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TRANSITIONAL PROBLEMS FROM REFORM TO GROWTH: SAFETY NETS AND FINANCIAL EFFICIENCY IN THE ADJUSTING EGYPTIAN ECONOMY

by

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RÉSUMÉ

Depuis quelques années les problèmes liés aux réformes économiques dans les pays ayant mis en oeuvre une politique d'ajustement ont fait l'objet de nombreux travaux de recherche. En revanche, les coûts sociaux de l'ajustement, ainsi que les difficultés posées par le passage de la réforme à la croissance, ont moins retenu l'attention. En Égypte par exemple, où un programme d'ajustement économique est engagé depuis 1991, cette transition est difficile, tant du point de vue social que financier.

La première partie de ce document examine le fonds social récemment créé en Égypte (1991), et notamment la capacité de ses programmes de base et de ses mécanismes spécifiques à établir un système efficace de protection sociale à moyen terme. La seconde partie du document étudie le système d'intermédiation financière égyptien, qui ne parvient pas à transformer les liquidités considérables de l'épargne en capital réel à long terme, accentuant ainsi l'intervalle entre réforme et croissance.

En conclusion, il apparaît qu'un système efficace d'intermédiation financière, ainsi qu'un système généralisé de protection sociale, soient nécessaires pour atténuer les problèmes durant le passage de la réforme à la croissance.

SUMMARY

In recent years, considerable analytical work has been done on issues of economic reform in countries undertaking adjustment. Less attention has been devoted to the social costs of adjustment and the transitional problems during the period from reform to growth. The Egyptian economic adjustment since 1991 is a good case in point, as Egypt is facing difficult transitional problems, of both social and financial nature.

The first part of this paper discusses Egypt's newly established social fund (1991), notably the adequacy of its core programmes and targeting mechanism for providing an appropriate "social safety net" in the medium term. The second part of the paper deals with Egypt's financial intermediation system, which is unable to convert large amounts of liquid savings into long-term real capital, hence increasing the time-lag between reform and growth.

It is concluded that an efficient system of financial intermediation and a comprehensive social safety net are needed to mitigate the transitional problems during the period from reform to growth.

PREFACE

An efficient social safety net, targeting adjustment-induced poverty, and financial systems that contribute to sustainable growth by converting savings into productive investment are the central tenets of comprehensive reform. The first element serves the political survival of reform by compensating the short-term losers of reform, such as labour released from public enterprises. The second element helps avoid supply failures by providing finance for new, potentially productive business activities.

Professor Mahmoud Abdel-Fadil from the University of Cairo, Egypt, a Visiting Fellow at the OECD Development Centre during 1994, argues in this paper that neither element works properly in Egypt. This country is thus a typical case of a developing economy for which the costs of the transition from reform to growth are high, with rising unemployment and signs of adjustment fatigue. In this paper, part of the research programme "From Reform to Growth", Professor Abdel-Fadil recommends a more comprehensive anti-poverty strategy, based on exchange entitlements and institutional arrangements to widen and deepen Egypt's capital markets. These recommendations, if put into practice, could help minimise the social costs of adjustment and the time lag between reform and growth. Other developing countries in current or post-adjustment situations can draw lessons from this paper, based on Egypt's real experience, which could help them to deal with the problems that have become as familiar to them as to Egypt.

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INTRODUCTION

Economic reform has to be based on the economic realities of the country concerned rather than textbook paradigms, since the feasibility, distributional impact and success of reforms depend on taking into account the existing institutions. Egypt's own experience with economic reform and structural adjustment programmes reveals a need for greater consistency between strategic targets and instruments during the transition from reform to growth. We shall argue that efficient "safety nets" and financial systems can alleviate the social costs of transition and reform, and reduce the time-lag between reform and growth, thus avoiding serious supply failures and mounting unemployment. In turn, this should enhance the political feasibility of the reform and help head off the social and political unrest that currently appears to be a major threat.

The main aims of this study are to assess Egypt's newly established *social fund* and to explain why the current institutional arrangements have not channeled the vast amounts of liquid domestic savings towards productive investment, which could contribute to self-sustaining growth.

In March 1990, the Government of Egypt initiated a comprehensive structural adjustment programme involving the standard price and trade liberalisation policies, as well as an ambitious programme of privatisation and public enterprise reform. The first phase of the reforms (1991-1993) was supported by an IMF stand-by arrangement, a World Bank structural adjustment loan, and debt and debt service relief, including an agreement with Paris Club creditors.

The first phase of the economic reform and structural adjustment included "a major reduction in the fiscal deficit; the initiation of financial liberalisation, including the decontrol of interest rates and the unification of the exchange rate system; the establishment of a Treasury bill market; the liberalisation of most prices and the adjustment of energy prices to come closer to their opportunity costs; the start of a multi-year programme for liberalising the trade regime, including the removal of many non-tariff barriers to trade and the reduction of the maximum tariff rate"[1].

The second phase of the economic reform and structural adjustment (effectively starting in January 1994) focuses on real and financial sector reforms. This is being supported by an IMF three-year extended arrangement, a World Bank structural adjustment monitoring program, and further debt and debt service relief by the Paris Club creditors. "The main aims of the Government are to consolidate the gains that were made during the first phase of the 1991-93 period and to deepen the structural reforms, in order to put in place an economic environment conducive to a strong and sustainable supply-side response from the private sector"[2].

Nonetheless, the long-term challenges facing the Egyptian economy entail difficult transitional problems from reform to growth, namely: (i) improving the economy's growth-performance over the medium term; (ii) expanding the economy's job-creating capacity; (iii) minimising the social costs of transition and adjustment (i.e. adjustment-induced poverty).

Egypt is thus a typical case of a developing economy in which there are high transition costs during the period from reform to growth. There are already clear signs of "structural-adjustment fatigue", as unemployment is rising, especially among the youth and school graduates. The pre-reform unemployment rate in 1990 was already 15 per cent.

On the other hand, Egypt's financial system is unable to convert domestic liquid savings into long-term real capital, thus increasing the time-lag between reform and growth. The economy needs to establish efficient financial institutions, to ensure greater mobilisation of domestic financial resources in an "over-liquid" economy.

This study is divided into four sections. Section 1 examines the social costs of structural adjustment and its redistributive impact. It is also assesses the adequacy of the core programmes and targeting mechanism of the newly established social fund (1991). The section concludes by recommending a more comprehensive anti-poverty strategy based on the concept of exchange entitlements. Section 2 deals with broad trends of the savings effort in the Egyptian economy during the 1980s, and examines the volatility and unsustainability of the recent upsurge in national savings.

Section 3 addresses problems of financial intermediation in the Egyptian economy, and the financial system's inability to transform and channel liquid savings into productive investment. The analysis in this section shows that what matters for growth is not the quantity of savings but the quality of these savings. Some policy measures and institutional arrangements are suggested for widening and deepening Egypt's capital markets, and for improving their performance.

Section 4 notes the challenges and pitfalls lying ahead on the transitional path from reform to growth. The Conclusion again briefly stresses the need for consistency between strategic target and instrument to minimise the social costs of adjustment as well as the time-lag between reform and growth.

1. Safety Nets and the Economic and Social Costs of Adjustment

Adjustment policies are *redistributive* by nature, and the most frequent problems governments face when carrying out liberalisation and adjustment policies involve an unacceptable distribution of economic benefits and social burdens.

A study of an adjustment programme's impact on income distribution should focus on the possible adverse effects of new measures on the *sources* and *uses* of the income of various socio-economic groups. This "highlights the potential need for compensatory policies to cushion the impact on the poor (and the vulnerable groups)"[3].

1.1 Social Safety Nets and Adjustment Programmes

The World Bank has proposed using aid-financed social funds as the main instrument for alleviating poverty under structural adjustment. This approach emphasizes establishing social safety nets to deal with the short-term costs of adjustment[4]. The IMF, for its part, pays special attention to the cost-effectiveness of safety nets and to the sustainability of their financing[5].

Financed by donors and thus not transferring resources from the State budget, the main objective of these safety nets is enhancing the political feasibility of economic reform and structural adjustment[6]. For example, the Emergency Social Fund (ESF) established in 1985 in Bolivia[7] and the Programme of Actions to Minimise the Social Costs of Adjustment (PAMSCAD) in Ghana provided for compensatory measures for workers laid-off from the public sector[8].

Social safety nets could be extended to cover a number of basic areas[22]:

i)   Social insurance , such as unemployment and health insurance;

ii) Income-support measures, for the poor and the unemployed (including public works programmes);

iii) Limited rationing schemes for basic wage-goods, well-targeted for poor sections of the population (i.e., the chronically poor;

iv) Job retraining for members of the labor force who lose jobs as a result of restructuring;

v)   Family allowances and cash welfare transfers to households that are identified as poor or likely to be poor;

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vi)   Old age income maintenance schemes.

Some safety nets would only exist during the transition period from reform to growth, while others could remain as an integral part of a market-based economy[10]. For instance, a limited rationing system is normally intended to cover only transition periods, and should be limited to the quantities normally consumed by the poorest one or two deciles of the population[11]. By contrast, unemployment insurance could become part of a formal social security system under which eligibility, benefits, etc. would depend on the financing options.

Social safety nets have to be a compromise between social and political considerations on the one hand, and what is fiscally and macroeconomically feasible on the other[12]. While social safety nets are intended to create political support for the structural adjustment process, the real challenge is avoiding politicisation and reaching the poorest deciles of the poor[13].

1.2   Egypt's Social Safety Net

Assistance to the poor in Egypt has been provided primarily through an extensive system of untargeted subsidies. These subsidies covered basic foods, electricity, housing, transport, and energy products. The food subsidy programme was the most extensive and open-ended one (especially the bread subsidy). At the peak in the 1982-83 financial year, the budget allocations for all kinds of subsidies and transfers amounted to more than 13 per cent of GDP[14]. Faced with growing budget deficits, the government began to cut many social expenditures, including the costly food subsidy programme. By the 1993-94 financial year, the total budget for all kinds of explicit subsidies and transfers amounted only to about 4 per cent of GDP[15].

Since the poor spend a larger share of their income on food than do the top or middle income deciles, food subsidy cuts had negative effects on income distribution and nutrition. When the reform was initiated in 1991, Egypt had no programme to help unemployed and displaced workers. To meet this deficiency, in March 1991 the government established its own social safety net, *The Social Fund for Development* (SFD), to provide income- and employment-generating opportunities for the socioeconomic groups which are most vulnerable to the negative impact of economic reform and structural adjustment programmes. The SFD is scheduled to expire by December 31, 1996. However, an option still under discussion is converting the social fund into a permanent poverty agency having a broad mandate (like India's National Reconstruction Fund), rather than retaining it as "a temporary institution with an initial four year life span to reflect the emergency nature of its intervention"[16].

The SFD's main priorities have been generating income and employment, and providing essential physical infrastructure and public services. More precisely, the SFD has six core programmes as follows[17]:

(a) *Direct employment creation through the provision of essential municipal services.* This programme is designed to undertake numerous small-scale labour-intensive public works projects, covering areas such as rehabilitation of water supply and sewerage systems, streets and roads; canal cleaning; solid waste collection; etc. Priority is to be given to areas with high poverty incidence and unemployment rates. It was estimated that 300 000 short-term jobs (of three-months) would be generated by this programme;

(b) *The Enterprise Development Programme,* for providing integrated packages of credit, technical assistance and training to help unemployed people to start-up productive activities, and to help small enterprises to expand their businesses and create new jobs. Loans would be extended at market interest rates through existing financial intermediaries. It was estimated that 70 000 micro-enterprises could be funded by this programme;

(c) *The Labor Mobility Enhancement Programme,* which is designed to facilitate the redeployment of workers displaced by public-enterprise reform. This includes the retraining of displaced workers, as all displaced workers in public enterprises would be eligible for a retraining allowance. Public and private enterprises willing to offer employment and training to displaced workers would receive the retraining allowance over a period of 12 months as a compensation for the training provided.

(d) *The Community Development Programme* includes improvements in basic and primary health care programmes, mother and child nutrition programmes, short-term literacy activities, and a variety of self-help productive activities, thus providing essential services among the poorest and most vulnerable groups.

(e) *The Institutional Development Programme,* which is designed to strengthen SFD's targeting, monitoring and evaluation systems, including the development of enhanced mechanisms for: (i) better targeting of subsidies; (ii) protecting essential public services used by the poor; and (iii) improving the efficiency of various direct transfer schemes, thus rationalising the priorities of social sector expenditures. This should help to strengthen the government's ability to formulate and monitor future poverty alleviation programmes.

(f) *The Public Transport Services Programme.* This programme focuses on the low-income groups of Greater Cairo and Alexandria who rely on public buses as their only means of transportation. The programme aims at facilitating their movement to nearby

labor markets by improving transportation through maintenance services, carried out by low-income inhabitants of the two cities.

In the first year, the SFD found it difficult to target funds to alleviate poverty. The targeting was very rudimentary, consisting ranking various districts in the country by relative levels of poverty, based on four crude indicators. The SFD was also subjected to political pressures (from various ministers) to support certain projects which were inconsistent with the agreed selection criteria.

1.3   Poverty-Targeting

The success of SFD interventions will largely depend on an ability to target those groups in society likely to suffer a decline in their living standards during the transitional adjustment period. This delicate task requires the development of an appropriate poverty-targeting map to identify the socioeconomic groups suffering high poverty incidence and the areas where there is a high concentration of poverty and unemployment. This, in turn, requires the application of clear appraisal criteria.

The lack of discrimination between different poverty groups gives rise to unfocused policies. In other words, *gross characterisation of poverty* by the conventional poverty-line methodology, leads to distortions of public policy[18]. According to N. Kakwani, income among the poor is unequally distributed, so any index of absolute poverty is bound to be an inadequate measure of the *intensity* of poverty[19]. This is because "more inequality of income among the poor, with the mean income remaining unchanged, implies greater hardship to the extremely poor in a society"[20].

Thus there is a pressing need for a clear differentiation among various poverty groups, based on the severity of deprivation and the lack of sources of income (formal or informal). The familiar *head-count measure* normally conceals the degree of intensification of poverty among various groups.

The method suggested by Foster, Green, and Thorbecke (1984) to decompose poverty indices to capture three aspects of poverty, could be useful in studying the impact of adjustment policies on the widening and deepening of poverty[21]. Their poverty indices take the following form:

adjustment policies on the widening and deepening poverty[1]. Their class of poverty indices takes the following form:

$$P_\alpha = \frac{1}{N} \sum_{i=1}^{q} [(y_p - y_i) \ / \ y_p]^\alpha$$

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a) the prevalence of absolute poverty as measured by the number — or the fraction — in the total population living below a certain specified poverty line;

b) the intensity of poverty as reflected by the extent to which the income of the poor lies below a certain poverty line (i.e. poverty-income gap);

c) the degree of income inequality prevailing among the poor.

Thus, if $\alpha = 0$, index P_α becomes $P_\alpha = q/N$, which has been referred to as the head-count index. It reflects the proportion of the total population lying below the poverty line, i.e., the proportion of poor in the total population. This measure is indifferent to the extent of poverty of the poor. It is only sensitive to their number and reflects the prevalence of poverty[22]. Comparing the evolution of this index over time indicates the extent of poverty-widening.

Alternatively, with $\alpha = 1$, the poverty index P_α becomes:

$$P^1 = 1/N \sum_{i=1}^{q} [Y_p - Y_i] \ / \ Y_p \ = \ I P_o$$

Where I is the "income gap ratio", i.e., the mean income gap of the poor, $(Y_p - Y)$, where $Y = \Sigma Y_i/q$ is the mean expenditure (income) of the poor, expressed as a fraction of poverty line. Thus, P_1 is the income gap ratio multiplied by the head-count index. This index, provides a good measure of the extent or intensity of poverty as it reflects how far the poor are from the poverty line[23]. The evolution of this index over time reflects poverty-deepening. The greater the value of x, the greater the weight which is put on the poorest during an intensification of poverty.

Relying on pre-reform expenditure data derived from the 1990-91 Family Budget Survey, poverty indices for urban and rural Egypt were calculated on the basis of the preceding formula, and with reference to various poverty lines. The results of these calculations are reported in Tables 1, 2 and 3.

Despite the limitations of the data drawn from the Family Budget sample surveys, as the lowest decile may be completely missing or severely underreported, the pre-reform poverty assessment indicates very clearly that Upper Egypt has the greatest incidence of poverty, especially in terms of the depth and severity of poverty as measured by P_2. The number of poor is greatest in certain governorates of Upper Egypt, namely Assiut, Sohag and Fayoum, which are the principal areas where sociopolitical violence has recently occurred.

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The incidence of poverty is likely to worsen during the reform and adjustment period extending until the middle of 1996. Thus an efficient targeting mechanism by region and poverty level could help identify various poverty groups, ranging from the ultra-poor[24] to those just below the poverty line or some other cutoff point.

1.4 The Limitations of Social Fund Interventions

The SFD was established in early 1991 to mitigate the transitional costs and the adverse effects of economic reforms and structural adjustment programmes on low-income groups and to protect the vulnerable sections of the population. The $613 million fund, backed by the World Bank and 16 other donors, was designed to act as a safety net during the transitional adjustment period. As of 15 November 1993, the Social Fund had committed $183.6 million and disbursed $71.7 million for 233 projects and studies relating to its six core programmes[25].

The Social Fund's success is measured in terms of assisting displaced public enterprise workers and providing income- and employment-generating activities for those most vulnerable to the negative impact of the economic reform and structural adjustment. Table 4 shows what the Fund's programmes did in areas of permanent and temporary job creation as of 31 October 1993. This table indicates that during two years (1992 and 1993), the SFD created at most 113 000 permanent jobs, a modest figure in a country with 15 per cent unemployment and a relatively large population.

This performance is also rather modest in comparison with that of Bolivia's Emergency Social Fund. It was reported that the Bolivian programme generated up to 20 000 man-months of employment per month when the programme was in full gear. On the other hand, infrastructure projects — sewerage, low-income housing, schools, and health posts, among others — benefited 1.2 million people in low-income rural and urban areas[26]. For purposes of comparison, it may be noted that Bolivia's population is roughly one-eighth of Egypt's population of about 56 million.

Given the extensive poverty in Egypt and the relatively limited resources of the SFD, the targeting system needs further fine-tuning, both in terms of regions and socioeconomic groups. It is also reasonable to question whether the SFD's top policy-making body has the necessary input from the vulnerable groups in the Egyptian society. Eight of the 17 members of the SFD board of directors are cabinet ministers (including the prime minister), while the others are prominent members of Egypt's business community, there being no representation from beneficiary groups such as trade unions or community leaders.

Table 1. Poverty Indices for Urban and Rural Region
(Poverty line = LE 730.0759 for urban areas and LE 484.5729 for rural areas)

	Relative Poverty Line			Contribution to National Poverty			% No. of Individual
	PO	P1	P2	PO	P1	P2	Individual
URBAN	37.59	10.13	3.73	100.00	100.00	100.00	100.00
Urban govemates	31.70	8.84	3.43	35.18	36.38	38.32	41.71
Urban lower	38.59	9.73	3.38	30.19	28.25	26.67	29.40
Urban upper	45.70	12.69	4.64	33.53	34.53	34.33	27.58
RURAL	25.34	5.05	1.49	100.00	100.00	100.00	100.00
Rural lower	17.23	2.82	0.71	38.74	31.85	27.06	56.99
Rural upper	36.25	8.12	2.59	58.68	65.96	71.29	41.03

Source: H. El-Laithy, *Spatial and Time Dimensions of Poverty*, processed, Department of Statistics, Faculty of Economics and Political Sciences, Cairo University, Cairo, March 1994.

Table 2. Poverty Indices for Urban and Rural Region
(Poverty line = LE 697.452 for urban areas and LE 437.617 for rural areas)

		Absolute Poverty Line			Contribution to National Poverty			% No. of Individual
		PO	P1	P2	PO	P1	P2	Individual
URBAN		34.09	8.91	3.19	100.00	100.00	100.00	100.00
	Urban govemates	28.74	7.82	2.97	35.17	36.61	38.83	41.71
	Urban lower	34.67	8.45	2.86	29.91	27.90	26.31	29.40
	Urban upper	41.87	11.21	3.96	33.88	34.70	34.23	27.58
RURAL		17.62	3.23	0.92	100.00	100.00	100.00	100.00
	Rural lower	10.76	1.58	0.40	34.79	27.89	24.69	56.99
	Rural upper	26.93	5.53	1.66	62.69	70.19	74.07	41.03

Source: As in Table 1.

Table 3. Poverty Indices for Urban and Rural Region
(Poverty line = LE 365.0379 for urban areas and LE 242.2865 for rural areas)

		Ultra Relative Poverty Line			Contribution to National Poverty			% No of Individual
		P0	P1	P2	P0	P1	P2	Individual
URBAN		4.46	0.71	0.17	100.00	100.00	100.00	100.00
	Urban governates	4.62	0.83	0.23	43.20	48.82	55.02	41.71
	Urban lower	3.43	0.56	0.13	22.63	22.97	22.97	29.40
	Urban upper	5.46	0.72	0.14	33.77	27.98	21.92	27.58
RURAL		0.98	0.17	0.03	100.00	100.00	100.00	100.00
	Rural lower	0.39	0.07	0.01	22.75	22.75	22.75	56.99
	Rural upper	1.85	0.32	0.06	77.25	77.25	77.25	41.03

Source: As in Table 1.

Table 4. Social Fund Programmes: Permanent and Temporary Job Creation
(as of 31 October 1993)

	Programme	Created Job Opportunities			
		Temporary	Permanent	Total Employment	Cost of job creation (L.E.)
1.	Community development	13 453	70 741	84 194	585
2.	Public works	8 194	410	8 604	3 411
3.	Enterprise development	1 000	40 696	41 696	3 300
4.	Employment and retraining (labour mobility)	150	966	1 116	3 375
	TOTAL	22 797	112 813	135 610	1 637

*   Computed by the author (there is no distinction made here between "temporary" and "permanent" jobs.

Source: SFD, Semi-Annual Report, Cairo, Nov. 1993, Table 6, p. 24

On the other hand, the limited mandate of the SFD is not a comprehensive strategy for alleviating poverty and cushioning the transitional adjustment costs. Such a strategy would require: (i) a welfare programme, especially designed for the ultra-poor who depend on income transfers; (ii) an economic approach for the chronic poor who are engaged in economic activity but have insufficient or unstable earnings; and (iii) retraining and rehabilitation programmes for those poor who will be hurt by the economic restructuring and labor shedding[27].

The exchange entitlements approach, put forward by Professor Amartya Sen, appears to be appropriate for such strategy[28]. A worsening or improvement of the exchange entitlements of one single individual (or a household) — according to Sen — is normally dependent on three factors: (i) the employment possibilities open to him; (ii) the rate of exchange between his labor power (i.e. working hours) and the income reward; and (iii) the vector of prices of basic goods and services.

This concept allows for at least two types of exchange mappings: a) the exchange of labor power for income, depending on the labor market conditions; and the possibilities of moving between different segments of the labor market (i.e., formal, grey, black); and b) the exchange of money income for a bundle of goods and services, depending on the set of prices prevailing in the market.

Hence, the command over resources by poor groups of the population, as defined by the exchange entitlement set, depends on three key parameters: the effective working hours, the average earnings per hour worked, and the price vector of basic goods and services. Once a *starvation set* is identified (i.e. the ultra-poor), the relative degree of deprivation of different groups of the population can be established[29].

More important still is the fact the exchange entitlements approach permits a clearer differentiation between the different circumstances leading to poverty: insufficient employment opportunities, low earnings per work hour, and high prices of basic goods and services. In turn, this could help policy-makers fine-tune policy instruments (i.e. generating employment opportunities, manipulating levels of disposable income, controlling or subsidising prices of basic goods and services) within the framework of a programme for alleviating poverty and helping the needy.

In the absence of such a comprehensive approach, there is a risk of not mitigating the social costs of adjustment during the transition from reform to growth. The possible consequences of that for sociopolitical stability are obvious.

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2. The Saving Effort: Basic Trends, Volatility and Sustainability

The unsustainability of Egypt's national saving effort may be gauged from the data presented in Table 5 and Figure 1. These data show very clearly the low level of domestic savings generated within the domestic economy, and that domestic saving has been declining since the mid-1980s. On the other hand, the main source of national savings comes from workers' remittances and unrequited private transfers. Such external sources of national savings are highly volatile, and do not constitute a reliable and sustainable source of finance for the country's future investment programmes.

2.1 The Risks and Volatility of an Over-Liquid Economy

Egypt's gross national savings was 28 per cent of GNP during the 1980s. This compares favorably with 25 per cent for Morocco, 23 per cent for Turkey, and 21.5 per cent for Brazil during the same period (1980-89)[30]. Nevertheless, gross national savings in Egypt is less than high-saving countries in Asia, such as Indonesia (30.4 per cent)[31], Malaysia (32.2 per cent) and South Korea (31.2 per cent). The availability of national savings may not be much of a problem in Egypt in the medium term, but at issue are: (i) the highly liquid nature of these savings; and (ii) the unsustainability of such high levels of national savings over time, given the current structure of the domestic economy and the volatility of external factors.

Total private liquidity is usually defined in the Egyptian context as domestic M2 plus foreign currency deposits of the private sector valued in Egyptian pounds. Foreign currency deposits may not be perfect substitutes for domestic money as a source of liquidity, since they might be held primarily as a permanent store of wealth. According to the IMF, "if foreign currency deposits are not perfectly substitutable for domestic money, an autonomous increase in foreign currency deposits would increase demand for goods and services to a lesser extent than an equivalent increase in domestic money"[51].

In recent years there has been a dramatic increase in private sector liquidity as a result of the narrow range of competitive domestic assets and the limited investment outlets open to small and medium-size savers. In fact, the growth rate of private sector liquidity accelerated in recent years, from an annual rate of approximately 14 per cent during FY 1987-88 to around 22 per cent during FYs 1990-91 and 1991-92 (see Table 6). The most important component of the growing private sector liquidity is time deposits (in Egyptian pounds), which increased at an average rate of about 27 per cent during the five-year period ending April 1992[33]. This indicatesthat many private agents want to remain liquid and not bind any resources that cannot be freed instantaneously[34].

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Figure 1. Egypt's Saving Effort (1977-1991)

Legend: GDS/GDP, GNS/GNP, GS2/GDP

Table 5. Egypt's Saving Effort: Broad Trends (1977-91)
(at current prices)

Savings aggregates	Years	1977	1978	1979	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
(1)	Gross domestic savings (millions of LE)	1 597	1 683	2 228	3 154	3 024	4 053	3 739	4 295	4 320	2 972	4 451	3 765	3 787	6 951
(2)	Gross national savings (millions of LE)	2 081	2 692	3 245	3 714	3 697	5 508	5 280	5 868	5 642	6 871	9 688	10 428	12 978	25 050
(3)	(1)/(2) per cent	76.7	62.5	68.7	84.9	81.8	73.6	70.8	73.2	76.6	43.2	45.9	36.1	29.2	27.7
(4)	Workers' remittances and unrequited private transfers (millions of LE)	387	714	1 588	1 561	1 690	2 719	3 655	3 339	3 178	3 834	5 959	6 842	8 344	11 153
(5)	Gross domestic investment (millions of LE)	2 399	3 054	4 300	5 208	5 569	6 278	6 796	7 358	7 409	8 150	13 187	15 269	17 276	20 164
(6)	The savings investment gap (millions of LE) [(6)-(2)] = foreign savings	318	362	1 055	1 494	1 872	770	1 516	1 490	1 767	1 279	3 499	4 841	4 298	-4 886
(7)	Foreign savings as percentage of GDP	3.9	3.7	8.4	8.7	9.0	3.1	5.4	4.6	4.9	2.8	6.4	7.3	5.5	-4.9

Source: Raw data drawn from: The *World Bank Report*, *op. cit.* Ratios computed by author.

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Confidence in the exchange rate and the availability of resources for growth are necessary but not sufficient conditions for stimulating domestic production and investment. In Egypt, private "liquid" savings are of extraordinary size, more than sufficient to underwrite vigorous growth if they could be efficiently mobilised. R. Dornbusch (1990a, 1990b) observed that in the aftermath of stabilization and reform policies in developing countries, most of the domestic savings and repatriated wealth continues to be placed "in liquid form in financial markets rather than in plant and equipment"[35]. Thus "wealth-holders" will wait "until the front loading of investment returns is sufficient to compensate them for the risk of relinquishing the liquidity option of a wait-and-see position"[36].

This "waiting option" could last indefinitely because of "residual aggregate uncertainty" about the sustainability of a whole series of economic and political equilibria. A "triggering mechanism" is needed to break out of the vicious circle underlying the "waiting option". In short, the post-stabilization difficulties are serious and there is no automatic transition to growth. The key question is how a new "growth equilibrium" can be triggered.

2.2   Currency Substitution and the Extent of the "Dollarisation"

Given the large amount of "liquid" and "uncommitted" savings, there is an active process of "currency substitution". "Currency substitution" is usually measured by residents' holdings of deposits denominated in foreign currency, both in absolute terms and relative to their domestic currency balances[37]. When this process is occurring, money balances denominated in foreign currency increasingly substitute for domestic money as a unit of account and as a store of value, but not necessarily as a "means of payment". The literature on this question indicates that the process of currency substitution in developing countries (especially in Latin America) is largely associated with changes in the effectiveness of fiscal, monetary and exchange rate policies[38].

A survey of issues raised in the literature on currency substitution suggests that the main factor in currency substitution is an actual (or expected) decline in the purchasing power of domestic money holdings (in terms of future command over resources), which can be caused by[39]:

i)   increased domestic inflationary pressures (actual or perceived);
ii) expectations of exchange rate depreciations; and
iii) lower interest rates on domestic currency holdings (i.e. the differential between foreign and domestic interest rates).

Table 6. **Egypt: Evolution of Private Sector Deposits with the Commercial Banks (1987-1993)**

(in million of Egyptian pounds, current prices)

End of June Balances

Type of Deposits	1987	% Annual Change	1988	% Annual Change	1989	% Annual Change	1990	% Annual Change	1991	% Annual Change	1992	% Annual Change	1993	% Annual Change
A. Deposits in local currency														
— Private business sector	2 144	---	2 402	+12.0	2 726	+13.5	3 080	+13.0	3 210	+4.2	5 350*	+66.7*	6 660*	+24.5*
— Household sector	10 769	---	12 150	+12.8	14 036	+15.5	16 790	+19.6	20 991	+25.0	35 179*	+67.6*	52 982*	+50.6*
Total	12 913	---	14 552	+12.7	16 762	+15.2	19 870	+18.5	24 201	+21.8	40 529*	+67.5	59 642*	+47.2
B. Deposits in foreign currency														
— Private business sector	2 655	---	3 865	+45.6	4 793	+24.0	5 874	+22.5	8 594	+46.3	5 702*	-33*	5 101*	-10.5*
— Household sector	6 567	---	11 496	+75.0	15 137	+31.7	19 155	+26.5	27 809	+45.2	25 075*	-10*	20 106*	-20.0*
Total	9 222	---	15 361	+66.6	19 930	+29.7	25 029	+25.6	36 403	+45.4	30 777	-15	25 207	-18

* Figures reflecting the process of currency substitution (i.e. de-dollarisation), starting the financial year 1991/92.

** Percentage annual changes computed by the author.

Source: Central Bank of Egypt, *Annual Report 1992/93*, p. 175.

These three effects may actually oppose each other (i.e. higher rates of returns on domestic currency holdings and expectations of exchange rate devaluation). Thus their combined impact will depend on the relative strength of each determinant in influencing agents' portfolio decisions. The substitution process may also be affected by uncertainties concerning future sociopolitical developments in the country concerned.

In Egypt, interest rates on local currency deposits were administered throughout the 1980s, and the liberalisation of domestic interest rates only began in January 1991 (see Table 7). The demand for foreign currency deposits increased substantially after 1985-86, when the adjustable commercial bank exchange rate, rather than the fixed and overvalued Central Bank rate, was applied to foreign currency deposits. As a result, there was large-scale currency substitution from Egyptian pounds (LE) to foreign currencies. The proportion of domestic currency deposits in total private liquidity declined to about one-third after 1984-85.

Table 7. **Egypt: Selected Monetary Indicators (1986-91)**
(in percentages unless otherwise indicated)

	FY86	FY87	FY88	FY89	FY90	FY91
Average nominal deposit rate[1]	11.0	11.0	11.0	12.0	12.0	16.0
Average nominal lending rate[2]	14.0	15.0	15.0	16.0	17.0	18.0
Domestic inflation	16.1	25.2	14.2	20.2	21.2	14.7
Average nominal exchange rate (LE/$)	1.069	1.273	1.761	1.937	2.229	2.974
Real GDP growth	2.7	2.5	3.9	3.0	2.5	2.3
Real deposit rate[2]	-4.4	-11.3	-2.8	-6.8	-7.6	1.1
Real lending rate[2]	-1.8	-8.1	0.7	-3.5	-3.5	2.9
Real effective exchange rate index[3]	75.5	70.8	106.6	105.4	100.0	104.7
M2 growth rate[4]	16.3	12.4	11.1	12.3	21.4	13.4
M2 / GDP	73.3	69.9	64.4	60.2	60.7	55.1

1.   On deposits and loans with a maturity of one year of less;
2.   Defined as $(1+i)/(1+f) - 1$, where "i" is the nominal interest rate and "f" is the inflation rate (CPI);
3.   Defined as the weighted end of the period 'Free Bank Market" rate of LE to currencies of major trading partners, expressed in prices of the base year (June 1990 = 100);
4.   M2 is defined as the sum of currency, demand deposits and time and savings deposits denominated in local currency.

Source: Unpublished IMF data.

This process of "private dollarisation"[40] since the mid-1980s, may be gauged from the following set of indicators[41]:

Rate of private dollarisation (%)

FY 1986	FY 1987	FY 1988	FY 1989	FY 1990	FY 1991	FY 1992	FY 1993
54.0	53.7	54.6	56.5	57.9	62.0	45.0	32.0

When interest rates on domestic currency deposits were liberalised in early 1991, there was large-scale reverse "currency substitution" (i.e. de-dollarisation), especially from April 1991 to April 1992. As a result, the dollarisation of domestic savings was reversed, with the foreign currency-denominated share of broad money (M2) falling to 40 per cent by the end of April 1992[42]. By contrast, Egypt's private sector switched its liabilities towards US dollar-denominated private credit, which increased from 23 per cent of total private credit in 1991 to about 33 per cent in September 1993.

In general, increased domestic inflationary pressures and a deterioration of the external accounts are normally considered to be clear signs of future exchange rate depreciation, and agents hedge against this risk by substituting foreign currency-denominated balances for local currency-denominated balances[43], and vice versa. Nonetheless, the current process of "reverse" currency substitution (de-dollarisation) remains highly unstable and volatile in an over-liquid economy like the Egyptian one. The risk remains that the high stock of liquid monetary assets could be converted back to dollars or leave Egypt altogether, if the political situation were to deteriorate[44]. The fragile stability of the exchange rate of the Egyptian pound, and the unsustainability of the high interest rates offered on Treasury bills (see Section 3) are potentially disturbing factors in this respect.

In situations of high political and institutional uncertainty, holdings of foreign currency-denominated balances become the primary "refuge asset", regardless of any yield or capital gains considerations, or of inflationary expectations.

2.3 Substitution Between Domestic Financial Assets, and the Formal-Informal Linkages

There was systematic substitution of "informal" financial assets for "formal" financial assets and instruments during the 1980s. This substitution was quite significant in the market for retail savings, and reached its peak by the middle of the 1980s. While changes in the proxy for interest rate differentials were not found to be statistically significant in explaining variations in the extent of currency substitution in Egypt over the period 1980-86 (El-Erian, 1988, p. 98), it is highly likely that "interest rate differentials" were significant in explaining variations in the substitution between domestic financial assets. This lends support to the argument that the

differential in interest rates (or returns) on deposits in banks and on financial instruments in the "gray" market, only affect the allocation of savings between banks and the "gray" market[45].

The high rates of return (around 24 per cent per annum) on the informal financial instruments associated with the Islamic companies for investment of funds (ICIF) in Egypt, attracted some 9-12 billion LE of liquid private savings during most of the 1980s. In particular, because of repression of domestic financial markets in the 1980s, administered average nominal deposit interest rates on formal financial assets did not exceed 12 per cent per annum throughout the 1980s, while the average real deposit rates were mostly negative[46].

As a result of fungibility, the informal financial sector is part of a continuum with the formal financial sector. The two sectors have multiple competitive and complementary relationships (see Chandavarkar, 1988, 1990). There are, in fact, demonstrable linkages between the two sectors (or markets) on the "savings" side. In Egypt, as in Thailand, substantial flows of savings into the informal financial institutions have been observed in response to higher rates of interest on chit funds, pyramid schemes, etc[47].

In Egypt during the first half of the 1980s, at least one-third of the household sector fresh savings flows leaked out to the informal (gray) financial market (ICIF)[48]. Agents tended to ignore the "riskiness" of informal financial instruments, and they were mainly attracted by the high nominal (and real) yields of such instruments. However, as result of increasing deregulation and liberalisation of the formal financial sector, the interest rate differentials between the formal and informal domestic financial instruments narrowed substantially during the last three years.

Since financial liberalisation began in early 1991, Egyptian savers have gradually switched their funds from informal sector financial instruments (i.e. issued by Islamic companies for investment of funds) into formal sector financial assets in the form of Treasury bills with an interest rate almost at parity with informal (gray) financial instruments. Therefore, Treasury bills earning a nominal interest rate of 18-20 per cent were generally considered to be gross substitutes for the widely held financial instruments offered by the informal Islamic companies for investment of funds (ICIF). In this situation, the government faces the risk of operating a pyramid scheme by issuing unlimited quantities of Treasury bills with little regard to financial sustainability and inter-generational equity considerations, as will be discussed in the next section.

3. Liquid Savings and Problems of Financial Intermediation

3.1 The Problem of Financial Intermediation in Egypt

As we have already argued, there will be major constraints to mobilising resources in the Egyptian economy as long as there is inefficient financial intermediation. The destabilizing nature of the vast amounts of money capital invested in short-term financial instruments, with no counterpart on the real side of the economy, poses a serious threat to growth and overall macroeconomic stability. The establishment of efficient institutions and mechanisms of financial intermediation would make capital allocation itself more efficient.

Hence, the real challenge is to develop new financial instruments and institutions to transform the recent infusion of short-term (hot to warm) money into medium- and long-term investment funds which would generate a dynamic cycle of growth and increasing employment.

At present, "formal" financial intermediation in Egypt takes place mainly through the banking and insurance sectors: commercial banks (27), commercial and investment banks (35), and four specialised banks. An important government-owned financial intermediary, the National Investment Bank (NIB) has had the responsibility for mobilising finance for the domestic currency component of public sector investment since the early 1980s. "To this end, the NIB receives on deposit the surpluses of the public pension and insurance funds and lends these to the public enterprises and the Government over [a] 10-15 years' period. Total assets of the NIB amounted to LE 35 billion as of June 1990[49]", of which the reserves of the combined social insurance funds reached the level of LE 21 billion at the end of FY 1990-91[50].

The bulk of assets of the insurance sector were invested in government bonds (around 10 per cent of the sector's total investment in 1992), loans to the government (78 per cent of the sector's total investment), and deposits with the banking sector (around 8 per cent of the total sector investment). This is shown in Table 8. Thus the insurance sector (insurance and reinsurance companies) primarily lends to the government, and rarely invests outside these confines. Such a lopsided investment pattern is unhealthy.

All this indicates the narrow base of capital markets and financial intermediation in Egypt, as well as the limited menu of financial assets (mostly highly liquid assets), with no secondary market in treasury instruments, no commercial bond market, and no forward currency market[51], and no financial conglomerates.

Table 8. The Investment Pattern of the Funds of the Insurance Sector in Egypt (1991-92)
(Values in LE million)

Assets		End of June 1991		End of June 1992	
		Value	Percentage	Value	Percentage
A.	Land and real estate	213	0.58	229	0.5
B.	*Total financial assets*	5 448	14.9	5 863	13.6
B.2	Government bonds and bills	(3 915)	(10.7)	(4 116)	(9.5)
B.3	Investment certificates	(987)	(2.7)	(1 053)	(2.4)
B.4	Other financial instruments	(546)	(1.9)	(694)	(1.6)
C.	Loans:	28 495	77.9	33 794	78.3
	(of which loans extended to the government)	(28 386)	(77.6)	(33 664)	(78.0)
D.	Deposits with the banking sector	2 441	6.7	3 266	7.6
	Total	36 597	100	43 152	100

Source: CBE, *Annual Report 1992/93*, p. 202.

The problems confronting capital markets and financial intermediation in Egypt may be gauged by a number of worrisome indicators:

i) The very high level of "excess liquidity" of the commercial banking sector. This "excess liquidity" (as measured by the ratio of deposits with foreign banks to total deposits) is rapidly increasing as follows (also, see Table 9):

1987	1988	1989	1990	1991	1992	1993
6%	10%	13%	16%	24%	30%	26%

It should be noted, however, that the four big public sector commercial banks (National Bank of Egypt, Bank MISR, Cairo Bank and the Alexandria Bank) had an excess of deposits over granted loans of the order of LE 55 billion (60 per cent of the total deposits) in June 1993.

ii) the role played by the informal "Islamic companies for investment of funds" up to June 1988. Their assets had expanded to around LE 4-5 billion in June 1988, according to the most conservative estimates[52]. The frequency distribution of these deposits tended to be highly skewed as can be seen from the data concerning one of the biggest Islamic companies for investment of funds by the end of the 1980s (see Table 10 and Figure 2).

Figure 2. Lorenz curve for the Distribution of Deposits with ICPF in Egypt (late 1980's)
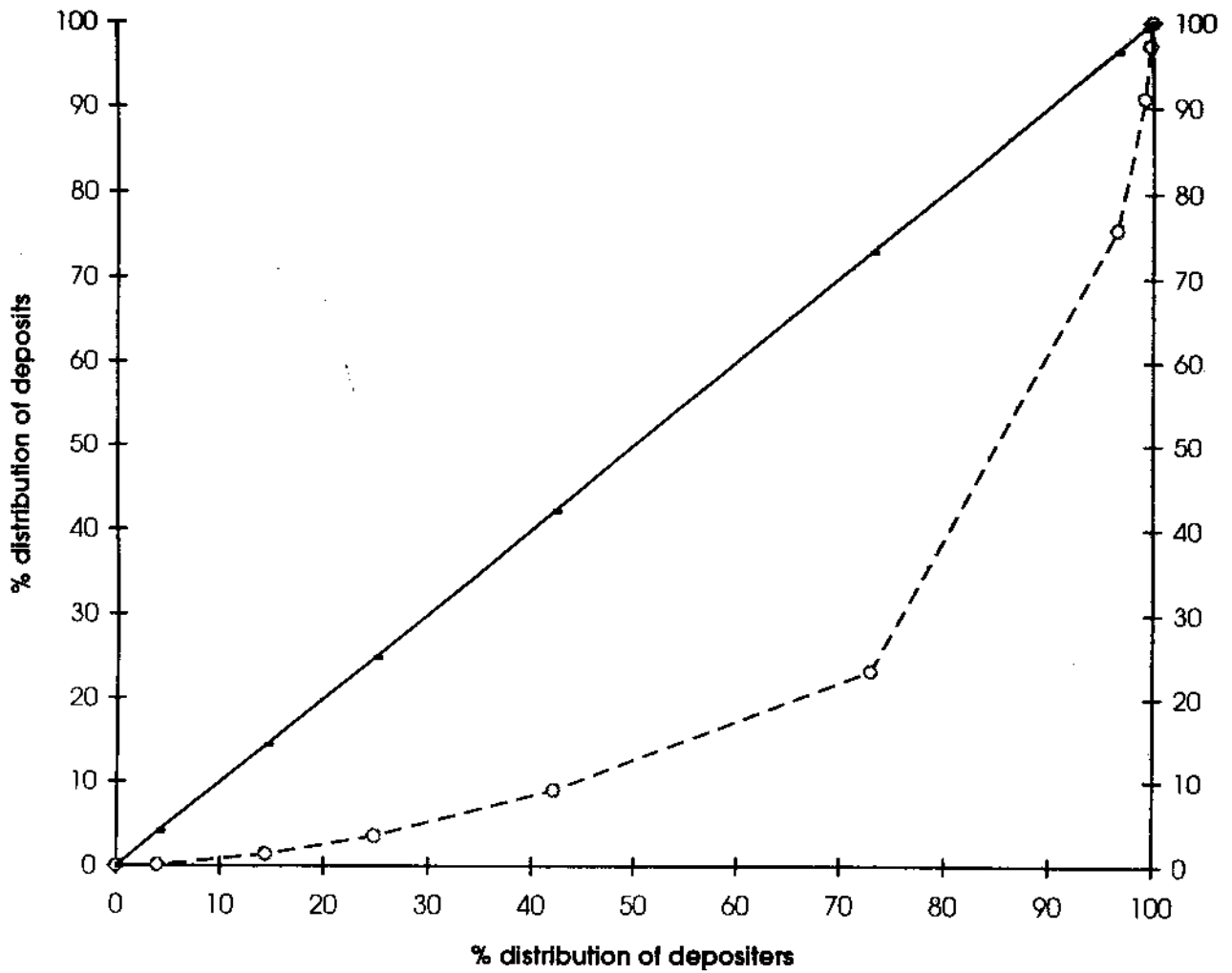
Table 9. **Egypt: The Consolidated Financial Position of Commercial Banks: Selected Indicators**

(values in LE billion)

Indicators		End of June stocks						
		1987	1988	1989	1990	1991	1992	1993
1.	Total deposits	30.8	41.1	48.9	59.6	81.6	99.1	117.6
2.	Total lending and discounting balances	20.1	23.7	27.0	33.9	43.4	40.4	49.6
3.	(2)/(1) %	65%	58%	55%	57%	53%	41%	42%
4.	Government bonds held by the banking sector (including TB)	—	5.9	6.1	6.2	14.2	31.1	40.4
5.	(4)/(1) %	—	14%	12%	10%	17%	31%	34%
6.	Deposits and balances with cross border foreign banks (i.e. *excess liquidity*)	6.1	10.2	12.8	16.1	24.3	29.9	25.6
7.	(6)/(1) %	20%	25%	26%	27%	30%	30%	22%

Note: Ratios computed by the author.

Source: CBE, *Annual Report 1992/93*, Table (4/2), p. 173.

Table 10. **Egypt, Frequency Distribution of Deposits with One of the Largest ICPF, late 1980s**

Deciles	Relative frequencies (%)		% cum	
	Depositors	Deposits	Depositors	Deposits
C1	4.00	0.10	0	0
C2	10.40	1.30	4.00	0.10
C3	10.40	2.10	14.40	1.40
C4	17.30	5.50	24.80	3.50
C5	30.90	14.20	42.10	9.00
C6	23.50	52.60	73.00	23.20
C7	2.7	15.2	96.50	75.80
C8	0.6	6.2	99.20	91.00
C9	0.2	2.8	99.80	97.20
	100.00	100.00	100.00	100.00

Gini coefficient 0.58.

Source: Unpublished data communicated to the author.

iii) Capital flight was substantial for Egypt in recent years. Egypt was among the ten countries most affected by this problem during 1981-91, according to the World Bank's residual measure of "capital flight"[53] (see Figure 3). Moreover, the ratio of the stock of "flight capital" in 1991 was twice as much the stock of external debt in 1991[54].

iv) The domestic capital market's absorption remains relatively limited. This "absorption capacity" can gradually increase by a widening and deepening of the capital market, accompanied by financial innovation to meet the preferences and habits of Egyptian savers. An expansion of private share ownership and active share trading could help broaden the capital market base in Egypt.

The potential for capital market widening may be judged by the value of the Egyptian banks' stocks of foreign assets, which are quite substantial, as can be seen from the following data[55]:

Egyptian banks' stocks of the foreign assets ($ billions, end-of-period stocks)

| 1987	1988	1989	1990	1991	1992
7.8	7.3	8.5	10.4	12.6	11.4

3.2 The Stock Market and the Inherent Weakness of Egypt's Capital Market

President Anwar Sadat's open-door (infitah) policy, introduced in 1974, encouraged private investment and initiated a slow transition towards a market economy. However, trading on Egypt's stock market remains very thin, despite recent efforts to encourage a revival. At present, the stock exchanges of Cairo and Alexandria are not a significant source of capital, as few transactions take place (see Table 11) and the market suffers from illiquidity[56].

The current weakness of Egypt's stock market constitutes a major impediment to the mobilisation of domestic savings and repatriated capital, and ultimately to any large-scale privatisation programme. Egyptian savers, who have traditionally confined their investments to real estate or interest-bearing bank deposits, show little inclination to risk their monetary capital on the stock exchange[57].

Although the re-emerging Egyptian stock exchange market is still in its infancy[58], it is characterised by a relatively limited supply of equities in the primary markets, and weak investor demand for equities in the secondary markets (where issued shares are already traded). Among the major factors limiting the supply and demand of equities in Egypt's stock market are the following:

Figure 3. **Top Ten Countries for World Bank Residual Measure**
Average Annual Flows 1981-91

Millions of US $
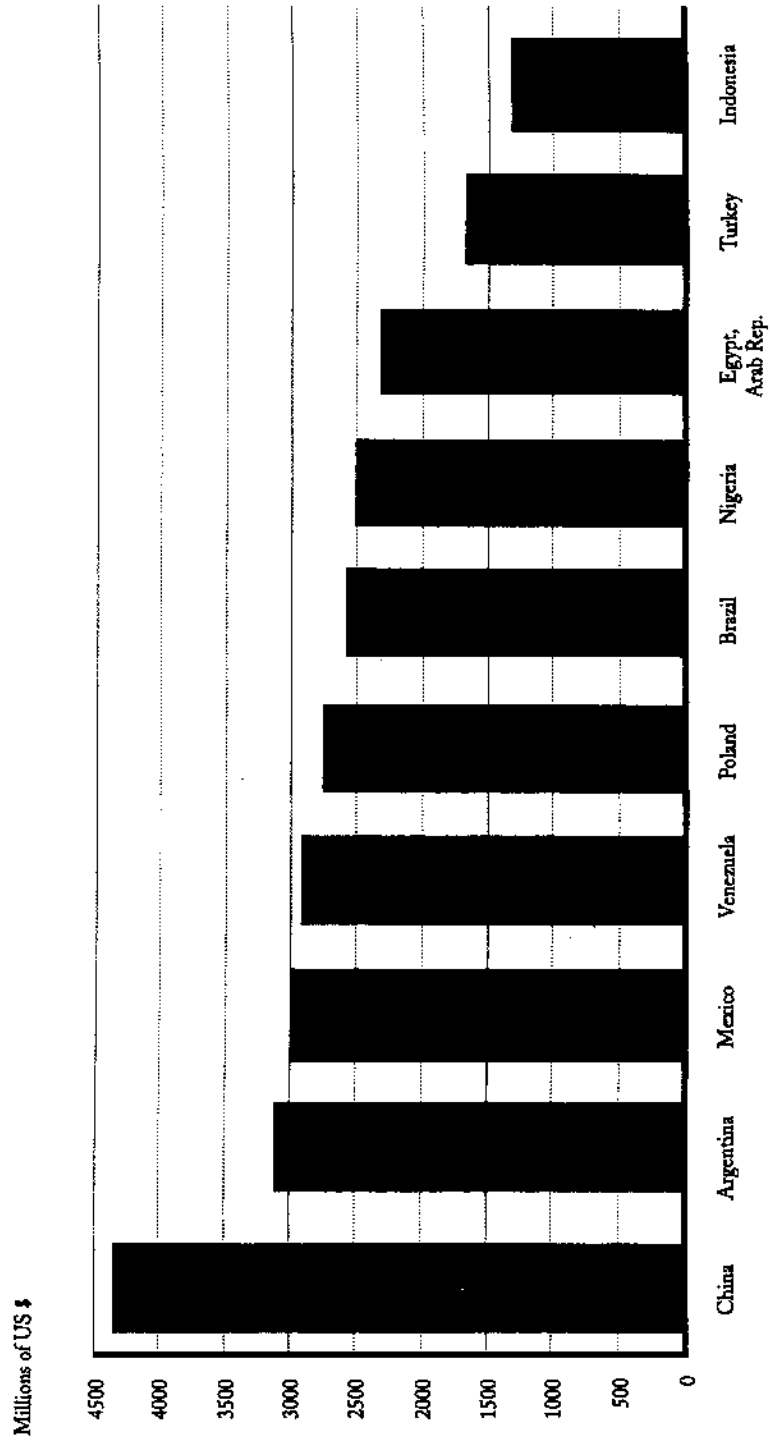
Source : Stijn Claessens and David Naudé, Recent Estimates of Capital Flight, WPS 1186 (Washington : The World Bank, Sept. 1993), p.18

Table 11. Cairo's Stock Market: Basic Indices (1992-93)
(Values in millions)

Type of company	End of June 1992			End of June 1993		
	No. of listed companies	Capitalisation (in LE)	Capitalisation (in $)	No. of listed companies	Capitalisation (in LE)	Capitalisation (in $)
(a) Open joint stock companies	163	1 074	375	155	1 221	390
	(26%)	(33%)	(38%)	(24%)	(33%)	(27%)
(b) Closed family joint stock companies	472	2 156	606	499	2 423	1 038
	(74%)	(67%)	(62%)	(76%)	(66%)	(73%)
(c) Total	635	3 230	981	654	3 644	1 428

Source: CBE, *Annual Report 1992/93*, p. 73. Ratios computed by the author.

a) the high proportion of family-owned companies, as closed family companies constitute about 75 per cent of all listed companies;

b) the reluctance to disclose full information to the public, and the lack of transparency with regard to accounting and auditing standards;

c) the preference of Egyptian savers for real estate or interest-bearing deposits, due to risk aversion against possible capital loss and a lack of understanding of equity market operations;

d) the undeveloped financial sector infrastructure and institutions[59].

The illiquidity of the small re-emerging stock exchange exchanges in Egypt is indicated by the low and declining trading volume (see Table 12), resulting from tight family control over large proportion of shares, and an uncertain trading atmosphere. In the 1992-93 financial year, the attractive treasury bill issues could have adversely affected the volume of trading on the Cairo and Alexandria stock exchanges. A recent empirical study indicated that active trading on Egypt's stock exchanges is confined to the shares of only 30 companies, which are financially healthy and distribute handsome dividends[60].

Furthermore, the thinness and narrowness of Egypt's stock market is shown by its small capitalisation, which was 6 per cent of GDP in 1990, and by the negligible value of shares issued as a percentage of new capital raised (10 per cent in 1990)[61]. These characteristics are shared by other emerging stock markets in reforming developing countries, as in Indonesia, Turkey and Venezuela (see Table 13).

Institutional investors and managers of mutual funds are known to be considering Egypt for private investment. Closed-end country funds, as a collective investment instrument, could play a major role in the future to broaden the capital markets base in Egypt, while avoiding "hot money" effects[62]. Barclays Bank and Schroder Asseily have already established a $50 million fund to invest in Egypt, while Salomon Brothers has been contemplating an "Egypt fund"[63]. In addition, the National Bank of Egypt recently created a mutual fund worth LE 100 million to promote investment in stocks. The IFC could also play an important promotional role in this respect. Country funds listed on major stock markets could facilitate investment decisions by individual investors, who normally would shy away from investing in an emerging developing country's market.

On the institutional side, the absence of specialised underwriters impedes the development of the primary market, where companies raise capital by selling new issues of shares. Institutional investors such as privatised pension funds and insurance companies could play a leading role in this area.

Table 12. **Volume of Trading in Cairo and Alexandria Stock Exchanges (1991-93)**

Indicators	Cairo stock exchange			Alexandria stock exchange		
	FY 1991-92	FY 1992-93	% change	FY 1991-92	FY 1992-93	% change
A. Equities denominated in Egyptian Pounds						
— Quantities transacted (in millions)	16	14	-11.7%	2	0.9	-57%
— Market values (in millions)	220	335	+52.3%	15	12.8*	-17%
B. Equities denominated in $						
— Quantities transacted (in millions)	5.1	10.7	+109.4%	0.3	0.02	-93%
— Market values (in millions)	77	70	-9.0%**	2.1	0.4	-81%

* The bulk of the transactions were confined to only three companies.
** This is due to a decline of "market values" with respect to "nominal values".

Source: CBE, Annual Report 1992/93, pp. 74-75.

Table 13. Comparative: International Stock Market Growth Indices: 1986-90
($ million)

Index (year of reform)	1986	1987	1988	1989	1990
Egypt (Cairo only/1991)					
Market capitalisation	1 716	1 826	1 760	1 841	1 833
Annual turnover	180	167	115	140	237
Turnover ratio (%)	10.5	9.1	6.5	7.6	12.9
Number of listed companies	387	430	483	510	573
Indonesia (1988)					
Market capitalisation	81	68	253	2 254	8 081
Annual turnover	1	3	4	541	3 992
Turnover ratio (%)	1.2	4.4	1.6	24.0	49.4
Number of listed companies	24	24	24	57	125
Turkey (1985/86)					
Market capitalisation	935	3 221	1 135	6 783	19 065
Annual turnover	13	115	101	798	5 841
Turnover ratio (%)	1.4	3.6	8.9	11.8	30.6
Number of listed companies	40	50	50	50	110
Venezuela (1988)					
Market capitalisation	1 510	2 278	1 816	1 472	8 361
Annual turnover	52	148	221	93	2 232
Turnover ratio (%)	3.4	6.5	12.2	6.3	26.7
Number of listed companies	108	110	60	60	66

Source: IFC, "Emerging Stock Markets Factbook", 1991, as quoted in *The World Bank Report on Egypt's Financial Sector*, Vol. III, Appendix AXII, Table (AXII.2), p. 52.

The Capital Markets Law No. 95 of 1992 contained a number of provisions which could help broaden Egypt's capital markets base and activate share trading[64]:

a) the law introduces, *inter alia*, the concept of bearer shares, exempts dividend income from general income tax, and limits the capital gains tax to 2 per cent[65].

b) the law permits public listing of foreign shares on Egypt's stock markets if these shares satisfy certain conditions;

c) the law provides for a degree of openness to foreign investors, while safeguarding against the control of domestic corporations by foreign capital;

d) the law reduces the degree of closure and family control of officially listed shares, by requiring that 30 per cent of the total shares of any single company be offered for public subscription, and that there cannot be less than 150 subscribers (Egyptian or foreign).

This new openness of Egyptian capital markets could help Egyptian shares to be listed on major stock exchanges in the future.

3.3 The Need for the Developing Securities Markets

The mobilisation of long-term domestic savings depends, in the initial phase, on the successful development of securities markets. This, in turn, requires a radical change in the investment policies of pension funds, insurance companies and investment companies. They will have to be encouraged to invest their assets in securities rather than only in bank deposits and government financial instruments.

The cumulative contractual social insurance savings lent to the National Investment Bank (NIB) amounted to LE 54 billion at the end of June 1993. Some of these funds could be recycled to the securities markets, to obtain the best mix of risk and return, thus ensuring high returns for pension funds. A larger securities market would balance and stabilize the financial system by a process of domestic diversification[66], and partly free pension funds from serving as a captive market for government debt[67].

On the other hand, non-performing bank loans, owed by potentially viable industrial companies, could be converted into medium- or long-term securities to be traded on the stock exchanges. Bank Misr of Egypt floated a similar idea some time ago, e.g., issuing industrial securities with maturities of three to five years as part of a big conversion operation, in which a sizeable portion of the bank's loan portfolio would be converted into new security issues, thus shifting the debt burden to the private sector. Such a conversion would not harm the indebted companies, but would free the bank from slow-performing loans and inject new blood into the securities

market. Securitisation of bank loans could contribute to the broadening and deepening of the country's capital markets. Recently, Hoechst Orient,a German-Egyptian joint pharmaceutical venture, issued the first Egyptian corporate bonds, a LE 30 million issue with five-year maturity, underwritten by Banque Parisbas[68].

An appropriate regulatory and legal framework for stock and bond markets constitutes a necessary condition for the development of capital markets in Egypt, but the efficient mobilisation of domestic resources requires the emergence of a "critical mass" of financial institutions and agents: key professional services; a resourceful banking system; and dealers, brokers and underwriters. The importance of this may be summarised as follows:

i)   Professional financial services are critical in providing the accounting and the credit analysis capacity needed for risk and portfolio analysis;

ii)   The banking sector could play an active role in investment advisory services, including underwriting new issues and converting bank loans into equities;

iii)   A network of modern dealers, brokers and financial services companies provides the infrastructure necessary for an efficient and expanding capital market;

iv)   There is a need for financial innovation offering new flexible instruments, such as quasi-equity securities (i.e. shares convertible into bonds and vice versa).

These various elements should be complementary and well co-ordinated in the development of an integrated capital market. The absence of co-ordination and synchronisation of these elements could hinder any large-scale privatisation programme. On the other hand, the lack of co-ordination of monetary (interest and exchange rates) and fiscal (Treasury bill issues) policies could seriously hinder the privatisation programme through the "income" and "substitution" effects.

3.4   The Queston of Treasury Bills

A new expanding Treasury bill market has been established since January 1991. Outstanding Treasury bills amounted to LE 8.5 billion at the end of December 1991, LE 17 billion at the end of June 1992, and LE 30.5 billion by the end of June 1993 (see Table 14). The consolidated stock of Government bonds (including Treasury bills) stood at LE 97 billion by June 1993, as compared with LE 44 billion in June 1990[69], that is, before the present fiscal stabilization and liberalisation programme had been put into effect.

Table 14. Egypt: The Outstanding Stock of Treasury Bills, by Major Holders
(LE million)

Sectors	End June 1992		End June 1993		Absolute Change in Holdings of TBs (values)
	Value	%	Value	%	
1. Public economic authorities	80.5	0.5	524.3	1.7	+ 444
2. Public sector commercial banks	7 232	42.4	11 314	37.0	+ 4 081
3. Private and joint venture banks	6 467	37.9	11 969	39.2	+ 5 502
4. Specialised banks			20	0.1	+ 20
5. Public sector insurance companies	324	1.9	1 214	4.0	+ 890
6. Other insurance companies	54	0.3	118	0.4	+ 64
7. Private business sector	1 678	9.8	3 196	10.5	+ 1 518
8. Household sector	679	4.0	1 442	4.7	+ 762
9. Other	538	3.2	739	2.4	+ 201
Total	17 052	100	30 536	100	+13 484

Source: CBE, Annual Report, various issues.

There is no guarantee that the domestic debt/GDP ratio will not continue to rise in the medium term. The critical yardstick here is the annual rate of increase of total government domestic indebtedness compared to the economy's annual sustainable growth rate. Total government indebtedness increased about 5 per cent per annum during FY 1991-92, thus outpacing the GDP growth rate. If this trend persists in the future, the long-term perils of issuing Treasury bills will become more obvious.

At present, Treasury bills (as the prime form of domestic financial assets) enjoy a "rent element"[70], which acts as a brake on private investment in productive activities, hence reducing the economy's growth potential. In other words, if the present policy of issuing Treasury bills is maintained, it could prove to be costly in terms of lower growth and serious supply failures in the future.

Since savings are essentially an "instrumental variable", their aggregate level and composition should be considered in relation to their ultimate use for promoting growth and enhancing total factor productivity (Chandavarkar,1990, p. 13). Thus the question of Treasury bills should be evaluated in terms of growth perspectives and inter-temporal equity.

Although issuing Treasury bills on a large scale could serve as an effective instrument to target monetary variables and exchange rates in the short term[71], the long-term macro impact of such a policy is more questionable. With the share of

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interest payments on total domestic Egyptian debt in current government expenditures increasing rapidly over time — 24 per cent in FY 1991, 28 per cent in FY 1992, and 35 per cent in FY 1993 — there could be an increased risk of government insolvency in the medium term, due to the inter-temporal government budget constraint[72].

On the other hand, the market of Treasury bills remains dominated by short-term maturities (i.e. 91 to 182 days), reflecting a lack of confidence over the longer term.

4. From Reform to Growth: Challenges and Pitfalls

In general, the goal of economic reform and structural adjustment in developing countries is high quality growth. It is usually claimed that successful structural adjustment raises growth prospects in the medium term, typically after a transitional period of low growth or outright recession. It is widely assumed that there is a U-shaped transitional growth-path after an initial period of structural adjustment and financial liberalisation. There is no reliable mechanism to ensure that this occurs, since a good deal depends on the supply responses and the behavior of private investment, and on the efficient reallocation of national savings.

Nonetheless, a recent World Bank report on *Egypt's Financial Policy for Adjustment and Growth* (September 1993), painted an optimistic picture of future investment and growth prospects, stating:

> "The resources available for gross domestic investment could exceed 25 per cent of GDP in the medium term. If financial liberalisation and complementary structural reforms are also successful in raising the efficiency of investment allocation, the combined higher quantity and quality of domestic investment could start a virtuous cycle between saving, investment and growth, similar to that observed in successful economies such as Korea, Malaysia and Chile"[73].

This assessment tends to underplay the formidable tasks ahead and the delicate modifications necessary before sustainable development is possible. A virtuous cycle between saving, investment, and growth in the Egyptian economy will not only require a substantial increase in private investment, but employment and total factor productivity will also have to grow at a much faster pace than in recent years. Issues of industrial growth, human capital formation, technological advances, and export competitiveness need to be addressed in this context.

In Egypt, the liberalisation of financial markets and the capital account preceded reforms on the real side of the economy. The time lag between reform and growth will therefore be prolonged as a result of the rapid pace of liberalisation of the

financial markets and capital account, on the one hand, and the slow pace of reforms on the real (and institutional) side of the economy, on the other.

Given the relatively underdeveloped character of Egypt's financial system and the thinness of capital markets in the medium term, the saving-investment-growth nexus is not yet firmly established. Thus a high growth policy depends less on the aggregate level of savings, than in transforming the vast amounts of liquid savings into productive and efficient assets (through widening and deepening of financial intermediation), as it was argued in the preceding section. Moreover, the volume of aggregate investment in itself does not ensure vigorous and sustained growth for, as pointed out by Angus Deaton: "across developing countries, there is at best only a very weak relation between saving and growth, perhaps because it is the *productivity* of investment that is crucial not its *volume* "[74].

Nonetheless, the difficulty of the transition from reform to growth is reflected in economic theory's relative silence on the effects of liberalisation on growth; "there is a curious lack of correspondence between instrument and target in current structural adjustment programmes"[75]. This "gap" points to a major weakness of the present conception of structural adjustment, for without substantial resource reallocation — the so-called supply response — the long-term dynamic efficiency gains from liberalisation will not materialise[76], despite initial success in monetary and financial stabilization.

Given the limited supply of arable land and irrigation water in Egypt, "there is only a limited potential for acceleration in the rate of growth of output in the agriculture sector"[77]. Thus without vigorous growth in the nonagricultural sectors, the Egyptian economy will not be able to grow fast enough to create productive employment opportunities on a sustainable basis.

CONCLUSION

Egypt's recent experience with economic reform and structural adjustment shows very clearly the need for a high degree of consistency between strategic targets and instruments during the transitional path from "reform" to "growth". This may be summarised as follows:

	Strategic target	Strategic instrument
1.	Minimising the time-lag between reform and growth	Efficient financial system
2.	Minimising the social costs of adjustment	Comprehensive safety nets

Inconsistencies between strategic targets and instruments will certainly affect the long-term credibility of the reform and adjustment process.

Notes

1. Document presented to the World Bank Consultative Group Meeting for Egypt, held in Paris (January 1994).

2. *Ibid.*

3. IMF (1988), p. 8.

4. Cf. IMF Survey (1993), p. 178.

5. *Ibid.*, p. 180.

6. Cf. J.-D. LAFAY and J. LECAILLON (1993), p. 81.

7. Cf. C. GRAHAM (1992).

8. *Ibid.*

9. P. GLEWWE and J. VAN DER GAUG (1988), p. 28; and E. AHMAD (1992).

10. AHMAD, *op. cit., p.* 312.

11. *Ibid.*, p. 321.

12. Cf. X. MARET and G. SCHWARZ (1993), p.1.

13. C. GRAHAM (1992), p. 1234.

14. Cf. *Document to the Consultative Meeting for Egypt, op. cit.*, p. 9.

15. *Ibid.*

16. IDA (1991), p. 4.

17. Cf. WORLD BANK (1991b).

18. Cf.A. SEN (1981),p. 157.

19. Cf. N.C. KAKWANI (1980), p. 330.

20. *Ibid.*

21. J. FOSTER, J. GREER, and E. THORBECKE (1984), pp. 761-765.

22. Cf. H. EL-LAITHY and H. KHEIR EL-DINE (1993), p. 5.

23. *Ibid.*

24. According to Lipton the "ultra-poor are defined as those households whose food consumption is equal to less than 85 per cent of the minimum level of food expenditures calculated to estimate the "poverty-line". These "ultra-poor" may be characterised as belonging to the "starvation set".

25. Cf. Mid-term project evaluation Aid-Memoire, World Bank, Nov. 1993, p. 3

26. GRAHAM (1992), p. 1234.

27. WORLD BANK (1991a).

28. Cf..A.K.SEN, *op.cit* ., p. 3.

29. *Ibid.*, p. 157.

30. WORLD BANK, *World Development Report*, 1992, Table (A5), p. 185.

31. *Ibid.*

32. IMF (1992), *Arab Republic of Egypt—Recent Economic Developments*, SH/92/55, unpublished report, Appendix IV, Washington, D.C., August, p. 79.

33. *Ibid.*, P. 28.

34. Cf. S. BORNER, A. BRUNETTI, and B. WEDER (1994), p. 39. Also forthcoming by Oxford University Press.

35. R. DORNBUSCH (1990), p. 43.

36. *Ibid.*

37. Cf. M. EL-ERIAN (1988), p. 86.

38. See, for instance the works of Canto (1985), Gruben and Lawler (1983), Fasano-Filho (1986) Ramirez-Rojas (1985), and Salama (1989).

39. EL-ERIAN, *loc. cit.*

40. Defined as the ratio of private sector foreign currency deposits to private sector total deposits. However, this measure tends to underestimate the degree of "dollarisation" in the national economy, because it fails to take into account cash holdings of foreign exchange among the public, a widespread practice in Egypt.

41.   Unpublished IMF data.

42.   *Ibid.*

43.   EL-ERIAN, *loc. cit, p.* 102.

44.   Cf. *Middle Eastern Economic Survey* , 36/34, 24 May 1993.

45.   Cf. B.VALE (1986), p. 7.

46.   The real deposit rates for the second half of the 1980s were as follows:

FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
-4.4%	-11.3%	-2.8%	-6.8%	-7.6%

Source: Unpublished IMF data.

47.   See CHANDAVARKAR (1990), p. 27.

48.   Cf. M. ABDEL-FADIL (1989).

49.   IMF (1993a), p. 27.

50.   WORLD BANK (1993), *Egypt: Financial Policy for Adjustment and Growth*, Vol. 3, Appendix AIX, Table AIX-6.

51.   "Bank regulations effectively prevent the development of a forward market, although this is expected to be changed in the Foreign Exchange law currently under preparation. (A strong demand for forward pounds could come from Egypt's tourism companies which take bookings for holidays several months before they receive payment for them in foreign currency.)". *Middle Eastern Economic Survey* 36/34 (24 May 1993), p. B2.

52.   This figure does not represent the "peak level" of deposits, which occurred about1985 and is believed to have been around LE 7 billion. These companies were effectively curtailed following the enactment of Law No. 146 of June 1988, which brought them under the supervision of the capital market authorities. Cf. M. ABDEL-FADIL (1989), pp. 17.

53.   The World Bank measures "capital flight" as the sum of the following identified outflows: net short-term capital outflows; portfolio investment, other bonds; change in deposit money banks' foreign assets. To this is added all unidentified outflows (i.e. net errors and omissions). This measure may be indicative of the trend rather than yielding exact absolute orders of magnitude. Cf. S. CLAESSEN and D. NAUDÉ (1993).

54. *Ibid.*, pp. 19-20.

55. IMF (1993b), p. 61.

56. Cf. IMF (1993a).

57. *Financial Times*, 27 June 1988.

58. The Cairo stock market was one of the most Important and active stock markets in the developing world in the early 1950s.

59. For a more detailed discussion of the factors limiting supply and demand of equities in developing countries, see P. POPIEL (1988); and UNIDO (1991), pp. 164-165.

60. Cf. H. ABBASS ZAKI (1994), p. 11.

61. Cf. World Bank (1993), *Egypt: Financial Policy for Adjustment and Growth*, Vol. 3, Appendix AXII, Table AXII.1, p. 51.

62. Closed-end country funds constitute "an arrangement which enables an individual investor to withdraw from a particular developing country without requiring the country to supply foreign exchange, since this holding is bought by another foreign investor. UNIDO, *Industry and Development, op. cit., p.* 166.

63. *Middle Eastern Economic Survey , op. cit.*

64. Cf. *Al-Ahram Daily*, 21 March 1994.

65. Cf. *Middle Eastern Economic Survey* , 36/34 (24 May 1993), p. B2.

66. Cf. D. GILL (1986).

67. Cf. H. REISEN (1994).

68. Cf. *Financial Times*, supplement on Egypt, 22 April 1994.

69. CBE, *Annual Report 1992/93*, p. 204.

70. This argument rests on the premise that no current "average" domestic investment project yields such high (net) rates of return (i.e. net risk premium and tax liability).

71. Cf. H. REISEN (1993), p. 141.

72. The inter-temporal government budget constraint can be written within a two-period model, as follows:

$$x = g + \frac{B}{P}(1+i) - R(1+r^*)$$

where:

g is non-interest real government expenditure;
P is the price level in period (1);
B is the stock of nominal bonds outstanding at the end of period (0);
i is the nominal interest rate from period (0) to period (1);
R is the stock of interest-bearing reserves at the end of period (0);
r^* is the international interest rate.

In other words, future government income (taxes), X, Is equal to government expenditures plus the cost of servicing present debt (interest plus amortization), minus gross revenue from international reserves. See G. CALVO (1991), p. 922.

73. WORLD BANK (1993), p. xxix.

74 DEATON (1990), p. 87.

75. D. RODRIK (1990), p. 934.

76. *Ibid., p.* 939.

77. Cf. World Bank Consultative Group Document, *op. cit.*

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