

EGYPT: RECENT ECONOMIC DEVELOPMENTS & POLICY REFORM OPTIONS

Robert Myers, 5/9/01-No. 1
(Slightly Revised, 8/02)

TAPR, Cairo, Egypt

INTRODUCTION

0. Egypt is an economy well favored by location and a large, educated, entrepreneurial workforce. She has the potential to achieve sustained GDP growth rates of 8%-10% per year, or about double the growth rates of the last several years. Such faster growth is achievable mainly through policy reforms that allow a significant expansion of participation in private investment and price competition in the domestic economy. Most of the gains would be derived from increased productivity of labor and investment so that they would be accompanied by minimal increases in resource use and environmental degradation. Instead, wider participation in private investment and employment activities would improve income distribution through markedly reducing poverty in Egypt.

1. The Egyptian/USAID Policy Reform Program is based on the premise that altering policy related incentives in the Egyptian economy will lead to greater growth of GDP, employment and more equitably distributed income. This paper examines nine policy issue areas.¹ The intent was to identify policy reforms in at least these areas that will change incentives so as to expand domestic and international trade and private investment. International experience supports the conclusion that overly intrusive and/or inconsistent government interventions to control economic behavior suppress personal, private productive initiatives, thus reducing growth in social welfare.

2. In light of this, the aim of the Policy Reform Program is to foster policy reforms that reduce, streamline and reorient economic interventions so as to improve the incentive atmosphere and stimulate private economic initiatives. It is assumed that competitive markets will emerge and grow naturally as long as private initiative is not constrained by excessive Government interventions. The primary aim of the Policy Reform Program is, therefore to make Egypt's economic incentive system support more private initiative and the emergence of larger, more competitive markets. It is reasoned that an improved, more open incentive system will result in greater, quicker achievement of SO 16, or more internal and international trade² and greater, more fragmented and competitive private investment. These will in turn lead to more private, formal sector employment and more, more equitably distributed GDP growth.

¹ The nine areas are: (1) Exchange Rate/Monetary Policy/Stabilization; (2) Privatization; (3) Financial Service Growth [Bank, NBFI, Insurance Reform]; (4) Commercial Law Reform & Corporate Governance; (5) Fiscal Policy/Public Debt Management; (6) Competition Policy, IPR & IT; (7) Labor, Poverty & Civil Service Reform; (8) Trade/WTO/Customs/Traded Services; (9) Data Timeliness & Accuracy

² Recent findings suggest that internal and international trade usually rise together. That is, that except in extractive and enclave industries, expanding international trade involves a companion expansion of internal trade. See, Ceglowski, Janet. "Has Globalization Created a Borderless World?" in Globalization and the Challenges of a New Century: A Reader, edited by Patrick O'Meara, Howard D. Mehlinger, and Matthew Krain, Bloomington, IN: Indiana University Press, 2000, pp.101-111.

3. A most important element in altering the incentive system in developmentally favorable ways is changing relative prices and costs, or productive incentives so that individuals earn more income from private productive employment so that they need less income from transfers. These latter, unrequited transfers are called “rents”. Activities aimed at obtaining them, called “rent seeking”, reduce GDP growth below what it otherwise could be.³ Those engaged in rent seeking are not otherwise employed in productive endeavors. In a sense, a government that is unwilling to countenance changes in relative domestic costs and prices is unlikely to attain a competitive, productive economy. Frequently the reforms and/or their implementation are viewed as being socially costly. However, the opposite can be the case when reforms increase GDP growth so as to more than offset these costs.

4. This paper sets out Egypt's current economic status and offers some general policy reform prescriptions for the Egyptian economy that are employment sympathetic. They are consistent with the natural expansion of trade in domestic and international markets and of private investment and through these, of productive employment. These policy prescriptions form the main general content of the USAID/Egyptian Development Support Program. The remainder of the paper is in two parts. The first, (Part I) sets out the current economic status in Egypt, subdivided according to first macroeconomic and then microeconomic considerations. The second (Part II), sets out conceptual backgrounds in the nine policy areas and suggests the general sorts of incentive-based policy reforms that are appropriate for Egypt at this time

I. CURRENT ECONOMIC STATUS

A. Macroeconomic Considerations

5. This section views developments in macroeconomic aggregates from the perspective of expanding private investment and trade in Egypt. The officially published data for 1999/00 are internally consistent and present a positive picture of macroeconomic developments, including a 6.5% real GDP growth rate and low inflation and unemployment. Egyptians don't seem to believe the GDP growth figures in this picture. Instead they are complaining about something that used to be called a “liquidity crisis” and is now being called a “slowdown”. There is talk that a correctly measured real GDP growth rate would be less than 6.5%. Indeed it seems likely that the 6.5% figure is affected by expansion of coverage of the value of output in the informal economy, particularly of earnings by informally provided business, health, education trade and transport services.

6. A slowdown is inconsistent with two other recent developments. One is pressure on the LE/\$ exchange rate, which was for several years 3.4, but which has risen over the last eight months to 3.85. The other is LE 9 billion budget deficit blowup for the 1998/99 & 1999/00 fiscal years. This should have caused inflation. However, the inflationary impact seems to have been mitigated somewhat by a large buildup of GOE/NIB

³ These are called, “opportunity losses,” or opportunity costs.

payments arrears. At the same time, CBE has maintained fairly tight constraints on credit expansion, but allowed a switch so that much of the recent credit increases go to GOE instead of to the private sector. The arrears, tight credit constraints on the private sector, and GOE jawboning have held inflation in check but have severely soured the business and private investment and trade atmosphere.

7. Although incomes in households should be buoyant, the “slowdown” seems to consist of a less-than-normal increase in household consumption demand. That is, an increase in household propensities to save. In effect, there is pent up savings demand in the household sector, which has limited attractive options for holding them. This would explain the increase in the savings-related demand for foreign exchange. It also suggests that GOE could alleviate many of the current economic problems by issuing bonds to households to cover the GOE/NIB payments arrears.

National Accounts, Employment and Price Level Developments

8. Table 1 below shows that real GDP growth and investment have been both relatively high and increasing over the last four years up through June 2000. During the same period officially reported unemployment and inflation have been relatively low and declining. It is reasonable to assume that these data were subjected to the IMF financial framework consistency check. The data and trends therefore present an internally consistent and quite positive picture of macroeconomic developments.

Table 1: National Accounts, Unemployment and Inflation

	<u>96/97</u>	<u>97/98</u>	<u>98/99</u>	<u>99/00</u>
1. Real GDP per Capita (LE)	2884	2991	3101	3232
2. Real Growth Rate	5.3	5.7	6.1	6.5
3. Consumption Share (%)	68	68	68	67
4. Investment Share (%)	14	16	18	20
5. Unemployment Rate	8.8	8.3	7.9	7.4
6. Annual Inflation Rate	6.2	3.8	3.8	2.8

Source: Monthly Economic Digest, MOEFT: Feb. 2001.

9. Few people believe the data in Table 1, but it is difficult to find an alternative, consistent scenario. The press and many people believe that 1999/00 was a “slowdown” year with a real GDP growth rate of less than 6.5%. This would be consistent with a further fall in inflation, to 2.8%, but not with the increased demand for foreign exchange and imports.

10. Many also believe that the 2.8% inflation rate is understated but this too poses problems. An understated inflation rate could explain how a rapidly growing nominal GDP was under-deflated to get 6.5% rather than lower real GDP growth in 1999/00. However, prices outside the CPI don’t seem to be rising and Egyptians acknowledge that

GOE prevents, through direct intervention or jawboning, price increases in the formal economy, “to protect the poor”. In addition, price increases are not consistent with the slowdown theme. It is possible that there are pockets of unsatisfied demand that threaten to be inflationary, but for the present are not creating pressure on prices.⁴

11. Following discussions with statisticians, it seems most likely that the nominal GDP figures for 1999/00 confound two effects. One is (slower) GDP growth in the formal economy and the other is expanded coverage of the informal economy.⁵ Assuming this is correct, and that real formal sector GDP growth in 1999/00 was less than 6.5%, it is interesting to speculate on whether the implied expenditure cuts occurred in consumption or investment. Given that we know that there were significant increases in public sector investment (see Table 2 below) it is likely that the major reductions occurred in household consumption rather than household saving. Such a relative increase in saving could well explain both the existence of pockets of excess demand and the increased demand for foreign exchange (as an asset to hold) in the face of a slight slowdown.⁶

Budgetary and Fiscal Matters

12. Table 2 (next page) shows that there was a huge increase in GOE capital expenditures (row 2b) and the overall deficit (row 5) in 1998/99 and after. The financing of the deficit blowup was mainly through increased borrowing from NIB (rows 6b & 6c). This proved to be a relatively roundabout and low-interest-cost way of financing the deficit.

⁴Egyptian businessmen, claim that they can't increase hiring because, "How can we enhance our payrolls while we are suffering from a dollar shortage, lack of cash liquidity, inflation, recession and the dwindling purchasing power of the Egyptian pound?" The Egyptian Mail, 4/8/01, p. 1.

⁵ See: Robert Myers, “DSP 2: Note 5. Should the Government of Egypt Try to Bring Informal Firms into the Formal Economy? 11/6/00, TAPR, Cairo, Egypt.

⁶ See Robert Myers, “DSP 2: Note 2. The Liquidity, Exchange & Interest Rate Problems in Egypt,” 10/12/00, TAPR, Cairo, Egypt.

Table 2: National Budget and Domestic Debt (LE billion)

	<u>96/97</u>	<u>97/98</u>	<u>98/99</u>	<u>99/00</u>
1. Total Revenues	64.5	68.0	73.3	79.4
2. Total Expenditures (of which)	66.8	70.8	86.0	91.7
2a. Current Expenditures	(53.0)	(54.7)	(60.2)	(67.2)
2b. Capital Expenditures	(14.0)	(15.6)	(25.3)	(24.1)
5. <u>Overall Deficit</u>	<u>-2.3</u>	<u>-2.8</u>	<u>-12.7</u>	<u>-12.3</u>
6. Total Dom. Debt-end FY(o/w)	148	160	182	202
6a. Securities (Mainly T-Bonds/Bills)	(90)	(85)	(78)	(78)
6b. GOE-Owed to NIB (net.)	(35)	(52)	(70)	(87)
6c GOE-Owed to Pub. Auth.(net)	(23)	(23)	(34)	(37)

Source: Monthly Economic Digest, MOEFT: Feb. 2001

13. This 350% jump in the deficit, from LE 2.8 to LE 12.7 billion is a significantly complicating matter for macroeconomic stability. Without some exceptional policy initiatives to crowd out domestic demand, this jump would be inflationary. It appears that those responsible for stabilization were a bit caught off guard by this budget deficit blowup and undertook no extraordinary initiatives. However, the CBE allowed only moderate increases in credit expansion.

14. In addition, GOE seems to have relied on a series of non-market, administrative interventions to suppress the inflationary impact of the deficit blowup. These apparently included the following: i) jawboning price restraints; ii) imposing extra restraints on private sector imports, including raising local currency coverage requirements to 100%; iii) using GOE dominance of the banking sector (not interest rates) to impose severe restrictions on credit to the private sector; and iv) building up GOE accounts payable to the private sector, known in public finance parlance as “arrears”.⁷ The result of these actions is that accommodation to the deficit blowup has been forced onto formal sector private businessmen and to some extent onto households who must increase their savings by holding domestic currency given the unavailability of other attractive savings assets.

15. Should GOE attempt to significantly increase revenues to close the deficit? Probably not, unless it is intended to make the large jump in GOE investment expenditures permanent. This would be contrary to GOE’s stated desire to see a relative expansion of private sector activity. Also, greater transfers from abroad will not reduce inflationary pressures unless accompanied by larger BOP trade deficits. Higher domestic taxes would also make things worse from a structural viewpoint, but could improve macroeconomic balances if directed solely at domestic consumption. English language newspapers for the period of 4/11-4/14/2001 carried stories that the second and third tranche GST extensions/increases in the GST will be enacted. If so, they will represent an increase in GOE fiscal intervention unless accompanied by a reduction in business profits tax rates so as to implement a revenue neutral improvement in the incentive impact of the tax system. Otherwise the tax increases will crowd out private business activity.

⁷ Guesses of the size of these arrears have ranged from a low of LE 5 billion to a high of LE 25 billion.

Monetary and Financial Developments

16. It is said that there is currently a liquidity problem in Egypt, but Table 3 (below row 3) shows that the problem is more localized to Egypt's formal, "non-government" sector. The impact of these credit expansion data is difficult to discern primarily because there are no official figures on the size of GOE/NIB arrears to the "non-government" sector. However, it appears from row 1 of Table 3 that overall credit expansion rose from a usual 14% per year to 20% and 24% respectively, before being reined back to about 14% per year for 1999/00 and beyond. An interesting mystery is why the increases in the rates of overall credit expansion (row 1, Table 3) didn't cause more inflation. Instead, the official figures show that the credit increase was accompanied by declines in the inflation rate (see row 6 of Table 1).

Table 3. Egypt: Percentage Change in Domestic Credit (NDA) & Money
(Annual changes; July-June. Percentages rounded)

	Actual					Estimate
	95/96	96/97	97/98	98/99	99/00	00/01
1. Net Domestic Assets	15%	14%	20%	24%	13%	14%
2. Credit to GOE	12%	15%	15%	31%	10%	14%
3. Credit to Non-Govt. ⁸	24%	24%	18%	22%	13%	14%
4. Total Liquidity (M2)	10%	15%	9%	12%	9%	---
5. Velocity (GDP/M2)	1.4	1.3	1.3	1.2	1.2	---

Source: Monthly Economic Digest, MOEFT: Feb. 2001.

17. Also unclear is how much of the "non-government" sector is truly private and how much is actually SOEs and other GOE owned and controlled institutions. It is likely that SOEs constitute a large portion of this sector, but they get unknown amounts of their credit from outside of the banking system. Whatever the case, row 3 of Table 3 suggests that the private formal economy has experienced either a severe or very severe credit restriction, depending on the size of their holdings of GOE/NIB arrears. It is not clear how these arrears are being handled in the official monetary data.

⁸ This includes NIB and SOEs.

Interest Rate Developments

18. Table 4 below shows that significant interest rate adjustments were not made to help offset the effects of the deficit blowup.⁹ One would have expected them to rise substantially in order to stimulate household saving and crowd out consumer and lower productivity business demands for credit. Instead, administrative interventions and jawboning seem to have been used to force accommodation to the deficit increase.

Table 4: Domestic Interest Rates (as at end of month)

	<u>Jun,96</u>	<u>Jun,97</u>	<u>Jun, 98</u>	<u>Jun,99</u>	<u>Jun,00</u>
1. Discount Rate	13.50	12.25	12.25	12.00	12.00
2. Three month deposits	10.50	9.90	9.00	9.14	9.25
3. Bk. Loans, 1 year & under	15.50	13.20	13.20	12.84	13.11
4. Interbank (CAIBOR as of 7/00)	10.30	8.70	9.10	11.30	11.10
5. T-Bill rates (rough approx.)	10.20	9-10	8.84	8.85	9.00

Source: Monthly Economic Digest, MOEFT: Feb. 2001.

19. It seems likely that GOE/CBE eschewed the chance to use an indirect, incentive-based policy involving raising domestic interest rates. A possible reason for this is a GOE desire to avoid higher budgetary interest costs. This might explain why GOE reduced T-Bonds/Bills outstanding following the inflation of the early 1990s and opted instead for financing deficits by borrowing from NIB (see Table 2, rows 6a, 6b, & 6c). It also may explain the sizable but unknown increase in GOE arrears.

20. A preoccupation with keeping interest rates and deficit financing charges too low may reflect a lack of appreciation of the difference between financial and real costs. Alternatively it may reflect a GOE belief that real rates of return to public sector investments are higher than for domestically financed private investment. Either way, GOE's approach to financing the budget deficit and the deficit blowup resulted in crowding out of private investment rather than household consumption. A more active interest rate policy, e.g., through issuing bonds to the non-bank public, would have allowed private households to save in more attractive ways. Such an interest rate initiative would also have relieved much of the pressure on the exchange rate caused by the deficit blowup.

21. The arrears buildup may have negative longer-run consequences. One is likely to be higher, risk-adjusted charges for goods and services provided to the Government. Another is possible confusion regarding the intended thrust of economic policy initiatives. Both were unnecessary. There is a solution to the arrears problem that is

⁹ One hears that businessmen have occasionally been charged 17%-19% for credit. The data in Table 4 don't show this. However, the main point is that CBE didn't raise interest rates to allocate drastically reduced amounts of credit. Instead, GOE or GOE owned banks apparently administratively allocated the credit cutbacks.

startlingly simple and effective. GOE could either swap tradable bonds¹⁰ for the arrears or issue bonds to the non-bank public and settle the arrears with cash. The swap approach was actually suggested by some businessmen in Egypt. It has been used effectively elsewhere, including in Senegal in the late 1980s.

22. Given that the arrears are a *fait accompli* the bonds could carry normal interest rates and be exchanged “at face” for the arrears. However, private businessmen must be able to trade the bonds to households in order to solve their liquidity problem and foster a privately initiated bond market. Although this bond-swap approach to the arrears problem will raise budgetary interest costs somewhat, it is much more sympathetic to private sector growth. This will in turn result in greater tax revenues that will easily cover the larger budgetary interest costs. In addition, households will get access to a new, attractive savings instrument.

23. The credit cutbacks and the GOE/NIB payments arrears may adversely affect the solvency of the major GOE owned banks. The relationship between public sector bankers and businessmen is not the usual “arms length” one. These relationships rather than profit-maximizing behavior have influenced these bankers’ perceptions of creditworthiness and, therefore, businessmen’s access to additional credit from these banks. This has led to a situation in which moves to raise prices in order to increase profits and creditworthiness can engender displeasure and lower creditworthiness.

24. The budget deficit blowup, the GOE/NIB payments arrears and the severe tightening of credit to private businessmen has disrupted this traditional banker/businessman relationship and its positive influence on the creditworthiness of businessmen, who are the client base for the major banks in Egypt. These banks perceive that the creditworthiness of their client base has deteriorated. Businessmen can’t receive payments for the arrears and they can’t raise output prices. On this basis, the banks are reluctant to extend even the meager increases in credit allowed them by CBE. However, these businesses need increases in (subsidized) credit to survive without raising prices. The net result is a potentially degenerative situation in which declining business creditworthiness leads to solvency problems amongst the large Egyptian banks.

International Trade, Exchange Rate & Foreign Debt Developments

25. Table 5 (next page-rows 1, & 2) shows a huge disparity between Egypt’s high levels of imports and relatively low levels of exports of visible goods. This leads to large deficits on the balance of trade (row 3). This deficit is nearly offset by large currency inflows from surpluses of service exports and from transfers from abroad. The result is that Egypt has relatively low BOP current account deficits (Table 5, row 6) that would be the envy of most other countries with economies the size of Egypt’s. At its highest (1997/98), the BOP current account deficit was 2.4% of GDP expenditures. In all other years, it was a much lower percentage.

¹⁰ It would be far better if the bonds are bearer bonds.

Table 5: BOP Accounts, External Debt & Exchange Rates

	<u>96/97</u>	<u>97/98</u>	<u>98/99</u>	<u>99/00</u>	<u>Est.00/01</u>
1. Imports (\$ B)	15.6	16.9	17.0	17.9	
2. Exports (\$ B)	5.3	5.1	4.4	6.4	
3. <u>Trade Bal. (\$ B)</u>	<u>-10.3</u>	<u>-11.8</u>	<u>-12.6</u>	<u>-11.5</u>	
4. Net Service Exports (\$ B)	6.2	4.7	6.0	5.6	
5. Net Transfers to Egypt (\$ B)	4.0	4.6	4.9	4.7	
6. <u>Bal. on Cur. A/C (\$ B)</u>	<u>+0.1</u>	<u>-2.5</u>	<u>-1.7</u>	<u>-1.2</u>	
7. External Debt (\$ B)	28.8	28.1	28.2	27.8	27.1 [#]
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>Jan. 2001</u>
8. \$/LE Exchange Rate	3.4	3.41	3.42	3.65	3.86

Source: Monthly Economic Digest, MOEFT: Feb. 2001.

End Dec. 2000.

26. The extent of non-export foreign exchange receipts, and correspondingly low BOP current account deficits, has allowed Egypt to use some capital inflows to retire some external debt (Table 5, row 7) during a period when several major developing countries have been increasing and/or rescheduling it. This is a marked improvement over the late 1980s, when mounting external debt servicing problems forced the Government to submit to a three-stage rescheduling program beginning in July 1991. Since then, GOE not only slightly reduced external debt, but also increased international currency reserves from about \$12 billion at the end of 1991 to a high of slightly over \$20 billion in July 1997. Thereafter, international reserves fall relatively quickly to \$14 billion in June 2000 as GOE staunchly defended a LE3.4 = \$1.00 exchange rate that appears to be overvalued.

27. GOE's defense of an overvalued exchange rate through administrative interventions and sales of \$6 billion of foreign exchange is not consistent with incentive-based policy initiatives. In fact, it is not clear that a once-and-for-all devaluation will change much in the real formal economy, given GOE desires to influence prices and costs. To be effective, devaluation must raise output prices relative to input costs so as to increase the profitability of formal sector production/investment. Price interventions to suppress inflation are not likely to be compatible with the higher output prices needed to increase private businessmen's profits and make the devaluation effective.

28. In this context, recent discussions regarding initiating large Euro-Bond debt issues are unsettling.¹¹ Foreign borrowing by governments (rather than Central Banks) should not be used to support the exchange rate. Public sector foreign borrowing may be appropriate in situations involving a significant volume of highly profitable domestic investments and an acute shortage of domestic savings, as reflected in very high, market

¹¹ See Robert Myers, "DSP 2: Economic Vignette 2. Why GOE Should Not Borrow from Abroad" 11/16/00, TAPR, Cairo, Egypt.

determined domestic interest rates. However, until markets are liberalized in Egypt, returns to investments will be low and there will likely be excess, or involuntary domestic savings. In fact, given that GOE controls gross import values, it is mainly household demand to save foreign exchange that is putting pressure on the exchange rate.

29. At first sighting the enormous excess of imports over exports cries out for the adoption of export promotion policies/programs in Egypt. However, the relatively small BOP current account deficits dictate caution. An autonomous expansion of exports heightens excess aggregate demand, not a desirable occurrence on the heels of a deficit blowout that has not yet been adequately adjusted to. Furthermore, the success of such export promotion programs will, per force rest on expanded production/investment of the private formal sector. This is precisely the sector that has been chosen, instead of household consumers, to retrench in order to accommodate the deficit blowout.

30. It appears from a macroeconomic perspective that export expansion programs would be a mixed blessing in the current macroeconomic setting. Such programs would reduce welfare unless they are accompanied by increases in imports of similar magnitude that offset their expansionary impact on aggregate demand. The implications of this are that export promotion programs should not be undertaken to relieve pressure on the exchange rate, but rather as part of a program to increase the competitiveness of the Egyptian economy.

B. Microeconomic Considerations

31. Microeconomics mainly concerns incentives in, and structures of factor (labor and capital) and output markets. The actual incentives are the incomes and profits earned by the (private) owners of these inputs and outputs. Differences in income and profit earnings are determined by differences in prices and costs, which are in turn determined by free markets that represent households' economic preferences. Thus, in a free enterprise economy, free markets determine prices that in turn affect profits, and through them, production and private investment. Different economic structures affect the distribution pattern of incentives differently. In Egypt, there are essentially two sets of these markets, one set of three markets for the formal economy and one set of three markets for the informal economy. The structures and incentive (price-cost) patterns in these two markets are very different.

32. In terms of expanding private investment and trade (i.e., SO 16) it is presumed that growth in private investment (an expansion of private capital markets) causes growth in employment (an expansion of the labor markets). The expansion of these two sets of factor markets leads to expansion of output markets, or growth in trade. In addition, an increase in employment and/or labor productivity directly raises household incomes and reduces poverty. Micro-economists also assume that exchange rates are equilibrium ones. Because of this producers/traders are indifferent between receiving an amount of foreign exchange or the converted amount of domestic currency. As a result, an expansion of traded output is perceived as being equally valuable, or welfare enhancing, whether it is traded domestically or exported.

33. The above describes a market economy in which consumer preferences play a large role in determining how much of what sorts of output is produced and traded. This in turn determines the growth in profits and private investment. Governments can intervene in “market friendly” ways using taxes and subsidies. These taxes and subsidies can be explicit or implicit. If explicit, they appear in the budget, either as revenue or cash outflows to the private sector. If implicit, they are dictums, regulations, agreements, understandings, etc. concerning how the Government expects the private sector to behave.¹²

34. Governments can also intervene in non-market ways, e.g., by dictating prices, costs and production levels, thus ignoring consumer preferences. This approach, reflective of Egypt in the 1970s and 1980s, failed primarily for two reasons. First, planners couldn’t possibly get the whole array of relative prices and costs right. The theory couldn’t possibly be applied successfully. Second, government acceptance of all this responsibility led to a gigantic moral hazard problem. The people, on whose effort the government depends, adopted a let-the-government-do-it ethic and significantly reduced their work effort in the formal economy (and expended it in the informal economy). The result has been a call for “liberalization” or the re-establishment of free-market systems in which consumer preferences establish prices, costs, profits, trade and private investment and employment.

35. This examination of the current microeconomic status of the economy suggests that there are four areas requiring immediate attention. One concerns the importance of allowing complete ease of entry in the formal economy in order to stimulate price competition. Greater competition will increase productive efficiency and through that lead to higher growth in employment, income, GDP and exports. A second is that a primary ingredient in easing private investor entry or participation in the formal economy is faster, more complete and credible privatization that reduces GOE involvement in production. Unfortunately, larger public investment programs, including the spending on the Mega projects appears to be a move in the opposite direction.

36. A third concerns possible insolvency in some large financial institutions. This would lead to a need for a balance sheet rescue operation, but it should be done in such a way that is consistent with the development of a host of new, private competing “for profit” providers of financial services. Finally, there is the issue of how to expand trade (domestic and foreign) in welfare increasing ways. A crucial step is to accept all of the WTO agreements. Beyond this, it is best to recognize that the best way to promote more trade/exports is to reduce intervention and monopoly behavior in the domestic economy, so that competition can flourish and productive efficiency and private investment can grow more rapidly.

¹² Economists have techniques to calculate the explicit or “effective” values of these implicit taxes and subsidies. Two examples are calculations of effective tax rates and effective rates of protection (ERPs).

Structural Characteristics of the Economy: The Formal and Informal Sectors

37. The informal economy in Egypt is huge. At about 80%-100% of the formal economy,¹³ it may be the largest in the world. It is easiest to treat it as if it is 100% of or equal in size to the formal economy. It exists mainly because entry into the formal economy is so difficult and/or costly. It consists of activities that are not legally constituted or licensed.¹⁴ They are unregulated and don't file for or pay taxes. A most important characteristic of the informal economy is ease of entry; it is open to participation by all. The informal economy has shaky legal standing and no direct access to formal sector credit or to imports. Because of the way CBE controls credit extended to buy foreign exchange and imports, informal firms can not import directly, but must instead get their imports from formal firms. With exceptions, the output of the informal economy is consumable services. Economists tend to call this output non-tradable.

38. There is considerable price competition in the informal economy. Operators there are price takers. Increases/decreases in output demand (e.g., income-induced shifts in demand) stimulate rapid entry and exit of firms rather than changes in output prices. This too contributes to the competitive nature of the informal economy. Conceptually one can think of the supply curves in the informal economy as being extremely elastic or horizontal. Because of this, there is virtually no rent in the informal economy.

39. In spite of unfettered competition informal businesses are financially, but not technically efficient. Financial efficiency means that informal businesses are very responsive to changes in prices. They equate all the "marginals". Wherever and whenever possible, cheaper inputs are substituted for more expensive ones. In particular labor, which is cheap and abundant, is used whenever possible. Unfortunately, the informal economy is technically inefficient in the sense that it uses a lot of physical inputs (imports and non-renewable resources) per unit of output. The cost of physical inputs or tradables is a large portion of output prices, so that value added, or the compensation paid to human resources per unit of output is low. The major reason for the lack of technical efficiency is the absence of economies of scale. Informal sector firms must stay too small to avoid discovery.

40. Much of Egypt's formal economy is characterized by a lack of both financial and technical efficiency. A major reason is that there is very little freedom of entry and exit and little price competition in formal output or factor markets. Output prices are adjusted to costs rather than the other way around.¹⁵ The formal economy has been dominated by

¹³ Schneider, Friedrich and Dominik Enste. "Shadow economies around the World: Size, causes and consequences." (IMF working paper ; WP/00/26) International Monetary Fund, Fiscal Affairs Department, February, 2000. This study says Egypt's informal is 80% of its formal economy. Full text available in pdf format at: <http://www.imf.org/external/pubs/cat/longres.cfm?sk&sk=3435.0>. Because I think these estimates are conservative, and for heuristic purposes, I will say that Egypt's informal economy is 100% or equal in size to its formal sector.

¹⁴ Footnote Hernando De Soto's work in Egypt through ECES.

¹⁵ For instance, Egyptians know that the devaluation of the LE/\$ exchange rate will result in domestic price increases rather than reductions in the volumes of imported inputs.

public enterprises, or by a relatively few influential, non-competing private businessmen. In essence much of the formal economy has only public sector investment or private investment that is negotiated with GOE.¹⁶ A distinguishing characteristic is that only formal firms have access to foreign exchange and import entitlements.

41. A significant share of formal sector investment is done by the public sector. These are mainly in infrastructure or in large, vertically integrated public enterprise investments. Many operate in monopoly/oligopoly settings. They are large but nearly always have very low total factor productivity (TFP) and low or negative real rates of return. Most don't take advantage of economies of scale, instead operating at too low capacity levels. They provide a lot of employment, but labor productivity is low. By international standards, the resource use or technical efficiency of most of these public sector firms is low.

42. Something that might be called "private negotiated investments" makes up much of the formal sector or recorded (roughly estimated) private investment in Egypt. In fact, the negotiations themselves constitute barriers to entry and exit. As with public sector investments, many of these private formal sector investments are relatively large, vertically integrated investments. The negotiations tend to involve the costs that must be borne, or the conditions private investors must accept in order to operate in domestic output markets. These entitle the affected private investors to operate along side public corporations in protected or monopoly/oligopoly settings. This primarily means that they, like the public enterprises, adjust to shocks mainly by changing output prices rather than by changing production processes so as to raise productivity and lower per unit costs.¹⁷ Because of this, many are technically inefficient by international standards.

¹⁶ The IMF RED presents rough estimates of the fixed investment/GDP ratio. This is about 19% in the last two years, but because GOE transfers to NIB and NIB expenditures are not effectively netted out, this figure contains double counting as well as being subject to other errors. In addition, there are no separate figures for private investment. In an earlier RED, the IMF estimated that purely private investment, excluding investment by public corporations, was estimated at 4% of GDP.

¹⁷ To understand the beneficial role that price/cost shocks can have in a competitive environment see, Eric J. Bartelsman and Mark Doms, "Understanding Productivity: Lessons from Longitudinal Microdata." *JOURNAL OF ECONOMIC LITERATURE*, Vol38, (Sept. 2000, pp. 569-594).

43. For the most part, enterprises financed by either public or private negotiated investment operate in small domestic markets where demand grows only slowly. Virtually all operate at less than full capacity and at less than maximum profitability.¹⁸ In this setting, the entry of new competing enterprises is seen as duplicative and wasteful.¹⁹ Cost-plus pricing rather than cost minimization is the vogue. High levels of vertical integration mean that economies of specialization are rare. Even so, existing investors are anxious to negotiate agreements for new investments with GOE officials.

44. Many of these new investments by existing businessmen inhibit the entry of new investors and the enlargement of the investor pool and increased competition. Although this may change, a small pool of businessmen currently undertake most of the large private investments in Egypt.²⁰ This monopoly/oligopoly structure of much of the formal economy means that many formal economy supply curves are very inelastic. Without GOE jawboning, increases in aggregate demand would mainly stimulate price rather than output increases. For this reason, there is the potential for the presence of large amounts of rent in the formal economy.

Privatization

45. The dominance of publicly owned investments is a major reason why much of the formal economy is monopolized and noncompetitive. Oppositely, the lack of competition is why many formal sector enterprises, public or private are inefficient.²¹ Hence the importance in DSP of reducing GOE's role in production, through privatization. However, concurrent with the budget deficit blowup, the pace of privatization has slowed. A widely held belief is that this is because too little revenue will be obtained from sales during this "slowdown". If GOE does something besides privatization to re-attain more rapid economic growth, it is expected that interest in the firms to be sold will pick up and GOE can garner more revenue from privatization.

46. However, significant improvement of the formal economy in Egypt is unlikely without privatization. The privatization revenue issue aside, more rapid privatization could be a keystone initiative for reacting appropriately, from a demand management

¹⁸ A common argument is that capital utilization is limited by lack of imports. However, if Egyptian enterprises operated at international levels of efficiency, they could expand capacity utilization and profits by importing in order to expand exports.

¹⁹ The English language EGYPTIAN GAZETTE of May 2, 2001, p. 7 contains an article with the following quote by Saeed Abdul-Khaliq, undersecretary in MOEFT. "Copycat economy [he means duplicate investments] means wasting resources that could be directed to other areas more vital to the national economy." The article goes on to say, "He shared the view that repeating the same types of investments meant that supply would exceed demand, ending in slow sales and sell offs (liquidations). This entails less profits in both the medium and long terms." There have been also press clippings suggesting that more private banks and insurance companies are similarly superfluous.

²⁰ See Robert Myers, "DSP 2: Economic Vignette 1. Are Ten Owner/Managers for 200 Companies Better or Worse Than 200? 11/2/00: TAPR, Cairo, Egypt.

²¹ Merih Celasan, State-Owned Enterprises in the Middle East and North Africa: Privatization, Performance and Reform, contains the following statements. "The key determinant of the degree of inefficiency relative to the economic ideal is the degree of competition introduced in the market." And, "In markets that are regulated or oligopolistic, both private and public firms are likely to be inefficient...."

perspective, to the budget deficit blowup. Assuming primarily domestic sales, privatization would, like domestic bond issues, reduce any inflationary pressures that are currently being suppressed through non-market means.

47. In addition to causing the macroeconomic or budget deficit blowup, the Mega projects represent a complicating factor in GOE's efforts to reduce its role in the production of goods and services. The projects represent a major increase in public sector investment and imply significant continuing involvement in the productive economy. This has occurred along side expectations that privatization will reduce GOE's involvement in domestic investment and production. Without appropriate acknowledgement of and attention to this apparent policy conflict, there will be a poor understanding of GOE's actual policy intentions.

48. At a minimum it seems that alleviating private investor skittishness requires GOE to explain how it intends to operate the Mega projects in ways that are consistent with a longer-run expansion of private investment and production. This is by no means an impossible task, but it will not be easy. It requires a public coalescence of ideologically diverse Ministries, including those for Agriculture and Supply and Home Trade, around free market, private enterprise principles. Following this it would involve agreement on operating principles that allow private investors/farmers to use Mega project capital to make privately earned profits.

Competition Policy

49. The comparative description of the formal and informal economies above demonstrates two important points. One point is the extreme importance of ease of entry and exit for fostering price competition. There is fierce price competition in the informal economy because it is so easy to start new businesses. Supply is very elastic so that price controls aren't necessary. Price competition in the formal economy is very uneven, due in part to the extent of GOE ownership and the difficulties that new investors face when trying to initiate competing investments. In general, supply elasticities are much lower in the formal economy. This tends to rationalize price controls.

50. The other point relates to the extent to which competition in the formal economy is encouraged by GOE. To date GOE's encouragement of competition has been rather tepid. There seems to be a view that a large number of competing firms is duplicative and wasteful,²² at least in "important" sub-sectors. There seems to be a belief that direct GOE regulation of monopolies will more efficiently control prices and profits than will competition. Given this, GOE's approach has often been to engage directly in production through SOEs and/or to administratively limit the number of and regulate the prices and profits of private firms, at least in "key" sub-sectors. In this setting, it is doubtful that a newly redrafted, more freestanding Competition Law, by itself, will bring about significant structural changes and increased competition in the formal economy.

²² See footnote 19 above.

51. Besides a revised, more freestanding Law on Competition, officials in GOE must become convinced to free up entry and exit of private investors. A larger number of privately-owned, competing firms is superior to today's mixture of SOEs and regulated private monopolies. The superiority is in three dimensions that are of major concern to GOE. One is that increased competition will cause formal sector employment to rise, assuming labor markets are allowed to adjust. A second is that more competition will cause labor productivity and wages to rise. These two together will reduce poverty significantly. The third benefit of increased competition amongst formal sector firms would be a marked increase in welfare enhancing trade, including increased exports.

52. It is important to appreciate the fact that enhanced competition brings about these benefits, even though it is not yet understood why it happens.²³ Up until about fifteen years ago, it was felt that competition mainly did a better job than regulators of keeping prices and profits from rising. However, an increasing number of total factor productivity (TFP) studies make it clear that greater competition increases TFP or productive efficiency and lowers real output costs and prices. Increased TFP tends to lead to higher wages while lower output prices lead to increased production, employment and sales, including of exports. These increases in employment, wage bills and exports do not come from special government-led promotion programs, but from the effect that increased competition has on reducing costs and raising competitiveness and output levels.

Financial Sector or Financial Services Providers (FSPs)

53. A significant portion of the financial sector in Egypt is owned by GOE and heavily regulated by CBE. The main operating dictum for the bulk of the sector is an archaic one: It is supposed to provide savings, really credit, to finance investments, particularly public sector ones. This operational approach is in turn based on the view that at reasonably low interest rates, investment in developing countries is constrained mainly by a shortage in the supply of non-inflationary credit. This view has not been supported by experience, however.

54. This has led to a belief, still influential in Egypt, that the more rapid is the expansion of the supply of non-inflationary credit, the more rapid will be the expansion of investment. Through this "supply push" approach, credit expansion in Egypt has indeed been quite rapid. Most of it has come from a few GOE controlled financial institutions and, until recently, has gone to a relatively small group of borrowers. Much of the expansion of credit has financed investments that are operated inefficiently. Some of the credit has leaked out or been appropriated to finance personal consumption. Besides wasting resources, this supply-push approach to expanding lending has had implications for the solvency of the banking system.

55. In this older, supply-push approach, the characteristics of the demand for credit and investment, and the related profit potential of lending to new clients, is essentially ignored. The sector is not viewed as consisting of potentially profitable private investment opportunities that would be accompanied by increased employment and GDP.

²³ See Eric J. Bartelsman and Mark Doms, op. cit.

The demand of household savers and aspiring private investors is overlooked. In essence, the sector's structure, and dominance by GOE, make it ill-equipped to react to the rapidly changing and increasing household and new investor demands for a wide range of new financial services. Until recently, the main financial institutions have lent increasing amounts of credit to a fairly static rather than expanding group of clients.

56. There is a fairly standard, "best practice" approach to reforming financial sectors that are sliding into insolvency in the above way. It is perhaps best characterized by several publications by Gerry Caprio.²⁴ It stresses heavy Treasury/CBE/IFI involvement in resolving financial insolvency ("balance sheet") problems coupled with subsequent privatization of the "rescued" institutions. The approach has not been particularly successful. A major reason is that, even with privatization, the Caprio approach doesn't change the sector's oligopoly structure, nor its client pool. Instead, moral hazard problems have persisted and have led to the re-occurrence of balance sheet problems in a number of countries. Indeed the banking sector was restructured ten years ago because of previous problems, of this nature and also relating to the rescheduling of foreign debt.

57. It is important that rapid growth in private, "for profit" financial services be encouraged so that new institutions can cater to credit demands "around the edges" of the current formal sector client base. There are uncertainties with respect to this approach, because there is not an obvious solution path. Instead, this approach assumes that a large number of competing, financial service providers will find solutions to the problems as they go along. It follows from this that solutions to the balance sheet problems of the major existing financial institutions in the formal economy should be compatible rather than at odds with rapid growth "around the edges".

Trade in Goods & Services, WTO, & Trade Support Services (Customs, Etc.)

58. An examination of Egypt's trade issues suggests that formal sector trading is stifled by intervention and protection. This can be intuited from, among other things, the rapid growth of the volume of trade in the informal economy. There is a tendency in Egypt to see the solution to formal sector trade problems as involving new or different GOE intervention initiatives. An example is export promotion.²⁵ However, it is likely that the volume of domestic and foreign trade in Egypt will expand most rapidly and cheaply if economic interventions are reduced rather than just rationalized. Such de-escalation will also make it easier to comply with WTO agreements since their major thrust is the adoption of welfare enhancing (domestic and foreign) trade practices.

59. In referring to trade expansion, economists treat domestic and foreign trade equally. If the expansion of a country's international trade comes about in a welfare enhancing way it will, except in unusual cases be accompanied by an expansion of domestic trade and an improvement in domestic productive efficiency. These results are

²⁴ Gerard Caprio, Jr and Robert Cull, Bank Privatization and Regulation for Egypt. Distinguished Lecture Series 15, Published in August 2000 by ECES, Cairo, Egypt.

²⁵ See the four page Table of Contents of the **draft** Export Development Strategy of the MOEFT.

inherent in the demand and supply analysis that underlies, among other things the WTO trade agreements.

60. The trade analysis underlying the WTO agreements is based on the fundamental assumption that international trade occurs when domestic prices adjust to international markets in ways that create excess supplies in local markets. For example excess supply (and exports) occur when the adoption of an international price raises the local price above its local equilibrium level. This price increase restricts domestic demand (consumption) and expands domestic supply (production) to create the excess supply that is exported. This one event, if unaccompanied by increased imports of equal, offsetting value, is welfare reducing. Domestic consumption is restricted to provide the exports that earn more foreign exchange.

61. This stance is essentially reflective of a strategy involving reducing domestic consumption to create more exports in order to increase international reserves or households' foreign exchange balances. It appears to be the case in Egypt, sadly, that there is willingness amongst households to suffer welfare losses to acquire more foreign exchange simply because no equally attractive domestic saving alternatives are available. It appears that Egypt could reduce the demand for, rather than expanding the supply of foreign exchange through more exports, if only GOE were to issue attractive savings alternatives to foreign exchange. Thus it is that the issue of GOE bonds to households would contribute significantly to solving Egypt's liquidity problem. Foreign borrowing, on the other hand, delays the onset of, but increases the size of likely welfare losses.

62. The WTO agreements do not prevent this activity but instead focus on improving domestic competition so that international prices are accurately and completely reflected in domestic prices. Trade liberalization raises a domestic price and creates excess supply in the short run. However, expectations are that the higher price will attract the entry of additional producers who will a) expand local productive capacity and b) introduce more competition that will increase productive efficiency (e.g., through technological change). The end result of these favorable supply shifts is that the price increase to international levels stimulates greater domestic production, employment, income and consumption.

63. Two points are crucial about this example of trade liberalization or acceptance of all of the WTO agreements. One is that the price increase is a market-derived one that is credible. Producers know that they can sell increased amounts of output at the new higher price. Second, the longer-term expansion of output is the result of increased competition in domestic markets. The increased competition results from ease of entry and a larger number of investors and the improvements in productivity that the increased competition causes.

64. Devaluation of the exchange rate will affect exports in the same way as the above example of implementing WTO agreements. That is, as long as there is freedom of entry and relatively stiff price competition in the domestic economy, devaluation further raises the domestic prices of traded output. This in turn can stimulate increases in domestic production, employment, incomes and exports. However, without such competition, the

domestic currency price of traded output will not rise relative to non-traded output (this relative price change is the actual “real” devaluation) and the beneficial results of the price increase will not occur. This lesson is, therefore, that without implementation of the WTO agreements, or comprehensive economic liberalization, devaluation is not an effective policy tool.

65. The informal economy in Egypt can play a significant role in liberalization of the formal economy and of trade. It is very large and competitive and produces mostly services, called “non-tradables”. The informal economy has a comparative advantage in producing services. At present the formal economy purchases large amounts of high value added imports from abroad. The imports are of a “finished” nature, by virtue of their content of service inputs from their countries of origin. Given this, Egypt could dramatically increase welfare gains, and improve their distribution by liberalizing interactions between its formal and informal economies at the same time that it liberalizes trade between its formal and the international economies.

II. BACKGROUND & REFORM POSSIBILITIES IN NINE POLICY AREAS

(i) Exchange & Interest Rates/Monetary Policy/Stabilization²⁶

66. Egypt has used a fixed LE/\$ exchange rate as a nominal anchor to support stabilization efforts. However, nominal interest and exchange rates are probably too low to balance savings and the demand for credit and foreign exchange. There are also a variety of restrictions on imports. This leads to the existence of excess domestic demand for (domestic shortages of) tradable goods and foreign exchange to be held as savings. If GOE did not also control many domestic prices the domestic costs of tradable output would rise, thus stimulating more domestic production, trade and employment. To a large extent it is, therefore GOE’s desire to keep domestic prices low, in order to protect the poor, that interferes with growth in GDP and employment. As long as GOE is determined to prevent a relative rise in the prices of domestically traded output, this situation is likely to continue, even if the exchange rate is devalued.

67. The Egyptian data don’t show inflation or stagnation, but people talk about both currently being problems. It is possible that inflation is suppressed by GOE jawboning to keep prices down. This could lead to something that might be called a “monetary overhang”.²⁷ This might exist because consumers can’t save by purchasing the financial instruments they desire. The data also don’t show stagnation. It is possible that formal sector growth has declined sharply, but that the official GDP growth figures overstate formal sector growth by increasingly expanding coverage of informal economic activity.

²⁶ Two background papers relevant to this are: Hassan Selim, “DSP II: Major Objectives and Policy Analysis.” (pp. 4-6), Feb/Mar., 2001 and Robert Myers, “DSP2:Note 2. The Liquidity, Exchange & Interest Rate Problems in Egypt” October, 12, 2000.

²⁷ Indeed, the velocity of money has fallen, although only very slightly.

68. GOE influences the prices and availability of foreign exchange and the allocation of domestic credit, importantly through its control over key institutions in the financial system. The result is that excess demand isn't removed through price and cost adjustments in the formal economy. In particular, it prevents the prices of tradable output from rising relative to the prices of non-tradable output. This price adjustment, called a "real devaluation" is needed for greater growth in formal sector GDP and exports.

69. The primary rationale for these GOE price interventions is to prevent inflation, which devastated the Egyptian economy in the early and mid 1990s. GOE's influence over many tradable output prices is implicit rather than explicit. Essentially out-of-step producers that are seen as raising prices to increase profits, rather than e.g., adjusting to increased costs, may encounter enhanced difficulties of operation. Perhaps credit becomes harder for them to get, or some labor law irregularities are discovered. This is a system that, though not an "arms-length" one, has kept inflation rates low while enabling recorded GDP growth rates of about 5%-6% each year.

70. There are three types of reform initiatives that are consistent with a continuation of these implicit controls over tradable output prices (and profits). Two are considered under the subheading on competition below. They involve policies that lead to a willful lowering of input prices for, and expansion of the number of firms producing tradable output. The third, more suitably discussed here, is the role that liberalized interest rates and the creation of asset markets can have in stabilization and improved efficiency. Such liberalization involves selling GOE bonds to households through brokers. These brokers would make markets and break the bonds down into sizes that are of interest to household savers.

71. Bond sales will help with the crowding out of private demand by absorbing monetary overhangs (suppressed inflation).²⁸ In addition, issuing a diverse set of debt instruments would stimulate the development of privately operated domestic financial markets and services. The current economic situation suggests that it is possible to successfully issue a broad array of debt issues to the private businessmen and households. These would include government, infrastructure and industrial/banking bonds as well as mortgages. The primary purpose of the issues would be to foster market development although GOE could also raise more revenues in a non-inflationary way.

(ii) Privatization²⁹

72. Privatization can accomplish two important things. It can reduce GOE's role in production and, depending on how its done, it can contribute to liberalization of the economy. Ultimately it should result in the transfer of some of the responsibility for economic decision making to a diverse set of (competing) private businessmen. As it is currently conducted, privatization may not be contributing to liberalization to the extent that is desirable. There is an excessive preoccupation with the revenue that privatization

²⁸ It should be noted that more rapid privatization will also help sop up excess private sector demand.

²⁹ Background papers relevant to this are: Hassan Selim, "DSP II: Major Objectives and Policy Analysis." (pp. 25-28), Feb./Mar. 2001.

brings to the budget. This causes it to be a too carefully scripted process that is only slowly and slightly reducing GOE control over the economy. More significantly, the current process does not appear to be an arms-length one that would occur in liberalized asset markets. Instead, it can be seen as resembling a process of selling rights to produce, or monopoly rights, as well as selling productive assets.

73. If successful as a reform tool, privatization would foster liberalization in at least three significant economic areas. One is to stimulate the formation of competitive asset markets in which productive assets are evaluated and traded according to free market principles. A second is to improve productive efficiency, both in the firms being privatized and, through increased competition, in their respective sub-sectors. The third is to reduce moral hazard problems, or the extent to which individuals look to the GOE rather than themselves to produce economic output.³⁰

74. The absence of asset markets (and of effective bankruptcy procedures) makes investment and banking activities both difficult and risky for private Egyptian entrepreneurs. This in turn offsets efforts to stimulate more private investment. Egypt's privatization process is not now providing an impetus for the formation of free asset markets primarily because each privatization is treated as a unique, carefully scripted event rather than as a standard market-like, potentially repetitive transaction. Uniqueness is reinforced because the slow, deliberate pace of privatization allows each event to be treated as a discrete one.

75. As currently conducted Egypt's privatization process may have only a slight impact on increasing domestic competition and productive efficiency. Many of the privatized firms seem likely to be allowed to continue to have the protected and/or monopoly status that the SOE enjoyed. Because of this and in some cases the extension of tax breaks, potential buyers can offer handsome prices while agreeing to retain excessive amounts of labor. The current privatization process resembles less-than-transparent "negotiations" rather than market transactions. It is possible that there are expectations that the GOE will discourage new competing investments in the affected sub-sectors, at least for a while.

76. Finally it appears that the privatization process is not yet transparent and rapid enough to remove an overriding moral hazard problem in Egypt. That is, the perception that GOE rather than private entrepreneurial activity will step in and solve economic problems that arise. This has not worked well in the past, but most importantly, it is inconsistent with both the privatization process itself and GOE's expressed intention to reduce the public sector's role in production and allow the expansion of privately undertaken trade and investment.

³⁰ Moral hazard problems between governments and their citizens lead to reductions in private initiative. At first the government may rise to the occasion and supplement personal initiatives. This leads to an intensification of the moral hazard problem as citizens' expectations increase and their personal effort declines. Eventually the government can no longer expand further, but moral hazard prevents the re-emergence of personal initiative. Instead rationing, or informal activity takes over.

77. If it is to advance liberalization, it is important that Egypt's privatization process resemble the free market trading/marketing of the ownership of productive assets, not the sale of licenses allowing private investors to operate in Egypt. The privatization process could well be speeded up and become more standardized, routine and transparent. In short, the privatization process should contribute to the development of asset markets in Egypt and also be a part of the sales in those markets. In addition, it is important that GOE be clearly seen as withdrawing from productive activity.

(iii) Financial Sector Reform and Development³¹

78. The financial sector can provide financial services that contribute greatly to GDP growth. Traditional reasoning is that financial services are mainly needed to provide inputs or financing for investment and production. That is, that increasing financing volumes and lowering costs will indirectly increase GDP by fostering investment and production. This has not proved to be useful reasoning, however. Financing targeted for investment has gone astray and ended up financing consumption, particularly of imports.

79. A different view, supported by recent analysis³² is that encouragement of growth in the financial sector also directly increases GDP through the provision of consumption and consumption smoothing services, and by making it easier for households to save. The demand for all of these rises with income. In this view, investment and production can be "pulled up" by growth in (income elastic) consumer demand for financial services. Of considerable importance to this latter view is the significant impact on employment and wage growth that accompanies expansion in the breadth and volume of financial services.

80. The existing Egyptian financial sector is underdeveloped. It is significantly owned and controlled by GOE and has a heavy focus on servicing public sector financial demands. In some respects it is a quasi-government instrument that is not well suited to providing the breadth and volumes of financial services desired by private businessmen and consumers.

81. It may be that the best strategy involves stabilizing and shrinking the publicly owned institutions while removing constraints so that large numbers of competing, privately owned financial institutions can grow rapidly and become dominant in Egypt's financial sector. Following this, the public sector financial institutions can be restructured and sold. The alternative, to focus on reforming and then privatizing the existing public sector financial institutions will not stimulate development of the sorts of financial services demanded by modern private businessmen and consumers.

³¹ This is based partially on Hassan Selim, "DSP II: Major Objectives and Policy Analysis." (pp. 7-11), Feb./Mar. 2001 and "The Insurance Sector: Background Paper for the Design of DSP II." (Author Unknown)

³² Ross Levine, "Financial Development and Economic Growth: Views and Agenda" JOURNAL OF ECONOMIC LITERATURE, June 1997, vol. 35 Issue 2, pp. 688-726.

(iv) Rule of Law and Corporate Governance³³

82. It is useful to distinguish between behavioral changes that are induced, through alterations in economic incentives and those that are mandated through laws, regulations, decrees, etc. (all of which are hereinafter called “laws”). Most of the behavioral changes anticipated under DSP are likely to be most efficiently induced through alterations in price and cost incentives. However, there are exceptions involving amending laws and/or the administration of them. In the DSP, concerns about the rule of law mainly relate to how Egypt’s present laws and the administration of them reduce the actual and prospective profitability of private investment and commercial activity. Concerns about corporate governance mainly relate to how to insure that greater corporate profits are accompanied by increased, rather than reduced social welfare.

83. The present legal system, comprising both the laws and their administration is dominated by GOE and not well suited to rapid expansion of efficient, private economic activity. The system’s main problems are that it is very time-consuming and costly to use. Furthermore this time-cost element, or interest forgone, is not recognized in legal settlements. It can be used to intrude capriciously into legitimate economic activity and is seen as lacking transparency. It can be a hindrance to expansion of private commercial activity.

84. Perhaps a most significant oversight of reform advocates is ignoring the implications for legal system reform of the huge “illegal” informal economy in Egypt. Independent measurements find it to be approximately equal in size to that of the formal economy,³⁴ yet it seems to function without a formal legal system. The vibrancy of the informal economy suggests that the best legal system reforms, from the viewpoint of faster economic development, would be those that allow/encourage a unification of the formal and informal economies without reducing the value of output in either.

85. Truly successful legal system reform should envelop the informal economy in a way that encourages rather than kills it. It is likely that this rules out a completely GOE dominated and controlled reform of the legal system. Instead, it suggests that GOE sanction, even encourage expansion of privately provided legal services and also accept a process of codification of what works rather than what ought to work. This means that legal system reform/development and the re-drafting of laws should occur along with more rapid and efficient economic development rather than being a prerequisite to it. Sanctioning the expansion of private legal services entails codifying and GOE acceptance of legal outcomes arrived at privately. However, encouraging the expansion of legal services might require some subsidization of the infrastructure needed by a growing number of private legal service providers.

³³ This is based partially on: Hassan Selim, “DSP II: Major Objectives and Policy Analysis.” (pp. 22-24), Feb./Mar. 2001; Ali Kamel, “Corporate Governance Report-DSP II Design,” 11/13/00; and, USAID/CLDP, “Statement of Work- Commercial Law Development,” 6/10/1997.

³⁴ See footnote 13 above.

86. Corporate governance issues apply mainly to companies where ownership and management are separate. In such circumstances, principal/agent problems can arise because of slow or incomplete transmission of information. Without a good and timely information flow, managers can behave in ways detrimental to owners' and creditors' (and society's) welfare. It is generally held that pursuit of the dual goals of profit and long-term net worth maximization will maximize owner and society's welfare. This presumes, of course that profits are earned fairly, rather than, e.g., by not paying creditors. Devious managerial behavior, involving asset stripping, transfer pricing (where profits are shifted out of the firm), or not paying creditors, etc. can reduce real profits, net worth and owner (and society) welfare.

87. There are two approaches to solving such principal/agent problems, one legal and the other economic in nature. Both entail clearly establishing expectations regarding managerial behavior. The economic approach involves designing salary incentive schemes that induce behavior that maximizes owner (and societal) welfare. The legal approach is to direct managers, through corporate laws, codes of conduct, etc. regarding how to behave properly. The responsibility for drafting and enforcing such laws or codes of conduct rests awkwardly and uneasily amongst the government, business and legal systems in each country.

88. Not surprisingly economists favor improving in-firm incentives as the most efficient and effective way to solve corporate governance problems. If effective this approach also requires considerable competition in capital markets so that poorly performing managers are quickly exposed. Lawyers, on the other hand favor prescribing appropriate behavior through re-drafting old, or drafting new laws, codes, etc. However, this requires a separate administrative or implementing system and a well-functioning legal system that is independent both from government and corporate influences.

(v) Fiscal Policy and Debt Management.³⁵

89. By most accounts the Egyptian budget process is in need of considerable strengthening. A 1973 Budget Preparation Law (53/1973) is still applicable, but affects things only slightly. Its age and the advancing sophistication of financial activities suggest that the relevance of the Law is slight. Because there is a vast array of Treasury accounts into which revenue can be placed and out of which expenditures can be drawn, normal budgetary control and accounting procedures are of reduced relevance. To date, controls are weak and accounting and reporting procedures are lacking.

90. Given this budgetary situation much will have to be developed before Egypt can have precise, well-implemented fiscal policy. However, because those that matter have

³⁵ This is based partially on: Hassan Selim, "DSP II: Major Objectives and Policy Analysis." (pp. 29-31), Feb./Mar. 2001; No author/date, "Public Debt Management" (7pp.); World Bank-off of web-, "Public Expenditure Management Handbook." (10pp.); Jim Norris, "Budget Management & 'Next Steps to develop an OMB'"-summary of Handbook- (6pp.), 8/9/00; No author/date, "Fiscal Policies in Egypt." (6pp.); IMF-off of web-"Manual on Fiscal Transparency: Introduction and Part III" (11pp. total).

similar, somewhat conservative fiscal policy views, Egypt has a fiscal policy stance, but without much in the way of normal fiscal controls to implement it.

91. Regardless of the nature of fiscal policy, it is the case that the current budgetary procedures cause macro and micro economic problems that need addressing to encourage private formal sector investment and trade. On the macro side, there seems to be no transparency mechanism that signals the onset of a jump in the budget deficit. It appears that virtually everyone was caught off guard when the overall deficit jumped hugely, from LE 3.8 billion in 1997/98 to about LE 12.3 billion each year for the 1998/99, 1999/00 and 2000/01 fiscal years.

92. In this recent situation GOE seems to have relied mainly on non-market interventions to suppress inflation. Two significant interventions were to induce the GOE controlled banks to limit customer access to credit and foreign exchange. There may also have been suggestions that increases in output prices would be frowned upon and could lead to additional problems. These interventions not codified and mostly informal, are inconsistent with economic liberalization, “arms-length” behavior and a greater role for more efficient, private, formal sector activity.

93. There were policies that GOE might have adopted that are consistent with greater economic liberalization and improved longer-term private sector growth prospects. Primary among these would be to sell bonds to households or, that is, to the private sector. This is an important reform thrust of the DSP reform program. Had GOE speeded the pace of the relevant DSP reforms and had there been greater coordination and willingness amongst economic ministries, such bond sales would have been a much more welfare increasing policy option for GOE.

94. Two microeconomic problems stand out with respect to budgetary procedures. One relates to the uneven incentive effects of the tax system. The standards by which to judge the incentive effects of tax systems, as set out by Shalizi and Squire,³⁶ involve doing an assessment assuming revenue neutrality. That is, abstracting from concerns about the deficit by asking the question, “given the most recent year’s tax revenues, can the same amount be raised through tax reforms that improve development incentives?” The overriding principle is to shift taxes off of private business and investment (capital) and onto consumption expenditures. Doing so will cause domestic output prices to rise relative to the prices of inputs or costs of production.

95. This reform principle says that countries should first introduce a General Sales Tax and then raise tax rates and tax collections on consumption expenditures (i.e., on consumers) in order to be able to reduce taxes on and tax collections from private producers/investors. Egypt has already introduced a GST, but the suggestion of increasing taxes and prices paid by consumers may elicit protests that this will cause unacceptable harm to all those Egyptians who are already suffering poverty.

³⁶ Lyn Squire and Zmarak Shalizi, Lessons of Tax Reform. World Bank, 1991:Washington, DC.

96. In fact, the logic of raising taxes on consumers, and lowering them on private producers/investors is that this will increase formal sector private investment, employment and household incomes. This amounts to giving the poor jobs and earned income rather than transfers. In addition, since it is supposed to be a revenue neutral tax reform, consumers should be as well off as before in terms of net consumption expenditures, but better off in terms of increased savings. In short, increasing the GST while reducing taxes on producer/investor profits and inputs helps solve a poverty problem by increasing employment, rather than spreading a stagnating amount of price-related transfers to a growing number of poor.

97. At present only about 30% of GOE tax revenue is garnered via GST.³⁷ Another 30% come from business profits taxes and another 33% come from other indirect taxes, e.g., on imports and inputs. In an ideal system, 80%-90% would come from the GST and the remainder of the tax revenues would come from something like an “excess profits/capital gains tax” or a tax on super normal profits. Profits would be calculated using very liberal (rapid) depreciation rates. In such a system there would be absolutely no exemptions from the GST for any consumption expenditures on final goods or services. However, the GST would be steeply graduated, with low tax rates on basic needs and very high tax rates on luxury goods and services. The unemployed poor could be given vouchers to cover the cost, including the GST of their basic needs.

98. The other microeconomic problem relates to the high cost but low real value of public sector output provided through the budget. GOE provision of these public goods and services can be direct (e.g., education, etc.) or indirect through GOE purchases or contracting out. It is assumed that problems with GOE purchases can be ameliorated by efforts to change and strengthen GOE contracting and purchasing procedures. These problems, that is, the high cost but low quantity and value of publicly provided services requires significant improvements in what is called “Public Expenditure Management” or PEM for short.

99. The high cost and low real value of directly provided government services results from two, inter-related fiscal problems. One, a PEM problem, is an imbalance in the current budget between (very high) expenditures for public sector employment (civil service wages and salaries- or Bab I) and (very low) expenditures for the goods and services they need to perform their jobs (Bab II). This is referred to as the operation and maintenance (O & M) problem. Public servants don’t have the money to buy the goods and services (e.g., textbooks, petrol, etc.) needed to do their jobs properly.

100. The other problem relates to poor public sector work incentives. It derives from the view that GOE must be the employer of last resort in the formal economy. The lack of non-GOE job opportunities in the formal economy causes excessive government employment and a steady deterioration of work incentives and public sector worker productivity.

³⁷ Taxes represent about 65% of GOE revenue, with the rest (LE 24 b or about \$ 7 b) being mainly transfers from abroad. All these percentages are for FY1997/98.

101. Solutions to this problem involve GOE publicly eschewing the employer-of-last-resort role in favor of stimulating more private formal sector investment and employment. In Egypt stimulating more private formal sector employment needn't begin with employment-specific fiscal policy initiatives. Instead, GOE's first initiatives could involve both, increasing the credibility and effectiveness of free-market oriented fiscal/monetary/stabilization policies, and relatively massive economic liberalization/deregulation to enable expansion of private market and formal sector investment. Until and unless these initiatives are credibly completed, it will be both costly and ineffective to initiate specific fiscal programs targeted at increasing private sector employment.

102. The final dimension of fiscal policy to be considered is GOE's approach to managing its domestic and foreign debt. Until the establishment of the Debt Management Unit, GOE's debt management policy was unclear. Ever since Egypt's May 1991 foreign debt rescheduling, eminent economic personages in Egypt have vowed not to increase, and if possible to reduce foreign debt. From then until now it has done pretty much as it has promised, although the GOE is currently considering undertaking placements in the Eurobond market.

103. Regarding domestic debt, the absence of free domestic debt markets is a legacy of GOE's past economic policies. In this case, freely operating debt or bond markets would enable market determined rather than GOE controlled interest rates. It will also loosen GOE's influence over the banking sector and commercial credit. In the past, GOE deficits were apparently financed mainly through T-Bond and T-Bill sales to banks, but T-Bond and T-Bill amounts outstanding have not changed appreciably since 1993/94. Instead, deficits, including the recent dramatic rise, have been mainly financed through steep increases in GOE borrowing from NIB and other Public Economic Authorities. Much of these funds were, in turn derived from pension funds and insurance companies. This approach to financing deficits will not effectively crowd out excess aggregate demand in a way consistent with greater economic liberalization and with encouraging more private sector investment and trade in the longer-term.

(vi) Competition Policy, IPR & IT³⁸

104. In the Socialist 1970s and 1980s, when planning was in vogue, a primary approach to development involved stimulating the growth and regulation of monopoly firms. It was thought that planners could control prices in such a way that monopolists would not restrict output but would produce the same level and distribution of GDP as a perfectly competitive free-market "twin". This led to the sanctioning of regulated monopolies as a development tool. From that time to today, the ability of investors to start up new, competing businesses, so called freedom of entry, has been restricted in many countries.

³⁸ This is based partially on: Hassan Selim, "DSP II: Major Objectives and Policy Analysis." (pp. 32-36), Feb./Mar. 2001; Author Unknown, "Concept Paper: Regulatory Reform and Competition in Egypt." (date unknown)- 10 pp; and Rasha Abdel-Hakim, "Competition Policy; Case of Egypt." (4/18/2001)- 13pp.

105. Foremost amongst the theoretical economic benefits expected from this regulated monopoly approach is to achieve economies of scale so that Egyptian firms will be highly efficient. In addition, regulated monopolies can earn greater, more concentrated internally generated investment funds or profits. These would be easily available to finance yet more large, monopoly investments. There were administrative benefits as well. It is easier for governments to collect taxes, etc. from a small number of large companies.

106. There is still substantial belief in Egypt that GOE should decide for significant sub-sectors what investments are needed, despite the fact that this approach has not been particularly successful. Much of the formal sector is protected and not very efficient or profitable. Private sector monopolies appear to be overlooked by GOE because of some of the conveniences they bring. A relatively small group of businessmen receives most of the new credit and make most of the new investments, thus inhibiting entry of new investors and competition. It is for this reason that so few businessmen own so many different businesses.³⁹

107. In return, monopoly businessmen engage in profligate hiring or excessive employment in order to accommodate friends and reduce unemployment. To do this, they forgo maximum profits in favor of excessive payrolls. They also pay large tax bills. On the whole the relationship ignores the investment and saving desires of large numbers of households and potential entrepreneurs outside of a small investor circle.

108. In fact, there is a moral hazard problem associated with a tough GOE campaign to increase competition. The current businessmen eschew monopoly profits and operate inefficiently in order to provide social benefits to compensate for their monopoly status. They will feel that the rules have been changed if GOE prosecutes them for monopoly behavior. Many may simply go out of business rather than pay the fines envisaged in the draft Competition Law.

109. It is currently the case that the proposed competition law is to be introduced into a situation where GOE accepts a substantial amount of quasi monopolization. The current levels of monopolization are consistent with extensive government ownership of productive firms and with limits on easy investor entry and exit. Without significant other reforms, passage of the competition law by itself will change little. This leads to a possible danger that scant change following the passage of the law, in terms of a lack of increased competition, might serve to confirm the wisdom of continuing to regulate monopolies.

110. The draft law proposed by MOEFT⁴⁰ contains 42 articles in eight chapters. It aims at addressing the legislative gap that should be filled in order to promote a competitive domestic market, encourage foreign investment and provide the prerequisites for globalization. Chapter one mainly sets out exemptions from coverage of the law. There seems to be a fair amount of GOE discretion in this matter. Chapters two and three define

³⁹ See “DSP 2: Economic Vignette 1. Are Ten Owner/Managers for 200 Companies Better or Worse Than 200? Draft, Robert Myers, 11/2/00

⁴⁰ Apparently there is a separate proposed law drafted by the Ministry of Home Supply.

and delineate the meanings of anti-competitive activities and dominant positions. Chapter five deals with permissible and non-permissible GOE activities, mainly with respect to traded items. Chapter six covers mergers and acquisitions of firms with a combined capital of over LE 50 million. Chapter seven establishes an implementing Cabinet agency for protecting competition while chapter eight establishes penalties for conducting the prohibited behavior set out in chapter two. These penalties are legal rather than economic in nature, consisting of fines and jail terms. Conspicuous in its absence is breaking up the ownership of monopoly firms so that they become separate competing entities. It is also unclear if private parties who feel aggrieved can initiate court actions under the law against alleged monopolists.

111. Most of the relatively small group of existing businessmen is not in favor of the law. A primary fear is that it provides GOE with an intervention tool that might not be applied evenly. Their concerns may be well founded, but their opposition is not surprising. Perhaps more important is the relative silence of aspiring investors who at present have great difficulty entering into and enlarging the investor circle. It is possible that they have so many hurdles to jump, including the labor law and a host of ministerial dictums and license requirements, that they are too distracted to speak up. In fact, it is possible that a significant easing of investor entry and exit requirements would have a bigger impact on domestic competition than the passage of the competition law.

112. The WTO sanctioned intellectual property rights (IPR) agreement deals with the international acceptance of patents, copyrights, etc. These are time-bound exemptions or exceptions to competition laws. They are generally the purview of lawyers, but the economic issues giving rise to them are important. They allow the temporary earning of monopoly profits to finance R & D or technological innovation. These agreements may appear to be welfare reducing for Egypt if viewed from a static rather than dynamic viewpoint. However, if the Egyptian economy becomes more open and competitive, GOE accession to the IPR agreement could stimulate significant private, welfare enhancing investment involving foreign/Egyptian partnerships.

113. The information technology agreement (ITA) will also work significantly to Egypt's advantage if accompanied by more liberalization and competition (ease of entry) in the domestic economy. This is particularly the case if direct access to IT imports is enlarged. The agreement is a sector-specific application of WTO principles. In general this specificity is frowned on. However, because IT has raised productivity so dramatically across all other productive sectors in other countries, there is compelling reason for its early liberalization. Of note is the impact of IT agreements on increasing the productivity of service providers. Given this, an IT agreement could have a significantly beneficial impact on incomes and productivity in the informal economy.

(vii) Data Issues: Improving the Accuracy and Awareness of Economic Information

114. In Egypt the needs of researchers, businessmen and policymakers for timely and accurate economic data clash with a pervasive inattention to the need to publicly release accurate data. Frequently, relatively comprehensive and accurate data are collected but

not released publicly. Sometimes, even their existence is unknown outside of a small group of officials. Alternatively, data may be poorly defined and explained and/or collected/published in non-standard ways.

115. Given the importance that is attached to freely accessible, easily understandable and accurate information, the lack of it in Egypt is costly. For one thing, rumors substitute for facts.⁴¹ For another, the selective provision of information conveys monopoly privileges. It also prevents the use of data that are obtained unofficially for analysis that is to be made public. And finally, when the credibility of the published data are suspect, people feel free to make capricious “adjustments” whenever it appears advantageous. In the end, these problems with Egyptian data raise costs by fostering inappropriate decisions by policymakers, businessmen and researchers.

116. There is a tendency to reason that data credibility problems in Egypt result from shortcomings in the completeness and accuracy of data collection. However, it is also likely that there are problems associated with a lack of awareness, understanding and free public access to the data that are currently collected. The following examination of issues surrounding the widely questioned 6.5% 1999/2000 real GDP growth rate demonstrates some problems associated with the collection and dissemination of data in Egypt. In addition, it suggests two solutions.

117. The 6.5% real GDP growth rate for 1999/00 is generally considered to be too high, even though it is the official but provisional figure issued by the Ministry of Planning.⁴² It is based on surveys of the nominal value of production of visible establishments and farms. These survey results are grossed up by estimates of the nominal value of invisible, formal sector (i.e., licensed) services. There is official recognition that these estimates omit or under-report the value of informally provided services in the education, health, business and trade and transport sectors. Some provisional attempts to expand coverage of estimates for these are being made, but most fundamentally, the design and conduct of next five-year standard survey will be changed to specifically cover these informal services. Although it is likely that this 6.5% figure passed an IMF financial consistency check, it is also possible that a lower real GDP growth rates would also pass that check, as long as prices not covered by the CPI rose at faster rates than the CPI.

118. In the event, there have been independent estimates suggesting that Egypt’s 1999/00 real GDP growth rate was below 6.5% suggesting a “slowdown” compared to the 6.1% official growth rate recorded for 1998/99. Indeed, the press has adopted the slowdown theme, which is consistent with the declining inflation rate but not with the depreciating exchange rate. The problem is that people tend to believe these independent estimates and the press more than they believe the official data. A lack of transparency

⁴¹ See “About rumors and how to eliminate their bad effects.” *The Egyptian Gazette* (English), April 25, 2001, p. 1.

⁴² The Ministry of Planning gathers these data on nominal GDP and its components in order to establish the latest base year for the Plan. It makes some of the data available to other ministries for publication. There are a lot of other data that are not made available to the public, however.

regarding what the data are, how they are collected and what they mean is a major part of the problem.

119. In addition, there is a lack of awareness, even within the present statistical apparatus, of the need in a more global economy for timely publication of well explained, internationally standardized data. Educating existing statistical staff to appreciate and perform these new informational functions is likely to be only marginally effective. Many are performing other functions.

120. Probably more effective would be to establish a new institution, within the statistical apparatus, charged with increasing the publication of, and access to user-friendly statistical information. Such a new institution, perhaps called the **Statistical Policy Unit** is currently under discussion. Its main focus would be to improve the standardization of data and statistical transparency. It should embrace the transparency precedent that a release to one is a release to all. Such an SPU would probably require new staffing and re-training in order to standardize data definitions and outputs and inventory and broadly (probably electronically) publicize both the availability of data series and the data themselves.

(viii) Fair Trade, WTO, & Trade Support Services (Customs, Etc.)

121. Economists talk about free trade, politicians talk about fair trade. The difference between the two is essentially the role played by governments and WTO. In the theory of free trade there is no government and no WTO. Based on this theory, trade liberalization essentially means reducing and finally eliminating government economic interventions altogether. The argument that trade liberalization will inevitably increase welfare is derived from the free trade doctrine. It is among the most compelling and widely believed in the world. Indeed, the welfare benefits of full trade liberalization can be enormous, primarily because of the impact that trade liberalization can have on domestic production.

122. Fair trade and the WTO agenda deal with harmonizing the government interventions of different countries so that the gains from trade liberalization are distributed fairly. The ultimate success of the fair trade agenda is free trade agreements. These yield gains from liberalization, more rational government interventions, and more efficient, non-corrupt government institutions and administrative mechanisms associated with trade. The rapid and efficient implementation of fair trade by governments can be a highly beneficial focus of external donor assistance.

123. The benefits of freer trade. The gains from trade accrue independently of any changes in BOP deficits/surpluses. That is, trade liberalization is not recommended as a way of directly changing the trade, current account or overall BOP balances. Instead, the gains from trade come from greater productive efficiency in the domestic economy. This is in turn expected to result from the impact that greater price competition has on improving the efficiency of domestic producers. In fact, from the perspective of greater growth in GDP and employment, a particularly favorable scenario would be trade

liberalization that leads to an equal value increase in both imports and exports.⁴³ That is, growth in the volume of trade with no change in the various BOP balances.

124. International trade is actually the result of the expansion or spillover of domestic markets across country boundaries. Unless there are asymmetric government interventions in domestic versus international markets, there are no significant analytical differences between the two. The gains from more and/or freer trade, and the costs of trade restrictions are the same, whether the markets are only domestic or also international. However, international markets define the extremity of market freedom and competition against which the freedom and competitiveness of small country domestic markets can be tested.

125. These internationally provided competitiveness benchmarks and the increased size of markets are major reasons for trade liberalization. Opening up to international trade causes increased domestic competition, which in turn causes increased productive efficiency and changes in relative prices⁴⁴ in domestic markets. It is increased competition, not greater imports or exports that raises productive efficiency. However, greater productive efficiency can lead to more imports and exports if domestic markets are too small to absorb all of the increases in production that result from greater productive efficiency.

126. The major presumption of free trade advocates is that liberalization will increase welfare if it results in altered relative prices and increased competition so that productive efficiency in the domestic economy increases. The relative price changes and increases in competition are a package: They must happen together. Trade liberalization that doesn't bring about this collection of changes is not welfare increasing. If all occur together, imports and exports will both expand, ideally, or at least conceptually, in a way that is BOP neutral. The trade, current account and overall BOP balances will remain unchanged.

127. The trade liberalization that has been tried so far by Egypt (e.g., tariff and NTB reductions) has not been particularly effective, mainly because it hasn't altered relative prices nor increased competition and productive efficiency in the domestic economy. It has probably not, therefore been welfare increasing. There are two important reasons for this. One is that changes in relative prices don't seem to happen. The other perhaps related to this, is that the costs of any remaining NTBs seem to rise and offset the expected price impact of the reforms.⁴⁵ Together these prevent the desirable effects of trade liberalization from occurring. In particular, the changes that have occurred so far don't seem to have changed producer/investor behavior. Instead, the apparent absence of

⁴³ Even better would be for the imports to be of the low value added, input variety that go first to the informal economy for further processing and then to the formal economy as inputs to their outputs.

⁴⁴ The change in relative prices that is expected to occur is called a devaluation of the "real exchange rate". This real exchange rate is defined by trade economists (but not by the IMF & international financiers) as the ratio of the prices of tradable to non-tradable output.

⁴⁵ Egyptian businessmen tend to say that NTBs, not tariffs are the binding problem. A tariff reduction mainly means they have to pay more for GOE-provided trade services, so their gross import costs end up being the same.

price competition and of free entry and exit in the domestic economy seems to have led to little change. Without this, trade liberalization can not improve welfare in a sustainable way. Instead, it will most likely worsen BOP current account deficits and engender a re-imposition of restrictions.

128. Government Interventions and Fair Trade The impetus for fair trade comes from the recognition that the introduction of a trade restriction into an international free trade system by one government can cause it to receive a transfer of welfare from other countries. This is called “beggar-thy-neighbor” behavior. Such behavior engenders retaliation in the form of countervailing trade restrictions. The result is worldwide reductions in trade and economic welfare.

129. WTO was established to prevent predatory behavior that increases one country’s welfare by transferring it from abroad. In essence, WTO establishes the rules of fair trade. However, the fair trade rules are based on free trade principles. This means that if GOE follows WTO principles in expanding Egypt’s trade and welfare, there will be a net gain in Egypt’s welfare, along with an increase in world welfare rather than a transfer of welfare from other countries to Egypt. That is, there will be trade creation, rather than trade diversion. It is fortuitous that WTO, established to prevent predatory behavior that increases welfare at the expense of others is now mainly engaged in convincing governments to stop adopting policies that reduce their own welfare. The basic WTO premise is that when countries agree to WTO principles they also agree with each other.

130. There are four main WTO principles. First, treat all foreign trade equally, regardless of country of origin (most favored nation principle). Second, treat internal trade the same as foreign trade. Third, reduce trade barriers to WTO approved levels (i.e., to the same levels as all other countries). Fourth, eliminate NTBs so that all countries use only (the same levels of) tariffs for protection and revenue. Egypt is furthest along in implementing the first but has made less progress in accomplishing the fourth. In addition, the second, or equal treatment of home/foreign trade may become an increasingly onerous problem as removal of NTB’s on foreign trade progresses. This derives partly from the fact that the responsibility for domestic trade lies with one ministry (Home Supply) while that for international trade lies in a separate ministry (MOEFT). It is possible that Egyptians tend to see compliance with WTO agreements as mainly benefiting foreigners. It may require a significant, rather costly effort in **trade training** to convince the large number of relevant GOE officials of the potential requirements and domestic benefits of compliance with WTO agreements. Defraying these costs and providing technical assistance are fruitful areas for donor assistance.

131. At this stage, major progress on trade liberalization is likely to come by increasing the speed and extent of compliance with WTO agreements, rather than as part of other international trade initiatives. Thus, for example, even when Egypt engages in discussions/negotiations regarding joining in free trade areas, etc., it should be in the context of increasing compliance with WTO agreements, rather than as a substitute. In addition, the major immediate focus should be on reducing NTBs. These are particularly costly in Egypt because GOE is still the sole provider of many Trade Support Services

(TSS). These are mostly provided under competitive conditions by private investors in other countries. Reducing NTBs in Egypt entails both GOE agreement to comply with WTO obligations (e.g., on customs inspections, valuations and standards applications and on IT, IPR, etc.) and privatization of trade support services.

132. This latter should be done in a way that encourages private investment and competition. If done properly, the private provision of trade support services will improve the domestic economy in at least four ways. First, trade support services will be more efficiently provided in more user-friendly ways, thus lowering trade-related costs. Second, GOE budgetary costs for training for and providing more modern, efficient TSS will be reduced/eliminated. Third, private, small scale, service investment opportunities will be increased. And finally, the increased private investment will increase productive employment and wage bills.

133. Export Promotion, Subsidies and the Administration of WTO Trade Rules The removal of NTBs, through the adoption of international/WTO conventions and procedures, and by increasing the role of private, competing TSS providers should reduce GOE costs and the amount of GOE administrative machinery associated with international trade. These reductions in GOE's role in international trade will be partially offset by some required new GOE initiatives relating to export promotion (subsidies) and international trade remedies such as dumping and retaliation.

134. Ironically, careful compliance with the WTO agreement on export promotion (subsidies) and trade remedies mainly involves stimulating increased competition and productive efficiency in the domestic economy. Doing so will result in trade creation (domestic and foreign) rather than trade diversion. It is assumed that increased productive efficiency, along with increased domestic competition, will lower output costs and prices, thus increasing trade. In WTO language, "green" (internationally acceptable) subsidies stimulate trade creation, "red" (internationally prohibited) subsidies cause trade diversion.

135. According to WTO convention, there is a presumption of a subsidy, and a trade welfare loss, when the external price of traded output is below its domestic price equivalent. In addition, there is a presumption of subsidization when certain favors are not extended to all producers but are reserved for certain (let's say, exporting) producers. As a generalization the WTO makes no distinction between differing producing sub-sectors (e.g., between agriculture and industry).⁴⁶ The only general type of acceptable subsidy is an infant industry one, although when applied in practice this encompasses two general forms. A true infant industry subsidy can not be a recurrent one. Instead it must be a lump sum, or once-and-for-all grant. In addition, the test of "infant" producers is a productive efficiency one.⁴⁷ It is that once they start operations, these firms should experience increases in productivity or falling per-unit costs purely as a result of more and more production. That is, once started as a result of an infant industry grant, per-unit costs must decline over time purely as a result of continued/expanded operation.

⁴⁶ There are several legal loopholes however.

⁴⁷ As is the test for trade creation.

136. As applied in practice, this dictum has resulted in acceptance of two types of subsidies as being welfare increasing. One is making lump sum grants available to any and all investors who want to start businesses that have “infant” attributes and prospects. Such subsidies must be accompanied by reductions/removal of government economic interventions that restrict entry and exit and competition.

137. Generally speaking, subsidies that offset government-imposed distortions are frowned upon.⁴⁸ Such subsidies have been found to be very difficult to accurately calculate and subject to enormous abuse. As a result, WTO has endorsed removing the distortions rather than trying to offset their impact with subsidies. The other is to help defray the (supposedly infant or startup) costs of emergent private suppliers of trade support services in general and of international marketing services in particular. These too, would necessarily be accompanied by reductions in GOE implemented NTBs.

138. Once again, the presumption is that the subsidies will be lump sum or once-and-for-all grants rather than recurrent transfers. There is a presumption that these services are privately provided. In general they are provided by the public sector in Egypt. This means that even if subsidized, their provision is too slow, costly and ineffective. Allowing private initiative to take over and develop them would be better than GOE providing invisible subsidies through continued monopolization of these services.

139. The above suggests that “export promotion” is a crosscutting issue that will involve several ministries. To comply with WTO agreements, export promotion should be focused on improving productive efficiency and price competition in the domestic economy. In infant industry cases the subsidy can be explicit, although it must be a lump sum one with no prior limitations on its capture. For most, however, the “subsidies” would be implicit, and in the form of removal of cost increasing interventions and/or of barriers to entry (competition).

140. Finally there is a need for GOE to foster efficient growth in the trade remedy adjudication process. This will involve some relatively hefty startup costs and considerable recourse to international legal and economic expertise. It is an area where international aid donors can make a significant contribution.

(ix) Poverty, Labor and Civil Service Reform⁴⁹

141. The two most fundamental problems in Egypt are the underemployment of labor, or the low average number of hours worked per week, and low average and marginal labor productivity. Together these explain the bulk of Egypt’s poverty problem as well as

⁴⁸ An exception to this is that certain tax rebates for exports are permitted/encouraged.

⁴⁹ This is based partially on: Hassan Selim, “DSP II: Major Objectives and Policy Analysis.” (pp. 29-31), Feb./Mar. 2001; F. Shaker, “The transformation of the Egyptian Labor Market.” 11/12/00, 8 pp.; Author Unknown, “Labor and Civil Service Reforms.” 11/14/00, 14 pp.; Mervat Fikry, “Civil Service Reform in Egypt.” 12/9/00, 34 pp.; Mervat Fikry, “Concept Paper: Child Labor Issues and Influence on Exports.” 4/28/01, 48 pp.

its work/leisure incentive problems. If both labor productivity and the number of hours worked per household were to increase, most of the poverty would disappear. Official data give too positive a picture of the amount of employment, especially in terms of the number of hours worked. Were it not for the informal economy, the extent of the unemployment would probably be destabilizing. In addition, there is hardly any official mention of the problem of low labor productivity, even though raising it significantly would be the single most important benefit of a policy reform effort.

142. The Size of Egypt's Workforce, Unemployment and Labor Productivity An Article on p. 2 of the July 26, 1999 Egyptian Gazette gives the latest CAPMAS figure for the size of Egypt's workforce as 15.6 million people (16 million in 2000). This seems too low and not a credible figure. This CAPMAS figure implies that Egypt's workforce is 24% of the estimated population of 65 million. This is low, given the fact that Egypt's population age profile shows a large bulge of Egyptians in their teens, twenties and thirties.

143. A rule of thumb is that the workforce for populations with normal age distributions is about 33% of the population (21.4 million for Egypt). However, given the age distribution of Egypt's population, the workforce could well be near 40% of the population or about 26 million. A different CAPMAS figure is that the workforce is 17.3 million, not including women engaged in subsistence agriculture. The number of these women is generously estimated to be 6 million,⁵⁰ which would bring this estimate to about 23.3 million or between the World Bank estimate of 22.3 million and the ILO estimate of 23.8 million.⁵¹

144. The official unemployment rate, with unemployment being defined as those wanting work but who haven't worked in the previous week, has been declining. It was 8.3% in 1997/98 and 7.4% or about 1.5 million persons in 1999/00.⁵² This latest figure implies a workforce of 20.2 million people. Use of the 40% convention mentioned in above implies that this figure of 20.2 million is most probably 6 million too low. That is, Egypt's workforce is probably something like 26 million today. This would give a "gross" unemployment rate of about 28.8% (adding 6 million to the 1.5 "actively seeking work" to get gross unemployment of 7.5 million and then dividing 7.5 million by 26 million).

145. The most fundamental economic problem in Egypt standpoint, it is the low productivity of labor, due mainly to poor incentives. Disputes over the actual size of the workforce affect estimates of gross labor productivity or GDP/workforce. Egypt's GDP and labor productivity are relatively low, even for a workforce in the smaller end (17 million) of the estimated range. Should the workforce and employment be at the higher end of the range, average labor productivity would be lower still. Studies cited in the

⁵⁰ Private correspondence with Dr. Ragui Assaad.

⁵¹ These different CAPMAS, World Bank and ILO figures are cited on p. 14 of a draft entitled, "Jobs, Employment and Labor Markets in Egypt," dated July 30, 1999 and done by Checchi-Louis Berger International, Inc.

⁵² This 1.5 million is in the Egyptian Gazette, May 2, 2001, page 7.

Checchi/Berger study⁵³ as coming from the Global Competitiveness Report rank the productivity of Egyptian labor as very low. Egyptian labor is given a number of 47 where 1 is the highest labor productivity and 50 is the lowest.

146. Given this, it is no wonder that family earnings are so low for most Egyptian households. This has implications for Egypt's work/leisure incentive system, particularly the number of those seeking work, and for the size of the student population beyond the basic educational level. In Egypt, the opportunity cost of being a student, beyond the basic educational level is very low. This means that the educational system will, as it currently is, experience considerable pressure from 'students' who are enrolled simply because they can not work more than a few hours a week, for very low earnings. Unfortunately, it is also the case in these circumstances, that the incentive to learn is low, given that there is a weak relationship between expertise and wages.

147. There are anecdotes supporting the presumption that labor productivity in Egypt is low because of poor work incentives.⁵⁴ These anecdotes assume nationality neutrality, or that the same productivity differences would emerge even if the nationalities were switched (Egyptians there, Europeans/Americans here). A reported result of a pair-wise comparison of productivity in European and Egyptian civil services, is that the average Egyptian civil servant accomplishes in a day what the average European civil servant accomplishes in twenty minutes. Another is that it takes 25,000 customs workers in Egypt to handle the same amount of international trade traffic as 250 workers handle in the USA's port of Baltimore. And finally, it is roughly the case that a particular segment of the Cairo court system handles the same amount of court cases as the Cook County, USA court system, but requires five times as many personnel.

148. It is traditionally reasoned, e.g., by national planners that significant increases in investment will raise the number of hours worked to "full employment" levels. Conceptually this is true, but it hasn't worked in practice. A major reason is that increases in public sector, or "credit-pushed" private investment have been accompanied by continued low labor productivity. This in turn is due to continued poor work incentives.

149. The lessons of the "new economy" are that both employment and labor productivity increase with increases in private sector price competition.⁵⁵ In Egypt this argues strongly for reducing public sector crowding out of private investment (by reducing GOE investment expenditures and privatizing SOEs). In addition, removal of barriers to free investor entry and exit is important. Finally, reforms must aim at ensuring, through deregulation and enforcement of competition policies, that price competition flourishes amongst a growing number of private producers/investors.

150. Civil Service Reform The civil/public service in Egypt is overstaffed and underpaid, with weak professional incentives. In spite of this, it wields political influence that

⁵³ Ibid, p. 31.

⁵⁴ Because comparisons are difficult, these anecdotes are very rough indicators.

⁵⁵ Eric J. Bartelsman and Mark Doms, "Understanding Productivity: Lessons from Longitudinal Microdata." JOURNAL OF ECONOMIC LITERATURE, Vol38, (Sept. 2000, pp. 569-594).

can lead to resisting efforts to reform it. Because of this, civil service reform will not occur unless reforms in other economic areas are successful. If other reforms are successful, public sector employees can willingly leave the civil service for better jobs elsewhere. A particular requirement is that significant increases occur in employment and wage (labor productivity) prospects in the private formal sector. Without these, it will not be possible to reduce the number and raise the per-worker productivity and compensation of civil servants in Egypt.

151. There are simply too many public servants in Egypt. By one estimate⁵⁶ about one-third of the workforce or 7.5-8.5 million people are employed by GOE as regular and contract workers. Many of these public servants can position themselves so as to inhibit or facilitate business activity. This leaves them in a position to collect gratuities and allows them to do things slowly and inefficiently. As with the classic definition of negative marginal productivity, it is likely that overall economic productivity and output in Egypt would rise, perhaps significantly, as the number of redundancies of public servants, even if on full pay, increases. The main problem is that the civil service has acted as an employer of last resort. This has caused enormous over-employment in the civil service and, as the rate of net public sector hiring has fallen, increased transition times in the public educational system. It has also rationalized excessive expansion of civil servant functions.

152. Reforms in three main areas are called for. First, the amount of civil service administrative activity and the number of authorized civil service positions should be rationalized/reduced so as to decrease the number of civil servants required. A second reform would be to achieve a significant reduction in the number of publicly paid workers, even without similar reductions in the public sector wage bill. This will allow those who remain to receive higher wages, hopefully in conjunction with relatively lower supplementary payments.⁵⁷ And finally, the issue of civil service performance and malfeasance, including bribe taking must be addressed.

153. The lessons of other reforms are that these performance/malfeasance problems only disappear when they are addressed directly, rather than indirectly, e.g., through reform of salary schedules.⁵⁸ It appears that it is necessary to institute positive incentives for improved performance and penalties for poor performance. In addition, there seems to be a need for special investigative units to ferret out corruption. They must be imbued with sufficient power and stature so that their findings result in the imposition of penalties, including dismissal.⁵⁹

----END---

⁵⁶ This is a World Bank estimate.

⁵⁷ The amounts of supplementary payments in the civil service are huge, even though their incentive implications may be counterproductive.

⁵⁸ There is a significant debate over this. Susan Rose-Ackerman (Corruption and Government: causes, consequences, and reform. Cambridge, U.K.; New York: Cambridge University Press, 1999) covers the debate but takes a minority view that appropriate wage structures will ameliorate corruption.

⁵⁹ Daron Acemoglu and Thierry Verdier, "The Choice Between Market Failures and Corruption." AMERICAN ECONOMIC REVIEW, Vol. 90, No. 1 (March 2000), pp 194-211.