PROGRAMS OPTIONS FOR
USAID ASSISTANCE TO EGYPT'S
INDUSTRIAL SECTOR

AGENCY FOR INTERNATIONAL DEVELOPMENT
NEAR EAST BUREAU

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position of telling GOE that reform is the sine qua non for future assistance to the public sector. However, we understand that in fact USAID/Washington will not provide assistance to the Egyptian public sector unless there is "significant reform of the public sector."

Our approach to this study therefore extended beyond solely developing the technical requisites of program options. Rather, the approach recognized that there is a need within USAID to better define its organizational purpose and role vis a vis the Egyptian industrial sector and AID/Washington; and a need for USAID and GOE to clarify and perhaps simplify their relationship with one another. In the first phase the Coopers & Lybrand team attempted to bridge this gap by clarifying the perceptions, attitudes and approaches of the various actors to the industrial development process. The use of the Egyptian counterpart team was crucial in this effort. In the second phase the need for dialogue was even more apparent.

The issue of structural reform and the role of USAID in relation to reform is a sensitive issue to the Government of Egypt. First, sovereignty is an issue, second the GOE does not see structural reform as a precondition of the U. S. assistance program, and third the GOE believes it has made significant progress towards liberalization without goading from outside agencies. Because of this sensitivity the team believed that our approach to program options must consider the broad and complex context within which these programs

PREFACE

In May 1982, Coopers & Lybrand conducted the first phase of a two part evaluation* of USAID/Cairo's assistance to the industrial sector in Egypt. The purpose of the phase one study was to evaluate the various modes of project and non-project support to the sector in terms of their purposes and objectives, the manner in which the projects were to work, and their accomplishments to date. Our general conclusion was that there were serious implementation problems because projects were designed without a comprehensive assessment of need and in the absence of a coherent operational strategy. USAID now wishes to capitalize on the lessons learned from these past interventions and develop new approaches to provide assistance to Egypt's industrial sector. This is the purpose of this second phase of our study.

In initial discussions with USAID/Cairo officials the Coopers & Lybrand team was informed that the prime focus of this study was to be on developing program options which could be directly linked to reform movement on the part of the Government of Egypt. In essence, USAID/Cairo stated that it wished to develop those options which could be "supportive" of GOE efforts to move toward structural reform and was not intended to be "confrontational," i.e., to place USAID in the

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* For a complete description of the background for this evaluation see Evaluation of the Industrial Production Project and other Industrial Sector Programs, Coopers & Lybrand, May 1982, submitted to USAID/Cairo.

must operate, ranging from the internal orientation of USAID as an organization to the political realities which currently exist in Egypt. In effect it forced us to be sensitive to questions and issues which ranged beyond the specifics of our scope of work. Therefore, we relied heavily on the opinions and impressions of a number of key individuals — individuals whose insights and impressions acted as a basis for our conclusions and recommendations.* When possible and appropriate we used quantitative data and documents to support our assessment. Yet the very nature of the study compelled us to rely most often on the judgment of informed people; some with formal power and access to official information, others with informal access to current ideas, trends and thinking in government circles.

As a result of our approach the program options presented in the final chapter of this report are realistic, appropriate to the context of Egyptian industrial growth, yet consistent with USAID criteria.

Outline of the Report

The Coopers & Lybrand team believes that prior to presenting the three program options for consideration a number of issues must be addressed by USAID as part of their management decision-making process. Most of these issues focus on the role of USAID as a donor agency in Egypt and on the sensitive issues central to structural reform. We believe

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* For a complete list of interviewees, see Appendix I.

USAID must address these issues as a management group prior to selection of a program option to assist the Egyptian industrial sector.

In Chapter I we present our assessment of the Egyptian situation today and its impact on perceptions concerning industrial development, and a summary of our conclusions concerning the issues of structural reform.

Within the realities of the Egyptian situation today, Chaper II analyzes the economic reform to date and assesses future development. Chapter III reviews USAID's performance in the industrial sector and describes the progress USAID has made in developing a more strategic approach to industrial development, while Chapter IV cautions that this strategy may not be followed because of an organizational preoccupation with structural reform of Egypt's economy. Further it suggests that USAID should better define its organizational role if it is to assume any strategic importance in Egypt. Chapter V assesses the various institutions USAID could use to channel its funds to the industrial sector and concludes that the banking system, under certain circumstances, is a viable alternative. Chapter VI presents three program options which incorporate the issues raised in this report.

I. THE EGYPTIAN POLITICAL AND ECONOMIC ENVIRONMENT, AND UNITED STATES AID TO EGYPT'S INDUSTRIAL SECTOR

The current political and psychological situation of Egypt acts as the background to any realistic assessment of the economic issues facing the country. We know, for example, that most notions such as free enterprise, a market oriented economy, the role of the public sector, and even the factor of time have in Egypt a connotation which differs greatly from the one usually accepted in the western industrialized countries. At the same time the political structure varies as well. Therefore an analysis about the role of USAID to influence the evolution towards a more rational and more market oriented economy in Egypt must inevitably begin with a few remarks about the present general situation of the country.

A. POLITICAL SITUATION

The political situat.on of Egypt is clearly very fragile. Many of the views of influential people we interviewed still reflect the time when Nasser was President, emphasizing the need to have social concern for the people while preventing social inequalities. By contrast, these same people are concerned that the Sadat period and the "open door" policy is a period of renewed social inequalities. For example, the "infitah" and the move towards free enterprise are associated with the image of a small group of people building a fortune and living in an ostentatious way which contrasts with the very limited means of a majority of the population.

Moreover, the Muslim fundamentalist movement is an underlying concern. Their activism compels every Egyptian political leader to listen attentively to the "undercurrents" of the society.

The constraints deriving from an explosive demography and the present Middle East situation also add to these elements of instability. People have stated that President Mubarak must be very cautious because some elements are searching for issues that could be used for destabilizing purposes.

B. ECONOMIC SITUATION

This political background indicates why the economy of the nation is closely linked to what is inevitably the first goal: the political stability of the nation. In our opinion the Egyptian Government will not hesitate, under the present circumstances, to ignore the rules of a rational economy or even to arbitrate in favor of economically unsound decisions if it is necessary to maintain the political balance of the nation. Such "irrational" options are conceivable because of two characteristics of the present economic Egyptian scene. First, almost a generation of intellectuals has been taught in terms of a centrally directed economy with a strong public sector and this way of thinking is still quite prominent in the minds of most of the people influential around the Government — politicians, newspapermen, union leaders and university professors. Though we cannot substantiate it, some key people we interviewed said that if influential

Egyptian leaders were asked their preference for a market versus centrally directed method of running the economy, many would still be in favor of the latter.

Our interviews also indicated that a significant proportion of influential Egyptians consider a strong public sector as a natural part of national life, and an essential symbolic part of the independence of the nation. Except for a hundred years, Egypt, in its 5,000 year long history, has always known a very centrally directed economy and those 100 years of free enterprise have made few marks on the nation. In 1952, when Nasser came into power, only 5% of the firms in Egypt were controlled by Egyptians; the other companies were led by Lebanese, French, English, Italian, Greek or Jewish people.

Since the Egyptians consider the public sector as a very important part of their independence, the Government is in no position to attack what is a myth deep in Egyptians' minds; and the most liberal people in Egypt, even those who have been educated in the United States do not imagine the possibility of questioning the existence of the public sector. Therefore if the United States stated publicly that the liberalization of the Egyptian economy is a condition for continuing U. S. economic assistance to the public sector, the Egyptian Government would be compelled to react vigorously, leading to a severe confrontation situation.

C. PUBLIC AND PRIVATE SECTORS

Though the public sector must be considered as a "fact of life" for the conceivable future in the Egyptian economy, it is generally accepted that it must be considerably rationalized to become more effective. The Egyptian Government also appears to acknowledge the need for a greater private sector role. In fact, the evolution leading to the current growth of the private sector is striking. Whereas the number of joint stock companies was reduced from 935 to 36 between January and June 1961, and increased by 27 units only from then on until 1981, more than 500 joint venture firms, of private joint status have been formed under the regime of Law 43(1974). This trend in private sector development may be increased by the implementation of Law 159, which was published in Late July, 1982 and removes most of the legal constraints limiting the development of private sector firms.

As for the public sector industrial firms, a new "public sector" law will be presented to the National Party and submitted to Parliament next November. This law is aimed at rationalizing the public sector through a reform of the pricing system, of wage policy and of public sector management itself. In fact, we have been told that the President has already made the decision to reform the public sector along these lines and that the discussions which are currently taking place in Government and which will take place in the Party and Parliament are mostly intended to let the political world debate the issues before the new law is published and enforced some time next year.

D. UNITED STATES ASSISTANCE TO EGYPT'S PUBLIC SECTOR

Against this background, it is the major conclusion of our report that it is unrealistic to condition USAID assistance to the public sector on "significant reform." We agree some reforming laws are necessary, but on the whole, considering the strength of the forces opposed to a complete liberalization of the Egyptian economy, it probably is wise to accept that the reform will come progressively in an evolutionary manner. In fact, we believe that the reform will be quicker to come, and its scope deeper, it if is accomplished in this way and not put forward officially as a major target of United States policy. With the exception of very confidential meetings at the highest level, there is little that can be done from the outside to influence the decision of the Egyptian Government. Any major condition put forward officially for the provision of aid to the public sector will be deemed as an unacceptable interference and in fact may damage United States efforts to assist private sector development.

U. S. aid to Egypt's industrial sector may nevertheless play a significant role if it can be reoriented, or readjusted, to assist Egypt during its current economic transition. In the following chapters we provide information and our recommendations on how USAID can use several program options to provide assistance to the industrial sector effectively. These options recognize the realities of the critical relationship between the public and private sectors — both economically and politically. The next chapter begins the process by describing the realities of the reform movement in the public sector.

II. POLICY REFORM IN EGYPT

A. OVERVIEW

With the announcement of the open-door policy in late 1973, considerable hopes were raised regarding liberalization and overall policy reform in Egypt. More than eight years have gone by and many observers are disheartened by what they see as a lack of progress in actually implementing substantive change. For evidence, they point to the continuation of a comprehensive system of subsidies, to an economy still dominated by an apparently inefficient public sector constrained by a tentacular bureaucracy and to a wide array of policies seemingly designed to shackle the private sector. This view has led some to argue that, to the extent possible, increased pressure ought to be brought to bear on the Government of Egypt to hasten the process of change.

It appears that this view is based on a series of misunderstandings and that the policy implication that has been drawn may have disastrous consequences. It implies a confrontational type of mode, which is specifically what AID wants to avoid, and is likely to draw a negative response, as was pointed out in Chapter I. More important, it is entirely unnecessary. The pessimistic view of the reform movement in Egypt seems to be based partly on lack of information, partly on an inadequate appreciation of the constraints faced by the Government of Egypt and partly by an undue impatience that may seem appropriate in the West, but is not in the East. The fact of the matter is that there has been steady, sustained policy reform in Egypt since 1973, in both the public and private sectors. And this momentum has continued into 1982. To push too much harder would be to risk many of the gains that have been achieved.

The following pages will outline several of the areas in which policy reform may be deemed desirable, and discuss the progress that is being made in each case.

B. AREAS OF POLICY REFORM

1. Public Sector Liberalization

After the process of nationalization of all major industry was completed in 1961, a Soviet-style industrialization policy was adopted; consequently the Egyptian public sector expanded rapidly during the 1960's. The different public enterprises were controlled by thirty-eight public organizations (moassasats), one for each industry. By the late 1960's, the disadvantages of a centralized system were becoming apparent. Apart from the wage, employment and price controls that were an essential part of government policy (and which will be discussed later), there were the usual types of problems relating to managerial autonomy. The need constantly to get central approval for relatively unimportant decisions combined with approval procedures that were lengthy and bureaucratic were bound to affect the companies' performance adversely.

A major step toward rectifying this problem was taken in 1975 with the passage of Law 111,* as part of a re-structuring of public sector administration. The holding companies (moassasats) were abolished and replaced by supreme councils for each industry. The idea was to take only the most important decisions — particularly price changes and investment decisions — at the "center" and leave the companies freer to make day-to-day decisions. The boards of directors (and hence implicitly the chairmen) were given additional control over the operation of their companies; they were to prepare the draft general plan, other plans for production and equipment replacement, provision and development of finances, and so on.

More important than the legal statement was the actual implementation of the new policy. In our conversations with company chairmen, it was apparent that many do feel they have substantial autonomy although there is always room for improvement. One recurring theme related to autonomy in making purchasing decisions. Above a certain limit, managers would have to go through GOFI procurement procedures, which are tedious and cause long delays. (When both AID and GOFI procedures were involved, the result was a nightmare!) The ceiling, however, has been steadily raised, up to LE 3 million now. Further, several chairmen said that they could frequently break up larger purchases into smaller components, each below the ceiling. This type of behavior is clearly possibly only in a regime where central controls are not being vigorously enforced.

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* For a brief description of the key elements in Law 111 and other important Laws, see Appendix II.

As a general rule, we had the impressions that successful chairmen, particularly those making profits, had somewhat more autonomy than the rest. Whether this was because the government permitted it or whether these managers were aggressive enough to go out and take it is hard to surmise. In principle, a policy that consciously rewards the best managers with autonomy has much in its favor. In Egypt, however, with its highly distorted price system, it is not easy to observe the best managers. Thus there exists a need for a uniform, comprehensive evaluation system based on shadow prices as an interim measure.*

Despite our general impression that managers can and frequently do get some autonomy, much remains to be done. There is a surprisingly consistent view that ownership must be separated from management. From our conversations, we found that this view is supported by company officials, ministries, labor bodies and academics. There are two important channels of movement in this direction. First, with the passage of Law 159(1981),** it is now possible for public sector managers to form wholly-owned subsidiaries under Law 159, which would place these subsidiaries in the private sector. Accordingly they would be much freer of government controls than their mother companies. At least one company chairman

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* Incidentally, it appears that what Egyptians call "economic" prices are not the same as appropriate shadow prices; economic prices are taken to mean prices that cover costs of production.

** See Section Two for further discussion, and Appendix II for a brief description of this law.

we spoke to already has plans to set up such a company.

Second, there is currently active discussion of a new public sector law. Two proposals for public sector reform were under consideration in 1981; these have now been replaced by a third. It is embodied in a paper prepared recently by the Ministers of Industry and Economy, and it has been discussed twice by the Supreme Committee for Policies and Economic Affairs. It will be presented shortly to the Council of Ministers and all indications are that a draft law based on the approach will be presented to the People's Assembly when it next reconvenes in November. Considering the momentum for public sector reform, it is our judgment that the law will pass in 1983. It is not unrealistic to hope for its passage by mid-year.

Apart from the Government initiative on this matter, most public sector enterprise managers themselves want greater freedom of action, and they are supported in this by the labor unions, which provide the workers' representatives who sit on the boards of directors. The labor unions are in fact firm supporters of greater managerial autonomy for the public sector enterprises and public sector enterprise reform so long as their essential demands are met for continuation of two sets of acquired rights: workers' representation on the boards of directors and the current system of profit sharing. Thus support for the new law seems widespread. However, we cannot predict at this time what opposing forces may emerge in the course of implementation.

To turn to the proposed law itself, we believe that the suggested changes are a significant step towards the goal of managerial autonomy. "The separation of ownership from management" is stated as one of the four key principles of the proposal. Certainly its purpose and effect are to place more decision-making authority at the company level rather than at the center. For example, our unofficial translation of the proposal says, "...companies are independent units. No central authority is allowed to interfere in any manner. The company's board of directors is the sole authority to determine the company's activity." In fact, the board of directors will have enhanced powers under the law.

Overseeing the public sector companies will be several national organizations. The proposal paper goes to great lengths to argue that these national organizations are not to be confused with the public organizations (moassasats) that existed during 1962-75, and indeed, the powers of the national organizations are considerably more limited. Many of the public organizations' powers are embodied in the companies' general assemblies. Although this appears to be a desirable step, the paper suggests that the board of directors of the relevant national organization should serve as the general assembly of a company. This would nullify some of the decentralization effect sought and, therefore, deserves revision. A number of key decisions — including price and wage decisions — are delegated to the company's board of directors and of course this is a major step in the right direction. (These are considered in greater detail in sections three and four below.)

Overall, the proposed law seeks to give all public sector companies the privileges given to Law 43 companies; this also will imply considerably more managerial autonomy.

2. <u>Private Sector Liberalization</u>

It was the contention of USAID/Cairo's Industry Sector Strategy Annex to the Egypt FY1984 CDSS that the key element of change needed to achieve liberalization of Egypt's industrial sector is the easing of restrictions on entry of the private sector into industrial activities hitherto explicitly or implicitly reserved for the public sector. Greater ease of entry in the first place leads directly to expansion of the share of the private sector in industrial production. It also puts pressure on the public sector enterprises to operate on more competitively determined market terms, and to demand from the government authorities the greater freedom of action normally available to the private sector but not to the public sector enterprises.

Great strides have been made in liberalizing the private sector. By far the most important step was the passage of Law 43(1974). This was originally intended to encompass joint ventures between Egyptian and foreign capital, but was extended to purely Egyptian firms by an amendment in 1977. Firms organized under this law are free to set prices, wages and employment conditions, can maintain foreign currency accounts, can import equipment and export goods without a license and enjoy a generous tax holiday. That the law provided a strong incentive for entry is clear. The private sector's share in industrial investment rose from four percent in 1974 to 12% in 1975-78 and to 13% in 1979. GOFI estimates the share of private sector's share of the value of output of manufacturing to have increased from 25% in 1976 to 32% in 1981. New joint venture investments approved under Law 43 since 1974 reached a cumulative total of 1,626 (valued at LE 9.0 billion) by end 1981, of which around 1,000 (valued at LE 5.4 billion) were in operation or under construction; about 30% of the approved investments were in industry. This is a major achievement, specially compared with figures for private sector joint-stock company formation under Law 26 (1954). No new companies were formed during 1961-71 and only 27 during 1971-81.

Nevertheless, there is some feeling that Law 43 could have performed better in the industrial sector, and it is therefore instructive to examine the impediments to private sector expansion. Although we did encounter complaints regarding government red-tape as a deterrent to private investment, the two most important reasons that more private funds are not being invested in industry are purely market ones: (a) the labor force is unreliable, and skilled workers frequently leave for higher wages in other Arab states once their training is complete; and (b) high interest rates in the West make risky investments in Egypt relatively less attractive. A large proportion of investible funds with Egypt-based banks find their way to foreign capital markets. Under these circumstances, it is fair to say that external conditions constitute an important (if not the most important) factor inhibiting Egyptian private sector development in particular and industrial development in general.

Two other factors, however, must be mentioned. First, there continues to be a fear of possible nationalization, which shortens the time horizons of potential investors. Law 43 explicitly rules out this possibility, but of course in principle such laws are always revokable. The best guarantees against nationalization are political and economic stability — as these come over time, the confidence of private investors will improve. Second, private sector companies face the possibility of public sector competition and claim it is unfair when the public sector companies are subsidized. With the pricing policy embodied in the new public sector law (see section three below), this will become less of a problem.

Another important step in private sector liberalization is the passage of Law 159(1981), for which the executing regulations were signed on June 23. This law simplifies considerably the procedure for forming joint-stock and limited partnership companies and makes it mandatory for the relevant government agency to respond to an application for incorporation within thirty days. Further, Law 159 companies will enjoy all the privileges of Law 43 companies, except the freedom to repatriate profits. Lastly, there is no bar to public sector companies forming subsidiaries under this law. Thus, we regard it as a major step towards the increased privatization of the economy. The issuing of the executing regulations, we believe, is an important signal that the process of liberalization begun by President Sadat will indeed continue under President Mubarak. Mention should also be made here that the corporate tax rate was reduced recently from 41% to 32%, a further incentive for private investment.

One barrier to private enterprise that does continue is the requirement of Government approval for new investments. To some extent this may be desirable in an economy which cannot afford the costs of excess capacity being built. At the same time, it is important that the government not play more than a minimal coordinating role. The key, therefore, is the actual practice of the approval process. There are signs that this is indeed being streamlined. Recently 514 new private sector projects were approved — all had been presented within the last six months. And the Deputy Chairman of GOFI declared that the turnaround time would now be thirty days, the requirement laid down in Law 159.

Another cause for optimism is the growing consensus in Egyptian policy making circles that the industrial branches reserved for the public sector should be limited to branches (such as steel making) which are considered strategic for the economy, but that the production of consumer durables should be opened to the private sector. The change in atmosphere in this respect over the last two years is remarkable. In 1979, production of washing machines was opened to the private sector but the public sector company Ideal was able to fight off attempts to divest it of its monopoly of production of refrigerators. Today, although Ideal is still the only Egyptian producer of refrigerators, even such firm supporters of public sector enterprise as the Egyptian Federation of Trade Unions state as a matter of self-evident fact that refrigerator production is an area for private sector competition with the public sector.

3. Pricing Policy

The most glaring source of inefficiency in the Egyptian economy is surely the distorted price structure. The need for price reform has been discussed for years now with little movement in actual practice. The "bread riots" of January, 1977 in response to announced price increases served to underline the difficulties associated with pushing prices too much. Our assessment, based on our conversations with a wide range of people, is that it is extremely unlikely that retail prices of "sensitive" goods such as food items, "popular" cloth and housing will soon be changed. In the present situation of relative political instability, tampering with these prices would be too risky a path to follow. Nevertheless, it should be noted that the large subsidies to essential goods are a tremendous drain on the treasury, a fact that was pointedly mentioned by President Mubarak in his recent July 26 speech.* This point has also been attracting a lot of editorial attention recently.

Certainly the pessimistic assessment does not apply to pricing reform in other areas. There seem to be several areas of movement. First, as the economy gets increasingly

* He noted that subsidies on bread alone cost the treasury more than the entire revenues from the Suez Canal.

"privatized," especially following Laws 43 and 159, a smaller proportion of output will have controlled prices. This is true not only because the private sector is free to set prices within certain limits, but also because public sector companies are freer to set prices when they are selling to the private sector.

Further, public sector expansion is often taking place through Law 43 and may accelerate under Law 159. These "public sector" companies are freer of price controls since they are regarded as part of the private sector. In at least one case, a public sector company raised its price by phasing out its production and replacing it with production from a subsidiary joint venture under law 43, although this has naturally been severely criticized.

Second, public sector managers now frequently have the option to set prices for new products. In practice, this is used to raise prices simply by changing the original product slightly. Of course this tactic cannot be applied everywhere. For example, there is limited flexibility to change the specifications, and hence the price, of cement. But the technique is easily used in the pricing of pharmaceuticals. There have also been some price increases of existing products, either on an experimental basis (e.g., soap) or if the goods are non-essential. There has been talk of using this method to actually remove subsidies on some consumer goods in an incremental way, e.g., cigarettes and toilet articles.

Third, there is active discussion of an intermediate rationalization step with regard to public sector prices, namely to recognize the subsidies involved explicitly at the distribution stage rather than hiding them at the factory level. This is an important component of the new public sector law that was discussed in section one above. Specifically, company chairmen are empowered to set prices to cover cost plus an adequate profit margin, provided these do not exceed the import cost of the commodity. This kind of instruction has two problems: (1) the import cost is normally taken inclusive of tariffs, so that we may often find the "cost-plus" price to be lower than that of imported goods in the domestic market but higher than the international price; and (2) there may frequently be excess demand at the announced price, and it is unclear whether managers will be permitted to find the market price. Certainly when the goods are actually sold at subsidized prices it will be extremely difficult for the manufacturer to establish the free market price which would be the appropriate one for signalling purposes. Also, the need to cover cost is suitable only when the prices of intermediate goods have been set appropriately. Nevertheless, the separation of the ex-factory price from the retail price will serve three very useful purposes: (1) it will provide better signals to both producers and users of a wide range of goods, particularly intermediate goods that are priced correctly; (2) it is liable to result in greater managerial autonomy where public sector firms become more profitable; and (3) by making the subsidies explicit, it will increase the pressure to remove some of them or at least to clarify the extent of government support involved.

4. <u>Wage and Employment Policy</u>

Another classic Egyptian problem relates to wage and employment policy. Here again, major steps have been taken within the last few years to restore some type of rationality to the labor market. The private sector, for example, is now largely free of any labor-related controls. Law 43 and Law 159 eliminate any salary guidelines. Under Law 159, the only labor-related guidelines are that some worker representation is required on the board, and 10% of net profit must be distributed to workers in the form of bonuses (up to a maximum of their annual salary). Clearly neither of these regulations imposes significant restrictions on the firms.

In the public sector, matters are not quite as simple. The stereotypical image of public sector companies until quite recently was that they were tremendously overstaffed due to government policies requiring the hiring of all graduates, and were severely limited by government guidelines on wages. We found an extremely different atmosphere now, however. The primary legal instrument for change was Law 48 (1978), which gave public sector companies considerable freedom to set their own employment policy. For example, the board of directors was empowered to design, implement and amend the organizational structure of the company and to determine hiring procedures. Each enterprise also was expected to devise its own evaluation and incentive system. Although base pay scales were fixed by the government and were uniform across companies, each company was given considerable leeway to fix bonuses, special and merit allowances, incentives, etc.

In practice, we found some variation in the actual implementation of this policy. Many company chairmen felt they were free to set their own hiring practices and acknowledged that they were no longer under any great pressure to hire people they did not want or need. In fact, a frequently mentioned problem was a shortage of workers. Some did still feel they had an overhang of surplus workers, which would need to work itself out through attrition or company expansion. With regard to graduates, it is now government policy to "delay" their employment by up to three years if necessary and to absorb them in administrative departments rather than the companies. Overall, therefore, companies feel they have some control now on their staffing levels.

On salaries, the base pay guidelines set by the government are unrealistically low and, on their own, would make it impossible for public sector companies to compete with the private sector or with employers in oil-rich Arab states. All companies supplement the base salaries by "incentive" payments that vary from 40% to 150% or even 200% on top of the base pay. The "poorer" companies have less ability to make such payments unilaterally and hence have less control of their labor force. This is an important way in which managerial autonomy is implicitly linked to financial solvency of the company. Even the highest supplements, however, do not appear to bring a worker's total compensation on a par with what he could make in the private sector or other Arab states. The biggest problem faced by public sector managers is therefore that of labor flight, particularly to the Arab countries — something that is in a sense external to the economy. As in the case of capital flight occurring due to high interest rates in the West, there is little that Egypt can do to tackle this problem. One step that might ameliorate it somewhat, however, would be to let public sector companies freely set their own wages, which would be possible if they were also free to set prices.

This reform is on the immediate horizon as an important component of the new public sector law proposal. As part of the need to free public firms from restrictions and regulations that impede progress, it has been recognized that companies should be able to set their own wage policy, within some broad guidelines. The proposal points out the successes achieved in the banking, insurance and petroleum sectors. Thus the specific economy-wide fixed pay scales would be e[illegible]nated and perhaps some vague minimum and maximum guidelines would be announced. As long as the maximum figures are reasonable, this will be a further important step in granting managers control over wage and employment policy. The system of incentives would continue anyway where necessary. Combined with the already-granted freedoms on hiring, this law might complete the major reforms for labor policy in the public sector.

5. Public-Private Equality

The treatment of the public and private sectors is becoming more equal. Of course the most significant development is that there does now exist a growing, dynamic private sector, in sharp contrast to ten years ago. This is an achievement of major proportions that must not be forgotten. There still exist in Egypt strong forces opposed to such development, and it is indeed remarkable that liberalization of the private sector has advanced as rapidly as it has. In fact, this rapid expansion makes other reform measures, such as removal of subsidies, more difficult to implement, since private sector growth has been accompanied by a worsening of income distribution.

The most interesting aspect of the public-private comparison in Egypt is that pressure for equality of treatment is now coming primarily from the public sector side of the equation. At the same time, the private sector is concerned about discriminatory electricity prices and access to foreign exchange, and the potential competition from subsidized public companies. However, the private sector firms are not subject to most government price and wage controls, and under Laws 43 and 159, have considerable freedom with regard to foreign currencies and trade transactions. In this situation, it is the public sector companies that are pushing for more liberalization, and for once the political leadership also seems convinced that they must be freed so as to be able to compete with the private sector. Thus the new proposed public sector law calls for public sector companies to be granted the freedoms and privileges granted to Law 43 companies. Note that the same provision was made for the private sector under Law 159. Specific liberalization of price and wage policies for the public sector have already been discussed.

For the public sector companies, there will be a price for this freedom — they will have to do without subsidized inputs. As firms begin to price on a cost-plus basis, intermediate inputs will be priced more realistically. The introduction of more rational electricity prices, at least for industrial use, will also be more easily accomplished as part of this process. We feel that the chances of this reform coming about are extremely good, since all concerned parties, including labor, support its general thrust.

One other way in which the harmonious co-existence of public and private sectors may come about is through an appropriate division of industries between public and private sectors. Similar to the industrialization strategy adopted in India, this would suggest certain industries for public sector expansion and reserve others — particularly consumer goods — for the private sector. In this scheme, it is possible to select those industries for which public sector production is most appropriate. Several individuals we spoke to indicated that this kind of division is under informal discussion, although no specific proposal has been tabled.

6. Foreign Trade

One of the most important elements of the open-door policy was precisely the opening up of the Egyptian economy to foreign trade. There has been great liberalization of foreign currency controls and also of trade itself.

The liberalization of the banking system is dealt with in Chapter V. The creation of the parallel foreign exchange market is an important step towards more market-oriented transactions. Since exchange rates are floating in most Western countries, this may be deemed desirable, although the superiority of floating over fixed exchange rates is still a matter of some debate. The private sector complaint that they should be able to buy hard currency at the official rate is hardly tenable; what is desirable is for the public sector to use the market rate also. This will be a likely result of the proposed public sector law. It should then be possible to have a unified and free exchange market. Laws 43 and 159 also removed licensing requirements for the import of capital equipment and for exports.

C. SUMMARY

To summarize, there has been substantial liberalization and policy reform in Egypt during the last eight or nine years. The private sector has grown enormously following Law 43, and the passage of Law 159 is likely to reinforce that trend. The public sector has been the beneficiary of major changes in managerial autonomy, especially through Laws 111 (1975) and 48 (1978). It is our sense that in fact the autonomy available to public sector managers is frequently not used to its fullest extent: a symptom that the country has limited ability to absorb liberalization. Further reform, however, is very much in the air. We can look ahead to a period when the public sector will be free of many more restrictions and will be able to operate like Law 43 companies. Wage and employment policy has already been liberalized to a large extent and the new public sector law will basically complete the process. Major price reform is also to be expected.

This is not to say that Egypt will be almost like a laissez faire economy in a few years. The existence, strength and continued growth of the public sector are basic tenets of Egyptian policy and are not negotiable. They are seen as the pillar on which Egyptian independence rests. The subsidization of basic commodities is another policy on which little movement can be expected. This is partly a matter of policy and partly of political expediency. What can be expected is for more rational pricing to occur on non-essential goods and for subsidies to be recognized explicitly. Producers of subsidized goods would then face more appropriate signals for the value of their output.

It would be unreasonable and unrealistic to expect public sector managers to be granted complete freedom to make investment decisions. Such autonomy could easily be misused. The real goal should be to make the oversight procedure simple and unburdensome. Company chairmen we spoke to did not particularly complain that investments they really wanted were not approved. The key complaint related to the delays involved in going through the tedious purchase procedures. These therefore need to be streamlined. Perhaps the ceiling on autonomous purchase decisions could be steadily raised as a reward for good performance. For this last, it is vital that the GOE have a comprehensive and uniform evaluation procedure, which makes explicit the values they attach to their different objectives. AID may usefully fund the setting up of such an evaluation system.

This also relates to the use of banking criteria as a way of allocating investment funds. In an economy where prices are as distorted as they are at present, such financial-type criteria make little sense from the social point of view. As the price reforms outlined in the new public sector law come into effect, such criteria may become a little more meaningful, although market prices are still unlikely to approximate true shadow prices. More important, it is obvious that the Egyptian capital market is far from perfect. Reliance on the market to allocate funds efficiently therefore does not even have a theoretical justification. The use of economic rates of return seems much more desirable.

The key points of this chapter are:

(1) There has been a substantial amount of liberalization and reform in the past decade.

(2) The Egyptian economy has a limited capacity to accept and absorb liberalization.

(3) As a result, reform must be of an evolutionary nature.

(4) This evolution is progressing in a substantive way. Egyptians have indeed internalized the continuing need for further reform.

AID must consider these factors, the recent history of events and Egyptian reality as it designs an effective aid program.

III. AID'S PERFORMANCE AND STRATEGY IN THE INDUSTRIAL SECTOR

A. OVERVIEW OF U. S. AID TO THE INDUSTRIAL SECTOR

Between FY1975-81, USAID obligated more than $1.4 billion for the industrial sector in Egypt, 37% of the cumulative U. S. aid package.* The following discussion briefly describes AID's major activities in the industrial sector, their achievements and shortcomings, and lessons for the future as AID develops a new industrial assistance program.**

1. Objectives

AID's industrial programs (described in Appendix III) have not emerged from a coherent and well-defined industrial strategy. Rather, AID's involvement in the industrial sector began in an unstructured way, with the primary objective of absorbing the high level of funds provided by the U. S. government to Egypt. Neither the objectives nor the component parts of the programs were designed to be complementary nor to fit into an overall strategy, although they did share broad goals and common activities to an extent. Exhibit III-1 shows the key programs and the services provided by each:

- the Commodity Import Program
- direct project assistance
- the Industrial Production Program
- Development Industrial Bank

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* Excluding P.L. 480; the share drops to 22% if P.L. 480 is included.

** A detailed discussion and comparison of these programs can be found in Chapter Five of the Phase 1 Report, May, 1982.

EXHIBIT III-1

AID ASSISTANCE TO INDUSTRIAL SECTOR

Program / Service	CIP	IPP	Dir. Projects	DIB*	PIE**	IPI		
						MDP	ITAP	Local*
Training								
Companies	x FY82	x				x		x
Financial Institutions				x	x			
Feasibility Study		x	x					
Loan	x	x	x	x	x			
Technical/ Management Assistance	X FY82	x		x (to DIB)		x	x	
Environmental Study and Equipment		x						

* Principally Private Sector

** Exclusively Private Sector

* Private Investment Encouragement Fund
* Industrial Productivity Improvement

Exhibit III-2 summarizes the diverse goals sought by AID programs over the past seven years. It is first apparent that the most common objectives have been capital rehabilitation and institution building, the latter aimed variously at ministries, banks and/or companies. Second, structural reform has been sought to date through only two programs, the IPP and the direct projects, and in both as implied goals. Third, the largest single program in the industrial sector — the CIP, with 62% of all industrial sector expenditures — has maintained the simple goal of balance of payment assistance, without explicit recognition of other outcomes, from the obvious one of modernization of capital stock to the more abstract goals of increased national income and productivity, sought through the less dramatic expenditures of other programs.

2. Achievements

The impact of AID's involvement with the industrial sector is mixed; in many cases, because of the delayed implementation, projects have not advanced sufficiently to measure outcomes. Achievements to date include:

* Some modernization of industrial capital stock (principally through the CIP and direct projects to date).
* Balance of payments assistance (principally through the CIP).

EXHIBIT III-2

GOAL \ Program	CIP	IPP	Dir. Proj.	DIB	PIE	IPI MDP	IPI ITAP	IPI Voca.
Balance of Payments	•	•	•					
Capital Rehabilitation		•	•	•	•			
Increase Productivity		•					•	•
Structural Reform		•	•					
Increase National Income		•						
Institution Building		•		•	•	•	•	•
Improved Environment		•						
Private Sector Productivity/Efficiency				•	•			
Encouraging long-term Lending					•			
Increase supply of and demand for management services						•		
Increase employment		•					•	•
Expansion of industrial sector							•	•
Increase productive use of technology							•	
Develop training techniques								•

- Some institutional development (particularly in the DIB).
- Within AID, a better awareness of the problems facing Egypt's industrial sector.
- Within GOE, the banking community and companies, greater awareness and experience in conducting feasibility studies and in their use in making investment decisions.
- Increased experience with procedural issues, which could lead to more compatibility between the USAID and GOE systems, and a willingness to experiment (e.g., DIB loans below $1 million are now exempt from the U. S. carrier requirement).
- A greater base of experienced project officers within AID to manage the system.
- An established presence in the Egyptian industrial sector.

3. Problems

The AID program, despite its growing achievements, has been beset by a number of problems which in large part have resulted from the absence of a comprehensive assessment of need and a coherent operational strategy. Programs have not been targeted toward any particular industrial sector or set of institutions; instead, rather a shotgun approach has been adopted. Moreover, the rationale for AID's approach has not been effectively articulated to the GOE nor would it be immediately apparent to observers from the range and amounts of money applied. Another result is the limited coordination and interaction among the various AID modes of assistance, even where goals do overlap.

A second problem is the inconsistent and incoherent application of decision criteria. The IPP, for instance, initially specified only a minimum economic rate of return of 15%; this was later supplemented by a 15% financial rate of return requirement. As noted in detail in the Phase I report, the opaque evolution and application of these criteria led to considerable confusion, uncertainty and frustration on the part of GOFI and the companies as to the reasons for AID's rejections of projects, as well as considerable time and expense in feasibility studies which could have been cut short, had AID been explicit in its criteria at an earlier decision point.

Yet CIP projects, on occasion as large as those of the IPP, require no minimum financial or economic rate of return nor even a feasibility study; expenditures are justified in a four-to-six page "Activity Justification Paper." In the direct projects, a 15% ERR and 15% FRR were neither necessary nor sufficient conditions for approval; one $95 million project with both rates <u>below</u> 15% was approved while another with both rates exceeding 15% was rejected. Nor is the discrepancy confined to public sector programs; DIB loans specify a 15% financial rate of return while PIE loans required a 15% economic rate and a financial rate to "exceed the effective cost of funds." The proposed Production Credit

Project has flipped back to a 15% financial rate of return requirement.

A third shortcoming is that discussions have focused on procedural issues such as procurement and contracting, crowding out more substantive dialogues on goals and policy change, and contributing to the slow and cumbersome disbursement of funds. In the IPP, for instance, only $6 million out of $145 million have been disbursed to date, principally for feasibility studies. In the DIB only $21 million, or 66%, of the available $31.5 million have been disbursed in the six years of the program's operation. The PIE fund approved since 1978 only $[illegible] 8 million in loans out of the $30 million credit availa[illegible] two joint investors have withdrawn, leaving actual loan commitments of only $1.8 million. The direct projects have fallen behind schedule as well.

The slow disbursement has led to another problem: AID's presence, with the possible exception of the CIP, has not been particularly visible. Despite the large sums obligated for the industrial sector, AID is not perceived as a significant factor; in some circles it is even viewed negatively relative to other possible investment sources. AID has, in most cases, made little or no effort to "market" its funds, although in the more recent IPI an explicit marketing component is built in. In a financial market where AID funds are perceived as costly, due to the generally market-level interest rates and tied aid provisions, more vigorous marketing efforts will be essential.

The lack of visibility, slow disbursement and excessive procedural emphasis have contributed to a lack of credibility which has hindered the effective exercise of policy leverage. In the two programs where policy reform was implicitly sought — the IPF and direct project assistance — it has not been realized. For example, in the IPF the goal of structural reform should have been stated clearly and included as part of the decision criteria for investments if in fact those structural issues could be directly or indirectly related to productivity. In the direct projects, no progress on pricing has been achieved, but at least in the case of Mehallah, by May, 1982 AID had come to recognize that "the company's freedom to set prices is limited" and that "the dialogue with the GOE on textile pricing policies and subsidies must take place on a much broader scale outside the scope of this particular project."

4. Lessons

AID's experience to date in the industrial sector has, despite its flaws, built a foundation from which to build a new program. The following lessons should be considered as AID develops its approach:

- AID must adopt a consistent strategy for its activities in the industrial sector if it wishes to maximize program effectiveness and policy leverage. A piecemeal, "target of opportunity approach" is likely to lead only to frustration on the part of both GOE and U. S. participants.

- AID must take greater advantage of the potential for interaction among its programs; the implementation of the IPI components, just beginning, provides an ideal opportunity for this.
- AID must move beyond the tools of individual project and financial leverage in order to influence policy effectively, incorporating, for example, more systematic policy dialogues, and the provision of economic information into its activities.
- AID must adopt selection criteria consistent with its overall strategy, make those criteria explicit to the GOE and participants at the outset, and apply them in a consistent and coherent manner.
- AID must recognize that its movement into a "wholesaler" role carries with it the willingness to give up a detailed, ongoing oversight role and constant procedural haggling; both the wholesaler role and any goal of institution building require that AID "let go" of its hitherto paternalistic oversight role to a significant degree, as does the goal of maximizing AID's limited staff resources.
- AID must more vigorously market its programs to ensure widespread use of its funds and, equally importantly, to secure its place as a visible and influential source of investment funding.

B. AID's STRATEGY FOR THE FUTURE

USAID has begun the process of developing a framework for its operations and addressing some of the issues described above. The CDSS industrial strategy is evidence of this process. In this section we describe this strategy and what we conclude is the current perception of the strategy.

1. Boston University Sector Strategy Study

Exhibit III-3 summarizes the strategy developed in the Boston University study. Its theme is to leverage currently available resources (such as AID finances) for investment in new plant and rehabilitation, concentrating on industries in which Egypt has comparative advantage. Thus the strategy would attempt to use Egypt's special advantages, particularly skilled labor and proximity to European and Arab markets, in an export-led growth strategy. Although the study made an attempt to identify the specific industries in which investment would be suitable, much more work along that line is needed before the strategy can be successfully implemented. However, the Boston University approach does provide a framework within which a truly comprehensive strategy can be developed.

2. USAID's Industrial Sector Strategy

In the FY1984 CDSS, USAID generally adopted the Boston University strategy. Thus, they support an industrialization strategy, with some emphasis on exports, and agree with the principle that public sector enterprises need to operate more efficiently. However, they went beyond the Boston University

EXHIBIT III- 3

STRATEGY ASSESSMENT

Income from Suez Canal, oil, tourism and from remittances and foreign aid →

- Can be "seeded" to create productive jobs or
- Used to support additional workers as government employees

→

Creating productive jobs is preferred for various economic reasons: creation of jobs= indcreased demand/ use of labor= real wages →

Jobs would be created by developing a large, productive, labor intensive industrial sector (industrialization) which focuses on exports of manufactured goods →

Strategy to Achieve Industrialization Includes:

- increase the efficiency and the output of existing industry particularly public enterprise
- allocation of additional resources to industry that would otherwise go to expand government emloyment or to other activities with a lower rate of return
- obtain additional resources from abroad, including private investment
- made it attractive for Egyptians to save and invest in industry
- substantially increase the rate of investment in industry

In short, this strategy would set up a self-reinforcing process in which a rapidly expanding, labor intensive industrial sector generates further resources for its own development; the existence of attractive jobs in industry diminished the pressure for unneeded jobs in government; and the increased productivity and competition in industry allows a removal of some controls without sharp price rises

---

- change the incentive system for public and private managers to induce them to use less capital, more labor

However, there are both assets and liabilities to industrialization:

<u>Assets</u>

- inexpensive labor
- large number of women who could work in industry
- proximity to Europeans/Arab markets
- adequate foreign exchange
- relatively high education

<u>Liabilities</u>

- perverse incentives for private and public managers
- distorted prices
- overstaffing
- ineffective control system
- inadequate infrastructure
- lack of technical and professional personnel

Most problems to industrialization would yield to changed policies

A number of policies and programs could help bring about rapid, labor intensive industrial development with focus on export of manufactured goods

- exchange rate which increases the profitability of manufactured exports
- eliminate controls over exports
- change prices of industrial inputs and products or "de-link" prices of consumers and producers
- flexible credit and higher interest rates which are variable
- reform wage and labor productivity policies:
  - improve management
  - increase incentives for labor and management
  - decrease overstaffing
  - increase training especially for women
- in addition to macro policy changes micro changes should occur in
  - managerial autonomy
  - incentive systems (signaling)

Based on assessment of Egypt's comparative advantage:

food-vegetable oils, jams, starch
textiles
leather products
cotton underwear
cosmetics
cement
bicycles

=

<u>USAID Programmatic Support for Industrialization</u>

- outline of needed macro-economic policies
- steps to increase attractiveness of exports
- availability of credit to private firms
- breaking link between producer and consumer prices for industrial goods
- stress on labor intensive investment
- takes advantage of supply of female labor
- promotes efficiency of public sector companies
- provides training and incentive schemes for industrial workers and managers

focus on investment by stating that their goals would best be achieved by pursuing two basic objectives in the area of industrial policy reform:

- to expand the share of the private sector in industrial production by removing policy restrictions on entry and other policy discrimination against the private sector.
- to increase efficiency and productivity in existing public sector industries.

This view was reinforced by the NEAC reaction to the strategy statement.

The present consensus within USAID/Cairo is, to paraphrase the FY1984 CDSS Policy Issues Annex, that AID should be seen as "even handed with respect to Egypt's public and private sectors, or it may end up empty handed" in its efforts to promote Egypt's private sector. AID believes its approach should be non-confrontational, seeking to support reform movements within the Government of Egypt, the trade unions and the public sector enterprises themselves for liberalization and reform of the policy environment within which Egyptian industry operates. Where the USAID Mission is divided is on the question of the extent of public sector reform USAID should require as a pre-condition for further commitments to public sector investment. The outcome of this debate will have significant implications for USAID as an organization.

Although the CDSS states that growth can be achieved both by increasing investment and by reforming existing policies and procedures, the policy reform objectives in the strategy seem to have become the dominant theme. The issue of increased investment is viewed as a means to policy reform. In our opinion USAID may wish to consider the implications of focusing on policy reform as the prime vehicle for economic growth. It appears to us that if industrial growth basically captures the thrust of USAID's strategy then the proper organizational role for USAID would be to focus on methods to increase investment (long term) rather than focusing on methods to bring about reform.

In the following section we describe areas where there is agreement with the GOE on goals and which act as a basis for focusing future USAID programs.

C. USAID AND GOE CONSENSUS

This section reviews the goals, policies and program orientation of the GOE and AID, revealing the key areas of consensus between the two parties.

1. Goals

As summarized previously in Exhibit III-2, in the past AID's goals were developed on a program-by-program basis and not derived from a single strategic approach. The most important, or oft-mentioned, program goals included:

- institution building
- capital rehabilitation
- balance of payments assistance
- increased employment
- increased productivity

As AID moves into the future, it has laid out a more developed set of goals for its activities.

The broad macro goals which AID supports are:

- increase GNP
- increase employment
- improve balance of payments through reduced imports and increased exports
- increase the industrial sector's share of GNP

The specific industrial sector goal expected to contribute to the macro goals is:

> to rationalize Egypt's industrial sector so that investment and operational decisions are based on market criteria

Specific objectives within the industrial sector are:

- to increase the private sector's share of industrial production
- to promote increased efficiency and productivity in the public sector

To turn to GOE goals, one statement is provided in an unofficial translation of the FY82/83 plan. Six principles are presented, supporting two overriding goals of economic stability and monetary equilibrium:

1. Concentrate on consolidation and development of the economic performance of existing productive capacity.

Priorities: Food
Clothing
Construction materials

2. Increase efficiency and productivity of the productive sector, including supporting services that are linked to commodity production, such as transport, communication, education and health.

- Growth rate of 9.8% for commodity production vs. 6.1% for productive services

3. Increase self-reliance/reduce balance of payments.

- Increase commodity and service exports

4. Increase investment through savings rather than through inflationary deficit finance.

- Attract Arab and foreign capital through inspiring confidence
- Open investment channels
- Overcome administrative obstacles and bureaucracy which impede project implementation and management

5. Improve individual consumption and the standard of living.

- Guarantee the optimum and effective distribution of total local output to satisfy the masses' consumer needs
- Provide basic public services, such as education and health, for free or for a marginal fee
- Direct subsidies to those of limited income

6. Optimize use of human resources

- Recognizing that government and service sectors have absorbed numerous workers, disguising unemployment, increasingly workers are to be directed into the highly productive manufacturing and construction sectors
- Enhance rural development, agricultural development and smaller enterprises in order to limit migration to cities

- Training — technical, administrative and management — in both the public and private sectors

- The armed forces should play a role in providing vocational and professional training

Additional goals cited by GOFI in a June, 1982 report, Industrial Opportunities in Egypt, include:

- establish integrated industrial zones

- rationalize energy use

- optimize use of mineral resources

- optimize use of local raw materials

- strengthen open door economy, expanding foreign partnerships and giving priority to the Egyptian private sector to participate in joint venture projects

- transfer of technology

- improve productivity through vocational training, scientific practice and quality control

- spread of small scale industries throughout the country

President Mubarak's July 26th speech also provided a picture of the GOE's goals for the industrial sector, noting first that economic reform will take time and that stability was the most important prerequisite of economic reform. A key point was the strong encouragement of private sector productive enterprises including removing obstacles. Private sector development was explicitly noted as being perfectly consistent with continued development of the public sector. Finally, although subsidies would not be abolished, the fact that the speech illuminated the cost of various subsidies lends credence to the notion that their budget costs are of significant concern to senior GOE policy makers and will increasingly be discussed.

Further evidence of the government's intent to promote the private sector was presented at the Ministry of Industry's recent meeting with industrial unions and industry leaders, to discuss "means of developing and promoting the private sector in order to play a more effective role in industrial development."

In large measure, then, AID and the GOE share a common framework of goals for the economy, in particular both favoring steps toward:

- a larger industrial share of national production
- improvement in the balance of payments
- development of private sector industry

Perhaps the principal divergence lies beneath the macro goals, where there is a difference of emphasis, with the GOE focused on equity concerns as well as issues of efficiency.

2. Policies

In terms of policy reform, a consensus within the GOE that reform is forthcoming was prevalent throughout our discussions. Yet, as noted in Chapter II, there is not likely to be a structural reform but rather a series of efforts that will continue the Egyptian economy's evolution since 1974.

The greatest area of consensus between GOE and AID lies in management changes for the public sector, i.e., AID's list of constraints affecting the public sector. The proposed public sector law will make significant progress toward easing employment policies and management policies; where there is less movement expected is in the area of decentralized financial and investment decision-making.

There is a broad consensus between GOE and AID in the second area of policy reform, private sector constraints; i.e., the GOE is actively encouraging private sector participation in the industrial economy, particularly in certain areas such as building materials. Whether the exact method of that liberalization matches AID's list in the CDSS, e.g., tax reform, discriminatory pricing, etc. — is unclear.

In the final area of policy changes sought — pricing and interest rates — there exists the least consensus. The budget crunch has given the long-standing discussion of subsidies a new urgency. In addition, the experiments and discussion of moving subsidies away from the point of production to the distribution stage (i.e., out of the companies' budgets to the ministries) are important steps. However, there is a strong commitment to maintain subsidies at least for basic consumer needs, as affirmed in Mubarak's speech. In its industrial strategy AID recognizes the difficulty of achieving reform in this area, and expects it to take time.

3. Programs

In translating goals and policy changes into programs, AID proposed to concentrate on private sector capital formation, public sector rehabilitation conditioned on reform, and appropriate assistance in terms of training and technology adaptation. This is largely consistent with the GOE view, as represented, for example, in GOFI's list of investment requirements:

- technical knowhow (including licensing)

- equity participation
- loans
- services (engineering, product development)
- training
- market access
- management

Thus, there is a significant consensus between the GOE and AID in terms of goals and programs; where they diverge is in the extent of policy reform to be achieved within the near term. However, there is a sufficiently large area of agreement that AID should be able to mobilize its financial resources in a way that meets the mutual objectives of both countries.

IV. AN ASSESSMENT OF USAID'S STRATEGY: NEW PERSPECTIVES

A. OVERVIEW

In the previous chapter we concluded that USAID's operational strategy for industrial development in Egypt is focused primarily on structural reform which allows the public sector to be more efficient, and structural reform which allows the private sector to increase its share of industrial production. This conclusion is reinforced by USAID/Cairo officials who state that essentially they are looking for "targets of opportunity" through which they can support GOE efforts at structural reform. There is no concerted effort to focus those funds either on specific sub-sectors or on products where Egypt has a comparative advantage. In essence, it appears to be an attempt to establish a reward system for "good behavior," i.e., market-oriented behavior on the part of the GOE. Though USAID has gone through considerable time and expense to develop an overall development strategy for investment of its funds, it is our conclusion that the plans to carry out that strategy too narrowly emphasize achieving economic reform through financial leverage.

The essence of this strategy is captured by the criteria USAID has proposed to use to select program options for future assistance to the public sector. These criteria are:

> Continued support for the public sector should be based on interventions that promote "structural"

reform, i.e., reforms in pricing, employment, investment, production, economic analysis and associated policies which would eventually enable or permit the public sector to operate efficiently in a more competitively determined market environment.

- Support for the public sector should facilitate private sector industrial development by encouraging such reforms as easier market entry; greater access to credit, foreign exchange and imports; and more equitable tax treatment.
- Support for the public sector should be based on demonstrably appropriate institutional arrangements and criteria for evaluating assistance proposals , for efficiently channelling forms of assistance and for achieving the desired objectives.
- The management role for USAID should economize on scarce USAID management resources.
- There should be strong prospects for rapid disbursement and/or commitment of obligated funds.

An analysis of these program characteristics reveals current USAID perceptions as to the purpose, role and function of USAID as an organization. The first two characteristics imply that the purpose of USAID is to promote structural reform. The assumption is that if economic reform is achieved it will have a greater impact on economic development in Egypt than merely transfering financial and technical resources into a system that will inherently misallocate those resources.

Since that argument apparently has been accepted by USAID, it appears to have adopted an organizational role which is consistent with that purpose. USAID now basically views itself as an organization which is simultaneously an advocate for economic reform and a promoter of an economic ideology which is private sector oriented. Its role as a reform organization has in fact become its strategy for economic development.

In carrying out that role USAID now defines its function as a wholesaler, acting as a financial institution to transfer bulk financial resources on a conditional basis rather than focusing specifically on achieving economic results through projects. This function as an organization is again wholly consistent with its stated organizational purpose and role. However, we are concerned that placing structural reform as central to USAID strategy is not in the best interests of USAID or the Government of Egypt.

B. REFORM AS A STRATEGY

In our preceding chapters we have presented our assessment of the realities of the public sector. We believe that there has been reform in the industrial sector and that there have been specific accomplishments toward rationalizing the public sector. In addition our interviews with key individuals and our analysis of the reform effort to date lead us to conclude that this effort is evolutionary in nature and proceeding at a more rapid pace than is generally recognized by USAID.

It is also our conclusion that support of the public sector is essential for private sector development. For example, private investors expressed to us the fear that AID withdrawal from the public industrial sector could ironically backfire against the private sector. If the public sector physical plant decays to such an extent that it is no longer capable of producing the country's needs, they argue, the private sector may face increased pressure and control and even nationalization. Therefore, excessively emphasizing elements of a strategy which preconditions assistance to the public sector on an ill defined "significant reform" of the public sector may have a negative impact on USAID's ability to achieve its objectives as an organization.

Our interviews indicate that this approach to reform has inherent weaknesses. First of all, from the Egyptian point of view it is politically unsound. An industrial strategy that does not effectively deal with the public sector will divorce USAID from a powerful constituency group (company chairmen and Government officials) whose assistance is critical to any successful approach to a private sector development strategy.

Secondly, the approach is perceived as confrontational by the Egyptians regardless of the manner in which USAID may state its case. Should funds be cut off at this time for future public sector projects, USAID will have effectively removed itself from a leverage position, even though it may maintain some presence through projects already underway.

There is no effective way that USAID can "quietly" remove itself from the sector without the GOE being aware of it and negatively reacting to it.

Third, the quid pro quo approach to USAID assistance may have appeal as a leverage mechanism to some but in reality we believe it will actually be counterproductive. The Egyptians have internalized the need for reform, and any open movement on USAID's part to condition its assistance to reform may be a political setback for those Egyptians who have pursued reform by making it an "Egyptian" issue. Reform of the Egyptian public sector must never be viewed as a USAID effort. This point has been made in the USAID CDSS and has been substantiated by our own assessment of the situation.

Fourth, a strategy which bases assistance on the condition of reform may force USAID into a position where in effect it cannot carry out its intentions. Unlike some other donor agencies, the USAID program is political as well as economic — a fact known to the Egyptians. Therefore, if it is true that there is a certain overall level of assistance which must be provided to Egypt, then shifting USAID funds from public sector industry to another "acceptable" sector in reality only becomes a financial shell-game with all its attendant frustrations, mis-spent energies and lack of results.

Finally, having a strategy that places structural reform as a specific goal or objective has a tendency to focus USAID internal management energies on an issue which at best can be only marginally influential and at worst is politically damaging to the USAID program. These managerial energies are thus distracted from pursuing other issues such as disbursement of obligated funds and establishing an effective issue oriented dialogue with the Egyptians. In summary, having a general strategy for economic development in Egypt which heavily emphasizes reform as an objective places USAID in a tenuous position of advocating an ideology and preferred methods rather than focusing on end results. USAID in our opinion must position itself better before it embarks on seeking structural reform.

C. AN ALTERNATIVE ROLE FOR USAID

Our assessment in Phase I of this project, and our interviews in this second phase lead us to conclude that USAID can plan a more effective role in assisting the Government of Egypt to make its industrial sector more effective in contributing toward growth, equity and stability of the economy.

In developing program options for support of the public sector in Egypt we believe that USAID should operate from a new organizational framework which:

- Defines its role as a donor agency in clearer terms vis-a-vis Egypt's industrial sector
- Establishes a general strategy for fulfilling its role which has specific goals and objectives
- Develops a more comprehensive role in structural reform which uses mechanisms other than conditional aid.

As a donor agency, USAID can play an important part in the industrial sector. As we pointed out in our Phase I report, USAID in relation to GOE and other donor agencies was capable of providing a significant part of the financial resources in hard currency necessary for rehabilitation of capital equipment. However, problems arose in distributing those resources partly because USAID was unclear what role it was trying to fulfill.

In terms of future involvement in the industrial sector USAID may wish to define its role as that of financial intermediary. Thus it can perform a function the GOE and other financial institutions cannot or are unwilling to fulfill at the present time. This role may be defined as a catalyst for change which focuses on a major problem concerning the use of long term capital for investment. The role is described in more detail in the program option section of this report. However, the financial intermediary role places USAID much closer to two groups who are central to industrial development, the bankers and the chairmen of public and private sector companies. If USAID can define its role as a bridging mechanism for these groups, it can play a part no one else at the present time is able to carry out.

Our second point is that as USAID better defines its role in the industrial sector, it should also develop a clearer strategy for fulfilling that role. For example, we suggest that the current industrial annex to the CDSS should be more specific in terms of goals and operational tactics. Though policy reform is an admirable intent, more specific accomplishments should be stated which are consistent with GOE goals, e.g., increasing the capital available used for long term investment. If USAID has no clear operational plan, then the CDSS in effect becomes a list of things to do with no clearly defined approach to carry out the strategy. Additionally, industrial projects such as the Management Development for Productivity, Industrial Technology Application and Vocational Training projects will not be linked in a concerted way and the multiplier effect of those projects will be lost. USAID will thus revert to a "target of opportunity" approach for industrial development. We suggest that the time is opportune for USAID to review the Boston University strategy, enter into a dialogue with GOE and agree on some criteria for its investment.

Our third point is based on comments we made in Chapter Six of our Phase I report. Since USAID is concerned about structural reform, we have suggested that the approach be more broad based. We indicated in that report (and emphasize it in this one) that USAID should not deal with economic reform based on financial leverage alone. It must instead rely on the other mechanisms we described: economic dialogue, economic information, project selection and coordination with other donor agencies. Our conclusion from both phases of this study is that USAID has not positioned itself in relation to the industrial sector to influence structural reform effectively.

In summary our discussion and interviews with key Egyptian and American personnel lead us to observe that USAID has four basic organizational scenarios it can follow:

1. Focus primarily on structural reform in the Egyptian economy and only provide assistance contingent upon specific reform accomplishments. There would be no specific strategy for development and rewarding reform efforts would be on a target of opportunity basis.

2. Design a strategy for economic development but focus primarily on structural reform which may or may not achieve specific economic results.

3. Design and follow a strategy which aims specifically at achieving economic results and contributes to structural reform.

4. Have no strategy and look for projects as targets of opportunity to invest USAID funds.

As our phase one study indicated, USAID has operated under Scenario 4 until the present time. From an organizational development perspective it is understandable why this has occurred. For a variety of reasons it appears that USAID may be in the process of repeating its past mistakes by emphasizing the structural reform element while ignoring other elements. Essentially it is following Scenario 1. This scenario does not seem to be consistent with statements in the CDSS which seem to reflect more realistically the Egyptian situation.

We suggest therefore that USAID Cairo and Washington refine the current strategy and follow it in a way which achieves economic results which in turn will contribute to structural reform. The following chapter analyzes the Egyptian institutions which USAID could use to implement its strategy.

V. INSTITUTIONAL ASSESSMENT

A. INTRODUCTION

The purpose of this chapter is to assess the potential of various institutions and institutional forms in the industrial sector to act as effective channels of funds or to further other AID concerns discussed previously, including structural reform. Where appropriate (e.g., a new institution), we describe briefly the characteristics of the institution. In view of the particular interest expressed by USAID (in the scope of work) in the banking system as a potentially important channel for USAID funds, a major part of this chapter is devoted to banking institutions. The various institutions considered are:

- Government of Egypt (GOE)
- Ministries
- New institution
- Existing third party institution
- Public sector companies
- Small-scale enterprise fund
- Venture capital firms
- Stock market
- Banking system

B. THE INSTITUTIONS

1. Government of Egypt (GOE)

Obviously, the GOE is a key institution in undertaking structural reform of the economy, but is not dealt with at length here in view of its coverage in earlier chapters. One suggestion put forward within USAID is that for positive movement on such reform, USAID would provide GOE with a global amount of aid for use as GOE saw fit — the "blank check" approach. The probable disadvantages of such a direct approach to structural reform were set out in Chapter III. In addition, we consider that there is no objective way of relating amounts of aid to levels and rates of structural change. In our view the key relationship between USAID and GOE should be one of dialogue and subtle persuasion, bolstered by financial leverage through other institutions rather than directly on GOE.

2. Ministries

There are a number of limitations in respect to the Ministries and their agencies (as distinct from GOE) as vehicles for structural reform or as channels of funds. They are tainted in the eyes of USAID and of some company chairmen with failures to move quickly enough in the past and also are seen to have vested interests in terms of their existing powers (e.g., for investment and pricing decisions) which would be threatened. They also are subject to pressures other than the solely industrial and economic. Finally, demands on USAID management resources would probably be considerable.

It would be unrealistic, however, in the Egyptian economy which is likely to remain heavily committed to the public sector, to expect liberalization of the public sector to the extent that public sector companies would have complete freedom to invest, whether in amount or in terms of investment decision criteria. At best, the companies would be permitted whatever level of investment could be financed from internally generated funds plus a specified level of externally funded investment. Consequently, there is a need to improve the relevant investment skills and the awareness and acceptance of relevant investment criteria within the Ministries in order that obstacles to the operation of USAID modes are minimized.

In view of their economic responsibilities, the Ministries do have a role in furthering the climate for structural reform, though subject of course to acceptance at the highest political level. Here also, therefore, we believe that USAID's relationship should be one of informal persuasive dialogue and provision of persuasive economic analysis (probably linked to existing USAID project assistance). These modes would be designed to strengthen beliefs in reform where they exist and to dispel doubts by demonstrating the impact of existing policies, thereby increasing pressure for reform and maintaining reform as a largely internal process.

3. <u>New Institution</u>

Such an institution would probably take the form of a third party investment bank, which would be independent from both USAID and GOE on a day-to-day basis. Its capital would be provided by USAID and possibly GOE (and potentially, other donors) on an annual basis subject to review of performance and plans at a strategic level. It would operate within strategic guidelines laid down by GOE in consultation with USAID. Desirably, it should lend to both the public and private industrial sector.

The board might comprise key representatives of the Egyptian business and banking community as well as of relevant Ministries or public agencies. At officer level there should be full capacity for project preparation, appraisal, loans and evaluation.

A major advantage would be that a new institution would not be burdened by perceived past failures, whether on the part of GOE or USAID. It could operate flexibly enough to offer a wide range of funding terms and to cope with both public and private sector requirements. In dealing with both sectors, it would offer a useful forum for a dialogue on further structural reforms.

The bank would be able to take equity positions in enterprises without raising the political difficulty of ownership by the U. S. Government. Finally, once established, a third party institution might be expected to minimize demands on USAID management resources. Demands might be further reduced if existing AID modes were rationalized and channelled through the new institution.

The major disadvantage must be that the institution would be essentially another bank of which Egypt has many. It would be a further drain on scarce Egyptian management resources and considerable time would be required (two to three years) to establish the institution. There would also be a substantial risk that neither GOE nor USAID would in practice adopt a hands off approach.

4. Existing Third Party Institution

There are a variety of third party institutions interested in industrial development in Egyptian industry including:

a) other aid agencies, e.g., IBRD, Arab Development Bank;

b) the Egypt-U. S. Business Council; and

c) the Alumni Association of the National Institute for Management Development.

although (b) and (c) clearly would not be appropriate as channels of funds.

The advantage of using another aid agency would be that it would already be established with relevant institutional capacity and procedures. Channelling U. S. aid in this way would, however, substantially reduce its visibility and would probably reduce the ability of USAID to direct the flow of its assistance to particular sub-sectors of the economy. Nonetheless, such agencies and other third party institutions such as those listed have an important role to play in a two-way dialogue, informing USAID's perception of th current economic scene on the one hand and stimulating the groundswell for continuing reform on the other. Indeed, it may be appropriate for USAID to consider initiating a small, high-level dialogue group, comprising Egyptians aware of the U. S. scene and Americans aware of the Egyptian scene, for the purposes of assessing both economic trends and new initiatives.

5. Public Sector Companies

Public sector companies as agents of structural reform are particularly dependent on the management style and qualities of their chairmen and these vary considerably across companies. Discrete policy changes can only be made by GOE but we have found that there are many ways in which chairmen may institute their own "reform" within existing policies. Thus, for example:

a) one chairman has deliberately undertaken product differentiation in order to set higher prices for the new products than were possible for existing products; and

b) another chairman transfers unwanted employees to undesirable locations in lieu of being able to fire them.

While public sector company chairmen may be seen as part of the existing structure which is to be reformed, it is also true that they are best placed to know the problems of the public sector and to want them changed. USAID could facilitate structural reform through the companies in two ways:

a) when funding projects with individual companies, by seeking to ensure that the company maximizes its opportunities for liberalization within the existing framework, e.g., by product differentiation hence allowing uncontrolled pricing;

b) by a continuing dialogue with chairmen, probably in selected industries, and bringing them together in seminars to exchange experiences, with the aim of stimulating and supporting pressure for reform from inside the public sector. Assurance of financial support to mitigate the impact of change would also be vital — for instance, financing of fuel efficient equipment to meet the challenge of economic electricity prices.

6. Small-scale Enterprise Fund

The Production Credit project incorporates a small-scale enterprise credit component, channelling term lending and some equity participation to small-scale enterprises initially through the Development Industrial Bank. The arguments for such assistance are already documented within USAID and are not repeated here. It is, however, worth noting that such assistance could have important benefits for both the private and public sectors. It could, for instance, finance the smaller feeder industries for the public industrial sector, the prices of their outputs being uncontrolled. It could help in generating a supply of enterprise managers, considerable employment opportunities (since small enterprises tend to be labor intensive and also may be large employers in aggregate) and the establishment of an increasing number of Law 159 companies.

7. Venture Capital Firms

Such firms have already been dealt with for USAID by the PRE Team. They could be firms established independently of USAID or GOE, though subject to regular review of their performance. Their capital could be provided by USAID and their role would be to provide seed capital to new enterprises, in conjunction with other funding sources. They would operate within strategic guidelines set by GOE in consultation with USAID, which would probably include target rates of return.

Such firms could readily be involved with private and public sector companies, where the latter established Law 43 joint ventures or Law 159 subsidiaries. In encouraging the establishment of such companies, these firms would also be encouraging the liberalization associated with Laws 43 and 159. They would have the advantage of being at arms length from, yet visibly funded by, USAID, and their operations could prove to be natural precursors to greater stock market activity through trading in the shares of companies in which they were involved. They would also achieve a multiplier effect by financing only part of enterprises' capital requirements. They would not, however, be appropriate financing or reform vehicles for existing public sector companies per se.

8. <u>Stock Market</u>

The stock market also was examined by the PRE Team, in relation to the private sector. As regards the public industrial sector, the divestiture of public enterprise ownership, through public offerings of shares to be listed on the Stock Exchange, is not thought to be practical given the Egyptian commitment at least to maintain the present size and facilities of the public industrial sector. A provision in Law 111 prohibits dilution of the public share in publicly owned companies. There are anyway a number of other issues which suggest that the stock market is unlikely to be relevant to USAID's industrial strategy in the short and medium term.

Existing middle class investors were badly burned by the nationalizations of 1961 and the memories of these still linger. There are at present a small number of investors, with relatively large fortunes, who could be purchasers of attractively priced shares, if some of the profitable public sector companies were put on the market (though such an approach is very unlikely to be acceptable to GOE). At present, even profitable public sector companies whose shares are partly owned by the public do not constitute an attractive investment medium (in relation to their par value, in view of the relatively small share of their profits available for distribution after provisions for reserves and workers participation. It is a requirement that new share issues have to be made at par value.

Recent changes in the companies law and the taxation law give some tax advantages for corporations to list their shares and for individuals to own them. It will be a relatively slow process, however, to get enough companies into the stock market and in turn to get their shares distributed to smaller investors.

Insurance companies have been relatively active in participating in new Law 43 equity investments and could therefore be significant potential purchasers of shares, particularly in light of the new tax laws which give individuals tax advantages for buying insurance policies, thus increasing potential resources of the insurance companies. From the point of view of divesting public enterprise ownership, insurance companies could constitute a middle ground: while the larger ones are in the public sector, their ownership of public sector industrial enterprises would still constitute some measure of decentralization away from direct Ministry of Industry control.

9. Banking System

The utilization of the banking system as a vehicle for U. S. aid (whether through banks acting individually or in consortium) has a number of attractions. Such an approach would be visibly market oriented and the institutions involved are by definition conversant with the use of banking criteria. They are already established and, subject to strengthening of project appraisal capacity in some instances, could commence lending quite rapidly. Relationships with other institutions, particularly GOE, are also in force. International banks, which may prove important for financing of joint ventures are already established. Finally, their flexibility as institutions offers considerable benefits: they could readily deal with public or private sector companies, could take equity or loan positions and in many instances are used to doing this, and could offer other necessary business facilities, such as foreign exchange transactions. It must be said, however, that the role of the banks would be one of smoothing the path of agreed structural reforms and not one of initiating them.

There are a number of cautionary points, however. Even if funds were available in the banking system, public sector companies would not apply for them unless the terms were right, in their view. Subsequently, if a loan were taken up by a public sector company which was then unable to service the loan, there may be a political difficulty of foreclosing on such a company (though this would apply to any funding option and could be obviated through a loan guarantee scheme).

It would be necessary to ensure that loans for funds provided by USAID were not simply substituting for loans which would have occurred in the absence of USAID, although since there is relatively little term lending at present, this is unlikely to be a problem. Adequate project appraisal capacity would also be essential. It would be desirable to select those banks willing and able to take a sufficiently positive approach to seek out investment opportunities and package them prior to financing. Oversight of bank lending would be required to ensure that banks were themselves credit-worthy and also that they did not lend to poor risks, simply because it was aid money they were lending or because a loan guarantee existed.

C. DETAILED REVIEW OF THE BANKING SYSTEM

Turning now to a detailed review of the banking system, it should be noted that no other branch of economic activity has been as profoundly changed by the "Open Door" policy. After a previous transformation in the Nasser years from private ownership and operation to state ownership and control, Egypt's banking system has become a mixed system in which private banks are playing an increasingly important role in the saving, credit creation and investment processes.

1. <u>The Structure of the New System</u>

At the present time, the chief agency of control and regulation is the Central Bank of Egypt (CBE). The CBE is expected to perform the duties of a modern central bank, implementing monetary policy and regulating the commercial banks under its control.

The core commercial banking sector is composed of four public sector banks: The National Bank of Egypt, The Bank of Alexandria, Banque Misr and Banque du Caire. These banks comprised the state system before 1974, but since then the number has grown to more than 80 commercial and investment banks, including representative offices of foreign banks. Besides these banking institutions there are about a dozen investment houses, pension funds and insurance companies.

2. <u>Roles and Effectiveness</u>

The intent of this section is to describe briefly the purposes and focus of the main agencies or groups of institutions in the Egyptian banking system, and to assess their effectiveness in achieving these desired ends.

a. The Central Bank of Egypt

The CBE was established in 1961 from the issue department of the National Bank of Egypt. At that time its responsibilities included holding government deposits, acting as a financial agent of the government and issuing notes. With the proliferation of banking institutions after 1973, new regulatory powers were required. Through a number of legal measures, including amendment of the Banking and Credit

Law 163 (1957), the Central Bank of Egypt and Banking System Law 120(1975), Law 43(1974) as amended by Law 32(1977), the CBE is charged with the responsibility of controlling the volume and price of credit and regulating banks doing business in Egypt. To achieve these purposes certain policy devices are available, including control of:

1. lending and deposit rates of interest,
2. reserve requirement ratios,
3. liquidity ratios,
4. loan/deposit ratios, and
5. foreign currency reserve requirements.

Since only the last of these controls applies to foreign currency, Law 43 and the foreign branch banks doing business in foreign exchange are in practice largely outside of the range of direct control of the CBE. Their only direct CBE constraint is a 15% reserve requirement on foreign currency deposits. They receive interest on these CBE deposits at rates close to LIBOR, so this constraint is not a costly one.

Concerning management of the LE supply, all of the operating ratios above are massive and cumbersome tools of policy. A fairly small change in one of these can create or destroy millions of pounds worth of lending capacity and the money supply. The CBE has no device for making marginal, smoothing adjustments in credit outstanding. In fact, open market operations, the most useful and versatile of all the conventional tools of policy, are conspicuously absent from the CBE's list of policy instruments. There is no secondary market for government securities nor rediscounting mechanism through which the CBE might trade in order to regulate commercial bank reserves and lending capacities.

In fact the CBE can scarcely be said to operate a cogent monetary policy, for it is in practice the handmaiden of the Ministry of Finance. Whatever its declared purposes may be, it has in practice become an agency for monetizing government debt. According to IMF statistics, during the four years between 1975 and 1979, government received LE 11,760 million and spent LE 19,008 million, thus producing a cumulative deficit of LE 7,248 million. During the same period, CBE claims on central and local government rose by LE 4,690 million. The inference is that in Egypt government deficits are financed largely by selling debt to the central bank. When the government sells debt to the central bank and spends the proceeds, new money is pumped into the economy and, if this method of finance is persistently followed, inflationary potential is accumulated. In Egypt, the habit of financing growing deficits by money creation is building a dangerous potential for inflation that is presently masked by price and resource allocation controls.

From 1975 through 1979, for example, CBE claims on government grew at a compound rate of 42.3% a year, while the monetary base (commercial bank reserves plus currency outstanding) grew 23.8% a year. When we note that during the same period real GDP grew at the rate of 8.4%, there is evidently a large potential here for inflation. During the period commercial bank demand deposits grew 24.5% a year, while savings, time and foreign currency deposits grew at a compound rate of 44.8% a year. The rise in the deposit rate banks are allowed to pay on pound deposits doubtlessly accounts for much of the increased attractiveness of quasi money, as well the fact that a rising share of these quasi money deposits is in the form of foreign exchange deposits on which rates are not controlled by the central bank. The growth of this kind of liquidity means that the CBE's control of the money supply is very imprecise and that a growing pool of liquidity is overhanging the Egyptian money market. Should the system be liberalized to the extend that conversion of quasi-money into LE transactions balances becomes attractive, a substantial expansion in spending could be fueled. By 1981 the IMF estimate of M2 had reached LE 12.8 billion, of which transactions money was only LE 6.3 billion.

The present modus operandi of the CBE does not lend itself to coping with inflationary pressures in a market economy, nor does it hold much promise at present for serving as an efficient channel for USAID funds. Potentially, a CBE rediscount window and securities trading desk could be appropriate official outlets for intermediate term USAID funds, combining efficiency and rapid disbursement with minimal call on USAID management resources. In view of its history and bureaucratic orientation, we suggest that in practice the CBE would be a difficult partner for USAID in innovative financial experimentation.

b. Public Sector Commercial Banks

With the complete nationalization of the banking system in 1961, opportunities for financial innovation and modernization virtually disappeared. Between 1961 and 1974, consolidation reduced the commercial banking system to the four key institutions mentioned above. By the early 1970's each had been assigned specialized lending functions. The National Bank of Egypt specialized in foreign trade, the Bank of Alexandria in manufacturing loans, especially to the private sector, Banque Misr concentrated on financing domestic trade and some agricultural finance, while Banque du Caire specialized in lending to public sector companies. In addition to these commercial banks, there were specialized banks established to deal in mortgages, social security funds and credit to the cooperatives. Nominally presiding over this institutional framework was the CBE, which by the late 1960's, had become essentially the government's paymaster for public sector enterprises. By the 1970's, public sector financial decision-making prerogatives were concentrated in the hands of the Ministry of Economy.

Clearly, in this kind of financial environment banking innovation was difficult, if not impossible. In practice, the banking system was the instrument of the state for controlling general economic activity. The tendency toward lending specialization may have produced some scale economies and fostered narrow expertise in specific lines of commercial banking, but it also denied bankers the opportunity of gaining experience in diversified banking operations that are the hall mark of modern "supermarket" banking. Thus Egypt entered the era of liberalization with some constraining institutional deficits.

Although there are perhaps some residual deficiences remaining today, our meetings, interviews and discussions suggest that competition with the private banking sector is improving attitudes and methods of operation in the state sector. In our view, involvement of the public sector banks in longer term lending to public and private sector industrial borrowers would contribute significantly to the expertise of these banks in project evaluation, to the quality of their information systems and to their operational efficiency in general. Although their present efficiency may be less than that of the private banks, we recommend that the public sector banks be included in any USAID program to increase long term capital formation. Learning by doing is perhaps the best teacher and the modernization of the public sector is clearly served by their inclusion.

c. The Private Banking Sector

Certainly the most interesting and propitious aspect c Egyptian banking and credit is the development of private banking since 1973. The private banking sector is divided legalistically into commercial and investment banking branches, but, as far as the term pattern of lending is concerned, this distinction is of little practical significance. Most of the Law 43 joint venture and branch bankers interviewed said their loans were mostly to finance short term trade, but virtually all said they either had some two to seven year loans outstanding or were considering such transactions. Rollovers, however, appear to be used with growing frequency by both public and private sector borrowers so that medium term lending is larger than reported.

Although only those banks with at least 51% Egyptian ownership may deal in LE, the relative attractiveness of dollar funds means this is no particular disadvantage. Most foreign currency banks are involved in financing public sector imports, as well as those of the private sector.

Under existing regulations, the LE deposit and lending rates of Egyptian commercial banks are kept below competitive levels while foreign branch and joint venture banks are free to set rates on foreign currency denominated funds without restriction. Foreign currency deposits now receive the London bid rate minus 0.25%, while lending rates are LIBOR plus a spread of 1.38 to 2.50%. It should be noted, however, that pound lending rates authorized by the CBE have been raised progressively in recent years. At present, the required minimum rate on commercial loans is 16%, with no upper limit. Other rates authorized by the CBE are 13 to 15% on loans to the service industry, and a maximum rate of 13%, without a minimum, for industry and agriculture. Thus the cost of commercial credit in pounds can now be set by the market, as long as the equilibrium rate is not less than 16%.

While the present mixed currency system serves to attract dollars and other currency earned by Egyptians working abroad, when coupled with the generally poor investment climate it tends also to generate an excess supply of loanable funds. As banks abhor idle balances, funds not utilized in Egypt are transmitted to foreign eurodollar centers. The net claims of local banks on foreign banks tended to grow from 1978 through 1980, although they declined sharply in 1981. Even so, the representatives of the foreign branch banks interviewed were unanimous in their view that there is no shortage of dollar liquidity in Egypt. The evidence clearly supports this view.

Exhibit V-1

Net Claims on Foreign Banks (LE MM)

Type of Bank	1978	1979	1980	1981
Public Sector Banks	832	775	670	-78
Joint Venture and Private	143	207	398	660
Investment Banks	120	98	134	146
Foreign Branch Banks	243	281	261	42
TOTAL	1338	1361	1463	770

Source: Central Bank of Egypt

More than a hint of financial dualism is now apparent in the Egyptian banking system. The development of the private banking sector under Law 43 is changing the structure of the industry, and two distinct elements are now evident:

one resistant to change, defensive and bureaucratic; the other modern, expansive and geared to the world loanable funds market. In the market for foreign currency short term funds, conditions at present closely resemble those described by the competitive industry model. The price of funds is determined by world demand and supply, and the local market takes the price as given. Local borrowers can have virtually all the funds they desire at the world price.

As an institution, the private commercial banks offer the best prospect for channelling USAID funds into productive capital formation. These firms are attune to modern business practices and their market orientation implies that they could provide flexibility and rapid disbursement of funds. It is our impression that there is a collective capacity for project evaluation within the banking community which could be developed, and their links to the international system mean that whatever analytical services are needed can be purchased.

Furthermore, we suggest that public sector commercial banks should be included as funding channels. They are in the process of modernization and their inclusion would stimulate financial development in general. But having noted these favorable aspects, we should also observe that the attitude of the GOE in practice toward funding public sector firms by this mechanism is hard to predict. While several spokesmen for the public sector have assured us that the authorities would not interfere with this approach, we cannot be sure of the official response until it is tried. Even so, our conclusion is that funding through some mechanism involving the cooperation of the commercial banks is so promising that alternatives deserve consideration and experimentation.

d. Islamic Banks

The Koran forbids usury and the Shariah (religious law) construes this to include all interest payments. Profit, on the other hand, is meritorious. Since economic efficiency requires that saving should be rewarded and that capital should be allocated to more productive uses, legal devices have evolved for circumventing this prohibition. One traditional method is the double sale, in which the borrower sells the lender an asset for cash and then immediately buys it back for a greater amount, payable on some future date. The difference in prices is an implicit interest payment for the interim use of resources. Employing similar devices, Islamic banking is a systematic replacement of interest by profit in all financial transactions.

Islamic banks are multi-function institutions that are engaged in both commercial and investment banking. Their earnings are derived from short term profit sharing and medium term redeemable participation in enterprise. When an Islamic bank takes an intermediate term stake in a new venture , the other partners must agree on a suitable schedule for retiring the bank's equity position.

There are three kinds of deposits offered by Islamic banks to the public. Current deposits are not interest bearing, while savings and investment deposits earn dividend rates that are competitive with the current deposit interest rates offered by ordinary banking institutions.

Holders of investment deposits must agree to leave their funds with the bank for at least six months.

It is too early to evaluate the performance of the two main Islamic institutions in Egypt. The Islamic International Bank for Investment and Development, the one visited in connection with this study, has only been in operation since October, 1981. The Faisal Islamic Bank has been in operation somewhat longer and has seen its total assets grow from $38.7mn in 1979 to $197.2mn in 1980. From conversation it appeared that the IIBID is finding that the short term nature of its deposits is restricting its ability to make longer term investments. It also can be noted that only five percent of the Faisal Islamic Bank's deposits were investment deposits in 1980. Thus it may be that some bank liabilities analogous to longer term CDs will have to be offered the public before these institutions become significant suppliers of longer term capital to industry. Like the more conventional banks, these institutions, in the existing economic environment, are not prepared to put a substantial share of their loanable funds into longer term lending. Semantic differences notwithstanding, the Islamic banks in Egypt are in spirit, function and orientation very much part of the private commercial banking system. They, as do the other banks, represent a promising channel for USAID capital.

e. Capital Market Institutions

Although the opening of Egypt to multinational banks has increased the availability of loanable funds, most lending is of a short term commercial nature, provided by public sector banks. The table following is a synthesis of data taken from A. D. Little, Review and Evaluation of Small-Scale Enterprises in Egypt and CBE data. We suspect that these data may not be complete or comprehensive. They are included here only to provide a sense of proportion and a context for discussion.

Exhibit V-2

The Structure of Credit, 1980 (LE MM)

	Public Sector Banks		Private Sector Banks		Total
	Commercial	Investment (DIB)	Commercial	Investment	
Short Term Commercial Credit	5862	18	725	443	7048
Term Loans:					
1 year or less	n.a.	45		386	431
More than 1 year	41	65	52	63	221
Total	5903	128	777	892	7700

These data indicate that most lending (92%) is short term commercial credit and most credit (77%) is supplied by public commercial banks. Of the lending accounted for here, only eight percent is term credit and only three percent is for more than one year. As already noted, however, rollovers most likely increase the real share of intermediate term credit. Nevertheless, banking institutions in Egypt are largely engaged in intermediation that provides for consumption rather than capital formation. Given the thinness of the organized capital market, it should be worthwhile to examine two public agencies which are of central importance in the capital formation process. These institutions are the National Investment Bank (NIB) and the Development Industrial Bank (DIB).

f. The National Investment Bank

The National Investment Bank (NIB) is a conduit and control device for public funds, rather than a bank in the usual sense. Established by Law 119(1980), NIB is part of an attempt to consolidate, rationalize and simplify the system of separate budgets and funds that previously had complicated state finance. Its primary purposes are to finance all projects included in the plan and to monitor the progress of project implementation. Each project has its own account and the system is designed to prevent transferring funds among projects or to current account as has happened in the past. About 60% of NIB's projects are received through GOFI, with the approval of the Ministry involved and the Ministry of Planning. At the present time, NIB has more than 1000 projects in process.

The sources of NIB funds include pension fund collections, postal savings, public company surpluses, state budgetary transfers and borrowings from the National Bank of Egypt. We have been told that any operating deficits are covered by the Ministry of Finance. At the present time, NIB's average interest cost is about nine percent, while its lending rates range from three percent on social welfare projects to 11% on export oriented projects. There is a new list of proposed NIB lending rates which is as follows:

Export industry	6-13 percent
Construction and productive industry	11 "
Social services	6 "
Housing	7.5 "
Land reclamation	6 "
Utilities	7.5 "

Most NIB projects are for one year's duration or less, but some are for as many as three years.

In conclusion, NIB is essentially a funding channel for public sector projects that have survived the bureaucratic decision process involving the Ministries of Planning, Finance, Industry, Economy and Investment. At present NIB funding depends on a fairly narrow circle of public agencies. Foreign assistance funds attached to particular projects apparently pass to NIB through the Ministry of Investment and Economic Cooperation. Although NIB merits consideration as a channel for foreign assistance, there may be too many diverse bureaucratic interests involved for it to serve the particular purposes of USAID at this time. Indeed, a USAID strategy based on funding the NIB would require a great amount of preliminary discussion and compromise, followed by continuous dialogue and conciliation in practice.

g. **Development Industrial Bank**

The Development Industrial Bank of Egypt (DIB) was established in 1975 as a public sector institution and commenced operations in 1976 by assuming the functions and responsibilities for the portfolio of the Special Services to Private Industrial Sector Unit of the Bank of Alexandria. The DIB is wholly owned by the Ministry of Finance, on whose behalf the Central Bank of Egypt exercises considerable control over the management and operations of the DIB.

The DIB provides medium and long term financing primarily to the industrial sector of the economy, but also to non-industrial prospects in tourism and other service industries. It provided financing to the public industrial sector until approximately two years ago. We understand that at most such loans represented some 20% of DIB's lending portfolio, which has diminished to a current level of some 15% since loans are no longer made to the public sector. (Donors generally restrict sub-loans to private sector organizations.) Up until three years ago the various industrial national organizations provided letters of guarantee for loans to public sector companies. Following the dissolution of these national organizations, such guarantees were no longer available. We understand that the DIB has suffered some difficulties with repayments from public sector companies and that rescheduling is undertaken in preference to more drastic action.

Interest rates vary, from 14 to 16% currently, depending on the type and scale of the borrowers. Donors are said to specify minimum but not maximum rates of interest to borrowers. There is apparently considerable demand for DIB loans at the interest rates charged. Effective interest rates are somewhat above those quoted since borrowers have to make an interest free cash deposit with DIB. Repayment periods may go up to fifteen years, although twelve years is the normal maximum. Average repayment periods are seven to eight years including a one-to-two years grace period. Security for a loan is preferably a bank guarantee but otherwise a mortgage is taken over fixed assets. Foreign exchange risk is borne by the borrowers.

We understand that DIB has had considerable difficulty in marketing USAID finance to borrowers when other financing has been available.

Equity positions are rarely taken though participations include banks, a leasing company and brick works. Equity participation does not usually exceed 25%, and board membership would probably be required for a stake in excess of 10%. It is not essential that a loan accompany equity participation.

DIB has a substantial project appraisal capacity, although there have been criticisms in the past of bottlenecks and delays on the appraisal process.

Despite very real attractions, DIB is thought to be an unsuitable channel for AID support to the public industrial sector for two reasons:

a) its concentration on private sector financing;

b) its difficulties experienced in past USAID funding.

3. USAID Strategy and the Banking System

The preceding sections point to some conclusions that warrant being kept in mind when considering policy options based on various uses of the existing system. One is that there is a tendency for short term loanable funds to be in excess supply. GOE financing methods, worker remittances and other sources of dollar earnings are generating rapid growth in bank reserves which CBE is continuously striving to keep bottled up by interest rate policy and by its numerous restrictive policy ratios. Excess dollar liquidity has been finding its way into eurodollar deposits abroad.

A second point of importance is that dual nature of the system. We conclude that substantial project research and evaluation capacity reside in the Law 43 banks and the larger international networks they represent. On the other hand, we feel much less confident about the project appraisal capabilities of the more traditional public sector banks. Furthermore, we doubt that the NIB would be useful in its present mode of operation and suspect that management attitudes at the DIB do not lend themselves readily to USAID goals. In any use of the commercial banking system, institutional or contractual features would have to be designed to assure that funds were used in Egypt in conformance with USAID goals and not in foreign currency markets abroad or in undesirable projects in Egypt.

In conversations with the CBE a recurring theme concerned the threat of domestic inflation and the impact injections of USAID capital funds might have on local markets. Stability as well as liquidity concerns are natural and appropriate for central bankers, and any new institutional arrangements for funding capital projects should include consultation with the CBE, as well as the Ministry of Finance.

Furthermore, in our view the CBE represents considerable potential usefulness in future USAID funding policies. Before this potential can be realized, however, CBE needs a larger degree of policy autonomy from the Ministry of Finance than it has at present. Concerning treasury policy, getting government expenditures more in line with revenues would make CBE's control of bank reserves easier and the development of a secondary securities market could make CBE's control activities less abrupt and disruptive in their impact on the general economy. Selling short term securities to the public while buying long term securities, for example, would tend to absorb cash and to release capital funds, thus serving stability and development goals simultaneously. Such operations, however, presuppose considerable freedom from continuous treasury pressure to finance deficits.

Given these considerations, we suggest that careful discussion with the responsible authorities and thoroughgoing evaluation of the institutions involved precede USAID intervention in the capital market. Finally, given the abundance of short term funds and the official concern for inflation, policy should be designed to convert short term funds into long term funds, rather than simply injecting extra liquidity into the system.

D. OVERALL ASSESSMENT

Our assessment of the various institutions suggests that there is scope for USAID to make a multi-institutional approach to support and reform the public industrial sector. The institutional assessment, in the light of the various criteria emerging in the course of this chapter, is summarized in Exhibit V-3.

EXHIBIT V-3

INSTITUTIONAL ASSESSMENT

Institutions / Potential Capability Criteria	Government of Egypt	Ministries	New Institutions	Existing Third Party Institut.	Public Sector Companies	Small Enterprise Fund	Banking System	Venture Capital Firms	Stock Market
1. Generate structural reform	x								
2. Facilitate structural reform	x	x	x	x	x	x	x	x	x
3. Appropriate and efficient channel of funds			x			x	x	x	
4. Flexible channel of funds			x			x	x		
5. Project appraisal capacity		x	x	x (some)	x (some)	x	x	x	
6. Market orientation			x			x	x	x	x
7. Minimal call on USAID management			x (eventually)			x	x	x	x
8. Potential for rapid disbursement of funds		x			x		x		
9. Forum for dialogue/ economic information	x	x	x	x	x				
10. Primarily economic motives			x	x		x	x	x	x
11. Acceptability to GOE	x	x			x	x	x		

x means institution meets criteria

VI. PROGRAM OPTIONS

A. INTRODUCTION

Logically, any program option must include four distinct elements: a mode, a target recipient group, a channel and the terms on which aid is made available. There are several different candidates for each of these elements. Further, a particular selection for one element may be quite consistent with a wide range of selections for the other three. Thus there exist in principle a vast number of possible program options, each with a particular selection for each element.

Exhibit VI-1 illustrates this idea. The exhibit consists of a table with four columns for the four elements that any program option must contain. In designing an option, one would select one or more items from each column. Thus one option might be to use the banking system (channel) to provide preferential-interest loans (terms) for the capital equipment purchases (mode) of Law 43 and Law 159 companies (target). Clearly many such combinations exist, although some would make more sense than others. For example, it would not be reasonable to try to channel funds through ministries to Law 159 companies. The key point to be made here is that, given a strategy, the appropriate selection of the elements becomes possible. Thus the development of a consistent overall strategy is a necessary pre-condition to the selection and effective implementation of a program option.

EXHIBIT VI-1

THE COMPONENTS OF PROGRAM OPTIONS

Modes

- Capital Projects (loan or equity)
- Capital equipment (CIP model)
- Training
  - management
  - vocational
  - financial
- Information/Dialogue
  - feasibility studies
  - economic analyses
  - forums, seminars
  - other donor ties
- Withdrawal from public sector (zero funding)
  - total
  - selective (IPI, CIP, health continue?)
- Export encouragement
- U.S. procedural changes
- One year waiting period

Targets

- Public sector, perhaps conditioned on reform
- Law 159 companies
- Law 43 companies
- Holding companies, e.g., for specific industry
- Specific industries, e.g., feeder industries
- Regional targets
- Infrastructure (alone or coupled with companies)

Channels

- GOE (the blank check approach)
- Ministries (the IPP approach)
- Banking (individual or consortium)
- New fund
- New institution (new third party investment bank)
- Small enterprise fund
- Venture capital firms
- Stock market
- Contractor firms
- Existing third party institution
- Auction funds

Terms

- Equity plus loans
- Loans alone, with or with out preferential rates
- Equity, possibly tempora
- Variable interest rates
- Loans with "creative features," e.g., progre ssive interest rates
- Target interest payments
- Grants
- Maintenance of value requirements
- Loan guarantees

In the specific program options that follow, we have concentrated largely on one element in each as being the key creative feature of the option. This key element might then have associated with it a limited range of choices for the other elements. We find however that AID could frequently have considerable flexibility choosing among the other elements.

We suggest three options for AID's consideration:

- an industrial investment fund
- auctioning funds to the financial system
- an integrated, sectorally-focused program

These are not meant to be mutually exclusive. In designing them, we took into consideration AID's requirements, the conclusions we reached in Chapter III and the criteria listed in Exhibit VI-2. The following discussion describes the goals and operational approach of each option, its advantages and disadvantages, and the degree to which it meets AID's strategic criteria.

EXHIBIT VI-2

CRITERIA FOR SELECTION OF PROGRAM OPTIONS

- Creates capital for long term investment
- Rapid disbursement of funds to productive units
- Forum for economic dialogue
- Adaptable to changed circumstances
- Acceptable to GOE
- Acceptable to target group
- Adaptable to multiple needs in GOE and USAID economic strategy
- Builds capacity to respond to future needs
- Develops linkage between sources and users of capital
- Independent of GOE and USAID operational control
- Strategic in scope
- Facilitates structural reform
- Encourages market signals
- Public and private sector oriented
- Linkage with other donor agencies
- Minimal use of USAID management resources

B. INDUSTRIAL INVESTMENT FUND

1. Goal and Approach

The goal of the program is to promote economic growth and employment in Egypt by providing an industrial finance fund for long term lending, accessible to both the public and private industrial sectors. The fund has two key objectives:

- to provide long term capital for investment by lengthening and leveraging existing liquidity
- to create alternative sources of capital by strengthening linkages between public sector firms and the banking community

Given the process and structure for approving and implementing public sector investment in Egypt, public sector firms have developed little experience with banking criteria, and commercial bankers generally have little understanding of the capabilities and long term investment needs of public sector firms. Borrowing is limited to short term loans for operating expenses, although these are apparently frequently rolled over, disguising longer term loans. As noted previously, the banking community is reluctant to make long term loans, given the perceived risk in the Egyptian environment, historically, and the opportunity cost of funds which could be invested more lucratively elsewhere. By sharing the risk of long term investments, the fund will encourage greater private investment and thus play a key role in introducing and strengthening linkages between the banks and public sector companies. The fund will provide an important learning experience for both parties, while simultaneously maintaining linkages to the private sector.

The creative element of the option is its flexibility. While its key feature is the channel, it can incorporate a wide range of modes, targets and terms. Further, it is dynamic approach, in that it can evolve in a number of directions over time to accommodate the changing needs and interests of both the GOE and AID.

2. Institution

A key to the program's success is that U. S. funding will be channelled through a new, independent, nonbureaucratic fund unencumbered by existing staff or other agendas. As will be elaborated upon below, the fund will not operate as an institution but rather as a flow-through mechanism between AID and financial institutions. It will serve as a complement rather than a competitor to existing institutions such as the National Investment Bank. In time, we expect it to be self-generating, continuing to mobilize capital even in the absence of AID participation.

3. Operation

a. Funding Levels and Sources. The fund should be initiated by a substantial commitment from the U. S., perhaps $50-100 million annually at the outset. The annual commitments could gradually rise to a level of, perhaps, $200 million. The increments would be based upon a review of the fund's performance and the speed of disbursement.

Another factor would be the level of participation by other donors, including the GOE. Advantages of GOE participation include the possible enhancement of a constructive economic dialogue and availability of local currency for lending. Disadvantages, at least at the outset, might be the potential risk of a delayed startup, and the increased com[illegible] of decision-making. Similarly, participation by othe[illegible]teral or multilateral donors, such as the World Bank or Arab nations, poses greater complexity and the loss of a clear U. S. identity, offset by the gain of political neutrality. Joint participation, whether by the GOE and/or other donors, also offers the potential to dilute tied U. S. aid requirements, which have been a disincentive to U. S. loan acceptance in the past. In weighing the advantages and disadvantages of other donor participation, then, AID must evaluate the level of visibility it desires, the problem of tied procurement rules, the complexity of administering the fund, and the potential for policy leverage offered by joint or sole U. S. funding. The key to the fund is precisely its flexibility; it can start off with U. S. funding but be designed to accommodate future participation by other donors, including the possibility of an eventual phase-out of U. S. participation or operation as a revolving fund.

b. Mechanism. The fund will shift as much responsibility as possible, for project creation, appraisal and administration, away from AID and onto existing financial institutions. In other words, the financial sector and the public sector companies, rather than AID, should become the driving force to bring industrial projects to the fund. The question arises, how can banks and public sector companies be encouraged to do so? In order to answer this question, we need to understand the types of risks that are involved.

Bankers face three main kinds of risk. These include the risks of loss through default, interest rate fluctuations and foreign exchange rate changes. Greater default risk is normally associated with longer term loans, so given the uncertain future of Egypt, bankers have good reason to prefer short term loans to long term loans. Concerning interest risk, a banker considering a five year loan must ask himself whether the average interest associated with five one year loans might not exceed the rate he can obtain on the five year loan. If so, he will decline to make the five year loan in order to avoid this loss. Finally, a borrower taking part of a long term loan in foreign exchange that must be paid back in foreign exchange runs the risk that the rate at time of repayment may be less favorable than the rate at the time the loan is made. Although the forward exchange market offers the possibility of hedging, the time duration offered by the market might not be sufficient in the case of long term industrial loans.

Given the term structure of their deposits, then, banks are unwilling to lend long term, since they would then face a large interest rate risk. As a basic principle, we would agrue that economic agents should not be forced to bear risks over which they have no control. Thus it would be desirable for the fund to absorb the risks of interest rate fluctuations, thereby giving banks greater freedom to lend long term. At the same time, banks should be expected to bear default risk, since it is their proper function to judge the degree of risk involved and to decide whether to accept or reject that degree of risk. Since the fund will rely on the judgments of the banks regarding the viability of the projects being funded, it is vital that banks have a strong incentive to do a good job. Bankers we spoke to seemed quite prepared to bear some of this burden, although they appeared reluctant to bear all the credit risk of public sector companies unless they were backed by a Government guarantee. Of course a 100% guarantee would eliminate the risk of default entirely and thereby defeat the purpose. It may be worthwhile to consider a partial guarantee, however. This could be part of a rediscount facility at the Central Bank, which in itself is highly desirable, and which we urge AID to support vigorously.

With regard to companies, we would argue that they should not be asked to bear any interest rate or foreign exchange risk, since they influence neither. The major question here, however, is whether public companies will be permitted to deal in this way with commercial banks. Currently, each public sector company is instructed to do all its investment banking with one of the four major public sector banks. But there is no legal barrier to diversifying to other banks. Further, there is a keen awareness in Egypt today of the need to look for new channels for investible resources. This is, for example, specifically mentioned in the new public sector law. The ability of the fund to leverage additional private funds, we expect, will be so attractive that some loosening up of effective central controls on firms' investment decisions is very likely.

The fund could participate then through three distinct mechanisms, separately or as a hybrid:

(1) The fund could make loans to companies that are cofinanced by banks or other financial institutions such as insurance companies or the investment funds of professional syndicates. A participating bank, which was itself extending a loan or equity participation to a project, would present a project to the fund to meet additional foreign exchange or local currency needs. The cofinancing institution would thus be supplying both financing (and therefore sharing the risk) and professional judgment as to the project's viability. The latter is especially important given the fund's intended minimum staff.

As argued earlier, it is critical that the default risk be shared by the fund and the bank throughout the period. Any percentage sharing ratio is possible: bankers we spoke to are in principle willing to take 50% or more. The interest rate risk would be borne by the fund. Bankers seemed somewhat unwilling to accept terms of longer than seven years; to allow for this, the banks could receive all their repayments in the earlier maturities, while the last few might accrue exclusively to the fund.

(2) The fund could provide all of the needed funds for an industrial project loan in the form of a term deposit with

the bank. This approach thus reduces the liquidity risk of banks traditionally reluctant to tie up their funds for long term lending, while the bank faces all of the credit risk in return for the potential income from the term deposits. Like the first mechanism, this approach minimizes the management drain on the fund and AID by relying on the project appraisal capability of the bank or other participating financial institution.

(3) As a variant of the second mechanism, the fund could place tranches with selected banks with guidelines for the types of investments that would be permissible. In other words, rather than waiting for a bank to come forward with a specific project, as in the second approach, the fund would deposit a sum in advance of any specific project ready for funding. The proposal might be attractive to banks, in that they would receive a block of funds at once, and poses the least administrative burden for the fund, but has the possible disadvantage of reducing the fund's control over project selection and timing. To prevent speculation a commitment fee should be charged on unused funds.

c. Management. Two approaches are possible for managing the fund, which will operate independently of any existing Egyptian institution. The fund could be managed by a skeleton staff consisting of a Director and Assistant Director, each with previous banking experience, and appropriate clerical support. Alternatively, management of the fund could be contracted out to a professional financial management firm such as an international investment banking house. In either case, the fund would be audited by an independent accountant who would monitor disbursements, and advised, e.g., on contractual arrangements, by an outside attorney. The staff or contractor would be responsible for management of the funds, i.e., treasury operations, if the first or second options were chosen.

In either case the fund would be overseen by a board of directors composed of five to seven Egyptian and American bankers, government representatives and members of the business community, rotated on a staggered basis every two years. It should be emphasized that the fund must operate independently. The function of the board would be to establish and review policies and guidelines for the fund, to review the fund's effectiveness periodically, and formally to approve loans, already evaluated by the banks.

d. Eligibility. The financial partners (or recipients of term deposits) should include a representative mix of public and private banks, including foreign branch banks and Islamic banks. Other financial institutions such as insurance companies and pension funds could participate directly or belong to syndicates managed by banks.

Projects eligible for loan or equity assistance would include capital plant modernization and, in the case of new or spinoff companies, new facilities. To encourage structural reform, or as a rationing device should the demand for the use of the fund exceed its availability, the Board may wish to consider guidelines such as:

- high economic rate of return
- Law 43 status
- Law 159 status
- industries in which Egypt has comparative advantage
- companies in a sector in which price controls have been lifted
- companies in a sector in which private entry has been liberalized
- labor intensive industries
- companies participating in an experimental management autonomy program
- joint public/private sector industrial projects
- companies whose managers have participated in financial and management training programs
- feeder industries to a sector deemed significant

The Board may wish to allocate a fixed proportion (say, 50%) of the funds to public sector companies (including companies outside the jurisdiction of the Ministry of Industry[1] and the remainder to private or joint venture companies, or alternatively allocate the funds on an open basis. The risk of the latter is that large public projects could quickly absorb all the fund's annual capital, unless a ceiling per loan were applied. Another approach would be to earmark all funds, at least for the initial years, to a particular sector, such as food processing or building materials. A proportion of the funds could be earmarked for small enterprise; the small enterprise portion of the Production Credit Project, for example, could eventually be incorporated within the fund.

e. Terms. The banks or participating financial institutions would pay a fee for the use of the fund contribution, perhaps the Central Bank's maximum industrial rate less a spread sufficient to attract bank participation. The borrower would be lent, in turn, the fund contribution at the CBE rate or less, depending on whether concessional rates are necessary to attract borrowers given the costs of tied U. S. aid. A progressive interest scheme might be effective, especially for new businesses, in which borrowers pay 75% of the CBE the first year, 80% the next, and so on, until the full rate is reached. The fund would make up the difference. This system imposes interest rate risk on both the borrower and the fund, given the fluctuating CBE band, which is undesirable. As an alternative the fund could charge a fixed rate, with a gradually increasing fixed schedule of rates for the first five years. A ten year repayment schedule, with a two year grace period, is envisioned (consistent with the Production Credit Project).

The fund may wish to target some of the interest repayments (e.g., 2% out of a 12% rate) for a particular purpose, such as vocational training, or accounting or management assistance. Such peripheral programs imply, of course, a more extensive staff than the skeletal version envisioned at the outset.

4. Advantages

The fund approach offers a number of advantages:

- Flexibility to incorporate a number of donors, financial mechanisms, recipients and to accommodate changes over time
- Increases ties between the banking system and public industrial firms, which will be increasingly important as public sector firms create spinoff joint ventures
- Leverages and lengthens liquidity for industrial projects
- Encourages greater investment from the capital market
- Shifts the burden of project review and management from AID to the financial system
- Creates the basis for future reform leverage and policy dialogues
- Potentially strengthens links between AID and other donors
- Could evolve into a mechanism that could consolidate other AID programs such as the unspent portion of the PIE fund and the small enterprise portion of the Production Credit Project
- Could become a revolving fund and hence a permanent source of investible resources
- Has the potential to coordinate with other AID programs such as the Management Development, ITAP and Vocational Training programs

5. <u>Disadvantages</u>

- Startup time may be marginally longer than would be required by direct funding of banks
- Depending on the size, composition and vested interests of the board of directors, there could be potential infighting over criteria, etc.
- An excessively complex weighting scheme for rationing funds could bog down the disbursement process or be a disincentive to bank participation
- Without concessionary interest, at least in the early years of repayment, participants may not be interested, given the added costs of tied aid
- AID insistence on reviewing every transaction (despite its intention of a hands off policy) could destroy the fund's effectiveness, making industrial participants as disillusioned with the fund as some now are with other AID industrial programs
- Because projects will be screened through banks, financial rate of return will undoubtedly be an inherent criteria. Thus, some socially desirable projects with low financial rates of return may be screened out before even reaching the fund.

6. <u>AID Criteria</u>

<u>Structural Reform of Public Sector</u>. Projects could be funded in liberalized sectors (such as building materials). The introduction of public sector companies to the commercial banking system will encourage autonomy.

Private Sector Support. The fund will be accessible to private sector industrial projects, and could encourage joint venture spinoffs or ventures under Law 159.

Appropriate Institutional Arrangements. The fund will rely on the expertise and capability of proven financial institutions, without setting up a bureaucracy of its own.

Economize on AID Management Resources. The fund, by shifting responsibility for evaluation and loan management to banks, will conserve AID resources.

Rapid Disbursement of Funds. The fund approach ensures a rapid disbursement, particularly if disseminated among a number of banks.

C. AUCTION

1. Goals and Approach

The goals of employing the auction process are to disburse capital resources quickly to the industrial sector of Egypt for use in long term investments at least cost in terms of scarce USAID management resources. Through design of the approach to be followed, it should be possible to encourage the liberalization of the public sector and the development of the private sector.

The basic approach would be for USAID to put up for bidding a supply of non-negotiable venture capital certificates, worth say $100,000 each. These could be convertible in pounds or dollars. USAID could provide the required funds or share in pooled resources with other donor agencies. Bidding would be by invitation only. A variety of bidders could be invited, including public and private sector production units and banks.

To attract Islamic Banks and those adverse to paying explicit interest, there would be no contractual reference to interest payment. Instead, USAID would specify when periodic payments for a successfully bid certificate would fall due, but bidders would specify the annual amounts they propose to pay. In stating its terms for bidding, USAID would make clear that a successful bidder's payment stream should include venture capital dividends as a return on USAID's commitment of resources to Egyptian enterprise.

The wide range of choice available to firms in determining the size distribution of the payment stream permits each to take into account the length of the project gestation period, start up costs, break even points and such matters that are best known to entrepreneurs and specialists in production. Each proposed pattern of payments, however, implies a particular compound yield to maturity which USAID would calculate and use in determining which bids to accept. Alternatively, USAID could choose an appropriate discount rate and calculate the present value of each proposed payment stream. Using either method a suitable cutoff point would be selected below which no bids would be accepted.

2. Institutional Requirements

Assuming that USAID would not wish to be involved directly in the actual auctioning process, some effective institutional outlet would be required. One possibility would be for the fund proposed earlier in this chapter to conduct auctions in addition to its other financing methods. Alternatively, arrangements could be made to have the certificates auctioned by a trading desk established in the Central Bank of Egypt. This would have the advantage of encouraging the involvement of the CBE in marketing operations, which would be constructive in view of the need for secondary markets in both short and longer term securities. On the other hand, we caution that a bureaucratic attitude might make the CBE a difficult participant in innovative financial operations. While we suggest that the possibilities of collaboration with the CBE should be explored, we are not sanguine concerning CBE's usefulness at this time.

Given this appraisal of the CBE, it seems best to rely on the proposed fund or on a trading desk lodged in one of the more reputable modern sector banks which would auction funds on behalf of USAID or a consortium of financial institutions of which USAID would be a member. Such an agency could also provide whatever audit and review services USAID might require. Involvement of the banking community would provide expertise and knowledge of market conditions that otherwise might not be available.

3. Operation

It is quite obvious that any funding method such as the auction process can incorporate an almost infinite combination of alternative rules of action, terms and qualifications. It seems, nevertheless, that there are certain major strategy questions that need to be addressed. These include the currency denomination of the certificates, the procurement problems associated with USAID funds, the distribution of risks among those involved in the auction process and the likely efficiency of the process in terms of the allocation of resources.

Concerning currency, the certificates offered for bids could be denominated in either pounds or dollars, but, since the primary purpose is to put capital funds into the hands of domestic capital users, it seems that the choice should be one most favorable to local industry. It seems reasonable that the certificates should be denominated and paid for in pounds, with the provision that USAID would convert pounds to dollars at whatever rate the bidder is authorized to trade currency.

The problems that are associated with marketing financial resources that are tied to United States procurement are not unique to the auction process as a way of disbursing funds. Since each alternative disbursement method must deal with the problem in its own way, some discussion is appropriate here. It should be noted, however, that this is a complex problem that extends beyond the scope of this study.

In considering procurement in the context of this option, procedural choices depend to some extent on the purposes the auction is intended to serve. If its purposes are to provide a means for rapid disbursement of USAID resources at least USAID managerial cost, then simplicity in operation points to the alternative of letting bidders discount their proposed dividend payment streams until U. S. procurement becomes marginally attractive. If, on the other hand, the purpose is to discover the "pure" return on capital, then two variable bidding might be desirable. In this case, bidders might be asked to propose exchange rates they find acceptable for converting pounds to procurement dollars, as well as their payment schedules. Bidders could then trade one cost against the other in determining their optimum comprehensive bids.

Concerning risk, there are so many variations possible on the theme of risk reduction that, given the present scope of work, perhaps some general assumptions and broad principles will suffice.

We assume that exchange risk can be disposed of either by suitable contractual commitments by USAID to successful bidders, or by hedging through the forward market by the bidders themselves. More important are the default and interest risks borne by banks.

Observation suggests that Egyptian banks are firms that try to maximize profits under conditions of uncertainty. Higher yielding loans and securities tend to be associated with higher risk, so that bank portfolio managers must weigh yields against risk in judging the merits of loan applications. Assuming that the returns on alternative assets are not perfectly correlated, banks can always reduce risk through portfolio diversification. This means lending to a large number and variety of individuals and firms for different terms and in different regions, including abroad. In Egypt at the present time, however, diversification does not include longer term industrial loans, as loan assets are concentrated in short term trade credit and the eurodollar market. One obvious reason is the general climate of uncertainty that discourages longer term lending. Another is the relatively high, if temporary, level of interest rates abroad and the relative risklessness of the eurodollar market. Lack of modern industrial experience perhaps plays a part also.

At any rate, to offset the perceived risks associated with longer lending to industry, USAID might consider including conditions in its auction contracts whereby it shares default and interest risk with secondary lenders in direct proportion to the duration of the secondary lending to which bidders commit themselves.

Banks can also be encouraged to bid for USAID auction funds by offering flexibility in liability management as they respond to changing interest expectations. While it should be desirable for long term lending purposes to provide banks with long payment periods, say ten years, contractual agreements should also include prepayment provisions, by which buyers of certificates could cancel their obligation to USAID by paying off the principal plus a dividend determined by the length of time the buyer had access to the funds and the implied yield initially bid.

Turning next to the question of resource allocation, answers depend in part on one's confidence in the market's ability to produce socially desirable results. Given the structure of prices in Egypt, a strong case can be made for including contractual restrictions on the types of loans or investments for which USAID resources might be used. Restricting bidders to the ultimate production of traded goods would be a simple and attractive stipulation. In addition, liberalization of the public sector could be encouraged by explicitly inviting bids from firms or representatives of sectors that have engaged in competitive pricing, paid incentive wages, introduced new products or permitted the entry of competing private sector firms. In effect, innovative and progressive firms could be chosen and rewarded. Through selection of rate of return cutoff points, USAID could influence the efficiency of resource allocation and by varying the cutoff points among different types or classes of bidders it could provide selective encouragement or reward desirable behavior.

4. Advantages

It seems clear that the auction approach provides several attractive advantages. It should without question achieve the goals of speed in disbursement of funds and low USAID administrative cost. Furthermore, it should provide some extraordinarily useful information about the effective demand for capital in Egypt and it could be conducted with little or no bureaucratic growth. It should have broad appeal, as Islamic institutions need not be discouraged by dealing in interest. Finally, the possibilities for including attractive terms for bidders suggest that in operation the auction process could indeed stimulate capital formation, while encouraging innovation in the public sector.

5. Disadvantages

The primary disadvantage of the auction system is that USAID would have no voice in choosing the specific projects financed by the resources it provides through the auction process. In fact, the nature of the process is such that precise control is not possible. We do suggest, however, that through devices such as those mentioned above, the broad divisions of resource allocation could be strongly influenced. With additional time and thought this objection could be reduced to an acceptable level.

6. AID Criteria

Structural Reform of the Public Sector. Use of selectivity in invitation and acceptance of bids could reward firms for past liberalizing behavior and encourage future innovation. Funds passed through banks to firms would increase linkage between public sector and the commercial banks.

Private Sector Support. The auction process would increase the supply of long term funds available to the private sector.

Appropriate Institutional Arrangements. The process would require a minimal addition to bureaucracy and would rely on the project evaluation and other elements of expertise in the banking community.

Economize on AID Management Resources. This is one of the major attractions of the auction process.

Rapid Disbursement of Funds. The auction process should provide for extraordinarily rapid disbursement.

D. STRATEGIC INDUSTRIAL FOCUS

1. Goals and Approach

This option is bolder in concept than the other two. Essentially it would focus a significant amount of integrated USAID resources (financial, training, technology, information) on one or more specific sub-sectors of industry which would be chosen because they represent the core of an Egyptian economic growth strategy. It may relate either to the basic industrial development of the country or to the building up of its internationally competitive industrial strength.

In this respect we note that influential Egyptians see the development of their country on narrow lines moving from the raw materials existing in Egypt to the finished products that they may eventually export. In contrast, as the Boston University report mentions, the "Far Eastern pattern" of development has shown how, for a country with a large, educated labor force the assembly of parts produced elsewhere in the world may be profitable. Moreover, it becomes possible to forge a backward linkage to manufacture equipment and a forward linkage to produce modern consumer goods. This approach in a country like Egypt ought to complement the need to develop the basic industrial sectors of industry.

The goals of this option therefore would be to:

- reduce the balance of payments deficit
- increase employment
- increase export share of GNP
- increase industrial growth

This would be accomplished by USAID assisting the GOE in developing and implementing on an incremental basis a long term economic growth strategy. One condition of the success of this option is to make a considerable effort, at a very high level, to discuss with Egyptian authorities the usefulness of the "Far Eastern pattern" of development which should parallel the strengthening of the country's key basic industries. It would involve a broad range of aid from economic studies to significant amounts of capital. All would be integrated and focused on a particular sector initially and could gradually expand to others.

2. Institution

A central feature of this option would be the appointment by the president of a task force composed of a limited number of high level U. S. and Egyptian businessmen, experienced in the development of export-oriented industries in a developing country context. This panel would be expected to play a vital role in a wide variety of areas such as advising on export promotion and the pursuit of overseas markets or in the identification of potential constraints to growth and suggestions for their avoidance.

A professional Secretariat would be required to coordinate activities and to liaise between participating institutions. It would, however, be kept to a minimum level of staff, making use of independent professionals for much of the work involved in this option (including the detailed analytical and appraisal work).

To be efficient, this option should be backed by a significant amount of assistance — several hundred million dollars. Provision of the aid would take place through a number of channels. Thus, funding could in principle be routed through the public or private sector banks and/or through the NIB and DIB though we have remarked elsewhere on the inadvisability of using these last two institutions. In fact the target is more important than the channel in this option.

3. Operation

The approach has two fundamental thrusts:

a) a focus on manufactured export or import substitution industries within a coherent economic strategy; and

b) the provision of aid on an integrated basis.

Focus

We consider that USAID should move rapidly to follow up the Boston University study with the aim of improving data in those areas where it was remarked as being weak, in order to establish more conclusively the comparative advantage of Egyptian manufacturing. While that is happening USAID should enter a policy dialogue with GOE at the ministerial level intended to demonstrate the compatability of GOE economic goals, the Boston University report recommendations and this strategic industrial focus approach to provision of U. S. aid.

This process need not take unduly long in our view. In order to further USAID industrial support as rapidly as possible, however, we suggest that there is a need to move concurrently with establishing the framework for an economic strategy as proposed above. USAID should as an act of faith consider the provision of aid to one or more of the industries of the type listed in the Boston University report as being ones in which Egypt has comparative advantage. Essentially these were either based on local raw materials, especially those which are costly to ship and therefore natural for import-substitution (such as cement and vegetable oils) or on intensive use of labor (such as micro-processors or ready-made garments).

Such a pattern of development should take place in an internationally competitive environment which, for certain products, may not require a domestic market, but for others, may comprise an important home market presently filled by imports.

We believe that this approach offers a potential driving force for economic growth.

Integrated Approach

One obstacle to the efficient delivery of aid is that it is generally spread over a variety of different modes. Thus, for example, at present there are four general USAID programs devoted to increasing productivity, bettering management and modernizing technology (i.e., IPI, ITAP, VTP and IPP). In our view, by concentrating these components in an integrated way on a selected industry or enterprise (or even to a project within an enterprise) the contribution of each of the components may be enhanced and the efficiency of U. S.

assistance much increased because all the facets of the aid would be applied together on the same project in a very practical way: for which ever industry or industries USAID focused upon, the supply of equipment would be integrated with technical assistance to improve management and productivity to the standards required to use the equipment most efficiently.

The aid to a particular industry could also be expected to generate activity in feeder industries. The inter-relationship of industries and sector might be expected to lead readily to identification of other industries requiring assistance, e.g., to remedy "bottleneck" situations. Both public and private sector enterprises should be eligible for aid. While USAID funding might be concessional initially, rising annually to a market rate, it is unlikely in the short term that GOE be expected to dismantle its structure of interest rates differentiated by type of industry. Consequently, negotiations would be necessary on which projects would be financed by whom within the overall industrial focus.

4. <u>Advantages</u>

Such an approach would be welcomed by GOE so long as it did not lead to unbalanced growth in the economy as a whole. Depending on the industry, it could meet Ministry of Finance desire to enable public enterprises to change their product mix and achieve greater price flexibility and profitability. Looking ahead some years, if USAID were to withdraw, it would leave behind a capability for assessing the total resource needs of an industry (physical, financial, information and human) and more importantly a key change of emphasis in economic policy.

As mentioned earlier, a comprehensive integrated and focused approach is likely to be more effective than a "targets of opportunity approach" and could also have an important demonstration effect for other industries. Further, it could well achieve the most economic use of existing assets.

We consider that the option offers a direct and effective way of linking aid and structural reform. The approach proposed would give the Egyptian industry a sense of the international economic life and could enable more competitive pricing, more efficient staffing practices, abandonment of subsidy, and the public and private sector to compete on equal terms. Alternatively, movement in these areas could be part of the criteria for selecting the industry to be assisted. Finally, the approach is compatible with the consensus goals of USAID and GOE of seeking improved balance of payments and increased export share of GNP, employment and industrial growth.

5. Disadvantages

There is concern within USAID at the relatively poor track record to date of aid to particular industries. We suggest, however, that the particular emphasis of this option, i.e., meeting a particular manufacturing need within an industry and applying integrated aid to it, offers greater potential for success than failure, especially if, before the choice is made a careful study of the industry or sector has been undertaken.

It may be argued that there are differences in social, economic or political culture between Egypt and the Far East which render inappropriate the focus we propose. We do not imagine that Egypt would follow an identical economic path to those of the Far Eastern economies but suggest that the approach put forward would point the Egyptian economy in the right direction for a successful evolution.

6. USAID Criteria

To sum up this approach in relation to specified USAID criteria:

Facilitate Structural Reform. This option offers potential to facilitate structural reform whether by incorporating liberalization in the industry selection criteria or by enabling product differentiation to occur and hence price flexibility to be achieved.

Promote Private Sector. This would be facilitated either directly through assistance to private sector companies or indirectly, for instance, by enabling public sector companies to establish joint venture companies or by aided public sector activity generating activity in feeder industries.

Channel of Funds. As mentioned, the target of aid in this option is more important than the channel of funds. A government-to-government grant may be appropriate if the highest levels waive the bureaucratic procedures. Otherwise this option ought to use the banking system.

USAID Management Resources. The option would require a limited staff for the board of directors Secretariat, but the demand on USAID management resources would be minimal, by concentrating administration on the Secretariat, independent contractors and other existing agencies.

Rapid Disbursement/Obligations of Funds. This will act as a criteria to choose the appropriate channel of funds described above.