Bank Privatization and Regulation for Egypt

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FOREWORD

Privatizing one of the four public banks in Egypt has been on the government agenda for years. More recently, however, there was an announcement that plans had been temporarily halted for lack of consensus. The reactions to this announcement were mixed. Some see it as a lost opportunity for upgrading the banking system, increasing its efficiency, and enhancing its contribution to economic growth. Others see it as appropriate, citing the failing efforts at bank privatization elsewhere (e.g., Chile in the early 1980s and Mexico more recently). Was this decision a missed opportunity or an appropriate course of action?

Caprio and Cull attempt to answer this question. They explore whether the privatization of banks in developing countries has been beneficial to the economy or not. They identify the preconditions for successful privatization of banks more broadly. Based on the answers to both questions, they assess the readiness of the Egyptian economy for bank privatization. Finally, they conclude by offering their views about the most reasonable course of action for Egypt.

By offering this new paper and a summary of the engaging discussion that followed its presentation, ECES hopes to help reconcile the divergent views that brought Egypt's efforts at bank privatization to a standstill. Perhaps more importantly, it is hoped that the publication will provide a useful roadmap outlining the actions necessary for successful privatization, should a decision be made in this direction.

Ahmed Galal

Executive Director, ECES

August 2000

تقديم

أعلنت الحكومة مؤخراً إرجاء مشروع خصخصة أحد بنوك القطاع العام الأربعة، والمدرج على أجندة الحكومة منذ سنوات طويلة، وذلك لعدم توافر التأييد الكاف. وقد اختلفت ردود الأفعال إزاء هذا التصريح؛ فالبعض يرى أن هذا التأجيل قد أضاع فرصة تطوير القطاع المصرفى وزيادة كفاءته وكذلك رفع درجة مساهمته فى النمو الاقتصادى. فى حين يؤيد البعض الآخر هذا التأجيل مستندين فى ذلك إلى فشل جهود خصخصة البنوك فى بعض الدول كشيلى فى أوائل الثمانينيات وماحدث فى المكسيك مؤخراً. ويثير هذا التضارب التساؤل التالى: هل يعتبر هذا القرار فرصة ضائعة فعلاً أم قراراً مناسباً اقتضته الظروف الراهنة؟

وقد حاول كلاً من د. جيرار كابريو ود. روبرت كول التصدى لهذا السؤال من خلال استعراض تجربة خصخصة البنوك فى بعض الدول لمعرفة ما إذا كانت قد عادت بالنفع على اقتصاداتها من عدمه. ثم انتقلا بعد ذلك إلى تحديد الشروط الواجب توافرها لإنجاح خصخصة البنوك بشكل عام. واستناداً إلى ما تقدم، قام الباحثان بتقييم مدى استعداد الاقتصاد المصرى للبدء فى خصخصة البنوك. ثم طرحا فى النهاية تصوراتهما للأسلوب الأكثر ملائمة لخصخصة البنوك فى مصر.

ويأمل المركز المصرى للدراسات الاقتصادية أن تسهم هذه الورقة والمناقشات التى أعقبتها فى التوفيق بين وجهات النظر المتضاربة والتى أدت فى النهاية إلى تجميد فكرة خصخصة البنوك. ونعتقد أن هذه الدراسة يمكن الاسترشاد بها فى وضع خطة عمل، توضح الإجراءات الضرورية لضمان نجاح خصخصة البنوك فى مصر.

د.أحمد جلال
المدير التنفيذى
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About the Speaker

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Gerard Caprio is a leading authority in the field of financial reform in transitional and developing economies. Before joining the World Bank in 1988, Dr. Caprio was Vice President and Head of Global Economics at JP Morgan. He also held economists positions at the Federal Reserve Board and the IMF, and taught graduate-level international economics at George Washington University.

Jerry has researched and written extensively on financial sector policy, financial reform, and monetary policy implementation. Recent publications include *Reforming Finance: Historical Implications for Policy* and *Financial Reform: Theory and Experience*. His current area of research focuses on the links between financial sector regulation/supervision and the performance of financial institutions, as well as financial crises.

PART I

BANK PRIVATIZATION AND REGULATION FOR EGYPT[1]

1. Introduction

Whether, when, and how to privatize banks is a pressing topic at the turn of the millennium. Despite much discussion and increased private sector activity in most countries' banking systems, over 40 percent of the world's population lives in countries in which the majority of bank assets are in majority-owned state banks. In Egypt, majority-owned state banks account for about two-thirds of all banking assets, a figure that in a 1998 survey of 100 countries was only surpassed by China, India, and Lesotho.

State-ownership in banking continues to be popular in many countries for several reasons. First, there is the concern that with private ownership, excessive concentration in banking may lead to limited access to credit by many parts of society. Second, a popular sentiment – reinforced by abuses at and failures of private banks in many countries – is that banking is too important to leave to the private sector. Third, the failure of some privatization efforts, most notably the crisis in Mexico that occurred two years after that privatization effort concluded, understandably has made even governments that are sympathetic to a greater role for the private sector in banking cautious. More generally, the combination of information asymmetries between suppliers and users of funds, combined with intertemporal trade (money today in exchange for money tomorrow) and demandable debt makes banking particularly fragile and creates a case for government intervention, including possibly ownership.

Notwithstanding the possible downside risks, anecdotal and empirical evidence favor efforts to encourage greater private participation in banking. Although it is true that poorly

[1] The authors would like to express their gratitude to Iffath Sharif for assistance with the regulatory data, Malak Reda for assistance with Egyptian bank data, as well as Faika El-Refaie and Ahmed Galal for their enlightening discussions. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

regulated private banks can incur large losses that are passed on to depositors and, more frequently, to taxpayers, some of the largest losses in history have been incurred by state banks. Credit Lyonnais (France) and Banespa (Brazil), for example, both had losses estimated in the range of $22 - $28 billion dollars, and a variety of countries with state-owned banks, such as Hungary, Argentina, and Mexico periodically had to inject capital to absorb losses. Eventually it was in part the cost of these injections that led to privatization efforts. Although many transitional economies experienced bank failures in the years after transition started, often these problems occurred in or due to the activities of state banks, and virtually all these economies annually injected funds into government banks in the pre-transition era.

The difficulty with state ownership in banking, as in other industries, is one of incentives. Although in theory government employees could be paid and motivated as private employees, this rarely occurs in practice. Indeed, the norm in economies with both state and private banks is for employees at the latter to earn salaries that are far above those in the state banks. Governments could even consider retaining ownership but contracting out the management of banks to private parties, but fortunately have not done so, as management contracts have been found to work only in industries in which quality is easily verified and reputation is paramount.[2]

In sum, it seems that bank privatization, while potentially dangerous if done poorly, is even more dangerous to avoid altogether, and only recently have the inefficiencies of government ownership been demonstrated empirically. Barth, Caprio, and Levine (1999) show that greater state ownership of banks tends to be associated with more poorly developed banks, non-banks, and securities markets. Even though the proponents of state ownership of banks argue that it helps overcome informational problems and better direct scarce capital to highly productive projects, they find that on average, greater state

[2] See World Bank, 1995. Hotels are an example satisfying both criteria for management contracts. Since it is difficult for depositors, creditors, supervisors, and even management to evaluate the health of bank portfolios, and since the importance of reputation – once paramount in banking – in most countries is diminished by the presence of implicit or explicit deposit insurance, banking is not well-suited to management contracts.

ownership of banks tends to be associated with higher interest rate spreads, less financial sector development, and even less developed nonbanks. Moreover, they note that underdeveloped financial systems tend to exert a negative influence on long-run growth.[3]

Using a separate database on government ownership, LaPorta, Lopez-de Silanes, and Shleifer (1999) reach the same conclusion, and carry out the calculation for the cost to growth of greater government ownership, which they find to be significant and to operate through the productivity channel. That is, there is no significant difference in the savings mobilized, as a function of the percentage of assets in state banks, but government-owned banks are more likely to allocate capital to low productivity investments. A separate study (Wurgler, 1999) shows that the productivity channel through which a better financial system induces higher growth is by more expeditiously taking capital away from loss making enterprises. Although the link to state ownership has not yet been shown in this latter effort (as state ownership data only recently became available), anecdotal evidence and the authors' experience suggest that this is indeed likely to be important; in particular, when state owned banks lend to state enterprises, decisions to 'pull the plug' on loans often are not made quickly and with an eye to maximizing profitability.

Since bank privatization can yield real benefits, and as there is considerable scope for it in Egypt, this paper reviews in Section II the preconditions for successful bank privatization, and in Section III looks at how Egypt compares internationally in terms of financial regulation, supervision, and competition. Section IV then reviews lessons from bank privatization efforts elsewhere to suggest what might occur in Egypt if bank privatization is pursued and in a suitable regulatory environment. Section V offers some conclusions should Egyptian authorities decide to proceed along this path. As a caveat, it will become clear that the authors are not experts on Egypt, but rather in this paper attempt to bring the benefit of comparative work to the discussion on the role of state ownership in banking.

[3] See Levine, Loayza, and Beck, 1999.

2. The Pre-conditions for Successful Bank Privatization

> *If a banker is working for you and making money, watch him; if he is making good money, watch him closely; if he is making great money, watch him closer still; and if he is making fantastic money, fire him, for he must be taking risks that you don't understand.*
>
> *-Maxim among bank CEOs, recalled at the time of the Barings failure*

Monitoring banks is difficult. Even presidents of banks have difficulty staying on top of all the risks that their institution is taking, as the above quote attests. Stated differently, all potential monitors of banks – whether they are insiders, such as majority owners and management; or various outsiders, such as creditors and minority shareholders, depositors, or supervisors – suffer from asymmetric information, and these asymmetries are more pronounced the less developed are accounting, auditing, and the general information environment. There is no magic solution to this problem, or at least not without the risk of substantially cutting back on financial intermediation. Here we briefly try to convey some of the lessons offered elsewhere regarding how to achieve a safe and sound banking system.[4]

If monitoring banks is difficult, then one approach to improving the safety and soundness of the system is to rely on as many well-motivated and well-informed monitors as possible. There are three distinct groups that can monitor banks: bank owners (and managers), the market (including uninsured debtholders and other possible 'co-owners') and supervisors. Efforts to improve the capacity and incentives for each of these groups to perform their function effectively would appear sensible, given both the uncertainty about which group is more effective and because ideally, these three monitors would complement one another.

Well-motivated owners are the first line of defense against unsafe banking practice. Indeed, given the alacrity with which banks increasingly can alter their exposure using derivatives, increasingly owners must be the first line of defense. Majority shareholders and top management should have control over the access to information about their banks.

[4] See Caprio and Honohan, 1999, and World Bank, 1998.

However, they may not always have strong incentives to do such laborious monitoring, in part as a result of limited liability, which limits their downside losses. While no substantial increase in the liability of general shareholders is in prospect, a number of countries have experimented with a policy of increased personal liability for bank directors (as for other company directors). The design challenge here is to make the bankers liable only for bad personal performance, and not for poor but unforeseeable business outcomes. For example, in New Zealand, bank directors are liable in cases involving disclosure of incomplete or erroneous information. In the same spirit, many countries are moving toward a pre-commitment approach toward regulation (Kupiec and O'Brien, 1997), according to which bankers agree with supervisors on the models and procedures they will use to evaluate their risks, but are then subject to penalties for violating these procedures. Ultimately, large penalties can be a way around liability limits and can help reduce excessive risktaking.

High capital ratios are a second way to put more of owners' assets at risk. It is not always clear, however, that greater capital will induce greater prudence, and indeed could encourage greater risktaking in order to permit a healthy return on that capital. Whenever bank regulation attempts to require bankers to hold greater capital than they would desire based on their own optimization decisions, then some regulatory evasion or arbitrage can be expected. Since regulators can try to control the quantity of capital but not its quality, excessive reliance on capital ratios may not be prudent.

Beyond present capital, as it is usually understood, is the future profitability of the bank, the present value of which constitutes the bank's franchise value. Bank owners who enjoy a high franchise value will be induced to behave prudently – if there is a threat of closure for failing banks – in order to ensure that they will be around to collect the profits. The incentive that honest banking earns healthy profits should help to induce greater safety and soundness.

In addition to owners, markets can provide additional leverage to monitor the soundness of the bank. If the market suspects that a bank is taking risks significantly in excess of the norm, then the interest rate that the bank must pay to attract funds presumably would rise,

leading it to curtail its activities. There is evidence that depositors monitor banks even when apparently covered by deposit insurance, perhaps because the credibility of the deposit guarantee is in doubt (Martinez-Peria and Schmukler, 1999). Ensuring that adequate and reliable information is disclosed by banks is crucial to ensuring the quality of this monitoring.

To increase the discipline of private creditor monitoring, and to increase incentives for the private production of information about banks, proposals have been made to require banks to issue a special class of debt which would subordinate to all other claims, bar equity capital. Essentially, in the case of bankruptcy, holders of this subordinated debt would lose their money first. This debt would have to be issued in such a way that the debt-holders were at an arm's length from the bank; for many developing countries, it might suffice to follow the suggestion from Calomiris (1997) that such debt be issued abroad.

This class of debt would provide an additional private buffer to be drawn on before a government bank bailout became necessary. But more importantly, it would establish a new set of concerned and watchful eyes on banks. Subordinated debt-holders will demand better information and disclosure. The market price of this debt would also provide a useful signal of market participants' assessment of the bank’s health. A scheme along these lines was initiated in Argentina in 1997 that specifies that the holders of the subordinated debt should be entities of substance independent of the bank's shareholders, and requires issue of the debt in relatively lumpy amounts on a regular basis (Calomiris, 1997; Caprio and Honohan, 1999).

Lastly, strengthening official bank supervision can help improve the safety and soundness of banking, and well-motivated supervisors can supplement the monitoring provided by owners and markets. Improvements in bank supervision have been endorsed by the Basel Committee on Bank Supervision, which has provided its Core Principles of Bank Supervision as a guide for such efforts. In addition to the need for certain supervisory powers, supervisors need to have the incentive and the information to do their job well. Bank supervisors often are paid less than bankers, and the gap seems to be much

larger in emerging markets, where financial liberalization and the arrival of high-wage foreign banks have often greatly increased remuneration in the private financial sector. As a result, developing country supervisory agencies have difficulty in retaining skilled supervisors – who often have the skills to work in the private sector if they choose. Moreover, poorly paid supervisors are especially susceptible to implicit revolving door arrangements in which future jobs are traded for light supervision. In many industrial economies, bank supervisors are paid above the normal civil service pay scale, in recognition of their key role.

Supervisors can also be constrained to act responsibly by reducing some of their discretion – that is by mandating "prompt corrective action" under certain circumstances such as when bank capital falls below certain mandated amounts, for example. Limiting discretion is controversial, but some countries have emulated the United States' 'FIDICIA' legislation that requires more stringent supervisory interventions as banks' true capital position declines.[5] Finally, supervisors must have adequate legal protection against personal lawsuits, including those brought by aggrieved owners of the banks being regulated. In many emerging markets, the risk for a regulator of incurring personal liability in the performance of official duties is a real one, which has a chilling effect on regulatory intervention.

3. Egypt Compared with Other Countries

3.1. The Adequacy of the Regulatory Framework

If the regulatory environment is important for the functioning of the banking system, then how does Egypt compare with other countries? It is difficult to compare regulatory environments, much less the way in which the regulations are supervised. Nevertheless, this section attempts the former task of comparing the bank regulatory environment. Just as individual banks can be assessed by their capital, asset quality, management, earnings,

[5] The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 mandated certain supervisory actions and interventions as the net worth of a bank deteriorates (Kane, 1989; Barth, 1991; Benston and Kaufman, 1997), and arose in reaction to the finding that the losses from the U.S. Savings and Loans crisis were larger due to regulatory forbearance.

liquidity, and systems; regulatory environments can be compared by using similar criteria, assessing not how these measures compare for all the banks in a country, but rather how the country's requirements and overall environment compares with those of others. A previous effort (Caprio, 1998) assembled data needed to do these assessments for about a dozen Asian and Latin American countries, and in this section we show how Egypt compares in this framework.[6]

Capital is assessed in this study by the minimum required capital-asset ratio, as well as its definition. The more restrictive the allowances for recognizing asset revaluations as part of capital, or the more that risk taking is explicitly accounted for in constituting minimum ratios, the higher the ranking. Countries, such as Argentina, that vary the minimum capital ratio as a function of individual banks' market and credit risks score higher. Asset quality is proxied by the definition of non-performing loans (the number of days till a loan becomes non-performing) and the provisioning required once this judgment is made. Management quality is the most difficult to compare, but the arbitrary assumption made here is that countries with more assets in foreign banks enjoy better-managed assets; foreign ownership also brings better diversification. Management quality could be regarded as separate from regulation, but is included in an index of the regulatory environment as indicating the types of owners that are allowed into the industry.[7] We also report on the regulatory index when this variable is dropped. Earnings are not included, as they relate only partly to regulations or the environment, but more to cyclical considerations (as well as to accounting conventions). Minimum liquidity requirements, the inclusion of foreign exchange as a separate reason for liquidity, and the extent of its remuneration are included in the liquidity indicator.[8]

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[6] A current World Bank research project is extending this information to a wider variety of countries and also quantifying some supervisory variables.

[7] There is no intention to suggest that authorities should admit more foreign banks regardless of the initial conditions in banking and at a rapid pace, as foreign banks in some settings could be a source of instability. There are solid banks in developing countries that are domestic banks. But it is at least arguable that foreign banks, the majority of which are from OECD countries, have better banking and in particular risk management skills. Claessens, Demirguc-Kunt, and Huizinga show that foreign bank entry leads to lower profits and overheads for domestic banks, increases the stability of the financial system and promotes long term growth.

[8] If liquidity requirements are not well-remunerated, then bankers will do their best to avoid them.

The environment in which banks function is affected by their operating environment and the degree of transparency, which here are included as part of the broad regulatory environment. The overall operating environment is estimated by measures of property rights (the poorer these are defined, the more difficult it becomes to secure credit); creditors' rights, which indicate the ability of creditors to secure repayment; and a measure of the enforcement of the laws (LaPorta et al, 1998, and Levine, 1999). Finally, transparency is perhaps the most difficult to gauge. The ranking here is based on whether bank ratings are required, the number of top 10 banks with ratings from international firms (judged to be superior in emerging markets to local counterparts and less susceptible to corruption), and an index of corruption. The latter is included because the greater the extent of corruption, the less likely it is that disclosed information will be accurate.

Several caveats are in order. Except for Egypt and India, these measures are, as of late 1997 for the East Asian and Latin American countries, before most of the East Asian crisis countries made any significant changes in their regulations. However, the components of the operating environment and the corruption index (part of the transparency measure) for the most part are from the early 1990s. Since the latter variables only change slowly, this lag is not likely to be a significant drawback. Except for those variables, other observations for Egypt are based on a World Bank survey as of late 1999.

An important aspect of the overall index is that, given the absence of empirical analysis of the role of different parts of the regulatory environment, *each category is equally weighted*, clearly an arbitrary rule of thumb. Each category has its proponents: some argue that management is key, others that loan classification and provisioning matters most, and in the wake of the Asian crisis, transparency is receiving much greater emphasis. Liquidity likely should receive even more importance, and indeed some of the countries that had sizable liquidity requirements, such as Egypt, India, and Argentina, avoided crises in recent years.

Proponents of narrow regulatory evaluations alone would prefer to include only capital, assets, and liquidity, which would change the rankings somewhat, as noted below. Only further research, once a broader dataset is available, will possibly settle this issue. Lastly, until

data on or proxies for supervisory effort become available, it is not possible to determine how the regulations are enforced. With these caveats, Table 1 shows the overall 'CAMELOT' rankings, with lower numbers indicating a higher rating. Appendix A contains the details behind each category.

Table 1. Summary Measures of the Bank Regulatory Environment

Country	*Capital*	*Assets*	*Management*	*Liquidity*	*Operating Environment*	*Transparency*	*Total*	*Rank*
Singapore	1	6	2	6	1	1	17	1
Argentina	1	4	3	5	10	2	25	2
Hong Kong	3	10	1	3	2	6	25	2
Chile	6	1	5	9	6	2	29	4
Brazil	9	3	4	4	11	5	36	5
Peru	6	2	6	1	14	10	39	6
Malaysia	6	10	8	9	4	9	46	7
Philippines	3	6	7	9	12	12	49	8
Korea	12	10	11	13	3	4	53	9
Colombia	3	4	12	8	13	11	51	10
Indonesia	9	9	9	14	8	8	57	11
India	12	13	10	2	7	14	58	12
Egypt	9	8	13	7	9	12	58	12
Thailand	12	14	14	9	5	7	60	14

As is evident, several clusters of economies stand out, with Singapore, Argentina, Hong Kong, and Chile showing the strongest regulatory environment, followed in the order shown in the Table. Egypt scores substantially below the average, though the data are perhaps better suited to showing relative areas for improvement. Also, the rankings may understate the present health of various systems. In Hong Kong, for example, official regulations do not require a given amount of provisioning even once a loan is in arrears by 180 days (hence a lower score here). Yet, the authorities encourage provisioning, and Hong Kong Shanghai Bank, a very large part of the 'Hong Kong' banking system, may have much stricter standards and a first-rate market and credit risk management system.

In Egypt, the low ranking is partly attributable to two factors. First, the arbitrary assessment of management, without which (removing this variable, would set all countries equal on bank management skills) Egypt's rank increases to 12th. Second, Egypt scores quite low on the transparency of the regulatory environment, itself a function of the requirement for banks to be rated, the percentage of top banks rated by international firms,

and the index of corruption, which has implications for the value of information that is published.[9] Egypt's operating environment is also rather low. Notwithstanding the fact that its laws generally favor protecting creditors' rights, property rights score poorly and the enforcement of the legal system is judged to be relatively weak.

It should be noted that the comparison in Table 1 is on bank regulation systems, which at best may only correspond to the health of the banks in the long run. Caprio (1998) showed that there was a relationship between how well countries scored and their run-up of interest rates in the Asian crisis, meaning that in addition to any panic by foreign investors, weak regulatory systems appear to help explain the occurrence of crises. However, it is again necessary to highlight that the ranking here weights all factors equally. India, which actually scores below Egypt overall, did not experience significant fallout from the East Asian crisis largely due to its high liquidity ratios and the fact that Indian banks generally were holding significant amounts of excess liquidity – with ratios of liquid to total assets over 50 percent. Similarly, though not quite as large, Egypt has relatively high liquid asset requirements and the state banks, at least as of 1998, were holding excess liquidity.

If the authorities wish to move to a greater role for private banks and more lending, it would be important to consider improvements to the regulatory environment. For example, Egypt's strengths – the categories in which it receives the higher ratings – are its liquidity, asset quality, and to a lesser extent, capital requirements. In conjunction with healthy franchise value (suggested below for the current private banks), this may provide adequate incentives for owners to monitor banks. On the other hand, the weakest parts of the regulatory environment – those showing the greatest room for improvement – are in the areas of management (if the variable is well-measured here), transparency, and some facets of the operating environment. Greater transparency, combined with improvements in the legal system, will permit greater confidence and monitoring by the market.

[9] Another indicator of low transparency is that notwithstanding some popular support for Islamic banking, there is relatively little such activity in Egypt, whereas in the United States, where there is no religious support for Islamic banks, they are quite widespread, but are called mutual funds (have equity instruments on both sides of their balance sheets, rather than fixed interest debt).

Lastly, we have not been able to obtain data on how supervisory salaries compare with those in private banks or the turnover/skills problems at the Central Bank. If supervisory salaries are substantially below those in the private sector or if staff turnover is high, this usually indicates a skills problem and would need to be addressed to maximize the benefits and minimize the risks of bank privatization.

3.2. Competitive Environment

We lack sufficient data to permit detailed analysis of asset portfolio composition and competitive dynamics in the Egyptian banking sector. We do have some data from banks' financial statements, which enable us to make three main points. First, the state banks dominate the sector as they do in few other countries. Second, despite recent growth on the part of private banks, they are unlikely to overtake state banks any time soon. Third, on basic measures of performance, the state banks, despite some recent improvements, continue to lag behind the private banks by a large margin. In addition, the state banks' share of total deposits (over 60 percent) is higher than their share of total loans (about 50 percent), which suggests that these banks are tying up an exorbitant share of Egypt's investable resources, while not converting those resources into productive lending.

Market Structure. As noted above, compared with most other countries, Egypt's banking sector is heavily tilted toward state banks. Figure 1 and Table 2 describe the market shares of assets, loans, and deposits for public and private banks from 1995 to 1999. Public banks are divided into two groups: the so-called big four, which includes the National Bank of Egypt, Banque Misr, Banque du Caire, and Bank of Alexandria; and the state specialized banks which include the Principal Bank for Development and Agriculture, Arab Land Bank, Credit Foncier Egyptien, and the Industrial Development Bank of Egypt.[10] Some of the state banks did not provide balance sheets and income statements for 1999, so we used their balance sheet data from 1998. Because most banks' assets, deposits, and loans were growing, using 1998 data

[10] Data on total assets, loans, and deposits for the Egyptian banking sector were taken from the annual reports of the Central Bank of Egypt.

should understate slightly the market shares for state banks in 1999. The banks used in this analysis are listed by type in Appendix B.

Figure 1. State Bank Market Share

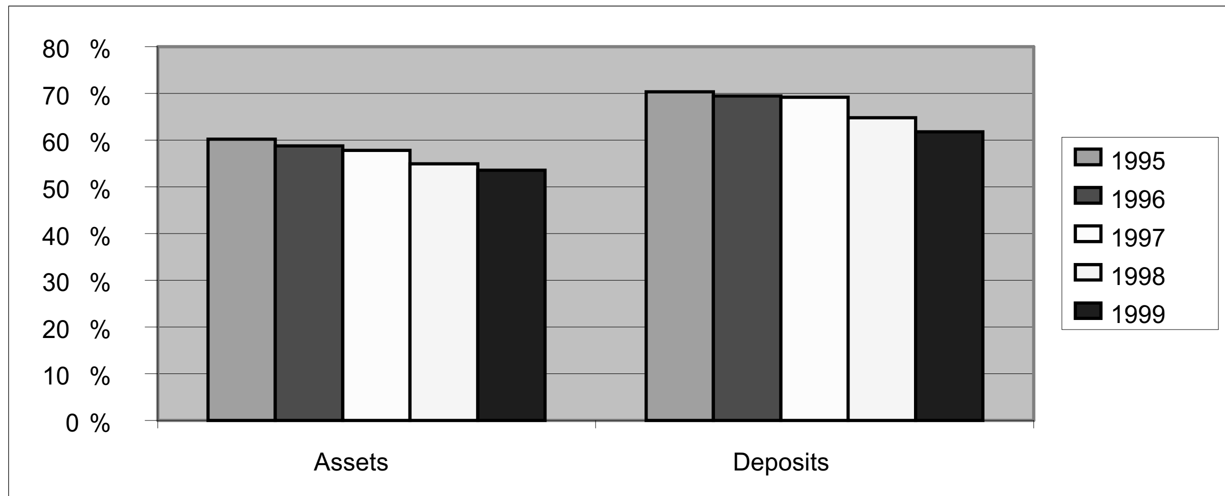


Table 2. Market Structure and Sample Characteristics

Share of Total Assets (%)			
Year	Big Four	State Specialized	Private*
1995	54.3	5.9	39.8
1996	52.9	5.8	41.2
1997	51.6	6.1	42.3
1998	49.0	5.9	45.1
1999	47.8	5.8	46.4
Share of Total Deposits (%)			
Year	Big Four	State Specialized	Private*
1995	67.1	3.2	29.7
1996	65.8	3.7	30.5
1997	65.4	3.7	30.9
1998	61.4	3.3	35.2
1999	58.3	3.5	38.2
Share of Total Loans (%)			
Year	Big Four	State Specialized	Private*
1995	53.2	10.3	36.5
1996	49.9	9.2	40.9
1997	46.1	9.4	44.4
1998	42.8	9.8	47.4
1999	40.3	8.9	50.9

Note: * Only includes those banks in the Kompass Dataset.

The most striking feature of the data is the dominance of the big four, which account for about sixty percent of the sector's deposits and over half of its assets. Because the Kompass data for 1999 are incomplete, one can reliably infer trends only from 1995 to 1998. There is evidence of some loss of asset, deposit, and loan share for the big four. Private banks increased their shares during this period, while the state specialized banks roughly maintained their shares. Still, the rate of decline by the big four has not been dramatic enough to threaten their dominant status:

> Nearly two-thirds of commercial bank deposits are controlled by the four state - owned banks, which have shown no inclination to reduce the intere st rate paid on those deposits. Their intransigence effectively prevents the private sector from reducing the rate that they pay. The best the banks have been able to do, while maintaining their deposit base, is to offer slightly lower interest rates tha n the public banks and significantly better service. Until the public banks reduce their rates, however, private banks will be unable to do so without losing depositors.
>
> (Kompass International, 1998)

The dominance of the big four in attracting deposits has repercussions on credit allocation because they do not appear to be effective intermediaries of investable resources. Kompass notes that they, "loan primarily to the public sector, making their portfolios inferior" to those of the private banks. We present additional performance measures below that offer some support for that view. However, the market shares for loans versus deposits are themselves telling – the big four attract sixty percent of total deposits, but provide only a little over forty percent of total loans, and that share is declining.

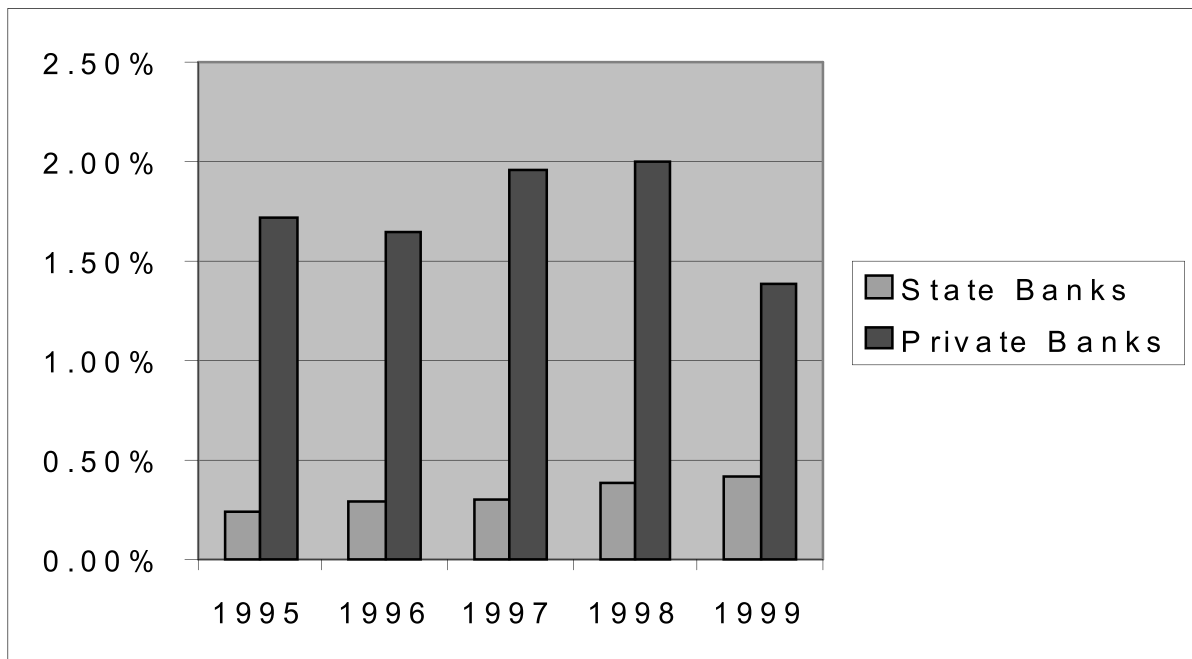
Performance by Bank Type. The big four appear to be a substantial impediment to the growth of private banking in Egypt. The balance sheet and income statements provided by Kompass are sufficient to permit some basic performance comparisons between different types of banks which reinforce that conclusion (See Figure 2 and Table 3). Returns on both assets and equity were much higher for private banks than for either the big four or the state specialized banks.[11] From 1995 to 1998, the eight state banks reported average returns on assets (ROA) from .2 to .45 percent; the private banks' average return ranged from 1.65 to 2.0

[11] Return on assets is calculated as net profit after taxes divided by total assets; return on equity = net profit after taxes/(total assets – total non-equity liabilities).

percent. ROA figures for 1999 are from mid-year, and thus understate the actual returns achieved over the whole year, although those, too, indicate that private banks enjoy a big advantage over state banks.

Disparities in return on equity (ROE) were similar. The big four reported ROE ranging from 5-9 percent from 1995 to 1998, while the state specialized banks averaged 2-4 percent.[12] The private banks averaged from 19-21 percent from 1995 to 1998. However, even within the subset of so-called private banks, there is substantial variation in ownership structures, and state-owned enterprises often own a large percentage of the shares in these firms. Because the average for the private banks incorporates banks with substantial state ownership participation, it is likely to understate the differences between state banks and fully privately-controlled ones. In the next sub-section, we identify a subset of banks that are truly privately-controlled and then describe their performance characteristics to further bolster this point.

Figure 2. Return on Assets



[12] The calculations for the big four do not include Banque du Caire because we lacked their income statement.

Table 3. Performance by Type of Bank

Return on Assets			
Year	Big Four	State Specialized	Private
1995	0.20 % (n=3)	0.28 % (n=4)	1.72 % (n=29)
1996	0.23 % (n=3)	0.33 % (n=4)	1.65 % (n=34)
1997	0.35 % (n=3)	0.27 % (n=4)	1.96 % (n=35)
1998	0.43 % (n=3)	0.35 % (n=3)	2.00 % (n=35)
1999	0.39 % (n=2)	0.45 % (n=2)	1.39 % (n=32)
Return on Equity			
Year	Big Four	State Specialized	Private
1995	5.10 % (n=3)	2.64 % (n=4)	21.49 % (n=29)
1996	5.87 % (n=3)	3.35 % (n=4)	20.19 % (n=34)
1997	7.83 % (n=3)	3.55 % (n=4)	20.12 % (n=35)
1998	9.27 % (n=3)	3.65 % (n=3)	19.04 % (n=35)
1999	8.87 % (n=2)	6.70 % (n=2)	15.09 % (n=32)

The evidence on market shares and these simple returns comparisons square well with the international evidence on state ownership in banking. As noted, Barth, Caprio, and Levine (2000) find that state ownership is associated with more poorly developed banks, non-banks, and securities markets. Moreover, greater state ownership of banks tends to be associated with higher interest rate spreads and less rapid financial sector development, which exert a negative influence on long-run growth. Egypt appears to have these problems.

3.3. Foreign Entry – A Better Ownership Structure?

Although state ownership participation has been a notable feature of all foreign bank entry in Egypt, there is a potentially important distinction between those banks that are majority foreign-owned and those that are not. Prior to June 1996, foreign institutions were

restricted to offshore banking or minority stakes in joint venture banks.[13] Foreign investors have moved rapidly at a handful of banks to take advantage of the June 1996 legislation that allowed them to take majority stakes in Egyptian banks. These include Banque du Caire & de Paris, Credit International d'Egypte, Misr International Bank, and National Societe Generale. Asset shares for all banks with foreign ownership participation grew slightly, from 12.7 percent in 1995 to 14.1 percent in 1997. Asset shares for majority foreign-owned banks also increased, from 4.9 percent in 1995 to 5.2 percent in 1997, but that increase is mostly due to the addition of two banks – Banque du Caire & de Paris and Credit International d'Egypte – to that category during this period.

Table 3. Partial vs. Majority Foreign Ownership

Year	**Foreign Ownership Participation**			**Majority Foreign Ownership**		
	No. of Banks	Assets (mn LE)	Market Share	No. of Banks	Assets (mn LE)	Market Share
1995	11	29,971	12.7 %	2	11,520	4.9 %
1996	12	35,527	13.6 %	3	13,014	5.0 %
1997	12	41,770	14.1 %	4	15,301	5.2 %
1998	12	42,763	13.0 %	4	15,304	4.6 %
1999	11*	42,186	12.0 %	4	15,801	4.5 %

Note: * Some banks did not report financial statements for 1999.

We should also note that there was a change in the tax code in 1998 that may have had an effect on figures for that year. Prior to 1998, banks enjoyed a tax exemption on income earned from investment in government securities. Kompass notes that most private banks used this loophole to "drastically reduce, and in some cases eliminate" their tax burdens. With the change in the law, many private banks restructured their asset portfolios, and many increased their provisions in expectation of an increased tax burden. State banks were much less affected by this change, perhaps because they face a different tax situation than do the private banks.

The figures in Table 3 suggest that the reduction in state banks' market share, especially the big four, should not necessarily be attributed to growth on the part of majority foreign

[13] Branches of foreign banks have also been free to conduct local currency business since 1993 provided they are capitalized at a minimum of US$15 million.

owned banks. Although the government has made an attempt to divest itself of stakes in joint ventures with foreign banks, it does not appear that that effort has, to this point, substantially affected sector structure. We note that our conversations with local banking experts indicated that the Kompass data may understate the degree of foreign ownership in joint ventures after the divestiture program. However, provided the Kompass ownership data aren't too misleading, they suggest that private banks *other than* the majority foreign ones are most responsible for the dip in market share of the state banks.

This is potentially important because there are also indications that majority foreign owned banks performed somewhat better than other private banks. From the perspective of banking sector health, therefore, it would have been more encouraging had the Kompass data indicated that it was the majority foreign banks that gained market share at the expense of the state banks. The following table (Table 4) presents data for the banks that had majority foreign ownership from 1995 to 1999. Those banks substantially reduced their holdings of cash and government securities during this period, and they increased their shares of loans. They gradually increased lending through 1997, and then had a steep jump in 1998, coinciding with the change in the tax code and a substantial reduction in their holdings of government securities. Lending also increased slightly in 1999.

Table 4. Foreign Majority-Owned Banks

Portfolio Orientation, % Loans			
Year	Majority Foreign-Owned	Other Private	State-Owned
1995	39.5 %	47.5%	63.8%
1996	47.3%	52.9%	63.8%
1997	51.9%	55.2%	64.2%
1998	60.3%	59.2%	63.6%
1999	61.8%	61.2%	66.8%
Return on Assets			
Year	Majority Foreign-Owned	Other Private	State-Owned
1995	1.37%	1.74%	0.24%
1996	2.23%	1.59%	0.29%
1997	2.04%	1.95%	0.31%
1998	1.94%	1.57%	0.39%
1999	1.04%	1.44%	0.42%

Table 4. Foreign Majority-Owned Banks (continued)

Assets per Employee			
Year	Majority Foreign-Owned	Other Private	State-Owned
1995	9337.4	3008.6	2262.7
1996	8404.4	3292.1	2439.4
1997	8374.7	3877.4	2816.6
1998	8020.4	4274.8	2911.2
1999	7568.1	4393.7	3314.5

Despite the shift in portfolio orientation, their performance and efficiency measures were better than other banks after the establishment of foreign majority ownership. They had the highest assets per employee and deposits per employee in the banking sector, although those ratios did decline somewhat from 1995 to 1999. Declines on those ratios were likely attributable to the change in business orientation – local lending may be more labor-intensive than other activities.

During the shift to lending, however, majority foreign owned banks maintained ROA levels higher than the typical private bank. From 1996 to 1998, they had an average ROA near 2.1 percent; the other private banks averaged 1.7 percent. In 1995, the majority foreign owned banks did lag behind the other private banks, but Kompass notes that ownership transformation at these banks was not complete until 1996, and an initial period of dislocation was probably to be expected. Again, the 1999 figures are for mid-year for many of the banks, and so, although the majority foreign banks lagged behind the others, no reliable inference can be drawn. Similar overall comparisons hold for other simple returns measures such as ROE. In short, there is evidence that banks with foreign majority ownership outperformed the others, even as they became increasingly oriented toward lending.

The market share data and the performance indicators demonstrate that the Egyptian banking sector is dominated by state banks that are relatively poor intermediaries of investable resources on traditional measures. Even among the so-called private banks, there are many that have substantial state ownership. It may come as little surprise, therefore, that the banks in which foreign investors own majority stakes, outperform the other private banks. Moreover,

given the lack of transparency in the sector described above, the performance differences between state-influenced banks (the state-owned banks and the pseudo-private banks) and the truly privately controlled may be substantially understated. If so, there are huge potential fiscal savings that could come from privatization. Based on those savings, and potentially large improvements in the quality of financial intermediation, there is a strong case that can be made in favor of bank privatization in Egypt. The next section draws on experience from other countries to explain the expectations for post-privatization performance.

4. Post-Privatization Performance

The empirical literature on the post-privatization performance of banks indicates mixed success. Performance improvements are possible, but only if certain aspects of the transaction are done correctly, and if the regulatory and competitive environments are healthy. For example, in their recent cross-country study, Verbrugge, Megginson, and Owens (2000) found only limited improvement in bank profitability, operating efficiency, leverage, and non-interest revenue after privatization.[14] They attributed such meager improvement to the substantial stakes that remained under government control following 'privatization.' Similarly, the Czech government retained significant stakes in many banks after the initial rounds of privatization, and only very recently have they made strides to cede actual control to private investors. Hungary, for all its ballyhooed success in attracting foreign investors, had to re-capitalize its banks multiple times before the sales were completed.[15] This lesson may be potentially applicable to Egypt: bank privatizations designed to maintain state influence are not worth doing. Although the literature is not sufficiently developed to yield a list of the necessary and sufficient conditions to ensure successful bank privatization, this section summarizes the experience in other countries and describes a number of potentially important issues.

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[14] The authors relied upon four sources – *Privatization International,* the *London Times*, the *New York Times*, and the *Wall Street Journal* – to create their sample. They limited their empirical analysis to bank privatizations undertaken through public securities offerings, which meant that few banks from developing countries were included.

[15] Suranyi (1998) reports that the state owned 67.7 percent of banking capital, while foreign interests held only 12.4 percent at the outset of 1994. By the end of 1997, foreigners held 60.8 percent of total banking capital and the government held only 12.4 percent. The initial attempts to clean the portfolios of these banks began in 1992, and subsequent recapitalizations occurred in 1994 (Bonin and Wachtel, 2000).

4.1. Fiscal Benefits

One point to emphasize is that the potential fiscal savings associated with privatization may be quite large. Clarke and Cull (1999, Table 1) compare the costs of re-capitalizing a typical provincial bank in Argentina, based on their average loss rates from 1991-96, with the short-term cost of privatization. In practice, those loss rates were likely to be understated. The poor performance of the provincial banks meant they had good reason to be less than forthcoming when reporting loan quality to the Central Bank of Argentina. This view is supported by the results of external audits conducted at the time of privatization. In any event, even based on the observed loss rate, they found that the present value of the future re-capitalization required by Argentinean law far exceeded the maximum short-term costs associated with privatization. These short-term costs came from realizing and cleaning up the past losses of the provincial banks.

In particular, the present discounted value of the recapitalization payments required under Argentine prudential regulation for a typical provincial bank (25 million pesos in net worth) would have been 383 million pesos. The typical residual entity that was created from such a bank would have had only 125 million pesos in liabilities. These simulation results indicate that, if a province recovered none of the assets of its residual entity, and paid off all its residual liabilities immediately, the costs would have been less than one-third of the estimate of the discounted recapitalization costs. This ignores the sales price received for the privatized entity, which would have been another source of fiscal benefit.[16]

In most cases, by avoiding the future losses of the state-owned bank, privatization should offer substantial fiscal benefits. Of course, it is not only state-owned banks that sometimes need re-capitalization. Failed or failing private banks often require intervention, and some are bailed out. The potential fiscal benefits of bank privatization, therefore, depend critically on a sound regulatory and supervisory environment that does not foster a bailout culture and catches small problems at privatized banks before they become big ones.

[16] The sales prices in these transactions, however, tended to be less than 10 million pesos. The simulations are described in more detail in Clarke and Cull (1999). Similar results obtain for various discount rates and for various plausible assumptions about capital loss rates.

4.2. Recognizing and Resolving Past Losses

Since public banks tend be insolvent prior to sale, governments often must consider various forms of restructuring to attract buyers. This was most pronounced in the transition economies of Eastern Europe and the Former Soviet Union, where the old 'monobanks' first were broken up along functional or geographic lines. However, the fundamental restructuring problem, which appears to apply in most situations, was handling the mountain of non-performing assets in the portfolios of insolvent state-owned banks. A recent econometric cross-country study of bank privatization notes:

> Effective methods of dealing with bad loans prior to or during the privatization process are essential. This problem is especially severe in situations where uncollectable loans are outstanding to state-owned enterprises.
>
> (Verbrugge, Megginson, and Owens, 2000)[17]

In their study of bank privatization in the transition economies, Bonin and Wachtel (2000) are more specific about the appropriate method for handling the bad loan problem: "Recapitalization is a necessary condition for a successful transfer of governance to an external owner. Weak banks must be restructured and endowed properly before a sale is considered." We take an agnostic approach on specific methods noting, for example, that Argentina's relatively successful privatization centered on the creation of residual entities for the low-quality assets and liabilities not assumed by the private purchaser. In addition, an insolvent state-owned bank could be sold in its entirety to whoever bids the least negative price.[18] Whatever the method, however, most sources agree that handling accumulated bad loans is the vital aspect of bank privatization.

Because non-performing loans can be hidden, often through credit rollovers or debt restructuring, the public may be unaware of the depth of the problems with the portfolios of

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[17] Those authors limited their empirical analysis to privatizations undertaken through public securities offerings. As they note, an important drawback to their approach is that they leave out privatizations undertaken through sales to strategic investors (foreign or domestic) or through vouchers (as was customary in many transition economies). Because capital markets are poorly developed in most of the World Bank's client countries, these two methods have been used more widely than offerings of securities.

[18] Ramachandran (1995) points out that this is essentially the approach taken by the Resolution Trust Corporation in the United States. However, in practice, it may be impossible to sell banks for 'negative' prices for political reasons.

state-owned banks. The upshot of these problems is that, when privatization occurs and the portfolio is rigorously examined, there is often 'sticker shock' associated with the costs of clean up. Our best quantitative evidence on this issue comes from the provincial bank privatizations in Argentina. As part of the privatization program, these banks were required to undergo rigorous external audits prior to sale. Clarke and Cull (1999) report that their ratios of net worth to liabilities (required to be 11.5 percent under Argentine regulation) dropped by fifteen percentage points after these audits. Because most of the public provincial banks had net worth ratios near 5 percent prior to privatization (well below the standard), the fifteen percentage point dip implied a post-audit ratio of –10 percent. In one case, the ratio dipped to –60 percent. Bank privatization is likely, therefore, to reveal insolvency, perhaps very deep insolvency. Fear of revealing such an insolvency is understandable, but ironically it is often that fear that prevents politicians from capturing the long-term fiscal benefits associated with bank privatization described above.

International experience suggests that successful privatization will entail at least some recognition and resolution of past losses. Sufficient fiscal resources must be found. In Argentina, the Central Bank had long rediscounted the loans of the public provincial banks. Because many of these loans were non-performing, the federal government, through the Central Bank, bore the costs of poor provincial bank performance. Privatization did not occur until the role of the Central Bank changed and the Argentine federal government, in conjunction with the World Bank and the Inter-American Development Bank, developed a program for the resolution of past provincial bank losses.[19] In Brazil, a similar situation occurred, except that the federal government undertook the program on its own, without support from international donors.[20] In both cases, however, provincial (or state) politicians received 'federal' financial assistance to clean up the balance sheets of their bank in return for their agreement to privatize.

[19] See Clarke and Cull (2000) for a more detailed description of the program.
[20] Maia (1999), Ness (2000). Absent the fiscal leverage of the international donor community, the Brazilian program has, thus far, achieved far fewer privatizations than the Argentine program. As of January 2000, only six of about thirty of Brazil's state commercial banks had been privatized (Makler, 2000).

In the Mexican case, the authorities have now agreed to re-privatize their intervened banks in return for World Bank financial assistance. The goal is first to create solvent institutions and then search for new owners. World Bank loan proceeds will be disbursed for individual bank sales, the terms of which will be approved on a case by case basis. Restrictions on foreign participation in the sector have eased due to a growing recognition that foreign banks could foster more stable financial sector development. To the extent that Egypt's public banks have hidden losses, as many state-owned banks do, covering fiscal costs will likely be an important part of the bank privatization process.

4.3. Staffing and Branching

Many state banks are significantly overstaffed or have inefficient branch networks. As a result, a part of the efficiency gains associated with privatization comes from laying off surplus workers or closing branches (sometimes in rural areas), and governments often have to decide how much cost saving restructuring is politically feasible. Clarke and Cull (2000) provide econometric evidence that the most overstaffed provincial banks, a sign of the political power of those workers, and the banks that most dominated the local banking market, were the slowest to privatize. Their paper also points out systematic differences in the Argentine privatization contracts stemming from the provinces' fiscal situations, the extent of overstaffing at the bank, and the dominance of the bank relative to the local banking sector. In particular, provinces in dire fiscal straits protected the jobs of fewer bank employees and shifted a higher share of assets and liabilities of the public provincial bank onto the purchaser. By contrast, those with overstaffed banks that dominated the local financial landscape protected more jobs and shifted fewer assets and liabilities over to the purchaser.

The big four and the state specialized banks had lower assets per employee than did the private banks, and the gap widened from 1995 to 1998 (Table 5).[21] The difference on these ratios is especially striking when comparing the state banks with the private banks that have majority foreign ownership (compare Table 4 and Table 5). The private banks now also have a

[21] Kompass provides balance sheet information for only two of the big four banks in 1999. As a result, we can make reliable comparisons between groups only through 1998.

higher ratio of deposits per employee than the state banks, although they didn't overtake the big four on this measure until 1998. Assuming the private banks have made appropriate staffing decisions, these ratios suggest that the state banks are overstaffed. Successful bank privatization likely will entail that the excess labor problem be adequately addressed.

Table 5. Efficiency and Staffing by Bank Type, 1995-1998

Assets per Employee			
Year	Big Four	State Specialized	Private
1995	3105.3	1630.8	3445.0
1996	3321.4	1777.9	3743.2
1997	3683.7	2166.2	4391.4
1998	3882.6	1939.8	4702.9
Deposits per Employee			
Year	Big Four	State Specialized	Private
1995	2498.1	381.6	2182.5
1996	2729.3	415.5	2477.3
1997	3052.1	524.1	2923.6
1998	3132.0	231.2	3299.0

Argentina is, at present, the only case that provides sufficient observations to permit econometric analysis over the trade-offs between protecting jobs and achieving successful bank privatization. The Argentine experience suggests that efficiency improvements require some labor shedding, and they will also likely entail the closure of branches. While neither of those measures were politically easy, the Argentine authorities permitted enough flexibility through negotiation that the purchasers and the provincial governments were able to craft mutually beneficial agreements that were politically feasible. The sheer number of transactions (seventeen banks across sixteen provinces) suggests that the privatization program was a success. Moreover, although the post-privatization period has been short, these banks have reasonable performance indicators and have shifted their lending away from the public sector (Clarke and Cull, 2000). They now compete more directly with other private banks than before, and total credit to these provinces has been restored to its pre-privatization levels.

At least one local expert indicates that there are legal impediments that explicitly prohibit the most direct methods to confront overstaffing in Egypt's state banks: "The overstaffing problem is a legacy of socialism. Gradually, as people retire, things will change. It will take some time, though, because according to the law you cannot fire people." (Mohammed el-Barbary, deputy governor of the Central Bank)[22] However, there may be other ways to address the problem. Khattab's comprehensive summary of Egypt's experience with privatization (1999) points out that worker opposition to privatization has been mollified through programs that permit workers to purchase shares in the privatized firm on a privileged basis. In addition, Egypt has had success in reducing excess labor through optional early retirement plans (buy-outs) that were part of many privatizations.

4.4. Competitive Environment – Foreign Entry

Meyendorff and Snyder (1997) point out that the effects of bank privatization may depend on the level of competition in the sector. In contrast to banks in the Czech Republic and Poland, Hungarian banks faced substantial competition, in particular from the *de novo* entry of foreign banks. The result was "aggressive expansion in the number and quality of services offered, sharply declining interest rate spreads, and internal reorganization involving dramatic cuts in redundant staff." Given their current small size, it is unclear whether private banks in Egypt could offer the same competitive discipline. However, the rapid growth in lending and the relatively strong performance of the majority foreign-owned joint ventures is an encouraging sign.

Another factor that affects bank privatization results more directly is the government's attitude toward foreign investors. This may have less bearing on the likelihood of privatization than the other factors already mentioned, but it may have substantial effects on the long-run prospects of the privatized bank for several reasons. Foreign banks have an international reputation to protect; their asset portfolios are internationally diversified; and most face better supervision and regulation in their home country than they would in a typical developing country.

[22] As quoted in *Middle East Economic Digest*, June 26, 1998.

The Mexican experience is especially instructive. All Mexican banks were nationalized in 1982, and the first attempt at large-scale privatization, which culminated in 1992, produced some curious results. Most noticeably, although foreign investors could not participate in the bidding, the banks sold for high multiples of book value. It remains unclear whether the bids overstated the actual cash that changed hands, reflected a rational expectation of regulatory forbearance and a probable future bailout if times grew tough, or were a reflection of immense expected profits. It is also interesting that the Mexicans sold these banks in their entirety, with provisions neither for residual entities nor for re-capitalization. After engineering a rapid lending boom from 1992 to 1994, these banks all began to fail. The 1994-1995 Tequila Crisis exposed the weaknesses of the system, bringing about recognition that foreign ownership and improved regulatory, supervisory, and accounting practices would benefit the sector. As noted, the second round of privatization, much of it to foreign owners, is still in process, some five years after the crisis.

Although it can be politically controversial, some countries have encouraged foreign buyers, presumably anticipating that foreign management could improve bank performance. For example, Hungary actively encouraged foreign participation, trying hard to make the banks attractive to foreign buyers. Egypt has taken more measured steps with respect to foreign bank entry. Beginning in the 1970s, foreign banks were allowed to enter, but only by forming joint ventures with state-owned banks, and the state has been slow to cede effective control of those ventures to foreign interests. At least one local expert indicates that privatization of one of the big four to foreign interests is unlikely in the near term:

> "People are very concerned about the privatization of public sector banks. Therefore the government is likely to do it gradually and is unlikely to allow non -Egyptians to invest at first."
> -Inas El-Hagrassy, general manager, National Bank of Egypt, Research Division[23]

If the authorities are interested in encouraging bank privatization, attempts to change this bias would be worthwhile. As Guillermo Ortiz, then Finance Minister of Mexico put it in the fall of 1997, when asked what lessons he would draw from Mexico's experience for East Asia, "...had

[23] As quoted in *Middle East Economic Digest.*

we allowed foreign participation the first time we sold our banks, we would have saved ourselves considerable cost, and another round of re-privatization."[24]

5. Conclusions

Greater state ownership tends to lead to less financial sector development and lower growth, and as growth is the most significant determinant of the incomes of the poor (Dollar and Kraay, 2000), also to higher poverty levels. This finding, combined with the prevalence of state owned banks, leads us to expect more countries to pursue privatization.[25] Yet, bank privatization in a weak regulatory environment (Mexico in 1992) can lead to crisis, while in a strong regulatory environment (Argentina, currently), can lead to a more resilient banking sector. Thus, as Egypt scores near the top in terms of the percentage of assets in state-owned banks, the authorities may wish to consider ways to increase the private sector's role in banking. To that end, this paper has furnished some guidelines as to the regulatory pre-conditions for a robust banking sector, as well as some indication as to where Egypt stands compared to selected economies in that score.

As noted, the 'science' of comparing regulatory regimes is in its infancy, and lacking other information, we arbitrarily attributed equal weights to all categories in our regulatory index, which will almost surely be found to be incorrect. On this basis, Egypt received a low score. However, Egypt appears to be closer to a similarly low-scoring India, rather than to the crisis countries of East Asia, especially in terms of relatively high liquidity ratios. Thus we argue that if the authorities wish to encourage greater intermediation and, in particular, a larger role for private banks, then improvements in the regulatory environment should be a priority.

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[24] Recalled by the senior author, who organized that panel. Note the other lesson Ortiz named was that the authorities should have begun efforts to improve their regulatory-supervisory environment and their transparency before they sold off all their banks to private interests.

[25] There is no intention to suggest that state ownership makes development impossible, as one advanced economy, Germany, has shown that development is possible with significant (40 percent) state ownership. Still, this is the exception, and most other high income economies feature 0-15 percent of assets in state banks. Information failures create a rationale for interventions in the financial sector, though state ownership does not appear to be the best method for resolving them.

Important areas include transparency, disclosure, property rights, and the judicial enforcement of legal protections for creditors.

These changes will take time and, to paraphrase Jean Monnet, are best begun as soon as possible. To the extent that the authorities wish to consider privatization early, we would recommend a phased approach, and an attempt, following Guillermo Ortiz's advice, to select private owners who likely will not need as much oversight, namely good foreign banks. State banks dominate Egypt's banking sector as they do in few other countries, and overstaffing is recognized by local experts as an impediment to privatization. Egypt's successful privatization experience in other sectors suggests that these obstacles can be overcome, but government officials will have to 'buy in' to the empirical results linking private sector ownership with faster growth and lower poverty levels if privatization is to take-off.

APPENDIX

Appendix A. Components of the CAMELOT Ratings for Banking System Regulation [*]

Table A1. Capital

Country	*Definition*	*Minimum Ratio*	*Rank*
Singapore	Only Tier 1 eligible	12	1
Argentina	Capital ratio geared to CAMEL rating and interest rates; capital req. for market risk added, with bonds of duration over 2.5 years requiring higher capital	11.5	1
Hong Kong	70 percent of revaluation reserves eligible for inclusion. Minimum can be raised up to 12 percent for licensed banks, 16 percent for restricted license or deposit-taking company; institutions required to observe a 'trigger' 1 percent above the minimum. Capital requirement for market risk as of late-97.	8	3
Chile	Only LT sub debt, up to 20 percent of capital; risk weight for mortgages above Basle norm.	8	6
Brazil	25 percent Reval. reserves, loss reserves, included tier 2	8	9
Peru	No revaluation accounts, sub debt permitted; min. capital ratio raised by 150-200 percent for overdue loans.	8	6
Malaysia	Only tier 1 in 8 percent	8	6
Philippines	No tier 2, unweighted (all at 100 percent)	10	3
Korea	Up to 45 percent of revaluation gains included in tier 2 capital	8	12
Colombia	150 percent risk weight for loans, only 50 percent of revaluation assets	9	3
Indonesia	Sub. debt up to 50 percent	8	9
India	45 percent of reval. Gains in tier 2; tier 2 max. 100 percent of tier 1	8	12
Egypt	25 percent of reval. gains included	8	9
Thailand	Tier 2 includes revaluation accounts, provisions, unrealized securities, profit/loss, subordinated debt.	8.5	12

Table A2. Loan Classification

Country	*Days to NPL*	*Minimum initial provision*	*Comments*	*Rank*
Singapore	Sub. risk		loan value-8[†] collateral (50% min).	6
Argentina	90	0.25	1% provision on normal loans, max. single, 15%	4
Hong Kong	180	no general rule	max. single, 25%	10
Chile	30/90	60%/n.a.		1
Brazil	60	100		3
Peru	60/90	50-60%		2
Malaysia	180	0/1% gen. provisions, 20% once loan is substandard		10
Philippines	sub. risk	0.25		6
Korea	180	0.2		10
Colombia	90	0.5		4
Indonesia	90	0.1	max. single, 25%; max. group, 60%	9
India	210	10% not net of provisions		13
Egypt	90	20	25% FX	8
Thailand	360	0.15		14

Note: [†] on unsecured balances

[*] In addition to various national sources and those noted following various tables, sources included: JP Morgan (1997), Ramos (1997), Hong Kong Monetary Authority (1997) and IMF (1997).

Table A3. Management (Foreign Ownership)

Country	*% of assets in foreign banks*	*Rank*
Singapore	61.6	2
Argentina	42.9	3
Hong Kong	65.6	1
Chile	33.1	5
Brazil	33.6	4
Peru	28	6
Malaysia	14.6	8
Philippines	15	7
Korea	8	11
Colombia	5.3	12
Indonesia	10.8	9
India	8.3	10
Egypt	4.2	13
Thailand	1.8	14

Table A4. Liquidity

Country	*Ratio(s)*	*Forex*	*Remuneration*	*Rank*
Singapore	24%		watched closely	6
Argentina	20% on liabilities up to 89 days, 15% for 90-179; 10% for 180-365; and 0 for over 365 days. Approx. 9.7% additional as Repos.	watched closely	mostly remunerated, half offshore	5
Hong Kong	25% of liabilities	watched closely	mostly remunerated	3
Chile	9% on demand, 3.6% on time			9
Brazil	78/15/20			4
Peru	9%, plus 36% additional		mostly dollar deposits, so 45%	1
Malaysia	13.50%	no restrictions		9
Philippines	13%			9
Korea	3%			13
Colombia	21%, 10%			8
Indonesia	35.50%	mostly prohibited	mostly remunerated	14
India	5% on demand, 2% on time			2
Egypt	20%	25FX	not remunerated	7
Thailand	7%			9

Table A5. Operating Environment

Country	*Property Rights*[‡]	*Creditor Rights*[§]	*Enforcement*[§]	*Rank*
Singapore	1	1	8.715	1
Argentina	2	-1	5.13	10
Hong Kong	1	1	8.52	2
Chile	1	-1	6.91	6
Brazil	3	-2	6.31	11
Peru	3	-2	3.59	14
Malaysia	2	1	7.105	4
Philippines	2	-2	3.765	12
Korea	1	1	6.97	3
Colombia	3	-2	4.55	13
Indonesia	2.5	1	5.035	8
India	3	1	5.14	7
Egypt	3	1	5.11	9
Thailand	2.5	1	6.91	5

Note: In ranking for operating environment, those with a "1" on property rights get ranked first (hence a 4-way tie); those with a 2.5 get a 5 (2-way tie), and those with a 2 come next, etc. Creditors' rights are ranked in the same manner (except that ratings range from a low of –2 to a high of 1), and enforcement of the legal system is ranked linearly from the high of Singapore to the low of the Philippines.

‡ 1998 Index of Economic Freedom.

§ Levine (1997) and La Porta, Lopez de Silanes, Shleifer and Vishny (1997).

Table A6. Transparency

Country	*Bank Rating Required*[‖]	*Top 10 Banks w/ International Ratings*[‖]	*Corruption*[#]	*Rank*
Singapore	0	10	8.22	1
Argentina	1	10	6.02	2
Hong Kong	0	3	8.52	6
Chile	2	10	5.3	2
Brazil	0	9	6.32	5
Peru	1	6	4.7	10
Malaysia	0	2	7.38	9
Philippines	0	8	2.92	12
Korea	0	10	5.3	4
Colombia	0	5	5	11
Indonesia	0	10	2.15	8
India	0	0	4.58	14
Egypt	0	7	3.87	12
Thailand	0	9	5.8	7

Note: For transparency, those countries requiring banks to be rated get a 1, those without this requirement get a 0; the number of top 10 banks and the corruption measures are ranked as above, and rankings then totaled in the same manner, with the lowest score getting a first place, etc.

‖ BIS Annual Report, 1997, and World Bank data.

La Porta, et al.

Appendix B. Banks Used in the Analysis

Table B1. Assets of Selected Egyptian Banks, 1997

Bank	*1997 Assets, LE 000s*
Big Four	
National Bank of Egypt	53,759,897
Banque Misr	49,882,236
Banque du Caire	28,548,000
Bank of Alexandria	20,320,385
State Specialized	
Principal Bank for Development and Agriculture	9,852,344
Arab Land Bank	3,769,264
Credit Foncier Egyptien	2,563,649
Industrial Development Bank of Egypt	1,860,569
Private	
Egyptian/Arab Owned	
Faisal Islamic Bank	6,215,443
Housing and Development Bank	5,375,231
Watany Bank of Egypt	2,618,161
Egyptian British Bank	2,150,840
Egyptian Gulf Bank	2,140,351
Egyptian/Arab + State Owned	
Suez Canal Bank	7,370,071
National Bank for Development	5,896,750
Misr Exterior Bank	5,422,464
Mohandes Bank	3,676,431
Islamic International Bank for Investment and Development	2,592,500
Export Development Bank of Egypt	2,500,475
Delta International Bank	1,793,916
Egyptian Saudi Finance Bank	1,559,041
United Bank of Egypt	1,417,202
Egypt Arab African Bank	1,363,982
Arab Investment Bank	1,231,904
Misr Iran Development Bank	1,160,970
Alexandria Commercial and Maritime Bank	1,093,587
Egyptian Commercial Bank	1,074,828
Arab African International Bank	997,995
Commerce and Development Bank/Al-Tegaryoun	900,185
Port Said National Bank for Development	335,162
Egyptian Workers Bank	230,822
Egyptian/Arab + State + Foreign Owned	
Egyptian American Bank	5,307,541
National Societe Generale	3,935,864
Societe Arabe Internacionale de Banque	400,800
Cairo Far East Bank	374,888
State + Foreign Owned	
Commercial Intational Bank	13,473,413
Misr International Bank	8,970,760
Banque du Caire Barclays	2,237,930
Misr Romania Bank	1,486,929
Credit International d'Egypte	1,272,870
Banque du Caire & de Paris	1,121,290
Misr America International Bank	953,007

PART II: DISCUSSION
BANK PRIVATIZATION AND REGULATION IN EGYPT

Participants in the discussion following Gerard Caprio and Robert Cull's presentation included Abdel Aziz M. Hegazy, President of Abdel Aziz Hegazy & Co., Accounting and Management Consultants and former Prime Minister; Adel Bishai, professor of international economics at the American University in Cairo; Ahmed Galal, Executive Director of the Egyptian Center for Economic Studies; Dina Khayatt, Chairperson of Lazard Asset Management Egypt; Faika El-Refaie, ECES Economic Consultant; Fouad Sultan, Chairman and Managing Director of Al Ahly for Development and Investment (ADI) and former Minister of Tourism; Mohamed Ozalp, Senior General Manager and Member of the Management Committee of Misr International Bank; Samir Korayem, Chairman of Orbit Stock Brokerage House; Taher Helmy, Partner of Baker & McKenzie Law Firm and ECES Chairman; and Yasser Sobhi, economic journalist for Al Ahram Newspaper. The following is a summary of the discussion.

Participant: We have all been waiting for bank privatization, but we must consider the experiences of countries where it was unsuccessful. My understanding is that it was not only because the regulatory regime was not ready that the privatization of public banks in Mexico initially backfired. What were the main reasons behind the failure of this first attempt at privatizing Mexico's banks?

Speaker: That is a good question. Although regulatory reform is incredibly important, it is not the only factor that needs attention. Aside from an inadequate regulatory environment, poor timing/pacing of the privatization efforts, a lack of real capital, or an absence of good information that allows outsiders to manage the sales can all contribute to failure.

In Mexico's case, the absence of a solid regulatory environment was indeed a factor that contributed to the initial failure, as has been admitted by Mexican officials. However, there

were other factors that also helped to render Mexico's effort unsuccessful. Not only did they choose to privatize the entire banking sector in a 13-month period, but they also opted to sell the banks in their entirety without cleaning their balance sheets and would not allow foreign investment. Furthermore, at the time Mexico sold its banks, they were being sold for large multiples like 3 or 5 times the book value of the assets, which is high for what banks normally sell for.

It is difficult, however, to verify the quality of such capital and it may well have been borrowed, in which case it was less than it appeared.

Participant: I am interested in hearing what you consider to be the basic minimum requirements for an adequate regulatory environment, if you feel that an answer is even available at this point.

Speaker: We have only started in the last year and half to assemble information to answer that question. There has never been any source of data or information that allows us to compare regulatory systems across countries. We now have responses from about 105 countries to a fairly lengthy questionnaire on different components of the regulatory environment, but there has been little change in the percentage of government ownership in the banking sector outside the transition world. The examples of privatization are relatively limited to Argentina and Mexico. Thus, there is not yet any broad-based empirical comparison across the transition countries. Still, the basic premise is to increase disclosure and provide incentives for large creditors to monitor banks so that there are many motivated and well-informed monitors.

Participant: When you speak about the regulatory environment, are you talking about a broad overview of the whole legal system in the country?

Speaker: Yes. The regulatory environment includes the regulatory and judicial systems, as well as the operating environment and the transparency of the system. It is basically comprised

of all the elements that affect the ability of owners, markets, and supervisors to oversee the health of the institution.

Participant: I question whether the private sector in this country really looks forward to privatizing the four public banks or if some people are enjoying the existence of public banks and doing better with them than if these banks were privatized, paradoxical as this may appear.

Speaker: I think that within some limits, the private banks like to have public sector banks around. There are many countries that have effectively eliminated all state ownership, but there are also a lot of countries that are quite successful with some state ownership. We are not creating the case that the optimum level of state ownership is necessarily zero. Although, some countries with relatively low private ownership are still going to reduce it further. France's banking sector, for example, was 17 percent state-owned in 1997, and has now been reduced to 8 percent. I do, however, think that private banks may like it when state-owned banks are a smaller or less dominant part of the financial sector because it means less competition. If they are sold to good owners, they are going to face more pressure for their profits. Now, because Egypt still has a high percentage of state ownership, the state owned banks might be strangling the growth of the private owned banks, so I am not sure if they like it that much.

Participant: I wonder whether your conclusions will change if you take into account the following observations: First, the 1999 figures on liquidity and the public sector and market shares will probably be significantly less than those that you quoted.

Second, the foreign banks in Egypt – which you are putting a lot of emphasis on – have a very limited market share here and a minimal impact on the market. Do they really deserve the amount of emphasis you have placed on them?

Third, as a banker, I have personally found that, contrary to what you have said, the smaller banks are presently distorting the market more than the public sector banks in terms of raising interest rates, lending, inter-bank borrowings, etc.

Speaker: If the smaller banks do have a distorting influence, then their days are limited. They will surely be thrown out of the system if they keep it up. That is, by the way, one rule that supervisors in some countries use as a way to decide how to concentrate the supervisory resources. If a bank's deposits grow much faster than the average, it immediately gets extra examinations to see if there is excessive risk-taking or not.

Concerning the emphasis I have put on foreign banks, the ranking was exclusively determined by the share of assets in the banking system that were in majority, foreign-owned banks. So, in effect, that is what contributes to Egypt's relatively low rank. Now that the Mexican authorities have realized the problem of privatizing exclusively to domestic owners in the first round, they have been selling to foreign entities and the share is up to about 32 or 33 percent.

Finally, on the new liquidity ratios changing this presentation, since I was speaking about a regulatory environment, I was looking at what would be the *minimum requirements* of liquidity ratios. In 1997-1998, Egyptian Banks were still holding liquidity well above the required ratios. As long as they haven't gone below the 20 percent requirement, then it wouldn't change what I have said so far.

Participant: Is Egypt's banking sector in need of capital? I ask this question simply because, before privatization, foreign capital in the banking sector was minimal. Egypt's banking sector has repeatedly suffered from the actions of foreign banks that decided to participate in the process of privatization only to withdraw shortly after. If one of the targets of privatization is the need of capital - foreign capital, in particular – then we must be aware that foreign capital is usually very scarce in the banking sector.

Secondly, is management a top priority for action? If it is, then we must recognize that the present management deficiency is due to the government's old system of controlling the banking sector, under which there has been little development in the technology of running the banking sector. I think that the central bank and the four banks should introduce better, more

modern management and technology into the financial sector as a whole – not only to banks, but to the insurance companies and investment firms as well.

Speaker: As I am sure you know, we cannot look at the banking sector in isolation. If one believes, as the evidence suggests, that banking is extremely important to growth, then the quality of the owners that one can entice is going to depend on the overall investment environment in Egypt. Sometimes when foreign banks come in and then retreat again, it is because the environment is less conducive to earning profits than they originally thought. The reasons why it may be less conducive vary; it may be the fiscal situation, or maybe the taxes applied on foreign banks, or that the client firms are not performing well and they don't see any prospect for turning them around. Thus, one cannot solve this problem by simply placing an advertisement that you are now willing to consider foreign ownership, you must also consider what climate is going to attract the best possible owner.

In terms of whether public sector managers – or even private managers hired by the government to run a public bank – can do the job better, the answer of the empirical evidence generally shows that no, they cannot. If they could, we wouldn't find this association between greater state ownership and lower growth. A World Bank study, "Bureaucrats in Business," for example, evaluated the performances of government officials running state enterprises in the non-bank sectors to find out whether contracts with private managers motivated them to behave well. The conclusion of the study was that this basically only works in industries that are really easy to monitor and where reputation matters a lot. Banks used to be high in terms of reputation, but as long as there is an implicit government guarantee, it actually does not matter nearly as much. They clearly are not easy to monitor. So in that sense, they would not be good candidates for trying to use management contracts with state ownership.

Participant: The experience here in Egypt is that most of those who are now working in the private sector are coming from the public sector. Due to the climate of management in the private sector, they are doing far better in terms of performance.

Speaker: Yes, I think one of the most attractive incentives these public-turned-private managers have is that, in the private sector, they are able to take actions rather than being hesitant.

Participant: You seem to be discouraging debt as a source of buying banks, but I don't know if this advice is directed to the government or the banks. Second, when banks are sold or privatized, they are usually sold at 3 to 4 times the assets value, which you consider very high. What precautions should we take against over-valuation? We noticed that in some of the privatized companies, the share prices were set at too high a level and the market did not accept them.

Speaker: On the first point, it was truly directed to the government, especially as to whether the regulations or a tax system's features encourage greater debt. But basically, the strategy is that even within that debt, one makes sure that you are not encouraging too much short-term debt and not enough long-term. Short-term debt can flee quickly.

On debt versus equity, it is indirectly addressed to the banks. If the regulatory environment allows or encourages banks to leverage themselves successively, then that will encourage more debt in the economy, other things being equal. Thus, tightening the regulatory framework under banks will limit the encouragement of debt and stimulate equity market development.

On the precautions for over-valuation, this is a tricky area. One interesting experience to consider is that of Poland. They planned to privatize their banks over a 6 to 8 year period, privatizing one or two banks every year. Because the concern is always prior to privatization, the bank managers who were running the still-state-owned banks had their pay restructured so that a lot of their pay was deferred stock options that only had value based on the future sale price of the bank. If bank management thinks that private owners are going to replace them, they will have an incentive to try to strip assets out of the bank, and one wants to constrain that.

But in the process, beside that positive incentive, they also increase the disclosure requirements for banks that were being sold. I think the multiples were between 2.25 and 3, or so.

A related point that also comes up is that governments are basing their decision of whether the time is right for privatization on whether they are going to get enough for their banks or will have to sell at a low multiple. My view is that we should be more concerned about converting these bank managers into private managers as soon as possible. In other words, the other gains from that sale are so great that you shouldn't be paying attention to the price as the main gain from privatization. The main gain for bank privatization is that we are going to end up with resources being allocated more efficiently and higher growth to your economy. The sooner you get to see that, the better off you'll be.

Participant: Just to complement what you were saying, I do believe that valuation is more art than science. Actually, it is almost impossible to get it right. Why? Because you are basing your valuation on the future. The future has so many variables and there are so many uncertainties. Even if you forecast accurately, things can change because the government can change policies and these policies will have an impact on the value of the company or bank. So in the midst of all this, how can you solve the problem and get it right? I believe the focus should be on the process. You need to make sure it is as open as possible and that you have as many bids as possible. That is the only way you can guarantee you are getting the highest price. Trying to get it right by yourself will not work very well.

Participant: Undoubtedly, there is a need for closing the gaps in the legal framework. Although the Egyptian government achieved a great success in stabilizing the economy in 1991, we are lagging far behind in building up a legal framework for the economy. I do not believe we should be putting off privatizing the public sector banks on account that we must build a strong legal framework in advance. This is a way for the authorities to continue wasting resources. Whether the government is controlling 55 percent or 70 percent of domestic credit, if you add the state owned banks' indirect control of the joint ventures, you find that the bulk

of investment credit is still being controlled by the state. The resources have been directed at mega-projects at the expense of the private sector.

I fully agree with the previous statement that there are some business people here in Egypt who would like to continue the state owned banks' activity. This, however, is part of the distorted economy where some are benefiting from the existing distortions in banks. I believe that the privatization of one or two state owned banks is the most attractive option if we want to achieve the final goal of transforming the economy into a free market where the private sector is given the lead.

Speaker: I agree with those points very much. Let me discuss the legal environment further, since the pre-conditions that involve it have come up in several cases. There is often the presumption that the legal and judiciary systems take a long time to change, and that therefore, one can't move quickly. Actually, it is interesting that recently in Mexico, they did move quickly. When, for example, they had a problem where although their bankruptcy code was ok, the court system was not enforcing it and delays would take years, they set up a process to enforce bankruptcy. Now when a firm is in restructuring, it goes to an independent arbitrator called a conciliator appointed by the government to oversee the process under a specific time limit depending on the size of the firm. When the time runs out, the remaining assets are automatically auctioned off and they don't go to court on it. Once they passed that law, it dramatically sped up restructuring decisions. It didn't take a decade to retrain the judges and reeducate them. It went very quickly, so one can consider different opportunities like that.

Participant: What are the lessons learned from other countries that can help us deal with the problem of joint venture and equity ownership of the state banks?

Speaker: Joint ventures are not good at re-allocating resources specifically because of their links to large state owned banks. In another study I've previously mentioned, it was found that even when the state owns only 20 to 25 percent of the bank, it still ends up controlling the bank and lending to state-owned enterprises instead of private sector firms. So, making sure that one

dramatically reduces the state's ownership is important. Argentina's case is a good example of this. It was found that a year or two after the Argentine banks were privatized, they weren't lending to state enterprises as they had been when they were under state ownership. I think that suggests that they began allocating resources to better uses.

Participant: I have one comment concerning the role of the portfolio of public sector banks, which I think has been significantly improved in the last few years. In 1994, the government stopped endorsing or guaranteeing the ability of any public sector company to borrow. Thus, all public sector companies were given the freedom to deal with any public or private bank, which are under the same supervision of the CBE. The present portfolio of public sector banks is an inheritance from the past, and these banks are taking the necessary actions to dilute it progressively. I believe they have taken large steps in this direction.

There are two questions I would like to ask. Based on the information you have amassed on two thirds of our banking sector, do you think that we have already reached an acceptable degree of transparency in banking information? Secondly, I question the role of the public sector banks in helping the central bank to achieve its monetary policy targets, especially in the foreign exchange market vis-à-vis privatization of these banks. There is a trade-off between having public sector banks assist the Central bank to achieve its targets, and privatization to enhance competitiveness in the banking sector. What is your opinion on this?

Speaker: On the first point, if the portfolio of the public sector banks has improved, then that may mean that the fiscal costs should not perhaps be as much of a deterrent as it might have been otherwise. My point is that still, it is hard as outsiders or maybe even as insiders to know exactly how good or bad the quality of the portfolio really is.

On transparency, based on the cross-country indicator that we have, there still is quite a ways to go for Egypt. But I only reviewed those relatively adequate indicators, which actually gives me an opportunity for an advertisement – about a year ago, the World Bank and the IMF started doing joint financial sector assessments in which we diagnose in detail the health of the

financial system including looking at how transparent are the systems in detail relative to other countries. We also (if we can get the data) do stress tests of individual bank's portfolios, assessing how different shocks will affect them. This approach certainly offers a more thorough diagnosis of the regulatory environment than you have here and so it would be opportune for Egypt to volunteer to have one done.

Certainly, you can implement monetary policy without a large degree of public sector ownership (that what most of the industrial countries do), although it does mean a change of habit. Back in the mid-1970s, the Governor of the Central Bank of Malaysia was known to remark to an IMF team that was trying to convince Malaysia to move to market-oriented instruments for monetary policy, pointing to the telephone on his desk, that that was his instrument of monetary policy and that it worked very well. But they have moved to using other instruments there. So, it certainly is possible, if that was your question.

Participant: In the face of rapid technological development, my question concerns the licensing for banking. I don't have a firm grasp of what is going to happen with the telecommunication revolution, but if you can imagine a situation in a couple of years where you don't even need a license to service the Egyptian market or you don't need to own a heavily overstaffed bank, why would anyone buy one of these huge banks? What kind of regulations should be introduced other than the traditional? And what is the government supposed to do to entice owners to come and buy? I don't think that it is a seller's market; I believe it is a buyer's market.

Speaker: If it does become technologically possible for offshore banks to operate without a license or an Egyptian residence, then the government's primary duty will be to educate people to the fact that if they are dealing with an entity that the government has no control over, they are obviously at risk. There isn't any question of positive guarantees being supplied to banks that are not licensed here. Thus, the regulatory concern is with the banks that are licensed to operate in Egypt because, even in countries with or without deposit insurance, the government

may still bear some responsibility to them. If the big bank fails in a country without deposit insurance, the deposits end up being covered. The government still has to worry about the banks that are domestically located, so the concerns on the regulatory environment are still valid.

You're right that we go through waves as to whether countries have to entice owners or fend them off. Again, one needs to pinpoint which overall investment climate in Egypt will attract good banks. There are also a variety of African countries that, much to their dismay, attracted BCCI and Meridian, which ended up being very poor foreign banks. Similarly, when foreign banks come in, you want to make sure that you diversify the sources from where they are coming from. In Thailand, for example, they allowed a number of Japanese banks to enter in the late 1980s. When the Japanese banks got into trouble, they retreated and actually set-off the crisis in Thailand. In contrast, Argentina has banks from Hong Kong, Canada, the United States, Spain, and the UK. They are pretty well diversified, so even if a shock happened in the US, they still have capital coming in from other countries.

Participant: I thought moving forward with the privatization of just one bank would not be very risky, but are you telling us that it could be dangerous if the environment is not yet ready?

Speaker: No, I definitely did not mean to imply that a country must postpone the sale of any banks until the environment is ready. To effect a major change on the ownership of two thirds of the banking system in the country, clearly you want to make sure the regulatory environment is ready – which may take some time. Although I would note that Argentina, on the other hand, privatized successfully with exceptional speed. In 1991, M_2 to the GDP in Argentina was down to about 6 percent. Their extensive banking crises in the 1980s (which, according to official data, are still considered the largest in the world) cost them 54 percent of GNP and led to extreme hyperinflation. Beginning their regulatory reforms in 1991, they stepped them up dramatically in 1994 and were able to withstand the Asian crisis shock exceptionally well. Thus, successful privatization does not have to take a decade if the

authorities make a firm commitment. Argentina was able to improve the information disclosure dramatically, upgrade their capital requirements, and reduce the liquidity requirements. They also let in foreign banks. In fact, presently nine out of the top ten largest banks in Argentina are majority foreign owned by good names – Morgan, Citibank, Hong Kong, Shanghai, etc. Thus, I reiterate that, while a country need not necessarily stall all privatization efforts, there are requirements that come with privatization and in order to be successful in the long term, one should start with them as soon as possible.

List of Attendees

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Distinguished Lecture Series

Among the issues currently being debated in Egypt is whether, when, and how the country should resume its efforts at bank privatization. Between those who fully oppose the idea altogether and those who fully endorse it, there are some who find it difficult to discern whether going through with the privatization of Egypt's "Big Four" public banks may or may not be essential to achieve overall economic development and modernization. More than anything, the debate needs the voice of experience to help fill in the gaps and guide the course.

Highlighting specific steps that led to success in different countries, Gerard Caprio, Jr. and Robert Cull attempt to broadly identify the preconditions for successful bank privatization and thus assess the readiness of the Egyptian economy for such actions. For countries that are drafting a privatization plan, they also offer useful advice on crucial decisions such as the timing and speed of privatization, setting reasonable bank prices, selecting and training private managers, allowing foreign ownership, and various strategies to simultaneously reform the country's regulatory environment. Overall, their articulate message draws attention to the many different levels on which a country must approach bank privatization. Egypt surely stands to benefit from such insight.

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