63302

# EGYPT – Affordable Mortgage Finance Program Development Policy Loan (Loan No. 7747-EG)

## Release of the Second Tranche–Full Compliance

1. This note summarizes the progress made under the Affordable Mortgage Finance Program Development Policy Loan (DPL)—implemented by the Ministry of Investment through the Guarantee and Subsidy Fund (GSF)—to the Arab Republic of Egypt. The Bank approved the three-tranche US$ 300 million loan to the Government of Egypt on September 24, 2009, and the operation was signed and declared effective on December 12, 2009 and April 27, 2010 respectively. The first tranche of US$ 100 million was released on 27 April, 2010.

2. The following notes that the three prior actions required for the release of the second tranche have been met by the borrower as outlined in the Loan Agreement, namely: (i) the parameters of the program have been approved by the Board of the Guarantee and Subsidy Fund (GSF) on December 30, 2010, verified by GSF's Board of Directors on February 13, 2011, post-revolution and conveyed to the Minister of Investment on May 10, 2011; (ii) the on- and off-site monitoring and evaluation system has been become an integral part of the GSF Procedure Manual that was approved by GSF Board of Directors on March 30, 2011; and (iii) the Ministry of Finance has been developing nationwide database on house market information, including house values, which is shared with the Ministry of Housing by a Protocol signed between the two ministries.

3. Compliance with the three prior actions was verified by a World Bank supervision mission (24-28 July) which spoke to the relevant counterparts and required the necessary evidence to confirm compliance.

4. The note describes the macroeconomic policy framework of the Borrower, and ensures that it is appropriate and is consistent with the objectives of the Program.

## I. Background

5. The DPL supports the Government of Egypt in implementing its Affordable Mortgage Finance Program. The main policy areas which the loan supports are: (i) strengthening the legal, regulatory, and institutional framework for the mortgage finance subsidy program to be effectively operated by the Guarantee and Subsidy Fund (GSF); (ii) developing an effective and efficient mortgage finance subsidies mechanism that will expand mortgage lending and therefore housing affordability for low and middle income groups; and (iii) improving the institutional framework to enhance transparency and targeting of housing subsidies, moving away from supply side and official budget implicit subsidies to a more efficient demand side system.

6. The main development objective of this DPL is to enhance access to housing for the broad low and middle income sector through the reform of the current system of inefficient and poorly targeted supply-side subsidies for housing and replace them with a transparent and economically efficient demand-side subsidy system. Through this program, the direct subsidy to the developer is eliminated and instead a transparent direct subsidy is issued to qualifying beneficiaries through the GSF, the project's implementing agent.

7. While the subsidy will be administered by the government, it will be delivered in partnership with private sector lenders. This will allow the government to focus on its regulatory and supervisory role while the private sector (developers and lenders) provide the units and the financing through mortgages. The subsidy will be split between down-payments and buy-down monthly installments during the first seven years of a mortgage loan with the parameters and subsidy amount varying according to the beneficiary's income level.

8. The operation helps satisfy the achievement of the strategic objectives of the Country Assistance Strategy (CAS) of 2005, and the CAS Progress Report of 2008. It addresses two key strategic objectives of the CAS, namely: (i) facilitating private sector development through improving financial sector competitiveness and efficiency; and (ii) promoting equity. The operation contributes to the consolidation of the reform, the further development of the financial sector, and enhancing access to financial intermediation. With the development of the mortgage market it has become feasible to implement a demand oriented household subsidy linked to commercial mortgage credit that can generate a supply response in both new and existing housing markets.

9. This program also offers a number of benefits, which include:

- Decreasing the per unit amount currently needed to provide housing for underserved low and middle income households.
- Opening access to housing to a broader category of the population, whilst at the same time deepening the financial sector.
- Allowing government funds in the project to leverage private sector capital in the form of mortgage loans.
- Enhancing the efficiency of the use of government funds combined with the private sector, allowing the freeing up of some fiscal resources that had been used for low and middle income housing, to be re-directed for those with lower incomes who would not be credit worthy enough for a mortgage loan.

10. Supporting low-income housing and providing effective, efficient and well targeted subsidies is more a priority post-revolution and for the transition government than ever before. One of the key demands of the Egyptians today is a safe shelter for the poor, and this is exactly the essence of the

program this DPL supports. This operations is given priority by all ministers and not only the relevant ministry because, building housing with all its multiplier effects, creates job opportunity through construction sector and also many other sectors.

## II. Recent Economic Developments

11. The macroeconomic policy framework of the Borrower is appropriate and is consistent with the objectives of the Program. The recent developments, and the changes in the macro-economic framework, have a favorable policy impact as the target group of the program (monthly income between LE 1,500 and LE 2,500) now represents an even lower segment of the income distribution. The indicators related to the program, namely, the salaries have increased; the mortgage interest rates and house prices have remained constant as evident in the mid-corridor rate of the Central Bank of Egypt (CBE) that remains unchanged at nine percent, so do mortgage rates. Moreover, there is no recent changes in house prices observed.

12. Until the recent political upheaval, the economy was showing positive signs of recovery from the mild effects of the global crisis. Egypt's economic growth was on a recovery path, registering 5.1 percent in FY10 and 5.6 percent in the first half of FY11(up from 4.7 percent in FY09), driven mostly by domestic consumption and robust activity in sectors such as construction, tourism, and communication. These were the most affected sectors by the revolution, leading to a GDP contraction of 4.2 percent y-o-y in the quarter ending in March.

13. Inflation and unemployment remain challenging concerns. Consumer Price Index (CPI) inflation oscillated between 10 and 11 percent during the last year, and stood at 11.9 percent in May 2011. This is the fourth year in a row with a double-digit inflation rate. Food price inflation, the main driver of inflation, fluctuated between 18 and 22 percent over the last year. The recent increase in global food prices, along with domestic factors, is likely to further pressure food prices in Egypt. Core inflation[1] rose from a stable level of 7 percent to 8.8 percent in May 2011. The Producer Price Index inflation stood at 20 percent in March 2011,[2] after peaking at 16.9 percent in October 2010. Also, before the recent political events, unemployment had declined to 8.9 percent in Q1-FY11, down from a peak of 9.4 percent a year ago. Unemployment rose to 11.9% by the end of March due to the growth slowdown and because 183,000 Egyptians workers have returned from Libya.[3]

14. ***External balances showed weakening signs in the first half of FY11.*** The current account deficit slightly narrowed in FY10 to 2 percent of GDP, from 2.3 percent in FY09. In the first half of FY11, the current account deficit remained unchanged at 0.6 percent of GDP (or US$1.4 billion) as in the corresponding period of the previous year. But the capital account surplus declined from 1.5 to 1.2 percent of GDP over the same period. Consequently, the previous US$2.7-billion surplus in the balance of payments (1.2 percent of GDP) dropped to US$571 million (0.2 percent of GDP).

15. ***External debt is relatively low, though on the rise in US$ terms.*** The external debt has been declining as a share to GDP from 27.6 percent in end-FY06 to 15.9 percent in end-FY10, and further to 14.7 percent in end H1-FY11. Yet, in terms of U.S. dollars the external debt has been rising (from US$ 29.6 billion to US$33.7 billion and then to US$35 billion, respectively). Only 9 percent of total external debt is short term, and the debt service accounts for only 5.4 percent of exports of goods and services.

16. ***CBE foreign currency assets declined by US$ 16 billion since end-December 2010.*** Net international reserves (NIR) in December 2010 stood at US$36 billion and the central bank foreign currency deposits in commerical banks ("unoffcial reserves") reached US$7 billion. By the end of June, NIR had declined to US$26.5 billion and the CBE's foreign currency deposits had run down to a few

[1] Excluding fruits and vegetables and some regulated items.
[2] PPI data are published every other month. The data for March has not yet been published.
[3] As of March 14, 2011.

million. This level represents around 5 months of merchandise imports and more than 8 times the total value of short-term external debt, and can cushion the short-term implications of the current political unrest. However, NIR are expected to fall further over the coming months and until more economic stability has been attained as the sources of foreign currency reserves continue to exhibit weak and fragile recovery (namely tourism, and merchandise exports), while demand for foreign currency reserves grows, especially on imports of essential of food items, pressuring the overall level of reserves. At the end of March 2011, foreigners held less than 10 percent of government T-bills (about US$5 billion). An unwinding of those positions exerted pressure on the exchange rate and international reserves, during the period January-March.

17. ***So far, CBE interventions have attenuated exchange rate depreciation.*** The Egyptian pound has been depreciating since late December 2009, and lost 5.7 percent of its value against the US dollar during 2010, and another 3 percent since the start of 2011 to stand at LE5.9762/US$ as of April 5. The Egyptian Pound is expected to continue to depreciate gradually over the coming months by virtue of the trade deficit and the unsettled political environment, although weaker imports' growth, linked with an overall slowdown in economic activity, will reduce the pace at which this happens. The CBE ruled out any restrictions on investors' transfers of money outside Egypt or from the Egyptian Pound to other currencies, but it extended the clearance period to five days, instead of two, as a temporary precautionary measure. The CBE has also announced its intention to allow the exchange rate to depreciate gradually, letting it reflect the status of supply and demand in the market without targeting a specific exchange rate, and intervening only in case of major imbalances or speculation.

18. ***Domestic public debt has continued its upward trend.*** The net domestic public debt as a share of GDP reached a trough of 43.2 percent in June 2008, and has been increasing, to reach 49.7 percent in June 2010. During the capital inflow period (up to November 2010) the share of T-bills in the outstanding ***stock*** of government securities declined from 66 percent a year ago to 57 percent in end-September 2010, reflecting the extension of domestic debt maturity. With growing foreign appetite for Egypt debt, the share of domestic banks' holdings of T-bills declined from 70.3 percent in November 2009, to 62.3 percent in June 2010 and further to 53.3 percent in November 2010. Foreign customers hold less than 10 percent of total T-bills (approximately US$5 billion) and foreign bank branches in Egypt hold 2 percent. The increase in yields already suggests an increase in risk premium to continue to attract buyers, especially in the absence of an effective secondary market. The trend is expected to continue given the deterioration of public finances in the medium term. This years fiscal deficit is expected to be equivalent to 9.5% of GDP, and it is programmed to be 8.6% of GDP in FY12.

19. ***The evolution of domestic public debt and credit of the banking system show a worrying trend since the global financial crisis of 2008.*** Fiscal adjustment and vigorous private sector economic activity prior to the global crisis had reduced the share of net claims on the government within credit of the banking system in local currency to 44 percent. Due to the slowdown of private investment since the global crisis, and the delay of the of the fiscal adjustment program, demand for private credit stalled while the public sector increased its financing needs. Consequently, the share of banking sector net claims on the government rose to 60 percent od domestic credit in local currency by March 2011. The continuation of this trend may become an obstacle for recovery of private investment, and hence cautious public debt management would need to rebalance the composition of the liabilities to make sure that the government's financing strategy does not impede private sector growth.

20. ***CBE has kept interest rates unchanged since September 2009.*** After a loose monetary policy between February and September 2009 to support economic recovery in the aftermath of the 2008 global crisis, the CBE has since then kept its overnight deposit and lending rates unchanged at 8.25 percent and 9.75 percent, respectively; the discount rate was also left unchanged at 8.5 percent. Commercial banks' interest rates for lending and deposits have hovered around 11 percent and 6.5 percent, respectively, since

September 2010. The 91-day T-bill rate jumped from an average of 9 percent before the January 2011 events to around 12 percent in June.

21. ***The Egyptian Exchange (EE) reopened on March 23 after a seven-week halt.*** Egypt's share prices declined by 21 percent in January, mainly because of panic selling triggered by the political upheaval. Concerns about large withdrawals from the market were behind postponing the opening of the market five times. The market resumed trading just two business days before the end of the 40 business day Morgan Stanley Capital International (MSCI) grace period, otherwise EE would have been excluded from international indices. Egypt's benchmark EGX30 Index plummeted 12 percent on March 23 and 24 to the lowest level in almost two years, but climbed 5.3 percent to 5212.08 on March 27, and has been fluctuating in a narrow band since then to close at 5445.76 on April 5. This indicates a market stabilization as political stability is being restored, but also support from foreign governments, in particular of the Kuwait Investment Authority, by investing in the Cairo stock exchange.

## IV. Progress against Tranche Release Criteria

***Condition 1: Strengthening the legal, regulatory and institutional framework for the mortgage finance subsidy program through determination of the subsidy parameters in line with changes in macro-economic and housing sector changes***

22. **The condition has been met –** The parameters are set and adjusted by the Board of GSF Allowing GSF[4] to adjust subsidy parameters is necessary as it would be impractical to require a legal change or decree every year when parameters are reviewed. The GSF has a mandate from the Ministry of Investment for setting the terms of the subsidy program. The safeguards in the system are that, any change needs to be approved by its board which includes representatives from Central Bank of Egypt (CBE), the Ministry of Housing, Utilities, and Urban Communities, Ministry of Investment, and market participants. It is clear that GSF is a vehicle for implementing government policy for low income housing and as such the GSF program will be aligned with the broader objectives of government in the financial sector and housing sectors (see page 6 of the Letter of Development Policy)

23. The parameters of the program were approved on December 30, 2010, and verified on February 13, 2011, post-revolution by the GSF's Board of Directors. These updated parameters were conveyed to the Minister of Investment on May 10, 2011. The team has reviewed the two Board minutes and confirms that these new parameters were adopted. These parameters have also been reviewed by the team during a supervision mission (June 26-Jul 1, 2011) with GSF and the Ministry of Housing, Utilities, and New Urban Communities. Since the revolution, significant changes had occurred in the macro-economic framework. Inflation has increased and there is anecdotal evidence that salaries have been raised. This has a favorable policy impact as the target group of the program (monthly income between LE 1,500 and LE 2,500) now represents an even lower segment of the income distribution. Other key parameters are mortgage interest rates and house prices. As the mid-corridor rate of the Central Bank of Egypt (CBE) remains unchanged at nine percent, so do mortgage rates. No recent changes in house prices have been observed.

***Condition 2: Developing an effective and efficient mortgage finance subsidy mechanism through establishment by Ministry of Investment of on- and off-site monitoring and evaluation systems***

24. **The condition has been met.** The on- and off-site monitoring and evaluation system has become an integral part of the GSF Procedure Manual which has been approved by the Board of Directors on

[4] Note that GSF recently changed its name to Mortgage Finance Fund (MFF) in line with the objective of separating the subsidy function from the guarantee function which the GSF carried out jointly.

March 30, 2011. In accordance with the terms of the Master Agreement[5], lenders are required to report on a monthly basis to GSF, the status of all funded subsidy loans. The Procurement Manual, Procedure 4 (lender servicing and reporting) outlines the requirement for reporting by the lenders is detailed, while Procedure 5 (lenders on-site audits and operations audits) describes step by step the auditing process. A number of reporting forms are annexed to the Manual. Accordingly, GSF will need to provide reports to the Government, accounting for the subsidy funds disbursed and providing information that will allow the Government and GSF Board to assess the results of the programs. Additional reporting needs are designed to support GSF management in the analysis of the current subsidy program requirements. The team confirms that the necessary due diligence was done, and that the required executive actions and institutional measures were taken with regards to establishing the monitoring and evaluation system in GSF.

25. The World Bank supervision mission did the necessary due diligence to confirm that monitoring and evaluation system had been prepared and would be brought into action as the subsidy program takes effect during 2011.

***Condition 3: Improvement of the institutional framework to enhance transparency and targeting of housing subsidies though compilation of housing market information***

26. **The condition has been met.** The Ministry of Finance, in the context of the real estate tax, has been developing nationwide data on house market information, including, house values, land prices, and housing transactions. The team visited the Ministry of Finance, the department in charge of collecting the housing database, and were satisfied with the methodology adopted, and the quality of data collected. This database covers all of the 30 million of properties that exist in Egypt, whether they are taxable or not. Annual update surveys will be conducted. This database is shared with the Ministry of Housing, Utilities and Urban Community by a Protocol signed between the two ministries to this effect. The team noted that there is good cooperation between the two ministries, and sharing of data has been effective, and was used in updating the parameters under trigger one.

27. The World Bank supervision team reviewed the protocol between Ministry of Finance and Ministry of Housing, Utilities and Urban Development, and were satisfied with it, and that there was actual sharing of information.

## IV. Conclusion

28. In view of the overall performance and progress with the implementation of the program supported by the Loan, and in compliance with the specific conditions of release as described in Section B of Schedule I of the Loan Agreement, the Bank has informed the Borrower of the availability of the second tranche in the equivalent of US$100 million.

[5] It is the agreement between GSF and the participating lenders (banks and mortgage finance companies) in the program.

# Annex 1: Selected Indicators, FY05-FY10 and World Bank Projections until FY13

| | FY05 | FY06 | FY07 | FY08 | FY09 | FY10 | FY11* | FY12* | FY13* |
|---|---|---|---|---|---|---|---|---|---|
| | Actual | | | | | | *Projections* | | |
| **Output** | | | | | | | | | |
| Nominal GDP at Market Prices (billion LE) | 538.5 | 617.7 | 744.8 | 895.5 | 1042.2 | 1206.7 | 1351.5 | 1547.5 | 1795.1 |
| Real GDP annual growth rate (%) | 4.5 | 6.8 | 7.1 | 7.2 | 4.7 | 5.2 | 1.0 | 3.5 | *6.0* |
| Nominal GDP (billion US$) | 89.8 | 107.4 | 130.4 | 162.8 | 189.1 | 219.0 | 232.0 | 255.2 | 289.5 |
| Unemploment rate (%) | 11.2 | 10.6 | 8.9 | 8.7 | 9.4 | 9.2 | 10.0 | 9.5 | *9.0* |
| **Prices** | | | | | | | | | |
| CPI inflation rate (%) | 11.4 | 4.2 | 11.0 | 11.7 | 16.2 | 11.7 | 11.1 | 11.0 | *10.0* |
| Nominal Exchange Rate (period average LE/$) | 6.00 | 5.75 | 5.71 | 5.50 | 5.51 | 5.51 | 5.83 | 6.06 | 6.20 |
| *% of GDP, unless otherwise mentioned* | | | | | | | | | |
| **External sector** | | | | | | | | | |
| Trade deficit | 11.6 | 11.2 | 12.5 | 14.4 | 13.3 | 11.5 | 11.0 | 11.5 | 12.0 |
| Exports of goods | 15.4 | 17.2 | 16.9 | 18.1 | 13.3 | 10.9 | 10.5 | 11.1 | 11.9 |
| *in million US$* | *13.8* | *18.5* | *22.0* | *29.4* | *25.2* | *23.9* | *24.3* | *28.0* | *34.3* |
| Imports of goods | 27.0 | 28.3 | 29.4 | 32.5 | 26.6 | 22.4 | 21.5 | 22.6 | 23.9 |
| *in million US$* | *24.2* | *30.4* | *38.3* | *52.8* | *50.3* | *49.0* | *49.8* | *57.1* | *68.7* |
| Current account balance (+=surplus) | 3.2 | 1.6 | 1.7 | 0.5 | -2.3 | -2.0 | -2.3 | -2.0 | -1.2 |
| Exports of Non-factor services of which | 15.7 | 14.4 | 13.3 | 14.7 | 11.6 | 10.4 | 9.2 | 9.9 | 10.7 |
| *Tourism (US$ billion)* | *6.4* | *7.2* | *8.2* | *10.8* | *10.5* | *11.6* | *10.8* | *12.4* | *15.5* |
| *Suez Canal (US$ billion)* | *3.3* | *3.6* | *4.2* | *5.2* | *4.7* | *4.5* | *5.0* | *5.5* | *6.4* |
| Imports of Non-factor services | 6.7 | 7.2 | 5.4 | 6.4 | 5.0 | 3.7 | 3.2 | 3.6 | 3.8 |
| Net Foreign direct investment** | 4.4 | 5.7 | 8.5 | 8.2 | 4.3 | 3.1 | 1.5 | 2.2 | 2.8 |
| *in US$ billion* | *3.9* | *6.0* | *10.5* | *12.1* | *6.8* | *5.8* | *1.9* | *4.0* | *7.5* |
| Balance of Payments (+ = surplus) | 4.0 | 3.0 | 4.0 | 3.3 | -1.8 | 1.5 | -3.2 | -1.5 | 1.0 |
| *in US$ billion* | *3.6* | *3.3* | *5.3* | *5.4* | *-3.4* | *3.4* | *-7.5* | *-3.8* | *2.8* |
| Gross Public External Debt | 31.0 | 27.6 | 22.8 | 20.1 | 16.9 | 15.9 | 16.2 | 15.3 | 13.5 |
| *in US$ billion* | *28.9* | *29.6* | *29.9* | 33.9 | 31.5 | 33.7 | 37.7 | 39.0 | 39.0 |
| Gross Foreign Exchange Reserves (billion US$) | 19.3 | 23.0 | 28.6 | 34.6 | 31.3 | 35.2 | 27.7 | 23.9 | 26.8 |
| (in months of imports of G&NFS) | *7.7* | 7.2 | 7.6 | 6.6 | 6.3 | 7.4 | 5.8 | 4.6 | 4.8 |
| **Investment and Saving** | | | | | | | | | |
| Gross capital formation◎ | 18.0 | 18.7 | 20.9 | 22.4 | 19.2 | 18.9 | 17.5 | 18.2 | 20.0 |
| Gross Domestic Saving | 15.7 | 17.1 | 16.3 | 16.8 | 12.6 | 14.1 | 11.5 | 10.7 | 11.4 |
| Gross national savings | 15.4 | 16.8 | 16.8 | 17.7 | 13.4 | 14.2 | 9.5 | 9.0 | 10.2 |
| **Public Finances (Budget Sector)** | | | | | | | | | |
| Total revenues (including grants) | 20.6 | 24.5 | 24.2 | 24.7 | 27.1 | 22.2 | 20.0 | 20.2 | 22.4 |
| of which Tax revenues | 14.1 | 15.8 | 15.3 | 15.3 | 15.7 | 14.1 | 13.8 | 13.7 | 15.1 |
| Expenditures*** | 30.0 | 33.6 | 29.8 | 31.5 | 33.7 | 30.3 | 29.9 | 29.6 | 30.5 |
| *of which* Domestic interest | 5.5 | 5.5 | 6.0 | 5.2 | 4.7 | 5.8 | 5.8 | 6.2 | 6.2 |
| Foreign interest | 0.6 | 0.5 | 0.4 | 0.4 | 0.3 | 0.2 | 0.3 | 0.3 | 0.3 |
| primary deficit | 3.5 | 2.2 | 0.9 | -1.2 | -1.8 | -2.2 | -3.0 | -2.9 | -1.6 |
| overall deficit | 9.6 | 8.2 | 7.3 | -6.8 | -6.9 | -8.2 | -9.3 | -9.4 | -8.1 |

* World Bank Staff Projections

** Net Foreign Direct Investment is Direct Investment Abroad minus Direct Investment of Egypt as reported in the CBE Monthly Statistical Bulletin

*** Expenditures for the budget sector do not include the net acquisition of financial assets