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Egypt and the Fund

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It is indeed a great pleasure to be in Cairo, and especially to have the opportunity to talk to you today about Egypt's stabilization and reform efforts, and the associated standby agreement between Egypt and the IMF.

In fact, my talk today comes exactly one month after the Board of the IMF approved a 24-month stand-by arrangement in support of Egypt's reform program -- though, as some of you here today know, it is a bit more than a month after the discussions on a possible program began.

And it is also a great pleasure to be meeting under the auspices of the Egyptian Center for Economic Studies -- a Center that is contributing to high quality economic discussions in Egypt and that illustrates that the private sector can play an important role in informing and supporting the country's economic reform efforts. I believe strongly in the importance of independent, fully professional, policy research and discussion in improving the quality of a country's economic policies, and the development of this center during the last two years is a very favorable sign in that direction.

What I would like to do in my presentation is to discuss key elements of Egypt's economic reform program, and its associated agreement with the Fund, and what should be expected from it. In doing so, I will draw on the experience that the Fund has accumulated in supporting reform programs worldwide.

Let me start with some background on the economic framework in which this new program is being implemented.

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1 7 percent last fiscal year as compared to over 20

I. Egypt's Macroeconomic Stabilization

Egypt is now in the early part of the second stage of its economic reform program. The first stage -- macroeconomic stabilization -- started in 1990, and its beginning was embodied in a standby agreement with the IMF. The process of macroeconomic stabilization has continued for most of this decade, and the process has been successful.

Consider the changes in the macroeconomic situation this decade:

- Inflation averaged 7 percent last fiscal year as compared to over 20 percent in 1988/89;

- Gross reserves have increased almost five-fold--from under US$4 billion in June 1989 to almost US$19 billion in June 1996;

- A significant sign of stabilization is the reversal of dollarization, with the ratio of foreign currency deposits in total deposits falling from 45 percent in June 1989 to 23 percent in June 1996;

- Interest rates have steadily declined.

Strong and consistent policy efforts, notably fiscal adjustment and tight monetary policy, lie behind this improvement. The budget deficit fell from 18 percent of GDP in 1988/89 to 1.3 percent last year. Concurrently, the rate of domestic liquidity expansion halved to 10 percent. The provision of debt relief by bilateral official creditors helped secure stability in the external accounts.

Supporting the tightening of monetary and fiscal policies were important structural reforms in the macroeconomic area -- a broadening of the tax system, liberalization of interest rates, and unification of exchange rates.

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Stage one, macroeconomic stabilization and reform, has been successful. With continued monetary and fiscal discipline, and with further structural reforms, Egypt's macroeconomic base can be secured.

II. Stage II: Structural Reforms

By contrast, the performance of the real side of the economy has lagged below Egypt's potential, economic performance generally has been less favorable than quite a wide set of comparator countries:

- The slow growth of GDP -- indeed per capita GDP has been essentially stagnant -- has contributed to Egypt's high unemployment;

- Not surprisingly, the disappointing growth performance was associated with low levels of savings and investment (averaging about 17 and 20 percent of GDP, respectively);

- Relative to other countries, Egypt has fallen behind in integrating into the world economy, as evidenced by the low share of international trade in GDP, and low levels of foreign direct investment and portfolio flows.

- This occurred at a time of increasing globalization of technology and financial markets, multilateral trade liberalization under the Uruguay Round and, in the case of the Middle East and North Africa, the imminent partnership with the European Union.

It is against this background that the Egyptian authorities have developed their strategy for economic growth, to be achieved through structural reforms of the domestic economy and integration into the world economy. Please excuse me for stating the obvious and repeating why Egypt needs economic growth: put positively, the only way for the living standards of all the Egyptian people to increase, and to reduce poverty, is through sustained high growth, and the only way for this great country to modernize and take its rightful place in the world is through economic growth; put negatively, Egypt cannot allow itself to fall further behind its potential.

A sustained growth rate of at least 6 percent per year is probably necessary to increase living standards, to provide the more than 400,000 new jobs each year needed to avert an increase in unemployment, and to reduce poverty.

Is 6 percent growth possible? The answer is yes: many countries around the world have grown at 6 percent per year and more, over long periods. They have done that by pursuing the right economic, social, and educational policies,
the macroeconomic stabilization effort and the broadening and widening of

Egypt has all the potential needed to reach such growth rates. Now it is putting the right policies in place -- and the IMF is happy to be able to support Egypt's efforts.

The negotiation of the standby agreement between Egypt and the Fund took time, as consensus had to be reached on a number of issues--and not only between the Egyptian economic team and the Fund, but also within Egyptian society.

What does the program entail? In essence, it involves the consolidation of structural reforms. It envisages a change in the public sector/private sector balance, as well as a change in the orientation of the economy. The private sector is being called on to take the lead in a more competitive, outward-oriented environment with the public sector focussing on complementary functions and addressing market failures.

- On <u>macroeconomic policy</u>, the program targets continued fiscal restraint (with a deficit at around 1 percent of GDP), and monetary restraint (with liquidity growth of 9 percent for 1996/97) aimed at reducing inflation further and assuring that structural reforms are not blown off course by macroeconomic difficulties;

- <u>Structural reforms</u> cover 5 main areas:

-- First, wide scale <u>privatization</u> through, inter alia, divestiture this fiscal year of one-third of the book value of public enterprises under Law 203, followed by a further one-third in 1997/98, and divestiture of the predominant share of public bank holdings in joint-venture banks by December 1997;

-- Second, <u>trade liberalization</u> through reductions in the maximum tariff and elimination of nontariff barriers on exports and imports;

-- Third, further <u>structural fiscal reforms</u> including steps to develop the General Sales Tax into a modern broad b...
-- Finally, the program includes a series of <u>regulatory</u> reforms aimed at
strengthening tax administration and the productive nature of government spending;

-- Fourth, <u>financial sector reforms</u>, including the deepening of money, securities, and exchange markets in the context of further improvements in prudential regulation and supervision -- and let me emphasize how crucial it is to develop the regulatory and supervisory framework rapidly, before potential capital flows subject the financial system to greater stresses than it has experienced in the past;

-- Finally, the ...
increasing the transparency and predictability of the system and ensuring more of a level playing field among different economic actors and activities.

The program has been designed with the potential social costs of adjustment very much in mind. The budget for the Social Fund is being maintained. Privatization receipts will be available if needed to compensate those who lose their jobs as a result. Spending on health and education are budgeted to increase during the program -- and of course, over the longer run, it is sustained growth that will reduce poverty.

III. <u>Will it work</u>?

The current standby agreement covers the period through September 1998. What can be expected from the full and timely implementation of the program? Allow me to start with a perhaps surprising word of caution. The market response -- international as well as domestic -- to Egypt's reform program has been so enthusiastic as to be misleading about the typical lag between the introduction of structural reforms and increases in growth.

It typically takes several years -- as much as three to five -- after the start of a reform program before sustained growth begins. We have seen such a lag all over the world. The period may be shorter in the case of Egypt, because unlike many other reforming countries, it is starting from macroeconomic equilibrium. But it is

important to remind ourselves, and the Egyptian people, that significantly higher
... to establish itself ... government saving rising first and private saving following suit ... private savings as the

Why? Because sustained growth requires a sustained increase in the rate of investment, and it takes a sustained period of commitment to new policies before investors are willing to build new plants and set up new companies. The policies in the program are aimed at increasing the economy's investment levels to about 23 percent of GDP -- with the increase coming from private investment -- along with improvements in capital efficiency.

We expect most of the increased investment to be financed through national saving, which is expected to increase from 17 to 21 percent of GDP, with government ... private saving following suit. Increases in private saving are expected to result from both increased corporate savings as the efficiency of the corporate sector (public and private) improves, and through increased household savings as financial sector reforms take hold.

It is worth emphasizing that countries do not develop primarily on the basis of foreign saving and investment. The great bulk of saving that finances investment in each country is domestic. Foreign investment is important because it brings in some more saving, more so because it brings in new technology and business methods, and even more so, because the policies that are needed to make investment attractive for foreigners are precisely the policies that will make investment attractive for domestic residents.

The program is expected to increase the efficiency of investment as a result of privatization, reform of the trade and regulatory regimes, and financial sector reforms. The program will encourage greater export-orientation, a more dynamic private sector, a refocusing of government operations, and a deeper and more efficient process of financial intermediation.

If investment can be increased to 23 percent of GDP, and with reasonable increases in the efficiency of investment, the rate of growth can be increased to at least 6 percent per annum. This would imply the possibility of creating 450,000-500,000 additional jobs a year.

Inflation would fall further -- to 5 percent -- while Egypt would maintain a healthy foreign exchange cushion. Public debt levels would also decline.

IV. Pitfalls and prospects

groups of the population be protected, and as mentioned previously, the

If the process can be sustained, if Egypt maintains macroeconomic stability while undertaking structural reforms and integrating with the world economy, then the growth process can become self-sustaining, and saving, investment and growth could eventually exceed the levels targeted in the program -- as a virtuous circle of growth begins. But that is a hope for the future and an incentive for the present, not the basis on which to plan current policies.

Instead it is important to anticipate difficulties. Two stand out. First, it is inevitable that the process will have winners and losers. It is essential that the most vulnerable groups of the population be protected, and as mentioned previously, the program provides for the necessary measures. Second, is the capital inflows problem. A country as attractive as this one can be for foreign investors may attract so much foreign capital that there is pressure for an exchange rate appreciation that may not be sustainable. Many countries have experienced such inflows, and there is no fully satisfactory way of dealing with them. The best answer is to increase domestic saving: that can be done through fiscal contraction as well as increases in private saving if this can be brought about. Some appreciation of the currency may be warranted. It is more important to make sure that the financial system is robust, and able to withstand surges in capital flows in either direction. The dangers come mainly from inflows of short-term rather than longer-term and direct investment, so that measures to discourage the former and encourage the latter help to prevent the problem arising. There is more to be said on this topic -- and if the program goes as well as we all hope -- there will be more to be done on this issue, but I will not pursue it further here.

There are other well-known lessons of international experience. Reform is a process and not a set of discrete actions. It takes a tremendous amount of effort to gain the momentum for reform and establish policy credibility. A stop-go reform mode not only undermines economic development directly but also erodes the much-needed credibility of the reform effort.

There is also the challenge of maintaining policy focus at a time when the need to move forward with reforms is perhaps less pressing than in the past. It helps that the economic program is home-grown and does not stem from a crisis situation but rather from the Government's conviction that it is in the interest of

Egypt and its people. Sustaining this conviction is the real guarantor of sustained implementation.

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In conclusion, let me note that Egypt is in an enviable situation to launch Phase II of its stabilization and growth program, the growth phase, what Prime Minister Ganzoury has called "the economic take-off stage".

Strengthening the economy will come not only from the policies that the Government will implement but also from the support of the domestic business community.

Egypt's business community is rightly evolving away from one that lives off the state to one that aggressively pursues market opportunities both in and outside Egypt.

I know from my discussions with Egyptian business leaders that many of them work actively in favor of liberalization and deregulation, realizing that the country's growth potential lies in competing effectively in international markets and not in a highly protected and narrow domestic market.

I am confident too that the business community understands, and will act forcefully on, the importance of social factors in economic development, supporting Government efforts to improve health and education services, reduce poverty, and retrain workers consistent with the new realities of the globalized word economy. Partnership between the public and private sectors holds the key to Egypt's rapid economic development.

I can assure you that the IMF too will be with you, doing everything possible -- advice, analysis, technical assistance, and programs when needed -- to help the process and be part of what can and should be a wonderful success story, not only for Egypt but for the region.

-- Thank you