Memorandum of Understanding for the Agricultural Production and Credit Project- Policy Reform Component, 1990-1993

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***N**ATIONAL **A**GRICULTURAL **R**ESEARCH **P**ROJECT*

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Memo of Understanding
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MEMORANDUM OF UNDERSTANDING FOR THE AGRICULTURAL PRODUCTION AND CREDIT PROJECT--POLICY REFORM COMPONENT, 1990-93

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* To be completed by November 1990 and incorporated into the present Memorandum of Understanding.

September 24, 1990

Memorandum of Understanding for the
APC Policy Reform Component, 1990-93

Summary and Recommendation. To continue the program of economic policy reforms begun in 1986 for Egypt's agricultural sector, the Ministry of Agriculture (MOA) has developed a plan for further actions over the next several years. Section I below summarizes the major long term goals for the sector developed by the Government of Egypt (GOE) in 1986-87. Section II presents the main medium term targets that have now been set for the period covered by the present memorandum. The MOA and other concerned ministries will develop the specific policy measures that will be needed to achieve those medium term targets.

USAID agrees with the importance of the long term and medium term targets that the GOE has established and agrees to assist the Government toward those goals. In that connection, the Agricultural Production and Credit (APC) Project is currently being amended by USAID to increase the authorized level of funding by $150 million for the Policy Reform Component. It is intended that those funds will be disbursed in tranches based on periodic assessment by USAID that the GOE is making satisfactory progress toward implementing its policy reform program. Section III describes a series of benchmarks against which the MOA and USAID will measure such progress.

We recommend that Sections II and III of the present memorandum be considered as the basis for the Policy Reform Component to be supported by the current amendment to the APC Project.

For the MOA: YHassan ________ OElKholei ________

For PBDAC: AHEzzi ________ MNoor ________ KNasser ________

For USAID: DClark ________ DDod ________

I. Long Term Goals for Agricultural Sector Policy

The GOE continues its commitment to comprehensive reform of the agricultural sector through actions, as indicated in the previous 'Agreed Minutes' to the APC policy component of March 1987, to

A. remove government farm price controls;
B. remove government crop area controls, considering technical constraints of the cropping pattern;
C. remove government crop procurement quotas;
D. remove government constraints on private sector processing and marketing of farm products and inputs (including import/export);
E. eliminate subsidies of farm inputs; and
F. limit state ownership of land.

II. Main Agreed Targets for the Medium Term

The Government of Egypt has determined that the next phase of its economic reform program for agriculture should emphasize increased cotton procurement prices, liberalization of rice marketing, elimination of farm input subsidies, and divestiture and liberalization of farm input supply activities that presently are managed mainly by the Principal Bank for Development and Agricultural Credit (PBDAC). During this period of change, the Government and the Ministry of Agriculture will also take necessary actions to protect and improve the longer-term financial strength of PBDAC as a sound credit institution.

Adjusted cotton prices and reduced government controls over rice. By the 1992 season, the Government of Egypt proposes to adjust the net procurement price for cotton to at least 66 percent of the international price and to eliminate the current requirement to deliver to the government 1.5 ton of rice per feddan. For cotton, the Higher Policy Committee has decided (November 1989) that the average procurement price paid will be adjusted to 66 percent of the international price by 1992.

The intention of shifting the procurement price to this level is to provide improved incentives for the cotton farmer to produce a better yield and to grow cotton in preference to alternative field crops that have less economic value to the nation.

For rice, the Higher Policy Committee has determined that the Ministry of Supply delivery quota should be reduced to 1.0 ton in 1990 and should be eliminated by 1992. In addition, by 1992 the Ministry of Supply will remove its current prohibitions on the private sector concerning the possession, milling, and intergovernorate transport of rice.

Elimination of farm input subsidies. By the end of 1993, all budgetary and exchange rate subsidies are planned to be removed from nitrogen and phosphate fertilizers and from all other farm inputs--with the possible exception of subsidies for cotton pest control, farm credit and potassium sulfate. In addition, the Government plans to modify its current administrative pricing of fertilizer and of livestock feed ingredients--so that the ex-factory prices of these products will be more uniform among all buyers.

Government divestiture and liberalization of marketing for fertilizer, livestock feed, seed, and other inputs. In a series of steps through 1993, the Government intends to eliminate substantially all controls over private processing, intergovernorate transport, and wholesale and retail trade for these farm inputs. In general, all restrictions over private trade for commodities that are presently not subsidized will be eliminated at an early date, while restrictions over other individual inputs will be removed at the point when the budget and exchange rate subsidies for the affected commodity have been eliminated. In addition, PBDAC will adapt its marketing margins for seed and other individual inputs to reflect the normal commercial cost of such wholesale and retail trade, and thus, to permit and encourage trading by new dealers.

On a parallel track, PBDAC will reduce substantially or eliminate its current retail and wholesale distribution activities for fertilizer, livestock feed, seed and machinery. By the end of the period covered by the present memorandum, it is anticipated that nonpublic sector distributors will be responsible for a substantial share of the distribution of fertilizer, seed, livestock feed, and machinery.

Financial strengthening for PBDAC as a credit institution. PBDAC's capital and operating income will be supported and protected by the Government during the period covered by the present memorandum in order to correct current weaknesses in the capital structure and to overcome the temporary costs to the Bank from divestiture of its input trading activities. The targets for improvement in PBDAC's financial strength will be achieved through a combination of

- GOE capital contributions corresponding to the local currency equivalent of the dollar disbursements by USAID;

- retention by PBDAC of part of the gross interest earnings attributable to SFPP- and APC-related capital contributions; and

- measures by PBDAC to enhance its current net income from banking and credit operations and to reduce its residual operating costs related to the input supply operations that will have been discontinued.

Possible additional economic policy initiatives. On the basis of studies of current policies, controls, and economic distortions that affect adversely the performance of the agricultural sector, the MOA may propose inclusion of other elements into the agricultural sector policy reform program. By mutual agreement with USAID, those elements may be incorporated into an amended list of measures supported by the APC Economic Policy Component.

III. Benchmarks for Implementation of Economic Reforms

In light of the agreed medium-term objectives, USAID will periodically review and assess progress of the GOE's economic reforms in the agricultural sector since completion of the first phase of the APC policy component in 1989. Those assessments will focus primarily on the benchmarks of performance outlined below and will provide a basis for USAID to release resources during the period of the policy changes covered by the present memorandum.

A. Fourth Tranche Benchmarks

1. The cotton procurement price will be adjusted so as to eliminate at least one third of the difference between the price prevailing in 1989 and the medium term target (that is, two thirds of the international price).

2. The quota for mandatory delivery of rice to the government will be reduced to no more than 1.0 ton per feddan.

3. The retail prices of fertilizers handled by public sector distributors will be adjusted to reflect
   - revision of local ex-factory prices to their full costs of production* or to prices based on market forces;
   - revision of the exchange rate applied to public sector imports of fertilizers;
   - adjustment of marketing margins and commissions between factory and retail points of sale to a full commercial basis.

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* It is understood that ex-factory prices for fertilizer reserved for PBDAC are intended to be set on the basis of 'standard costs' of production and to be adjusted on at least an annual basis. However, implementation of that arrangement is contingent upon agreement between the Ministry of Industry and the World Bank concerning the definition and calculation of standard costs.

The combined budget subsidy for local and imported fertilizers will not exceed the corresponding budget subsidy for FY 1988/89.

4. Prices and quantities of low-priced livestock feed will be adjusted so as to eliminate one third or more of preexisting, implicit subsidies for wheat bran and cottonseed cake.

5. Charges for cotton pest control will be adjusted to reflect changes in pesticide application practices and in the foreign exchange costs of cotton pesticides owing to revision of the foreign exchange rate (contingent on achievement of a cotton price that allows benchmark A.1 to be fulfilled).

6. The GOE will adjust policies, decrees, and laws on the marketing of unsubsidized inputs so as to reduce the quantities of commercial farm inputs marketed by the public sector, using the following guidelines.

   a. Private sector dealers will be permitted to trade and transport all farm inputs that are no longer subsidized.

   b. For purposes of meeting farmers' quotas of fixed price fertilizer, local factories' annual distribution of fertilizer to PBDAC at fixed prices will not exceed the following amounts:

   - 4.2 million tons of nitrogen (15.5 percent nutrient content);
   - 1.0 million tons of phosphate (15 percent nutrient content).

   c. To meet farmers' additional needs for fertilizer, private dealers, coops, or PBDAC will purchase fertilizers from local factories on equal terms and at prices based on market forces. Such fertilizer will be freely transported and will be resold on a nonsubsidized basis, free from price controls.

d. The quantity of livestock feed mixes marketed through PBDAC or other public sector dealers will be reduced to a maximum of 80 percent of the quantity marketed by PBDAC in 1989.

e. Imports of corn by PBDAC will be reduced from a monthly target of 150,000 tons to a monthly target of 100,000 tons (or to a lesser amount, contingent on foreign exchange availability to the private sector).

f. Marketing by PBDAC of privately produced and processed seed will be reduced by raising the commission charged by PBDAC to 15 percent or more of the retail price. Marketing charges by PBDAC on seed supplied by public sector processors will also be reviewed for adjustment to a normal commercial level.

7. Subsidized farm credit for crop or animal production purposes will be restricted to a uniform maximum amount per feddan for each registered farmer. Interest rates on all other new agricultural loans (other than some loans for new activities which need promotion) will be moved to market levels. Total interest subsidies on all types of farm credit will not exceed the level of LE 105 million per year.

8. The MOA will develop a phased plan to withdraw from the affairs of cooperatives, except for selected regulatory and financial audit functions reserved for the public sector.

B. Fifth Tranche Benchmarks

1. The cotton procurement price will be adjusted so as to eliminate at least one half of the difference between the price prevailing in 1990 and the medium term target (that is, two-thirds of the international price).

2. The quota for mandatory delivery of rice to the government will be reduced to no more than 0.5 ton per feddan. GOE restrictions on possession, milling, and intergovernorate transport of rice will be relaxed so as to promote more efficient processing and marketing of overquota rice by the private sector.

3. The retail prices of fertilizers handled by public sector distributors will be adjusted to reflect elimination of the preferential exchange rate applied to public sector imports of fertilizer. The combined budget subsidy for local and imported fertilizers will not exceed the corresponding budget subsidy for FY 1988/89.

4. Prices and quantities of low-priced livestock feed will be adjusted so as to eliminate one half or more of the remaining implicit subsidies for wheat bran and cottonseed cake.

5. Charges for cotton pest control will be adjusted so that the combined total of explicit and implicit public sector subsidies will be reduced to three fourths of the corresponding total pest control subsidy for FY 1988/89 (contingent on achievement of a cotton price that allows benchmark B.1 to be fulfilled).

6. The MOA will adjust policies, decrees, and laws on the marketing of unsubsidized farm inputs so as to reduce the quantities of commercial farm inputs marketed by the public sector, using the following guidelines.

   a. Private sector dealers will be permitted to trade and transport all farm inputs that are no longer subsidized.

   b. For purposes of meeting farmers' quotas of fixed price fertilizer, local factories' annual distribution of fertilizer to PBDAC at fixed prices will not exceed the following amounts:

- 4.0 million tons of nitrogen (15.5 percent nutrient content), plus a share of production of ammonium nitrate from new facilities to compensate for the decline from the previous year in PBDAC imports of nitrogen;
- 0.9 million tons of phosphate (15 percent nutrient content).

c. To meet farmers' additional needs for fertilizer, private dealers, coops, or PBDAC will purchase fertilizers from local factories on equal terms and at prices based on market forces. Such fertilizer will be freely transported and will be resold on a nonsubsidized basis, free from price controls.

d. The quantity of livestock feed mixes marketed through PBDAC and other public sector dealers will be reduced to a maximum of 60 percent of the quantity marketed during 1989.

e. Imports and marketing of corn by PBDAC will be reduced to a monthly target of 50,000 tons (or to a lesser amount, contingent on foreign exchange availability to the private sector).

f. Marketing charges by PBDAC on seed supplied by public sector processors, with the possible exception of cotton seed, will be adjusted to a full commercial basis for the summer 1991 and winter 1991/92 seasons in accordance with the findings, if available, from the review noted in Benchmark A.6.f.

7. The system for subsidized farm credit for crop production will be reviewed by PBDAC with the intention of concentrating the benefits on farmers who bear the burden of producing low-priced, government-controlled crops or who are undertaking new activities that need promotion. Interest subsidies on agricultural loans will not exceed the level of LE 105 million per year.

8. The MOA will submit to the Higher Policy Committee a new law that would enable agricultural cooperatives to function as independent, private agribusinesses. The MOA will also have implemented its scheduled measures to withdraw from the affairs of cooperatives, except for selected regulatory and financial audit functions reserved for the public sector.

[9. Targets will be achieved for PBDAC capital, for its operating income, and for changes in its organization and staff, based on benchmarks to be established within one year of the present memorandum. (These targets will reflect plans for divestiture of input-handling facilities and other elements of the PBDAC strategic plan to be developed during 1990.)]

[10. Toward reforming the seed processing sector, additional benchmarks will be added to deal with issues raised in Annex F and in the National Seed Seminar, such as:

- institutionally separating seed development (regulation, certification, control, etc.) from seed production and processing activities;

- submitting new seed legislation to the Higher Policy Committee which would redefine the role of the public sector, provide increased incentives to the private sector, and allow divestiture of current seed processing facilities; and

- selling or closing a number of seed processing facilities.]

C. Sixth Tranche Benchmarks

1. The cotton procurement price will be adjusted to equal or exceed the medium term target (that is, two-thirds of the international price).

2. The quota for mandatory delivery of rice to the government will be eliminated. All GOE prohibitions and restrictions on possession, milling, transport, and marketing of rice by the private sector will be eliminated.

3. By the end of 1992, the retail prices of fertilizers will be adjusted so as to eliminate all remaining subsidies on fertilizer (with the possible exception of subsidies for potassium sulfate)

4. Prices for all wheat bran and cottonseed cake will be raised to levels that fully reflect either border prices or local, free-market prices.

5. Charges for cotton pest control will be adjusted so that the combined total of explicit and implicit public sector subsidies will be reduced to one half of the corresponding total pest control subsidy for FY 1988/89 (contingent on achievement of a cotton price that allows benchmark C.1 to be fulfilled).

6. The MOA will adjust marketing policies for farm inputs so as to reduce the quantities of commercial farm inputs processed and marketed by the public sector, using the following guidelines.

   a. Private sector dealers will be permitted to trade and transport all farm inputs that are no longer subsidized.

   b. By the end of 1992, all fertilizer dealers (PBDAC, cooperatives, other private dealers) will have access on equal terms to imported and locally produced fertilizers. Local factories' annual distribution of fertilizer to PBDAC at fixed prices will not exceed the following amounts:

      - 3.8 million tons of nitrogen (15.5 percent nutrient content), plus a share of production of ammonium nitrate

from new facilities to compensate for the cumulative decline in PBDAC imports of nitrogen;
- 0.8 million tons of phosphate (15 percent nutrient content).

c. By the end of 1992, public sector distribution of low-priced, 'unified' livestock feed will be discontinued.

d. Imports and marketing of corn by PBDAC will be eliminated.

7. Interest subsidies on agricultural loans will not exceed the level of LE 105 million per year.

[8. Targets will be achieved for PBDAC capital, for its operating income, and for changes in its organization and staff, based on benchmarks to be established. (Refer to the PBDAC strategic plans developed during 1990 and 1991.)]

[9. An additional benchmark will be included concerning seed legislation and the privatization of public sector seed facilities. (Refer to Annex F and further development of the seed sector plan.)]

IV. Monitoring the Implementation of Economic Reforms

A. Responsibilities of the MOA Monitoring Unit

The economic staff of the Ministry of Agriculture will conduct a series of surveys and studies to determine the rate of progress toward achieving the benchmarks and medium term targets described in Sections II and III, preceding. These surveys and studies will include

- a baseline assessment of initial conditions in the areas for which agreed medium term targets have been established;

- a series of annual reports to present quantified estimates of progress toward achievement of the benchmarks set for the successive performance disbursements (tranches 4, 5, and 6);

- supplementary, interim reports concerning achievement of any specific benchmarks that might not have been fully achieved at the time of the previous annual report;

- specific separate studies required to revise or set benchmarks for tranches 5 and 6.

The monitoring unit responsible for these survey, analysis, and reporting activities will be the office of the Economic Advisor to the Minister of Agriculture. However, PBDAC will be independently responsible for preparing timely, parallel reports concerning its financial situation, its strategic plans, and the implementation of divestiture of its input marketing activities.

If available, preliminary results of the baseline study by the monitoring unit will be incorporated into annexes to the current memorandum that will present the MOA plans for reform of the cotton subsector, the fertilizer marketing system, and the livestock feed marketing system. Similarly, PBDAC will prepare baseline data that will be necessary to evaluate its subsequent financial performance and the progress toward divestiture of its commercial and input supply functions.

B. Consultations and Annual Reports

Prior to final issuance of each annual report, the MOA Policy Committee and USAID will meet to review all major economic policy developments since the last previous tranche and to discuss the methodology and preliminary new results developed by the monitoring unit for the forthcoming report.

It is expected that each annual report will contain

- estimates of prices, quantities, and market shares of the main input dealers, including the most recently completed crop season or accounting period (to allow evaluation of current benchmarks);

- a summary (for the period since the preceding annual report) of all major decrees, laws, or changes in regulatory policy that bear on the main medium-term targets identified in the present memorandum;

- in the case of the second and subsequent annual reports, revised estimates (based on more complete data or surveys) of the progress achieved during the earlier period(s) toward the medium term goals and previous benchmarks.

C. Methodology for Evaluating Benchmarks

Many of the agreed benchmarks for tranches 4, 5, and 6 involve the movement of local prices for major farm outputs and inputs toward the respective levels of economic prices for those products. In such cases, measurement of progress toward the benchmark objective requires for each product

- current measurement or estimation of the local price;
- current identification and estimation of the corresponding border price;
- application of an appropriate prevailing exchange rate to translate the border price into its local-currency equivalent;
- estimation of handling and processing costs from the border to the local point of sale (such as the farm gate).

Local prices. In general, accurate and up-to-date measurements are available for local prices of farm inputs which are the subject of agreed benchmarks. A precise schedule of local cotton procurement prices is also generally available prior to harvest. However, accurate and current data are not readily available for certain local prices. Thus, the GOE will conduct special surveys to measure

- free or black market prices of livestock feed mixes, wheat bran, and, if available, cottonseed cake; and
- ex-factory prices of locally produced fertilizer sold to non public sector distributors.

In addition, to measure progress toward the medium term goal of improved incentives to grow cotton in preference to alternative field crops, it is planned that the MOA monitoring unit will make its best efforts

- to conduct farm budget surveys for cotton, berseem, maize, rice, and wheat in the main producing regions; and
- to collect and report more timely, survey-based information than is currently available on the prices and yields for the competing crops of berseem, maize, rice, and wheat.

Economic prices. In general, economic prices for farm inputs and outputs will be evaluated as contemporaneous border prices, adjusted for local handling and processing costs. However, the GOE proposes and USAID accepts that 'agreed target prices' may be used in lieu of economic prices for cotton prices and for locally-produced fertilizer.

For cotton, the agreed target price is considered as a moving average of the fob export price of the typical varieties and grades of cotton exported by Egypt. The moving average will be based upon dollar prices of lint exports to market economies over the previous five years, with an adjustment for processing costs and the current value of byproducts.

For tranche 4, consideration will be given to assessing progress toward the medium-term target for cotton prices through comparison of a

Cabinet-approved and published schedule of procurement prices for the 1991 crop with the projected moving average of the fob export prices. Thus, published cotton procurement prices that, prospectively, would satisfy benchmark B.1 for tranche 5 would also, retrospectively, satisfy benchmark A.1 for tranche 4.

For ex-factory prices of locally produced fertilizers, it is anticipated that the agreed target prices may be based in part on estimates of 'standard costs' of production of the local factory, using an up-to-date (e.g., annual) assessment of variable costs and revaluation of company assets. The definition of standard costs in Egypt's fertilizer sector would be determined in consultations between the GOE and the World Bank. As an alternative to standard costs, the GOE and USAID will consider that agreed targets for ex-factory prices may be based on border prices for the same or similar fertilizers, with an appropriate discount to reflect conditions of bagging or product-quality that do not meet international standards. While the MOA will accept one or both of the above alternatives, it is possible that the Ministry of Industry may choose some different, 'full cost' basis for setting ex-factory prices. USAID considers that, for purposes of the current Memorandum of Understanding, such alternative 'full cost' pricing would be accepted as a 'nonsubsidized price' if the factory pricing and marketing scheme ensures that locally marketed fertilizer will be available on a non-rationed basis, and on equal terms, to all private and public sector dealers.

<u>Appropriate exchange rate</u>. Wherever comparisons of local with international prices are required, benchmarks will be evaluated on the basis of the prevailing market exchange rate of the Egyptian pound. For that purpose, USAID staff have suggested that the relevant international fob or cif price should be converted into LE on the basis of the main market exchange rate currently in use for general commercial imports of the private sector. MOA economic staff have suggested that it should be assumed that the commercial bank market exchange rate will have been

agreed upon between the Government of Egypt and the International Monetary Fund and, if that is the case (as USAID would accept), the commercial bank rate would be considered the prevailing rate.

Regarding the evaluation of cotton prices, MOA and USAID have considered two different possibilities for selecting the exchange rates to assess the level of local cotton procurement prices. One possibility is that the moving average cotton export price would be translated at the exchange rate that prevails at the time of payment to the farmer for the newly procured cotton crop. A second possibility is that the moving average export price would be translated at the exchange rate prevailing on the date of announcement (prior to planting) of the new procurement price. USAID consider that the second approach, using the dates of announcement, might be appropriate--but only if some safeguard (as proposed below) existed against significant devaluations of the pound that would subsequently undermine the intended incentives to increase cultivation and improve crop management of cotton.

In light of the necessity to develop and maintain improved incentives for farmers to cultivate cotton, the MOA considers that the Government of Egypt should take all reasonable steps to ensure that the procurement price should be raised by 1992 to two thirds of the world price, as the Cabinet has determined and approved. If, after initial announcement of the procurement prices for each season, the planned progress toward that goal is threatened by unexpected devaluation of the currency, the MOA will initiate corrective action to adjust the cotton procurement price during the season and to restore a proper incentive to the cotton farmers.