Macroeconomic Reforms and Resilience: International Experience and Egypt Specifics

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FOREWORD

The Egyptian economy has proven to be resilient during the past global economic crisis, with real GDP growth reaching 4.7 percent during 2008/2009 and 5.1 percent for the first three quarters of 2009/2010. Egypt's resilience to external shocks could be attributed to macroeconomic reforms undertaken over the past decade, as evident by more diversity of sectoral sources of growth, fiscal reforms that availed the space to introduce timely countercyclical packages, and monetary reforms that increased the ability of the Central Bank to weather external shocks and contain domestic inflationary pressures.

What are the payoffs from macroeconomic reforms? Whether such reforms yield higher long-term growth has long been controversial. The experience of the Great Recession suggests that other important benefits may have been neglected in the controversy over the growth benefits of reform. Specifically, in contrast with previous international recessions, recovery from the Great Recession has been led by emerging and developing economies, many of which have implemented significant reforms over the past two decades. How much of the resilience of these economies can be attributed to these reforms? Drawing on international experiences, Professor Peter Montiel will focus on the desirability of further reforms in Egypt towards achieving its potential capacity and increasing its scope to weather shocks towards achieving better diversification and distribution of growth that balance the economic and social agendas and ensure that the benefits of reforms are sustainable going forward.

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تقديم

أثبت الاقتصاد المصري خلال الأزمة الاقتصادية العالمية الأخيرة قدرته على تحمل الأزمات، إذ بلغ معدل نمو الناتج المحلي الإجمالي الحقيقي ٤,٧% خلال السنة المالية ٢٠٠٩/٢٠٠٨ و٥,١% خلال الثلاثة أرباع الأولى من السنة المالية ٢٠١٠/٢٠٠٩. ويمكن إرجاع هذا الأداء الإيجابي إلى الإصلاحات الاقتصادية الكلية التي اتخذتها مصر خلال العقد الماضي، والتي أسفرت عن العديد من المكاسب ومنها تعدد مصادر النمو، والإصلاحات المالية العامة التي أتاحت المجال لتطبيق سياسات مضادة للاتجاهات الاقتصادية الدورية، والإصلاحات النقدية التي عززت من قدرة البنك المركزي على مواجهة الأزمات الخارجية والحد من الضغوط التضخمية. والسؤال المطروح هو: ما طبيعة المكاسب التي تترتب على الإصلاحات الاقتصادية الكلية؟

ترجع أهمية الإجابة عن هذا السؤال إلى الجدل الدائر حول مساهمة تلك الإصلاحات في زيادة النمو طويل الأجل، وكذلك إلى الدروس المستفادة مما يُطلق عليه حاليا "الركود الكبير"، والتي تشير إلى أن الاقتصادات التي نفذت إصلاحات اقتصادية باتت في وضع أفضل للتصدي للأزمات الاقتصادية. وتحديدا، فإنه خلافا لفترات الركود السابقة جاء التعافي الاقتصادي خلال الركود الأخير مدفوعا بالنشاط الاقتصادي في الاقتصادات الصاعدة والنامية، والتي اتخذ العديد منها إصلاحات كبيرة على مدى العقدين الماضيين. فإلى أي مدى يمكن إرجاع قدرة هذه الاقتصادات على تحمل الأزمات إلى هذه الإصلاحات؟ في معرض الإجابة عن هذا السؤال يستند الدكتور بيتر مونتيل في هذه المحاضرة المتميزة إلى الخبرة الدولية في هذا الصدد بهدف استخلاص مجموعة من المقترحات لتدعيم قدرة الاقتصاد المصري على تحقيق إمكاناته في النمو وقدرته على الصمود أمام الأزمات والوصول إلى مستوى أفضل من التنويع والتوزيع للنمو بما يحقق التوازن بين الأهداف الاقتصادية والاجتماعية ويضمن استدامة مكاسب الإصلاح مستقبلا.

د. ماجدة قنديل

المدير التنفيذي ومدير البحوث

المركز المصري للدراسات الاقتصادية

نوفمبر ٢٠١٠

About the Speaker

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Peter J. Montiel is currently Farleigh S. Dickinson Jr. '41 Professor of Economics at Williams College, USA. Previously, he held several academic and advisory positions at many prominent institutions including the University of Manchester, Oberlin College, Amherst College, Florida International University, Journal of Development Economics, Berkeley Electronics Journals of Economic Development and Growth, Journal of International Economics and Economic Policy , InterAmerican Development Bank, the IMF, the World Bank, the Monetary Authority of Singapore, Central Bank of Ecuador and Central Bank of Venezuela. Peter Montiel has published extensively on macroeconomics, informal financial markets, exchange rate misalignment, fiscal policies and contractionary devaluation in developing countries, among others.

PART I

MACROECONOMIC REFORMS AND RESILIENCE: INTERNATIONAL EXPERIENCE AND EGYPT SPECIFICS

INTRODUCTION

The last two decades have been a period of intensive economic reform in emerging and developing economies, including in Middle Eastern countries such as Egypt. These reforms have proven immensely controversial, partly because they were seen as imposed by outsiders, partly because—as reforms always do—they challenged domestic political equilibria, and partly because the intellectual foundation for these reforms was perceived as dubious. The outsiders demanding reforms tended to be the international financial institutions based in Washington D.C., as well as the US Treasury. The reforms advocated by these institutions have sometimes been summed up as "privatize, liberalize, and stabilize." This market-friendly reform strategy was dubbed by Williamson (1990) the "Washington Consensus," and is referred to by critics as "market fundamentalism," or "neoliberalism." Some critics have argued that the content of the "Consensus" was too narrow,[1] while others have argued that it was too broad.[2]

The debate over reform strategies has taken it for granted that the objective of reforms is to stimulate growth. Consequently, criticism of orthodox reform has often centered on the dual observations that countries that have grown rapidly in the past have not always adopted orthodox reform prescriptions, and countries that have adopted orthodox reform prescriptions

[1] Stiglitz (1998) argued that the strategy embodied in the Consensus needed "broader goals and more instruments." Specifically, he claimed that it neglected government effectiveness, transparency, sound financial regulation, competition policy, and policies for technology transfer.

[2] The "growth diagnostics" strategy of Hausmann, Rodrik, and Velasco (2008), for example, is based on identifying the binding constraints on growth, rather than adopting a multitude of reforms in the hope of kick-starting growth. For applications to Egypt, see Dobranogov and Iqbal (2005) as well as Enders (2007).

have often not grown very rapidly.[3] While such a perspective is not inappropriate in the sense that the objective of reform is ultimately to improve living standards, this may be to take too narrow a view of the potential benefits of reform. There are two reasons for this. First, economic welfare depends not just on the *level* of income that a country achieves, but also on the *stability* of that income. When people are risk-averse and cannot easily stabilize their consumption levels in the face of fluctuations in their incomes, income stability can make an independent contribution to economic welfare. Second, income stability may matter not just for its own sake, but also for its *eventual* effect on economic growth. There is substantial evidence that short-run volatility may have negative effects on long-run growth rates, but little is known about the time frame over which these effects can be expected to materialize. Thus, reforms that enhance income stability may improve economic welfare both directly and indirectly. Yet the role of economic reforms in promoting income stability has received little attention to date.

The Great Recession of 2007-10 provides an excellent opportunity to take stock of the extent to which the macroeconomic reforms of the last two decades have indeed helped to reduce macroeconomic vulnerability among emerging and developing economies, and thus helped those economies become more resilient in the face of shocks, permitting us to draw lessons for countries such as Egypt that are relative latecomers to the reform process. Not only did this recession generate a series of particularly severe shocks for emerging and developing economies, but intriguingly, it has been unique among recent recessions in that international recovery has actually been led by such economies. The key question to be addressed in this paper concerns the extent to which this growth resilience among emerging and developing economies can be attributed to the macroeconomic reforms that these countries implemented prior to the outbreak of the recession in 2007, and if so, what this tells us about desirable features of the future path of reform in Egypt.

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[3] On the former, see Rodrik (2004). On the latter, see Easterly, Loayza, and Montiel (1997), Fernandez-Arias and Montiel (2001), Loayza, Fajnzylber, and Calderon (2004), and Montiel and Serven (2006).

The first four sections provide the requisite background. In the next section I will examine some "stylized facts" about growth volatility in developing countries, to establish the fact that growth volatility has historically been very high in such countries. Section II briefly considers the implications of such volatility for economic welfare as well as for long-term economic growth. Section III reviews what we know about why growth has proven to be so much more volatile in emerging and developing countries than in high-income countries. Its purpose is to investigate whether the sources of high volatility in these countries are likely to be such that they can indeed be addressed through the types of reforms that these economies have recently implemented. Section IV then documents the content of reform in the two decades or so leading up to the Great Recession and considers where Egypt stands in this reform process. This sets the stage for an examination of experience with the Great Recession itself. The effects of the recession on the macroeconomic environment facing emerging and developing economies—in other words, the channels of transmission of the recession to those economies— is the subject of Section V. This is followed by an examination of these countries' macroeconomic policy responses in Section VI. Section VII then examines the post-crisis performance of those economies and links it to the reforms that they previously undertook. The final section draws out implications for resiliency and growth in Egypt.

I. GROWTH VOLATILITY IN DEVELOPING COUNTRIES

Many observers of the international growth experience have noted that growth rates tend to be much more volatile in developing countries than in high-income ones. The classic study is by Easterly, Kremer, and Summers (1993). They noted that growth rates have been highly unstable over time, while country characteristics are highly persistent.[4] Growth persistence was low both over various period lengths, as well as across various country subsamples. Among developing countries, growth volatility was not just due to weather-induced volatility in their relatively large agricultural sectors, because persistence was low for other sectors as

[4] Across decades, they found the correlation of growth rates to be on the order of 0.1-0.3, while that of country characteristics was 0.6-0.9.

well. They found factor accumulation to be more persistent than growth rates, so TFP growth rates tended to be even less persistent than growth rates.

Subsequent work has confirmed these findings. Pritchett (2000), for example, documented higher growth volatility in developing countries using various measures. As one illustration, he found that the R-squared of a simple regression of the log of real GDP per capita on a single trend clustered around 0.9 for OECD countries, but tended to be much lower and more widely distributed for developing countries. He also found that, while the ratio of the standard deviation of growth rates to trend growth rates tended to be about 1 in industrial countries, it has historically been about 4 in developing countries.

These volatility results obviously imply that periods of exceptionally fast growth as well as of exceptionally low growth are common in emerging and developing economies. Consistent with this observation, Rodrik (2004) has argued that the problem in generating sustained growth in low-income countries is not that growth never *starts* there, but instead that high-growth spurts tend to fizzle out after a short time. The question, of course, is why. Rodrik implicates the interaction of external shocks with domestic fragility. He therefore argues that a strategy for sustained growth should focus on removing binding constraints to growth in the short run, in order to get growth started, combined with the adoption of reforms that improve resiliency to external shocks in the long run, so as to sustain growth once it starts. I will come back to this in Section IV.

The other side of the coin is that there must be frequent periods of exceptionally *low* growth in emerging and developing countries. Negative growth rates, resulting in actual drops in output, are an extreme example. Becker and Mauro (2006) have documented the frequency and duration of output drops for emerging and developing economies over the period 1970-2001. They found that the frequency, duration and overall costs of such episodes were indeed negatively correlated with per capita income, and that developing economies were more susceptible to such episodes than were emerging ones. Of interest for the issue considered in

this paper, while emerging economies only experienced an absolute output drop on average every 16 years, these drops proved to be very persistent: the median length of time it took for output to recover its pre-drop level was 6 years.[5] Partly because of such persistence, the cumulative output loss during such episodes was very large: about 40 percent of pre-shock GDP. Although the frequency of such episodes was about the same among developing countries, their consequences were much more dramatic: both the duration as well as the total cost were about twice as large as those for emerging economies.

The key observation is that growth has historically been very volatile among emerging and developing economies: episodes of boom and bust have been quite frequent among such countries. High-growth episodes are not at all uncommon, but they tend to fizzle out. While extreme growth collapses may not be particularly common, when they do happen they tend to be very serious: they persist for extended periods and are associated with substantial income losses. This last observation is especially worth re-emphasizing for our purposes: when growth collapses happen among emerging and developing countries, such countries have historically found it difficult to extricate themselves from such situations, resulting in prolonged periods of stagnation with large income losses. "Lost half-decades" have been the rule, not the exception.

II. Implications of Volatility for Growth and Welfare

From a simple accounting perspective, low persistence (high volatility) of growth reconciles the enormous variation in growth rates with the remarkable stability of relative incomes across countries. Major changes in country income rankings would have required large *persistent* differences in growth rates, favoring those countries that were initially poorer. Yet, as already indicated, such persistence does not arise primarily because frequent growth accelerations in precisely those countries where convergence should drive higher growth rates—i.e., emerging

[5] The finding that absolute drops in output (negative growth rates) are relatively rare among emerging economies is not inconsistent with high growth volatility among such economies, because emerging economies tend to have higher average growth rates than both advanced and developing economies on average.

and developing countries—tend to be offset by severe adverse growth events. High growth volatility thus tends to be associated with lower long-run growth.

There is ample empirical evidence for this relationship. The classic reference is Ramey and Ramey (1995). More recently, Hnatskova and Loayza (2003) confirm this relationship. Consistent with the discussion in the last section, they show that the negative relationship between volatility and growth is mostly due to prolonged large recessions, rather than to normal cyclical fluctuations. Fatas (2000) shows not only that “business cycles cast long shadows” —i.e., that severe recessions have permanent adverse effects on growth rates, but also that the negative relationship between volatility and growth is larger for poor countries and for countries—like Egypt—with a lower degree of financial development. Finally, Cerra and Saxena (2005) provide a different type of evidence in the form of a case study—specifically, an analysis of the long run effects of the Asian crisis on the income levels (and therefore the long-run growth rates) of the affected countries. Consistent with the evidence cited above, they found evidence of permanent losses in the levels of output of the affected countries.

The welfare implications of these findings are quite important. As Wang and Wen (2008) show, the well-known Lucas (1987) finding that further stabilizing the US economy would yield a relatively small welfare gain is erroneous—and the true welfare gain is several orders of magnitude larger—when policies to reduce fluctuations can yield permanently higher growth rates. This result is only magnified when, as in the case of emerging and developing countries, the initial level of volatility is higher and the adverse link between volatility and growth is stronger.

III. Sources of Volatility

Explanations for macroeconomic volatility tend to be of two types. Researchers who have examined cross-country differences in volatility have tended to emphasize structural factors, such as country size, political system (democracy versus autocracy), the extent of income and wealth inequality, the level of institutional development (as measured along various dimensions, such as limits on the executive, mechanisms for conflict resolution, and financial development), the degree of diversification in production, and the economy's degree of real and financial openness. For our purposes, the roles of such variables can be interpreted as determining a country's susceptibility to shocks as well as its fragility in response to such shocks.

A different strand of literature, typically focused on individual-country experiences (e.g., case studies), has emphasized the roles of domestic macroeconomic policy regimes, especially concerning fiscal policy (degree of procyclicality), monetary policy (central bank independence and the monetary policy regime) and exchange rate policies (e.g., fixed versus floating, the performance of "hard" exchange rate pegs).

Of course, these perspectives are not mutually exclusive. A common-sense interpretation of the sources of volatility would view observed volatility as the outcome of a complex interaction among the frequency and severity of shocks and the fragility of the domestic economy in the face of such shocks in the absence of a policy response, on the one hand, and the effectiveness of domestic policy responses, on the other. Indeed, it is possible to read much of the evidence on the determinants of volatility in exactly this way.

Easterly, Islam, and Stiglitz (2000), for example, found that much of growth volatility at 10-year horizons could be explained by low-persistence shocks and the policy responses to them. They found that shock variables (including the inflow of external transfers/GDP) added substantial explanatory power to simple growth regressions during both the 1970s and 1980s. Their shock variables displayed low persistence across decades, and there was evidence that

policy responses to these shocks played independent roles in explaining growth performance. For example, shock variables helped to explain the black market premium—indicative of policy responses based on quantitative restrictions on trade and capital flows—which has a robust negative effect on growth.

Another way to get a handle on why volatility exists is to examine what causes growth accelerations and decelerations. There has been substantial work on this issue. In a recent paper, Hausmann, Pritchett, and Rodrik (2005) found that growth accelerations tend to be quite frequent in the international experience.[6] However, accelerations proved to be highly unpredictable. To try to explain them, they used probit regressions with explanatory variables consisting of the external context (a dummy for favorable TOT changes), domestic economic policies (in the form of the Sachs-Warner measure of economic reform and a measure of financial liberalization), political circumstances (a dummy for regime change, and separate dummies for positive and negative regime changes), and year effects. They found that the TOT dummy, change in regime, and economic reform all had positive coefficients (i.e., they were all associated with growth accelerations), but only the first two were statistically significant, with regime change in the direction of *autocracy* having a more powerful effect than in the direction of democracy. Financial liberalization had a strong positive impact. Yet, this specification did not accurately predict many growth accelerations. In particular, most proved to be unrelated to political change, few were preceded by economic reforms, and few reforms were followed by growth accelerations. More importantly, the determinants of accelerations depended on whether the acceleration was sustained or not. Positive TOT shocks and financial liberalization helped in predicting only unsustained accelerations, while positive political change and reform affected only sustained accelerations. They concluded that sustained and unsustained accelerations are triggered by different conditions.

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[6] They define a growth acceleration as increases in per capita growth of 2 percent or more that were sustained for at least 8 years, with a post-acceleration growth rate of at least 3 percent per year and with post-acceleration output that exceeded the pre-episode income level.

Another perspective comes from the work by Becker and Mauro (2006) on output drops. They found that external shocks played an important role for both emerging and developing economies, but that financial and macroeconomic shocks, especially "sudden stops," were more important for emerging economies, while terms of trade shocks were most costly for developing countries.

The upshot from these observations is that sustained growth accelerations tend to be associated with financial and macroeconomic reforms, and that episodes of negative growth rates are associated with financial and macroeconomic shocks. The question, of course, is what accounts for chronic or severe episodes of macroeconomic imbalance or instability?

In principle, such episodes could arise in two ways: they could represent shocks *created* by inappropriate domestic financial and macroeconomic policies, or they could emerge from poor macroeconomic responses to exogenous shocks. There is evidence that both have been important in emerging and developing countries, and that the policies implicated have run the full macroeconomic gamut of fiscal, monetary, exchange rate, and financial-sector policies.

Fiscal Insolvency and Procyclicality

An important source of macroeconomic shocks in such countries has been actual or prospective fiscal insolvency, in the form of unsustainable debt levels. Debt defaults have been quite common among emerging and developing economies, and Chuhan and Sturzenegger (2004) have estimated that defaults have been associated with growth shortfalls of about 2 percent per year on average over a two-year horizon and 0.8 percent on average over a six-year horizon. Moreover, high levels of debt and prospective insolvency have been associated with procyclical fiscal policies, as revenue shortfalls during recessions have caused creditors to refuse to finance fiscal deficits in heavily-indebted countries, forcing governments in such

countries to adopt measures such as reduced spending or increased taxation that have tended to aggravate recessions (see Gavin and Perotti 1997).[7]

Fiscal dominance and absence of monetary autonomy

Shortcomings in monetary policy have played a similar role. Just as have debt defaults, episodes of sustained high inflation and brief hyperinflation have historically been quite common among emerging and developing economies, resulting in growth volatility associated both with the period of high inflation itself as well as with its eventual stabilization. These episodes have often been associated with the monetization of fiscal deficits, as the result of *de jure* or *de facto* fiscal dominance. But a history of high inflation has also served to paralyze monetary policy as a stabilization instrument, because the fear that monetary expansion would trigger self-fulfilling inflationary expectations has often prevented central banks in emerging and developing economies from lowering interest rates in response to recessions. Indeed, a perceived need to convince markets that monetary financing would not be forthcoming for fiscal deficits caused by recession has often caused monetary *tightening*—and thus procyclicality—in countries with an inflationary history.

Exchange rate regimes

The absence of monetary credibility has caused many emerging and developing economies to rely on the exchange rate as a nominal anchor. Consequently, fixed exchange rate regimes have been much more common among emerging and developing economies than among high-income countries (Reinhart and Rogoff 2002). Moreover, even those countries that have

[7] Gavin and Perotti and many others have documented fiscal procyclicality in Latin America, but the problem applies much more widely. The International Monetary Fund, for example, using pairwise correlations between spending growth and GDP growth, as well as measures of fiscal amplitude (the difference between spending growth when GDP growth is above its median value and when it is below) found that fiscal policy was procyclical in sub-Saharan Africa during 1980-2008 (IMF 2009c). This fiscal procyclicality was more pronounced for countries with high debt ratios and weaker institutions, and was more pronounced for capital than for current spending.

floated *de jure* have often exhibited "fear of floating," so their exchange rates have been rigid *de facto* (Calvo and Reinhart 2002). This has had two implications for growth volatility. First, "soft" exchange rate pegs have proven vulnerable to currency crises, with associated negative effects on growth rates. Second, the unwillingness to countenance exchange rate flexibility has prevented the use of the exchange rate as a tool of stabilization policy. Indeed, defending the exchange rate in the face of capital outflows has been an important factor in rendering monetary policy procyclical, as in immediate post-crisis Asia.

Financial sector policy

Finally, inappropriate liberalization of the domestic financial sector—liberalization without the appropriate regulatory and supervisory safeguards in place—has also aggravated boom and bust cycles in emerging and developing economies. Poor regulation and supervision of a liberalized financial sector has in many cases (e.g., Chile 1978-81, Mexico 1989-93, East and Southeast Asia 1994-96) facilitated the emergence of currency mismatches and of credit booms and asset price bubbles that have been associated with unsustainably high growth rates, and the resulting vulnerability of banks' balance sheets has not only tended to magnify the effects of exogenous shocks, by coupling them with a banking crisis, but has also helped to paralyze monetary policy for fear of adverse effects on banks' balance sheets.

IV. What Has Been Reformed

Pritchett (2000) argues that variables in growth regressions tend to have significant effects because they are symptoms of one of three syndromes that are harmful for growth:

a. State-led development with a non-developmental state.

b. Excessive inward orientation.

c. Chronic or severe episodes of macroeconomic imbalance or instability.

These findings provide the rationale for the orthodox prescription of "privatize, liberalize, stabilize" embodied in the Washington Consensus. But it is worth noting that reforms of these

types need not necessarily be stabilizing. In particular, to the extent that the "liberalize" component involves enhanced real and financial openness, the effects on macroeconomic stability are ambiguous, since reforms of this type increase the economy's exposure to external shocks while simultaneously altering its response to domestic shocks in ways that may be either stabilizing or destabilizing. Moreover, "second generation" reforms, especially those directed at the domestic financial sector, may also prove to be either stabilizing or destabilizing, depending on how they are implemented.

One would think that the "stabilize" component of the Consensus would be stabilizing—by definition! But that is not necessarily the case. Reforms to macroeconomic institutions and policy regimes may promote income stability in two ways. First, a reformed institutional and policy environment may prevent domestic macroeconomic policies from themselves becoming a source of instability. Second, a reformed environment may reduce macroeconomic *vulnerability*, in the sense that it makes an economy less susceptible to large fluctuations triggered by non-policy exogenous shocks. It can do so by reducing fragility—i.e., by weakening the mechanisms that tend to amplify the effects of exogenous shocks—or by increasing the flexibility and effectiveness of stabilization policies that can be deployed to counter the effects of such shocks. However, once again the effects on volatility depend on how macroeconomic reforms are implemented. The key issue here is a tradeoff between credibility and flexibility. Reforms that seek to ensure that domestic macroeconomic policies do not themselves become a source of shocks—and thus emphasize the credibility of the domestic macroeconomic policy framework—may create rigidities that simultaneously make the economy more vulnerable to exogenous shocks and less capable of compensating for those shocks by undertaking stabilizing policy responses. Examples are dollarization and balanced-budget fiscal rules.

The key point, then, is that what matters for stability is not reform *per se*, but rather *what* has been reformed, and *how*.

In this respect, the news is relatively good for emerging and developing economies: while the reforms of the 1990s and 2000s may have left these countries more exposed to external shocks, the content of those reforms would lead one to expect—at least in principle—much more resiliency in the face of such shocks. There are several reasons to reach this conclusion. To explore these, in the rest of this section I will examine the macroeconomic reforms that have been implemented by emerging and developing economies in general, and in Egypt in particular, over the last two decades, focusing on macroeconomic reforms in the areas of trade, the capital account, domestic financial systems, exchange rate regimes, monetary policy and fiscal policy.

Trade Reforms

Trade liberalization (the replacement of quantitative restrictions (QRs) with tariffs, movements to uniform tariffs, and tariff reductions), has been ongoing among emerging and developing economies over the past two decades. This has had the effect of making these countries increasingly integrated with the world economy. Asian countries, for example, did not close themselves off from the international economy after the Asian crisis. Instead, their real and financial integration with the rest of the world actually *increased* during the subsequent decade. During the decade of the 2000s, the emerging economies in this region remained highly open to trade, and they continued to be heavily dependent on exports to the OECD countries, primarily of manufactured goods, and especially of electronics, which accounted for about a third of the region's exports during this time. Both Korea and Singapore signed bilateral free trade agreements with the United States during that time. Intraregional trade within Asia also increased strongly over the decade of the 2000s, partly as the result of the creation of the ASEAN Free Trade Area. Elsewhere, the lowering of trade barriers in Latin America and the Caribbean included the signing of both regional and bilateral free trade agreements with the United States, including NAFTA, CAFTA-DR, and bilateral agreements with Chile and Peru, as well as pending agreements with Colombia and Panama. Similarly, all

of the countries in emerging Europe—including Turkey—have actively pursued real and financial integration with industrial Europe over the past two decades.

Increased trade was accompanied by increased geographic diversification of trade for most emerging and developing countries during the boom years of 2003-07. Latin American exports rely less on the United States and more on Asia, for example, and Asia has become a larger consumer of African primary commodities in recent years than the traditional partners of Europe and the United States, with about a quarter of African exports going to Asia.

The IMF finds, however, that Middle East and North Africa, Afghanistan, and Pakistan (MENAP) oil importing countries, the group within which Egypt is found, remain relatively closed, with goods exports at 15 percent of GDP, compared with 25 percent for emerging and developing countries as a whole. This is so despite the MENAP countries' proximity to large markets (IMF 2010a). It estimates that bringing commercial openness in this region to the average of Emerging Asia would increase growth by nearly a full percentage point. And Egypt has been relatively restrictive even by the standards of this group. The country's average tariff rate has tended to be higher than that of the group as a whole. However, Egypt has more recently simplified and reduced its tariffs. The number of tariff bands was cut to 6 from 27, the average tariff rate from 14.6 percent to 9.1 percent, fees and surcharges were removed from some imports to comply with WTO regulations, and some customs procedures were simplified. However, Egypt continues to rank 115th out of 139 countries in the World Economic Forum's Global Competitiveness Report.

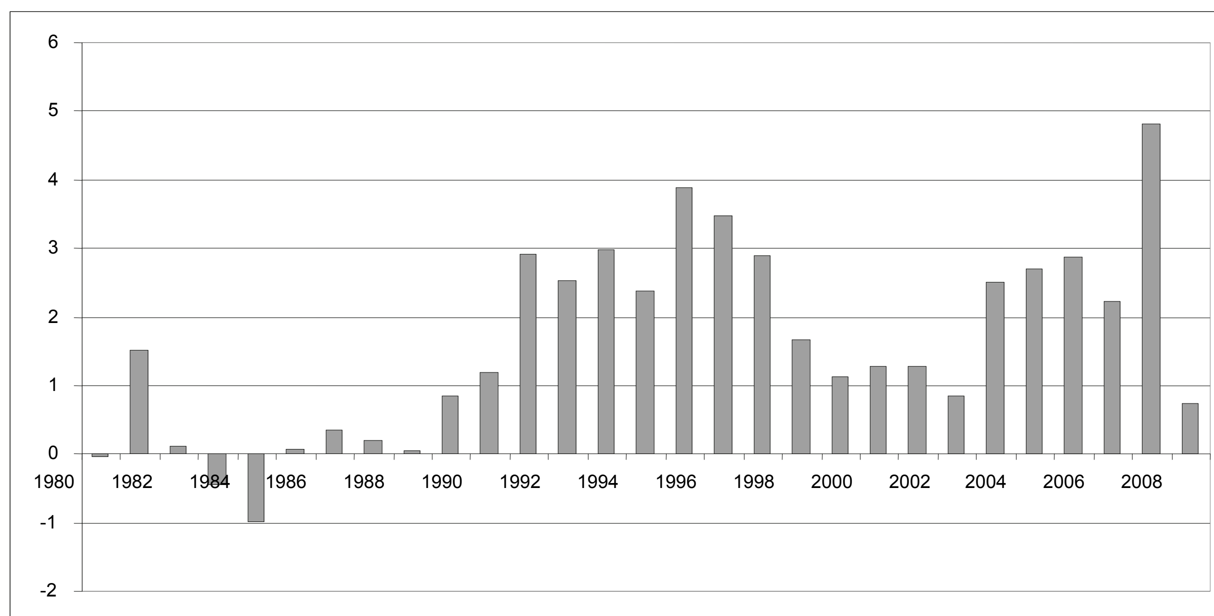
Financial Openness

As a result of the capital account liberalization that they undertook after 2000, emerging and developing economies also became more integrated financially with the rest of the world. One consequence of this increased financial integration was that these countries began to receive large gross private capital inflows after 2003, as shown in Figure 1. Moreover, larger inflows

have been accompanied by larger gross outflows, largely as the result of capital account liberalization.

Evidence of increased financial integration over the past two decades abounds for emerging and developing countries in all regions of the world. Institutional investors (mutual and pension funds), for example, played a major role in the nineties. As an indication of their growing impact during this period, in 1986 there were 19 emerging-market country funds and nine regional or global emerging market funds. By 1995, however, there were 500 country funds and nearly 800 global or regional emerging market funds. The combined assets of all emerging market funds rose from $1.9 billion in 1986 to $132 billion in the middle of 1996.

Figure 1. Total Capital Inflows to Emerging and Developing Economies, 1980-2008
(as a percent of GDP)

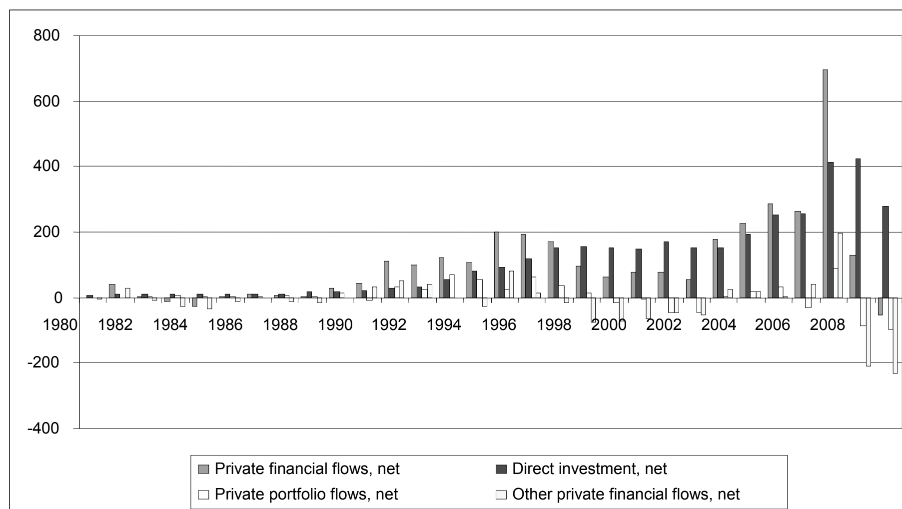


Source: IMF, *World Economic Outlook Database,* April 2010.

Relative to the early 1990s capital-inflow episode, the share of FDI in capital inflows during this more recent episode was much larger, while that of portfolio inflows was much smaller (Figure 2).

Even so, non-FDI flows became very large. Firms in Asia significantly increased their issuance of foreign exchange-denominated bonds in international financial markets after 2003, and private external debt almost doubled in that region from 1997 to 2005 (IMF 2006a). US holdings of Asian securities increased from 4.6 percent of the GDP of those economies in 1994 to 13.1 percent in mid-2006, while emerging Asian holdings of US securities increased from 10 percent of the Asian countries' GDP to 28 percent during the same period. According to the IMF (2006b), Asian-focused hedge funds more than quintupled in number (to approximately 1150) from 2002 to 2006, and the correlations in stock market returns between Asian emerging economies and the United States increased sharply from 1990-96 to 2000-07. Over the course of the decade of the 2000s, firms in Latin America also gained increased access to international capital markets. According to the IMF (2008c), by 2007 corporations in Latin America derived some 25 percent of their net new financing from foreign sources.

Figure 2. Composition of Net Private Capital Inflows to Emerging and Developing Economies, 1980-2008 (in billion $)



Source: Montiel (2011).

As one would expect, large inflows were associated with lower sovereign risk premia for emerging and developing economies during this period. Such premia were especially low for countries such as China, Malaysia, and Thailand, and they declined after early 2004 for

Indonesia and the Philippines as well. In Latin America sovereign spreads had historically tended to move with those of high yield US corporate bonds, which are relatively volatile. But before the recent crisis, countries such as Brazil, Colombia, Mexico, and Peru had seen their spreads begin to move more closely with those of investment grade corporations, which tend to be much more stable. Even in sub-Saharan Africa, which has in the past had very limited access to private financial markets, international rating agencies had begun to rate sovereigns[8] and, although these ratings remain far below investment grade, some countries in the region (Botswana, Ghana, Kenya, Nigeria, Uganda, and Zambia) began to receive private portfolio flows in small amounts, despite the fact that in addition to trade restrictions, *de jure* restrictions on capital flows remain extensive in the region.

Egypt had also maintained extensive capital account restrictions before 1994. These restrictions began to be progressively relaxed after that time, and over the course of the next decade Egypt's capital account became fully liberalized *de jure*. However, the evidence suggests that the country remains only imperfectly integrated with international financial markets *de facto* (Al-Nashar 2010).

As mentioned above, increased openness and the resulting increased integration with world markets has made emerging and developing countries more vulnerable to external shocks, both financial and real. Osterholm and Zettelmeyer (2007), for example, estimate that external factors account for more than half of the medium-term variance of Latin American growth, with external financial conditions accounting for about 35 percent, foreign growth for 10-15 percent, and commodity price fluctuations for 5-6 percent.

Domestic Financial Reform

A key source of macroeconomic vulnerability is the health of the financial system. As a result of financial reforms undertaken over the past decade and a half, including improvements in financial regulation and supervision, enhanced competition in the financial system, and in

[8] 14 countries were rated by Standard and Poor's and 12 by Fitch by 2006.

some cases the recent resolution of banking crises, the financial systems of many emerging and developing economies are healthier today than they have been in the past. The entry of foreign banks has also significantly contributed to the health of domestic financial systems, especially in Latin America and sub-Saharan Africa.

Substantial reforms of domestic banking systems were undertaken in several Asian countries after the 1997-98 crisis, which had been partially caused by inappropriate financial liberalization during the late 1980s. Banking systems were recapitalized, privatized, and opened to foreign investment, directed lending was sharply curtailed, bank supervision was improved, and non-performing loan (NPL) ratios were drastically reduced. In addition, the Asian Bond Market Initiative was launched as a joint effort by countries in the region to promote the development of local and regional bond markets by improving market infrastructure and the regulatory environment. The legal framework for corporate governance was improved by strengthening accounting standards, limiting cross-holdings, and increasing shareholder rights. In 1997 many Asian firms were highly leveraged, with large unhedged foreign-currency exposure, large short-term debt, and low profitability. After the crisis, firms in emerging Asia decreased their vulnerability to financial shocks by deleveraging, strongly increasing their profitability, and holding more liquid assets. Partly due to these improvements in corporate governance and corporate balance sheets, but also to improvements in market infrastructure, stock markets in Asia grew rapidly and increased in both liquidity and breadth in the post-crisis period. Portfolio equity inflows to these markets also grew rapidly, and foreign participation in Asian equity markets was about a third of the total at the end of 2005.

As in Asia, financial reform was driven in Latin America by the experience of earlier crises following uncontrolled financial liberalization (especially in Chile in 1981-82 and Mexico in 1994). Reform continued during the 2003-07 boom years before the Great Recession. Credit market infrastructure improved in countries such as Brazil and Mexico, with strengthened credit information systems and loan recovery frameworks. Indicators of banking

system health improved during this period.[9] Financial dollarization, an important phenomenon in the region owing to its high-inflation past, was on a decreasing trend on both sides of banks' balance sheets over time. Though the banking system is dominant in financial intermediation in the region, countries such as Chile, Colombia, Brazil, Mexico, Panama, Peru, and Trinidad and Tobago have well-established domestic stock and bond markets. These markets have become larger and more liquid during recent years, and domestic firms have been raising an increasing amount of capital in those markets.

The situation is more mixed in sub-Saharan Africa. Banks are even more dominant as financial intermediaries in that region than in Asia or Latin America. Nineteen countries experienced large banking crises in the late 1980s and early 1990s, and banking systems have been reformed in many of those countries over the two decades since. Though banks tend to be adequately capitalized, they remain hampered by weak legal and regulatory frameworks. Nonetheless, because the banking systems in these countries tend to be highly concentrated banks have high margins and are profitable. However, concentration ratios have been declining, and foreign ownership has been rising. The majority of banking assets are foreign owned in about 20 sub-Saharan African countries.

The state of the banking systems in the Middle East and Central Asia was mixed before the Great Recession. In the Middle East they were basically sound, in part because of conservative lending policies. Prudential indicators were strong, and capital adequacy ratios high. However, the banking sectors in the formerly centrally-planned economies of the Caucasus and Central Asia remained weak and fragmented, with the government playing a very large role and state banks remaining inefficient.

[9] The IMF (2007b) cites several indicators of such improvement, including high levels of bank profitability and capitalization, reduced overhead costs in banking, reduced ratios of non-performing loans, and reduced foreign currency exposure. According to the IMF (2009d), banks in the region had median capital-asset ratios of about 15 percent, compared to a mandated ratio under the international Basel II guidelines of 8 percent.

Finally, the situation was rather different in Emerging Europe. Banking sectors were liberalized there after transition in the early 1990s. However, the institutional infrastructure for the financial sector remains deficient in many countries, and in particular, the local subsidiaries of foreign banks have not always been well capitalized (IMF 2007a). Many banks in the region relied heavily on nondeposit funding, especially from parent banks in Western Europe, before the outbreak of the Great Recession. Moreover, while their domestic loans were generally denominated in foreign currency, they tended to be extended to unhedged domestic borrowers, supporting activities in the nontraded goods sector such as real estate investments.

In the specific case of Egypt, some reforms have been introduced, but the financial system continues to be inefficient. Much of the banking sector remains public, and the evidence supports the view that governance is poor. The return on assets, for example, was lower than that of all other MENAP oil importers in 2009 (IMF 2010b), and the system experienced a build-up in NPLs to over 18 percent of banking sector assets by the end of 2006. The Central Bank of Egypt (CBE) launched a first phase of reforms in 2004 to strengthen supervision, restructure and consolidate banks, and clean up NPLs, with the intention of reducing financial sector vulnerabilities. However, NPLs were still at 13.4 percent in 2009.

Exchange Rate Management

The key development in the area of exchange rate management is that many emerging and developing economies have transitioned to more flexible exchange rate arrangements, reducing vulnerability to the disruptive discrete exchange rate depreciations that are associated with currency crises, and providing an automatic stabilizing effect in response to external financial shocks. Moreover, despite still being pronounced in some countries, financial

dollarization has declined, reducing the impact of a factor that has weakened or even reversed the otherwise expansionary effect of exchange rate depreciation in the past.[10]

The Asian crisis caused several countries in East and Southeast Asia to move to more flexible exchange rate arrangements, and exchange rate regimes in Asia were on the whole (with the important exceptions of China and Malaysia) substantially more flexible in the decade of the 2000s than they had been before the Asian crisis. Even China, which had not wavered from a fixed exchange rate policy, announced a move toward a more flexible exchange rate arrangement in 2005, revaluing its currency and announcing that its value would henceforth be set against a basket of currencies, rather than against the US dollar). On the same day, Malaysia abandoned the fixed dollar peg that it had implemented in response to the crisis in September of 1998 in favor of a tightly managed float. Thus, most exchange rate regimes in the region had effectively become managed floats by 2005. However, these regimes remained heavily managed, as central banks engaged in heavy sterilized intervention to avoid real exchange rate appreciation.[11] As a result, by 2005 real effective exchange rates among emerging market economies in Asia remained more depreciated than prior to the crisis, and heavy central bank intervention in foreign exchange markets resulted in Asian economies building up truly massive stocks of foreign exchange reserves by 2007.

As in Asia, exchange rate regimes also evolved in Latin America during this period. Argentina and Brazil, which had pegs in 1996-97, were operating managed floats by 2005, and Chile, Mexico, and Peru all were allowing more exchange rate variability in their managed floats by 2005 than they had in the mid-90s. Importantly, firms in the region appear to have

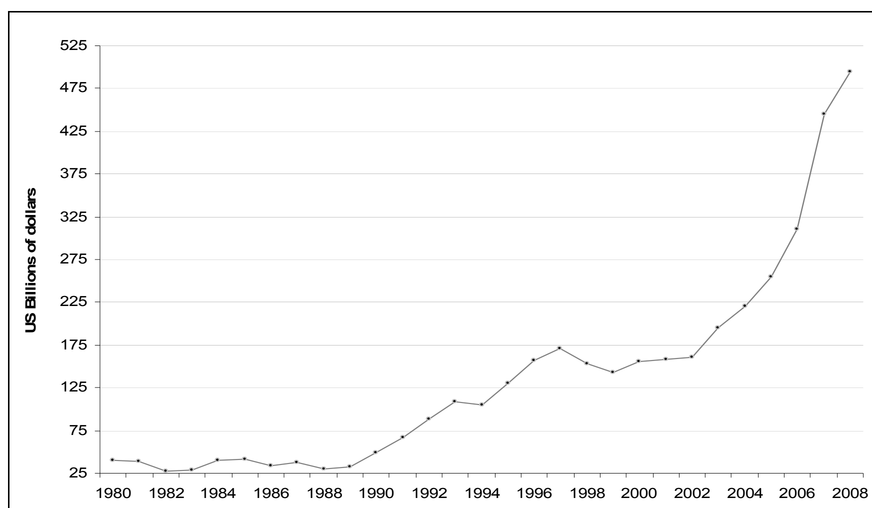
[10] To the extent that currency mismatches are induced by fixed exchange rate regimes combined with lax financial regulation, improved regulation and more flexible exchange rate management could be behind the reduction in the extent of such mismatches in Latin America.

[11] For the evolution of exchange rate regimes in post-crisis Asia, see Hernandez and Montiel (2003).

substantially reduced currency mismatches in their balance sheets, making them less vulnerable to currency risk.[12]

Also as in Asia, many countries in the region responded to large inflows of foreign resources during 2003-07 by intervening heavily in foreign exchange markets to resist real exchange rate appreciation, and consequently accumulated very large stocks of foreign exchange reserves, as shown in Figure 3.

Figure 3. Aggregate International Reserves in LAC, 1980-2008



Source: World Economic Outlook, April 2009. Stock of reserves at year-end, in billion US dollars.

Although the move to floating rates was less pronounced outside of emerging Asia and Latin America, reserve accumulation was a common feature. For example, about a third of the countries in the Middle East and Central Asia maintained fixed exchange rates against the US dollar. But both those countries as well as those with more flexible currencies, effectively found themselves managing their currencies so as to avoid real appreciation. Consequently, both countries with fixed regimes as well as those with managed floats accumulated large stocks of foreign exchange reserves prior to 2007. While this was especially true of the oil

[12] A survey of 1200 firms in Argentina, Brazil, Chile, Colombia, Mexico and Peru by the IMF (2008d) found that the share of foreign currency liabilities on these firms' balance sheets had been reduced from 37 percent in 1998 to 17 percent in 2007.

exporters, it was true for the other country groups as well. Many countries in sub-Saharan Africa similarly continued to maintain fixed exchange rates. However, as elsewhere, nominal exchange rate stability and reserve accumulation were common even in countries with managed floats, such as South Africa. The median value of foreign exchange reserves in the region was 13 percent of GDP at the outset of the crisis, compared to 5 percent in the 1970s and less in the 1980s.

Emerging Europe was once again somewhat different. In seeking to integrate with Western Europe, many of the countries in emerging Europe maintained fixed exchange rates. While these countries also received large capital inflows in the pre-crisis period, those inflows were just enough to finance large current account deficits. Therefore, unlike emerging and developing economies in other regions, those in emerging Europe entered the Great Recession with low ratios of reserves to short-term external debt. For half the countries in the region this ratio was well below 100 percent, and for another quarter it was close to or somewhat above 100 percent. Only in the Baltics and Belarus was this ratio well above 100 percent (IMF 2008b).

Egypt participated in this general movement toward more flexible exchange rates. The Egyptian pound was floated in January 2003, and it depreciated by 35 percent over 2003, even though an *ad hoc* system of administrative guidance was imposed not long after the float (government imports were frozen, exporters were required to sell 75 percent of their foreign currency proceeds to domestic banks, and foreign investors' remittances of profits and dividends were made subject to delays), such that a parallel premium remained for the next 18 months or so. However, these restrictions were removed and a foreign exchange interbank market was established in 2004. The country officially maintains a managed float.

Monetary Policy

In the area of monetary policy, the key developments internationally are that central banks have been strengthened as macroeconomic institutions in many emerging and developing

economies. Not only have they been accorded legal independence, but they have taken responsibility for maintaining low and stable inflation rates—often by adopting formal inflation targeting—and to a significant extent they have achieved that goal in recent years, enhancing their credibility.

Many central banks in emerging Asia moved to inflation targeting frameworks when they adopted floating exchange rates after the Asian crisis. Policy rates in those countries have been sensitive to the behavior of inflation, increasing when inflation has accelerated and decreasing when it has slowed.[13] In Latin America, formal inflation targeting was implemented in Brazil, Chile, Colombia, Mexico and Peru. Average inflation rates fell to about 3.5 percent in these countries, and the gap between targeted and actual inflation closed from 2.5 percent to about 0.5 percent (IMF 2006c). Costa Rica, Uruguay and Paraguay also moved toward inflation targeting during this period.[14] Less has happened in this area outside of emerging Asia and Latin America. In sub-Saharan Africa, for example, only three countries (South Africa, Ghana and Mauritius) maintain an inflation targeting regime. Other countries that do not target the exchange rate use some type of monetary anchor.

Again, Egypt has participated in these reforms belatedly and in a limited way. A domestic-currency interbank market was created in 2001, and a new Banking Law passed in fiscal year 2003/04 enhanced the CBE's independence. The CBE subsequently established a separate monetary policy unit and introduced new open market operations, including deposit windows. A corridor for overnight facilities was established as the bank's main policy instrument in 2005. Inflation increased and became more variable after the exchange rate was

[13] An indication that monetary policy credibility has become well established in Asia is that inflation expectations increased much less than the increase in headline inflation when higher world food and energy prices drove headline inflation higher in 2007-08.

[14] As in Asia, there is evidence that inflation targeting has made inflation expectations in these countries more firmly anchored, in the sense that these changes in headline inflation had very small effects on expected future inflation (see IMF 2008b). Aside from this exogenous external shock late in the decade, inflation remained subdued in most countries of the region during the 2003-07 boom.

floated, and Egypt remains among the countries with the highest sustained inflation rate among the MENAP oil importers. The CBE announced its intention to move toward an inflation targeting regime in the future.

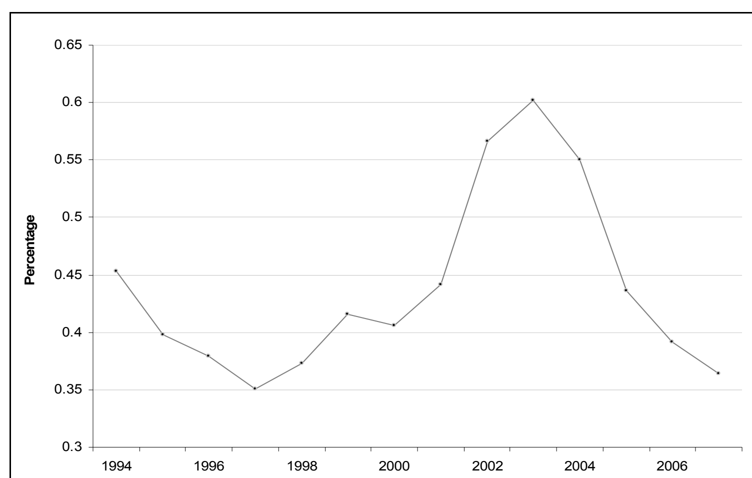
Fiscal Policy

Reforms in the fiscal area have encompassed both fiscal institutions and fiscal policy regimes. The reform of fiscal institutions has typically taken the form of the enactment of fiscal responsibility laws of various types. In some cases reforms in expenditure processes, improvements in tax administration, and reforms of the tax structure have enhanced the flexibility of fiscal systems and strengthened the effects of automatic fiscal stabilizers. But the most important changes in fiscal policy regimes have involved the demonstration in many countries of both the political will as well as the economic ability to make significant fiscal adjustments—especially to exercise fiscal restraint during good times. This has been an important break from the procyclical fiscal behavior of the past. These reforms and changes in fiscal policy regimes have enhanced fiscal credibility, as evidenced in many cases by reductions in sovereign risk premia. One important consequence of these changes in fiscal performance is that public debt stocks as a proportion of GDP have declined in many emerging and developing countries over the past several years.

In Latin America, fiscal responsibility laws were in place in Argentina, Brazil, Chile, Colombia, Ecuador, Panama, Peru, and Venezuela by 2007 (Corbacho and Schwartz 2007). For the region as a whole, the primary fiscal surplus averaged over 3 percent of GDP on a GDP-weighted average basis in Latin America and the Caribbean during the boom years of 2003-07. While public sector spending indeed increased during this period in many countries, the increase in spending proved to be restrained relative to previous boom times. Overall, the IMF (2007b) estimated that most countries in the region (with the exception of Venezuela) were running cyclically-adjusted primary surpluses in 2007. One consequence was that public sector debt-GDP ratios fell from a regional average of 77 percent of GDP in 2002 to 50

percent in 2007 (Figure 4). At the same time, governments in the region made a conscious effort to improve the structure of public debt, in the sense that they replaced a large share of their foreign-currency debt with domestic-currency debt, and several countries (Colombia, Mexico, Peru, and Brazil) began to be able to issue long-maturity domestic currency debt, a sign of confidence in long-run price stability.

Figure 4. Aggregate Public Sector Debt to GDP in LAC



Source: Latin Macro Watch, IDB 2009.

Note: Estimation based on data available for countries representing more than 90 percent of regional GDP.

In emerging Asia, partly as a legacy of the costs of financial restructuring and fiscal stimulus after the Asian crisis, the ratio of public debt to GDP for the region increased from 26 to 36 percent from 1996 to 1999. By 2008, government debt still stood at about 33 percent of GDP. While higher than its pre-crisis value, this ratio remains relatively low by international standards, especially for a fast-growing region. In the oil-exporting countries of the Middle East and Central Asia, the effects of the boom were dampened by fiscal policies. Though most oil-exporting countries have no formal fiscal rules, during the pre-crisis period they tended to base their budgets on conservative oil price projections and to save excess oil receipts in stabilization funds. Consequently, except for Kazakhstan, these countries tended to save most of the additional revenues associated with higher oil prices. While higher oil prices resulted in

rapid growth, therefore, it did so in the context of large current account surpluses in these countries. While the oil-exporting countries tended to have positive (and in some cases very large) public sector assets, the other countries in the region had relatively large stocks of government debt at the beginning of the decade of the 2000s. Debt to GDP ratios were in excess of 70 percent of GDP among the emerging market economies and averaged in the neighborhood of 80 percent of GDP in the low-income countries. Although fiscal policies were less restrained in these countries than in the oil-exporting countries, deficits were sufficiently moderate that ratios of public sector debt to GDP declined over time in the majority of these countries. Debt to GDP ratios remained high, however (in excess of 60 percent) in Egypt, Jordan, Lebanon, and Mauritania.

Countries in sub-Saharan Africa (except for some oil exporters) have tended to sustain overall fiscal deficits in the vicinity of 3-4 percent of GDP, about a third of which are financed by external grants, and public sector debt to GDP ratios have traditionally been very high. However, in the pre-crisis period, oil exporters, like those of the Middle East, reacted to high oil prices with sound fiscal policies, saving most of the increased revenues. This experience was not limited to the oil exporter, however. While fiscal balances in sub-Saharan Africa as a whole had been strongly negative at the outbreak of previous crises in 1975, 1982, and 1991, they were slightly positive on average for the region as a whole when this crisis began. Overall, 72 percent of all sub-Saharan African countries had surpluses in their primary fiscal balances during 2006-08, compared to 28 percent in 1991-95. In the region as a whole, public sector debt to GDP ratios were substantially reduced from 2000 to 2007 as the result of debt relief under the HIPC initiative, rapid growth, and conservative fiscal policies. The median debt to GDP ratio in 2007 was 40 percent , and 71 percent of all sub-Saharan African countries had ratios of public sector debt to GDP of less than 60 percent, compared to 33 percent in 1991. As a result of their conservative fiscal policies, oil exporters and South Africa accumulated substantial reserves, and other countries kept reserves roughly stable, with FDI

flows and concessional financing sufficient to offset current account deficits that tend to run at 3-4 percent of GDP on average.

Public sector balance sheets remained relatively strong in emerging Europe, in the sense that public sector debt/GDP ratios tended to be lower than those in other emerging-economy regions.

Egypt has historically had high levels of public debt by the standards of the region (only Jordan and Mauritania had higher debt to GDP ratios in 2009 among MENAP oil importers). The ratio of public debt to GDP declined through the 1990s, but began to rise after FY 2000, and was at 76 percent of GDP at the end of 2009. Egypt's government is largely funded with domestic debt, some 70 percent of which is held by domestic financial institutions, suggesting limited private sector intermediation. External debt is roughly a third of total debt, and is largely concessional, owed mainly to official sources, and tilted to medium and long term. There was no major debt reduction in Egypt comparable to, say, the LAC-7 countries during the pre-crisis period, and no major reform of fiscal institutions, though a tax reform bill was enacted.

In short, emerging and developing economies became increasingly integrated with the world economy during the past two decades, along both real and financial dimensions. While this has increased their exposure to external shocks, a better composition of external financing, stronger domestic financial systems with improved corporate governance, better monetary policy frameworks, strong fiscal positions, more flexible exchange rate regimes, and large reserve accumulation have all reduced vulnerability and placed these economies in a more favorable position to respond to such shocks with expansionary policies. All of these factors suggest that the large external shock that the current crisis represented for emerging and developing economies would be less disruptive than the history of these economies would otherwise have led one to believe. Most important, perhaps, is that reforms to the domestic financial system and moves to more flexible exchange rate regimes rendered the sudden

disruptions associated with banking and currency crises less likely, that the credibility gained by financial and macroeconomic policy institutions would make short-run deviations from medium-term policy stances less disruptive to expectations, and that policymakers entered the crisis with means at their disposal to counter shocks—in the form of large reserve stocks—that were not available to them in the past.

V. Crisis Transmission and Impact

The Great Recession began with a collapse in housing prices in the United States, which triggered a financial panic because of the opaque nature of securitized mortgage instruments, which quickly became "toxic assets." The financial panic was followed by a collapse of real activity as the result of reduced asset values and the freezing up of credit flows. An initial channel of international transmission was financial, and primarily affected Western European countries whose private capital markets are tightly integrated with those of the United States, and whose financial institutions had acquired toxic assets issued in the United States. However, financial institutions in emerging and developing countries did not typically acquire such assets, so they did not experience the direct hit suffered by similar institutions in many industrial countries.

A second financial link was less direct, but had more worldwide effect. As the crisis deepened in the advanced economies, all projections for the world economy became more uncertain. This increase in worldwide economic and political uncertainty acted like a "monsoon effect" that sharply reduced productive asset values throughout the world. Stock markets elsewhere around the world moved in sympathy, and the crisis spread through a worldwide decline in equity prices, affecting more directly emerging and developing economies with more highly developed stock markets.

A third financial channel of transmission operated through a reallocation of international financial portfolios from risky assets to those assets perceived as safest: United States government obligations and gold. This had two important implications. First, it increased

sovereign borrowing costs for emerging and developing countries. Second, countries with currencies closely tied to the US dollar faced an additional negative shock in the form of real effective exchange rate appreciation, pulled along by the appreciation of the dollar, while those with floating rates faced pressure for their currencies to depreciate as capital flowed out of their economies. Whether this resulted in an additional negative effect on aggregate demand in these countries or a positive one depended on their domestic vulnerability to exchange rate depreciation.

The fourth channel of transmission arose from a dramatic contraction in economic activity in the North Atlantic economies. This manifested itself in three "real" channels of transmission: a decline in the demand for the exports of developing countries, a reduction in commodity prices, and a sharp contraction in flows of worker remittances.

The crisis had differential effects on emerging and developing economies, depending on the nature of their links with the international economy. The initial impact of the crisis on Asian economies was financial. Stock markets peaked in many Asian countries in October of 2007, and by February 2009, they had fallen by 60 percent. Net portfolio equity inflows and bank lending flows collapsed, and access to external bond financing became much harder. Increased "real" integration also caused the crisis to be transmitted to Asia through markets for goods and services. Exports to the United States and the European Union from emerging Asia fell sharply in 2007, and emerging economies in Asia suffered some of the sharpest contractions in real output experienced anywhere, including in the industrial countries where the crisis originated. Real GDP in emerging Asia excluding China and India contracted by 15 percent on an annualized basis in the fourth quarter of 2008, for example, compared to six percent in the United States.

Similar events played out in Latin America. Asset values collapsed in the seven largest Latin American countries, which had the most developed stock markets, during the second half of 2008. In addition, Latin American governments faced a sharp increase in their costs of

access to international financial markets by the end of 2007, and there was a substantial shortening of maturities of rolled-over debt. The increase in the perceived risk of assets issued by Latin American governments and firms also resulted in capital outflows from the region. Given the substantial importance of markets in the United States and the European Union for these countries, export revenues fell dramatically, albeit somewhat later than in Asia (in mid-2008, rather than early in 2007), as the result of contractions both in export volumes as well as prices. Finally, countries in the region, especially Mexico and countries in Central America, suffered a sharp contraction in flows of workers' remittances.

In the Middle East and Central Asia, the collapse in oil prices caused by the reduced level of economic activity in oil-importing countries played an important role in crisis transmission. As in other regions, stock markets contracted and spreads for banks that borrowed heavily from abroad widened. Similar to elsewhere, countries in the Middle East and Central Asia also suffered a decline in FDI flows, reduced demand for the region's exports, lower tourism receipts, and a sharp reduction in flows of worker remittances. Because many countries in this region were pegged to the US dollar, the 'safe haven' appreciation of the dollar resulted in a real effective appreciation of their currencies, adding an additional contractionary shock.

Because countries in sub-Saharan Africa (except for South Africa) are only weakly integrated with international financial markets, crisis transmission through financial channels was less important there than elsewhere. The most important financial channel of transmission for most countries in the region was reduced FDI inflows. As in other regions, real transmission occurred through reduced demand for exports, lower commodity prices, and reduced flows of remittances. Other than South Africa, oil exporters were hit hardest and first in mid-2008.

Countries in emerging Europe are highly integrated with Western Europe, in both real and financial markets, and they rely much more on external bank financing than do other

emerging economies. Pressure to reduce leverage in the parent banks of Eastern European subsidiaries led to a contraction of credit to the emerging economies in Europe. As in Asia, the crisis hit early. Sovereign risk premia began to turn up in mid-2007, and increased continuously thereafter. Private external bond issues also contracted sharply in mid-2007, and stock prices turned down at the same time. The sharp contraction in foreign bank credit to these countries caused the collapse of a real estate boom that had emerged in the Baltic economies prior to 2007, which contributed to dramatic contractions in economic activity in these countries, similar to those observed in Asia and in countries, such as Mexico, that were tightly integrated with advanced economies at the epicenter of the crisis.

The upshot is that emerging and developing economies had not "decoupled" at the outset of the Great Recession. Far from it, the macroeconomic reforms that they had implemented in the decade and a half or so prior to the crisis—particularly the "liberalizing" reforms that caused them to open their current and capital accounts, and therefore to greatly increase their real and financial integration with the advanced economies—if anything made them more susceptible to the crisis in the advanced economies, through a diverse set of transmission channels. Moreover, the reform and development of their domestic financial sectors, by strengthening cross-border banking links and giving a more prominent role to stock markets in the domestic economy, may independently have strengthened financial channels of transmission. Not surprisingly, then, emerging and developing economies all over the world suffered severe initial output contractions, in many cases much more severe than those that afflicted the countries at the epicenter of the crisis.

VI. POLICY RESPONSE

Based on past experience, the effect of such severe output contractions in emerging and developing economies would have been expected to have been a prolonged period of stagnation, perhaps another "lost decade," such as the one that Latin America suffered through after the 1982 debt crisis. Dislocations in domestic financial systems, the drying up of capital

inflows as a result of a loss of confidence by international investors, and procyclical fiscal policies focused on reductions in public sector investment, driven by revenue shortfalls and the absence of means to finance deficits other than by printing money, would all have contributed to such an outcome. Such destructive policies would have been abetted by high inflation if the difficulty of financing fiscal deficits caused the affected countries to turn on the monetary spigot (as after the 1982 Latin American crisis), or by its opposite—very tight monetary policies—if worries about currency mismatches in domestic balance sheets constrained monetary expansion (as after the 1997 Asian crisis). Such outcomes would have been expected to have been even more likely if recovery were slow in the advanced economies, as has indeed been the case this time around.

A Break from the Past

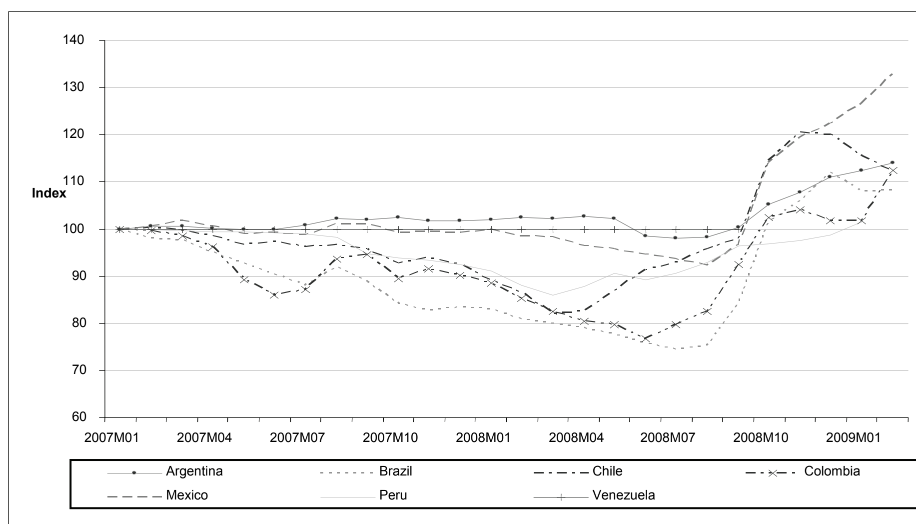
In fact, in the majority of emerging economies as well as many developing countries, none of this happened. Countries that had undertaken significant macroeconomic reforms prior to the crisis instead responded to the severe external shock that the Great Recession represented for them by adopting countercyclical policies—in some cases very aggressive ones.

The resiliency of reformed financial sectors in emerging economies, and lessons learned from the past about how to safeguard these systems, provided an important buffer for these economies. Asian credit markets, for example, were not disrupted in 2007, when these countries' exports collapsed. Although confidence in some Asian banks suffered after the collapse of Lehman Brothers in September of 2008, several governments (Hong Kong, Indonesia, Malaysia, Singapore, and Taiwan) quickly created liquidity facilities and expanded deposit insurance. As a result, credit did not freeze up in Asia, as it did temporarily in the United States and Western Europe. A similar situation prevailed in Latin America. Credit continued to flow, and the authorities quickly provided safeguards to backstop the domestic financial system. Liquidity support was provided to financial institutions in Argentina, Brazil, Chile, Costa Rica, Colombia, Guatemala, Mexico, and Peru, the scope of institutions with

access to central bank discount windows was widened, and reserve requirements on banks were lowered.

Floating exchange rates also contributed to stabilizing aggregate demand in most (but not all) emerging economies. The "safe haven" effect that saw capital flow from all over the world into US Treasury bills put pressure on the exchange rates of emerging economies with floating rates to depreciate. Most such economies did not resist depreciation, though several accepted some reserve losses in order to smooth their exchange rate changes. The Korean won and Indonesian rupiah, for example, depreciated about 20 and 10 percent in nominal effective terms from September 2008 to March 2009. The experience of the LAC-7 countries is shown in Figure 5.

Figure 5. Bilateral US Dollar Exchange Rate Indexes in LAC7 (January 2007=100)



Source: International Financial Statistics (2009).

Low inflation and monetary credibility made it possible for a large number of both emerging and developing economies, both with floating as well as officially-determined exchange rates, to respond to the crisis with monetary easing, without fear of igniting inflation expectations. Monetary conditions began to be eased in Asia the spring of 2007, when the recession began to affect Asian exports, and easing became more aggressive in the last quarter

of 2008, after the collapse of Lehman Brothers. The median decline in policy rates in the region from the 3rd quarter of 2008 to the 2nd quarter of 2009 exceeded 2 ¼ percent, five times as much as in past recessions (IMF 2009b). China, India, Korea, Taiwan and the ASEAN 5 (including Vietnam) all lowered policy rates or decreased reserve requirements in the last quarter of 2008. Policy rates in many countries were allowed to become negative in real terms, whether measured relative to headline or to core inflation. Monetary policy turned expansionary in Latin America somewhat later than in Asia, but as in Asia became even more expansionary in late 2008. Policy rates were lowered in all the major inflation-targeting emerging economies in the region, beginning with Colombia in December of 2008, as well as in non-inflation targeting countries such as the Dominican Republic, Honduras, Paraguay, and Venezuela (IMF 2009d). In sub-Saharan Africa, two-thirds of the countries lowered one or more policy interest rates after the crisis began.

Modest debt levels and large stocks of foreign exchange reserves created the "fiscal space" for many emerging economies to implement fiscal expansions without fear of perceived threats to fiscal solvency. The IMF's (2009a) calculations show a positive fiscal stimulus in China, India, the four tigers, and the ASEAN-4 economies (Indonesia, Malaysia, the Philippines, and Thailand) during 2009 that were comparable or larger in size than those on the G-20 countries on average (2 ¾ percent of GDP, compared to about 2 percent in the G-20 countries).[15] Throughout the region discretionary fiscal measures were heavily weighted toward spending, especially investment in infrastructure, and were implemented quickly. The Fund found the fiscal policy response to the current recession in Asia to be stronger than in past recessions, with a median increase in the fiscal deficit of over 3 ½ percent, more than double the response after the Asian crisis. Aggressive fiscal policy responses were also implemented in Latin America, though those packages were more modest than those in Asia. The fiscal authorities in commodity-exporting financially integrated countries, the IMF's

[15] China announced a large fiscal stimulus package in November of 2007 focused on a massive program of public investment. The four "tiger" economies of Hong Kong, Korea, Singapore and Taiwan allowed an increase in their fiscal deficits by 2 ¼ percent of GDP in 2008.

identification of the countries in the region with the most developed institutions for policy formulation (Brazil, Chile, Colombia, Mexico and Peru), provided the most support, increasing their average domestic primary deficit by some 3.5 percent of GDP in 2009. This reflected not just automatic stabilizers, but also discretionary measures, since the cyclically-adjusted primary balance was loosened in those countries, resulting in positive fiscal impulses. Fiscal policy was eased in some three quarters of sub-Saharan African countries in response to the Great Recession (IMF 2009c). Fiscal deficits increased as the result of automatic stabilizers as well as discretionary responses. The IMF (2010c) notes that nearly two-thirds of the sub-Saharan African countries that experienced growth slowdowns as a result of the crisis were actually able to increase government spending to stabilize their economies. The turnaround in fiscal balances amounted to some 6 percent of GDP on average in 2008, a sharp contrast with experience during past recessions. Countercyclical fiscal policies were implemented in particular in the middle-income countries of the region, where public sector debt ratios were lowest. For those countries, the increase in deficits was due primarily to discretionary spending increases. In oil-exporting countries and low-income countries, by contrast, decreases in revenues dominated. Fiscal targets were loosened in about three-quarters of the countries in the region with IMF agreements (IMF 2009c). In the Middle East and Central Asia, countries with substantial fiscal cushions, such as Saudi Arabia and the United Arab Emirates in particular, but also Algeria and Libya, undertook substantial fiscal stimulus programs, as in Asia and Latin America. Where they were present, sovereign wealth funds responded to the contraction in capital inflows associated with the crisis by lending more actively in their domestic economies and funding public sector projects. Fiscal stimulus was also widely undertaken by countries in the Caucasus and Central Asia, especially in countries such as Azerbaijan, Turkmenistan and Uzbekistan, which had saved during the boom. This international experience reflects the gradual easing of constraints on countercyclical fiscal response in the form of high debt, high inflation, and large fiscal deficits during boom times.

More of the Same

However, this experience was not uniformly shared among developing countries. Problems in the financial sectors of emerging Europe resulted in credit collapses and contributed to severe output contractions there. In addition to recapitalizing banks, all of the emerging economies in Europe had to substantially increase deposit guarantees, many of those countries negotiated adjustment programs with the International Monetary Fund, in exchange for exceptional financing. As of April 14, 2009, IMF programs were in place in Belarus, Bosnia-Herzegovina, Hungary, Latvia, Romania, Serbia, and Ukraine, and Poland availed itself of the IMF's unconditional new Financial Credit Line. Outside Europe, Kazhakstan had a major banking crisis that was reminiscent of crises in Asia, Mexico, and Chile in previous decades.

Despite capital outflows, exchange rate depreciation was also not universal. Most European emerging economies kept their exchange rates stable against the euro, and since their trade was dominated by Eurozone countries, real effective exchange rate depreciation did not make a significant contribution to shoring up demand. The same was true, of course for countries in sub-Saharan Africa, such as those in the CFA franc zone, that maintain fixed rates against the euro. Dollarized economies in Latin America, such as Ecuador and El Salvador, and many countries in the Middle East, both oil exporters and importers, that maintain fixed or heavily managed exchange rates against the US dollar, saw their nominal effective exchange rates appreciate, following the appreciation of the dollar. Since some of these countries, particularly the Middle East oil exporters, also tended to have higher inflation rates than their trading partners, their real effective exchange rates appreciated as well, thus behaving pro-cyclically. On the other hand, countries in the Caucasus and Central Asia with more flexible exchange rate regimes were constrained on the extent to which they could allow their currencies to depreciate by an old problem: currency mismatches in the balance sheets of their banks and corporations.

Several emerging and a larger group of developing countries in Asia were not in a position to mount a forceful policy response to the crisis. Fiscal policy was actually tightened on average among the group of countries that the IMF classifies as "other" commodity exporters in Latin America (Argentina, Bolivia, Ecuador, Paraguay, Suriname, Trinidad and Tobago, and Venezuela,) resulting in negative fiscal impulses, and thus pro-cyclical fiscal policy. Ecuador and Venezuela, for example, planned to cut spending by 10 percent in 2009. Similarly, tourism-intensive commodity importing countries, the IMF's term for a variety of small economies in the Caribbean, tended to have large stocks of public debt on average, and maintained fixed exchange rates in the context of open capital accounts with a fairly high degree of financial integration. These countries consequently had little scope for either fiscal *or* monetary stimulus. Most developing economies in Asia found themselves in similar fiscal straits. Those countries were hit by lower commodity prices, reduced demand for nontraditional exports such as garments, lower tourism receipts, and reduced FDI flows. However, weak public solvency positions, reduced fiscal revenues because of lower commodity prices and lower revenue from import taxes, ineffective monetary transmission mechanisms, and inflexible exchange rates rendered countercyclical responses much more difficult to implement in those countries. A similar situation played out in the Middle East. Many countries in that region simply had no fiscal cushions. This was true of oil exporters such as Iran, Sudan, and Yemen, which had to reduce their fiscal deficits in the face of the crisis in order to preserve fiscal sustainability. It was also true on average of the oil-importing countries in the region, which averaged public sector debt to GDP ratios of over 60 percent. Indeed, according to the IMF (2009c), the majority of Middle Eastern oil importing countries adopted pro-cyclical policies in response to the crisis, tightening fiscal policy to preserve fiscal sustainability in the face of declining revenues.

Egypt

After the Lehman crisis, foreign investors withdrew from Egypt’s stock and government bond markets, and both sovereign and CDS spreads rose. The Egyptian pound depreciated by about

6 percent between October 2008 and March 2009. In the monetary area, the CBE reiterated a 100 percent guarantee for local bank deposits, and cut interest rates sharply. Overnight deposit and lending rates were cut 6 times between February and September 2009, by cumulative amounts of 3.25 and 3.75 percent respectively. On the fiscal side, additional infrastructure expenditure was undertaken equivalent to about 1 percent of GDP, plus an additional 1 percent from public-private partnership (PPP) investments. Revenue-increasing reforms, such as introducing the property tax, broadening the VAT, and phasing out energy subsidies, were postponed.

VII. Post-crisis Performance

The pattern of economic recovery among emerging and developing countries followed closely that of the policy response. The heavily export-dependent economies in the Asian region suffered the sharpest output contractions as the result of the crisis, but also the most determined policy response and the fastest recoveries. While the initiation of recovery in Asia during the first quarter of 2009 was led by exports (as the result of an inventory cycle in the United States and the European Union), it was also supported by expansionary domestic policies. Simulations with the IMF's Global Integrated Monetary and Fiscal model (GIMF) reported in IMF (2010a) estimate that fiscal stimulus in those countries added 1 ¾ percent on average to growth in Asia during the first half of 2009. The region benefited in particular from an increase in regional exports to China, responding to the boost given to Chinese demand by the infrastructure investment associated with Chinese fiscal stimulus, as well as to increased private investment in that country caused by the countercyclical relaxation of credit restrictions. These measures, together with the recovery in world trade, had the effect that by August of 2009, alone among the major economies of the world China was growing at rates above its long-run trend. Foreign capital to begin to flow into Asian countries once again in the second quarter of 2009, and inflows of portfolio equity capital contributed to a sharp rebound in regional stock markets, which soon returned close to pre-crisis levels. Already in

2009, the combination of sustained current account surpluses and restored capital inflows caused Asian economies to begin to accumulate foreign exchange reserves once again.

Latin America also sustained a strong recovery in 2009. It was driven by a combination of expansionary domestic policies, the recovery in world demand for manufactured goods mentioned above, and improved commodity prices, in turn driven by the rapid recovery in the commodity-intensive Asian economies. Both of these components of the external environment began to recover in 2009, though other components, such as remittances and tourism, did not. This meant that the large commodity-exporting countries in the region recovered more quickly than the smaller commodity-importing ones. The IMF (2009e) estimates that Latin America's improved policy environment cut the output cost of the external shocks associated with the Great Recession from the third quarter of 2008 to the second quarter of 2009 in half for Brazil, Chile, Colombia, Mexico and Peru (the financially-integrated commodity exporters), from a projected decline of 8 percent in real GDP to an actual one of about 4 percent. For the other sub-groups of countries in the region, on the other hand, which were constrained from adopting equally stimulative fiscal and monetary measures, recovery from the Great Recession was much more dependent on the external environment: the "other" commodity exporters were assisted in recovery by increases in world commodity prices, while the commodity-importing countries in the region were hampered by the slow recovery of tourism and workers' remittances. As in Asia, capital inflows also returned to Latin America rather quickly. Large nonresident portfolio outflows turned out to be short-lived, and inflows returned to the larger countries in the first part of 2009. Overall, foreign exchange reserves remained above end-2007 levels in the region.

Except for South Africa, most countries in the sub-Saharan African region seem to have hit bottom in the first quarter of 2009. In contrast with past crises, recovery in the region was faster than in the rest of the world, both because more policy shock absorbers such as lower interest rates were at work, and because countries in the region were able to resist harmful measures such as procyclical fiscal policies and increased trade restrictions. While growth

rates averaged over 6 percent from 2003 to 2008, growth fell to 2 percent in 2009, but was already projected by the IMF to recover to 4 1/2 percent in 2010 and to over 5 percent in 2011 (IMF 2010c).

Oil importing countries in the Middle East and Central Asia were hit less hard by the crisis than oil exporters, because of their limited financial links with the rest of the world as well as their limited manufactured exports. However, the crisis was acute for oil importers in the Caucasus and Central Asia, because of their close links with Russia, an oil-exporting country that suffered a sharp contraction in 2009. While several countries in the region have implemented countercyclical monetary and fiscal policies, high levels of public debt have forced them to moderate the size of their fiscal stimulus and restrict its duration. Accordingly, these countries have been particularly affected by the crisis. On the other hand, countercyclical policies helped many oil exporters in the Middle East as well as in the Caucasus and Central Asia to moderate their growth slowdowns. Kazakhstan, however, is a special case. Banks in Kazakhstan relied heavily on borrowing from foreign banks and used those funds, often in the form of short-term liabilities, for lending to unhedged domestic borrowers in construction and real estate, very much as in the Baltics. The depreciation of the domestic currency and curtailed supply of external bank loans caused Kazakhstan to suffer a severe Asian-style banking crisis from which it has not yet emerged at the time of writing.

Finally, the pattern of recovery in emerging Europe was linked both to the policy response to the crisis as well as to pre-crisis vulnerabilities, especially in the financial sector. Countries such as Hungary, Latvia and Romania had failed to build up fiscal space during the boom years to allow them to undertake countercyclical fiscal policies in response to the crisis, and their fiscal policies therefore responded procyclically, prolonging the output contraction in those countries. Financial sector distress slowed the recovery process in Estonia and Lithuania. By contrast Turkey, which was able to undertake countercyclical fiscal measures and avoided the financial sector weaknesses of the Baltic countries, was projected by the IMF to recover to

growth rates of over 5 percent in 2010 and over 3 percent in 2011, after contracting by 4.7 percent in 2009.

Egypt presented a more muted scenario. The country's limited integration with international markets limited the initial impacts of the crisis on the Egyptian economy, and its limited scope for maneuver on both the monetary and fiscal sides produced a correspondingly limited response. The growth rate, which had been in the vicinity of 7 percent during the period 2007-08, fell only to 4.7 percent in 2009 and was projected by the IMF to recover to 5½ percent in 2010-11 and to 6 ½ percent by 2012.

VIII. Summary and Conclusions

What are the lessons from the international experience with the Great Recession—and of the country's own experience—for macroeconomic resilience in Egypt?

Egypt did not escape the effects of the recession, but precisely because the growth-oriented components of its reform—real and financial openness, and domestic financial development—lagged what was done in many other emerging economies, it did not suffer the devastating contractions that affected the dynamic, highly-integrated Asian and Latin American economies or the Eastern European economies with weak financial systems. Egypt's policy response was appropriately countercyclical but not dramatically so, as befits both the more limited size of the adverse shock that the country confronted as well as its more limited capacity to respond.

But the reform process is ongoing in Egypt. This means that the country's external vulnerability is likely to increase, as is its vulnerability to domestic financial sector shocks. The key implication is that the premium on macroeconomic flexibility is likely to be substantially higher for Egypt in the future than it has been in the past. Because increasing CBE and fiscal credibility, accumulating reserves, and reducing debt stocks are all processes that take time, the country will need to prepare beforehand. In doing so, it faces some serious challenges:

- In the monetary area, accumulating reserves is compatible with resisting real exchange rate appreciation, but sterilization has fiscal costs. This means that the CBE may need a fiscal backstop, while protecting its independence.
- In the fiscal area, reducing the debt squeezes the resources available for public investment.

If public investment and fiscal cushions are both very productive, the country's development priorities will call for financing both of them. The need for future macroeconomic flexibility thus suggests a high priority for efficient public expenditure allocation as well as the mobilization of larger public sector revenues through low marginal tax rates and a wide tax base. Building macroeconomic resiliency is investing in development. The key lesson of the Great Recession for Egypt, as for other late-reforming countries, is that such investments should not be shortchanged.

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Part II: Summary of Discussion

Participants in the discussion that followed Professor Peter Montiel's lecture included Taher Helmy, Magda Kandil, Rania Al-Mashat, Yomn Al-Hamaky, Amina Ghanem, Alia Al-Mahdy, Tarek Khalil and Dalia Al-Edel. The following is a summary of the discussion.

Moderator: Thank you very much for a very enlightening lecture. You have given us a lot of food for thought. Egypt has indeed embarked on a process of reform, albeit a bit late as you have mentioned. As you also correctly stated, we were not as integrated in the world economy as other countries during the recent financial crisis—hence its limited impact on Egypt—because of the fact that we are late comers to the fold of reformers. However, that doesn't mean that we are immune to problems, especially that we are increasingly getting more integrated into the world economy. We have no choice but to continue on the growth path for various reasons. We have to create jobs to reduce the unemployment problem; this is very important for social stability. The challenge is how to manage increased vulnerability as a result of further integration into the world economy. Maintaining some sort of policy flexibility is probably key to ensuring that we can weather shocks when they come.

Participant: I have to say that the financial crisis has created a big challenge for those of us working in emerging economies like Egypt, where people have become cynical due to what they saw happen in advanced economies, and I think you have alluded to this in your presentation. People have also been cynical about the long-term approach of liberalization and trade openness to realize higher growth. They look at what is happening around the world and say if these economies are not recovering to whom we are going to export. The other point I want to get your input about is the government role in this process. I understand the importance of policy flexibility and the premium attached to it, but regulations and the role of the government are also as important. The other point is long-term strategy. The concern is not

only about resilience to shocks in the short-term; if we don't care about our standard of living and domestic demand, how are we going to sustain growth going forward. I am interested in hearing your perspective on the aftermath of the crisis, and given the challenge we are facing, how do you address the concerns about vulnerability to shocks as well as cynicism about adopting this particular philosophy as the way forward; how to sustain the growth process if the export markets are not recovering, and what do we need to do domestically to make sure our domestic demand is not weak as other economies suffer.

Speaker: It is quite true that people have become very cynical. But the question is what exactly the cynicism is about! It is very hard to deny that trade openness and financial reform have been tremendously powerful engines of growth. Being cynical about that is simply ignoring facts. The goal in countries like Egypt is to achieve more growth, and to have more growth we need to learn from others and share ideas. Opening up means sharing ideas with the rest of the world, which is how societies progress and how economies grow. So, being cynical about opening up is just ignoring reality. I do think, therefore, that there is a germ of truth in the view that increasing the role of markets and opening up trade promotes growth. But it is also quite true that doing so opens countries up to all kinds of vulnerabilities and that's exactly what is going on now. More open economies have suffered more in the current crisis. If you want to protect yourself from these kinds of shocks you can close up, but in that case you will not grow. So, opening up is ultimately the way to go. But if you want to do that successfully, you need to invest in ways that allow you to respond to external shocks when they come.

The second part of the question is, if industrial countries are not growing, who are we going to sell to? How to make up for that gap? My answer is that this is exactly where macroeconomic flexibility comes in. A country like Egypt has tremendous social needs. There are tremendous opportunities here for public investments, or projects that the public sector can undertake. But when should you do these things? You shouldn't do them when the economy is booming

because then the returns to private investments will be very high, and the cost of resources for the government will also be very high. The time to do such things is precisely when the economy is in a recession. What you need to do is be ready to step in to meet some of those social needs when external demand slackens; in other words, when you can't sell to the world you sell to yourself. What you need, in my opinion, is a counter-cyclical public investment strategy. To me, that is a way of protecting yourselves from the vulnerabilities that inherently come with openness. So, say to the cynical people: if you are being cynical about the prospective benefits from growth that you are going to get from exchanging ideas and engaging with the rest of the world, then you are just ignoring the facts. If you are saying that because of the exposure to external shocks that opening up brings, you have to protect yourself, then you are right. You can do so by investing in macroeconomic flexibility, so that you can indeed undertake public investments when things go bad, so that you can be in a position of having an expansionary monetary policy when you are in a recession. But you have got to make the investment in acquiring that type of flexibility now.

What you should also be cynical about is too much orthodoxy: the view that macroeconomic discipline is an end in itself; because it is not. You do not want to reduce fiscal deficits just for the sake of doing so. You want to do so during good times precisely so you can have the scope to endure them when you need them to compensate for the loss of foreign markets, say because of an international recession. So, what I am saying is: be cynical about the right things. But also be alert to what the facts are about how countries have historically been able to grow, and to the things you have to do to protect yourselves when you engage with the world in your pursuit of growth.

Participant: You said that one of the purposes of reform is to achieve economic growth. How would we basically tie that with for example the growth rate in China? China has been growing very rapidly, but is now accused of being the main source of global economic

imbalances. I think what is more important than the reform achieved is the type of economic growth achieved. Is it balanced, is it sustainable? This is extremely timely for the case of Egypt. Also, I agree with the policies advocated by the Washington Consensus. However, the challenge for policy-makers is the sequencing of these reforms, making sure as you pointed out that macroeconomic mismanagement doesn't take place. You mentioned that our financial sector has gone through some reform but not fully. I would like to draw a distinction here between banking sector reform and the non-banking financial reforms. I think that the landscape of the banking sector has changed dramatically since 2004, and we can no longer say that there is state control in the banking sector.

Speaker: As you said, China has been accused of having an unbalanced kind of growth. From my perspective, we need to draw a distinction here. If that is a negative thing, the question is: negative for whom? Is it negative for China, or for the non-Chinese? China's growth has been following the pattern that was established by East and South East Asian countries before, which is precisely an outward-oriented strategy linked to trade and exchange of technology with the rest of the world based on manufactured exports. Has it worked for China? Yes, Chinese living standards have improved dramatically over the past 30 years. Is China responsible for the world's great imbalances and need to rebalance the world economy? That is more complicated. China indeed has a huge current account surplus and has accumulated very large foreign exchange reserves, and both of them are indeed direct consequences of the particular growth strategy that China adopted. The problem is that when you are in a world where an outward-oriented strategy is being pursued by a relatively poor country, and when that poor country has grown up to the point where it matters in the world economy, the other countries are going to complain. But does that mean that the strategy is bad for China, or that China is solely responsible for world imbalances? We can't conclude that until we examine policies in countries on the other side of those imbalances.

About sequencing, I do believe that outward-orientation and trade are the way to go. The market is quite powerful and it is hard to imagine any successful economic growth strategy that doesn't focus on the market and trade. But, really the point I am trying to make is that in order for that strategy ultimately to be successful there are certain things you have to do ahead of time, so sequencing is indeed an important issue. I think that is an important matter for Egypt. You have to create buffers so you can protect yourself from the vulnerability that comes with that strategy. What does that mean? It is indeed a statement about sequencing. You have to begin now laying the groundwork for being in a position where you can use your macroeconomic policies to offset the external shocks that will come with an outward-oriented strategy.

Participant: I believe that there are three reasons behind the successful experience of South East Asia: i) macroeconomic stabilization, ii) institutional reform, and iii) resource usage efficiency. I believe these aspects play an important role in managing external shocks. My second comment is about flexibility and rigidity. Don't you think that the government should play a significant role in this regard? The Chinese experience during the crisis indicates the importance of using the internal market as a gestation period after which they succeeded to score 6.7 percent of growth and higher despite the impact of the financial crisis. My third comment is about the challenges facing Egypt in the fiscal area. You mentioned that reducing public deficit affects public expenditures; there is a new law recently approved by parliament in Egypt on private-public partnership. I think this will help increase the government's public expenditure capabilities, but we will still have to face the challenge of unemployment.

Speaker: I completely agree on the unemployment issue. I didn't talk about it because I took the motivation for growth as being given. After all, why do we want to grow? Clearly, to provide employment for a growing population is one big reason, and this is a critical issue not just in Egypt, but in the whole region. The unemployment problem is pervasive throughout the

region. Growth will help, but flexibility and liberalized labor markets will also help. We need not just to grow faster but to absorb more people for each percentage point of growth.

On the question of South East Asia and the role of efficient resource allocation, I completely agree with that. One of the debates about South East Asia has been whether they grew fast because they sacrificed, saved and worked hard, or because they became more productive and their total factor productivity increased very rapidly. If you look at China, its investment rates are incredible; it has the lowest consumption to GDP ratio in the world. But in the end growth is about consuming, so in the final analysis this is not necessarily good news. But looking at evidence from South East Asia, I don't think that high investment is all there is to it. I find great difficulty in arguing that TFP growth was not part of the story. I think those countries grew fast because they saved and worked hard, but also because they allocated resources efficiently. So, I couldn't agree more on the need to allocate resources efficiently here. Of course, in order to do that we need a well-functioning financial market, meaning : i) a financial market that is competitive, and ii) a financial market supported by an appropriate institutional framework, making sure that individuals have the tendency to use resources in a productive way.

Regarding your point about the Chinese compensation for recession through expansionary fiscal policy, that is exactly what the Indians and the Chinese have done right. They have responded to the crisis with expansionary policies. My real question was how did they manage to do that? In the past they weren't able to do that. So, what changed, I think, it is their investment in macroeconomic flexibility, which enhanced their willingness to incur higher deficits, to incur more debts in the short run to deal with the crisis.

Participant: You mentioned that Egypt didn't suffer much from the crisis because it has been a late reformer, I would rather say it has been a slow reformer. Actually, Egypt is facing many

challenges. The growth rate is not high enough. We are talking about a modest 4.7 percent during the crisis, so it is not like the growth rate in China or India. We do have several problems, in addition to the limited growth rate: a rather high inflation rate; a negative interest rate; a low and declining investment rate; a growing public debt and a high budget deficit. And despite the fact that we have a negative interest rate, the only investment that is growing is public investment rather than private investment.

Additionally, we have to think about what kind of growth we should target. Is it equitable growth? We might have a growth of 4-5 percent but people don't feel it because it is not equitable growth. Is it employment generating growth? To conclude, I would like to mention that an open economy is certainly essential, but restrictions could be imposed in certain areas when needed, however closing the country once again is not advisable at all. But still we have the problem of growing at a rate of 5 percent, which does not increase welfare. So, how do we deal with that?

Speaker: You mentioned the high inflation rate. That is truly a persistent problem and I think one of the investments in macroeconomic credibility and flexibility that is important is to get the inflation rate down. I know the Central Bank of Egypt is planning to undertake inflation targeting at some point in the future; when that happens it will be extremely important for the Central Bank to be able to deliver on its promises regarding the inflation rate. That is a form of the investment in credibility and flexibility I was referring to earlier.

On the fiscal deficit and public sector debt, it is true that they are high in Egypt when one just looks at the ratios to GDP. However, it makes a great difference if you have a ratio of debt to GDP of 80 percent that much of it is contracted at 2-3 percent concessional rate. So, the composition of the debt is very important as well. In Egypt most of the external debt is concessional rather than market-based. The external debt is not that big, most of the debt is

domestic and is held by the banking system. It is worrisome, however, when commercial banks hold a lot of government debt because that is not what banks are supposed to do. Banks are supposed to intermediate between private agents. So, the question is: why do Egyptian banks hold so much government debt? Why are they not intermediating with the private sector? This worries me more than the overall debt ratio.

That takes us to your point about investment, why is public investment high? Private investment is problematic all over the world today, because we are living in times of tremendous uncertainty. We do not know what the future holds, and these times are not times that people tend to invest. I understand that we want high private investment rates, but it is not surprising that private investments are slow at a time when economic uncertainty is high. Public investment is high only in a relative sense.

Concerning your question on how to generate more equitable growth, there are countries that have been more successful than others in that respect. Unfortunately, the experience of the world in the past couple of decades is not very positive in this area. Inequality has increased in many places around the world. The good news is that poverty has decreased the most in countries that have grown the fastest. So, India and China have been the countries that had the biggest impact on poverty in absolute sense. But I think in the last couple of decades, no country has been a dramatic story of fast growth with better distribution.

Participant: While I agree with your conclusion that "the challenge is mostly fiscal," I don't think Egypt will be able to do what Ireland and Greece did: suddenly take fiscal austerity measures to address the deficit. This is because the fiscal deficit is a reflection of other macro problems that we have. If you look at the profile of expenditures, 75 percent of it is current and only 25 percent is channeled to investment. This pattern will not lead to sustainable and balanced growth. Also, one of the reasons why growth has been volatile is that when there is a

need for fiscal austerity measures, it is public investment that gets reduced not current expenditures.

Current expenditures include subsidies, debt service payments and wages. In the absence of a good social security system we can't reduce subsidies. We have recently enacted a new pension law, but we have yet to see how it will protect the people and then start reducing subsidies. Wages are another form of social security. In the absence of a good business environment for private investment, people prefer to work for the government. There is also a problem with the labor law, which is very strict and doesn't give enough incentives for the private sector to hire people. Needless to say, the list of institutional challenges is very long.

Speaker: I didn't say that Egypt should do what Ireland and Greece have done. That is not what I meant by "it is mostly fiscal". What I meant is that you need to have a revenue system that gives you the resources to get your debt situation under control as an investment in future macroeconomic flexibility, and at the same time invest in the kind of things that are going to make the society better off. It's doing both things at once that to me is a fiscal challenge. It is not a question of fiscal austerity right now. In fact, fiscal austerity in Ireland and Greece is precisely an example of the pro-cyclical fiscal policies that are to be avoided. What Ireland and Greece are doing now makes their recessions worse. But they have no choice, and my whole point about Egypt is: be sure that you are never in that position. Don't put yourself in a position where, because you opened up in order to grow, when you are hit with an external shock such as the one we are experiencing now you are forced to respond in a way that could aggravate an already severe recession. In order to prevent that, you have to invest now, take the measures now to put yourself in a better position to cope with such shocks in the future.

Regarding the budget, that is the usual problem, it is very difficult to cut anything. But decisions have to be made at the end, because if you are spending more on subsidies, you are

spending less on education and health. You can certainly justify subsidies to help those who are most disadvantaged. But in most countries, subsidies are going to a large extent to the middle class and even to people who are better off.

Participant: I agree with your statement that the challenge is achieving growth while reducing vulnerability. As recurrently stated in this session, we need to continue to open up and integrate into the global economy, but in the meantime we also need to be careful, maintain policy flexibility and prepare for adverse events in the future.

Speaker: It is a tradeoff. There is no other road to rapid growth than opening up. But with that comes exposure to external shocks. So, invest in the right policies now to be more prepared to confront adverse events in the future and to ensure sustained rapid growth. In other words, make investments today that will allow you to mitigate the adverse effects of tomorrow's shocks. But we have to be careful when we emphasize macro-stability. Macro-stability is not something that should be sought for its own sake. Don't think that you want to hold reserves just because you need to have larger reserve stocks. Don't think that you want to pay debt because less debt is always better than more debt. You invest in macro stability so that you can use it, so that when times are bad, you are able to draw down reserves and run larger fiscal deficits. There are times when it is important to have a larger fiscal deficit and incur more debt. But unless you plan for those ahead of time, you will not have the space to do it.

Participant: You mentioned the complementarities between rigidity and flexibility of policy implementation. Could you provide more insight about the timing of policy flexibility?

Speaker: The timing is a function of the policies. Some policies are essentially almost automatic. So, if you have a flexible exchange rate like in Turkey or South East Asia, or if you have already adopted, like Egypt, a managed float, then the timing can be instantaneous. As

soon as capital flies out, the exchange rate depreciates, your goods become more competitive and you are helping to sustain demand; that is an automatic mechanism.

But the timing is different when it comes to monetary and fiscal policies. Monetary policy should respond as soon as it becomes clear that there is a need for it. The ability to do that is why monetary policy has become the dominant stabilization policy around the world. Here the timing has to do with the recognition of a problem. When it comes to fiscal policy, matters are different. Because resources are scarce, it takes time for the political system to decide what to spend on in times of recession, even after a problem has been recognized. The solution could be, for example, a public investment bank or a public investment budget that is ready when the time comes. You need what are called shovel-ready projects, projects that you know are needed but that the government doesn't implement when the economy is booming and there is no macroeconomic space. So, if you know you need to improve your internal transportation system, for example, you don't want to do it when the economy is operating at full capacity because you don't have macroeconomic space then. So, what do you do? You create a means to implement that project quickly when the economy contracts.

Moderator: Thank you very much for your thoroughness in answering questions and for your insightful lecture. I would also like to thank all participants for their relevant questions on this important topic.