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The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

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EC/O/66 - 113

July 5, 1966

United Arab Republic: Policy Memorandum

1. The attached Economic Policy Memorandum on the United Arab Republic from the Europe and Middle East Department (EC/O/66 - 113/1, dated July 5, 1966) will be discussed at an Economic Committee meeting on Friday, July 8, 1966.

C. F. Owen
Secretary

Attachment

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

Messrs. Friedman	Bell	Maiss
Kamarck	Edelman	McDiarmid
Fontein	Gilmartin	Sadove
Adler	King (B.B.)	Thompson
Avramovic	Larsen	Weiner
Rist	Lipkowitz	Wright
de Vries		
Collier		

Also: Mr. Woods and Mr. Knapp.

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EC/O/66-113/1

July 5, 1966

ECONOMIC COMMITTEE

Economic Policy Memorandum from the Europe and Middle East Department

UNITED ARAB REPUBLIC

I. Introduction

1. The Bank has made only one loan for a project in the United Arab Republic. This was a loan of $56.5 million made in 1959 for the improvement of the Suez Canal. The Bank has, however, been involved with the U.A.R. in several other matters. Before the Suez loan the Bank appraised the Aswan High Dam project and agreed to provide assistance for it on certain conditions. Not all these conditions could be met, however, so no loan was made. The Bank was also involved in the clearing of the Suez Canal after the 1956 crisis and in the negotiations for compensation for the nationalization of the Suez Canal Company.

2. In 1961 the U.A.R. nationalized a great many enterprises and arrangements for the compensation of former foreign owners have not all been completed. This is one of the principal factors which have stood in the way of any operations in the U.A.R. by the Bank or IDA in the last five years. An economic mission visited the U.A.R. at the end of 1962 but no lending could be contemplated largely because the compensation problems had not been resolved.

3. In September 1965 the U.A.R. Government requested the Bank to send another mission preparatory to considering projects for lending; the Government claimed that all compensation problems were either settled or that they had made an acceptable offer to settle them. The Bank agreed to send a mission and the mission which has prepared the attached report visited the U.A.R. in February and March of this year.

4. The compensation issue will be an important factor influencing Bank lending. An agreement with the Shell Company, which has one of the principal outstanding claims, has just been signed by President Nasser but still has to be ratified by the U.A.R. Parliament. Although the U.A.R. has made progress there are a number of claims still outstanding. Evidence of continued progress will be a necessary condition for Bank lending.

II. Issues

5. The issues before the Committee are:

i) the creditworthiness of the U.A.R.;
ii) the eligibility of the U.A.R. for IDA credits.

III. Discussion of the Issues

6. The report makes it clear that there is both a short-term and a long-term problem in the control of the U.A.R.'s balance of payments. In the long-run the influences which will determine the success of the development effort and hence the stability of the balance of payments are, broadly speaking, three. These are, firstly, the problem of savings, secondly, the problem of exports and thirdly, the problem of the general organization of the economy, particularly the industrial sector.

7. Savings. There have been deficits in the U.A.R. balance of payments more or less continuously since the end of World War II. They have been financed first by means of the substantial amounts of sterling which Egypt accumulated during the war and then, by external borrowing. In 1959 the Government prepared a comprehensive development plan for the years 1959/60 to 1964/65 which was intended to be the first of two such plans which would double the national income over ten years. The result was that after 1959 investment increased considerably but internal savings rose very little; hence the deficit in the balance of payments widened and the Government resorted to drawings on the IMF and short-term borrowing to supplement the long-term loans it had obtained for various projects in the development plan.

8. In 1962 and again in 1964 the Government introduced programs for stabilizing the economy with the assistance of the IMF but these did not produce any permanent improvement in the balance of payments primarily because the conditions stipulated by the IMF were not adhered to. In the fall of 1965 some changes within the Government were made and a new Prime Minister appointed. In December 1965 the Government introduced a series of measures to restore some balance to the deteriorating economic situation. Several taxes were increased and the prices of many consumer goods were raised. These measures do represent a real attempt to do something about the economy's problems; unfortunately they do not seem to be producing the results which were hoped for. It appears that the amount of additional revenue was less than expected and that government expenditure has continued to increase. Another indication of an attempt to control the balance of payments problem is that the size of the new development plan for the period 1965/66 to 1969/70 has been reduced. This has been done by stretching the plan over seven years rather than five which could have a substantial effect on the investment rate in the first five of the seven years. Nevertheless if the new investment program is to be carried through while at the same time the balance of payments deficit is to be reduced, then there must be an increase in internal savings.

9. In the end this is a question of the priority attached by the Government to the balance of payments. In the last five years the balance of payments has suffered from the Government's understandable desire to demonstrate that it is doing something to raise the standard of living of the people, from rising expenditure on social services, particularly education and especially from rising defense expenditures culminating in the war in Yemen. There is, however, no economic reason why the U.A.R. should not be able to carry out a reasonable investment program with only

a manageable rise in external debt providing that consumption and expenditure on defense and social services are kept under control. The regime is, of course, a military one and much of its cohesion and dynamism spring from its position as the symbol of "Arab socialism" and of opposition to the right-wing Arab states, to Israel and to "western neo-colonialism." The difficulties which face such a regime in an attempt to pull in its political horns for balance of payments reasons need no emphasis.

10. Exports. For many decades Egypt's export earnings have depended almost entirely on its cotton crop and the world price of cotton and only recently has any tendency towards a diversification of exports appeared. Since 1958 export earnings have grown only at about 3% a year and it seems clear that for sound economic development exports must rise more rapidly. This need arises not merely from the desirability of relieving the present acute shortage of foreign exchange but also to provide a base for further external borrowing. The report concludes that it would be reasonable to assume that the rate of growth of exports could be doubled if appropriate policies are followed. One of the principal reasons why the growth of exports has been so slow has been that production of exportable commodities has only just kept pace with consumption. Thus the same measures of restraint which are required to control consumption and hence increase savings would also serve to increase exports. The behavior of exports will also be influenced by the policies pursued by the Government in dealing with the problems of economic organization discussed below.

11. The organization of the economy. After the nationalizations of 1961 the economy has been subjected to a steadily increasing degree of central control. The problems arising in this field are discussed in more detail in Section IV.B. of the report. Control over prices, wages and foreign exchange means in practice that key decisions have to be taken by the controllers rather than by the enterprises themselves. With these decisions taken out of their hands it is not surprising that the efficiency of many enterprises seems to have declined and a general problem of lack of incentives has appeared. This "incentives" problem has been the subject of considerable recent discussion and a new law has been prepared which is supposed to clarify the responsibilities of directors of enterprises and to increase their authority. However, the whole issue requires a more fundamental solution. What seems really needed is determined drive towards decentralization of decision making and responsibility and this requires a deliberate attempt to make more use of prices and competition and less of quantitative controls to ensure that enterprises operate in the public interest.

12. In many ways -- general decentralization, greater use of prices, a more realistic exchange rate, more emphasis on exports and less on the saving of imports, more competition, both inside the country and from imports -- the kind of change in direction which is required in the U.A.R. seems very similar to that which is taking place in India. Unfortunately, there seems little realization of the true nature of the problem within the U.A.R. The managers of the enterprises are sometimes very vocal in their complaints; but there does not seem to be any significant group within the Government that is consciously pushing in the right direction. The risk

of being labelled anti-Arab Socialist or too pro-West is presumably a deterrent. It seems more likely than not that, in this respect, things may have to get worse before they get better and if so, this may be the biggest obstacle to satisfactory economic growth over the next five years.

13. So much for the long-term problem. The short-term problem comprises $73.2 million repurchase obligations to the IMF over the next two years, commercial bank debts amounting to about $250 million, an amount which is so large that rolling it over every year is becoming increasingly difficult, and, in addition, some commercial arrears the amount of which is not certain. Since Egypt's foreign exchange reserves are negligible any fall in export receipts is immediately translated into an increase in commercial arrears. Some refinancing operation to reduce short-term debt and permit some build-up of reserves would clearly be desirable; unfortunately it is difficult to imagine how any such operation would be politically possible in present circumstances. The U.A.R. has no diplomatic relations with the U.K. and Germany, two of its principal creditors. The compensation issue would also stand in the way. The U.S. Government is at present considering whether it can continue to provide PL 480 assistance to the U.A.R. and it will be difficult enough to continue assistance at the present rate. Moreover, any debt re-scheduling operation would presumably require some arrangement for amounts owed to eastern European countries under bilateral trade and payments agreements. In view of all these complications, an arrangement for debt re-scheduling in the near future does not seem possible. An improvement in the balance of payments is therefore all the more urgent.

IV. Conclusion and Recommendations

14. There appear to be three possible directions which the U.A.R. economy could take in the near future:

i) The Government might continue in the direction symbolized by the measures of December 1965 and gradually succeed in improving the balance of payments, reducing short-term debt and accumulating some exchange reserves.

ii) On the other hand a serious payments crisis might develop, if for example, the situation in Yemen deteriorated or if the U.S. Government eliminated or seriously reduced the amount of PL 480 assistance.

iii) The U.A.R. might succeed in steering a middle course between the two described above. While it manages to avoid the necessity of a moratorium or rescue operation it nevertheless continues to spend up to the limit of available resources.

15. In either of the first two cases the problem for the Bank is not difficult; in the first it could lend, while in the second it could not. It is the third situation which presents the Bank with a difficult decision and unfortunately this situation seems much the most likely. In these circumstances it would be difficult to justify any lending to the U.A.R., either by the Bank or IDA. What is required is some evidence of the change

in direction which is necessary to overcome the immediate balance of payments problem and to ensure the creditworthiness of the U.A.R. in the long-run.

16. The U.A.R. would qualify for IDA assistance on grounds of poverty - its income per head is only $150 equivalent - and on grounds of creditworthiness since its external debt is already so high that it is important to obtain new funds on as soft terms as possible. From the point of view of economic performance, the major inadequacy is again shown in the balance of payments which reflects the excess demand in the economy, so that an improvement in this respect is as necessary for IDA as for the Bank. In other respects the economic performance of the U.A.R., while it could certainly be improved, is not such as to make it ineligible for IDA.

17. At the present time the U.A.R. wishes to reach some understanding with the IMF. To obtain such an understanding, the IMF will require an adjustment of the exchange system together with the usual limits on credit expansion designed to prevent domestic inflation. The IMF would also expect the introduction of a more realistic pricing policy, particularly to ensure that any change in the exchange rate is reflected in the domestic price system.

18. In deciding upon the conditions under which we would be prepared to begin lending, there appear to be two possibilities.

a) We could inform the U.A.R. that we cannot contemplate the appraisal of any projects until adequate measures have been taken to improve the balance of payments. The adequacy of any measures would, in practice, have to be judged by whether or not they were acceptable to the IMF because we could not require less than the IMF nor could we reasonably insist on more. We would, in fact, be making a stand-by agreement with the IMF a condition of our lending.

b) We could inform the U.A.R. that we are in principle prepared to lend and that we are ready to appraise projects. However, the presentation of any loan or credit to the Executive Directors would be subject to our being satisfied, firstly, about the compensation issue and, secondly, that adequate steps were being taken to deal with the balance of payments. This would put us in a position parallel to the IMF rather than, so to speak, standing behind it. Both institutions would be looking for the same kinds of measures before taking action.

19. I believe the balance of advantage lies with the second alternative. By taking a position similar but not identical to that of the IMF we would re-enforce the pressure on the U.A.R. to take more action. At the same time our willingness to begin the appraisal of projects would make clear to the Government that we are really interested in lending to the U.A.R.

Douglas J. Fontein
Deputy Director

Attachment: Summary and Conclusions of the economic report "The Economy of the United Arab Republic."

SUMMARY AND CONCLUSIONS

(From economic report "The Economy of the United Arab Republic)

1. The development problem in the U.A.R. is dominated by the pressure of a population growing at about 2.8% per year. The total population is estimated at 31 million almost all of which is concentrated in the valley and the delta of the Nile where irrigated agriculture is possible. The population density in this restricted area is around 500 per square mile which is one of the highest in the world. To provide income and employment for the growing population the U.A.R. Government has programs for bringing new land under cultivation to use the water available from the High Dam, for improving the productivity of the land already cultivated and for the development of industry. In addition to agriculture and industry the U.A.R. has three other significant economic assets; namely, the Suez Canal, the tourist trade and petroleum. The Canal is a most important source of hard currency earnings; the tourist trade, while less important as a source of income than the Canal, is growing rapidly and may have greater potential in the long-run. Petroleum production is also small, at least by Middle Eastern standards, but a great deal of exploration is going on; Egypt is at present a net importer of petroleum products but hopes to reverse the position in the next five years.

2. In the first half of this century income per head in Egypt probably fell, perhaps by as much as 20%. After the war the position improved and income per head began to rise slowly despite the rapid increase in population which began at this time. From the revolution of 1952 until 1960 the national product grew probably at between 3.5% and 4.0%.per year. In 1960 a comprehensive development plan was introduced, investment was increased and the growth rate increased to perhaps 6.5% per year. The acceleration was, however, accompanied by a sharp increase in the balance of payments deficit since the rise in investment was not matched by any corresponding rise in domestic savings. The consequence was a rapid increase in external debt both long-term debt incurred in connection with development projects and short-term debt accumulated in an effort to bridge the balance of payments gap since foreign exchange reserves were virtually exhausted. Import restrictions and exchange control measures were tightened and consequently an acute shortage of foreign exchange has appeared.

3. A new development plan has been in preparation for some time and the main outlines have recently been made public. The new plan envisages a total investment of LE 3.2 million over seven years. The decision to make the plan cover seven years instead of five is in effect a reduction of the investment target from the levels which were under discussion early this year. The really important issue, however, is how the plan is to be financed. If the balance of payments position is to be held under control internal savings will have to be relatively larger than they have been in the last five years. According to the new plan only 15% of total investment is to be financed by imported resources as against 27.5% during the previous plan period. How much of an increase in the proportion of income saved will be required depends upon the rate of growth which is actually achieved. Assuming however that the capital output ratio is approximately the same as it appears to have been during the first plan the rate of growth of output would be around 7.4% per year and the proportion of the additional output saved would have to be 22% to 23% as against an average of 19% during the last five years. This does

not appear an unreasonably large increase and in view of the degree of control which the Government can exercise over the economy and the level of consumption, there should be no economic reason why it could not be reached. The main reason why savings did not rise sufficiently during the last five years was the pressure of increasing government consumption on social services and defence. In practice, therefore, the most obvious need is to curtail expenditure in these directions.

4. The growth rate which will be achieved will depend on the progress made in agriculture and industry. During the last plan agricultural output rose at about 3.5% per year which was larger than the growth of population but the margin between them was not large enough to satisfy the increase in demand for food and to provide sufficient additional exports. However, in many periods in the past, for example between the mid-thirties and 1960, the population growth was substantially greater than the increase in agricultural output. Broadly speaking agricultural output can be increased in two ways: "horizontal" expansion, that is, bringing new land under cultivation, and "vertical" expansion, or increasing the productivity of land already cultivated. Horizontal expansion requires water which may come either from the more efficient use of existing water or from new sources such as the High Dam. Construction of the High Dam has gone well and is ahead of schedule and the prospect of additional water has meant a considerable emphasis on horizontal expansion both in the last plan and in the new one. Horizontal expansion also has the advantage of providing new employment opportunities for the agricultural population which in a country such as Egypt is a matter of urgency. On the other hand it is expensive and yields its results only after a considerable time lag. A large part of the investment in agriculture during the first plan, for example, that on the High Dam itself, has not yet produced any increase in output at all. (The High Dam did, however, prevent a reduction in output which would otherwise have occurred as a result of a low flood in 1965). Vertical expansion, on the other hand, yields much more output per unit of capital but its progress is determined less by the availability of finance but by the rate at which social and organizational obstacles, such as the resistance of the peasant to the Government's attempts to change and improve methods of cultivation, can be overcome.

5. The emphasis placed by the Government on industrialization in an overpopulated country such as Egypt is understandable. Egypt already has a sizeable industrial sector and industry now accounts for 22% of the gross national product. Since the end of the war industrial production has increased on the average at about 5% per year but with the industrialization drive associated with the last Five-Year Plan it rose to 8.9%. Industries based on the processing of local raw materials such as cotton and food products are still predominant in Egypt. A steel plant using local ore has, however, encountered difficulties apparently largely due to the low quality of the ore. The Government has also put a lot of stress on the development of import saving industries; some of these, particularly the engineering and metal products industries, have not been able to operate as economically as had been hoped - their demand for imported materials and components is high and because of the shortage of foreign exchange they are forced to operate below capacity. These industries are still, however, quite a small proportion of the whole industrial sector.

6. An important long-run problem for Egyptian industry concerns the degree and method of control by the Government over economic enterprises. In 1961 all the major enterprises, both Egyptian and foreign, were nationalized and since then the Government has been trying to devise a satisfactory solution to the problem of operating Government-owned industrial enterprises and of planning investment in industry. Since this is a problem of the utmost difficulty, a satisfactory solution has not yet been found. The problem of which decisions and how many decisions are to be taken at the center and which by the enterprise is closely linked to the whole problem of price and wage control and the use of prices versus administered targets as methods of controlling or influencing enterprises. The effect of price control has been to pull the control of enterprises into the Government ministries and thus to reduce their freedom of action. The Government is now attempting to deal with the erosion of incentives which this has produced. This issue runs very deep since in the end it concerns the kind of economy and society in which the people wish to live.

7. Little need be said of other sectors in this summary. In electric power the picture is dominated by the High Dam, the first two units of which will come into use at the end of 1967. This, together with thermal capacity already under construction will take care of Egypt's needs for some time so that no important investment decisions have to be taken in the near future. Egypt has a good transport network of railways, roads and waterways but the expansion of the system in the last few years has been insufficient and transport has become a bottleneck. There is a good railway system which is economic and well run but more could be done to obtain the most benefit from the waterways.

Conclusion

8. The U.A.R. is facing an immediate balance of payments problem which is made difficult to handle because of a considerable amount of short-term debt. The short-term debt is composed of repurchase obligations to the IMF amounting to $122 million, commercial bank debts amounting to $250 million which are usually rolled over every year but which have now become so large that this is becoming difficult, and some commercial arrears, the amount of which is not certain. This short-term problem requires for its solution a sharp temporary improvement in the balance of payments so as to reduce short-term debt and restore reserves. This could be supplemented by some form of re-financing. However, it is not easy in present circumstances to see how any re-financing operation could be organized.

9. In the longer run the U.A.R.'s problem is to finance its future growth with less reliance on foreign capital so that its balance of payments is kept under control and the volume of external debt maintained within manageable limits. At present the U.A.R.'s long-term external debt is $1.4 billion equivalent of which $881 million is now disbursed and outstanding. Debt service, excluding service on military credits, is now about 16% of foreign exchange earnings. If the new investment plan is to be financed using foreign

resources for only 15% of the total required, the gross borrowing over the next five years would have to be about \$1.3 billion - \$725 million for the new plan plus \$570 million amortization. The effect of such borrowing on the debt service will depend on the terms of the new borrowing and on the rate at which the U.A.R. can increase its foreign exchange earnings. Export earnings in the past have fluctuated considerably but with only a modest upward trend of perhaps 3% per year. There seems, however, no reason why this should not be raised to between 6% and 7% per year. Egypt produces many commodities which can find markets abroad; the important point is that internal consumption should not rise so fast that potential exportable surpluses are instead consumed at home. Assuming, however, a 6% to 7% increase in exports, gross borrowing on the scale mentioned above would be possible without any increase in the debt service ratio provided all the new borrowing could be in the form of conventional long-term loans (i.e., loans with debt service equal to 10% of the principal amount). This would represent a considerable improvement in the structure of the external debt since at present the annual debt service is 16.7% of the principal amount. If there were no improvement in debt structure the debt service ratio would rise to 20%.

10. In sum, therefore, the long-run problem of debt management in the U.A.R. is amenable to a solution compatible with a satisfactory rate of growth. The debt is, however, already quite sizeable and it is important that it should not increase as rapidly as it has in the last few years. This requires some change in the direction of Government policy. Last December the Government introduced a number of measures which indicate that such a change may be under way. The measures became necessary in order to restore some balance to the Government budget and they included significant increases in taxes and in the prices of many important consumer goods. It is still, however, too early to judge whether these measures really represent a permanent change in direction by the Government or whether, after the immediate urgency has been overcome, the policies of the last few years which have led to the present difficulties will be resumed.

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