

Egypt—Economy Slows as Reforms Lose Steam

The Egyptian economy slowed considerably in 2001/02. Real GDP grew at about 3%, down from more than 5% in 1999/2000. Domestic investment stagnated, while unemployment, about 10%, remained high. The slowdown in investment and output is a consequence of global, regional, and domestic factors. Tourism declined sharply after the September 11 terrorist attacks. Security concerns in the region heightened against the backdrop of the Israeli-Palestinian conflict. With a poorly functioning exchange rate regime, the growth benefits of the range of reforms begun in 1991 were exhausted (box 6.1). The government is pushing forward new reforms, but political, constitutional, and strategic considerations constrain them. Sound and faithful implementation remains a challenge.

Monetary policy was sound in 2002. Inflation rose marginally, from 2.2% in 2001 to 3% by the end of 2002, as the Central Bank pursued an expansionary monetary policy stance to stimulate the economy. But the fiscal deficit has been rising steadily since 1998/99, reaching nearly 6% of GDP in 2001/02. The budget proposals for 2002/03 project a 12% increase in expenditure, with the wage bill a big part of the increase. Some mega projects, notably the Toshka agricultural and land reclamation project, also contribute to the rise.

The rising share of domestic debt service obligations has amplified pressure on the deficit. The government allocates more budget resources to pay interest on public debt than to the social sector. Domestic debt service is now the largest single expenditure item, accounting for 6–7% of GDP in 2001/02. With economic growth slowing and domestic interest rates high and rising, the debt to GDP ratio is likely to continue to rise.

The poorly functioning exchange rate regime has hobbled economic performance. The fixed peg, in use until 2000, led to significant real appreciation of the Egyptian pound, eroding the country's export competitiveness and adding to balance of payments problems, accentuated in the late 1990s when external shocks widened the current account deficit. In addition, premature capital account liberalization forced higher domestic interest rates and tighter monetary policy as efforts were made to defend the pound.

The trade and current account deficits have since declined to 7.8% and 0.4% of GDP in 2001/02, more the consequence of economic slowdown and import restrictions than of sustained export expansion. Reforming the exchange rate regime is thus critical to

The poorly functioning exchange rate regime has hobbled economic performance

Box 6.1

The ebb and flow of reforms in the last decade

Under the Economic Reform and Structural Adjustment Program begun in 1991, Egypt has taken major steps to make its economy market-driven and outward-oriented. In recent years the reform program has slowed somewhat due to political and administrative constraints and fears that free market reforms could adversely affect social sectors. Reforms have included the following components:

Macroeconomic stabilization

The budget deficit was reduced through expenditure cuts, improvements in tax administration and tax collection, a new sales tax, and increased user fees for petroleum and electricity. By June 1993/94 the fiscal deficit had fallen to 2.1% of GDP, from 20% in 1991.

Monetary policy reform focused on reducing the growth rate of broad money and providing credit to the private sector to promote investment. Inflation was reduced from nearly 20% in 1991 to less than 5% by 1997.

Economic liberalization

This included liberalization of the trade regime and accession to the World Trade Organization in 1995. A privatization programme was initiated, and the state reduced its role in the economy. In the financial sector interest rate ceilings on domestic currency deposits were lifted, rules discriminating against private banks were eliminated, foreign banks were allowed to operate in local currency, and restrictions on bank fees and commissions were removed. In addition, banking sector supervision requirements were strengthened.

In June 1998 parliament ratified amendments to the banking and insurance laws to allow full private sector ownership. But banking privatization remained controversial, and none of the four big state banks has yet been sold. Corporate and commercial laws and the labour code were revised to attract investment and support privatization. But attempts to increase labour market competitiveness have been constrained by political opposition and concerns about possible negative social impacts.

Public sector reform

The Egyptian government has drawn up a comprehensive fiscal reform program, with a view to enhancing the business environment. A broad tax reform program was launched by the Ministry of Finance, including the transformation of the general sales tax into a value-added tax. Improvements were made to public sector budgeting and financial processes. But reform of the public sector is politically controversial, especially if it involves labour shedding. In addition, efforts to improve efficiency and transparency have been hampered by skills constraints within ministries.

In November 2002 the government introduced major reforms in monetary and fiscal policies and the exchange rate regime, with the hope of addressing the policy inertia and getting the economy moving again.

Source: Economic Commission for Africa, from official sources.

restoring growth and stability. How the recent move to a floating regime will work in practice and how it will affect the overall orientation of macroeconomic policy remain to be seen.

Strong growth in the 1990s reduced poverty for significant segments of the population and supported an expanding middle and professional class, helping transform Egypt into an emerging modern economy (box 6.2) Despite these gains, poverty remains or has even increased for large segments of the population, particularly those in rural and southern areas. Egypt lags behind many middle and low income countries in literacy rates, average years of schooling, and life expectancy at birth.

Box 6.2

Egypt—an emerging modern economy

Egypt has made considerable progress in transforming itself into a more diversified, emerging modern economy. Although enormous challenges remain, significant improvements are evident:

- Electricity consumption per capita, 350 megawatts in 1977, rose to 1,500 megawatts in 2002.
- Telephone lines per 100, 1.3 in 1977, rose to 7.5 in 1999.
- Privately owned cars, 312,000 in 1977, rose to 2 million in 2000.
- The fertility rate, 5.3 in 1977, dropped to 3.4 in 2000.
- Infant mortality, 120 deaths per 1,000 in 1977, fell to 37 in 2000.
- Adult illiteracy fell to 45% in 2000.
- Population, 38 million in 1977, rose to 65.2 million in 2001.
- Labour force, 9.5 million in 1977, rose to 24 million in 2000.
- Gross national income (GNI) per capita rose from \$410 in 1977 to \$1,490 in 2000.

The economy has become more diversified in recent decades, though the process stabilized in the 1980s and 1990s (see table). Key sectors driving the diversification include food products, textiles, aluminium, cement, and transport equipment. In addition, services such as tourism have become increasingly important. The economy's growing diversification suggests that Egypt is less vulnerable to sectoral shocks today than it was 30 years ago.

Hirschman-Herfindahl index for GDP, investment, and employment, 1969/70–1999/2000

Item	1969/70	1975	1980/81	1984/85	1989/90	1994/95	1999/2000
GDP	0.22	0.21	0.15	0.14	0.16	0.14	0.15
Investment	0.19	0.21	0.15	0.14	0.12	0.09	0.10
Employment	0.33	0.29	0.22	0.23	0.21	0.19	0.17

Note: A value of zero indicates complete diversification and a value of one, complete concentration.

Source: Kheir El-Din 2001.

Source: UNDP 2002; World Bank 2003; Economic Commission for Africa, from official sources.

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The medium-term outlook is bright but fragile. On the upside, GDP growth is likely to recover to around 4%, reflecting a rebound in transport and tourism (after the war in Iraq) and the Toshka project's boost to agriculture. Manufacturing growth is also expected to pick up if the depreciation of the Egyptian pound spurs demand for Egypt's exports. But the downside risks are significant. These include poor business confidence, clouded by confusion over the conduct of exchange rate policy, and the monetary and fiscal stance. The Middle East political situation poses another large downside risk. And the high tariff and nontariff barriers, even after substantial tariff reductions in the 1990s, are unlikely to inspire investor confidence in the economy.

The Egyptian economy thus stands at a crossroads. Either it will resume growth at higher rates than in the past few years. Or it will succumb to the inertia and vagaries of global and regional economic and political environments. More than 10 years of macroeconomic and structural reforms, which have transformed Egypt into a more diversified economy, seem to have run their course.

The first priority is to bring greater clarity to the conduct of macroeconomic policy. The contradictions apparent in recent years, particularly in monetary and exchange rate management, need to be resolved to reinstate macroeconomic stability and build investor confidence. The greater flexibility of the exchange rate regime may help, but considerable uncertainty surrounds the likely effects of the recent flotation. A coherent trade and industrial policy to drive productivity improvements in emerging sectors is required to boost exports. This will require reinvigorating the private sector and expanding state capacity, both in economic policymaking and in political management to overcome vested interests and build a strong constituency to move forward. In addition, Egypt's success in enhancing its international competitiveness and in moving from a resource-based to an investment-driven economy depends on progress in the social sectors, particularly in education.

Recent economic developments

Egypt's economic performance has weakened sharply, a trend that continued in 2001/02. Contributing are constraints to agricultural development, industry's lack of competitiveness, vulnerability of services to regional instabilities, and a slowdown in investment growth.

Overall performance—growth stagnates

After averaging 5.4% a year in 1995–99, growth slowed to 5.1% in 1999/2000 and 3.5% in 2000/01 (figure 6.1). Real GDP growth is estimated at about 3% for 2001/02, though the final figure may be even lower.

Global, regional, and local factors all contributed to the slowdown, including the effects of the attacks on the World Trade Center in New York on September 11, 2001, and

the heightened security concerns in the region, which hit key sectors such as tourism. Macroeconomic policy also came under pressure because of problems with the exchange rate regime.

During 2002 there were signs of declining or stagnant production, falling capacity use, and lower investment and employment growth, particularly in manufacturing and construction but also in such services as restaurants and finance. According to the biannual business survey of the Egyptian Center for Economic Studies, 70% of firms said that production had declined or stagnated in the first half of 2002, 31% that domestic sales were lower, with 41% reporting no change in sales (ECES 2002). In addition, 77% of firms reported that capacity use stayed the same or declined, and 88% that employment had stagnated or declined. Expectations for the last half of 2002 improved marginally. Although most firms did not expect dramatic improvements in the economy, they seemed more optimistic than in recent years.

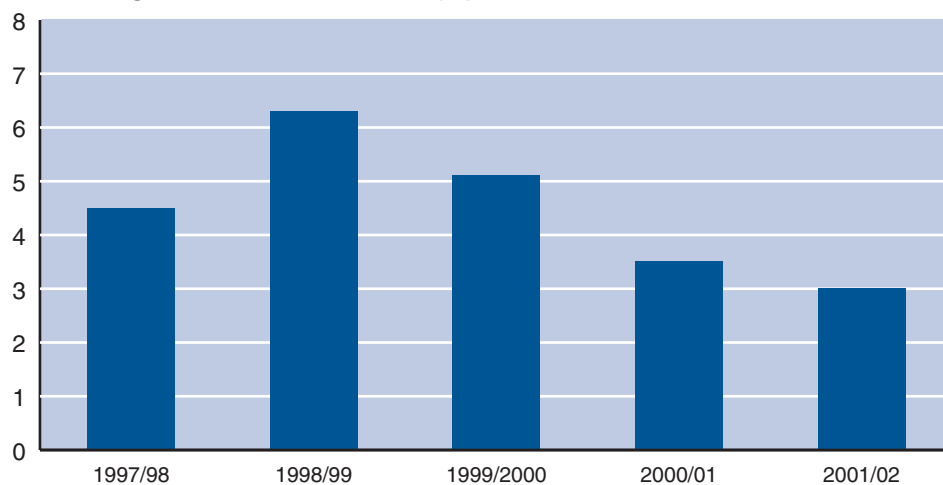
Among domestic factors the overvalued exchange rate and the high interest rates required to defend the pound led to a deterioration in productive activities, particularly in tradable goods. The government recently announced a shift to a freely floating exchange rate, continuing the gradually increasing flexibility of recent years. The details of the policy framework remain unclear, however. The coming months will thus be critical in fostering business confidence by reestablishing credibility and consistency among the different elements of economic policy. The regional political situation poses further risks for the economy. The government estimates that the Iraq conflict may have cost the economy up to \$5 billion.

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Figure 6.1

Growth slowing

Real GDP growth, 1997/98–2001/02 (%)



Source: Economic Commission for Africa, from official sources.

Agriculture—constraints to development of full potential

Agriculture remains a key sector of the Egyptian economy, accounting for some 17% of GDP, 28% of employment, and 20% of commodity exports (table 6.1 and figure 6.2). It grew at 3.4% in 2001/02, broadly in line with GDP. All agricultural prices have been decontrolled, except for cotton and sugarcane. And almost all subsidies for fertilizer, pesticides, and seeds have been removed. Energy continues to be provided at reduced rates, and water is provided to farmers free of charge. The sector has responded strongly to a combination of improved incentives and increased use of high-yielding varieties, registering growth of 3–4% in recent years. As a result, Egypt has partially closed the gap between food demand and supply while increasing exports, though it remains a major importer of wheat.

Table 6.1

Sectoral shares of GDP, 1997/98–2001/02 (%)

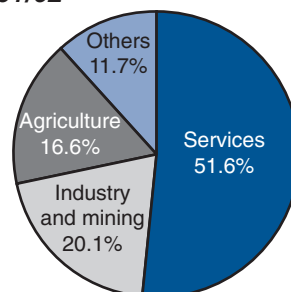
Sector	1997/98	1998/99	1999/2000	2000/01	2001/02
Agriculture	17.3	16.8	16.5	16.5	16.6
Industry and mining	18.6	19.2	19.7	19.9	20.1
Crude oil and oil products	6.3	5.9	5.6	4.8	4.8
Electricity	1.8	1.8	1.9	1.9	1.9
Construction and building	5.4	5.2	5.1	5.0	5.0
Services sectors	32.4	32.8	33.3	33.5	32.7
Transportation, Suez Canal	9.5	9.3	9.2	9.2	9.2
Trade, finance, and insurance	21.6	22.0	22.2	22.6	22.4
Hotels and restaurants	1.3	1.5	1.9	1.7	1.2
Social services sectors	18.3	18.2	17.9	18.3	18.8
Real estate	1.8	1.9	1.9	2.0	2.0
Public utilities	0.4	0.4	0.4	0.4	0.5
Social insurance	0.1	0.1	0.1	0.1	0.1
Government services	7.9	7.6	7.6	7.7	8.0
Personal and social services	8.1	8.3	8.0	8.1	8.3

Source: Economic Commission for Africa, from official sources.

Figure 6.2

Agriculture still significant

Sectoral shares of GDP, 2001/02



Source: Economic Commission for Africa, from official sources.

Despite this strong performance, the sector's full potential has yet to be realized. There is good scope for greater production for domestic consumption and export, benefiting employment, rural incomes, and foreign exchange earnings. According to a recent study, raising agricultural growth from 2.8% a year to 4.8% would create an additional 300,000 jobs a year (DAI 2002).

Severely constraining the further development of agriculture is the availability of water. The Toshka mega project, one of the main efforts to address this, involves the reclamation of 500,000 acres of arid land at the southwestern edge of the western desert using water from Lake Nasser. Part of the land area will be operated by a private enterprise producing fruits and vegetables for export, expected to generate 40,000 jobs by 2010.

Realizing agriculture's greater potential requires further reforms to reduce the cost of production and marketing, expand the area under cultivation, improve the efficiency of resource use, and increase the use of high-yielding varieties. Egypt has good potential to increase agricultural production and boost horticultural exports, particularly following the signing of the European Union Association Agreement, a wide-ranging initiative including provisions allowing easier access for Egyptian goods into European markets. The challenge is to ensure that the appropriate policy and institutional measures are implemented to take full advantage of Egypt's comparative advantage in this sector.

“Manufacturing has been transformed by the privatization of state-owned enterprises and general liberalization”

Industry—lacking international competitiveness

Industrial sectors contribute around 20% of GDP and about 14% of employment. Between 1996 and 2000 industry excluding mining expanded at 8% a year in real terms. In the last decade manufacturing has been transformed by the privatization of state-owned enterprises and general liberalization. But its performance has lagged behind that in other emerging lower middle income economies in growth and the contribution to GDP and exports (table 6.2). The sector is concentrated on a few key activities such as textiles and clothing, food and beverages, furniture, and metallurgy. However,

Table 6.2

Manufacturing growth, 1990 and 2000 (average annual %)

Country/group	1990–2000	
Egypt	6.3	
Lower middle income	8.9	
Indicator	1990	2000
Manufacturing value added (% of GDP)		
Egypt	18	19
Lower middle income	27	27
Share of manufactures in total exports (% of total)		
Egypt	42	37
Lower middle income	59	59

Source: Economic Commission for Africa, from official sources.

several other activities are growing rapidly, in particular pharmaceuticals, automotive assembly, and electronics.

“*Services make the largest contribution to GDP at around 50%, topped by tourism, financial services, and receipts from the Suez Canal*”

Small and medium-size enterprises account for more than 90% of firms (Mobarak 2001). There is also a large and dynamic informal sector, estimated to account for 25–30% of industrial output. The dominance of smaller firms in Egypt’s manufacturing reflects regulatory and institutional constraints that discourage the growth of larger firms—including a lack of finance to facilitate expansion. Overall, the small and medium-size firms have not yet realized their full potential as an engine for growth and employment. Key issues relate to the business and institutional environment—improving the transparency and credibility of public policy, strengthening regulatory structures, and removing the anti-export bias of overall policy.

Services—vulnerable to regional instabilities

Services make the largest contribution to GDP at around 50%, topped by tourism, financial services, and receipts from the Suez Canal. Tourism receipts account for about 5% of GDP, but unofficial estimates indicate that indirect effects boost the contribution to 15% of GDP and 8% of employment (American Chamber of Commerce in Egypt 2002). The fastest growing services over the last five years were finance and trade (8.4% a year) and restaurants and hotels (6% a year).

A key characteristic of the services sector is its sensitivity to external shocks and political tensions in the region. The September 11 attack on the United States and the Middle East crisis had a major impact, spilling over to the whole economy, particularly tourism. Tourism arrivals from Western Europe and North America fell significantly in 2001. Though this decline was slightly offset by arrivals from the Middle East and other countries, government revenue suffered because tourists from Western Europe and North America spend more on average.

Overall, the growth of trade, tourism, finance, and transportation slowed to an estimated 4.8% in 2001/02, down from more than 11% in 1998/99.

Employment and wages—unemployment persistently high

Unemployment rose slightly from 8.8% in 1996/97 to 9% in 2001/02, well above the 7.3% targeted in the fourth five-year plan of 1997/98–2001/02. Unemployment is particularly high for young people (20.1% for those ages 15–29 years) and the educated. According to the 1996 population census, the female unemployment rate was 20.3%, a very significant gender imbalance. Official data are likely to grossly underestimate unemployment—most analysts put the true rate at about twice the official figure, around 15% (El-Issawy forthcoming).

In Egypt’s segmented labour market, wages in the public sector are subject to fiscal constraints, while those in the private sector are determined largely by supply and demand. Over time, however, the boundaries separating the public and private spheres

of employment have diminished (table 6.3). During 1996/97–2001/02 the share of the government and other public sector enterprises in employment fell from 34.5% to 30% and the share of the private sector rose from 65.5% to 70%. The labour market as a whole has become more competitive, with wage determination more flexible, but the supply of labour is increasing faster than the demand.

Consumption and investment—investment growth tailing off

High interest rates and uncertainties about monetary and exchange rate policy held back capital formation by both the government and the private sector. Domestic investment fell from 20% of GDP in 1997/98 to 16% in 2001/02, significantly lower than the rate targeted in the fourth five-year plan (figure 6.3). Private consumption also lagged behind targeted levels, reflecting a lack of consumer confidence in a climate of economic uncertainty.

During 1995–99, however, investment expenditure grew much faster than GDP in real terms, with gross fixed capital formation expanding at an average annual rate of more than 9% (World Bank 2002b). For public investment this may have been the consequence of a relaxation of fiscal targets and investment allocations outside of the budget. For private investment the increase may be explained by macroeconomic stability until the late 1990s and the greater availability of credit in the mid-1990s. Most investment was for production for the local market rather than for export, perhaps reflecting the absence of structural reform, the lack of an industrial policy, and the incentives flowing from real appreciation of the currency.

Macroeconomic policy and trends

The move to a more flexible exchange rate may provide greater scope for monetary policy to stimulate economic growth. Financial sector reform of both banks and capital

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Table 6.3

Changes in the distribution of employment by institutional sector, 1996/97 and 2001/02

Sector	1996/97		2001/02	
	Number of workers (millions)	Share (%)	Number of workers (millions)	Share (%)
Public	5.7	34.5	5.4	30.0
Government	3.6	22.6	4.0	22.3
Public economic authorities	1.0	6.4	0.9	5.2
Public business sector	0.9	5.5	0.5	2.5
Private	10.4	65.5	12.6	70.0
Private agricultural	4.7	29.5	5.0	28.0
Private nonagricultural	5.7	36.0	7.5	42.0

Source: Economic Commission for Africa, from official sources.

markets is needed to boost investment. Fiscal policy needs to rein in deficits and reduce the debt burden to avoid stifling growth.

“As Egypt moves to a more flexible exchange rate, monetary policy will have more scope to stimulate the economy”

Monetary policy—complicated by exchange rate regime

The central bank loosened monetary policy in 2001/02 to stimulate the economy (box 6.3). M1 grew 7.6% in 2000/01 and 12.1% in 2001/02.¹ And overall domestic liquidity (M2) growth reached 11.6% in 2000/01 and an estimated 15.4% in 2001/02 (table 6.4).² Before 2001 monetary policy was restrictive, protecting an overvalued currency. Money supply, M1, rose a modest 1.8% in 1999/2000, significantly less than the 11% nominal growth in GDP. Interbank interest rates, more sensitive to market conditions than deposit rates, shot up to nearly 15% by the beginning of 1999/2000. Over 2000/01 and 2001/02 interbank rates continued to show a high degree of volatility and have remained high, frequently peaking above 10% (figure 6.4). This tight monetary policy, coupled with external shocks in the late 1990s, took the growth momentum out of the Egyptian economy.

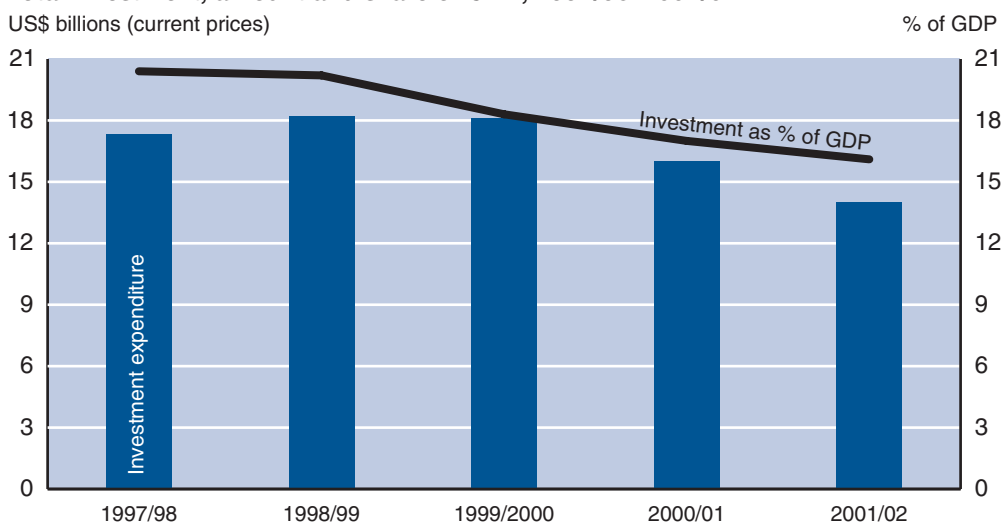
Since the mid-1990s inflation has declined considerably, thanks largely to the price anchor provided by the fixed exchange rate in place until the summer of 2000 (figure 6.5). Inflation rose marginally, from 2.2% in 2001 to 3% at the end of 2002, with the policy switch to monetary expansion.

Under the fixed exchange regime the effectiveness of monetary policy was severely limited. The widening current account deficit after 1998 generated tensions in macro-economic policy, because monetary authorities had to pursue restrictive policies to

Figure 6.3

Investment slides downward

Total investment, amount and share of GDP, 1997/98–2001/02



Source: Economic Commission for Africa, from official sources.

defend an overvalued currency, and the resultant increases in interest rates put pressure on fiscal deficits and discouraged investment. The overvalued currency eroded the country's competitiveness and harmed the export sector.

Box 6.3

Monetary policy reform—towards more liquidity

The government has taken steps to re-orient monetary policy to provide greater liquidity to the economic system. Key recent measures:

- Reducing the reserve requirement ratio for local currency deposits from 15% to 14% in September 2001.
- Including treasury bills with maturities of less than 15 days in calculations for up to 10% of the reserves of each bank in September 2001.
- Excluding saving instruments of three years or more from the denominator of the reserve requirement ratio in April 2001.
- Reducing the rediscount rate twice—from 12% to 11.5% in April 2001 and to 10% in November 2002.
- Establishing a new interbank rate guideline system (Cairo Interbank Offering Rate) in September 2000. Most (around 90%) of the banking sector participates in the system.

In addition, monetary reforms were announced in November 2002 by the central bank to pave the way for floating the currency. Key measures included overnight loans and deposits at the central bank and greater use of the discount rate in monetary management.

Source: Economic Commission for Africa, from official sources.

Table 6.4

Recent monetary aggregates, end-June 1999–2002 (billions of Egyptian pounds)

Monetary aggregate	1999	2000	2001	2002
Money supply, M1	48.8	49.7	53.5	60.0
Growth (year on year, %)	11.9	1.8	7.6	12.1
Currency in circulation outside banks	32.9	35.0	38.2	42.3
Demand deposits in Egyptian pounds	16.0	14.7	15.3	17.5
Quasi money	185.7	205.5	231.4	268.9
Time and saving deposits in Egyptian pounds	145.3	157.8	170.8	192.7
Demand deposits in foreign exchange	4.2	5.1	6.7	8.3
Time & Saving Deposits in forex	36.2	42.7	53.8	67.9
Domestic liquidity, M2 (M1 + quasi money)	234.6	255.3	284.9	328.7
Growth (year on year %)	11.4	8.8	11.6	15.4

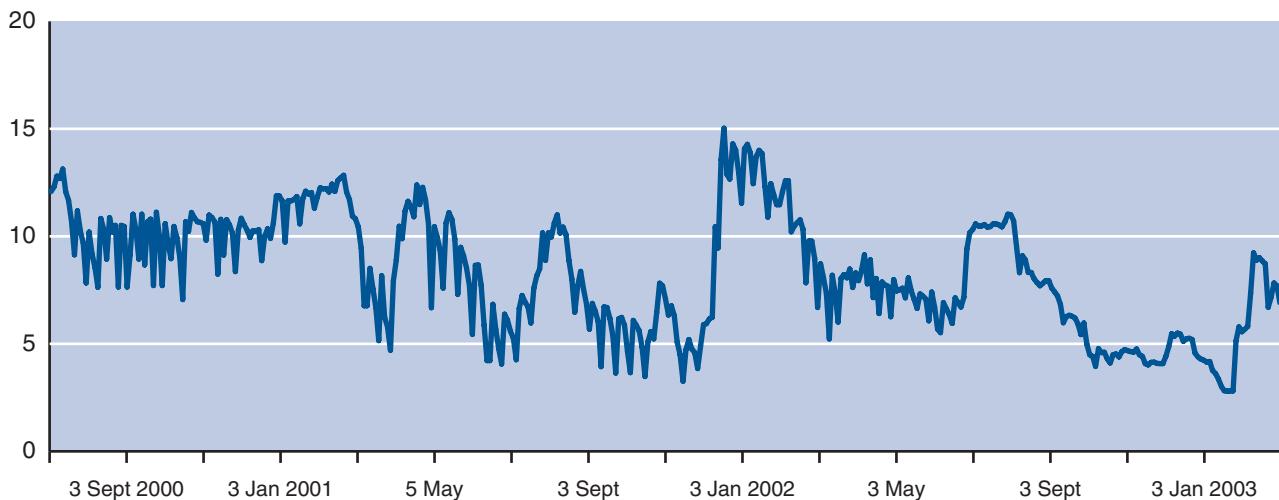
Source: Economic Commission for Africa, from official sources.

As Egypt moves to a more flexible exchange rate, monetary policy will have more scope and power, raising the question of the most relevant monetary target. The central bank has announced that, with the floating exchange rate, inflation will be the new monetary policy target, beginning in the second half of 2003. In the meantime the central bank will use a money supply target. Designing a coherent targeting framework is likely to be

Figure 6.4

Volatile interbank rates, with peaks above 10%

Trends in overnight interbank interest rates, 2000–03 (%)

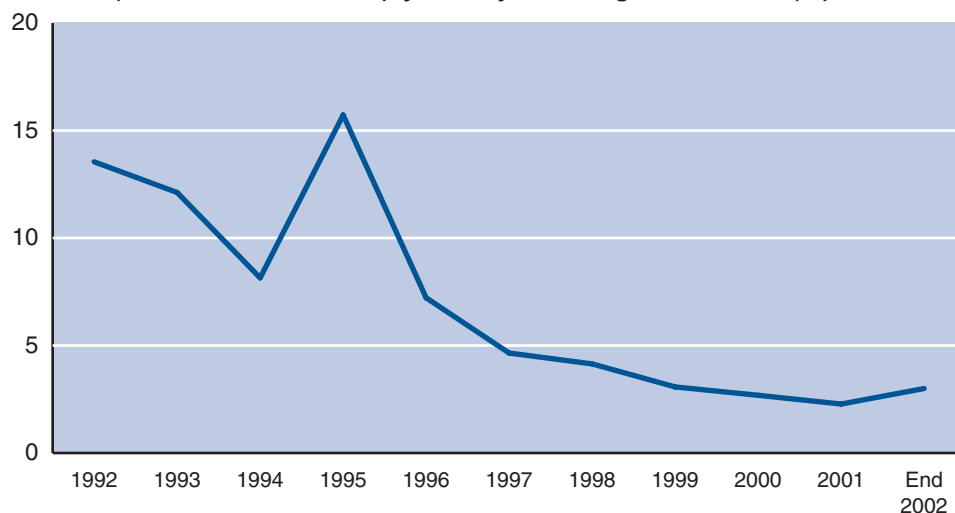


Source: Bloomberg, 6 March 2003.

Figure 6.5

Inflation tamed

Inflation (Consumer Price Index), year on year change, 1992–2002 (%)



Source: Economic Commission for Africa, from official sources.

hampered by a lack of necessary data, expertise, and central bank power. This calls for clarifying the objectives of monetary policy and improving the quality of data. Monetary policy will also benefit from new open-market operations and secondary markets in government securities. The greater use of repos³ by the central bank is welcome.

Financial sector policies

Egypt's banking sector has more than 60 banks, including 28 commercial banks and 31 merchant and investment banks. The four public sector commercial banks dominate the market, with around half of total assets, though their share has been declining as private entry increased competition. Financial reform initially focused on developing indirect instruments of liquidity management, interest and credit liberalization, and opening to foreign banks, with credit allocations shifting in favour of the private sector. The emphasis of ongoing reforms is to continue to increase the competitiveness of financial markets by divesting the remaining state shares in joint-venture and public banks and by increasing private involvement. With foreign entry increasing competition, the central bank is promoting the merger of small and medium-size banking institutions to create stronger banking entities capable of competition with foreign banks in the Egyptian market.

High levels of nonperforming loans, which rose from 12% in June 1999 to 15% in September 2000, are a drag on performance. The bad loans are a consequence of the lack of clear financial boundaries between government-owned banks and other state institutions, such as ministries and public enterprises—and of lending based on social and political connections rather than financial viability. Long-term solutions must establish clearer lines of division and accountability between the public sector and financial institutions.

A key plank of banking reform concerns the independence of the central bank (box 6.4). A bill boosting its independence and clearly defining its role in monetary policy is being discussed, but parliament has yet to enact it into law (box 6.5). This move, closely connected to efforts to improve supervision, must be seen within the context of the broader requirement for increased transparency and accountability. A number of uncertainties remain about how the central bank will operate under the direct supervision of the president.

Nonperforming loans have also complicated attempts to restructure the financial sector by privatizing banks, though the key obstacle is the controversy surrounding bank sell-offs. In June 1998 parliament approved legislation permitting full privatization of the four public sector banks. One bank has been evaluated in preparation for privatization, but the sale has yet to take place. Divestiture of government stakes in the joint-venture banks is largely complete, with only one still having public ownership above 20%.

Capital markets—positive recent developments

Egyptian capital markets have long suffered from limited liquidity and patchy performance, with the fortunes of the stock exchange closely linked to privatization and foreign participation. The heyday of activity was January 2000. The market has been on the decline ever since, reflecting waning privatization efforts, slowing of the economy,

“Steps to improve the banking sector's performance have been hampered by high levels of nonperforming loans”

Box 6.4

Double-edged reforms

Various reforms are under consideration in a broad range of areas. Although this shows the resolve of government to move ahead with reform, there are several risks if the reforms are not managed carefully:

- Current moves to strengthen the central bank include placing it under the direct supervision of the president. It is not clear how this shift will affect the operation of monetary policy. Although placing the bank under the president's authority could help to insulate it from bureaucratic pressures, there is also a chance that the move could politicize the bank's operations, weakening its credibility.
- A proposed income tax law would increase tax exemptions for low-income groups, which could increase the fiscal deficit and the risk of macroeconomic instability. The law also contains exemptions for certain commercial activities, which could increase the scope for rent-seeking by firms.
- The proposed bank bill would allow the government to provide loans to bridge the seasonal deficit in public sector institutions, which can amount to as much as 10% of government deposits. This could slow privatization and increase the size of the government sector.
- The proposed competition and antimonopoly bill could be used to investigate more than 90 mergers between Egyptian and foreign companies. Although a credible competition regime is essential as Egypt moves towards a more market-based economy, these provisions in the new law have the potential to increase business uncertainty.

Source: Economic Commission for Africa, from official sources.

Box 6.5

Strengthening the financial sector's institutional framework

New legislation under discussion aims at strengthening the central bank and fostering better transparency in the financial sector. Its key provisions:

- The central bank is to be responsible directly to the president.
- The central bank is to be given greater responsibility in the formulation of monetary, credit, and banking policies.
- The central bank's capital is to be raised from 100 million Egyptian pounds to 1,000 million Egyptian pounds.
- Banks' minimum paid-up capital is to be raised from 100 million Egyptian pounds to 200 million Egyptian pounds.
- The maximum exposure of banks to a single customer is to be reduced from 30% to 15% of the bank's capital base.

Source: Economic Commission for Africa, from official sources.

and mounting pressure on the pound. The trends were partly in line with the global decline of the stock markets in the wake of the September 11, 2001 attacks, but they also reflect the local economic slowdown and faltering privatization efforts.

National pension funds and insurance companies have recently begun to invest in the stock market, which should deepen the market and increase liquidity. In addition, the recent placement of global depository receipts (GDRs) on world financial markets will strengthen the link between Egypt's capital market and global markets.⁴ Nine Egyptian companies have issued GDRs on international markets. At year-end 2001 those GDRs represented about 7% of market capitalization on the Egyptian stock exchange. This link was further strengthened by the launch of Egypt's dual tranche inaugural bond on June 29, 2001.

Despite the significant development of Egypt's capital market over the 1990s, enforcing disclosure requirements and combating insider trading are badly needed to enhance transparency and to combat destabilizing speculative behavior. Further deepening and expansion of the market depend on banking reforms and progress with privatization.

“National pension funds and insurance companies have recently begun to invest in the stock market, which should deepen the market and increase liquidity”

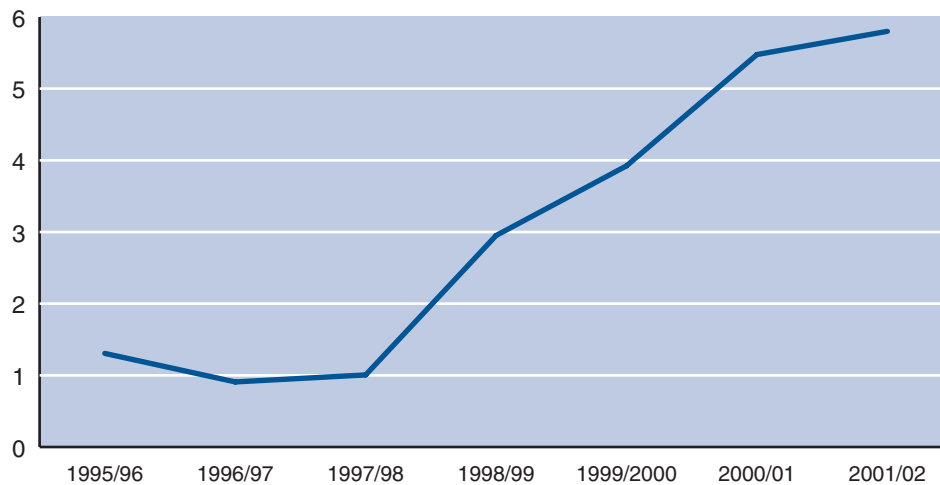
Developments in the fiscal sector—deficit on the rise

The fiscal deficit has been rising steadily since 1998/99, reaching over 5% of GDP by 2001 and 5.8% in 2002 (figure 6.6).⁵ A number of mega projects, notably the Toshka agricultural and land reclamation project, have required substantial resources. Ongoing trade liberalization has placed downward pressure on customs revenues. Inherited social commitments, such as bread subsidies and the social safety net, impose huge claims on the budget. And domestic debt servicing has further drained the expenditure side of the budget.

Figure 6.6

Deficit rising

Fiscal balance, 1995/96–2001/02 (% of GDP)



Source: Economic Commission for Africa, from official sources.

“
Interest payments on domestic debt now account for 24% of planned current expenditure and 18% of total expenditure
 ”

The budget proposals for 2002/03 project a 12% increase in total expenditure (appendix table). The wage bill, at 32% of planned current expenditure and 25% of total expenditure accounts for a significant proportion to this increase. In addition, interest payments on domestic debt now account for 24% of planned current expenditure and 18% of total expenditure. These expenditure items account for roughly half of total actual spending. Cutting the wage bill would be politically difficult. Delays in the repayment of domestic public debt have added to the macroeconomic problems, making the government likely to try to meet its obligations. The high proportion of these items in total expenditure seriously reduces the authorities' room to manoeuvre in fiscal management.

Domestic debt is the subject of much public debate, with growing concerns about rising debt service payments. The fiscal deficit has been fully financed from domestic sources, not by seigniorage but by issuing treasury bills and delaying payment to companies involved in major projects—a reflection of Egypt's resolve to reduce the burden of external debt. Growth in debt has tended to outpace GDP growth, pushing up the debt to GDP ratio (table 6.5). Interest payments on domestic debt are crowding out budget allocations for investment and social expenditure. With the growth of the economy slowing and domestic interest rates still high, the debt to GDP ratio is likely to continue to rise.

Persistent deficits are a product of long-term political factors. Vested interests have constrained reform of the public economic authorities and unprofitable state-owned industries, a major drain on the budget. In addition, the government has repeatedly stated

Table 6.5
Public domestic debt, 1999/2000–2001/02 (US\$ millions)

Debt component	1999/2000	2000/01	2001/02
Total public debt	58,970	61,961	59,070
Government	48,008	51,046	49,808
Securities	22,688	34,993	37,354
T-bonds	11,924	24,062	21,241
T-bills	7,416	7,686	10,583
Social security	885	794	450
Housing bonds	41	36	31
Banks recapitalization bonds	2,104	2,109	2,118
Other	319	306	285
Government borrowing from the National Investment Bank	25,976	26,498	25,618
Credit balances with banking sector	-655	-10,445	-13,164
Public economic authorities	10,962	10,915	9,263
Balances with banking sector	-1,151	-868	-1,347
Balances with the National Investment Bank	12,112	11,783	10,610
Public debt to GDP (%)	59	66	69

Source: Economic Commission for Africa, from official sources.

the need to maintain social spending and consumer subsidies in order to avoid social discontent, particularly in the light of fears that poverty could stoke support for Islamist groups.

These structural problems have made fiscal policy inflexible, eroding its role in fine-tuning the economy. The government is taking steps to address some of the problems. A Public Debt Management Department was recently established in the Ministry of Finance to minimize the cost of public debt—rescheduling some existing debt, replacing high-cost with low-cost debt, replacing short-term with long-term debt, and enhancing the operation of primary and secondary markets in government securities.

Fiscal reform is also making the budget more transparent and comprehensive, expenditure priorities more explicit, and the budget process more results oriented and performance based. With public expenditure at 27% of GDP in 2002, efforts to improve its quality are critical. The share of state spending in GDP, at 31% in 1998, is higher than the average of 19% for lower middle income countries. Budget comprehensiveness is being improved through the use of a multiyear medium-term expenditure framework. The tax reform agenda includes improving income tax administration and combating tax evasion, so as to create a more transparent and equitable system. Coverage of indirect taxes is being extended, and registration and collection procedures are being strengthened.

Overall, this reform agenda is very ambitious and likely to run up against significant human and other resource constraints within ministries. More fundamentally, it will be difficult to push fiscal reform forward without a significant constituency for such reform. Without strong political commitment, interest group resistance may stifle these efforts.

The external sector

The widening current account deficit from the late 1990s put pressure on the fixed exchange rate because of relatively free capital flows. Recent moves towards a more flexible exchange rate regime may help to reduce tensions between different policy targets. Egypt has made progress on trade liberalization, but nonoil export performance has been disappointing. The external debt stock has fallen over the last decade because of debt write-offs and the government's reliance on domestic financing.

Exchange rate outlook uncertain—current account deficit narrows

Over the 1990s Egypt's dollar exchange rate peg was an important part of the government's anti-inflation strategy. But following deterioration in the balance of payments in 1998, the currency has come under consistent downward pressure, complicating the conduct of macroeconomic policy. The central bank's initial response to the sudden deterioration in the external balances was to assume that the pressure on the current account was only temporary. Attempts to defend the currency peg first by administrative

“*Vested interests have constrained reform of the public economic authorities and unprofitable state-owned industries*”

controls—and then by drawing down international reserves and widening interest rate differentials—were insufficient, as balance of payments problems continued to put pressure on the currency. The problems eventually led to a major policy shift towards the end of 2000, when the government started moving towards a more flexible exchange rate.

“The government announced a move to float the currency from the end of January 2003—it could bring greater clarity to monetary policy”

In a continuing trend towards greater flexibility, the government announced a move to float the currency from the end of January 2003. The Egyptian pound quickly fell to around 5.50 to the dollar at the beginning of February 2003, from the December 2002 average of 4.63. Details of the new policy framework remain unclear. If credibility is established quickly, the move could bring greater clarity to macroeconomic policy. But liberalized capital flows bring several risks. Any rapid depreciation of the currency with relatively free capital flows could constrain the interest rate reductions needed to support domestic investment and growth—a particular danger in the uncertain regional context. Egypt’s limited financial development and thin capital markets could add to exchange rate volatility. High interest rates would then have implications for fiscal policy, putting upward pressure on the deficit as a result of high interest repayments on domestic debt.

For the currency regime to support the real economy, the real exchange rate must be allowed to maintain the country’s competitiveness among its main trading partners. Egypt’s fixed rate regime led to gross misalignments of the exchange rate: the pound was allowed to appreciate even in nominal terms against the currencies of key trading partners such as the European Union and Japan. For the European Union, Egypt’s largest trading partner, this occurred even against the background of a trade deficit with EU countries in 1996–2000.

Even the increased flexibility of the crawling peg regime, introduced at the end of January 2001, did not reverse the misalignment. The central bank announced a central rate of 3.85 pounds to the dollar, with transactions allowed within a 1% band around the central rate. The central rate was revised several times, and the band was subsequently widened. By November 2002 the pound had fallen to 4.65. This depreciation against the dollar came after a long period of real appreciation over the 1990s, so it is doubtful whether the depreciation under the crawling peg regime was sufficient to correct for the real appreciation before 2001 (box 6.6 and figure 6.7).

These tensions have underpinned the ambiguous and often muddled conduct of exchange rate management in recent years. They emerged more starkly as shocks in 1997–98 put more pressure on the exchange rate peg—the slump in tourism after the Luxor massacre, the decline in Suez canal receipts during the East Asian crisis, and the collapse in oil prices.

These events pushed the current account into significant deficit in 1998 for the first time since the 1980s (figure 6.8). Egypt has long run trade deficits, driven by imports under the “open door” policy of the 1970s unaccompanied by adequate increases in exports. This was sustainable in the 1970s and 1980s because of high oil revenues and substantial foreign aid, but these inflows became more unstable over the 1980s and 1990s. The trade

deficit exceeded 14% of GDP in 1997/98–1998/99 as exports were hurt by falling oil prices and limited expansion in nonoil exports. Transfer flows and service exports brought the current account deficit to a tolerable 2% of GDP on average. The trade deficit

Box 6.6

Exiting from a fixed rate regime

In an era of increasing capital mobility many developing countries are moving towards more flexible exchange rate regimes, including Egypt. The increased geographic diversification of developing countries' trade has posed particular problems for single currency pegs, a problem illustrated vividly in Egypt's case. But the choice of exchange rate regime is not between completely fixed and completely floating. There is a spectrum of possible arrangements between these extremes, such as managed or "dirty" floats and systems based on bands or adjustable pegs. But analysts have pointed out the vulnerability of intermediate exchange rate systems to speculative attack and argue for either free floating or hard-peg regimes (Obstfeld and Rogoff 1995).

A shift from a pegged regime, as in Egypt, does not imply a sudden move to a completely floating regime. Very few countries allow completely unfettered movements in their exchange rates. For developing countries whose capital and foreign exchange markets are typically underdeveloped, a pure floating regime would lead to sharp and undesirable increases in volatility. For countries exiting from a fixed peg, this means that some form of exchange rate management is likely to continue to be important. Even so, the shift to a more flexible regime means that monetary policy no longer needs to be closely tied to the needs of exchange rate stabilization.

Developing countries have typically exited from pegs as their currencies came under downward pressure, reserves were declining, and growth was slowing. Following exits, exchange rate volatility often increased, the value of currencies fell sharply while prices shot up, and output remained depressed for some time.

Chile and Poland managed to exit when their currencies were subject to upward pressures and there was macroeconomic stability. So exit did not come within a context of crisis or serious concerns about policy credibility. Major economic instability was therefore avoided.

In Egypt the ideal conditions for an orderly exit are not in place: the currency has been under consistent downward pressure, there are signs of capital flight, concerns surround the government's policy credibility, and the external environment is not favourable while regional political instabilities are increasing.

A number of challenges are therefore raised by the shift to the new exchange rate regime. First, policy credibility needs to be established quickly. In particular, as the exchange rate ceases to act as an anchor for monetary policy, a new policy anchor needs to be established and made credible. For Egypt it will be particularly important for the central bank to build up institutional credibility and to develop the expertise necessary to manage a more independent monetary policy. Second, more transparent and disciplined budget management will help to stem any rapid depreciation of the currency early in the float. Third, adequate regulation of the financial system will be essential under the new regime.

Source: *Draws on Eichengreen and Masson 1998.*

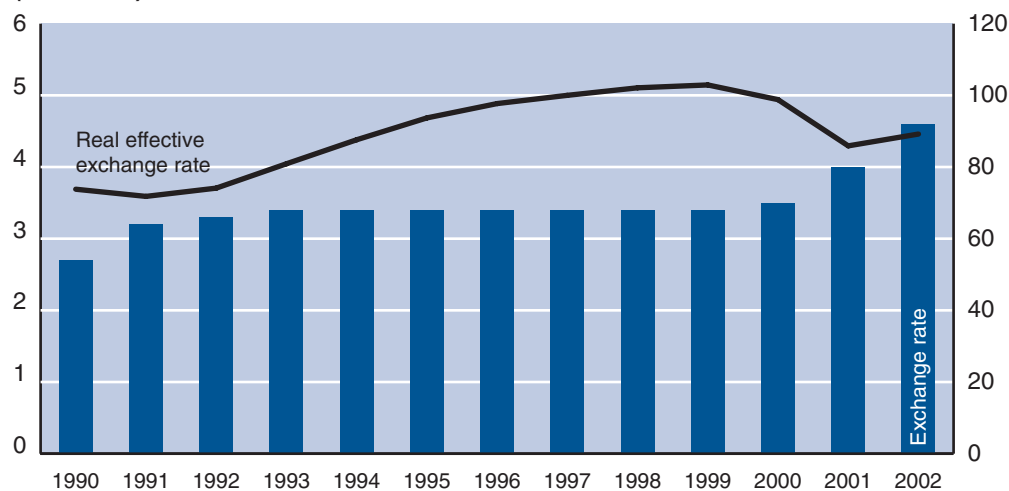
narrowed to 7.8% of GDP in 2001/02 and the current account deficit to 0.4%. But the reduction was primarily the result of economic slowdown and restrictions on imports and foreign exchange imposed by the government, not of sustained export expansion.

Egypt's recent experience seems to support the long-held hypothesis that under a fixed exchange rate regime capital mobility undermines the possibility of orienting monetary

Figure 6.7

Did the crawling peg correct for the real appreciation before 2000?

Pound to dollar exchange rate and real effective exchange rate, 1990–2002 (1997=100)

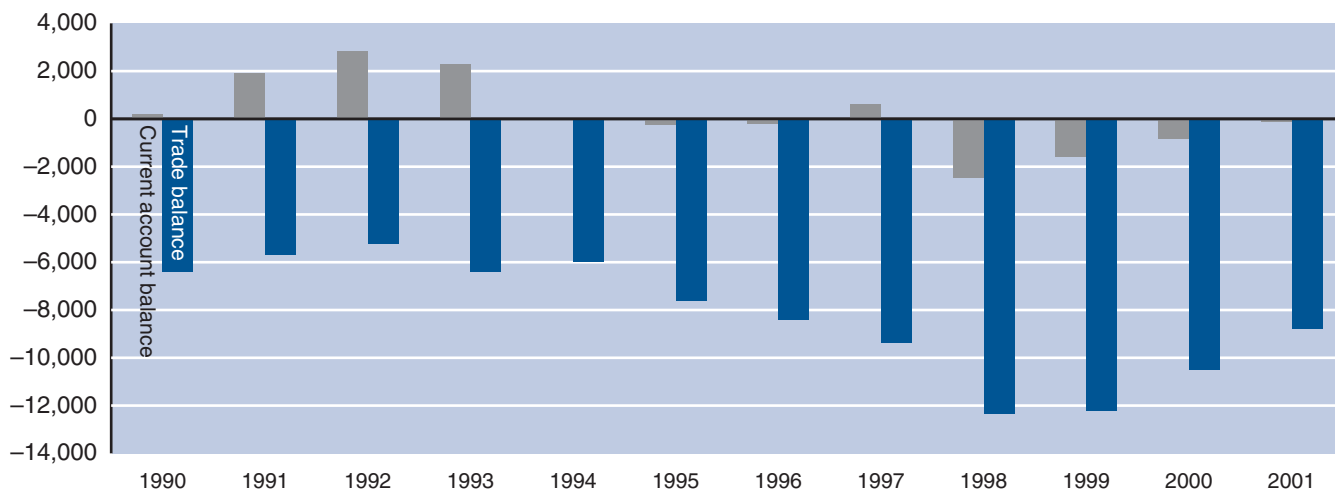


Source: EIU 2002, based on a trade-weighted basket of currencies.

Figure 6.8

Deficits widening then narrowing

Historical trends in trade and current account balances, 1990–2001 (US\$ billions)



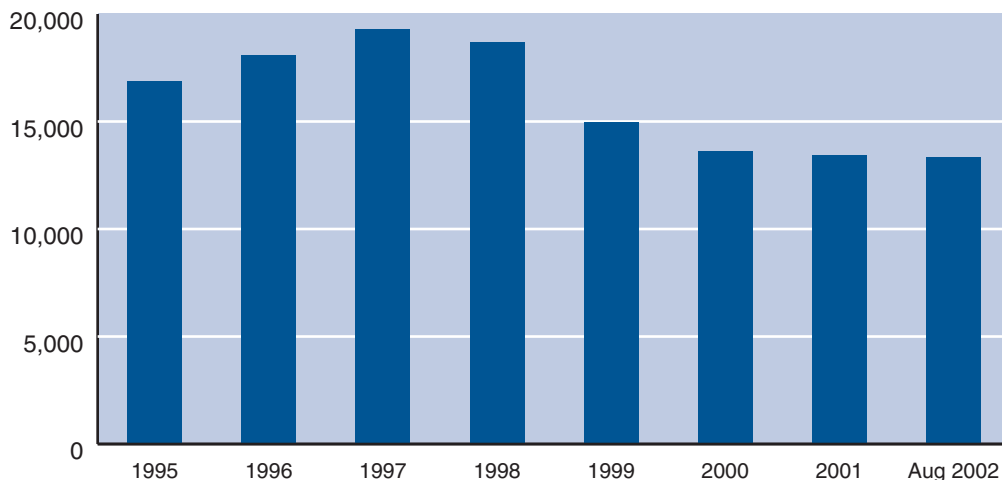
Source: Economic Commission for Africa, from official sources.

policy towards the needs of the domestic economy. With a widening current account deficit, the central bank maintained capital mobility in pursuit of a good sovereign investment rating. In a delicate balancing act, interest rate reductions have been constrained by the virtually free movement of capital in and out of Egypt, given the aim of stabilizing the exchange rate. This led to a substantial reduction in international reserves (figure 6.9) partly to finance capital outflows (figure 6.10). Liberalization of the capital account has therefore complicated foreign exchange policy (box 6.7).

Figure 6.9

Running down foreign reserves . . .

International reserves, foreign exchange plus gold, 1995–2002 (US\$ billions)

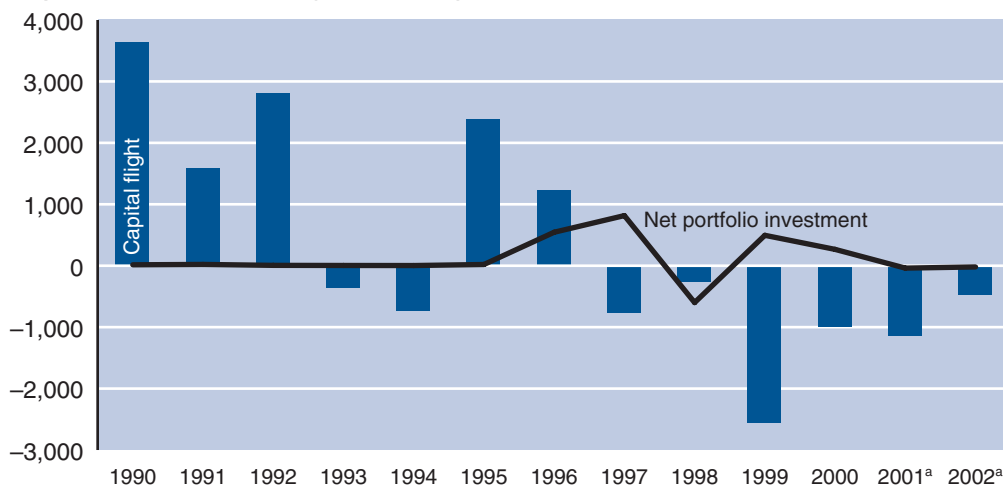


Source: Economic Commission for Africa, from official sources.

Figure 6.10

. . . To finance capital flight

Capital flows, 1990–2002 (US\$ billions)



a. Estimated.

Source: EIU, based on IMF data.

Box 6.7

Capital account liberalization: lessons from Egypt

Egypt's capital account was largely liberalized in 1994. Since the Asian crises there has been increasing ambivalence about the desirability of fully liberalized capital accounts for developing countries and greater awareness of the need for appropriate sequencing of reforms to reap the potential benefits. A number of benefits and costs have been identified in relation to such liberalization (Gilbert and others 2000):

Benefits	Costs
Promotes allocative efficiency in the use of capital globally	Complicates macro policy as capital flows restrict monetary policy
Allows portfolio diversification and so risk spreading by investors	Generates considerable economic risks
Promotes macro discipline as the potential for inflows and outflows of capital force governments to adopt good policies	Makes pegged exchange rates unviable
Promotes financial market discipline as capital mobility necessitates building robust financial systems	Reduces tax base through capital outflows
Reduces corruption opportunities as officials do not have the power of discretion over financial flows in liberalized systems	Provides only limited growth benefits, according to econometric evidence

For transition and developing economies, the Asian crises have taught two main lessons for capital account liberalization:

- Poorly regulated financial sectors can generate serious problems under liberalized capital regimes.
- Continuing with a fixed exchange regime under capital liberalization is problematic and increases the possibility of financial crises.

Sequencing is thus an important issue for developing countries. McKinnon (1991) has argued that financial liberalization should come only after fiscal reform and the achievement of manageable levels of inflation and liberalization of the domestic capital market and the current account. When domestic markets remain protected and supporting supervisory and regulatory institutions are weak, the benefits from capital account liberalization are likely to be limited and the potential costs high. For Egypt capital account liberalization also complicated macroeconomic management under a fixed exchange rate. Although the situation was far from a dramatic Asian-style crisis, the sequencing of reforms may not have been optimal. Capital flows meant that monetary policy became delinked from the needs of the domestic economy to defend the exchange rate.

Source: Gilbert, Irwin, and Vines 2000; McKinnon 1991.

Trade liberalization and export promotion—faster diversification needed

Egypt has moved quickly on trade liberalization through commitments under the General Agreement on Tariffs and Trade and the World Trade Organization (WTO) and through bilateral and regional trade agreements. Tariffs have been reduced, while quotas and other nontariff restrictions have been removed. Import tariffs have come down from a range of 0.7–120% in May 1991 to 5–40%. And as part of WTO commitments, Egypt eliminated the import ban on textiles and clothing. But these reforms did not do enough to promote exports (table 6.6). Rather than attract resources to exportables, the reduction in protection of import-substituting activities led to a reallocation of resources to nontradables, particularly with the overvalued exchange rate.

Industrial protection without disciplining mechanisms to enhance productivity and competitiveness will make future success in the global market more difficult. The rent-seeking of protected industries, which prefer to produce for the shielded local market, will need to be addressed to enhance the export potential of the country. This challenge is as much political and economic as administrative. The modest level of educational attainment and human capital and skill constraints greatly reduce the country's capacity to benefit from skill-intensive higher value-added exports.

Against this background the government declared export expansion critical for strengthening the economy, and the Ministry of Foreign Trade announced an export promotion strategy for 2001–03. The strategy seeks to nearly double exports of five priority sectors, from \$2,661 million in 2000 to \$5,107 million in 2003: textiles and readymade garments; agricultural products such as rice and oranges; chemical, pharmaceutical, and medical supplies; building and construction materials and iron and steel; and processed food. Together, these items account for about 50% of merchandise exports in 2002. The strategy includes new institutional infrastructure for exports, international action to promote Egyptian exports, and sectoral policies. Given the deep structural constraints underlying Egypt's poor export performance, the targets appear optimistic.

Table 6.6

Exports by commodity type, 2002 (US\$ millions)

Export	2002
Total exports	4,697
Fuel and oil products	1,530
Nonoil	3,167
Raw cotton	330
Raw materials	282
Semimanufactured goods	585
Finished goods	1,537
Free-zone goods	433

Source: Economic Commission for Africa, from official sources.

“Tariffs have been reduced, while quotas and other nontariff restrictions have been removed.”

External debt—remains manageable

Egypt's external debt stands at about \$28 billion in 2002/03, down from the alarming \$50 billion reached in 1990 (table 6.7). The reduction was largely the result of debt write-offs through a 1991 Paris Club deal. Half the debt is owed to bilateral donors. Around 90% of Egypt's current external debt stock is medium- and long-term public and publicly guaranteed. Medium- and long-term private nonguaranteed debt amounts to 1.9%, and short-term debt to only 7.5%.

“Egypt's external debt stands at about \$28 billion in 2002/03, down from the alarming \$50 billion reached in 1990”

The net present value of Egypt's external debt fell to 23% of gross national income (GNI) in 2000 and 107% of exports of goods and services, well below the thresholds for debt sustainability under the Heavily Indebted Poor Countries Initiative. In the same year debt service amounted to 1.8% of GDP and 8.4% of exports of goods and services (World Bank 2002b). Over the 1990s the government has been cautious about taking on new borrowing, wary of falling back into the debt problems of the 1980s. Servicing external debt took up only 2% of total public expenditure in 2001/02, with interest payments on domestic debt now dwarfing those for foreign debt.

Structural reforms and impacts

Although efforts have been made to improve the efficiency of institutions, many weaknesses remain and further reform will be difficult. Privatization has slowed. The private sector has expanded but remains uncompetitive internationally. Industrial upgrading and technology transfer are now priorities.

Table 6.7

Public external debt, 1999/2000–2002/03 (US\$ millions)

Debt component	1999/2000	2000/01	2001/02	2002/03 Q1
Total external debt	27,783	26,560	28,660	28,251
Rescheduled bilateral debt	16,292	14,779	15,336	15,012
Official development assistance	7,969	7,345	7,456	7,332
Other	8,323	7,434	7,881	7,680
Other bilateral debt	4,226	3,894	4,057	4,006
Paris Club countries	3,677	3,353	3,405	3,059
Other countries	549	541	652	946
International and regional institutions	4,275	4,310	4,697	4,679
Supplier and buyer credits	981	896	924	1,184
Sovereign bonds	—	—	952	857
Short-term debt	1,628	2,207	2,150	2,201
Deposits	657	1,311	1,339	1,357
Other short-term facilities	972	896	812	844
Private sector debt (nonguaranteed)	381	473	542	311

Source: *Economic Commission for Africa, from official sources.*

Institutional change—made difficult by vested interests

Political factors have constrained institutional reform. For example, a proposed competition and antimonopoly bill has been the subject of intermittent discussion for almost 10 years. Although several versions of the bill have been publicized, the legislation has not yet been submitted to the People's Assembly, on the strength of business opposition. This is a vital piece of unfinished business to enhance institutional reforms, promote governance, and improve resource allocation. Similarly, a proposed labour bill would significantly change the labour code, establishing employers' right to hire and fire. After nearly a decade of lobbying by various interest groups, and stiff opposition from labour unions, the bill never passed.

Such deeply rooted institutional ossification can only undermine the country's international competitiveness. This is illustrated most recently in the country's declining ranking in the Growth Competitiveness Index from 40 in 2000 to 44 in 2001 and in the Current Competitiveness Index ranking from 39 to 40 (World Economic Forum 2001).

Despite the barriers some measures have been taken to improve the institutional environment, especially in its effect on business operations and economic performance. To address inefficiencies in the legal system and in the bureaucracy, the Ministry of Justice recently set up a Judicial Reform Commission, which in collaboration with other government bodies is reviewing legislative changes to the commercial and business legal framework. New laws on intellectual property rights, money laundering, and special economic zones were passed in 2002.

But only limited progress has been made in cutting red tape and streamlining the cumbersome regulations holding back investment and operations. Much remains to be done to improve the entrenched and overstaffed bureaucracy. A new ministry in charge of civil service reform was established in 1997, with a mandate to recommend measures to improve the efficiency of civil service through training, evaluation, and performance-related schemes. This was perhaps ill-advised, because the new ministry only added to an already bloated bureaucracy instead of fighting it.

Regional and subregional integration—strengthening links with the rest of Africa

Egypt has strengthened its economic and trade ties with the rest of Africa, especially with countries south of the Sahara. The most significant step in this direction was the decision to join the Common Market for Eastern and Southern Africa (COMESA) in 1998, in pursuit of economic and strategic objectives. This was shortly followed by accession to COMESA's free trade area. As of August 2000 Egypt had achieved a 90% tariff reduction on imports from COMESA members. But trade with COMESA countries accounted for only 1.1% of exports and 1.3% of imports in 2000. The United States and Europe remain Egypt's main trading partners.

“Only limited progress has been made in cutting red tape and streamlining the cumbersome regulations holding back investment and operations**”**

“
*Bilateral and regional
free trade agreements
have become a
feature of Egypt’s
foreign trade policy in
recent years*”

Bilateral and regional free trade agreements have also become a feature of Egypt’s foreign trade policy in recent years. Bilateral agreements were signed with Libya and Syria in 1990; with Jordan, Lebanon, Morocco, and Tunisia in 1998; and with Iraq and Saudi Arabia in 2001. Egypt is a founding member of the Arab Common Market and a member of the Greater Arab Free Trade Area, initiated in 1998, to be completed in 10 years. More recently, Egypt and the European Union initialed the Egypt-EU Partnership Agreement in June 2001, establishing a free trade area over a 12-year period.

As a result of this web of trade arrangements, Egypt’s customs and trade regime has become cumbersome and unwieldy. Various agreements stipulate different tariffs, rules of origin, and exemptions, adding to transaction costs. There is thus scope for simplifying Egypt’s trade regime to eliminate inconsistencies and ambiguities and to reduce transaction costs.

The private sector

Strengthening the private sector is a major plank in Egypt’s reform agenda. The Economic Reform and Structural Adjustment Programme framework of 1991 had a strong private sector reform component, with measures to eliminate discrimination against the private sector in obtaining licenses, purchasing inputs and energy, and obtaining credit. This shifted economic activity towards the private sector, but the sector has yet to build up international competitiveness. Nonoil exports remain weak. And recent efforts to strengthen the sector face such constraints as the lack of relevant skills in the workforce, poor transparency in the business and legal spheres, and often confusing and contradictory government policies towards private enterprise.

Privatization. Egypt’s privatization program gathered steam in 1995, four years after the introduction of the adjustment program. In the first quarter of 2002 close to 60% of state-owned companies subject to the privatization enabling law, had shifted to private hands.⁶ Altogether 188 entities (of 314) have been privatized since 1995, with proceeds of 16.9 billion pounds. The privatization effort peaked in 1997–2000, with an average of 25–30 transactions worth 2.5–3.5 billion pounds annually. But the process slowed in 2001, with only 13 privatization transactions, generating proceeds of 1.1 billion pounds. It appears that the privatization process has reached its limits because of political inertia. In an attempt to reignite the privatization process, the Public Enterprise Office introduced alternative methods for privatization, including asset unbundling and leasing with an option to buy.

Despite the slowdown, privatization has increased the contribution of the private sector to GDP, investment, and employment in nonagricultural activities (table 6.8). In the medium and long terms this will improve the economy’s competitiveness.

The government has outlined a National Strategy for Economic and Social Development for 1997/98–2016/17, according a central place to the private sector in commodities and services. The premise is that a market economy requires a central role for the private sector in investment and production, even in areas traditionally the

domain of the government, such as roads, ports, and power. The ambitious target for private investment is at least 80% of total investments.

But simply rolling back the state in favour of the private sector is not a panacea. The critical reform challenge is to reinvigorate the state in its interactions with the private sector, focusing more on enhancing quality. Facilitating private activities through deeper legal and regulatory reforms and less red tape is crucial for private sector development (box 6.8).

Limited financing to small and medium-size enterprises. Private manufacturing in Egypt is mostly by small and medium-size enterprises. In 1996 more than 90% of manufacturing entities in the private sector were sole proprietorships. Bank credit to small and medium-size enterprises has traditionally been limited, especially for startups. Financing is thus essentially the equity the single owner can provide. Several initiatives have been introduced to deal with this single most binding constraint to developing the private sector in Egypt. The Credit Guarantee Company guarantees bank loans to small enterprises in all business activities except trade. Three venture capital companies have been established, all still at an early stage of development. And the Social Fund for Development has also been providing finance to small enterprises.

“Simply rolling back the state in favour of the private sector is not a panacea—the challenge is to reinvigorate the state in its interactions with the private sector”

Strategic actions for technology development and transfer

In addition to capital deepening and more efficient resource use in existing sectors, faster growth depends on entering into higher productivity sectors and activities. Success is likely to depend on institutional and political restructuring, to shift influence from vested interests likely to oppose moves to a more efficient and productive industrial base through reforms that will generate winners and losers.

A recent report on science and technology has identified two main areas for strategic action: supporting competitiveness and innovation as a basis for exports, and accelerating technology transfer to Egypt through foreign direct investment, with several sectors identified as promising (box 6.9).

Table 6.8

Public and private shares in GDP, investment, and employment in nonagricultural activities, selected years (%)

Year	GDP		Investment		Employment	
	Public	Private	Public	Private	Public	Private
1969/70	60.0	40.0	87.8	12.2	52.4	47.6
1975	58.8	41.1	85.0	15.0	53.9	46.1
1980/81	64.1	35.9	68.7	31.3	53.5	46.5
1984/85	52.3	47.7	60.4	39.6	51.4	48.6
1989/90	41.4	58.6	54.9	45.1	48.9	51.1
1994/95	42.8	57.3	59.4	40.6	47.4	52.6
1999/2000	32.2	67.8	32.9	67.1	42.1	57.9

Source: Kheir-El-Din 2001.

Egypt's potential for attracting foreign direct investment to develop information technology, software, and support services rests on a large and growing domestic market, reasonable infrastructure, and good human resources. The country has a potential comparative advantage in Arabic software applications. But realizing that potential requires

Box 6.8

Measures to support the private sector

The main areas for developing the private sector include:

- Deeper regulatory reform.
- A broader privatization effort that includes the economic authorities. There are 62 public economic authorities in Egypt. The proposed reform is to corporatize them, starting with the most viable.
- Reforming the commercial judicial system.
- Simplifying labour codes (with special emphasis on labour mobility).
- Devising innovative schemes to secure long-term credit to the private sector and formal credit to micro and small enterprises.
- Streamlining bureaucratic procedures throughout local and central government.
- Devising market-driven mechanisms for technological improvement and quality control.
- Building a system for gathering and disseminating basic, reliable, and timely economic data and information relevant to private business planning.

In addition, specific steps have been taken in the past few years to encourage the private sector, both domestic and foreign. The most important:

- A new Investment Guarantees and Incentives Law makes tax incentives automatic, streamlines procedures, and offers greater tax incentives for designated priority regions and activities (such as infrastructure, auto parts, software and tourism).
- A new government procurement law aims at improving predictability and encouraging competition in procurement, thereby opening up more space for the private sector.
- New legislation allows build-operate-transfer contracts for electricity distribution companies and power stations. A regulatory authority was also established to supervise these operations.
- The National Telecommunications Authority has been corporatized, transforming it to a joint stock company, the Egyptian Telecommunications Company (Egypt Telecom). A telecommunications regulatory agency was set up. The private sector was licensed to provide mobile phone services.
- General and specialized ports, as well as platforms in existing ports, may now be established and operated through build-operate-transfer contracts and concessions to the private sector. In addition, build-own-operate-transfer contracts were awarded for airport projects in Marsa Alam, Hurghada, and Alamein and for the Fayoum–Alexandria and Fayoum–Dayrout road projects.

Source: Economic Commission for Africa, from official sources.

a coherent strategy to attract foreign investment. Greater attention also has to go to improving the quality and delivery standards of local firms—and to improving the skills base of the workforce. Strategic alliances with transnational companies will continue to be essential for developing subcontracting and other linkages.

Developments in the social sector

Judged solely by per capita income, Egypt is a lower middle income country as defined by the World Bank. Although it has made significant progress in improving social conditions, much remains to be achieved. Large segments of the population still live in extreme poverty, and a great many cannot read and write. In addition, there is strong gender imbalance in unemployment rates, average years of schooling, and adult illiteracy. The inability to exploit the full potential of its citizens limits Egypt's competitiveness in the global marketplace.

Box 6.9

Potential high-growth emerging sectors

Information technology

The decision to target information technology as one of the strategic action areas rests on the fact that Egypt is the largest market for information technology products in the Middle East. The United Nations Industrial Development Organization (UNIDO) estimates that the hardware market is growing faster in Egypt than in the world market. A new Ministry of Telecommunications and Information Technology was established in 1999, and there are plans to establish a technology valley in the Sinai, east of Ismailia.

This potential, along with the government's declared policy of targeting this sector, has attracted a number of transnational corporations to Egypt. Xerox has built a plant in the new 6th of October industrial city to manufacture and assemble office equipment for the local and regional markets. In 1997 Xerox Egypt exported a large proportion of its production to European and Middle Eastern countries. The company supports its business growth by investing in human resources development, through a training center offering managerial and technical training

Software and support services

Egypt has great, but largely untapped, potential as an attractive location for multinational software companies. IBM has located one of its regional scientific centres in Cairo to promote information technology in Egypt and to preempt piracy. Microsoft organizes training courses in collaboration with the Information and Decision Support Center through the Information Technology Institute. It also has agreed to make original software available to Egyptian colleges and universities and government departments on attractive terms. Oracle, in its bid to become the largest multinational software company in the country, is targeting government defense and security, oil and natural gas, private business, and banking and finance.

Source: Economic Commission for Africa, from official sources.

“
Two main areas
for strategic action:
supporting
competitiveness and
innovation as a basis
for exports, and
accelerating technology
transfer to Egypt
through foreign direct
investment
”

“Public expenditure on health as a proportion of GDP is lower in Egypt than in other middle income countries, at 1.8% of GDP compared with 2.3%”

Health—improvements despite low public outlays

Public expenditure on health as a proportion of GDP is lower in Egypt than in other middle income countries, at 1.8% of GDP compared with 2.3%. But Egypt has seen faster improvements in some key health indicators than comparator countries (table 6.9). Life expectancy increased from 56 to 67 years between 1980 and 1999, an improvement of almost 20%, compared with the average of less than 5% for lower middle income countries. Infant mortality fell from 120 per 1,000 live births in 1980 to 47 in 1999, a 61% improvement, partly the result of reductions in diarrhea-related deaths through the use of oral rehydration therapy (EIU 2002). Child immunization is now nearly universal.

But access to health services remains uneven, with an urban bias in health care facilities creating barriers for poor and rural segments of the population. Fast population growth and inadequate health care funding have resulted in congestion. The government continues to be the main provider and financier of health care, though private provision and financing are increasing.

There is also an urban bias in other public services required for good health. Of the nonpoor, 82% had access to indoor drinking water, compared with 61% of the poor in 1999/2000. The gap is even wider for access to sewerage (World Bank 2002a). There is also a clear regional disparity, with the lowest access in southern and rural areas.

Education—mismatch with labour market requirements

Egypt fares poorly in education, too. At 5.8% of GDP public expenditure on education is below the average for lower middle income countries. This low expenditure is reflected in a number of indicators. Adult literacy in 2000 was 55%, but higher for men than for women. Primary enrolment rates in 2000 were 99%, but secondary enrolment

Table 6.9

Comparative health outcomes, Egypt and lower middle income countries, selected years

Health indicators	Egypt			Lower middle income		
	1980	1999	% change	1980	1999	% change
Life expectancy (years)	56	67	19.6	66	69	4.5
Infant mortality (per 1,000 live births)	120	47	-60.8	55	32	-41.8
	1995-99			1995-99		
Child immunization, measles (%)		96			87	
Child immunization, DPT (%)		95			87	
	1990-98			1990-98		
Public health spending (% of GDP)		1.8			2.3	
Health spending per capita (\$)		48			62	

Source: Economic Commission for Africa, from official sources.

rates were just 51%. The system appears not to have coped well with the huge expansion of the education system, in terms of the quality of schooling.

In higher education Egypt has made considerable progress in expanding enrolment, giving it one of the largest university systems in Africa and the Middle East (table 6.10). There are 12 government universities, with 8 affiliated branches and 20 campuses. All but 1 of the 25 governorates have a university presence. The number of admitted students rose from 58,400 in 1973/74 to 200,600 in 1999/2000, total enrolment from 239,340 to 1,175,160, and the number of graduates from 32,030 to 195,200 a year. In 1998/99 women made up 44% of enrolment, up from 36% in 1992/93, as female enrolment tripled while male enrolment doubled. The gap between male and female enrolment is closing very quickly.

Government policy is to admit all high school graduates, and the expansion of secondary education in the 1980s increased demand for university places. There are also many repeaters. These factors, coupled with limited opportunities to study abroad, increased total enrolment.

Despite the growth in higher education, the system is failing to provide the skills most relevant to the labour market, which has long been unable to absorb the many university students graduating each year. Labour market demand for secondary school-educated workers is especially low, constituting only 4% of the total, partly reflecting their lack of skills. Around 55% of the unemployed have a secondary education. A recent survey shows that business owners prefer workers with practical business training rather than institutional certification (Evans-Klock and Lin Lean Lim 1997).

Educational attainment across different segments of the population appears to be closely connected to regional disparities in living standards and poverty. Reductions in poverty are strongly correlated with increases in education (table 6.11), although not uniformly

“Despite the growth in higher education, the system is failing to provide the skills most relevant to the labour market, which has long been unable to absorb the many university students graduating each year”

Table 6.10
Students enrolled in universities, by gender, 1989/90–1999/2000

Enrolment	1989/90	1994/95	1995/96	1999/2000
Total enrolment	467,611	597,964	755,606	1,175,155
Male students				
Number	302,838	355,876	431,838	626,843
%	65.0	59.5	57.2	53.3
Female students				
Number	164,773	242,088	323,768	548,312
%	35.0	40.5	42.8	46.7
Ratio of female to male students (%)	54.4	68.0	75.0	87.5

Source: Economic Commission for Africa, from official sources.

“Poverty is higher in Egypt than the average for Arab countries”

across regions. In northern and urban Egypt the returns to education seem to have increased over the 1990s, whereas in southern areas education shows lower returns, reflecting regional disparities in the pace of development (World Bank 2002a). A gender gap in education was also apparent: the illiteracy rate in 1999/2000 for 12- to 15-year-olds was twice as high for girls as boys, though this was less marked in urban areas.

As Egypt seeks to upgrade its industrial base and diversify the economy to compete effectively in global markets, it is vitally important that its educational institutions address the skills gap (box 6.10). Moreover, the regional and gender inequalities in education need to be addressed as a priority.

Inequality and poverty alleviation

Poverty is higher in Egypt than the average for Arab countries. Around 20% of the population fell under the \$2 a day poverty line in 1999/2000, compared with 7% in Jordan in 1997 and 15% in Algeria in 1995 (World Bank 2002a). Even so, 2.7% of the population came out of poverty between 1995/96 and 1999/2000, aided by rapid growth of the economy and expansionary fiscal policies. But the economic slowdown in recent years is likely to reverse some of these gains. There are also indications that income disparities have grown wider, with per capita expenditures of the bottom 20% of the population growing less than average between 1995/96 and 1999/2000, perhaps the result of some free market reforms (World Bank 2002a).

Widespread deprivation and social discontent are evident in stagnant living standards for broad segments of the population—both a political and a social problem for the government, especially with the threat of Islamic insurgency. The high rate of employment and underemployment is a critical socioeconomic problem.

Poverty has a strong regional dimension, with southern and rural areas traditionally having much lower living standards than northern and urban areas (figures 6.11, 6.12, and 6.13). The incidence of poverty in rural northern Egypt is lower than the incidence of poverty in urban southern Egypt.

Table 6.11
Educational attainment, by poverty level, 1999/2000 (%)

Educational attainment	Nonpoor	Poor	All
Illiterate	28.4	45.7	31.1
Read and write	15.9	17	16.1
Basic education	22.5	23.4	22.6
Secondary	21.3	11.9	19.8
Diploma	2.9	0.8	2.6
University	8.8	1.1	7.5
Post-university	0.3	0.0	0.3

Source: Economic Commission for Africa, from official sources.

Even as absolute poverty declined overall, it increased in southern Egypt between 1995/96 and 1999/2000, largely a result of the concentration of such high-growth sectors as manufacturing, construction, and trade in northern and urban areas (World Bank 2002a). It also appears that the share of high-return crops, such as rice and tomatoes, in the agricultural sector in southern Egypt declined between 1995 and 1999, with a larger share going to the north. It is thus clear that antipoverty programs should focus on southern Egypt.

The social insurance system and the social assistance programmes, under the Ministry of Insurance and Social Affairs, are intended to alleviate poverty. But the average monthly benefit from the pension and social assistance schemes was a trickle, at just 8% of average household expenditure in the low-expenditure group in 1999/2000 (Korayem 2002). In addition only 20% of the extreme poor in Egypt receive assistance through the government social assistance schemes (ILO 1999). Some measures seem to have had more of an impact. For example, the bread subsidy may have taken some 730,000 people out of poverty (World Bank 2000a). But access to key public services is regressive, with large gaps between the poor and nonpoor in access to water, sewerage, and sanitation.

Box 6.10

Key challenges facing higher education

The government is exploring ways to link universities to the labour market and to the private sector to make students more employable. It is also considering a national apprenticeship program, in view of the high dropout rate in higher education. Other challenges:

Legislative reform. Universities need more autonomy and independence. They should be able to recruit and fire staff and to respond quickly to a rapidly changing international education environment without always obtaining permission from the Ministry of Higher Education.

Resource allocation. There is a need to improve allocative efficiency within the education system. For example, higher education institutions should be allowed to divert funding from low enrolment courses to areas of higher need.

Quality assurance. The huge expansion of access has eroded quality. The government needs to consider whether further expansion of access is necessary before quality assurance programs are fully implemented. Under the system being contemplated, the Supreme Council of Universities will be responsible for assuring quality.

Infrastructure and information technology. The size of the higher education system is a challenge for reform and the use of information technology. The system of short-term funding and the lack of an articulated information technology acquisition and replacement plan has led to an inconsistent and unproductive approach to implementation. Within individual universities there is a shortage of modern information technology for teaching, libraries, and research. Information technology has not been directly integrated into the course curriculum and used to promote enhanced delivery of the course material or to extend delivery beyond the lecture hall.

Source: Economic Commission on Africa, from official sources.

“Poverty has a strong regional dimension, with southern and rural areas having much lower living standards”

Medium-term prospects—clouded by external environment

“GDP growth is likely to recover to around 4%, reflecting a rebound in tourism and transport and a boost to agriculture”

GDP growth is likely to recover to around 4%, reflecting a rebound in tourism and transport and a boost to agriculture with the inauguration of the Toshka project. Manufacturing growth should also pick up, as depreciation of the Egyptian pound spurs export demand. But business confidence is a large uncertainty for this forecast because of confusion over policy directions. Much depends on the future conduct of exchange rate policy and monetary and fiscal policy.

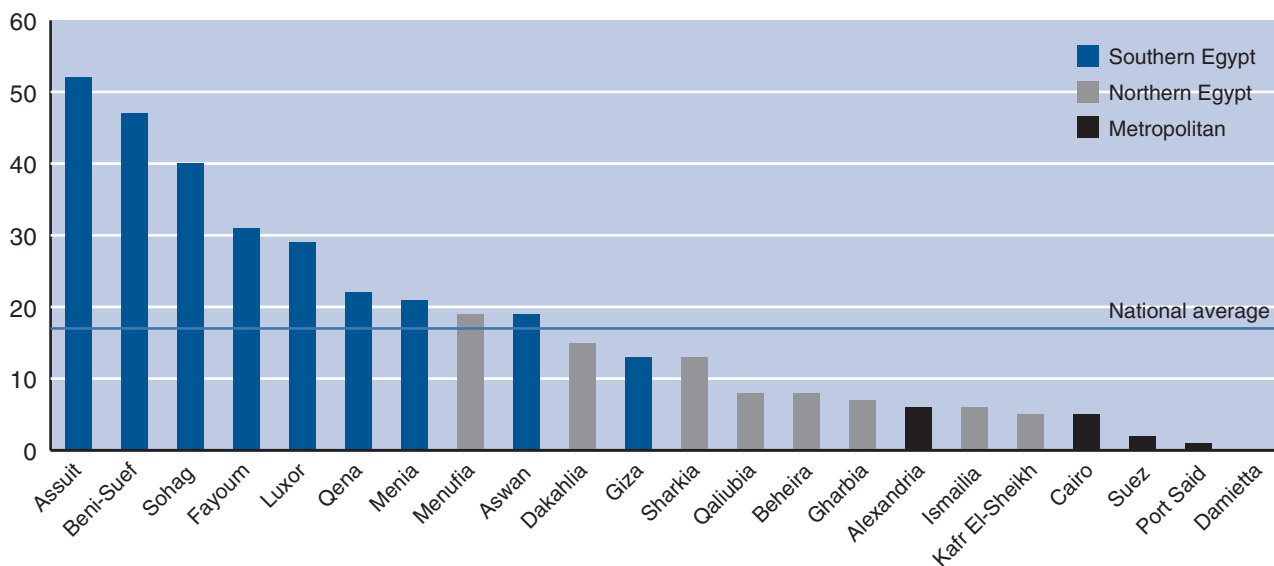
If security in the Middle East deteriorates, this could hurt the Egyptian economy, particularly tourism. Predictions about external imbalances are highly uncertain, but the current account deficit is likely to increase over the next two years to around 1% of GDP.

Sheer inertia and the large domestic public debt may widen the fiscal deficit. Because the real domestic interest rate is higher than the GDP growth rate, interest payments may continue to claim a rising proportion of public expenditure, thus fueling a widening budget deficit. The recently established Public Debt Management Department, if effective, may eventually arrest the rapid growth of domestic debt. In the medium term, however, the budget deficit is likely to stay high, approaching 6% of GDP over the next two years.

Figure 6.11

Poverty higher in southern and rural areas

Poverty incidence by governorate, 1999–2000 (%)



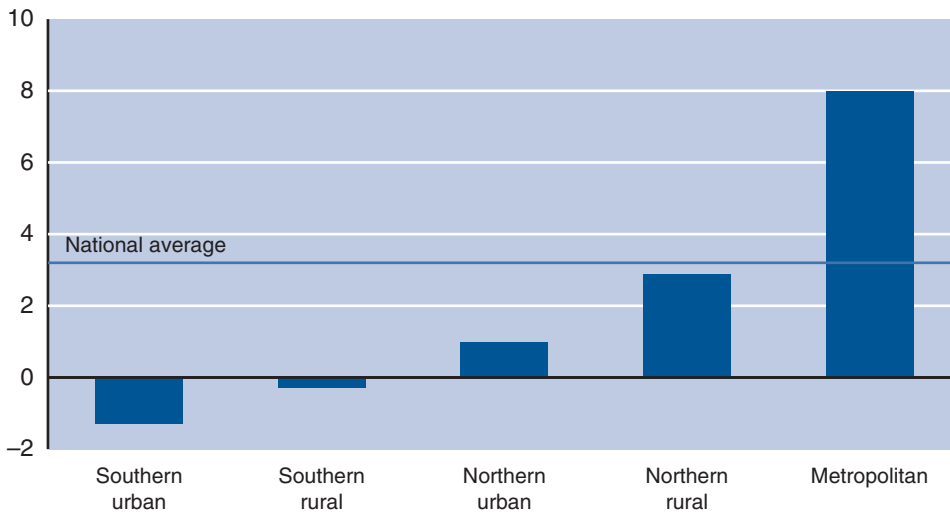
Source: World Bank 2002a.

Egypt faces two broad policy challenges. The first is to bring greater clarity to the conduct of macroeconomic policy in the medium term. The contradictions apparent in recent years, particularly in monetary and exchange rate management, need to be

Figure 6.12

Consumption growing fastest in metropolitan areas, slowest in southern urban areas

Annual real growth in per capita expenditures, 1995–2000 (%)

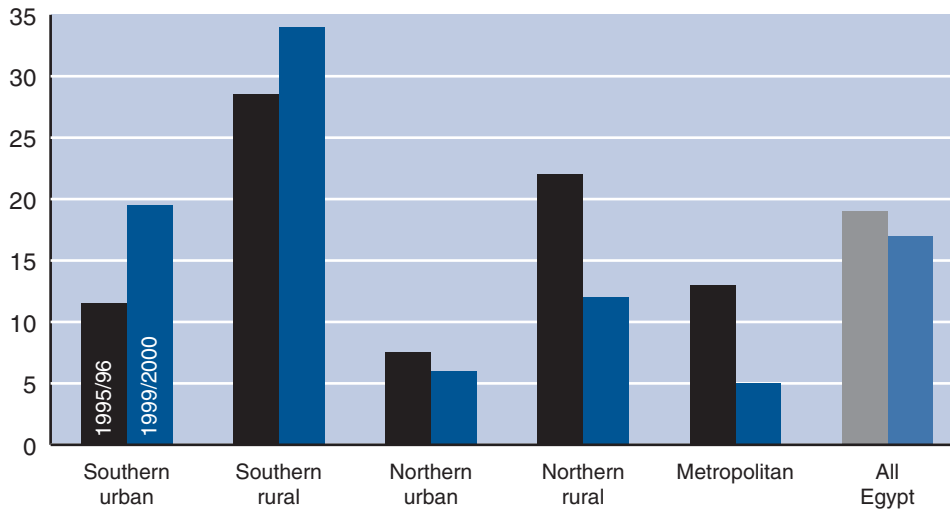


Source: World Bank 2002a.

Figure 6.13

Poverty down most in metropolitan areas, but rising in southern rural and urban areas

Regional poverty incidence, 1995/96 and 1999/2000 (%)



Source: World Bank 2002a.

resolved. The flexible exchange rate may help, but the recent flotation of the pound could bring short-term exchange rate volatility, particularly with Egypt's shallow capital markets and regional political instability.

“ *The second policy challenge is institutional renewal, particularly for the relationship between the state and the private sector* **”**

The second policy challenge is institutional renewal, particularly for the relationship between the state and the private sector. Simplistic calls for rolling back the state are not the solution. Instead, the relationship between the state and the private sector needs to be considered in innovative ways. If the government is to push strategic sectors identified in the recently introduced export promotion strategy and National Strategy for Economic and Social Development, it must avoid creating a raft of protected, uncompetitive firms.

Institutional, legal, and regulatory mechanisms need to be put in place to create an enabling environment for the private sector to operate. This will require political courage from the government. In addition, weaknesses in various sectors will have to be dealt with if developmental dividends are to materialize, by diversifying and upgrading the industrial base, leading to better export performance, higher and more sustained growth, and improved living standards. In particular, a big push is needed in education, to foster skills and business-oriented knowledge.

Notes

1. M1 is local currency outside the banking system and local currency demand deposits.
2. M2 is M1 plus local currency time and savings deposits plus foreign currency deposit, time, and savings accounts.
3. An agreement with a promise by the seller to buy a security back from the purchaser at a specified price at a designated future date.
4. Global depository receipts are globally traded receipt representing ownership of shares in a foreign company.
5. Including the operations of the National Investment Bank and the General Authority for the Supply of Commodities brings the 2002 deficit to 7.2% of GDP.
6. The law did not apply to all companies, such as those in the banking and insurance sectors.

Appendix

Budget proposals, 2001/02 and 2002/03 (US\$ billions)

Item	2001/02	2002/03	% change
Current spending	22.1	23.3	10
Wages	7.2	7.5	9
Other	14.9	15.7	10
Pensions	2.3	2.5	13
Education	4.4	4.6	9
Health care	1.6	1.7	12
Subsidies	1.4	1.4	8
Interest on domestic debt	5.2	5.6	14
Interest on foreign debt	0.5	0.5	4
Capital spending	6.5	7.3	18
Investment	3.4	4.2	26
Other capital spending	3.0	3.2	8
Total spending	28.6	30.6	12
Current revenue	21.2	21.1	3
Tax revenue	15.6	15.6	4
General income tax	6.6	6.7	5
Custom duties	3.1	3.0	0
Sales tax	4.5	4.4	4
Other duties	0.0	1.4	—
Non tax revenue	5.7	5.5	1
Petroleum authority	1.1	1.0	-4
Suez canal authority	0.8	0.9	11
Central Bank of Egypt	1.1	1.0	-4
Economic authorities	0.2	0.1	-14
Capital revenue	2.7	3.0	17
Investments	0.9	1.4	54
Capital transfers	1.7	1.6	-3
Total revenue	23.9	24.1	5
Total balance	-4.7	-6.5	45

Source: EIU 2002.

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