is guided by a well thought out master plan that addresses specific tasks with defined target dates. This plan has been reviewed and endorsed by the World Bank along with a number of renowned international bankers, lawyers and restructuring specialists. The program is now in the implementation phase and ahead of schedule. Specifically, the reform strategy is framed to methodically and systematically address three key issues: (i) strengthening the banking system through consolidation and privatization of smaller joint venture and public sector banks, (ii) restructuring of public sector banks, including through recapitalization, and (iii) resolution of the problem of non-performing loans (NPLs).

Main accomplishments to date include the completion of four merger and/or sale transactions of joint venture banks with nine more transactions expected by end-2005, as well as the initiation of the privatization process of Bank of Alexandria under the supervision of an international audit firm whose terms of reference conform to the IAS standards. With respect to restructuring, an international team of expertise is in place to evaluate the loan portfolios of public sector banks and assess their risk profiles, under the supervision of the Banking and Restructuring Unit (BRU) of the central bank and in collaboration with the European Union. The European Central Bank has also been actively involved in the restructuring of banking supervision at the central bank through a project that it describes as the largest in its history.

With respect to funding the recapitalization needs of the public sector banks, the central bank is contemplating the activation of a US$2 billion guarantee facility under the supplemental agreement with the U.S. Treasury to partly finance the recapitalization. The World Bank has also been solicited to coordinate part of the international funding to be raised from donor countries and agencies, as well as assist in setting the mechanisms and timing of the recapitalization process with a view of linking recapitalization to the resolution of NPLs.

Regarding NPLs, a monitoring unit was established in the central bank, with counterpart units in public sector banks. A number of very large cases have been resolved, resulting in the successful rescheduling of over 26 percent of private sector NPLs with public sector banks. Consequently, the central bank initiated a new comprehensive program for resolving conflicts between borrowers and banks which was approved by the central bank board and communicated to the market. In its initial stage, the program targets 246 borrowers with over LE 100 million each and comprising 55 percent of NPLs in the public sector. The Arbitration Committees to oversee the documentation and procedures for this complex process have already been established. Additionally, target dates have been set for the resolution of all NPLs in public sector banks within 18 months, the progress of which is being monitored on a quarterly basis by the BRU of the central bank.

In the insurance sector, the plan aims to expand private sector participation, including through privatization of one of four state-owned insurance companies. Other measures are underway to develop the mortgage market, deepen the capital market, and strengthen financial regulation and supervision. These measures represent an important initiative to stimulate private sector growth.

Structural Reforms and Other Issues

The government has stepped up its privatization program while also modifying its approach in privatizing state-owned companies by offering these companies for sale before their restructuring is completed. The sale price therefore reflects the commitment of the buyer to future investment in the company and assumption of its liabilities, including its workforce. Under this approach, the government is relieved of the substantial investment costs typically incurred to restructure these companies prior to their sale. Between July 2004 and April 2005, a total of 22 companies had been privatized, yielding approximately LE 3.3 billion in proceeds—which exceed the combined proceeds of the past four years. The majority of these proceeds will be used to reduce the stock of government debt. It should be pointed that total employment in state-owned enterprises has been reduced drastically from 1.3 million workers to 400 thousand workers since the privatization process began in 1991.

As regards the trade and the regulatory regimes, these have been liberalized considerably with the implementation of tariff reforms in September 2004. The weighted average tariff rate was reduced from 14.6 percent to 9.1 percent, with the biggest cuts effected on imports of raw and intermediate industrial products. The tariff structure was simplified and rendered more transparent by reducing the number of *ad valorem* tariff rates from 27 to 6. Various exemptions were removed and all export taxes, as well as several service fees and import surcharges, were eliminated. The trade system was rendered more business friendly by removing sources of discretionary determination of custom rates on industrial and non-industrial imports. These tariff reductions are only the first step to further reductions in tariff levels. Customs administration reforms aimed at simplifying the system have been underway for some time.

Egypt has also met some important milestones with respect to data issues. In January 2005, Egypt formally subscribed to the IMF Special Data Dissemination System (SDDS). Additionally, the authorities participated in a Data ROSC in 2003, the recommendations of which are currently being adopted by the relevant authorities, with technical assistance from the Fund. Specifically, the authorities have recognized the shortcomings in the balance of payments statistics, particularly in recording FDI inflows, and in their price statistics. The authorities have requested Fund assistance in these two areas, given the importance of FDI flows to the oil and gas sector in Egypt, and in view of their efforts to move to a full fledged inflation targeting regime over a two-year span. The government has a heightened awareness of the importance of improving the country's statistical base to keep up with the pace of its reforms and to support its ambitious reform agenda. Work on this aspect is underway.

Finally, the authorities recognize the challenges that lie ahead in sustaining the pace of economic reforms to reinvigorate the domestic economy and stimulate private and foreign investment. The accomplishments thus far have instilled a renewed sense of confidence in the economy and could act as an impetus for further far-reaching reforms to address the ambitious agenda. I would like to conclude by expressing our gratitude to the Fund for the provision of valuable technical assistance in support of the reform effort.

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

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

Background

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

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

[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.

and the elimination of the surrender requirement. Favorable trends in the balance of payments have contributed to the orderly functioning of the market since its inception.

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

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

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

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

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

Executive Board Assessment

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

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

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

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

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

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

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

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

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

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

Directors welcomed the relaunching of Egypt's privatization program. They noted that the sales finalized since late 2004 and the public listing of companies up for sale in 2005 attested