PD-AAU-127

INTERNATIONAL DEVELOPMENT COOPERATION AGENCY

AGENCY FOR INTERNATIONAL DEVELOPMENT

WASHINGTON, D.C. 20523

PROJECT PAPER

EGYPT: Private Enterprise Credit
(263-0201)

July 30, 1986

PROJECT DATA SHEET

[illegible] Republic of Egypt

[illegible] Near East [03]

2. PROJECT NUMBER [263-0201]

5. PROJECT TITLE [Private Enterprise Credit]

[illegible]CT ASSISTANCE COMPLETION (PACD) MM DD YY [09 30 91]

7. ESTIMATED DATE OF OBLIGATION (Under "B:" below, enter 1, 2, 3, or 4)

A. Initial FY [86] B. Quarter [2] C. Final FY [88]

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant)	(80,000)	( )	(80,000)	(235,000)	( )	(235,000
(Loan)	( )	( )	( )	( )	( )	(
Other U.S. 1.						
2.						
Host Country		3,676	3,676		44,118	44,118
Other Donor(s)						
TOTALS	80,000	3,676	83,676	235,000	44,118	[illegible]

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH CODE 1. Grant	2. Loan	D. OBLIGATIONS TO DATE 1. Grant	2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	2. Loan	F. LIFE OF PROJECT 1. Grant	2. Loan
(1)						80,000		235,000	
(2)									
(3)									
(4)									
TOTALS						80,000		235,000	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	N/A						
B. Amount							

13. PROJECT PURPOSE (maximum 480 characters)

To expand investment of productive private sector enterprises, including a broad range of activities in manufacturing, agri-business, and service industries such as tourism and health.

14. SCHEDULED EVALUATIONS

Interim MM YY [03 88] MM YY [ ] Final MM YY [03 90]

15. SOURCE/ORIGIN OF GOODS AND SERVICES

[X] 000 [ ] 941 [X] Local [ ] Other (Specify) ______

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ______ page PP Amendment)

Implementation plan and method of financing are included in this project paper and meet with FM's approval.

Concurrence: AD/FM, for Terrence J. McMahon

17. APPROVED BY

Signature

Title Frank B. Kimball
Director, USAID/Cairo

30 JUL 1986

Date Signed MM DD YY

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION MM DD YY

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UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

PROJECT AUTHORIZATION

Name of Country: Arab Republic of Egypt

Name of Project: Private Enterprise Credit

Number of Project: 263-0201

1. Pursuant to Section 531 of the Foreign Assistance Act of 1961, as amended (the "Act"), I hereby authorize the Private Enterprise Credit Project (the "Project") for the Arab Republic of Egypt ("Cooperating Country") involving planned obligations not to exceed Two Hundred Thirty-Five Million United States Dollars ($235,000,000) in grant funds over three years from the date of authorization, subject to the availability of funds in accordance with the A.I.D. OYB/allotment process, to help in financing the foreign-exchange and local-currency costs of goods and services required for the Project. The planned life of project is approximately five years from the date of initial obligation.

2. The Project will assist the Grantee to increase the private sector's contribution to Egypt's productive output by: (a) expanding investment of productive private sector enterprises in areas such as manufacturing, agri-business, service industries, mining, transportation, communications, tourism, education, health and land reclamation; and (b) financing the importation of raw materials, intermediate goods and capital equipment.

3. The Project Agreement, which may be negotiated and executed by the officer to whom such authority is delegated in accordance with A.I.D. regulations and delegations of authority, shall be subject to the following essential terms, covenants and major conditions, together with such other terms, covenants and conditions as A.I.D. may deem appropriate.

A. Source and Origin of Commodities, Nationality of Services

Commodities financed by A.I.D. under the Project shall have their source and origin in the Cooperating Country or in the United States, except as A.I.D. may otherwise agree in writing. Except for ocean shipping, the suppliers of commodities or services shall have the Cooperating Country or the United States as their place of nationality, except as A.I.D. may otherwise agree in writing. Ocean shipping financed by A.I.D. under the Project shall, except as A.I.D. may otherwise agree in writing, be financed on flag vessels of the United States.

B. Requirements Precedent to Disbursement

The Grant Agreement shall contain requirements precedent that provide in substance that the Cooperating Country shall furnish to A.I.D. in form and substance satisfactory to A.I.D.:

(1) A statement of the names and titles, of the persons who will act as the representatives of the Cooperating Country, together with a specimen signature of each person specified in such statement;

(2) An amendment to the Memorandum of Understanding regarding the Special Account providing that Twenty Million Egyptian Pounds (LE 20,000,000) of the amount currently on deposit in the Special Account shall be made available for use by the Small-Scale Enterprise Credit Guarantee Facility.

(3) For the Project Finance Facility Component, evidence of formal approval by the General Authority for Investment and A.I.D.:

(a) of subloans under the Private Investment Encouragement Fund (A.I.D. Project No. 263-0097) totaling at least Ten Million U.S. Dollars ($10,000,000);

(b) that funds will be provided for co-financing sub-loans with Participating Banks and that such funds will be managed by the Participating Banks as agents; and

(c) of the continuation of the Advisory Board, established under Project No. 263-0097, to review sub-projects, recommend their approval or disapproval, and monitor the implementation of the Project Finance Facility.

(4) For the Private Sector Commodity Import Program, an acceptable circular or other official document issued by the Ministry of Planning and International Cooperation (MPIC), as jointly agreed upon by MPIC and A.I.D., setting forth in necessary and sufficient detail terms and conditions applicable to loans made under such component.

C. Covenants

The Grant Agreement shall contain covenants in substance as follows:

(i) The Grantee shall undertake periodic discussions, not less than once a year, with A.I.D. and private sector business groups, such as the Egyptian Businessmen's Association and the American Chamber of Commerce in Egypt:

(a) To assess performance of project credit components and discuss ways to improve operating procedures; and

(b) To discuss further financial intermediation efforts that could be undertaken to facilitate growth of the private sector.

(2) (a) Grantee will establish a Special Account in the Central Bank of Egypt and, except as the parties may otherwise agree in writing, deposit therein currency of the Government of the Arab Republic of Egypt in amounts equal to proceeds accuring to the Grantee or any authorized agency thereof as a result of the sale or importation of commodities financed hereunder or as the repayment of loans under the Project.

(b) Funds deposited in the Special Account pursuant to this Agreement may be used for such purposes as are described in the Memorandum of Understanding Regarding the Special Account, dated June 30, 1980, as amended.

(c) Deposits to the Special Account in local currency will be made in accordance with payment procedures agreed upon in writing by the parties or described in circulars issued by the Grantee.

(d) The Grantee shall make such deposits at the highest rate of exchange prevailing and declared for foreign exchange currency by the competent authorities of the Arab Republic of Egypt.

(e) Any unencumbered balances of funds which remain in the Special Account upon termination of the assistance program shall be used for such purposes as may, subject to applicable law, be agreed to between Grantee and A.I.D.

(f) The Grantee will maintain and use fully, in monitoring Special Account deposits and balances, the accounting system developed and installed in fulfillment of Requirement Precedent 3.2(a) under the Fiscal Year 1984 Commodity Import Program.

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(g) The Grantee will exert its best efforts to reach agreement with A.I.D., as soon as practicable after execution of this Agreement, on an amendment to the Memorandum of Understanding regarding the Special Account to include Egyptian pounds to be generated under the Grant.

(3) The Grantee shall create an administrative system, satisfactory to A.I.D., that will facilitate implementation of the Small-Scale Enterprise Credit Guarantee Facility. The system shall include, inter alia, criteria for selection of banks to participate in the Small-Scale Enterprise Credit Guarantee Facility; Facility operational criteria and procedures; and, a framework for maintaining accounting records of all Facility transactions. Grantee and A.I.D. shall jointly review the performance of the Facility and decide policy and procedural modifications on a semi-annual basis.

(4) A.I.D. and the Grantee will jointly approve the selection of banks to participate in Small-Scale Enterprise Credit Guarantee Facility.

Frank B. Kimball

Frank B. Kimball, Director
USAID/Egypt

Date July 30, 1986

MJW
Drafter:LEG:MWilliams, A/SLA

Clearances:

AD/DPPE:GLaudato: GRC Date 7/24/86
AD/FM:FMiller: [illegible] Date 7/29/86
AD/IS:RvanRaalte: In draft Date 7/24/86
OD/FI:JSuma: [illegible] Date 7/29/86
IS/FI:JWatson: In draft Date 7/24/86

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IV: Government of Egypt:

Ministry of Economy:

Mr. Sultan Abu Ali, Minister
Mr. Mohamed Ghazali, Private Investment Encouragement Fund, Secretary
Mr. Fahri Makki, PIE Fund Economic Consultant

Ministry of Planning & International Cooperation:

Mr. Kamal Ahmad El-Ganzoury, Minister
Mr. Ahmad Abdel Salam Zaki, Administrator of the Department for Economic Cooperation with U.S.A.

Private Investment Encouragement Fund Advisory Board

V. Support Staff:

Ms. Sahar Bibawi, USAID/Cairo
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Ms. Phyllis I. Bozzelli, AECWA Contractor

Executive Summary

The Private Enterprise Credit (PEC) Project evolved out of two previous projects and a series of private sector and Egyptian banking system studies. The main thrust of the project is to increase the private sector's contribution to Egyptian productive output, while at the same time expanding investment of productive private sector enterprises. PEC is expected to be an improvement over its predecessors and is, inter alia, intended to further expand agent banks' management and administrative responsibilities, and thus reduce USAID/GOE involvement in the sub-loan approval process. It also aims to help improve the institutional capabilities of the banks and encourage them to deal with a new type of borrower to whom the banks have been previously reluctant to extend financing.

PEC will provide $235 million in U.S. foreign assistance to the Egyptian private sector over a five and one-half-year Life of Project essentially in the form of: short-term credit to finance the importation of raw materials, and intermediate and capital goods; medium and long-term credit for plant start-up, modernization and/or expansion; and funds for the capitalization of a new small-scale enterprise credit guarantee fund, under the following components.

1) Project Finance Facility: This component provides $117,337,000 for medium and long-term credit for plant start-up, modernization and/or expansion, and is essentially a modified version of the Private Investment Encouragement Fund (PIEF), established in 1979 by AID and the GOE's Ministry of Economy.

   The Project Finance Facility (the modified PIEF) will be set up under a co-financing arrangement with selected Egyptian participating banks that serve as agent/managers for the facility. The PIEF Advisory Board, reinstated in March 1985, presently reviews and monitors PIEF project activities, and recommends approval/disapproval of sub-loans to the Ministry of Economy, which has responsibility for project implementation. This Board will continue these activities under the PEC Project.

2) Private Sector CIP (Commodity Import Program): This component provides $117,337,000 in short-term financing to private sector companies for the importation of raw materials, intermediate goods and capital equipment from the United States. This facility is an outgrowth of USAID's efforts to meet the short and medium-term credit needs of the Egyptian private sector. These efforts began with the Private Sector Commodity Import Program in 1977 and continue under the Production Credit Project (PCP) launched in 1982.

   Over the past four years, PCP has provided a total of $87 million for short-term credit activities and $1 million for technical assistance, training and studies. The project was designed to help meet the financial needs of productive private sector enterprises. Funding under PCP is provided through ten public and private sector participating banks under the guidelines of General Circular No. 1, issued by the Ministry of

Planning and International Cooperation. Suggested modifications to the Production Credit Project described in an evaluation conducted in December 1984 and the findings of the April 1985 Term Credit Assessment Report, plus the recommendations in a March 1986 draft report prepared by the Regional Inspector General/Audit, Cairo helped form the basis for PEC's Private Sector Commodity Import Program. Further refinements to the program will be undertaken as needed through amendment to the operating circular.

3) Small-Scale Enterprise Credit Guarantee Fund: The third Private Enterprise Credit component, the Small-Scale Enterprise Credit Guarantee Fund, is a new program facility intended to facilitate the access of small-scale enterprises (SSE's) into the formal Egyptian banking system. This component is based on USAID/Cairo's June 1985 report on small-scale enterprises, and upon discussions with GOE officials, and public and private sector banks.

   The objectives of the Small-Scale Enterprise Credit Guarantee Fund include:
   a) Increasing the amount of SSE lending within Egypt;
   b) Broadening the financial services provided by the Egyptian banking industry; and
   c) Establishing a permanent credit guarantee fund as part of the Egyptian banking system.

   The Small-Scale Enterprise Credit Guarantee Fund is being offered to allay banks' fears of defaults by small-scale enterprises by providing partial repayment of loan principal and thus reducing the risk shouldered by commercial banks in lending to these firms. The Fund will be initially capitalized by the Special Account in the Central Bank of Egypt and, subsequently, with the reflows from the Project Finance and Private Sector CIP facilities. It is expected that, by creating this Fund, participating banks will lower their collateral requirements and simplify loan application/approval procedures for SSE's, thus making credit more accessible to these smaller borrowers.

   Management of the Credit Guarantee Fund will be the responsibility of a bank to be selected by USAID and the GOE's Ministry of Planning and International Cooperation (MPIC). Clear guidelines for SSE lending will be prepared to facilitate Fund management. In addition, the USAID/MPIC will: review the Fund's performance, discuss policy and procedural modifications, and modify the target group and client lending limits.

Project Objectives: As stated earlier, USAID plans to use the PEC to increase the private sector's contribution to Egyptian productive output, while expanding productive private investment. USAID hopes to achieve these objectives by reducing obstacles to the operation and establishment of private enterprise in Egypt through the use of incentives.

For example, there is limited term credit available to private enterprises within the formal Egyptian banking system. Without acceptable credit, private sector companies find it difficult to start up, expand or upgrade plant operations. Through PEC's Project Finance Facility, USAID can support selected Egyptian banks in making term credit available to the private sector.

Another barrier to the day-to-day operations of Egyptian private companies is the shortage of foreign exchange for operating purposes. PEC will provide a source of foreign exchange for private sector needs via its Private Sector CIP so that private companies can obtain the needed raw materials, and intermediate and capital inputs to conduct normal operations.

To help increase Egyptian bank lending to small-scale enterprises, the Small-Scale Enterprise Credit Guarantee Fund is being established. This Fund encourages banks to lend to small-scale enterprises, and concommitantly persuades them to lower collateral requirements to these borrowers.

By overcoming some of the obstacles to establishing and operating private enterprises, especially those relating to credit and foreign exchange availability, Private Enterprise Credit will assist the private sector to better function in the restrictive, government-controlled Egyptian environment.

Obligation Data: A description of PEC's planned obligations by fiscal year follows. For a projection of expenditures by fiscal year, see Section II, Table 3.

Illustrative Obligation Plan

	Private Sector CIP	Proj. Finan. Facility	Evaluations/ Audits	Total
1986	$ 50,000	$ 30,000	---	$ 80,000
1987	57,337	57,337	$ 326	115,000
1988	10,000	30,000	---	40,000
Total	$117,337*	$117,337*	$ 326	$235,000

* It is expected that all project funds will be obligated by end of year 3.

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I. PROJECT RATIONALE AND DESCRIPTION

A. Project Rationale

1. Development Problem

a. Private Sector Role

If Egypt is to advance economically, then the Egyptian private sector must take a larger role in economic development; Egypt is still in transition from a highly centralized, regulated economy to a mixed economy where public and private sectors cooperate. In recent history, Egypt's economy has been marked by radical changes rather than gradual evolution. In the first half of this century, the economy was controlled by private owners, many of whom were foreigners protected by colonial laws. In 1952, the Nasser coup started a new era, but within a decade political and economic tensions resulted in massive sequestration of industry, insurance and banking owned by Egyptian and foreign citizens. Egypt moved rapidly towards a socialistic, highly-controlled economy. However, the government could not afford its political and economic aspirations. The economy lost efficiency: investment in infrastructure and industry decreased; maintenance was neglected; production dropped; power failures increased; even irrigation canals became choked with weeds and contamination.

The Open Door Policy of 1974 marked a sharp turn towards a mixed economy. Egypt reopened its doors to Arab and foreign investment under a new, liberal foreign investment law developed with Ford Foundation assistance. The government encouraged Egyptians to invest in private sector activities and undertook many liberalizing reform measures.

Today, some people criticize the rate of progress. Certainly, Egypt's rate of progress does not compare with countries like Korea and Taiwan in similar 10-year periods. There are many deterrents to rapid liberalization, but they require major expenditures of funds (e.g., rebuilding of physical infrastructure or significant changes in attitudes of government bureaucrats who are paid relatively poorly and who feel that business is a right sanctioned by government). Constraints to faster expansion of the private sector are being addressed, in various degrees, by the Egyptian Government. Progress, however, may continue to be slow because of the magnitude and types of changes required. Some constraints remain:

-- Price distortions caused by government-decreed pricing which give incorrect signals to businessmen and consumers. Energy prices are substantially below world prices and affect production decisions. Foreign exchange rates undervalue machinery purchased abroad relative to domestic labor, thus distorting capital/labor ratios and leading to a misallocation of resources;

-- Regulations that pervade business. Businessmen cannot operate without government permission: imports, exports, investments, and some prices changes all require government permits. Permits are slow in coming for several reasons: regulations are unclear, bureaucrats make arbitrary interpretations which require time to appeal, applications often languish in processing, etc.;

-- Infrastructure, needing rehabilitation, slowing the pace of business. The lack of adequate telecommunications and postal delivery results in hand-carrying messages that, in turn, exacerbates clogged transportation networks. A lack of water and electric utility connections, reduces production efficiency; and

-- Credit available in only limited forms. Short-term loans in local currency to well-known traders with adequate collateral are available. However, long-term loans particularly for establishment of new industrial projects are difficult to obtain.

A key requirement for continued expansion of private sector participation is the availability of credit. The banking system is constrained making it difficult for borrowers to locate certain kinds of credit. The first constraint is the availability of foreign exchange. The government maintains a multi-tiered exchange rate system, with the highest cost foreign exchange going to the private sector. Access to foreign exchange by private entrepreneurs and business is through the "own" market which is characterized by periods of great volatility, brought about by artificial constraints, such as the recent and well-publicized crackdown on private money changers by the GOE. Uncertainties regarding foreign exchange are clearly an impediment to the private sector. The establishment of a unified market rate for foreign exchange is a matter of constant discussion among the GOE, IMF, and donor agencies. Many analysts assert that the GOE's maze of various mandated exchange rates produces only an impression that foreign exchange is unavailable. USAID foreign exchange rate discussions with the GOE have been the major policy dialogue issue related to this project (see Section I.2. AID Policy Issues).

A second constraint is the banking system's preoccupation with obtaining excessive collateral to support loans, thus preventing most small-scale businesses from borrowing. The banking system is collateral-conscious because bankers may be held liable for loan losses and will not be promoted if losses occur. Small-scale entrepreneurs often lack the 180-200% of loan amounts in land, buildings and fixed assets required as collateral. Supplemental to a reduced collateral requirement, a new guarantee system can more efficiently cover bankers' risks because it will eliminate difficult problems of valuation of assets, foreclosure, etc.

A third constraint is the Central Bank's interest rate structure for loans. First, the Central Bank has decreed different nominal loan rates according to economic sectors: Industry and agriculture pay 11-13%, small farmer credit 14%, service sector 13-15%, and the commerce sector minimum 16% with no upper limit. This rate structure was supposed to expand industrial and agricultural investment with lower loan rates. It has, however, had the opposite effect: bankers prefer making high profit commercial loans to low profit industrial and agricultural loans. The 11-13% rate on industrial loans does not cover banks' cost of funds if their source of funds is from one-year savings deposits with an effective cost of 13.3% including mandatory 25% reserve requirements (see Annex E-3, Table 2). It is not clear why the government persists in this policy. Second, the Central Bank does not differentiate between interest charged for short and long-term loans. Banks do not receive

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higher interest rates to compensate for higher risks associated with longer-term loans. Thus, banks have no incentive to lend for longer periods and prefer 30 to 90-day loans. Banking statistics indicate that about 85% of all loans are one year or less. Therefore, the Central Bank's decreed interest rate structure is contradictory: it encourages short-term commercial loans and discourages long-term industrial loans, hardly the prescription for economic development. Consequently, it is relatively easy for a well-established trading company to find a 90-day working capital loan in Egyptian Pounds. In contrast, the industrial company looking for a multi-year, foreign exchange loan to expand production will find few interested bankers.

This project attempts to lead banks to lend on a longer-term basis to encourage establishment of new plants and expansion or modernization of existing plants. It increases private sector enterprises' access to foreign exchange. It will also establish a guarantee system for small-scale entrepreneurs, thereby increasing their access to bank credit. In addition, it can contribute to a policy dialogue that seeks changes in the financial and banking systems.

b. <u>Demand for Funds</u>

Demand for funds has become a major question, given the increase in the foreign exchange rate to the Commercial Bank Incentive Rate (December 1985: LE 1.36 = US $1.00) from the previous project rate of LE 1.00 = US $1.00. Although the Bank Incentive Rate provides a substantial 25% discount from the free market rate (December 1985: LE 1.85), this rate may not provide a sufficient enougn discount to compensate borrowers for additional costs of tied AID procurement. The critical variable in calculating demand for AID funds involves an assessment of the real cost to borrowers imposed by AID's U.S. source/origin requirements. The underlying economic concept which determines this relationship is comparative advantage. With some products, the U.S. has a significant comparative advantage. Even at the present free market rate, Egyptians continue to purchase U.S. equipment and supplies (e.g., computers and polyethelene). There are other products with which the U.S. has a low comparative advantage and Egyptian businesses may not want to import U.S. products even at below market exchange rates. For many Egyptian businesses, there is the question of competitiveness and suitability of U.S. equipment and supplies. In a project such as this, however, it is necessary to formulate a single foreign exchange rate which will cover a broad band of U.S. goods with some degree of comparative advantage.

To improve our understanding of demand for AID funds at the Commercial Bank Incentive Rate of exchange, the Mission conducted two types of studies. The first study was based upon results of a questionnaire used to poll Production Credit Project borrowers. The second study examined changes in the exchange rate of the U.S. dollar against the currencies of Egypt's five primary trading partners, taking into consideration the differences in inflation rates among the countries.

These studies substantiate the conclusion that U.S. products are overpriced in the Egyptian market. Annex H presents the methodology utilized in each study and the statistical data compiled.

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2. AID Policy Issues

a. Country Development Strategy Statement

The Private Enterprise Credit Project conforms to the Country Development Strategy Statement (CDSS) for FY 1986, which lists development of the private sector as one of five focal areas in the strategy outline approved by the Administrator. The Industry Sector Statement, included in the CDSS, anticipated a level of funding of $95 million for Production Credit in FY 86, with similar amounts planned for FY 87, 88 and 89. This project, with a life of project funding of $235 million over the period FY 86-91, is well within these boundaries of anticipated assistance to the private sector. In addition, the CDSS states explicitly that private sector initiatives appear to be most feasible through intermediate credit institutions, augmented by a short-term credit program. Updates to the CDSS, and Congressional Presentations prepared since 1984, have continued to emphasize USAID's intent to strengthen the private sector in Egypt by increasing its access to short and intermediate-term credit.

b. Economic Policy Dialogue

Over the past ten years, economic reforms in Egypt have moved unevenly and very slowly. Reform measures and other actions have often been implemented in a fragmented and piecemeal fashion. The cost of continuing the slow paced reforms of the past (as measured by the balance of payments) has been a deficit of $1.3 billion, financed by a drawdown in reserves of over $500 million, with the remainder not paid (implicit rescheduling) in 1984/1985. The result has been a $32.5 billion debt level. Further deterioration to a $2.0 billion balance of payments (BOP) deficit is projected for 1985, with a parallel growing, unmanageable debt burden. In response to the worsening in Egypt's BOP gap and deterioration in other monetary and fiscal balances, the Mission has intensified its efforts to engage the Egyptian government in an economic policy dialogue.

Many of the points in the economic policy dialogue agenda proposed by the GOE, are closely related to improving the climate for the private sector in Egypt. Progress in lowering the budget deficit and BOP gap likely would, over the long run, reduce the inflation rate and Egyptian pound depreciation, two factors which presently impact negatively on the private sector. One policy dialogue agenda item specifically calls for a number of measures the GOE can take to support faster growth of the private sector. Progress on this item will mean more opportunities for private sector involvement in marketing and distribution services initially and a much greater participation in manufacturing activities in the future.

The PEC project will support the macroeconomic dialogue by providing needed credit to the private sector, using a market-oriented cost of capital. The terms and conditions of credit made available under this program will be directed at counteracting existing Egyptian regulations that discriminate against term lending to the private sector. As the macroeconomic dialogue proceeds and its recommendations are implemented in the form of more market-oriented exchange rates and interest rates, the PEC program can adjust

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its lending terms and conditions accordingly to lower the implicit subsidy element. Funding under this project can be phased down (and out) as credit markets are freed from GOE domination.

c. Foreign Exchange Rate Applicable to Project Transactions

The choice of an appropriate foreign exchange rate was an issue for the preceding Production Credit Project (PCP) and to a lesser extent, the earlier Private Sector CIP Program. This occurred because Egypt, like many less-developed countries, has an overvalued official exchange rate. Foreign assistance is valued at that rate. The more the official rate differs from the market rate, the greater the problem of resource misallocation. In an attempt to avoid that problem, the $20 million add-on to the Production Credit Project was changed from the official rate of LE 0.84 = $1 to LE 1 = $1. However, a problem persists due to the continued deterioration of the Egyptian Pound (LE).

In December 1985, the Production Credit Project (PCP) provided U.S. imports to the Egyptian private sector at a rate of LE 1 = $1. The free market rate was LE 1.85 = $1. If an importer gained access to PCP funds, he paid LE 10,000 for $10,000 of U.S. imports. If he lacked access to PCP financing he most likely purchased non-U.S. goods and/or equipment. However, assuming a need for U.S. imports and the absence of PCP, then he paid LE 18,500 (LE 1.85 = $1). Clearly, if two importers imported the same commodities from the U.S., and one purchased free market foreign exchange at LE 1.85 = $1 and one used PCP at LE 1 = $1, then the importer with PCP funding received a significant benefit. To some extent the advantage would be offset by the extra local currency costs associated with AID-financed transactions that are not levied with free market transactions (e.g., proforma invoices, obtaining appropriate price quotes, supplier certifications, etc).

The 1984 PCP evaluation found that on average, the higher cost of buying in the U.S. was in the range of 20-30% depending upon which commodities are imported. Since December 1984, the U.S. dollar has fallen 8-12% against all major European currencies. In addition, during the last year, U.S. inflation remained low; the wholesale sale price index has shown almost no increase. Thus, the extra cost for U.S. source has probably declined since 1984.

Since AID is interested in improving Egypt's economic performance, project imports should be priced at their true scarcity value. Unless there are additional costs, use of an overvalued exchange rate results in a net benefit in terms of resource transfer to Egyptian importers. This differential is offset to some extent by source and origin requirements. To the extent that there is a net foreign exchange benefit, the effective cost of capital to the private sector is artificially reduced. This, in theory, provides an incentive to invest in projects with lower than desirable rates of economic return. It also may encourage inappropriate capital intensive investments resulting in lower output, employment and growth than would otherwise occur. When offering foreign exchange at lower than market rates, AID may allocate it on a basis other than price. However, first-come first-served allocation (or any other technique) will probably lead to an inefficient portfolio of investment projects.

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Egypt's public sector industries suffer from uneconomical price controls, poor management and inefficient production technology. These negative factors are offset in part by subsidies and access to cheap capital and cheap foreign exchange. Even with these benefits, they earn less than a 2% return on their capital investment. For the most part, AID's private sector strategy is designed to demonstrate that Egypt can benefit from an efficient and competitive private sector. The private sector should not adopt the uneconomic practices of the public sector. A generalized exchange rate subsidy which lowers the effective cost of capital for the private sector is not an economically desirable feature.

For a more detailed description of the foreign exchange rate issue and the analysis undertaken by USAID to determine an appropriate rate, please review Annex E-3.

When the original Production Credit Project (PCP) was designed in 1982, the free market or "own" exchange rate was approximately 20% higher than the official rate. As the PCP was implemented, the spread between the official and free market rates steadily increased. By the end of 1984, the free rate was 35% higher than the official rate. A spread that could be defended as appropriate to offset U.S. source and origin requirements at the outset of the project was exceeded.

The 1984 PCP Evaluation recommended that future programs reduce the foreign exchange differential. When the USAID Mission negotiated in March 1985 the follow-on $20 million project, the Project's foreign exchange rate was set at LE 1 = $1. Simultaneously, the Commodity Import Program's rate was set at LE .93 = $1. With the free rate at LE 1.30, project resources were only 23% less than the free rate (0.3 divided by 1.3 = 23%).

However, by October 1985, when the $20 million was ready for disbursement, the free rate was LE 1.65. Project resources were 39% less than the free rate. If the free rate continues to rise, the benefit will be greater.

The following conclusions can be drawn:

-- To the extent that there is a major exchange rate differential, the effective cost of capital is reduced. Private sector importers, who receive an allocation, receive a substantial benefit. With "low" priced capital imports, there may be a tendency to invest in projects that are not economically sound and hence, the Egyptian economy will suffer;

-- While this differential is offset to some extent by U.S. source/origin requirements, it does not appear likely that an exchange rate differential of more than 20 to 30% can be justified; and

-- There is no way of predicting what the free rate will be in the future; consequently, the uncertainty makes a fixed rate inappropriate.

Since the project will make disbursements over a 3-4 year period, the key requirement is flexibility. The project's foreign exchange rate should move with the free market. Otherwise, there is a danger that the rate selected for AID's tied procurement will create further market distortion.

There are two ways to provide flexibility: (1) tie project exchange rates to an existing flexible rate such as the fluctuating Commercial Bank Incentive Rate, or (2) set the project rate in relation to the free rate. The PEC project will utilize the bank incentive rate for its two components.

Use of Commercial Bank Incentive Rate

The Commercial Bank Incentive Rate was LE 1.36 = $1 in December 1985. This rate shares common sources of supply with the free rate and has been changed from time to time in response to changes in the free market rate.

The Commercial Bank Incentive Rate is administratively set by the Central Bank and the leading commercial banks. Since many public corporations and agencies use this rate, there is an incentive for the Central Bank and the GOE to keep it low. Both private and public sector purchasers should use a market-oriented rate to avoid distortions in the economy. A potential problem could arise if the GOE allows the spread between the commercial and free rates to widen (then project imports would be priced too cheaply) or if the gap narrowed (then U.S. goods would be too expensive and project disbursement would drop).

For a discussion of alternative project foreign exchange rates, please turn to Annex E-3.

d. Interest Rate

In order to encourage effective development efforts, capital must be appropriately valued. For importers under this project, the effective cost of capital is determined by the foreign exchange rate and the interest and fees charged for financing the imported equipment and materials.

The Private Sector CIP and Project Finance facilities will provide imports and related short-term and long-term credit. The PEC project will use Central Bank of Egypt interest rates. A trade sector credit will have a nominal interest rate of 16-18% and an effective cost (when additional charges are included) of 22-28%. For industrial and agricultural sector credit, the nominal interest rate will be 11-13%. The Private Sector CIP Facility effective rate is 21-23% and the Project Finance Facility effective rate is 20-22%. With inflation running around 20%, these interest rates appear to exceed the inflation rate and therefore represent a positive interest rate. As discussed in previous sections, Central Bank of Egypt (CBE) regulations discourage longer-term industrial lending. Banks are able to earn a more favorable return on short-term loans.

Rational resource allocations require interest rates sufficiently in excess of the rate of inflation to effectively ration capital and to stimulate saving. As compared to short-term credits, longer-term credits face more uncertainty and therefore should be priced at a higher interest rate. In Egypt they are not. This issue, however, is not one which can be resolved in the context of

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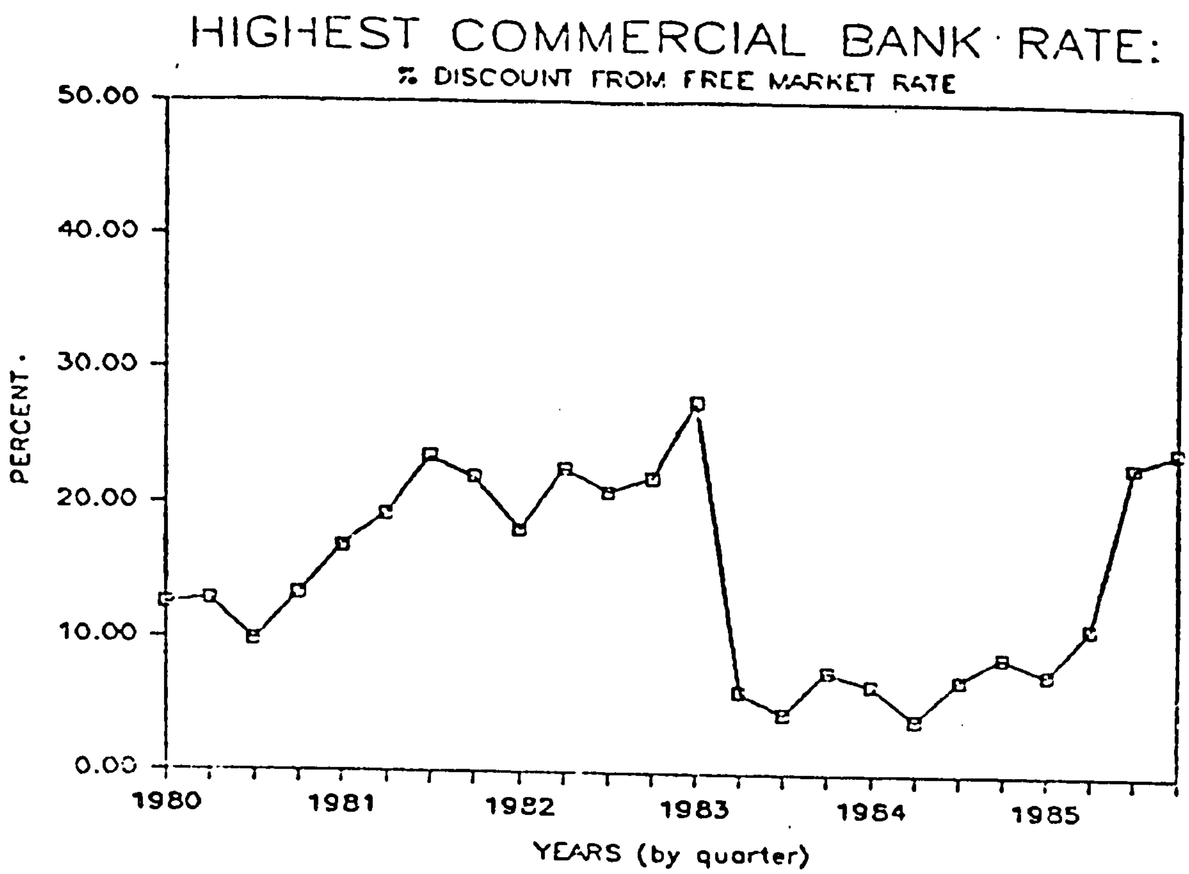
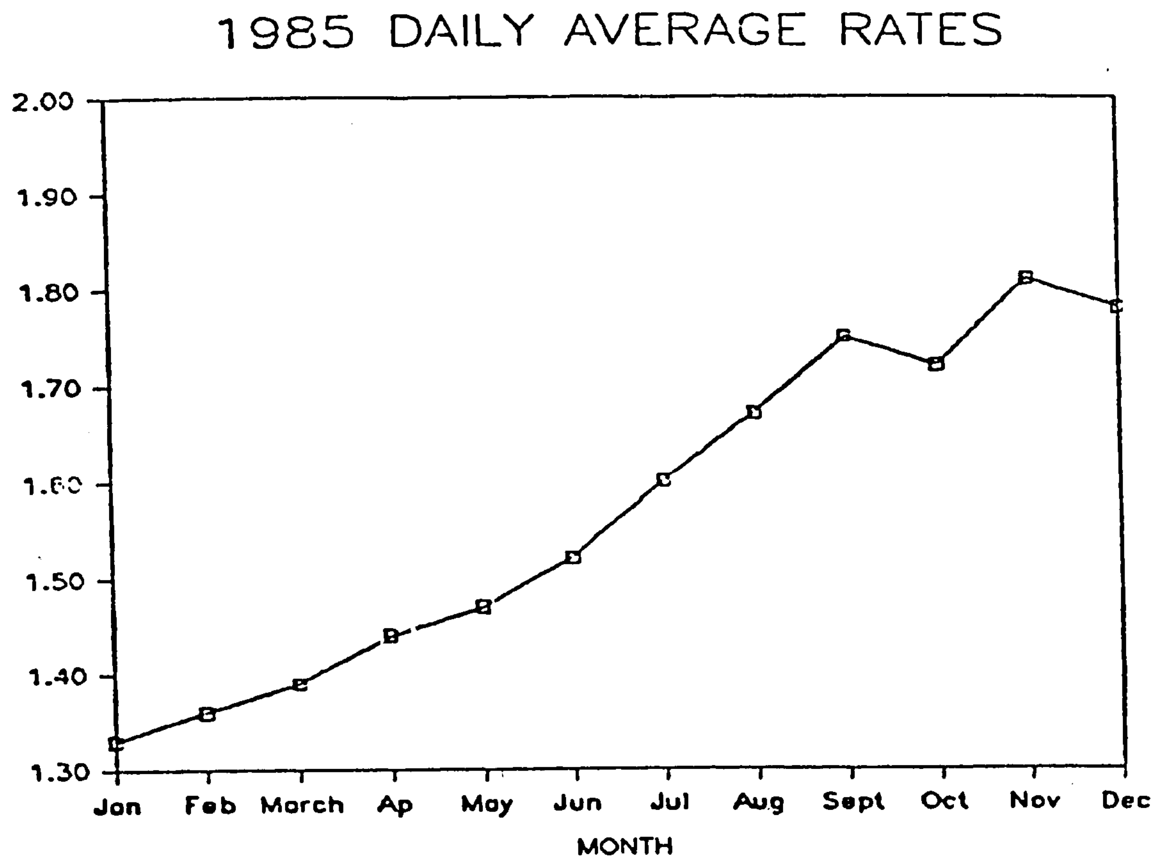


Years (quarter)		Free Market Rate	Highest Commercial Bank Rate	Discount
1980	Q1	0.800	0.700	12.5
	Q2	0.803	0.700	12.8
	Q3	0.776	0.700	9.8
	Q4	0.807	0.700	13.3
1981	Q1	0.842	0.700	16.9
	Q2	0.867	0.700	19.3
	Q3	0.915	0.700	23.5
	Q4	0.982	0.766	22.0
1982	Q1	1.015	0.832	18.0
	Q2	1.075	0.832	22.6
	Q3	1.052	0.832	20.9
	Q4	1.066	0.832	22.0
1983	Q1	1.150	0.832	27.7
	Q2	1.150	1.080	6.1
	Q3	1.130	1.080	4.4
	Q4	1.180	1.090	7.6
1984	Q1	1.200	1.120	6.7
	Q2	1.230	1.180	4.1
	Q3	1.270	1.180	7.1
	Q4	1.316	1.200	8.8
1985	Q1	1.360	1.258	7.5
	Q2	1.480	1.317	11.0
	Q3	1.670	1.284	23.1
	Q4	1.770	1.340	24.3



1985 Daily Average Rates

Month	Daily Average
Jan	1.33
Feb	1.36
March	1.39
Ap	1.44
May	1.47
Jun	1.52
Jul	1.60
Aug	1.67
Sept	1.75
Oct	1.72
Nov	1.81
Dec	1.78

a single project or by partial adjustments in one sector or one project. It is a macro policy objective that will be part of the Mission's overall policy dialogue effort. The project will examine the economic rate of return for individual term credits. That will help screen out inappropriate investments. However, if the problem is to be solved, Egypt will have to dismantle restrictions on interest rates.

e. Recommendations

The two major economic issues facing the project are the foreign exchange and interest rates. These two rates combined with associated loan fees determine the effective cost of capital for firms that use the Private Sector CIP and Project Finance facilities.

To the extent that there is a net subsidy, the effective cost of capital to the private sector is artificially reduced. This provides an incentive to invest in projects with lower than desirable rates of economic return. The economic analysis of this project paper indicates that foreign exchange pricing should be flexibly adjusted to reflect the rate in the "free market." On the interest rate side, CBE short-term rates are appropriate. Longer-term rates, however, need to be increased above the CBE maximum levels in the long-run, but currently a credit subsidy may be necessary to offset the Egyptian rate structure bias against term loans.

The question of how to price project capital resources is a question of strategy. Adjustments may be made to the foreign exchange rate, the interest rate, a mixture of the two or by imposing a "user" fee. The important point is to achieve an appropriate, effective cost for capital.

AID is not the only donor confronting this problem. The World Bank has been negotiating since mid-1984 with the GOE and the Export Development Bank of Egypt (EDBE) on interest and foreign exchange rates for the World Bank's $125 million Export Industries Development Project and other projects. The World Bank has not yet completed negotiations, but it appears that the foreign exchange rate will be set at the Commercial Bank Incentive Rate. The bank incentive rate in effect on the day a contract is signed will be the rate used by the project, since this is currently the official rate closest to the free market rate. Over the life of the project, the goal is to provide funds at or very close to the free market rate.

Interest rates for World Bank-supported industry credits will be set above the CBE maximum of 11-13%. While the end-loans from the EDBE to its borrower will be repayable in Egyptian pounds, the loans from the World Bank to EDBE will be denominated in U.S. dollars. Since CBE interest rate controls only apply to Egyptian pound loans, they will not apply to World Bank sub-loans. The rates negotiated in October 1985 were 14-15%. The foreign exchange risk is borne by the EDBE (i.e., the GOE).

The World Bank is close to negotiating a more market-oriented foreign exchange and interest rate package. AID will attempt to coordinate with the World Bank's approach while acknowledging the fundamental differences in the two programs, both in implementation and in policy. Two major differences between

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World Bank money and U.S. funding is that World Bank funds are not tied to country-specific procurement and are restricted to borrowers engaged in export activities. Importers can import from the cheapest world market source. Both World Bank and AID programs have conditions imposed on the users of these funds. AID's source and origin procurement restrictions may necessitate an adjustment to reflect the potential additional cost of tied aid.

In discussions with bankers, they suggest that borrowers may be reluctant to use AID resources if they are offered at 14-15%. The banks state that they are ready to lend their own local currency, but not foreign exchange, for economically feasible projects at the CBE ceiling of 11-13%. AID will seek a more market-oriented interest rate, but recognizes the difficulties in attempting to deviate from the CBE interest rate schedule. There are indications that the CBE may revise its schedule in the near future.

3. GOE Plans

The GOE places a high priority on commodity production in the current five-year plan and recent pronouncements by government officials suggest that investment in the industrial sector will be a principal emphasis of the five-year plan beginning in 1987. In a speech before the Egyptian-American Chamber of Commerce (November 1985), Prime Minister Ali Lufti renewed the GOE pledge of support for private sector productive activities.

Several important policy and legislative changes have been adopted to stimulate private-sector expansion over the past 12 years (e.g., Public Law 43 encouraging joint ventures, the Companies Law providing incentives for private-company formation, establishment of a Capital Market Authority and other measures).

Despite these improvements, progress toward shifting economic activity from public to private operation has been very slow. Public enterprises are reluctant to give up their activities and private investors (domestic and foreign) are understandably cautious when the rules are stacked so heavily against them through controls on price, interest rates and foreign exchange transactions.

As discussed elsewhere in this paper, the GOE effectively discourages term lending for productive activity through the low ceilings imposed on interest rate loans to industry and agriculture. Since there is no evidence that the GOE plans to remove the interest rate controls, or otherwise provide for access to term credit for private firms, the major purpose of this project is to use U.S. funds to help offset GOE regulations that inhibit loans to the private sector, especially term loans.

4. Complementary USAID Credit Activities

a. On-going Projects/Project Components

USAID's major on-going credit activities include: the Private Investment Encouragement Fund (263-0097), Private Sector Production Credit (263-0147), Small Farmer Production Credit (263-0079) and the Housing and Community

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Upgrading Project (263-0066). The two former projects have been subsumed under Private Enterprise Credit, and will not be covered in this section.

The Small Farmer Production Credit Project was designed as a pilot loan program in three governorates to test how farm production might be increased through improvements in credit management, extension services and input supply. The original project and subsequent amendment provide $49 million, principally for training, technical assistance and village bank credit funds. Under Small Farmer Production Credit, which is being implemented through the Principal Bank for Development and Agricultural Credit (PBDAC), village bank personnel are trained, granted considerable autonomy, and provided with incentive pay in an effort to improve services to small farmers. In addition, credit and extension services are provided for a variety of crop, livestock and agri-business enterprises. As of October 31, 1985, over $27.2 million has been disbursed under this project.

The Housing and Community Upgrading Project (the Helwan Project) contains a $4 million credit component designed to provide sub-loans, at terms of five to ten years, for home improvement, and dwelling expansion and upgrading in lower income areas, and is the first experiment in providing home improvement loans to low income households through the informal sector. The Helwan Project also provides $183,000 for inventory, shop improvement and working capital loans for micro-enterprises. All loans are channeled through an established semi-public sector bank, Credit Foncier d'Egypte.

b. Future Projects/Project Components

Concurrently with the design of Private Enterprise Credit, USAID is examining three additional projects and/or components of new projects intended to meet existing credit needs within Egypt. The first of such activities, the Agricultural Production Credit Project (263-0202), is a follow-on to Small Farmer Production Credit. The project is in the concept paper stage and is expected to provide further financial/technical assistance support, in FY 86, to the PBDAC's village banking system. It is envisioned that Agricultural Production Credit, comprising several governorates, will provide approximately $120 million in AID funds for short-term loans to small farmers for seasonal inputs, and medium and long-term loans for land improvement, equipment, facilities and agri-business development. The project will also upgrade extension services to farmers, as well as assist the private sector to become more involved in agriculture. In addition, technical assistance, training, and vehicles will be provided to approximately 300 or more village banks under the PBDAC's village banking system.

A further USAID activity, the Local Development II (LD-II) Project (263-0182), is scheduled, subject to available funding, to include a private enterprise credit component of approximately $20 million. A proposal for the design of this component, submitted by the Match Institution, entails providing short and medium-term local currency credit for small-scale entrepreneurs in rural and secondary cities.

Unlike many sector-specific, targeted credit programs, the design of LD-II's credit component will be based upon a demand-responsive credit distribution

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model. Interest rates will be set to insure price cost recovery, and lending operations will be physically close to where the rural borrowers live and work. Additional characteristics of this demand-responsive credit system include: a) lending without restriction to purpose, b) a flexible collateral system, c) small loan size, d) a large volume of small loans to reduce the administrative costs per loan, and e) cash loans as opposed to in-kind lending.

A third project, the <u>Urban Development Support Project</u> (263-0199), is currently a shelf project in the design stage, and will be a follow-on to the Housing and Community Upgrading Project. This project is expected to provide, in FY 86, $35 million in loans similar to those under the Helwan Project, and may perhaps include private sources of loan financing. In addition, new participant banks may be brought into the program to supplement activities already undertaken by Credit Foncier d'Egypte.

Many of the above projects were/are being designed to serve the needs of farmers, micro-scale enterprises and very small-scale businesses located in Cairo, rural areas and secondary cities. Private Enterprise Credit, like many of USAID's other credit programs, focuses on the working capital needs of the private business sector. PEC, however, does more than that; it focuses on the private sector's medium and long-term credit needs, as well. It also provides for a much needed guarantee facility to induce bankers to lend to the above high risk borrowers. As such, PEC complements USAID's other credit activities.

B. <u>Project Objectives</u>

1. <u>Goal and Purpose</u>

The project <u>goal</u> is to assist in the increase in Egyptian productive output through the private sector which has already increased substantially since the Open Door Policy began in 1974. Private sector contribution to industrial output increased from LE 475 million (FY 1974) to LE 2,927 million (FY 1983/84) which on a percentage basis was, respectively, 25% and 34% of total industrial output. Recently, the total private contribution (including industrial, agricultural and service sectors) to GDP was estimated at 60%. See the Logical Framework, Annex B.

The project <u>purpose</u> is to expand investment in productive private sector enterprises, including a broad range of activities in manufacturing, agri-business and service industries such as tourism and health. Private sector investment in the industrial and services sectors has grown since initiation of the Open Door Policy although it is still relatively small compared to government investment. In FY 1974, for instance, private sector gross fixed investment was LE 27.5 million, or 4% of total investment. In FY 1983/84, it was LE 1.6 billion, or 24% a six-fold proportional increase.

2. <u>Relation to Outputs</u>

Statistical information is not available to substantiate the correlation between project-induced increases in private sector investment with increases in Egyptian productive output. However, indications of the relative magnitude

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of project impact can be inferred. Various other measurements indicate that this project may have a significant impact on private sector investment.

-- Project funds should provide an additional annual increase in private sector importation of raw materials, intermediate goods and capital goods. In the absence of this project, most private firms would have to turn to the "own exchange" or free market for foreign exchange to finance their industrial support needs. In 1983/84, "own exchange" imports of raw materials, intermediate goods and capital goods totaled $1.6 billion. The project supplements such funds. The project's $235 million foreign exchange components, expected to disburse over a three to five-year period, would finance roughly $50-75 million per year, or 3 to 5% of supplementary imports.

-- Project funds should provide substantial annual increases in private industrial sector investment. USAID/Cairo projections of Egyptian industrial sector investment show a minimum real growth rate of 5% a year for the period 1985/86 to 1988/89. Industrial investment (in constant 1984 LE) will increase from LE 1.26 billion in 1984/85 to LE 1.53 billion in 1988/89. Based on the GOE Five-Year Plan, a minimum of 25% of that investment will be in the private sector. Thus, of roughly LE 1.4 billion a year in total investment, LE .35 billion will be in the private sector. Assuming that project funds disburse over a three-to-five year period and also mobilize additional funds of LE 660 million from banks and owners, investments may average LE 200-300 million a year. With private industrial investment projected at LE 350 million a year, the project is expected to induce a major increase in private investment. It should be understood, however, that not all project funds will be used for industrial sector investment; some will be used for service sector activities. The inclusion of traders into the program will be considered during project implementation.

-- Project funds will provide an additional annual increase in private sector loans from commercial banks. As of January 30, 1985, the IMF lists total outstanding credit to the private sector (denominated in Egyptian Pounds) at LE 7.5 billion. Within that amount, LE 5.3 billion was provided by commercial banks. For 1982/83 and 1983/84, the increase in new commercial bank loans to the private sector was roughly LE 800 million a year. Industry and trade received approximately half of that amount or LE 400 million. That LE 400 million was substantially below the LE 1,300 million of 1981/82 and LE 770 million of 1980/81. While credit to trade and industry will probably recover from its present low level, the GOE appears committed to keeping credit expansion limited. Project funds of $235 million in foreign exchange will help assure that productive credit needs are met. With anticipated project disbursements of $50-75 million a year for three to five years, Egypt's trade and industrial credit may be able to expand, if Central Bank credit constraints permit.

C. Project Elements

1. Introduction

As noted in the preceding section, the primary purpose of this project is to assist in the expansion of productive private sector enterprises in Egypt.

However, since USAID's program is government to government and since we want to encourage the private sector to respond to market signals rather than government assistance, it is difficult to bridge the gap between the desire to target our financial resources for the private sector and the realities of the private sector environment in Egypt. The path from a GOE grant agreement to multiple private entrepreneurs requires the use of various intermediaries.

Each one of these intermediaries has its own set of constraints that limit our ability to reach the private entrepreneur in the undistorted way that we desire. Another problem is that the AID "project" process does not fit within the same timeframe as most private investment decision-making processes. Thus, our plan is to put into place various "mechanisms" that we can fund on a continuing as-needed basis.

This project provides the credit mechanism; another will support the technical information and institutional requirements; and others will address management, banker training needs. Once these mechanisms are in place, then it will be up to the private sector to sustain them by the demand it creates through usage.

Another, non-project, mechanism for support to the private sector is policy dialogue. Rather than make policy dialogue project-specific, it is being personally conducted by the Mission Director on a macro-level, using the entire portfolio as the basis for our policy involvement.

By conceptualizing our support to the private sector around a series of such devices, we can better organize the management of our portfolio and can better spread the involvement of the intermediaries between us and the entrepreneurs. In this way, for example, the credit mechanism can develop at its own pace and demand without being constrained by the institutional support activities, which can be channeled through other mechanisms.

The strategic design of this particular mechanism - an umbrella project for private sector credit facilities - derives from nearly a decade of experience in implementing private sector projects and completion of a large number of studies, evaluations, etc. The latest of these studies, the April 1985 Term Credit Assessment Report, forms the conceptual basis for this project. Annex H presents a Summary of Recommendations from this Study. Key recommendations were:

-- Flexible umbrella project based chiefly upon existing credit facilities;
-- Foreign exchange rate at market rate;
-- Delegation of sub-loan approvals to banks;
-- Borrowing rates to approximate the cost of capital;
-- Targeting of borrowers (e.g., exporters); and
-- Detailed suggestions to improve operational effectiveness.

This new umbrella project builds upon two existing private sector credit facilities, the Production Credit Project (PCP) and the Private Investment Encouragement Fund (PIEF). The $88 million PCP provides dollar credit to individual Egyptian firms, including foreign joint ventures, to import goods from the U.S. It originated in 1977 as the private sector allocation of the

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Commodity Import Program and has had a long and successful life. The PIEF provides dollar loans for U.S. goods and services for medium to large-scale plant establishments or expansions on a co-financing basis with local banks. This project has had a rocky history: it was obligated in 1979, partially deobligated in 1983, and reobligated in 1985 at $33 million. The first sub-loan has just been completed. To assure against a repetition of PIEF inactivity, the PEC's Project Finance Facility will not approve disbursements until at least $10 million of the PIEF (Project No. 263-0097) has been fully approved and earmarked.

The third project element will be a new Small-Scale Enterprise Credit Guarantee Fund to partially guarantee bank loans to increase the amount of SSE lending. Each project component is described in more detail in the following sections.

2. Components

a. Project Finance Facility

(1) Background/History

In September 1979, USAID/Cairo signed a grant agreement with the Ministry of Economy of the Government of Egypt to provide up to $33 million for the Private Investment Encouragement Fund (PIEF). The purpose of PIEF is to provide medium to long-term credit to private sector companies to finance new productive facilities and expand and modernize existing facilities. PIEF is a co-financier along with selected Egyptian participating banks. The banks serve as agents and manage all sub-loans financed through PIEF.

The Ministry of Economy (MOE) is responsible for implementing this project component. An Advisory Board was created in early 1981 to review and monitor the implementation of the Fund and report its findings and recommendations to the Ministry of Economy. The Board was advisory: the MOE could accept or reject its findings and recommendations. The MOE signed in March 1980, a host country contract with Robert R. Nathan Associates, Inc., a U.S. consulting firm, to provide technical assistance to the project. By late 1982, the only disbursements from the project were payments under the contract (approximately $805,000), although at least 14 loan proposals requesting more than $40 million were received and four sub-loans were approved by AID for approximately $6.6 million.

With operational deficiencies coupled with other impediments, the project was formally suspended by AID in April 1982. This notification of suspension included conditions to be met to remove suspension. They were: (1) acquisition of two staff members with some prior banking experience and knowledge of financial analysis; (2) establishment of some basic procedures for review and decision-making of loan requests; and, (3) contractual or other relationships with legal, economic/financial and accounting/auditing firms to bolster Fund staff.

During the period from 1981 through 1982, AID proposed alternatives to the PIEF staff dilemma, namely: (1) placing the management of PIEF with a

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commercial or a public sector bank; (2) placing PIEF management with an appropriate consulting firm; (3) merging the PIEF project with a large USAID/Cairo umbrella project. These options were reviewed, but never acted upon by the GOE.

Finally, in August 1983, AID and GOE mutually agreed to deobligate $22.195 million of the $33 million AID grant leaving a balance of $10.805 million. However, both AID and GOE agreed to renew efforts to launch the project and make it operational.

In a spirit of mutual cooperation and convinced that the PIEF concept had merit, USAID and the MOE's Investment Authority agreed that the balance of $10.805 million should be utilized to resurrect the project incorporating those operational and technical changes that would offer a practical means for disbursing project funds. In May 1984, General Motors Egypt (GME) requested a $5 million sub-loan from PIEF. USAID and GOE agreed to process the GME request using it as a model or test case as a way to establish some practical procedure for setting up a bank agreement, appraising the loan, executing the loan and disbursing the funds. On August 30, 1984, the Investment Authority's new Deputy Chairman (Dr. Sultan Abou Ali) and USAID agreed to continue working together to process GME's loan application on a test basis. Of major significance, both governmental entities agreed that, regardless of the outcome of GME's sub-loan request, they would work together to relaunch PIEF.

From September 1984 through April 1985, substantial negotiations were undertaken to establish the requisite framework contributing to: (1) making PIEF operational, and (2) funding the GME's sub-loan. First, Chase National Bank (Egypt), GME's bank, and Misr Iran Development Bank were selected as the initial agent banks to manage PIEF sub-loans plus fulfill the requirements of participating banks by co-financing with PIEF. Second, it was agreed by USAID and GOE that the conditions for removing the 1982 suspension had been met. Finally, the participating bank agreement was executed by all parties in April 1985.

Both USAID and GOE believe that with the recently modified PIEF lending criteria, PIEF can reduce its risk and concommittantly rely upon the participating bank to: (1) protect both the bank's own majority interest in the total investment as well as PIEF's; and, (2) handle the project appraisal activity on behalf of the PIEF in its agent capacity.

A bank's majority interest in the total investment ensures that the participating bank's level of risk is much greater than PIEF's exposure to a sub-loan borrower's default. Therefore, the participating bank's incentive to conduct a professional and in-depth project appraisal on its own behalf and the PIEF is highly significant. Conversely, in the event the sub-loan borrower encounters financial difficulty, the participating bank's need and incentive to aggressively take the lead to confront and, presumably, resolve the problems on behalf of itself and the PIEF is very substantial.

The events and decisions made in 1984 and 1985 underscore the project's original intent and goal to create a format, wherein all parties can act with a degree of flexibility and be responsive to any perceived need for change.

The revitalized PIEF operating structure meets the objective to shift management and administrative responsibility to the agent banks to reduce the burden of creating staff increases at both GOE and AID to serve PIEF loan demands. Utilizing a post-audit system, USAID and GOE involvement with PIEF can be limited. This alleviates to a significant extent, requirements to expand GOE or AID staff resources.

In early 1985, the GOE asked to resurrect the project and use part of the remaining funds for a $5 million term credit to help finance the new General Motors Egypt truck assembly plant. On June 11, 1985, the USAID/Cairo Mission executed a second amendment to the PIEF Authorization by obligating $22.195 million to the $10.805 million already obligated. In July, the GOE and AID signed the Second Amendment to the Project Grant Agreement and the Fund. Thus approximately $33 million became available for sub-project lending. The General Motors Egypt loan documents were signed in October and USAID approved the loan for disbursement in Janaury 1986.

A condition to AID/Washington approval of PEC is: "to insure against a repetition of Fund inactivity, the ANPAC approved the PID subject to the condition that the PIE Fund be fully operational (i.e., full approval and commitment of at least $10 million of the current $33 million available) before the Mission authorizes this project." This condition has been met.

(2) Assessment Recommendations

In April 1985, Report of Term Credit Assessment Team Visit to Egypt, prepared by E. H. Clarke (AID/Washington, Bureau for Program and Policy Coordination), et al, proposed a simple, straight-forward strategy of folding together the two existing projects (Production Credit and Private Investment Encouragement Fund) in a new umbrella project, i.e., Private Enterprise Credit. Annex H provides a summary of the assessment team's recommendations.

(3) Proposed Activity

The Project Finance Component of this project (i.e., PIEF) will modify operating procedures for improved effeciency and responsiveness to private sector needs. As USAID, GOE and banks gain experience with PIEF, recommendations for modifications will arise. Periodic reviews will also facilitate a process of implementing procedural changes.

Based upon the General Motors Egypt loan experience, USAID analysis, and various USAID consultants plus discussions with the Minister of Economy and the PIEF staff, revisions to PIEF will include:

-- Increasing the number of participating banks by encouraging banks to submit their requests for admission to the PIEF Advisory Board. Currently four of the nine banks participating in the Production Credit project are approved banks in PIEF. Suggested criteria for selection of Participating Banks by the PIEF Advisory Board is presented in Annex G.

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-- A more simplified procedure for processing PIEF loan applications as presented in Annex G.

-- Upon the approval by the PIEF Advisory Board and USAID of five PIEF sub-loan projects, USAID and GOE will discontinue direct involvement in the loan approval process. Thereafter, both entities will rely upon periodic discussions, reports, evaluations and post-audits to assure proper manangement of the Fund by the participating agent banks. The role of PIEF and USAID will be to set policy and lending criteria and to consider exceptions to the PIEF Terms and Conditions Guidelines.

-- For most sub-loan projects, the participating banks are provided the following general guideline: with a 3:1 debt/equity ratio, PIEF's loan may not exceed 20% of the total project cost; at a 2:1 debt/equity ratio, PIEF's loan may not exceed 30%; and, at a 1:1 debt/equity ratio, PIEF's loan amount should not exceed 40% of total project cost. See Annex G.

-- The foreign exchange rate will be the prevailing commercial bank incentive rate (December 1985: 1.36 LE =1.00 USD).

-- Participating banks will furnish periodic reports, perhaps quarterly, to PIEF and USAID describing applications received and reasons for disapproval. Over a period of time, this information may provide justification for amending PIEF lending criteria and/or procedures.

-- After six months use, the Participating Bank Agreement will be revised to facilitate usage of a more simplified document. Discussions will be held to solicit suggested modification from the banks, PIEF staff and USAID.

-- There will be no maximum PIEF loan amount. However, based upon Central Bank regulations and the banking industry's experience, it is likely most loans will not exceed $5 million.

-- With the exception of projects capitalized with a 1:1 debt/equity ratio, bank financing will equal and preferably exceed the PIEF loan amount. In the event a participating bank proposes a PIEF loan in an amount exceeding the bank's loan (i.e., projects with a 1:1 debt/equity ratio), it is proposed that the bank guarantee repayment of the PIEF loan.

-- Interest rates will be negotiated by the banks. Central Bank interest rate schedules will apply, currently 11-13% for industrial loans. With few exceptions, PIEF and bank term loans will have identical interest rates.

-- In cooperation with the participating banks, a concerted effort will be undertaken by PIEF and USAID to agree upon standard forms, e.g, notes, mortgages and loan agreements, that will be approved for use by the banks without further review.

-- Loan terms and repayments should be structured based upon cash flow projections. Grace periods (up to 36 months) and maturity (up to 12 years) must be justified in the project appraisal/financial analysis. Repayment schedules will be established on the basis of cash flow.

The foregoing is a representative example of expanding the authority and responsibility of participating banks in their role as agents for the Fund. At the present time, the participating banks are responsible for day-to-day implementation of Fund investments in sub-projects. Succinctly, PIEF is now operational. Demand for existing and additional funds is demonstrated by the number of potential investors inquiring about the timing and availability of project financing. The Fund will continue to serve as a co-financier with participating banks and the banks will manage Fund investments as agents of the Fund. PIEF loans will finance imported capital goods and materials related to productive facilities in Egypt. It may also finance services. Under the existing $33 million PIEF obligation, funds are available to finance training of bank officers and others in appraisal of invesstment projects and other banking and financial skills. This project element is coordinated with related technical assistance presently supported by the Production Credit Project.

b. Private Sector Commodity Import Program Facility

(1) Background/History

The Private Sector Commodity Import Program (CIP) Facility under the PEC project is a continuation of AID's effort to meet the short and medium-term credit needs of the Egyptian private sector. The Production Credit Project (PCP) was authorized in August 1982 and amended in March 1985. Its goal is to increase the private sector's investment and contribution to Egyptian productive output. Also, it seeks to assist in the development of a financial system with the capacity to meet the financial needs of productive private sector enterprises. The project provides a total of $87 million for short-term credit activities and an additional $1 million for technical assistance, training and studies.

The short-term credit activity provides funding to private sector entities through nine participating banks, both public and private sector, to finance the importation of goods and equipment from the U.S. The procedures for the program were formalized in General Circular No. 1 of 1983 issued by the Ministry of Planning and International Cooperation. This Circular was replaced in August of 1985 by General Circular No. 1 for 1985, currently in effect.

Under the original Circular, all Egyptian private sector firms were eligible to participate, although slightly different rules were applied to those importing for resale rather than end-use. Law 43 companies, which were originally ineligible to participate, were later added. The general provisions of the original circular were as follows:

Eligible commodities

-- For end-users, the entire AID Commodity Eligibility List.
-- For traders, a narrow positive list of 19 items.

Transaction Size

-- $10,000 minimum.
-- $500,000 maximum.
-- No more than $1 million per client per year.

Credit Terms

	End-Users:	Traders
-- Down payment	25%	40%
-- Interest rate	industry 13% max. services 13-15%	16% minimum no maximum
-- Repayment period	12 months for raw materials 18 months for intermediate goods 3 years for capital equipment	6 months

-- All repayments in local currency at the highest official rate prevailing on the date of repayment

Competitive Requirements

Per AID Regulation One, importers were to follow good commercial practice which generally requires three offers.

Upon approval of the transaction by one of the participating banks, it was forwarded to USAID for concurrance. Once the Letter of Credit was opened to the U.S. supplier, the participating bank assumed an indebtedness to the Central Bank of Egypt, and thus took the credit risk. Full principal and interest collected by the bank were remitted to a Special Account maintained at the Central Bank.

After some start-up difficulties the project became operational in August 1983. The table below briefly summarizes the activity under the project through September 1985.

Table 1

TOTAL LIFE OF PROJECT

	No.	Dollars
Transactions Received	531	91,761,265
Concurred	403	66,736,336
Rejected	84	16,783,818
Cancelled	44	8,241,110

The average transaction size for the project was $165,599. The following table breaks down transactions by size.

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Table 2

Transaction Size	No.	Value
less than or equal to 100,000	188	$ 8,680.685
between 100,000 and 200,000	92	12,706,927
between 200,000 and 300,000	57	14,125,499
between 300,000 and 400,000	10	3,436,069
between 400,000 and 500,000	53	25,689,703
over 500,000	3	2,097,450
TOTAL	403	$66,736,333

The breakdown of transaction by end-use vs. trade is also interesting. As demonstrated by the following table, traders accounted for only 29% of all transactions by value.

Table 3

	No.	Value
End-Use	238	$47,566,880
Trade	165	19,169,456
	403	$66,736,336

Transactions seemed to flow to private sector banks at a rate which approximates their share of the total market. Private sector banks processed 36% of all transactions by value. Each bank was given an initial allocation of $3 million; additional funds were allocated to banks on a first-come first-served basis.

Table 4

Bank	Public Sector	Private Sector	Percentage of Total Transactions by Value
Chase National Bank		X	14.65
Egyptian American Bank		X	11.02
Misr-Iran Development Bank		X	5.20
Arab Investment Bank		X	5.21
Bank of Alexandria	X		17.90
Banque du Caire	X		17.92
National Bank of Egypt	X		14.72
Misr Bank	X		8.96
Development Industrial Bank	X		4.45
Total	63.92	36.08	100%

A review of imported commodities demonstrates a variety of items financed by PCP:

-- Agricultural spray aircraft and spare parts
-- Industrial chemicals
-- Computers
-- Generators
-- Irrigation equipment
-- Heavy construction machinery such as bulldozers and cranes
-- Medical equipment
-- Polyester yarn
-- Polyethylene for plastics
-- Pumps
-- Vegetable seeds
-- Soybean meal
-- Welding equipment

(2) Evaluation Recommendations

An evaluation of the PCP was completed in December 1984. The evaluation concluded that the project provided a highly-efficient vehicle for meeting the foreign exchange needs of the private sector, but that it was less successful in providing short and medium-term credit. Difficulties with the credit portion of the project were a result of the Maintenance of Value provisions, which forced importers to assume an exchange rate risk, and the Central Bank's interest rate structure which allows commercial banks to charge higher rates on short-term trade financing than for longer-term (and higher risk) lending for production.

The evaluation report made the following recommendations with respect to the credit component of this project and future credit projects:

-- Remove Maintenance of Value (MOV);
-- Develop a flexible mechanism for adjusting the effective foreign exchange rate applicable to the program, taking into account the cost of AID's U.S. source/origin requirements (estimated at 20% - 30%);
-- Initiate a dialogue with the GOE to encourage the development of an interest rate structure that encourages term lending;
-- Program local currency generations to encourage improvements in credit markets or to support export development; and
-- Provide term credit in foreign exchange and local currency to firms with export potential and/or comparative advantage.

(3) PCP Amendment No. 1

On March 6, 1985 a $20 million amendment for the Production Credit Project was authorized. Negotiations with the GOE (MPIC) on a new operating circular were not concluded until September 22, 1985, when General Circular No. 1 for 1985 was formally accepted. In the interim, the Report of Term Credit Assessment Team Visit to Egypt (April 1985) made a number of specific recommendations regarding the Production Credit Project (see Annex H for a summary of those recommendations).

General Circular No. 1 for 1985 modified the PCP in a number of ways:

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-- MOV was dropped;
-- The exchange rate was increased from LE .84 = $1.00 to LE 1.00 = $1.00;
-- Competitive requirement was modified from 3 offers to a reasonable number of offers;
-- Repayment period for capital goods was extended to 5 years;
-- Traders were eliminated from the program;
-- Annual customer usage limits were reduced to $250,000 for raw materials and intermediate goods and $650,000 for capital equipment; and
-- MPIC is required to review and approve all transactions prior to bank approval and submission to AID.

Some comment is required on the last three points. While the evaluation did not specifically recommend elimination of traders, it did point out that Central Bank interest rates provide a higher return to banks for this type of lending (16% minimum interest rate with no maximum) than for term lending for production (13% maximum for industry). Given the limited resources available under PCP, the decision was made to concentrate our resoures on the productive end users.

The last two points are clearly contrary to the direction in which AID would like to proceed. These were included in the Circular by MPIC.

Activity related to the $20 million authorized under Amendment No. 1 is summarized below. These figures are for the period September 22, 1985, when the new Circular was accepted, until December 12, 1985:

	No.	Dollars
Concurred	91	$12,653,967
Rejected	32	4,049,724
Cancelled	3	449,685
Total	126	$17,153,376

(4) Proposed Activity

The proposed Private Sector CIP, under the Private Enterprise Credit Project, will continue the activities initiated under PCP with certain modifications. These modifications are designed to make the program more efficient and more responsive to the credit needs of the productive private sector. Given that the demand for these funds is likely to exceed the supply, the program will seek to encourage specific types of activities. These objectives are:

-- To maximize the use of the facility to meet the credit needs of the productive private sector and minimize its use as simply a window for below-market foreign exchange;
-- To favor credit for new plant construction, plant expansion or replacement of capital equipment in existing plants and minimize use of the facility to meet the raw materials requirements of established firms;
-- To encourage lending to new firms which have not previously used the program;

-- To encourage lending to firms outside of Cairo and Alexandria; and
-- To encourage lending to small-scale firms.

Participating banks will be given a written statement of AID and GOE objectives under this program, and periodic evaluations of bank performance will be undertaken. Funds will be allocated to banks based on their responsiveness in meeting these objectives.

The Private Sector CIP, like PCP, will be governed by an operating circular issued by MPIC and accepted by AID. In negotiations with MPIC, AID will seek the following modifications to the program:

-- Repayments will be made at the bank incentive rate on the date the letter of credit is opened;
-- Annual customer usage rates will be $250,000 for raw materials and intermediate goods, $1,000,000 for capital equipment, with the total not to exceed $1,000,000;
-- Banks will assume a greater role in approving transactions. Prior review by MPIC will be eliminated. Banks will be delegated by AID the right to approve transactions without prior review;
-- Additional banks will be added, not to exceed a total of 12 for the first year, with a review after that; and
-- AID and the GOE will monitor activities under the Private Sector CIP and modify the operating circular as necessary to bring actual performance in line with the program's stated objectives.

AID will also seek to involve representatives from the private sector, such as the Egyptian Businessmen's Association and the American Chamber of Commerce in Egypt, in considering ways to improve and modify the program.

c. Small-Scale Enterprise Credit Guarantee Program

(1) Summary of Terms and Conditions

The Small-Scale Enterprise Credit Guarantee Program is designed to provide participating commercial banks with an insurance mechanism against default in order to encourage them to make their excess local currency liquidity available for working capital and capital goods loans to Small-Scale Enterprises. The Credit Guarantee Fund (CGF), will be initially allocated from the AID/GOE Special Account in an amount of LE 20,000,000 and subsequently allocated from reflows from the Production Credit and Private Investment Encouragement Fund programs. CGF will receive a total funding of LE 60,000,000 as the need for more funding arises over the first five years of the program. Day-to-day management of the Fund will be carried out by a private commercial bank, supervised by an Advisory Committee comprised of representatives of the managing bank and participating banks with USAID project officers available for consultation and assistance, as needed. The Fund is intended to become a permanent feature of the Egyptian banking system and to grow in size at an annual rate of about 7% once it is fully funded.

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Management of the Credit Guarantee Fund

1.	Recommended Managing Agent for the CGF:	An Egyptian commercial bank is to be selected immediately following PEC project authorization. The PP design team recommends consideration be given to Arab Investment Bank as an appropriate managing agent.
2.	Allocation of reflows:	Year 1 LE 20,000,000 Year 2 LE 10,000,000 Year 3 LE 10,000,000 Year 4 LE 10,000,000 Year 5 LE 10,000,000 TOTAL LE 60,000,000
3.	Administrative Costs:	Estimated at .5% of value of CGF once fully funded.
4.	Estimated Net Default Rate:	5% per annum.
5.	Share of Default Covered by CGF:	To be determined by the CGF Advisory Committee. It is likely that most guarantees will exceed 50%.
6.	Investment of Fund:	2 to 3-year time deposits with commercial banks earning 12%/annum.
7.	Other Income:	10% per annum earned on balance of passbook savings account maintained for administrative expenses and default claim payments.
8.	Checks & Balances:	Advisory Committee to review policies and procedures. Spot checks of fund management by independent CPA firm contracted by AID. Annual audit.
9.	Recommended Participating Banks:	Arab Investment Bank, Development Industrial Bank, National Bank for Development, Export Development Bank of Egypt, Bank of Alexandria, Credit Foncier. Other aggressive private sector commercial banks seeking new clientele.
10.	Payment of Claims:	Upon submission and validation of required documentation according to guidelines established by Advisory Committee.

Conditions for Participation

1.	Target Group:	DIB's and World Bank's definition of Very Small-Scale Enterprises (VSSE's) will be used. This definition specifies industrial firms with fixed assets not exceeding LE 285,000 (in 1985), excluding land and buildings. (To be adjusted annually.)
2.	Purpose of Loans:	Working capital. Purchase of capital equipment.
3.	Minimum Loan Amount:	LE 10,000.
4.	Maximum Loan Amount:	Working Capital: LE 100,000. Capital Equipment: LE 200,000. (To be adjusted annually.)
5.	Term of Loans: Working Capital: Capital Equipment:	Up to 2 years, no grace period. Up to 5 years, 1-year grace period.
6.	Interest Rate:	13% or the highest Central Bank of Egypt specified rate for industry.
7.	Management Fee:	Up to 1.5%, one-time, up front.
8.	Commitment Fee:	Up to 1% on un-utilized balance.
9.	Loan Guarantee Fee:	Up to 2% on outstanding balance. Half goes to Fund, half retained by the banks.
10.	Collateral, Downpayment, Compensating Balance Requirements:	To be negotiated between banks and clients.
	Promotion of Program to Banks:	Seminars for the participating banks.
	Promotion of Program to Borrowers:	Through SSITD, the proposed Business Development Center, the participating banks, and judicious use of the media.

(2) Proposed Activity

This section suggests the general terms of a proposed Small-Scale Enterprise Credit Guarantee Program, which would facilitate the access of a large number of small-scale enterprises (SSE's) into the formal Egyptian banking system for the first time. This paper grew out of discussions of Dr. Aly Helmy's

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detailed preliminary report on Small-Scale Enterprises within USAID's Industry and Support offices, with senior officers of nine public and private sector commercial banks, with a department chief of the Central Bank of Egypt, the Directors of the Egyptian Industrial Design Development Center (EIDDC) and the Small-Scale Industries and Training Department (SSITD), and selected small-scale entrepreneurs in Cairo.

Throughout this section, the general definitions used for enterprises on the lower end of the economic scale will be those established by the World Bank and the Development Industrial Bank (DIB). For our purposes, Very Small-Scale and Small-Scale Enterprises will be grouped together and labeled Small-Scale Enterprises. Annex J presents a more detailed explanation of World Bank's definitions.

(a) Objectives

The objectives of the Small-Scale Enterprise Credit Guarantee Program are the following:

-- To encourage utilization of local currency in the Egyptian commercial banking system for financing working capital and production asset needs of small-scale enterprises (SSE's);

-- To provide selected commercial banks with: (a) incentives to increase the amount of lending to SSE's and, (b) technical assistance to make policy and procedural modifications to assure success of such loans;

-- To broaden the domestic market of the Egyptian banking industry by successfully introducing a new generation of borrowers into the system; and

-- To establish a Credit Guarantee Fund (CGF) as a permanent insurance mechanism in the Egyptian banking system to offset the higher risk of lending to smaller, less-sophisticated enterprises. With operating experience, it may be desirable to broaden CGF's activities to include direct or co-financing to SSE's.

As the Helmy Report has pointed out, the role played by SSE's in Egyptian industry has been important in terms of contribution to industrial output. It is estimated that in 1984, firms employing between 10 to 50 employees contributed about 61.4% of the private sector's industrial production. This represents about 21% of total industrial output.

SSE's also comprise the lion's share of non-artisanal industrial firms, representing 90.6% or 11,774 of the 13,000 private industrial firms registered with the Federation of Egyptian Industries (FEI).

(c) Credit Constraints

Despite the important role played by SSE's in Egyptian industry, the majority of these firms have been denied access to institutional sources of financing for fixed investment and working capital. Many SSE's perform poorly due to lack of raw materials in adequate quantity and quality, shortages of spare parts, obsolete equipment for which parts cannot be acquired, and aging equipment requiring continuous repairs. A number of the above problems arise from the difficulty many SSE's have in obtaining credit, the lack of adequate information on supplies, and inadequate working capital financing.

Commercial banks, in general, have not been keen to develop a SSE portfolio due to the perception that such loans bear a higher risk and higher administrative costs. Typical credit analysis procedures and collateral requirements are often too stringent for SSE's. Many SSE's do not keep acceptable financial records, making it difficult for a bank to measure a client's credit worthiness by conventional spreadsheet analysis.

Collateral requirements may represent up to 300% of the value of loans. The most important collateral sought by banks are land and buildings. This practice has severely limited SSE's access to bank credit, since the majority of SSE's do not own the land and/or the buildings where their factories are located.

The owners of many SSE's have also been reticent to seek financial assistance from commercial banks. Interviews and case studies carried out by Arthur D. Little and Partnership for Productivity noted numerous complaints from small entrepreneurs vis-a-vis the commercial banks. Cumbersome loan application procedures and collateral requirements in relation to the size of loan requested discourage many small business owners from seeking bank credit. Others are wary of divulging information concerning profitability of their enterprise for fear that it might fall into the wrong hands.

Lack of assistance in project formulation is another important constraint related to the problems associated with financial intermediation. Many entrepreneurs, particularly those with newer and smaller firms, have difficulties in collecting relevant information and properly formulating projects. Few banks are structured to offer such assistance and business extension programs are still very limited. Many small establishments need assistance to improve the layout of their production line, evaluate and select appropriate technology, and improve the quality of their products in order to increase capacity utilization, productivity and quality standards. Many owners/managers lack management skills for maintaining financial records, planning and budgeting, marketing, and dealing with outside institutions.

(d) Credit Services Currently Available to SSE's

Presently, only one bank seriously attempts to address the financing needs of SSE firms, the Development Industrial Bank (DIB). In 1978, about 25% of DIB's term-lending approvals were to SSE's; in 1982/83, this had risen to 30% and is expected to reach 50% in 1986. However, in view of the large number of SSE and artisanal enterprises, DIB's 9,000 loans to date (1976-1985) to SSE's and artisans account for only a small part of the SSE market, especially when it is noted that many of these loans are to repeat customers.

Furthermore, while 82% of the total number of DIB loans have been made to firms with less than LE 300,000 in fixed assets, the bulk of DIB's lending (80% of loans outstanding) has been allocated to firms with fixed assets exceeding this figure. In fact, 69.5% of the DIB portfolio is comprised of companies with over LE 720,000 in fixed assets. Therefore, it is apparent that the DIB, for all of the commendable pioneering work it has done in making bank credit available to the small-scale entrepreneur, still targets most of its portfolio to medium-scale industries.

(e) Target Group

Based upon available data and interviews with commercial banks and technical assistance organizations, it is evident there remains a considerable demand for formal credit among SSE's.

For consistency, World Bank and DIB's definitions will be used for specifying the CGF's target group. Moreover, it is believed that relatively small firms of the SSE sector (with 10 to 50 employees and managed by the owner and/or principle partner) have been less successful than others in obtaining bank credit. Thus, DIB's definition of Very Small-Scale Enterprises (VSSE's) will be used for specifying SSE's program beneficiaries. Currently, this definition is: industrial firms with fixed assets valued at not more than LE 285,000 excluding land and buildings. It is expected that the definition of the target group will be adjusted annually in order to be in line with DIB's VSSE definition.

It is this group - the vast majority of private sector enterprises - which holds the greatest potential for individual growth and future expansion of the commercial credit market in Egypt.

(3) Technical Approach

Initially, the design team considered the utilization of LE 60 million from local currency reflows from Production Credit and Private Investment Encouragement Fund for the establishment of both a SSE loan fund, over a 6-year period.

However, given the excessive local currency liquidity in the Egyptian banking system, adding LE 60 million has little appeal to commercial banks. With the exception of the National Bank for Development (NBD), all banks interviewed indicated they had little need for additional local currency. Typically, banks can obtain funds from each other by drawing on established lines of credit at an inter-bank rate of 8.0 - 9.5% with terms up to 5 years.

Every bank expressed strong interest in the establishment of a Credit Guarantee Fund (CGF) to help insure the participating banks against bad debts arising from loans to the higher risk, small-scale enterprise sector.

Banks state that no similar guarantee fund currently exists in Egypt. However, they state that a guarantee scheme was established in the early 1950's, but was quickly depleted when the economy became centrally-planned. Also, the Export Development Bank of Egypt (EDBE) is currently planning a credit guarantee and insurance scheme to cover exporters against commercial and non-commercial risks.

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(a) The Credit Guarantee Fund (CGF)

PEC will utilize initally LE 20 million from the Special Account in the Central Bank of Egypt and, subsequently, an additional LE 40 million in reflows for the establishment of a self-financing loan guarantee fund for small-scale enterprises.

The purpose of the Fund is to insure a portion of the increased risk shouldered by commercial banks in lending to smaller, less-sophisticated private enterprises with no formal credit history. The Fund is intended to encourage banks to lower their collateral requirements and simplify loan application and approval procedures for SSE's, thus making credit more accessible to this kind of borrower.

(b) Management of the Credit Guarantee Fund

Five different options were considered for the management of the guarantee fund. For a description of those options, please turn to Annex J. It is anticipated that selection of an Egyptian commercial bank as the CGF manager will be made shortly after PEC implementation commences. Based upon analysis completed to date, the PP design team suggests that Arab Investment Bank possesses many of the characteristics of an ideal candidate.

(c) Checks and Balances

Regardless of which bank or organization is selected as manager/agent of the Credit Guarantee Fund, a series of checks and balances will be built into the system to assure smooth functioning and correct use of funds.

Clear guidelines and criteria will be prepared to facilitate management of the fund, and to assure that the clients served fall into the target group, that the participating banks are treated fairly and equitably, and that claims against the fund are properly validated and promptly processed.

USAID and the GOE's MPIC will review the performance of the fund and decide policy and procedural modifications on a semi-annual basis. Annually, they will adjust the definition of the target group and the per client lending limits for inflation, and fix each participating bank's maximum annual coverage by the fund.

An independent CPA firm will conduct periodic spot checks of the Fund's books and report on the adherence of Fund's management to the guidelines. The cost of such audits should be covered by the Fund.

(4) Mechanics of the Guarantee Program

The Credit Guarantee Fund will be established in the first year of the program with LE 20 million from the Special Account in the Central Bank of Egypt and subsequently, with reflows from the PCP and PIEF programs. Since the Fund is new and some time will be required to set it up, train the participating banks' personnel, and promote the program among small entrepreneurs; the funding will be staggered over five years as follows:

Year 1	LE 20,000,000
Year 2	LE 10,000,000

Year 3		LE 10,000,000
Year 4		LE 10,000,000
Year 5		LE 10,000,000
	TOTAL:	LE 60,000,000

Given the current liquidity situation in Egypt, it is doubtful that one bank will be willing or able to accept such a large amount of local currency at time deposit rates of 11% to 13%. Therefore, the managing bank in cooperation with USAID project officers will probably have to allocate the CGF funds among several banks to obtain the highest return possible.

Since guarantees under the program will only be applied to new loans, most of which will be for terms of at least one year, it is highly unlikely that any claims will be made against the Guarantee Fund before Year 3. Therefore, except for withdrawals to cover administrative costs, the fund should be able to grow in nominal terms at around 10% to 11% in each of the first two years. (Cash flow projections for the fund are available in USAID's Office of Finance and Investment.) In subsequent years is is expected that the Fund's worth will grow at about a 5% - 7% rate.

Even when the CGF is fully funded, only a small portion of the fund will have to be kept in a current account to cover withdrawals for administrative costs and validated claims against the Fund. The bulk of the Fund can be invested in medium-term instruments which should assure a healthy rate of growth.

Actual default rates for small enterprise loans at the DIB and public sector banks are quite low, ranging from 1 - 2.5%. However, the total amount of these loans that are affected by arrears of 3 months to 2 years may be twice that. Furthermore, the proposed credit guarantee program is targeting a group that has been only marginally served by the Egyptian commercial banking system up to now. Therefore, the CGF will guarantee a loan portfolio equivalent to 100% of its value. This policy can be reviewed and modified by the CGF Advisory Committee at its regular annual policy meetings once the Fund has gained some history, say after Year 4.

(a) Administrative Costs of the CGF

Total administrative cost of the CGF is not expected to exceed .5% of the value of the Fund (i.e., LE 300,000) when the Fund receives its full funding of LE 60 million. The CGF managing bank will provide estimated start-up and annual operating budgets for the Fund's management.

(b) Lending Limits

USAID AND MPIC will determine the size of portfolio that a participating bank can guarantee each year. These limits will be based upon availability of guarantee funds, the past performance of each bank, and the capacity of each bank to utilize the allocation. The USAID/MPIC might consider keeping a modest reserve for banks which attained their annual limit and can make effective use of additional guarantees.

SSE's credit needs can be divided into two major categories:

-- Short-term financing of working capital for off-the-shelf procurement of raw materials, intermediate or final goods which are needed for operating the enterprise at/or near capacity; and

-- Medium-term financing for the procurement of machinery and equipment, either to replace outdated and depreciated ones, currently in use, or for expanding productive capacity.

Loans qualifying for guarantee under the CGF are limited to these two categories. Short-term financing of working capital can be for up to two years. Medium-term financing for equipment purchase can be up to five years, with a grace period of up to one year.

(c) Loan Size Limitations

Given the characteristics of the target group, it is intended that a limit of LE 100,000 and LE 200,000 be applied to working capital loans and medium-term equipment loans, respectively. These limits can be adjusted annually for inflation by the Advisory Committee.

(d) Currency of Payment and Repayment

SSE's will be granted loans in local currency for financing their working capital needs and procurement of local capital equipment. Repayment of loans will also be made in LE.

(e) Interest Rate

Interest rates are determined by the Central Bank of Egypt (CBE). Currently, interest rates for industrial activities are limited to between 11% to 13% per annum. It is anticipated that, due to the higher risk of lending to small, untried enterprises, the interest rate charged on loans to SSE's will usually be 13%.

(f) Management Fee

Most banks commit a greater amount of resources to establish the credit worthiness of a new SSE client than for a regular customer with a proven track record. Therefore, participating banks may consider charging up to a 1.5% one-time, up-front management fee for packaging the SSE loan.

(g) Commitment Fee

Because administrative costs for managing a large number of small loans, providing some supplementary technical assistance to clients, and scheduling more frequent follow up visits are certain to be higher than for larger clients, participating banks may charge clients served under the guarantee program up to a 1% annual commitment fee on the outstanding balance of the loan.

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(h) Loan Guarantee Fee

To offset a portion of the remaining default risk shouldered by the participating banks and to pass on part of the cost of the guarantee program to the beneficiaries, the banks may collect a loan guarantee fee of up to 2% per annum on the outstanding balance of the loan. Half of this fee will be paid to the CGF and half retained by the participating banks.

Thus, the effective annual interest rate to the borrower would be in the 17% range, which should not be overly burdensome. From the banker's point of view, given that they are normally able to access local currency funds from other commercial banks at 8 - 9.5%, the proposed interest and fee structure would theoretically provide for a gross spread of 8 - 9.5%. It is anticipated that spread will be attractive to the banks.

There has been some concern expressed that such interest rates would be overly burdensome to SSE's. According to a survey of 900 SSE's carried out by the ILO Management Advisor to the Engineering and Industrial Design Redevelopment Center (EIDDC), the average financial rate of return on investment was about 24%. Furthermore, individual entrepreneurs stated that the collateral requirements and the processing time for a bank loan are of much greater concern to the prospective SSE borrower than a few extra interest points.

(i) Down payment, Collateral, Compensating Balance Requirements

No such requirements will be specified by the Fund. This will be left to the discretion of each participating bank to determine on a case-by-case basis. However, whenever possible banks may use a hire-purchase arrangement for medium-term loans for the purchase of capital equipment and pledge of goods in the case of working capital loans.

(5) Technical Assistance Requirements: Establishment of Credit Guarantee Fund

Although credit guarantee schemes are quite common in western countries and in many developing nations in conjunction with donor-financed small-scale enterprise development programs, they are a novelty in Egypt. The success of such a program will depend very much on the reputation of the managing bank, the quality of its staff, and its ability to process claims fairly and efficiently.

Therefore, the bank responsible for the management of the guarantee fund will initially require some assistance in setting it up from a qualified banking expert who has designed and managed the internal administrative systems for similar funds elsewhere. The anticipated length of contract would be four months.

The responsibilities of this counsultant would include:

-- Establishing a simple set of guidelines for the review and approval of projects submitted under the program by participating banks;

-- Establishing the criteria and documentation required for the timely validation and payment of claims presented to the Fund's management by participating banks;

-- Establishing an information and statistical analysis system to monitor and evaluate the performance of the Fund and the loans covered by it. Such a system should be kept relatively simple and should be standardized with all of the participating banks;

-- Designing all of the forms required to assure the smooth day-to-day operation of the Fund; and

-- It will be proposed that funding for this assistance be provided by the Production Credit Project (263-0147) or the Business Support and Investment Project (263-0159).

II. COST ESTIMATE AND FINANCIAL PLAN

A. Cost Estimate

USAID's proposed contribution to the Private Enterprise Credit (PEC) Project is $235 million. Of this amount, approximately $234.7 million will be used to provide credit to a variety of private sector users under the Private Sector CIP and Project Finance facilities (see Table 1 at end of this section for breakdown). Funds placed in these two facilities will cover the cost of private sector requests for credit expected during the project's first three years. The $234.7 million funding level is based on the Production Credit Project's (PCP) $3 million per month approval rate for transactions and an estimated approval rate of $35-40 million per annum by the Project Finance Facility.

The Private Sector CIP Facility should generate comparable expenditures on the part of individual borrowers in local currency for customs duties, raw material and capital improvement costs, as well as other costs associated with utilization of the borrowed funds.

The Project Finance Facility is expected to generate three to four times the Egyptian pound equivalent of the $117.3 million in USAID funds placed into that facility. As such, AID funds will mobilize $234 million in participating bank funds and $234 million in borrowers' equity contributions (see Table 1 for funds generation). This generation of funds will occur assuming AID funds account for only 20% of total project costs approved under the Project Finance Facility.

Over the life of the project, all local currency reflows from the Private Sector CIP and Project Finance facilities will be placed in the AID/GOE Special Account as described in an amendment to the memorandum of understanding. These reflows, which will come almost exclusively from the Private Sector CIP Facility for the first three years of the project, will constitute the source of Egyptian pound funds to be placed in a guarantee fund to cover small borrower loan defaults. LE 20 million from the AID/GOE Special

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Account will be immediately placed into the credit guarantee fund under the Small-Scale Business Facility. The amendment to the memorandum will stipulate that all proceeds generated by these components shall be deposited into the AID/GOE Special Account at the Central Bank of Egypt and that LE 60,000,000 shall be made available as the need for more funding arises.

In FY 86, funds will be allocated as follows: $50 million to the Private Sector CIP Facility and $30 million to the Project Finance Facility. Subsequent fiscal year obligations will depend upon how well funds move under each facility during the previous fiscal year; as funds under each facility are expended, incremental funds will be obligated to the facilities on the basis of projected disbursements.

To cover the cost of the project evaluations scheduled for 1988 and 1990, as well as audit costs, a budget line item of $326,000 is included in the project budget. This category will include $40,000 for costs associated with periodic post-audit inspections under the project. General evaluation guidelines may be found in Section VII. A breakdown of the costs to conduct the evaluations and audits may be found in Table 2 at the end of this section.

In order to provide for the efficient use of project funds, budget line items may be varied, subject to written approval of a Project Implementation Letter approved by USAID and the GOE.

B. Financial Plan

Table 3 represents the anticipated infusion of AID and GOE funds by fiscal year for the life of project. It is expected that all project funds will be committed during the first three years under the Private Sector CIP and Project Finance facilities. It is further envisioned that LE 20,000,000 from the AID/GOE Special Account will be immediately made available and, subsequently, project reflows will allow full capitalization of the credit guarantee fund under the Small-Scale Business Facility. As such, any excess local currency reflows above and beyond the LE 60 million will then be available for transfer from the Special Account to related private sector credit activities as the need for more funding arises.

Table 1

Estimated Project Costs and Funds Generation 1/
(FY 1986, 1987, 1988)

($U.S. 000s) 2/	USAID	Participating Banks	Borrowers' Equity	GOE Contribution	Total
Project Facilities					
Private Sector CIP	$117,337	---	---	---	$117,337
Project Finance	117,337 3/	$234,674	234,674	---	586,685 3/
Small-Scale Busines	---	---	$ 44,118	$44,118 4/	88,236 4/
Evaluations/Audits	326 6/	---	---	---	326 6/
Total	$235,000	$234,674 5/	$278,792 5/	$44,118	$792,584

1/ See Table 3 of this section for cost breakdown by fiscal year.
2/ Participating Banks, Borrowers' Equity and GOE Contribution are converted to $U.S. at rate of 1.36 L.E. = 1 $U.S.
3/ Assumes USAID funds are approximately 20% of total project costs.
4/ Estimated allocation from GOE special account (i.e., local currency reflows from USAID foreign exchange sub-loans under both the Private Sector CIP and Project Finance facilities), converted to dollars.
5/ Conservative estimate reflecting current criteria. In actuality, mobilization of bank and borrower funds should exceed the Egyptian pound equivalent of $469 million and $557 million, respectively.
6/ See separate evaluation cost plan, Table 2 of this Section.

Table 2

Evaluation and Audit Cost Plan

Category	Description	Estimated cost
Salaries	$250/da.x 6da./wk. x 4 wk./mo. x 8 mo.	$ 48,000
Per Diem	30 da./mo x $77/da. x 8 mo.	18,480
Overhead	2.2 x base salaries (48,000)	105,600
Airfare	8 round trips (Wash./Cairo/Wash.) @ $2,000 per round trip	16,000
Surveys	2 surveys of $30,000 each	60,000
Other Direct	$300/evaluation x 2 evaluations	600
Logistical and Secretarial Support		20,000
Sub-total (evaluations)		268,680
Audit Costs		40,000
Sub-total (audits & evaluations)		$308,680
Contingency 6% (approx.)		17,320
Grand Total		$326,000

Table 3

Projection of Expenditure by Fiscal Year

Fiscal Year	Pvt. Sector CIP Facility	Proj. Finan. Facility	Evaluations/ Audits	Total
1986	$ 4,000	—	—	$ 4,000
1987	50,000	$ 36,000	—	86,000
1988	50,000	36,000	$163	86,163
1989	13,000	36,000	—	49,000
1990	337	9,337	163	9,837
Total	$117,337	$117,337	$326	$235,000

III. IMPLEMENTATION PLAN

A. Project Finance Component

1. Implementing Agencies (Participating Agent Banks, GOE and USAID)

The PEC project will be implemented by Egyptian banks which already have experience operating Production Credit (263-0147) and are gaining experience with PIEF (263-0097). Banks act as agents for the PIEF in accordance with the terms of the "Participating Bank Agreement." Supporters of PIEF have always underscored the significance of one of the design's most important characteristics (i.e., flexibility to efficiently react to changes in the Egyptian financial and banking milieu). By allowing this Fund's structure and implementation techniques to evolve from interaction within the banking system and private sector investment environment, modifications or adjustments can be undertaken in a beneficial way.

This flexible concept permits maximum involvement of the Egyptian banking sector through co-lending arrangements with selected participating institutions. As PEC develops further operational experience, it may enlarge the number of participating banks to expand the availability of term credit to a wider spectrum of potential borrowers.

Presently, there are no plans for the creation of an institution (bank, finance company, etc.) devoted to the employment and administration of reflows. There is flexibility, however, to allow for the establishment of such an entity in later years, assuming evidence leads to favor such an endeavor. 1984-1985 discussions with Sultan Abou Ali, pertaining to PIEF's resurrection, emphasized his interest (as Deputy Chairman of the Investment Authority and Director of PIEF; on March 30, 1985, he became Minister of Economy) in eventually creating an independent investment bank to manage both new funding and reflows to the PIEF.

The Ministry of Economy with its Investment Authority continues to be the designated implementing agency and is advised on policy by a PIEF Advisory Board. (This arrangement will continue under PEC.) The Board is comprised of government and private sector representatives (see Annex G for its present list of members). To assure continuity and to handle day-to-day administrative matters, the Deputy Chairman of the Investment Authority has been appointed the Director of PIEF; if needed, Authority staff is called in unusually complicated cases to review and recommend approval/disapproval of sub-projects for Fund financing submitted by the participating banks. The staff's recommendations will be submitted to the Advisory Board for a final, sub-project financing decision.

Criteria for review, approval/disapproval has been established by the Advisory Board with assistance from USAID. A PIEF Project Information Checklist utilized in the PIEF sub-project loan proposal approval process is found in Annex G. Under the existing process, USAID also reviews and approves the sub-projects before financing can take place.

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A major objective is to expand the authority and responsibility of participating banks in their role as agents for the Fund. At the present time, the participating banks are responsible for day-to-day implementation of Fund investments in sub-projects. With an increase in confidence based on a successful operating history, GOE and USAID will take steps, when appropriate, to minimize government controls and regulations. It is intended that the participating banks, with strengthened management capability and improved project appraisal capability and project financing experience, will become a prime source of project implementation responsibility.

It is envisioned that upon approval by USAID of five PFF sub-loan projects, both USAID and the Ministry of Economy will no longer directly participate in the loan approval process. Thereafter, the Advisory Board and USAID will receive periodic reports, evaluations and post-audits that provide evidence to assure Fund monies are properly handled by the participating agent banks.

The Private Enterprise Credit Project Finance Component implementation plan corresponds closely with the PIEF plan designed in 1979. Inherent in all planning under this activity is the built-in flexibility to adjust and make modifications in response to the reality of operating in the "marketplace."

2. Investments in Sub-Projects:

The project funds will be administered by already-established credit institutions. These institutions are public and private banks established under the GOE regulations and are following their accounting procedures. Determination was made by USAID that GOE accounting procedures are satisfactory.

A simplified procedure for processing sub-project loan applications is presented in Annex G.

3. Implementation Schedule

From mid-1984 to April 1985, USAID worked closely with the Ministry of Economy's Investment Authority to relaunch the PIEF. Throughout, the Investment Authority, as well as other GOE entities, were responsive and supportive of this effort. In April 1985, the PIEF was renewed and became operational. It is anticipated that presently the obligated $33 million will be fully allocated to sub-projects by the end of FY86; the Private Enterprise Credit Project Finance Component ($117.3 million) will be fully allocated to sub-projects by the end of FY89.

4. Terminal Dates

a. The PIEF (263-0097) terminal date for satisfaction of conditions precedent to initial disbursement has been met. See Section VI, Conditions and Covenants, describing new conditions precedent to disbursement.

b. With the reobligation of $22.195 million (July 31, 1985) the Project Assistance Completion Date (PACD) for Project 263-0097 was extended from September 30, 1985, to September 30, 1989; allowing sufficient time to approve sub-projects, receive equipment and services and allow for start of sub-project operations. The PACD for Private Enterprise Credit (263-0201) is September 30, 1991.

c. Terminal Date for Disbursements will be nine months after PACD. This period should permit disbursements of funds under Letters of Credit opened pursuant to the last Letter of Commitment.

B. Private Sector CIP Component; Implementing Agencies and Responsibilities

The implementing agencies for the Private Sector CIP Facility will be the participating banks, USAID, and the GOE as represented by MPIC. Primary implementation responsibility will rest with the banks who will act in accordance with the rules and procedures set forth in an Operating Circular to be issued by MPIC with the concurrence of USAID.

The banks will process and approve transactions in accordance with AID regulations and the Operating Circular. USAID will review all transactions approved by the banks on a post audit basis. Results of this review process will be used to reduce or eliminate individual bank's independent approval authority as needed.

The participating bank, after approving a transaction, will request the U.S. Letter of Commitment Bank to issue an irrevocable Letter of Credit to the U.S. supplier. The Bank L/Com method of payment, which was used under the PCP, will continue to be used. Given the large number of relatively small transactions expected under this program (the average transaction size under PCP was approximately $165,000), this is the most appropriate payment procedure.

The participating banks assume a liability to the special account for the principle amount of each transaction at the time the L/C is opened. Thus, each bank assures the credit risk on behalf of its client. Full principal and interest collected by the banks will be paid into the special account.

The participating banks will also issue periodic reports to MPIC and USAID, as required in the Operating Circular, on the status of this element of the project. Adjustments to the program can be made at any time, through amendment of the Operating Circular, when jointly agreed to by USAID and MPIC. Representatives of the business community, such as the Egyptian Businessmen's Association and the American Chamber of Commerce in Egypt, will be asked to provide suggestions on ways to modify and improve the program, in conjunction with periodic discussions to be held between AID and MPIC.

For purposes of meeting 50/50 shipping requirements, this project element will be combined with Commodity Import Program (CIP) Grant 263-K-607. Prior to committing more than $50 million for the Private Sector CIP, USAID/Cairo will again consult with AID/Washington to identify a new CIP Grant which could be used to make up any shortfall in meeting U.S. cargo preference. This procedure is identical to that followed under the Production Credit Project and has been agreed to by AID/Washington (see Annex K).

C. Procurement & Gray Amendment Requirements

The project will be implemented over a five and one-half-year period which is anticipated to allow sufficient time for disbursement of funds by participating banks (represented by payments to U.S. suppliers under Letters of Credit) and arrival of goods/equipment in Egypt.

Procurement financed by sub-loans from the Project Finance Component will be conducted in accordance with the guidelines presently set forth in the PIEF Participating Bank Agreement. These guidelines reflect requirements applicable to U.S. dollar procurements by intermediate credit institution sub-borrowers under AID Handbook 1, Supplement B, Chapter 19. Procurement by private sector importers under the Private Sector CIP component will be governed by Regulation 1 and will involve use of competitive negotiation under Regulation 1, Section 201.23. For the Small-Scale Business Facility, guarantees are to be extended from local currency reflows. Consequently, AID procurement regulations do not apply.

With respect to cargo preference rules, we have obtained a determination from AID/Washington that current and prospective use of U.S. flag shipping under CIP grant is sufficient to enable AID to meet its statutory obligations without specific compliance by this project. (See Annex K.)

Periodic post-audits will be undertaken to assure project funds have been expended in accordance with project criteria and designed sub-loan procedures. These audits plus project evaluations are included in the project financing plan with a budget of $326,000. At present, the majority of audit and evaluation work is expected to be carried out with in-house AID overseas and TDY staff. What limited outside contracting is deemed necessary for this work is planned to be procured on a direct contract basis with project funds.

Careful consideration has been given to Early Alert identification of opportunities for minority and Small Business Administration 8(a) firms. The only significant opportunities for such firms are in the areas of audit and evaluation. Every effort will be made to assure solicitation of interest from minority and SBA 8(a) firms. It will be incumbent upon USAID, during the audit and evaluation contracting process, to generate greater participation in the AID/Egypt program of Historically Black Colleges and Universities, SBA 8(a) firms, minority and women-owned firms and minority-controlled Private Voluntary Organizations.

In accordance with AID's Early Alert System, USAID certifies that, prior to authorization of this project, for all proposed direct contracts full consideration will be given to the potential involvement of the target group entities and the specific steps to be taken to ensure such involvement.

IV. MONITORING PLAN - CREDIT COMPONENTS

The PIEF and Production Credit project papers outlined the format for USAID monitoring credit projects. The USAID Office of Finance and Investment (FI) will maintain, initially, frequent but not daily contact with MOE and MPIC staff, participating banks and sub-project borrowers to monitor project progress and visit project sites. The USAID project officers will draw on assistance from other divisions as needed (e.g., engineering, legal, program economists, etc.). In addition, following receipt of post-audit reports and as the need arises, periodic consultations will be scheduled with the Ministry of Economy, Investment Authority, PIEF Advisory Board, et al, to assess portfolio impact, problems, management and appropriate adjustments to the implementation plan. As operating experience develops, USAID's and GOE's direct involvement is expected to lessen based on experience and portfolio status reports prepared by the banks. Both USAID and GOE will be available, on a case-by-case basis, to address problems confronted by PIEF staff and participating banks.

Until such time as USAID and GOE involvement is reduced, USAID approval of sub-projects proposed for PIEF investment will follow standard Mission procedures: review and endorsement by FI office if favorable; and approval by the Associate Director, Industry and Support on an appropriate Action Memorandum prepared by FI.

For the credit components, standardized reports will flow from the participating banks to USAID and the GOE. These reports will include the following information:

1. Letter of Commitment (L/Com)

   - number of L/Com and amount
   - date of opening, validity period
   - US correspondent bank

2. Letters of Credit (L/C)

   - L/Com number (source of funds) and number of L/C amount (increases and decreases) and conditions, U.S. bank name of client, name of supplier date of opening, validity period disbursements and balance of L/C

3. Problems encountered and issues requiring resolution, additional information.

Under the Private Sector CIP Component, each participating bank is required to submit monthly reports to MPIC with copies to USAID.

V. SUMMARY OF ANALYSES

A. Institutional & Administrative Analyses

A unique characteristic of PEC is the reliance upon the existing Egyptian banking industry and credit lending systems for project implementation. PEC does not establish a new institution nor does it revise current Egyptian bank law. Annex E-1 describes how the designated implementing organizations (participating banks, PIEF Advisory Board, Ministry of Economy/Investment Authority, Ministry of Planning and International Cooperation and the Central Bank of Egypt) will interact within the structure of the Egyptian banking industry. Over the past few years, banking consultants to USAID/Cairo have been consistently of the opinion that, in Egypt, there are enough banks which are sufficiently capable and experienced to properly handle a project of PEC's scope. Furthermore, Mission personnel have accumulated seven years' experience in working with major Egyptian banks. Based upon this experience, USAID believes that there exist Egyptian banks which possess expertise and staff capable of performing on a level that would be expected of them under PEC.

The Institutional and Administrative Analyses conclude that the PEC project must continue in a focused and disciplined manner if it is to be successful in contributing to increasing private sector productive investment in Egypt. USAID and GOE counterpart agencies will need to meet with key business and financial people throughout Egypt (e.g., Egyptian Businessmen's Association, U.S./Egypt Joint Business Council, American Chamber of Commerce in Egypt) to discuss and review PEC lending services and methods of collaboration.

B. Financial Analysis

Project funds flowing through existing financial institutions constitute a relatively small portion of total credit in Egypt, and limitations on the size of transactions prevent program loans from dominating the portfolio of any financial institution. Except for the Small-Scale Enterprise Credit Guarantee Program, which is funded from Egyptian Pounds placed in a special account, project financing is not dependent upon contributions from the GOE or other sources. Based on the relative small impact of this project on total credit, and on the experience with previous credit projects operating through the Egyptian financial system, there is a solid basis for expecting that financing under this project will flow smoothly, and all loans will be adequately funded and repaid on schedule. The exact mix of credit instruments and financing institutions cannot be determined in advance. See Annex E-2 which presents the PEC project Financial Analysis.

C. Economic Analysis

The project will improve the access to foreign exchange and term credit for private enterprise in Egypt by countervailing GOE regulations that currently are biased against private firms. As a result of this project, there will be a more market-oriented (and hence, more efficient) allocation of resources, in general, and a more efficient use of USAID funds, in particular. The total value of these benefits is a function of the differential in productivity between public and private firms (assuming USAID funds otherwise would go primarily to encourage further public sector production), and the degree to which the resource mix (land, labor, capital, entrepreneurship) is improved within the private sector. Although this rate of return cannot be estimated in advance, since the mix of borrowing firms is not known, both elements of the function should work toward a positive economic benefit (i.e., private sector activity in Egypt is more productive than public sector activity, and reducing the constraint on term lending will permit more appropriate resource combinations within the private sector). Annex E-3 further describes the Economic Analysis undertaken for this project.

D. Social Soundness Analysis

The purpose of this social soundness analysis, presented in Annex E-4, is to: (1) examine the extent to which the proposed project is compatible with the existing business environment into which it will be introduced; (2) determine the adequacy of incentives to ensure participation by targeted banks and small-scale entrepreneurs; (3) determine the spread effects of project resources beyond the life of the project; and (4) identify how the project will affect different categories of small and medium-scale enterprises (SME's).

The focus of this social soundness analysis is the third component, the Small-Scale Business Facility, principally because it is brand new, but also because it will target a population with little or no previous access to bank credit and financial assistance. This population consists of small and medium-scale entrepreneurs. Under this project component, the incentive to encourage banks to participate by broadening their clientele base to include small and medium-scale enterprises is the Credit Guarantee Fund. Within the constraints matrix revealed by the data, a guarantee fund has the potential for being an appropriate response.

Spread Effects: Institutionalization of Access to Credit. The institutional mechanisms which will ensure continued availability of funds for term credit once the project is completed will be of two types: (1) financial: interest income from incremental reflow deposits averaging a 5 - 7% rate of growth will sustain the Fund and (2) social: the gradual establishment of trust and confidence by banking officials in a targeted portion of the SME community, resulting from working together over a period of time. Hopefully, this new trust and confidence will lead to some changes in attitude, perceived and real, about the risks involved in making loans to members of the SME community. The long-term desired change is an institutional one, namely, a lowering of the collateral requirements for small-scale entrepreneurs, the majority of whom own neither the land nor the buildings where their shops and factories are located. The spread effects of this project will be maximized throughout the SME community if participating banks feel, after a period of working with the SME community, confident enough to lower the collateral requirements. The entire SME community would benefit from this change in a long-standing banking practice.

E. Environmental Summary

The Private Sector CIP and Small-Scale Business facilities are granted Categorical Exclusions pursuant to Section 216.2(c)(2) under 22 CFR 216.2 of "AID Environmental Procedures" dated October 23, 1980. The USAID Environmental Advisor for Industrial Pollution Control and the Mission Environmental Officer, in conjunction with the AID/W Environmental Officer for ANE/PD/ENV, reviewed standards previously established for PIEF sub-borrowers for possible application under the Small-Scale Business Facility. This group subsequently decided that PIEF standards could be applied to this facility, thereby exempting these sub-loans from the preparation of full-field Environmental Assessments or Environmental Impact Statements under 22 CFR 21[illegible].2 if initial Assessments for these activities demonstrated negative or negligible impact on the environment.

All applicants for the Project Finance Facility are still required to submit an Environmental Review following the outline included in the PIEF Participating Bank Agreement. Copies are readily available in USAID's FI Office and AID/W's ANE/PD/Egypt Office. This review is intended to assure that proposed project-funded activities comply with the basic environmental procedures of AID as specified in 22 CFR Part 216 "AID Environmental Procedures" dated October 23, 1980. This form, following submission by individual sub-borrowers, will be reviewed by the USAID Environmental Advisor for Industrial Pollution Control and/or the Mission Environmental Officer who will provide comments on the proposed project activity. See Annex E-5 for PEC's environmental clearance written by the Mission's Environmental Officer, as well as the Environmental Review referred to above.

VI. CONDITIONS AND COVENANTS

A. Requirements Precedent to Disbursement

1. General

Prior to any disbursement or to the issuance by AID of any documentation to which disbursement would be made under the Private Enterprise Credit Project, the Grantee shall, except as the Parties may otherwise agree in writing, furnish to AID, in satisfactory form and substance:

a. A statement of the names and titles of the persons authorized as the representatives of the Grantee, together with a specimen signature of each person specified in such statement.

b. An amendment to the Memorandum of Understanding regarding the Special Account providing that LE 20,000,000 of the amount currently on deposit in the Special Account shall be made available for use by the Small-Scale Enterprise Credit Guarantee Fund.

2. Component-Specific Requirements

Prior to any disbursement or to the issuance by AID of any documentation pursuant to which disbursement would be made under the Private Enterprise Credit Project for specific credit components, the Grantee shall, except as the Parties otherwise agree in writing, furnish to AID, in satisfactory form and substance:

a. For the Project Finance Facility, evidence of formal approval by the General Authority for Investment and Free Zones (the "Investment Authority") and AID: 1) of sub-loans under the Private Investment Encouragement Fund (AID Project No. 263-0097) totaling at least $10 million; (2) that funds will be provided for co-financing sub-loans with Participating Banks and that such funds will be managed by the Participating Banks as agents; and (3) of the continuation of the Advisory Board, established under Project No. 263-0097, to review sub-projects, recommend their approval or disapproval, and monitor the implementation of the Project Finance Facility.

b. For the Private Sector Commodity Import Program, an acceptable circular or other official document issued by the Ministry of Planning and International Cooperation (MPIC), as jointly agreed upon by MPIC and AID, setting forth in necessary and sufficient detail terms and conditions applicable to loans made under such component.

Prior to the satisfaction of the requirements precedent in Section VI. A. 2, the Parties may amend the Illustrative Financial Plan to reallocate funds between project components.

B. Covenants

1. Project Evaluation

The Parties agree to establish an evaluation program as part of the Project. Except as the Parties otherwise agree in writing, the program will include, during the implementation of the Project and at one or more points thereafter:

a. Evaluation of progress toward attainment of the objectives of the Project;

b. Identification and evaluation of problem areas or constraints which may inhibit such attainment;

c. Assessment of how such information may be used to help overcome such problems; and

d. Collection and analysis of data needed to assess, to the degree feasible, the overall development impact of the Project.

2. Periodic Discussions

The Grantee shall undertake periodic discussions, not less than once a year, with AID and private sector business groups, such as the Egyptian Businessmen's Association and the American Chamber of Commerce in Egypt:

a. To discuss performance of the project credit components and discuss ways to improve operating procedures; and

b. To discuss further financial intermediation efforts that could be undertaken to facilitate growth of the private sector.

3. <u>Special Account</u>

a. Grantee will establish a Special Account in the Central Bank of Egypt and, except as the parties may otherwise agree in writing, deposit therein currency of the Government of the Arab Republic of Egypt in amounts equal to proceeds accruing to the Grantee or any authorized agency thereof as a result of the sale or importation of commodities financed hereunder or as the repayment of loans under the Project.

b. Funds deposited in the Special Account pursuant to the Private Enterprise Credit Grant Agreement may be used for such purposes as are described in the Memorandum of Understanding regarding the Special Account, dated June 30, 1980, as amended, and that an additional portion of such deposits, as may be agreed by the parties, shall be made available to AID to meet part of its local currency administrative requirements in Egypt.

c. Deposits to the Special Account in local currency will be made in accordance with payment procedures agreed upon in writing by the parties or described in circulars issued by the Grantee.

d. Except as AID may otherwise agree in writing, the Grantee shall make such deposits at the highest rate of exchange prevailing and declared for foreign exchange currency by the competent authorities of the Arab Republic of Egypt.

e. Any unencumbered balances of funds which remain in the Special Account upon termination of the assistance program shall be used for such purposes as may, subject to applicable law, be agreed to between Grantee and AID.

f. The Grantee will maintain and use fully, in monitoring Special Account deposits and balances, the accounting system developed and installed in fulfillment of Requirement Precedent 3.2(a) under the Fiscal Year 1984 Commodity Import Program.

g. The Grantee will exert its best efforts to reach agreement with AID, as soon as practicable after execution of the PEC Grant Agreement, on an amendment to the Memorandum of Understanding regarding the Special Account to include Egyptian pounds to be generated under the Grant.

4. <u>Administration of Small-Scale Enterprise Credit Guarantee Fund</u>

The Grantee shall create an administrative system, sastisfactory to AID, that will facilitate implementation of the Small-Scale Enterprise Credit Guarantee Fund. The system shall include, inter alia, criteria for selection of banks to participate in the Small-Scale Enterprise Credit Guarantee Fund; Fund operational criteria and procedures; and, a framework for maintaining accounting records of all Fund transactions. Grantee and AID shall jointly review the performance of the Fund and decide policy and procedural modifications on a semi-annual basis.

5. Small-Scale Enterprise Banks

Grantee and AID will jointly approve the selection of banks to participate in the Small-Scale Enterprise Credit Guarantee Fund.

6. Ratification

The Grantee shall take all necessary action to complete all legal procedures necessary to ratification of the Grant Agreement and will notify AID as promptly as possible of the fact of such ratification.

VII. PRIVATE ENTERPRISE CREDIT EVALUATION PLAN

The project design team has identified a series of evaluation questions intended to assess both project implementation progress and impact. Data collection during the project and timing and scope of evaluations will be based upon these questions.

To determine project impact, evaluations will examine the following questions: Did the project result in additional credit availability to private industry, and for which industries? Did project funds bring about increases in private sector imports of raw materials and capital goods? Did they result in substantial annual increases in private sector investment? What was the project's impact on private sector output, capacity utilization, employment, and exports? What has been the project's influence on USAID's policy dialogue related to foreign exchange rates, industrial credit interest rates, and expansion of private investment opportunities? How have the banks' attitudes, relationships and procedures regarding industrial borrowers changed?

Questions on project implementation progress will center around whether procedures for loan approval and commodity procurement are appropriate and whether the project has adequate flexibility to accommodate implementation problems. Particular emphasis is placed on the small-scale enterprise component, since this is the only entirely new activity in the project.

The primary evaluation questions are summarized, along with a description of the data gathering and analysis requirements, in Annex L-1, Evaluation Framework.

The information needed to answer evaluation questions will be generated through annual review of nation-level statistics; bank appraisal reports and user-firm-level data; user surveys carried out twice during the project; interviews with project personnel, participating banks and credit users; and review of project documents. It may be necessary to ask participating banks to expand slightly upon the information they require from loan applicants to provide the data needed for evaluation. This will be determined early in project implementation.

Annual project reviews will be held by the project committee and key Egyptian counterpart personnel. These will review implementation progress and make recommendations for design modifications as necessary. In conjunction with these reviews, project staff will conduct annual post-audits for the project finance facility, to review participating banks' loan documents and ensure compliance with project loan criteria and guidelines.

A mid-term evaluation will take place prior to the third project obligation in 1988, assuming satisfactory implementation progress. An end-of-project evaluation will occur in 1990. These will draw on data gathered throughout the course of the project, results of annual reviews, and special surveys. The annual reviews will probably suggest changes to the evaluation questions listed in Annex L-1. Funding has been set aside for an outside evaluation team for both evaluations.

A-1

ACTION: AID-6 INFO: ECON ECON /6

VZCZCCR0820
PP RUEHEG
DE RUEHC #5696/01 2602158
ZNR UUUUU ZZH
P 172150Z SEP 85
FM SECSTATE WASHDC
TO AMEMBASSY CAIRO PRIORITY 7436
BT
UNCLAS SECTION 01 OF 02 STATE 285696

LOC: 16 SEP 85 CN: 33774 CHRG: AID DIST: AID

Action Info
IS OPPE
Due 9/19

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: EGYPT - PRIVATE ENTERPRISE CREDIT PROJECT PID (2630201)

THE ANPAC MET ON SEPTEMBER 5, 1985, TO REVIEW SUBJECT PID AND APPROVED THE MISSION PROCEEDING WITH THE PROJECT DESIGN AND PP IN ACCORDANCE WITH THE APPROACHES OUTLINED BELOW. AID/W APPRECIATES THE TDY OF ICN PRESSLEY, AD/IS, WHICH HAS BEEN MOST HELPFUL NOT ONLY IN SPEEDING ANPAC APPROVAL BUT ALSO IN REVIEWING PARTS OF IS PORTFOLIO. THE FOLLOWING ISSUES WERE DISCUSSED AND RESOLVED AS NOTED:

A. ECONOMIC POLICY DIALOGUE: THE PID DOES NOT DESCRIBE THE RELATIONSHIP OF THIS PROJECT AND ITS MACRO-ECONOMIC ASPECTS TO THE ONGOING ECONOMIC POLICY DIALOGUE WITH THE GOE. ALTHOUGH SPECIFIC PROJECTS ARE NOT TO BE TIED TO SPECIFIC ISSUES OF THE POLICY DIALOGUE, THE ANPAC FELT THAT THE PP SHOULD INCLUDE A FULL DISCUSSION ON HOW THIS PROJECT REINFORCES THE ON-GOING ECONOMIC REFORM DIALOGUE.

B. FOREIGN EXCHANGE RATE: THE PID DISCUSSES A QUOTE IDEAL UNQUOTE APPROACH TO DEALING WITH THIS ISSUE.

WHILE THE PID IS NOT EXPLICIT ON HOW THE MISSION INTENDS TO PURSUE THESE ISSUES WITH THE GOE, WE UNDERSTAND THE MISSION AIMS TO OBTAIN THE QUOTE OWN UNQUOTE RATE BUT APPRECIATES THAT THE GOE MAY DISAGREE. THE ANPAC DISCUSSED THE HISTORY OF THIS ISSUE, ITS IMPLICATIONS FOR THE ENTIRE PROJECT PORTFOLIO, AND THE PERSONAL INTEREST OF THE ADMINISTRATOR IN SEEKING A SIGNIFICANT UPWARD ADJUSTMENT IN THE CURRENT RATE. THE CURRENT POSITION OF THE IBRD WAS ALSO REVIEWED. IN CONCLUSION, THE ANPAC APPROVED THE PID BASED UPON THE MISSION'S SUCCESSFULLY NEGOTIATING AT LEAST THE USE OF THE QUOTE BANK INCENTIVE RATE UNQUOTE AS A QUOTE FLOOR UNQUOTE EXCHANGE RATE. CALCULATING THIS RATE COULD INCLUDE THE USE OF FEES, ETC., SO THAT THE BANK INCENTIVE RATE, CURRENTLY ABOUT 20 POINTS (I.E., LE 1.26) BELOW THE FREE MARKET RATE, WOULD APPROXIMATE THE REAL COST OF CAPITAL WITH AN ALLOWANCE (I.E., THE ABOVE 20 POINTS) FOR AN INCENTIVE TO BUY I.S.

GOODS. IF THE BANK INCENTIVE RATE CANNOT BE OBTAINED, THE ANPAC RECOMMENDED THAT THE MISSION BE REQUIRED TO CONSULT WITH AID/W ON HOW BEST TO PROCEED ON THIS ISSUE BEFORE PROCEEDING WITH AUTHORIZATION. FURTHERMORE, THE ANPAC FELT THAT THE MISSION SHOULD SEEK WAYS TO MAINTAIN FLEXIBILITY IN CRITERIA FOR OBLIGATING FUTURE ANNUAL TRANCHES TO ASSURE MOVEMENT TOWARDS A FREE MARKET RATE.

C. GENERAL TRANSACTIONS FACILITY: AS NOTED, THE ANPAC RECOMMENDED THE ESTABLISHMENT OF A FOREIGN EXCHANGE RATE THAT APPROACHES THE COST OF CAPITAL, AS DESCRIBED ABOVE, TO ENSURE THAT THE PROGRAM SERVES BOTH AS A SOURCE OF FOREIGN EXCHANGE AND AS A CREDIT FACILITY. THE MISSION'S ELIMINATION OF THE MAINTENANCE OF VALUE PROVISION SHOULD ALSO HELP RESOLVE THIS PROBLEM. IN ADDITION, THE ANPAC RECOMMENDED THAT THE MISSION SHOULD NEGOTIATE A CHANGE IN THE RECENTLY REVISED CIRCULAR NO. 1 TO DECREASE GOE CONTROL OVER PRIVATE SECTOR PROGRAMS FINANCED UNDER THE PROGRAM AND REACH AGREEMENT UPON PROCEDURES WHICH WILL EVIDENCE THIS DIMINISHING ROLE, WHICH SHOULD BE OUTLINED IN THE PP.

D. PROJECT FINANCE FACILITY:

(1) ASSURANCE OF OPERATIONS: THE ANPAC REVIEWED THE SEVERAL YEARS OF NEGOTIATIONS, AUDIT RECOMMENDATIONS TO TERMINATE THE PIE FUND, AND DEOBLIGATION AND SUBSEQUENT REOBLIGATION ON RECEIPT OF ASSURANCES FROM THE GOE. HOWEVER, THE PIE FUND HAS NOT YET STARTED OPERATIONS, ALTHOUGH THE PID AND OTHER REPORTS INDICATE THAT IT IS ABOUT TO DO SO. TO INSURE AGAINST A REPETITION OF FUND INACTIVITY, THE ANPAC APPROVED THE PID SUBJECT TO THE

CONDITION THAT THE PIE FUND BE FULLY OPERATIONAL (I.E., FULL APPROVAL AND COMMITMENT OF AT LEAST DOLS 12 MILLION OF THE CURRENT DOLS 33 MILLION AVAILABLE) BEFORE THE MISSION AUTHORIZES THIS PROJECT.

-(2) INTEREST RATES: THE ANPAC SUPPORTS FULLY THE MISSION'S DIALOGUE ON RAISING INTEREST RATES TO A UNIFORM LEVEL FOR ALL SECTORS.

-(3) DEMAND FOR FUNDS: ON THE ASSUMPTION THAT THE MACROECONOMIC ISSUES CAN BE ADDRESSED SUCCESSFULLY, THERE REMAINS TO BE DETERMINED A SERIES OF ANALYSES DEMONSTRATING DEMAND FOR FUNDS FOR BANKABLE PROJECTS WITHIN THE ESTABLISHED PRIORITY SECTORS AT A HIGHER COST OF CAPITAL THAN IS PRESENTLY THE CASE. THE ANPAC DISCUSSED POTENTIAL APPLICANTS INCLUDING THE GM CAR-RELATED JOINT VENTURE COMPANIES PLUS OTHERS: THE IMPORTANT QUESTION IS WHETHER THEY WILL SEEK THESE FUNDS IF THE BORROWING COST APPROACHES THE COST OF CAPITAL.

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THE ANPAC SUGGESTS THAT THE PP ANALYZE THE DEMAND FOR FUNDS UNDER THE ASSUMPTION THAT THERE WILL BE A SUCCESSFUL NEGOTIATION OF THE EXCHANGE RATE AND INTEREST RATE ISSUES.

(4) TARGETTING: THE ANPAC AGREES WITH THE MISSION THAT TARGETTING OF BORROWERS WILL NOT BE NEEDED IN EARLY PROJECT STAGES. IF, HOWEVER, DEMAND FOR FUNDS SUBSTANTIALLY EXCEEDS AVAILABILITY OF FUNDS IN LATER YEARS, THE MISSION WILL WANT TO DEVELOP CRITERIA FOR TARGETTING CLASSES OF PREFERRED BORROWERS. THE ANPAC SUGGESTS THAT THE MISSION BUILD INTO THE PROJECT STRUCTURE A MECHANISM FOR PERIODIC (E.G., ANNUAL) REVIEW OF THIS QUESTION BEFORE OBLIGATING FUTURE TRANCHES.

E. SMALL SCALE ENTERPRISE (SSE) FACILITY:

-(1) PROJECT DESCRIPTION: THE ANPAC CONCLUDED THAT WHILE THE ATTEMPT TO INCLUDE SSE IN THIS PROGRAM IS A WORTHY GOAL, THE LACK OF SPECIFICITY AND KNOWLEDGE OF HOW IT WILL BE IMPLEMENTED RAISES THE QUESTION OF WHETHER IT CAN BE SUCCESSFULLY IMPLEMENTED WITHIN AN ALREADY COMPLICATED PROGRAM. THE ANPAC RECOMMENDS THAT THE MISSION STAFF OUT FULLY THE IMPLICATIONS OF MANAGING THIS PROGRAM PRIOR TO INCLUDING IT IN THE PP.

-(2) RELATIONSHIP TO SIMILAR PROJECTS: IT IS NOT CLEAR HOW THIS PROJECT COMPONENT WILL RELATE TO SSE ACTIVITIES CONTEMPLATED UNDER THE LOCAL DEVELOPMENT II AND FARM CREDIT PROJECTS, WHICH ARE, RESPECTIVELY, IN THE DESIGN

AND CONCEPT STAGES. THE PP SHOULD EXPLAIN HOW THESE PROJECTS WILL COMPLEMENT EACH OTHER, AS WELL AS PROVIDE AN ANALYSIS OF THE FINDINGS OF A LARGE NUMBER OF STUDIES TO DATE ON SSE AND WHY THE MISSION HAS CHOSEN DIFFERING PROJECT APPROACHES. THE ANPAC RECOMMENDED THIS ANALYSIS SO THAT THE ALTERNATIVE APPROACHES UNDER DISCUSSION BY VARIOUS OFFICES IN THE MISSION RESULT IN COMPLEMENTARY AND NOT COMPETING SSE PROJECT COMPONENTS.

F. EVALUATION: THE PID PROVIDES PRELIMINARY INDICATIONS OF MISSION THINKING ON EVALUATION. THE ANPAC CONSIDERED THIS AN AREA TO BE ADDRESSED IN THE PP IN DETAIL. THE PP SHOULD DESCRIBE HOW SUCCESS OR FAILURE IS TO BE DEFINED, THE DATA BASE REQUIRED FOR MAKING THIS DECISION, AND THE DATA COLLECTION/GENERATION NEEDED FOR EVALUATION MEASUREMENTS.

G. OTHER: THE ANPAC RECOMMENDED THAT THE DOLS 18 MILLION CONTINGENCY SHOULD BE REEXAMINED; IT IS NOT A COST OR ESCALATION CONTINGENCY. SHULTZ
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Clarification of ANPAC PID Review Cable

In January 1986, AID/W revised Part D of the ANPAC PID Review cable so that the project could be authorized. However, no funds will be disbursed under the Project Finance Facility until $10 million of the $33 million currently available under PIEF has been earmarked.

ANNEX B

Project Design Summary

Logical Framework

Life of Project: 6 Years

From: FY 86 to FY 92
Total U.S. Funding: $235 Million
Date Prepared: Jan. 1986

Project Title & Number: Private Enterprise Credit (263-0201)

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Program or Sector Goal: The broader objective to which this project contributes:	Measures of Goal Achievement:		Assumptions for achieving goal targets:
To increase the private sector's contribution to Egyptian productive output.	1. Output of Egyptian private sector increases in real terms. 2. Private sector share of output increases relative to public sector.	1. GOE published economic statistics. 2. IMF published reports.	GOE continues to liberalize economy, foster private sector growth initiatives and accept AID program intervention in credit sector.
Project Purpose:	Conditions that will indicate purpose has been achieved: End of Project Status:		Assumptions for achieving purpose:
To expand investment of productive private sector enterprises.	1. Real private sector investment increases and increases relative to public sector. 2. Increase in private sector use of banking system resulting from improved services.	1. AID records 2. Bank records 3. Special studies and evaluations 4. Sector evaluations	1. Egyptian financial system responsive to AID project initiatives, and continues to expand its own capacity and capabilities. 2. Private sector projects requiring financing are viable from banker's perspectives. 3. Private sector is willing to utilize assistance. 4. General business climate is favorable.

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Project Title & Number: Private Enterprise Credit (263-0201)

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
Outputs: 1. Credit mechanism for Private Sector CIP and Project Finance Facility. 2. Guarantee fund for small-scale business on self-sustaining basis.	Magnitude of Outputs: 1. At least 59 project term loans. 2. At least 750 Private Sector CIP loans. 3. LE 60 million in loan guarantee fund; approx. 1,000 guarantees.	1. AID records. 2. Bank records. 3. Evaluations.	Assumptions for achieving outputs: 1. Banks actively participating as planned. 2. Borrowers of FX find premium rate acceptable. 3. Small-scale enterprises willing to pay guarantee fees.
Inputs: Credit facilities	Implementation Target (Type and Quantity): (see table below)	Project records	Assumptions for providing inputs: 1. Grant agreement negotiations successful 2. Conditions Precedent met in timely manner.

	U.S.$ (000s)
Credit	
Private Sector CIP	$117,337
Project Finance	117,337
Small-Scale Business Guarantee Fund	---
Evaluation/Audits	326
Total	$235,000

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Annex C

5C(2) PROJECT CHECKLIST

PRIVATE ENTERPRISE CREDIT
263-0201

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A. includes criteria applicable to all projects. Part B. applies to projects funded from specific sources only: B.1. applies to all projects funded with Development Assistance loans, and B.3. applies to projects funded from ESF.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?

GENERAL CRITERIA FOR PROJECT

1. FY 1986 Continuing Resolution Sec. 524; FAA Sec. 634A.

Describe how authorizing and appropriations committees of Senate and House have been or will be notified concerning the project.

a) Congressional committees will be notified in accordance with regular Agency procedures. No funds will be obligated for the Project until AID/W notifies USAID/Egypt that the CN waiting period has expired.

2. FAA Sec. 611(a)(1). Prior to obligation in excess of $500,000, will there be (a) engineering, financial or other plans necessary to carry out the assistance and (b) a reasonably firm estimte of the cost to the U.S. of the assistance?

a) Yes.

b) Yes.

3. FAA Sec. 611(a)(2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance?

All international agreements must be ratified by the People's Assembly. In the past, the Assembly has ratifi all grant agreements in a timely manner.

4. FAA Sec. 611(b); FY 1986 Continuing Resolution Sec. 501. If for water or water-related land resource construction, has project met the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, et seq.)? (See AID Handbook 3 for new guidelines.)

   N/A.

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and all U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability effectively to maintain and utilize the project?

   N/A

6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs.

   The project is not susceptible to execution as a regional multilateral project.

7. FAA Sec. 601(a). Information and conclusions whether projects will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; and (c) encourage development and use of cooperatives, and credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

   a) Yes.
   b) Yes.
   c) Private banks will participate in the Project.
   d) Yes.
   E) Yes.
   F) Yes.

8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).	Private enterprise in the United States will obtain increased export and investment opportunities as a result of the Project
9. FAA Sec. 612(b), 636(h); FY 1986 Continuing Resolution Sec. 507. Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.	Local currency generated by the Project will be deposited in the Special Account.
10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No.
11. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	N/A
12. FY 1986 Continuing Resolution Sec. 522. If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity?	N/A

13. FAA 118(c) and (d). Does the project comply with the environomental procedures set forth in AID Regulation 16. Does the project or program take into consideration the problem of the destruction of tropical forests?

Yes; N/A.

14. FAA 121(d). If a Sahel project, has a determination been made that the host government has an adequate sysem for accounting for and controlling receipt and expenditure of project funds (dollars or local currency generated therefrom)?

N/A.

15. FY 1986 Continuing Resolution Sec. 533. Is disbursement of the assistance conditioned solely on the basis of the policies of any multilateral institution?

No.

16. ISDCA of 1985 Sec. 310. For development assistance projects, how much of the funds will be available only for activities of economically and socially disadvantaged enterprises, historically black colleges and universities, and private and voluntary organizations which are controlled by individuals who are black Americans, Hispanic Americans, or Native Americans, or who are economically or socially disadvantaged (including women)?

N/A.

3. Economic Support Fund Project Criteria

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible is this assistance consistent with the policy directions, purposes, and programs of part I of the FAA?

Yes.

b.

No.

c. ISDCA of 1985 Sec. 207. Will ESF funds be used to finance the construction of, or the operation or maintenance of, or the supplying of fuel for, a nuclear facility? If so, has the President certified

No.

that such country is a party to the Treaty on the Non-Proliferation of Nuclear Weapons or the Treaty for the Prohibition of Nuclear Weapons in Latin America (the "Treaty of Tlatelolco"), cooperates fully with the IAEA, and pursues nonproliferation policies consistent with those of the United States?

d. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made?

Yes.

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. Procurement

1. FAA Sec. 602. Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed? — Yes.

2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or under delegation from him?? — Yes.

3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company? — N/A.

4. FAA Sec. 604(e); ISDCA of 1980 Sec. 705(a). If offshore procurement of agricultural commodity or product is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.) — N/A.

5.	<u>FAA Sec. 604(g)</u>. Will construction or engineering services be procured from firms of countries which receive direct economic assistance under the FAA and which are otherwise eligible under Code 941, but which have attained a competitive capability in international markets in one of these areas? Do these countries permit United States firms to compete for construction or engineering services financed from assistance programs of these countries?	N/A
6.	<u>FAA Sec. 603</u>. Is the shipping excluded from compliance with requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 per centum of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?	All applicable shipping rules will be followed.
7.	<u>FAA Sec. 621</u>. If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? If the facilities of other Federal agencies will be utilized, are they particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?	Yes.

8. <u>International Air Transportation Fair Competitive Practices Act, 1974</u>. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available? — Yes.

9. <u>FY 1986 Continuing Resolution Sec. 504</u>. If the U.S. Government is a party to a contract for procurement, does the contract contain a provisio[n] authorizing termination of such contract for the convenience of the United States? — Yes.

B. <u>Construction</u>

1. <u>FAA Sec. 601(d)</u>. If capital (e.g., construction) project, will U.S. engineering and professional services be used? — N/A

<u>FAA Sec. 611(c)</u>. If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable? — N/A

<u>FAA Sec. 620(k)</u>. If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP)? — N/A

C. Other Restrictions

1. FAA Sec. 122(b). If development loan, is interest rate at least 2% per annum during grace period and at least 3% per annum thereafter? N/A.

FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights? N/A.

FAA Sec. 620(h). Do arrangements exist to insure that United States foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries? Yes.

Will arrangements preclude use of financing:

a. FAA Sec. 104(f); FY 1986 Continuing Resolution Sec. 526. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo

Yes.

Yes.

sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; (4) to lobby for abortion? | Yes.

Yes.

b. <u>FAA Sec. 488</u>. To reimburse persons, in the form of cash payments, whose illicit drug crops are eradicated? Yes.

c. <u>FAA Sec. 620(g)</u>. To compensate owners for expropriated nationalized property? Yes.

d. <u>FAA Sec. 660</u>. To provide training or advice or provide any financial support for police, prisons, or other law enforcement forces, except for narcotics programs? Yes.

e. <u>FAA Sec. 662</u>. For CIA activities? Yes.

f. <u>FAA Sec. 636(i)</u>. For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained? Yes.

g.	FY 1986 Continuing Resolution, Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for military personnel?	Yes.
h.	FY 1986 Continuing Resolution, Sec. 505. To pay U.N. assessments, arrearages or dues?	Yes.
i.	FY 1986 Continuing Resolution, Sec. 506. To carry out provisions of FAA section 209(d) (Transfer of FAA funds to multilateral organizations for lending)?	Yes.
j.	FY 1986 Continuing Resolution, Sec. 510. To finance the export of nuclear equipment, fuel, or technology?	Yes.
k.	FY 1986 Continuing Resolution, Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?	The assistance will not be used to suppress human rights.
l.	FY 1986 Continuing Resolution, Sec. 516. To be used for publicity or propaganda purposes within U.S. not authorized by Congress?	Yes.

ANNEX D

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ARAB REPUBLIC OF EGYPT
MINISTRY OF PLANNING AND INTERNATIONAL COOPERATION

DEPARTMENT FOR ECONOMIC COOPERATION
WITH U.S.A.

00512

FI

July 10 , 1986

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ACTION TO IS DPPE
ACTION TAKEN ____ DUE DATE 7/23
NAM INITIALS ____

Mr. Frank B. Kimball
USAID Director
USAID / C

Subject: Private Enterprise Credit Program
Project NO. 263-0201
Request for Assistance

Dear Mr. Kimball:

The Government of Egypt wishes to extend the flow of credit to the productive private sector. For this purpose, the GOE requests AID grant assistance in the amount of $ 235 million during the life of this project to finance the following activities:

1. Short to medium term credit to finance private sector imports of capital equipment, intermediate goods, and raw materials from the U.S.

2. Medium to long term credit to finance plant start up, modernization and / or expansion.

3. Evaluations and audits to assess program effectiveness.

The project should have the flexibility so that funds can be shifted form one credit element to the other meet demand.

on behalf of the Government of Egypt I would appreciate your favorable consideration of this grant assistance request based on the general criteria set forth herein.

Sincerely yours,

Ahmad Abdel Salam

Ahmad Abdel Salam Zaki
Administrator.

ANNEX E-1

Institutional/Administrative Analyses

A. Introduction/Background

Implementation of the Private Enterprise Credit Project (PEC) relies upon the existing Egyptian banking industry and credit lending systems. PEC does not establish a new institution nor does it revise current Egyptian bank law.

Other sections of this project paper describe the lengthy historical development of the predecessor projects (Production Credit and the Private Investment Encouragement Fund), specifically, the evolutionary structural process and flexible implementation concept. These private sector credit projects were intentionally designed to avoid a rigid framework, to be flexible and innovative enough to react, with reasonable efficiency, to new market situations. The same is true of Private Enterprise Credit; as PEC matures over time, project components will evolve into new structures, subject to Egyptian market conditions.

It is important to note that, while this institutional analysis refers to the Egyptian banking system and the responsibilities of the different ministerial representatives, the success of PEC depends almost entirely on participating bank personnel for project implementation and administration. The banks must be encouraged to incur costs to attract the type of personnel needed by PEC. Costs for salaries and training are high compared to average bank expenses. In the event participating banks choose to hire less-qualified people in an effort to save administrative overhead costs over the life of PEC, then the chances of PEC success will be jeopardized.

A key advantage to fully utilizing PEC's organizational structure is that the operational system is highly diffuse. It literally spreads formal authority and responsibility over several levels of government and public sector/private sector banking entities.

B. Implementing Organizations

1. Participating Banks

The PEC project seeks to induce Egyptian private banks to implement the credit program and help achieve the desired improvements in Egypt's financial structure. Over the past few years, banking consultants to USAID/Cairo have been consistently of the opinion that, in Egypt, there are enough banks which are sufficiently capable and experienced to properly handle a project of PEC's scope. Furthermore, Mission personnel have accumulated seven years' experience in working with major Egyptian banks. The Mission has conducted negotiations and business transactions with men and women at various levels within these banks. Such widespread experience has led USAID to believe that there exist Egyptian banks which possess expertise and staff capable of performing on a level that would be expected of them under PEC.

Many middle and senior-level bank executives have received in-depth training in Egypt, Europe and the United States. Many attended banking seminars in Cairo conducted by major international banks (e.g., Chase Manhattan, Citibank, Barclays, Bank of America, American Express, et al). These same executives are presently directing implementation activities associated under Production Credit and the Private Investment Encouragement Fund. USAID, the GOE and independent consultants who evaluated the performance of these banks, asserted that they should continue to administer the same activities under the PEC project.

Under the Project Finance Facility each participating bank determines the technical, financial and economic feasibility of each project coming to its attention and recommends to the Private Investment Encouragement Fund (PIEF) Advisory Board that a given project be financed under the PIEF bank co-financing arrangement. The bank manages the co-financing portfolio over the full life of the PIEF financing. The bank selects projects for PIEF co-financing approval, based on pre-determined criteria and the provisions agreed to in the Participating Bank Agreement executed between the bank and the PIEF. Experience gained under the existing PIEF project support the conclusion that the participating banks are capable of exercising their duties and responsibilities related to this project element.

The specific implementation responsibilities of the participating banks related to the Private Sector CIP Facility require the banks to review all proposed transactions for compliance with AID Regulation One, the AID Commodity Eligibility Listing, and the Operating Circular. There are currently nine banks under the Production Credit project which have over the past three years demonstrated their ability to handle this task. A maximum of three new banks will be added to the program.

USAID will review all transactions approved by the banks on a post-audit basis. Individual bank's independent approval authority can be adjusted down or eliminated as needed based on the results of the post audit procedure.

Once a transaction has been passed, the participating bank will telex the U.S. Letter of Committment bank to open a Letter of Credit to the U.S. supplier. Banks will also be responsible for passing copies of all Letters of Credit and periodic reports, as specified in the operating circular, to USAID. These procedures have worked well under the Production Credit Project.

The loan guarantee fund under the Small-Scale Enterprise Component of the project is a new activity. As discussed above, the design team examined a variety of options for administering this fund and concluded it would be most efficiently run by a commercial bank. The team determined that the Arab Investment Bank (AIB) has the staff, space, and motivation to manage a guarantee program for small-scale borrowers. AIB has been an active and competent participant in the Production Credit project over the past three years. While the final decision on which commercial bank should administer the Guarantee Fund has not been made, it is clear from the research done by the design team that there is at least one, and probably more, commercial banks capable of administering this activity.

2. Private Investment Encouragement Fund Advisory Board

In early 1985, a new Private Investment Encouragement Fund Advisory Board was formed (see Annex G-1 for Board Membership). The Board has successfully resolved issues and made requisite decisions in fulfillment of its prescribed responsibilities under the PIEF. Throughout the past year, the Board has evaluated numerous proposed projects requesting PIEF financing, and to date, the Mission has not been critical of the Board's procedures and decision-making process. The Board has provided direction and formulated flexible lending criteria to meet Egyptian market conditions and sustain prudent financing principles. Both the Minister of Economy (he is also Chairman of the PIEF Advisory Board) and the USAID Mission Director agree that the Board is providing proper leadership and is fulfilling its oversight function.

3. Ministry of Economy/Investment Authority

In August 1984, a new Deputy Chairman of the Investment Authority, an integral part of the Ministry of Economy, was appointed. This same individual became Minister of Economy in March 1985, and continues to hold the position of IA Deputy Chairman. He has spent more than a year organizing both entities with the objective of giving a strong push to activities supporting the Egyptian private sector and encouraging foreign investment in Egypt, particularly from the United States.

The Deputy Chairman appointed an Investment Authority employee to the position of Secretary to the PIEF with full-time administrative responsibility for the PIEF's daily activities. In addition, a professor of economics from Zagazig University has been employed on a part-time basis to review all loan applications as well as project and credit appraisals submitted by participating banks and either review or disapprove them. As the number of applications increases, it is anticipated that this person will either become a full-time employee or another part-time person with the same expertise will be hired.

Since the PIEF will depend upon the participating banks for handling most, if not all, administrative matters, ministerial control over the execution of PIEF policy will be maintained through the Investment Authority staff assigned to the PIEF.

4. Ministry of Planning and International Cooperation (MPIC)

MPIC serves as the GOE counterpart for Production Credit operations. Both the Minister and the Administrator for Economic Cooperation with the USA will provide support for the Private Sector CIP Facility under the PEC project. MPIC will be responsible for negotiating and issuing the operating circular which governs this component. They will retain authority to approve transactions in excess of the size limits stated in the Circular and will be responsible for issuing amendments to the Circular, with AID approval, to modify the program. Experience over the past three years offer ample justification for continued use of the GOE official circular describing the terms and conditions for all sub-loan transactions. Throughout the early years of the project's life, a concerted effort will be made by USAID and MPIC to delegate increased responsibility for project implementation to the participating banks. This will reduce governmental involvement in the sub-loan approval process.

5. Central Bank of Egypt

Production Credit has established a sub-account in the Central Bank for the deposit of Egyptian pound (LE) repayments by participating banks. This procedure is based upon the mechanism used for repayments made by public sector banks in the prior Private Sector Commodity Import Program, and is readily adaptable for all private sector bank participants. The PIEF also has a special designated account to handle LE repayments from sub-loan borrowers. Under PEC, a new memorandum of understanding (MOU) will be negotiated with the GOE to assure that reflows from private sector term credit programs will be, by definition, reserved for private sector use in areas of significant developmental impact.

There are no current plans for the creation of a new institution to administer reflows. The Minister of Economy, however, has suggested the establishment of an investment bank after the reflows from PIEF have reached a level to support the employment of such an institution.

A key objective in USAID's policy dialogue with the GOE in the context of the PEC project, will be the engagement of the Central Bank in a discussion concerning the upgrading and expansion of financial intermediation activities. Past attempts to pursue this objective with MPIC and MOE have met with limited success. The MOE, in particular, has deferred to the Central Bank for responding to USAID's requests to explore financial intermediation issues. It is expected that the Central Bank will become somewhat more receptive to meeting with USAID as the new Prime Minister (appointed in September 1985) achieves his policy goal of expanding the role of the private sector (industry and banking) and reducing bureaucratic banking obstacles that discourage foreign investment in Egypt. It is hoped that USAID will eventually be able to work with both the Prime Minister and the Central Bank, simultaneously, to make the Central Bank's policies and procedures more attractive and acceptable to the private sector. Specifically, the Central Bank needs to begin simplifying procedures governing imports and exports. An effort needs to be exerted to reduce the transaction costs and delays associated with current importation arrangements, related costs of financial transactions and regulatory requirements imposed by both the U.S. and the GOE.

To date, the Central Bank has been unwilling to launch a discount facility despite official authority to do so. The reason for this is unclear as assisting banks to overcome temporary periods of illiquidity is a Central Bank function. Knowing that the Central Bank will perform this function consistently is of considerable psychological value in building the confidence bankers need to expand term lending. The Central Bank of Egypt as such will have the greatest potential impact upon PEC's success or failure: if the Bank does not efficiently perform all of its prescribed functions, it will diminish the banking system's overall performance. At this time, the Central Bank has a reputation of not facilitating, through the development of new standards and procedures, the growth of the private sector enough to enlarge foreign investment. The Central Bank's involvement in bank training has been embryonic. It does not engage in a significant effort to enhance banking skills within its own organization let alone the banking industry at large. This subject will be on the agenda for Central Bank/USAID discussions.

C. Structure of the Banking Industry

The Open-Door Policy brought fundamental changes in the Egyptian economy. These changes brought major changes to the banking sector which until the end of 1974 was comprised of the Central Bank, four nationalized public sector commercial banks, three specialized public sector banks and two multi-national off-shore banks. In contrast by June 30th, 1984, 10 years later, 100 banks operated in Egypt. The Central Bank classifies banks into several groups: commercial banks (44); investment banks (32); public sector specialized banks (21); and unregistered banks (3). Banks are listed in Table C-1.

The commercial banks are composed of the four public sector banks, 39 Law 43 private and joint venture banks, and Faisal Islamic Bank which is incorporated under a special law. These banks dominate the industry: they control 75% of the assets, hold 88% of the deposits and make 75% of the loans.

Business and investment banks total 31 units, of which 21 units are branches of foreign banks dealing only in foreign currencies; the other 10 institutions are organized under Law 43 or special laws. These banks control about 17% of total banking assets, 10% of deposits, and 14% of loans.

The specialized banks include the two real estate banks, the Development Industrial Bank and the Principal Agricultural Credit Bank with its 17 affiliates in governorates. These banks hold about 10% of assets, 3% of deposits and make about 11% of loans.

D. Central Bank and Monetary Policy

The Central Bank of Egypt performs the functions normally expected of a central bank, including setting monetary policy, examining banks, and gathering financial statistics. As a result of recent GOE organizational changes, the Governor of the Central Bank of Egypt reports to the Prime Minister instead of the Minister of Economy. This change signals that the Central Bank will operate somewhat more independently than before; however, we understand that the Minister of Economy still plays an active role in determining monetary policy.

Monetary policy instruments include direct control of interest rates and quantitative restrictions on lending activity. Unlike the U.S. system which relies predominately on instruments which indirectly influence interest rates (i.e., open market operations, reserve requirements, and discount rate), the Egyptian system operates by decree and directly imposes the desired limitations on banking practices. Egyptian instruments are:

-- Interest rates for deposits and loans are decreed. Since 1975, interest rates have been increased several times, for example: 30-day time deposits from 2% to 6%; savings accounts from 4% to 10%; and industrial loans from 7-8% to 11-13%. Interest rates are given in Table C-2;

-- Reserve requirements are 25% of local currency deposits and 15% of foreign currency deposits. The Central Bank pays banks no interest for local currency reserves, but pays the 3-month London Interbank Bid rate for foreign currency reserves. In contrast, U.S. reserves requirements are substantially lower, less than one-half of these requirements;

-- Liquidity ratio is 30% of total bank assets. Included as liquid items are: cash, balances with the Central Bank and government securities;

-- Loan ceiling ratio prohibits making loans amounting to more than 65% of deposits. The numerator counts loans to both public and private sector companies (except for food security projects) and denominator includes their deposits;

-- Credit expansion rates are proscribed for loans to private trading and household sectors in excess, respectively, of 12% and 10% per annum;

-- Discount rate is established (presently 13%) but the Central Bank does not make available any discount facilities;

-- Single customer limits are established by the Central Bank, based upon good practice;

-- Loans to a single client cannot exceed 25% of a <u>bank's</u> capital and reserves;

-- Equity owned by a bank cannot exceed 25% of a <u>company's</u> total equity; and

-- Bank equity participations cannot exceed a company's <u>paid-in</u> capital and reserves.

E. <u>Deposit and Loan Structure</u> (Source: Ahmed Foda, <u>Banking Sector Survey</u>, June, 1982).

The largest depositor is the household sector (which contributes over 50% of deposits) and the largest borrowers are the private business sector (50% of loans) and also the government sector and public sector companies, with smaller percentages. Although percentages may vary in developed economies, the basic trend is the same: households supply funds for private business sector use. When Egyptian loans are examined by activity, major borrowers are: trade sector - about 33%; industry sector -- about 28%; and services sector -- about 20%; agriculture and other sectors are minor users of credit. Figures for deposits and loans are given in Tables C-3 and C-4.

Although interest rates on time and savings deposits are low relative to the overall inflation rate, Egyptian savers have steadily increased their holdings of financial assets, particularly time and savings deposits. Interest rates to depositors in local currency, when measured on a real, not nominal, basis (i.e., with removal of inflation factor) have been consistently negative for the past decade.

In Egypt, individuals can invest in foreign currency denominated time deposits, often the Eurodollar market. Statistics show approximately 45% of time deposits are held in foreign currencies. Such savers obtain two financial benefits to protect their wealth: high interest rates and appreciation of foreign currencies against the Egyptian Pound. For example, three-month interest rates in the Eurodollar markets in the January 1982 were about 16% (considerably above Egyptian savings rate of 8.5%) and during the year, the pound depreciated only about 4% against foreign currencies in the free ("own") foreign exchange market. Thus, depositors benefited from positive, real interest rates. In contrast, during the past year, Eurodollar interest rates approximated 10%, similar to domestic rates, but the Egyptian pound substantially depreciated against foreign currencies (about 25% for the U.S.Dollar). Thus, domestic interest rate and foreign exchange policies make foreign currency deposits more attractive than Egyptian pound deposits.

F. Constraints

The Egyptian banking system suffers from some of the customary problems of developing financial systems: reluctance to do term lending; lenders' demands for collateral far in excess of loan value; long deposit lines; insufficient variety of savings instruments; and lack of sufficient, well-trained staff. The list can be readily extended; however, only a few key issues are relevant to this project. They are:

-- Foreign exchange rate, which is described in the PP, Section I-A, 2-c;

-- Interest rate in two areas: adequacy of general levels (which are less than rates of inflation) and perversity of the low 11-13% rate for industrial and agricultural loans (traders pay 16%). These are described in the PP, Section I-A, 2-d;

-- Excess liquidity resulting from excess reserves reduces bank earnings because of lost investment opportunities. Egyptian commercial banks have excess reserves which in June 1984, amounted to 36.3%, or 11.3% over the required 25% ratio. Bankers explain the reason for excess reserves as imposition of the 65% loan/deposit ratio, which has successfully dampened credit expansion, and also lack of appropriate investment alternatives, such as a government or commercial short-term securities or inter-bank loans. Why they hold non-earning assets while at the same time encouraging interest earning deposits is unclear; and

-- Net Supply of Foreign Funds. Egyptian depositors make deposits in foreign currencies to obtain positive real investment returns, either from interest rate or foreign currency appreciation. For identical reasons, Egyptian borrowers avoid foreign currency loans which they can expect to repay at higher interest and principal amounts compared to domestic currency borrowing. Consequently, Central Bank deposit and loan statistics show Egypt is a "net supplier" of foreign currencies to Euromarkets. These statistics do not include holdings outside of Central Bank control.

G. Conclusions

The PEC project must continue in a focused and disciplined manner if it is to be successful in contributing to increasing private sector productive investment in Egypt. This requirement is equally important in ensuring the development of term lending and other banking services. Given the PEC's relatively small initial lending resources and strong indications that immediate demands from prospective clients will be large, PEC must stress the development of a constructive, cooperative relationship with the Egyptian and international, financial and business communities.

The PEC must provide clear guidelines on its financing capabilities, standards and services to the business community. USAID and GOE counterpart agencies will need to meet with key business and financial people throughout Egypt to discuss and review PEC lending services and methods of collaboration.

BANKS REGISTERED WITH THE CENTRAL BANK OF EGYPT

Commercial Banks (Public Sector)

1. Bank Misr
2. Bank of Alexandria
3. Banque du Caire
4. National Bank of Egypt

Commercial Banks (Law 43)

5. Chase National Bank
6. Misr International Bank
7. Egyptian American Bank
8. Misr Romania Bank
9. Banque du Caire et de Paris
10. Misr America International Bank
11. Nile Bank
12. Suez Canal Bank
13. Alexandria Kuwait International Bank
14. Cairo Far East Bank
15. Delta International Bank
16. Faisal Islamic Bank*
17. Mohandes Bank
18. El Ahram Bank
19. El Watany Bank of Egypt

20/36. National Development Bank and 16 Governorate Banks

37. Bank of Commerce & Development (El Togareyoon)
38. Bank of Credit & Commerce (Misr)
39. Alexandria Commercial & Maritime Bank
40. Egyptian International Bank (Al Misri Al Aalami)
41. Misr Exterior
42. Egyptian Gulf Bank
43. Hong Kong Egyptian Bank
44. Egyptian Workers' Bank

Business and Investment Banks (Law 43)

45. Misr Iran Development Bank
46. Cairo Barclays International Bank
47. Societe Arabe Internationale de Banque
48. Credit International Egyptian Bank
49. National Societe General Bank
50. Arab Union Bank for Development & Investment

51. Housing & Reconstruction Bank*
52. Islamic International Bank for Investment & Development
53. Arab African International Bank*
54. Misr Arab African Bank

<u>Business and Investment Banks (Branches of Foreign Banks)</u>

55. American Express International Banking Corporation
56. Abu-Dhabi National Bank
57. Citibank
58. Bank of America
59. Bank of Credit & Commerce International
60. Bank Saderat Iran
61. Banka Commerciala Italiana
62. Arab Bank Limited
63. Bank Melli Iran
64. Lloyds Bank International Limited
65. The Bank of Nova Scotia
66. Oman Bank Limited
67. National Bank of Pakistan
68. National Bank of Greece
69. Gamal Trust Bank
70. Banque Credit Swiss
71. Banque Credit Lyonnais
72. Oman National Bank Limited
73. Middle East Bank Limited
74. Banque Paribas
75. El Rafedeen Bank
76. Arab Investment Bank

<u>Public Sector Specialized Banks</u>

77. Arab Land Bank
78. Credit Foncier Egyptien
79. Development Industrial Bank
80. Principal Bank for Development and Agricultural Credit
81/97. Agricultural Banks in Governorates (17 Banks)

<u>Banks not Registered with the Central Bank</u>

98. Manufacturers Hanover Trust Company
99. Arab International Bank
100. Nasser Social Bank**

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* Established by special decree.
** Sometimes not included among banks.

Source: Foda, Banking Sector Survey

Table 2

CENTRAL BANK OF EGYPT
Interest Rate Structure
(Percentages)

Circular No. / Rate	226 12/29/75 Individuals	226 12/29/75 Institutions	228 2/28/77 Individuals	228 2/28/77 Institutions	236 6/15/78	241 12/28/78	245 3/29/79	248 3/27/80	250 3/26/80	260 1/1/81	262 8/1/81	7/1/82
Time Deposits												
7-15 days (min. LE. 100,000)	-	-	-	-	-	-	4.0	4.5	4.5	5.0	5.0	5.0
16-30 days (a)	2.0	2.0	3.0	2.5	4.0	5.0	5.0	5.5	5.5	6.0	6.0	6.0
1-3 months	3.0	2.5	4.0	3.0	4.5	5.5	5.5	6.0	6.5	7.5	7.5	7.5
3-6 months	4.0	3.0	5.0	4.0	5.5	6.0	6.0	7.0	7.5	8.5	8.5	8.5
6-12 months	4.0	3.5	5.5	4.5	6.0	6.5	6.5	7.5	8.0	9.0	9.5	9.5
1-2 years	5.0	4.0	6.0	5.0	6.5	7.0	7.0	8.0	9.0	9.5	10.0	11.0
2-3 years	-	-	-	-	7.0	7.5	7.5	8.5	9.5	10.5	10.5	12.0
3-5 years	-	-	-	-	-	8.0	8.0	9.0	10.0	11.0	11.0	12.5
5 years	-	-	-	-	-	8.5	8.5	9.5	10.5	11.5	11.5	13.0
Savings Deposits	4.0		5.0		5.0	6.0	6.0	7.0	8.0	8.5	8.5	10.0
Lending Rates (Min-Max)	7-8		8-9		9-11	10-12	10-12	11-13	12-14	13-15	13-15	11-16 (b)
Lending for Cotton/Export	6.75		7.75		8.5	9.5	10-11	11-12	11-13	11-13	11-13	13
CBE Discount Rate	6.0		7.0		8.0	9.0	9.0	10.0	11.0	12.0	12.0	13.0

(a) Minimum deposits: LE 10,000 to 3/29/79; LE 50,000 from 3/30/79 to 12/31/80; LE 100,000 since 1/1/81.

(b)	Min.	Max.
Industry/Agriculture	11	13
Services	13	15
Commerce	16	-

Source: Central Bank of Egypt, Annual Report 1983/84

Table 3

DEPOSITS AND LOANS - BY SECTOR
(LE Millions)

DEPOSITS	June 30, 1983 Amount	%	June 30, 1984 Amount	%
Government Sector	1,498.2	9.5	1,832.0	9.6
Public Sector Companies	2,938.5	18.5	3,443.4	18.0
Private Business Sector	2,812.4	17.7	3,310.3	17.3
Household Sector	8,141.1	51.4	10,134.1	53.1
Foreign Sector	466.1	2.9	384.6	2.0
Total	15,856.3	100.0	19,104.4	100.0
LOANS				
Government Sector	2,230.2	17.5	3,893.7	23.6
Public Sector Companies	2,856.0	22.4	3,439.2	20.8
Private Business Sector	6,465.5	50.7	8,009.9	48.5
Household Sector	660.5	5.2	597.4	3.6
Foreign Sector	538.1	4.2	574.6	3.5
Total	12,750.3	100.0	16,514.8	100.0

Source: Central Bank of Egypt, Annual Report 1983/84

Table 4

DEPOSITS AND LOANS - BY ACTIVITY

(LE Millions)

	June 30, 1983		June 30, 1984	
DEPOSITS	Amount	%	Amount	%
Agriculture Sector	348.6	2.2	262.7	1.4
Industry Sector	2,122.9	13.4	2,460.5	12.9
Trade Sector	1,788.5	11.3	2,269.4	11.9
Services Sector	2,127.1	13.4	2,524.6	13.2
Undistributed Sectors	9,469.2	59.7	11,587.2	60.6
Total	15,856.3	100.0	19,104.4	100.0
LOANS				
Agriculture Sector	790.0	6.2	1,149.3	7.0
Industry Sector	3,659.4	28.7	4,570.0	27.6
Trade Sector	4,463.0	35.0	5,515.4	33.4
Services Sector	2,418.8	19.0	3,320.9	20.1
Undistributed Sectors	1,419.1	11.1	1,959.2	11.9
Total	12,750.3	100.0	16,514.8	100.0

Source: Central Bank of Egypt, Annual Report 1983/84

ANNEX E-2

Financial Analysis

The detailed financial plan is presented in Section II-B of this PP. That section provides details on the three components of the project: Transactions Facility imports and local currency credit; Project Finance Facility investment imports and local currency credit; Small-Scale Business Facility; and the Technical Assistance Component. For each component, the AID dollar and local currency shares are described along with the inputs being provided by the GOE, banks, and Egyptian business firms.

A. Private Sector CIP Screening

As discussed in the Economic Analysis Section (Annex E-3), it is not possible to do a detailed analysis of the economic sub-sectors and firms that will benefit from this project. In fact, the nature of this project precludes such pre-selection. The project is designed to be market-driven. The interest rate and foreign exchange rate applicable to project transactions will reflect appropriate rates (less the Foreign Exchange discount that represents the extra cost of tied aid.) Funds will be available on a first-come, first-served basis to eligible firms. AID and the GOE will not try to second-guess a firm that feels it has an investment opportunity that will yield a profit. The only exception will be for the Project Finance Facility where economic and financial viability will be criterion for approval.

B. Role of the Commercial Banks

The previous Production Credit Project (PCP) developed a network of nine banks that effectively implemented the program. The project will continue with the successful PCP procedure of relying on those banks to handle the processing of project transactions. By using the banks, the project will be handled in a market-oriented style that follows normal Egyptian business practices. To encourage rapid disbursements, funds will be provided to those banks that are able to move funds. Those that perform efficiently and quickly will receive more funding. Those that lag behind will not receive funds. By rewarding the efficient banks with more funds, the project will be able to move AID funds quickly and effectively.

Based on discussions with bankers, it appears that they will be eager to participate in the project. Part of the reason is competitive. From 1975 to 1982 the number of commercial and investment banks increased from four to about 75. Now that economic growth is slowing, competition is increasing, banks view the project as another source of finance for their customers. It is part of the total package of services that they can offer to their customers.

In addition to the competitive/service aspect, bankers find AID business profitable. They have an impressive array of charges: the letter of credit fee, compensating balance and miscellaneous fees and charges. The December

1984 PCP Evaluation found that a 16-18%, six-month loan (when all additional costs were included) had an effective cost to the borrower of roughly 27%.

Egyptian banks are very risk averse, require high collateral and charge high fees, but there is a natural incentive for them to participate in the project as a way to expand their market share and to increase their profits.

ANNEX E-3

Economic Analysis

A. Economic Setting

1. Background

In 1974 with the introduction of the "Open Door" policy Egypt made a radical departure from the centrally planned economy that had been constructed during the late 1950's and the 1960's. One of the reform measures allowed foreign banks to establish branches and joint ventures. As a result, within ten years the number of commercial banks grew from the original four public sector institutions to more than 63 deposit banks. Foreign investment in other sectors also expanded rapidly under the generous provisions of Law 43 of 1974.

The economy was also buoyed by external factors during the 1970's and early 1980's. Recent oil discoveries placed Egypt among the ranks of oil exporters at a time when prices were rapidly escalating. Developments in world petroleum markets had two additional favorable impacts on the Egyptian economy. Skilled Egyptian workers found themselves in great demand in the booming Gulf States. Commencing in 1982, a widened and deepened Suez Canal generated substantially increased earnings from oil tanker traffic

As a result, the balance of payments pressures that had threatened Egypt before the Open Door were eased and government revenues increased. From 1974 to 1984/85, petroleum exports increased from $0.1 billion to $2.6 billion. Suez Canal revenues rose from $0.1 billion to $1.0 billion, workers' remittances increased from $0.3 to $4.[illegible] billion, and tourism receipts increased from $0.4 billion to $1.2 billion.

The surge in foreign exchange revenues was solely in oil, workers' remittances, tourism and Suez Canal earnings. It was unrelated to any growth in productivity of the commodity producing sectors of the Egyptian economy. With a rigid and increasingly overvalued foreign exchange rate, imports were favored over exports. In addition, various price controls and subsidies encouraged financial, service and real estate investments rather than the production of tradeable goods. The low level of investments in agriculture and industry led to stagnant production in wheat, cotton, rice. millet, vegetables and many industrial products.

Inflation steadily increased from less than 5% in the early 1970's to 15-20% in the 1980's. The rigidity in the exchange rate and low levels of productive investment were reflected in the balance of payments. While oil, remittances, Suez and tourism earnings increased from $0.9 billion in 1974 to $8.9 billion in 1984/85, all other exports declined from $1.6 billion in 1974 to $1.3 billion in 1984/85. On the other hand, imports increased from $3.5 billion in 1974 to $11.7 billion in 1984/85. Food imports have increased steadily while a surge in capital equipment imports took place during the late 1970's.

The result of all of these events, plus an increase in government investment was a strong rate of growth in real GDP. From 1975 to 1982 GNP growth averaged 8.4% per annum. From 1982-1984, this slowed to an estimated 4%, partly as a result of falling government investment expenditures.

The sectoral rates of growth diverged widely. Annual agricultural growth ranged from 1.4 to 3%, industry and mining from 6.2 to 7.2%, with petroleum growth varying from 14.5 to 25.4% annually.

Despite steady movement towards liberalization of the economy, many sectors are heavily controlled. Prices of many products, notably agricultural products, and energy (oil and electricity) are fixed at far below world levels, and basic consumer goods are heavily subsidized. Heavily subsidized government plants still account for the bulk of the output of heavy industry. The government budgets run large deficits to finance these activities.

Maintaining the price of bread below production costs has been the main GOE policy for keeping the cost of living low for poor or low-income consumers. The cost to the GOE of producing subsidized bread, when bread was priced at one piaster, was roughly LE 0.8 billion per year. GOE subsidies to cover losses on distributing maize, edible oils, sugar, frozen chickens and other foodstuffs are nearly LE 1.0 billion per year. The prices of transportation, water and other utilities and many industrial commodities are fixed so low, substantial losses result. Explicit subsidies to these enterprises totaled LE 300 million in 1981/82. The textile corporation represented LE 126 million of that subsidy bill. Table 1 summarizes the growing subsidy bill and the resulting GOE budget deficit.

<u>Table 1</u>

<u>Subsidies and GOE Budget Deficit</u>

	1978	1979	1980/81	1981/82	1982/83	1983/84
Explicit Subsidies	710	1,352	2,166	2,142	2,054	2,436
Budgetary Deficit	2,139	2,903	2,529	3,964	4,286	5,110

Implicit subsidies are far greater than explicit subsidies. The largest implicit subsidy is for the energy sector. If international prices were applied to petroleum products and electricity, energy profit transfers to the GOE would be at least LE 4 billion higher. Other implicit subsidies are estimated at LE 1 billion. Another way of looking at implicit subsidies is to analyze the return GOE enterprises earn on their invested capital. In 1981/82, they transferred profits of LE 306 million to the central government. That represents less than a 2% return on the capital employed in those enterprises. If a 10% rate of return could have been achieved, profit transfers would have jumped by LE 1.2 billion. The GOE budget deficit has more than doubled in the last five years. The GOE must take action to reduce both explicit and implicit subsidies if it is ever to bring the deficit under control.

2. Future Prospects

The rapid economic expansion of the past decade masked some structural difficulties that must be addressed in the coming y[illegible] Egypt weathered the 1982-83 worldwide recession rather well, earnings, Suez Canal duties, worker remittances and oil export ea[illegible] be expected to sustain high rates of growth into the 1990's. It [illegible] that the economy be reoriented toward the production of agri[illegible] industrial products in which Egypt has a comparative advanta[illegible] require steady movement away from rigid price controls and towar[illegible] prices that will provide positive incentives to produce such com[illegible] will also require a financial system geared to meeting the credit [illegible] private producers of products which Egypt can export competitivel[illegible] can be efficiently produced as import substitutes. The Private Credit Project can be viewed in this context.

3. Egyptian Industry

In the 1960's, all heavy industries and most other i[illegible] nationalized. Today the industrial sector is still dominate[illegible] firms. Even though Law 43 of 1974 increased the private secto[illegible] public sector still accounts for 65 to 70% of the value [illegible] production, overall, and in such areas as spinning and weaving [illegible] is even larger. The private sector predominates in mining an[illegible] while woodworking products and leather products are exclusively pri[illegible] public sector is predominant in fixed capital formation. Priv[illegible] investment represents only 20 to 25% of the total, but this is [illegible] increase from the 5% share of a decade ago.

Until the early 1980's, the combination of high domestic demand [illegible] disincentives to production for export caused most industrial produ[illegible] sold domestically. In the late 1970's and early 1980's industr[illegible] stagnated, causing the export share of industrial production to s[illegible] from 14% in 1978 to 6.5% in 1982/83.

This trend was reversed in 1983/84 as exports increased to 7.5% of [illegible] production. Removal of foreign exchange surrender requirements help[illegible] private exports, the value of non-oil exports rose by over 28% i[illegible] Public sector non-textile exports rose 41%, and textile exports [illegible] produce an overall 18% rise in industrial exports. Public sector [illegible] sector companies now meet 45% of their foreign exchange needs [illegible] earnings.

4. Overall Monetary and Credit Developments

From 1980/81 to 1983/84 the overall GOE deficit (on a commitmen[illegible] increased from LE 2.6 billion to LE 5.1 billion. Since the [illegible] financed in large part by an expansion in the money supply, the inf[illegible] has been rising and is presently in the range 15 to 20%. While th[illegible] monetary expansion has been coming down, the economy has seen a [illegible] growth in liquidity and a large credit expansion. The economy is [illegible] liquidity.

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In 1981/82 the rate of increase in domestic credit was 44%. By 1982/83 it had fallen to 33%, it was 23% in 1983/84 and was only 19% for the 12 months ending in January 1985. Changes in liquidity (money and quasi-money) moved with those of domestic credit. In 1980/81, growth in private sector credit far exceeded that for the public sector. This continued into 1981/82, until November, when the Central Bank imposed credit ceilings and a loan/deposit ratio of 65%. Other restrictions were also added. But enforcement came gradually and private sector credit still grew at a 66% rate, and the money supply expanded accordingly. By 1982/83, the effects of the reforms were being felt, and the increase in credit was only 27%. In 1983/84 it was 24%. While the growth in credit to the private sector has slowed, it still is substantial. In addition, throughout the 1980's, private sector credit has expanded at a faster pace than public sector credit. Private sector credit is not being squeezed to benefit public sector demands.

An important factor in private sector liquidity in recent years has been credit to the public sector. In 1980/81, with oil revenues and canal dues rising, the government was a net depositor in the banking system. That was the last time the government provided funds to the banking system. In 1981/82, net claims on the public sector increased 38% over the year before. In both 1982/83 and 1983/84, the increase was 17%. The rate of net domestic credit expansion has come down from the high levels of the early 1980's. Still, as pointed out above, the growth in private sector credit has been greater than growth in public sector credit.

To summarize, changes in the overall volume of liquidity and credit in the economy in recent years have been the result of borrowing by the public sector and of regulations designed to fight inflation. While the rate of increase has slowed, the system still generates domestic credit at a rate substantially above the growth in real GNP. (In the 12 months up to January 1985, net domestic credit increased 19% and GNP growth was probably around 4%.)

5. Local Currency, Term-Lending Prospects

A crucial issue in assessing credit availability is the extent to which the rapidly growing volume of domestic credit has generated resource flows to meet specific needs, in particular term-credit needs (loans with a maturity of over one year.). The interest rate structure that emerges from Central Bank regulations and ceilings has had the unintended effect of building in a disincentive for commercial banks to lend domestic currency for term loans, with a corresponding bias in favor of short-term commercial loans.

The IMF (See Table 2) found that banks effectively pay from 13 to 16% per annum to attract Egyptian pound deposits. Yet regulations allow maximum charges of only 11 to 13% on loans to agriculture and industry. There is thus a built-in disincentive to lend to these sectors. On the other hand, permissible rates on commercial and services loans allow a positive bank spread. The December 1984 Production Credit Evaluation found that banks received at least a 20% return on commercial and service loans. The net result is a domestic interest rate structure that favors lending for commerce and services and discourages extension of credit to agriculture and industry. In addition, there is a bias against term-loans. The December 1984 Evaluation found that 85% of commercial banks loans were for one year or less. There is no effective incentive to provide term-loans. As the 1984 Evaluation pointed out, one of the most important impediments to private sector development seems to be the lack of longer-term funding in domestic currency. While there is adequate short-term commercial credit, there is a lack of longer-term funding to support industrial investment needs. The PEC's Project Finance Facility deals with the need for longer-term credit. Other portions of the project deal with short-term credit needs.

Table 2

Egypt: Structure of Commercial Banks' Interest Rates Since December 1, 1983
(In percent per annum)

	Interest Paid to Depositors	Effective Interest Cost to Banks 1/
Deposits		
6 months	9.5	12.67
1 year	11.0	14.67
2 years	12.0	16.00
Savings	10.0	13.33
	Interest Charged to Borrowers	
	(Minimum)	(Maximum)
Loans		
Agriculture and Industry	11.0	13.00
Services	13.0	15.0
Commerce	16.0	--2/

	Alternative Yields (Circa April 1985) (in percent)
Domestic rate of inflation	10.0 3/
Approximate yield on foreign currency deposits held with domestic banks (in domestic currency) 4/	23.0

Source: Extracted from IMF, Arab Republic of Egypt -- Recent Economic Developments. July 10, 1985, p. 126.

1/ Interest rate paid to depositors adjusted to take account of the 25% cash reserve requirements on deposits. To obtain LE 75 in loanable funds, a bank must attract LE 100 in deposits. If a depositor is paid 9.5%, the effective cost of the loanable funds would be 12.67%, 9.5% divided by .75.

2/ No limit.

3/ USAID Mission estimate for inflation is 15-20%.

4/ After adjustment for rate of depreciation in the "own exchange rate" during the previous 12 months (i.e., 14% per annum).

While the Central Bank's attempts to curb inflation have led to a slowing in growth of credit to the private sector, there does not appear to be an aggregate shortage of domestic liquidity. Credit controls mask the effect that a distorted interest rate structure may have on sectoral allocations of credit. It nonetheless seems warranted to conclude that the removal of these distortions, or providing means of compensating for them, would improve the structure of lending to the private sector. This project, along with the Mission's on-going policy dialogue efforts should help direct credit to more productive uses.

A final observation needs to be made on Egypt's interest rate structure. With inflation running near 20% and most interest rates fixed at artificially low levels, effective interest rates are often negative. This discourages saving and leads to investment misallocations. Rational resource allocation would require interest rates sufficiently in excess of inflation to effectively ration investment and to stimulate saving. If this project and other efforts are to increase the flow of longer-term industrial investment, Egypt must move toward positive, real rates of interest. This is an important macroeconomic policy issue that must be resolved as a part of the Mission/GOE overall policy dialogue effort.

6. Balance of Payments Developments

It has already been noted that Egypt's Balance of Payments fortunes improved markedly in the wake of the Gulf oil boom of 1979. There has been a slight deterioration, however, since 1982/83. Worker remittances and Suez Canal dues have remained level at about $4.5 billion and $0.95 billion per year respectively, while imports have risen by $1.0 billion per year and debt service payments by $0.9 billion a year. Oil export earnings have declined by about $0.2 billion a year.

Egypt's current account deficit has been roughly offset by its capital account, which has been in surplus by some $1.0 billion in most recent years.

From the mid-1970's, the Egyptian banking system was a net exporter of short-term funds, largely to Euromarkets. Eurodollar balances peaked at $1.4 billion in 1979 and have steadily declined since that time. In mid-1981, they turned negative. By February 1985, the Egyptian banking system was $20 billion in debt to the Eurodollar market. (Source: IMF July 10, 1985, report, Page 43.)

7. Egypt's Exchange Rate System

Egypt's foreign exchange system, though considerably liberalized since 1976, is still highly complex and fragmented. While there are a large number of effective exchange rates, the bulk of transactions take place within three foreign exchange pools.

The central bank pool handles exports of petroleum, cotton, and rice; Suez canal dues; imports of five essential foodstuffs, insecticides, and fertilizers; and most capital transactions of the public sector. The commercial bank pool receives receipts from worker's remittances, tourism, and exports not going through the central bank pool. The commercial bank pool provides foreign exchange for public sector payments not covered by the central bank pool. The Free Market or "own exchange market" shares common sources of supply with the commercial bank pool (worker's remittances, tourism, and exports) and satisfies the demand for the bulk of private sector imports.

Over the years, as Egypt's balance of payments situation has deteriorated, transaction categories have been moved from the increasingly overvalued central pool to one of the premium pools. On an overall basis, since 1979, this has resulted in a 60% effective devaluation. See Table 3.

The Free Market was established as a legal market in 1976. It makes Egypt fairly unique among LDCs -- Egyptians are able to buy, sell and hold foreign exchange, as long as transactions take place through commercial bank accounts. During the first half of 1985 the Free Market rate averaged LE 1.45 equals $1. During December 1985, the rate averaged LE 1.85 = $1. In 1983/84, 26% of current account transactions took place through the Free Market pool.

The commercial bank pool handles 33% of current account transactions. Two exchange rates prevail in the pool: The official rate (LE 0.84 = $1), which applies to a limited volume of public sector transactions and aid flows; and the bulk of transactions, which take place at a premium rate which was LE 1.36 in December 1985.

Over the years, the volume of transactions handled by the commercial bank pool has increased as more and more commodities have been moved from the central bank pool into the commercial bank pool.

The foreign exchange rate for the commercial bank pool is set by a committee composed of representatives from the Ministry of Economy, the Central Bank, all public sector banks, and four commercial banks. While the rate is administratively determined, the pool shares common sources of supply with the commercial bank pool (worker's remittances, tourism, and exports). In past years it has been set below but, generally followed the ups and downs of the Free Market Rate until the bank incentive rate was introduced in 1983. Since that time the spread initially dropped sharply then widened. See data presented in Section I,2,C entitled, "Highest Commercial Bank Rate." It usually was 7 to 15% below the Free Market Rate. (See Table 3). During 1985 the spread widened as the Free Market Rate steadily depreciated and the commercial pool rate was not increased. In December 1985, the rate was LE 1.36 = $1, which was 26% below the Free Market Rate of LE 1.85 = $1.

The central bank pool or "official exchange rate" has been set at LE 0.7 = $1 since January 1, 1979. A special exchange rate of LE 0.40 = $1 (plus a 15% premium) applies to bilateral payments agreements with China, North Korea and the U.S.S.R. Since 1979 the central bank rate has become more and more overvalued. It is presently less than half of the Free Market Rate. Since it funds the import of basic foodstuffs, any increase in this rate would require an increase in food prices or more government food subsidies. Therefore, it is politically difficult to increase this exchange rate. Some 41% of 1983/84 current account transactions took place through the central bank pool.

B. Economic Impact of the Project

1. Economic Rates of Return

At the Project Paper stage, it is impossible to determine what the economic rate of return will be for individual project-supported investments. At this time, we do not know what transactions will come forward. While it would be theoretically possible to do a financial and economic rate of return analysis for each transaction, in most cases such efforts will not be necessary.

The project will be providing resources to the private sector. Each businessman will have to determine the profitability of his own investment. While there are distortions in Egypt's economic system, the worst excesses are in the public sector. These include energy, infrastructure, consumer subsidies and government heavy industry. All face a major distortion in investment because of an overvalued exchange rate. Most private firms avoid producing products that face government price controls.

2. Use of Discounted Free Rate

The free rate is a legal and known quantity. The Central Bank of Egypt collects daily quotations from the commercial banks that deal in the market. The project rate could be fixed at the rate (free rate less the discount) in effect when a letter of credit was opened. A drawback of this approach is that it creates another new foreign exchange rate at the same time the GOE (with support of the U.S., IMF, World Bank and others) is considering options to rationalize and consolidate the large number of foreign exchange rates now in effect. Another problem would be in determining the discount. Should it be 15, 20, 30 or 40%? If it is too large, project funds will be too cheap. If it is too small, disbursements will be slow. This discount rate is likely to produce enormous administrative problems. It requires a determination of a rate for each transaction, monitoring correct amounts of repayments and special account flows.

Interest costs will also move toward the true cost of capital. The December 1984 PCP evaluation found that one year nominal interest rates of 16-18% yield an effective rate of 22%, when all additional fees and charges are included. That level appears reasonable. Since foreign exchange and credit will be moved toward a more realistic level, project funds will tend to flow into their most economic uses.

The most important exception might be in sectors where gross distortions exist (poultry, livestock, and energy intensive industries) and longer-term loans. Longer-term loans present a particular problem since the term credit market is small, and interest rates are artificially low. For term loans and "special sectors" that face inappropriate price signals, special pre-approval analysis will be required. The applicant will prepare a financial and economic analysis for those transactions. Such transactions will have to demonstrate an acceptable financial and economic rate of return.

3. Project Financed Import of Capital Goods and Raw Materials

The Private Sector CIP Facility ($127.3 million) will finance the import of raw materials, spares and capital goods. That amount is quite small when compared to Egypt's major sources of foreign exchange revenue. In 1984/85 they were: $4.2 billion in worker remittances, $2.6 billion in oil exports, and $1.2 billion from tourism earnings.

Another way of looking at the issue is to look at it from the importers' perspective. In the absence of this project, most private firms would have to turn to the "own exchange" or Free Market for the foreign exchange needed to finance their industrial import needs.

In 1983/84 "own exchange" imports of raw materials, intermediate goods and capital goods totaled $1.6 billion. The project provides a supplement to "own exchange" availabilities.

The $127.3 million foreign exchange Private Sector CIP Component of the project is expected to disburse over a four-year period. That would finance roughly $30-40 million a year of additive imports. The $30-40 million of additional imports represents only 2-2.5% of the $1.6 billion of "own exchange" imports. While the availability of project-financed imports may be important to an individual firm, from the macro, foreign exchange perspective, the project will have only a minor impact on foreign exchange availabilities. Although the project's foreign exchange impact is limited, the credit portion of the project should be more significant.

4. Impact of the Project on Egypt's Credit Markets

a. Credit Market Problems

Egypt's financial system, while very conservative, has worked well at mobilizing short-term savings and providing short-term credits. It has done poorly with term lending and industrial investment.

Egypt's bankers are generally risk averters. They require heavily collateralized loans, with a short maturity and charge the borrower numerous fees. In order for the Egyptian credit market to develop into a more sophisticated market which provides term lending, both bankers and borrowers will need a higher level of confidence in Egypt's medium and long-term economic and political environment.

The Central Bank of Egypt (CBE) has a number of controls and limits on bank operations which restrict the development of a term credit market. In the interest of encouraging longer-term investments, the CBE has set a maximum interest rate ceiling of 13% on industrial term credit. In order to discourage short-term credits, a minimum interest rate of 16-18% has been set. Not surprisingly, banks are lending where the profit lies. They have nearly 85% of their loans in short-term credits with a maturity of one year or less. The Government regulation designed to encourage term lending has had the opposite effect. Another problem is that the CBE is not officially a lender of last resort. There is no Central Bank discount window in Egypt.

Since banks cannot discount their loans, they lack a readily available source of liquidity. This increases their desire to maintain most of their loans on a short-term basis.

b. Private Sector CIP Facility

As of January 30, 1985, the IMF lists total outstanding credit to the private sector (denominated in Egyptian Pounds) at LE 7.5 billion. Within that amount, LE 5.3 billion was provided by commercial banks. For 1982/83 and 1983/84, the increase in new commercial bank loans to the private sector was roughly LE 800 million a year. Industry and trade received approximately half of that amount; LE 400 million. That LE 400 million was substantially below the LE 1300 million of 1981/82 and LE 770 million of 1980/81.

While credit to trade and industry will probably recover from its present low level, the GOE appears committed to keeping credit expansion limited. The Private Sector CIP Facility of this project ($127.3 million) will help assure that productive credit needs are met. With anticipated project disbursements of $30-40 million a year for three years, Egypt's trade and industrial credit will be able to expand by an additional 10% a year. A 10% credit expansion targeted on productive private industrial enterprises will have a significant impact on economic growth. In addition, since the credit expansion will be generated by imported commodities, it will not be inflationary.

c. Project Finance Facility

Analyzing the impact of the $107.3 million Project Finance Facility is more difficult. The Project Finance Facility will finance longer-term, capital investments of an expansion/modernization nature, by medium to large-scale enterprises.

USAID Mission projections of Egyptian industrial sector investment show a minimum real growth rate of 5% a year for the period 1985/86 to 1988/89. Industrial investment (in constant 1984 LE) will increase from LE 1.26 billion in 1984/85 to LE 1.53 billion in 1988/89. Based on the GOE Five-Year Plan, a minimum of 25% of that investment will be in the private sector. Thus, of roughly LE 1.4 billion a year in total investment, LE 0.35 billion will be in the private sector. Assuming that the Project Finance Facility disburses over a four-year period, disbursements will average some $30 million a year. With private investment projected at LE 350 million a year, the Project Finance Facility will allow private investment to expand and reach a level roughly 10% higher and will help remove the bias against long-term finance. While these are very rough macro estimates, they do give an order of magnitude. It is clear from these macro projections that the Project Finance Facility will have a significant impact on private sector industrial investment.

ANNEX E-4

SOCIAL SOUNDNESS ANALYSIS

A. Introduction

1. Purpose

The purpose of this social soundness analysis is to: (1) examine the extent to which the proposed project is compatible with the existing business environment into which it will be introduced; (2) determine the adequacy of incentives to ensure participation by targeted banks and small-scale entrepreneurs; (3) determine the spread effects of project resources beyond the life of the project; and (4) identify how the project will affect different categories of small and medium-scale enterprises (SME's).

2. Project Components

This is an umbrella project with three components. It combines two existing projects, the Production Credit Project (PCP), the Private Investment Encouragement Fund (PIEF), and adds a new activity designed to offer a Small-Scale Guarantee Facility. The first component, the Private Sector CIP Facility, is a continuation of the Production Credit Project. Under this umbrella project, the component will follow the current PCP, as amended, with modifications. There is a thorough description of this component in the PP, consequently, this analysis does not focus on it.

The second component, the Project Finance Facility, is the PIEF with modified operating procedures for improved efficiency and responsiveness to private sector needs. It is designed to support large-scale undertakings of a start-up or expansion/modernization nature. Just as with the first component, there is an extensive discussion of this component in the PP, so this analysis does not focus on it.

The focus of this social soundness analysis will be the third component, the Small-Scale Guarantee Facility, principally because it is brand new, but also because it will target a population with little or no previous access to bank credit and financial assistance. This population consists of small and medium-scale entrepreneurs (SME's).

3. Project Target Groups

The private industrial sector in Egypt is almost synonymous with small and medium-scale enterprises, concentrated in the production of food products, manufacturing (wooden furniture, metal products, leather products, and plastics), ready-made garments and building materials. This sector consists of approximately 13,000 small and medium-scale businesses employing between 10 to 50 workers. Fixed assets (excluding land and buildings) not exceeding LE 2.75 million in 1983 prices is the World Bank's definition for this set of businesses. There are about 250,000 artisanal enterprises employing less than 10 workers with total fixed assets (excluding land and buildings) not exceeding LE 210,000. Small and medium-scale enterprises employed approximately 624,000 Egyptians in 1981/82, the equivalent of just over 40% of total industrial employment.

Some of Egypt's banks will be targeted in this project, especially those already participating in the PCP project. The Central Bank of Egypt, Development Industrial Bank and several private commercial banks are proposed to participate in this project.

4. Methodology

To complement data from evaluation reports, assessments, the Private Enterprise Credit PID and several sets of case studies, notably, the August 1985 Partnership for Productivity (PFP) case studies, as well as information based on discussions with other USAID staff, a very modest set of interviews were conducted consisting of 6 business people and 2 bank officials. Interviews were all based on a single visit to these people and one round table discussion held in the office of Dr. Gamal Mawara, an industrial engineer and private consultant to businesses in Egypt.

B. Sociocultural Feasibility: The Environment for Development of the Private Sector

1. GOE Response to the Private Business Community

The feasibility of implementing this project was determined, in large part, by the business environment into which the project will be introduced. Egypt has not enjoyed a great deal of success in attracting private sector investment. High level government officials articulate national investment objectives and priorities, including support for the private sector. Yet, today, the words have not been transformed into substantive and meaningful action. A deterrent to increasing private investment is the widespread distrust of private enterprises held both within government circles and throughout the general population. For nearly ten years, USAID has sought expansion of the private sector's role in the Egyptian economy. Encountering enormous GOE resistance throughout the Egyptian bureaucracy has limited any real achievement. Within this environment, USAID is making another effort through this project. At the time the PID was completed in August 1985, a statement by the PID team was that "the probability of accomplishing this long established objective is not as favorable as we would prefer."

2. Private Enterprises Response to the Business Community

The perception of businessmen interviewed and data from the August 1985 Partners for Productivity (PFP) survey is that available market information is neither trustworthy nor accurate, hence not useful. Interviews revealed that one of the principal reasons small businesses fail is the lack of appropriate market information. Currently, planning by a majority of small businesses is based on guess work and rumor. Reliance on rumor often leads to a loss of money and, hence, a loss of confidence and enthusiasm in the business environment. Consequently, there is an unwillingness to invest in expansion due to uncertainty of market intelligence. The entrepreneurial spirit is stifled in Egypt which ultimately translates into less income and fewer jobs for Egyptians. This stifling of the entrepreneurial spirit is the result of a number of constraints.

3. Constraints to More Effective Production in the Private Sector

a. The Banking Community and Some Major Constraints to Dealing with the SME Community

(1) Collateral Requirements

One of the major constraints to forging an improved business climate between banks and the SME community is the stiff collateral requirement imposed by banks on loans to this sector. Bank officials have not reached out to small-scale businessmen because the latter is perceived to be a high risk group; hence does not enjoy the confidence of bank officials. Information gathered during interviews supports the PFP case study data that small and medium-scale business people consider these collateral requirements to be unreasonable and the guarantees for loans to be excessive.

Bank officials support their case in the following manner: the Development Industrial Bank (DIB), for example, feels that since mortgage policies are not in operation in Egypt, and most real estate is not legally registered, it is very difficult to place a lien on private property. In addition, legal processes which deal with this issue are very lengthy and complicated.

Along these same lines, officials pointed out that Egyptian business people generally have more than one set of business records, one for tax purposes, another for their banker and yet a third for their own use. Some have no records at all, thus rendering any sound spread sheet analysis of the soundness of the business impossible. In such cases, the DIB seeks to secure its loan by imposing stiff collateral requirements, usually requiring that land and buildings be put up to guarantee the loan. Officials point out that since it makes little sense to impose collateral requirements based on a portion of a building (i.e., one-half or one-quarter of a building), in case of default, the Bank will move to recoup its losses by selling these real assets in their entirety.

(2) Amount of Time to Process a Loan

Another major constraint on the banking side is the amount of time it takes to process and approve a loan. This project component intends to "simplify loan application and approval procedures for SME's, thus making credit more accessible to this kind of borrower." One of the findings in the PFP case studies was that loan application procedures are complicated and lengthy, requiring more than one year, in some cases. This lengthy and complicated process is one of the reasons SME's have not been interested in approaching banks for loans. The Development Industrial Bank (DIB) response to this problem is that some loans (amounts exceeding LE 500,000) require the approval of the international funding institution in Washington, Europe, etc. Application delays in these instances are thus considered to be beyond the control of the DIB. For loans less than LE 500,000, DIB officials reported that the application process should take not more than three months. The SME's interviewed reported, in all cases, that the length of time to process a loan was at least one year.

Regarding this same problem, Mr. Imran Kahn, General Manager of the Egyptian-American Bank (EAB), pointed to a frequent occurrence in which business records are carried in the head of the business person rather than on a spread sheet that can be examined. Loan applications are, therefore, handled by an investigation department of the Bank which conducts a thorough check on the business and the owner's credit reputation with other banks. He explained that Egyptian banks have not yet developed an efficient cross-referencing system on clients and are therefore forced to spend considerable time and money in obtaining credit information on a prospective client, thus lengthening the overall loan application process.

Banks are also hard pressed to make informed decisions about the potential profitability of a new project submitted by an applicant because of the lack of industry-specific information. Evaluation of the worthiness and credibility of an application is stretched out in time because information required to move the applicaton procedure along is either not available or is not easily forthcoming.

(3) The Cost of Capital: Interest Rates

The cost of capital or interest rates is considered by businessmen to be too high. This opinion was expressed by businessmen. They pointed out that even if credit becomes more accessible to them, they will not be able to afford it because the effective rate makes the capital too expensive. They explained that the obligatory deposits percentage plus additional charges for servicing the loan would move a short-term nominal interest rate of 16-18% to an effective interest rate of 20-24%. The perception is that the cost of capital, though more accessible under this proposed project component, would be a disincentive to borrowing.

In light of World Bank data (See "Staff Appraisal Report: Small and Medium-Scale Industry Project," May 1984, p. 10) on inflation rates, the perception held by these businessmen may not accurately reflect the environment for borrowing. World Bank data indicate that the "annual inflation rate is estimated to decline from 18% in 1982 to 14% in 1984 and 12% in 1986. Consequently, the DIB rates, including the interest rates on the proposed World Bank loan, as well as the mix of foreign and local currency loans to be received by DIB sub-borrowers, would be positive in real terms."

The interest rate issue is discussed in more substantive detail in the Economic Analysis of the PP with recommendations for how to best address the issue for this project. Consequently, the point this analysis makes is that credit must be accessible at a cost businessmen are willing to accept, otherwise, there may be too few borrowers to bring about realization of one of the objectives of the project, namely, to get more credit into the hands of small and medium-scale entrepreneurs.

(4) Foreign Exchange Rates

Since this is a local currency or LE-generated project, the foreign exchange rate does not really affect its feasibility. Egyptian pounds generated, however, will be the reflow from the PCP project and from the PIEF program; hence the more efficiently Egyptian pounds are generated from those two projects, the more efficiently this guarantee facility will be.

b. Small and Medium-Scale Enterprises and Major Constraints

Findings distilled from interviews support data from existing case studies as well as conclusions drawn concerning major constraints faced by small and medium-scale entrepreneurs. The most critical constraints to be addressed are:

-- Absence of accurate and useful marketing information and marketing services;

-- Lack of adequate credit and financial assistance;

-- Insufficient technical, administrative and managerial skills; and

-- Shortage of adequate skilled labor.

An important fact that emerged from the interviews was that the small and medium-scale enterprises are not homogenous or monolithic when it comes to prioritizing their constraints. For example, the credit constraint appears to be less of a constraint for producers of ready-made garments than for food processing and manufacturing entrepreneurs.

In order to provide some flavor of what small and medium-scale enterprises are like, within the context of their constraints, brief composite descriptions are provided for the manufacturing, food processing and ready-made garment businesses. Ready-made garment businesses are discussed with some hesitancy because of U.S. political sensitivities concerning developing assistance to the textile industry, but it is from among these businesses that we find the largest number of female shop owners as well as large numbers of female employees.

(1) Manufacturing Businesses

-- Access to Credit. A majority of manufacturing businesses have already established working capital lines of credit with local banks and/or borrowed to finance the purchase of equipment.

-- Absence/Availability of Marketing Information and Statistics. Manufacturing producers indicated a great awareness of the domestic market in general. One reason for this is the greater availability of published data from various governmental sources which provides these businesses with information on production volumes for different products.

On the supply side, larger engineering companies import between 25-50% of required production inputs and have thus established relationships with several foreign suppliers. In the areas of both raw materials and equipment, the majority of suppliers are European and, to a lesser extent, Japanese. A number of owners report that they do participate in manufacturing exhibitions and fairs outside Egypt on a regular basis; hence, manage to keep in touch with developments in their field. They also reported that despite this travel, they have little or no contact with American companies engaged in the same or similar lines of production.

-- Diversified Marketing Channels. A majority of these manufacturing businesses have national marketing and distribution networks already in place. Several have their own retail showroom as well as a sales or distribution team which covers areas outside their particular geographical location.

(2) Food Processing Businesses

-- Access to Credit. There is insufficient credit and financial assistance to meet the needs of the food processing sector. The agricultural credit and development bank offers subsidized interest rates on food security loans, however, the mechanisms for accessing these loans is not clear to many producers in this sector.

-- Absence/Availability of Marketing Information and Statistics. Lack of marketing information, knowledge and statistics about consumer product acceptance, tastes, affordable prices, purchasing habits - all classified by geographical location - makes it difficult for SME food processing businesses to gauge consumer demand. The Ministry of Agriculture has developed an extensive data base of information on agricultural production, but to date, few statistics are available on food processing activities.

-- Skilled Labor Shortages. Entrepreneurs interviewed believe that a major constraint to improved productivity is the shortage of skilled workers. In their opinion these shortages are a result of:

-- Low wages and salaries for skilled personnel which causes migration to other Middle Eastern countries;

-- Shortages of training centers; and

-- Failure of the education system to meet the country's development needs through curriculum planning that would address relevant manpower needs.

-- Lack of Modern Up-to-Date Technology for Food Distribution. The shortage of modern technology in food distribution channels in Egypt has contributed to significant food losses. These losses have reached 40% in some instances. Specific activities which require technological improvements are (1) warehousing and storage; (2) refrigerated transport; (3) grading; (4) packaging; and (5) quality and health control.

-- Training. Training in the above five areas of technology are virtually non-existent.

-- Limited Contact With Other Companies/Factories. A number of food processing businesses are located in rural areas of Egypt, thus, often unaware of technological developments in the food industry. They have little contact with larger companies in Cairo and Alexandria as well as with foreign companies which may be able to produce technical assistance or participate as a joint venture partner. USAID efforts in forging business links between American companies and Egyptian companies are targeted to large firms rather than to small and medium-scale enterprises.

(3) Ready-Made Garment Sector

As I mentioned earlier, it is from among these businesses that we find the largest number of female owners and a large number of female workers.

-- Access to Credit. Availability of credit is not perceived, in and of itself, as a solution to problems plaguing these businesses. Business people interviewed pointed out that improvements in the level of productivity are a high priority and relate more to in-service training, attitudes towards employees, the development of commercial marketing channels, and improved techniques for satisfying quality standards.

-- Absence/Availability of Marketing Information and Statistics. Uncertainty about the direction of the domestic market is the result of the absence of marketing information and statistics. These business people tend to be very cautious and conservative, in part, because of this constraint; hence, there is little incentive to either expand current facilities or to strike out in any creative direction in order to introduce new product lines.

-- Lack of Diversified Marketing Channels. Virtual dependence on the public sector as a buyer is what keeps a majority of these producers in business. In fact, as pointed out in the PFP study, many small factories would likely cease to exist if not for their sub-contracting relationship with the Ministry of Supply. This dependence on the public sector subjects these producers to an unpredictable demand market as well as major fluctuations in production. Since additional marketing channels are virtually non-existent, these producers are forced to operate in a limiting market environment.

-- Training and Upgrading Skills. The major priority expressed by garment producers was the need for industry-wide training for workers and a more positive attitude concerning the industry's image. The most frequently cited training needs were for improvement in cutting, designing and pattern-making skills because of the desire to improve production quality. Increasing sophistication of Egyptian consumers is placing greater demands on final product quality. Consequently, owners and managers expressed the opinion that, for the industry as a whole, changing consumer demands require greater emphasis on basic training and upgrading of skills for industry workers.

Based on data used for this analysis, small and medium-scale enterprises need assistance in the following areas in order to address or overcome major constraints:

Information and communication services;

-- Credit and financial assistance;

-- Technical and administrative assistance; and

-- Vocational training.

The concerns expressed by people interviewed along with information from the case studies concerning bank procedures suggest the need to expand technical assistance to participating banks. The purpose of expanding technical assistance to the banks would be to improve the credit delivery mechanisms now in place. The DIB, for example, has already agreed to technical assistance in improving its budgeting, accounting, financial control and management information system. These are currently under implementation with a further agreement by the Bank to strengthen its internal audit procedures and reinforce its economic appraisal of projects. Economic appraisals need to be improved by more extensive use of shadow prices for inputs, and application of more realistic assumptions on variables (including capital costs, exchange rate, debt servicing, project implementation schedules, unit production costs, and unit profit margins).

4. Incentives and Participation

Under this project component, the incentive to encourage banks to participate by broadening their clientele base to include small and medium-scale enterprises is the Credit Guarantee Fund. The proposed Fund would be LE 60 million in reflows from the PCP and the PIEF program for the establishment of a loan guarantee fund for participating banks. The purpose of this Fund would be to underwrite risk perceived by banks if loans are made to the high-risk SME community. Dr. Aly Helmy (USAID/Cairo) and Josh Walton (Partnership for Productivity, Project Paper design team members, report from interviews conducted with a number of bankers that each, without exception, expressed strong interest in the establishment of such a Fund.

Within the constraints matrix revealed by the data, a guarantee fund has the potential for being an appropriate response. There are, however, several issues to be taken into consideration in the refinement of the Credit Guarantee Fund design:

-- The Credit Guarantee Fund is an incentive to banks to participate in this project;

-- One of the direct beneficiaries of the creation of this Fund will be the banks;

-- The Fund, in and of itself, will not be sufficient to encourage participation of the SME community; and

-- Incentives to ensure the participation of the SME community must be in the form of services in addition to credit and financial assistance.

A refinement of the Guarantee Fund design would be to take into consideration the fact that addressing the credit constraint alone will not ensure the participation of small and medium-scale entrepreneurs.

Small and medium-scale enterprises are not functioning in a service-delivery vacuum. A number of services are currently delivered through institutions such as the Engineering and Industrial Design Development Center (EIDDC); American Chamber of Commerce; Egyptian Chamber of Commerce; Federation of Egyptian Industries; Egypt International Business Center (EIBC); Productivity and Vocational Training Department, Ministry of Industry (PVTD); and of course, several banks, the most prominent of which is the Development Industrial Bank.

The problem with services provided by these institutions, according to business people interviewed, is the gaps in availability and accuracy of marketing and trade information, technical expansion services and management and training services. To illustrate the point, one businessman pointed out that the Egypt International Business Center under its former appellation, the Delta International Business Center, had a total membership of approximately 200 private sector individuals involved in tourism, manufacturing, trade, etc., and offered a wide range of business, economic and consultancy services. The organization was solely funded by member dues which were LE 1,500 per year for an individual membership and LE 5,000 per year for a corporate membership. A majority of its members lost confidence in the organization as they began to recognize a gap between actual services provided and annual dues.

An effective complementary or tandem project would require an assessment of where small and medium-scale entrepreneurs feel the major service-delivery gaps are and what kinds of assistance they feel would be necessary to fill those gaps.

5. Obstacles to Project Implementation

a. Lack of Enthusiasm in the Fund by the Central Bank of Egypt (CBE).

One critical exception to concurrence in the establishment of the Credit Guarantee Fund appears to be the Central Bank of Egypt. The Helmy/Walton analysis of the credit facility states that "in conversations that the team had with CBE representatives, there was a noted lack of enthusiasm for collaborating in the establishment of such a fund." Currently, local currency reflows are managed by the CBE. Helmy/Walton felt that if an implementation decision is made to channel management of the Fund through the CBE, then, the constraint of lengthy and complicated loan application procedures is almost certain to remain in effect because of over-bureaucratized practices at the CBE. They point out that it is unlikely that the Fund would be able to earn as high an income if managed by the CBE because the CBE makes loans at 7.5% to 9.5%.

b. Lowered Collateral Requirements

Even if private commercial banks manage the Fund, the problem of lowered collateral requirements may be an obstacle to effective implementation. The credit facility analysis points out that the Fund "is intended to encourage banks to lower their collateral requirements..." In seeking clarification of this statement, A. Helmy explained that the banks approach stated that since the money to be loaned out will be the banks' money, rather than USAID's money, bank officials will be obliged to use their own discretion in determining collateral requirements. They are willing to lower these requirements to around 150% of the total value of the loan, rather than impose the standard 300%, but this determination will be made on a case-by-case basis. In other words, lowered collateral will not automatically flow from the existence of this Fund.

This issue of anticipated lower collateral requirements should be monitored closely by the project officer, and the project committee because conservatism is so deeply ingrained in the banking system that bankers may very well continue to operate with great caution in establishing collateral requirements for a new and heretofore high-risk clientele. Practices resulting from custom and experience are not easy to change. For example, the general manager of the Egyptian-American Bank (EAB), Mr. Imran Khan, stated during the PFP survey interview that he believes "the collateral requirements imposed by Egyptian banks are both warranted and fair."

6. Islamic Principles and Access to Credit

Each of the persons interviewed stated that peronal adherence to Islamic principles would not prohibit their participation in a credit program with a non-Islamic financial institution. A prominent Islamic bank in Egypt is the Nasser Bank, a government organization financed fully by the Egyptian government, which was established in 1972. As an Islamic financial institution, the Nasser Bank does not operate on the interest rate principle, but rather, on the basis of taking an equity position in the businesses or projects it finances. It extends financial assistance in amounts ranging from several LE million to only a few thousand LE. The Bank also has a social welfare orientation. Some of its on-going activities include supplementing retirement benefits, providing grants to university students, to poor and needy and to divorced women. According to data from the PFP survey, the Bank's financial statement for 1984 indicates a profit of over LE 27 million. It has 24 branches throughout Egypt and a total staff of 2,000.

Nasser Bank finances any commercial or trade activity which offers a quick return on investment. The Bank's technical staff studies proposed investments and makes a determination regarding their participation within a 1-3 month period. There is, however, no clear written document outlining the Bank's policy regarding loans. Each case is treated individually.

Despite the Bank's orientation toward social welfare and loans to small businesses on the equity principle, there is no term credit window in this bank.

B. Spread Effects: Institutionalization of Access to Credit

The institutional mechanisms which will ensure continued availability of funds for term credit once the project is completed will be of two types:

-- Financial. Interest income from incremental reflow deposits averaging a 5% - 7% rate of growth will sustain the Fund; and

-- Social. The gradual establishment of trust and confidence by banking officials in a targeted portion of the SME community, resulting from working together over a period of time. Hopefully, this new trust and confidence will lead to some changes in attitude, perceived and real, about the risks involved in making loans to members of the SME community. The long-term desired change is an institutional one, namely, a lowering of the collateral requirements for small-scale entrepreneurs, the majority of whom own neither the land nor the buildings where their shops and factories are located.

The spread effects of this project will be maximized throughout the SME community if participating banks feel, after a period of working with the SME community, confident enough to lower the collateral requirements. The entire SME community would benefit from this change in a long-standing banking practice.

C. Social Consequences and Benefit Incidence

1. Social Consequences and Project Assumptions

The social consequences or impact of the Small-Scale Enterprise Credit Guarantee Project Component will depend, to a great extent, on the validity of the assumptions made concerning the achievement of the goal and purpose. One of the assumptions for achievement at both the goal and purpose level is that the Egyptian financial system will be responsive to AID project initiatives. That assumption was made during the development of the PID. Helmy and Walton discovered that the CBE registered a "noted lack of enthusiasm for collaborating in the establishment of the Fund." This lack of enthusiasm could mean that the assumption made is no longer valid because the CBE has not fully understood the purpose of the Fund or does not want management of the reflows for the Fund to be channeled to any bank except the CBE. The reason(s) should be clarified as soon as possible to ensure that the project will be approved by the GOE and implementation will not be held hostage to foot dragging and lackluster cooperation by the CBE. The Bank's resistance to the establishment of the Fund could represent another deterrent to increasing private sector investment in Egypt.

In the long-run, this project expects goal and purpose achievement through changes in institutional practices and procedures. Consequently, this project component is more than just the provision of a credit mechanism, it is a catalyst for bringing about changes in banking practices and procedures, especially those concerning collateral requirements and the amount of time it takes to process and approve a loan. Changes in institutional behavior are critical to improvements in the business climate and ultimately, to an increase in the production capacity of the private sector.

Yet, an implicit assumption not addressed in the design is the willingness of GOE financial institutions, especially the CBE, to accept the need for modifications in long-standing banking practices and procedures. The level of institutional change required for the project to be successful must be determined to ensure that project implementation objectives can be met and that impact will be sustained beyond the life of this project.

2. Benefit Incidence

The Credit Guarantee Fund may, in theory, affect three groups in small and medium scale businesses, namely, women who own and work in ready-made garment businesses; new businesses; and businesses that may generate a satisfactory return to the investment, but may not be involved in an expansion of employment or of fixed assets.

a. Women in the Ready-Made Garment Business

Data used in this analysis reveal that several women own small ready-made garment shops. These same shops tend to employ a majority of women. U.S. laws governing the extent and type of development assistance to textile industries outside the U.S. may be operable for this project component. If so, women shop owners and employees will be affected.

b. New Firms

The Credit Guarantee Fund Facility analysis discussed two categories of eligibility for loans under the Fund: 1) those businesses requiring "short-term financing of working capital for off-the-shelf procurement of raw materials, intermediate or final goods which are needed for operating the enterprise at/or near capacity," and 2) those businesses requiring "medium-term financing for importing machinery and equipment, either to replace outdated and depreciated ones, currently in use, or for expanding productive capacity."

There is no mention of new firms, just starting up and requiring capital to purchase raw materials, equipment, etc. Will new businesses be affected by this project component? If not, the criteria established for eligibility should be clear on this point. This issue will be carefully considered during the early implementation of the project.

c. Firms Not Involved in Expansion of Employment or of Fixed Assets

Another group that may be affected by this project are businesses that may generate a satisfactory return to investment, but may not be involved in an expansion of employment or of fixed assets. Many ready-made garment businesses wish to invest in raising output and labor productivity without increasing employment.

Again, it is suggested that loan eligibility criteria be established so that there is no ambiguity about who is eligible under this project.

ANNEX E-5

Environmental Analysis

This annex presents the Environmental Clearance memorandum for the PEC Project prepared by the Mission Environmental Officer, and serves as the project paper's Environmental Analysis. A sample of the Environmental Review referred to in the memorandum and in Section V-E of this paper is included as follows:

ENVIRONMENTAL REVIEW PROCEDURES

INTRODUCTION

All applicants for the Private Enterprise Credit Project 263-0201, are required to submit an Environmental Review for proposed projects which follows the outline below. This review is intended to assure that proposed project funded activities comply with the basic environmental procedures of the United States Agency for International Development (AID) as legally mandated in 22 CFR 216, "AID Environmental Procedures" (October 23, 1980). The form will be reviewed by the Mission Environmental Advisor for Industrial Pollution Control and/or the Mission Environmental Officer, who will provide comments and have been delegated by the Bureau Environmental Coordinator authority to provide clearances for environmental reviews of all activities funded under the Project.

It should be noted that the environmental legislation and regulations used within the United States, such as air and water quality standards, do not apply to projects AID finances. The only legislation which covers such uses of U.S. Government funds, as used by AID, are "AID Environmental Procedures" mentioned above. In addition, the United States Environmental Protection Agency does not have legal or technical jurisdiction over United States Government funded activities conducted outside the United States.

FORMAT

It is requested that applicants prepare an Environmental Review which conforms with the format provided below. This format is illustrative and may be modified to meet the needs of the specific project under review.

1.0 Project

1.1 Project Title

1.2 Project Location

1.3 Describe the land requirements for the facility. Specify if the construction of the facility will result in a change of land use types or the conversion of agricultural or wetlands.

1.4 Describe the present land use classification at the site of the facility and in immediately adjacent lands. Specify if the facility will be in conformance with the developmental master plan for the area.

1.5 Describe present and projected water demands and water quality requirements. Identify the source(s) and anticipated types of use within the facility. Describe any plans for water/wastewater reuse.

1.6 Describe the present and projected energy requirements. Identify the source(s) of energy.

1.7 Describe the existing and projected workforce. Specify where the work force will reside.

1.8 Describe the existing and planned types of transportation access to the facility. Specify if construction or operational activities at the facility will require ungrading or alternation of the transportation network.

1.9 Describe if the proposed new facility or expansion of the existing facility will result in the anticipated destruction or disturbance of archaeological or historical sites.

2.0 DESCRIPTION OF MANUFACTURING PROCESS

2.1 Describe the existing manufacturing process(es). Provide a general schematic plan of the facility for technical review.

2.2 Describe planned manufacturing process(es) in future expansions. Provide a general schematic plan of the planned facility for technical review.

3.0 WATER USAGE AND WASTEWATER MANAGEMENT

3.1 Characterize wastewater and provide flow data.

3.2 Describe the process related contaminants and pollutants.

3.3 Describe the coverable products and raw materials. Identify their projected volumes and use.

3.4 Describe the existing in-plant pollution control systems.

3.5 Describe the existing end-of-pipe pollution control systems.

3.6 Describe the exisiting and/or projected treatability of wastewater.

3.7 Description of point(s) of wastewater discharge and characterization of receiving wasters.

4.0 AIR QUALITY MANAGEMENT

4.1 Characterization of air emission and volumns. This should include gases, vapors, fumes, aerosols and particulates. The predominant wind direction and average velocity should be noted.

4.2 Describe the process related contaminants and pollutants.

4.3 Describe recoverable products and raw materials. Identify their projected volumes and use.

4.4 Describe the existing in-plant pollution control systems.

4.5 Describe the existing end-of-stack pollution control systems.

4.6 Describe the existing and/or projected emission systems, dust suppression or other types.

4.7 Description of point(s) of air emission discharge and characterization of in-plant and/or ambient air quality.

5.0 SOLID AND HAZARDOUS WASTE MANAGEMENT

5.1 Characterize existing or planned solid waste. Specify its composition, storage and management control system.

5.2 Describe existing and planned on-site and off-site solid waste disposal measures.

5.3 Characterize existing on potential hazardous materials which may be produced or stored at the facility. Specify its chemical composition, storage site and management control system.

5.4 Describe existing and planned on-site and off-site hazardous waste disposal measures.

6.0 INDUSTRIAL HEALTH AND SAFETY MANAGEMENT

6.1 Describe measures for industrial health and safety. Specify management responsibilities for these concerns and describe training programs.

6.2 Describe existing and planned programs for monitoring industrial health and safety measures at the facility.

7.0 GOVERNMENT OF EGYPT MEASURES FOR POLLUTION CONTROL

7.1 Describe measures which will be adopted in the proposed project funded activity to address the requirements of the following Government of Egypt laws concerning water quality and wastewater disposal:

Law 93 of 1962 (Attachment No. 1) which is implemented by the Ministry of Housing and under authority of Ministerial Decree 649 of 1962 (Attachment No. 2);

Law 48 of 1982 (Attachment No. 3) which is implemented by the Ministry of Irrigation under authority of Ministerial Decree 8 of 1983 (Attachment No. 4).

7.2 Describe the extent to which water quality and wastewater discharge comply with Government of Egypt norms as specified in the laws cited above. If the discharge will not comply describe the reasons for non-compliance.

7.3 Describe existing or planned monitoring system for water quality and wastewater disposal in the proposed facility.

7.4 Describe measures which will be adopted in the proposed project funded activity to address the requirements of the following Government of Egypt laws concerning air quality and emissions:

Presidential Decree No. 864 of 1969 (Attachment No. 5) which is implemented by the Ministry of Health under authority of Ministerial Decree 470 of 1971 (Attachment No. 6).

7.5 Describe the extent to which air emissions comply with Government of Egypt norms as specified in the laws cited above. If the emissions will not comply, describe the reasons for non-compliance.

7.6 Describe existing or planned monitoring system for air quality in the proposed facility.

7.7 It should be noted that there are no current Government of Egypt laws or regulations which address the issue of solid or hazardous wastes; however, applicants are expected to adopt cost-effective and professionally responsible management measures.

8.0 MITIGATION MEASURES FOR POLLUTION CONTROL

8.1 If applicable, describe design modifications or treatment technologies which would bring the facility into full compliance with Government of Egypt laws and regulations.

8.2 If applicable, provide a cost estimate using the best available technology for preliminary and detailed engineering designs which would be required to meet minimal requirements under the Government of Egypt laws and regulations. This should include an estimate of capital and recurrent costs for the design modification or treatment process.

9.0 MANAGEMENT AND TRAINING FOR INDUSTRIAL POLLUTION CONTROL

9.1 Describe present management and training capabilities and future requirements for industrial pollution control.

9.2 Describe short and long-term plans for operation and maintenance of the industrial pollution control system(s). Identify how such activities will be managed and financed.

10.0 ARCHAEOLOGICAL AND HISTORICAL SITES

10.1 Describe any archaeological and/or historical sites within or in the immediate vicinity of the project area.

10.2 If such features exist the applicant must provide a determination from the Department of Antiquities stating what types of mitigation activities will be required.

11.0 RARE AND/OR ENDANGERED SPECIES

11.1 Provide information concerning the presence of any rare or endangered plant and/or animal species in the project area.

11.2 Provide information concerning the presence of critical habitat for rare and/or endangered species in the project area.

11.3 If such species and/or critical habitats exist, the applicant must provide a determination from the Egyptian Wildlife Service stating what types of mitigation activities are required.

12.0 LIST OR PREPARERS

The document shall contain a list of personnel who prepared the Environmental Review and state their qualifications and experience.

13.0 LIST OF PERSONS CONTACTED

The document shall contain a list of persons contacted in the process of preparing the Environment Review and note their title and position.

14.0 LIST OF REFERENCES

The document shall contain a list of references used in the preparation of the Environmental Review.

LIST OF CONTACTS

UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT (USAID)

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USAID Mission to Egypt
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LIST OF ATTACHMENTS

Attachment No. 1:	Public Law 93 of 1962, "Discharge of Industrial Waste."
Attachment No. 2:	Ministerial Decree 649 of 1962, "Concerning Executive Regulation for Law 93 of 1962 Concerned with Wastewater Disposal."
Attachment No. 3:	Law 48 of 1982, "Concerning Pollution Protection of the River Nile and the Water Drains."
Attachment No. 4:	Ministerial Decree 8 of 1983, "Protection of the Nile River."

Attachment No. 5: Presidential Decree No. 864 of 1969, "The Assignment of a High Committee for the Protection of Air from Pollution."

Attachment No. 6: Ministerial Decree 470 of 1971, "Maximal Allowable Concentration in Atmosphere of Work and General Outside Atmosphere."

ANNEX F

Implementation Schedule

A. Overall Project

The PEC implementation schedule is projected to be:

Date	Major Actions	Responsibility
May 1986	Project Authorization/Signature of Grant Agreement	USAID/GOE
July 1986	Completion of Initial Conditions Precedent	GOE
July 1986	Initiation of Program by Participating Banks	Banks
August 1987	Evaluation	USAID/GOE
August 1990	Evaluation	USAID/GOE
September 1991	Projection Assistance Completion Date (PACD)	GOE
March 1992	All Funds Disbursed/ Terminal Disbursement Date (TDD)	Banks/GOE

B. Credit Guarantee Fund

DATE	MAJOR ACTIONS	RESPONSIBILITY
May 1986	-Project Authorization/ Signature of Grant Agreement	USAID/GOE
July 1986	-CGF Time Deposit Accounts Established	
August 1986	-Advisory Committee Formed and First Meeting Held*	USAID
September 1986	-Reflows of LE 5,000,000 Deposited	USAID
September 1986	-Introductory Seminar for All Interested Banks	USAID/Participating Banks
October 1986	-Final Selection of First Group of Participating Banks	USAID

December 1986	-Advisory Committee Meets : Coordinate Allocation of Guarantee	ttee
	-Initial Promotion of Pr. by Banks	
	-Announcement of Partici Banks in Trade Journal	
January 1987	-Initiation of Program Participating Banks	
June 1987	-Reflows of LE 10,000,000 Deposited	
	-Advisory Committee Adjus Limits and Allocations Banks	
August 1987	-Evaluation	/GOE
April 1988	-Project Committee Evaluati	/GOE

*N.B.: The Advisory Committee will meet s larch and September, to discuss policies and procedures, all ntees, approve the participation of new banks, adjust targ and review overall performance of the Fund.

June 1988	-Reflows of LE 15,000,000 Deposited	
	-Advisory Committee Meeti	ttee
	-Additional Banks Approved for Participation	
June 1989	-Reflows of LE 15,000,000 Deposited	
	-Advisory Committee Meetin	.ttee
	-Additional Banks Approved for Participation	
April 1990	-Project Committee Evalua	GOE
June 1990	-Reflows of LE 15,000,000 Deposited	
	-Advisory Committee Meeting	ittee
August 1991	-Evaluation	)/GOE

ANNEX G

Private Investment Encouragement Fund

1. Advisory Board

Dr. Mohamed Zaki Shafie
Professor, Ein Shams University

Dr. Helmy Mahmoud El Nomor
Professor, Cairo University

Mr. Mohamed Ezzat Ghidan
Chairman, Federation of
Egyptian Chamber of Commerce
Member, Shourah Council

Mr. Said El Tawil
Chairman, Egyptian Business Association

Dr. Motaz Bellah Ahmed Mansour
General Manager,
Misr Iran Development Bank

Dr. Eng. Adel Gazarin
Chairman, Public Sector Authority
for Engineering and Industry
President, Federation of Egyptian Industries

2. Guidelines for Private Investment Encouragement Fund/Project Finance Facility

A. Summary

The Private Investment Encouragement Fund (PIEF) is designed to stimulate growth and modernization of the Egyptian private sector. The PIEF provides medium to long-term credit to private sector companies to finance new productive facilities or to expand or modernize existing facilities. The fund is a project financing facility aimed at enhancing the growth of medium to larger-size enterprises. It is also a co-financing facility where Egyptian participating banks contribute towards project financing. The participating banks serve as agents for the fund to manage the co-financing portfolio. The participating bank determines the technical, financial and economic feasibility of each project brought to its attention and recommends to PIEF that a selected project should be financed under the bank-PIEF co-financing arrangement. The bank manages the co-financing portfolio over the full life of the PIEF financing. The bank selects projects for PIEF co-financing approval, based on the pre-determined criteria outlined below and general provisions agreed to in a Participating Bank Agreement executed between the bank and PIEF. USAID/Cairo approval is also required.

B. Guidelines:	PIEF Limits
Egyptian Ownership:	Not Less Than 30%.
Government or Public Sector Ownersnip:	Not to Exceed 30%.
Total Project Cost:	Not Less Than 1.5 Million Pounds or Equivalent FX.
Minimum PIEF Loan Amount:	Not Less than $300,000.
Maximum PIEF Loan Amount	With 1:1 debt/equity ratio Not to Exceed 40% of total project cost; 2:1 D/E ratio = 30%; 3:1 D/E ratio = 20%. Bank Co-financing Loan Amount normally will equal & preferably exceed PIEF loan amount. Bank financing to be term financing; operating/working capital financing does not count.
Maximum Debt/Equity Ratio:	3/1.
Interest Rate:	As negotiated by Bank. Both Bank and Fund rates will normally be identical.
Repayment Period:	As needed, but not to exceed 12 years including grace period not to exceed 36 months.
Foreign Exchange Rate:	Commercial Bank Premium Rate, fixed upon date of loan execution.
Internal Rate of Return (IRR):	Exceeds the Effective Interest Rate on all Loans.
Economic Rate of Return (ERR):	Positive - details for calculation available at the bank.
Environmental Review:	Review Completed - Details for Environmental Review available at the Bank.

Terms & Conditions for Co-financed Loan:	(a) as set forth in the PIEF Participating Bank Agreement, and (b) as negotiated;
Special Articles in Bank Loan Agreement with Borrower:	As negotiated with banks and PIEF.
Economic Focus:	Increase the private sector's role in the economy, by expanding investment in private sector productive areas.

3. <u>Criteria for Bank Participation</u>

The following criteria for approval of Participating Banks should be considered:

-- Board membership (i.e., background, skills, etc.);

-- Bank management team (i.e., background, education, etc.);

-- Capital and surplus;

-- Loan specialties, if any;

-- Experience in term lending;

-- Quality of support staff in areas such as:

  -- Appraisal;
  -- Ability to prepare financial projections, etc.;
  -- Economics;

-- Length of time in business; and

-- Reputation.

4. Loan Application Procedure

Step 1: Borrower prepares a preliminary project description for proposed plant start-up, modernization and/or expansion. Cost estimates are based upon quotations received from suppliers for necessary equipment, supplies, etc. Borrower then takes proposal to participating bank (henceforth, "bank").

Step 2: Bank makes a preliminary evaluation to determine if project is acceptable, and if so, prepares plan for project review, and contacts Investment Authority (GAFI) and USAID to discuss the proposal.

Step 3: Following preliminary expression of interest in proposal by GAFI and USAID, bank undertakes review of project. If bank's credit/project reviews acceptable, bank formally approves its portion of project financing and formally requests PIE Fund co-financing.

Step 4: PIE Fund and USAID formally approve investment on basis of bank's financing request and credit/project reviews.

Step 5: Bank concludes loan agreements, collateral and other documentary requirements with borrower and PIE Fund. Upon request, USAID issues letter of commitment (L/COM) to bank in amount of PIE Fund's portion. This L/COM will provide funds for the opening of letters of credit (L/C's) for all items eligible under the AID Commodity Eligibility List, and contains a provision for standard advance payments and other terms as needed. AID-direct L/Com's will be used for the payment of services other than commodity-related services. The bank L/Com method of payment is the most appropriate payment procedure due to the large number of relatively small transactions expected for the procurement of commodities under the Project Finance Component of the project. Due to the minimal availability of foreign currency in Egypt, the direct L/Com method of payment is the most appropriate payment procedure when purchasing services.

Step 6: Borrower makes awards to equipment suppliers on basis of AID regulations (per Annex 1, PIE Fund Participating Bank Agreement dated 3/3/85).

Step 7: Bank issues letters of credit, keeping records of PIE Fund disbursements to borrowers; goods arrive and are installed; plant begins production.

Step 8: Bank monitors repayments, compliance with covenants and continued validity of mortgage and other security arrangements, etc. Bank's management obligation, as agent of PIE Fund, ceases with final repayment of PIE Fund loan. Bank agrees, however, to maintain all agreed-upon documents, for PIE Fund review, for a period of three years following final repayment of each PIE Fund loan.

ANNEX H

Demand for Credit Funds & Recommendations for Future Credit Activities

A. Demand for Credit Funds

To improve our understanding of demand for AID funds at the Bank Incentive Rate of exchange, the Mission conducted two types of studies. The first study was based upon results of a questionnaire used to poll Production Credit Project borrowers. The second study was based upon an examination of the changes in the exchange rate of the U.S. dollar against the currencies of Egypt's primary trading partners, taking into account the different inflation rates among the countries.

The first study is based upon a questionnaire which USAID sent to borrowers under the Production Credit Project in late 1984, as part of the December evaluation. The questionnaire asked for comparative prices of U.S. and non-U.S. goods. It was mailed to more than 300 companies, and 32 companies provided relevant responses. Results were tabulated in January 1985 and demonstrate (based upon this sample) that U.S. goods on an F.O.B. basis were 22% more expensive than non-U.S. goods and on a C.I.F. basis were 27% more expensive. A copy of the questionnaire is available in USAID's Office of Finance and Investment.

The second study provides a more theoretical approach to the problem. The primary reason why U.S. goods are thought to be uncompetitive in Egypt (and elsewhere) is the strength of the U.S. dollar. The U.S. dollar has appreciated against the currencies of Egypt's primary trading partners by an average of approximately 80% for the period 1980-1985. If the rise in the dollar's value is discounted by the amount which could reasonably be attributed to higher inflation rates in the other countries, the value of the dollar has still risen by approximately 65%. The contention is that this figure provides a rough approximation of the degree to which U.S. goods may be considered overpriced in the Egyptian market (i.e., the cost to Egyptian borrowers of using AID's program).

The relative purchasing power parity doctrine states that if a country has a balance of payments equilibrium during some period, then subsequent movements in its exchange rate should be based on relative changes in price levels. For example, if prices in country A double relative to prices in country B, then the currency of B should appreciate by 100% with respect to the currency of country A. Table 1 summarizes the changes in CPI and FX rates for Egypt's five main trading partners in 1980. During that year, the U.S. had a $1.86 billion surplus on its capital account. Germany provides a striking case. While the inflation rate in Germany was actually 9.3% lower than in the U.S. for the five-year period in question, its currency depreciated against the dollar by 68.5%.

In Table 1, the figures in Column D represent the appreciation of the dollar over and above what could be explained by relative inflation rates.

D = A - (B-C) where
A = % change in FX rate vs. U.S. dollar
B = % change in CPI for foreign country
C = B - % change in CPI for U.S. (30.6%)

The average of D for Egypt's five main trading partners is 67.24%.

The above analysis is admittedly rough. We may argue whether the CPI is the appropriate price index, if 1980 is a good base year, or what is the effect of structural changes in the economies concerned since 1980. Nevertheless, this analysis supports studies done elsewhere which conclude that U.S. products are overpriced in the Egyptian market. If anything, it may cause us to determine that we have previously underestimated the size of the problem.

Potential Investors
Currently Active in Egypt
(Examples at Pre-Feasibility or Feasibility Phase)

Company	Estimated Project Cost (Millions)	Project Type
Abbott Labs	6.0	Infant formula & drugs
Ralston Purina	2.0	Concentrate feeds
General Motors Car Project & Feeder Industries *	150.0	Cars & components
Proctor & Gamble	26.0	Soaps
Lincoln Electric	7.0	Industrial engines & welding
Colonial Rubber Works, Inc.	50.0	Rubber products - feed industries
Ebasco	4.0	Industrial infrastructure for oil and heavy industry
G.A. Technology	Unknown	Food processing
Gorman - Rupp	Unknown	Industrial equip. & pumps
American Standard	Unknown	Brass water fixtures
National Can	20.0	Tin plate
South Eastern/Ross Breeders	Unknown	Poultry

Combustion Engineering	Unknown	Industrial equip,. for oil & chemical industries
Kenney	2.0	Drapery hardware

* The Government of Egypt (GOE) formally approved General Motors' (GM's) proposal in April 1986 to establish a Law 43 joint venture company for the purpose of assembling passenger cars in Egypt. GM's proposal, as accepted by the GOE, is to assemble a medium-size Opel and a small-size Opel in Egypt using the El Nasr Car Company as the principal assembler on a sub-contract basis. In exchange for the license to be the exclusive passanger car assembler in Egypt, GM has agreed to develop the automotive component parts industry in Egypt such that by the end of five years, the cars will have more than 50% of their components manufactured locally. Additionally, GM will export back to Opel in Europe substantial quantities of component parts manufactured in Egypt, as well as other non-traditional exports developed by its trading arm, Motors Trading Company. Through these exports, GM plans to offset a major portion of the costs of importing the car kits from Opel.

  As a result of this scheme, 10-15 new joint venture companies in the component parts industry are expected to be approved over the next year or two. Only a few of these companies have completed their feasibility work thus far, but all are expected to apply for financing under the Project Finance Facility. The amount of loans will vary considerably as a result of differing capital intensity of the product, as well as the differing needs for U.S. equipment. On one extreme, there may be a new radial tire company, which could use as much as $100 million in U.S. equipment. More likely, most companies that have visited USAID offices have indicated a need for $1-2 million each.

  The GM joint venture itself has already indicated a need for approximately $36 million to be used for U.S. equipment and U.S. management services. If ten other companies start up in 1987, each needing $2 million, then there will be a need for $56 million just for the GM project.

B. Recommendations for Future Credit Activities

1. For Term Credit Facility

In April 1985, Report of Term Credit Assessment Team Visit to Egypt, prepared by E. H. Clarke (AID/Washington, Bureau for Program and Policy Coordination), et al, proposed a simple, straight forward strategy of folding together the two existing projects (Production Credit and Private Investment Encouragement Fund) into a new umbrella project (i.e., Private Enterprise Credit). This Assessment made the following specific recommendations concerning a private sector credit program in Egypt:

-- Operate on customary standards of prudent banking;
-- Deliver credit through or in cooperation with the Egyptian banking system;
-- This program should not undertake equity investments;

-- Add participating banks as authorized program participants;
-- Coordinate the Private Sector CIP and Project Finance facilities to provide a flexible means of obligating funds among the two sub-projects;
-- Target project assistance to sectors where Egypt has a comparative advantage;
-- The Export Development Bank of Egypt should be examined as a possible channel for reflows, from Production Credit and PIEF, to any local currency financing facility;
-- All loans of $2 million or less require only simple PIEF concurrence. This assumes that ten percent of the participating bank's paid-in capital and reserves exceeds the loan amount;
-- During project appraisal process, focus on appropriate measure of economic rate of return and delegate other elements of appraisal process to participating banks;
-- Place a high priority on ability of cash flow to service debt;
-- Transaction limits are not necessarily subject to the constraints of project percentages, debt/equity ratios and Central Bank/participating bank lending limits;
-- A maturity limit of twelve years is acceptable for exceptional cases; and
-- The 20% of total project cost lending limit, currently stipulated for PIEF, can be increased if equity exceeds the required ratio (currently 3:1).

2. <u>For Production Credit-Type Facility</u>

-- Reduce downpayment requirement for importers;
-- Increase transaction size limits for medium-term lending to over $1 million;
-- Extend repayment period for capital equipment to five years;
-- Develop specialized lending arrangements for selected sectors;
-- Eliminate requirement for three offers; and
-- Keep traders in program.

TABLE 1

Country	% Change in FX Rate vs US $ 1980 - 1985 A	% Change in CPI 1980 - 1985 B	B - % Change in US CPI (B - 30.6%) C	A - C = D C
Germany	+ 68.5	+ 21.3	- 9.3	77.8
Italy	+ 128.0	+ 89.4	+ 58.80	69.2
France	+ 121.0	+ 58.3	+ 27.7	93.2
Japan	+ 9.8	+ 14.0	- 16.60	26.4
UK	+ 81.6	+ 42.7	+ 12.10	69.5

TOTAL 336.50
Average 336.20/5 = 67.24

Annex I

Other Donor Activity

This section is based on Ahmed S. Foda's Term Credit Study prepared for USAID/Cairo in April 1985.

A. All Sources of Credit

Local credit generally originates from five main sources: banks, insurance companies, individuals, suppliers and foreign institutions. In Egypt, banks provide a major source of credit funds, but generally only for short-term, trade-related activities, not for medium or long-term financing. Insurance Companies, ordinarily sources of credit in many parts of the world, do not traditionally engage in providing credit in Egypt, but invest in time deposits, real estate and equity participations.

The amount of credit provided by individuals (or moneylenders) is almost impossible to determine. Moneylenders generally finance only short-term, equity-type transactions due to Islamic usury laws, which prohibit the charging of interest. These individuals derive their profits from the difference between what they pay for commodities and the price for which they sell them. Participation by moneylenders in more complicated, longer-term industrial and agricultural transactions remains low due to the large size and intricate nature of these transactions.

The availability of local supplier credit depends upon the products supplied. For example, since few capital goods are produced in Egypt, the amount of supplier credit available for capital goods domestically is relatively low. Supplier credit is available mostly for short-term transactions (not more than 90 days) between wholesalers/importers and retailers/consumers.

The most significant source of credit is foreign-sourced (i.e., from USAID, international institutions, Europe, Asia and Australia). In the case of international institutions and Europe, aid channeled to the private sector is done through private sector industrial and agricultural projects, as well as small-scale industry. (The following section will provide a discussion of foreign credit sources as of April 1985. Since Private Enterprise Credit is concerned with providing credit to the Egyptian private sector, this section will focus on foreign-sourced credits earmarked for that sector. It is interesting to note that at the time the Foda Study was written, no donor country had any term credit projects similar to USAID's Production Credit or PIE Fund.)

B. Foreign Sources of Credit

The major source of financing is provided by international institutions, which represent practically the only source of untied aid to Egypt. The World Bank (IBRD) and its agencies, such as the International Finance Corporation (IFC) and the International Development Association (IDA), are the major international institutions which finance the Egyptian private sector. These organizations are responsible for nearly half of all loans to Egypt from international institutions. IFC participates in Egyptian joint ventures in an effort to help develop the Egyptian private sector. IDA, the only agency that offered soft loans (loans at concessional rates), terminated its program over two years ago when Egypt's per capita income level reached IDA's cut-off point for development assistance eligibility.

(For additional information concerning World Bank activities, please see the following tables. Table 1 presents loan amounts and terms of lending from various international institutions to the Egyptian Development Industrial Bank (DIB) and the GOE. Table 2 presents terms for sub-loans by the DIB/GOE to the Egyptian private sector. Table 3 shows IFC's investments in Egyptian joint venture companies.)

A second source of financing is Western Europe. This area includes a large number of international donor countries, such as West Germany, France, Switzerland and Britain, which provide specific financing to the private sector in Egypt.

Until 1983, Germany was the only country which granted untied aid. This situation changed in 1983 when Germany began to impose certain credit restrictions on Egypt in order to guarantee that the grant part of German financing goes to German contractors.

Since 1973, Germany has granted Egypt an average of DM 250 million on an annual basis for capital assistance in the form of soft loans to the public sector. In 1985, however, this annual budget decreased to DM 234 million, with the difference being made up by grants for technical assistance. In the meantime, during 1981-82, DM 50 million in funding above Germany's annual budget for Egypt was allocated to the private sector. Under this allocation, approximately DM 15 million was earmarked for the private sector through the Agricultural Development Bank.

In addition to the above, Germany is involved in the formation of German-Egyptian joint ventures, and has thus far planned fifty such ventures, four of which are presently in the production stage.

Another European donor, France, made two loans to the private sector through Bank Misr between 1982 and 1984. In addition, France has made available open lines of credit for use by the private sector.

Switzerland, a third donor country, established certain conditions preceding the commitment of Swiss aid. An Egyptian importer, for example, must first submit a request to the Ministry of Planning and International Cooperation (MPIC) for assistance. If MPIC approves the request, judging it to coincide with Egypt's economic development needs, the request is sent to the Federal Office of External Affairs in Switzerland (OFAEE), which then analyzes the demand for funds according to its own development criteria.

Egypt allocated 10% of the first Swiss loan in 1978 to the private sector. A second Swiss loan was granted in 1984 with 15% of its total amount allocated for private sector small-scale production.

(Table 4 shows German, French and Swiss loans to the private sector including loan terms to the Central Bank of Egypt and to various Egyptian banks. Table 5 presents terms for relending such funds to DIB and then to the private sector. No similar data is available for British assistance. British banks, however, provide financing to Egyptian borrowing institutions via specific lines of credit. It is known that most U.K. supplier credit benefits the public sector and that most U.K. financing is available to Egypt in the form of export credit.)

Except for Japan, data is lacking on loans granted from Asia and Australia, as well as the terms of lending and relending to the private sector. As of March 1984, Japan has committed nearly $1,354 million as official development aid. This assistance has been divided between project and commodity loans. Project loans are made in areas such as: transportation, housing, water supply and sewage, agriculture, electricity, communication and industry. Commodity loans since 1979 have provided for export credits to facilitate the import of equipment on deferred repayment terms. In addition, Japanese assistance often shows up in the form of Japanese government participations in private sector projects, as well as direct investment by the Japanese private sector, which not only help supplement the shortage of Egyptian capital, but provide for the transfer of management expertise and technology.

ANNEX J-1

MANAGEMENT OF CREDIT GUARANTEE FUND

Five different options were considered for the management of the guarantee fund. PEC's project paper design team recommends the Arab Investment Bank as the CGF manager.

-- Administering the fund through the Central Bank.of Egypt (CBE).

This was initially thought to be a natural role for the CBE, since they are charged with the regular supervision and examination of commercial banks, and therefore have an established monitoring relationship with all the participant banks.

The major argument against assigning the management of the fund to the CBE, according to commercial bankers, is that the processing of claims is almost certain to be over-bureaucratized and prolonged. It is also unlikely that the CGF would be able to earn as high an income if it is controlled by the CBE, since the Central Bank loans funds out at 7.5 - 9.5%. Furthermore, administrative costs are likely to be higher at the CBE since there will be no real incentive to keep these costs down. Lastly, in conversations that the team had with CBE representatives, there was a noted lack of enthusiasm for collaborating in the establishment of such a fund.

-- Administering the CGF through an insurance company.

Since the Guarantee Fund is essentially an insurance program for bad debts, it was felt that an insurance company would have a clear understanding of how to manage it efficiently and would already have the necessary facilities and staff in place to do so.

A visit to a branch of the largest insurance company in Egypt, Misr Insurance, left the team with some serious doubts as to the advisability of collaborating with a public sector insurance company.

One drawback of placing the fund with an insurance company is that the fund would have to make some income provisions for the managing company rather than recycling all net income back into the fund.

-- Administering the CGF through the Egyptian Banker's Association.

This option was suggested by a banker. However, it is doubtful that this kind of organization is structured to manage such a fund nor that it has the experience, staff and facilities to do so.

-- Providing each participant bank with its own guarantee fund.

This is another option suggested by a banker. The obvious complexity of monitoring several different guarantee funds is grounds for rejecting this option out of hand, not to mention the difficulty of establishing effective checks and balances in such a system. Total administrative cost would certainly be higher as well.

The only real advantage (from a bank's point of view, naturally) is that claims would be processed more rapidly if it was all done under one roof.

-- Having a single non-participating bank administer the Fund.

<u>Pros</u>

-- Centralized management of the Fund by an institution that would understand its purpose and function.
-- Likelihood of available staff and space.
-- Likelihood of efficient management and rapid processing of claims.
-- Separation of guarantee function from the institutions responsible for credit function, thus facilitating the establishment of checks and balances.
-- Equitable treatment of all participating banks.

<u>Cons</u>

-- Likelihood that a non-participating managing bank would want to earn some income off of the fund, thus limiting somewhat the fund's growth potential.
-- Difficulty in finding a bank oriented towards the special requirements of appraising an SSE loan, though this could be rectified through technical assistance and clear loan approval guidelines.

-- Having a single participating bank administer the fund.

<u>Pros</u>

-- Centralized management of the fund by an institution that would understand its purpose and function.
-- Likelihood of available staff and space.
-- Likelihood of efficient management and rapid processing of claims.
   -- An established orientation towards serving the SSE segment of the market and an understanding of the specific problems involved in doing so.
   -- Likelihood that the bank would administer the fund at cost since it is a participant in the program.

<u>Cons</u>

-- Possible need for stricter supervision of fund management.
-- Possible more favorable treatment of one participating bank over another.

After reviewing and discussing these options, the design team recommended two banks considered as managers of the CGF: the new Export Development Bank of Egypt and the Arab Investment Bank.

Export Development Bank of Egypt (EDBE)

This bank has been brought to our attention for the following reasons:

-- They are soon to be a participant of both the PCP and PIEF programs.
-- They are new and likely to be looking for depositors. Therefore, they might be willing and able to pay high interest rates on time deposits for the guarantee fund.
-- They are planning a credit guarantee fund of their own.
-- They appear to be highly efficient and are utilizing state-of-the-art banking systems and technology.
-- As part of their long-range planning, they are already establishing SSE portfolio to develop new customers for the future.

On the other side of the ledger, the EDBE has little in the way of a proven track record. This lack of experience will make it difficult to win the confidence of other participating banks. Moreover, it might require some income from the CGF if it is not participating in the program.

The Arab Investment Bank

The Arab Investment Bank has impressed the team members during their visits for the following reasons:

-- The quality of the management and internal operations of the bank appear to be superior to most others that were visited.
-- The bank is very customer-oriented in its attitude and has some experience in lending to small and medium scale enterprises, though not to the CGF's specified target group.
-- The bank has a successful 7-year lending history and a healthy balance sheet.
-- The bank has the staff, space, and motivation to manage a program oriented towards bringing SSE's into the formal credit market.
-- The bank would be willing to manage the CGF at cost.
-- The bank is agreeable to supervision by an advisory committee and independent spot checks of the management of the CGF by AID-appointed auditors.

After further discussion, the design team felt that the newness of the Export Development Bank would be a serious handicap in its dealings with more experienced participating banks. This concern was expressed by EDBE executives themselves. Furthermore, the EDBE is actively building a SSE portfolio with an eye towards its future client base, and should be considered for participating in the program.

Therefore, the design team recommends that the Arab Investment Bank be given consideration as the managing agent for the Credit Guarantee Fund.

ANNEX J-2

PREVIOUS STUDIES AND RECOMMENDATIONS

A. Introduction

The purpose of this section is to discuss previous Small-Scale Enterprise (SSE) studies financed by USAID/Cairo, or prepared in-house, which are relevant to the proposed SSE component of this project.

These four studies are:

1. Arthur D. Little International's study submitted in March 1982. This study was prepared in two volumes entitled:

   -- Phase I: Review and Evaluation of Small-Scale Enterprises in Egypt;

   -- Phase II: A Strategy for Support of Small-Scale Enterprises in Egypt.

2. Dr. Aly Helmy's Report entitled Small-Scale Industrial Enterprises in Egypt, June 1985. This report served as the basis for PEC's Small-Scale Business Facility.

3. Match Institution SSE Report, submitted to USAID/Cairo in June 1985. This Report was entitled Small-Scale Enterprise Credit Delivery Systems For Rural Egypt.

4. Partnership For Productivity (PFP) Reports submitted to USAID/Cairo in August 1985, was entitled Small Business Capacity Development. PFP's report was prepared in three volumes:

   -- Case Studies;
   -- Research Findings Analysis;
   -- Alternatives and Recommendations.

B. A.D. Little's Study

This study formulates and recommends a program for supporting the development of SSE's in Egypt. The study indicates that the role of SSE's is important since a large number of firms in Egypt are in this category. In addition, SSE's contribute significantly to industrial output.

The study estimates that there are 7,530 privately-owned firms with 10 or more employees. Approximately 92%, or 6,900, employ between 10 and 50 employees, while 7%, or 510, have between 51 and 200 workers. Only 1% of these firms, or 120, have over 200 employees.

Private sector firms accounted for 29% (or LE 1.77 billion) of the estimated LE 6.1 billion industrial output in 1980. Establishments with 10 to 50 employees (i.e., SSEs accounted for 66% of private sector industrial output, about LE 1.2 billion. Actual SSE contributions to total industrial output is probably much greater because of the practice of SSE's of under-reporting output in order to reduce tax payments. In addition, a large number of SSE's are unregistered. Hence, their contribution to industrial output does not always show up in official statistics.

The study indicates that Egyptian SSE's are constrained by:

-- Lack of medium-term working capital for purchasing materials and spare parts;
-- Some SSE's show a tendency not to borrow due to "high" interest rates and reluctance to commit to large fixed payments in an uncertain future. On the other hand, a very significant number of SSEs, especially the more dynamic ones, are eager to obtain bank credit and are not averse to the payment of interest or repayment of principal in installments;
-- Shortages of skilled labor due to off-shore employment in neighboring countries;
-- Lack of adequate factory space for expansion;
-- Inadequate inventories of materials and spare parts leading to high levels of machine idleness;
-- Deficient management skills in finance and marketing areas;
-- Excessive regulatory requirements which create unnecessary red tape and adversely affect operations;
-- Inadequate infrastructure relating to electricity, telephone and industrial sites creates problems for new and expanding SSE's;
-- Lack of a high-level agency or individual with a mandate to effectively promote the expansion and strengthening of SSE's;
-- Lack of information and performance statistics on SSE's. Thus, the formulation of specific and effective SSE policies is unlikely in the absence of basic information about the sector;
-- Lack of domestic and export market information on SSE's, as well as information on available technology and equipment. What information is available is not disseminated to SSEs anyway; and
-- Absence of support institutions to provide technical assistance to SSE's. The Engineering and Industrial Design Development Center (EIDDC) has begun to provide technical assistance (with World Bank financing) but its role at this time is limited.

The study indicates that the credit constraints experienced by SSE's stem from the following reasons:

-- Financial institutions tend not to lend to SSE's, because banks prefer to lend to larger firms which can fulfill bank collateral requirements; and
-- Institutional channels for SSE financing are highly limited; only the Development Industrial Bank (DIB) represents a funding source for SSE's. DIB's role has been rather limited relative to the large number of SSE's operating in Egypt.

The A.D. Little Study provides several recommendations for assisting in alleviating/removing the above SSE constraints. The study categorized its proposed projects into three groups: immediate, short-term, and medium to long- term.

Immediate projects in order of priority:

- -- Establishment of a $56 million medium-term credit program over a five-year period;
- -- Organization of an SSE conference;
- -- Technical assistance to strengthen the Federation of Egyptian Industries (FEI);
- -- Implementation of the planned Industrial Technology Application Project (ITAP) in the EIDDC;
- -- Development of an SSE data base;
- -- Establishment of a legal reform task force; and
- -- Streamlining of the project approval process in GOFI.

Short-term projects(i.e., one to two-year projects):

- -- Establishment of an SSE council;
- -- Technical assistance in project formulation;
- -- Establishment of an SSE industrial task force;
- -- A pilot project in bulk buying;
- -- Dissemination of management materials;
- -- Diagnostic study of the labor situation in Egypt;
- -- Information about U.S. equipment and technology; and
- -- A pilot project in vocational training pilot.

Medium to long-term projects (i.e., five-year projects period):

- -- Management of SSE programs and funds by the SSE council;
- -- Regulatory reform;
- -- Spare parts locating and expediting service;
- -- Expanded export promotion program;
- -- Expanded bulk buying project;
- -- Technology transfer advisory service;
- -- Promotion of subcontracting opportunities;
- -- Expanded vocational training program; and
- -- Purchasing policy favoring SSEs.

C. Helmy's SSE Report*

This report had dual objectives: To assess the role currently played by small-scale industrial enterprises in the Egyptian economy, and propose the terms of credit programs to satisfy SSEs credit needs. The report indicated that the role played by SSEs in Egyptian industry has been quite important in terms of their contribution to industrial output. It is estimated that in 1984, SSEs employing between 10 to 50 employees, contributed about 61.4% to the value of the private sector's industrial output. This represents about 21% of total industrial output. Moreover, it is estimated that firms employing between 10 and 100 workers contribute about 66%, and enterprises with 10 to 200 employees contribute about 75%. This 75% represents 25.7% of the value of total industrial production in Egypt.

This report has indicated that firms employing between 10 and 50 individuals represent about [illegible].6% of the estimated 13,000 privately-owned industrial firms operating in Egypt. The number of firms employing between 10 and 100 individuals represent 95%, and firms employing between 10 and 200 employees represent about 98.6% of the total number of private sector establishments.

From the above, it is evident that SSEs play an important role in the Egyptian economy, in general, and Egyptian industry, in particular, in terms of their contribution to industrial output and the number of industrial firms operating in Egypt. In addition, the private sector's role in Egyptian industry has been steadily growing since the adoption of the Open Door Policy of 1974. According to the Ministry of Industry's statistics the Private Sector's contribution to total industrial output was at 34.3% or LE 2,929.4 million, in 1984.

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* Dr. Aly Helmy's Small-Scale Industrial Enterprises in Egypt: Assessment of Role and Proposed Credit Programs. USAID/Cairo, June 1985.

Helmy's report emphasized that the private sector's actual contribution to Egyptian industry should be much higher than 34.3%. The reasons: (a) Egyptian privately-owned firms usually under-report the level of their output, investment and number of employees in order to reduce their tax payments; (b) the output of artisanal firms which are involved in industrial type activities is not included in the above figures. This is true since firms with one to nine employees are not under the Ministry of Industry's supervision. The report indicated that the estimated output of the 250,000 artisans (micro-scale enterprises) involved in industrial type activities represent 15% of total industrial production. Based on the above, Helmy's report estimated that the private sector's contribution to Egyptian industry would exceed 45%.

According to the report, the constraints and problems hindering SSEs' growth and productivity can be summarized as follows:

-- Production Constraints arising from machine breakdown due to old age, and the lack of spare parts, skilled workers and raw materials;

-- Labor Contraints stemming from the lack of skilled workers who are unwilling to subject themselves to the discipline that working in a factory entails. Moreover, Egyptian workers often seek lower-paying jobs in public sector enterprises because of the perceived security associated with these firms;

-- Marketing Constraints arising from SSE managers'/owners' perceptions that marketing is a third-level priority following production and finance. Moreover, the unavailability of a network of organized distribution outlets and centers, for the majority of SSE's represents a major constraint;

-- Deficient Managerial Skills since the majority of SSE managers lacking the proper training in bookkeeping, accounting, modern production techniques and processes, production planning, and the forecasting of cash flows;

-- Lack of Appropriately-Priced Sites, which have prevented the majority of SSE's from expanding their productive capacity by relocating to larger sites;

-- Quantity and Rigidity of Laws and Regulations, which have adversely affected SSEs' growth and productivity. Furthermore, the continuous change in these laws and regulations have destabilized SSE decision making; and

-- Lack of Stability in Economic Policies, which have had a destabilizing impact on the private sector, in general, and SSEs, in particular.

The report highlighted SSEs' use of credit. It indicated that the majority of SSE's have been denied bank credit because they lack the required collateral requested by financial institutions (i.e., land and buildings). Furthermore, the majority of SSE's does not keep adequate financial records; hence, their credit worthiness cannot be established based on these records. This problem is further aggravated by the extremely conservative lending practices of Egyptian bankers. The value of collateral, which must be pledged by borrowers, usually represents 300% (or more) of the size of the loan. These conservative lending practices have worked against SSE interests. The majority of SSE's, therefore, raise needed funds either through relatives and friends, or by taking on additional partners.

The majority of SSE's operate at 50% below capacity mainly for the following two reasons:

-- Lack of funds for financing their working capital; and
-- Lack of funds for replacing their old, worn-out and outdated machinery and equipment.

Based on the above, the report stated that SSE credit needs can be divided into two major categories:

-- Short-term financing of working capital for the procurement of raw materials, intermediate goods, spare parts, tools, as well as other items under operating costs; and
-- Medium-term financing for machinery and equipment procurement.

According to the report, removing credit constraints will enable SSE's to operate near capacity, thus increasing their productivity and growth. Benefits to the Egyptian economy will be expressed in terms of increasing the supply of goods, incomes, employment, investment, etc.

-- Recommendations

The report's first recommendation was to establish a $20 million per year working capital credit program, wherein banks would be given U.S. dollars to on-lend Egyptian Pounds, up to one year. LE sub-loans would be used to finance off-the-shelf purchase of raw materials, intermediate goods, spare parts, etc. Loans could be granted according to the CBE's established rates of interest. Furthermore, no down payment would be required since the proposed credit program is aimed at solving SSEs' liquidity problems. Moreover, collateral requirements should not exceed loan size.

The second major recommendation was the establishment of a second credit program, a $20 million medium-term facility. The purpose of this second credit program is to provide loans to SSE's in foreign exchange for importing U.S. equipment and machinery. A two-year grace period and five-year repayment period were suggested in order to make the credit program attractive to SSE's. Interest charges to borrowers would be at the rates established by the CBE. Other fees should also be collected from borrowers (up to 1%). Repayment of loans should be undertaken in Pounds at the exchange rate prevailing when the loan agreement is signed between borrower and participating bank. It was suggested that down payment would be between 10 and 15%. Moreover, the report suggested that the imported machinery and equipment could be used as the required collateral for obtaining loans. Complete ownership of machinery and equipment would remain with the participating bank until the loan is paid in its entirety. Finally, the report suggested that $120,000 should be the upper funding limit for the medium-term credit program.

Helmy's report indicated that in or[illegible]ntice banks to participate in the two proposed USAID credit programs [illegible] options were suggested. These options were divided into two cate[illegible]

The first category included four options such as:

1st: The Interest Spread Option;
2nd: The Reverse Interest Spread Option;
3rd: Percentage For Funds Management Option;
4th: Fee Per Loan Granted Option.

Only one of the above options should be considered for adoption by USAID. It is worth pointing out that participation by banks depends on the kind of incentives they may obtain from the proposed SSE's credit programs.

The second category of options included the following:

A Credit Guarantee Fund;
Training of Participating Banks Personnel.

From the banks' point of view, the last two options should be the key factors for the success of the two proposed credit programs. On one hand, the Credit Guarantee Fund should serve the following two purposes:

1st: Provide participating banks with some security, thus reducing their perceived risk exposure when serving a certain clientele, i.e., SSEs, which they have been reluctant to accommodate;

2nd: Reduce the amount of requested collateral by participating banks.

The training for participating bank personnel would be on a grant basis. It should prove very attractive from a bank's point of view, since it increases the proficiency of its employees in carrying out daily duties.

It is suggested that five banks participate in each proposed credit program. Each bank would be allocated $4 million, thus bringing total funding to $40 million for the first year of the program.

The "Fee Per Loan Option," which is suggested for adoption, should cost about $200,000 per bank. This will bring the overall cost of this option to $2 million per year. The "Credit Guarantee Option" would require a USAID contribution between $3 to $4 million for establishing it. The "Credit Guarantee Fund" requires equal contribution by the GOE.

The "Training of Participating Banks Personnel Option" should cost between $65,000 and $130,000 assuming that the training would be specifically designed for this group of bank employees.

Total funding of the proposed SSE credit programs would cost between $45,065 thousand and $46,130 thousand annually.

D. The Match Report*

The purpose of this report was to assess the status of SSE credit needs in rural and secondary cities, and recommend a plan of action for meeting these credit needs and specific reform strategies for GOE/USAID consideration.

The Match Report recommended the "demand responsive model" of credit delivery as an alternative to the "supply-lending model" for its superior characteristics:

1. Operating according to market forces instead of external factors;

2. Providing physical access to rural borrowers close to their residence and employment; and

3. Recovering all cost of operation from the borrower.

The Match Report recommended two different credit delivery models for USAID/GOE consideration. The first is a private sector model to be developed and implemented with the National Bank for Development and its network of governorates banks. The second, a public sector model to be developed and implemented with the Local Development Fund (LDF). The latter would combine private sector banking approaches with public sector economic development methods. The report suggested the implementation of the two models in separate governorates in order to determine, through case studies, the relative success of each model.

Both models would be committed to: (a) Establishing a credit delivery system at the village level; (b) Requiring the borrower ultimately to bear the real cost of the program; (c) Concentrating on loans below LE 10,000; and (d) Promoting diversification among rural private sector micro-scale borrowers.

The report suggested that lending rates for Regional Development Banks be established between 22.3 and 27%, but it would be most unlikely that any borrowing would be done at these relatively high rates, especially when current CBE's lending rates to industry and agriculture are between 11 and 13%. Furthermore, the CBE's interest rate for food security loans is currently 7%. It is therefore most unlikely that the CBE/GOE would ever agree to the lending rates (in rural areas/secondary cities) proposed by the Match Report. The overall cost of the Match Report proposals would be LE 36 million over a five-year period.

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* The Match Institution, Small-Scale Enterprise Credit Delivery Systems for Rural Egypt, June 30, 1985.

E. Partnership for Productivity's Report*

Partnership for Productivity (PFP) was responsible for assessing the outlook and prospects of small to medium-size enterprises (SME's). This was done by:

-- Conducting case studies of 36 private sector firms in three sub-sectors (food-processing, ready-made garments, and engineering);
-- Identifying models of success among these firms, as well as problems of productivity;
-- Assessing services currently provided to SME's; and
-- Recommending strategies to remove constraints on the dissemination and utilization of business information.

PFP concluded that:

-- The SME sector is not presently served by existing public and private sector institutions;
-- Both public and private institutions have the will to increase services but not necessarily the means; and
-- For information and services to be credible to and accepted by SME's, they must originate from institutions that are credible and non-threatening to them; and
-- Missing from this scenario is a fabric for intra-and inter-organizational communications.

The contractor's report submitted in August 1985 recommended a general strategy to formalize a network of existing private and public sector institutions as a coordinating body that would provide services to small and medium-size businesses, as well as add to their institutional capacity and create new mechanisms as necessary to fill the gap in needed services to SME's. Seven key services that need to be strengthened, coordinated, or created are:

-- Information and communication services
-- Extension services;
-- Credit and financial assistance;
-- Policy dialogue;
-- Technical assistance;
-- Vocational training;
-- Special economic activity.

Budget estimates over five years called for a cost of $2,613,000 in U.S. currency and $4,560,000 in Egyptian currency. Thus, total funding for PFP's proposed programs would be $7,173,000.

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* Partnership For Productivity/International, Small Business Capacity Development: Outlook And Prospects For the Egyptian Private Sector. August, 1985

ANNEX J-3

WORLD BANK DEFINITIONS FOR SIZES OF ENTERPRISES

-- Artisans

Firms employing less than 10 workers, usually family members, engaged in small workshop operations with fixed assets, excluding land and buildings, not exceeding LE 25,000.

-- Very Small-Scale Enterprises (VSSE's)

Firms with fixed assets not exceeding LE 285,000 (in 1985 prices), excluding land and buildings. These firms are usually operating out of a leased building and/or land with a workforce of between 10 and 50 workers managed by the owner or principal partner of the company.

-- Small-Scale Enterprises (SSE's)

Firms with fixed assets valued at more than LE 285,000 but not exceeding LE 570,000 (in 1985 prices), excluding land and buildings. The general characteristic of these firms is similar to VSSE's, though they tend to be somewhat more sophisticated in their management systems. These firms usually employ between 51 and 100 employees.

-- Medium-Scale Enterprises (MSE's)

Firms with fixed assets valued at more than LE 570,000 but not exceeding LE 3.5 million. These companies are more likely to own their land and buildings where their factories are located. Moreover, these firms utilize a more formal management structure. Furthermore, these enterprises often boast a history of successful borrowing from commercial banks or the Development Industrial Bank (DIB).

These definitions are adjusted annually by the World Bank and the DIB according to movements in the Egyptian wholesale price index. Inflation is currently running at about 20% per annum.

ANNEX J-4

CRITERIA FOR PARTICIPATING BANK SELECTION AND NUMBER OF PARTICIPATING BANKS UNDER CREDIT GUARANTEE PROGRAM

A. Criteria

The selection of banks for participating in the proposed "Small-Scale Enterprise Credit Guarantee Program" should be based on the following criteria:

-- Lending history showing willingness to respond to SSE's credit needs.
-- Bank should have demonstrated its adoption of developmental objectives through its lending practices. Thus, public and private sector development banks should be primary candidates.
-- Previous participation in USAID's credit programs, with a demonstration of good performance, should be considered as a major advantage for program participation.
-- Selected banks should have branches located in areas other than Greater Cairo and Alexandria. This will ensure maximum reach to SSE's located in areas other than the two major metropoli.
-- The selected bank should be willing to commit the necessary personnel, time and effort to the proposed credit program. In addition, each selected bank should have the capacity and ability to process a large number of small loans.
-- The selected bank should be willing to commit time and its own funds for promoting, marketing and administering the proposed credit program.
-- The selected bank's charter should entitle it to conduct business in local currency.

It is worth pointing out, that bank selection should not require fulfillment of each and every criterion from the seven stated above. Selected banks should fulfill as many criteria as possible.

B. Number of Participating Banks

Banks selection should initially be made from the nine banks currently participating in USAID's PCP AND PIEF credit programs. The National Bank for Development (NBD) should also be considered. The major advantages that this bank may bring to the proposed credit program are:

-- It has a network of 15 Governorate banks located all over Egypt, providing maximum reach to SSE's located in small towns.
-- NBD is a development bank; its lending practices should reflect its developmental nature.

It is expected that between 4 to 5 banks would be willing to participate in the SSE credit guarantee program.

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CLASS: UNCLASSIFIED
CHRGE: AID U4/16/86
APPRV: CD/CMT:RRICHARDSO
DRFTD: DOD/CMT:DCOWLES:M
CLEAR: NONE
DISTR: AID-6 DCM

AIDAC

FOR AAM/OS/ANE

DPPE

E.O. 12356: N/A
SUBJECT: PRIVATE ENTERPRISE CREDIT PROJECT, NO. 263 - 0201
\- 50/50 SHIPPING

REF: STATE 109233

USAID/CAIRO, AFTER CONSULTATION WITH APPROPRIATE GRANT MANAGER, RECOMMENDS COMBINING CIP-PRIVATE SECTOR ELEMENT OF SUBJECT PROJECT, VALUED AT 50 MILLION DOLS. FOR FIRST YEAR, WITH CIP GRANT 263-K-607 FOR PURPOSES OF MEETING 50/50 SHIPPING. THE PREDECESSOR TO THE CIP-PRIVATE SECTOR, THE PCP, HAD OVER 70 PERCENT OF ALL CARGOS BY VALUE SHIPPED ON U.S. FLAG VESSELS. WE EXPECT THIS PATTERN TO BE REPEATED BUT ARE PREPARED TO MAKE UP ANY SHORT FALL OUT OF GRANT 607. PLEASE ADVISE.
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UNCLASSIFIED STATE 109233

ACTION: AID-6 INFO: CHARGE A/DCM ECON /9

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PP RUEHEG
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UNCLAS STATE 109233

LOC: 90 226
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CN: 25407
CHRG: AID
DIST: AID

ACTION TO 15 DPPE
ACTION TAKEN ______ DUE DATE 4/10
NAME INITIALS ______

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: PRIVATE ENTERPRISE CREDIT PROJECT (PEC) NO. (263-0201) - 50/50 SHIPPING

REF: (A) CAIRO 00836, (B) CAIRO 05957, (C) CAIRO 07831

1. REGRET DELAY IN RESPONSE TO REF A. AFTER CONSIDERABLE DISCUSSION AND ANALYSIS IN AID/W, SER/AAM/TRANS HAS NO OBJECTION IN PRINCIPLE TO USAID CAIRO COMBINING PROJECT 263-0201 WITH CIP PROGRAM. AS OF NOW, HOWEVER, WE ARE UNABLE TO IDENTIFY A CIP GRANT WHICH WE CAN PROJECT TO BE AHEAD ON U.S. FLAG AT THE END OF THE YEAR BY USD 50 MILLION THAT WOULD BE REQUIRED IN ORDER TO COMBINE IT WITH PEC 263-0201. AID/W STATISTICS ON ACTUAL PAYMENTS MADE AS OF 28 FEBRUARY 86 INDICATE THE FOLLOWING GRANTS HAVE MORE THAN USD 50 MILLION REMAINING:

EXPIRATION DATE	GRANT	OBLIGATED	EXPEND	UNEXPENDED
8/31/86	263-K-607	300,000,000	146,946,292	153,053,708
3/15/87	263-K-610	200,000,000	7,249,392	192,750,608

HOWEVER, IT IS NOT CLEAR HOW MUCH OF THE REMAINING

BALANCES OF THESE GRANTS WILL INVOLVE OCEAN FREIGHT. MOREOVER, COMPLIANCE IS MEASURED NOT ONLY IN TERMS OF THE REVENUE GENERATED FROM FREIGHT BUT ALSO ON THE ACTUAL TONNAGE MOVED. THE MOST IMPORTANT COMPLICATING FACTOR IN IDENTIFYING AN APPROPRIATE CIP PROGRAM WITH WHICH TO COMBINE THIS PROJECT IS THAT AID/W STATISTICS ON A PARTICULAR CIP PROGRAM PROVIDE ONLY HISTORIC INFORMATION. PROJECTIONS ON FUTURE PROGRAM ACTIVITY MUST BE MADE IN ORDER TO SELECT AN APPROPRIATE GRANT.

RECOMMEND THAT THESE POTENTIAL GRANTS BE DISCUSSED ITH GEOGRAPHIC BUREAU OR OTHER ELEMENTS IN USAID CAIRO TO DETERMINE WHAT CIP PROGRAMS OR GRANTS MAY, DURING THE CALENDAR YEAR, GENERATE SUFFICIENT ACTIVITY AND TONNAGE TO ASSURE OVERALL CARGO PREFERENCE COMPLIANCE WHEN COMBINED WITH 263-0201. BASED ON CONCURRENCE OF APPROPRIATE GRANT MANAGERS, SER/AAM/TRANS IS INCLINED TO MAKE AN EXPEDITIOUS APPROVAL. SHULTZ

ANNEX L-1

EVALUATION/AUDITS

A. Scope of Evaluation/Audits

AID/Washington's review of the PID pointed to the evaluation plan as an area which should be addressed in detail during PP design. "The PP should describe how success or failure is to be defined, the data base required for making this decision, and the data collection/generation needed for evaluation measurements."

In preparing the Project Paper, the project design team identified evaluation questions which need to be answered, at both the output and purpose levels, and in addition established some purpose-level benchmarks by which to measure project impact.

The resultant evaluation plan is ambitious. It will require a higher level of data collection and manipulation than was done under the PCP and the PIEF. It will require a small amount of additional data collection by the participating banks, and perhaps a brief new form to be completed by each user firm. It will require some data compilation by project staff.

The primary evaluation questions are summarized, along with a brief description of data gathering and analysis requirements, in Annex L-2, "Evaluation Framework."

The details of the table will need to be worked out in detail during the first three months of project implementation.

B. Data Collection for Evaluations/Audits

To provide the information needed to answer the evaluation questions, the following data collection methods will be used:

1. Collection of national level statistics on level of private sector loans from commercial banks (question #1 from the table), broken down by major industrial classification (#2); on private sector imports of raw materials, capital goods and intermediate goods (#5); on levels of foreign exchange available to major categories of industries (#6); on dollar-to-pound exchange rates (#6); and on levels of private industrial sector investment (#9). These statistics should be collected at the beginning of project life, to serve as a baseline for later comparison, and after each year of project life. It is likely, however, that since project impact will require several years to be felt, three years of data collection may be required for trends to become apparent on some indicators.

2. Bank appraisal reports and user-firm-level data. Some of the evaluation questions will require specific firm-by-firm information in order to develop a profile of firms using project credit and uses of the loans.

This information is required for all three components. Some of the information is already collected by banks as part of their loan appraisal process, but some additional data -- collected either by the banks through their existing loan application procedures or by user firms through a brief questionaire -- may be required.

3. User survey: Purposive sample surveys will be carried out of user firms from all three project components during the two formal evaluations planned for this activity.

4. Interviews with project personnel, participating banks, a small number of credit users, and for the SSE component, a small number of interviews with loan applicants, including some whose applications have been denied. These will be used to obtain perceptions of these individuals on progress on implementation, constraints to use of the loans, and needed changes in design.

5. Review of project documents. This feeds into the review of implementation progress.

C. <u>Data Analysis and Review -- Evaluations/Audits</u>

There have been several mechanisms for review and evaluation built into the project which will utilize the data collected above. These are:

1. Annual project reviews, by the project committee and key Egyptian counterpart personnel. These are geared primarily towards the project finance facility and the SSE component, since the implementation procedures for these two components are not yet fully tested and may require some design changes. The annual reviews will utilize project documents, personal experiences of the participants, and the data which has been collected through the first two data collection techniques described above. The project committee will be responsible for compiling the data so that it can be analyzed at the annual reviews. Project committee members may also wish to carry out a few representative user firm interviews prior to the meetings.

2. Post audits for the project finance facility. A USAID team will periodically review a participating bank's loan documents and conduct appropriate interviews with borrowers to assure compliance with PEC's loan criteria and guidelines. It is envisioned that the team will be comprised of staff members from the Offices of Finance and Investment, Legal, Financial Management and, as needed, other technical offices. Furthermore, the Mission's Inspector General Office will conduct full-scale audits in accordance with AID standard methods and procedures. Therefore, both reviews and audits can be accomplished utilizing existing Mission personnel capabilities and funding.

3. Mid-term and final evaluations. If project implementation proceeds satisfactorily, there will be an interim evaluation prior to the third obligation in 1988. An end-of-project evaluation will occur in 1990. Funding has been set aside for an outside evaluation team for each of these evaluations. The team will be able to draw heavily from the data collection

and analysis of the annual project reviews as well as from the audit reports discussed above. In addition, each evaluation will include a purposive sample survey of user firms, as well as a more extensive set of interviews with user firms and participating banks than was done for the annual reviews. The annual reviews will probably suggest changes or additions to the evaluation questions listed in Annex L-2 for consideration by the evaluation team.

D. Personnel and Budgetary Requirements of the Evaluation Plan

The evaluation plan described above lays additional, though minimal, reporting requirements on the participating banks and user firms. Precisely what additional reporting requirements we can reasonably ask banks to provide must be determined during the first three months of implementation. The plan lays heavier responsibility upon the project committee, particularly the project officer and the Mission economist. These individuals are asked to compile data received from banks and user firms and provide preliminary analysis for use at the annual reviews and by the evaluation team; as well as to examine trends in relevant national statistics. In addition, the project committee will be responsible for defining the evaluation questions and their means of measurement in greater detail than is presented here.

ANNEX L-2

EVALUATION FRAMEWORK

A. Questions of Impact	Means of Measurement	Who and When
Did the project result in additional credit availability to private industry? The PP estimates project funds may provide an additional annual increase in private sector loans from commercial banks. With project disbursements of $50-$75 million annually, industrial credit may expand annually, if Central Bank credit constraints permit.	Review of national statistics on levels of private sector loans from commercial banks, and comparison with levels projected in the PP. Baseline data collection required for this analysis, using national statistics.	PAAD economist backstop. Baseline information should be collected at beginning of the project, with comparative information collected annually.
Specifically, for each project component, for which industries is presence of this credit a major factor?	Review of % of project credit going to specific industry categories and comparison with credit available for these categories of industries nationwide, (1) from analysis of project statistics compared with national statistics, (2) from interviews with credit users under the project.	Evaluation team. Comparison of project statistics with national statistics should be undertaken at each evaluation. Evaluation sample survey of users should query as to availability of credit from non-project sources.
What term, interest rate and fees were charged?	Descriptive review and analysis of project experience, based upon review of project documents, interviews with banks, and survey of user firms noted above.	Evaluation team.

What are the "real" costs of credit, including additional costs of higher-priced U.S. goods and shipping? Was "discount" to industries to cover these costs adequate?	Analysis of assumptions made in PP regarding differential required to make project funds attractive, against actual project experience, i.e., (1) actual fluctuations in exchange rate and difference between free market rate and project rate. (2) comparison of costs of U.S. goods and shipping vs. major foreign sources in a sampling of key industrial categories which used project resources (3) survey of business users to get their perceptions of costs, a la P.C.P. evaluation of 1984. (4) analysis of costs and revenues to banks for providing credit (discussed below).	Evaluation team can provide analysis, based upon: (1) review of national statistics. (2) information collected by project staff on commodity costs for key industries -- this may require a special information-gathering survey. (3) survey data, and (4) interviews with banks and results of post-audits.
Did project funds provide the projected additional annual increase in private sector importation of raw materials, capital goods, intermediate goods?	Collect baseline info and annual comparison info on private sector imports of these three categories. Examine annual increases and compare with the $50-$75 million increases projected in the PP. National statistics can be used. No additional info gathering required.	PAAD economist backstop.
What was the importance of project FX for imports for specific industries?	Review of industries using FX from the project. (1) Comparison of % FX project resources going to specific categories of industries compared to total FX actually used by these industries. (2) Interviews with project users. Sample survey noted above can be used.	(1) PAAD Economist. (2) Evaluation Team.

How did exchange rate used by the project affect project viability?	This is also discussed below. Adequacy of exchange rate should be judged by (1) actual demand for the project funds by industries, and (2) analysis of exchange rate fluctuations and comparison of costs of U.S. vs. non-U.S. goods.	Evaluation team.
Was mix of commodities and firms supported appropriate in terms of comparative advantage to Egypt?	Review of firms receiving assistance under the project, categorized by major industry. Analysis of Egypt's comparative advantage in each industry.	PAAD economist and Evaluation team.
Did the project funds provide substantial annual increases in private industrial sector investment? USAID projections show minimum real growth without the project.	Review of national statistics on levels of private industrial sector investment, and comparison of actual increases with increases anticipated in the PP, and with actual disbursements under the project.	PAAD economist backstop or Evaluation team.
For all components, measures of increased output, capacity utilization, employment and exports due to project.	(1) Using appraisal data normally collected by banks prior to approving loans, obtain sample/respresentative info on firms that anticipated increases of industrial output, capacity utilization, employment, and exports, broken down, if possible, into FX and non-FX components of the loans. (2) During 1st and 2nd evaluations, sample firms which have utilized project credit to obtain info on actual increases in these elements.	Collection by banks. Analysis on quarterly basis by USAID project officer. It will be necessary to develop simple format so that manipulation of data is quick and easy. Evaluation team.

Effect of project on USAID Mission policy dialogue. Relationship to IBRD and IMF negotiations. Major areas of policy dialogue in this project are: (1) FX rates to be used (2) Industrial credit interest rates (3) Opening of opportunities for private investment in more areas.	(1) Re FX rates: Review of discussions with GOE and agreed-upon terms for project, as it relates to IBRD and IMF negotiations. (2) Review of negotiations on interest rates, especially for term credit and SSE loans for any evidence of increasing flexibility. (3) Project experience in assisting industries moving into new areas, especially through PFF -- using anecdotal or case study approach.	Evaluation team, using project records and interviews with project staff, GOE reps., banks, and industry users.
Benefit to Egyptian banks: (a) For each component, what term, interest rate, and fees were earned? (b) Were new types of lending initiated? (c) Were new relationships developed with private sector banks? (d) What benefits did banks derive from L.E. loans to SSE users? (e) Did new relationships/trust develop between SSE firms and banks?	(a) Review of participating bank loan procedures and fee structure, (b) Review of bank procedures and discussions with principals. (c) Review of participating bank reports, and discussions with new U.S. bank participants. (d) Review of loans under SSE component, bank procedures and fees in this area, and discussions with bankers involved.	Evaluation team.
For the small-scale enterprise component, describe range of type and size of firm using this project component. What has been employment impact?	On the basis of periodic samples of representative firms, review of users of loan fund, including categorization by major industry type, amount of capitalization and number of employees.	Project committee, for annual reviews of this component -- using existing bank appraisal reports.

B. Implementation Questions	Measures	Who?
Were project procedures for loan approval and commodity procurement adequate to ensure project criteria were met yet limit red tape and excessively strict regulation which discourage firm applications?	Annual review of implementation experience. Separate review for each project component, with emphasis on PFF and SSE components.	Project committee, including participating banks and GOE project principals.
Was the project flexible enough to accommodate changes to overcome implementation problems.	Review of implementation experience, discussions with project principals.	Same as above.
Was project performance at levels anticipated during design in terms of: -number of loans approved -average processing time -rate of disbursement If not, why not?.	Project documents. Information processed for each annual review. Information processed separately for each project component. Information should be available from banks' regular reports to USAID. USAID may need to introduce reporting format which will aid in compiling and analyzing data.	Project committee as above.
On SSE component, has presence of "loan guarantee" fund been adequate incentive for banks to provide term credit on LE loans? Have bank terms been appropriate to cover their risk without providing disincentive to potential users?	Number of users of SSE component as compared to PP expectation. Analysis of bank costs and returns under agreed-upon procedures. Interviews with sample of loan applicants as well as bank managers.	PAAD economist, evaluation team.

Have users been prompt in repaying loans to date? If not, why not?	Review of project records on loan users.	Evaluation team.
Is availability of SSE credit adequate to enable plant expansion or modernization of these firms, or were auxiliary inputs required (e.g., management training, new accounting procedures, etc.) If so, was firm able to obtain these inputs from project T.A. or on its own?	Review of bank appraisal reports and progress reports. Sample of representative firms. Interviews with bank loan officers and project staff.	Evaluation team.
What unanticipated implementation problems were identified during implementation, and how were they or how should they be dealt with?	Review of project documents and discussions with project principals. Interviews with project users. This can be done at annual review.	Project committee as above.