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ISSUES IN STABILIZATION
AND STRUCTURAL ADJUSTMENT
SOME APPLICATIONS
TO THE EGYPTIAN CASE

DAHLIA ANWAR EL HAWARY

1997

thesis
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School of Business, Economics and Mass Communications

Economics Department

Issues in Stabilization and Structural Adjustment: Some Applications to the Egyptian Case

By

Dahlia Anwar El Hawary

January 1997

1997
6

THIS THESIS FOR THE MASTER'S OF ARTS DEGREE
IN ECONOMICS

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List of Abbreviations

ACs	Affiliated Companies
BCCM	Bank of Credit & Commerce in Misr
BOP	Balance of Payment
CBE	Central Bank of Egypt
CDP	Community Development Program
CEM	Country Economic Memorandum
CMA	Capital Market Authority
CPI	Consumer Price Index
ECG	Egyptian Cotton Gazette
EDP	Enterprise Development Program
EFF	Extended Fund Facility
EFG	Egyptian Financial Group
EIU	Economic Intelligence Unit
ERP	Employment & Retraining Program
ERSAP	Economic Reform & Structural Adjustment Program
ESAs	Employee Shareholding Associations
FDI	Foreign Direct Investment
FY	Fiscal Year
GAFI	General Authority for Investment
GATT	General Agreement on Tariff & Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GOE	Government of Egypt
GOFI	General Organization for Industrialization
HCs	Holding Companies
ICR	Implementation Completion Report
IDP	Institutional Development Program
IMF	International Monetary Fund
ISI	Import Substitution Industrialization
LCs	Letters of Credit
LDCs	Less Developing Countries
LRMC	Long Run Marginal Cost
MIC	Ministry of International Cooperation
MOE	Ministry of Economy
MOI	Ministry of Industry
MOP	Ministry of Planning
N/A	Not Available
NAFTA	North America Free Trade Agreement
NTBs	Non Tariff Barriers

ODP	Open Door Policy
OECD	Organization for Economic Cooperation & Development
OPEC	Organization for Petroleum Exporting Countries
PEO	Public Enterprise Office
PEs	Public Enterprises
PSIC	Public Sector Information Center
PWP	Public Works Program
QRs	Quantitative Restrictions
R & D	Research & Development
REER	Real Effective Exchange Rate
RER	Real Exchange Rate
SAL	Structural Adjustment Loan
SAMP	Structural Adjustment Monitoring Program
SBA	Stand By Agreement
SDR	Special Drawing Rights
SFD	Social Fund For Development
SOEs	State Owned Enterprises
TBs	Treasury Bills
TL	Turkish Lira
VAT	Value Added Taxes

Abstract

This work provides an analytical approach to the most critical issues in the context of the actual implementation of stabilization & structural adjustment reforms in Less Developing Countries (LDCs) with minimal emphasis on political considerations. The study establishes a conceptual framework for the scope, sequencing, speed and macro & micro implications of opening up capital & trade flows as integral components of a coherent reform package. This is based on an extensive review of the theoretical, methodological & empirical work in order to identify policy guidelines and conditions for the implementation of a successful liberalization process. The reform experiences of four developing countries: Mexico, Chile, Turkey & Korea, are closley examined to underline the sequencing & speed of reform efforts with respect to stabilization versus structural adjustment as well as trade versus capital account liberalization. The theoretical framework supported by the reform experiences of these countries provide adequate tools for the assessment of the so far made progress on the 1990s' Egyptian Reform Program.

Introduction

Purpose of Work:

In 1991, Egypt has embarked on an economic reform and structural adjustment program (ERSAP) whose ultimate objective has been the restoration of a sustainable dynamic growth trend. This has dictated the implementation of a number of stabilization as well as structural adjustment reforms aiming at the creation of a non inflationary stable environment and stimulation of the role of the private sector in economic life. The Government of Egypt has attempted to achieve these goals through the adoption of prudent fiscal & monetary policies, public sector reform & privatization, deregulation of the business climate and liberalization of domestic goods and financial markets.

This work underlines the most important factors determining the growth prospects of the Egyptian economy in the wake of the implementation of the ongoing reform program. It also questions the effectiveness of the 1991 ERSAP in initiating an automatic growth process in view of the challenges currently facing the economy, and that may prolong the transitional period between reform and growth. The main objective of this work is to provide an assessment of Egypt's 1991 ERSAP with respect to the scope, speed and sequencing of reforms with special emphasis on the complementarity and consistency of domestic policies necessary to achieve the medium & long term targets of the reform program.

In this regard, focus is made on the main policy lessons in the context of the actual implementation of structural adjustment & stabilization efforts in four developing countries: Mexico, Chile, Turkey & Korea. The relevance of the sequencing and speed of liberalization measures is underlined, particularly with respect to the opening of the capital & trade accounts due to their significant weight in determining the success of the overall reform program as suggested by country experiences.

Scope of Work:

Part One comprises three chapters presenting a review of the theoretical, methodological & empirical work for the liberalization of domestic financial and goods markets. This underlines the most important macro & micro implications of capital and trade liberalization in order to highlight the necessity of maintaining a high degree of complementarity between reform measures on all fronts. This part provides some basic analytical tools for assessing the coherence of Egypt's 1991 ERSAP from different perspectives.

Chapter one presents a literature review of the ongoing debate over the *optimal sequencing* of the implementation of reforms. The dynamics of stabilization and structural adjustment reforms are discussed, and the main sources of tension between the two main pillars of reform programs are explored. This chapter sheds light on the most important issues in the context of the sequencing of liberalization of capital flows as an integral part of financial reform, versus trade liberalization as a major structural reform.

Chapter two provides an outline for the theoretical framework for liberalization of financial markets in the developing world. This presents a description of the major characteristics of financial markets in LDCs, the reasons for imposing capital controls in pre-reform period and the rationale for financial opening that is currently undertaken in most LDCs. The scope of financial liberalization is also presented, with emphasis on its macro & micro economic implications.

Chapter three designs trade reform as a major component of structural adjustment in LDCs. This entails a discussion of gains from trade liberalization as well as the different approaches to policy reforms. The chapter also establishes policy conditions for a successful trade liberalization, and discusses the components of import liberalization policy as well as other trade related reforms.

Part two extracts policy lessons from the Mexican, Chilean, Turkish & Korean experiences in the course of the implementation of economic reform programs in order to establish policy implications for the Egyptian case. Focus is made on the *sequential order* in which markets have been opened up and its effect on the performance of countries under study. Among other factors, the sequencing of reforms will be partly used to analyze the different degrees of success achieved in reforming these economies.

Part three focusses on the Egyptian experience with stabilization & structural adjustment reforms, and highlights the progress so far made since the adoption of ERSAP in 1991. A snapshot is made of the pre- reform era in order to grasp a good understanding of the magnitude of the macro imbalances & micro distortions that urged the initiation of the 1990s' reform program. Special attention is paid to the partial nature of Al infitah policy in the early 1970s and to the piecemeal approach of the 1987 reform attempts that both failed to trigger a positive sustainable growth response. An attempt is made to appraise the 1991 ERSAP from different perspectives including scope, speed & sequencing of reforms with emphasis on the main difficulties challenging the sustainability of the overall program as well as its success in establishing a dynamic long term growth process.

The analysis is based on a rigorous review of the trends in each of the critical variables at both the macro and sectoral levels. The purpose is to link policy measures with macroeconomic and sectoral outcomes and to assess the potential for the resumption of GDP growth rate above the population rate. Data and information are official sources including the Central Bank of Egypt (CBE), the Ministry of Industry, Ministry of Planning, Ministry of Public Business Sector, Ministry of State for Economic Affairs & Ministry of Economy as well as the World Bank and the IMF. The analysis also attempts to highlight the various evaluations made by economists, government officials and international institutions.

Part One:

REVIEW OF THE THEORETICAL, METHODOLOGICAL

& EMPIRICAL WORK

FOR ECONOMIC LIBERALIZATION

Chapter One: Literature Review of the Debate over the Optimal Sequencing of Reforms

Introduction:

During the 1980s, the world economy witnessed a dramatic shift away from the long standing *inward oriented* development policy that embraced import substituting industrialization strategies (ISI) (Edwards, 1993). The protectionist influence on both economists and politicians began to cave in during the past decade when fiscal, foreign exchange and financial constraints sharply tightened in LDCs due to a series of severe external oil, interest rate & terms of trade shocks. These all revealed the developing economies' vulnerability that was further crystallized by the debt crisis emerging in 1982 (Taylor, 1993).

Consequently, liberalization has gradually become a popular concept in the economic discipline due to a number of developments that have all contributed to reassessment of the validity of inward oriented economic policies. Economic studies have concluded that LDCs adopting outward- looking development policies have outperformed their counterparts engaged in more inward oriented strategies. This has been demonstrated by higher rates of economic growth, output, employment, economic efficiency and more importantly by better & faster adjustment to external shocks (Khan & Zahler, 1983).

First, The "***demonstration effect***", exhibited by the South East Asian countries, had led to such reorientation. In these economies, outward oriented strategies have been aggressively implemented, and contributed to their spectacular growth. The consensus is that the one common factor that explains such rapid growth trend of one generation of East Asian tigers after another has been the export led approaches adopted as a necessary condition for accelerated development. This has been the case even though each country in question adopted its own speed and sequencing of liberalization.

The miraculous growth of East Asian tigers has been contrasted by the poor performance of Latin American countries over the past decade as these had been sticking to protectionism. According to the World Development reports of 1989 and 1990, the annual rate of real GDP growth averaged 7.9% in East Asian economies as compared to only 1.6% in Latin American countries over the 1989- 90 period. The collapse of the Communist economies in Central & Eastern Europe in the early 1990s has also added an impetus to the reorientation of previously adopted policies, and supported the growing skepticism about the effectiveness of ISI policies in promoting economic growth (Edwards, 1993).

Second, ***globalization***, the ultimate outcome of modern revolution in the information & communication technology, has presented a real challenge to the developing world as it has brought about an increasing integration of the world economy. This has drawn all countries, both developed and developing, into closer international relationships leading to a growing interdependence between their goods and capital markets (Khan & Zahler, 1983). It seems that no country can currently afford to ignore the new global challenge due to the ensuing cost of being marginalized and failing to acquire the necessary dynamics for establishing a self sustaining growth through access to the world market, foreign direct investment (FDI), capital flows, technological progress and managerial improvements.

Third, ***opening up financial & trade sectors*** to the world economy has recently emerged at the top of the policy agenda in reforming LDCs due to their high expected benefits. Trade opening contributes to the development process of a country by offering greater opportunities to exploit both its comparative advantages and economies of scale (Khan & Zahler, 1983), as thoroughly discussed in chapter three. Similarly, the design of *"correct"* financial policies, including regulations governing capital movements, has significant effect on the capacity of an economy to raise capital both domestically & externally. This also enhances competition and efficiency in the domestic financial system, as elaborated in chapter two (Polack, 1990).

These factors have all played a significant role in shaping ambitious LDCs' economic reform programs that basically aim at providing the fundamental dynamics necessary for a country to strategically position itself in the world market. Despite the soundness of liberalization policies on economic grounds, only a handful of developing countries have completed the process. For instance, only 43 LDCs & 16 post communist countries have opened up their goods markets by the 1990s (Sachs & Warner, 1995), whereas the number of industrial countries with complete capital account convertibility reached 9 in 1990, with only one developing country attaining this degree of liberalization (Mathieson & Suarez, 1993).

To date, most LDCs have been reluctant to liberalize their financial and trade regimes, and have continued to control their goods & capital flows. This is due to equity and welfare considerations that have been justified on the basis of transitory costs resulting when a country moves from a relatively closed economy to an open one (Edwards, 1992).

In case of the least developed economies which are still at a very rudimentary structure of the economy, there is a major concern that early opening up may have long term costs such that they may loose the opportunity of catching up with the advanced world. This is because these lack the basic fundamentals for a potential strong economic performance, such as, adequate industrial base, managerial skills and stable domestic markets. In these cases, the question of protection is still being debated.

This study is only concerned with countries that have reached a semi- developed stage like Egypt, and where the options are clearly set within the frame of time and sequencing. For these middle income developing countries, the question is not whether to open up or not but rather how fast and in what sequence.

Liberalization may result in domestic market disruption as local firms have to restructure and to improve their production techniques in order to adjust to new world quality & price trends. This may lead to temporary losses in output, employment and installed & non- shiftable capital as a result of the liquidation of inefficient firms. These costs present the unavoidably high price to be paid for the change in economic policy at least in the short run (Daveri, 1991).

Another concern is that although increased openness to financial flows entails great promise for higher economic efficiency, it also carries the risks associated with the destabilizing effect of large capital inflows (IMF, 1995a). These may ultimately raise the vulnerability of recipient economies to the sudden reversal of such inflows as a result of domestic political shocks and policy shortcomings as particularly demonstrated by the 1994 Mexican experience that is discussed in Chapter four. In that sense, opening up presents a potential threat to LDCs that lack the basic dynamics for macro economic stability.

That is why, recent economic literature attempts to provide answers to pressing questions about the actual implementation, speed, order & policy package of reform programs. Specifically, the "*sequencing dilemma*" addressing the order of market liberalization has become one of the most intriguing issues to policy makers and economic analysts (Edwards, 1992).

I - Stabilization & Structural Adjustment: Main Cornerstones of Reform Programs:

Stabilization & structural adjustment efforts principally aim at restoring macroeconomic stability as well as at restructuring domestic economies in order to establish a solid basis for a sustainable growth process (Daveri, 1991). It is useful to draw a clear cut distinction between the most direct goals of each component of the reform program.

A - Dynamics of Stabilization & Structural Adjustment:

On the one hand, stabilization focusses on restoration of the financial viability of the reforming economy, and entails the correction of its major macro imbalances; namely, high BOP & budget deficits as well as high inflation rate. These are targeted through a number of policies including fiscal control to curb public expenditures and to raise government revenues as well as monetary reform to reduce the level of domestic credit expansion & the rate of growth in money supply. This is in addition to reform of the exchange rate to maintain it at a sufficiently competitive and flexible level in order to enable the economy to better manage its external sector. Such policies have been generally effective in eliminating the imbalances on the financial side of the economy over a short time period.

On the other hand, structural adjustment addresses the real side of the economy, and aim at reforming relative prices as well as institutions. These efforts improve the resource allocative mechanism, enhance economic efficiency, and raise the economy's growth potential by eliminating the various distortions inherent in the institutional and incentive frameworks (Thomas, Chhibber, Dailami, De Melo, 1991). According to the World Bank, adjustment also dictates a redefinition of the role of the State in the economy to reduce its scope of activities to "*strategic*" sectors (Handoussa, 1993a).

Economic restructuring entails the implementation of a number of reforms to trigger a positive supply response from the private sector whose increased participation in economic life has become essential to the success of reform in LDCs. These include privatization, deregulation of the investment climate, trade liberalization, price decontrol and activation of the capital market. Such measures are essential to build up confidence of the private sector in the reform process in order to raise local saving and investment rates considered to be the main vehicles for a self sustained growth process.

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B - Sources of Tension Between Stabilization & Liberalization:

Precedence of stabilization over liberalization has been the principal policy recommendation made in the literature. Indeed, stabilization has been considered a precondition for any form of liberalization due to the difficulty of enhancing the overall efficiency of the economy in an inflationary environment. This is because macroeconomic instability lessens the effectiveness of liberalization dynamics (Daveri, 1991).

That is why, stabilization efforts should be consolidated before opening up local markets as high inflation generates serious distortions that send inappropriate market signals under liberalization (Edwards, 1992). Indeed, high inflation leads to price volatility that inhibits the establishment of a correct price structure necessary to reflect the real opportunity cost of economic resources (Daveri, 1991).

Macroeconomic disequilibrium also limits the investment capacity of LDCs that are generally burdened by heavy domestic & foreign debts. These create negative perceptions about the strength of the economy and its ability to honor its obligations, and may detrimentally affect the confidence of the private sector in reform, and lead to capital flight (Daveri, 1991).

This is coupled by the conflicting goals of financial & trade liberalization with the essentials of stabilization. In other words, policy measures used to attain economic stability may hinder the objectives of liberalization and vice versa. Indeed, LDCs initially respond to mounting macroeconomic pressures by imposing the so called "BOP motivated controls" including trade, capital & exchange rate restrictions used to control the outflow of foreign reserves. In that sense, an effective opening up of trade & financial markets cannot materialize when LDCs resort to import compression and restriction of capital flows in face of BOP problems (Edwards, 1992).

More importantly, the real exchange rate (RER)[1] has been the main source of tension between stabilization and liberalization during reform. On the one hand, an effective disinflation process results in real appreciation since it relies on the use of fixed nominal exchange rate as an anchor to expectations and local prices. This defeats the principles of a successful trade liberalization that must be supported by real depreciation necessary to enhance the competitiveness of tradables. On the other hand, the dynamics of trade liberalization presents fiscal pressures on the budget and hence on inflation. This is because real devaluation raises the domestic currency cost of servicing foreign debt, and tariff reduction or elimination entails a cut in government revenues (Edwards, 1992).

This is in addition to the inconveniences associated with financial opening prior to stabilization. Liberalization subjects the State's financial assets to high competition from a wide variety of foreign saving opportunities. This may force governments to offer high real interest rates to enhance the attractiveness of their financial assets, and ultimately increase their debt burden. Financial opening also allows capital flight that further worsens the external imbalances of the economy at a time when additional resources are needed to finance deficits in non inflationary manner (Daveri, 1991, p.17).

II - Trade Liberalization Versus Financial Opening

The "***optimal sequencing***" of trade versus financial liberalization has become a major issue of concern to decision makers in LDCs. This presents a dilemma involving a competition between policy instruments in order to reach a balance among the possibly conflicting goals of liberalization (Edwards, 1992). The purpose of the next two chapters is to analyze in depth the implications of each of the two main contending approaches: the capital first & the trade first sequence within a credible reform package. In the remaining part of this chapter, a summary presentation of each argument and its proponents' views is given as it appears in the extensive literature on subject.

[1] The RER is defined in Appendix (A)

A. ***The unifying theme of the first line of thought is a "capital account - first sequencing of structural reforms".*** This entails the reduction of restrictions on the importation of capital prior to the implementation of trade reform. The rationale behind this policy recommendation is that capital account liberalization allows an increased reliance on foreign funds. These are expected to significantly reduce the friction emerging during the implementation of major structural reforms. The argument is made that such reliance consequently raises the political acceptability of the overall reform program (Edwards, 1992). In other words, availability of foreign financial assistance & other capital inflows in the form of FDI, joint ventures & portfolio capital, is considered to be essential during the early reform stages. This is because these smooth the adjustment process by minimizing its short run costs during the transitory period. That is why, the argument is strongly made to urge multilateral institutions to provide extensive financial assistance to indebted developing countries that are committed to reforming their external sectors. Proponents of the sequencing approach present evidence from countries such as Korea, Malysia & Indonesia as detailed in Chapter Two.

B. ***The philosophy underlying the second line of thought is a "Trade reform - first sequencing of liberalization".*** This prescribes the implementation of trade reform prior to the liberalization of the capital account based on three important considerations. The removal of capital account restrictions before trade reform results in real exchange rate appreciation at a time when depreciation is required, and this reduces the degree of protection in the traded goods sector when implementing the tariff reduction reform (Edwards, 1992). This is in addition to the unsustainable and short term nature of large capital inflows implying that LDCs should not rely on such foreign injections in the establishment of their medium & long term growth process. This view is also based on the different speeds at which the asset and goods markets clear, whereby attainment of equilibrium in the goods market takes some time whereas asset markets clear almost instantaneously. Thus, a synchronization of the structural reform process calls for the liberalization of goods market before the capital account (Edwards, 1992) as elaborated in Chapter Three.

C. **Issues of utmost importance in the context of the liberalization sequencing:** There are four major issues that can be singled out in assessing the relative merits of either alternative to sequencing. These include the implications for movements of the real exchange rate, the welfare effects of alternative sequencing scenarios, the speed of the liberalization process and the degree of credibility in the reform process.

1. **Behavior of the Real Exchange Rate (RER):** Recent discussions on the appropriate sequencing of structural reforms have focussed on the real exchange rate behavior during liberalization, and have concentrated on studying its implications. This is because the RER is at the heart of the disagreement between proponents of the capital first & the trade first sequence as thoroughly discussed in the next two chapters.

2. **Welfare Effects of Alternative Sequencing Scenarios:** The political economic aspect of reform has been a major source of concern to policy makers in most reforming economies. This has been subject to a number of studies that addressed the sequencing dilemma from a welfare perspective to analyze the costs of each possible sequencing scenario. Particularly, the studies presented at the 1986 World Bank Conference stressed upon the potential unemployment effect of structural reforms (Edwards, 1992).

In his work "Agriculture & the Sequencing of Structural Adjustment: A Welfare Perspective" Edwards (1992) demonstrates that there exists no definitive welfare based theorems to establish any particular reform order. The analysis of the welfare consequences of alternative sequencing scenarios, based on a four-sector intertemporal general equilibrium model, concludes that policy recommendations should be based on macro management and credibility considerations (Edwards, 1992).

In general, the liberalization process is expected to generate both winners and losers. Specifically, local consumers will benefit from higher efficiency gains resulting from improved domestic production in face of strong foreign competitive pressures. This is in addition to gains accrued by workers and entrepreneurs that have been already operating in outward oriented exportable sectors, and whose accessibility to the world market will be further strengthened (Daveri, 1991).

On the other hand, reform measures hit the most vulnerable groups of the society as a result of the dynamics of stabilization and structural adjustment efforts. Indeed, a successful stabilization dictates the adoption of contractionary fiscal policies in order to balance the government budget through revenue enhancing and expenditure tightening tools. These include tax & price increases, subsidy removal and reduction in investment allocations to public health and education services that are basically used by the poor (El Leithy, 1995).

This is combined by the inevitable cost of economic restructuring that entails the privatization of state owned enterprises (SOEs). This may lead to significant job losses, and would abolish the opportunity of using the public sector as a major source for employment creation in LDCs (El Leithy, 1995). In that sense, it can be stated that poverty & unemployment present the highest social costs and the most important welfare consequences of reform.

3. Speed of Liberalization: The speed at which the liberalization process should be carried out is a political choice that has to be made between a *gradual* and "*big bang*" implementation of reform measures. The appropriate speed of the reform process has been emphasized in a number of studies conducted by S. Edwards & Van Wijhbergen (1982- 83), and has been recently discussed by Edwards (1992) in his work "Terms of Trade, Tariffs and Labor Market adjustment in Developing Countries" (Edwards, 1992).

Some economists support the abrupt dismantling of existing controls based on credibility considerations. Specifically, it is argued that the longer the time lag between a formal commitment to reform and its actual implementation, the greater the opportunity for interest groups to slow up or even to halt the process (Corden, 1987).

On the other hand, most studies recommend a gradual reform process to allow the reforming economy a sufficient time period to react to liberalization. This would permit local institutions and industries the opportunity to restructure themselves in order to improve their performance, to take advantage of fresh investment opportunities and to enhance their international competitiveness (Edwards, 1992). More importantly, *gradualism* is strongly supported on welfare grounds as it generally reduces employment dislocations, resulting in the highly protected import substituting industries. These will be balanced by higher employment opportunities created in the export sector (Corden, 1987).

4. Credibility of reforms: The success of an economic reform program, in terms of its effectiveness & sustainability, depends to a great extent on its degree of credibility. Building up credibility is a gradual and cumulative process during which the degree of commitment and consistency of the reforming government is continuously being tested by the various interest groups (Calvo, 1988). According to Bruno (1993) and Daveri (1991), uncertainty about the seriousness of the government in proceeding with reform may inhibit the intended positive supply response necessary to increase investment and to initiate a dynamic growth process.

The role of credibility in the liberalization process was theoretically discussed by both Stockman (1982) and Calvo (1983). In his article "On the Costs of Temporary liberalization / Stabilization Experiments", Calvo indicates that if economic agents do not believe in the credibility of a specific reform measure, liberalizing other sectors may ultimately result in welfare losses (Edwards, 1992).

A good example is to liberalize the capital account when credibility of the import reform is low. According to Calvo, people will use the foreign funds to import larger quantity of goods, more than what would have been imported if trade reforms were credible. In that case, lack of credibility is equivalent to distortions as over importation will immediately result in BOP problems (Corden, 1987).

That is why, it is recommended that in LDCs where governments lack credibility, capital controls should not be lifted until the trade liberalization program is solidified. This is because under such circumstances, capital mobility magnifies the existing distortions in the trade sector (Calvo, 1988). This underlines the significance of a consistent and credible policy package in the success of an economic reform. In his work "Establishing Credibility: Strategic Considerations", T. Schelling (1982) stresses upon the importance of transparency as a key element during the implementation of the reform program in order to eliminate any misunderstandings or uncertainties about the government's intentions (Daveri, 1991, p.34).

In this respect, institutional reforms present a solution to the credibility problem since they are perceived as *"investment in reputation", and* present a binding pre- commitment about the future conduct of a reforming government (Daveri, 1991). Indeed, reforming the institutional structure of an economy as well as improving its administrative capacity reduces economic agents' uncertainty about reform, and minimizes their transaction costs. Consequently, this raises the efficiency of public investment, promotes private investment, and ultimately contributes to growth by realizing the expected efficiency gains from the opening of domestic financial & goods markets (Easterly & Wetzel, 1989).

Chapter Two: Capital Account Liberalization As An Integral Part of Financial Reform

I - Rationale For Financial Opening:

A - Expected Efficiency Gains From Financial Opening:

The ultimate objective of financial deregulation is to promote the economic performance of nonfinancial sectors of the economy through enhancement of *"competitive efficiency"* in the financial markets. Financial liberalization is expected to stimulate the functioning of domestic markets, reduce transaction costs, and improve the pricing, quality & diversification of assets (Fischer & Reisen, 1993).

This can be attained through *improved allocative efficiency* by eliminating quantity and price restrictions in order to correctly price the risks & returns, associated with holding financial claims, and to direct global savings towards the most productive forms of investment. This is in addition to *higher operational efficiency* that results from increased competition between different players in the market, squeezes intermediation margins, increases returns to lenders and stimulates innovation. Furthermore, liberalization leads to *better dynamic efficiency* due to specialization in the production of a wider range of financial products and services that are tailored to the continuously changing needs of consumers (Fischer & Reisen, 1993).

B - Theoretical Foundation For Financial Liberalization:

The current support to financial liberalization in LDCs has been based on expected positive growth effects. It has been argued that these can be accomplished through the establishment of positive real interest rates expected to stimulate the growth of savings and financial assets. Consequently, the increased stock of assets eases liquidity constraints facing the local banking system, and this accelerates mobilization of investment financing considered to be a key engine for growth (Fischer & Reisen, 1993).

Theoretically, the overall investment ratio will be raised due to the greater availability of investment funds mobilized through both domestic & international capital markets as liberalization facilitates access to foreign credit. Moreover, the average investment productivity is expected to increase as the efficient dynamics of competition, between financial intermediaries, will ensure the financing of the highest yielding investment projects (Fischer & Reisen, 1993).

In other words, this argument postulates that *greater & better* quality of investment will ultimately result in higher rates of economic growth. This reasoning also stipulates that welfare gains, associated with financial opening, will be derived from increased resource allocation efficiency that will satisfy the varied liquidity preferences and risk attitudes of both savers and investors internationally (Fischer & Reisen, 1993).

Recommendations have been strongly made by some economists in favor of the early opening of the capital account prior to reforming other sectors of the economy, particularly the trade sphere. These have been based on the need to minimize political opposition to trade reform by reducing short run unemployment effects and other adjustment costs generally associated with liberalization policies (Mathieson & Suarez, 1993).

A. Krueger (1981, 1984 & 1989) has been one of the strong proponents of the capital - first liberalization order. In her article "Capital Movements & Trade in a Dynamic Perspective", Krueger (1990) attributes Korea's success with outward oriented policies and its spectacular growth to the availability of foreign financing during the period from 1962 to 1979. According to Krueger's counterfactual simulation analysis, Korea would have only reached 70% of its growth rate in the absence of these capital inflows (Edwards, 1992).

In his article "Southeast Asian & the Impossible Trinity", Reisen (1993) states that proponents of the early opening of the capital account refer to the experiences of Malysia and Indonesia to defend their arguments. In these countries, capital controls could not have been effective as Singapore's financial center has been an informal credit market to these countries (Fischer & Reisen, 1994).

While open capital accounts have resulted in restraints on both fiscal & monetary policies in Malysia and Indonesia, they imposed a notably healthy discipline on their government budgets. As a result, the Indonesian & Malysian authorities have succeeded in diversifying their exports, keeping inflation at low levels and fostering growth of their economies (Fischer & Reisen, 1994).

Interestingly, the sequencing of reform in Indonesia virtually challenges the *orthodox* order established in the development literature as the capital account was first opened in 1971, and was followed by a gradual trade liberalization in the early 1980s. In 1983- 84, ceilings on banks' credits were eliminated, and interest rates were freed. The institutional aspects of the financial system were deregulated in 1988 through the early 1990s (Fischer & Reisen, 1994).

II - Features of Financial markets during pre- reform period:

During the 1970s, most LDCs were characterized by financial repression whereby real deposit & lending interest rates were negative, the creation of new financial instruments was discouraged, and entry into the financial market was restricted. This followed from use of a variety of controls, such as, ceilings on interest rates below the market clearing levels, high reserve requirements and restrictions on capital movements (Fischer & Reisen, 1993).

By the mid 1980s, LDCs' access to foreign credit in the international market was sharply curtailed in the aftermath of the 1982 debt crisis. In order to relieve their dried up financing environment, LDCs have embarked on a broad *"international debt strategy"* based on external financial support to reschedule their debt obligations as well as on structural adjustment programs to restore stability of their financial systems. Nevertheless, the slow growth performance of LDCs coupled by difficulty in mobilizing new bank loans shifted emphasis of the debt strategy away from the relaxation of LDCs' liquidity pressures towards a fundamental restructuring of LDCs' external liabilities (Erian & Kumar, 1994).

As of the second half of 1993, an estimated $ 116 billion of developing country sovereign debt had been restructured under debt & debt service reduction operations. This resulted in a gross reduction in the present value of obligations amounting to some $ 51 billion at a cost of $ 18 billion. It is worth noting that the debt reduction operations have served as a precursor for the reestablishment of LDCs' access to the international capital market; particularly, for equity & bond financing. This is indicated by the marked difference between voluntary bank lending to LDCs amounting to $ 2.9 billion in 1990-92 compared to $ 32 billion in form of international bond & equity flows (El Erian & Kumar, 1994).

In their study "Private Market Financing For Developing Countries", Collyns & Charles (1993) show that the share of portfolio equity & bond financing as a percentage of total external capital flows to LDCs rose from 1.4% in 1971- 76 to 3.1% in 1982- 88 to 16% in 1992 whereas FDI rose from 10.8% to 10.6% & 18% over the same time periods (El Erian & Kumar, 1994). In general, net capital flows to the developing world have reached an annual average of more than $ 130 billion between 1990 & 1994 to present a fourfold increase over the 1983- 89 period (IMF, 1995a, p.49).

III - Capital Controls During Pre- Reform Period:

Over the past few decades, capital flight reflected domestic residents' desire to diversify their investment portfolios, to hedge against expected devaluations of their national currency, to obtain higher returns, and to avoid taxes & confiscation of their financial assets (Polack, 1990). LDCs imposed high restrictions on capital flows in order to retain domestic savings and to avoid foreign control of domestic assets (Mathieson & Suarez, 1993).

More importantly, fears from a sharp change in the economy's foreign exchange reserves and from an excessive exchange rate volatility induced governments to tax financial transactions in order to limit volatile short- term capital flows. Indeed, doubts about the coherence of economic policy have seriously affected investors' holdings of domestic and foreign assets in many LDCs such as Egypt in late 1980s as well as Turkey and Mexico in early 1990s when short term flows reflected the private sector's attempt to protect the real value of their investment portfolios (Mathieson & Suarez, 1993).

Among the various measures used to restrict capital flows are foreign exchange controls that effectively reduced the automaticity of transferring foreign currency outside LDCs, and hence presented a strong disincentive to FDI in the developing world (Unctad, 1995). This is in addition to quantitative restrictions that imposed limitations on the external asset & liability position of local financial institutions, and confined the domestic operations of foreign financial institutions as well as the real estate & direct investment of non-bank residents. Interest equalization and transaction taxes on external financial transactions were also used to discourage capital flows by eliminating the high yield that induces local residents to hold foreign financial assets, or encourages foreigners to purchase domestic claims (Mathieson & Suarez, 1993).

Effective capital controls have been defined as those that can isolate domestic financial markets *completely* from international ones, and can establish local interest rates independently from international rates. It may be stated that controls have not been always effective as various channels were used for their evasion, such as, the under and overinvoicing of export & import contracts. Transfer pricing policies, used by multinational companies, have also enabled them to shift funds in and out of a country. This is in addition to remittances of savings, by foreign workers in the domestic economy and by nationals working abroad, that have been used as vehicles for the acquisition or remission of foreign assets (Mathieson & Suarez, 1993).

Controls constitute a major source of inefficiencies as they limit the access of local economic agents and institutions to international financial markets, and discourage the repatriation of flight capital. This also inhibits risk diversification, and increases the exposure of residents' wealth and income positions to macroeconomic shocks as their investment portfolios become less diversified. Moreover, enforcement of these controls developed rent seeking activities, such as bribery, leading to moral hazard as it created an implicit market value for the licensing of restricted capital account transactions (Mathieson & Suarez, 1993).

Capital account liberalization has become of great importance since the outbreak of the 1982 debt crisis as credit rationing by international commercial banks has been diminishing, and LDCs' need for the repatriation of flight capital has increased. It may be generally stated that the increasingly *de facto* opening of the capital account has revealed the ineffectiveness of capital controls in face of the growing trade integration, financial innovation and opening by other countries (Fischer & Reisen, 1994).

IV - Scope of Capital Account Convertibility:

A - Surges in Capital Inflows:

Experience demonstrates that the initial phases of capital account liberalization in LDCs have witnessed massive net capital inflows including repatriation of flight capital and external assets even when sustainability of the reform program is still uncertain (Fischer & Reisen, 1993). Stabilization entails the adoption of tight credit & monetary policies leading to an increase in interest rates that are freed after being repressed for a long time, and that are effective in attracting large capital inflows to reforming economies over the short run. In the long run, extensive reform efforts stimulate large inflows in response to macroeconomic stability and improved potential benefits from real & financial investment (Schadler, Carkovic, Bennett & Kahn, 1993).

Capital inflows may be beneficial to reforming LDCs as they ease their external financial constraints, reduce domestic interest rates, and may ultimately promote investment & growth. However, these inflows have constituted a real policy concern as they challenge the macroeconomic stability of recipient economies through their *overheating* effects associated with the abundant availability of external financing (Schadler, etal 1993).

These negative effects include the widening of the current account deficit that reflects a growing gap between private savings and investments. Surges in capital inflows also lead to an increase in consumption level that is only durable if it is associated with higher income growth generated from the real investment of such inflows. Moreover, inflows can result in higher and sustained inflation levels as they may weaken control over the monetary policy by pushing up monetary aggregates, and presenting upward pressures on the prices of goods, real estate & financial assets (Schadler, etal 1993).

Real exchange rate appreciation, caused by an acceleration in domestic demand, for either consumption or investment, has been considered the most unwelcome effect of capital inflows. This is due to its harmful effect on competitiveness of the external sector of an economy (Schadler, etal 1993) as explained in the next two subsections analyzing the implications of capital account liberalization on the most important policy variables at the macro & microeconomic levels.

B - Macroeconomics of Capital Account Liberalization:

The macroeconomic pros & cons of opening up the capital account have been closely examined in light of its implications on the exchange rate regime. Most policy makers have been concerned about the anticipated behavior of the exchange rate in the aftermath of such liberalization. This growing concern has been justified on the basis that the exchange rate does not merely act as an asset price, but also functions as a relative price linking the domestic goods market to the world. Hence, its movements seriously affect the external competitiveness of local production (Fischer & Reisen, 1993).

That is why, most LDCs have been reluctant to liberalize their capital flows due to fears from problems associated with the anticipated *"overshooting"* of the real exchange rate. This has been attributed to large capital inflows that ultimately lead to a temporary real exchange rate appreciation, above its long run equilibrium level (Fischer & Reisen, 1993).

In their article " Disequilibrium & Structural Adjustment", S. Edwards & Van Winjnbergen (1989) describes the emerging situation as similar to the "*Dutch disease*" effects of a major discovery of natural resources. This is because real appreciation is further reinforced by the spending boom caused by the wealth effect resulting from the "*euphoric*" revaluation of domestic assets as perceived by local and foreign investors in light of the improved economic conditions (Fischer & Reisen, 1993).

More importantly, real appreciation induces the relocation of production resources and activities from the tradable to the non tradable sector that witnesses excessive investments during the inflows period. This is due to the declining competitiveness of tradables relative to imports given the overvalued exchange rate. Consequently, the industrial output decreases, and the manufacturing sector faces the *de- industrialization* risk. It should be noted that the resulting suboptimal investment activities undertaken in the traded goods sector cannot be easily reversed in terms of cost and time (Fischer & Reisen, 1993).

Nevertheless, it has been argued that real appreciation presents a significant danger on the real sector of the economy in absence of a well functioning capital market especially when the domestic industrial sector lacks access to necessary funds in order to restructure. In other words, the possible access to borrowing funds would allow local export firms the opportunity to adjust their investment activities until the goods sector regains its competitiveness; i.e, until the exchange rate returns to its long run equilibrium level (Fischer & Reisen, 1993). In this regard, development of capital market becomes a must to channel necessary resources to domestic industries.

C - Microeconomics of Financial Opening:

1 - Interest Rate Behavior During Reform: Emergence of high local interest rates has been one of the most interesting aspects of financial reform (Fischer & Reisen, 1994). This has been witnessed in most reforming economies where real interest rates turn to be positive after being systematically negative during periods of financial repression. Short term real interest rates reached high levels in Chile & Argentina where annual real borrowing rates averaged 41 % & 17 % during (1975- 81) & (1977- 80) respectively, the periods over which financial opening took place (Fischer & Reisen, 1993).

A number of factors has been listed for the increase in real interest rates after the opening up of the capital accounts in LDCs. It has been argued that establishing the credibility of a reforming government necessitates its adherence to anti- inflationary measures typically dictating the implementation of restrictive monetary & credit policies that give rise to high real interest rate. In other words, such increase can be interpreted as an adjustment to slower monetary and credit expansion in order to equilibrate the growing demand for money (Mathieson & Suarez, 1993).

High loan rates also denote the risky lending activities in countries where prudential supervision of the financial system has been inadequate. This is in addition to the inconsistent macroeconomic & exchange rate policies, adopted in most LDCs, and that have casted doubts about the sustainability of the exchange rate policy. As a result, this has fueled the exchange risk premium, and led foreign & domestic lenders to demand higher yields on their deposits in an anticipation of a large depreciation of national currency (Mathieson & Suarez, 1993).

Similarly, domestic interest rates embody a high implicit default risk premium in LDCs where private and official borrowers cannot honor their debt service obligations. In this respect, it is interesting to note movements in annual real interest rates in relation to perception of the default risk, associated with the debt overhang. These were empirically linked by Kohr & Suarez (1991) in their work "Interest Rates in Mexico" where they noted that interest rates on short term peso denominated paper (Cetes) declined from 52.3% in 1988 to 11.8% in 1993. This was interpreted by Mexico's agreement with foreign commercial banks in 1990 to reschedule its external debts (Mathieson & Suarez, 1993).

2 - **Financial Deepening:** This is an important indicator of the ability of an economy's financial institutions to mobilize saving resources. Deepening can be measured by the evolution of monetary aggregates relative to GDP or GNP. Liberalization is expected to stimulate the growth of financial assets as it allows the financial sector to compete more efficiently with the real one for mobilization of scarce saving resources. This can be realized through establishment of positive real interest rates raising the return on financial holdings and through expansion of institutional system permitting the creation of a wider variety of more appealing financial assets (Fischer & Reisen, 1993).

In their article "Domestic Resource Mobilization in Thailand: A Success Case for Financial Deepening", Corsepius & Fischer (1988) empirically proved that higher interest rates induced Thaii households to shift their savings portfolios away from real estate in favor of interest bearing instruments. They also showed that improved access to financial institutions contributed to the process of financial deepening as the extended depository branch network system reduced transaction costs, and ultimately increased the effective return of financial assets. According to Balino & Sundararajan (1986), local time and savings deposits dramatically grew in Indonesia, by around 66% in real terms in 1983- 84, the period over which the financial sector was deregulated (Fischer & Reisen, 1993).

3 - Savings, Investment & Growth: Financial reform is generally expected to increase savings and investments, and to ultimately enhance the economy's growth prospects. In this respect it is interesting to note the considerable impact of credibility in influencing the behavior of domestic savings and investments in the wake of financial liberalization (Fischer & Reisen, 1993).

Experience shows that interest rate liberalization has not significantly encouraged long term financial intermediation in reforming LDCs. In his article "Goodbye Financial Repression, Hello Financial Crash", Diaz- Alejandro (1985) shows that financial reforms did not encourage intermediation beyond a one year maturity in Urugway. It is estimated that 98% of all commercial bank outstanding credit was of a six month maturity by the end of 1979 (Fischer & Reisen, 1993).

In this sense, the maturity structure of financial assets reflects the impact of macroeconomic stability on the acceptability of long term saving instruments during liberalization. Indeed, dominance of short term instruments denotes the public's reluctance to hold longer term assets due to anticipation and fear from high rates of inflation as well as uncertainty about the future course of interest rates in the long run (Fischer & Reisen, 1993).

During the 1980s, the ability of the Indonesian banking system to provide medium & long term credit was constrained by the pronounced volatility of interest rates & mismatch of maturities between short term liabilities and loans required for investment financing. Conversely, the Malaysian system experienced an increase in the share of time deposits over 12 months from 16.8% in 1981 to 56.2% in 1987 due to macroeconomic stability reflected by low inflation rates during the 1980s (Fischer & Reisen, 1993).

Furthermore, it is observed that financial opening has not stimulated investment in physical capital in most LDCs in the wake of liberalization. This has been partly attributed to the persistently high interest rates that encourage financial intermediation and speculative investment in financial assets (Fischer & Reisen, 1993). This can also be interpreted by investors' reluctance to make irreversible investment decisions in real capital during the initial phase of liberalization (Dornbusch, 1990).

This reflects general uncertainty about sustainability of the reform program as entrepreneurs assume the *wait & see* position before they take the risk of starting any new long term investments. That is why, they prefer to invest in more liquid forms of capital; such as, financial assets and portfolio investment that can be easily reversed in case of unfavorable developments (Dornbusch, 1990). In this respect, government credibility & commitment to reform play a critical role in gaining the private sector support for the program.

D - Policies Towards Capital Account Convertibility:

Economies that establish prudent macro & micro reforms stand to obtain the highest efficiency and risk diversification gains from capital account liberalization. These reforms encompass a variety of policies that aim at enhancing the safety & the soundness of the domestic financial system. They are also designed to improve the absorptive capacity of the home economy to massive capital inflows, to reduce differences between domestic & external financial market conditions and to mitigate the effects of the high asset price movements & real exchange rate overshooting usually witnessed in the wake of financial liberalization. These are all important steps to eliminate the incentives for economic agents to move their funds abroad (Mathieson & Suarez, 1993).

1 - Macroeconomic Management:

a. Fiscal Control: A liberalized capital account narrows LDCs' options to reduce budget deficits for a number of important considerations. Specifically, the dismantling of capital controls undermines a government's ability to lower interest rates on domestic debt in order to avoid capital flight, and this ultimately raises LDCs' domestic debt-servicing costs (Fischer & Reisen, 1993).

Sale of government bonds may also be ineffective particularly when a country is highly indebted both externally & domestically. Under such circumstance, doubts may be raised about the country's ability to service the newly issued debt, hence about its creditworthiness, and this provides domestic residents strong incentives to move their funds abroad (Matheison & Suarez, 1993).

The newly reformed financial system also precludes the option of forcing State banks to hold domestic public debt as they had been historically captive lenders to the government, and this weakened their capital positions in face of threats from potential foreign bank entry. Moreover, taxation of domestic bond returns is not a feasible solution under liberalization as local savers will demand high yields on any government debt they are holding as compared to foreign one (Fischer & Reisen, 1994).

For all the above considerations, solid fiscal consolidation is considered a prerequisite for a successful financial opening in order to obviate the need for domestic financial repression (Fischer & Reisen, 1994). In the short term, fiscal reform focusses on budget control through various direct measures such as: cuts in public outlays for consumption & investment, elimination of subsidies and reform of the public sector (Fischer & Reisen, 1993).

In the long run, fiscal control depends on the implementation of a successful tax reform that aims at broadening the tax base and simplifying its tax structure. Failure to broaden the tax base has been the principal cause for weak tax efforts in most LDCs due to administrative and technical defects in the processes of tax assessment & collection (Fischer & Reisen, 1993).

A rare exception has been the Indonesian's 1983 tax reform program whereby authorities wisely allowed a two year adjustment period for the necessary changes. These included modernization of the accounting system, training of tax officials as well as legislative reforms all denoting a credible commitment on the part of the government for reform (Fischer & Reisen, 1993).

b. Policy Responses to Surges in Capital Inflows: Potential dangers associated with surges in capital inflows have induced policy makers to design a number of counteracting measures. These aim at creating a balance between governments' desire to benefit from higher investment & growth prospects afforded by such inflows, and to offset their destabilizing effects (Schadler, etal 1993).

Sterilization has been the first line of defense used during the early capital inflow episode as it can be rapidly implemented. It is broadly defined as a deceleration or drop in net domestic assets to offset the monetary effects of capital inflows and to develop a cushion of reserves against a possible reversal. This involves various mechanisms including open market operations, sales of government liabilities, direct credit controls as well as increases in reserve requirements on bank deposits (Schadler, etal 1993).

In a review of the experiences of Chile, Colombia, Mexico, Spain & Thailand, it is found that the decline in net domestic assets slacken after the first year of using sterilization. This is owed to reduced reliance on aggressive sterilization for a number of reasons. This is because of the large quasi- fiscal costs associated with sterilization specifically in case of open market operations. The net cost to the Central Bank per issued bond is the difference between the interest paid on domestic bonds and the interest earned on foreign reserves. This difference ranged in 1990/ 91 from virtually zero in Thailand to over 10 percent in Chile & Spain, and the direct costs of government bond sales reached 0.8% of GDP in 1991 in Colombia (Schadler, etal 1993).

Moreover, sterilization forces foreign inflows into purchasing government bonds, and this deprives the economy from potential benefits of real investments & growth afforded by such incoming flows as was the case in Thailand. More importantly, this policy intensifies the conditions that initially attract large inflows, by putting an upward pressure on domestic interest rates and hence sustaining an important source of additional inflows. Indeed, the Colombian experience in 1992 shows that a marked reduction in sterilization resulted in a significant drop in short term interest rates, a slackening of inflows and a deceleration of monetary aggregates (Schadler, etal 1993).

Nominal depreciation has also been employed as a second line of defense by most LDCs that resort to adjusting their exchange rate policies when sterilization can no longer be undertaken on a sufficient scale to reduce money growth and inflation to targeted levels. As inflows raise demand for non traded goods, and exert upward pressures on prices & the real exchange rate, policy makers consider nominal depreciation to reduce inflationary pressures in the economy (Schadler, etal 1993).

2 - Micro Economic Reforms: Credit market segmentation, lack of competition in domestic banking sector, insufficient prudential regulation & supervision and inefficient capital markets have all characterized financial markets in LDCs, and may frustrate the indented outcomes of financial liberalization. That is why, reform should address micro policy areas to ensure a successful opening (Fischer & Reisen, 1993).

Competition can be stimulated by abolishing restrictions on the operations of banks & financial institutions, and encouraging the creation of new financial instruments to provide a wider scope of financial substitutes better tailored to clients' needs. This is in addition to removal of interest ceilings, elimination of subsidized loans to priority sectors and privatization of state owned banks (Fischer & Reisen, 1993).

It should be noted that the overhang of non- performing loans in the local banking system constitutes an effective barrier to financial opening as it places national institutions at a disadvantage relative to foreign ones. That is why, attention should be paid to the design of possible rescue measures depending on the size & structure of local banking system, the magnitude of loss unbacked by banks' equity and the country's legislative framework (Fischer & Reisen, 1993).

Recapitalization of the banking sector can take various forms, such as, the State purchase of non performing loans to be swapped for bonds as was adopted by Chile in the 1980s. This approach had been costly to the budget as bad loans had to be absorbed by the state, and new funds were used as interest payments on issued bonds. In his article "How The 1981- 83 Chilean Banking Crisis Was Handled", Larrain (1989) estimate Chile's costs of such rescue operations to reach 44% of GDP during the 1982- 85 period (Fischer & Reisen, 1994).

Another form entails a lesser degree of State intervention and hence a lower cost through the injection of new capital either from the existing shareholders or from public funds to meet the minimum capital adequacy requirements as was followed by Malysia. A final solution is to merge ailing banks with sound domestic or foreign banks (Fischer & Reisen, 1993). It may be generally stated that introducing the threat of foreign bank entry into the domestic market forces local institutions to rationalize their operating costs to be able to face foreign competition.

Development of equity markets in LDCs and their integration within the international market has become an important instrument for mobilizing domestic & foreign savings. This is because of the increasing competitive pressures on industrial countries' aid flows & FDI as well as the limited availability of LDCs' domestic finance relative to their development needs. In their study "Corporate Financial Structures in Developing Countries", Hamid & Singh (1994) emphasize the role of equity financing in the development of rapidly growing East Asian economies (El Erian & Kumar, 1994).

A consensus would seem to have been reached in the literature about the beneficial role of equity markets in economic development as they can lead to an increase in the steady state growth path of LDCs through their conducive effects. Indeed, these markets stimulate financial resources needed for productive investment opportunities by increasing liquidity and widening the set of instruments available to savers seeking diversification of their portfolios (El Erian & Kumar, 1994).

Positive externality effects are also expected from improvements in financial intermediation by reducing the so- called recognition problem. In other words, internationalization of LDCs' financial markets increases investors' awareness of potential investment opportunities in LDCs worldwide, and this consequently enlarges the scope for FDI in these economies. In addition, the internationalization process of local markets provides LDCs access to a variety of cost effective hedging tools that are useful to minimize the cost of unfavorable world price developments (El Erian & Kumar, 1994).

It is worth noting that structural reforms, ensuring technological progress, reducing transactions costs, minimizing risks associated with investment in financial assets, led to a sharp increase in total capitalization of 38 emerging stock markets in Asian and Latin American countries, reaching $ 1 trillion in 1993 compared to less than $ 100 million in 1983 (El Erian & Kumar, 1994). Prudential regulation & supervision are also necessary elements of a successful financial opening in order to ensure the soundness of the whole system by preventing unsound banking practices, such as, interlocking lending among banks & firms and concentration of loans to specific entities (Fischer & Reisen, 1993).

These are all important measures in order to deter the recurrence of non - performing loans, and to raise the expected revenue from investment in financial assets. That is why, institutional arrangements should establish an early warning system between authorities and financial institutions. This can act as a cushion against unexpected losses to protect economic agents' interests and to maintain general confidence in the system (Fischer & Reisen, 1993).

3 - Sequencing and Speed of Capital Account Liberalization: The nature of capital flows provides policy makers adequate tools to design the most suitable sequencing for opening up the capital account. That is why, flows must be distinguished by their use; i.e, whether they are for FDI, for real investment, for financial investment or for consumption in order to provide a guarantee against financial crises (Fischer & Reisen, 1994).

The standard policy advice with respect to sequencing has been to start the opening up process by liberalizing FDI & trade related finance. These are to be followed by the dismantling of controls on portfolio investment flows and finally those on short term capital flows. Fischer & Reisen (1992) confirmed that the latter type of flows should be relaxed only after extensive progress has been made on the stabilization and reform fronts (Fischer & Reisen, 1994).

There exist two reasons for nominating FDI & trade related capital flows as candidates for early liberalization. Indeed, these flows are necessary elements for the initial stages of development in LDCs. More importantly, they are unlikely to disrupt the stability of an economy in contrast to other types that embed overheating effects (Mathieson & Suarez, 1993)

The speed at which a country can move to full capital account convertibility depends to a great extent on its willingness to undertake further policy measures that reinforce the credibility of the reform program. The Chilean disappointing experience, in the 1970s, suggests that consistency of macro & micro economic policies is more crucial to the sustainability of an open capital account than the sequencing & speed of removing capital controls.

This indicates that capital account liberalization does not inevitably lead to financial crashes; indeed, much depends on the timing of the opening relative to the prerequisite institutional & policy measures. In general, gradualism is recommended in phasing out capital controls so as to allow such liberalization to be in harmony with improvements in other policy areas. This is because capital account convertibility dictates a high degree of consistency between macroeconomic, financial & exchange rate policies (Fischer & Reisen, 1994).

Country experiences with financial liberalization have been classified according to their scope & speed. Comprehensive internal & external financial opening was completed in Argentine in the late 1970s & early 1980s over a short period of time. Interest rates were left to be determined by market forces in 1977, capital controls were removed in 1979, and reduction of entry restrictions & reserve requirements was gradually introduced over the period of 1977- 81 (Fischer & Reisen, 1993).

Liberalization was more gradual internally and more limited externally in both Taiwan & Thailand where capital controls were gradually removed, and positive interest rates were maintained through use of credible macroeconomic policies that successfully reduced inflation. This was coupled by the gradual liberalization of controls on banks' operations (Fischer & Reisen, 1993).

Chapter Three: Design of Trade Reform As A Major Component of Structural Adjustment In LDCs:

I - Rationale for Trade Policy Reform:

A - Approaches to Trade Reform:

A successful trade policy reform comprises elements of a shift to greater neutrality and of liberalization through a reduction in existing distortions. A shift towards neutrality encompasses policy changes that result in nearly uniform effects on the price incentives among exportable, importable & nontrdables as well as on the sale of products in the local or foreign markets (Nash & Thomas, 1991). Indeed, a trade system is defined to be completely neutral if it operates as it would in the absence of government interference (Michaely, Papageorgiou & Choksi, 1989).

Trade liberalization entails the reduction in tariff levels and in quantitative restrictions (QRs) so as to use the price mechanism based on international prices (Thomas, Matin, Nash, 1990). The main objective of trade liberalization is to expose protected domestic industries to greater external competitive pressures in order to improve their performance and enhance their economic & operational efficiency. Reform also targets improvement in the BOP position by strengthening the competitiveness of a country's external sector and expanding its exports & import substitute industries (World Bank, 1992a).

Gains from trade opening essentially rest on the principle of comparative advantage as well as on benefits of exploiting economies of large scale (Corden, 1987). These all lead to the improvement of allocative resource efficiency, and the stimulation of a higher degree of specialization in production along the economy's comparative advantage. The growth of export activities is also expected to be boosted through the removal of anti- export bias. In addition to production gains, the equalization of local with world relative traded goods' prices provides a consumption gain that increases the community's welfare, and changes consumption patterns (Michaely, 1986).

It is worth noting that successful experiences with trade reforms can be found in liberalizing as well as in interventionist but relatively neutral policy regimes. The first group of LDCs includes Mexico, Chile & Turkey, whereas the second includes Korea & Taiwan where government assistance was significant during their initial development stages. Indeed, a few number of countries managed to develop their export sectors while highly protecting their domestic goods competing with imports. Specifically, Korea achieved strong export growth while adopting protectionist policies by avoiding exchange rate overvaluation and through vigorous state intervention providing export subsidies during the 1960s & 70s (Thomas, etal 1991).

Thus, an outwardly oriented economy can be achieved either through a relatively *hands off* approach or through *selective* government assistance (Thomas, etal 1991). It should be noted that either reform approach should be supplemented by an adequate exchange rate, a stable macroeconomic environment and a sound administrative framework as discussed in section II.

B - Theoretical Ground for Gains from Trade Liberalization:

This section briefly reviews some of the recent literature that strongly supports the opening up of trade sectors in LDCs based on the positive relation between trade outward orientation & growth. Recent developments in the theory of endogenous economic growth, largely influenced by Romer (1986) & Lucas (1988), have established a long run equilibrium relationship between trade openness & economic growth. Specifically, Romer's model (1989) stipulates that open trade regimes enable countries to reach higher equilibrium growth levels through greater devotion to R & D. This results in a higher degree of specialization in manufacturing intermediate inputs, and ultimately reduces production costs (Edwards, 1993).

In addition, Romer (1991) argues that trade openness provides access to imported inputs that embody new technology, increases the effective market size facing producers, thus raises returns to innovation, and affects a country's specialization in research intensive production (Harrison, 1995). Grossman & Helpman (1991) and Edwards (1992) have developed models whereby a higher degree of openness allows LDCs to absorb technology developed in more advanced countries at a faster rate, and hence to grow more rapidly (Edwards, 1993).

Despite their firm theoretical grounds, the new models of endogenous growth do not provide strong empirical evidence for analyzing the relation between a liberal trade policy & long run growth. Indeed, most analyses studying the effect of trade opening on LDCs' economic performance have particularly focussed on the relation between exports & aggregate GDP growth (Edwards, 1993).

Cross- country econometric works have mostly followed a two- stage methodology whereby the first *assumes* rather than tests that liberalized economies experience faster growth of exports, and the second stage tests the hypothesis relating a more rapid rate of GDP growth to a faster growth of exports. These works are criticized for unsatisfactory analysis of the sense of causality between the growth of exports & GDP. This is because they assume that free trade leads to a superior export performance resulting in a higher GDP growth, whereas the reversed sense of causality attributing export increase to GDP growth has been ignored (Edwards, 1993).

In her study "Foreign Trade Regimes & Economic Development: Liberalization Attempts & Consequences", A. Krueger (1978) econometrically tests the hypothesis positively relating a liberalized trade regime to GDP growth, and concludes that it is the reduction in anti export-bias that results in higher export response rather than trade liberalization per see (Edwards, 1993). It has also been argued that sound educational & macroeconomic policies are necessary to support a positive response from trade reform policies. This is noted by G. Helleiner (1986) in his article "Outward Orientation: Import Instability & African Economic Growth", where emphasis is made that a developing country must have a minimum threshold level of development before expected benefits from liberalization can materialize (Harrison, 1995).

Furthermore, the role of world market conditions on the feasibility of a successful trade opening strategy has often been ignored in most analyses of the effect of trade liberalization on LDCs' economic performance. Based on their work "Trade policy & Growth of Developing Countries", Gray & Singer (1988) conclude that outward orientation should not be considered a universal solution for all LDCs as there exists no positive correlation between export & GDP growth for countries facing unfavorable world demand conditions (Edwards, 1993).

In her paper "Openness & Growth: Time Series, Cross Country Analyses For Developing Countries", A. Harrison (1995) portrays the various methods used to investigate the direction of causality between openness & growth, and suggests that the debate on such direction is by no means resolved (Harisson, 1995). Investigating channels through which greater outward orientation affects growth presents an interesting task for future research (Edwards, 1993).

With regards to the sequencing of structural reforms, the literature demonstrates a widespread agreement on the postponement of capital account liberalization until the completion of trade reform. These recommendations have been mainly based on real exchange grounds to reflect most economists' concern about the inevitable cost of a premature opening of the capital account (Corden, 1987), as discussed earlier in chapter Two.

R. Mckinnon (1973) was the first economist to emphasize the need to avoid foreign capital injections during trade reform, and to stress that capital controls should be relaxed only after the elimination of trade & other industrial sector distortions. This is because the availability of large capital inflows inhibits the sufficient depreciation of the exchange rate. This contradicts the essence of trade reform as depreciation is strongly required to enhance the competitiveness of the tradable sector during the reductions of import tariffs (Edwards, 1992).

Along the same line of thought, Corden (1987), Corbo & De Melo (1987) note that real exchange rate management becomes more difficult under capital account liberalization. This has been marked by the unsuccessful structural reform efforts in three Latin American nations Argentina, Chile & Uruguay during the early 1980s. Such outcome was mainly attributed to persistent real appreciation in the aftermath of financial liberalization (Corden, 1987). Michaeley (1987) also explains that long term performance of the real exchange rate distinguishes between *" liberalizes & non liberalizes "* as the former tend to maintain a stable & competitive real exchange rate over the long run, while the latter let it suffer from fluctuations (Edwards, 1992).

Reaction of the equilibrium real exchange rate to changes in both tariffs and capital flows, among other variables, was empirically investigated by S. Edwards in 1989. The analysis was based on a time series data for a group of 12 LDCs, and showed that tariff reduction results in the depreciation of real exchange rate, while the increase in capital inflows leads to real appreciation (Edwards, 1992).

In their works, Brecher & Diaz Alejandro (1977), Frenkel (1982 & 1983), Edwards (1989) Mckinnon (1991) & Ostry (1991), argue that structural reforms should start by the elimination of domestic distortions existing in the goods market (Mathieson & Suarez, 1993). Specifically, emphasis is made on the need to complete trade liberalization, particularly tariff reduction, prior to capital account liberalization. This is because opening up local goods markets in a developing country improves its resource allocation mechanism, and allows the economy to *efficiently* use abundant capital inflows, accompanying financial liberalization, by channeling them into the most productive investment activities (Schadler, etal 1993).

In this respect, it is interesting to note that proponents of the capital first liberalization sequence are not fully committed to their policy advice. This is demonstrated by Krueger's discussion of the order perspective of the liberalization process in her work "How to Liberalize a Small Open Economy ?" where she recognizes the potential costs associated with the serious misallocation of investment funds as a result of opening up the capital account in the presence of trade distortions (Edwards, 1992).

This is particularly true when the existing trade regime is highly protected, and profitability of domestic industries does not reflect their real competitiveness in the world market. In that case, new investments are channeled into sub-optimal directions and foreign capital primarily flows into heavily protected industries. This ultimately results in lower benefits to the reforming country and possibly in a social loss as local consumers of protected products in effect subsidize foreign capital (Corden, 1987).

It is also argued that fiscal consolidation should precede trade liberalization so that a reforming government does not face any financial need as budget control minimizes the need for capital inflows during trade reform (Mathieson & Suarez, 1993). Mckinnon (1973) point out to the temporariness of foreign capital inflows, and state that LDCs should not rely on such injections. They should instead undertake radical reforms to improve the efficiency of their economies through the elimination of existing chronic distortions (Edwards, 1992).

Proponents of this liberalization order also refer to the Korean experience with large capital inflows since the mid 1960s. In his article "International Capital Market and Economic Liberalization In LDCs", Mckinnon (1984) points out to the significant costs generated by the abundance of foreign funds that led to high inflation, through the monetization of the funds, and to some degree of regression in Korea s' financial liberalization (Edwards, 1992).

Moreover, supporters of this sequencing approach refute the successful liberalization experiences of both Malysia & Indonesia that opened up their capital account prior to trade liberalization. In their article "Financial Opening: When, Why & How", Fischer & Reisen (1994) provide institutional explanations for the success of these countries in keeping inflation low and the exchange rate at competitive levels despite their open capital markets (Fischer & Reisen 1994).

Fischer & Reisen (1994) explain that both governments controlled a large share of foreign exchange earnings, from oil & gas exports in the past, that were used to counteract movements in the private capital account. In Indonesia, growing exports have allowed private companies to gain international credit standing while the government share in foreign exchange has been shrinking over time. This urged government intervention to manipulate the liquidity arising in the banking system in order to defend the local currency by using PEs' bank deposits to purchase certificates of the Central Bank. Similarly, Malysian institutions played an important role in managing domestic liquidity, but this did not prevent the early 1980s' sharp recession from turning into a financial crisis. In response, the government undertook major financial reforms, and Malysia is currently considered a model for bank supervision & prudential regulation.

II - Implementation of Trade Policy Reform:

Trade restrictiveness was enforced in LDCs through use of restraining tools, such as, import constraints on inputs used for export production, QRs on non competitive & competitive imports, tariff rates & tariff rate dispersion. Reform entails the implementation of various liberalizing measures on the export and import fronts. This section discusses how LDCs can move away from distorted trade policy regimes towards new systems where governments have more neutral positions towards trade (Thomas, etal 1991).

A - Import Policy Reform:

Import regimes in LDCs have been mainly controlled through licensing the importation of goods classified on the list of restricted or banned products. This generally entails costs derived from uncertainty, excessive paper work and rent seeking activities associated with a system in which licenses are issued at the discretion of relevant authorities. Restrictiveness of such system can be reduced by broadening the list of products for which licenses can be used, and by allowing their transferability (Thomas, etal 1991).

Switching to a negative list system, requiring the licensing of all banned imports and permitting the unrestricted importation of all unlisted products, has been considered a key liberalization element in import policy reform in LDCs. Indeed, this system reduces the scope of discretionary decisions, and enhances transparency (Thomas, etal 1990). Nevertheless, production and consumption gains expected from import liberalization cannot materialize by using the negative list and other nontariff barriers.

This is because these delink the local market from the world, isolate protected industries from competitive trends in terms of quality, pricing & production, and seriously affect their competitive positions internationally. That is why, tariffs have been used as a transitional measure during the removal of import restrictions to allow for a gradual reduction of protection on import substituting goods (Thomas, etal 1991).

The main objective of tariff reform is to reduce the dispersion and the average level of protection. The tariff rate is usually set at approximately the level of difference between domestic & international prices, and then this rate is reduced in stages. Tariff structure has generally been escalated with rates rising with the degree of processing of the product that needs to be protected. This increases the effective protection of later stage processes while it provides low or even negative effective protection at the earlier processing stages (Thomas, etal 1991).

Trade reform aims at an eventual tariff structure with rates as low as possible, and this sometimes conflicts with budgetary targets when the need to raise government revenue is a binding constraint. That is why, tariff reform is usually coordinated with domestic tax reforms to permit deeper reduction in tariffs more than would otherwise be fiscally acceptable. In cases where tariffs cannot be sufficiently lowered, priority is directed to elimination of exemptions or to taxation of highly protected domestic products. Harmonization of tariff rates on imports with tax rates on domestic production of import competing goods requires a well designed tax apparatus to tax consumption of domestic products through a value added or a sale tax (Thomas, etal 1991).

B - Trade Related Reforms:

1 - Stable and Competitive Exchange Rate: Exchange rate adjustment is an integral key element of a coherent trade reform policy package. Real devaluation coupled by the unification of the exchange rate system ultimately improves incentives for exports and efficient import substitutes (Thomas, etal 1990). This should be accompanied by appropriate macroeconomic policies to sufficiently reduce the fiscal deficit and its consequent monetary expansion in order to eliminate their inflationary impact and to achieve real deprecation of the exchange rate (Thomas, etal 1991).

Maintaining a competitive real exchange rate has been an indispensable factor in the development of exports in LDCs with real devaluation used to restore their external competitiveness. This played a major role in increasing exports in Chile and Colombia during the 1970s. In their work "How Does Uncertainty about the Real Exchange Rate Affect Export ?", Caballero & Corbo (1989) argue that overvaluation combined with unpredictable fluctuations of the real exchange rate are hostile to the development of exports (Thomas, etal 1991).

The *orthodox analysis* stipulates that real devaluation essentially deals with BOP problems as it increases supply of and decreases demand for foreign exchange. This is realized by raising the domestic currency prices of imports, and shifting the pattern of local demand away from imports to export and import- competing industries. This is necessary to avoid the deterioration of the current account in the wake of the opening up process. Consequently, this leads to an expansion in the industrial output of tradable goods and to a decline in the demand for & production of non tradables in order to free resources to satisfy the increasing demand for tradables (Corden, 1987).

The export sector and import- competing industries are expected to generate extra employment opportunities to serve the new local and foreign demand enhanced by real devaluation. This by itself will compensate for labor layoffs that may be witnessed in import-substituting industries after liberalization. Moreover, access to cheaper inputs in the world market will enable local industries to reduce their cost of production, and to expand their output, hence to recruit more labor (Corden, 1987).

Greater reliance on exchange rate depreciation presents a shift from commercial policy protection to exchange rate protection. Indeed, real devaluation facilitates the removal of QRs imposed for BOP considerations rather than for protection reasons. This explains why the rapid removal of QRs in a number LDCs such as Bolivia (1985) & Mexico (1985) was accompanied by large devaluations that rendered import controls redundant by narrowing the gap between the world and local prices of import substitutes (Thomas, etal 1991).

It can be stated that the essential feature of devaluation is that it results in the improvement of the resource allocation process in the economy as it sends right signals about the real competitiveness of the tradables in the world market. Real devaluation is also expected to generate higher national income, driven by an increase in export volume, that will lead to higher consumption levels and to more tax revenues that will improve the fiscal balance (Corden, 1987).

2 - **Infrastructure and Institutional Reforms:** A rapid increase in output from export and efficient import- substitution industries is necessary in the wake of trade reform in order to avert BOP crises as intense export response increases the availability of foreign exchange. That is why, efforts should be directed to strengthening the supply response to rapidly absorb resources released from the highly protected sectors towards their most efficient use through institutional & infrastructure reforms considered complements of a successful trade liberalization program (Thomas, etal 1991).

Reforming domestic regulatory policies is important to eliminate interference with the incentive structure through market entry & exit regulations, foreign investment controls and determined capacity levels in each industry. These restrictions hinder the domestic market from rapidly adjusting to trade reforms introduced to enhance the operational & economic efficiency of local enterprises. Restricting free movements, in or out, of the market was costly in Poland during the early 1970s as this prevented inefficient firms from shutting down, and deterred the entry & expansion of efficient ones (Thomas, etal 1991).

Trade liberalization rationalizes the market structure as it counter affects protective domestic policies contributing to fragmented production patterns that allow firms to operate profitably on inefficient small scales in absence of threat from potential market entry. Reform also stimulates the restructuring of domestic firms through adjustment of their operation scales & workforce to new world market demands and through specialization in production activities. Reforms in Argentina, Chile & Mexico led to a higher degree of specialization in production as well as to mergers & liquidation of insolvent firms (Thomas, etal 1991).

Strengthening the financial sector is also necessary to support trade reforms in order to sufficiently supply credit to firms that need to expand in the wake of liberalization. This requires restructuring of the sector to assure sound credit decisions as explained in chapter two. A well developed capital market is also crucial for export promotion to provide access to foreign exchange resources needed for marketing & service expenses abroad, importation of inputs, preshipment credit & term finance for investment (Thomas, etal 1991).

Developing an adequate physical & educational infrastructure plays an important role in the stimulation of a positive supply response to trade reform as demonstrated by East Asian experience. This suggests that educational infrastructure has been the nucleus of successful trade liberalization, and proposes that the mere orientation of an economy towards export production stimulates a cumulative learning process on the part of all participants. In these countries, State organizations have closely cooperated with the private sector to offer them consulting services and market information in order to improve their productivity, technology & quality control. This has ultimately upgraded the functioning of the export sector, and created an educated skilled workforce & experienced entrepreneurs as a result of greater exposure to the most recent trends in the world (Thomas, etal 1991).

Sufficient attention should be also paid to providing the export sector with a rapid, reliable & tax free access to imported inputs in order to free the production of exports from delays, nontariff barriers, import taxes, even when there exist domestic substitutes for imported inputs. In this respect, efficient schemes should be designed, and can take various forms such as: providing duty waivers & exemptions from restrictions on the importation of inputs for established manufacturers. These may also be duty drawback system as in Korea, a temporary admission system as in Morocco, or duty exemptions as in Thailand & Indonesia (Thomas, etal 1991).

In addition, improving the functioning of the trade sector in LDCs requires the establishment of an efficient infrastructure, such as, highways, airports, transport & telecommunications facilities, technology development, quality control, warehouses, information & market services. It is important to note that the mode of public expenditure adjustment to stabilization has very important implications for trade policy reform as efficient public spending is essential to ensure a positive supply response from the private sector. Indeed, entrepreneurs will be reluctant to respond to trade reform as long as supporting investment in infrastructure remains inadequate in terms of either level or focus on priority sectors (Thomas, etal 1991)

C - Sequencing and Speed of Trade Liberalization:

During the initial phases of trade reform, emphasis is made on real devaluation considered to be a priority when all trade reforms cannot be simultaneously implemented due to a country's limited administrative or budgetary capacity (Thomas, etal 1991). It is argued that real develauation should *precede* the completion of trade reform as its potential beneficial effects on exports may be developed with a time lag because supply is usually inelastic in the short run, especially when exports are primary goods or manufactured products. Thus, export promotion through exchange rate adjustment is feasible in the medium and long run as it allows tradable production the time to expand on the import competing and export fronts (Corden, 1987).

In their works, Balassa (1985), Michaely (1986) & Corden (1987) emphasize the role of real exchange rate realignment in the design of trade reform packages, and point out to the sequencing of reforms in the export and import areas as an important aspect of trade liberalization. According to them, trade reform should start by establishing a neutral incentive system between exportable and import substitutes. This can be realized by reducing restrictions on export & import fronts, switching from QRs to tariffs, and by reducing the level & dispersion of tariff rates (Thomas, etal 1991).

Import policy reform starts by replacing nontariff barriers with tariffs that provide roughly the same level of protection. This step improves resource allocation, increases transparency, reduces rent seeking and improves the fiscal situation. Reducing tariff dispersion should follow in order to proceed towards a uniform incentive structure accompanied by a reduction in the average tariff rates to reduce protection levels (Thomas, etal 1991).

Macroeconomic stability, real exchange rate devaluation, consistency of trade reforms with fiscal & monetary policies and the forcefulness of the initial reform steps reflect to a great extent the degree of government credibility. These all are necessary to prove the seriousness of trade reforms, to send signals to economic agents about the new positive changes in the economy, and hence to mobilize public support to reform in general (Thomas, etal 1991). Credibility of reforms is crucial for ensuring a positive supply response from the private sector. Indeed, entrepreneurs will be reluctant to make irreversible investment decisions to expand production in newly profitable sectors as long as doubts cast the economic environment. Inadequate commitment to the reform program limits its sustainability as explained earlier in chapter One.

The trade reform program should be transparent, decisive & well publicized in advance of its implementation to allow the various concerned parties to undertake necessary adjustments. Opposition to reform should be expected from those who stand to lose from policy changes, and this may ultimately delay or reverse reductions in protection as was the case in Zimbabwe & Yugoslavia. That is why, steps towards import liberalization combined with staged devaluations of the real exchange rate can be the best policy mix for gaining the support of exporters & some import substitutes to counterbalance the opposition of those whose protection is being removed (Thomas, etal 1991).

Based on their work "The Design of Trade Liberalization" entailing a study of the liberalization experiences of 19 countries in Asia, Latin America & Mediterranean area, Michaely, Choksi & Papageorgiou (1989) provide useful policy recommendations with respect to the pace of trade liberalization. The study reveals that successful liberalization programs have been supported by strong, bold & major rather than by marginal policy actions in order to signal out a real change in the economic policy. It also denotes that there exists no specific time frame for the implementation of successful trade reform. Nevertheless, it indicates that observations of successful liberalization experiences suggest a period of 6 to 7 years to move from massive controls to approach free trade (Michaely, etal 1989).

Part Two:

POLICY LESSONS FROM

REFORM EXPERIENCES OF

KOREA, MEXICO, CHILE & TURKEY

Chapter Four: Country Experiences with Economic Reform

The purpose of this chapter is to establish general policy implications for the 1990s' Egyptian reform, based on the country experiences of Mexico, Chile, Turkey & Korea. These are particularly selected as their reform history provides a number of lessons that distinguish between successful and non successful reformers. During the past two decades, the developing world was seriously hit by negative global shocks, denoted by the increase in interest rates & in oil prices and the deterioration in terms of trade, all leading to heavy foreign exchange losses. These were coupled by severe structural imbalances on the domestic front that increased LDCs' vulnerability to such adverse external developments (Thomas, Chibber, Dailami & De Melo, 1991).

Chile (1973), Turkey (1980) and Mexico (1982) initiated their reform efforts in the wake of foreign exchange crises when injections of capital flows ceased in recognition of the imbalanced economic structure of these countries over relying on external debt. Indeed, the securing of future foreign exchange resources had been conditional upon adoption of reform programs in these three countries, as was the case in Egypt during the 1987 reform attempts. In this regard, Korea stands by itself as the reason behind its 1980 recession had been its ambitious industrialization program that was hit by the decline in world demand. In other words, the source of imbalance in the case of Korea had been cyclical, and Korea had shown its ability to face crises like the 1973 oil shock with determination.

The chapter focusses on the sequencing and pace of liberalization efforts with respect to stabilization versus structural adjustment reforms as well as trade versus financial opening. A summary is made of the reform measures used to liberalize trade and the capital account as well as the outcome of these adjustment programs. This is coupled by a discussion of the general policy lessons that can be extracted from these experiences as well as the challenges currently facing these economies. Table (1) presents some of the most important indicators for macro economic performance of the two successfully completed reforms in Korea & Chile, and the ongoing reform programs in Mexico & Turkey.

Table (1)

Macroeconomic Indicators For The Four Countries Under Study (%)

Country	GDP Growth	Inflation Rate	Fiscal Balance/ GDP	Unemployment Rate	Foreign Debt/ GDP	Total Trade/ GDP	Private Investment/ GDP	Public Investment/ GDP
Chile								
Before (1971 – 74)	0.8	240.3	−14.7	5.4	75.5	29	5.2	8.8
During (1975 – 88)	3.1	67.8	−3.1	15.8	89.7	49.5	8.8	6.7
After (1989 – 93)	7.1	18.6	0.6	6.1	59.5	62.2	14.2	7.2
Korea								
Before (1975 – 79)	9.5	16.7	−1.6	3.8	36.8	63.9	21.8	6.1
During (1980 – 81)	2.3	25	−3.9	4.9	49.4	75.6	21.6	7.8
After (1982 – 93)	8.8	5.2	−0.9	3.2	30.2	65.7	24	7.7
Mexico								
Before (1975 – 87)	3.7	43.3	−7.2	4.8	53.2	52.2	12.7	8.6
During (1988 – 93)	2.5	48.7	−2.7	3.2	–	50.7	14.5	4.9
Turkey **								
Before (1977 – 79)	2.1	N/A	−5.6	N/A	25.3	15.7	14	17.6
During (1980 – 93)	4.7	51.2	−3.7	N/A	38.2	37.9	12.4	8.5

Source: World Bank (1995d)

* Ratios are in terms of GNP, and are calcualted from different sources: World Bank (1995a), Uygur (1995), Senses & Yamada (1990) and Celasun & Tansel (1993).

I- MEXICO:

The 1982 debt crisis reflected Mexico's high vulnerability to external factors as GDP fell by around 6% in 1982- 83. The deteriorating economic condition was signaled by rapid capital flight, reaching $ 7 billion in 1982, in response to the emerging crisis that is explained in terms of a general lack of credibility (Nash, 1991). This resulted from failed stabilization efforts since mid 1981, nationalization of private commercial banks in September 1982 and forced conversion of foreign currency accounts into pesos at an artificially low exchange rate (Ortiz, 1991).

A - Early Reform Attempts (1983 - 1987):

1 - Stabilization: This reform stage is characterized by failure to stabilize the economy as inflation slowly declined to 80% in 1983 & to just below 60% in 1984, and jumped to nearly 160% by the end of 1987 compared to 20- 25% during the 1978- 81 period (Kate, 1992). This can be attributed to rapid credit expansion to the private sector, revival of public investment during 1983- 85 (Ortiz, 1991) and to the 1986 oil shock denoting failure to reduce the economy's vulnerability to volatile oil export revenues. By mid 1985, foreign currency losses reached $ 500 million per month (Nash, 1991).

To avoid depletion of foreign reserves, focus was made on the protection of the BOP position through budget control, tight credit and active exchange rate policies (Ortiz, 1991). Consequently, public investment declined from 10% to 5% of GDP, and current spending fell from 26% to 20% of GDP between 1982- 87. Price reform began by the end of 1986 to reduce the coverage of national production under strict price controls to 37% relative to 55% in 1982, and public sector prices increased by 80% in 1987. This was coupled by gradual reduction in subsidies on basic foods in 1983 and their elimination in 1987 to be compensated by instituted programs of targeted food stamps (Nash, 1991).

2 - **Structural Adjustment:**

a - Trade Reform: Import reform began in July 1985 by reduction of licensing coverage from 92.2% to 47.1% while subjecting all goods competing with local production to import control. QRs' coverage was also reduced from 49.8% of 1983 production to 25% of 1986 production. The weighted average tariff rate was increased from 23.5% to 28.5 % to compensate for the lost protection, and the maximum tariff was lowered from 100% in 1983 to 50% in 1986 and to 30% in 1987 (Kate, 1992).

A number of export promotion measures was introduced to ensure exporters access to foreign exchange necessary to import equipment for export manufacturing, and to intermediate inputs under an import admission scheme providing rebates of duties & indirect taxes. Other export facilities allowed exporters to retain their foreign exchange earnings for future imports and simplified export insurance, guarantee schemes & administrative procedures. This was coupled by elimination of controls on imports used as inputs for exports and reduction of the coverage of QRs on export from 85% of non oil exports in 1980 to 44% in 1985 (Nash, 1991).

The exchange rate policy consolidated trade reform efforts during the 1985 adjustment, with 20% devaluation, as nominal depreciation was kept ahead of local inflation until the end of 1986. This kept imports low, replaced quantitative protection (Kate, 1992), and resulted in a trade surplus in 1987 as non oil exports reached 230% of their 1982 level (Nash, 1991). Trade opening was further supported by the adopted wage policy whereby real manufacturing wages declined by 25% in 1981- 87 to enhance Mexico's cost advantages over other export oriented countries (Nash, 1991).

b - Capital Account Liberalization: The capital account was gradually liberalized in 1986 when a debt- equity conversion program was launched to enable foreign investors to purchase public debt in the secondary market at discounts up to 30% (Nash, 1991). In that respect, Mexico followed the orthodox sequencing during 1985- 86, as it substantially liberalized its trade regime while the capital account was partially closed (Kate, 1992).

3 - **Outcome of the 1985- 87 Adjustment:** The 1986 oil shock demonstrated Mexico's continued reliance on oil exports revenues to be the main growth engine as it cost the economy high foreign exchange losses reaching 5% of GDP. As a result, economic activity suffered a severe decline as GDP fell 3.8% in 1986 to grow by only 1% in 1987/ 88. According to the World Bank report (1988) "Mexico: Trade Policy Reform & Economic adjustment", the 1985 program failed to eliminate sectoral distortions inhibiting a correct shift towards export expansion and efficient import substitution. The 1985 reform did not also simplify the regulatory environment that tightly controlled foreign investment until 1989 and the labor market, and this raised the cost of restructuring (Nash, 1991).

This reflected an initial philosophy of delayed economic restructuring for local industry as long as trade reform does not lead to higher imports. However, structural adjustment became a must three years after the initiation of trade liberalization as a result of the slow 1987 devaluation when imports rose from a monthly level of around $ 800 million in the early 1987 to almost $ 2 billion by the end of 1988 (Kate, 1992).

More importantly, reform efforts were undermined by the effect of persistent inflation on interest rates, hence on the cost of servicing domestic debt. As a result, total public spending rose to 47% of GDP in 1987 compared to an average of 34% over the 1978- 81 period. Inflation also eroded price increases in 1988, and allowed prices in real terms to rise by only 20% over the 1987 level (Nash, 1991).

B - The 1987- 94 Economic Solidarity Pact:

A comprehensive reform program *"The Economic Solidarity Pact"* was launched in December 1987, and remained in effect throughout 1994 to restore macroeconomic stability, attain external viability and to deepen Mexico's transformation to a market oriented economy. Fiscal control, debt restructuring, privatization & trade liberalization have been the key elements of this reform strategy. This stage was featured by coordination between the State, labor unions & private business sector to stabilize the economy (Kate, 1992). Indeed, inflation was reduced to 51.7% in 1988 to 30% in 1990, 12% in 1992, and reached 7.1% in 1994 (IMF, 1995b).

Fiscal control was targeted through revenue enhancing & expenditure limiting measures including the 1987 Tax Reform Act that broadened the tax base, increased corporate tax revenues as a percentage of GDP, improved collection rates, and eliminated all tax subsidies in 1988 (Nash, 1991). Public sector reform was also accelerated, and turned the operational balance from a deficit of 3% of GDP in 1988 to a surplus of 0.4% in 1994 (IMF, 1995b).

The exchange rate was unified and allowed to depreciate in nominal terms by 17% between 1990 & 1993 (Masson & Agenor, 1996) through the adopted intervention band that kept a fixed floor, and allowed the ceiling to depreciate at a preannounced rate. Consequently, the band widened from less than 1.5% at the end of 1991 to 9% at the end of 1993 (IMF, 1995b). Devaluation consolidated trade liberalization efforts as the maximum tariff was lowered to 20%, all import permits were eliminated in 1988, and the average tariff rate was reduced to 10% by March 1989 (Schadler, etal 1993). During the 1990s, trade policy entailed negotiations of free trade agreements with Western countries, US & Canada (IMF, 1995b).

Financial liberalization was rapidly completed in 1988- 89 when interest rates were freed, banks' credit & lending controls were removed, and compulsory liquidity ratios were abolished (IMF, 1995b). A broad range of financial assets was also created to accommodate higher private credit demand (Schadler, etal 1993) expanding at an annual average rate of 66% in nominal terms between 1988- 92. Consequently, financial deepening strengthened as broad money M4 growth nominally averaged 40% over the same period (IMF, 1995b).

Restrictions on FDI were completely loosened in 1989 (Nash, 1991), and full foreign ownership of firms was allowed in some industries (Mathieson & Suarez, 1993). This deregulation was coupled by the privatization of 18 Mexican commercial banks between 1990-92. Monetary policy entailed sterilization of capital inflows through sale of government issued instruments. Inflows surged to an average of 6% of GDP between 1990 & early 1994. This resulted from the successful restructuring of official external debt which dropped from 50% of GDP in 1988 to 24% in 1994 and in response to approval of the NAFTA agreement (IMF, 1995b).

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FDI represented fifth of the 1990- 93 inflows while the rest consisted of portfolio investment in the capital market, direct foreign borrowing by the private sector as well as repatriation of capital flight. Consequently, Bank of Mexico's gross holding of international reserves reached $ 25.5 billion by the end of 1993 up from $ 6.5 billion in 1989. Sale of government instruments was promoted by Mexico's improved prospects with real GDP growth recovering to 3.5% between 1989- 94, inflation averaging 20% between 1989 -92 & 7.7% in 1993- 94, and manufactured exports annually averaging 17% and accounting for 80% of total exports over the same period (IMF, 1995b).

Nevertheless, these improvements were accompanied by the widening of the current account deficit from 2.5% of GDP in 1988/89 to 6.75% in 1992 to 8% in 1994 (IMF, 1995b). This resulted from use of expansionary policies, and was coupled by rapid expansion in banks' credit to the private sector and the financial sector in 1994 (Masson & Agenor, 1996).

Moreover, the real effective exchange rate appreciated by 35% between 1990 & 93 as a result of insufficient nominal depreciation (Masson & Agenor, 1996). This was coupled by the high growth of imports which reached 52.4% in 1988, 22.1% in 1991 & 20.3% in 1994 while the value of non oil exports grew by only 18.7%, 12.1% & 17% over the same time period (IMF, 1995b). Total trade to GDP ratio averaged 50.7% over the 1988- 93 period as indicated in table (1).

C - **The 1994 Financial Crisis**:

In December 1994, Mexico witnessed a financial crisis leading to the peso collapse due to a combination of domestic political shocks and policy shortcomings. On the economic front, the growing current account deficit increased reserve losses, and led to a higher dependence on short term borrowing (Masson & Agenor, 1996). In addition, the sequence of political disturbances on the domestic front created an unstable environment with considerable degree of uncertainty. As a result, capital inflows abruptly declined, and gross foreign reserves fell by $ 19 billion between December 1993 & December 1994 (IMF, 1995b).

Doubling interest rates on short term peso- denominated paper (Cetes) to reach 18%, allowing the peso to move to the upper limit of the exchange rate band in addition to the $ 6.75 billion short- term credit from NAFTA initially eased pressures in the financial market. However, the situation changed when interest rates started to decline as $ 13 billion of private sector holdings of Cetes were replaced by short- term instruments indexed to dollars between March & October 1994 (IMF, 1995b).

The Pact renewal by mid 1994 temporarily stabilized the financial market that was soon disturbed by rumors of possible change in the exchange rate policy. This led to an additional flight from the peso & more international reserves losses that were further aggravated by the policy decision to fix short- term interest rates at 13- 14% until December 1994 (IMF, 1995b).

As a result of its failure to lift the ceiling of the exchange rate intervention band to 15% and to support the currency at 4 pesos per dollar, the government declined its strong commitment to a managed exchange rate regime, and allowed the peso to float. This adversely affected the financial market, and led to the sharp January 1995 depreciation with the peso worth only 40% of its value in mid December 1994. By 1995, an international financial rescue package was prepared to support the Mexican economy in order to restore creditworthiness in the world market (IMF, 1995b).

II - CHILE:

A - Early Reform (1974- 1985):

Chile has been an early reformer that initiated a series of ambitious economic reforms in the wake of the first oil shock in 1973 at both stabilization and structural adjustment fronts. These led to an initial period of success, with real GDP growth averaging 4.1% between 1975 & 80, that was shortly aborted in the midst of a severe recession in 1982 when the ratio of external debt to GDP reached 70.5% (Moran, 1991).

Comprehensive financial liberalization was completed over a short time period during 1974- 81 starting with interest rate liberalization, banks denationalization and the reduction of reserve requirements (Fischer & Reisen, 1993). This is in addition to capital account liberalization completely removing restrictions on FDI in 1975 and partially eliminating controls on private external investment in 1977 (Clavijo, 1995). This was followed by elimination of restrictions on external medium- term capital flows in 1979, whereas controls on short term capital inflows were maintained until December 1981 (Mathieson & Suarez, 1993).

Price decontrol began in 1975, and was followed by trade liberalization in 1976 to exert downward pressures on price increases in the tradable sector in order to combat inflation (Corbo & Solimano, 1991). This entailed removal of all QRs on imports as well as gradual reduction of tariffs to ranges of (0-35%) in 1977 & to (0-10%) in 1979 (Clavijo, 1995). This was coupled by the social security reform in 1981 (Clavijo, 1995) transforming the publicly supported system into one based on private savings and investments (Moran, 1991).

Fiscal reform entailed the introduction of the value added taxes (VAT) system in 1975 as well as the implementation of a bold privatization program that generated large revenues to the budget annually averaging 6.2% of GDP during 1975- 80. As a result, the fiscal deficit turned into a surplus of 3% of GDP over this period (Clavijo, 1995). This privatization phase was featured by the role of the State in financing private sector acquisition of divested entities, and lacked enforcement of screening procedures necessary to prevent joint interlocking ownership between financial and corporate institutions (Andic, 1992).

Despite the adoption of tight fiscal and monetary policies, inflation averaged 98.3% between 1975 - 81 (Clavijo, 1995). This induced a shift in the adopted exchange rate policies varying between passive crawling peg, pre- announced daily devaluation and fixed rate systems that all failed to stabilize the economy as real devaluation was slower than the difference between local and world inflation rates. Consequently, this widened the spread between local and world interest rates (Mathieson & Suarez, 1993), and led to massive capital inflows. These resulted in 37% real appreciation by the end of 1980 as well as a tenfold increase in foreign exchange reserves equivalent to 7% of GDP between 1977- 81 (Fischer & Reisen, 1993).

In his work "Goodby Financial Repression, Hello Financial Crash", C. Alejandro (1985) describes Chile's early financial liberalization as a fiasco leading to bank crises with non performing loans constituting 8.5% of total loans in 1983 (Fischer & Reisen, 1994). This necessitated intervention of the Central Bank in 1983 to save the five largest banks, to liquidate a few financial institutions, to provide financial assistance to local banks whose deposits were publicly guaranteed and to impose upper limits on nominal interest rates (Moran, 1991).

Following the 1984 debt rescheduling agreement with commercial creditors, a large public investment program was launched in an attempt to stimulate real GDP growing at 6.3% in 1984 compared to a real decline of 0.7% in 1983 (Clavijo, 1995). Consequently, the current account deficit widened from 5.7% of GDP in 1983 to 10.7% in 1984. This ultimately led to reversal of previous trade reforms as tariffs were leveled off at 35% by the end of 1984 (Moran, 1991).

B - The 1985 Adjustment Program:

The 1985 adjustment program tackled the most chronic problems of the economy on all fronts in order to restore non inflationary sustainable growth and macroeconomic balance. This dictated debt rescheduling, fiscal reform, domestic resource mobilization, rehabilitation of corporate & financial sectors, trade reform, maintaining competitive exchange rate as well as stimulating FDI (Moran, 1991).

1 - **Stabilization Program:** Adoption of the 1985 adjustment program was instrumental in concluding Chile's external debt restructuring agreements. These were complemented by two innovative debt conversion mechanisms: buyback & debt equity swap respectively converting external debt into local debt certificates sold in the capital market and into equity investment (Moran, 1991). Consequently, Chile's external debt as a percentage of GDP declined from a peak of 140% in 1985 to 60% in 1990 & to 40% by 1994 (Clavijo, 1995).

In addition, inflation was reduced to an annual average of 14.7% between 1990- 95 compared to an average of 20.8% in 1982- 89. The fiscal balance also turned from a deficit of 2.6% of GDP in 1985 to surpluses of 2.5% in 1988, 3.2% in 1992 (Suarez & Weisbrod, 1995), and averaged 0.75% in 1993- 94 as a result of both revenue increases and expenditure cuts (Clavijo, 1995).

Fiscal reform initially involved a general tax reduction of maximum rates from 56% to 50%, enlargement of income tax brackets as well as exemption of retained earnings from personal income taxed at a flat rate of 10%. This was important to promote local savings and investments necessary to cover transitory costs resulting from the privatization of social security system, from public debt servicing obligations and losses of the financial crises (Moran, 1991).

Subsequently, personal income tax brackets were lowered from (0 - 57) in 1986 to (5 - 50) in 1992, corporate income taxes from (10 - 37) to (15 - 35), and the VAT increased from 8.2% in 1975 to 18% in 1994 (Edwards, 1995). As a result, investment gradually increased from 17.2% of GDP in 1985 & to 26.6% in 1994, and savings grew from 19.7% to 28% of GDP respectively (Braga, Nogues & Rajapatirana, 1995). The private investment share of GDP reached 14.2%, whereas public investment averaged 7.2% between 1989- 93, as indicated in table (1). Social spending and poverty reduction policies have become an integral part of the 1990s reform agenda aiming at an increase in social expenditures by nearly 1 to 2% of GDP through tax increases (Clavijo, 1995).

2 - **Structural Adjustment:**

a - Restructuring of Financial & Corporate Sectors: Recapitalization and reprivatization of previously divested entities presented the core of the 1985 reform as the initial privatization phase (1975- 80) led to excessive joint ownership, resulting in heavy asset concentration with weak financial and industrial conglomerates (Andic, 1992). This is because financial opening relaxed supervisory banking regulations, and allowed risky lending practices to insolvent but affiliated firms (Fischer & Reisen, 1994). Recapitalization cost the Central Bank enormous losses averaging over 6% of GDP in 1983- 84 and 11% during 1985- 86. This enabled ailing financial institutions and corporates to stretch their losses over a long period and to improve their debt- equity ratios (Moran, 1991).

This was coupled by the enactment of a new banking law in 1987 to strengthen the supervisory & legal framework of domestic banking sector to prevent future crises and to establish greater accountability in banking activities. In addition, the general deposit guarantee scheme was gradually replaced by a limited one spreading risk among shareholders, bank creditors, depositors and the State (Moran, 1991).

The privatization process regained its momentum in 1986, and was featured *popular capitalism* as the government ensured redistribution of shares among a wide range of ownership between small and large investors. Progress proceeded during the 1990s to divest public services including the national airline and electric power plants (Andic, 1992). This significantly contributed to fiscal consolidation as total revenues accruing to the budget reached 9.4% of GDP in 1990 (World Bank, 1995b).

b - Trade Reform: Import reform entailed gradual reduction of tariffs from 35% to 30% in March 1985, to 20% in July 1985 & to 15% in January 1988 (Moran, 1991). This was followed by the adoption of a uniform 11% tariff rate during the 1989- 91 period and the complete removal of all QRs in 1993 (Braga, etal 1995).

A series of export promotion reforms were employed, such as, elimination of stamp & value added taxes on investment for export production, reduction of banks' reserves needed for export credit, provision of fiscal credits up to 10% of the FOB value of exports and removal of the 20% uniform tariff on imported capital goods & intermediate inputs for exports (Braga, etal 1995). Institutional & technical assistance was also expanded through establishment of export credit insurance programs & State agencies to encourage FDI in export oriented activities (Moran, 1991).

As a result, export growth annually averaged 9.8% between 1985 - 94 in contrast to less than 1% growth in 1981- 84, while annual import growth averaged 10.5% between 1985- 94 compared to a real decline of 4.8% between 1981- 84 (Braga, etal 1995). Total trade to GDP ratio reached 62.2% in 1989- 93 as compared to only 29% in the pre- reform era as shown in table (1).

The competitive behavior of the exchange rate contributed to export promotion as real devaluation reached around 50% during 1984- 89 through continuous adjustment of nominal exchange rate for differences between local & foreign inflation rates (Corbo & Silmano, 1991). A reference band system was also adopted in the 1990s to allow for a higher degree of flexibility in managing the exchange rate (Clavijo, 1995).

It can be stated that the 1985- 90 period was featured by Chile's adjustment to newly adopted structural reforms that enabled the economy to maintain vigorous real GDP growth averaging 6.3% between 1990 & 1995 relative to a modest average rate of 3.3% during the 1980s. This was coupled by reduction in open unemployment falling from 11.1% in 1982- 89 to 5.2% as a result of accelerating real growth in a flexible labor market (Clavijo, 1995).

III - TURKEY:

A - The 1980 Adjustment Program:

In January 1980, an economic reform program was launched to announce a radical shift in the orientation of the economy from inward to outward looking strategies (Ozatay & Sak, 1995). While the short run goals of the program aimed at stabilization of the economy, long run objectives targeted a wide scope of structural reforms including public sector reform, export promotion and financial liberalization to stimulate private savings and investment (Uygur, 1995).

1 - Stabilization: The 1980 reform failed to achieve its primary target stabilization that was *temporarily* attained during its initial phase when inflation was reduced from 133% in 1980 to 35% in 1981 (Krueger & Akton, 1992), averaged 37% during 1982- 87 as a result of restrictive fiscal and monetary policies (Foroutan, 1991). However, disinflation worsened from 1988 onwards as inflation jumped to 75% in 1988, and oscillated between 60 & 80% between 1989 & 94 (Scaciavillani, 1995). Fluctuations in the inflation rate were reflected by movements in the fiscal deficit rising from 1.7% of GNP in 1981 to 3.4% in 1987, averaging 3.8% between 1988- 92, and reaching 6.7% of GNP in 1993 & 3.8% in 1994 (Uygur, 1995).

This was the outcome of a number of factors that raised domestic demand, and lowered the exchange rate during the late 80s & early 90s. These included expansionary policies, real wage increases in the manufacturing sector by about 28% in 1989, 25% in 1990 & 34% in 1991 as well as decline of nominal interest rates behind rising inflation. In addition, domestic debt (TBs) increased from an average of 3.9% of GNP between 1981- 86 to 6.1% over the 1987- 91 period, and accelerated to 13.9% in 1994. This had been coupled by the increase in foreign borrowing from 30.3% of GNP between 1981- 83 to 49.7% in 1994 (Uygur, 1995).

Failure to control inflation was partly attributed to the limited nature of the 1983 public sector reform. This undermined price decontrol efforts sharply increasing prices at rates between 50 & 100% in 1984 (Uygur, 1995), and hence improving PEs' profits that accounted for 1.55% of GNP in 1985 (Foroutan, 1991). However, this improvement was offset by the poor performance of PEs whose value added share as a percentage of GDP stagnated around 7% between 1983- 91 (World Bank, 1995b).

2 - Structural Adjustment:

a - Trade Reform: The exchange rate was the chief policy instrument used for export promotion during the 1980 trade liberalization program. Reform started by unification of the multiple exchange rate system (Foroutan, 1991) as well as by a series of large devaluations of the fixed exchange rate reaching more than 50% in nominal terms in 1980 (Krueger & Akton, 1992). This led to a cumulative real depreciation of over 33% between 1980 & 86 (Foroutan, 1991).

Various measures were introduced to permit a higher demand for foreign currency, and hence led to an increase in the equilibrium exchange rate (Krueger & Akton, 1992). These allowed banks to retain up to 80% of their foreign currency receipts to cover acceptance credit obligations to finance imports, reduced requirements for advance deposits on imports, and permitted exporters to retain 5% of their foreign exchange receipts (Krueger & Akton, 1992). Other export facilities entailed the elimination of duties on imports used for export production, simplification of administrative procedures associated with exportation as well as provision of direct incentives; such as, subsidized export credits (Foroutan, 1991).

On the other hand, import liberalization was cautious due to fears from potential BOP problems, and started by elimination of the quota list in mid 1981. By December 1983, a negative list was introduced to allow importation of all unprohibited goods, and most QRs in the form of prohibitions & licensing requirements were abolished by 1988 (Foroutan, 1991).

A large scale tariff rationalization reduced the average tariff by 20 % in 1984, and import procedures were greatly simplified (Krueger & Akton, 1992). Nevertheless, much of these efforts was temporarily reversed as import levies were imposed to effectively raise the average tariff from 7.4% in 1984 to 12.5% in 1988 in order to protect PEs unable to face foreign competition (World Bank, 1995b). In 1989/ 90, overall tariff plus surcharge rates were lowered (Uygur, 1995).

Exports positively responded to the 1980 reforms, and became the main growth engine as they more than trippled between 1980- 87 (Siam, 1995) with the manufacturing share increasing from 36% to 79% (Uygur, 1995). However, export growth significantly slowed after 1987 as a result of the substantial decline in real exchange rate appreciating by a total of 30% between 1989- 90. This reduced the share of exports in GNP from 21.4% in 1987 (Aktan, 1995) to 13.7% in 1993 to reach its 1986 level (Uygur, 1995).

Imports increased from 15.4% of GDP in 1981- 83 to 18.4% in 1989, 19.1% in 1993 & 20.1% in 1994 (Uygur, 1995). Import increase and export decline were reflected in the trade deficit increasing from $ 3.2 billion in 1987 to $ 9.5 billion in 1990 & $ 14.2 in 1993 (Ozatay & Sak, 1995). The trade balance showed a recovery in 1994 as the deficit declined to $4.2 billion (Ozatay & Sak, 1995) due to export increase to reach 21.1% of GDP (Uygur, 1995).

b - Reform of the Financial Sector: Financial reform initially focussed on internal restructuring in order to modernize the financial sector, deregulate banks, free interest rates partially liberalized in 1980, enact a new Law for regulating the auditing & accounting profession in 1983 and eliminate taxes on financial transactions in 1984 (Foroutan, 1991). Major liberalization began in 1989 with the relaxation of conditions on profit transfer & capital repatriation (Krueger & Akton, 1992), reduction of restrictions on the Turkish Lira (TL) convertibility, and encouraging the operation of foreign banks in Turkey (Foroutan, 1991). Residents were also allowed to buy foreign securities abroad, foreign investors were able to enter the capital market, and national banks were permitted to extend foreign currency credits to foreign companies (Uygur, 1995).

Turkey's financial liberalization process succeeded to mobilize large saving resources as market capitalization in Istanbul Stock Exchange, established in early 1980s, increased from $ 938.9 million in 1986 to $ 37.8 billion in 1993 (Sak, 1994). In addition, the share of private savings in GNP rose from an average of 13.6% between 1982- 85, to 19.3% between 1987- 90 and 23% over the 1991-94 period (Uygur, 1995).

B - The 1993 Currency Substitution Crisis:

In 1993, the Turkish economy experienced a currency substitution crisis when the ratio of TL holdings to foreign currency holdings declined from 4.5 in 1989 to 1 in 1994 (Scacciavillini, 1995). This resulted from persistent imbalances denoted by expansionary policies, limited public sector reform, contributing to large fiscal deficits, as well as heavy reliance on domestic & foreign borrowing. These reversed the rapid GDP growth trend averaging 5.2% between 1981- 86, and that was followed by the 1987 spectacular growth of 9.5%, supported by expansionist policies for electoral reasons, as real growth slowed to an average of 4.3% between 1988- 93, and declined by 5.4% in 1994 (Uygur, 1995).

These imbalances undermined stabilization efforts and sustained inflation leading to high interest rates that further widened the fiscal deficit. In addition, real TL appreciation from 1989 onwards was attributed to substantial capital account liberalization leading to surges in speculative capital inflows (Uygur, 1995). These reached $ 3 billion between 1989- 93, compared to only $ 1 billion during 1985- 88, to exploit interest rate differential with nominal rates averaging 73% between 1989- 93 (Ozatay & Sak, 1995).

By the end of 1993, demand for foreign exchange increased whereas demand for TBs declined to underline the widespread instability in the financial markets in response to Turkey's reduced credit rating by international institutions and to discontinuation of foreign credit. This induced the Central Bank to intervene in the foreign exchange market to suddenly depreciate the exchange rate by 13.6% in mid January 1994 (Uygur, 1995).

Despite the announcement of a stabilization program in mid 1994, demand for foreign exchange was not reversed, and TBs were not sold except when real interest rates reached a phenomenal level of more than 100%. The crisis seriously harmed the real sector of the economy as resources shifted from tradable to non tradable sector. This was denoted by the decreased share of tradables in gross fixed capital investment from 36.7% in 1985 to 26.5% in 1993 and by the decline in manufacturing output to twice as low as in 1980 (Uygur, 1995).

Consequently, inflation further jumped to 120.7%, the real exchange rate overshooted by more than 170% (Uygur, 1995), and unemployment increased to 15.9% of the labor force up from 12.1% in 1977 (Aktan, 1995). The situation was reversed by mid 1995 as the stabilization program has been in place, and inflation was reduced to two digit level in the range of 70 - 80% (Uygur, 1995).

IV - KOREA:

The Korean economy achieved outstanding performance under the government led growth strategy during the 1960s & 70s when real GNP annually averaged 10.4% between 1965- 73 & 9.6% in mid 1970s. This rapid growth trend was shortly interrupted by the 1980 recession slowing real GNP growth to 4% between 1980- 83 (Alesina, 1987). The 1980 recession reflected the worsened external payment position accompanied by domestic structural imbalances. Specifically, expansionary policies were used to support the ambitious industrialization program that dictated a radical shift in the industrial structure, in investment allocation mechanism and in the structural composition of exports from light to large scale heavy industries perceived as the key to advanced industrial status (Dailami, 1991).

A - The 1980 Reform Program:

External as well as internal imbalances forced a rethinking of economic strategy in early 1980s when Korea decisively opted for the adoption of rapid tight macroeconomic and outward oriented trade policies necessary to enhance its competitiveness in the world market (IMF, 1995b). The growth momentum was successfully resumed with the relaxation of some regulatory policies in the 1980s and the acceleration of the liberalization process in the 1990s safe - guarded by prudent macro policies that are used in consistency with the new globalization philosophy (Oum & Cho, 1995).

1 - Stabilization Process: Stable competitive real exchange rate and contractionary policies were adopted to reduce inflation to 7.2% in 1982, an average of 3.5% between 1983-88 (Dailami, 1991) and of 6.8% between 1989- 94 (IMF, 1995b). Tight monetary policy resulted in positive interest rates mainly maintained through credible economic policies (Fischer & Reisen, 1993). This reduced private investment by 11.5% to reflect rationalized capital investment, averaging 17% during 1984- 88, to keep productive capacity in line with demand growth (Dailami, 1991). Private investment reached 24% of GDP, while public investment averaged 7.7% over the 1982- 93 period, as shown in table (1).

In 1980, the won was devalued by 17% (Dailami, 1991) under the newly adopted managed float exchange rate system whereby the won was pegged to a basket of major foreign currencies. It is worth noting that the current account balance was directly targeted in the 1980s through the exchange rate policy direction: depreciating when the balance exhibits deficit and appreciating when it turns into surplus. Subsequently, a market average exchange rate system was adopted in 1990 to determine the exchange rate through demands for and supplies of foreign currencies. This system sets the real effective exchange rate (REER)[1] as a weighted average of real exchange rates of the major trading partners to indicate the competitiveness of Korean products in the world market (Oum & Cho, 1995).

2 - Structural Adjustment: During the 1981- 85 period, structural reform initially focussed on promoting the performance of the industrial sector, considered the key engine to growth. That is why, a wide range of trade & medium term financial reforms were introduced to expose domestic industry to greater external competitive pressures, to reduce the role of the State in the finance process and to provide access to capital and technology (Dailami, 1991).

a - Trade reform: Import policy reform was gradual as it started in 1981 with the reduction of non tariff barriers. Import liberalization ratio, denoting the automatically approved imports as a percentage of total imports, increased from 69% in 1980 to 80% in 1983, to 93.6% in 1987 & to 94.8% in 1988. The average tariff rate was also reduced from 31.7% in 1982 to 21% in 1985 & 18.1% in 1988, and the tariff schedule was narrowed to reach uniform rates of 5 to 10% for raw materials, 20% for intermediate goods & 20- 30% for capital goods (Dailami, 1991). The Korean approach to current account adjustment was unique, and facilitated trade liberalization efforts as strong export performance after 1981 enabled the economy to sustain import growth throughout the 1980s & 90s (Dailami, 1991). The ratio of total trade to GDP reached 75.6% in (1980- 81) and averaged 65.7% in post reform era as shown in table (1).

[1] The REER is defined in Appendix (A)

b - Financial Reform: During the early 1980s, financial liberalization was slow, internally gradual and externally limited to reflect fears from financial institution failure. Reform started in 1982 with gradual interest rate liberalization between 1982- 88, privatization of national commercial banks, and relaxation of entry barriers for non bank institutions as well as foreign banks (Fischer & Reisen, 1994).

A shift was gradually made in 1983 from State direct intervention in credit allocation and monetary policy to indirect measures through reserve requirements, open market operations and market determined interest rates. This was followed in 1984- 85 by the introduction of new financial instruments to enhance the capacity of local institutions to mobilize savings (Dailami, 1991), and by the relaxation of restrictions on the holding of foreign currency denominated deposit in 1991 (World Bank, 1993a).

The opening up process was speeded up in 1993 with the liberalization of all interest rates except for those on demand deposits and simplification of credit controls. This is in addition to the stimulation of foreign investment in the capital market by raising the ceiling for foreign stock investment from 10 to 15% as well as by allowing the issuance and listing of foreign stocks in the market in 1997 (Hong, 1995, p.4).

A foreign exchange policy reform plan was formulated by December 1994 to expedite capital account liberalization and to transform Korea's foreign exchange system from regulation to liberalization to meet the standards of advanced countries. FDI promotion is recognized as an indispensable element of globalization; that is why, a "one stop service system" was introduced in 1994 to further deregulate foreign investment (Hong, 1995).

By 1997, deregulation is expected to encompass all business sectors, except for those related to national security and public interest, and will be accompanied by more attractive financial & tax incentives. These reforms are supported by infrastructure development in transportation and communication annually costing substantial capital investment estimated at $ 20 billion (Hong, 1995).

The Korean economy recorded a rapid real GDP growth averaging 6.2% in mid 1980s, 7.5% between 1990- 94 (IMF, 1995) & 9.6% over the first half of 1995 (Hong, 1995). Growth was led by the manufacturing sector growing at 10.4%, exports at 16.2% & capital investment at 23.3% in 1994 (Kim, 1995).

Priority was awarded to price stability presenting a current concern as inflation increased from 4.8% in 1993 to 6.2% in 1994 & 5.5% in 1995 (Hong, 1995). This was due to recent wage increases in the industrial sector averaging around 14.3% between 1991- 94 and reflecting tight labor market conditions. This also resulted from the sudden jump in the price of some imported raw materials & fuels (Kim, 1995). The budget deficit stood at less than 2 to 3% of GDP in 1995 (Oum & Cho, 1995), and unemployment reached 2.4% in 1994 (Kim, 1995).

The current account balance swung from a surplus of $ 0.4 billion in 1993 to a deficit of $ 4.8 billion in 1994 to reflect an increase in the growth rate of imports from 2.5% in 1993 to 22.1% in 1994, ahead of the 16.2% growth in exports in 1994 up from 7.3% in 1993 (Kim, 1995). However, this deficit is manageable as it only presents less than 2% of GDP, and imports of capital goods account for 90% of it, showing the acquired strength in capital intensive heavy industry (Hong, 1995).

V - General Policy Lessons

The reform history of these four countries highlights the weight of serious reforms in achieving a speedy growth recovery. Sustained stabilization efforts coupled by deepened structural reforms allowed Chile to safely integrate into the world economy in the 1990s, and made Korea's recovery relatively rapid. In contrast, Mexico & Turkey s' recent crises dictated the initiation of new stabilization programs in 1995. These experiences demonstrate the unquestionable impact of sound management of policy instruments, particularly the degree of consistency between policy variables in addition to the scope, speed and sequencing of reforms in ensuring the success of the overall reform program.

A - Successful Reform Stories and Current Challenges:

The impressive growth performance achieved by both the Korean & Chilean economies, averaging 8.8% & 7.1% respectively after the implementation of reform, underlines the basic fundamentals required for a successful recovery. This is primarily attributed to sound macro management that maintained economic stability, reducing inflation from an average of 240% to 18% in Chile, and from 16% to 5% in Korea, over the pre & post reform periods as indicated in table (1). Overcoming inflation resulted from the adoption of tight fiscal and monetary policies that turned the budget deficit into a surplus of 0.6% in Chile, and reduced it to only 0.9% in Korea during the post reform era.

During the past three decades, Korea has been a remarkable success story as the economy has always adjusted rapidly to new demands of the global market. It has been argued that over-emphasis on the promotion of heavy industries was the only weakness that the Korean economy suffered from during its initial development stage. And yet, economic strategy aimed at the development of a strong industrial base as the main growth engine mainly have necessitated the shift from the focus primarily made on light industries in the 1960s & 70s, and towards heavy industries by the mid 70s.

During the 1990s, economic expansion was spread to all industries in order to achieve a sustained balanced growth with industrial production growing at 11.1% in 1994, and average capacity utilization ratio reaching its maximum of 82.7% since 1985 (Kim 1985). It may be stated that Korea's strong economic structure ensured an automatic resumption of the growth momentum. This was only interrupted during the 1980 recession when growth slowed to 2.3% as shown in table (1), and then accelerated upon the rapid adoption of contractionary policies and continued pursuit of an outward oriented strategy.

Similarly, Chile has recently received high investment grade ratings as the Institutional Investor's Country Credit Ratings in 1995 ranked it at a competitive position among emerging markets like Thailand (Galal, 1995). This may be attributed to deepened structural reforms that enabled the economy an increased reliance on FDI, averaging 2- 5% of GDP in early 1990s, and on long term debt borrowing that largely contributed to financing Chile's growing capital stock. These have acted as engines for sustainable growth, and have been stimulated by real growth acceleration as well as by significant increases in labor productivity averaging 2.7% annually during the 1990s compared to an average of 1% in 1983- 89 (Clavijo, 1995).

According to the IMF report (1995) "World Economic Outlook", Korea's experience with structural adjustment & stabilization efforts serves as a model in terms of the desirable sequencing and speed of reforms with high priority awarded to stabilization in early 1980s. Major structural adjustment reforms were gradually completed, and concentrated on trade reform, while financial opening was slow and limited during the early 1980s, and was expedited in early 1990s after the solidification of real sector reforms.

Strong export performance enabled Korea to sustain growth of imports that were gradually liberalized over the 1981- 88 period, and that mainly consisted of capital goods necessary to serve the rapidly growing industrial sector. Korea's cautious financial opening reflects great awareness of its significant weight in ensuring a correct integration into the global economy in the 1990s.

In this respect, the Korean experience demonstrates wise management of the real exchange rate that targeted the current account in the 1980s during trade liberalization, and succeeded to insulate the Korean economy from large capital inflows over the first half of the 1990s. Indeed, the new exchange rate system has effectively targeted the capital account through a widened band. This allows the REER to flexibly fluctuate within 10% range in the 1990s as nominal depreciation has been kept in pace with local inflation (Oum & Cho, 1995).

In contrast, Chile's 1982 financial crisis, resulting from failed stabilization attempts and substantial financial liberalization, has significantly contributed to the prevailing lack of enthusiasm with respect to early and rapid dismantling of capital controls. Such disappointing outcome was largely influenced by real appreciation that resulted from massive capital inflows prompted by early financial opening, and attracted by sustained interest differentials.

This is in addition to the premature privatization attempts that led to excessive joint ownership, and seriously affected production & investment decisions. Inconsistent policies ultimately led to reversal of early trade reforms in 1984, and later necessitated the reprivatization and recapitalization of previously divested entities. This heavily cost the Central Bank of Chile as was the case in Egypt during the 1991 ERSAP, as discussed in Part Three.

It may be stated that Chile's non- inflationary dynamic growth during the post 1985 period is mainly attributed to its reform approach that simultaneously corrected the major imbalances in order to avoid pitfalls of the initial unsuccessful experience. Indeed, fiscal control, reprivatization, financial reform, maintaining a competitive & stable real exchange rate and trade liberalization have all complemented each other, and contributed to the acceleration of the economy's growth achieved over a five year period during the early 1990s.

Despite their satisfactory growth performance, both the Korean & Chilean economies are currently facing new challenges that are typical outcomes of the new liberalization phase in most developing economies including Egypt in the 1990s. Specifically, a full scale financial liberalization in Korea is expected to induce large appreciation of the won and to worsen the current account in the short term. The Korean economy has so far been largely immune from the destabilizing effects of large inflows that reached more than 2% of GDP in the 1990s because of the strong industrial sector that has been awarded the highest priority in the economy (Oum & Cho, 1995). However, potential fears may materialize in the future as foreign investment flows to Korea, totalling $ 1,317 million in 1994, have been mainly directed to the service sector due to increased labor cost over the past years (Kim, 1995).

It is argued that sterilization of substantial capital inflows can be only used in the short term as it cannot effectively serve in the long run since it may sustain high interest rates, and ultimately lead to more capital inflows. Recommendations focus on the reduction of local inflation, averaging 5% a year in 1990s & above the 2% rate in developed countries, through conservative monetary policies to lower high nominal local interest rates presenting the primary reason for large capital inflows (Oum & Cho, 1995).

In Chile, concerns about sustainability of FDI flows placed a great weight on the mobilization of domestic savings. That is why, a new Capital Market Law was approved in 1994 in order to develop a new range of financial instruments capable of attracting local resources. External competitiveness is also challenged by the 1% increase in unit labor costs, with real wage demands surpassing productivity gains in the 1990s, and by 16% real appreciation in 1994 over the 1989 level as a result of large short term capital inflows. This has been reflected by the widened current account deficit averaging almost 3 to 4% of GDP in 1993- 94 compared to an average of less than 2% of GDP between 1989 & 1992 (Clavijo, 1995).

Capital inflows are estimated at 2 to 3% of GDP in the early 1990s, and are stimulated by persistent positive interest rate differentials ranging between 5 to 15% over the 1990- 95 period. Sterilization, of such inflows, was only partially used due to the high quasi- fiscal losses incurred by the Central Bank, and selective capital controls are maintained in order to avoid potential disruption of domestic markets.

The Chilean economy is currently facing the dilemma of maintaining domestic interest rates at a sufficiently moderate level to satisfy both domestic & external consistency. While interest rate reduction is necessary to minimize short term capital inflows in order to avoid their destabilizing effect on the real exchange rate, high rates are needed in order to promote local savings (Clavijo, 1995). It may be stated that Egypt is currently facing the same interest rate dilemma.

B - Unsuccessful Reform Experiences and Factors Behind Crises:

Mexico and Turkey's recent crises send warning signals to reforming LDCs, and stress upon stabilization as a prerequisite for a sustainable non inflationary growth through strengthened structural reforms. Growth has averaged 2.5% in Mexico & 4.7% in Turkey, while inflation respectively averaged 48.7% & 51.2% during the implementation of reform efforts, as shown in table (1). The slow growth performance in these economies may be mainly attributed to poor economic management that failed to contain inflationary pressures in spite of the adoption of suitable sequencing & pace of reforms.

During its early reform attempts (1983- 87), Mexico followed the orthodox sequencing initially focussing on stabilization in 1983 then addressing structural adjustments efforts in 1985. The trade regime was substantially liberalized in 1985, while partial capital account liberalization was cautiously allowed in 1986 through debt conversion scheme. However, failure to stabilize as well as reluctance to restructure the economy undermined reform efforts on all fronts. This urged the adoption of the 1987 program whose comprehensiveness succeeded to simultaneously address the stabilization and structural adjustment fronts of reform.

Under the 1987 Mexico's Solidarity Pact, the trade liberalization process was accelerated, and the financial sector was significantly opened in 1989 after solidification of trade reform. Similarly, Turkey's 1980 stabilization and structural adjustment efforts were simultaneously, and gradually implemented. Trade reform started with rapid export promotion and cautious import liberalization, while financial liberalization slowly began in 1983, and was followed by substantial capital account liberalization in 1989.

Mexico's external competitiveness was enhanced by real wage decrease in the manufacturing sector and by real devaluation that gradually replaced quantitative protection, postponed the exposure of domestic industries to foreign competition, and supported the completion of trade liberalization during the late 1980s. In Turkey, real devaluation was also the chief policy instrument used for export promotion during the 1980- 86 period, while import liberalization efforts were temporarily reversed to protect the poorly performing PEs, and were only resumed in the early 1990s.

Nevertheless, the strong export performance was significantly slowed in Turkey after 1987 and in Mexico by the early 1990s due to real appreciation. This resulted from insufficient nominal deprecation between 1990- 93 in Mexico, and from the 1989 substantial capital account liberalization in Turkey where the real sector was seriously affected as heavy investments were channeled to the non tradables sector.

The 1994 peso collapse in Mexico and the 1993 currency substitution crisis in Turkey characterize the detrimental consequences of general lack of credibility in government policy. It may be argued that this directly followed from failed stabilization attempts that followed from the use of expansionary policies. This ultimately undermined economic agents' assessment of the state strategy, and hence adversely affected the overall reform program.

Both economies have generally suffered from persistent imbalances denoted by the relaxation of monetary policies to serve political considerations and rapid credit expansion in Mexico, as well as by the heavy reliance on local & foreign borrowing and limited public sector reform in Turkey. These raised Turkey and Mexico s' vulnerability to external financial resources that rapidly shrunk in face of severe political disturbances in Mexico and in response to the widening imbalances in Turkey. It is interesting to note that these weaknesses characterized the Egyptian economy during the 1987 reform attempts that inadequately addressed the economy's major imbalances at both the macro & micro levels, as discussed in next Part.

These crises underline the high cost of the poor management of monetary and exchange rate policies. Specifically, the Mexican authorities' decision to lower the interest rates led to a considerable shift from Cetes to short term dollar- indexed instruments and hence to more flight from the peso. Furthermore, Turkey's 1994 sudden and major depreciation presented an unsuccessful attempt to raise the exchange rate and to regain public confidence in the value of the local currency. In this respect, it may be emphasized that reallocation of factors of production & financial resources depends to a great extent on the degree of credibility in government policy to ensure a positive supply response from economic agents. This currently presents an important determinant of the success of the 1991 Egyptian reform program.

The main thrust of the Mexican & Turkish experiences stresses upon the development of structural dynamics within the economy to mobilize scarce local and foreign exchange resources as demand for external capital flows has become highly competitive in the global market. That is why, the 1994 Turkish reform agenda awarded export promotion policies priority as a key element of long term growth strategy because exports present a major source for foreign exchange revenues that were in shortage during 1994 & mid 1995 when access to external borrowing ceased. It may be also argued that the investment climate should be improved in LDCs in order to attract more stable types of capital in the form of FDI that contributes to the stability of the economy. This is in contrast to portfolio investment that can be easily liquidated, and leads to rapid capital flight & heavy foreign exchange losses in face of emerging political and economic disruptions.

The theoretical framework, literature review & the reform experiences of the four countries under study have all demonstrated that the success of a reform program depends to a great extent on the design of a consistent package that ensures the appropriate scope, speed & sequencing of liberalization measures. This is in addition to the commitment and flexibility of policy makers to revise their package in response to domestic and external circumstances in the short and medium terms.

Macroeconomic stability has been established as a prerequisite for a successful liberalization process. This has been advocated in order to avoid the potential problems associated with opening up domestic markets in an inflationary environment. Strong arguments have also been made in favor of the postponement of capital account liberalization until trade reforms are solidified. Reasons for this policy stance have been closely related to the behavior of the real exchange rate. In addition, emphasis has been made on the adoption of coherent domestic policies as inconsistency has been judged to be one of the main causes behind the reversal of reforms.

The comprehensiveness of reforms has also been strongly supported as a key ingredient to the success of LDCs in exploiting complementarities between different reform tools. For instance, success of trade liberalization, entailing tariff reduction, depends to a great extent on other supportive policies such as maintaining a competitive real exchange rate as well as reforming the regulatory framework & restructuring the public sector. With regards to speed of reforms, there has been no consensus in the literature, and yet country examples in this work suggest that gradualism is preferable for LDCs in order to reduce transitional costs and to avoid the risk of reversal.

Part Three:

STABILIZATION &

STRUCTURAL ADJUSTMENT REFORMS

in EGYPT

Chapter Five: Stabilization & Structural Adjustment Reforms in Egypt

The past five years have been witnessing extensive reform efforts exerted in the course of the economic reform and structural adjustment program (ERSAP) launched in 1991 in accordance with the Stand By & Structural Adjustment agreements signed with the IMF and the World Bank respectively. This chapter presents an assessment of the progress made on the stabilization and structural adjustment fronts with respect to the scope, speed & sequencing of the 1991 reform with special emphasis on the main difficulties presenting a real challenge to the sustainability of the overall program.

Particular attention is paid to portraying the Egyptian economy in the pre - reform era, over the past three decades 1960-1990, during which some developments seriously affected the Egyptian institutional & incentive frameworks whose reform presents the core of the undergoing reform program. The chapter starts with a snapshot of the Open Door Policy (ODP) initiated in 1974 as well as a discussion of the unfulfilled objectives of the 1987 reform attempt. This overview is important to appreciate the pressing need for the 1991 reform program in view of unsustainable economic imbalances that grew over the past decades as a result of poor macro management.

This delayed economic restructuring during Al Infitah period when the rapid growth trend was afforded by a windfall of large exogenous foreign revenues. These ultimately increased Egypt's vulnerability to external shocks as was evident by the mid 1980s' recession in the wake of the 1982 unfavorable external developments. Precedence was also awarded to political stability over economic rationality during the 1987 reform attempts as underlined by the adoption of a partial approach to economic reform.

It can be stated that policies of the 1970s & 80s did not succeed to develop structural dynamics within the economy to reach and maintain a long- term rapid growth trend. In this respect, this chapter provides a clear contrast between the incomplete nature of the ODP distorting the economic environment and the piecemeal nature of the 1987 reform threatening the economic stability on the one hand, and the comprehensive scope of the 1991 ERSAP aiming at the development of a correct mechanism for establishing a long term sustainable non - inflationary growth on the other hand.

I - Overview of the Egyptian Economy During the Pre- Reform Period:

During the 1960s, Egypt had been featured by a centralized State ownership regime as a result of the massive wave of nationalization leading to a drastic reduction in the share of the private sector in the economy (Aktan, 1995). This had been justified in light of socialist ideologies governing state policy under the non- market oriented system prevailing in most LDCs where the inward oriented development philosophy dominated and embraced import substitution industrialization (ISI) policies (Andic, 1992).

The scope of the role of the state, manipulating the various aspects of economic activity, reflected its persistence on achieving certain social policy goals. These included provision of basic goods & services at lower cost, generation of employment opportunities, better distribution of income and mobilization of resources as well as undertaking the role of an immature private sector (Andic, 1992).

It can be stated that state management had been wasteful as it provided indiscriminate income transfers & subsidies to both the rich and poor segments of the economy, fixed prices below economic cost, and enforced hiring practices in the public sector and the government bureaucracy (Handoussa, 1993a). Indeed, social objectives proved to be costly to the economy in terms of foregone substantial potential revenues and slow economic growth as GDP stagnated at no more than 3% annually, to barely keep pace with the rise in population by the early 1970s (EIU, 1995).

A - Snapshot Of the Open Door Policy (ODP) in 1974:

Egypt initiated the ODP in 1974, declaring a new economic era "Al Infitah" that presented a radical reorientation of the Egyptian economy from the socialist regime of the 1960s towards a market system, with the reinstatement of private ownership in the economic sphere.

1 - Objectives of the Open Door Policy (ODP): Stimulating the role of the private sector in the economy was the primary objective of the ODP as Egypt recognized the need for an efficient local entrepreneurial base whose natural evolution was interrupted by the nationalization process during the 1950s & 60s. That is why the introduction of an attractive incentive legislative package became a must in order to encourage private sector participation - both foreign and domestic - during the new era. Indeed, the investment encouragement code was revived by the enactment of Law no. 43 in 1974 to attract private investment flows into all areas of the economy (Handoussa, 1993a).

The Law provided privileges for the operation of private capital: Egyptian, Arab and foreign through tax incentives and various exemptions from labor Laws, export & import licensing requirements as well as from restrictions on minimum export requirements and on industrial locations. This was accompanied by the dismantling of public sector monopolies in the banking & foreign trade sectors, the relaxation of the exchange rate regime and the abolishment of most controls on capital flows as all Law 43 projects could freely purchase foreign exchange in the local market and transfer their profits abroad (Handoussa, 1993a).

These changes were essential to enhance the attractiveness of the Egyptian investment climate to benefit from the new favorable external developments; namely, the early 1970s oil boom offering the economy great prospects for large capital inflows from: Arab oil exporting countries, workers' remittances and direct oil sales. Indeed, Law 43/ 1974 succeeded to attract private capital flows increasing from an annual average of less than LE 200 million to LE 800 million between the second half of 1970s & the first half of the 1980s and peaking at LE 1.5 billion in 1987 (Handoussa, 1993a).

The private sector's share of economic activity expanded significantly as reflected by the increase in aggregate demand from 63% in 1975- 79 to 74% in 1985- 87. Private investment was sustained at around 8% of GDP between 1975 & 1987 while private consumption jumped from 66% of GDP in the first half of the 80s to 77% in 1987 (Handoussa, 1991).

2 - **Effects of ODP as a Partial Liberalization Policy:** Despite the economic opening undertaken during the early 70s, the Egyptian economy had not undergone a radical shift to adjust to the new era. The incomplete nature of ODP reforms had inhibited a correct supply response from economic agents due to inconsistencies in the incentive structure & the institutional framework that ultimately created a distorted economic environment resulting in significant waste in production and investment (Handoussa, 1995).

First, the partially liberalized incentive structure detrimentally affected resource allocative efficiency within different sectors of the economy as it distorted the relative price system. This resulted in an anti- labor bias, inefficient output mix and suboptimal investment decisions. In her work "Reform Policies For Egypt's Manufacturing Sector", Handoussa (1991) indicates the low labor absorption between the 1970 & 1984 in spite of the industrial sector growing at an annual rate of 7% in value added. Indeed, the capital labor ratio accelerated at an annual rate of 10% while labor growth slowed down to 2% compared to 9.6% in 1960 - 65 & 3.7% in 1965 - 71.

Similarly, studies of the agricultural sector, by Morsi (1986) and by Kheir El Din & Clark (1979) show that the system of price controls coupled with subsidies on specific inputs created large gaps between profitability at domestic and at world prices. This led to misallocation of land to various crops and to a general reluctance on the part of farmers to invest in the improvement of yields and to cultivate traditional crops with high comparative advantage. In contrast the paper on "Efficiency Issues in the Allocation of Loans for Food Security Projects" by Handoussa & Kaldas (1986) indicates that distorted price signals attracted substantial investments into low value added activities such as: animal husbandry & dairy farms. These were highly subsidized, and realized huge profits to large capitalists with negative real economic returns (Handoussa, 1995).

Partial liberalization also resulted in an imbalanced distribution of aggregate private investment over time. In her work "Egypt's Investment Strategy, Policies & Performance Since the Infitah", Handoussa (1991) underlines the significant decline in the share of the commodity sectors combined with an unprecedented growth of the non productive services.

Second, the inconsistent nature of the institutional structure inhibited the economy from achieving its most direct objectives under the ODP: export promotion and growth of private investment. These were subject to a number of constraints that raised transaction costs, and prevented market entry by potential participants (Handoussa, 1995). Indeed, manufactured exports stagnated between the mid 1970 & mid 1980s as a result of the anti- export bias inherent in the investment licensing system dominated by (GAFI) & (GOFI). This contradicted the essence of export promotion as merits of new projects were judged on the basis of their capacity to satisfy local demand gaps (Handoussa, 1993a).

In his work Legislating Infitah: Investment, Currency & Foreign Trade Laws, Fahmy (1988) refers to contradictions in the legislative framework during infitah when new laws were enacted to encourage private investment without undertaking significant amendments in the existing body of old legislation that served requirements of the socialist regime. This resulted in an ambiguous investment climate as laws were contradictory, and new bureaucratic agencies were established to clarify and simplify new investors' transactions.

As a result of these constraints and in spite of the attractive investment code, exports of private firms operating under Law 43/ 1974 were valued at only $ 26 million in 1984/85 compared to their imports of $ 609 million in 1983/84. FDI contribution in aggregate investment had also been modest as its share in the accumulated equity capital of industrial projects under Law 43/ 1974 and its replacement Law 230/ 1989 was estimated at 30%. Indeed, FDI had been concentrated in tourism & banking sectors, and mostly channeled into import substitution industries (Handousa, 1993a, p.78).

3 - **Indicators of Growing Macro Imbalances During 1980s:** The transition from a socialist to a market oriented economy during Infitah had both its positive & negative repercussions on the Egyptian economy over the mid 70s and early 80s. On the one hand, the ODP succeeded to accelerate annual GDP growth reaching 9% between 1974 & 84 and to double per capita income from $ 334 to $ 700 by 1984 (Handoussa, 1991).

Rapid growth had been stimulated by the foreign exchange boom from foreign aid, FDI, oil exports, workers' remittances, tourism and Suez canal revenues surging between the mid 1970s & 1980s (Handoussa, 1991). Indeed, the combined share of foreign currency revenues in GDP had risen from 6% in 1974 to 40% in 1984 when the BOP receipts on current account reached a peak of $ 13.5 billion (Handoussa, 1993a).

On the other hand, the ODP failed to restructure the economy due to continued state intervention in different sectors of the economy through a combination of rigid domestic prices, tight import restrictions and the adopted multiple exchange rate system allowing for real appreciation by 28% from 1970 to 1982 and by a further 38% from 1982 to 1985 (World Bank, 1989). That is why, import restrictions were essentially used to maintain external equilibrium without resorting to exchange rate adjustments (GATT, 1992).

Subsidized domestic prices also burdened the budget, and led to serious distortions in the economy. For instance, low energy prices cost the budget around 6% of GDP in lost revenues as of 1984/ 85, and encouraged the development of high energy intensive projects such as the Aluminum industries assessed to be economically non viable at real opportunity cost of energy. Fixed railway and public transport tariffs also resulted in lost revenues of LE 236 million & LE 78 million respectively in 1984/85 (Handoussa, 1993a).

These distortive policies supported the ISI strategy that was largely financed through the exogenous foreign currency earnings, sustaining the ambitious program of public investment expenditures amounting to 20% of GDP over the boom period. The 1975- 82 period underlines poor management of the budget as fiscal policies had been expansionary with expenditures rising from 49% to 64% of GDP and the explicit subsidy bill peaking at 13.4% of GDP in 1981/82. These surpassed the significant increase in revenues from 29% to 42% of GDP between 1975/76 & 1981/82 (Handoussa, 1993a).

In addition, windfall of foreign currency revenues subjected the economy to a dutch disease syndrome that resulted in real exchange rate overvaluation by 50% in face of massive capital inflows over the boom period (Handoussa, 1993a). This had misallocated Egypt's investment expenditures, averaging 30% of GDP over the boom period, with domestic supply shifting away from the production of tradables towards nontradables: infrastructure, housing, electricity, transport & other services (Handoussa, 1991).

In her work "The Impact of Foreign Assistance on Egypt's Economic Development: 1952-1986", Handoussa (1991) underlines the serious deterioration in the competitive position of Egyptian non oil exports over the boom period. These declined from $ 1.6 billion in 1974 to $ 1.3 billion in 1984, while merchandise imports surged from an annual average of $ 1.5 billion in 1970- 75 to $ 9.2 billion in 1976- 84 (Handoussa, 1993a).

Vulnerability of the Egyptian economy had been indicated by its overall unsatisfactory performance in face of severe external shocks during the early 80s. The 1982 decline in world oil prices led to a sharp fall in petroleum exports, accounting for 32% of Egypt's foreign exchange revenues, from $ 3.3 billion in 1981/ 82 to $ 1.4 billion in 1986/ 87 (Handoussa, 1993a). In addition, the increase in international interest rates raised the annual debt service from $ 1.3 billion to $ 4.4 billion and the foreign debt outstanding from $ 24.3 billion to $ 38.5 billion over the same period (World Bank, 1989). This was combined by deterioration in the terms of trade costing 11% of GDP (Handoussa, 1991).

These negative developments ultimately led to an economic recession during the second half of the 1980s as annual growth slowed to about 2.5%, inflation reached 20% a year, and unemployment rose from 5% in mid 1970s to more than 15% of total labor force (Aktan, 1995). As a result, the BOP deficit peaked at 15% of GDP, and the budget deficit reached 23% of GDP in 1986/ 87 (Handoussa, 1993a).

B - Early Reform Attempts During (1987- 89):

It can be stated that Egypt's significant reliance on foreign exchange earnings, mainly oil export revenues, as the main engines sustaining its growth during the mid 70 to early 80s had not urgently called for either the development of efficient structural dynamics within the economy to maintain real growth, or for the implementation of a serious reform program to cure the various imbalances distorting the economic environment. However, the situation dramatically changed in face of the 1982 external shocks when such revenues declined, and the GOE could no longer pursue its expansionary policies. Indeed, gross fixed investment sharply declined from 30% to 19.3% of GDP, and public investment halved from its peak of 22.9% to 11.4% of GDP between 1982 and 1987 (World Bank, 1989).

By mid 1987, the external position of the Egyptian economy worsened, and Egypt was ranked as one of the most highly indebted countries in the world with foreign debt surpassing $ 40 billion, and the ratio of debt to GDP reaching 113% (World Bank, 1989). This mirrored the real dimensions of mid 1980s' crisis that necessitated adoption of the 1987 reform package in accordance with the IMF Stand-By agreement signed in May 1987, and used as the basis for the rescheduling of Egypt's official publicly guaranteed debt at the Paris Club (Handoussa, 1993a).

According to the World Bank report (1990) & IMF documents, the GOE's reluctance to fully employ policy tools in the fiscal, monetary and exchange rate areas directly contributed to its failure to control inflation that surpassed 20% over the 1989- 90 period. After a promising start, the 1987 agreement with the IMF was terminated by the end of 1988 after drawing SDR 116 million out of the Stand By SDR 250 million (Handoussa, 1993a).

Lack of political will was primarily responsible for the unfulfilled objectives of the 1987 reform attempts whose limited scope inhibited a positive growth response. Fears from potential political costs, especially in the aftermath of the 1986 riots & domestic disturbances, had undoubtedly influenced the GOE's decision to adopt a piecemeal approach to economic reform during the 1987 - 89 period.

A trade off was evidently made between economic gains and political stability as had been demonstrated by the government's inadequate attempts to improve economic performance. This subsection outlines the GOE's partial approach to control the fiscal deficit, reform the exchange rate system & establish real positive interest rates and the subsequent failure to stabilize the economy. It also demonstrates that the 1987 attempts had not succeeded to eliminate distortions on the real side of the economy because of its limited approach to liberalize the trade regime and to reform the public sector.

First, The 1987 reform failed to effectively control the overall budget deficit that was only reduced from 24% of GDP in 1982 to 20% in 1987 (Handoussa, 1993a) and to 18.4% in 1990 (World Bank, 1995d). As a percentage of GDP, government expenditures significantly declined from 64% to 41% between 1982- 87 as a result of cuts in explicit consumer subsidies from 13% to 6% and in implicit energy & exchange rate subsidies from 18% in 1985/86 to 14.6% in 1987/88 (World Bank, 1989). However, expenditures rose again to 46% of GDP between 1989 & 1990 (World Bank, 1995d).

This was combined by the large fall in government revenues from 42% of GDP in 1981/82 (Handoussa, 1991) to 30.8% in 1987/88 (US Embassy, 1991) to 27.7% in 1990 (World Bank, 1995d), mostly as a result of the decline in the world oil prices. The debt servicing burden also rose sharply with interest payments amounting to LE 2,780 million in 1987/88 relative to LE 1,253 million in 1984/85 (Handoussa, 1993a). It can be stated that the expenditure tightening measures employed during the 1987 reform had not been sufficient as they were not complemented by revenue enhancing tools such as tax increases and strong price decontrol, for publicly produced goods & services, necessary for fiscal consolidation.

Price liberalization progressed in areas where the private sector dominated such as agriculture as delivery quotas were removed for all crops except for cotton, sugar cane & half of the rice crop (World Bank, 1989). However, such decontrol was only confined to the food and textile products in the industrial sector, while other products were subject to a pricing formula that allowed recovery of operating costs in addition to 15% rate of return on employed capital (World Bank, 1993b, p.69).

Moreover, the increase in energy prices was not effective as it only averaged around 36% of world market level by mid 1989 (Handoussa, 1993a). In addition, public authorities providing water, railways, electricity and urban transport services continued to offer their services at fixed prices below operating costs. According to estimates of the World Bank report (1992) "Public Sector Investment Review", this resulted in an annual loss of LE 4 billion in 1990/ 91 (Handoussa, 1993a).

Second, The 1987 reform failed to control the annual growth of money supply that was initially reduced to 11.5% in 1987/88 down from more than 22% between 1982 & 1986, as it rose to 20% in 1990/91 (Handoussa, 1993a). In addition, the increase in nominal interest rate by 2 and 3 percentage points in 1987 and 1989 respectively was insufficient in face of the high inflation fluctuating around 25% during the mid 1980s (Handoussa, 1991).

This resulted in persistently high negative real interest rates that impeded the full mobilization of local savings, and encouraged speculative activities and the holding of foreign currency deposits increasing from 25% to 40% of total money supply between mid 1985 - 88. Failure to establish real positive rates inhibited rationalization of investment allocation and use of capital intensive technologies, heavily adopted since the mid 1970s, as well as repatriation of workers' savings abroad estimated at $ 2 to 3 billion annually (World Bank, 1989).

Third, The 1987 trade and exchange rate reforms did not target export promotion with focus made on limited import liberalization. Indeed, the 1987 reforms were partial as no steps were made towards the unification of the exchange rate system. This was coupled by the limited impact of the 15% real devaluation of the commercial rate, over the 1987- 89 period, that was undermined by the 50% inflation rate resulting in around 30% real appreciation (Handoussa, 1993a). This harmed Egypt's external sector as denoted by stagnation of non oil exports with merchandise exports reaching only $ 2.6 billion in 1990, less than 9% of GDP, while imports, mainly food items, stood at $ 9.2 billion in 1990 (GATT, 1992).

Trade reform began in 1986 with a 50% tariff reduction across the board, elimination of import surcharges & duties associated with tariffs, removal of the import licensing system and introduction of the banned list allowing free importation of all products except those conditionally prohibited. Escalation of tariffs was also revised to maintain consistent positive protection rates for every stage of local processing activity with the average tariff set at 19.7% for raw materials, 21.8% for semi manufactured and 41.6% for finished goods (GATT, 1992, p.51- 53).

According to the GATT report (1992) "Trade Policy Review Mechanism: Egypt", the banned list was lengthy as the number of products on the list accounted for 12.5% of the total value of imports in 1987 (Handoussa, 1993a). Indeed, more items were added to the list in 1987 & 89, and reductions in its product coverage only started in May 1990 (GATT, 1992, p.46). Despite rationalization of the tariff structure and the slight reduction in the nominal protection rates from 48.1% to 47.1%, trade reform efforts did not reduce the level of effective protection (Handoussa, 1993a, p.112).

Fourth, The 1987 reform did not succeed to reduce the dominant role of the public sector in economic life as indicated by its rising share from 36.5% of GDP in 1986/87 to 40% in 1991/1992, as well as by its continued role to provide job opportunities that grew by 10% over the 1986/87 - 1989/90 period. Reform had by no means limited the contribution of the public sector in sectoral GDP as its share marginally declined between 1986/87 & 1991/92 in the following sectors: manufacturing from 50% to 42.1%, construction from 35.1% to 33.2%, banking from 77% to 74.3% and transport & communications from 56.9% to 49.2%, while the electricity sector remained fully controlled by the state (World Bank, 1993b, p.62).

The implementation of the 1987 reform had been deliberately slow and partial in an attempt to avoid potential social & political costs associated with a bolder and more comprehensive program (Handoussa, 1993a). However, the ensuing economic costs were high in terms of failure to stabilize the economy as well as the emergence of uncertainty about the future course of the economy. This ultimately led to the acceleration of currency substitution process with private sector holdings of foreign currency increasing from 41.6% of total deposits in 1980 to 52.9% in 1990, and to the activation of capital flight reaching its maximum in 1989 of an estimated figure of LE 63.3 billion (Moheildin, 1995).

These mainly resulted from deteriorating economic conditions during the late 1980s reflected by the decline in nominal GDP per capita from $ 730 in 1984/85 to $ 645 in 1989/90 (GATT, 1992), persistent high inflationary pressures, worsening external position as the size of accumulated foreign debt mounted to $ 50 billion in 1990 (Handoussa, 1993a) to present 160% of GDP (World Bank, 1995d). These negative developments were further aggravated by the 1990 Gulf crisis that seriously hit the Egyptian economy with the resulting financial losses estimated at $ 20 billion. These accounted for the return of about half a million workers from the Gulf, loss of tourism & trade revenues and cost of military intervention (Handoussa, 1993a).

The 1990 regional crisis enabled Egypt to profit from its strategic political asset. Egypt was generously compensated with forgiveness of its debt to the Gulf countries as well as of its outstanding military debt to the United States amounting $ 7.2 billion & $ 7.5 billion respectively, in addition to an emergency aid of $ 3.5 billion (Handoussa, 1993a). This was coupled by significant grants from European Union & other Western Countries. As a result, the level of gross development assistance from the OECD & OPEC countries peaked at $ 9.98 billion in 1991 up from $ 1.75 billion in 1989 (EIU, 1995).

Such political environment paved the road for the introduction of the 1991 ERSAP that was supported by a three year SDR 400 million Stand- By credit arrangement with the IMF, and backed by a $ 300 million Structural Adjustment Loan (SAL) from the World Bank (EIU, 1995). The 1991 negotiations between the GOE and the two international lending institutions were featured by readiness and willingness on the part of both parties to make concessions with respect to the scope and pace of the new reform program as the GOE accepted a comprehensive approach to reform, while the IMF and the World Bank agreed on the gradual implementation of the liberalization program (Handoussa, 1993a).

II - Assessment of the Economic Reform Program From 1991- 1996

Stabilization & restructuring of the economy have been at the center of the 1991 reform program in order to ensure a successful transition to an outward oriented economy and to avoid the pitfalls of the 1987 attempts. These had become imperative to achieve the ERSAP's main objectives: stimulation of economic growth and achievement of internal & external equilibrium through correction of macro- economic imbalances and introduction of market oriented practices (World Bank, 1996).

Egypt has succeeded with respect to the achievement of impressive stabilization targets as well as the implementation of major structural adjustment reforms since the initiation of its economic reform program in 1991. According to the Implementation Completion Report (ICR) Egypt: SAL by the world Bank in January 1996: "*The overall success of the program, supported by the SAL, was probably due to at least three factors: timing, content and assistance. The GOE should be commended for the very impressive progress made towards stabilization of the economy given the comprehensive nature of the reform program*" (World Bank, 1996).

It can be stated that the success of the 1991 reform program has denoted the GOE's commitment to accomplish its reform goals. This is indicated by its far reaching approach to reform whose comprehensive scope has addressed all sectors of the economy at both the macro & micro levels to ensure a radical elimination of the various distortions in the institutional & incentive structures of the economy.

Indeed, the 1991 ERSAP agenda has dictated a high degree of coordination between various tools such as: price, fiscal, monetary & exchange rate instruments to achieve set targets. According to IMF report (1991) "Arab Republic of Egypt: Review of Stand- By Arrangement", these basically aimed at reduction of the budget deficit from 17% of GDP in 1990/91 to 6.5 % in 1992/93 & to 3.5% in 1995/96, of the current account deficit from 12% of GDP in 1990/91 to less than 7% by 1995/96 and of the inflation rate (CPI) from 25% to only 4.8% over the same time period (Handoussa, 1993b).

Initial targets were successfully accomplished by March 1993, and Egypt commenced the second phase of reform in July 1993 under the Structural adjustment Monitoring Program (SAMP) providing technical support without any financial assistance, upon the request of the GOE given its improved BOP position in October 1993 (World Bank, 1996). This was followed by an agreement with the IMF in September 1993 on a new three- year Extended Fund Facility (EFF) backed by $ 569 million (EIU, 1995).

Impressive fiscal consolidation, successful debt rescheduling as well as strong foreign exchange receipts from tourism, workers' remittances & Suez Canal have all led to major improvement in the BOP position reaching a surplus of $ 1.7 billion in FY 1994 (World Bank, 1996), of $ 0.7 billion in FY 1995 (CBE, 1995) and $ 0.5 billion in 1996 (IMF, 1996). This swung from deficits of $ 1.7 billion and of $ 1.2 billion in 1988/89 & 1989/90 respectively to a surplus of $ 2 billion in 1990/91, $ 5.9 in 1991/92 & $ 4 billion in 1992/93 (MIC, 1993). As a percentage of GDP, the current account also altered from a deficit of 3.7% in 1989/90 to surpluses of 3.1% in 1990/91, 10.4% in 1992/93, 9.8% in 1993/94, 0.3% in 1994/95, and is estimated to reach 1.5% in 1995/96 (MOE, 1996).

Table (2) provides a review of some of the key indicators of the macro economic performance of the Egyptian economy over the pre (1988- 90) & during (1991- 95) ERSAP periods. Variables on the financial side of the economy, including the budget deficit and inflation rate, do all demonstrate Egypt's success with stabilization rapidly accomplished over the 1991-95 period, and which is considered to be the most direct and automatic component of the reform program. It may be stated that the GOE succeeded to develop an effective mechanism for permanent stabilization of the economy. This was realized through the adoption of tight monetary policy as well as fiscal control that reduced inflation from an average of 18.9% and the budget deficit from an average of 20.9% over the 1988- 90 period, as illustrated in table (2), to only 7% and to 1.3% of GDP respectively in 1996 (MOE, 1996).

In an attempt to establish a criteria for evaluating the so far made progress on stabilization & structural adjustment fronts, it can be stated that such recovery has been mainly attributed to serious stabilization efforts wisely managing the fiscal, monetary & exchange rate reforms that have created high expectations about the future performance of the economy. These have succeeded to reverse persistent capital flight over the past decade, to stimulate large capital inflows, and to ultimately raise the level of international reserves with the CBE.

In contrast, the real challenge to the success of the 1991 reform program lies on the real side of the economy where progress has been proceeding at a much slower pace to reflect the difficulty & non automaticity of the implementation of structural adjustment reforms. This is because these dictate a comprehensive restructuring of the Egyptian economy that had been suffering from major incentive & institutional distortions developed over the past three decades. More importantly, these may inhibit the generation of a positive supply response since growth is a structural process whose stimulation requires the development of essential dynamics within the economy. However, it should be stated that the new GOE has recently issued a body of Laws and decrees, since January 1996, to establish a consistent institutional & legal framework for economic liberalization, especially with respect to investment promotion, tax reforms and elimination of bureaucracy (COM, 1996).

In that sense, Egypt has adopted the recommended sequence for reform as the 1991 ERSAP initially focussed on stabilization of the economy, then switched to intensification of structural adjustment efforts under the SAMP and EFF in 1993. In other words, focus shifted away from correction of monetary and fiscal imbalances towards deepening of structural reforms (EIU, 1995). Indeed, Egypt succeeded to establish a more stable macroeconomic environment with inflation reduced to an average of 16.5% over the first reform phase in 1991- 93 (World Bank, 1995d) and to an average of 8.1% during the second reform phase in 1993- 96 compared to a rate higher than 20% during the 1989- 90 period (Handoussa, 1993a).

Table (2)

Key Indicators of the Macro Economic Performance of the Egyptian Economy (in percent)

	Pre – ERSAP			*During – ERSAP*				
Indicators	1988	1989	1990	1991	1992	1993	1994	1995
GDP growth	3.9	3	2.4	2.1	0.3	2.5	3.9	4.7
Inflation rate (CPI)	14.2	21.2	21.4	22.3	17	10.4	9	8.4
Budget Deficit / GDP	24.5	18.3	20	17	5.2	4.1	2.5	1.5
Unemployment Rate	8.9	8.9	8.5	8.6	9	10	9.8	9.6
Foreign Debt / GDP	161.8	150.6	160	117	117.4	106.7	98.8	93.1
Total Trade / GDP	40.3	61.4	75	74.5	70	62	54	64.5
Private Investment / GDP	3.7	5.4	3.4	9.7	7.1	8.2	10.3	9.9
Public Investment / GDP	20.2	17.5	18.1	10.3	10.4	8.4	7.2	7

Note: figures & ratios are extracted and calculated from different sources: (MOP, 1996), (CBE, 1995) (Handoussa, 1993a), (World Bank, 1994, 1995c, 1995d & 1996), (Us Embassy, 1991) & (MOE, 1996).

The Egyptian economy witnessed a modest increase in annual real GDP growth rate from 2.5% in 1992/93, to 3.9% in 1993/94, to 4.7% in 1994/95, and is expected to reach 4.9% in 1995/96 (MOP, 1996). It seems that economic restructuring should be strengthened in order to reach the ambitious 8% target that is set by the new GOE to be attained by the end of the century, and that is expected to sufficiently alleviate poverty and reduce unemployment that has averaged 8.8% & 9.4% of the total labor force respectively over the pre and during ERSAP period as indicated in table (2).

That is why, price decontrol, trade liberalization, investment deregulation, public enterprise sector reform & privatization constitute the backbone of reform during the second phase (1993 - 1996). It may be stated that these have become essential to consolidate gains from the first reform phase in order to ensure the creation of an economic environment conducive to generate a sustainable positive supply response. The private investment share in GDP has modestly increased to average 9% of GDP since the initiation of ERSAP, compared to a low share of 4.2% over the 1988- 90 period as shown in table (2).

This section analytically displays the progress achieved in the course of the 1991 stabilization & structural adjustment programs. A discussion is made of the prospects for rapid growth in view of the challenges currently facing the Egyptian economy, and that can delay its transition from reform to growth with special emphasis on requisite measures necessary to provide Egypt with a push towards its take off stage.

In this respect, an attempt is made to tackle a number of questions concerning sustainability of the overall reform program. Specifically, these address the inevitable social costs incurred during adjustment and the schemes developed to counteract their impact on the most vulnerable groups in the economy.

Light is also shed on the efficiency of the domestic financial system in the mobilization of local savings given the uncertainties about the future sustainability of foreign financial assistance over the medium and long terms. According to the World Bank estimates (1994), Egypt's cost of external funding is expected to increase given the projected decline in official grants by over 50% in nominal terms from an annual average of $ 2.5 billion in FYs 1991- 93 to about $ 1.1 billion in FYs 97- 2001 (World Bank, 1994, p.9).

It is also important to explore the economy's capacity to intermediate the large capital funds flowing into the newly reforming economy in order to minimize their potential destabilizing impact on the real sector. This leads to questions about competitiveness of the real exchange rate and its potential role in the promotion of non- il exports as a main drive for an export led growth in the near future. This is considered in light of Egypt's sequence of reform with respect to capital versus trade liberalization as the 1991 reform efforts have slowly liberalized the trade sector while the financial market and the capital account have been substantially opened up.

A - Fundamentals of the 1991 Stabilization Program:

In this section, an attempt is made to analyze Egypt's stabilization program in the context of the theoretical literature and country experiences in order to determine the extent to which Egypt followed a particular course with respect to the scope, speed and sequencing of reforms. The 1991 IMF stabilization program has succeeded to control inflation that was slowed down from over 20% in FY 1991 to 9% in FY 1994 (World Bank, 1996), to 8.4% in 1995 and to 7% in 1996 (MOE, 1996, p.11). This has been achieved through a combination of policy instruments adopted to target the fiscal, monetary and exchange rate fronts.

1 - Fiscal Policies: The World Bank Implementation Completion Report of 1996 underlines the GOE's impressive accomplishment with respect to fiscal adjustment reducing the budget deficit to 2.5% of GDP in FY 1994 (World Bank, 1996), to 1.5% in FY 1995 and to 1.3% of GDP in 1996 (MOE, 1996). This was reduced from 20% and 17% of GDP in 1989/90 - 1990/91 respectively to 4.7% over the 1992- 93 period (World Bank, 1994).

This has been achieved through a number of expenditure tightening and revenue enhancing measures that ultimately reduced total expenditures to 36.6% of GDP, and increased total revenues to 35% of GDP in FY 1995 compared to respective shares of 46.1% & 29% in FY 1990/91 (World Bank, 1995d). It can be stated that subsidy removal and price decontrol have significantly contributed to fiscal consolidation. Table (3) presents trends in the composition of the government budget over the 1990/91 - 1994/95 period to contrast between sources of revenues and expenditures during the pre & during ERSAP era.

On the revenue side, taxes increased from 15.7% of GDP in 1990/91 to 21.5% in 1994/95, while revenues from local government and public sector authorities stagnated at around 1.7% between 1990/91 & 1994/95. In addition, non tax revenues slightly increased from 8.5% of GDP in 1990/91 to 10% in 1994/95 (World Bank, 1995d).

This is partly due to the decontrol of energy prices whereby the weighted average domestic prices of petroleum products were raised to reach 100% of their international level, and electricity prices reached 74% of LRMC in July 1994 (World Bank, 1996). Indeed, the 1992 energy price increase was translated into additional budget revenues estimated at more than LE 3 billion annually (Handoussa, 1993a).

On the expenditure side, subsidies declined from 3.4% of GDP in 1990/91 to 2.3% in 1994/95 (World Bank, 1995d). Indeed, the commodity coverage of subsidies was limited to popular bread, limited quantity of edible oil & sugar in 1993 (MIC, 1993), and all subsidies for fertilizers, seeds & pesticides were eliminated by 1994 (EIU, 1995). Furthermore, government investment outlays were reduced to 10.4% of GDP in FY 1992 and to around 7% in FYs 1994 and 1995 (World Bank, 1996) down from a peak of 22.9% by mid 1980s (Handoussa, 1991) & 18.1% in FY 1990 (World Bank, 1996).

Nevertheless, wages and salaries continue to present a burden on the budget as they averaged an annual share of 7.34% of GDP over the 1990/91 - 1994/95 period (World Bank, 1995d). According to the GOE's 1997 Civil Service Reform Plan, this burden is expected to be relieved as the plan targets a 2% annual reduction in civil service employment (IMF, 1996, p.18). It should be also noted that Egypt's recent relief of the last tranche of the Paris Club debt has positive implications on the economy's debt servicing obligations as explained in section (4).

Table (3)

General Goverment Budget & Financing 1990/ 91 – 1994 /95

(In Percent of GDP)

Item	1990/91	1991/92	1992/93	1993/94	1994/95
(A) Total Revenues	29	35	35.5	35.2	35
1. Central Goverment	24.2	30.2	31.2	31.5	31.5
Tax Revenue	15.7	20.6	20.8	21.2	21.5
Non Tax Revenue	8.5	9.6	10.3	10.3	10
Transferred Profits	7.1	7.5	7.1	6.2	6.1
Other	1.4	2.1	3.2	4.1	3.9
2. Local Goverment	1.1	1.2	1.4	1.2	1.2
3. Public Service Authorities	0.6	0.6	0.7	0.6	0.6
4. Investment Self – Financing	3	2.9	1.8	1.4	1.3
5. Sales of Assets	0	0.1	0.5	0.5	0.4
(B) Total Expenditures	46.1	40.2	39.5	37.7	36.6
1. Current Expenditures	30.1	30.6	31.2	30.8	29.4
Wages & Salaries	7.2	6.8	7.5	7.5	7.7
Pension Payments	2.2	2.3	2.7	2.6	2.5
Material & Supplies	1.5	1.5	1.8	1.8	1.8
Subsidies	3.4	3.8	3	2.3	2.3
Defense	4.3	4.1	4.2	4	4
Other	1.5	1.4	1.6	1.6	1.6
Public Authority Deficits	0.6	0.3	0.2	0	0
Capital Exp. Net & In. Funds	–0.4	–0.8	0	–0.3	–0.4
Interest Payments	7.1	8	10.1	11	9.9
Domestic Debt	4.2	5.4	7.1	8	7.4
Foreign Debt	2.9	2.7	3	3.1	2.5
2. Transfers for Restructuring	6.2	0	0	0	0.1
3. Investment Expenditures	10.3	10.4	8.4	7.1	7.1
4. GASC Borrowing	2.3	2.3	0.1	–0.1	0
Overall Deficits (Ex. Grants)	–17.2	–5.2	–4.1	–2.5	–1.6

Source: World Bank (1995d) – Based on figures of Ministry of Finance

2 - Monetary Policies: Monetary reform has primarily aimed at the establishment of positive interest rates as well as the restriction of monetary expansion surpassing 30% in 1990 in order to contain inflation fluctuating between 25% and 30% by end of 1980s (Handoussa, 1993a, p.95). The GOE has succeeded to control growth of broad money supply from 28% in FY 1991 to about 12% in FY 1994 (World Bank, 1996) & to 11.1% in 1995 (MOP, 1996), and to reduce nominal interest rates on Treasury Bills (TBs) from an average of 20% over the 1991- 95 period to 10.5% in 1996 (MOE, 1996). More importantly, positive real interest rates were maintained at an average of 4.6% over the 1993- 95 period (World Bank, 1995d), and reached 3.5% in FY 1996 (MOE, 1996) through the adoption of tight monetary policies that relied on both direct and indirect credit controls (Handoussa, 1993a).

Direct credit to the public sector has been limited through enforcement of financial discipline on PEs in order to harden the "soft budget constraint" whereby PEs used to enjoy privileges in the form of budget subsidies & loans at low interest rates from local banks. This has been dictated by Public Sector reform to ensure that no direct or indirect subsidies can be provided to ACs, and that debt financing can be only obtained at market terms as PEs can no longer borrow from the banking sector on concessional terms (PEO, 1993).

Indirect monetary control entailed the use of treasury bill (TBs) auctions conducted weekly starting January 1991 when interest rate ceilings were abolished, and banks were allowed to set their deposit & lending rates freely. It may be stated that the new system has denoted a real change in monetary policy whereby TBs have become the CBE's main tool to regulate money and credit as TBs have presented a guide for the determination of market interest rates (Handoussa, 1993a). TBs have also acted as main sterilization tools to absorb the excess monetary liquidity in the market and to finance the fiscal deficit since the government can no longer borrow directly from the CBE (Shoura, 1996, p.98).

Sterilization added a new burden to the budget as it raised the stock of domestic debt service payments from LE 4.1 billion in June 1991 (World Bank, 1995d) to LE 11.2 billion in 1994/ 95 (CBE, 1995, p.122). This resulted from the rapid growth in TBs debt increasing from 4% of GDP in 1991, to 24% in June 1994 & to 17.3% of GDP in June 1995, all of which with maximum one year maturity (CBE, 1995, p. 118).

That is why, the GOE has resorted to direct policy instruments such as moral suasion to control credit expansion by asking banks to maintain higher levels of excess reserves, reaching LE 4.8 billion in September 1994, as deposits with the CBE at interest rates below the market level (World Bank, 1995d). This practice denotes the GOE's anticipation of potential portfolio shift from local to foreign currency as a result of lower interest rate differentials that may take place when interest rate equilibration is left to the market (World Bank, 1995c, p.158).

In addition, the GOE has resorted to bond issuance starting April 1995 in order to restructure its domestic debt by extending its maturity to be able to better manage and service its borrowing obligations. The first tranche of five- year maturity government bonds, worth LE 3 billion and at a fixed interest rate of 12% (CBE, 1995), was supplemented by a further issue of LE 4 billion of 5 to 7 year bonds in August 1996 (IMF, 1996, p.24).

3 - **Reform of the Exchange Rate System**: This has aimed at unifying and maintaining the exchange rate at a sufficiently flexible competitive level to reflect its real scarcity value in transactions across all sectors of the economy. Reform began in 1991 with temporary replacement of the multiple exchange rate regime by a transitional dual system that entailed the operation of a free rate, in the secondary market, that determines the exchange rate for the entire system along with the CBE's primary market rate that adjusts within 5% of the free rate (Handoussa, 1993a).

The dual system was unified in October 1991 (GATT, 1992), and the free rate has been applied to all transactions in the economy (Handoussa, 1993a). The exchange rate reform involved a shift from a fixed to a flexible peg whereby the Egyptian pound has been pegged to the American dollar ($) (Abdel Khalek, 1994). Monetary policy has succeeded to maintain the stability of the exchange rate whose value slightly changed within the range of LE 3.3 to 3.4 per US$ 1 over the 1992 - 96 period (MOE, 1996, p.11).

It can be stated that floatation of the Egyptian currency has restricted the CBE's interventionist activities to the selling and buying of foreign exchange to defend the value of the pound against the dollar. Public anticipation of future devaluations, to be imposed by the IMF, urged the CBE's intervention twice in July & December 1994 by selling dollars[1] in order to prevent speculation in the exchange market and to maintain the real exchange rate at LE 3. 39 per dollar (EIU, 1995).

The nominal exchange rate was depreciated by 34.3% in 1990, an average of 12.9% in 1991- 92 and an average of 0.6% between 1993 & 95 (World Bank, 1995d). However, the real effective exchange rate appreciated by a cumulative of 35% between February 1991 & June 1994 (World Bank, 1995c), by an average of 20% in 1995 and of 27% over the first half of 1996[2]. This has been attributed to the slow disinflation process combined with the use of a relatively fixed nominal exchange rate against the dollar (World Bank, 1995c, p.159).

[1] This is based on a discussion with Mr. Mamdouh Habssa, an official in the research department of the Central Bank of Egypt

[2] Source is Ministry of State for Economic Affairs - Based on IMF calculations

It seems that the 1994 disagreement between the GOE & the IMF with respect to further real devaluation reflected the state's concern about its detrimental effect on public confidence in local currency. The GOE has argued that the potentially positive impact of real devaluation on short term export competitiveness will be offset by threatening the repatriation of overseas Egyptian capital funds, estimated at $ 120 billion, as well as by raising the already high import bill in Egyptian currency, thus producing inflation (EIU, 1995, p.54).

In this respect, it is important to consider the *cost push effect of devaluation* given the high intermediate import content of domestic production. Indeed, Egyptian imports are expected to be inelastic to changes in the exchange rate in view of their structure (Abdel Khalek, 1994, p.9) as the share of intermediate imports has averaged 47% of total merchandise imports between 1991/ 92 & 1995/96 (MOP, 1996, p.75).

This is in addition to the share of capital goods reaching an average of 25.4% over the same time period (MOP, 1996). It has been argued that these structural characteristics will ultimately increase the cost of domestic production, and may negatively affect the competitiveness of tradables sectors producing exportables or import substitutes (Abdel Khalek, 1994) as further discussed in section (B) under the trade liberalization component of ERSAP.

4 - Debt Rescheduling: Egypt's improved external debt status has ranked it among the moderately indebted countries as foreign debt declined from $ 51 billion in 1989 to an average of $ 42 billion between 1992 & 1995 (World Bank, 1995d), and fell to around $ 31 billion in mid 1996 (MOE, 1996, p.11). In addition, foreign debt to GDP ratio declined from over 150% before reform to 93% in FY 1995 (World Bank, 1995d) and to around 49% in FY 1996 (MOE, 1996). The debt service ratio also decreased from about 47% before reform to 17% in FY 1995 (World Bank, 1996) and to only 14.3% in mid 1996 (MOE, 1996).

This has been achieved through the Paris Club debt relief agreement, signed in May 1991, that initially aimed at halving Egypt's official public debt over the 1991- 1994 period (Handoussa, 1993a, p.26). It also entailed a 30% reduction in interest payments in non-concessional official debt as well as rescheduling of the remaining 50% Paris Club debt over 25 years (EIU, 1995).

The debt restructuring mechanism was implemented in three phases based on the satisfactory performance of the reform program under the IMF arrangements (World Bank, 1996). The first phase relieved Egypt from 15% of the present value of debt service, estimated at $ 28 billion of official & government guaranteed civilian & military Paris club debt, in July 1991 after the approval of the SAL & SBA (EIU, 1995). This was followed by a second phase writing off a further 15%, of the same amount, in October 1993 upon satisfactory completion of the 1991 ERSAP in March 1993 (World Bank, 1996).

The final phase, providing a 20% reduction in the present value of debt service in July 1994, was delayed upon the first review of the EFF due to disagreement between the GOE & the IMF on the macroeconomic policy framework (World Bank, 1996) mainly with respect to the question of devaluation and the pace of the privatization program. In October 1996, Egypt was relieved from the last tranche of the Paris Club debt upon the IMF recommendation.

It may be stated that acceleration of the privatization program, during the third and last quarters of 1996, significantly contributed to such outcome as the GOE demonstrated its strong commitment to the reinforcement of structural reforms. According to the IMF revised projections in November 1996, the new forecast of Egypt's debt profile is positively affected by such relief as the total effect of the debt release amounts to around $ 6 billion, and interest obligations will be annually reduced by about $ 400 million over the 1997 - 2000 period (IMF, 1996).

B - Evaluation of Structural Adjustment Reform

Price decontrol, trade liberalization & public enterprise sector reform have constituted the key elements of the 1991 structural adjustment package targeting the correction of existing distortions in the price structure that sent wrong market signals over the past three decades. It can be stated that these reforms have become imperative so that domestic prices truly reflect the real scarcity of economic resources, and hence result in a more efficient resource use. Special attention has also been paid to reform of the legislative code, financial opening and reactivation of the capital market in order to efficiently mobilize local & foreign saving resources and to enhance attractive investment opportunities.

1 - **Deregulation of Factor & Goods Markets:** According to the World Bank Implementation Completion Report (1996), the GOE has achieved an important progress in the course of the deregulation of the input and output markets (World Bank, 1996). It should be noted that the 1991 price reform presents continuation of the 1986 liberalization efforts with respect to the gradual phasing out of subsidies and the decontrol of prices in the energy, agriculture & industrial sectors (Handoussa, 1993a).

a - **Manufacturing Sector:** Prices of almost all industrial products have been freed except for a limited quantity of sugar, flour & edible oil that are allocated to rationed cards as well as cigarettes[1]. Pharmaceuticals present the only sector that is still under control due to its special socio- political nature, and whose prices are determined by the Ministry of Health according to a cost plus pricing formula[2].

[1] Source is the Ministry of Supply & Internal Trade

[2] Source is the Ministry of Industry - Based on an interview with Mr. Ahmed Saleh, First Under Secretary of MOI

b - **Energy Sector:** It can be stated that the significant increase in energy prices, since the 1987 reform & throughout the 1990s, has been effective in reducing the high consumption growth rates experienced during the eighties (Messiha, 1995). This has led to energy conservation that released substantial petroleum products for export reaching 48.9% of total exports in 1993/94 (EIU, 1995). The decline in energy consumption rates has varied among the different sectors of the economy as shown in table (4). These have moderately decreased in the industrial (Ind) & the Transport (Tr) sectors whereas the agricultural (AGR), residential and commercial (R & C) sectors have actually recorded negative growth rates over the 1992/93 - 93/94 period (Messiha, 1995).

Table (4)

Average Annual Growth Rate of Energy Consumption by Sector

5 Year Plans	Ind	Tr	R & C	Agr	Other	Overall
82/83- 86/87	5.7	44.4	8.7	1.5	5.3	12.4
87/88- 91/92	6.3	1.7	0.003	-0.37	7.5	3.7
92/93- 93/94	4.7	zero	-4.2	-6	22	1.9

Source: Messiha (1995)

c - **Agricultural sector:** Prices of all agricultural goods have been fully liberalized by 1994, except for sugar (World Bank, 1996). The 1991 price reform aimed at the discontinuation of compulsory delivery quotas for sugar cane, rice & cotton whose prices remained fixed despite the 1986 price reform that virtually removed controls from all crops except for these (EIU, 1995). In February 1991, delivery quotas for rice were cancelled, and cotton producer prices, raised to 50% of their world level, were further increased to 66% in 1991/92 (GATT, 1992). Subsidies for fertilizers & pesticides, used for cotton cultivation, were halved in June 1991, and the animal fodder subsidy was eliminated in December 1991 (Handoussa, 1993a).

The Cotton Market Law & its executive regulations were passed in 1994 to deregulate the cotton subsector, to restructure its internal trade and to eliminate public sector trade monopoly (ECG, 1995). The Cotton price has also been liberalized except for a price floor set on the basis of world level for short staple cotton (MIC, 1993).

In general, price decontrol has led to gains in agricultural output growing at 2.5%, 3.8%, 2.9% & 3.1% over the 1992/93 - 1995/96 period, and attaining self sufficiency levels in the production of important commodities such as: rice, beans, fruit & vegetables (EIU, 1995). This resulted in the increase in agricultural exports to reach 9.6% of total exports in 1993/94 & 13.9% in 1994/95 (CBE, 1995).

2 - Trade Liberalization: The 1991 trade reform has focussed on the elimination of restrictions on both the import and export sides. Reform initially aimed at a 10% annual reduction in the standard maximum tariff rate to reach 50% as well as a reduction of 10% for all other tariffs in the range of 30% and above by the end of 1995 (EIU, 1995). In this respect, progress with trade liberalization has been slow as the decline in the maximum tariff, from 160% in 1988 to 70% in 1995 (World Bank, 1995c), has fallen behind the schedule and reached 55% in 1996 (IMF, 1996, p.11). The average tariff rate has also been gradually reduced from 31% in 1988 to 28% in 1995 (World Bank, 1995c, p.3) and to 17% in 1996[3].

Trade reform began in March 1991 with the reduction of the coverage of import bans from 37.2% to 23% of total agricultural & industrial output (Handoussa, 1993a), and was further reduced to reach 10.1% in February 1993 as compared to the second tranche release target of 10.6% (World Bank, 1996). The production coverage ratio of conditionally prohibited goods on the banned list was also reduced from 52 to 41% in May 1991 (GATT, 1992, p57).

[3] Source is the Ministry of State for Economic Affairs

According to the World Bank ICR (1996), the GOE has gone beyond its targets with regard to reduction of tariff preferences and number of items subject to prior approval, to lifting export bans & quotas, as well as with respect to suspension of all LCs previously requested for importation (Handoussa, 1993a). Preferences & exceptions to the maximum tariff were largely eliminated, and tariffs on nearly all capital goods were reduced to 5- 10 percent (World Bank, 1995d, p.36). All NTBs were also removed except for very few items, and these on textile imports were reviewed for their ultimate abolishment according to the Urugway Round (World Bank, 1996).

The quality control system on imports has been improved with a high degree of transparency ensured (World Bank, 1996). Indeed, information on products subject to this system began to be published, inspection fees were reviewed and the harmonized system of commodity classification was adopted (MIC, 1993). This was accompanied by simplification of administrative procedures as well as improvement of the duty drawback & temporary admission schemes for exports; for instance, duty payments can be refunded within one week, and bonded warehouses facilities are used (GATT, 1992, p.75).

From an analytical point of view, it is noted that the trade balance has exhibited no signs of improvement since reform as trade deficit, presenting 17% of GDP in 1995, increased to LE 23.1 billion & to LE 27.1 billion in 1993/94 & 1995/96 respectively (MOP, 1996) compared to deficits of LE 13.4 billion in 1991 & 17.5 billion in 1992 (EIU, 1995). In addition, trade openness, calculated as (total merchandise imports + total merchandise exports) to GDP ratio, has fallen from 40.8% in 1992, to 38.5% in 1993 and to 37.6% in 1995[4].

[4] This is calculated from figures from (MOP, 1996), (CBE, 1995) & (World Bank, 1996)

According to the World Bank ICR (1996), trade reform has not yet succeeded to reverse the long trend loss in competitiveness despite the increase in non traditional exports since 1994/95 (World Bank, 1995d). This is indicated by the stagnated share of merchandise exports at an average of 37% of total exports over the 1991/92 - 1995/96 period (MOP, 1996, p.77). It can be stated that the Egyptian program for trade reform has so far focussed on import liberalization while no major measures have been undertaken with respect to export promotion (Abdel Khalek, 1994, p.34).

In a review of the composition of Egyptian exports, it is noted that oil exports have constituted a high share averaging 43% of total merchandise exports between 1991/92 & 1995/96. This has been in contrast to the modest share of agricultural exports averaging 8% of total merchandise exports, while industrial exports have exhibited a higher average of 35% over the 1991/92 - 1995/96 period, with impressive shares of 40% & 43% over the last two years (MOP, 1996, p.75).

It seems that the competitive position of Egyptian exports has been weakened due to real exchange rate cumulative appreciation, over the 1991- 1996 period, that led to competitiveness loss posing questions about the potential role of the export sector in promoting growth in the near future. This resulted from the adoption of fixed nominal exchange rate against the dollar, combined with the relatively slow decline in domestic inflation that has been higher than Egypt's main trading partner countries (World Bank, 1995d, p.2).

According to some economists, the weakened position of Egyptian exports in the world market, coupled by the reduced protection of import substituting activities may result in a shift of resources from the tradables to non tradables sectors, and this may expose the Egyptian economy to the risk of *de - industrialization* (Abdel Khalek, 1994). It may be argued, however, that the Egyptian economy is currently immune from such risk given its low unit labor cost of production as the cost of wage is estimated at only 9% of total output value (MOE, 1996).

In this sense, Egypt possess a competitive edge over its trading partners in terms of its abundant labor force currently estimated at 17 million and low manufacturing wages falling in real terms as a result of the 1987 & 1991 large devaluations. This is in addition to the overall labor productivity rising by 63% over the 1980- 92 period, based on the UNIDO's industrial statistics (MOE, 1996, P.43).

Thus, it may be stated that Egypt's comparative advantage lies in its labor intensive industries such as textiles and food processing, in addition to energy intensive projects, relying on the country's reserves of natural gas. It should be also noted that Egyptian exports are currently supported by the growing service sector providing exporters with information about foreign markets, world standards & specifications, packaging and advertising services as well as credit & guarantee facilities extended by the newly liberalized financial sector (MOE, 1996).

3 - Reform of the Business Climate: This has been one of the most vital issues on the reform agenda in order to remove bureaucratic obstacles to the active participation of the private sector whose investment share of GDP stood at 3.4% in FY 1990 in contrast to government share of 18.1% (World Bank, 1996). According to the World Bank report "Private Sector Development in Egypt: Status & Challenge" (1994), the Egyptian investment climate has suffered from a number of deficiencies on the legislative and administrative levels.

These include restrictive labor laws, weak protection of consumer & intellectual property rights, inadequate trade legislation, inefficient public institutions for policy administration & enforcement, time consuming litigation procedures and cumbersome tax administration (World Bank, 1994). More importantly, it has been argued that lack of supportive infrastructure, such as, efficient credit mechanisms and sufficiently educated workforce and management base inhibited the investment take off in Egypt during the past two decades (EIU, 1995).

That is why special attention has been paid to the preparation of a new Investment Incentives Law that aim at ameliorating the investment climate in Egypt through provision of tax holidays & incentives as well as insurance against the risk of *confiscation or nationalization*. This is in addition to the new Corporate Law, including bankruptcy, antitrust, merger & arbitration provisions, whose main objective is to simplify the incorporation rules & procedures into the Egyptian market[5]. A labor Law is currently drafted in order to increase labor market flexibility and mobility, and to enhance its efficiency (IMF, 1996, p.26).

It is worth mentioning that the new liberal business environment currently allows the full foreign ownership of projects, and makes no discrimination between local and foreign investors. More importantly, capital and profit can be freely repatriated, and transaction costs including registration fees have been abolished (MOE, 1996, p.15).

Reform of the investment environment started in December 1990 by the abolishment of the investment licensing process in July 1991 (Handoussa, 1993a). This was coupled by the announcement of an explicit negative list, denoting sectors & activities for which licensing approvals were necessary, that was simplified in June 1992 (World Bank, 1995c). The list was completely abolished by the end of 1993 as non- automatic approval has only been limited to projects related to health, security & environment activities whereby investment approvals are to be granted from the concerned ministries[6].

[5] Source is the PEO- These Laws are being currently drafted to be approved by the Ministerial Council before the end of 1996

[6] Source is GAFI

This resulted in simplification of administrative works related to the approval of new investment projects, and altered the nature of both GAFI & GOFI's roles from controlling investors to supporting them with the necessary information about the domestic market. Indeed, registration has been automatic for new projects to be approved within a maximum of 2 weeks (Handoussa, 1993a), and companies are currently exempted from application for business expansion and changes in product mix (World Bank, 1995c).

This has been in addition to the abolishment of controls on private placement services & job advertising as well as streamlining decrees issued by Governerates for approvals & legal requirements for establishing companies, changing plant location and market exit (World Bank, 1995d, p.26). In order to enhance private sector participation, public sector monopolies for cement & fertilizer distribution have been phased out, and private sector dealers have been licensed (MIC, 1993). This has been accompanied by the removal of quantity & geographical restrictions on their distribution (World Bank, 1996).

Special attention has also been paid to reforming the tax system through increases in tax rates, improvements in its administration and shift from specific to ad valorem taxes. This has also entailed the restructuring of stamp tax & custom tariffs, with rates revised according to inflation and the discontinuation of renewal of corporate tax holidays in July 1993 (MIC, 1993). The General Sales Tax was also introduced to narrow dispersion of tax rates and to reduce the incidence of specific rates (GATT, 1992, p.55). A Global Income Tax law was enacted in December 1993 to reduce top marginal tax from 65 to 48% and to apply a single rate structure to most sources of income to replace the past four schedular taxes & the complementary general income tax (World Bank, 1995d) in order to speed rationalization of the personal taxation system and the reform of the corporate income tax (EIU, 1995).

In a review of the distribution of private investment since financial liberalization in 1991, it is found that FDI has remained low, by international standards, at just 4% of total private sector investment in Egypt. This has accounted for only 0.5% of GDP, and has been mainly concentrated in manufacturing & banking sector with respective shares of 50% & 30%. Nevertheless, FDI flows to Egypt are expected to be further stimulated, and to exceed $ 1 billion annually in response to improvements made in the investment climate (MOE, 1996, p.5). Private direct investment has also shown a modest share at 9% of GDP according to World Bank estimates, and has been concentrated in bank deposits and highly yielding & low risk TBs partly used to sterilize capital inflows (EIU, 1995).

Participation of the private sector in GDP has stagnated at 63.3% in 1995/96 in contrast to 61.2% in 1991/92. The highest shares have been made in the following sectors respectively: agriculture, real estate, trade, tourism & construction. These have been followed by industry, transportation, the insurance & finance sectors as shown in table (5) presenting the sectoral share of the private sector in GDP over the 1991/92 - 1995/ 96 period (MOP, 1996, p.44).

Table (5)

Trend in Sectoral Share of the Private Sector in GDP

Over the 1991/92 - 1995/96 Period

Sector	1991/92	1995/96
Agriculture	98.8	98.7
Industry	58.1	62.2
Petroleum & products	17.3	16.1
Construction	70.8	72.1
Transport & Communication	47.9	51.3
Trade	89.7	93.3
Finance	29.3	30.5
Insurance	39.5	40.4
Hotels & Restaurants	84.7	85.2
Real Estate	94.6	94.4
Total	61.2	63.3

Source: MOP (1996)

4 - **Public Enterprise Sector Reform:** This aims at reducing the role of the State in the economy through the creation of a wide base for share ownership and the transfer of PEs' assets to potential private owners with technical know- how, expertise, management competence and financial strength. Privatization and restructuring have been the main vehicles for public enterprise sector reform. These basically aim at improving the operational & financial efficiency of the whole sector as well as controlling its huge losses that reached LE 2.1 billion in FY 1991 (PSIC, 1992).

Table (6) presents the key indicators for PEs' financial performance over the 1992- 95 period over which the overall losses of LE 63, 306 million turned into a net profit of LE 1.2 billion as of June 1995. On the other hand, efficiency indicators exhibit slow signs of improvement in productivity, as shown in table (7), to reflect the need for a fundamental change in the scope of PEs' operational, marketing & management techniques (PEO, 1996).

Table (6)

(In LE Thousands)

Fiscal Years	Total Profit	Total Losses	Net Profit	Accumulated Losses
1992/93	2,342,155	(2,405,461)	(63,306)	(6,060,698)
1993/94	2,908,979	(2,299,183)	609,796	(7,943,401)
1994/95	3,705,762	(2,488,304)	1,217,458	(9,589,471)

Source: PEO (1996)

Table (7)[7]

Fiscal Years	Return on Assets (%)	Return on Sales (in LE)	Labor Profitability (in LE)	Labor Productivity (in LE)
1992/93	(0.1)	Zero	(0.06)	46,52
1993/94	0.6	0.01	0.61	50,73
1994/95	1.2	0.02	1.28	57,03

Source: PEO (1996)

It can be stated that the GOE has succeeded with respect to the preparation of the legal & institutional framework necessary to ensure an effective implementation of the program. Indeed, the release of the second tranche has been recommended on the basis of the overall progress made in the sector, and that underlines the GOE's determination to proceed with the program (World Bank, 1996).

Enactment of a new Public Enterprise Law 203 in May 1991 presented an initial step for the regulation of the sector and the introduction of a radical change in the scope of PEs' objectives towards profit maximization & cost rationalization under the new market oriented system. The Law separates ownership from management, and embodies a high degree of *autonomy* enabling PEs to operate on economic commercial basis with a minimal degree of State interference in day to day decisions (PEO, 1993).

[7] Appendix (A) includes a definition of efficiency indicators

This also dictates enforcement of the *accountability* principle on the part of the management of both the HCs & the ACs whose Board of Directors can be fired upon a decision from the HC's General Assembly for non satisfactory performance. Sound administrative regulations have been developed within the structure of each PE to create a solid basis for the use of a Reward System adopted for the assessment of management and employees' performance in light of the accomplishment of planned profit targets (PEO, 1993).

Issuance of the General Procedures & Guidelines for Government Programs of Privatization, Restructuring & Reward System in early 1993 has ensured a high degree of transparency for the program. This was followed by a radical change in the structure of the existing 27 HCs & their 314 ACs reorganized into a smaller number of 17 HCs, and later to 16 HCs in 1996[8]. This has become a necessity in order to eliminate HCs' monopoly power ensured by the old structure whereby each HC grouped all PEs specialized in the production of a certain activity. The new structure led to the diversification of HCs' portfolios allowing ACs an adequate exposure to market forces by subjecting them to real competition from both private & public counterparts.

According to the World Bank Implementation Completion Report (1996), privatization has been slow & hesitant (World Bank, 1996) with the 1991 book value of divested PEs reaching only 5.5% of the total book value of all Law 203 Companies as of the first Quarter of 1996. This has been achieved through sale of majority interest in 13 PEs, sale of a minority holdings in 17 PEs and liquidation of 10 PEs. The slow pace of privatization has been explained in light of the two main factors that virtually crippled its progress, namely, high PEs' indebtedness to the banking sector, amounting to LE 36.5 billion, as well as labor redundancy estimated at 25% of total PEs's labor force of 950,000 employees as of 1995 figures (PEO, 1996).

[8] Source is the PEO - The General Guidelines for Privatization were updated in September 1996.

Alternative solutions have being carefully studied, yet no decisions have been made at the level of the whole sector due to the significant costs of such problems in terms of high banking sector exposure as well as endangering social and political stability. Meanwhile, case by case solutions have been designed as PEs individually agree with banks on debt rescheduling, and social schemes are developed by the Social Fund for Development (SFD) to tackle the labor redundancy problem as explained in section (7) (PEO, 1996).

It may be stated that opponents of privatization have mainly focussed on its high social cost in terms of major labor dislocations expected in the course of Public Sector Reform. It is worth noting, however, that the workforce in this sector accounts for less than 6% of Egypt's total labor force whereas the Civil Service's share is more than 17.5%, and presents a burden on the Government budget as discussed earlier in section (A). It can be also argued that the size of the Public Sector labor force has been gradually rationalized since mid 1980s as a result of virtual termination of forced hiring practices and through attrition. According to estimates of the MOI in 1991, this allowed 16 industrial PEs to reduce their work force by 10% between 1985 & 1990, to raise real labor productivity by 10% annually, and to increase their net profits threefold in 1988/ 89 (Handoussa, 1991).

The GOE recognizes the significant weight of the social aspect of privatization in ensuring the success of the overall reform program. That is why assurance has been continuously made that no dismissal will be allowed during the reform process. More importantly, the GOE has wisely encouraged employees to participate in the process by allowing labor ownership of divested PEs through employee shareholding associations (ESAs) that have acquired around LE 3.5 billion of offered assets (World Bank, 1995d, p.3).

The privatization process has gained momentum upon the GOE's announcement in early 1996 to speed up the implementation pace over the next two years. The 1996 -98 privatization program encompasses the sale of 91 PEs (PEO, 1996), accounting for 59% of the net worth of all Law 203 companies (IMF, 1996), either to the public in the stock market or to anchor investors as shown in Annex (I). This program denotes the GOE's intention to divest more than 25% of the Public Business Sector by mid 1998 (PEO, 1996). This is in addition to the divestiture of Law 203 companies' major interest in joint ventures (IMF, 1996, p.9).

5 - Financial Liberalization: It can be stated that reform of the financial sector has significantly improved perceptions about the future performance of the Egyptian economy. This has stimulated large capital inflows that increased the level of international reserves held by the CBE from $ 6.4 billion in 1991 to $ 18.5 billion in May 1996, presenting 18 months of imports of goods & services in FY 1995 (MOE, 1996, p.2). This has also triggered a process of de- dollarization that is measured by the change in the ratio of total foreign currency deposits to total deposits (Abdel Khalek, 1994, p.24). Indeed, this ratio declined from a peak of 61% in June 1991, to 43% in June 1992, to 32% in June 1993 (Abdel Khalek, 1994), to 27% in June 1994, and reached 29% as of June 1995 (CBE, 1995).

According to Egyptian authorities (1992), an estimated amount of $ 1.4 billion switched from foreign currency accounts to LE deposits in response to higher nominal interest rates, liberal foreign exchange transactions and the unification of the exchange rate (GATT, 1992). This started in the wake of interest rate liberalization with the ratio of local currency deposits to GDP increasing from 29.4% in FY 1991 to 48.4% in FY 1995 (MOE, 1996, p.67).

a - Capital Account Liberalization: Free capital account transfer was stipulated by the new foreign currency Law 38 issued in April 1994 to abolish all restrictions on foreign exchange transactions (CBE, 1995). This allows the unlimited transfer of foreign currency in or out of Egypt and between individuals within the country (EIU, 1995, p.54).

The only remaining foreign exchange control, committing foreigners by a five year transfer period for real estate sale proceeds, was eliminated in July 1996 (IMF, 1996). As for the convertibility of the Egyptian Pound, it remains non - convertible and cannot taken outside of Egypt (EIU, 1995). Capital account liberalization has been gradually implemented starting February 1991 when foreign exchange was made freely transferable abroad, and authorized banks and nonbank dealers were free to sell foreign exchange to individuals, public & private sector entities (Schadler, etal 1993, p.20).

b - Reform of the Banking or Financial Sector: The Egyptian banking sector has been highly dominated by the four large public sector banks: National Bank of Egypt, Banque Misr, Bank of Alexandria and Banque du Caire accounting for 55% of the whole system's total assets. Indeed, private banks associated with these state owned banks present more than 90% of total assets of commercial banks (EIU, 1995).

Reform started as early as December 1990 with the reduction of required reserve ratio on Egyptian deposits from 25 to 15% & from 15 to 10% on foreign currency deposits (MIC, 1993) and the modification of liquidation ratios to minimum of 20% of Egyptian liabilities & to 25% of foreign currency liabilities in January 1991 (World Bank, 1992b). This was followed by the recapitalization of the banking sector as the CBE injected $ 2 billion into the four major banks to improve their capital structure (Handoussa, 1993a) as was the case in Chile during the 1985 adjustment program.

One of the most important reforms has been the enforcement of discipline on banking operations in mid 1991 by introducing new regulations on risk concentrations & loan classifications, provisioning, and imposing limits on foreign exchange exposure to 15% of capital. This is in addition to subjecting public sector banks to detailed auditing by local and international firms along the CBE's issued guidelines (World Bank, 1992b).

This has been coupled by the enactment of a new banking Law 37 in June 1992 aiming at the modernization of the sector along the international norms, and strengthening the CBE's supervisory power over banks (EIU, 1995). In 1993, the GOE approved the legal basis for the establishment of a deposit insurance fund to serve as an explicit rescue mechanism for protecting depositors in response to the collapse of BCCM in 1991 (Moheildin, 1995, p17). This has been coupled by allowing branches of foreign banks to conduct business in Egyptian currency for the first time in 1993 (EIU, 1995).

According to the World Bank report (1992) "Egypt: Financial Policy for Adjustment and Growth", privatization as well as elimination of entry & exit market barriers are instrumental for stimulating the operational efficiency of the banking sector. The proposed sequence for privatization is to sell joint venture banks prior to public sector ones (World Bank, 1992b).

However, privatization of the sector has been limited to sale of equity of joint venture banks to employee shareholding association (ESAs) (World Bank, 1995d, p.3). This is in addition to divestiture of public banks' major holdings in only two joint venture banks as of 1996. In the process, the GOE approved a draft of the new Banking and Credit Law amendments allowing foreigners to own more than 49% of the capital of joint venture banks (MOE, 1996, p.69). It has been argued that the state's reluctance to privatize the sector denotes unwillingness to yield its share in profitable joint venture banks as well as its prudence to reveal the books of its four public owned banks to public investigation with non performing loans reaching 30% of total loans according to the World Bank estimates in 1992 (Moheildin, 1995).

6 - **Development of the Capital Market:** The current reform recognizes the pressing need to revitalize the Capital Market due to its significant role in capital mobilization and in the promotion of private sector ownership of state owned companies through public offerings & subscriptions. That is why, a new comprehensive Capital Market Law 95 came to force in April 1993 (Fag El Nour, 1994). This aims at stimulation of the stock & bond markets in order to provide new alternative sources for corporate financing that heavily relied on the banking sector in the past two decades (EFG, 1996, p.45). Law 95/ 1993 establishes the Capital Market Authority (CMA) as an independent technical authority in charge of the regulation of the market and the development of its infrastructure (Fag El Nour, 1994).

The real challenge facing the development of the Capital Market is to regain public confidence eroded over the past three decades. This resulted from the nationalization & expropriation in the 1960s, hit & run activities abusing the soft laws during infitah, and the decline of Islamic Investment Companies in late 1980s, that led to the stagnation of the market (Moheildin, 1995). This was indicated by the decline in stock market capitalization as a percentage of GDP from 12% in 1958 to only 1% in the 1970s & early 1980s (World Bank, 1992b, p.175). In addition, the role of the market in saving mobilization was reduced as it only allocated 3% of new private capital during 1989- 91 in contrast to 50% in 1958- 61 (Moheildin, 1995).

Failure to reactivate the securities markets during the 70s & 80s was partly attributed to the unfair competition from the banking sector providing subsidized lending rates until 1991. This is in addition to the discriminative tax treatment exempting government bonds & bank deposits from all forms of taxes while subjecting corporate securities to various ones (Moheildin, 1995).

That is why a number of measures have been undertaken to enhance the attractiveness of local financial assets, such as, removal of income tax on stocks and bonds (EFG, 1996), of the 2% capital gain tax on stocks and the stamp tax on financial transactions (IMF, 1996, p.24). Foreign investment in the stock market has also been allowed and accounted for 20% of the value of transactions in June 1996, with more than 125 foreign financial institutions participating in the market (MOE, 1996, p.16). The capital market activation has stimulated the development of a strong basis for financial intermediation with large institutions offering key professional services, such as, brokerage, underwriting and fund & portfolio management (MOE, 1996, p.71).

Law 95/1992 has also undertaken decisive steps to improve investors' confidence and to protect their rights & interests. These include enforcing fair & transparent trading practices, committing listed firms to comply with international accounting standards to ease assessment by investors. This is in addition to preparation of prospectuses to be approved by the CMA prior to proceeding with a public offering, and ensuring an immediate access to sufficient information as daily bulletins about market transactions are published (Fag El Nour, 1994). A central depository system was also introduced in May 1996 to enhance development of the market (IMF, 1996).

As a result of these changes, the market has witnessed an impressive increase in the volume of trading transactions from 17.7 million in 1993 to 72.7 million in 1995 as well as in the value of traded shares & bonds from LE 569 million to LE 3.8 billion over the same time period. In addition, the number of traded companies in the Stock exchange increased from 264 in 1993 to 352 in 1995 as shown in table (8) (CMA, 1996).

Total market capitalization reached LE 27.4 billion in 1995 compared to LE 12.8 billion in 1993. This increased from less than one percent of GDP in 1986 to 7% in 1992, to 15% of GDP in 1995 (CMA, 1996) and to 16.3% in 1996 (MOE, 1996, p.16). Bond issuance coupled by the 1996- 98 privatization program are expected to further activate the market.

Table (8)
Trading in the Egyptian Stock Exchange Between 1993 & 96

Description	1993	1994	1995	1996*
Value of Trading (LE Million)	568.6	2557.2	3849.4	2253.7
Volume of Trading (Million)	17.7	59.8	72.2	47.3
Number of traded Companies	264	300	352	260
Market Capitalization (LE Million)	12,807	14,480	27,420	28,357

* As of May 31, 1996
Source: Capital Market Authority (1996).

7 - Social Safety Net: *Poverty & unemployment* have presented two principal problems to reform, and have been aggravated by the 1991 ERSAP measures. These have been used to tighten fiscal control, such as, price and tax increases, subsidy removal and labor redeployment expected in the course of public sector reform. Such immediate costs have burdened the public, and generally created lack of popular support to reform during its initial stage. According to the World Bank estimates, 20 to 30 % of Egyptians live in poverty (World Bank, 1995e). Based on official estimates, unemployment has only averaged 9.6% of total labor force between 1991/92 & 1995/96, and the labor force has increased by 3.1% to outpace annual population growth of 2.6% over the 1981/82 - 1995/96 period (MOP, 1996, p.62).

Special attention has been paid to the development of social assistance schemes necessary to minimize social costs during the transitory period of reform and to alleviate their impact on the poorer segments of the society. Indeed, the GOE has attempted to avoid potential social & political unrest, at least in the short run until the expected benefits from reform are materialized. A social safety net program is currently under preparation to provide social welfare transfers serving the lowest income groups estimated at 4 million persons (MEO, 1996, p.25).

The Social Fund for Development (SFD) was also established in March 1991 to answer the pressing needs of targeted groups, such as, the unskilled & semi-skilled unemployed workers and the households headed by women. Poverty reduction through employment generation and community development efforts constitutes the main objective of SFD (World Bank, 1995c).

According to the GOE & the World Bank's evaluation of the performance of SFD, this has been successful to create between 50,000 to 70,000 jobs annually, almost 25% of all non agricultural annual jobs (world Bank, 1995e), and it is estimated that six million people have directly benefitted from SFD (World Bank, 1995c). A set of core programs and projects has been developed to create new employment opportunities and to reduce the existing unemployment, and financed by the donor community providing the SFD with $ 600 million (SFD, 1995).

(1) Public Works Program (PWP) creates direct employment through provision of labor intensive infrastructure & municipal works in rural areas such as: rehabilitation of water supply & sewerage systems and canal cleaning (SFD, 1995). A total of 59 projects are being undertaken, and have created 13,642 temporary & 1,995 permanent jobs (MOP, 1996, p222). It is estimated that 300,000 short term jobs will be generated by the PWP (Abdel Fadil, 1994).

(2) Community Development Program (CDP) aims at improving the quality of life for the most vulnerable groups of the society by providing them with essential services through basic & primary health care programs, mother & child nutrition programs (Abdel Fadil, 1994). The CDP directs special attention to governerates of upper Egypt, and focusses on the eradication of illiteracy as education is recognized to be an indispensable key for development (SFD, 1995). A number of 138 projects have been contracted, and have created 19,268 temporary & 80,613 permanent jobs (MOP, 1996).

(3) Enterprise Development Program (EDP) targets the development of small sustainable enterprises to generate job opportunities for all groups of the unemployed. This is realized through the provision of integrated packages of credit, technical assistance & training for target groups. Technical assistance entails: identification of investment opportunities, quality counselling & marketing (SFD, 1995). It is estimated that EDP has provided 50,520 temporary & 111,462 permanent job opportunities through the implementation of 93 projects (MOP, 1996).

(4) Employment & Retraining Program (ERP) is mainly designed to tackle labor redundancy problems, suffered by most PEs undergoing restructuring & privatization, through redeployment or voluntary retraining programs that aim at improving the productivity of redundant workers. In addition, ERP undertakes the training of the unemployed graduates that are interested in acquiring skills that are highly demanded (SFD, 1995). 43 projects have been contracted, and created 1,047 temporary & 1,955 permanent job opportunities (MOP, 1996).

(5) Institutional Development Program (IDP) aims at strengthening SFD's targeting, monitoring & evaluation systems in order to reinforce the government capacity to assess the impact of economic reform on the living conditions of the poor. This is necessary to enhance the GOE's ability to design and monitor future poverty alleviation & social safety net programs (SFD, 1995). This created 351 thousand temporary jobs under 46 projects (MOP, 1996).

C - Prospects For Growth of the Egyptian Economy:

Over the past two decades, priority was awarded to political stability over economic rationality, and valuable opportunities for early reforms were wasted in mid 1970s when foreign exchange revenues were abundant as well as in the late 1980s when serious reform packages were proposed by the World Bank & the IMF to eliminate the various distortions at the macro & micro levels of the economy. The cost of delayed economic restructuring has been high in terms of sluggish growth, stagnant non oil exports and unsustainable foreign debt burden surpassing Egypt's servicing capacity. These factors have all slowed Egypt's integration into the world economy, and negatively affected its creditworthiness internationally.

It may be stated that the Egyptian economy currently cannot afford delays or mistakes in the course of implementation of its 1991 ERSAP given the process of globalization urging LDCs to move at a speedy pace towards economic liberalization. Indeed, reforming economies are competing to acquire the beneficial dynamics of integration which now seem necessary for establishing a self- sustained growth process. This can be achieved through access to the world market, capital investment and FDI presenting a viable channel for technology transfer, improvement of managerial skills and employment generation. In this respect, Egypt has lagged behind the four countries under study, that initiated their reform efforts over the past two decades, and rapidly progressed with the liberalization of their goods & financial markets during the first half of the 1990s.

This section discusses the main difficulties challenging the sustainability of the 1991 ERSAP with special emphasis on the scope, speed and sequencing of reforms in addition to the degree of consistency between policy tools and targets. The source of growth potentials in Egypt is explored in light of the core of the third reform phase over the 1996- 98 period. Special attention is paid to examining the capacity of the local financial system for efficient resource mobilization as well as the readiness of the Egyptian economy to compete in the world market. This is in addition to assessing the soundness of monetary policy, exchange rate management and the forcefulness of the privatization program since they all play a significant role in reflecting the degree of the government's credibility.

1 - The Current Challenges Facing the 1991 ERSAP: It seems that strengthening stabilization & structural adjustment efforts has become a precondition for the Egyptian economy to achieve a speedy growth recovery and to safely integrate into the world market as has been demonstrated by the Chilean and Korean experiences. While fiscal consolidation presents an important objective of the third reform phase, aiming to reduce the budget deficit to only 1.1% of GDP in 1996/97 (IMF,1996), reinforcement of structural reforms constitutes its backbone in order to allow a larger share of private sector participation in economic life and to promote private savings and investments.

These have become indispensable vehicles to generate higher employment opportunities, to raise the standard of living for Egyptians and to accelerate economic growth in Egypt. In this sense, it may be stated that Egypt's growth potential, speed and strength are mainly determined by the private sector's supply response to the 1990s' reform.

As it has been noted in Part One, greater and better quality of investment is expected to result in higher rates of economic growth. Indeed, arguments have been made about the effectiveness of higher volumes of investment in initiating a circular relationship between saving, investment and growth in Egypt, close to the one experienced by successful economies, such as, Chile, Korea & Malysia.

It can be noted however, that a rapid & sustainable growth policy significantly depends on the efficient transformation of large and liquid savings into productive assets rather than on the aggregate level of savings. In other words, resource availability is a necessary but insufficient condition for stimulating investment, production and growth (Abdel Fadil, 1994).

It may be stated that the Egyptian economy has not suffered from resource mobilization problems but rather from their efficient allocation (World Bank, 1992b, Ch1. p.3). This was demonstrated by the amount of deposits mobilized by the Islamic investment Companies in the late 1980s, and estimated at LE 4 to 5 billion in 1988 to present more than 12% of time & saving deposits held within the banking sector (Moheildin, 1995). This is in addition to the high share of gross national saving reaching 28% of GDP during the 1980s, and the impressive financial deepening whereby the ratio of M2 to GDP reached 58% in 1988/89 to outperform Korea with 40%, Turkey 29% in 1987/88 and Mexico 27% in 1990 (World Bank, 1992b). These indicators denote Egypt's ability to mobilize saving resources as explained earlier in Part One.

Nevertheless, impressive resource mobilization was slowed in the first half of the 1990s when the share of gross national savings in GDP stagnated at an average of 20% of GDP between 1990/91 - 1994/95 (MOE, 1996, p.12), and M2/GDP reached only 13.1% in 1993 and 9.5% in 1994 (World Bank, 1996). More importantly, reluctance to commit savings to long term investment was reflected in the dramatic growth of private sector liquidity denoting a degree of uncertainty about the future course of interest rates over the long run as was discussed in Chapter Two. Indeed, current deposits grew at an average of 42% between 1989 to 1992 and 33% in 1993 to 1995 (CBE, 1995, p.117). Portfolio investment also increased over the past few years in response to the reactivation of Egypt's Capital Market.

Fears have been expressed about the short term and unstable nature of such liquid investments that may expose the economy to the potential risk of reversal of the *capital repatriation and de- dollarization* processes which started in the wake of the 1991 financial reform offering higher real interest rates and attractive differential between Egyptian & dollar deposit rates. Such reversal may rapidly materialize in face of political and institutional uncertainty, and endanger stability of the whole economy as was the case in Mexico & Turkey in the early 1990s.

That is why strengthening the efficiency of the local financial system, to convert liquid savings and infusions of short term capital flows into medium to long term investment funds, seems to be mandatory in order to avoid potential disruptions in the financial market and the whole economy. Indeed, long term savings & investments may be expected to generate a dynamic cycle of production, employment generation and growth through a higher contribution to capital formation reaching 21% of GDP in 1995/96 (MOP, 1996, p.235).

The capital market presents a viable vehicle for efficient resource mobilization by channelling large domestic and foreign savings towards corporate finance. Institutional investors, such as the pension funds and insurance companies, can play a leading role in broadening the capital market base. The government is currently considering investment of these funds' abundant savings in the securities market rather than in bank deposits and government bonds (PEO, 1996).

In addition to the necessity of efficient reallocation of financial resources, the saving-investment- growth argument ignores the Egyptian economy's weaknesses in the systems of human capital formation, enhancing export competitiveness, upgrading technological levels and strengthening the industrial base, all preconditions to realize rapid growth through savings and investment (Abdel Fadil, 1994). These may be viewed as the missing links in such a circular relationship, and imply the need for special attention to investment in human capital, promotion of exports, restructuring of the local industry and stimulation of FDI as a main channel for technology transfer and labor creation.

The state seems to have awarded special attention to the development of the existing infrastructure as well as improvement of the education system as a venue for investment in human capital in recognition of the importance of such factors in triggering an effective response from the private sector. Basic education, preventive health care and development of infrastructure have become the core of the undergoing public investment reform program (World Bank, 1995c). These are necessary improvements for Egypt to gain the expected benefits of liberalization as discussed in Chapter Three.

Indeed, the government has raised the investment share of education & health services to an average of 7.1% over the four year period from 1992/93- 1995/96 compared to only 3.2% & 3.9% respectively over the First & Second five year plans (1982- 92). Investment in infrastructure has stood at 48.5% of total investment allocations during 1982- 87, at 49.5% over 1987- 92, and remained at a high level of 49.6% during 1992/93- 1995/96 (MOP, 1996, p.49).

Private investment and FDI are considered reliable candidates for realizing the potential benefits of the ongoing reform program as they can establish a strong productive base in Egypt. This offers Egypt the opportunity to initiate a dynamic mechanism for the resumption of sustainable growth, and to minimize its vulnerability to external sources of foreign exchange revenues that acted as the driving forces during the mid 1970s- 1980s period.

Private expansion of the industrial sector, whose contribution in GDP stagnated at 17% between 1975 and 1995 (MOE, 1996, p.42), would directly serve the purpose of the 1991 ERSAP as it is expected to generate large employment opportunities and to reduce the economy's vulnerability to the destabilizing effects of large short term capital inflows as was the case in Korea. In other words, giving priority to the development of the industrial sector would protect Egypt from the *de- industrialization* risk by shifting scarce economic resources from the non tradables to the tradables sector.

In this respect, it is worth noting that high nominal interest rates have been the primary source of attraction for large capital inflows reaching $ 832 million in 1996, and estimated to reach $ 1.6 billion by the year 2000 (MOE, 1996, p.105). It has been argued that Egypt is currently facing the interest rate dilemma that has been witnessed by Chile in the 1990s. Specifically, while high interest rates are essential to raise return on local savings such as bank deposits & TBs, interest rate reduction is necessary to promote private investment and to minimize the disruptive effects of short term capital inflows on the real sector.

According to policy makers, high nominal & real interest rates will be consistently lowered through further disinflation in the near future[1]. Accelerating the disinflation process is expected to enhance the competitiveness of Egyptian non oil exports by reducing local inflation to levels that are close to those of Egypt's main trading partners.

The exchange rate management policy has been assessed to have both its positive and negative implications on the Egyptian economy. Specifically, it has been argued that the current pegged exchange rate system has so far succeeded to raise public confidence in the value & stability of local currency versus the American dollar over the past five years. Nevertheless, questions have been raised about sustainability of the exchange rate policy as a nominal anchor and its negative impact on Egypt's external competitiveness.

Based on the four country reform experiences, strong export performance is necessary as it would present a major source of foreign exchange revenues, and would allow Egypt to successfully sustain the growth of its imports of capital goods & intermediate inputs necessary for the development of local production as has been particularly the case in Korea. In Part One, we have seen that real devaluation is a necessary element of a successful trade reform policy package in order to enhance the competitiveness of tradables. Unlike Chile, Korea, Mexico and Turkey, real devaluation does not currently seem to be a policy tool neither on the government's or the IMF's agenda for export promotion.

[1] This is based on a discussion by H.E. Dr. Youssef Boutros Ghaly, the current Minister of State for Economic affairs, in the Cairo MENA Economic Conference held in November 1996.

It seems that Egypt would have to improve its competitive edge in the international market by raising its labor productivity as in Chile, as well as by reducing local inflation below its trading partners' levels as in Korea. It should be also noted that the adoption of a more flexible exchange rate system, as a key element of the current reform package, may be recommended not only to enhance the competitiveness of Egyptian exports, but also to effectively target the liberalized capital account. This would allow the real effective exchange rate to flexibly fluctuate in order to keep nominal depreciation in pace with local inflation as has been the case in Korea during the 1990s.

In addition, strengthened public sector reform is expected to significantly contribute to the restructuring of domestic industry by improving its efficiency as well as enhancing its external competitiveness. This is necessary to avoid the reversal of trade liberalization efforts to protect insolvent PEs as was the case in Turkey in the late 1980s or to reduce the current account deficit as took place in Chile in 1984. This is also important to avoid reprivatization experienced in Chile in the 1970s to ensure sound investment & production decisions by prospective buyers.

Privatization is expected to reinforce stabilization as it directly contributes to fiscal and monetary control by reducing public investment expenditures and limiting the automatic financial support that used to be guaranteed to the public sector. It seems that the government has not yet decided upon prioritizing the use of sale proceeds among the restructuring of ailing companies, compensating redundant labor during reform, and relieving public debt.

It is worth noting that the privatization program has heavily relied over the past few years on the stock market for divestiture of companies' shares, while only six PEs were sold to anchor investors. It may be argued that such approach has so far limited divested PEs' opportunities to improve their managerial skills and their know how, as these present direct benefits of sale to anchor investors.

The government has recently changed its privatization methodology for the 1996- 98 program whereby a minimum of 39 companies will be offered for sale to strategic investors (PEO, 1996). Nevertheless, it should be noted that such approach has its own risks as it largely depends on potential buyers' interest to invest in Egypt, and this is largely determined by the GOE's seriousness and ability to offer PEs unburdened from redundant labor and accumulated losses without endangering the social & political stability of the economy.

In this respect, privatization dictates a high degree of coordination with other reform areas, such as, the SFD in order to minimize short term social costs as well as the banking sector in order to reduce local banks' exposure to non performing loans owed by PEs. Proposals have been made for the development of innovative mechanisms to convert the large non performing loans into medium & long term traded securities. The soundness of the whole system dictates the enforcement of a proper system of bank prudential regulation & supervision to prevent the recurrence of problem loans whether to the private or public sector.

More importantly, it has been argued that issuance of government financial instruments, namely, TBs & bonds, has had a crowding effect on the sale of PEs' shares in the stock market. Indeed, the rate of return on most offered PEs has not been competitive with the 12% fixed yield from government bonds that the government has launched over the past two years. In this respect, it may be stated that the role of TBs should be reconsidered as they served as an effective sterilization instrument to reduce monetary expansion during the early reform phase.

However, the mounting domestic debt may endanger the government's solvency in the medium term, and raise negative perceptions about economic stability (Abdel Fadil, 1994). Indeed, the rapid accumulation of domestic debt presents a fiscal challenge as its servicing obligations have substantially increased to peak at 11.3% of GDP in FY 1994 (World Bank, 1995c), and reached 7.2% of GDP in FY 1995 (CBE, 1995, p.122).

It may be stated that the ultimate risk threatening the sustainability of ERSAP is failure to generate a strong supply response from the private sector whose role in the current reform phase is essential to restore a sustainable growth trend. *Policy uncertainty* about the GOE's commitment to deepen structural reforms, political stability and the economy's vulnerability to external revenues, seems to have negatively affected Egypt's creditworthiness in the world over the past few years (World Bank, 1995d, p.11). This was emphasized in Galal's work (1995), based on a random survey of 45 private sector firms in 1992, where policy uncertainty was ranked as the most binding constraint to private investment in Egypt, followed by tax administration, access to finance, availability of inputs & labor regulation.

Gaining the confidence of the private sector has become a challenging task to the government, and determination to pursue the reform program has been based on recognition of the high magnitude of potential costs that policy reversal may trigger. Indeed, loss of credibility can automatically lead to capital flight as well as shrinkage of private sector share in total investments reaching 49% in 1995/96 compared to only 20% in 1981/82 (MOP, 1996, p.33). In that sense, *credibility* is a prerequisite to realize long term efficiency gains from stabilization & liberalization as discussed in Chapter One. This is because the success of the 1991 reform process depends to a great extent on a substantial reallocation mechanism in order to shift scarce resources from wasteful towards more efficient & competitive uses, and this largely depends on the degree of confidence in the stability of the economic & political regime.

2 - Conclusion: Egypt has followed the policy advice recommending the consolidation of stabilization prior to structural adjustment efforts as well as the implementation of trade reform prior to capital account liberalization. The GOE has *also prudently opted for the gradual implementation* of reform in order to carefully handle potential opposition that may be developed by the various affected groups in the society. This has been justified in light of the unstable political circumstances that Egypt has experienced over the past few years.

The comprehensive scope of the 1991 ERSAP has so far succeeded to simultaneously reform the financial and real sector of the economy with stabilization proceeding at a faster pace than structural adjustment over the past five years. It seems that the government has to ensure a high degree of consistency between achieving financial & real policy targets by maintaining a balance between money variables through TBs & bond issuance, fiscal prudence and privatization.

To conclude, it may be stated that sustained political & economic stability, low labor cost, big domestic market, improved business environment, higher creditworthiness have all improved Egypt's ranking in the world economy as Egypt was included in 1995 for the first time in the World Competitiveness Report, prepared by the World Economic Forum, based on various indicators for economic strength and business opportunities (MOE, 1996). Furthermore, international Credit Rating Agencies have recently awarded Egypt a moderate investment grade that is equivalent to that of Mexico & Turkey, lower to that of Chile and much below Korea's grade. This has been based on assessment of Egypt's credit strengths and weaknesses that are expected to be improved in the near future (Goldman Sachs, 1996).

Given the unquestionable role of the private sector during the next phase, the need to deepen structural reforms seems to be urgent in order to send "right" signals to private entrepreneurs about the government's irreversible commitment to reform. That is why the government is currently focussing on *institutional reforms* in order to promote FDI and private investment presenting the main pillar for Egypt's growth in the near future.

Over the past few years, a dialogue has been initiated between the private sector and the GOE whose emphasis has shifted away from *competing* with the private sector, in industrial, trade & financial activities, towards *complementing* it role. This can be realized by prioritizing public investments for the development of human capital, physical infrastructure, and social programs to alleviate transitional costs.

The Real Exchange Rate (RER):

This can be defined in three different ways that all reflect LDCs' competitiveness in the world market, relative to a base year (Fischer & Reisen, 1993):

a. The nominal exchange rate multiplied by a foreign price index and divided by a domestic price index,

b. The domestic price level of tradable deflated by the domestic price level of nontradables, and

c. The ratio of nominal exchange rate to a wage index.

The Real Effective Exchange (REER):

This can be calculated as a weighted average of the real exchange rates of a country's main trading partners in order to reflect the competitiveness of its exports in the world market[1].

Efficiency Indicators:

These are some of the indicators used to reflect the efficiency of Public Enterprises (PEO, 1996):

a. Labor Productivity = Sales/ number of workers (in LE)

b. Labor Profitability = Net After Tax Profit/ number of workers (in LE)

c. Return on Sales = Net After Tax Profit/ Sales (in %)

d. Return on Assets = Net After Tax Profit/ total Assets (in %)

[1] This is based on calculations of Ministry of State for Economic Affairs

ARAB REPUBLIC OF EGYPT
Ministry of Public Enterprise Sector

EGYPTIAN PRIVATIZATION PROGRAM
1996, 1997, & 1998

ARAB REPUBLIC OF EGYPT
Ministry of Public Enterprise Sector

EGYPTIAN PRIVATIZATION PROGRAM
FOR THE PERIOD FROM OCT. TO DEC. 1996

Companies Offered Through the Stock Market (Minority)	Companies Offered Through the Stock Market (Majority)	Companies Offered to An Anchor Investor (Majority)	Companies Prepared to be Sold An Anchor Investor (Majority)
1 Kahira Pharmaceuticals & Chemical Industries.	1 Damietta for Container Handling.	1 Industrial Gases.	1 The Delta Industries (IDEAL).
2 General Company for Silos & Storage	2 Paints and Chemical Industries.	2 The Egyptian Co. for Foods (BISCOMISR)	2 Engineering Enterprises for Steel Works. (STEELCO).
3 Alexandria Pharmaceuticals and Chemical Industries.	3 Egyptian Electro Cables.	3 El-Ahram Beverages.	3 Egyptian Metallic Constructions (METALCO).
	4 Misr Free Shops.	4 El Amereya Cement	4 El Nasr Wool and Selected Textiles. (STIA).
	5 The Egyptian General Warehouses.		5 Societé du Papier du Moyen Orient (SIMO).
	6 Misr El Gedida Housing & Development		6 El Nasr Glass and Crystal.
			7 Misr Dairies & Food

Total 20 Companies

EGYPTIAN PRIVATIZATION PROGRAM
FOR THE YEAR 1997

ARAB REPUBLIC OF EGYPT

Ministry of Public Enterprise Sector

Companies Offered Through the Stock Market (Minority)

1 Egyptian Pharmaceutical Trading.

2 Misr Pharmaceutical Industries.

3 El Gomhouria Pharmaceuticals and Medical Appliances.

4 Chemical Industries Development.(CID)

5 El Nile Pharmaceutical and Chemical Industries.

6 Misr Aluminum

7 Eastern for Tobacco and Cigarettes. (EASTERN COMPANY)

Companies Offered Through the Stock Market (Majority)

1 El Maadi Development and Reconstruction.

2 Suez Mechanical Stevedoring.

3 Port Said Containers Handling.

4 Egyptian Marine Supply and Contracting

5 Egyptian Maritime Transport

6 United Arab Stevedoring

7 Alexandria for Container Handling.

Toura Portland Cement.

9 Helwan Portland Cement.

10 General Egyptian for Railway Wagons (SEMAF).

11 UniArab Spinning and Weaving

Companies Offered to An Anchor Investor (Majority)

1 The Delta Industries (IDEAL).

2 Nasr Engineering Refrigeration (KOLDAIR).

3 Egyptian Elecro Cables.

4 PHILLIPS

5 Assiut Cement

6 Engineering Enterprises for Steel Works.(STEELCO).

7 Egyptian Metallic Construction (METALCO).

8 Upper Egypt General for Contracting

9 Giza General for Contracting

10 El Nasr Wool and Selected Textiles. (STIA).

11 The Modern Textiles (BOLVARA).

12 Omar Effendi

13 Consumption Goods & Clothes (SIDNAWI)

14 Societé du Papier du Moyen Orient (SIMO).

15 Paper Converting (VERTA).

16 BATA

17 Societé Industrielle Moharram Press.

18 Porcelain Dinner Ware & Utility Ware (CHINI).

19 El Nasr Glass and Crystal.

20 El Nasr for Particile Board and Resins (MANSURA).

21 Kafr El Sheikh Rice Mills.

22 Edfina for Preserved Foods.

23 El Nasr for Preserved Foods (KAHA).

24 Misr Car Trading

25 Misr Import & Export

26 Commercial for Woods

27 El Nasr Import & Export

28 Cairo Silk Textiles

29 Misr Mechanical and Electrical Projects (KAHROMICA).

30 United for Trade and Distribution

31 Arab for Textile Trade

32 Nile Car Repair

33 Grand Hotels of Egypt

34 Egyptian Hotels

Total	52 Companies

ARAB REPUBLIC OF EGYPT
Ministry of Public Enterprise Sector

EGYPTIAN PRIVATIZATION PROGRAM
FOR THE PERIOD FROM JANUARY TO JUNE 1998

ARAB REPUBLIC OF EGYPT
Ministry of Public Enterprise Sector

Companies to be Offered Through the Stock Market or to An Anchor Investor From January to June 1998 (MAJORITY)

1 Egyptian Copper Factories

2 Spring & Transport Needs Manufacturing

3 The Tractor & Engineering

4 Delta Steel Mills *

5 El Nasr Steel Pipes *

6 The National Metal Industries

7 Egyptian Contracting (EL ABD)

8 El Wadi Cotton Ginning

9 Societé Nationale du Papier

10 Egyptian Chemical Industries (KIMA)

11 Societé Nationale de Matiers Plastiques *

12 Societé Generale D'Industrie du Papier (RAKTA)

13 Tanta Flax & Oil

Sinai Manganese

15 Egyptian Refractories *

16 Gharbia Rice Mills

17 Rice Marketing *

18 The Nile Cotton Ginning *

19 The General Jute Products *

20 El Nasr Civil Works

21 The General for Electrical Projects

22 El Nasr Clothing & Textiles (KABO) *

23 Damietta Spinning & Weaving

24 Arab Carpet & Upholstery

25 Misr for Manufacturing Textiles & Clothing Equipment *

26 Delta Cotton Ginning *

Total 26 Companies

* Companies to be offered during the first quarter (Jan - Mar) 1998, while the rest during the secohd quarter (Apr - Jun) 1998

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