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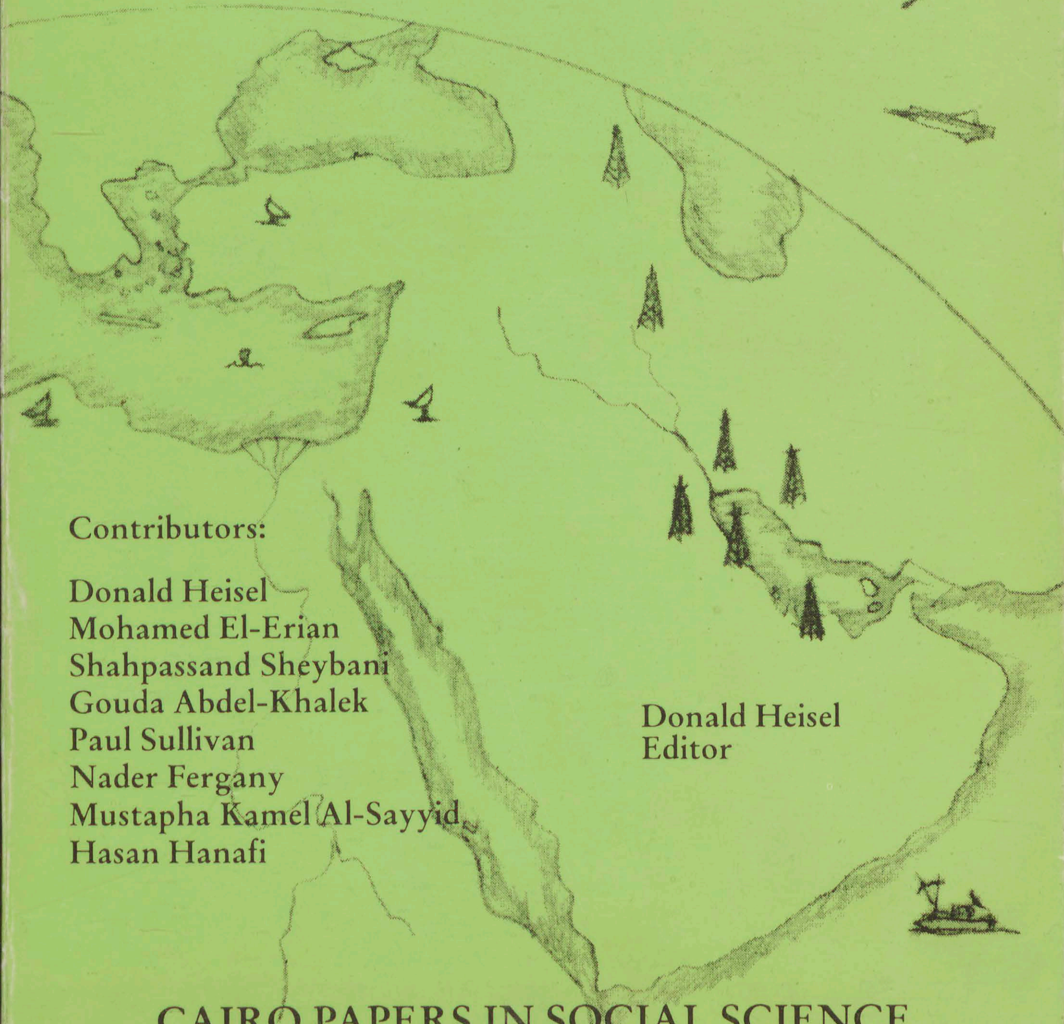

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EGYPT'S ECONOMIC REFORM AND THE CHALLENGES OF GLOBALIZATION

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After a series of protracted negotiations starting in 1989, Egypt has concluded agreements with both the International Monetary Fund (in May 1991) and the World Bank (in November 1991) on a stabilization and adjustment package. These agreements make up the core of the recently christened Economic Reform and Structural Adjustment Program (ERSAP). We have argued elsewhere, on the basis of Egypt's past experience, that the package fails to take serious account of some important structural features of the Egyptian economy--food deficit, dollarization, and the prevalence of significant idle capacity (Abdel-Khalek, 1994). It was also maintained that the ERSAP package followed the wrong sequence by stressing trade, interest-rate and exchange-rate "reform" before dealing with the real economy. In other words, exchange appears to have taken precedence over production. We also argued that the sustainability of the program could prove problematic in view of the draconian nature of some of the components and the harsh conditionality attached. It may be said that the recent package represents, in a real sense, a natural extension of the policies that were adopted since the mid-seventies under the Open-Door Policy (*infitah*). However, it seems to go much further in reworking the institutional fabric of the Egyptian economy to become a truly private enterprise, market-oriented economy.

Several analyses of Egypt's previous stabilization and adjustment attempts are now available (Abdel-Khalek, 1987). But there are only a few studies dealing with ERSAP (Abdel-Khalek, 1994, 1995; Korayem, 1993). The purpose of this study is to provide an account of the set of measures proposed under ERSAP, to serve as a basis for analyzing their macroeconomic effects. In this paper we shall argue that globalization imposes rigid limits on the use of certain policy instruments. In particular, using a nominal exchange-rate peg to anchor reform may, in the context of capital mobility and global financial markets, prove destabilizing in the final analysis.

By the late 1980s, Egypt faced a crisis that prompted the government to engage in negotiations with the World Bank and the IMF. Real gross GDP growth fell below population growth, resulting in a deterioration of income per capita (Table 1).[1] Unemployment appearëd on the rise, reaching some 10-15 per cent of the labor force.[2] Domestic inflation did not abate. Both the fiscal deficit and the current account deficit showed no sign of improvement. The economy was increasingly overburdened by debt overhang; debt outstanding and disbursed (DOD) reached the US$ 50 billion mark by the end of June 1990, a staggering 144 per cent of GDP. With only half the annual debt service obligations (of around US$ 6 billion) actually paid, accumulating debt arrears reached US$ 11 billion in 1989/1990. There is little doubt therefore that the country was facing a severe crisis and a deterioration in its creditworthiness.

All this was against the backdrop of a sharp decline in the terms of trade since 1982. In addition, the country was hit hard by the strongest external shock of its post second-world-war history by the Gulf crisis of 1990 and its ensuing events. It is estimated that the direct economic cost to the Egyptian economy of the Gulf crisis ranges from US$ 2.5 billion (Abdel-Khalek, 1991) to $ 3.6 billion (World Bank, 1990).

It was in response to these developments that a stand-by agreement was concluded in May 1991 with the IMF. It was coupled with a structural adjustment loan in November of the same year. Together, they make up the initial phase of Egypt's ERSAP. This is the first real structural adjustment package in the history of Egypt's relation with the Bretton Woods institutions.

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[1] This entailed significant changes in Egypt's international economic standing. Thus, in 1990 it moved for the first time from the lower stratum of the group of middle-income countries to the group of low-income countries, according to the World Bank World Development Report classification. Also, it requalified Egypt for interest-free resources from IDA, the no-interest loan affiliate of the World Bank.

[2] Unemployment data in Egypt are a bit confusing. The latest figures based on the final results of the population census of 1986 give a figure of 11.1% of the labor force 15 years and older. However, other national surveys taken around the same time produce slightly lower figures. The incidence of unemployment is dangerously high among the youth; possibly reaching 31% for those aged 20 to 25 years. According to the 1995/96 Labor Force Sample Survey, the overall unemployment rate was 11.3%.

ERSAP: The Main Components

The ultimate objective of ERSAP[3] is to restore economic growth and to improve living standards in a sustained fashion. Its focus is three policy areas: stabilization, structural adjustment, and social policies. The main components are the following: (a) Macroeconomic reforms, (b) Public enterprise reform, (c) Domestic price liberalization, (d) Foreign trade liberalization, (e) Private sector reform, and (f) the Social Fund for Development (SFD).

Table 1

Selected Economic Indicators, 1985/1986 through 1991/1992

	1985/1986	1986/1987	1987/1988	1988/1989	1989/1990	1990/1991	1991/1992
Real GDP growth (%)	2.7	2.5	3.9	3.0	2.5	2.3	0.3
Domestic inflation	16.1	25.2	14.2	20.2	21.2	14.7	21.1
Average nominal exchange-rate*	1.069	1.273	1.761	1.937	2.229	3.009	3.331
Average nominal deposit rate**	11.0	11.0	11.0	12.0	12.0	16.0	17.1
Average nominal lending rate**	14.0	15.0	15.0	16.0	17.0	18.0	22.0
M2 growth rate (%)***	16.3	12.4	11.1	12.3	21.4	13.4	34.4
Overall fiscal deficit/GDP (%)	23.1	19.3	24.5	18.1	16.5	20.0	7.2
Current account/GDP (%)#	-9.4	-5.2	-4.0	-9.3	-10.5	-7.4	2.8
DOD/GDP (%)	118.0	131.4	155.0	127.9	144.3	119.1	109.5
Merchandise terms of trade##			61.4	59.8	56.7	59.7	

* LE = US$

** Rate on deposits and loans with maturity less than one year.

*** M2=currency + demand deposits + LE time and savings deposits

Excluding official transfers

1982 = 100. Data are for calendar years.

Sources: All data are from World Bank (1992) p. 165, except for merchandise terms of trade.

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3 Information in this section is drawn from various unpublished material of the World Bank, the IMF, and the Egyptian government. Most important is the letter of intent of April 1991. The Central Bank of Egypt's annual submissions to the Peopleís Assembly, Report on Monetary and Credit Conditions, was also used, especially the one for 1991/1992.

Each of these components is outlined briefly, and a number of critical comments offered. The treatment is not exhaustive; it focuses on the more important aspects of the program.

Macroeconomic Reform. The thrust of macroeconomic reform is to implement a development strategy to achieve sustainable economic growth consistent with the country's ability to service foreign debt. As mentioned, this is the stabilization foundation for ERSAP. It encompasses fiscal policy, the interest rate and the exchange-rate regime. The fiscal adjustment lies at the heart of the stabilization package, and involves trimming both the overall and the bank financed parts of the fiscal deficit. As shown in Table 2, the target was to bring down the ratio of the overall budget deficit to GDP from an estimated high of 22 per cent for 1990/1991[4] to a mere 1.5 per cent by 1995/1996. It stipulates a slight reduction in the ratio of public expenditure to GDP[5] and a substantial hike in the share of public revenue, from about 25 per cent to about 40 per cent of GDP. But it is interesting to note that, in relative terms, central government non-tax revenue was to provide most of the targeted adjustment: through price increases, particularly energy prices. The increase in tax revenue was to be mainly through greater reliance on indirect taxation (a comprehensive sales tax, escalation of stamp tax).

The large shift in the structure of total expenditure over the program period is extremely important on both equity and efficiency grounds. The fiscal component of the program involves an almost tripling of the ratio of interest payments, which would be doubled in just one year--between 1989-1990 and 1990-1991. This was perhaps due to the liberalization of domestic interest rates and the placement of treasury bills (TBs). This tremendous rise in interest payments should have a negative impact on income distribution--a rise in the share paid to the rentier class. According to data of the Central Bank of Egypt, the stock of TBs outstanding at the end of June 1992

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4 Data concerning the fiscal deficit leave much to be desired. The figures reported in Tables 1 and 2 are taken from two documents of the World Bank, and they differ for the two common years, 1989/1990 and 1990/1991. Figures in Table 1 seem consistently about 2 percentage points below those of Table 2. We could not satisfactorily account for the discrepancy.

5 Abstracting from the exceptionally high ratio in 1990/1991, for the reasons explained in the note to Table 2.

exceeded LE 17 billion. More than 80 per cent of the TB stock is held by the banking system, about 6 per cent each by the private business sector and insurance companies, and about 4 per cent by the household sector.

On the expenditure side, measures include cutting food and fertilizer subsidies and public investment outlays. The latter is obviously the more significant from a growth point of view. Public sector investment outlays were to be reduced by 5 percentage points in real terms between 1989/1990 and 1992/1993. It was assumed that such withdrawal of the government would "crowd in" private investment. The package also stipulated strong wage and salary restrain, actually amounting to a labor squeeze.

With regard to interest rate and monetary policy, ERSAP involves removing all interest rate ceilings, imposing specific domestic credit ceilings that favor the private sector, eliminating any direct credit line between the Central Bank of Egypt and the government, and developing a market for TBs. Interest rates were liberalized and the first TB auction was held in January 1991.

On the exchange-rate, ERSAP included devaluation, simplifying the exchange-rate system and ensuring a competitive rate. Anticipating the formal agreement with the IMF in May 1991, a dual exchange-rate system consisting of a primary and a secondary market went into effect on 27 February 1991.[6] The new two-tier system replaced the multiple exchange-rate system; it involved partial unification and a maxi-devaluation of the Egyptian pound by some 20-25 per cent in 1991. The control mechanism for the entire system is the rate in the secondary market, which is determined freely; the rate in the primary market is set within 5 per cent below the former. Finally, unification of the exchange-rate was effected on 8 October 1991, when the free foreign exchange market was established, involving exchange-rate unification and a dirty float. According to the new system, the Egyptian pound is pegged to the US dollar. The Central Bank of Egypt (CBE) interferes in the foreign exchange market to stabilize the LE-US$

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6 This is an interesting example of front-loading of conditionality, and cross-conditionality seems excessive. The IMF requires approval of the World Bank with regard to privatization and energy prices, while the Bank in turn insists on the Fund agreeing to the exchange-rate and interest-rate measures. With regard to the budget, the Bank examines expenditure measures while the Fund is concerned with revenue measures.

rate. Exchange-rates of the pound vis-à-vis other currencies seem to be derived from the exchange-rate of the US dollar with these currencies.

Table 2

Fiscal Variables under ERSAP (% of GDP)

	Fiscal Year						
	1989/1990	1990/1991	1991/1992	1992/1993	1993/1994	1994/1995	1995/1996
Total Revenue o/w	*25.37*	*29.56*	*36.89*	*36.69*	*38.27*	*39.29*	*39.96*
CG Tax Revenue	14.91	18.48	23.77	23.12	23.65	23.91	23.95
CG Non-Tax Rev.	4.93	7.63	9.59	10.51	11.55	12.32	12.98
Total Expenditure	*43.81*	*51.47*	*47.12*	*45.15*	*44.65*	*43.45*	*42.08*
Current Exp.	28.05	32.40	33.80	35.92	35.48	34.75	33.86
of which: Interest	4.60	9.33	11.29	13.20	13.08	12.93	12.54
Capital Exp.*	15.76	19.06	13.32	10.22	9.17	8.70	8.22
Final Deficit	*18.44*	*21.91*	*10.24*	*6.58*	*5.42*	*3.33*	*1.52*
of which:							
Bank Finance	9.68	1.81	0.87	0.000	0.000	0.000	0.000

* Capital Expenditure includes public enterprise investment and structural reform related expenditure. For fiscal year 1991, it includes LE 6.1 billion (=6% of GDP) as government transfer to the four public sector banks to close their foreign currency exposure. This was mainly financed from Gulf crisis-related foreign financing.
Source: World Bank (1991), p. 13.

All payments and transfers for international transactions, both current and capital, may be effected without restrictions. Egypt has thus moved to full capital mobility for the first time in more than forty years.

Public Enterprise Reform. Structural adjustment measures related to public enterprise reform address the issues of autonomy and restructuring. The autonomy part involves promulgating a new public investment law that gives freedom to public enterprises (PEs) and the establishment of a new regulatory environment common to both the public and the private sectors. Thus, the Public Business Sector Law (Law 203 for 1991) replaced the previous one (Law #97 for 1983). According to the new law, PEs will be reorganized according to a three-tiered structure that includes the apex institutions (the Public Sector Office) at the top, holding companies in the middle, and their affiliated companies at the base. The law also allows for privatization of PEs, including asset sales, divestiture, and contracts with private management teams. When the reform is complete, PEs will operate under the same rules as the private sector; their managers will have the freedom to decide on investment, product mix, pricing, staffing. Moreover, it was decided to stop financing PEs' new investments using National Investment Bank (NIB) funds. Instead, they mobilize their resources from retained earnings, loans from the banking system, or placements on the capital market.

Domestic Price Liberalization. Measures in this category include a scheduled full decontrol of ex-factory prices of industrial products produced by the public sector. Such decontrol takes account of the competitiveness of the domestic market and the pace of import liberalization. By the second tranche release of the structural adjustment loan, only a small number of noncompetitive products, basic foodstuffs and/or products benefiting from implicit input subsidies will be subject to price controls. Their prices will be subsequently decontrolled more gradually. As to energy prices, domestic petroleum product prices and the price of natural gas were to be raised gradually to eventual parity with world prices by June 1995--at the prevailing exchange-rate. Weighted-averages of petroleum prices as a percentage of international equivalents were to be increased 11 points by May of each year for the period 1992-1995 inclusive. Natural gas price increases would be equivalent to that of fuel oil prices. Electricity prices are also to be adjusted upwards as a proportion of, and towards eventual equality with, the long-run marginal cost (LRMC), also by June 1995. As a percentage of LRMC, these average prices would be increased 10 points every year during 1992-1995 to reach 100 per cent (from 59 per cent in May 1991). In the agricultural sector, measures include the removal of the delivery quota for rice, raising cotton prices to bring them closer to world prices, and the decontrol of prices and distribution of pesticides, fertilizers, and animal feed.

Foreign Trade Liberalization. For the first phase of ERSAP, the main measures include:

- reducing the list of commodities protected by import bans from close to 40 per cent to less than 30 per cent of industrial domestic output;

- changing the tariff structure so that the maximum rate will be 80 per cent and the minimum 10 per cent;
- eliminating discretionary allocation of foreign exchange by the banking system;
- gradual elimination of non-tariff barriers (NTBs) other than import suspensions and import bans, starting with a 50 per cent reduction in NTBs before the formal start of ERSAP. (See Table 3.)

These targets were exceeded in the second phase of ERSAP, which started in 1993. For example, the maximum tariff rate is now down to 55 per cent, with only minor exceptions.

Table 3

Domestic Production Coverage of Non-Tariff Barriers (as % of domestic output)

	Public Sector		Private Sector		Total	
	March 1990	June 1991	March 1990	June 1991	March 1990	June 1991
Exports						
Export Bans	9.5	4.2	1.9	1.1	4.9	2.3
Other NTBs	15.2	4.5	1.5	0.0	7.0	1.9
All Export NTBS	*24.8*	*8.8*	*3.3*	*1.1*	*11.9*	*4.2*
Imports						
Import Bans	49.2	41.2	29.3	10.3	37.2	22.7
Agriculture	n.a.	n.a.	n.a.	n.a.	35.9	9.8
Manufacturing and mining	n.a	n.a	n.a	n.a	37.8	28.5
All Import NTBs	*76.4*	*47.5*	*36.3*	*10.9*	*52.5*	*35.6*

Source: World Bank (1991), Tables 4 and 5.

Private Sector. The most important measures are:

- automatic approval of all private investment projects, domestic or foreign, which are not on a negative list to be officially published;
- decontrol of prices in the private sector, except for a limited number of strategic items;

- entitlement of private companies to distribute output of public-sector monopolies which are being phased out under industrial pricing liberalization (e.g. cement and fertilizers).

The Social Fund for Development. The SFD is a temporary measure to provide short-term relief to target groups negatively affected by the other measures of ERSAP or by the Gulf crisis. Financial resources of the equivalent of US$ 500-600 million are earmarked to the various activities of the SFD by the Egyptian government, UNDP, IDA and other bilateral and multilateral donors.

It should be noted that perhaps the most immediate and tangible result of the SBA with the IMF (as part of ERSAP) is that it paved the way for consideration of debt reduction and rescheduling through the Paris Club. In the Paris Club meeting of 24-25 May 1991, creditor countries agreed to restructure Egypt's official and officially guaranteed medium and long-term debt, including arrears. (Outstanding debt eligible for restructuring does not include the remainder of US debt or debt concentrated after a cutoff date established at the previous rescheduling in May 1987.) The debt stock eligible for restructuring totaled some US$ 20-25 billion; it was agreed to reduce its present value by 50 per cent, in three consecutive phases, commensurate with progress in implementation. The second reduction (of 15 per cent) went into effect in September 1993, following the signing of a new agreement between the Egyptian government and the IMF. The third and final reduction (of 20 per cent) took place in October 1996. Although this does not itself solve Egypt's external debt problems, there is little doubt that it gave the country a reasonable respite.

The Macroeconomic Effects of ERSAP

In this part of the study, we shall examine the most likely effects of ERSAP at the macroeconomic level. Some aspects of the economic impact of ERSAP were discussed elsewhere, dealing with effects on the balance of payments, the budget deficit, inflation and output and employment (Korayem, 1993). Special emphasis will be placed here on particular elements of ERSAP that we deem critical for highlighting the challenges of globalization, in particular exchange reform and financial liberalization.

Monetary and fiscal policies under the program will only be dealt with in the context of examining the elements just mentioned.

Both the foreign exchange regime and the exchange-rate had undergone fundamental changes, even before the official start of ERSAP. The changes involved moving from fixed parity to a flexible peg, and from multiple rates to a unified rate. There were a number of maxi-devaluations in the process. This is well documented elsewhere. (For details, see Abdel-Khalek, 1995; and El-Rifa'e, 1992.)

Some observations are in order regarding exchange-rate policy under ERSAP. The culmination of exchange reform with the establishment of the free market in foreign exchange ushers in a new phase. The Egyptian pound was pegged to the American dollar since the unification of the exchange-rate on October 8, 1991. Both current and capital transactions have been almost completely liberalized.[7] In order to deepen the foreign exchange market, non-bank foreign exchange dealers have been allowed, with restrictions on their operations increasingly liberalized.[8]

The question whether the Egyptian pound is overvalued is not an easy one to answer rigorously for several reasons.[9] A more practical and important one is whether the Egyptian pound has appreciated since 1991. We may argue that one aspect of financial liberalization--the liberalization of interest rates in conjunction with liberalizing capital transactions in the balance of payments and the commitment of the Central Bank of Egypt to stabilize the pound-dollar nominal exchange-rate--may have resulted in an appreciation of the pound. Whether that amounts to an overvaluation of the pound depends on whether the initial rate was an equilibrium one or not.

The natural starting point is to estimate the real exchange-rate (RER) for the Egyptian pound. The RER, as usually defined, is the nominal

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[7] Only three minor restrictions remain: (a) the bilateral payments agreement with the Sudan; (b) the special liquidation accounts from expired bilateral payments agreements; and (c) outstanding arrears with non-Paris Club members, and non-conclusion of a bilateral agreement with one Paris Club member.

[8] See the memorandum on Economic Policy of the Egyptian government submitted to the IMF.

[9] First, it rests on the problematic assumption that an equilibrium exchange-rate can be determined in practice. Second, with multiple exchange-rates for most of the period, changes in the "aggregate" or "overall" nominal exchange-rate are difficult to calculate. Third, there is the perennial problem of constructing price indices that reflect accurately differential inflation rates in Egypt vis-a-vis its major trading partners.

exchange-rate (NER) adjusted by the differential inflation rate (i.e., the ratio of domestic to foreign price indices).[10]

With the liberalization of interest rates on pound positions effective January 3, 1991, banks have become free to set pound-deposit interest rates subject to a minimum of 12 per cent annually for 3-month deposits. This minimum level was dropped in 1992/1993 (Central Bank of Egypt, 1992/93). As a result of the tight monetary policy under ERSAP, interest rates on pound deposits in the domestic banking system rose sharply. The rate on 3-month pound deposits jumped from 8.5 per cent on an annual basis at the end of December 1990 to 13.6 per cent at the end of June 1991--a 60 per cent increase. It peaked at the end of January 1992, reaching 17.2 per cent annually. There was a downward trend thereafter. The major factor behind the movement in the interest rate on pound deposits is the government treasury bills auction, which determines the rate on the bills. The latter in turn determines the discount rate, since the Central Bank of Egypt sets the discount rate at 2 percentage points above the rate on 3-month (91 day) TBs, and hence the pound lending interest rate (Central Bank of Egypt, 1991/1992).

When compared to the LIBOR interest rate on US dollar deposits, the interest differential rose from 0.59 percentage points at the end of December 1990 to a staggering 13.02 per cent at the end of January 1991 (see Table 4). Even after the ensuing decline in the interest rates on domestic pound deposits, the differential was still more than 10 percentage points. At the

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[10] In the literature, reference is often made to the concept of the effective exchange-rate and hence to the nominal effective exchange-rate (NEER) and the real effective exchange-rate (REER). The effective exchange-rate takes into account changes in other currencies' exchange-rates. Distinguishing the effective exchange-rate has become almost common practice after the collapse of the fixed parities system of Bretton Woods and the ensuing wide variations in individual currencies' exchange-rates. The rationale for this is that the exchange is basically a relative price that is supposed to be an indicator of competitiveness, and thus it is important to take into account the changes in other currencies' nominal exchange-rates as well. The concept of effective exchange-rate makes good sense in the context of an adjustable-peg system, but it becomes rather fuzzy under a floating regime. The RER may be expressed in several formulae, depending on how the exchange-rate is viewed. For example, if the exchange-rate is viewed as the price of the foreign currency (measured in units of local currency), then the RER may be viewed as the price of a real dollar in terms of real domestic currency units. According to this perspective, RER is simply the relative price variable in the standard demand-supply analysis.

same time, the monetary authorities remain committed to a fairly stable pound-dollar exchange-rate over the period--around LE 3.33 per dollar--thus eliminating foreign exchange risks. With free capital mobility, this policy resulted in large short-term capital inflows.

Table 4

Deposit Interest Rates on Egyptian Pounds and LIBOR Rates for US$

End of Month	3-month pound deposits (1)	3-month US$ LIBOR (2)	Interest Differential (3)=(1)-(2)	LE/US$ Rate
Dec.1990	8.5a	7.91	0.59	
June 199	13.6	6.20	7.40	3.3409
Jan. 1992	17.2	4.18	13.02	
June 1992	16.7	3.99	12.71	3.3211
Dec. 1992	15.1	3.63	11.47	
June 1993	13.5	3.24b	10.26	3.3525

Notes: a. in effect from January 1981
b. March 1993.

Sources: Central Bank of Egypt, *Annual Report*, various years.

Monetary policy during the latter phase of ERSAP has three main targets: (I) to control monetary expansion; (ii) to stabilize the pound-dollar exchange-rate; and (iii) to bring down the pound interest rate in order to encourage investment. The instruments used are credit ceilings and the issue of treasury bills (Central Bank of Egypt, 1992-1993). This is a classic case of too few instruments chosen to achieve a given set of targets.

Furthermore, there may be a built-in conflict among these targets under conditions of free capital mobility. With an initial high interest rate, the nominal exchange-rate anchor may lead to monetary expansion. This is because interest rate differential attracts short-term capital inflows (hot money), which tends to push up the value of the pound. To avert that, the Central Bank intervenes in the foreign exchange market, buying dollars in exchange for pounds. Unless such foreign exchange inflows are sterilized, the money supply tends to increase. The government has used treasury bills well in excess of the needs of financing its fiscal deficit, partly to sterilize capital inflows. Domestic debt accumulated, partly representing the other side of accumulated international reserves with the Central Bank. The other part is increased pound liquidity in the domestic banking system. (See Table 5.)

Thus, in order to stabilize the value of the pound in the face of capital inflows attracted by the interest rate differential, the Central Bank of Egypt bought US$ 4.7 billion during 1991/1992, raising its foreign exchange reserves to US$ 10.5 billion at the end of June 1992. Net purchases during 1992/1993 amounted to US$ 5.2 billion, raising foreign exchange reserves to some US$ 15 billion at the end of June 1993 (Central Bank of Egypt, 1992/1993). The increased pound liquidity in the banking system was used largely to buy treasury bills.[11] Treasury bills issued during 1991/1992 amounted to LE 13.1 billion, whereas only LE 3.6 billion of treasury bills proceeds were used to cover the budget deficit for the year. As a result, government deposits with the Central Bank increased by LE 7.2 billion in 1991/1992, more than half the value of treasury bills issued during that year.[12] Only about 27 per cent of the proceeds of treasury bills issued during 1991/1992 were used to cover the fiscal deficit; the rest went to sterilize foreign capital inflows.

Table 5

Treasury Bills Issued, Interest Rates and International Reserves

	1991/1992	1992/1993
Total TBs issued (LE billion)	13.1	13.4
To cover deficit	3.6	2.6
To mop up liquidity*	9.5	10.8
Interest rate on 3-month TBs (%)	20.7	18.3
International reserves (US$ billion; end of June)	10.5	15.0

*Mostly government deposits with the Central Bank of Egypt.
Source: Central Bank of Egypt, *Annual Reports*, 1991/1992 and 1992/1993.

[11] It should be noted that interest income on treasury bills is tax-free.

[12] This is the difference between the stock at the end of June 1992 and 1993 (LE 17.1 billion and LE 4 billion, respectively). The source of figures in this paragraph is the Central Bank of Egypt, *Annual Report 1991/1992*, especially pp. 40, 79, 87 and 225.

The figures for 1992/1993 show more increase in the proportion of treasury bills issued motivated by monetary rather than fiscal considerations (that is, mopping up liquidity rather than covering the budget deficit).

Fiscal policy was thus subordinated to monetary policy, and the cost of such policy mix has to be carefully considered in the overall assessment of ERSAP.[13] Obviously, the culprit is capital mobility. Using the data in Table (4) regarding TB issues to mop up liquidity and the average interest rate on 3-month TB's, one may estimate the fiscal cost of such policy. For example, in 1991/1992, treasury bills issued to sterilize capital inflows amounted to LE 9.5 billion (representing 73 per cent of TB issues for the year). The interest rate on this debt averaged 18.4 per cent. Hence, the interest payment on this addition to the debt for 1991/1992 is some LE 1.75 billion. On the positive side of the ledger, one should record the interest income that the government receives on its deposits with the Central Bank, made possible by issuing TBs is excess of the need to finance the fiscal deficit. The interest rate on such deposits is set at 2 percentage points below the rate on TBs. In general, however, these payments are government resources that could have been devoted to alternative uses. There are clear distributional aspects involved in such policy; if these funds have to be raised by collecting taxes, as they should in the final analysis, then Egyptian tax payers are in effect subsidizing the holder of TBs--the foreign and local rentiers.

What has been the impact of exchange-rate policy adopted under ERSAP? As mentioned above, since there is capital mobility (thanks to liberalization of capital transactions in the balance of payments) and pegging of the pound to the dollar, financial liberalization leads to capital inflows. The money supply increases in the process, except for sterilization, thereby increasing inflationary pressures in the economy. If we add the impact of price liberalization as part of the structural adjustment component of ERSAP (see Korayem, 1993), we should expect inflationary pressures

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[13] This may be reminiscent of Mundell's famous model where capital mobility frustrated either monetary policy (under fixed exchange-rates) or fiscal policy (under flexible exchange rates). But there remains one important difference: in the Mundell scheme capital mobility meant the same interest rate at home and abroad--that is, there is only one type of assets. In the Egyptian case, on the other hand, the problem is complicated by the coexistence of two competing assets (dollar and pound positions). See Mundell, 1963.

which, if not arrested, may result in a steadily rising price level. The inevitable consequence of a nominal anchor and high domestic inflation relative to Egypt's major trading partners is the appreciation of the Egyptian pound. Calculations indicate that over the period 1991-1993 the Egyptian pound has appreciated against the American dollar by about 20 per cent (Abdel-Khalek, 1995).

The conclusion we can safely draw on the basis of available evidence is that the period representing the first phase of ERSAP witnessed real appreciation of the Egyptian pound. Such real appreciation entails some loss of competitiveness in international exchange. The implication of this for the trade balance must be examined. Before we deal with this aspect, we reiterate that the main factor for the appreciation of the pound is the financial liberalization of capital transactions in the balance of payments. With the pound pegged to the American dollar, foreign exchange risk was virtually eliminated, at least in the short run, opening the door for massive capital inflows driven by interest arbitrage. Interest rate differential between pound deposits and deposits denominated in foreign currency in the local banking system triggered a shift from the latter to the former. This is a process of de-dollarization fuelled by the expectation of negligible exchange risk. De-dollarization may be measured in various ways. The indicator used here is the change in the ratio of total foreign currency deposits to total time deposits in the banking system. This indicator considers foreign currency both as a means of payments and as a store of value. From a peak of 61 per cent in June 1991 it fell to 32 per cent in June 1993. Other indicators do not differ greatly.

This clearly demonstrates the remarkable sensitivity of the ratio of foreign-currency-to-pound deposits with respect to interest rate differentials. It should be emphasized that such sensitivity is made possible by a nominal exchange-rate anchor and maintaining capital mobility. This also clearly epitomizes the process of globalization.

The magnitude of capital inflows induced by interest rate differentials has been steadily growing. Private unrequited transfers amounted to US$ 3.751 billion during 1990/1991, US$ 5.748 billion during 1991/1992 and US$ 7.260 billion in 1992/1993. The scale and nature of capital inflows into Egypt during the first phase of ERSAP, 1991/1993, may provide yet another version of the Dutch disease. Massive capital inflows led to an appreciation of the pound, which we estimated above to be in the order of 20% over the period. Expressed differently, the relative price of non-tradables has been rising under ERSAP. As should be theoretically expected, this must initiate a resource pull into sectors producing non-tradables.

Table 6

Deposits in the Banking System, 1989-1993
(LE in millions, at mid-year)

	1989	1990	1991	1992	1993
Current deposits in LE	4.534	5.177	5.234	8.963	10.605
Time deposits in LE	17.593	21.083	25440	54.164*	77.465*
Total deposits in LE	**22.127**	**26.260**	**30.764**	**63.127**	**88.070**
Percentage (%)	**44**	**44**	**39**	**57**	**68**
Current deposits in foreign currency	2.995	3.288	4.725	6.813	7.100
Time deposits in foreign currency	25.243	31.276	44.114	40.231	34.204*
Total deposits in foreign currency	**28.238**	**34.564**	**48.839**	**47.044**	**41.301**
Percentage (%)	**56**	**56**	**61**	**43**	**32**
Grand Total	**50.365**	**60.824**	**79.603**	**110.171**	**129.374**
Percentage(%)	**100**	**100**	**100**	**100**	**100**

*Includes retained or frozen deposits.
Source: Central Bank of Egypt, *Annual Report 1990/1991*, Table 5/3-5/4, and Central Bank of Egypt, *Annual Report 1992/1993*, p. 59.

With the nominal exchange-rate anchor, such capital inflows led to the accumulation of foreign currency reserves with the monetary authorities. Thus, international reserves of the Central Bank of Egypt (excluding gold) rose from only the equivalent of US$ 2.684 billion at the end of 1990 to US$ 12.904 billion at the end of 1993, equivalent to about 120 per cent of annual imports. This level of foreign international reserves is unprecedented in Egypt's recent economic history--the Sterling balances aside.[14] With

[14] The Sterling balances accumulated during the Second World War. It was the Sterling equivalent of Egyptian pound expenditure of the British and allied forces in Egypt during the war, and amounted to the equivalent of LE 430 million in 1946. M.Z. Shefei, 1986.

both the nominal anchor and capital mobility, the stage was set for the endogenous determination of foreign exchange reserves (Blejer and Leiderman, 1981). Domestic debt accumulated in parallel, representing the other side of misaligned economic fundamentals: interest rate, inflation rate and nominal exchange-rate.

Concluding Remarks

The foregoing analysis underscores the fact that globalization imposes rigid limitations on the use of certain policy instruments for stabilization and adjustment. Such globalization is manifested by the increasing integration of financial markets, trade liberalization and capital mobility. In the context of globalization of financial markets, interest differentials may induce massive short-term capital movements. The absence of foreign exchange risk under a nominal anchor encourages uncovered interest arbitrage. If a restrictive monetary policy is applied to reduce aggregate demand and maintain external balance, domestic interest rates will rise. The persistence of high interest rates produces a number of negative effects: It makes fiscal adjustment more difficult, and involves a high cost of sterilization. The experience of the Southern Cone countries (Argentina, Chile and Uruguay) in the late seventies and early eighties and the Mexican experience of the mid-nineties reveals that bad management of capital inflows and large domestic debt may lead to instability detrimental to development.

Moreover, real appreciation may reduce the savings rate as consumers substitute present for future consumption in anticipation of devaluation (Cardoso, 1996). High interest rates may be more effective in generating liquidity than in attracting savings. Available evidence seems to provide support for this. Bank credit to the household sector in Egyptian pounds rose by 47.4 per cent in 1994-1995 (rising from LE 8.4 billion to LE 12.3 billion). A substantial proportion of these resources was used to finance the purchase of consumer durables and real estate. The World Bank reports a fall in national savings in Egypt (including official transfers) by 7 percentage points during the period 1990/1991 to 1994/1995 (World Bank, 1995).

To conclude, the Egyptian experience under ERSAP may be reminiscent of the experience of Mexico and the debacle that led to the financial crisis of 1994/1995. As in the Mexican case, the economic fundamentals do not seem to be properly aligned. The pound appears to be appreciating; there is a large domestic public debt; and there is a rising trade deficit counterbalanced by short-term capital inflows. In addition, there is a fall in the savings rate and the rate of investment, and hence the growth of the economy is sluggish. Such a combination is both extremely fragile and eventually unsustainable.

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