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Economic Policy Memorandum

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ECONOMIC COMMITTEE

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EC/O/68 - 48

May 21, 1968

U.A.R.: Economic Policy Memorandum

1. The attached Economic Policy Memorandum on the U.A.R. from the Middle East and North Africa Department (EC/O/68-48/1, dated May 21, 1968) will be discussed at the Economic Committee meeting which will be held on Thursday, May 23, 1968.

C. F. Owen
Secretary

Attachment

Secretary's Department

D I S T R I B U T I O N

Messrs. Friedman	Adler	Orcutt
Kamarck	Collier	Sadove
Lejeune	King (B.B.)	Thompson
Avramovic	Larsen	van der Mel
Bell	Lipkowitz	Weiner
Krishnaswamy	McDiarmid	Wright
Rist		
Stevenson		

Also: Mr. McNamara, Mr. Knapp, Sir Denis Rickett and Mr. Shoaib.

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EC/O/68 - 48/1

May 21, 1968

ECONOMIC COMMITTEE

Economic Policy Memorandum from the
Middle East and North Africa Department

UNITED ARAB REPUBLIC

I. Introduction

1. The last time the Committee considered the United Arab Republic was in July 1966. The Committee had before it an economic report prepared by a mission which had visited the UAR in February 1966. This mission had been sent in the expectation that one of the major issues which had stood in the way of Bank lending in the UAR, namely, the question of compensation for nationalized enterprises, would soon be largely settled. It was also expected that the UAR would soon undertake a stabilization program and a reform of its exchange system in connection with a proposed standby agreement with the IMF. The Committee took the position that because of the seriousness of the country's short-term balance of payments problem, such measures would be necessary before the UAR could be considered eligible for any lending by the Bank or IDA. The Committee also felt (See EC/M/66-34 of July 13, 1966) that if a successful development program were to be carried out there would have to be some retrenchment in non-development expenditure, a shift of resources to production for export, some decentralization of economic decision making together with greater reliance on price and market incentives and an external borrowing policy which would keep the burden of debt within tolerable limits. The Committee recommended that a mission should visit the UAR to convey the position of the Bank and to discuss with the Government the Bank's latest economic report and to identify possible projects for financing.

2. A mission went to Egypt in September 1966, timed to arrive immediately after a Fund mission which was to work out the details of the stabilization program. In the event, however, the government and the Fund failed to reach an agreement. At the same time there was a rather far-reaching change in the government in which the Prime Minister, Zakaria Moheiddin, and Dr. Kaissouni, who had been the principal minister dealing with the Fund, lost their positions. As a result, negotiations with the Fund were temporarily discontinued. Another

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Fund mission visited the UAR in October 1966. Although there was an agreement in principle, the views differed on the extent of necessary adjustments and an agreement could not be reached. In December 1966, the UAR stopped making payments to the Fund, claiming among other things that it was unable to repay because the U.S. had not renewed PL 480 assistance which amounted to more than U.S. \$ 150 million annually. In the absence of this assistance, the UAR had to apply its foreign exchange resources to buy wheat in the open market.

3. After further discussions between the Fund and the UAR, in early summer 1967, an agreement was reached on the terms of a stabilization program including an adjustment of the exchange system. However, before the agreement could be formally approved the Arab-Israeli war broke out. The discussions were resumed again in late 1967. A Fund mission returned from Cairo towards the end of November with a proposal providing for a Fund drawing, plus compensatory finance, to enable the UAR to roll over completely its immediate liability to the Fund. In previous talks, measures directly and indirectly intended to adjust the exchange rate had been the key elements in the discussions. In the November discussions the UAR representatives argued that, for the time being, such adjustments would not be advantageous since foreign exchange earnings were determined by other factors. They expressed their willingness to make adjustments when normal circumstances returned. The Fund accepted this position. With the help of some bank credits from U.K., Germany and Italy, the UAR repaid the outstanding arrears. Following this repayment the IMF approved in March 1968 two drawings by the UAR amounting to US \$ 63 million. They consisted of (a) a US \$ 40 million drawing in support of efforts by the national authorities to strengthen the UAR's domestic economic situation as well as its payments position, and (b) a US \$ 23 million drawing to assist the country in meeting payments difficulties caused by a temporary shortfall in export earnings during the year ended November 30, 1967. In connection with these operations the UAR Government undertook to take action on the rate of exchange as soon as conditions permitted.

II. Issues

4. The issues before the Committee are:

- (i) the creditworthiness of the UAR;
- (ii) the eligibility of the UAR for IDA credits.

III. Discussion of the Issues

5. Any discussion of economic issues concerning the UAR at the present time takes place against the background of the recent war with Israel and the great political uncertainties which hang over the immediate future. Egypt's most important source of hard currency, the Suez Canal, is closed and the economy is largely being maintained by emergency aid from Saudi Arabia, Libya and Kuwait. In these circumstances Egypt cannot be regarded as creditworthy for Bank lending. Moreover, the debt service ratio, even without any allowance for military credits, the amount of which is not known, amounts to 18½% of total foreign exchange earnings and the burden of debt service is likely to rise. The only exception might be an enclave project such as the enlargement of the Suez Canal or the construction of a pipeline across the isthmus, for which specific security could be obtained.

6. As regards eligibility for IDA, the UAR is eligible on grounds of poverty with an income per head of about \$ 160 and on grounds of lack of creditworthiness for the reasons given above. There remains the question of economic performance. The principal aspects of performance are those of economic growth, balance of payments management including the question of arrears, fiscal performance including the question of defense expenditures and the compensation problem.

7. Measured by the increase in GDP the memorandum on the current economic situation indicates that the performance of the UAR over the last decade has been satisfactory. In many respects the management of economic affairs in the UAR is fairly sophisticated as compared with many other countries at a similar stage of development. The whole irrigation system, for example, is reasonably efficient, and so are some of the older industries such as textiles. On the other hand, there are a number of problems arising from the introduction of a form of centralized control after the nationalizations of 1961 which are reflected in the difficult situation faced by many of the newer industrial plants established in the last decade. The UAR is no longer wedded to the present rigid system of central control and it is recognized that changes need to be made. Thinking has not, however, reached the stage of defining a new system of organization to leave more initiative with individual undertakings. Liberalization of essential imports would be an important factor in this connection, but the weak external payments position in any case probably precludes significant progress in this direction at the present time.

8. The measures to maintain revenue that have been introduced since the June war show that a determined effort is being made to improve the services budget; the investment budget indicates that expenditure is being kept down to hold in check resort to deficit financing.

9. The balance of payments' deficits which the UAR has been incurring for many years are the reflection of the economy's most pressing problem, namely to carry out an adequate investment effort without undue reliance on foreign resources. This has created the short-run difficulty which has appeared in the form of substantial arrears in debt payments, mostly for suppliers' credits. These amounted to \$ 95 million at the end of December 1967. The arrears on all commercial bank credits have been rescheduled and are being paid on time. For the suppliers' credits, rescheduling agreements have been reached with Germany and Italy, which account for \$ 29 million and discussions are taking place with Japan, Canada, Denmark and the Netherlands regarding another \$ 9.4 million. A "temporary arrangement" has been agreed with the U.K. for \$ 6.1 million. This leaves some \$ 50 million, of which \$ 38 million was payable to the United States on account of loans from AID, Eximbank, and CCC. Egypt ceased to make payments on these debts after diplomatic relations with the United States were broken last June. The government has made a statement reflecting a desire to discuss some arrangements for dealing with these payments, but as of the present moment, no new developments have taken place.

10. It is clear that much the most important factor which will influence both the budget and the balance of payments in the future, will be the course of defense expenditure. In the short run, defense spending determines the budget deficit and in the long run a reduction in defense expenditure is the most obvious way in which additional internal resources could be found to support a new development plan.

11. Some progress has been made with the problem of compensation for sequestrated and nationalized properties. The main outstanding matters are the nationalized UK properties, the Belgium tramways and the Dutch brewery; the amounts involved are not very large.

IV. Conclusion

12. For several years the government of the UAR has been facing a situation in which it was becoming increasingly difficult to find sufficient foreign aid to meet the gap in its resources produced by high investment and current government expenditure and a level of savings which, while not low, was nevertheless not high enough. At first, in 1962 and 1964, the government's efforts to adjust to its problem came to very little, but as the position grew worse it became increasingly evident that stronger measures were necessary. In

practice, economic policy was determined by the degree to which those members of the government, who attached importance to sound economic management, were able to prevail against political and military considerations. However, after some false starts, the government had by May 1967 reached an agreement in principle with the Fund which did include a de facto devaluation. This reflected the government's acceptance of the point that the improvement in the balance of payments should be given a higher priority than it had been accorded in the past. There is little doubt that the lessons of the experience of the last few years have been learned by many in the government so that, in this respect, the prospects for the future have improved. The war of last June did not really bring any fundamental change to this picture except that it left Egypt dependent on its Arab neighbors instead of on the Suez Canal. It also provided the government with the political circumstances necessary for it to make the further retrenchments which were required.

13. A decision regarding IDA eligibility must be taken with this history of evolving policy in mind. Although much remains to be done regarding settlement of arrears, rescheduling of debt, compensation and, not least, exchange rate policy, much has been done in all of these respects. A justification for IDA lending would therefore have to rest on a record of improvement and would have to include an expectation that the record would be continued. Whether it will or not depends very largely, of course, on political events in the Middle East. Finally, it is relevant to note that, unless some lending operations are undertaken in Egypt, the Bank can have little further influence on economic policies.

14. In the light of these considerations it is my opinion that, at the present time and subject to the continuation of the improvement in economic policy experienced over the last eighteen months, the UAR should not be regarded as ineligible for IDA lending.

Michael L. Lejeune
Director