

**Stabilization and Adjustment in Egypt  
in the 1990s: Progress and Problems**

by

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## I - Introduction

For most developing countries, the 1980s have been characterized as the "lost" development decade, after a relatively encouraging economic performance in the 1970s. In the eighties, many developing countries witnessed a sharp deterioration in their foreign exchange earnings, due to collapsing primary commodity prices in world markets. Meanwhile, the global debt crisis, starting after the Mexican debt service moratorium in mid-1982, made international credit rare. High interest rates -created by tight macroeconomic policies in industrialized countries to fight inflation- accentuated further the problem, by increasing debt obligations of developing countries. Protectionist measures, imposed by the developed world, have been also responsible for the financial crisis facing developing countries.

These unfavourable external factors are, however, only part of the picture. In many developing countries, the growth of the 1970s occurred despite the presence of serious structural imbalances, due mainly to foreign exchange bonanza and/or large external borrowing. The fall of these external sources of growth in the 1980s accentuated macroeconomic imbalances, and made developing countries unable to find short term solutions to their problems. Domestic economic mismanagement was also responsible; some countries did not address major internal problems when external conditions were favourable, while others did not respond correctly when unfavourable external shocks took place.

The combination of external and internal factors has created severe economic hardships in developing countries, especially in the second half of the eighties. Negative or marginal economic growth, increasing poverty, deteriorating quality of life, high inflation and unemployment rates, persistent balance of payments deficits, and unsustainable debt service all became common aspects in most developing countries. For many, the solution was to seek

help from the International Monetary Fund (IMF) and the World Bank, which -after the outbreak of the debt crisis- expanded conditional lending. By the early 1990s, most Third World countries were applying stabilization and structural adjustment programmes, a necessary condition for receiving financial assistance and debt relief from the Bretton Woods institutions and creditor states.

In Egypt, despite unsuccessful past attempts to implement IMF-backed packages, the government reached -in 1991- new agreements with both the IMF and the World Bank on a stabilization and adjustment programme. The programme, which covers numerous policies and sectors and extends up to 1998, aims at reducing internal and external financial imbalances, and re-establishing Egypt's creditworthiness. It also aims to create, by the second half of the 1990s, the basis for a non-inflationary economic and employment growth, based on market forces and private sector expansion. The programme provides also gradual and conditional debt relief.

After three years of implementation, the impact of the programme on Egypt's economic performance has been considerable. In addition, deep structural transformations have taken place, with varying economic and social effects.

The purpose of this paper is to review and assess critically the main components of the reform package. It also evaluates Egypt's economic performance under the programme. Part four, the core of this study, accomplishes these goals. Parts two and three provide, respectively, a glance on Egypt's economy and its past relations with the IMF. Concluding remarks, including policy recommendations, are presented in part five. The statistical annex contains data on major economic variables.

## II - The Egyptian Economy

This section briefly presents the main characteristics of the Egyptian economy. It is not an attempt to explain why these characteristics exist; it merely serves as a necessary introduction to a better understanding of the impact of the 1991 reform package on the economy.

Egypt has the largest population in the Arab world (54 million in 1990). Its inhabitants, growing at an annual rate of 2.2%, are crowded into 3% only of total area, with one of the highest densities in the world. Almost 47% of them live in urban areas. In 1990, per capita GDP was estimated at US\$ 610 (World Bank, 1993, p.154). According to 1988 data (UNDP, 1990, statistical annex), only 27% of the people are in the labour force, mainly because of young population composition (average age in 1985 was 20 years), and marginal participation of females (their share in total labour force in 1989 was 10%).

Table (1) shows that the service sector, including public administration, is the main source of output and employment. Its importance does not reflect a developed economy. Rather, it marks a simple industry, and an agricultural sector in crisis; manufacturing, the most dynamic section of industry, generated - in 1986- only 13% of GDP (World Bank, 1993, p.179). The agricultural sector, which employs 38% of the labour force, provided only 18% of total output in 1987. We note also that external migration is a main source of employment, and forms a structural component of the Egyptian labour market; between one and two million Egyptians worked abroad at any point of time in late 1970s and during the eighties, mainly in the Gulf states (Fergany, 1991, p.1).

The Egyptian economy features many macroeconomic imbalances. The budget deficit averaged about 20% of GDP during the eighties

(table 2). It was financed in part by foreign loans and borrowing from the banking system (monetization), leading to higher foreign debt and participating in fuelling inflation. Current account deficit increased considerably in the same period, reaching 11% of GDP in 1989, despite slow growth of imports (table 8). This reflects -in part- the sharp decline in oil exports, given the high share of oil in total commodity exports (51% in 1991 -table 4). However, in Egypt, services receipts (mainly tourism income, Suez canal transit revenues, and workers' remittances) are the primary sources of current account earnings. In 1990, they provided 70% of current account receipts (table 8). Nevertheless, the collapse of oil prices in the second half of the eighties reduced not only oil exports but also Suez canal dues and remittances of Egyptians working in oil-exporting countries. Meanwhile, external debt grew rapidly, and the debt burden reached unsustainable level (table 5). Egypt's declining creditworthiness in the second half of the eighties further reduced capital inflows. As a result, the balance of payments registered substantial deficits (table 8).

The persistent large trade deficit is one manifestation of Egypt's structural problems. In 1990, commodity exports covered only 34% of commodity imports. This points to unfavourable conditions in international oil markets, and weak performance of non-oil exports (except textiles and clothes). It also denotes large food deficit; food import's bill absorbed, in 1991, 60% of commodity exports' revenues. In 1988, Egypt produced only 22% of its food needs (Sadowski, 1991, p.15). The food deficit features also in the budget deficit since food subsidies form a sizable amount (20% in late eighties) of government expenditures (IMF, 1991-b, p.44). In addition, the economy suffers from wide real resources gap. In 1990, gross domestic saving formed 5% of GDP, compared to 22% for investment, implying heavy dependence on foreign savings, in form of debt and grants (data from World Bank, 1993, p.158).

These imbalances have been present for a long time, especially since early seventies. They were veiled by Egypt's rapid economic growth during the period 1975-1985. But high growth rates in that period did not ease poverty, and Egypt's structural problems remained unsolved. We note also that despite past growth, the unemployment problem has aggravated, largely because the main sources of output growth provided insufficient employment opportunities, given a rapidly growing labour force. For example, oil production and Suez canal services, which were the major source of growth in the last two decades, employ less than 1% of the labour force (World Bank, 1992-b, p.174). In 1990, unemployment rate was estimated at 17% (USE, 1993, p.8). Macroeconomic imbalances also accelerated inflation rate, reaching 21% in 1990 (table 7).

The public sector played a dominant role in the economy. After the 1952 revolution, and under Nasser's regime, the public sector was the driving force in an import substitution development strategy that focused on building heavy industry. During the same era, the government role extended rapidly because the strategy also aimed at providing minimum living standard for all the population, through a comprehensive social welfare system. In 1974, after about four years in power, Sadat initiated "Al-Infitah" (the Open-Door) policy, under which foreign investment and private capital were given important privileges. As mentioned earlier, the economy depended heavily on external sources of growth, during the second half of the eighties. In addition, development plans were abandoned, and the focus was on promoting services (especially tourism) and consumer goods industries. Mubarak, who has been president since 1981, applied -in the eighties- a more conservative version of the Open-Door policy. His regime reintroduced planning, invested heavily in infrastructure, and provided more protection to local producers. During the same period however, the economy depended more than ever on foreign debt. And in the second half of the eighties, it witnessed the decline of its major external

sources of income.

Despite the gradual revival of private sector activities after 1974, the size of the public sector is still large. Two-thirds of nonagricultural GDP is produced in the public sector. In manufacturing, its share totals 75% (World Bank, 1993, p. 154). On the other hand, by the end of the eighties, the economy was still heavily controlled. Agriculture, which is dominated by private farms, was strictly regulated, with farmers required to produce according to government orders and to sell their crops to the government at below market prices. Many production and investment activities in other sectors, especially in industry, were also subject to direct controls, mainly to secure public sector monopolies. Furthermore, local producers enjoyed protection from foreign competition through import bans and high tariffs.

Finally -before 1991- prices of many goods were not market-determined, in particular those of basic foodstuffs (such as bread, rice, and sugar) and public sector's industrial production. Factor prices were also administratively controlled, including interest rates, the exchange rate, and rents. As a result, large part of the economic activity was carried out in unofficial (black) markets.

### **III - Egypt and the IMF: Overview of Past Relations**

Egypt is a founding member of the IMF. In 1962, it signed the first loan agreement with the Fund after a balance of payments crisis, caused by a short term decrease in export revenues and higher capital commitments due to nationalisation. The IMF offered UK£ 20 million in form of credit facilities. In return, Egypt agreed -among other steps- to devalue the pound by 20% (Abdel khalek, 1987, p.38).

The relations with the IMF and the World bank were dormant

until mid 1970s, due mainly to Egypt's opposition to US foreign policy[1]. But in 1974, the Egyptian government adopted "Al-Infitah" which aimed to attract foreign investment and to give larger role to private sector in the development process. In the interim, political and economic relations with the USA were intensifying at the expense of Egypt's traditional links with the (former) Soviet Union, especially after the Peace Treaty with Israel in 1979. This shift in Egypt's economic and political directions was in large part responsible for the growing ties with the Bretton Woods institutions in the second half of the 1970s.

In 1976, a new balance of payments crisis led Egypt to submit a letter of intent to the IMF. The letter specified a one year reform programme and furnished the basis for a stand-by arrangement by which Egypt was to receive SDR 125 million. Another letter, presented to the IMF in June 1978, formed the basis for an extended credit facility in the amount of SDR 600 million, to be purchased over a three year period starting 1979. In the two letters, Egypt agreed to apply certain measures, which included reducing the budget deficit, cutting subsidies, implementing tight monetary and credit policies, reducing price distortions, and devaluing the pound[2].

In practice however, the Egyptian government did not apply these measures. Widespread riots in January 1977, caused by an attempt to cut consumer subsidies, forced the government to revoke IMF-backed policies. As a result, the IMF -after disbursing SDR 75 million- ended the extended credit facility in 1979. On the other hand, soaring oil prices due to the second energy crisis of 1979-80 provided increasing revenues for the government and eased its financial problems. Foreign aid -mainly American- also helped in financing Egypt's external deficit.

Despite its external imbalances, the Egyptian economy grew at a high rate of 7.5% between 1975 and 1982 (table 6). Egypt's

prosperity was based on the surge in foreign exchange receipts. High prices and increasing oil production in Sinai boosted petroleum exports. Large labour migration to booming oil exporting economies in the Gulf increased substantially workers' remittances. Increasing shipment activities to and from the Gulf augmented Egypt's proceeds from the Suez Canal. External borrowing and tourism were also important sources of foreign currency. By the early eighties, the economy had become heavily dependent on oil and services. Revenues were derived -either directly or indirectly- from expanding oil industry in Egypt and abroad. The rise in revenues did not increase Egypt's foreign reserves but was accompanied instead by a large increase in imports. Growing revenues and foreign aid helped to finance external deficits whereas high output growth veiled Egypt's persistent structural problems.

Favourable forces in the world oil market proved to be temporary. The steady decline in oil prices in the first half of the eighties decreased Egypt's economic growth to 5.7% between 1982 and 1986 (table 6). It was not until 1986 that the economy slumped into deep crisis. Collapsing prices caused a sharp decline in oil exports, despite increasing production. The abrupt decline in oil prices created an economic recession in the Gulf countries and, as a result, a deterioration in workers' remittances and Suez Canal dues. At the same time old debt, owed to the Gulf states and rescheduled in the mid-1970s, fell due. The world debt crisis of the eighties made credit more scarce. The main source of international capital for developing countries became conditional lending, provided by the IMF and the World Bank. Meanwhile, American financial assistance to Egypt was stagnant, due to efforts to control the fiscal deficit in the USA. In sum, declining exports and capital inflows decreased Egypt's ability to service its growing debt obligations, given stagnant but high level of imports.

These developments pushed Egypt -in 1986- to seek help from

the IMF. In May 1987, a letter of intent submitted to the IMF gave Egypt access to SDR 250 million through an 18 month stand-by arrangement. The 1987/88 package focused on reducing inflation and restoring external financial imbalances through short term stabilization policies. The main measures included partial unification of the exchange rate market -implying a 60% devaluation of the pound for most transactions, raising domestic energy prices, raising interest rates, reducing the fiscal deficit, and establishing a more liberalized agricultural sector by increasing procurement prices for crops and eliminating compulsory delivery quotas. In return, Paris Club creditors agreed to reschedule US\$ 10 billion (25%) of Egypt's debt for 10 years with grace period of 5 years (USAID, 1992-a, p.11).

However, after disbursing SDR 120 million, IMF support was discontinued. Based on the first review of Egypt's actual policies, the IMF regarded the steps taken by the government insufficient and fell short of the agreed-upon policies. The government on the other hand considered IMF demands too harsh and called for a more gradual approach to reform.

Meanwhile, persistent world oil glut in the second half of the eighties kept oil prices low and accentuated Egypt's internal and external problems. Output growth was below population growth, unemployment and inflation continued to rise, balance of payments deficit persisted, and the debt burden reached unprecedented level[3]. In particular, Egypt was unable to service the high interest pre-1985 US military debt[4]. Given the Brooke Amendment, Egypt was under the risk of losing automatically all US financial aid if military arrears extend beyond one year.

As a result, the Egyptian government started new negotiations with the IMF and the World Bank in 1989. During these negotiations, the government continued to apply -on a selective basis- IMF recommendations. This partial implementation was necessary in order

to provide evidence to the IMF that Egypt was committed in principle to economic reform. In passing, we note that the World Bank operations in Egypt were limited -during the seventies and the eighties- to financing specific projects, mainly in infrastructure. In the reform package of 1991 however, the World Bank assistance took the form of a policy-based loan.

After three years of negotiations, Egypt concluded agreement on stabilization and structural adjustment package with both the IMF and the World Bank. External developments helped in making this agreement possible. The Iraqi invasion of Kuwait in 1990 was a mixed blessing to the Egyptian economy. Egypt lost large revenues due to lower tourism and workers' remittances[5]. In addition, the crisis in the Gulf created substantial wave of return migration which put the already depressed economy under additional pressures, and threatened to destabilize the society. On the other hand, capital flight from the Gulf and high petroleum earnings -due to temporary increase in oil prices- had positive effects. But the major factor that benefited Egypt's economy was political. After its position in the crisis, Egypt regained the recognition of the USA and the Gulf states for its role as a major regional balancing force, politically and militarily. As a result, they acknowledged -more than ever- that Egypt's internal stability is crucial to their interests. This created favourable economic implications to Egypt. The USA and other countries -mainly in the Gulf- wrote off US\$ 13 billion of Egyptian debt. Debt cancellation gave Egypt an opportunity to accept and implement IMF demands, especially since it was promised further relief once an agreement should be signed and successfully applied.

#### **IV - The Economic Reform Programme: Objectives, Policies and Effects**

In May 1991, Egypt concluded a stand-by arrangement with the IMF. Shortly after, a structural adjustment loan agreement was

reached with the World Bank. Both accords formed the basis of what is officially called in Egypt the Economic Reform Programme (ERP). ERP is a set of short and medium term policies developed by the World Bank and the IMF in collaboration with the Egyptian government.

Unlike the reform packages of the seventies and the eighties, ERP is comprehensive; it covers the whole economy and extends up to 1998. Formally, the first phase of ERP started with IMF approval of 1991 letter of intent. Egypt is now in the second phase of ERP which started in July 1993. ERP also differs from previous packages in that it did not focus on stabilization measures. Rather, it gives a prominent role to structural adjustment policies. In addition, most ERP policies were initiated simultaneously, a change from the piecemeal reforms of the 1980s (USE, 1993, p.3). The 1991 agreement reflects not only the need for IMF help to overcome a temporary unfavourable external shock (collapse of oil price), but also the government's desire to change deeply its economic strategy by adopting liberal policies aimed at achieving export-led growth through private sector expansion. In fact, the government -to some extent- had no choice; applying these policies was a condition imposed by IMF, the World Bank, and USA so that Egypt can benefit from substantial debt relief.

The final objective of the reform programme was "to create, over the medium term, a decentralized market-based, outward oriented economy that will restore non-inflationary growth and Egypt's creditworthiness. The economy will be characterized by a rapidly growing private sector operating in a free, competitive, and stable environment, with the scaled-down public sector operating in the same competitive environment ...." (IMF, 1991-a, p.3). In other words, ERP aims -through stabilization policies- to reduce the internal and external financial imbalances, and to increase Egypt's ability to service foreign debt. On the other hand, structural adjustment policies plan to create, by the end of

the 1990s, a new pattern of resource allocation based on market forces where the private sector becomes the primary source for income and employment generation.

In the following sections, we attempt to review and assess the main components of the reform package. We apply the traditional classification by dividing reform measures into two categories. The first category (stabilization) includes fiscal and monetary policies, and exchange rate reform. The second category (structural adjustment) covers price and trade liberalization, as well as public and private sector reforms. Debt relief and the Social Fund for Development, which present efforts by international creditors to help Egypt cope with these reforms, are addressed separately. The impact on main macroeconomic variables is also discussed, either separately or within each policy. However, this classification is mainly useful for presentation purposes, and is not rigidly applied; most of the reforms address both stabilization and structural adjustment problems. For example, liberalizing domestic petroleum prices -which is classified as an adjustment measure- reduces the budget deficit by raising new revenues to government. On the other hand, devaluation, a stabilization policy aimed at eliminating current account deficit, is one aspect of price liberalization (structural adjustment).

## **1 - Debt Relief and Financial Assistance**

After the agreements of 1991, Egypt received from the IMF SDR 278 million stand-by loan, and from the World Bank a U\$ 300 million structural adjustment loan. At the same time, Paris Club creditors agreed to write-off -in three steps- 50% of Egypt's official civilian debt, estimated at U\$ 25 billion. The first 15% was cancelled in May 1991. Another 15% was phased out in July 1993, after a successful completion of the first phase of ERP, according to IMF criteria. The last 20% (U\$ 3.8 billion) will be eliminated in 1994 if Egypt continues to adopt successfully ERP policies[6].

In addition, Paris Club agreed to reschedule part of the remaining debt. This debt relief programme is considered very generous, in light of Paris Club accords with other debtors[7]. In 1991 also, the USA forgave US\$ 7 billion of military debt, as a reward to Egypt for its role in the Gulf war. For the same reason, other countries -mainly the Gulf states- wrote off another US\$ 6 billion (USE, 1992, p.4).

As a result, Egypt's total debt decreased at the outset of the reform programme by about 30%, to reach US\$ 34 billion in 1992 (table 5). Debt relief has been a key factor in enabling Egypt to improve internal and external financial imbalances as we will see later. Instead of channelling the revenues generated by ERP policies to debt service, Egypt was able to keep them internally. However, the impact on the real economy was small since these resources were -in large part- kept in the form of foreign currency reserves in the Central Bank. After the approval of August 1993 letter of intent, the IMF offered Egypt SDR 400 million over 3 years. However, due to accumulating reserves, Egypt decided not to use the loan (Alahram, 6/8/93). Finally, foreign donors -headed by the International Development Association- provided US\$ 613 million to establish, in 1991, the Social Fund for Development (SFD).

In brief, the IMF stand-by loan aims to support the implementation of stabilization policies, while the World Bank loan assists Egypt in applying structural adjustment policies. The goal of the SFD is to minimize the effect of these policies on the poor. Lastly, the purpose of the gradual debt relief is to encourage Egypt to conduct ERP measures, reduce their costs, and ensure continuous commitment to reform -in terms of policies and time schedule.

## **2 - Stabilization Policies**

Stabilization policies include measures designed to compress aggregate demand, in order to curtail inflation, and restore macroeconomic balances in the short term (for example achieving more balanced current account and fiscal budget). They also contain restrictive policies, imposed to face inflationary shocks resulting from certain structural adjustment measures, such as price liberalization. The stabilization package, therefore, includes exchange rate, fiscal, monetary, and credit policies. Under ERP arrangements, IMF staff are responsible for designing and monitoring these policies.

### **2.1 - Exchange Rate Policies**

The reform of the exchange rate system usually constitutes the first policy a country under structural adjustment programme undertakes. During the first phase of ERP, the exchange rate system was unified. This implied also a 20% devaluation of the Egyptian pound. Another important change was granting a permission to non-bank foreign exchange dealers to operate in the market, but they were not allowed to perform other banking functions (IMF, 1991-c, p.51).

Since the initial devaluation in April 1991, the exchange rate has been stable around LE 3.3 per US\$. And with real interest rates on the pound higher than those on the US dollar (especially at the beginning of ERP), many savers preferred to convert foreign currency into Egyptian pounds, a behaviour that has supported further the stability of the pound. In FY92 for example, the foreign exchange market attracted about US\$ 2 billion (CBE, 1993, p.90). Furthermore, there has been a situation of excess supply in the foreign currency market. Tight macro-policies have squeezed imports, causing a reduction in the demand for foreign currencies. High interest rates on the pound reduced further the demand of

foreign currencies by financial investors. Lower interest payments -due to external debt relief- was also responsible. As a result, the Central Bank intervened several times in the market by buying US dollars to built reserves and to avoid an appreciation of the pound. The Central Bank reserves increased from U\$ 6.3 billion in March 1991 to 17 billion in June 1994 (Alsharq Alawsat, 25/7/94). Foreign exchange market reform has been successful in eliminating foreign currency shortages.

Before the implementation of ERP, Egypt's economy was highly dollarized. Thus, devaluation led to an increase in the value (in pounds) of foreign currency deposits -the wealth effect (Abdel-Khalek, 1987, p.6). Encouraged by high real domestic interest rates and stable exchange rate, holders of these deposits switched them into Egyptian pound accounts. This increased domestic liquidity and put pressure on prices. More important, devaluation increased domestic prices through higher import costs. It initiated an inflationary wave which was eliminated only by tight monetary and fiscal policies, causing severe recessionary effects. Devaluation has also affected negatively public sector entities and private firms that have obligations denominated in foreign currency.

Despite the government success in stabilizing the value of the pound in the free market for more than three years, the IMF asked the authorities -in mid 1994- to devalue the Egyptian currency by 25% to promote exports. According to IMF, devaluation induces exports and decreases imports, leading to lower trade deficit. Theoretically, this is true if export and import elasticities are such that the Marshall-Lerner condition is satisfied, ie domestic supply of tradable goods is elastic (Abdel-Khalek, 1987, p.7). In Egypt, this is not be the case. Supply side rigidities limit the ability to reallocate resources away from non tradable goods and towards tradables. Also, other structural aspects, such as the food deficit and limited cultivable area, prevent the development of a

surplus to export in many areas where the country can build comparative advantage (cotton and rice for example), unless improving food self sufficiency is dropped as a goal[8].

In addition, a large part of Egypt's imports are essential either for consumption or production, implying low elasticity of demand. In FY92, foodstuff formed 21% of total imports. The share of intermediate and capital goods was, respectively, 38% and 22% (table 4). Devaluation therefore increases investment costs and the prices of domestic goods including exports. This is especially true in Egypt since the import component of its non oil exports is large (Abdel-Khalek, 1987, p.6). Here devaluation may well undermine Egypt's competitiveness in the world market. Therefore, devaluation will increase and not decrease the trade deficit. On the other hand, Export promotion in Egypt depends on more crucial elements such as enhancing product quality, increasing the productivity of the export sector, increasing government assistance to exporters (such as extending credit facilities, removing export taxes, lowering duties on imported components, improving economic infrastructure etc). In addition, the development of world energy demand heavily affects the pattern of exports since oil forms about half of Egypt's exports. Despite the earlier devaluation of 1991, Egypt's exports declined to US\$ 3.5 billion in FY92 from 3.9 billion in the previous year (table 8).

In fact, IMF demands for new devaluation triggered pressures on the pound. Holders of Egyptian funds expected that the government will -sooner or later- comply and devalue. As a result, the demand for US dollars increased abruptly in late June 1994, forcing the Central Bank to sell dollars in the market, for the first time since the exchange rate unification. The Central Bank intervention was successful and prevented the exchange rate from surpassing 3.4 pounds per dollar (Alsharq Alawsat, 27/7/94). However, the Central Bank is able to stabilize the pound only in the short run. If the current expectations are enforced, switching

to US funds will progress and pound depreciation will be inevitable.

## **2.2 - Fiscal Policies**

Under ERP, fiscal policies are designed to achieve a primary goal: reducing the budget deficit, both the overall and the bank-financed part. In quantitative terms, the deficit should be reduced by FY96 to 1.5% of GDP, from 20% in FY90. The Egyptian government has been successful in performing this task: the deficit was 5.2% of GDP in FY92 and 3.5% in FY93. Deficit reduction was even faster than what the IMF originally asked for (table 2). In real terms, government expenditure was reduced by 5% in FY92, compared to a 32% increase in revenues (table 3). Expenditure compression was realized mainly by slashing public investment, reducing subsidies, and -to a lesser extent- limiting wages growth.

In Egypt, the fiscal deficit has been an important source of inflation and external debt. In 1990, the budget deficit was 22% foreign-financed and 53% bank-financed (CBE, 1993, p.80). Therefore, reducing the deficit promotes price stability and participates in reducing foreign debt. However, the adjustment programme in Egypt fights inflation by relying too much on expenditure-reducing policies: not much attention is given to policies that deal with structural aspects of price instability. The IMF considers inflation as a monetary phenomenon and therefore should be eliminated by applying tight macroeconomic policies. However, in developing countries such as Egypt, inflation is not exclusively a demand-pull phenomenon. It reflects also supply rigidities and cost-push factors which need to be dealt with. Also, under widespread poverty and underdevelopment, government expenditure in many areas -such as infrastructure, health and education- should not be decreased but rather increased. What is important is to make the best possible effort to finance spending using real resources. And in the medium run, deficit reduction must

be performed not on an accounting basis (revenue equals expenditure), but by dealing with the structural factors that give rise to the deficit.

Between FY91 and FY92, current expenditure decreased by 5% while capital spending dropped by 40% (in real terms), leading to a substantial change in expenditure structure: investment spending as percentage of total expenditure was 24%, compared to 35% in the previous year. Given the large role of government in capital accumulation (in FY89, public sector investment was 69% of total investment), the substantial decrease in investment spending will have very negative effects on growth in the future.

In addition, subsidies for essential goods were eliminated or largely reduced. ERP goal is to abolish all subsidies by FY95. The remaining subsidies for edible oil and sugar will be eliminated during FY94 while those for bread and flour will be phased out in FY95 (World Bank, 1992-a, p.13). As a result, prices of basic foodstuffs have increased rapidly, with adverse effects on consumers, especially the poor. Also, in FY92 the government's real wage bill decreased by 7% despite 15% rise in nominal wages[9].

As we will show later, spending cuts have reduced the role of government in providing essential services, with damaging effects on low income groups. On the other hand, tight monetary policy and public sector restructuring led to a reduction in transfer payments to public enterprises, and as a result, to lower spending[10]: Financing the deficit of public enterprises decreased by about 50% in FY92 (CBE, 1993, p. 83).

In addition to spending constraints, government revenues have been increased through different measures such as higher indirect taxes, higher custom duties, higher charges for government services, and higher prices for public products and utilities. In particular, higher energy prices have been a major source of new

revenues for the government. In 1990, the average of domestic petroleum prices increased by 43%. In May 1991, it was raised by 53% to reach 45% of world price level. Another increase was adopted in 1991 to raise the price to 56% of world equivalence. According to ERP, the government is also committed to raise petroleum prices by 11% annually, in order to attain full equality with world prices in June 1995 (World Bank, 1991, Annex 2). Also, the government increased electricity price by 38% in 1990 and 50% in 1991. The goal is to cover the long run marginal cost in June 1995, by increasing the price 10% annually (World Bank, 1991, Annex 2).

It is understandable to raise energy prices since they were originally set at very low level, leading to excessive energy consumption and inefficient uses. However, it is not a good policy to adopt the world market price as the bench mark. Raising energy price to world level ignores the underdeveloped state of the Egyptian economy. In other words, additional -and more important- criteria should be considered, such as per capita income. In addition, 85% of oil consumption in Egypt is of intermediate nature (Abdel-Khalek, 1987, p.16). Thus, higher oil price increases significantly production costs and leads to higher prices for final goods. Furthermore, adopting world level price ties the local economy to unstable world energy market, and to exchange rate fluctuations (since conversion of local prices to international equivalents is based -according to the World Bank formula- on the prevailing exchange rate). In brief, excessive increase in energy prices creates unfavourable conditions to both producers and consumers.

Another major source of government revenues was the introduction -in May 1991- of a new indirect tax, the General Sales Tax (GST). It is being developed gradually to cover more activities, to become a value added tax by the end of 1994 (Alahram, 13/6/93). The GST increased government revenues substantially, but contributed also to business recession and

significant drop in sales. It is estimated that the GST lowered sales by 50% and retail profits by 10-20% (Alsharq Alawsat 24/6/93).

Higher revenues have been provided also by higher income and corporate tax revenues, higher duties on imports, higher service fees and higher non-tax revenues - mainly from Suez Canal and the petroleum sector. It is clear that government revenues have been increased primarily through indirect taxes and price increases. Since these measures redistribute income against low income groups, the burden of raising revenues relied mainly on the poor.

As a result of these developments, the resources available to finance the deficit were higher than the deficit itself in FY92, leading to a reduction in the government debt to the banking system. Another important positive development was the drop in the share of both domestic bank finance and foreign finance in total deficit financing; a larger part of the deficit is now financed by domestic real resources. The share of domestic non-bank finance increased due mainly to the use of treasury bills. The bills' share in domestic non-bank finance increased from none in FY90 to 47% in FY92 (CBE, 1993, p.100).

### **2.3 - Monetary and Credit Policies**

As part of ERP, the government has adopted tight monetary policies. Growth in nominal broad money supply (M3) fell from 28% in FY91 to 14% in FY92 (CBE, 1993, p.165). The Central Bank decreased considerably its financing of the rest of the banking system and the government. Instead, the Central Bank started in January 1991 a public treasury bill auction, to finance government operations. In addition, interest rates were set free in order to increase savings and to lower the dollarization rate (the share of foreign currency deposits in total domestic liquidity). The

deposit rates offered by financial institutions. Interest rate distortions were also eliminated. Before ERP, the banking system made preferential interest rates available to certain sectors of the economy such as the government, public sector companies, industry, and agriculture. In June 1991, the average discount rate reached 21% compared to 14% in May 1989 (CBE, 1993, p.66). The government announced that its goal is to keep treasury bill rate at four percentage points higher than inflation rate (Alahram, 15/8/93).

With stable exchange rate and positive real interest rates, there has been large capital inflow, mainly in the form of workers' remittances, which increased by 37% to reach US\$ 5.2 billion in FY92 (table 8). This inflow created excess liquidity in banks. As a result, the Central Bank continuously intervened by selling treasury bills to absorb liquidity as a means to control inflation, and to prevent the interest rate from decreasing to avoid capital outflow.

High interest rates have severely depressed investment and growth. In May 1991, ceilings on bank lending were imposed as anti-inflationary measure. Total bank lending decreased by 4% in FY92 compared to 24% increase in 1991 (CBE, 1993, p.38). In October 1992, ceilings were ended for the private sector because of excess liquidity in banks. However, private sector demand for credit continued to be low due to the induced recession created by macroeconomic policies. And given their high return and safety, government bonds were very attractive to individuals and financial institutions -especially commercial banks. Therefore, treasury bills participated in lowering lending to productive investment activities -a crowding out effect. The Share of loans in bank assets decreased to 33% in FY92 from 39% in FY91 while portfolio investment share increased to 20.3% from 11.1% (CBE, 1993, p.38). These developments suggest that there has been a redistribution of income in favour of the rentier economy.

It should be noted also that high interest rates increased interest payments on domestic debt. Excessive use of treasury bills as a means of deficit financing may have dangerous effects in the future. Treasury bills are usually used for short term fiscal imbalances. Since Egypt's budget deficit reflects long term structural problems, excessive use of the bills leads to debt accumulation. If the structural problems are not addressed, the government may find itself in the future in financial crisis forcing it to borrow from the Central Bank, hence launching inflation again. The government's domestic debt increased from LE 52 billion in mid-1990 to 125 billion in mid-1994 (Alsharq Alawsat, 17/8/94).

The government has recently lowered interest rates by limiting treasury bills issuing. As a result, the interest rate decreased to 12% by November 1993 (Alahram, 20/11/93). However, the current depressed demand reduces the prospects of investment growth. Under IMF directions, the Government plans to lower nominal interest rate to 7% by mid 1995 (Alsharq Alawsat, 27/7/94). This may lead to capital outflow and depreciation of the Egyptian pound, unless inflation is brought to a very low level (developing country standard), which requires -given the IMF focus on demand pull measures- tighter macroeconomic policies.

Another positive outcome of current ERP policies is the decrease in the dollarization rate of the Egyptian economy. A stable exchange rate, positive domestic real interest rates, and low interest rates on the US dollar (about 3%) have changed substantially the structure of bank deposits. Egyptian pound denominated deposits increased by 60% in FY92 while foreign currency deposits decreased by 12%. This lowered the dollarization rate from 55% in 1991 to 27% in 1993 (Alsharq Alawsat, 28/4/94).

Along with monetary reform, the government introduced new

policies regarding the banking sector. Their goals are to reduce public sector dominance, to increase competition, and to strengthen the banking system. In 1991, out of 81 banks in Egypt, the four public sector commercial banks held 65% of total deposits (USAID, 1991, p.21). Thirty three of the banks were owned -totally or partially- by foreigners. Despite extensive presence, foreign banks were restricted in their operations. For example, they were not allowed to operate in local currency. Under ERP, these restrictions were removed. Also, many barriers that limit the entry of new banks were abolished. Clearly, these steps open widely the Egyptian economy to the operations of international banks and financial firms. On the other hand, measures were imposed to strengthen the banking system. For example, each bank was required to reach a capital adequacy ratio -capital as a percentage of risk weighted assets- of 8% by 1993. This goal was set following the guidelines of the Basle Committee of the industrial countries. Other steps include limit on loans to a single borrower, higher liquid asset requirement (especially for foreign liabilities), and stronger Central Bank supervision. In particular, the government assigned special audits for the four public sector commercial banks. Also, a deposit insurance system was adopted (USE, 1993, p.5).

### **3 - Structural Adjustment Policies**

The purpose of adjustment policies is to improve efficiency in the domestic economy, by increasing local and foreign competition, removing regulations and controls, and relying on the market price mechanism in resource allocation. This approach is viewed by the World Bank as the only way to stimulate medium and long-term growth. Structural adjustment policies include price and trade liberalization, and public and private sector reforms. While the IMF deals with stabilization issues, the World Bank monitors Egypt's commitment to structural reforms. Despite this division of labour, there is complete coordination between the IMF and the World Bank; the IMF requires positive assessment from the World

Bank on Egypt's progress in adjustment issues, in order to continue stand-by assistance and to give green light to Egypt's creditors to write off or reschedule debt. On the other hand, the World Bank structural adjustment loan disbursement cannot continue unless the IMF confirms that Egypt is progressing on stabilization matters.

### **3.1 - Price Liberalization**

During the first phase of ERP, the prices of all industrial public sector goods were set free except for some products -basic foodstuffs, cotton yarn and cigarettes. In agriculture, price deregulation led to the elimination of input subsidies (livestock feed, pesticides, fertilizers), and all controls on output prices, except for cotton for which controls will be eliminated by July 1995. However, the cotton procurement price is being raised gradually to international price level. In the transportation sector, public companies have been increasing -on a yearly basis- prices of their services to equate revenues with costs by FY98. Electricity prices should also attain the long run marginal cost by June 1995. The average price of petroleum products was equal to 90% of the world price in August 1993 (Alahram, 25/7/93). Under ERP, decontrol of the domestic pricing system should be complete by July 1995.

According to the IMF, price controls resulted in high consumption rates, low investment, and inefficient distribution of resources, leading to high inflation which affected mainly the poor. Therefore, government controls which were placed to protect the poor ended by hurting them through inflation (World Bank, 1990, p.6). However, price liberalization has created by itself high rates of inflation. Although the inflation rate is currently at 7%, price deregulation occurred mainly in 1991 and 1992. In the latter year, inflation reached 26% (American Chamber, 1993, p.37). Also, many prices are still increasing -food and energy for example- but are not reflected in the overall inflation rate because strict

macro-policies counter their effects through more spending cuts and tighter monetary policies.

The immediate consequence of price liberalization policy is the general decline of real earnings. Low income urban households are likely to suffer more. They now pay more for food, utilities (water and electricity), and transport (buses and railways). Poor households in rural areas may suffer less simply because many of them lack these services and utilities. In general, the increase in energy prices affects the poor indirectly, through higher food prices and transport fees. However, the rise in kerosene price will have a direct impact because it is used by the poor -mainly in the countryside- for lighting and cooking purposes.

The net effect of price liberalization will also be negative on small farmers and landless rural households. A study for the World Bank showed that price liberalization in agriculture will benefit -in terms of income- all producers except those who do not own the land (35% of all producers). But if we take into account the effects of higher food prices, the study argues, the net effect will be positive for large producers only, i.e. those with more than 5 feddans (1 feddan = 0.42 hectares). These producers form only 5.4% of the total number of landlords and 3.5% of all producers (World Bank, 1990, p.107).

In terms of output however, increasing agricultural output prices is a positive supply side measure. Up to late 1980s, agriculture was under heavy government intervention. The goal was to assure cheap food prices for urban population, and to use the surplus originated in agriculture to develop other sectors. In practice, government policies caused a deterioration in agricultural output (especially for cotton, wheat, rice, and sugar can), and led to very large food deficit. Free output prices will induce growth in the agricultural production. However, liberalizing input prices and tightening credit to farmers, which also have been

undertaken under ERP, create counter effects. But it is expected that the net effect on output will be positive, especially in the medium term.

We should note that -eventually- free prices and trade lead to another form of dollarization; market forces raise local prices to international price levels, especially for tradable goods. As a result, price liberalization lowers real earnings in the domestic economy, and sets prices that reflect real earnings of the developed world.

### **3.2 - Trade Liberalization**

According to ERP, Egypt is committed to promote free trade by removing all non-tariff barriers, lowering import tariffs, simplifying import procedures, and removing all restrictions on exports. Also, reliance on public trading companies will be eliminated. In March 1990, 36% of tradable goods output in agriculture and industry was protected by quantitative restrictions, including import bans (USAID, 1992-b, p.31). By July 1993, the percentage dropped to 5% only (Alahram, 30/7/93). All remaining quantitative barriers, which now protect products of the textile industry only, will be phased out by 1997. In addition, tariffs' structure was largely changed; the margin between maximum and minimum tariff was narrowed by July 1993 to the 10-80% range, from the previous 0.7-120% range, with very few exceptions applied to some luxury goods (cars and wine) and a monopoly product (cigarettes) (Alahram, 30/7/93). The IMF goal was to reduce the maximum tariff to 50% in 1995 (Alsharq Alawsat, 27/7/94). Many import procedures were considerably simplified, and public sector monopoly to import certain goods (such as cement and wheat) was phased out. In addition, taxes and almost all quantitative restrictions on exports were abolished.

The objective of lifting quantitative restrictions and

lowering tariff barriers is to reduce protection of local producers. Foreign competition, according to IMF, increases the efficiency of domestic industries and ensures better resource allocation in the economy. This in turn promotes growth, and provides consumers with better quality products and lower prices. The IMF argument assumes pure competition, including perfect factor mobility, which is unrealistic given the present structural rigidities in Egypt's economy. Trade liberalization will impose unbalanced competition, leading to the elimination of many local industries and widespread lay-offs; the net effect of free trade may be negative. In addition, there are serious fears of dumping subsidised products in the Egyptian market. This concerns mainly agricultural products originated in North America and the European Union. Also, there are concerns that cheap consumer goods produced in South East Asia will phase out some local industries -particularly the textile industry which employs thousands of workers. The situation in practice will become worse given the current widespread manipulation of import prices; many importers submit low invoice prices, which lead to a reduction in government revenues and limit local producers' ability to compete.

More liberal trade is recommended if performed on selective basis. For example, lowering tariffs on products that are used as inputs and which are not produced domestically will benefit production, either for the local market or to export. Furthermore, tariffs and quantitative restrictions can be reduced to put pressures on domestic products to develop, but not to the extent of eliminating the products themselves. We note also that raising the minimum tariff level to 10% increased the cost of some basic food imports which used to enter almost duty free. This will negatively affect the poor.

It is interesting to note that while the IMF is forcing developing countries to remove quantitative barriers, it is unable to convince many developed nations to eliminate subsidies to their

local producers and to abolish the quotas system which protects some of their markets (for example the textile industry in the European Union).

### **3.3 - Private Sector Reform**

The government has taken many steps to promote private sector expansion. According to ERP, the private sector is the only source of future growth given the current down-sizing of the public sector. In the past, many regulations were imposed primarily to ensure public sector monopoly over some sectors and activities. For example, the government had the right to block any investment, and to control production capacity of private firms. Under ERP, investment licensing requirements were effectively eliminated except for a negative list of products for which government approval is required. The list, and all public sector monopolies, should be abolished by 1995. Removing entry barriers will also eliminate the de facto monopoly that some private firms enjoy. In addition, administrative procedures have been considerably simplified. For example, investment projects are currently automatically approved, and registration process has been significantly eased. Import controls are now confined mainly to tariff barriers, and export activities have been exempted from almost all controls including taxes. Constraints on capital movements were also removed.

The government has already introduced -in 1989- a new investment law. A major aspect of the law is that it contains too many privileges and exemptions. Any project established under the law is exempted from all taxes for five years. The exemption period can reach in some cases 15 years. The law gives the same treatment to projects established through debt-equity swaps: investors can now buy Egypt's external liabilities with large discount (30-50%) and convert them into domestic currency and then use the proceeds to establish tax exempted projects[11]. The law in practice

deprives the government of revenues which are greatly needed. Exemptions and privileges should not be general but rather restricted to certain activities the government wants to develop.

The impact of the macroeconomic policies -initiated by ERP- on the private sector is considerable. Price liberalization, exchange rate stability and low inflation will induce investment. Other factors will have, however, counter effects. Prices of local and imported inputs have increased considerably due to price liberalization and devaluation, leading to higher production costs. This will have negative effects in the short run since firms will be able eventually to include these increases in their output prices. But high prices for final goods -as well as tight macro policies- have reduced the purchasing power, and caused a severe compression in aggregate demand. In addition, free trade means -in many activities- unbalanced competition with foreign firms, which will destroy numerous private projects. High interest rates have been also a major source of slow private investment. The international environment imposes other challenges; considerable trade barriers are still imposed on Third World exports to developed countries, limiting the scope of investing in export activities. Also, rising unemployment and depressed real incomes create political problems, which contribute to uncertainty about the future among business. Under unstable conditions, the private sector prefers to "wait and see". This behaviour aggravates the economic crisis and causes further delay in output growth. Finally, the public sector in Egypt has been -in some instances- an important source of assistance to the formal private sector, through direct and indirect subsidies and by developing local infra-structure. The informal sector also depends on the growth of the urban formal sector for a good portion of its income. In short, given the high degree of dependence on the public sector, the net effect of its decline may be negative on the private sector in terms of output and employment growth, especially in the short and medium spans.

### **3.4 - Public Sector Reform (Privatization)**

The major structural change ERP aims to achieve is public sector privatization. Despite numerous efforts -since 1974- to reduce its role, the public sector still occupies an important position in Egypt's economy. In 1990, it provided 40% of GDP, 36% of total employment, and 56% of investment (USAID, 1992-a, p.32). As part of ERP, the government introduced in October 1991 Law 203 (The Public Enterprise Sector Law). It is a transitional law, imposed to facilitate privatization; all Law 203 companies will be eventually privatized. The law covers 380 enterprises owned by the central government. Most of these enterprises were reorganized as subsidiaries of 17 newly formed holding companies. About 50 public sector enterprises were excluded from the law. They include companies considered strategic by the government such as those producing military equipments and those working in the petroleum sector as well as the Suez Canal Authority and Egypt Air (USAID, 1992-b, p.32). Banks and insurance companies were also excluded since they will be organized under a separate financial sector reform programme. The main feature of Law 203 is that it separates ownership from management. The holding companies took over management responsibility from the government. As a result, the holding companies and their affiliates have full autonomy with no direct control from government. They will monitor their affiliates, evaluate their performance, and make decisions regarding their future (restructuring, divestiture or liquidation). Each holding company appoints the managers of the affiliates which have now a primary goal: profit maximization. Their managers have the right to make free decision regarding pricing, inputs, wages increases, employment, etc. Meanwhile, the government is committed to discontinue financing public sector companies through the budget, and to eliminate any explicit or implicit subsidization. Instead, these companies are free to borrow from the capital market, according to the same rules applied to private sector (IMF, 1991-a,

p.6). Each holding company is run by a board of directors, who are accountable to a general assembly. The members of the assembly were appointed by the prime minister and drawn from within the public and private sectors -including businessmen, bankers, economists, legal advisors and union representatives. Clearly, the government still has an indirect control on these companies.

It was estimated that Law 203 companies employ 1.2 million workers (World Bank, 1991, Annex IV). Their book value of assets was around LE 80 billion (US\$ 24 billion) in June 1993 (American Chamber, 1993, p.9) although their market value is higher. Law 203 companies work in all sectors of the economy. In particular, they account for as much as 70% of Egypt's total manufacturing capacity (USE, 1993, p.6).

In addition, government assets in several joint venture companies will also be sold to the private sector by 1994. On the other hand, the central government has already started privatizing the much smaller firms controlled by local governments (about 2000). By mid 1993, some 1500 were sold (Alsharq Alawsat, 24/6/93).

A new organization, the Public Enterprise Office, was set in November 1991 to conduct the technical aspects of privatization, including the evaluation of public enterprises' assets. The Office, which is funded by the World Bank and other donors, is under the direct responsibility of the prime minister. In February 1993, the Office declared plans to sell 85 Law 203 companies by 1994 (Alahram, 8/3/93). These are mainly profitable small and medium sized companies with minimal legal and labour problems. The first candidates for privatization are concentrated in the tourism sector, especially luxury hotels. The other 235 companies suffer from severe financial imbalances and overstaffing. Therefore, they will be privatized after a period of adjustment. Holding companies and public sector banks, which have significant shares in state owned enterprises, are also taking part in the process. The

government also intends to sell the shares of these banks in 22 banks by June 1995 (Alahram, 8/3/93).

In practice however, privatization has been slow. The government expects now that 51 -instead of 85- companies will be privatized by June 94. In 1993, 20 companies were put for sale, but by April 1994 only 3 were sold (Alsharq Alawsat, 19/3/94). Slow privatization is the main source of disagreement between the IMF and Egypt. According to the IMF, lower interest rates and the lack of real investment opportunities (due to compressed demand) will induce the excess capital in banks to leave, unless privatization is accelerated. In other words, buying public sector companies is the only option available for capital, given the current conditions. IMF suggests that privatization should be complete in three years (Alam Alyom, 29/6/93). Given the actual pattern however, Law 230 companies will be privatized in -at least- 10 years. The current conditions makes IMF demand unrealistic; most public sector companies -as mentioned above- suffer from several weaknesses and therefore are not attractive for investors, unless they are sold for excessively low price. Even for some healthier companies, there are problems of estimating a fair value for their assets[12]. It is expected that most public companies will be sold at low prices; many developing countries are implementing -simultaneously- privatization programmes. Investors, especially foreigners, have the option to choose among different firms in different countries. In other words, competition among sellers will lead to low sale prices.

On the other hand, the size of many public properties offered for sale is large. At the same time, potential buyers are ranked according to their financial capabilities. Given the limited means of most local investors, and the difficulties that local entrepreneurs face during the current recession, these properties are being sold mainly to foreigners: the fear of foreign control of Egypt's economic assets is real. There are also concerns of

replacing public monopolies with private ones. For example, the two bottling companies -which are currently offered for sale- control 80% of the local soft drink market (American Chamber, 1993, p.11). In addition, most public sector firms have been sold through bidding. As a result, the general public participation in owning these firms has been limited. There is a need to convert public firms' assets into shares, in order to assure larger participation in ownership, especially from workers. However, the large number and substantial value of firms to be privatized, and the small and underdeveloped state of the domestic capital market, restrict this option. With the IMF pressing to accelerate the privatization process, the Egyptian government is relying more on the bidding system.

Another problem relates to the excessive indebtedness of large number of public enterprises; most Law 203 companies need financial restructuring to become attractive for buyers. Under tight monetary and fiscal policies, the government cannot provide new funds to these companies. Injecting new equity funds is also constrained by the underdevelopment of the financial market, as well as high and safe returns on treasury bills. The debt of Law 203 firms to the banking system is estimated at LE 105 billion (US\$ 31 billion), of which LE 42 billion to the National Investment Bank alone (Alam Alyom, 19/7/93). In this situation, many of these firms are selling part of their assets to raise revenues. In particular, they are liquidating their "idle" assets. In some cases, these idle capacities are a result of the current austerity measures. In other cases, they reflect structural factors that need to be corrected. Egypt's capital stock is being dismantled to provide liquidity in order to reduce the budget deficit, to service foreign debt, and to respect the IMF timetable of privatization.

Privatization of public sector banks (including their shares in joint venture banks), and other financial institutions such as insurance companies, imposes similar challenges. Under the intended

reform, state development banks will also be eventually phased out. The Egyptian government has been resisting IMF demands to proceed with privatization of the financial sector. Until mid 1994, no action was taken in this regard. However, there are signs that this resistance is weakening. Recently, the government announced plans to sell shares of two public sector commercial banks in 1995 (Alsharq Alawsat, 25/7/94). The elimination of development banks, which are a main source of credit to both agriculture and industry, and commercial banks' tendency to portfolio investment, will cause a disassociation of the banking system from the real economy.

The biggest problem, however, concerns the large number of workers to be laid off a cause of privatization. We will discuss this later. For now, we mention the problem of financing lay-off benefits. Although the Social Fund for Development will provide part of the benefits (from donors' resources), the government has to find real resources to finance compensation schemes. Under tight fiscal policy, these resources are scarce.

#### **4- The Impact on Key Economic Variables**

##### **4.1 - Balance of Payments Evolution**

As a result of ERP policies, the balance of payments registered a surplus in FY91 and FY92. This was mainly caused by the surplus of the current account (table 8). The improvement in the current account was due to a rise in tourism and Suez Canal receipts. Also, high domestic interest rates and stable pound attracted large capital inflows, mainly remittances. Part of the surplus is also due to Paris Club debt relief, which decreased interest payments.

However, this favourable financial performance should not hide the structural external imbalances of the Egyptian economy. To a substantial degree, the balance of payments improvement resulted

from flows which are vulnerable to external developments and could quickly reverse, or from receipts that do not represent the primary sources of growth. For example, capital outflow can occur if domestic interest rates become too low. In 1993, tourism receipts collapsed due to violence against tourists, and are expected to be 60% lower than original forecasts (Alahram, 26/7/9). The trade balance clearly reflects the problems of the real economy. Very slow economic growth, caused by monetary and fiscal policies, kept imports stagnant between FY91 and FY92 (table 8). But imports are still much higher than exports, which declined despite devaluation. Commodity exports in FY92 covered only 30% of commodity imports. Because of the current large trade deficit, and given the low elasticity of Egyptian demand for imports and the low elasticity of foreign demand on Egypt's exports, further devaluation -as proposed by the IMF- may in fact enlarge and not reduce the deficit. The decline of exports reflects in part unfavourable terms of trade due to lower oil prices. It shows heavy dependence on oil and weak non-oil export sector. In addition, Egypt lost certain markets due to political developments in eastern Europe. The composition of imports shows a typical developing country that depends on the industrialized world to provide not only technology but also foodstuff due to large food deficit.

The IMF -through ERP- assumes that the external imbalances are exclusively Egypt's responsibility. The Fund argues that Egypt's inability to adjust to external shocks is due to internal problems. However, many of the above factors are external and structural in nature. For example, collapsing terms of trade -due to declining commodity prices - reflect in part the need for structural reforms to the international economic system as well[13]. However, given their current economic and political weight, developing countries are unable to get such reforms. And this seems likely to continue in the future.

## **4.2 - Inflation**

Following the liberalization of prices in 1990 and 1991 -including interest rates and the exchange rate- inflation measured by the urban consumer price index peaked at 26% in January 1992 (American Chamber, 1993, p.37). However, tight fiscal and monetary policies brought it down to 11% in 1993 and to 7-8% in early 1994 (Alsharq Alawsat, 28/4/94). Table (7) shows inflation path on a yearly basis (June to June) in the period 1988-92. The government goal is to reach 5% in 1995 (World Bank, 1991, Annex 2). Clearly, the authorities have been effective in controlling inflation. The IMF considers low inflation rate as a key element for economic growth; low inflation rate will enable the government to lower interest rates and induce investment. However, lower inflation has been achieved by compressing aggregate demand, which has decreased capital formation in the private sector. Besides, low interest rates may cause capital outflow and deterioration in the value of the Egyptian pound. The unstable foreign exchange market was in the past a main source of inflation and business hesitation to develop productive investment. ERP policies, including the removal of all restrictions on capital movement, has forced Egypt to choose between attracting world capital and achieve financial stability on one hand and encouraging growth and investment on the other hand.

## **4.3 - Growth Performance**

Under ERP, real GDP growth has been flat. In FY92, GDP growth rate was 0.3% and is estimated to be around 1% in FY93 (table 6). This performance entailed significant changes in Egypt's international economic position. In 1990, Egypt moved from the lower stratum of the group of middle income countries to the group of low income countries, according to the World Bank classification. The IMF declared that this poor performance is better than expected[14]. It also argues that in order to stabilize

the economy, economic recession is a must. The World Bank states that per capita income will only rise by FY95, and that GDP growth will not reach 4% until FY98 (World Bank, 1991, Annex I). In other words, Egypt should sacrifice in the short term in order to restore growth in the long run.

However, ERP policies may have created a conflict between short term stabilisation and long term growth. For example, large cuts in health and education expenditures inhibit the development of human capital, a crucial factor of long term growth. Physical capital has also experienced a real decline. Given the large role of the public sector in capital formation, tight fiscal policy has caused a deterioration in the overall rate of investment. The ratio of fixed capital formation to GDP decreased from 24% in 1989 to 18% in 1992 (World Bank, 1992-b, p.179 & 1993-a, p.158). The IMF argues that ERP policies will eventually increase private investment and growth. However, the private sector expansion might be too small too late. As noted earlier, foreign competition, high interest rates, low aggregate demand, and other implications of the current adjustment programme may indeed restrict the growth of the private sector, particularly in productive activities. The decline of the public sector could itself become a factor, since the role of the government is -in many activities- complementary to that of the private sector. As a result, Egypt's prospect of high growth in the near future is deemed to be limited. It must be remembered that, due to unfavourable international conditions in the 1980s, and ERP policies in the first half of the 1990s, Egypt's real growth since 1986 has been insignificant, and almost always below population growth (2.8%) (table 6).

#### **4.4 - Wages and Employment**

According to the IMF, the Egyptian government should use wages policy as an instrument to curb inflation; imposing controls over wages growth in the public sector, i.e. de-indexation, would

prevent inflation that might occur if wages were raised in response to price increases caused by devaluation and price liberalization[15]. Employment policy, on the other hand, aims at reducing over-staffing in the public sector, in order to enhance efficiency. Theoretically, the ultimate goal of the policy is to improve resource allocation by re-allocating labour from public to more efficient private sector. In practice however, this policy will lead -as we will argue- to larger under-utilization of resources, i.e. more unemployment. Both employment and wages policies share the objective of reducing the fiscal deficit by restraining wage bill growth.

Due to political instability, the Egyptian government has avoided reducing its wage bill through lay-offs. Instead, it has relied almost totally on real wage reductions. Employment policy has been confined mainly to halting new hiring and encouraging voluntary displacement of workers. As a result, real wages in government and public enterprises have been experiencing considerable decline; nominal wage increases have been insufficient compared to compensate for the rise in prices. In FY92, nominal wages in the public sector were increased by 15%. This increase was the fifth since FY88 bringing the cumulative increase in wages between FY88 and FY92 to 80%, compared to a cumulative inflation rate of 133% (CBE, 1993, p.80). This implies a decline of about 40% in real wages in the public sector. Despite that, the IMF considers this policy too generous. The government, under IMF pressures, promised to reduce real wages by 15% during FY93 alone (IMF, 1992-b, p.15). However, it failed to achieve this target. Instead, the government decreased the wages increase of FY93 to 10% (Alsharq Alawsat, 24/6/93). It is obvious that nominal wage increases are inevitable, given current social and political tensions. In this context, we mention that although workers of public enterprises are unionized, their unions are state controlled, and strike action has been, until very recently, prohibited by law. Furthermore, government employees are not unionized. With lower real wages,

higher prices, and reduced food subsidies, workers in the public sector have experienced a noticeable decline in their living standards.

Apparently, the current wages policy has decreased further the performance of the public sector, although the goal is to raise its productivity. With low real wages, the highly qualified workers in the public sector moved to the private sector or migrated abroad. Those who did not are in general less qualified. Consequently, the quality of work in the public sector has deteriorated even further.

On the other hand, wages in the private formal sector are determined to a large degree with respect to their level in the public sector. Wages in the private sector, although higher than those prevailing in the public sector, have been kept low due to the decline of real wages in the latter. Wages in the private formal sector may have become low, relative to the level of effort or productivity of the sector's workers.

The largest problem facing the privatization process relates to lay-offs. Until now, the government still insists that any reduction in the public work force will come through voluntary agreements based on adequate compensation payments, and through retraining and relocation schemes provided by the SFD. However, it is not clear how the government will stick to this policy in the near future. All remaining public enterprises suffer from various degrees of labour hoarding. Privatization will make future lay-offs unavoidable. Some suggest that the government should impose conditions on privatized companies regarding their employment policies. Clearly, this is not feasible since the new laws prevent the government from intervening in the management of the private sector. Besides, any conditional privatization will discourage entrepreneurs from buying firms.

The World Bank estimates that unemployment rate will double as

a result of privatization (New York Times, 17/10/93). The official unemployment rate is 10% at the end of 1992, but other estimates give much higher figures, around 17% (USE, 1993, p.8). Therefore, the impact of privatization will be detrimental. A study by the World Bank estimated that 10% of public enterprises' workers should be displaced, ie 120,000 (World Bank, 1991, Annex IV). The study proposes to displace 40,000 workers "every 6 months". It also estimates total layoff costs of displacing 40,000 workers in FY92 (because of early retirement benefits, unemployment insurance benefits, and separation benefits) at LE 60.2 million. If we add another LE 62.4 million in benefits provided by the SFD (LE 1560 per displaced worker as the study suggests), total benefits per worker will be about LE 3065. Given that the average monthly wage per worker in the public sector is LE 165 per month (according to the same study), lay-off "benefits" per worker are equivalent to the salary earned in 18 months. It must be emphasized that many workers will not receive these benefits. For example, the study estimates that only 50% of the workers in the state enterprises are eligible for unemployment insurance, and 20% of them for early retirement benefits. It is worth mentioning also that each member of the board of directors in the newly formed holding companies receives a monthly salary of LE 4000. The members-together- receive also 5% of the company's profits (American Chamber, 1993, p.15). Although these figures may be justified given the experience the members have and their opportunity cost, it is an indicator of the current type of income redistribution generated by ERP. Besides, in many instances the task of these members is limited to attending one or two meetings each month.

In addition, specific groups or sectors have been more affected than others by the new labour market conditions. Older workers may have been facing discrimination in hiring (if any) and firing. Due to inadequate pensions, many workers in their sixties have remained in jobs. Harder economic conditions caused by ERP could have created noticeable displacement of employed pensioners,

mainly in the formal private sector. This will worsen their already very poor standard of living. With early retirement schemes, those in their fifties are under pressures to retire early. This applies mainly to those working in the public sector. Older workers have been seen as the "easy option" (Fisher, 1993, p.12).

The educated youth are the most vulnerable group to the government's current employment policy. In the past, the government and public enterprises were the principal sources of employment for this group. Under the current measures, these employment channels have been totally closed. As a result, unemployment rates are considerably higher among the educated youth and the new entrants to the labour market. Currently, 75% of the unemployed are graduates of universities and technical institutions (USE, 1992, p.9). The public sector has been also the main source of urban employment. In 1986, the public sector provided 53% of non agricultural employment (World Bank, 1990, p.4). Therefore, unemployment in the cities is more likely to increase at higher rate than the national average. Also, this implies that privatization will change the structure of employment in Egypt, towards lower share of the industrial sector.

The IMF believes that the private sector is able eventually to expand employment, absorbing those released from the public sector. As mentioned above, the IMF suggests that correcting the distortions in relative prices (capital/labour) will shift the economy towards more labour intensive techniques. This conclusion is doubtful. Although real interest rates were negative in the past, large segment of the private sector relied on personal resources and unofficial capital markets to acquire capital. Financial market liberalization will facilitate the use of capital equipments since the private sector becomes able to search for funds in the capital market. For the informal sector, the cost of borrowing may in fact decrease. As a result, financial market deregulation will encourage and not discourage the use of capital

intensive methods. Any future growth of the private sector will probably be accompanied by slower growth in employment.

As mentioned before, the private sector depends to a large degree on public sector growth. In particular, downsizing the public sector contracts the demand on the informal sector activities. In the interim, many displaced workers of the public sector move to those activities, leading to an increase in labour supply, and therefore to downward pressures on incomes in the informal sector. Since both the informal and the public sectors have been the main source of employment in the past, the impact on labour utilization will be highly negative.

To facilitate the implementation of ERP policies, a new labour law was introduced in 1993. In the past, workers were protected by many laws which make firing very difficult even for private companies. In fact, lay-offs due to economic factors were practically impossible. This was a factor in increasing entrepreneurs' tendency to apply capital intensive methods since labour became a quasi-fixed factor. The new law overcomes these constraints. The government has already eliminated in late 1980s the guaranteed employment policy in public enterprises. Probably, the government will officially cancel this same policy in its agencies, although it has been abandoned in practice for a number of years.

## **5 - The Provision of Social Services**

Expenditure reduction -enforced by ERP- has affected negatively the government's role in providing social services such as health and education. Despite the lack of data regarding the situation of the social sector in the aftermath of ERP, a general outline -based on recent trends- can be formed, since the reduction in real spending on social services started in the late 1980s.

Spending cuts have decreased considerably the availability of medical care. Also, by expanding cost recovery schemes, a dual system has been created in which the availability and quality of health services are determined according to the patient's ability to pay. Expenditure compression reduced considerably real wages in the health sector, but the share of wages in total spending has been increasing (World Bank, 1990, p.113). This indicates substantial cuts in other categories of expenditures. As a result, medical centres are facing severe shortages in drugs and health equipments. In other words, the quality of health services has deteriorated too. Medical facilities are also suffering continuous physical deterioration due to lack of funds for maintenance and renovations. Although the World Health Organization recommends that health expenditure reaches 5% of GDP, it decreased in Egypt to 0.6% in FY90 from 0.9% in FY86 (World Bank, 1990, Annex J). Under ERP policies, the percentage may have become lower.

On the other hand, higher cost will reduce the demand for health services by low income groups. With higher food prices, larger percentage of their income will be addressed to food purchase. As a result, many diseases may prevail. The situation is very critical since common diseases in Egypt are poverty-related, and many preventive programmes were cancelled due to absence of funds.

In addition, the government has practically abandoned the system of free education, even for primary school. Fees have been imposed in all levels of education, sometimes in the form of (compulsory) donations. Spending cuts -since the mid eighties- lowered the share of education expenditure in GDP to 3.3% in 1990 from 4.4% in 1986 (World Bank, 1990, Annex J). The share of non-wage expenditure in total educational spending is in decline, causing a deterioration in the availability and quality of education as well as in the physical infrastructure (World Bank, 1990, p.116). The number of students in class have reached eighty

in many schools. Higher costs will also decrease the demand for education, especially in the countryside[16]. With current literacy rate at 45%, and primary drop out rate at 36%, ERP policies may hinder past efforts to overcome illiteracy (UNDP, 1993, statistical annex).

Meanwhile, the elimination of subsidies has raised food prices. The Egyptian food subsidy programme used to be one of the largest in the world. It covered 93% of Egypt's population (World Bank, 1990, p.54). As a result, the financial burden of the programme was very high and the system supported large numbers of people who did not need subsidization. Therefore a major reform was indeed needed. But the solution should not be the total elimination of the system as ERP policies aim to achieve. The impact on the poor will be highly negative. It has been estimated that in 1991 the lowest income category of households spent 75% of their income on subsidized food (USE, 1992, p.8). In late 1980s, food availability in Egypt was comparable to levels in developed countries and far exceed the average availability for developing countries (World Bank, 1990, p.23). Current observations assert that poor households have already changed their food consumption pattern, by eliminating meat and some vegetables and fruits from their menus, as a result of ERP policies. The situation becomes dangerous when we know that many diseases are related to insufficient nutrition. For example, 38% of preschoolers are anemic with 11% severely anemic (World Bank, 1990, p.23).

These developments are very concerning, given an already low level of human development. Furthermore, as a result of ERP policies, Egypt moved from the 110th position in 1992 to 124 in 1993, in the Human Development Report in which the United Nations ranks the world's countries according to their level of human development. This is significant for a one year change.

## 6 - IMF Performance Criteria

Under stabilization and structural adjustment programmes, both the IMF and the World Bank use a set of indicators to monitor and assess the performance of the country concerned. Some of these indicators are the inflation rate, interest rates, the budget deficit, balance of payments situation, the exchange rate, credit aggregates, arrears on external debt servicing obligations, and GDP growth rate. This set of indicators focuses mainly on the financial aspects of the economy. It shows that problems of the real economy are not at the top of the IMF agenda. Rather, the goal is to improve -at any cost- the financial situation to enable the country to service its debt. This applies even to programmes where structural adjustment plays a large role, such as ERP.

Besides, all these indicators ignore the distributional effects of adjustment policies, since they are based on average measures. As a result, the economic and social impact on certain regions and groups, especially the poor, is always underestimated. This is particularly true in Egypt where income, sex, and regional disparities are acute. For example, literacy rate among males is currently at 60%, compared to 45% for females. The share of urban population with access to water is 92%, whereas the percentage is 56% for rural population (UNDP, 1993, statistical annex).

In addition, IMF indicators fail to reflect the adverse effects of adjustment on the quality of life. The social indicators of development have very limited weight in the IMF's evaluation schema. As a result, the social dimension of adjustment is often undervalued.

## **7 - The Social Fund and the Targeting Approach to Poverty Alleviation**

As noted earlier, to alleviate the costs of implementing ERP policies on some sections of the population, the International Development Agency and other foreign donors established, in 1991, the Social Fund for Development with a capital of US\$ 610 million.

The SFD is a transitory institution (5-10 years) that intends to facilitate labour mobility by providing training and compensations to the displaced workers of the public sector. This function is intended to support privatization of public enterprises. The SFD provides also direct assistance -in the form of cash transfers- to targeted groups. It also aims at generating employment by directly creating short term jobs (public works), and by financing small scale private projects and providing technical assistance to them (World Bank, 1991, p.52).

The SFD announces that it will approve only projects designed to benefit the poorest segments of the population. However, there is no guarantee that such a goal will be achieved. First, the fund acts as a financial intermediary. Its job is to study and fund projects but not to implement them. Second, the SFD is demand driven; its projects are only determined by the requests it receives for funding (Abdel Latif, 1992, p.10). In other words, the fund does not look for projects that might benefit the poor. Since interest on SFD loans are determined in line with market rates, there is little chance that those receiving funding belong to the poorest sections of the population.

The financial resources provided to the SFD are large, relative to similar funds established in other developing countries. Given the magnitude of the poverty problem in Egypt however, the targeted population to be served by the SFD is

limited. The SFD will have -at best- a partial role in alleviating the costs of adjustment. According to World Bank estimates, 22% of total households were under the poverty line in 1982, but another study set the figure at 30% (World Bank, 1990, p.6). In any case, the poverty problem in Egypt is much larger than what these numbers suggest since the poverty line is by itself determined subjectively[17].

We note that the use of the SFD's resources is subject to the donors' consent. Although they do not own the SFD, their influence stems from the fact that many of its operations need a prior approval of the IDA as a representative of the donors (Abdel Latif, 1992, p.15).

The SFD has been slow to act; despite expectations by the World Bank that the SFD will disburse about US\$ 260 million in its first year of operation (1991), only US\$ 35 million were spent by May 1993 (USE, 1993, p.7). This shows that the SFD is heavily directed by bureaucratic considerations. In fact, its board of directors consists of 17 members, including the prime minister and seven ministers. Given the temporary nature of the fund, it is questionable whether such a huge board is needed. The large number of ministers asserts the idea that the SFD is just another government agency, with all its traditional problems. The presence of seven ministers may create conflicts; each minister could try to support programmes that benefit areas under the coverage of his ministry. With the current structure of the SFD's administrative body, it is unlikely that it will be able to replicate the successful experiences of other developing countries with similar social funds. The success of the Bolivian fund for example reflects in part the fact that it was administered by a small number of professionals, away from government control (Abdel Latif, 1992, p.13). As a result, it was able to achieve its goals more effectively, and to respond swiftly to the challenges created by adjustment policies.

Under the idea of a "social safety net", the World Bank recommends that transfer payments should be addressed only to those deemed (by the authorities) to need them since a more universal scheme of social protection would be impossible, due to severe funding cuts. However, it is not clear how the targeted groups are defined. As previously noted, determining who is and who is not eligible for aid is very subjective in a country where poverty is widespread. A targeted approach to transfers will inevitably avoid compensating large segments of the poor. Also, past experiences show that a successful targeting requires a relatively developed administrative structure, which is lacking in Egypt. Moreover, compensation programmes suffer serious financial problems. Under current fiscal measures, the government is required to compress expenditure to the limit. On the other hand, the decline of real wages makes it impossible to increase the workers' participation in financing those programmes. Lower economic demand, credit constraints, foreign competition, and increasing non labour costs limit the role of private sector employers in any compensation schemes. As a result, social security programmes are underfunded and unable to provide adequate compensations. Pensions to formal sector workers are only partially indexed for inflation, while compensations for the displaced workers in the public sector are limited. In fact, unemployment insurance programmes will not be able to function properly in the face of massive displacement. These programmes are set to deal mainly with cyclical and not structural unemployment. Finally, for the informal sector, compensation programmes (for inflation or unemployment) are totally absent.

## V - Conclusion

After three years of implementation, the stabilization and structural adjustment programme in Egypt has led to lower inflation, reduced budget deficit, stable exchange rate, large capital inflows, and balance of payments surplus. In this context, the programme has been successful in reducing external and internal imbalances. Considerable debt relief played an important factor in these achievements. What is less certain, however, is the sustainability of this performance. Many achievements on the financial front are due to factors that can be quickly reversed (such as capital movements).

On the other hand, macroeconomic stability was realized at a very low equilibrium level of income. Real growth has been below 1% in 1992 and 1993, causing a constant decline in per capita income. Overall capital accumulation decreased considerably, reflecting the private sector's inability to compensate the planned decline in the government's investment effort.

As a result of tight ERP policies, the unemployment rate has reached 17%, hitting mainly the educated youth and new entrants to the labour force. The unemployment problem will become an acute crisis in the near future when privatization progresses. On the other hand, at the outset of ERP, the inflation rate increased substantially due to price liberalization -including interest rates and the exchange rate. And despite the current decline in inflation, real earnings -especially in the public sector- are decreasing. As a result the unemployed, those working in low real wage jobs in the formal sector, and those enrolled in survival activities in the informal sector are experiencing severe financial hardship. The recessionary impact of ERP poses an important question as to whether the cost of low inflation -in terms of lower output and higher unemployment- is justified in a developing

country such as Egypt where resources are already grossly under-utilized.

The problem is aggravated by the lack of effective forms of social protection against inflation and unemployment. As a result of tight fiscal policy and a targeted approach to poverty alleviation, the government compensates only part of those affected by ERP, and provides them with insufficient levels of assistance compared to their losses. Furthermore, the SFD has been slow to act despite the availability of resources due to its bureaucratic format.

Large cuts in public spending have reduced the quality and the availability of social services including health and education. The result has been a deterioration in human capital formation which, together with the decline in physical capital due to low investment effort, will lead to lower growth in the future; ERP may have created conflict between short term stabilization and long term growth.

In addition, the distributive impact of ERP has been considerable. There has been a redistribution of income from the productive side of the economy (especially industry) to the rentier side. Reform policies have had very negative effects on the poor; lower real earnings, reduced social services and food subsidies, and relying on indirect taxes to raise revenues have caused a substantial deterioration in the relative position of low income groups, leading to further polarization of income and wealth. It is difficult to conclude that a noticeable redistribution of income from public to private sector has occurred. Privatization and public expenditure compression caused mainly a reduction in total income since the private sector has not expanded enough to compensate the declining role of the public sector.

There is no disagreement over the need for reforms. The

argument relies however on the nature of policies required to achieve the final goal: sustainable growth in the medium term. Social indicators should be considered when recommending and assessing reforms. It is clear from the Egyptian experience that what are usually called "side effects" of adjustment -in reference to the impact on human capital and the poor- are in practice not marginal as the term might suggest. ERP must take into account the social dimension of adjustment. One way is to set minimum standards for health, education, and nutrition provided to the poor and vulnerable groups (Cornia, 1987, p.135).

Also, more weight must be given -in the evaluation schemes of ERP progress- to factors that reflect the conditions in the real economy such as output growth, unemployment rate, and investment to GDP ratio. There has been too much emphasis on demand curtailment to achieve stabilization. More role should be assigned to policies that deal with supply rigidities. Price liberalization alone may not succeed in inducing enough production; in agriculture, price liberalization has led to a considerable increase in output. However, the gains would have been greater if other measures were also introduced such as improving infra-structure (irrigation for example), assisting farmers technically and financially (credit) and in marketing (Streeten, 1987, p. 1474). However, under the current tight fiscal and monetary policies, opposite policies are conducted; credit to agricultural producers (especially small farmers) has been severely reduced as well as government spending on infra-structure.

The role of the government should be designed carefully. In Egypt, it plays in some sectors a complementary role to that of the private sector. Thus, downsizing the public sector should be based on case by case evaluation. Government intervention is not perfect and neither is the market system. Therefore, the government's role should be determined after evaluating the pros and cons of both systems in each situation (Streeten, 1987, p.1478). Furthermore, in

some activities such as health and education, the role of government needs to be expanded.

Under tight policies, there is a need to enhance resource allocation. For example, in 1990 preventive services (including disease control programmes) and primary care received together 37% of the Ministry of Health budget whereas the hospitals' share was 61% (World Bank, 1990, p.73). Here, resources should be redistributed from curative care to preventive and basic care. Similarly, in education university students who represent 10% of a given age-cohort benefit from 50% of total education expenditures (World Bank, 1990, p.78). Therefore, there is a scope to improve the overall education status by switching resources towards basic education. However, current austerity measures have led to lower government spending in all fields.

The reform programme in Egypt should move quickly from ensuring stabilization to promoting growth. Thus, assisting private sector expansion is crucial, especially small scale projects in agriculture and industry. One way to do so is by strengthening development banks, rather than eliminating them as outlined in the reform programme. Promoting non-traditional exports is also important. This can be done by supporting exporters by extending credit, lowering tariffs on inputs, offering subsidies but not through further devaluation of the pound as the IMF demands. Moreover, import substitution and export promotion should not be considered mutually exclusive. Thus, improving food self-sufficiency and expanding the production of industrial goods for the local market must get similar support from the government.

In addition, ERP should focus more on policies that enhance sustainability, even if sometimes they clash with the concept of liberalization (Rodrick, 1990, p.943). For instance, privatization should be performed gradually. Otherwise, mass displacement of workers will increase current social and political tensions,

forcing the government to reverse its policies. Too much demand compression to fight inflation -which reflects also supply rigidities- may lead to the same outcome.

The simultaneous adoption of numerous structural changes may also backfire. The implementation of free trade, when local producers experience a compressed aggregate demand and reduced government assistance, will cause the phasing out of some domestic industries instead of improving efficiency as ERP suggests. The IMF call to start privatizing the financial sector may lead, given the current acute problems facing privatization in the real sector, to a total collapse as other countries' experiences show (Russia for example). In short, too fast structural changes will cause more harm than the intended benefits and may jeopardize sustainability.

Finally, it is necessary to conduct similar structural reforms both in developed countries and in the international economic system. The debt crisis in developing countries is also a result of falling terms of trade and protectionist policies in the developed world. Until these reforms are in place, the IMF should give more role to external factors in formulating and evaluating adjustment policies in Egypt [18].

## Endnotes

[1] In 1954, the World Bank refused -under USA pressures- to finance what was then one of the largest infrastructure projects in the world -the High Dam. Instead, Egypt had to rely on Soviet assistance to build the dam. Ironically, US position was the main booster of Egypt's relations with the (former) Soviet Union.

[2] For a detailed evaluation of these short term programmes, see (Abdel Khalek, 1987).

[3] In 1990, debt arrears attained US\$ 11 billion. From World Bank (1991, p.3).

[4] Since 1985, all military assistance to Egypt has been in form of grants. In 1993, American aid to Egypt reached US\$ 2.26 billion (16% of US foreign aid budget). Aid was distributed as follows: 1.3 billion in military grants, 0.815 billion in economic grants, and 0.145 in concessionary food credit. Data are from EIU (1993, p.8).

[5] The World Bank estimated Egypt's lost earnings -because of the war- at US\$ 3.4 billion. See World Bank (1991, p.9).

[6] The IMF delayed in July 1994 the cancellation of the last 20%, due to disagreement with the Egyptian authorities over the pace of structural adjustment policies, mainly privatization and trade liberalization.

[7] Poland is the only country that received a similar treatment, ie 50% conditional reduction of external debt.

[8] In 1988, food import dependency ratio was 45.2%. From UNDP (1993, statistical tables).

[9] Nominal wages deflated by Consumer Price Index. Data are from CBE (1993).

[10] The narrow definition of "public sector" includes only public sector enterprises. A broader definition contains the government too.

[11] Since the beginning of reforms in 1991, the Ministry of Economy has approved demands from foreign investors to buy US 2 billion of Egyptian debt (Alsharq Alawsat, 2/3/1994).

[12] In one case (Misr for Tax-Free Shops Company), the government had to cancel the bid, due to low level of the highest offer price (proposed by foreigners).

[13] A US\$ 1 per barrel fall in oil price worsens foreign exchange earnings by about US 100 million annually, as does a 5% increase in food import prices. From IMF (1992, p.10).

[14] The World Bank original estimates of GDP growth in the first two years of ERP (1991 and 1992) were respectively -1.5% and -3%. See World Bank (1991, Annex I).

[15] Excessive wage increases (at rates higher than productivity growth) can lead indirectly to higher prices, by raising the fiscal deficit and -as a result- the money supply. Another reason for wages control is that, by facing privatization, workers may have the incentive to de-capitalize public firms: profits needed to re-invest may instead be paid out in higher wages. From Coricelli (1992, p.75).

[16] According to the World Bank (1990, p.103), it is estimated that 8.3% of the children (under 14 years) work.

[17] For example, in the USA where per capita income is about US\$ 20000, 19% of the population lives under poverty line.

[18] The 1986 IMF agreement with Mexico is a precedent, in which measures were set to secure an increase in resource flows if the oil price or the growth rate falls below a certain level. From Cornia (1987, p.140).

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**Statistical Appendix**

Table (1)  
Structure of Output and Labour Force (percent)

| Share of / in | Production (1990) | Labour Force (1987) |
|---------------|-------------------|---------------------|
| Agriculture   | 18                | 38                  |
| Industry      | 30                | 13                  |
| Services      | 52                | 49                  |
| Total         | 100               | 100                 |

Source: World Bank, Trends in Developing Countries, 1993, p.158;  
UNDP, Human Development Report 1990, statistical annex.

Table (2)  
The Budget Deficit (percent of GDP)

| Year       | Actual Deficit | Projected Deficit** |
|------------|----------------|---------------------|
| FY82/FY90* | 20.4           | ..                  |
| FY91       | 20             | ..                  |
| FY92       | 5.2            | 7.1                 |
| FY93       | 3.5            | 6.6                 |
| FY94       | ..             | 5.4                 |
| FY95       | ..             | 3.3                 |
| FY96       | ..             | 1.5                 |

\* Average

\*\* IMF projections

Source: Actual data are from CBE, Annual Report 1992, p.79  
except for 1993 (from Alsharq Alawsat 10/11/93)  
Projected data are from IMF. Letter of Intent, 1991, p.112.

Table (3)  
Government Revenues and Expenditures, L.E Billion, Real Figures

|              | FY89  | FY90  | FY91  | FY92  | Change 91/92 (%) |
|--------------|-------|-------|-------|-------|------------------|
| Revenues     | 12.50 | 12.32 | 13.33 | 17.59 | 31.90            |
| Expenditures | 20.63 | 20.48 | 21.21 | 20.22 | -4.67            |
| Current      | 12.70 | 12.61 | 13.85 | 15.38 | 11.06            |
| Capital      | 7.92  | 7.82  | 7.37  | 4.84  | -34.25           |

Source: Calculated from CBE, Annual Report 1991, p.70;  
CBE, Annual Report 1992, p.45

Table (4)  
Composition of Commodity Imports and  
Exports (percent), 1991

| <u>Imports</u>                         | (%) |
|--|-----|
| Foodstuff                              | 21  |
| Intermediate goods                     | 38  |
| Capital goods                          | 22  |
| Other                                  | 19  |
| <u>Exports</u>                         |     |
| Cotton (raw)                           | 2   |
| Other agricultural goods               | 4   |
| Oil                                    | 51  |
| Cotton yarn and textiles               | 14  |
| Chemicals                              | 5   |
| Engineering and<br>metallurgical goods | 7   |

Source: CBE, Annual Report 1992, p.232

Table (5) : The Debt Burden

| Year | Total Debt (U\$ billion) | Debt Service (%)* |
|------|--------------------------|-------------------|
| FY82 | 20.50                    | 20                |
| FY86 | 37.80                    | 34                |
| FY88 | 41.00                    | 17                |
| FY89 | 44.20                    | 44                |
| FY90 | 46.10                    | 46                |
| FY91 | 34.00                    | 18                |
| FY92 | 35.00                    | 22                |

\* of current account receipts

Source: IMF, Arab Republic of Egypt: Recent Economic Developments, 1992, p.138

Table (6): Rates of Growth (percent)

| Year     | GDP Growth (%) | Year | GDP Growth (%) |
|----------|----------------|------|----------------|
| 1975-82* | 7.50           | FY86 | 2.70           |
| 1983-86* | 5.70           | FY87 | 2.50           |
| 1987-92* | 2.40           | FY88 | 4.00           |
| FY82     | 10.9           | FY89 | 3.00           |
| FY83     | 7.50           | FY90 | 2.40           |
| FY84     | 6.10           | FY91 | 2.1            |
| FY85     | 6.60           | FY92 | 0.3            |

\* Period average

Source: FY82-FY87: World Bank, Report and Recommendation of the President, 1991; FY88-FY92: IMF, Staff Report, 1992

Table (7): Inflation rate, Percent\*

|      |    |
|------|----|
| FY88 | 10 |
| FY89 | 17 |
| FY90 | 21 |
| FY91 | 21 |
| FY92 | 10 |

\* Based on Consumer Price Index (Urban)

Source: CBE, Annual Report, 1993, p.170

Table (8)  
Balance of Payments: Selected Items, US billions

|   | 1986/87 | 1987/88 | 1988/89 | 1989/90 | 1990/91 | 1991/92* |
|---|---------|---------|---------|---------|---------|----------|
| Commodity Exports                         | 2.6     | 3.1     | 2.8     | 3.1     | 3.9     | 3.5      |
| Petroleum                                 | 1.2     | 1.4     | 1.1     | 1.3     | 2       | 1.5      |
| Commodity Imports                         | -8      | -9.8    | -10.3   | -11.4   | -11.4   | -11.5    |
| Trade Balance                             | -5.4    | -6.7    | -7.5    | -8.3    | -7.5    | -8       |
| Services Receipts                         | 4.4     | 4.8     | 5.4     | 6.1     | 6.7     | 7.6      |
| Suez Canal dues                           | 1.1     | 1.3     | 1.3     | 1.5     | 1.7     | 2        |
| Tourism                                   | 0.4     | 0.9     | 0.9     | 1.1     | 0.9     | 1.3      |
| Services Payments                         | -4.1    | -4.2    | -4.7    | -5.2    | -6.2    | -4.2     |
| Interest due**                            | -2      | -2.4    | -2.5    | -3      | -3.7    | -1.7     |
| Services Balance                          | 0.3     | 0.6     | 0.7     | 0.9     | 0.5     | 3.4      |
| Workers Remittances                       | 3       | 3.4     | 3.5     | 3.7     | 3.8     | 5.2      |
| Current Account Balance (excl. off trans) | -2      | -2.7    | -3.3    | -3.7    | -3.2    | 0.6      |
| Official Transfers (off trans.)           | 1       | 0.7     | 0.8     | 1.1     | 4.8     | 1.5      |
| Current Account Balance (incl. off trans) | -1      | -2      | -2.5    | -2.6    | 1.6     | 2.1      |
| Capital account                           | -0.8    | -0.4    | -0.4    | -1.2    | -1      | 2.8      |
| Overall Balance                           | -1.5    | -1.9    | -1.7    | -1.2    | 2       | 5.5      |

\* Estimates

\*\* includes late interest

Source: IMF, Arab Republic of Egypt: Recent Economic Developments, 1992, Annex I