

# INTRODUCTION

Although the ideological stance of Egypt shifted toward socialism, nationalization, and a closed economy in the 1960s, and then back to an open-door policy in the mid 1970s, some features are common to the entire period. Successive governments have relied on centralized administration, public sector dominance over economic activity-despite privatization efforts-and a generous social contract that provides open-ended subsidies-despite attempts at rationalization and targeting.

Each decade of the second half of the twentieth century has had a different focus and different achievements. During the 1950s the country was able to overcome social inequality through reducing disparities in income and wealth distribution. During the 1960s education and health services expanded significantly as well as jobs in the public sector. In addition, the government guaranteed jobs to university and secondary school graduates.

During the 1970s subsidies became an important tool in securing a social safety net. Efforts also began to make better use of the desert: new communities were established to reduce urban concentration and industrial pollution. During the 1980s the focus was on expanding and upgrading the country's infrastructure. A new population policy constrained runaway population growth and emphasized basic health care for women and children.

The cost of these achievements was high and the growth path appeared to be unsus-

tainable. Policymakers often lost sight of the tradeoffs involved in these achievements. An early emphasis on university education neglected basic education, leaving nearly half of the adult population illiterate. Too much emphasis on subsidies left too few resources for investment and led to growing indebtedness. The drive toward employment in the government and public sector lowered real wages and reduced productivity. If Egypt is to achieve sustainable growth, a better balance must be struck between equity and efficiency, the resource base must be better utilized, and the country's most important asset-its people-must play a larger role in the process. These objectives require reformation of the institutional framework to allow people to participate at every stage of development. While public spending must be used to prioritize human development, decentralization and democratization must be accelerated and shared by civil society.

In 1991 Egypt adopted a bold economic reform and stabilization program to address a problematic social and economic situation which manifested itself in rising structural unemployment, mounting external debt, double-digit inflation, and increasingly negative fiscal and external deficits. Stabilization and liberalization have been achieved, significantly raising the country's creditworthiness. However, although macroeconomic indicators have improved, stabilization has had a number of negative impacts-sluggish GDP growth, mounting unemployment and increased poverty-which must be addressed if development is to be sustained.

Resumption of high levels of investment is essential, and should be boosted by private sector confidence and by a well-focused public program for developing social and physical infrastructure. Egypt needs to launch a second reform program, one that achieves structural adjustment and institutional reform, creates an equitable and self-reliant society, promotes sustained growth, and allows its citizens to achieve living standards commensurate with the country's potentials.

After this introductory chapter, Egypt's Profile contains five chapters, each concerned with one thematic issue addressing its qualitative and quantitative dimensions. The five chapters are successively: Chapter 1, a macroeconomic overview followed by fiscal and monetary issues; Chapter 2 addresses finance issues, covering financial performance indicators, capital market, banking sector policies, etc; Chapter 3 deals with trade issues. It analyzes key trade policies, import and export statistics, further examines trade in services, FDI trends and regulations, and highlights regional trade agreements. Chapter 4 focuses on governance and institutional issues. It includes an analysis of policy-making process; it also examines the range of political actors, legal structures and institutions. Chapter 5 is devoted to labor and human resource development issues and an analysis of labor market performance and labor market institutions is presented. An examination of the legal framework for the labor market, employment and wage trends, education and training, women and development, social protection and poverty is also covered.

The main findings of the five chapter may be successively summarized as follows:

## **1. Macro Economic, Fiscal, and Monetary Policies**

On the macro economic, fiscal, and monetary policy fronts, economic growth in Egypt has shown a declining trend since 1998-99 despite a strong performance following the successful stabilization program implemented in 1991. However, the Egyptian economy faced three major external shocks, in 1997-98: the emerging markets crises, the Luxor attack on tourists, and the sharp decline in oil prices in 1998.

Egypt's GDP growth rate started to decline largely due to a combination of the lagged effects of these three external shocks and the global economic fallout from the events of September 11, 2001, aggravated by the recent war in Iraq and the consequent uncertain and unstable political conditions in the region. The slowdown continued till 2002-03, compounded by rising inflation, high unemployment rate, widening fiscal deficit and growing domestic debt. Moreover, economic activity continued to be constrained by high real interest rates, poor levels of productivity and competitiveness, a shortage of foreign currencies, and a depressed regional and global environment.

It is common for a small "open" economy to be exposed and affected by external shocks; however, exposure does not necessarily imply vulnerability. It is the responsibility of the government to deal with these shocks in order to minimize their negative consequences. This requires taking the right measures at the right time. In that context, there is an urgent need for serious fiscal reforms in the areas of taxation, subsidization and public debt in addition to expediting the privatization process.

There is a need to strengthen fiscal performance, not just through tax reforms and expediting privatization, but also through more radical measures at the revenues and expenditures side of the budget. Improving fiscal performance does not only require tax reform and enhancing tax administration, but it also warrants revising expenditure items in the budget, realigning their priorities, and securing their effectiveness. Most of these measures, if carefully designed and targeted should not affect the poor. To the contrary, delays in restructuring expenditure priorities and sources of revenue are more likely to have a negative impact on the poor. Examples of restructuring measures include addressing the issue of implicit subsidies-adjusting the prices of petroleum products to reflect changes in international prices, and increasing electricity prices, which have been kept constant since 1991, to reflect changes in the cost of production. This does not require just a single shift in prices, but involves the establishment of a mechanism based on objective criteria through which the prices of such products would be revised according to market conditions without administrative intervention. Moreover, it is essential to revise tax holidays and exemptions and to put a cap on annual increases in wages and salaries not exceeding the annual change in the consumers' price index.

Another flagrant example of not taking the right measures at the right time is the management of the foreign exchange policy. Since the slowdown in GDP growth observed in 1997-98 and the accompanying deterioration in the external position, the government has resisted the devaluation of the Egyptian pound by injecting sums from the international reserves into the foreign exchange market. International reserves declined from 18 billion dollars in 1999 to 14 billion dollars in the year 2000. Chronic shortages of foreign

liquidity, the absence of a market-clearing mechanism, and inadequate institutional framework compelled the government to announce successive devaluations of the pound between 2000 and 2003 until it suddenly announced in January 2003 the free float of the Egyptian currency. This regime needed to be supported by an inflation-targeting framework for monetary policy. This framework, in turn, requires certain preconditions to be implemented effectively. These preconditions are strong fiscal position, a well-developed financial system, well-understood channels between monetary instruments and inflation, a reliable methodology for projecting and forecasting inflation, transparent policies, and finally Central Bank independence together with a clear mandate to achieve price stability. Until now, and after more than 18 months have elapsed since the free float was announced, the only progress achieved has been on the legal front. Law no 88/2003 has been issued, granting the Central Bank its operational independence. Other preconditions, including the development of an appropriate institutional infrastructure and monetary policy instruments are still under consideration. However, it is mainly effective implementation, rather than issuance of laws, that is required for an effective monetary policy to be achieved.

## **2. Financial Policy**

As to issues of financial policy, the analysis emphasizes progress in reforming financial markets in Egypt over the last decade of the twentieth century, although there is still much to be done. While reform of the financial sector focuses on liberalizing particular financial variables, it appears that little attention has been given to institutional reform at the micro level of financial intermediaries. There is a need for a financial policy to deal with the required reforms that

should include reform of institutions, instruments, market structure and conditions, as well as the future of the financial sector at large and its position in the region.

The profile highlights issues of financial sector reform, emphasizing financial liberalization in the banking as well as the insurance sectors, recent legal changes, development of supervisory and regulatory bodies, institutional reform and corporate governance, soundness of the financial system, and financial innovations, particularly in the banking sector and the capital market.

Micro prudential indicators give mixed signals for the soundness of the banking system in Egypt and reveal several areas of deficiencies. Despite these deficiencies, banks are supported by a stable and strong deposit base. Indicators reveal the better performance of private banks as opposed to public banks. Although still retaining public confidence, the portfolio conditions of the four public banks are raising concerns, as the public banks have been used to channel resources to public sector companies and preferred private sector users, some with questionable creditworthiness. Public banks in Egypt tend to have lower incentives to identify problem loans, to minimize costs, and to innovate. They are confronted with little competition, their losses are often covered by the government, and they are protected from closure. Promoting more effective market discipline in the financial system could be supported by privatizing the banking sector, promoting a more contestable banking system, and moving toward a competitively neutral regulatory environment. However, it is worth noting in that respect, that privatization of public banks is not one of the government's priorities. The focus is instead on changing the management of these banks. Furthermore, the government has

tended to privatize public sector shares in joint venture banks.

Capital market funding and development of securitization is essential. An amendment to the capital market law has been drafted, offering an adequate legal framework for securitization. The proposed law is generally well conceived and integrated within a flexible capital market law regarding bond markets.

Although there are a number of positive features in the Egyptian financial system, there are still areas of deficiencies. Discussion has been raised regarding the benefits and costs of unifying financial regulatory bodies under one umbrella, creating an Egyptian Financial Services Authority. Such a "super regulator" will solve the problem of a lack of supervisory coordination in a growing market where traditional barriers between different service providers are being reduced. Since the abolition of the Ministry of Economy in 2001, responsibility for the financial sector has been scattered between the prime minister, who is politically accountable for the banking system; the minister of planning, who is responsible for insurance companies; the minister of foreign trade, who is responsible for the capital market; and mortgage financing, which is under the minister of housing; and leasing companies under the Investment Authority. This situation has been addressed with recent cabinet reshuffle and restructuring. A Ministry of Investment has been created in July 2004. The newly established ministry is responsible for designing the financial policy and for coordinating among various financial sub sectors. It is responsible and accountable for the financial sector including the Investment Authority, the Insurance sub sector, the capital market, mortgage financing, and the public enterprise sector, without any involvement in implementation and supervision, which remain the

responsibility of various regulators of financial sub sectors.

The Central Bank as a supervisory authority over other banks has kept its independence by reporting directly to the President.

It is however premature to assess the efficiency of this move which appears to be in the right direction

### **3. Foreign Trade**

Regarding foreign trade issues, although Egypt was among the first countries in the MENA region to adhere to an open-market, export-promoting strategy, it has neither succeeded in achieving high export performance and growth nor did it attract significant levels of foreign direct investment (FDI). Qualitative changes in exports, in terms of increased diversification, have been achieved but remain short of responding to world demand and alignment with changes of export structure in the main trading partners. Egypt's reliance on exports of fuels, agricultural raw materials, and material-based manufacturing (textiles, garments, leather goods, wooden furniture, and other similar materials) remain predominant. Knowledge-based (high technology content) exports are minimal, hardly reaching one percent of manufactured exports. Main imports continue to be machinery, equipment, and means of transport, in addition to food products. Egypt's major trading partners are the EU and the USA, however, the share of Arab countries and of other countries of the world have increased.

As a member of the WTO, Egypt is not fully benefiting from available opportunities. Moreover, during the 1990s, Egypt joined a number of regional trade agreements and is still negotiating others, yet the benefits of entering such agreements remain modest.

The deficit in trade balance has been widening, but is attenuated, and is occasionally more than compensated by the services balance surplus, mainly due to tourism revenues and Suez Canal proceeds, and by workers remittances. These alleviated the negative impact of merchandise trade on the current account.

Inflows of FDI have been hovering around an average of US \$1 billion yearly, and portfolio investments are limited and irregular.

The most binding constraints on export performance are the lack of human skills and technical capacity, as well as supply factors, distorted incentives structures, and flawed market signals, rather than by external demand conditions, which affect the competitive position of exports . These supply factors are either of a structural nature or relate to policy barriers. Structural factors include limited export supply capacities, high production and transaction costs, institutional and bureaucratic impediments, and the anti-competitive behavior of firms, which in the absence of a clear competition policy resulted in highly concentrated domestic markets structures and high domestic profit margins. Policy barriers include relatively high and dispersed tariff structures unmatched by an efficient rebate scheme to compensate its anti-export bias effect, fairly high sales tax and other financial levies and surcharges on exports and imports, and an overvalued exchange rate, all of which led to a distorted incentives structure. These distortions favored domestic sales at the expense of exports and discouraged investments, both domestic and foreign, from building up further export capacities.

Network industry and services sectors (telecommunications, transportation, financial services, electricity, etc.) have undergone serious attempts at modernization. Their

performance has improved and their capacity to support the participation of domestic firms in investment and external trade has been enhanced. However, there is still room for improvement. To illustrate, the banking and insurance sectors provide no special financing and insurance schemes for exports, unlike other developing and newly developed countries that have succeeded in their export promotion drives.

This analysis emphasizes factors increasing costs of production and of exports, yet competition does not only rely on low costs. Development of reputation for quality and reliability in export markets is also necessary. Specializing in "niche" products that can be differentiated from those of external competitors is required. Focusing on high value added products per unit of domestic input and emphasizing quality are warranted. Building effective marketing channels, ensuring that production meets foreign market requirements and responds to quality standards, and creating an export "culture" are also required.

Membership in the WTO and participation in several regional trade agreements with the EU, and with Arab and African countries may offer wider market access to Egypt's exports, improve the credibility of Egypt's policies, and present better investment potentials. However, marked efforts have to be exerted at the macro-economic level, such as raising the domestic savings rate and directing additional investments to build supply capacity in exportables. This further requires improving the investment climate through addressing structural constraints by reducing high production and transaction costs, alleviating institutional impediments and bureaucratic intricacies, enhancing domestic competition, and addressing the anti-competitive behavior of firms.

Redressing the domestic incentive structure resulting from policy barriers is also required. This entails further reduction of the tariff levels and dispersion of the tariff structure, alleviation of the burden of the general sales tax on inputs to exportable and pervasive financial levies and administrative measures associated with trade and investment activities. Avoiding overvaluation of the exchange rate compared with other competing countries and ensuring its flexibility and stability are also compelling necessities.

These macro-economic requirements have to be supplemented with identification and alleviation of export constraints at the sector or activity level and further, at the firm level.

#### **4. Governance and Institutional Issues**

As to governance and institutional issues, the focus will be restricted here to issues related to the investment and business climate. The expression "investment and business climate" refers to the wide range of laws, regulations, policies, and customs which collectively form the environment in which business is conducted.

There is no doubt that the investment regime has been successful in attracting local and foreign investments, although with varying degrees of success throughout the period considered. However, two shortcomings have persistently plagued this regime. The first is the unclear rationale for the inclusion of certain industries and activities in a manner that reflects particular interests, and the second is the excessive reliance on offering tax relief and other exemptions as a means of attracting investors.

An overall investment climate that includes macroeconomic stability, sound monetary policy, an effective payments system, a pre-

dictable and efficient judicial system, sound corporate governance practices, fair and predictable taxes, flexible labor regulations, adequate communications infrastructure, and generally comfortable living conditions are what constitute an attractive investment climate.

It has been shown that the process of reforming Egypt's governance structure is dynamic but too slow. The constitutional framework contains some positive elements and others that must be revised. The regulatory environment of laws of investment, capital market, and property rights has manifested an ability to correct itself and to respond to market needs. Nevertheless, after more than three decades of pursuing a policy aimed at encouraging investment and promoting freedom of economic behavior, the regulatory and institutional framework for promoting private business, whether local or foreign, is still lagging. Three overall issues have not yet been properly addressed. The first is the emphasis on piecemeal and exceptional law making intended to resolve one or more problem for investors in the absence of an overall framework for the required comprehensive regulatory framework. Thus partial reforms have tended to lose their effectiveness by the counter effect of persisting rules. The second issue is the failure-despite great efforts and investment of resources-to significantly reform the bureaucracy in a way that achieves a noted impact, thus leaving the investors facing problems of incompetence, delay, and sometimes corruption. The third issue is the inability to achieve a breakthrough in reducing the time spent and in enhancing the certainty of outcome of court litigation, which severely constrain the judicial recourse available to investors and entrepreneurs.

Finally, the political context of accountability and contestability exhibits vibrance and self-

corrective power, although less here than in other areas. Further opening of political positions to competition and a more enabling, liberal environment to support NGOs are still required to improve the environment of accountability of the government, the bureaucracy, and the private sector alike.

## **5. Labor and Human Development**

In terms of labor and human development issues, over the past twenty years, the employment situation rose to the top of public policy concerns, as economic restructuring and reform failed to redress the high youth unemployment rate and stagnating real wages. Developments in the labor market have been shaped by the interaction of two sets of forces.

- (i) Labor supply pressures driven by the growth of the working age population and the rise in its educational attainment, leading to the largest ever cohort of new entrants to the labor market.
- (ii) On the demand side, the slowdown of hiring by the government combined with the decline in size of the state-owned enterprise sector has curtailed the major labor absorption mechanisms in the Egyptian economy.

These declining labor demand trends were further compounded by the continuing loss of employment in agriculture and the slowdown in international labor migration.

Although discussions and attempts at reforming the labor market regulations instituted in the 1950s have been underway since 1994, a new labor law allowing employers some flexibility in hiring and firing was only enacted in April 2003. The delay in adopting more flexible rules at a time of greater reliance on the private sector for labor absorption resulted in a sweeping informali-

zation of the labor market. The growth of informal employment in Egypt is reflected in the growing importance of small and micro enterprises in the Egyptian private sector and to the spread of informal hiring practices in the large private enterprise in their attempt to evade restrictive labor regulations. Despite attempts to constrain hiring in the government and in the state-owned enterprise sectors, the public sector continues to be the dominant employer of educated workers in Egypt.

The combination of increasing labor supply and incomplete structural change on the demand side has produced poor labor market outcomes over the past decade. Based on official statistics, the unemployment rate increased from 8% in 1990 to 11% in 1995 and settled around 9% in 2001. This is widely agreed to be an understatement of the unemployment rate. Open unemployment is heavily concentrated among educated workers, especially those with secondary school certificates. Of 1.8 million unemployed in 2001, 97% had a secondary education or above, of which 69% were secondary school graduates. Real wages fell significantly between 1985 and 1995, a period of slow growth and painful macroeconomic reforms. Real wages appeared to have recovered somewhat since then, but most of the improvement was for workers in state-owned enterprises rather than in the private sector.

Gender continues to be a major line of segmentation in the Egyptian labor market. Women are more than four times as likely to be unemployed as men, according to official statistics. Those who work earn significantly less than men in the private sector, even after taking into consideration education and experience. These gender gaps are not only large, but they are also increasing over time. These growing gender gaps appear to be

attributable to the slowdown of hiring in the government, where women are treated as relatively equal to men, and to significant barriers to entry into the labor market that women are facing in many parts of the Egyptian private sector.

Besides being significantly higher among females than among males, open unemployment in Egypt is increasingly concentrated among young, educated new entrants to the labor market who would have, in the past, been eligible for public employment guarantee. In contrast to open unemployment, visible underemployment, defined as involuntary part-time work, primarily affects lesser-educated males in casual wage employment. This is undoubtedly the form of underemployment that is most closely related to poverty in Egypt.

Turning to the performance of real wages in the 1990s, official wage data are only available for state-owned enterprises and formal private sector enterprises with ten or more employees and hence the picture regarding wages is only partially complete. Real wages eroded throughout the 1980s. They fell at an average annual rate of 5.4% from 1982 to 1991 in state-owned enterprises and at a rate of 4.5% in the formal private sector. The decline was felt across all industries. Real wages recovered slightly in the 1990s, especially from 1995 to 2001. In state-owned enterprises, wages increased at an average annual rate of 3.9%, returning to their 1978 level. In the formal private sector they only recovered at a rate of 0.8% annually, barely approaching their 1976 level. These results, although not reflecting a complete picture of what happened in the overall private sector, which is largely informal, are sufficient to conclude that real wages in the private sector have been essentially stagnant after a decade of real wage erosion in the 1980s.

Furthermore, it may be concluded that wages in Egypt have been sufficiently flexible and that the modest performance of the private sector in employment creation cannot be attributed to wage inflexibility.

Finally, a major change in the rules governing labor markets was instituted in April 2003 with the adoption of the new labor law no 12/2003. The new law increases the flexibility of employers to terminate the employment relationship due to economic necessity. It also stipulates that definite duration employment contracts can be renewed an indefinite number of times rather than immediately turning into indefinite duration contracts upon renewal. It specifies the terms of compensation or severance pay that workers would receive if laid off. On the collective labor-relations side, the major novelty in the law is that it grants workers a limited right to strike.

It is too early to determine the effect of these institutional changes on the Egyptian labor market. However, the effect in the immediate future is likely to be small. The job security rules of the old labor regime were so strict that private employers routinely hired workers without the benefit of legal employment contracts or forced new recruits to sign undated letters of resignation before starting their jobs. Moreover, the new law only applies to new employment contracts rather than existing ones, so existing job protection remains in force. These legal reforms will be most significant for state-owned enterprises and privatized firms that have a major portion of their workforce under the protection of legal contracts. They will also be relevant to foreign investors who might have been scared away by the strict job security rules that were previously applied. Together with expected reforms in tax and corporate regulations, the new labor law is a sign of increased market liberalization in the Egyptian economy.

**In summary**, monetary, fiscal, and financial reforms, which were successfully applied starting 1991, enhanced macroeconomic performance in Egypt. The inflation rate declined, the exchange rate stabilized, foreign reserves accumulated, and the fiscal deficit as a proportion of GDP reached a one-digit figure. However, delays in implementing structural and institutional reforms constrained the economy and limited its capacity to react to external shocks and to adapt to exogenous developments. Unemployment rates increased, investment rates slowed down, unused productive capacities rose, growth of manufactured exports lagged, and recessionary tendencies shifted to stagnation. These developments made structural and institutional reform more difficult but at the same time more compelling. A clear plan of action coupled with time-determined programs for implementing comprehensive structural and institutional changes have to be prepared, with a particular focus on:

- (i) Removing barriers to domestic and foreign investment and supporting small as well as medium and large enterprises.
- (ii) Giving priority to social spending in education and health services, emphasizing quality and labor market requirements.
- (iii) Speeding up the pace of reforms without exaggerating their social implications and their expected outcomes on the poor.

Most of these measures, if carefully designed and targeted may have a limited social impact. Furthermore, delays in implementing the required reforms are likely to have a deeper long-run negative impact on the poor.

## References

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