottlenecks caused by red tape and cumbersome taxation. Recognizing the scope of the customs reforms introduced last year, Egypt has been ranked first by the World Bank's Global Competitiveness Report in customs procedures reform. This reflects the facilitation of commercial documentation procedures and the reduction in the number of customs approvals from 26 to only 5. Moreover, legislation is currently being drafted to set up specialized economic courts, to circumvent bureaucratic hurdles and streamline the judicial framework governing business contracts. In the same vein, a ministerial committee has also been established to expedite dispute settlement procedures with the private sector.

13. Finally, the Egyptian authorities are committed to the vigorous pursuit of their reform agenda to achieve a structurally higher growth. They would like to express their appreciation for the extensive and highly valuable technical assistance they are receiving from the Fund in support of their reform efforts, and thank staff for a productive consultation and well-balanced report. They look forward to continued close collaboration with the Fund in the period ahead.