PN-AAU-937

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Country Development Strategy Statement

FY 1986

EGYPT

ANNEX D

INDUSTRY SECTOR STRATEGY

APRIL 1984

Agency for International Development
Washington, D.C. 20523

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INDUSTRY SECTOR STRATEGY

1. Why Industry? Goals, Objectives and Purposes

Industrial development is essential to several of the factors upon which Egypt's central goal of continued economic growth depends, in particular increased productivity, increased commodity output, increased foreign exchange earnings, and increased employment opportunities to absorb a rapidly increasing labor force.

In most modern economies, industry offers the greatest scope for increasing the productivity (and income level) of the work force. With severe limitations on the expansion of agricultural production, industry will have to provide increasing volumes of the commodity output needed to sustain growth.

Continued economic growth requires adequate foreign exchange to purchase raw materials for domestic production, equipment goods for capital expansion, and consumer goods to absorb consumer demand for commodities not produced in-country in sufficient volume or at all. The future is uncertain for two of Egypt's main sources of foreign exchange, petroleum exports and workers' remittances, so that industrial exports (including processed foodstuffs) will be essential for sustaining future foreign exchange availabilities.

Independently of the pace of agricultural growth, an increasing share of Egypt's population will be living in urban areas. An expansion of urban-located industrial production is necessary as an underpinning to growth of the urban economy. For the population that stays rural, off-farm quasi-industrial production activities are needed to raise rural income levels.

There are two sets of intermediate objectives enunciated in the current Five Year Plan that the GOE wishes to attain in order to achieve industry's contribution to the goal of economic growth: an increase in capital investment in industry; and rationalization of the price structure and management environment within which Egyptian industry operates, including, as a policy instrument, increasing the role of the private sector. Increasing capital investment involves the relatively simple task of finding the necessary local and foreign currency resources to finance rehabilitation of existing plant and the creation of new capacity. Rationalization of the price structure and management environment is much more difficult because the issues involved are highly political.

With respect to the price structure, within the GOE, the Ministry of Planning, the Ministry of Industry and the Higher Policy Committee are cognisant of the problem of distorted input and output prices, but also are highly sensitive to the political implications of trying to remove the distortions. The political sensitivity of the price distortions arises primarily because their immediate purpose is to subsidize commodities produced for consumption by low-income households: the price distortions serve as disguised (implicit) subsidies. Rationalizing prices and making subsidies undisguised (explicit) would lead, at least temporarily, to the politically unpalatable result of increasing the central government budget deficit. In addition, a host of vested interests (ranging from over-protected import-substitution industries in both the public and private sectors, to the inefficient "Russian sector" of Egyptian industry that includes the KIMA ammonia plant, the Nag Hamadi aluminum plant, and the Helwan steelworks) are sustained by the price distortions and have political influence.

With respect to the management environment, the political constraints are two-fold. In the first place, an important part of the GOE's political constituency consists of the government officials and university intellectuals who accept the basic premises of Nasser's Arab Socialism: the inviolability and predominance of the public sector, and relegation of the private sector to a secondary role. Secondly, given the lack of a tradition of stockholder supervision of management of private corporations, the GOE basically mistrusts the motives of public sector company managers, fearing that their own interest in personal gain may outweigh their concern with the corporate interest of their companies.

The GOE therefore finds it easier to seek additional resources for industrial investment than to tackle the problems of price and management reforms. In the mid-1970s when President Sadat evicted the Russians and switched Egypt to the U.S. side in the East-West conflict, the U.S. and other Western donors, including the IBRD, accepted the obvious need for resources to rescue Egyptian industry from the state of deterioration inherited from the Nasser regime. The U.S. and these other donors are now much more concerned that lack of reform will vitiate the positive effects of installing new capacity.

The purposes of USAID's past and current programs in support of Egyptian industry are straightforward:

- to help sustain the level of public sector industrial production by providing raw materials, spare parts and equipment through the Commodity Import Program (CIP);

- to help sustain the level of private sector industrial production by providing these same inputs through the private sector CIP ($137 million obligated) last funded in FY 1981 and the Production Credit I project (0147) ($68 million obligated) funded in FY 1982;

- to rehabilitate and to expand public sector industrial capacity by capital assistance through investment projects specifically in textiles (0010) ($96 million obligated) and salines (0072) ($13 million obligated), and through the umbrella Industrial Production project (IPP) (0101) ($145 million obligated);

- to rehabilitate and to expand private sector industrial capacity through capital assistance to the cement industry ($237 million under projects 0012 and 0052) and capital assistance through the Development Industrial Bank (DIB) (0018 and 0045) ($34 million obligated);

- to increase productivity and the efficiency with which resources are used by providing management development, technology transfer, and vocational training services to both public and and private sector firms through sub-projects within the Industrial Productivity Improvement project (0090) ($39 million obligated);

- to improve the investment climate for the private sector by technical assistance for relevant private sector activities under the Business Support and Investment Project (0159) ($9.1 million obligated in FY 1983);

- to introduce term-lending for industry and other business purposes in support of the private sector. The Private Investment Encouragement Fund (PIE Fund) (0097) never got started, and over two-thirds ($21.2 million) of its original funding has been de-obligated, The remainder ($10 million) has been left in the project for a last effort to see if the PIE Fund can be made to work as a pilot project. The USAID's proposal to establish a medium-term credit project for the private sector (Production Credit II) (0166) was not accepted by the GOE; the USAID is exploring the possibility of opening an experimental credit "window" under Production Credit I as an alternative.

The central objective of the USAID's strategy for future programs in industry is movement of Egypt's industry toward a market economy through (a) more rational pricing policies, particularly for public sector industry, (b) greater managerial autonomy for public sector enterprises, and (c) greater scope for private sector industry and greater equality of treatment of private and public sector enterprises by the GOE.

Some of the reforms that the USAID advocates are already happening, at the Egyptian pace. Some price adjustments are being made in energy, in the effective exchange rate for exports and imports, and elsewhere. Under Mohamed El-Gharouri as Minister of Industry and Mineral Resources, licensing of new private sector industrial activities by the Ministry of Industry has become easier and faster. Early in 1983, the People's Assembly passed a new Public Sector Company Law (Law 97/1983 Regarding Public Sector Organizations and Companies) that appears somewhat less liberal in scope than earlier drafts, but the implementation regulations now being worked out are intended to support greater autonomy for public sector company managers. Public sector managers claim that one of the apparently retrograde provisions, the re-institution of industry branch authorities (holding companies) as umbrellas of the enterprises in the various branches of industry, will turn out to be neutral or liberalizing rather than restrictive with respect to managerial autonomy. Directors of the new holding companies point out that one of the side effects of the new system is that it transfers to them much of the supervisory authority now exercised by the General Organization for Industry (GOFI), which is generally considered to be a major stumbling block to efficient functioning of public sector industry.

1. An Industrial Strategy for Egypt

Egypt's industry sector is hampered by a multiplicity of sources of economic, managerial, and technological inefficiency. Without some basic adjustments in the price structure that defines economic inefficiency, USAID assistance may serve only to perpetuate and reinforce the existing structure rather than to rationalize it. Similarly, without significant reform of the management of Egypt's public sector enterprises, part of the technological and resource benefit of USAID's assistance to public sector industrial enterprises is vitiated.

We are fairly clear on what Egypt's industrial strategy should be, from the Boston University "Industrial Sector Strategy Assessment" prepared for USAID/Cairo in 1981-1982 and from the January 1983 World Bank study on "Issues of Trade Strategy and Investment Planning" (Report No. 4136-EGT). The objective for Egypt should be an expansion of industrial output that makes efficient use of domestic resources within a price system that gives correct signals for resource allocation.

The Boston University study identified a number of constraints to Egypt's industrial expansion, among them: price/cost distortions; institutional constraints; administrative restrictions on private sector operations (which actually have become less severe over the last two years); managerial inefficiencies of public sector industry; and the narrowness of the Egyptian market combined with the difficulties of breaking into export markets.

The World Bank study examined the structure of price distortions affecting industry. These include not only (a) the basic underpricing of energy and foreign exchange that distort resource allocation throughout the economy, but also (b) an ad hoc system of infant-industry protection that has led (i) to widespread differences between financial rates of return (at nominal prices) and economic rates of return (at shadow prices) and (ii) to an "almost randomly distorted structure of incentives". One of the striking conclusions of the World Bank study is that price distortions result in sharp divergences in financial and economic profitability. Indeed, financial and economic profitability point in opposite directions in almost all sub-sectors of manufacturing, as shown in Table 1 below.

Table 1

ECONOMIC AND FINANCIAL RATES OF RETURN ON INDUSTRIAL PRODUCTION IN EGYPT, SINGLE YEAR ESTIMATES, 1980/1981
(percent)

Branch of industry	Economic rate of return	Financial rate of return
Cotton textiles	13.6	5.9
Wool textiles	14.1	15.5
Jute products	-5.1	17.5
Carpets	4.2	18.3
Oils, soaps & detergents	14.4	-6.6
Sugar	34.2	7.1
Processed vegetables	12.3	2.2
Oils & essences	78.1	17.6
Starch & yeast	45.0	6.2
Artificial fibers	-9.5	1.9
Non-edible oils	-11.1	3.8
Coke	-17.4	-20.7
Leather & tanning	8.3	4.1
Iron & steel	2.7	10.9
Aluminum	-21.0	12.5
Non-ferrous metals	-3.1	15.5
Steel pipes	-2.0	18.9
Formed & shaped steel	6.4	11.7
Ferrous castings	-46.2	-6.7
Road motor vehicles	-32.7	-13.4
Railway carriages	17.3	12.1
Bicycles & motorcycles	-3.2	1.5
Industrial electrical products	52.6	24.4
Electric consumer durables	20.0	15.8
Consumer electronics	-3.6	20.5
Ceramics	-12.8	2.4
China & glass	-16.4	20.6

Source: World Bank, Arab Republic of Egypt: Issues of Trade Strategy and Investment Planning, Report No. 4136-EGT, January 14, 1983, Table E, p.xviii.

A correct GOE strategy for Egypt's industry would seek to eliminate (or drastically reduce) these price distortions and other constraints. For the public sector enterprises, this implies linking greater enterprise autonomy with price reform. For the private sector, it implies an acceleration of the GOE's easing of private sector entry into product lines hitherto explicity or implicitly reserved for the public sector.

The Ministry of Industry is acutely aware of the problem of distorted input and output prices, and is using shadow prices for internal evaluations of public sector industrial investment proposals. (The results of some of the Ministry of Industry's calculations are reflected in the chapters on shadow pricing and on comparative advantage in the World Bank study on "Issues of Trade Strategy and Investment Planning".) Such internal valuations can screen out uneconomic projects. The difficulty that remains is how to affect actual market prices so that they too reflect comparative advantage in an economic system where pricing decisions of public sector enterprises are political decisions to be referred to the Prime Minister and the Cabinet before they can be implemented. A significant beginning on rationalizing input prices to industry is being made in the energy field where price distortions are most egregious and all-pervading. On the output side, public sector enterprise managers nibble away at price controls by creating and selling new products for which prices are not controlled. There is still a long way to go. USAID's policy dialogue on prices contributes to movement in the right direction.

The Mission's basic objective with respect to Egypt's industrial sector is to support economically efficient expansion of Egypt's industrial output, whether in the public sector or in the private sector. The NEAC review of the Industry Sector Strategy Annex to the Egypt FY 1984 CDSS in May 1982 (FY82 STATE 133436) endorsed "improving the efficiency of the public sector with investments in the public sector for capital rehabilitation and some expansion conditioned upon progress in public sector reform and the relaxation of some of the present restrictions against the private sector." To achieve this objective, the Mission (a) supports expansion of the share of the private sector in industrial production and (b) channels its assistance to public sector industry toward increasing efficiency and productivity in existing public sector enterprises. The USAID's engagement in the industry sector serves to keep open the dialogue on accelerating the movement of Egypt's industry toward a market economy through price reform, expanding the private sector, and reinforcement of management autonomy in the public sector.

The strategy problem for the USAID is how best to promote the reforms needed to make Egyptian industry more efficient. One caricature of an optimal strategy is that we first persuade the GOE to eliminate all policy bottlenecks so that the only remaining constraints are lack of resources and technological lags that we then can address by a transfer of resources, by technology transfer, and by technical assistance. In the real world, we have to deal with the slow pace of desirable (and desired) changes, with conflicting political pressures, with bureaucratic obstacles created by both the GOE and A.I.D., and with the need to use resource transfers to engage the recipients in a dialogue that facilitates persuasion.

Our proposed optimal strategy, therefore, is one that aims at achieving a reasonable degree of policy change at the same time that we attack the resource and technological constraints. Our policy-constrained strategy is a fall-back position that keeps USAID involved with industry in a situation where there is insufficient likelihood of policy change to justify heavy resource transfers. Complete cessation of assistance to industry is not entertained here as an option.

3. An Industry Sector Strategy for USAID/Egypt

a. Key Policy Areas

The key policy areas relevant to USAID support to industry are the following:

- rationalization of output prices to cover public enterprise costs. If subsidies to consumers are considered necessary by the GOE, the subsidies should be made explicit as part of current expenditure in the GOE budget instead of being disguised as enterprise deficits to be covered by borrowing or capital transfers in the GOE capital budget;

- equality of treatment in the pricing of inputs to private and public sector firms. The major anomaly at present is the pricing of energy inputs to the private sector cement industry where Law 43 companies that have received capital assistance from A.I.D. (Suez Cement and Qattamiya Cement) are paying international prices for fuel (as they should) while their older and less efficient public sector competitors still pay pre-OPEC domestic Egyptian fuel prices. However, in December 1983 the GOE decided to double the price of fuel (mazout and natural gas) and electricity inputs to public sector cement plants, effective early in 1984;

- pricing of electricity inputs to energy-intensive public sector firms at economic prices;

- easing of the restrictions on entry of private sector firms into industrial production;

- rationalization of marketing of inputs and outputs of key sub-sectors (e.g. garments and suppliers to automotive industry) that offer particularly promosing opportunities for a larger role for the private sector and for USAID technical assistance;

- easier access by private sector industry to medium and long term credit.

b. Instruments of Intervention

The instruments available to the USAID for assistance to Egyptian industry include the following:

- resource support to private sector industry through short and medium tertm credit, and technical assistance;

- provision of raw materials, spare parts, and equipment through the public sector CIP (about half of which goes directly or indirectly to industry);

- capital assistance to public sector enterprises in selected branches that are economically efficient, i.e. that show respectable economic (as well as financial) rates of return;

- development of a more intensive dialogue with the GOE (Ministry of Industry, Ministry of Planning, Ministry of Economy, Federation of Industries, National Investment Bank, Development Industrial Bank) on pricing policies and investment priorities;

- an intensification of technical assistance efforts toward both public sector industry and small-and-medium scale private industry;

- technical and resource assistance to sub-sectoral institutions (e.g. the new public sector umbrella holding companies, the Federation of Industries, trade and professional associations) to help strengthen alternatives to traditional public sector control agencies, to contribute to re-organization and rationalization of the certain sub-sectors, and to provide for an expanded role for the private sector;

- institutional and financial support to the promotion of Egyptian industrial exports.

c. Optimal Strategy

Under our proposed optimal strategy, the USAID will continue to use all of the instruments listed above, including the provision of resources for capital rehabilitation and expansion in public sector industry. This assumes that perceptible movement in the key policy areas either (a) is occurring independently of our programs or (b) will be induced by the intervention proposed by A.I.D. or (c) can be negotiated as part of the assistance package. Possible candidates for capital assistance are discussed in the section on program implications below. Our present feeling is that there will be enough movement on policy to apply this kind of optimal strategy.

d. Policy-Constrained Strategy

Under our policy-constrained strategy, which assumes that sufficient movement in the key policy areas will not be forthcoming, new USAID capital resources for public sector industry will be severely restricted or eliminated; but we would continue to use the other instruments listed above.

4. Program Implications for the Industry Sector

a. USAID Programs Under the Optimal Strategy

Programs included under the optimal strategy address the technological, managerial and resource constraints on industrial growth in Egypt.

The technological constraints on private and public sector industry, are the focus of the Industrial Technology Application sub-project ($10 million) under the current Industrial Productivity Improvement project (0090). Management constraints are addressed directly by the Management Development for Productivity sub-project ($8.5 million) under the same Industrial Productivity Improvement project. Both technological and management constraints will also be addressed by the Feeder Industries project (0171) proposed in the USAID's FY1984 Annual Budget Submission. We propose an eventual extension of the Industrial Productivity Improvement project.

We do not propose another all-purpose umbrella project like the IPP (0101). The IPP will be effective in rehabilitating and expanding the enterprises that it is assisting; and it is having a positive effect on the pricing and management situations: by modernizing the enterprises assisted and making them viable, the IPP is helping to increase management autonomy; and by enabling the enterprises to produce new lines of output, the IPP has had an indirect effect in circumventing price distortions. Nevertheless, the sub-projects have been difficult to negotiate through GOFI and they have been slow to implement.

Getting USAID resources to private sector industry has not turned out to be an easy task. Credit for imports from the U.S. through the Development Industrial Bank (DIB) under projects 0018 and 0045 moves much more slowly than untied World Bank funds made available through the same institution. Establishing a project for term lending to the private sector through other banks than the DIB will require resolution of the issues that blocked negotiation of Production Credit II during FY1983: whether the funds should be on-lent in dollars or in LE; if on-lending is in LE, at what exchange rate the dollars will be converted for deposit into the revolving fund; through which banks the funds will be on-lent. The USAID's position on the exchange rate question vis-a-vis AID/W regarding on-lending in tied dollars is that a premium over the own-exchange rate is needed to offset the competitive disadvantage of U.S. exports to Egypt as compared with those from Europe and Japan.

The least complicated kind of resource transfer would be co-financing with the World Bank of a major economically viable industrial project such as one of the two ammonia plants that the World Bank is proposing as additions to its portfolio in Egypt. The new plant(s) would use natural gas from the Suez area as a feedstock and would replace the energy-inefficient Russian-built KIMA electrolysis plant that is one of Egypt's major anti-economic users of power from Aswan. Building an ammonia plant would reduce the medium term requirement for additional electricity generating capacity. At the same time, additional production of ammonia would provide one of the inputs to compound fertilizers needed by Egyptian agriculture and would be a potential source of export earnings. There is no doubt of the economic and financial viability of the proposed plants. The World Bank estimates the cost of each ammonia plant at $350 million and is seeking a co-financier.

A related possibility for co-financing with the World Bank is a phosphate mine and phosphoric acid plant complex at Abu Tartour, if it can be demonstrated that the operation would be economically viable. (A positive outcome of the benefit-cost calculations requires other projects than the phosphate mine in the New Valley development to which to attribute infrastructure costs.) Phosphate rock and phosphoric acid production from Abu Tartour would be exportable. The phosphoric acid would be available as an input for local production of ammonium-phosphate compound fertilisers that would support growth in agricultural output.

Another option for capital assistance to a major industrial enterprise would be USAID support for a new cement plant, which the GOE considers to be of high priority. Such a plant would be established as a Law 43 company rather than as a public sector company even through it would be largely GOE-owned.

Other areas in which the USAID intends to explore project possibilities are:

- rationalization of key sub-sectors (e.g. garments, automotive parts, food-processing) that offer particularly promising opportunities for an enhanded role of the private sector and for an effective and efficient targeting of USAID technical assitance services;

- the development of export-oriented industrial production, whether by the private sector or the public sector;

- greater support to small and medium scale private sector industry.

b. USAID Programs Under the Policy-Constrained Strategy

Programs in support both of private and public sector industry are contingent on resolution of policy questions. If movement toward price rationalization is considered to be too slow throughout public sector industry, even if a USAID project would achieve that aim in a single sub-branch (such as ammonia fertilizer production), then resource support to public sector industry out of the USAID portfolio will be sharply reduced. Similarly, if the issues relating to term credit cannot be resolved, the private sector lending element of the portfolio is at risk. In any event, the USAID would try to continue the management assistance and technological assistance activities outline above, as well as activities related to export promotion and development of small and medium scale industrial enterprises.

c. Budget Implications

The budgetary implications of these alternative strategies are shown in Table 2 (annual average over the period under review).

Table 2

BUDGET IMPLICATIONS OF ALTERNATIVE STRATEGIES FOR INDUSTRY SECTOR
(in millions of dollars per year)

Type of project	Optimal strategy	Policy-constrained strategy
Technology and management assistance	10	10
Private sector credit	30	30
Capital support to public sector	50	-
Export promotion and small scale enterprise promotion	10	10
Total	100	50