CLASSIFICATION

AID 1120-1

PAAD

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROGRAM ASSISTANCE APPROVAL DOCUMENT

1. PAAD NO. 263-K-623

Judy Britt
PCS

2. COUNTRY Egypt

3. CATEGORY CASH TRANSFER

PDCBK480

4. DATE March 10, 1991

5. TO: Marshall D. Brown, DIR

6. OYB CHANGE NO.

7. FROM Samuel L. Skogstad, AD/EAS

8. OYB INCREASE None

TO BE TAKEN FROM: ECONOMIC SUPPORT FUND

9. APPROVAL REQUESTED FOR COMMITMENT OF: $ 115 million

10. APPROPRIATION —

11. TYPE FUNDING: ☐ LOAN ☒ GRANT

12. LOCAL CURRENCY ARRANGEMENT: ☐ INFORMAL ☐ FORMAL ☐ NONE

13. ESTIMATED DELIVERY PERIOD: 20 days (disbursement)

14. TRANSACTION ELIGIBILITY DATE: N/A

15. COMMODITIES FINANCED

16. PERMITTED SOURCE

U.S. only $ 115 million

Limited F.W.:

Free World:

Cash:

17. ESTIMATED SOURCE:

U.S.: 115 million

Industrialized Countries:

Local:

Other:

18. SUMMARY DESCRIPTION

This program provides Cash Transfer assistance to support the Government in meeting extraordinary Balance of Payments pressure pursuant to: (a) Major liberalization of the financial sector, including the markets for foreign exchange and domestic finance; (b) liberalization of the import regime; and (c) ongoing economic consequences for Egypt of the Persian Gulf crisis. The funding also supports Egypt's efforts through structural reform to liberalize and modernize the national economy, with a view ultimately to becoming an effective participant in the competitive international economic system. Progress toward agreements with the World Bank on a structural Adjustment Loan and the IMF on a Standby agreement are further evidence of Egypt's commitment to policy reform. That progress both reinforces and is reinforced by this cash transfer.

19. CLEARANCES

	DATE
AD/EAS, SSkogstad	5/12/91
AD/LEG, MWard	5 29 91
AD/FM, NWijesooriya	5/13/91
(A) AD/PDS, FMiller	5/13/91
DDIR, GWachtenheim	

20. ACTION

☒ APPROVED ☐ DISAPPROVED

Marshall Brown — AUTHORIZED SIGNATURE — May 14 1991 DATE

Marshall D. Brown, Director, USAID/CAIRO

TITLE

CLASSIFICATION:

UNCLASSIFIED

UNITED STATES

AGENCY FOR INTERNATIONAL DEVELOPMENT

EGYPT: CASH TRANSFER (FY 1991 appropriation)

AID GRANT NO. 263-K-623

UNCLASSIFIED

EGYPT: U.S. FY 1991 CASH TRANSFER

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I. The Setting For U.S. Economic Assistance

The overall objective of U.S. economic assistance to Egypt is to foster economic and social development. Economic assistance is one of the key elements of broader U.S. support to facilitate and encourage the establishment of a permanent, comprehensive regional peace.

Egypt's traditional leadership role in the region can be expected to increase following the expulsion of Iraqi forces from Kuwait. As a strong advocate of regional peace, this role for Egypt is consistent with U.S. foreign policy interests in the region. However, Egypt's ability to continue this role is influenced by domestic economic conditions. For the past few years, the economy has been very fragile as a result of deficits in the government budget and in the balance of payments that have exceeded financing available from foreign creditors and appear to have exhausted the government's foreign exchange reserves. Despite the recent forgiveness of Egypt's Foreign Military Sales (FMS) debt to the United States, the nation has a large external debt and related annual debt service obligations. Since 1987, real economic growth has essentially stopped and real wages appear to have declined--contributing to the potential for social instability and discontent.

Egypt has received generous financial support from the United States and her coalition allies to help defray the immediate Gulf-related costs. However, some of the adverse effects, such as disastrous tourism losses and dramatically reduced worker remittances, will have depressing effects for months to come. Realistically, Egypt faces an outlook of continued economic austerity and, possibly, of some further decline in living standards for at least another year or two. During the past three years, Egypt's external deficit on current account has been at a level of about $3 billion per year. This deficit appears unsustainably high, and the government has accumulated large debt service arrears since the end of its Paris Club rescheduling in mid-1988. Thus, most analysts have felt that Egypt would need to raise exports and take other adjustment measures that would enable the country to live within its means. More recently, the goal of external financial balance seems likely to be more difficult to achieve, as Egypt experiences the full economic consequences of Iraq's invasion of Kuwait. (The induced decline in Egypt's tourism and remittances from Egyptian workers is projected for 1990/91 to exceed by over $ 1 billion the positive impact of Egypt's higher oil export revenue owing to increased world oil prices.)

To reestablish Egypt's financial stability and a sound basis for future economic growth, the government intends to adopt both a program of macroeconomic adjustment and a program of structural adjustments. The centerpiece of the macroeconomic program is to be an IMF standby arrangement, the terms of which are now agreed. When the standby arrangement is in place, Egypt will seek a generous Paris Club rescheduling of current debt service payments and arrearages, which the Paris Club has already substantially accepted in principle. The standby arrangement and Paris Club rescheduling are also expected to result in the reopening of some international lines of credit.

The government is negotiating a Structural Adjustment Loan with the IBRD and hopes to complete the agreement as soon as the IMF standby arrangement is in place. The program of structural adjustments to Egypt's economy intends to change the system from central management and control to a greater reliance on markets. That program would broaden and intensify structural policy adjustments that, with the encouragement of USAID and other donors, the government has introduced since 1986 in sectors such as agriculture, the decentralized governmental units, and tourism.

U.S. economic assistance is provided to Egypt in the forms of project and sector assistance, commodity import programs and as cash transfers. The present, proposed cash transfer is based on an assessment of urgent balance of payments need that is projected for the period through December 1991. Since 1986 the provision of cash transfers for Egypt has been agreed to by Congress in order to support significant economic reforms undertaken by the government. Early in 1991, the Government of Egypt made substantial progress in implementing reform measures. By far the most important of these were the liberalization of the foreign exchange market regime, deregulation of bank deposit and lending rates of interest, and the adoption of rational, non-inflationary means of budget deficit financing. (This includes a system of Treasury bill auctions.)

Since the FY 1990 cash transfer was disbursed in August 1990, the government has made continued progress in policies related to privatizing public sector enterprises, eliminating subsidies, and correcting distorted producer prices for commodities such as fertilizer and rice. Government restrictions on marketing of fertilizer and rice have been significantly reduced and, in fact, these liberalization measures are ahead of schedule. The release of this cash transfer is in recognition and support of these policy reform measures.

II. Balance of Payments Analysis

A. <u>A Temporary, But Strong External Payments Situation (74-82)</u>. From 1974 to the 1981/82 fiscal year, Egypt's external accounts were bolstered by several related events, as follows: Suez canal revenues rose from zero to $0.9 billion; net petroleum earnings from $187 million to $3.2 billion; workers' remittances from $189 million to $3.9 billion; tourism revenues from $265 million to $611 million; see Table 1. Earnings from these four key producers of foreign exchange increased by $6.0 billion, and commodity imports surged from $3.6 billion to $13.4 billion. During this period Egypt experienced a variant of an economic disorder termed "Dutch disease," whereby the boom in petroleum, tourism, remittance and

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Suez canal income was not associated with an increase in foreign exchange reserves but was accompanied instead by an equally large increase in commodity imports. By the early 1980s, the economy had become heavily dependent on the continuous rapid increase in oil exports, Suez canal dues, and workers' remittances to finance rapidly growing imports.

B. Balance-of-payments Deterioration of the 1980s. Beginning in 1981/82, Egypt's balance of payments showed signs of serious deterioration, as the current account deficit passed $3 billion. The evidence of Table 1 indicates a large and persistent negative trade balance, growing interest payments, and stagnation of Suez canal revenues. No new sources of foreign exchange earnings emerged, and the current account deficit was largely financed by government borrowing which moved up from under $20 billion in 1982 to about $38 billion in 1986. In 1985/86 the capital account registered accruals of debt service arrears amounting to $1.1 billion. Thus, by 1986 ordinary commercial credit sources and donor flows could no longer finance the excessive foreign payments, and the government was building up arrearages to most of its foreign creditors. The ensuing years brought further deterioration. By 1988/89 the trade deficit was $7.6 billion under the pressure of sharply lower petroleum earnings while the capital account balance had moved from accustomed net inflows in excess of $2.0 billion annually to a net outflow of $0.7 billion. In 1988/89 external payment arrears reached $4.3 billion and the strong decline in external net lending to private and official sectors also confirmed Egypt's diminished access to external ordinary finance.

C. Remedial Actions. In 1985/86 the government introduced a series of measures to alleviate the balance of payments problem including a real depreciation of the Egyptian pound and trade restrictions to control demand for foreign exchange. In 1986 the government also initiated negotiations with the IMF on an economic stabilization and adjustment program to be supported by a standby arrangement and by a Paris Club debt rescheduling. The GOE reached an agreement with the IMF in April 1987 and subsequently a package of economic reforms was introduced and a Paris Club rescheduling was concluded to defer $6.4 billion of debt service arrears and obligations that had been scheduled to be paid during January 1987-June 1988. However, this rescheduling and domestic policy reforms were not adequate to arrest the underlying balance of payments disequilibrium and restore external creditworthiness. The policy shortfalls included inadequate reduction of the public sector deficit and, therefore, continued undue reliance on money creation to help finance the fiscal deficit with associated pressures toward inflation and exchange rate depreciation. In late 1989 Egyptian authorities again sought IMF and World Bank assistance to construct a viable economic reform program, and negotiations continued through 1990 on a new standby arrangement and a World Bank Structural Adjustment Loan. Fundamental issues in these discussions have included the size of exchange rate and interest rate corrections, the schedule for eliminating key price distortions, and a program for reducing the public sector deficit to a manageable level.

D. Impacts of the Gulf Crisis. The Gulf crisis and war have impacted both negatively and positively on Egypt's balance of payments, that is with exceptionally high losses accompanied also by exceptionally high external assistance. An official estimate for Egypt's 1990/91 balance of payments is not yet available. However, as points of departure, estimates presented in Table 1 for 1988/89 and 1989/90 can be viewed as useful guides to 1990/91 performance. Table 2 presents our estimate of the impact from the the Gulf crisis and war on Egypt's 1990/91 B/P current account. It can be noted that the Government of Egypt also has some expenditures that are strictly domestic expenditures for refugee repatriation and job creation, which are estimated by us at about $ 770 million, but which impact only marginally on the current account of the balance of payments. Turning to the expected net negative impact on Egypt's balance of payments, offsetting the $ 2.8 billion negative impact presented in Table 2, Egypt has received pledges of exceptional assistance related to the Gulf war and crisis approximating $ 4.3 billion. This assistance is composed of (a) cash foreign exchange grants and credits and (b) the accelerated utilization of existing signed grants and loans. The former impact is presently estimated in the range of $ 1.5 billion to $ 2.0 billion for 1990/91. The latter is more speculative as to amount and timing. Even though accelerated utilization is agreed upon, we expect that delays may reduce the amount utilized in 1990/91.

As a summary view, present estimates suggest that the B/P cost of the Gulf crisis for the current fiscal year has been fully financed. If so, this would place the remaining current account deficit at the same order of magnitude as for 1989/90. This then leaves the open question as to how a deficit approximating $3.0 billion will be covered. Forgiveness of military debt owed to the U.S.G. is one part of the answer with a net favorable impact of $ 700 million in CY 1991. The remainder of the answer, with a likely order of magnitude of $ 1.5-2.0 billion, lies either in continued building up of debt service arrearages or a substantial rescheduling of external debt service. Such a gap-filling rescheduling by Paris Club creditors has been approved in principle, by them, provided the GOE adopts sufficient policy measures to win a Standby Agreement with the IMF (which will also imply a Structural Adjustment Loan from the World Bank). Consequently, although the FY 1991 USAID Cash Transfer is relatively small in terms of Egypt's existing balance of payments gap, it is a significant complement to other sources of assistance, all with the goal of assisting the Egyptian effort to strengthen national economic performance.

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Table 1: Balance of Payments, Selected Years & Items, 1974-1989/90
(in billions of dollars)

	1974	1978	1981/82	1985/86	1988/89	1989/90
Trade Balance	-1.7	-3.4	-7.6	-5.9	-7.5	-7.6
Commodity Exports, FOB	1.9	2.6	5.8	3.4	2.8	3.2
--Petroleum	0.3	1.3	4.7	2.2	1.1	1.2
--Non-Petroleum	1.6	1.3	1.1	1.2	1.7	2.0
Commodity Imports, CIF	-3.6	-6.0	-13.4	-9.3	-10.3	-10.8
Tourism inflow	0.3	0.7	0.6	0.8	2.1	2.2
Suez Canal	--	0.5	0.9	1.0	1.3	1.5
Workers'remittances	0.2	1.7	1.9	3.0	3.5	3.7
Official interest	-0.1	-0.3	-0.9	-2.3	-3.4	-3.6
Current Account Balance	-1.6	-1.4	-3.5	-3.2	-3.4	-3.1
Direct Investment	0.1	0.4	0.9	1.3	0.1	
Private Loans	0.1	0.1	--	0.1	-1.3	
Official Loans & Grants	1.2	1.8	1.4	1.1	0.5	
Capital Account Balance	1.4	2.3	2.3	2.5	-0.7	
Errors & Omissions	-0.9	-0.5	1.2	--	-0.7	
Change in Arrears				1.1	4.3	
Over-all Balance*	-1.1	0.5	--	0.4	-0.5	

Note: * Negative indicates increase in net international reserves of the banking system.

Table 2: Impact of the Gulf Crisis & War on Egypt's Balance of Payments Current Account, 1990/91

Current Account Items	Impact for 1990/91 (Millions of US dollars)
Petroleum Export Revenue	+ 650
Suez Canal Tolls	- 175
Tourism Receipts	- 1700
Boycott of Iraqi Trade	- 100
Lower Egypt Air earnings	- 170
Reduced workers' remittances	- 1050
Loss on Egyptian firms' contracts	- 150
Current account impact of refugee and job creation repatriation*	- 135
Total B/P Current Account Impact	- 2830

NOTE: * This estimate includes only 30 % of the total cost of refugee repatriation and none of the costs of job creation for refugees. These other costs are local currency costs of the GOE and are estimated at $770 million.

III. Structural Adjustment Program

The Egyptian economy became highly centralized following the revolution of 1952. In the industrial sector, outright public ownership of industrial firms became the norm. Rigid public sector regulation was imposed on those economic segments that escaped nationalization. The price system was prohibited from performing the function of allocating resources according to scarcities and consumer preferences. State planning decrees took over that function. Economic efficiency was not the dominant objective of the state, and the resulting configuration of the economy was one that, by the late 1980's, had become a major impediment to any economic progress at all.

Goods for which there existed an eager external market (high quality cotton and cotton garments most notably) were substantially prevented from entering export markets and earning precious foreign exchange. Production facilities (in cement, for example) were operated using technologies that were so inefficient they had virtually no possibility of covering their operating cost. Factory sizes and locations were selected on the basis of criteria unrelated to international competitive norms. Product mix was dictated to protect inefficient public enterprises. Credit markets were operated in a manner that, de facto, penalized saving relative to consumption, related credit availability positively to the size and duration of operating losses, encouraged inadequate fiscal management and assured annual bouts of price inflation. Information and data, even of the most innocuous kind in a national security sense, often were treated as a state secret.

In this environment, private investment, needless to say, was small and was often mis-directed in response to distorted price and cost relationships. The market-supporting institutions that help a competitive, private enterprise economy to work smoothly, promptly and efficiently, were not formed. Thus there is no significant private equity market nor public sector understanding of how to oversee its integrity. Markets in financial instruments for hedging risk are underdeveloped or non existent. Institutions and trade associations for private export promotion and, in general, for connection with international marketing channels and information sources are not well developed and have not been encouraged.

Against this daunting structural backdrop, USAID has, since 1984, conducted a comprehensive policy dialogue with the GOE. Its principal objective has been to complement the efforts of other donors, especially the World Bank (IBRD), to correct those elements of policy that prevent the realization of the economic efficiency and growth that a healthy private market economy, directed by a set of prices and costs determined by the forces of competitive supply and demand, can deliver. Our emphasis has been on the financial markets (for both domestic credit and foreign exchange), agriculture, the trade regime, and, to a lesser extent, the industrial sector.

In mid-1989, the government began discussions with the World Bank for a Structural Adjustment Loan (SAL). The policy agenda for the SAL focuses on reforms in industrial policy; price liberalization for industry, energy, and agriculture; and the trade regime. It would be complementary to the macroeconomic reform program the GOE and the IMF have negotiated. In early 1991, significant progress was made in designing the reform program and setting its implementation schedule. The important elements of this agenda include: 1) the sale of public companies and assets owned by the public sector; 2) the transformation of the remaining public sector companies to a more market oriented basis of operation; 3) liberalizing investment laws to remove barriers to private sector investment; 4) significant reductions in subsidies in energy, transportation, pharmaceuticals, consumer goods and agricultural inputs; 5) significant improvement in the pricing of cotton and rice; 6) a reduced and tightly controlled government investment budget; 7) removal of trade restrictions; and 8) reform of the tariff structure.

Since 1984, USAID has provided to the Government of Egypt $1.3 billion as Cash Transfers. The provision of Cash Transfers has been closely associated with USAID's policy dialogue effort, and since 1986, Cash Transfers have been conditioned on the implementation of economic reforms. The FY 1986 Cash Transfer recognized a significant reform in the trade regime and customs tariffs. The FY 1987 Cash Transfer was supported by exchange market reforms which led to the May 1987 standby arrangement with the IMF and Paris Club rescheduling. The FY 1988 Cash Transfer was supported by a wide range of reforms including modifications in the exchange rate system, improved energy pricing and the opening of the tourist sector to significant private sector involvement. The FY 1989 Cash Transfer was based on substantial measures that were taken to further correct energy prices, to rein in consumer subsidies, and to begin the process of liberalizing industrial sector prices. The FY 1990 transfer, disbursed in August 1990, was timely as it helped Egypt manage the immediate and direct costs it suffered due to Saddam Hussein's invasion of Kuwait. It also was a recognition of progress of the GOE's privatization, industrial price liberalization and agricultural sector policy reforms that strengthened the private market mechanism.

IV. Justification for the Cash Transfer for FY 1991

A. Relationship of Assistance to Egypt's Foreign Exchange Requirements

As described in Section II.C, the proposed USAID Cash Transfer for FY 1991 is expected to help meet Egypt's balance of payments financing needs during the period April-December 1991. During that period, the greatest needs for the economy will be to finance imports and other foreign exchange needs of the Egyptian private sector. USAID staff projects that the private sector will continue to suffer a sharp decline in available foreign exchange from tourism and remittances--the two main sources that feed the secondary (private) foreign exchange market.

In contrast, the public sector may show a marked improvement in its availability of foreign exchange--through its higher oil export revenues, receipt of new cash transfers from Arab donors, and fast-disbursing assistance from the U.S. Government. There may well be some offsetting budgetary and foreign exchange costs to the GOE--for example, an ongoing military presence in the Gulf. Although the net foreign exchange (and budgetary) receipts to the government during 1990/91 from oil revenue and from official transfers are likely to show a substantial increase in comparison to 1989/90, it now seems likely that the world market price for oil will be well below Fall 1990 values.

Against this background, it is probable that during coming months the GOE will need to sell some of its foreign exchange proceeds in the commercial bank market in order to allocate foreign exchange efficiently in the economy as a whole. The newly improved foreign exchange system will lead to a more efficient overall integration of the commercial bank and Central Bank exchange markets. It is the intention of the Government and the IMF that the new foreign exchange market reform represents only the first step toward the full unification and deregulation of the market within one year. USAID believes that the proposed Cash Transfer for FY 1991 will be helpful to the GOE in weathering the short term exchange market pressures that invariably attend major changes in the foreign exchange regime.

B. Significant Economic Reforms

As established in the Foreign Assistance Appropriations Act for FY 1991, Cash Transfer assistance for Egypt may be provided "with the understanding that Egypt will undertake significant economic reforms which are additional to those which were undertaken in previous fiscal years." A number of such reforms were reported in the PAAD for the FY 1990 Cash Transfer. Additional recent reform measures that have been implemented are noted and discussed below. These reforms provide evidence of continuing GOE resolve to implement a structural adjustment program that will shift the economy from central control to a market basis and is considered to justify the release of the proposed FY 1991 Cash Transfer.

1. Foreign Exchange Market

The GOE has implemented a foreign exchange market regime that is an important step to full unification with a single, market-determined exchange rate. It replaces the previous chaotic and highly distorted system which was characterized by an unrealistic "official" market, a lawful market allowing banks only as traders, and myriad black markets and rates. Under the new system, there will be two markets, called "Primary" and "Secondary." The primary market will be supplied from exports, Suez Canal revenues and government transfers. Payments through the primary market will consist, in the first instance, of Central Bank obligations. If surplus funds are available public and private sector imports will be financed as well. The secondary market will have as its source of foreign exchange, workers' remittances, tourism and transfers. It is expected that each of the two markets will have about half of annual transactions. The exchange rate in the secondary market will be established freely according to the forces of supply and demand. The primary market rate (the LE price of units of foreign exchange) will be set by the Central Bank daily, and will not be less than 95 percent of the secondary rate.

In establishing the new regime, the GOE also committed itself to the following additional liberalizing measures:

* Non-bank foreign exchange dealers are free to sell and purchase foreign currency (cash and travellers'checks) on a "no questions asked" basis.

* Forward foreign exchange purchase and sale contracts may now be entered into.

There are widespread rumors of banks declining to buy and sell foreign exchange freely and of Central Bank "jawboning" to try to keep the exchange rate from moving "too much" and "too soon." This is common in the early stages of liberalization, and is usually short-lived. Nevertheless it bears watching, and both the IMF and USAID/Cairo are monitoring the new system closely. The final step in the full unification is to occur within one year according to a GOE-IMF understanding. At that time public and private buyers and sellers will deal in a single market in which the exchange rate is determined by market demand and supply.

2. Deregulation of Interest Rates

In January, the Central Bank eliminated official ceilings on interest rates on both the assets and the liabilities of banks. This step, which had long been encouraged by USAID as well as by the IMF and the World Bank, is an important complement to the liberalization of the foreign exchange market. Egyptian banks will now be able to compete more effectively for Egyptian savings that have frequently been lodged in financially more attractive foreign bank accounts. In addition, it is anticipated that, as the free market gains confidence and aggressiveness, it may offer rates high enough to induce higher levels of saving as well.

Perhaps as important as its potential payoff in mobilizing saving, is the rationing function the market for loanable funds can now perform. Presumably, interest rates on loans will rise to become positive in real terms and will thereby deprive projects that can not meet that performance test of finance. In time, and coupled with other reforms now being imposed on banks, this should mean that publicly owned enterprises that now produce goods and services of less value than the resources consumed in producing them, will have to improve their efficiency or close. Thus, the reform of banking markets is of great importance in both the structural and the macroeconomic realms.

3. Rationalization of Deficit Finance and Strengthening Monetary Policy Instruments

With technical assistance from the IMF and AID, the GOE established in January an auction market for Treasury Bills, with no regulation of yields. This new channel of borrowing will replace the former system under which the GOE financed much of its deficit spending by way of overdrafts drawn on the Central Bank. This change should help establish competitive real rates of interest, give the private sector an even chance at scarce credit, and improve Central Bank control of monetary expansion.

A parallel measure established a policy of maintaining the Central Bank's discount rate (the interest rate at which banks borrow from the Central Bank) at 2 percentage points above the latest T-Bill auction rate of interest. This move is in the direction of making the discount rate a penalty rate so that banks will repair to the discount window only as a last resort to meet their reserve requirement. This will improve the Central Bank's ability to regulate the growth of monetary aggregates consistently with monetary policy targets.

4. Reduced Subsidies.

Inflationary finance of the public sector budget has been a long-standing problem in Egypt. Both the IMF and the World Bank, in addition to USAID, have placed this problem high on the list of hurdles to be overcome. Subsidies to consumer goods are very high in Egypt and have been a significant part of the problem.

In the past four months, significant measures have been adopted by the GOE to reduce budget deficits. In December and January, the Ministry of Supply implemented sharp reductions in the subsidies to basic consumer goods provided through the ration system. Rice, tea and soap were among the basic consumer basket items whose prices increased as a consequence of these measures. In the aggregate, these measures are expected to lower the GOE's food subsidy an impressive LE 477 million, which is in the neighborhood of one half of one percent of GDP.

As in the case of planned increases in energy prices, in the neighborhood of 50 percent, to which the GOE has now agreed with the World Bank and the IMF, these are significant and politically difficult increases in the cost of living for low income families. It confirms the Government's willingness to take short-term risks in the interest of longer term economic development.

5. Liberalization of Rice Market

Under the terms of an agreement between USAID and the GOE on the Agricultural Production and Credit Project, the GOE was to phase out by 1992 the 25-year old system of forced delivery of half the rice crop to the Government at far below world market prices. Intermediate benchmarks were established for 1990 and 1991. Additionally, government imposed restrictions on the private milling and marketing of the other half of the rice crop were to be phased out over the same time period. After meeting the 1990 benchmarks, the GOE moved in 1991 to meet all of the liberalization targets that had been set for 1992.

Independent checks by USAID confirm that farmers have been informed that the 1991 procurement quotas have been cancelled and that the marketing restrictions are no longer in effect. This represents a significant advance as the area planted in rice, at about one million feddans, rivals the area dedicated to cotton. Rice has considerable export potential as well as some potential substitutability for imported feed grains, once the price incentives of international market conditions are permitted to reach Egyptian farmers.

V. Other U.S. Non-project Assistance

A. Commodity Import Program

Since the resumption of economic assistance to Egypt in 1975, $4.6 billion have been provided under the Commodity Import Programs. Currently, $200 million are provided annually to Egypt by legislative earmark for public sector and private sector CIPs. These CIPs help finance imports of needed raw materials and other commodities.

This year, the amount of resources Congressionally earmarked for CIP has been divided to provide $50 million to the public sector and $150 million to the private sector. This split follows from the government's increased emphasis on greater private sector involvement in the economy. During the past few years, and particularly last year, the government has eliminated its import monopoly on a number of important commodities, including wheat and corn. In addition, the government has been attempting to change the policy environment to encourage greater private sector exports. The private sector has shown an interest in assuming the responsibility to import bulk agricultural commodities.

The private sector CIP has helped the private sector gain access to foreign exchange throughout the last three years of tight public sector control of the foreign exchange market. The recent liberalization, once it is fully operative, should go a long way toward eliminating the difficulty the private sector has had in securing foreign exchange. This situation is being monitored carefully. Nevertheless, we anticipate that the FY 1991 CIP will continue to be important to the private sector.

B. Concessional Programs for Agricultural Commodities

From 1975 through 1990, the U.S. government financed $3.3 billion in PL480 Title I and III commodities. The FY90 program level was initially set at $153 million but was supplemented in August 1990 by an additional $50 million for commodity deliveries in September-December 1990. The major portion of this assistance has been for wheat grain and flour. These PL480 shipments complement GSM-102 guaranteed and CIP-financed shipments of corn, vegetable oil, tallow and of other consumer goods in helping provide a higher level of domestic consumption than Egypt's stringent balance of payments situation would otherwise permit.

During the Spring of 1991 an additional $ 55 million of agricultural commodities are to be provided to Egypt under Section 416 of the Agricultural Act of 1949. The commodities are expected to include sorghum, corn, and butter oil.

VI. Impact on U.S. Balance of Payments

Part of the Cash Transfer grant is expected to be spent on imports from the United States, and part on debt service payments owed to or guaranteed by the U.S. Government. However, it is not expected that the Cash Transfer would result in any continuing positive or negative effects on the U.S. balance of payments.

VII. Cash Transfer Implementation

A. Uses of Cash Transfer Proceeds

Grant proceeds may be used by the Government of Egypt (GOE) for any or all of the following purposes determined by the GOE to be necessary for balance of payments purposes:

(1) Financing the import of capital goods, raw materials and other goods and related services deemed essential by the GOE. The source and origin will be AID Geographic Code 000 unless otherwise requested by the Government and agreed to by AID.

(2) Servicing of U.S. Government or U.S. Government guaranteed debt* except military or "ineligible" debt. "Ineligible" debt refers to debt arising from, for example, police related equipment or other items considered by AID to be inappropriate for AID financing. (A Grant Agreement covenant will prohibit such "ineligible" expenditures.)

(3) Other purposes or uses as subsequently agreed between the parties (e.g., payment of non-U.S. debt or non-U.S. guaranteed debt or procurement of commodities from non-U.S. source/origin).

In negotiating the above uses, we noted that under AID's Amplified Policy Guidance for ESF Cash Transfers (October 20, 1987), countries receiving cash transfer assistance may use the proceeds for purposes (1) and (2) noted above (imports from the U.S. and debt service to the U.S.) in that order of preference. In this regard, the GOE has indicated its intention to use the cash transfer proceeds for items (1) and (2). USAID considers that any combination of these two uses - (1) or (2) - would be appropriate under the circumstances and that we need not require a specific justification for the combination which the GOE in fact chooses. Also, we believe the GOE should be encouraged to use cash transfer resources, within the parameters of the two specified eligible uses, for purposes which the GOE determines for itself are most effective and efficient. In sum, we believe the above-outlined arrangements concerning use of proceeds - arrangements which will permit the GOE to make its own choices within two categories of eligible uses - reflect a due appreciation for AID's policy preferences within the Egyptian context. Thus we do not plan to carry the concept of an "order of preference" over into the Grant Agreement -- since to do so would raise, undesirably we believe, issues for still further negotiation, justification and documentation subsequent to Grant Agreement execution. Therefore, the Grant Agreement will not reflect any "order of preference" between the two specified eligible uses. However, should the GOE later wish to use cash transfer proceeds for <u>other</u> purposes, then AID would request the GOE to provide us with evidence that no pressing requirements exist under the two specified uses before AID would concur in alternative uses.

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* The AID/W policy guidance does not explicitly equate debt <u>guaranteed by</u> the USG with debt <u>owed to</u> the USG. However, the policy purposes seem very similar and we are, in fact, equating the two for this purpose.

Also, we note from the AID/W cash transfer policy guidance that any use of cash transfer proceeds to service debt owed to any institution (U.S. or otherwise) is permissible only where a showing can be made that such debt service requirement "is a significant barrier to growth and development." In the case of Egypt, the critical element is that continuation by the GOE of debt service payments to U.S. and other official creditors is necessary to maintain sufficient creditworthiness to gain access to new loans and grants from those creditors. Such loans and grants are, in turn, required to finance a major portion of the foreign exchange and investment expenditures needed to facilitate a resumption of economic growth.

USAID has not yet been advised by the authorities of the Central Bank of Egypt regarding the planned allocation of this Cash Transfer between commodity import financing and debt service payments.

B. Special Account for Cash Transfer Dollars

A provision of the FY 91 Appropriations Act specifies that countries receiving cash transfer assistance establish a separate account for the dollar assistance. Policy guidance on ESF Cash Transfer Assistance in Handbook 1 and AID-issued guidance for the financial management of dollar separate accounts in STATE 194322 (June 17, 1990) offer further guidance on interpreting this provision. Accordingly, the following procedures apply to the establishment of this account for Egypt:

This account will be used solely for the receipt of FY 91 appropriated cash transfer assistance from AID. The proceeds will not be co-mingled with other funds from any other source. Should any interest be earned on such account, such interest will be treated as though it were grant proceeds received under the terms of the cash transfer agreement. Any required redeposits (from hypothetical misuse of funds) will be similarly treated.

C. Monitoring and Audit

Egypt will advise AID in writing quarterly of disbursements and the uses to which such grant proceeds have been put. The accounting books and records will be available for inspection by USAID or AID's designee for a period of three years following the date of last disbursement of the grant. Evidence of uses would include letters of credit for imports, cancelled documents of loan indebtedness, and the like.

The grant agreement and implementation letters will contain provisions for accounting, reporting and monitoring of the grant proceeds in conformance with dollar special account guidance issued in State 194322 dated 6/17/90. Specifically in regard to this guidance and the need to assure the capability of the implementing agency (GOE Central Bank) to adequately manage the special non-comingled account, the Mission has reached a positive determination. This judgment is based on the Bank's excellent management of the FY 1989 and FY 1990 cash transfer special accounts, the fact that this authorization is for a very similar program, and the fact that Regional Inspector General/Cairo conducted an assessment of the FY 1988 cash transfer special account transactions with no adverse findings on the Bank's management. The capability of the implementing agency is therefore reasonably assured.

D. Local Currency

FAA Section 531 (d) requires that, to the maximum extent feasible, ESF-funded Commodity Import Programs and "other program assistance" be used to generate local currencies, not less than 50 percent of which is used to support activities consistent with the objectives of FAA Sections 103 to 106.

"Generations" occur for this purpose when commodities are imported using Cash Transfer funds; and "generations" are computed (as under Commodity Import Program arrangements) on the basis of the highest official exchange rate (LE per dollar) available to importers for any transaction. The grant agreement will not require local currency generations for Cash Transfer dollars used to pay eligible debt service. The reason for this is that such deposits typically would not be financed by any new government revenue (e.g., from resale of imported commodities). Section 575 of the FY 1991 Appropriations Act requires that a separate account be established for local currency generations. The Grant Agreement will provide that any such local currency generations will be deposited in a new separate account at the Central Bank and not be commingled with any other funds.

VIII. Beneficiaries

As the FY 1989 CDSS stated, over the long run, a comprehensive reform program will benefit the poor by stimulating employment opportunities as the economic situation improves. Structural changes induced by sectoral policy reforms and expected to shift the economy toward relatively more labor intensive production technologies. The resulting increases in demand for labor should help raise wage rates as well as employment.

The cash transfer will help to alleviate some of the negative impacts of the current period of austerity, job losses associated with the Iraqi invasion of Kuwait, and a condition of economic stagnation in Egypt--by providing badly needed foreign exchange resources for commodity imports and debt payment. Further, the cash transfer affords USAID a voice in policy discussions with the GOE to advise on the needed direction of reform to lead toward a sustainable, growing economy where incomes and employment will increase.

To assist a resumption of growth driven by private sector investment, the Government is preparing and has begun to implement a significant liberalization of investment procedures and the external trade regime. It is also about to embark upon a restructuring of inefficient public sector industries. These programs are expected to improve the investment climate, create new jobs and income, and to expand exports and foreign exchange savings.

IX. Recommendation

The Project Committee recommends that, at this time, a $115 million cash transfer to the Government of Egypt (GOE) be approved and authorized. An OMB funds apportionment for this transfer was reported to the Mission on May 17, 1991. Obligation of funds (through execution of a Grant Agreement) would take place upon satisfactory outcome of the Congressional Notification procedure.

X. Authority

Under Delegation of Authority No. 653, the Egypt Mission Director may approve and authorize non-project assistance without dollar limitation when a Program Assistance Initial Proposal (PAIP) has been approved by AID/W for programs over $20 million. In this case, AID/W did not require preparation of a PAIP, and approved authorization of this cash transfer on the basis of consultations between USAID and AID/W.

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NONPROJECT ASSISTANCE STATUTORY CHECKLIST

As of the date this checklist was prepared the General Counsel's office had not yet issued the FY 1991 Statutory Checklists. What follows is the FY 1990 checklist for nonproject assistance, the substance of which is nearly identical to this year's legislation. What few changes have been made, as in the Cash Transfer provisions of the Appropriation Act, have been included herein.

GROSS REFERENCES:	IS COUNTRY CHECKLIST UP TO DATE?	Yes
	HAS STANDARD ITEM CHECKLIST BEEN REVIEWED?	Yes

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1.	FY 1990 Appropriate Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project.	Congressional Notification submitted on May 1, 1991. Waiting period expired without objection on May 16, 1991.
2.	FAA Sec. 611 (a) (2). If further legislation action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?	N/A. Signed grant agreements are submitted for *pro forma* ratification by the legislature, but the signed agreements are legally binding and effective without such ratification.
3.	FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs.	No. The assistance will not have a direct effect on regional development programs.
4.	FAA Sec. 601(a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and	The assistance supports economic reforms which are favorable to (a), (b) and (e). The reforms are neutral to (c) (d) and (f).

competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions.

5.	FAA Sec. 601(b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	The assistance will not directly encourage U.S. private trade or investment or private U.S. participation in Foreign Assistance Programs.
6.	FAA Sec. 121(d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds?	N/A

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a.	FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?	Yes Yes
b.	FAA Sec. 531(e). Will assistance under this chapter be used for military or paramilitary activities?	No
c.	FAA Sec. 531(d). Will ESF funds made available for commodity import programs or other program assistance be	Dollars may be used to finance commodity imports in which case an equivalent amount of Egyptian pounds

used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

will be generated and used for the same developmental purposes as local currency generated under CIP and other programs, subject to the 1980 Memorandum of Understanding Regarding Special Account, as amended. At least 50 percent of the local currency will support such activities in accordance with the 1980 Memorandum of Understanding Regarding Special Account, as amended.

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

N/A (assistance is provided as cash transfer, not as commodity grant, but dollar-financed commodity imports will generate local currency subject to special account arrangements).

e. FY 1991 Appropriations Act, Title II, under heading "Economic Support Fund," and Sec. 575. If assistance is in the form of a cash transfer; (a) Are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) Will all local currencies that may be generated with funds provided as a cash transfer to such a country also be deposited in a special account, and has A.I.D. entered into an agreement with that government setting forth the amount of the local currencies to be generated, the terms and conditions under which they are to be used, and the responsibilities of A.I.D. and that government to monitor and account for deposits and disbursements? (c) Will such local currencies be used for such purposes as debt and deficit financing or project and sector assistance activities, or for the administrative requirements of the USG? (d) Has

(a) Yes
(b) Yes
(c) Yes
(d) Yes

Congress received prior notification providing in detail how the funds will be used, including the U.S. interests that will be served by the assistance, and, as appropriate, the economic policy reforms that will be promoted by the cash transfer assistance?

2. Nonproject Criteria for Development Assistance

a. FAA Secs. 102(a), 111, 113, 281(a). Extent to which activity will: (1) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (2) help develop cooperatives especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economics of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries?

N/A

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21. Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source

N/A

is used for assistance, include relevant paragraph for each fund source):

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made;
(b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated

delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens nonformal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

(4) [106] for energy, private voluntary organizations, and selected development problems; if so, extent activity is:

(i)(a) concerned with data collection and analysis, the training of skilled, personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises marketing systems for small producers, and financial for other institutions to help urban poor participate in economic and social development.

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multidonor development plan which calls for equitable burden-sharing with other donors; (b) has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?