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Report of Private Sector Reconnaissance

Team Visit to Egypt

May 5 to May 15, 1982

Sponsored by AID Private Enterprise Bureau

**John E. Mullen
June 17, 1982**

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I. Overview

A. Purpose

1. The designated purposes of the mission were to examine the availability of medium and long-term financing - debt and equity - for private sector investment in Egypt, particularly for productive enterprises; the ability of existing institutions to provide that financing; whether the lack of good, properly packaged projects was a constraint to investment; other constraints to investment; and the opportunities for AID to support the development of the private sector. This mission differed from other Private Enterprise Bureau (PRE) reconnaissance missions in that its focus was not to identify specific projects for possible PRE support. Rather, because of the size of the Egypt program (\$750 million of new financing annually), the team focused on the role of the private sector in Egypt's development process and on the question of whether significant support from AID for the private sector is warranted.

B. PRE Team; Activities

2. The team consisted of:

John E. Mullen, AID Assistant General Counsel,
Team Leader

George M. Ferris, Jr., Chief Executive Officer,
Ferris & Co., Washington, D. C.

P. M. Mathew, formerly senior advisor on capital
markets and development banks, IBRD and IFC

Henry S. Terrell, Chief, International Banking
Section, Federal Reserve Board

The team consulted with Thomas M. Flattery, Gamal Elfaransawi and Mounir Sabry, Vice-Presidents of Manufacturers Hanover Bank. James Winkelman, Cairo representative for the International Executive Service Corps, attended many interviews.

at the invitation of the PRE Team. For USAID/Cairo Van McCutcheon, Assistant Director for Industry and Trade, or a member of his staff attended most of the team's interviews and provided mission views. Mission Director, Don Brown and Deputy Mission Director Owen Cylke also attended several interviews.

The team met with U.S. Embassy and Egyptian Government officials including Deputy Prime Minister Ibrahim, the Ministers of Finance, Industry, and Planning, and Central Bank Governor Shalaby. The team also met with U.S. and Egyptian bankers and businessmen and participated in the Egypt-U.S. Business Council meeting on May 11-12 (See Agenda, Annex A). The team had an exit conference with Mission Director Brown and USAID staff on May 13.

C. Summary of Conclusions

3. The team found it impossible to pinpoint a particular cause for the relatively small amount of term investment in the private sector. Rather it found a complex, inter-related series of constraints ranging from psychological factors, to government policies on exchange and interest rates, subsidies and taxes (which contribute to high profitability for short-term investments), to the size of the public sector and cumbersome bureaucratic processes; that prevent funds (which are available)^{1/} from being channeled into developmentally sound projects (which also are available).^{2/} The latter factors, the size and influence of the public sector and inadequate management in key ministries, are principal causes of delays (or, even prevention) of needed approvals in the investment process, which is a major problem.

4. Despite the many constraints on private sector expansion in Egypt, the team also found many positive factors, such as positive governmental actions in the past eight years including revisions in various investment and tax laws, a large market, relatively skilled labor, entrepreneurs with money, an advantageous location to export to markets in Europe and the Persian Gulf, understanding at high levels in the economic and financial ministries of the workings of a market economy, and a proclaimed policy of permitting the private sector to expand relative to the public sector. In this environment, despite the constraints, the private sector has grown rapidly, though in some ways, for example imports of luxury goods and real estate speculation, that the Egyptian Government does not favor.

^{1/} Egyptian banks, for example, currently are net exporters of capital, the out-flow composed mostly of short-term Eurodollar deposits.

^{2/} See paragraph 10.

5. In many respects, Egypt is a classic case for designation as a target country for encouraging development through the private sector. Prior to 1954, private enterprise flourished in Egypt, but the wealth was in the hands of a small upper class. The takeover of private enterprises by the Nasser Government resulted over the next 20 years in a more even distribution of income but that occurred at the expense of growth and efficiency in Egypt's productive capacity. The "open door" policy announced by President Sadat in 1974 has led to a "mixed economy" in which two-thirds of industrial output is in the public sector and one-third in the private sector. There is general agreement that the private sector has become much more dynamic and efficient than the public sector, in part because the Government encumbers public sector companies with attempted solutions of social problems. The pace and methods of the evolution toward a larger private sector are the core issues for the Egyptian Government and for AID.

6. In the environment described above, the PRE team finds it important for AID to expand its support for the private sector. This conclusion rests on the merits of economic efficiency and the critical developmental role that the private sector can play in increasing production, employment, and living standards in all segments of society. It is strengthened, however, by the fact that the level of AID assistance is determined by political considerations, and funds not provided in support of the private sector will go to the public sector. The amounts and approaches currently being considered by USAID/Cairo appear justifiable. Despite the availability of funds in the Egyptian economy, it is appropriate for AID at this time to stimulate longer term investment through the provision of medium and long term financing. Government policy changes, which ultimately can accomplish this through market mechanisms, will come slowly. Any AID project providing financing, however, must be carefully structured to ensure additionality (not the substitution of AID funds for other available funds) and good management.

7. The aims of AID's private sector strategy in Egypt should be:

- to encourage at the political level more enthusiastic endorsement of long-term private sector expansion and clarification of the roles of the public and private sectors;
- to find ways to utilize our assistance to induce new positive actions which underscore that endorsement, such as the reduction of subsidies, elimination of price ceilings, elimination of the dual exchange rate, permitting private purchase of shares of public sector

companies, and streamlining or elimination of some licensing and approval requirements, including the "approval" or veto right of ministries controlling public sector companies over private sector applications in the same industrial area;

- to increase liquidity and longer term funding for joint venture and development banks in order to expand longer-term financing;
- to reduce risks and increase profitability of long-term investments vis-a-vis short-term investments;
- to have the flexibility to support new private sector institutions such as venture capital or underwriting firms which are broad-based and have proven management capability.

II. The Private Sector Environment

A. Positive Factors

8. Private sector industry in Egypt comprises approximately 500 enterprises employing more than 50 workers each, 4,500 employing 10-50 workers, and 113,000 employing less than 10 workers. Sectors in which they operate prominently are textile processing and garments, food processing, metal products including construction materials, leather products, furniture and plastics. About three-fourths of private industrial establishments are concentrated in the cities of Cairo and Alexandria. Almost half of industrial employment and a third of industrial output are contributed by the private sector, which accounts for only about 13% of capital invested in the industrial sector.^{3/}

9. Positive changes in law and policy in the past eight years include the following:

- The promulgation of Law 43 in 1974, as amended by Law 32 of 1977, providing incentives for the establishment of local/foreign joint-venture companies.

^{3/} IBRD - Report No. 3595 EGT, Nov. 1981.

- Progressive reforms in the foreign exchange regime which, despite its continuing discrimination against the private sector, still affords some access, without official regulation, to foreign exchange for the private sector.
- The recent revision of the company law and the income tax law. The former is a major step in modernizing the old concepts governing corporations, including the grant to wholly Egyptian corporations of incentives and benefits available previously only to Law 43 joint-ventures. The new tax law provides a significantly more equitable treatment of taxpayers, both individual and corporate, bringing down the corporate tax from 41% to 32% and the marginal individual tax from 95% to 50%, raising the exemption limits, and granting significant (but still insufficient) incentives for the ownership of corporate shares as compared to debt instruments.
- The establishment of a Capital Markets Authority in 1979 to stimulate the growth of a securities market. The Authority is, unfortunately, a long way from becoming a significant force in the market.
- The channelling of credit derived from public international and bilateral sources, including AID, to banks and specialized institutions to support a growing investment activity.

These measures cannot by any means point to a well-planned, sustained or enthusiastic stance on the part of the Government in support of the private sector. They do evidence, however, a reasonable degree of commitment, given the pervasive dominance of the public sector over a whole generation.

10. Partly as a consequence of these measures, but more as a result of inherent dynamism and creativity, the private sector has achieved an impressive degree of growth, especially in the last 5-6 years, as shown by the following facts:

- Outstanding term credit granted to the private sector by banks has increased from about L.E. 80 million as of December 1978 to more than L.E. 400 million by December 1981.
- The contribution of the private sector to manufacturing output has grown from 25% of the value of industrial output in 1978 to 32% in 1981.^{4/}
- The private sector's share in industrial investment has grown from 4% by 1974 to 12% in 1975-78 and 13% in 1979.^{5/}
- Approvals of wholly Egyptian private sector investment proposals have increased from a value of L.E. 67 million in 1975 to L.E. 160 million in 1980 and L.E. 584 million in January-July, 1981; a total of 3282 applications were made through mid 1981 for a value of L.E. 1.1 billion.^{6/}
- The number of approved investments for joint ventures has increased to a cumulative number of 1,626, with a cumulative value of about L.E. 9 billion, by year-end 1981, with about 1,000 projects with a value of L.E. 5.4 billion in operation or under construction.^{7/} An attrition rate of some 40% generally has to be applied to approvals to arrive an estimate of those that would result in real investments.
- The number of private and joint-venture banks grew from zero in 1974 to 67 in 1980.^{8/}

^{4/} IBRD Report 3595 EGT, Nov. 1981.

^{5/} Id.

^{6/} From data furnished by the General Organization for Industrialization (GOFI).

^{7/} Investment and Tax Free Zone Authority - Facts and Figures, IX, 1981.

^{8/} Manufacturers Hanover Trust - Cairo Banking Gazetteer 1980. The PRE Team heard current estimates as high as 80, but did not obtain confirmation.

- Some 140 companies have issued stock in the market in the last five years ranging in value from L.E. 200,000 to L.E. 14 million each, indicating the potential availability of a substantial pool of shares for trading when investors have achieved their initial goals.
- Banks and insurance companies hold a substantial pool of the equity of joint-venture companies, which creates additional potential for a securities market in due course, if these institutions can be persuaded to revolve their portfolio.

11. The growth of the private sector has been stimulated by the availability to the banking sector of a significant amount of foreign exchange remittances generated by the Egyptian community working in the oil-exporting countries. 9/ The level of these remittances is currently estimated at about \$700 million annually, accounting for about one-fourth of the foreign exchange earnings of the country. These remittances have simultaneously stimulated the rapid expansion of the private and joint-venture banking system, as well as the government commercial banks, with total private deposits denominated in foreign currencies equal to about \$2.4 billion at the end of 1981.

12. There has occurred concurrently a growth in entrepreneurial activities, although the overall level of sophistication in the entrepreneurial group continues to be low. The entrepreneurial pool has increased in size and sophistication by traders moving into manufacturing to protect their markets, emigrant Egyptians returning with capital to start new enterprises, public sector managers with know-how moving into the private sector, and artisans developing mechanized processes. This process is spearheading a small but significant move towards modernization in industry and business.

B. Constraints on Private Sector Investment

13. Constraints on term investment in the private sector are generally known and acknowledged and will not be discussed at length in this report. In listing the many, often related, constraints, however, it is important to emphasize that it is the environment created by these many constraints, not simply a shortage of medium and long-term financing or of good projects, that restrains private sector investment.

9/ It can be argued that in the long run the loss in educated entrepreneurial talent outweighs the positive effects of the remittances.

(1) The Socialist Past

14. After 20 years of socialism, there was a lack of familiarity with and trust in a market economy when the "open door" policy was instituted in 1974. People were not in the habit of taking economic risks and making investments. Experience since 1974 has shown that there is profit in private short-term investment and trade. There have not yet been similar examples in any significant number of successful, longer term private investment.

(2) Uncertainty

15. There are two kinds of uncertainty that affect private sector investment, one external, one internal. The first is the political stability of the Middle East, without which foreign investors in particular will remain wary. The second, and perhaps more important, is concern over a return to state socialism. Many investors are not convinced that a vigorous open door policy is permanent, despite official pronouncements.

16. The latter uncertainty is buttressed by a lack of enthusiastic, clear support for the open door policy by the Mubarak government. Potential investors, local and foreign, perceive bias in favor of the public sector - at the political level and particularly at the bureaucratic level in terms of approvals of new projects. Whatever the actual policy, these perceptions create uncertainty, caution, and a reduced willingness to initiate long-term investment projects.

(3) Law and Government Policies

17. Exchange Rates. Exchange rate policies discriminate against the private sector in two ways. Dual rates ^{10/} discriminate by permitting public sector companies to obtain foreign exchange (mostly dollars) for imports or capital requirements at 84 piasters to \$1 while private competitors have to buy foreign exchange on the free market. While the PRE Team was in Cairo the free market rate varied from 100 to 120 piasters to \$1. The fact that the official ("incentive") rate is fixed by the Government also discriminates. Private sector borrowers who convert the proceeds of their foreign currency loans at a rate of 100 or 120 piasters to \$1 must expect that they probably will have to buy foreign exchange at a considerably higher rate when the

^{10/} Until recently there have been three rates: the official rate of 70 piasters to \$1; the incentive rate of 84 piasters to \$1; and the free Market rate referred to as the "own" exchange rate. For practical purposes, all public transactions are now conducted at the "incentive" rate of 84 to 1. ?

time comes to repay their loan. Although public sector borrowers may also have to anticipate a higher Government fixed rate, this is less of a deterrent than if they had to anticipate a free market rate in a period in which the Egyptian pound has steadily declined against the dollar.

18. Price Ceilings. Price Ceilings on products of public sector companies which result in prices not reflective of economic cost are a serious problem for private sector competitors. The latter usually are not covered by ceilings. Nevertheless, when the subsidized public sector firm does have a ceiling on its product, the private sector competitor often cannot compete at the fixed price and therefore can sell its product only on quality and service or when demand exceeds public sector supply.

19. Taxation. Interest on Egyptian pound deposits is tax free up to 10 percent; interest on foreign exchange deposits is tax free up to 15 percent. This provides a strong attraction for deposits.

20. There are also some inducements to make term investments, especially under the recent tax law. Under the new law, interest on bonds of companies with shares listed on the exchanges is tax free up to the interest rates set for bank deposits. Law 43 joint venture companies, and now wholly Egyptian-owned companies organized under the new companies law, enjoy a five-year tax holiday on profits. Shareholders also are not taxed on dividends for the period.

21. Nevertheless, the PRE team repeatedly heard the argument that there rarely are profits, much less dividends, during the first several years and, therefore, that there is at most a one or two year tax holiday, if that. Thereafter, the company is taxed at 32 percent, (though a percentage, equal to the current local currency deposit interest rate, now 10 percent, of the value of paid-in capital is exempted from the corporate tax). Dividends on shares registered on the securities market are exempt up to 50% of the total distribution; thereafter they are taxed at individual rates, which graduate to a maximum of 50 percent. Despite the great progress made in the new income tax law, therefore, the tax breaks on bank deposits contrasted to the double taxation on corporate income and dividends still represent a strong disincentive to equity investments.

22. Other Policies. There are a variety of other constraints against productive private sector investment, stemming from law or government policy, that the PRE Team did not examine in detail. These include: (a) the allegation that the private sector receives less favored treatment on access to raw materials and utilities; (b) customs laws which do not

provide sufficient protection to new industries; and (c) the inability of the foreign investor to immediately repatriate his capital upon liquidation of the investment. W

(4) Bureaucracy and Inadequate Management

23. The PRE team made no attempt to catalogue the bureaucratic and human problems deterring productive private sector investment. Such problems are clearly present, however. The Investment Authority is currently a major problem, for several reasons. (a) The Authority has little in-house expertise to evaluate the projects it must approve. For that reason and political reasons, projects are sent to various ministries, which increases processing time and sets up a conflict of interest because the ministries often have direct authority over public sector companies in the same area as the proposed investment. (b) The Authority recently has had weak management and an unwillingness at the top to delegate. While the PRE team was in Cairo, the head of the Investment Authority was removed.

24. There is overlapping authority among ministries. For example, the Ministry of Planning and the Ministry of Industry would both decide whether a particular sector could absorb more private sector capacity.

(5) Lack of Professional Skills

25. In general there is a lack of financial sophistication in Egypt. Good accounting, auditing, business, and management consultant firms exist in Egypt, but not yet in sufficient quantity to serve a vigorous private sector growth at all levels of the private sector. A manifestation of this lack is the complaint that proposed projects often are not properly packaged.

(6) Institutional Gap

26. There clearly are institutional gaps that inhibit or will inhibit private sector growth. These are not currently major problems, but new institutions will have to be created as the private sector becomes more sophisticated, some sooner than others. Included in this category are venture capital, underwriting, project packaging, brokerage, and leasing firms.

C. The Financial Sector

(1) The Banking System

27. There are four large public sector banks which are descendants of foreign-owned banks nationalized after the Suez crisis in 1956: National Bank of Egypt, Bank of Alexandria, Bank Misr, and Banque du Caire. Two Arab-financed banks, Arab International and Arab African, also financed investment projects during the Nasser period.

28. Law 43 (1974) and the new banking law (Law 120/1975) opened up the banking sector to foreign participation. Under these laws, joint ventures that are 51 percent owned by Egyptians may engage in Egyptian pound and foreign exchange transactions. Joint ventures 51 percent owned by foreign interests may engage only in foreign exchange transactions.^{11/} Branch offices of foreign banks may only accept deposits and lend in foreign currencies. There are also a growing number of wholly Egyptian-owned private sector banks and banks chartered according to Islamic principles. There is one free zone, joint venture bank, Manufacturers Hanover. In all, there are currently at least 75 banks in Egypt, a dramatic change from eight years ago.

29. The Central Bank of Egypt (CBE) was created in 1961 from the National Bank of Egypt. It is independent and growing in scope, but still limited in the role it can play vis-a-vis the private sector.

30. The Development Industrial Bank (DIB) was established in 1975 by a merger between an old Government industrial fund and the term finance wing of the Government-owned Bank of Alexandria to provide support for the "open door" policy. It is a public sector development bank owned and regulated by the CBE. It specializes in providing term credit and working capital to small industrial enterprises. The average loan as of year-end 1981 was L.E. 40,000. In recent times the Bank has begun to make a few larger loans, as well as to invest selectively in equities. It presently has around 4,500 loans in its portfolio. Its total net financing of term loans, including undisbursed commitments as of 1981, was L.E. 148 million, making it the largest source by far of term credit. Its assets at year-end 1981 amounted to L.E. 129 million.^{12/}

^{11/} Cairo Barclay's ownership is 50 percent Egyptian, 50 percent foreign.

^{12/} Development Industrial Bank - Statement of condition as at December 31, 1981.

31. The DIB's resources are derived from its share capital, borrowings from the CBE, less significant borrowings from the Government banks, lines of credit from public international and bilateral sources, and its own cash generation. AID has provided it with \$31.5 million in term credits. The World Bank is its largest creditor, having lent it a total of \$250 million including a recent loan of \$120 million which has not yet become effective. The DIB lends in both Egyptian pounds and foreign currencies, the latter being used primarily to finance the import component of investment projects.

32. DIB is a conservatively managed institution with a good capacity for evaluating small loans, and an acceptable capacity for larger loans. Its supervision capability is moderate, but, has been adequate so far because the industrial boom and inflation have greatly reduced the risk of near-term portfolio losses. It has had very few losses, and maintains a significant amount in provisions against losses. Its market coverage, however, is limited to Cairo (through two offices), Alexandria (one office), and Tanta (one office).

33. The Misr-Iran Development Bank (MIDB) is a Law 43 investment bank established in 1975 and originally owned equally by Iranian and Egyptian public sector financial institutions. Following recent political developments in Iran, its Iranian holdings have been reduced to 25 percent and control now has been clearly established in Egyptian hands. Its paid-in capital is L.E. 40 million; it has a retained surplus of around L.E. 1.2 million.^{13/}

34. MIDB specializes in providing equity, term loans and financial services, including syndication to medium and large-sized industrial enterprises. While in the past it operated exclusively in foreign currencies, it now has sufficient Egyptian ownership, to operate both in foreign and Egyptian currencies. It has financed 35 projects so far for a total commitment of \$78 million, averaging \$2.2 million per project. It is a significant investor in equity (\$14 million committed) and also undertakes project development work. Staff technical capability is high by Egypt's standards and, in spite its public ownership, it operates on businesslike basis.

35. MIDB's term resources are derived mainly from its own equity (\$41 million), medium term paper including certificates of deposit issued to local investors (\$22 million), and a World Bank loan (\$30 million). Its equity and term lending activities are financed solely from these sources. It also undertakes working capital financing for its clients, accepts short-term deposits, and engages in money market transactions on its own account in the Eurodollar market.

^{13/} Source of all MIDB statistical information: MIDB

36. The MIDB is a dynamic institution providing the investment community with services that are both new and vital. It is reported, however, to have incurred heavy losses very recently through currency and maturity mismatching and in transactions secured with gold. Its financial position, in spite of these difficulties, is considered satisfactory.

(2) Bank Term Lending to Private Sector Borrowers

37. The diverse array of banking institutions discussed in the preceding section does relatively little term lending to private Egyptian borrowers. The reasons for this have been alluded to previously. In summary, they include: (1) the high profitability and low risk to the banks of short-term trade financing associated with the recent import boom and the fact that the CBE establishes various interest rates and fees on loans, (2) the short-term nature of deposits at banking institutions, which discourages longer term lending; (3) the policy of state-ownership of major productive enterprises which to date has limited the number of potential private competitors seeking financing; (4) the fact that the four major public sector banks typically finance public rather than private sector enterprises and thus had limited contact with private businessmen; (5) the relatively high risks associated with lending long-term to private borrowers in a developing economy without a clear official policy of encouragement of a private sector; (6) the lack of a well-established discount facility at the CBE which reduces the liquidity position of banks; and, (7) the structure of Egyptian banking regulations, whose effects on lending and capital flows are discussed more fully below. Term-lending to private borrowers by non-Egyptian-controlled banks is further inhibited by costs and difficulties that all foreign investors have in acquiring title to real property in Egypt, which means that foreign-controlled banks are less able to protect themselves by attaching real collateral in the event of non-performance on a loan.

38. Table 1 indicates the recent experience in bank term-lending, Egyptian pounds and foreign exchange, to private borrowers. Despite the problems noted above, the growth of such lending has been impressive in recent years, increasing from LE 71 million at year-end 1978 to LE 394 at year-end 1981.^{14/} Although impressive in terms of growth, such

^{14/} The data on outstanding term-loans may understate the true amount of such credits since in fact many short-term credits are often rolled over into longer-term loans. However, for considering the financing of long-term private investment it is useful to have some measure of the funds that private borrowers have committed for longer-term.

lack of discount facility at CBE reduces liquidity of banks

lending amounts to less than 2 percent of total assets of banks in Egypt; thus there is considerable room for an expansion of such lending in the portfolio of the banks.^{15/}

TABLE 1
Bank Term-Lending to Private Sector Borrowers a/
(Millions of L.E.)

| <u>Type of Bank</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|--|----------------------|----------------------|----------------------|----------------------|
| Public Sector Commercial Bank | 15 | 25 | 41 | 75 |
| Joint Venture & Private Commercial Banks ^{b/} | 14 | 30 | 52 | 90 |
| Business & Investment Banks ^{c/} | 9 | 35 | 32 | 53 |
| Branches of Foreign Banks | 6 | 11 | 19 | 47 |
| Development Industrial Bank | 27 | 52 | 87 | 129 |
| Total | 71 | 153 | 231 | 394 |

Source: Data provided by Dr. Ahmed Foda, based on statistical reports submitted to CBE.

- a/ Includes loans of over one-year maturity to agriculture, industry, commerce and services.
- b/ Other commercial banks majority-owned by Egyptian interests authorized to accept deposits in Egyptian Pounds.
- c/ Banks without authority to accept deposits in Egyptian currency which included at the end of 1981 MIDB, Cairo-Barclays, and Arab-Investment Bank.

^{15/} For the four public sector banks, such lending amounts to about one percent of their total assets, while for joint venture and private commercial banks it was two percent of total assets, and for business and investment banks about six percent of total assets. Total loans from all banks to private borrowers totalled L.E. 3.55 billion as of December 1981, of which L.E. 925 million was in foreign currency. The L.E. 3.55 billion was 46% of total lending to private and public borrowers. (See Annex B for additional discussion.)

All Banks
~~Public Sector Banks~~
total lending 54% to public 46% to priv.

39. Table 2 indicates the major sectors to which the banks have extended term-credit. Between year-end 1978 and year-end 1981, term-credit to private borrowers in all four identified sectors increased rapidly, with the largest absolute increases in the industry and service sectors.

TABLE 2

Structure of Bank Term-Lending to Private Borrowers^{a/}
(L.E. Millions)

| <u>Sector</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|---------------|--------------------------|--------------------------|--------------------------|--------------------------|
| Agriculture | <u>14</u> | 24 | 27 | <u>85</u> |
| Industry | 40 | 65 | 111 | 185 |
| Commerce | 6 | 11 | 21 | 27 |
| Services | <u>21</u> | <u>45</u> | <u>70</u> | <u>133</u> |
| TOTAL | 82 | 144 | 229 | 430 |

Source: Same as Table 1. Totals differ slightly from Table 1 because of a slightly different bank sample and an incomplete breakdown by sector for some reporting banks.

a/ Details may not add to totals because of rounding.

40. Existing Egyptian banking regulations affect the willingness of banks to extend credit in Egypt. Under existing regulations banks in Egypt are limited in the rates of interest they can offer on Egyptian pound deposits and receive on loans denominated in Egyptian pounds.^{16/}

41. Local residents are permitted, however, to hold foreign currency deposits at banks and banks are permitted to extend foreign currency denominated loans free of any interest rate limitations.^{17/} This freedom for foreign currency banking is in part designed to attract funds earned in foreign currencies by Egyptians working overseas, mainly in the Persian Gulf. Interest rates on foreign currency deposits and loans tend to follow interest rates in the Eurodollar market.

42. The net effect of having a regulated Egyptian pound banking system and a free system in foreign currencies is that Egyptian banking transactions with private entities are increasingly being conducted in foreign currencies as shown in Table 3. This is particularly true for deposits as Egyptian private investors are holding an increasing proportion of their deposits in foreign currencies which offer the dual advantage of higher interest rates and protection against any devaluation of the Egyptian pound. The proportion of total private savings and time deposits denominated in foreign currencies -- a measure of the way private individuals chose to hold their wealth -- more than doubled from 20 percent in 1978 to 43 percent in 1981. *Egyptian foreign currency deposits/savings = 43% of total in 1981.*

^{16/} The deposit rate ceilings depend upon the maturity of the deposits but are currently about 10% for most time and savings deposits, with no interest paid on demand deposits. The regulations on lending interest rates currently permit interest to be charged on loans of 13-15% which, given the demand for loans in Egyptian pounds means virtually all loans are placed at 15% and banks tend to ration such loans to low-risk borrowers and to projects with low administrative costs.

^{17/} There is a 15 percent reserve requirement on foreign currency deposits; but this reserve deposit at the Central Bank of Egypt receives interest at approximately the London Interbank Offer Rate, (LIBOR) so it is of minimal cost to the banks.

TABLE 3

Private Sector Transactions with Banks: By Currency
(L.E. Millions)

| <u>Deposits from Private Sector</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| <u>Total Deposits</u> | 1,917 | 2,684 | 3,959 | 6,208 |
| Egyptian Pounds | 1,470 | 1,886 | 2,594 | 3,851 |
| Foreign Currency | 447 | 798 | 1,365 | 2,357 |
| Foreign Currency as Percent of Total | (23) | (29) | (34) | (38) |
| <u>Time and Savings Deposits</u> | 860 | 1,481 | 2,383 | 4,076 |
| Egyptian Pounds | 692 | 981 | 1,444 | 2,334 |
| Foreign Currency | 168 | 500 | 939 | 1,742 |
| Foreign Currency as Percent of Total | (20) | (34) | (39) | (43) |
| <u>Total Credits to Private Sector</u> | 557 | 948 | 1,658 | 3,548 |
| Egyptian Pounds | 490 | 765 | 1,250 | 2,625 |
| Foreign Currency | 67 | 182 | 408 | 925 |
| Foreign Currency as Percent of Total | (12) | (19) | (25) | (26) |
| Memorandum Credits to private sector as percent of deposits received from private sector. | | | | |
| Total | (29) | (35) | (40) | (57) |
| In Egyptian Pounds | (33) | (40) | (48) | (68) |
| In Foreign Currencies | (15) | (22) | (30) | (39) |

Source: same as Table 1.

43. The effect of this changing form in which depositors hold balances is that the Egyptian banking system has a large supply of foreign currencies (mainly dollars) and must look for appropriate investment outlets. Local private (and public) borrowers tend to be reluctant to borrow dollars for other than short-term transactions such as international trade because they are paying higher internationally-determined interest rates as well as accepting exchange rate risks.

44. As a result of these policies, Egyptian banks have deposits in foreign currencies in excess of their ability to extend foreign currency loans. Thus the banks redeposit these funds on a net basis with banks outside Egypt, largely in Euromarket centers such as London, Paris, Luxembourg, and Bahrain as shown in Table 4, which indicates the net position of Egyptian banks with banks outside Egypt.^{18/} This in turn reduces credit resources available to lend to all sectors in Egypt.

TABLE 4

Net Position of Banking Institutions with Banks Outside Egypt
(L.E. Millions)
Net Position with Banks outside Egypt^{a/}

| <u>Type of Banking Institution</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|--|----------------------|----------------------|----------------------|----------------------|
| Public Sector Banks | -832 | -775 | -670 | +78 ^{b/} |
| Joint Venture & Private Commercial Banks | -143 | -207 | -398 | -660 |
| Business and Investment Banks | -120 | -98 | -134 | -146 |
| Branches of Foreign Banks | -243 | -281 | -261 | -42 |
| Position of above Banks | -1,338 | -1,361 | -1,463 | -770 |

Source: Same as Table 1.

^{a/} A plus means net liabilities to foreign banks (funds brought into Egypt) and a minus means net claims on foreign banks (funds exported from Egypt).

^{b/} The only quarterly reporting date between December 1978 and December 1981 for which this number was not negative. Between December 1980 and December 1981, the four large public sector banks reduced their borrowings from the CBE by L.E. 1.5 billion and increased their deposits at the CBE by L.E. .3 billion. This large shift of L.E. 1.8 billion in net claims on the CBE may explain why the four large public sector banks were not net placers of Eurodollars at year end 1981.

^{18/} Data collected by the Bank for International Settlements indicated that at year-end 1981 Egyptian residents (including banks) had placed \$1.1 billion net in the Eurocurrency markets.

D. The Capital Market

45. Prior to the wave of nationalization of companies in the late 1950's and early 1960's, Egypt had active stock exchanges in Alexandria and Cairo. Although both exchanges have remained open, the value of trading drastically decreased beginning in 1959. The value of stocks traded on the Cairo exchange totalled L.E. 66.7 million 1958. It fell to L.E. 2.8 million in 1965. In the ensuing years, the trend generally has been slowly upward. In 1981 stocks totalling L.E. 9.1 million were traded on the Cairo exchange.^{19/}

46. A Presidential decree of December 15, 1979 established the Capital Market Authority. The General Regulations for the Stock Exchanges and the new companies and tax laws have improved the legal/regulatory climate for the growth of a capital market. Taken together, these changes have produced some progress. (See paragraph 10, above.)

47. Nevertheless, volume on the exchanges remains small and institutional gaps remain. Other than the law changes, little has been done to implement the comprehensive study and recommendations of Robert R. Nathan Associates, completed in September, 1979. Neither brokerage, underwriting, venture capital nor leasing firms now exist, though the PRE Team heard plans for all of them discussed by various individuals.

48. Despite the drawbacks, here too the PRE Team found potential for growth. In paragraph 10 various indications of potential for rapid growth in the capital market are discussed. The joint venture banks, the public sector banks and the development banks can and do take equity positions. Insurance companies and pension funds, unlike the case in most developing countries, are a significant factor in Egypt. The Misr Insurance Company, for example, one of the large public sector insurance companies, has 25% of its portfolio in equities. There also are individuals, limited in number but sufficient in wealth, who could be important elements in the development of a capital market in the proper economic climate. An Egyptian joint venture of General Motors was able to raise L.E. 30 million equity from local individual investors. (See Annex C for additional discussion of the development of capital markets).

^{19/} Figures from attachment to "Brief note on the Capital Market in Egypt", prepared for U.S. SEC by Egypt Capital Market Authority (1982).

III. The Development Problem and AID's Role

A. Introduction

49. Substantial and increasing amounts of wealth are being held in foreign exchange in Egypt. Because of the profitability of short-term deposits and trade compared to the relatively high risk term investment, this wealth is not being invested in productive investments beneficial to Egypt.

50. As discussed above, the causes of this situation are many and are relatively well known. Law and policy changes dealing with tax, subsidy/price, interest rate restrictions on Egyptian pound deposits and loans at local banks, and exchange rate problems are the most important means for correcting the situation. Political commitment, better managers, and more training are also critical.

51. Assuming that such changes will not come overnight, however, the issue is how AID can assist in and accelerate the process. Because the problem is multi-faceted, it is not simply a matter of large injections of term funds to "prime the pump". USAID/Cairo is developing two broad, flexible instruments, one for financing and one for business support, which would attack the constraints discussed in this report. In general, the PRE Team believes the USAID approach is the correct one.

B. Equity

(1) The Issue

52. Bankers and businessmen told the PRE Team that debt financing was not a problem for good projects with sufficient equity. The development issue is whether to address the problem from the equity side or whether making term debt financing available on sufficiently, attractive terms would draw equity into desirable investments. The PRE Team concluded, as did the Nathan study and USAID/Cairo in its Private Investment Encouragement (PIE) Fund project, that the equity issue should be addressed directly. Any equity programs should have several objectives including: (a) channelling funds into productive investment; (b) building a capital market; (c) avoiding the creation of artificial institutions or mechanisms; and (d) stimulating equity investment from others.

(2) The Role of Existing Institutions

53. The joint venture banks, the public sector banks, and the development banks all invest in equity. The first two categories play an important but limited role. Rather than attempting to expand their investment function,

however, it would be more appropriate for them to remain essentially commercial banks and to invest in venture capital firms possessing appropriate project analysis capability. This not only would further the growth of equity capital on a sound basis, but also would expand the banks' source of future lending opportunities.

54. The development banks, DIB and MIDB, have more experience than the commercial banks with equity financing and have better project analysis capability. Neither institution acts as an investment banker or underwriter. Both place the securities they purchase in their own portfolio. They are also unlike venture capital firms in that they tend to hold on to the securities.

55. The PIE Fund has the authority to take equity positions, but has not done so in the four projects it has approved to date.^{20/} USAID/Cairo is considering re-designing the PIE fund in the context of a larger credit project, but in its initial phase would not include the equity function. PIE

56. The PRE Team was not a project design team and did not have the time or capacity to study in detail the PIE Fund, the proposed USAID/Cairo credit project, or the "Development Credit Fund" recently proposed by American Express International. The latter two proposals would channel term credit to participating banking institutions, an approach the PRE Team supports, but would ignore equity, at least initially. If one utilizes the banking system instead of a single institution (like the PIE Fund), it would be somewhat unusual to channel funds to them for equity investments. Although conceptually there is no reason why a mechanism could not be developed for AID funds to be borrowed by the banks for equity investment, this would not be appropriate, for example, for a rediscount facility in the CBE. Central Banks have little experience in evaluating equity investments in non-financial businesses and would not want that substantially greater degree of risk. Moreover, channelling AID funds through a "lead bank" that ~~it~~ is in competition with its borrowers, as the Mission is now considering, might raise conflict of interest problems. (A similar problem would exist on the debt side.) Nevertheless the PRE Team believes that any term financing project should consider, as the PIE Fund did, means for providing equity as well as debt financing.

^{20/} The projects are currently being reviewed by USAID/Cairo. Other PIE Fund activities have been suspended pending a review of management problems.

(3) New Institutions; Development of a Capital Market

57. The American Section of the Egypt-U.S. Business Council proposed the establishment of a venture capital firm, with AID and IFC support, with \$100 million of initial capital. Because of opposition during the action group meetings in Cairo, the proposal was reduced to a recommendation that AID consider further steps to support debt and equity financing.

58. The PRE Team believes that the development of venture capital firms is an important factor both in filling the equity gap and the development of the capital market. Venture capital private placements logically precede public offerings in the capital raising process. Local banks could be expected to provide a substantial portion of the equity of the venture capital firms, thereby indirectly channeling their capital into long-term investments. Although the PRE Team did not examine or discuss the American section's proposal for a large venture capital firm, the Team generally felt that a single firm of that size was not the best approach, particularly given the small size of the investments such a firm would support. However, stimulating several venture capital firms of considerably smaller scale should be seriously considered by AID.

Several smaller scale venture capital firms

59. An additional benefit to this approach, as opposed to that of the PIE Fund, is that AID funds would have greater leverage from the outset. Each venture capital firm that received AID support presumably would raise substantial amounts of capital from other sources. Thus there is double leverage when the firm takes a minority position in an investment.

60. AID also should consider ways to support the development of an investment banking community.^{21/} Such middlemen could educate the owners of private companies, promoting the advantages of going public, while at the same time, educating the general public as to the advantages of

^{21/} An example of a firm currently being discussed is an underwriting firm being organized by a former Minister of Finance, with the National Bank of Egypt as lead investor and local banks participating. AID, through the mission or PRE, could support opportunities of this kind - through financing of feasibility studies or organization costs if not direct investment. Critical elements for AID support would be the involvement of organizers of proven ability, high reputation, and contacts in and out of government, as well as the provision of adequate capital from reliable sources.

owning shares in Egyptian companies (assuming appropriate incentives have been provided by the Government). In addition they must bring together entrepreneurs and potential investors thereby vitalizing the capital markets.

C. Debt

(1) Introduction

61. The PRE Team believes that during the transitional stage toward a more market-oriented economy in Egypt, it is appropriate for AID to continue to provide medium and long-term credit for the private sector as it has done in the loan to DIB and the PIE Fund. There is no question that due to the economic factors discussed above, sufficient funds are not now being invested in productive enterprises and that it is critical that it occur now. Provision of foreign assistance funds should never be seen as a substitute for policy change, however, and means must be found by AID to utilize the provision of its funds as a stimulus for policy change.

62. The PRE Team's assignment was not to design a project. Accordingly, it makes no recommendations on project design. The following sections, however, discuss a variety of factors which should be considered by USAID/Cairo.

(2) Additionality

63. Any AID credit project should seek to stimulate additional medium and long-term investment not just provide it. A principal way of doing this is requiring co-financing, as does the PIE Fund. If it is decided to channel money to public and private sector banks for investment, conditions must be imposed to ensure that the AID funds are not substituted for investment that otherwise would have taken place with bank funds.

(3) Risk

64. Credit Risk. If the banking system is used, it is preferable that the credit risk should be entirely on the borrowing/relending bank to ensure that the bank uses its expertise to evaluate projects.

65. Foreign Exchange Risk. Under both the AID loan for the DIB and the PIE Fund, loans were in dollars with repayment fixed at the unified rate. With a lower cost and absence of exchange rate risk, these funds are much more valuable to the borrower than funds obtained on the open market. The PRE Team believes that the cost of money to the ultimate borrower, including interest rates, fees, and terms,

*loans fixed
at unified
exchange
rate*

should be as close to market costs as is possible, given the development purpose and the need to have the funds utilized efficiently. If procurement is tied to U.S. source and origin, some adjustment has to be made for the higher cost of U.S. goods and services. But the exchange rate risk should not be borne entirely by the AID funds or the Egyptian Government.

(4) AID Approvals

66. If the banking system is used, AID approvals should be kept to a minimum, especially for smaller loans. To the extent possible consistent with development goals and prudent management, positive and negative lists of eligible types of projects should be utilized in lieu of mission approvals.^{22/} Not only does an additional approval take time but USAID/Cairo does not have the personnel to review a high volume of private sector investment proposals.

(5) Creation of New Institutions

67. Although, as discussed above, the PRE Team favors support for institutions such as venture capital and investment banking firms with adequate financing and good management, it believes that the presumption should be against the creation of a new institution principally to carry out an AID project. The difficulties in establishing institutions, as witness the PIE Fund, are well understood. In Egypt there are existing alternatives which should be utilized if possible.

68. The advantages of a PIE Fund vehicle are that equity can be taken directly and complicated arrangements with other banks avoided. The principal disadvantages are bureaucratic, the loss of the expertise of the banks, and the catalytic effect of involving the banks at an earlier stage in the project process. If it is decided to utilize existing institutions to channel AID funds to the commercial banks, the MIDB and the CBE are possible vehicles. ?

(6) Use of existing Institutions

69. DIB and MIDB. USAID/Cairo is considering another loan to DIB for small-scale enterprise and a loan to MIDB as a "lead bank" for channeling funds to commercial banks. As discussed in II. C., above, the PRE Team found each bank capable of handling the program considered for it. The "lead bank" concept, as noted above, may present conflict problems if the lead bank is a competitor of the user banks.

^{22/} If approvals are reduced, AID should carry out periodic reviews to assure itself of the acceptability of project content and to make changes in criteria and processing methods if low standards appear to prevail.

70. Creation of a Central Bank Discount Facility

One means of stimulating the flow of long-term bank credit to the private sector would be to establish a discount facility within the CBE. AID could support the establishment of such a facility by providing either a fund or a line of credit which would be activated when a banking institution presented for discount a long-term loan to a private borrower. The facility would make acquiring such long-term assets attractive to banks by increasing their liquidity.^{23/} The facility could discount the loans on a short-term basis, thereby providing liquidity support, or it could hold the loans until maturity thus serving as the ultimate source of funding for the credits. In either case, the credit risk should remain with the bank initiating the loan.

71. The establishment of the discount facility would have to overcome two immediate problems: (1) the relative inexperience to date at the CBE with discounting; and, (2) the assurance that the fund would be used for "additional" lending rather than having the banks discount loans that they have already made that happen to be eligible for discounting. The former problem would require consultation with the CBE about possible technical assistance of an experienced discount officer.

*eligibility
of loans*

72. The additionality problem is much more complex. As noted above, banking regulations in Egypt currently encourage an outflow of foreign exchange resources through the banking system. One way to encourage banks to expand their term-lending would be to base individual bank access to the facility for long-term funds on the percentage increase in its eligible loans over a recent period. Such a restriction encourages but does not insure additionality, since banks expanding their portfolios rapidly might be the ones to take advantage of the facility.

73. The discount facility has the twin advantages of simplicity and strengthening the CBE with a capability that is a natural function of a central bank. It should be seriously considered by USAID/Cairo.

(7) Loan Management; Taking Later Maturities

74. The PRE Team favors a system in which loans with AID funds are managed by bank co-lenders - with guidelines and reports to AID. In such cases, utilizing AID funds for later

23/To maximize the liquidity, the discounting should occur with a minimum of delays and approvals; however at the outset AID might wish to approve all discounts above a certain amount or limit the size of the fund on a trial basis.

maturities can create problems because the managing bank is at no risk after its portion is repaid. The discount facility approach would eliminate this problem as would any other facility which lent AID funds to commercial banks at medium or long-term, since the borrowing banks would be at risk with the AID funds as well as their own.

8. Risk Insurance

75. Since the banks utilizing AID funds would always be at risk, it would be helpful to establish a credit insurance system, either in the CBE or the insurance companies. It also would increase the use and utility of the system to establish a risk insurance system for borrowers, particularly small ones. As part of its broad, flexible approach, USAID Cairo should consider the establishment of such systems, financed mainly through an initial allocation of capital, supplemented by small premiums levied on loans made.

D. Training

76. Throughout the foregoing sections, the subject of training has recurred. Any credit or other private sector project must have a technical assistance or training element. > *

IV. Conclusions

77. It is neither a shortage of funds nor good projects as such that limits term investments in productive enterprises in Egypt. Rather a complex of factors deter investment, ranging from the psychological, to bureaucratic, to government policies that make short-term investment relatively more profitable.

78. The private sector in Egypt appears far more dynamic and efficient than the public sector. Given Egypt's location, market size, relatively skilled labor force, entrepreneurial class with money, and other building blocks for a market economy, it has an opportunity to stimulate real growth in productivity through the private sector.

79. Although AID and other donors can act as catalysts, the prerequisites for sustained, long-term, private sector growth are enthusiastic endorsement of the "open door" policy by the Mubarak Government, coupled with policy changes in such areas as subsidies, prices, exchange rates, taxes, and the elimination of red tape, bureaucratic problems, and the perception (if not reality) that the public sector is favored over the private sector.

80. Despite the constraints on the private sector, there are many positive factors in the present environment, notably the continuing passage of important new liberalizing laws. In this environment, it is important for AID to strongly support the private sector in two ways:

- (1) by finding ways to induce policy change through the provision of assistance, and
- (2) by directly supporting the private sector through projects that provide financing for developmentally-sound projects and attack constraints.

This support is justified because the increased productivity is important to the success of Egypt's development goals. Moreover, because the AID level of \$750 million is politically determined, our assistance will support the expansion of the inefficient public sector if not utilized for the private sector.

81. New AID projects that provide financing should be guided by the following:

- any facility shall be viewed as a temporary means of providing or inducing the creation of term financing and not as a substitute for the policy changes essential to a market economy;
- the creation of new institutions to carry out AID initiatives should be avoided if possible;
- the two development banks and the private and public sector commercial banks should be utilized;
- means for providing equity as well as debt financing should be found;
- care must be taken to insure that additional term investment results from the provision of AID financing;
- a discount facility in the CBE should be considered as a vehicle for increasing the capacity of the banks to provide term financing;

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- the credit risk of the ultimate borrower should be borne by the participating banks;
 - financing derived from AID should be made available on terms as close as possible to the true economic cost of the funds consistent with the objective of moving the funds and spurring investment; in so doing the cost of tied U.S. procurement on the one hand and the substantial benefit to the borrower of a fixed, official, repayment exchange rate (AID's past practice) on the other hand, shall be considered; and
 - AID approvals should be kept to a minimum and substitute means found to ensure that AID funds are utilized for productive investments consistent with AID and Egyptian development goals.
82. Other AID private sector projects should:
- be sufficiently flexible to support venture capital, investment banking, leasing and other firms, important to the development of a capital market;
 - support Egyptian efforts to eliminate constraints to private sector investment and to direct the dynamism of the private sector toward development and away from unproductive activities, including investment in the Eurodollar market; and
 - place a high priority on training and technical assistance, for example to increase the in-house analytical capability of the Investment Authority and, if appropriate, to assist the CBE in establishing a discount facility. 

May 13, 1982

PRIVATE SECTOR INVESTMENT TEAMAGENDA (AMENDMENT (6))Wednesday, May 5, 1982Attendees

| | | | |
|-------|--|--|------------|
| 9:30 | Meeting with Mr. McCutcheon | USAID offices, 5th Floor | Team |
| 10.15 | Meeting with David Dunford | Embassy Eco. Att. | Team/USAID |
| 12:00 | Meeting with Mr Niaz Moustafa Chairman Egypt/US Business Council | USAID offices 5th Floor | Team/USAID |
| 2:00 | Meeting with Mr. Ahmed Foda Financial Consultant | USAID offices, 5th Floor | Team/USAID |
| 3:00 | Meeting with Mr. D. Brown AID/Cairo Director | USAID Con.Room, 9th Floor | Team/USAID |
| 4:00 | John Bentley Legal Advisor Tel: 901860 | USAID - 5th Floor Conference Room Cairo Center | Team/USAID |

Thursday, May 6, 1982

Attendees

8:30 Meeting with Mr. Fouad Soltan
Vice Chairman & Managing Director
Misr Iran Development Bank
8, Adly St.
Tel. 922-297

Team/McCutcheon

10:00 Meeting with Mr. Abdel Hamid Kabodan
Chairman, Development Industrial Bank
110 Galaa St.

Team/Hagen

12:00 Meeting with the Ambassador
D.C.M.
Com. Att.

Team/USAID

1:00 Dr. Abdel Moneim El Banna
Executive Director
Private Investment Encouragement
Fund (PIE Fund)
Tel: 702-307

Cairo Center, 5th Floor
Conference Room

Friday, May 7, 1982

Open

5:30 - 7:30 Cocktail at the Suma's Residence
Maadi/Degla
No. 18 Road 213
Top Floor Apt. #10
Tel 28219
Tel. 774666, Ext. 8-307

Attendees

AID/W Team

Mr. John Mullen
Mr. Henry Terrell
Mr. P.M. Mathew
Mr. & Mrs. George Ferris
Mr. G. Elfaransawi

Mr. & Mrs Brown
Mr. & Mrs Cylke
Mr. & Mrs McCutcheon
Mr. & Mrs. Blackton

Mr. & Mrs. Karns
Mr. & Mrs. Hagen
Mr. & Mrs. Binns
Mr. Nagui Fayoumi
Mrs. Mona Megalla
Mr. & Mrs. Bentley

Mr. & Mrs. Precht
Mr. & Mrs. Dunford
Mr. Rosen

GAO Susan Gibbs
Marilyn Ferdinand
Robert Miller

Mr. & Mrs Samir Fahmy
Mr. & Mrs. Geoffrey Scott
Mr. & Mrs Ahmed Foda

Saturday, May 8, 1982

| | | <u>Attendees</u> |
|-------|---|---------------------------------|
| 10:00 | Meeting with Mr. Shalaby Central Bank Governor 31 Kasr El Nil St. Tel: 744001 | Mullen Terrell McCutcheon |
| 11:00 | Meeting with Ms Salwa at the Central Bank Control Dept. Same as above | Terrell |
| 11:00 | Meeting with Mr. Fouad Hussein Ex. Minister of Finance Delta Int'l Business Center 9th Floor, 48, Giza St. Tel. 701133 | Team/USAID |
| 1:00 | Meeting with Mr. Ahmed Zaki Abdel Hadi General Manager, Misr Insurance Co. 7 Talaat Harb St., First Floor Tel: 752-600 & 752-758 | Team/Suma |
| 2:30 | Technical Review | Team/USAID |

Sunday, May 9, 1982

Attendees

| | | |
|-------|--|-----------------------------|
| 9:00 | Meeting with H.E. Dr. Salah Hamed Minister of Finance Ministry of Finance Lazogly Sq., Tel: 21055 & 26790 | Team Cylke McCutcheon |
| 10:00 | Meeting with Dr. Fouad Iskander Senior Undersecretary of State for Economic Corporation And Mr. Ismail Kamel Investment and Free Zone Authority Tel: 21899/906130 | Team McCutcheon Cylke |
| 10:30 | Meeting with H.E. Mr. Mohamed Abdel Fattah Ibrahim Deputy Prime Minister | Team Cylke McCutcheon |
| 1:00 | Meeting with H.E. Eng. Fouad Abu Zaghla Minister of Industry Ministry of Industry 4, Latin America Street, Garden City Tel: 849413 - 23247 | Team/ McCutcheon |
| 1:00 | Meeting with Mr. Mahmoud Fahmy Chairman, Capital Market Authority 8, Adly St., Cairo Tel: 930-053 | Ferris Karns |
| 3:30 | Meeting with Ahmad Foda Financial Consultant 1, Yemen St., Flat 18, 7th Floor Giza Tel: 842951 | Terrell/USAID |
| 4:45 | Meeting with General Accounting Office Miss Susan Gibbs and Team Cairo Center, 5th Fl., | Team/USAID |

7:30/930 Cocktail - Reception given by Director Brown
To welcome Private Sector Investment Team
At the American Embassy Guest House
El Shams Bldg, 1103 Cornish El-Nil
(Apt 32 - 6th Floor)
Garden City
Tel: 28219, Ext: 383

Attendees

AID/W Team

Mr. John Mullen
Mr. Henry Terrell
Mr. P.M. Mathew
Mr. & Mrs. George Ferris
Mr. Gamal El-Faransawi

AM. Embassy

Mr. & Mrs. A. Atherton
Mr. & Mrs. Precht
Mr. & Mrs. Dunford
Mr. & Mrs. Rosen

USAID/CAIRO

Mr. & Mrs. O. Cylke
Mr. & Mrs. V. McCutcheon
Mr. & Mrs. JBlackton
Mr. & Mrs. J. Suma
Mr. & Mrs. M. Karns
Mr. & Mrs. Hagen
Mr. & Mrs. Binns
Mr. & Mrs. N. Fayoumi
Mrs. M. Megalla
Ms. M. Charobim

Banks

Joint Venture & Private Sector Banks

| | |
|---|--------------|
| Dr. & Mrs. Farid W. Saad (Vice President) | AEIB |
| Mr. & Mrs. Ibrahim Al Abraham (Chairman & Managing Director) | AAIB |
| Mr. & Mrs. Essam Aldin S. Gabr (General Manager) | AAIB |
| Mr. & Mrs. Sam Zavatti (Vice President & Manager) | BOA |
| Mr. & Mrs. Gavin Green (Director & Joint Gen. Manager) | CBIB |
| Mr. & Mrs. Roger L. Crevier (Managing Director) | CNB |
| Mr. & Mrs. Henry F. Batchelder (Vice President) | City Bank |
| Mr. & Mrs. Abdel Hamid Kabodan (Chairman) | DIB |
| Mr. & Mrs. George Issa (General Manager) | DIB |
| Mr. & Mrs. Omar Osman (Vice Chairman) | DIB |
| Mr. & Mrs. Moustafa Nour Eldin (Chairman) | EAB |
| Mr. Eli Baroudi (Vice Chairman & Managing Director) | EAB |
| Mr. & Mrs. Geoffrey H. Clayton (Manager) | Lloyds Int'l |
| Mr. & Mrs. Lewis F. Staples (Vice President & Manager) | Mfr.Hanover |
| Mr. & Mrs. Tom Flattery (Vice President) | MIDB |
| Mr. & Mrs. Fouad Sultan (Vice Chairman & Managing Director) | MIDB |
| Mr. & Mrs. Motaz Mansour (General Manager) | MIDB |

Central Bank

Mr. & Mrs. Mohamed Saleh Amin Shalaby (Deputy Governor)
Mr. & Mrs. Aly Mohamed Negm (Sub-Governor)

GOE

Mr. & Mrs. Mohamed Abdel Fatah Ibrahim
(Deputy Prime Minister for Economic & Financial Affairs)

Dr. & Mrs. Mohamed Salah El-Din Hamed
(Minister of Finance)

Dr. & Mrs. Fouad Hashem
(Minister of Investment & International Cooperation)

Mr & Mrs. Fouad Iskandar (Senior Undersecretary of State
for Economic Cooperation with the U.S.A.)

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Mr. & Mrs. Hussein Rifaat (General Manager)
(Ministry of Investment & International Cooperation)

Mrs & Mrs. Kamal El-Ganzouri
(Minister of Planning)

Mr. & Mrs. Ismail Ghanem (Deputy Chairman)
Investment & Free Zone Authority

Mr. & Mrs. Ismail Kamel (First Undersecretary for Egyptian Commerce
Representation)
Investment & Free Zones Authority

Mr. & Mrs Mohamed Fahmy (Chairman)
Capital Market Authority

Mr. & Mrs. Ismail Mohamed Hassan (Deputy)
Capital Market Authority

Eng. & Mrs. Fouad Abu-Zaghla
(Minister of Industry)

Mr. & Mrs. Abdel Moneim El-Mehelmy (Deputy Chairman)
General Organization for Industrialization (GOFI)

OTHER

Mr. & Mrs. Niazi Moustafa (Chairman Egypt/US Business Council)
Mr. & Mrs. Mohamed Ghorouri (Chairman Federation of Egyptian Industries)
Mr. & Mrs. Ahmed Foda (Financial Consultant)
Mr. & Mrs. K. Hussein (Ex Minister of Finance)
Mr. & Mrs. Sayed Omar (Counsellor of the State Legal Advisor)
Mr. & Mrs. Samir Fahmy (Chase World Info Corp.)
Mr. & Mrs. Geoffrey Scott (Vice President & Resident Project Manager)
Chase World Info Corp.
Mr. & Mrs. Bentley
Mr. & Mrs. Sherif Hassan (Middle East Representative of I.F.C.)

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U.S. Business

| | |
|--|--------------------------------------|
| Mr. & Mrs. Max Badia (Managing Director) | Union Carbide |
| Mr. & Mrs. Mike Kitchen | Squibb |
| Mr. & Mrs. Hastings | Egyptian American Agriculture Co. |
| Mr. & Mrs. David Wilkie | AMOCO |
| Mr. & Mrs. Noonan | Arab-American Vehicles |
| Mr. & Mrs. George Debakey | Rockwell Int'l. |

GAO Team

Ms. Susan Gibbs
Ms. Marilyn Ferdinand
Mr. Robert Miller

Monday, May 10, 1982

Attendees

| | | |
|-------|--|---------------------------|
| 9:00 | Meeting with Mr. Henry Batchelder | Mullen |
| 9:30 | Vice President, City Bank 4, Ahmed Basha St. Behind El Nil Hotel Garden City Tel: 27246, 20938, 29523 | Terrell Karns |
| 9:00 | Meeting with Eng. Abdel Moneim El-Mehelmy Deputy Chairman General Organization For Industrialization (GOFI) 6, Khalil Agha St., Garden City Tel: 24640 | Ferris Mathew USAID |
| 10:30 | Meeting with Mr. Samir Fahmy Vice President & Director Advisory Group Chase World Information Corporation Cairo Center, USAID Office, 5th Fl. | Team/USAID |
| 12:30 | Meeting with H.E. Minister of Planning Mr. Kamal El-Ganzoury National Planning Institute Nasr City - From El-Tayaran St., Tel: 603-684 | Team Brown |
| 4:00 | Round Table Meeting at the Commercial Section Ext. 223/255 | |

Participants:

Max Badia, Union Carbide
Henry Batchelder, Citibank
Roger Crevier, Chase National Bank
Ray Curtis, McDermott
George DeBakey, Rockwell International
Don Stuart, American Medical International
Richard Thornton, General Motors
David Wilkie, AMOCO

U.S. Embassy:

Theodore Rosen, Commercial Counselor
Edward Ruse, Commercial Officer
David Dunford, Economic Counselor
Shaun Donnelly, Economic Officer
Van McCutcheon, Assistant Director,
Office of Industry and Trade, AID
James Suma, Office Director, Office of
Investment and Finance, AID
Mr. Michael Hager, Legal Advisor, AID
Mr. John Bentley, Contract Legal Advisor

Other Guests:

Bert Planagan, Director, Office of Near East,
Dept. of Commerce
Bud Berman, President, Kellwood International
John Sarpa, US Chamber of Commerce
Kathy Young, US Chamber of Commerce

8:00 Dinner given by Mr. Fouad Soltan
Vice Chairman & Managing Director
Misr Iran Development Bank
Tel: 924860-922297
Felcon Room Restaurant Level,
Ramsis Hilton

Attendees:

Mr. John Mullen
Mr. Henry Terrell
Mr. P.M. Mathew
Mr. George Ferris
Mr. James Winkelman
Mr. Donald Brown
Mr. Van McCutcheon
Mr. David Dunford

EGYPT-U.S. BUSINESS COUNCIL
SEVENTH ANNUAL MEETING
May 11-12, 1982
Cairo, Egypt

Schedule and Agenda *

Tuesday, May 11.

| | |
|---------------------|---|
| 7:30 am - 8:45 am | U.S. Section Breakfast (Arousa Room) |
| 9:00 am - 9:45 am | U.S. Government Briefing - U.S. Embassy |
| 8:30 am - 9:45 am | Egyptian Delegation Meeting (Amira Room) |
| 10:00 am - 11:30 am | <u>First Plenary Session (Ball Room)</u> |
| 10:00 am - 10:15 am | Introductions and CoChairmen's Remarks |
| 10:15 am - 10:45 am | U.S. Government Programs in Egypt |
| | A. Report on the Agency for International Development |
| | - Don Brown, Director AID - Egypt |
| | - John Mullen, Assistant General Counsel, AID, Leader of AID Reconnaissance Mission to Egypt |
| 10:45 am - 11:30 am | B. Panel Presentation by Other U.S. Government Offices |
| | - David Dunford, Counselor for Economic Affairs, U.S. Embassy |
| | - Albert J. Planagan, Acting Director Office of the Near East, U.S. Department of Commerce |
| | - Gordon Hunt, Director, Marketing Services, Overseas Private Investment Corporation |
| | - Phyllis Bonanno, Director, Office of Private Sector Liaison, Office of the United States Trade Representative |
| 11:30 am - 11:50 am | Coffee Break |
| 11:50 am - 1:00 pm | <u>Second Plenary Session (Ball Room)</u> |
| 12:00 pm - 12:15 pm | Official Welcome |
| | H.E. Dr. Fouad Moheiddin, Prime Minister |
| 12:15 pm - 12:30 pm | Welcoming Remarks |
| | Alfred L. Atherton, Jr. |
| | United States Ambassador to Egypt |

Unless otherwise indicated, all functions will be held at the Nile Hilton Hotel

12:30 pm - 12:45 pm

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Review of the Egyptian Economy,
H.E. Mohamed Abdul Fattah Ibrahim
Deputy Prime Minister for Economic and
Financial Affairs

12:45 pm - 1:00 pm

Review of the U.S. Economy
John C. Haley, Executive Vice President
The Chase Manhattan Bank

1:15 pm - 2:30 pm

Luncheon hosted by Niazi Mostafa, Chairman
Egyptian Section - Guest Speaker,
H.E. Adel Taher, Minister of Tourism and
Civil Aviation (Ball Room C)

2:45 pm - 5:30 pm

Third Plenary Session (Ball Room)

- Panel presentations by Egyptian Government Ministers:
 - H.E. Dr. Fouad Hashem, Minister of Economy
 - H.E. Eng. Fouad Abou Zaghla, Minister of Industry
 - H.E. Dr. Youssef Wally, Minister of Agriculture
 - H.E. Dr. Kamal El Ganzoury, Minister of Planning

8:00 pm

Reception-Dinner hosted by Egyptian
Section (Belvedere)

Wednesday, May 12

9:00 am - 1:00 pm

Concurrent Action Group Meetings

- A. Investment Promotion (Arousa Room)
 - 1. AID/Business Council Cooperation
 - 2. Investment Climate, Recent Developments
- B. Project Opportunities (Ball Room)

1:15 pm - 2:30 pm

Luncheon hosted by Frank Considine,
Chairman, U.S. Section. (Ball Room C)

2:45 pm - 4:00 pm

Fourth Plenary Session (Ball Room)

- Review of Action Committee Reports
- Education and Training
 - Investment Promotion
 - Export Promotion
 - Project Opportunities

4:15 pm

Closing Session

Plans for Meeting in U.S.
Joint Communique

4:30 pm

Adjournment

7:00 pm - 9:00 pm

Reception hosted by
Alfred L. Atherton, Jr., Ambassador
to Egypt, at his residence

Tuesday, May 11, 1982

Attendees

| | | |
|-------------|---|---------------|
| 9:00-10:00 | Meeting with Mr. George Issa, General Manager Development Industrial Bank (DIB) 110 El Galaa Street Tel: 778954 | Mathew/Hagen |
| 11:00 | Meeting with Mr. Thomas J. Ransom, Vice President and Mr. Janos F. Koenig, Assist. Vice President Bank of America, Cairo Center M - Floor | Terrell/USAID |
| 13:00-14:30 | Meeting with Mr. Sherif Hassan IFC Special Representative Middle East Tel: 25045 - 23923 Issa El Ayouty, Vice Chairman The Nile Bank; Ismail Sabry, Director Agro Industrial Consultants and Delta Sugar Co. Sarwat Abdel Ghaffar, Chairman and Managing Director Misr International Bank during luncheon (Egypt-U.S. BUSINESS COUNCIL) NILE HILTON HOTEL | Team |

Wednesday, May 12, 1982

| | | |
|------|---|------------|
| 9:00 | Meeting with Mr. Fouad Iskander Senior Undersecretary of State for Economic Corporation with U.S. | Team/USAID |
|------|---|------------|

Thursday, May 13, 1982

| | | |
|-------|---|-----------------------------------|
| 11:00 | Meeting with Mr. John Blackton Deputy Assistant Director for Industry and Trade | Mullen/Mathew |
| 4:00 | USAID/Cairo Exit Conference Conference Room Cairo Center - 9th Floor | Dir. Brown Team USAID Staff |

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Henry S. Terrell
June 1, 1982

The Egyptian Banking System and
Credit to Private Sector Borrowers

Introduction

The Egyptian banking system has changed dramatically in recent years and Egypt currently has a diverse array of banking institutions. In the past, Egyptian banking was dominated by four major public sector banks. Recently, however, the laws in Egypt have been amended as part of the "open-door" policy begun in 1974. Law 43, implementing that policy, permitted foreign investment in Egyptian banks, but restricted the new banks to dealing in non-local currencies unless their share capital was at least 51 percent owned by Egyptian interests.

The major types of banking institutions currently operating in Egypt are: (1) the four large publicly-owned commercial banks; (2) privately-owned commercial banks wholly or majority-owned by Egyptians which may deal in local and foreign currencies; (3) foreign majority-owned joint-venture banks which are called investment or business banks and which may only deal in foreign currencies; (4) branches of foreign banks which also may only deal in foreign currencies; and (5) specialized institutions, such as the Development Industrial Bank (DIB), which are set up for special purposes.^{1/}

Institutional Factors Affecting Lending

Despite the variety of banking institutions in Egypt, these institutions have until recently been very limited lenders of funds to private borrowers, particularly in the area of providing long-term funds for investment projects. The reasons for the lack of lending (and particularly

1/ For a more complete description of the Egyptian banking system including the legislative framework see Banking Structures and Sources of Finance in the Middle East, edited by the Banker Research Unit, London 1980, pp. 152-192.

term-lending) to private borrowers are quite varied and include: (1) the very high profitability and low risk to the banks for short-term trade financing associated with the recent import boom and the fact that the Central Bank of Egypt (CBE) establishes various interest rates and fees on transactions; (2) the short-term nature of deposits at banking institutions which discourages longer-term loan commitments; (3) the policy of state-ownership of major productive enterprises which to date has limited the number of potential private borrowers; (4) the fact that the four major public sector banks have typically financed the major public sector enterprises and thus have had limited contact with private borrowers; (5) the relatively high risks associated with private lending, and especially long-term lending to private borrowers, in a developing economy without a clear official policy of encouragement of a private sector;^{2/} (6) the lack of a well-established discount facility at the CBE which reduces the liquidity of the banking system and discourages long-term lending; and (7) the structure of Egyptian banking regulations, the affects of which on bank lending and capital flows are discussed more fully below. Term-lending to private borrowers by local offices of non-Egyptian-controlled banks is further inhibited by costs and difficulties that all foreign parties have in acquiring title to real property in Egypt, which means that foreign-controlled banks are less able to protect themselves by attaching real collateral in the event of non-performance on a loan, and by the fact that these institutions are restricted to non-local currency activities.

2/ Among the difficulties facing private investors in Egypt, two specific problems are competition with state-owned enterprises which may be operated at a loss or receive various subsidies such as access to inputs and foreign exchange at preferential rates, and the fact that in the consumer area a private venture may have price controls imposed which would not allow it to sell its product at a price that covers its costs of operation. Both of these problems reduce the incentives for investing in long-term capacity.

Disc

The Growth of Lending to Private Sector Borrowers

Despite the difficulties noted above, the three-year period from December 1978 through December 1981 has witnessed a rapid expansion in bank credits to the private sector as shown in Table 1. In that three-year period credits to private sector borrowers increased seven-fold and currently account for nearly one-half of the loans of all banking institutions in Egypt. (in amt or #?) As shown in Table 1 about one-third of the increase in total bank credit to the private sector is denominated in foreign currencies which suggests that it is largely related to financing international trade.^{3/}

Table 2 indicates the recent experience in bank term lending to private borrowers. Despite the constraints on bank term-lending cited earlier, the growth of such lending has been impressive in recent years, as outstanding loans increased from LE 71 million at year-end 1978 to LE 394 million at year-end 1981.^{4/} Although impressive in terms of growth, such lending at year-end 1981 amounted to less than 2 percent of total assets of banks in Egypt; thus considerable room exists for an expansion of such lending in the portfolio of the banks.^{5/} The great bulk of the increase in such lending has taken place at the newly created joint venture commercial banks, investment

3/ In this three-year period the four large public sector banks accounted for less than one-half of the total increase in bank credit to private borrowers, thus the increase occurred mainly at the newly-created financial institutions.

4/ The data on outstanding term-loans may understate the true amount of such credits since in fact many short-term credits are often rolled over into long-term loans. Many small-scale enterprises finance both their short- and longer-term capital needs through overdraft facilities in the name of their principal owner which are recorded as household rather than business loans.

5/ For the four public sector banks such lending amounted to about one percent of their total assets, while for joint venture and private commercial banks it was 2 percent of total assets, and for business and investment banks about 6 percent of total assets.

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TABLE 1

Loans to Public and Private Sector Nonbank Entities
by Egyptian Banking System
(LE Millions)

| | <u>December</u> <u>1978</u> | <u>December</u> <u>1979</u> | <u>December</u> <u>1980</u> | <u>December</u> <u>1981</u> |
|---|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| <u>All Loans</u> | 2,455 | 3,126 | 4,692 | 7,763 |
| To Public Borrowers | 1,898 | 2,179 | 3,033 | 4,215 |
| To Private Borrowers | 557 | 948 | 1,658 | 3,549 |
| Private as Percent of Total | (23) | (30) | (35) | (46) |
| | | | | |
| <u>Egyptian Currency Loans</u> | 2,267 | 2,727 | 3,989 | 6,421 |
| To Public Borrowers | 1,777 | 1,962 | 2,739 | 3,796 |
| To Private Borrowers | 490 | 765 | 1,250 | 2,626 |
| Private as Percent of Total | (22) | (28) | (31) | (41) |
| | | | | |
| <u>Foreign Currency Loans</u> | 188 | 399 | 703 | 1,342 |
| To Public Borrowers | 120 | 216 | 294 | 419 |
| To Private Borrowers | 68 | 183 | 409 | 923 |
| Private as Percent of Total | (36) | (46) | (58) | (69) |
| | | | | |
| Memorandum: Credits to private sector as percent of deposits received from private sector | | | | |
| Total | (29) | (35) | (40) | (57) |
| In Egyptian Pounds | (33) | (40) | (48) | (68) |
| In Foreign Currencies | (15) | (22) | (30) | (39) |

1/ Includes loans in Egyptian pounds (LE) and foreign currencies. Data in these and subsequent tables was provided by Dr. Achmed Foda who derived them from statistical reports submitted to CBE.

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TABLE 2

Term Loans to Private Sector Borrowers^{1/2/}
(Millions of LE)

| <u>Type of Bank</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| Public Sector Commercial Bank | 15 | 25 | 41 | 75 |
| Joint Venture and Private Commercial Banks ^{2/} | 14 | 30 | 52 | 90 |
| Business and Investment Banks ^{3/} | 9 | 35 | 32 | 53 |
| Branches of Foreign Banks | 6 | 11 | 19 | 47 |
| Development Industrial Bank | <u>27</u> | <u>52</u> | <u>87</u> | <u>129</u> |
| Total | 71 | 153 | 231 | 394 |

1/ Includes loans of over one-year maturity to agriculture, industry, commerce and services in both Egyptian pounds (LE) and foreign currencies.

2/ Other commercial banks majority-owned by Egyptian interests authorized to accept deposits in Egyptian pounds.

3/ Banks without authority to accept deposits in Egyptian currency including Misr-Iran Development Bank (MIDB) and Cairo-Barclays.

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banks, branches of foreign banks, and in particular at the Development Industrial Bank (DIB) which alone accounted for almost one-third of the total increase in term lending to private Egyptian borrowers.^{6/}

The memorandum information in Table 1 indicates a definite change in the relationship of the Egyptian private sector and banks in the last three years. In earlier years, the private sector, largely households, was a large depositor with banks and public sector entities were the principal borrowers from banks. In recent years these relationships have changed somewhat and private sector borrowers are receiving a larger proportion of the private funds deposited with banks in Egypt.

Table 3 indicates the major sectors to which the banks have extended term credit. Between year-end 1978 and year-end 1981 term credit to private borrowers in all four identified sectors increased rapidly, with the largest absolute increases in the industry and service sectors.

Regulations, Bank Lending, and Capital Flows

In addition to the factors noted earlier, existing Egyptian banking regulations affect the willingness of banks to extend credit in Egypt and should be considered explicitly by AID in designing programs to support bank financing of the private sector. Under existing regulations banks in Egypt are limited in the rates of interest they can offer on Egyptian pound deposits and receive on loans denominated in Egyptian pounds.^{7/} Local residents are, however, permitted to hold foreign-currency-deposits at banks, and banks are

^{6/} The DIB is a development bank whose shares are owned by the CBE. It makes loans in Egyptian pounds and foreign currencies to small and medium size private businesses. A principal source of its funds is loans from the IBRD.

^{7/} The deposit rate ceilings depend upon the maturity of the deposits but are currently about 10 percent for most time and savings deposits, with no interest paid on demand deposits. The regulations on lending interest rates currently permit interest to be charge' on loans of 13-15 percent, which given the demand for loans in Egyptian pounds means virtually all loans are placed at 15 percent and banks tend to ration such loans to low-risk borrowers and to projects with low administrative costs.

TABLE 3

Structure of Bank Term Lending to Private Borrowers^{1/}
(LE Millions)

| <u>Sector</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|---------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| Agriculture | 14 | 24 | 27 | 85 |
| Industry | 40 | 65 | 111 | 185 |
| Commerce | 6 | 11 | 21 | 27 |
| Services | <u>21</u> | <u>45</u> | <u>70</u> | <u>133</u> |
| Total ^{2/} | 82 | 144 | 229 | 430 |

1/ Details may not add to totals because of rounding.

2/ Totals differ slightly from totals in Table 2 because of slightly wider institutional coverage and lack of complete breakdown for some reporters on loans to specific sectors.

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permitted to extend foreign-currency-denominated loans free of any interest rate limitations.^{8/} This freedom for foreign currency banking is in part designed to attract funds earned in foreign currencies by Egyptians working overseas, mainly in the Gulf. Interest rates on foreign currency deposits and loans tend to follow interest rates in the Eurodollar market.

The effect, however, of having a regulated Egyptian pound banking system and a free system in foreign currencies is that Egyptian banking transactions with private entities are increasingly being conducted in foreign currencies as shown in Table 4. This is particularly true for deposits as Egyptian private investors are holding an increasing proportion of their deposits in foreign currencies which offer the dual advantage of higher interest rates and protection against any devaluation of the Egyptian pound. The proportion of total private savings and time deposits denominated in foreign currencies -- a measure of the way private individuals choose to hold their wealth -- has more than doubled from 20 percent in 1978 to 43 percent in 1981, and should be expected to increase in the future.

The changing form in which depositors hold balances is that the Egyptian banking system has a large supply of foreign currencies (mainly dollars) and must look for appropriate investment outlets. Local private (and public) borrowers tend to be reluctant to borrow dollars for transactions other than those related to international trade, such as to finance exports where they will receive payment in foreign currencies, or, to finance foreign exchange needed to pay for imports related to a investment project, because they will be forced to pay higher internationally-determined interest rates as well as accept exchange rate risks.

^{8/} There is a 15 percent reserve requirement on foreign currency deposits; but this reserve deposit at the Central Bank of Egypt receives interest at approximately the London Interbank offer rate (LIBOR) so it is of minimal cost to the banks.

TABLE 4

Private Sector Transactions with Banks: By Currency
(LE Millions)

| <u>Deposits from Private Sector</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|--|--------------------------|--------------------------|--------------------------|--------------------------|
| <u>Total Deposits</u> | 1,917 | 2,684 | 3,959 | 6,208 |
| Egyptian Pounds | 1,470 | 1,886 | 2,594 | 3,851 |
| Foreign Currency | 447 | 798 | 1,365 | 2,357 |
| Foreign Currency as Percent of Total | (23) | (29) | (34) | (38) |
| | | | | |
| <u>Time and Savings Deposits</u> | 860 | 1,481 | 2,383 | 4,076 |
| Egyptian Pounds | 692 | 981 | 1,444 | 2,334 |
| Foreign Currency | 168 | 500 | 939 | 1,742 |
| Foreign Currency as Percent of Total | (20) | (34) | (39) | (43) |
| | | | | |
| <u>Total Credits to Private Sector</u> | 557 | 948 | 1,658 | 3,548 |
| Egyptian Pounds | 490 | 765 | 1,250 | 2,625 |
| Foreign Currency | 67 | 182 | 408 | 925 |
| Foreign Currency as Percent of Total | (12) | (19) | (25) | (26) |

As a result of these structural policies, Egyptian banks have deposits in foreign currencies in excess of their ability to extend foreign currency loans, thus the banks redeposit the excess funds on the order of \$1 billion with banks outside Egypt, largely in Euromarket centers such as London, Paris, Luxembourg, and Bahrain. Table 5 indicates the net position of banks in Egypt with banks outside Egypt.^{9/}

In addition to the regulations on interest rates noted above, banks in Egypt are subject to a variety of monetary policy restraints which also restrict their ability to extend credits to both private and public borrowers. These restraints, which are only applicable to transactions in Egyptian pounds, include reserve requirements of 25 percent on all deposits of less than two years maturity, a required loan/deposit ratio of 65 percent which means banks can only lend 65 piastres for every pound they receive in deposits, and separate ceilings on total credits to specific types of borrowers.^{10/} It is of course difficult to determine which of these constraints is in fact binding on the banks' behavior, and it may well not be the same constraint binds all banks. While such restraints may be useful for monetary policy implementation they do limit the willingness of banks to extend credit to both private and public sector borrowers.

Summary and Conclusions

Despite the variety of constraints on bank lending to private borrowers, the recent record of expansion of Egyptian banks in extending such credits has been impressive. The existence, however, of an unregulated banking

^{9/} Data collected by the Bank for International Settlements (BIS) indicate that at year-end 1981 Egyptian residents (including banks) had deposits of \$5 billion at reporting banks, while all Egyptian borrowers (including banks) had borrowed only \$3.9 billion from these banks. Thus, Egyptian residents were net suppliers on that date of \$1.1 billion to the Eurocurrency markets.

^{10/} These current ceilings limit increases in credit to commerce and housing to 3 percent every 3 months, and credit to the family sector to 2-1/2 percent every 3 months.

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TABLE 5

Net Positions of Banking Institutions in Egypt with
Banks Outside Egypt
(LE Millions)

Net Position with Banks Outside Egypt^{1/}

| <u>Type of Banking Institution</u> | <u>December 1978</u> | <u>December 1979</u> | <u>December 1980</u> | <u>December 1981</u> |
|---|--------------------------|--------------------------|--------------------------|--------------------------|
| Public Sector Banks | -832 | -775 | -670 | +78 ^{2/} |
| Joint Venture and Private Commercial Banks | -143 | -207 | -398 | -660 |
| Business and Investment Banks | -120 | -98 | -134 | -146 |
| Branches of Foreign Banks | <u>-243</u> | <u>-281</u> | <u>-261</u> | <u>-42</u> |
| Position of above Banks | -1,338 | -1,361 | -1,463 | -770 |

1/ A plus means net liabilities to foreign banks (funds brought into Egypt) and a minus means net claims on foreign banks (funds exported from Egypt).

2/ The only quarterly reporting date between December 1978 and December 1981 for which this number was not negative. Between December 1980 and December 1981 the four large public sector banks reduced their borrowings from the CBE by LE 1.5 billion and increased their deposits at the CBE by LE .3 billion. This large shift of LE 1.8 billion in net claims on the central bank may explain why the four large public sector banks were not net placers of Eurodollars at year-end 1981.

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system in foreign currencies operating alongside a tightly-regulated system of domestic currency banking means that the former will expand rapidly at the expense of the latter, that Egyptians residents will increasingly conduct their banking transactions in foreign currencies, and that the CBE will lose control over domestic monetary and credit conditions. The existence of disequilibrium lending rates in Egyptian pounds and free market rates in external currencies means that banks will have an increasingly large excess supply of foreign currency deposits relative to the local demand for loans denominated in foreign currencies and will place the excess funds in the offshore Eurocurrency market.

**PRESENT STATUS AND NECESSARY INITIATIVES
CAPITAL MARKET - EGYPT**

George M. Ferris, Jr.

June 1, 1982

Present Status and Necessary Initiatives
Capital Market

I. Overall Environment

A. Government Attitude

While there are general pronouncements from top-level Government Officials concerning a desire for the private sector to play an increasing role in the development of Egypt, there is presently a lack of clear definition as to how the private and public sectors will interact. Hopefully, some clarification will be forthcoming at the time of budget presentation. In the meantime, the public sector receives favored treatment in the form of financing costs, foreign exchange, utility rate differentials and availability of raw materials.

The Investment Authority, which was originally established to assist the development of the private sector, has become a deterrent, primarily because of a screening system which requires the authority to farm out specific requests to the Ministry of Industry and Ministry of Planning for review and analysis. This procedure results in public sector companies being called upon to pass judgement on potential private sector competitors. Chase Bank has submitted 22 proposals for private sector enterprises since 12/11/81 with none as yet approved. Such inactivity can be interpreted as a lack of enthusiasm on the part of the GOE for not only the Chase project but also the whole private sector development concept.

As regards the Capital Market, it is easy to obtain from the Government general statements of support. What is needed, however, are

specific project proposals to point up for discussion and resolution specific Governmental policies detrimental to creating a climate which encourages investment of the peoples' savings and institutions' funds into equity and long-term commitments.

B. Accounting

While accounting in Egypt is not totally by international standards, the historic British presence in the Country has assured a degree of reliability greater than in most developing countries. This discipline is one in which technical assistance is always worth-while. In the meantime, lack of reliability in accounting and lack of complete integrity in the tax collection system do not appear to be major obstacles to the creation of viable capital market.

C. Availability of Funds

1. Institutions

Because of 10% tax-free yields on local currency deposits and 15% tax free, on eurodollar deposits, the commercial banks have no shortage of short-term funds. There is a justified reluctance, however, to commit a significant proportion of such deposits to long-term loans, especially since 1974 when such commitments ceased to carry Government guarantees.

The development banks, especially DIB and MIDB, do make long-term commitments, DIB mostly in the form of term loans and MIDB, 75% loans and 25% equity. Considerable funds appear to be available through these institutions.

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Insurance companies and pension funds, contrary to capital market status of most developing countries, are a significant factor in Egypt -- a real plus for capital market development. At least one insurance company has committed as much as 25% of its portfolio to equities and some of the private pension funds have also made such commitments, but to a lesser degree.

AID established a Private Investment Encouragement Fund (PIE) to provide long-term loans on a participating basis with commercial banks to companies with at least 70% private ownership. Due to lack of appropriate administrative procedures, no funds have actually been dispersed. In summary, the institutions appear on balance to be a positive factor on which to build a capital market, with the exception of the lack of a true venture capital entity.

2. Individual Investors

These are individuals, limited in number but sufficient in wealth, for the development of a capital market if the proper economic climate is provided. Further, remittances from abroad are creating a middle class. Prestigious names such as General Motors and Union Carbide had no difficulty, even in the present climate of uncertainty, in raising LE. 30,000,000 and LE 2,000,000 equity respectively in the local market, the former totally from individuals. In any evolution of a capital market in a developing country, those few of great wealth lead the way with private investment in a limited number of investments considered excellent risk/reward opportunities.

D. Existing Securities Market

Stock exchanges exist in both Cairo and Alexandria and while their existence will be useful when an environment conducive to a capital market unfolds, the exchanges are of no real value at this time due to the inadequate "float" (number of shares freely tradeable) of most if not all issues. Institutions can be established but will not flourish until incentives conducive to equity and debt ownership exist. (Discussed below).

E. Composition of Business Enterprises

Approximately 80% of all private business enterprises in Egypt have total assets of less than LE. 300,000. This creates a special problem for distribution of capital, even when available, not to mention the fact that normal project analysis becomes economically unfeasible. Only through commercial banks, with wide branch networks and local knowledge, could capital resources be tapped by such enterprises.

II. Incentives

A capital market can not be legislated into being. Incentives must be provided to make it in the self interest of the owner of a family business to "open up", incentives for the investing public, both individuals and institutions, to want to own shares and long-term debt in such enterprises, and finally, incentives making it profitable and prestigious for the middleman to promote the process, putting the buyers and sellers together.

A. Incentives for distributing Ownership

1. Pricing

The initial offering of a company's shares is at nominal or par value. If the company is a highly profitable family business, such a system is not conducive to "opening up" since par value does not take into account the established success of the business. Korea found an extreme reluctance on the part of sound private companies to go public until it changed its pricing policy from par value to allowing premiums based on proven profitability for first public offerings of established businesses. Par or nominal value is appropriate only for new ventures and such enterprises are better financed by private placements since they have to yet establish their ability to earn a profit.

2. Tax Policy

Tax policy (and integrity of the tax system) is the second major incentive (or disincentive) for "opening up" companies to public ownership. The new tax law provided a 5-year tax "holiday" from date of incorporation for joint ventures and all Egyptian companies with more than 50 employees. In effect, if it takes a new venture 3 years to reach a stage of profitability, the tax "holiday" is of value only for two years. For established companies, the "holiday" is reduced to the extent the company was incorporated prior to the effectiveness of the new law. The greatest incentive which could be provided for capital market development would be to apply the tax "holiday" to five years from the date of the initial public offering.

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3. Red Tape

Red tape is considered a major deterrant to the establishment of new ventures, whether wholly Egyptian or joint ventures. At least two ministries and one authority are involved in each application and not only is there a lack of coordination between the ministries and lack of a feeling of need for expediency, but even in some instances, conflicting objectives. Ways must be found to streamline the process and make the investment authority a proponent rather than obstacle to the growth of the private sector.

B. Incentives for Purchasing Shares

1. Comparative yield

Investors will not subject their capital to risk unless the potential for an additional increment of return over the savings rate justifies that risk. All but the most sophisticated investors do not understand the concept of appreciation and total return. Consequently, they compare the after-tax dividend return and returns on savings accounts in determining whether to seek investments other than savings accounts. Savings accounts currently provide 10% tax free interest on Egyptian pound accounts and 15% tax free rate on Eurodollar accounts. When compared to the likely aftertax return on dividends, there is certainly little incentive to buy ownership in Egyptian business. Dividends are tax free for the first 5 years of a new corporation but there is little likelihood of dividends during this period. Further, since there would be no return in the initial years, the comparative yield to the institutional or individual

investor would need be extremely attractive in subsequent years to justify investment.

Presently, corporations are given a credit against their income for tax purposes equal to the local savings rate times their paid-up capital (10% rather than the 15% obtained on foreign currency savings) The net income is then taxed at 32% and any after-tax income paid out in the form of a dividend, once the tax "holiday" has ended, is 50% subject to individual rates (which graduate to a maximum of 50%). If equity investment is to be encouraged, double taxation must be completely eliminated, or interest on savings accounts, taxed. The comparative yield must be improved, the tax treatment on dividends and interest on savings accounts equalized, if broadening of the equity capital market is to be achieved. Further, interest on long-term debt is not attractive when it is exempted from tax only to the extent of the local savings rate while most monied individuals and institutions are currently obtaining approximately 15% tax free.

2. Favorable Investment Experiences

One of the biggest catalysts attracting private investors is circulation of stories of successful investments. As individuals experience favorable results, others will be attracted. Conversely, unfavorable investments early in the development of the capital market will set back its growth for years. Consequently, to insure favorable results, only sizeable companies with proven favorable earnings trends should be encouraged initially to distribute bonds

and shares to the general public.

The question might be raised as to whether such a policy implies discrimination against smaller companies. There are three logical steps of financing. First, the entrepreneur, his family and friends invest money to start the venture. Secondly, a private placement, whereby a sophisticated investor, keenly aware of the risks involved, contributes capital on a basis which provides a favorable risk-reward ratio. The private placement is the logical role for the investment banks and any venture capital firm. Finally, the public offering takes place when, and only when, the company has demonstrated a favorable earnings trend over several years. Any attempt to accelerate the public offering increases the chances of an unfavorable investment experience for the general public.

3. Liquidity (the ability to dispose of an investment)

There have been significant private equity investments by a few sophisticated individuals and institutional investors but a broadening of the capital market will not occur until a degree of liquidity is achieved. Such will develop only as the general public is enticed to the market by improved comparative yields and stories of favorable investment experiences.

C. Status and Incentives for Middlemen

1. Commercial Banks

Private sector loans have increased 500% over the last four years

in spite of the fact that term loans are not nearly as profitable as short-term lending. While the increase is dramatic, it is from a very small base and the total of term loans is very, very small in relation to the total capital market. Providing a rediscount facility would be a major step in making term loan activity more profitable. #

Banks have limited equity investments but this should not be a major thrust for them. It is far more appropriate for them to invest in a venture capital firm possessing appropriate project analysis capability. Such action would not only further the growth of equity capital on a sound basis but would also expand the banks' source of future lending activities.

Banks presently are acting as subscription agents, but not underwriters, for public issuance of shares. There have been approximately 150 instances of such in the last 4-5 years. This activity is most appropriate in developing countries where only banks have widespread branch networks capable of reaching out to the people.

2. Investment Banks

DIB and MIDB are the entities most closely resembling investment banks, with the Arab Investment Company following to a lesser degree. DIB utilizes primarily term loans which, unlike investment banks, it places in its own portfolio and as previously mentioned, is presently invested approximately 75% in term loans, 25% equities.

An investment banking community is key to the development of a capital market. The middlemen must educate the owners of private

companies, promoting the advantages of going public, while at the same time, educating the general public as to the advantages of owning shares in Egyptian industry (assuming appropriate incentives have been provided by the Government). In addition, they must bring together buyers and sellers in the marketplace, thereby vitalizing the capital market.

To attract individuals (and capital) capable of performing this essential function requires profitability. It is important that this profitability be of a constructive nature. In too many developing countries the securities industry relies upon "free riding", a practice detrimental to the capital market for its profitability. "Free riding" is the process whereby the underwriters buy the entire issue, initially distribute only a small portion of the shares, thereby creating a scarcity of supply and false sense of demand, push up the market price and then sell the retained shares at higher price levels to the public for huge profits for themselves but at the expense of the issuing company which does not receive the higher price and at the expense of the buying public which purchased at inflated levels. Any newly created investment bank must first establish a degree of activity to carry its overhead while developing interest in equity underwritings. The Government can demonstrate its support for new underwriting entities by encouraging their utilization in more traditional project finance activities which will generate an early income flow. Fees from venture capital placements would also assist in generating income and creating profitability.

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