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California State Polytechnic University, Pomona
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Foreign Exchange Liberalization and It's
Impact on Economic Growth and Stability
of the Egyptian Economy: A Case Study

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Preface

With the dual objectives of providing information on successful experiments in economic growth that might be replicated elsewhere and of providing information to faculty of California State Polytechnic University, Pomona that could help them in working in developing countries, the International Center of Cal Poly Pomona has produced a series of short monographs for distribution to appropriate faculty, AID officials, developing country institutions, and assistance agencies.

Seven such monographs are being issued, principally based on case studies. Their preparation and publication have been made possible by a Matching Support Grant from the Office of Research and University Relations, Bureau for Science and Technology, of the United States Agency for International Development.

This monograph, "Foreign Exchange Liberalization and It's Impact on Economic Growth and Stability of the Egyptian Economy: A Case Study", written by Cal Poly Economics Professor, Dr. Taha Al-Sabea, focuses on the current impact of foreign exchange policy on the Egyptian economy. The analytical conclusions based on the model developed could be of use elsewhere with similar environmental setting where black market is among economic bottlenecks.

Additional monographs in the series cover EXCEL for Managers (in French), Interactive Electronic Distance Education in Zimbabwe, Women Who are Making a Difference in Swaziland, Women Managers in the Banking Industry in India, Student Career-Related Services in Egypt at Cairo and Suez Canal Universities, and Strategies to Achieve a World Class Manufacture in Mexico (in Spanish).

The International Center of Cal Poly, Pomona would welcome observations on these monographs from recipients.



Richard F. Pedersen
Director, International Programs

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**FOREIGN EXCHANGE LIBERALIZATION AND ITS
IMPACT ON ECONOMIC GROWTH AND STABILITY OF
THE EGYPTIAN ECONOMY: A CASE STUDY**

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ABSTRACT

The Egyptian economy is a unique one compared with other Middle Eastern countries. Egypt was a pioneer in developing banking systems and foreign exchange transactions. Egypt has gone through three stages of economic adjustment. The first one was started in 1945 when Egypt joined the International Monetary Fund and the British Sterling Areas. In the year of 1947, Egypt withdrew from the Sterling Areas and practiced restricted foreign exchange control. The second stage was associated with a Socialist Transition and the nationalization of banks and the private sector. During this period, foreign exchange control continued by the Central Bank. Through 1960-1973, the Egyptian economy suffered an acute shortage of foreign exchange and a decline in the public sector for both goods and services, as well as a chronic deficit in the Balance of Payments. The third stage started with the "Infitah" policy (Economic Openness) and a free market oriented economy began to prevail in the Egyptian economy. This was a turning point in the transformation of the society from a Socialist to a Free Market economy.

Another era is between 1973-1987 in which the Foreign Exchange control continued by the Central Bank with a variety of Rate of Exchanges (e.g. Basic Rate, official rate, special rate, bank rate, bank pool rate and new bank rate). The black market became the most attractive rate of exchange for tourism, imports and Worker's Remittances. Finally, in February 1991, the government created a free market for foreign exchange where the market forces of supply and demand were the real power in determining the rate of exchange for the Egyptian Pound. The Central Bank began to use the "open market operation" as a tool to manipulate the market and to achieve a stable rate of exchange. The creation of the free rate of exchange market was a successful step to achieving growth, stability and economic development for Egypt.

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I. INTRODUCTION

Since the end of the Second World War and the establishment of the International Monetary Fund, World Bank, and subsequent creation of the United Nations as a world organization, the Global Nations were divided into three parts: a) the Communist Block, b) the Western Democracy Block, and c) the Less Developed countries (Third World) in which the latter represented two thirds of the globe.

The creation of the International Monetary Fund was a starting point to create a stable Rate of Exchange among nations and to bring a new era of growth that is development and stability to the International Financial System.

In 1945 the "dollar" was picked up by the International Monetary Fund as a key currency and was pegged to the gold price at \$35.00 per ounce of fine gold. The gold equation was developed, and a Fixed Rate of Exchange prevailed among international currencies. One percent fluctuation was allowed to the current rate of the I.M.F. members, but the U.S.S.R. and other Communist countries were exempted from the I.M.F. membership. The Fixed Rate of Exchange was derived from the following gold equation. An example is:

	<u>U.S.A.</u>		<u>U.K.</u>		
1948	\$35.00/oz	+	£ 12/oz	=	\$2.80 equal one Pound

This gold equation explains that as long as any member of the I.M.F. pegged the price of their currency to the gold price, a rate of exchange will be fixed as long as the U.S. dollar was fixed to \$35.00 per ounce of fine gold.

The Dilemma of the Developing Nations

Since the 1950's, Foreign Exchange, "Hard currency," became a serious problem facing the Developing Nations in both the Reserve of Foreign Exchange and the continuous deficit in their Balance of Payments accounts. Therefore, the developing Nations continue to follow the fixed rate of exchange and strict control of Foreign Exchange. In most of these developing countries, a Black Market has developed and flourished. Consequently, this phenomenon has affected the economies of these countries in the form of economic, social, and political uncertainty. Therefore, obtaining foreign exchange became the primary objective of each government in the Developing Countries. In the course of economic development, the Foreign Exchange issue has become an important problem to be discussed and solved.

Moreover, the fixed Rate of Exchange system continued to exist among members of the I.M.F. until the 1970's when the United States and Western European countries agreed to abolish the gold equation formula (fixed rate), and adopted the "Floating of the Currency System." The concept of Foreign Exchange or hard currency consists of the currencies of the most advanced industrial nations: U.S.A., Canada, Japan, and Western European

countries. Therefore, the currencies of the aforementioned countries became the most acceptable, desirable currency for exchange among nations. As a result, a new "Cash Money Market" was developed for these demanded currencies.

This monograph concerns Egypt, and shows how the Egyptian government has initiated a new policy to liberalize the Foreign Exchange market, and has removed all restriction on currency transfer through establishing a Free Money Market Exchange for foreign currencies. Such a policy has a direct impact on domestic saving, investment and production. The Egyptian's new policy of Free Exchange Market for foreign currency can be adopted and applied by Middle Eastern countries and other developing nations where similarities in their economies exist, such as: Algeria, Tunisia, Libya, Morocco, Iraq, Yemen, Syria, Sudan, Jordan, Turkey and Pakistan. This new policy will deal with Egypt as a case of study.

In fact, Egypt's economic future rests on the continuation of the climate of Democracy, free enterprise system, rule of law, and stability. There are about 40-50 billion in secret funds held by Egyptian abroad which can be encouraged to return and stimulate the Nation's development and to participate in building a new Egypt.

II. Development of Banking and Money in Egypt

The first bank was established in Egypt in 1842 by King Muhamed Ali. A few years later, the bank announced bankruptcy and closed. At that time most of the money exchange was carried out by merchants and some financiers, particularly in the countryside. Private banks were founded on a small scale by some European and Egyptian Jews. Most of these banks were concentrated in the city of Alexandria; followed by another European bank called The Anglo Egyptian Bank in 1864. In 1898 another bank was established and named Casa de Scanto et di Ris Parimo. Most of these banks were owned by European bankers.

On the government level, the first government owned bank was established in 1898 and named the National Bank of Egypt. In 1898 the Egyptian Pound was adopted as the national currency and pegged at 8.5 grams of fine gold. Egypt was under the "Gold Standard", and the national bank began to issue bank-notes

The first private Egyptian bank was founded in 1921 and called "Bank of Misr." Most of the stock shares were owned by Egyptian citizens and by 1936, the Federation of Egyptian Banks was established.

During the First World War, Egypt was unable to import gold as a cover to the Egyptian pound. On August 2, 1924, a decree was sent by the government to authorize the national Bank of Misr to stop redeeming the Egyptian pound in gold. Therefore, the Egyptian pound gained unlimited power in the redemption of payment

In 1916, the Government allowed the National Bank of Misr to accept United Kingdom treasury banknotes as a cover for the Egyptian Pound instead of gold. This monetary tie to the British Pound Sterling continued until 1947. In 1948, Egypt withdrew from the Sterling Pound Area and a strict control of Foreign Exchange began to be applied until the 1980's. By the 1990's foreign exchange control was lifted and a free market for foreign exchange was initiated.

Generally speaking, the Egyptian economy depended mainly on the export of cotton and other agricultural products as a major source of foreign exchange.

On July 8, 1947 the government enacted Law No. 80 to control the foreign exchange market. The following are some of the main contents:

1. No Egyptian citizen or foreign resident can hold a foreign exchange currency.
2. Every citizen or resident entering the country from abroad must declare foreign currency and sell it to the central bank at the prevailing rate of exchange at the time of entry.
3. Dealing in foreign currency must be through government authorized banks.
4. Every person who applies to buy foreign currency must indicate the purpose to use it, e.g., travel abroad, business or imports.

5. Penalties will be imposed on violators of foreign exchange laws.

Since 1947 Egypt began to develop a shortage of foreign exchange reserves. The Central Bank began to adopt new monetary policies to create a new channel to earn foreign currency. In October, 1949, the Central Bank created what is called a "Export Account System." This system is based on intermediary agents who will accept payment in the Egyptian Pound for their export product which is mainly cotton. The Central Bank, on the other hand, will be free to earn and use foreign exchange reserves to finance imports of consumer and capital goods. The impact of these transactions resulted in the depreciation of the Egyptian Pound abroad. By 1953, the government canceled the "Export Account System," and replaced it with the "Import Privilege System." The Central Bank found that the "Export Account System" damaged the rate of exchange for the Egyptian Pound and resulted in a decline of foreign exchange earnings, particularly, the export of cotton.

On the other hand, the "Import Privilege System" allowed the exporters of cotton to obtain the full value of their exports in U.S. or Canadian dollars. The cotton exporters were allowed to give-up a certain percentage of their earnings in U.S. and Canadian dollar reserves to other importers to enable them to import needy goods for the country. The "Import Privilege System" was abolished in 1954.

In 1958 the government began to sign bilateral agreements with the Eastern Communist block, African, and a few Arab countries. The bilateral agreement was based on a Barter Agreement and sometimes loans are paid in local currency. The Rate of Exchange was fixed by the monetary authorities of both countries engaged in trade agreements. This system was canceled in 1968.

Banking Development, 1950 -1960

In 1950, most of the private commercial banks were owned by European bankers. The function of these banks is to finance foreign trade, particularly the cotton crop which was the main agricultural product in Egypt. Lending to finance cotton exports were operated by the London money market. In 1951, there were twenty-five banks operating in Egypt. Three of these were English, two French, two Greek and one Belgian. The Greek bank, for example, was responsible for financing business activities for the largest Greek community living in Alexandria. Of course, there were three other national banks, namely the Cairo Bank, Republic Bank, and the National Bank of Egypt (NBE), which was the largest and the dominant one. Most of the above banks concentrated their banking activities in Cairo and Alexandria. The National Bank of Egypt began to open branches in Sudan, Libya and Saudi Arabia. The Cairo Bank opened branches in Syria, Jordan, Lebanon and Saudi Arabia.

The National Bank of Egypt (NBE) was the real power of the monetary authority during this period. In 1957, the NBE became the Central Bank for the State. The Central Bank became responsible for lending, exchange and credit facilitation. The Central Bank began to practice the tools of the monetary policy. The reserve ratio (was limited to 12.5%) and liquidity of money, up to 30% of the deposits, were required by commercial banks and other

state banks. According to Law No. 22 of 1957, commercial banks were required to be joint-stock companies whose capital would be owned by Egyptian nationals and under Egyptian administration. French and British banks were nationalized by the Egyptian government and put under the control of the Economic Development Organization, which was later merged with other state banks. Law No. 22 of 1957 authorized the Central Bank to supervise the operation of the Mortgage Bank, Agricultural Bank and the Industrial Bank.

The period between 1950-1960 was characterized by less participation in banking deposits by individuals. Deposits by individuals reached LE 2.0 per average citizen. (See Table No. 1.) Individual deposits, at the same time, were sufficient for transaction for two months. The percentage of currency in circulation was 54% to the quantity of money (M1 + M2). This percent is considered a risk percentage comparing it with other countries, which are very advanced in the banking system. Government current accounts of deposits and credit represented 84% of all banking transactions which were offered by the Central Bank. The government share of credit jumped to 91% of banking transactions in 1954. While the commercial bank's share reached 12% of the banking credit transactions. The commercial banks offered the private sectors 92% of their credit transactions. At the same time the government increased its borrowing from the commercial banks up to 7% in 1953 and up to 11% in 1959.

Table No. 9 is concerned with the distribution of banking credit and shows that financing cotton trade contributed 57% of the total banking credit activities in 1958. The industrial sector represented 29% and other small handcraft business represented 9%, while building construction obtained 5% of the total banking credit operation.

We may observe some points over the development of the monetary system between 1950-1960. This period is characterized with stability in the growth of money and credit bank reserves grew 4.5% annually. The Central Bank lending grew only 21% annually during the mentioned period. Money grew only 1% annually, while local liquidity growth was 3.5% per annum. Consequently, price levels, on the other hand, grew only 0.6% per annum, while the gross domestic product increased only 1%. Therefore, economic growth was very slow compared with other developing countries in the Middle East. The slow growth in money and credit attributed to the moderate borrowing from the Central Bank by the government. Another factor is the bank's policy to keep a large portion of the liquidity in their vault. It was a period of slow growth and price stability.

The Socialist Transition

According to Law No. 250 of 1960, the National Bank of Egypt (NBE) was divided into a separate Central Bank of Egypt and a Commercial National Bank of Egypt. In 1961, and according to Law No. 116, the Socialist government of late President Nasser, a new era of nationalization process of the private sector began. The nationalization process and merger reduced the number of banks to five major banks in 1964. These five banks were owned and operated by the government. On the other hand, each of the five state banks became responsible or financing the activities of the public sector as well as those of the private sector.

The government gave the power to the Bank of Misr to provide financing for domestic trade; the National Bank for foreign trade, particularly the export of cotton and rice; and Banque de Cairo responsibility for financing the services in the public sector. While the Industrial Bank, which merged with Alexandria Bank, was responsible for financing the industrial sectors, Law No. 116 of 1961 gave the freedom to individuals to deal with anyone of the aforementioned banks. The government became the sole monopoly of the major sector of the economy. Such a drastic government involvement led to a heavy public expenditure and a chronic budget deficit.

The Socialist Transition, 1960-1973, (See table No. 10) experienced different approaches to banking activities. The government, through nationalization of the banking industry, resulted in less banking activities by individuals and the private sector. Current accounts by individuals increased from 6 to 8 Egyptian Pounds while Savings Accounts increased from 2 to 6 Pounds per year. It was a slow growth in the banking activities by individuals and the private sector. Individuals, who used to hold their current account for two months in the 1950's, reduced the time to 38 days in the 1970's. On the other hand, borrowing by private sectors dropped from 92% in the 1950's to 45% in the 1970's. The government captured 60% of the banking system's credit operations. The decline in the activities of the banking system during the Socialist transition hindered economic development and growth of the Egyptian economy during this period, 1960-1973.

To conclude that the Socialist Transition experienced only 8.8% in money growth, while the government was the major borrower from the Central and the Commercial Banks. The expansion of money associated with moderate inflation. The price level remained low, due to the fact that the government began to subsidize some of the consumer goods such as tea, sugar, bread and medicine. Some prices were fixed by the government. Gross domestic product increased 4.8% annually.

The economic Openness Policy "Infitah" which began to take place during Sadat's administration, and the enactment of Laws to liberalize the economy from Socialist Transition to a free enterprise economy reflected on the expansion of the banking system as well as economic activities. The share of current accounts for individuals increased from LE 8 Pound during 1960-1970 to LE 51 Pounds. It was a 17% annual increase. While the saving account deposits increased to LE 237 Pounds compared with previous periods under the socialist transition. In addition, as we will see in the coming discussion, that the government allowed individuals and the private sector to deposit their foreign exchange in dollars, especially worker's remittances, and earned higher interest which reached 16% in the International Money Market. The higher rate of interest on saving deposits resulted in the decline of the velocity of money and the rate of inflation. (see Table No. 10).

Table No. 11 (see Appendix) shows that the government share of banking activities increased between 1974-1982. The government share reached 63% in 1974 and 68% in 1981 respectively. The mentioned increase in banking credit activities was provided by the Central Bank. From 1982-1992, the Banking Industry experienced growth in the commercial banks and the appearance of the black market as the real power in determining the rate

of exchange of the Egyptian Pound. Although the government continues to apply restricted foreign exchange control, in 1987 through 1992 the government began to liberalize its monetary policy and allowed the creation and the establishment of the free exchange currency market and the elimination and collapse of the black market.

The openness economic policy (Infitah) from 1973-1982 was associated with high growth of the money supply and high rate of inflation. The money supply increased 24% annually, and liquidity 32%, while the inflation rate reached 14% per annum, even though government subsidies, to a lesser extent, continued to be practiced by the government as a means to counteract inflation.

Egyptian Currency and Rate of Exchange

The Egyptian pound called The Geneih is divided into 100 Piaster (Kirsh in Arabic) or 1000 Milliems. After the creation of the International Monetary Fund in 1945, the Egyptian Pound was pegged to the dollar at \$2.80 per Pound. The Egyptian Pound has gone through a cycle of devaluation and adjustment.

On December 18, 1970 the U.S. dollar was floated in the International Market, but the Central Bank of Egypt declared that the official rate would remain at \$2.30 per pound. Following the devaluation of the U.S. dollar in 1973, the Egyptian Pound rested at US \$2.55 per unit, while the Tourist Rate jumped to \$1.61 per Egyptian Pound.

Devaluation Cycles of the Egyptian Pound

Later in February 1973, the Tourist Rate jumped to US \$1.70 per Egyptian unit for both residents and non-residents. In May 1974, the Central Bank came back to the official fixed rate of exchange with restricted control by the Monetary Authority. But, by September 1975, the Egyptian Pound was partially devalued at US \$1.50. This rate was given to the local residents to import goods from abroad. While at the same time, in the Free Zone at Port Said, the Egyptian Pound was rated at \$1.33 as a Free Market Rate. By 1976 the Resident Import License was abolished, and a new devaluation of the Egyptian Pound reached US \$1.44. By January 1979 the Egyptian Pound was fixed at \$2.55 with non-member countries of the International Monetary Funds. By 1983 the Egyptian Monetary Authority added 20 percent on the Foreign Exchange Rate for residents who traveled abroad. By 1984 the Monetary Authority devalued the Egyptian Pound and established a new rate of \$0.893 as a purchasing rate for Worker's Remittances while the selling rate was set up at \$0.877 per Pound.

III. The New Economic Reform - Openness Economic Policy

The Openness Economic policy started in April 1973, and later this policy was based on the "October Paper." In this "October Paper" new economic thought began to take place among politicians as well as government officials. It is a change in the whole economic structure from the Socialist to the Free Market economy. It was a turning point in the philosophy of the Arab Socialist Party of Egypt, which was founded by President Nasser and revised by President Sadat.

The Spirit of this "Openness Economic Policy" was to give the opportunities to local, foreign and Arab investors to operate in Egypt. The mentioned economic policy is associated with the following laws and rules:

- 1) Law No. 43 of 1974 concerning the foreign, Arabs Investment and Free Zone.
- 2) Law No. 137 concerning imports and exports.
- 3) Law No. 120 of 1974, concerning the Central Bank and the Banking Authority.
- 4) Declaration of Port Said as a Free Zone beginning 1976.
- 5) Law No. 97 of 1976, to replace the old Law No. 80 of 1948 of the Foreign Exchange Control

Law No. 97, of 1976 was a stimulus to create a new and free market of foreign exchange and allowed individuals, private corporations, and banks to deposit in dollar accounts. The law allowed the freedom to hold foreign currency. Dealing in foreign currency has to go through authorized banks. The purpose and the objectives of Law No. 97 of 1976 is to create a free market for international currency similar to the European, Japanese and U.S.A. cash market. The foreign currency market was established in 1991-1992. In fact, the power and the application of Law No. 97 ended a cycle of devaluation of the Egyptian Pound for several years. The mentioned law created a unified free rate of exchange for the Egyptian Pound.

Also, Law No. 97 allowed Egyptians working abroad to bring in-kind both consumer and capital goods. The Law allows that any citizen who holds foreign currency is permitted through the banking system to import certain commodities or raw materials if he owns a factory or manufacturing firm. Law No. 227 of 1976 allowed citizens holding dollar deposits to import any commodity without any restrictions. The importer has to deposit between 25-70% in dollars as a letter of credit (LC) through the Central Bank.

Table No. 1

**Imports Value From Private Remittances
Deposits in Dollars
(\$ million)**

<u>Year</u>	<u>Imports Value</u>
1976	\$235.9
1977	178.9
1978	838.9
1979	1,199.0
1980/1981	1,503.4
1987/1988	1,523.7
1988/1989	1,814.3
1989/1990	1,919.5
1990/1991	1,989.3

Source: Central Bank of Egypt: Development and Organization of Foreign Exchange Market, May, 1992, p. 16.

According to Law No. 97 of 1976, the table shows a high growth in the volume of imports by individuals and private sectors from their dollar deposits. During a period of five years, the figure of imports jumped from \$235.9 million in 1976 to \$1.989 million in 1991. This is due to the establishment of the Free Exchange Money Market.

Law No. 5 of 1985 ceased the privileges of imports from dollar deposits as a step to counteract the black market and let the banking system take the responsibility rather than individuals. Here the banking institutions depleted their dollar reserves and the government stopped the operations again.

In 1985, the government again allowed and permitted individuals who held dollar deposits to import commodities from abroad with advance deposits ranging from 15, 20, 40 and 50% of the total bill of imports. Some commodities were not allowed to be imported as a step to protect domestic production. The government, on the other hand, encouraged the private sectors to import materials to meet the demand for domestic production and investment. During the period, the rate of exchange in the imports transactions was determined by arbitrary decision of the Central Bank, depending on the need and demand for dollars. The Rate of Exchange was not based on a free market formula. Consequently, the black market dealers began to offer higher than the Central Bank Rate on dollar exchange. This step by the currency dealers aimed to maximize the highest profit and, of course, the victims will be the average consumers. The demand by currency dealers and the rise in the dollar exchange rate did not reflect the real increase in the dollar value in the international market in 1987. It was cheated by the black market currency dealers.

;This chaotic situation in the currency market forced the government to offer a very high rate of exchange for worker's remittances with privileges to import. Table 2 shows the official new bank rate which was offered to Worker's Remittances (0.4555).

By February, 1991, with accordance to Law No. 117, the government allowed the creation of the International Money Market of Foreign Exchange. It was a turning point in the history of the monetary system in Egypt.

Table No. 3 shows the inflow of worker's remittances through the government channel, and due to the new rate of exchange for dollar savings deposits. The table also shows that the worker's remittances jumped from \$755.1 million in 1976 to \$1.7 billion in 1978 and to \$2.1 billion in 1981.

Table No. 2

Official Exchange Rates
In U.S. Dollars Per Egyptian Pound At End of Year

	1985	1986	1987	1988
Basic Rate	\$2.55	2.55	2.55	2.55
Official Rate	1.429	1.429	1.429	1.429
Special Rates	-	-	0.944	0.905
	2.065	2.120	2.696	2.585
	2.555	2.555	2.555	2.555
	-	-	1.020	0.769
Official Free Rate	0.575	0.518	0.454	-
Bank Rate	1.200	-	-	-
Bank Pool Rate	0.743	0.732	0.533	-
New Bank Rate	-	-	0.455	0.425

Source: *Country Report, Egypt Economic Indicator*, 1992.

The above table shows the continuing variation of different rates of exchange during the period 1985-1988, which was authorized by the Committee of Foreign Exchange. Some of the above rates have been either established or abolished. For example, the bank rate was abolished in July of 1986; while the new bank rate was created in May of 1987 (0.4555) to the U.S. dollar.

Table No. 3

**Migrant Worker's Remittances and GNP
Reported Inflows in Egypt
1970-1981 (millions of \$)**

Year	Remittances	GNP
1970	29.0	2,427
1971	27.1	3,086
1972	104.2	3,403
1973	116.8	3,634
1974	268.2	3,949
1975	365.5	4,349
1976	755.1	4,346
1977	928.2	6,618
1978	1,772.8	8,210
1979	2,213.2	9,788
1980	2,695.5	12,610
1981	2,181.4	18,041

Source: U.N. *World Economic Survey*, 1983.

The government authorized the Central Bank to give a special treatment to worker's remittances, reached 35 percent higher than the official rate of exchange at the current rate. Later, the government increased the percent to 50% higher to encourage workers depositors to convert their dollar saving deposits into local pound. This special treatment for worker's remittances called the "equilibrium market". By 1976 and later the percent on the Rate of Exchange jumped to 78%. All of these monetary policies by the Central Bank intended to acquire dollar reserves to cover the deficit in the balance of payments.

In December 28, 1983 several rates of exchange were applied by the Central Bank, depending on the type of foreign exchange dealings. The Arab countries, the U.S.S.R. and other Communist countries were treated differently from Europe, Japan and the U.S.A. But, the rate of the Egyptian Pound at \$1.42 continued to be applied for international debt, oil, cotton and rice shipments.

The above devaluations and adjustments show the instability in the Egyptian Pound and its impact on the economy as a whole. The unstable policy of the Rate of Exchange of the Egyptian Pound resulted in an inflationary growth and reduced the purchasing power of the average Egyptian citizen. Between 1970-1987 was a period of "Unstable Growth" in the economy. The Black Market flourished very fast and resulted in the creation of interest

groups, specifically the currency dealers, and corruption among government officials and the business community. Such a market was very difficult to control.

The export of oil, cotton, rice and beans is the sole monopoly of the government. The Central Bank, on the other hand, is responsible for keeping the Foreign Exchange Reserves. One big step which has been initiated is the permission for Egyptian workers who work in the Arab Gulf states, Libya, and Iraq to open checking and savings accounts in "dollar deposits" with the Foreign Currency Free Account. This step, as we will see later, stimulated a huge amount of Foreign Exchange to be transferred to the homeland by Egyptian workers abroad. Such savings by workers' remittances was deposited in dollars accounts and paid interest with the prevailing International Currency Market; or, if it converted to Egyptian Pound, interest will be double compared with Eurodollars Rate of Interest. (It reached 20% in local currency.) Such a policy stimulated domestic investment, savings and increased the economy production.

The "Central Bank Pool Currency" has continued to be the official Rate of Exchange until May 11, 1992. This Rate of Exchange is applied mostly on the receipts side: export of petroleum, cotton, rice and Suez Canal tolls. On the payment side, this includes foodstuffs, wheat, oil, tea and sugar. Also, it was extended to include all public sector and external debt transactions.

The "Commercial Bank Pool Currency" received most of tourism, worker's remittances, and exports not going through the Bank Pool. The black market, on the other hand, shared most of the worker's remittances and tourism. The Black Market was providing the private sector for the currency needed for both visible and invisible foreign exchange transactions.

By May 11, 1987, the Foreign Exchange Committee came with a "new bank Foreign Exchange Market" which authorized commercial banks and two travel agencies to operate in this Exchange Market. The technical operation of the new Rate of Exchange was based on the following practices – from the supply side, commercial banks were allowed to draw resources from worker's remittances deposits, tourist spending and private sector export earnings.

The new Exchange Market is permitted to provide Foreign Exchange for public and private sectors, both visible and invisible transactions. Generally speaking, the Central Bank of Egypt carried out two thirds of the exchange transactions of both imports and exports, and about forty percent of invisible transactions. The Exchange Rate was set by the Central Bank US\$ = LE 1.1. The Bank Pool Rate was abolished in 1988.

Finally, the Foreign Exchange System has gone through the following two markets:

1. Preliminary Market
2. The Free Market

By October 8, 1991, the preliminary market was abolished and the Free Market became the only one in Foreign Exchange transactions.

The Black Market and Government Control of Foreign Exchange

In 1984 the government (both the Ministry of Economics and the Foreign Exchange Authority) began a huge crackdown on the Black Market operations. These operations including the seizure of the assets of 18 banks and Foreign Exchange dealers. The above monetary authority was convinced that such hard measures and crackdowns on the black market operations would come to an end, and the government would have a free hand in determining and controlling the Foreign Exchange. The Central Bank (see Table No. 4.) allowed commercial banks to deal up to 75% of their reserves in Foreign Exchange, while the other 25% was to be allocated to the Central Bank itself. The system was called "Own Exchange," whereby importers had set aside their own Foreign Exchange to pay for their imports. The Central Bank, on the other hand, prohibited public corporations from using their Foreign Exchange from the exports to finance their imports of raw materials. This policy was canceled

At the same time, private importers could no longer use the Foreign Exchange deposits in their Free Market Account to pay for their imports. Such policy of strict Foreign Exchange control forced the resignation of both the Minister of Economics and the Central Bank Governor.

The new approach by the "Monetary Authority" is to depreciate the premium rate of the Egyptian Pound to the same quotation of the Black Market. This is a turning point in the long fluctuation of the Egyptian Pound and a step to destroy and abolish the Black Market and its Marketers. During the period of strict Foreign Exchange, new interest groups developed in both the Ministry of Economics, Central Bank and Black Market operations. Whenever the agents of the above Monetary Authority "busted" the blackmarket dealers, they would be rewarded with huge bonuses. Naturally, there was an opposition group within the Monetary System to equate the Black Market quotation with that of the official Foreign Exchange Rate.

The year 1986 witnessed an economic, political, and social change in Egypt, because of rumors as well as weekly and monthly changes in government policies toward the economy and particularly the rate of the Egyptian Pound. Consequently, the Black Market quotation was raised 25% above the premium rate. Also, international terrorism affected the tourist industry. At the same time the Iraqi government limited the average remittances of Egyptian workers to \$1200 per year. (There are 1.5 million Egyptian workers in Iraq.) In addition, about 25% of the Egyptian workers and expatriates returned home from the Arab Gulf States, due to the drop in the oil prices and the bankruptcy of foreign and local companies operating in the mentioned countries. There are other factors which contributed to the flourishing of the Black Market, part of the blame is the demand by drug cartels for hard currency to finance \$1 billion in illegal drug traffic (mostly Hashish) and the other in the drop in oil production due to technical matters and maintenance. Also, payment of

interest on the international debt affected the government reserve of Foreign Exchange.

Therefore, 1986 was a year of acute austerity. The price of oil for domestic consumption jumped to 25% while the export price was reduced 36%. Other measures included the banning of importation of automobiles and certain food stuffs. Tariffs reached 100% on imported goods. The official rate for the Egyptian Pound was depreciated from \$1.429 in 1987 to the "New Bank Rate," which reached \$0.455 per Egyptian Pound at the end of 1987 (see Table No. 3).

The new government headed by Dr. Atef Sidki with the agreement of I.M.F. agreed to liberalize the Rate of Interest to stimulate investment and to adopt a new reform for the exchange rate.

The new policy adopted by the government consisted of the following steps:

- 1) Allowing Public sector corporations and institutions to purchase U.S. dollars from the Black Market to give the ability to import raw materials and pay debts.
- 2) The U.S.S.R. canceled all interest on their debt.
- 3) A new loan was granted by the E.E.C. (\$200 million.)
- 4) Banks were required to reduce loans by 2.5% to counter growing inflation.
- 5) Commercial banks were required to transfer 3% of the U.S. dollar reserve to the Central Bank in exchange for the Egyptian Pound.

Table No. 4

Black Market Rates of Local Currency
In U.S. Dollar Per Egyptian Pound At End of Year

Month	1985	1986	1987	1988	1989
January	\$ 0.76	0.59	0.53	0.47	0.40
February	0.73	0.62	0.50	0.50	0.41
March	0.78	0.60	0.49	0.48	0.39
April	0.71	0.60	0.47	0.48	0.37
May	0.78	0.60	0.50	0.44	0.32
June	0.69	0.55	0.47	0.42	0.32
July	0.69	0.57	0.46	0.40	—
August	0.65	0.55	0.48	0.42	—
September	0.56	0.54	0.48	0.42	—
October	0.58	0.53	0.51	0.45	—
November	0.60	0.51	0.54	0.45	—
December	0.58	0.50	0.48	0.41	—

Source: *World Currency Year Book, 1989.*

Table No. 4 shows the rate of exchange which was offered by the Black Market dealers. In 1989, for example, the official rate was US \$1.49 while the Black Market was \$1.76 in January and by December the rate declined to \$0.58 per Egyptian Pound. The table also shows the continuing decline of the rate of the Egyptian Pound in the Black Market.

The decline in the rate of exchange continued through 1986 and 1987 respectively. The Black Market offered Egyptian expatriates more competitively priced local currency for their remittance earnings than the Central Bank, or commercial private banks. For example, in 1984, Mr. Sami Ali Hassan's, who is called the "Boss" of the money exchangers, annual transactions reached \$2 billion from the worker's remittances. With the arrest of Mr. Hassan, one Egyptian Pound declined from US \$1.35 to US \$2.00. The Black Market continues to dominate the Egyptian currency market and had become a very prosperous market, until its collapse in 1991, when the government initiated the "Free Market Exchange Rate" which is similar to the International Money Market.

Development of the Free Market of the Exchange Rate

The goal of the Monetary Authority is to establish a unified and stable rate of exchange for the Egyptian Pound. The Monetary Authority was convinced that a stable rate of exchange would bring a huge amount of Foreign Exchange to the government. The "shortage" of Foreign Exchange is the real bottleneck for Egypt's foreign trade. Therefore, by May 1987, the government decided to establish a "Free Exchange Market," which is subject to the market forces of supply and demand. The other goal of the Monetary Authority is to stop the numerical rate of exchange which was used by the Central Bank and other monetary authorities.

The daily determination of the rate of exchange was supervised daily by a committee of the state banking system, after the market was closed. The criteria by the "Committee" is to monitor the foreign exchange revenues, its uses by banks and taking the dollar as a base for international currency fluctuation. Foreign currencies are determined according to their relation (link) to the dollar. It was a step to create an international money market.

Unfortunately, banks began to hesitate to meet the demand by importers for payment in dollars. Another factor was that the domestic interest paid in the Egyptian Pound was lagging behind the rate of inflation. (The inflation rate was 25% while interest capped at 18% annually.) Such a phenomenon created a new demand by Egyptian savers to deposit their remittances in dollars as a savings deposit, plus the dollar savings was paying higher interest during this time. This situation created what is called "dollar handling" as the way to deal in the currency market. This chaotic situation continued to operate until February 1991. The black market began to operate effectively to meet the demand of importers. The black market began to offer a higher rate than the government was offering for dollar exchange; the gap was so wide between the official and the black market. In January 1985

the black market rate was \$0.76, while the official rate was \$1.429 per Egyptian Pound. In June 1988, the black market rate reached \$0.42 while the official rate remained at \$1.429 per Egyptian Pound (see Tables 2 and 3).

By February 1991 the government enacted Law No. 117 of 1991 to manage and organize the Foreign Exchange Market and allowed the creation of the following markets:

- 1) The Preliminary Market
- 2) Free Market of Foreign Exchange

The preliminary market is a continuation of the previous rate of exchange which was supervised by the "Banking Committee." There were some administrative change by allowing the Ministry of Economy and Foreign Trade to have a great hand in the Monetary Authority decision in supervising and monitoring the Rate of Exchange. The Rate of Exchange was determined according to the dollar fluctuation in London. The preliminary market was dealing mostly in the public sector exports, except tourism. The preliminary market was allowed to meet the need of the public and private sectors from dollar deposits. The above responsibilities were given to the authorized banks only.

The major turning point in the history of the Foreign Exchange Market was in February 1992 when the government merged the preliminary market with the Free Exchange Market. Law No. 491 set up the legal framework for the Free Exchange Market .

Free Exchange Currency Market

Earning of foreign exchange (visible and invisible) for the Free Exchange Market can be obtained from the following sources

- 1) Tourism
- 2) Traveler's checks and international money orders.
- 3) Export of commodities
- 4) Grant and government loans
- 5) Worker's remittances

According to Law No. 491, 1992, the government allowed the following agencies to deal in the foreign exchange currency market

- 1) The Central Bank of Egypt
- 2) Authorized banks by the government
- 3) Authorized companies (private currency exchange companies)

The spirit of Law No. 491, 1992, is to establish a free rate of exchange for the Egyptian Pound without intervention of government agencies or other monetary authorities. The Central Bank, authorized banks and private exchange companies were given the freedom to determine the rate of exchange, conditionally. The latter has to declare and advertise publicly the values of the rate of exchange of each currency. Law No. 491 prohibited

excessive speculation in the currency market so that stability of the market will prevail in a healthy atmosphere.

To monitor the operation of the foreign exchange market, the government required banks and private currency exchangers to be connected to a central headquarters and operate with the Central Bank computer system. Thus, the Central Bank will watch the fluctuation in the rate of exchange morning, noon and when the market is closed. The Central Bank, on the other hand, is authorized to practice the "open market" policy in buying and selling currencies for the purpose of stabilizing the market from excessive fluctuation. Also, the Central Bank limited the maximize size of foreign exchange balances. When the balances exceed the maximum level, the Central Bank will buy the surplus at the prevailing price. Also, banks and private currency exchangers were required to report their daily operations in volume and size.

The Role of Private Exchange Companies

Due to the creation of the Free Foreign Exchange Market, about 100 currency exchange companies applied for a license to operate in the market. Presently, there are seventy currency exchange companies licensed to operate.

The private currency exchange companies are required to adhere to the following rules:

1. Compulsory stock holder corporation
2. Stocks have to be titled to Egyptians only
3. The capital of the company should not be less than one million pounds
4. The sole goal of the company is to buy and sell banknotes, travel checks and international money orders.
5. The private exchange companies are not allowed to practice bank's activities, e.g., transfer and receive money from aboard.
6. The president of the company has to be experienced in the field of money and finance.

Table No. 5 shows that the operation of the free market in foreign exchange resulted in a huge amount of Foreign Exchange Revenues (reserves). The Free Market Revenues increased from \$295 million in March 1991 to \$1.2 billion in December 1991 and the total revenue reached \$6.8 billion; while the net revenue reached \$5.7 billion (\$1.1 billion expanded through inter-bank operations). Comparing the Free Market figure to the banking market, the net revenues reached \$3.2 billion. It is half of what the Free Market achieved during 10 months.

The Table (5) also shows the noticeable increase in revenue between January 1992 and April, 1992. The figure reached \$1.1 billion as a total revenue. Finally, within fourteen months, the Free Exchange Market revenues reached \$11.9 billion, while the banking market achieved only \$3.5 billion.

Regarding the uses of foreign exchange by the Free Market, Table No. 6 shows in March 1991-December 1991, the "uses" jumped from \$266 million to \$1.2 billion. The total uses in 1991 reached \$6.7 billion, while the Banking Market "uses" reached only \$3.2 billion. During January 1992, the figure was \$1.255 for Free Market; while the Banking Market uses were \$314 million. In brief, the total Uses by the Free Market reached \$11.7 billion compared with \$3.5 billion by the Banking Market.

The above figures in both revenues and USES, shows the potential size of the Free Market operations. These operations, unfortunately, were the monopoly of the Black Market before the creation of the Free Market. It is a giant growth in the Foreign Exchange Market as well as successful growth.

Table No. 5

Foreign Exchange Transactions (Revenues)
1991-1992

A. Revenues (Million dollars)

Month	Year	Free Market 1991-1992		Banking Market 1990-1991	
		Total Revenue	Interbank Operations	Net Revenue	Net Revenue
March	1991	\$ 295	00	295	\$ 308
April	"	254	00	254	265
May	"	205	00	205	371
June	"	322	7	315	335
July	"	573	28	545	382
August	"	753	69	684	409
September	"	863	27	836	328
October	"	1,016	378	738	303
November	"	1,358	450	809	280
December	"	<u>1,241</u>	<u>346</u>	<u>909</u>	
TOTAL		6,880	1,105	3,270	
January	1992	1,262	310	952	300
February	"	1,261	266	995	000
March	"	363	174	189	000
April	"	<u>1,177</u>	<u>31</u>	<u>1,146</u>	<u>000</u>
TOTAL		11,943	1,886	10,057	3,570

Source: Central Bank of Egypt. *Development of the Exchange Rate in Egypt*. May 1992.

Table No. 6

Foreign Exchange Transaction (Uses)
1991-1992

B. Uses (In millions)

Month	Year	Total Uses	Inter Bank	Net Uses	Uses of Banking Market 1990/1991
March	1991	\$ 266	00	266	306
April	1991	256	00	256	250
May	1991	214	00	214	332
June	1991	310	4	306	370
July	1991	499	73	426	292
August	1991	754	312	442	316
September	1991	826	350	476	355
October	1991	928	397	315	335
November	1991	1,444	734	710	342
December	1991	<u>1,285</u>	<u>335</u>	<u>950</u>	<u>337</u>
TOTAL		6,782	2,205	4,577	3,285
January	1992	1,255	332	923	314
February	1992	1,309	560	749	000
March	1992	1,140	429	711	000
April	1992	<u>1,296</u>	<u>499</u>	<u>797</u>	<u>000</u>
TOTAL		11,782	4,025	7,757	3,599

Source: *Ibid.*

Manipulation of the Central Bank to Stabilize the Egyptian Currency

Open Market Operation

To secure the stability of the Egyptian pound, the Central Bank of Egypt began to apply an Open Market policy in buying and selling the Egyptian pound in the free market. This policy is similar to the Open Market policy of the U.S. Federal Reserve Bank in dealing with bonds and government securities.

During the month of August, 1992, the Central Bank purchased \$4.5 billion from the free market of foreign exchange. It was aimed to stabilize the Egyptian pound against the dollar. In fact, this step by the Central Bank was announced by President Mubarak to the Egyptian Parliament. It is the first time in the history of the Central Bank to take such an action.

In the past two decades, Egyptian workers who migrated to the rich oil countries (Iraq, Saudi Arabia, United Arab Emirates, Libya, Algeria and Kuwait) accumulated what is called "dollar hoarding." Egyptian workers began to deposit their savings in dollars with Egyptian banks, while other Arab banks deposits were in local currency. Such permitted policy by the Central Bank encouraged Egyptian workers to deposit their remittances in dollars without fear of the fluctuation of the dollar in the black market, as had happened in the past several years. The black market was the dominant power during that period (1970-1990). It became so easy and free for every Egyptian citizen to walk into any bank of Free Currency Exchangers and buy or sell dollars.

The value of the dollar was stabilized, unified, and the "Black Market" disappeared. We cannot deny the fact that the Worker's Remittances represent a huge portion of the Egyptian Bank deposits in dollars. The "dollar hoarding" phenomenon, which dominated the mentality of the average Egyptian citizen, who holds dollar deposits from remittances, began to diminish and disappeared from the society. The manipulation of the Central Bank to stabilize the Egyptian pound against the dollar was the real factor behind the disappearance of the "dollar hoarding." Egyptians who hold dollar deposits in their savings began to realize that their earning represented only 3 percent as interest on saving. This 3 percent, represented the international money market on dollar savings. At the same time, the Central Bank began to offer 18 percent interest in local currency of the dollar saving converted to the Egyptian pound. This comparison shows it is an "economic loss" to depositors in dollar savings accounts. Consequently, and due to the increase of dollar deposits (supply), most of Egyptian depositors began to withdraw their dollar savings and deposited them in Egyptian Pound Savings accounts and earned 18 percent annual interest. Such a step by the Egyptian depositors avoided any loss in the foreseen fluctuation in the interest on the dollar. The dollar is subject to uncertain fluctuations in the International Money Market.

In September 1992, the Central Bank purchased another \$10 billion from the Free Market Currency Exchange as a measure to stabilize the market, and kept it as a foreign Exchange Reserve, and in case for future intervention in the Money Market. This step was taken by the Central Bank of offset an expected increase in the dollar due to the decline of the German interest rate in the European market.

Some Egyptian Bankers and Economists suggest that the mentioned policy by the Central Bank saved the Egyptian pound in the Free Market; otherwise, the Egyptian Pound would have reached £2.50 to US/one dollar. The Egyptian bankers continue to recommend and advise Egyptian depositors to convert their dollar deposits into the Egyptian pound and avoid the interfluctuation in the money market. (See tables 5 and 6.) The dollar fluctuation in the International Market caused by the continuing economic recession, deficit and other economic factors in the U.S.A. Consequently, any change in the dollar rate of interest, has direct impact on the rate of interest in Egypt. The decline in the money market interest is a world phenomenon and reflects on every country which is dealing with cash and the money market.

A new study by the Academic for Scientific Research in Egypt shows a high growth in private commercial and investment banks which attracted the Egyptian depositors to save, more than the public banks in this respect. The new banks achieved annual growth of 30 percent compared with government banks between 1982-1992. It is the first time that the dollar rate has declined against the Egyptian pound. This is due to the Open Market Operation by the Central Bank in buying and selling dollars in the Free Market of Foreign Exchange. Again, the Private Currency Exchange Firms have also contributed to the stability of the rate of exchange of the Egyptian pound.

As a result of the manipulation of the money market by the Central Bank of Egypt, higher interest rates on dollar deposits began to decline. The stability in the exchange rate of the money market contributed to a higher marginal propensity to invest and a decline in the marginal propensity to save. This is a turning point in the process of capital formation in Egypt.

To the average Egyptian citizen, the motivation is to invest only if the investment gives higher earnings. For the past five years, most of the dollar depositors began to transfer their savings from the dollar to the Egyptian pound saving. Comparatively speaking, the dollar saving gives three percent, while the Egyptian saving deposit offers 18 to 20 percent. Some Egyptian savors began to invest their money in Islamic banks or investment corporations, where the earning reached 24 percent in the institutions. Unfortunately, most investors in the mentioned Islamic investment institutions lost their entire savings because of mismanagement and corruption. The best example is Al-Rayan Islamic Investment Corporation which shocked the entire economic and political system of Egypt. This phenomenon indicates the motivated mentality of the average Egyptian saver, who is guided by higher interest, or economic return on investment.

To guide the masses of Egyptian savers to invest and channel their savings in productive projects such as Capital Equipment Corporation, land, factories and building projects, it is necessary for the Central Banks and other banking institutions to explain the simple economic concept that investment in stocks of capital projects, productions corporation reward a higher return and more than the 18 percent offer by the banking system in the long run.

Finally, to educate an Egyptian saver on economic return on investment can take the following example: A share of stock of L 100 in construction corporation yields 12 percent per annum. This assumption does not mean the return on investment is only 12 pounds a year. The stock value might go up from L 100 to L 160 pounds for a period of three years. Therefore, the annual return of each share will be L 20 pounds annually. In conclusion, the final return on investment of each share of stock will reach L 32 pounds a year. If compared, this increase in the stock value will be greater than the return of 18 percent on saving deposits which are offered by the banking system. It is a simple economic concept.

The public sector which includes both production of Consumers and Capital goods as well as services will be de-nationalized in the coming few months as part of the new economic reform which was adopted by the government and passed by the Parliament. It is necessary for the private sector to support this reform and purchase a share of stocks of the public sectors. Moreover, it is a turning point in the Egyptian economy toward a free market system.

On the other hand, the Central Bank can play a great role in encouraging the public sector's ownership by private investors by financing 30 to 50 percent of the public stock per share as a loan with minimum interest charged. This step will increase the chance to the masses to participate as private investors. Commercial and private banks can play the same role of the Central Bank.

IV. Sources of Foreign Exchange and the Balance of Payment

Suez Canal Tolls

The Suez Canal tolls are considered one of the major sources of foreign exchange to Egypt, followed by oil, tourism and cotton exports. By January 1992, the transit tolls were increased by 9-18 percent. This toll increase raised the revenue to a high record of \$1.89 billion in 1992. An increase of \$120 million dollars compared with 1991.

Tourism

Tourism is another source of earning of foreign exchange. The Ministry of Tourism initiated a huge project to promote the tourist industry in Egypt. In April 1992, the government of Egypt awarded a contract to the International Finance Corporation to build two hotels in Al-Qusair on the Red Sea coast. Also, as part of the goals of the Ministry of Tourism the diversification from traditional Nile bound tourism towards the country's beach holiday attractions, which will attract tourists. The government is planning to invest \$200 million in the Red Sea area. Annual earnings of foreign exchange from tourism reached \$2 billion in 1992.

Worker's Remittances

Remittances are defined as the portion of the international migrant worker's earnings sent back from the country of employment to the country of origin. Remittances are considered to be an inexpensive source of foreign exchange which enables the country to finance their imports. The shortage of the foreign exchange constitutes an obstacle in the development process; thus remittances in some countries e.g. Turkey, Pakistan and Egypt may play a key role in the relief of the production bottlenecks. In the case of Egypt which is the topic concerned, remittances shape many of the economic activities. In fact, remittances have become the major theme of the ongoing debate concerning the cost and benefits of international migration for the sending countries. (See Table No. 1.)

The concept of remittance of migrants has dominated the economic literature for the past three decades. Professor Chandavarkar reviewed the users of remittances in Turkey, Portugal, Yugoslavia, Yemen Arab Republic and India where he found empirical studies. In Turkey, for example, migrant's savings were being used and channeled for housing with some portion of it going into small factories and shops. While in Portugal, 38% of remittances were spent on land and housing, 32% for domestic appliances. In Yugoslavia it was mostly invested in productive investment. In Yemen, the use of remittances to purchase land in the cities, which led to higher prices. In the case of India, the remittances went into land, jewelry and buildings.

Impact of Remittances on Economic Activities

It is proven that the impact of remittances on economic activities in the sending countries had a positive balance of payment effect. The effect was noticed by the way in which they were used which was of crucial significance for the economies of the migrant's home.

National Income Impact

Remittances have a significant impact on major economic indicators, as in the case of Egypt. This case has been noticed on the growth of GNP, savings and the balance of payment, particularly for the period 1970-1992. It was estimated that the remittances represent 8-13% of the GNP of Egypt during the mentioned period. In the case of Egypt, the remittances encouraged the government to enact new laws to deal with these funds, particularly in dealing with special rates of exchange.

Inflation Effect

In the case of Egypt, the Egyptian people are intended to have high propensity to consume, specifically, on consumer's goods, housing and land. Therefore, the increase in the domestic consumption has a positive impact on the output through an increase in aggregate demand. Inflation in Egypt which reached 20% was partially aggravated by remittances and it generates a demand more than the capacity of the economy to offer. In some cases it creates a chaotic situation as in the so called Islamic corporation, which attracted a huge portion of Egyptian savings and ended in bankruptcy and the loss of the entire savings.

Import Effects

The Central Bank of Egypt, with special privileges, allowed the remitted recipients to use part of the remittances to import consumer and capital goods. Therefore, remittances induced and enhanced an increase in the amount of imports, approximately 10%.

Effect of Worker's Remittances

The effect on worker's remittances on the Egyptian Economy is one of the major factors to influence economic growth prospects and the increase in foreign exchange in Egypt is the rapid growth of the inflow of remittances from the Egyptian workers in the Oil-rich countries of the Arab Gulf States. During the oil crises in 1970's, where the oil price jumped from \$3.00/b to the highest of \$47.00/b, the dollar reserves of the Gulf State reached unbelievable figures: Saudi Arabia \$285 b; Iraq, \$45 b; Kuwait, \$85 b; and U.A.E., \$55 billion. The oil Gulf States began a major plan for reconstruction of their economies. The demand for skilled and unskilled labor increased rapidly. The oil-rich countries gave a first priority to Arab laborers. Iraq absorbed between 1-2 million Egyptian immigrants to work in the industrial, agricultural and service sectors. Saudi Arabia, Kuwait, Qatar, and the U.A.E. absorbed around half million Egyptian workers. Libya and Algeria absorbed 200 thousand

Egyptian workers. They are typically young males living in subsistence level condition, they save a large percentage of their incomes and remit a large proportion to their families back home. Culturally, Egyptians are known in the Arab world as very attached to their homeland.

The impact of remittances has contributed to the labor force by creating new jobs as well as improving education, health and productivity. These phenomena are considered to be a social benefit. The other side of the impact of the remittances has been noticed in the urban area of economies and less attention on the rural areas. If some of these remittances were directed toward improving the economies of the rural areas, it might add to productive investment and diversification of agriculture as well as non-agricultural activities in the rural economies and have a positive impact and improve the poverty among rural people.

Generally speaking, worker's remittances effect can be summarized:

- 1) The effect of the net flow of remittances show an increase in private consumption of non-food items, import of capital goods, import of raw materials and intermediate goods and gross investment.
- 2) The net flow of remittances increased the cost-of-living index through its effect on money supply (see Table 2).
- 3) Remittances were used in purchasing housing and land for speculative purposes, which stimulated inflation.
- 4) Direct effect of remittances on the gross domestic product via the supply side of the economy and price level.
- 5) From the multiplier point of view, one pound increase in net remittances flow will increase consumption of food and consumption of non-food, increase government spending, increase gross investment, increase the import of raw materials, increase imports of other goods and increase the gross domestic product.
- 6) The flow of remittances may shift the power relationship at the community kinship and family level. It became, to some, the social securities for relatives and kinship.

Development in the Balance of Payments

During the 1970's severe balance of payment pressures were experienced by the Egyptian economy as a result of continuous domestic recessions, stagnating exports, and a heavy burden of defense expenditures. However, the situation was greatly improved because of the increasing foreign exchange receipts from petroleum, the Suez Canal dues and the remittances of the Egyptian workers abroad.

Hence, it can be seen that total current receipts surged from \$1.1 billion in 1971, to \$2.8 billion in 1975 and continued to rise until it reached \$16.8 billion in FY 1990/1991. This continuous rise in these revenues enabled the economy to sustain equally rising imports and other payments. (See Table No. 12.)

However, the current account deficit continued to persist until 1989/90. The rise in tourism and industrial exports on one hand, and the restraint on imports and the decline in interest

payments on the other hand contributed much to the sharp decline in the current account deficit to \$0.4 and 0.3 billion in 1986/87 and 1987/88. The steady rise in tourism earnings of 25 to 50 percent annually can be attributed to political stability and depreciation of the exchange rate. In the late 1970's and until 1987, industrial exports were stagnant due to a rapid increase in local consumption and to decreasing competitiveness of Egyptian manufactured products. In 1987, export regulations were simplified and a more favorable exchange rate was applied which resulted in a sharp rise in industrial exports which showed the effectiveness of proper exchange rates in stimulating exports.

Furthermore, several reforms were adopted between 1986 and 1988 which reduced the import bias in the economy. Imports were greatly reduced from about \$12.0 billion to about \$10.0 billion due to a sharp drop of about 60 percent in the real effective exchange rate of the Egyptian pound in assessing customs duties on imports. However, this decline in imports did not continue but increased in the following years. This was due to over-valuing the exchange rate while the Egyptian government failed to increase the customs exchange rate. As a result, imports were stimulated, exports, particularly non-petroleum exports, were discouraged and the government revenues from customs were less than it should have been. Exports of agricultural products have been declining in the 1980's due to a rapid annual population growth of 2-8 percent, rapid urbanization, inadequate procurement prices, excessive government regulations and a rigid exchange rate. However, the recent rising trend in agricultural products exports occurred as a result of adopting a more realistic exchange rate, liberalized agricultural controls and increasing the procurement prices of many crops.

Egypt has sizeable oil and gas reserves. As a result of a highly subsidized prices, domestic consumption has been rising at more than 10 percent annually in the 1980's, while exports of crude oil continued to fall in the latter half of the 1980's. Only in 1990/91 have receipts of petroleum exports surged as a result of imposing a more realistic price in the domestic market, thus limiting local consumption and increased industrial efficiency.

Egyptian worker's remittances have been increasing throughout the 1980's except during 1985/86 and 1986/87 when it slightly declined which was attributed to lower wages and increased competition from Asians working in the Middle East. However, these remittances have slowly increased until it reached its highest level of \$3.8 billion in 1990/91, assisted by exchange rate depreciation. The adopted appropriate market-based exchange rate, the rise of interest rates on deposits in Egyptian pounds and the improved investment-climate are the contributing factors for these increased remittances. They constitute a main source of revenue in the Egyptian Balance of Payments and a major factor in converting the persistent deficit into a surplus of \$1.4 billion that year (1990/91).

The realization of this dramatic surplus of \$1.4 billion in 90/91 is primarily due to the debt relief realized through the Paris Club and to the cancellation of U.S. military debts. Among the factors that contribute to improving the Balance of Payments situation are those related to the Gulf crises. The most notable of these factors are the temporary rise in volume and

prices of oil sales, capital flight from the Gulf area to Egypt and the special assistance received by Egypt.

Over the near-term, Egypt's major exchange earners: remittances, tourism and Suez Canal fees, are expected to remain firm. Oil exports revenues will depend primarily on international price developments. This performance, along with the debt relief described above and aid pledged of the July World Bank-Sponsored Consultative Group Meeting, should allow Egypt to sustain a positive balance of payment.

V. Empirical Study of Egyptian Monetary Policy

Objective of Study

The purpose of this study is to investigate empirically the objectives and patterns of Egyptian central bank policies during the 1970-1988 period. Our approach is similar to those taken in previous studies in that it will develop a monetary policy reaction function which allows for the testing of different policy responses.

A key motivation for this study is to examine whether discretionary monetary policy can be used to achieve ends in addition to budget monetization in the absence of well developed financial markets. Specifically, our interest centers on addressing the question of whether the Egyptian monetary authorities have engaged in discretionary monetary policy activities.

Methodology

The first part of our study consists of specifying a policy reaction function for the monetary authorities. In accord with most models of the determination of monetary policy in developing countries, we chose changes in the central banks' holdings of domestic credit as the appropriate indicator of monetary policy (policy instrument). As Egypt has been on a fixed exchange rate for the majority of the period under study, other monetary aggregates such as the money supply are subject to external influences are not under the control of the domestic monetary authorities. We did not chose interest rates either since they were often set by the government and were not adjusted in a discretionary manner.

The second part of our study consists of specifying the variables that affect monetary policy. Toward this end, our choice of independent variables was based on the openness of the economy, the kind of exchange rate regime present, and the domestic factors that policymakers are most likely to respond to.

Following the work of Porzecanski (1979), we hypothesize two types of policy which guide the response of the monetary authorities: accommodating and stabilizing (counter cyclical). If the Egyptian monetary authorities follow an accommodating policy, changes in real output and prices will be accommodated with changes in domestic credit in the same direction. To maintain policy autonomy, the authorities will offset (sterilize) foreign reserve inflows. Finally, exchange rate (domestic price of foreign currency) changes will lead to changes in domestic credit in the same direction in order to accommodate the resulting changes in the current account and output.

If the Egyptian authorities follow a stabilizing policy, changes in real output and prices lead to opposite changes in the supply of domestic credit to the economy. to achieve and maintain external equilibrium in a fixed exchange rate regime, foreign reserve flows will not be offset or sterilized. Finally, the effects of exchange rate changes will now be offset by opposite movements in domestic credit.

In order to econometrically estimate the monetary policy reaction function and to distinguish between these policies, the following equation was estimated:

$$DC_t = B_1 + B_2 FA_t + B_3 FX_t + B_4 GAP_t + B_5 INF_t + B_{6t} + e_t$$

where,

DC =	% change in domestic credit.
FA =	% change in foreign assets.
FX =	% change in the nominal bilateral rate between the Egyptian currency and the U.S. \$.
GAP =	The difference between real output and values derived from a regression of real output on trend.
INF =	% change in the CPI.
T =	Time trend.

Under an accommodative policy, the following signs would be expected:

$$B_2 < 0, B_3, B_4, B_5, B_6 > 0$$

And under a stabilizing (counter cyclical) policy, the following signs would be expected:

$$B_2 > 0, B_3, B_4, B_5 < 0, B_6 > 0$$

Data Sources

Quarterly data were obtained from the International Financial Statistics of the International Monetary Fund.

Empirical Results

The results of the estimate of the monetary reaction function are presented in Table 7. Heteroscedasticity was detected and corrected by using the White's heteroscedastic consistent estimates of the standard errors. The DW-test statistic for first-order serial correlation fell in the inconclusive region. Therefore, we resorted to the Breusch/Godfrey LM test statistics to test for the presence of an AR(1)/MA(1) to AR(3)/MA(3) processes. The absence of these processes could not be rejected at both the 5% and 1% level.

Table No. 7
Statistical Analysis

Variable	Coefficient	t-statistic
CONSTANT	0.129	5.85**
FA	-0.215	-5.28**
FX	-0.019	-1.05
GAP	-0.422-05	-3.32**
INF	-0.061	-0.21
T	-0.16-02	-3.52**

F= 7.26**

**Significant at the 1% level.

The results indicate that monetary policy has been used by the Egyptian monetary authorities as a tool of policy since changes in domestic credit respond systematically to a few determinants. The F-statistic indicates that the explanatory variables are jointly significant at the 1% level.

With the exception of the FX and INF variables, the remaining coefficients are statistically significant at the 1% level. The statistical significance of the FA and GAP variables show evidence of the influence of both foreign and domestic sector variables.

The negative coefficients on FA (sterilization) and GAP (counter cyclical) indicates that the Egyptian monetary authorities practice a combination of both accommodating and stabilizing policies. That is, they stabilize with respect to movements in domestic variables, and accommodate foreign variables.

Conclusions

The empirical results show that both domestic and foreign-sector variables are important determinant of monetary policy in Egypt. Therefore, even in the absence of well developed financial markets, the monetary authorities have attempted to preserve monetary control by offsetting some proportion of the monetary impact of reserve flows. At the same time, the empirical evidence indicates counter cyclical policy with respect to the output gap to dampen changes in aggregate demand. Thus, these findings suggest that monetary policy in Egypt has been used to attain ends in addition to budget monetization.

VI. Conclusions and Recommendations

Egypt is the first country in the Arab world which pioneered in banking and foreign exchange transaction. The first bank was founded in 1845. The banking system in Egypt is linked to European banks, particularly English banks. Due to the fact that Egypt is the major supplier of cotton to European countries, Egypt was under the Gold Standard until 1936. In 1945 Egypt joined the International Monetary Fund and pegged its currency (the Pound) to the "Sterling Area", and in 1948 Egypt withdrew from the "Sterling Areas" and began to impose strict control over the foreign exchange transactions. During the Socialist transition, the National Bank of Egypt was divided into a separate Bank of Egypt and a Commercial National Bank of Egypt. Foreign exchange control continued as a monopoly of the Central Bank of Egypt. In 1961, the Socialist government of Late President Nasser nationalized all private banks and the banking establishments became the monopoly of the state. During the period (1960-1970), Egypt developed a severe shortage of Foreign Exchange and a chronic deficit in the balance of payments. This is due to the inefficiency of the public sector of the economy and the gradual disappearance of the private sector in both services and production.

The decline in the activities of the banking system during the Socialist Transition hindered economic development and growth of the Egyptian economy during the given period, 1960-1973. During the same mentioned period, the economy experienced only 8.8 percent in money growth. This situation continued until President Sadat, initiated the Economic Openness Policy (Infitah) in 1973 and began to liberalize the economy from the Socialist Transition to a free market economy from 1973 - 1987. The banking industry experienced growth in the commercial banks, and unfortunately with the appearance of the black market as the real power influenced the determination of the rate of exchange for the Egyptian Pound. The black market attracted the tourist market and Worker's Remittances. But, the government continued to apply restricted foreign exchange control, and often offered "Special Rates" of exchange to tourist industry and Worker's Remittances. This special treatment did not stop the attracted rate of exchange by the black market. This situation continued until 1987, when the government began to liberalize its monetary policy and allowed the creation of a Free Exchange currency market.

Removing Foreign Exchange control and allowing the market forces to determine the rate of exchange was a great step toward liberalization of the bottleneck for the Egyptian currency. Also, permitting non-bank dealers (money exchangers), to operate in the Free Market, made the money market efficient and competitive.

On the other hand, liberalization of the rate of exchange, stimulated the government with confidence to remove import and export restrictions, and promoted private sector trade. The Ministry of Economic and Foreign Trade approached a new policy by lifting the ban on imports and reducing it 50% on certain commodities. The new policy is to free the import's restriction in the near future. The Central Bank, on the other hand, has removed the Letter of Credit (LC), and the required advanced deposit for imports has been reduced and may be abolished soon. On certain commodities, the Central Bank eliminated a prior

approval for export licenses on certain commodities. The number of products banned from exports was reduced from twenty items six. In October 1991, the rate of exchange became a unified rate.

The Free Exchange Market operations created a stable exchange rate and eliminated the black market activities. Between January 1, 1991 and December 1991, the change in the Egyptian Pound was only 0.01% while before the creation of the Free Market, the change in the Egyptian Pound reached 15%. It is a great achievement in the stability of the Egyptian Pound.

Reforming the Exchange System proved a major success, and foreign exchange is now freely prevailing. The Foreign Exchange Market created huge dollar reserves for the Central Bank. The Exchange Rate is part of the comprehensive economic reform. The result of such a reform materialized in a stabilization policy of the government. The de-regulation and de-control of the rate of exchange, and the rate of interest, helped liberalization to take place in the economy. Liberalization in the public and private sector should move very fast to achieve a efficient and productive economy.

Currently, the Egyptian economy is the right path for economic growth and development. Development is a growth-plus change. Changes in population structure must take place and family planning programs must be implemented by the government.

To move the Egyptian economy toward a market oriented system, the following recommendations should be implemented:

1. Monetary policy should be applied to reduce monetary growth, in order to offset the growing rate of inflation.
2. De-control of the rate of interest.
3. Freedom of lending and deposits.
4. Open market operation by the Central Bank to stabilize the money market should be a policy guide and tool to be implemented.
5. Promoting and working to establish a stock exchange market. This market will divert the savings from the current high rate of interest to investment in productive projects.
6. The money market should be supervised effectively by the Central Bank to bring confidence to the average Egyptian investor and to pave the road and to make the Egyptian currency convertible with other international currencies.
7. Government should reduce cash subsidies on agricultural crops, fertilizers, and other products. Let the free market take care of it.
8. Privatization of the public sector.

Finally, Egyptian economy in the coming few years will be a model for economic growth, development and stability in the Middle East. There is a great opportunity for the Middle Eastern countries to follow the Economic path of the Egyptian Model. The Egyptian Model will be similar to the Pacific Rim countries who are following the South Korean, Hong-Kong and Taiwan Market oriented economic model.

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Appendices

Table No. 8
Economic Indicator of the Monetary System in Egypt
1951-1959

Year	1951	1952	1953	1954	1955	1956	1957	1958	1959
Share of Individuals to Current Account	6.4	5.3	4.8	5.2	5.4	5.7	6.4	6.0	6.5
Share of Individuals to Savings Deposits	1.5	1.6	2.0	2.2	2.3	2.2	2.2	2.8	3.3
Velocity of Money	2.6		2.5		3.1	2.7			
Percentage of Money in Circulation to Quantity of Money		60	54	55	54	57	54	54	51
Percentage of Money to the Monetary Base		70	67	71	64	72	71	71	71
Commercial Banks Percentage of Reserve to Total Credit	40	33	34	23	30	25	26	12	21
Commercial Banks Percentage of Reserve to Total Deposit	33	27	27	22	27	24	24	22	20
Commercial Banks Duration of Current Account Daily							65	57	61

Source: Aljarehi, M., *Development of the Monetary Policy in Egypt*, 1982.

Table No. 9
Sectoral Distribution for Banking Credit
end 1958
(In millions of Egyptian Pound)

Sector	Amount	%
Agriculture & Fishing	6.0	2.5
Industry	67.6	28.5
Trade		
a) Cotton	79.3	
b) Agr. Crop	57.8	
Transportation	4.4	1.9
Other Sectors	21.8	9.2

Source: Aljarehi, Ibid.

Table No. 10
Economic Indicator of the Monetary System in Egypt
1960-1973

Year	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
Share of Individuals to Current Account	6.3	7.4	6.1	6.1	6.9	6.8	7.8	7.9	8.0	7.7	7.7	8.4	10.2	11.9
Share of Individuals to Savings Deposits	3.0	3.2	5.0	6.2	6.2	6.7	6.0	6.5	7.0	7.8	8.1	7.0	7.6	9.3
Velocity of Money	3.4	3.2	3.4	3.3	3.0	3.4	3.5	3.5	3.5	3.6	3.8	3.7	3.5	3.0
Percentage of Money in Circulation to Quantity of Money	54	56	63	67	67	69	65	64	64	67	67	66	64	64
Percentage of Money to the Monetary Base	72	79	82	83	84	82	82	75	76	76	70	70	79	78
Commercial Banks Percentage of Reserve to Total Credit	23	16	13	13	14	15	13	16	16	17	22	12	15	21
Commercial Banks Percentage of Reserve to Total Deposit	23	18	17	18	19	21	21	26	26	28	37	22	25	29
Commercial Banks Duration of Current Account Daily	56	5	7	41	36	34	34	38	39	39	31	29	28	31

Source: Aljarehi, *Ibid.*

Table No. 11
Economic Indicator of the Monetary System in Egypt
1974-1982

Year	1974	1975	1976	1977	1978	1979	1980	1981	1982
Share of Individuals to Current Account	15.2	19.0	22.4	30.8	34.4	41.4	34.4	41.4	50.8
Share of Individuals to Savings Deposits	13.7	15.2	21.7	29.9	41.7	60.8	99.0	150.8	236.7
Velocity of Money	2.8	2.6	2.8	2.5	2.4	2.4	3.7	3.8	4.0
Percentage of Money in Circulation to Quantity of Money	63	62	62	60	62	61	70	68	67
Percentage of Money to the Monetary Base	75	80	80	84	83	78	72	65	50
Commercial Banks Percentage of Reserve to Total Credit	22	15	15	14	12	16	17	23	43
Commercial Banks Percentage of Reserve to Total Deposit	31	25	24	18	14	16	19	22	37
Commercial Banks Duration of Current Account Daily	34	32	33	35	40	42	22	24	23

Source: Aljarehi, *Ibid.*

Table No. 12

**Balance of Payment on Current Account
(US \$ billion)**

	1971	1975	1980	83/84	84/85	85/86	86/87	87/88	88/89	89/90	90/91
CREDIT											
Petroleum Exports	0.0	0.2	3.0	3.0	2.9	2.2	1.4	1.5	1.1	1.2	2.0
Other Exports	0.9	1.4	1.1	1.4	1.3	1.2	1.4	1.7	1.6	1.9	1.9
Suez Canal	0.0	0.1	0.7	1.0	0.9	1.0	1.1	1.3	1.3	1.5	1.7
Tourism	0.1	0.4	0.7	1.0	1.2	0.8	1.2	1.6	0.9	1.1	0.9
Workers Remittances	0.0	0.4	2.7	3.0	3.5	3.0	3.0	3.4	3.5	3.7	3.8
Other Receipts	0.1	0.3	1.2	2.4	2.3	2.2	2.6	2.6	4.8	5.3	6.5
TOTAL	1.1	2.8	9.4	12.7	12.1	10.4	10.7	12.1	13.2	14.7	16.8
DEBITS											
Imports	-1.2	-4.7	-9.0	-10.3	-10.5	-9.5	-8.0	-9.8	-10.4	-11.4	-11.4
Interest Payment	-0.1	-0.1	-0.5	-1.2	-1.0	-1.3	-1.1	-0.8	-1.1	-1.7	-1.5
Other Service Payment	-0.3	-0.6	-1.6	-1.9	-1.8	-2.1	-2.0	-1.8	-2.2	-2.3	-2.5
TOTAL	-1.6	-5.4	-11.1	-13.4	-13.3	-12.9	-11.1	-12.4	-13.7	-15.4	-15.4
Current Account Deficit	-0.5	-2.6	-1.7	-0.6	-1.2	-2.5	-0.4	-0.3	-0.5	-0.7	-1.4

Source: Central Bank of Egypt, 1990. (Data 1971-1988.)

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