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REPORT ON ECONOMIC CONDITIONS IN EGYPT
1995-96

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I. Summary & Introduction

During 1995/96, the Egyptian economy achieved significant growth compared with its performance since the start of the economic reform period. Real GDP increased by 4.2%, reflecting a 2% increase in real GDP per capita.[1] The inflation rate declined from 10.5% in 1994/95 to 9.3%, while the fiscal deficit remained constant at 1.3% of GDP, which was the target set for the year. Interest rates continued to decline, with the three month treasury bill rate falling to 10.2% in June, 1996, down from 10.9% in June, 1995. Unemployment is officially estimated to have declined slightly from 9.6% to 9.4%. The current account of the balance of payments was in deficit because of a deterioration in the trade deficit, but the increase in the capital account helped to keep the overall balance in surplus. The debt burden has decreased from US $33 billion in 1994/95 to US $31 billion in 1995/96. The ability to service the debt has remained strong, with the debt service ratio (debt service as percentage of current receipts including transfers) at 10.7% in 1995/96. The relative importance of the private sector in economic activity has been growing at a slow rate, with the private sector accounting now for 63% of GDP (compared to 61% in 1991/92) and 68% of total employment. The growth in productivity in the private sector has increased rapidly in the last two years, reaching 3% in 1995/96 compared to -0.5% for the public sector.

The higher rate of economic growth achieved in 1995/96 has been fostered by the results of reform measures implemented since 1991 and has been partly enhanced by the change in priorities adopted by the new government, which was appointed in January 1996. The new government has accelerated the tempo of structural reform after a period of stagnation. The Government of Egypt (GOE) has taken several important measures to speed up the liberalization process and induce economic growth: 1) tariffs on imports were reduced; 2) the restriction on foreign majority ownership of joint venture banks was lifted; 3) privatization was put on the top of the agenda and a comprehensive privatization plan was announced for 1996/97; and 4) investment approvals and procedures were streamlined to attract

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[1] The main source of data in this report is the IMF's "Article IV Consultation and Recent Economic Developments", 1995 and 1996. The accuracy as well as the methodology of generating the data provided by the GOE to the IMF has been questioned by many. Fortunately, the GOE's current and future efforts are expected to improve the quality of data.

foreign investment. The new government's commitment to moving ahead with the economic reform process resulted in the resumption of the negotiations with the IMF and the signing of a two-year Stand-by Agreement in October 1996. Following on from this Agreement, the Paris Club approved the release of the third and last tranche of debt relief amounting to US $4.2 billion.

The MENA or Cairo Economic Conference held in November 1996 was a significant event in many aspects. It was an opportunity for Egypt to convince the world business community of its commitment to economic reform and structural adjustment and to attract many foreign investors. President Mubarak, in a much-commended speech given at the Conference, outlined three major thrusts to achieve economic growth: greater openness to the global economy; increased investments; and improved productivity. It also reflected the new role envisaged for the government: "There is a new governance in Egypt, one based on transparency in the formation of policies, in the institutions that manage them, and in the data that evaluate them." In addition to the publicity that Egypt gained from the Conference, several project deals were agreed upon, the most important of which is the Egypt/Turkey liquified gas project.

The new government considers raising living standards and creating additional employment opportunities as the main challenge for the medium term. It has set a target of 8% annual growth rate of the economy in the next five years. To achieve this goal, however, more reforms have to be implemented. The role of the private sector has to be further enhanced by removing the remaining obstacles impeding the growth of private sector involvement, the financial sector needs to be revitalized, trade has to be further liberalized, and social conditions have to be improved. Moreover, private saving and investment levels have to be boosted in order to achieve the desired increase in GDP growth rate. In fact, both USAID and the Egyptian government agree on the need for the following remaining reforms: restructuring the tax system; removing the remaining impediments to trade by streamlining quality controls and allowing more private sector participation in port services; speeding up the privatization process; improving the investment regime; and strengthening the financial market institutions.

II. Update on Economic Developments

A. Fiscal Policy:

The actual fiscal deficit for 1995/96, amounting to 1.3% of GDP, remained in line with the original budget target for that year and at the same level as last year. Total revenues increased by 9% in nominal terms (from 56 billion Egyptian Pounds (LE) to LE 61 billion), mainly due to an increase in tax collections, but declined, relative to GDP (from 27.8% to 27.2%). Current expenditures decreased commensurately, from 23.8% of GDP to 23.2%, because of lower debt service costs and more expenditure controls, while capital expenditures remained constant in terms of GDP. Some observers argue that the reason that budget revenues did not rise in terms of GDP was due to the delay in transforming the sales tax into a full fledged Value Added Tax (VAT). However, it is also argued that the implementation of the VAT, scheduled for July, 1997, might not result in a tangible increase in net revenues due to the large administrative burden associated with it.

On the financing side, the GOE relied totally on bank domestic finance (2% of GDP in 1995/96 compared to -2.1% in 1994/95), marking a switch after three years of heavy dependence on non-bank finance (e.g. treasury bills).

B. Monetary, Financial and Exchange Rate Developments:

According to Central Bank data, the broad money supply growth rate declined from 16% in 1992/93, to 11% in 1994/95, and to 10.5% in 1995/96. In contrast to the previous year, the rate of expansion of foreign currency deposits declined sharply in 1995/96 (from 19% to 1%), while that of local currency almost doubled. Accordingly, the share of foreign currency deposits in the overall money supply decreased from 25% in 1994/95, to 23% in 1995/96, reflecting a tendency towards de-dollarization of the Egyptian economy.

The nominal exchange rate has remained virtually constant at LE 3.39 per US $, mainly as a result of the Central bank intervention policy directed at keeping the nominal exchange rate constant and limiting credit and liquidity creation. In real effective terms, however, the Egyptian Pound appreciated by 9% in 1995/96 compared to 1994/95 and, according to IMF calculations, by about 40% in the period 1991-96 . The issue of the LE appreciation has been controversial and was a stumbling block in the Egypt/IMF negotiations for two years. The IMF and others argue that the LE appreciation has disadvantaged Egyptian exporters. However, many government officials believe that a devaluation will not necessarily increase exports but will worsen the trade deficit because Egyptians will have to pay more LE to purchase imports. They also argue that a stable foreign exchange rate is important for attracting foreign investment.

The real appreciation of the LE has been coupled with a decline in the interest rate differential between the LE and dollar denominated assets. These two factors combined have resulted in a reduction in the growth of foreign currency reserves. In 1995/96, the growth in foreign currency reserves amounted to only $0.5 billion compared to $1.3 billion in 1994/95 and $1.5 billion in 1993/94.

The major developments in the financial sector were focused on the stock exchange market. Although the stock market in Egypt is still small, it is growing at a rapid rate, and is expected to keep booming, especially with the current high pace of privatization. According to Flemings Research, 1996, the outstanding performance of Egypt's capital market makes it "one of the most attractive emerging stock markets for the second half of the decade". [2] The following are the most important developments in the stock market in 1995/96: 1) market capitalization reached LE 37 billion during 1996 compared to LE 11 billion in 1992; 2) the total value of shares and securities traded increased from LE 3 billion in FY 1995 to LE 5 billion in FY 1996; 3) four new investment funds were given license; 4) the number of foreign exchange dealers increased from 90 in June 1995 to 98 in June 1996; 5) the 2% tax on capital gains on the sale of shares stipulated in Law 95 was abolished in June 1996 and mutual funds were exempted from the 40% tax imposed on their earnings; 6) Egypt's first global depository receipt issue was made in July 1996 when the Commercial International Bank issued 20% of its share capital on the London Stock Exchange; and 7) the Capital Markets Authority (CMA) signed an agreement with the US Securities & Exchange Commission (SEC) for technical assistance and information exchange in February 1996.

C. Balance of Payments:

The recovery in the Balance of Payments in 1994/95, due to an unprecedented growth in exports (a 51% increase in 1994/95 over 1993/94) was not sustained in 1995/96. According to IMF data, imports grew by 15% growth in 1995/96. Most of this increase was due to a growth in imports of capital and intermediate goods, reflecting an expansion in economic activity. Meanwhile, exports declined by 7%, a decline of about US $414 million, of which US $210 million was a decrease in cotton exports. This resulted in a substantial widening of the trade deficit to reach about 14% of GDP. The recent reductions in tariff rates are expected to encourage imports in the near future, but it is hoped that they will also stimulate exports by reducing the cost of production to some export industries such as textiles.[3] To have a tangible positive impact on exports however, the GOE should concentrate its efforts on eliminating the remaining obstacles facing exporters. These administrative and bureaucratic impediments were estimated by the World Bank at 10% of the total costs of exports.[4]

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[2] "Egypt Economic Profile, an Overview", Ministry of Economy and International Cooperation, 1996, p.10.

[3] See the section on private sector development for details on the tariff changes.

[4] According to the World Bank calculations, Egypt's exports of textiles, iron & steel products, and aluminum products are among the highest in the MENA region in terms of comparative

Developments in the service and transfers account were mixed: the surplus in the services balance increased by 32% in 1995/96 compared to 1994/95 due to a surge in tourism revenues. Meanwhile, workers remittances declined by 16% mainly as a result of the decrease in the interest rate differentials between the domestic and world markets and the unfavorable economic conditions in the Gulf area. Income from the Suez Canal and investment declined by 8% and 4% respectively, while official transfers remained constant in nominal terms at US $0.9 billion.

Despite the deterioration in the current account balance, the increase in the capital account helped to keep the overall balance in surplus and only slightly lower than the previous year.

D. Population, Employment and Output:

a) Population: Egypt's population in 1996 is estimated at 60.2 million, up by 2% over the previous year, and by an annual average rate of 2.1% over the last four years. The growth in the labor force and employment was faster, averaging 3% in the same period. As a result, the percentage of employed people increased from 24.6% in 1991/92 to 25.5% in 1995/96.

b) Unemployment Rate: Estimates of unemployment are diverse and differ greatly between the official and unofficial sources. According to the Ministry of Planning data, the unemployment rate declined from 10.1% in 1992/93 to an estimated 9.4% in 1995/96, while CAPMAS Labor Survey estimates the rate at 11.3% in 1995. According to CAPMAS survey results, 96% of the unemployed have at least completed their middle level education, and 69% are below 25 years of age. Unofficial estimates of the unemployment rate are in the range of 13%-15% or more.

c) Employment Structure: The sectoral distribution of labor has not changed much during the past five years. In 1995/96, the commodity sector absorbed around 53% of total employment, compared to 54% in 1991/92. Within the commodity sector, the growth in employment has not been uniform; the growth in employment in the industrial sector declined from 4% in 1994/95 to 3.3% in 1995/96, while it slightly increased in the agriculture sector from 1.3% to 1.4%.

The share of the private sector in overall employment increased slightly from 67% in 1991/92 to 68% in 1995/96. The sector distribution, however, underwent greater changes; private sector employment in industry grew from 58% to 61%, and from 65.5% to 68% in the Production Services Sector (which includes

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advantage.

transportation, trade, finance, insurance and tourism). One possible explanation for the increase in those two sectors is the move towards privatization, especially in industry and hotels in the last three years.

d) GDP Structure: Estimates of GDP and real GDP growth rates differ from one source to the other. According to Ministry of Planning data, real GDP grew by 4.2% in 1994/95, and is estimated to have increased by 4.9% in 1995/96. IMF estimates, however, are 3.2% and 4.2% for the last two years, respectively.

The share of the private sector in real GDP increased from 61% in 1991/92, to 63% in 1995/96. The greatest increase of private sector involvement was in the industrial sector (from 58% to 62% of value added in the industrial sector) and the production services sector (from 62% to 66% of value added in this sector).

E. External Debt and Debt Service:

According to Central Bank of Egypt and IMF reports, total external debt amounted to $31 billion in June 1996, compared to $33 billion in the previous year. In October 1996, the Paris Club approved, after a delay of two years, the release of the third and last tranche of debt relief amounting to $4.2 billion. This approval as a result of Egypt's signing of a Stand-by Agreement with the IMF.

According to IMF data, the debt service ratio (interest and amortization as a percent of current account receipts including transfers), amounted to 10.3% in 1994/95, down from 12.0% in 1993/94, and is estimated to have reached 10.7% in 1995/96.

F. Privatization and Private Sector Development:

Privatization activities underwent a considerable switch during the past year, both in pace and method. This was mainly initiated after the appointment of the new government, which placed privatization at the top of its agenda. A new undersecretariate has been tasked with the monitoring and progress evaluation of the privatized Public Sector Enterprises (PSEs). This committee has developed a comprehensive three year privatization program for PSEs.

The method of privatizing the PSEs has been changing over time, from selling shares to employees (Employees Stock Associations) in 1994, to initial public offers (IPOs) in 1996 [5]. The newest trend is to sell the whole PSE to an anchor

[5] IPO is the method of offering and selling shares on the stock exchange.

investor. One major disadvantage of this method, compared to other options, is that the time required to conclude a privatization transaction is often longer. However, it is appropriate for the Egyptian market, as the firms that are privatized need the technical expertise that can be provided by an anchor investor.

Privatization efforts in 1996 resulted in privatizing 13 PSEs through IPOs; liquidating one PSE and selling two companies to anchor investors. In total, the privatization program succeeded in privatizing/liquidating 39 companies to date, representing about 12.4% of the initial Law 203 companies.

On the banking side, the GOE privatized six joint venture banks in 1996. Consequently, as of Oct. 31, 1996, a total of 15 joint venture banks are privately owned and only eight are still majority-owned by public entities. Alternatively, if we assess the joint venture banks' ownership structure in light of the GOE plan, which aims at reducing state bank ownership to below 20%, only eight joint venture banks have reached the target. While five venture banks are still majority-owned by state banks and ten are privately owned, the state banks own between 20% to 49% of their capital. The GOE also privatized one joint venture insurance company.

The GOE has agreed to limit the use of the sales proceeds from privatization to debt retirement/financial restructuring of public enterprises to be privatized: employee compensation; costs of selling public enterprises; and reduction of domestic public debt.

On the deregulation side, important legislative changes took place during the last year. The banking law was amended by Law 97 of 1996, allowing for majority foreign ownership of joint venture banks. The commercial registration law was also amended by Law 98 of 1996, allowing for the registration of foreigners to engage in export activities. Ministerial Decree no. 178, issued in September, 1996, simplified the procedures and accelerated industrial registration and licensing of local investment. The GOE has also drafted a competition (anti-trust) law and an anti-dumping law, both due for submission to Parliament within the next month.

On the trade side, tariff rates on imports were reduced. The maximum tariff rate was reduced from 70% to 55%, while rates between 50% and 30% were reduced by 10 percentage points. The new tariff structure, which should decrease the cost of imports for certain key export industries, is expected, when combined with several decrees that were issued to simplify export procedures, to stimulate export growth and improve the competitive position of Egyptian goods in the world market.

III. <u>Economic Reform Activities</u>

A. The IMF Agreement:

Egypt completed its IMF and World Bank programs in March 1993. A new three year IMF Extended Fund Facility (EFF) was approved by the IMF in September 1993. In 1994, a major disagreement between the GOE and the IMF over the issue of the LE devaluation resulted in the EFF becoming non-operative. The negotiations over a new stand-by began in March 1996, after the new government proved its commitment to the economic reform process, and after the IMF chose to concentrate on accelerating structural adjustment instead of focusing on currency devaluation. The negotiations culminated in the signing of a new two year Stand-by Agreement in October 1996.

The new IMF Agreement, with the intention of achieving annual growth rates of 6%, focuses on deepening economic reforms, especially the privatization of state enterprises, the reduction of trade barriers, and the deregulation of the business climate. A provisional stand-by credit of SDR 271.4 million is included in the Agreement, with the understanding that Egypt is not currently in need of this facility, as it does not face balance of payments problems.

On the macro side, the IMF program concentrates on further reducing the budget deficit to 1.1% of GDP, and on stabilizing the inflation rate at 6.3% in 1996/97. Trade liberalization measures include the reduction of the maximum tariff rate to 40% and limiting the number of tariff bands to seven by July, 1998. The 3%-4% import surcharge fee has to be reduced to 1%. Fiscal reform includes the extension of the sales tax to a full value added tax by July 1997, and the reduction of civil service employment by 2% per annum from 1996/97.

B. USAID Programs

Through its Sector Policy Reform (SPR) Programs, USAID is promoting policy reforms in the financial, fiscal, trade, enterprise, and the environment sectors. USAID is also promoting, in separate programs, policy reforms in the agricultural sector, including the liberalization of the markets for agricultural crops, and enhanced private sector participation in agricultural input distribution. USAID's active policy programs also encompass the power, telecommunications, water, and wastewater sectors. In addition, the Mission has developed a Growth Through Globalization activity to support the private sector and reinforce the efforts made to improve Egypt's competitive position in the world economy.

Under the second year of SPR I which ended June, 1995, USAID disbursed $185 million of a total of $200 million. A new SPR II program, composed of a two-year matrix of policy reforms, started in June, 1995. This program covers trade liberalization, financial market reform, protection of the environment, and private sector support. Since the first year of SPR II , twelve measures have been achieved. A disbursement of $80 million, representing the amounts related to eight measures, has been made, while an additional $35 million for the remainder of the twelve achieved measures will be disbursed shortly. In 1996, a new SPR III program was signed with the GOE. The two programs (SPR II and SPR III) are expected to help the GOE undertake faster and greater reforms.

Among other activities, USAID is providing technical assistance to: 1) the Ministry of Economy and International Cooperation to improve policy formulation in the areas of trade, deregulation, and financial sector reform; 2) the Central Bank of Egypt to improve its functions; 3) the Capital Market Authority to enforce international accounting and auditing standards and prudential regulations; 4) the Ministry of Scientific Research to improve Egypt's Intellectual Property Rights system; 5) the Ministry of Trade and Supply to strengthen the trade policy analysis; and 6) the Central Agency for Public Mobilization and Statistics to improve the quality of statistics, as well as other activities.

C. The US-Egypt partnership for Economic Growth and Development (PEGAD)

In September, 1994, President Mubarak and Vice President Gore announced the establishment of the U.S.-Egypt Partnership for Economic Growth and Development. The Partnership's main objective is to promote sustainable and equitable economic growth in Egypt through broadening and strengthening the economic relations between the United States and Egypt, especially in the areas of trade and investment, and deepening the linkages between the private sector in the two countries.

In an attempt to boost economic growth efforts, Vice President Gore visited Cairo in mid January, 1996 and met with President Mubarak and PM Ganzouri. In July, 1996, President Mubarak followed up with a visit to Washington.

The Partnership consists of four inter-government sub-committees, supporting efforts in the areas of trade & finance, science and technology, education, and environment, and the President's Council, composed of 15 U.S. and 15 Egyptian business leaders. Thus far, the Partnership has had some significant achievements. The President's Council has presented to President Mubarak and V.P. Gore its views on the steps required to promote bilateral trade and investment. A US $2 million bilateral science & technology agreement was signed to enhance joint research projects, especially in the private sectors. Other projects that the Partnership is sponsoring include: improving the competitiveness of Egyptian exports, enhancing technology transfer in agriculture and computer related private sector activities, upgrading the technical capabilities within the Ministry of

Economy and the Central Bank, enforcing environmental quality controls in touristic areas, promoting programs for improving Cairo air quality, and providing in-service teacher training. These activities are aimed at providing assistance in the areas that need technical support the most, in an attempt to foster sustainable economic growth.