

Egypt

Beyond Stabilization, Toward a Dynamic Market Economy

By a Staff Team led by Howard Handy



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The following symbols have been used throughout this paper:

- ... to indicate that data are not available;
- n.a. to indicate not applicable;
- to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
- between years or months (e.g., 1994–95 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years (e.g., 1994/95) to indicate a crop or fiscal (financial) year.

“Billion” means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term “country,” as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

This occasional paper is a collection of studies focusing on economic developments in Egypt during the 1990s, a period of transformation toward a dynamic market economy. The studies were prepared in conjunction with the Article IV review of the Egyptian economy undertaken in October 1997.

The paper is a collaborative work coordinated by Howard Handy. The principal authors of the sections are Christopher Lane (Section I), Amer Bisat (Section II and Section IV, with Joannes Mongardini), James Daniel (Sections III and VII), Arvind Subramanian and Robert Khan (Sections V and X), Arvind Subramanian (Section VIII), Joannes Mongardini (Section VI), and Peter Allum (Section IX).

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The views expressed here are solely those of the authors and do not necessarily reflect the opinions of IMF Executive Directors or the Government of Egypt.

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List of Abbreviations

ARDL	autoregressive distributed lag
ASEAN	Association of South East Asian Nations
BOT	build-operate-transfer
BCCI	Bank for Credit and Commerce International
CAA	Central Auditing Agency
CBE	Central Bank of Egypt
CMA	Capital Market Authority
ECES	Egypt Centre for Economic Studies
ECM	error correction model
EGPC	Egyptian General Petroleum Corporation
EISA	Egyptian Insurance Supervisory Authority
ERER	equilibrium real exchange rate
ESA	Employee Shareholder Association
EU	European Union
GDP	gross domestic product
GDR	global depository receipt
G-7	Group of Seven, industrial nations
GST	general sales tax
HIPC	highly indebted poor countries
IAS	international accounting standards
M2	broad money
MEMR	multilateral exchange rate model (of the IMF)
MENA	Middle East and North Africa
MULTIMOD	multicurrency macroeconomic model (of the IMF)
NAIRU	nonaccelerating inflation rate of unemployment
NDA	net domestic assets
NEER	nominal effective exchange rate
NGO	nongovernmental organizations
NIB	National Investment Bank
NIR	net international reserves
OECD	Organization for Economic Cooperation and Development
OIN	other items net
PEO	Public Enterprise Office
QR	quantitative restriction
REER	real effective exchange rate
repo	repurchase operations
SCA	Suez Canal Authority
SFD	Social Fund for Development
SUMED	Suez-Mediterranean (oil pipeline)
TFP	total factor productivity
TOT	terms of trade
USAID	U.S. Agency for International Development
VAT	value-added tax

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I Introduction

By the standards of recent experience with economic stabilization, Egypt in the 1990s is a remarkable success story. Determined macroeconomic policy, together with some favorable external developments, has brought much reduced inflation, led to improved public finances, a stable currency, and a strengthened banking system, together with a sound balance of payments position. On the heels of a severe contraction in 1991/92–1992/93, given yearly population growth of over 2 percent, there is now increasing evidence of renewed private sector confidence manifested in rising investment, accelerating growth, and increased incomes.¹

Against the background of impressive progress on stabilization, there has also been a reinvigoration of a program of structural reform. The objective, most evident since 1996, has been to promote private sector development and roll back the once pervasive scope of state controls. Building on reforms implemented earlier in the decade, considerable progress has been made in privatization, deregulating protected sectors, reducing distortions from pricing and subsidy policies, and removing other obstacles to trade and investment. Private investment is responding positively to liberalization and is increasingly the motor for growth.

Nonetheless, the task of delivering sustained growth of output and employment is incomplete. Investment and domestic saving rates remain low compared with successful emerging economies and, indeed, compared with earlier periods of state-led development in Egypt. Despite relatively competitive labor costs, labor-intensive production remains well below potential, while merchandise exports are limited and narrowly focused. In addition, structural impediments, which hold back rapid improvement of living standards, remain to be addressed in a range of sectors.

An Assessment of Stabilization

In 1990/91, at the outset of the adjustment program, the limits of Egypt's state-led development

policy had been reached. A major fiscal imbalance existed, with the central government deficit amounting to over 20 percent of GDP. Inflation was running at 20 percent. Several years of expansionary fiscal policy had led to an accumulation of debt to unmanageable levels with a commensurately heavy burden of debt service. Declining productivity growth was reflected in low growth and stagnant incomes per head. Weak export growth, excess domestic demand, and large debt-servicing costs were major factors in the current account deficit (before official transfers), widening to over 8 percent GDP. The authorities were reliant on exceptional financing, including accumulating arrears on external debt service. Confidence in the Egyptian pound was steadily ebbing; U.S. dollar bank deposits had risen to almost half the share of total domestic liquidity (Table 1 summarizes key indicators during the stabilization period).

Following the 1990/91 regional crisis, a concerted stabilization effort was launched based on four main principles:

- *Rapid reduction of the fiscal deficit.* An upfront fiscal adjustment was achieved in the first year of the stabilization program with a substantive revenue effort and significant expenditure restructuring and reduction. Further steady progress in deficit reduction was made in each of the five successive years to 1996/97. On the revenue side, the main increases were based on adjustment of the exchange rate, which boosted Suez Canal revenues and oil company profits, as well as the introduction of a general sales tax. On the expenditure side, deep cuts were made in the extensive capital investment budget and significant reductions of untargeted subsidies were achieved while other expenditures, including wages, were relatively protected.
- *Currency and financial system reform.* Early in the stabilization program major reforms were implemented in the financial sector to strengthen the banking system and develop effective monetary instruments to control liquidity. In early 1991, the different foreign exchange markets were effectively unified. Concurrently,

¹See Subramanian (1997), for a detailed discussion of the Egyptian stabilization experience.

Table 1. Key Economic Indicators

	Prestabilization 1988/89–1990/91	Stabilization 1991/92–1993/94	Stabilization and Growth 1994/95–1996/97
(Percent change)			
Real GDP growth	2.5	1.2	4.1
Inflation	20.3	13.8	7.6
(In percent of GDP)			
Total debt (end of period)	146.9	125.5	90.6
Current account balance	–3.7	4.6	0.9
Fiscal balance	–15.6	–3.3	–1.2
Gross investment	27.2	17.0	17.2
Net international reserves			
In billions U.S. dollars	6.9	17.0	20.3
In months of imports	7.2	19.2	16.8
Average exchange rate (LE/US\$)	2.74	3.34	3.39

Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

official limits on interest rates were lifted and auctions for the sale of treasury bills were introduced. During 1992 and 1993, direct credit controls to private and public sectors were lifted.

- *Use of the exchange rate as a nominal anchor together with active management of liquidity.* Starting in 1991, the exchange rate was de facto pegged to the U.S. dollar. An active sterilization policy was followed to dampen the expansionary impact of capital inflows using treasury bill sales with the proceeds deposited at the Central Bank of Egypt (CBE). The rapid accumulation of foreign exchange reserves early in the stabilization period amplified the authorities' commitment to the exchange rate peg and in turn led to reduced inflation expectations.
- *Improved poverty alleviation policies.* To counteract the short-run effects of lower consumer subsidies during the adjustment program, Egypt created the Social Fund for Development (SFD) in 1991 to protect and improve the status of key vulnerable groups. The Social Fund for Development helped alleviate poverty through labor-intensive public works, support for micro enterprises, basic community services, retraining, and improved monitoring of living standards.

Impact of Key Stabilization Policies

The initially adverse effects of stabilization on growth were clearly felt in the first two years when the fiscal contraction was most evident, particularly in investment spending. Since 1993/94, growth has

continued to pick up gradually and rising investment, primarily from the private sector, has helped to accelerate growth. The pace of investment and productivity during the stabilization period, however, has remained a concern, particularly in view of demographic pressures that entail rapid labor force growth. A central conclusion that emerges in Section II is that a further increase in the level and efficiency of investment will be required to deliver the official medium-term growth objective of over 7 percent; the estimated additional investment need, on the order of 6–8 percent of GDP, would depend upon a parallel increase in Egypt's saving rate.

As regards Egypt's fiscal position, the speedy reduction of central government borrowing, particularly from foreign sources, quickly reversed the debt stock buildup. The primary balance switched into surplus in the first year of stabilization and since then has averaged over 5 percent of GDP. Correspondingly, the debt stock dropped from 147 percent of GDP at the outset of stabilization to 90 percent in 1996/97. In conjunction with debt reduction and rescheduling, servicing payments have been substantially reduced, thereby reinforcing the initial fiscal adjustment.² Notwithstanding the efforts already made, further efforts may be required to boost revenues over the medium term (Section III). A number of structural weaknesses in the tax base, notably the reliance on oil production, Suez Canal proceeds, and

²The size of the primary surplus was sufficient to reduce the debt stock in the absence of debt reduction.

customs tariffs will likely produce declining revenues. Moreover, Egypt's sales tax and income tax systems are administratively complex and relatively inefficient at generating revenue by regional standards. To this extent, a key fiscal objective is to press ahead with reform of the tax system to enhance efficiency and underpin efforts to further increase domestic saving. A number of important tax reforms, particularly with respect to sales tax, stamp duties, and corporate income tax, are in preparation.

Tighter control of liquidity growth quickly affected inflation; it was halved in the first three years of stabilization. Moreover, the liberalization of interest rates against the backdrop of falling inflation generated significantly positive real rates of interest on domestic deposits and, in the context of a stable nominal exchange rate, helped reverse dollarization. Also, Egyptian banks were able to increase interest margins and strengthen their capital and reserve adequacy. Section IV underscores the appropriateness of money-based stabilization policy and notes the difficulties of applying inflation targeting in the Egyptian environment.

Renewed confidence in Egypt's stabilization effort together with broad exchange rate stability contributed to sizable capital inflows during the period 1991/92–1993/94 and 1996/97. These inflows, which peaked at 6 percent of GDP in 1991/92, posed a real challenge to the stabilization program. At the same time, to sterilize the impact of inflows on liquidity growth, the authorities undertook an active program of treasury bill sales. As a result of intervention to counter upward pressure on the pound, the CBE was able to build foreign exchange coverage from 7 months of imports in mid-1991 to 19 months by mid-1994. Since 1994, coverage has dipped somewhat yet remains well above that in most emerging markets. Section V notes that Egypt's vulnerability to rapid outflows (e.g., from contagion effects) is greatly lessened by the strong fundamentals in the fiscal and current accounts.

The substantive reserve cushion has clearly reduced concerns over the durability of the exchange rate peg. Nonetheless, some concerns have arisen from domestic inflation running at rates somewhat above U.S. dollar price inflation. Thus, the real effective exchange rate (using relative consumer prices) has appreciated by 30 percent from its historic low point in mid-1991 to the end of 1996 and unit labor cost indices indicate varying degrees of real appreciation in the range of 25–60 percent over this period. Section VI suggests that the actual exchange rate has closely tracked the fundamental, or equilibrium, exchange rate throughout the post-1991 period, in contrast to the previous period when large and persistent deviations were observed. A central conclusion is that the reduction of the net

present value of external debt through debt reduction during the stabilization period warrants a significant real appreciation of the equilibrium exchange rate.

The broader welfare impact of the stabilization program has been a recurrent theme in determining the pace and sequencing of reform. As outlined in Section VII, during the stabilization period to 1995/96 the incidence of poverty appeared to be stable, in part as a result of the targeted social safety net administered by the newly established Social Fund for Development. The reduction of subsidies during stabilization, notably on food, appears to have been achieved by focusing remaining expenditures on products consumed predominantly by target low-income groups, for example, particular types of bread. Moreover, the impact of public sector employment shrinkage has been cushioned by relatively generous severance payments. Nonetheless, it is clear that without accelerated growth and structural reform, the prospects for further improvements in health and education indicators, which lag behind regional averages, are limited.

The Challenge of Structural Reform

A sustained reinvigoration of Egypt's structural reform effort is essential to strengthen investment and growth, in the context of integrated global capital and goods markets, as well as rapid regional economic liberalization: meeting the structural reform challenge will ensure that Egypt maintains its leading role in the Middle East. Competing in the global market requires further development of policies toward trade liberalization, privatization, public sector reform, structural fiscal reform, financial sector deepening, and measures to improve private sector incentives. In the regional context, Egypt, along with Israel, Jordan, Morocco, and Tunisia, is moving forward with nondiscriminatory trade liberalization, while negotiating association agreements with the European Union (EU). Moreover, regional economic integration will increasingly require harmonized trade and investment policies. As noted below, good progress has been made since early 1996 in several reform areas; however, more needs to be done to achieve Egypt's ambitious growth targets.

Continuing efforts are needed to reduce the reach of the public sector in Egypt. The privatization program has been a notable achievement, particularly since being reactivated in 1996: more than one-third of the state portfolio has been divested, and divestiture proceeds have ranked high in comparison with other transforming economies. Privatization has focused on the divestiture of majority stakes of nonfinancial public enterprises and reducing state in-

volvement in banking and insurance. As analyzed in Section VIII, for the strong pace of privatization to be sustained, a broader range of state assets will need to be added to the sales portfolio. In this respect, the authorities have moved toward a bolder privatization program that includes sale of a minority stake in the state telecommunications authority in 1998. Also, continuation of the privatization program, together with the creation of contestable markets in privatized sectors on an adequate regulatory framework, or both, will help raise productivity growth and domestic savings.

Egypt has traditionally had a strong “banking habit” with high levels of financial intermediation, notwithstanding extensive state controls in the sector. The progress of financial sector reform, as mentioned in the discussion of stabilization, initially focused on developing indirect instruments of liquidity management and enhancing the attractiveness of domestic currency banking assets through interest and credit liberalization. The second phase of reform in the financial sector aimed to increase competitiveness of financial markets by divesting state ownership of joint-venture banks and increasing private involvement in commercial banking, securities, and insurance. In large part, these reforms have underpinned an expansion of financial asset intermediation, particularly in the equity markets, and have contributed to a strengthening of banking profitabil-

ity and bank soundness. These themes are reviewed in Section IX.

Liberalization of the external trade regime is a cornerstone to enhancing the competitiveness of Egyptian production. A review of progress made indicates substantial reductions of average tariffs since 1990/91, together with elimination of export duties and almost complete elimination of quantitative import restrictions. While this progress was marked by a substantial expansion of goods and services exports in the 1990s, reversing the trend of the late 1970s and 1980s, a number of significant concerns remain. One particular concern is that merchandise non-oil exports remain weak; volumes have barely shifted since the early 1990s and Egypt’s world market share has fallen. As discussed in Section X, a number of aspects of the trade regime continue to inhibit trade, notably restrictive quality controls, some tariff peaks and higher-than-average duty rates in a regional perspective, and cumbersome customs procedures, as well as problems in the foreign investment regime. Looking ahead, the prospects for future liberalization as a result of the Uruguay Round are relatively limited, as bindings were in general higher than applied rates. Bilateral agreements, particularly the Egypt-EU Association Agreement, which is close to finalization, and a continuation of unilateral actions in areas of concern will need to provide the impetus of reform.

II A Historical Examination of Growth, Investment, and Saving

Egypt's growth performance has been uneven. After growing rapidly during the 1970s and first half of the 1980s, output decelerated and generally fell short of population growth rates. Economic growth has recently picked up and is estimated at about 5 percent in 1996/97. Sustaining this trend over the medium term with the aim of improving living standards and creating job opportunities for a rapidly growing labor force has emerged as the central objective of the Egyptian Government's recently intensified reform effort.

The key to meeting the growth challenge is to raise investment levels, improve investment efficiency, and ensure that investment is financed in a sustainable manner. To this end, this section examines the nexus of growth, investment, and savings in Egypt over the past three decades.

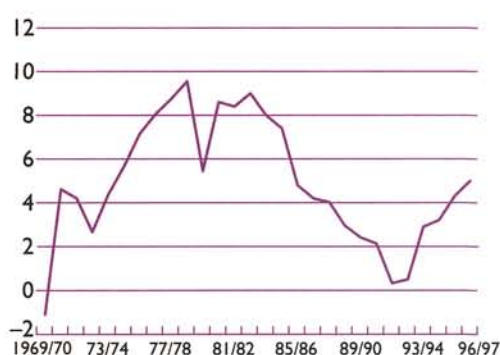
The Growth Record

From the early 1950s, the government adopted an import substitution, state-led growth development policy. Initially, the strategy produced modest growth rates averaging 3.5 percent a year during 1952–73.³ The twin oil shocks (1973 and 1979) created a regional boom that had direct effects on Egypt (through higher oil revenues), as well as indirect effects (through workers' remittances, foreign aid, and tourism), resulting in abundant financing for investment. Growth was also fueled by the "*infitah*" (open-door) reform policies starting in 1975, in which the private sector was accorded wider scope for operations, and by a series of laws encouraging investment, inter alia, through incentives.⁴ As a result of these factors, real GDP grew sharply, averaging 8.4 percent a year between 1974/75 and 1984/85 (see Figure 1).

³Details of methods used in constructing the database can be found in Bisat, El-Erian, and El-Gamal (forthcoming). Hansen and Nashashibi (1975) offer an exhaustive analysis of Egypt's early economic performance.

⁴For a discussion of policies under the *infitah*, see Ikram (1980), and Handoussa (1990).

Figure 1. Real GDP Growth
(Change in percent)

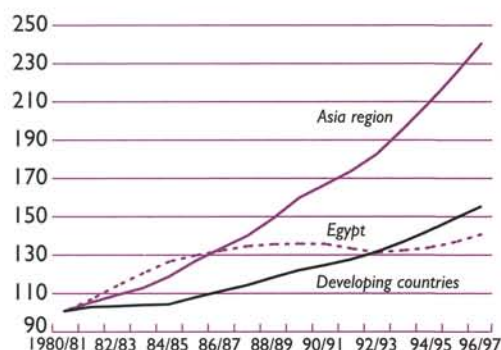


Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

By the mid-1980s, growth was stagnating and macroeconomic imbalances were widening. Inflation was in excess of 20 percent a year, the current account deficit was more than 10 percent of GDP, and external arrears were accumulating. These imbalances reflected substantial fiscal deficits and expansionary monetary policy. Market inefficiencies were fostered by administrative restrictions: administered prices, interest rate ceilings, multiple (and overvalued) official exchange rates, administrative allocations of foreign exchange, and restrictions on the private and foreign sectors. The financial sector suffered from segmentation, limits on competition, mandatory and subsidized credit allocations, and negative real rates of interest. The private sector was "crowded out" by a development strategy that relied on large-scale public ownership combined with import substitution and a limited focus on export promotion. Also, investment in human capital was low as evidenced by relatively weak social indicators.

The collapse of world oil prices in the mid-1980s had negative spillover effects on Egypt, including

Figure 2. Real Per Capita GDP Growth
(1980/81 = 100)



Sources: Data provided by the Egyptian authorities; IMF, World Economic Outlook database.

lower remittances and aid. At the same time, the economic slowdown was exacerbated by the above distortions. As a consequence, real activity decelerated and real GDP growth averaged 3 percent during 1985/86–1992/93, with only a 1 percent annual rate between 1989/90 and 1992/93.

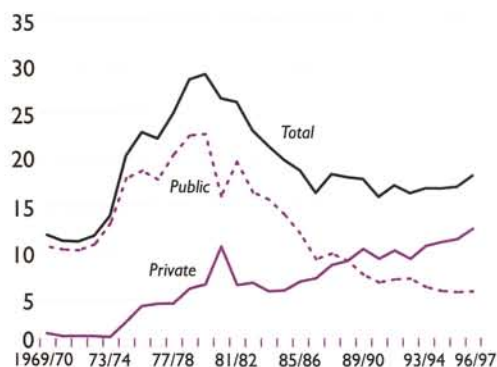
The impact of Egypt's faltering growth was accentuated by high population growth (see Figure 2). While real per capita GDP initially grew faster than the average for all developing countries, its level was surpassed by the Asian countries in 1986/87, and eventually by the average for all developing countries. Put differently, while Egypt's real per capita GDP was a third higher in the early 1990s than a decade earlier, the real per capita GDP of the Asian region had grown (during the same period) by more than 80 percent.

Egypt entered a new phase of economic growth in the early 1990s. Following the successful implementation of a macroeconomic adjustment program, the government embarked on an ambitious program of structural reforms aiming at revitalizing the economy, integrating it globally, and ensuring that the private sector would play the key role. Favorable results are in evidence with real GDP growth estimated to have accelerated to 5 percent during 1996/97.

The Investment Record

Capital accumulation is a key contributor to growth. In tandem with GDP growth, investment rates in Egypt rose sharply until the early 1980s (see

Figure 3. Investment Rates
(In percent of GDP)



Source: Data provided by the Egyptian authorities.

Figure 3).⁵ The latter reflected the passage of a number of pro-investment laws, as well as an intensification of petroleum exploration activities. Moreover, investment opportunities during that period benefited from abundant financing linked to the regional boom. During the high investment period (1974/75–1981/82), the investment rate more than doubled from 12 percent of GDP (during the earlier five-year period) to just under 25 percent of GDP.

Collapsing international oil prices in the mid-1980s sharply curtailed investment financing. At the same time, remaining market distortions eventually became too important for investors to ignore. Indeed, while real GDP growth rates decelerated starting in the mid-1980s, the decline in investment expenditures began a few years earlier. The contraction continued through the early 1990s with the rate averaging only 18 percent of GDP during 1982/83–1992/93 consistent with a real contraction of –0.8 percent a year. Moreover, the decline was progressive with the investment rate reaching less than 15 percent of GDP by the early 1990s. As with growth, the consolidation of macroeconomic stability and the implementation of a comprehensive structural reform program during the past few years have had a positive effect on investment expenditures, which appear to have regained momentum.

Egypt's investment record can be better understood by examining its various components.

⁵The investment variable refers to fixed capital formation (i.e., excluding changes in stocks).

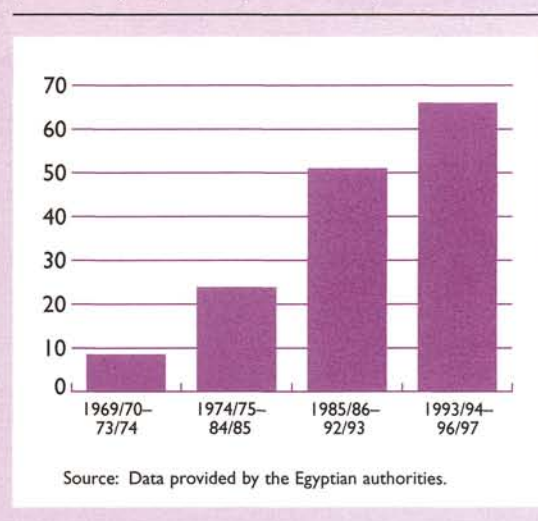
- *The boom/bust behavior of Egyptian investment was largely a public sector phenomenon.* At its peak in the late 1970s, public investment reached 22 percent of GDP, of which half was accounted for by public enterprise investment. About 80 percent of public investment was spent on “economic sectors” that competed with the private sector. These expenditures contributed to unsustainable fiscal deficits, rising external indebtedness, and mounting public enterprise losses. A financing crisis emerged in the late 1980s that led to a sharp contraction in public investment; the latter has recently stood at less than 10 percent of GDP.⁶
- *The prevalence of economic distortions and crowding out by the public sector translated into low private investment rates.* Even during the high-investment and high-growth period, private investment averaged only 5 percent of GDP. Moreover, the private sector did not compensate for the contraction in public investment starting in the late 1980s. Although private investment has gathered strength more recently (Figure 4), its level (12 percent of GDP in 1996/97) remains well below that prevailing in the fast-growing Asian economies (24 percent of GDP in 1996).
- *Egypt’s investment rate has been significantly lower than in other developing country regions.* In particular, after initially outperforming comparator regions (including the Asian region), Egypt’s investment rate lagged since the late 1980s. Moreover, despite the momentum of the past few years, the rate remains below the developing country average.

The dynamics of investment behavior have been studied by Bisat, El-Erian, El-Gamal, and Mongelli (1996). They estimate the speed at which investment adjusts to changes in the optimal capital stock using panel data for Middle Eastern and North African countries over the period 1980–94. The underlying model is the flexible accelerator model, according to which an increase in output spurs future streams of investment as firms gradually adjust toward an optimal capital-output ratio. For Egypt (grouped with Algeria, Israel, Jordan, and Tunisia) investment was

⁶About half of public investment is spent on infrastructure; around 15 percent on education and health and the remainder on housing and general public services. There is a break in public sector investment data after 1993 owing to the reclassification of public enterprise investment from public to private sector accounts. In the post-1993 years, official public sector investment includes only the general government and investment by public authorities. Those averaged about 5 percent a year. Estimates of public enterprise investment amount to about 5 percent of GDP.

Figure 4. Private Investment

(Period average, in percent of total investment)



found to adjust relatively quickly to gaps between desired and actual capital stock. Moreover, the conclusions suggest a high capital output ratio that is, capital intensive investment, and a relatively low depreciation rate.

Bisat, El-Erian, and El-Gamal (forthcoming) estimate the same model for Egypt over two partially overlapping sample periods: 1970/71–1985/86 and 1981/82–1996/97. They find that the speed of investment adjustment was much smaller in the earlier period (about 44 percent) than in the later period (119 percent). The conclusion is consistent with the observation that during the early period, investment was mostly of public origin, and hence less likely to respond to economic factors.

Factor Productivity

The previous analysis illustrates the association between investment and growth rates in Egypt. The framework of growth accounting distinguishes between (1) growth that is accounted for by increases in the quantities of factor inputs, typically capital and labor, and (2) growth that is accounted for by increases in the efficiency in the use of inputs or total factor productivity growth. Often referred to as technology, total factor productivity (TFP) encompasses all methods used to produce goods and services with factors of production. Improvements in technology increase the productivity of all factors of production, and thus also raise total output. Growth based on increases in factor inputs is sometimes called extensive growth, whereas growth based on TFP is called intensive growth.

For the period as a whole, the average Egyptian TFP growth rate was estimated at 2.4 percent a year. Evidence suggests a structural break in the behavior of TFP: for the early subperiod (1970/71–1985/86), the average TFP growth rate was estimated at 5 percent while for the later subperiod (1981/82–1996/97), it was estimated at 1.8 percent. In terms of contribution to growth, the econometric estimates indicate that, for the period as a whole, TFP growth accounted for nearly two-thirds of output growth. For the early period, it accounted for all of the growth, while for the later period, it accounted for approximately half the growth.

High TFP growth in the early period may reflect a number of economic and methodological factors. First, improvements in TFP may lag actual investment spending by a number of years: high TFP growth rates in the 1970s may be associated with large investment projects undertaken earlier (e.g., the Aswan Dam).

Second, during the early period, significant resources went into social sectors such as education, health, and nutrition, reflected in TFP rising owing to an improved quality of human capital. From their low base in the 1960s, social indicators such as illiteracy, school enrollment, and access to health services improved. As documented by a number of empirical studies, investment in human capital can have high returns in terms of improving productivity and growth.

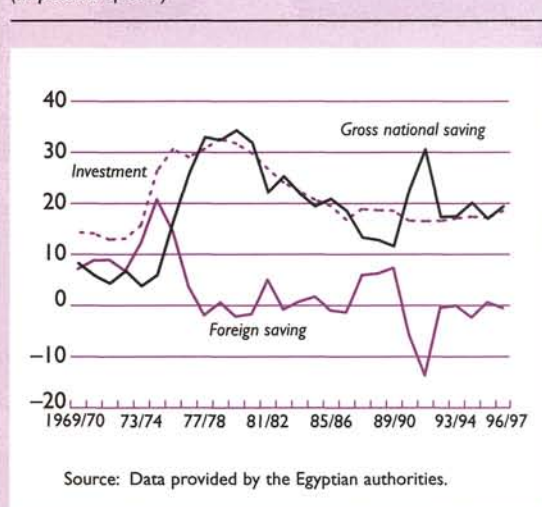
Finally, there may also be a methodological explanation for the high TFP growth rates estimated for the early period. In particular, the effect of some capital projects (e.g., power plants) may have been underestimated owing to the use of overvalued exchange rates. At the same time, services rendered by such projects may have also been underpriced (e.g., electricity tariffs) due to subsidies; this would result in artificially higher value added from investments using such services. Consequently, the growth accounting estimates may underestimate the contribution of capital accumulation to growth during the early period and overestimate that of factor productivity.

Investment Financing: National and Foreign Savings

This section considers the composition and sustainability of patterns of investment financing, noting that investment should be financed in a stable and sustainable manner to minimize vulnerability to exogenous financing shocks.

By definition, investment can be financed through national or foreign saving (see Figure 5). A judgment as to the sustainability of investment financing sources requires an examination of its two compo-

Figure 5. Saving-Investment Balance
(In percent of GDP)



nents. First, sustained current account deficits—the counterpart of foreign savings—require offsetting capital inflows. In Egypt, those tended to be of a largely debt-creating nature, which eventually led to the debt crisis and to the need for exceptional debt relief. Moreover, Egypt has historically relied on foreign aid to cover its external needs. Throughout the period under investigation, foreign direct investment tended to be quite small.

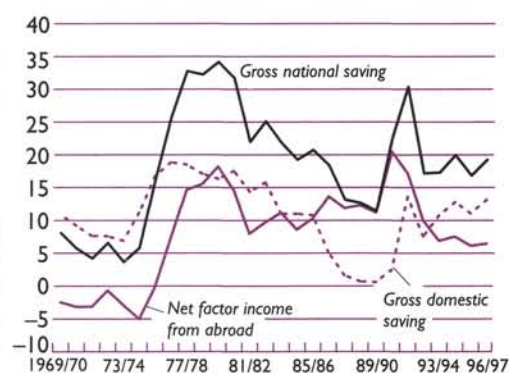
Until 1991/92, Egypt's investment rate continuously exceeded national saving rates. Consequently, Egypt relied heavily on foreign savings (i.e., current account deficits) to finance its investment needs: for the period 1969/70–1990/91, foreign savings accounted for more than a third of investment financing. By the early 1990s, the situation had changed significantly with the external balances registering either surpluses or very small deficits.

Nonetheless, national saving closely traced investment rates: it rose sharply during the high-investment and high-growth period (1974/75–1984/85) averaging 21 percent of GDP—a moderately high level by international standards—and fell equally sharply during the low investment and low growth period of 1985/86–1991/92, averaging only 13 percent of GDP. Since then, as reliance on foreign saving declined and as investment rates rose, national saving became a more important source of investment financing.

The two main components of national saving are net factor income from abroad⁷ and domestic saving

⁷Net factor income from abroad is defined as the sum of workers' remittances and net interest income.

Figure 6. Components of National Saving
(In percent of GDP)

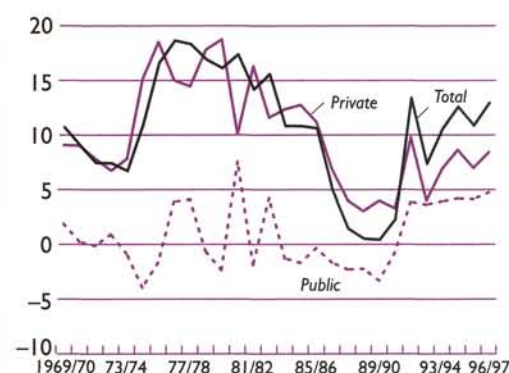


Source: Data provided by the Egyptian authorities.

(see Figure 6). Until the mid-1970s, net factor income was negative; thereafter, it became a large contributor to investment financing (averaging 7.5 percent of GDP during 1975/76–1996/97, or the equivalent of a third of total investment during that period). The main factor behind the dramatic growth in net factor income is the surge in workers' remittances following the twin oil shocks and the simultaneous labor movement from Egypt to the Gulf countries and Iraq. More recently, net factor income has been rising as debt-service payments have been reduced and as interest income on foreign reserves rose.

The private sector is the driving force behind domestic saving, although fiscal consolidation has made the public sector a net contributor in the 1990s (see Figure 7).⁸ Until fiscal adjustment took hold, public saving averaged minus 0.3 percent of GDP; indeed, it was negative in 15 of the 22 years spanning 1969/1970–1990/91. Public saving rates have since averaged 4 percent of GDP. Private sector domestic saving has strongly traced investment and growth behavior. Private saving rose sharply during the high-investment and high-growth period essentially fueled by high economic growth rates, relative price stability, and the announcement of the *infatih* program with its promise of a larger private sector role. It fell sharply during the low-investment and

Figure 7. Gross Domestic Saving
(In percent of GDP)



Source: Data provided by the Egyptian authorities.

low-growth period. The lackluster saving behavior during 1981/82–1990/91 reflected a number of factors including limited outlets for mobilizing and allocating higher private savings due to financial market imperfections, negative real interest rates, and incentives, biased by overvalued exchange rates in favor of current consumption. In addition, macroeconomic instability created an uncertain environment that discouraged saving. With the reversal of the above factors in the past few years, private domestic saving has staged a comeback and has ranged between 5 percent and 6 percent of GDP.

In summary, the high-investment period in Egypt tended to be financed by unsustainable forms of financing: deficit financing (the counterpart of low public saving), and debt-generating foreign saving. Moreover, a large share of such financing originated from unstable sources over which the domestic policymakers had little control (foreign aid and workers' remittances). Indeed, as the Egyptian economy faced strong financing constraints in the early 1980s, investment itself contracted and growth eventually suffered. Recently, the economy has started to rely on more stable forms of financing for example, foreign direct investment and private saving.

Egypt's Medium-Term Growth Challenge

This last section assesses the requirements and likelihood of the Egyptian authorities' achieving

⁸Public domestic saving is defined as fiscal revenues minus current expenditures minus the government's net interest from abroad.

Table 2. Illustrative Scenarios of Real GDP Growth and Investment Rates

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Unchanged growth scenario Capital elasticity of growth = 0.3; total factor productivity growth = 1.8 ¹							
Real GDP growth	5.0	5.0	5.1	5.2	5.4	5.5	5.6
Investment/GDP	18.1	20.0	21.1	22.3	23.6	25.0	26.5
Accelerated growth scenario Capital elasticity of growth = 0.4; total factor productivity growth = 2.25 ¹							
Real GDP growth	5.0	5.9	6.1	6.3	6.5	6.7	6.9
Investment/GDP	18.1	20.5	21.4	22.4	23.5	24.8	26.1

Source: IMF staff estimates.

¹GDP growth is based on the growth-accounting framework described in pages 7–8 assuming population growth of about 2 percent, a capital depreciation rate of 5 percent, and starting from the actual 1996/97 capital-output ratio of about 1.9.

their objective of raising annual real GDP growth rate to about 7 percent over the medium term.

Two scenarios for GDP growth and investment rates are presented in Table 2 for the combinations of differing growth rates of TFP, and the capital elasticity of growth. At current (i.e., “late period”) TFP growth rates (1.8 percent a year) and under a conservative assumption on capital return (output elasticity of capital of 0.3), Egypt would have to raise its investment rate by over 8 percentage points of GDP over the next six years to achieve a growth rate of around 5½ percent a year. On the other hand, with an improvement in the growth rate of TFP to 2.25 percent combined with a slightly higher capital elasticity of growth (0.4), Egypt could reach a GDP growth rate of approximately 7 percent with the same investment rate path.

The challenge of raising investment rates by up to 8 percentage points is clearly not easy. Moreover, the economy would have to find financing for such investment. The Egyptian Government is committed to a policy of fiscal prudence, which would eliminate recourse to deficit financing of investment. At the same time, reliance on net foreign income from abroad (mainly workers’ remittances) would be limited by projected lower demand for Egyptian labor from regional markets. The economy could tap foreign savings; however, in order to avoid past mistakes, it would be optimal for such foreign savings to be mainly associated with foreign direct investment rather than debt-creating flows. In addition, macroeconomic stability implies a limit on how large current account deficits can be in a certain country. Therefore, if the Egyptian economy were to successfully generate higher investment rates, it appears that

private domestic savings would have to rise simultaneously.

Nonetheless, from indications over the past few years, Egypt appears to have entered a high-growth, high-investment, and high saving trajectory. This is not the first time in its modern history that the economy was on such a path. The current trajectory should differ from earlier ones in at least four respects:

- Investment should primarily originate from the private sector with the public sector focusing on infrastructure and social investment.
- Private sector investment has to become more responsive to growth in output so that Egypt can enter into a virtuous cycle of high growth and high investment.
- At the same time, the efficiency of private investment has to improve from the low levels recorded more recently.
- Investment has to rely on stable and sustainable forms of financing.

What is necessary for these four conditions to materialize? Both theory and empirical evidence illustrate that four factors contribute to higher and more efficient investment as well as to higher levels of domestic saving: maintaining stable macroeconomic conditions; accelerating structural reforms; investing more effectively in the social sectors; and strengthening the institutional and information base. The recent stabilization and reform effort implemented in Egypt over the past few years clearly illustrates that the economy is on the right track for achieving these conditions and meeting the growth

challenge. In this regard, after four years of economic stability, both the level and efficiency of investment are on an upward trend. This clearly reflects the expanded role of the private sector, including build-operate-transfer projects in the en-

ergy sector, cement and fertilizer projects, and other power-intensive sectors. The private sector has also been invited to invest in telecommunications and ports and is expected to play a central role in the New Valley development project.

III Current Fiscal Situation and Medium-Term Outlook

Fiscal consolidation has been a cornerstone of Egypt's successful stabilization.⁹ Over the recent period, new revenue sources were tapped while expenditures were curtailed, particularly subsidies and investment. This section assesses Egypt's current fiscal position: the evolution of the fiscal deficit and public saving compares favorably with other Middle Eastern and North African countries; on the revenue side, regional comparisons indicate low yields for taxes on personal incomes and consumption. A brief discussion of expenditure patterns is also presented and a baseline medium-term fiscal projection is outlined. The central conclusion is that the gradual structural decline of revenues is likely to continue, offset by reductions in projected debt service. To generate increased public saving and to develop a tax system suited to a dynamic private sector economy, further tax reform is likely to be required.

Current Situation and Regional Comparisons

The fiscal deficit for 1996/97 was about 0.9 percent of GDP (see Table 3). The primary balance (before interest payments) and the current balance (before capital expenditure and net lending) were similarly healthy, both at about 5 percent of GDP. The deficit is entirely domestically financed, mainly through sales of treasury debt and borrowing from the National Investment Bank (NIB).

Revenue accounts for about 26 percent of GDP. Profit taxes and transfers from the Egyptian General Petroleum Corporation (EGPC) and the Suez Canal Authority (SCA), at 5.2 percent of GDP, make up 20 percent of total revenue. Tax revenue (excluding the EGPC and SCA) makes up 55 percent of total revenue. The major tax sources are the general sales tax (GST) (4.5 percent of GDP), customs duties (3.2 percent of GDP), and the corporate income tax (2.9 percent of GDP). Expenditure accounts for about 27 percent of GDP, mainly current expenditure

(21.2 percent of GDP). Of current expenditure, 58 percent, evenly split, goes on interest payments and the wage bill.

Regional Comparisons

Compared with similar countries in the region, Egypt's fiscal position in 1996/97 is sound. The overall and primary balances, except for Algeria, are the strongest, and the current balance (a measure of public saving) is the third highest. The reason why Egypt's fiscal balance is comparatively strong is because it spends relatively less than the regional average rather than raising more revenue. Only the Islamic Republic of Iran and Turkey spend less, but more than half of the countries raise more revenue.

Although Egypt raises the average amount of revenue for the region, the revenue sources are different. Most important, it raises relatively little tax revenue. The average tax revenue for the sample is 16.3 percent of GDP and Egypt only raises 13.9 percent of GDP. Of the countries with less hydrocarbon revenue, only Turkey and Pakistan raise (marginally) less tax revenue. Countries such as Israel, Morocco, and Tunisia all raise at least 20 percent of GDP from this source. The principal reason for low tax revenue is low yield from taxes on personal incomes and consumption.

Egypt's taxation of goods and services, through the GST and excises, raises only 4.5 percent of GDP compared with an average of 6.5 percent for the region, while Israel and Morocco both raise over 10 percent of GDP from this source. The GST was introduced in 1991, amalgamating many ad hoc excise duties and production taxes, and led to a revenue increase of about 1.5 percent of GDP. Nonetheless, Egypt still receives less revenue per percentage point of the standard rate than all the other major regional countries except Pakistan. Also Egypt's standard rate of 10 percent is the lowest, which, combined with a narrow base, mainly explains its low yield (see Table 4).

The base for GST is narrowed by exclusion of wholesale and retail trade and exemptions for services and is significantly narrower than most GST

⁹Appendix I presents a summary of the tax system.

Table 3. Cross-Country Comparisons of Central Government Operations*(In percent of GDP)*

	Algeria 1996	Israel 1995	Jordan 1996	Morocco 1996	Pakistan 1995/96	Tunisia 1996	Turkey 1995	Syrian Arab Republic 1996	Islamic Republic of Iran 1995/96	Average Excl. Egypt	Egypt 1996/97	Average Incl. Egypt
Revenue	33.0	40.8	29.2	23.0	17.2	24.8	17.5	26.4	22.6	26.0	25.7	26.0
Tax revenue	11.6	35.4	16.9	20.9	13.5	19.7	13.8	11.1	4.0	16.3	13.9	16.1
Goods and services	5.2	13.7	7.6	10.1	5.8	9.8	5.5	0.9	0.2	6.5	4.5	6.3
International trade	3.4	0.2	4.5	3.7	4.1	4.0	2.5	2.8	0.7	2.9	3.2	2.9
Income	2.7	15.9	3.4	6.0	3.5	4.4	5.9	3.7	3.1	5.4	3.6	5.2
Corporate	1.4	3.1	2.4	2.2	...	2.1	1.7	2.9	1.8	2.2	2.9	2.3
Personal	1.3	12.9	1.0	3.8	...	2.4	4.2	0.8	1.3	3.4	0.7	3.1
Other taxes	0.4	5.5	1.4	1.0	0.2	1.4	0.0	3.8	0.0	1.5	2.6	1.6
Nontax revenue	0.6	5.4	12.3	2.1	3.7	3.3	3.7	5.5	2.6	4.4	6.5	4.6
Hydrocarbon revenue ¹	20.8	0.0	0.0	0.0	0.0	1.9	0.0	9.7	16.0	5.4	5.2	5.4
Expenditure	28.7	47.8	33.8	26.7	23.4	34.5	21.6	29.0	26.3	30.2	26.6	29.8
Current	21.9	43.3	27.9	21.5	19.9	27.5	20.1	15.8	19.2	24.1	21.3	23.8
Primary	18.6	36.8	23.3	16.0	14.0	23.1	12.7	15.5	...	20.0	15.1	19.5
Wages and salaries	8.9	7.0	6.6	10.8	...	10.4	6.4	4.4	...	7.8	6.1	7.6
Other goods and services	2.2	8.5	1.7	3.9	...	2.0	1.4	2.5	...	3.2	3.1	3.2
Transfers and subsidies	7.4	21.3	6.6	1.3	3.5	10.7	5.0	1.5	...	7.2	1.9	6.6
Defense	...	...	8.1	...	...	...	...	6.1	2.8	5.7	2.9	5.0
Other	0.0	0.0	0.4	0.0	...	0.0	0.0	1.0	...	...	1.1	...
Interest	3.3	6.5	4.6	5.5	5.9	4.4	7.3	0.3	...	4.7	6.2	4.9
Capital and net lending	6.8	4.5	5.9	5.2	3.5	7.1	1.1	13.2	7.1	6.0	5.3	6.0
Balance	4.3	-7.0	-4.6	-3.8	-6.1	-9.7	-4.1	-2.6	-3.8	-4.2	-0.9	-3.8
Primary	7.6	-0.5	-0.1	1.7	-0.2	-5.3	3.2	-2.3	...	0.5	5.2	1.0
Current	11.1	-2.5	1.3	1.4	-2.6	-2.6	-3.0	10.5	3.4	1.9	4.4	2.1

Sources: IMF staff; and IMF, *Government Finance Statistics*.¹Includes Suez Canal for Egypt.

Table 4. Regional Comparison of VAT and GST Rates¹

(In percent)

Country	Principal Rate	Other Rates	Coverage ²	Scope ³	Revenue ⁴	Productivity ⁵
Algeria	14	7, 21	G + S	W	6.1	0.44
Israel	17	6.5	G + S	R	12.0	0.70
Jordan	10	20, 5	G ⁶	M	3.5	0.35
Morocco	20	7, 10, 14	G + S	R	6.1	0.31
Pakistan	12.5	10	G ⁶	M	2.2	0.18
Tunisia	17	6, 29	G + S	R	5.3	0.31
Turkey	16	1, 8, 25	G + S	R	4.6	0.29
Average	15.2				5.7	0.37
Egypt	10	5, 25	G ⁶	M	3.1	0.31

Source: IMF.

¹Data refer to 1997 or 1996/97.²G = goods; S = services.³M = import and manufacturing stage; W = wholesale stage; R = retail and wholesale stage.⁴For Egypt and Jordan, excludes excise revenue classified under the GST.⁵Revenue yield for each percentage point of the standard rate.⁶Selected services are taxed.

and VAT bases in the region, except for Jordan and Pakistan. The higher GST rate of 25 percent only brings in about 5 percent of GST revenue yet adds considerable administrative complexity, as well as making the GST less neutral. While other countries in the region (except Israel and Morocco) have a higher rate, most countries of the Organization for Economic Cooperation and Development (OECD) do not, reflecting the VAT's role for revenue generation compared with the income tax's role for redistribution. Egypt also levies many excises in the form of special GST rates for which no input credit can be claimed.¹⁰

The comparatively low yield for personal income tax is particularly striking: Egypt raises only 0.7 percent of GDP compared with 3.4 percent for the region, while tax rates are comparable with the regional average (see Table 5). As an illustrative example, if Egypt were to raise the average amount of personal income tax for the region, the budget would gain 2.7 percent of GDP in revenue, or alternatively, all stamp taxes, fees, and local government levies could be eliminated without affecting revenue. The erosion of corporate income tax yield through extensive tax incentives is discussed in Box 1.

¹⁰Also, no credit is allowed for the taxed inputs in the production of taxed services creating tax cascading. Credit for GST paid earlier in the production process is also not allowed for capital goods leading to discrimination against domestic capital goods industries, cascading, and a tax on exports.

Egypt spends relatively less than other countries in the region.¹¹ On average, other countries' spending is 3.6 percent of GDP or higher, mainly on current expenditure. More noticeable still is that Egypt's current primary expenditure is almost 5 percent of GDP lower than the average for the region; only Turkey and Pakistan spend less. Comparing the components of primary current expenditure is difficult, but the main explanation seems to be relatively low outlays on transfers and subsidies, (reflecting Egypt's recent reforms) and to a lesser extent, on civil service.

Medium-Term Outlook

Over the last few years, expenditure has been declining faster than revenue. An IMF staff assessment of prospective fiscal developments assuming broadly unchanged policies from 1997/98 fiscal year, detailed below, indicates that over the next five years, revenue will continue to fall; but the rate of expenditure reduction will slow, leaving the overall balance broadly stable (see Table 6).

Revenue

Total revenue is likely to decrease 3 percentage points from 25.7 percent of GDP in 1996/97 to

¹¹Excluding foreign-financed defense expenditure.

Table 5. Regional Maximum Corporate and Personal Income Tax Rates¹

(In percent)

	Corporate	Personal
Algeria	38	50
Iran, Islamic Republic of	54	54
Israel	36	50
Jordan	25	30
Morocco	35	44
Pakistan	35	20
Tunisia	35	35
Turkey	35	55
Syrian Arab Republic	55	15
Average	39	39
Egypt	42	34 ²

Sources: International tax summaries; and IMF.

¹Higher rates may apply to selected sectors, for example, banks.

²A rate of 50 percent applies to individual business income.

22.7 percent of GDP by year 2001/02, mainly due to lower EGPC and SCA remittances and stamp taxes.

Income taxes from sources other than the EGPC, SCA, and the CBE¹² are likely to remain broadly stable in relation to GDP. Both the corporate and personal components have been constantly around 3.0 percent of GDP since 1992/93, reflecting their naturally buoyant bases. Improvements to corporate income tax legislation are under consideration, however, including: (1) the elimination of interest expense to the extent of exempt interest income; (2) the elimination of the system of "additions and discounts," a presumptive withholding tax, to be replaced by within-year estimated advance payments; and (3) granting tax deduction for loan-loss provisions.¹³

Taxes on goods and services (GST revenues) around year 2000 are likely to increase marginally in the next couple of years then fall back. The extension of the GST to the wholesale and retail sectors in 1998 should secure about 0.5 percent of GDP of additional revenue with the increase spread over the next couple of years. For 1997/98, the gain will be largely offset by granting input credit to new capital goods, although benefits should show up in 1998/99.

¹²Central Bank of Egypt income taxes and transfers are inherently difficult to project and are assumed to be constant in relation to GDP.

¹³Also, in October 1997, the Egyptian authorities adopted a simplified system of calculating depreciation of capital assets.

While total GST revenue as a share of GDP will be boosted by GST extension to the trading sector, it will, however, be eroded by the comparatively weak growth in landed import value (on which slightly less than half of the GST was collected in 1995/96). By year 2001/02, GST revenue is likely to be the same as in 1996/97.

Budgetary contributions from the EGPC will continue to decline, although at a slightly lower rate. Domestic sales revenue is likely to be buoyant. Even without price increases, domestic sales have been growing faster than nominal GDP. A continued reduction of implicit subsidies for petroleum products, as the government intends, will help boost these receipts. In contrast, export proceeds will continue to decline. With only minor increases in volume and fairly stable prices, export proceeds will continue to stagnate in U.S. dollar terms and decline in relation to GDP. In total, EGPC's contribution to the budget could fall from 3.2 percent of GDP in 1996/97 to 2.5 percent of GDP in 2001/02.

The prospects for Suez Canal Authority remittances and revenues also look weak. Remittances

Box 1. Corporate Tax Incentives

Egypt's extensive system of tax holidays and other incentives means many companies do not pay income tax. The system creates a number of compelling problems. Tax incentives are inequitable and inefficient, creating effective tax rates that vary both between and within sectors. They also involve a large revenue loss and arbitrary and ambiguous distinctions about what qualifies and what does not. Moreover, they are not that important in investment decisions. Economic stability, infrastructure, natural resources, trained labor, clean government, and a stable, simple, and certain tax system are all more important. Many foreign countries subject the untaxed income to their own income tax, thus transferring money from the Egyptian treasury to the foreign treasury.

Important benefits could be obtained from streamlining the design of the incentives. Tax holidays, the major incentive granted in Egypt, are particularly inefficient and costly. Loss-making firms do not benefit, and highly profitable investments are attracted that are likely to have been invested anyway. Tax holidays also tend to favor some specific sectors, benefit old firms and extensions more than new firms, and are difficult to abolish. Automatic tax credits and accelerated depreciation have considerable advantages compared with tax holidays. They benefit only new investment activity, encourage longer-term investment, are easier to control, monitor, and administer, and, most important, they benefit each tax-paying firm equally regardless of the extent of their profits.

Table 6. Summary of Government Operations¹*(In percent of GDP)*

	1991/92	1992/93	1993/94	1994/95	Preliminary Actual		Program		1999/00	2000/01	2001/02
					1995/96	1996/97	1997/98	1998/99			
Total revenue	29.6	29.7	30.4	27.8	27.0	25.7	24.6	24.1	23.4	23.0	22.7
Central government	25.8	26.5	27.2	25.2	24.5	23.0	22.0	21.6	20.9	20.5	20.3
Tax revenue	17.5	17.4	18.1	17.1	17.0	16.1	15.8	15.7	15.3	15.2	15.2
From incomes	7.2	7.1	6.9	6.1	6.1	5.8	5.6	5.5	5.4	5.1	5.0
From domestic goods and services	4.5	4.6	4.7	4.7	4.6	4.5	4.5	4.7	4.5	4.6	4.6
From international trade	3.3	3.2	3.5	3.5	3.5	3.2	3.1	3.0	3.1	3.2	3.2
Other	2.4	2.6	3.0	2.9	2.7	2.6	2.5	2.5	2.4	2.3	2.3
Nontax return	8.3	9.1	9.1	8.1	7.5	6.9	6.3	5.9	5.6	5.3	5.1
Other	3.8	3.2	3.2	2.6	2.6	2.7	2.6	2.6	2.5	2.5	2.4
Total expenditure	33.8	33.2	32.5	29.1	28.4	26.6	25.6	24.9	24.4	23.9	23.4
Current expenditure	26.0	26.3	26.6	23.8	23.1	21.3	20.3	19.6	19.1	18.6	18.1
Wages and salaries	5.8	6.2	6.4	6.2	6.2	6.1	6.1	6.1	6.0	6.0	6.0
Pension Fund payments	2.0	2.2	2.3	2.1	1.9	1.7	1.6	1.6	1.5	1.4	1.3
Materials and supplies	1.3	1.5	1.7	1.5	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Defense ²	3.5	3.5	3.4	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.3
Interest	6.8	8.5	9.5	7.4	7.1	6.2	5.5	5.1	5.0	4.7	4.5
Subsidies	5.5	2.8	1.9	1.9	1.9	1.6	1.6	1.5	1.5	1.4	1.4
Other	1.2	1.4	1.5	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Capital expenditure	7.8	7.0	5.9	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Investment	8.5	7.1	6.2	5.6	5.6	5.6	5.5	5.5	5.5	5.5	5.5
Of which											
Self-financing	2.3	1.5	1.4	1.1	1.1	1.2	1.2	1.2	1.2	1.1	1.1
Net capital and investment funds	-0.7	-0.1	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2
Overall balance	-4.2	-3.5	-2.1	-1.3	-1.3	-0.9	-0.9	-0.7	-1.0	-0.9	-0.6
Primary balance	2.6	5.0	7.4	6.1	5.8	5.2	4.6	4.4	4.0	3.8	3.8
Current balance	3.6	3.4	3.7	4.0	4.0	4.4	4.4	4.6	4.3	4.4	4.7
Revenue from EGPC and SCA	8.3	8.4	7.5	6.5	5.9	5.2	4.8	4.6	4.4	4.1	4.0

Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

¹Includes the central government, local governments, General Authority for Supply of Commodities, and investment expenditure (and its financing) of the public authorities; not of public sector companies.²Excludes foreign-financed defense expenditure. Total defense expenditure estimated at \$3.5 billion.

have been broadly constant in U.S. dollar terms and have fallen as a share of GDP from 3.8 percent in 1991/92 to 2.0 percent in 1996/97.¹⁴ The stagnant remittances (in U.S. dollar terms) reflect stagnant SCA revenues which in turn indicate a number of factors: (1) greater competition from the SUMED pipeline,¹⁵ the land route, and the Cape route; (2) larger vessel size (many vessels cannot pass through the Canal or pay less per ton); and (3) foreign direct investment (e.g., the number of automobile carriers has fallen). To combat these factors, the SCA instituted a scheme to give reductions to vessels on voyages where the canal route is relatively less advantageous, kept other transit dues unchanged since 1994, and has been working with Jordan to increase traffic between the Suez Canal and Aqaba. There is also an ongoing project to increase the Suez Canal's draft. Nevertheless, these factors are only likely to maintain the current revenue levels. The SCA remittances will thus likely continue to fall, from 2.0 percent of GDP in 1996/97 to 1.5 percent of GDP by 2001/02.

Despite cutting import tariffs in recent years, Egypt still relies relatively heavily on import duties. The maximum rate of 55 percent (with higher rates applying to automobiles, tobacco, and alcoholic beverages) is high, and, combined with the minimum 4 percent import surcharge and extensive quality controls, the system hinders the development of international trade (see Section X for a comprehensive discussion of trade liberalization issues). Taxes on international trade (customs duties) will continue their recent decline over the next two to three years, as further general tariff cuts are scheduled for July 1998; beyond this there may be further tariff cuts due to the impact of an EU partnership agreement. Import growth is expected to pick up by 2001/02; import duties should contribute roughly the same share of GDP as in 1996/97.

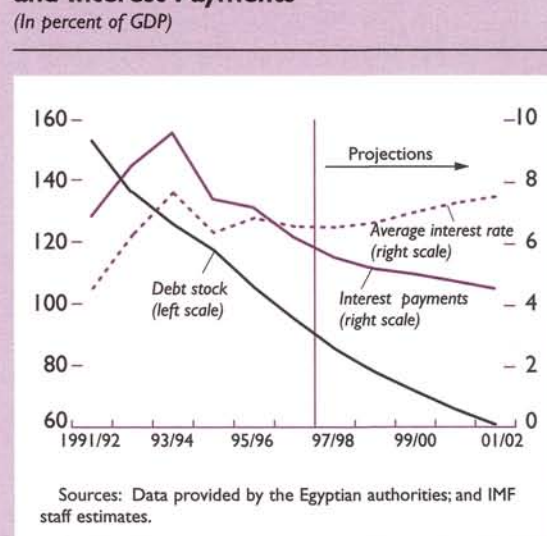
Other taxes will continue to decline in importance, reflecting their inelastic base and a more diversified economy. The main "other taxes" are stamp taxes, which are levied on a myriad of transactions.¹⁶ Half

¹⁴Suez Canal Authority revenues fell from \$1.959 billion in 1995 to \$1.881 billion in 1996. The number of oil tankers was down by 8 percent, the total number of ships down by 3 percent, and tonnage down by 2 percent. The average transit dues per ship fell from \$129,735 in 1995 to \$127,690 in 1996. The most important revenue sources were (1) container ships; (2) bulk carriers; and (3) oil tankers, respectively. Transit dues relate to tonnage, type of vessel, transit time, and point of origin.

¹⁵The 200-mile SUMED pipeline has a capacity of about 2.5 million barrels a day and is a joint venture between Egypt, Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar. An extension that would traverse the Red Sea from Ain Sukhna to the closest point on the Saudi coast near Sharm al Sheikh is under consideration.

¹⁶Royalties and development duties from the EGPC and SCA are also in this category, but they too are likely to be less than

Figure 8. Actual and Projected Debt Stock and Interest Payments
(In percent of GDP)



of these taxes are specific and have not been regularly raised in line with inflation. Assuming continued erosion at recent rates, revenue from this source is likely to fall to 2.3 percent of GDP in 2001/02 (down from 2.6 percent in 1996/97 and 3.0 percent in 1993/94). Other nontax revenue is also expected to continue to decline. The most important categories, fees, interest income, and self-financed investment of the public authorities are unlikely to keep pace with nominal GDP growth. Profit transfers from public enterprises (excluding EGPC, SCA, and the CBE) are likely to decline as the most profitable enterprises are privatized.

Expenditure

Total expenditure is likely to decrease by 3.2 percentage points in the next five years; from 26.6 percent of GDP in 1996/97 to 23.4 percent of GDP by 2001/02. A key factor will be the continued reduction in interest payments (see Figure 8). Having declined from a peak of 9.5 percent of GDP in 1993/94 to 6.2 percent of GDP in 1996/97, interest payments could fall a further 1.7 percentage points to reach 4.5 percent of GDP by 2001/02. The total debt stock will also fall over the period 1996/97–2001/02 from 95 percent of GDP (\$70 billion) to 73 percent of

fully buoyant. Stamp taxes are levied on goods and services, including contracts, payments from government agencies, bank loans, documents, receipts, checks, certificates, bank accounts, salaries, and advertisements at rates between 0.8 percent and 20 percent.

GDP (\$73 billion). This fall in both interest payments and declining debt stock mainly reflects the growing economy—both the nominal debt stock and interest payments rise—and the average interest rate moderates only slightly.

Primary current expenditure will also continue to fall, but much slower than in the past. The wage bill outlays on materials and supplies and other current expenditure are all expected to be constant in terms of GDP. Some further savings are likely to come from pension fund payments, defense outlays, and subsidies (mainly reflecting the stagnant international price of wheat). Also, spending on health, education, and the SFD is projected to be maintained at the current level of 4.5 percent of GDP (see Section VII). Investment expenditure, despite the New Valley project, projected to cost about a billion pounds (or about 0.4 percent of GDP) annually for the next five years beginning from 1997/98, will be kept constant at about 5.5 percent of GDP.

Fiscal Balances

The overall balance is not likely to change significantly over the next four to five years. The current fiscal balance will move broadly in line with the overall balance, but because primary expenditure is only marginally reduced while revenue falls strongly, the primary balance will decline considerably, falling by 1.4 percentage points of GDP by 2001/02.

In the context of the overall macroeconomic framework, the risks to the fiscal projections are limited. On the revenue side, the main risks would be from delays in extending the general sales tax. More substantial risks lie on the expenditure side. Interest payments are projected to decline strongly, which rely on a continued decline in domestic interest rates, strong real GDP growth, and considerable privatiza-

tion proceeds. Subsidy and defense spending are also vulnerable to increases in world wheat prices and developments in the security situation. The projections also assume only limited budgetary financing of the New Valley project.

Are the baseline projected fiscal balances sufficient to achieve Egypt's medium-term objective of sustained, high growth? At about 1 percent of GDP, and with the financing from noncentral bank sources, the overall deficit is consistent with the inflation and current account objectives. If financing is predominantly from domestic sources, the low levels of borrowing are unlikely to increase domestic real interest rates and thus crowd out domestic borrowing and investment. Similarly, foreign financing, because of the stability of the exchange rate and the sustainable level of debt stock, is unlikely to lead to debt-servicing problems.

Both the debt stock and interest payments are likely to decline over the medium term in relation to GDP (see Figure 8). The combination of a primary surplus and a real growth rate above the real interest rate implies a steadily declining stock of debt in relation to GDP. As the primary balance is expected to remain well in surplus, there is no pressing need to bolster it, other than to accelerate debt repayment. There is a good reason to increase the level of government saving, approximated by the current fiscal balance. As Section II explains, achieving a sustainable growth rate of about 7 percent by 2001/02 requires a significant increase in investment and domestic saving. Specifically, domestic saving needs to rise by about 4 percentage points of GDP by 2001/02. The current fiscal balance, however, is projected to be constant over this period. This increase in total saving may well occur but is far from certain. By improving the public sector's contribution, the government could significantly help achieve Egypt's ambitious medium-term economic goals.

IV Inflation

Although Egypt's inflation is approaching industrial country rates, its past record has been uneven. Until the early 1970s, inflation was low, averaging below 5 percent (see Figure 9). The situation changed in the aftermath of the first oil shock in 1973: through the mid-1980s, inflation averaged 13 percent a year. Subsequently, the pace of inflation accelerated to average more than 20 percent annually during the 1986–92 period. In the early 1990s, the Egyptian authorities undertook a bold stabilization program. This has brought inflation down to single-digit levels in 1993/94 and to just over 6 percent in 1996/97.

Main Variables Influencing Egypt's Inflation Record

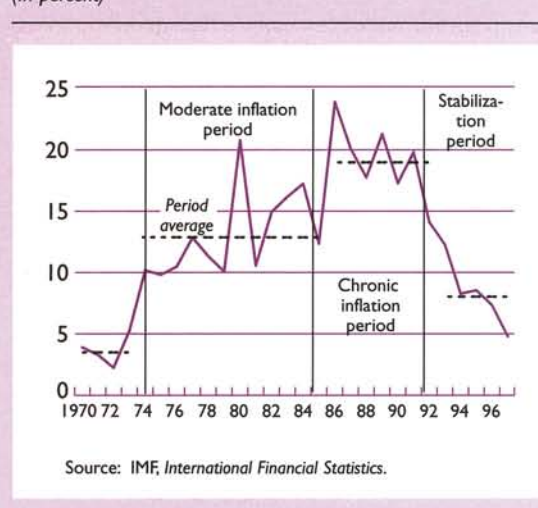
By definition, the price level is related to the volume of real activity, the stock of money, and the velocity of circulation of the monetary aggregate.¹⁷ Table 7 summarizes the growth rates for these variables distinguishing between four periods: the early period of 1970/71–1972/73; the high growth/moderate inflation period (1973/74–1985/86); the low growth/chronic inflation period (1986/87–1991/92); and the stabilization period (1992/93–1996/97).

Monetary growth. In the pre-oil shock period, money growth tended to be low. During the period following the first oil shock, moderately high inflation was accommodated by a rapid monetary expansion averaging nearly 30 percent every year. In the subsequent low-growth and chronic inflation period, growth of broad money decelerated and averaged only 20 percent a year. The stabilization period (i.e., since the early 1990s) was associated with further (and sharp) deceleration in monetary growth.

Real output. In the early 1970s, Egypt entered a high-growth period with real GDP averaging more than 8 percent annually. In the subsequent high in-

¹⁷As expressed in the Fisher identity $MV = PQ$, where M = money supply, V = velocity of money, P = price level, and Q = volume of transactions (real GDP).

Figure 9. Rates of Consumer Price Inflation
(In percent)



flation period, real GDP growth decelerated and averaged only 3 percent a year. As the country underwent stabilization, growth rates initially contracted but have more recently recovered: in 1996/97, real GDP is estimated to have grown by 5 percent.

Velocity. Velocity is inversely related to money demand. The rapid GDP growth of the moderate inflation period was associated with sharp increases in money demand implying a contraction of velocity contracted at an annual rate of nearly 5 percent a year. The subsequent period saw a clear reversal as the level of velocity rose at the annual average rate of 3 percent a year. The reversal was related to liberalization of foreign exchange deposits and of the exchange rate on such deposits. This, in the context of high inflation, created an incentive for a move away from domestic currency holding. In turn, dollarization rose from 29 percent of broad money in 1985/86 to 47 percent in 1991/92.

As stabilization took hold, velocity initially rose. As confidence in the domestic currency improved

Table 7. Summary Growth Rates of Variables Affecting Inflation*(In percent a year)*

	Early Period 1970/71–1972/73	High-Growth/Moderate Inflation Period 1973/74–1985/86	Low- Growth/Chronic Inflation Period 1986/87–1991/92	Stabilization Period 1992/93–1996/97
Inflation	3.0	12.3	20.2	8.6
Money supply	8.8	28.5	20.8	12.7
Real GDP	4.3	8.1	3.2	3.2
Velocity	–0.9	–4.8	3.0	–0.5

Source: IMF staff estimates.

(as evidenced by a decline in the dollarization rate from 47 percent in 1991/92 to 24 percent in 1996/97), velocity started to decline again. In fact, during the past year (1996/97), velocity is estimated to have declined by a sharp 3 percent.

To quantify the extent to which each of the three variables, that is, money, real activity, and velocity “contributed” to inflation during the various periods, the Fisher quantity of money identity is decomposed as

$$\pi = M^* + V^* - Q^* + \epsilon, \quad (1)$$

where π is inflation, M^* is the proportionate change in broad money, V^* is the proportionate change in velocity, Q^* is the proportionate change in real output, and ϵ is a residual item.¹⁸ Thus, inflation is di-

¹⁸The Fisher identity is set in terms of levels, that is, $MV = PQ$. At levels of inflation up to about 30 percent, the relationship $\pi = M^* + V^* - Q^*$ holds approximately. When inflation is larger, a residual error item (ϵ) accounting for cross products becomes significant.

rectly correlated with increases in the monetary aggregate, given an unchanged level of real activity and velocity. Dividing both sides by π permits a determination of each variables’ percentage contributions to total inflation (Table 8).

In the post-oil shock period, Egyptian inflation was largely a monetary phenomenon: broad money growth contributed to more than twice total inflation. The monetary expansion, however, was partly accommodated by strong real GDP growth and an increase in money demand resulting in slower velocity of broad money.

Surprisingly, during the chronic inflation period that is, when inflation accelerated to more than 20 percent a year, monetary growth had less of an impact on inflation than during the high-growth and moderate inflation period. However, the deceleration of GDP meant a more limited role for real activity in offsetting the inflationary impact of monetary growth. Moreover, the turnaround in the direction of money demand (largely associated with the dollar-

Table 8. Contributors to Inflation*(In percent of total inflation)*

	Early Period 1970/71–1972/73	High-Growth/Moderate Inflation Period 1973/74–1985/86	Low- Growth/Chronic Inflation Period 1986/87–1991/92	Stabilization Period 1992/93–1996/97
Inflation	100	100	100	100
Broad money	306	231	106	149
Velocity	–41	–43	13	–14
Real output	–146	–67	–17	–42
Residual	–19	–21	–2	7

Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

ization period) signified that the demand for additional money in the system had faltered, thus adding significantly to inflationary pressures.

During the stabilization period, the sharp deceleration in money growth was closely correlated with reduced inflation. Real GDP growth also had an important offset on inflation, and the reversal in the direction of velocity played an even stronger role in offsetting inflation. This process culminated in 1996/97 when, despite a strong growth in money supply (15 percent), inflation fell to only 6 percent a year mainly due to the continuing sharp decline in velocity.

Monetary Developments

The previous discussion demonstrated that monetary growth has historically been closely correlated with inflation in Egypt. In this section, we describe the factors affecting money supply by decomposing the growth of the counterparts to broad money into changes in the net foreign assets of the banking system and to changes in the banking system's domestic credit (see Table 9). The latter is further decomposed into credit to the public sector (government and state-owned enterprises) and the private sector. The residual item comprises "other items net," which includes valuation gains and losses.

Inflation during the high-growth and moderate inflation period was largely a monetary phenomenon. In turn, money growth was explained by a sharp growth in credit to the public sector—itsself a reflection of rising budget deficits. During that period, net foreign assets of the banking sector were declining,

entailing a contractionary impact on the growth of broad money.

In the subsequent chronic inflation period (1986/87–1991/92), domestic credit creation remained the key to overall money growth (albeit to a lesser extent than in the previous period). Here again, credit growth to the public sector was the key to overall monetary growth. Moreover, as dollarization took place, the change in net foreign assets added to upward pressure on monetary growth.

The stabilization period witnessed an important structural transformation in factors explaining monetary growth. Most important, as the budget deficit declined, credit to the public sector became a relatively insignificant counterpart to total monetary growth. Instead, the sharp increase in credit to the private sector (which may have had important implications for real growth) emerged as the most important contributor. Surges in capital inflows and the subsequent rise in the level of official international reserves also placed sustained upward pressure on monetary aggregates.

Estimation of Money Demand

The previous sections focused on the causes of Egypt's inflation record through the decomposition of the Fisherian quantity of money identity. In this section, the impact of inflation on the behavior of money demand is analyzed by estimating a standard money demand equation. The nominal demand for money is estimated to be given by the following equation, using annual data from 1970/71–1996/97, with the expected sign of the coefficient shown in parentheses:

Table 9. Factors Affecting Money Supply

(In percent of beginning period money stock)

	Early Period	High-Growth/ Moderate Inflation Period	Low-Growth/ Chronic Inflation Period	Stabilization Period
Total money	100	100	100	100
Net foreign assets	-85	-9	17	44
Domestic credit	217	126	108	88
To public sector (net)	187	89	78	15
To private sector	24	33	25	73
To other banks	6	4	5	1
Other items (net)	-32	-17	-24	-33

Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

$$\log(M_t) = \beta_0 + \beta_1 \log(CPI_t) + \beta_2 \log(GDP_t) + \beta_3 Inf_t + \beta_4 Int_t + \beta_5 Int_t^* + u_t \quad (2)$$

(+)
(+)
(-)
(-)
(+/-)

M represents the nominal monetary aggregate, CPI is the consumer price index, GDP is the real gross domestic product index, Inf is the inflation rate, Int is an average interest rate measured in local currency, and Int^* is the equivalent offshore interest rate.¹⁹ To determine the stability of the money demand in relation to different monetary aggregates, estimation results will be presented below for currency in circulation (CUR), domestic liquidity ($M2X$) excluding foreign currency deposits, and total liquidity ($M2$).²⁰

Before proceeding with estimation of money demand, tests for the stationarity of the variables were undertaken to determine the appropriate estimation procedure. The results show that all the level variables can be regarded as nonstationary, but their first derivative with respect to time can only be considered stationary in the case of domestic liquidity ($M2X$), inflation (Inf), and the off shore interest rate (Int^*). For this reason, the results below are estimated using the augmented autoregressive distributed lag procedure (ARDL) described in Pesaran and Shin (1995) and Pesaran and Pesaran (1996), which is independent of the stationarity classification needed under alternative econometric procedures. The ARDL procedure has been shown to give consistent and asymptotically efficient estimates, thus allowing for inference on the long-run coefficients.

Results

To employ the ARDL procedure, the hypothesis testing the long-run joint significance of the independent variables in a standard error correction model need not be rejected.²¹ The statistics for the

joint test for each of the equations are considered and the results show that the hypothesis cannot be rejected at the 1 percent confidence interval (see Table 10).

Almost all independent variables have similar coefficients in all three regressions. The elasticity on real GDP is above 1 in all regressions, a feature that is common to money demand estimates in most economies and is interpreted as an indicator of financial deepening. The coefficient on the CPI is significant but the value is below 1 (unity is the predicted value in the absence of *money illusion*). Part of the reason for the low coefficient may be due to some measurement problems in Egypt's consumer price index. It may also be an indication of a slow response in money holdings to changes in prices.

As expected, the coefficient on inflation is negative and statistically significant. This is consistent with the notion that the private sector under high inflation will reduce its holdings of the currency to minimize the impact of the inflation tax. The interest elasticity is estimated positive in all three regressions, but it is statistically significant only in the regression for total liquidity ($M2$).

The coefficient on the offshore interest rate is positive and statistically significant, except for the regression for domestic liquidity ($M2X$), where the exclusion of foreign currency deposits weakens the statistical relationship. The positive coefficient on the offshore interest rate (Int^*) is puzzling, since interest arbitrage would suggest that higher offshore interest rates net of currency depreciation may lead to capital outflow. In this case, capital account restrictions in Egypt up to 1991 may have attenuated this link and strengthened the effects on domestic foreign currency deposits. The dummy variable encompassing the peak of the dollarization experience is only significant for the regression on total liquidity as expected, as this is the only monetary variable involving dollar-denominated deposits.

Standard diagnostic tests were also run for all three regressions and are presented in the bottom part of Table 10, with the confidence interval shown in parentheses below the statistics. The only significant problems relate to the regression for domestic liquidity ($M2X$), where the hypotheses of serial correlation and heteroskedasticity cannot be rejected at the 10 percent confidence interval. In all other cases, the diagnostic tests can be rejected at the 1 percent confidence interval.

Overall, the results in Table 10 suggest that the nominal demand for money in Egypt is closely associated with the price level, real output, and inflation and that dollarization in the form of foreign currency deposits played a significant role in monetary developments during the second half of the 1980s. Moreover, of the three measures of money analyzed here,

¹⁹The model estimates the demand for nominal money balances with the price level (CPI) included as a dependent variable, rather than estimating demand for real money balances with the assumption of no money illusion.

²⁰The available data for estimating Egypt's money demand is limited and the results presented should therefore be interpreted with caution. Monetary aggregates are annual averages of monthly observations from the IMF's *International Financial Statistics (IFS)* database. The time series for the consumer price index and real GDP are obtained from official sources. In the absence of a complete treasury bill or interbank market interest rate series for the whole sample period, an average of the three-month lending and borrowing rate was used to proxy for the domestic interest rate (Int). The offshore interest rate (Int^*) was calculated as the three-month Eurodollar offer rate in London minus the actual depreciation of the Egyptian pound vis-à-vis the U.S. dollar during the same period.

²¹This test is based on a nonstandard F -distribution given in Pesaran and Pesaran (1996).

Table 10. ARDL Long-Run Estimates of Money Demand, 1973/74–1996/97

	Monetary Aggregates		
	Currency (<i>CUR</i>)	Domestic liquidity (<i>M2X</i>)	Total liquidity (<i>M2</i>)
Joint significance test	1.0616	2.9595	3.0573
		<i>Estimation results¹</i>	
Constant		–1.0553 (–3.7197)	–0.99063 (–19.6103)
Real GDP (<i>GDP</i>)	1.0674 (8.6650)	1.8680 (6.1225)	1.6932 (26.5963)
Consumer price index (<i>CPI</i>)	0.55573 (6.3237)	0.62516 (6.9213)	0.65314 (37.1576)
Inflation (<i>Inf</i>)	–0.22165 (–4.0477)	–0.15793 (–3.1394)	–0.13123 (–25.102)
Interest (<i>Int</i>)	0.004702 (0.79304)	0.010384 (1.4085)	0.019414 (15.4216)
Offshore interest rate (<i>Int*</i>)	0.012427 (3.3592)	–0.001082 (–0.87496)	0.003946 (3.1348)
Dummy variable 1985/86–1991/92			0.0076002 (4.6671)
Error correction model variable	–0.31561 (–4.6538)	–1.4496 (–2.4086)	–5.3960 (–8.9574)
Adjusted <i>R</i> ²	0.94095	0.99926	0.99995
		<i>Diagnostic tests²</i>	
Serial correlation	16.768 (0.001)	2.6278 (0.105)	18.3284 (0.001)
Functional form	15.872 (0.001)	4.4565 (0.035)	5.1605 (0.023)
Heteroskedasticity	4.7210 (0.030)	0.48045 (0.488)	2.7495 (0.097)

Source: IMF staff estimates.

¹Numbers in parentheses represent t-statistics.²Numbers in parentheses for diagnostic tests show the confidence interval.

narrow (*CUR*) and broad money (*M2*) demand have been the most robust over the period, tending to confirm the appropriateness of targeting money demand in Egypt as a guide to monetary policy, provided that out-of-sample projections of independent variables can be confidently projected.

Monetary Policy Objectives with Moderate Inflation

Previous sections have shown the extent of Egypt's successful reduction of inflationary pressures in the last six years. The main source of the success lies ultimately in the improved fiscal stance, which has over the years alleviated the pressure on domestic liquidity growth coming from the financing

of the government deficit. In addition, the successful management of capital inflows in 1991–93, and again in 1996–97, has ensured that inflation has been kept under control in spite of the large increases in net foreign assets of the banking system (see Section V for a discussion of policy responses to capital inflows). Looking ahead, both the ongoing trade liberalization and the structural reforms should increase competition, thus reducing pressure on prices from monopolistic practices. This structural element is likely to further contribute to disinflation.

At this juncture in the stabilization process, with annual inflation in the region of 5 percent, two important issues in Egypt's monetary policy require close scrutiny. First, what should be Egypt's medium-term inflation target given its growth objectives? And second, what policies and institutional aspects can best achieve this target?

What Rate of Inflation?

The optimal rate of inflation a country should target has been extensively discussed in the academic literature, with somewhat inconclusive results. While there is a broad consensus on the negative effects on investment and growth of inflation rates above 10 percent, there is little agreement on the relative benefits of price stability (0–2 percent inflation) versus moderate inflation (2–10 percent). Arguments in favor of somewhat higher inflation targets have also been supported for developing and transitional economies with significant nominal rigidities, on the basis that liberalization and structural reforms induce substantial changes in relative prices and thus put upward pressure on inflation.

From a theoretical perspective, an assessment of the optimal inflation target can be divided into three aspects: (1) short-term costs of disinflation, (2) medium- and long-term benefits of low inflation on growth, and (3) the credibility effect of low inflationary policies.²²

The short-term costs of disinflation are well-known and are associated with the extensive literature on the Phillips curve. The policy implication is that, to bring down inflation, aggregate demand needs to be reduced so as to alleviate pressure on prices and the cost structure of production. In particular, the slope of the Phillips curve, the so-called sacrifice ratio, gives a quantitative measure of the short-run output cost involved in disinflation policies. In countries where the Phillips curve is estimated to be nonlinear, the sacrifice ratio will be higher at lower rates of inflation.

The theoretical and empirical evidence on the impact of moderate inflation on investment and growth is mixed.²³ On the theoretical side, it is argued that macroeconomic uncertainty associated with inflation reduces the incentives for domestic and foreign investment and thus leads to a lower growth path. It is unclear though what rate of inflation will bring about this negative impact on investment. On the empirical side, there is some evidence that moderate rates of inflation compared with price stability may actually foster investment and growth, as they allow enough flexibility for relative prices to adjust to structural changes brought about by growth. The benefits of moderate inflation or price stability are therefore not easily quantified, and this leads to the contention between the arguments in favor, or against, strict price stability vis-à-vis moderate inflation.

The credibility of monetary policy may be of particular relevance to the Egyptian case. From Barro and

Gordon (1983), it is clear that the systematic pursuit of low inflation over the medium term has the added benefit that it increases the credibility of the central bank in the eyes of the private sector and thus reduces the uncertainty associated with the “inflation bias” of monetary policy. The benefit of increased credibility is cumulative inasmuch as central banks are recognized to have either a strong or moderate stance against inflation from their past performance. The issue of credibility is particularly important for Egypt, as the monetary authorities since 1991 have signaled their commitment to low inflation through the maintenance of a narrow band between the Egyptian pound and the U.S. dollar. The exchange rate policy has been successful in reducing inflationary expectations, as shown by the steady decline of real interest rates, thus adding credibility to monetary policy.

Further efforts will be needed to increase credibility in Egypt’s monetary policy in the years ahead, as indicated by the premium associated with short-term domestic interest rates—typically about 3 percentage points over comparable U.S. rates. The pegging of the Egyptian pound to the U.S. dollar in the presence of a significant, if falling, inflation differential has generated real exchange rate appreciation. In Section VI, it is shown how such real appreciation is approximately consistent with underlying internal and external equilibrium, in particular higher productivity growth rates in Egypt and with the prolonged confidence effects of the Paris Club debt reduction. Should economic fundamentals (terms of trade, productivity growth, and so forth) point to a more moderate appreciation of the equilibrium rate in the future, the maintenance of the exchange rate band may require additional disinflation so as to bring the Egyptian inflation rate closer in line with that of the United States. Unless this is accomplished, and unless there are substantial improvements in Egypt’s average productivity, the erosion in competitiveness brought about by the inflation differential may reduce the attractiveness of Egyptian investments and put pressure on the balance of payment in the medium term. The cost of the additional disinflation effort will consist of further moderation of aggregate demand in the short run. The benefit will be the achievement of price stability, which could possibly induce further domestic and foreign investment in the medium term and added credibility to monetary policy. If the current rate of inflation is deemed appropriate based on the overall assessment of costs and benefits, a more flexible exchange rate policy would likely be required.

How to Achieve the Inflation Target?

In addition to the question of what Egypt’s optimal inflation target should be, there is also the parallel

²²For an overview of the costs and benefits of inflation see Fischer (1996), Marty and Thornton (1995), and Selody (1990).

²³See Barro (1995), Bruno and Easterly (1995), Fischer (1993), and Sarel (1996).

issue of how best to achieve the target from a policy and an institutional perspective. The implementation of the inflation target involves the issue of which monetary framework to use for the conduct of monetary policy and, more generally, how to manage short-term liquidity to the banking system and improve the institutional arrangements to achieve this goal.

The choice of an effective framework for conducting monetary policy is a vibrant topic in the theoretical literature. In many countries, the discussion in recent years has focused on the merits of targeting monetary aggregates or future inflation.²⁴ The former involves the targeting of either narrow or broad money to a growth rate that is consistent with that of the real economy plus the desired inflation objective. The latter involves the announcement of an official inflation target for the medium term, and the formulation and publication of an inflation forecasting model that links the set of instruments used for liquidity control, usually short-term interest rates, to the inflation forecast for the medium term (12 months to 24 months ahead).

The adoption of direct inflation targeting in a number of industrial countries and its success in reducing inflation in recent years²⁵ suggest that there may be advantages to targeting inflation directly. One of the main motivations for switching to inflation targeting is that the demand for money tends to

become relatively unstable as financial innovation loosens the relationship between narrow money and domestic credit. Also, a direct inflation-targeting framework prescribes greater transparency in the formulation and operation of monetary policy. This gives the private sector a way to measure directly the performance of the central bank; hence, it reduces the uncertainty surrounding monetary policy.

While the case for inflation targeting in Egypt is not as strong as in other economies, it still reveals important institutional aspects that need further enhancement. Many of these enhancements are already under way. Supported by technical assistance from the IMF and the U.S. Agency for International Development (USAID), the Egyptian authorities are improving the statistical database on real sector indicators, which should aid in the conduct of monetary policy. In addition, the set of monetary instruments is being widened by the introduction of sale and repurchase (repo) operations and reverse repo operations and by lengthening the maturity structure of government debt. The repo market will allow for improved short-term liquidity management and foster the secondary market for short-term government debt. The lengthening of the maturity structure will provide additional liquidity to the long end of the market and thus deepen the financial system. All these actions should, in the medium term, improve the monetary policy framework and facilitate the effective implementation of monetary policy.

²⁴For an interesting discussion relating to the forthcoming European Central Bank, see Ramaswamy (1997).

²⁵For a complete discussion of inflation targeting and its performance so far, see IMF (1996). In Egypt, major problems would hinder the adoption of a direct inflation target. Most important, the lack of a comprehensive and timely database of indicators on real sector activity would severely impair the inflation forecasting

casting exercise. Additionally, the relatively small set of short-term instruments available to the central bank would leave limited flexibility to respond to adverse shocks, thus increasing the volatility of the monetary aggregates. Moreover, the robustness of the nominal demand for money function may suggest that money targeting is a more effective alternative.

V Capital Inflows: Managing Success

The increase of capital inflows into Egypt during the past two years represents a marked change in investor sentiment and a recognition in financial markets that there has been a fundamental improvement in economic policies. While the recent episode reflects the authorities' clear commitment to break with the past, capital inflows are by no means a new phenomenon in Egypt. Between 1991 and 1994, capital inflows soared, spurred by fiscal and structural policy reforms. A tightening of credit conditions also played a role, as high interest rates created strong incentives for capital inflows in the context of the ongoing stabilization effort. When this policy mix proved unsustainable, and monetary policy was relaxed, the inflows gradually subsided before resurging in 1996/97, following the adoption of a more comprehensive stabilization and structural reform program.

This current episode of inflows appears to be built on a firmer basis, and early evidence is that the economy has withstood reasonably well the recent volatility witnessed in other emerging markets. Nonetheless, continued efforts are required to strengthen policies, including through the development of a deep and effectively supervised financial sector, if Egypt is to reap the benefits of a dynamic world market and consistently attract higher inflows of foreign investment, technology, and know-how. In charting Egypt's future course, the broader experience of reforming emerging market economies that have experienced surges in capital inflows in the 1980s and 1990s provides important insight on how to deal with the "challenges of success."

Capital Inflows in Egypt During 1991/92–1993/94

Following the Middle East regional crisis in 1991, the launching of a comprehensive stabilization program comprising strengthened financial policies, and exchange and interest rate liberalization, Egypt experienced a substantial surge in capital inflows. Net international reserves rose by over \$11 billion for the three years beginning in 1991/92, following three

years of small declines, on average (Table 11). While data limitations cloud the assessment of the motivation and source of inflows, they appear to have included repatriation of flight capital of Egyptians, a move abetted by the then unsettled conditions in the region, as well as increased workers' remittances, and other inflows from international investors attracted by a high interest rate differential.²⁶ Compared with the pre-inflow experience, workers' remittances, short-term flows, and errors and omissions increased by about \$3 billion (6 percent of GDP) during 1991/92–1992/93.

Changing conditions in the industrial world and notably the reduction in interest rates between 1990 and 1992 played a contributing role in inducing mobile capital to seek more profitable investment outlets, particularly in emerging markets (Calvo, Leiderman, and Reinhart, 1993). The political disruptions in the Middle East in 1990–91 further bolstered the perception of Egypt as a safe haven for regional investors.

In addition to the external influences, there were policy changes affecting the domestic economy. Egypt introduced a major fiscal adjustment beginning in 1991/92 (see Section III). This durable improvement in the public sector created expectations of lower inflation, stable exchange rates, and a more viable external position. Further, the Paris Club debt-reduction agreement of 1991 offered the promise of sharply lower debt service for Egypt, contributing to an improved perception of Egypt's external viability. Domestic productivity improvements may have also played a role, although stagnant or declining non-oil export growth and rising unit labor costs in the public sector would appear to belie the importance of that factor. Moreover, while some microeconomic reforms were initiated in 1991, for example, decontrol of interest rates and unification of the exchange system, productivity-boosting structural reforms were not comprehensively implemented.

²⁶For additional discussion of the Egyptian experience, see Schadler, Carkovic, Bennett, and Kahn (1993).

Table 11. Summary Balance of Payments*(In billions of U.S. dollars; annual average)*

	1988/89–90/91	1991/92	1992/93	1993/94	1994/95	1995/96	Preliminary 1996/97
Current account	-1.2	3.7	2.2	0.2	0.4	-0.2	0.6
Trade balance	-7.5	-6.3	-7.3	-7.3	-7.9	-9.5	-9.8
Services balance (net)	1.4	3.0	2.6	3.5	4.0	5.8	6.2
Remittances and foreign aid	4.9	7.0	6.9	4.0	4.2	3.5	4.1
Capital account	0.9	3.3	1.0	2.1	0.5	0.8	2.1
Medium- and long-term loans (net)	0.2	0.3	0.1	0.2	0.2	-0.2	-0.3
Foreign direct investment	0.7	0.5	0.5	1.3	0.7	0.6	0.7
Portfolio investments	0.0	0.0	0.0	0.0	0.0	0.3	1.5
Other flows	0.0	2.5	0.4	0.6	-0.4	0.2	0.2
Errors and omissions	0.0	-1.7	1.2	-0.6	-0.1	-0.0	-0.7
Net international reserves increase (-)	0.3	-5.3	-4.3	-1.7	-0.8	-0.6	-1.9

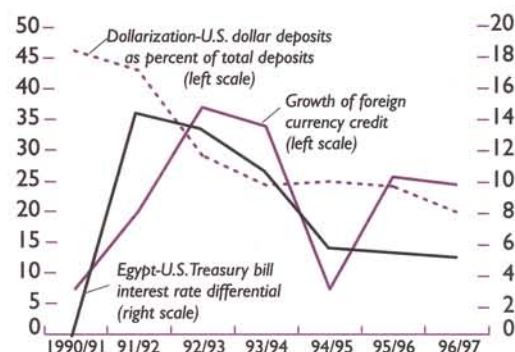
Sources: IMF staff estimates; Subramanian (1997).

A more important proximate cause of the capital inflows in 1991/92 was a sharp tightening of credit policies that led initially to high real interest rates. The interest differential with U.S. interest rates rose to 14.2 percent in 1991/92, before declining to 13.2 percent in 1992/93 and 10.5 percent in 1993/94. The interest differential drew capital into Egypt and prompted portfolio shifts by domestic residents reflected in both sides of banks' balance sheets. On the liability side, dedollarization accelerated during the capital inflow period. On the asset side, there was an upsurge in demand for foreign currency borrowing by residents, resulting in the growth rate of the aggregate rate rising from less than 7 percent in 1990/91, to over 30 percent a year during 1991/92–1993/94 (Figure 10).

Policy Response

The policy response to this early episode of capital inflows relied on sterilization, at the level of the central bank, as the first line of defense (see Figure 11). Sterilization could be implemented quickly and provided time to assess the more durable options. It was effected through sales of government securities, the proceeds from which were deposited into a government account at the central bank, reducing the net domestic assets of the CBE. Consequently, the net domestic assets (NDA) of the CBE declined sharply between 1990/91 and 1993/94; this policy found its counterpart in an increase in the outstanding stock of treasury bills by about LE 31 billion (\$9 billion) to LE 35 billion during the capital

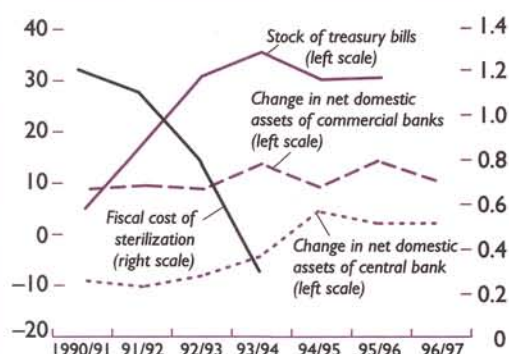
inflows episode (see Figure 12). The direct fiscal costs of sterilization were significant because of the large differential between the U.S. and Egyptian financial assets; on an uncovered interest parity basis, these costs amounted to a cumulative 3.9 percent of annual GDP between 1990/91 and 1993/94. Capital inflows also were absorbed through increased excess reserves holdings by the commercial banks, some of which received interest from the CBE; over five

Figure 10. Financial System Confidence Indicators*(In percent)*

Source: Data provided by the Egyptian authorities.

Figure 11. Sterilization Indicators

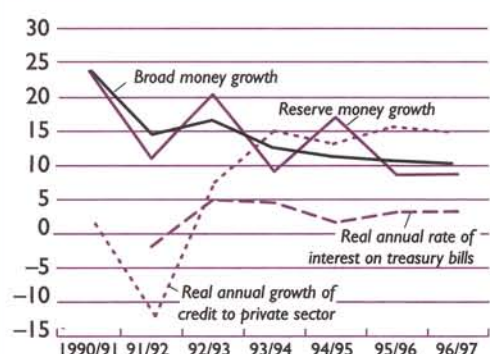
(In billions of Egyptian pounds)



Source: Data provided by the Egyptian authorities.

Figure 12. Monetary Indicators

(In percent)



Source: Data provided by the Egyptian authorities.

years, the costs from these operations totaled about 1.3 percent of GDP, for total sterilization costs of over 5 percent of GDP.²⁷

Continued tight fiscal policy through the capital inflow years also helped to absorb the inflows but was not in and of itself seen as a response to the inflows; in any case, further adjustment would have seemed to be excessively deflationary. During this period, the trade and capital account regime remained relatively stable.

Surges in capital inflows contributed to substantially easier conditions in the domestic money markets. In 1993/94, the last year of the inflows episode, nominal interest rates had fallen by over 4 percentage points and real credit growth had rebounded. This fall in the nominal interest rate ensued in the face of aggressive sterilization and increased money demand (there was a decline in velocity of about 7 percent over the three-year inflow period), reflecting increased credibility of the fixed exchange rate. Even-

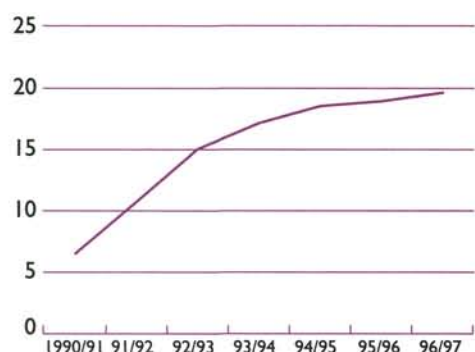
tually, declining interest rates moderated the inflows. Notwithstanding the increase in liquidity, inflation declined appreciably and in a very short space of time—over the three-year period—from over 21 percent to 9 percent. The sharp fiscal contraction just prior to and coincident with the inflows as well as the tight monetary stance helped in the battle against inflation.

The increased inflows led to a sharp increase in the net foreign assets of the central bank (see Figure 13). Over the period, the import coverage of gross reserves of the central bank rose from about 6.7 months at the beginning of the episode to 19 months toward the end, giving Egypt a large cushion of reserves, strengthening external viability, and contributing to the growing credibility of the exchange parity. Given that one of the main risks associated with a surge in inflows is their volatility, an important indicator of a cushion against reversal is the ratio of cumulative inflows to reserves. At the end of the first episode of capital inflows, this ratio stood at about 3.5, substantially higher than countries such as Spain and Thailand at that time (see Schadler, Carkovic, Bennett, and Kahn, 1993).

The capital inflow years, particularly the first two (1991/92–1992/93), coincided with reduced real activity occasioned inter alia by the fiscal contraction, as well as a decline in the terms of trade. Private consumption rose appreciably during the inflow years as pent-up demand pressures were released. Investment, especially public investment, had faced a severe contraction in the years leading up to the inflow of foreign capital and remained broadly unchanged during the inflow episode. Banking system problems

²⁷Sterilization of commercial bank reserves involved the sales of government treasury bills, the bulk of which (about 80 percent) was held by the commercial banks. Between 1990/91 and 1993/94, the increase in net international reserves (NIR) of the CBE was partially offset by a decline in net domestic assets (NDA) of the CBE, matched broadly by an increase in NDA of the banking system (excluding the CBE). If account is made of lost tax revenue (interest income is exempt from income taxation), the fiscal cost totaled about 10 percent of GDP between 1991/92 and 1995/96.

A more comprehensive and accurate estimate of the fiscal costs of sterilization should take account of the higher interest (relative to the counterfactual of no sterilization) on all government debt engendered by sterilization.

Figure 13. Gross Official Reserves*(End of period; in billions of U.S. dollars)*

Source: Data provided by the Egyptian authorities.

did emerge at the start of the period, involving the accumulation of bad debts requiring an infusion of capital for insolvent banks at a significant budgetary cost (5.5 percent of GDP in 1990/91).

Egypt responded to the capital inflows by preserving the nominal anchor and resisting any nominal appreciation of the exchange rate. During the inflow episode, the real exchange rate appreciated cumulatively by about 27 percent owing in large part to the inflation differential with its trading partners.

The Interregnum, 1994/95–1995/96, and Current Phase, Post-1995/96

During 1994–96 capital inflows slowed markedly. The slowdown reflected a number of factors, including a decline in the interest differential and a pause in the adjustment effort, as well as concerns about economic prospects. The capital account surplus declined to $\frac{3}{4}$ of 1 percent of GDP, remittances steadied, and the process of dedollarization was in abeyance. During this period, the interest rate differential between Egyptian and dollar-denominated assets was about 5 percentage points.

Capital inflows picked up again beginning in 1996. Preliminary estimates for 1996/97 indicate net capital inflows of about \$2 billion, stronger than in the previous two years (inflows averaged around \$0.6 billion in 1994/95–1995/96) but about the same level in dollar terms as in 1993/94. Portfolio investment is now estimated at \$1.5 billion, compared with \$250 million in 1995/96). Nonresidents' net purchases of equities (buoyed by the privatization pro-

gram) amounted to some \$700 million in 1996/97 accounting, in part, for the doubling of equity prices through the end of January 1997.²⁸ Nonresidents' net purchases of treasury bills and bonds, which had previously been modest, picked up in the second half of 1996/97 and are estimated at \$700 million for 1996/97.

The most recent capital inflows appear to differ in character from those of the early 1990s (see Table 12). Whereas the latter represented, in large part, repatriation by residents of flight capital, the more recent inflows include portfolio inflows by foreign institutional investors. Overseas demand for Egyptian equity and treasury bills increased after agency ratings on Egyptian sovereign debt improved. The timing of the second phase of inflows, coming at a time of strengthened financial policies and a significant advance in privatization, and the consequent decline in nominal interest rates to below 9 percent (the interest differential vis-à-vis U.S. assets narrowed to less than 4 percent) suggest a credibility effect resulting from the policy commitments and actions of the government.

As a result of the policy of preventing a nominal appreciation, the increased inflows amounting to about \$1.5 billion (or 9.8 percent of reserve money) led to a sharp increase in the net foreign assets of the CBE. Unlike in phase I, reserve money and liquidity growth did pick up by about 2 percentage points. Broad money growth might have been higher still, but for the decline in the money multiplier resulting from the buildup of excess reserves in the banking system. The growth in credit aggregates remained steady, providing financing for the higher level of activity.

The capital inflows have thus far not imparted inflationary pressures on the Egyptian economy. Higher monetary growth has been consistent with declining inflation, reflecting in part a higher demand for money and continued fiscal restraint. A further appreciation of the real exchange rate was due more to the nominal effective appreciation of the Egyptian pound (by about 9 percent in the year to June 1997), as the dollar appreciated against other major countries, than to an inflationary impulse occasioned by the capital inflows.

²⁸In the first half 1996/97, most of the increase in portfolio inflows was accounted for by foreign purchases of equities, made available during the privatization program. In particular, global depository receipt (GDR) issues served as an attractive instrument for drawing foreign capital, accounting for between 45 and 50 percent of the inflows into equities. In the second half, inflows into equities slowed down considerably.

Table 12. Comparison of Capital Inflow Phases

Indicator	Phase I (1991/92–1993/94)	Phase II (1996/97)
Characteristics	Probably return of flight capital to banking system.	Portfolio investment by foreign institutions in domestic equities and government securities.
Investors	Probably residents and overseas workers.	International financial institutions (private).
Magnitudes	Cumulative net flows of \$6.4 billion (14 percent of GDP).	\$2.1 billion (2.8 percent of GDP).
Influences	External and internal.	Predominantly internal.
Policy responses	Aggressive sterilization.	Some sterilization, but mostly feeding into liquidity growth.
Effects of inflows		
Nominal interest rates	Decrease.	Decrease.
Real interest rates	Decrease.	Increase.
Monetary aggregates	Deceleration in growth rate of liquidity.	Increase in liquidity growth.
Equity prices	No impact.	Sharp increase.
Inflation	Deceleration.	Deceleration.
Real exchange rate	Appreciation.	Appreciation.
Savings and investment	Decrease.	Increase.

Source: IMF staff.

Impact of Flows on Capital Markets

Inflows have had a significant impact on capital market activity. Since 1994, the Egyptian capital market has witnessed an enormous increase in activity: trading value has recorded a 43-fold increase between 1993 and 1997; market capitalization has increased from about 8 percent of GDP in 1993/94 to 24 percent of GDP in 1996/97; the number of transactions has risen from about 12,000 in 1993 to more than 23 million in 1996; and the number of new equity issues (excluding fixed-income instruments), an index of primary market activity, has increased from LE 2.1 billion in 1993 to about LE 18 billion in 1997. Foreign participation in the stock market has similarly displayed a strong increase, accounting for nearly 35 percent of transactions in 1997 from negligible levels in 1992.

This market performance has been founded on a number of factors, including the achievement of macroeconomic stability in the first half of the 1990s, and more recently by the acceleration of the structural firms. It has also been facilitated by the improved regulation of the capital market. In 1992, Egypt adopted the Capital Market Law aimed at

streamlining all preexisting regulations and providing the legal framework for the further development and enhanced regulation of the capital market.

Although prices on the stock market increased 54 percent in the first two months, generating fears of exaggerated valuation that could subsequently lead to a disruptive meltdown, there has been a correction of prices of about 20 percent (between the end of February and mid-June 1997), resulting in more realistic valuations. The price-earnings ratio of about 13 for the Egyptian market is not high by the standards of other emerging markets. Indeed, even at the peak of prices in February, Egyptian P/E ratios were lower than in many other emerging markets (Table 13).²⁹

One potentially worrying sign is the behavior of stock prices of housing-related firms and what it signals about the real estate market. Between the end of June 1996, and the end of December 1996, housing

²⁹Moreover, and very important, this correction has occurred without any mishaps in the clearing and settlement system. Indeed, the average settlement period has been reduced substantially from over $T + 25$ days to about $T + 4 - 5$ days during the recent episode of capital inflows.

Table 13. Price-Earnings Ratios for Selected Emerging Market Economies¹

Price-Earnings Ratio		Price-Earnings Ratio	
Europe		Asia	
Czech Republic	12.0	China	45.5
Hungary	14.8	Sri Lanka	10.6
Poland	14.2	Taiwan Province of China	28.7
Turkey	11.9	India	10.9
Latin America		Indonesia	17.5
Argentina	27.2	Korea	18.4
Chile	14.3	Malaysia	
Mexico	13.2	Philippines	28.4
Venezuela	12.9	Thailand	25.8
Middle East and North Africa			13.3
Jordan	16.9	Sub-Saharan Africa	
Egypt	15.1	Nigeria	7.0
		South Africa	14.7
		Zimbabwe	12.9

Source: International Finance Corporation (IFC).

¹Data for November 1996, except Egypt, which are for February 1997.

stock prices increased 378 percent, compared with 62 percent for the general market index. From their peak, prices have declined by about 20 percent for the general index and about 13 percent for the housing index. In 1996/97, price-earnings ratios increased from 6.9 to about 14 for the general index, but from 9 to about 25 for the housing index. Although, it is premature to infer overheating in the real estate market on the basis of these figures (in part because the housing index comprises five companies of which two account for the bulk of market capitalization), they nevertheless bear close monitoring.

Policy Dilemma of Capital Inflows

While capital inflows are inherently desirable as a means of supplementing domestic financing for investment, surges in capital inflows (and outflows) can pose difficult policy challenges as they also entail macroeconomic and institutional risks. Certainly, the task of macroeconomic management is more complex as, in the absence of policy measures, inflows drive monetary expansion, undermining inflation-reduction efforts; real exchange rate appreciation, not offset by productivity growth, can entail adverse consequences for the tradable goods sector. Further, banks and other financial institutions face increased opportunities but higher risks. While inflows can generate higher returns, the reversal of such

inflows can pose risks to institutions with unsound portfolios or low capitalization; insofar as surges in capital inflows lead to rapid credit growth, this can overwhelm the capacity of markets to allocate such resources effectively and may support unprofitable investments, or unsound consumer credit.

There is no unique or simple way of maximizing the beneficial impact of capital inflows while minimizing the risks for the macroeconomy and the integrity of the financial system. The various policy options, which include a rebalancing of the macroeconomic policy mix, structural actions, and direct disincentive measures, need to be weighed carefully as each involves important trade-offs. This means giving due consideration to (1) the magnitude of the inflows; (2) the composition of the flows; (3) the macroeconomic impact of inflows: capital inflows put upward pressure on monetary aggregates, prices, the real exchange rate, and external accounts; and (4) the robustness of institutions in the financial sector in terms of their ability to intermediate the funds while limiting risky exposures.

Macroeconomic Policy Stance

To reduce the risks, the following policy options were available to Egyptian authorities when faced with substantial capital inflows:

Sterilized intervention. This has been the cornerstone of the Egyptian response to the capital inflows to date and has effectively served to counter upward

pressure on the currency while allowing a temporary respite for the implementation of fundamental reforms. To date, the fiscal costs have been modest.

Unsterilized intervention with tighter fiscal policy. In the spring of 1997, the authorities allowed domestic interest rates to decline in line with market forces, reducing the incentives for capital inflows. At the same time, tight fiscal policies minimized the inflationary pressures associated with such capital inflows.

Nominal exchange rate appreciation. If the level of capital inflows exceeds the authorities' capacity for policy correction as outlined above, a degree of real effective appreciation of the exchange rate may be inevitable. In this event, nominal exchange rate appreciation will hinge on the extent to which productivity and efficiency gains are taking place in the economy. It should not be regarded as irreversible and thus would need to be combined with changes to the system that impart greater flexibility. In Egypt, the buildup of sizable reserves would suggest that external viability is in no immediate danger from the 10 percent real appreciation over the past year. However, given the large real appreciation of the pound and the consequent lackluster performance of the tradable goods sector, an outward-looking strategy must involve market-oriented policies aimed at preventing any further deterioration in competitiveness.

Direct disincentives to inflows. In some cases, countries have found it necessary to implement measures that aim directly at discouraging capital inflows. If such measures are used, they are best limited to taxation measures (as opposed to quantitative controls), which impact short-term portfolio flows and are imposed for a short period as market participants often find ways of circumventing such measures. Consequently, such measures should be seen as a last resort.

Supportive Structural Reforms

In addition to adjusting the macroeconomic stance, structural reform initiatives can also form part of a strategy to deal with capital surges:

Trade liberalization. Import liberalization can minimize the inflationary impact of higher capital inflows (as higher demand feeds through into imports rather than monetary growth) and can establish the basis for higher levels of investment and growth.

Other structural reforms to encourage investment. Measures to strengthen private sector investment, including privatization, deregulation, and the elimination of excessive bureaucracy, have helped to ensure that increased capital inflows (foreign saving) finance higher investment rather than current (consumer and public) spending.

Banking reform is an important complement to the policy options outlined above. The Egyptian authorities are continuing their efforts to strengthen banking and supervision, and the institutional capacity of the Capital Market Authority (CMA), and the CBE to enforce effectively the prudential regulations; improving the standards of reporting and disclosure and enforcing them more effectively; activating the secondary market for debt instruments to increase liquidity and improve price setting (this would include greater securitization of existing debt instruments); and ensuring a steady supply of assets, through privatization, to prevent overheating and to improve market liquidity. To date, there is little evidence to suggest a shift to riskier or less efficient banking activities. Overall credit growth in 1996/97, at 22 percent, has been slower than in the previous three years, and available information on sectoral composition of lending does not suggest a problem.

Synthesis

Various IMF studies have identified a number of characteristics common to several countries experiencing surges in capital inflows during the past two decades: a track record of fiscal consolidation; a recent depreciation of the real exchange rate; structural reforms improving supply conditions and liberalizing financial markets; debt restructuring or reduction; and a tightening of credit policies. Some of these characteristics are applicable to the present Egyptian economic situation: fiscal performance has been good, with the 1996/97 deficit expected to be under 1 percent of GDP; the structural reform effort has been accelerated; the Paris Club has approved the last tranche of debt reduction further alleviating debt overhang concerns.

There are a number of important differences between the two periods of capital inflows that Egypt has experienced:

- There is presently confidence that capital inflows can be sustained because the policy signals are primarily internal and driven by improved fundamentals relative to the past. As a result, Egypt's situation appears less vulnerable today than that in other major emerging markets that have recently witnessed market pressures—the current account stronger, the size of the inflows smaller, and the pressures on the financial system more limited. But caution is still required in the period ahead.
- Capital inflows have also been influenced by external developments—although probably to a limited extent up to now relative to the past. There have been modest movements in domes-

tic interest rates both in Egypt and the United States over the past year, but the resulting change in interest differentials has probably been insufficient to trigger major capital shifts between the two currencies. More important, in this respect, has been the shift in confidence in favor of Egypt, which will have reduced the risk-adjusted interest differential. Consequently, the fiscal costs of sterilization are likely to be small in the current episode as interest differentials have narrowed considerably compared with the previous episode.

- Finally, real exchange rate appreciation in the period preceding the current phase of inflows, and the attendant lackluster performance of the tradable goods sector (in contrast, services have performed quite admirably), highlights the need for focused reforms that address competitiveness in these sectors.

In view of the market volatility and the possibility of contagion and bandwagon effects, and the likely continuation of inflows as investor confidence is maintained, continued vigilance is warranted.

VI Sustainability of the Exchange Rate Regime

Over the past six years the Egyptian pound has moved in a 3 percent range vis-à-vis the dollar, and any upward or downward pressure on the exchange rate has been accommodated through passive intervention. There is no doubt that Egypt has prospered under this hard currency policy, with the exchange rate providing a nominal anchor. The benefits of this strategy include low inflation, disciplined financial policy, and a stable external environment. Capital inflows have bolstered long-term growth prospects by increasing investment and confidence. At the same time, the real effective exchange rate has appreciated by about 30 percent during 1991–96 owing to substantial inflation differentials in the early part of the period with partner countries. Clearly, this real appreciation would not represent an overvaluation if it resulted from a recovery from an undervalued exchange rate, if productivity growth in the tradable sector was substantially larger than compared with trading partner countries, or if the appreciation reflected changes in other fundamentals, such as those inducing higher confidence in the Egyptian market.

To address this issue, we estimate the *equilibrium real exchange rate* for the Egyptian pound, that is, the level of the real exchange rate that is consistent with the internal and external equilibrium. We find that before 1991 the real exchange rate was significantly overvalued relative to its estimated equilibrium level but has since adjusted to a level broadly consistent with the equilibrium rate.

Nominal and Real Exchange Rate Developments

Movements in the exchange rate in the 1987–91 period (prior to pegging of the Egyptian pound to the U.S. dollar) are closely linked to moves to liberalize the exchange regime.³⁰ Until May 1987, the interbank foreign exchange market was organized into two official pools, the central bank pool and the

commercial bank pool, each handling different foreign exchange transactions. The official exchange rates were set by the Egyptian authorities (at LE 0.7 and LE 1.36 per U.S. dollar, respectively) and did not reflect market forces. In addition, a formally illegal nonbank free market was officially tolerated. In May 1987, a new bank foreign exchange market was introduced. The rate was initially set at LE 2.165 to the U.S. dollar, well below the pool rate, and subsequently allowed to slide, to reach LE 3.0 at the end of 1990. The central bank pool rate was devalued a number of times to reach LE 2.0 on July 1, 1990. The old commercial bank pool ceased to exist in March 1989.³¹

To simplify the exchange rate system and ensure a competitive exchange rate, the multiple exchange rate system was replaced by a temporary dual exchange system consisting of a primary market and a secondary (free) market in February 1991, and subsequently these markets were unified in October 1991. Since then the Egyptian pound has been freely traded in a single exchange market with the authorities intervening to maintain the rate in a tight band against the U.S. dollar (Figure 14).

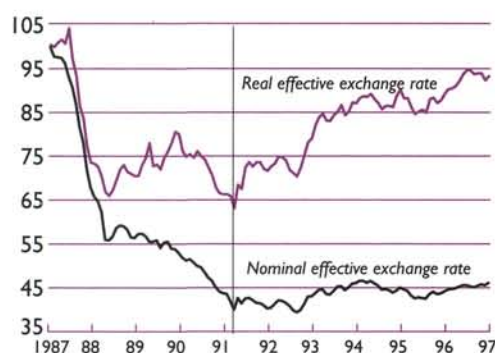
The administered exchange rates led to specific commodity shortages prior to liberalization in 1987, indicating that the Egyptian pound was overvalued. The real effective exchange rate depreciated sharply during 1987, as an increasing share of transactions went through the new (depreciated) exchange market. In 1988 and 1989, a modest real appreciation occurred as administrative adjustments tended to lag behind inflation; subsequently, they were reversed in 1990/91 as the exchange markets were unified. In the early years of pegging to the U.S. dollar with a market-determined exchange rate, there was a substantive real appreciation. Since 1993, the real appreciation has been very modest as domestic inflation fell to single digits.

³⁰See also Guitián and Nsouli (1996), and Subramanian (1997).

³¹Until the liberalization of the exchange system in February 1991, the transaction-volume-weighted average of the multiple exchange rates vis-à-vis the U.S. dollar is used to calculate the dollar exchange rate and underlies the calculations of the effective exchange rates in this paper.

Figure 14. Nominal and Real Effective Exchange Rate, January 1987–December 1996

(January 1987 = 100)



Source: IMF.

Equilibrium Real Exchange Rate

Macroeconomic stabilization together with liberalization of the external sector may pose a challenge to external competitiveness. As stabilization is often associated with fiscal tightening and high real interest rates, and if the capital market is sufficiently liberal, this will usually induce substantial capital inflows, putting upward pressure on the real exchange rate. This has been Egypt's recent experience, as it has also been for Chile, Malaysia, Mexico, and Argentina for example.³² In these circumstances, the policymaker is faced with the option of intervening in the exchange market and tightening fiscal policy to counteract the upward pressure to maintain competitiveness or, alternatively, of leaving the policy unchanged, thereby raising the specter of an unsustainable current account deficit down the road. For Egypt, this policy dilemma translates into a choice between keeping the current peg or introducing flexibility in the exchange rate, hoping for a market driven correction to follow in the medium term.

Accordingly, it is important to determine whether a real exchange rate appreciation is consistent with the fundamentals of the economy after the process of liberalization or if it represents an overvaluation—defined here as a short-term misalignment of the exchange rate induced by fiscal or monetary policy.³³ If

the exchange rate is in line with fundamentals, there is no reason to believe that a move to a more flexible exchange rate would lead to the desired depreciation. On the other hand, if the real exchange rate is misaligned, a flexible exchange rate would tend to reduce the misalignment over the medium term.

The description of movements in the real effective exchange rate in the previous section highlights the need for a reference rate that is consistent with economic fundamentals, the equilibrium real exchange rate (ERER).

Literature Review

The ERER can be defined as the level of the real exchange rate that is consistent with internal equilibrium (in terms of the goods and labor market) and external equilibrium (in terms of a sustainable current account). The relatively large theoretical and empirical literature on the topic can be classified into two categories.³⁴ The first comprises theoretical works that identify the ERER as the exchange rate compatible with a nonaccelerating inflation rate of unemployment (NAIRU) (Frenkel and Razin, 1987; Clark and others (1994)) or with a normative target for the current account (Williamson, 1994). It also comprises numerous empirical studies aiming at the identification of the ERER for the major industrial economies, such as those implemented by the IMF on the basis of the multilateral exchange rate model (MEMR) or multicurrency macroeconomic model (MULTIMOD), as well as those done by Stein (1995) on the estimation of the U.S. dollar equilibrium exchange rate.

In the second category, the seminal work by Edwards (1989 and 1994) represents the first substantial endeavor to build an equilibrium exchange rate model specifically for developing countries. Within this context, the ERER is defined as the relative price of tradables to nontradables that, *ceteris paribus*, results in the simultaneous attainment of internal and external equilibrium. Elbadawi (1994) develops a simplified version of Edwards's model that requires a smaller set of fundamental variables, and using this framework provides estimates of the ERER for Chile, Ghana, and India. In estimating Egypt's ERER, we will follow Edwards's methodology.

Edwards's Model

Edwards's (1989) basic model is an intertemporal general equilibrium model of a small open economy in which both tradables and nontradables are exchanged. Time is limited to two periods; identifying

³²See Quirk and Evans (1995).

³³For a useful discussion of the definitions of overvaluation in the context of the behavior of the U.S. dollar in the first half of the 1980s, see Frankel (1993, Section VI).

³⁴For a good review of the literature on this subject, see Williamson (1994).

Box 2. Determinants of the Real Exchange Rate in Edwards's Model

In Edwards's empirical study of 33 developing countries, he identifies the following set of fundamental variables affecting the equilibrium in the real exchange rate (ERER) ($FUND_{it}$):

- An improvement in the terms of trade (TOT), defined as the ratio of the world price of a country's exports over the world price of its imports, will have a positive impact on the current account and thus lead to an appreciation of the ERER.
- A shift toward government consumption of nontradables (GCN) vis-à-vis tradables will improve the current account and thus lead to an appreciation of the ERER.
- A liberalization of controls over capital flows ($KCON$) could either improve or worsen the capital account, depending on the interest rate differential between the domestic and the world economy prior to the liberalization (i.e., depending on whether the controls acted, on balance, to deter inflows or outflows). If the removal of such controls leads to a higher (lower) level of capital inflows, the ERER would appreciate (depreciate).
- A relaxation of the severity of trade restrictions and exchange controls ($XCON$) usually leads to an increase of imports, a worsening of the current account, and thus a depreciation of the ERER.
- Faster technological progress ($TECH$) is usually reflected in stronger productivity growth for the tradable sector (Balassa-Samuelson effect) and thus leads to an appreciation of the ERER.
- An increase in the ratio of investment to GDP (INV) will increase absorption, worsen the current account, and lead to a depreciation of the ERER.

In addition to the fundamental variables outlined above, Edwards uses the following proxies for policy variables (Z_t):

- The excess supply of domestic credit (EXC), defined as the increase in domestic credit that is unmatched by higher growth in the economy. Under a flexible exchange rate, excessive monetary expansion will lower interest rates, boost the domestic demand for nontradables, and thus induce an appreciation of the real effective exchange rate (REER). Under a fixed exchange rate, an excessive monetary expansion would be immediately reversed by a capital outflow, leaving the REER unchanged.
- The ratio of fiscal deficit to lagged high-powered money (DEH). Under a flexible exchange rate, an increase in the fiscal deficit relative to the monetary base in the previous period (loose fiscal policy) will increase domestic demand for nontradables and thus lead to an appreciation of the REER. Under a fixed exchange rate, loose fiscal policy will initially boost domestic demand with the upward pressure on interest rates dampened by capital inflows and no impact on the REER. In the long run, the higher demand for nontradables will put upward pressure on inflation and thus lead to a REER appreciation.

For the specific case of Egypt, this data set should be augmented by the following fundamental variables in the estimation of the real exchange rate:

- An increase in the debt-service ratio ($DEBT$), which includes private and official transfers, will worsen the sustainability of the current account and thus lead to a depreciation of the ERER.
- A Middle East conflict dummy ($MECON$) spanning the period August 1990 to March 1991. A negative exogenous shock like the Middle East conflict of 1990–91 would put downward pressure on the REER.
- The variable for the nominal depreciation ($NDEP$) will be measured by changes in the nominal effective exchange rate (NEER).

the short- and long-run behavior of the economy, the model has also been extended to an infinite horizon without substantial differences. Internal equilibrium is defined in the model as the clearing of all nontradable markets (static equilibrium). External equilibrium is attained when the net present value of future current accounts is non-negative, given the level of exogenous long-run capital inflows (dynamic equilibrium). These two equilibrium conditions identify a unique ERER. Agents in the model are endowed with perfect foresight so that they will immediately respond to an unsustainable current account by changing their consumption and investment decisions.

The kernel of Edwards's empirical analysis is to determine the equilibrium real exchange rate by disentangling fundamental changes in the level of the

actual rate from temporary influences brought about by nominal exchange rate shifts as well as monetary and fiscal policy deviations. Two equations describe the long-run behavior of the exchange rate as the function of fundamentals and the short-run influences on the dynamics of the real exchange rate. Both can be combined in the following reduced form equation for the real exchange rate:

$$\log(e_t) = \gamma_0 + \gamma_1 \log(FUND_{it}) + (1 - \theta) \log(e_{t-1}) - \lambda(Z_t - Z_t^*) + \phi NDEP_t + v_{it}, \quad (3)$$

where ($FUND_{it}$) is a vector of fundamental variables affecting the equilibrium real exchange rate ($Z_t - Z_t^*$) is a vector of the deviation of policy variables from their equilibrium, and ($NDEP_t$) is the nominal exchange rate depreciation. The variables are de-

fined in Box 2. The estimates of the parameters γ_i can provide an estimate of the equilibrium real exchange rate and θ indicates the speed of adjustment to equilibrium. In deriving the equilibrium rate, it is assumed that the long-run elasticities of the nominal depreciation and the policy variables are zero, that is, all policy and nominal factors do not affect the equilibrium exchange rate.

Determinants of the Real Exchange Rate

While the data set outlined in Box 2 is ideal for the empirical estimation of Edwards's model, it is clear that operationally some of these variables are not readily available. For Egypt, the limited availability and frequency of the required data necessitates estimation using total government consumption as a proxy for government consumption of non tradable goods, the lagged capital account balance as a percentage of GDP (as a proxy for controls over capital flows), and a dummy variable to account for the trade and exchange liberalization in January 1991, when most exchange restrictions were lifted. Technological progress is based on total factor productivity estimates derived by Bisat, El-Erian, and Helbling (1997). Six out of 11 variables³⁵ in the data set are only available on an annual basis, compared with a monthly basis for the remainder; it made sense therefore to interpolate the monthly variables linearly, where necessary.³⁶ The most important variables are presented in Figures 15–18.

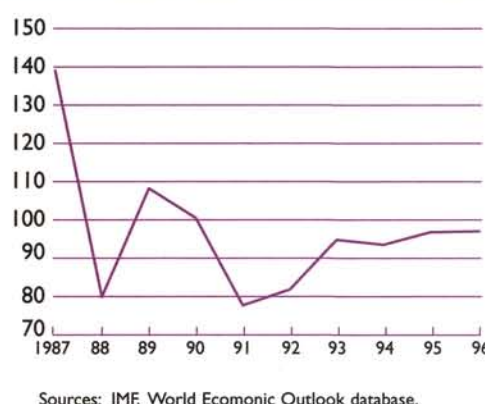
Results

To choose the appropriate estimation procedure for equation (3), we test first for the stationarity of the fundamental variables using the augmented Dickey-Fuller test and then proceed with the appropriate estimation procedure. All variables, except for the terms of trade variable (*TOT*), can be considered stationary in first differences. For the variable *TOT*, we are unable to reject either the $I(0)$ or $I(1)$ process, possibly indicating that the variable is fractionally integrated. The difference stationarity of the real effective exchange rate is consistent with most other empirical studies of the real exchange rate.

Estimation Results

The presence of a fractionally integrated process does not allow employment of standard cointegration

Figure 15. Terms of Trade
(1990 = 100)



techniques. We hence adopt Pesaran and Shin's (1995) method based on an augmented autoregressive distributed lag procedure. Augmented ARDL estimates are asymptotically consistent and provide asymptotically valid inferences on the long-run results even in the presence of fractionally integrated processes.

We first find evidence of a long-run relation between the fundamental variables.³⁷ Second, through the specification search procedure we eliminate the *XCON* and *INV* variables from the data set as the coefficients on these variables were insignificant.³⁸ Finally, we apply the augmented ARDL procedure to derive short- and long-run estimates of equation (3).³⁹

Table 14 presents the short-term estimates. Overall, the table shows that all of the estimates on the fundamental variables and the nominal depreciation have the expected sign and are significant at the 99th percentile. The error correction model estimate

³⁷The F -statistic for testing the significance of lagged variables in an error correction formulation is 4.7941, well above the 99th percentile critical band. Under the null hypothesis of no cointegration, the F -distribution is nonstandard and the test involves a critical band rather than a critical value; see Pesaran and Pesaran (1996). We can therefore reject the hypothesis of no long-run relation.

³⁸This elimination also solves the problem of multicollinearity between the variables *INV* and *TECH*.

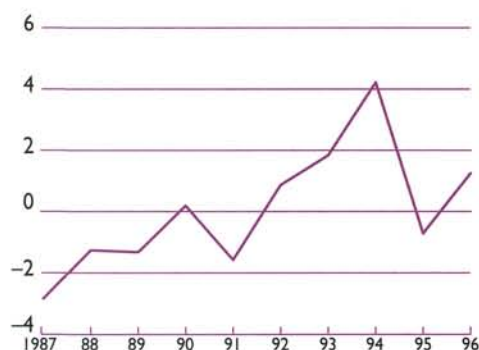
³⁹We assumed that all fundamental variables could be cointegrated. In keeping with the Edwards's model, we limited the maximum lag to one.

³⁵These are, *TOT*, *GCON*, *KCON*, *TECH*, *INV*, and *DEBT*.

³⁶To make sure that the linear interpolation does not affect our estimation, we compared correlation matrices before and after the interpolation. We found no significant statistical difference.

Figure 16. Capital Account Balance

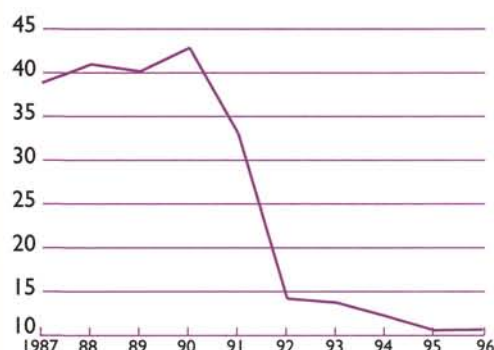
(In percent of GDP; fiscal year ended June)



Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

Figure 18. Debt-Service Ratio

(As a percent of current account receipts)



Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

(ecm) is highly significant and supports the significance of the cointegration procedure.

The proxies for monetary (*EXC*) and fiscal policy (*DEH*) perform poorly in the estimation however. The coefficients on *DEH* and *EXC* are not statistically different from zero and the coefficient on *EXC* is not consistent with Edwards's model. The results of these variables are probably affected by the de facto change in exchange rate regime during the

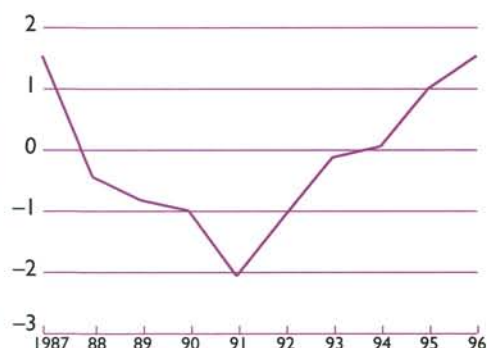
sample period, and thus provide limited insight into the effects of monetary and fiscal policy. Given Edwards's assumption that their elasticity in the long run is zero, the lack of significance will not actually affect our derivation of the ERER below.

It is also worth highlighting that the estimated coefficient on the lagged real effective exchange rate (REER) implies a relatively slow speed of adjustment to shocks in the fundamental variables. In fact, a positive unitary shock would be reflected in the equilibrium rate by 50 percent after 5 months, by 75 percent after 8 months, and by 90 percent after 11 months. While this may seem surprising, this coefficient is well within the range of results obtained by Edwards's (1989) and Elbadawi (1994) for other developing countries.⁴⁰

Table 15 gives the long-run estimates of the fundamental variables, given the underlying economic assumption that the long-run elasticities on the nominal depreciation and the policy variables are zero. The derivation of the long-run estimates using the ARDL procedure is consistent with Edwards's method outlined in the previous section. The results in Table 15 are encouraging as they show that all the long-run coefficients are statistically significant at the 99th percentile. We can therefore have sufficient confidence in the statistical significance of the ERER, as it is derived from these estimates.

Figure 17. Estimates of Total Factor Productivity

(Annual percent change)



Source: Bisat, El-Erian, and Helbling (1997).

⁴⁰Edwards's estimates for the speed of adjustment θ are in the range 0.739–0.941. Elbadawi's estimates are 0.67–0.78.

**Table 14. Short-Run ARDL Estimates Dependent Value:
Real Effective Exchange Rate Sample Period,
February 1987–December 1996**

	Coefficient	t-Value
Lag (<i>REER</i>)	0.7918	14.9589
Constant	2.3946	3.1271
Terms of trade (<i>TOT</i>)	0.2629	3.7632
Government consumption in percent of GDP (<i>GCN</i>)	0.1447	2.3067
Lagged capital account balance in percent of GDP (<i>KCON</i> ₋₁)	-1.3170	-3.3135
Technological innovation (<i>TECH</i>)	0.3773	1.6726
Middle East conflict of 1990–91 (<i>MECON</i>)	-0.0114	-3.1354
Debt-service ratio (<i>DEBT</i>)	-0.1592	-1.9683
Nominal depreciation (<i>NDEP</i>)	0.3502	9.9193
Ratio of fiscal deficit to <i>H</i> -Money (<i>DEH</i>)	0.0139	0.5597
Excessive credit (<i>EXC</i>)	-0.0012	-0.0977
Error correction model variable (-1)	-2.0818	-3.9329
Sample size = 119 observations	$R^2 = 0.6463$	$s = 0.00714$

Source: IMF staff estimates.

Derivation of Equilibrium Real Exchange Rate

The coefficients provided in Table 15 are used in the derivation of the equilibrium real exchange rate. Following Edwards's, we calculate 12-month moving averages of the fundamental variables so as to smooth out temporary volatility.⁴¹

⁴¹This reduces our sample by 12 observations. The dummy variable for the Middle East conflict of 1990–91 (*MECON*) is not smoothed for obvious reasons.

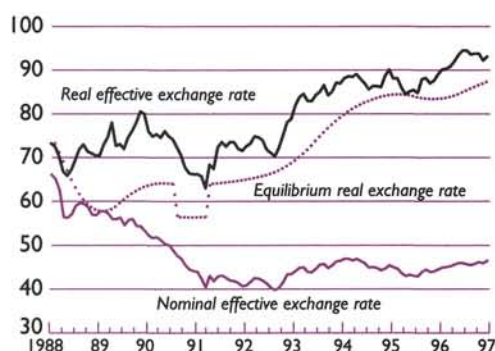
Figure 19 presents the time series of the REER, the NEER and the estimated ERER (marked with dots) for the period January 1988 to December 1996. The confidence interval around the ERER is estimated to be equal to ± 1.0026 . When the actual rate is above (below) the equilibrium rate, it indicates that the real exchange rate is overvalued (undervalued), because of temporary effects (the monetary or fiscal policy stance). Figure 20 presents the difference between the REER and the ERER for the same period.

**Table 15. Long-Run ARDL Estimates Dependent Value:
Real Effective Exchange Rate Sample Period,
February 1987–December 1996**

	Coefficient	t-Value
Terms of trade (<i>TOT</i>)	1.2633	7.1498
Government consumption in percent of GDP (<i>GCN</i>)	0.6951	2.3839
Lagged capital account balance in percent of GDP (<i>KCON</i> ₋₁)	-6.3263	-4.3982
Technological progress (<i>TECH</i>)	1.8125	2.2885
Middle East conflict of 1990–91 (<i>MECON</i>)	-0.0545	-3.1976
Debt-service ratio (<i>DEBT</i>)	-0.7645	-2.1328

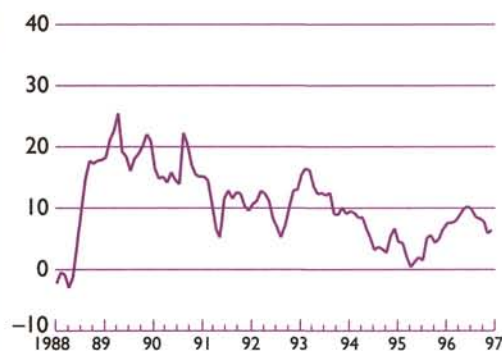
Source: IMF staff estimates.

Figure 19. Actual Versus Equilibrium Real Effective Exchange Rate, January 1988–December 1996
(January 1987 = 100)



Source: IMF staff estimates.

Figure 20. Difference Between Actual Equilibrium Real Effective Exchange Rate, January 1998–December 1996
(In percent of actual rate)



Source: IMF staff estimates.

The results shown in Figures 19 and 20 are quite striking: in the first part of the period up to the beginning of 1991 the REER is substantially misaligned with the equilibrium rate; since then, the REER has moved closer to equilibrium, and in spite of a subsequent overvaluation in the second half of 1995 and the beginning of 1996, at the end of 1996 the difference between the actual and its equilibrium rate is about 7 percent. This suggests that Egypt's real exchange rate has on average moved closer to its equilibrium rate in the past six years. The two sharp dips in the time series of the EREER represent the estimated impact of the Gulf war from August 1990 to March 1991.

The source of this change in the relationship between the actual and equilibrium real exchange rate is due to the large appreciation of the EREER in the period 1991–95. To better understand the sources of this appreciation, Table 16 presents the breakdown in the contribution of the different fundamental variables during the last six years of the sample. The largest contribution by far is that of the reduction in the debt-service ratio (*DEBT*), accounting for 122 percent of the increase in the EREER. The second largest contribution is technological innovation (*TECH*) accounting for 27 percent of the increase, followed by the impact of the conflict (*MECON*) 8 percent. The other variables contributed to a depreciation in the EREER, with the worsening of the terms of trade (*TOT*) accounting for a 28 percent decrease, capital controls accounting for a 20 percent decrease, and finally the scaling back of government consumption of nontradables accounting for a 9 percent decrease.

Overall, these results seem to confirm the sizable impact of debt rescheduling and forgiveness on the external position of developing countries. In the case of Egypt, in the period 1991–96 the rescheduling of Paris Club debt implied a cumulative reduction in the net present value of the outstanding foreign debt stock of 55 percent, thus reducing the debt-service ratio from 33 percent in 1991 to below 10 percent in 1996. At the same time, the EREER appreciated by about 35 percent. Moreover, indirect support for this analysis also comes from the parallel literature on the impact of official development assistance on developing countries' competitiveness; there it is shown that prolonged international aid, in the form of grants or concessional lending, will result in an (equilibrium) appreciation of the real exchange rate. The theoretical argument behind this result runs parallel to the impact of the reduction in a country's debt burden indicated above.

The main conclusion from the analysis above is that the lifting of this *debt overhang* has had a significant impact on the external position of the economy, which is in turn reflected in the appreciation of the real exchange rate. Mongardini (1998) shows how such empirical evidence is consistent with Edwards's model.

Summary of Results

The estimation of the equilibrium real exchange rate for Egypt suggests that while the real exchange rate was substantially overvalued at the turn of the

Table 16. Contribution of Economic Fundamentals to the Equilibrium Real Exchange Rate, January 1991–December 1996

(In percent)

	Elasticity	Contribution
Terms of trade (<i>TOT</i>)	1.2633	-28.37
Government consumption in percent of GDP (<i>GCN</i>)	0.6951	-9.28
Lagged capital account balance in percent of GDP (<i>KCON</i> ₋₁)	-6.3263	-19.57
Technical progress (<i>TECH</i>)	1.8125	26.94
Middle East conflict of 1990–91 (<i>MECON</i>)	-0.0545	8.28
Debt-service ratio (<i>DEBT</i>)	-0.7645	121.98
Total	-3.3744	99.99

Source: IMF staff estimates.

decade (by about 20 percent above the equilibrium rate over the period between 1989 and 1991), it has since moved into closer convergence with the equilibrium rate. The overvaluation averaged less than 10 percent between 1991 and 1996, and the convergence trend brought the actual real exchange rate in line with the equilibrium line by mid-1995. Although, the REER is estimated to have appreciated by 7 percent vis-à-vis the EREER as of the end of 1996, the current success in lowering inflation (4 percent during July–September 1997, a period that is outside the estimation sample) is likely to contribute to the correction of such a small deviation.

It is important to interpret these results with caution. While the econometric results are statistically significant, the derivation of the equilibrium real exchange rate is ultimately dependent upon the assumptions underlying Edwards's model. The results should not therefore be taken as a conclusive determination of Egypt's equilibrium real exchange rate. Rather, we intended to offer an alternative insight into the developments of Egypt's competitiveness over the past ten years. In addition, these results should not be interpreted as suggesting an appropri-

ate long-term growth strategy for the Egyptian economy. The theory of the equilibrium real exchange rate does not take into account the well-known benefits of a dynamic export sector, which is particularly relevant in Egypt's case, given that non-oil exports only account for about 3½ percent of GDP.

In the course of estimating the equilibrium real exchange rate, we concluded that the Paris Club debt relief phased in during the period 1991–96 had a significant impact on Egypt's real effective exchange rate. This result is consistent with the theoretical framework underlying the empirical investigation (see Mongardini, 1998). This is a novel result that may have important policy implications not only for Egypt but also for other developing countries that will benefit in the future from significant debt rescheduling, like those countries currently being considered for the multilateral initiative for highly indebted poor countries (HIPC).⁴²

⁴²For a summary of these initiatives as well as the benefits of debt relief in general, see IMF (1994).

VII Poverty, Social Safety Net, and Human Development Issues

Overview of Social Indicators

Despite improvements, Egypt is still a relatively low-income country.⁴³ While income per capita is well above the average for sub-Saharan Africa and also South Asian economies, Egypt ranked the 51st poorest out of 133 countries on the basis of income per person (see Table 17). Compared with similar countries in the region, Egypt only comes above Pakistan. Income per person in U.S. dollars is half that of Jordan, and less than a third that of Turkey. However, in terms of income expressed in purchasing power parity, Egypt compares favorably with Jordan and Morocco.

Nearly 12 percent of Egypt's population lives on less than \$1 a day (expressed at purchasing power parity), markedly higher than regional comparators, where data are available. Using poverty lines based on a minimum standard diet, about 44 percent of the population does not spend enough to obtain the nutritional minimum.⁴⁴ Certain groups are particularly disadvantaged. Women head about a third of urban low-income households and are twice as likely to be unemployed. Social indicators for women also lag behind those of similar regional countries; for example, female primary school enrollment is only 85 percent of the male enrollment rate.⁴⁵ The highest rates of poverty are in the rural areas of upper and lower Egypt. The average rural Egyptian is a third poorer, twice as likely to be ultrapoor and illiterate as the average urban inhabitant. The poorest households also have very old or very young members. The more children in a household, the poorer it is.

Egypt's health and education indicators also remain weak. Adult illiteracy, at 49 percent, is very high, although lower than for Morocco and Pak-

istan.⁴⁶ The quality of education remains low, with graduates lacking the essential training to acquire skills needed in the job market. Infant mortality is very high, only lower than that of Pakistan and almost twice that of Jordan and the Syrian Arab Republic. Life expectancy at 63 years is again only higher than Pakistan's, which broadly reflects the poor health situation.

There is a close link between the high prevalence of absolute poverty and rates of unemployment: estimates of unemployment range from 10 percent to 22 percent of the labor force. While not as high as Algeria's, Egypt's unemployment rate is probably one of the highest in the region. While rapid labor force growth is part of the explanation, about 560,000 new jobs must be created annually to absorb new entrants and dent the unemployment rate—faster labor force growth rates in Pakistan, the Syrian Arab Republic, Jordan, Tunisia, and Israel have not led to unemployment rates higher than Egypt's. Its adjustment program initiated in 1990/91, which centered on strong fiscal adjustment, especially subsidy reduction, has not appeared to have had any negative short-term impact on the poor. The incidence of poverty has remained remarkably stable between 1990/91 and 1995/96.⁴⁷ Inequality appears to have fallen in four of the eight regions over the past five years, and overall, the poorest quintile's share of total income has risen, narrowing the gap between rich and poor.

Social Safety Net Mechanisms

The main elements of Egypt's social safety net are consumer subsidies (both for major food items and nonfood household items, such as electricity and water), cash transfers and social insurance programs, income supplement and microcredit programs, and voluntary organizations' welfare and development programs. The Social Fund for Development was es-

⁴³This overview draws on material in the World Bank Country Economic Memorandum, "Egypt: Issues in Sustaining Economic Growth" of March 1997, and data reported are from the World Bank databases, unless otherwise indicated.

⁴⁴Based on household income, expenditure and consumption surveys carried out by the Egyptian authorities in 1995/96 and Cardiff (forthcoming).

⁴⁵Female primary school enrollment is, however, higher than in Morocco and Pakistan.

⁴⁶Adult illiteracy for women is 65 percent.

⁴⁷See Cardiff (forthcoming).

Table 17. Regional Human Development Indicators*(In percent, for 1995, unless otherwise specified)*

	Global GNP Per Capita Ranking ¹	U.S. Dollar GNP Per Capita	Population Growth Rate ²	Labor Force Growth Rate ²	Unemploy- ment ³	Percent in Poverty ⁴	Lowest Quintile Income Share ⁵	Life Expectancy at Birth	Adult Illiteracy	Primary Enrollment ⁶		Infant Mortality ⁷	Infant Mal- nutrition ⁸
										Female	Male		
Israel	113	15,920	3.5	3.5	6	...	6	77	...	96	95	8	...
Turkey	85	2,780	1.7	2.1	12	...	...	67	18	98	107	...	...
Tunisia	73	1,820	1.9	3	15	3.9	5.9	69	33	113	123	39	...
Algeria	69	1,600	2.2	4.1	28	1.6	6.9	70	38	96	111	34	9
Jordan	68	1,510	5.7	5.3	14	2.5	5.9	70	13	95	94	31	17
Syrian Arab Republic	59	1,120	3	3.5	9	...	...	68	...	99	111	32	...
Morocco	58	1,110	2	2.6	23	1.1	6.6	65	56	60	85	55	9
Egypt	51	790	2	2.7	10-22	7.6	11.9	63	49	89	105	56	9
Pakistan	35	460	2.9	3.3	5-10	11.6	8.4	60	62	49	80	90	40

Sources: All series from World Bank, *World Development Report* (Washington, 1997), except unemployment, which are IMF staff estimates.¹Ranking from 1 (lowest) to 133 (highest).²Average 1990-95.³Latest available data. For Egypt and Pakistan, lower estimate is official and, higher estimate is Central Intelligence Agency.⁴Percentage of population living on less than \$1 a day (at purchasing power parity), 1981-95.⁵Share of income or consumption. Latest available data. Data for Egypt relate to 1995/96.⁶Data refer to 1993, except Egypt, 1995.⁷Per 1,000 live births.⁸Percent of children under five that are malnourished.

established in 1991 to cushion the impact of adjustment on the poor.

Consumer Subsidies

Generalized food subsidies have traditionally been a major component of the social safety net.⁴⁸ They proved to be very expensive and have been greatly pared down. Currently, only bread, wheat flour, edible oil, and sugar are subsidized. Bread and wheat flour (mainly sold to private bakeries) are available without restriction; edible oil and sugar are distributed on a monthly quota basis to consumers through ration cards. Only the two most basic forms of bread, *shami* and *balady*, are subsidized.

Bread is the staple food, with average consumption of about two and a half loaves a person a day, making up about 37 percent of the total daily calorie consumption. The bread and wheat flour subsidy amounted to about 1 percent of GDP in 1996/97. While the subsidy is not explicitly targeted, because the food is consumed proportionately more by the poor who rely heavily on it, it is effectively self-targeted.

Piped water is heavily subsidized for domestic, especially low-volume, consumers. A lack of reliable and consolidated information makes it difficult to estimate the aggregate water subsidy. Electricity is used by the poor, but predominantly only for lighting, and small residential consumers are cross-subsidized by large commercial customers. Oil products, despite recent price increases, also remain subsidized. The main subsidies are for fuel oil, kerosene (heavily used by the poor), and gas oil.

Social Fund for Development

To cushion the impact of the economic reform program adopted in 1990, the SFD was established in 1991. It was intended to assist, in the short term, low-income groups most directly affected by the economic reform and to strengthen the government's institutional capacity to design and monitor poverty alleviation policies.

For the first phase of the SFD, the specific target groups identified by a program of surveys were women and children; new graduates; unemployed youth; small entrepreneurs; and employees leaving public sector jobs. The core SFD programs are the following:

(1) *The public works program* attempts to improve basic services and infrastructure in rural and low-income areas by creating temporary employment by funding labor-intensive projects (typically roads, water, and irrigation-related projects).

(2) *The community development program* has two projects: productive activities project centering on employment-generating activities, and the micro and cottage industry level. The social development activities project aims at improving the delivery of basic community services (mainly health and education).

(3) *The enterprise development project* creates jobs by lending (via banks) to small and micro enterprises.

(4) *The employment and retraining project* funds programs that assist public sector workers whose firms are restructured.

(5) *The institutional development project* aims to improve the government's ability to identify and monitor the impact of economic and social policy on living standards.

All the major components of the SFD's work will continue in the second phase following the generally positive assessment of the first phase. Greater emphasis will be placed on targeting, sustainability, decentralization, and impact assessment. The small business program is to become an independent, permanent, body lending to a wider range of small businesses (estimated at 20,000–25,000 a year). The labor retraining program will also be expanded to include skills development and will be retitled human resource development. The public works project is being scaled back (by almost half) following donor and government opinion that this should be the responsibility of line ministries. The community development program has been doubled. More resources will be spent on working with local institutions and nongovernmental organizations (NGOs).

⁴⁸This section is based on Ali and Adams, Jr. (1996).

VIII Privatization and Restructuring the Public Sector

The principal objectives of this section are to (1) review the size and operations of the Egyptian public sector; (2) assess the major changes of the public sector contribution to economic activity and the performance of state enterprises over the stabilization period; and (3) assess the performance of the privatization program, particularly in the period from early 1996 when the program was more aggressively promoted.

In broad terms the following conclusions are reached:

- The public sector accounts for a large share of economic activity—about one-third of economic output and employment—in Egypt, which has not really diminished over time.
- The scope of Egypt's current privatization plan will increase the share of the private sector economic activity, although an intensification of the effort—in downsizing the civil service, in divesting the banking and insurance sectors, and in widening the privatization program to encompass infrastructure—will be required to maximize its benefits.
- The performance of the public enterprise sector (under Law 203) in the late 1980s and 1990s was very poor, as reflected in a number of financial and economic indicators. Aggregate profits declined sharply and indebtedness rose, while rising unit labor costs and a striking decline in total factor productivity averaging about 3 percent a year signaled deteriorating competitiveness.
- The magnitude of the recent privatization effort since January 1996 has been remarkable: the divestiture so far represents about 35 percent of the initial portfolio, and the market value of companies privatized accounts for about 7 percent of GDP. The pace of privatization that has been established also compares very favorably with recent international experience.

Scope and Operations of Public Sector

In Egypt, the public sector encompasses a wide variety of entities and economic activities. The main

elements of the public sector in early 1996, at the start of the intensified reform program were:

- the central government, comprising all the line ministries, and local governments;
- the service authorities, about 100 in number and consisting of (1) various regulatory bodies in agriculture, industry, transportation and communication, trade, finance (including the capital market authority), housing and reconstruction, and health; (2) the educational institutions, including the universities; and (3) assorted other bodies in culture, tourism, and presidential services;
- the economic authorities, over 60 in number including those responsible for power generation, telecommunications, the Suez Canal, the petroleum company (EGPC), the railways and national airline, the post office, government supplies, and water and port authorities;
- the nonfinancial public economic enterprises, about 314 in number (called affiliated companies) and covered by Law 203, which are largely concentrated in the industrial sector, but also include hotels, electricity distribution companies, and transport and port-related companies. These affiliated companies are distributed between and controlled by 17 holding companies. The affiliated companies in turn own holdings in about 184 joint-venture companies, which are partnerships between the private and the public sectors. In addition, a few large industrial enterprises—military production, iron and steel, and so forth—that fall under Law 97;
- the banking sector, comprising the 4 public commercial banks, 26 joint-venture banks, and 21 public specialized banks, which are in turn supervised by the CBE;
- the insurance sector comprising the three public insurance companies, a reinsurance company, and five joint venture insurance companies, which are supervised by the Egyptian Insurance Supervisory Authority (EISA); and finally,

- the public pension fund and social security systems, and the National Investment Bank (NIB), which invests the surplus of contributions to social funds over payments.

Public Sector Output Contribution

The public sector entities enumerated above can be roughly mapped by economic sectors in order to gauge their contribution to total output as follows:

- central and local governments and service authorities correspond to the economic category of government services;
- economic authorities correspond to the agglomeration in the national accounts of petroleum, electricity, construction, transport and communication, Suez Canal, and public utilities;
- the Law 203 companies and other publicly owned enterprises under Law 97 correspond to the category of industry and mining, trade, housing, and restaurants and hotels; and
- banking, insurance, and pension funds are the main components of financial services.⁴⁹

The overall quantitative contribution of the public sector in GDP has remained virtually unchanged in the last decade (Table 18). The relative stability of the public sector share can be analyzed through a decomposition into a *privatization* effect and a *composition* effect. The privatization effect relates to the change in the contribution of the private sector within each sector of activity. The private sector's role has been increasing in virtually every sector except petroleum, with relatively large increases in participation in industry, mining, construction, trade, and finance.

Despite the increasing privatization of economic activity, owing to the composition effect, the overall output of the private sector in the economy has not posted commensurate gains. Output growth has been skewed toward sectors where the public sector has a higher-than-average share of activity and away from sectors where public sector activity is low. The composition effect is most pronounced in relation to agriculture, which is almost entirely in the hands of the private sector, where output has declined from 20 percent to 16 percent of GDP. By contrast, in the petroleum sector, where the public sector is increas-

ingly dominant, the share of output has increased from 3 percent in 1987/88 to 9 percent in 1995/96. The composition effect has worked in favor of raising the aggregate share of the private sector in both government and social services sectors whose weight in GDP has declined modestly.

In terms of the size of the government as an employer, in 1995/96, 34 percent of the labor force was employed in the government, slightly below the public sector share of value added (see Table 19). Within the public sector, over 4 million were employed in the central and local government and service authorities, 0.96 million in the public enterprise sector, and economic authorities employed about half a million personnel.

In all likelihood, the data presented understate the size of the public sector. In relation to GDP, the underestimation arises because the national income accounts do not include grant-financed military expenditures, which constitute about 3 percent of GDP. Also, the joint-venture companies in the industrial sector (about 184) are classified as private sector, whereas in reality some of them are majority owned or controlled by the public sector. In relation to employment, the underestimation of the size of the government arises because military personnel (estimated at about 450,000–500,000) are excluded.

The largest contributors to GDP are the economic authorities (18 percent of total GDP), which account for less than 3 percent of the total labor force. At the other extreme, the civil service (comprising the central and local governments and service authorities) accounts for about 7 percent of total economic activity but a disproportionate share (24 percent) of the total labor force and nearly two-thirds of total government employment. The public enterprise sector, including the Law 97 companies, produces about 10 percent of the economy's GDP, while employing about 6 percent of the total labor force. Thus, within the government, labor productivity as measured by the output per employee is the highest in the economic authorities and lowest in the civil service.

Financial Operations Within the Public Sector

Financial relations between the various public sector entities are complex and, in some cases, not particularly transparent or conducive to efficient use of public resources. The ongoing rationalization of financial relations will contribute toward enhancing the efficiency of the public sector and assist in deepening the privatization program. Table 20 summarizes the nature and magnitude of financial relations between different government entities.

⁴⁹This mapping is not exact in a few cases, for example, the electricity distribution companies, which are part of the electricity sector in the national income accounts, fall under Law 203. Similarly, there are some Law 203 companies in the transport and communications sector and hotel sector that do not belong in the category of industry and mining in the national accounts.

Table 18. Gross Domestic Product by Ownership¹

(In percent)

Sector	1987/88		1991/92		1995/96	
	Share of sector in total GDP	Share of private sector in sectoral output	Share of sector in total GDP	Share of private sector in sectoral output	Share of sector in total GDP	Share of private sector in sectoral output
Agriculture and irrigation	20.2	98.6	16.5	98.8	16.0	98.7
Industry and mining	17.1	49.8	16.6	58.1	17.6	62.2
Petroleum	3.3	26.8	9.9	17.3	9.4	16.1
Electricity	1.1	0.0	1.7	0.0	1.7	0.0
Construction	5.7	65.5	5.1	70.8	5.1	72.1
Transportation, communication, and storage	8.1	35.1	11.3	28.1	10.5	33.4
Trade, finance, and insurance	22.1	70.6	20.1	79.2	20.8	81.5
Restaurants and hotels	1.2	84.4	1.8	84.7	1.7	85.2
Housing	3.2	93.7	1.8	94.6	1.8	94.4
Utilities	0.3	0.0	0.3	0.0	0.3	0.0
Social insurance	0.1	0.0	0.1	0.0	0.1	0.0
Government services	9.0	0.0	7.1	0.0	7.2	0.0
Social services	8.6	100.0	7.6	100.0	7.7	100.0
Total	100.0	64.1	100.0	61.2	100.0	63.3
<i>Memorandum items</i>						
Primary sector	20.2	98.6	16.5	98.8	16.0	98.7
Manufacturing ²	20.4	46.0	26.5	42.8	27.0	46.2
Services	59.4	58.5	57.0	58.9	57.1	61.5

Sources: Data provided by the Egyptian authorities; and IMF staff estimates.

¹Figures for 1987/88 are at 1986/87 prices, while those for the other years are at 1991/92 prices.²Includes petroleum.**Table 19. Size and Composition of Public Sector by Type of Entity**

Public Entity	Share of Public Sector Output	Public Sector Share in Total GDP	Employment	Distribution Public Sector Employment	Public Sector Employment as Share of Labor Force	Public Sector Output Per Employee
	(In percent)		(In thousands; 1995)	(In percent)		(In Egyptian pounds)
Central and local government and service authorities	19.4	7.3	4,089	73.2	24.9	2,592
Economic authorities ¹	46.7	17.5	455	8.1	2.8	56,044
Public enterprise sector ²	25.8	9.6	964	17.2	5.9	14,627
Banking sector	7.0	2.6	65	1.2	0.4	58,462
Insurance	0.1	0.0	16	0.3	0.1	3,438
Social insurance	0.2	0.1	n.a.	n.a.	n.a.	n.a.
Others ³	0.9	0.3	n.a.	n.a.	n.a.	n.a.
Total	100.0	37.4	5,589	100.0	34.0	9,779

Sources: Central Bank of Egypt, *Annual Report*, 1994/95; and IMF staff estimates.¹Includes petroleum, electricity, transportation and communication, Suez Canal, and public utilities.²Includes industry and mining, construction and building, trade and restaurants, and tourism and hotels.³Includes agriculture and real estate.

Budget

The budget encompasses the activities of the central and local governments and the public service authorities. It also includes the investment expenditures of the economic authorities and their associated financing.⁵⁰ The budget, until recently, guaranteed the loans contracted by the economic authorities. Public investment in the budget is financed by borrowing from the NIB, which really amounts to captive government borrowing from the pension funds.

Public Enterprises

Since 1992/93, public enterprises have been excluded from the budget and have not received explicit budgetary transfers or subsidies, although budgetary arrears to these enterprises remain. Public enterprises' outstanding debt to the banking system amounts to about LE 32 billion, of which about 60–70 percent is estimated as doubtful or bad debt. These debts are expected to be settled from privatization proceeds. There are also unresolved financial issues between the public enterprises and the economic authorities, especially between the electricity distribution companies and the electricity authority. Public enterprises also have outstanding financial obligations to the NIB estimated at about LE 10 billion, some of which is being progressively converted from debt to equity.

Social Insurance and Pension Funds

The social insurance and pension fund receives employer contributions from the central government and annual payments to compensate beneficiaries for the inflation-induced erosion in their benefits. The excess of inflows (including the returns on investments with the NIB) over current payments is transferred to the NIB, which is the de facto pension fund manager. These surpluses are lent to the government to finance public investment. The outstanding deposits of the pension fund with the NIB amount to about LE 67 billion and are currently remunerated by the NIB at about 13 percent. The NIB in turn charges the government about 13 percent interest for loans, which is well above the current treasury bill rate of about 8.8 percent, offering scope for rationalization.

⁵⁰One implication of this partial assimilation of the economic authorities in the budget is that measured public saving could be incorrect insofar as the true financial position of the economic authorities is different from that reflected in the budget, where transfers to the economic authorities are identically equal to their investment. But if economic authorities are actually incurring losses, that is, dissaving, this would not be reflected in the budget. Another classification issue that needs to be borne in mind is that private investment in the national income accounts includes that undertaken by the public enterprise sector.

Between 1981–89, the average return on the pension funds (in turn reflecting NIB's lending to government, the economic authorities, and the public enterprises) was minus 12 percent in real terms.

The Reform Agenda

A central objective of the Egyptian Government's program of economic reforms is to increase the level of real growth, with a greater role for the private sector envisioned as one of the principal policy instruments. The description above facilitates an assessment of the likely quantitative impact of the policy reforms undertaken by the Egyptian Government. The elements of the reform that would have an impact on the size and role of the government are:

(1) *Civil service reform*: The government envisages a reduction in the size of the civil service by 2 percent a year. This would affect 7 percent of output and 25 percent of the labor force.

(2) *Privatization of nonfinancial enterprises*: The government is committed to reducing the size of Law 203 companies by about one-third in each of the two years of the program. If successful, this would reduce the public sector's role in industrial sector activity by about 25 percentage points, from 38 percent to about 13 percent; and in total output by about 6.4 percentage points of GDP from about 9.6 percent to 3.2 percent.

(3) *Privatization of the banking system*: The government's reform program, envisaging the privatization of the joint-venture banks and one of the public sector banks, would bring roughly half the sector into private sector control from the current 70 percent. In terms of overall GDP, about 1 percent to 2 percent of additional output would pass from public sector to private sector control.

(4) *Privatization of insurance companies*: The government's reform effort would bring another third of the sector into private hands.

(5) *Privatization of infrastructure*: Although not strictly part of the Stand-By Arrangement, the government has avowed greater private sector involvement in relation to a number of infrastructure sectors, which together account for about 18 percent of GDP. One difference from the other privatization initiatives is that in relation to infrastructure, private sector involvement is likely to take the form of acquisition or management of new rather than existing assets. Thus, in electricity, airports, and some port facilities, new investments will be open to the private sector in the form of build-operate-transfer (BOT) projects.

Table 20: Financial Transactions Between Public Entities

	Budget ¹	Banking Sector	Economic Authorities	National Investment Bank
Budget		Borrows from the central bank and the banking system and maintains deposits. Currently, government's borrowing from (deposits with) the CBE amounts to LE 32 (27) billion, and borrowing from (deposits with) from the rest of the banking system about LE 48 (15.4) billion.	Investment expenditures and financing of economic authorities (EAs) included in budget; Budgetary arrears to EAs estimated at LE 4 billion; government guarantees loans contracted by EAs and has repaid about LE 7 billion on behalf of EAs.	Borrows from National Investment Bank (NIB). Outstanding debt to NIB about LE 45 billion. Interest rate on debt varies considerably. Government amortization payments shown above the line.
Law 203 companies	Excluded from budget; budgetary arrears to these companies estimated at LE 12 billion.	Outstanding debt to banking system about LE 32 billion of which about 60–70 percent is estimated as doubtful or bad. Deposits amount to LE 19 billion.	Electricity distribution companies owe about LE 3 billion in arrears to the electricity authority.	Outstanding debt of Law 203 companies about LE 10 billion; extent of bad or doubtful debt unknown.
Social insurance and pension fund	Budget contributes to pension fund in the form of employer's contribution as well as annual top-up for inflation-related benefits to beneficiaries.			Pension fund transfers excess of inflows (which includes returns on deposits with NIB) less payments to beneficiaries to NIB, which finances government investment expenditures. Outstanding deposits of pension fund about LE 67 billion and currently remunerated by NIB at about 13 percent above treasury bill rate.
National Investment Bank		NIB cannot borrow from banking system but operates a deposit account at the CBE.	Outstanding debt of EAs to NIB about LE 10 billion. Size of debt and arrears unknown.	
Economic authorities		Borrowings from (deposits with) banking system are LE 9 (17) billion.		

Source: Data provided by the Egyptian authorities.

¹ Central, local government, and service authorities.

The Public Enterprise Sector, Law 203

To improve public enterprise performance, a public enterprise law was approved in 1991, known as Law 203; it aimed to increase commercial orientation, management accountability, and autonomy of

public enterprises. Most public enterprises were delinked from the line ministries and brought under 27 newly created holding companies. A further reorganization was implemented in 1993 to reduce the number of holding companies to 17 and to prevent sectoral concentration under any one holding company. The holding companies were responsible for

Table 21. Indicators of Public Enterprises' Financial Performance*(In billions of Egyptian pounds, unless otherwise specified)*

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Operating revenues	36.7	44.1	48.9	50.4	52.4	55.5	55.1
Other revenues	4.5	5.8	6.8	6.7	7.1	7.5	4.3
Wages and salaries	4.0	4.5	4.8	5.2	5.5	5.8	6.1
Earnings before interest and tax	...	4.6	6.3	7.5	8.4	9.1	9.8
Interest	1.8	2.2	3.3	4.0	4.2	4.1	4.1
Profits of profitable companies ¹	1.5	1.8	2.1	2.5	3.1	3.6	3.9
Losses of losing companies	-0.3	-0.6	-1.6	-2.5	-2.4	-2.4	-3.3
Net profits	1.2	1.2	0.5	0.0	0.7	1.1	0.7
Number of profitable companies	260	254	224	204	214	202	196
Number of losing companies	54	60	90	108	99	88	92
Number of companies left as under Law 203	314	314	314	312	313	290	288
Carried loss balances	-2.0	-2.4	-3.9	-6.2	-7.9	-9.8	-12
Net assets ²	...	62.5	69.6	76.7	84.8	88.3	90.3
Total debt ³	...	47.1	53.5	60.8	67.6	70.4	74.9
Net equity ⁴	...	10.7	10.6	9.9	9.5	10.1	8.6

Source: Data provided by the Egyptian authorities.

¹After tax.²Net of provisions for depreciation and for accounts receivable.³Includes trade credits and about 50 percent of accounts payable.⁴Includes reserves.

approving the business plans of the public enterprises, assessing their restructuring needs, and initiating the plans for their privatization. In addition, a Public Enterprise Office (PEO) was established in November 1991 as part of the newly created Ministry of Public Enterprises.

Financial and Economic Performance of Law 203 Companies

Variable standards of accounting and reporting complicate the assessment of the true financial health of the Egyptian public sector. Since the late 1980s, the financial performance of Law 203 companies has been poor and has deteriorated over time (Table 21). Of the 314 companies that constituted the initial portfolio, 54 were financially unprofitable compared with about 100 companies today, that is, about one-third of the current portfolio comprises loss-making companies. Aggregate profits, about LE 1.2 billion in 1989/90, have declined to LE 0.7 billion, representing a drop of over 70 percent in real terms; as a result, the accumulated losses carried on the balance sheets have increased from LE 2 billion in 1989/90 to LE 12 billion at the end of June 1996. The variance of profits among Law 203 companies has also risen from a combination of sharply rising profits in some companies and sharply rising losses in others.

In addition, the return to capital for Law 203 companies shows a deteriorating trend as indicated by Galal (1996). The ratio of net current surplus to revalued capital employed, which measures the returns to capital if it were purchased at market prices today, was about 5–5.5 percent during the 1990s, and the ratio of after-tax profits to net worth declined from about 11 percent in 1988/89 to 7 percent in 1993/94. Rising indebtedness (including accounts receivable) during the 1990s, from LE 47.1 billion in 1990/91 to about LE 75 billion today, also points toward a less comfortable picture than suggested by aggregate profit figures. Loss-making companies, comprising about one-third of the total portfolio, accounted for close to 70 percent of overall debt, which not only accords with anecdotal evidence of weak corporate governance but also reflects indirect subsidization of the public sector through the banking system.

The weak financial performance of public sector enterprises has been reflected in adverse developments of broader economic indicators of public sector performance (Table 22). Over the past six years, gross value added of all Law 203 companies has grown on average at about 11 percent, and in real terms has declined at about 7 percent a year. Declining efficiency is reflected in sharp adverse movements in a number of productivity indicators. Since 1989/90, unit labor costs in the public sector have risen by about 16 percent a year in local currency

Table 22. Indicators of Public Enterprises' Economic Performance*(In annual percent change, unless otherwise specified)*

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Gross value added (in billions of Egyptian pounds)	9.2	10.2	10.8	11.1	12.0	13.0	12.4
Gross value-added growth	...	10.8	5.7	3.2	8.4	7.8	-4.4
Gross real value-added growth ¹	...	-14.6	-11.3	-8.9	5.4	-3.2	-9.8
Number of employees (in thousands)	1,083	1,063	1,061	1,045	1,008	964	908
Labor productivity of growth	...	-13.0	-11.1	-7.5	9.3	1.2	-4.2
Total factor productivity growth ²	...	-14.0	-9.2	-1.6	10.3	-0.7	n.a
Unit labor cost growth	...	31.0	19.9	19.2	1.0	8.9	16.1
Profitability index	...	-0.9	-0.7	-4.9	1.8	2.3	-8.8
International competitiveness (1989/90 = 100) ³	100	100.1	109.5	139	160.9	165	186
Nominal wage growth	...	13.9	6.6	10.3	10.3	10.2	11.2
Real wage growth	...	-0.7	-11.9	-0.8	1.2	0.6	3.7
Dollar wage growth	...	-33.8	-14.6	9.5	9.5	9.9	11.2
Gross saving (in billions of Egyptian pounds) ⁴	2.6	2.7	2.3	2.0	2.8	3.2	2.9
Gross saving (in percent of GDP)	2.9	2.4	1.7	1.3	1.6	1.6	1.3
Depreciation (in billions of Egyptian pounds)	1.4	1.5	1.8	2.0	2.1	2.1	2.2

Source: Data provided by the Egyptian authorities.

¹Nominal value added deflated by price deflator for industry.²Capital stock series obtained from Galal (1996); capital deflator from IMF's World Economic Outlook database; capital's share in output, following Sarel (1997) was assumed to be 0.308.³Growth in unit labor cost of Egyptian public sector against that in partner countries measured in a common currency. Rising value denotes deterioration in competitiveness.⁴Galal (1996). Understates saving because it excludes certain provisions for taxes.

terms. Relative to U.S. dollar unit labor costs in partner countries, competitiveness of the Egyptian public sector has deteriorated cumulatively by about 86 percent. Another indicator of declining profitability is the ratio of prices to unit labor costs in the public sector that has reduced the returns to capital, a symptom also reflected in the rising share of wages to value added. Most tellingly, total factor productivity during the early 1990s declined at about 3 percent a year, notwithstanding an employment decline of about 2.6 percent a year.

Lackluster export performance in Egypt has its roots in an inefficient public sector, which has accounted on average for about 50–60 percent of Egypt's non-oil exports. Stagnant public sector exports, coupled with a relatively small, albeit dynamic private sector, have entailed poor export performance in the aggregate.

Real wages in the public sector have remained constant through the 1990s, while employment has declined significantly—by about 180,000 (almost 20 percent of the public sector workforce). Although this accomplishment results in part from a change in composition, namely, the transfer of public sector companies to private hands, downsizing of the labor force without social discontent ranks as one of the major accomplishments of the reform program.

The public sector's contribution to national saving (including taxes paid) declined from about 4 percent of GDP to 2 percent (Galal, 1996); in the late 1980s, the public sector exerted a large claim on economy-wide resources as high investment (at about 6–8 percent of GDP) exceeded savings. Since 1990/91, the demands of stabilization and attendant fiscal adjustment compressed investment in the public sector so that by the early 1990s, it became a net saver. Nevertheless, in light of its inefficiencies, substantial scope for generating more savings in the public sector remains (see Box 3).

Review of Privatization

The total privatization effort has involved the sale of interests in 84 companies with a market value of about LE 17.7 billion, which represents about 7 percent of GDP, and about 35 percent of current market value of the initial privatization portfolio. Privatization can be divided into two phases. During the first phase running from 1993/94 to January 1996, 3 companies were sold outright to the private sector (anchor investor sales) and 16 were partially divested (proportions ranging from 5 percent to 20 percent), through the stock market. The second phase has seen

Box 3. Impact of Privatization on Increasing Saving

The Egyptian Government's objective of achieving a consistent rate of growth of 7 percent hinges on raising the level of investment and domestic saving. The latter is estimated to rise from the current level of about 18 percent of GDP to about 24–25 percent of GDP in the medium term. A bulk of this increase is expected to come from nongovernment saving, in particular, aided by the privatization program. What orders of magnitude can be expected in the Egyptian case?

Privatization is likely to take two forms: privatization of the profitable companies and liquidation of the loss-making companies the latter involving stripping and selling a company's assets, as well as retrenchment and redeployment of labor. The impact on savings in the first case will arise from more efficient operation, yielding higher profits and savings, including through greater investment. This impact could take time as changed ownership and improved management practices take effect. On the other hand, the impact on saving (rather on dissaving) through liquidation could have an immediate impact as unprofitable operations are discontinued.

This impact, which needs to take account of the severance payments that would have to be paid out to the labor that is rendered redundant, can be approximated as follows. The losses of loss-making enterprises in 1994/95 amounted to about LE 3.3 billion (1.6 percent of GDP). Liquidation could arrest dissaving of this magnitude. Offsetting the reduced dissaving would be the one-off severance costs, which would be about LE 4 billion at the current rate of compensation (LE 16,000 per employee for about 250,000 employees). Donors, through the Social Fund, are expected to defray about 30 percent of these costs. The burden on the budget (directly or through foregone privatization receipts) would be about LE 2.8 billion (1.4 percent of GDP). Hence, for a one-off reduction in savings of 1.4 percent of GDP, there would be an annual (permanent) reduction in dissaving of about 1.6 percent of GDP. The impact of liquidation can therefore be significant.

The impact of increases in saving through privatization of profitable companies has been estimated by Galal (1996). According to his estimates, privatization of 50 percent of public enterprises could augment saving by about 2.1 percent of GDP, a large part of which would be accounted for by an assumed increase in investment that is expected to result from privatization, and the rest by an increase in total factor productivity of about 1.5 percent a year. Total saving from the above two channels could therefore yield about 3–3.5 percent of GDP in the medium term.

a discernible acceleration in the pace of privatization, with 65 companies sold, supported by a deep-

ening of the preparatory effort, as well as broadening in the types of companies sold and the modalities employed. Table 23 summarizes the achievements of the program so far.

Out of the original portfolio of 314 companies, the government has sold controlling interests in 68, and minority interest in another 16:

- Majority interest privatization has been effected through sales to anchor investors (7), flotations through the stock market (32, the predominant modality), liquidation of companies (18), sales of constituent assets of companies (1), and sales to Employee Shareholder Associations (ESAs) (10). The current market value of these privatized companies is about LE 14 billion (about 5.6 percent of GDP). Majority privatization involved selling, on average, a substantial portion—about 78 percent—of the government's stake in the enterprises, well above the minimum of 51 percent, to assure investors about the government's seriousness in this area. The companies that have been privatized have been spread over a number of sectors including agriculture, real estate and construction, food and beverages, milling, pharmaceutical, cement, chemicals and fertilizers, engineering, retail, and textiles.
- Sale of minority interest involved an average divestiture by the government amounting to about 34 percent. The market value of these companies is about LE 9.9 billion (about 4 percent of GDP).

Proceeds from the privatizations completed between January 1996 and the end of June 1997 amounted to LE 5.2 billion (a little over 2 percent of GDP). Of this amount, about 40 percent was used to settle debts owed to the banking system, 55 percent has been transferred to the banking system en route to being transferred to the budget to retire debt; the remainder has been used to restructure labor.

How does Egypt's current privatization effort compare with recent international experience? Table 24 shows the receipts from privatization for a number of countries—industrial, developing, and transition—since 1980. A number of European and Latin American countries have undertaken large programs as reflected in the receipts from privatization. However, when the effort is normalized to take account of a country's relative size and the pace of privatization—the indicator being privatization receipts a year as a share of GDP—Egypt's recent experience ranks among the top four countries. Its privatization rate, of about 1.5 percent of GDP a year, is bettered only by Hungary, Malaysia, and the Czech Republic. The performance is especially remarkable because a major share of privatization receipts for many of the

Table 23. Privatization Program, January 1993–September 1997*(In millions of Egyptian pounds, unless otherwise specified)*

	Number of Companies	Percent of Company Sold	Book Value of Equity (June 30, 1993)	Market Value of Equity (Sept. 1997)	Market Value of Equity Sold (Sept. 1997)
Majority privatization					
Of which	68	78.5	2,949	14,283	10,528
Anchor investor sales	7	91.0	251	1,737	1,593
Stock market flotations	32	65.3	1,712	10,397	6,786
Liquidations	18	100.0	123	1,404	1,404
Sale of constituent assets	1	100.0	500	500	500
Sale to employee shareholder associations	10	95.0	364	245	245
Minority privatization (stock market flotations)	16	34.1	1,360	9,901	3,374
Total privatization effort ¹	84	64.5	4,310	17,657	13,902
Total portfolio (as of June 1993)	314	n.a.	10,100	50,400	50,400
Total effort (in percent of initial portfolio)	26.8	n.a.	42.7	35.0	27.6

Source: Data provided by the Egyptian authorities.

¹In column 4, the entire market value of a company is deemed as the privatization effort for majority privatizations; for minority privatizations, only the amount sold is included in the privatization effort.

countries in Table 24 emanated from privatizing the infrastructure sector, which has yielded large revenues, involving few transactions. Egypt's privatization effort so far does not encompass this sector, yet it has been able to establish a pace of privatization that compares very favorably with recent international efforts at privatization.

Outstanding Issues in Privatization

The Egyptian privatization effort since 1996 has been remarkable. Can the pace be sustained and can the government achieve its target of divesting its stake in two-thirds of the public sector by the end of 1998? The deteriorating quality of the remaining portfolio gives reason to anticipate a deceleration in the pace. Of the 84 companies sold thus far, about 60 percent have involved privatization of profitable companies. To be on course for the overall target, an increasing share of the privatization effort will need to involve unviable or marginal companies, which will be more difficult; for unviable companies, job losses and the associated financial costs will have to be incurred. On the other hand, for marginal companies, successful sales can be effected only if the sale

price is low enough to reflect the underlying financial situation of the company or, if financial restructuring is undertaken, large costs may need to be incurred prior to sale.

Owing to the relatively low wage rates, the costs of restructuring in Egypt are not high and do not pose an insurmountable obstacle to privatization. The average annual wage (and benefits) per employee in 1995/96 amounted to LE 6,500. Given the norm that voluntary redundancy entails a payment of three years' salary and benefits and assuming that about one-third of the labor force is excessive, the total costs of labor restructuring will require a one-time expenditure of LE 6 billion (\$1.7 billion) which amounts to about 2.5 percent of GDP, an amount that can be absorbed by the government without great difficulty. Donors through the SFD have committed to defraying about \$200 million of these costs, ameliorating to some extent the fiscal burden of labor restructuring.

One of the major difficulties in initiating the privatization program, and in gaining public acceptance for it, relates to the pricing of public sector assets. The government had to strike a balance between setting a price that would be attractive for investors in a new, unfamiliar market, and high enough to con-

Table 24. Cross-Country Privatization Record*(In billions of U.S. dollars, unless otherwise specified)*

Country	Years	Cumulative Privatization Receipts	Privatization Receipts a Year	
(In percent of GDP) ¹				
Transition economies				
Hungary	1989–95	8.0	1.14	3.0
Poland	1990–95	3.0	0.50	0.6
Czech Republic	1993–95	2.3	0.77	1.9
Developing economies				
Mexico	1988–95	27.3	3.41	1.1
Argentina	1988–95	18.2	2.28	1.2
Chile	1973–91	3.4	0.38	1.2
Brazil	1989–95	9.7	1.39	0.3
Venezuela	1990–95	2.5	0.42	0.7
Philippines	1989–95	3.4	0.49	0.9
Malaysia	1988–95	9.2	1.15	2.1
Industrial economies				
United Kingdom	1979–95	96.7	6.04	0.8
France	1985–95	34.1	3.41	0.3
Italy	1985–95	17.0	1.70	0.2
New Zealand	1985–95	9.0	0.90	2.2
Spain	1985–95	8.3	0.83	0.2
Canada	1985–95	7.6	0.76	0.2
Portugal	1985–95	5.3	0.53	0.8
Egypt	1996–97	1.5	1.02	1.5

Sources: World Bank Privatization Database; and data provided by the Egyptian authorities.

¹GDP figure is average for the years covered by the privatization and is obtained from the IMF's World Economic Outlook database.

vince the public that assets were not being sold too cheaply. The response to this dilemma was heavy recourse to the stock market to effect the initial sales, where a relatively transparent process of attracting investors ensured that the public's fears could be allayed. The relative lack of anchor investor sales in the overall privatization effort, which involves a less transparent process of bilateral negotiations with investors, reflects in part the continuing need to establish credibility on the issue of asset valuation.

The problem of pricing may be critical in the case for companies that are marginal. Given that the government has correctly ruled out the restructuring of marginal and unviable companies prior to sale, privatization of such companies would necessarily entail setting low, even negative, prices to foster investor interest. Another impediment to efficient pricing relates to the role of the Central Auditing Agency (CAA), the government's watchdog, which has often assessed Law 203 companies beyond investor perception of reasonable value, complicating the task of the government in setting prices. To some extent, the government has overcome problems re-

lated to pricing by instituting a tripartite committee, comprising representatives from the PEO, CMA, and the CAA, which is able to balance the conflicting requirements and arrive at a workable solution.

Possible approaches to overcoming problems related to anchor sales include publicly announcing regulations and guidelines pertaining to these transactions. Committing to transparency and certainty of procedure, by imposing ex post costs for reneging on this commitment, could avoid arbitrariness in decision making and attendant loss in credibility.

Labor participation in and endorsement of the program of privatization was seen as essential to its success, as evidenced by the lack of social discontent in the face of employment reductions. Initially, labor participation took the form of selling minority stakes to ESAs—ranging from 5 percent to 10 percent. While this was seen as an essential palliative for furthering privatization, majority sales to ESAs were seriously questioned. Legal, economic, and political concerns underlie the perception that sales to ESAs did not represent genuine transfer of ownership to the private sector.

Table 25. Performance of Employee Shareholder Association-Held Companies

(In millions of Egyptian pounds, unless otherwise specified)

Company	Preprivatization Profit ¹	Postprivatization Profit ²	Change (In percent)
Egyptian Akareya	6.7	11.4	69.3
Consulting Office for Design	0.3	0.3	-11.3
Regwa	2.1	5.3	153.5
Beheira	6.5	10.8	64.1
Arab for Land Reclamation	6.6	10.4	56.7
Egyptian Dredging	5.4	3.9	-28.3
General for Land Reclamation	8.6	11.0	27.6
Mechanical Excavation	3.0	3.7	23.8
Upper Egypt Dredging	1.5	0.6	-59.2
Kom Ombo	12.0	15.9	32.3
Number of companies that improved performance			7
Average increase in profits for companies that improved performance			61.1

Source: Data provided by the Egyptian authorities.

¹Average for 1991/92 and 1992/93.

²Average for 1994/95 and 1995/96.

There is reason to believe that sales to ESAs may be an efficient mode of privatization. First, although purchases by ESAs are paid for over an eight-year period, legally they are deemed to be the owners, as evidenced in the transfer of the enterprise from Law 203 to Law 159, which governs private enterprises. Moreover, an ESA—as an entity—can immediately sell a share of the company equivalent to the portion of the loan repaid. Second, notwithstanding the fact of deferred purchase, which at first sight is different from and arguably less onerous than a regular privatization transaction, the terms of an ESA sale involve financing costs of about 8 percent, which is close to market rates of interest. Third, the decision to sell to an ESA is based on an evaluation of all possibilities of divestiture and is not politically motivated. Often, the decision to sell to an ESA is the only option available given the lack of investor interest in the company concerned. In some cases, liquidation, which is socially expensive and politically sensitive, may be the only alternative to the ESA sale.

The empirical evidence indicates the financial performance of the companies that were sold to ESAs in 1994 has improved post privatization. Table 25 indicates that in seven of these ten companies, profits improved by a substantial margin—over 60 percent on average—after privatization, which supports the view that ESA sales lead to the efficiency gains that are a central objective of privatization.

Public sector enterprises are heavily indebted to the Egyptian banking system and a portion of their loans is known to be nonperforming. Insofar as banks have provisioned against these debts, the banking system does not need to be reliant on proceeds from privatization to secure its financial position. However, the proceeds from privatization will contribute to strengthening the banking system. Thus far, about LE 2.1 billion, of total proceeds of LE 5.2 billion, has been used to settle public enterprise debts with the banking system.

Lessons from a number of recent experiences with privatization demonstrate that privatization need not of itself inject more competition into the economy. It could easily lead to public monopolies being transformed to private ones; in some cases, the aggrandizement of new owners has provoked a popular backlash against the entire program of privatization. Attention must therefore be paid to market structure. In Egypt, contestable markets depend most crucially on removal of barriers to trade, which remain high, with exposure to foreign competition constituting the most effective and immediate way of engendering efficient resource allocation. In nontradable sectors, trade liberalization may not be adequate, which raises the need for a regulatory framework that can provide the legal basis for facilitating greater competition. Speedy passage of the draft competition law would help in this regard.

IX Modernizing Egypt's Financial Markets

This section analyzes the development of Egypt's financial system, from state control through the reforms initiated during the 1990s. The results of the reforms are described together with the continuing efforts that are under way in bank privatization, financial sector broadening, and strengthening of prudential regulation and supervision.

A Historic Overview of Egypt's Financial System

The wave of nationalizations during 1959–61 had a dramatic impact on Egypt's financial system. Following the confiscation and nationalization of Egypt's 27 commercial and specialized banks, the banking system was consolidated into four noncompeting state banks, each focusing on separate economic sectors. In 1974, under the "open door policy," Egypt authorized the establishment of "joint-venture" banks with minority foreign participation. Foreign banks were also permitted to open branches in Egypt. By 1995, the banking system had expanded to 28 commercial banks, 32 investment and merchant banks, and 7 specialized banks. Despite the emergence of new banking institutions, the "big four" state banks continued to account for over three-fourths of commercial bank deposits based on their extensive branch network, with a similar share of total lending (Table 26). The new commercial banks established under the open door policy focused on lending to private sector clients and multinationals.

Until 1990, Egypt's banking system was highly repressed. The CBE imposed interest rate limits on bank deposits and loans that were well below the rate of inflation. In particular, preferential interest rates were mandated for loans to public enterprises and to industrial and agricultural enterprises. At the same time, banks' operating costs were increased by a 25 percent (unremunerated) reserve requirement on domestic currency liabilities. While overall liquidity growth was largely determined by the borrowing needs of the government, the central bank also limited credit expansion to public sector companies and the private sector

using maximum loan-to-deposit ratios and bank-specific ceilings for certain classes of credits.

Highly negative rates of return on domestic currency deposits resulted in a shift to foreign currency accounts offered by domestic banks. (Such accounts benefited from a lower reserve requirement (15 percent) than domestic currency accounts.) By 1990/91, slightly over one-half of all deposits of the private sector and public sector companies were denominated in foreign currency. For the most part, banks used these deposits to finance overseas investments (capital outflows).

Although new banking institutions emerged during the 1970s and 1980s, the securities market remained underdeveloped. Public banks continued to dominate the financing of the state-owned companies, while the securities industry was hampered by the absence of a governing securities law, inadequate regulation and supervision, and weak accounting, auditing, and financial disclosure practices. Financial intermediaries such as mutual funds, finance companies, leasing companies, brokers, discount houses, money changers, and market makers were lacking. In addition, the insurance sector was underdeveloped and largely state owned.

Role of Egypt's Banks in Intermediating Saving

Economic studies have shown that countries with "developed" financial systems tend to show stronger economic growth (see Box 4). On this basis, it would appear that the repression and distortions of Egypt's banking system probably acted as a drag on economic growth through the 1980s.

Although it is difficult to measure the depth and efficiency of financial markets from aggregate financial data, research has commonly shown that stronger growth is linked to high ratios of broad money to GDP and high shares of bank credit channeled to the private sector. On the basis of the former indicator, Egypt's banking system would appear to have been relatively deep. Thus, in 1980, the ratio of M2 to GDP stood at 67 percent, over twice the aver-

Table 26. Commercial Banks' Balance Sheets, 1985–96

	Total Assets/ Liabilities	Assets		Liabilities					Provisions	Capital	
		Loans and discounts	Other assets	Deposits	Capital and reserves	Provisions	Other liabilities				
(In billions of Egyptian pounds)										(In percent of loans)	(In percent of assets)
Commercial banks											
1985	39.6	18.2	21.4	26.1	1.4	...	24.7	...	3.5		
1988	65.1	25.0	40.2	44.6	1.7	...	42.9	...	2.6		
1990	101.5	39.5	62.1	70.5	2.4	4.6	24.0	11.6	2.4		
1991	130.9	45.1	85.8	89.6	5.6	6.1	29.7	13.4	4.3		
1992	153.0	46.0	107.0	111.0	6.0	8.5	27.5	18.6	3.9		
1993	166.3	55.5	110.7	120.4	6.6	9.9	29.4	17.8	4.0		
1994	183.5	74.0	109.5	132.0	7.5	11.7	32.2	15.8	4.1		
1995	202.4	92.1	110.3	144.9	8.0	13.7	35.7	14.9	4.0		
1996	228.0	110.9	117.1	162.9	8.8	16.2	40.2	14.6	3.9		
Public commercial banks											
1992/93	115.2	44.2	71.0	90.9	4.3	7.3	12.7	16.6	3.8		
1993/94	122.1	50.2	71.9	95.4	4.5	8.8	13.4	17.6	3.7		
1994/95	135.4	58.9	76.5	104.7	4.7	10.5	15.6	17.8	3.5		
1995/96	136.4	62.6	73.9	113.6	4.9	12.2	5.7	19.4	3.6		
1996/97	152.6	70.3	82.3	128.0	6.2	12.2	6.2	17.4	4.1		
Memorandum items											
Public banks as share of all commercial banks ¹											
1992/93	72.2	87.1	65.3	78.6	68.8	79.7	44.6	...	...
1993/94	69.8	77.6	65.3	75.6	63.6	81.9	43.4	...	...
1994/95	70.2	70.9	69.7	75.6	60.0	82.4	45.9	...	...
1995/96	63.4	61.7	65.0	73.8	58.5	81.3	15.0	...	...

Sources: National Bank of Egypt, *Economic Bulletin*, Vol. I (1997); and year-end financial results for public banks.

¹Financial year estimates for commercial banks are based on averages of calendar year data.

age of 31 percent for developing economies (Table 27). Savings were largely channeled to the government sector and public enterprises (accounting for 82 percent of banking system credit) rather than to private enterprises (with a 15 percent share of such credit). As a result, credit to the private sector represented 14 percent of GDP in 1980, well below the average of 21 percent for developing countries (Table 27).

The emergence of new, somewhat more independent, banking institutions during the 1980s and fiscal adjustment in the 1990s permitted increased financing of private sector activities. By 1995, credit to the private sector had risen to 33 percent of GDP, exceeding the average of 27 percent for developing countries. The Egyptian banking system compared less favorably, however, with those of the fastest growing developing economies where credit to the private sector stood at 42 percent of GDP (Table 27).

In sum, Egypt's banking system at the end of the 1980s was dominated by state ownership; constrained by onerous restrictions on deposit taking

and lending; and subject to weak prudential regulation and supervision. At the same time, however, a number of new (typically small) banking institutions were emerging, and lending to the private sector was rising (although from low levels). It was against this background that the reforms of the 1990s were initiated.

Financial System Reforms, 1991–95

In early 1991, the Egyptian authorities initiated an important series of reforms with the goal of giving a central role to market forces in the mobilization of savings, allocation of credit, and conduct of monetary policy. The separate aspects of this reform effort are discussed below.

Banking System Reforms

In January 1991, to address the growing dollarization of the Egyptian economy, the authorities liberalized banks' lending and deposit rates (other than for

Box 4. Financial Markets and Economic Growth

Efficient capital markets can raise saving and investment (and, by implication, economic output) in a number of ways. Financial institutions, by identifying productive investment activities, offer savers a higher real rate of return than they could earn independently, thereby encouraging higher levels of saving.

Financial institutions can also foster increased and more productive investments. Uncertainties about market demand or untested technologies can deter investments in projects by single individuals (even where the potential returns are large). Financing may be available, however, where such risks are shared between investors (using financial institutions, equity markets, and so forth). Similarly, market specialization, which offers higher productivity, but also higher economic risk, may not be feasible without the use of capital markets to pool the associated risk. Capital markets also provide investors with higher liquidity than would direct investment, reducing the risks of committing a high proportion of their wealth to productive purposes. Last, the cost of gathering information on investment opportunities are high for individual investors, and without institutions to undertake this function for investors, the pattern of investment is likely to be inefficient.

Based on these arguments, a highly developed and efficient financial sector should contribute to a higher level (although not necessarily higher rate of growth) of economic activity. In practice, economists have found that countries with deep financial systems also tend to exhibit strong rates of growth.¹ One possible explanation is the existence of economies of scale in the financial sector. As described above, a strong financial sector can foster increased investment and production. This, in turn, may generate demand for additional and more sophisticated financial services, which can have further beneficial effects on potential output.

¹For a survey of the literature, see Berthélemy and Varoudakis (1996).

demand deposits, where a prohibition on interest payments was removed beginning in May 1993). Subsequently, ceilings on bank lending to the private sector and bank-specific ceilings on lending to public sector companies were removed in October 1992 and July 1993, respectively. Steps were also taken to reduce the competitive advantages of the public sector banks. In particular, public sector companies were authorized to deal with all banks without prior permission from a public sector bank. To streamline the public sector banks, 15 development banks were merged with the main development bank in Cairo in December 1992.

The response to liberalization was positive. By June 1992, a significant increase in returns on domestic currency bank deposits, combined with lower rates of inflation, succeeded in restoring a positive real rate of return. As a result, the share of foreign currency deposits in broad money declined from 51 percent in June 1991 to 29 percent by December 1992.

Monetary Policy Reforms

With the elimination of direct credit ceilings on the private sector and public sector companies, the CBE moved toward increased reliance on indirect monetary policy instruments. To this end, the CBE instituted from January 1991 weekly auctions of three-month treasury bills. Over time, the supply of debt to the market was increased and longer maturities were introduced—6-month treasury bills from December 1991, and 12-month bills from March 1992. The CBE has relied, in part, on the sale and redemption of treasury bills to regulate banks' reserves, and thereby credit expansion.

To strengthen the CBE's control over monetary conditions, changes were introduced to the reserve requirement policy. In particular, the coverage of the reserve requirement was extended to deposits of all maturities. In addition, to limit reserve creation through refinancing facilities, the CBE raised the rediscount rate to 2 percentage points above the most recent treasury bill auction rate.

Prudential Supervision and Regulation

Prudential supervision and regulation were generally inadequate during the 1970s and 1980s. For example, banks were not subject to guidelines for capital adequacy or foreign currency exposure (except as required at start-up). As a result, by late 1990, the foreign currency liabilities of the four public sector commercial banks had risen to about \$2.1 billion (or 7 percent of total assets), a level viewed as a risk to the banking system. This exposure, and the associated undercapitalization was addressed in May 1991, through a \$1.8 billion (LE 6.1 billion) recapitalization financed through the sale of bonds denominated in foreign currency.

To strengthen the banking system, new prudential guidelines were introduced in 1991 for foreign currency exposure, capital adequacy, asset classification and provisioning, bank liquidity, and auditing. This was followed in 1992 by guidelines covering investment concentration abroad, and in 1993 by regulations on credit concentration (Appendix II).

Table 27. Indicators of Financial Intermediation

	Number of Countries	GNP Per Capita 1990	M2/GDP Ratio		Credit to Private Sector		
			1980	1990	1980	1990	1995
		(In U.S. dollars)			(In percent of GDP)		
Egypt	1	600	67.0	85.9	14.1	25.4	32.6
Developing countries	72	1,173	30.6	38.6	21.1	23.7	27.4
Fastest growing ¹	12	1,203	38.9	59.8	22.5	38.4	41.9
Other countries	60	1,168	28.9	34.4	20.8	21.1	24.8
Regional comparators							
African economies	25	566	25.7	26.1	18.1	16.9	18.9
Asian economies	13	736	31.7	45.7	19.2	32.0	36.6
Middle Eastern and North African economies	9	2,110	47.0	65.5	24.5	31.3	36.4
Western Hemisphere economies	25	1,619	29.0	37.7	23.8	23.9	28.3

Source: IMF, *International Financial Statistics Yearbook*, 1996.¹Per capita GDP growth averaging 2 percent or more a year.

Securities Industry Reforms

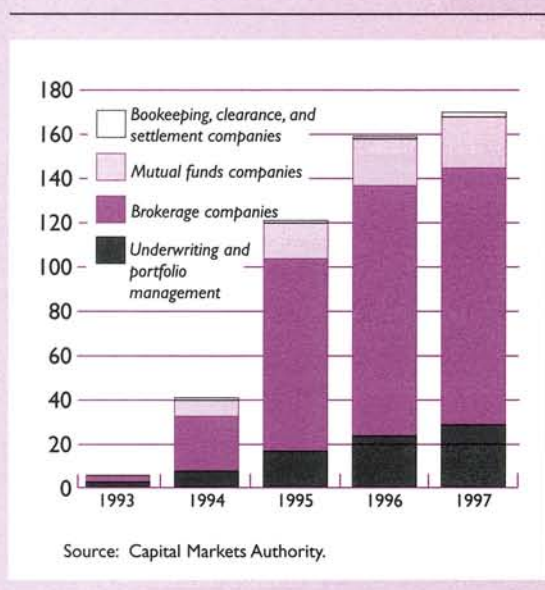
In 1992, with a view to revitalizing the stock and bond markets as well as assisting investment and privatization, the government adopted a new Capital Market Law (Law 95) streamlining all preexisting capital market regulations. The provisions (Box 5), including the legal framework, facilitated a marked expansion in the size of the securities industry. The number of securities intermediary firms, which stood at 48 in 1993/94, increased by over 150 during 1994–96 (Figure 21). Stock market activity increased correspondingly, with turnover rising from an annual average of LE 531 million during 1991–93 to over LE 10 billion in 1996. New issues through the stock market rose from LE 2.1 billion in 1993 to over LE 16 billion in 1996. During this period, the stock market began to rival the banking system as a means of financial intermediation: new issues as a percentage of new bank credit rose from 18 percent in 1993 to about 80 percent in early 1997 (Table 28).

The market for public and corporate bonds has also seen rapid expansion in the past few years: while placements of corporate bonds on the domestic market were limited to \$30 million for the three-year period 1993–95, new corporate issues totaled \$270 million in 1996 and were expected to rise further in 1997. In addition, two tranches of treasury bonds were issued in 1995 and 1996, valued at LE 3 billion and LE 4 billion, respectively (about \$0.9 billion and \$1.2 billion). To date, secondary trading in these treasury bonds has been limited.

Box 5. The Capital Market Law of 1992

The core provisions of Egypt's 1992 Capital Market Law are summarized below:

- The law established an independent Capital Market Authority (CMA) charged with supervising and regulating the securities industry.
- A legal framework was established governing specialized capital markets companies. Minimum capital requirements were established ranging from LE 250,000 for brokerage firms to LE 10 million for venture capital companies.
- Corporate bonds were authorized to be officially listed, and the previous 7 percent interest ceiling was eliminated. Bearer shares were also authorized.
- Taxes on the income from most stocks and bonds were eliminated.
- Recourse to arbitration was established for resolving legal disputes.
- Investors' rights were strengthened by provisions prohibiting unfair market practices. At the same time, foreign investors (institutional and individual) were given full access to the market.
- Financial disclosure was strengthened. Publicly traded companies and their auditors were required to follow international accounting and auditing standards, and companies were required to issue semiannual financial statements. The stock exchange and CMA have also published periodic reports regarding trading and market conditions.

Figure 21. Cumulative Number of Securities Intermediaries Licensed

Exchange System Reforms

In the late 1980s, Egypt operated a segmented exchange regime with three different exchange rates (broadly applicable to official transactions conducted by the central bank; the operations of the commercial banks; and transactions outside the banking system). From February 1991, this was replaced by a transitional two-rate system, and in November 1991, the regime was fully unified with a single, market-determined rate of exchange. Additional elements of the reform of the exchange regime included the abolition of exchange rate guarantees formerly provided by the central bank; elimination of limits on exchange rate spreads for banks' customers; and the authorization of nonbank foreign exchange dealers.

Reinvigorating the Reform Process, 1996–97

Launching a new phase of adjustment and reform by the Government of Egypt in 1996 included elements designed to broaden and deepen the financial liberalization initiated in the first half of the decade. Key elements are summarized below.

Financial Sector Privatization

Joint-venture banks. Although the liberalization of entry to the banking system during the 1970s resulted in the establishment of 26 joint-venture banks, these institutions were subject to equity holdings by

the state banks, the NIB, and the state insurance companies. In 1993/94, the government decided to initiate a divestiture of public holdings in these banks, and the public banks totally or partially divested their holdings in eight joint-venture banks by the end of 1995. Notwithstanding this, eight joint-venture banks continued to be majority owned by state banks⁵¹ and were held in other joint-venture minority holdings of over 20 percent. Furthermore, the NIB and insurance companies had holdings of between 20 percent and 40 percent in five institutions.

The process of divestiture was revitalized in 1996 and 1997, and by the end of September 1997, the state banks had limited their majority holdings to three joint-venture banks, and reduced their holdings to below 20 percent in all but two other banks. In addition, the state insurance companies had reduced their holdings to below 20 percent for all but three institutions. The government anticipates further progress in divesting the remaining state holdings in the months ahead.

Public commercial banks. As a further element of its financial liberalization program, the government decided in 1996 to privatize one of the four public commercial banks. Progress has been made in auditing the balance sheets of the candidate institution, and draft legislation is being submitted to parliament. Privatization is envisaged within six months of the enabling legislation.

Insurance companies. The government is committed to increasing private participation in the insurance industry, and public holdings were recently divested in two joint-venture insurance companies, leaving all four such institutions under majority private ownership by June 1997. As a further measure, the government intends to privatize one of the three state insurance companies. Audits are under way, and draft legislation is to be presented to parliament shortly. As with the state bank, privatization is envisaged within six months of the enabling legislation.

Prudential Regulation and Supervision

Banking system. By 1996, the regulatory framework for the Egyptian banking system was broadly in line with international practice, but improvements were still needed in the quality and quantity of financial data reported by banks. Accordingly, in mid-1997, the authorities required banks to prepare and publish financial reports on the basis of international accounting standards (IAS). The first such reports

⁵¹Excluding the Export Development Bank of Egypt, which, although a joint-venture bank, is to remain majority owned by the public sector.

Table 28. Indicators of Stock Market Development

	1985–90	1991–93	1994	1995	1996	Jan–Apr 1997 ¹
Trading value (in millions of Egyptian pounds)	179	531	2,557	3,849	10,968	25,995
Trading volume (in millions)	8.6	23.3	59.8	72.2	207.8	350.7
Number of traded companies	157	240	300	352	354	...
Market capitalization (in billions of Egyptian pounds)	3.6	10.8	14.5	27.4	48.1	...
New issues ² (in billions of Egyptian pounds)	...	2.1 ³	4.9	8.3	16.5	19.9
<i>Memorandum item</i>						
New issues as percentage of new banking system credit ⁴	...	18.3 ³	31.2	38.5	69.9	80.2

Source: Capital Markets Authority (CMA).

¹At an annual fixed rate.

²Excluding government bond placements through the stock market, totaling LE 7 billion in 1995 and 1996.

³Data are for 1993.

⁴As a percentage of the net increase in banking system credit to households, businesses, and public sector companies.

will be for the final quarter of calendar 1997. To further improve transparency, the central bank also intends to publish from early 1998 aggregate data on key performance ratios for the banking system. With a view to strengthening banking supervision, on- and off-site supervision manuals have been revised, with technical assistance from U.S. Agency for International Development (USAID), and an early-warning system is being developed in conjunction with technical assistance from USAID and the EU.

Securities markets. For the securities markets, parallel steps have been taken to improve the quality of financial data. In October 1997, the government published corporate guidelines on IAS, and required joint-stock companies to prepare future accounts based on IAS. Steps have also been taken to strengthen rules for corporate disclosure. To protect investors, the stock market intends to establish in the next few months a compensation fund to cover potential settlement losses arising from defaults by capital market institutions. Priority is also being given to upgrading the prudential rules governing the activities of securities intermediary firms including in regard to their capital adequacy and code of conduct.

Banking Soundness

International experience is increasingly clear on the central importance of a sound financial system. Systemic weaknesses can contribute to the onset and depth of macroeconomic crises. In Egypt, consider-

able progress has been made in reestablishing a sound banking system during the current decade, as summarized below.⁵²

Capital adequacy. Banking losses in the late 1980s contributed to a sharp deterioration in the capital-asset ratio of the banking system, from 3.5 percent in 1985 to 2.4 percent in 1990 (unadjusted for risk basis). A publicly financed capital injection in 1991 produced a sharp recovery in capitalization (to 4.3 percent). Subsequently, through the end of 1996, the capitalization ratio has been broadly constant (Tables 26 and 29). On a risk-adjusted basis, the average capital adequacy ratio for the banking system was 10.6 percent at the end of 1996, up from 10.0 percent a year earlier. All four public sector banks and all but three joint-venture and private banks met the Basle 8 percent minimum capital adequacy ratio at the end of June 1997. The latter three banks are small (accounting for less than 3 percent of banking assets) and capital increases are envisaged in the near term.

Loan losses and provisioning. Commercial banks entered the 1990s with substantial nonperforming loans, and provisioning for such loans exceeded 18 percent of the total loan booked at the end of 1992

⁵²At present, indicators of the Egyptian banking performance are fragmentary. This report is based on published financial statements for the public commercial banks; aggregate published data for the commercial banks; and data provided by the Egyptian authorities.

Table 29. Performance Indicators for the Banking System

	1993	1994	June 1995	1996	1997 ¹
	(In percent)				
Capital and reserves as a ratio of risk-weighted assets					
Banking system ²	...	9.9	9.7	10.0	10.6
Public commercial banks	...	...	...	9.1	9.5
Capital and reserves as a ratio of assets (non-risk-weighted)					
Banking system ³	4.2	4.7	4.6	...	...
Commercial banks ⁴	4.0	4.1	4.0	3.9	...
Public commercial banks	3.8	3.7	3.5	3.6	4.1
Provisioning as a share of lending and discounts					
Commercial banks ⁴	17.8	15.8	14.9	14.6	...
Public commercial banks	16.6	17.6	17.8	19.4	17.4
Profitability ratio as share of assets					
Big four state banks	0.17	0.18	0.20	0.23	0.39
Profitability ratio as share of equity					
Big four state banks	4.45	4.83	5.53	6.37	9.60
	(In millions of Egyptian pounds)				
Assets per employee					
Big four state banks	...	...	3.1	...	...
Selected joint-venture banks	...	...	5.8	...	...
Selected foreign banks	...	...	13.5	...	...

Sources: Data provided by the Egyptian authorities; audited banks' statements; and IMF staff estimates.

¹Subject to auditing.

²Excluding specialized banks and branches of foreign banks.

³Excluding specialized banks.

⁴Data for the end of December.

(Table 26). Subsequently, a gradual decline in provisioning appears to have signaled a parallel decline in nonperforming loans. Thus, on official estimates, nonperforming loans declined from 14.7 percent of total loans in June 1996 to 13.4 percent in June 1997.⁵³ Banks reportedly comply with all provisioning guidelines, and total provisions are equivalent to about 80 percent of nonperforming loans at the end of June 1997.

Banking profitability. Based on published financial statements, a number of Egypt's joint-venture banks are highly profitable, with rates of return on equity of 20 percent or more. By contrast, the state commercial banks have been much less profitable, with returns averaging less than 5 percent in the three years to June 1995, rising to a little under 10 percent in 1996/97 (Table 29). The growing profitability of the state banks appears to reflect, in part,

lower provisioning expenses, as provisions declined as a share of the loan book.

Efficiency. Based on a limited sample of banks' asset-employee ratios, the joint-venture banks and branches of foreign banks appear more efficient than the state commercial banks. Thus, for every LE 15 million of assets, the state commercial banks have about five employees, compared with three for the joint-venture banks, and one for branches of foreign banks (Table 29). This difference is probably related, in part, to the more extensive branch networks of the state banks.

Recent Banking Sector Developments

Egypt's adjustment and reform efforts during the 1990s, including steps toward financial liberalization, have led to changes in the pattern of banking sector activity. Two aspects of these changes are discussed in the paragraphs below: the evolution of deposits and banking credit denominated in foreign currencies, and the changing pattern of credit allocation.

⁵³The incidence of nonperforming loans is estimated to be the same for the public commercial banks as for the industry as a whole.

Table 30. Banks' Foreign Currency Assets and Liabilities¹

	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	Sept. 1997
<i>(In percent of total foreign currency assets and liabilities)</i>										
Foreign currency assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Assets abroad	58.0	59.8	54.8	59.3	56.4	52.8	53.0	46.8	42.3	38.7
Credit to residents	26.6	25.3	29.5	30.4	37.0	40.9	40.3	46.4	51.8	55.5
Deposits at central bank	15.5	14.9	15.7	10.3	6.6	6.2	6.7	6.8	5.9	5.8
Foreign currency liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Foreign liabilities	21.0	20.0	12.5	15.8	13.7	12.4	10.9	9.7	14.6	15.7
Deposits by residents	76.3	76.7	82.8	79.3	72.2	73.4	74.2	75.4	69.9	68.2
Liabilities to central bank	2.7	3.2	4.7	4.9	14.1	14.3	14.9	14.9	15.4	16.1
<i>Memorandum items</i>										
Dollarization ratio ²										
Foreign currency deposits	43.4	44.8	50.7	37.3	26.7	23.4	25.1	22.9	19.4	18.3
Foreign currency loans	23.6	21.7	19.5	22.0	25.3	26.9	23.3	23.6	25.3	26.5
<i>(In millions of U.S. dollars)</i>										
Private external proceeds ³	...	...	...	8,242	8,177	7,180	9,004	9,305	9,927	10,526
Foreign currency credit ⁴	...	...	...	2,844	4,014	4,952	5,370	6,687	8,946	9,531
Ratio of foreign currency credit to private external proceeds	...	...	...	34.5	49.1	69.0	59.6	71.9	90.1	90.5

Sources: Central Bank of Egypt; and IMF staff estimates.

¹Excluding the Central Bank of Egypt.²Private sector and public sector companies. Foreign currency deposits and loans as percent of total deposits and loans.³Foreign currency incomes from non-oil exports, tourism, and other services.⁴Private sector, excluding public sector companies.

Banking System Dollarization

Foreign currency deposits. Egypt's successful stabilization efforts during the early 1990s, combined with high domestic interest rates, contributed to a rapid unwinding of banks' foreign currency deposits. For the private sector and public sector companies, the share of deposits held in foreign currencies fell by more than half in the three years to 1993/94 (declining from 50.4 percent to 23.4 percent). After a small increase in 1994/95 (associated with uncertainty about the exchange regime), this trend continued in subsequent years, falling to a low of 18 percent in September 1997 (Table 30).

Foreign currency credit. The share of bank credit denominated in foreign currencies has been relatively stable over the past ten years, in the range of 20 percent to 27 percent (Table 30), with temporary shifts toward the top of this range during periods of sustained capital inflows and confidence in the exchange regime (e.g., 1993/94 and 1996/97). Over the period since 1991, foreign currency credit has risen significantly faster than foreign currency deposits. As a result, banks have restructured their foreign currency balance sheets, drawing down investments

abroad and expanding domestic foreign currency credit. Thus, in the five years to 1996/97, the share of overseas investments in total foreign currency assets fell from 59 percent to 42 percent, while foreign currency credit rose from 30 percent to 51 percent.

Although recent developments are consistent with banks limiting their overall foreign currency exposure, there may be an increase in credit risk, to the extent that foreign currency credit is less secure than investments abroad. Concerns would relate, in particular, to the risks of loan default in the event of depreciation of the Egyptian pound. In this connection, it is noteworthy that while foreign currency credit to the private sector represented some 35 percent of private commercial foreign currency earnings in 1991/92, this figure rose to about 90 percent by 1996/97 (Table 30). The challenge to banking supervision that these trends represent is recognized by the authorities, who maintain a close watch on banks' foreign currency lending.

Patterns of Lending

The evolution of the banking system during the past decade has been associated with a changing pat-

Table 31. Distribution of Credit Extended by Commercial Banks to the Private Sector

	Average			
	1989/90– 1990/91	1991/92	1992/93– 1994/95	1995/96– 1996/97
<i>(In millions of Egyptian pounds)</i>				
By economic sector				
Agriculture	71	–183	102	351
Industry	1,233	–15	2,336	3,386
Trade	353	488	2,383	4,257
Services	527	24	1,586	2,980
Households	158	549	1,859	1,535
Total	2,340	863	8,267	12,509
By institutional classification				
Corporate business sector	1,349	85	3,144	5,917
Unincorporated businesses	972	266	3,443	5,615
Cooperative societies	37	66	108	213
Households	158	549	1,859	1,535
Total	2,514	966	8,555	13,280
<i>(In percent of new credit extended)</i>				
By economic sector				
Agriculture	3.0	–21.2	1.2	2.8
Industry	52.7	–1.7	28.3	27.1
Trade	15.1	56.5	28.8	34.0
Services	22.5	2.8	19.2	23.8
Households	6.7	63.6	22.5	12.3
Total	100.0	100.0	100.0	100.0
By institutional classification				
Corporate business sector	53.6	8.8	36.8	44.6
Unincorporated businesses	38.6	27.5	40.3	42.3
Cooperative societies	1.5	6.8	1.3	1.6
Households	6.3	56.8	21.7	11.6
Total	100.0	100.0	100.0	100.0

Source: Central Bank of Egypt.

tern of credit allocation, both in terms of economic sector and type of borrower. Data on the composition of new credit to the private sector for the eight-year period 1989/90–1996/97 is summarized in Table 31. Although the data are partial, representing about two-thirds of total new credit to the private sector, certain features can be determined. Prior to the financial liberalization (1989/90–1990/91), credit was focused on the industrial and services sectors (representing 53 percent and 23 percent of net credit growth, respectively). In 1991/92, however, a sharp contraction of credit growth at the outset of the stabilization exercise was focused on these two sectors, along with

agriculture; instead, the bulk of the new credit was extended to the trade sector and households.

As credit growth recovered its pace in the 1990s, two trends are noteworthy. First, while the share of industrial credit recovered sharply after the 1991/92 contraction, it remained substantially lower than in the late 1980s. The counterpart was a sustained higher allocation of new credit to the trade and (to a lesser extent) household sectors. It is also noteworthy that the most recent period of intensified economic reform has been associated with a decline in the share of new credit going to the household sector, contrary to experience in many reforming countries.

X Trade Liberalization

This section reviews Egypt's efforts to establish a more open and outward-oriented trade regime as part of its market reform and growth strategy. Trade reform has proceeded sporadically since the mid-1980s but has gathered strength since early 1996. Building on the Uruguay Round of multilateral trade liberalization, Egypt has recently made important progress in reducing tariffs and eliminating import bans and is now focused on dismantling nontariff barriers that are seen by market participants and analysts alike as perhaps the main impediment to a sustained expansion in non-oil exports. The forthcoming free-trade agreement with the EU should reinforce these reforms. Nonetheless, Egypt's trade regime remains more closed compared with other fast-growing emerging economies. This suggests that there remains an untapped potential for trade liberalization to serve as a "launching pad" to a sustained higher growth path.

Overview

Egypt took a series of trade reforms from the mid-1980s to 1996 aimed at reducing tariff and nontariff restrictions and enhancing the transparency of the trade regime. High tariff rates were reduced, with the maximum rate cut from 120 percent prior to May 1991 to 70 percent in February 1994, and the dispersion of tariffs was also narrowed. The government eliminated a large number of quantitative restrictions (QRs) on imports, excluding those maintained for health and security reasons. Foreign exchange budgeting was eliminated and restrictions on private sector imports and exports of cotton were lifted. All export taxes were eliminated in late 1992, and the only remaining export nontariff barrier was a ban on exports of raw hides, which is scheduled to be removed in 1998. A variety of nontariff barriers that discriminated against foreign firms were eliminated and efforts made to reduce nontariff barriers and eliminate "red tape."⁵⁴ As a result, the average statutory tariff

(excluding import surcharges) was reduced by nearly 20 percentage points to 28 percent between 1989 and 1996, effective protection was reduced, and the production coverage of QRs declined from about 37 percent of agricultural and manufacturing output in 1991 to about 4 percent in 1996.

Despite this progress, Egypt's trade system remained relatively restrictive. As of the middle of 1996, the general tariff schedule ranged from zero to 70 percent, substantially higher tariff rates applied to alcohol, tobacco, and automobiles, and import surcharges of 2–5 percent applied to all imports. Consequently, prior to the recent liberalization effort, Egypt's tariff schedule was among the most restrictive in the region and significantly higher than the other emerging markets (Table 32). In addition, while import bans were substantially reduced during 1991–93 (remaining import bans on textiles and garments are estimated to cover less than 5 percent of tradable goods output), some were replaced by restrictive quality controls. Further, in the view of many traders, cumbersome customs procedures inhibited imports and, by discouraging foreign investment and the import of intermediate goods, ultimately had a serious negative effect on non-oil exports.

As a consequence, looking over the period between the mid-1980s and 1996, it is clear that Egypt had not maximized the potential benefits from the liberalization of the trade regime and, consequently, in some respects was becoming less integrated in the world economy:

- Egypt's share of world exports had fallen over the period 1985–96, while regional competitors—Morocco and Tunisia to name two—did better at maintaining their market share (Figure 22). Also, Egypt's share of world imports has fallen relatively steadily since the mid-1980s, countering the usual trend toward higher

⁵⁴Specifically, legislative efforts have been undertaken to discontinue the discriminatory treatment of foreign trading compa-

nies; governmental approval (and suspensions of letters of credit) for imports were abolished in 1993; investment-related controls on imports of equipment were abolished in 1993, as were import restrictions maintained by the Ministry of Military Production.

Table 32. Weighted Average Tariff in Southern Mediterranean Countries and Other Regions
(In percent)

	Weighted Average Tariff March 1996
Algeria (1992)	21.6
Egypt	28
Israel	7.2
Jordan	19.8
Lebanon	24.2
Morocco	20.3
Syrian Arab Republic	17.2
Tunisia	31.7
East Asia ¹	21.3
Central Europe ²	9.1
High-income countries ³	5.8
Latin America ⁴	14.1
South Asia ⁵	47.1
Sub-Saharan Africa	14.8
Developing countries	21.4
World	8.2

Source: Havrylyshyn (1996).

¹Indonesia, Korea, Macau, Malaysia, the Philippines, Thailand.

²Czech and Slovak Republics, Hungary, Poland, Romania.

³Australia, Canada, European Union, Hong Kong SAR, Iceland, Japan, New Zealand, Singapore, Sweden.

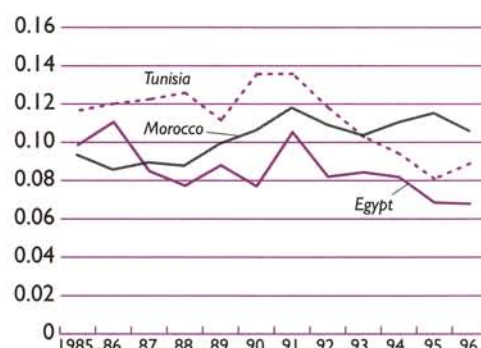
⁴Argentina, Brazil, Chile, Colombia, Jamaica, Mexico, Peru, El Salvador, Uruguay, Venezuela.

⁵India, Sri Lanka.

market share as developing countries industrialize and shift production toward investment and import-intensive production (Figure 23).

- Further, Egypt's market share in the key EU market declined from 1 percent in 1985 to 0.5 percent in 1995.
- Trade to GDP totaled 62 percent during 1991–95 (Table 33), about equal to the MENA average and below trade shares for Jordan, Lebanon, Tunisia, and Israel (although above that for Morocco).
- The ratios are somewhat better for traded services than merchandise trade, where—boosted by tourism—Egypt's exports of services during the 1990s totaled 68 percent of exports of goods and services, well above the MENA average (Table 34).
- Trade remains concentrated. As in much of the MENA area, exports are highly concentrated in

Figure 22. Share of World Exports
(In percent)



Source: IMF, Direction of Trade Statistics.

mineral fuels: oil exports represent over half of merchandise exports while textile and clothing exports make up more than half of manufactured exports. Imports are mainly manufactured goods and food. The high concentration of Egypt's trade, combined with the variability of international oil prices, contributed to volatility in Egypt's terms of trade.

To reinvigorate the reform effort, the government has moved to cut tariffs further, reducing the maximum rate to 50 percent in July 1997. Other high rates were reduced by 5 percent and the import surcharge was cut by 1 percent. Further cuts are planned in the period ahead, but the overall approach remains gradual and incremental, reflecting concerns that faster reform will worsen unemployment in the short run.

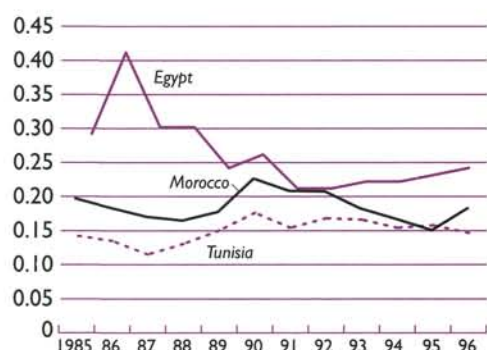
Reinvigorating the Momentum of Reform

The current reform effort that the authorities embarked on is based on spurring growth through greater export orientation and integration in a global economy. These benefits are well appreciated: a study of the effects of trade liberalization on the countries of the MENA region (Alonso-Gamo, Fennell, and Sakr, 1997, p. 1) noted that

... closer integration, specifically through trade reform, leads to a higher level of economic growth as a result of improved resource allocation and economic efficiency. Furthermore, by increasing competitiveness of domestic

Figure 23. Share of World Imports

(In percent)

Source: IMF, *Direction of Trade Statistics*.

production—trade reform can enhance export prospects, leading to an improvement in the trade balance and the overall balance of payments position. Other spillover effects from trade—higher productivity levels that stem from technology transfers from the industrial countries and the interaction between trade and the stock of foreign research and development capital—are also clear.

Egypt's program of trade reform has three strands: (1) multilateral liberalization through the implementation of commitments made in the Uruguay Round; (2) bilateral trade liberalization with the EU through negotiation of a framework agreement, (negotiations are already far advanced); and (3) a comprehensive unilateral reform of the trade regime. The authorities' program aims at substantially reducing the restrictiveness of Egypt's trade regime, mainly by eliminating the remaining import nontariff barriers and further tariff reductions.

Multilateral Liberalization Through the Uruguay Round

The Uruguay Round concluded in April 1994 provided for increased market access for industrial products; services and intellectual property were integrated into the multilateral framework while agriculture, textiles, and clothing were brought into the framework of multilateral rules. Also, the functioning of the world trade system was strengthened through improvements in rules on subsidies, on antidumping and countervailing actions, and through improved multilateral dispute settlement procedures. By requiring all countries to adhere to nearly all Uruguay Round agreements, thereby reducing the special dispensations offered to developing countries, the Round facilitated the increased integration of the multilateral trading system.

There is general agreement that the net effect of the Uruguay Round on Egypt is likely to be mod-

Table 33. Merchandise and Service Trade in Selected MENA Countries

(In percent of GDP)

	Average				
	1976–80	1981–85	1986–90	1991–95	1996
Algeria	63.6	53.9	32.9	50.7	55.1
Egypt	55.2	54.1	48.6	61.9	52.9
Iran, Islamic Republic of	54.0	28.1	31.7	48.2	32.0
Israel	85.6	82.0	81.9	77.1	77.1
Jordan	134.8	151.6	113.2	127.2	123.6
Lebanon	118.3	170.0	187.4	103.8	84.1
Libya	93.8	86.2	54.5	47.6	40.3
Morocco	48.9	54.7	50.3	55.8	55.8
Sudan	33.1	33.8	24.0	38.8	29.4
Syrian Arab Republic	58.8	38.9	25.8	62.9	67.5
Tunisia	69.8	81.2	81.2	86.7	84.7
Yemen, Republic of	56.3	43.2	39.5	35.6	98.9
MENA	84.2	72.8	60.1	65.6	66.0

Source: IMF, *World Economic Outlook* database.

est.⁵⁵ The main impact of the Round, through changes in the trade regime and the external trading environment, is likely to be as follows:

- Improved access to international markets is expected to increase exports driven largely by an increase in Egypt's textile quotas. The Round will produce significant progress in removing nontariff measures facing Egypt—as well as other MENA exporters—especially in agriculture, and in textiles and clothing during the ten-year transition period provided for elimination of quotas.
- Egypt's commitment to “bindings”—not to raise the level of its tariffs above specified levels without consulting or compensating its trading partners, or both—provides greater predictability of trade policy and insurance against future reversal. Egypt bound 100 percent of its tariff lines in agriculture (as was required of all countries) and about 97 percent of its tariff lines in the industrial sector and has agreed to forgo other duties and charges. The bindings in December 1994 were already on average about

5 percentage points above applied rates, and the “water in the bound tariff” (the extent to which actual tariffs are below bindings, allowing room for future increases) has subsequently risen to above 10 percent. Nonetheless, Egypt's Uruguay Round commitments led to some, albeit limited, incremental liberalization.⁵⁶

- Egypt, like all countries, committed to eliminate all quantitative restrictions on agriculture. Also, as part of the Uruguay Round agreement, Egypt has agreed to eliminate the import ban on textiles by January 1, 1998, and on clothing by January 1, 2001.
- Although Egypt is a large net food importer, the impact of the Uruguay Round on its food import bill was expected to be minor, on account of the limited increase in food prices that was expected.
- Elements of the Uruguay Round could have adverse consequences for Egypt, particularly in the short term, because the most-favored-nation

⁵⁵For estimates of the global effects of the Round, see Francois and others (1995), Hertel and others (1996), and Goldin and van der Mensbrugghe (1995). These studies emphasize that countries that undertake the most meaningful liberalization and improve the supply capacity of their economies stand to gain the most from the Uruguay Round.

⁵⁶The commitment to bindings led to effective reduction in about 10 percent of all tariff lines (excluding the textiles and clothing sector) for which tariffs in December 1995 were above the bound levels. For these lines, the average reduction was about 11 percent, with slightly larger tariff reductions in the industrial sector, yielding average price reductions in the domestic market of about 6 percent..

Table 34. MENA Region: Exports of Services

(In percent of total exports of goods and services)

	1991	1992	1993	1994	1995	1996
All MENA countries	19.4	19.9	20.7	20.2	20.5	19.6
Oil exporting MENA countries	12.9	11.8	12.7	10.9	11.4	10.9
Of which						
Algeria	3.7	5	5.4	7.2	6.2	5.4
Libya	0.9	3.2	1.7	4.1	...	...
Non-oil exporting MENA countries	40.1	43.2	41.7	40.8	40	40.1
Of which						
Egypt	67.4	67.4	68.5	70	67.2	68.4
Israel	34.8	36.2	33.5	32.2	34	33
Jordan	43.7	54.3	55.8	52.3	49.1	50.4
Lebanon	60.4	60.3	65.8	62.5	64.5	61.6
Morocco	31	39.1	30.7	28	22.5	25.1
Sudan	16.6	16.2	15.2	18.8	15.1	13.5
Tunisia	27.5	32.8	35.1	32.6	31.2	32.1
Yemen, Republic of	15.9	15.6	14.9	7.7	8.2	8.9

Source: IMF, World Economic Outlook database.

tariff cuts incorporated in the Uruguay Round will reduce preference margins that Egypt has enjoyed with the EU.

Overall, the Uruguay Round is not expected to produce significant effects, except in the textile and clothing sectors. While Egypt did undertake important commitments to lock in its trade regime and render it more transparent by binding its entire tariff schedule, incremental liberalization was not significant, except for the elimination of import restrictions in poultry and textiles and clothing. Although bound rates are in general higher than applied rates, the latter remain high in absolute terms and in comparison with several other developing countries. Imports are expected to increase modestly, mainly because of the liberalization commitments described above. But exports are expected to rise by a comparable amount, so that the net effect is likely to be quite small (Table 35). Fiscal effects are also estimated to be modest. The finding of little net effect has been largely confirmed by subsequent academic studies.

The Egypt-EU Association Agreement: A Bilateral Approach to Opening Markets

Negotiations are close to conclusion on an association agreement between Egypt and the European Union.⁵⁷ The framework agreement would further liberalize the Egyptian market: free trade in raw materials and intermediate capital goods within five years, expanded quotas in agriculture and textiles, and free trade in industrial goods by 2010. Most framework agreements follow a common structure or "template." To date, in the Mediterranean basin, full association agreements have been signed with Israel, Morocco, Tunisia, and Jordan. It is expected that these agreements will be ratified by the 15 EU members by early 1998.

Agriculture has proven to be a critical area of contention in the negotiation. In a number of key areas—oranges, rice, and potatoes to name a few—constraints imposed by the common agricultural policy and considerations related to EU enlargement have been a stumbling block. In certain areas, Egypt (and other MENA countries) had previously received *de facto* preferential treatment, and the association agreements, while normalizing trade, close some loopholes that had benefited the region. More generally, the Egyptians have sought to base quotas in agriculture to some extent on projected postliberalization trade flows rather than "traditional trade

Table 35. Summary Impact of the Uruguay Round in 2005

(In millions of 1993/94 U.S. dollars)

Effect	Magnitude
Balance of payments effects	
Increase in imports	247
Of which	
Liberalization	220
Higher food prices ¹	26
Increase in exports	240
Of which ²	
Textiles quota expansion	241
Most-favored-nation tariff cuts	4
Preference erosion	-6
Net effect	-7
Fiscal effect	
Change in revenue	-11

Source: IMF staff estimates.

¹Based on the scenario with higher food price increases; in the alternative scenario imports would increase by only \$4 million.

²The export numbers are obtained from the results for the three largest markets extended to all OECD markets

flows," reflecting Egypt's efforts to modernize and industrialize the agricultural sector and expand exports in nontraditional areas. A variety of additional issues, including labor rights and mobility, duty drawback, and rules of origin on key products (dyes in shirts—a traditional Egyptian product—do not count for origin purposes, while printing does), are also under discussion.

There are good reasons to believe that Europe will remain an important trading partner and that expanded market access through the agreement could play an important role in the Egyptian trade reform effort. Europe is a natural trading partner for Egypt and the potential for market growth is strong. Currently, Egypt has only 1/2 of 1 percent of total EU imports; in most analysts' views there is substantial room for improvement. Egypt's relatively low wages suggest that it could be a natural assembler of consumer goods for the EU. In this regard, Egypt (and other countries in the region) seeks more generous cumulation rules for products produced in multiple countries.

Unilateral Trade Reform

In addition to negotiating the trade liberalization in bilateral and multilateral forums, Egypt has committed to a major market opening effort on a unilateral basis beginning in 1996. This effort codifies re-

⁵⁷It normally takes at least one year following signing for the European Parliament to ratify the agreement and make it effective.

forms agreed to elsewhere and also goes further to expand trade as part of the authorities' growth-oriented strategy.

These measures will also reduce the reliance of the government on trade taxes with greater reliance on consumption based taxation. The major focus of unilateral trade reform is in the following areas:

- Significant tariff reductions in the general maximum rate and a reduction in other high rates, in a number of steps between September 1996 and July 1998. The maximum rate was reduced to 50 percent, and other high rates reduced by 5 percent, on July 1, 1997.
- A gradual reduction in the import surcharge. The higher rate surcharge was reduced from 4 per-

cent to 3 percent on July 1, 1997; the lower rate remains at 2 percent.

- Tariffs on automobiles were initially cut in October 1996, but other exemptions to the general tariff structure (e.g., alcohol and tobacco) are not scheduled to be eliminated in the immediate future.
- The import ban on poultry was eliminated in July 1997 and replaced with an 80 percent tariff.
- Egypt's system of mandatory quality controls on imports is being reviewed. A high-level study of customs procedures and mandatory quality controls is nearly concluded, and procedures will be modified in late 1997 and early 1998 to eliminate restrictive features.

Appendix I Tax Summary

Appendix I provides a summary of the tax system as of July 1, 1997. The tables start with a description of taxes levied by the central government followed by taxes levied by local governments.

Each tax is described in terms of the relevant legislative act, the definition of the tax base, the main exemptions and deductions that are applicable and the tax rates.

Tax Summary as of July 1, 1997

Tax	Base	Exemptions and Deductions	Rates						
A. Central Government									
I. Taxes on income and profits									
1.1 Taxes on corporations									
Law No. 157/1981 amended by Law No. 187/1993.	<p>An annual tax on accrued net taxable profits earned in Egypt by both foreign and domestic corporations (including limited partnerships, joint stock companies, and public sector enterprises) engaged in manufacturing, commerce, banking, mining, real estate brokerage, commercial leasing activities, and so forth. Tax year is calendar year unless stated otherwise in company's articles.</p> <p>Taxable profits include:</p> <ul style="list-style-type: none">• realized nonreinvested capital gains; and• ten percent of income from moveable capital (for joint stock companies, dividends received from Egyptian investment joint stock companies are exempt). <p>Forms of corporate business include:</p> <ul style="list-style-type: none">• joint stock company• limited liability company• partnerships limited by shares <p>They are governed by Companies' Law No. 159/1981.</p>	<p>Deductions allowed cover all business expenses, including actual rent or estimated rental value of premises, wage and bonuses to be statutorily granted to workers, social security contributions on their behalf, savings fund and pension fund contributions (up to 20 percent of the wage bill), inventory costs, interest, royalties, remunerations to Board of Directors and allowances to major shareholders to attend general meetings, subscriptions to governments, contributions to charitable and social institutions (up to 7 percent of net profits), bad debt and loss reserves (up to 5 percent of net profits), and all other taxes paid.</p> <p>Joint stock companies can deduct a portion of paid up equity equal to the interest rate declared by the Central Bank of Egypt.</p> <p>Depreciation allowances are granted on depreciable assets mainly using the straight line method at varying rates (the following act only as guidelines): buildings—2 percent, furniture—6 percent, hotel furniture—12.5 percent, and machinery—10 percent. In addition, there is a depreciation allowance of 25 percent of the cost of new machinery and equipment in the first year.</p> <p>In addition to the above deductions and allowances, executive regulations allow gifts and donations (up to 7 percent of chargeable profits) in lieu of entertainment expenses and other public relations expenses.</p> <p>Losses are allowed to be carried forward for five years; losses from one source are not allowed to be offset against profits</p>	<p>Profits above LE 18,000 a year (subject to the above deductions, exemptions, and so forth) are taxed as follows:</p> <table><tr><td>Industrial and export profits</td><td>32 percent</td></tr><tr><td>Profits from oil exploration production</td><td>40.55 percent</td></tr><tr><td>Other profits</td><td>40 percent</td></tr></table> <p>In addition, a development duty of 2 percent is applied to all profits above LE 18,000 annually.</p> <p>There are no withholding taxes on dividend distributions.</p> <p>Corporations are required to withhold:</p> <p>(1) Interest: 32 percent on the amount paid plus 2 percent development tax on interest in excess of LE 18,000 a year;</p> <p>(2) Royalty payments:</p> <ul style="list-style-type: none">• 32 percent on the amount paid if a company carries on activity in Egypt.• If the company does not practice any activity in Egypt, the gross amount of the royalty payments is subject to 32 percent withholding tax plus 2 percent development duty when the payment exceeds LE 18,000 annually. <p>(3) Dividend:</p> <ul style="list-style-type: none">• If a company does not carry on an activity in Egypt, dividend distribution shall be subject to 32 percent withholding tax plus 2 percent development duty when the amount exceeds LE 18,000 annually.	Industrial and export profits	32 percent	Profits from oil exploration production	40.55 percent	Other profits	40 percent
Industrial and export profits	32 percent								
Profits from oil exploration production	40.55 percent								
Other profits	40 percent								

1.2 Taxes on individuals

Individual taxes are based on the "Global Income Tax Law," No. 187/1993. However, the law distinguishes five categories of income: immovable property income, commercial and industrial activities income, noncommercial/liberal professional income, moveable capital income, and salaries and wage income. The first three are calculated according to a graduated rate schedule. Salaries and wages are taxed according to a separate graduated rate schedule. Income from moveable (financial) capital is taxed separately as described below. The tax on Egyptians is Law No. 208/1994. Declarations must be sent to the tax directorate before April 1; wages and salaries tax is deducted at source. Law No. 208/1994 imposes a tax on income derived by Egyptians performing employee services abroad.

Unified tax is levied on five categories of income:

(1) Tax on wages and salaries

The base is labor compensation in the form of salaries, wages, allowances, gratuities, and benefits in kind.

from another source.

There is no adjustment for inflation.

Exemptions

(1) Law No. 59/1979 provides a 10-year tax holiday in New Urban Communities (NUCs).

(2) Law No. 230/1989 provides an indefinite tax holiday for direct taxes (on corporate profits and dividends at the individual level) for investment in free zones (seven are currently operating; two more will be coming on stream shortly). For investments outside free zones, projects must fall under specific, though broad, categories, such as industry and tourism sectors. All qualified investments receive 5 to 15 years holiday for corporate tax and individual income tax on dividends. All imported machinery and equipment is then subject to a 5 percent customs duty.

(3) Law No. 187/1993 provides a 5-year corporate income tax holiday for industrial corporations employing 50 or more workers (dividends at the individual level are exempt from the tax on moveable capital).

- There are no withholding taxes on dividend distributions if the company paying the dividends carries on the activity in Egypt and is subject to corporate income tax.

(1) Tax on wages and salaries

Employment-related pensions are exempt as are wages of a daily worker provided the employment is not permanent and the worker has no other source of income. Annuities paid by insurance companies for policies with a period of less than ten years are also exempt.

Allowances that do not in total exceed LE 4,000 a year are deductible from income. These include life insurance premiums, contributions to the Egyptian state social insurance and certain private insurance funds schemes, an occupational allowance, representation allowance, and production incentive bonuses. Personal allowances are LE 1,440 for single persons, and LE 1,680 for married couples without children or unmarried with children, and LE 1,920 for a married person supporting one or more children.

(1) Tax on wages and salaries

The tax rates on taxable incomes are:

Up to LE 50,000	20 percent
Over LE 50,000	32 percent

This tax is withheld at source, and incomes in excess of LE 18,000 are subject to an additional 2 percent development duty.

Tax Summary (continued)

Tax	Base	Exemptions and Deductions	Rates
		In addition, some other allowable deductions from the tax base include:	
		<ul style="list-style-type: none"> • contributions to the Egyptian state social insurance; • life insurance premiums and certified private insurance funds scheme provided the total amount does not exceed 15 percent of total income or LE 1,000, whichever is less. 	
	(2) "Unified" tax on income from commercial and industrial activities, professions, and real estate activities. The Egyptian firm subject to this tax includes sole partnerships, general partnerships, and simple limited partnerships.	(2) "Unified" tax: Under the tax on commercial and industrial activities, the following deductions apply: rents of either owner-occupied or owned by the business; annual depreciation based on historical cost, net of initial allowances; direct taxes except those paid under this law; donations; actual and doubtful financial losses; social insurance payments; contributions for employees to special savings and pension funds (up to 20 percent of payroll); mobile capital revenue and taxes on agricultural land and real estate, with 10 percent of these revenues included in the base of the unified tax. Losses may be carried forward for five years. There are various exemptions, including profits from stock breeding and fishing and private insurance funds.	(2) "Unified" tax: The amount of tax owing on profits is calculated as follows:
	<ul style="list-style-type: none"> • For the tax on <i>commercial and industrial activities income</i>, the base is net profits, including capital gains, letting of commercial and furnished premises or plants, selling assets, building or dealing in real estate, exploitation of natural resources, poultry farms, animal husbandry, and land reclamations. Net profits also include 10 percent of moveable capital and real estate revenues. • The tax on <i>noncommercial professions</i> applies to income earned in Egypt or abroad. • The <i>real estate wealth</i> tax is applied to agricultural land revenues and building revenues. The revenues are based on the assessment used for property taxes under Law No. 56. 	<p>Up to LE 2,500 20 percent</p> <p>LE 2,501–7,000 27 percent</p> <p>LE 7,001–16,000 35 percent</p> <p>LE 16,001–27,000 40 percent</p> <p>LE 27,001–68,000 45 percent</p> <p>Over LE 68,000 48 percent</p> <p>In addition, the development duty of 2 percent is applied to the unified income tax base above LE 18,000. Personal allowances are the same as those under the wage and salary tax.</p>	
	(3) The tax on moveable capital is applied (at the source) on payments to both residents and nonresidents and includes interest payments (except for interest on savings accounts of banks supervised by the Central Bank of Egypt and debentures of public banks) and foreign dividends (net of foreign taxes).	(3) Besides interest on bank savings accounts, other exempt forms of income include proceeds of loans and credit facilities granted to the government and public agencies; proceeds due on balances of free foreign currency; proceeds of public issued debentures issued by joint stock companies that do not exceed the prescribed interest rate of the central bank; and cash or in-kind benefits related to lotteries done by insurance or savings companies.	(3) Income subject to the moveable capital tax is taxed at 32 percent. For income above LE 18,000 annually, an additional 2 percent development duty is levied.

(4) Law 208/1994 established a tax on the earned income of nonresident Egyptians, except those who have emigrated permanently and who meet the requirements of Article (8) of Immigration Law No. 111/1983.

Law No. 208/1994 establishes a tax on the earned income of Egyptians performing employee services abroad.

(4) Exemptions are social security payments; other savings payments deducted or in accordance with social security regulations of Egypt or the state where employed; family support; foreign taxes.

(4) The nonresident tax on annual earned income is:

Up to LE 20,000	1 percent
LE 20,001–40,000	2 percent
Over LE 40,000	3 percent

1.3 Other taxes on individuals

(1) Capital gains

Individuals are not subject to a tax on capital gains except for sales of real estate or building sites within the boundaries of Egyptian cities. Such gains are taxed at a rate of 5 percent of the value of the property, and gains are not subject to income tax.

None.

(2) Estate duty

Estate duty is payable at rates ranging from 5 percent to 15 percent. A number of exemptions apply.

(3) Inheritance tax

Inheritance tax was abolished in 1989.

2. Social Security Contributions

Law No. 79/1975, as amended by Law No. 25/1977 and No. 47/1984.

Social security contributions are levied on both government employees and employees of publicly owned enterprises. Employee contributions are withheld at source. None of the revenues revert to the government but are retained by an off-budget pension fund. Revenue in excess of pension fund payments and operating costs are earmarked for public sector investment financing. Most private sector employees are covered by another fund.

Contribution by percent of payroll

• On annual salary up to LE 3,600

Employer	26.0
Employee	14.0

• LE 3,600–9,600

Employer	24.0
Employee	11.0

• On tradesmen and other workers employed by a contractor for the duration of a contract or part thereof.

Employer	18.0
Employee	10.0

3. Payroll Taxes

See Stamp duties.

Tax Summary (continued)

Tax	Base	Exemptions and Deductions	Rates
4. Real Estate Taxes			
(1) Agricultural land tax: Decree Law No. 53/1935 and Law No. 113/1939.	Besides the provisions of the income tax that apply to agricultural land and buildings, real estate taxes are levied on the assessed annual rental value of agricultural land and property.	(1) For the agricultural tax, 20 percent of estimated rental value is deducted, and properties of less than 3 feddans are exempt.	(1) The basic rate for agricultural land is 14 percent.
(2) Buildings tax: Decree 56/1954 as amended by Laws No. 129/1961 and No. 136/1981		(2) For the buildings tax, a deduction of 20 percent of the annual rental value is allowed for maintenance and other expenditures. Exemptions include residential buildings built after 1981 that are not "luxury"; most rural buildings; buildings with a rental value of less than LE 10 a year; buildings used by schools, hospitals, and religious institutions; and buildings specifically exempt under various laws.	(2) The rates for the buildings tax range from 10 to 40 percent depending on the number of rooms. Cairo and Alexandria are taxed 2 percentage points higher.
5. Taxes on Goods and Services			
5.1 General Sales Tax			
Law No. 11/1991, Decree No. 180/91, No. 295/93, No. 304/93, No. 39/94.	A sales tax applied at the manufacturing level on imported and domestically produced goods (with exceptions) and specified services. Services included are tourism, telecommunications, electricity, and professional brokers.	<p>Firms with turnover of less than LE 54,000 are exempt. Input credit can be obtained by registered firms for goods only, except for "Table 1" goods as listed under rates. Exports are zero-rated. Untaxed goods are exempt. Free zones are exempt if the items are sold abroad or to other free zones.</p> <p>Exempt items (schedule A): Milk products; edible oils made from seeds, fixed, liquid, hard or refined; products of mills with the exception of excellent flours or imported yeasted flours; products and manufactures canned or prepared from meat; products and canned manufactured or prepared fish except caviar and smoked fish; vegetables, fruits, beans, seeds, spices, prepared or packed, fresh or frozen or preserved except imported; halawa, tahini; food prepared and sold by restaurants other than tourist restaurants; all kinds of controlled bread; natural gas and butane gas for retail; waste of food manufactures, food for animals, birds, or fish except dogs, cats, and ornamental fish; popular clothes distributed by the</p>	<p>The rates range from 5 to 25 percent with most goods subject to the standard 10 percent tax on gross sales.</p> <p>(1) 5 percent</p> <ul style="list-style-type: none"> • Services Hotels, tourist services, and restaurants. Air conditioned transport between governorates. Local telephone and telegraph services. • Goods Coffee. All flour products except controlled bread. Soap and manufactured household cleaners. Fertilizers. Purification materials and insecticides. Gypsum. Wood sawn lengthwise. <p>(2) 10 percent</p> <ul style="list-style-type: none"> • Services Telex and facsimile services. Sound and light shows.

Ministry of Supply and Trade; pastry, paper, scrap, and ancient products made of paper or paperboard used only in the manufacture of paper; paper for journals, printing, and writing; books, circulars, and printing of similar nature from some papers; newspapers, magazines, and printed circulars; paper money and coins except memorial coins; and macaroni from flour.

International communications.
Telephone installation and connection services.
Private car rental.
Express delivery services.
Cleaning and security services.
Real estate brokering.
Car dealerships.
• Goods
All other goods not taxed at other rates or exempt

(3) 25 percent

Color television sets.
Refrigerators.
Deep freezers of 10 cubic feet or more.
Sound recorders or reproducers.
Air conditioners.
Cameras and their parts.
Perfumes, cosmetics, preparations for the care of skin and hair.
Chandeliers and their parts.
Video tapes.
Personal motor vehicles between 1600 and 2000 cc, passenger, cargo, cars, and jeeps.

"Table 1" Goods:

<i>Item</i>	<i>GST rate (percent)</i>
• Tea (basic)	6.7 ¹
• Sugar	4.3 ¹
• Mineral water, soft drinks, and juices	
Imported	32.5
Domestic	
Less than 250 cm	50.0
Above 250 cm	60.0
• Beer	
Alcoholic	100.0
Non-alcoholic	60.0
• Tobacco	
Unprocessed	
For water pipes	100.0
Others	75.0
Processed	
Cigar and pipe	200.0
Cigarettes (domestic)	
Less than piastres 65	141.4 ¹
More than piastres 65	60.5 ¹
Others	50.0
• Petroleum products	
Gas	25.4 ¹
White spirits	
Kerosene	3.4 ¹
Solar	
Diesel oil	
Fuel oil	0.5 ¹

Tax Summary (continued)

Tax	Base	Exemptions and Deductions	Rates
			Lubricating oil 0.5 ¹ Lubricating preparations 0.3 ¹ • Pure ethyl alcohol 375.0 ¹ • Processed alcohol for fuel 17.7 ¹ • Alcoholic beverages 100.0 • Medicines (except exempt by decree) Imported 1.6 Domestic 5.0 • Equipment for handicapped exempt • Vegetable oil (nonrationed) Imported 0.8 ¹ Domestic 1.4 ¹ • Hydrogenated animal or vegetable fat/oil 1.7 ¹ • Hydraulic cement 2.1 ¹
5.2 Excises			
• Development duty			
Law No. 147/1984 amended by Law No. 5/1986 and by Law No. 520/1994. See Development duty under income taxation.	Levy of taxes on selected goods and services.		Selected items
5.3 Selective issues on services			
See Stamp duties.			• 25 percent on price of tickets issued in local currency for foreign travel. • 20-40 percent on cost of parties and receptions held in hotels and public halls. • 5 percent of auction price for auction sales. • LE 1 per item if price exceeds LE 15 bought at duty-free shops. • Passport fees at specific rates.
B. Local Government			
1. Taxes on Income and Profits			
None			
2. Social Security Contributions			
None			
3. Payroll Taxes			
None			
4. Taxes on Property			
Local authority duty. Legal reference not available.	A local tax is levied on the same basis as the agricultural land tax and the buildings tax. The proceeds from this tax are earmarked for the individual governorate.	See agricultural land and buildings tax in central government.	See agricultural land and buildings tax in central government.

5. Taxes on Goods and Services

5.1 Selective tax on services

(1) Hotel tax

Legal reference not available.

A tax is charged on the total value of amounts charged to a hotel account.

None.

Tax is levied at 2 percent of the total hotel bill in Cairo. Rates vary from one governorate to another.

(2) Motor vehicle tax

No details available.

6. Taxes on International Trade

6.1 Import duties

Customs Law No. 66/1963, as amended. Decree No. 351/1986; Law No. 186/1986; Law No. 187/1986; No. 304/1989; No. 305/1989; No. 178/1991; No. 294/1993; No. 38/1994.

Customs tariff consists of a single column based on the Brussels Tariff Nomenclature. Ad valorem duties are applied to a fair market c.i.f. import price. The valuation of imports for assessing customs duties is based on the free market foreign exchange rate as stated by the central bank.

Exemptions from customs duties include:

(1) imports by the Ministry of Defense, the companies, units, and organizations subject to the Ministry of Military Production; by the National Security Authority of special devices, necessary for its activity; by the Republic Presidency of articles for formal use; and by the Ministry of Interior;

(2) gifts and donations to the government;

(3) personal effects belonging to passengers;

(4) imports by the establishments authorized to be in free zones (except motor cars and furniture);

(5) articles and small riding motor cars equipped with special medical equipment;

(6) personal effects for members of the diplomatic corps, and imports by embassies;

(7) articles that are exempt by a decree of the President of the Republic.

Goods in transit and goods that enter specified free zones are exempt from import duties and excises. Duties may be refunded on imports that are embodied in exports if the reexportation takes place within one year after the duties were paid.

Under the program of investment incentives for approved undertakings, customs duties may be excused for specific periods, but a minimum unified rate of 5 percent is collected on all exempt imports.

All duties, with the exception of those levied on tobacco, are ad valorem.

Rates mainly vary between 5 percent and 70 percent. The rate of 1 percent is levied on 33 items of foodstuffs. Rates of 5 and 10 percent are levied on most other foodstuffs. Duties for many industrial supplies range from 5 percent to 20 percent. Eighteen categories of machinery and durable goods are subject to 10 percent tariff, the rest between 30 percent and 70 percent. Duties on consumer goods are generally higher: 40 percent to 70 percent, for example, color television sets, 70 percent, refrigerators, 50 percent to 70 percent.

Exceptions include alcoholic beverages, taxed at 600–3,000 percent (300 percent at tourist facilities), and passenger vehicles taxed at 135–160 percent.

Specific duties in the range of LE 6.1–9.0 per kilogram are levied on tobacco products.

Tax Summary (concluded)

Tax	Base	Exemptions and Deductions	Rates														
		<p>The assembly industries may request permission that their assembled products be treated according to the following provisions:</p> <p>(1) The completely knocked-down parts, imported by the factories to be assembled, under supervision of the customs administration are subject to the import duty rate imposed on the final product, less 20 percent.</p> <p>(2) In case locally manufactured parts are used, the imported parts are subject to the duty rates applicable to the finished product, after being reduced according to the following proportions (with a maximum limit of 75 percent) or the established import duty on the imported parts, whichever is lower:</p> <table> <tr> <th>Proportion of the locally manufactured parts to the parts entering in the finished product (In percent)</th> <th>Reduction in import duty</th> </tr> <tr> <td>20</td> <td>25</td> </tr> <tr> <td>30</td> <td>30</td> </tr> <tr> <td>40</td> <td>40</td> </tr> <tr> <td>50</td> <td>50</td> </tr> <tr> <td>60</td> <td>60</td> </tr> <tr> <td>over 65</td> <td>75</td> </tr> </table>	Proportion of the locally manufactured parts to the parts entering in the finished product (In percent)	Reduction in import duty	20	25	30	30	40	40	50	50	60	60	over 65	75	
Proportion of the locally manufactured parts to the parts entering in the finished product (In percent)	Reduction in import duty																
20	25																
30	30																
40	40																
50	50																
60	60																
over 65	75																
6.2 Export duties																	
Customs Law No. 66/1963, as amended, and Decree No. 351/1986.	Specific or ad valorem duties are levied on the export of a small number of commodities: raw hides and skins, molasses, metal waste and scrap, and antiques over 100 years old.	None.	Illustrative export duties are LE 11 per metric ton of metal waste and scrap, LE 0.6 per 100 kilograms of molasses, and LE 1.2 per metric ton of raw hide. Antiques, 5 percent of their value.														
7. Other Taxes																	
7.1 Poll taxes																	
None.																	

7.2 Stamp duty

Law No. 111/1980; Law No. 95/1986; Law No. 104/1987; Law 224/1989.

Stamp duties are levied on a wide range of documents including deeds, applications, contracts, permits, registration, insurance premiums, checks, invoices, lotteries, education degrees, stocks, promissory notes, bearer notes of guarantee, publicity and advertisements, judicial papers, passenger tickets, water, electricity, gas, telephone, and salaries of government and public sector companies. Bank credits are also subject to annual stamp tax equal to 1 percent. Stamp duties may be dimensional, specific, proportional, or graduated. The tax is collected by means of stamped paper, stamps, a control plate, or in cash.

Under the program of investment incentives for approved undertakings, the tax may be excused or reduced. Stamp duties are not changed on interactions between government departments.

There are many varied rates.

Selected rates

- LE 50 for registration of a company in the commercial register.
- LE 0.1 on bank checks and vouchers carrying a signature as a development duty plus 0.3 stamp duty.
- 0.3 percent on bills of exchange, promissory notes and bearer notes as stamp duty plus 0.1 development duty.
- LE 900 to 1,800 on the formation of a company. (Corporations: joint stock company, limited liability company of partnerships limited by shares governed by Law No. 159 of 1981)
- LE 90 on the formation of partnerships.

¹Ad valorem equivalent of specific rates.

Appendix II Prudential Requirements for the Banking System

This appendix provides a brief summary of the prudential regulations of the Central Bank of Egypt in respect of commercial banking procedures.

Foreign currency exposure. In April 1991, the central bank required that all banks limit foreign currency liabilities as a ratio to foreign assets (and the inverse) to 105 percent, while the net foreign currency position was limited to 15 percent of each bank's capital. From January 1994, foreign currency exposure was limited to 10 percent of capital (in single currency terms) and 20 percent of capital (in gross aggregate terms).

Capital adequacy ratio. In January 1991, the central bank established a capital adequacy ratio equivalent to 8 percent of risk-weighted assets, in accordance with the guidelines developed by the Basle Committee. In 1992, minimum capital requirements for Egyptian banks were increased to LE 100 million for authorized capital and LE 50 million for paid-up capital; branches of foreign banks were required to show a minimum capital base of not less than \$15 million.

Asset classification and provisioning. In May 1991, strengthened guidelines were issued governing loan classification and provisioning.⁵⁸

Reserve requirements. In December 1990, the reserve requirement ratio on Egyptian pound deposits was extended to all deposits (rather than deposits exceeding two years' maturity). At the same time, the minimum reserve was reduced to 15 percent for domestic currency liabilities and 10 percent for foreign currency liabilities.

Credit concentration. From May 1993, commercial banks' credit to single customers (in the form of share holdings or direct lending) has been limited to 30 percent of capital (on the Basle definition). At the same time, the Banking Law requires that credit to a single customer should not exceed 25 percent of a bank's paid-up capital and reserves. In September 1995, these regulations were extended to business

and investment banks. A schedule for ensuring compliance with this limit by the end of December 1996 was in place by the end of December 1993. Banks are also required to limit share ownership in all companies to not more than issued capital and reserves.

Liquidity ratio. In January 1991, the scope of the minimum liquidity ratio was widened, while the ratio was reduced from 30 percent to 20 percent. A new liquidity ratio of 25 percent was also initiated for foreign currency liabilities. The liquidity ratios were also extended to business and investment banks.

Investment concentration abroad. From November 1992, all banks (other than branches of foreign banks) were required to limit investments with single foreign correspondents to not more than 10 percent of total investments abroad (or \$3 million, whichever is higher). Moreover, total investments with foreign correspondents should not exceed 40 percent of capital (according to the Basle definition).

Reporting and auditing arrangements. In 1991, the central bank introduced special audits for the four public banks. In 1997, banks were required to prepare and publish their financial statements according to international accounting standards.

Intervention procedures. Under legislation approved in 1992, the central bank can require a bank facing financial difficulty to raise additional capital. It may also request banks not to distribute profits until the level of provisions becomes adequate. If a bank fails to meet the necessary capital requirements, the central bank may order that the bank be liquidated or merged with another bank.

Deposit insurance. Egypt does not have a formal system of deposit insurance. In the past, the difficulties of individual banks have been met in an ad hoc manner by the central bank or government. For example, in 1991, a joint venture between Bank for Credit and Commerce International (BCCI) and a local partner experienced difficulties that prompted the central bank to request other banks to lend support in the form of an interest-free loan equivalent to 0.25 percent of their deposits. Subsequently, the joint venture merged with a public sector bank following the collapse of BCCI, supported by a loan from the central bank.

⁵⁸Loans were classified into substandard, doubtful, and loss categories, depending on whether interest payments were 3, 6, or 12 months late. Corresponding provisions were set at 20 percent, 50 percent, and 100 percent of the relevant loan amount.

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