PD-AAU-244

IAN-47063

AUDIT OF
PRODUCTION CREDIT PROJECT
USAID/EGYPT PROJECT NO. 263-0147
Audit Report No. 6-263-86-11
September 30, 1986

UNITED STATES GOVERNMENT

memorandum

DATE: September 30, 1986

REPLY TO ATTN OF: Joseph R. Ferri, RIG/A/Cairo

SUBJECT: Audit of Production Credit Project
USAID/Egypt Project No. 263-0147

TO: Mr. Frank B. Kimball, Director USAID/Egypt

This report presents the results of audit of the Production Credit Project; USAID/Egypt Project No. 263-0147. The objectives of this program results audit were to: determine whether project goals were achievable; assess whether the indicators for measuring project success were valid; determine whether the project was being implemented in a manner likely to bring about the desired outcomes; assess compliance with applicable laws and regulations; and test internal controls.

The audit showed that the project goals could not be achieved, indicators for measuring project success were invalid, and the project was being implemented in a manner that was unlikely to bring about the desired outcomes. Tested items were in compliance with applicable laws and regulations. Internal controls were adequate in regard to the transactions traced through to participating bank records.

Several changes were made during the period of project implementation that improved the way in which the project functioned. Fundamentally, however, the project was incapable of achieving its broadly stated goals. Inability to overcome the constraints of a subsdized exchange rate and an interest rate structure imposed by the Government of Egypt precluded the project from being effectively implemented on a market-oriented basis. These problems, combined with the lack of incentives for participating banks to make the types of loans intended, allowed project funds to flow to firms least in need of the financial assistance provided. This latter problem could have been lessened had the Mission established priorities for private sector development and channeled project funds to firms in these sectors, but this was not done.

We made recommendations in each of these areas to correct the problems noted. USAID/Egypt said that the intent of our recommendation concerning design issues was met in the follow-on Private Enterprise Credit Project. It said solutions to the exchange rate and interest rate issues would continue to be pursued, but in the context of overall policy dialogue with the Government of Egypt. The Mission saw no need to provide participating banks additional incentives and rejected the idea of targeting the use of project funds.

As a result of these comments, a review and analysis of documentation pertaining to the follow-on Private Sector Commodity Import Program Facility component of the Private Enterprise Credit Project was made in July 1986. This additional work was done because the Mission took the position that some of the problems identified had been corrected in the follow-on project. Accordingly, we wanted to find out whether this was correct and/or new approaches had been taken which may lead to the early resolution of these problems. Unfortunately, the follow-on project remains essentially unchanged in terms of the issues addressed in this report. Further, this project does not appear to be adequately justified in the context of the real objectives and, therefore, is vulnerable to criticism of being implemented in a manner that runs counter to the achievement of the stated project goal and purpose. We have two main concerns with the follow-on project.

First, rather than using market-oriented approaches for allocating project resources, it appears that the real purpose of the project is to simply provide subsidized forms of financial assistance to offset those received by public sector activities against which private investors compete. Setting up a dual system of subsidies for the private sector only reinforces the system of irrational subsidies which the Mission is seeking to eliminate on the public sector side. Thus, rather than breaking down barriers impeding private sector growth and development based on the true cost of capital, the project is probably reinforcing these barriers by promoting subsidies which distort the real cost of investment decisions.

Second, project documentation shows that there has not been, nor is there likely to be, any near term policy reforms by the Government of Egypt in regard to the major impediments to project success--specifically the exchange rate and interest rate issues. The Project Paper acknowledges that the major policy reforms underlying the assumptions for achieving goal targets are both unlikely and transcend the capabilities of this project to achieve. This leads us to conclude that the environment does not now exist, nor is it soon likely to exist, to implement the Private Sector Commodity Import Program Facility component as presently justified.

We, therefore, disagreed with USAID/Egypt's response on most matters. The follow-on Private Sector Commodity Import Program Facility component of the Private Enterprise Credit Project has essentially remained unchanged in terms of the design issues addressed. For example, the project goal and purpose, the basis for measuring project goal achievement, and the assumptions for achieving goal targets are the same as in the Production Credit Project. These goals and the basis for measuring their achievement are no more realistic or achievable than they were for the Production Credit Project. Also, the follow-on project continues to tie solutions to the exchange rate and interest rate issues to policy dialogue between USAID/Egypt and the Government of Egypt which means that it is unlikely that any movement will be forthcoming on these issues in the near future. Moreover, the follow-on project proposes no new incentives for participating banks to align their interests in the project with those of the Mission. While USAID/Egypt rejected the idea of targeting, the follow-on project sets forth loan objectives for the participating banks that clearly represent a viable form of targeting. However, this targeting is not sufficiently definitive or far-reaching. More specific targeting of project funds is necessary if there is to be adequate assurance that project funds reach those sectors and firms most deserving of support.

The House Committee on Appropriations expressed concern regarding distortions in the Egyptian economy in connection with the 1987 foreign assistance appropriations bill, stating that "long-term economic viability in Egypt can best be achieved by fundamental economic reform." In keeping with this concern, USAID credit programs in Egypt should be structured in a manner supporting this objective rather than reinforcing existing economic distortions.

We appreciated the courtesies extended to our staff during the audit. A summary of USAID/Egypt comments and Office of the Inspector General comments is included at the end of each findings section. The full text of USAID/Egypt's comments is included in the report as Appendix 1. Please advise us within 30 days of any actions taken or contemplated to close the recommendations.

EXECUTIVE SUMMARY

USAID/Egypt entered into a $68-million grant agreement with the Government of Egypt in September 1982 funding the Production Credit Project, No. 263-0147. An additional $20 million was authorized in March 1985 making the project total $88 million and extending the project completion date into fiscal year 1986. The primary project goal was to increase the private sector's contribution to Egyptian productive output by providing foreign exchange on credit terms. By expanding credit availability, the project was to directly facilitate increased private sector involvement in the Egyptian economy, thereby promoting long-term economic growth and employment. The Production Credit Project was followed by the Private Enterprise Credit Project estimated to cost $235 million. This new project included a Private Sector Commodity Import Program Facility funded at about $117 million that essentially continued the activities carried out under the Production Credit Project.

The objectives of this program results audit were to: determine whether project goals were achievable; assess whether the indicators for measuring project success were valid; determine whether the project was being implemented in a manner likely to bring about the desired outcomes; assess compliance with applicable laws and regulations; and test internal controls.

The audit showed that the project goals could not be achieved, indicators for measuring project success were invalid, and the project was being implemented in a manner that was unlikely to bring about the desired outcomes. Tested items were in compliance with applicable laws and regulations. Internal controls were adequate in regard to the transactions traced through to participating bank records.

Several changes were made during the period of project implementation that improved the way in which the project functioned. Fundamentally, however, the project was incapable of achieving its broadly stated goals. Inability to overcome the constraints of a subsidized exchange rate and an interest rate structure imposed by the Government of Egypt precluded the project from being effectively implemented on a market-oriented basis. These problems, combined with the lack of incentives for participating banks to make the types of loans intended, allowed project funds to flow to firms least in need of the financial assistance provided. This latter problem could have been lessened had the Mission established priorities for private sector development and channeled project funds to firms in these sectors, but this was not done.

With a relatively modest funding level, the project did not contain sufficient leverage to achieve the broadly stated goals of increasing Egyptian private sector productive output and expanding investment for productive private sector enterprises. Neither the project goal nor purpose were supported by detailed economic analysis of the development need to be addressed, nor were they linked to the specific design problems identified in the Project Paper as major constraints to private sector development. Indicators of goal achievement were neither valid, verifiable, nor quantifiable as required by AID Handbook 3. Many of the design issues addressed in this section of the report were raised when the project was in the approval process, but were never dealt with effectively by USAID/Egypt prior to project approval or in the four years since. The issues, therefore, were present throughout the life of the project and adversely affected implementation. Government of Egypt actions exacerbated the project design problems and further impeded chances of project success.

We recommended that the follow-on Private Sector Commodity Import Program Facility be redesigned around realistic project goals and a specific developmental need that it is capable of addressing, and that objectively verifiable indicators to measure goal achievements be developed. USAID/Egypt said the follow-on project met the intent of our recommendation.

USAID/Egypt was unsuccessful in getting the Government of Egypt to make the policy reforms that were prerequisites to project success. These reforms centered on the exchange rate at which project transactions were to be repaid and the interest rate to be charged borrowers of project funds. The Mission's inability to get the Government of Egypt to move on these issues meant that the exchange rate used to repay project transactions was far below the actual market rate, and that the interest rate charged borrowers of project funds was undervalued and discouraged long-term lending. The Mission was unsuccessful in overcoming these constraints through a policy dialogue with the Government of Egypt prior to project approval and in the four years since. This precluded effective project implementation with the exchange rate issue having the most serious consequences.

We recommended that USAID/Egypt find a solution to the exchange rate problem for the follow-on Private Sector Commodity Import Program Facility that is not tied to ongoing policy dialogue with the Government of Egypt. USAID/Egypt said that this was neither possible nor realistic. We also recommended that USAID/Egypt determine what the real market interest rate would be for the types of loans to be made, and justify any deviation from this rate in terms of attaining project goals. USAID/Egypt agreed that the interest rate structure in Egypt discouraged long-term lending and encouraged short-term trade financing but felt obligated to use the existing structure while seeking changes in it.

Project success was conditioned ultimately on the quality of implementation by the nine participating banks. These banks, however, were not provided incentives to align their interests in the project with those of the Mission. For example, banks received the same flat fee regardless of whether the transaction was paid in cash or on credit terms. This fee did not vary with the credit risks involved or other costs associated with the transaction. Further, these banks were required to assume the full financial responsibility for both principal and interest payments when credit terms were used, but received no added compensation for this risk. As a result, bank officials we interviewed tended to restrict participation in the project to their good customers with the highest credit ratings. These were not the firms most likely to make the best use of the funds in a manner supporting project goals.

We recommended that USAID/Egypt establish a system of incentives for the participating banks to align their interests in the project with those of the Mission and thus make the types of loans that would best support project goals. USAID/Egypt saw no need to provide further incentives to participating banks.

The project was successful in moving funds into the private sector, but not necessarily in ways supporting the project goals of expanded Egyptian private sector output and employment. USAID/Egypt did not identify priorities for private sector development nor establish criteria to ensure project funds were targeted to meet these priorities. Further, because the project was not operated on a market-oriented approach, market forces could not be relied on to determine the appropriate allocation of project resources. As a result, assurance was lacking that project funds were used in the manner intended. Based on discussions with selected Egyptian importers, there were many indications that this was not happening.

We recommended that USAID/Egypt establish priorities for private sector development along with criteria for targeting project funds to sectors and firms that are most likely to achieve project goals of expanded output and employment. USAID/Egypt said that it had examined the issue of targeting and had rejected it.

Office of the Inspector General

characterized by critics as simply a cheap foreign exchange window rather than an effective mechanism for assisting the

AUDIT OF

PRODUCTION CREDIT PROJECT

TABLE OF CONTENTS

PART III - EXHIBITS AND APPENDICES

A. EXHIBITS

1. Office Of Inspector General Analysis Of Design And Approval Documents Related To The Private Enterprise Credit Project

2. History Of Concern Over the Exchange Rate Issue

3. List Of Commodities Imported For Selected Transactions

B. APPENDICES

1. Management Comments

2. List Of Recommendations

3. Report Distribution

AUDIT OF
PRODUCTION CREDIT PROJECT

PART I - INTRODUCTION

A. Background

On September 25, 1982, USAID/Egypt entered into a $68-million grant agreement with the Government of Egypt (GOE) funding the Production Credit Project (PCP). In March 1985, an additional $20 million was authorized, raising the project total to $88 million. The primary goal of PCP was to increase the private sector's contribution to Egyptian productive output by providing foreign exchange on credit terms. By expanding credit availability, the project was to directly facilitate increased private sector involvement in the Egyptian economy, thereby promoting long-term economic growth and employment.

The project had two components: (1) $87 million of foreign exchange credits to be made available to the private sector to finance purchases of certain raw materials and capital goods from the United States; and (2) $1 million for technical assistance. Credit funds were to be made available to private sector end-users or traders that conducted business with such end-users through eligible private and public sector banks. Technical assistance funds were to be made available to finance training activities and studies related to the flow of credit to the private sector.

The original project completion date of March 31, 1985 was extended into fiscal year 1986 by amendment #1 to the grant agreement. As of December 31, 1985, the full $87 million of exchange credits had been allocated to nine participating banks and USAID/Egypt had approved 520 separate applications totaling $82 million received from these banks. Most of the approvals resulted in loans being made through these banks to Egyptian importers. Loan repayments including accrued interest were to be made by the importers in Egyptian pounds and deposited by the banks into a Special Account established in the Central Bank of Egypt. Funds in the Special Account were to be used for purposes mutually agreed to between USAID/Egypt and the GOE.

As a result of an AID Project Evaluation Summary approved in February 1985, improvements were made in the project including: (1) changing the exchange rate used to calculate borrowers' repayments from Egyptian pounds (LE).84 to LE1.00 to the U.S. dollar; and (2) dropping the maintenance of value requirement which meant that borrowers no longer had to assume the risk of having to repay a greater amount of money due to a pound devaluation. Also, traders were eliminated from participating in the project in 1985 because of Mission concerns that they were capitalizing on the below-market exchange rate.

The Project Paper for a new Private Enterprise Credit Project (PECP) was signed in July 1986. This project, estimated to cost $235 million, included a Private Sector Commodity Import Program Facility funded at about $117 million that essentially continued the activities carried out under PCP.

B. Audit Objectives And Scope

This program results audit covered project transactions and activities from the commencement of PCP operations in August 1983 through November 1985. The audit objectives were to:

-- determine whether project goals were achievable;

-- assess whether the indicators for measuring project success were valid;

-- determine whether the project was being implemented in a manner likely to bring about the desired outcomes;

-- assess compliance with applicable laws and regulations; and

-- test internal controls.

The audit included an examination of project authorization documents and other pertinent files and records maintained by USAID/Egypt and AID/Washington. Mission and AID/Washington officials responsible for project design and implementation were interviewed.

Using a listing of Mission-approved transactions through November 19, 1985, 47 transactions were selected--every tenth one--for a detailed review. These transactions totaled $7.6 million of the $76.8 million for the entire universe and are listed in Exhibit 3. These transactions were traced through Mission records to determine: (1) what commodities were being imported and who was importing them; (2) how the USAID/Egypt review and approval process worked; and (3) whether this process was adequate to ensure compliance with applicable AID policies and regulations.

Thirty-five of the transactions in the sample universe totaling $5.8 million were traced to underlying documentation in four of the banks participating in the project, two public and two private. The purpose of this step was to: (1) verify the completeness and accuracy of Mission records, and (2) obtain bank comments on the project as a whole and specifically their role in it. These visits were followed up by interviews with eight importers that had received project funds--two from each of the four banks--to obtain their views concerning project benefits and possible improvements. As of November 1985, a total of 289 Egyptian importers had received PCP funds.

No previous audits of this specific project were made. However, the audit drew from a comprehensive study of the private sector Commodity Import Program made by the Area Auditor General/Egypt in 1980, and an AID evaluation report of this project approved in February 1985. The audit work was done between September 1985 and January 1986. The audit was made in accordance with generally accepted government auditing standards.

Following receipt of formal USAID/Egypt comments on July 8, 1986, documentation pertaining to PECP was reviewed and analyzed. This was necessary because the Mission took the position that some of the problems identified in this report had been corrected in the follow-on Private Sector Commodity Import Program Facility component of this project.

Our analysis of PECP is contained in Exhibit 1 of this report.

AUDIT OF
PRODUCTION CREDIT PROJECT

PART II - RESULTS OF AUDIT

The audit showed that the project goals could not be achieved, indicators for measuring project success were invalid, and the project was being implemented in a manner that was unlikely to bring about the desired outcomes. Tested items were in compliance with applicable laws and regulations and nothing came to our attention that would indicate that untested items were not in compliance. In addition, internal controls were adequate in regard to the transactions traced through to participating bank records.

Several improvements were made during the period of project implementation. Fundamentally, however, the project was incapable of achieving the broadly stated goals. Further, USAID/Egypt's inability to overcome the constraints of a subsidized exchange rate and an interest rate structure imposed by the GOE precluded the project from being effectively implemented on a market-oriented basis. These problems, combined with the lack of incentives for participating banks to make the types of loans intended, allowed project funds to flow to firms least in need of the financial assistance provided. This latter problem could have been lessened had the Mission established priorities for private sector development and channeled project funds to firms in these sectors, but this was not done.

This report makes five recommendations calling for project redesign and improved project implementation to be applied in the follow-on Private Sector Commodity Import Program Facility component of PECP.

We recommended: having design efforts take place around realistic project goals and a specific developmental need that it is capable of addressing; developing objectively verifiable indicators to measure goal achievement; finding solutions to the problems of the exchange rate at which project transactions are repaid and the interest rates charged borrowers of project funds; establishing a system of incentives for the participating banks to align their interests in the project with those of the Mission and thus make the types of loans that would best support project goals; and establishing priorities for private sector development along with criteria for targeting project funds to sectors and firms that are most likely to achieve project goals of expanded output and employment.

A. Findings And Recommendations

1. The Project Could Not Achieve Its Broadly Stated Goals

With a relatively modest funding level, the project did not contain sufficient leverage to achieve the broadly stated goals of increasing Egyptian private sector productive output and expanding investment for productive private sector enterprises. Neither the project goal nor purpose were supported by detailed economic analysis of the development need to be addressed, nor were they linked to the specific design problems identified in the Project Paper as major constraints to private sector development. Indicators of goal achievement were neither valid, verifiable, nor quantifiable as required by AID Handbook 3. Many of the design issues addressed in this section of the report were raised when the project was in the approval process, but were never dealt with effectively by USAID/Egypt prior to project approval or in the four years since. The issues, therefore, were present throughout the life of the project and adversely affected implementation. GOE actions exacerbated the project design problems and further impeded chances of project success.

Recommendation No. 1

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility:

a. design this component around a meaningful and realistic goal and purpose and a specific developmental need that it is capable of addressing; and

b. develop quantifiable indicators that can be objectively verified to measure goal achievement.

Discussion

The Project Paper approved in September 1982 stated that the PCP goal was to increase the private sector's contribution to Egyptian productive output, and the purpose was to expand investment for productive private sector enterprises. By assisting in developing an Egyptian financial system with the capability and capacity to provide short, medium, and long-term private sector credit needs and expanding credit availability, this project was intended to directly facilitate increased private sector involvement in the Egyptian economy. This in turn was to promote long-term economic growth and employment.

Two major problems were identified in the Project Paper as constraints to private sector growth:

-- Competition from the public sector which had access to foreign exchange at the official exchange rate; this access in essence was a subsidy since the official rate has historically been below the market rate for foreign exchange.

-- Uncertainty among potential private investors as to the medium and long-term political environment in Egypt with respect to the treatment of the private sector.

Recognizing that the type of assistance envisioned was a complex undertaking with multiple facets and policy implications, the Project Paper stated that the project was to lay the groundwork for future interventions in the financial markets to support productive private sector activities. The project was also to provide for AID participation with the GOE in developing sectoral credit policies more favorable to long-term lending. Although initial project funding was to be concentrated in short-term financing, the project was to permit AID to move increasingly into longer term financing as appropriate mechanisms were developed and government policy and the marketplace came into closer convergence.

Accepting that the Project Paper correctly described the constraints to private sector growth, there was no connecting link between the problems identified and PCP's stated goals.

The project subgoal was the development of the Egyptian financial system's capability to service the full range of private sector financing needs. The Project Paper identified some of these needs, but contained no detailed assessment of the obstacles preventing their achievement and how the project was to assist in overcoming these obstacles. Given the size of private sector foreign exchange requirements, estimated at $3.5 billion annually, it was unrealistic to expect that a project initially authorized at $67 million and spread over a 30-month period would be able to achieve the basic structural reforms in the banking system that were envisioned.

Development Need

A problem in identifying the specific developmental need to be addressed was known at the time the project was approved in September 1982. An August 1982 memorandum from the Bureau for

3. Participating Banks Lacked Adequate Incentives To Support Project Initiatives

Project success was conditioned ultimately on the quality of

Program and Policy Coordination criticized the project design for failing to adequately explain the development need to be met and for not stating why AID was engaging in this activity.

A March 1984 cable to USAID/Egypt, in connection with the $20-million increase in project funding, revealed continuing uncertainty about the development need to be addressed. AID/Washington expressed concern that it still lacked a clear understanding of how the Egyptian financial system operated. Increased understanding was necessary to properly design the follow-on project as well as to ensure that AID/Washington and the Mission had the same goals in mind.

Bank officials we talked to stated that they thought the intended beneficiaries of the project were U.S. exporters, Egyptian importers, and in some cases both. When told that the project was justified within AID on the achievement of overall policy reforms to enhance private sector development and investment, one bank official expressed surprise. This official stated that PCP was certainly beneficial to those importers receiving assistance, but that the project was too small to have any real benefit to the private sector as a whole. It would make no difference if the project disappeared tomorrow.

Goal Achievement

Measurement of the extent to which the project goal was being achieved was based on the assumption that increases in private sector output resulting from project disbursements would be reflected in, and adequately measured by, published statistical reports reflecting economic movements at the macrolevel.

Economic statistics gathered from such sources, however, could not accurately gauge PCP achievements given the modest size of project funding. The initial PCP authorization of $67 million represented less than one percent of the private sector's foreign exchange needs over the 30-month period in which the funds were to be disbursed. By contrast, a December 1984 AID report on the Commodity Import Program in Egypt stated that the macroeconomic effects of even the $300 million per year spent under that program were marginal in statistical terms. This report further stated that a significant macroimpact could only be achieved through a multifold increase in funding levels. It was inappropriate, therefore, to base conclusions about project success or failure on statistical reports reflecting movements at the macrolevel.

The logical framework set forth the following assumptions for achieving goal targets: the GOE would continue to liberalize the economy; foster private sector growth initiatives; and accept AID intervention in the credit sector. However, at the time of project approval, it was acknowledged that major policy reforms such as those dealing with exchange rate and interest rate issues transcended the capabilities of this project. Yet, the project was to be determined a success if major policy reforms happened, and a failure if they did not. In evolving, the PCP was measured by factors never identified as indicators of goal achievement in the logical framework, such as ability to rapidly move funds into the private sector.

A September 1982 memorandum from the Near East Bureau, requesting the Administrator's signature on the grant authorization, acknowledged that the lack of the required separate economic analysis in the Project Paper had been a major issue. Assurance was given that future efforts in the credit area would be based on complete economic and social analyses. An economic analysis was required by AID Handbook 3 to establish the relationship between project costs and the benefits to be derived in ways that can be quantified. Amendment #1 to the grant agreement was signed by USAID/Egypt on March 6, 1985, and added $20 million to project funding, but again no substantive economic analysis was done.

Section 621(b) of the Foreign Assistance Act requires AID to have a management system that includes the definition of objectives, the development of quantitative indicators of progress toward these objectives, the orderly consideration of alternative means for accomplishing such objectives, and the adoption of methods for comparing actual results of programs and projects with those anticipated when they were undertaken. AID Handbook 3, Chapter 12, states that AID's evaluation policies conform to the guidance provided by Section 621(b), including the development of quantitative indicators of progress. These requirements were not met in the design of PCP or the successor Private Sector Commodity Import Program Facility.

GOE Actions

The GOE did not carry out its commitments under the PCP, but instead took actions that impeded project implementation. While the GOE has continued to state its support for new private sector investment, impediments to private sector investment and development continue through a variety of import regulations and other measures.

Section 4.1 of the grant agreement required that the GOE, prior to the disbursement of grant funds, provide evidence of the formal establishment of a permanent Private Sector Steering

Committee to engage in regular discussions between the Mission, the GOE, and representatives of the private sector on credit and related issues. The Mission inappropriately considered that this condition precedent was met in July 1983 when Ministerial Decree No. 109 was issued establishing the Committee. Although established on paper, the Committee never met as many of the GOE members were soon transferred to other jobs unrelated to the project.

A second key condition precedent to the disbursement of funds required by Section 4.3 of the grant agreement was that the GOE establish an implementation plan for the training, technical cooperation, and studies activity component of this project. Such activities, estimated to cost $1 million, were to improve a variety of banking skills, including staff project appraisal capability and institutional capacity to review, approve and monitor transactions or subloans financed under this project. In addition, studies were authorized related to credit and the development of new financial instruments for the Egyptian banking system.

The date for meeting this condition precedent was extended three times and then waived in May 1984. The Mission subsequently received an evaluation plan from the GOE setting forth the date for beginning the first phase of training in March 1985 by sending eight participants to the United States. This date was 30 months after project authorization and the month in which project implementation was to be completed under the original grant agreement. As of the completion of our fieldwork in January 1986, $134,000 had been disbursed under this component. At that time, the Mission was also reviewing a proposal submitted by the Egyptian Bankers Training Institute for the purchase of training material and equipment totaling $500,000.

Problems also were experienced with the Ministry of Planning and International Cooperation (MPIC) relating to revisions in General Circular No. 1. This Circular was first issued in July 1983 and set forth formalized procedures by which the project was to operate. After the Mission thought negotiations for revisions to the Circular were completed in May 1985, MPIC unilaterally made changes that delayed start-up of fund disbursements under the $20-million project increment. The revised Circular was formally accepted by USAID/Egypt in September 1985, but the Circular contained provisions that the Mission took strong exception to. Of primary concern was the requirement that MPIC review all transactions prior to USAID/Egypt approval.

Collectively, these GOE actions suggest less than strong support for the project. This attitude needs to be closely assessed in the context of defining future project initiatives and the opportunities that exist for their achievement.

Management Comments

USAID/Egypt recognized that the PCP goals were ambitious and that some of the macroeconomic data to measure project effectiveness was not soundly based. Since the obligation of funds in 1982, a great deal of time and effort have gone into studying the Egyptian financial system. The follow-on PECP incorporates these results into its design. Accordingly, USAID/Egypt was of the opinion that the new project complied with Recommendation No. 1 to the extent possible given the factors surrounding the AID program in Egypt.

Office Of Inspector General Comments

Much work undoubtedly has gone into better understanding the Egyptian financial system. It is unclear, however, how this work has improved the follow-on Private Sector Commodity Import Program Facility of PECP.

The Project Paper for PECP has essentially remained unchanged from the Project Paper for PCP in terms of the issues addressed in this section of the report. For example, the project goal and purpose; the basis for measuring project goal achievement; and the assumptions for achieving goal targets, are all the same for PCP. At the same time, none of the major economic problems plaguing PCP were resolved nor were any new approaches for dealing with them developed. Further, the Project Paper contained no basis for optimism that the GOE was likely to move soon on these issues, or otherwise create an environment in which the project could effectively function.

Accordingly, the intent of Recommendation No. 1 has not been met.

2. Constraints Under Which The Project Operated Did Not Allow For Effective Implementation

USAID/Egypt was unsuccessful in getting the GOE to make the policy reforms that were prerequisites to project success. These reforms centered on the exchange rate at which project transactions were to be repaid and the interest rate to be charged borrowers of project funds. The Mission's inability to get the GOE to move on these issues meant that the exchange rate used to repay project transactions was far below the actual market rate, and that the interest rate charged borrowers of project funds was undervalued and discouraged long-term lending. The Mission was unsuccessful in overcoming these constraints through a policy dialogue with the GOE prior to project approval and in the four years since. This precluded effective project implementation with the exchange rate issue having the most serious consequences.

Recommendation No. 2

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, find a solution to the exchange rate problem that is not tied to ongoing policy dialogue with the Government of Egypt. The rate selected should be as close to the market value of foreign exchange as possible, and any deviation from the market rate should be justified. Any spread between the market exchange rate and the exchange rate used for transaction repayments should be indexed and kept constant over time.

Recommendation No. 3

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, determine what the real market interest rate would be for the types of loans to be made. If this rate is not adopted, any deviation should be justified and the effect on the attainment of project goals should be explained.

Discussion

Private sector importers having access to project dollars were provided a subsidy through the exchange rate. The value of this subsidy increased over time to the point where foreign exchange was being provided under the project at 43 percent less than market value by the completion of our fieldwork in January 1986. Expressed another way, the exchange rate used contained a 77-percent subsidy. This subsidy led to the project being characterized by critics as simply a cheap foreign exchange window rather than an effective mechanism for assisting the private sector satisfy its foreign exchange and credit requirements. Details concerning the exchange rate issue are contained in Exhibit 2.

From the time the project was submitted for approval, it was the center of considerable controversy. There were design problems which would not allow the project to function within limits that some in AID desired, specifically critics in the Bureau for Program and Policy Coordination (PPC). PPC took exception to the exchange rate at which transactions were to be repaid and the interest rate charged borrowers of project funds. Both of these rates were controlled by GOE policies that would not allow the project to operate in a free market environment.

Several courses of action were considered at the time the project was submitted for approval. Ultimately, a decision was made to reduce funding levels and limit the project scope to short-term credit interventions until satisfactory progress had been made towards resolving these issues. This approach limited the leverage available to get the GOE to move on reform issues.

The project as approved, therefore, contained only a short-term credit component with longer term credit components to follow contingent upon satisfactory progress being made in achieving the necessary reforms. The terms short, medium, and long-term credit were not defined. Project officials told us that short-term credit is up to one year; medium-term credit is one to three years; and long-term credit is over three years.

In an August 27, 1982 memorandum to the Administrator, the Near East Bureau provided the following rationale for this decision:

> "We are prepared to reemphasize our policy concerns to the Mission in the areas of interest rates and the foreign exchange regime, however, we point out that it was the Mission's judgement that these concerns could not be met, at least during the final four months of fiscal year 1982, that, in large part caused the Mission to give up the long-term credit component for this fiscal year."

It is evident from the above memorandum that even before PCP was formally approved in September 1982, the Bureau considered the project had problems with interest rates and exchange rates that could not be solved through the leverage the project could generate. Discussions concerning these problems were made part of the overall policy dialogue between the Mission and the GOE, but they remained unresolved as of the time the fieldwork was completed in January 1986.

Exchange Rates

In a November 27, 1985 response to a Regional Inspector General for Audit, Cairo memorandum expressing concern over the exchange rate issue, the Mission Director stated that the exchange rate was the highest priority issue in negotiations with the GOE. In these negotiations, the Mission was seeking approval to use the Commerical Bank Incentive Rate of LE1.35 to the U.S. dollar for PCP transactions. While this rate was much below the market rate, which was about LE1.77 to the dollar in January 1986, it was far better than the rate of LE1.00 to the dollar used for PCP transactions. (In August 1986, agreement was reached with the GOE to use the Commercial Bank Incentive Rate for certain dollar conversions and this rate is to be used for the follow-on project.)

The exchange rate subsidy appears to have changed the nature of the project from the originally intended purposes. Rather than focusing on constraints related to the private sector's access to foreign exchange, the actual effect of the project was to establish a system of subsidies for the private sector designed to offset subsidies provided the public sector. This thinking is recorded in Amendment #1 to the grant agreement signed in March 1985:

> "The Production Credit Project was developed during 1982 in order to continue AID's efforts to alleviate the constraint posed by the lack of foreign exchange for the Egyptian private sector at terms comparable to those for the public sector. The virtual monopoly of the latter group in securing foreign exchange at official rates of exchange (currently LE0.84 = US$1.00) has been one of the many impediments to private sector growth in Egypt."

The Egyptian system of subsidies favors the public sector vis-a-vis the private sector in terms of satisfying the need for capital. The private sector, therefore, is at a disadvantage in competing with the public sector for markets. The solution to this problem lies in getting the preferential treatment given the public sector removed. Setting up a dual system of subsidies for the private sector only serves to reinforce the system of irrational subsidies which the Mission is seeking to eliminate on the public sector side.

A June 1985 discussion paper addressing exchange rates used for credit programs prepared by the Mission's Office of Policy Analysis and Development supports this view. This document states that whereas programs such as PCP will represent a significant portion of future U.S. assistance to Egypt, they are not designed to assist private sector entrepreneurs that cannot obtain credit in sufficient quantities or with satisfactory maturities. Rather, due to the manner in which these programs are structured, the deeply discounted exchange rate may be the principal attraction of these programs. As a result, exchange rate subsidies are not in the best interest of either the GOE, which receives no benefit from them, or the U.S. assistance program, which seeks to make the most productive use of its scarce resources.

This paper further states that in the past the exchange rate discount has served as a rough proxy for the compensation to borrowers necessary to offset the conditions attached to loans, especially U.S. source and origin requirements. However, experience has shown that the cost of such procurement conditions is not closely related to differentials between the official and market exchange rates as this varies considerably over time and by type of transaction. Given these conditions, the paper established the principle that the exchange rate is not the appropriate means for adjusting lending costs under U.S. credit programs such as PCP.

Because the project offered below-market foreign exchange from the outset in 1982, it is not possible to know whether project dollars would have moved at acceptable rates were the dollars priced at their market value. Mission officials expressed concern that project dollars would not move at market rates. This concern indicates that the actual availability of foreign exchange is not the main problem, but rather the price at which the foreign exchange is available.

Subsidized foreign exchange lowers the cost of doing business and can translate into higher profit margins for those with access to it. As discussed later in this report, several firms we talked with admitted they were attracted to the project solely because of the cheap foreign exchange that added to profits. Subsidized foreign exchange also can lead to unwise investment decisions and eventually to business failures.

Credits provided in this manner tend, therefore, not to be used in ways that are best for the economy as a whole. According to a 1980 Area Auditor General/Egypt report, the subsidized exchange rate under the predecessor private sector CIP was a magnet for abuse and created the opportunity for the corruption and wrongdoing that was documented in the report. Therefore, even if a subsidy to the private sector was the principal project objective sought, exchange rate subsidies are the least desirable way to achieve the objective due to the: (1) potential created for windfall profits to be made by those not needing the subsidy; and (2) distortions created in investment decisions on the part of those who really do need financing assistance.

Even with the successful negotiations with the GOE and application of the Commercial Bank Incentive Rate to USAID credit programs, this higher rate is not without drawbacks. At LE1.35 to the dollar, this rate is still 24 percent under the market rate which was LE1.77 to the dollar at the completion of our fieldwork.1/ This means the repayment rate contains more of a subsidy element than it did at the time the controversy over this issue began in 1982.

Over time, it is possible that the spread between the Commercial Bank Incentive Rate and the actual market rate could be just as great as the exchange rates applied to PCP transactions. Thus, the use of the LE1.35 to the dollar rate must be considered a stopgap measure that alleviates the problem but does not fully correct it. The Mission, therefore, needs to seek a more lasting solution which will, among other advantages, free it from continuing to have to renegotiate a rate applicable to USAID credit programs every time there is a serious change in the value of the Egyptian pound relative to the U.S. dollar.

The House Committee on Appropriations expressed concern regarding distortions in the Egyptian economy in connection with the 1987 foreign assistance appropriations bill, stating that "long-term economic viability in Egypt can best be achieved by fundamental economic reform." In keeping with this concern, USAID credit programs in Egypt should be structured in a manner supporting this objective rather than reinforcing existing economic distortions.

Management Comments

USAID/Egypt welcomed a solution to the exchange rate question which would meet the criteria set forth in our recommendation. However, the Mission did not believe that a solution outside GOE policy dialogue is either possible or realistic. Further, the

---

1/ As of September 1986, the market rate was about LE1.93 to the U.S. dollar.

Commercial Bank Incentive Rate is to be applied to project transactions under PECP. The Mission contends that this is a flexible rate intended to track changes in the economy.

USAID/Egypt said that the report did not discuss the size of the subsidy that existed between the market exchange rate and the rate used to repay project transactions. It noted that there were some very real costs associated with the use of PCP funds. Further, the report did not contain support for the allegation that the project had been characterized as a cheap foreign exchange window. The Mission also said that with the elimination of traders from the project, the potential for windfall profits no longer posed a significant threat. Finally, the Mission believed that the subsidy element in the foreign exchange provided did not add any meaningful distortion in investment decisions over what would ideally occur in a market economy.

Office Of Inspector General Comments

Negotiating policy reforms with the GOE has proved to be a long and arduous task for USAID/Egypt, particularly in the area of exchange rates. The policy reform approach did not solve the exchange rate problem in the four years since the inception of PCP. Further, the PECP Project Paper provides no basis for optimism that a solution will soon be forthcoming. Rather, the leverage inherent in credit projects to bring about economic reforms will be dissipated under the policy dialogue approach. In the meantime, repayments continue to be made at significantly less than market rates with no mechanism in place to adjust for differences caused by market fluctuations.

We disagree that seeking a solution for the follow-on Private Sector Commodity Import Program Facility that is not tied to overall policy reforms would be impossible or unrealistic. In fact, such a precedent has already been set by the Mission in 1985 when it obtained an increase in repayment terms from LE0.84 to LE1.00 to the dollar. This was done in connection with the $20-million increase in PCP funding and did not accompany an overall change in GOE monetary policy.

It is unclear why USAID/Egypt took the position, in the report comments and in the PECP Project Paper, that the Commercial Bank Incentive Rate is flexible and could be expected to move in rough concert with the free market exchange rate. In March 1986, or four months before both documents were signed in July 1986, the Mission's Office of Policy Analysis and Development completed an analysis showing that this rate was neither close to, nor was any attempt made to keep it close to, the free market rate. Based on the divergence that existed between the Commercial Bank Incentive Rate of LE1.36 and the free market rate of LE1.93 as of September 1986, the use of this rate results in at least a 40-percent exchange rate subsidy.

USAID/Egypt was correct in saying that the report does not discuss the actual amount of the subsidy element inherent in the exchange rate used for transaction repayments. We did not feel that the amount of this subsidy could be generalized over the many hundreds of transactions involved, a position which is supported both by the Office of Policy Analysis and Development and the PECP Project Paper. Moreover, PCP was supposed to be a project that used a market-oriented approach to facilitate increased private sector involvement in the Egyptian economy and thereby promoted long-term economic growth and employment. The project was not authorized on the basis that a subsidy of some description was needed to accomplish these goals.

Concerning the availability of cheap foreign exchange, a 77-percent exchange rate subsidy in the loan repayment rate that existed at the time we completed our fieldwork would have to be considered a bargain. The Bureau for Program and Policy Coordination was the first to criticize the project as a cheap foreign exchange window in 1982 when the exchange rate subsidy was only 20 percent. Several others have made the same criticism since that time. For example, an April 1984 Term Credit Assessment Report recommended that the market foreign exchange rate be used for this project in order to serve both as a source of foreign exchange and as a credit facility. The team making this study concluded that the low exchange rate induced businessmen to borrow funds for the purpose of obtaining cheap foreign exchange; then they repaid the loans quickly and, in effect, did not use the credit facilities. As noted in the Mission's comments, the fact that about 24 percent of PCP transactions were made on a cash basis supports this conclusion.

Elimination of traders from PCP removed one group that could capitalize on the subsidy element for purposes of making windfall profits. As long as a large subsidy element exists, however, attempts will be made to capitalize on it. According to the PECP Project Paper, the follow-on Private Sector Commodity Import Program Facility will be used to meet legitimate credit needs and not simply as a window for below-market foreign exchange. Accordingly, the use of the facility to meet the raw materials requirements of established firms will be restricted, and lending to new firms that have not previously used project funds will be encouraged. These steps should strengthen the project and reduce the opportunities for windfall profits.

Regarding private sector investment decisions, the PECP Project Paper concludes that to the extent there is a major exchange rate differential, the effective cost of capital is reduced. In turn, low-priced capital creates a tendency to make investments which are not economically sound. We would agree with these statements.

Interest Rates

Interest rates applicable to loans made by banks in Egypt are set by the Central Bank of Egypt. Even the highest interest rates allowed by the Central Bank of Egypt are below the rate of inflation which in 1985 was estimated at about 20 percent. These interest rates are a maximum of 13 percent for industry, 13 to 15 percent for the service sector, and a minimum of 16 percent for trade transactions.

This interest rate structure discourages Egyptian banks from extending medium and long-term credit. Bankers tend to make loans yielding the highest returns and having the lowest risk. Thus, banks would prefer to loan funds for six months on trade transactions yielding a minimum of 16 percent interest, for example, than for riskier loans of longer duration allowing for business expansion on which the banks receive a maximum return of 13 percent. Of the 30 completed transactions that we traced to USAID/Egypt and bank records, 25, or about 83 percent, were for terms of one year or less. Three of the remaining five transactions were for terms between one and three years; two transactions were for over three years.

The interest rate issue surfaced as far back as April 1982 in a review by the Near East Advisory Committee--five months prior to project approval. At that time the Committee recommended that the Mission determine what the real market interest rate would be and require participating banks to lend at that rate. If this was not done, then the Comittee felt that the Mission should be required to explain and justify deviations from this approach.

The interest rate structure continues to be addressed in the context of the Mission's overall policy dialogue with the GOE, but was not considered an issue appropriate to address within the context of PCP. In the absence of a change in the interest rate structure, however, follow-on initiatives involving longer term extensions of credit must find ways to encourage banks to undertake riskier and less profitable longer term lending to sectors and firms deserving of support.

Management Comments

USAID/Egypt agreed that the interest rate structure in Egypt discouraged long-term lending and encouraged short-term trade financing. Nevertheless, the Mission did not expect to negotiate a separate interest rate for the follow-on Private Sector Commodity Import Program Facility because of an obligation to use interest rates prescribed by the Central Bank of Egypt even while seeking changes in this schedule.

Office Of Inspector General Comments

Many of the criticisms of below-market foreign exchange discussed earlier can be applied to undervalued interest rates. This is because these are the two major factors that determine the effective cost of capital and thus establish the economic parameters of investment decisions made by the private sector. Simply stated, the cost of capital is artificially reduced and investment decisions distorted when exchange rates and interest rates combined result in a net subsidy. Firms that have adequate access to credit, typically those in need of short-term loans, will apply for project funds, thus reducing the pool of funds available for productive private sector firms that can't find adequate medium to long-term credit. For this reason, such subsidies that reduce the cost of capital are not in the best interest of the GOE, which receives no benefit from them, or the U.S. assistance program, which seeks to make the most productive use of its scarce resources. In the case of PCP and the follow-on Private Sector Commodity Import Program Facility, the basic purpose of the project is changed from one based on a market-oriented approach for allocating project resources to one which simply provides subsidized forms of financial assistance. This assistance offsets subsidies received by public sector activities against which private investors compete.

If the Private Sector Commodity Import Program Facility is to use the current Central Bank of Egypt interest rate structure, other means are needed to encourage banks to undertake riskier and less profitable longer term lending to sectors and firms deserving of support. One way this can be done is to structure a system of incentives for bank participation as discussed in the next section.

3. Participating Banks Lacked Adequate Incentives To Support Project Initiatives

Project success was conditioned ultimately on the quality of implementation by the nine participating banks. These banks, however, were not provided incentives to align their interests in the project with those of the Mission. For example, banks received the same flat fee regardless of whether the transaction was paid in cash or on credit terms. This fee did not vary with the credit risks involved or other costs associated with the transaction. Further, these banks were required to assume the full financial responsibility for both principal and interest payments when credit terms were used, but received no added compensation for this risk. As a result, bank officials we interviewed tended to restrict participation in the project to their best customers with the highest credit ratings. These were not the firms most likely to make the best use of the funds in a manner supporting project goals.

Recommendation No. 4

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, establish a system of incentives that is in alignment with the costs and risks incurred by participating banks to: (1) engage in the types of transactions that best achieve stated project goals; and (2) encourage lending additional to that which otherwise would occur in the absence of the project.

Discussion

The project was implemented through nine participating banks--five public and four private--under General Circular No. 1. This Circular set forth the formalized procedures by which the project was to operate. Once Circular terms and conditions were agreed to between the Mission and the GOE, the primary responsibility for successful project implementation resided with the participating banks.

These banks were allowed a flat fee established by the Central Bank of Egypt stated as a percentage of the letter of credit amount regardless of whether the transaction was paid in cash or on credit terms. Banks were not allowed to keep the interest collected nor were they allowed additional compensation for the costs incurred in: (1) setting up the loan; (2) administering the loan; (3) making principal and interest payments to the Central Bank of Egypt in accordance with Circular terms; or (4) meeting Central Bank of Egypt and Mission reporting requirements.

Additionally, participating banks were required to assume full financial responsibility to the Central Bank of Egypt for any default by the customer in principal as well as interest payments.

We visited four of the nine participating banks--two public and two private--to: (1) verify the completeness and accuracy of Mission records; and (2) obtain bank comments on the project as a whole and specifically their role in it. A total of 35 transactions valued at $5.8 million were traced to underlying documentation in these four banks. No discrepancies were found in the documentation underlying these transactions which included principal and interest payments made by the participating banks to the Central Bank of Egypt.

We learned the most through discussions with the officials in the private sector banks. The information obtained orally and presented in this section, therefore, is primarily based on discussions with private sector banking officials.

One of the key objectives in visiting these banks was to find out how the project benefited them and their customers. All of the banks visited said that at the LE1.00 to the U.S. dollar exchange rate, they could use all of the foreign exchange they could get under the project. One of the private sector banks said it had to ration project funds by restricting amounts provided individual customers to $150,000 a year. The reason given for this practice was that the below-market exchange rate created a far greater demand for funds than could be met through the allocations received from USAID/Egypt.

The advantage of participating in the project expressed by both private sector banks was that it allowed them to offer their customers a financially advantageous service that was not otherwise possible. In the course of doing so, the banks were able to nurture customer goodwill.

It was not surprising, therefore, that private sector bank officials stated that access to PCP funds was generally limited to customers who had existing lines of credit and excellent credit ratings. These also tended to be their largest customers who were engaged in manufacturing. Sometimes these customers had sufficient Egyptian pounds to pay cash for the commodities purchased under the project or generated revenues to repay the debt over a very short production cycle of six months or less. This tendency to pay cash was confirmed in the transactions selected for review. Of the 35 transactions totaling $5.8 million in our sample group, 13 transactions totaling $2.3 million were paid in cash. That is, the payments were made without interest shortly after the goods were shipped from the United States.

One private sector bank official stated that his bank would not establish a new relationship (i.e. accept a new customer) for the purpose of engaging in a PCP transaction regardless of the transaction size. Bank policy requires that a full credit analysis be done before accepting any new customer and this cannot be economically justified for a single transaction. In the case of its regular customers, this bank would only reluctantly engage in small PCP transactions. When this was done, the customer was required to pay cash because the transaction cost too much in time and money to set up and administer loans for small amounts even though five-year terms were allowed for some transactions by the latest Circular.

This bank official stated that the policies by which his bank operated were applied worldwide and were not deviated from regardless of what was allowed by the Circular. Because of a requirement to assume the customer's liability to the Central Bank of Egypt for project transactions, the bank would not give approval unless a transactions fell within the customer's approved credit limit and the bank would have made a local currency loan in the same amount.

An official from the other private sector bank told us that when credit terms are extended under PCP, revenues are lost that they would otherwise earn from local currency loans made at the same interest rate to enable their customers to pay cash for the transaction. These bank officials pointed out that banks were not allowed to keep the interest collected from customers when credit was provided under PCP.

Officials of both private sector banks said they would not engage in project transactions unless they would make a local currency loan to the importer to finance the transaction under existing lines of credit. This meant that the credit terms available under the project substituted for credit that the banks would have extended if such terms were absent. Thus, these project transactions could not be considered additive nor could their impact be considered developmental.

That participating banks relied on intangible forms of compensation is also significant. One reason is that this concept is divorced from market realities which AID is attempting to promote through the project. Another reason is that, in the absence of forms of compensation that would allow the project to operate on a market approach, the project invited abuse due to the profits that stood to be made from the below-market foreign exchange.

Management Comments

USAID/Egypt clearly recognized that the interests of the banks implementing the program and those of AID would not always coincide. Nevertheless, the audit recommendation was rejected for three reasons. First, no further incentives were needed to attract banks to this program as there were many more banks willing to join than could be accepted. Second, bank profits in Egypt heretofore have been notoriously high and there was no need to use AID funds to increase them further. Third, banks were earning additional fees and commissions on capital that were additive to their own assets. Thus, the Mission saw no need to provide further incentives to participating banks.

Office Of Inspector General Comments

USAID/Egypt evidently misunderstood the intent of the audit recommendation. The success of credit initiatives such as PCP depends not only on the willingness of banks to participate in the project but also to align their interests with those of the Mission. These interests are not served by a fee structure that provides no incentives to pursue these interests and many incentives not to.

The deeply discounted exchange rate is a powerful incentive for banks to want to participate in the program and thus there are more than enough banks willing to do so. However, this should not be construed as evidence that these banks are willing to make the types of loans USAID/Egypt is interested in having made, such as those for longer durations and for riskier types of transactions.

Given present incentives, it makes little sense for participating banks to direct project funds to other than their best customers with the highest credit ratings. This conclusion is based on the fact that the demand for PCP funds was greater than supply, a substantial financial benefit accrued to those having access to the funds, and banks had to assume full financial responsibility to the Central Bank of Egypt for both principal and interest payments. On the other hand, these recipients were not those most likely to make the best use of project funds in achieving expanded productive output and employment.

The follow-on Private Sector Commodity Import Program Facility contains several modifications intended to achieve specific outcomes. These include: maximizing use of the Facility to meet legitimate credit needs; favoring plant construction and expansion; and encouraging lending to small-scale firms and those which have not previously used the project. At the same time, the banks are to assume a greater role in approving transactions without prior review by USAID/Egypt. In our opinion, it is not realistic to expect these outcomes in the absence of a system of incentives designed to bring them about. While we believe these changes are appropriate and will serve to strengthen the project, we also feel that they provide further reinforcement for the need to adopt our report recommendation if they are to be successfully implemented.

4. Better Targeting Of Project Funds Is Needed

The project was successful in moving funds into the private sector, but not necessarily in ways supporting the project goals of expanded Egyptian private sector output and employment. USAID/Egypt did not identify priorities for private sector development nor establish criteria to ensure project funds were targeted to meet these priorities. Further, because the project was not operated on a market-oriented approach, market forces could not be relied on to determine the appropriate allocation of project resources. As a result, assurance was lacking that project funds were used in the manner intended. Based on discussions with selected Egyptian importers, there were many indications this was not happening.

Recommendation No. 5

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, establish:

a. priorities for private sector development; and

b. criteria for targeting project funds to sectors and firms within those sectors that are most likely to use these funds to achieve project goals.

Discussion

An April 1982 memorandum setting forth the Near East Advisory Committee comments on the Project Identification Document stated that while employment generation was a major thrust of the Mission's strategy in Egypt, the proposed project made no attempt to address how to assist in attaining this important and critical objective. Accordingly, there was a recommendation that the Project Paper incorporate employment potential directly into the project design. Included in the ways mentioned to do this were using employment as a criterion for loan approval and using project funds to identify productive sectors with the greatest potential for employment generation. Notwithstanding the concerns expressed, the Project Paper did not explore or set forth criteria for dealing with this issue.

The disclosure that participating banks were provided with no incentives to participate in the types of transactions that would most likely result in expanded output and employment led to our concern that the transactions entered into were not likely to be additive. In other words, the transactions did not cause investment decisions to be made that would not have been made in the absence of the project and their impact, therefore, could not be expected to be developmental.

Eight importers who had received project funds were interviewed --two from each of the four banks--to obtain their views concerning project benefits and possible improvements. A representative cross section of PCP customers engaged in different types of business activities was selected. Two were traders and six were end-users. The end-users were engaged in the production of products such as batteries, poultry, electrical cable, pharmaceuticals, and plastic bags. The commodities imported included copper wire rod, plastics, animal feed, small equipment, solid news-board, and parts for earth-moving equipment. These transactions ranged from $10,000 to $500,000 and totaled $1.1 million. The commodities imported and the firms importing them are included in Exhibit 3.

These importers were candid in acknowledging that their primary attraction to the project was the cheap foreign exchange. Ease of obtaining foreign exchange was a secondary advantage. Most, if not all, of the commodities obtained would have been purchased even if project credits were not available, although probably not from U.S. suppliers. When asked how an increase in the exchange rate would affect their desire to continue participating in the project, the importers stated that an increase might force them to consider obtaining their foreign exchange requirements from other sources.

In the case of the larger Law-43 (joint) Egyptian ownership companies, the foreign exchange obtained under the project tended to be small in relation to their total annual needs, ranging from four to seven percent. Conversely, the amount of foreign exchange supplied under the project to the smaller firms tended to be much greater in proportion to total requirements, ranging from 17 to 75 percent.

The effect that PCP credits had on business operations was unknown because the underlying financial records of the firms visited were not reviewed. It appeared, however, that these credits primarily served to add to existing profit margins. This view was supported by both private sector banks officials who stated that the transactions engaged in by their banks served to increase the profits that would otherwise be made by their customers. In the case of one large Law-43 company, a company official said that the subsidy element helped offset losses resulting from GOE pricing policies. This official said that the same item would have been purchased from the same source (i.e. their parent company in the United States) even had the company not received project funds.

The most frequent suggestion to make the project better was to establish funding targeting. Recognizing that funds were limited and probably would never be large in relation to total private sector needs, there was a feeling that more tangible accomplishments would be possible if criteria were established for the targeting of project funds.

The interviews also raised questions concerning the uses made of project funds and whether these uses were appropriate given limited project resources. For example, a large Law-43 company was in an industry where the GOE dictated production levels as well as the prices charged for products. In some cases, these prices were below the cost of producing the products. The company could not get a price increase approved for the products and continues to lose money producing them. Company officials told us that the subsidized foreign exchange obtained under the project is used to help offset the deficit incurred in producing one of the products with the greatest losses.

The types of activities engaged in by the importers interviewed raised a number of questions concerning the use of project funds.

- -- Should PCP funds be used to help keep a company solvent, or product lines profitable, when GOE policies control the prices that can be charged?
- -- Should PCP funds be used to benefit Law-43 companies that have some degree of government ownership and thus cannot be considered fully private sector?
- -- Should PCP funds be used to help offset pricing policies imposed by the GOE on an industry and companies within that industry regardless of the degree of private ownership?
- -- Should both large and small companies alike be entitled to equal participation in PCP when the relative benefits to be derived differ vastly?

Most importers could purchase any item on the AID eligible commodity list under PCP with certain exceptions such as luxury goods and consumer goods that are not eligible for financing under the provisions of General Circular No. 1. The resulting participation is too broad. USAID/Egypt and the GOE need to establish which sectors of the economy have priority over others. Further, a "needs" test to be applied to importers within those sectors would ensure that project dollars result in something additional to that which would have happened in their absence. This test is clearly not met when dollars are provided large multinational firms to substitute for dollars these firms would have obtained at market rates to import the same items.

The commodities imported and the firms importing them are listed in Exhibit 3. Analysis of the related transactions showed how Egyptian importers realize windfall profits. The potential for these profits is greatest when the cost of money represents a substantial part of total costs and the commodities imported move quickly at established market prices. In such cases, a 70-percent plus foreign exchange subsidy could directly translate into a multifold increase in profits with none of the benefits passed on to the ultimate consumer or to the economy as a whole.

Because the Mission determined that the possibility of windfall profits was most prevalent in the case of traders, they were eliminated from the project. To a lesser extent, windfall profits are still possible for many of the transactions engaged in under PCP. Most of the imported commodities in our sample were raw materials used in manufacturing basic end products like plastic bags, or otherwise quickly consumed like feed used in the production of chickens sold two days after they are hatched. Accordingly, the cost of capital represented a large part of total costs. None of the firms interviewed lowered their product prices as a result of the discounted foreign exchange; one firm said it would not be allowed to lower prices as they were set by the GOE.

Priorities for private sector development should be identified and workable criteria established to funnel project dollars to sectors and firms that are most deserving in terms of these priorities.

Management Comments

USAID/Egypt said that the issue of targeting was examined on several occasions and rejected, and that targeting was exceptionally complex and fraught with implementation problems. The Mission questioned the premise that USAID/Egypt make judgements about which firms or sectors have potential and/or a comparative advantage in production in the complicated Egyptian marketplace.

Office Of Inspector General Comments

Had PCP operated on a market-oriented approach, we would agree with USAID/Egypt that there would probably not be a compelling need to target funds. This is because market forces could be relied on to determine the appropriate allocation of project resources. As documented earlier in this report in regard to the exchange rate, interest rate, and fee structure for participating banks, however, PCP and the successor Private Sector Commodity Import Program Facility are largely divorced from market realities. In the absence of any fundamental forward movement about these issues, we continue to believe that targeting is needed if there is to be any assurance that project funds reach those sectors and firms most deserving of support.

While the documentation underlying the Private Enterprise Credit Project supports the Mission's position that targeting had been examined, we found no evidence of rejection. In fact, the modifications set forth in the Project Paper for the Private Sector Commodity Import Program Facility, as discussed in both the previous section and this section of the report, clearly represent a form of targeting. We do not believe, however, that this targeting is sufficiently definitive or far-reaching. The Project Paper, for example, shows concern for the agricultural sector in connection with a discussion of the interest rate structure, and the Project Identification Document discusses the need to provide funds to firms with export potential. These ideas were not brought forward, however, in terms of the lending objectives to be given the participating banks. Further, we question whether the lending objectives to be given the banks are workable. This is because no specific criteria or mechanism was set forth for evaluating performance against these objectives.

B. Compliance And Internal Control

Compliance

The audit showed that the project was not in compliance with AID regulations requiring establishment of realistic and achievable project goals supported by sound economic and social analyses and verifiable indicators of goal achievement that can be objectively verified. The project also was not in substantive compliance with conditions precedent relating to establishment of a committee for purposes of discussion on credit and related issues. Another condition precedent related to establishing an implementation plan for the training, technical cooperation, and studies component was waived. Other than the items cited, tested items were in compliance with applicable laws and regulations. Nothing came to our attention that would indicate that untested items were not in compliance.

Internal Control

Internal controls were adequate in regard to the transactions traced through to participating bank records, which included principal and interest payments made by these banks to the Central Bank of Egypt. Possible weaknesses were noted in the control systems over deposits made into the Special Account as a result of loan repayments. This issue is the subject of a separate audit by the Regional Inspector General for Audit, Cairo.

PART III - EXHIBITS AND APPENDICES

Office Of Inspector General Analysis Of Design And Approval Documents Related To The Private Enterprise Credit Project

This analysis was done in August 1986 because USAID/Egypt responded to the draft report on the Production Credit Project by saying some of the problems reported on would be corrected in the follow-on Private Enterprise Credit Project. The analysis is presented in the same sequence as the findings in the report text so readers can consider each of the issues separately.

From fiscal year 1977 through fiscal year 1981, $137 million was disbursed under the private sector component of the Commodity Import Program. Drawing on this experience, the Production Credit Project was developed in 1982 along similar lines. A new Private Enterprise Credit Project was approved by USAID/Egypt in July 1986. The project contains three major components, two of which are to receive funding totaling almost $235 million. This funding is to be split evenly between these two components and spread over a three to four year disbursement period. One of these two components--the Private Sector Commodity Import Program Facility--represents a continuation of the efforts carried out under the Production Credit Project.

Project Goal And Purpose

The Project Paper for the Private Enterprise Credit Project stated that the project goal was to increase the private sector's contribution to Egyptian productive output and the project purpose was to expand investment of productive private sector enterprises. Thus, the goal and purpose for the project as a whole were the same as those for the Production Credit Project. Although the Project Paper for the Private Enterprise Credit Project contained much more data than the Project Paper for the Production Credit Project, the goal and purpose were no more realistic or achievable.

The Project Paper for the Private Enterprise Credit Project ackowledged the inability of the Mission to overcome the major economic reform problems confronting the Production Credit Project in the four years since its inception--specifically the exchange rate and interest rate issues--but proposed no new approaches for dealing with them. Further, the paper was not optimistic that the Government of Egypt was likely to move soon on these issues, or otherwise create an environment in which the project could effectively function.

Also, the logical framework for the Private Enterprise Credit Project set forth the same published statistical reports as stated for the Production Credit Project reflecting economic movements at the macro level as the basis for measuring the achievement of the project goal. Economic statistics gathered from such sources can not accurately gauge project achievements given the modest size of project funding levels. The Project Paper admits statistical information is not available to substantiate the correlation between project-induced increases in private sector investment with increases in Egyptian productive output. The Project Paper adds that the relative magnitude of project impact can only be inferred.

The logical framework sets forth the same assumptions for achieving goal targets while acknowledging that the major policy reforms underlying these assumptions were both unlikely and transcended the capabilities of this project to achieve.

The following statement, taken from the Project Paper, appears to reflect a general frustration concerning the overall slow rate of progress USAID/Egypt has been able to make during the last ten years in dealing with major economic reform issues affecting the private sector.

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

Exchange Rates

The Project Identification Document stated that the foreign exchange rate to be applied to USAID credit programs in Egypt was a key issue. When U.S. dollars are passed through to borrowers at a deeply discounted exchange rate, access to cheap foreign exchange becomes a principal attraction. Firms having access to credit will apply for funds simply to obtain the foreign exchange discount, thereby reducing the pool of funds available for productive private sector firms that can't find adequate medium to long-term credit in the Egyptian market. For this reason, the Project Identification Document stated that exchange rate subsidies are not in the best interest of either the Government of Egypt, which receives no benefit from them, or the U.S. assistance program, which seeks to make the most productive use of its scarce resources.

In regard to the Production Credit Project, the Project Identification Document stated that the exchange rate discount had increased over time to an amount far greater than could be justified by the higher cost of U.S. goods. It stated that the follow-on Private Enterprise Credit Project should (1) be developed using the principle that the exchange rate is not the appropriate means for adjusting lending costs under U.S. credit programs, and (2) use an exchange rate which is at, or close to, open market rates. Also, the exchange rate selected should move up or down in rough concert with the market rate.

The Project Paper stated:

> "Since AID is interested in improving Egypt's economic performance, project imports should be priced at their true scarcity value. Unless there are additional costs, use of an overvalued exchange rate results in a net benefit in terms of resource transfer to Egyptian importers. To the extent that there is a net foreign exchange benefit, the effective cost of capital to the private sector is artificially reduced. This, in theory, provides an incentive to invest in projects with lower than desirable rates of economic return. It also may encourage inappropriate capital intensive investments resulting in lower output, employment and growth than would otherwise occur."

The Project Paper stated that the Commercial Bank Incentive Rate was to be used for Private Enterprise Credit Project transactions to avoid further market distortions because it fluctuated in relation to the free market rate. It noted, however, that many public corporations and agencies use the rate and, since it is administratively set by the Central Bank of Egypt, the Government of Egypt has an incentive to keep it low.

A March 1986 memorandum from the Mission's Office of Policy Analysis and Development to the Mission's Deputy Director noted that no attempt was being made to keep the Commercial Bank Incentive Rate close to the free market rate. This statement was based on an analysis showing the bank incentive rate was LE1.275 to the U.S. dollar when it was established in April 1985 and nearly one year later had increased to LE1.34 to the dollar (a 6.5 piaster, or five percent increase). During this same period, the free market rate had risen from LE1.41 to the dollar to LE1.81 to the dollar (a 40 piaster, or 28 percent increase). It concluded, therefore, that prevailing market considerations calling for a much higher rate had lost out to Government of Egypt economic policies calling for maintaining an undervalued exchange rate.

This divergence in rates has continued. Between March and September 1986, the Commercial Bank Incentive Rate had increased to LE1.36 to the dollar (a 2 piaster, or one percent increase) whereas the market rate had increased to LE1.93 to the dollar (a 12 piaster, or seven percent increase). Thus, the exchange rate to be used for project repayments under the Private Sector Commodity Import Program Facility already contains a 42-percent subsidy element prior to the disbursement of any project funds. This subsidy, which could increase even further, is already twice the subsidy that was strongly opposed by the Bureau for Program and Policy Coordination at the time the Production Credit Project was approved in September 1982.

Interest Rates

A September 1985 memorandum setting forth the Asia and Near East Project Advisory Committee comments on the Project Identification Document stated that interest rate distortions will affect all three project components, but would have a more pronounced impact on credit having longer repayment schedules. This memorandum stated:

"In Egypt, interest rates on loans are set by the Central Bank without regard to market forces and are presently: minimum 16 percent for traders, 13 - 15 percent for service sector, and 11 - 13 percent for industry and agriculture. Such a rate structure discourages bankers from lending to industry and agriculture, thereby hindering development in those sectors. The PID proposes to develop a formula of interest rate plus extra fees so that the cost of borrowing for the industry and service sectors equals the 16 percent rate for traders."

The Project Identification Document explained that bankers like higher returns and, therefore, prefer to make loans to traders rather than industrial and agricultural borrowers. The document pointed out that the interest rates allowed to be charged industry and agriculture may not be adequate to cover the cost of funds let alone the costs of loan administration, bad debts, or provide for a profit. This document further stated:

"Consequently, the design team will recalculate costs and, if needed, will recommend a formula or combination of interest rates and extra fees so that cost of borrowing for industry and services is approximately equal to traders' cost of borrowing. If the GOE cannot agree to such fees, then the Mission may consider incentive payments to banks for a limited period."

The Project Paper stated in regards to the same issue:

"Since there is no evidence that the GOE plans to remove the interest rate controls, or otherwise provide for access to term credit for private firms, the major purpose of this project is to use U.S. funds to help offset GOE regulations that inhibit loans to the private sector, especially term loans."

The Project Paper went on to state that borrowers might not use AID resources if they are offered at 14 to 15 percent interest rates. The paper appeared to reflect a continuation of the same concern expressed in the Asia and Near East Project Advisory Committee review as to whether there would be a demand for funds for bankable projects at a higher cost of capital than presently exists.

The comments regarding interest rates concern us for a number of reasons. First, they show there has not been, nor is there likely to be, any policy change by the Government of Egypt in regards to interest rates in the near future. Second, even if these rates were increased for longer term extensions of credits, there may be a limited demand for the funds due to the lack of any demonstrated bankable projects at the higher cost of capital. Third, rather than using market oriented approaches for allocating project resources, it appears that the real purpose of the project is to simply provide subsidized forms of financial assistance to offset those received by public sector activities against which private investors compete. Setting up a dual system of subsidies for the private sector only reinforces the system of irrational subsidies which the Mission is seeking to eliminate on the public sector side.

It appears that the Private Enterprise Credit Project has not been adequately justified in the context of its real objectives and is vulnerable to criticism that it is to be implemented in a manner that runs counter to the achievement of its stated project goal and purpose and the assumptions underlying their achievement. Rather than breaking down barriers impeding private sector growth and development based on the true cost of capital, the project is probably reinforcing these barriers by promoting subsidies which distort the real cost of investment decisions.

Incentives To Participating Banks

The Project Paper for the Private Enterprise Credit Project contained no discussion of the financial incentives provided participating banks. However, it outlined several changes to be made in the Private Sector Commodity Import Program Facility to make this component more efficient and responsive to the credit needs of the private sector. The paper stated that the demand for funds was likely to exceed supply, and thus it was necessary to establish objecives for encouraging specific types of activities. These objectives were fivefold:

-- To maximize the use of the facility to meet the credit needs of the productive private sector and minimize its use as simply a window for below-market foreign exchange.

-- To favor credit for new plant construction, plant expansion, or replacement of capital equipment in existing plants, and not to meet the raw materials requirements of established firms.

-- To encourage lending to new firms which have not previously received project funding.

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

-- To encourage lending to small-scale firms.

Participating banks are to be given a written statement of USAID/Egypt and Government of Egypt objectives and periodic evaluations are to be undertaken. Fund allocation is to be based on the responsiveness of the banks in meeting these objectives. These banks are to assume a greater role and will be delegated the right to approve transactions without prior review by the Mission. However, no specific criteria or mechanism was set forth for evaluating performance against these objectives.

Targeting Of Project Funds

In addressing the issue of whether the Private Enterprise Credit Project should target credit to specific industries or types of borrowers, the Project Identification Document states:

> "It is noted that future program strategies include selection of specific target sectors consistent with AID's fundamental private sector development objectives, such as the automotive industry, tourism, horticulture exports and export development in general. The PP design team will consider sectoral targeting since funds available for private sector purposes are not substantial enough to have meaningful impact if spread throughout the economy."

The document further stated that the design team must consider providing guidance to participating banks in terms of AID's preferences for lending. Examples cited were firms that export, manufacture products in which Egypt has a comparative advantage, and produce products which have an economic advantage over imports.

The Asia and Near East Project Advisory Committee review comments noted that if the demand for funds substantially exceeds availability, the Mission will want to develop criteria for targeting classes of preferred borrowers. It was suggested at this time that the Mission build into the project structure a mechanism for the annual review of this question.

In connection with the Private Sector Commodity Import Program, the Project Paper states that the demand for funds is likely to exceed supply and set forth objectives to be given to the participating banks to be used in evaluating their performance. These objectives include favoring credit for new plant construction, plant expansion, or replacement of capital equipment in existing plants; minimizing the use of the facility to meet the raw materials requirements of established firms; encouraging lending to new firms which have not previously received project funding; and encouraging lending to small-scale firms.

History Of Concern Over The Exchange Rate Issue

The Project Identification Document for the Production Credit Project was approved on the basis that either credit was to be provided in local currency, leaving the borrower to obtain foreign exchange in the open market, or that the foreign exchange loaned out would be repaid at market rates. By the time of project approval in September 1982, however, this mechanism had been revised where loans made in U.S. dollars were to be repaid in Egyptian pounds at the official exchange rate. At that time, the official rate was LE.84 to the dollar whereas the market rate was LE1.00 to the U.S. dollar. This represented approximately a 20 percent subsidy which surfaced as a major issue at the time the action memorandum was signed on September 21, 1982 authorizing the grant agreement.

The Bureau for Program and Policy Coordination was most vocal in its objections to this subsidy because they felt it was not justified, against Agency policy, and contrary to the agreements reached in the development of the Project Paper. Program and Policy Coordination's arguments against this subsidy were that it:

- -- Represented a major departure from the original project design. Rather than the project requiring private sector importers to conduct business within the discipline of the market, the discounted foreign exchange would allow them to engage in transactions which would not be profitable at the free market exchange rate.

- -- Perpetuates existing economic dislocations rather than encouraging their elimination. Thus it runs counter to building a healthy private sector based on real-cost investments. When a project is structured so that profits can be made from most any investment, this negates the notion of free market forces and competition.

- -- Reinforces the notion that the United States and the Government of Egypt are promoting a liberalization of the Egyptian economy in a manner which contributes to the enrichment of a few while ignoring the needs of the many.

The Bureau for Program and Policy Coordination further objected to the $20 million project amendment because of this subsidy for the exact same reasons. In an August 1984 memorandum, the Bureau for Program and Policy Coordination noted that circumstances had changed substantially for the worse since the time of original project approval, with the spread between the official rate and market rate more than doubling. The Bureau for Program and Policy Coordination stated that they believed that private sector demands for foreign exchange were being met far better then than when the project was approved in 1982 and that the project was serving to substitute subsidized money for market rate money.

The spread between the official rate and the market rate was a source of concern to the team that prepared the Project Evaluation Summary on the Production Credit Project approved in February 1985. Their report stated that this spread was beyond what could be justified and that foreign exchange costs should be increased. This report further stated that exchange rate subsidies which lower the effective cost of capital are not economically desirable, explaining that:

> "To the extent that there is a net subsidy, the effective cost of capital to the private sector is artificially reduced. This provides an incentive to invest in projects with lower than desirable rates of economic return. The result is lower output, employment and growth than would otherwise occur. When offering foreign exchange at lower than market rates, the donor must choose between providing all the credit that is demanded at that rate, or of restricting the amount while allocating it by nonprice rationing. In the former case, one must ask how long the donor intends to supply all that the market will take. In the latter, first come first served rationing will probably lead to an inefficient portfolio of investment projects."

Early into the audit of the Production Credit Project, we drafted a memorandum dated October 1, 1985 to the Mission Director outlining our concerns over the exchange rate issue. By that time, the market rate had increased to LE1.70 to the dollar whereas the exchange rate applicable to project disbursements had increased to only LE1.00. This constituted almost a 40 percent discount, meaning that those participating in the Production Credit Project could obtain dollars at only 60 percent of their market value. Since the date of our memorandum, the Mission has aggressively pursued a policy dialogue with the Government of Egypt to use the bank incentive rate for Production Credit Project transactions which has approximately a LE1.35 to the dollar exchange rate.

In an October 27, 1985 letter to Ministry of Planning and International Cooperation, the Mission Director stated:

"With regard to Private Enterprise Credit, our paramount concern is that this program not only stimulate productive private enterprises but that it also conserve foreign exchange and allocate that foreign exchange to the most economically productive activities. Imports of capital goods and intermediate products at below their free market value would result in commercial operations which would receive unneeded subsidies, and become a drain on the economy, thus defeating the purpose of the program. I believe the best way to prevent this is to provide foreign exchange at a rate which reflects current market conditions in Egypt. I also recognize that there is some need to discount dollars under this program because of U.S. and Government of Egypt procedures and because of the current high cost of U.S. goods and transportation. I, therefore, propose that we use the fluctuating commercial bank incentive rate as the basis for calculating repayment under the Private Enterprise Credit Project."

In a November 27, 1985 response to our memorandum, the Mission Director stated that in negotiations with the Government of Egypt concerning the Private Enterprise Credit Project, USAID/Egypt made the exchange rate their highest priority issue. He further stated that he was not happy with a continuation of a subsidy to the private sector through this project, but did not expect a rapid change in policy to permit the project to operate at a market exchange rate. In August 1986, agreement was reached with the Government of Egypt to use the Commercial Bank Incentive Rate for USAID/Egypt credit projects.

LIST OF COMMODITIES IMPORTED FOR SELECTED TRANSACTIONS

Importer/End-Users	Commodity	Transaction Amount
1. Amoun Contracting Company Import, Export and Agencies	Telescopic Crane	$151,367
2. Bim Bim Sweet Factory	Bubble Base	174,507
3. Taki Vita	Toulene Dusoynate	250,000
4. Union Carbide Egypt	Solid News-board	10,140
5. Walid For Food Security	Soybean Meal	242,896
6. Thomas Factory For Household Appliances	Electrical Motors For Washing Machines	186,500
7. Squibb Egypt	Punches and Dyes for a Press	12,618
8. Seti First Travel	Marine Motors Generators, Accessories	265,229
9. Salama Plastic Factory	Low Density Polyethylene	250,000
10. Pfizer Egypt	Switchboard	32,034
11. Plasto Metals Factory	Low Density Polyethylene	339,950

12. Ahmed Mostafa Ahmed Aly	Irrigation System	69,059
13. Asfour Company For Crystal Production	Air Compressor	91,200
14. Cairo Trading and Distribution Company	Polypropylene	14,000
15. Delta Plastic Company	High Density Polyethylene	229,015
16. Dr. Mohamed Aly El-Meligui	Ultra Sonic Scanning System	30,000
17. Egyptian Company For Electric Wires	Copper Wire Rod	162,670
18. Egyptian Food Industries	Citric Acid	38,752
19. El-Derwy Farm For Food Security	Soybean Meal	499,968
20. El Nisr Brush Factory	Bristles	249,845
21. El Shehaby Factory for Tin and Plastic Works	Polyethylene High Density	98,222
22. Port Said For Plastics	Polyethylene	99,707
23. German School for Sisters of St. Charles Barromeo	B [illegible]'s	36,500
24. International Company For Readymade Garments	Prefabricated Building	307,254
25. Magdi Mounir Ghobrial	Copper Wire Rod	190,000
26. Makhlouf Sons For Plastics	Polypropylene	67,200

u3

27. Middle Delta For Plastic	Polyethylene High Density	78,834
28. Misr Poultry	Parent Chicken Breeding Stock	116,708
29. Mokhtar Abd El-Halim Maamoun	Soybean Meal	499,800
30. Nassar Plastics Factory	Polyvinyl Chloride	79,650

Importer/Traders

1. Al Watania Company For Trade and Chemicals	Vegetable Seeds	38,573
2. Anwar Basta Export and Import Company	Spare Parts for Earth Moving Equipment	163,234
3. Carlin Middle East	Spare Parts for Earth Moving Equipment	271,714
4. Chemical Laboratory "Dr. Ahmed Fouad Hettal"	Laboratory Equipment	10,005
5. Commerce Company	Lifts	30,078
6. Egyptian Company For Importing, Contracting and Trade	Refrigeration Equipment	69,850
7. Egyptian Seeds Oil and Chemicals Company	Vegetable Seeds	173,856
8. El Ektessadia Company	Generator Set with Diesel Engine	117,486
9. Gesca Company	Medical Equipment	117,850
10. International Trade and Industry Corporation	Polyethylene	358,392

11. Magdy Ezzat Elia	Polyethylene	61,750
12. Marine Propulsion and Supply Organization	Welding Machines	45,300
13. Misr Trading and Investment Company	Freon Gas	120,939
14. El Tawil Manufacturing and Trading Company	Polyethylene	78,225
15. Sofico Pharmaceuticals	Polyethylene	499,845
16. TransWorld For Trading and Agencies Company	Polyethylene	282,100
17. Salem Company	Prefabricated Building	256,793
Total		$7,569,615

UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

CAIRO EGYPT

8 JUL 1986

M E M O R A N D U M

TO: Mr. Joseph R. Ferri, RIG/A/Cairo

FROM: Frank B. Kimball, Director

SUBJECT: Draft Audit Report on Production Credit Project - No. 263-0147

The mission's response to the subject report is attached.

Thank you.

Att: a/s above

UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

CAIRO, EGYPT

July 3, 1986

TO: Joseph R. Ferri, RIG/A

FROM: David L. Cowles, DOD/CMT and James C. Suma, OD/F

THROUGH: Homi Jamshed, Controller Office

SUBJECT: Draft Audit Report: Production Credit Project - USAID/Egypt Project NO. 263-0147

The draft audit report on the Production Credit Project is termed a Program Results audit. We found that the scope goes well beyond that of a traditional audit.

On page 6 the audit concludes that, ".... USAID/Egypt's transaction review and approval process was adequate to insure compliance with AID policies and regulations. In addition, no discrepancies were found in the transactions traced through to participating bank records. Internal controls over transaction approvals and disbursements were adequate." Given the 520 separate transactions approved by USAID as of the December 31, 1985 audit closing date, we are gratified by the audit's conclusion which reinforces the earlier project evaluation finding concerning the quality of project execution. As of 6/30/86, 586 transactions worth $86,829,228.77 had been approved in like fashion.

The audit goes on to discuss and examine such additional issues as whether the indices set forth in the logical framework for measuring project success were valid and realistic, and whether the project was being implemented in a manner supporting its stated goals, and likely to bring about the desired outcomes. We note that the audit duplicates, to a marked extent, work done by a four man team mobilized to evaluate the Production Credit Project in December of 1984. Interestingly and we believe worthy of mention the final audit report, is that the conclusions of the prior project evaluation and this audit report do differ on several major issues.

The draft audit report relies and draws extensively on a review of internal AID correspondence, files, and documents. It cites and quotes cables and memos in which such issues as interest rates and foreign exchange rates were extensively discussed and debated within AID before decision. In this respect, the audit provides little new information or data on the impact and results of the credit program but does reargue the decisions previously made by Mission management. Furthermore, while on page 5 the audit states its "findings and conclusions" were discussed periodically with the Project Officer at informal meetings, it is a fact that at no time were these findings and conclusions discussed with the Office Director or other Mission management 1/ why a particular course of action was decided and embarked upon. Given the

1/ Auditor's Note - The Project Officer was designated as Mission liaison for the audit, and throughout our review he was kept thoroughly informed. The Office Director never requested a briefing; however, complete discussions were held with the Office Director on all matters in the draft report prior to requesting the Mission's official comments.

conditions under which AID programs in Egypt operate, we believe this management input would be highly important for a balance report. Also credit activities to the private sector here have and remain controversial. We think the audit, despite its volume, misses the policy considerations involved

Hereafter this response to the draft audit report will not proceed page by page but will instead deal with each of the five audit recommendations. Please do note however that the project number for the Production Credit Project is incorrectly shown on the title page as 263-0047; the correct number is 263-0147. In Appendix 1, audit recommendations 3 and 4 are identical.

Recommendation No. 1

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Enterprise Credit Project (PEC):

a. redesign the project around meaningful and realistic goals and purposes and a specific developmental need it is capable of addressing; and
b. develop quantifiable indicators that are capable of being objectively verified to measure goal achievement.

Response

We recognize that the project goals under the Production Credit Project (PCP) were ambitious and that some of the macro-economic data to measure project effectiveness was not soundly based. This was a major finding of the earlier Evaluation Report as well.

Since the obligation of funds for the PCP in August of 1982, a great deal of time and effort has been spent studying the Egyptian financial system and its shortcomings in meeting private sector financial needs. The Foda Term Credit Study and his prior Banking Survey plus the Term Credit Assessment Report, available in FI, are but three such efforts we undertook.

The PEC project incorporates the results of these various study efforts into its design. The Mission's opinion is that the new project complies with Recommendation No. 1, to the extent possible given the basic factors involving the AID program in Egypt. For example:

- the goals are more realistic than those of its PCP predecessor
- the problem is much better understood
- the resources to address the problem are greater
- there are multiple interventions including a long-term credit element, and a small scale enterprise credit guarantee fund
- the short to medium term credit element has been modified and will be implemented as a CIP
- the quantifiable indicators have been established to measure goal achievement.

Recommendation No. 2

We recommend that USAID/Egypt prior to authorizing the disbursement of funds under the follow-on PIC project; find a solution to the exchange rate problem that is not tied to overall GOE policy reform. The mechanism selected for loan repayments should contain an objective measure of the value of the foreign exchange provided. Any spread between market exchange rates and exchange rates used for transaction repayments should be indexed and kept constant over time.

Response

The Mission, as well as IMF and the World Bank, seek and would welcome a solution to the exchange rate question which would meet the criteria set forth in this recommendation. However, we do not believe that a quick and easy solution outside of GOE policy reform is either possible or realistic Two points in this regard. The Administrator of AID has determined that through policy dialogue, the seeking of GOE macro-economic reform is an essential, vital element of the AID program to Egypt. To recommend that USAID/Cairo implement its credit program outside of this strategy is not acceptable and we are obliged to reject this recommendation.

Number two is that as of 7/1/86, the "bank incentive rate" will be applied to all AID credit programs and projects. This is a flexible rate, currently 1.37:1, that is intended to track changes in the economy.

The specific proposal discussed on page 32 of the audit report, which is referred to as the auction method, is one of many such options which the Mission has considered. This particular proposal was discussed with Ministry of Economy officials who rejected the idea outright. The acceptance by the GOE of any exchange rate is a major policy reform. The Misson will continue to vigorously pursue its goal of exchange rate reform, but it is unrealistic and not feasible to expect that an optimal solution to this issue will be possible for one project outside of the overall policy dialogue and GOE economic reform measures. . . . a private sector project at that.

In the discussion section of the audit related to this issue, a number of highly negative consequences are attributed to the foreign exchange subsidy. It is interesting to note that nowhere in the audit is the size of the subsidy discussed. As a matter of information, the market rate was approximately LE. .92:$1 when the project was obligated versus the legal rate of .84:$1. Also there are some very real costs to borrowers associated with using the PCP and these costs should also be taken into consideration in any calculation of the net subsidy to users, i.e. determination of the effective cost of capital vs citing looking at the interest rate only. The 25% down payment required by the program is but one small example.

On page 27 this subsidy is characterized by unnamed critics as making the PCP a cheap foreign exchange window. This allegation is not supported by available data on the project which shows that less than 24% of all transactions by value were conducted on a cash basis.

1/ Auditor's Note - The proposal referred to was deleted from the final report.

On page 32 the audit goes on to report that the subsidy creates a potential for windfall profits and creates distortions in investment decisions. With the joint GOE-USAID decision to eliminate traders the Mission believes that the potential for windfall profits no longer poses a significiant threat to the program. Given the distortions inherent in the economy of Egypt, which is still dominated by the public sector, we do not believe that a subsidy element from this one project adds in any meaningful way to a distortion of investment decisions in Egypt over what would ideally occur in a market economy. Further, in accordance with "The Theory of the Second Best," it may be entirely possible that by eliminating all subsidies to the private sector while they are maintained in the public sector, the pattern of investment decisions would be further removed from those which one would seek under optimal conditions. In conclusion, while the Mission endorses the goal of a unified exchange rate, the audit has not adequately documented its case that the negative impact of a less than perfect solution preclude the Mission from obligating funds to the PEC project.

Recommendation No. 3

We recommend the USAID/Egypt prior to authorizing the disbursement of funds under the follow-on PEC project justify the interest rates to be used by participating banks for lending under the project in terms of achieving project goals.

Response

The interest rate structure in Egypt for all LE lending in Egypt is established by the Central Bank. It does discourage banks from term lending and encourages short term trade financing. Interest rates are another of the Missions important policy issues. Never-the-less, the Mission believes it is possible to implement a meaningful credit project under current conditions and that the basic rationale for the AID program to Egypt necessitates intervention versus non participation and abstinence.

The PCP project eliminated trader transactions in October of 1985 on the basis that their credit needs were adequately met. Since that time almost 60% of all transactions by value passed by USAID included credit terms of 1 year or greater. Further, we note one of the major findings of the prior Evaluation Report, concluded that the effective borrowing rate for PCP users for a 1 year credit is between 21-23%. Given the then estimated 20% inflation rate for Egypt, borrowers experienced positive real rates In summary, we are obliged reject this audit recommendation since we can not expect to negotiate a separate project interest rate with the Central Bank for this follow-on project when credit to the private sector is an integral part of our private sector strategy. Therefore we will be obligated to utilize the Central Bank lending rate structure while seeking changes in this schedule.

Recommendation No. 4

We recommend the USAID/Egypt prior to authorizing the disbursement of funds under the follow-on PEC project, establish a system of incentives that is in alignment with the costs being incurred by participating banks. The system should encourage banks to engage in the types of transactions that achieve stated project goals, and engage in term lending additional to that which would have been provided by the participating banks.

Response

The Mission clearly recognizes that the interest of the banks implementing the program and those of AID will not always coincide. We do not find it surprising that banks lent funds to those customers who had existing lines of credit or that banks made loans in accordance with overall bank lending policies. We find the audit conclusion that, "these recipient firms are not the firms most likely to make the best use of these funds in achieving expanded productive output and employment," startling. We see no reason why firms with good credit ratings would be unable to contribute to the project's stated goals and, in fact, are those firms most likely to contribute to increased production and employment which Egypt so drastically needs now.

The audit also states that there are numerous cases where the bank was willing to lend its own funds to customers and that in these instances project transactions cannot be considered additive. This ignores the issue of foreign exchange availability. Without foreign exchange provided by the project there would be no transaction despite the banks willingness to lend local currency.

On page 42 there is a troubling comment that as a result of the fee structure which is not market oriented, "the project invites abuse due to the profits that stand to be made from the below market foreign exchange!" There are no samples of such abuse documented and it is difficult to reconcile this charge with the earlier conclusion on page 6 that no discrepancies were found in the transactions traced through the participating bank records.

We reject Recommendation No. 4 for the following reasons. First and foremeost, no further incentive is needed to attract the banks to this program. We have many more bank applicants eager to join the program than we can possibly handle under the program. Second, bank profits in Egypt heretofore with no competition on fees and commissions (set of the Central Bank) have been nortoriously high compared with other countries. We see no need to use AID funds to increase the bank's profitability. Lastly the statement on page 42 "It also means that the bank is losing revenue that it could be making on these transactions which it is entitled to make", we question. We regard this statement in error since, the bank is earning additional fees and commissions on capital that is additive to its own assets, i.e. the bank is generating revenue on an external source of capital made available to it by USAID and GOE. The funds in question are not bank funds and yet it generates revenue from use of these funds. We see no need to provide further incentives when a great number of banks want to join the program.

Note the Mission does not reject the idea for trying to further align the banks interests with those of AID. Rather than seek a major modification in the national bank fee structure, which would be a impossible task to negotiate with the Central Bank, a number of steps are proposed under our new credit project.

- banks will be given a written list of AID's criteria for judging their performance under the CIP - Private Sector. Additional funds will not be allocated based on first come first served, as in the past, but on how well banks conform to stated goals. Banks will be evaluated on such points as:

  1. How many new customers they proposed, i.e. never used PCP before?
  2. How many clients outside Cairo/Alexandria were proposed?
  3. What were the credit terms allowed by the circular extended to clients?
  4. What is the average size of the client which the bank submits transactions for?
  5. What is the average transaction size?

- transaction limits will be further revised in favor capital equipment,
- the project will set up a small scale guarantee fund to assist firms which have not previously had access to credit.

Recommendation No. 5

We recommend that USAID/Egypt prior to authorizing the disbursement of funds for the follow-on PEC Project establish:

a. priorities for private sector development; and

b. criteria for targeting project funds to sectors and firms within those sectors that are likely to achieve the stated project goals of expanding private sector output and employment.

Response

The audit report correctly states that USAID/Egypt did not attempt to identify priorities within the private sector nor to target funds to meet these priorities, deciding instead to allow the market place to determine how project resources are allocated. The Misson has examined the issue of targeting on several occassions and rejected it. First, targeting is exceptionally complex and fraught with problems in implementation and interpertation. Fundamentally we question the premise that USAID interpose its judgement as to which firms or sectors have potential and /or a comparative advantage in production in this complicated market place. Can we be sure that AII's in-house judgement in all cases and at all times will be superior to that of the private businessman reacting to market forces? We believe market forces best determine the answer.

As a practical matter, suggestions such as the one on page 49 that a "needs" test should be applied to each transaction to ensure that project dollars will result in something additional, and the USAID and GOE, as specified on the bottom of page 4e, establish which sectors and "what commodities within these sectors" be eligible is unrealistic, impractical and technically not feasible. We estimate that USAID will process over 330 transactions a year under the private sector CIP. Clearly the kind of analysis called for by the audit would take more resources, time and effort than the Mission can afford and more importantly, involve a judgement we believe best be left to the private sector and market forces.

The audit concludes that as a result of the lack of targeting, there were no assurances that project funds were used in a manner which would achieve the stated goals and that "there were many indications this was not happening." In support of this conclusion, the audit presents the results of interviews which they carried out with eight importers! We do not believe this sample size is large enough to generate meaningful conclusions regarding project performance. Further, we refer to the prior project evaluation report which, based on a review of 288 transactions, which concluded that the types of commodities and industries receiving PCP funds showed they were appropriate to Egypts needs.

We reject Recommendation No. 5 as neither technically nor fundamentally sound.

cc: Mr. Terrence J. McMahon, FM/AD

LIST OF RECOMMENDATIONS

Recommendation No. 4 20

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, establish a system of incentives that is in alignment with the costs and risks incurred by participating banks to: (1) engage in the types of transactions that best achieve stated project goals; and (2) encourage lending additional to that which otherwise would occur in the absence of the project.

Recommendation No. 5 25

We recommend that USAID/Egypt, prior to authorizing the disbursement of funds under the follow-on Private Sector Commodity Import Program Facility, establish:

a. priorities for private sector development; and

b. criteria for targeting project funds to sectors and firms within those sectors that are most likely to use these funds to achieve project goals.

REPORT DISTRIBUTION

	No. of Copies
Mission Director, USAID/Egypt	10
Assistant Administrator, Bureau For Asia And Near East (ANE)	5
Office Of Egypt Affairs (ANE/E)	1
Audit Liaison Office (ANE/DP)	1
Assistant Administrator, Bureau For External Affairs (XA)	2
Office Of Press Relations (XA/PR)	1
Office Of Legislative Affairs (LEG)	1
Office Of The General Counsel (GC)	1
Assistant To The Administrator For Management (AA/M)	2
Office Of Financial Management (M/FM/ASD)	2
Senior Assistant Administrator For Bureau For Science And Technology (SAA/S&T)	1
Center For Development Information And Evaluation (PPC/CDIE)	3
Inspector General	1
Deputy Inspector General	1
Office Of Policy, Plans And Oversight (IG/PPO)	2
Office Of Programs And Systems Audit (IG/PSA)	1
Office Of Legal Counsel (IG/LC)	1
Executive Management Staff (IG/EMS)	12
Assistant Inspector General For Investigations And Inspections (IG/II)	1
Regional Inspector General For Investigations And Inspections/Cairo (RIG/II/C)	1
RIG/A/Dakar	1
RIG/A/Manila	1
RIG/A/Nairobi	1
RIG/A/Singapore	1
RIG/A/Tegucigalpa	1
RIG/A/Washington	1

56