Working Paper No. 253

Challenges of Economic Reform in Egypt

by

T.N. Srinivasan

September 2005

Stanford University

John A. and Cynthia Fry Gunn Building

366 Galvez Street | Stanford, CA | 94305-6015

* Samuel C. Park, Jr. Professor of Economics, Yale University, New Haven, Connecticut, and Senior Visiting Fellow, Stanford Center for International Development, Stanford University, Stanford, California.
Challenges of Economic Reform in Egypt

T. N. Srinivasan*

JEL Classification Codes: E62, I30, O40, O55
Keywords: economic growth, fiscal policy, poverty, Egypt

1. Introduction

I am grateful for the opportunity for the second time to address this gathering of academic economists engaged in important research on the Egyptian economy and policy makers, whose task it is to translate findings of research into concrete policy actions. It is always a pleasure to be among colleagues, including Professors Heba Nasser and Heba Handoussa, with whom I had the privilege of exchanging ideas in the past.

Since my last visit a year ago, there have been several important, and in some ways radical, changes in Egypt’s economic and political landscape. Last June, there was a great deal of uncertainty about the composition of the new government about to assume office and its likely policy stance. The Egyptian economy then was, to put it mildly, stagnating, and the need for undertaking major reforms was urgent. As they say, one year is an eon in politics. As an outsider, I found a very dramatic change for the better in the political and economic landscape within a short period. Of course, at the very top of the list of changes is the unexpected announcement by President Mubarak in February this year of direct elections, with more than one candidate competing, for the office of the President. A national referendum on rules for the elections was held in May. I do not have the intimate knowledge of Egyptian politics to assess the criticism that these rules are much too restrictive and would, in effect, maintain the dominance of the ruling party. Whether this is indeed the case or not, I would suggest that by the

* Samuel C. Park, Jr. Professor of Economics, Yale University, New Haven, Connecticut, and Senior Visiting Fellow, Stanford Center for International Development, Stanford University, Stanford, California.
very announcement of direct elections, the President has unalterably changed the character of political intercourse. Actions and public expression of views, which earlier were difficult to undertake, if not unthinkable altogether, no longer seem so. The optimist in me wants to believe that the President’s action has initiated a process that is not only irreversible, but which inevitably has to lead to further opening of the political system. The only question, and I do not wish to minimize its relevance and importance, is whether the dynamics of this process of transition to a liberal democracy will be orderly, peaceful and smooth or chaotic, violent and sudden.

The government of Prime Minister Ahmed Nazif and his ministerial economic troika (or trinity depending on one’s preference for a word with secular or religious connotations!), consisting of Ministers Youssef Boutros-Ghali, Rashid Mohammad Rashid and Mahmoud Mohieddin, have in a short span of less than a year done a remarkable job by undertaking a number of significant reforms in deregulations, privatization, the financial and fiscal sectors. Even the normally staid IMF (2005a, p. 5) has used strong words of praise for these reforms: “The new cabinet quickly established its credentials by implementing a number of economic reforms and announcing plans to restructure the financial sector and privatize most state enterprises. Since then, work has continued at a steady pace.” I thought the best use of my limited time today would be, first, to recapitulate briefly the state of the Egyptian economy and its problems last June, then, go on to discuss how the ongoing reforms are addressing some of these problems, and, finally, touch on future challenges for realizing Egypt’s potential as a dynamic, private-sector driven market economy, well integrated into the global economy. These challenges, as the IMF (ibid) noted after praising recent reforms, are considerable.

---

1 I am sure my friend Jagdish Bhagwati would want to claim part of the credit that goes to Minister Boutros-Ghali, having been his teacher at MIT!
2. **Egyptian Economy in June 2004**

In my assessment of the Egyptian economy last year, I had noted that Egypt’s growth performance over the four decades since 1965 had been lackluster. Its average growth of 5% per year during that period was largely due to the rapid growth exceeding 7% per year on the average during the decade 1975-85. This growth resulted primarily from rapid capital accumulation. In the other decades (with the exception of the five years of 1995-2000, when growth averaged around 5.75%), the growth rate was under 4% per year. In fact, during 2000-2003 the average rate of growth has been only around 3% per year. This growth performance, by all accounts, was way short of the potential of the Egyptian economy.

The other disquieting features of the economy were a slow down in investment, particularly private investment and a rise in inflation and in unemployment. The Egyptian consumer price index (CPI) is heavily weighted by commodities subject to price controls and, as such, is not a good measure of inflation. The wholesale price index (WPI), which is a less distorted measure, showed that inflation had been rising at an increasing rate since 2002, reaching a high of 21.7% in January 2004, up from 10.3% in January 2003. The unemployment rate rose from 9.0% in 2002 to 10% in 2003, and it was expected to rise further to 11% in 2004. There are no long time series data on poverty based on household surveys. According to one source of data, poverty, as measured by the proportion of individuals living below the national poverty line, showed only a small decrease of 2%, from 25% in 1990-91 to 23% in 1995-96. In fact, urban poverty increased by about 2% in the same period. Another source (El-Laithy et al. 2003) suggested that poverty fell by 2% from an average of 19% in 1991-95 to 17% in 1996-2000 and rose to 20% in 2001-02.
Egyptian fiscal data are not yet fully transparent. Although on a budget basis the fiscal deficit was 6% of GDP in 2002-03 and thus not excessively high, there were several off-budget items, including contingent liabilities. Subsidies and transfer were high and accounted for nearly 4.5% of GDP. For example, the price of the common baladi bread had been fixed at the same nominal level of 5 piastres per loaf since 1988! This subsidy, and that on higher quality fino bread, which was introduced in 2003 for the first time in over twelve years, was putting an increasing subsidy burden on the budget. Gross public debt to GDP exceeded 100% in 2002-03, and net public debt was estimated around 70% of GDP in June 2004. Although gross external debt at 30% of GDP is less than a third of total public debt, still the overall debt situation was not healthy.

Turning to the external sector, Egypt was a very closed economy. Exports, at about $8 billion, accounted for only 10% of GDP. Exports of petroleum products, cotton yarn, textiles and garments, and agricultural products together accounted for more than a third of exports. The value of imports were double that of exports, the deficit being financed in large part by earnings from tourism, Suez Canal receipts, and workers’ remittances. The current account had been in surplus for two years. For a lower middle-income developing country such as Egypt, a current account surplus is an anomaly—the economy should be investing more than it saves, thus running a current account deficit that is financed by sustainable capital inflows. In fact, net foreign direct and portfolio investment flows into Egypt were very modest, less than $1 billion. There was also evidence that Egyptians hold their savings abroad rather than invest in the domestic economy. This was yet another indicator of the poor domestic investment climate.

The exchange rate was briefly allowed to float in early 2003, and the parallel market rate moved closer to the official rate. This experiment at floating was effectively abandoned in mid-
2003, and the parallel rate has begun to diverge again from the official rate. Exchange rate management is non-transparent, with official “persuasion” being the tool, rather than the use of monetary policy or of reserves. In fact, the movements in the official exchange rate, the reserves, and the interest rate are kept controlled and limited through non-transparent means.

The public sector was dominant in many sectors of the economy, including the financial sector, with the government owning several commercial banks. The cotton textile industry is publicly owned. Non-performing loans of the commercial banks were around 20% of their gross loans in September 2003. The average returns on assets and on equity in publicly owned banks were much lower than those of other banks. The banking system in general, and publicly owned banks in particular, were in effect serving as lenders to the government by holding a large share of public debt. The primary market for public debt is in its infancy, and there is no secondary market. This being the case, and with interest rates allowed to move only in a narrow range, and that too through not very transparent mechanisms, it was hard to say how, in fact, monetary policy was formulated and implemented.

The above assessment of the economic situation last year led me to make a few recommendations, a number of which seem to have been implemented since, though, of course, I cannot take credit for it! After all, what I recommended had also been proposed by Egyptian economists as well as international agencies involved in advising and assisting Egypt. In order to set the stage for assessing, and indeed highlighting, the significance of the reforms initiated by the ministerial troika, let me recall my recommendations. First of all, the economy had to become far more open than it is and become better integrated with the world economy—trade barriers had to be brought down substantially. Even after trade liberalization in the 1990s, unweighted tariffs were still around 20%. There were a large number of tariff lines and
dispersed tariff bands. In addition, there were administrative fees and surcharges, as well as many exemptions from tariffs. All these made the system very complex and opaque in its incentive structure. High tariffs and other barriers raised the cost of inputs, and their variability created uncertainty. These reduced the competitiveness of Egyptian exports. Not only was the share of exports in GDP relatively low, the export basket was not diversified and the share of manufactured exports (often the most dynamic in many countries) was low. All these needed to be corrected.

Second, the facts that the exchange rate policies were non-transparent and the floating of the pound was reversed after a brief period did not send the right signals, both for Egyptians planning to invest in the export sector and for foreign investors. Also, there were multiple exchange rates. As noted earlier, the inflexible exchange rate, interest rate and reserve policies are major constraints on efficient macroeconomic management. This being the case, there was an urgent need for an overhaul of the policy-making apparatus, introducing greater transparency, lesser uncertainty and greater flexibility.

Third, Egypt still seemed to cling to a now widely discredited regime of state domination in the economy. There is no doubt that there should be far less government intervention in the economy, particularly in the form of public ownership of enterprises producing private goods and services and direct controls on private economic activities. Whatever interventions there are have to work through the market and prices, with sound macroeconomic and fiscal policies being the primary tools of economic management. Structural reforms in the financial sector, public enterprises and foreign trade cannot be allowed to languish, as they seem to have been since the 1990s.
Fourth, there must be a determined effort to push forward the programme of privatization. The ambitious plan announced early in 2004 envisaging privatization of an overwhelming majority of the existing 178 non-bank public enterprises should be implemented. Unless there is a convincing social rationale for the government to continue to own a commercial enterprise, it should be privatized. From this perspective, the cotton textile industry seems ripe for privatization. In addition, public ownership of commercial banks has to be reduced significantly. When the government owns banks, it is virtually impossible to commit credibly not to bail out failing banks, particularly the large ones. Inevitably, the government ends up recapitalizing failing banks and the non-performing loans of the banks become contingent liabilities of the government. The facts that in 2001 state banks were recapitalized to the extent of £E9.4 billion and in March 2003 there was another injection of capital to the tune of £E4.0 billion were ample evidence that lowering of public ownership of banks was urgent.

Fifth, gross public debt at over 100% of GDP was high, and the fact that there were significant off-budget expenses and liabilities made the situation even more disquieting. The authorities should make the budgeting process more transparent and begin to address the difficult issue of subsidies.

3. Recent Reforms, Economic Performance and Future Challenges

3.1 GDP Growth

There is some encouraging evidence that the stagnation in growth since 2000 has been broken. According to IMF (2005a, Table 1), revised estimate of rate of real GDP growth in 2003-2004 was 4.1%, compared to 3.1% in 2002-2003. The projected growth rates for 2004-05 and 2005-06 are respectively 4.8% and 5.0%. The growth pick-up has been driven in part by strong export performance and an increase in private consumption. World Bank (2005, Table
4.1) data indicate that annual rate of real GDP growth in Egypt during 1990-2003, at 4.5%, compared favorably with the average rate of 3.9% for the group of lower middle income economies and, even more so, with the average of 3.2% for the group of Middle Eastern and North African economies. Egypt is a member and the largest economy in both groups, so that Egypt’s performance has a large impact on group performance. This in turn means that Egypt has performed better than the average performance of all other economies in each group. Yet, Egypt does not do well when compared to South Asian (SA) countries, including India, the largest economy, which are much poorer. The average annual rate of GDP for 1990-2003 for SA (India) was 5.4% (5.8%). Since SA economies are expected to grow even faster in the near future, the projected acceleration in Egyptian growth, to around 5% in the next couple of years, would still make Egypt a relatively slow-growing economy. Since GDP growth is just an overall indicator that summarizes the performance of the economy in different sectors, a shortfall in it relative to other comparable countries is a pointer to the challenges in accelerating growth, which can be identified only by analyzing the constraints, opportunities and policy options at a disaggregated level.

IMF (2005b) reports on an exercise decomposing aggregate GDP growth into the contributions of growth of inputs (physical and human capital) and total factor productivity (TFP). I need not remind this knowledgeable audience that such exercises are based on a number of assumptions, not all of them statistically testable, as well as the use of data that are subject to measurement errors, and as such, their findings have to be interpreted cautiously. For whatever it is worth, the following are the conclusions from the IMF exercise, along with my comments on them.
(i) Annual rate of GDP growth slowed from 6% during 1961-1980 to 4.8% during the 1980s and 1990s, and further slowed to 3.5% during 2001-2004. This is the growth stagnation to which I drew attention last year. Fortunately, as noted above, there is some recent evidence of growth revival.

(ii) Growth in output per worker exhibits a declining since the early 1980s and is currently below the trend of the 1960s. There is a strong cyclical pattern, with large fluctuations around the trend from 1960 to the mid-1980s. Since this exercise is purely a statistical separation of trends from growth, it has nothing to say on the sources of these large fluctuations or of trend growth.

(iii) Turning to the trend, the contribution of growth of physical capital per worker to growth of GDP per worker was 35% during 1961-1980, rose to 50% during 1981-2000, and fell to 14% during 2001-2004. The contribution of TFP growth was 50% during 1961-1980, fell to a low of 6% during 1980-2000, and has since recovered to 54% during 2001-2004.

A simple, though not inappropriate description of these findings would be to say that in the 1960-1980 period, the economy grew relatively fast from a low base. It is not surprising that TFP growth was substantial during this period. It is very likely that the 1980-2000 period represents the heyday of state-directed inward-oriented development, with investment directed to industries and sectors which the domestic production was low or non-existent, but in which Egypt probably did not have a comparative advantage. If this is indeed the case, the rapid growth of these industries as well as GDP, the rise in the contribution of physical capital, fall in that of TFP growth, and fall in the rate of growth of output per worker compared to 1960-1980, are all understandable. The subsequent fall in the rate of the growth of output per worker from 1.8% in 1980-2000 to 1.3% in 2001-2004 is modest. However, the fall in the contribution of
physical capital and a rise in that of TFP growth perhaps reflect improvements in utilization of capacity accumulated during 1980-2000. The fact that the rate of investment slowed down from about 20% of GDP during 1980-2000 to 17% since is suggestive of excess capacity creation during 1980-2000. It is also evident that gains in TFP due to improved capacity utilization alone cannot be sustained indefinitely. If the recent growth pick-up is to be sustained, investment in physical capital has to be raised and TFP growth has to be accelerated.

3.2 Fiscal Situation

3.2.1 Data Issues

Last year, I had referred to the deficiencies in Egyptian macroeconomic data in general and fiscal data in particular. These deficiencies make the task of monitoring economic performance, and of instituting needed policy corrections considerably difficult. IMF (2005a, Appendix III) describes the current situation. It points out that “Staff resources at the Ministry of Finance for the calculation of fiscal data are limited, and all processes in the accounting system are done manually, which has an impact on efficiency. Fiscal data are reported primarily on a cash basis. However, investment expenditures in the budget sector and accounts of the Social Insurance Funds and economic authorities are reported on an accrual basis.” Fiscal policy instruments are essential components in the kit of macroeconomic policy tools. Unless fiscal data present a reasonably accurate picture of the actual fiscal situation, formulating appropriate fiscal policies could become an exercise in futility. Although Egypt is said to compile its National Accounts based on the UN Statistical Office’s 1993 System, the data apparently have many shortcomings according to IMF. I could not find consistent accounts of capital formation and its financing. It would be analytically very useful to have data that distinguish private (corporate, unincorporated enterprises, household) and public (general government, public
enterprise) sectors. The financing of capital formation from domestic and external savings should be properly accounted, with the data on external savings being consistent with balance of payments data. Since neither the World Bank nor the IMF reports that I consulted had such data, I concluded that they were unavailable. If I am not mistaken, this is a serious problem.\(^2\)

India’s Central Statistical Organization (CSO) regularly publishes annual and quarterly data on National Accounts, with the so-called “advanced” estimates for the fiscal year published about two months before the end of the year. A year later, a revised set of “quick” estimates for the same fiscal year are published, followed by “provisional” estimates after another year. Although fully revised and final estimates appear nearly three years after the end of the fiscal year, the revisions from provisional and quick estimates are usually small.

Estimates of capital formation and its financing are one of the most important accounts in the Indian data, although there are some well known and long understood problems with these data. I invite you to read the report of the National Statistical Commission (GOI 2001) for an exhaustive account of the strengths and weaknesses of India’s statistical system and my critique of it (Srinivasan 2003). One of the facts highlighted by the data on savings and capital formation is that households (inclusive of unincorporated enterprises) accounted for 87% of the total gross domestic savings of 28.1% of GDP at market prices. What is more, only 47% of total household savings was in the form of financial assets, the rest being in the form of direct investment in physical assets. The latter of course does not go through the process of financial intermediation. There are a number of issues relating to financial sector reform, availability of new financial products and their impact on household saving and its composition. These cannot be analyzed without such data. As far as I know, there are very few developing countries, and Egypt is not one of them, for which such data are regularly published. The importance of reliable, timely and

\(^2\) Egypt subscribed to the IMF’s Special Data Dissemination Standards (SDDS) only recently, on 31 January 2005.
adequate macro and microeconomic data for sound policy making cannot be overstated. Egypt has a long way to go in this regard.

3.2.2 Fiscal Deficit and Public Debt

Official estimates of the fiscal deficit do not include other debt creating operations of the government, such as those of the National Investment Bank (NIB), supplier’s credit (including transfers to social insurance funds), arrears in payments, etc. According to IMF (2005a, Table 1), official estimate of fiscal deficit was 2.5% of GDP in 2003-2004 (projected to be respectively 3.1% and 2.9% in 2004-2005 and 2005-2006). The other debt creating operations added a much larger 4.1% to the deficit (projected to be at 4.0% in 2004-2005 and 2005-2006). Thus, total deficit will be in the range of 6.6%-7.1% during 2003-2004 – 2005-2006. Although this is not as high as the deficit in other developing countries, such as India (which ran a fiscal deficit of over 9.7% in 2003-2004 before including disinvestment receipts of 0.5% of GDP, according to IMF (2005c, Table 6)), it adds to already high public debt. Thus, a major challenge is to achieve fiscal consolidation and reduce public debt to sustainable levels.

On the expenditure side, an important contributor to the fiscal deficit in Egypt, as well as in India, are subsidies on various products, including food, fuel and fertilizer. In both countries, there are implicit subsidies that are not reflected in the budget, as well as explicit ones that are. In Section 2, I mentioned subsidies for bread in Egypt as one of the important ones. I do not want to be misunderstood: there usually is a strong social rationale for some subsidies (such as, for example, for education, health and nutrition of the poor). However, one has to examine the social rationale for an existing set of subsidies and also whether the same social objectives could be achieved at lower cost to the public budget through other means.
At the request of India’s Finance Minister, the National Institute of Public Finance and Policy (NIPFP) examined the subsidies (implicit and explicit) of the central government. It did not cover subsidies of the state governments, particularly on electricity, which were substantial. The NIPFP report (MOF 2004) suggested a three-tier (Merit I, Merit II and Non-Merit) hierarchy of the government’s social and economic services. In its view, “while merit goods deserve subsidization in varying degrees, Merit I dominates Merit II in terms of desirability of subsidization. Furthermore, the case for subsidizing non-merit goods becomes a tenuous one” (MOF 2004, p. 2). Yet, non-merit subsidies accounted for 58% of the total subsidies in 2003-04! There has been very little change in 1987-88 when subsidies accounted for 4.53% of GDP and in 2003-04 the percentage was 4.18 (MOF 2004, Table 2.4). Explicit subsidies at 1.7% of GDP accounted for 40% of total subsidies. It would be timely and instructive to undertake a similar study for Egypt.

The three products that involved large and explicit central government budget subsidies in India were fertilizer, food and fuel, and rationalizing and reducing these subsidies have been politically almost impossible. There were large subsidies on electric power in state government budgets, both explicit and implicit. I suspect the situation in Egypt is no different, although Egypt successfully raised the subsidized prices of subsidized fuel and electricity in 2004. Fertilizer sector in Egypt and India have a number of similarities: significant public ownership, heavy regulation, price controls and interventions and subsidization.

---

3 The details of the three categories are:

- Merit I – Elementary education, primary health-care, prevention and control of diseases, social welfare and nutrition, soil and water conservation, economy and environment.
- Merit II – Education (other than elementary), sports and youth services, family welfare, urban development, forestry, agricultural research and education, other agricultural programmes, special programmes for rural development, land reforms, other rural development programmes, special programmes for north-eastern areas, flood control and drainage, non-convention energy, village and small industries, ports and light houses, roads and bridges, inland water transport, atomic energy research, space research, oceanographic research, other scientific research, census surveys and statistics, and meteorology.
- Non-Merit – All others.
According to the *Economist* (2005, p. 23), a number of ministries influence the output of fertilizers in Egypt: the Ministry of Petroleum determines the supply of natural gas feedstock for production, the Ministry of Agriculture imposes price controls, and the Ministry of Foreign Trade and Industry restricts imports by the private sector so as to protect domestic industry and restricts exports if domestic market prices rise too much. The heavy hand of the state has deterred domestic and foreign investment in the industry and also made privatization of state-owned plants virtually impossible.

In India, the historically public sector invested in fertilizer production at different points in time with all manner of feedstock, such as coal, naptha, fuel oil and natural gas! Fortunately, the plant that once used electrolysis of water to produce hydrogen to be converted into ammonia has been converted to other feedstock. The cost of product from plants of different ages and feedstocks varied substantially. The dominant objective of public policy was limiting fertilizer imports to only the amount that cannot be supplied by the domestic industry, and that all plants, regardless of their costs were to operate. This, together with the objective that farmers should be able to purchase fertilizer at a “reasonable” price, meant a complicated price-subsidy scheme in which the government purchased fertilizers from domestic producers, at a so-called “retention” price to producers that varied from plant to plant, imported fertilizer at the world market price, and pooled domestic and imported fertilizers at a common price to farmers. This scheme made it very difficult to disentangle the subsidies to high cost producers and those to farmers from the overall subsidy expenditure in the budget. Several government appointed committees have periodically proposed rationalization of the complex system. However, there is no inclination to phase-out internationally uncompetitive domestic plants and to target the subsidies to poor farmers.
In Egypt, Minister Rashid has apparently reached an agreement with the relevant ministries for the lifting of price restrictions and export quotas. The Agriculture Ministry will buy all domestic out at world market prices, and farmers will be subsidized through cash transfers from the budget. If fully implemented, these steps are major improvements in the present system. However, with world prices currently three times those in Egypt, a shift to purchase of all domestic output at market prices would mean a substantial increase in subsidy outlays from the budget, unless subsidies are successfully targeted to a subset of poor farmers, leaving others to pay the full market price. The Indian experience suggests that this is not an easy task.

On the revenue side, tax revenue as a proportion of GDP, at around 14% of GDP (IMF 2005a, Table 3), is not high. The expected reduction in external tariffs, though desirable from the perspective of needed opening of the economy further, would reduce tax revenues, at least in the short run. In fact, IMF (ibid) projects a reduction in tax revenue to 12.9% of GDP in 2005-2006, from 13.7% in 2004-2005, in part due to a fall in customs revenues. It is clear that a component of fiscal reform has to be tax reform that results in a widening of the tax base, reduction in rates and dependence on indirect taxes in goods, services and trade. On tax reforms, the Indian situation is similar, although India’s fiscal system is more complicated than Egypt’s since India is a federal country and faces well-known problems of fiscal federalism (see Singh and Srinivasan 2005). Based on the recommendations of several expert committees, India is engaged in the reform of its tax system (although India’s fiscal system is more complicated than Egypt’s since India is a federal country). The very recent introduction of a system of value added taxes to replace cascading sales taxes is a significant step in this process. In Egypt, the Nazif government’s raising of prices of subsidized fuel and proposed modification of tax law,
simplifying the rate structure and reducing personal and corporate income tax rates, are all important steps.

Turning now to public debt, gross public debt in Egypt is the sum of domestic and external (government guaranteed) debt of the consolidated general government. It excludes the contingent liabilities of the Social Insurance Funds (SIFs) and outstanding arrears. Net debt is obtained by subtracting government deposits in the banking system. (IMF (2005b, Table 1, p. 25) data show that gross (net) public debt as a proportion of GDP was 117.8% (68.5%) in 1994. It fell to 75.4% (47.4%) in 2000, only to rise back to 111.9% (65.7%) in 2004. However, the share of external debt in gross (net) debt steadily declined from 50% (53%) in 1994 to 35% (33%) in 2000, and further to 31% (30%) in 2004. IMF (2005b) points out that Egypt’s gross public debt is high compared to around 65% of GDP during 2000-2004 in a sample of emerging market economies excluding Egypt. India’s public debt was 81.4% of GDP in 2003, with less than a tenth of it being external.

Egypt’s external debt has been managed prudently since the debt rescheduling of the 1990s. Also, in the domestic debt, loans from banks have fallen steadily, with most of the increase coming from government securities of long maturities. IMF (2005a, 2005b) and Alba et al. (2004) have analyzed the sustainability of Egypt’s debt. IMF (2005a) considered the following two alternative scenarios and did stress checks on them:

The first (baseline) scenario assumes that government borrowing remains between 6½-7 percent of GDP until 2009/10, while the second assumes that government borrowing falls by about 1 percent of GDP per annum. Two results are noteworthy. First, keeping government borrowing at the levels of recent years would not reduce the public debt-to-GDP ratio, and could lead to a ratio of 80 percent by 2009/10 if growth slowed suddenly. Second, a decline in government borrowing of 1 percent of GDP per annum for five years would lower the public debt ratio by about 8 percentage points of GDP; [IMF] staff regards this as the minimum adjustment needed to place public debt on a firmly declining path,
thereby creating room to absorb shocks and contingent liabilities, particularly related to bank restructuring (IMF 2005a, p. 17, emphasis added).

Clearly, fiscal consolidation based on tax reform, control over public spending, including, importantly, on subsidies, anticipating and allowing for the likely cost of financial sector reforms to address problems of non-performing loans and capital inadequacies, is the challenging task for bringing debt under control. In India, the central parliament and several state legislatures have enacted Fiscal Reforms and Budget Management laws. The law mandates a time path for eliminating the excess of current expenditures over current revenues (the so-called “revenue deficit” in the India budgetary terminology) and also for reducing the overall fiscal deficit by a specified time. Certain exigencies led to the postponement of the specified target dates. Further, the central finance minister, in his budget for the current fiscal year, pushed the “pause button,” as he called it, on the steps necessary to be on the projected path of deficit reduction in the central legislation. The experience with state legislation is not adequate to assess progress. Nonetheless, it may be worthwhile for Egypt to examine the Indian experience and enact similar legislation if appropriate.

3.3 External Sector

In Section 2, I pointed out that in last June, Egyptian exchange rate policies were not transparent, the attempt at floating the pound had been reversed, and there were multiple exchange rates. There have been major reforms since then; the exchange rate has been unified, an interbank market for foreign exchange has been set up and the surrender requirement on export proceeds has been abolished. In January 2005, Egypt accepted obligations to ensure convertibility of the pound for current transactions, under IMF Article VIII. The exchange rate in the parallel market, which fetched a premium of over 15% over the official rate in late 2003,
has now converged to the official rate, although the parallel market continues to function. Improved confidence in the stability of the pound has led to its appreciation—in fact, the authorities have intervened by purchasing foreign currency so as to prevent the pound from appreciating too much. It looks as if Egypt is joining the club of emerging market economies and also other developing countries, which include India, in managing its formally floating currency in a way that the exchange rate moves in a very narrow band. This club has been characterized as exhibiting a fear of floating for various reasons (Calvo and Reinhart 2002). Nonetheless, there is a virtual sea change for the better in Egyptian exchange rate policy management compared to last year.

IMF (2005b, Section 1), examines the relationship between movements in nominal exchange rates and wholesale and consumer prices in Egypt during the period of flexible exchange rates through a recursive vector autoregression model. In theory, as long as there is some pass-through to domestic prices of the cost of imports or prices of exports due to changes in exchange rates (or in border or world prices), movement in exchange rates (and expectations of movements) would affect domestic prices and inflation. Egyptian data show that CPI remained stable during 2000-2003, although there was a sizeable depreciation of the pound. Only after a new series of CPI with update weights was introduced in July 2003, a rise in CPI inflation due to pound depreciation is seen. On the other hand, pound depreciation had a larger impact on inflation as measured by the WPI, although with a long lag between depreciation and inflation. The study thus found a statistically insignificant pass-through to the CPI and significant, but slow (taking between six to twelve months), pass-through to WPI, which was also much lower and slower as compared to other emerging markets in recent years.
I noted in Section 2 the problem of large weights of administered prices in CPI and this distorts the index for measuring inflation. IMF (2005b, Section 1) attempts to construct “counter-factual” CPI to counter this problem. The use of this counterfactual suggests that CPI inflation would have been 2 to 3 percentage points higher if the dynamic relationship between the exchange rate and prices identified in the late 1990s had been maintained. Be that as it may, in general, when economies liberalize their trade and exchange rate regimes, more and better goods and services become available. It is essential to revise price indexes to allow for this.

Egypt has been running a surplus in its external current account since 2001. It is estimated at 3.4% of GDP in 2003-2004 and projected to rise to 4.2% in 2004-2005 and then gradually fall to 1.9% in 2000-2010 (IMF 2005a, Table 7). However, this surplus is the result of a growing surplus in services trade (basically, tourism and Suez Canal revenues) offsetting a growing deficit in merchandise trade. As I noted in Section 2, it is anomalous for developing countries such as Egypt and India to run surpluses on current account, instead of deficits financed by sustainable capital inflows, so that the economy invests more in growth promoting assets than its domestic savings could finance.

The fact remains, and I have drawn attention to this as well in Section 2, in its capital account, Egypt received less than $1.5 billion (or 1% of GDP) in FDI and portfolio flows of around $0.3 billion in 2004, whereas capital outflows through the banking system and others accounted for $5.9 billion (Economist 2005, p. 39). It remains to be seen whether the reforms of the ministerial troika will instill enough confidence in their ability to manage the economy so that this very unhealthy situation is reversed.

The value of exports from Egypt has grown at a snail’s pace of 1.8% per year on the average during 1990-2002 and the value of imports grew slightly faster at 3.2%. In contrast,
value of Indian exports (imports) grew by 9.1% (9.3%) during the same period (World Bank 2005). Nearly 44% of exports were fuels, with manufacturing accounting for only 31% in Egypt. Manufactured exports accounted for more than three-fourths of India’s exports. India’s success in the export of software and information technology enabled services is well known. These accounted for three-fourths of India’s commercial services export of $25 billion. The share of such exports in Egypt’s export of commercial services was only about a quarter. Clearly, Egypt can and should do much better than it has done in merchandise and commercial service exports.

The Nazif government has cut weighted average tariff rate from 14.6% to 9.1%, reduced the number of tariff bands and eliminated import fees and surcharges. These are steps in the right direction. It has also set up Qualified Industrial Zones, enabling products manufactured in the zones to receive tariff free-entry into the United States (under the US-Israeli Free Trade Agreement), as long as 11.7% of the components are of Israeli origin. The expectation is that these zones will partially offset the losses in textile and apparel exports after the expiry of the Multi-Fibre Arrangement on 1 January 2005 (IMF 2005a, Box 2). Creation of special zones, whether to take advantage of the US-Israel Free Trade Agreement or more generally, as in China, to suspend onerous restrictions that operate elsewhere in the economy, raise a serious policy issue. They simply avoid, rather than face, the politically difficult and challenging task of creating a policy environment that is hospitable to private investment and encourages growth of exports in the country as a whole, rather than from just the special zones.

3.4 Privatization

The Nazif government has announced plans for privatizing most state-owned firms, including in sectors that were previously off limits. Between July 2004 and March 2005, 17 non-financial companies have been privatized. In Section 2, I mentioned that the cotton textile
industry was ripe for privatization. The sale of ESCO textile company to a businessman, apparently without consulting its workers, has spawned a strike by workers that has not ended as yet (Economist 2005, pp. 24-25). Privatization, in erstwhile state-controlled and dirigiste economies such as Egypt and India is politically difficult. In India, and I have no doubt this is true in Egypt as well, intelligent and rational economists as well as policy makers succumb to the deceptive and specious argument that market profit-loss considerations, rather than social cost-benefit rationale, should determine whether an enterprise continues to be owned in the public sector or to be brought into the public sector if it is not. The National Common Minimum Programme of the ruling United Progressive Alliance in India has categorically ruled out privatizing the very large public enterprises that earn profits. Interestingly, the Ministry of Finance (MOF 2005) tried to refute the argument that a profitable public enterprise in a competitive market should not be privatized, and one, which is profitable, only because of its exercise of market power, could be privatized. Its refutation was not through an examination of the rationale of the argument, but simply by showing that the government made more money by privatizing such enterprises than from the profits they remitted to the government. A rational basis for privatization decisions is to apply social-cost benefit calculus so that a public enterprise should not be privatized if retaining it in the public sector will yield a higher net social benefit compared to privatizing it, taking full account of the market structure of the industry. For example, turning a profit making public monopoly into a private monopoly is not likely to yield significant net social benefit.

Another controversial issue is the use of resources generated from sale of public equity. In India, a National Investment Fund has been created into which the realization from sale of minority holdings in profitable enterprises would be deposited, with the fund being managed
professionally. The Fund will invest in social sector projects and selected public enterprises. The Fund seems to have been created more as a response to critiques of privatization, rather than on the basis of any analysis of the alternatives to the use of sale proceeds from public equity. It is not obvious that social returns to public resources from investments of the fund would be higher than those from using them to reduce the budget deficit or public debt. In any case, it is high time that a proper social cost benefit evaluation of India’s public sector enterprises is undertaken. The Economist (2005) notes, the sales of publicly owned assets in telecommunications and banks in Egypt will be challenging. But this challenge has to be met within a reasonable period of time if the Egyptian economy is to perform at its potential.

3.5 Financial Sector

The Nazif government has announced a comprehensive financial sector restructuring with a five-year horizon comprising mergers, sale of stakes in joint venture banks, resolution of non-performing loans (NPLs) from public and private enterprises, privatization of a state bank, and reform of non-bank financial sector. A deadline of June 2005 has been imposed for banks to meet capital adequacy requirements by raising their paid-up capital. A Bank Restructuring Unit, staffed by professionals, has been set up at the Central Bank of Egypt (IMF 2005a, Box 2). IMF (ibid, p. 21) notes that while the restructuring plan is indeed comprehensive, “The specifics concerning the modalities and sequence of some critical components still need to be developed, particularly the mechanisms to resolve the NPLs of public and private enterprises, and the assessment of banks’ recapitalization needs.”

According to Economist (2005, p. 25) the government has invited international investment banks to advise on the sale of Bank of Alexandria, which had assets of US$6.4 billion and a net worth of $268 million. The government plans to sell Banque du Caire, to be followed
by the sale of Banque Misr, Egypt’s second largest bank. There are no plans to sell National Bank of Egypt, the largest bank. Economist (ibid) noted that NPLs of the state-owned banking system are a major barrier to privatization and quotes the governor of the Central Bank of Egypt as having said in mid-April 2005 that, “the numbers that are publishes are much smaller than the reality; the problem is much bigger than that,” but also having added that it would be possible to resolve the problem within four to five years. Economist (ibid) also reports progress regarding consolidation of bank and divestment of holdings of state-owned banks in joint ventures.

The determination of the Nazif government in pushing ahead with reforms of the financial sector is commendable and welcome. However, one cannot but wonder whether even after the proposed sales of banks and divestment, the fact that the largest bank will continue to be fully owned by the government would come in the way of ensuring that political interference in business decisions of banks regarding credit allocations will be largely eliminated. If it is not, the reduction of the existing stock of NPLs will be short-lived, and a new stock will soon begin to accumulate. More generally, it is not certain that any government, including that of Egypt, will allow a large bank or financial institution, private or public, to fail. This “too big to be allowed to fail” syndrome is hard to avoid. Also, cleaning up NPLs and raising capital adequacy of banks to the extent consistent with the risk characteristics of the portfolio of loans of Egyptian banks (that is, not simply meeting some external norms, such as Basle II) would require expenditures from the budget, which will worsen the already bad fiscal situation.

In India also, the public sector holds a dominant position in the banking system since the nationalization of banks starting in 1969. Although some foreign banks and a few small Indian private banks continued to operate after 1969, and new private banks have entered the sector since the reforms of the 1990s, public sector banks still owned 75% of the assets of all
commercial banks. Their NPLs constituted 7.8% (3.5%) of their total loan advances (assets) as compared to 4.6% (2.1%) for foreign banks, and 5.8% (2.8%) for Indian private sector banks (MOF 2005, Tables 3.4 and 3.5). The government has recognized the need for urgently completing financial sector reform. But it has ruled out reducing public sector equity in banks below 51%. Only twenty Indian banks are among the list of the top 1,000 of the world’s banks, and the largest Indian bank ranks 82nd in this list, and it is not even a tenth in size of the 9th largest (Leeladhar 2005). It is clear that as financial services get increasingly integrated globally, Egypt and India cannot afford to cling to public sector domination of the financial sector.

3.6 Human Development and Poverty

In Section 2, I referred to the absence in Egypt, unlike in India, of a long time series poverty estimates and cited two different sources with differing estimates. A recent study (El-Saharty et al., 2005) of the World Bank reports that, “unlike most developing countries, Egypt has experienced a low level of overall poverty incidences as well as remarkable decline in poverty during the last decade.” It credits El-Laithy et al. (2003) for this finding. It reports the following poverty data (headcount ratio) for two (lower and upper) poverty lines (El-Saharty et al. 2005, Table 3):

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lower Poverty Line</strong></td>
<td>24.32</td>
<td>19.41</td>
<td>16.74</td>
<td>10.80</td>
</tr>
<tr>
<td><strong>Upper Poverty Line</strong></td>
<td>49.27</td>
<td>51.43</td>
<td>42.63</td>
<td>30.25</td>
</tr>
</tbody>
</table>

These figures bring out the well-known fact that poverty headcounts are highly sensitive to the poverty line. Poverty as measured using upper poverty line showed an increase in poverty between 1990-1991 and 1995-1996, while that measured by the lower poverty line showed a
June 20, 2005

decrease. While poverty measured using either poverty line showed a decrease between 1995-1996 and 199-2000, that measured with the upper poverty line showed a larger relative decline.

I do not attach much value, other than hortatory and rhetorical, to the so-called Millennium Development Goals (MDGs) adopted at the Millennium Summit of the United Nations for reasons set forth in Srinivasan (2005). As such, I do not view it as relevant or important to judge Egypt’s performance relative to the targets set in MDGs, as El-Saharty et al. (2005) do. Egypt’s performance, or lack thereof, has to be judged relative to its own potential. Thus, if Egypt can potentially eliminate poverty by 2015 or earlier but is not making enough progress in doing so, it would concern me whether or not Egypt meets the MDG target for halving poverty between 1995 and 2015. Viewed from this perspective, some of the challenges identified by El-Saharty et al. (2005) for addressing problems require attention. These include: the pervasive differentials and gaps in delivery, availability and quality of publicly financed services and programs, as well as gender gaps; the fragmented legal system; inadequate opportunities for the civil society to participate actively in the development process; and finally, lack of reliable and timely data for monitoring progress (El-Saharty et al., 2005, p. 50).

Let me conclude by repeating my optimistic note at the end of last year’s talk. The Egyptian economy could achieve its potential with a widening and deepening of structural reforms, since there are several basic strengths waiting to be energized. Unlike many developing countries, Egypt has a fairly good physical infrastructure of power, transport and communications. The labour force is educated. The natural resource base of Egypt is also substantial. Egypt is centrally located in terms of its proximity to major European markets and to its natural hinterland of the Middle East and North Africa. Trade liberalization following the recently concluded association agreement with the EU and, even more importantly, a broader
multilateral liberalization (following, hopefully, a successful conclusion of the Doha Round),
should push Egypt to integrate much further with the global economy, thereby accelerating its
growth. I urge the government to make a credible commitment to structural reform, particularly
in trade, financial sector, and privatization, in order to accelerate economic growth and ensure
Egypt gains its rightful position among nations.
References


