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An Action Plan for Engendering Capital Market Growth in Egypt

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Abstract

Engendering capital market growth is essential to bring the Egyptian stock market out of its slump and ensure sustainable economic growth. A short-term plan should revive domestic and international demand for shares by controlling the supply of financial securities and enhancing the quality of issues. Pricing of shares, improving market capitalization and liquidity, enhancing market depth and developing the debt market are essential features of a short-term action plan. For long-term capital market growth the basic foundations must be improved, including the regulatory framework, human resources and the technological infrastructure of the market. It is necessary to foster an active secondary market and develop a culture of shareholders. Establishing Cairo as the financial center of the Middle East and Africa will build on Egypt's existing resources in the service sector and ensure future growth.

ملخـــــص

يعتبر تحقيق نمو رأس المال أمراً أساسيا إخراج سوق الأوراق المالية فى مصر وهدتها وضمان تواصل النمو الاقتصادى. ومن الممكن أن يؤدى وضع خطة عمل قصيرة الأجل إلى إحياء الطلب المحلى والدولى على الأسهم عن طريق التحكم فى عرض الأوراق المالية وتحسين نوعيات الإصدار. ولعل أهم الملامح الأساسية لخطة العمل قصيرة الجل تتركز فى تسعير الأسهم وتحسين كل من الرسملة والسيولة فى السوق، وزيادة عمق السوق، وتنمية سوق السندات. أما فى الأجل الطويل فإن تنمية سوق رأس المال تتطلب تحسين القواعد السياسية بما فى ذلك الإطار التشريعى والتنظيمى، والموارد البشرية والبنية التكنولوجية الأساسية للسوق. بالإضافة إلى ذلك، فإنه من المهم تدعيم السوق الثانوى وتنمية وعى حاملى الأسهم. إن العمل على ترسيخ القاهرة كمركز مالى للشرق الأوسط وأفريقيا سيؤدى إلى زيادة موارد مصر الحالية من قطاع الخدمات،

وإلى ضمان النمو المستقبلى

I. Introduction[1]

This paper addresses the prospects for capital market growth in Egypt and proposes both a short-term and a long-term plan to revive the market from its current setback. The rise of the Egyptian market began in 1996 when international investors showed interest and domestic retail and mutual fund demand accelerated. After reaching its market peak price in February 1997, the market has been on a steady decline, casting doubts on Egypt's future as a prosperous emerging market.

The Asian financial crisis of 1997 is among the factors behind Egypt's market decline. The crisis prompted international investors to reduce their commitment to emerging markets. The current weakness in emerging markets implies that total market capitalization is $1.5 trillion or that an estimated $900 billion to $1 trillion of market value has been lost. As a result, emerging markets now represent no more than 8 percent of total world market capitalization. Egypt's share of capitalization is about $20 billion or 0.8 percent of emerging market capitalization. The substantial reallocation of funds previously invested in emerging markets has had a lesser effect on the markets of the Middle East and Africa than on those of Asia, but the impact is still being felt in Egypt. It is noteworthy that of the top 200 companies' capitalization in emerging markets, there is not a single Egyptian company.

Other factors impacted the Egyptian market directly, including the lack of large offerings in growth sectors, the interpretation of the Bank Law 5/1998 and the Luxor terrorist attack last November. In the domestic market, the supply of new public offerings through privatization, faltered in several consecutive issues due to buyers' lack of interest in the offered price terms and the earning prospects of the issuer. Meanwhile, there has been slow growth in the mutual fund market. These factors have thwarted an economic rebound, and the market currently languishes at an average market price earnings ratio (PE) of 9.4X.

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[1] Since preparing this report in July 1998 emerging markets continue to unravel. In 1997, the Asian crisis developed, and 1998 has brought the Russian default on its external debt and the collapse of its stock market reversing the stellar performance of 1997.

Three factors are seen as affecting investors' losses and raising risks. First, the commodity price deflation (oil, metal, timber and others) that began during the Asian crisis and spread to Latin America. Second, weak macroeconomic fundamentals, including government deficits as in the cases of Brazil and Russia at 6 and 7 percent of GDP respectively; rising inflation; large external debts and current account deficits. The effect of the Russian debt default on international commercial banks will become clearer over the coming weeks. Third, emerging market investors will raise their equity risk premium and shrink portfolio commitments in these markets.

Egypt has been less affected than other emerging markets and has a solid macroeconomic base to build upon. It has adopted a gradualist approach and should continue to build its human resources, infrastructure and regulatory foundation. In time, these efforts will be rewarded with increased investment once public sentiment changes and stability returns to world markets.

In order to stop the gradual decline of the Egyptian market and engender sustainable growth in the capital market, short-term and long-term plans are necessary. A short-term plan should focus on the quality of offerings, improving the weak secondary market, the traded volume and liquidity, and attracting investors to the Egyptian market once again. Section two outlines this short-term capital market plan.

A long-term plan requires three strategic considerations for building sustainable capital market growth. First, it is necessary to deepen the capital market foundations. This can be achieved by strengthening the regulatory framework, developing human resources, and developing the market's technological infrastructure. The second strategic goal is establish Egypt as the regional financial center for Middle East and Africa. And third, it is necessary to create a shareholding culture and an active secondary market in order to ensure long-term growth. Section three analyzes these goals and explains how they can be achieved.

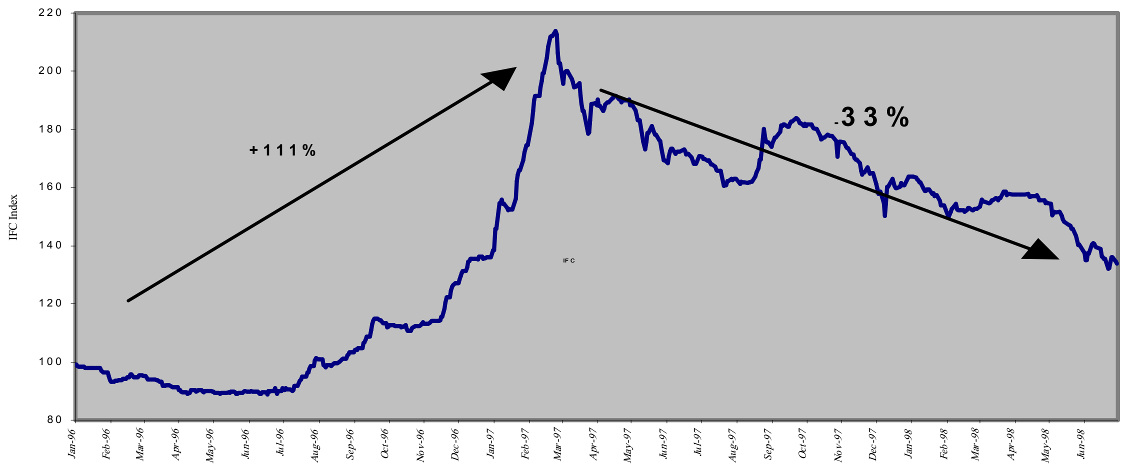
Section four provides a brief conclusion of this discussion on the Egyptian capital markets.

II. Formulating a Short-term Capital Market Action Plan

The Egyptian stock market is witnessing a 'buyers' strike' on recent public offerings issued on the exchange. While domestic and international investors have shown interest in issues from private sector companies that were for the most part marketed internationally. It is evident that the market is no longer a 'sellers' market' where privatization issues are immediately taken up, but is rather a 'buyers' market' where investors have matured and are more discerning when buying both shares and funds.

Does this mean that Egypt is facing a market crisis? The answer is, no, given that in the past two years the market rose 137 percent and has now given up 37 percent of its gains from peak levels. This would hardly qualify as a crisis. *(See Exhibit 1)* The second question that arises is whether the weak stock market behavior is unique to Egypt. In examining other emerging markets, it becomes apparent that this is not the case. The International Finance Corporation (IFC) composite has declined 19 percent in dollar terms this year, and international mutual fund investors have also pulled their emerging market funds from markets outside Asia. A good example is Latin America,

Exhibit 1. IFC Index for the Egyptian Stock Market from January 1996- June 1998



Source: IFC Index.

where certain markets have lost their liquidity particularly where the driving force was from international investors and where the privatization program had run its course. Due to declining oil prices in July 1998, the Venezuelan market dropped by 48.2 percent, Chile by 13.2 percent, Peru by 22.2 percent, and Argentina 19 percent. This fall in market prices occurred despite rising corporate profitability.

The primary problem is that the momentum of the Egyptian stock market has decreased. This issue must be addressed by focusing on the needs of both the foreign and domestic investor. The market must recapture the commitment of the domestic and international investor because, in Egypt's case, the greater part of the privatization program remains, particularly in large utility offerings. The program's success is seen as an integral part of Egypt's economic reforms and the goal to achieve a growth rate of 6 to 8 percent. Effective measures and procedures must be adopted and implemented for the distribution of these privatization issues to domestic and international markets. There is still demand for financial securities in sectors with companies that have strong fundamental characteristics and are attractively priced, such as telecommunications and electrical utilities.

The Current Supply and Demand of Shares

In order to analyze the market conditions in Egypt, and since the price of shares is ultimately determined by supply and demand, it is necessary to take a closer look at the factors affecting prices for both the international and domestic investor.

Demand for Shares

This section examines the nature of international and domestic demand for shares. Most investors buying company shares fall into three categories: growth investors, value investors and traders or speculators. While the economic indicators and fundamentals in Egypt are positive, investors mainly focus on capital market liquidity, market depth and the number of companies with reasonable market capitalization and liquidity. This permits fund managers to diversify risk and invest the unit size per company that impacts the return on their portfolio. These principal investment criteria will also dictate the amount of funds the fund manager can commit to that emerging market.[2]

International investors. International investors in Egyptian shares have been primarily growth-oriented investors investing through country funds, while domestic investors have been primarily speculators investing in retail. Domestic mutual funds are primarily open-end funds where investors can redeem their units into cash, and holders are primarily individuals whose tolerance for risk is limited. In weak market conditions and price declines these individuals exercise their redemptions and convert to cash. This implies that the fund manager has to maintain a large liquidity ratio and may also be forced to sell positions in his portfolio in order to meet redemption obligations. The manager may even be forced to sell at a time when he would want to be a buyer or at least maintain his position. Mutual funds in Egypt have been investing in stocks with strong fundamentals and growth prospects.

Speculative funds are known as hedge funds where the units holders are seeking risk and willing to maintain large trading positions. Such funds are now witnessing heavy losses in Asia and Russia. No hedge funds have invested in Egypt due to the limited liquidity, the lack of derivative instruments such as options, and the absence foreign exchange futures market. Recently, there has been interest in forming private equity funds and restructuring funds that can be categorized as value investments. To date, other domestic institutional interests have been modest but are expected to develop in light of the large privatization issues that are anticipated.

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[2] The starting point in the analysis can be assessment, which is either based on a top-down or a bottom-up approach to investment. Top-down approach assumes an analysis of macroeconomic indicators and then looks at individual companies while the bottom-up approach focuses primarily on company fundamentals.

In emerging markets, international investors primarily examine the macro indicators in order to assess the domestic currency-risk exposure. For example, a dollar-based investor will calculate estimated returns on equity investments on a dollar basis and will also want to determine whether there are any currency hedging instruments. Egypt at the moment is a dollar economy and has enjoyed exchange rate stability, whereas in other markets with an endemic inflation rate, like Turkey, investors have to take the currency risk into account. Nevertheless, because of the liquidity of the Turkish market, international investors still make up 55 percent of the activity, despite weak fundamentals. The investors' next consideration, after liquidity and depth, is sectoral and company fundamentals.

Most international investors in the Egyptian market fall into the growth investor category, relying on portfolio country funds and emerging market funds. In 1996/1997, international investors took an interest in the Egyptian stock market. Five global depository receipt (GDR) issues in London were actively traded with a turnover of $800 million. This led to several research reports on the Egyptian market. There has been little interest from the third category, which is mainly in the form of hedge funds due to the absence of futures and option instruments. In 1997/98 (to date), international investors have invested approximately $1.2 billion dollars. In 1998, no new GDRs were floated; however, a number of private placements attracted international demand.

In 1997, the London Stock Exchange published a list of its top 20 traded GDR stocks including two issuers from Egypt.*(See Exhibit 2)* The London Exchange is seeing a growing number of new listings from emerging markets, and it has a valuable role to play in channeling investment to the fast-growing economies of the world. The Exchange operates a specific emerging markets sector on SEAQ international. In 1997, 31 companies from emerging markets chose London listings of £2.6 billion, including the first companies to list in London from Egypt, China, Jordan and Latvia. (*See Exhibit 3)* By the end of 1997, 163 companies from emerging markets were listed on the London exchange. Although there were five new Egyptian issues on the London Exchange in 1997, and the trading volume in Egyptian GDRs amounted to $800 million in the last 12 months, there have been no new issue listings for Egypt in 1998. In the London secondary market, the 20 most active GDRs include two

Egyptian companies. The London Stock Exchange requires at least two market makers to be in a GDR to ensure that the market is liquid.

Exhibit 2. The 20 Active Global Depository Receipts on the London Stock Market, 1997

Company	Country	Turnover Value (Million £)	Number of Bargains
State Bank of India	India	807.4	4,001
Samsung Electric	South Korea	721.9	5,690
Videsh Sanchar Nigam	India	679.5	2,971
Acer	Taiwan	577.0	2,800
Pliva	Croatia	488.4	2,743
Hellenic Telecom Organization	Greece	406.4	869
Commercial International Bank	Egypt	370.1	2,313
Housing and Commercial Bank	South Korea	364.5	2,271
Borosdchem	Hungary	347.3	1,483
Kookmin Bank	South Korea	333.8	2,413
Asustek Computer	Taiwan	322.4	1,745
Industrial Credit and Investment	India	287.1	1,906
Silicon Precision Industries	Taiwan	279.9	1,603
BSES	India	232.2	1,422
Ashanti Goldfields	Ghana	222.8	1,297
Suez Cement	Egypt	220.6	1,777
Komecni Bank	Czech Republic	212.1	1,584
KGMH Polska Miedz	Poland	202.2	1,246
Bajaj Auto	India	198.4	1,311
Cho Hung Bank	South Korea	195.7	1,876
Total		***7,469***	***43,321***

Source: London Stock Exchange, *Factbook,* 1998.

Exhibit 3. International Listings on the London Stock Exchange

Country of Incorporation	Number of Listings
Argentina	1
Bahrain	1
Brazil	1
British Virgin Islands	1
China	3
Cook Islands	1
Croatia	1
Czech Republic	2
Egypt	**5**
Ghana	1
Hungary	3
India	17
Indonesia	2
Israel	8
Jordan	1
Kenya	1
Latvia	1
Lebanon	2
Malaysia	5
Mauritius	4
Morocco	3
Panama	2
Papua New Guinea	1
Poland	3
Russia	3
Slovenia	2
South Africa	57
South Korea	12
Taiwan	12
Thailand	1
Turkey	3
Zambia	1
Zimbabwe	3
Total	***163***

Source: London Stock Exchange, *Factbook*, 1998.

It is important to point out that in 1997, GDR issues were instrumental in bringing the Egyptian market to the attention of investors and were also useful in raising capital. It is worth comparing the marketing methodology of two joint-venture bank equity offerings: a GDR offering for Misr International Bank (MIBank) and a domestic offering for the Egyptian American Bank (EAB). Both issues were offered in the same time frame in 1997 and elicited different levels of interest from investors. The first was successfully priced and the issue was oversubscribed, while the second issue, a much smaller offering, was not well received and had difficulty being placed. These two cases highlight the differences in the pre-selling approach, the offering methodology, and the implementation of pricing and allotment in GDRs compared to the domestic market offerings. A study of this comparison would demonstrate to investors and issuers the difference between the domestic market in Egypt and the GDR market.

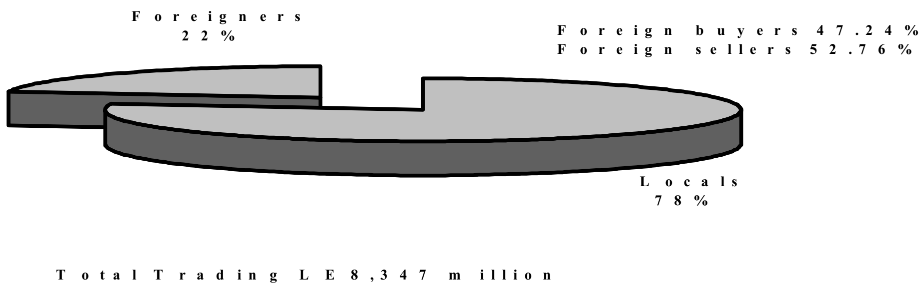
Generally speaking, international investors' activity on the Egyptian Stock Market in 1997 was predominantly on the buy side at LE4.3 billion with LE2.4 billion on the sell side. This represented LE6.72 billion or 33 percent of total trading activity. As seen in Exhibit 4, this represents 21 percent on the buy side and 12 percent on the sell side. Exhibit 5 gives the breakdown of international investors' activity in the first six months of 1998. It indicates that the international investor is still active in the Egyptian market controlling 44 percent of the total value LE7.8 billion with 21 percent on the buy side and 23 percent on the sell side. In the months of May and June, however, these investors became net buyers once again.

Exhibit 4. International Investors' Trading Activity in January-June 1998

Month	*Buying Value (million LE)*	*% Total Value Traded*	*Selling Value (million LE)*	*% Total Value Traded*	*Total Value Traded*
January	178.77	21.24	196.66	23.37	841.69
February	257.87	14.23	367.99	20.30	1,812.64
March	419.4	24.08	499.55	28.68	1,741.79
April	260.09	26.18	275.76	27.76	993.47
May	282.18	20.16	271.47	19.39	1,399.69
June	231.56	23.08	212.45	21.18	1,003.04
Total	*1,629.97*	*20.92*	*1,823.90*	*23.41*	*7,792.31*

Source: Cairo and Alexandria Stock Exchanges.

Exhibit 5. Foreign vs. Local Investors in Terms of Value Traded (January – June 1998)



Source: Cairo and Alexandria Stock Exchanges.

A Comparison of International Investors' Activity in Emerging Markets. The Egyptian stock market has experienced tremendous capital market growth since 1992; however, it is useful to compare Egypt's progress with that of other emerging markets. This requires examining the key factors which interest international investors: first, market liquidity, depth and capitalization; second, company fundamentals; and finally, Egypt's macroeconomic indicators.

According to a *Business Week* survey of July 1998, there is not a single Egyptian company featured among the top 200 companies in emerging markets. Exhibit 6 shows that companies from Morocco, Amman, Turkey, the Czech Republic, Greece and Hungary have joined this ranking after the decline in Southeast Asian stocks. Investors pulling out of Asia have gravitated to these markets. Thus, in 1998, Greece's index, for example, increased by 61 percent and Turkey's by 33 percent. Companies that have joined this ranking represent different economic sectors, namely banking, telecommunications, multi-industry groups, energy, oil, airlines and cement. It is also evident from the survey that the companies best insulated from the deflationary forces are those in high growth industries, such as telecommunications, which dominate the top 10 companies on the emerging market list, namely the telecom companies of Greece, Mexico, China, and Brazil.

Exhibit 6 demonstrates that some markets have characteristics that should serve as indicators to guide the process of formulating a plan for the Egyptian capital market. For example, Greece and other European markets vying for European Monetary Unit (EMU) membership are undergoing a convergence of macroeconomic indicators with a downward trend in interest rates. This is causing a shift from bank deposits and fixed income to shares. Seven European countries experienced mutual fund growth reaching $94 billion in the first six months of 1998. Italy, for example, had a $6.8 billion equity mutual fund inflow in March. With the market being driven by lower interest rates in addition to the above mentioned, emerging Europe is now of prime interest to fund managers.

Exhibit 6. Companies Listed Among the Top 200 Emerging Market Companies*

Turkey	*Czech Rep.*	*Morocco*	*Jordan*	*Greece*	*Hungary*
Turkiye Is Bankasi $5261 Million (43) - *Banking*	**SPT Telecom** $4142 Million (65) - *Telecom*	**Omnium** **Nord African (ONA)** $1965 Million (154) – *Multi-Industry*	**Arab Bank** $2537 Million (113) - *Banking*	**Hellenic Telecom Organization** $13334 Million (8) - *Telecom*	**MATAV** $5912 Million (38) - *Engineering*
Tupras–Turkiye Petrol Rafikeriler $4167 Million (64) - *Oil*				**Hellenic Bottling** $4788 Million (51) - *Beverages*	**Mol Magyar Olajes Gazipari** $2231 Million (132) - *Energy*
Akbank $3678 Million (75) - *Banking*				**National Bank of Greece** $4334 Million (59) - *Banking*	
HACI Omar Sabanci Holding $3049 Million (91) - *Multi Industry*				**ALPHA Credit Bank** $4135 Million (66) - *Banking*	
KOC Holding $3040 Million (92) - *Industry*				**ERGO Bank** $2306 Million (127) - *Banking*	
Turk Hava Yollari $2845 Million (101) -*Airlines*				**Titan Cement** $1578 Million (197) – *Cement*	
Yapi–Ve Kredi Banksi $2081 Million (146) - *Banking*					
Petkim Petrokimya Holding $1771 Million (173) - *Oil*					
Petrol Ofisi $1734 Million (180) - *Oil*					
Turkiye Bankasi $1703 Million (186) - *Banking*					

**Shows name of company, market capitalization, ranking in 200 shares, and section grouping.*
Source: Business Week, 13 July 1998.

Other emerging markets are suffering from severe price drops, which, in turn, have caused liquidity shrinkage in those markets. This has caused international investors to retreat and place a higher risk premium on their equities. Yet a market such as Turkey, which has risen 34 percent to date this year, continues to enjoy a liquidity of $400 million traded per day in equities (55 percent international). This rise is taking place despite negative macroeconomic fundamentals such as inflation, political instability and budget deficits. Liquidity is therefore the primary requirement for both international investors and domestic institutions and should be a vital component for Egypt's capital market plan.

Although emerging markets have had their problems in the past year, the price performance in US dollar terms shows that some of these markets also enjoyed spectacular returns for the same year. *(See Exhibit 7)* Nevertheless, they remain volatile and have trouble sustaining returns. Russia, the stellar performer of 1997, is now facing devaluation and the stock market is declining rapidly. Meanwhile, Greece, Turkey and Morocco are performing well in 1998. What does the Egyptian market offer to investors in emerging markets? Placing the Egyptian market among emerging markets, it is important to keep in mind the figures listed in Exhibit 8, where Egypt represents 0.77 percent of total emerging market capitalization..

Exhibit 7. Price Performance in US$ Terms

Best Emerging Market	*% Price Increase*	*Best Major Markets*	*% Price Increase*
1997 Russia AKM Composite	158 %	Switzerland SBC General	30 %
1996 Hungary Budapest SE	127 %	Finland Helsinki SE	35 %
1995 Israel Mishtanim 100	15 %	Switzerland SBC	38 %
1994 Brazil Bovespa	59 %	Finland Helsinki SE	42 %
1993 Poland Warsaw General	784 %	Hong Kong Hang Seng	116 %
1992 China Shanghai Composite	147 %	Hong Kong Hang Seng	29 %

Source: Merrill Lynch, September 1997.

Exhibit 8: Comparison of Market Capitalization

World Stock Market Capitalization	$21,731.8 billion
Total Emerging Markets Capitalization	$2,576.3 billion (12 %)
Emerging Asia	$1,405.2 billion
Emerging Latin America	$581.3 billion
Emerging Europe/Middle East	$295.8 billion*
Emerging Sub-Saharan Africa	$294.0 billion

**Includes Egypt at $20 billion market cap or 0.77 percent of emerging market capitalization.*
Source: Merrill Lynch, September 1997.

Portfolio investors in the Egyptian market focus on the top 30 companies, which represent 50 percent of market capitalization. These range from a market capitalization of $140 million to $1.1 billion dollars. More importantly, taking the stock market float into consideration would restrict them to focus on only the top 15 companies. This is because the investor's principal concern is liquidity, which ensures entry and exit from the market. It is evident that the Egyptian market has limited choice and needs larger offerings in the utility sector in order to recapture international investor's interest as well as provide market liquidity. This is particularly relevant at this stage of market development since there still is not sufficient depth in the secondary market. Market depth only develops over time when there is sufficient product, when there is broad market participation of a multitude of buyers and sellers, and when a shareholding culture is established. As for interest rates, domestic rates in Egypt have been declining for several years and inflation rates are declining. Declining rates also drive investors to the stock market looking for higher returns in equities rather than deposits and fixed income securities.

The Egyptian market was also compared with other markets in the region; namely, Morocco, Turkey, Jordan, Oman, Lebanon and Tunisia. Exhibit 9 compares the largest market capitalization stocks. On one hand, Morocco, Turkey, and Jordan have companies with a higher market capitalization than Egypt. This is despite the fact that total market capitalization for both Jordan and Morocco is smaller than Egypt. This is because Egypt has a broader stock market in terms of the number of listed companies, but they are not large capitalization stocks. On the other hand, Oman, Lebanon, and Tunisia are smaller markets in terms of both market size and number of companies and sectoral choice. Once utilities such as the telecom and the electric companies are privatized, Egypt will then have a large number of capitalization issues and will be able to offer a broad choice of companies for investors.

Domestic Investors. Domestic fund managers face the same asset/liquidity constraints as international investors in diversifying and building up their portfolio. Open-end funds have to monitor their liquidity and cannot stray too far from the top 30 companies when developing their funds. The domestic market is comprised of retail and institutional investors; the latter consisting primarily of closed-end and open-end funds and, to a lesser extent, banks and insurance companies. In 1997, the domestic market represented 67 percent of the trading volume, the balance being taken up by international investors.

Exhibit 9. Comparison of Top 15 Market Capitalizations for Selected MENA Countries

Turkey	Market Cap. (Million US$)	**Morocco**	Market Cap. (Million US$)	**Egypt**	Market Cap. (Million US$)	**Jordan**	Market Cap. (Million US$)	**Oman**	Market Cap. (Million US$)	**Beirut***	Market Cap.	**Tunisia**	Market Cap.
Turkiye Isbank A	7,514	ONA Holding Co.	2,081	Suez Cement	902	Arab Bank	2,376	Oman Int'l. Bank	529	Solidere A	1,346	Tunis Air	230
Turkiye Isbank C	5,479	BCM Bank	1,347	Abu Keir Fertilizers	896	Arab Potash	670	National Bank of Oman	519	Solidere B	772	BIAT	171
Tupras	4,108	BMCE Bank	1,091	Egyptian Aluminum	780	Housing Bank	384	Commercial Bank of Oman	393	Baque Audi	392	Banque de Tunisie	159
Akbank	3,999	SNI Holding Co	1,069	Commercial Int'l. Bank	742	Jordan Cement	173	Bank Muscat Ahli Oman	357	Societè des Ciments Lib.	205	UBCI	152
Koc Holding	3,076	Brasseries du Maroc	954	Egypt Gas	574	Jordan Phosphate	150	Oman National Holding	272	Banque Libannaise de Com.	170	STB	148
Turkiye Isbank B	2,905	Samir Refineries	816	Misr International Bank	536	Jordan National Bank	97	Oman Cement	269	Bank of Beirut	168	BNA	135
Turk Hava Yollari	2,653	Lafarge Ciments	813	Heliopolis Housing	499	Jordan Petrol Refineries	96	Oman Flour Mills	229	Eternit	10	Banque de Sud	135
Yapi Kredi Banka	2,590	Wafa Bank	736	Eastern Tobacco	474	Cairo Amman Bank	65	Ominvest	216	Societè Lib. De Ciment B.	7	Banque de l'Habitat	121
Petrol Ofisi	1,792	Lesieur	557	Alex. Iron & Steel	444	Jordan Hotel & Tour.	64	Oman EM Inv. Hold. (OM)	204	Societè Lib. De Ciment N.	7	Arab Tunisian Bank	111
Garanti Bankasi	1,731	Ciments du Maroc	524	National Cement	402	Arab Int'l. Hotel	63	Oman EM Inv. Hold. (EM)	204	Uniceramic Co.	6	Amen Bank	85
Petkim Petrokim	1,553	Centrale Laitiere	498	Nasr City for Housing	391	Arab Pharmaceuticals	61	Shell Oman Marketing	184			BTEI	83
Cukurova Elektrik	1,393	Cior Cements	467	Helwan Cement	376	Arab Int'l. for Investment	57	Al Ahlia Portfolio Secur.	174			SFBT	79
Arcelik	972	CDM Bank	424	Misr Exterior Bank	352	Industrial Dev. Bank	53	United Power	165			Union Int'l. de Banque (UIB)	68
Eregli Demir	930	BMCI Bank	346	Ameriyah Cement	342	Arab Jordan Inv. Bank	52	Dhofar Int'l. Development	139			Societè Chimique Alkima	62
Turkiye Sise Com	748	CIH Bank	322	Al-Ahram Beverages	296	Arab Banking Corp.	50	Oman Inv. & Finance	127			SNMVT-Monoprix	45
Total	**$41,443**		**$12,047**		**$8,006**		**$4,412**		**$3,983**		**$3,082**		**$1,786**
Exchange Rate	$1=265,690 TL		$1= 9.7862 MD		$1=3.42 LE		$1=0.771 JD		$1=0.385 RO		$1=1,510.6LL		$1=1.1655TD

**Beirut Stock Exchange has only 10 listed companies.*

Source: MEED Money, 1 July 1998.

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Retail demand for the past three years has been primarily through participation in new offerings, and for a period of time it was a sellers' market. Subscribers would oversubscribe their demand in issues and trade those in the secondary market. The stated government goal was to create a broad base of shareholders, which was achieved through the sale of a number of tranches in several issues. This methodology created a market which is primarily retail oriented with numerous odd-lot holdings. It also led to secondary market trading that is dominated by odd-lot trades at 66 percent of trading volume, with mutual funds, banks and foreign investors taking up the balance.

In the past six months, the quality of issues in the primary market has declined and investors' appetites are declining, since they became more discerning in their demand. The rigidity in the sellers' pricing terms and conditions did not help the primary market, and issues were not withdrawn in the face of lackluster demand for the offerings. Thus it has become important to assess the supply of offerings, control their timing and adopt a more market-responsive approach to selling securities to both domestic and international investors.

Another interesting comparison that shows the changing climate among domestic investors is between the offerings of Misr Aluminum and MobiNil issues. These two issues were offered to investors in the domestic market during the same week in 1998. Although they were both offered in the same market, investors clearly discerned the attractive prospect of the cellular phone company. The aluminum issue was expensively priced at 14X earnings, while the MobiNil issue was reasonably priced and, accordingly, heavily oversubscribed. It is now the most actively traded share on the Cairo and Alexandria Stock Exchanges. This case shows that buyers are becoming more discerning in their appetite for new issues and that demand is present for growth companies.

The Supply of Shares through Offerings

The secondary market on stock exchanges is supplied with new products through new issues, which are the lifeline of the market. A liquid secondary market also allows buyers and sellers to interact. For the past three years, the Egyptian market was fed with issues following corporate privatization and these were particularly successful from May 1996 to 1997. These issues were placed primarily with individuals, and the allotment policy led to the creation of numerous odd lots and a diffusion of ownership. Allotment to institutions and funds was in some cases seen as small relative to demand. In many cases, this would lead these institutions to sell, thus taking a short-term investment view, or if feasible, to accumulate a position from the secondary market.

There have also been a number of private placements, primarily capital increases, sold to international institutions and clients of high net worth. These issues were oversubscribed, and the offering process reflected the marketing effort. There was a more extensive pre-selling effort, more disclosure documentation, a 3 percent placement fee and greater flexibility in applying an allotment policy. This is a positive development showing that the private sector is now using the capital market to raise capital. It is anticipated that other private sector companies will also begin using the market as a venue for raising capital in the future.

In 1998, the quality of supply of such issues deteriorated, and it seems that issuers strayed from fundamental analysis in assessing market demand and evaluation of the companies on offer. A simplistic approach was taken emphasizing a benchmark PE multiple of 10X to companies on offer. This is despite the fact that an examination of the secondary market indicates a significant difference in the PE multiples applied to different sectors. Exhibit 10 shows the current PE as of July 2, 1998 for different market sectors.

Exhibit 10. Comparison of Sector Price Earnings for the Egyptian Stock Market

Sector	***PE Multiple***
Agriculture	5.5X
Building Materials	9.5X
Cement	10.1X
Distributors	8.5X
Engineering	9.4X
Food and Beverage	10.7X
Financing	9.1X
Housing	13.7X
Mills	4.6X
Paper	10X
Pharmaceuticals	10.7X
Support	5.5X
Textiles	11.9X
Transport	6.5X
Tourism	14.1X
Market Average	9.4X

Source: Cairo and Alexandria Stock Exchanges, *Daily Bulletin*, June 1998.

Clearly, there are significant differences between the various sectors, and therefore the new pricing benchmark of PE 8X in share offerings is an over simplified approach that ignores the general fundamental conditions in specific industries. A review of the stock market indices also clearly demonstrates the disparity in their price behavior when we compare the Egyptian IFC index with the broader Capital Market Authority Index.*(See Exhibit 11)* The exchange is currently developing a more representative index for the stock market.

Fundamental analysis of companies on offer should focus on a company's earning growth prospects, its competitive position including ease of entry in the industry, its ability to react and grow in the future without subsidies or public sector support, and improvements in its unit cost of production. The focus in disclosure documents should be on future cash flows and not on historical performance. In addition, with tariff protection gradually dwindling under the GATT, companies will have to prove that they can survive in a competitive environment.

Exhibit 11. CMA and IFC Price Indices for January 1996 – June 1998

Source: CMA and IFC.

Pricing Shares in the Egyptian Market

Privatization has been the driving force behind the Egyptian market over the past four years. This has supplied the market with a variety of financial shares. Issues were offered to investors in the domestic market and initially all issues were oversubscribed by the public retail demand. In recent months, buyers have abstained from purchasing stocks from the primary market on the basis that offering prices were relatively high and some of the sectors on offer had weak fundamentals. Other factors, such as the Asian crisis, also contributed to the malaise. Investors' hesitancy prompted a review of the offering methodology and resulted in the current preference for the book-building method with underwriting to determine the fair market pricing of the issue.

In the Egyptian secondary market, the automated trades are conducted by price and time priority where the orders are queued and buy-and-sell orders matched for an order-driven market. No quote-driven market currently exists, and this would require several market makers in Egyptian securities. Automated, order-driven systems are transparent and have been proven in many markets; however, this transparency is achieved, to some extent, at the expense of the liquidity that is obtained in price-driven or quote-driven markets.

Market Capitalization and Liquidity in the Egyptian Market

It is important to examine market liquidity because it is of primary concern to both domestic and international institutional investors. Investors focus on liquidity and capitalization in order to ensure that they can invest in a unit size that will have an impact on their portfolios' performance. Typically, any single investment position would represent 3 to 5 percent of the portfolio. Based on this assumption, and maintaining a 20 percent cash/deposits equivalent liquidity, a portfolio should have a maximum of 25 companies. Investors are also concerned about the volume and value traded per day in a company — a measure of liquidity — in addition to the number of transactions, frequency and speed of transaction and bid-offer spreads. A fund manager assess the size of funds and the risk diversification allowed by the market.

The Top 20 Market Capitalizations

An examination of the top 20 Egyptian market capitalization stocks in July 1998 shows that market capitalization varied between $174 million and $880 million at a time when average market PE is 9.6X.*(See Exhibit 12)* Five of the top 20 capitalization stocks have issued GDRs.

Exhibit 12. Top 20 Market Capitalizations on the Egyptian Stock Market

Company	*Market Capitalization (LE)*	*Operating Revenue (thousand LE)*	*Net Profit (thousand LE)*	*Shareholders' Equity (thousand LE)*
Abu Keir Fertilizers	2,991,333,764	613,576	217,583	700,574
Suez Cement	2,898,960,265	519,298	232,000	402,021
Commercial International Bank (CIB)	1,860,500,000	482,801	267,559	1,201,034
Misr International Bank	1,751,850,000	321,147	189,879	554,364
Heliopolis for Housing & Construction	1,691,107,920	141,174	84,435	63,996
Eastern Company for Tobacco	1,582,750,000	1,480,398	150,967	598,438
Canal Shipping Agencies	1,389,966,400	274,105	206,281	535,877
National Cement	1,376,000,000	400,571	40,690	144,935
Nasr City forHousing	1,316,160,000	129,115	115,046	91,437
Misr Exterior Bank	1,204,500,000	168,832	66,250	262,131
Ameriyah Cement	1,152,800,000	391,262	166,658	197,542
Alexandria Iron & Steel	1,063,930,000	1,384,481	120,784	896,620
Al Ahram Beverages	1,012,500,000	149,152	53,913	135,043
Paint and Chemical Industries (PACHIN)	987,600,000	285,123	104,934	303,913
National Societè Generale Bank	963,150,000	158,319	79,038	250,451
Egyptian Int'l. Pharmaceuticals (EPICO)	950,586,000	305,514	75,822	180,116
Oriental Weavers	945,000,000	337,389	72,141	270,622
Egyptian American Bank	766,800,000	169,100	95,077	395,881
Helwan Portland Cement	669,599,618	923,259	241,979	237,174
Export Development Bank of Egypt	593,325,000	67,224	47,295	459,279
Average 20 companies	***1,358,420,948***	***435,092***	***131,417***	***394,072***

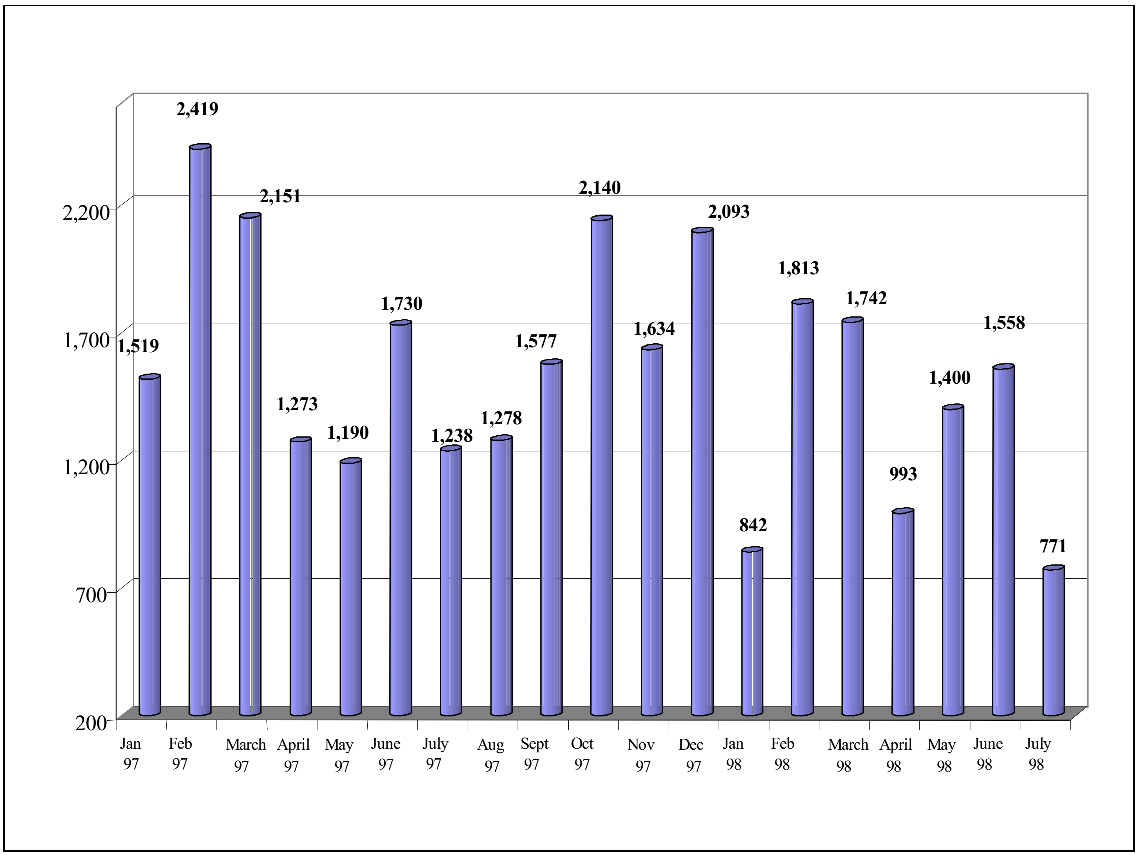
Source: Cairo and Alexandria Stock Exchanges, Research Department.

Exhibit 9 compares the top company shares for Turkey, Morocco, Egypt, Jordan, Oman, Lebanon, and Tunisia. Some of the markets, such as Morocco, Jordan and Turkey offer portfolio investors more diverse choices among large companies. The Moroccan exchange lists five companies with a market capitalization above $1 billion; Jordan has one bank listed above $2 billion. In comparison, the Egyptian market needs larger issues with a significant public float.

An Examination of Egyptian Stock Market Liquidity

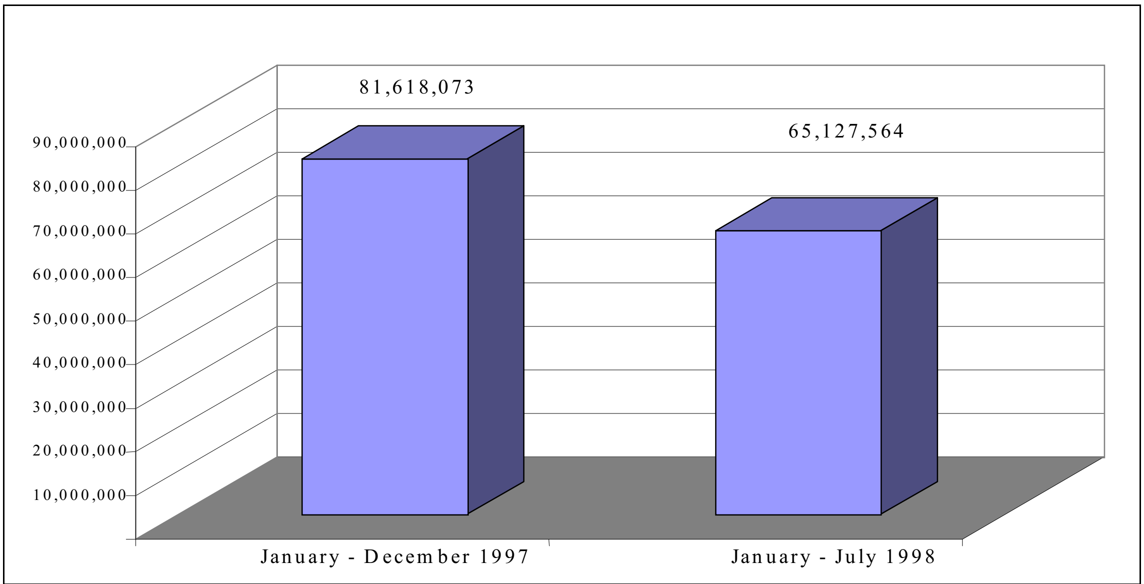
Exhibit 13.1 highlights the decline in value traded in the Egyptian market. The troughs shown in the graph indicate the decrease in the value traded per day. This decline is due to fewer primary issues in 1998. In fact, several sessions during June and July 1998 witnessed a traded value as low as LE30 million. This is also evident in Exhibit 13.2 which indicated the value traded per day during the twelve month period ending in December 1997 and the seven month period ending in July 1998. Accordingly, the primary market will continue to have a profound impact on the volume and value traded until liquidity in the secondary market improves.

Exhibit 13.1. Monthly Traded Value from January 1997 through July 1998.



Source: Cairo and Alexandria Stock Exchange, Research Department.

Exhibit 13.2. Average Traded Value Per Day



Source: Cairo and Alexandria Stock Exchange, Research Department.

For the period January to July 1998, Exhibits 14 and 15 show the liquidity ratios for the top 20 stocks traded in terms of value and volume. Based on these figures, it is worth noting that 55.9 percent of total value traded is represented by 20 companies of which 16 percent is in recent new issues, 12.8 percent in banks and 10.5 percent in cement stocks. These 20 companies represent 59.2 percent of the total volume traded of which 25.2 percent is in new issues and 10.7 percent in banks. It is obvious from these statistics that new issues and banks were the two principal factors affecting the value of trade (30 percent) and the volume of trade (36 percent) in the first six months of 1998.

A number of the actively traded stocks are not among the large capitalization stocks since in some cases the holding companies still have a holding that will be divested. The GDRs are represented in terms of value (four issues) and volume (three company issues) among the active 20 companies. Banking stocks are well represented in the active list with CIB, Misr International Bank and Societè Generale accounting for 12.8 percent of traded value. These were also active due to various interpretations of the new tax law regarding the treatment of double tax exemptions.

Two cases offered in the primary market in the same week are also represented. The first, Misr Aluminum, was the second most actively traded stock in terms of value (6.3 percent) and the third most active in terms of volume of shares (5.1 percent). The issue was placed at a high price in the primary market and showed a weak performance in the secondary market. The second case, the MobiNil issue, was well received in the primary market and is the second most actively traded stock in terms of volume (5.6 percent). In terms of value, it has not traded above par value, but in the over the counter (OTC) market it was traded at a gray market price double par value, which would then have placed it among the most active in terms of value traded. Almost 20 percent of traded volume was in CIB, Misr Aluminum and MobiNil issues. The cement sector was also well represented by Helwan, Suez, Ameriyah and Torrah companies, representing a total of 8.9 percent of total traded volume in the six month period.

Exhibit 14. Liquidity Indicators for Top 20 Companies According to Value (Jan. 1, 1998 – June 30, 1998)

Company	*Trading Value (LE)*	*Total Market Trade (%)*	*Market Capitalization (LE)*	*Market Capitalization (%)*	*Average Trade/Day* (LE)*
Commercial Int'l. Bank (CIB)	726,907,964	8.9	1,876,000,000	38.75	4,038,378
Misr for Aluminum	514,263,750	6.3	2,759,600,000	18.64	2,857,021
Helwan Cement	331,298,424	4.1	668,816,308	49.54	1,840,547
Misr Gas	275,026,945	3.4	196,800,000	139.75	1,527,927
Industrial & Engineering Projects	266,809,424	3.3	318,180,000	83.85	1,482,275
Nasr City for Housing	223,930,033	2.7	1,184,800,000	18.90	1,244,056
Ameriyah Cement	202,176,545	2.5	1,169,000,000	17.29	1,123,203
Misr International Bank	195,380,467	2.4	1,800,000,000	10.85	1,085,447
Egyptian Financial and Industrial	194,624,737	2.4	456,286,276	42.65	1,081,249
Egyptian for Int'l. Tourism Proj.	181,574,435	2.2	226,800,000	80.06	1,008,747
Delta Industrial	174,800,892	2.1	513,700,000	34.03	971,116
Suez Cement	162,720,971	2.0	2,886,362,176	5.64	904,005
Upper Egypt Mills	156,062,648	1.9	318,640,000	48.98	867,015
Oriental Weavers	155,950,419	1.9	943,650,000	16.53	866,391
Portland Torrah Cement	153,822,446	1.9	4,746,256,600	32.41	854,569
Egyptian Int'l. for Medicine	149,731,000	1.8	915,582,000	16.35	831,839
Paint and Chemical Industries	140,026,596	1.7	958,900,000	14.60	777,926
Middle and West Delta Mills	125,801,511	1.5	318,750,000	39.47	698,897
National Societè Generale Bank	125,292,257	1.5	942,300,000	13.30	696,068
El Mahmoudia for Construction	117,676,201	1.4	59,080,000	199.18	653,757
Total		***55.9***			

** Based on 180 days.*
Source: Cairo and Alexandria Stock Exchanges, Research Department.

Exhibit 15. Liquidity Indicators for Top 20 Companies According to Volume of Trade (Jan. 1, 1998 – June 30, 1998)

Company	*Trading Volume (LE)*	*Total Market Trade (%)*	*Market Capitalization (LE)*	*Market Capitalization (%)*	*Average Trade/Day (LE)**
Commercial Int'l. Bank (CIB)	13,035,693	9.2	1,876,000,000	0.69	72,421
MobiNil	7,896,260	5.6	343,200,000	2.30	43,868
Misr for Aluminum	7,221,942	5.1	2,759,600,000	0.26	40,122
Egyptian for Int'l. Tourism Projects	6,264,550	4.4	226,800,000	2.76	34,803
Bisco Misr	5,544,650	3.9	162,150,000	3.42	30,804
Helwan Cement	4,925,745	3.5	668,816,308	0.74	27,365
Egyptian Financial and Industrial	4,506,791	3.2	318,180,000	1.42	25,038
Olympic Group	3,901,386	2.7	433,125,000	0.90	21,674
El Mahmoudia for Construction	3,390,188	2.4	59,080,000	5.74	18,834
Ameriyah Cement	2,992,392	2.1	1,169,000,000	0.26	16,624
Upper Egypt Mills	2,854,684	2.0	318,640,000	0.90	15,859
El Nasr for Civil Works	2,849,035	2.0	137,800,000	2.07	15,828
Delta Industrial	2,615,069	1.8	513,700,000	0.51	14,528
Arab, United & Bolivara for Spinning	2,436,738	1.7	96,055,360	2.54	13,537
Suez Cement	2,365,143	1.7	2,886,362,176	0.08	13,140
Alexandria Spinning & Weaving	2,361,607	1.7	138,875,137	1.70	13,120
Middle and West Delta Mills	2,264,442	1.6	318,750,000	0.71	12,580
Portland Torrah Cement	225,409	1.6	474,625,660	0.47	12,363
Misr International Bank	2,202,861	1.5	1,800,000,000	0.12	12,238
Oriental Weavers	2,142,113	1.5	943,650,000	0.23	11,901
Total		***59.2***			

** Based on 180 days.*
Source: Cairo and Alexandria Stock Exchanges, Research Department.

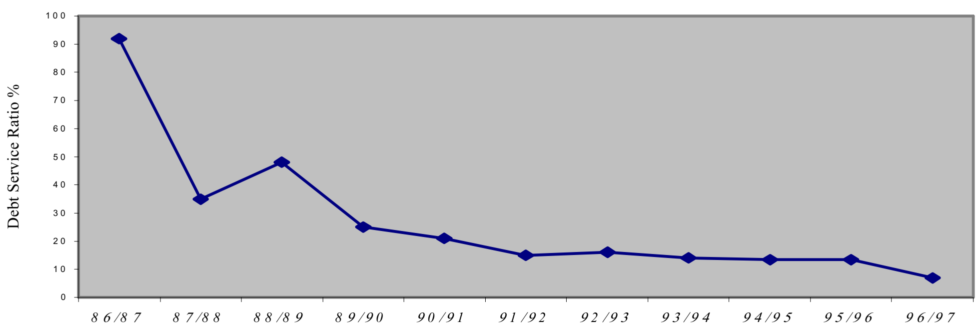
Finally, in the first six months of 1998, liquidity of the Egyptian market was dominated by the primary market, as reflected in the traded value of issues in Misr Aluminum, Egypt Gas, Egypt Tourism Company, MobiNil, and El Mahmoudia Contracting Company. A look at the demand for these issues indicates that marketing to foreign demand was not part of the primary promotion strategy. The emphasis was rather on seeking retail demand.

In general, market capitalization must be broadened, and the primary market should focus on larger issues that will attract both domestic and foreign institutional interest in Egypt's market alongside retail interest. The secondary market is initially affected by the financial securities that have been placed in new issues. This is because in the life of a company the most active trading takes place in the first 18 months after pricing until the shares are in portfolios. Furthermore, offering new, quality, sizeable offerings is essential to reverse the trend of declining secondary market liquidity.

The Case for Developing the Debt Market

Another significant achievement that should attract investors to the Egyptian market is the significant progress made in reducing debt and managing the macroeconomy. Egypt can use attractive terms in tapping the international market, but this requires introducing debt instruments of various maturities in the international market. Exhibits 16 and 17, showing Egypt's debt service ratio and the foreign debt as a percentage of GDP, highlight the strong fundamentals of the economy. Reserves of $21 billion measured against external debt of $27.8 billion, with a present value of $18 billion, imply that Egypt has a net credit position.

Exhibit 16. Egypt's Debt Service Ratio



Source: The Ministry of Economy.

Exhibit 17. Egypt's Foreign Debt as a Percentage of GDP

Source: The Ministry of Economy.

This strong debt position should be used to finance future growth in the economy, fund large infrastructure projects, and focus on the Egyptian service sector. Government agencies can therefore use the Egyptian government's terms as benchmarks enabling them to fund their projects via debt issues rather than bank loans. Typically, bond markets require benchmarks as a guideline to price other fixed income instruments. For example, in the United States, T-bills and medium- and long-term bonds are used as benchmarks and corporate bonds are priced by comparing them with government bonds in terms of yield. Government bonds are seen as reflecting sovereign risk and the highest quality of credit risk. Private sector financing of infrastructure projects and government agencies can use these bond issues as benchmarks and ratings against which they evaluate other types of fixed income risk. Furthermore, it is necessary to set up a secondary market, which requires a transparent and dedicated electronic screen network between dealers.

Formulating the Capital Market Plan

The following table, from John Train's *The Craft of Investing*, outlines and summarizes the key ingredients that are typically of interest to emerging market investors and should be used as a guideline in developing the capital market in Egypt.

Strategic Requirements

1. An active stock market.
2. A convertible currency.
3. Political stability with a commitment to free enterprise and minimal regulation.

Tactical Requirements

1. Country must be improving more than is realized.
2. Interest rates should be declining.
3. General valuations should be attractive.
4. There should be slack industry capacity utilization.

Specific Company Requirements

1. The market capitalization per ton, or of whatever capacity, should be attractive compared to similar countries.
2. The direction of the company's balance sheet should be favorable, particularly with regards to cash.
3. The company's stock should be relatively strong, and it may be safer to buy when a stock is gaining favor in its market.

The Egyptian market scores high on a number of these points, particularly with regards to the tactical requirements. In terms of the specific company requirements, if implemented, the planned second stage of privatization should fulfill a number of these requirements. Large telecommunications and electric utility issues will capture investor interest. Local pensions should begin participating in equities in order to coincide with the major privatization of these utilities. Given the low debt scenario, a policy for issuing government securities on a regular basis, regardless of budgetary needs, should be adopted for setting benchmarks and creating a yield curve.

On the macro level, the policies being implemented should foster economic growth focusing on competitive advantage. This will also have positive impact on the growth of the Egyptian capital market.

A Short-term Action Plan

Based on this analysis thus far, the following steps are recommended in order to revive market activity:

- Capture investors' attention at a time when Egypt does not have any companies featured among the top 200 emerging companies. A rise in PE ratios and an offering of the telecom issue would do this.
- Issue additional GDR offerings, such as Ameriyah Cement.
- Capitalize on the strong macroeconomic fundamentals with particular emphasis on Egypt's strong debt position and issue fixed income securities on the international market through a regular program.
- Expand market breadth by introducing the telecom and electricity companies to the market; however, the supply of issues has to be controlled and issues prioritized. At the moment, the market requires quality issues.
- Increase domestic market depth to include pension funds, mutual funds and insurance companies.
- Aggressively market Egypt with international investors to engender growth in the economy and encourage direct investments. The market needs more research that is sponsored by international firms.
- Controlling mutual fund redemptions that instigate further selling in a weak market. In the absence of bank credit facilities to temporarily alleviate the pressure on forced selling, the market will continue to face supply of additional stock. Credit lines should be instituted to reduce this supply. This is a short-term measure but will have a net positive effect.
- The Egyptian market, if included in the Morgan Stanley investible index, will also attract fund manager's interest. This will have a net positive effect in portfolio flows.

III. Formulating a Long -term Capital Market Plan

While a short-term plan for the capital market will address the current 'buyers' strike', a long-term plan is essential to ensure growth through the efficient use of the capital market. First, this plan should seek to deepen the foundations of the capital market to engender economic growth which requires improving the market infrastructure, human resources, and regulatory development. Second, a long-term objective should be to establish Cairo as a financial center for the Middle East and Africa by focusing on the service industries. Third, creating a shareholder's culture and fostering an active secondary market are essential for long-term capital market development.

Engendering Economic Growth

The Egyptian economy must ensure its long-term growth through the efficient use of the capital market. The principal role of the capital market is to make savings more readily available to investors by creating liquidity. To date, pension funds and insurance companies are mainly investing in government securities and bank deposits. Collective investment schemes in the form of mutual funds are relatively new; therefore, the equity market has been primarily a retail market.

A liquid capital market also attracts private international savings and gives foreign direct investors exit options, thus encouraging direct and portfolio investments. The privatization process and capital market are mutually reinforcing; while privatization increases the supply of securities providing the market with depth, the growth of the capital market enables more offerings to be absorbed in the domestic market. Recently, private sector companies tapped the capital market, and if the privatization program is implemented for utility companies, the market will indeed achieve greater depth and breadth. This will be reflected in increased market capitalization to GDP and less concentration on a handful of stocks — currently 30 stocks represent 50 percent of market capitalization. In order to broaden the market — the domestic base of market participation — a concerted public awareness program should be launched. More funds are also required in the market, and the long-term savings institutions should participate by investing in funds in addition to direct investments.

Building Foundations

To establish a successful capital market, policy makers have to continue to develop its principal foundations: regulation, human resources, and a market microstructure.

Developing the Regulatory Framework

A June 1998 study by the *Economist* on financial centers indicated that having a strong regulatory framework focusing on the protection of retail and wholesale investors is one of the primary reasons why some cities succeed in becoming international financial centers. In Egypt's case, regulatory efforts should be focused on: observing the standards of disclosure in the documentation of offerings and the periodic announcements of any material events; insider dealing measures; relatedparty transactions; corporate governance; shareholder minority rights; and takeover regulations.

In many emerging markets, regulation is implemented sequentially: first, changing the laws; second, preparing the sales; and third, enforcing the regulations. As the government pulls out of certain sectors, it does not establish a strong regulatory organization to monitor private sector activities and thus falters in the enforcement of the regulatory process. This was the case with the Mexican banking crisis and the crisis in Thailand and Indonesia. In many cases, the problems in emerging markets would have been avoided if the focus was on who was buying the companies rather than on the prices being paid, and more vigilance was given to the behavior of the privatized company after the sales.

Developing a Master Plan for Human Resources

A large percentage of the Egyptian economy is in the service sector, with the remaining balance split between manufacturing and agriculture. Human skills development in the service sector will enable Cairo to establish itself as a world class service center. Areas of emphasis should include tourism, transportation, shipping, insurance, finance, software, accounting, banking, consultancy, contracting and legal services. Developing these service industries will create job opportunities for university graduates and establish Cairo as a financial and service center for the Middle East and Africa. Ultimately, developing services for export could narrow Egypt's trade deficit.

Market Microstructure

Market microstructure has a direct impact on the four fundamental market attributes: liquidity, efficiency, trading costs and volatility. The type of trading system, the way transactions are handled and how information, such as corporate developments, is broadcast to market participants all influence the fundamental workings of the market. Because liquid and efficient markets will be less volatile than illiquid and inefficient markets, the market microstructure should be developed for the maximum benefit of the market. Circuit breakers and mechanisms are incorporated in trading systems and impact liquidity, which implies that tradeoffs need to be analyzed.

Developing the market's infrastructure requires installing systems for trading and surveillance infrastructure, clearing, settlement, central depository and payment, as well as communication networks. Egypt has a unique opportunity to leapfrog many markets whose historical structure now acts as an impediment to progress. One of the key areas is that of communication network and its impact on the service sector.

In the Egyptian capital market, the Stock Exchange is undergoing a modernization program of the trading, clearing, settlement and payment systems. A program is currently being studied to include order routing and collection, back-office solutions for the market, and news dissemination systems using satellite broadcasting in order to foster public awareness and broaden the domestic market base. The chart herein shows the role of information technology in the overall process of executing an order.*(See Exhibit 18)* In addition, Exhibit 19 demonstrates how news dissemination using high speed digital lines and satellite broadcasting can broaden dissemination of stock exchange, trade data feed, and financial information on listed companies.

Establish Cairo as a Financial Center

The Middle East and Africa do not have a viable international financial center. In the early 1970s, Bahrain was active in channeling surplus funds and was vying to become such a center. The focus in Bahrain, at the time, on commercial banking activity was successfully implemented. This effort did not, however, include capital markets, as was the case in other parts of the world where privatization in emerging markets fueled the development of stock exchanges and secondary market activity.

Developments that occurred in the 1990s, such as the Gulf War, the waning influence of OPEC, and the development of capital markets, caused the economies of the Middle East and North Africa to be viewed as emerging markets at different stages of development. Egypt has been successful in its macroeconomic program and the privatization effort. This led to the growth of the capital market and made it a viable objective for Egypt to become the leading market in the region. Achieving this goal requires developing a master plan for Cairo to maximize its geographic advantage to become the financial center of the region. This master plan must focus on developing an international offshore service zone in Cairo targeting multinational corporations, international banks, software companies, insurance companies, and law and accounting firms. This offshore zone will complement the growth of the domestic market and help in achieving the prerequisites for a developed capital market; namely, a sound regulatory framework, quality human resources, and state-of-the-art infrastructure.

A May 9, 1998 survey conducted by the *Economist* identifies the principal trends and factors affecting financial centers. These can be briefly summarized as:

Principal Trends for Financial Centers

- Traders do not need to go to markets anymore because computer networks can take markets to traders.
- Certain types of activities have become commoditized and now seek lower cost locations; hence, the growth of offshore centers.
- Headquarter activities and skilled employees will continue to cluster in financial centers regardless of national boundaries.

Future Prospects for Financial Centers

- A single European currency will create new financial markets in Europe.
- To make financial centers more competitive, financial markets, such as Japan, are being deregulated.
- Technology is affecting the way centers compete.
- The growing volume of capital is looking for locales with low-cost, high-quality skills and/or minimal regulation; hence, rapid growth of offshore financial centers.
- These centers focus on three time zones: North America, Europe and Asia.

Measurement Standards for a Financial Center

- Size of the domestic market for stocks and bonds.
- Measures of sophistication, such as market size to GDP and the presence of a future market.
- Other measures, such as the foreign exchange market, size of international bank lending, advice on cross-border mergers and acquisitions also determine the success of a center.
- For most of the financial centers, domestic market strength is playing a diminishing role.

Analysis of Factors

- *Cost*: financial centers are expensive places from which to conduct business.
- *Time zones*: banks typically have branches in three time zones (the United States, Europe and Asia) to allow for 24-hour trading.
- *Information*: risk managers need to be close to the sources of information.
- *Trade rules*: certain rules encourage dispersion, such as the European directive on personal data. This has led to the centralization of operations in three time zones.
- *Securitization*: removes the need for borrowers to be located next to lenders; however, bond lenders need to know their borrowers creditworthiness and a corporation's financial condition. As the EMU becomes a reality, it is anticipated that a broad European bond market will emerge. Asia and Africa also need to develop their bond markets.
- *Technology*: makes distance less of a barrier.
- *Products*: financial products are becoming more global and less local. The industry is being broken down into fields of specialization.
- *Risks*: management needs to have risk analysis centralized in the financial center of each respective zone.
- *Other factors*: large banks and financial firms are merging and promoting cross-selling products in financial markets.

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In terms of the nature of financial centers and world trends, it is useful to examine the success of Dublin as a financial center that was established in 1987 and has managed to attract 400 multinational corporations. The principal attractions for Dublin are cost effectiveness, an attractive tax regime, skilled labor and an investor-friendly environment supported by sound infrastructure. Based on Dublin as a model, both Cairo and Alexandria would therefore have to develop service zones, near the city centers, with modern office facilities, top-notch communication facilities, excellent road access, and parking and open-space requirements for supporting facilities. These facilities should be marketed to international educational institutions and professional bodies and associations in the banking, legal, accountancy, consulting, and insurance fields. The zone should have special legal and administrative status to ensure that zonal laws are respected and quality is maintained. In addition, there should be an attractive tax regime, inviting terms for developers to build such facilities, and various benefits to lessors of office space in order to attract multinational corporations, and banks, to establish themselves in Egypt, as they have in Dublin.

A focus on technology, emphasizing telecommunication and software services, must be part of the plan, so that Egypt can capitalize on its relative advantage in the domain of software services for administration and back-office services. It is noteworthy that firms in New York and London, such as British Telecom, AT&T and British Airways, process their billing and invoices in India and Jamaica. Cairo could take advantage of its geographic location and become the low-cost processing center for multinationals in the Middle East and Africa, perhaps exporting services internationally.*(See Annex, pp. 34-35)*

Because other cities in the Middle East region are vying for the role of regional financial center, it is necessary to begin this project as soon as possible. The current project to relocate the stock exchange to the Citadel area could be the nucleus of a plan to develop a financial zone.

The Structure of Financial Centers

Two strategies are being implemented by financial institutions in financial centers. First, the 'Hub and Spoke' strategy divides activities between the central hub — where strategic planning, project management, product development and risk management is conducted — and the spoke areas beyond, which are used for sales, marketing and customer relations. Second, the cost analysis strategy is being used to locate business activities with administrative tasks, such as the clearing and settling of trades outside financial centers, while other activities, such as offerings, mergers and acquisitions, and fund management, are done in financial centers.

To make Egypt a major financial center, it is necessary to use both strategies in order to benefit from being a 'first mover' to specialize in finance and capture economies of scale. For both strategies, human resources in professional services are required, and centers tend to form where these skills are available. It is essential that a human resources development plan be included in the financial center project.

To ensure the success of an offshore financial zone, it is necessary to focus on:

1) *The Legal Framework:* The financial zone should offer tax breaks, tax holidays and a strong cost advantage.
2) *Marketing:* Promotion in the zone is necessary for financial and educational services and software service companies.
3) *Facilities:* The zone must be equipped with state-of-the-art telecommunication facilities, easy access, and modern building facilities.
4) *Attractive Regulatory Framework*: regulation is increasingly becoming an important factor in attracting firms to emerging financial centers. This is currently evident in the United Kingdom and in the recent moves in Tokyo to deregulate the financial industry. Therefore, steps have to be taken in Egypt to modify corporate law and capital market law regulations in accordance with international standards. Laws should differentiate between wholesale business and retail business. It is evident from the success of certain centers that the commercial laws should strike a balance between regulating business tightly and less so for professional wholesale services. Standards and procedures must also be set for market participants.

According to the previously mentioned *Economist* survey of financial centers, financial centers decline in importance in those markets where regulation has not kept pace with financial developments. It is therefore important to develop the legal framework for Egypt's capital market, as discussed previously. This will constitute one more compelling reason for international institutions to be based in Cairo.

The challenge is to form a deep secondary market base in the domestic Egyptian market. This will ensure long-term success. While in the initial stages of an emerging market the driving force behind growth is the supply of issues from privatization, this does not necessarily ensure sustainability of market activity in the secondary market. Several emerging markets are currently experiencing a severe drop in liquidity due to withdrawal of some foreign investors, particularly in markets where macro fundamentals are weak and liquidity is thin. Liquidity also suffers if privatization has run its course as a driving force and the market fails to achieve enough domestic depth through pension funds, mutual funds and long-term domestic institutions, because markets require a multitude of buyers and sellers forming a wide shareholding base.

In Egypt, mutual funds are not dominant factors which enable the public to participate and all households to have a stake in the market. Egypt currently has only 18 funds in a market with 130,000 unit holders, while Morocco has 44 funds and a greater number of unit holders. By comparison, there are currently 7,000 funds in the US market with 45 percent of all households currently participating in the market. For the first time, the total assets of mutual funds in 1998, amounting to $4.6 trillion globally, are surpassing bank assets. Fifty percent of these funds are in equities. In Europe, the mutual fund revolution is also taking shape with $94 billion entering equity mutual funds in the past six months. While in Europe there are an estimated $1.4 trillion in mutual funds, of which 25 percent is in equities, the development of the EMU currency and the drop in interest rates are fueling mutual fund growth in equities thereby broadening market depth of shareholders. Even in Germany, this culture is now taking hold, and in Japan the market is also adopting transparent standards. For Egypt to join the mutual fund revolution, funds should target retail investors. For example, pension reform, such as contributory retirement savings plans like the American IRA, would lead to the creation of new long-term mutual funds alongside open-ended funds. This is necessary to achieve sustainability and secondary market depth. In the United States, pension reform has led to the fact that a high percentage of the money dedicated to mutual funds is pension money of IRA accounts. Because these are of longer duration and build up the long-term savings that finance growth, they give stability to the market and are not subject to redemption.

Creating market awareness is also essential; however, a fine balance has to be struck in that regard. There are often too many sources of information and too many instant experts on the market giving the public conflicting views. The continuous flow of information will not lead to a market rise. The market will only react to specific actions, and may even react negatively to market information presented irrationally. A period of time is needed to digest the market information at hand and pundits should refrain from making immediate statements to the press. What is needed in Egypt is the implementation of a series of positive steps to change market sentiment and build momentum.

ANNEX:

KEY FACTS ABOUT THE CITY OF LONDON

Source: British Invisibles, "Key Facts About the City of London," April 1998.

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