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Egypt Country Profile

The Road Ahead for Egypt

Economic Research Forum, Egypt
Institut de La Méditerranée, France

Femise Coordinators

December 2004

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For The Arab Countries Iran And Turkey

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Preface

The Country Profiles project launched by the Economic Research Forum and the Institut de La MÈditerranÈe represents an attempt to provide researchers in the region with an opportunity to present their own point of view concerning the major developments in their own countries and identifying policies for reform.

The Country Profile project is coordinated by the Economic Research Forum (ERF) and the Institut de la MÈditerranÈe (IM) within the frame work of the FEMISE programme supported by the European Commission. The project also receives funding from the Arab Fund for Economic and Social Development. The project will produce 10 Country Profiles for the South Mediterranean Countries. ERF coordinates five of those ten countries: Egypt, Jordan, Syria, Turkey and Palestine. Also the Arab Fund will support the production of three more countries from the Gulf, namely: Oman, Qatar and Yemen.

The Country Profiles' objective is to monitor the transition of the countries in question with an analytical view that could assist the policy-making community in designing their reform efforts. State-of-the-art methods of analysis are employed in order to assess performance, and suggest alternative trajectories and policy prescriptions for economically and socially sustainable growth. Also, the use of consistent sets of quantitative and qualitative data, whenever possible, will ensure cross-comparisons among countries.

The Profiles cover five thematic areas addressing in an empirical and analytical manner the following topics:

(1) Macroeconomic and Fiscal Issues;
(2) Financial Issues;
(3) Trade Issues;
(4) Governance and Institutional Issues; and
(5) Labour and Human Resource Development Issues

Moreover, a comparative perspective is provided by comparing the position of the countries studied against established benchmarks using a multi-criterion analysis.

The present Country Profile for Egypt is the first to be published in the series. The significance of this volume is primarily due to the fact that it provides a "home-grown" point of view on the different facets of development in the Egyptian economy. This is the value added of this volume. Certainly, there are several reviews of the Egyptian economy, and we might and we might wonder as to why another such effort, but the significant characteristic of the present one is that it represents a point of view from within.

Moreover, this was not a traditional publication by a group of researchers that ends up on a shelf. In fact, it was the subject of dialogue at different levels. First, it was a dialogue among its authors themselves; secondly, it was the subject of a dialogue and peer review by economists from the MENA region during the 10th ERF Conference in Marakesh (December 2003). Finally, and perhaps most important, this volume has been the subject of a rich debate in a national seminar which brought together government ministers, representatives of the business community, members of Parliament and representatives of the civil community. The donor community was represented by embassies and the European Commission. The former Prime Minister was also engaged in a lively debate on the contents of the Profile. The ultimate test came when two of the main authors of the Profile were appointed to the new government in Egypt. This provided a unique opportunity for them to put their views into action; a task which they were not hesitant to undertake.

It is hoped that this volume and the modality of doing research in this way, provide a model for serious work that crosses the gap between research and policy- making in our region.

Samir Radwan
Managing Director

INTRODUCTION

Although the ideological stance of Egypt shifted toward socialism, nationalization, and a closed economy in the 1960s, and then back to an open-door policy in the mid 1970s, some features are common to the entire period. Successive governments have relied on centralized administration, public sector dominance over economic activity-despite privatization efforts-and a generous social contract that provides open-ended subsidies-despite attempts at rationalization and targeting.

Each decade of the second half of the twentieth century has had a different focus and different achievements. During the 1950s the country was able to overcome social inequality through reducing disparities in income and wealth distribution. During the 1960s education and health services expanded significantly as well as jobs in the public sector. In addition, the government guaranteed jobs to university and secondary school graduates.

During the 1970s subsidies became an important tool in securing a social safety net. Efforts also began to make better use of the desert: new communities were established to reduce urban concentration and industrial pollution. During the 1980s the focus was on expanding and upgrading the country's infrastructure. A new population policy constrained runaway population growth and emphasized basic health care for women and children.

The cost of these achievements was high and the growth path appeared to be unsustainable. Policymakers often lost sight of the tradeoffs involved in these achievements. An early emphasis on university education neglected basic education, leaving nearly half of the adult population illiterate. Too much emphasis on subsidies left too few resources for investment and led to growing indebtedness. The drive toward employment in the government and public sector lowered real wages and reduced productivity. If Egypt is to achieve sustainable growth, a better balance must be struck between equity and efficiency, the resource base must be better utilized, and the country's most important asset-its people-must play a larger role in the process. These objectives require reformation of the institutional framework to allow people to participate at every stage of development. While public spending must be used to prioritize human development, decentralization and democratization must be accelerated and shared by civil society.

In 1991 Egypt adopted a bold economic reform and stabilization program to address a problematic social and economic situation which manifested itself in rising structural unemployment, mounting external debt, double-digit inflation, and increasingly negative fiscal and external deficits. Stabilization and liberalization have been achieved, significantly raising the country's creditworthiness. However, although macroeconomic indicators have improved, stabilization has had a number of negative impacts-sluggish GDP growth, mounting unemployment and increased poverty-which must be addressed if development is to be sustained.

Resumption of high levels of investment is essential, and should be boosted by private sector confidence and by a well-focused public program for developing social and physical infrastructure. Egypt needs to launch a second reform program, one that achieves structural adjustment and institutional reform, creates an equitable and self-reliant society, promotes sustained growth, and allows its citizens to achieve living standards commensurate with the country's potentials.

After this introductory chapter, Egypt's Profile contains five chapters, each concerned with one thematic issue addressing its qualitative and quantitative dimensions. The five chapters are successively: Chapter 1, a macroeconomic overview followed by fiscal and monetary issues; Chapter 2 addresses finance issues, covering financial performance indicators, capital market, banking sector policies, etc; Chapter 3 deals with trade issues. It analyzes key trade policies, import and export statistics, further examines trade in services, FDI trends and regulations, and highlights regional trade agreements. Chapter 4 focuses on governance and institutional issues. It includes an analysis of policy-making process; it also examines the range of political actors, legal structures and institutions. Chapter 5 is devoted to labor and human resource development issues and an analysis of labor market performance and labor market institutions is presented. An examination of the legal framework for the labor market, employment and wage trends, education and training, women and development, social protection and poverty is also covered.

The main findings of the five chapter may be successively summarized as follows:

1. Macro Economic, Fiscal, and Monetary Policies

On the macro economic, fiscal, and monetary policy fronts, economic growth in Egypt has shown a declining trend since 1998-99 despite a strong performance following the successful stabilization program implemented in 1991. However, the Egyptian economy faced three major external shocks, in 1997-98: the emerging markets crises, the Luxor attack on tourists, and the sharp decline in oil prices in 1998.

Egypt's GDP growth rate started to decline largely due to a combination of the lagged effects of these three external shocks and the global economic fallout from the events of September 11, 2001, aggravated by the recent war in Iraq and the consequent uncertain and unstable political conditions in the region. The slowdown continued till 2002-03, compounded by rising inflation, high unemployment rate, widening fiscal deficit and growing domestic debt. Moreover, economic activity continued to be constrained by high real interest rates, poor levels of productivity and competitiveness, a shortage of foreign currencies, and a depressed regional and global environment.

It is common for a small "open" economy to be exposed and affected by external shocks; however, exposure does not necessarily imply vulnerability. It is the responsibility of the government to deal with these shocks in order to minimize their negative consequences. This requires taking the right measures at the right time. In that context, there is an urgent need for serious fiscal reforms in the areas of taxation, subsidization and public debt in addition to expediting the privatization process.

There is a need to strengthen fiscal performance, not just through tax reforms and expediting privatization, but also through more radical measures at the revenues and expenditures side of the budget. Improving fiscal performance does not only require tax reform and enhancing tax administration, but it also warrants revising expenditure items in the budget, realigning their priorities, and securing their effectiveness. Most of these measures, if carefully designed and targeted should not affect the poor. To the contrary, delays in restructuring expenditure priorities and sources of revenue are more likely to have a negative impact on the poor. Examples of restructuring measures include addressing the issue of implicit subsidies-adjusting the prices of petroleum products to reflect changes in international prices, and increasing electricity prices, which have been kept constant since 1991, to reflect changes in the cost of production. This does not require just a single shift in prices, but involves the establishment of a mechanism based on objective criteria through which the prices of such products would be revised according to market conditions without administrative intervention. Moreover, it is essential to revise tax holidays and exemptions and to put a cap on annual increases in wages and salaries not exceeding the annual change in the consumers' price index.

Another flagrant example of not taking the right measures at the right time is the management of the foreign exchange policy. Since the slowdown in GDP growth observed in 1997-98 and the accompanying deterioration in the external position, the government has resisted the devaluation of the Egyptian pound by injecting sums from the international reserves into the foreign exchange market. International reserves declined from 18 billion dollars in 1999 to 14 billion dollars in the year 2000. Chronic shortages of foreign liquidity, the absence of a market-clearing mechanism, and inadequate institutional framework compelled the government to announce successive devaluations of the pound between 2000 and 2003 until it suddenly announced in January 2003 the free float of the Egyptian currency. This regime needed to be supported by an inflation-targeting framework for monetary policy. This framework, in turn, requires certain preconditions to be implemented effectively. These preconditions are strong fiscal position, a well-developed financial system, well-understood channels between monetary instruments and inflation, a reliable methodology for projecting and forecasting inflation, transparent policies, and finally Central Bank independence together with a clear mandate to achieve price stability. Until now, and after more than 18 months have elapsed since the free float was announced, the only progress achieved has been on the legal front. Law no 88/2003 has been issued, granting the Central Bank its operational independence. Other preconditions, including the development of an appropriate institutional infrastructure and monetary policy instruments are still under considera-tion. However, it is mainly effective implementation, rather than issuance of laws, that is required for an effective monetary policy to be achieved.

2. Financial Policy

As to issues of financial policy, the analysis emphasizes progress in reforming financial markets in Egypt over the last decade of the twentieth century, although there is still much to be done. While reform of the financial sector focuses on liberalizing particular financial variables, it appears that little attention has been given to institutional reform at the micro level of financial intermediaries. There is a need for a financial policy to deal with the required reforms that should include reform of institutions, instruments, market structure and conditions, as well as the future of the financial sector at large and its position in the region.

The profile highlights issues of financial sector reform, emphasizing financial liberalization in the banking as well as the insurance sectors, recent legal changes, development of supervisory and regulatory bodies, institutional reform and corporate governance, soundness of the financial system, and financial innovations, particularly in the banking sector and the capital market.

Micro prudential indicators give mixed signals for the soundness of the banking system in Egypt and reveal several areas of deficiencies. Despite these deficiencies, banks are supported by a stable and strong deposit base. Indicators reveal the better performance of private banks as opposed to public banks. Although still retaining public confidence, the portfolio conditions of the four public banks are raising concerns, as the public banks have been used to channel resources to public sector companies and preferred private sector users, some with questionable creditworthiness. Public banks in Egypt tend to have lower incentives to identify problem loans, to minimize costs, and to innovate. They are confronted with little competition, their losses are often covered by the government, and they are protected from closure. Promoting more effective market discipline in the financial system could be supported by privatizing the banking sector, promoting a more contestable banking system, and moving toward a competitively neutral regulatory environment. However, it is worth noting in that respect, that privatization of public banks is not one of the government's priorities. The focus is instead on changing the management of these banks. Furthermore, the government has tended to privatize public sector shares in joint venture banks.

Capital market funding and development of securitization is essential. An amendment to the capital market law has been drafted, offering an adequate legal framework for securitization. The proposed law is generally well conceived and integrated within a flexible capital market law regarding bond markets.

Although there are a number of positive features in the Egyptian financial system, there are still areas of deficiencies. Discussion has been raised regarding the benefits and costs of unifying financial regulatory bodies under one umbrella, creating an Egyptian Financial Services Authority. Such a "super regulator" will solve the problem of a lack of supervisory coordination in a growing market where traditional barriers between different service providers are being reduced. Since the abolition of the Ministry of Economy in 2001, responsibility for the financial sector has been scattered between the prime minister, who is politically accountable for the banking system; the minister of planning, who is responsible for insurance companies; the minister of foreign trade, who is responsible for the capital market; and mortgage financing, which is under the minister of housing; and leasing companies under the Investment Authority. This situation has been addressed with recent cabinet reshuffle and restructuring. A Ministry of Investment has been created in July 2004. The newly established ministry is responsible for desiging the financial policy and for coordinating among various financial sub sectors. It is responsable and accountable for the financial sector including the Investment Authority, the Insurance sub sector, the capital market, mortgage financing, and the public enterprise sector, without any involvement in implementation and supervision, which remain the responsibility of various regulators of financial sub sectors.

The Central Bank as a supervisory authority over other banks has kept its independence by reporting directly to the President.

It is however premature to assess the efficiency of this move which appears to be in the right direction

3. Foreign Trade

Regarding foreign trade issues, although Egypt was among the first countries in the MENA region to adhere to an open-market, export-promoting strategy, it has neither succeeded in achieving high export performance and growth nor did it attract significant levels of foreign direct investment (FDI). Qualitative changes in exports, in terms of increased diversification, have been achieved but remain short of responding to world demand and alignment with changes of export structure in the main trading partners. Egypt's reliance on exports of fuels, agricultural raw materials, and material-based manufacturing (textiles, garments, leather goods, wooden furniture, and other similar materials) remain predominant. Knowledge-based (high technology content) exports are minimal, hardly reaching one percent of manufactured exports. Main imports continue to be machinery, equipment, and means of transport, in addition to food products. Egypt's major trading partners are the EU and the USA, however, the share of Arab countries and of other countries of the world have increased.

As a member of the WTO, Egypt is not fully benefiting from available opportunities. Moreover, during the 1990s, Egypt joined a number of regional trade agreements and is still negotiating others, yet the benefits of entering such agreements remain modest. The deficit in trade balance has been widening, but is attenuated, and is occasionally more than compensated by the services balance surplus, mainly due to tourism revenues and Suez Canal proceeds, and by workers remittances. These alleviated the negative impact of merchandise trade on the current account.

Inflows of FDI have been hovering around an average of US $1 billion yearly, and portfolio investments are limited and irregular.

The most binding constraints on export performance are the lack of human skills and technical capacity, as well as supply factors, distorted incentives structures, and flawed market signals, rather than by external demand conditions, which affect the competitive position of exports . These supply factors are either of a structural nature or relate to policy barriers. Structural factors include limited export supply capacities, high production and transaction costs, institutional and bureaucratic impediments, and the anti-competitive behavior of firms, which in the absence of a clear competition policy resulted in highly concentrated domestic markets structures and high domestic profit margins. Policy barriers include relatively high and dispersed tariff structures unmatched by an efficient rebate scheme to compensate its anti-export bias effect, fairly high sales tax and other financial levies and surcharges on exports and imports, and an overvalued exchange rate, all of which led to a distorted incentives structure. These distortions favored domestic sales at the expense of exports and discouraged investments, both domestic and foreign, from building up further export capacities.

Network industry and services sectors (telecommunications, transportation, finan-cial services, electricity, etc.) have undergone serious attempts at moderni-zation. Their performance has improved and their capacity to support the participation of domestic firms in investment and external trade has been enhanced. However, there is still room for improvement. To illustrate, the banking and insurance sectors provide no special financing and insurance schemes for exports, unlike other developing and newly developed countries that have succeeded in their export promotion drives.

This analysis emphasizes factors increasing costs of production and of exports, yet competition does not only rely on low costs. Development of reputation for quality and reliability in export markets is also necessary. Specializing in "niche" products that can be differentiated from those of external competitors is required. Focusing on high value added products per unit of domestic input and emphasizing quality are warranted. Building effective marketing channels, ensuring that production meets foreign market requirements and responds to quality standards, and creating an export "culture" are also required.

Membership in the WTO and participation in several regional trade agreements with the EU, and with Arab and African countries may offer wider market access to Egypt's exports, improve the credibility of Egypt's policies, and present better investment potentials. However, marked efforts have to be exerted at the macro-economic level, such as raising the domestic savings rate and directing additional investments to build supply capacity in exportables. This further requires improving the investment climate through addressing structural constraints by reducing high production and transaction costs, alleviating institutional impediments and bureaucratic intricacies, enhancing domestic competition, and addressing the anti-competitive behavior of firms.

Redressing the domestic incentive structure resulting from policy barriers is also required. This entails further reduction of the tariff levels and dispersion of the tariff structure, alleviation of the burden of the general sales tax on inputs to exportable and pervasive financial levies and administrative measures associated with trade and investment activities. Avoiding overvaluation of the exchange rate compared with other competing countries and ensuring its flexibility and stability are also compelling necessities.

These macro-economic requirements have to be supplemented with identification and alleviation of export constraints at the sector or activity level and further, at the firm level.

4. Governance and Institutional Issues

As to governance and institutional issues, the focus will be restricted here to issues related to the investment and business climate. The expression "investment and business climate" refers to the wide range of laws, regulations, policies, and customs which collectively form the environment in which business is conducted.

There is no doubt that the investment regime has been successful in attracting local and foreign investments, although with varying degrees of success throughout the period considered. However, two shortcomings have persistently plagued this regime. The first is the unclear rationale for the inclusion of certain industries and activities in a manner that reflects particular interests, and the second is the excessive reliance on offering tax relief and other exemptions as a means of attracting investors.

An overall investment climate that includes macroeconomic stability, sound monetary policy, an effective payments system, a predictable and efficient judicial system, sound corporate governance practices, fair and predictable taxes, flexible labor regulations, adequate communications infrastructure, and generally comfortable living conditions are what constitute an attractive investment climate.

It has been shown that the process of reforming Egypt's governance structure is dynamic but too slow. The constitutional framework contains some positive elements and others that must be revised. The regulatory environment of laws of investment, capital market, and property rights has manifested an ability to correct itself and to respond to market needs. Nevertheless, after more than three decades of pursuing a policy aimed at encouraging investment and promoting freedom of economic behavior, the regulatory and institutional framework for promoting private business, whether local or foreign, is still lagging. Three overall issues have not yet been properly addressed. The first is the emphasis on piecemeal and exceptional law making intended to resolve one or more problem for investors in the absence of an overall framework for the required comprehensive regulatory framework. Thus partial reforms have tended to lose their effectiveness by the counter effect of persisting rules. The second issue is the failure-despite great efforts and investment of resources-to significantly reform the bureaucracy in a way that achieves a noted impact, thus leaving the investors facing problems of incompetence, delay, and sometimes corruption. The third issue is the inability to achieve a breakthrough in reducing the time spent and in enhancing the certainty of outcome of court litigation, which severely constrain the judicial recourse available to investors and entrepreneurs.

Finally, the political context of accountability and contestability exhibits vibrance and self-corrective power, although less here than in other areas. Further opening of political positions to competition and a more enabling, liberal environment to support NGOs are still required to improve the environment of accountability of the government, the bureaucracy, and the private sector alike.

5. Labor and Human Development

In terms of labor and human development issues, over the past twenty years, the employment situation rose to the top of public policy concerns, as economic restructuring and reform failed to redress the high youth unemployment rate and stagnating real wages. Developments in the labor market have been shaped by the interaction of two sets of forces.

(i) Labor supply pressures driven by the growth of the working age population and the rise in its educational attainment, leading to the largest ever cohort of new entrants to the labor market.
(ii) On the demand side, the slowdown of hiring by the government combined with the decline in size of the state-owned enterprise sector has curtailed the major labor absorption mechanisms in the Egyptian economy.

These declining labor demand trends were further compounded by the continuing loss of employment in agriculture and the slowdown in international labor migration.
Although discussions and attempts at reforming the labor market regulations instituted in the 1950s have been underway since 1994, a new labor law allowing employers some flexibility in hiring and firing was only enacted in April 2003. The delay in adopting more flexible rules at a time of greater reliance on the private sector for labor absorption resulted in a sweeping informali-

zation of the labor market. The growth of informal employment in Egypt is reflected in the growing importance of small and micro enterprises in the Egyptian private sector and to the spread of informal hiring practices in the large private enterprise in their attempt to evade restrictive labor regulations. Despite attempts to constrain hiring in the government and in the state-owned enterprise sectors, the public sector continues to be the dominant employer of educated workers in Egypt.

The combination of increasing labor supply and incomplete structural change on the demand side has produced poor labor market outcomes over the past decade. Based on official statistics, the unemployment rate increased from 8% in 1990 to 11% in 1995 and settled around 9% in 2001. This is widely agreed to be an understatement of the unemployment rate. Open unemployment is heavily concentrated among educated workers, especially those with secondary school certificates. Of 1.8 million unemployed in 2001, 97% had a secondary education or above, of which 69% were secondary school graduates. Real wages fell significantly between 1985 and 1995, a period of slow growth and painful macroeconomic reforms. Real wages appeared to have recovered somewhat since then, but most of the improvement was for workers in state-owned enterprises rather than in the private sector.

Gender continues to be a major line of segmentation in the Egyptian labor market. Women are more than four times as likely to be unemployed as men, according to official statistics. Those who work earn significantly less than men in the private sector, even after taking into consideration education and experience. These gender gaps are not only large, but they are also increasing over time. These growing gender gaps appear to be attributable to the slowdown of hiring in the government, where women are treated as relatively equal to men, and to significant barriers to entry into the labor market that women are facing in many parts of the Egyptian private sector.

Besides being significantly higher among females than among males, open unemployment in Egypt is increasingly concentrated among young, educated new entrants to the labor market who would have, in the past, been eligible for public employment guarantee. In contrast to open unemployment, visible underemployment, defined as involuntary part-time work, primarily affects lesser-educated males in casual wage employment. This is undoubtedly the form of underemployment that is most closely related to poverty in Egypt.

Turning to the performance of real wages in the 1990s, official wage data are only available for state-owned enterprises and formal private sector enterprises with ten or more employees and hence the picture regarding wages is only partially complete. Real wages eroded throughout the 1980s. They fell at an average annual rate of 5.4% from 1982 to 1991 in state-owned enterprises and at a rate of 4.5% in the formal private sector. The decline was felt across all industries. Real wages recovered slightly in the 1990s, especially from 1995 to 2001. In state-owned enterprises, wages increased at an average annual rate of 3.9%, returning to their 1978 level. In the formal private sector they only recovered at a rate of 0.8% annually, barely approaching their 1976 level. These results, although not reflecting a complete picture of what happened in the overall private sector, which is largely informal, are sufficient to conclude that real wages in the private sector have been essentially stagnant after a decade of real wage erosion in the 1980s.

Furthermore, it may be concluded that wages in Egypt have been sufficiently flexible and that the modest performance of the private sector in employment creation cannot be attributed to wage inflexibility.

Finally, a major change in the rules governing labor markets was instituted in April 2003 with the adoption of the new labor law no 12/2003. The new law increases the flexibility of employers to terminate the employment relationship due to economic necessity. It also stipulates that definite duration employment contracts can be renewed an indefinite number of times rather than immediately turning into indefinite duration contracts upon renewal. It specifies the terms of compensation or severance pay that workers would receive if laid off. On the collective labor-relations side, the major novelty in the law is that it grants workers a limited right to strike.

It is too early to determine the effect of these institutional changes on the Egyptian labor market. However, the effect in the immediate future is likely to be small. The job security rules of the old labor regime were so strict that private employers routinely hired workers without the benefit of legal employment contracts or forced new recruits to sign undated letters of resignation before starting their jobs. Moreover, the new law only applies to new employment contracts rather than existing ones, so existing job protection remains in force. These legal reforms will be most significant for state-owned enterprises and privatized firms that have a major portion of their workforce under the protection of legal contracts. They will also be relevant to foreign investors who might have been scared away by the strict job security rules that were previously applied. Together with expected reforms in tax and corporate regulations, the new labor law is a sign of increased market liberalization in the Egyptian economy.

In summary, monetary, fiscal, and financial reforms, which were successfully applied starting 1991, enhanced macroeconomic performance in Egypt. The inflation rate declined, the exchange rate stabilized, foreign reserves accumulated, and the fiscal deficit as a proportion of GDP reached a one-digit figure. However, delays in implementing structural and institutional reforms constrained the economy and limited its capacity to react to external shocks and to adapt to exogenous developments. Unemployment rates increased, investment rates slowed down, unused productive capacities rose, growth of manufactured exports lagged, and recessionary tendencies shifted to stagnation. These developments made structural and institutional reform more difficult but at the same time more compelling. A clear plan of action coupled with time-determined programs for implementing comprehensive structural and institutional changes have to be prepared, with a particular focus on:

(i) Removing barriers to domestic and foreign investment and supporting small as well as medium and large enterprises.
(ii) Giving priority to social spending in education and health services, emphasizing quality and labor market requirements.
(iii) Speeding up the pace of reforms without exaggerating their social implications and their expected outcomes on the poor.

Most of these measures, if carefully designed and targeted may have a limited social impact. Furthermore, delays in implementing the required reforms are likely to have a deeper long-run negative impact on the poor.

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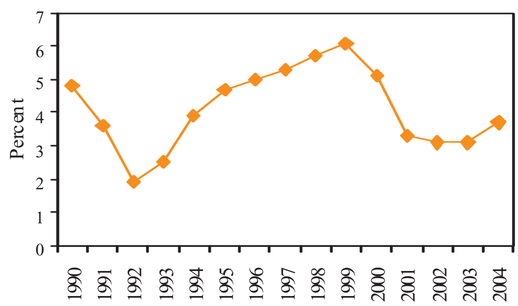
Chapter One
Macroeconomic Policy and Performance

1. Macroeconomic Overview

To judge the economic record of Egypt, one should look at economic outcomes. Such outcomes are the result of many factors along with the economic policy adopted by the current as well as past governments. Since 1998-99[1] the economy has shown a downward trend after a strong performance following the launch of the stabilization program in 1991. In the late 1990s, the Egyptian economy was exposed to various external shocks. The deteriorating macroeconomic environment was evident in the slowing economic growth, the rising inflation, high unemployment rate, and widening fiscal deficit. Moreover, economic activity continued to be hindered by high real interest rates, poor levels of competitiveness, a shortage of foreign currency, and a depressed regional and global environment. The deterioration in macroeconomic performance should not only be attributed to external shocks, which are not unusual for a small open economy to be exposed to, but also to inadequate macroeconomic management.

Figure 1.1: Growth of Real GDP at Factor Price

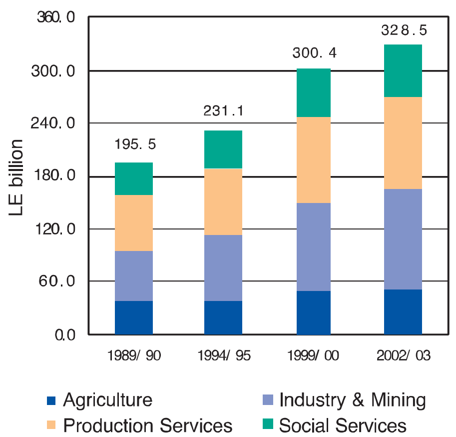


Source: Ministry of Foreign Trade, Monthly Economic Digest.

1.1 Economic Growth

Economic growth in Egypt has shown a declining trend since 1998-99, after the strong performance following the stabilization program. In the early 1990s, the economy suffered from serious internal and external imbalances. However, the reform program managed to reduce these macroeconomic imbalances and to establish conditions for sustainable growth. The growth rate of GDP picked up in 1994-95, to reach its peak at 6.3% in 1998-99 (Figure 1.1). Economic growth during this period could be attributed to the increase in investments, which was largely inventory accumulation rather than gross fixed capital formation, and public investments, mainly large infrastructure schemes significantly picked up[2].

Figure1.2: GDP at Factor Cost & Sectoral Breakdown



Source: Ministry of Foreign Trade.
Note: Industry & Mining sector includes petroleum, electricity and construction

As far as the sectoral structure of the economy is concerned, as shown in Figure 1.2, the

Egyptian economy is considered to be a services-based economy. Despite a slight decline in their share, the production and social services put together continue to constitute almost 49% of GDP in 2002-03. The industry and mining sector which includes electricity, construction, and petroleum witnessed an increase in its share in the economy from 29% in 1989-90 to approximately 35% in 2002-03 at the expense of the agriculture sector which has the lowest share in the economy at 16%.

Real growth rate of the commodity sector, i.e. industry and agriculture was 2.2% in 2002-03. The slow performance is attributed to the decline in activities of the construction and building sector, which recorded a negative growth rate of 4.8%. Growth in the rest of the sectors, i.e. agriculture, mining and crude petroleum, manufacturing, and oil products had an average of 2.7%.

The performance of the production services sector, which comprises 31.9% of GDP, was much better than that of the commodities sector. Notably, the Suez Canal's contribution grew by 23% and the restaurants and hotels sector grew by 19%. The transportation and telecommunications sectors grew by 5%. The wholesale and retail sectors grew by 1.9% while the financial intermediation sector grew by 2.3%. As for the social services sector, its relative weight reports 17.3% of GDP, and while the general government sector showed a growth of 2.7% in 2002-03, other activities contributing to this sector, i.e., education, health, and the rest of social services grew by 3.1%.

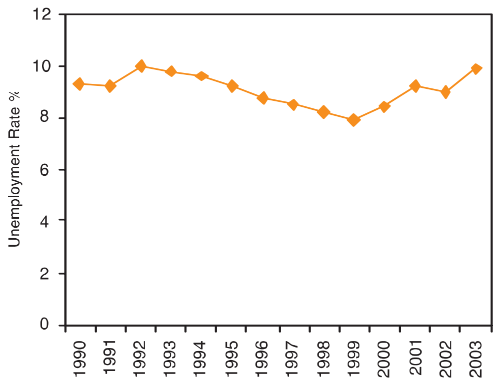
The Egyptian economy has been confronted with five main external shocks. Since 1999-2000, the GDP growth rate started to decline, largely due to a combination of the lagged effect of the first three external shocks: the emerging market crises, the Luxor incident, and the sharp decline of oil prices in 1998, as well as, the lack of economic structural reform efforts. This was followed by the global economic fallout from the September 11 terrorist attacks in 2001. The situation was aggravated by the more recent war in Iraq, and the consequent uncertain political conditions in the region, and the sluggish global environment. This slowdown was evident in real sector indicators, and in privately conducted business surveys.[3]

The slowdown in economic growth continued in 2001-02, approaching 3% according to official figures. Economic activity in 2002-03 continued to be hindered by a shortage of foreign currency, inactive monetary policy, high real interest rates, a widening budget deficit, and a depressed regional and global environment. This all resulted in keeping the real GDP growth rate in the 2-3% range, which is below the Egyptian economy's potential, and almost half of what is required to provide new job opportunities for the rapidly growing labor force. Real GDP growth rate during the last three years was slightly over 3%; however it is projected to be in the range of 3.5% to 4% in 2003-04. Growth is likely to have recovered somewhat, led by a rebound in tourism receipts and rising export earnings. At the same time, domestic demand is likely to have picked up, supported by a continuing fiscal expansion.

1.2 Unemployment

Egypt's labor force has been growing at a higher rate than that of the number of jobs created. After remaining relatively steady in the 1990s, unemployment rate has shown a slight rise since 1999. It increased from 8.4% in 2001 to 9.9% in 2003 (Figure 1.3). It is likely that official figures do not capture the full extent of unemployment. It is believed that the rate is effectively higher, especially if underemployment is taken into consideration. Underemployment is considered a widespread problem in Egypt, particularly in the public sector, which continues to employ more than 30% of Egypt's total labor force. The reforms that Egypt embarked on in the 1990s have not only changed the structure of the labor market but have also reduced the government's ability to generate jobs. The new labor law is planned to address these issues and other inefficiencies in the previous law. The impact of the law on the labor market has been largely debated, especially regarding its impact on the flexibility of the labor market in the future.

Figure 1.3: Unemployment Rate

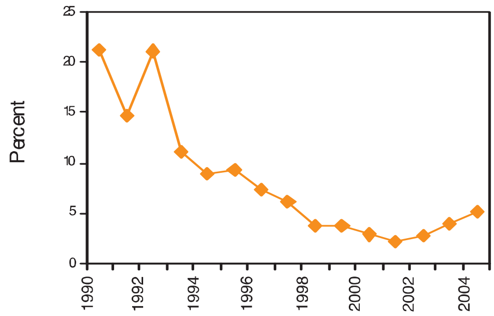


Source: Ministry of Foreign Trade, Monthly Economic Digest.

1.3 Inflation Rate

One of the main achievements of the 1990s stabilization program, with its reliance on the pegging of the Egyptian pound to the US dollar as a nominal anchor and the control of budget deficit was the significant reduction in the inflation rate. It fell from 21.1% in 1992 to 2.6% in 2000 (Figure 1.4). During the first half of the 1990s, the authorities adopted a tight monetary policy, accompanied with sterilization measures to dampen the expansionary impact of capital inflows using T-bills sales at high positive real interest rates. This, inter alia, led to rapid accumulation of the foreign exchange reserves early in the stabilization program, and amplified the authorities' commitment to the exchange rate peg, which in turn reduced inflation expectations.[4]

Figure 1.4: Inflation Rate (Annual)



Source: Central Bank of Egypt (CBE), Annual Report (various issues).

Inflation remained stable in the second half of the 1990s; however, as discussed below, it started to increase in 2000 with the devaluation of the Egyptian pound. A further increase was witnessed following the depreciation of the Egyptian pound, which accompanied the liberalization of the foreign exchange rate in January 2003, and the consequent increase in prices of imports, as well as the negative expectations, regarding the stability of the pound. However, it is worth noting that the government's maintenance of explicit and implicit subsidies on several items, such as basic food staples, medicine, water, electricity, and fuel will mitigate the pass-through effect of the exchange rate.

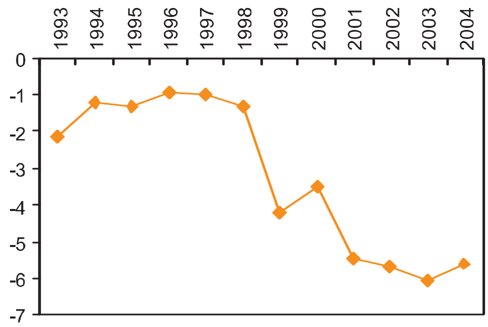
Recent increases in the consumer price index (CPI) of about 5% appear to understate "underlying" inflation, due to the inclusion of subsidized products and possibly other compilation problems. Other inflation measures, as discussed below, suggest somewhat higher inflation, with the wholesale price index (WPI) rising by almost 12% in the year to September 2003.

The wide disparity between the CPI and the WPI stems from the different weightings and types of goods included in each basket. The CPI gives more weight to subsidized goods such as bread, fuel, medicines, and electricity, while the WPI is more heavily influenced by imported raw materials such as farm products, machinery, and metals. Nevertheless, the size of the discrepancy suggests that the basket for the CPI may be underestimating the full extent of consumer price increases. The overall impact of inflation will therefore be far more evident among higher income groups, whose consumption extends beyond basic goods and services.

1.4 Budget Deficit

A significant reduction in the budget deficit (from 21% of GDP in 1986-87) was one of the main positive outcomes of the economic reform program of the 1990s. As shown in Figure 1.5, the fiscal deficit declined to reach 1% of GDP in 1997-98. This rapid decline was achieved with increasing revenue efforts and significant expenditure reduction. On the revenue side, the main increases were based on exchange rate adjustment, which increased Suez Canal revenues and oil companies' profits, in addition to 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.

Figure 1.5: Fiscal Deficit as a Percent of GDP



Source: CBE, Annual Report (various issues).

The overall fiscal deficit in 1998-99 started to increase, and reached 4.2% of GDP and rose further in 2000-01 to reach 5.5% of GDP. Fiscal slippage reflects rapid growth of recurrent expenditures set against weak revenue performance. Investments in large infrastructure schemes were estimated at around LE 25.3 billion in 1998-99, accounting for 8% of GDP. Despite the government's attempts to reduce the budget deficit through various measures, including the rationalization of public investment[5] , and an increase in tax revenues via the introduction of the second and third stages of the sales tax, the preliminary actual fiscal deficit reached 5.8% of GDP in 2001-02, and is estimated at 6.1% in 2002-03. Given its negative implications, the widening budget deficit has become a prime issue of concern.[6] For 2003-04, updated fiscal projections show a deficit of about 5.6% of GDP at the level of the budget of the central government, implying that the deficit in 2003-04 would decline slightly from that in 2002-03.

The fiscal deficit of the central government continued to widen in 2002-03, reaching 6.2% of GDP. Although the general government deficit remained stable, at 2.4% of GDP, this was only made possible by a rising surplus at the Social Insurance Funds. The budget for 2003-04, foresees the central government deficit narrowing to 5.8% of GDP. However, in the absence of new revenue measures, it seems unlikely that this target will be achieved, and it is expected that the deficit would widen to 6.5 or 7% of GDP in 2004-05.

Figure 1.6: Trade Balance

Source: Ministry of Foreign Trade, Monthly Economic Digest.

1.5 External Position

Egypt's external position has been partially responsible for the deteriorating economic performance. As previously mentioned, the external position in Egypt has been worsening since 1998, following a series of external shocks, as reflected in the deficit in the balance of payments, the deteriorating terms of trade, and the sizable loss in international reserves, as well as the increase in external debt as a percentage of GDP. Recently, the war in Iraq and regional tensions have led to, among other things, a fall in the tourism revenue and non-oil exports.[7] However, external position is still considered within bound.

As far as the balance of payments is concerned, the Egyptian economy witnessed a growing current account deficit in the wake of the East Asian financial crises. The sharp devaluation of the East Asian currencies adversely affected the competitive advantage of Egyptian exports, resulting in a decline in exports. Moreover, the sudden decline in oil prices resulted in another export shock, and accordingly a deterioration in Egypt's terms of trade. This resulted in a current account problem that was aggravated by the decline in the tourism receipts following the Luxor incident. The capital account also witnessed an increase in capital outflow and a decrease in capital inflows, which resulted in a capital account deficit of roughly one percent of GDP in 1999-2000. Estimates indicate that the current account deficit has declined, reaching roughly 0.03% of GDP in 2000-01 due to increasing export proceeds, and relative improvements in Egypt's terms of trade.

1.5.1 Trade balance

The appreciation of the Egyptian pound in the late 1990s had adverse effects on Egypt's external competitiveness. Egypt's share of exports to its two largest markets, the United States and the European Union, declined in the last decade. As shown in Figure 1.6, Egyptian exports grew slightly in the early 1990s and then witnessed a decline from 1996-97 to 1998-99. At a first glance, this decline can be explained, to a great extent, by the decline in Egyptian competitiveness in the wake of the Asian crisis, and the real appreciation of domestic currency. However, Egyptian exports started to increase in 1999-2000. As for imports, the 1990s have witnessed an increase, largely due to an overvalued Egyptian pound during most of the period, credit expansion, and relatively high growth rates until 1997-98, when a decline in imports was realized.

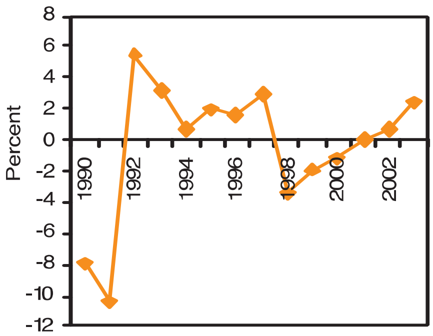
A slight improvement in the trade deficit has occurred since 1999-2000. Preliminary figures for 2002-03 show a trade deficit of US $6.6 billion which is approximately half the trade deficit in 1998-99. This is mainly due to a decline in imports rather than an improvement in exports. The shortage in foreign exchange coupled with the recession, reduced demand for imports. However, at the projected real growth rates of GDP (3 to 3.5%) it is likely for the trade deficit to be in a range of 7 to 10% of GDP in 2002-03 and 2003-04.

The war in Iraq-an important importer from Egypt under the UN oil-for-food program-has negatively affected the Egyptian trade balance.

1.5.2 Current account

The surplus in trade in services for Egypt, as shown in Figure 1.7, has offset the trade deficit. After being in moderate deficit in the late 1990s, the current account was almost in balance in 2000-01. During the 1990s, remittances from Egyptian workers abroad, Suez Canal dues, and tourism have managed to maintain a healthy position of the current account, which was in surplus from 1991-92 to 1996-97, then turned to be in moderate deficit from 1997-98 to 1999-2000, then almost in balance since 2000-01.

Figure 1.7: Current Account (as a percentage of GDP)



Source: CBE, Annual Report (various issues)

The balance of the current account shows a surplus of US $1.9 billion in the fiscal year 2002-03 compared to a deficit of US $1.7 billion in 1998-99. Such improvements were mainly attributed to the improvement in the trade deficit reflecting reduced import demand as well as rising exports as mentioned above, the increase in the Suez Canal revenues from US $1.8 billion in 1998-99 to US $2.2 billion in 2002-03, and the increase in the tourism sector revenues from US $3.2 billion to US $3.8 billion during the same period.[8] However, workers remittances remained stable without significant change ranging between US $2.8 billion to US $3.0 billion during the same period.[9]

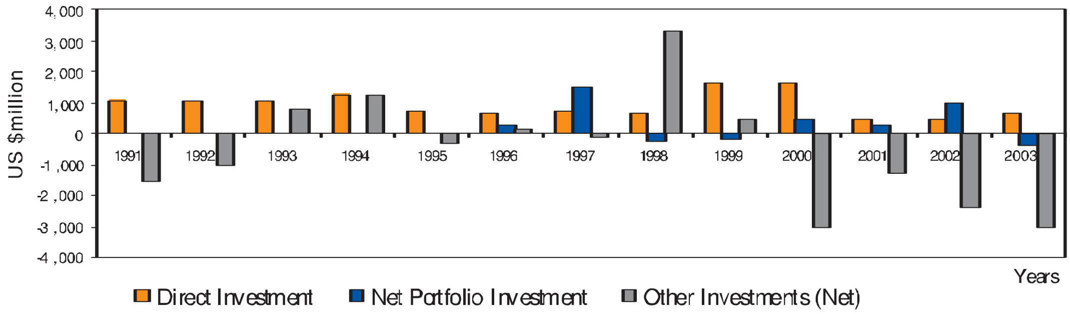
With strong growth in non-oil exports, amounting to US $1.4 billion in the first quarter of 2003-04, compared to US $1.2 billion in the first quarter of the preceding year, Suez Canal earnings, and tourism, the external current account surplus widened further during the first quarter of 2003-04 (July to September 2003) to US $1.5 billion, compared US $1.2 billion in the last quarter of 2002-03 and just US $0.1 billion in the first quarter of 2002-03.

1.5.3 Capital account

Capital flows during the first half of the 1990s differed from those in the second half. Despite data limitations, it appears that the former represent, in large, repatriation by residents of flight capital to the banking system, whereas the latter, until 1998, includes portfolio inflows by foreign institutional investors. The change can be attributed to two main factors: first, the sovereign rating of Egypt by Standard and Poor's in 1997 at (BBB-), which stimulated demand by foreigners for Egyptian equity and treasury bills; and second, the strengthened financial policies and the progress in privatization.

However, capital inflows-largely in the form of portfolio investments rather than foreign direct investment-were relatively volatile and subject to abrupt reversal. With the decline in the interest differentials and the slow down in the adjustment efforts, capital inflows declined given that a significant part of the inflow was into the treasury bills market and was purely interest rate arbitrage (Figure 1.8).[10] During most of the 1990s, capital inflows did not expose the Egyptian economy to serious risks, and fiscal costs have been modest.[11] Since 1998-99, capital

Figure 1.8: Composition of Capital Account



Source: CBE, Annual Report (various issues).

account started to drop to reach a deficit of US $974 million in 1999-2000.

The capital account continued to deteriorate during 2003. The capital account deficit increased from US $963 million in 2001-02 to US $2.7 in 2002-03. Capital inflows-largely in the form of portfolio investments-remained relatively volatile. Consequently, the poor performance of capital account in 2003 is largely due to the large net outflows in 'other investment,' indicating continued capital flight. Portfolio investment were negative during the first three quarter of 2003, while foreign direct investment improved slightly during the same period compared to previous year, although still low when compared to the late 1990s. Nevertheless, capital inflows, thus far, have not exposed the Egyptian economy to serious risks, and fiscal costs have been modest.

Large net capital outflows are contributing to parallel exchange market activity. The process of deposit dollarization has accelerated over the past year, resulting in large capital outflows through the banking system. At the same time, new foreign borrowing and other capital inflows remain limited. While some capital outflows are financed from current account earnings, others probably reflect demand for foreign exchange, which is putting upward pressure on the parallel market.

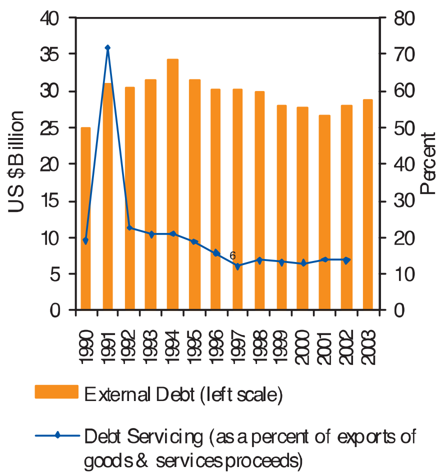
Put together, the balance of payments position has improved significantly. The overall balance shows a surplus of US $546 million in 2002-03 compared to a deficit of US $2 billion in 1999-2000. The improvement is clearly attributed to exports of services and the decline in imports as discussed above. However, the balance of payments performance suffers from very limited exports base and vulnerability to external shocks, which was evident since 1996-97. In addition the balance of payments reflects significant volatility in capital flows, which have deteriorated in volume and composition during the last five years.

1.5.4 External debt and debt service

Egypt has a favorable external debt position: a relatively low debt and debt service ratios, as well as, a favorable maturity profile. A significant decline in foreign debt was witnessed during the 1990s (Figure 1.9). Foreign debt as a percentage of GDP started to decline from a level that exceeded the country's GDP in 1989-90 to almost 27% of GDP in 2000-01. Despite the recent increase in fiscal deficit, foreign debt continued to fall, indicating the government's reluctance to finance the deficit by resorting to foreign borrowing. In fact, Egypt has been a net payer over the last five years. Debt service ratios have been also falling significantly.

Egypt displays a favorable debt structure. As of the year 1999-2000, total foreign debt was around US $27.8 billion, of which over 90% is medium and long term, and on favorable terms, implying a fairly healthy debt position from the point of view of external vulner-ability. Moreover, the debt service ratios are favorable by emerging economies standards.

Figure 1.9: External Debt and Debt Service



Source: World Bank database.

Egypt's external debt stock remained stable in dollar terms during 2002-03, at US $28.7 billion. But, owing to a depreciation in the value of the US dollar, the country's non-dollar-denominated debt increased when expressed in dollars. Around one third of Egypt's external debt is denominated in non-dollar currencies, primarily the euro. Nevertheless, Egypt's external debt remains relatively light, accounting for 36% of GDP in 2002-03. However, the January 2003 depreciation of the pound has contributed to a notable increase in the ratio of debt to GDP since 2000-01, when it stood at 28% of GDP. It is noteworthy that the bulk of Egypt's external obligations are in the form of government debt to official creditors at long maturities and low interest rates; consequently, the debt service is considered modest, standing at just 12% of exports of goods and services in 2002-03.

The government has issued in June 2001 a Eurobond-the first Egyptian sovereign issue. The government announced that the issuance of the bond had five main objectives: first, to establish a benchmark for future borrowing by the private sector; second, to diversify the financing options for the government through a new way of penetrating international capital markets; third, achieve "visibility" in the international markets through the marketing efforts and subsequently the trading of the bond in the secondary market; fourth, assist in funding projects in the country through lending the proceeds to local borrowers; and fifth, establish a yield curve for Egyptian sovereign bonds in international markets. These objectives, with the exception of the second and to some extent the third, have never been achieved, which made the issue, despite its favorable financial performance in terms of yield to maturity, subject to criticism. The cost of borrowing through this channel is considered to be high compared to other sources of funding such as regional funds, especially that the benchmarking effect has not, thus far, been realized.

Egypt was downgraded by two international rating agencies during the fiscal year 2002-03. Both, Standard & Poor's and Fitch downgraded Egypt's sovereign credit rating in mid-2002 from the investment grade of BBB- to the speculative grade of BB+. In addition, Egypt's long-term sovereign local currency was downgraded by Standard & Poor's in August 2003 from BBB to BBB- and the outlook for all of its local and foreign currency ratings was revised from stable to negative. However, the Egyptian Eurobond, being primarily held by local and regional investors and providing an average real return of 18.5% was not affected and maintained low volatility.

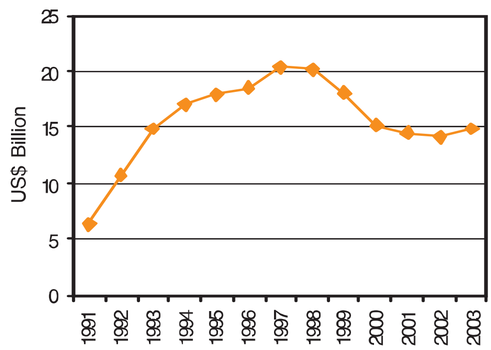
Although, external debt is expected to rise slightly in 2003, it should remain relatively low, accounting for around 36% of GDP. In addition, more than 75% of the external debt is sovereign, with a large portion of it on concessional, medium- and long-term. Moreover, debt service remains comfortable, at 10.5% of current account receipts for the first three quarters of the fiscal year 2002-03.

1.5.5 International reserves

International reserves have been stable after the significant drain of the late 1990s. Following the execution of the stabilization program, Egypt managed to build a sizable cushion of foreign exchange reserves.[12] The high differential between the interest rate on the Egyptian and dollar-denominated currencies led to a large surge of capital inflows, which helped in building the country's foreign reserves. It increased from US $6.4 billion in 1991 (sufficient to cover three months of imports) to US $20.4 billion in 1997 (covering around 11 months of imports).

However, in 1998 foreign exchange reserves started to decline (Figure 1.10). This decline reflects the central bank's efforts to curtail the expansion in credit growth and relieve the pressure on the exchange rate. The central bank initially conducted its intervention in the foreign currency market by drawing down on its foreign currency deposits with commercial banks by about US $2 billion. Banks reduced net foreign assets on their own account by a further US $500 million, lowering the banks' net foreign assets cover of their foreign currency deposit liabilities to about 20% in 1999, against about 50% in June 1997.

Figure 1.10: Net Foreign Reserves



Source: World Bank database.

Subsequently, the central bank began to satisfy the excess demand for foreign exchange from its own reserves, while maintaining the three 'sacred' values: foreign reserves, the exchange rate, and the fiscal deficit.[13] Consequently, foreign reserves fell from around US $18 billion in 1999 to roughly US $14 billion in 2000, covering about seven months of imports-a level that is still considered comfortable by international standards. The adoption of an adjustable peg system was inadequate, and pressures on international reserves persisted.

The Central Bank's intervention to defend the foreign exchange rate was not prompt, and the volume of foreign reserves released was lower than what the market required. The 'piecemeal' injection of foreign reserves in the market was not effective or sufficient in filling the gap, causing a credibility problem. As a result, there was an increase in speculation and an 'artificial' demand for dollars that led to the depreciation of the Egyptian pound, the appearance of a black market, and an increase in transactions outside the banks. Even prior to the adoption of the free float in January 2003, foreign reserves were stable during most of the year 2002 as the authorities restricted further depletion of international reserves through restricting injection of dollars in the market. As of mid-

2003, net official reserves reached about US $14.8 billion, covering around twelve months of commodity imports, and exceeding the safe percentage (six months) set by international institutions. Therefore, the level of foreign reserves is still considered comfortable by international standards.

2. Fiscal Policy

2.1 Fiscal Performance

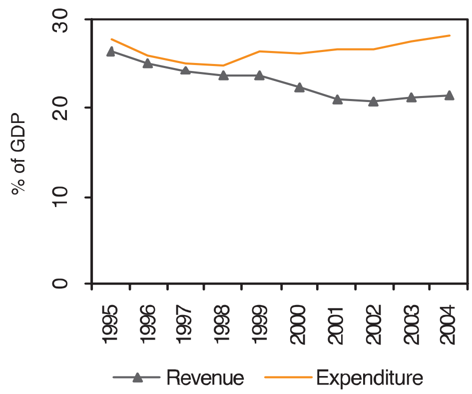
Since the late-1990s, Egypt's economic performance began to deteriorate, and fiscal deficit widened. Fiscal slippage reflects modest growth of recurrent expenditures set against weak revenue performance (Figure 1.11).

2.1.1 Fiscal deficit

The fiscal deficit of the central government has widened in 2002-03, while the general government deficit remained small.[14] The fiscal deficit of the central government increased from 3% of GDP in 1998-99 to an estimate of 6.1% in 2002-03. The deficit is projected to reach 5.6% in the current budget ending June 2004. The improved fiscal outlook for 2003-04 represents a number of factors that include growing revenue collections, partly reflecting the depreciation of the pound and the inflation pass through; at the same time, the authorities are holding expenditures under control, despite higher inflation; in addition, real interest rates have fallen to slightly negative levels, limiting the growth of the government interest bill.

By the year 1999-2000, the fiscal deficit was estimated at 3.5% of GDP, rising to close to 6% of GDP when National Investment Bank[15] (NIB) net lending and General Authority for Supply Commodities[16] (GASC) subsidies are included. After consolidating the surplus of the Social Insurance Funds[17] (SIFs), the fiscal deficit of the general government falls to under one percent of GDP. The SIFs often generate large operating surpluses, including employee and employer contributions, other budgetary transfers, and SIF expenditures. However, the operating surpluses of the SIFs are likely to shrink over the decade ahead as pension benefit payments begin to rise more quickly than contributions. The benefit payments and early retirement schemes have been rising, reflecting annual adjustments well in excess of inflation. This will eventually pose challenges for the NIB as it adjusts to a shrinking financing base.

Figure 1.11: Summary of Fiscal Operations (percentage of GDP)



Source: Ministry of Foreign Trade, Leading Financial Indicators (various issues).

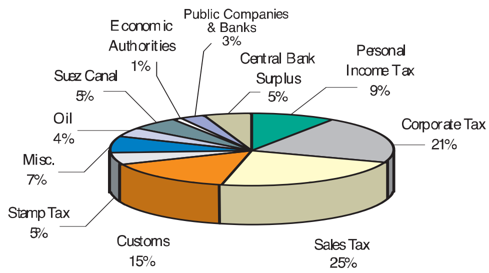
The fiscal deficit has been mostly financed through the domestic banking system, which accounted for approximately 6% of GDP in 2002-03. Consequently, there has been a gradual but significant increase in the government's total debt. Gross internal public debt has increased from 91% in 2001-02 to 103% of GDP in 2002-03. If the large deposits of the government with the banking system and the blocked accounts, held against external debt to Paris Club creditors at the Central Bank of Egypt (CBE) are taken into account, it appears that the net debt is significantly smaller than the gross debt. However, net government debt has increased from 61.3% in 2001-02 to 6 8.2% in 2002-03.

It may be argued that recently, large budget deficits have become more the rule than the exception in emerging markets. For example, Central European countries have seen a dramatic increase in their budget deficits. Hungary and the Czech Republic's deficits as a proportion to GDP are likely to exceed 7 and 8.5% respectively. In Asia, the situation is not better as, in the Philippines and India, the budget deficit will be in the neighborhood of 7 and 10% of GDP respectively. Even in the case of OECD countries where two thirds of them had budget surpluses three years ago, they currently are in deficit. The combined budget deficit of the OECD was estimated at 3.6% of GDP for 2003 at the beginning of the year, which is expected to reach an actual deficit of 4 to 4.5% due to lower than expected growth. The two different cases of Turkey and Brazil demonstrated in their most recent financial crises how crucial a budget policy focused on confidence building can be. A loss of confidence can encourage capital flight and trigger a balance of payments and financial crisis.[18] However, in the case of Egypt, the problem of fiscal deficit in the context of relatively high public debt to GDP ratio and high domestic interest rates should not be taken lightly, and serious measures are urgently required at both the revenues and expenditures sides of the budget to deal with the problem.

2.1.2 Public revenue

During the last few years public finance in many developing countries has suffered from structural deterioration in both tax and non-tax revenues. Such deterioration is associated with the decline of sovereign revenue from mineral resources, the short-term implications of trade liberalization, and a decrease in monopolistic profits previously enjoyed by the state before privatization.[19] Egypt's slowing economic growth and deteriorating regional and global environ-ment are reflected on the revenues side, which is not expected to exceed 22% of GDP in the fiscal year 2003-04, compared to the higher ratio of 26.5% in 1994-95. Figure 1.12 shows the composition of central government revenues with sales and corporate taxes, together forming the main source of revenue.

Figure 1.12: Revenues 2003/04



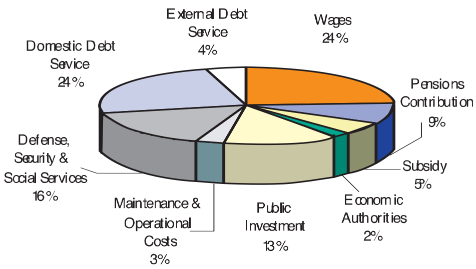
Source: People's Assembly Budget Committee Report (2003).

Corporate taxes have been vulnerable to recent profit declines, and the outstanding arrears to be settled have been larger than currently projected. On the trade taxes side, revenues are expected to continue to decline in the short term as Egypt implements tariff reductions in the context of regional trading agreements and trade reforms. However, such reduction is likely to be offset by the recent depreciation of the Egyptian pound. Increase in non-tax receipts from public economic authorities is uncertain but it is anticipated that the grants component will increase in the form of bilateral and multilateral financial assistance.

2.1.3 Public expenditure

Expenditure is estimated to rise in 2003-04 to 28.3% of GDP from 26.2% in 1999-2000. Figure 1.13 illustrates the composition of public expenditure where servicing of both domestic and external debt, at 28.2% of total expenditure, has become the main item of spending. This is due to the increase in the cost of servicing the external debt, which is inflated in local currency by the depreciation of the pound. Moreover, servicing of the government's domestic debt increased as a result of an increase in Treasury Bills' rates since January 2003.

Figure 1.13: Expenditure 2003/4



Source: People's Assembly Budget Committee Report (2003).

The second main item of spending, at approximately 24.5% of total, is wages and salaries.[20] This is an item that has increased steadily during the last decade due to an approach adopted by the successive governments to compensate workers in the government and public sectors for increases in the cost of living, and to support the government in the provision of jobs for part of the growing labor force in the absence of opportunities in the private sector. Moreover, subsidies to basic commodities, contributions to pensions and transfers to public economic authorities account for roughly 16% of total expenditure.

2.2 Key Fiscal Reforms and Challenges

2.2.1 Tax reforms

Taxation in Egypt is either direct, such as the unified personal income tax, salary tax, corporate and real estate tax; or indirect, such as sales tax, customs, stamps, recreation taxes, and social insurance. The tax laws are complex and embody many exemptions that are ambiguous, particularly in identifying eligible activities, which gives room for discriminatory behavior by the tax authorities.

Tax administration has been cited as a chronic constraint to private sector development for years. There is lack of trust between tax collectors and taxpayers, as disputes are settled inefficiently and estimation of taxable profits is arbitrary. Investors' complaints are revolving more around tax administration rather than the extent of taxes themselves. The criteria for tax assessment are ambiguous, and tax collectors have significant discretionary powers, which lead tax officers and taxpayers to extreme initial bargaining positions. Investors report that they do not know how much taxes they actually have to pay. Investors also complain that the process of tax assessment and collection is time consuming and costly. In many instances, it leads to underreporting of taxable income or tax evasion and often takes years to resolve in courts. Moreover, taxpayers complain that tax collectors tend to overestimate taxes to meet the collection targets.

A program of fiscal structural reforms was launched in 2001 to address lagging revenue performance. A number of important steps were taken to address the deteriorating fiscal accounts. The general sales tax was extended to the wholesale and retail sectors in 2001. It was recommended by international institutions that the general sales tax be converted to a full value-added tax, which would involve introducing input crediting at all stages of the production process and unify the treatment of all goods and services under the tax.

A new income tax law is expected to be submitted to the parliament. This new law would apply tax rates according to total income rather than separate taxes according to the source of income. The law will seek to streamline the number of personal tax bands and unify treatment of personal income; it will unify corporate tax rates of corporate investment, employment, pension contributions, and listings on the stock exchange. Tax exemption of interest earnings is also being reviewed.

There are three main pillars for the new tax law. First, it has been proposed to lower the tax rates from their current rate of 40% on corporations, and 32% on manufacturing and exporting companies to a unified rate of 25%. There are also attempts to reduce it even further. It has been argued that the high tax rates in Egypt have been primarily responsible for tax evasion, thus limiting tax revenues.

The second pillar is to improve tax administration, which is considered by taxpayers to be the main factor that hinders their business, increases their transaction costs, and prevents their compliance with the tax law. This is largely due to the inefficient bureaucratic, and in some cases, corrupt tax collectors. Improving tax administration and streamlining bureaucratic procedures is considered a crucial step, even at the current tax rates, to enhance the competitiveness of Egyptian businesses and to provide a fair treatment for tax payers. It is also required to move away from the current system, which relies heavily on widespread audits and inspections, to a reformed system that focuses on categories of taxpayers that have a tendency to evade paying taxes.

The third pillar is to revise the incentives structure in order to enhance the readiness of current and potential taxpayers to fulfill their obligations. The revision of incentives comes in two forms, first by increasing the penalties for tax evaders, and second, by providing some discounts and benefits for those that cooperate effectively with the tax authorities. On the sales tax side, there is a need to deal with the problem of taxing capital goods as inputs for the manufacturing industry. Currently they are subject to five percent sales tax. By the same token, there is a need to consider the treatment of production inputs. There is also a need to deal with the pending cases between the sales tax authority and the taxpayers.

Customs tariffs have been one of the main issues of concern. Three issues of priority stand out for immediate action. First, there is a need to reduce the high tariff rates, to bring them close to the rates in peer countries. Currently, the simple average for tariffs in Egypt is 20.5% while the weighted average is 15.4%. Second, there are various distortions in the structure of the tariff rate, which need to be removed in order to enhance the competitiveness of the Egyptian economy, and lower the burden on local consumers. Third, there is a need to revise the law, because one of its articles provides incentives for the usage of domestic components in the production, up to 60% of components used in manufacture, for customs duty reductions. While the intention was to increase the local value added of the products, it ended up by a reverse outcome as the quality of the inputs were sacrificed in favor of customs incentives, which eventually reduced the competitiveness of Egyptian industries.

On September 8, 2004 radical changes on the tariff structure have been enacted. The number of tariff bands has been reduced from 27 to 6, tariff rates on most imports have been cut, bringing the average rate on imports down. Yet this reduction has been partially offset by the devaluation on the Egyptian pound for tariff valuation to bring it to parity with the bank exchange rate. Furthermore, import fees and surcharges have been annulled.

It is worth noting that there are no reliable figures available on the losses to the treasury due to tax evasion and inefficiency of tax collection. However, there is a proxy for such losses in the form of tax arrears. In the year 2003, it has been estimated that the general tax arrears for the year 1999-2000 were LE 16.1 billion, rising from LE 13.1 billion in 1998-99; customs arrears were LE 3.6 billion in 1999-2000, coming down from LE 4.3 billion in 1998-99, while sales tax arrears were the lowest at LE 0.7 billion in 1999-2000, rising from LE 0.6 billion in 1998-99. The significance of such arrears would be realized if one notices that they were as high as 21.5% of the current revenue in 1999-2000, compared to 20.5% in 1998-99.[21]

2.2.2 Tax holidays

The introduction of the new tax law has initiated a healthy debate regarding the costs and benefits of the numerous tax exemptions and holidays (Box 1.1). Most tax holidays have been adopted since the 1970s with the object of increasing private local and foreign investment in the country. It is believed by a group of business people that tax holidays are necessary just to avoid dealing with the tax authorities regardless of the tax rate. However, it is currently realized that any fiscal reform should tackle this issue by providing a good exit strategy that does not raise concerns regarding the credibility of the government or put investment in Egypt at a disadvantageous position vis-à-vis its competitors, especially within the region.

2.2.3 Subsidies

The reforms of the early 1990s entailed the reduction of the fiscal deficit, which was mainly achieved through the reduction in expenditure, namely government investments, while protecting expenditure on the social sector. One of the items that were subject to cuts was subsidies. Although they were limited to three commodities, wheat flour, sugar, and cooking oil, compared to 18 items in 1980, they cost the budget LE 8 billion in the budget of the fiscal year 2003-04. Egypt has a large food subsidy program that has created a relatively effective social safety net. However, this system has also drained budgetary resources and has proven to be poorly targeted. There has been an ongoing debate about reforming the system with the objective of improving its effectiveness.

These discussions are extremely sensitive politically, especially regarding the issue of food subsidies. Hence, Egypt faces the dilemma that policymakers and those contempla-

Box 1.1: Tax Holidays and Other Exemptions

Under Egyptian laws there are different tax holidays and exemptions, including:

- Five year exemption from corporate tax starting from the first financial year after activities commence.
- Five year exemption from income and distributed profits, starting from the first financial year after the start of business activity.
- Twenty year exemption on income and profits starting from the first financial year of business in Kharga, Baris, Farafra, Siwa, East Owaynat, and Toshka.
- Ten year tax holiday for projects in new urban communities, industrial parks, and remote areas, as well as land reclamation projects.
- Permission to export and import equipment without registration requirements.
  Customs duties flat rate of 5 % on imported equipment.
- Exemption from stamp duties, registration, and notarization fees on project contracts for three years, effective as of the date of registration in the commercial registry.

ting food subsidy reform face in developing countries. Reforms that have the greatest chance of success are those that reduce access of the wealthy while increasing access of the needy. However, the timing, sequencing, and trade-offs of such reforms have to be taken into account before they are implemented.[22]

Moreover, it is not only food subsidies that are forming a burden on the budget. There are subsidies in the form of transfers to public authorities, which stood at LE 2.5 billion in 2003. This figure excludes implicit subsidies to various sectors that are not included in the budget, such as the implicit subsidy borne by the energy sector, which alone averaged LE 15 billion per annum during the last four years due to the difference between local and international prices and the depreciation in the Egyptian pound.

2.2.4 Privatization of the public sector

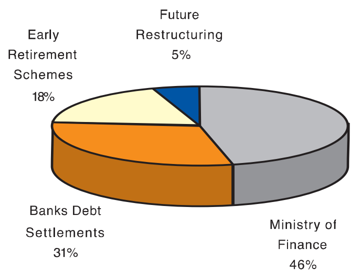
An integral part of the reform program of the early 1990s in Egypt was the privatization of the public sector. While many public entities have been productive and profitable, a large number has been economically inefficient, making heavy losses and representing a fiscal burden on the government.

There have also tangible results related to increased productivity and economic efficiency. The performance of the public enterprises was poor at the early stage of the privatization program, when the government was more focused on achieving targets and deadlines for divestiture rather than improving efficiency and productivity of the public enterprises. Recently the performance of both the public enterprises that remained under state control and those that were transferred to the private sector have greatly improved. Financial performance indicators have on average shown better management, higher productivity, and more efficient use of resources.[23]

On the fiscal side, privatization has had a significant impact on reducing the burden on the government's fiscal resources by not only cutting future losses of the public sector, but by bringing in an immediate increase in public revenues through sale proceeds. There have been considerable amounts of sales proceeds. Privatization of non-financial public enterprises, for example, has generated as of March 2000 more than LE 14.16 billion in proceeds. This figure does not include sales to employee share associations (ESAs), which have not made payments or receipts from the liquidations. The allocation and uses of the proceeds have gone through a number of iterations during the program period. Proceeds of such transactions amounted to LE 16.7 billion of which only LE 14.4 billion have been actually collected. As of March 2004, the proceeds of the privatization program have been utilized as follows: around 46% were transferred to the Ministry of Finance to reduce the budget deficit, 31% were used to settle banks debts, 18% for early retirement schemes, and 5% was allocated for future restructuring (Figure 1.14).[24]

The slowdown in privatization in 2001 paralleled the global downturn in sales. The sale of the remaining enterprises, especially the large ones in the textile sector that account for the majority of the operating losses of the state enterprise sector, poses a challenge for the government.

Figure 1.14: Uses of Sales Proceeds



Source: Ministry of Public Enterprises

In order to speed up the privatization program, the government, left with numerous loss-making companies, resorted to alternative methods of privatization. These include unbundling of public assets and leasing with the option to buy, as well as offering incentives such as removal of real estate value from companies valuations and five-year tax exemption for buying distressed public enterprises. Moreover, the government has recently announced its commitment to privatize 66 public companies within a new privatization plan for the period from 2004 to 2007. However, there are concerns that although the proposed debt restructuring could eliminate public enterprises' past debts, it will not prevent these companies from incurring losses in the future. These losses should not be financed by bonds issued by the holding companies or through new loans from banks.

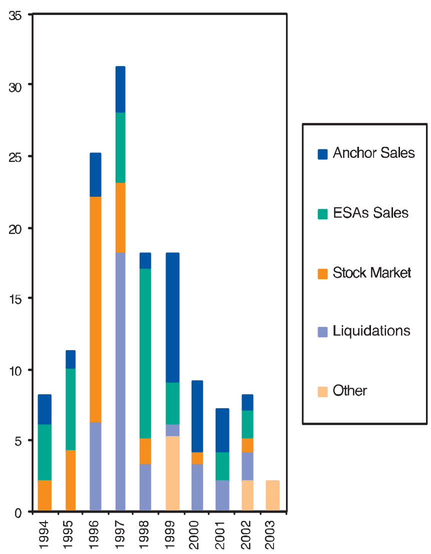
The new strategy announced by the Ministry of Public Enterprises for the privatization of the remaining public enterprises for the period from 2004 to 2007, is expected to activate the privatization process. The program is multifaceted. It includes better outreach to both local, and foreign investors, and an incentive package addressing various aspects of the transaction. This package

Box 1.2: Progress in the Privatization of Public Enterprises in Egypt

The privatization program in Egypt could be divided into three main phases. First, at the early stages of privatization the pace was slow, mainly due to the time required to introduce the necessary legislative and regulatory arrangements. Furthermore the socioeconomic culture had not yet been ready to accept the concept of privatization. The second phase was in early 1996 when the constitutional court upheld the right of the government to privatize the public sector, after which the privatization program gained momentum, mainly through stock market floatations of profitable enterprises. The third stage started when the government was left with a large proportion of unviable companies. At this stage, the pace of privatization slowed down, making the authorities more inclined to presale restructuring in order to prepare the remaining companies for privatization.

On aggregate, 197 public enterprises out of the 314 Law 203 companies have been privatized as of March 2004 (Figure b.1). These include 133 enterprises that were majority sold, of which 29 to anchor investors, 38 through public offerings, 33 to ESAs, and 33 liquidated, as well as 16 enterprises that were partially sold. In addition, 48 factories and assets were sold, leased, or made management contracts.

Figure b.1: Privatized Companies by Method of Sale (1994-2002)



Source: Ministry of Public Enterprises includes: (i) Transferring excess land and idle assets to the relevant holding company prior to offering any company for privatization in order to downsize the company and make it more lucrative economically. Moreover, working capital items like inventory and receivables could also be transferred to the holding company upon the investor's request; (ii) Streamlining the process of asset valuation. For example, the valuation of land is made according to the price of the nearest new industrial community, where the terms of payments are granted to the investor conditional on his acceptance to keep the labor force of the privatized company. Buildings, machinery, equipment, and furniture, as well as, inventory and receivables are to be valued at net book value; (iii) Transferring the outstanding debt of public enterprises to banks as well as other liabilities to the holding company. This is considered one of the major incentives offered by the government since it aims at rendering the company a healthy investment opportunity for the potential buyer; (iv) The surplus of profitable public enterprises will be directed from the budget of the holding company to cover the restructuring debt service obligations, allowing for cross-financing; and (v) The potential investor can enjoy tax holidays and other incentives stipulated by Investment Incentives Law 8 for 1997.

2.2.5 Public debt management

The outstanding external debt relative to GDP reached 36% by the end of June 2003, which is relatively low by international standards. In addition, most of Egypt's debt consists of soft public, medium, and long-term loans. Both external debt and debt service had been steadily reduced in recent years, as shown in Figure 1.9 above.

Box 1.3: Challenges Facing the Privatization Program in Egypt

The privatization program is facing several challenges, including:

(i) The procedures associated with the sale of public enterprises is often lack clarity, and are cumbersome and lengthy, as well as costly for both the government and potential buyers. This has in turn increased the transaction time and costs to such an extent that it jeopardizes viability and turns domestic and foreign entrepreneurs and investors away from the program.

(ii) The privatization program is supported at the ministerial and highest levels; however, it was wavering and at times inconsistent at the Holding Companies (HCs) and Affiliate Companies (ACs) level. Such inconsistency has in many instances, eroded the creditability of the program and negatively impacted its outcome.

(iii) Initially, HCs were established as temporary organizations but have tended to maintain their status quo. Privatization diminishes their power, and hence they tend to want to keep ACs under their control. Hence, the continued existence of the HCs needs to be examined, and in case their continuation proves essential, then clear terms of reference are required to ensure no conflict of interest.

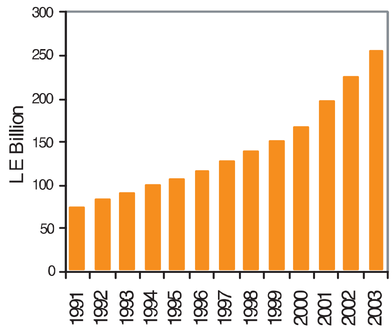
(iv) A large portion of the remaining public enterprises are companies characterized by declining revenues, high debts and bank overdrafts, surplus labor, and obsolete assets. The resources required to keep these companies operating could erode previous gains, burdening the government further. Thus, it is vital to privatize the remaining companies in the portfolio.

However, as shown in Figure 1.15, as a result of the recent increase in budget deficit, gross domestic debt has been increasing by an annual average of approximately 12% during the period from 1998 to 2002.

At a 7% budget deficit for the year 2003-04, the net public debt to GDP ratio would reach 72% of GDP, which constitutes an increase of 25 percentage points compared to the end of June 2000 ratio. These figures clearly show unsustainable development of the fiscal policy,[25] accompanied with serious implications on domestic credit allocation. Under the current funding patterns of the budget, public borrowing from the domestic banking system would swallow up credit at the expense of a crowded-out private sector, undermining economic momentum.

Against this background, it is worth noting that focusing on a single indicator, i.e. public debt ratios in terms of GDP to assess the efficacy of public debt management and fiscal sustainability may be misleading. Such a simplistic approach is subject to several limitations attributed, inter alia, to its vulnerability to changes in the discount factor, time paths of government expendi-tures, the behavior of private sector.[26] A recent study[27] on fiscal sustainability in Egypt has shown that the country's debt structure is rather safe and is not likely to suffer from a contagion effect or disruptive sudden stops in capital flows, and under a worst case scenario assumptions that involve 50% drop in oil prices, a sudden increase in interest rates, a drop in growth, and widespread bankruptcies would add two points of GDP to debt stabilizing primary surplus. In another study,[28] fiscal sustain-ability has been examined using a simple consistent accounting framework and has shown that Egypt has six years, starting in 2003, to bring its fiscal management in order before the debt level creates macroeconomic instability. However, it should not be understood from these studies that public debt and its management are not issues of concern and priority for economic policy in Egypt which warrants immediate action along the reform measures outlined above.

Figure 1.15: Domestic Debt



Source: CBE, Annual Report (various issues

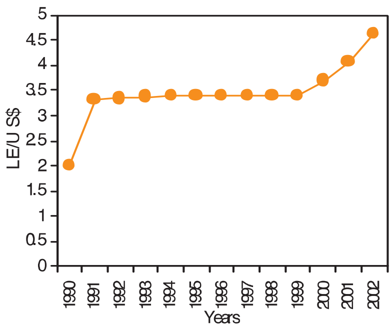
3. Exchange Rate and Monetary Policies

3.1 Exchange Rate Policy

3.1.1 The exchange rate peg

Prior to the pegging of the Egyptian pound to the US dollar, the official exchange rate was set by the authorities and did not reflect market forces. A black market coexisted with the official market, and was active and agile. To ensure a competitive exchange rate, and to simplify the system, the multiple exchange rate system[29] was replaced in February 1991 by a dual exchange system, which included a primary restricted market and a secondary free market. The two markets were unified in October 1991. As shown in Figure 1.16, from this date on and until 1998, the Egyptian pound was freely traded in a single exchange market with limited intervention by the authorities to maintain the rate within an 'implicit' band against the US dollar. However, in the early 1990s, there was a significant real appreciation of the pound but following the decline in the inflation rate since 1993; the appreciation of the pound became modest.[30] Moreover, in June 1994, easing capital account restrictions liberalized further the foreign exchange market.[31]

Figure 1.16: Official Annual Exchange Rate



Source: International Financial Statistics (IFS), and CBE, Annual Report (various issues).

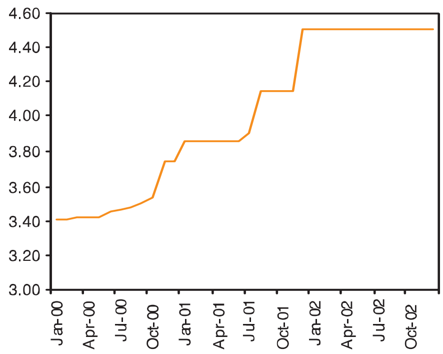
Nevertheless, the steady appreciation of the pound undermined the country's competitiveness. This took place while the country experienced severe deteriorations in its trade balance and capital account in the aftermath of the Asian crisis, augmented by the decline in oil prices and tourism receipts. All these factors brought significant pressure on Egypt's official nominal exchange rate, which in response started to increase slightly since mid-1999 (Figure 1.16).

To deal with the pressures on the Egyptian pound, the central bank introduced in 1998, through a 'gentlemen's agreement,' tighter import requirements by banks (100% local currency cash cover for imports credit). Although the government was apparently able to defend the de facto peg to the US dollar, nevertheless shortages of foreign currency periodically occurred and the inter-dealer exchange rate diverged from the official rate. Expectations of a devaluation made depositors either dollarize their deposits within the Egyptian banking system or withdraw their bank deposits and convert them into foreign currency deposits abroad. Maintaining the pegged exchange rate required regular intervention from the central bank.[32] Such intervention was financed by drawing down from the central bank's net foreign reserves and its foreign exchange deposits with commercial banks.[33]

3.1.2 The adjustable currency band

Despite several devaluations of the Egyptian pound, it was still overvalued, and shortages of foreign currency continued, which in turn led to the reemergence of a black market for foreign exchange. The volatility in exchange rates, which was partly a result of inconsistency of the monetary and exchange rate policies, also contributed to capital flight. Total foreign exchange reserves estimated to have been lost in support of the foreign exchange regime was around US $6 billion between 1998 and 2000, which is more than one third of net foreign reserves. Another complication was that the depreciation of the Egyptian pound was not fully recognized by the central bank, indicating that the central bank is defending a non-equilibrium exchange rate through futile loss of reserves.

Figure 1.17: Nominal Exchange Rate Central Rate (January 2000-December 2002)



Source: CBE, Monthly Statistical Bulletin (various issues)

Egypt replaced the de facto peg to the US dollar regime, which was introduced in 1991, by an adjustable currency band in January 2001-a move which followed a 12% depreciation of the pound during the period from

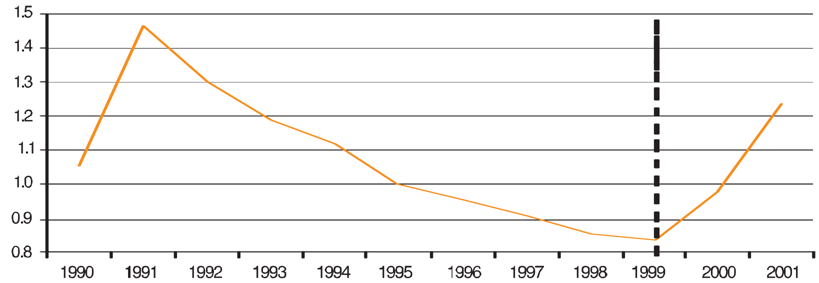
March 2000 to January 2001. The adjustable currency band had a central rate of LE 3.85 per US dollar with a band of ± 1%. The central rate was depreciated to LE 4.15 per US dollar, and the band was widened to ± 3% (Figure 1.17). The central rate was adjusted further to LE 4.51 per US dollar in June 2002 with the same ± 3% band. Thus, under the adjustable peg system, until January 2003, the Egyptian pound was devalued, in several steps, by a cumulative rate of 48% against the US dollar. Nevertheless, the pressure on the exchange rate did not subside, reflecting the loss of credibility in the exchange rate regime despite a tightening in the monetary policy.

Box 1.4: Egypt's Real Exchange Rate Developments

Measuring Egypt's real exchange rate is vital for developing an international competitiveness index for the country. Such an index can be used to assess export sector degree of competitiveness. Policies adopted during the 1990s, motivated by the need to maintain price stability and minimizing inflationary pressures that would rise from 'expensive' imported goods, have resulted in exchange rate misalignment with adverse effects on economic growth, competitiveness,. and allocation of resources [DomaÇ and Shabsigh (1999), p. 21].

Following many recent empirical studies, the most convenient and practical definition of real exchange rate can be summarized as follows (RER=E*WPITP/EGCPI), where E stands for Egypt nominal official exchange rate, WPITP stands for wholesale price index of country's most prominent trade partner, and EGCPI for Egypt domestic consumer price index.Thus, an increase in RER or depreciation in the real exchange rate index, holding international prices constant, implies a decline in the cost of producing domestic tradable goods and hence an improvement in the country's international competitiveness stance.

Figure b.2: Real Exchange Rate (1990-2002)



Source: Ministry of Foreign Trade.

Using this definition, Egypt's RER index was calculated for the period 1990-2001. Detailed scrutiny of figure (b.2) reveals a continuous appreciation trend of Egypt's RER in the aftermath of the 1991 unification and liberalization of the foreign exchange market and relaxation of capital controls. Consequently, such steady appreciation undermined the country's international competitiveness. However, starting in 1999 and thereafter, a reversal in the trend followed due to successive devaluations of nominal official exchange rate.

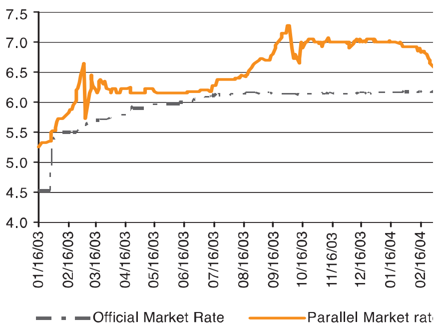
Since January 2003, a significant depreciation in the official rate, 33%, was witnessed as a result of the free float decision. According to the Ministry of Foreign Trade Monthly Bulletin, the initial impact on the exports sector during the period January-June 2003 was significantly positive, as non-oil exports increased by 22%. However, such impact is not widely reflected in the economy as the exports base compared to GDP is still limited.

3.1.3 The free float

In January 2003, Egypt abandoned an adjustable peg regime and adopted a floating exchange rate.[34] Under this regime, the Egyptian pound moved to a free float where the central bank is not going to intervene in the foreign exchange market unless to counter major imbalances and sharp swings in the exchange rate. The move was considered as "an important policy milestone" by the International Monetary Fund (IMF);[35] and it was considered a move to enhance "Egypt's competitiveness while improving its ability to adjust to external shocks."[36]

As shown in Figure 1.18, the floating of the Egyptian pound led to an immediate depreciation of approximately 15% in its value on the first day of trading (from LE 4.65:US $1 to LE 5.39:US $1). After six months of the introduction of the new regime, the official rate is close to LE 6.15 per US dollar, i.e. with a further depreciation of 14%. Nevertheless, the rate is not yet market-clearing and the parallel market still exists although the two markets' rates are converging. The spread in July 2003 was about four percent compared to 15% in January 2003.

Figure 1.18: Official and Parallel Markets Exchange Rate (January 2003-April 2004)



Source: Central Bank of Egypt.

Realizing that there is a 'leakage' of foreign currency out of the official market, the government took several measures to regulate the movement of hard currencies in and out of the banking system. Among these measures was to freeze government imports for three months except for basic food items and essential products. In March 2003, the prime minister issued Decree 506 of 2003 introducing foreign exchange surrender requirements, which compelled all exporters to sell 75% of their foreign earnings to domestic banks at the official rate, and to keep the remaining 25% in the banking system. This decree, along with some other measures such as the prevention of foreign exchange dealers to quote their own rates, is considered as a form of market distortion that should only be enforced in the short term until the market stabilizes.

However, the new foreign exchange rate regime is expected to have positive impacts on the economy. First, foreign investments that have been on hold are expected to be induced as regional political conditions stabilize. Foreign institutional investors, who have avoided the market in anticipation of the elimination of the gap between the parallel and official rates, are likely to regain confidence and direct some flows back to Egypt. This will consequently take the privatization program back to rail. Second, exports are expected to boom as foreign exchange becomes more available. Third, capital outflows that have been a drain on net foreign assets of the banking system are likely to return.[37]

3.1.4 Challenges facing the 'free-float' regime

Despite the healthy position of the balance of payments in general and the current account in particular, and some initial progress in liquidity, the supply of foreign exchange does not meet the growing demand. The parallel market is still active quoting prices higher than the official rate, as shown in Figure 1.18. After the free float some convergence was witnessed between the official and the parallel markets noticeably during the period from May 2003 to mid-July 2003. However, unhealthy interventions in the official market by attempting to buy dollars from a few small banks, without completing the transactions, followed by complaints by foreign investors of delays in repatriation of profit and dividends, and the subsequent announce-ment by the Central Bank of an increase in international reserves, while the market has been complaining of severe shortage of foreign currencies, resulted in loss of credibility in the new foreign exchange regime.

Currently, the foreign exchange available to the banking system is sold in the retail market, which suffers from shortfalls that are dealt with through ad hoc queuing arrangements. The absence of a market clearing rate and lack of availability of foreign currency have been undermining the credibility of the free float, and enhancing the speculative proportion of the demand for foreign currency in Egypt. Although it has been announced that there is no intervention by the authorities in the determination of the exchange rate, some form of self regulation to 'please' the authorities have been practiced by the operating banks.

Moreover, the absence of a formal modern inter-bank foreign exchange market is considered one of the main institutional problems that face the development of an organized exchange market in Egypt. Currently, banks are quoting a single, retail client-based, bid-ask spread. There is an immediate need to establish an inter-bank market based on a regulatory framework, with adequate technical and infrastructural support. It is expected that the prime minister, according to Article 112 of the new Banking Law 88 of 2003, would issue a decree with the regulatory framework of the inter-bank market that would include a convention for dealers. However, it is more important to equip the central bank with the qualified expertise required to run the system, and provide an assurance to the market of its credibility.

Needless to say, under the new exchange rate regime there is a need for a disciplined fiscal policy along the lines discussed above to maintain confidence in the Egyptian pound in the medium- and long-term. In addition, structural reforms such as the acceleration of privatization and trade liberalization are also required in order to enhance investment, and encourage capital inflows, strengthening the balance of payments. Primarily, the floating of the exchange rate and the loss of the dollar as a nominal anchor, have emphasized the need for a sound monetary policy to provide an alternative anchor and to keep inflation rate low, especially under the inflationary impact of the depreciation associated with the free float.

3.2 Monetary Policy

Egypt's monetary policy was formulated in the 1990s to support the exchange rate peg. Provided that the central bank had sufficient reserves, any disequilibrium in the money market was resolved mainly by changes in the foreign reserves held by the central bank. Under these conditions, the monetary policy would have only temporary effects on domestic markets. However, when the peg was challenged amid the external shocks of late 1997, there was an economic policy dilemma.

Economic management, at the time, apparently confused economic instruments with ultimate targets. Some 'sacred' economic values, were created, causing monetary and fiscal policy to be directed towards achieving these 'targets,' namely one percent fiscal deficit-to-GDP, US $20 billion of international reserves, and a figure of LE 3.4 as a nominal value of the dollar against the pound. These figures, through the influence of the media, became criteria for judging the performance of economic policy by the public, which made any change in them a politically sensitive matter.

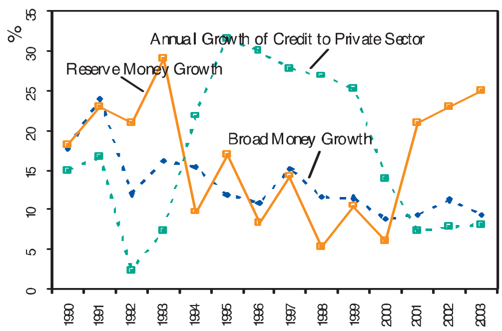
However, from a technical perspective, it was not possible to pursue an active monetary policy while a fixed exchange rate regime was applied along with an open capital account.[38] With increasing flexibility in the exchange rate since the year 2000, monetary policy started to take greater importance for maintaining low inflation. Nevertheless, the monetary policy has been facing a challenge of limited monetary tools and lack of transparency especially in the Treasury Bills market. Interest rates are closely managed and have been almost fixed for years. As shown in Figure 1.20, the central bank discount rate has been almost fixed and the insensitive to changes in market conditions, while the inter-bank rate in a thin and shallow market, was extremely variable. Deposit and lending rates remain high with wide spreads, while complaints from banks' borrowers are persistent.

3.2.1 Controlling the growth of money

The main guidance to the monetary policy was based on the monitoring and control of money growth. The growth rate of broad money, which is determined by the central bank, is based on the projection of real GDP growth rate and expected inflation rate. As shown in Figure 20, the period from mid 1990s to the year 2000 was characterized by a tight monetary condition, as reflected in the slow down in the growth rate of M2 and reserve money, to support the Egyptian pound. Tight financial policies that started in 1999, as well as limits on credit expansion resulted in a significant decline of credit to the private sector. The increase in government borrowing since 2000 has contributed to the decline in private sector credit. It is worth mentioning that part of government borrowing was used to finance its arrears to the private sector,[39] which provided an indirect source of liquidity to the private sector. Given the swift downturn in private credit growth after years of rapid expansion, the quality of bank loans have deteriorated. Further, claims on the private sector during late 2002 grew by only 0.1% compared to 7% during the corresponding period in the previous year. Meanwhile there was an increase in the growth rate of total claims on the public sector from 9% to 13% during the same period.[40]

From the year 2000 to the year 2003, growth of broad money ranged between 8.5% and 11.5%, in consistence with the monetary objectives in terms of anticipated economic growth and controlled inflation. The growth of broad money is projected at 8.5% for the year 2004, with a target to limit inflation to a range of 4% to 4.5% (Figure 1.19).

Figure 1.19: Monetary Survey



Source: CBE, Annual Report (various issues).

3.2.2 Limited use of monetary instruments

Other than the control of money supply, the use of monetary policy instruments was limited. Despite the significant depreciation in the exchange rate and the noted decline in the real economic growth rate, the discount rate of the central bank did not change with the exception of a recent cut of 100 basis points in December 2002 to reach 10%. This was followed by a cut in the deposit rates by 100 to 150 basis points to reach as low as 8.5%. However, lending rates at an average of 14% have not followed, widening the spread (Figure 1.20).

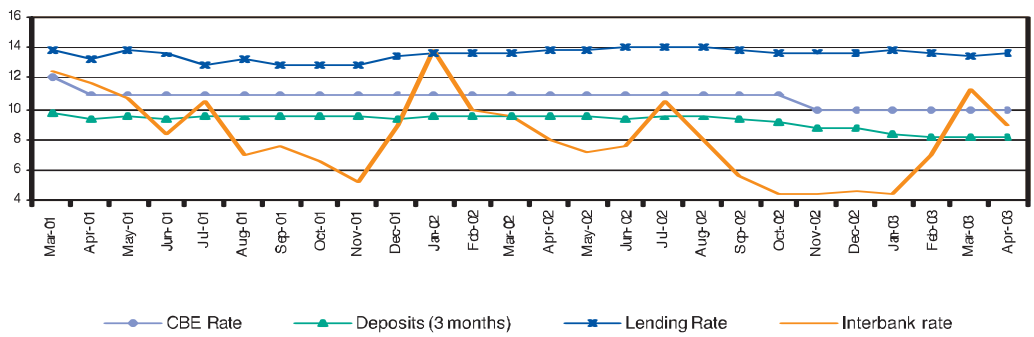
There are many explanations for such behavior of the lending rates, first it is claimed that there is a lag between the deposit rate cut and a lending rate cut. Second, it was argued that the deposit rate cut was followed by the free float which was associated with a tendency to tighten monetary policy and increase interest rates in fear of dollarization which exceeded 27% of total deposits in the year 2003, approximately ten percent higher than the 1990s average. The third explanation is attributed to the quality of banks' portfolios, which suffer from a high ratio of non-performing loans. This encourages the banks to utilize the high spread in dealing with their portfolio problems instead of passing the reduction to their borrowers and despite a reduction in the deposit reserve requirements from 15% to 14% in September 2001, followed by exempting deposits with more than three years maturity from the reserve requirements rule.

3.2.3 Controlling inflation as a target of monetary policy

As shown in Figure 1.21 below, one of the main achievements of the 1990s stabilization program was bringing inflation down, from an official average of more than 20% during the late 1980s to single digit levels, starting in 1994. This decline is attributed to an improved fiscal stance, which was previously a cause of pressure on domestic liquidity. There was also an adequate management of capital inflows through sterilization measures, which prevented the increases in net foreign assets of the banking system to cause inflation.

However, since the end of February 2003, the inflation rate, has been showing a continuous upward trend, which is more reflected in the wholesale price index rather than the CPI index that suffers from a downward bias because of the significant share of subsidized items in its basket. This upward trend is stimulated by a rise in the prices of food, beverages, and tobacco, along with an increase in the prices of wood and farm products. Such an increase in those prices has mainly occurred due to the pass-through effect of the continuous depreciation of the Egyptian

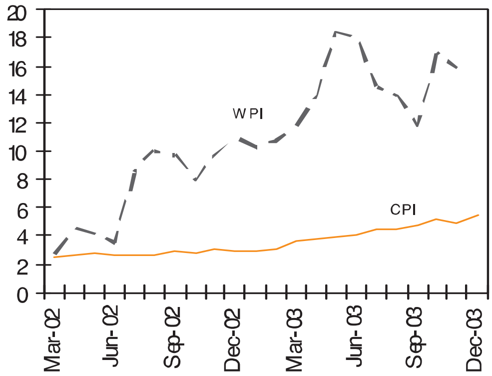
Figure 1.20: Interest Rates



Source: CBE, Monthly Statistical Bulletin (various issues).

pound, in addition to the prevailing negative expectations and the absence of effective monetary policy.

Figure 1.21: Inflation Rate (Monthly)



Source: Ministry of Foreign Trade.

3.2.4 Inflation targeting

Inflation targeting[41] as a framework of monetary policy in Egypt requires serious measures to develop a monetary policy in Egypt to underpin the free float. These measures go beyond the mere drafting of a framework of the monetary policy in order to deal with required efficiency of implementation.

The free float regime in Egypt needs to be supported by an inflation targeting as a framework for monetary policy. The central bank has announced on its website[42] that it is going to adopt an inflation-targeting framework after the enactment of the new bank law. More than three months have passed since the issuance of the law,[43] but no details were provided regarding the necessary measures for the implementation of the 'new' monetary policy.

We argue that inflation targeting can be an adequate framework for monetary policy in Egypt, mainly because it lacks, in general, some of the drawbacks of the two alternative regimes.[44] The first alternative regime is the adoption of a pre-announced or a pre-determined path for the exchange rate as a nominal anchor cannot be pursued, despite its advantages and disadvantages, after the adoption of the free float. The second alternative is the targeting of monetary aggregates, such as the broad measure of money M2, which is currently adopted in Egypt. This regime has many advantages, such as the relative straightforwardness of implementation, but suffers from the problem that the demand for money has shown significant fluctuations and structural changes. This caused severe instability between money supply and the policy objective, in the form of a particular level of inflation, and made many countries abandon this regime, which is viewed as unreliable. Moreover, the targeting of monetary aggregates does not provide the relevant economic agents with the frequently required signals of monetary policy.

Thus, inflation targeting has been chosen by many countries in the context of moving from a fixed exchange rate to a more flexible one, but with variant degrees of flexibility of implementation from country to country depending on the initial conditions, institutional arrangements, and priorities of economic policy. Moreover, in the specific case of Egypt, there is a track record of maintaining relatively low inflation rates. Even before the start of the 1990s stabilization program, inflation rates were relatively low compared to other developing countries due to its large monetary base relative to GDP. This indicates a high possibility of success of an inflation-targeting framework if effectively implemented.

However, inflation targeting has not been, so far, adopted widely in emerging markets and there are skeptical arguments against its viability in a developing country like Egypt. There are concerns that the monetary transmission mechanism is not efficient enough, quality of data and its analysis are not adequate, and the financial sector development is insufficient. These problems, inter alia, would cause difficulties in the development and implementation of inflation targeting in Egypt. However, most, if not all, of the required preconditions for the successful implementation of inflation targeting also apply to other regimes so it is inevitable to address them.[45] These preconditions: are namely, strong fiscal position, a well-developed financial system, well-understood channels between monetary instruments and inflation, a reliable methodology for providing inflation projections and forecasts, transparent policies, and finally, central bank instruments' independence and a clear mandate to achieve price stability.[46] In other words, "the journey towards inflation targeting is as important as the destination." [47]

It has been claimed by the government and the CBE that these preconditions are under progress, or at least, being considered. However, there is a significant improvement as far as the operational independence of the central bank is concerned. As shown in Box 5, the new banking law provides the necessary legal support for the inflation-targeting framework in Egypt. Nevertheless, the quality of implementation of the legal provisions and significant improvements in developing the infrastructure and instruments of monetary policy are of crucial importance for inflation targeting to succeed.

4. Overall Assessment and Key Development Recommendations

The Egyptian economy managed to enjoy positive trends in its macroeconomic performance until its exposure to major external shocks starting in 1997. The deteriorating macroeconomic environment was evident in the slowing economic growth, rising inflation, high unemployment rate, widening fiscal deficit, and growing domestic debt. Moreover, economic activity continued to be hindered by high real interest rates, poor

Box 1.5: The New Banking Law 88 of 2003 and the Monetary Policy

- The CBE is "a public juristic personality affiliated with the president." (Article 1)
- The mandate of the CBE is to achieve price stability and to maintain the soundness of the banking system. (Article 5)
- The CBE agrees with the government on the targets of monetary policy within a coordination council to be established by a Presidential Decree. (Article 5)
- The CBE is solely responsible for conducting and implementing monetary, credit, and banking policies. (Article 5)
- The CBE is free to choose the instruments and provisions required for achieving its targets. (Article 6)
- The governor of the CBE and his two deputies are appointed by the president for a renewable period of 4 years. (Article 10)
- The board of the CBE is the competent authority, as far as the achievement of the targets of the central bank and the design and implementation of monetary, credit, and banking policies are concerned. (Article 14)
- The choice of instruments and measures of monetary policy is the responsibility of the Board of the CBE. (Article 14)
- The CBE should provide reports on monetary, credit, banking, and external debt developments to the president, the prime minister and the speakers of the Lower House and the Upper House of parliament. (Article 28)
- The CBE should disclose its monetary measures and publish them in the Official Gazette. (Article 29).

levels of competitiveness, a shortage of foreign currency, and a depressed regional and global environment. It is common for a small 'open' economy to be exposed and affected by external shocks; however, exposure does not inevitably imply vulnerability. It is within the realm of economic management and governance that controlling for the degree of exposure matters most. While the internal fundamentals are suffering from weaknesses, the external position, as far as the balance of payments, and external debt are concerned, has improved.

After all, it is the responsibility of the government to deal with these shocks in order to minimize their negative consequences. This requires taking the right measures at the right time-an absent virtue in Egypt where economic policymaking was criticized for doing too little, too late. In that context, there is an urgent need for serious fiscal reforms in the areas of taxation, subsidization, and public debt, in addition to expediting the privatization process.

There is a need to strengthen the fiscal performance, not just through tax reforms and expediting privatization, but also through more radical measures at the revenues and expenditures sides of the budget. Most of these measures, if carefully designed and targeted, should not affect the poor. Examples of these measures are addressing the issue of implicit subsidies-adjusting the pricing of petroleum products to reflect changes in international prices, and increasing electricity prices to reflect changes in the cost of production. What is also needed in this regards is not just a mere 'one-off' shift in prices but the establishment of a mechanism based on objective criteria through which prices of such products would be revised according to market conditions without administrative intervention. This approach would depoliticize these matters, and provide a timely and adequate framework for price adjustments. Moreover, it is essential to revise the tax holidays and exemptions, and to put a cap on annual increases in wages and salaries at a maximum equivalent to the CPI annual change. Needless to say, these measures are in need of political support and right timing, bearing in mind that any delay would only cause more harm and require harsher measures in due course.

The foreign exchange market in Egypt is fragmented and suffers from chronic shortage of liquidity, an absence of market clearing rate, inadequate institutional framework, and ineffective monetary policy. The free float regime in Egypt needs to be supported by an inflation-targeting frame-work for monetary policy. However, there are certain preconditions which are required for this framework to be implemented effective-ly. These preconditions are strong fiscal position, a well-developed financial system, well-understood channels between monetary instruments and inflation, a reliable method-ology for providing inflation projections and forecasts, transparent policies, and finally, central bank instruments' independence and a clear mandate to achieve price stability. We notice that the only progress was in the legal front as the central bank has been granted its operational independence by the provisions of the new law. However, it is mainly effective implementation rather than issuance of laws that is required for an effective monetary policy to be achieved.

Notes

1 The fiscal year in Egypt runs from July 1 through June 30.

2 These include the New Valley irrigation schemes in the desert southwest of Aswan, Toshka, and the port and indus-

trial development zones in East Port Said and Suez.

3 For example electricity generated for industrial production dropped from an annual growth rate of 19 % in 1999 to 3.7 % in 2000 [Information and Decision Support Center (2000), p. 4].

4 International Monetary Fund (1998), pp. 2-4.

5 The annual growth rates of public investment was around 5 % in 1992 compared to 62 % in 1999, but in 2000 it dropped by 19 %.

6 The widening of the budget deficit has been one of the main reasons behind the recent downgrade of the rating of the Egyptian economy by Standard & Poor's in August 2003.

7 The appreciation of the Egyptian pound could be another explanation. Exports declined by 4 % in 1997/98 and further by 13 % in 1998/99, however, they increased in 1999/2000 by 44 % compared to the previous year.

8 Ministry of Foreign Trade (2003),p. 12.

9 CBE (2003), p. 54.

10 In this context, Egypt should not be singled out as a country with such experience with capital inflows. Other emerging markets witnessed the same trends, thanks to the combination of fixed exchange rates and significant interest rate differentials.

11 To avoid negative impact of inflows on money supply and liquidity policy, sterilization efforts were required. Proceeds from the sales of treasury bills were deposited in the central bank. Sterilization of such flows can result in the rapid build up of domestic debt, which beyond a certain point can cast doubt on the sustainability of the reform. However, the cost of sterilization were estimated by the IMF at 0.6 % of GDP for the period from 1991 to 1997, a level that is not considered as alarming [IMF (1998), p. 13].

12 As part of the financial reform program, the minimum reserve requirement imposed on foreign currency deposits was reduced from 15 % to 10 %.

13 Mohieldin (2001), p. 13.

14 It is worth noting that due to accounting issues, in particular concerning the operations of the National Investment Bank (NIB), the data on general government deficit are less reliable indicators of fiscal performance, compared to central government.

15 The NIB was established in 1980 to manage the surplus of the SIFs. Although it receives postal savings and issues its own investment certificates, the bulk of its financing comprises SIF investments.

16 The GASC is an agent of the government that imports basic commodities, such as wheat and sugar, and sells them to the public at subsidized prices.

17 The SIF was established in 1975, comprising two funds: (i) Government Sector Fund insuring 4 million government workers; and (ii) Public and Private Sector Fund insuring 6 million workers in public enterprises, private sector workers, self-employed, and workers abroad. The system provides coverage against old age, disability, and death.

18 Dresdner Bank (2003), p. 30.

19 Nashashibi (2002), p.3.

20 Expenditure on wages and salaries increased from 7.3 % of GDP in 2002 to 7.6 % in 2003.

21 People's Assembly Budget Committee Report (2003), p. 141, p. 147, and p. 151.

22 Gutner (2002), p. 13.

23 For details see Nasr (2000), p.9.

24 This deficit reduction was greatly assis-

ted by the forgiveness of external public debt in the early 1990s.

25 As indicated by Izquiedo and Panizza (2003), p. 1, fiscal sustainability can be achieved if policies adopted in the country lead to a situation in which it can satisfy its budget constraint.

26 Horne (1991), p. 23.

27 Izquiedo and Panizza (2003), pp. 36-37.

28 Alba et al (2003), pp 28-30.

29 Egypt employed a multiple exchange rate arrangement in 1969 to serve two purposes: (i) to cushion the adverse impact of maintaining an overvalued exchange rate on the country's competitiveness; and (ii) to provide an incentive for the increasing number of Egyptian workers abroad to transfer their remittances to the country. By the end of 1976, the foreign exchange market was segmented as there were three pools of foreign exchange transactions: the central bank pool, commercial banks pool, and the parallel market. Such arrangement led to a steady appreciation of the real exchange rate of the pound, as well as an increase in the spread between different pools. This encouraged the government in May 1987 to introduce a new arrangement, where the initial rate was set at close to the 'free' market rate and where a committee was to adjust it to reflect market forces. Under this arrangement, the market was able to attract most of the transactions and commercial banks pool ceased in March 1989.

30 Handy et al. (1998), p. 34.

31 Additional elements of the reform of the exchange regime included the abolition of exchange rate guarantees formerly provided by the CBE elimination of limits on exchange rate spreads for banks' customers and the authorization of non-bank foreign exchange dealers. Moreover, according to the Foreign Exchange Law of 1994 individuals and entities were allowed to retain and transfer foreign exchange. The new law stipulates that banks can engage in all foreign exchange transactions. Under this law, exporters and tourism companies are no longer obliged to repatriate their foreign exchange proceeds to Egypt [IMF (1998a), p. 60].

32 The central bank sells foreign exchange through its dealing room based on daily information received on the exchange rates posted by banks and foreign exchange dealers, foreign exchange position of banks, and banks' demand.

33 Intervention has averaged about US$ 400-500 million per month, and peaked in September 1999 at US$ 878 million.

34 The new regime was announced by the Prime Minister on January 28, 2003, and it was based on three main elements: first, that banks are free to determine the price of the pound vis-à-vis foreign currencies; second, foreign exchange dealers are to quote one of the operating banks; and third, no extra charges by the banks for foreign exchange transactions are permitted.

35 IMF (2003), p. 4.

36 Standard & Poors (2003), p. 1.

37 Khoury, (2003), p. 11.

38 This is known as the 'impossible trinity,' which implies that economic policy can not maintain a fixed exchange rate regime, an open capital market, and adopt an independent monetary policy designed to achieve domestic targets [Dornbusch (2001), p. 241].

39 These arrears were accumulated as a result of investment of large projects. The accurate figures of such arrears and the precise duration of their accumulation are not available. How-ever, it is reported that the government has made

payments to the private sector to settle these arrears in the fiscal years 2000 and 2001 amounting to 1.5 % and 2.3 % of GDP respectively.

40 Institute of International Finance (2003), p.8.

41 Bernanke et al., (1999) defines inflation targeting as "a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledg-ment that low, stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining those objectives." [Bernanke, Ben et al., (1999), p. 4].

42 In May 2003, the following announcement was on the official website of the CBE in Arabic and English: "Although the new framework for the Bank's monetary policy in which inflation targeting will be the final goal of the monetary policy was set for public discussions for the last 5 months, the actual application of the new framework will start after the enactment of the new Central Bank Law during the second half of 2003. As the CBE is applying now the monetary policy which is operative for the past 10 years, and with the developments in the foreign exchange policy to adopt a floating system, the existing monetary policy will not use the exchange rate as its nominal anchor. For the transitional period remaining until the application of the inflation targeting monetary policy, the CBE will continue to target M2 growth rate of 10 % by the end of June 2003 as was planned before."

43 The new law has been issued and published on June 15, 2003.

44 Blejer et al. (2003), p. 2.

45 Goldstein (2002), p. 64.

46 Schaechter, et al. (2000), p. 4.

47 The authors would like to thank David Lubin for this quote.

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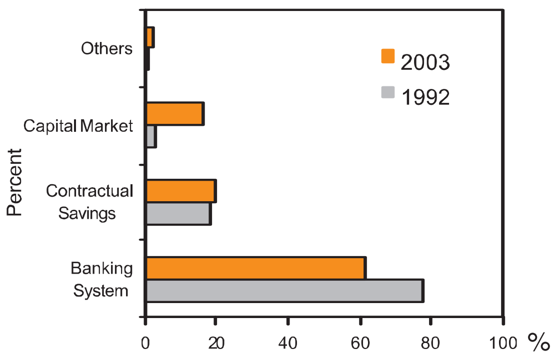
Chapter Two
Financial Policy Issues

1. Salient Features, Structure and Development of The Financial System

A well-developed, diversified, and sound financial system is essential for sustainable economic development. The Egyptian financial system is characterized by a large banking sector, accounting for more than 62% of aggregate financial assets as of June 2003; a contractual savings sector, including social insurance funds, commercial insurance, and pension schemes, accounting for around 20%; and a capital market, accounting for 16% (Figure 2.1). Ancillary financial firms such as leasing companies are present, but remain rather undeveloped, while venture capital firms[1] and factoring companies are almost nonexistent, however, their financial services are being provided by some of the operating banks. Despite the growth in the banking system, its share since 1993 has been declining by approximately 15 percentage points, as non-bank financial intermediaries have been growing faster.

Figure 2.1: The Structure of the Financial Market (1992, 2002)



Source: Central Bank of Egypt (CBE), Egyptian Insurance Supervisory Authority (EISA), and Capital Market Authority (CMA).

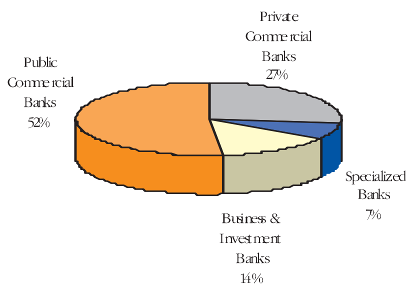
1.1 The Banking System

Total assets of the Egyptian banking system amount to LE 498 billion, roughly 120% of GDP as of 2003 while total domestic credit accounts to almost 54% of GDP. The main source of growth in the banks' assets over the past decade has been credit to the private sector; both business and household accounting for more than 53% of total credit advances (Annex B, Table B2.1), although a slight decline was witnessed in 2002 and 2003.

Until the issuance of the new banking law[2] in 2003, banks in Egypt were classified as commercial or business and investment banks, though the functional significance of this classification diminished as they became involved in a wide range of commercial banking activities. There are 55 banks operating in Egypt of which 24 are commercial banks, and 28 business and investment banks, in addition to three specialized banks. In terms of ownership structure, four of the commercial banks are publicly owned and 20 are private and joint venture, while the business and investment banks comprise 10 private and joint venture and 18 branches of foreign banks (Annex B, Table B2.2). The three specialized banks are publicly owned, and are assigned the task of providing mid- and long-term financing for agriculture, industry and real estate. Specialized banks' total assets accounted for about 5% of GDP. These banks mainly cater for the private sector and depend in their fund raising on the inter-bank market, as well as, borrowing from nonfinancial intermediaries.[3]

The banking system is dominated by public ownership. Public banks both commercial and specialized account for around 58.6% of the system's assets in 2003 (Figure 2.2 and Annex B, Table B2.3). Ownership of the banking system has not changed as rapidly as was foreseen some years ago. Despite the legal preparation in 1998 for privatizing public banks, it has not yet been accomplished while public sector shares in joint venture banks have not yet been completed.[4]

Figure 2.2: Market Structure of the Banking System by Assets as of June 2003



Source: CBE, Annual Report (2002/03)

1.2 The Capital Market

The economic reforms and the privatization program of the early 1990s have stimulated the stock market activity in Egypt, after remaining dormant for more than 30 years (1961-1992). During the period from 1992 to 1996, the Capital Market Authority (CMA) played an instrumental role in initiating and leading the effort for the revival of the Egyptian stock market. The Capital Market Law 95 of 1992 laid the regulatory framework within which financial intermediaries, such as brokers, venture-capital firms, underwriters, and fund managers can operate. The principal tool used to activate the stock market was through public offerings. This provided the impetus for the revival of the stock market activity. Later, private companies approached the stock market for raising capital.

The stock exchange is trading equities of over a thousand companies on one official[5] and two "unofficial" boards as of 2003.[6] The main instruments traded comprise common stocks, preferred stocks, government bonds, corporate bonds, and close-ended funds. Government, national investment bank (NIB), and some corporate bonds are also traded on the stock exchange market, though the market capitalization of these is much smaller. The government bonds, accounting for 17% of traded bonds, are mainly housing and treasury bonds,[7] with maturities ranging from 7 to 10 years to activate the fixed income market and establish the basis of the yield curve. The development bonds are mainly the NIB bonds, accounting for 66% of traded bonds while corporate bonds are for companies, bank, and other financial institutions, accounting for 17% as of 2002 (Annex B Table B2.5).

There are currently 31 portfolio managers and 26 local mutual funds investing in Egyptian securities, of which 22 are open-ended and four closed. The total size of the mutual funds amount to LE 3.9 billion as of 2003 and the total return ranges from a negative return to a positive return of 57%. Six of these funds focus mainly on fixed income and money market products while the rest focus on equities. The capital market is not well diversified and has provided a rather poor risk-return trade-off by comparison with other emerging markets. There is little risk reduction in the form of derivatives whether provided by banks or otherwise.

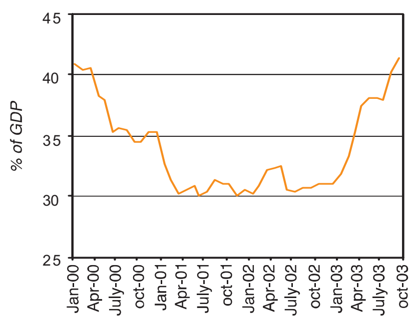
During the period from 1995 to 1997, the capital market has been boosted by the extensive program of privatization of public enterprises, a program that has resulted in the privatization of more than half of the public enterprises. Since the implementation of the capital market reforms of 1992, and the relatively limited barriers of entry, the number of brokers has significantly increased. However, since 1998, the stock exchange has been suffering from a low level of activity, due to local and global adverse macroeconomic factors. The slowdown in market activity has put pressure on the financial conditions of brokers, and many companies have decided to freeze their capital market activities. There has been an apparent decline in the value of securities traded in 2001 and 2002 as opposed to 2000 (Annex B, Table B2.6). The value of traded securities fell from LE 41 billion in 2000 to LE 25 billion in 2001, accounting for more than a 31% drop. The same level of activity had been maintained during 2002, recording total trading value of LE 26 billion. Bonds, mainly government bonds accounted for a large share of the trading activity (40% and 55% in 2001 and 2002 respectively).

Over the period from 1994 to 2003, public offerings via the stock market amounted to LE 8 billion. Over the same period, liquidity in the market was moderate, with annual turnover varying by 22% and 34% of market capitalization. By the end of 2002, the turnover ratio was 34.3% compared to 6% at the end of 1992. As of 2002, Egypt's price-to-earnings ratio (P/E) was 7.6 times, the fourth lowest P/E ratio recorded among 17 emerging markets. In addition, Egypt ranked only third among these 17 emerging markets in terms of the highest dividend yield, recording 5.3%. The top 100 listed companies accounted for 91% of the value traded and 81% of volume traded in 2002; foreign participation represented around 16.2% of the value traded.

After the announcement of the floatation of the Egyptian pound on January 28, 2003 and until February 29, 2004 all local indexes of the stock market witnessed spectacular increases: the Capital Market Authority Index (CMAI), the Egyptian Financial Group Index (EFGI), Prime Investment Index, Commercial International Bank Company Index (CIBC-100) and Cairo and Alexandria Stock Exchange index (CASE) witnessed increases of 28%, 101%, 89%, 22% and 25% respectively.

During the same period, market capitalization increased by 34% to reach LE 174.8 billion, representing 42.1% of GDP at the end of February 2004 compared with LE 130 billion at the end of January 2003 (Figure 2.3). These increases were partly due to the floatation of the Egyptian pound and to increases in foreign portfolio investments in the Egyptian stock market. The performance of the Egyptian stock market was also highly correlated to that of emerging markets in 2003.

Figure 2.3: Market Capitalization-to-GDP



Source: Ministry of Foreign Trade.

1.3 Contractual Savings

The contractual savings sector in Egypt has been growing. The sector's assets as a percentage of GDP have been increasing throughout the late 1990s, reaching about 45% in 2002 compared to 37% in 1997. The contractual savings sector is dominated by the social insurance funds, which are centrally and publicly managed, accounting for 91%

of the sector's assets, while pension funds account for around six percent of the sector's assets.[8] Contractual savings institutions invest most of their portfolios in long-term government securities. However, the bulk of these funds' investments in government securities are mostly mandatory.

1.3.1 Insurance sector

The structure of the insurance sector is not conducive to promoting the efficient development of the financial market. The industry's total annual premium as of June 2002 was less than one percent of GDP, compared to the regional average of 5%. Total investments of the insurance industry amount to only 3% of GDP. The insurance sector is free from systemic risk. The insurance industry, on aggregate, realizes net positive gains. The strong financial performance of the insurance companies could be partially due to their substantial holdings of real estate.[9] These holdings are carried at book value, or original cost, and it is likely that these properties may have greater market values. Rating agencies such as Standard & Poor's gave A and A+ to the public insurance companies for "claims-paying ability rating" in 2002.

However, the Egyptian insurance industry is still considered underdeveloped, with annual insurance premia representing only 1.1% of GDP, compared to 5% in other emerging economies. Per capita spending on insurance is also low in Egypt, estimated at US $9, compared to the emerging market average of around US $37. This low figure implies that individuals and corporations are exposed to higher risks, and that they are incurring a large opportunity cost by not channeling their funds into investment instruments with reasonable yields. Moreover, corporations are also under-insured even against basic risks like fire, theft, and property damage. The main reasons behind the underdevelopment of the insurance industry include a lack of insurance awareness, religious considerations, and limited product lines. Another impediment is the tax system, as reflected in the large tax levied on premia paid to insurance companies.[10]

The insurance sector in Egypt is dominated by public sector ownership. As of June 2003, there are sixteen insurance companies, of which three are publicly owned, accounting for about 90% of the industry in terms of policyholder claims in life or non-life insurance. Two of the joint venture insurance companies operate in free zones, though their activities are no longer limited to the free zone as they have been recently granted approval to operate in local non-life insurance activities.

The non-life insurance companies account for 68% of total direct premia, while life insurance accounts for 32% as of 2003 (Annex B, Table B2.7). However, these percentages would differ if measured in terms of premium income, as new entrants build market share, where public sector companies would account for only 72% of the market, and the remaining twelve private sector both foreign and local, accounting for the rest. In addition, there is one reinsurance company that is also publicly owned.

The market structure has witnessed minimal changes over the last decade. However, due to competition from new entrants, the public sector share is expected to decline. Despite the government's announcements regarding the privatization of the insurance sector, negligible progress has been made, as will be discussed below. It is believed that in order to privatize these companies, considerable re-structuring is required.

The regulations of the insurance sector allow insurance companies flexibility in making investment decisions of the reserves they hold in support of policyholder obligations.

This created demand for capital market products that was not met with sufficient supply. This in turn led insurance companies to continue investing most of their assets in government bonds or bank deposits. However, recently the insurance companies have been diversifying away from bank deposits into shares and other securities. In 2003, around 37% of investments of the insurance companies were in fixed-term bank deposits, 32% in shares and other securities, and 26% in government bonds (Annex B, Table B2.8). Moreover, the law does not encourage insurance companies to invest abroad, and they are not even permitted to purchase Euro Bonds.

Although 2001 and 2002 were difficult years for most insurance and reinsurance companies around the world, Egyptian insurance companies were performing well with the increase in aviation, accident, and marine business. The war in Iraq has also maintained marine transport insurance at prohibitively high rates, and the burden on reinsurance premia has also been increasing. Official figures for 2002 show that the insurance premium growth is 10% per annum, compared to an average global increase of about two percent.[11]

1.3.2 Pension schemes

The financial assets of the public pension system represent about 41% of GDP as of 2003, most of which is in deposits at the NIB.[12] The number of private pension funds has increased from 607 in 2002 to 618 in 2003, most of which operate in the life and retirement insurance sectors. The laws governing these funds are the same laws governing insurance companies. As of 2003, these funds invested more than 64% of their portfolio in government bonds, 29% in fixed-term bank deposits, and only 3.3% in shares and other securities. Recently, though, investments have shifted into equities in a substantial way, reaching close to the ceiling of 30% allowed by regulations.

The financial performance of public pension funds is moderate, and its market penetration has been low. There are concerns regarding the growing deficit in the medium-term, and the increasing reliance on fiscal support. Although mandatory contributions are relatively high, benefits are even higher, and include cost of living adjustments that are financed by annual transfers from the government budget to the social insurance system. From 8% of government current expenditure in 1995, the transfer reached 13% in 2003, and is now the second main source of revenue, representing half of the social security system's annual surplus. This increasing surplus is mainly invested in the NIB, which in turn lends it to the government.[13]

1.4 Leasing Services

The leasing industry was established in Egypt by Law 95 of 1995 with further amendments in late 2003 provided in Law 16 of 2001.[14] Leasing companies come under the Companies Authority which reports directly to the prime minister.[15] By registering companies and checking their registration requirements, the Companies Authority plays an administrative rather than a regulatory role.

The leasing industry is not well developed in Egypt, despite its potential for supporting the development of small and medium enterprises (SMEs), and other economic activities. The share of leasing industry in total gross fixed investments in Egypt is remarkably low compared to other developing countries, and the number of leasing companies remains limited: around 180 companies, of which only six are active. The annual volume of leases is quite small, and only around 4,000 leasing contracts have been made as of the year 2003. Previously, the leasing industry was stagnant during the last few years; however, it is expected to pick up, partially as a result of the overall low level of liquidity in banks, which could push customers to look for alternative means of financing.

The majority of leasing companies in Egypt are controlled by banks (50%) or bank-affiliates (17%). The remaining leasing companies (33%) are 'captive'[16] subsidiaries of non-financial firms and are not providing finance to third parties. Development of the leasing industry in Egypt has been hampered by an unsupportive institutional environment, mainly due to difficulties in the repossession of assets, related to inadequate enforcement of ownership rights, as well as, delays in the collection of overdue payments.[17] In addition, secondary markets for used equipment are still not fully developed. Together with poor market conditions in Egypt, the aforementioned factors have reduced the potential ability of leasing companies to reach out to its clients, especially the new ones just entering the market.

Another impediment for the leasing industry, and for the financial system at large, is the unavailability of credit information on potential clients, especially when dealing with client-based leasing. This problem is more serious for leasing companies that are not subsidiaries to banks and hence have no access to the public credit registry of the Central Bank.[18] This distorts the leasing industry and inhibits the growth of non-bank leasing companies. Some non-bank leasing companies often resort to bank references, indicating the creditworthiness of their clients, based on the request from the latter. However, banks are not always efficient and prompt in providing such references. Another constraint is the lack of long-term funding,[19] or its relatively high cost when available, which shortens the length of leasing contracts.

1.5 Mortgage Finance

Egypt has been making major strides in recent years toward the development and emergence of a new system of mortgage finance. The new system is expected to open new opportunities for both Egyptian households and market investors. The affordability of and access to better housing for Egyptian households, mostly through longer amortization terms, is the primary objective of this system. Gains from financial sector efficiency should also be achieved through the introduction of new financial securities to help unlock new sources of financing for the real estate sector. The development of a mortgage market should greatly improve the efficiency of the housing finance system.

In the past, housing finance in Egypt was typically financed through a deferred installment system. Under such arrange-ment, the ownership title is formally transferred only when the last installment is paid. If purchasers are willing to offer cash they can secure the property at a discount. This system is obviously not a good one for purchasers in that they are paying a significantly higher rate of interest than they would be able to obtain if they could have a loan secured by the property. It is also not good for developers because it ties up their funds, although they are well secured.

Real Estate Finance Law 148 of 2001 was passed in June 2001, setting out the foundations for a market-based system. This law introduced various mechanisms for long-term mortgage financing, which are expected to enhance the real estate market. Some progress has also been achieved in establishing a new government regulatory institution to oversee newly specialized mortgage lending companies, and to prepare the executive regulations for the law. In addition, the government has been taking action to streamline property registration processes and to put in place the judicial infrastructure that will underpin the mortgage market.

Substantial progress was made in strengthening the legal and institutional framework for the mortgage market in early 2004. In terms of enhancing the property registration process, the government has further reduced property registration fees from 4.5% to 3% in February 2004 through the issuance of Law 3 of 2004 amending Property Registration Law 70 of 1964. The Ministry of Justice has also undertaken various measures to streamline the process of property registration, which may have hindered the development of the mortgage market in the past.

In addition, amendments to the Capital Market Law 95 of 1992, Central Lodging and Listing Law 93 of 2000, and the Real Estate Finance Law 148 of 2001 to address the shortfalls in the laws and to incorporate measures to help strengthen the framework for securities and securitization were approved by the president of Egypt in March 2004. Such amendments are expected to be ratified by parliament during the current session. In that respect, a new committee has also been formed, led by the Chairman of CMA, to revisit the executive regulations of the mortgage market law and the Presidential decree establishing the mortgage guarantee fund.

Another important development is that the board of directors for the Guarantee and Subsidy Fund for Real Estate under the General Authority for Real Estate Finance (GARF) has been established to prepare the social safety net and social housing finance aspects of the mortgage law. The Ministry of Finance is currently considering the establishment of a secondary market liquidity facility by the National Investment Bank (NIB) to help jump-start the funding side of the market. In January 2004, the first private real estate finance company was established, in which IFC has 20% equity stake.

Nevertheless, much remains to be done to complete the foundations for a comprehensive, well-functioning mortgage market. The housing finance market in Egypt faces several challenges. One of the major constraints is the high tax and inefficient procedures for land registration. Lenders have not been able to take possession of properties when borrowers have defaulted; the new Real Estate Finance Law attempts to address this problem. There is no consistent approach to property valuation, making the valuation process of limited use. The Central Bank has imposed a 5% limit on credit extended to the real estate sector, and mortgage loans are not currently available. The purchase of new houses is generally financed by developers; deferred installment arrangements imply an effective interest rate of about 20%.

The responsibility of supervision of the mortgage market is split between two regulatory bodies: the CBE supervising banking loans, and GARF, under the auspices of the Ministry of Housing and New Communities. The CBE has imposed a 5% ceiling on mortgage loans, in addition to a 7% overall ceiling for all advances to the real estate and tourism sectors. Many banks are believed to be well above the limit.[20] The Real Estate Finance Law envisages another lending institution: real estate mortgage companies that will be raising their money on the wholesale markets and, if existing, will be supervised by GARF.

1.6 Payments System

Cash is the major payment instrument in Egypt, particularly between individuals, while checks, which are largely used for payments between corporations and for salary and pension payments, are the second. Debit cards have been introduced by banks but are not yet widely used.

Checks are supported by a relatively adequate and improving clearing and settlement system owned and operated by the Central Bank. The system is currently undergoing major technical updates. The Central Bank started to administer payments and clearing between banks, as well asissuing regulations regarding the execution of payments and account clearing between banks.

Under the new banking law, the CBE will be able to perform oversight on payment systems. In order to further improve the payments system in Egypt, the authorities established a legal basis for the Central Bank to operate and oversee payment systems; minimizing credit risks, which include online monitoring of the participants' balances and control of participants balances prior to debiting; general improvement of the security level, including establishment of second sites, access control; clarification of exemption criteria and observance of the responsibilities for central banks outlined in the Core Principles for Systemically Important Payment Systems (CPSIPS).

The CBE has initiated a modernized payment system plan that includes: (i) the establishment of the Automated Cairo Clearing House; (ii) the establishment of Payment System Department within the CBE; (iii) the approval of the electronic signature law that will facilitate e-commerce and e-banking services; and (iv) the initiation of a pilot project allowing five banks to monitor online reserve account balances held in the central bank.

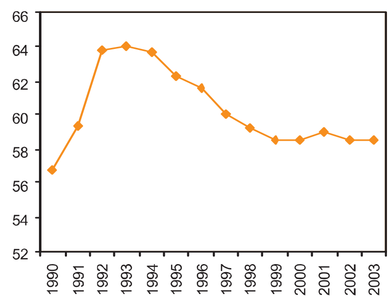
2. Quantitative Microprudential Indicators of the Banking Sector

The Egyptian banking sector is dominated by public banks in terms of amount of assets and number of branches. Despite their declining share (Figure 2.4), collectively, public banks still account for more than 58% of the sector's assets, as of 2003. They have a significant market share in retail and corporate banking services through their large branch networks and ties with public sector entities. They are also participants in the equity capital of most joint venture banks. On the other hand, private banks play a less dominant role in the market for loanable funds and focus more on trade-related financial services to the private sector. Although private and joint venture banks are growing rapidly, many remain relatively small, with modest branching. However, the dominance of public banks does not encourage sector reform, and leaves a market that is highly concentrated and lacking competition.

The implications of a sound banking system for economic growth and macroeconomic stability, as well as the recent surge in banking crises and their increasingly high costs,[21] renders a healthy banking system of special importance in Egypt. This thereby makes systemic stability of the Egyptian banking system a policy objective in its own right, creating a need to identify problem areas at an early stage. This will in turn require identifying main areas of vulnerabilities and 'early warning' indicators. Moreover, the on-going financial liberalization in Egypt accentuates the need for ensuring a stable and well-performing banking system, the dominant component of the financial system.

Assessing the performance and vulnerability of the Egyptian banking system entails some quantitative analysis. This involves financial analysis pertaining to bank-specific microprudential ratios, comprising a set of indicators, namely capital adequacy, asset quality, management soundness, earnings, liquidity, and sensitivity to market risk. These variables can be used as early warning signal that a banking system is likely to experience difficulties. A comparative analysis[22] is then undertaken between microprudential indicators of public sector banks and private banks.[23] Moreover, monitoring micro-prudential indicators for changes over time can also help in providing an indication of possible emergence of a banking system problem.[24]

Figure 2.4: Public Sector Banks' Assets-to-Total Assets



Source: CBE, Annual Report (various issues).

It is worth noting that there are a few limitations regarding the data used in terms of quality and aggregation.[25] Banks' data, in general, should be treated with caution, and in particular those of developing countries. There are several shortcomings that emanate from differences in capital structure, product mix, and accounting procedures among individual banks and over time.[26] However, these indicators can still give a rough indication of areas of vulnerabilities.

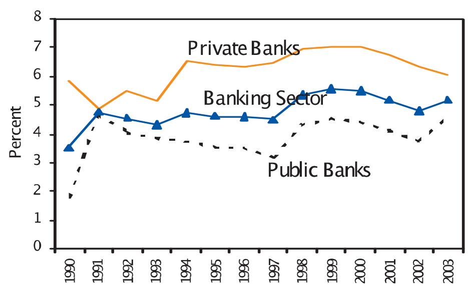
2.1 Capital Adequacy

Capital is crucial for banks since it acts as a cushion against shocks and allows banks to continue honoring claims. The Egyptian banking system was undercapitalized in 1990. The government injected around LE 1.3 billion in 1991 to enable banks to comply with the Basel capital adequacy ratio of 8%.[27] The capital adequacy ratio has on average shown an upward trend in the 1990s while a decline was witnessed in 2001 and 2002.

Although the banking system on aggregate is in compliance with the Basel minimum capital adequacy ratio of 8%, it is still considered low compared to other developing countries facing similar risks. In general, banks operating in developing countries, especially those with unsophisticated risk management systems should maintain much higher capitalization levels. Moreover, compliance of the banking system on aggregate does not necessarily mean compliance of individual banks. Equity-to-assets ratio-a proxy for capital adequacy-shows that public banks in 2003 averaged only about 4.6%, as opposed to 6.1% for private banks (Figure 2.5).

The equity-to-assets ratio of public banks increased sharply from 1.8% in 1990 to 4.7% in one year, showing clearly a capitalization recovery as a result of the capital injection (Annex B, Table B2.9). This was followed by a downward trend for public banks until 1998, reflecting a capital adequacy problem, after which the ratio started to recover to reach 4.5% in 1999. Since 2000, the equity-to-assets ratio showed a declining trend to reach 3.7% by 2002, but increased again by 2003.

Figure 2.5: Equity-to-Assets Ratios (non-risk weighted)



Source: CBE, Annual Report.

In contrast, the equity-to-assets ratio of private banks, after a slight drop in 1991,[28] followed an upward trend in the 1990s. Private banks were initially better capitalized at 5.8% in 1990, and the ratio followed an upward trend to reach 7% in 2000, indicating a higher quality portfolio. Private banks have relatively better credit selection mechanism, and have mainly been involved with viable public sector institutions and top private sector companies.

Consistently, capital risk, which indicates how far asset values may decline before the position of a bank's depositors and other creditors is put at risk, is higher for public sector banks compared to private banks, despite the capital injection to recapitalize public sector banks in the early 1990s. Similar to public banks, private banks' equity-to-assets ratio showed a declining trend since the year 2000 to reach 6.3% in 2002. However, an increase was witnessed in 2003 for public banks, reflecting the capital injection of around LE 4 billion in March 2003, which was done to support banks meeting their new minimum risk-weighted capitalization ratio of 10%. The new banking law has significantly raised the minimum capital requirements from the previous levels of LE 100 million for domestic banks and US$ 15 million for branches of foreign banks to LE 500 million, and US$ 50 million, respectively. According to the new law, banks should meet these requirements within one year that could be extended up to a maximum of three years at the CBE's discretion.

2.2 Asset Quality

Asset quality indicators include elements at both the lending, and borrowing institutions level. Proxies for assets quality for the banking system in Egypt, such as credit concentration, foreign currency-denominated lending, nonperforming loans, and corporate default risk, give mixed signals in terms of vulnerability.

2.2.1 Sectoral credit concentration

The breakdown of banks' credit by sector shows a clear transformation in the structure of public banks' loans in favor of the private sector. Credit extended to the private sector has been increasing from 47% in 1990 to more than 70% in 2003 (Annex B, Tables B2.10, B2.11, B2.12, and B2.13). This sizable shift toward private sector lending could be attributed to the privatization program and the 1991 regulations that required banks to diversify their portfolios and to tighten their credit policies, as well as the authorities' decision to eliminate the preferential treatment in the terms and conditions of loans granted to public enterprises, thus allowing for greater competition. This change has been consistent with the government's policy of stimulating private investments. On the other hand, public enterprises were allowed to deal with all banks without prior permission; however, although public enterprises received increased credit from private banks, their share of this credit did not rise.

The possiblilty that the decisions as to which private enterprises get credit is still informally influenced by the government cannot be excluded, however. Moreover, an increase in private sector credit has to be interpreted with caution for several reasons. First, some projects undertaken in part by the private sector are government-lead initiatives such as the mega projects. Second, there is an issue of rolling over of loans: not every increase in credit advances to the private sector can be considered a net credit or an indication of fresh funding to the private sector.[29]

However, private credit as a percentage of GDP fell from 62% in 2001-02 to 53% in 2002-03. This could be attributed to the financial difficulties facing banks that make them cautious in extending credit.

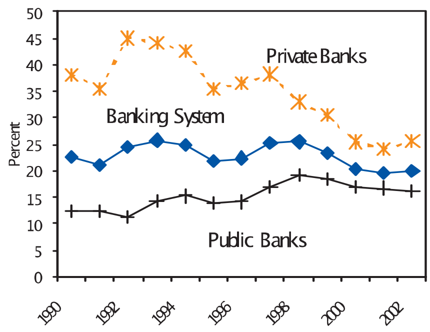
Although, sectoral credit concentration does not suggest serious problems, data on credit allocation are not totally reliable and prudently disaggregated. In some cases, loans could be provided for a particular pur-pose but effectively are used for another, especially if there is a restriction on limits, such as that on real estate. In addition, there is a loan classification problem at the banks level, as well as lack of adequate supervision by the CBE on the sectoral concentration of bank lending. This is crucial for ensuring a diversified portfolio risk, especially in case of potential problems, such as that associated with real estate.

2.2.2 Foreign currency-denominated lending

A rapid increase in foreign currency-denominated credit can signal vulnerability in the banking system. Although the foreign exchange risk is carried by the borrower, it often implies a higher credit risk to the lender. An unexpected devaluation could negatively affect the performance of banks through an increase in nonperforming loans. In terms of risk management, the CBE has established aggregate ceilings on long and short foreign currency positions that limit such exposures.[30]

The ratio of foreign currency-denominated lending has been generally higher for private banks compared to public banks (Figure 2.6). This is because the private sector-the largest demanders of foreign currency-is the private banks' main client. As the lending pattern of public banks shifted during the 1990s in favor of the private sector, the foreign currency-denominated lending witnessed an upward trend for public banks.

Figure 2.6: Foreign Currency-Denominated Lending-to-Total Lending



Source: CBE, Annual Report (various issues).

The share of foreign currency-denominated credit has been relatively stable during the last decade, ranging from 22% to 28%, with temporary upward shifts during periods of sustained capital inflows and confidence in the exchange regime. However, the shortage in foreign currency since 1998 following the series of external shocks that hit the economy resulted in the depreciation of the exchange rate. The resulting foreign currency exposure, and the increase in risk, as well as the new directives by the Central Bank on foreign currency lending led to the decline in foreign currency-denominated lending-to-total lending. There are still concerns about the risk of loan default in the case of further depreciation of the Egyptian pound, which would magnify the banking problem.

In an attempt to ease the situation of scarcity of foreign currency and reduce the foreign exchange risk, the government undertook several measures. To curb the surge in imports following the East Asian crisis of 1997, a decree was issued in 1998 through which rules of origin were used to hinder the entry of foreign products into the country especially through free zones. Furthermore, the Central Bank instructed banks to restrict lending in foreign currency only to those who have an adequate source of foreign exchange earnings. Banks had to restrict their credit facilities to traders for import finance, and traders had to self-finance the total value of their imports.[31]

An informal understanding was reached between the central bank and other banks in 1999, requiring 100% advance deposits in foreign currency for imports of certain commodities. This resulted in a decline in foreign currency-denominated lending especially in private and joint venture banks from 38% in 1997 to 24% in 2001 (Annex B, Table B2.14). The continuous depreciation of the Egyptian pound following the recent adoption of a more flexible exchange rate regime has adversely affected the quality of banks' assets increasing defaults on foreign currency loans.

2.2.3 Nonperforming loans and inadequate provisions

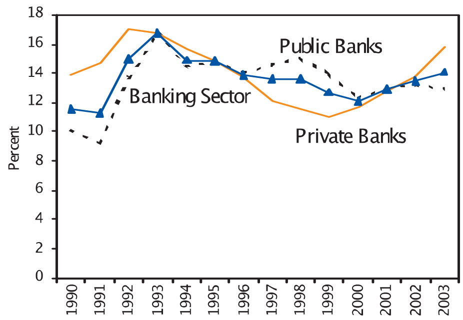
Banks' asset quality was also adversely affected by the substantial amount of nonperforming loans resulting from previous directed lending to loss-making public enterprises, which were not protected by adequate provisions. The implementation of the tighter asset classification and provisioning (AC&P) measures in 1991-recommended by the Basel Committee-made banks build substantial loan-loss provisions to compen-sate for previous understatements, as reflected by the significant increase in provision-to-loans ratio-a proxy for non-performing loans assuming adequate provisioning for bad and doubtful loans.

Public banks' adjustment to the new regulation has been facilitated by the privatization proceeds. More than one-third of the proceeds from the sale of public enterprises and public banks' shares in joint venture banks were used to settle arrears to public banks, which resulted in an improvement in their loans portfolio.[32] Private banks adjusted with reasonable speed to the tighter regulations, since most of them were already following prudent lending policies.

Nonperforming loans declined from 30% of total loans in 1992 to 13.4% in 1997 until they reached around 11.7% in 1999.[33] However, since 2000, an increase was witnessed, where the ratio of nonperforming loans to total loans reached 20% in 2003, as reflected in the provisions-to-total loans ratio-a proxy for nonperforming loans assuming adequate provisioning (Figure 2.7, and Annex B, Table B2.15). This rise could be attributed to the deteriorating macro-economic environment. Another explanation could be that the new management, especially of the four public banks, has been keen on estimating actual losses that have been incurred in the past, and making adequate provisions for them.

The actual level of nonperforming loans is expected to be higher if strict loan classification criteria were applied, and if rolling-over of loans is taken into account. A large portion of the loans is in the form of overdraft facilities that are not categorized as nonperforming, and hence this classification has not fully captured the accurate figure of nonperforming loans. Furthermore, a sizable part of nonperforming loans has been restructured, under very concessional terms. This may represent hidden weaknesses in the banks' portfolio.

Figure 2.7: Provisions-to-Loans Ratio



Source: CBE, Annual Report

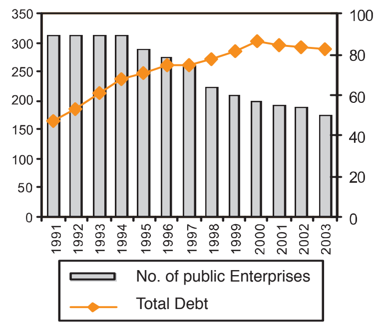
Moreover, banks are not required to classify or provision against loans to the government but they are required to classify and provision against loans to other public sector entities, except where a written guarantee is provided by the Ministry of Finance. As a result, their balance sheets do not reflect their actual status and profits might be exaggerated. There are also cases where bankers manipulate the classification of nonperforming loans by classifying bad loans as good, and so avoid making provisions.[34] Such incidents of "cosmetic mismanage-ment" have contributed to crises in several developing countries.

2.2.4 Loans outstanding to loss-making public sector entities

Increasing loans to loss-making public entities may signal significant credit risk. Public banks were more subject to government intervention and directed lending to public enterprises and priority projects. Most of these loans were government guaranteed to loss-making companies. The public sector was the public banks' main customer, accounting for 75% of total public banks' loans in 1991.

Most public enterprises in Egypt are highly leveraged and externally indebted. Their indebtedness increased from around LE 24.9 billion in 2001-02 to LE 29.5 billion in 2002-03 (Figure 2.8).[35] Despite the increase in accumulated losses of public enterprises, public banks continued to extend them loans (Annex B, Table B2.16). Consequently, non-performing loans and bad debt accumulated over the years in public banks, in spite of government's effort to settle public enterprises' debts and arrears.

Figure 2.8: Number of Public Sector Enterprises and Total Debt



Source: Ministry of Public Enterprise Office.

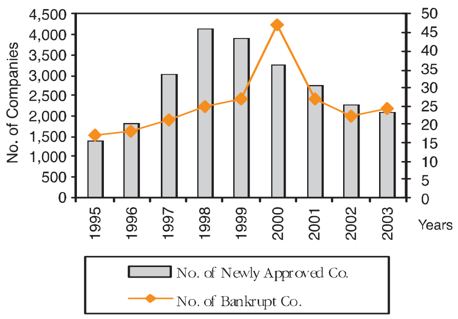
Loans extended to the public sector started to decline in 1993. Banks, mainly public banks, were expected to clean up their loan portfolios, and were no longer permitted to lend more than 30% of their capital to any single borrower. Moreover, the preferential treatment granted to the public sector in terms of having access to easy credit was removed. Government guarantees were not sufficient for extending loans, even to big public sector enterprises, unless approved by the Ministry of Finance. Despite the government's effort to settling public enterprises' debts and arrears, public banks are still burdened with nonperforming loans of the loss-making public enterprises accumulated over the years.

However, the government has recently announced its plans to divert the surplus of the profitable public enterprises from the budget to settle bank debts. The government's proposed debt restructuring is expected to help in eliminating the public enterprises debts, however, it will not prevent future losses from accumulating if loss-making companies are not privatized or liquidated.

2.2.5 Corporate default risk

The quality of the banking system's loan portfolio is directly dependent on the creditworthiness of its borrowers. Problems in corporations were brought to the surface with the deterioration in economic conditions. The economic conditions and the liquidity shortage in the late 1990s particularly stressed borrowers with internal inefficiency, or over-expanded activities.[36] The number of companies in Egypt that announced their bankruptcy was 47 in 2000 compared to 27 in 1999, more than 74% increase over a year's time (Figure 2.9). A number of well-known businessmen left the country, leaving behind bank debts reported at LE 1.5 billion.[37] The increase in the number of companies declaring bankruptcies, that were thus unable to service their debt, signaled distress in the banking system in the late 1990s. At the same time, the number of newly established companies declined from 4,156 in 1998 to 2,150 in 2003 (see Annex B, Table B2.19).

Figure 2.9: Number of Project Approvals and Cases of Bankruptcy



Source: General Authority for Investment (GAFI).

2.3 Management Indicators

Management indicators, although improving in the 1990s, still highlighted inefficient operations. Expense ratio and earnings per employee show that on aggregate the banking system is not operating efficiently, and that public banks in particular have higher operating costs and lower earning per employee ratio, indicating lower efficiency and over-staffing compared to private banks (Tables 2.1 and 2.2). Despite the authorities' efforts to change the management of public sector banks and bring in bankers with significant experience in international commercial banking, no signs of improvements have yet been reflected in the management indicators as of June 2003.

Table 2.1: Expense Ratio (in percent)*

	Public Banks	Private Banks
1998	75.99	67.41
1999	78.78	73.72
2000	82.99	81.78
2001	84.02	87.65
2002	86.23	92.13
2003	87.11	95.65

*Notes: * Calculated as the ratio of expenses-to-total revenue.*
Source: CBE.

Table 2.2: Earnings per Employee (LE million)

	Public Banks	Private Banks
1998	16.32	22.79
1999	18.35	25.21
2000	20.82	28.49
2001	20.45	28.98
2002	19.81	29.14
2003	18.98	29.87

Source: CBE.

The banking system in Egypt has a relatively low density and is characterized by geographic concentration, indicating that the market is suffering from a low level of competition, and is lacking incentives for improvements. The extensive branch network of public banks explains some of the higher cost structure. These branches are considered overstaffed

2.4 Earnings and Profitability Indicators

Profitability indicators put banks operating in Egypt at a modest level compared to other developing countries. In the 1990s, returns on assets and equity although increasing, were still relatively low (Table 2.3). However, earnings indicators deteriorated during the period from 2000 to 2003. There is great disparity between profitability of public and private banks, where the latter are performing much better.[38] To a large extent, this poor performance of public banks can be attributed to the sizable additions they had to make in recent years to loan-loss provisions.

Table 2.3: Profitability Indicators (in percent)

Year	Return on Assets* Public Banks	Return on Assets* Private Banks	Return on Equity** Public Banks	Return on Equity** Private Banks
1994	0.20	1.70	4.10	28.00
1995	0.20	1.72	5.10	21.49
1996	0.25	1.65	5.87	20.19
1997	0.37	1.96	7.83	20.12
1998	0.42	2.03	9.27	19.04
1999	0.43	1.50	10.37	20.35
2000	0.51	1.46	13.48	20.38
2001	0.42	1.40	12.65	18.42
2002	0.38	1.35	10.86	16.02
2003	0.36	1.33	10.85	16.01

*Notes: * Calculated as net profit after taxes divided by total assets.*
*** Calculated as net profit after tax divided by equity.*
Source: CBE.

Another principal indicator of profitability, interest rate spreads, narrowed initially in mid-1990s until it stabilized, in nominal terms, at a relatively high level in the late 1990s. However, since 2000, spreads have been narrowing, reflecting improvement in the intermediation process of the banking system, but lower profitability (Figure 2.10).

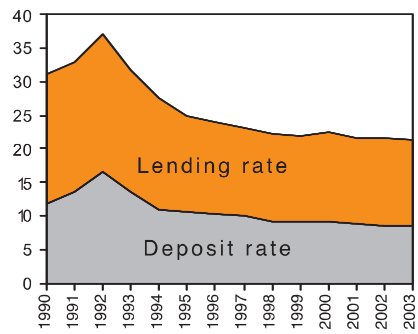


Figure 2.10: Interest Rate Spreads
Source: CBE, Annual Report (various issues).

This could be attributed to lack of competition, and to the oligopolistic structure of the market. Spreads varied widely among individual banks, but on aggregate, public banks registered lower interest rate spreads than private banks. The lower interest margin of public banks could be attributed to the interest rate concessions and repackaging of loans that have been recently restructured.

2.5 Liquidity Indicators

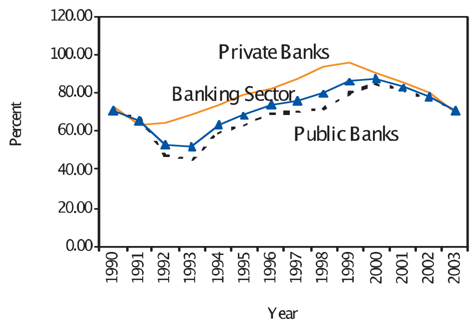
The banking system in Egypt has been characterized by high liquidity during the first half of the 1990s that declined slightly over the second half of the decade. Since the year 2000, the banking system experienced a high level of liquidity, as evident in the rising liquid assets-to-total assets ratios, fewer banks borrowing from the Central Bank, and decreasing inter-bank rates. In addition, the funding structure, which is a key aspect of liquidity, shows that the banking system in Egypt has a strong and stable deposit base with a favorable maturity structure. Empirical evidence reveals that public banks are less liquid compared to private banks.

2.5.1 Maturity structure of banks' assets

Indicators that reflect the maturity structure of the assets portfolio, such as the share of liquid assets-to-total assets, reveal high liquidity of the Egyptian banking system during the early 1990s (Annex B, Table B2.20), which is also reflected in the decline in the loans-to-deposits ratio (Figure 2.11 and (Annex B, Table B2.21). This could be attributed to a drop in the demand for loans due to the slowdown in public investments that is likely to have affected related private sector activity, and to the increase in real interest rates. However, it could also be attributed to the reluctance of banks to extend loans with the objective of preventing further increases in nonperforming loans in response to the financial difficulties confronting them, as well as the deterior-ating macroeconomic environment. This reflects banks' ability to deal with potential deposit runs, but on the other hand, excess liquidity reflects a high perceived risk on the bankers and investors' side, as well as inefficiency in the intermediation process. A high liquidity ratio indicates that banks are holding a high ratio of liquid to total assets.

In response to the decline in liquidity in the late 1990s, which was associated with the tight monetary conditions, some banks resorted to issuing bonds in order to lengthen the maturity of their funding, in addition to taking advantage of the fact that unlike deposits, banks do not have to maintain the 15% reserves ratio at the Central Bank for bonds. With the local funding sources drying up, several banks have resorted to syndicated borrowing from abroad to boost their funding bases.[39] Most banks in Egypt structure their assets and liabilities to match repricing maturities in addressing interest rate risk. However, the loans-to-deposits ratio started to decline after 2000, indicating a return to higher liquidity in the banking system.

Figure 2.11: Loans-to-Deposits Ratio

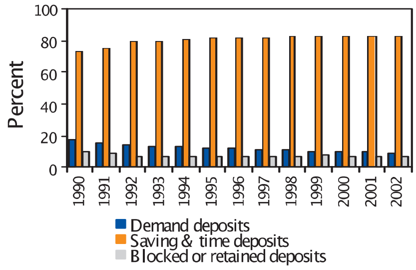


Source: CBE, Annual Report (various issues).

2.5.2 Maturity structure of banks' liabilities

A major shortening in the maturity structure of banks' liabilities may imply a higher liquidity risk. The funding structure, which is a key aspect of liquidity shows that the banking system in Egypt has a strong and stable deposit base. Deposits remain the major source of funds for Egyptian banks, accounting for more than two-thirds of the banking system's total liabilities in 2003. Bank deposits have been growing at an average of 11% over the past seven years. (Annex B, Table B2.22) As of June 2003, total deposits of the banking system (excluding CBE) reached some LE 403 billion, of which LE 324 billion were time and savings deposits.[40] The main source of deposits for the banking system is the household sector accounting for more than 66% of total deposits in 2000. It should be noted that under tax regulations, interest income is not explicitly taxable. In terms of maturity structure, savings and time deposits account for more than 89% of total deposits (Figure 2.12).

Figure 2.12: Sources of Banks Funds-Different Kind of Deposits as Percent of Total Deposits



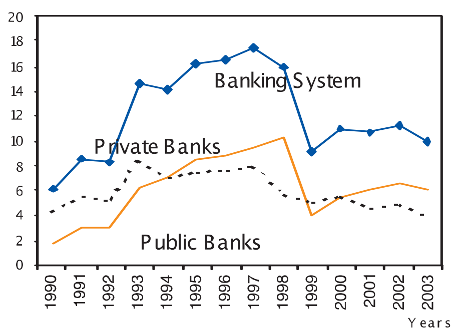
Source: CBE, Annual Report (various issues, and "Credit and Monetary Development Report" (various issues).

2.5.3 Central Bank credit to the banking system

Central Bank credit to the banking system in Egypt showed a remarkable increase in absolute terms in the late 1990s, reflecting a liquidity problem in the system. Borrowing of banks jumped from LE 4.6 billion in 1990 to more than LE 15 billion in 1997, as shown in Figure 2.13 and (Annex B, Table B2.23).[41]

However, in terms of total liabilities, banks' borrowing from the Central Bank increased only slightly from 5.3% in 1990 to 6.8% in 1995. The change has been more noticeable for public banks (from 2.6% in 1990 to 5.9% in 1995), while that for private banks have almost not changed during the same period. The ratio of Central Bank credit-to-bank liabilities, started to decline in 1996, however, a slight increase was witnessed starting in 2000, signaling a liquidity problem in the banking system.

Figure 2.13: Central Bank Credit to Banks

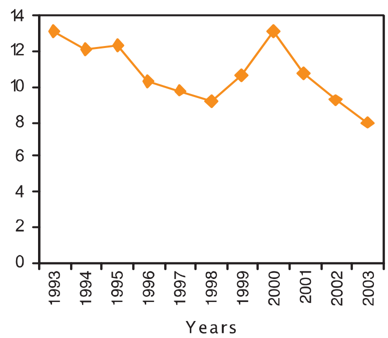


Source: CBE, Annual Report (various issues).

2.5.4 Segmentation of inter-bank rates

The inter-bank market in Egypt accounted for around 10% of the consolidated balance sheet of banks in the 1990s. It is the main means of filling the liquidity gap in the banking system. The interbank market is in the form of overnight to up to 3-month deposits; however, most interbank trans-actions were of one-week, one-month, and three-month maturities.[42] Commercial banks were the most active participants during the 1990s, mainly private banks that reached almost 90% of the market share in 1995 (Table 2.4). The volume of inter-bank transactions fluctuated only slightly during the early 1990s with the changing liquidity. During this period, inter-bank interest rates varied within a narrow range, and were less than interest rates on customers' loans, leaving a profit margin for the bank seeking liquidity.[43] However, interest rates on inter-bank transactions were relatively higher in 1993 because of the high interest rates on treasury bills, but then started to decline until 1998 (Figure 2.14). However, in the late 1990s, inter-bank rates increased sharply and became volatile, reflecting a liquidity problem and tight monetary conditions. The liquidity problem has pushed interest rates up, which in turn increased inter-bank rates to the extent that it sometimes exceeded the average interest rate on customers' loans.[44]

Figure 2.14: Overnight Interbank Rates



Source: CBE, Annual Report (various issues).

Table 2.4: Interbank Participation (in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Puiblic Banks	36.30	33.72	35.97	13.92	16.59	10.09	13.39	10.17	18.95	25.62	29.56	24.58	21.72	21.66
Prv. Banks	63.70	66.28	64.03	86.08	83.41	89.91	86.61	89.83	81.05	74.38	70.44	75.42	78.28	77.04

Source: CBE, Annual Reports (various issues).

The improving liquidity conditions in 2002 and 2003 resulted in a slight easing up of inter-bank rates. The inter-bank market is expected to be strengthened with the development of a reference rate known as the Cairo Inter-bank Offer Rate (CIBOR), first posted on July 2000, which is expected to improve transparency. However, CIBOR was not effectively in use by most operating banks.

2.6 Sensitivity to Financial Market Risks

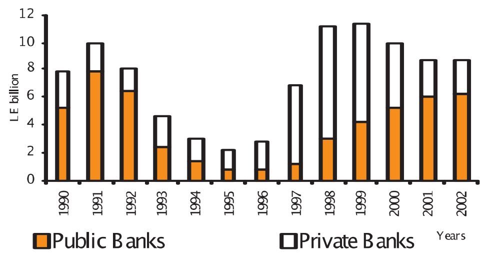
The banking system in Egypt, similar to other systems involved in diversified operations, is confronted with various financial market risks, including the exchange rate risk, the credit risk, and the equity risk. These risks are considered, on the whole, relatively low.

2.6.1 Foreign exchange risk

Increased reliance on foreign borrowing and large, open foreign exchange positions, as reflected in the ratio of banking system's liabilities to correspondents abroad to total liabilities, can signal a high vulnerability of the system to exchange rate swings. Egypt has regulations limiting banks' foreign currency positions.[45]

Liabilities of Egyptian banks to correspondents abroad have declined since 1992 through the mid-1990s as shown in Figure 2.15. This decline was a result of capital inflows after the liberalization of the exchange rate, and the rise in interest rates on the Egyptian pound relative to the U.S. dollar. Capital inflows and de-dollarization enabled banks to easily reduce their foreign liabilities. Consequently, banks were left in a comfortable foreign exchange position. In contrast, banks' liabilities to correspondents abroad to total liabilities increased from 3.6% in 1996 to 14.5 in 1998. This was especially evident in business and invest-ment banks where the ratio of liabilities to foreign correspondents-to-total liabilities reached 12.5% in the same year.

Figure 2.15: Liabilities of Banks to Correspondents Abroad



Source: CBE, Annual Report, and author's estimates.

Currency mismatches that occur when a bank borrows in foreign currency and lends in domestic currency can increase the bank's fragility by exposing it to an unpredictable exchange rate policy. Even if banks hedge their foreign currency position by lending in that currency, they can still be affected by devaluation if their borrowers are unhedged. In response to the depreciation of the Egyptian pound in 1999, banks reduced their foreign currency borrowing in order to minimize the downside risks associated with over-exposure to such borrowing. This is reflected in the decline in banks' liabilities to foreign correspon-dents to total liabilities ratio of 5.9% in 2002. It is worth noting that a foreign exchange exposure ratio is imposed by the Central Bank, and supervising banks' compliance to such limitations is achieved on daily basis.

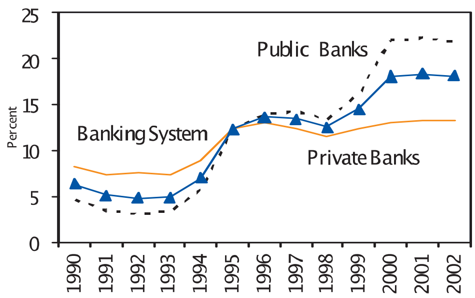
2.6.2 Credit risk

Credit risk was low in the early 1990s, as banks were inclined to limit their medium-quality loans. However, credit risk has increased for some banks as a result of the high credit expansion rates and liquidity shortage, which led to several firms showing signs of distress, if not bankruptcy.

Credit risk-measured as the ratio of medium- and long-term loans to total assets was on aggregate low in the early 1990s, as banks were inclined to limit their medium-quality loans. The banking system is dominated by short-term financial intermediation. The lack of long-term lending results in a maturity mismatch for those who borrow short-term to finance long-term projects, rolling them over year after year on the balance sheets. It should be noted that in the absence of long-term investments such pressures could be subsided.

In 1996, the ratio of medium- and long-term loans to total assets increased substantially-by almost 50%-in 1996 compared to 1990, as demonstrated in Figure 2.16. In 2000, the ratio for business and investment banks have remained in the range of 11 and 14%, while that for public banks have increased significantly to reach 22%. Low credit risk is usually reflected in a high return on equity.

Figure 2.16: Medium- and Long-Term Loans-to-Total Assets*



Source: CBE, Annual Report, and author's estimates.

Consistently, bank rating agencies believe that credit risk has increased for some banks as a result of deterioration in credit quality near the end of the decade.[46] Risks were particularly high, since banks went into the cycle of high credit expansion rates, while the economy was going through a liquidity shortage, and several private firms were showing signs of distress.

2.6.3 Equity price risk

Since banks in Egypt are allowed to engage in stock market trading, banks are also exposed to equity risk. Banks can hold up to 40% of capital in individual financial and nonfinancial enterprises with an aggregate limit of 100% of capital. These limits are considered high by international standards. Moreover, the CBE, aware of the fact that the volatility of the stock market can affect the soundness of the banking system, requires banks to apply 'suitable' margins on lending for purchases of equities or in lending against equities, and also watches closely the developments in such lending, which by the end of 1999 accounted for 2.4% of banks' total loans portfolio.[47]

Overall, the microprudential indicators used to assess the health of the Egyptian banking system show steady improvement since 1992; however, a deterioration has been witnessed since the year 2000, largely due to the deteriorating macroeconomic environment. Moreover, private banks better performance compared to public banks, since the latter have been subject to government-directed lending either to the public sector or to preferred private sector enterprises. This has distorted the incentive system and adherence to sound practices. The condition of the banking system has also been adversely affected by the deteriorating macroeconomic environment, the decline in economic growth, and the depreciating exchange rate. In sum, empirical evidence reveals the existence of certain vulnerabilities in the banking system in Egypt but this does not necessarily mean that a crisis is looming, they highlight areas of concern, and point to the need to accelerate the reforms required to prevent such occurrences.

3. Key Financial Sector Reform Issues

During the last decade, the Egyptian financial system was the focus of the reform efforts, which mainly took the form of financial liberalization, though from a narrow perspective. At the start of these reform efforts, it was realized that the financial system in Egypt was repressed in the sense that there were, inter alia, interest rate ceilings, high reserve requirements, and directed lending, in addition to dominant state-ownership of banks. The securities market was still underdeveloped due to lack of governing securities law, inadequate regulation, and supervision and weak accounting, auditing, and financial disclosure practices. The insurance sector also was underdeveloped and largely publicly owned. In addition, financial intermediaries such as mutual funds, finance companies, leasing companies, brokers, discount houses, money changers, and market makers were lacking. Nevertheless, one can distinguish between few specific financial reform measures, including the liberalization of financial variables, lifting restrictions on foreign ownership of financial institutions, and improving the legal and regulatory framework governing the financial sector.[48]

3.1 Financial Liberalization

An integral part of the reform and structural adjustment program of the early 1990s was the liberalization of the financial system. The financial sector reforms of the 1990s could be divided into two main phases.[49] The first phase focused on developing effective monetary and financial instruments, as well as strengthening the financial system through exchange rate, interest rate, and credit reforms. The main objective behind these reforms was to give a central role to market forces in the mobilization of savings and allocation of credit. The second phase focused on increasing competitiveness of the financial system through the enhancement of private sector participation in commercial banking, securities, and insurance compa-nies. These reforms, which were supported by changes in laws, aimed at expanding financial intermediation, and in particular, strengthening the performance of the banking system.

3.1.1 Banking sector

Measures taken in moving toward a more liberalized banking system included removing official limits on interest rates. In 1991 interest rates were liberalized in order to reduce demand for credit and encourage more savings. The increase in interest rates along with the fall in inflation generated significantly positive real rates of interest on domestic deposits. In the context of a stable exchange rate, it helped reduce dollarization, which in turn reduced concerns over the durability of the exchange rate peg.

At the same time, the government issued treasury bills with the objective of initiating a market mechanism to determine interest rates, introducing an instrument to regulate banks' reserves, and absorb excess liquidity, as well as dampen the impact of capital inflows. Proceeds were deposited at the CBE, which helped in the accumulation of foreign reserves in the early stage of the stabilization program.

Direct credit ceilings were cancelled and indirect schemes of monetary control were introduced. Direct ceilings on bank lending to the private and public sectors were eliminated in 1992 and 1993, respectively. The CBE limited credit expansion to the public and private sector using maximum loan-to-deposit ratios and bank specific ceilings for certain classes of credit. Banks had to diversify their portfolios and tighten their credit policies by limiting loans to rent-seeking activities and favored clients.

All preferential treatments granted to the public sector in the terms and conditions of bank loans were removed. The competitive advantages of public banks were reduced. Specifically, public enterprises were allowed to deal with all banks without prior permission from public banks. In order to meet these developments, the ratios of liquidity and reserve requirements were reduced. In addition, the Central Bank raised the discount rate to two percentage points above the treasury bills auction rate.

On aggregate, the outcome of the first phase of liberalization was positive. By June 1992, a positive real rate of return was attained through an increase in interest rates on domestic currency bank deposits, combined with lower rates of inflation, which in turn significantly reduced the dollarization ratio from 51% in 1991 to 29% in 1992, in addition to the unification and stabilization of the exchange rate.[50]

Once stabilization was achieved, the government launched the second phase of the reforms in 1996, designed with the intention to broaden and deepen the financial system, through privatization, and improving prudential regulation and supervision. The structure of the Egyptian banking system was affected by several mergers that took place in the early 1990s. Moreover, the government was committed to privatizing the public sector shares in the 24 joint venture banks[51] in order to improve banks' competitiveness, and privatizing one of the four public banks.

In order to facilitate the process of privatizing public shares in joint venture banks, several regulatory measures were undertaken. The four public banks were requested in 1994, to reduce their shares in joint venture banks to less than 51%. Furthermore in 1996 they were requested to reduce their shares to a maximum of 20%. In order to enhance competitiveness and efficiency, majority foreign ownership (more than 49%) was also permitted in the joint venture banks through Law 97 of 1996. This law also liberalized charges and fees for banking services.[52]

The privatization of the banking system has been lagging. None of the four public banks has been privatized, and the issue does not seem to be a government priority despite the regulatory preparation through the issuance of Law 25 of 1998.[53] Privatizing public banks in Egypt has been considered a politically sensitive issue, since this sector has been envisioned as "strategic" and too important to be left to the private sector. It is apparent that the authorities' have recently shifted their focus from privatization to improving management of these banks.

Moreover, the government's commitment to privatize the public sector shares in joint venture banks has not yet been accomplished. Although, public banks' shares in joint venture banks have been reduced, more than half are still majority-owned directly or indirectly by the public sector. Not all public sector banks have complied with the government's set target of reducing each public bank's share in joint venture banks to below 20%. Even for those that did, majority public ownership was still maintained through multiple public banks' ownership in a single joint venture bank. Moreover, divestiture of public sector banks' share in joint venture banks by itself will not achieve total privatization of joint venture banks because other non-bank public entities may still have shares in them.[54]

The institutional framework of the banking system in Egypt still suffers from several deficiencies despite some improvements associated with financial liberalization. This could be largely attributed to the dominance of public banks. There is still evidence of poor corporate governance, and weak incentive system. This is especially evident in public banks, which were subject to government interference; however this does not mean that private ownership guaranteed good governance. There were also cases of insider and connected lending, as well as, cases of mismanagement.

In December 2003, the governor of the CBE was removed before finishing his four-year term, and a new board of directors was appointed. The new management of the Central Bank is committed to a comprehensive banking sector reform program, comprising three main components: (i) banking sector restructuring; (ii) consolidation through mergers and acquisitions; and (iii) privatization. In that context, the government has announced its commitment to privatize the remaining public sector shares in the joint venture banks.

This program would be backed by a more efficient central bank regulatory and supervisory oversight, in addition to effective implementation of risk-based supervision that is founded on sound internal systems, ongoing reporting, and risk management capacity.

3.1.2 Insurance sector

Similar to the banking sector, the insurance sector in Egypt is still dominated by public ownership, despite the government's commitment to privatize it. The liberalization of the insurance sector is essential: first, to comply with international trade agreements;[55] and second, to expand the sector so that it can be an effective tool in generating domestic savings which can be used to finance growth. The government's approach was to start first with the privatization of the joint venture insurance companies, followed by the state insurance companies.[56]

The privatization of the insurance sector was initiated with the issuance of Law 91 of 1995, which required public insurance companies to sell their shares in joint venture insurance companies by April 1998. Later on, Law 156 of 1998 was issued, permitting the private sector to acquire up to 100% of the shares of the four public insurance companies, in addition to allowing foreign management. However, privatization of the insurance sector actually started in 1999 with the selling of public sector shares in joint venture companies. Moreover, the private sector, local and foreign, was encouraged to participate and enter the insurance sector in 1999. Consequently, two new specialized companies were established.

In addition to the removal of ownership and management restrictions, several measures were undertaken to ensure consumer protection and claims settlements. Compulsory rates in the fire and auto sub-sector were abolished and legal amendments were made to ensure that rates were market-driven. Another recent measure towards a more liberalized insurance sector was the Ministerial Decree, which gradually elimin-ates requiring insurance companies to reinsure 30% of non-life and 50% of life insurance with the Egyptian reinsurance company, by 2003.

Liberalization of the insurance sector has already resulted in the establishment of a number of new joint ventures involving major international insurers. However, there is still a need for the government to improve the insurance sector's supervisory and regulatory framework to match the challenges of foreign competition and new entry in the market by the private sector, in addition to the requirements of screening and monitoring the new products.

3.2 Recent Legal Reforms

On the legislative front, a range of reforms affecting the financial sector has been undertaken (Annex C). At the banking sector level, after public discussions for almost two years, the new banking law was passed in June 2003, and its executive regulations were issued on March 2004. This law addresses many of the deficiencies in previous laws governing the banking system (see Box 2.1).

One of the immediate implications of the law is the improvement of capitalization of operating banks. However, some of the banks will not be able to reach the minimum capital requirements within the specified period of three years. This may result in a wave of mergers and acquisitions, and reduction in the number of operating banks in an already 'over-banked' market.

The law will also indirectly result in enhancing competition in the banking sector through lowering and eliminating barriers, which limited operational flexibility, such as the distinction between specialized, business, and commercial banks; and the special treatment of public banks. Despite the attempt to establish a mechanism for dealing with defaulting clients, and to provide a framework for settling bad loans, there is still a need to introduce amendments in the commercial code to establish adequate exit rules and facilitate debt workouts.

The law regarding electronic signatures was approved by the Shura Council and is to be discussed by the People's Assembly. The law gives electronic signatures legal power, which will facilitate e-commerce and e-banking services. The banking system will also be benefiting from other legal developments such as the new corporate law and the accounting and auditing standards and rules.

Moreover, amendments to the Capital Market Law, the Central Lodging and Listing Law, and the Real Estate Finance Law are being considered. These amendments intend to address insider trading and provisions for investment banking; to facilitate and regulate securitization, aiming to activate the market for asset-backed securities; and to address the deficiencies in the Real Estate Finance Law, regarding mortgage backed securities.

Another recent legal reform was the passage of the anti-money laundering (AML) law. Even before the issuance of the law, banks were required to obtain sufficient information and documents to meet the 'know your customer' principle.[57] Similar regulations were later issued by the CMA and Egyptian Insurance Supervisory Authority (EISA). However, these regulations suffered from several deficiencies. They did not address combating the financing of terrorism (CTF) and were issued by the regulatory authorities, namely CBE, CMA, and EISA under their respective laws.[58]

Since mid-2001, Egypt was responsive to the international request for anti-money laundering measures and anti-financing of terrorism. Several efforts were undertaken by different financial regulatory bodies to address these deficiencies. In July 2001 the CBE amended the existing regulation for banks and added rules dealing with beneficial ownership, after which the CMA and EISA issued regulations on AML to their respective industries.

Box 2.1: Highlights of the Main Changes Associated with the New Banking Law 88 of 2003

- The separation between regulatory functions, management responsibilities and ownership rights.
- Enhancing the powers of the board of the CBE regarding design and enforcement of prudential regulation.
- Applying corporate governance rules on all banks including the public ones, with emphasis on internal audit and control.
- Abolishing the old 'artificial' distinction between commercial, business, and specialized banks.
- Increasing the minimum paid in capital to LE 500 million for domestic banks and US$ 50 million for branches of foreign banks.
- Establishing a fund, with identified resources, to provide adequate compensation for the management of public sector banks.
- Reconfirmation of the possibility of the private sector to own shares, without limits, in public banks.
- Introducing the concept of connected lending and regulating it.
- Improving bank ownership rules.
- Obliging banks to disclose information on regular basis.
- Protecting the confidentiality of bank accounts.
- Establishing the principles of loan settlements and workouts.
- Revising the penalties according to recent domestic developments and international norms.

In June 2001, Egypt was identified under the Financial Action Task Force (FATF) as non-cooperative in the fighting of money laundering because no effective law criminalizing money laundering or requiring non-bank institutions to identify their customers existed. Consequently, Law 80 of 2002 was issued to ensure that funding going through the banking system, whether deposits, transfers, or investment capital, would be scrutinized to ensure that they are not associated with criminal activity (see Box 2.2). The law stipulates the formation of a Board of Trustees of the Financial Intelligence Unit to supervise the implementation of the law. Egypt has been removed from the list of non-cooperating countries and territories blacklist on February 27, 2004. Egypt has fulfilled all of the legal and institutional requirements in accordance with the FATF recommendations and measures. However, Egypt will remain on the "watch list" for 12 months and FATF will continue to monitor closely the ongoing implementation of the anti-money laundering system in Egypt.

3.3 Financial Regulation and Quality of Supervision

The liberalization of the financial system required the strengthening of the Central Bank's regulatory authority. Several steps in terms of regulation and supervision were taken during the 1990s, with the objective of securing financial stability. In 1991, new prudential regulations were introduced for capital adequacy, foreign currency exposure, asset classification and provisioning, bank liquidity, and auditing (Annex D). Subsequently, in 1992, guidelines covering international and domestic investment concentration limits were introduced, and in 1993 credit concentration limits were imposed. By 1996, the regulatory framework was in compliance with international standards, but improvements were required in the quantity and quality of banks' data. Consequently, in 1997,[59] banks were required to produce financial reports based on international accounting standards (IAS).[60]

However, bank supervision in Egypt is hampered by several limitations: first, the CBE is by law "an autonomous legal entity, to have an independent budget, and to be exempted from administrative rules governing the public sector." The law is not a sufficient indicator of central bank's independence as it usually does not specify explicitly the relationship between the governor and the political authority; and even when the law is quite explicit, actual practices may deviate from it. In Egypt, the governor's personality and the nature of his relationship with the government is a critical element in determining the degree of independence.

Second, there is a lack of clarity in the role and responsibilities of the Central Bank's board members. Responsibilities are not clearly defined. There is a degree of overlap between the role of the chairman and the board, leading to uncertainty in final decision making.[61] Moreover, there is no standard set of rules that clarifies the role of the members of the board who are representing other institutions, and the extent to which their role should be confined to the representation of the institution.

Third, the significant increase in the number of banks and branches has not been met by an equivalent increase in the CBE's Control Department number of employees or resources.[62] Consequently, on-site monitoring was not undertaken in all banks. Moreover, the Central Bank's staff is not sufficiently trained in the use of the new computerized techniques used by operating banks, especially foreign ones. Only recently has regular training been provided and some progress made in automating reporting under offsite supervision.[63] Nevertheless, the Central Bank effectively did not carry out periodical inspections for all banks, and had to basically rely on periodical information submitted by banks without being able to verify their reliability.

Fourth, the inadequate legal and judicial system made banks reluctant to go for ban-

Box 2.2: Anti-Money Laundering Law 80 of 2002

The new AML law, which applies to all financial institutions, prohibits laundering money generated through crimes of terrorism, financing of such crimes, or their methods of implementation. It requires financial institutions to establish preventive measures and procedures against money laundering, as well as oblige them to hold books and records containing information on all local and international operations suspected to involve money laundering and to make such records available to the competent judicial authorities. A database will also be established in order to coordinate and share information with other regulatory authorities internally and abroad.

The law also imposes penalties, ranging from imprisonment for up to three to seven years and a penalty fees, in addition to confiscation of the relevant funds. Similar to most civil laws, the provisions on confiscation of crime proceeds or assets used to finance terrorism are governed by the Code for Criminal Procedures. International cooperation in AML and Combating the Financing of Terrorism (CFT) issues are governed by bilateral and multilateral treaties and practices.

The Ministry of Justice is responsible for the Penal Code and the Code of Criminal Procedure, including criminalization of AML and CFT, as well as international legal cooperation. The Financial Intelligence Unit (FIU) is housed in and funded by the CBE. It is responsible for ensuring compliance with the assessment principles. The unit will receive and analyze unusual transaction reports from the reporting entities designated in the AML Law.

kruptcy and foreclosing procedures on loan defaulters. The procedures are slow and cumbersome. Loan recovery procedures often drag on for several years. In many cases, banks would continue to extend credit to some privileged and connected parties despite their poor financial condition, weak feasibility of their projects, or insufficient collateral. A few of these defaulters even fled the country to avoid legal action or managed to delay legal action for a long period of time. In addition, the legal procedures for dealing with insolvent banks are not clear, and legal actions are not prompt.

Moreover, there were insolvent and inefficient banks left to operate, making it difficult to distinguish between sound and unsound banks. In some cases, such banks were recapitalized; an approach that might be right to avoid financial instability, but at an explicit fiscal cost that should not be ignored. However, the CBE has been strict in changing management and taking measures to ensure credit standards are not violated again. Significant measures have been taken to improve the regulatory and supervisory role of the Central Bank. The problem now is not the lack of authority on the side of the Central Bank to regulate and supervise the banking system; it is the extent to which this authority is practiced.

However, improving bank supervision should not be at the expense of banks' autonomy and decision making. Since mismanagement can endanger the banking system, the Central Bank was given the right to approve all boards of directors and managers, while banks have complied with the prudential regulations imposed by the Central Bank. Regulators were given explicit legal authority to close down or order mergers of banks that were not complying with various liquidity and capital ratios.

The new unified banking law, passed in 2003, tends to address many of the deficiencies in previous laws. Issues addressed include clearly defined responsibility of different stakeholders, namely managers, and board of directors and avoiding credit concentration and connected lending. Requirements concerning connected exposures have been tightened under the new law. More comprehensive definition was put for connected parties. A limit on connected exposures and a system to enable the Central Bank to monitor compliance with the limit were put in place.

The capital market is regulated by the CMA, which comes under the Ministry of Foreign Trade. The mandate of the CMA is to cover surveillance, market development, regulation and market information. The regulatory framework within which financial intermediaries such as brokers, fund management firms, venture-capital firms, and under-writings, can operate is clearly defined by the Capital Market Law 95 of 1992. Egypt has been included in the Morgan Stanley Capital International, Emerging Markets Free Index, and the All Country World Index as of the end of May 2001.

The regulatory framework has been refined and improved gradually to keep pace with the market's requirements as it has matured. The Capital Market Law has undergone vital amendments, with the adoption of new rules and regulations in order to ensure transparency, efficiency, and fair competition. The present regulatory framework of the securities market is in line with the International Organization of Securities Commission's Objectives and Principles of Securities Regulation. Since the adoption of the Capital Market Law of 1992, regulation of the capital market have been constantly improved. The issuance of the Central Depository Law of 2000 has enhanced market security since it involved the upgrading of the technical infrastructure in line with international standards. Transparency of the capital market is adequate.

Several dramatic innovations took place in infrastructure of the capital market, which are expected to enhance market efficiency. One of the most recent developments is the new automated trading system. An advanced surveillance system allows both on-line at Cairo and Alexandria Stock Exchange (CASE) and off-line surveillance at CMA. A settlement Guarantee Fund (SGF) has been established to ensure timely settlement of transactions.

The CMA, not only implemented rules of disclosure for the CASE listed companies, but the authority itself has taken steps to make its own procedures within the capital market more open and transparent. CASE is also pushing through approval of membership rules. These will create stronger financial institutions, providing the market with more customers and helping create liquidity. To reduce market distortions, the +/-5% change limit imposed on individual stocks during trading sessions was removed for more than 15 actively traded shares. A new trading mechanism was initiated in July 2002. This has helped to add liquidity to the stock exchange. The CASE also created 'over the counter' trading, aimed at assisting shareholders in de-listed companies, and is working with the New York Stock Exchange and other exchanges from around the world to formulate an efficient dispute resolution system.

The insurance sector in Egypt is supervised and regulated by the EISA that reports since the July 2004 cabinet reshuffle and restructuring to the newly established Ministry of Investment. It is governed by Law 10 of 1981, as amended by Law 91 of 1995, which continues to provide a reasonable framework for the insurance industry. The system of supervision implemented by EISA is adequate. Although legislation allows for the creation of a guarantee fund for the compensation of any policyholder who risks losing money as a result of the failure of an insurance company, the authorities never felt obliged to establish such a system since no insurance company has failed in Egypt. The insurance regulatory and supervisory system of the insurance sector in Egypt is observant of most of the core principles of the International Association of Insurance Supervisors (IAIS). Minimum capital levels are high, and the reserve requirements imposed by EISA are adequate. However, flexibility is required in adjusting the legal requirements to provide for the new environment, as new companies and new products enter the market.

3.4 Institutional Transformation and Corporate Governance

The structure and efficiency of a country's banking and financial system is often shaped by the nature of its institutional and regulatory framework. The base for corporate governance of the financial system in Egypt is a set of laws and regulations including the basic company, civil, and security laws, the regulations of the stock exchange, and the accounting standards. However, a well-enforced legal framework is a necessary but insufficient condition for sound corporate governance.[64] Pressure on the regulators stems less from the passing of regulations, than from their ability to enact those regulations. For example, equipping the banking sector with the incentives for proper governance is dependent upon the Central Bank's ability and willingness to enact the regulatory powers with which it has been armed since Law 163 of 1957. By this law, banks can have their registration cancelled and their license withdrawn if they break the law.

Despite improvements associated with the liberalization of the financial system in Egypt, internal governance still suffers from several deficiencies. Poor governance is mainly attributed to the public sector dominance in most financial sector activities. Both the banking and the insurance sectors that account for more than 80% of the system's assets as of 2002 are dominated of the public sector. They are characterized by weak internal governance, poor management, and a lack of performance incentives as reflected in the previously mentioned performance indicators.

The banking sector was not often run on a commercial basis and was subject to political direction in lending heavily to the public sector. Until the early 1990s, public banks were subject to directed lending. They were often ordered to give credit to public enterprises and priority projects. Most of these loans were government guaranteed to loss-making companies that the government would bail out at the end. There was no incentive for the management to minimize losses or maximize profits. Consequently, nonperforming loans and bad debt accumulated over the years, making it difficult to clean up the banks' balance sheets. This in turn discouraged the development of credit-evaluation skills, and led to the problem of adverse selection. Moreover, the banks' portfolios were not sufficiently diversified, and growth in risky assets (especially lending to real estate) was observed.

The incentive structure of public banks is different from that of private ones in that public banks have other operational objectives than profitability and soundness. There were conflicts of interest between owners and managers. Managers do not necessarily pursue the interest of the shareholders, especially minority shareholders. Treating managers of public banks as civil servants, with the job guarantee and lack of incentives, has reduced managers' performance.

However, starting in 1993, public banks were no longer permitted to lend more than 30% of their capital and reserves to any single client, even if it was a large public sector enterprise. Although this has led to a decline in the public sector's share of credit, banks continued to lend to public sector enterprises that were highly leveraged and externally indebted. Not only were public banks subject to poor corporate governance, private banks were also. In many cases, private ownership resulted in unsound practices. Private banks did not diversify risk and extended insider loans to owners and connected borrowers. 'Relationship banking' was especially common in private and joint venture banks. Bank managers often cooperated when the bank belonged to the same conglomerate as the borrower, and favored influential shareholders. Other bankers continued to lend to unprofitable firms, especially big firms, to prevent them from going bankrupt, thus exposing the bank to problems.

In terms of credit risk management in Egypt, limits were imposed in 1993 on credit facilities to an individual client not to exceed 30% of banks' capital.[65] In addition, regulations on connected lending were set, prohibiting banks from extending credit to members of its board of directors or external auditors. However, lending to shareholders, managers, and family members is permitted, after approval of the CBE. Although such practices are limited by law, data show a high degree of loan concentration to a limited category of private sector.[66] Poor lending policies often lead to excessive risk concentration, resulting from the high proportion of loans to a single borrower or a specific sector.

Another feature of weak corporate governance that is especially common in joint venture banks, is when bank shareholders exert pressure to obtain loans on preferential terms. There were several incidents where credit was mainly allocated to the privileged private sector-the shareholders' network of clients and friends. This took priority over assessing risks and balancing risk with returns on investment. The privileged private sector was sometimes allowed to borrow despite poor financial condition and insufficient collateral. Some of them defaulted, fled the country to avoid legal action, or managed to delay legal action for a long period of time.

Entrepreneurs were often eager to buy shares in banks to ensure access to easy credit. Owning shares in a bank would give the entrepreneur access to finance capital either in the form of overdrafts or renewable short-term loans. The situation was apparently safe, as long as the bank "cooperated" by rolling over the loans. As a result, several banks were overextended with poorly performing loan portfolio. However, the Central Bank has limited shareholder's access to credit since 1992, through careful monitoring and enforcement of regulations.

It is worth noting that the Central Bank has recently initiated a bank management and corporate governance plan. In terms of public banks, as previously mentioned, the government has changed the management and has brought in bankers with significant experience in international commercial banking. Nevertheless, the impacts of such an approach on the performance of these banks have not yet been evident. Similarly, steps have been taken toward exercising the right to protect the depositors' interests and introducing changes in the management of private and joint venture banks. Moreover, the CBE has issued guidelines for the compulsory formation of audit committees in all licensed banks. However, it is early to assess the impact of these reforms on the banking system governance.

The contractual savings sector is, similarly, dominated by public ownership. The social insurance funds that account for 91% of the sector's assets are centrally and publicly managed. Contractual savings institutions, as previously noted, invest most of their portfolios in long-term government securities. Moreover, the bulk of funds' investments in government securities is mostly mandatory. Such public dominance has hindered the development of the sector.

Good corporate governance should protect the interest of shareholders-public or private. By law all shareholders have equal rights, which is in compliance with the OECD standards of "one share-one vote." Shareholders who hold their shares with custodians, especially GDRs[Need to define this abbreviation - not used before.], are denied voting rights. GDR depositories are not allowed to vote separately, but rather they vote in ways desired by the management that appointed them. However, the CMA board has the power to enforce shareholders rights and to suspend resolutions of the General Assembly if they are to benefit a certain category of shareholders.

Only in the 1990s were public banks treated as profit-making institutions, rather than instruments of economic and social policy. Preferential lending to the public sector was eliminated, and since 1994, banks had to give similar treatment to both public and private sectors. Consequently, the 1990s witnessed a clear transformation in bank loan structure in favor of the private sector. Even though credit allocated to the private sector increased substantially while that for the public sector declined, the private and the public sectors are not distinct blocs of interest. In some cases, private investors implemented publicly endorsed projects. Hence, classifying banks by their capital ownership implies that such ownership determines the kind of management and policies implemented, although in fact, the actions of bank managers do not necessarily reflect the interest of shareholders.[67]

In terms of corporate governance in the stock exchange, a decree was issued to regulate primary dealer activities in government bonds in order to deepen the domestic debt market, and to create a yield curve for the term structure interest rates as a benchmark for private sector debt issuance. In addition, new listing and delisting rules were issued, enforcing more disclosure and transparency requirements in order to raise the quality of listed companies, foster transparency, and protect investors and minority shareholders. There have also been efforts in framing the securities market reforms within the corporate governance principles issued by OECD, in terms of developing corporate governance culture among listed companies in the stock exchange.

Regular corporate governance tools appear to function normally in Egypt: general meetings are held, board members are selected to represent shareholders' interest, and dividends are distributed. However, when comparing Egypt's corporate governance policy framework with emerging international standards and OECD principles, several areas of concern arise, including: protection of basic shareholder ownership rights, assignment of responsibilities, oversight of management, board independence, loyalty duties, voting, takeovers, and enforcement. Egypt's Company Law[68] - similar to the French one-is the "least shareholder-friendly of all legal systems.

3.5 Market Discipline

In recent years it has been increasingly recognized that effective banking supervision, although vital, is not sufficient to promote financial stability. The maintenance of a sound and efficient financial system also requires a strong degree of market discipline. This in turn, requires high quality public disclosure, strong corporate governance, ownership structures conducive to market discipline, contestable and competitive financial markets, and a competitive financial sector regulatory framework. In recent years, there has been growing concern about the need to increase the role of market discipline in the financial systems. Lack of market discipline is often associated with poor disclosure and transparency of bank operations, the existence of financial safety nets, strict entry procedures, and lack of provisions for an exit policy for troubled banks.

Efforts have been exerted during the last decade to bring corporate financial reporting requirements in line with International Accounting Standards (IAS). Consequently, some progress has been achieved in accounting and disclosure requirements for financial institutions, and development of Egyptian Accounting Standards benchmarked against IAS. However, there is lack of a legislative framework that includes an appropriate regulatory framework for the practicing auditors; weaknesses in the professional education and training arrangements; and an inadequate enforcement mechanism to ensure compliance with applicable accounting and auditing standards.

Although there are a number of positive features in the Egyptian financial system that help promoting market discipline, there are still areas of deficiencies. In terms of the banking system, the Central Bank has been enhancing the disclosure of information to the public requiring banks, since mid-1997, to prepare and publish financial reports on the basis of IAS. This was a major step in improving transparency and hence confidence in the financial sector. However, according to Moody's (2000), some banks' financial statements still fall short of full compliance, especially in the area of disclosure.[69] To further improve transparency, in April 1997 the CBE started publishing a monthly Bulletin, containing information on key economic and financial developments but on aggregate basis. In addition, the Central Bank is providing the on-site inspection manual to the banks in an effort to broaden their knowledge about banking supervision requirements.

The various sectors of the Egyptian financial system are in general in compliance with the core principles of good regulation. Yet Egyptian banks are usually reluctant to disclose more information than what is available in the published balance sheet. Moreover, the balance sheets of banks are not of consistent structure, which makes comparative analysis difficult.[70] Some banks publish balance sheets without income statements, making it difficult to assess their financial status and to ascertain whether they incur losses or achieve profits. Other banks delay publishing balance sheets or hide essential information to avoid possible deposit runs or declines in raising new funds following the release of unfavorable information.

The effectiveness of credit limits is also undermined by the lack of consolidated accounting standards. Despite the risk associated with credit concentration, the Central Bank supervisory body focuses mainly on ensuring that loans extended to an individual borrower by each bank separately is within the stipulated limits. Moreover, credit concentration risk is estimated on the basis of loans extended to a specific company, rather than an individual borrower. To be of significance, limits should apply to groups of related companies on a consolidated basis. This is particularly important when dealing with customers who have multi-economic activities. In response, in 1999 the CBE requested banks to provide periodical detailed information on debit positions of borrowers exceeding LE 100 million, in addition to maintaining a credit reporting system that provides information on borrowers' total credit exposure and payments records.

The banking system in Egypt had two main financial safety nets, the lender of last resort and an implicit deposit insurance scheme. Lender of last resort has been a feature of the Egyptian banking system since the issuance of Law 163 of 1957, which made the CBE responsible for providing troubled banks with emergency funds. Additional power was granted to the Central Bank when conducting rescue operations in 1992. However, such a safety net encourages banks to take excessive risk, confident that the government will bail them out when facing serious problems.

Despite the nonexistence of an explicit deposit insurance scheme in Egypt, it was still clear that the government would protect deposits of public banks and "large" private banks. Such implicit deposit insurance prevented bank runs but at the same time removed the discipline associated with that risk.[71] Depositors were not concerned about the riskiness of the banks' portfolio and bankers were encouraged to take bigger risks. Although a deposit insurance fund was introduced in 1992, it has not yet been implemented.

For a market to be competitive, there should not be any significant entry or exit barriers. The Egyptian banking system has suffered from the use of restrictive regulations such as licenses and permits, which prevented new entry and limited competition. In addition, regulatory barriers to entry include restrictions on the licensing of domestic banks and branching, as well as restrictions on foreign bank entry and on the types of activities that banks are allowed to undertake. The main concerns used to justify restrictive entry regulations include: 'cream skimming' by private and foreign banks; acquiring dominant positions in the domestic market; 'hit and run' activities due to lack of commitment; protecting the interests of existing banks, especially public banks; and allocating most of domestically mobilized funds abroad. However, these concerns should be carefully looked at.[72]

Maintaining an adequate exit mechanism is also crucial for achieving an efficient market. Banks in Egypt were not allowed to fail. This has come into effect not through prudential policies or measures that enhance efficiency of banks, but rather through the support of the Central Bank and the rest of the banking system to weak banks. Weak banks were left in operation while adequate measures such as restructuring, merging, or liquidation were not applied. To prevent financial instability, recapitalization is sometimes required, which entails a fiscal cost. As a result, inefficient banks were encouraged to indulge in high-risk activities, while sound banks were forced to subsidize them.

In terms of compliance with anti-money laundering, the new law is expected to address deficiencies in previous laws. However, regarding implementation, the CBE needs to develop its capacity to supervise banks in the area of detecting and preventing money laundering and other financial crimes as its current expertise and systems in this area are still underdeveloped.

3.6 Financial Innovation

The financial system in Egypt has undergone a series of technological advancements and most of its sectors started a modernization program in the 1990s.

3.6.1 The banking system

Banks have started to offer a range of services to accommodate customer's growing needs. With customers becoming more knowledgeable and demanding, technological advances are pressuring banks to change. Most banks are reacting with cost-control strategies, business re-engineering, diversification of marketing channels, and customer-focused banking services, along with upgraded technology. In addition to automated teller machines (ATMs), banks are adopting a variety of customer retaining management (CRM) systems, including call centers, interactive voice response (IVR), electronic banking, and mobile banking. For the economy as a whole, the shift to a cashless society would be accompanied by greater awareness of banking, increased deposits and lending, and improved liquidity.

3.6.2 The capital market

A modern and robust technology infrastructure has been implemented at the stock exchange. This includes the installation of telecommunications and networking infrastructure, linking all market entities to the stock exchange. This system allows for the expansion of the number of remote trading terminals, ensuring wide coverage and accessibility of the trading system for information broadcast, as well as for trading accessibility. This network represents the backbone for the spread of trading to other locations all over Egypt. The stock exchange has also started to implant institution-wide information systems, and to equip itself with intelligent decision support and strategic planning tools and information.

The trading system in the CASE witnessed a gradual evolution from an open cut-cry system prior to 1992 to an automated order-drive system. As a result of the growth in business, the stock exchange has procured the second phase of automation, a system conforming to international standards. In May 1998, the stock exchange was provided with a new trading, clearing, and settlement system in order to cope with the increasing trading volume.

The stock exchange has undertaken steps toward enhancing investors' protection in the market. The development of an advanced surveillance system has been completed, which will avail the exchange with real time on-line functionality equipped with a complete range of alerts and freezes on the order level, as well as information from the listed companies for off-line surveillance. Moreover, in August 1999, an information dissemination company was established to ensure that news on stock prices are reflected in a prompt and efficient manner.

3.6.3 The insurance sector

There has been very limited product innovation in the insurance industry. The conditionality of prior approval of EISA in terms of the forms and wording which companies propose to use in their policy contracts has hindered the introduction of new products and curbed innovation in the insurance industry. However, the recent entrance of new companies, especially the subsidiaries of international insurance groups, has brought in some changes.

New life insurance companies have introduced investment-linked products, as opposed to the common form of with-profits endowment assurance or group insurance contracts. An example is the establishment of a cooperative insurance company by the government with the objective of providing lenders with a credit guarantee as security for loans made to SMEs that meet certain qualifications. Several developments took place in the insurance industry in 2002, including changes in the auto insurance law and the social insurance legislation. In addition, a new health insurance law has been prepared by EISA, and is currently negotiated with the government.

4. Overall Assessment and Key Recommendations

While the reform of the financial sector focused on liberalization of particular financial variables, little attention was given to institutional reform at the micro level of financial intermediaries. There is a need for a financial policy to deal with the required reforms that should cover the institutions, instruments, market structure and conditions, as well as, the future of the financial sector at large, and its position in the region. There have been some discussions regarding the benefits and costs of unifying financial regulatory bodies under one umbrella, and creating an Egyptian Financial Services Authority. Such a 'super' regulator will solve problems related to lack of supervisory coordination in a market that grows with a reduction of the traditional barriers between different financial services providers.

The microprudential indicators gave mixed signals for the soundness of the banking system in Egypt, and revealed several areas of deficiencies, including: a relatively low capital adequacy ratio, poor quality of banks' assets, modest earnings and profitability, declining liquidity, and a fair level of exposure to several forms of financial markets risk. However, it was noted that banks are supported by a stable and strong deposit base. Indicators have revealed the better performance of private sector banks in comparison to public banks.

Although still retaining public confidence, the portfolio condition of the four public banks has been a source of concern for several years, in that they have been used to channel resources to public sector and preferred private sector users, some of whose creditworthiness has been in question. This in turn, has distorted the incentive system and adherence to sound practices. Public banks in Egypt tend to have a lower incentive to identify problem loans, to minimize costs, and to innovate. They are confronted with little competition, their losses are often covered by the government, and they are protected from closure. The sharp decline in economic growth and the decline in the exchange rate only add to these concerns. Moreover, the inefficient performance of public banks could distort the financial market, creating inefficiency in resource allocation in the long-term. In that respect, it is worth noting that privatization of public banks has not been one of the government's priorities. The focus is more on changing the management of these banks.

Promoting more effective market discipline in the financial system could be supported by privatizing the banking sector, promoting a more contestable banking system, and moving toward a more competitively neutral regulatory environment. Removing the links between the ownership of private banks on one hand, and public banks and the government on the other, would increase the competitiveness of the banking system and enhance potential of financial innovation. In that context it is crucial for the government to privatize public sector shares in joint venture banks.

Capital market funding and development of securitization is essential. The amendment to the capital market law has been drafted, offering a simple and adequate legal framework for securitization. This initiative should greatly facilitate the mortgage securitization process. The proposed law is generally well conceived and integrated within a flexible capital market law about bond markets.

The insurance sector is still dominated by three state-owned companies, despite their declining market share with competition from new entrants. Although the government has announced plans to privatize these insurance companies and has commissioned evaluations and due diligence by international investment banks and actuaries, privatization has not been achieved. The insurance sector is underdeveloped when compared with that of other countries in the region.

It is essential to proceed with the process of deregulation. Insurance companies need to operate independently without government interference. There is a need for an adequate regulatory system that ensures compliance with internationally accepted standards. In order to move ahead with the privatization of publicly owned insurance companies, major restructuring is necessary. It would be useful to separate problematic accounts and non-insurance related assets such as real estate portfolios. Moreover, the entry of foreign competitors in the market should be organized and gradually phased in. The participation of foreign companies would enhance competition in the market and encourage the introduction of new technology.

In order for mortgage financing to develop successfully, several issues need to be addressed. The responsibility for developing mortgage finance should be separated from responsibility for low-income housing. There should be arrangements to ensure an industry input into regulation and development of mortgage finance. Generally accepted procedures for lenders taking possession in the case of defaulting should be settled and implemented, and generally accepted principles for valuation must be introduced and valuers should be legally liable for their valuations. Obstacles to land registration must be removed. There should be no limit on the proportion of a bank's loan portfolio in the form of loans to individuals secured on residential property. There should be no attempt to impose social obligations on lenders or developers. Resources should not be devoted to seeking to develop securitization at this stage.

As far as the leasing industry is concerned, there is a need to protect creditors rights, give leasing firms better access to long-term funding sources, ensure the transparency and consistence of accounting rules, and improve the dissemination of information on the leasing industry. In addition, improvement in the repossession and enforcement climate would be most beneficial to the development of small scale leasing. In order to develop non-bank leasing companies there is a need to expand their access to the public registry or at least encourage banks to provide them with credit reference on request of their clients. Moreover, developing the bond market would offer improved access to long-term funds and extend the average maturity of the leasing contract.

Overall, the absence of a policy making body, after the abolishment of the Ministry of Economy in 2001, created a lacuna in the design and implementation of policies and measures addressing this sector at large. As far as policy and political responsibility are concerned, the banking sector remained under the mandate of the Prime Minister; insurance sector reported to the Minister of Planning; the Securities Market was affiliated to the Ministry of Foreign Trade; the mortgage finance was the responsibility of the Ministry of Housing, and the leasing companies were accommodated at the Investment Authority. The newly established Ministry of Investment is expected to fulfill the function of an efficient financial policy making body, that would effectively work as a coordinating agent between different financial sub-sectors with the exeption of the banking sector and the Central Bank.

Notes

1 As of June 2003, only 16 venture capital firms were registered in the capital market, and only one is currently operating. Moreover, these companies are licensed to do a wide range of activities, and the majority of their business is investment banking activities such as corporate restructuring and managing investment funds, rather than pure venture capital finance.

2 The Central Bank, Banking System, and Money Law 88 of 2003 includes 135 Articles.

3 The Principal Bank for Development and Agricultural Credit has an extensive branch network with over one thousand branches throughout the country, providing a range of financial services in rural areas, some of which are at subsidized rates. The other two specialized development banks are the Egyptian Industrial Development Bank and the Arab Egyptian Real Estate Bank.

4 This will be discussed in detail under the

section of liberalization of the financial system below.

5 For the company to be included in the official list, it must offer 30 % of its ownership to the public and must have 150 shareholders.

6 The official board has about 154 companies listed, while the first unofficial board has about 750.

7 Treasury bonds were issued in 1995 to restructure domestic public debt towards longer term maturities and stimulate the securities market, and to enable the CBE to manage liquidity through open market operations.

8 EISA (2003), Annual Report.

9 However, this could be disputed since the liquidity of these assets might be doubtful for several reasons, including lack of demand, ambiguous laws governing property title, and in some cases the protection of tenants by rent controls, thus the property does not generate considerable yields.

10 Taxes include a 21.6 % on the value of each property premium, 16.6 % for marine cargo, and 4 % on life insurance premia.

11 EISA (2003), Annual Report.

12 The NIB is a depository for the sizable reserves of the social security funds, in addition to the much smaller resources of the postal savings system. It also raises funds through the issuance of bonds in the market. More than half of its resources are invested in special government bonds. These bonds were paying in the past a much lower rate of remuneration than the market, however, since 1992, the interest rate has been set at a rate that is close to market.

13 Since 1998 the interest rate is fixed at 12 % per annum of 15 years maturity.

14 The amended law made two major developments: First, it allowed the leasing of cars; and second it imposed a minimum capital requirement for new entries in the industry when previously there was no limitation on the entrance of any company. However, these changes will only be effective with the issuance of the new executive regulations.

15 Previously the leasing industry came under the Ministry of Economy before it was abolished.

16 'Captive' leasing companies are those that are wholly-owned subsidiaries of a manufacturer established to support the sales of its parent's products and services, with over 50 % of its portfolio in the parent company's products.

17 Egyptian leasing companies instead resorted to negotiations with customers and rescheduled leases, when they believe this to be a viable solution. This approach is partly due to the above mentioned difficulties of repossession and the poorly developed secondary market.

18 Banks have helped their affiliate leasing companies to have access to credit information on potential customers either through their credit departments or through the Public Credit Registry at the Central Bank of Egypt, which currently is available only to banks.

19 The relatively limited development of capital markets and the current domestic economic situation do not support the issuance of bonds to provide for long-term funding and the small size of the leasing companies in Egypt may not allow them to access the primary bond market.

20 Nasr (2001), p13.

21 IMF reports that during the last two decades well over three-quarters of its member countries have undergone

significant banking difficulties. These crises have afflicted every region, and countries at every level of economic development. Beyond their sheer number, these events have been costly in terms of draining the countries' financial and institutional resources-resulting in losses, misallocation of resources, and slower growth. In some countries, the direct fiscal cost of resolving the banking crises through recapitaliztion of insolvent banks-often borne by the government in the form of public money-has exceeded ten % of GDP. Indirect costs could be much higher in terms of economic slowdown, falling trade and production, macroeconomic instability, and exchange rate crises.

22 Literature has often shown that looking at public banks that were subject to government intervention, and hence more liable to be vulnerable, would be useful for analyzing the performance of the banking system [IMF (2000a), p. 5].

23 Private banks would include joint venture and foreign branches.

24 It is worth noting that breaks in time series could occur if there are changes in the regulations and accounting norms.

25 It is recognized that data availability for some of the foregoing indicators will be of variable quality. Another drawback is that aggregation of bank data may be potentially misleading as it may conceal or misrepresent problems by offsetting positive and negative signals from different individual banks. For example, deterioration in individual banks may not be apparent in aggregate data.

26 In the case of Egypt, different banks used different accounting practices regarding valuation of the quality of assets and depreciation until the adoption of the Egyptian Accounting Standards in 1997, which are compatible with international norms. In addition, some banks indulged in practices that distorted the quality of information like window dressing, which may produce misleading indicators.

27 An exception was banks that were not adequately capitalized. For example, banks with capital adequacy ratio of 7-8 % in December 1990 were required to comply by December 1992, while those with a ratio of less than 7 % were allowed till December 1993.

28 Business and investment banks' capital fell from LE1.12 billion in 1990 to LE967 million in 1991.

29 It is very hard to find data that differentiate between fresh funding and rolling over of credit.

30 Ten % of capital for a single currency, 20 % of capital for the aggregate of all currencies, and 20 % for intraday positions, to which banks must comply on daily basis.

31 Such restrictions can result in a reduction in banks' commission and fee income generated from issuing letters of credit, in addition to reducing banks' interest income derived from lending.

32 For details see Nasr (2000), p. 34.

33 The General Department for the Compilation of the Banking Credit Risk.

34 Accounting practices in the past regarding provisioning were driven more by efforts to streamline reported earnings rather than presenting a fair picture of the true book value. However, as disclosure norms became more strict, and international practices are applied, provisioning is expected to improve.

35 For more details see IMF (1998), pp. 50-51, and Nasr (2000), pp. 9-10.

36 A stratified sample of 200 large manufacturing and construction firms reveals the poor performance and unfulfilled

expectations of Egyptian firms during the second half of the fiscal year 2000 [Egyptian Center for Economic Studies (ECES), "Business Barometer", July 2003, p. 2].

37 32 Moody's Banking System Outlook (2000), p. 4.

38 Returns on assets of the four public banks ranged between 0.2 % and 0.5 % during the period from 1995 to 2002, while that for private banks ranged between 1.5 % and 2.0 %. Similarly, private banks' returns on equity ranged between 19 % and 21.5 %, against 4.1 % and 15.2 % for public banks.

39 In the late 1990s a number of banks went to the international syndication market to supplement their funding needs. Individual borrowing ranged from US$100 million to US$250 million, totaling to US$1 billion for the banking system. This amount is manageable, but the potential risk undertaken should be assessed.

40 Deposits represent a larger share of public banks liabilities compared to private and joint venture banks (75 percent and 63 percent respectively as of 2000). The private and joint venture banks rely more on corporate and interbank funding. One of the main challenges they face is raising funds at low costs to finance their business. Many private and foreign banks have been borrowing from financial institutions abroad, and are resorting to local and international bond markets.

41 This increase can be partly due to the placement of foreign currency deposits by the central bank, and the soft loan to Banque Misr in support of its acquisition of Bank of Credit and Commerce International.

42 El-Refaie (1998), p. 40.

43 Interest rate on interbank transactions ranged between 11.5 percent and 14.3 percent, compared to 18.2 percent on bank loans to customers.

44 Overnight interbank interest rate increased from an average of 9.3 percent in 1998 to 11 percent in the first quarter of 1999. Average interest on interbank transactions in 1999 was around 13.9 percent against 12.8 percent interest rate on loans granted to customers [EFG-Hermes, (1999), p. 9].

45 All banks operating in Egypt were requested in March 1991, to maintain a ratio of foreign currency liabilities to foreign assets, and vice versa, of 105 percent, while the net foreign currency position was limited to 15 percent of each bank's capital [IMF (1998), p. 82].

46 See for example Moody's (2000), p.1.

47 IMF (2000b), p. 33.

48 It is worth noting that Egypt started to take concrete liberalization measures in terms of market access and foreign ownership rights well before the negotiations of the General Agreement of Trade in Services (GATS), and it was clear that Egypt's commitments under the GATS, regarding the liberalization of the financial system were limited compared to its 'commitments' under the Economic Reform and Structural Adjustment Program (ERSAP). [For more details see Mohieldin (1997), p. 10].

49 IMF (1998), p. 4.

50 For more details on exchange rate reforms in Egypt, see Chapter 1.

51 Public ownership in joint-venture banks includes public banks, insurance companies, NIB and other public entities.

52 IMF (1998), p. 58.

53 Before 1998, public banks were subject to the same law as all public companies, namely Law 97 of 1983, which did not allow the transfer of shares from public

companies, except to another. Even when Law 203 of 1991 was passed, allowing public companies to sell their shares, public banks were not covered by this law.

54 The prevailing reluctance among public entities for total privatization is partly because of the general perception that it is difficult to find alternative investments that yield equivalent profits at an equally low risk. Investing in joint venture banks is in many cases considered among one of the best earning assets in the public sector portfolio, especially in view of the downturn of the capital market. In fact, the public sector's share in small banks has been increased again in a few banks as a result of capital increases. Another impediment to the privatization program was the complexity of the evaluation procedures, especially in valuing assets and real estate.

55 Egypt is committed to comply with the GATS by 2005.

56 A valuation of the four publicly owned insurance companies was conducted by two international investment banks.

57 According to Memo No 809 of 2001, dated June 7, 2001 that was amended in July 5, 2001 by Memo No 913 of 2001, providing for rules on dealing with beneficial ownership.

58 Law 120 of 1975 for the banking system, Law 95 of 1992 for the capital market, and Law 10 of 1981 as amended by Law 91 for 1995 for insurance companies.

59 In 1991, the CBE introduced special audit for the four public banks.

60 See IMF (1998), p. 60, and Bahaa Eldin and Mohieldin (1998), p. 124.

61 Bahaa Eldin and Mohieldin (1998), p. 14.

62 The CBE employs 245 professional supervisory staff, an increase of some 10% in the last few years and further increases are expected.

63 IMF (2000b), p. 31.

64 For details see CARANA (2000), pp. 38-42.

65 The 30 % limit was imposed in 1993 on all claims on individual clients, including equities and not just credit facilities. Previously banks could have an equity investment in a company equal to 100 % of the bank's capital and credit exposure of 25 % of its capital, i.e. an exposure of 125 % of its capital in a single client [Bahaa Eldin and Mohieldin (1998), p. 13].

66 In June 2000, more than 40 percent of total loans (ranging from LE100 million to more than LE1 billion) were allocated to 0.25 percent of banks' clients under unconsolidated basis [CBE (2001), p. 13].

67 Henry (1996), p. 227.

68 Companies Law 159 of 1981 contains provisions on most Egyptian companies. It should be noted that a new draft Unified Companies Law exists but has not been passed yet.

69 Moody's (2000), p. 10.

70 For details see Bahaa Eldin and Mohieldin (1998), p. 127.

71 World Bank (1989), p. 76.

72 For example the political concern of foreign banks acquiring dominant positions in the domestic market should not be addressed by restricting entry but by applying antitrust measures. Although the withdrawal of international banks from the market may signal a problem in the domestic market, which may have a negative impact on the banking environment, in reality, withdrawal is often due to problems in the home rather than the host country. In terms, of protecting the interest of existing banks, improving their efficiency is a better

approach than protecting inefficient banks. Another reason used to justify restrictive entry regulations is concern that foreign banks would move domestically-mobilized funds abroad. However, public banks are not different from foreign banks in terms of geographic allocation of resources. Hence, it is not a problem of foreign banks only but that of the banking system as a whole. It is more an issue of improving the investment opportunities domestically and enhancing market stability.

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Chapter Three
Trade Issues

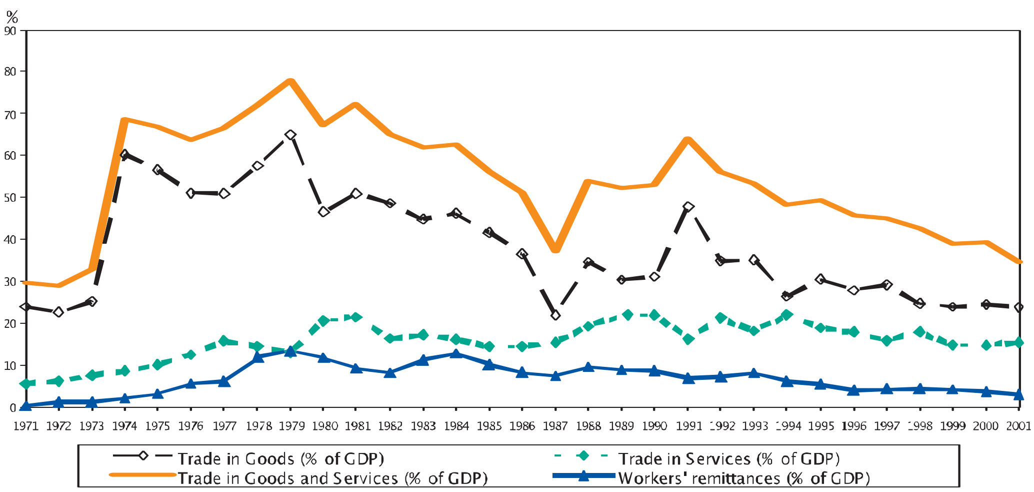
1. Egypt's Integration in the World Economy

Decades of protectionism, import substituting policies and statist interventions have taken their toll and inhibited the development of a free economy in Egypt. Although the country has adopted, since the mid-1970s, an "open-door" policy, its economic integration in the world and its role in external trade and investment have been on the decline.

Despite rapid expansion in world trade, Egypt's share in total world exports of goods and services has dropped from 0.15% in 1980 to 0.10% in 1990, and further to 0.07% in 2000 (WTO website, 2003). The traditional openness indicator (exports + imports of goods/GDP) indicates the relative disengagement of the Egyptian economy from the world economy where said indicator decreased from 46.6% in 1980 to 31.2% in 1990 and further to 24.6% in 2000. Figure 3.1 shows the development of the traditional openness indicator when combined with exports and imports of services and workers' remittances. The four indicators show the same trend, with an upsurge starting the mid-1970s reaching a peak in 1979, and since then following a downward trend till 2001.

Furthermore, Egypt's share of merchandise exports to GDP over the period 1985-2001 when compared with a sample of selected economies from various regions has remained meager, as reflected in Table 3.1. These shares are significantly higher in developing and in newly industrialized countries such as Indonesia, South Korea, Malaysia, Mexico, and the Philippines, which followed export-led growth policies or in more advanced economies of the Mediterr-anean region (Portugal and Spain).

Figure 3.1: Openness Indicators



Source: World Bank, World Development Indicators CDRom, 2003

Even MENA countries-Jordan, Morocco, Syria, Tunisia and Turkey-which had achieved low ratios of exports to GDP at the beginning of the period considered, or had continued to follow import substitution strategies till the end of the 1970s or 1980s, have succeeded, by the 1990s, to direct much higher shares of GDP to exports than Egypt. Egypt appeared to be the only country in the sample, which concluded in 2001, with a lower share of exports to GDP than in 1985.

Table 3.1: Share of Merchandise Exports in GDP(Percent)

Country	1985	1990	1995	2000	2001
Egypt	10.7	8.1	5.7	4.7	4.2
Indonesia	21.0	22.4	22.5	40.8	38.8
Jordan	15.4	26.5	26.0	22.4	26.0
Korea	32.4	25.7	25.6	37.3	35.6
Malaysia	48.6	66.9	83.2	109.0	99.9
Mexico	14.5	15.5	27.8	28.7	25.7
Morocco	16.8	16.5	20.9	22.3	20.8
Philippines	15.0	18.3	23.6	53.2	45.0
Portugal	23.1	23.0	21.2	23.0	21.8
Spain	14.1	10.9	16.7	20.5	18.9
Syria	10.0	34.2	31.3	25.9	23.0
Tunisia	20.7	28.7	30.4	30.1	33.0
Turkey	11.8	8.6	12.8	13.9	21.1

Source: World Bank, World Development Indicators, CDRom, 2003.

Moreover, despite tremendous growth in investment flows in the last quarter of the twentieth century, foreign direct investment to Egypt hovered around an average of US$ 1 billion, while net portfolio investment fluctuated sharply, but remained modest over the 1990s.

1.1 Relations with the WTO

Egypt, a contracting signatory of the GATT since 1970, has remained an active member where it has always led the developing countries, together with India and Brazil, in their demands. Egypt joined the World Trade Organization (WTO) in 1995 and has adhered to all its agreements, with the exception of one of the pluri-lateral agreements (government procurement). Its stand has not changed much where it has preferred gradual liberalization. However, the pace toward liberalization has recently accelerated as a result of Egypt's adoption of an explicit export oriented strategy, its adherence to numerous regional trade agreements, and its commitment to domestic reform liberalization initiatives, including privatization and deregulation.

Nevertheless, Egypt has stressed that it faces problems in implementing a number of the WTO agreements, particularly those concerning trade related intellectual property rights (TRIPS), technical barriers to trade (TBT), and sanitary and phytosanitary measures (SPS). The lack of human skills and technical capacity are the most binding constraints to effectively enforce such agreements. Moreover, the abolishment of the Agreement on Textiles and Clothing (ATC) is expected to put Egypt in a disadvantaged position vis-à-vis stronger competitors such as India, Pakistan, and China, as the existence of quotas has shielded Egypt from competition with such countries. Available data show that Egypt was not able to fulfill its quota of textiles and ready-made garments in the USA and the EU (Ministry of Foreign Trade 2003) (See Tables B3.1, Annex B).

The Government of Egypt's (GOE) stand regarding liberalization of the agricultural sector is inconsistent with Egypt's current position of net food importer, as full liberalization of trade in agriculture is expected to negatively impact net food importers due to expected increases in world prices of agricultural products when domestic and export supports are removed in developed countries. In addition, with successive devaluations of the Egyptian pound, it is likely that the import bill of basic food will increase. Nevertheless, the GOE led by the Ministry of Foreign Trade (newly established in 2001 after the abolition of the Ministry of Economy) has emphasized the need for liberalization of agricultural trade and better market access to be able to utilize Egypt's, as well as other developing countries, comparative advantage. Empirical studies (see Hoekman et. al 2002; Tokarick 2003) have shown that reduction of domestic support in developed countries is likely to have negative effects on Egypt. To be able to utilize the comparative advantage that Egypt enjoys in a number of agricultural products, given the natural supply constraints of water and arable land, a major shift in policies concerning this sector needs to be devised. New technology in irrigation methods restricting use of water should be applied, identifying brands that enjoy both a compar-ative advantage and low water utilization should be encouraged, and the GOE's public awareness programs directed to the farmers on the best practice adaptable technologies should be intensified. The supply side constraints should thus be better addressed before opening up this sector. Liberalization of agricultural trade is not favored by the EU (the largest trading partner for Egypt) and would have, when implemented, serious negative implications on Egypt's trade balan-ce at least in the short and medium terms.

1.2 Regional Integration

Egypt, starting in the mid-1990s, joined a large number of regional trade agreements (RTAs), and is still in the process of negotiating others (Table 3.2). Among the most important RTAs that Egypt has joined recently is the Association Agreement with the EU (signed in June, 2002 and ratified by the Egyptian Parliament in April 2003). The cornerstone of this Agreement is the establishment of a free trade area within a transitional period of 12 years, during which Egypt will have to gradually phase out all tariff and non-tariff barriers against manufactured imports from the EU. Automobiles, as an exception, will be liberalized within 16 years. Agriculture, agro-industrial products, and services are either dealt with under other limited liberalization modes or left out completely. Moreover, Egypt joined the Greater Arab Free Trade Area (GAFTA) with member countries of the Arab League in 1997. The GAFTA aims at full elimination of tariffs and non-tariff barriers within a 10 year transitional period with a 10% reduction each year starting in 1998. A decision has been recently taken to end the transitional period by 2005 instead of 2007. In addition to the GAFTA, Egypt is engaged in preferential bilateral trade agreements with a large number of Arab countries including Lebanon, Syria, Morocco, Tunisia, Libya, Jordan, and Iraq (Ministry of Foreign Trade 2003). Egypt has also joined the Common Market for East and South Africa (COMESA) since 2001. The COMESA is a free trade area among 22 African countries that aims at reaching deeper stages of regional integra-tion. Currently, Egypt is negotiating a free trade area with the European Free Trade Area (EFTA) countries, and with the Economic and Monetary Union of West Africa countries (EMUWA). It has lately established a free trade area with the triad (Jordan, Tunisia, and Morocco) under the Agadir Declaration. The main aim is to benefit from the accumulation of inputs allowed under the Pan European Rules of Origin in the EU's preferential trade agreements. According to this system, countries that have signed a free trade area with the EU and bilateral free trade among themselves and follow the same rules of origin are allowed to cumulate inputs (Ghoneim et al. 2003). Finally, Egypt has been trying for the past few years to negotiate a free trade area with the USA, which has started in 1999 by signing the Trade and Investment Framework Agreement (TIFA). However, this initiative hasn't been so far successful in materializing. A number of other bilateral free trade agreements are in the pipeline to be negotiated (with Turkey, South Africa, Nigeria, India, Sri Lanka, Australia, and Japan).

The strategy behind being engaged in such a large number of regional trade agreements is far from clear as the main hindrance to market access for Egyptian exports is supply constraints, including lack of incentives and right market signals, hence opening up to the outside world without prior solution to these bottlenecks is likely to increase the trade deficit in the short and medium terms without achieving tangible benefits. This has been the case with the COMESA where Egypt, since its adherence, has suffered from continued increases in trade deficit. In 1997, Egypt's trade deficit with the COMESA was $102 million, it increased to $155 million in 2000 (www.comesa.int). Moreover, the consistency among such different regional trade agreements requires in-depth analysis, especially when it comes to regulatory issues as rules of origin and regulatory harmonization. The reason is that if such agreements are not consistent, they may entail extra costs, which would prevent the exporters from benefiting from improved market access.

Egypt does not have its own non-preferential rules of origin scheme, instead it adopted a number of different schemes of preferential rules of origin in the free trade areas it has joined. With the EU it has adopted the Pan European Rules of Origin scheme, which is mainly based on a hybrid mixture of value added, product specific process and change in tariff heading criteria. With the exception of textiles, the Pan European rules of origin are not considered to be hindering access of Egyptian exports to the EU market (Ghoneim 2003). In the COMESA, a value added scheme of 35% is adopted. However Egypt succeeded in raising it to 45% for imports originating in other COMESA countries when entering Egypt. In the case of GAFTA, the situation is still stumbling among Arab countries to reach a detailed scheme of rules of origin, however the criterion adopted for general rules of origin is a value added scheme of 40%.

Table 3.2: Membership of Egypt in Regional Trade Agreements (RTAs)

Year	Name of Agreement
1998 (entry into force)	GAFTA (free trade area to be reached by 2007)
1998 (entry into force)	COMESA (free trade area already taking place, aim to reach a customs union by 2004)
2002 (signature and ratification)	EU-Med Partnership Agreement (free trade area to be reached after 12 years from entry into force of the agreement, with one exception)
2001 (initiated) 2004 (signature)	Aghadir Declaration (free trade area with similar rules of origin to be reached soon)
1999 (signing and entry into force)	TIFA (agreement to enhance trade and investment)
Potential under negotiations or discussion*	Free trade area with EFTA, Turkey, South Africa, Nigeria, Australia, India, Tanzania, Sri Lanka, and EMUWA, Japan
In the 1990s	A number of bilateral preferential trade agreements with Arab countries including Lebanon, Syria, Morocco, Tunisia, Libya, Jordan, and Iraq

Source: Ministry of Foreign Trade (2003), Aggregated Foreign Trade Report.
**This is based on what has been mentioned in the newspaper as stated by officials.*

2. Trends and Indicators of Trade Patterns

2.1 Trade and Services Balances

The deficit in trade balance has widened significantly over the last two decades. Egypt's trade balance has performed negatively compared to that of services where tourism receipts and Suez Canal revenues have compensated for the negative performance of merchandise exports. In addition, labor remittances also played a significant role in compensating the trade deficit. Figure 3.2 reveals that the surplus in services balance has partially offset the negative impact of the chronic and widening deficit in trade balance on the current account and on the overall balance of payments.

Since 2001, the government has undertaken a number of devaluations leading to a more than 40% decline of the Egyptian pound vis-à-vis the US dollar. Such devaluations have been complemented by a recent announcement of the flotation of the Egyptian pound (January 29, 2003). Whether the exchange rate decisions will have a positive impact on the trade balance is still not clear, as supply constraints that negatively affect Egyptian exports are numerous, and devaluation alone is not likely to enhance competitiveness.

2.2 Direction of Trade

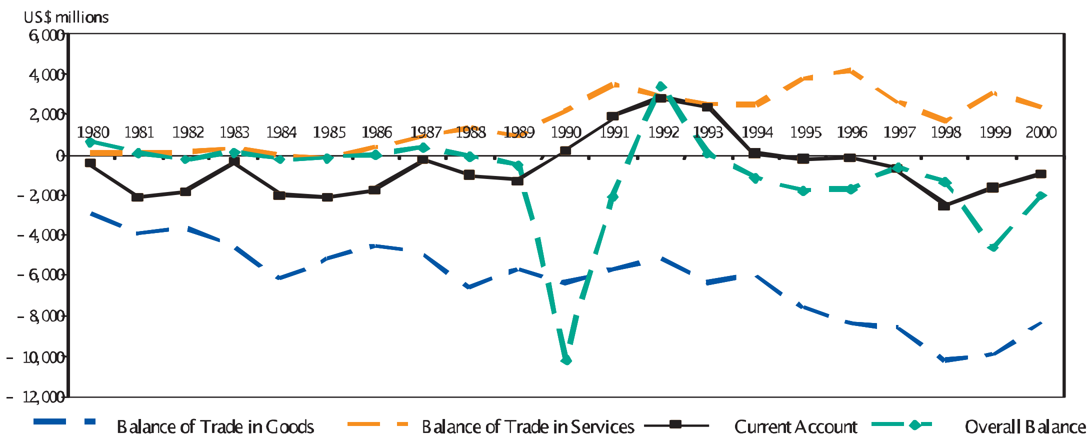
The European Union as a bloc remains Egypt's largest trading partner, currently accounting on average for 30-35% of Egypt's imports and exports. The USA comes next (and is Egypt's largest single trading partner country) (See Figures 3.3 and 3.4), accounting for around 15% of Egypt's merchandise imports and 10% of its exports. Arab countries absorb less than 9% of Egyptian exports and account for about 9% of imports, while the rest of the world accounts for around 50% of Egyptian exports and imports. The geographical distribution did not change much between 1980 and 2001, however, slight export and import geographical diversification can be observed, as the share of the rest of the world increased.

2.3 Composition of Trade

2.3.1 Merchandise exports

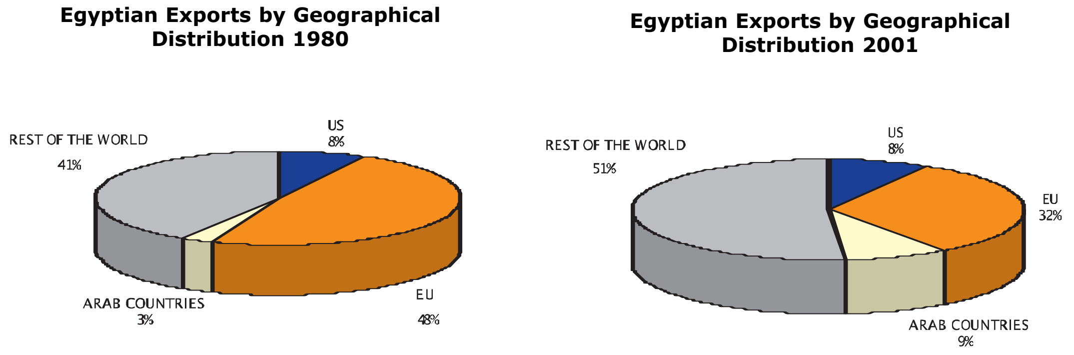
Egypt's leading merchandise exports are crude oil and petroleum products ($2.3 billion in 2001), followed by finished goods (chiefly textiles and apparel), and agricultural raw materials (cotton and other agricultural products).

Figure 3.2: Balance of Trade, Balance of Services, Current Account and Overall Balance



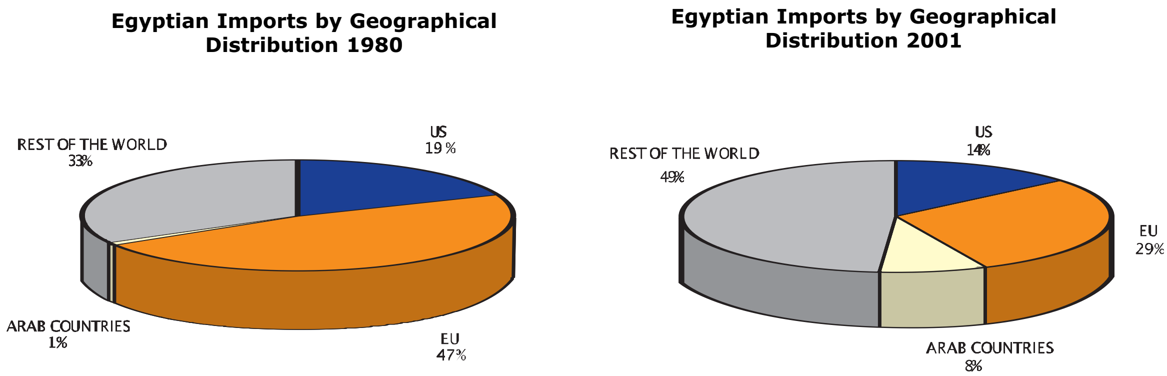
Source: IMF, International Financial Statistical Yearbook, 2002.

Figure 3.3: Egyptian Exports Geographical Distribution, 1980 and 2001



Source: Author's calculations based on International Monetary Fund, Trade Statistics Yearbook, 1987 and 2002.

Figure 3.4: Egyptian Imports Geographical Distribution, 1980, 2001



Source: Author's calculations based on International Monetary Fund, Trade Statistics Yearbook, 1987 and 2002.

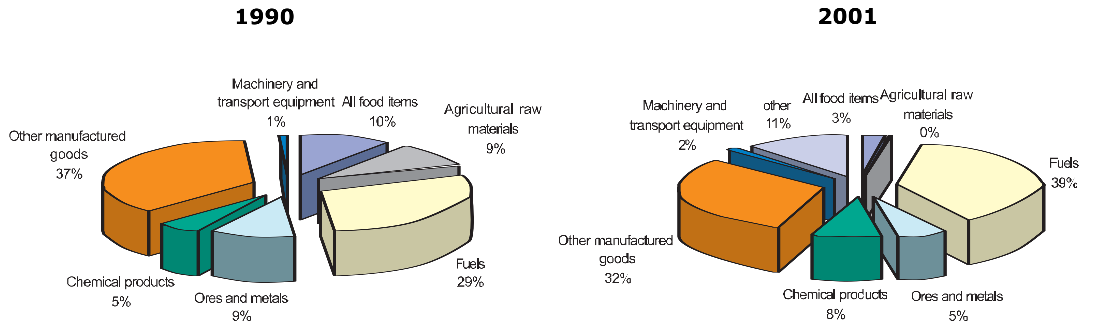
Figure 3.5 shows the product distribution of Egyptian exports. The volatility of international prices of fuels and other ores and metals causes large fluctuations in their shares and hence in the shares of other product groups in the commodity structure of exports. Exports of chemical products increased notably between 1990 and 2001, although the share of manufactured goods has tended to decline. Egyptian exports of high-tech products are negligible. They never reached 1% of Egyptian manufactured exports, as reflected in Table 3.3.

Table 3.3: High-Technology Exports as a Percentage of Manufactured Exports

Country Name	Average (1995-2001)
Philippines	62.4
Malaysia	51.8
Korea	28.0
Morocco	5.5
Turkey	2.6
Tunisia	2.3
Egypt	0.3

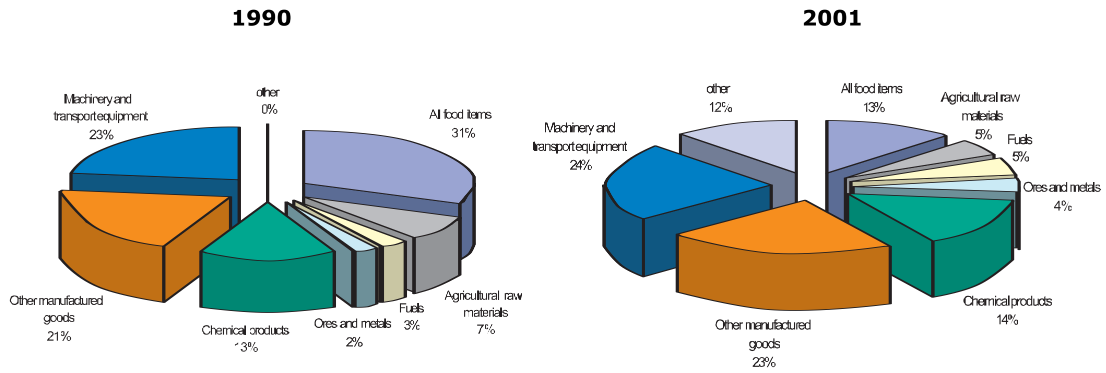
Notes: High-technology exports are products with high R&D intensity. They include high-technology products such as in aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery.
Source: World Bank, World Development Indicators, CDRom, 2003.

Figure 3.5: Export Structure by Main Categories



Source: UNCTAD, Handbook of Statistics, 2002.

Figure 3.6: Import Structure by Main Categories



Source: UNCTAD, Handbook of Statistics, 2002

2.3.2 Merchandise imports

Figure 3.6 depicts the structure of imports. Leading imports include machinery and transport equipment, and food items, which showed a declining, share from 31% in 1990 to 13% in 2001. The share of other (unallocated products) imports increased tremendously, from zero in 1990 to 12% in 2001.

2.3.3 Exports of services

There are two important service sectors which contribute positively to the Egyptian external balance, namely: tourism and transportation (mainly Suez Canal revenues). Tourism, according to official sources, contributes about 4.3% of GDP and over 20% of exports of goods and services. Some studies have shown that this figure is underestimated, as it does not account for indirect impact of tourism on the economy. When accounting for such indirect impact, the contribution of tourism to GDP could rise to 11% (Tohamy and Swinsco 2000). However, tourism is highly vulnerable to external shocks, as confirmed by the Luxor attack on tourists in November 1997 and the September 11, 2001 events when tourism revenues dropped by more than 30% (US Embassy 2002a).

Suez Canal revenues as a share of GDP remained stable for the past decade because of increased global reliance on other means of transportation (chiefly pipelines and air). They rank second in terms of exports proceeds, providing 12% of total Egyptian exports of goods and services and around 3% of GDP (see Table 3.4) in 2002-03.
A number of indicators have been calculated to assess the performance of Egyptian

exports in terms of structure of exports having revealed comparative advantage (RCA), sources of export growth, export diversification, prospects for intra-regional trade, and export similarity index.

2.4 Revealed Comparative Advantage (RCA)

2.4.1 Exports of goods

Exports enjoying RCA have remained stagnant since 1985. (Table B3.2 in Annex B) indicates that the composition and number of exports with RCA changed very little.

Egypt has a comparative advantage in refined fuels, cotton, agricultural raw materials, food products, ores and metals. Although Egypt's advantage in food products is being eroded, the ranking of RCA for manufactures by materials (SITC6) has been fluctuating, but Egypt kept an export potential in their production. They are composed of labor-intensive products employing materials like fibers, leather and wood as basic inputs.

2.4.2 Exports of services

The revealed comparative advantage for a number of services has been calculated as shown in Table 3.5. Egypt enjoys an RCA in a number of services sectors: transport (mainly due to Suez Canal), travel, and communications. It used to enjoy an RCA in the 'other business services' category (includes merchanting and other trade-related services; operational leasing services; and miscellaneous business, professional, and technical services), but lost it since 2000. On the other hand, the construction services seem to have gained potential and are expected to acquire an RCA soon.

2.5 Sources of Export Growth

Export growth is determined by factors related to both demand and supply. Following the methodology developed by UNCTAD, export growth may be attributed to three factors: changes in global demand, changes in competitive conditions within the country, and product diversification. The effect of changes in world demand on the country's exports is measured by the change in total value of world trade of these exports, assuming the country's share in global trade remains unchanged. Whereas the influence of change in competitiveness is reflected by the change in the country's share of trade, it is measu-

Table 3.4: Worker Remittances, Tourism, and Suez Canal Revenues as Percentages of GDP, and of Exports of Goods and Services (1997/98-2002/03)

	1998/99	1999/00	2000/01	2001/02	2002/03*
Worker remit./ GDP**	n.a***	n.a	3.1	3.4	3.7
Worker remit. / exports of goods and services	n.a	n.a	15.1	17.6	15.9
Tourism /GDP	3.6	4.5	4.6	3.9	4.8
Tourism /exports of goods and services	20.9	24.2	23.0	20.4	20.4
Suez Canal / GDP	2.0	1.9	2.0	2.1	2.8
Suez Canal / exports of goods and services	11.4	10.0	9.8	10.9	12.0

*: Preliminary, **: Current Market Price, ***: not available

Notes: Export of Goods and Services, Tourism and Suez Canal were transformed into Egyptian Pounds from US Dollars using the exchange rate published in Ministry of Foreign Trade (Feb., 2004) Monthly Economic Digest

Source: Calculated by the Authors based on data from Central Bank of Egypt (2003), Annual Time Series, on-line version and Ministry of Foreign Trade (Feb., 2004) Monthly Economic Digest.

red by the difference between exports that may have been realized in a given year, if the country's share of world exports had remained as in the initial period, and exports actually achieved in the given year. Any difference between actual changes in the country's exports and the sum of these demand and competitive factors is attributed to product diversification.

Table 3.6 shows the results of applying this methodology on Egypt's broad categories of exports: foods, agricultural raw materials, fuels, ores and metals, and manufactures in 1990, 1995, and 1999. External demand has only constrained Egypt's exports of fuels during the sub-period 1990-1995, while increase in world demand benefited all export categories. However, the loss of competitiveness in all export categories-except

Table 3.5: Revealed Comparative Advantage for Egyptian Exports of Services

	1995	1996	1997	1998	1999	2000	2001	2002
Transport	1.57	1.28	1.20	1.43	1.31	1.24	1.36	1.40
Travel	0.97	1.07	1.27	1.03	1.33	1.46	1.49	1.38
Communications	1.30	1.15	0.97	1.26	1.18	1.53	1.26	1.19
Construction	0.00	0.05	0.28	0.22	0.50	0.52	0.79	0.93
Computer & information services	0.01	0.01	0.04	0.06	0.04	0.11	0.10	0.10
Insurance	0.07	0.18	0.21	0.25	0.49	0.17	0.06	0.09
Financial services	0.22	0.16	0.10	0.15	0.17	0.09	0.14	0.19
Royalties & license fees	0.12	0.13	0.12	0.14	0.10	0.12	0.09	0.07
Other business services	1.01	1.27	1.06	1.27	1.01	0.97	0.87	0.82
Personal, cultural &, recreational services	0.03	0.09	0.12	0.12	0.16	0.11	0.15	0.41
Government services n.i.e.	0.98	0.56	0.88	1.13	0.76	0.43	0.96	0.72

Source: UNCTAD Handbook of Statistics, on-line, 2003, authors' calculations.

Table 3.6: The Impact of Demand and Competitiveness Factors On Egypt's Exports (1990-2000) ($ million)

	Value of Exports			Factors Underlying Export Change			
	1990	1995	1999	1990-1995		1995-2000*	
				Demand[1]	Compet.[2]	Demand[1]	Compet.[2]
All food items	250	338	312	96.5	-13.2	-20.3	-5.3
Agric. raw materials	245	210	277	56.3	-124.9	-55.1	101.4
Fuels	230	220	154	-56.6	555.0	503.5	-813.1
Ores & metals	762	1,285	1,292	60.9	-97.2	12.0	-85.0
Manufactured goods	1,095	1,388	1,299	491.6	-307.3	253.2	-425.1
Total	2,582	3,444	3,501	1,090.5	-334.3	652.2	-731.5

** Egypt's export structure is for 1999 while that of the world relates to year 2000.*
(1)Demand: The demand factor isolates the effects of changes in global demand and is measured by the change in exports that would have occurred had there been no change in Egypt's share in world exports.
(2)Competitiveness: The competitive factor shows the change in Egyptian exports due to changes in the country's export market share.
Source: Authors' calculations based on UNCTAD Handbook of Statistics, 2002.

for ores and metals-constrained export growth due to increased world demand. During the sub-period 1995-2000, demand conditions remained favorable except for foods and agricultural raw materials. Egypt also experienced, over the same sub-period, losses of competitiveness in all export categories except agricultural raw materials.

Egypt's export growth during the 1990s appears to have been mainly constrained by supply factors affecting its competitive position rather than by external demand conditions.

2.6 Diversification of Egypt's Exports

The product concentration index showed an increased diversification of Egypt's exports between 1980 and 1990, however it fluctuated afterwards around a relatively stagnant level, as indicated in Table 3.7. Compared to the majority of other comparator countries, Egypt lags behind.

The product diversification index of Egypt confirms what the concentration index reveals. It appears that in 1995 and in 2000, the structure of Egyptian exports, as well as that of Jordan, Morocco, and Tunisia was much less diversified than that of other comparator countries, as their respective diversification indices are higher (meaning less diversified products) than for the selected countries whether in the MENA region or outside. The relatively low diversity of Egypt's exports indicates modest prospects for increased intra-regional trade, as the supply capacity of Egypt for many key exports appears limited with respect to that of non-Arab comparator countries. The other Arab countries in the table appear to suffer from similar limitations.

The number of new exports introduced in the Egyptian exports structure increased when measured at a 4 SITC digit level. Table 3.8 shows that the newly introduced products in the Egyptian exports structure (excluding those which represent less than 2% of total Egyptian exports) have more than doubled, hence revealing a positive development.

Table 3.8: New Commodities at 4-digit SITC

	1990	**1995**	**2000**
No. of new commodities (base year 1985)*	15	29	39

Source: Authors' calculations based on World Bank and ECLAC, TradeCan Database, 2002.
**The number of products always refer to 1985 as the benchmark.*

Table 3.7: Export Diversification Indices for Egypt and other Selected Countries of the Region and the World (1980-2001)

	Concentration Index					**Diversification Index**				
Country	**1980**	**1990**	**1995**	**2000**	**2001**	**1980**	**1990**	**1995**	**2000**	**2001**
Egypt	0.58	0.24	0.24	0.45	0.29	n.a	0.70	0.74	0.82	0.68
Jordan	n.a	0.37	n.a	0.16	0.19	n.a	0.74	0.75	0.65	0.67
Korea	0.09	0.10	0.15	0.16	0.14	0.65	0.53	0.44	0.42	0.42
Morocco	0.31	0.16	0.17	0.17	0.17	0.80	0.76	0.77	0.74	0.75
Thailand	n.a	0.10	0.08	0.11	0.10	0.76	0.60	0.49	0.41	0.40
Tunisia	0.48	0.20	0.21	0.20	0.19	0.67	0.66	0.69	0.67	0.65
Turkey	0.23	0.12	0.11	0.09	0.09	n.a	0.664	0.64	0.58	0.55

Source: UNCTAD, Handbook of Statistics on-line, 2003.

The intra-industry trade (IIT) index (Table 3.9) reflects an increase in intra-industry trade for Egypt, although remaining modest, as the percentage of intra-industry trade hardly reaches 13% of total commodity trade.

Table 3.9: Intra-Industry Trade of Egypt (1981-2000) (Percent)

Year	IIT	Year	IIT
1981	2.9	1991	9.0
1982	2.5	1992	9.7
1983	5.3	1993	9.6
1984	3.8	1994	8.7
1985	3.3	1995	8.7
1986	3.5	1996	7.5
1987	3.3	1997	9.8
1988	4.7	1998	10.7
1989	6.3	1999	12.9
1990	7.1		

Calculated at 4-digit SITC
Source:, Authors' calculations based on UNCTAD, COM-Trade Database, 2002 .

2.7 Export Similarity

2.7.1 Similarity with Arab countries

Export similarity indices between Arab countries are generally higher than between individual Arab countries and other countries in the selected sample (see Table 3.10).

This reflects similar factor endowments in the Arab countries, particularly Jordan, Morocco and Tunisia, and further Syria and other MENA countries such as Turkey. The challenge is thus to develop "niche" products with differentiated characteristics which would find distinct channels in neighboring countries and to promote intra-industry trade, which has been shown to be still modest for Egypt.

Furthermore, the challenge for increased intra-regional trade is to expand the range of products that Egypt can competitively export. However, the relatively low diversity of Egypt's exports limits the prospects of enhanced intra-regional trade, and although there are indications of increased export diversity, there is still room for increased diversification.

2.7.2 Similarity with main trading partners

Despite positive qualitative developments in the structure of Egyptian exports, including more diversification and introduction of new products, Egypt is not following the changes of export structure of its two main trading partners (the EU and the USA).

The deviation of Egyptian exports structure from that of the two partners presented in Table 3.11 shows that over time exports have deviated away from the structure of exports of these trading partners. The rationale behind this indicator is to show the sophisti-

Table 3.10: Export Similarity Index Matrix, (average 1996-1999)

Country	Egypt	Algeria	Indonesia	Jordan	Malaysia	Morocco	Philippines	Singapore	Thailand	Tunisia
Egypt	100									
Algeria	22.9	100								
Indonesia	29.0	17.3	100							
Jordan	32.8	30.5	27.4	100						
Malaysia	16.4	14.5	43.3	22.2	100					
Morocco	35.4	32.4	34.3	36.3	17.7	100				
Philippines	20.6	15.1	36.7	18.3	74.1	28.7	100			
Singapore	15.5	17.4	30.5	16.5	73.6	16.3	65.2	100		
Thailand	29.7	18.9	50.6	23.1	60.8	34.9	59.5	57.3	100	
Tunisia	33.6	23.0	41.7	31.7	28.5	58.7	34.8	24.3	35.7	100

Calculated at 2-digit HS
Source: Authors' calculations based on International Trade Center, PC-TAS CD-ROM , 1996-2000.

cation of Egyptian exports. The more the exports structure is similar to that of the EU and the USA, the more likely Egyptian exports are to show higher degree of sophistication and diversification (for a similar indicator see Hoekman 1995).

Table 3.11: Percentage Deviation of the Structure of Egyptian Exports from the Structure of EU and USA Exports

	1990	1995	1999	2001
Deviation* (Percentage)	49.7	54.4	57.1	56.0

Source: Authors' Calculations based on UNCTAD, Handbook of Statistics, 2002

** Deviation formula:*

where i: $$\sqrt{\sum_i \left(X_{i,EGY} - X_{i,EU\&USA}\right)^2}$$

represents commodities and Xi: is the percentage share of exports of commodity i.

Realistically, little is to be expected in terms of improved market access to the EU for Egypt's manufactured exports as they already enjoy duty-free access under the 1977 European Cooperation Agreement. An important opportunity for exports-based on experience of countries in the region which implemented a partnership agreement with the EU-is the potential increase in outward processing and production sharing activities. Furthermore, European investors may increasingly engage in sub-contracting and production-sharing activities in the regional partner economies by creating new productive units and supplying the existing ones with inputs and know-how to produce high value added products for export to European markets. This, however, requires improving the domestic investment climate.

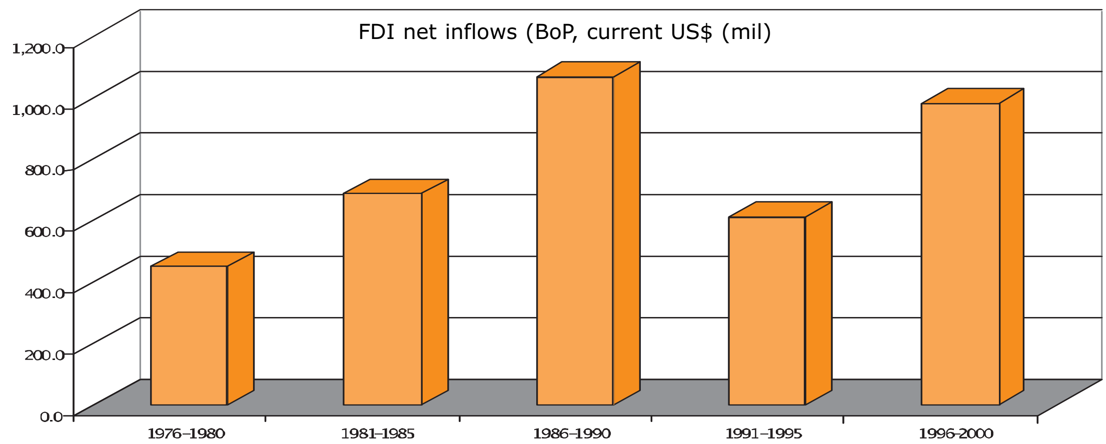
3. Investment Flows

3.1 Foreign Direct Investment (FDI)

FDI flowing to Egypt has experienced a cyclical pattern. Figure 3.7 shows five-year averages of FDI to smooth yearly variations. FDI inflows reached their peak in the period 1986-1990 and declined afterward. Annual FDI inflows averaged around $1 billion per year from mid-1990s through 2000. It reached a peak of $1.6 billion in fiscal year 1999-2000. However, it fell to only $509 million in 2000-01 and further to around $390 million through the first three quarters of 2001-02 because of slowdown of the Egyptian economy and investors' perception of lagging progress in economic reform (US Embassy 2002b).

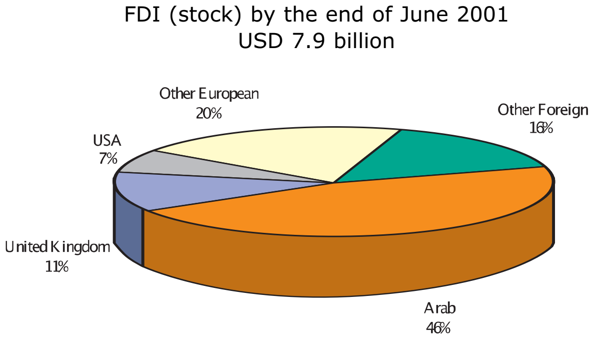
Most FDI is concentrated in petroleum and telecommunication sectors. Data on FDI in Egypt are limited and only reflect the sectoral distribution of foreign participation by

Figure 3.7: Foreign Direct Investment in Egypt (1976-2000), five- year averages



Source: World Bank, World Development Indicators, CDRom, 2002 activity after excluding petroleum and telecommunications. Table 3.12 and Figure 3.8 relate to firms registered under Law 8/1997. Arab investments represent 46% of the stock of FDI, while European and USA investments make up respectively 31% and 7% of the stock of FDI.

Figure 3.8: Foreign Direct Investments (stock) by the end of June 2001



Source: The Egyptian-British Chamber of Commerce (website: www.theebcc.com)

3.2 Portfolio Investment

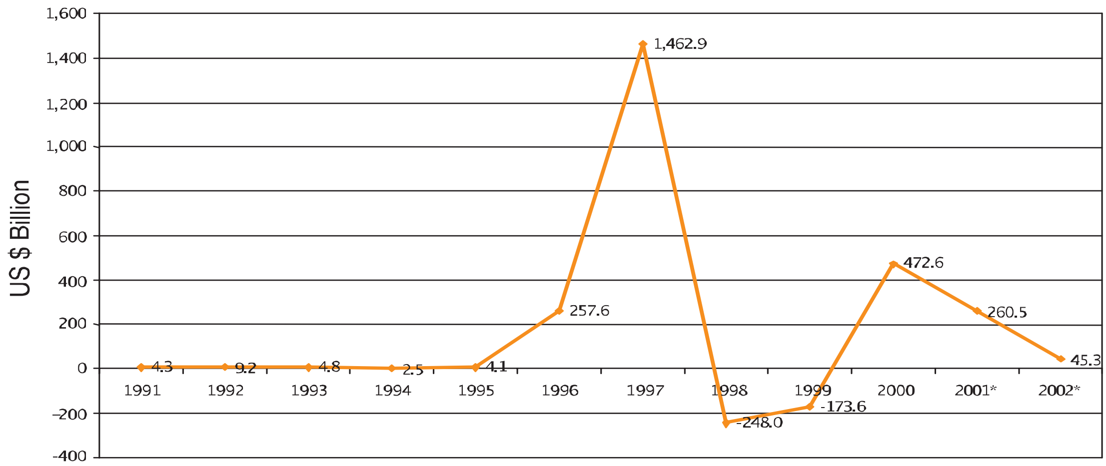
Portfolio investment hit a high of almost $1.5 billion net inflows in FY 1996/97, but turned negative in the wake of the Southeast Asian economic crisis. It has not recovered since then, posting a net outflow in FY 1997/98 and 1998/99 and registering small inflows in FY 1999/00 and 2000/01 averaging $ 360 million. (US Investment Climate Report 2002). Figure 3.9 shows the net inflow of portfolio investment over the period 1990-2002. As indicated, the 1997 crises (Luxor tourist crisis and Southeast Asian crisis) marked the beginning of a difficult time for portfolio investment. Starting 1999, portfolio investment showed signs of improvement; however, they were not sustained. The sharp increase in portfolio investment starting mid-1996 and 1997 is mainly due to marked privatization efforts through public offerings that boosted the stock market. The subsequent decline in 1998 was mainly due to external shocks associated with the East Asian and Russian stock markets' crises that diverted international investors from emerging to mature markets.

Table 3.12: Foreign Participation in Investment Companies by Activity until December 31, 1999 (values in LE million)

Activity	Capital	Investment Costs	Foreign Participation	Percentage of Foreign Participation to Capital
Textile	2,708	5,134	652	24.1
Food & Beverages	5,268	9,330	2,047	38.9
Chemicals	9,571	17,789	1,801	18.8
Wood Production	468	792	52	11.1
Engineering	5,583	9,981	1,096	19.6
Building Materials	4,777	10,847	911	19.1
Metallurgical	4,581	9,839	748	16.3
Pharmaceuticals	2,044	3,400	595	29.1
Mining	393	722	41	10.4
Total Industry	35,348	67,834	7,943	22.5
Agriculture	4,085	11,245	678	16.6
Construction	7,005	17,046	2,110	30.1
Tourism	25,938	47,708	4,478	17.3
Finance	17,191	17,191	4,919	28.6
Services	6,928	13,061	803	11.6
Grand Total	115,042	222,569	27,764	24.1

Source: Ministry of Foreign Trade, Egypt 2002.

Figure 3.9: Net Portfolio Investment in Egypt (1991- 2002)



*Notes: *Estimated CBE, actual CMA : 295 million US$ **Estimated CBE, actual CMA: 197*
Source: Central Bank of Egypt

4. Laws, Regulations and Policies for Trade and Investment

4.1. The Tariff Structure

The tariff structure is one of the main economic policy tools. Trade reforms started in August 1986 with a major tariff reform where tariff categories were reduced from 43 to 10, the minimum tariff was raised to 5% and the maximum rate reduced to 160% (Kheir-El-Din & El Dersh 1992; Refaat 2000). These reforms continued with the announcement of the Economic Reform and Structural Adjustment Program (ERSAP) in 1991. Table 3.13 traces the developments in tariff rates over the 1990s.

4.1.1 Height of the tariff

Egypt has successfully decreased its average most favored nation (MFN) tariff rate. The simple average MFN tariff has fallen from 42.2% in 1991 to 26.8% (30.2% including other duties and import surcharges) in 1998 and further to 20.5% before the latest tariff reform of September 2004. Lower tariff rates initiated in 1994 were partially mitigated by the imposition of "customs user" surcharge and other surcharges (3% for products with tariff rates below 30% and 4% for ones with tariff rate above 30%) (El-Mikawy & Ghoneim 2003).

Table 3.13: Development in Tariff Rates in Egypt (percent)

Year	Maximum Tariff Rate	Comments	Simple Mean Tariff	Coefficient of Variation of Tariff Rates	Share of Lines with International Peaks	Share of Lines with Specific Tariffs
1986	160		47.5			
1991	100					
1993	80	Short list of exceptions	42.2			
1994	70	Short list of exceptions				
1995	N/A	N/A	25.6	129.7	53.1	1.2
1996-97	55, then 50	Short list of exceptions				
1998	40	Short list of exceptions	26.8	147.4	47.4	9.5

Source: Kheir-El-Din and El Dersh (1992), WTO (1999).

However, Egypt remains one of the most restrictive countries in the region, as shown in Table 3.14. Nevertheless, the low percentage of customs duties to GDP indicates that trade reform should not be as difficult as the reform in countries where such percentage is high.

As previously mentioned, the latest tariff reform reduced the number of tariff bands. It included cutting tariff rates on most imports, and eleminating all import fees and surcharges. However, the net effect of these tariff reductions have been partially offset by the revaluation of the dollar - for customs valuation purposes- bringing it to parity with the bank rate.

Table 3.14: Southern Mediterranean Arab Countries: Import Taxation 1999-2000

	Trade Restrictiveness Rating[1]	Average MFN Tariff[2]	Effective Imports Tariff[3]	Custom Duties (percent of GDP)
Maghreb				
Algeria	7	23.7	13.5	2.0
Morocco	8	34.0	15.0	4.7
Tunisia	8	35.9	10.1	2.8
Mashreq				
Egypt[3]	8	30.2	15.1	2.8
Jordan	6	16.0	5.3	4.7
Lebanon	7	21.0	21.4	7.5
Syria	10	35.0	7.2	2.0
West Bank and Gaza[4]	4	8.8	9.1	7.1

Source: Nashashibi, 2002.

[1] IMF restrictiveness rating, with 10 being the most restrictive

[2] Includes other duties and import surcharges. And observations are for the most recent year available

[3] Custom duties on imports divided by the value of imports

[4] Since WBG is in a custom union with Israel, the index for Israel applies.

4.1.2 Tariff dispersion and escalation

Further investigation of the tariff rates shows a highly dispersed tariff structure. Duties differ considerably across sectors; they range from zero to 40% as a norm and reach exceptionally high levels for some items (tobacco, automobiles, alcoholic beverages). An indication of this dispersion is given by the coefficient of variation. The higher this coefficient, the more differentiated the tariff structure will be. Another indication of dispersion is given by the tariff peaks or spikes, which refer to the ratio of lines for which the tariff rates exceed a reference level to the total number of lines. The reference level, which we call international peaks, is 15%. A large ratio of peaks implies a highly non-uniform tariff structure.

Egypt's tariff structure has been characterized by significant escalation, with tariffs on raw materials considerably lower than those on semi- and fully processed goods. In 1998, the average ad valorem duty applied on primary products was 14.5% compared to 20.2% on semi-processed goods and 32.9% on fully processed products, which accounted for 57% of all imported items (El-Mikawy and Ghoneim 2003 and WTO 1999). Tariff escalation is particularly high on textiles and leather, and on basic metal industries where average tariffs on finished products are at least five times higher than the tariff on raw materials. Escalation is also marked on wood and wooden furniture.

In light of these figures (Table 3.13) and of comparisons with other countries (Table 3.14) it is fair to conclude that tariffs in Egypt remain high in general, and quite dispersed, implying a strong import-substitution bias and a persistent distortionary effect.

4.1.3 Egypt's tariff structure and commitments to WTO

In 1998, over 98% of Egyptian tariff lines were subject to bound rates with an average of 40% (expected to decline to 37% by 2005) when tariff peaks are excluded. The percentage of tariff lines subject to bounds (98%) compares positively with an average of 73% for developing countries (WTO 1999). Table B3.3 in Annex B shows the applied non-weighted tariff rates in 1999 and the bound rates in 2005 as well as the "water in the tariff." The water in the tariff is highest among the three categories of alcoholic beverages, and is in some cases (as textiles) not calculated, as there is negative water in the tariff. In other words, Egypt's applied rate (or equivalent in case of specific tariffs) is higher than the corresponding bound rate. With the exclusion of the three categories of alcoholic beverages, the average range of water in the tariff is 10-20% while the average bound rate of 40% is far above the average applied rate. This gives great leeway for backsliding on reforms.

In late 2001, tariff rates were reduced on a number of items (inputs and intermediate goods) and were raised on other items (final goods) hence increasing tariff dispersion and tariff escalation. They were reduced further in 2004.

4.2 Non-Tariff Barriers

Starting in 1986, Egypt also embarked on an aggressive program for dismantling non-tariff barriers (NTBs).

4.2.1 Non-tariff barriers on imports

Removal of NTBs on imports included abolishing the import licensing system, decreasing the number of tariff exemptions allowed, and removing import bans. Letters of credit suspensions, prior approvals by specified authorities, servicing facilities requirements, public sector monopolies, and prior import deposits were removed or considerably liberalized. However, a major drawback is the use of different exchange rates for tariff calculations. This flow has been averted with the recently enacted tariff reform. On the whole, these reforms were successful in turning quantitative restrictions into price measures, hence allowing the price mechanism a larger room to play its role.

4.2.2 Non-tariff barriers on exports

The NTBs affecting exports, including the prior approval of the government for certain commodities and other forms of red-tape measures, such as the monopoly of the public sector in domestic procurement of certain foreign products for exporting, were also removed.

4.2.3 Remaining constraints

The only remaining non-tariff measure-to distinguish it from NTBs-is quality control, which affects imports and exports. A list of products covering 1,550 tariff lines (25% of all tariff lines) was made subject to mandatory quality control requirements. In 2002, the list announced by the Ministry of Foreign Trade included 1351 tariff lines. A number of ministries and agencies are involved in setting these standards and the bulk of such standards are related to food and agricultural products with the main aim of ensuring health and safety measures. However, the system suffers from non-transparency and redundancy, which impose large economic costs on traders. The problems of enforcement of standards which act as NTBs include the following: confusing quality with safety, multiplicity of centers of authority, and lack of transparency. All such issues result in high compliance costs making selling on the domestic market more profitable for domestic producers than exporting (Kheir-El-Din 2000a).

A presidential decree was issued in 1999 (Decree 106/1999) to alleviate the cumbersome custom and quality control procedures on traders. The decree aimed at consolidating all activities of the concerned quality control agencies and institutions in one stage undertaken by the General Organization on Exports and Imports Control (GOEIC). The decree also announced the adoption of a

"White List" of exporters and importers that had developed a good reputation in adhering to quality and standard rules, and that are exempted from the cumbersome procedures of GOEIC and other import and export inspection agencies. These exporters and importers are only subject to random checking (an exception are food imports). However, the decree is not likely to bring substantial positive effect. First, the decree opted for a 'positive list approach,' where only exporters and importers that have developed good reputation are allowed to benefit from this special treatment. Had the approach been a 'negative list approach' where all exporters and importers benefit from random checking till they prove not worthy of this treatment, the decree would have had substantial positive effects. Second, by exempting certain exporters and importers from cumbersome procedures of customs clearance and quality control, the government is discriminating against other traders. Those privileged traders are likely to be dominant figures in the export/import business and are likely to have been used to circumvent these awkward procedures. Thus, such a decree does not affect the trade activity per se, though it might still reduce profits of those who are not on the "White List" and of other non-dominant traders and/or potential traders who have to face these clumsy procedures. This, in turn, reduces their incentives to export and hence leads to a diversion toward selling in the domestic market instead (Ghoneim 2000).

Egyptian ports suffer from delays in customs clearance, inefficiency in handling transit issues, etc. The average sea clearance time in Egyptian ports is estimated at ten days compared to 30 minutes in Belgium, one day in Greece, and two days in the United Arab Emirates (Zarrouk 2000 and Wilson, et. al. 2002). Other studies have reported longer time periods to clear certain types of goods (US Embassy 2002a). This has significantly increased trade-related transaction costs in Egypt which, when combined with high costs of port services (handling of a container and other related services in Egypt cost at least 30% more than in other ports in Southern Mediterranean countries [World Bank 1995]), explain the magnitude of trade related problems that Egypt suffers on its borders. Thus, while freight costs from Egypt to Europe are lower than for other countries, the transportation costs of loading and stevedoring are higher, making the total transportation cost in Egypt the highest compared to other countries in the Mediterranean region. Consequently, Egypt's proximity to Europe does not count for much, given these inefficiencies, especially the fact that transport costs account for 10% of the cost of imported inputs, and hence reduce the ability of Egyptian export industries to compete internationally (Benham 1997). The prime minister announced in June 2003 that privatization of management in four ports will take place over the coming three years to overcome cumbersome procedures and reduce transaction costs. This initiative has been undertaken to emulate the good performance of the privatized Ain El-Sokhna Port (Al Ahram 26/6/2003).

4.3 Other Laws and Regulations Affecting Trade and the Investment Climate

Export Promotion Law 155/2002 was passed to enhance exports after the establishment of the Ministry of Foreign Trade in 2002. It aims at alleviating a number of bureaucratic obstacles to exporting by streamlining export procedures and combining the concerned export supervisory authorities into one. It gives the GOEIC, together with the Customs Authority, responsibility for administering the duty drawback and the temporary admission schemes. The tax rebate system for exporters is also to be improved through the establishment of a central unit, under joint supervision of the Finance and Foreign Trade ministries. In an attempt to reduce the number of extra and often informal costs that exporters endure, the law states that only the Ministry of Foreign Trade, in coordination with concerned ministries, can impose financial charges on exports. The law also establishes an Export Support Fund, the regulation and management of which is to be set out by presidential decree. Nevertheless, the law has been criticized by the business community as being considerably less comprehensive than the initial draft.

As for promoting investment, Law 8/1997 streamlined all kinds of discrimination between domestic and foreign investors. It opened new activities for investments in manufacturing, agriculture, services, and public utilities. It provides guarantees against nationalization, confiscation, seizure, requisition, blocking, and placing under custody or sequestration. It also offers guarantees against full or partial exprop-riation of real estate and investment project property. Amendments to Law 8 have been introduced in 2004. Such amendments aim mainly at accelerating the dispute resolution process, reducing transaction costs faced by the investor through the establishment of One Stop Shop, and consolidating decisions related to investment under the authority of GAFI, rather than being scattered among different governmental agencies and governorates. These amendments consider-ably facilitate entry procedures; however, they do not address difficulties facing businesses during implementation, neither do they facilitate exit procedures.

Furthermore, Egypt has seven active free zones in Nasr City (near Cairo Airport), Alexandria, Damietta, Ismailia, Sixth of October City, Suez, and Port Said. New extensions are being added to Damietta and new zones are planned in North Sinai and the Red Sea. Free zones are subject to Investment Law 8 and are open to investment in any activity. Companies producing largely for export (normally 80% or more of total production) may be established in free zones and operate in foreign currency. Egyptian and foreign investors have equal rights to operate in free zones. Companies operating there are exempted from customs duties, sales taxes or taxes and fees on capital assets and intermediate goods. Concession agreements in such areas as petroleum, natural gas and mineral exploration and exploitation, al-though not explicitly covered by Investment Law 8, receive many of the privileges of free zone ventures. Concession agreements must be negotiated separately with the GOE and are subject to legislative approval.

Egypt passed a new law for protecting intellectual property rights in 2002 (Law 82/2002) in line with the commitments of Egypt according to the Trade Related Intellectual Property Rights (TRIPS) Agreement. Moreover, an antidumping law in 1998 (Law161/1998) that follows the guidelines of Article XI in the GATT agreement was enacted. However, Egypt still lacks a competition law. In general, Egypt, lacks a full comprehensive competition policy, not only due to the absence of competition law, but also because of the high average tariff rate, absence of a conducive business and investment environment, and a weak institu-tional infrastructure that governs investment and trade relations. Several initiatives to improve the institutional infrastructure have been undertaken, but problems arise in implementation and the enforcement mechanism still suffers from deficiencies.

Finally, the People's Assembly approved in May 2002 the Special Economic Zones (SEZ) Law 83/2002 which allows the establishment of special zones for industrial, agricultural, or service activities specifically designed for the export market. The law allows firms operating in these zones to import, duty free, capital equipment, raw materials, and intermediate goods. These imports will further be exempted from sales tax and other surcharges. Companies established in the new zones will further enjoy lower corporate taxes; they will operate under more flexible labor regulations, and benefit from other incentives. However, it is still too early to assess the impact of such laws enhancing the trade and investment climate.

5. Explaining Egypt's Export Performance

Improved market access conditions and increased competition in world markets resulting from implementation of WTO agreements and from regional trading arrangements lay the burden of enhancing Egypt's exports mainly on domestic factors. These factors are either of a structural nature or relate to policy barriers.

5.1 Structural Factors

Structural factors constraining export performance include limited export supply capacity, high production and transactions costs, institutional impediments, and anti-competitive behavior.

5.1.1 Limited export supply capacity

Expanding foreign demand has had a small effect on Egypt's exports. Moreover, the percentage of exports to total GDP has hardly reached 6%. These observations may be explained by the low domestic supply elasticity of tradables and the rapidly growing domestic demand, which absorbed the largest share of output and restricted export possibilities. Increase in domestic demand raised the price of domestic factors of production-labor and land-and of other non-traded goods and services in relation to the price of traded goods, which is primarily determined internationally. Higher prices for non-traded goods and services relative to that of traded goods, particularly exportables, made it more profitable to invest in the former rather than the latter. This deprived exportables of means of expanding supply capacity in the medium term (Kheir-El-Din 2000b). This further emphasizes the issue of lack of correct incentives and market signals which led to diverting production from exportables to non-tradables.

Improving export performance would primarily require reducing domestic absorption. The major challenge is thus to raise domestic savings rates and direct investments to build supply capacity in exportables. This would further require improving the investment climate.

5.1.2 High labor and other factor costs

Despite prevalence of unemployment, and due to labor market rigidities and distortions, unit labor cost in Egypt is high. The wage rate in Egypt is the lowest in MENA, however, when compared to labor productivity, it appears that the labor cost per unit of manufacturing output in Egypt is higher than in other competing countries in the region. Shortage of skilled workers and lack of discipline supported by restrictive labor regulations that obstruct firing, all contribute to raising labor costs. Land costs are also high compared to other competing countries of the region.

Table 3.15 illustrates the development of unit labor costs by manufacturing activities, where, between 1970 and 1999, unit labor costs appear to have increased (in ten cases), while, in other cases, they remained constant (two cases) on average. The decline in unit labor cost in many manufacturing activities (16 cases) was not impressive, with the exception of few industries. This means that wage increases were higher than productivity increases, hence leading to further loss of competitiveness.

5.1.3 Services costs

Prices of non-traded services relative to those of traded goods tend to be high in Egypt. High costs of freight and transportation services, of financial services, of litigation procedures, and of telecommunications, all raise the costs of export-ables relative to their price.

5.1.4 Institutional impediments to exporting

Egypt does not provide any kind of subsidies to agricultural or industrial exports. However, the new export law (Law No. 155/2002) has allocated some funding for enhancement of exports. The system of supporting exports is undertaken in two forms. The first is reimbursing the exporter for some of his costs (which differs from one commodity to another) based on the volume of exports, and the second is a discount on international transportation costs. This system (named tax rebate) has started to operate in late 2001 targeting some specific products while lists of other exports are still to follow. Assessment of the system of export support is discount on international transpor-tation costs. Assess-ment of the system is also premature due to the short time that has elapsed since initiating the system, the recession facing the Egyptian economy, as well as the slow down in inter-

Table 3.15: Labor Cost (per $) in Egyptian Manufacturing

ISIC Code	Definition	Average 1970s	Average 1980	Average 1990
311	Food products	0.52	0.54	0.33
313	Beverages	0.48	0.47	0.34
314	Tobacco	0.43	0.42	0.44
321	Textiles	0.58	0.70	0.61
322	Wearing apparel, except footwear	0.59	0.55	0.35
323	Leather products	0.89	0.64	4.56
324	Footwear, except rubber or plastic	0.52	0.60	0.63
331	Wood products, except furniture	0.51	0.76	1.05
332	Furniture, except metal	0.67	0.63	0.58
341	Paper and products	0.36	0.46	0.36
342	Printing and publishing	0.66	0.78	0.52
351	Industrial chemicals	0.65	0.64	0.36
352	Other chemicals	0.39	0.46	0.31
353	Petroleum refineries	0.56	0.61	0.13
354	Misc. petroleum and coal products	0.14	0.30	0.36
355	Rubber products	0.32	0.58	0.52
356	Plastic products	0.42	0.28	0.34
361	Pottery, china, earthenware	0.38	0.47	0.47
362	Glass and products	0.78	0.68	0.51
369	Other non-metallic mineral products	0.46	0.41	0.30
371	Iron and steel	1.09	2.23	0.57
372	Non-ferrous metals	0.47	1.09	0.43
381	Fabricated metal products	0.55	0.53	0.44
382	Machinery, except electrical	0.47	0.75	0.44
383	Machinery, electric	0.32	0.41	0.37
384	Transport equipment	0.55	0.70	0.44
385	Professional & scientific equipment	0.61	0.78	1.55
390	Other manufactured products	0.48	0.73	0.47

Source: UNIDO Industrial Statistics Database, 2000.

national economic activity, especially since 2001 and particularly after the events of September 11 of that year.

Finally, successive devaluations of the Egyptian pound make the assessment more complicated. The system lacks two main elements: First, it lacks the ability to penalize exporters who benefit from the support and do not perform well as there are no specific targets set at the firm level (the system has a carrot but no stick). Second, it is designed for large exporters who have a record of exporting and does not help new or potential exporters as they cannot benefit from the system if they lack an export history (El-Mikawy and Ghoneim 2003). One counteraction was recently undertaken in 2003 by Prime Ministerial Decree No.506/2003, followed by the decree of the Minister of Foreign Trade No.139/2003 that require exporters to remit 75% of their foreign currency receipts arising from exports to domestic banks and receive their equivalent in domestic currency. The decrees were initiated to ensure the availability of foreign currency. However, the implications of such decrees on exporting are likely to be negative due to the prevalence of black market for foreign exchange, and the inability of banks to secure the required foreign currency to exporters.

Adding such impediments to cumbersome customs procedures and inspection regulations, it appears that the bias against exports is a natural outcome of prevailing policies and regulations. Reducing institutional constraints through limiting the number of institutions and enhancing bureaucratic efficiency is warranted. These constraints, although not all specific to export activities, increase the cost of doing business in Egypt compared to that in neighboring countries. Institutional constraints also include dealings with tax administration, commercial dispute settlements, and unofficial payments. The income tax structure also needs to be revised, reducing its rates and increasing the level of incomes exempted there from. Table 3.16 provides a ranking of what the exporting community views as the main institutional impediments. The assessment indicates the ranking of transaction costs related to the institutional framework that governs export and import procedures.

Table 3.16: Assessment of Institutional Constraints to Exports

Institution	**Constraints ranked according to the level of impediments they provide**
Unofficial payments to customs officials	1
Customs procedures related to imported inputs	2
Tariff levels on the imported inputs	3
Laws and regulations concerning imports	4
Drawback mechanism	5
Laws and regulations concerning exports	6
Customs procedures related to exports	7

Source: Ghoneim, 2000.

5.1.5 Anti-competitive behavior

The markets for both goods and services have lately experienced a large number of mergers and acquisitions that could have anticompetitive effects. From 1996 to May 2003, the number of mergers and acquisitions reached more than 126 cases in different sectors despite the slowdown of the Egyptian economy (Cairo and Alexandria Stock Exchanges 2003). Anticompetitive behavior was evident in a number of markets including cement, steel, and audiovisual production, to name a few. The absence of a competition law increased the premium of selling domestically and deterred potential new players from entering the markets and directing their production for exporting.

5.2 Policy Barriers

Egypt, like most countries, has protected its manufacturing industries. It has traditionally protected import-substituting industries over exports, and industry over agriculture, principally through imposing high tariffs on imported commodities. Moreover, Egypt has relied on indirect taxes as a source of government revenue. These taxes increase costs of production and hinder export expansion. They further raise domestic prices and the financial profitability of domestic sales compared to that of exports thus entailing an anti-export bias. Finally, the overvalued exchange rate of the Egyptian pound is believed to have limited export competitiveness. All these factors led to a distorted incentives structure.

5.2.1 Overvaluation of the exchange rate

The impact of the nominal or real appreciation of the exchange rate on export competitiveness is controversial. The existing body of theoretical and empirical literature failed to reach a consensus on the impact of this factor on exports. In the Egyptian case, the impact of the exchange rate appreciation on the Egyptian exports was marginal relative to the more impeding obstacles related to institutional infrastructure and behavioral attitudes (Kheir-El-Din and El Shawarby 2000 and El Shawarby 2000).

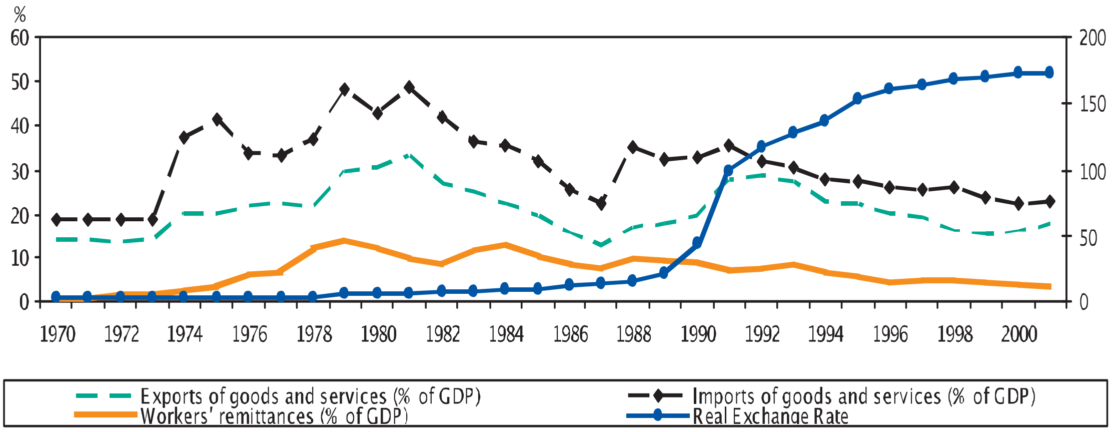
The 1980s experienced a system of multiple exchange rates where three nominal rates prevailed. In February 1991, the three rates were abolished and replaced temporarily by a dual flexible-peg exchange rate system which was further unified and the nominal exchange rate was devalued to 3.342 L.E./$ (Kheir-El-Din and El Shawarby 2000).

From February 1991 to 2003, the nominal exchange rate was used as an anchor where the Egyptian pound was pegged to the US dollar. Concurrently, the real exchange rate experienced several developments. First, it was believed to be highly overvalued till the reform of 1991, which moved the real effective exchange rate closer to its equilibrium level. Then, the real exchange rate experienced appreciation further exacerbated by the 1997 Luxor incident and the East Asian crisis. The resulting pressures on the nominal exchange rate to appreciate forced the government to draw from international reserves that declined substantially by approximately $5.5 billion between 1997 and 2000 (WDI 2002).

The continued shortage of foreign exchange and the failure to satisfy demands for foreign currencies constituted a serious impediment to economic growth. Despite a cumulative devaluation of 32% in pound terms since June 2000, the pressure on the foreign exchange market continued. A promising start to foreign exchange regime reform in August 2001 accompanied by an additional devaluation of 17.4% in pound terms was overtaken by the events of September 11. A further devaluation in December 2001 did not solve the imbalance. A black market in foreign exchange reemerged because of the dollar scarcity; it further carried a premium exceeding 10% over the legal commercial maximum throughout the first half of 2002. The continuous pressure on the Central Bank of Egypt (CBE) net reserve balance called for a revision of the pegged exchange rate system. In 2002, the CBE announced successive devaluations of the local currency from 3.40 L.E./US$ to 3.85 L.E./US$ and finally to 4.20 L.E./US$, with a plus or minus 3% margin for banks to trade on, in an effort to overcome the black market emergence and to bring available foreign currencies back to the banking system. Finally, in January 2003, the Egyptian Government announced its decision to freely float the Egyptian pound.

The impact of these developments on Egyptian exports performance is still difficult to assess; however, Figure 3.10 shows the relationship between the real exchange rate (RER) and exports. The figure shows a negative relationship between RER and exports; hence it is safe to argue that overvaluation had negatively affected the competitiveness of Egyptian exports abroad. Whether the devaluation will have a positive impact on exports after taking into consideration the costs associated with devaluation (e.g. inflation) is still not clear.

Figure 3.10: Relationship between Real Exchange Rate, Exports, and Imports of Goods and Services, and Workers' Remittances



Source: World Bank, WDI CD-ROM, 2003.

5.2.2 Anti-export bias entailed by the tariff structure

Effective protection implied by the nominal tariff structure has been estimated in 1998 at 8.2% for agriculture, 34.2% for manufacturing and 30.5% overall (Kheir-El-Din 2000b). It has tended to decline with the decline in nominal tariffs, but remained highly dispersed. Table B3.4 in Annex B, illustrates the level and development of effective protection in manufacturing from 1994 to 2000.

This tariff structure entails an anti-export bias illustrated in Table 3.17. Exporters sell their products at international prices while they pay the domestic price including tariffs for their inputs. This burdens exports with substantial negative effective protection and further discourages exporting in favor of domestic sales. Incentives against exporting have declined between 1994 and 2002 for the whole economy and for manufacturing.

Within manufacturing, anti-export bias has increased significantly in the textile sector and marginally in wood industry. The incentives against exports are highest in clothing, footwear, furniture, leather products, porcelain products, and spinning and weaving industries as shown in the table 3.17.

5.2.3 The general sales tax (GST)

The GST is a fairly high, non-uniform tax. It is applied at the manufacturing level on imported and domestically produced goods. It is also imposed on certain services. The rates range from 5 to 25%, with a standard tax on goods of 10%. There are some exceptionally high GST rates on some goods such as beverages, cigars, and cigarettes.

While GST is applied to both imported and domestically produced goods, it is applied to imports on a duty inclusive basis, thus magnifying the effect of existing tariffs. It raises the costs of imported inputs by the rate of GST multiplied by the import value augmented with the tariff rate. It thus raises export costs (Kheir-El-Din 2000b).

Table 3.17: Developments in Tariff Induced Bias against Exports (Percent)

	1994	**1998**	**2002**
Economy-wide average*	23.0	16.6	17.4
Manufacturing average*	25.5	17.9	18.9
Bias by industry			
Food Processing	5.7	5.1	5.1
Cotton Ginning	5.0	5.0	5.0
Spinning and Weaving	30.0	26.9	28.8
Ready-made Garments	64.9	36.8	593.0
Leather Products less footwear	40.6	26.2	34.0
Footwear	66.7	37.9	40.8
Wood Products Less Furniture	5.0	4.4	5.9
Furniture	64.6	36.4	35.4
Paper & Printing	7.4	7.0	6.9
Chemical Products less oil refining	5.1	4.9	5.0
Rubber & Plastic Products	29.3	22.6	23.1
Porcelain Products	46.8	29.9	29.9
Glass Products	28.8	21.1	21.3
Non-metallic Products	17.4	14.8	15.8
Metals and Iron Products	18.2	13.9	14.0
Machinery & Equipment	9.5	7.2	7.2
Transportation Means	27.6	23.9	23.9

*Notes: *Excluding beverages, tobacco, and clothing industries.*
Source: Refaat, Amal, 2003.

5.2.4 Other financial levies on exports and imports

On the import side, a large number of administrative controls, although considerably reduced, still burden the import process. These procedures relate to customs clearance, quality control and testing for specification and product standards. Fees charged for inspection activities and associated delays and stamp duties add to the costs of imported inputs. They are detrimental to competitiveness of domestic production.

Firms producing for export are subject to certification by a number of official bodies especially those involved in agricultural exports, foodstuffs and textiles. However, the variety of fees imposed on exporters has been streamlined and restricted to charges approved by the Ministry of Foreign Trade. Although, there has been a marked effort to alleviate their burden on exporters, they require consolidation in a low flat fee, unless they are a payment for a service actually provided. In this case, they should be based on a cost-recovery basis.

5.2.5 Duty drawbacks

Drawback and temporary admissions schemes have been streamlined and improved, however they still lack efficiency (see for example Prime Ministerial Decree No. 1635 of 2002). Drawback is only available for firms that import intermediate inputs and then export the processed product. There is no possibility for claiming drawback for imported inputs sourced from the domestic market. Most countries that have succeeded in promoting their exports have adopted rebate schemes that allow exporters to obtain a rebate of tariffs and other charges paid on imported inputs even if they did not import them directly. The idea is that since exporters sell in world markets at the international price, they should pay for their inputs the international price to be able to compete with other foreign producers.

The combination of all the aforementioned factors has resulted in a premium for producers selling in the domestic market when compared to selling abroad. The premium a producer gets for selling domestically has been measured to be higher than if he decided to export by a range of 5-40 percentage points on the rate of returns on equity and 1-10 percentage points on the rate of returns on assets as shown in Table 3.18 (ECES, 2001).

Table 3.18: Rates of Returns on Equity and Assets for Exporters and Domestic Producers

	Exporter	Domestic Market Producer		
		Elasticity = -1.0	Elasticity =-1.1	Elasticity =0.9
Rate of Returns on Equity	19.0	43.3	24.9	60.1
Rate of Returns on Assets	4.8	10.4	6.0	14.9

Source: ECES Policy View Point, 2001.

As a result, the business community is more focused on the domestic market and lost track of the changes in the world demand. Table 3.19 reveals that the Egyptian exports structure is becoming biased toward products that are facing a declining world demand (declining stars and retreats) whereas it is deviating away from products that are experiencing an increase in world demand (rising stars and missed opportunities). This result suggests that the incentives structure does not favor products with rising export demand but rather products with declining export demand.

Table 3.19: Structure of Egyptian Exports According to their Share in Exports Structure and Following the World Demand Changes (percent)

	Rising Stars	Declining Stars	Missed Opportunities	Retreats
1986	50.0	19.4	16.2	14.4
1990	49.3	29.0	9.7	12.0
1995	45.2	38.2	5.5	11.1
2000	36.3	44.7	2.8	16.3

Notes: Base Year 1985
Source: World Bank and ECLAC, TradeCAN Database, 2002, Authors' calculations.

6. Network Industries and Services

6.1 Developments

An efficient network industry and service sector contributes to the balance of payments because it is an important determinant of firms competitiveness. Key sectors that influence the ability of firms to participate in external trade are telecommunications, transportation, financial services, and other business support services such as accounting and legal services.

The network industries and services have experienced serious attempts at modernization over the last decade. Additionally, there has been a great deal of liberalization in these sectors. Egypt has made commitments in the transportation and financial sectors in the GATS agreement. This was followed by joining the Basic Telecommunications Agreement in 2002 and the Information Technology Agreement in 2003. Moreover, domestic laws and regulations impose little restrictions on foreign participation. It has further liberalized and privatized a large number of activities in network industries.

6.2 Barriers to Trade in Particular Sectors

6.2.1 Telecommunications

Until 1998, Public Law 153 granted the Arab Republic of Egypt National Telecommunications Organization (ARENTO) exclusive responsibility for the establishment and operation of the national telecommunications network and for international interconnec-tions. The performance of ARENTO was suffering from a number of deficiencies. It was able to fulfill only 65% of the applications for new basic telephone lines and failed to address the large unexpressed demand (Mohieldin 1997). In 2002, a new law for telecommunications was issued, ending the monopoly of

ARENTO and stimulating market forces. Previous studies on the cost of service rate emphasized that almost all services provided by ARENTO required price reform. The price of obtaining a telephone line in Egypt was relatively high. The official price for obtaining a telephone line in Cairo in 1997 was $295 and the waiting time was between one to two years; to obtain an urgent line the price was increased to $885 with the waiting time reduced to two to three months. However, the official price underestimated the cost of obtaining a telephone line as when an apartment was purchased, the buyer had to pay an additional charge for not having to wait for the installation period of a new line which might last several years. These charges reflect the overall transaction costs, including waiting time and other charges associated with obtaining a telephone. The price of a telephone line in Egypt was over 16 times as high as in Malaysia. The monopoly of ARENTO resulted in low efficiency of basic telecommunications. Low quality and high price were the main characteristics of such service industry. These features started to change dramatically recently.

Following the global revolution in the telecommunication industry, Egypt identified this industry as a potential non-traditional growth industry. Starting with the establish-ment of the new Ministry of Communications and Information Technology in 1997, the GOE has taken concerted steps toward enhancing this important sector. The information technology (IT) sector defied the overall economic trend in Egypt in 2001, growing at an estimated 17%, but growth probably slowed to single digits (although still well above the overall pace for the economy) in the first half of 2002. The first step undertaken in the reform was the privatization of the incumbent global system for mobiles (GSM) operator in 1997 and the issuance of a second GSM license in 1998. The number of subscribers grew from 177,000 in 1998 to 3.6 million in January 2002, compared with only 7 million fixed telephone lines in the country. The second step has separated the incumbent fixed line operator from the related ministry into an independent company (Telecom Egypt). In 1998, Law 19 transformed ARENTO into a joint-stock company wholly owned by the GOE. Serious steps have been taken to privatize Telecom Egypt, but were later postponed due to global negative trends witnessed in the telecommunications indus-try starting 2000. Other steps in the reform process include complete digitization of the fixed line network by mid-2000 and an ambitious expansion plan to cover all areas in Egypt has been adopted.

Moreover, the Internet service has witnessed a dramatic improvement in recent years, where Telecom Egypt struck deals with service providers to offer their service to the public on a "revenue-sharing" basis with Telecom Egypt. Users are no longer required to pay subscriptions (which required an average of $20 per month earlier) rather they have to pay the regular cost of outgoing calls. Furthermore, leased line services have been introduced by Telecom Egypt and third party resellers were allowed to sell them in the local market. At the same time, Telecom Egypt recently launched the initiative of "a computer for each home," where it provided personal computer systems to the public at low cost and on favorable credit terms. Also, a new law (Law of Electronic Signature) to govern e-commerce has been recently approved by parliament. Internet penetration is rising steeply, from an estimated 600,000 Internet users in January 2002 to 2.5 million users by the end of 2003.

Programs aimed at training recent graduates (with technical and non-technical degrees in communications) have been launched. Training programs include technical and managerial aspects related to communication and information technology. In addition, there are currently over 25000 public phones spread in the country covering most urban areas and some rural areas.

Telecom Egypt started a tariff-restructuring plan to prepare the company for further liberalization of the industry. Rapid changes to put the fixed telephone services in line with international developments worldwide and to cope with new technologies are taking place. Price adjustments have been implemented with the rise in tariffs on local calls and decline of tariffs on international ones. Tariffs for local calls remain among the cheapest in the world despite the fact that they were revised upward in 1997. On the other hand, the tariffs for international calls have been revised downward during the last few years, with a reduction that reached for example, almost 60% for calls to the USA (Ministry of Foreign Trade 2003). Hence, privatization, deregulation, and enhanced competition in this sector positively affected its perfor-mance. Services improved for the consumer and transactions costs declined. Nevertheless, the duopolistic situation in the field of mobile service is still acting as a bar-rier against intensive competition which could help to reduce transaction costs and enhance the efficiency of this segment of the industry.

Tables B3.5a and B3.5b in Annex B illustrate the increased availability of telephone services in Egypt and the low price of such services. They point to the improved relative position of Egypt vis-à-vis other comparator countries in terms of service availability. Further, in terms of price, Egypt is among the lowest.

Regarding mobile services, the entry to the market is still restrained to allow the incumbent firms to recover their sunk costs. However, most restrictions are to be released by 2005. There are no restrictions on private and/or foreign ownership in the field of mobile phone service.

6.2.2 Financial services

Banking and insurance services are reviewed successively.

Banking Sector

The banking sector is easily accessible and does not suffer any kinds of constraints with regards to capital flows. Concerning entry of foreign banks, market access is controlled via prudential regulations subject to the discretionary power of the Central Bank of Egypt. There is no explicit subsidization or protection for state-owned banks, yet there are restrictions imposed by the CBE to ensure that the banking system does not face any drastic changes that might affect its stability. In fact, state-owned banks are sometimes used as tools to impose certain behaviors (such as inter-bank borrowing rates) on other banks.

Ownership in capital of banks has several limitations that are imposed to ensure the stability of the banking system, and protection from any abuse of the dominant role that can be played by one of the major shareholders.

Regulation is the sole responsibility of the Central Bank. Many of the CBE's decisions are subject to its discretionary power. However, despite the strict control of the CBE on banks in Egypt, many have failed to meet the capital adequacy requirements that Basel convention has asserted. Chapter 2 provides a detailed analysis of the market structure of the banking sector and of its performance.

Insurance

The insurance sector in Egypt was dominated by state-owned enterprises until very recently. It is currently passing through a transitional period toward openness and increased participation of private domestic and foreign capital. In 2000, several major equity transactions took place in the Egyptian insurance sector, where AIG took interest in one of the Egyptian private insurance companies. Allianz and Legal & General also took interest in two different private companies. In addition, licenses were granted for the establishment of two new insurance companies.

Regarding ownership, there are no restrictions on foreign ownership, at least as Egypt's GATS commitments reveal. However, there are restrictions on single ownership (whether national or foreign) where it is not allowed to exceed 10% of capital.

The regulatory body of this sector is the Egyptian Insurance Supervisory Authority (EISA), which is not fully independent from the ministry that overlooks its actions and policies. This Authority is currently supervised by the Ministry of Planning, with no clear justification or rationale for this arrangement.

The market structure of the insurance sector is more of the oligopolistic type with high concentration ratios. The largest four firms constitute over 50% of the total non-life insurance premium. The case in life insurance is to a large extent similar to the non-life insurance. However, the market contains, in numerical terms, an almost equal number of private and state-owned players.

Finally, although the financial sector in Egypt is being liberalized and reinforced, as highlighted in Chapter 2, no specific export financing or insurance schemes are available.

Electricity

The electricity sector has experienced a substantial degree of reform since 1998. The legal status of the Authority of Electricity, which owns the companies dealing with production, transportation, and distribution of electric power, has been changed to a holding company. Reforms were complemented in year 2000 by the unbundling of activities of those companies and restricting them to only one activity rather than being engaged in production, transportation, and distribution. Private sector participation has been allowed and has increased intensively by the use of BOOT contracts, especially in the field of production. Moreover, the participation of domestic and foreign private investment has taken place in activities related to distribution. A regulatory body, established since 1997, has been responsible for monitoring all such activities to ensure quality and reasonable prices. However, not all companies fall under the authority of the regulatory body. The aim of such reform is to reduce the burden of subsidizing electricity on the government where subsidies reach more than L.E. 1.6 billion yearly. Privatization of many companies is on the agenda of the government, however it is delayed due to their large indebtedness, which makes them not viable for selling. Further, there are still debates about the best way of privatizing utilities whether through selling to an anchor investor or through the stock exchange, as this might have several social and political repercussions.

This sector has experienced a move toward liberalization and reform. However, it continues to suffer from inefficiencies. The pricing of electricity is still an issue that needs to be considered. Since 1992 the prices of electricity set by the government did not change despite the inflation experienced, particularly after the 2003 depreciation of the Egyptian pound. This increased the burden of subsidization on the government. A move toward correcting the situation has been undertaken via the implementation of a prudent price discriminatory system, although there is more to be done.

Electricity is essential for Egypt's expanding manufacturing and industrial sectors. Currently, electric energy consumption is around 69 billion kmh; 36% is used by industry. The demand for electricity has been increasing by 5.6% annually during the last decade, and is projected to continue growing, to reach 120 billion kmh by 2010 (Ministry of Foreign Trade 2003). Egypt's per capita electricity consumption has almost doubled over the past fifteen years. It exceeds that of Morocco, Syria, and Tunisia (see Annex B, Table B3.6a). Domestic production covers consumption requirements, however, there are no indicators that reveal the development of quality of this important production input. In addition, production of electricity in Egypt, though lower than in other comparator countries outside the MENA region, is growing at a high rate (almost 50% in 5 years), and exceeds the amount of electricity produced by Jordan, Morocco, Syria, and Tunisia together (Annex B, Table B3.6b).

Transportation

Over the previous decade, the major evident improvement in transportation appeared in air and road transportation, where the number of airports more than doubled and the length of paved roads increased by more than 75%. The railways did not experience the same kind of progress (see Table B3.7, Annex B). Maritime transport, though it did not expand in terms of number of ports, experienced an impressive move toward deregulation and attempts at privatization. In fact, the privately managed Ain El-Sokhna port, which has achieved impressive success, is seen as a model for other ports to emulate. Privatization is expected to reduce sharply the transaction costs incurred by traders in ports (e.g. costs of handling, loading, etc) where the transaction costs related to such activities monopolized by the government, was reported to be, in Alexandria, almost 30% higher than in other ports of the Mediterranean (World Bank 1995).

7. Conclusions and Policy Requirements

Egypt was among the first countries in the MENA region to announce its adherence to an open market, export promoting strategy. Yet it has neither succeeded in achieving high export performance and growth, nor did it attract significant levels of FDI. As a member of the WTO, it is not fully benefiting from available opportunities and is facing some difficulties in implementation. The most binding constraints to effectively enforce such agreements are the lack of human skills and of technical capacity. Moreover, during the 1990s, Egypt joined a number of regional trade arrangements and is still negotiating others, yet the benefits of entering such agreements remain modest and the underlying strategy is not clear.

The deficit in trade balance has been widening, but was attenuated-and occasionally more than compensated-by the services balance surplus, mainly due to tourism revenues, Suez Canal proceeds, and workers' remittances. This alleviated the negative impact of merchandise trade on both the current account and the overall balance of payments.

Qualitative changes in exports, in terms of increased diversification, have been achieved but remained short of responding to world demand and alignment with changes of export structure in the main trading partners. Egypt's reliance on exports of fuels, agricultural raw materials, and material-based manufacturing (textiles, garments, leather goods, wooden furniture, etc.) remains predominant. Knowledge-based (high technology content) exports are minimal.

Inflows of FDI have been hovering around an average of US$1 billion yearly, and portfolio investments were limited and irregular.

Egypt's export growth during the 1990s appeared to have been mainly constrained by supply factors, including distorted incentives and flawed market signals, affecting its competitive position, rather than by external demand conditions. These factors are either of a structural nature or relate to policy barriers. Structural factors include limited export supply capacity, high production and transactions costs, institutional impediments, and anti-competitive behavior of firms, which in the absence of a clear competition policy has resulted in highly concentrated domestic markets structures and high domestic profit margins. Policy barriers include relatively high and dispersed tariff structures that are unmatched by an efficient rebate scheme to compensate its anti-export bias effect, fairly high sales tax and other financial levels and surcharges on exports and imports, and overvaluation of the exchange rate, which all led to a distorted incentives structure. These distortions led, in turn, to favoring domestic sales at the expense of exports and to discouraging investments, both domestic and foreign, from engaging in building up further export capacities.

Network industry and service sectors (telecommunications, transportation, financial services, electricity, and so on) have experienced serious attempts at modernization. However, there is still room for improving their performance and for enhancing their capacity to support participation of domestic firms in investment and external trade. To illustrate, the banking and insurance sectors provide no special financing and insurance schemes for exports, unlike other developing and newly developed countries which succeeded in their export promotion drive.

The previous analysis emphasized factors increasing the costs of production and of exports. Nevertheless, competition cannot only rely on low costs. Development of reputation for quality and reliability in export markets is necessary. Although Egyptian export performance has generally been modest, there are individual exporters who have succeeded in establishing good export channels and in raising their exports significantly through specializing in "niche" products where they could differentiate their output from other exporters. They have basically focused on high value-added products per unit of domestic input and have emphasized quality.

Most Egyptian exporters suffer from weakness in marketing, low awareness of developments of world demand, and lack of attention or capacity for meeting quality standards required by foreign buyers. They have to produce goods that meet foreign market requirements and to identify potential clients for their products. This presumes knowledge of available technologies and of available know-how to upgrade existing plants. Improving responsiveness to world market needs, accessing efficient labor inputs, suitable capital equipment and appropriate intermediate inputs to ensure that quality standards are met, are all required. Finally, building effective marketing channels is essential and creating an export "culture" is required.

Membership in the WTO and of several RTAs; partnership with the EU; and regional trade arrangement with Arab and African countries within GAFTA and COMESA may offer wider access to Egypt's exports, improve credibility of Egypt's policies, and present better investment potentials. However, Egypt has to exert marked efforts at the macro-economic level, raising domestic savings rate and directing additional investments to build supply capacity in exportables. This further requires improving the investment climate through addressing structural constraints by reducing high production and transactions costs, alleviating institutional impediments and bureaucratic intricacies, enhancing domestic competition, and addressing anti-competitive behavior of firms.

Although these structural barriers have been reduced, they still constrain domestic manufacturing activities and services, and lay additional burdens on external trade. Redressing the domestic incentives structure resulting from policy barriers is further required. This entails reducing further the level and dispersion of the tariff structure, alleviating the burden of the general sales tax on inputs to exportable products and of the pervasive financial levies and administrative measures associated with trade and investment activities, avoiding overvaluation of the exchange rate compared with other competing countries, and ensuring its flexibility and stability. These macroeconomic requirements have to be supplemented with identification and alleviation of export constraints at the sector or activity level and further at the firm level.

To conclude, there is a great need for developing a clear vision of trade and investment policies that must be shared and implemented jointly by both the government and the private sector. Once such vision is formulated, a roadmap on how to address the aforementioned structural and policy barriers can be established in a transparent manner. The costs of opening up should be identified a priori, the methods of how to tackle them and compensation mechanisms should be set in place, and the responsibility of those who benefit from the opening of the economy toward those harmed by it should be stressed. Finally, methods of strengthening the export-oriented lobbies should be seriously considered while at the same time creating the right incentive structure and market signals.

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Chapter Four
Governance Issues and Institutional Issues

1. Introduction and Methodology

1.1 Introduction

The concept of good governance has gone beyond the financial principles of responsible and transparent management. It now includes political rules and conditions that increase the chances for participative, competitive, and accountable exercise of power, as well as strengthen the rule of law. For some time in the 1980s and early 1990s, the convergence of countries toward good governance was expected to happen by the power of example (imitation), the power of embarrassment (emulation), and by tech-nical capacity building (democracy promotion projects). Now it has become evident that the process of enhancing accountability is too subtle and requires a better understanding of the entire macroenvironment of economics, politics, and civil society in order to enhance the business environment and overall growth performance.[1] This chapter of the profile will keep to the understanding of good governance as explained above, particularly with respect to economic decision making. It is a process by which to establish rules that ensure responsible and competent exercise of power and management of economic resources in a fair and transparent manner. This process is interactive with political institutions and interpretations.

With respect to Arab countries, there has been a debate on how their Islamic-ness may constrain or promote "good" governance. Samuel Huntington, Lawrence Harrison, and David Landes have represented the pessimistic group. In contrast, the less pessimistic group[2] has claimed that Islam is no impediment to democracy and good governance in Arab countries.[3] The focus in this chapter highlights the need to understand the intimate processes of constitutional design, lawmaking for economic reform, law enforcement, and the expansion of political accountability mechanisms rather than religion per se.

Thus, in spite of the fact that the subject matter of this chapter is governance as it relates in particular to economic decision making, the following narrative will discuss in some length the broader governance framework represented by the constitutional system, as well as the legal foundations for the legislative, executive, and judicial authorities. This will permit the discussion on economic governance to be placed in the right overall context of political and institutional governance and will highlight the inseparable link between both spheres.

1.2 Why Governance Matters

This chapter is based on the assumption that good governance matters when considering the economic profile of a country. Good governance ultimately is about how a country is governed, how decisions are made, how policy is implemented, and the extent to which people feel that such policy is fair and therefore believe themselves compelled to abide by it. Good economic policy may not necessarily be a result of good governance as the latter is not a guarantee for good economic policy. Indeed, the world has seen several cases throughout the 1980s and 1990s-particularly in Asia and Latin America-which made economic progress in the absence of good governance.

However, it is argued here that good governance is a necessary component and prerequisite for long term, sustainable, and enduring economic success. On the one hand, good governance is what ensures that better policies and decisions are made, including those affecting the economy. On the other hand, the participation of various stakeholders in the decision making process is likely to allow the decisions and the policies adopted by government to be more comprehensively accepted, especially when these policies overhaul an existing (and malfunctioning) social contract. And finally, the observance of good governance in economic policymaking ensures an environment of accountability where those responsible for sound decision making are rewarded and those behind bad policies are checked, corrected, and/or replaced.

1.3 Methodology

The Kaufman et al dataset will be used (Section 2) to give a quantitative impression of where Egypt stands in relationship to other countries in the MENA region and outside it since 1996. Though not definitive and largely subjective, reflecting businessmen's perceptions, the Kaufman et al dataset encompasses a reasonably comprehensive definition of governance and a wide synthesis of other indicators and data sets (Annex B, Table B4.1). Its findings are therefore presented to provide an overview of how Egypt is generally perceived and ranked in comparison to other countries.[4]

The review of Egypt's ranking in the Kaufman et al dataset will be followed by a qualitative narration of the key aspects of governance in Egypt, especially those that pertain to economic decision making and the business environment (Sections 3-8). The focus will be on the constitutional framework, the political system, the investment climate, and finally, civil society organizations. The narrative sections have relied primarily on primary sources such as laws, decrees, and decisions forming the overall legal and legislative framework.

2. Egypt's Rank over Time and Comparative Perspective

2.1 Over Time

Dividing the total number of countries in the Kaufmann dataset into three groups according to rank (lowest quarter, middle group, and uppermost quarter), we realize that Egypt has occupied the lowest quarter in the case of voice and accountability since 2000 with the lowest score being in 2002. Since 1998 Egypt has been in the middle group with respect to regulatory quality, rule of law, control of corruption, and government effectiveness; however, its rank deteriorated between 1996 and 2002. If one looks at the estimate scores, it appears that Egypt has consistently scored in the negative with respect to voice and accountability, political stability, and control of corruption (except for 1996 when the control of corruption score was 0.11). In contrast, Egypt's score on rule of law has constantly been positive, though never crossing the 0.25 mark. Government effectiveness and the regulatory framework left the negative range in 1998 and 2000 to return to it again in 2002 (see Annex B, Tables B4.1 and B4.2).

2.2 In Comparative Perspective

Egypt's scores since 1996 are compared to those of Morocco, Tunisia, Jordan, Mexico, and Poland. The reasons for the comparisons are as follows:

- Inside the MENA region-excluding the Gulf countries-Morocco, Tunisia, and Jordan have witnessed extensive reform efforts especially on the economic front.

- Outside the MENA region, Mexico has had 70 years of one-party rule but managed to end such monopoly and join NAFTA, while facing a challenge to reduce poverty. Poland is another comparator that has a well-known history of vibrant political transition from communist rule and became a member of the EU in May 2004, while facing a challenge of modernizing its industries in a vastly agricultural economy.

How does Egypt compare to the selected MENA countries in terms of rank and estimate score? Morocco and Jordan occupy predominantly the middle group of percentile ranks, with no exception. Tunisia, like Egypt, has constantly occupied a rank in the lowest quarter with respect to voice and accountability. However, Tunisia occupied a higher rank than the other three countries (Egypt, Morocco, and Jordan) with respect to government effectiveness and control of corruption since 1998. As to the estimated scores of Morocco, Jordan, and Tunisia, all three have constantly maintained negative scores on voice and accountability. Morocco and Jordan returned to negative scores on political stability in 2002. On all other accounts, the three countries have maintained positive scores, albeit never crossing the 0.9 mark. However, Morocco and Tunisia have dropped to negative scores on control of corruption and the regulatory framework respectively in 2002 (Annex B, Table B4.2).

Comparing Egypt and Mexico, the latter outperformed Egypt on voice and accountability, on political stability and regulatory quality both in rank and score. Mexico took large strides in controlling corruption (both in terms of rank and score) while Egypt's rank and score worsened. As to rule of law, Egypt outperforms Mexico in rank and score though both worsened their performance since 1996. As to Poland, which has been doing noticeably better than Mexico on all accounts except regulatory quality, the distance to Egypt widens even more. Poland tends to be in the uppermost quarter with the exception of rule of law and control of corruption where it still maintains a better position than Egypt.

While the above indicators capture how Egypt is generally perceived in opinion polls and surveys of businessmen, we now turn in the next sections to an analytical narrative of the institutional environment of economic reform. This should allow for an appreciation of the political and institutional context in which economic decisions are made, and to explain the perceptions captured in the aforementioned ranking.

3. Constitutional Framework

3.1 Background

Constitutions tend to be deceiving. In spite of the fact that most constitutions in the world include language that is similar in establishing and guaranteeing basic rights, including rights of freedom, belief, association, expression, ownership, and fair trial, the extent of variation in practice and frequent abuse of such rights illustrates the extent to which constitutional principles are not in themselves a sufficient guarantee. Judicial independence and the role of civil society in monitoring such practices are equally important in determining the final outcome. Hence, this chapter does not confine itself to Egypt's constitutional provisions, but rather addresses the context by which such provisions are complemented by laws and regulations and are put into practice.

Egypt's current constitution was issued in 1971, and has only been amended once since that time, in 1980. In spite of the fact that it is not Egypt's first constitution, it was an early sign of the regime's determination to return to a state of normalcy and of institutional rule of law following the 1960s during which the legitimacy of the regime was derived from its revolutionary credentials, its achievements in liberating the nation from foreign occupation, and its record in achieving social transformation. The 1971 constitution, however, was careful in also preserving the status quo, and thus its provisions reflect mixed messages and ideologies as will be described below.

3.2 Basic Rights

The Egyptian Constitution embodies a number of fundamental principles. These include multiparty political system (Article 5), equality of citizens and non-discrimination (Article 40), personal freedom (Article 41), religious freedom (Article 46), freedom of expression (Article 47), press freedom (Article 48), freedom of association and of forming organizations, syndicates, and unions (Articles 54 to 56), and judicial independence (Articles 65, 165, 166, and 168). The Constitution embodies the separation of three powers: legislative, executive, and judicial. The political system is a presidential, highly centralized, one. Even the de jure autonomy of certain State organs remains de facto a legal construction that is often not substantively observed.

3.3 Economic Foundations

The Egyptian Constitution carries a significant bias toward socialist principles and central planning. Egypt is described as a socialist democratic country and its economic system as socialist democracy (Articles 1 and 4). The economy is to be organized in accordance with development plans that guarantee fairness of distribution, the elimination of unemployment, guaranteed minimum wages, and the tying of wages to production (Article 23). More broadly, each citizen is deemed to have the right to participate in the country's national product (Article 2), based on the overall notion that the means of production are controlled-albeit not owned-by the People (Article 24).

Property is recognized as private, public, and cooperative (Article 29). Public property is the most prominent as the public sector is considered to "lead progress in all fields" (Article 30), whereas private ownership-although protected (Article 34)-is represented by "non-abusive" capital (Article 32). Only one specific restriction on private property is explicitly stated in the case of land ownership, although it is stated as being regulated by law without further specification in the Constitution (Article 37). General sequestration of property is forbidden (Article 36) although nationalization remains an option within the restrictions that it be regulated by law, for the public interest, and against fair compensation (Article 35).

The Constitution provides certain social and welfare guarantees. Employment, for example, is deemed "a right, a duty, and an honor guaranteed by the State" (Article 13). Employees are entitled to participate in the management and profits of projects in which they are employed (Article 26). Cultural, social, and health services are guaranteed by the State (Article 16), although not explicitly stated to be freely provided. Every citizen has the right to be educated (Article 18) and education, provided by State institutions, is free (Article 20).

3.4 Higher Constitutional Court

One of the most valuable additions made in the 1971 Constitution is the establishment of a Higher Constitutional Court (Articles 17-178). This is the court with the sole jurisdiction to review and decide upon the constitutionality of laws and decrees. It is also entitled-although not on an exclusive basis-to interpret laws. The introduction of the Higher Constitutional Court into the Egyptian legal system is one of the most remarkable and effective developments in upholding the spirit and letter of the Constitution. Since its establishment, this Court has acquired a reputation of independence and integrity which has continuously been reinforced by its readiness to declare laws unconstitutional even when they were strongly advocated and supported by the government. This has been the case both with laws pertaining to the overall political and civic governance of the country as well as more specifically in matters of economic legislation. Relevant examples include the decision by the Court to declare unconstitutional various parliamentary elections laws, Law No. 84 of 2002 regulating the establishment and operations of civil non-profit organizations, and Law No. 208 of 1994 concerning the imposition of an income tax on Egyptians working abroad.

3.5 Islamic Law and the Constitution

The whole basis and philosophy of the Egyptian legal system seemed to be heading toward a complete change as a result of the amendment of Article (2) of the Constitution. Previously, this Article stated that the principles of Islamic Shari'a (Islamic Jurisprudence) were a source of legislation. The 1980 amendment altered the wording of this Article so that principles of Islamic Shari'a became the principal source of legislation. The amendment-part of a limited referendum on a number of changes in the Constitution, including allowing the president of the Republic an unlimited number of renewals of presidency-is now considered to have been an articulation of the growing tendency to legitimize the State's policies and standing on Islamic terms, appease the growing Islamic movement, and lure mass support for a leadership whose popularity was severally reduced. In the end, very little in substantive legislation was affected by it. It did, however, confuse the nature of Egyptian law and shed doubt on the legality and constitutionality of many laws and policies. Addressing this issue, the Higher Constitutional Court did not face the problem head on, but rather succeeded in limiting the effect of the amendment by asserting that it was a principle directed at the members of the legislature when considering and issuing new laws, but was not in itself a reason to strike out any laws on the basis of unconstitutionality.

3.6 The Debate on the Amendment of the Constitution

Provisions of any constitutional text are intended to be broad and on the whole unspecific in order to provide the overall basis for the legal system in the country and to establish the principal foundations for the organization of the state and its governance institutions. It is not surprising that the articles of the Egyptian constitution adopt the same approach in laying down the broad principles and avoiding details of legal treatment. However, in doing so, the Constitution adopts language that is often not merely broad but too unspecific, thus conveying contradictory messages. The Constitution undoubtedly is based on the premise that socialism and central planning are the basis of economic policy. But it expresses this position in language that is also careful in respecting private property, then again ensuring that it is referring to "non-abusive" capital. The same attitude may be identified with regard to other matters. Freedom of expression is protected, but only "within the limits of the law, of self criticism, and of constructive criticism" (Article 47). In the same manner, each citizen has a right to the national product of the nation but with respect to his/her work or "non-abusive ownership" (Article 25) and the State "guarantees the conciliation of women's duties toward their families and their work in society, and their equality with men in political, social, cultural, and economic fields, without prejudice to the provisions of Islamic Shari'a" (Article 11).

It is this unspecific, non-committal language that has perhaps allowed the Egyptian constitution to survive with limited alteration for more than three decades. This is particularly remarkable in view of the fact that those three decades have witnessed a radical shift in economic policy, expressed in measures and laws that allowed the gradual opening up of the economy and even a certain amount of privatization. This transformation has not gone unchallenged. But in 1997, the Higher Constitutional Court ruled in favor of the Public Business Sector Law (more commonly known as the Privatization Law) No. 203 of 1991 on the basis that references to socialist principles in the Constitution are not in contradiction with a policy that aims at expanding the basis of asset ownership among the People.

No less controversial is Article (148), which grants the president of the Republic the power to declare a state of emergency, provided it is submitted to the parliament within fifteen days (Article 148). Although the principle of granting the president such powers in itself is widely accepted, the length and perpetuity of the state of emergency and the unspecific determination of its nature in the Constitution are often the subject of criticism as they render what should normally be an exceptional situation more of a general condition.

It is in this light that the debate concerning the amendment of the Constitution should be seen. A debate has been forming recently around the whole subject of constitutional review. Traditionally, opposition parties have made the focus of such request Article (148) of the Constitution as discussed above, as well as Article (76), which provides for the selection of the president through a two-stage process and not through a directly contested election. More recently, the debate has included wider reforms for the political system.

In spite of the importance of the issues mentioned above, a more important debate needs to take place and to be a public and transparent one concerning not merely the political governance process but also the economic foundations of modern Egypt, the relation between State and religion, the role of women in society, and the level of welfare to be provided to people. This debate may have to draw attention to the need to differentiate between rights and their regulation, for as it stands, the Egyptian constitution tends to guarantee rights and regulate them in the same breath and thus has given much leeway for their over-regulation by the state.

4. The Law Making Process and the Quality of Regulatory Reform

4.1 Composition

The legislative authority in Egypt is represented by Parliament, itself consisting of two chambers: the People's Assembly and the Shura Council. The People's Assembly is the elected body of representatives-except ten members appointed by Presidential Decree-entrusted with issuing laws. The Shura Council is a consultative body, the members of which are two-thirds elected and one-third appointed by Presidential Decree. The Shura Council was instituted as part of the 1980 amendment to the Constitution.[5]

The People's Assembly fulfills various functions in addition to issuing laws. These include reviewing the State's budget and approving its closing yearly accounts (Articles 86 and 118), supervising the performance of the Executive Authority (Article 86), and determining the validity of its own membership (Article 93).

The Constitution does not specify any particular election system or procedures. However, it does state that at least half of the members of the People's Assembly must be workers or peasants as defined by the law (Article 87), that voting must be through a direct, public and secret process (Article 87), and must be undertaken under supervision of members of the judiciary (Article 89). The lack of specific reference to a particular type of electoral system, rules, or principles has led to some legal confusion (and constitutional challenges) concerning which best system to adopt. The current Election Law, No. 13 of 2000 has not faced the same kind of constitutional challenge. The elections conducted in 2001 under this law were the first to be entirely under the direct supervision of the judiciary, although the degree of fairness and transparency seemed to have varied from one place to the other depending on local circumstances. Recently, however, the president of the Republic announced that a new election law may be forthcoming, but no further details were offered. How the country proceeds on this matter will undoubtedly affect Egypt's ranking in terms of voice and accountability.

The fact, however, that the People's Assembly itself is by virtue of Article (93) of the Constitution empowered to decide on the validity of its membership is an unusual and unsatisfactory position, as it allows the members themselves to decide on matters that pertain to the validity of their own election, thus casting doubt on the potential conflicting interests that may be involved in such a situation.

4.2 The Law Making Process

Laws are proposed by the GOE and communicated to Parliament by the president of the Republic, or are proposed by members of the parliament. A draft law prepared by the government will typically be accepted in principle by the Cabinet of Ministers, then reviewed by State Council and the Ministry of Justice. Upon the final approval of the draft law by the Council of Ministers, it will be formally sent to the President of the Republic who has the power to refer it to Parliament. Recently the ruling party-the National Democratic Party-has started to play a significant role in the debate that precedes the formal proposition of legislation to Parliament. Once approved by Parliament, the draft law is sent back again in its final form to the president of the Republic, who will either approve the law and formally issue it, or will disapprove it. In the latter case the President may return the draft law to Parliament within 30 days. If Parliament again votes on it favorably by a two-thirds majority, then the law is deemed approved.

The president of the Republic, in addition to formally issuing laws approved by Parliament, has some significant powers in issuing presidential decrees that have the force of law. Such powers are used in two cases: during the parliamentary recess provided exceptional and emergency conditions warrant the use of such powers; in this case, such decrees have to be rectified by Parliament or else they are deemed null and void. The second case where the president has the authority to issue such decrees is upon the delegation of Parliament itself by a two-thirds majority vote.

4.3 Effectiveness of Law Making for Regulatory Reform

The process described above is based on clear and specific procedures which ensure that laws are reviewed and discussed in a transparent manner in Parliament. The practice, however, leaves a lot to be desired, especially with respect to economic legislation.

In recent years, economic legislation has suffered from a number of problems which have had a negative impact on the quality of regulatory reform (both in the sense of policy making and policy execution). The first of these problems is the relative detachment of economic policy from the legislation that accompanies it, as was, for example, the case with the recent enactment of the Mortgage Finance Law No. 148 of 2001 which was issued in isolation from the rest of the policies, institutions, and rules required to put its provisions in application. The result is that more than two years after its enactment, the law has not been applied. The second problem is the lack of sufficient basic legal and market research in the possible effects that a new law may have, leading to continuous changes and amendments even in newly enacted laws.[6] The third problem is the lack of coordination between the various entities entrusted with the preparation of the draft laws within the governmental system, leading to competing drafts for the same subject matter, as is the case with efforts to issue a law governing small and medium enterprises and with the efforts to issue a competition law. Alternatively, this confusion may also lead to laws conveying conflicting signals and policies, as was the case with the Special Economic Zones Law Number 83 of 2002 which liberalized the labor regime for projects established within the new economic zones whereas the newly enacted Labor Law No. 12 of 2003 reiterated the traditional employee protective provisions which the Economic Zones Law attempted to circumvent. Irrespective of which attitude is the better one, the mere existence of two systems with regard to such an important social issue represents an unhealthy duality. The whole lawmaking process also suffers from the lack of organized and institutional mechanisms for providing the law makers-especially members of the parliament-with the continuous technical support and expertise that allows them to properly assess and contribute to the debate in a constructive manner. A forthcoming study by the Center for Development Research (ZEF) at the University of Bonn in Germany has looked into these issues in detail.

4.4 The Law Making Process and Inclusiveness

The process of design and formulation of laws and regulations lacks benchmarks of inclusiveness. As much as the participatory dimension is measured during the process of government selection, there is little in terms of measurement of the participatory dimension of the law making process. Laws and-less so-regulations are embedded in a process of design, formulation, issuance, implementation, and corrective feedback.

In each stage of this process there could be room for various stakeholders to voice their opinion on the process, its outcome, and its impact. The law making process can be made more inclusive when it becomes more representative of public interests and more open to pubic deliberation, i.e. when more interested parties are allowed to express their views. The best of all worlds is one in which not only the few would have the opportunity to voice their opinion but as many stakeholders as possible could do so and in as transparent and accountable a manner as could be. The aforementioned forthcoming study by ZEF also looks into these issues.

The ruling party has recently been contributing positively to widening the debate on future policies and draft laws. There is an increasing tendency to involve think tanks (e.g. Egyptian Centre for Economic Studies and Economic Research Forum), interest groups (business associations and chambers), professional associations (lawyers, accountants), and individual experts in the process of deliberation on new or amended laws. The process is being gradually institutionalized. However, Egypt has still some way to go to achieve equal opportunity-especially for the less privileged-in a transparent process of deliberating laws and regulations.

5. Government Effectiveness and Accountability

Government effectiveness in running daily operations and delivering services is measured in most polls and surveys by asking questions related to public utilities and infrastructure, bureaucratic service, economic management, and commitment to policy. In this section, we trace the characterizing features of bureaucratic effectiveness in Egypt and their role as impediments to accountability of the government process.

5.1 Constitutional Basis

The dominance of the president of the republic over the Executive Authority is an important feature of Egypt's constitutional basis.[7] Not only are ministers appointed, removed and their portfolios determined by Presidential Decree (Article 141), but the Constitution is based on the assumption that the powers of the ministers are derived from those of the president. Thus the president presides over the meetings of the Council of the Ministers which he attends (Article 142). He is also accorded the power of issuing executive regulations to various laws though he may delegate it to ministers (Article 144). The president also issues decisions necessary for the establishment and organization of public authorities (Article 146). 5.2 Local Government Government in Egypt is decentralized and divided into independent administrative units; governorates, cities, and villages. Each level has its corresponding locally elected council, half of which at least must be composed of peasants and workers (Constitution, Articles 161 and 162). Governors have the authority of the president of the republic in their respective governorates, except in matters that are deemed of a sovereign nature. However, the fact that governors are appointed and removed by presidential decree is the main factor, which-for all practical purposes-reduces their independence.

5.3 Inter-governmental Cooperation

The formal venue for inter-ministerial cooperation is the Council of Ministers, where the whole government policy is determined. Specific files and subjects are often assigned to a group of ministers or ministries to pursue collectively. In addition, significant cross-representation exists on various boards and councils where different ministers would be represented, as is the case with the board of directors of the Central Bank of Egypt.

However, in terms of jurisdiction of ministries concerned with the management of the economy, some overlap and confusion exists. Until 2001, there existed a Ministry of Economy with overall responsibility for economic affairs. The Central Bank of Egypt, the Capital Market Authority, the Insurance Supervision Authority, the Companies Department, the Mortgage Finance Authority, and the Financial Leasing Register all reported to the Minister of Economy. Other ministries directly involved in the management of the economy were the Ministries of Finance, Planning, Public Enterprise, and Foreign Trade. However, in 2001 the Ministry of Economy was abolished and its previous competences were distributed as follows: the Central Bank of Egypt was to become independent and to report directly to the prime minister (later following the issuance of the Banking Law to the president of the republic); the Capital Market Authority was to go to the Minister of Foreign Trade, the Mortgage Finance Authority to the Minister of Housing, the Insurance Supervision Authority to the Minister of Planning, and both the Companies Department and the Financial Leasing Register to the General Authority for Investments and Free Zones.

The outcome of this transition was to fragment financial regulation among various ministries and sacrifice the major method of intergovernmental cooperation that had existed through the unified supervision of one ministry. Moreover, in some cases the redistribution of supervisory authority led to unsatisfactory conclusions, as was the case with the transfer of supervision over the Mortgage Finance Authority to the Ministry of Housing. This should also be contrasted to the world trend as of the late 1990s to unify and consolidate financial supervision under one roof and to reduce the fragmentation of economic and financial regulation.

As indicated earlir, this fragmentation is expected to be averted by the establishment of the Ministry of Investment, which is now responsible for the Investment Authority, the Insurance subsector, the capital market, mortgage financing and the public enterprise sector

5.4 Parallel Systems

One of the most important developments that have occurred in the overall structure of the Executive Authority in Egypt in the last decade has been the increasing reliance and enlargement of parallel systems within government ministries and other public organs. Parallel systems in this context signify the administrative layer that gets to be imbedded into a traditional bureaucracy, usually benefiting from additional resources not available to the traditional track and with direct access to the decision making persons, usually to the ministers themselves.

The rationale for introducing these parallel structures in Egypt was quite straightforward: the difficulty of attracting the needed kind and level of expertise, talent, and skill on the basis of the traditional employment terms of the government. To be able to hire experts with skills and knowledge and experience compatible to those available to the private sector-often to the international market-the government would need to pay private sector, international remuneration. In the absence of any possibility in the current circumstances to raise the overall level of salaries and compensation within the government bureaucracy, parallel structures are an obvious and reasonable alternative.

Parallel systems, however, need to be properly set up in order to avoid some of their potential negative consequences. Chief among these consequences are: (i) the potential fragmentation of the bureaucratic apparatus, leading to the issuance of conflicting opinions and positions by the same institution; (ii) the risk of frustration and discouragement among those in the traditional track; (iii) the risk of discontinuity of the parallel system especially when it is not sufficiently integrated into the traditional track; and (iv) the problems caused by the lack of accountability of those in the parallel system. The latter problem is particularly worth consideration. Often those in the parallel system combine two characteristics that are inherently contradictory, one is the capacity to influence the decision makers more than those in the traditional track, and the second is the lack of formal mandate as the legal and formal responsibility remains with those in the traditional positions.

It may not be possible for Egypt in the short term to abandon the experiment of parallel system-especially since it has also provided a number of successful examples. But it is also necessary to redress some of the short-comings of this experiment, especially by ensuring a serious degree of cooperation and integration between the traditional and parallel systems, and by ensuring that every government employee, whether in this track or the other, is accountable and responsible for his/her actions and decisions. Accountability of those in formal office to the public opinion is a necessary safeguard for government effectiveness and regulatory quality.

6. The Judicial Authority and the Rule of Law

The Egyptian Constitution guarantees the independence of the judiciary. Moreover, it provides that court hearings are public except if so decided by the court itself (Article 169), and that there is an independent track for administrative adjudication (Article 172).

6.1 Selection and Structure

The selection of members of the judiciary is based on the graduation marks of law students from the various faculties of law. This allows them to become members of the public prosecution service first, through which they progress for a few years until they are ready to either join the judiciary or proceed in their prosecution careers. The selection process is fair, in the sense that those graduating top of their classes will normally be entitled to join the ranks of the judiciary irrespective of their personal or family connections. Whether reliance on the university grading system is necessarily conducive to the best selection outcome or not is a different matter and is one that pertains to the whole education process.

All litigation is conducted in a preliminary stage which may be followed-upon any of the party's request-by an appeal process. Ordinary litigation may then be subject to further review by the Cassation Court, whereas administrative litigation may be reviewed by the Higher Administrative Court. The Constitution provides that the accused is deemed innocent until proven otherwise (Article 67), that crimes must be defined in law and penalties are personal and may only be imposed by court decision (Articles 66 and 67), that no administrative decision or act may be immune from judicial review (Article 68), and that each individual has the right to be prosecuted by his/her "normal" judge (Article 68). The latter provision has caused significant debate in recent years in view of the jurisdiction granted to military courts over certain state security crimes.

6.2 Integrity, Consistency and Efficiency

Although the Egyptian judiciary maintains a reputation of integrity, independence, and fairness, its overall state has increasingly been the subject of criticism by observers, professionals, investors, and ordinary parties alike due to the time that it takes to resolve disputes through the ordinary judicial channels, and to the uncertainty of the outcome of litigation. This criticism has been reflected in the country's score on two specific questions in the Global Competitive-ness Report of 2003-04.[8] Observers of judiciary performance on the ground would find this criticism true; an ordinary course of civil or commercial litigation is likely to take several years before it is finally resolved. Most of the delay is typically caused by procedural tactics adopted by whichever party is keen on maintaining the status quo. Justice delayed to this extent must in some measure be denied irrespective of its outcome. This delay has also been the cause for other ailments of the judicial system, including resorting to extra-judicial and illegal means of enforcing rights. It is this aspect of the judicial process that has probably caused Egypt's ranking in terms of rule of law, and the reform of the judicial process has become one of the most pressing issues today.

The above problems are particularly acute and relevant with regard to disputes relating to economic and commercial activities. Here the judicial system has reached a point where it is no longer responding to the basic requirements of investors-foreign and Egyptian alike-the need for simple judicial redress. The delay in resolving commercial and financial disputes translates directly into tangible transaction and opportunity costs. Moreover, with the increasing sophistication of capital market, banking, financial leasing, and other financial transactions, it is not any longer possible to rely on the traditional unspecialized training of members of the prosecution and judiciary alike.

6.3 The Debate on Specialized Courts

The above problems have led to the emergence in the last few years of a growing trend in legal circles that argues for the establishment of specialized commercial or economic courts. The pragmatic rationale behind this approach is undeniably attractive; commercial disputes would be reviewed and resolved by specialized courts with dedicated and better-compensated commercial judges, faster procedures, lower costs, and more certain outcomes.

However, there are some drawbacks to this approach. On the one hand, there is the difficulty of determining which types of disputes deserve such fast track treatment and which do not. Under the criterion of cost of finance, banking and capital market activities would certainly come first. However, from the point of view of attracting investment, disputes relating to company law, investment law, labor law, and insurance would also qualify. Once the principle of differentiation between urgent disputes and less urgent ones is accepted, every constituency will lobby for the special treatment of its activities.[9] On the other hand, even if it were possible to properly define and carve out an area of law which would be subject to special litigation, it would not be possible to insulate it entirely from the rest of the legal system, and parties to litigation would ultimately be brought back again in the traditional track. Another potential risk in adopting this pragmatic approach is that where special emphasis is placed on one section of the judiciary it is bound to lead-perhaps inadvertently-to the relative decline of the rest of the system.

Comprehensive legal reforms are thus unavoidable if a real change in the degree of judicial efficiency and certainty is to be achieved. And within this overall reform, there should be scope for better compen-sation of judges, providing specialized training programs and career paths for them, a review of the cumbersome litigation procedures, and a reform of the legal profession.

6.4 Corruption

High indicators of corruption are a reflection of weak governance, accountability, and inclusiveness.[10] However, there is a debate on whether corruption greases the wheels of growth or sands them.[11] This argument is complex because of the variety of corruption indicators and the non-linearity of a country's corruption rates and its economic performance. Corruption's influence on growth is often mediated through a wider institutional environment of effective bureaucracy and rule of law.

In the case of Egypt, indicators (as measured by the Global Competitiveness Report [GCR]) manifest a case of medium corruption rates, as perceived by businessmen responding to the GCR survey. Of a total of 13 questions on corruption, Egypt's score on eight questions is slightly above the mean (of the score of 102 countries), surpassing the scores of Morocco, Poland, and Mexico. On five questions its score is slightly below the mean (Annex B, Table B4.3).

However, some telling issues need to be stressed. The 13 questions on corruption in public institutions may be seen to represent two different levels of irregularity. One level is that of high corruption or political state capture. In this case, state decisions on laws, regulations, and public policy are directly influenced by big business individuals to the benefit of the business firm or individual. This includes questions about decisions favoring individuals, irregular payments in public contracts, irregular payments to influence policy or judicial decisions, and diversion of public funds to the benefit of a firm, individual, or business group. On all of these questions, Egypt's score is slightly above the mean score of the 102 countries in the data set. Nevertheless, one question is telling of the general environment of trust. When asked how much they trust political officials' financial honesty, businessmen's responses made Egypt come off worse than Morocco, Tunisia, and Jordan (Annex B, Table B4.3), indicating a prevalent sense of high level corruption and a medium sense of state capture.

The other level of corruption is that of bureaucratic corruption in which many more bureaucrats are involved. Though difficult to measure, five questions in the GCR may be used as proxies. On four of the five questions, Egypt's score is below the mean score for all 102 countries. An indicator of this lower level of corruption needs to take note of the increasing number of interlocutors who crowd the corridors of many bureaucratic agencies. Though they often get the work done, they are often intermediaries in the process of bribery and public resource diversion. Moreover, they are not account-able to anyone and no minister or head of department can reprimand them for any wrong doing or commit them to bureaucratic reform.

Egypt's score and its performance with respect to the combating of corruption could be improved. New laws are not needed so much as greater transparency in the decision making process at all levels which would allow for the growth of a sense of responsibility and accountability.

7. Investment and Business Environment

7.1 Background

The term investment and business environment has become synonymous in the current usage and literature with a wide range of laws, regulations, policies, and customs that collectively form the environment in which business is conducted. The mere realization by the Egyptian government of this notion and what it entails is in itself a breakthrough in so far as it diverts from the long established policy of promoting one aspect of the investment environment without sufficiently considering its wider context. The following sections will describe the central idea of investment promotion in Egyptian regulation over the last three decades. This will be followed by an assessment of capital market regulation, corporate governance standards, and will conclude with an assessment of the investment regime from a regulatory and institutional perspective. This all must be considered in the broader context of political and institutional governance described in the previous sections.

7.2 The Investment Law Regime

Since the early inception of the return to a more open market economy in the early 1970s, one central idea has dominated the thinking of policy makers in Egypt, which is that investors-originally foreign and later local-must be presented with a sufficient amount of incentives, tax and otherwise, in order to encourage them to invest in Egypt.

The first law to express this policy was the prematurely enacted Law No. 65 of 1971, which identified certain fields of investment and offered foreign investors in those fields generous benefits and privileges.[12] Following the conclusion of the 1973 military confrontation between Egypt and Israel, a subsequent investment law had a better chance of success. This was the Arab and Foreign Investment and Free Zones Law No. 43 of 1974, also known as the "Open Door Law." The law did not differ much from its predecessor. The highlighting of "Arab" capital versus "foreign" capital was a mere expression of post-war courtesy to potential Arab investors expected to reward Egypt's political and military sacrifices with significant investments. In fact, the investment law did not discriminate between nationalities, but rather between sources of capital. Thus any foreignor "hard" as it was described then-currency transferred from abroad through official channels was eligible for the benefits accorded to Arab and foreign capital, irrespective of the nationality of its owner. This Investment Law was significantly amended in 1997-in accordance with Law No. 3- and later entirely replaced by another Investment Law No. 230 of 1989. In 1997, the current Investment Guarantees and Incentives Law No. 8 replaced the preceding one and remains the main legislation in the investment regime, and in April 2004 it was again amended, this time by Law No. 13.

Throughout these developments, the central idea that attracting investments in certain priority fields-which changed with each new law-requires the offering of tax, customs, and other benefits has not been altered.[13] The current legislation also provides investors with certain guarantees, including immunity from nationalization, compulsory pricing, and the right to own real estate property (Law No. 8 of 1997).

There is no doubt that the investment regime has been successful in attracting local and foreign investments, albeit with varying degrees of success throughout its time. But two shortcomings have persistently plagued this regime; the first is the often unclear rationale for the inclusion of certain industries and activities in its scope in a manner that reflects particular interests; and the second is the excessive reliance on offering tax and other exemptions as a means of attracting investors. An overall investment climate that includes macro-economic stability, sound monetary policy, an effective payments system, a predictable and efficient judicial system, sound corporate governance practices, fair and predictable taxes (but not necessarily tax exemptions altogether), flexible labor regulations, adequate communications infrastructure, and general comfortable living is what constitutes an attractive investment climate.

Recently, however, a new law was passed under the name of the Special Economic

Zones Law No. 83 of 2002. The significance of this law is that instead of being exclusively concerned with the traditional tools of attracting investment, such as tax holidays and customs exemptions, it is the first attempt to deal with the investment environment in its totality. Thus, unlike its predecessors, this law grants not a full tax exemption, but a reduced unified tax rate on all activities and incomes generated in the zone which it covers, equal to 10%. It also attempts to deal with issues of taxation and customs clearance not by merely reducing the rates, but by instituting new and alternative methods of tax and customs administration in the hope of reducing the bureaucracy involved dramatically and allowing it to function-with the help of private sector agents-in an efficient manner. Further, the law exempts employment contracts entered into between parties engaged in activities inside the designated zone from the strict constraints on downsizing the labor force found in the Egyptian Labor Law. And finally the Special Economic Zones Law sets out certain rules and provisions for the planning of the relevant zone and the construction of infrastructure in a manner intended to reduce the administrative burdens associated with traditional zoning and local council supervisory rules.

However, this law, by instituting new principles within a limited zone, raises a whole new set of issues concerning the duality of the legal system, especially in the absence of justification-except political concerns-for improving the regulatory environment inside a fenced zone and leaving the rest of the economy under traditional controls.

7.3 Capital Market Regulations

Unlike the investment law regime in Egypt, capital market regulations showed a significant development over the last decade in the direction of strengthening the regulatory framework and encouraging investors by granting them the protection of a well regulated system.

The current capital market law was issued by Law No. 95 of 1992. This date marks the reactivation of the capital market in Egypt after almost three decades of inactivity.[14] In 1992 the market was reinvigorated not by the mere issuance of a law, but by the initiation, a few years before, of a privatization program. But the reactivation of the capital market in Egypt carried a heavy burden inherited by investors and regulators alike as a result of the collapse of the Islamic investment companies in the second half of the 1980s. This experience affected the regulatory approach of legislators and regulators alike and brought about an excessive bias toward systemic risk concerns and over-constraining the market. The built-in assumptions in the capital market law are to restrict all securities activities unless explicitly authorized and licensed by the Capital Market Authority. The Authority has wide powers as regards to the licensing of securities companies, the supervision over their activities, and the canceling of illegal or suspicious trades.

That a legal system and a regulatory authority stress so much the issues of systemic risk and market failure is not in itself surprising, nor objectionable. Recently, however, this excessive bias began to make way for the recognition of the need to deregulate the market from unnecessary constraints, and to take an investor protection-based approach to regulation. This change in approach is evident in the changes in the regulatory environment in the securities market as of the late 1990s.

In 1998, new rules of conduct for brokers and portfolio managers were added to the Capital Market Law Executive Regulations. The emphasis in these rules was entirely on strengthening the disclosure requirements, clarifying the conflict of interest rules, and providing new protections for the small investor when dealing with one of these securities companies.[15] This was followed in 2000 with the establishment of a settlement guarantee fund which ensures that all transactions traded on the exchange are properly and accurately concluded until settlement without interruption or risk of default. And finally, in 2000 the Central Securities Depository Law No. 93 was issued to improve dramatically the settlement process of securities trading and eliminate some of the most risky concerns in the securities market.

7.4 Corporate Governance

Until a few years ago, governance of corporate entities was an academic concern that did not attract much attention among policy makers. Its rise to prominence has been quite remarkable and indicative at the same time of the importance accorded recently by various officials and regulators to the need to conform to international standards.

On the whole, principles of corporate governance are observed in Egyptian law. This reflects in particular the developments that took place in the area of law and regulatory reform for companies and securities trading. Moreover, the draft Unified Company Law-still under discussion-closes most of the remaining gaps and responds to most outstanding issues.

The weakness that will continue to exist for some time, however, with regard to corporate governance is less related to the texts of the company or capital market laws themselves than to two other related factors. The first is the need to raise public awareness with regard to the importance of good governance and minority rights among investors; and the second is to strengthen the judicial recourse accorded to those whose governance rights are infringed upon.[16]

7.5 Property Rights

Clear and reliable property rights allow economic agents to protect and make use of their assets, which enhances their disposable wealth and their well-being. Well-protected property rights also serve to attract investors

In Egypt, property rights are poorly recorded and therefore inadequately protected. It is rare to encounter a household in Egypt that is not either involved in real estate disputes or is unable to ascertain its rights over a certain asset. In addition to the direct economic cost for the society for failing to provide individuals with the certainty of ownership, other indirect costs that are rarely accounted for include the cost of litigation both for the parties involved as well as for the judicial system, and the psychological costs of people living in a state of uncertainty concerning what is often their most valuable asset. The reason for this failure to register and protect real estate ownership was too often associated with the high cost of registration. More recently, however, it has become clear that the registration fees are but one aspect of the problem. Informal ownership is now deemed to be the result primarily of a wholly inadequate legal and regulatory framework which relies on formal requirements that are often difficult to fulfill and are in any case of little substantive value, thus leading to the perpetuation of informality and the use of illicit payments even by those willing to pay the required fees.

The issue of informal ownership does not affect real estate assets alone, but has a bearing on ownership rights of movable assets as well, including intangible intellectual property rights. A recently enacted Intellectual Property Protection Law No. 82 of 2002 promises to improve the overall environment, but its application remains to be sufficiently comprehensive. The GOE in any case is putting significant resources and effort in ensuring a more serious application and respect of the law.

It should also be noted that a few positive developments have taken place in this field. Research undertaken over the last few years by the Peruvian Institute of Liberty and Democracy in collaboration with the Egyptian Center for Economic Studies has had a significant impact in raising public awareness on this matter. Certain property rights, such as ownership of financial securities, are now properly recorded and protected in a manner consistent with international best practice. This was the result of a long but consistent process of legal and regulatory reform in the field of the capital market legislation as previously described. And although this type of ownership, compared to real estate properties, is but a minor "fringe" type of ownership, its protection does provide a precedent and an indication that the authorities are taking the matter seriously.

Moreover, with the gradually increasing public awareness of the need to formalize property rights in Egypt-both real estate and business-there is a great chance that this matter will be translated into policy in the near future. This would have a major impact not only on the general investment and business climate, but also on the overall rule of law perception as it will allow people to fully enjoy the fruits of their legal property and will reduce litigation and disputes concerning such property.

8. Civil Society, the Media, and Civic Liberties

An active civil society has come to represent a fundamental component of good governance. Firstly, civil society is the place where social capital is to be found, and that entails rules and networks of collective action, cooperation, compromise, and trust. This is true of charity NGOs, of NGOs that focus on service delivery as well as advocacy, and NGOs that focus on advocating the rights of consumers and economically and politically marginalized citizens. Secondly, civil society, especially advocacy NGOs, provides the institutional infrastructure for keeping government and bureaucracy accountable to a vast majority of citizens more frequently than during elections and beyond the accountability associated with parliamentary supervision of the Executive. Thirdly, advocacy NGOs are also capable of making the private sector accountable to general welfare. This is particularly true of advocacy and consumer protection NGOs.

Although the Egyptian constitution guarantees fundamental civic liberties as mentioned under sections III.a and III.b, there are three factors that weaken the ability of civil society organizations in Egypt to fulfill that role. These factors are: (a) rules that regulate their relationship to government, to the private sector, and to each other; (b) the media; and (c), a weak culture of compromise and organizational/ managerial skills.

The rules governing civil society in Egypt are affected by the state of emergency, which has been regularly renewed since the 1980s (renewed in the 1990s in three-year intervals in 1994, 1997, 2000, and 2003). Such a situation confers extra discretionary power on the Executive and especially undermines the accountability of the police. Most importantly, it scares NGO activists, especially advocates. Alongside emergency laws, there are also restrictions on public demonstrations (those allowed have to be with permission and within premises of universities, political party premises, syndicates, etc.). Meanwhile, laws regulating the establishment and activities of civil society reflect a philosophy of state control which goes back to the legacy of corporatist government-society relations. This relation-ship entailed subservience of civil society organizations to a state which claimed to be modernizer of society, producer and provider of most goods and services, and guarantor of the general interest. That was the spirit that guided Law 32 of 1964 regulating civil society activities until the late 1990s.

The transition period stretching over the 1970s and 1980s was a period in which the government gave up some of its revolutionary, developmental responsibilities and announced its readiness to share some of its responsibilities with the private sector. As the private sector could not promptly shoulder all responsibility, hundreds of civil society organizations (NGOs) were created to respond to the need for charity work, social development, and so on, so that now the Egyptian landscape of NGOs is said to include more than 14,000 NGOs. Most of these NGOs have been governed by Law 32 of 1964, which gave the State the right of permission, supervision, and suspension or dissolution of NGOs. Charity and service delivery NGOs were seen in better light than those of advocacy. To avoid such a situation, some civil society organizations opted to register as non-profit companies (i.e. governed by the civil law).

Law 32 of 1964 was replaced in 1999 by Law No. 153, and then by Law 84 of 2002. The government wanted to enhance its control of a mushrooming civil society that was receiving moral assistance and financial support from foreign governments and multi-lateral organizations. Law 153 of 1999 was considered unconstitutional by the Supreme Constitutional Court on procedural grounds. Thus, in June 2002, a new NGO law, which is based on Law 153, was promulgated after being approved by the Shura Council (Law 84). The new law does remove some of the obstacles and controls characteristic of the old regime and encourages NGOs to expand their financial base (e.g. right to function as juridical entity while Ministry of Social Affairs (MoSA) considers the application, right to engage in productive and service activities to raise funds, right to own real property, and various tax exemptions). However, the new law still bears the mark of a government that insists on having discretionary power over every aspect of civil society activities. Perhaps more importantly, the law maintains the attitude of its predecessors in maintaining the right to dissolve NGOs and to impose a myriad of procedural requirements in a manner that makes compliance the major preoccupation of civil society organizations.[17]

The year 2003 saw one good sign of liberalization of the regulatory regime in which civil society functions. The Egyptian parliament passed a law abolishing state security courts and establishing a national council for human rights. This may help improve the relationship between the state and advocacy NGOs, especially if the national council for human rights takes on the responsibility of monitoring state action against these organizations. Moreover, recent announcements by the GOE have indicated the potential for ending the state of emergency and for reviewing the Constitution.

No civil society can properly function without a strong and independent media. That is because broadcasting and communication to the wider public is one important means of exerting pressure, which has to be available to civil society if the latter is to be effective in keeping the state and private sectors accountable. The law of the press in Egypt has been an example of the dynamic process of liberalizing the regulatory framework of civil society. Law 93 of 1995 raised fines and prison sentences for crimes of defamation and expanded the right of detention of journalists. It was severely criticized by civil society organizations across the board, leading to its annulment by the president in 1996. The situation now leaves two organizations pushing for liberalization, at a time when both have pro-regime credentials. These are the Syndicate of Journalists and the Higher Council of the Press, which has regulatory and oversight prerogatives with respect to the "charter of honor." The latter sets the limits of how freedom of expression would be exercised. Outside of political parties, however, obtaining a license to issue a new publication or establish a broadcasting business remains extremely difficult, often due to excessive capital and other legal requirements. A gesture of good will has been recently made by the president, advocating the abolishment of imprisonment verdicts in "opinion cases" against journalists.

Aside from the legal framework in which civil societies function, a culture of trust, compromise, and organizational/managerial skills is a necessary requirement to the lively functioning of any civil society. Egypt can boast of thousands of NGOs, yet most assessments of their inner workings have spoken of strong hierarchical structures with strong personalities, weak tolerance of differing views, and problematic succession traditions (open fighting when the founding leader dies or when some board members disagree with him/her). The development model adopted since the 1950s has partially contributed to this culture of individualism, cynicism, and little willingness to change things.[18]

In sum, Egypt has a numerically strong civil society. The actual space available for expression of opinion and for action is, however, influenced by how the regulatory framework is in practice understood and implemented. This is where the general will to defend national security and the international image of Egypt often overshadows the goal of defending civil liberties. Nevertheless, there are manifestations of willingness to reform on the part of some elements of the ruling elite. There are also manifestations of a civil society which can mobilize extensive support to press for more reform (when the stakes are high such as in the case of the press law and relatively so in the case of NGO law 153 of 1999).

9. Democracy, Contestability, and Accountability

The Egyptian political system has successfully closed a transition from one-party rule (1954-1976) to a multi-party system (1976-present). It has also experimented with two electoral systems: majority and proportional representation by party lists (1984-1990). This democratic transition has been marred by several weaknesses. Firstly, the political parties, which increased from 3 in 1976 to 13 in the 1990s, have remained organizationally weak. Secondly, the electoral process has been weakened by low turnouts (below 50%), by pervasive vote rigging without judicial supervision (till 2000), and by weak competitiveness among political parties (due to lopsided support for the ruling elite by the various state agencies).[19]

This has left its mark on one cardinal pillar of good governance, namely contestability.[20] Contestability is thus left with two mechanisms outside the multiparty and electoral system. One is that of political leadership selection, which entails in the Egyptian context the selection of the political party(ies) that should dominate a majority inside parliament and the selection of the president who becomes an all-powerful head of state, appointing the prime minister and ministers. Egypt has had a weak record on both accounts. Quantitative indicators in the Kaufmann et al World Bank dataset demonstrate that Egypt had always occupied the lowest quarter of the 100-country dataset since 2000.[21] If one looks at the estimated scores, it appears that Egypt has constantly scored in the negative.[22] That is because political parties are weak in Egypt and the ruling party has enjoyed a two-thirds or more majority in parliament since the return to multiparty parliamentary elections in 1976. Presidential elections have not been any better. Sanctioned by the constitution, presidential elections in Egypt are not competitive, for the public gives a yes/no vote in a referendum in which only one candidate (nominated by Parliament) is present.

Since the parliament has always had a comfortable majority for the same ruling party (which changed names in 1979 from Misr to National Democratic Party [NDP]), there has never been any sign of competitiveness in the presidential nomination process inside parliament either.

The other mechanism of contestability is that of replacement of executive officials via parliament or popular scrutiny through media campaigns.[23] The public in Egypt has only two ways of replacing political figures, namely by exerting enough pressure on parliamentarians to push them to submit ministers to questioning and eventually to a vote of confidence. Or the public may put pressure on members of the executive via media campaigns, especially the written media. Both have occurred occasionally, though rarely have such pressure mechanisms led to the removal of political figures, and in those rare cases, public opinion was usually not credited with having achieved this result.

Two other interrelated areas have negatively affected contestability: political rights and administrative structures. Political rights entail liberal rights that expand freedom of expression and organization. Though allowed by constitution, such rights are often curtailed by an overall sense that national security is in jeopardy and that political activists, whether individuals or organizations, are guilty of jeopardizing national security until proven innocent. The best example of this is the law regulating the formation of civil society organizations. This law still requires a ministerial approval, which often is connected to a security clearance, before an organization is allowed to function.

A highly centralized administrative structure has negatively affected contestability. This type of political structure hampers citizens' ability to keep the bureaucracy accountable by reducing their ability to question and replace provincial leadership (governors) and communal government. Provincial governors are appointed by the president and are often former members of the military-police-security complex. This reduces the overall ability of the political system to have breeding grounds for popularly elected leadership. But most importantly, this reduces the ability of citizens to believe in their ability to change matters of most direct impact on their daily lives. The same goes for the communal level of political action. Though communal elections do exist, competitiveness is limited to the various members of the ruling party. Political parties often are weakly represented or weakly interested to running for local (as opposed to national) elections. Freeing up the provincial and local levels for more competition and contestability is often weighed against the possibility of a radical Islamic figure coming to power or a figure ill-suited to deal with a perceived Islamic danger (if this figure is not from within the police-military-security complex).

10. Conclusion

This chapter has manifested that the process of reform in Egypt's governance structure is partially dynamic and partially too slow. This has been demonstrated both quantitatively and qualitatively. The constitutional framework has been shown to contain some positive elements and others that must be subject to revision. The regulatory environ-ment of laws of investment, capital market, and property rights has manifested a healthy ability to correct itself and respond to market needs. However, where signs of slow reform are still to be seen, there needs to be deep institutional reform in the law-making and law enforcement processes. This chapter has shown why and how could be accomplished. Finally, the political context of accountability and contestability has been shown to similarly exhibit vibrance and self-corrective power, though less so than in other areas. More opening of political positions for competition and a more enabling liberal environment to support NGOs, especially those advocating citizen and consumer rights, could go a long way to improve the environment of accountability of govern-ment, bureaucracy, and private sector alike.

Notes

1 See World Bank Report of 2003 "Better Governance for Development in the Middle East and North Africa" Washington.

2 L. Harrison and S. Huntington (2000) Culture Matters. New York: Basic Books; D. Landes (1998) The Wealth and Poverty of Nations. London: Abacus.

3 A. Stepan and G. Robertson (2003) "An Arab more than Mulsim Electoral Gap" Journal of Democracy, vol 14, #3, p. 30-43.

4 The dataset of Daniel Kaufmann et al produces indicators which cover three cardinal areas of governance: 1) political rights and civic liberties which determine the processes of selection, monitoring and replacement of government (called voice and accountability): 2) the ability of government to formulate and implement policy (called regulatory quality and government effectiveness); 3) citizens' respect for and government's commitment to the rules of the game (called control of corruption and rule of law).

5 The role of the Shura Council, as stated in the Constitution, is merely consultative. Moreover its constitutional role is limited to reviewing laws that have an effect on the basic political and constitutional rights. Based on both considerations, few of the laws passed by Parliament were actually reviewed by the Shura Council in the last few years. This situation changed when, in 2001, the Higher Constitutional Court decided that the newly enacted Law for Non-Government Organizations was unconstitutional because the Government did not send it for review by the Shura Council in spite of it being a law that affects political rights. The consequence of this decision was that now the Government is much more careful to send draft laws to the Shura Council, even if they are not obviously related to political rights, in order to avoid the risk of unconstitutionality. It should, however, be noted that such procedure does not alter the fact that the Shura Council's opinion remains consultative and non-binding.

6 An example that may illustrate this problem is the new Code of Commerce issued by Law No. 17 of 1999 which set out new rules governing commercial papers (particularly bank checks), but

which was amended every two years since that time in order to postpone the application of that part of the Law until the market is ready for it.

7 According to Articles (137) and (153) of the Constitution, the Executive Authority is the Government headed by the President of the Republic.

8 World Bank (2003) Better Governance for Development in the Middle East and North Africa, p.93. The Global Competitiveness Report of 2003/04 shows Egypt's score on the question of independence of the judiciary of political influence falling below the mean score of the 102 countries that have participated in the survey as well as her score about the quality of the legal framework to settle disputes and challenge government (p. 470)

9 As happened recently with arguments made in favor of special courts for small and micro-enterprises, export related activities and special economic zones investments.

10 World Bank Report 2003 "Better Governance for Development in the Middle East and North Africa", p. 32.

11 Forthcoming paper by Pierre Guillaume Meon and Khalid Sekkat (2004) "Does Corruption Grease or Sand the Wheels of Growth?" Public Choice.

12 The chosen fields included banking, tourism, industry, as well as agricultural and land reclamation projects.

13 The current benefits include five, ten, or twenty year income tax exemption depending on the project's location, a five year exemption from certain stamp duties, a flat 5% import duty on all necessary machinery and equipment, as well as other less significant tax benefits.

14 The stock exchange, following the nationalizations of the 1960s was never formally closed, but the absence of traded paper meant that it went in a dormant stage.

15 Executive Regulations to the Capital Market Law No. 95 of 1992.

16 In 2004, an Egyptian Institute of Directors was established and its primary focus and mandate is to promote corporate governance in Egypt.

17 Center for Strategic Studies (2004) Strategic Economic Trends Report, Cairo: al-Ahram, pp. 287-302.

18 I. Harik (1997) Economic Policy Reform in Egypt. Gainesville: University Press of Florida

19 Noha El-Mikawy (1999) Building Consensus in Egypt's Transition Process. Cairo: American University in Cairo Press.

20 World Bank Report (2003) Better Governance for Development in the Middle East and North Africa, Washington..

21 Since 1998, Egypt has occupied a place within the middle group with respect to regulatory quality, rule of law, control of corruption and government effectiveness; however, its rank has been deteriorating between 1996 and 2002..

22 In contrast, Egypt's score on rule of law has constantly been positive, though never crossing the 0.25 mark. Government effectiveness and the regulatory framework seem to have left the negative range in 1998 and 2000 to return to it again in 2002.

23 In response to Dollar's and Kraay's claim that growth is enough to improve the life of the poor, Luebker, Smith and Weeks insisted that the growth package is not neutral in its distributional orientation. A lot depends on the country's social structure and power relations (Luebker, Smith and Weeks 2002; (Dollar and Kraay 2000). That meant

that there is a need to couple growth packages with pro-poor internal institutional reforms (Giovanni Andrea Cornia, 2003). Now the argument is for opening up the political system for civil society to participate in policy design, policy implementation and public goods provision in order to encourage economic accountability and transparency. This debate has been encouraged by a more encompassing definition of economic development which has come to include growth, choice and empowerment. Rule of law to protect citizens' and firms' rights, rule of law to enforce contracts, the freedom of information, and the existence of mechanisms of accountability- all have become crucial components of an enabling environment for economic growth (World Development Report Building Institutions for the Market 2002).

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Chapter Five
Labor and Human Resource Development

1. Overview: Demographic Transition, Structural Change, and Labor Market Performance

Over the past twenty years, the employment situation in Egypt has risen to the top of the public policy agenda as economic restructuring and reform failed to stem high youth unemployment rates and stagnating real wages. Developments in the labor market have been shaped by a combination of two powerful sets of forces: labor supply pressures driven by Egypt's demographics and an on-going structural transformation from a state-led to a market-oriented economy. The growth of the working age population and the rise in its educational attainment have led to the largest ever cohorts of new entrants to the labor market both in absolute and relative terms, significantly boosting labor supply. Currently, 35% of the working age population in Egypt is youth aged 15-24, which is close to the highest proportion ever, which occurred in 1980. The good news is that the labor supply pressures are bound to decline as the proportion of youth begins to decline steadily, starting sometime in the next five years. On the demand side, the slowdown of hiring in the government combined with an absolute decline in the size of the state-owned enterprise (SOE) sector have dramatically transformed the dominant labor absorption mechanisms of the Egyptian economy. These labor demand trends were further compounded by the continuing loss of employment in agriculture, which began several decades earlier, and the slowdown in international labor migration.

Although reforms in the highly inflexible labor market regulations in force since the 1950s have been attempted since 1994, a new labor law allowing employers some flexibility in hiring and firing was only enacted in April 2003. The lag in the adoption of new, more flexible rules at a time of much greater reliance on the private sector for labor absorption resulted in a sweeping informalization of the labor market. The growth of informal employment in Egypt is in part due to the continued importance of small and microenterprises in the Egyptian private sector, but also to the spread of informal hiring practices to large private enterprises, in their attempt to evade highly restrictive labor regulations. Despite the attempts to slow hiring in the government and the contraction of the SOE sector, the public sector continues to be the dominant employer of educated workers in Egypt.

The combination of a galloping increase in labor supply and incomplete structural change on the demand side has produced poor labor market outcomes over the past decade. Based on official statistics, the unemployment rate increased from 8% in 1990 to 11% in 1995, and settled at about 9% in 2001, although the figure for the latter years is probably understated due to changes in definitions introduced in 1997. As was the case in earlier periods, open unemployment is heavily concentrated among educated workers, especially those with secondary school certificates. Of 9.3 million unemployed in 2001, 97% had more than a secondary education, and 69% were only secondary school graduates. This group of new entrants, which consists primarily of technical school graduates is proving to be the hardest to employ. Real wages fell significantly from 1985 to 1995, a period of slow economic growth and painful macro-economic reforms. Real wages appear to have recovered somewhat since then, but most of the improvement was for workers in state-owned enterprises rather than in the private sector.

Gender continues to be a major line of segmentation in the Egyptian labor market. Women are more than four times as likely to be unemployed than men, according to official statistics. Those who work earn significantly less than men in the private sector, even after education and experience have been taken into account. These gender gaps in labor market outcomes are not only large but also appear to be increasing over time. The main culprit for these growing gender gaps appears to be the slowdown in hiring in the government, a sector that treats women fairly equally to men, and the significant barriers to entry women are facing in many parts of the Egyptian private sector.

2. The Evolution of Labor Supply

The growth and composition of the labor force in Egypt are driven by the dramatic increase in the size of the working age population in recent years and its increasing youthfulness, as well as by trends in labor force participation, which are primarily determined by the age and educational composition of the population. In what follows we first examine the growth and composition of the working age population, then analyze the pattern of labor force participation by age and education over time. Based on these trends, we develop labor force projections by sex, age, and educational attainment for the period 2005 to 2020.

2.1 The Demographic Transition and the Age Structure of Working-Age Population

Egypt has been one of the first countries in the Middle East and North Africa (MENA) region to initiate its demographic transition. Nevertheless,[1] it is only recently that the country has entered the third stage of the transition in which both fertility and mortality are falling steadily. Because fertility declines usually follow declines in early childhood mortality with a lag, the second stage in the demographic transition is characterized by rapid natural population growth and an increase in the proportion of children in the population. The third stage of the transition is initially characterized by a rapid growth in the proportion of youth, but more importantly, by the continued growth in the proportion of working age and decline in the proportion of children, leading to a long-run fall in the dependency rate.

Egypt was well into the second state of its demographic transition by the second half of the twentieth century. In 1950-55, death rates had fallen to 24 per thousand, whereas birth rates remained as high as 50 per thousand, leading to rapid natural growth of the population (see Figure 5.1). Crude death rates fell steadily throughout the second half of the century and are expected to stabilize at about 6 per thousand by 2005-10. Crude birth rates began to decline in the late 1960s, marking the beginning of the third phase of the transition. The peak rate of natural increase of 26.3 per thousand was attained in 1980-85 and it then began to decline to reach 20.3 per thousand in 1995-2000.

The main factors behind the decline in death rates are the general improvement in public health and living conditions brought about by the introduction of modern medicine and improvements in sewage disposal and water supply. The youngest benefited the most from these improvements, as reflected in the sharp decline in infant and child mortality since the mid-1960s.[2] According to data from demographic and health surveys conducted in 1980, 1988, 1992, 1995, and 2000, infant mortality fell from 141 per thousand live births in 1964-69 to only 44 per thousand in 1995-2000, a decline of nearly 70% over thirty years (See Table 5.1). The decline in child mortality was even more dramatic from 243 per thousand live births in 1964-69 to 54 per thousand in 1995-2000, a 78% decline.

Table 5.1: Infant and Child Mortality (per thousand)

	DHS*	
	Infant mortality	**Child**
mortality		
1964-69	141	243
1969-74	146	238
1974-79	132	191
1980-85	97	139
1985-90	82	110
1990-95	63	81
1995-2000	44	54

Source: El-Zanaty and Way (2001).
*Note: * Demographic and Health Surveys or Egypt Fertility Survey for figures prior to 1980.*
Note: To minimize problems due to recall error, the data reported here are those from the survey that is closest to the year being reported.

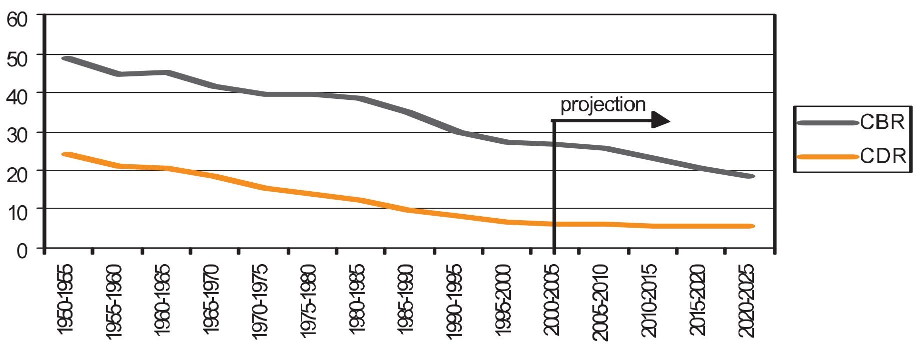
Because fertility reacts to such improvements in early childhood survival with a certain lag, the total fertility rate (TFR)[3] only began to decline in Egypt in the late 1960s and early 1970s. The decline in the TFR is fairly slow until the early 1980s and then accelerates from 1985 to 1995, only to slow down again in the second half of the 1990s. This overall decline masks urban/rural disparities. Although both regions experienced the same trend of decline, rural areas still have significantly higher fertility rates than urban areas.

Table 5.2: Total Fertility Rate (TFR) among Women Aged 15-49

	Urban	**Rural**	**Egypt**
1946-47	-	-	6.3
1959-60 -	-		6.7
1975-76	4.6	6.1	5.5
1979-80	-	-	5.3
1983-84	-	-	4.9
1985-88	3.5	5.4	4.4
1990-91	3.3	5.6	4.1
1989-92	2.9	4.9	3.9
1992-95	3.0	4.2	3.6
1997-2000	3.1	3.9	3.5

Source: For 1946-47 to 1975-76, Panel on Egypt of the Committee on Population and Demography (1982, p.17). For 1979 to 2000, El-Zanaty and Way (2001) Egypt Demographic Health Survey 2000.

Figure 5.1: The Demographic Transition in Egypt: Crude Birth and Death Rates 1950-2025



Source: UN (2003), World Population Prospects: The 2002 Revision.

A number of factors are responsible for this declining trend in fertility rates. These include higher educational attainment among young mothers, the role of the media in promoting an ideal family size, the political discourse on the negative impact of rapid population growth, the promotion of family planning programs, and the concomitant increase in the availability of effective contraceptive methods. Fertility decline was accelerated further by the trend toward delayed marriage, a trend that was reinforced by the nuclear family ideal in combination with the difficulty that young people encounter in obtaining housing.

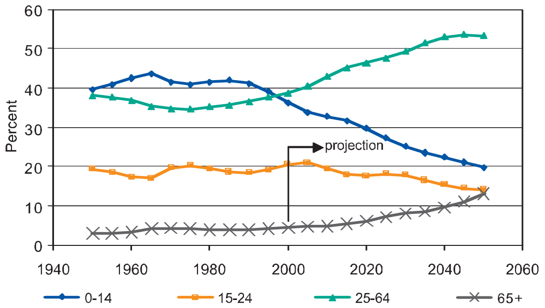
The demographic transition not only has consequences for the rate of population growth, but it also profoundly affects the age structure of the population (see Figure 5.2). In the second phase of the demographic transition, as early childhood mortality declines but birth rates remain high, the proportion of children under 15 in the population rose rapidly from 40 to 44% in merely 15 years (1950-65). The proportion of children then declined somewhat in the late 1960s as fertility began to decline, but the decline was short-lived as the population momentum of the large number of young parents born two decades previously came on line. By 1990, the proportion of children began to decline in earnest, falling steadily from 41% in that year to a projected 30% in 2020 and 20% in 2050. The average annual rate of growth of the child population is projected to decline to 0.8% per annum from 2005 to 2020, and then their absolute number is actually projected to decrease steadily from 2020 to 2050.

This change in the proportion of children in the population has fundamental consequences for the labor market in a number of ways. First, the growth rate in the number of children, which exceeded 3% per year from 1950 to 1965, combined with rising enrollments, put severe pressures on the education system, undoubtedly leading to a lowering of the quality of education. Once the rate of growth of children in the population begins slowing, there is an opportunity to invest more per child, provided that educational budgets continue to grow at the same rate. Second, the changing proportion of children has a profound impact on labor supply once it translates into a changing proportion of youths ready to enter the labor market. Labor force participation data (discussed below) indicate that the age interval 15-24 is the period in the life cycle where labor force participation rises rapidly, so that new entrants to the labor market are mostly from within this age group.

The periods from 1965 to 1975 and from 1990 to 2005 are the two periods in recent Egyptian history that demonstrate the highest rates of growth in the youth population in the 15-24 age group. In the first period, which was a reflection of the high fertility rates and falling early childhood mortality rates of the 1950s and early sixties, the youth population grew at an average rate of 3.3% per year, with their share in the population going from 17 to 20% in one decade. The second sub-period, which we are currently in, is a reflection of the population momentum built up in the first sub-period. These are the children of the large cohorts of parents born in the 1950s and sixties. The average rate of growth of the youth population, in the period 1990 to 2005, is estimated at 2.9% per year, with their share projected to reach an all-time high of 21% of the population in 2005. In 2005, one in three people of working age (15-64) will be a youth between the ages of 15 and 24. This ratio is projected to fall to one in five by 2050.

The good news, from a labor market perspective, is that demographic pressure on the Egyptian labor market will begin to subside significantly after 2005. The average annual rate of growth of the youth population will decline to 0.5% per annum for the period 2005 to 2010 and will be below 1% per year through 2025. The share of youth in the population is projected to decline from 21 to 18% from 2005 to 2015, to stabilize at this level for a decade and a half and then continue to decline steadily through 2050. The absolute number of youths 15 to 24 in Egypt is projected to peak at 19.3 million in 2030, and then decline by 0.4% per year for the following 20 years.

Figure 5.2: Age Structure of the Egyptian Population, 1950-2050



Source: United Nations Population Division. World Population Prospects: the 2002 Revision Data Base. Egypt Medium Variant

Figure 5.2 shows that according to United Nations projections, after two decades of stability at about 35% of the total population from 1965 to 1985, the share of the prime working age population (25-64) will increase steadily through 2045, where it will peak at 54%. The rate of growth of this component of the population is projected to average 2.6% per annum from 2005 to 2020, which is 54% higher than the projected rate of growth of the overall population during this period. Once the challenge of getting these potential workers into the labor force is overcome, these projections suggest that the number of workers per capita can potentially increase significantly, leading to lower dependency rates.

2.2 Trends of Labor Force Participation by Sex, Age, and Educational Attainment

This section presents the evolution of the labor force participation by gender, age, and educational attainment. The reason we focus on these three correlates of participation is that they are the most important determinants of the overall participation rate over time. Participation rates of males and females are affected by the life cycle, but those of Egyptian females, in particular, are also strongly shaped by educational attainment, with a major increase in participation for those who complete secondary education. Other factors clearly play important roles in participation, such as urban/rural location, marital status, and number of children, but can be relegated to a secondary position as compared to the first three variables.

Because of the complexity of the definition of what economic activity is and who engages in it, the measurement of female participation in the labor force is difficult and is subject to significant error. In Egypt, in particular, there were various attempts in the 1980s to reform the way female participation was measured, leading to measurements that are not comparable over time. The Egyptian Labor Force Sample survey in particular has provided an implausible time trend in participation, primarily because of varying practices in the enumeration of women engaged in subsistence agriculture. The lack of distinction between the extended definition of the labor force, which includes participation in subsistence activity, and the market definition that excludes such activities, led to unreliable estimates.[4]

As a result of these problems our analysis relies instead on a comparison of two surveys that were designed to be comparable, namely the special round of the Egyptian Labor Force Sample Survey conducted in October 1988 (LFSS 1988) and the Egypt Labor Market Survey conducted in October 1998 (ELMS 1998).[5] The LFSS 1988 uses the extended definition of the labor force, while ELMS 1998 allows for estimates using both definitions. The participation rates as reported by the regular LFSS are shown in Table B5.1 in the Annex B for comparison.

2.2.1 Trends in overall labor force participation

Overall labor force participation in Egypt remained fairly stable over the 1990s period at about 47% of the working age population using the market definition and 59% using the extended definition. This apparent stability masks opposing trends by gender. While male participation rates have been declining slowly over time, female participation has been increasing. According to the LFSS 1988 and ELMS 1998, male participation declined from 76.7% in 1998 to 72.3%, as shown in Table 5.3.

The estimates for male labor force participation do not vary significantly across the market and extended definitions of the labor force, but those for females do, especially in rural areas. As a result, the estimates of male participation obtained from the LFSS 1988 and ELMS 1998 are quite comparable to those obtained from the official annual labor force survey, which puts the overall male participation rate at 75.2% in 1990 and 73.1% in 2001. In contrast, there is a large difference in the estimated rates between the official annual survey and the sources being used here, both in terms of magnitude and trend. While the estimates shown in Table 5.3 above indicate that participation is increasing based on the extended definition, the official survey indicates that participation has declined from 28.9% in 1990 to 20.0% in 2001. What appears to be happening is that the annual LFSS was using a definition closer to the extended definition in 1990, but by 2001 is converging to something more closely resembling the market definition. In fact, estimates from 1997 to 2001 from the annual LFSS indicate that female labor force participation was constant at around 20%.

Table 5.3 Market and Extended Labor Force Participation Rate (%) by Sex and Urban-Rural Status, 1988, 1998, Ages 15-64

		Urban		Rural		Total	
Sex		**1988**	**1998**	**1988**	**1998**	**1988**	**1998**
Male							
	Market Labor Force	n.a.	70.8	n.a.	73.5	n.a.	72.3
	Extended Labor Force	74.4	70.8	78.8	73.6	76.7	72.3
Female							
	Market Labor Force	n.a.	25.5	n.a.	17.7	n.a.	21.2
	Extended Labor Force	28.5	33.0	53.5	56.6	41.8	46.0
All							
	Market Labor Force	n.a.	48.1	n.a.	45.7	n.a.	46.8
	Extended Labor Force	51.2	51.9	66.0	65.1	59.1	59.2

Source: Assaad (2002), based on data from LFSS 1988 and ELMS 1998.
n.a.: not available.

2.2.2 Labor force participation by age

The pattern of labor force participation by age for males and females and by urban/rural status is shown in Figure 5.3. As a reflection of higher enrollment in schooling, participation declined among young males and to a lesser extent among young females, in both urban and rural areas, from 1988 to 1998. There is almost universal participation among males in the 30 to 49 age group in both years, but rates of participation are falling for older males, especially in rural areas.

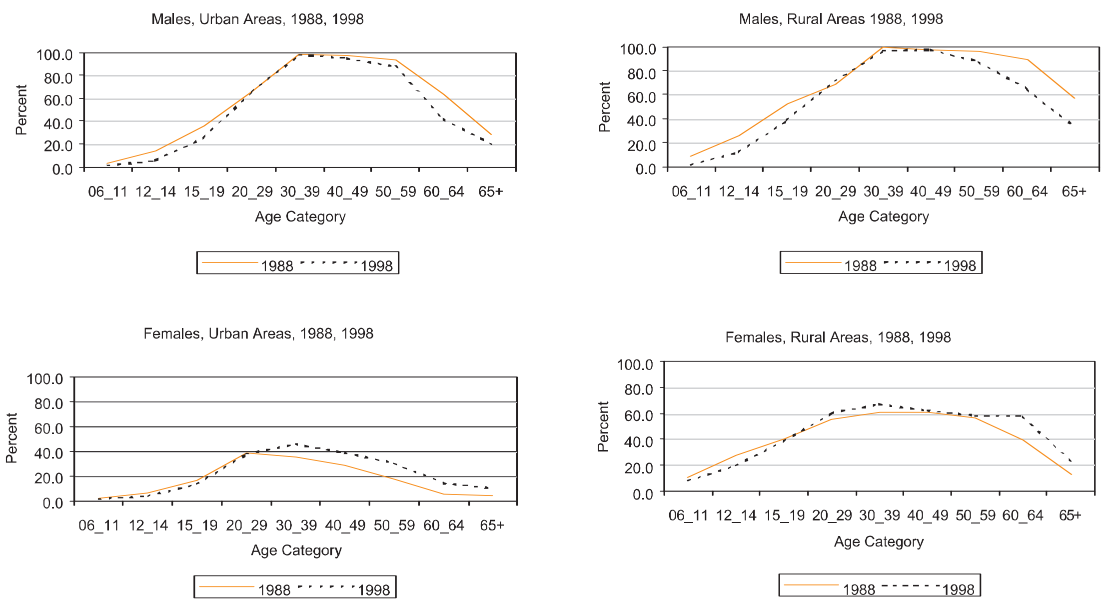
Assaad (2002) attributes this fall to earlier retirement among self-employed males in both contexts. Among females the pattern is reversed. Participation is increasing among older females over time, especially in urban areas. Assaad (2002) attributes virtually the entire increase to older female civil servants who are now more likely to hold on to their government jobs until retirement. This higher incidence of government employment among older females could be due to their increased educational attainment over time, since most female civil servants have at least a secondary education.

2.3 Labor Force Participation by Educational Attainment

The pattern of labor force participation by educational attainment is shown in Figure 5.4. Males of working age have high participation at high and low educational levels, but lower participation at less than intermediate and intermediate levels of education. This is simply an indication that these levels are not terminal levels of education, so that those who have them could still be continuing their schooling, and thus go out of the labor force. There is not much of a discernible pattern of time, except for a slight drop among less educated males and a slight increase among males with intermediate education.

For females, participation is strongly associated with the level of schooling. Participation is low up to the intermediate level and then increases sharply once that level is reached. This suggests that as more women achieve that level of education, overall female parti-ci-pation rises. Again, there is no significant change in the pattern of participation by education over time, suggesting that the chang-

Figure 5.3: Labor Force Participation Rates by Sex, Urban/Rural Location and Age Group, 1988, 1998



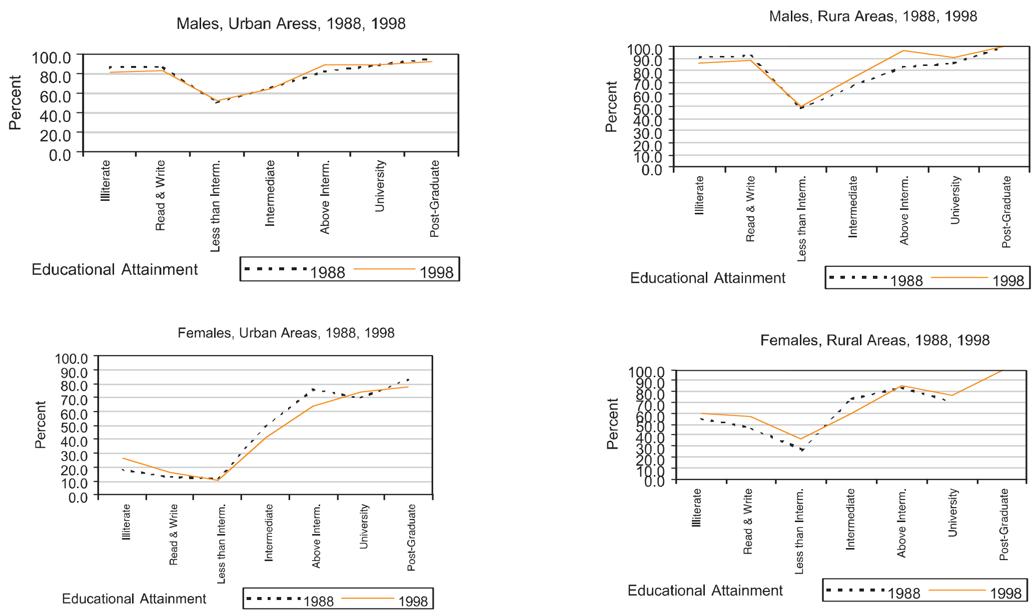
ing composition of the working age population toward higher levels of educational attain-ment is the main impetus for changing overall female participation.

2.4 Trends in Access to Education

Egyptian society has made important strides in providing access to formal education in recent years. From a purely quantitative standpoint, enrollment has risen significantly, rising from 61.3% in 1960-61 to 91.7 in 2000-2001 at the primary level, and from 17.1% to 71.1% at the upper secondary level (Egypt Human Development Report 2003).
The strength of the government's commitment to education is reflected in the proportion of its budget allocated to this sector. Whereas overall budget spending fell from 32% to 28% of GDP between 1994 and 1999, the share of education in GDP rose from 2.9% to 4.2% over the same period, with recurrent expenditure increasing some-what faster than investment expenditure. Even though this share is still lower than the 5.1% of GDP spent on education by the average lower middle-income country, it represents a substantial fiscal effort during a period of general fiscal austerity. Investment expenditure in the sector represents 24% of overall education expenditure (World Bank 2001).

The trend in the number of students completing the primary stage confirms that Egypt is finally going to have the opportunity to shift from a focus on education quantity to education quality, as the number of children of primary school age begins to drop. As shown in Annex Table B5.2, rising primary enrollment rates from the 1970s to the 1990s resulted in rates of growth of primary enrollment in excess of 5% per annum on average from 1973-74 to 1995-96, as compared to a 2.4% per annum increase in the overall population over the same period. However, this rate of growth slowed significantly in the second half of the 1990s to 1.8% per annum. A further examination of the data indicates that the number of children enrolled in both general and Azhari primary schools peaked in 1996-97 at 8.2 million and has been falling ever since to reach

Figure 5.4: Labor Force Participation Rates, by Sex, Urban Rural Location, and Educational Attainment, 1988, 1998.



Source: LFSS 1988 and ELMS 1998.

7.9 million in 2001-02 (CAPMAS 2003: 57-60). This suggests that the demographic window of opportunity is beginning to open at the primary education stage and that the government has a golden opportunity to start investing in improving education quality by reducing class sizes and increasing expenditure per child.

At the preparatory stage, rising enrollment rates and a continued increase in the number of children in the relevant age group continue to fuel enrollments and graduations. As shown in Annex Table B5.2, the number of graduates at that level has been growing at about 7% per annum throughout the 1990s.

The growth rate in secondary enrollment has fluctuated over the past three decades, going from 6.6% per annum in the 1970s to 3% in the 1980s, and back to 6.6% in the 1990s. However, the interesting pattern in secondary education is not its overall growth, which was undoubtedly rapid, but the changes in its composition over time between general and technical secondary, and among the branches of the technical secondary stream. In the 1970s, educational policy-makers favored the growth of the technical secondary stream, and, within it, favored the commercial branch, whose graduates grew at the scorching rate of 10.6% per annum from 1973-74 to 1981-82 (See Annex Table B5.2). The 1980s saw a continued emphasis on technical over general secondary education, but the growth in the number of graduates of the commercial branch was kept in check in favor of the industrial branch, which grew very rapidly. In the first half of the 1990s, both the technical and general streams grew very rapidly, at a rate in excess of 11% per annum and the commercial branch was back in favor. Data from the second half of the 1990s indicate that the brakes were activated on the technical secondary stream, whose graduates actually declined in abso-lute terms. However, data from 2001-02 not shown in the table indicate that there was a major reversal of that declining trend from 2000-01 to 2001-02. These data show that the number of graduates from the technical secondary stream increased by 16% in that year alone, completely reversing the decline that occurred in the previous five years.

These seemingly dramatic reversals in the composition of secondary graduates reveal a great deal of instability in education policy, with tremendous implications for the labor market. As has been shown above, technical secondary graduates tend to enter the labor market at high rates and, as will be shown below, they tend to fare very poorly in terms of employment and wages. In fact, we will show below that the rate of return to technical education in the private sector is in fact negative, even before taking into account the high unemployment rates of technical secondary graduates. After a period of huge increases in supply in these graduates, education policymakers decided in the 1990s to reverse course and severely curtail their numbers, by simply curtailing access to secondary education. This policy proved unsustainable, however, leading to a dramatic reversal in the late 1990s, which resulted in a huge increase in the number of technical secondary graduates from 2000-01 to 2001-02. More recent data are not avail-able to confirm whether this reversal in policy has in fact continued to the present date.

The evolution of the number of graduates from the higher education system shows similar tendencies toward policy instability. As shown in Annex Table B5.2, the number of university and higher technical institute graduates grew in excess of 10% per annum in the 1970s. The 1980s saw a dramatic slowdown in the number of university graduates, especially in the science-related fields, whose graduates declined in absolute terms. Overall the number of university graduates grew at only 2.5% per annum in the 1980s, with much of the growth being concentrated in law, the humanities, and social sciences. The number of higher institute graduates continued growing rapidly in the 1980s. In the first half of the 1990s, the growth of university graduates continued to be slow at 3.1% per annum, again with declining numbers in the sciences and moderately increasing numbers in the humanities and social sciences. In contrast to the 1980s, however, there was a dramatic reversal in the number of graduates from higher technical institutes, which declined at 8.9% per annum. The second half of the 1990s saw a return to the very rapid growth in the number of university graduates, which grew at an increcdible 13.5% per annum. The extremely rapid growth was spread evenly over the science-related fields and the humanities and social sciences. The number of graduates from higher technical institutes resumed their growth in the second half of the 1990s, but at a somewhat slower rate than that of university graduates.

The flow of graduates in the 1980s and first half of the 1990s shows clearly that the fastest growing category of the working age population during that period was among holders of technical secondary degrees, which are in general terminal degrees in Egypt. As we will see below, these are the categories of graduates that had the hardest time being absorbed by the labor market. The slow growth in the number of university graduates during that period suggests that their labor market absorption would be easier. However, subsequent dramatic growth in the number of university graduates in the second half of the 1990s has itself most likely resulted in significant difficulties for these graduates in recent years, although there is still scant evidence of that in labor market statistics.

2.5 Prospects for the Future Based on Labor Force Projections

To assess the extent of the employment challenge that Egypt is facing over the next 15 years, we carried out labor force projections that take into account the age composition of the population, the expected increase in its educational attainment over time, and the patterns of participation in the labor force by education and age. We used the UN's 2002 medium variant projections of the population by age and sex up to 2020 as the basis for the projection of working age population. We based our projections of educational attainment by age group and sex on the results of the LFSS 1988 and ELMS 1998. We allocated each age/sex group into one of three educational levels over time on the assumption that education is acquired prior to age 25 and that younger age groups will increase their attainment based on previously observed trends.[6]

As shown in Figure 5.5, our labor force projections indicate that the labor force is projected to increase from 23 million in 2005 to 27 million in 2010, to 34 million in 2020. According to these projections, the annual increment to the labor force will increase from 660,000 in the 1998-2005 period to 790,000 in the 2005 to 2010 period. It will then decline to 750,000 in the 2010 to 2015, only to increase again to 790,000 in the 2015-2020 period. The stability in the annual increment from 2005 onward shows that the relative growth of the labor force will be slowing over the next decade and a half. Because of the increase in the labor force participation of women as educational attainment rises, the rate of growth of the labor force will exceed that of the working age population.

Figure 5.5: Projection of Working-age Population and Labor Force by Sex, 2005-2020

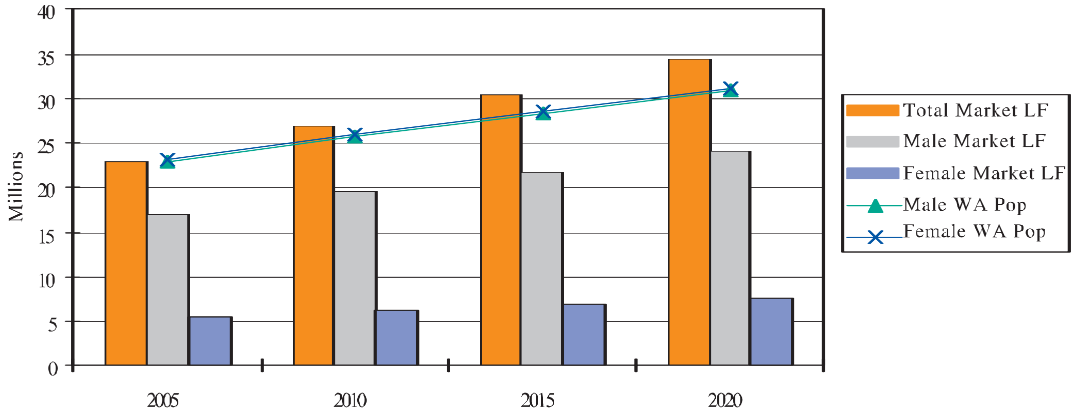
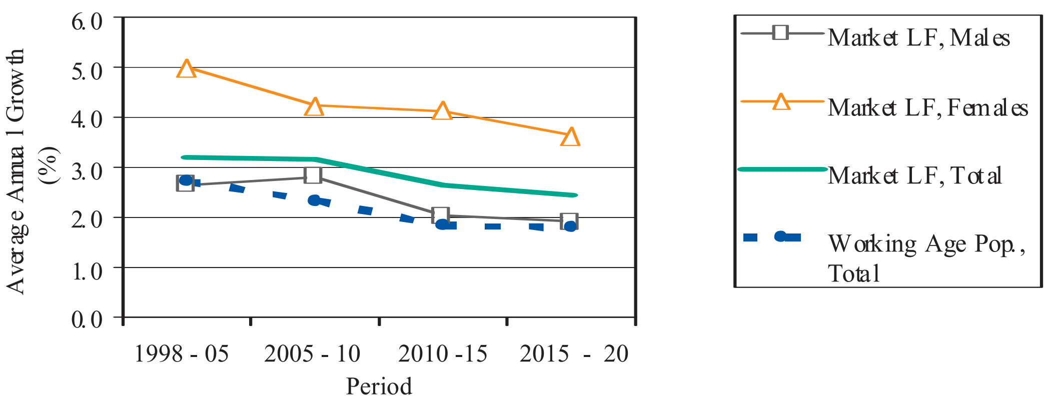


Figure 5.6 shows that the growth rate of the labor force is projected to exceed that of the working age population by half a percentage point through 2020. With the exception of the 2005-10 period, the entire difference can be attributed to the more rapid growth of the female labor force. In the 1998-2005 period, the female labor force is estimated to have grown at nearly twice the rate as the male labor force and to have added 250,000 out of 660,000 workers added every year.

The proportion of youth (15-24) in the labor force will reach a maximum in 2005 at 22% and is projected to decline to 17% by 2020. In contrast, the proportion of young prime age workers (25-34) will increase from 30% in 2005 to 34% in 2015, only to decline to 32% by 2020. The next 15 years will therefore be characterized by reduced pressure on entry and a significant increase in the number of workers per capita, providing Egypt with an important "demographic window of opportunity" (see Yousef and Williamson 2002). The education composition of the labor force will also change significantly. The proportion of workers with a secondary education or more is projected to increase from 60% in 2005 to 75% in 2020. However, as shown in Figure 5.7, the proportion of educated new entrants, the group that is posing the biggest employment challenge at the moment, will peak at 2005 and will then decline through 2020. This further confirms that 1998-2005 is the period of greatest supply pressures due to the flow of educated new entrants and that the subsequent period will be characterized by reduced demographic pressures on the labor market.

Figure 5.6: Projected Labor Force and Working-age Population Growth Rates, by Sex, 1988-2020



Source: Authors' estimates based on ELMS 1998 and UN population projections.

3. The Size and Structure of Labor Demand

In the state-led era of Egypt's economic development of the 1960s, government, public sector, and military employment played a major role in absorbing the growing supply of labor, as well as the increasing number of workers that were being shed from the agricultural sector. The expansion that ensued in the oil-boom era of 1973 to 1985 led to the rapid expansion of two new labor absorption mechanisms, namely non-tradable sectors represented by construction, transportation, and services, and international migration. Plentiful government revenues from oil sales and foreign aid in that era continued to fuel a rapid expansion of the government bureaucracy, although employment growth had already begun to subside in the state-owned sector in that period. Agriculture continued to shed labor in large numbers. Despite the booming economy of the time, this period experienced a steady increase in unemployment as government hiring could not keep up with the growing number of graduates seeking public sector employment (El-Ehwany and Metwally 2001).

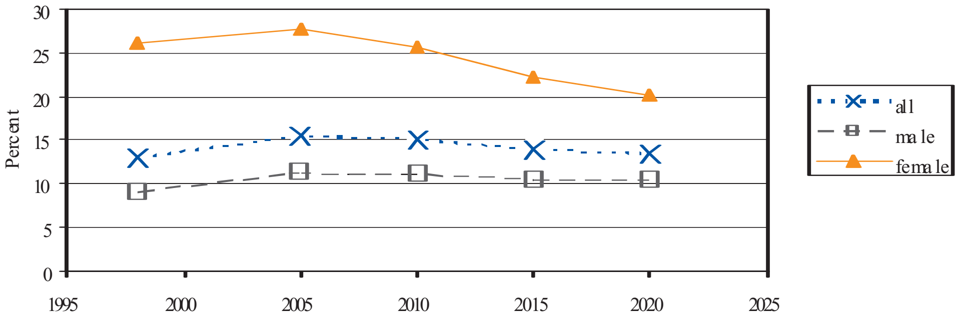
In the post-oil boom period of 1986 to 1990, GDP growth slowed considerably, leading to a slowdown in the non-tradable sectors. At the same time migration flows to the oil-rich countries slowed significantly, with migration to Iraq, the largest recipient of Egyptian workers at the time, reversing direction in the period 1988 to 1991. The promise of employment creation in the joint venture and private sector firms that thrived under the infitah policy never really materialized. As of 1988, less than 3% of non-agricultural employment in Egypt was in private firms with 50 workers or more. By 1990, only 1.3% of total employment was in joint venture and foreign-owned firms. In the subsequent analy-sis, we focus on developments during the 1990 to 2001 period, a period in which the Egyptian economy underwent major economic reforms and attempts at structural adjust-ment. We break up the period into two sub-periods, 1990-95 and 1995-01 to highlight changes that occurred within it.

3.1 Growth Performance and Sectoral Composition of Employment

Despite the stabilization program introduced in 1991 and the limits placed on government expenditures, expansion of civil service continued to be one of the primary mechanisms of labor absorption in the 1990s at the same time that employment in SOEs continued to contract. As shown in Table 5.4, the share of employment in the government increased from 22% in 1990 to 28% in 1997 and remained stable at this level until 2001. During the same period, the share of SOEs in total employment fell from 9.7% to 5.9%; this decrease being caused in part by a freeze on hiring and attrition and early retirement packages, but also by the re-classification of employment in privatized firms to the private sector. This decline in SOE emloyment is in line with the objectives of the Economic Reforms and Structural Adjustment Program (ERSAP) adopted in 1991.

Table 5.5 shows the average annual growth rates in each sector by sex. In both sub-periods the government work force was growing more rapidly than overall employment, although its growth slowed down somewhat in the second sub-period. The large decline in the female private sector growth rate in the first sub-period must be discounted since it is most probably due to the undercounting of women in subsistence agriculture in 1995 compared to 1990. However, the figure does suggest that the growth of the male private sector labor force was much more vigorous than that of females. These trends are confirmed by data from the LFSS 1988 and ELMS 98 that do not suffer from lack of comparability over time (See Assaad 2002).

Figure 5.7: Proportion of New Entrants (15-24) with Secondary Education and Above in Projected Labor Force, 1998-2020



Source: Authors' estimates based on ELMS 1998 and UN population projections.

Table 5.5: Annual Rate of Growth of Employment by Economic Sector and Sex (in %)

Economic Sector	**1990-1995**		
	Male	**Female**	**Total**
Government	3.8	4.1	3.9
Public Enterprises	-0.5	-5.0	-1.1
Total Public	2.4	2.9	2.5
Private Sector	2.0	-10.0	-0.7
Investment and others	0.5	-5.4	-1.2
Total	2.1	-5.4	0.4
Economic Sector	**1995-2001**		
	Male	**Female**	**Total**
Government	3.5	3.2	3.4
Public Enterprises	-4.6	-3.2	-4.5
Total Public	1.4	2.6	1.7
Private Sector	3.4	0.7	3.0
Investment and others	4.1	3.1	3.9
Total	2.8	1.6	2.6

Source: CAPMAS: LFSS, various years.

The evolution of the distribution of employment by economic activity over time reveals that the share of agriculture has steadily declined over the 1990s, continuing a decline that began as early as the 1960s. As shown in Table 5.6, the share of agriculture in total employment fell steadily from 40.5% in 1990 to 28.5% in 2001.[7] The other major tradable activity, manufacturing, also saw a drop in its share of total employment from 14% to 12% in the same period. The segments of the private sector that have grown the most rapidly in the 1990s are finance, insurance and real estate, trade, restaurants and hotels, and construction-all of which are non-tradable sectors. The growth of these non-tradable sectors may well be related to the significant appreciation of the real exchange rate during this period, which discouraged the growth of tradable industries.

In summarizing the trends in employment demand in the 1990s we can conclude the following. Although ERSAP aimed at reducing public spending, the fastest growing sector and the largest contributor to employment growth in Egypt continued to be the government sector. Government contributed 41.8% of net job creation. Teachers were the fastest growing occupational group with an average annual rate of 7.3% per year. Moreover, they contributed more than half of government employment growth. Also, more than half of the nearly 650,000 females who joined the government workforce over the decade became teachers (Afifi 2001).

The government sector is a particularly large employer of women in Egypt. In 1999 nearly 60% of all women working in the formal sector in urban areas were in the administration. And although in rural areas the corresponding ratio is considerably smaller, it is still very high at 24%. As a result, women make up 28% of total employment in government, compared to 18% of all the employed work force. The public sector outside administration employs much fewer women than men, however, and female employment also declined more rapidly during the period 1990s (World Bank and the National Council for Women 2002).

While growth in the 1990s created employment, it may not have created sustainable sources of income growth. The employment growth pattern above has some important implications. First, non-tradable sectors accounted for essentially all employ-ment growth, and thus are automatically constrained by the size of Egypt's domestic purchasing power spent on these non-tradable goods and services. (World Bank 2002)

Despite the success of the ERSAP, several constraints impede private sector development in Egypt. These constraints include entry regulations; bureaucratic government systems; the commercial judicial system; tax administration systems; and generally delays in introducing new legislation, which would further enhance private sector development. The main objective of the ERSAP program is to change from a centrally planned, public sector dominated economy towards a competitive market-based economy in which the private sector is to play the leading role. It is estimated that the private sector will have to increase its annual employment rate by at least 50% just to keep the unemployment rate constant (currently ranging between 8 and 10%).

3.2 Private Sector Responses to Economic Reform

According to the LFSS data, there were 9.9 million workers in the private sector, including 2.7 million females in 2001. In view of this situation, the hopes pinned on the large private sector for large-scale job creation were exaggerated. Even the more reliable generator of employment, non-establishments and micro and small enterprises in the private sector, are generally characterized by low productivity and modest earnings and hence cannot be relied upon to help boost employment creation and reduce poverty (Fergany 1998).

Besides the continued growth of government employment and the weakness of the tradables sectors during the 1990s, the other major trend in the Egyptian labor market in the 1990s was the significant informalization of employment. Employment in the informal sector, which is made up of individuals working in small and microenterprises and outside establishments is estimated to have grown from 2.4 million in 1976 to 4.8 million in the late 1990s, suggesting that 86% of private non-agricultural employment is in the informal sector (El-Ehwany and Metwally 2001; El-Ehwany and El-Laithy 2001). If informal employment is defined as including workers employed without the protection of legal employment contracts and social insur-ance coverage, informal employment would make up an even larger share of private non-agri-

Table 5.4: Distribution of Employment by Economic Sector (in%)

	1990	1991	1992	1993	1994	1995	1997	1998	1999	2000	2001
Government	22.1	22.9	24.2	25.6	25.7	26.3	28.0	27.1	26.6	27.7	27.7
Public Enterprises	9.7	9.8	9.8	8.8	9.4	9.0	8.2	7.2	6.5	6.3	5.9
Total Public	31.8	32.7	34.5	34.5	35.0	35.3	36.1	34.3	33.1	34.1	33.6
Private Sector	67.0	66.1	64.9	64.3	63.8	63.5	63.1	64.9	65.8	64.9	65.1
Investment & other	1.3	1.2	1.1	1.2	1.2	1.2	0.8	0.9	1.1	1.0	1.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CAPMAS, LFSS, various years.

cultural employment. Sixty-five percent of jobs taken up by new entrants to the labor market in the late 1990s were informal, compared to about 40% in the mid 1980s.

This analysis indicates the importance, and the growing role of the informal sector in Egypt, with respect to the absorption of employment and income generation for a remarkably high percentage of workers during the 1990s. Being widespread in both rural and urban areas, the informal sector is capable of absorbing females, males and youth, a high percentage of whom are engaged in productive activities. They do not conform with the stipulations of the labor and insurance laws, or with the other controls that govern the other sectors of the economy (El-Ehwany and El-Laithy 2001).

3.3 Micro, Small, and Medium Enterprises (MSME)[8]

Employment in small-scale industry is much less capital intensive than the economy at large. Fixed capital outlay per worker in small-scale industry is estimated to be less than one eighth of the national average in 1995 (LE 4000 and 33.7 thousand, respectively). The capital/output ratio of small-scale industry is considerably more favorable than in the economy at large: 0.68 compared to 2.5-2.8 during (1990-95) (Fergany 1998). The growth in number of microfirms has been phenomenal over the last two decades, but the depth of the regulatory constraints at the central and governorate levels discourages the bulk of these enterprises from registering or abiding by most of the rules of formalization. According to a Ministry of Economy report, a new starter in business must comply with at least 11 laws in order to get a trade license. (An in-depth survey of all new registered manufacturing firms in the medium to micro size [1 to 50 employees] over the six-year period 1986 to 1991 shows that only 6,747 were registered). This compares with an increase of 32,435 firms in that size group (Census of Manufacturing Establishments, 1986 and 1996) in the ten years period 1986 to 1996, with a ratio less than one fifth having formal registration status, even after adjusting for the difference in time interval (Handoussa 1999). Other reasons for the growth of informal sector could be:

- The limited role of the formal private sector in generating job opportunities and incomes
- The recessionary policies of ERSAP, as well as the restructuring and privatization of public enterprises, and their negative impact on formal employment, especially for women
- The nature of informal work for it is flexible and it neither requires high levels of education nor advanced skills

The micro, small, and medium enterprise sector (MSME) is subject to numerous constraints in Egypt like in most developing countries. The government, the private sec-tor, NGOs, business associations, as well as researchers and academics have been studying and exploring ways of providing support to the sector. The effort needed to revitalize informal small enterprises should amount to a (serious) national campaign. Public policy formulation and implementation should take into consideration the hetero-geneous nature of informal economic activity as well as current constraints to its development.

3.4 External Migration

Migration trends confirm that migration was an important element in absorbing the surplus of labor in the domestic labor market in the mid-1970s till the mid-1980s thanks to the oil boom and increasing oil revenues.

Table 5.6: Distribution of Total Employment by Economic Activity. 1990-2001 (in %)

Economic Sector	1990	1991	1992	1993	1994	1995	1997	1998	1999	2000	2001
Agriculture & Fisheries	40.5	38.3	38.4	35.3	34.5	33.4	31.3	29.8	28.7	29.6	28.5
Mining & Quarrying	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.3	0.3	0.3
Manufacturing	14.1	14.1	14.0	13.9	13.5	14.2	13.5	12.6	13.2	11.9	12.0
Utilities	0.8	1.0	1.0	1.0	1.0	1.1	1.2	1.3	1.2	1.2	1.2
Construction	6.1	6.6	6.1	6.5	6.7	6.4	7.3	8.0	7.9	7.9	7.7
Trade, Hotels & Restaurants	8.8	9.1	9.3	9.8	10.3	10.4	12.4	13.8	13.9	13.2	14.0
Transport, Storage, & Communication	5.5	6.2	5.4	5.5	5.6	6.0	5.8	5.9	6.3	6.5	6.5
Finance, Insurance & Real Estate	1.6	2.0	1.6	1.9	2.0	1.9	2.4	2.7	2.7	2.9	3.1
Services	21.8	22.2	23.8	25.9	26.0	26.3	25.5	25.6	25.8	26.4	26.7
Unclassified	0.4	0.1	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CAPMAS, LFSS, various years.

Egypt became a major labor exporter after adopting an "open door" policy in 1974. Most of the migration from the country was directed to Arab countries, especially the Gulf region. Declining labor demand by the oil-producing countries, which peaked around 1985 when migration accounted for 10-15% of the Egyptian labor force, has been accentuated by the decline in oil prices during the 1990s and by countries replacing foreign labor with nationals (Radwan 2002). At present, migration represents at best 1.2 million workers or 5% of the labor force as shown by CAPMAS data.

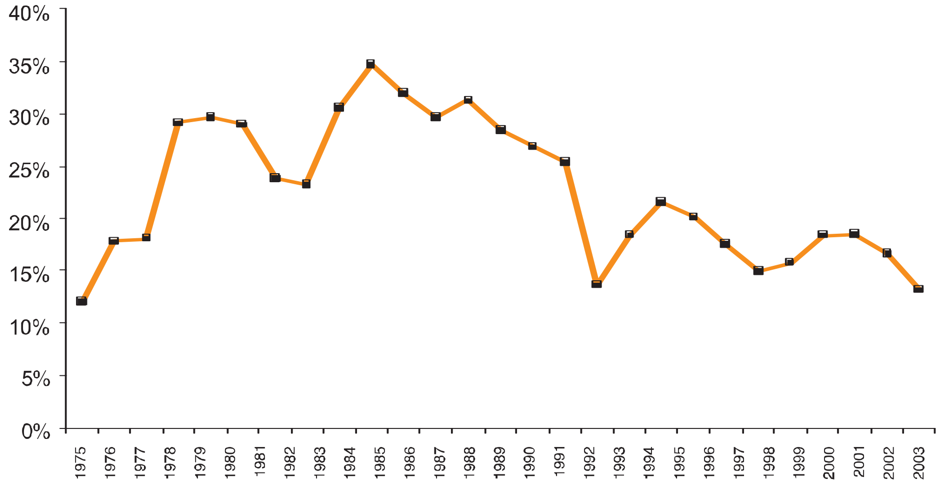
Labor migration declined after the 1991 Gulf War despite the limited size of the national labor force of the host countries and its disability to meet the aggregate labor demand. This led the host countries in the Gulf region to rely on Asian labor in spite of the high rates of unemployment in other Arab countries such as Egypt, Jordan, Syria, Yemen, Algeria, and Morocco.

In the wake of the crisis, it was estimated that more than 700,000 Egyptians returned from Iraq, Jordan, and Kuwait. One year after the liberation of Kuwait, the number of Egyptian workers there had not even reached the pre-invasion level.

Concerning the composition of migrants, we observe that 49% of Egyptian migrants reside in Saudi Arabia, followed by 18% in Libya, then 12% in Jordan. Iraq currently hosts 3% only of Egyptian migrants even though it used to be the major host country for Egyptian labor before the war.

Egyptian migrants' remittances represent one of the main sources of foreign currency despite the decline in numbers of migrants. Table 5.7 shows the evolution of these remittances since the Gulf War until the years 2001-2002. It is evident that remittances reached a peak in 1998-97 due to the rise in oil prices in this period and its gradual decline thereafter.

Figure 5.8: Remittances as a Share of GDP, 1975-20019



Source: World Bank, 2003 World Development Indicators CD-ROM.

Recent trends indicate that there has been a decline in remittances as a share of Egyptian GDP. Much of this can be attributed to the decline in oil prices in the Gulf, where Egyptian labor formed a large component of the labor force.

4. Labor Market Performance

4.1 Unemployment Trends Disaggregated by Gender, Age, and Education

4.1.1 Open Unemployment

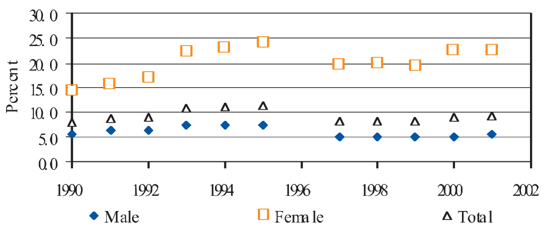
The Egyptian labor market in the 1990s and early 2000s was subjected to severe demographic pressures on the supply side, resulting in the largest ever cohort of new entrants, both in absolute and relative terms, at the time it was attempting to adjust to significant structural change in the economy. Although government employment continued to grow rapidly, the rate of hiring slowed down relative to earlier decades, especially considering the rapid growth in the number of graduates that had traditionally been hired by the government in the past. The private sector response to structural adjustment was uneven, with employment growth occurring principally in informal jobs in non-tradable activities.

From the point of view of labor market performance, the major trends in the 1990s were continued high, if not increasing, rates of unemployment, especially among educated new entrants; stagnating real wages; and significant barriers to entry for women in the private sector, and as a consequence a growing gender wage gap.

According to official statistics, shown in Figure 5.9, the open unemployment rate in 2001 stood at 9.2%. This is widely agreed to be an understatement of the unemployment rate. A change in the definition of unemployment starting in 1997 resulted in the significant drop observed in that year.[10] Ignoring that drop, the trend is clearly rising before and after that date.

As seen in Figure 5.9, female unemployment rates are nearly four times higher than those of males. Women also tend to be unemployed much longer durations. For 43% of unemployed females, the duration of unemployment is longer than three years as compared to 36% for unemployed males (Social Research Center 2003). This reflects the higher concentration of secondary school graduates among active females, as well as the greater incentive women have to queue for public sector jobs. Because women face considerable entry and wage discrimination in the private sector and are treated in a more egalitarian way in the government, they strongly prefer government jobs and are willing to wait much longer for them. Moreover, government employment is perceived to be much more compatible with women's domestic responsibilities after marriage than private employment.

Figure 5.9: Unemployment Rate by Sex, 1990-2001



Source: CAPMAS, LFSS, various years.

Open unemployment in Egypt is increasingly concentrated among young, educated new entrants, who would have in the past been eligible for the public employment guarantee. As shown in Table 5.8, the highest rates of unemployment are observed among those with intermediate (or secondary) education. Women at that level of education, in particular, suffer from unemployment rates in excess of 35%. The next highest rates are among those at the above intermediate level, which corresponds to graduates of higher institutes in Egypt. The third highest unemployment rates are among university graduates. Again, the apparent decline in the unemployment rates in 2001 should be interpreted with caution. The LFSS also shows that 70% of the unemployed were at the intermediate level of education in 2001, and another 27% had even higher education levels. This suggests that open unemploy-ment in Egypt is almost entirely a phenomenon that affects educated workers eligible for the public employment guarantee and willing to hold out for either a public sector job or one with similar characteristics.

4.1.2 Underemployment

Even if the absorption of the large cohorts of young educated new entrants is one of the major problems that the Egyptian labor market faces, open unemployment gives an incomplete representation of labor market mismatches. Indeed, evidence of underemployment contributes to the weakness of the labor market performances, highlighting

Table 5.7: The Evolution of Remittances from Egyptian Workers Abroad (Millions of US dollars)

Arab country	**91/92**	**92/93**	**93/94**	**94/95**	**95/96**	**96/97**	**97/98**	**98/99**	**99/00**	**00/01**	**1/02**
Saudi Arabia	12	51	521	506	564	728	783	794	738	681	612
Kuwait	51	184	280	437	532	596	602	596	411	222	246
Libya	-	-	5	8	10	7	7	5	3	3	3
Emirates	0	0	109	302	285	318	362	321	283	302	313
Bahrain	-	-	8	74	7	24	53	29	19	13	54
Sudan	-	-	4	5	5	7	2	3	1	1	2
Oman	-	-	12	12	9	14	11	12	12	11	11
Qatar	-	1	27	64	43	65	45	49	42	44	42
OtherArab countries	0	-	13	11	16	53	61	59	47	63	13
Total	63	236	976	1,420	1,470	1,812	1,925	1,868	1,555	1,341	1,297

Source: Central Bank of Egypt, unpublished data.

the mismatch between labor supply and demand. So to give a realistic picture of the labor market performances it is important to also address the issue of underemployment. Since, in Egypt, unemployment compensation is almost non-existent, a substantial number of individuals cannot afford to be unemployed and live without any income. This situation leads then to under-utilization of labor, which is likely to be considerable. Underemployment has two faces: a visible one and an invisible one. Visible underemployment is a situation in which an individual works involuntarily less than the normal duration of labor (40 hours per week in the case of Egypt) and is available to work more. It reflects an employment situation with low productivity, low wage, or overqualification of the individual with regard to their job. The invisible underemployment, although widely spread and a very serious problem, is very difficult to apprehend.

Assaad (2002) gives an evaluation of the evolution of underemployment from 1988 to 1998. He constructs a global index of underemployment[11] combining open unemployment, visible underemployment, and discouraged unemployment ratios as shares of the working age population (15-64). He finds that the overall under-employment ratio has remained stable at around 7.5% from 1988 to 1998 while its composition has changed:

- The open unemployment ratio has increased from 3.2% to 4.7%,
- part-time work fell from 4% to 2% over the ten-year period,
- discouraged unemployment is marginal as it represents less than 1% of the working age population 15-64 for both males and females and both years 1988 and 1998.

He finds that underemployment varies along gender lines: "men are much more likely to be involuntary part-time workers than women are, in part because they are much more likely to be casual wage-workers." Moreover, disparities exist by educational attainment: "casual workers who are strongly represented among the poor, were able to find more work to keep them fully occupied in 1998 than in 1988. Young educated workers who are seeking for regular employment, on the other hand, are facing a tougher labor market" (Assaad 2002).

Although invisible underemployment is certainly widespread and one of the most preoccupying problems facing the Egyptian labor market, it is very difficult to measure. There are no available data to picture this complex phenomenon. Nader Fergany (1998) proposed an indirect estimation of invisible underemployment related to the percentage of people employed with the desire of changing their main job using the LFSS 88. Even if his result is certainly underestimating the phenomenon, he still found that 9% of the employed in 1988 wanted to change their main job. This was mainly the case for urban males with intermediate and higher education. More-over, the reasons why they want this change may reflect some aspects of invisible underemployment. Indeed the main reasons referred to are: to have a more secure job, to find a less tiring job, to increase income, and finally to have a better correspondence between qualifications and work. This finding is all the more preoccupying since they think that better the job positions they are looking for are not available. Although this analysis relies on 1988 data it is expected that invisible underemployment is still consider-able.

4.2 The Inability of the Private Sector to Compensate Fully for the Slowdown in Public Sector Hiring of Graduates

The growth of open unemployment among

technical secondary school graduates in Egypt is a symptom of the growing mismatch between the output of the education system and needs of the labor market. This mismatch is partly due to the very rapid increase in the number of technical school graduates in the 1980s and first half of the nineties. It is also due in part to the fact that these graduates do not appear to possess skills that are demanded by the private sector, as demonstrated by the very low rates of return they are able to receive for their education in the private sector. As discussed in Section 2.4 above, the number of university graduates was deliberately kept in check in the 1980s and first half of the 1990s. As a result the unemployment rates of university graduates has been lower in the 1990s. University graduates have also been able to secure higher rates of return to their education in the private sector.

The data on the distribution and growth of employment and unemployment by educational attainment from 1988 to 1998 shown in B5.3a, Annex B indicate that the groups that have had the greatest growth in unemployment were also the groups where the labor force grew most rapidly. The fastest growing category in the labor force was that of holders of technical secondary degrees in industrial/agricultural specializations. The growth in unemployment within that group was even faster, and their share of the unemployed went from 9.7% to 28.8%. The rate of growth among holders of commercial secondary degrees was slower in the 1980s, reflecting the changes in the composition of technical graduates that occurred in the first half of the 1990s. If the data are limited to young new entrants in the 15-34 age group, a similar pattern emerges, confirming that the labor market was unable to adjust to the explosive growth of technical secondary graduates in the industrial/agricultural branches. In 1988, the unemployed were dominated by the technical secondary graduates in the commercial branch, which was probably the impetus for the changes in education policies that occurred in the first half of the 1990s.

The number of technical secondary school graduates in the private sector has been growing relatively fast, but it has more or less just managed to keep pace with the growth in their supply. It has not however, compensated for the slowdown of hiring of that category of workers in the government and the SOE sectors. Private sector hiring of those with primary and preparatory education has slightly exceeded the growth in their supply, but this has not fully compensated for their slow growth or even absolute decline in the SOE sector.

As shown in Annex Table B5.2, the explosive growth of technical secondary degrees in the

Table 5.8: Unemployment Rate by Educational Attainment and Gender in 1990, 1995 and 2001 (in%)

Educational Attainment	**1990**			**1995**			**2001**		
	Male	**Female**	**Total**	**Male**	**Female**	**Total**	**Male**	**Female**	**Total**
Illiterate	0.4	1.9	1.0	0.5	0.1	0.4	0.3	0.3	0.3
Read and write	0.9	5.2	1.2	0.6	2.1	0.6	0.3	5.2	0.6
Below intermediate	5.5	22.9	7.4	2.2	10.8	2.8	1.5	11.0	2.1
Intermediate	18.8	41.2	26.4	24.1	52.0	33.3	12.7	37.4	19.9
Above intermediate	17.7	26.7	21.1	16.5	24.9	19.4	7.1	20.2	11.0
University & above	11.7	21.0	14.2	9.7	17.5	11.8	9.3	20.3	12.3
Total	5.6	14.4	8.0	7.5	24.1	11.3	5.6	22.6	9.2

Source: CAPMAS, LFSS.

first half of the 1990s has slowed significantly in the second half as educational authority saw the rising unemployment rates among these graduates. However, it was replaced by rapid growth in the number of university graduates, which are likely to have experienced some serious unemployment problems in the first part of this decade. Unfortunately, the data available to us are unable to confirm that yet.

4.3 The Evolution of Real Wages

We now turn to the evolution of real wages in Egypt in the 1990s. Because official wage data are only available for state-owned enterprises and formal private sector enterprises with 10 workers and above, the picture we have regarding wages is necessarily partial. Table B5.4 in Annex B presents the index of real wages by economic activity from 1977 to 2001.[12] As shown in the table, real wages had been eroding throughout the 1980s, after increasing significantly from 1977 to 1982. From 1982 to 1991, real wages fell at an annual average rate of 5.4% in the SOE sector, and 4.5% in the formal private sector. The decline was felt across all industries. Real wages continued to decline in the first half of the 1990s, a period of relatively slow growth after the introduction of stabilization policies in 1991. From 1990 to 1995, real wages fell by 0.6% per annum in SOEs and by 2.8% per annum in the formal private sector. Wages recovered somewhat in the second half of the 1990s as a result of continued economic growth and slowing inflation. From 1995 to 2001, wages in the SOE sector increased at an average annual rate of 3.9%, recovering to the level they were at in 1978. In the formal private sector, they only recovered at a rate of 0.8% per annum, barely inching up to the level they were at in 1976.

Although these results do not provide a full measure of what happened in the overall private sector, which is primarily informal, they are sufficient to conclude that private sector real wages have been essentially stagnant after a decade of real wage erosion in the 1980s. We can also conclude that wages in Egypt have been sufficiently flexible and that the poor performance of the private sector in employment creation cannot be attributed to wage inflexibility.

4.4 Gender Segregation of the Labor Market

The final issue we address with respect to labor market performance is evidence that there are considerable barriers to entry for women in the private sector. Not only is the growth of paid employment significantly slower for females than for males in the private sector, but they also suffer from large gender wage gaps, even after education and experience have been taken into account. The female disadvantage in the private sector, combined with slowing employment growth in the government, translates into the much higher female unemployment rates discussed above. This issue is likely to be exacerbated in the future as the female labor supply rises much more rapidly than that of males in the foreseeable future.

The gender segregation of the labor market in Egypt means that most employed women outside the government are relegated to a small number of industries and occupations. Industries in which women are disproportionately represented include textile and garment manufacturing, social services, and banking and insurance. Females also dominate some professional occupations, such as teaching, nursing, and medical doctors. Their shares in these occupations are high (68% of nurses, 40% of teachers, and 27% of medical doctors) (World Bank and the National

Council for Women, 2002). In the manufacturing sector, women, like men, have a limited share. Women working in manufacturing are concentrated in labor-intensive industries such as textiles and garments, food processing, and pharma-ceuticals (43%, 14%, and 13% respectively of all female workers in the industrial sector [Social Research Center 2003]).

Female engagement in agriculture was always regarded as part of their role as housewives, and for long periods it was not considered an economic activity. In this sector the basic problem facing women is not related to lack of work opportunities, but to the fact that they are working all the time without any financial evaluation of their participation in this sector. Informal urban activities have also helped absorb a significant proportion of the female labor force. Informal work as self-employed or unpaid family workers is the most prevalent form of work for illiterate females (Social Research Center 2003).

Barriers to entry for women into the private sector are due to a number of factors, including employers who are unwilling to hire workers whose commitment to the labor force may be short-lived, predominant social norms, and attitudes limiting what constitutes gender-appropriate employment, and mobility constraints that limit women's job search activities to local labor markets. While female-specific mandates on employers to provide paid and unpaid maternity leaves, as well as child care provisions may also make them reluctant to hire women, the poor enforcement of these mandates in the private sector makes this an unlikely reason for not hiring women. Assaad (2002) shows that only 15% of new jobs obtained by women in the non-agricultural private sector in Egypt were protected by a legal employ-ment contract and therefore covered by these female-specific mandates.

As a result of these barriers, the private formal sector has been unable to compensate for the diminishing role of the public sector by providing work for female new entrants to the labor market. In fact, during the 1990s, the share of women employed in private non-agriculture wage work declined. Women have increasingly been pushed into the informal sector leading to an increase in informality among women, especially among new entrants (Wahba 2002).

4.4.1 Evolution of gender-based wage gaps

This section discusses the factors explaining the wage formation process giving particular attention to returns to work experience and education. It also aims at looking at the evolution of gender wage differentials across employment sectors. First we present the results of Mona Said's (2002) estimates of wage equations to evaluate the change in returns to experience and education. Second, we present further analysis on wage differentials undertaken by Assaad and Arntz (2002). Based on the wage estimates of Mona Said, they correct for observed characteristics along gender lines and over time.

The wage equations estimated by Mona Said (2002)[13] show a worrying pattern as both returns to seniority and to education have declined from 1988 to 1998. Returns to experience are still the highest in the public sector (particularly in the government). The devaluation of returns to experience was strongest in the private sector. In both 1988 and 1998, returns to experience for females are higher than for males in the public sector. The reverse is true in the private sector. Returns to education have decreased for both males and females. This decline is noticeable for all educational levels except for the extreme levels (lower than preparatory and higher institute and university). However, there are differentials by gender as returns to education for females are higher than for males in the government. Also, returns to education in the public sector are higher than in the private one (except at the university level). A sharp decline in returns to education is shown for white-collar workers with secondary education (and especially among females with technical secondary school certificates in the government).

Further analysis on wage differentials has been undertaken by Assaad and Arntz (2002). Their study aimed at determining the implicit effects of a change in gender wage differentials. Based on the wages equations specified by Mona Said (2002) they adjust gender wage differentials for the difference in observed characteristics across males and females and also over time.[14] The results shown in Table 5.9 demonstrate that such adjustments made a significant difference in explaining how gender wage differentials differ across sectors and how they change over time. When no adjustments are made, the overall gender wage differential declines from -17.3% in 1988 to -8.6% in 1998. But when correcting for differences in observed characteristics between males and females, the gender gap remains constant at -10.4% over the period.

Table 5.9: Crude and Corrected Gender Wage Differentials by Sector, 1988, 1998

	Crude		**Corrected**	
	1988	**1998**	**1988**	**1998**
Government	-7.7	1.0	-3.0	-3.0
SOE	-13.9	-4.9	-13.1	-22.9
Private	-30.2	-26.7	-19.7	-25.9
Private-regular	-36.9	-27.4	-28.8	-30.2
Private-irregular	-20.5	-15.6	-7.7	-18.9
All Wage workers	-17.3	-8.6	-10.4	-10.4

Source: Assaad and Arntz (2002).
Note: Differential = (female wage -male wage)/male wage.

When gender wage differentials are disaggregated by sector of ownership, Assaad and Arntz (2002) show that the government is still the most egalitarian employer, with a corrected wage gap of only -3% that is constant over time. The corrected wage gap in the SOE sector increased in 1998 reaching -23% compared to a gap of only -13% in 1988. This indicates that SOEs are increasingly behaving like private enterprises and abandoning the public sector's egalitarian wage-setting rules. The corrected wage gap is largest in the private sector, where it has also increased over the decade from -20% in 1988 to -26% in 1998.

Assaad and Arntz (2002) conclude that "the fact that gender wage differentials are largest for the sector that is most exposed to market forces and smallest in the government, the least exposed sector, suggests that the source of the differentials is not pure wage discrimination, where a male and a female of identical characteristics working in identical jobs are being paid different wages. It suggests instead that the source of the differentials is entry discrimination resulting from gender typing of jobs or other barriers to entry that restrict female wage workers to a few labor market segments."

4.5 Poverty and the Labor Market

4.5.1 Trends of poverty 1995/1996 - 1999/2000

Although several studies on poverty used different methodologies and thus illustrated different levels of poverty they all showed the same trend of increase in poverty from 1981 to 1996 in Egypt. This trend seems to have been reversed in the second half of the nineties. Based on the Household Income, Expenditures, and Consumption Surveys (HIECS) of 1995-96 and 1999-2000, the World Bank report on Poverty Reduction in

Egypt (2002) shows that all poverty indexes[15] fell for the country as a whole.

Table 5.10 below reveals that the poverty head count index (P0)[16] decreased from 19.4% in 1995-96 to 16.7% in 1999-2000 (corresponding to 10.7 million poor individuals). The poverty gap index (P1)[17] and the poverty severity index (P2)[18] confirm this tendency. The poverty gap in Egypt has slightly decreased from 3.4 to 3.0; that is, most poor people are concentrated just below the poverty line. But at the same time, a significant portion of the population is also just above the poverty line. This finding has important consequences in terms of policy. Indeed, an appropriate policy that targets the most vulnerable groups could greatly reduce the number of poor households. It also reveals that poverty levels are sensitive to the choice of poverty line. Severity of poverty (P2) is also very small for Egypt as a whole and declined from 0.91 to 0.8 from 1995/96 to 1999/2000 (World Bank 2002).

However, the overall declining trend in poverty reveals clear regional disparities. Upper Egypt (rural as well as urban parts) suffers from the highest poverty indexes in terms of incidence, poverty gap, and severity that are all well above indexes for other regions (cf. Table 5.10). Metropolitan regions suffer the least from poverty and Lower Egypt has an intermediate situation. Moreover, the situation of the poor worsened in Upper Egypt contrarily to Lower and metropolitan regions where all poverty indicators declined from 1995-96 to 1999-2000 (World Bank 2002).

This favorable result in terms of poverty trend for Egypt is offset by an increase in income distribution inequality. Indeed, the Gini coefficient at the national level rose from 34.5 to 37.8% over the same period (1995-2000). In terms of distribution of spending by quintiles of the population, it appears that, the bottom 20% of the population spend 7.6% of total expenditures while the richest 20% spend 45.8% of total expenditures in 1999-2000. While poverty declined as a whole, inequality increased, reflecting that the worsening situation in Upper Egypt outweighed the improvement in distribution in metropolitan areas and in Lower Egypt.

Thus, the relatively satisfactory growth experience of the second half of the nineties seems to have been unevenly distributed among the population. At the national level, the per capita expenditures growth rate was higher for the richest households than for the poorest ones and the poorest regions of Egypt did not benefit from increasing GDP, indicating that economic growth was not "pro poor" (World Bank 2002).

Table 5.10: Poverty Measures (Lower Poverty Line) by Region, 1995/1996 and 1999/2000 (in%)

	P0 (incidence of poverty)		**P1 (poverty gap)**		**P2 (severity of poverty)**	
	1995/96	**1999/2000**	**1995/96**	**1999/2000**	**1995/96**	**1999/2000**
Metropolitan	13.10	5.06	2.61	0.91	0.80	0.26
Lower Urban	8.34	6.17	1.25	0.93	0.26	0.23
Lower Rural	21.53	11.83	3.48	1.57	0.89	0.33
Upper Urban	10.82	19.23	1.81	3.90	0.46	1.18
Upper Rural	29.32	34.15	5.39	6.57	1.50	1.82
All Egypt	19.41	16.74	3.39	2.97	0.91	0.80

Source : World Bank (2002), Report No. 24234-EGT, Arab Republic of Egypt: Poverty Reduction in Egypt.

4.5.2 Links between poverty and labor market characteristics

Poverty is clearly inversely correlated with education. For example, 45.7% of the poor are illiterate as opposed to 28.4% of the non-poor; and the more individuals are educated the less likely they are to be poor. This relationship has important implications for the importance of education for poverty reduction. But at the same time, it has important implications for the inter-generational transmission of poverty, as the poor are the least able to invest in their children's human capital (World Bank 2002).

There is no strong relationship between unemployment and poverty. At the national level and in urban regions, unemployment is not correlated with poverty. This corroborates the fact that the poor can usually not afford to remain unemployed in the absence of unemployment insurance. In contrast, in rural areas poverty incidence increases with unemployment rates. This may be because casual agricultural workers are more likely to be represented among the unemployed in rural areas (World Bank 2002).

The relationship between poverty and employment characteristics is indicative of the labor market performance. Poverty prevalence is higher among unpaid workers and among the self-employed not hiring others. The irregularity of employment has also a strong correlation with poverty as occasional and seasonal workers are twice more likely to be poor than permanent workers. In fact, if wage workers were broken up into casual and regular wage workers, the relationship between poverty and casual wage work would be much more apparent.

Public sector workers are less likely to be poor than those in the private sector. Table 5.11 presents the poverty incidence by economic activity. Workers in agriculture, mining, and construction suffer the most from poverty as they are the most likely to be casual workers. On the other hand, workers in finance, electricity, and services sectors are less likely to be poor (poverty incidence ranging from 4% to 8% in 1999-2000) (World Bank 2002).

4.5.3 Poverty and productivity

The analysis of the relation between poverty, employment growth and productivity is very instructive. Table 5.11 illustrates the fact that "productivity development is consistent with poverty results." Poverty incidence declined faster in economic activities with high growth rates in labor productivity. Indeed, the head count index of poverty declined sharply in agriculture and manufacturing (by 5.2 and 3.7 percentage points respectively) corresponding to the sectors with substantial productivity growth rates for the period 1995-99. In contrast, incidence of poverty increased in the trade sector that experienced a sharp fall in labor productivity (World Bank 2002).

The poverty decline in the second half of the 1990s seems to be linked to the employment growth that resulted from the higher rates of growth achieved in the second half of the decade. However, employment creation has not necessarily coincided with the growth of labor productivity (Table 5.11). The sectors that experienced higher levels of labor productivity did not foster job creation. Indeed, value added per worker grew at the highest rates in the agriculture and manufacturing sectors (4.6% and 7.6% per year respectively) but employment declined in agriculture (-1.1% annually) and grew very slowly in manufacturing (0.7% per year) between 1995-96 and 1999-2000. On the other hand,

Table 5.11: Poverty Incidence by Economic Activities of Individuals, Employment, and Labor Productivity Growth Per Year (in%)

Economic Activity	Poverty Incidence		Employment Growth per year	Value Added per worker (annualgrowth rate)
	1995/1996	1999/2000	1995-1999	1995-1999
Agriculture	27.6	22.4	-1.1	4.6
Mining	4.1	19.9		
Manufacturing	14.9	11.2	0.7	7.6
Electricity	9.6	5.4		
Construction	22.5	18.5	8.4	2.7
Trade	11.3	13.2	18.4	-9.3
Transportation	14.5	11.0		
Finance	4.4	3.8		
Services	10.3	8.4		

Source: World Bank (2002), Report No. 24234-EGT, Arab Republic of Egypt: Poverty Reduction in Egypt.

the trade and construction sectors contributed significantly to job creation (18 and 8% per year respectively) whereas their labor productivity grew modestly (2.7% per year in construction) or even declined (-9.3% annually in trade).

The fact that employment creation was not related to productivity and that economic growth was essentially concentrated in non-tradable sectors puts into question the sustainability of economic growth in Egypt. Thus, the current slowdown in economic growth, associated with the pattern of growth favoring low productivity non-tradable sectors, jeopardizes poverty reduction in the future (World Bank 2002).

5. Labor Market Institutions[19]

5.1 Job Security Regulations

Examining the labor market institutions, issues related to job security deserve considerable attention. Generally, labor unions attempt to provide job security to their members through achieving one or more of the following objectives:

- Restricting the right to collective lay-off
- Restricting temporary contracts Guaranteeing jobs when the firm proprietorship changes.

In restricting the right to collective lay-off, unions seek the compliance with international standards that do not permit laying off workers without a reason, be it related to negligent performance or tight economic conditions. Regulating the process of workers' appeal and compensation is equally important in this perspective to guarantee workers' rights in case the employer refuses to act in accordance with internationally accepted standards.

Termination of individual work contracts has been made easier under the new Labor Law 12/2003. The employer can terminate the contract within a notice period that depends on the employee's length of service. Economic conditions under the new law can justify redundancies.

On the other hand, dismissed employees can appeal to a committee formed of five members including two judges and representatives from employers and labor organizations. The committee's decision is final. If the employee is found to be unfairly dismissed, the committee can require the employer to rehire him/her and/or provide a suitable compensation.

In the case of collective labor litigation, the former labor law 137/1981 required the employer to submit a lay-off request to a committee formed by the prime minister. Whether the request is based on partial or full suspension of operations, the employer needs to address his request to this committee. The new law provides a more flexible framework for the termination of work contracts.

If the dispute is not wholly settled within 30 days of its beginning, the two parties or either one can submit a request for mediation. A mediator is chosen from a list of mediators prepared by the Minister of Labor in consultation with the General Federation of Egyptian Trade Unions and Employers' Organizations as articulated in Article 171. If the mediator's recommendations are refused by one or both parties, a one-month arbitration process shall start. The employer cannot lay off workers during this negotiation process.
The flexibility of the new law is extended to temporary contracts. The law allows several renewals of temporary contracts without forcing the employer to move to a permanent employment status. It is only when the two parties continue to execute the definite-period contract after its expiry that the employment status automatically changes from temporary to permanent according to Article 105.

A change in firm proprietorship represents the most worrying threat to workers and consequently their union representatives. Ownership change may result from death, merger, or privatization of the business unit. Both the old and new laws have in common that labor contracts shall remain unchanged under such circumstances. However, the new law does not restrict the owner's freedom in deciding upon wage reductions he deems necessary for economic reasons.

It is worth noting that neither law applies to public servants of state agencies, including local government units and public authorities, nor to domestic service workers and the like. Public servants enjoy a higher level of job security as their contracts cannot be terminated. The promotion system is seniority rather than performance based. This rigid system consequently separates decisions such as promotion or termination of contract from the process of performance appraisal.

5.2 Social Insurance Regulations

The social security system in Egypt comprises two main types of programs. The first is social assistance in the form of cash transfers and soft loans to help initiate small economic activities, while the second is social insurance that is based on the notion of contributions. Social insurance systems are administered by the General Authority for Insurance and Pensions in cooperation with the General Authority for Social Insurance.
Not only are the contributions high in a way that results in high evasion rates, especially under a weak inspection system, but also they require employers to bear the greatest burden by assuming a two-thirds share. The two factors combined have encouraged 30% of the employers not to pay their assessed contributions. Although contributions should represent 36% of the basic salary and 31% of the variable salary, pensioners usually are dissatisfied with their low pensions that do not meet the most basic demands.

In this context, it might be necessary to point out that all government and public enterprise employees are covered by social insurance while a considerable percentage of private sector employees lack this privilege. Not only do employers evade insurance, but also employees in most cases are not aware of their rights and entitlements. The two factors combined deprive private sector employees from their assessed pensions. This represents one of the main reasons, together with the non-wage benefits, why employees still prefer government and public-enterprise over private sector employment.

In an attempt to improve the situation, Law 156/2002 has established an emergency relief fund for workers whose wages have been discontinued from partially or wholly closed establishments. The fund draws its resources from contributions of 1% of the basic wages of workers in all sectors, whether public or private, along with aid, donations, and investment yields.

It is worth noting that this law was part of the new labor law when it was first proposed. However, it was issued as a separate law almost eight months before the parliament approved the comprehensive labor law. This step highlights the government's commitment to assist workers and empower them under the new more liberal market regulations.

5.3 Wage Determination Rules

Unlike the old labor law that relied on regional committees to set appropriate wages, the recently approved law establishes a National Council for Wages. The Council will be chaired by the Minister of Planning and its main mission is to set minimum wages at the national level to create a balance between wages and prices.

The Council's mission also includes setting the minimum wage annual increments. However, these increments cannot be less than 7% of the basic salary upon which social insurance contributions are reckoned. The Council membership shall include appointed members on the basis of their positions or experiences, elected representatives from employers' organizations, and elected representatives from the General Federation of Egyptian Trade Unions. The prime minister shall form this council within sixty days of the law being put into force, on the condition that half the members belong to the first category while the other half is evenly divided between the second and third categories.

The enforcement of the Council's decisions remains questionable. While the regional committees under the old law had only an advisory role, the National Council for Wages is expected to have more authority in determining minimum wages and incre-ments. However, the law grants the establishment the right to refer its individual case back to the Council if it finds it impossible to finance the set annual increment due to economic difficulties. The Council shall reach a final decision within thirty days of the request submission.

On the other hand, the wages of all government employees are still determined according to the "Certificates' Pricing" system. This centralized system makes it the responsibility of the state to determine minimum wages, cost of living allowance, and annual increases. To avoid the inefficiencies inherited in this system, the government and public enterprise sectors sometimes resort to temporary employment. Under such contracts, the controls of hiring, and even wage limitations in the case of public enterprise only, are set according to the employing unit's demands and budget. However, this flexibility is associated with a lower level of job security.

Moreover, government and public-enterprise employees are eligible to receive allowances, incentives, and over-time compensation. The only condition is that these additions do not exceed 50% of the basic salary for government employees and 100% in the case of public sector employees. For these two categories of employees, the annual raise is proposed by the Ministry of Finance in the government budget presented to the Parliament every year. Upon the approval of the Parliament, the increment reached 20% of the basic salary in the early 1990s but stood at only 10% in recent years.

Box 5.1: Children at Work in Egypt

Despite the fact that access to basic education has greatly improved in the past decades and that child labor is prohibited by law[1], child work, although declining, is still persistent in Egypt. In 1998, out of 12.8 million children aged 6-14, 1.4 million were not attending school, 863 thousand were engaged in market and subsistence work and 2.2 million girls were participating in unpaid domestic work[2]. However from 1988 to 1998 child labor force participation (including market and subsistence activities) has declined sharply from 18.5 percent to 7.1 percent. Younger boys aged 6-11 witnessed the biggest decrease. This occurred jointly with an important increase in school enrollment among those aged 6-14 from 81% to 89% over the same period. Rural girls are the ones who benefited the most from this rise (Zibani, 2002).

Child labor in Egypt is highly segmented along gender lines. Boys aged 6-14 are mostly engaged in market work. The vast majority of them are engaged in agriculture followed by activities in food preparation, retail trade, restaurants, trades in furniture, wood and metal manufacturing, and construction and repair industries. In contrast, the estimates of girls at work are very sensitive to the definition of work used. In 1998, their participation rates (6-14 years old) vary from a low rate of 1.72 percent when only market activities are taken into account to a high 8.18 percent when subsistence activities are included and to a substantial 42.78 percent when adding domestic work. Apart from agriculture that plays a more predominant role than for boys, girls participate in a smaller range of market work industries: food preparation, textile and garment industries, retail trade and various personal services (Assaad, Levison and Zibani, 2001).

Moreover, almost half of the children engaged in market work are unpaid as many of them are unpaid family workers in agriculture. Nevertheless, children aged 6-14 working in market activities, spend on average more than 40 hours per week. And some of them, especially girls, combine market and subsistence work.

Assaad, Levison and Zibani (2001) establish a number of individual, household and community factors affecting work and schooling of children. As expected poverty has a negative impact on schooling for both boys and girls. But its effect on children work is more ambiguous as it varies along gender lines, the definition of work and urban/rural residence. While its impact is indirect for boys, the fact that girls are working (especially at home i.e. subsistence or domestic work) reduces directly their chances of school attendance.

Recent studies on child labor mentioned above (Assaad, Levison and Zibani, 2001 and Zibani, 2002) show that it is crucial to distinguish between the different types of work activities that can be done: market, subsistence and domestic work. Thus it is necessary to implement adequate policies that take into account the fact that boys and girls are engaged in different types of work activities.

In addition, child labor cannot simply be analyzed as school versus work. Indeed a substantial number of boys and girls combine school and work whereas other children neither go to school nor participate in economic activities. Thus more data are needed to better capture the relationship between different child work activities and school attendance, repetition and failure in education.

[1] Child law N°12 of 1996 establishes compulsory schooling for those aged 6-14, thus covering both primary and preparatory education, and prohibits labor under the age of 15.
[2] Market work refers to economic activities for the purpose of market exchanges. Subsistence work refers to animal husbandry and agricultural production for own consumption. Domestic work refers to all kind of unpaid housework.

The determination of the increment is not influenced by the consumer price index (CPI) that is perceived as non-indicative of the real inflation rate in the case of Egypt. For instance, although the CPI remained almost unchanged in the first five months of 2003, several parliament members requested the government to increase wages by at least 15% in the 2003-04 budget to mitigate the inflationary pressures resulting from the shift to a market-determined exchange rate system in January 2003.

It is important to point out that the public-enterprise sector has been given greater flexibility than the government administrative units in terms of employment and wages. Wages and conditions of employment can be set independently by the employing unit rather than being determined by the centralized system. This initiative, which started in 1987, aims at boosting productivity in the public-enterprise sector and matching its employment terms with those applied in the formal private sector.

5.4 Labor Unions and Collective Bargaining

The Egyptian constitution acknowledges labor rights in establishing unions and federations on democratic basis. Syndicate activities are allowed as long as they match the framework of the General Federation for Labor Unions' programs. The constitution highlights the main functions of the unions to include protecting workers' rights and interests, improving work conditions, and raising cultural and social standards for their members and contributing to the vocational training plans.

The General Federation also has the right to draft collective employment contracts, voice the workers' comments on all legislations of concern to them, and approve saving and other group funds. Syndicate membership in Egypt is generally low, it includes around 25% of the total workforce, only 4.5 million workers. However, this rate of participation is much higher than that of workers in other Arab countries with similar economic conditions. Yet this generally low rate of participation in Egypt can be attributed to the centralized structure of the syndicates and the government's continuous attempts to interfere and regulate their activities.

Actually, the government has been successful in limiting the role of labor unions and exercising control over their internal affairs. For instance, it issued Law 35/1976 that restricted the presence of workers who are members of professional syndicates on the executive councils of labor unions. It was only in 1993 that this law was ruled unconstitutional according to Egypt's constitution and international commitments.

The government was also keen to extend its control to union leadership. Not only could confederation leaders keep their positions after retirement thanks to Law 12/1995, but also federation and confederation leaders are entitled to remain in office even if promoted to management positions. Federation leaders were also given unrestricted authority to expel individuals from union membership. This power, coupled with the condition that workers should spend at least five years on a local executive board to be eligible to run for a federation office, managed to keep union leadership under control.
The close ties between union leadership and government usually included an exciting benefit package. Union leaders were often granted one or more of the following privileges/memberships to guarantee their loyalty to the government:

- Parliament/ Shura Council
- City councils as National Democratic Party (NDP) representatives
- Board of General Council of the Holding Companies (10% profit share)
- Workers' Bank, Workers' University, or a North Coast summer resort.

This lack of autonomy has repeatedly hindered workers' organizations from securing their members' rights. Syndicates actually failed to represent the stand of their members in several crucial situations such as Law 203/1991 concerning public enterprises. Privatization schemes pushed the differences between unions' leaders and members to the surface.

For instance, the sit-in that workers at Kafr al-Dawwar Spinning and Weaving Factory organized in 1994 to protest against management decisions turned out against the union council. Workers' demands were not confined to abolishing the new management policies of cutting back bonuses and dismissing labor for minor infractions, but also included the right to choose new representatives after the union council members preferred to side with the management rather than their colleagues.

In an attempt to close this gap, Article 145 of the new Labor Law 12/2003 establishes a consultative council for labor. Its membership gathers elected representatives from both employers and workers' organizations. The council's mission is to express the workers' view in draft laws related to work relationships and international labor agreements before being signed. The council also aims at strengthening the relationship between labor and employers as well as to propose solutions to prevent collective labor litigation in times of national economic crises.

Regarding collective bargaining, the new law shows a considerable degree of flexibility compared to previous labor laws. The law permits collective negotiation at all levels starting at the establishment level and reaching the national level. Collective negotiation may aim at improving labor terms and conditions, fostering cooperation between various labor parties to achieve workers' social development, and settling disputes between workers and employers.

During the collective negotiation process, the employer has no right to make decisions related to the issues under negotiation. If the two parties reach an agreement through negotiation, it is recorded as a binding collective agreement according to the terms of the law. If they fail to attain a common ground, either party may resort to the concerned administrative authority to initiate the mediation process.

Collective labor agreements need to be signed between one or more trade union organizations and the employer or a group of employers, or one or more of their organizations. For any organization to sign the agreement, the absolute majority of its board members must approve it in advance. Collective agreements shall cover a predetermined period not exceeding three years but can be renewed in the light of the prevailing new economic and social conditions. Collective labor litigation represents one of the most important areas that were subject to change under the new law. Aside from the mediation and arbitration processes previously discussed, the 2003 law acknowledges the right of workers to stage peaceful strikes. The law identifies strikes as a tool of collective bargaining rather than illegal work disturbances. Strikes are only prohibited in strategic or vital establishments that are related to national security or provide basic services to citizens.

However, the law requires the trade union committee organizing the strike to get the approval of the board of the concerned general trade union. This approval is conditioned upon the approval of two-thirds of the board members. Once the board approval is granted, the strike organizers need to notify the employer and the concerned administrative authority at least ten days in advance. This notification shall include the reason for the strike and its expected time limit.

Although it is obvious that organizing a strike necessitates lengthy, complicated procedures, the new law remains more flexible. The right to strike is given to workers under the new law rather than being severely penalized by the criminal law as was the case earlier.

The new law also enacts several changes that better address and protect the workers' rights. For example, the law emphasizes the importance of vocational training, workers' safety and health, and subjects the employer to financial and legal penalties in case of non-compliance with such regulations. The new law also prevents the employer from dismissing a worker for participating in a peaceful strike.

5.5 Labor Support

The government established the Social Fund for Development (SFD) so that creditors and donors could contribute to mitigate the negative impact of the structural reform program. The Fund aimed at retraining the displaced public sector workers so that they prepare themselves for reemployment. The government also promoted the idea of employee share in ownership plans (ESOP) to get employees committed to the financial success of the newly privatized firms.

In more recent years, the government favored early retirement plans to attract more foreign investors. As negotiated between the government and the Trade Union Confederation, the program offered a lump-sum compensation and a monthly stipend based on the employees' length of service. The beginning of the program was successful as many workers considered early retirement an opportunity, as they feared that a new labor law would strip them of any compensation while they had no unemployment insurance.

While the government expected displaced employees to invest in small businesses or stocks, they directed their money to large-scale expenses such as the marriage of their dependents. The rapid spending of the compensation or the failure of the investment plan left several workers to an unclear future. Actually, the program gradually became less attractive to workers. The negative experiences of those who tried the program left workers with the impression that the compensation could not meet their regular demands and finding new jobs to supplement their monthly stipends was a difficult task. Moreover, retiring workers could risk eviction from their inexpensive workers' housing units upon leaving the job.

5.6 Reform Initiatives

The new labor law is considered to be a step in a comprehensive plan that addresses market inefficiencies in Egypt. Several other laws have been drafted and will be presented to the parliament in the current and next sessions. The draft laws address different challenging areas such as tax, corporate regulations, SMEs, and competition. Issuing the executive statutes of these laws is capable of improving market conditions and boosting its efficiency.

Reform initiatives also include government plans to reconsider the current tariff structure, pensions' system, and privatization program. Not only has Egypt signed a partnership agreement with the EU that will come into force within a year, but also it is currently negotiating a free trade agreement with the USA. These commitments prove Egypt's willingness to open up its economy and become an integral part of the global market.

Officials affirmed on several occasions Egypt's commitment to resume the privatization program. The prime minister announced a time schedule to privatize 45 companies in light of the current market conditions. The adoption of a market-determined exchange rate system and proposing amendments to the current investment law show that Egypt is trying to combine legal and business reforms to attract foreign investments.

Together with the labor law, this reform agenda is expected to enable Egypt to resume its path towards development. It is true that Egypt's performance in recent years went below that of the early years of the ERSAP, yet the country managed to survive several shocks, (internal and external, political and economic) in a way that proves its ability to compete in the global market if it successfully embarks on the needed reforms.

It is still too early to determine the effect of these institutional changes on the Egyptian labor market. However, the effect in the immediate future is likely to be small. As mentioned earlier, the job security rules of the old labor regime were so draconian that private employers routinely hired workers without the benefit of legal employment contracts or forced new recruits to sign undated letters of resignation before starting their jobs. Moreover, the new law only applies to new employment contracts rather than existing ones, so that existing job protection remains. The legal reforms will be most significant for existing SOEs as well as privatized firms that have a significant portion of their workforce under the protection of legal contracts. It will also be quite relevant to foreign investors who might have been scared away by the strict job security rules that were previously on the books. Together with other reforms in tax and corporate regulations, the new law is a clear sign of increased market liberalization efforts in the Egyptian economy.

6. Conclusions

Our review of labor market conditions in Egypt suggests that the Egyptian labor market is currently being subjected to powerful labor supply pressures emanating from the stage Egypt is at in its demographic transition at the same time as the country is attempting to implement a major structural transformation from a state-led to a market-oriented economy. Supply pressures are currently at their peak, with the labor force growing at over 3% per annum. The female labor force is growing even faster at 5% per annum, as young women's participation rises with higher levels of education. The labor force is also becoming more educated, as the number of secondary school and university graduates grows much faster than the overall labor force. The number of technical secondary graduates, most of whom end up in the labor force, has grown at 6% per annum in the 1990s, after growing at 8% per annum in the 1980s. The number of university graduates has grown at 8% per annum, a significant acceleration over its 2.5% per annum growth rate in the 1980s. There have been major shifts in the composition of graduates in the past two decades as educational authorities tried to anticipate labor market demand. Invariably, however, it appears that when a certain level and type of education is emphasized, its graduates end up being more likely to be unemployed a few years later. For example, the acceleration of technical secondary graduates in the industrial branch in the 1980s and first half of the 1990s has resulted in a significant increase in unemployment among these graduates in the 1990s.

Now that demographic pressures on the education system are beginning to subside, education officials have a golden opportunity to start focusing on improving the quality of education. Despite improvements in enrollment rates, the rate of growth of primary school graduates has fallen to 1.8% per annum in the second half of the 1990s, after reaching nearly 6% per annum in the 1980s. This is a reflection of the fertility declines of the 1980s, which are only now being felt in the educational system and will continue to be felt as the proportion of children in the population declines steadily from here on. This is eventually going to relieve pressure on the secondary education system. This is an opportune moment to increase educational spending per child and to reap the benefits of the demographic window of opportunity on educational investments.

On the demand side, much of the growth of employment in the past decade was in non-tradable sectors like construction, transportation, trade, and services. Overvalued exchange rates in the 1990s contributed to the slower growth of tradeables, thus limiting employment growth to sectors where demand is essentially driven by domestic factors. Traditional sources of labor demand, such as government employment and external migration are still important, but are quickly being exhausted. New sources of labor demand, in particular demand from formal private sector firms, are not growing fast enough to absorb the slack, leading to a growth of informal employment and unemployment.

With respect to labor market performance, open unemployment continues to be the most visible problem, especially for educated youth. However, underemployment is also a serious problem, especially for casual wage workers who are often unable to find enough work to keep them fully employed. From a poverty perspective, this is an even more serious problem than open unemployment because it affects some of the most vulnerable groups in Egyptian society. In addition, there are serious barriers to entry into private sector employment for women. Women, whose ranks are swelled by increasing labor force participation rates, are relegated to a few segments of the labor market, where their growing supply is depressing wages relative to those of men.

The introduction of new, more flexible labor regulations provides an opportunity for re-regulating the labor market on the basis of more realistic rules. Prior to the passage of the new labor law in 2003, private employers routinely skirted labor market regulations by denying their workers the benefits of legal contracts. As a result, workers were often also denied social insurance coverage and any semblance of protection. By allowing greater flexibility in laying off workers, the new rules provide an opportunity for significantly increasing the extent of protection for private sector workers through broader enforcement.

Notes

1 The term "demographic transition" refers to the process by which a society goes from a situation with high levels of birth and death rates to a situation with

low levels of birth and death rates.

2 Infant mortality is the probability of dying between birth and age 1 expressed as deaths per thousand live births. Child mortality is the probability of dying between birth and age 5 also expressed as deaths per thousand live births.

3 Among women aged 15-49.

4 See Assaad (1997, 2002) for a discussion of this issue.

5 Much of this analysis is derived from Assaad (2002)

6 We assumed that the proportion of those with secondary degrees and above among the age bracket 18-24 will vary as a modified exponential and the proportion of those who are illiterate or just read and write will decline exponentially. The proportion of those with basic education was estimated as a residual. There was no need to break up educational attainment into more categories since, as seen in Figure 5.4, these three categories account for most of the variation in labor force participation rates among both men and women.

7 This decline is exaggerated somewhat by the artificial decline in female employment in agriculture from 1990 to 1995 due to methodological changes.

8 It is important to note that not all the micro, small and medium enterprises are part of the informal sector and vice versa. Certain criteria must be taken into consideration: registration, number of workers, the used capital, etc..

9 The share of remittances in GDP appears to be much larger than that shown in Table 3.4 of Chapter III, as the latter is restricted to remittances transferred through the banking system and hence registered as receipts in the balance of payments.

10 CAPMAS modified the definition in 1997 to eliminate from the ranks of the unemployed anyone who receives an income from whatever source, irrespective of their readiness for work and their search for it.

11 CAPMAS modified the definition in 1997 to eliminate from the ranks of the unemployed anyone who receives an income from whatever source, irrespective of their readiness for work and their search for it.

12 Real wages indexes are calculated on the base of nominal wages provided by the CAPMAS Establishment, Wages and Hours of Work surveys (EWHW) and on the Consumer price index of the IMF.

13 Mona Said (2002) has conducted a multivariate analysis of the wage formation process to take into account productivity differentials such as experience and education. Based on the LFSS 88 and ELMS 98 she estimates twelve wage equations where the dependent variable is the log hourly wages and where the explanatory variables comprise education levels, experience, experience squared, region of residence, marital status, unionization, regular/irregular job, in/out establishment, large establishment (more or less than 50 employees), blue/white collar job and economic activity (industry, services, agriculture). She estimates twelve separate wage equations to account for both years (1988, 1998), gender (male, female), and the employment sectors (government, public enterprises, private sector).

14 They use the average female characteristics in one year, say 1988, to predict male and female wages for both years, 1988 and 1998.

15 The World Bank report (2002) estimates an absolute poverty line based on household expenditures necessary to

meet the food and non- food basic needs (lower poverty line). The measure used in this report takes into account regional differences in relative prices, activity levels and the size and age composition of the household.

16 The headcount index (or incidence of poverty) measures the proportion of poor households in total population.

17 The poverty gap index measures the gap between household expenditures and the poverty line.

18 The poverty severity index measures the degree of inequality among the poor.

19 This section was drafted by Laila El-Khawaga.

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Annex A

EGYPT: Multi-Criteria Analysis

Multi-criteria analysis is a useful tool for benchmarking Egypt's performance with respect to a group of subjective and objective indicators. The aim is to supplement the analysis in the previous chapters with an assessment of Egypt's comparative performance vis-à-vis the 15 countries of the European Union (EU) before the latest enlargement (referred to hereinafter as EU-15), the new 10 countries in Central and Eastern Europe acceded to the EU in May 2004 (referred to hereinafter as EU-10), as well as the economies in the South Mediterranean region that are engaged in Association Agreements with the EU (referred to hereinafter as Mediterranean Partners - MPs).

The use of both subjective and objective indicators establishes the link between the economic policy framework and overall economic performance. The subjective indicators are essentially reflective of the policy environment on different levels encompassing macroeconomic and trade policies as well as the regulatory and institutional framework. The mirror-side of this policy framework is – to a large extent – reflected in the performance according to the objective indicators[1].

The objective criteria used in this report span different areas pertaining to main macroeconomic indicators affecting internal and external balances, openness indicators, as well as human development and information and communications technology (ICT) development. The subjective criteria relate to the optimality of regulation of economic activity, the stance of trade liberalization, and governance indicators.

With respect to the 14 objective indicators enlisted in figure (A.1), it appears that Egypt's performance have rather retreated or stagnated relative to last year[2]. The weakening aspects are mainly modest FDI performance (FDI inflows as a percentage of GDP), a protracted downturn that negatively affected recent growth performance, deterioration in the budget deficit, decline in credit provided to the private sector, as well as a slight increase in the debt service ratio. Those unfavorable outcomes have resulted from a multiplicity of factors detailed in previous chapters; the aim of this annex is to highlight their implications for Egypt's comparative performance.

In a comparative context, Egypt seems to be maintaining favorable performance in the external debt profile **(debt service ratio and external debt as a percentage of GDP)** relative to the three comparator groups – EU-15, EU-10, and MPs. This is primarily a reflection of a significant debt reduction in 1990 (within the framework of the Paris Club negotiations), as well as subsequent reluctance to rely on foreign borrowing to finance the budget deficit, despite an improvement in Egypt's international credit ratings.

Areas of concern relate mainly to the indicators of Egypt's integration into the global economy. The openness indicators **(per capita sum of exports and imports and FDI as a percentage of GDP)** highlight Egypt's weakness relative to comparators. The gap between Egypt and other MPs is particularly acute in the ratio of FDI to GDP.

[1] Refer to box (A.1) for details on the methodology and data sources.
[2] For a comparison with last year's figures, see "FEMISE. 2003. FEMISE Report on the Euro-Mediterranean Partnership". For the figures used in this report, they correspond to the years 2000-2002 depending on the latest updates available.

In terms of **inflation**, the successful disinflation experience of the 1990s have reduced inflation rates to low levels by international standards, with a continued erosion of the inflation differential between Egypt and its main trading partners. Despite being slightly behind other MPs on this indicator, Egypt's performance is at par with EU-15 and clearly surpasses EU-10.

Despite strong **growth performance** during the early 1990s, the recent slowdown in activity has brought Egypt's performance on that indicator to the level of other MPs. Although having a better position vis-à-vis EU-15, as they currently experience low growth rates, Egypt's growth still falls short of EU-10 performance. In addition, **GDP per capita** remains low relative to all comparator groups; however, it is worth noting that including Israel among the group of MPs largely inflates their corresponding figure.

Recent improvements in the **current account balance as a percentage of GDP** have enhanced Egypt's comparative position on this indictor, as it outperformed EU-10 countries, while remaining slightly behind MPs and EU-15. On the contrary, a deteriorating fiscal budget has outstripped Egypt of the stabilization benefits accrued during the 1990s as the **budget deficit** started to increase steadily since 1998/99. Currently, Egypt's position compares unfavorably to all comparator groups with respect to this indicator. On another front, the ratio of **credit to the private sector as a percentage of GDP** remains in favor of Egypt in comparison to both MPs and EU-10, whereas it lags behind EU-15.

With regard to human development indicators, there is large room for improving **life expectancy** and the **Human Development Index**, especially in comparison to EU-15 and EU-10. MPs' performance, although better than Egypt, remains lagging relative to Europe. As for indicators that proxy the level of development of ICT in Egypt, the figures reveal that Egypt falls behind all three comparator groups with respect to **number of telephone lines per capita** and **number of internet users per capita**. This indicates that investment in ICT should gain further momentum to promote a strong base for a knowledge-based and innovation-driven economy.

The analysis of the subjective indicators presents a more optimistic picture as it indicates improvement on half of the indicators enlisted in figure (A.1), while other indicators maintained the same position as last year. As indicated earlier, the subjective indicators mirror the policy stance whereas the objective indicators can be considered policy outcomes. Due to the presence of lags in policy impact, it is expected that this improvement in some of the subjective indicators will reflect positively on Egypt's objective indicators in the near future. The variables that witnessed an improvement in Egypt's comparative performance relative to last year are: tariff and non-tariff barriers, free trade in capital markets, regulation of foreign investments, regulation of economic activity in general, and control of the black market[3].

With regard to **tariff and non-tariff barriers**, Egypt continued reform of its tariff system, albeit at a slow pace, which caused an improvement over last year's stance, where now Egypt outperforms other MPs. However, the traditional tendency towards protectionism, coupled with the lingering of numerous non-tariff barriers, still act to Egypt's disadvantage in comparison with EU-15 and EU-

[3] It is worth noting that these subjective indicators are based on a myriad of indicators, some of which are of qualitative nature developed from responses to questionnaires and surveys undertaken by a number of independent organizations (see box (A.1) for the source used for each indicator). Therefore, they are conditioned to an extent by the general market sentiment in the economy under study, hence the name 'subjective' indicators.

10. A striking feature among Egypt's subjective indicators is that its performance with respect to the **free use of currencies** is at par with prevailing international standards as it positions Egypt on the top of class 5 along with EU-15 and EU-10, with a considerable gap between Egypt and other MPs to Egypt's favor.

As for the **protection of property rights** and **free trade in capital markets**, Egypt outperforms MPs on both indicators revealing the existence of positive perceptions regarding the lack of threat of expropriation, the security of contractual agreements, and the supporting legislation for capital market activity. Despite being at par with EU-10 performance, Egypt lags behind EU-15 countries that are characterized by more developed financial markets as well as better enforcement of protection of intellectual property rights.

On the optimality of regulation in Egypt, the figures reveal that Egypt's performance is generally not optimal in the **regulation** of economic activity relative to all comparators. This is primarily a reflection of the multiplicity of regulations, arbitrary decision-making, granting sizable discretionary power to government officials, as well as long-standing hurdles in tax and customs administration. However, perceptions are more positive with respect to the **regulation of foreign investment** where Egypt occupies a similar position to both MPs and EU-10, but is placed slightly behind EU-15. In addition, Egypt's performance on the indicator of **control of the black market** is largely close to MPs and EU-10.

On the governance front, utilizing the indicators of **voice and accountability** and the **control of corruption**, Egypt remains underperforming especially with regard to the latter indicator. Providing a stimulus for political and institutional reforms is deemed crucial to improve Egypt's performance on both fronts. Finally, with respect to **Moody's credit ratings**, Egypt's superior performance relative to MPs stems from a favorable external debt profile and relatively sustained success in macroeconomic stabilization. However, Egypt's performance remains lagging relative to EU-15 and EU-10 possibly due to concerns about the future course of the economy in light of slack economic growth coupled with ambiguity surrounding the new monetary policy regime.

When looking at the overall position in the objective criteria (figure A.2), Egypt lies at the lower half of the third class close to the average for all MPs, as well as Tunisia and Latvia. Egypt maintains a superior position relative to Slovakia, Estonia, Poland, Romania, Turkey, Bulgaria, Algeria, Morocco and Syria. However, Egypt needs concerted efforts to improve its position vis-à-vis the average for EU-10 and EU-15 as well as the Mashrek group, especially Jordan which is currently leap-frogging on several fronts.

With regard to the subjective criteria (figure A.3), Egypt maintains its position in the third class, albeit at a better position relative to the objective criteria. On this front, Egypt outperforms most MPs, except for Jordan, where continuing policy reforms have positioned it on the frontier between the third and fourth classes. In addition, a notable gap exists between Egypt and most countries in the EU-10 group as well as EU-15, which indicates the need for further reforms as discussed in various chapters of the report.

Annex A

Box A.1.: Details of the classification method used and countries fact-sheets

To compare the performance of various economies, we have applied a particular multicriteria method based on the concept of "outranking" and using the concept of tri: the "electre-tri" method developed at LAMSAD, University of Paris-Dauphine.

In concrete terms, it means assigning each country of the sample selected to classes of predefined categories sorted in a hierarchy so that class n°5, for example, gathers the best performing economies with regard to the criteria chosen, class n°4 covers those economies less powerful than class n°5, but more powerful than class n°3,and so forth. The assignment of an economy to a class rests on the comparison of the performances of this economy to previously established and hierarchical profiles. The comparison uses the principle of "outclassing"; which means that for the criteria chosen, economy A outclasses profile i when it obtains, in a majority of cases (fixed at 70%in the analysis) at least as good a result as that of the profile considered. If the economy in question outclasses profile no. 1, it is assigned to class n°5. In the contrary case, it is compared with profile no.2 with, in the event of a positive result, assignment to class n°4 or a comparison with the following profile, etc. If the economy is surclassed by all the profiles, it is assigned to the last class. In order to have robust results, the outclassing must be without ambiguity.

In addition to the imprecision of statistical measurements, it is advisable to know when the value of a statistical indicator must be judged better than another value. Does an indicator of human development of 0.910 really outclass a rate of 0.908? To face these problems, we use the possibility offered by the electre-tri method based on the use of pseudo-criteria: the definition of thresholds of indifference (Sa) and strict preference (Sp).

The threshold of indifference makes it possible to define, for a criterion, a minimal value Sa below which the difference between an economy and a profile, for this criterion, will be judged non relevant. Compared to the previous example, if one fixes the threshold of indifference Sa at 0.02, one considers the two values (0.910 and 0.908) like equivalent. If the threshold is fixed at 0.005 a value of 0.908 is judged worse than 0.910, while a value of 0.909 is equivalent to 0.910. The threshold of strict preference Sb defined also for each criterion indicates the value beyond which, for this criterion, there is a clear outclassing in the comparison. Sb is generally higher than Sa. In our example, by fixing Sa at 0.02 and Sb at 0.03, we consider that a value of 0.908 is equivalent to 0.910, but that a value of 0.907 (0.910-Sb) is worse than the two others.

Provided with these thresholds, the method calculates, for each economy, a outranking degree compared to each profile taking into account all the criteria; the degree varies between 0 and 1 and could be perceived as the relevance of the assertion: "this economy outclasses this profile". If, for a profile, this index is higher than a given value (70% in our analysis), the economy outranks this profile. It is this degree, which fixes the position of the point on the graphs. The procedure used to establish the profiles of comparison and the thresholds is crucial – so as to be able to have confidence in the posted results. In order to obtain the most objective possible results, we have applied systematic methods. We chose as a norm the 80th centile of the distribution for profile 1, the 60th centile for profile 2, the 40th centile for profile 3 and the 20th centile for profile 4. One can thus translate into simple terms the significance, for a criterion given, of the comparison between the performance of an economy and the norm of its associated profile. On 100 economies, if, for an indicator, the economy considered outclasses profile n°l, it is that it is located in the 20 first economies in terms of performance. If the economy, on the contrary, is surclassed by profile n°4, it is that 80% of the economies in the sample (from 120 to 203 countries of the World Bank, according to the specific criteria) do better than it for the criterion given. The centiles of the distribution are also at the base of the calculation of the thresholds.

Thus, the threshold Sa is equal to 5% of the distribution (and the threshold Sb is 7,5%): for example for profile 1, it is concerned with the difference between the 80th and the 75th centile. The principle is that in a classification of 100 economies, when a threshold has been placed at the nth place, the fact of being between the nth and the n+5th place is equivalent.

Sources of DATA:

Subjective criteria:

- Tariff and non tariff barriers (The Heritage Foundation-The Wall Street Journal),
- The free use of foreign currency (The Fraser Institute),
- Property rights (The Heritage Foundation-The Wall Street Journal),
- The freedom of exchange on the capital market (The Fraser Institute),
- The regulation of foreign investments(The Heritage Foundation-The Wall Street
- Journal),
- The regulation (The Heritage Foundation-The Wall Street Journal),
- Black market control(The Heritage Foundation-The Wall Street Journal),
- Participation and transparency (Kaufmann D., Kraay A., Zoido-Lobaton P.),
- Corruption control(Kaufmann D., Kraay A., Zoido- Lobaton P.),
- Moody's Ratings

Objective criteria:

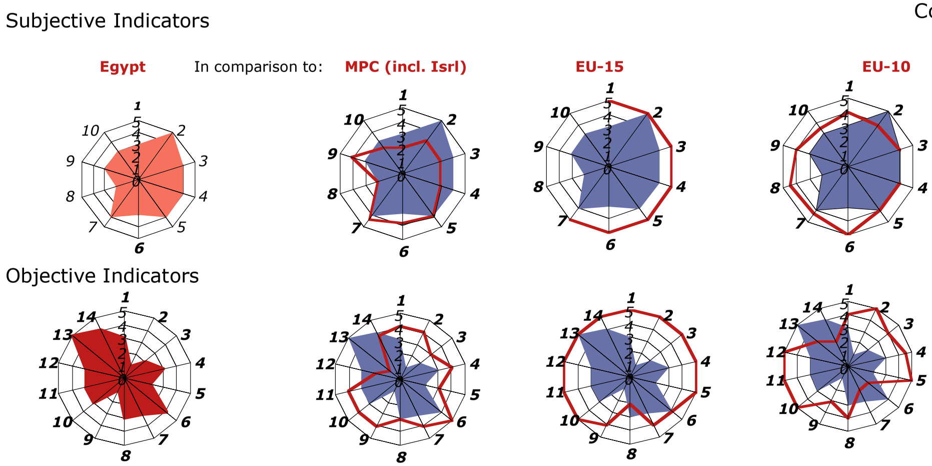
- Life expectancy(World Bank),
- Share of FDI in GDP (IMF),
- Openness measured by the exports+imports ratio per habitant (IMF and World Bank),
- GDP per capita(IMF and World Bank),
- Human Development Indicator(HDI, 2000, UNDP),
- Inflation (CPI, IMF and World Bank),
- Current account % of GDP (IMF and World Bank),
- GDP growth(IMF and World Bank),
- Budget deficit % of GDP(IMF and World Bank),
- Number of phone lines for each 1000 habitants (World Bank),
- Number of internet users for each 1000 habitants (World Bank),
- Debt Servic as % of exports of goods and services (World Bank),
- External debt as % of GDP (World Bank),
- Banks credit to private sector as % of GDP (IMF and World Bank).

Figure (A.1): Egypt's Compartative Peroformance on Subjective and Objective criteria

2002 or more recent data

Egypt

Subjective Indicators		*Objective indicators*
Tariff & Nontariff barriers	1	Life Expectancy
Free Use of Currencies	2	FDI (% of GDP)
Property Rights	3	Openness per capita (imports + exports)
Free Trade in Capital Markets	4	Per capita GDP ($PPP)
Regulations on Foreign investment	5	Human Development Indictaor
Regulation	6	Inflation (CPI)
Black Market Control	7	Current Account Balance (%GDP)
Voice & accountability	8	GDP Growth
Control of corruption	9	Budget Deficit
Rating Moodys	10	Telephone (main lines) per 000, 2002
	11	Internet User per 000, 2002
	12	Total debt service (% of exports of goods and services)
	13	External Debt (% GDP)
	14	Credit granted to Private Sector (% GDP)



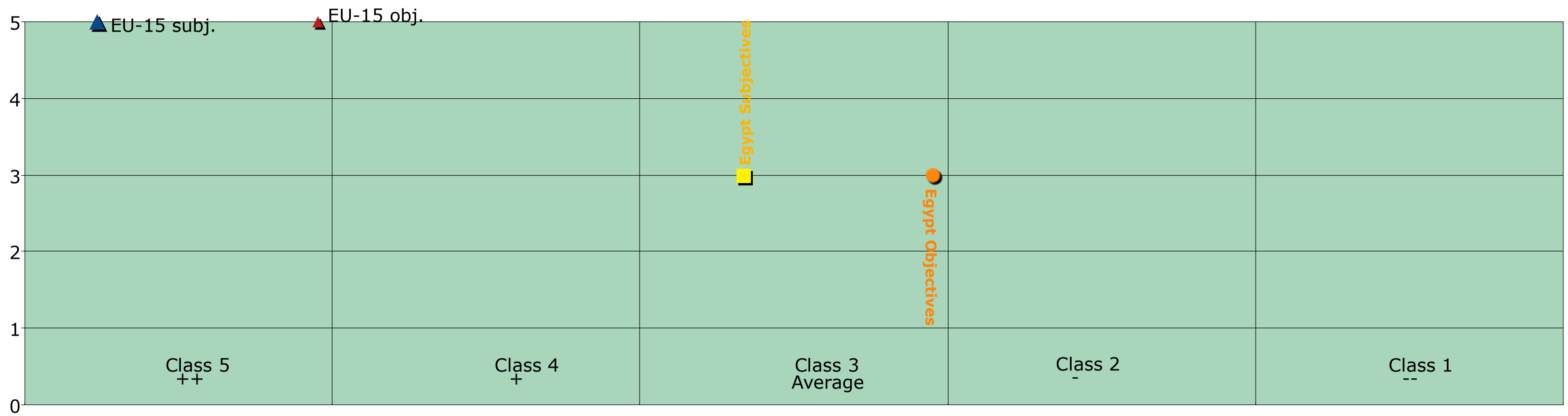


Figure (A.2): Objective Criteria

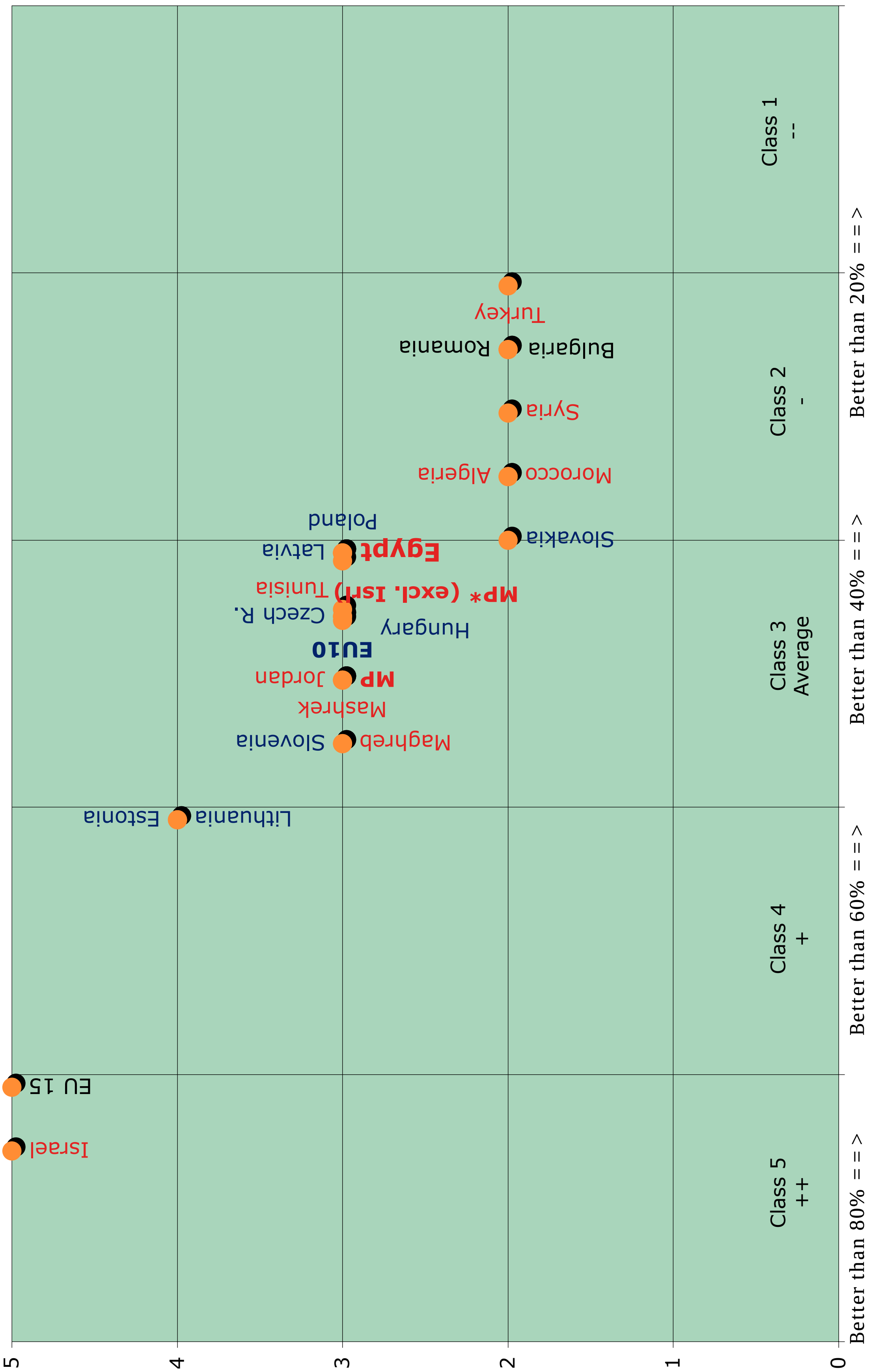
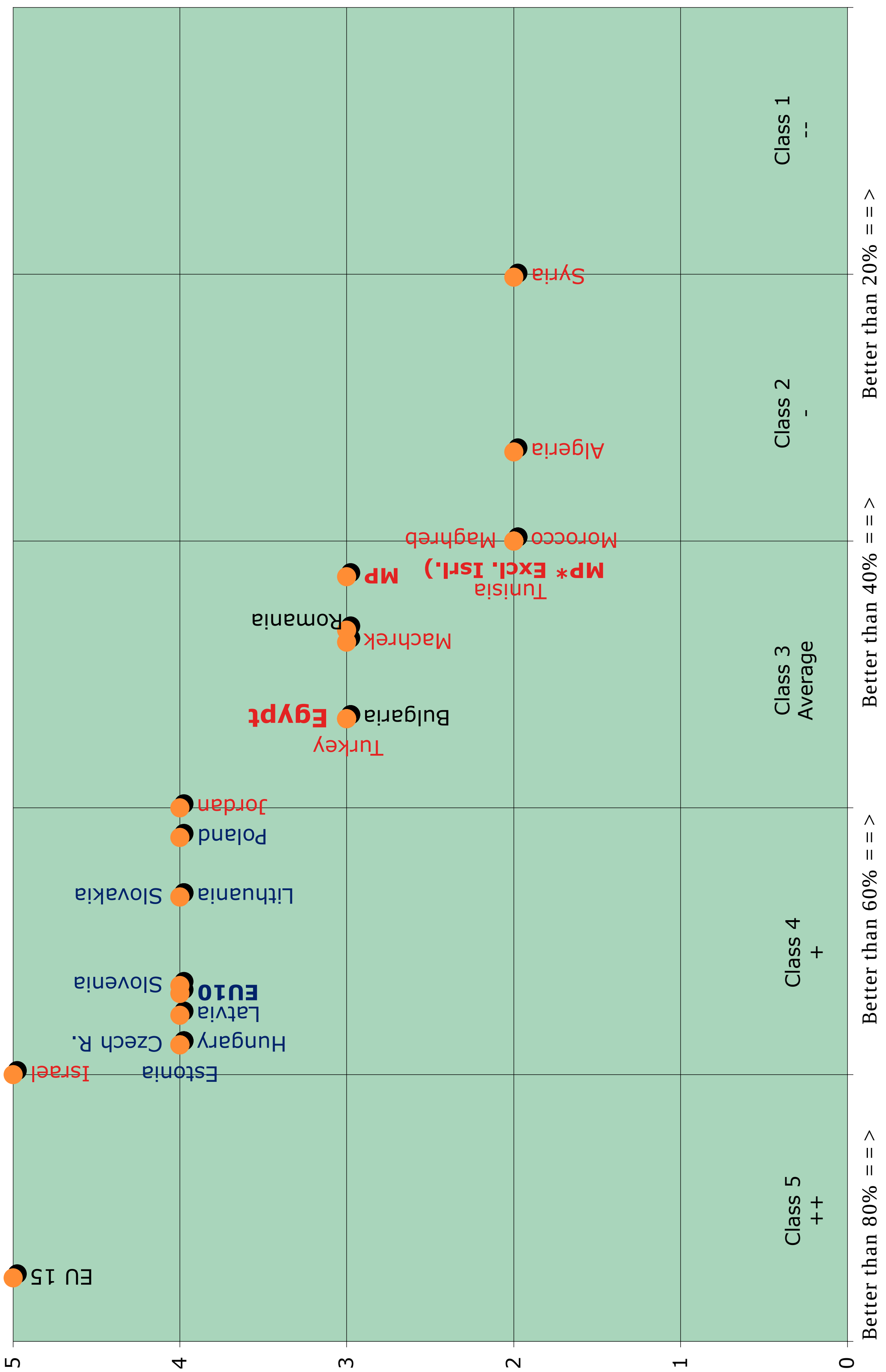


Figure (A.3). Subjective Criteria



Annex B

Performance of the Egyptian Economy

Table B2.1: Banking System Credit and Deposits *(LE billion)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Credit	49	61	58	68	88	107	129	152	179	204	227	241	260	284
Government	9	13	7	8	15	17	18	16	13	12	12	13	14	13
Public Enterprises	12	15	16	19	24	25	28	32	29	31	32	29	32	30
Private Enterprises	24	28	29	31	38	50	65	83	105	132	151	165	178	190
Households	1	2	2	7	9	13	16	20	30	26	29	31	32	32
Total Deposits	69	93	110	129	139	157	175	201	216	237	260	290	319	403
Government	6	11	16	20	18	21	27	29	32	32	38	42	46	67
Public Enterprises	9	11	11	12	14	17	18	20	17	16	15	16	15	17
Private Enterprises	11	14	13	14	17	20	23	32	36	43	45	46	48	55
Households	40	55	67	80	89	96	105	118	129	144	161	186	198	264

Source: CBE, Annual Reports (various issues).

Table B2.2: Ownership Structure of the Banking System

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of Banks														
Public Commercial Banks	4	4	4	4	4	4	4	4	4	4	4	4	4	4
Specialized Public Banks	4	4	4	4	4	4	4	4	4	4	4	3	3	3
Private Commercial & J.V. Banks	40	40	40	26	24	24	24	24	24	24	24	22	20	20
Business & Investment Banks	11	11	11	11	11	11	11	11	11	11	11	11	11	10
Branches of Foreign Banks	22	22	22	21	21	21	21	21	20	20	20	20	20	18
Number of Branches														
Public Commercial Banks	656	663	772	811	831	851	866	883	908	918	913	921	921	921
Specialized Public Banks	909	936	976	959	963	993	1,002	1,012	1,031	1,043	1,069	1,071	1,071	1,071
Private Commercial & J.V. Banks	221	251	254	253	261	273	288	298	312	323	340	367	367	413
Business & Investment Banks	43	45	74	74	80	86	88	90	98	105	112	126	126	120
Branches of Foreign Banks	45	45	45	36	39	38	41	42	42	45	47	51	51	48

Source: CBE, Annual Reports (various issues).

Table B2.3: Banking System Distribution of Assets, Loans and Deposits (in percent)

ASSETS	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Banks	56.82	59.38	63.85	64.03	63.69	62.25	61.58	60.07	59.26	58.58	58.56	59.04	58.57
Public Commercial Banks	49.31	52.55	57.00	58.23	57.83	56.69	55.71	54.04	52.78	51.59	51.69	52.20	51.95
Public Specialized Banks	7.51	6.83	6.85	5.80	5.86	5.56	5.87	6.03	6.48	6.99	6.87	6.84	6.62
Private Banks	43.18	40.62	36.15	35.97	36.32	37.75	38.43	39.93	40.75	41.42	41.44	40.96	41.42
Private Commercial Banks	25.26	24.30	22.66	21.96	23.14	23.42	24.12	26.04	26.42	27.05	26.95	26.79	26.87
Business & Investment Banks	17.92	16.32	13.50	14.01	13.18	14.33	14.30	13.89	14.33	14.37	14.49	14.17	14.55
LOANS													
Public Banks	61.31	63.36	61.84	61.49	60.51	63.28	62.87	60.34	57.53	57.99	59.99	60.11	59.67
Public Commercial Banks	48.62	51.43	48.74	49.66	50.57	53.23	53.07	50.04	46.99	47.34	49.40	49.16	48.77
Public Specialized Banks	12.69	11.93	13.10	11.83	9.94	10.05	9.80	10.30	10.54	10.65	10.59	10.95	10.90
Private Banks	38.46	36.54	37.87	38.51	38.44	36.73	37.12	39.66	42.47	42.01	40.01	39.89	40.33
Private Commercial Banks	22.22	20.52	22.23	23.74	24.18	23.46	24.16	26.61	28.62	28.07	26.57	26.46	26.23
Business & Investment Banks	16.24	16.02	15.64	14.76	14.72	13.27	12.96	13.04	13.85	13.94	13.44	13.43	14.10
DEPOSITS													
Public Banks	61.48	61.86	67.58	70.87	569.9	68.18	66.86	65.44	64.02	62.40	61.75	61.42	60.43
Public Commercial Banks	58.95	59.97	65.66	68.94	67.47	65.31	63.51	62.16	60.08	57.96	57.34	57.06	56.11
Public Specialized Banks	2.53	1.89	1.92	1.93	2.48	2.87	3.35	3.28	3.94	4.44	4.41	4.36	4.32
Private Banks	38.52	38.14	32.42	29.13	30.05	31.82	33.14	34.57	35.98	37.61	38.26	38.58	39.57
Private Commercial Banks	27.27	27.75	24.34	21.97	22.79	23.20	24.00	25.66	26.59	27.06	26.72	26.91	27.2
Business & Investment Banks	11.25	10.39	8.09	7.16	7.26	8.62	9.14	8.90	9.39	10.55	11.54	11.67	12.37

Table B2.4: Number of Banking Units and Density for Selected Years per Governorate

Governorate	End of June 1990			End of June 1995			End of June 2003		
	Population (million)	No. of banking units*	Banking density**	Population (million)	No. of banking units	Banking density	Population (million)	No. of banking units	Banking density
Cairo	6.4	285	0.45	7.2	373	0.52	7.4	439	0.59
Alexandria	3.2	115	0.36	3.7	137	0.37	3.6	155	0.43
Port-Said	0.5	26	0.52	0.5	32	0.64	0.5	35	0.70
Suez	0.4	17	0.43	0.4	22	0.55	0.4	20	0.50
Ismailia	0.6	29	0.48	0.6	34	0.57	0.8	46	0.58
Beheira	3.6	124	0.34	4.1	122	0.30	4.4	126	0.29
Damietta	0.8	34	0.43	1.8	42	0.23	1.0	49	0.49
Kafr El Sheikh	2.0	79	0.40	2.1	83	0.40	2.4	91	0.38
Gharbieh	3.1	107	0.35	3.6	112	0.31	3.7	114	0.31
Dakahlia	3.8	123	0.32	4.3	132	0.31	4.6	141	0.31
El Sharkia	3.8	139	0.37	4.3	150	0.35	4.7	165	0.35
El Monoufiah	2.4	74	0.31	2.6	82	0.32	3.0	89	0.30
Qaliubiya	2.9	76	0.26	3.2	83	0.26	3.6	85	0.24
Giza	4.3	115	0.27	4.6	159	0.35	5.2	203	0.39
Fayoum	1.7	51	0.30	1.8	63	0.35	2.2	67	0.30
Beni Souef	1.6	53	0.33	1.7	56	0.33	2.1	62	0.30
Menia	2.9	109	0.38	3.4	116	0.34	3.6	119	0.33
Assiout	2.4	82	0.34	2.9	86	0.30	3.1	103	0.33
Sohag	2.7	96	0.36	3.1	98	0.32	3.4	105	0.31
Kena	2.5	88	0.35	3.0	104	0.35	3.1	109	0.35
Aswan	0.9	38	0.42	0.9	48	0.53	1.1	53	0.48
Red Sea	0.1	10	1.00	0.1	22	2.20	0.2	25	1.25
El Wadi El Gedid	0.1	14	1.40	0.1	16	1.60	0.1	8	0.80
Matrouh	0.2	7	0.35	0.2	6	0.30	0.2	7	0.35
North & South Sinai	0.2	35	1.75	0.3	45	1.50	0.3	48	1.60
Total	**53.1**	**1,926**	**0.36**	**59.5**	**2,223**	**0.37**	**64.6**	**2,464**	**0.38**

* Including the head office and branches.

** Ten thousand individual per banking unit.

Source: Compiled by the author from Central Bank of Egypt, Economic Bulletin, and Central Agency for Public Mobilization and Statistical (CAPMAS), Yearbooks, (various issues).

Table B2.5: Traded Bond

Government bonds	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
No. of bonds	-	-	-	-	-	-	-	-	23	25	27	27	27
Nominal value (LE billion)	-	2.5	2.4	2.4	0.4	3.5	3.8	8.0	8.2	11.1	13.1	13.1	NA
Market capitalization (LE billion)	-	-	-	-	-	-	-	-	8.6	10.5	13.2	13.6	NA
Value traded (LE billion)	-	0.0	0.0	0.0	0.0	0.1	0.3	0.2	0.7	2.1	2.8	7.9	NA
Turnover % (end-year)	-	-	-	-	-	-	-	-	8.2	20.0	21.2	58.1	NA
Development bonds													
No. of bonds	-	-	-	-	-	-	-	-	94	89	102	108	106
Nominal value (LE billion)	-	-	-	-	-	0.0	0.4	1.8	1.0	1.0	1.2	1.3	NA
Market capitalization (LE billion)	-	-	-	-	-	-	-	-	0.9	1.0	1.1	1.3	NA
Value traded (LE billion)	-	-	-	0.02	0.01	0.02	0.01	0.01	0.00	0.00	0.02	0.40	NA
Turnover % (end-year)	-	-	-	-	-	-	-	-	0.1	0.01	1.82	3.0	NA
Corporate bonds													
No. of bonds	-	-	-	-	-	-	-	-	19	27	31	29	27
Nominal value (LE billion)	-	-	-	-	0.0	0.0	0.1	0.1	2.3	1.9	4.6	5.1	NA
Market capitalization (LE billion)	-	-	-	-	-	-	-	-	2.5	3.9	5.0	4.8	3.2
Value traded (LE billion)	-	-	-	-	0.00	0.00	0.05	0.13	0.4	0.2	0.3	0.5	NA
Turnover % (end-year)	-	-	-	-	-	-	-	-	4.1	5.1	6	10.4	NA
Total bonds													
No. of bonds	-	-	-	-	-	-	-	-	136	141	160	164	160
Nominal value (LE billion)	-	2.5	2.4	2.4	0.4	3.5	4.3	9.9	11.5	14.0	18.9	19.2	NA
Market capitalization (LE billion)	-	-	-	-	-	-	-	-	12.07	15.4	19.2	19.7	NA
Value traded (LE billion)	-	0.00	0.00	0.02	0.01	0.09	0.38	0.33	1.10	2.30	3.10	8.80	NA
Turnover % (end-year)	-	-	-	-	-	-	-	-	9.11	15.0	16.2	44.7	NA

Source: CBE, CMA and CASE. Data for equities refers to end-year and (for value traded) calendar year 2001.

Table B2.6: Stock Exchange

Official list	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
No. of companies	470	519	567	603	583	521	112	107	124	139	141	147	153
Nominal value (LE billion)	0.0	0.0	1.0	1.1	2.0	3.0	3.9	4.5	8.1	8.9	10.6	11.0	NA
Market capitalization (LE billion)	10.0	11.6	27.3	30.3	65.9	73.8	77.9	57.5	38.0	31.5	24.0	20.3	NA
Value traded (LE billion)	0.0	0.0	0.1	0.0	0.3	2.1	6.1	13.6	9.0	10.0	9.0	7.2	NA
Turnover % (end-year)	0.0	0.0	0.4	0.0	0.5	2.8	7.8	23.7	23.7	31.7	36.7	23.6	NA
Others													
No. of companies	59	63	68	71	117	225	530	543	710	881	935	963	971
Nominal value (LE billion)	0.6	0.8	0.8	0.8	2.1	7.4	9.8	13.8	22.5	38.2	65.2	72.0	NA
Market capitalization (LE billion)	9.5	10.9	17.2	14.4	101.3	53.8	101.3	311.4	298.1	245.4	94.9	64.1	NA
Value traded (LE billion)	0.0	0.1	0.2	0.2	0.7	1.4	2.3	5.7	7.9	20.9	31.9	17.7	NA
Turnover % (end-year)	0.0	0.9	1.2	1.4	0.7	2.6	2.3	1.8	2.7	8.5	32.8	28.4	NA
Total equities													
No. of companies	529	582	635	674	700	746	642	650	834	1020	1076	1110	1151
Nominal value (LE billion)	0.6	0.8	1.8	1.9	4.1	10.4	13.7	18.3	30.6	47.1	75.8	83.0	NA
Market capitalization (LE billion)	19.5	22.5	44.5	44.7	167.2	127.6	179.2	368.9	336.1	276.9	118.9	112.3	122.4
Value traded (LE billion)	0.0	0.1	0.3	0.2	1.0	3.5	8.4	19.3	16.9	30.9	40.9	24.9	25.9
Turnover % (end-year)	0.0	0.4	0.7	0.4	0.6	2.7	4.9	5.2	5.0	11.2	33.6	22.0	21.2

Annex B

Table B2.7: Insurance and Pension Funds *(in LE billion unless otherwise specified)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Insurance														
Number of entities	***9***	***9***	***9***	***9***	***11***	***11***	***11***	***12***	***13***	***13***	***15***	***16***	***17***	***20***
of which: private	*5*	*5*	*5*	*5*	*7*	*7*	*7*	*8*	*9*	*9*	*11*	*12*	*13*	*16*
Premium income	***1.02***	***0.95***	***1.09***	***1.19***	***1.32***	***1.64***	***1.69***	***1.72***	***1.83***	***1.96***	***2.04***	***2.10***	***2.28***	***2.88***
Life	*0.23*	*0.22*	*0.23*	*0.24*	*0.28*	*0.33*	*0.36*	*0.40*	*0.47*	*0.56*	*0.62*	*0.66*	*0.72*	*0.95*
Non-life	*0.79*	*0.73*	*0.86*	*0.93*	*1.04*	*1.31*	*1.33*	*1.32*	*1.37*	*1.40*	*1.42*	*1.46*	*1.56*	*1.95*
Investment funds	***3.81***	***4.62***	***5.46***	***5.87***	***6.45***	***7.21***	***8.37***	***9.65***	***10.32***	***11.31***	***12.43***	***12.81***	***12.84***	***14.05***
Private Pension Funds														
Number of entities	***330***	***336***	***408***	***411***	***504***	***535***	***544***	***554***	***577***	***591***	***595***	***600***	***607***	***618***
Premium income	***0.1***	***0.2***	***0.3***	***0.4***	***0.5***	***0.6***	***0.7***	***0.8***	***0.9***	***1.1***	***1.3***	***1.4***	***1.4***	***1.5***
Investment funds	***1.3***	***1.8***	***2.2***	***2.8***	***2.8***	***3.2***	***3.7***	***4.5***	***5.3***	***6.2***	***7.0***	***8.1***	***9.8***	***10.8***

Source: MFT Quarterly Economic Digest, (various issues).

Table B2.8: Investments of Insurance and Pension Funds

	Value *(LE million)*						**Share of Total Investment** *(in percent)*					
Insurance												
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Government bonds	***1,877***	***2,301***	***2,658***	***2,708***	***2,822***	***3,521***	***19.6***	***22.0***	***23.5***	***22.5***	***22.1***	***26.0***
Securities and shares	***2,782***	***3,277***	***3,823***	***4,160***	***4,444***	***4,333***	***29.0***	***31.3***	***33.8***	***34.5***	***34.8***	***32.0***
Real estate	***522***	***536***	***544***	***583***	***622***	***612***	***5.4***	***5.1***	***4.8***	***4.8***	***4.9***	***4.5***
Mortgage	***1***	***16***	***14***	***18***	***11***	***13***	***0.0***	***0.2***	***0.1***	***0.1***	***0.1***	***0.1***
Loans to policyholders	***45***	***52***	***67***	***83***	***98***	***116***	***0.5***	***0.5***	***0.6***	***0.7***	***0.8***	***0.9***
Other loans	***101***	***83***	***78***	***65***	***67***	***122***	***1.1***	***0.8***	***0.7***	***0.5***	***0.5***	***0.9***
Fixed deposits	***4,271***	***4,208***	***4,128***	***4,425***	***4,702***	***4,842***	***44.5***	***40.2***	***36.5***	***36.7***	***36.8***	***35.7***
TOTAL	**9,599**	**0,473**	**1,312**	**2,042**	**2,766**	**,548**	**100**	**100**	**100**	**100**	**100**	**100**
Pension Funds												
Government bonds	***2,520***	***3,069***	***3,685***	***4,268***	***4,837***	***6,109***	***55.8***	***57.7***	***59.6***	***61.0***	***60.0***	***61.4***
Securities and shares	***237***	***336***	***282***	***358***	***390***	***407***	***5.2***	***6.3***	***4.6***	***5.1***	***4.8***	***4.1***
Real estate	***185***	***185***	***124***	***140***	***145***	***166***	***4.1***	***3.5***	***2.0***	***2.0***	***1.8***	***1.7***
Loans to members	***123***	***101***	***116***	***141***	***138***	***185***	***2.7***	***1.9***	***1.9***	***2.0***	***1.7***	***1.9***
Fixed deposits	***1,383***	***1,544***	***1,915***	***1,996***	***2,492***	***2,913***	***30.6***	***29.0***	***30.9***	***28.5***	***30.9***	***29.3***
Other investments	***71***	***81***	***66***	***89***	***62***	***173***	***1.6***	***1.5***	***1.1***	***1.3***	***0.8***	***1.7***
TOTAL	**4,519**	**5,316**	**6,188**	**6,992**	**8,064**	**9,954**	**100**	**100**	**100**	**100**	**100**	**100**

Source: EISA, Annual Report (various issues).

Table B2.9: Equity-to-Assets Ratio (non-risk weighted) *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	***1.76***	***4.70***	***4.02***	***3.85***	***3.73***	***3.53***	***3.50***	***3.18***	***4.27***	***4.52***	***4.41***	***4.10***	***3.74***	***4.59***
Public Commercial Banks	***1.29***	***4.53***	***3.87***	***3.67***	***3.55***	***3.36***	***3.22***	***2.94***	***3.75***	***3.94***	***3.89***	***3.65***	***3.35***	***4.05***
Public Specialized Banks	***4.82***	***6.00***	***5.26***	***5.65***	***5.42***	***5.24***	***6.14***	***5.27***	***8.48***	***8.79***	***8.33***	***7.55***	***6.83***	***8.84***
Private and JV Banks	***5.81***	***4.85***	***5.46***	***5.15***	***6.51***	***6.38***	***6.33***	***6.48***	***6.97***	***7.00***	***7.01***	***6.73***	***6.29***	***6.03***
Private Commercial Banks	***5.29***	***4.66***	***5.07***	***4.87***	***6.02***	***6.08***	***5.87***	***5.81***	***6.80***	***6.89***	***7.05***	***6.67***	***6.14***	***Na***
Business & Inv Banks	***6.54***	***5.14***	***6.10***	***5.58***	***7.37***	***6.87***	***7.10***	***7.72***	***7.28***	***7.20***	***6.95***	***6.86***	***6.57***	***Na***
Banking System	***3.51***	***4.76***	***4.54***	***4.32***	***4.74***	***4.61***	***4.58***	***4.49***	***5.37***	***5.55***	***5.49***	***5.18***	***4.80***	***5.30***

Table B2.10: Private Sector Loans-to-Assets *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	15.38	12.72	11.16	8.97	10.39	13.30	16.96	19.52	23.88	29.73	33.53	33.61	32.89	31.10
Public Commercial Banks	9.99	7.91	7.04	8.06	9.51	12.46	16.26	18.59	23.03	28.96	33.10	32.91	32.04	30.46
Public Specialized Banks	50.75	49.77	45.41	18.17	19.08	21.87	23.59	27.91	30.88	35.35	36.76	38.99	39.49	36.20
Private and JV Banks	28.27	25.98	26.16	27.69	31.26	33.96	37.51	39.45	43.72	48.57	47.58	45.59	43.68	39.53
Private Commercial Banks	32.51	29.06	27.36	30.96	33.09	36.79	40.15	42.11	46.98	51.54	50.13	47.62	45.36	NA
Business & Inv Banks	22.28	21.40	24.15	22.57	28.03	29.33	33.07	34.47	37.71	43.00	42.83	41.76	40.58	NA
Banking System	19.48	16.95	15.52	14.85	16.97	19.98	23.48	25.92	30.02	35.08	36.82	36.05	35.04	34.60

Table B2.11: Household Sector Loans-to-Assets *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	0.90	0.70	0.74	3.79	4.76	6.25	7.10	7.47	8.01	9.20	9.50	8.74	8.17	7.12
Public Commercial Banks	0.65	0.50	0.56	0.77	1.72	3.08	3.58	3.66	4.00	4.79	4.71	4.27	3.91	3.16
Public Specialized Banks	2.53	2.25	2.25	34.09	34.76	38.57	40.59	41.59	40.67	41.70	45.55	42.88	41.59	38.75
Private and JV Banks	1.62	1.69	2.59	3.44	3.92	4.77	4.62	5.19	10.90	5.15	4.89	4.92	4.67	4.40
Private Commercial Banks	1.78	1.74	2.68	3.86	4.22	5.54	5.49	5.99	6.25	5.56	5.06	5.01	4.53	NA
Business & Inv Banks	1.40	1.61	2.46	2.77	3.41	3.51	3.16	3.69	19.48	4.37	4.58	4.76	4.92	NA
Banking System	1.12	1.03	1.32	3.46	4.21	5.39	5.81	6.19	8.63	7.03	7.10	6.72	6.30	5.99

Table B2.12: Government Sector Loans-to-Assets *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	11.20	11.79	4.51	4.73	9.35	9.41	9.60	7.34	4.94	4.34	4.06	3.98	3.63	2.69
Public Commercial Banks	10.22	11.24	3.14	3.47	8.58	8.30	8.67	6.30	3.88	3.38	3.40	3.58	3.28	2.38
Public Specialized Banks	17.68	11.43	12.07	11.22	11.44	11.99	12.59	13.00	13.53	14.93	15.16	15.05	14.15	15.19
Private and JV Banks	3.30	3.15	2.99	3.08	3.19	3.15	2.84	2.39	2.19	2.02	2.09	1.88	1.96	1.76
Private Commercial Banks	0.10	0.16	0.13	0.23	0.31	0.51	0.68	0.62	0.56	0.49	0.68	0.52	0.80	NA
Business & Inv Banks	7.80	7.60	7.80	7.56	8.26	7.46	6.48	5.70	5.19	4.89	4.71	4.45	4.10	NA
Banking System	7.24	7.75	3.70	3.91	6.72	6.67	6.61	5.06	3.59	3.16	3.03	2.92	2.75	2.30

Table B2.13: Public Sector Loans-to-Assets *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	16.73	15.14	13.97	14.16	17.37	15.98	16.30	16.00	13.20	13.34	12.85	10.35	9.56	9.19
Public Commercial Banks	19.26	17.10	15.64	15.56	19.12	17.54	18.02	17.78	14.82	15.14	14.56	11.55	10.65	10.07
Public Specialized Banks	0.11	0.00	0.08	0.09	0.08	0.08	0.00	0.00	0.00	0.00	0.00	1.19	1.01	2.18
Private and JV Banks	1.62	1.35	0.90	0.77	0.95	1.41	2.02	2.32	2.50	2.60	2.10	1.58	1.52	1.57
Private Commercial Banks	32.51	29.06	27.36	30.96	33.09	36.79	40.15	42.11	46.98	51.54	50.13	47.62	45.36	NA
Business & Inv Banks	1.97	1.69	0.59	0.29	0.47	0.97	1.77	3.05	3.60	3.66	2.71	1.80	2.07	NA
Banking System	9.49	8.93	8.65	8.83	10.78	9.93	10.22	9.94	8.30	8.31	7.86	6.32	5.84	6.04

Table B2.14: Foreign Currency-Denominated Lending as a Percent of Total Loans

(in percent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Public Sector Banks	12.38	12.43	11.21	14.3	15.28	13.9	14.18	16.88	19.3	18.32	16.8	16.73	16.15
Public Commercial Banks	13.40	13.66	11.96	15.97	16.70	15.54	15.88	19.58	22.99	21.86	20.00	19.99	19.31
Public Specialized Banks	8.56	7.16	8.52	7.50	7.41	5.79	4.99	3.76	3.03	2.62	2.33	2.12	2.00
Private and JV Banks	38.13	35.55	45.08	44.18	42.66	35.41	36.45	38.29	33.03	30.44	25.49	24.05	25.53
Private Commercial Banks	25.35	22.03	37.05	39.80	39.73	30.67	32.74	34.81	32.30	27.35	23.10	23.39	25.84
Business & Inv Banks	53.87	52.07	55.04	51.20	47.63	43.79	43.35	45.39	34.18	36.69	30.22	25.35	24.95
Banking System	22.57	20.99	24.51	25.82	24.81	21.86	22.45	25.37	25.48	23.43	20.32	19.65	19.93

Table B2.15: Provisions-to-Loans Ratios

(in percent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	10.14	9.22	13.67	16.67	14.46	14.81	14.04	14.57	15.05	13.98	12.35	12.95	13.25	12.93
Public Commercial Banks	10.90	9.44	14.81	18.08	18.33	15.91	15.21	16.10	16.83	15.46	13.37	13.73	13.94	13.49
Public Specialized Banks	7.27	8.26	9.57	10.75	10.49	8.96	7.68	7.14	7.15	7.22	7.58	9.49	10.16	10.42
Private and JV Banks	14.54	15.10	17.99	16.79	15.64	14.84	13.68	12.20	11.56	11.04	11.73	12.83	13.74	15.81
Private Commercial Banks	13.43	14.61	16.82	15.14	14.35	13.19	12.15	10.77	10.54	10.49	11.20	12.42	13.46	NA
Business & Inv Banks	16.07	15.72	19.64	19.44	17.82	17.74	16.53	15.11	13.66	12.16	12.76	13.63	14.27	NA
Banking System	11.62	11.28	14.96	16.72	14.87	14.82	13.90	13.63	13.00	12.73	12.10	12.90	13.45	14.08

Table B2.16: Indicators of Public Enterprises Financial Performance

(In billion of Egyptian pounds, unless otherwise specified

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Operating revenues	36.7	44.07	48.89	50.38	52.38	55.45	55.08	58.94	46.57	33.84	32.98	32.64	29.61	34.35
Other revenues	4.5	5.84	6.76	6.65	7.11	7.48	4.3	NA	NA	NA	NA	5.19	3.85	3.4
Wages and salaries	4	4.47	4.75	5.16	5.5	5.79	6.07	6.03	4.13	4.89	NA	NA	NA	NA
Earnings before interest & tax	NA	4.65	6.28	7.49	8.45	9.06	9.8	6.7	5.69	7.15	4.57	2.5	2.9	2.44
Interest	1.8	2.17	3.33	4.02	4.22	4.07	4.14	4.13	NA	NA	NA	2.95	2.6	3.2
Profits of profitable companies[1]	1.5	1.78	2.12	2.51	3.12	3.56	3.94	4.34	3.73	3.68	3.15	2.34	2.23	2.32
Losses of losing companies	-0.3	-0.59	-1.62	-2.47	-2.39	-2.45	-3.29	-2.51	-2.08	-1.6	-1.9	-2.7	-2.3	-3.59
Net profits	1.2	1.2	0.5	0.04	0.73	1.11	0.65	1.55	1.66	3.54	NA	NA	NA	NA
Net profit margin (%)	NA	NA	1	0.1	1.4	2.1	1.2	4.3	5.4	8.1	NA	NA	NA	NA
Return on investment (%)	NA	NA	NA	0.05	0.86	1.26	0.72	1.63	3.09	3.29	NA	NA	NA	NA
No. of profitable companies	260	254	224	204	214	202	184	180	165	168	150	116	117	113
No. of losing companies	54	60	90	108	99	88	92	82	59	41	50	62	62	61
No. of Co. left under Law 203	314	314	314	312	313	290	276	262	224	209	200	178	179	174
Carried loss balances[2]	-2	-2.37	-3.91	-6.17	-7.89	-9.76	-12	-13.28	-15.36	-10.28	NA	NA	NA	NA
Net assets	NA	62.53	69.56	76.73	84.85	88.28	90.27	94.86	53.57	63.1	62.1	60.4	62.5	56.07
Total debt	NA	47.13	53.5	60.79	67.58	70.4	74.88	74.37	NA	NA	NA	27.92	24.94	29.52
Net equity	NA	10.73	10.65	9.91	9.45	10.14	8.59	12.02	NA	NA	NA	NA	NA	NA

Source: Compiled by the author from the Public Enterprise Office. It should be noted that these are figures for companies under Law 203 and that this base number is decreasing with time, and hence comparing figures may be somewhat misleading.

1 Profitable companies are those which achieve a return on sales of 10% or more.

2 It should be noted that even in cases where a profitable company has an outstanding historical balance of carried losses, and is at present making profits it tends to allocate only a very small percentage of its profit to reducing its loss balance.

Table B2.17: Loans-to-Assets Ratio *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	44.75	41.27	31.71	32.75	42.77	45.79	50.39	50.62	50.80	57.32	60.76	57.41	54.76	50.35
Public Commercial Banks	40.75	37.79	27.86	29.08	39.92	42.30	47.00	46.66	46.58	53.10	56.68	53.11	50.46	46.35
Public Specialized Banks	71.07	68.04	63.69	69.57	70.90	81.32	82.55	86.15	85.15	88.45	91.40	90.30	88.48	82.30
Private and JV Banks	38.55	35.48	36.18	36.47	40.04	43.84	47.66	50.04	60.08	59.09	57.27	54.92	52.32	47.73
Private Commercial Banks	36.37	32.61	31.95	36.82	39.56	45.13	49.40	51.49	56.69	60.55	58.49	55.70	52.45	NA
Business & Inv Banks	41.63	39.75	43.26	35.93	40.89	41.75	44.71	47.32	66.33	56.35	55.02	53.44	52.09	NA
Banking System	39.14	36.43	31.19	32.22	39.47	42.68	46.61	47.52	51.26	54.26	55.50	52.78	50.41	49.26

Table B2.18 Loans-to-Equity Ratios *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	1482	791	689	780	935	1038	1187	1245	1047	1123	1152	1155	1190	1098
Public Commercial Banks	314	834	719	792	1123	1258	1461	1586	1241	1347	1457	1455	1508	1144
Public Specialized Banks	687	700	630	756	656	742	841	886	834	879	830	836	855	931
Private and JV Banks	636	774	709	644	555	608	630	613	911	782	792	780	792	792
Private Commercial Banks	663	731	663	709	615	687	753	773	862	845	817	816	832	NA
Business & Inv Banks	1474	1134	1211	1231	1309	1552	1344	1633	1004	1006	1097	1197	1296	NA
Banking System	2541	878	788	850	1148	1297	1441	1594	1189	1268	1377	1400	1465	950

Table B2.19: Number of Projects Approved and Cases of Bankruptcy

	1995	1996	1997	1998	1999	2000	2001	2002	2003
No. of Bankrupt Co.	17	18	21	25	27	47	27	22	26
No. of Newly Approved Co.	1,416	1,835	3,027	4,156	3,893	3,258	2,772	2,286	2150

Source: General Authority for Investment (GAFI).

Table B2.20: Liquidity Ratio[3] *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	40.72	50.78	61.05	59.08	51.22	48.28	44.18	44.89	44.15	37.42	34.61	42.46	39.60	44.56
Private and JV Banks	52.12	55.27	54.33	54.43	51.34	47.08	43.69	41.79	37.07	32.59	34.04	28.79	39.21	44.57
Banking System	45.65	52.61	58.62	57.41	51.26	47.83	43.99	43.65	41.26	35.42	34.37	36.86	39.44	44.57

3 Liquidity Ratio is the ratio of liquid assets (cash, InterBank claims of any maturity, government bonds and treasury bills) to total assets.

Table B2.21 Loans-to-Deposits Ratio *(in percent)*

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	69.33	66.52	47.55	45.34	59.07	63.21	69.29	69.97	71.58	79.73	84.60	81.19	77.15	71.11
Public Commercial Banks	57.13	55.61	38.39	37.64	51.90	55.51	61.58	61.08	62.29	70.03	75.02	71.47	67.90	62.76
Public Specialized Banks	353.7	412.5	361.6	320.0	254.2	238.5	215.5	238.7	213.3	206.5	209.2	208.4	197.3	177.10
Private and JV Banks	72.4	63.5	64.0	69.0	73.4	78.4	82.5	87.0	103.6	96.4	91.1	85.8	79.6	69.91
Private Commercial Banks	56.47	47.97	47.22	56.38	60.92	68.86	74.15	78.69	85.74	89.66	86.61	81.5	75.34	NA
Business & Inv Banks	111.18	104.8	114.5	107.7	112.6	104.9	104.5	111.4	154.1	113.7	101.4	95.41	89.07	NA
Banking System	68.8	64.1	51.9	51.2	61.8	66.2	71.3	73.5	79.9	82.4	83.4	79.5	74.9	70.63

Table B2.22: Rate of Growth of Deposits *(in percent)*

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	35.42	29.30	23.16	6.21	9.60	9.54	12.26	5.59	6.86	8.58	11.23	15.17	16.34
Public Commercial Banks	36.91	29.60	23.29	5.31	8.85	8.62	12.26	4.32	5.77	8.55	11.28	15.11	16.14
Public Specialized Banks	0.57	19.89	18.48	38.00	30.14	30.51	12.12	29.68	23.59	9.02	10.54	16.00	18.95
Private and JV Banks	19.70	(2.22)	17.25	16.37	30.82	22.34	23.91	19.40	18.57	20.59	12.78	20.03	21.24
Private Commercial Banks	16.34	2.18	26.62	20.59	29.38	24.43	30.14	21.85	16.68	20.84	12.63	18.29	NA
Business & Inv Banks	24.29	(7.86)	3.93	9.07	33.56	18.46	11.76	13.83	23.17	20.01	13.11	24.07	NA
Banking System	23.87	(3.53)	16.06	30.82	21.20	21.21	17.86	18.67	13.94	10.99	6.71	10.53	18.27

Table B2.23: Rate of Growth of Loans *(in percent)*

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Public Sector Banks	29.92	(7.57)	17.43	38.3	17.28	20.09	13.36	8.01	19.03	15.22	6.74	9.43	7.24
Public Commercial Banks	33.28	(10.53)	20.89	45.22	16.41	20.49	11.36	6.40	18.90	16.29	6.02	9.36	7.34
Public Specialized Banks	17.29	5.10	4.85	9.62	22.12	17.93	24.15	15.88	19.65	10.49	10.12	9.79	6.78
Private and JV Banks	16.74	1.51	13.73	18.07	27.55	22.08	26.20	33.69	6.67	5.44	6.18	11.47	6.43
Private Commercial Banks	16.34	2.18	26.62	20.59	29.38	24.43	30.14	21.85	16.68	4.65	6.07	9.26	NA
Business & Inv Banks	17.23	0.69	(2.25)	14.03	24.43	17.94	18.86	57.83	(9.10)	7.02	6.40	15.82	NA
Banking System	24.70	(4.21)	15.98	30.56	20.85	20.82	18.12	18.20	13.49	11.10	6.52	10.25	6.91

Table B3.1a: Quota Utilization of Textiles and Yarn Exports to the European Union (January - December 2002)

Item	Unit	Quota	Usage	Percentage of Usage
Cotton Yarn	***Ton***	***64860***	***17413***	***27***
Cotton Textiles	***Ton***	***22950***	***3785***	***16.5***

Source: Ministry of Foreign Trade, Aggregated Foreign Trade Report, January 2003.

Table B3.1b: Quota Utilization of Textiles and Yarn Exports to the United States (January - December 2002)

Item	Unit	Quota since 2002	Usage	Percentage of Usage
Yarn	***Kg.***	***15120341***	***9158038***	***60.6***
Cotton Cloth	***M^2***	***162117786***	***6057006***	***3.7***
Towels	***Kg.***	***2207655***	***663971***	***30.1***
Knitted Shirts & T-Shirts	***Dozen***	***4208146***	***2789089***	***66.3***
Un-Knitted Shirts	***Dozen***	***1743376***	***492983***	***28.3***

Source: Ministry of Foreign Trade, Aggregated Foreign Trade Report, January 2003.

Table B3.1c: Quota Utilization of Cotton Yarn and Cotton Cloth Exports to Turkey (January - December 2002)

Item	Exportation Period	Quota (Ton)	Usage (Ton)	Percentage of Usage
Cotton Yarn	***1/1-31/12/2002***	***6225***	***2219.7***	***37.2 percent***
Cotton Cloth	***1/1-31/12/2002***	***1285***	***71.93***	***5.6 percent***

Source: Ministry of Foreign Trade, Aggregated Foreign Trade Report, January 2003.

Table B3.2: Ranking of Top 20 commodities with RCA based on 3 digits SITC

Ranking / Year	1985	1990	1995	2000
1.	263 Cotton;	263 Cotton;	323 Briquettes; coke and semi-coke of coal, etc.;	263 Cotton;
2.	333 Petroleum oils, crude, also from bituminous minerals;	265 Vegetable textile fibers (excl. cotton and jute);	265 Vegetable textile fibers (excl. cotton and jute);	323 Briquettes; coke and semi-coke of coal, etc.;
3.	265 Vegetable textile fibers (excl. cotton and jute);	333 Petroleum oils, crude, also from bituminous minerals;	263 Cotton;	265 Vegetable textile fibers (excl. cotton and jute);
4.	684 Aluminum;	651 Textile yarn;	333 Petroleum oils, crude, also from bituminous minerals;	273 Stone, sand and gravel;
5.	651 Textile yarn;	323 Briquettes; coke and semi-coke of coal, etc.;	651 Textile yarn;	659 Floor coverings, etc.;
6.	075 Spices;	075 Spices;	334 Petroleum products, refined;	658 Made-up articles, wholly or chiefly of textile mat.;
7.	551 Essential oils, perfume and flavour materials;	941 Animals, live, n.e.s.;	075 Spices;	846 Under garments, knitted or crocheted;
8.	652 Cotton fabrics, woven;	684 Aluminum;	042 Rice;	333 Petroleum oils, crude, also from bituminous minerals;
9.	054 Vegetables, fresh, chilled, frozen or simply preserved;	042 Rice;	941 Animals, live, n.e.s.;	042 Rice;
10.	042 Rice;	289 Ores and concentrates of precious metals, waste, scrap;	054 Vegetables, fresh, chilled, frozen or simply preserved;	334 Petroleum products, refined;
11.	269 Old clothing and other old textile articles; rags;	334 Petroleum products, refined;	245 Fuel wood (excluding wood waste) and wood charcoal;	245 Fuel wood (excluding wood waste) and wood charcoal;
12.	334 Petroleum products, refined;	652 Cotton fabrics, woven;	659 Floor coverings, etc.;	651 Textile yarn;
13.	056 Vegetables, roots and tubers, prepared or preserved;	054 Vegetables, fresh, chilled, frozen or simply preserved;	658 Made-up articles, wholly or chiefly of textile mat.;	054 Vegetables, fresh, chilled, frozen or simply preserved;
14.	289 Ores and concentrates of precious metals, waste, scrap;	846 Under garments, knitted or crocheted;	844 Under garments, textile fab. (not knitted/crocheted);	562 Fertilizers, manufactured;
15.	061 Sugar and honey;	271 Fertilizers, crude;	652 Cotton fabrics, woven;	844 Under garments, textilefab. (not knitted/crocheted);
16.		658 Made-up articles, wholly or chiefly of textile mat.;	846 Under garments, knitted or crocheted;	075 Spices;
17.		291 Crude animal materials, n.e.s.;	675 Hoop and strip, of iron or steel;	684 Aluminum;
18.		056 Vegetables, roots and tubers, prepared or preserved;	289 Ores and concentrates of precious metals, waste, scrap;	289 Ores and concentrates of precious metals, waste, scrap;
19.		269 Old clothing and other old textile articles; rags;	684 Aluminum;	271 Fertilizers, crude;
20.		673 Iron and steel bars, rods, angles, shapes, sections;	056 Vegetables, roots and tubers, prepared or preserved;	056 Vegetables, roots and tubers, prepared or preserved;

Source: Authors' Calculation, Trade Can database, World Bank and ECLAC, 2002 edition

Table B3.3: Applied and Bound Tariffs on Imports, and Water in the Tariff by ISIC category, 1999

(Units and per cent)

ISIC Code	Products	No. of lines	Applied tariffs 1999		Final bound rate 2005		Water in the tariff
			Simple average	Range	Simple average	Range	
Total		**6,032**	**26.8**	**0-3,000**	**27.1**	**2-3,000**	**0.3**
1	**Agriculture, forestry and fishing**	*311*	*18.5*	*1-40*	*27.5*	*2-80*	*9.0*
111	*Agriculture and livestock production*	*225*	*19.3*	*1-40*	*27.9*	*2-80*	*8.6*
121	*Forestry*	*24*	*16.5*	*5-40*	*21.9*	*10-80*	*5.4*
122	*Logging*	*13*	*5.0*	*5-5*	*20.0*	*20-20*	*15.0*
130	*Fish and shellfish, live, fresh or frozen*	*49*	*19.2*	*3-40*	*30.1*	*5-60*	*10.9*
2	**Mining and quarrying**	*114*	*10.9*	*3-40*	*21.7*	*3-60*	*10.8*
210	*Coal mining*	*4*	*3.0*	*3-3*	*8.8*	*5-20*	*5.8*
220	*Crude petroleum and natural gas production*	*3*	*5.0*	*5-5*	*20.0*	*20-20*	*15.0*
230	*Metal ore mining*	*23*	*4.8*	*3-5*	*20.0*	*20-20*	*15.2*
290	*Other mining*	*84*	*13.2*	*5-40*	*22.9*	*3-60*	*9.7*
3	**Manufacturing**	*5,607*	*48.61*	*0-3,000*	*29.8*	*2-160*	
311	*Food products*	*458*	*23.32*	*1-80*	*31.5*	*5-80*	*8.2*
	Slaughtering, preparing and preserving meat	*87*	*26.59*	*3-80*	*37.8*	*5-80*	*11.2*
	Dairy products	*24*	*20.38*	*1-40*	*24.1*	*5-60*	*3.7*
	Canning and preserving of fruit and vegetables	*65*	*33.88*	*1-40*	*45.0*	*5-60*	*11.1*
	Fish products	*19*	*22.24*	*5-40*	*25.7*	*5-60*	*3.5*
	Manuf. of vegetable & animal oils/fats	*52*	*10.44*	*1-40*	*22.4*	*5-60*	*12.0*
	Grain mill products	*34*	*10.59*	*5-40*	*16.1*	*5-60*	*5.5*
	Manufacture of bakery products	*13*	*35.12*	*40-40*	*60.0*	*60-60*	*24.9*
	Sugar factories and refineries	*15*	*16.83*	*5-30*	*23.3*	*10-40*	*6.5*
	Cocoa, chocolate and sugar confectionery	*13*	*33.85*	*20-40*	*46.4*	*20-60*	*12.6*
312	*Other food products and animal feed*	*34*	*27.10*	*1-40*	*37.2*	*5-80*	*10.1*
	Other food products	*34*	*27.35*	*1-40*	*39.8*	*10-80*	*12.5*
	Prepared animal feed	*2*	*26.67*	*5-30*	*20.0*	*5-40*	
313	*Beverages*	*24*	*667.34*	*5-3,000*	*1,823.0*	*10-3,000*	*1155.7*
	Distilling, rectifying and blending spirits	*1*	*600.00*	*40-3,000*	*2,351.0*	*80-3,000*	*1751.0*
	Manufacture of wine	*7*	*2229.29*	*5-3,000*	*2,626.0*	*10-3,000*	*396.7*
	Manufacture of malt liquor	*3*	*420.00*	*30-1,200*	*430.0*	*45-1,200*	*10.0*
	- Soft drinks and mineral water	*10*	*40.00*	*40-40*	*70.0*	*60-80*	*30.0*
314	*Tobacco products*	*6*	*47.39*	*20-85*	*72.0*	*20-85*	*24.6*
321	*Textiles*	*727*	*37.73*	*5-54*	*28.8*	*5-60*	
	- Spinning, weaving and finishing textiles	*394*	*41.66*	*5-54*	*23.2*	*5-35*	
	- Made-up textile goods, exc. wearing apparel	*66*	*37.50*	*5-54*	*35.0*	*10-60*	
	- Knitting mills	*18*	*54.00*	*30-54*	*38.7*	*30-40*	
	- Carpets	*27*	*38.52*	*40-40*	*60.0*	*60-60*	*21.5*
	- Cordage, rope and twine	*12*	*27.92*	*20-30*	*30.0*	*30-30*	*2.1*

Cont...

ISIC Code	Products	No. of lines	Applied tariffs 1999		Final bound rate 2005		Water in the tariff
			Simple average	Range	Simple average	Range	
	- Textiles, n.e.s.	28	26.76	10-54	28.0	15-30	1.2
322	Clothing (except knitted or crocheted)	257	39.51	30-40	42.0	40-60	13.9
323	Leather and leather products	47	31.49	5-40	45.4	20-60	16.8
324	Leather footwear	15	40.00	30-40	56.8	40-60	18.2
331	Wood products, except furniture	73	21.37	5-40	39.6	10-60	18.2
	- Sawmills, planing and other wood mills	34	21.37	5-40	35.2	10-60	13.8
332	Wooden furniture (excl. metal)	23	39.78	30-40	58.3	20-60	18.5
341	Paper and product products	144	26.82	5-40	32.7	5-60	5.9
	- Pulp, paper and paperboard	107	19.25	5-40	23.6	5-60	4.4
	- Containers, boxes of paper & paperboard	8	34.38	10-40	60.0	60-60	25.6
342	Printing and publishing	27	19.89	0-40	42.4	20-60	22.5
351	Industrial chemicals	733	13.54	3-40	16.6	3-60	3.1
	- Basic industrial chemicals (exc. fertilizers)	524	11.03	3-40	12.4	3-60	1.4
	- Fertilizers and pesticides	27	17.22	5-30	28.6	20-40	11.4
	- Synthetic resins, plastic materials and man-made fibers (except glass)	117	12.36	3-40	29.2	5-60	16.8
352	Chemical products and pharmaceuticals	327	20.72	0-40	31.8	3-70	11.1
	- Paints, varnishes and lacquers	12	25.00	10-30	38.8	20-50	13.8
	- Drugs and medicines	64	6.41	1-40	12.9	3-70	6.5
	- Soap, cleaning preparations, perfumes	34	30.76	5-40	51.8	20-60	21.0
353	Petroleum refineries	23	15.76	5-30	21.7	10-40	5.9
354	Petroleum and coal products	8	13.13	3-20	23.8	20-40	10.7
355	Rubber products	68	30.00	0-40	37.9	2-60	7.9
	- Tire and tube industries	13	30.00	20-30	39.3	30-40	9.3
356	Plastic products	51	29.78	10-40	54.2	10-60	24.4
361	Pottery, china and earthenware	14	32.68	5-40	48.1	20-60	15.4
362	Glass and glass products	61	27.39	5-40	48.9	20-60	21.5
369	Other non-metallic mineral products	115	22.52	5-40	41.1	10-60	18.6
	- Structural clay products	14	24.40	5-30	31.3	10-60	6.9
	- Cement, lime and plaster	8	20.63	10-30	37.8	20-50	17.2
371	Iron and steel products	242	15.91	3-30	24.5	2-60	8.6
372	Non-ferrous basic metals	154	15.31	1-30	26.1	2-50	10.8
381	Metal products, except machinery and equipment, n.e.s.	257	23.59	5-40	40.3	2-60	16.7
	- Cutlery, hand tools and hardware	83	18.08	10-40	30.6	2-60	12.5
	- Metal furniture and fixtures	3	36.67	10-40	48.0	30-60	11.3
	- Structural metal products	23	16.01	5-40	41.9	20-60	25.9
382	Non-electrical machinery and equipment	567	8.06	0-40	20.2	2-70	12.1
	- Engines and turbines	18	7.08	5-40	11.1	5-20	4.0
	- Agricultural machinery and equipment	33	6.72	5-40	18.5	2-70	11.8

Cont...

ISIC Code	Products	No. of lines	Applied tariffs 1999		Final bound rate 2005		Water in the tariff
			Simple average	Range	Simple average	Range	
	- *Metal and woodworking machinery*	93	7.80	5-30	14.1	2-60	6.3
	- *Special industrial machinery and equipment*	138	6.80	5-30	10.9	2-30	4.1
	- *Office, computing & accounting machinery*	40	11.88	5-30	27.1	5-40	15.2
383	*Electrical machinery*	380	23.00	5-40	34.8	2-70	11.8
	- *Electrical motors and apparatus*	66	13.77	5-40	23.7	2-60	9.9
	- *Radio, television and communications*	99	16.79	5-40	34.6	10-60	17.8
	- *Electrical appliances and housewares*	25	38.42	10-40	54.8	30-60	16.4
384	*Transport equipment*	221	20.82	0-135	36.0	2-160	15.2
	- *Shipbuilding and repairing*	20	14.64	0-40	32.3	5-60	17.7
	- *Railway equipment*	22	6.59	5-20	19.7	2-40	13.1
	- *Motor vehicles*	52	56.57	5-135	45.7	2-160	
	- *Motorcycles and bicycles*	22	21.29	5-40	39.2	30-60	17.9
	- *Aircraft manufacture*	20	5.00	5-5	12.3	5-20	7.3
385	*Professional and scientific equipment*	249	14.71	5-40	24.4	2-60	9.7
	- *Professional and scientific measuring and controlling equipment,n.e.s.*	81	6.39	5-40	13.1	5-60	6.7
	- *Photographic and optical goods*	63	18.13	5-30	30.5	2-60	12.4
	- *Watches and clocks*	52	19.62	10-30	34.7	20-60	15.1
390	*Other manufactures*	247	20.39	0-40	42.8	10-60	22.4
	- *Jewellery and related articles*	22	23.33	0-30	46.1	20-60	22.8
	- *Musical instruments*	23	30.00	30-30	42.5	40-60	12.5
	- *Sporting goods*	22	7.84	5-40	28.9	20-60	21.1

Source: Madani, and Olarreaga (2002) for the applied rates and the WTO (1999) for the bound rates. Water in tariff is calculated by the authors.

Table B3.4: Effective Protection in the Egyptian Manufacturing Sector *(in percent)*

	1991/92 IO tables			1998/99 IO tables	
	1994	1998	2002	1998	2002
Food processing	8.1	7.4	7.4	5.8	1.5
Cotton ginning and pressing	-8.9	-6.2	-5.9	-11.1	-11.5
Spinning and weaving	50.3	44.9	48.2	36.2	38.4
Garments	82.8	44.3	826.0		
Garments and footwear				43.9	674.1
Leather products excl. shoes	60.9	38.7	50.8	33.2	43.6
Shoes	94.4	50.4	51.8		
Wood, wood products, excl. furniture	6.1	5.8	9.4		
Furniture	99.0	55.1	53.8		
Wood products including furniture				9.1	12.0
Paper and printing	17.1	16.2	16.0	15.2	15.0
Chemicals and products, excl. petroleum	9.6	9.5	9.7	9.2	6.9
Rubber, plastic and products	49.6	37.0	38.1	30.1	31.0
Porcelain, china, pottery	62.0	39.0	38.9		
Glass and products	40.0	28.9	29.2		
Mineral products,n.e.i.	20.5	17.6	19.0	20.9	19.6
Iron, steel, other base metals	22.1	16.6	16.8	15.4	12.0
Machinery and appliances	19.2	14.2	14.3	14.4	11.1
Transportation equipment	54.8	46.7	46.6	45.4	44.6
*Unweighted manufacturing average**	37.8	26.4	27.8	18.6	18.6
*Dispersion**	31.4	18.5	19.2	15.5	17.4

*Note: * Average and dispersion are for all industries included in the table excluding clothing.*
Source: Refaat, Amal (2003).

Table B3.5a: Number of Telephone Fixed Lines (per 1000 people)

Country	1985	1990	1995	2000	2001
Egypt, Arab Rep.	18	30	47	86	104
Indonesia	4	6	17	32	35
Jordan	56	58	58	123	127
Korea, Rep.	160	310	412	477	486
Malaysia	61	89	166	199	196
Mexico	50	65	94	125	137
Morocco	11	16	42	50	41
Philippines	9	10	21	40	42
Portugal	145	243	367	430	427
Spain	243	316	385	426	431
Syrian Arab Republic	43	41	68	103	103
Tunisia	26	38	58	100	109
Turkey	44	121	211	282	285

Source: World Bank, World Development Indicators, CDRom, 2003.

Table B3.5b: Average Cost of Local Telephone Call (US$ per three minutes)

Country	1985	1990	1995	2000	2001
Egypt, Arab Rep.	n.a.	n.a.	n.a.	0.01	0.01
Indonesia	n.a.	0.05	0.04	0.02	0.02
Jordan	n.a.	0.01	0.02	0.04	0.04
Korea, Rep.	n.a.	0.03	0.04	0.04	0.03
Malaysia	n.a.	0.04	0.05	0.02	0.02
Mexico	n.a.	0.10	0.07	0.15	0.16
Morocco	n.a.	n.a.	0.09	0.08	n.a.
Philippines	n.a.	n.a.	n.a.	n.a.	n.a.
Portugal	0.04	0.05	0.07	0.11	0.11
Spain	0.01	0.04	0.10	0.07	0.07
Syrian Arab Republic	n.a.	0.02	0.02	0.01	0.01
Tunisia	n.a.	0.07	0.07	0.02	0.02
Turkey	n.a.	0.06	0.06	0.12	0.12

Source: World Bank, World Development Indicators, CDRom, 2003.

Table B3.6a: Electric Power Consumption (kwh per capita)
In thousands

Country	1985	1990	1995	2000
Egypt, Arab Rep.	***0.498***	***0.690***	***0.762***	***0.976***
Indonesia	***0.078***	***0.156***	***0.258***	***0.384***
Jordan	***0.814***	***0.959***	***1.119***	***1.236***
Korea, Rep.	***1.243***	***2.202***	***4.040***	***5.607***
Malaysia	***0.800***	***1.095***	***1.903***	***2.628***
Mexico	***1.029***	***1.204***	***1.311***	***1.655***
Morocco	***0.275***	***0.340***	***0.404***	***0.447***
Philippines	***0.333***	***0.342***	***0.389***	***0.477***
Portugal	***1.762***	***2.379***	***2.902***	***3.834***
Spain	***2.677***	***3.239***	***3.594***	***4.653***
Syrian Arab Republic	***0.607***	***0.683***	***0.693***	***0.900***
Tunisia	***0.483***	***0.604***	***0.734***	***0.939***
Turkey	***0.566***	***0.801***	***1.075***	***1.468***

Source: World Bank, World Development Indicators, CDRom, 2003.

Table B3.6b: Electricity Production
(kwh)

Country	1985	1990	1995	2000
Egypt, Arab Rep.	***31,458,000***	***42,256,000***	***52,000,000***	***75,727,000***
Indonesia	***16,895,000***	***36,951,000***	***59,282,000***	***92,638,000***
Jordan	***2,495,000***	***3,638,000***	***5,616,000***	***7,375,000***
Korea, Rep.	***58,210,000***	***107,670,000***	***201,106,000***	***292,498,000***
Malaysia	***14,935,000***	***23,000,000***	***45,431,000***	***69,210,000***
Mexico	***92,989,000***	***122,681,000***	***152,548,000***	***204,373,000***
Morocco	***7,345,000***	***9,628,000***	***12,804,000***	***14,090,000***
Philippines	***22,766,000***	***25,245,000***	***33,554,000***	***45,290,000***
Portugal	***18,810,000***	***28,355,000***	***33,154,000***	***43,372,000***
Spain	***125,617,000***	***151,172,000***	***165,627,000***	***221,713,000***
Syrian Arab Republic	***7,898,000***	***11,611,000***	***15,300,000***	***22,626,000***
Tunisia	***4,220,000***	***5,811,000***	***7,670,000***	***10,576,000***
Turkey	***34,219,000***	***57,543,000***	***86,247,000***	***124,922,000***

Source: World Bank, World Development Indicators, CDRom, 2003.

Table B3.7: A Snapshot of the Transport Sector in Egypt

	1989	2001	2003
Maritime			
Number of Ports*	***8***	***8***	***9***
Total Capacity (circa million tons)	***43***	***52***	***73***
Number of Frequenting Liners	***8,263***	***9,400***	***10,550***
Number of Egyptian Vessels	***140***	***123***	***121***
Airways			
Number of Airports	***15***	***31***	***n.a.***
Number of Flights	***131,703***	***166,886***	***n.a.***
Number of Passengers	***10,975,748***	***13,153,285****	***n.a.***
Railways			
Number of Cargo Carriages	***11,244***	***12,573***	***12.8***
Number of Passenger Carriages	***3,458***	***3,241***	***368***
Length of Lines (km)	***8,600***	***9,432***	***9,700***
Roads			
Total Length of Paved Roads (km)	***23,962***	***42,000***	***45,345***

Source: Ministry of Foreign Trade, Investing In Egypt, 2003.
*Note: * Does not include Ain El-Sokhna port.*

Annex B

Table B4.1: Kaufmann et al Sources of Data

Source	Publication	Type of Data
Business Environment Risk Intelligence	*Business Risk Service*	*Poll **
Columbia University	*State Capacity Project*	*Poll*
Economist Intelligence Unit	*Country Risk Service*	*Poll*
European Bank for Reconstruction & Development	*Transition Report*	*Poll*
Freedom House	*Nations in Transition*	*Poll*
Freedom House	*Freedom in the World*	*Poll*
Gallup International	*Gallup Millennium Survey*	*Survey ***
Heritage Foundation / Wallstreet Journal	*Economic Freedom Index*	*Poll*
Institute for Management & Development	*World Competitiveness Yearbook*	*Survey*
Latinobarometro	*Latinobarometro Surveys*	*Survey*
Political Economic Risk Consultancy	*Asia Intelligence*	*Survey*
Political Risk Services	*International Country Risk Guide*	*Poll*
PriceWaterhouseCoopers	*Opacity Index*	*Survey*
Standard and Poor's DRI McGraw-Hill	*Country Risk Review*	*Poll*
World Bank	*Business Enterprise Environmen Survey*	*Survey*
World Bank	*World Business Environment Survey*	*Survey*
World Economic Forum	*Global Competitiveness Report*	*Survey*

** Polls = experts*
*** Surveys = businessmen or public in general*
Adapted from Kaufmann et al "Governance Matters II" 2002, p. 2, 3, & 18.

Table B4.2: World Bank Kaufman et.al, Ranking of Egypt and Other Comparator Countries according to Various Indicators of Good Governance

	Egypt		Morocco		Tunisia		Jordan		Turkey		Mexico		Poland	
	P. Rank	Estimate	P. Rank	Estimate	P. Rank	Estimate	P. Rank	Estimate	P. Rank	Estimate	P. Rank	Estimate	P. Rank	Estimate
Voice & Account														
2002	22.20	-0.87	40.40	-0.30	22.70	-0.83	38.40	-0.40	36.40	-0.47	59.60	0.33	83.30	1.11
2000	24.10	-0.81	35.10	-0.44	26.20	-0.71	45.00	-0.19	29.80	-0.65	55.00	0.09	83.80	1.12
1998	25.10	-0.83	34.00	-0.53	20.90	-0.92	44.00	-0.19	20.40	-0.92	45.00	-0.17	77.00	1.01
1996	26.70	-0.70	29.30	-0.60	33.00	-0.50	48.70	-0.14	38.20	-0.39	42.90	-0.21	76.40	0.95
Pol Stability														
2002	34.10	-0.35	39.50	-0.14	53.00	0.24	31.40	-0.44	27.00	-0.61	50.80	0.22	69.70	0.71
2000	49.10	-0.05	51.50	0.13	78.80	0.86	54.50	0.25	18.20	-0.99	45.50	-0.08	76.40	0.83
1998	42.40	-0.11	52.10	0.13	70.30	0.61	49.10	0.05	15.20	-1.06	24.80	-0.53	78.20	0.85
1996	36.60	-0.25	29.90	-0.36	57.90	0.28	59.80	0.36	12.20	-1.03	34.80	-0.27	67.10	0.53
Gov. Effective														
2002	46.90	-0.32	61.30	0.07	71.60	0.65	66.00	0.36	50.50	-0.20	61.90	-0.27	71.10	0.61
2000	67.90	0.35	58.70	0.08	88.00	1.32	71.20	0.43	55.40	-0.06	69.60	0.15	70.70	0.39
1998	60.10	0.01	71.00	0.29	82.50	0.85	77.00	0.63	41.00	-0.34	69.40	0.38	83.10	0.86
1996	41.90	-0.36	60.30	-0.10	74.90	0.39	67.00	0.09	61.50	-0.06	52.00	0.27	77.70	0.47
Requlat Quality														
2002	38.10	-0.45	55.20	0.02	53.60	-0.02	58.20	0.10	56.70	0.08	68.00	0.49	71.10	0.67
2000	50.30	0.10	64.90	0.42	74.60	0.65	76.80	0.67	56.80	0.24	76.20	0.66	73.00	0.60
1998	49.50	0.16	55.40	0.25	67.40	0.50	71.20	0.59	80.40	0.86	75.50	0.78	77.70	0.18
1996	40.30	-0.18	49.20	-0.06	52.50	-0.01	53.00	0.00	71.30	0.39	74.00	0.46	69.10	0.20
Rule of Law														
2002	57.70	0.09	59.30	0.11	61.30	0.27	62.90	0.33	55.20	0.00	52.10	-0.11	70.60	0.65
2000	62.70	0.23	65.90	0.33	70.30	0.48	71.90	0.57	60.50	0.07	45.90	-0.38	74.10	0.64
1998	64.90	0.17	70.80	0.54	69.70	0.44	73.00	0.60	65.90	0.19	40.50	-0.37	72.40	0.57
1996	63.90	0.22	62.70	0.18	59.60	0.06	63.30	0.19	58.40	0.02	55.40	-0.22	69.90	0.44
Control Corrupt														
2002	47.90	-0.29	58.20	-0.04	67.00	0.35	59.30	0.00	43.80	-0.38	52.10	-0.19	69.10	0.39
2000	54.30	-0.19	71.20	0.36	76.60	0.70	62.00	0.13	47.80	-0.30	44.00	-0.39	73.40	0.47
1998	56.30	-0.25	62.30	-0.10	68.30	0.11	71.60	0.20	65.60	-0.01	41.00	-0.46	77.00	0.49
1996	62.70	0.11	64.70	0.21	58.00	-0.04	56.70	-0.09	61.30	0.08	39.30	-0.31	72.70	0.38

Source: Raufmann et.al.

Table B4.3 Questions on Public Institutions Divided by Level of Corruption and Country Scores

Question	Country Score					
	Egypt	Morocco	Tunisia	Jordan	Mexico	Poland
High Corruption (Political Corruption)						
When deciding upon policies & contracts gov off (1=favor well connected firms/indiv, 7=neutral; mean 3.3)	3.8	3.2	4.7	4.0	3.4	2.9
Irregular pay'ts in public contracts (1=common, 7=never; mean 3.9)	4.5	3.0	4.6	5.0	4.0	3.5
Irregular pay'ts to influence gov policy, laws, regulations or decrees (1=common, 7=never; mean 4.2)	4.3	4.1	5.3	5.2	4.2	3.8
Irregular pay'ts in judicial decisions (1=common, 7=never; mean 4.5)	4.8	3.8	5.4	5.6	4.1	4.2
Diversion of pub funds to companies, indiv or groups (1=common, 7=never; mean 3.7)	3.9	3.3	5.0	5.2	3.3	3.2
Pub trust in financial honesty of politicians (1=very low, 7=very high; mean 2.7)	2.9	3.1	4.6	3.9	2.3	2.2
Prevalence of illegal pol donations to pol parties (1=common, 7=never; mean 3.6)	4.2	3.8	5.3	5.5	2.7	3.1
Extent of pol donations on policy outcome (1=very close link, 7=little direct influence; mean 3.8)	3.9	3.8	5.2	5.1	3.7	3.3
Bureaucratic Corruption						
Irregular pay'ts in exports & imports (1=common, 7=never; mean 4.7)	4.4	3.6	5.3	5.7	4.6	4.5
Irregular pay'ts in public utilities (1=common, 7=never; mean 5.0)	3.8	4.1	5.3	5.9	5.1	4.9
Irregular pay'ts in tax collection (1=common, 7=never; mean 4.8)	4.2	3.6	5.0	5.6	5.3	4.9
Irregular pay'ts in loan applications (1=common, 7= never; mean 4.9)	4.4	3.3	4.8	5.7	5.4	4.5
Other firms illegal pay'ts impose on your firm (1=large costs, 7=no costs; mean 3.9)	4.0	3.2	4.5	4.8	3.8	3.6

Source: World Economic Forum The Global Competitiveness Report 2003-2004. pp. 490-503.

Table B5.1 : Labor Force Participation rate (15-64) by Sex and Urban/Rural Location. 1990-2001

	1990	1991	1992	1993	1994	1995	1997	1998	1999	2000	2001
Males											
Urban	72.0	70.8	69.8	70.8	70.7	70.1	71.6	72.2	71.8	71.5	70.6
Rural	78.1	76.8	76.3	76.3	76.1	76.3	75.8	74.5	74.8	76.4	75.2
All	75.2	74.0	73.2	73.7	73.5	73.4	73.9	73.4	73.5	74.2	73.1
Females											
Urban	22.5	20.3	19.1	20.3	20.3	19.4	20.7	20.5	20.7	21.7	21.0
Rural	34.5	29.3	26.1	24.0	25.4	23.0	20.9	19.5	19.6	23.5	19.2
All	28.9	25.2	22.8	22.3	23.0	21.3	20.8	19.9	20.1	22.7	20.0
Total											
Urban	47.4	45.7	44.4	45.7	45.5	44.8	47.0	47.2	46.4	47.1	45.8
Rural	56.2	53.0	50.8	50.2	51.0	49.7	47.9	46.5	47.3	51.1	47.4
All	52.1	49.6	47.8	48.1	48.4	47.4	47.5	46.8	46.9	49.3	46.7

Source: Authors' calculations based on the regular LFSS rounds of 1990 and 2001.

Table B5.2: Number of Graduates from the Formal Schooling System, Based on Number of Students Who Passed General Examinations

	Number of Graduates					*Average Annual Growth Rate (%)*				
Specialization	***73/74***	***81/82***	***90/91***	***95/96***	***00/01***	***73/74-81/82***	***81/82-90/91***	***90/91-95/96***	***95/96-00/01***	***90/91-00/01***
All University	**37,574**	**86,841**	**108,276**	**126,353**	**248,451**	**10.5**	**2.5**	**3.1**	**13.5**	**8.3**
Health Sciences	*4,683*	*8,340*	*6,675*	*5,938*	*14,539*	*7.2*	*-2.5*	*-2.3*	*17.9*	*7.8*
Agriculture	*5,313*	*6,318*	*5,845*	*2,856*	*4,354*	*2.2*	*-0.9*	*-14.3*	*8.4*	*-2.9*
Engineering	*3,910*	*5,813*	*5,806*	*5,226*	*10,653*	*5.0*	*0.0*	*-2.1*	*14.2*	*6.1*
Sciences	*1,543*	*3,699*	*4,460*	*3,869*	*5,289*	*10.9*	*2.1*	*-2.8*	*6.3*	*1.7*
Other science-related fields	*570*	*5,943*	*4,219*	*4,800*	*12,787*	*29.3*	*-3.8*	*2.6*	*19.6*	*11.1*
All Sciences	**16,019**	**30,113**	**27,005**	**22,689**	**47,622**	**7.9**	**-1.2**	**-3.5**	**14.8**	**5.7**
Commerce	*7,549*	*20,502*	*22,378*	*30,694*	*47,586*	*12.5*	*1.0*	*6.3*	*8.8*	*7.5*
Law	*2,533*	*8,588*	*14,258*	*12,657*	*23,089*	*15.3*	*5.6*	*-2.4*	*12.0*	*4.8*
Education	*2,694*	*10,717*	*14,990*	*26,645*	*44,875*	*17.3*	*3.7*	*11.5*	*10.4*	*11.0*
Other Humanities & Social Sciences	*8,779*	*16,921*	*29,645*	*33,668*	*85,279*	*8.2*	*6.2*	*2.5*	*18.6*	*10.6*
All Humanities & Social Sciences	**21,555**	**56,728**	**81,271**	**103,664**	**200,829**	**12.1**	**4.0**	**4.9**	**13.2**	**9.0**
All Higher Technical Institutes	**6,998**	**16,836**	**35,112**	**22,506**	**30,154**	**11.0**	**8.2**	**-8.9**	**5.9**	**-1.5**
Commercial	*4,424*	*12,838*	*21,911*	*12,364*	*13,370*	*13.3*	*5.9*	*-11.4*	*1.6*	*-4.9*
Industrial	*2,574*	*3,998*	*13,201*	*10,142*	*16,784*	*5.5*	*13.3*	*-5.3*	*10.1*	*2.4*
All Secondary	**206,522**	**351,212**	**458,858**	**858,634**	**887,372**	**6.6**	**3.0**	**12.5**	**0.7**	**6.6**
All Technical Secondary	**82,264**	**179,585**	**281,912**	**547,831**	**509,750**	**9.8**	**5.0**	**13.3**	**-1.4**	**5.9**
Agricultural	*9,317*	*17,918*	*35,339*	*62,884*	*50,084*	*8.2*	*7.5*	*11.5*	*-4.6*	*3.5*
Commercial	*47,517*	*111,169*	*114,234*	*247,321*	*219,469*	*10.6*	*0.3*	*15.4*	*-2.4*	*6.5*
Industrial	*25,430*	*50,498*	*132,339*	*237,626*	*240,197*	*8.6*	*10.7*	*11.7*	*0.2*	*6.0*
General and Azhari Secondary	**124,258**	**171,627**	**176,946**	**310,803**	**377,622**	**4.0**	**0.3**	**11.3**	**3.9**	**7.6**
General and Azhari Preparatory	**274,113**	**431,125**	**631,811**	**952,772**	**1,288,994**	**5.7**	**4.2**	**8.2**	**6.0**	**7.1**
General and Azhari Primary	**399,565**	**582,534**	**984,181**	**1,259,201**	**1,377,455**	**4.7**	**5.8**	**4.9**	**1.8**	**3.4**

(4) Statistical Year Book of the Arab Republic of Egypt, 1952-1978 (Cairo, July 1979) for 73/74 figures.

Sources: (1) Statistical Year Book of the Arab Republic of Egypt, 1995-2002 (Cairo, June 2003) for 98/99 and 00/01 figures.
(2) Statistical Year Book of the Arab Republic of Egypt, 1990-1995 (Cairo, July 1996) for 90/91 figures.
(3) Statistical Year Book of the Arab Republic of Egypt, 1952-1986 (Cairo, June 1987) for 81/82 figures.

Table B5 .3.a Distribution and Growth Rates of Employment, Unemployment, and Labor Force by Sector and Educational Attainment, Ages 15-64

Educational Attainment	Govt.		Av. Annual	SOEs		Av. Annual	Private & other		Av. Annual	Unemployed		Av. Annual	Total Labor Force	
	1988	1998	Growth	1988	1998	Growth	1988	1998	Growth	1988	1998	Growth	1988	1998
Illiterate	10.7	6.3	-0.5	17.1	8.1	-10.1	63.5	46.7	-0.9	16.0	7.8	-0.5	47.7	32.8
Literate W/O diploma	11.9	6.9	-0.6	19.6	15.2	-5.1	13.6	10.6	-0.3	7.5	4.2	0.9	13.4	9.5
Primary	5.0	7.2	8.4	7.9	13.2	2.5	6.0	11.7	8.9	7.3	5.3	3.4	6.0	10.3
Preparatory	3.4	3.5	5.1	8.5	8.4	-2.7	5.0	6.7	5.1	4.7	3.0	2.1	5.0	5.8
General secondary	3.5	1.1	-7.2	4.3	2.6	-7.6	1.7	1.1	-2.8	1.7	1.5	5.5	2.3	1.2
Voc. Sec., industrial/agric	8.4	11.5	7.9	11.0	18.4	2.6	2.9	9.1	13.6	9.7	28.8	17.5	4.9	11.7
Voc. Sec., commerc/other	17.9	18.8	5.3	10.5	9.6	-3.4	2.7	6.3	10.9	33.2	24.5	3.6	7.7	10.7
Post-secondary institute	11.9	14.3	6.6	3.0	5.9	4.1	1.0	2.5	11.5	6.8	10.8	11.3	3.4	5.9
University & above	27.4	30.4	5.8	17.9	18.4	-2.3	3.7	5.4	5.9	13.3	13.9	7.1	9.6	12.2
Total	100.0	100.0	4.8	100.0	100.0	-2.6	100.0	100.0	2.2	100.0	100.0	6.6	100.0	100.0
Sample Size	1,775	2,189		760	489		6,083	5,084		531	704		9,149	8,466

Table B5.3.b: Distribution and Growth Rates of Employment, Unemployment, and Labor Force by Sector and Educational Attainment, Ages 15-34

Educational Attainmen	Govt.		Av. Annual	SOEs		Av. Annual	Private & other		Av. Annual	Unemployed		Av. Annual	Total Labor Force		Av. Annual
	1988	1998	Growth	1988	1998	Growth	1988	1998	Growth	1988	1998	Growth	1988	1998	Growth
Illiterate	4.6	3.5	-1.9	11.9	4.5	-15.0	55.8	34.3	-2.9	9.2	5.2	1.6	41.3	25.1	-2.9
Literate w/o diploma	4.5	1.7	-8.9	10.2	7.8	-8.1	11.8	9.1	-0.6	6.3	2.5	-1.8	10.1	7.1	-1.4
Primary	2.3	4.4	7.1	6.6	14.3	2.3	7.9	14.4	8.0	6.6	4.9	4.3	6.8	11.7	7.5
Preparatory	2.3	3.3	4.3	10.4	7.5	-8.7	7.4	8.5	3.3	5.1	2.9	1.7	6.6	7.0	2.6
General secondary	2.5	0.6	-13.3	5.5	3.2	-10.6	2.5	1.0	-7.1	1.7	1.3	4.3	2.6	1.1	-6.9
Voc. sec., industrial/agric	11.9	14.5	2.8	18.0	31.5	0.2	4.5	14.7	13.7	11.0	31.1	17.6	7.0	17.5	11.2
Voc. sec., commerc/other	27.3	18.8	-2.9	17.8	9.7	-11.4	4.5	9.8	9.8	38.2	26.0	3.4	11.7	13.3	3.4
Post-secondary institute	15.4	22.3	4.5	3.2	6.2	1.1	1.5	3.0	9.0	7.9	11.6	11.1	4.2	6.9	6.9
University & above	29.1	31.1	1.5	16.8	15.3	-6.4	4.1	5.3	4.6	14.0	14.5	7.6	9.5	10.4	3.0
Total	100.0	100.0	0.9	100.0	100.0	-5.4	100.0	100.0	2.0	100.0	100.0	7.3	100.0	100.0	2.1
Sample Size	815	680		296	138		3,383	2,749		456	636		4,950	4,203	

Table B5.4: Real Wages Index 1977-2001, 1991=100

		1977	1978	1982	1985	1986	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Agriculture	Public	182	133	145	201	123	104	99	100	100	93	104	96	88	99	84	118	113	129	101
	Private	145	161	146	179	144	112	107	120	100	94	107	119	117	113	124	124	144	138	110
	Total	159	138	141	183	126	105	101	102	100	90	101	99	92	98	93	111	115	118	90
Mining Quarrying (petroleum)	Public	186	163	158	159	174	135	135	138	100	109	98	99	101	94	133	102	97	195	171
	Private	123	78	133	137	118	128	103	109	100	101	100	95	68	86	76	99	101	128	106
	Total	121	104	141	116	131	149	95	107	100	90	100	95	79	84	93	108	108	169	138
Manufacturing	Public	129	134	173	107	96	128	115	119	100	99	101	102	101	107	113	115	131	142	149
	Private	123	128	152	127	119	123	117	106	100	95	93	97	84	82	93	89	94	94	107
	Total	129	134	170	111	106	128	118	117	100	99	100	102	96	99	106	105	115	115	123
Utilities (Gas, Water Electricity)	Public	-	144	160	99	114	114	129	84	100	72	96	83	78	91	80	95	95	473	135
	Private	-	-	-	163	104	98	41	-	100	69	42	73	30	73	62	68	79	115	94
	Total	-	144	160	99	118	114	122	84	100	73	96	83	77	91	80	97	95	441	144
Construction and Housing	Public	119	132	135	161	142	121	116	106	100	91	97	102	93	98	76	61	96	162	133
	Private	140	149	160	182	168	151	146	141	100	92	101	164	125	85	113	90	110	156	109
	Total	118	131	137	159	144	125	117	108	100	90	96	105	94	96	86	67	98	161	128
Trade, Hotels, Restaurants	Public	144	191	162	137	129	122	105	101	100	96	104	106	98	99	105	101	133	140	150
	Private	141	142	158	168	146	112	103	99	100	80	87	78	80	80	92	81	85	100	96
	Total	144	180	162	149	132	120	105	102	100	92	98	96	92	92	101	94	109	120	122
Transportation Communication	Public	140	142	152	158	132	134	113	108	100	98	138	111	102	119	100	149	123	129	180
	Private	144	170	193	193	157	145	144	129	100	101	100	126	106	98	97	94	113	103	119
	Total	139	141	159	163	139	138	121	111	100	99	129	111	100	114	99	136	119	122	164
Finance Insurance	Public	130	193	150	141	125	120	114	116	100	100	102	101	92	107	106	107	118	121	128
	Private	135	174	176	125	156	132	130	94	100	100	104	101	96	90	90	106	123	114	121
	Total	109	165	139	136	129	129	114	108	100	99	106	103	97	106	111	115	132	131	141
Services (social and Personal)	Public	159	137	140	164	158	118	121	144	100	73	89	97	80	121	78	83	103	124	83
	Private	142	146	147	152	137	122	103	105	100	99	87	97	104	87	90	83	101	108	97
	Total	143	143	148	150	144	121	105	112	100	95	88	98	102	92	91	84	102	110	98
Total	Public	135	145	163	129	135	125	118	113	100	97	103	102	97	105	105	108	144	172	148
	Private	116	124	150	137	143	126	116	108	100	93	95	96	87	85	93	92	99	101	108
	Total	129	138	158	130	137	125	115	112	100	96	100	99	93	98	101	102	126	139	128

Source: Authors' calculations based on data from CAPMAS, Establishment, Wages and Hours of Work Surveys (1977, 1978, 1982, 1985,1986, 1988-2001) and the IMF Consumer Price Index.

Annex C

Laws Related to the Financial System in Egypt

- *Law 57 of 1951, **for granting the National Bank of Egypt (NBE) the legal status of a central bank.***
- *Law 26 of 1954, **Reduced the minimum value of issued shares from LE 4 to LE 2. Made stock market listing compulsory for companies with capital of more than LE 50000.***
- *Law 22 of 1957, **for the Egyptianization of banks***
- *Law 161 of 1957, **for the general regulations of the stock exchanges.***
- *Law 163 of 1957**, for banks and credit.***
- *Law 7 of 1959, **Determined the maximum of distributable profits per the nominal value of the share.***
- *Presidential Decree No. 40 of 1960,**for the nationalization of the NBE.***
- *Presidential Decree No. 250 of 1960**for the CBE and the NBE.***
- *Law 117 of 1961, **for the nationalization of banks.***
- *Law 11 of 1961, **Amended Law 26 of 1954.***
- *Law 11 of 1961, **Allocated 25 percent of net profits to workers.***
- *Law 118 of 1961, **All banks, insurance companies, and other companies were nationalized.***
- *Law 119 of 1961, **Stated that 85 companies should have a minimum of 50 percent public ownership.***
- *Law 121 of 1961, **Determined that the maximum market value of owned shares not to exceed £E 10000 per shareholder in 139 companies. Amounts in excess of the limit were sequestrated.***
- *Law 61 of 1963 **for public authorities.***
- *Law 38 of 1963, **Nationalized the four cotton pressing companies.***
- *Law 65 of 1963, **Nationalized cotton mills.***
- *Law 72 of 1963, **Nationalized the pharmaceutical companies.***
- *Law 7 3of 1963, **220 companies specialized in chemical, metal, engineering, textiles products were nationalized.***
- *Law 77 of 1963, **Terminated mining and oil exploring contracts and nationalized mines and quarries.***
- *Law 78-81of 1963, **25 of the companies governed by Law 118 of 1961 were fully nationalized, including transport companies. Added 20 companies to the list of fully or partly nationalized companies.***
- *Law 65 of 1971, **established the Public Authority for Investment, and "free zones."***
- *Law 43 of 1974 & 32 of 1977, **Granted incentives and privileges to foreign investors. Some of foreign exchange market restrictions were removed to facilitate the purchase of securities.***
- *Law 43 of 1974, **for the Investment of Arab and Foreign Capital and Free Zones. It regulated foreign investment and free zones. This law opened the door for foreigners to access the market, who became able to enter into joint-venture with up to 49% participation. Full-fledged branches of foreign banks were also permitted.***
- *Law 173 of 1974, **allowed individuals to hold free foreign currency accounts provided that the funds were originally brought from abroad. New avenues for commercial banking were thus opened.***
- *Law 130 of 1975, **identified the role of the CBE and permitted the CBE to freely determine the discount rate and interest rates on lending and deposits.***
- *Law 97 of 1976, **allowed banks to enter into arbitrage operations, forward transactions, and lending in foreign currency.***

Annex C

- *Law 520 of 1979,* ***established the CMA. The law also allows the private sector to join the board of directors of the bank taking into consideration the percentage of their ownership. The number of board of directors should be between a minimum of 5 and a maximum of 15.***
- *Law 157 of 1981,* ***Granted joint stock companies tax incentives.***
- *Law 159 of 1981,* ***Amended law 26/1954 to facilitate the establishment of new joint stock companies and raising funds for the existent ones. Extended most of the tax privileges of Law 43 of 1974 enjoyed by foreign investors to indigenous ones.***
- *Law 146 of 1988,* ***Regulated Islamic Investment Companies. Allowed the issuance of variable return certificates by ESM.***
- *Law 230 of 1989,* ***Enhanced the role of the Investment Authority to encourage foreign and domestic investment.***
- *Law. 205 of 1990****, the Banking Secrecy Law. This law obliged Egyptian banks not to disclose any information related to their customers' accounts, deposits, savings or related transactions without the customers' permission.***
- *Law 203 of 1991,* ***Transferred public sector companies to public holding companies as a step towards privatization.***
- *Law 95 of 1992,* ***This comprehensive Capital Market Law aimed at stimulating the capital market under the reformprogramme supported jointly by the World Bank and the IMF.***
- *Law 37 of 1992****, introduced many significant changes in the banking sector, including delegating authority to CBE to be able to manage banks' merging, requiring all banks to be registered with CBE and to have an authorized capital of at least LE100 million and a paid-up capital of not less than LE50 million. The law also requires the establishment of a deposit insurance fund for all banks operating in Egypt including foreign banks.***
- *Law 101 of 1993****, establishes that for foreign bank branches to deal in Egyptian currency, they must have a working capital of at least US$15 million. Foreign banks can open representative offices subject to the supervision of CBE, provided that they have no branches in Egypt and restrict their activities to market studies of investment potentials.***
- *Law 95 of 1995,* ***This comprehensive Law concerns Financial Leasing in the Egyptian market.***
- *Law 91 of 1995,* ***which amended Insurance*** *Law 10 of 1981* ***set the groundwork for liberalizing the insurance market structure, deregulating pricing and tariffs and strengthening the supervisory role of EISA, with the ultimate objective of complying with WTO regulations.***
- *Tax Law 5 of 1998****, was issued to eliminate a loophole that allowed banks to deduct interest on incurred income to purchase tax free securities, thus encouraging banks to invest extensively in treasury bills at the expense of lending activities. The law also establishes a 5% increase in the amount of tax deductible provisions a bank can make up to 10% of net profits.***
- *Law 155 of 1998****, permits the privatization of the four public banks, allowing for full private sector ownership in the four public sector banks. This law has allowed the private sector including foreign investors to own shares up to 100% in state-owned banks, provided that the Central Bank grants its approval for any single investor to own more than 10% of the bank's shares.***
- *Law 80 of 2002,* ***This comprehensive Anti-Money Laundering Law requires financial institutions to establish preventive measures and procedures against money laundering and prohibits laundering money generated through crimes of terrorism, financing of such crimes, or their methods of implementation.***
- *Law 88 of 2003,* ***addresses many of the deficiencies in previous laws governing the banking system (details are highlighted in Box 1).***

Annex D

Prudential Regulations Governing the Banking Sector in Egypt

Prudential Measures	Description	Date of Issuance
Liquidity Requirements	***Banks were required to maintain a liquidity ratio of 20 percent for local currency and 25 percent for foreign currencies instead of 30 percent***	***December 1990***
Reserve Requirement	***The minimum reserve requirement on local currency deposits was reduced from 30 percent to 15 percent***	***December 1990***
Capital Adequacy Ratio	***All banks operating in Egypt except branches of foreign banks, were required to comply with the Basel Accord of a minimum capital adequacy ratio of 8 percent***	***January 1991***
Foreign Exchange Exposure Ratio	***All banks, except branches of foreign banks, were requested to maintain a ratio of foreign currency liabilities to foreign assets, and vise versa, of 105 percent, while the net foreign currency position was limited to 15 percent of each bank's capital***	***March 1991***
Asset Classification and Provisioning (AC&P)	***Banks were requested to comply with an AC&P solvency criterion in accordance with the Basel Committee recommendations***	***September 1991***
International Concentration Limits	***All banks except branches of foreign banks were subject to foreign investment concentration ratio***	***November 1992***
Domestic Concentration Limits	***Commercial banks' credit to single client were not to exceed in total 30 percent of the bank's capital, while the banks total shares in all companies should not exceed the bank's own issued capital and reserves***	***April 1993***
	Banks were not allowed to maintain more than 10 percent of any single currency of short or long-term position, and a maximum of 20 percent of all currencies including local currency	***September 1993***
	The minimum reserve requirement on foreign currency deposits was reduced from 15 percent to 10 percent	***December 1993***
	Business and Investment banks' share in a single company were not to exceed 40 percent of its issued capital	***September 1995***
	Specialized banks were limited to dealing with companies whose activity is related to the activity of the bank	

Source: Bahaa Eldin and Mohieldin (1998), IMF (1998), and El-Rifaei (1997).

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