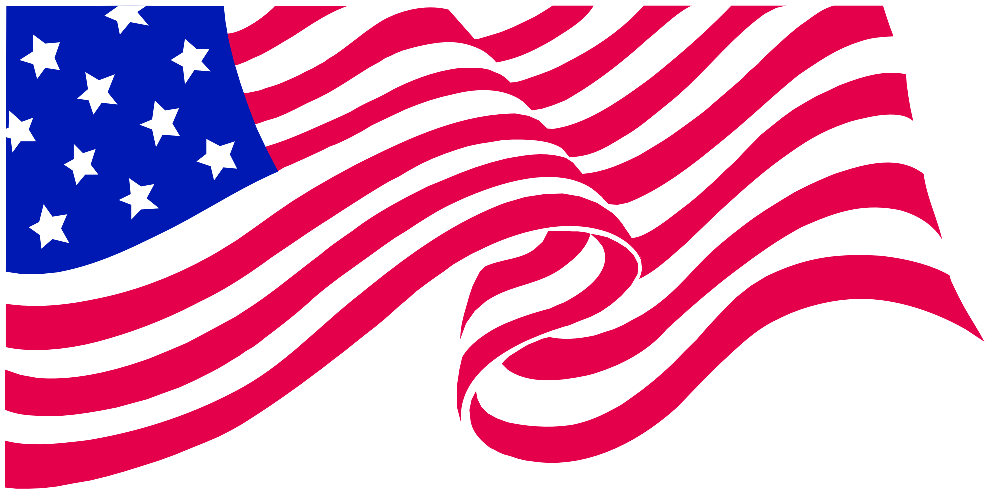

Economic Trends Report

Egypt

April 2006

Embassy of the United States of America

The information in this report covers developments through February 2006.

This report is a product of the **ECONOMIC AND POLITICAL SECTION** of the American Embassy, Cairo, Egypt. The Embassy welcomes questions or comments on this report. Comments should be directed to:

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MAJOR TRENDS AND OUTLOOK

With a real GDP growth rate in the range of 4.5-5.1% in the fiscal year July 2004 - June 2005 (FY 2004/2005 or FY 04/05), up from around 4.1% in FY 03/04, Egypt's economy appears to have broken out of the stagnation of 2000-2003. Strong foreign earnings have been the key driving force. We expect a rebound in private investment, including a strong component of foreign investment, to maintain the economic recovery in the near term. A pick up in domestic demand is also likely, and should aid in sustaining growth. The economic recovery has not, however, translated into badly needed job creation. With annual entrants to the labor market on the order of 600,000-700,000, unemployment remains a significant challenge. The official unemployment figure rose from 9.85% in FY 03/04 to 10% in FY 04/05, though some estimates place the real figure closer to 20%. While inflation figures for the Consumer Price Index (CPI) were relatively scarce until July 2004, official reports on the inflation level since then indicate double-digit inflation in the range of 17-18%. Starting in January 2005, however, inflation receded sharply and decreased to 3.2% by November 2005, giving the Central Bank leeway to cut back interest rates in a newly established inter-bank rate corridor system. We expect inflation to rise moderately from the current limits, given the fading impact of depreciation, a more expansionary monetary policy and domestic demand emerging from a low base.

In September 2004 the Central Bank established an inter-bank market for foreign exchange and in December 2004 officially adopted a convention governing trading in the market. Concurrently, the government abolished the foreign exchange surrender requirement. Coupled with surpluses in the current and financial accounts ($2.9 billion and $3.3 billion respectively in FY 04/05), these reforms led to a converging of the parallel and bank exchange rates and an appreciation of the Egyptian currency (Pound or £E) to 5.75-5.77/$ from 6.15-6.20/$. Despite upward pressure due to an increase in foreign exchange availability, we expect the Pound to remain stable or appreciate only slightly, in light of unstated reluctance by monetary authorities to accommodate a large appreciation. The projected fiscal deficit declined to 9.2% in the FY 05/06 budget approved by parliament, down from 10.3% in FY 04/05. In all likelihood, the actual deficit will increase over the previous fiscal year, unless the government undertakes comprehensive reform of subsidies and bloated public sector personnel rolls.

A vigorous parcel of reforms initiated by the government of Prime Minister Nazif in July 2004 has reversed several years of malaise in the domestic and foreign business community. Important structural reforms were initiated in Egypt's trade and tax regimes and the financial sector, and the privatization program was revitalized. The Cabinet reshuffle of December 2005 indicated that reform would continue. Reform-oriented ministers, including those in the ministries of finance, investment and foreign trade, remained in place and a number of other ministers with private sector credentials were appointed to key positions. The new Cabinet is expected to carry out additional reforms in the banking sector, public expenditure management and privatization. Continued reform should maintain the confidence that is needed to prompt higher private investment and domestic demand.

Low foreign debt and debt service will continue to be strong factors in Egypt's favor, with most debt long-term and concessional. Egypt's foreign exchange reserves are capable of covering more than ten months of imports. The sectoral outlook of the economy is bright, especially with the pro-reform trend confirmed by the composition of the new cabinet under the incumbent Prime Minister Dr. Ahmed Nazif. The foreign component – exports and foreign investment, either greenfield or through privatization – will play a major role in the growth and development of economic sectors.

KEY ECONOMIC TRENDS AND ISSUES

Macroeconomic Outlook: The modest recovery in economic growth in FY 03/04, officially 4.0%, became more pronounced in FY 04/05. The government announced preliminary growth figures of 5.1% for the fiscal year ending June 2005, apparently fulfilling the target for the year. With an annual population growth rate slightly above 2%, real per capita GDP increased by 3.1%, up from 2% in the previous year. While the increase in real per capita GDP is significant, it may not have translated into increased income for a large segment of the population, due to income distribution biases. Independent observations put the growth rate at 4.8-4.9%, slightly below the official figure. The government is targeting a 6% growth rate with its development plan for FY 05/06.

Accurate inflation figures, based on the CPI, were difficult to obtain prior to mid 2004. Since then the government has acted to address significant inadequacies in the Index, and incorporated changes in the basket of goods and services in order to provide a better assessment of inflation. Over the second half of 2004, the inflation rate according to CPI was in double-digits, hitting 17.3% in December 2004 – a lagged expression of the large nominal depreciation of the Pound in 2003. As of January 2005, inflation on the basis of CPI had fallen back from double digits and decreased to 3.2% by November 2005. The Wholesale Price Index (WPI), generally a better indicator of inflation, given its lower reliance on subsidized goods and services, also receded significantly from 13.9% in December 2004 to 3.8% in November 2005. The decline in inflation reflects the nominal appreciation of the Pound since the start of 2005 and a more focused monetary policy. Figures, however, point to a pick up in inflation in September 2005, with the WPI recording 7.7% on an annual basis. A jump in petroleum import values in the fourth quarter of FY 04/05 (April to June 2005) as well as a rise in prices of construction materials were the main factors affecting the pick up in inflation.

The pick up in economic growth has yet to translate into job creation. A preliminary official estimate of unemployment placed it at 10.0% in FY 04/05, up from 9.85% in FY 03/04, 9.9% in FY 02/03 and 9.0% in FY 01/02. The previous years' figures reflect upward revisions in June 2002 and June 2003. Outside observers suggest the effective rate of unemployment is significantly higher, perhaps as high as 20%. Under-employment and reliance on the informal economy (often estimated at one third to one half the size of official GDP) are also major features of Egypt's economy, as in many other developing countries. An independent field study, conducted by the Egyptian

Center for Economic Studies and the Institute of Liberty and Democracy in 2004, estimated the size of the workforce in the informal sector at 8.2 million individuals, compared to 6.8 million in the regular private sector and 5.9 million in the public sector. The study added that while this estimate of the informal sector was large, the actual figure could be even larger if the definition of informal sector were adjusted to incorporate enterprises not adhering to legal standards, such as tax payment. Official and private estimates put the number of job seekers entering the labor market annually at anywhere from 600,000 to 700,000. With a backlog of job seekers resulting from the sluggish growth of the past few years, actual annual employment demand could be even higher than the acknowledged figure. Underemployment is also a significant problem, primarily for the better-educated members of the workforce. Even during the high-growth years of the 1990s, employment creation did not fully meet the demand for jobs. We estimate that GDP growth rates need to rise well above 6% in order to absorb the demand for jobs. The urgency of employment creation and the social connotations of the problem present a major challenge for the new Cabinet, which has made stimulation of private sector led growth its main economic priority for the coming years.

As of June 2005, external debt amounted to $28.9 billion, slightly changed from $29.9 billion in June 2004. As a percentage of GDP, external debt sharply decreased from 38.1% in June 2004 to 30.0% in June 2005, reflecting the strengthening of the Pound. Over the course of the same year, the debt service ratio also retreated sharply from 9.2% to 7.9% – the lowest ratio since June 2002 – impacted by robust external earnings. The bulk of the debt (around 88%) is medium to long-term and around 70% of it is sovereign.

In March 2005, the reform efforts of the Nazif Cabinet prompted one international ratings institution – Standard and Poor’s (S&P) – to upgrade its outlook for Egypt from negative to stable. Despite the upgrade in outlook, S&P affirmed its 'BB+' long-term and 'B' short-term foreign currency and its 'BBB-' long-term and 'A-3' short-term local currency ratings for Egypt. S&P mentioned in its statement that the outlook revision reflected improvements in external liquidity, aided by a reinvigorated program of structural reforms and the related strengthening of Egypt's external balance sheet, which lowered external risks emanating from a widening budget deficit and a growing government debt burden. Concerns surrounding the unimproved public debt position prompted another institution – Moody’s – to downgrade Egypt's domestic currency long-term government bond rating to Baa1 from Baa3. In its statement, released in May 2005, Moody's Investors Service maintained all other bond ratings and the foreign currency country ceiling, and kept the rating outlook negative. According to Moody's, the downgrade reflected the continued deterioration of Egypt's public finances, which had prompted the agency to assign a negative outlook to the domestic currency bond rating in July 2001. Moody's pointed out, however, that the state of the country's public finances stood in sharp contrast to positive economic developments associated with the bold reformist stance of the new government and the strengthening of its external position.

Fiscal Developments: Significant changes in the country’s fiscal arena have taken place since the Nazif administration took office. The budget accounting methodology has been overhauled, somewhat improving transparency. The cost of some subsidies is now explicitly stated, along with actual level adjustments. The debt burden, however, remains a significant concern, one that will become more acute in the near future as the government executes a plan to re-capitalize the state-owned banks (see section on the banking sector).

In submitting the budget proposal for FY 04/05 to parliament, the Minister of Finance announced that the budget was prepared in accordance with the modified *GFSM-2001* (Government Finance Statistics Manual for 2001) of the IMF. The system is intended to provide a more accurate monitor of fiscal flows by relying on an accrual method that records resource flows at the actual time of occurrence. The Ministry of Finance (MOF) has also recently announced that a draft bill to establish a Treasury Single Account is in the pipeline. Such a law would prevent the continuous accumulation of government bank deposits in banks belonging to government institutions, an inefficiency in Egypt's cash management.

The two abovementioned reforms complement earlier moves in 2002, when the government revised its accounting method for budgetary "out-turns" (i.e., completed periods) to show three increasingly broad measures of the budget and deficits: a narrow budget that includes only line government agencies and programs; a broader definition that includes transfers to or from independent state-owned agencies, and a third definition that also includes the social insurance funds (social security), currently in surplus because of Egypt's growing working-age population. Earlier estimates of the budget deficit were based on features of the first and second definitions; the government now appears to have adopted the broadest definition as its benchmark of the deficit.

The government has revised its estimates of past budget deficits upwards several times in recent years. Based on the government's current reported figures in the new format, the budget deficit grew from 5.9% (narrow) and 2.5% (broad) in FY 01/02, to 6.1% (narrow) and 2.4% (broad) in FY 02/03. Preliminary actual figures indicate a deficit of 5.9% (narrow) and 2.4% (broad) in FY 03/04. The government estimates the deficit for FY 04/05 at 10.3% (broad). Provisional figures for the first nine months of FY 04/05 (July 2004 – March 2005) showed a deficit of 4.8% (narrow) and 2.7% (broad). Normally end-of-year transfers from the social investment funds' surplus and other revenue streams result in better annual figures than earlier out-turns might suggest. However, with no concrete spending cuts, final figures could easily bypass projections.

The FY 05/06 budget, as approved by the People's Assembly, included total expenditures of £E 187.8 billion (an increase of £E 27.8 billion, or 11% higher than FY 04/05). It estimated total revenues of £E 130.1 billion (an increase of £E 27.7 billion, or 10.2% over FY 04/05). The resultant fiscal deficit is £E 57.7 billion, or 9.2% of GDP based on an expected GDP of £E 629 billion and a GDP growth rate of 6%. In calculating the total required financing to cover the deficit, the new budget classification system reduces the deficit figure by the total of government holdings of "financial assets" (i.e., capital shares in public enterprises and authorities) and increased the deficit figure by the total of required repayment of debts. For the FY 05/06 budget, the £E 57.7 billion deficit is reduced by £E 1.73 billion, representing the government's capital shares in enterprises and authorities, and increased by £E 20.5 billion, representing repayment of local and foreign debt. The resultant figure for total financing need is £E 76.47 billion. Financing for the deficit will come from loans from the National Investment Bank (£E 14.1 billion), foreign loans (£E 909 million), and treasury bills and bonds (£E 61.4 billion). It is noteworthy that while privatization proceeds are not utilized in meeting any of these financing requirements, they are projected in the budget to rise from £E 150 million in FY 04/05 to £E 3 billion in 05/06, a dramatic increase of 1900%. The People's Assembly approved the budget in May 2005. (See annex for a copy of the budget.)

In addition to traditional social objectives and protection of the poor, the government's stated budgetary priorities include building transparency, modernizing the economy, fiscal decentralization, promoting investments, stabilizing prices, increasing employment and improving services while focusing on sectors with a comparative advantage. The largest proportion of the planned FY 05/06 budget, at £E 93.7 billion, or 50% of total expenditures, is earmarked for subsidies, grants and social benefits, including £E 8.2 billion for health and £E 24.7 billion for education. Nearly ¼ of the budget, or £E 45.8 billion, will go to paying public sector wages, up from the expected final wage bill of £E 41 billion for FY 04/05. The jump in public wages includes the annual social increment for wages of government employees, which was stipulated at 20% for FY 05/06 by a presidential decree, up from the 10% that had been stipulated annually since approximately 1993. The rise in the annual wage increase may be a delayed recognition by the government of the incongruity between wages and price increases following the Pound's devaluation in 2003-2005. The move, however, must also be assessed in light of the president's bid for re-election in Egypt's first multi-candidate presidential race in 2005.

The budget projects £E 35.4 billion for direct subsidies covering basic commodities and services, principally sugar, bread, and transportation, almost double the initial planning figure of £E 15.6 billion for FY 04/05. The increase results from the inclusion of energy subsidies in the line items of the budget. Previously, energy subsidies were classified as expenses in the operating budgets of public sector energy companies. We expect the subsidy bill to continue rising into FY 06/07 as the government proceeds with its stated intention of gradually incorporating all previously-undisclosed subsidies into the budget. According to the published budget, subsidies in FY 04/05 will include £E 9.7 billion for basic food products, down from £E 11.6 billion in FY 04/05 (the decrease being affected by the Pound's appreciation and international price changes), £E 8.96 billion for natural gas, £E 4.7 billion for butane gas, £E 6.1 for diesel fuel, £E 1.1 billion for fuel oil, £E 0.98 billion for gasoline, £E 0.22 billion for kerosene and £E 3.5 billion covering – without a breakdown – public transportation, export development, credit facilities and other forms of subsidies such as low-cost housing, farmer and cotton subsidies, pharmaceuticals and student health insurance.

The £E 110 billion-investment budget (£E 17.4 billion from the government, economic authorities, holding companies and public enterprises and £E 68 billion from the private sector – with a 62% weight for the latter) will support the government's sectoral development priorities especially in transportation, energy generation, tourism, agriculture, industry and utilities. The Ministry of Planning and Local Development is reportedly developing a database on the investment opportunities open to the private sector across all governorates.

Projected total revenues for FY 05/06 (not including the social insurance funds surplus) increased by 27% over the FY 04/05 revised figures to £E 130.1 billion. The new budget classification provides a three-tiered breakdown for revenues: 1) tax revenues of £E 81.6 billion, which includes personal and corporate income tax revenues (projected to increase by 12.9% over the FY 04/05 proposal to £E 40.9 billion), customs revenues (down 15% to £E 8.91 billion, as a result of the tariff cuts introduced in September 2004, the removal of surcharge fees and the Pound's appreciation), and sales tax revenues (up 13.3% to £E 14.7 billion); 2) grants, including grants from donor countries and organizations, which are set to decrease by 1.4% to £E 2.86 billion; and 3) "other revenues," which includes £E 27.7 billion in surpluses and profit transfers from state-owned banks, companies and other economic authorities. In the latter category, the surplus of the Egyptian General Petroleum Company (EGPC) is projected to increase by 180% to £E 12.6 billion, due to the transfer of the energy subsidy burden to the budgetary accounts and the generation of profits on the basis of high international crude oil prices. This will be accompanied by £E 7.5 billion from transfers of marketing proceeds by EGPC, £E 5.1 billion in proceeds from the sale of goods and services and £E 5.3 billion as accrued interest on re-credited loans, petroleum surcharges and utility fees. Total "other revenues" are therefore projected to increase 61.5%, to £E 45.7 billion in FY 05/06.

The budget plan of FY 05/06 projected a growth in total revenues 2.5 times that of the growth rate of expenditures, a reversal of growth patterns in FY 03/04 and FY 04/05. A reversal is also projected in the official deficit ratio, which declined between FY 04/05 and FY 05/06 as a percentage of GDP, partially due to a pick up in the economy, but also due to the considerable increase in surplus transfers from the EGPC and the Suez Canal Authority. While the changes in the budget accounting methodology partially explain the reversal in growth patterns, actual outcomes must still be considered in projecting and then managing expenditures and revenues by the government. Although tax and customs revenues had been projected at £E 65 billion in FY 00/01 and £E 69 billion in FY 01/02, they in fact remained flat at around £E 51 billion in both periods, as Egypt's recession reduced imports, incomes, and sales. Tax revenues grew to £E 55.7 billion in FY 02/03, but that was still well below budget projections of £E 65 billion. Tax revenues for FY 03/04 generated £E 67.2 billion, still below the planned figure of over £E 70 billion. Increased revenues from other sources (e.g., higher Suez Canal revenues) and cutbacks in spending are likely to close part of that gap, but we estimate that, absent additional measures to close the gap, the budget deficit could still be higher than the government projections, for both FY 04/05 and FY 05/06. Some international institutions are already estimating the broad measure of the deficit will widen to 3.1% of GDP in FY 05/06.

The above analysis points to the need for a comprehensive review of Egypt's fiscal policies, on both the revenue and expenditure side. As noted above, the government has stepped up its efforts to improve its fiscal management. On the basis of government-IMF consultations in the early months of 2005, the government agreed to embark on a multiyear framework to reduce the budget deficit. In presenting the budget of FY 05/06, the Minister of Finance stated before parliament that the budget deficit would be reduced by 1.5-2% each year over the period 2006/07-2007/08. Egypt's expansionary fiscal policy over the past several years has cushioned the impact of the recession, particularly on the lower classes. However, continuation of such a policy, especially through debt-creating operations, may make it difficult for the government to meet its growth targets, which make expansion of private sector investment imperative.

The government has introduced a new system for its debt management, termed the "Primary Dealers System," which was launched on July 4, 2004. The system authorizes a number of financial institutions registered with the MOF – thirteen to date, including banks and bond dealers – to underwrite primary issues of government securities and activate trading in the secondary market through sale, purchase and repurchase agreements of government securities. With this system in place, the cost of borrowing and public debt service is expected to decrease in the long run. It is also expected to help establish a proper yield curve reflecting actual supply and demand for government debt and encourage a more efficient bond market. While the yield curves displayed by the MOF show a declining trend since July 2004, it should be noted that the budget figures of FY 05/06 point to a growing burden of public debt incurred through governmental securities. Repayment of loans and maturation of government securities amount to £E 15.9 billion, an increase of 55.3% over FY 04/05. Claims on the government increased from £E 12.6 billion in June 2004 to £E 16 billion in June 2005, an increase of 27%, while claims on the private sector grew from £E 22.3 billion to £E 22.8 billion, a rise of only 2% over the same period. Nevertheless, it is interesting to note a deceleration in growth of government claims in 2005. In October 2005, year-on-year, government claims had increased by 14.2%, and commensurately private sector claims had increased by 4%. Credit to the household sector, an indication of recovering domestic demand, also grew considerably by 10.8% over the same period. Due to the non-performing loans problem and complicated legalities, private sector lending has not grown in real terms.

Another fiscal challenge is the growth of subsidies (particularly energy, as noted elsewhere in this report), the true scope of which will become more evident as the government continues to identify and disclose implicit subsidy costs in the budget. The economic platform of the ruling National Democratic Party (NDP), revised in September 2004, restated the government's plans to achieve better targeting of subsidies, without eliminating support for the poor. So far, however, the government has only modified subsidies of energy. In September 2004, the government raised the price of subsidized diesel fuel by 50% from £E 0.4/liter to £E 0.6/liter, with an exemption granted for bakeries producing "baladi" (low/medium quality) bread. The government also increased the price of natural gas for industrial use from $0.85 to $1.00 per thousand cubic feet. In October 2004 the price of electricity was raised by 19% and water fees in Cairo were increased from £E 0.12 to £E 0.23 per cubic meter. In February 2005, the government introduced new high-octane gasoline fuels – Gasoline 92 and 95 – priced at £E 1.40/liter and £E 1.75/liter, respectively. The prices for these new fuels were not as heavily subsidized as the prices for the lower octane fuels on the market, Gasoline 90 (£E 1.00/liter) and 80 (£E .90/liter). Some observers speculated that after the introduction of

Gasolines 92 and 95, the government would begin phasing out the lower octanes, thereby reducing the overall subsidy for gasoline fuel, but no further steps have been taken toward that end.

The government has restarted revenue reform after a hiatus of two years. In June 2005, parliament passed a new Income Tax Law that created a unified tax rate on corporate profits and across sources of personal income and reduced rates by 50%. The reduction in tax rates is expected to result in a revenue loss in the short run, projected at ₤E 4.6 billion for FY 05/06 (₤E 1.6 billion due to raising of family allowances, ₤E 3.2 billion due to cutting the corporate tax rate from 42% to 20%, ₤E 0.8 billion due to the impact of the law on various commercial, industrial and freelance professions and a deduction in revenue gain of ₤E 1 billion as a result of tax-forgiveness and resolution of tax disputes). Other measures in the legislation, especially the cancellation of all exemptions and tax holidays, are expected to offset this shortfall. As discussed elsewhere in this report, overall revenues increased considerably, in part due to increases in prices of domestic energy products and electricity. The law also stipulates measures to expand the tax base, including provisions to bring the informal sector into the formal economy.

On September 12, 2004, a presidential decree was issued promulgating wide-ranging reforms to Egypt's tariff structure. The amendments brought down the average weighted tariff from 14.1% to 9%. Customs surcharges, as much as 4% of an item's value, were removed altogether. Moreover, the number of tariff bands – reflecting the number of rate categories – were reduced from 27 to 6, immensely simplifying the customs structure and intending to reduce bureaucracy. In a statement from the MOF at the time of the decree, customs revenues were expected to fall by ₤E 3 billion for the first year but are now projected to fall by only ₤E 1.2 billion for FY 05/06 as a result of higher imports spurred by the lower tariffs. While the reforms were required under Egypt's WTO obligations, the Minister of Finance also stated that they were intended to reduce the cost of production inputs and industrial goods. In the first half of 2005, a sampling of firms across various economic sectors reported declines in input and final product prices, but also reported lower local and foreign sales.

Monetary Developments: In September 2004, Egypt established a long-planned inter-bank market for foreign exchange, and formally adopted a convention governing trading in the market in December 2004. This step capped Egypt's transition to a unified and liberalized exchange rate system, encouraged by a strong balance of payments performance. Moreover, the foreign exchange surrender requirement of export and tourism proceeds was annulled in December 2004 – eliminating remaining restrictions on foreign exchange transactions. This latter step brought Egypt into compliance with the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement. Egypt had notified the IMF of its acceptance of these obligations effective January 2, 2005. These obligations call on members not to impose restrictions on the making of payments and transfers for current international transactions, and from engaging in any discriminatory currency arrangements or multiple currency practices without IMF approval.

The inter-bank market – which allows banks with a shortage in dollars to borrow from banks with a surplus – effectively eliminated the parallel market and contributed to appreciation of the Pound's value, which reached £E 5.80/$ by mid January 2005, an appreciation of 7.5%. Clarification of exchange rate policy by the monetary authorities, combined with strong foreign earnings, further boosted confidence in the Pound. A spree of liquidation of cautionary currency holdings by corporations and individuals led to a drop in foreign currency deposits to 28.4% in 2004/05 from 32.7% at the end of 2003/04. The Pound's appreciation lost pace in 2005, despite continuation of the same upward forces on its value. Between January and June 2005, the rate was static, and since June only minimally appreciated to the level of £E 5.73/$1 for buying and £E 5.75/$1 for selling. By definition, the normal operation of an inter-bank market should generate daily and weekly variations. The Pound's stability implies that the authorities are reluctant to accommodate a large appreciation of the Pound, which would challenge external competitiveness, and indicates a resort to sterilization operations.

The banking law passed in June 2003 mandated a joint government-Central Bank monetary policy coordination council that would set the goals of monetary policy, while leaving the Central Bank free to determine what monetary tools it would use to implement that policy. Presidential Decree No. 17 was issued in January 2005, establishing the Monetary Policy Coordination Council (MPCC), which held its first and only meeting in April of the same year. The MPCC's stated goal of setting a medium-term target of inflation for Egypt has not yet been achieved.

The Monetary Policy Committee (MPC) – also stipulated in the banking law for the implementation of monetary policy – similarly became functional in 2005. The MPC held its first meeting on June 2, 2005 and decided to set its key interest rates, the overnight deposit and lending rates, at 9.5% and 12.5%, respectively – on a 'corridor' of 3%. With this mechanism, the Central Bank guarantees to take overnight deposits at the lower rate and lend overnight at the upper rate. The guarantee has reduced the size of the inter-bank market and rates have fallen close to the 9.5% level. The MPC maintained this corridor until its monthly meeting on September 1, 2005, when it decided to reduce the deposit rate from 9.5% to 9% and the lending rate from 12.5% to 11.5%, narrowing the interest corridor from 3% to 2.5%. According to statements by the MPC, the decision was based on the declining inflation rates witnessed during the second half of 2004-2005, which indicated lower inflationary expectations.

In its October meeting the MPC again reduced the corridor by reducing the lending rate to 11% while maintaining the deposit rate at 9%. In December, both lending and deposit rates were cut by 25 basis points to 10.75% and 8.75%, respectively. Most recently in January 2006, the MPC again reduced both the lending and deposit rates, by 50 basis points to 10.25% and 8.25%. In January 2006, the Central Bank also reduced the discount rate by 1% to 9%, the first such move since November 2002. February's MPC meeting produced no changes to either lending or deposit rates.

The decrease in policy rates since the establishment of the corridor system has prompted a series of interest rate cuts in the banking sector, but not on the lending side. Interest on one-year deposits has fallen from 7.8% in July 2004 to 7.6% in July 2005. Interest rates on Treasury bills also fell from 11.28% in July 2004 to 7.86% in July 2005. With these developments and the falling inflation rate, real interest rates have risen to positive values. Commercial lending rates are still in the 13-14% range. On the domestic liquidity front, broad money (M2) grew by 13.6% in FY 04/05, largely unchanged from 13.2% in FY 03/04. The net foreign asset position has grown considerably, by 78.8% in FY 04/05, owing to increased foreign earnings. Egypt's net international reserves have similarly boomed to a comfortable $21.2 billion at the end of October 2005. With the balance of a relatively stable exchange rate, dollarization (foreign currency deposits as a percentage of total liquidity) fell from 28.4% in March 2004 to 24.6% in June 2005.

The government and Central Bank appear to recognize that a flexible exchange regime requires a much more sophisticated monetary policy and improved technical expertise. The Central Bank Governor has repeatedly stated an intention to move toward an inflation-targeting monetary policy, with short-term interest rates as the operational target and changes in reserves the nominal anchor. The Central Bank expects to phase this policy in over a period of two years or more as staff expertise is upgraded to meet the demands of such a policy. Some progress has been made with the introduction of the corridor system. The MPC is relying on six undisclosed inflation indices, developed by the Central Bank, in addition to other factors such as credit and money supply growth in order to determine the future route of inflation.

The Central Bank's ability to hire and retain technically qualified staff in its monetary policy and foreign exchange trading units will be critical to the success of its effort to operate an effective monetary policy. Development of new instruments and procedures for open market operations also will be important. The Central Bank has embarked on a program to hire more qualified staff, with assistance from the United States Agency for International Development (USAID) and other donors. It also implemented a 40% pay increase for professional staff in early 2004.

Privatization: After four years of stalled privatizations and minimal levels of transactions and revenues, the privatization program was reinvigorated in July 2004. The results have been dramatic. Privatization proceeds in FY 04/05 leapt to £E 5.64 billion from £E 0.554 billion in FY 03/04, an annual figure unequalled in the history of the privatization program and higher than the total combined proceeds from the previous four years. The transactions over the past year included sale of 17 Law 203 firms (wholly state-owned) and 11 joint ventures. The dramatic pickup in the pace of the program reflects the goal set by the new Ministry of Investment (MOI), headed by one of Egypt's leading economic reform advocates, to increase investment in Egypt. The new ministry replaced the former Ministry of Public Enterprise (and takes over its portfolio of Law 203 companies and joint venture companies, which form the core of the privatization program).

The new Ministry has widely changed the thrust and structure of the privatization program, and used innovative methodology when necessary to overcome stumbling blocks. The privatization program was re-dubbed the "asset-management program," revealing the approach taken by the MOI of evaluating each asset in its portfolio – whether a parcel of land, a factory belonging to a company, or a whole company – as a prospective sale feature. The MOI slated 45 public enterprises for sale in 2005/2006. This flexible approach enabled the MOI to advance sales in loss-making and structurally problematic firms, such as those in the textiles sector. Between mid and end 2004, four textile factories were sold.

A major shift in the privatization program was abandonment of the concept of "strategic" or untouchable firms. These firms – generally profitable public enterprises or joint ventures (JV) – were considered emblematic of strong government presence in certain economic sectors, and hence not open to private control. The MOI indicated that these firms are now included in the privatization program. The sale of 30% of Suez Cement Company – the largest Egyptian cement producer – to Italcementi Group for £E 1.9 billion in March 2005, was a case in point. The Suez Cement deal raised the foreign company's stake in Suez Cement to 54%, granting it a majority of board seats in the company. Over the summer of 2005, the MOI also floated 20% of the shares in two very profitable JVs in the energy sector, Sidi Krir Petrochemicals Co. (SIDPEC) and Alexandria Mineral Oil Company (AMOC), as initial public offerings (IPOs). The energy sector had also previously been considered "strategic." SIDPEC is Egypt's largest producer of ethylene and polyethelene, while AMOC, though accounting for only 2% of Egypt's total refinery output, operates two modern complexes for mineral oils and paraffin wax production. The deals generated £E 1.6 billion and £E 900 million, respectively.

The MOI has also innovated its sales techniques. According to MOI sources, for the JVs already sold, and others to follow, privatization involved floating 20-30% of ownership on the stock market, selling 50-60% to an anchor investor, and retaining 20% for the government. According to the same source, the technique demonstrates the Minister of Investment's dual aim of stimulating the stock market through partial privatization while generating an opportunity for improvement of the companies through sale to a major investor.

The revamped privatization program has encountered some resistance. Labor issues have arisen in a large number of cases, and strikes have occurred at a number of companies. The Minister of Investment acknowledged these difficulties, and made efforts to incorporate labor representatives at all stages of the sale negotiations. He also formed a committee to draft modifications in the early retirement program. Proposed changes include a time deposit feature in the compensation package as opposed to a lump sum payment. The proposed changes would also lower the eligibility age for early retirement to 45 for females, while their male colleagues would become eligible at 50 years of age (compared to 50 for female employees and 55 for male employees currently). However, the reform package would apply to public enterprises only and not the administrative body of the government or any public service entities.

Outside the portfolio of the MOI, the government has made progress in divesting government shares in key economic sectors, such as banking and insurance. Seven joint venture banks, including Misr International Bank (MIBank) and National Societe Generale Bank (NSGB), Egyptian American Bank, and Commercial International Bank – the largest JV bank – have been divested of public shares. In late December 2005, the new Cabinet reconfirmed that Bank of Alexandria (BOA), one of the four state-owned banks, would be sold in part to a strategic investor and in part through an IPO on the stock exchange. Citigroup Global Markets Limited has been named strategic advisor for the sale. As of the printing of this report, BOA had confirmed that a first tranche of the bank, approximately 75-80%, would be sold to a strategic investor, while the remaining 15%-20% would be publicly offered after the sale of the first tranche. BOA intends to invite non-binding expressions of interest by potential investors before the end of March 2006, once the audit of its financial statements for the period July 1, 2005 to February 28, 2006 are released.

In mid-September 2005, Egypt commissioned an international consortium to evaluate and advise the government on the restructuring of its major state-owned insurance companies, opening the way for their privatization. The MOI selected the Paris-based BNP-Paribas, Egypt's CIB, and the New York-based insurance consultancy firm Milliman Global to do the job. The government and the consortium signed a contract in mid-February 2006. While the government has declared that all public insurance companies will be sold, industry insiders consider these companies less attractive than greenfield investments, due to overstaffing and idle investments amassed in real estate.

Further divesting of the government's ownership in key sectors of the economy would attract more foreign investment to modernize production capabilities, allow the private sector to pursue a more active role in economic activity, ensure more efficient allocation of economic resources, and increase local and ultimately external competitiveness. Social concerns, including job losses and prices of important consumption and production goods, will continue to be major challenges to continued privatization. The MOI has underlined that privatization is only part of the economic reform process, not its end. In its portfolio, the MOI aims to build investments in many sectors such as tourism, aviation, telecommunications, agriculture, food and financial services. Some sectors, such as aviation, are just being opened up to private investment, rather than being offered for privatization. Development of financial services is also of particular importance, as it will support needed reforms in privatization-targeted sectors.

Balance of Payments: Preliminary results for the balance of payments (BOP) in FY 04/05 recorded an overall surplus of $4.5 billion, compared to an overall deficit of $0.2 billion in the previous fiscal year. Net international reserves grew from $14.8 billion in June 2004 to $21.2 billion in October 2005. The current account continued to show a surplus for the fourth consecutive year, reaching $2.9 billion, down from $3.4 billion in FY03/04, mainly due to growth in the trade deficit. A significant turnaround in the capital and financial account, from a deficit of $5.0 billion in FY 03/04 to a surplus of $3.3 billion in FY 04/05, had the greatest impact on the final BOP figures. Changes in measurement methodology also influenced BOP figures, as the Central Bank included in investment inflows in the petroleum sector in calculations of the capital account for the first time in FY 04/05.

The Current Account experienced a negative change year-on-year between FY 03/04 and FY04/05, the first downward change since FY 97/98. This reversal was brought about by deterioration in the trade balance, with the trade deficit growing from $7.8 billion in FY 03/04 to $10.4 billion in FY 04/05. The deterioration was driven by a surge in the value of imports, particularly oil imports, which increased by 55.9%, mostly in the fourth quarter of the fiscal year (May – July 2005). The deterioration caused by the rise in oil imports was exacerbated by steep increases in the price and volume of refined petroleum products. Non-oil imports also increased by 28.5%. The tariff cuts in September 2004, cancellation of foreign exchange surrender requirements and a rise in investment-related imports all contributed to the increase in non-oil imports. Merchandise exports increased by 32.2%, rising to $13.8 billion, an indication that external demand was not negatively affected by the appreciation of the Pound that began in late 2004. While the impact of the economic recovery was clearly reflected on the import side – particularly with regard to production-driven demand – a translation into exports requires some time, taking into account the higher prices of raw materials induced by the Pound's appreciation. The gradual maturation of natural gas export plans is also expected to positively affect Egypt's export figures in FY 05/06 and onwards.

The Services Account remained buoyant. Tourism revenues increased in FY 04/05 to $6.4 billion, up 17.4% from $5.5 billion in FY 03/04. The sector proved resilient to external shocks over the year, including a charter plane crash in January 2004, and the Taba and Nuweiba terrorist attacks in October of the same year. According to the Ministry of Tourism, the latter resulted in only a 5% cancellation in hotel bookings. The attack in Sharm el Sheikh in July 2005 is not captured in the FY 04/05 tourism figures, though figures for the first quarter of 2005/2006 (July – September 2005) indicate a 7.4% fall in tourist numbers. The durability of the sector after the earlier attacks, however, suggests this downturn will be temporary. Suez Canal transit revenues, the second largest source of foreign earnings, surged 16% from $2.8 billion in FY 03/04 to $3.3 billion in FY 04/05.

The Capital and Financial Accounts moved from a deficit of $5.0 billion in FY 03/04 to a surplus of $3.3 billion in FY 04/05. In particular, FDI inflows into Egypt jumped from $407.2 million in FY 03/04 to $3.9 billion in FY 04/05. In addition to robust privatization proceeds, the rise in FDI was due primarily to the Central Bank's decision to include figures for investment flows to the oil and gas sector as an FDI component, a change from previous years. Privatization and oil sector investments generated $0.4 billion and $2.6 billion respectively. Net portfolio investments in Egypt, reflecting foreigners' investments in the stock exchange, spiraled from net outflows of $0.2 billion in FY 03/04 to net inflows of $0.8 billion in 2004/2005, prompted by a stock market rally that began in 2004 and became euphoric in 2005.

On the overall account of the BOP, net errors and omissions swerved sharply from a positive $1.4 billion to a negative $1.8 billion, indicating either an overstatement of inflows or understatement of outflows. The large change in value casts some doubt on the development of the external accounts and indicates the need for a more accurate monitoring of the source of flows through the banking sector and the Central Bank.

Banking sector representatives have indicated that the figures cited above may have resulted from over-reporting of oil export proceeds.

Direction and Composition of Trade: The European Union (EU) remains Egypt's largest trading partner, accounting for 32.4% of Egypt's imports and 37.2% of its exports in FY 04/05. Egypt's Partnership Agreement with the EU came into force in June 2004, strengthening the already substantial trade relationship. The U.S. is Egypt's next largest trading partner, and its largest single-country trading partner, accounting for approximately 21.6% of its imports and 33.5% of Egypt's exports in FY 04/05. Asian countries account for around 14.9% of imports and 10% of exports. Arab countries take 8.8% of imports and send 11.3% of exports; African countries, Russia, British Commonwealth countries and Australia take up the rest.

Egypt's leading merchandise export is crude oil and petroleum products ($2.2 billion in January – September 2005), followed by finished goods (chiefly steel, textiles and apparel), and raw materials (cotton and other agricultural products). From FY 03/04 to FY 04/05, steel exports continued to grow, from $847 million to $1.4 billion. Egyptian steel producers looked beyond the still weak domestic market and benefited from the steady rise in prices of steel products that began in the second quarter of 2004. Cement producers also continued exporting at high levels, principally to the booming Gulf region. Leading imports include intermediate goods (especially iron and steel products) and raw materials. Investment goods imports bounced back from a drop in 2003 to register $1.5 billion in 2004, and $993 million in the first half of 2005 alone.

Chief U.S. exports to Egypt include agricultural commodities (usually around $1 billion annually), capital goods, and equipment. The value of U.S. exports bounced back from a low of under $2.6 billion in 2003, to $3.1 billion in 2004 and continued to rise to $3.2 billion in 2005. Wheat exports rose from $401 million in 2003 to $426 million in 2004, but dropped again to $190 million in 2005. Egypt's exports to the U.S. had averaged $700-900 million in recent years, but jumped to $1.2 billion in 2004 and further to $2.1 billion in 2005. The impact of the Qualifying Industrial Zones (QIZ) program between Egypt and Israel has started to affect these statistics, with Egypt’s exports to the U.S. jumping by 75% between 2004 and 2005. Clothing, other textiles, crude oil, and oil products have typically been the largest exports. Egyptian steel exports to the U.S. decreased slightly from $0.25 million in 2004 to $0.1 million in 2005.

Egyptian trade and BOP data can be inconsistent, due to problems of source data and definitional discrepancies among governmental offices. The authorities assert that efforts are being made to reconcile such differences. The BOP figures previously included payments made by the government to foreign oil and gas companies for domestic production bought by the government and used in Egypt. This data has been excluded from July 1999 data and onwards. They also may include payments for transactions in which the Egyptian participant was a broker for a transaction between two other countries, as in trade figures for Iraq. Finally, BOP figures may report payments made to financial center banks (such as in New York) rather than recording the ultimate recipient, skewing the individual country trade statistics. Customs figures, on the other hand, appear to understate oil and perhaps other exports. The truth probably lies somewhere between the BOP statistics (always higher for both imports and exports) and customs figures. In reporting bilateral trade with the U.S., we have relied solely on U.S. government statistics. For other countries and regions, we have used a mixture of Egyptian customs and BOP figures and data from Egypt's trading partners.

MAJOR LEGISLATIVE AND REGULATORY DEVELOPMENTS

New legislation passed by the People's Assembly in the 2004/05 parliamentary session that ended in June 2005 included the Unified Income Tax Law and the Anti-Trust Law, and a number of amendments to the Export and Import Regulations, the Unified Banking Law, the Custom Tariffs and the Sales Tax Law. Parliament also approved a new Corporate Governance code.

Income Tax Law: On June 8, 2005 the People's Assembly issued the Unified Income Tax Law (Law 91 for 2005). The law dictates a unification of tax rates on corporate profits and across sources of personal income (including commercial, industrial and freelance professions). The corporate tax rate was reduced from 42% to 20% (but maintained at 40.55% for oil companies). The new legislation also eliminated exemptions and tax holidays stipulated in the Investment Incentives and Guarantees Law (Law 8 for 1997), with the exception of cultivation and land reclamation, animal breeding, fisheries and bee-hiving. The exemption cancellations were not applied retroactively, however. The Law further stipulated reform of the Tax Authority with the aim of changing the relationship between the Authority and taxpayers. According to the legislation, taxpayers will now submit a self-assessed return to the Tax Authority, which the latter must accept as accurate, with an option to audit the return. In the past, the Tax Authority had assessed corporate and personal taxes and presented the taxpayer with a bill, a lengthy process that was rife with uncertainty and potential for corruption. Reform of the tax system is expected to expand the tax base by encouraging the large informal sector to legalize its status. Executive regulations for the law were released in January 2006.

Anti-Trust Law: In January 2005, the People's Assembly approved an antitrust bill – the Law on Protection of Competition and Prohibition of Monopolistic Practices (Law No.3 for 2005), which sets a limit of 25% on market share above which a respective company could be subject to an antitrust investigation. The law does not be apply to utilities and infrastructure projects, such as water supply, sewage, electricity, telecommunications, transportation and natural gas. Penalties for companies that engage in monopolistic practices vary between £E 13,000 and £E 10 million. A new quasi-governmental body, the Egyptian Competition Authority, will implement the law and will be funded by direct government appropriations and/or donations from professional or academic bodies. The executive regulations of the law were issued in August 2005 and currently the Authority is setting up its structure and premises and hopes to start functioning by the middle of the second quarter of 2006.

Export and Import Regulations: In October 2005, new import and export regulations were issued, completely replacing Ministerial Decree 275/1991 and all of its amendments and interpretations. These regulations aim at giving industry and consumers more rapid access to traded goods while simplifying the process of exporting Egyptian goods to the rest of the world. The new regulations reduced the number of imported goods subject to inspection by the General Organization for Export and Import Control (GOEIC) and permitted importers to provide their own certificates of conformity from any internationally accredited laboratory inside or outside of Egypt. The new regulations also transferred responsibility for issuing and reviewing certificates of origin from GOEIC to the Egyptian Customs Administration. The regulations further introduced a mechanism for enforcing intellectual property rights at the border and eliminated the distinction between manufacturing and services industries for the purposes of preferential treatment of imported goods.

Custom Tariffs: On September 8, 2004, a presidential decree was issued amending the Egyptian customs tariff structure. Services fees and import surcharges were removed and the number of *ad valorem* tariff rates was reduced from 27 to 6. The new regulations also dismantled tariff inconsistencies, including sharp escalation and reverse progression on tariff rates, and rationalized national sub-headings above the six-digit level of the Harmonized System. The new tariff structure includes six tariff rates, pegged to the degree of processing, that range between 2% on raw materials, spare parts, and primary feeding products and 40% on durable consumer goods. The changes in tariffs brought down the officially announced weighted average tariff rate from 14.6 percent to 9.1 percent. The amendments also eliminated services fees and import surcharges ranging from 1 to 4%. The amendments effectively replaced the 10-digit, thirteen thousand-line tariff structure with a six-digit structure with less than six thousand tariff lines. This change should reduce disputes over product classification for customs purposes. Additionally, the changes eliminated export duties on 25 products that were in short supply on the domestic market. A number of high tariffs still exist, including duties on imported alcoholic beverages, tobacco and cigarettes and passenger vehicles with cylinder capacity above 2000 cc.

Banking Law Amendments: In June 2005, the People's Assembly approved an amendment to the Unified Banking Law of 2003 reducing the minimum capital requirements for foreign exchange bureaus to ₤E 5 million from the previous stipulation of ₤E 10 million. Amendments to the Law also allowed boards of directors of public banks to devise systems for rewarding employees on the basis of performance and level of accomplishment, without having to abide by the provisions of regulations governing public sector enterprises. Furthermore, the amendments extended a number of rules previously applicable to banks only to real estate companies, credit classification companies and finance institutions. These rules pertain to the confidentiality of client data and fees paid as collateral.

Sales Tax Law Amendments: In December 2004, the People's Assembly passed an amendment to the Sales Tax Law to reduce prices and attract new investment. The amendment reduced tax rates on several major supply commodities that were crucial to low-income groups. The amendment also included tax exemptions on all types of bread. In early 2005, Law No. 9 for 2005 was issued, which exempted capital goods from the sales tax.

Corporate Governance Guidelines: The MOI issued guidelines for private sector corporate governance, in the form of Ministerial Decree No. 332/2005, in October 2005. The guidelines were prepared in accordance with OECD corporate governance principles, and are not binding. The guidelines apply primarily to share-holding and limited-liability companies, established under Law 159 for 1981 (the Companies Law) and Law 95 for 1992 (the Capital Market Law), in addition to brokerages. The guidelines aim at achieving a balance between the interests of the company and those of the shareholders and also include rules pertaining to the general assemblies and boards of directors of companies. Moreover, companies are advised to issue an annual report to shareholders disclosing information on the finances and activities of the firm, its future prospects and the extent of its adherence to corporate governance rules. The guidelines also require the disclosure of information on the social and environmental policies of the firm and auditing of the company's accounts by means of an independent auditor. Guidelines for public enterprise sector are under preparation and will be legally binding when issued.

SECTORAL TRENDS AND PRINCIPAL GROWTH SECTORS

Services: Services account for roughly 50% of Egypt's GDP, with tourism and Suez Canal revenues being particularly important.

<u>Tourism:</u> Tourism is Egypt's largest foreign exchange earner and a key engine of growth. Hotels and restaurants – the key indicators for the tourism sector – recorded the highest growth among economic sectors in 2004/2005, at 35.1%. Official figures credit tourism with about 5.5% of GDP, but a 2001 report by the Egyptian Center for Economic Studies implied tourism's real direct and indirect share of GDP was 11%. Tourism arrivals and revenues, which declined sharply at the onset of the war in Iraq in March 2003, rebounded strongly shortly thereafter. Despite regional unrest and a number of security/terrorist incidents during 2004 and 2005, the tourism sector continued to grow and set new annual records.

Figures for 2005 indicate 6.5 million tourists visited Egypt in the first nine months of 2005, up 6% from 6.1 million during the same period in 2004. Stays in number of nights increased by 5.1% over the same period, rising from 62.9 million nights to 66.2 million nights. Revenues for the first quarter of 2005 were up 15.4% to $1.5 billion compared with $1.3 billion in the first quarter of 2004. Owing to another terrorist attack – wider in scale and psychological impact – that took place on July 23 in Sharm el Sheikh, total tourist arrivals dropped in the three months to follow. The industry, however, has not been significantly damaged, with the percentage decline in tourist arrivals receding from 15% to 12% and 3% in August, September and October, respectively. A significant increase in inflow of Arab tourists in the summer months, and a general perception of the internationality of recent terror incidents are factors to consider in the impact of external shocks recently on the Egyptian tourism industry. In mid December 2005 official statements indicated that the tourist number turnout for the year is expected at 8.5 million, 5% higher than 2004, though below the target of 9 million due to a strong Pound, weaker European economies and the Sharm bombings.

The composition of tourists started changing in late 2003 and early 2004, as figures indicated that some of the higher-spending nationalities, including West Europeans and the Japanese, who stayed away after September 11, were starting to visit Egypt again. Figures for U.S. tourists also showed around a 13% increase from 128,000 in the first nine months of 2004 to 145,000 in the first four months of 2005. Gulf vacationers are a significant component of the tourism inflow to Egypt, and they are considered among the top-spenders with longer stays.

Statements by government officials underlined the importance of the tourism sector during an inaugural ceremony of a new Luxor airport in July 2005. The government announced a plan to host 18 million tourists by the year 2015. This is projected to create 2 million jobs. The plan requires £E 8 billion in investment by the private sector. The official statements went on to suggest prospective adjustments to the sales tax system, to enable the tour industry to obtain refunds on imported inputs. Increases in sales tax on a number of services since May 2004, in addition to a departure tax on airline passenger tickets in October of the same year, are viewed as possible drags on the sector. The repeal of the foreign exchange surrender requirement in December 2004 was also an important investor-friendly move by the government. The new Minister of Tourism, appointed with the new Cabinet, is working on developing new tourism sub-sectors, including medical and conference tourism. Incidentally, a number of significant regional and international events have been recently hosted in Egypt, and Egypt has announced that it will host the World Economic Forum's regional meetings in May 2006.

With the policy approach of the government, the short- to mid-term outlook for the tourism sector remains bright, but depends on resilience vis-à-vis external shocks. Hotel and tour prices are returning to pre-September 11 levels. Higher prices and a stronger Pound should help increase tourism earnings, but may weaken Egypt's competitiveness with other destinations in the region. Construction of tourism facilities should be able to meet expected demand, hand in hand with modernization of airport structures and the prospect of opening up aviation services to the private sector.

<u>Suez Canal:</u> Suez Canal revenues continued their robust performance in FY 04/05, setting a new record of $3.3 billion compared to $2.82 billion in FY03/04 (itself a record). Increased trade flows from East Asia, especially India and China, are partially responsible for the rise in canal revenues, in addition to high global oil prices, which have made shorter transportation routes more desirable. We expect this trend to continue, as oil prices remain high and Asian trade activity grows. A 3% increase in canal tariffs, slated to take effect March 15, 2006, will further increase revenues. Several upgrades to the canal, including a plan to extend its depth to 66 feet, are scheduled for completion in 2006. A feasibility study is also underway to further deepen the canal to 72 feet. These improvements are likely to make the canal an even more attractive transportation route and maintain the high level of revenue experienced in the last few years.

Banking: Wide-ranging changes have taken place in the banking sector over the past year, with a comprehensive reform program for the sector – administered by the Central Bank– beginning to unfold gradually. The plan, drafted by the government and the Central Bank of Egypt over 8 months, follows recommendations of the Financial Sector Assessment Programme for Egypt, which was conducted jointly by the IMF and the World Bank in June 2002. Approved by the President in September 2004, the plan includes overall consolidation of the banking sector, sale of government shares in JV banks and restructuring of the public banks – to include resolution of the non-performing loans (NPL) problem – in preparation for eventual privatization. Adoption of this ambitious reform plan for the sector has boosted confidence among investors, with an increase in the number of banks listed on the stock exchange. Notwithstanding the significant changes in the sector, qualitative changes aimed at realizing a banking sector with a strong financial profile are still proving challenging.

On July 14, 2005, the deadline for banks to meet the capital requirement of ₤E 500 million stipulated in the Unified Banking Law of 2003 expired after a one-year extension. In August 2004, the Central Bank had issued a decree regulating how the capital increase requirement would be applied, and added a requirement for a capital adequacy ratio of at least 10%. The Central Bank also announced that the deadline of July 14, 2005 would be upheld, implying that consolidation in the banking sector would be forced if necessary. Prompted by the August decree, several mergers and acquisitions occurred across the industry in 2005. As of the end of 2005, 11 small banks had been merged into larger banks and the Central Bank had begun legal procedures to liquidate branches of three foreign banks that have not met the capital requirement. Problems have arisen where considerable differences existed between labor and remuneration structures among merged banks. Labor disagreements occurred when NSGB purchased MIBank in September 2005. The acquisition, valued at around $400 million, prompted mass resignations at MIBank for fear of and in protest against losing the higher employee benefits offered by MIBank.

Along with consolidation of the sector, the government's reform plan calls for divestiture of government shares in JV banks, the proceeds of which will be allocated for financial restructuring of state-owned banks. Divestiture of government shares in JV banks – which comprise 38% of banking entities in Egypt – has seen considerable progress in 2005. To date, six banks have been divested of public shares, namely, MIBank; NSGB; Misr-America International Bank; Egyptian-Commercial Bank; Misr-Romania Bank and Suez Canal Bank. In January 2006, approximately 75% of a large JV bank – the Egyptian-American Bank – was sold to Calyon Corporate and Investment Bank, part of the French Credit Agricole Group. In the following month, the sale of the largest JV bank – the Commercial International Bank – was concluded to a U.S. consortium led by Ripplewood Holdings, and including Eton Park Capital Management and RHJ International.

Official figures on total NPLs – the biggest challenge for reform in the banking sector – have not been disclosed since mid-2002, when NPLs were estimated at 16% of total outstanding loans. In its most recent report on Egypt, published in June 2005, the IMF indicated that NPLs had risen to over 25% of total loans by September 2004, compared to 20% in June 2003. To address the NPL problem, the government, Central Bank and state-owned banks began to pursue a policy of rescheduling bad debts, rather than prosecuting bad debtors in court. In September 2004, the government established an Arbitration Committee at the Central Bank to resolve bad debts and handle disputes between banks and borrowers. The government also set up a unit at the Central Bank to develop a long-term solution to the NPL problem. Over the course of 2005, the public banks announced some successes with this policy, including settlement of the debts of some major borrowers. In June 2005, however, S&P commented that Egyptian banks – particularly the public banks – were still under pressure in the medium term due to an unsustainable level of bad loans, which ill-equipped banks to face external shocks. In November 2005, Fitch Ratings estimated that NPLs in Egypt had risen to 30% of total loans. With differing statements about the portion of cases that have been resolved, we believe the problem is still considerable. Based on available information, we numerically estimate NPLs at ₤E 50-55 billion in public banks and ₤E 20 billion in private banks, for a total of ₤E 70-75 billion.

State-owned banks also hold around 90% of the debts of Law 203 companies (wholly state-owned enterprises). This debt, together with a very low loan provisions/loans ratio (14% in June 2005), renders the state-owned banks substantially undercapitalized. The cost of re-capitalization of the public banks has been put at 7-10% of GDP by external estimates, comprising a significant fiscal liability. Donor assistance, including the World Bank's $1 billion financial sector assistance scheme, is potentially available for re-capitalization purposes. In January 2006, the government announced an agreement between the MOF, MOI and the Central Bank for repayment of ₤E 32 billion in public enterprise debt arrears to the banking sector, including ₤E 25 billion in irregular loans. To date, the only concrete step in the implementation of this plan has been settlement of ₤E 6.9 billion in public sector debts to the Bank of Alexandria (BOA). Ninety percent of BOA's debts were NPLs. Fifty percent of BOA's debts were to the private sector, of which 70% were NPLs.

According to the banking sector reform plan, the main objective of restructuring and re-capitalizing the public banks is to prepare them for privatization. Some progress was made on this front in 2005. Privatization plans for the BOA moved along steadily, and as noted above, public sector debt arrears to BOA have been settled. Citibank was selected in mid-2005 as the advisor for the privatization and the audit of BOA's balance sheet was completed in late 2005. Though the government had initially planned to complete privatization of BOA by the end of 2005, more recent government statements indicated a target date of the second quarter of 2006 for initiation of the sale.

The government also announced a surprise move in September 2005: the merger of the second and the third largest state-owned banks, Banque Misr and Banque du Caire. Banque Misr, with assets of approximately ₤E 91 billion at the end FY 03/04, holds 17% of market share. Banque du Caire's assets stood at ₤E 45 billion at the end of FY 03/04, with 6-7% of market share. The planned merger would create the second largest state-owned bank (after NBE), with assets exceeding ₤E 130 billion ($22 billion), a figure very close to the NBE's total assets of £E 130 billion at the end of FY 03/04. While this move triggered questions about the prospects of privatizing the new entity, the government has remained quite discreet about the matter. It is our understanding that the merge *per se* would not be sufficient for a privatization, unless intensive financial, technical and administrative restructuring takes place. Such restructuring should address the issue of NPLs in these state banks. The credit portfolio of Banque du Caire involves the NPLs of two well-known Egyptian enterprises, each on the order of £E 1.7-2 billion.

Access to credit by the private sector remains a problem in Egypt's banking system, with the bulking of lending going to the public sector. Credit growth to the private sector fell from 4.1% in FY 03/04 to 2.2% in FY 04/05. A cautionary lending policy to the private sector is still prevalent in commercial banks, in part due to the recent capital boost requirements and the safer investment channels found in government debt instruments, which have also been issued in greater volumes recently. Banks' profitability has fared well, however, partially on account of interest income earned on government debts. Despite this cautionary approach, an increase in investment demand, coupled with signals from Central Bank on lending interest rates, as discussed elsewhere in this report, may cause private banks to reconsider lending strategies. An important measure to help evaluate creditworthiness of potential borrowers was taken in August 2005, when the Central Bank issued rules and procedures for the licensing of credit bureaus. The first credit bureau, Egyptian Credit Bureau or "ESTAILAM," was then established in September 2005, under Central Bank's supervision.

Capital Market: The rally that began in 2003 on the Cairo and Alexandria Stock Exchange (CASE) continued throughout 2005, enabling the Egyptian market to outperform other emerging markets against a backdrop of supportive domestic and international circumstances. The confidence boost generated by the Nazif Cabinet's credentials and its reform projects, higher foreign exchange availability in addition to emerging market and global economic growth, have all played a role in supporting the rally. Some analysts expressed concern about the potentially negative effect of the parliamentary elections in November and December 2005 on the market's confidence. These concerns appear to have been unfounded, however, as investor interest was drawn by a spree of privatization/IPOs late in the year and boosted by the Cabinet reshuffle the last week of December. Overall, the market achieved significant gains in 2005, and has grown by approximately 200% over the past two years. While services dominated the higher performance of 2004, the rally was supported in 2005 by a greater diversity of sectors, including previously dormant ones, such as textiles and smaller cap stocks. Companies were also seen competing for greater penetration, through offering of shares for capital increases. The subscriber base also increased by approximately 26% in 2005. Continued growth and financial deepening of the stock market will hinge on regional stability and the pace of continued economic reform.

The benchmark Hermes Financial Index skyrocketed by 133% from 15,534 points in April 2004 to 36,250.9 in April 2005, and increased further by 35% to 49,015.33 by October 2005. The total value of traded securities per month increased more than tenfold, from £E 1.9 billion in June 2004 to £E 11.6 billion in June 2005. Trading volume rose to 5.3 billion shares in 2005 compared to 2.4 billion shares in 2004. Foreigners' participation in trading volume was 21% in 2003, 27% in 2004 and rose to 30% in 2005. Foreign portfolio investment registered a net inflow of $831 million in FY 04/05 compared to a net outflow of $226 million in FY 03/04. As at December 2005, the market capitalization of CASE was approximately £E 456 billion, 87% of GDP, compared to £E 234 billion and 52.6% for the year in 2004. In 2005, shares in 441 of 744 listed companies were actively traded, with shares in an average of 95-110 companies trading on a daily basis.

The government continues to introduce measures to bring Egypt's capital market closer to international standards. Companies listed on the CASE are required to apply international accounting and disclosure standards. Stocks are supposed to be de-listed from the exchange if not traded for six months. In 2002 the Capital Market Authority board issued a decree giving companies listed on the CASE until August 30, 2003 to comply with listing regulations or be de-listed from the CASE. As the CASE began strictly enforcing the listing regulations, the number of listed companies fell from 1151 in December 2002 to 983 at the end of December 2003 and continued a downward trend to 803 by June 2004 and 744 by the end of December 2005. Transparency requirements are also more strictly enforced, with companies not reporting quarterly earnings or meeting other criteria being suspended from trade until the information is submitted. In November 2005, the World Federation of Exchanges accepted CASE as a full member – Egypt as such being the first Arab country to be given full membership in the organization. The move, reflecting a better commitment to international stock market standards, is expected to further boost confidence in the CASE.

In early 2005, a new chairman for the CASE was appointed. The new leadership has introduced new financial facilities and raised the proficiency at the exchange's brokerage firms. In March 2005, CASE began implementing a new automated system for linking trading with the clearing system. In August 2005, CASE announced that it would adopt a same-day trading system, which allows the selling of securities traded on that same day and same trading session. The system actually commenced in October 2005. At the same time, the CASE licensed ABN AMRO Bank to issue 500,000 dollar-denominated open-end certificates with a total issue value of $4.76 million using shares from the CASE 30 index as the underlying variable. The certificate's goal is to produce a value that tracks the performance of the exchange overall. The bank owns equity in all CASE 30 index components weighted on the basis of the CASE's copyrighted formula. The 500,000 certificates are "open-ended" because they do not have a set expiry date; the bank must give one-year notice if it plans to terminate the certificate, while the holder may exercise the certificate for the value of the underlying index at the end of March every year starting in 2007. ABN AMRO acts as the primary market maker, always offering the certificate for sale at a price it feels reflects the current performance with a 2.5% spread between the bid and ask price.

Also in 2005, the MOI issued Ministerial Decree No. 192, which added a new section to the executive regulations of the Capital Market Law No. 95 of 1992. The new regulations specified the organization of margin trading and short selling. While margin trading was authorized under previous amendments to the Capital Market Law, it had never been activated. Short selling was a new feature for the CASE, one that makes it possible for investors to achieve a return by borrowing financial securities. Short selling allows investors to borrow financial securities for a limited time period for the purpose of selling them and re-buying them and then delivering them once again to the custodian. The MOI also issued a decree to add several new clauses to the executive regulations of the Central Depository Law, allowing custodians to lend financial securities to investors through margin trading and short selling. CASE expects margin trading and short selling to be activated in the early part of 2006, in addition to online trading. While financial derivatives are so far absent from the Egyptian stock exchange, they are in the works, with open-end certificates, margin trading and short selling being introduced to prepare the market for accommodating futures and options.

Notwithstanding the multiple developments in the Egyptian securities market, realizing higher and sustained growth will require better enforcement of codes of conduct in trading and brokering practices and supervision thereof, in addition to more effective disclosure requirements and general maturing of the various components of the securities market framework.

In May 2002, the Minister of Finance issued decree number 480 of 2002, authorizing the establishment of a primary dealers system for government securities. The new system, which finally began operating on July 6, 2004, allows 13 financial institutions listed with the MOF, including banks and bond dealers, to underwrite primary issues of government securities and activate trading in the secondary market through sale, purchase, and repurchase agreements of government securities based on a multiple-price auction system. In FY 04/05, a total of 117 auctions were conducted (with a total value of £E 129.4 billion, of which 6 auctions were related to bond issues in the sum of £E 14 billion, and the remaining to treasury bills). £E 1 billion pertained to a 20-year bond issue, the longest maturity debt issued in many years. In the first half of FY 05/06, 63 auctions were implemented, with a total of £E 82.1 billion (8 issues of which are bonds in an amount of £E 16 billion). Interest rates have fallen from an average of 11-12.3% in July 2004, to 8-8.9% in December 2005, for the three maturities of 91, 182 and 364-day treasury bills. While the number and value of auctions is inimical to the size of government debt, it is still a positive indicator of lower off-balance sheet borrowing from the Central Bank for deficit financing purposes, and a relatively better-structured debt market.

<u>Insurance:</u> Egypt's insurance industry remains very small relative to other middle-income developing countries, with annual premiums accounting for only about 1.0% of GDP. The government reported total insurance sector assets at £E 18.6 billion at the end of FY 03/04 and £E 20.2 billion in FY 04/05, with an increase of 8.6%. Premium income was £E 4.03 billion in FY 03/04, up 32.8% over FY 02/03, and rose to £E 4.4 billion in FY 04/05, with an 8.9% increase. Non-life insurance amounted to £E 2.7 billion in FY 03/04, about two thirds of the total, a similar share to that maintained in FY 02/03, and rising by 28.5% over £E 2.1 billion in FY 02/03. It increased to £E 2.9 billion in FY 04/05, rising by 6.8%, and maintaining about the same share in total premiums. Life

insurance services continue to outperform non-life insurance, with premiums increasing to £E 1.3 billion in FY 03/04 from £E 939 million in the previous year with a growth rate 42.5%. In FY 04/05, life insurance grew by 16.7% to £E 1.5 billion. The percentage of insurance that each company must compulsorily reinsure with state-owned Egypt Reinsurance continues to be reduced, from 30% to 10% in 2003 for non-life insurance. For life insurance, it remains at 50%.

Four state-owned insurance and re-insurance companies continue to dominate the sector with over 70% of the market. The total number of companies in the market has not changed from 21 in 2004 (including at least six foreign insurance companies). In late June 2005, Egypt revised its services offer under the General Agreement for Trade in Services, which included some amendments regarding the insurance sector, allowing foreign branches and agencies to carry on business in free zones, provided that their activities are confined to the transactions carried out in convertible currencies.

If the government follows through on plans for further reform of the sector, including lowering the tax burden, which can be as high as 21% of premiums, as well as privatization of state-owned firms, there is likely to be substantial room for growth and foreign investment. Official valuations of the four large state-owned insurance companies, an important step toward privatization, were completed in mid-2001. The MOI announced in mid-September 2005 that Egypt had commissioned an international consortium to restructure its four state-owned insurance companies, opening the way for their privatization. The MOI selected the Paris-based BNP-Paribas, Egypt's CIB, and the New York-based insurance consultancy firm Milliman for the task. Once the restructuring is complete, a privatization plan for at least one of the companies will be devised, though an actual privatization is not expected in the near future.

Other Financial Services: The previously stagnant mortgage market showed some progress in 2005. According to official sources, as of September 30, 2005, the number of mortgage contracts concluded by the two mortgage finance companies in Egypt amounted to 275, with a total value of £E 82.96 million. Mortgage credit extended by banks as of the same date amounted to £E 118 million. These figures are in sharp contrast to zero mortgage credit prior to July 2004. According to government expectations, mortgage finance will continue to rise in the coming year. Mortgage finance involves at least 10-year credit in addition to sufficient collateral. This technicality is important in order to differentiate mortgage credit from housing loans, which are usually between 3-5 years.

Steps were taken by the Nazif Cabinet in 2005 to address various problems hindering the development of a mortgage credit system. Difficulties included cumbersome registration procedures, low levels of professional know-how in the field, as well as high costs of financing. At the legislative level, amendments were introduced to the executive charter of the Mortgage Law, the most important of which allows banks to assess clients' creditworthiness based on monthly salaries. Infrastructure issues were also tackled by the MFA, which is now conducting training for real estate appraisers on the basis of the executive regulations of the Real Estate Law, in order to issue them professional certification. Similarly, agents who will be entitled to certify foreclosure, eviction and other procedures are receiving preparation at the MFA. With regard to Egypt's complicated registration procedures, property title registration is now under development, with the government initiating a pilot project in the Dokki area of Cairo. Unlike urban registration, title registration for agricultural lands is well established. Registration fees have been reduced from 6% to 3% of the property amount; however, some observers maintain that this is still too costly. Little has been done though to address land ownership certification. Ownership transfer is usually not registered, due to cumbersome registration procedures and high costs, and a lack of awareness by the public.

The Central Bank is also addressing availability problems by permitting banks to lend at least 5% of their loan portfolio as real estate finance. The loan portfolio of Egyptian banks is estimated at around ₤E 350 billion. In April 2005, NBE signed a protocol to support the Real Estate Finance Guarantee and Support Fund (a fund stipulated under the Mortgage law). The fund will provide benefactors with a non-refundable grant equivalent to 15% of the value of a given unit with a limit of ₤E 10,000. The government has also amended the executive regulations of the law to classify potential beneficiaries of the fund's assistance as those with revenue of no more than ₤E 12,000 for single individuals and ₤E 18,000 for families. More work is required to develop the secondary market for mortgages. While securitization regulations were introduced into the Capital Market Law in May/June 2004, to date no securitization has been carried out. According to industry insiders, there are no strong financial notes meriting securitization. This perception may change as the number of mortgages increases and the stock market continues to thrive.

Given the backlog in demand for housing units by the middle and lower middle-classes, in addition to newly added demand each year on the order of 300,000 - 350,000 new housing units in line with a fast-growing population, it will take some time for the market to incorporate such demand. Added to this is demand for commercial and tourism-related property, especially as the government reduced restrictions on foreign property ownership in a number of touristic areas, namely the Red Sea, Hurghada, Sidi Abdel-Rahman and Ras Al-Hekma in Matrouh Governorate, in April 2005, through Prime Ministerial Decree No. 548 for 2005.

Energy: Gas exploration, development, and production continues to be among the brightest spots in the economy, and gas exports increased significantly in 2005 as new liquefied natural gas (LNG) plants came on line in the Nile Delta, the Western Desert and offshore in the Mediterranean. Oil production and exports, while declining, still play an important role in the economy. In FY 04/05 the oil and gas sector officially accounted for approximately 12% of GDP and more than one third of annual merchandise exports. In the first half of FY 05/06, earnings from oil and gas exports amounted to about $4.8 billion, a 75% increase over the same period in the previous fiscal year. The oil and gas sector continues to account for the bulk of foreign investment in Egypt, with participation from industry giants such as British Petroleum (BP), British Gas (BG), Italy's ENI, and Shell, as well as leading independent producers such as U.S.-based Apache and Devon. A number of other U.S.-based exploration, drilling, and oilfield services companies also work in Egypt, and this sector continues to present some of the country's best trade and investment opportunities.

Crude oil production has been in decline for some years, from a high of more than 920,000 barrels per day (BPD) in 1995 to an average of slightly higher than 655,000 BPD in the first ten months of 2005. Proven and probable crude oil reserves declined from about 4 billion barrels in the early 1980s to less than 3 billion in 2001, but have stabilized since then because of recent discoveries. Meanwhile, domestic consumption grew steadily through the 1990's, squeezing the available surplus of Egypt's largest single merchandise export. Domestic consumption had held steady for the last few years at approximately 470,000 BPD, but with the economic pick up in 2005, consumption levels rose to an average of 495,000 BPD in FY 04/05.

Gas and gas condensate production and reserves continue to rise. Over the last five years, production of natural gas has increased by approximately 75%, reaching more than 5.1 billion cubic feet per day by the end 2005. Approximately 1.6 billion cubic feet per day is dedicated for export and the rest is used for domestic consumption. During the same period, production of gas condensates doubled to 100,000 barrels per day, partially offsetting the decline in daily crude oil production. Proven reserves have almost tripled over the past ten years to more than 65 trillion cubic feet (TCF). The government estimates probable reserves at another 40-60 TCF, but other industry sources are less confident of this figure. Gas continued to account for approximately 50% of all hydrocarbon usage in Egypt in 2005. Most of the natural gas consumption in Egypt went to generate electricity; more than 60 percent of Egypt's total gas consumption was used by about 28 electrical power stations, feeding more than 90% of those stations' fuel needs. The remaining gas was used by about 500 industrial factories, more than 55,000 compressed natural gas vehicles, more than 2 million residents, and about 13,000 commercial customers.

The government began several rounds of new concession awards in 2003 and by June 2005 had signed a total of 36 new oil/gas exploration agreements with foreign companies such as BP, BG, Malaysia's Petronas, ENI's subsidiary IEOC, Shell, Apache and others. The new agreements provide for drilling of about 55 wells with a total investment of about $250 million in a total area of more than 25,000 square kilometers in addition to $61.55 million to be granted upon signing the contracts, (a sum know as a "signature bonus"). The majority of the agreements are for exploration in the Western Desert, the Mediterranean and the Nile Delta, as well as the Gulf of Suez. The Egyptian General Petroleum Corporation (EGPC) invited foreign companies for a new round of bids starting in late 2005 for exploration/exploitation under a production sharing agreement. This new round includes 13 exploration blocks in the Gulf of Suez, and the Eastern and Western Deserts' sedimentary basins. The closing date for the submission is mid February 2006.

In the first half of 2005, Apache announced two major natural gas discoveries, one onshore on the Mediterranean coast and another in the Western Desert, close to the Qasr field. The latter, the Syrah discovery, was quite significant, with estimated reserves of 2 trillion cubic feet of gas and 45 million barrels of condensate. The Syrah discovery was close to the 2004 Qasr Jurassic oil and gas field discovery. Apache's present Western Desert gross production is 300 million cubic feet (MMcF) of gas per day and the company plans to more than double that to 637 MMcf of gas per day as additional processing capacity comes on line over the next several years. Apache also announced a second discovery in early 2005 on a somewhat smaller scale. The Tanzanite 1X discovery, located onshore on Apache's West Mediterranean Concession, test-flowed 5,296 barrels of oil and 7.4 MMcf of gas per day. In October 2005 Apache reached an agreement with Amerada Hess Corporation to sell its 55 percent interest in the deepwater section of Egypt's West Mediterranean Concession to Amerada Hess Corporation for $413 million. According to Apache representatives, the transaction enables the company to focus on its Western Desert holdings, where it is the largest producer of both crude oil and natural gas. In the first nine months of 2005, Apache's gas production in Egypt increased 6 percent to 81,800 barrels of oil equivalent per day.

While oil discoveries were fewer in the last year, in June 2005 the government discovered three new wells in a shallow marine field about 2 kilometers from the western shore of the Gulf of Suez, in the Ras Gharib-Amr area. The Ras Gharib oil field was found about 50 years ago and the new discovery was the first significant finding in this area in 40 years. The total reserves of the new discoveries are estimated at more than 60 million barrels of crude oil. A second discovery, with estimated reserves of 12-14 million barrels of extra light crude, was also made at El Tamad field in the Nile Delta, the first oil discovery in the delta. A third discovery was announced in the Western Desert at an area known as the El Diyur Concession. An exploratory well in El Diyur showed reserves of crude oil with production of 1,000 BPD.

Although oil discoveries were fewer than gas in 2005, oil was the base for the second largest future flows deal ever negotiated in an emerging market. In late July 2005, EGPC closed a future flow securitization deal with Morgan Stanley acting as global coordinator and sole structuring Advisor. EGPC issued $1.55 billion in notes, based on an agreement by Petroleum Export Ltd. to purchase oil and naphtha from EGPC on a forward sales contract and sell to Morgan Stanley Capital Group, which acts as off taker/price hedge provider. In addition to Morgan Stanley, BNP Paribas, and Merrill Lynch were also underwriters.

Gas has the potential to become Egypt's largest merchandise export over the next decade. Currently, gas exports come chiefly from two main LNG plants, in Damietta and Idku. In January 2005, a new "LNG-highway" between Egypt and Spain came online when 136,000 cubic meters of LNG was shipped from Damietta, arriving at the Palos de la Frontera re-gasification terminal. The first LNG shipment to the U.S. also left Damietta in March 2005. The Damietta facility is operated by the Spanish-Egyptian Gas Company, which is owned by Spain's Union Fenosa Gas, ENI, the Egyptian Natural Gas Holding Company and EGPC.

BG, Malaysia's Petronas and Gaz de France own the Idku LNG facility, in conjunction with the government. The facility has an annual production capacity of 10 billion cubic feet. The majority of exports go to France, Italy and the U.S. The first LNG "train" came on line in late 2005. Exports of 3.2 billion cubic meters per year will also be shipped beginning in 2008 from the Idku facility to the Brindisi LNG terminal in southern Italy, under the terms of an agreement between BG and the Italian electricity company ENEL. Until these exports begin, production from the Idku facility will be supplied primarily to the Lake Charles LNG terminal in Louisiana, USA.

In December 2005 the second phase of the Arab Gas Line, located in Jordan, was completed. The second phase aims to transport the Egyptian natural gas delivered to Al Aqaba port in southern Jordan onward to the Samra and Rehab power stations in northern Jordan, through a 370-kilometer pipeline. The new pipeline is part of a broader plan to distribute future flows of Egyptian natural gas to the entire region, including the Zahrani refinery in northern Lebanon, the Syrian port of Banias and possibly Cyprus. Exports to Turkey by pipeline are also a longer-term prospect, though Egypt would face stiff competition in the Turkish market.

In June 2005 the governments of Israel and Egypt signed a memorandum of understanding (MOU) that could clear the way for a long-awaited $2.5 billion commercial gas deal between Eastern Mediterranean Gas (EMG) and the Israeli state-owned Electrical Company. While the technical details of the expected commercial deal are not known, 25 billion cubic meters of Egyptian natural gas will be exported over the coming fifteen years (an average of 1.7 billion cubic meters of gas per year) through an extension of the existing gas pipeline from the Egyptian port of El Arish to Ashkalon, Israel. The MOU provides a 'political umbrella' for the commercial agreement. Under the MOU, the Egyptian government commits to providing Egyptian gas to commercial companies (in the present case it is EMG) to then export it commercially to Israel. The Israeli government commits to provide tax incentives and exemptions for equipment and materials to be used for transporting the gas.

As another way of utilizing its gas surplus for both exports and domestic consumption, the government created the Egyptian Petrochemicals Holding Company (ECHEM) in 2002 to develop and implement a petrochemical industry master plan. The twenty-year plan envisions the establishment of up to 14 plants on Egypt's coastline to produce intermediate petrochemicals, such as propylene, linear alkyl benzene (LAB), and end-use consumer items. ECHEM estimates it needs $1 billion in foreign investment to implement the plan. In June 2004, the Egyptian Linear Alkyl Benzene Company awarded a contract to U.S.-based Fluor Corporation to manage development of a new facility in Alexandria for the production of linear alkyl benzene, which is principally used in detergents. The contract was finalized in late 2005 and the facility is expected to be operational in late 2007 or early 2008.

Despite its potential, questions persist about the future of the gas industry. There is considerable variance in estimates of probable gas reserves and some industry observers question whether Egypt's gas production will grow fast enough to keep up with all of the planned export sales, development of the petrochemicals industry, and growing domestic demand for natural gas. In October 2005 the government announced that it would only allocate one quarter of the proven reserves of natural gas for export, rather than one third as originally planned.

Domestic pricing policies also play a problematic role in oil and gas supply and demand. EGPC provides gas at cut-rate prices to power plants, which in turn provide low cost power to smaller consumers. The government heavily subsidizes butane cooking gas. Other petroleum products are sold at prices well below the international market, and perhaps below cost as well. For example, the price of petrol (gasoline) at the pump is well below world market prices (at 1 ₤E/liter, about $0.16/liter or $0.60/U.S. gallon at current exchange rates). Diesel, a significant proportion of which is imported, is only ₤E 0.40/liter, almost certainly below the cost of production.

These subsidies manifest themselves in smaller transfers from EGPC to the government budget, and thus have an indirect but enormous impact on government revenue. The cost of these explicit and implicit subsidies grows as Egypt's domestic consumption of oil and gas increases. The Minister of Petroleum publicly estimated that the cost of these direct and indirect subsidies had reached ₤E 20.5 billion by the second half of 2005. Other estimates have put the cost of energy (including electricity generation) at over ₤E 44 billion for 2006. As noted elsewhere in this report, rationalizing subsidies will be one of the government's key economic challenges over the next few years.

Currently, the electrical consumption in Egypt is divided between home use (37%), industry (35%) and the remaining 28% is for commercial and public facilities. To meet that demand, the government's long-term plan calls for the construction of up to 17 steam and/or combined-cycle power plants between 2003 and 2012 (i.e., over the course of the government's 2 five-year plans for 2002-07 and 2007-12). These plants would add an additional 12,875 megawatts (MW) of generating capacity, almost doubling Egypt's current capacity. Four of these power plants are now in operation (Cairo North 1&2 and El Nubariya 1&2). Financing and tendering for additional two 750 MW plants at Talkha and Kureimat are completed and expected to be in operation by the end of 2006. Financing for the ongoing and future projects is coming from international financial institutions (chiefly to date from the European Investment Bank and Arab Fund for Economic and Social Development, and Kuwait Fund for Arab Economic Development) and bilateral credit guarantee agencies (the U.S. Export-Import Bank is financing the Nubariya turbines being produced by General Electric).

The government's emphasis on increasing power production by constructing state-owned generation plants followed an earlier attempt to increase private-sector participation. By 2003, Egypt had added more than 2,000 MW in generating capacity through three privately owned Build-Own-Operate-Transfer (BOOT) projects. The government's concern over having to pay for that power in hard currency at a time when the Pound was losing value was the major factor in its decision to revert to more traditional government-run projects.

Construction: The construction and building-materials industries, which performed well in 2004 due to a construction boom in Persian Gulf countries, has continued to grow on buoyant export demand in 2005 and, to a lesser degree, a slight reemergence of domestic demand. Substantially higher prices pushed up the profitability of Egyptian cement and steel producers. On the negative side, those higher prices precluded a healthy rebound in domestic demand for building materials and led to accusations of monopolist practices in the sector and manipulation of prices. In fact, Egyptian steel rebar prices match prevailing world prices, and the domestic market structure prevents a domestic decline in prices if when international prices decline.

Government statistics put cement production at 28.72 million metric tons (mmt) for the FY 04/05, not much changed from the FY 03/04 figure of 28.73 mmt. The last recorded increase in production capacity was between FY 01/02 and FY 03/04. Following a dip in consumption in FY 03/04 to 24.5 mmt from 26.5 in FY 02/03, a small pick up to 25.2 mmt occurred in FY 04/05. More significant was the rise in exports, which increased by 104% from 4.2 mmt in FY 03/04 to 8.6 mmt in FY 04/05, demonstrating the move by suppliers to more lucrative markets abroad. Industry analysts, however, also point to an increase in local cement consumption by 16.4% to 21.2 mmt in the first nine months of 2005.

In September 2005, prices at private cement mills ranged between £E 306-309 per ton, up from around £E 130 per ton at the beginning of 2003 and £E 220 in 2004. Steel bar production in public companies fell drastically from 4.5 mmt in FY 03/04 to 1.98 mmt in FY 04/05, reflecting the dominant private sector component in the industry presently. Industry sources say steel rebar consumption stood at 2.75 million tons in the first nine months of 2005 and at 3.1 million tons in 2004. Production is reported to have equaled consumption, with companies keeping little or no inventories. Steel exports to the U.S. decreased from 333.7 mmt as a cumulative figure for the year to September 2004 to 171.8 mmt in the corresponding period of 2005, in line with an overall decline of the U.S. steel imports, despite a significant increase from some markets especially Russia and Turkey. Exports will continue to be important for Egypt's steel and cement producers over the coming years to fully exploit the large increases in capacity in the past few years.

Fortunately for Egypt's construction industry, the Gulf's construction boom shows no sign of abating. Exports to Europe are also expected to increase, part of which will be re-channeled to the Gulf boom. Huge demand in China is triggering capacity increases both globally and in China, posing a challenge to Egyptian exporters, but also an opportunity to carve out a market niche. On the domestic front, growth of demand for building materials has started picking up, despite the higher prices. Tourism construction and the recovery in the real estate market discussed elsewhere in this report will be important drivers together with national airport and port development plans.

Manufacturing: Over the past year, the manufacturing industry has benefited from the economic reforms introduced by Nazif’s government, which have brought about lower input prices and a cutback in bureaucratic red tape. Companies that suffered – yet survived – the recession between 2001 and 2003 are reporting higher investment and export levels. According to government statistics, Egypt's manufacturing sector accounts for approximately 20% of GDP and 14% of employment. Food processing and textile products account for the bulk of Egypt's manufacturing value, while other main sub-sectors include metallurgy, cement, fertilizers, and other consumer goods.

Automotive: Figures from the automotive industry indicate the number of sales (production and imports) in January to April 2005 at 35,030 vehicles compared to 22,130 vehicles in January to April 2004, a 58.3% increase. Sales of passenger cars over the said period increased by 52.9% from 17,289 to 26,440, with the bulk of the increase being for 1.5-1.6 liter capacity, which jumped by 84%. The rise in sales was triggered by the tariff cuts in September 2004. A presidential decree was issued that cut tariffs on imported vehicles and a number of input categories. For imported cars with engine sizes of 1,000 to 1,500 cubic centimeters, tariffs were cut from 55% to 40%. For cars between 1,500cc and 1,600cc, rates dropped from 100% to 40%. For cars larger than 1600 cc, the tariff remains 135%. Additionally, tariffs on trucks were brought down to between 12 and 32% (depending on size), from 40%. The new tariff structure set duties on automotive inputs and spare parts at between 5 and 12%, down from 23 and 33%.

While the local automotive industry welcomed the tariff reduction, many reservations remained. Automotive manufacturers and feeding industries maintain that tariffs on vehicle components remain too high, while other emerging countries have slashed them to around zero. New executive regulations for the Export and Import Law, issued October 2005, lifted the restriction that imported cars must be from the country of origin. As the industry remains largely import-dependent, this decision may lead to a rise in imported cars at the expense of locally assembled ones, especially with the declining exchange rate. Observers also expect the number of car agents as well as local assemblers to increase at the start of 2006. So far, nine different companies assemble vehicles. The fragmented production base offers few economies of scale and Egypt has thus far developed only limited feeder industries for vehicle parts. Egyptian automobile manufacturers will begin facing lower tariffs on automobiles imported from EU member nations in 2010. From that year until 2019, tariffs will be reduced 10% annually in accordance with the Egypt-EU Association Agreement.

With a large number of industries relying on imported inputs, the cut in import duties in late 2004 has expanded the possibilities for numerous businesses. Industries that are particularly benefiting are food processing and the white goods industry. Local sales from these industries have reported growth of 20% and higher in 2005. While to date manufacturing as a whole has not reported significant growth of international sales, longer term prospects for manufacturing will rely on the exploitation of export opportunities.

Textiles: The Egyptian textile industry is the second largest in the country (after food processing). It employs approximately one million people, equivalent to around 25% of the industrial workforce. It generates 27% of industrial production and 11% of manufacturing GDP and contributes to around 25% of non-oil exports. However, these figures encompass both new, business-savvy, well-equipped, and export-oriented firms (mostly private ones in the clothing industry) and older, unprofitable, largely state-owned firms employing outdated equipment and excessive workforces, particularly in the spinning and weaving sub-sectors. Despite the superior quality of Egyptian cotton, inefficient public spinning and weaving companies have difficulty competing internationally. Many clothing manufactures import their cloth, much of which originated from Egyptian cotton. This has led to a drop in yarn production between 1997-2004, by around 25%.

When internationally regulated garment and textile quotas ended with the expiration of the Multi-fiber Agreement on January 1, 2005, Egypt's share of these exports to the U.S. was expected to be lost to cheaper producers such as India and China. The Qualifying Industrial Zones (QIZ) program with Israel, which became effective on December 14, 2004, has been critical in helping Egypt maintain its U.S. market share. Under the terms of the U.S.-government-sponsored program, Egyptian manufacturers located within the QIZs are given duty free access to the U.S. market under the U.S.-Israeli Free Trade Agreement, provided that their exports contain at least 35% local content, including at least 11.7% Israeli content. The U.S. Trade Representative initially designated seven QIZs: Port Said Industrial City, 10th Ramadan Industrial City, Shobra El Khaimah, 15th of May Industrial City, Nasr City, South of Giza, and El Amria/Borg El Arab in Alexandria. In October 2005, the U.S. government approved the Egyptian government's request to expand by adding the four remaining industrial areas in the Cairo region – Obour City, Badr City, 6th October City, and Qalyoub – and two industrial areas in the Suez Canal region – Ismailia and Suez City.

By the end of November 2005, 471 companies were qualified to export under the QIZ program. The 70 companies that have exported under the program have all been apparel or textile manufacturers. During the first half of 2005, apparel exports to the U.S. increased by 5% to reach $61.6 million, while they increased by an additional 90% between July and September of 2005 to reach $116 million. The QIZ arrangement has contributed to increased foreign direct investment in the zones, which totaled $52.4 million between January and October 2005. Indian, Turkish and Taiwanese companies have shown interest in investing in the Egyptian textiles and apparel sector.

Even with the success of the QIZ program, modernization of the textile industry remains imperative. U.S. tariffs on textile imports will eventually be eliminated under WTO commitments and the QIZ benefit will evaporate. To do so effectively, the industry will have to address challenges such as quality control and improve design and upstream industries. The government is privatizing textile and apparel companies, and plans to use the proceeds for restructuring. A major challenge will be dealing with the sector's oversized workforce and costly payrolls and pensions. The government is also pursuing a donor-supported modernization program to upgrade factories, provide training, and finance early retirement.

Simplified procedures and paper work for exporters are being put in place, but the registration requirement has not changed. In December 2004 Egypt reduced tariffs for certain inputs for textile and apparel production and committed to a further round of tariff cuts for additional textile and apparel products in 2005. As of February 2006, however, this second round of reductions has not been implemented. Government figures have reported a growth in exports of textiles and ready-made clothes from $466.1 million in FY 03/04 to $602.7 million in FY 04/05, in part due to the overall economic upturn.

Pharmaceuticals: Government price controls on pharmaceuticals continue to debilitate the industry. While the Ministry of Health and Population has selectively raised pharmaceutical prices in recent years, it has not allowed for complete price adjustment to compensate for general inflation and the significant depreciation of the Pound in 2003. Because both domestic and foreign pharmaceutical companies rely heavily on imported inputs, profitability dropped sharply with the depreciation of the Pound, and some companies claim to be operating at a loss. Some companies have cut back their operations, including halting production of certain medicines.

The September 2004 tariff cuts reduced customs duties on most imports of pharmaceutical inputs and products from 10% to 2%. The government claimed that this would compensate local pharmaceutical companies for some of their losses from the 2003 devaluation. Although local companies, which produce mainly off-patent, generic products, are not suffering as much as foreign firms, price controls reduce their profitability and limit their ability to sustain and expand production. Despite these problems, investors remain interested in this sector. For example, in late 2004, a multinational pharmaceutical firm established a $40 million tablet-manufacturing plant in 6th of October City.

To promote growth of the pharmaceutical industry, the current policy of subsidizing drug prices for all consumers will have to change to cost-based pricing with subsidies aimed at the truly needy. The U.S. has also urged the government to address problems related to intellectual property rights (IPR) protection, particularly government approval of locally produced copies of protected innovative U.S. pharmaceuticals. The most recent approval was given in December 2005. In its annual review of foreign country IPR compliance, the U.S. government cited these approvals as a reason for elevating Egypt to the "Priority Watch List" in 2004.

IPR protection in Egypt should improve as a result of a number of important changes that have been initiated in 2005. Most importantly, pharmaceutical patent protection became effective on January 1, 2005. A huge backlog of patent applications pending since 1995 can now be reviewed and patents granted. Assistance from USAID has helped modernize the Egyptian Patent Office. This new office has significantly improved the quality and transparency of Egypt's registration system. Also in 2005, the Ministry of Foreign Trade and Industry proposed establishing a dispute settlement body for pharmaceutical issues, which would be comprised of representatives from local and multinational pharmaceutical companies working in Egypt.

We expect that the improved investment climate, increased foreign exchange availability and recovering local demand will lead to stronger pharmaceutical manufacturing performance in the coming year. Over the long term, with the Pound's strengthening and an increased demand for standard-adherent products in foreign markets, Egypt will need to improve quality to remain competitive.

Agriculture: Agriculture remains one of Egypt's most important sectors. Its growth rate in current prices increased from 5.6% in FY 03/04 to 6.3% in FY 04/05. Growing middle-income countries generally exhibit a decline in agriculture's share of GDP and employment, and Egypt is no exception. The sector's contribution to GDP has fallen gradually from 20% in FY 86/87 to 15% in FY 03/04, and the number of Egyptians employed in the sector has also fallen, from 33.8% of the total labor force in FY 90/91 to 28.4% in FY 01/02 and an estimated 27.6% in FY 04/05. The challenge for Egypt is to maintain and expand agricultural production for domestic and export markets while concurrently adding value and employment through the development of more agriculture-based processing activities. Since the mid-1980s, productivity gains have been achieved through long-term government commitment to policy reform and assistance from foreign donors (particularly USAID), closing the gap between domestic food supply and demand.

Egyptian wheat production was 7.1 million metric tons (mmt) in 2004, and rose to 8.1 mmt in 2005. Rice production was 3.93 mmt in 2004 and rose to 4.0 mmt in 2005. Despite these increases in production, Egypt remains a large food importer and a traditional market for U.S. grain exports. U.S. wheat exports had achieved 53% of Egypt's 6.8-mmt wheat import market in the 2003-2004 marketing year for wheat (MY 2003-2004 or 03-04; each crop has its own marketing year, therefore marketing year timeframes vary). This share fell to 24% of Egypt’s total wheat imports of 6.9 mmt in MY 04/05. A further decline due to price is expected for MY 05/06. Private sector companies are now sourcing more wheat from less expensive suppliers such as Russia, Ukraine, and Hungary.

Although cotton production in Egypt had been on the decline in recent years, standing at 190,000 metric tons (mt) in MY 03-04, production rebounded to 280,000 mt in MY 04-05. However, it is expected to drop again to 250,000 mt in MY 05-06, due to a worldwide drop in cotton prices in the previous season. In MY 04-05, the market price of the Giza 86 variety, for example, was reported at £E 590 compared to £E 1000 in MY 03-04. The prolonged price increases for local corn and rice are influencing farmers’ decisions to plant corn rather than cotton, particularly in Upper Egypt. While still a small share of total exports, horticultural exports, chiefly to Europe, represent a promising new market.

Reclamation and cultivation of desert land by private investors has also been on the rise. Cultivation along the Cairo-Alexandria Desert Road is a visible example. Agricultural exports have also been growing at a faster pace than in recent years. According to the Chairman of the Agricultural Exports Council, agricultural exports for 2005-2006 are expected to reach $1.514 billion, up from $1.253 billion in 2004-2005. This is due in part to the reform efforts of the incumbent Minister of Trade and Industry to address obstacles facing the sector particularly in airfreight services and customs procedures. Egypt expects that its Association Agreement with the European Union and development of the Toshka agricultural scheme will lead to large increases in fruit and vegetable exports.

Food processing for both the domestic and export markets is an industry with substantial growth potential, more so with the new lower tax rates on imports of raw materials.

The South Valley Development or "Toshka" project, located in Egypt's far south, aims to irrigate some 540,000 acres of arable arid soil with water from Lake Nasser. Since 1997, the government has been building a massive pumping station and irrigation canals to transport water for the project. Construction on the project slowed for several years, but according to the Ministry of Irrigation, all of its 21 pumping stations are now in operation. The main canal was completed in 2000. Construction is proceeding on four branch canals of 28 kilometers each, with the first two completed in January 2003, 90% of the third now complete and about 25% of the fourth. Saudi Prince Walid bin Talal's Kingdom Agricultural Development Corporation (KADCO) owns 120,000 acres that are managed by the U.S. firm Cadiz/Sun World (which has a 10% investment stake in the KADCO project), and is currently doing field tests on a portion of that land. This private sector project's aim is to grow fresh fruits and vegetable for export to Europe in the winter months. The Egyptian Holding Company for Trade has reclaimed 30,000 acres and will begin cultivation in the coming winter season.

Transportation and Infrastructure: In conjunction with the Minister of Civil Aviation's strategy to improve Egypt's aviation infrastructure and turn Cairo into a regional hub by 2007, the aviation sector witnessed vast improvements in airport services and a return to profitability for the national carrier. Egypt Air remains the dominant player in the sector and is the sole operator on most domestic routes. A few small airlines run charter businesses, mostly using leased aircraft, which bring tourists from Europe to Egypt. An even smaller number operate scheduled or charter domestic flights on a very small number of routes, chiefly to tourist destinations. Since 2003, the government has allowed some Arab airlines to operate scheduled flights directly into Egypt's other international airports (such as Sharm el Sheikh and Hurghada), rather than just to Cairo.

Egypt Air was converted into a holding company in 2002. To stem mounting losses, the national carrier announced in early 2004 that it was trimming its route network and raising prices on domestic routes. In May 2004, the People's Assembly passed new legislation instituting a departure tax on all airline flights and a surcharge on all air tickets sold in Egypt**.** This seemed to produce the desired results: the carrier posted a net profit of ₤E 644.4 million in FY 03-04 with total revenues of ₤E 947 million.

In August 2005 Boeing concluded a deal with EgyptAir for a firm order of six 737-800s with purchase options for an additional six. The deal is worth $850 million at list prices. Egypt Air currently has four Boeing 737-500s, five 777-200s and two 747-300s as part of their mixed fleet of airplanes. The airline will take delivery of its first 737-800 in September 2006, with the remaining airplanes joining its fleet out through December 2009. In 2003, Egypt Air signed a $750 million long-term lease-purchase agreement for seven new Airbus 330s to replace older Airbus 300/600s. It purchased five additional Airbus 320s for $185 million. Delivery of the Airbus 320s started in October 2003, a few months behind schedule, while delivery of the Airbus 330s started in July 2004.

In January 2004,a Paris-bound aircraft operated by Flash Airlines, a private Egyptian charter company, crashed into the sea shortly after take-off from Sharm El Sheikh, killing all 148 people on board, mostly French tourists. Working in conjunction with French and American investigators, the Egyptian Civil Aviation Authority's investigative team anticipates the release of the final accident report in early 2006.

Airport Modernization: In March 2004, the World Bank approved a $335 million loan to the government for airport modernization projects. Most of the loan was designated to finance the estimated $350-400 million construction of a long-planned third terminal at Cairo International Airport. The balance will make possible a new terminal in Sharm El Sheikh, Egypt's premier beach resort. The new Sharm El Sheikh terminal should double that airport's passenger-handling capacity. The upgrade of Luxor airport was completed in late 2003. The Japanese International Cooperation Bank also floated a $48 million loan to finance the construction of a new passenger terminal at Borg Al Arab airport outside Alexandria. In order to further airport management improvements, the Ministry of Civil Aviation awarded management contracts to foreign airport operators. German firm Fraport secured the contract for Cairo, while the French firm Aeroports de Paris secured contracts for the mainly tourist airports of Sharm El Sheikh, Hurghada, Luxor, Aswan, and Abu Simbel.

Egypt's first BOOT airport, Marsa Alam on the southern Red Sea coast, started operations in October 2001. It is now mainly a destination for tourist charter flights from Europe. A second BOOT airport at El Alamein, 40 kilometers from the primary resort area of Egypt's Mediterranean coast, opened with an inaugural charter flight from London in mid-2005. A proposed BOOT airport in Ain Sokhna is still on the government's agenda. Preliminary studies are being conducted by the NORGIC Group, an airport consultant group from Norway.

Sea Port Modernization: The government has allocated some £E 11 billion during the next five years for port development, which is expected to create some 250,000 jobs. The first phase of the Alexandria Port renovation was completed at a cost of £E 300 million. This has increased capacity to 44 million tons/year, up from 32 million tons/year in 2004 and represents about 60% of Egypt’s incoming and outgoing trade. Plans are underway to increase existing quays at the Port of Alexandria from 71 to 77 and in Dekheila from 9 to 17, in addition to introducing Electronic Data Management (EDM). In Alexandria, recent upgrades, consisting of deeper quays to receive larger vessels and the re-designing of storage areas and warehouses, have resulted in a smoother flow of goods and services and have combined with reforms in the Customs Authority to produce a sharp decrease in customs clearance times from three to four weeks last year to about one week at present.

To ease Egypt's dependence on Alexandria, the government has undertaken an £E 140 million project to improve EDM, customs procedures, road and rail connections, and other infrastructure at the port of Damietta, on the Mediterranean coast between Alexandria and the Suez Canal, which currently handles about 10% of all import traffic. Damietta also benefits from significantly more private-sector involvement and investment in cargo handling than other ports. Processing times have been cut dramatically to about four days.

President Mubarak inaugurated the port of Ain Sokhna, located on the Red Sea about 40 km south of Suez, in October 2002. Sokhna Port seeks to capitalize on Egypt's strategic location on the main trade routes between Europe and Asia. This is also the first fully private port, which now boasts a sector-leading 48-hour turnaround for clearing goods. This new port applies state-of-the-art technology including electronic data interchange and SMS messaging to inform clients of the status of their goods. Sokhna Port is also using bar codes to identify files and folders – a first in the Egyptian port industry – as well as specialized container scanning equipment, electronic banking, and GPS technology for container tracking.

One year after the inauguration of its first phase in December 2004, East Port Said Port is on track to become the largest in Egypt for container transshipment traffic. Having reached 650,000 container moves, the operator is investing $140 million for the second phase to widen the terminal from 1200 meters to 2900 meters, doubling container capacity to 1.2 million annually.

Information Technology and Telecommunications: Continued increases in mobile phone and computer penetration, combined with important legal and regulatory changes, kept this sector at the forefront of market-oriented reforms in Egypt over the past year. Industry estimates put the growth of the telecommunications sector at 20% annually, while a March 2005 assessment estimated 6-7 million Egyptians use 2.5 million computers, with a demand for 500,000 new computers annually. The government also made significant progress in e-government services in 2005. Nevertheless, less than 4% of the population owned computers in 2005, and more than 40% of the computer-owning population was concentrated in Cairo and Alexandria. Constraints on the sector's growth include insufficiently trained human resources, the absence of Internet training in school curricula, low Arabic content on the net, and lack of public awareness. Government-sponsored Internet centers and subsidized Internet cafes are beginning to address these constraints in towns throughout Egypt.

The government reported that Internet penetration increased from 1.6 million dial-up users in 2002 to about five million by August 2005. One reason was the very low dial-up fee, which is currently set at two piastres (0.33 cents) per minute. The government's "Broadband Initiative," introduced in May 2004, halved the price of ADSL service to £E 150 ($24) per month for 256K transmissions, and introduced Wi-Fi and Wi-Max technologies to the market. Official statements indicated that high-speed Internet service subscribers reached 66,000 by the end of July 2005.

The growth of cellular phone services in Egypt continues to be the most measurable indicator of IT potential in Egypt. Egypt's two providers are Vodafone Egypt, majority owned by Vodafone, with a 48% market share, and MobiNil, owned by majority partner Orange Telecom and Egyptian minority partner Orascom Telecommunications (OT), with a 52% market share. Official reports indicated that total mobile subscribers increased from 7.6 million in November 2004 to more than 13.5 million in November 2005 – compared with 10.3 million fixed phone lines at the end of September 2005.

Several major structural changes were proposed or implemented in Egypt's telecom industry over the last year. After much delay, the government finally carried through on plans to privatize Telecom Egypt (TE). In November 2005 the government divested 20% of TE through an IPO of 10%, or about 170 million shares, on the stock exchange. TE employees were able to purchase shares in the IPO at a 20% discount over the £E 14.8/share price offered to other investors. The remaining 10% of the total divestment was sold to financial institutions. The IPO met with an immediate rush for subscriptions, and by the time it closed on December 7, more than 1.5 billion shares had been requested – about 10 times more than the number available – with subscribers offering to pay more than £E 11.5 billion; only £E 2.31 billion would have been generated at the initial share price. In the first days of trading, the CASE 30 Index reached record highs, closing almost 246 points higher than the previous record high of 6091 points. By the last week of January 2006 the share price had leveled off at £E 18.8.

As part of an overall restructuring of TE, the company issued a corporate bond in February 2005, to increase its capital. The initial offering was £E 2 billion ($346.6 million), but demand reached £E 3.38 billion (i.e., 70 % higher than the initial offer). Foreign investment funds from the U.S., UK, Belgium, and UAE purchased more than £E 420 million of the issue. The government also terminated TE's monopoly over international phone calls with the granting of licenses for Voice over Internet Protocol (VoIP). In March 2005 the National Telecommunication Regulatory Authority (NTRA) introduced seven different types of licenses for VoIP applications that covered networks and national and international applications. It granted licenses to several different ISPs to use VoIP in Virtual Private Networks. Licenses for use of VoIP for broader communications are expected for 2006.

In December 2005 NTRA indicated that it would begin accepting bids for a third cell phone operator license in February 2006. According to NTRA and Ministry of Communication and Information Technology officials, the third operator will receive benefits that will enable it to compete with the two existing GSM operators (MobiNil and Vodafone). NTRA expects the third licensee to be operating by the end of 2006 or, at the latest, the second quarter of 2007. NTRA has indicated that it will consider all bids, regardless of technology, i.e., either GSM or CDMA.

OT Holdings, Egypt's largest private telecommunications company and a major mobile phone service provider in Africa and the Middle East, announced in May 2005 that it was purchasing Wind, Italian conglomerate Enel's telecom subsidiary, at a cost of Euro 17.2 billion. Wind was the third largest mobile operator in Italy, after Telecom Italia and Vodafone. In addition, Wind controlled Italian fixed-line telephone services with more than 30 million total subscribers. Several reports indicated that under the agreement, Enel would transfer all Wind's shares to a newly established fund called "Weather Investments," in which OT owned 73.9% of shares and Enel the remaining 26.1%. In May 2005, 62.75% of Wind's shares were transferred to Weather Investments, at a total cost of Euros 12.1 billion; the deal was due to be completed during the first half of 2006, when Weather Investments would purchase the remaining shares (37.25 %) and 50% plus one shares of OT.

In October 2003, OT also headed IRAQNA, a consortium that won the license for providing mobile telephone services in Iraq's central region, including Baghdad. Currently, OT owns all of IRAQNA's shares, with 1.5 million subscribers and an income of approximately $250 million during the first nine months of 2005. IRAQNA's license expired in late December 2005, but OT received an extension until the end of June 2006, and is expected to apply for a new license.

ECONOMIC COOPERATION

Regional Initiatives: In June 2001, Egypt signed an Association Agreement with the EU. The People's Assembly ratified the agreement in March 2003, and after ratification by all of the fifteen EU member states, the agreement came into effect in June 1, 2004 (the trade provisions of the agreement took effect on January 1, 2004). The agreement grants Egyptian exporters immediate duty-free and quota-free access to the European market for industrial goods, and expanded access for agricultural products that do not compete directly with European products. As for European access to the Egyptian market, the agreement requires Egypt to phase out customs duties on imports from the EU according to four schedules. For example, tariffs on raw materials and industrial equipment will drop to zero three years after the agreement enters into force; on semi-finished goods after 9 years; on consumer goods and finished products after 12 years; and on automobiles after 15 years. The agreement includes € 615 million in project assistance grants and € 1.1 billion in loans from the European Investment Bank, designed to help modernize Egyptian industry.

The 10th anniversary of the Barcelona Process was marked in 2005. During the year, the EU announced its intention to increase liberalization of trade in agricultural and agro-industrial goods with its Mediterranean partners. Informal consultations are ongoing. Egyptian agricultural exporters are keen to take this opportunity to achieve larger quotas for certain exporters.

Egypt has trade agreements with nearly every Arab country. In January 1998, Egypt began implementing the terms of the Greater Arab Free Trade Area Agreement (GAFTAA), an agreement among 11 Arab League members based on the Arab Common Market treaty of the 1960s. The GAFTAA called for the phasing out of existing tariffs by 2008. In January 2005, the 11 members agreed to accelerate the tariff phase out and fully eliminate tariffs. Extensive "negative" lists that exclude specific items from tariff elimination, however, impede the effectiveness of this agreement. One year on, the size of inter-Arab trade has not changed from 8% of total Arab trade, to due negative lists and the continued presence of significant non-tariff barriers in several member countries.

In February 2004, Egypt signed a free trade agreement (the Aghadir Agreement), with Tunisia, Morocco, and Jordan. The agreement commits the parties to remove all tariffs on trade between them and to intensify economic cooperation by harmonizing their standards and customs procedures. The agreement has not yet entered into force, as Morocco has not completed ratification. Tariffs were intended to be reduced 80% immediately and eliminated completely in 2005, if all parties had ratified and exchanged instruments of ratification in 2004. If instruments are exchanged in 2005, tariffs will be immediately eliminated. This free trade area is envisioned as part of the EU's Euro-Med process to promote freer trade between the EU and its Mediterranean neighbors. Egypt has been a member of the Common Market for Eastern and Southern Africa (COMESA) since 1998. Egypt enjoys tariff-free trade with the 11 members of COMESA, but faces varying tariff levels on trade with the other 9 members.

U.S.-Egypt Trade and Investment Framework Agreement: Egypt and the United States signed a Trade and Investment Framework Agreement (TIFA) in 1999. The TIFA provides a mechanism for identifying and undertaking measures to promote freer trade between Egypt and the United States. The agreement also established a TIFA Council composed of representatives of both governments, and chaired by a senior USTR official and the Egyptian Ministry of Foreign Trade and Industry. The Council first met in November 1999. Subsequent meetings resulted in the establishment of 13 working groups that review technical issues related to all major elements of bilateral trade. The working groups held their first sessions in December 2002 and have met regularly since then. The last TIFA Council meeting took place in Washington, DC in November 2005.

U.S. Economic Assistance: The U.S. government has provided Egypt more than $25 billion in economic assistance since 1978. USAID has been instrumental in putting into place the foundations for economic growth. In addition to infrastructure development (water, wastewater, power, and telecommunications), USAID has helped promote a favorable economic policy environment for private-sector development. Over the years, USAID programs have concentrated on job creation, economic growth and productivity, infrastructure development, education, democracy and governance, health and nutrition, the environment, and natural resource management. Recently, USAID's strategy has focused more on expanding the role of Egypt's private sector to help move Egypt from an assistance-based relationship to a relationship based on bilateral trade and investment. New areas of concentration under this approach include development of the information-technology sector, strengthening Egypt's capacity for human resource development, trade policy capacity building, financial sector reform, development of micro and small enterprises, and enhancement of Egypt's business and export competitiveness.

Economic assistance levels averaged over $800 million annually from the time of the Camp David accords (1978) until mid-1998. As part of an overall revision in U.S. assistance policy, aid levels have, by mutual agreement with the government, been on a downward glide path since 1999. The USAID budget for Egypt for U.S. FY 04 was $575 million, and $535 million for FY 05. Current planning is that economic assistance levels for Egypt will continue to be reduced by $40 million per year to a level of $407.5 million by 2009. Much of the assistance has been tied to the government's financial sector reform initiatives, under a Memorandum of Understanding signed in March 2005.

U.S. Support for Trade and Investment: The Overseas Private Investment Corporation (OPIC), the U.S. Export-Import Bank (Ex-Im Bank), and the Trade and Development Agency (TDA) are committed to supporting the growth of U.S.-Egyptian bilateral trade and investment. These agencies provide loans, insurance products, and other services, such as support for feasibility studies on major investments involving U.S. inputs. Several business missions from these agencies visit Egypt annually to explore possibilities for increasing their activities in Egypt. Information about Ex-Im Bank, OPIC, and TDA programs is available through their head offices in Washington or through the Embassy (see below). The U.S. Department of Commerce's Foreign Commercial Service (FCS) and the U.S. Department of Agriculture's Foreign Agricultural Service (FAS) provide assistance to U.S. exporters through their offices in Washington and in the Embassy in Cairo. The Embassy's Economic and Political Section also can provide guidance to current and potential American investors and information on current economic conditions in Egypt. See the over leaf of the front page for more information about these services.

POLITICAL ISSUES AFFECTING THE BUSINESS CLIMATE

Nature of Political Relationship with the United States: The U.S. and Egypt enjoy a strong and friendly relationship based on shared mutual interest in Middle East peace, stability and regional security, combating international terrorism, strengthening trade relations, and revitalizing the Egyptian economy. Multinational exercises, U.S. assistance to Egypt's military modernization program (valued at $1.3 billion annually), and Egypt's role as a contributor to various UN peacekeeping operations continually reinforce the U.S.-Egyptian military relationship.

Political System: In May 2005 the People's Assembly passed an amendment to the Constitution, which was subsequently endorsed in a public referendum, which allowed for a multi-candidate, competitive presidential election for the first time in the country's history. President Mubarak won re-election in September 2005 for a fifth six-year term. The President is empowered to appoint one or more Vice Presidents, the Prime Minister, the Cabinet, and Egypt's 26 provincial governors. The bicameral legislature includes the law-making People's Assembly and a consultative upper house, the Shura Council.

The NDP has been the ruling party since its foundation in 1978. In the 2005 parliamentary elections, NDP candidates, combined with independent candidates associated with the NDP to win a majority of seats in the People's Assembly. The number of seats held by independent candidates associated with the banned Muslim Brotherhood also increased substantially. There are 18 other recognized opposition parties, all of them small. A few of these parties have members in the People's Assembly and the Shura Council.

President Mubarak re-appointed 52 year-old Ahmed Nazif as Prime Minister in December 2005, and retained most of the Cabinet appointed in the July 2004 shuffle. Several business leaders were also added to the new Cabinet, including Mohamed Mansour as Minister of Transportation.

Terrorism/Political Violence: In April 2005 three terrorist incidents occurred in Cairo, in which small homemade bombs were detonated in crowded areas of the city. A large attack also occurred in Sharm el Sheikh in July 2005, when terrorists detonated several bombs in hotels, killing more than 100 people. While the potential for additional terrorist attacks does not pose a credible threat to the government, they could threaten the business climate and Egypt's vital tourist industry.

Recent democratic changes have open a public debate regarding the future of political reform in Egypt. This debate has generated frequent public demonstrations, most of which have remained peaceful. There have been incidents involving violence, however, but the violence was directed toward the government, not foreigners or foreign investment.

The government has reiterated its interest in foreign investment and its opposition to any boycott of U.S. products, and major threats to foreign investments and entities have not materialized. The overall security atmosphere for U.S. firms operating in Egypt remains excellent.

FURTHER RESOURCES

Additional information on economic and business issues in Egypt can be obtained from a number of sources supported by the U.S. and Egyptian governments, as well as business and research institutions. Below are several websites that may be of further interest. The Embassy takes no responsibility for non-U.S. government sites.

U.S. Government Websites:

www.cairo.usembassy.gov
Homepage of the U.S. Mission to Egypt

www.exim.gov
Export-Import Bank of the United States

www.opic.gov
Overseas Private Investment Corporation

www.usaid.gov
U.S. Agency for International Development

www.tda.gov
Trade and Development Agency

www.ita.doc.gov
Includes all homepages of International Trade Administration (ITA) entities

www.buyusa.gov/egypt/en
Home page of the Commercial Service in Egypt

www.ita.doc.gov/td/tic/
Home page of the Trade Information Center of the U.S. Department of Commerce

www.bea.gov
Bureau of Economic Analysis, U.S. Department of Commerce

www.scitechresources.gov
Catalog of US government science and technology-related websites

Egyptian Government Websites:

www.alhokoma.gov.eg
Egypt's government-on-line homepage, with links to many ministries

www.presidency.gov.eg
Egyptian Presidency

www.sis.gov.eg
State Information Service

www.parliament.gov.eg
Egyptian Parliament

www.idsc.gov.eg
Home page of the Cabinet Information and Decision Support Center

www.cbe.org.eg
Central Bank of Egypt

www.mfti.gov.eg
Ministry of Foreign Trade and Industry

www.investment.gov.eg
Ministry of Investment

www.mfa.gov.eg
Ministry of Foreign Affairs

www.capmas.gov.eg
Central Agency for Public Mobilization and Statistics (CAPMAS)

www.egyptse.com
Cairo and Alexandria Stock Exchange

Non-Governmental Websites:

www.eces.org.eg
Egyptian Center for Economic Studies

www.amcham.org.eg
American Chamber of Commerce in Egypt

www.erf.org.eg
Economic Research Forum for the Arab Countries, Iran and Turkey

www.us-egypt.org
U.S.-Egypt Business Council

www.arableagueonline.org
Arab League Website

www.egyptbic.com
Biotech info Center –Egypt

www.ndp.org.eg
National Democratic Party (NDP) website

www.fgf-egypt.org
Future Generation Foundation website

www.wto.org/english/thewto_e/countries_e/egypt_e.htm
World Trade Organization website - Egypt Page

www.ahram.org.eg
Al Ahram Newspaper

www.elakhbar.org.eg
Al Akhbar Newspaper

www.gn4me.com/alalamalyoum/index.jsp
Al Alam Alyom Newspaper

STATISTICAL ANNEX

COUNTRY DATA

Population: 71.3 million
Population Growth rate: 1.99%
Religions: Muslim 90% - Christian 10%
Government System: Presidential
Languages: Arabic
Work Week: Sat.–Wed. (gov't.); Sun.–Thurs. (bus.)

DOMESTIC ECONOMY

National Accounts

Egyptian fiscal year (July-June)
US$ billions unless stated otherwise

	FY01/02	**FY02/03**	**FY03/04**	**FY 04/05**
GDP (current prices, ₤E billion)	379	418	485	536
GDP (current prices)*	87.5 (2002)	81.4 (2003)	77.0 (2004)	91.7 (2005)
GDP real growth rate (%)	3.2	3.0	4.1	5.1
GDP/Per Capita*	1313.3 (2002)	1197.2 (2003)	1111.1 (2004)	1296.6 (2005)
Government Spending/GDP (%)	26.7	26.8	26.5	28.3
Consolidated Fiscal Deficit/GDP	2.5	2.4	2.4	5.7%**
Inflation (%) ***	2.4	7.1	9.5	3.1 (November 2005)
Wholesale Price Index (%, June of each year unless stated otherwise)	3.5	18.0	15.9	5.1
Unemployment (%)	9.0	9.9	9.85	10.0
Foreign Exchange Reserves	14.1	14.8	14.8	19.3
Reserves/months of imports	11.6	12	9.7	9.6
Avg. Exch. Rate for ₤E/$	4.348	5.13	6.18	6.02
End of Period Exch. Rate (June of each year)	4.51	6.03	6.22	5.78
Debt service ratio**** (%)	9.5	9.8	9.2	7.9
Total Foreign Debt/GDP	32.8	35.6	38.1	30.0
U.S. assistance (U.S. Fiscal Year) Military Economic	1.955 1.3 0.655	1.915 1.3 0.615	1.875 1.3 0.575	1.835 1.3 0.535

* IMF figures
** Preliminary figures
*** Inflation figures starting 2002/2003 are revised due to changes in the Urban Price Index
**** Debt Service is ratio of external debt service to current account receipts
Sources: Egyptian government, IMF, World Bank.

Key Sectoral Statistics

	2001	2002	2003	2004	2005
Tourism* Revenues (USD million) Total Arrivals (millions)	 3800 4.6	 3764 5.2	 4583 6.0	 6125 8.1	 2918 (Jan.-June) 6.5 (Jan.-Sept.)
Energy and Petroleum** Oil (crude) (avg. thous. barrels/day) Gas (billion cubic feet/day) Electricity (million Kilowatt/hour)	 639 2.4 75.6	 631 2.6 83.0	 618 3.3 91.4	 594 3.55 100.09	 657 (Jan-Oct) 4.1 Not yet avail.
Construction*** (million tons) Cement (domestic consumption +exports-imports) Steel (production, rebars)	 25.2 (FY00/01) 3.5	 27.4 (FY01/02) 3.5	 28.4 (FY02/03) 3.1	 28.7 (FY03/04) 3.1	 33.9 (FY04/05) 2.75 (Jan.-Sept.)
Agriculture****(million metric tons) Wheat Rice (milled) Sugar Cotton (thousand metric tons)	 6.2 3.6 1.4 310	 6.3 3.7 1.4 315	 6.5 3.9 1.3 190	 7.1 3.9 1.3 280	 8.1 4.0 1.4 250

* Ministry of Foreign Trade, Ministry of Tourism
** U.S. Dept. of Energy, Ministry of Petroleum, Ministry of Electricity (Elect. figures for fiscal years, oil and gas figures for calendar years)
*** Ministry of Investment, EFG-Hermes, Ezz Steel
**** U.S. Dept. of Agriculture, cotton is marketing year: Aug.-Sep.

TRADE AND INVESTMENT

US$ millions

	FY01/02	FY02/03	FY03/04	FY04/05*
Merchandise Exports	7121	8205	10453	13816
Petroleum and related products	2381	3161	3910	5276
Cotton and related products	526	796	976	1042
Merchandise Imports	14637	14764	18286	24193
Consumer Goods	2779	2593	2931	3202
Intermediate Goods	3702	4396	5247	6803
Capital Goods	3023	3179	3506	4895
Trade Deficit	7517	6559	7834	10377
Services (net)	3878	4907	7318	7843
Tourism Revenues	3423	3796	5475	6430
Suez Canal Revenues	1820	2236	2848	3307
Current Account Balance	614	1958	3418	2894
Foreign Direct Investment (flow)	428	701	407	3902

	FY01/02	FY02/03	FY03/04	FY04/05*
Portfolio Investment (flow)	999	(405)	(0.2)	0.8

* Provisional
Source: Central Bank of Egypt and Ministry of Foreign Trade and Industry

U.S. TRADE AND INVESTMENT

Calendar year
US$ millions

	2001	2002	2003	2004	2005
U.S. Exports to Egypt	3564.5	2868.6	2660.2	3077.8	3168.9
U.S. Imports from Egypt	882.3	1355.9**	1143.8	1283.8	2091.1
US Trade Balance with Egypt	2682.2	1512.7	1516.4	1682.5	1020.2
U.S. FDI (stock)	2537	2959	3533	4240	NA

** Includes temporary import of Egyptian antiquities museum touring exhibition, valued at $445 million
Source: U.S. Department of Commerce

PROPOSED STATE BUDGET – DRAFT AS PRESENTED TO PARLIAMENT

Field titles have been changed from last year's report due to new budget classifications
£E billions

	FY02/03	FY03/04	FY04/05 *	FY 05/06 **
Total Expenditures	143.01	159.60	177.43	187.82
Wages and Compensation	34.85	38.67	41.00	45.8
Purchase of Goods and Services	8.49	9.42	9.94	13.24
Interest	25.85	30.70	38.43	42.61
Subsidies, Grants and Social Benefits, including:	20.65	24.75	29.32	50.55
Contributions to Pensions	11.55	13.84	16.52	15.19
Direct Subsidies (Basic Commodities)	3.59	4.89	10.90	9.75
Direct Subsidies (Other)***	3.11	3.10	3.97	22.08 (petroleum products) 1.28 (others)
Other Expenses	18.26	20.99	21.05	18.19
Purchase of Non-Financial Assets (Investments)	20.25	22.85	20.26	17.40
Total Revenues	111.48	116.49	102.46	130.15
Taxes, including:	55.74	67.16	71.21	81.61

	FY02/03	FY03/04	FY04/05 *	FY 05/06**
Personal and Corporate Income	20.79	27.21	28.98	34.84
International Trade Transactions	8.24	9.24	7.93	9.11
Goods and Services, *of which*	23.14	26.57	28.90	32.37
Sales Taxes	20.66	22.65	24.54	25.50
Property	0.777	0.779	0.993	0.997
Other	2.79	3.36	4.20	4.29
Grants	3.29	5.05	2.90	2.86
Other Revenues, including:	30.12	29.67	28.35	45.68
Returns on Ownership	13.76	14.85	18.52	37.91
Petroleum Surplus	4.51	4.11	0.65	12.60
Suez Canal Surplus	4.14	5.08	7.19	10.47
Other Economic Authorities Surplus	0.59	0.66	0.37	0.93
Companies & Banks Profits	2.40	2.56	1.07	1.60
CBE Surplus	4.80	4.8	5.81	2.14

* Revised/Expected
** Targeted
*** Indirect subsidies for FY 03/04: £E 16.7 billion, FY 04/05: £E 23.4 billion.
Source: Ministry of Finance