# Egypt's Program for Stabilization and Structural Adjustment: An Assessment

Hans Löfgren

CAIRO PAPERS
IN SOCIAL SCIENCE

# THE ECONOMICS AND POLITICS OF STRUCTURAL ADJUSTMENT IN EGYPT

THIRD ANNUAL SYMPOSIUM

Volume 16, Monograph 3, Fall 1993

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## Introduction

In 1991, after a long period characterized by macro-imbalances, micro-level price distortions and severe barriers to foreign trade, Egypt embarked on a reform program supported by the International Monetary fund (IMF) and the World Bank. The primary purpose of this work is to present a critical analysis of this program. The main conclusion is that, in terms of its general direction, the current program promises to create an economy with faster growth due to its emphasis on reducing macro imbalances, price distortions and foreign trade barriers. However, the program's success would probably be enhanced by changes in some critical areas, especially foreign exchange management (aimed at maintaining a more stable real exchange rate), and reordered government spending priorities in favor of areas which address social concerns and enhance growth, most importantly in the areas of education and health. After a brief background on the Egyptian economy, the analysis turns to the economic reforms that were launched after 1991. These can be divided into two components, stabilization and structural changes. The discussion covers issues related to short-run stabilization, medium to long-run structural changes, prerequisites for rapid long-run growth, as well as some aspects related to policy implementation, especially how the reforms are sequenced and their credibility. Finally, the work's overall conclusions are presented.

## Background

Throughout the 1980's, the Egyptian macro-economy suffered severe imbalances, including large budget deficits (on average 10% of GDP), moderately high inflation rates (15-20%), and substantial deficits in the current account balance (an average of 5% of GDP). Tthe economy relied on a few highly variable sources for the bulk of its foreign exchange earnings: worker remittances, tourism, the Suez Canal and oil. Real GDP growth, in large part driven by growth in these sources of foreign exchange,

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* I would like to thank David Nygaard for his support, Farha Ghannam and Moataz El-Said for helpful comments on a draft of this paper, and Peter Illick for editing assistance. I am alone responsible for what follows.

was rapid during the period 1981-85, averaging around 7%. After the drastic fall in oil prices in 1986, the average growth rate slowed to 3% for 1986-89.[1]

A rapid increase in debt made it possible for Egypt to sustain the current account deficit. Between 1980 and 1989, the country's total foreign debt increased from $21 billion to $51 billion.[2] The country was finding it increasingly difficult to service its foreign obligations. In mid-1990, debt arrears (unpaid principal and interest on foreign loans) amounted to some $10 billion.[3]

Although the open-door policy, pursued after 1974, had generated a revitalized private sector in important respects, it fell far short of a full shift back to primary reliance on market mechanisms and the private sector.[4] By the end of the 1980s, large price distortions for foodstuffs and energy were maintained via government subsidies and price controls.[5] The levels of (multiple) foreign exchange rates were largely controlled administratively. Nominal interest rates were fixed far below the inflation rate. Foreign investment was limited to specific areas. Privatization of public assets was minimal. The public sector remained under strong central control in the areas of investment, financing and choice of product mix.[6] In the words of Amin, the situation under infitah was one in which "Economic policy fell between two stools, combining a halfhearted liberalization with a halfhearted adherence to a state-controlled economy".[7]

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1 World Bank, *World Tables 1992* (Baltimore: Johns Hopkins University Press, 1992) pp.236-39.

2 Ibid, pp. 238-39.

3 *The Economist*, April 6, 1991; *Middle East Economic Digest (MEED)*, May 31, 1991.

4 The growing private sector role is indicated by changes in its share of gross fixed investment. In the 1960's and early 1970's, this share was less than 10%; for the period 1977-81/82 it was 19%, for 1982/83-86/87 39%, and for 1986/87-91/92 43%. See Heba Handoussa, "Egypt's Investment Strategy Policies and Performance since the Infitah" in Said Al Naggar (ed.), *Investment Policies in the Arab Countries* (Washington D.C.: International Monetary Fund, 1990) pp. 156-57, 171-72; Ministry of Planning, ??? (Cairo: 1992) p. 70.

5 Alan Richards, "The Political Economy of Dilatory Reform: Egypt in the 1980's", *World Development*, Vol. 19:12, December 1991, p. 1729.

6 Presentation by Heba Handoussa at a *Middle East Times* seminar on Egypt's trade with Eastern Europe, Sept. 27, 1991.

7 Galal Amin, "Adjustment and Development: The Case of Egypt" in Al Naggar, ed., p. 103. Developments in the Egyptian economy in the 1970's and 1980's are also presented in more detail in, for example, Gouda Abdel-Khalek, *Egypt*, Country Study No. 9. Stabilization and Adjustment Policies and Programmes. World Institute for Development Economics Research of the United Nations University (WIDER), Helsinki, 1987; Richards, 1991; Heba Handoussa, "Crisis and Challenge: Prospects for the 1990's" in Heba Handoussa and Gillian Potter (eds.), *Employment and Structural Adjustment: Egypt in the 1990's* (Cairo: The American University in Cairo Press, 1991).

## Economic Reforms After 1991

In December 1990, President Mubarak announced a 1000-day program for the liberalization of Egypt's economy. In the spring of 1991, Egypt initiated a set of changes in economic policy, and reached a standby agreement with the IMF in May of that year as well as an agreement on a structural adjustment loan from the World Bank in November 1991. The agreement with the IMF paved the way for a deal with the Paris Club according to which a foreign debt write off amounting to $3 billion was set in motion as a first step in a debt reduction plan.

Like other economic reform programs supported by the IMF and the World Bank, the Egyptian program aims at macroeconomic stabilization and structural transformation of the economy toward increased reliance on market forces and the private sector. It also aims at stronger integration with the outside world. For Egypt, the major policy shifts between 1991 and the first half of 1993 have affected both the macro and micro areas, with stronger emphasis on the former.

**Stabilization policy.** Some data, indicative of recent macro-policy changes and their effects, are shown in Table 1. A key shift in the macro area is a substantial reduction in the government budget deficit, which fell to approximately 3.5% of GDP in 1992/93, and thereby exceeded initial targets.[8] This drop is due to both spending cuts and revenue boosting measures. In the latter area the 1991 introduction of a general sales tax was a major contributor.[9] Moreover, the growth rate in the money supply declined, reflecting the imposition of credit ceilings and the fact that the government budget deficit since 1991 has primarily been financed by weekly treasury bill auctions--a clear break with earlier reliance on borrowing from the Central Bank.[10] While interest rates were previously permitted to fluctuate only within narrow limits, in 1991 banks were given freedom to set virtually all deposit and lending rates. In practice, the interest rates on treasury bills have provided an anchor for bank interest rates. As a result,

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8 *MEED*, JUNE 7, 1991.

9 Between 1990/91 and 1991/92, government spending fell from 41% to 35% of GDP whereas government revenues grew from 26% to 30% of GDP. The total revenue share for "taxes on goods and services" went up from 12% to 15% in the same period, primarily due to the introduction of the sales tax. See Central Bank of Egypt, *Annual Report* (Cairo: 1992), p. 228-30 (Arabic version).

10 Central Bank, p. 230.

interest rates on bank deposits are close to or slightly above the inflation rate.[11]

**TABLE I**
**SELECTED INDICATORS OF RECENT POLICY AND PERFORMANCE (1989-93)**

| Indicator | 1989 | 1990 | 1991 | 1992 | 1993 |
|---|---|---|---|---|---|
| Budget Deficit (% of GNP)* | 17 | 15 | 14 | 7 | 3.5 |
| Money Supply (M1, % annual growth) | 9.2 | 16.6 | 8.1 | 8.8 | -- |
| Inflation (% per year, CPI) | 21.3 | 16.8 | 19.8 | 15 | -- |
| Real GDP (% annual growth)* | 3.0 | 2.6 | 2.3 | 2.8 | 1.5 |
| Current Account Surplus (Smil.)* | -469 | -634 | 1391 | 3763 | 2313 |

**Notes:**
* = data for fiscal years (1988=1988/89 etc.)
Data for 1992/93 are preliminary forecsts
1992/93 current account data is calculated from a Ministry of Planning forecast, using an exchange rate of L.E. 3.34/$.

**Sources:**
EIU, *Country Profile*, 1992/93, p. 35; *Country Report*, 1992, No. 3, p. 5; 1993, No. 1, p. 5; 1993, No. 2, pp. 3,6; IMF, International Financial Statistics, May 1993; Central Bank Annual Reports 1990/91, pp. 99-199 and 1991/92, p. 232; Ministry of Planning, Second Year of a 5-Year Plan, 1993, pp. 77-78.

Policies for the foreign exchange rate have also changed. In February 1991, the government merged the multiple rates into a single rate and

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11 *MEED*, January 18 and May 24, 1991; US Embassy (Cairo), Foreign Economic Trends and Their Implications for the United States: Report for the Arab Republic of Egypt, 1991, p. 7; IDSC (The Cabinet Information and Decision and Support Center), *Main Economic Indicators*, Egyptian Monthly Bulletin, February 1993.

depreciated the Egyptian pound by some 10% against the US dollar.[12] The capital account was also liberalized (i.e. restrictions on access and transfers to abroad were removed for dollars and other currencies, putting an end to a flourishing black market.[13] Since then, government exchange rate policy has aimed at maintaining a stable Egyptian pound rate vis-a-vis the dollar, a goal achieved via Central Bank interventions in the currency market.[14]

Lower budget deficits, less money supply growth, higher interest rates and the shift from gradual depreciation to a fixed nominal exchange rate have brought about a lower rate of inflation. Given the contractionary nature of these changes, GDP growth has declined further, to a rate of some 2% in recent years. Recent acts of terrorism, primarily aimed at tourists, government officials and Copts in parts of Upper Egypt, have deprived the economy of foreign exchange earnings and worsened the investment climate--the likely impact is a still lower growth rate in the near future.

The fact that nominal interest rates exceed inflation signals that Egypt, for the first time in a long time, has positive real interest rates. A combination of liberalized capital flows, nominal interest rates far above international levels and the expectation of a stable nominal exchange rate led to a much higher real return from placing funds in Egyptian pounds compared to dollars or any other major currencies.[15] The result was a large short-term capital inflows and strong encouragement to workers abroad to remit earnings back to Egypt. Together with the exceptional circumstances during the 1990/91 Gulf crisis (high oil prices and large transfers to the government), this has led to a positive net on the current account of the balance of payments in 1990/91-1992/93. (See Table 2 for disaggregated data on the current account.) Additional inflows on the capital account have helped to generate a large increase in Egypt's foreign currency reserves, from $2.7 billion in 1990 to an unprecedented level of $16 billion in the summer of 1993.[16]

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[12] *MEED*, March 15, 1991.

[13] Economist Intelligence Unit (EIU), *Egypt: Country Report*, 1992, No. 3, p. 15; Marcelo Giugale, *Captial-Account-Based Stabilization: Lebanon's Lesson for Egypt*. First Draft. Mimeo, Novermber 1992, p. 5. In preceeding years, when official rates overvalued the Egyptian pound, there was excess demand and (non-price) rationing of dollars, giving rise to a large black market. One rationale for capital account liberalization is that it encourages foreign direct investment.

[14] EIU, *Country Report*, 1992, No. 4, p. 15.

[15] For example, if the investor would keep his funds in US dollars, they would grow at a rate of some 3% per year, whereas, if shifted into Egyptian pounds for one year and subsequently transferred back into dollars (at a fixed nominal exchange rate), the growth rate would be some 15% (ignoring transaction costs). EIU, *Country Report*, 1992, No. 4, p. 15.

[16] *MEED*, August 6, 1993.

**Structural change.** In the area of structural change, the shift in policy direction has covered price policy, foreign trade, public sector reform, privatization and the conditions for private sector activities. In terms of the reform program, the overall purpose is to get closer to a competitive market economy in which producers and consumers face prices approximating opportunity costs for traded goods based on the international price level.

To this end, Egypt has seen significant changes in price and foreign trade policy. Among those goods whose prices are controlled administratively, petroleum product prices were raised from 35% to 80% of the international level between 1990 and the end of 1992. Electricity prices increased from 22% to 69% of the long run marginal cost (i.e. the marginal cost of additional production capacity).[17] Prices for industrial products, except for pharmaceuticals and a few other goods, have been decontrolled.[18] Subsidies on controlled food prices were reduced substantially in 1991 and 1992 although the socially and politically important bread subsidy remains largely intact.[19] In the agricultural sector, subsidies on most inputs have been terminated.[20] Between 1990 and 1992, cotton prices rose from 50% to 66% of the international level. However, in 1992, wheat prices were twice the average world level, proof that the direction of change has not been uniform.[21]

With respect to foreign trade, the number of goods banned for exports has been cut from twenty to two since 1991, and those with export quotas from seventeen to one. Export permits that earlier covered thirty-seven goods, have been entirely abolished.[22] In the same period, the number of items affected by import bans fell from 111 in 1992 to twenty six in 1993 while import tariffs narrowed from a standard range of 1-240% to 10-80%.[23] Other things being equal, this means that new export opportunities have been opened and local production has become more exposed to competition from imports. These factors tend to bring domestic relative price levels closer to their international equivalents.

In 1991, a reorganization of the public sector was initiated. More than 300 public companies are now subsidiaries under independent holding companies, replacing the previous general organizations that

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17 Richards, p. 1729; U.S. Embassy, *Foreign Economic Trends...*, 1993, p.7.
18 Ibid.
19 EIU, *Country Profile*, 1992, p. 18; *MEED*, July 10, 1992.
20 EIU, *Country Report*, 1993 No. 2, p. 25.
21 EIU, *Country Profile*, 1992, p. 21.
22 *Al-Hayat*, September 15, 1993.
23 *MEED*, August 21, 1992; August 13, 1993; June 7, 1991.

controlled state enterprises along the lines of government ministries. In principle, the companies are to be run on commercial lines, competing on equal terms with the private sector. Companies may be leased or sold to the private sector.[24] The impact of the reform on the management of public sector companies is not yet clear. This is also the case for the privatization process. Completed sales of public sector companies have so far been limited to a few hotels and small projects owned by the governorates. However, in the spring of 1993, 16 public-sector companies were offered for sale.[25]

The privatization issue remains highly controversial. There are fears that, given the absence of clear limits on sales to foreigners, national independence will suffer. The notion that the private sector is more efficient than the public sector is also contested.[26] Moreover, the determination of what constitutes the "true" value of the companies is hotly disputed.[27]

However, it seems that the conditions for the existing private sector have improved. One indicator is stronger guarantees for investors and less complicated investment approval procedures. In 1991, automatic approvals were issued for investments in all areas except those which appeared on a "negative" list.[28] Similarly, controls on the cropping pattern have been lifted step by step in agriculture. In the spring of 1993, they were limited to cotton and sugarcane.[29]

By the summer of 1993, there was every indication that government economic policy over the next few years will be an extension of the policies pursued since 1991. Budget and monetary policies will remain tight. The sales tax will be broadened to cover all goods and services. A unified income tax is to come into effect, replacing the current system of tax schedules linked to income source. Subsidy cuts, trade liberalization, and privatization will proceed in a gradual fashion. A new labor law will also follow. Policies along these lines were codified in a three-year agreement

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24 Close to fifty state-owned companies active in the following areas will be unaffected by the law: military production, oil, banks, iron and steel, aluminum, and the Suez Canal. *MEED*, June 28, and August 23, 1991, March 12, 1993; U.S. Embassy, *Foreign Economic Trends...* , 1992, p. 6; EIU, *Country Report*, No. 4, 1992, pp. 15-16; *MEED*, March 12, 1993.

25 *MEED*, March 12, 1993; *al-Hayat*, January 4, 1993.

26 Gouda Abdel Khalek, "Economic Libralization: A Misconception and an Erroneous Strategy", *al-Yasar*, February, 1992, p. 17 (in Arabic).

27 Hasan Badawi, "The Government Proves Its Shrewdness to the Fund", *al-Yasar*, April 1993, pp. 9-11 (in Arabic); Mahmoud Maraghi, Economic Reform ... or the Largest Deal in History", *al-Yasar*, April 1993, pp. 12-14 (in Arabic).

28 U.S. Embassy, *Foreign Economic Trends...*, 1991, p. 10; *MEED*, June 7 and 21, 1991; EIU, *Country Profile 1992*, p.29.

29 EIU, *Country Profile 1992*, pp.22-23.

with the IMF that was signed in September 1993. The coming second stage of the Paris Club debt reduction will lead to an additional $3 billion cut in Egypt's foreign debt. If, in July 1994, the IMF determines that Egypt has implemented the program, a third and final debt cut of $4 billion will follow.[30]

## Evaluation and Analysis of the Reform Program

The following tries to analyze Egypt's reform program, drawing on the information presented in the preceding section. The discussion will cover issues related to short-run stabilization, medium to long-run structural change, missing prerequisites for rapid long- run growth, as well as some aspects of policy implementation.

**Stabilization.** In the area of stabilization, we have seen that Egypt's policies have in recent years lead to positive real interest rates, and lower budget deficits and inflation rates while generating a balance-of-payments surplus without any significant fall in GDP growth. These are positive achievements. The balance-of-payments constraint that initially precipitated the need for stabilization has been loosened. Moreover, analysis of cross-section data for large country samples suggests that medium-run growth is enhanced by positive real interest rates and stability, the latter in large part indicated by low budget deficits and low inflation.[31]

However, the surplus in Egypt's balance of payments may only be temporary. The large capital inflows of recent years may turn into

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[30] *MEED*, March 19, July 16, and July 30, 1993; *al-Hayat*, September 22, 1993.

[31] Jacob A. Frenkel and Mohsin S. Khan, "The IMF Approach to Adjustment and Its Implications for Economic Development", paper presented at a joint session of the AEA/AAEA, Atlanta (December 28-30, 1989) pp. 27-30; Mohsin S. Khan, The Microeconomic Effects of Fund-Supported Adjustment Programs", *IMF Staff Papers*, Vol. 37, No. 2, 1990, pp. *218-219; Rudiger Dornbusch and Leslie C.H. Helmers (eds.), The Open Economy Tools for Policymakers in Developing Countries* (New York: Oxford University Press, 1991), p. 41. While being in broad agreement with these conclusions, Corden and Cooper point out that, for countries with non-accelerating moderate inflation (like Egypt in the 1980s), the importance of reduced inflation depends in the foreign exchange regime. The issue of exchange rate management will figure prominently in much of the following analysis. See Max Cordon, "Macroeconomic Policy and Growth: Some Lessons of Experience," *Proceedings of the World Bank Annual Conference on Development Economics:1990*, supplement to the World Bank Economic Review and the World Bank Research Observer, pp. 78-80, 82 (incl. comments and floor discussion of the paper); Richard N. Cooper, *Economic Stabilization in Developing Countries*, Occasional Paper No. 14 (San Fransisco: International Center for Economic Growth, 1991, pp. 62, 68-70, 74-79.

outflows at short notice if the expected return on funds placed in Egypt declines. If so, Egypt will have to devaluate its currency or lose foreign reserves.[32] In either case, the build-up of confidence in the pound would suffer a severe setback. This raises questions about the liberalization of international capital flows and foreign exchange management.

**Structural Change.** In pursuing structural change, Egypt's government has significantly reduced price distortions, partly liberalized foreign trade, and taken steps toward privatization and public sector decentralization. These issues are controversial since they are linked to the choice of development strategy. Nevertheless, there is little doubt that a majority of economists, also including most of those who maintain a healthy skepticism against excessive reliance on market mechanisms, would view this program as a move in the right direction. Considering the pre-reform state of the Egyptian economy--severe price distortions, low levels of manufactured exports, and the dominance of a centralized public sector--the program promises to generate a healthier balance between market mechanisms and central planning, between the public and private sectors, and between inward and outward orientations. With regard to price policy one may, along with critics of IMF and World Bank policies such as Shapiro and Taylor, note that to avoid long-term price distortions amounts to "little more than common sense".[33] Similarly, recent events (including the downfall of the Soviet bloc) suggest that planning from the top does not work for complex economies. Private firms in a decentralized market setting are better at decision making, with government playing an important role in providing backing and guidance.[34] This justifies public sector decentralization and privatization.

One of the aims of the reform program is to reduce Egypt's chronic deficit in goods trade. Table 2 shows that this deficit remains large and that improvements since 1990/91 are primarily due to increased oil income and lower imports rather than to expanded non-oil exports. This means that the domestic economy is deprived of an important potential source of demand stimulation during a period of contractionary domestic budget cuts. In light of current steps toward trade liberalization and measures to facilitate exports, it appears that the government now favors export

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[32] The capital account liberalization is most likely irreversible: the government cannot suddenly introduce capital controls without a very severe loss in credibility.

[33] Helen Shapiro and Lance Taylor, "The State and Industrial Strategy", *World Development*, Vol. 18, No. 16,1990, p. 876.

[34] Ibid, pp. 874-75.

expansion rather than import cuts.[35] As argued by Handoussa, Richards and El-Naggar, this seems to be the more promising path.[36] Several points can be marshaled in favor of this contention. First, Egypt's GDP share of manufactured exports is low compared to other less developed countries (LDCs) whereas its import share is more close to the average.[37] Second, on balance, empirical research findings weigh in favor of export orientation. For developing countries, export growth is not only positively related to growth, but also to job creation and poverty reduction.[38] Third, Egypt has for a very long time (at least since World War II) pursued import substitution.[39] Given that relatively large LDCs typically follow the "ISTE" rule--import substitute, then export--expansion seems long

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35 EIU, *Country Profile*, 1992, p.39. However, import cuts still seems to be a target. (See, for example, Ministry of Planning, *Statement of the Vice Prime Minister and the Minister of Planning on the Plan of Economic and Social Development for 1993/94*, May 1993, p. 13. This may inhibit export growth if it involves limited access to imported inputs for domestic exporters. Similarly, critics, such as Said al-Naggar suggest that government commitment to export expansion and outward orientation is still half-hearted (*al-Hayat*, October 18, 1993).

36 Heba Handoussa, "Crisis and Challenge: Prospects for the 1990's" in Handoussa and Potter, pp. 15-16; Richards, pp. 1722,1726; *al-Hayat*, October 18, 1993.

37 The following table compares 1991 export and import GDP shares for Egypt, the group of low and middle-income countries, and Turkey, a country similar to Egypt in terms of culture, population, size, geographical location and, until recently, a policy of import substitution.

| Region | Manufactured Exports (%of GDP) | Non-food Imports (% of GDP) |
|---|---|---|
| Egypt | 5.1 | 18.4 |
| Turkey | 9.5 | 20.4 |
| LMICs | 8.6 | 17.1 |

**Note:**
LMICs=Low and middle income countries except for countries in Europe and Central Asia.
Food imports (relatively high for Egypt) were excluded since they primarily reflect Egypt's lack of arable land).
**Source:** World Bank, *World Development Report* (New York: Oxford University Press, 1993) pp. 238-39, 242-43, 264-65, 268-69.

38 T.N. Srinivasan, "Development Thought, Strategy, and Policy: Then and Now". Background paper for World Development Report 1991, preliminary draft, October 1990, pp. 105-7.

39 Robert Mabro, *The Egyptian Economy: 1952-72* (Oxford: Claredon Press, 1974) p. 141.

overdue.[40] Fourth, diversification of Egypt's sources of foreign exchange is desirable because of the country's high degree of dependence on a few quite unreliable sources of foreign exchange. Finally, while constraints on access to export markets should be taken seriously, the history of LDCs over the last 40 years suggests that export pessimism has been unwarranted.[41] However, for most countries, pessimism about domestic demand for import substitutes would be more justified.

There are several reasons why Egypt's policy of trade liberalization, especially steps to reduce import barriers, should facilitate export expansion. It is easier for domestic producers to penetrate foreign markets if they have easy access to imported inputs (rather than being limited to domestic outputs). Experience of domestic producers from import competition may facilitate their future penetration of export markets. Finally, reduced protection for sectors facing import competition encourages investment in sectors with export potential. Nevertheless, after many years of protective high tariffs and import bans, it may be difficult for domestic industry to face import competition. In light of this, Egypt's policy of proceeding in a step-by-step fashion may be warranted, at least as long as the process is pursued within strict limits. It gives domestic industries time to prepare themselves for more competitive circumstances.

The policy of trade liberalization is challenged by the fact that (for reasons already discussed) the nominal exchange rate has remained stable in a setting where Egypt's inflation is significantly higher than US inflation: the real exchange rate has appreciated.[42] This combination of circumstances tends to undermine the competitiveness of Egypt's production of tradables, both exports and import substitutes.[43] Accordingly, current

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40 Shapiro and Taylor , p.869.

41 The fact that all exporters starting from January 1994 will have to comply with international quality specifications may become a serious constraint, both due to quality problems and because of the lack of government bodies able to test products without undue delays [*al-Ahram Weekly*, August 12-18, 1993]. On the lack of basis for export pessimism, see Paul Streeten, "A Cool Look at 'Outward-Looking' Strategies for Development", *The World Economy*, Vol. 5, No. 2, 1982, pp. 17-32; and Lance Taylor, "Economic Openess--Problems to the Century's End". Working Paper 41, World Institue for Development Economics Research of the United nations University (WIDER), Helsinki.

42 The real exchange rate may be defined as the ratio between the general price level abroad and the domestic price level expressed in common currency. The fact that non-oil exports have been stagnant since 1989/90 may be an indicator that the exchange rate is overvalued. (Cf. Floor discussion of Corden's paper [Corden, p. 97])

43 da Silva Lopes suggests that reduced protection against imports be accompanied by depreciation--since the devaluation in February 1991, Egypt

reports suggest that domestic producers find it increasingly difficult to face foreign competition.[44] If this exchange rate policy continues, it may undermine the political viability of import liberalization. The danger is that the industries which manage to secure protection from foreign competition will be those with the most political clout, not those with the strongest economic rationale for being protected.

This cannot continue for very long. Sooner or later expectations of a nominal depreciation will build up (unless trade liberalization is discontinued), encouraging capital flight and turning depreciation into a self-fulfilling prophecy. This danger is intensified by the recent fall in tourism revenues. The result, real exchange rate instability (without much impact on the long-run level of the nominal exchange rate), is likely to reduce long-run growth.[45] To reduce the risk of devaluation and capital flight, it is essential to further cut inflation, encourage exports, and, at an appropriate time, devalue the currency to restore competitiveness. The experience of many countries further speaks in favor of a subsequent shift to a policy of maintaining a stable real exchange rate via frequent changes in the nominal rate to account for inflation differentials, perhaps via a crawling peg arrangement.[46] Given its capital account liberalization, Egypt is constrained to set its nominal interest rates so as to assure savers of a real return close to international levels.

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has done the opposite. See Jose da Silva Lopes, "Policies of Economic Adjustment to Correct External Imbalances" in Alan Roe, Jayanta Roy, and Jayshree Sengupta (eds.), *Economic Adjustment in Algeria, Egypt, Jordan, Morocco, Pakistan, Tunisia, and Turkey*. EDI Policy Seminar Report, No. 15 (Washington D.C.: The World Bank, 1989), p. 29. Handoussa stresses the fact that Egypt's manufactured exports are highly sensitive to the real exchange rate and that poor export performance in the 1980s was partly due to an overvalued exchange rate. It is, however, striking that the debate in the Egyptian press is focused on tariff changes and the removal of import bans, not on the very crucial issue of the appreciating real exchange rate. See Handoussa, "Egypt's Investment Strategy...", pp. 11, 15.

44 *Al-Ahram Weekly*, February 4 and April 8-14, 1993.

45 Corden, p. 82.

46 da Silva Lopes, p. 28; Dornbusch, p. 27; Sebastian Edwards, *The Sequencing of Structural Adjustment and Stabilization*. Occasional Paper No. 43 (San Fransisco: International Center for Economic Growth, 1992) p. 16-19. For a crawling peg, the rate of depreciation would approximately equal the difference between the rates of inflation in the country in question and its major trading partners.

## TABLE 2
## DISAGGREGATED CURRENT ACCOUNT DATA
( $mil.; index 1990=100)

| INDICATOR | 1989 Value | 1989 Index | 1990 Value | 1990 Index | 1991 Value | 1991 Index | 1992 Value | 1992 Index | 1993 Value | 1993 Index |
|---|---|---|---|---|---|---|---|---|---|---|
| **REVENUES** | **13194** | **89** | **14764** | **100** | **16828** | **114** | **18788** | **127** | **18479** | **125** |
| Exports | | | | | | | | | | |
| Oil | 1066 | 87 | 1229 | 100 | 1971 | 160 | 1651 | 134 | 1703 | 139 |
| Other goods | 1631 | 85 | 1916 | 100 | 1985 | 104 | 1961 | 102 | | |
| Suez | 1307 | 89 | 1472 | 100 | 1662 | 113 | 1950 | 133 | 1935 | 131 |
| Tourism | 901 | 84 | 1072 | 100 | 924 | 86 | 1727 | 161 | 1706 | 159 |
| Other services | 4046 | 95 | 4239 | 100 | 5093 | 120 | 4884 | 115 | 4724 | 111 |
| Transfers | | | | | | | | | | |
| Government | 711 | 65 | 1094 | 100 | 1487 | 136 | 1123 | 103 | 933 | 85 |
| Workers | 3532 | 94 | 3743 | 100 | 3775 | 101 | 5467 | 146 | 5516 | 147 |
| **SPENDING** | **13663** | **89** | **15398** | **100** | **15437** | **100** | **15026** | **98** | **16166** | **105** |
| Imports | | | | | | | | | | |
| Goods | 10361 | 91 | 11441 | 100 | 11425 | 100 | 10040 | 88 | 10531 | 92 |
| Services | 3302 | 83 | 3957 | 100 | 4012 | 101 | 4986 | 126 | 5634 | 142 |
| **BALANCES** | | | | | | | | | | |
| Goods | -7664 | 92 | -8296 | 100 | -7538 | 91 | -6403 | 77 | -6867 | 83 |
| Services | 2952 | 104 | 2826 | 100 | 3667 | 130 | 3575 | 127 | 2731 | 97 |
| Transfers | 4243 | 88 | 4836 | 100 | 5262 | 109 | 6591 | 136 | 6449 | 133 |
| CURRENT ACCOUNT | -469 | -- | -634 | -- | 1391 | -- | 3763 | -- | 2313 | -- |

**Notes:**
Data are for fiscal years (1989=1988/89, etc.).
1992/93 data are preliminary estimates, calculated from Ministry of Planning LE data, using an exchange rate of LE 3.34/$.
1990 was selected as base year for the index as the last pre-reform year under non-war conditions.

**Sources:**
Central Bank, 1992, pp. 99-100; 1992, p. 232; Ministry of Planning, *Plan for Economic and Social Development for 1993/94: The Second Year of the Third Five-Year Plan (1992/93-1996/97)*, Vol. 1, April, 25, 1993, pp. 77-78 (in Arabic).

**Missing Prerequisites for Long-Run Growth.** There are some additional factors that may be necessary to achieve long-run growth. A most important missing factor over which the government has a large degree of control is investment in human capital. It is widely agreed that a highly skilled labor force is a prerequisite for rapid and broad-based growth.[47] Unfortunately, Egypt's achievements in this area are modest. Indicators such as literacy and life expectancy at birth suggest that Egypt belongs to the group of countries with "low human development"; among the members of the Arab League, only Yemen, Sudan, Somalia and Mauritania have lower values.[48] Hence, it is troublesome that according to available data, the GDP share for government spending on education and health, commonly used as an indicator of investment in human capital, recently has declined, from 5.4% in 1988/89 to 4.1% in 1991/92.[49] Moreover, there is reason to fear that nutritional and health standards, influencing the quality of Egypt's human capital, suffer as a result of general subsidy cuts in the absence of income growth or a social security network targeting the most needy.[50]

The government is also in full control of the level of real salaries going to Egypt's large bureaucracy. To maintain a cadre of motivated and talented administrators is becoming increasingly important because the reform process will generate high demands on government management using new instruments. The fact that average real salaries for this group declined drastically in the 1980s, both in absolute terms and relative to other groups (in both the public and private sectors) does not bode well.[51] Labor-intensive growth in the economy as a whole would obviously facilitate the relocation of large numbers of underemployed government administrators and thereby make it feasible to raise the real salaries of those remaining.

Along with investments in Egypt's human resources, high levels of efficient physical investments are essential for rapid growth. In recent years, the GDP share for physical investment has declined, from 26-28% in 1988/89

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47 Amin, p. 110; Shapiro and Taylor, p. 871; Stanley Fischer and Vinod Thomas, "Policies for Economic Development". Paper prepared for presentation at the December 1989 meetings of the Allied Social Science Associations in Atlanta, May 1990, p. 17.

48 United Nations Development Programme (UNDP), *Human Development Report 1992* (New York, Oxford University Press, 1992) p. 127-29.

49 IMF, *Government Statistics Yearbook 1991*, p. 247; *MEED*, June 26, 1992.

50 According to the planned budget for 1993/94, these trends for spending on education, health and subsidies continue. [*al-Ahram Weekly*, June 10-16, 1993]

51 World Bank, *Egypt: Alleviating Poverty during Structural Adjustment* (Washington D.C.: World Bank, 1990) p. 178.

and 1989/90 to 18-22% 1990/91-1992/93.[52] One consequence of increased reliance on private sector investment is that the government has relinquished some of its control over investment levels. A strong upsurge in business investment requires (and would reinforce) growth and optimism about the future. Nevertheless, there may be some room for countercyclical government investment (for example in infrastructure) and for policies establishing targeted incentives for labor-intensive short-gestation investments.[53] One rationale for steps to reduce price distortions is that they can raise investment efficiency. While Egypt has gained some efficiency in this regard, this would be enhanced by real depreciation and continued import liberalization.[54]

Finally, as the economy becomes more oriented toward markets, exports and decentralized decision making by firms, the input of a larger research community responsive to the needs of government and producers becomes more essential. In such a setting decisions become more complex for all participants. The most important constraints facing researchers is the lack of open access to timely, detailed and accurate data. Unfortunately, as for many other LDCs, there are serious gaps in Egypt's economic data base, data is often available only after long time lags, and data accuracy is questionable.[55] The resulting lack of knowledge about the consequences of alternative decisions lowers the quality of decision making. Together with limited government credibility, this discourages the private sector from carrying out irreversible investments and threatens to lower the efficiency of the investments that are undertaken.

**Aspects of Reform Implementation.** In addition to the content of the reform program, the sequencing of its different steps and the credibility of the reforms may have a strong influence on their economic effects. The **sequencing** of reforms in LDCs undergoing programs of stabilization

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52 IMF, *International Financial Statistics*, May 1993, p. 206; Ministry of Planning, *Plan for Economic and Social Development...*, p. 303.

53 Bhattacharya and Page have found that countercyclical public investment is one distinguishing mark of high-growth Asian economies. (Amar Bhattacharya and John M. Page Jr., "Adjustment, Investment and Growth in the High Performing Asian Economies". Paper prepared for the conference on "The New Development Economics in Global Context" at the American University in Cairo, May 28-30, 1992, p. 23.

54 da Silva Lopes, p. 26.

55 These assertions are justified by the following observations: (1) the most recent published household budget survey is from 1981/82; (2) actual GDP and government budget data are made available with a lag of some nine months (or more); and (3) recently the government changed its estimates of annual real GDP growth rates for the period 1988/89-1991/92 from around 2% to approximately 4% [*MEED*, August 20, 1993].

and structural adjustment has been the object of much research in recent years. For a country with Egypt's pre-reform characteristics (in essence, a highly regulated economy with macro imbalances but relatively moderate inflation), the emerging consensus favors simultaneous macro-stabilization and liberalization of the domestic economy and international trade, followed by liberalization of international capital flows.[56] Egypt deviated from this in its early liberalization of international capital flows. Most likely, exchange rate overvaluation has already reduced both net demand for Egypt's production of tradables and economic growth.[57] Growth may suffer in the future as uninhibited capital flows threaten to add to exchange rate and domestic price instability.

A program may be defined as **credible** if the government seems both determined and able to carry it out. Given the emphasis on the private sector in the Egyptian program, credibility is needed to convince this sector to embark on relatively irreversible capital investments. If in doubt about future policies, private investors have the option of keeping their capital in liquid form, thereby adding to economic stagnation. If they conclude that liberalization will be discontinued, they may invest in activities that are profitable under current policies, thereby reducing the gains from and adding to the resistance to future liberalization.[58]

For Egypt, credibility was boosted by the prompt initiation of a series of measures in 1991 as well as by continued budget deficit cuts. The conditional IMF and the World Bank support for the reforms, with associated carrots and sticks, added to this boost.[59] However, it was soon clear that the Egyptian government had opted for a very gradual implementation of the reform program. From the perspective of credibility, gradualism is a double-edged sword. On the positive side, a gradual reform program has a better chance of short-run political survival.[60] It is easier to monitor its effects and respond. In addition, there is more time for labor to move between sectors in response to liberalization measures, thereby minimizing transitional unemployment and related negative political repercussions. On the other hand, if change is introduced very slowly and with great hesitation, credibility may suffer as doubts arise as to whether the

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56 Edwards, pp. 16-17, 19.

57 This concern has been expressed by the IMF [EIU, *Country Report*, No. 4, 1992, p. 4].

58 Cooper, p. 64; Dornbusch, pp. 43-44; Fischer and Thomas, pp. 11, 24.

59 Dornbusch, pp. 43-45; Cooper, p. 65.

60 There may, however, be a long-run political cost in the form of less growth and lower incomes as a result of slow implementation.

government really intends to implement the program.[61] Unfortunately, in part this seems to be happening in Egypt: hesitant implementation of trade liberalization, public sector reform and privatization have attracted continuous complaints from economists as well as the World Bank and the IMF.[62] Slowness has also been the hallmark of the Social Fund for Development, the purpose of which is to facilitate structural adjustment by supporting, *inter alia*, small labor-intensive projects and public works. In its first year, the Fund did not implement or support a single project. In May 1993, it had only spent $36 million of $613 million in donor pledges.[63] This reinforces government hesitation about reforms that would reduce public sector employment. In addition, one gets the impression that some important reform measures have been implemented primarily in response to pressures from the IMF and the World Bank and this creates doubts that the reforms would continue in the absence of such pressure.[64]

## Conclusion

Considering the pre-reform state of the Egyptian economy, the broad thrust of the current reform program promises to raise growth and generate more healthy balances between state controls and market mechanisms and between the public and the private sectors.[65] The task is difficult. According to el-Naggar, annual growth rates around 10% are needed for Egypt to have a real chance of tackling its unemployment problem.[66]

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61 Michael, Bruno, "Opening Up: Liberalization with Stabilization" in Dornbusch and Helmers, pp. 230- 231.

62 *MEED*, March 5 and May 28 1993; EIU, *Country Report*, No. 2, 1993, p. 5; al-Hayat, February 27, 1993.

63 *Al-Hayat*, December 10, 1992; U.S. Embassy, *Foreign Economic Trends...*, 1992, pp. 6- 7, 1993, p. 7.

64 In 1991, measures to reduce the budget deficit and reform the foreign exchange system were preconditions for the IMF agreement [*MEED*, February 1 and 22, and June 7, 1991; U.S. Embassy, *Foreign Economic Trends...*, 1991, p. 10]. Energy prices were raised in the summer of 1992 in the wake of an IMF decision to suspend the second review of its agreement by three months [*MEED*, July 10, 1992]. In March 1993, government measures in the areas of trade liberalization and privatization led to the release of the second tranche of the World Bank Structural Adjustment Loan [*MEED*, March 12, 1993]. This observation is shared by the former Minister of Planning, Muhammed al-Imam who states that "reform, until now, has taken place unwillingly and under some kind of pressure and without a clear view" [*al-Ahram*, August 13, 1993].

65 Also after a relatively full implementation of the current structural adjustment program, there should be a considerable need for active state involvement in the economy, although often taking new forms compared to recent decades.

66 *Al-Hayat*, February 24, 1993.

The program's chances of success would be enhanced by changes in some critical areas, perhaps most important in foreign exchange management. Expansion in sectors producing tradable goods under a more liberal trade regime would be facilitated by a stable real exchange rate achieved through continuous adjustment of the nominal rate so as to assure that these sectors remain competitive. A stable real exchange rate would be compatible with a more stable nominal rate if inflation is lowered further and nominal interest rates are kept at levels assuring internationally competitive real returns on financial holdings in Egyptian pounds.

It would also be highly desirable to reorder government spending priorities in favor of areas that simultaneously address short-run social concerns and enhance activities that contribute to the development of a dynamic high-growth economy. The task would be facilitated by the development of some form of a "social contract" supporting forward-looking interaction between government, labor and employers. Current government spending priorities should favor education, health, public works, and programs to retrain workers, with emphasis on reaching out to low-income groups. Export support is also needed to encourage the accumulation of new experience from international competition, especially given existing disincentives such as import tariffs and the support given to import-substituting industries. The development of a social security network would make current economic restructuring faster and politically and socially less problematic. It would also enhance the economy's long-run dynamism. The quality of decision making would increase if the quality and coverage of data improved and if these were more easily accessible in a timely fashion. The credibility of the program would benefit from a faster and steadier reform pace. Finally, unemployment and material deprivation for a large part of Egypt's population are widely assumed to be major causes behind recent acts of terrorism. The upshot is that these acts further emphasize the need for faster labor-intensive growth as well as for stricter priorities in favor of social, educational and health services targeting disadvantaged groups.[67]

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[67] For a broader analysis, linking terrorism to a combination of mutually reinforcing social, political, cultural and nationalistic issues, see Saad Eddin Ibrahim, "Egypt: The Failure of the Ruling Elite in Dealing with ... the Simultaneous Crises", *al-Hayat*, April, 18, 1993.