Monetary Policy and Financial Sector Reform in Egypt:
The Record and the Challenges Ahead

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Abstract

This paper explains how the Egyptian monetary policy during the first half of the 1990s reduced macroeconomic imbalances and achieved economic stabilization. It also evaluates the recent pressures on the external position and the policy responses. On the basis of these findings, the paper identifies the challenges ahead, and takes a cursory look at ongoing efforts to revamp the instruments of monetary policy and modernize the institutional framework of the financial system.

ملخص

تتناول هذه الدراسة كيف أمكن للسياسة النقدية المتبعة خلال النصف الأول من التسعينات أن تقلل من الإختلالات الكلية فى الاقتصاد المصرى وتحقيق الاستقرار الاقتصادى، كما تبحث الضغوط التى تعرض لها الوضع الخارجى والسياسات التى إتخذت لمواجهتها. وبناء على ما تم التوصل إليه، تحدد الورقة التحديات المستقبلية، كما تلقى الضوء على الجهود المبذولة حالياً من اجل تدعيم أدوات السياسة النقدية وتحديث الإطار المؤسسى للنظام المالى.

I. Introduction

This paper seeks to present Egypt's recent record in the area of monetary policy and financial sector reform and to outline the challenges ahead. The study begins by discussing the role of monetary policies during the first half of the 1990s when Egypt made impressive progress in reducing macroeconomic imbalances and achieving stabilization. The second part then focuses on the sources and consequences of the recent pressures on the external position and the policy responses. Finally, the paper seeks to identify the challenges ahead and takes a cursory look at ongoing efforts to revamp the instruments of monetary policy and modernize the institutional framework of the financial system over the medium term.

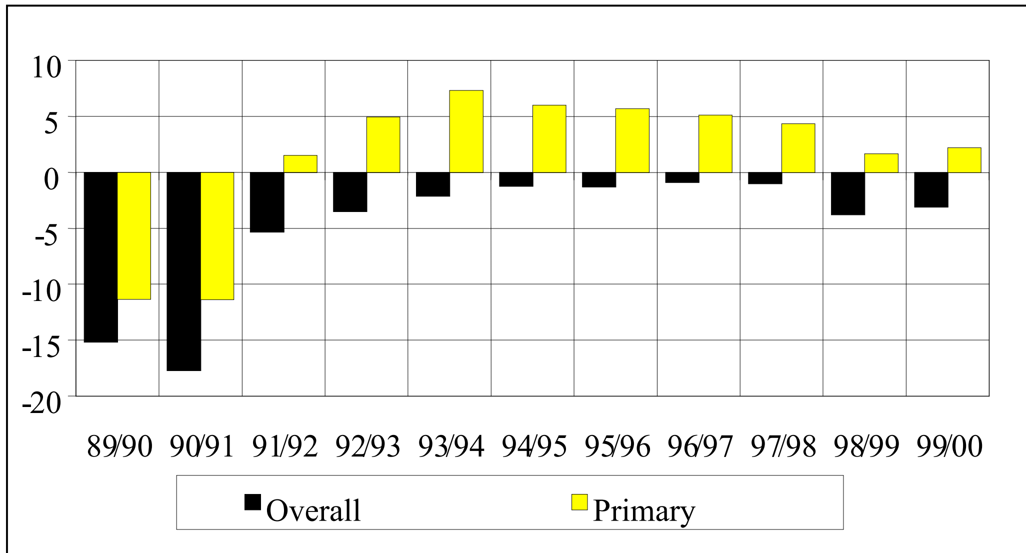
II. Monetary Policy in the Context of Stabilization 1991/92 - 1996/97

Egypt's efforts to achieve stabilization in the early 1990s proved to be remarkably successful. Central to the process were three critical elements: a massive fiscal adjustment; the liberalization and unification of the exchange system, including the adoption of an exchange rate anchor; and a supportive monetary policy, comprising quantified targets in the context of successive financial programs. This strategy brought about a significant reduction in inflation and a fundamental improvement in the external position thereby laying a firm foundation for higher and sustainable economic growth.

The leading edge of the adjustment strategy was in the area of fiscal policy. Following an up-front fiscal adjustment in 1991/92, the overall fiscal deficit was brought down to 2-3 percent of GDP in the mid 1990s from more than 15 percent of GDP at the turn of the decade (Chart 1). The magnitude of Egypt's fiscal adjustment is remarkable by the standards of other adjusting countries. The reduction in the overall deficit over five years, amounting to 12-13 percent of GDP, ranks among the most impressive such adjustments within the region and elsewhere (see Mackenzie, 1997).

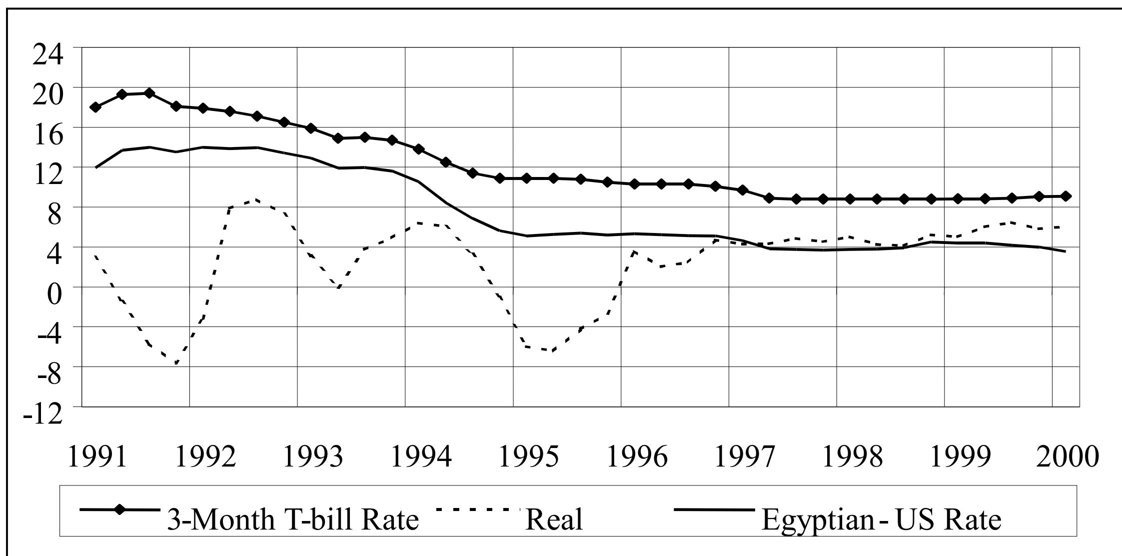
The fiscal adjustment was achieved through an increase in revenues combined with significant expenditure cuts and fiscal restructuring. On the revenue side, key developments included the introduction of the general sales tax (GST) and a boost to oil and Suez Canal revenues coming from the depreciation of the Egyptian pound. Meanwhile, on the expenditure side, the authorities made deep cuts in capital investment through a rationalization of the public investment program, and significantly reduced consumer subsidies. Major savings were achieved on external debt servicing following the Paris Club agreement of 1991 while the burden of servicing domestic debt eased with the decline in interest rates (Chart 2 and Table 1).

Chart 1. Fiscal Balances (% of GDP)



Source: Central Bank of Egypt and IIF estimates.

Chart 2. Interest Rates (%)



Source: Central Bank of Egypt and IIF estimates.

Table 1. Monetary and Income Indicators (annual % change)

	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00
T-bill Rate (nominal)	19.3	17.6	14.9	12.5	10.9	10.3	8.9	8.82	8.85	9.08
T-bill Rate (real)	4.6	-3.5	3.8	3.4	-2.4	-0.4	2.8	4.7	5.1	6.3
U.S. and LE T-bill Spread	13.7	13.9	11.9	8.5	5.3	5.3	3.8	3.8	4.4	3.5
Real GDP Growth	4.1	1.9	2.5	3.9	4.6	5.1	5.9	5.6	6.0	4.4
Inflation	14.7	21.1	11.1	9.1	13.3	10.7	6.1	4.1	3.8	2.8

Source: Central Bank of Egypt, IFS, and IIF estimates.

The fiscal adjustment did not take place in a vacuum. It was supported and facilitated by a reform of the exchange system and the adoption of monetary programming. In February 1991, the exchange rate system was de facto unified and liberalized. At about the same time, important steps were taken toward financial sector reform including the abolition of official controls on interest rates and the introduction of treasury bill auctions. Shortly afterwards, limits on lending to the private and public sectors were eliminated (1992 and 1993 respectively) and monetary policy was implemented within the context of a systematic and comprehensive financial programming framework.

The task for monetary policy was heightened by an upsurge in external capital inflows, a not uncommon event for countries implementing resolute stabilization programs. Over the three years ended June 1994,[1] cumulative capital inflows amounted to almost $5 billion, or about 11 percent of GDP. The potential expansionary impact of the capital inflow on domestic liquidity was largely sterilized through net sales of government securities (mainly t-bills) over and above what would have been needed for fiscal deficit financing during the period. Capital inflows continued (though at a slower pace) in the following three years (i.e. through the period ended June 1997) during which time Egypt attracted a further $2.5 billion, necessitating continued sterilization through issuance of government securities.

These operations entailed a substantial fiscal burden in that the budgetary cost of payment of interest on the domestic government securities used in the sterilization operations greatly exceeded the interest earnings on the increased holdings of foreign assets. Even though domestic interest rates were falling during the six-year period ended June 1997, a substantial positive spread remained in favor of Egyptian pounds: during the period, the spread narrowed from almost 14 percentage points to four (Chart 2). Subramanian has estimated the cumulative fiscal costs of sterilization at about 4 percent of GDP, or an average of 0.6 percent of GDP over the six stabilization years. He also points out that the fiscal cost was even larger if account is taken of the implicit and explicit support provided to the domestic banking system during that time.[2]

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[1] The fiscal year in Egypt runs from July 1 through June 30.
[2] Subramanian (1997).

Such costs, however, need to be weighed against the disadvantages of alternative policy options. For example, if the exchange rate had been allowed to appreciate, the external current account would undoubtedly have suffered, and the additional loss of competitiveness (on top of the already substantial appreciation of the pound in real effective terms)[3] would have been deflationary. Another option would have been to resort to capital controls on inward flows. Such action, however, would have run contrary to the broad thrust of policy —which was to liberalize external transactions and the domestic economy— and would have sent confusing signals to market participants.

In sum, and notwithstanding the fiscal costs, the policy strategy generally worked well. Liquidity growth was kept within bounds, despite the capital inflows, and confidence in the domestic currency was restored; for example, the dollarization ratio (as measured by the share of foreign currency deposits to M2) declined from 53 percent in 1990/91 to 22 percent in 1996/97 (Table 2 and Chart 3). As a result, substantial progress was achieved in reducing inflation and in strengthening the external position (Chart 4). The rate of increase in the consumer price index (CPI) fell from about 20 percent per annum in the early 1990s to 6 percent in 1996/97. Meanwhile, Egypt's holdings of official foreign reserves rose some six-fold, surpassing $20 billion in 1996/97, and there was a significant reduction in the burden of external debt and debt service. The latter was facilitated in part by substantial debt relief from the Paris Club. By 1996/97, Egypt's external debt service ratio had fallen to about 13 percent of current external receipts compared with more than 50 percent at the beginning of the 1990s. Moreover, the Ministry of Economy noted that the face value of Egypt's official international reserves exceeded the discounted present value of the country's official external debt, putting Egypt in a net creditor position vis-à-vis the rest of the world. Based on these indicators, Egypt was in an exceptionally strong external financial position relative to other emerging market economies.

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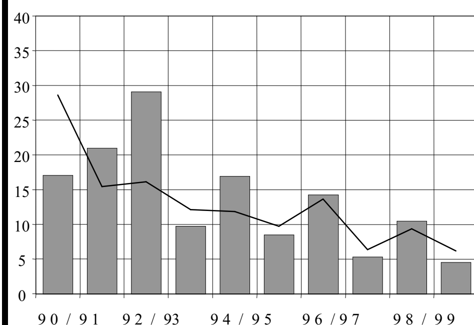
[3] During the period 1991/92 through 1996/97 the pound appreciated by some 40 percent in real effective terms.

Chart 3. Broad Money and Reserve Money (annual % change)



Source: Central Bank of Egypt and IIF estimates.

Chart 4a. Inflation* (%)

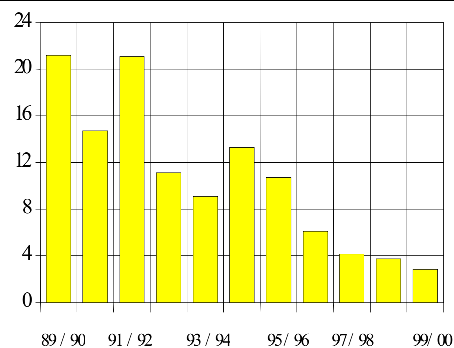


Chart 4b. Foreign Exchange Reserves ($ billion)**

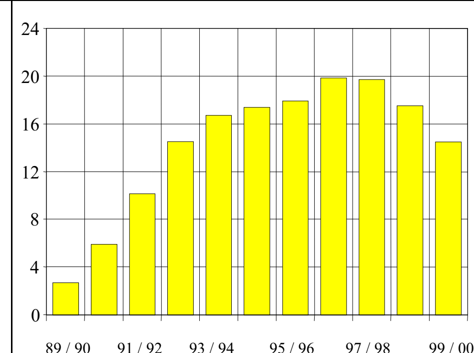
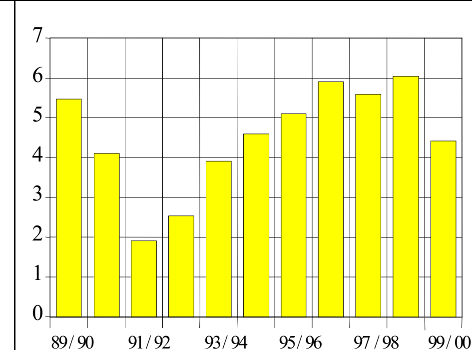


Chart 4c. Real GDP Growth (%)



Notes: * Year-on-year change in CPI; ** Official foreign exchange reserves (excluding gold).
Source: IFS and IIF estimates.

Table 2. Factors Affecting Liquidity (% change from previous year, LE billion)

	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00*
Net foreign assets	10.1	14.8	17.4	6.8	2.1	-0.3	7.9	-11.0	-15.6	-7.2
Domestic credit	19.9	1.2	5.9	12.7	18.1	22.1	24.8	24.9	40.0	23.7
Central government, net	*8.3*	*4.8*	*-4.1*	*0.4*	*1.6*	*1.7*	*-1.6*	*0.5*	*8.1*	*1.2*
Public enterprises	*7.2*	*-4.7*	*3.5*	*3.8*	*1.3*	*4.0*	*4.4*	*-1.5*	*2.2*	*2.0*
Private sector	*3.7*	*1.4*	*6.9*	*8.7*	*15.1*	*16.2*	*20.4*	*24.9*	*29.6*	*20.5*
Banking sector	*0.7*	*-0.3*	*-0.4*	*-0.2*	*0.1*	*0.2*	*1.7*	*0.9*	*0.1*	*0.1*
Other items, net	-9.4	-1.7	-6.0	-4.4	-3.7	-6.5	-9.4	-1.5	-5.0	-7.2
Broad money (M2)	20.7	14.3	17.3	15.1	16.5	15.2	23.4	12.4	19.4	9.3
(foreign currency deposits)	*17.7*	*-5.4*	*-6.7*	*0.2*	*6.8*	*1.1*	*-1.8*	*-1.0*	*2.3*	*7.6*
Quasi money	18.7	12.4	13.7	11.7	12.1	12.3	19.4	8.4	12.8	11.2
M1	2.0	1.9	3.5	3.3	4.4	3.0	3.9	4.0	6.6	-4.4
Memoranda (% change on previous year)										
Domestic credit	22.9	1.1	5.4	11.1	14.3	15.3	14.9	13.0	18.5	9.1
o/w private sector	*16.4*	*5.4*	*25.1*	*25.2*	*34.9*	*27.7*	*27.4*	*26.2*	*24.7*	*14.0*
M2	28.6	15.4	16.1	12.1	11.8	9.7	13.6	6.4	9.4	4.1
M1	7.9	7.0	12.0	10.1	12.1	7.2	8.9	8.4	12.8	-0.3
Foreign currency deposits (% of M2)	52.7	40.6	29.6	26.5	28.1	26.2	22.1	20.3	19.6	21.8

Note: *Indicates 12- month change during May 1999-May 2000.

Source: IMF: International Financial Statistics.

The successes on the stabilization front were accompanied by a gradual increase in the pace of real GDP growth over the period. However, the growth rate did not go much beyond 5.5 percent, which was clearly below potential and left little room for much needed growth in employment and real per capita incomes. This brought out the need for thorough-going structural reform, which the authorities recognized at the time would need to comprise three broad elements, namely: further liberalizing the domestic economy and reducing the barriers to external trade; stepping up the pace of government disengagement from productive sectors through broad-based privatization initiatives; and modernizing the financial system and the framework for monetary policy.

With these ends in view, the Government of Egypt developed a broad framework for structural reform in collaboration with the IMF in 1996, and a strong start was made in 1996/97. In particular, privatization was undertaken with new vigor and determination (yielding receipts equivalent to some 2 percent of GDP in 1996/97); a new, more liberal, investment law was enacted; important steps were taken to liberalize foreign trade through cuts in tariffs and the elimination of a few remaining non-tariff barriers; and moves were made on financial sector reform, notably through the divestiture by the publicly-owned commercial banks of their ownership stakes in the joint-venture banks.

These policies, combined with continued progress toward fiscal consolidation (the budget deficit was further reduced to 1.3 percent of GDP in 1996/97), and maintenance of credit and monetary aggregates within limits agreed with the IMF, resulted in a solid macroeconomic performance in 1996/97. While inflation was reduced to about 6 percent, the balance of payments was in surplus and real GDP growth approached 6 percent – the best growth performance in many years.

III. Monetary Policy in the Post-Stabilization Period 1997/98-1999/00

Circumstances changed markedly from late 1997 as did the setting and challenges for monetary policy. Egypt was hit by a succession of exogenous shocks that exacted a heavy toll on the balance of payments (Table 3). In the current account, earnings from tourism dropped precipitously in the wake of the Luxor tragedy, while export earnings from oil were sharply lower reflecting both the slump in world market prices as well as a further narrowing of the

exportable surplus. Together these shocks explain the bulk of the deterioration in the external current account in 1997/98. (viz. about $2.5 billion, or some 3.5 percentage points of GDP.)

Table 3. Summary Balance of Payments($ billion)

	96/97	97/98	98/99	99/00
Current account	0.2	-2.5	-1.7	-1.7
Capital account	1.2	-0.1	-1.6	0.1
Errors and omissions	-0.3	-1.0	-1.2	-0.6
Overall balance	1.0	-3.6	-4.5	-2.1
Financing (change in NFA)	-1.0	3.6	4.5	2.1
Official NIR	*-1.9*	*0.1*	*2.0*	*3.2*
Commercial banks	*0.9*	*3.5*	*2.5*	*-1.1*
o/w CBE deposits	*-0.1*	*0.1*	*2.0*	..
Memorandum Item (% of GDP)				
Current account	0.3	-3.0	-1.9	-1.8
Capital account	1.6	-0.1	-1.8	0.1
Overall balance	1.3	-4.4	-5.1	-2.3

Source: Egyptian authorities and IIF estimates.

The capital account also shifted into deficit in 1997/98 in the context of increasing contagion across emerging markets from the crises originating in Southeast Asia and Russia.[4] After portfolio inflows of about $1.5 billion in 1996/97, foreign investors were net sellers of Egyptian assets in 1997/98 contributing to net portfolio outflows of $250 million (comprising mainly the proceeds of maturing T-bills). These outflows were only partially offset by higher medium-term borrowing and foreign direct investment (FDI) (the latter swollen by receipts from the sales of mobile phone licenses in May 1998). The capital account deficit was perhaps understated to the extent of the steep increase in (negative) errors and omissions.

Overall, the balance of payments shifted into a deficit of about $3.6 billion in 1997/98 from a surplus of about $1 billion in the preceding year, a turnaround of almost 6 percent of GDP. What was also very significant (and this is a point which will be elaborated below) was that the financing of the deficit came principally from a reduction in the net foreign asset (NFA) position of the commercial banks: official reserves (NIR) declined only marginally.

Pressures on the external position intensified in 1998/99. Although the current account deficit narrowed to about 2 percent of GDP (from 3 percent) as the earlier shocks faded, the

[4] For analytical purposes we show the commercial banks as a financing item below the line. As discussed below, this treatment is based on the premise that capital flows pertaining to commercial banks during this period were not entirely autonomous.

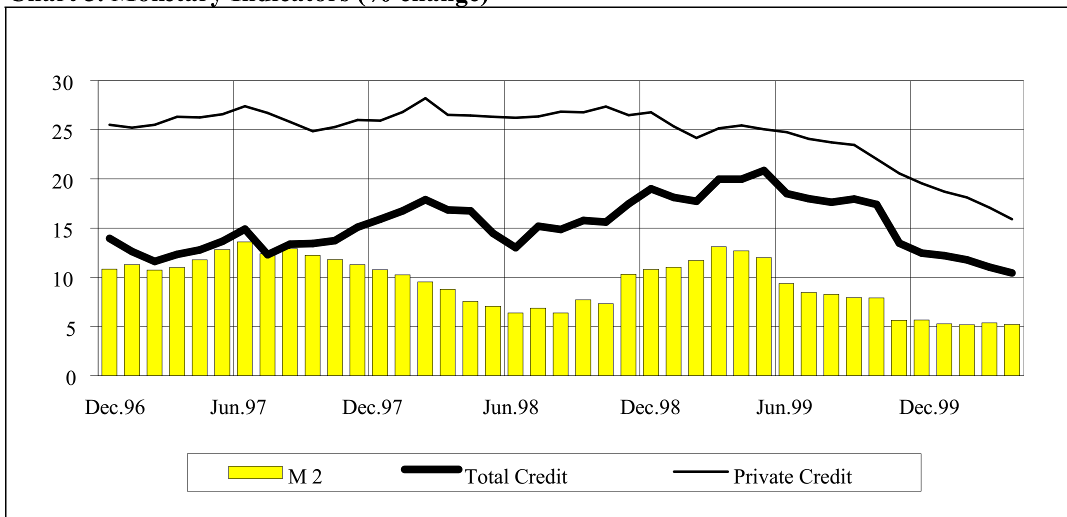
capital account deficit widened while negative errors and omissions rose further. As a result, the overall deficit widened to $4.5 billion (5 percent of GDP). Again, the commercial banks financed the greater part of the deficit through drawdowns of their NFA positions. However, NIR were also drawn down (by $2 billion), though at some $18 billion at end June 1999, they remained at very healthy levels.

The deterioration in Egypt's external position in 1997/98 and 1998/99 presented the authorities with something of a quandary in terms of developing a policy response. On the one hand, the authorities continued to view strong growth of the economy as a high priority, especially given the importance of generating new employment opportunities in the private sector to absorb not only the high natural rate of growth of the labor force (more than 3 percent annually) but also to make up for the loss of jobs in the public sector related to privatization. This made the authorities reluctant to tighten fiscal and monetary policies. On the other hand the authorities were anxious to sustain confidence in the Egyptian pound, and to retain the exchange rate anchor (i.e. the long-term peg to the US dollar) in spite of mounting market skepticism deriving in part from the hard landings experienced by a number of Southeast Asian countries at that time (notably Thailand and Korea) and the continued appreciation of the pound in real effective terms. (The pound was continuing to appreciate during this period, and by mid 1999 the cumulative real effective appreciation of the pound from 1991 approached 60 percent). Maintenance of very high official reserves was in all likelihood seen by the authorities as a crucial prerequisite sustaining market confidence in the exchange rate of the pound.

These largely self-imposed constraints on policy responses to the weakening of the external position effectively precluded fiscal and/or monetary tightening, a rundown of official external reserves, and/or a depreciation of the pound. This in turn produced a rather confused and confusing series of events. To begin with, there were few if any signs of tightening of credit and monetary policy. Interest rates on t-bills remained flat, and even though real interest rates were rising, due to the continued decline in inflation, domestic credit continued to grow at high, indeed rising, rates (Charts 5 and 6). While credit to the private sector continued to rise at annual rates in the vicinity of 25 percent through June 1999, higher bank financing requirements of the government became particularly evident in 1998/99.

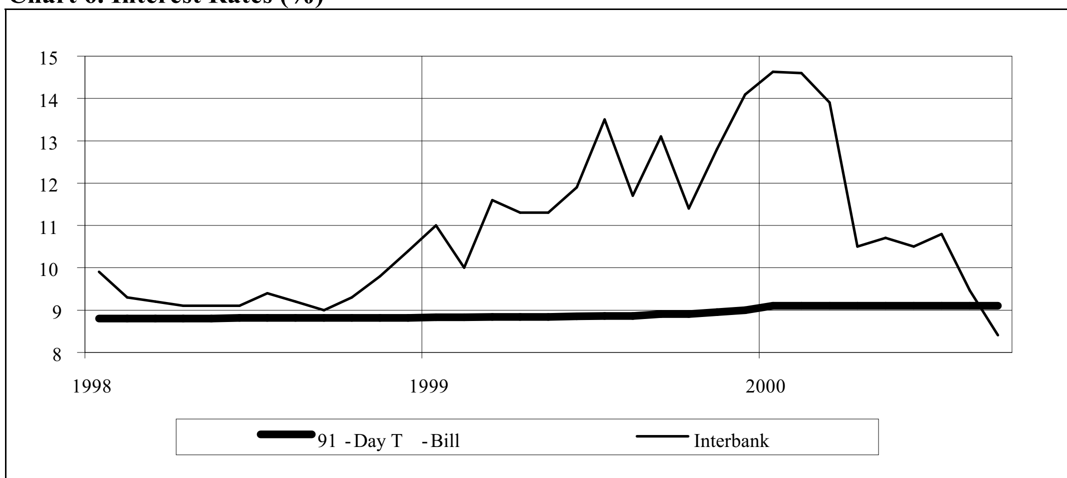
There were several factors at work that explain the high and rising growth rates of bank credit during this period when credit restraint would have been more appropriate given the pressures on the external position. First and foremost, the reliance upon the commercial banks to cover the bulk of the external financing gap entailed an increase in the banks' domestic liquidity and hence their lending capacity. Thus while the process served to alleviate the immediate pressure on the Central Bank's NIR, the conversion by the commercial banks of NFA into domestic lending (NDA) fuelled domestic demand and sustained pressure on the external position (This is in marked contrast to the situation when a central bank sells foreign exchange to the market and the domestic currency proceeds are automatically sterilized, unless the central bank acts deliberately to counteract this effect).

Chart 5. Monetary Indicators (% change)



Source: Central Bank of Egypt, IFS, and IIF estimates.

Chart 6. Interest Rates (%)



Source: Central Bank of Egypt.

Another development that added to the commercial banks' capacity to lend to the non-government sector was that the banks' holdings of government debt (mainly t-bills) fell off sharply during this period. (Though data are not available for 1997/98, Table 4 indicates that the commercial banks liquidated some LE10 billion of their holdings of government debt in 1998/99). In part, this may have been attributable to the effective taxation of interest income on t-bills from mid 1998 as well as to the stickiness of interest rates in t-bills.

Table 4. Financing of the Budget Deficit (LE billion)

	97/98	98/99	99/00e	2000/01f
Overall deficit	-2.8	-12.7	-12.8	-12.4
(% GDP)	-1.0	-4.2	-4.0	-3.7
Financing	2.8	12.7	12.8	12.4
Foreign financing, net	-1.3	-1.9	-2.7	-1.7
Domestic financing	2.1	15.6	12.7	11.0
Banks[1]	1.9	9.4	8.5	5.7
Central Bank	..	*19.1*	*14.2*	*9.6*
Commercial Banks	..	*-9.7*	*-5.7*	*-3.9*
Non-banks[2]	0.1	6.2	4.2	5.4
Privatization receipts[3]	2.1	0.9	1.7	2.0

Notes: e = estimate, f = IIF forecast;

[1] Including GASC borrowing;

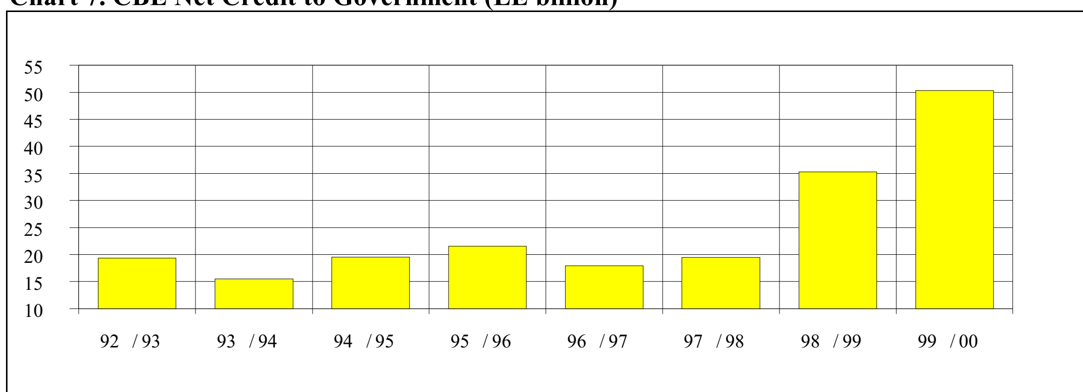
[2] Including Postal savings, Treasury bills and bonds;

[3] Privatization proceeds began to be included in the budget from 1997/98 onward.

Source: Ministry of Finance and IIF estimates.

The latter development was mirrored by an escalation of Central Bank credit to the government (Chart 7). Moreover, not only did the Central Bank need to make up for the retrenchment of commercial bank financing of the budget deficit, but it had to meet a strong increase in the government's financing requirements as well. Although the full extent of the problem did not become clear until the government announced revised fiscal data in early 2000, it was earlier evident from the monetary accounts and government debt data that the fiscal deficit was on the rise. The revised fiscal data corrected for previous underestimates of government borrowing from the National Investment Bank primarily to finance investment expenditures. For 1998/99, the overall fiscal deficit was revised upward to 4.2 percent of GDP (from 1.2 percent) and the government acknowledged the existence of domestic arrears (amounting to LE 20-25 billion).

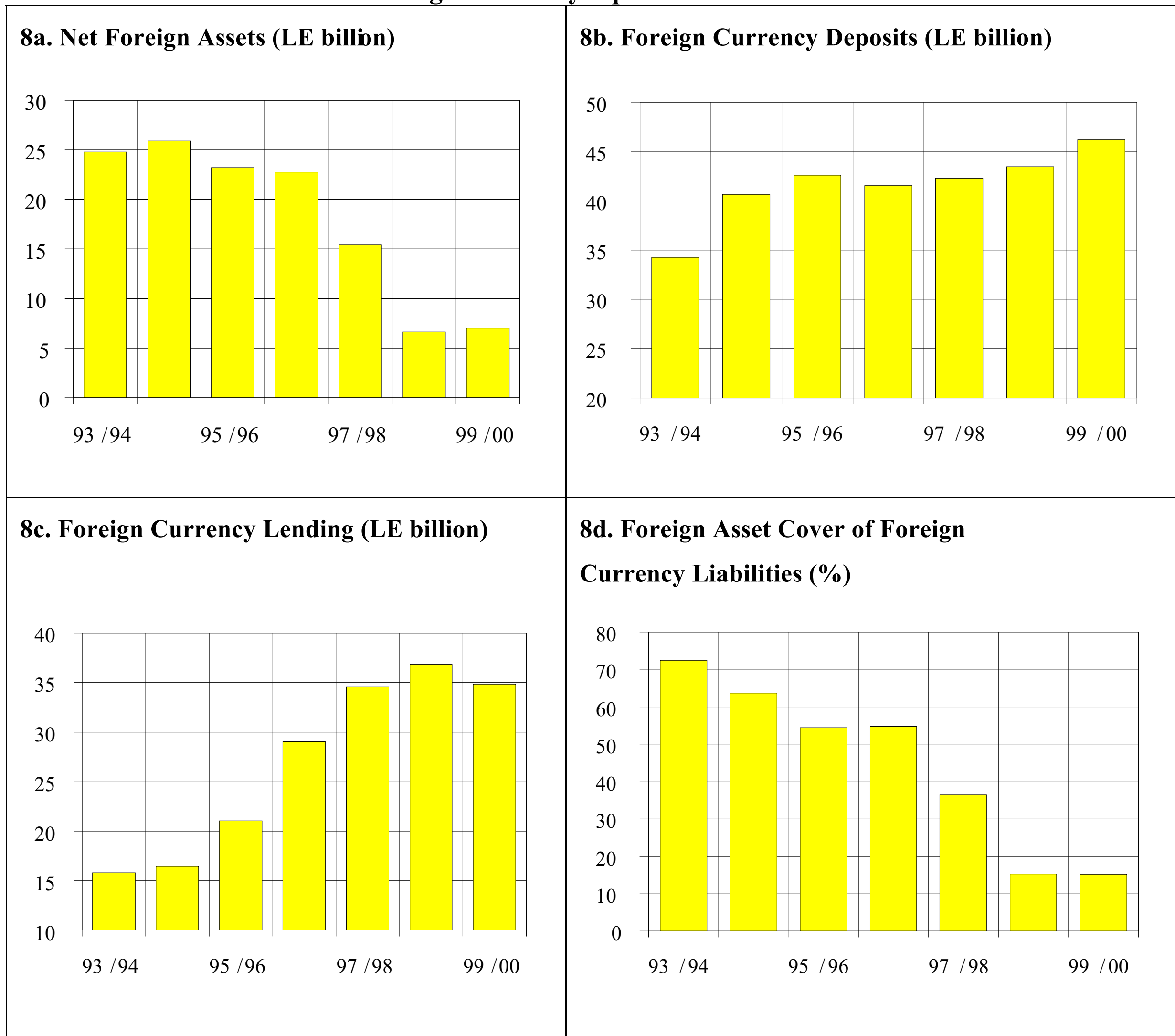
Chart 7. CBE Net Credit to Government (LE billion)



Source: Central Bank of Egypt.

This sequence of events had several implications, which, in a sense, constitute the "cost" of the measured policy response to the weakening balance of payments position from late 1997. In the first place, conditions in the foreign exchange market were unsettled. Downward pressure on the exchange rate of the pound persisted and divergences emerged between the exchange rate quoted by the Central Bank and the commercial banks on the one hand and the foreign exchange dealers on the other. Shortages of foreign exchange were observed from time to time, reportedly giving rise to an informal queuing system. There were occasional flashpoints including, for example, a spike in the exchange rate in the dealers market at LE 3.70 per dollar in August 1998. Second, there were a number of trade measures introduced in late 1998 and early 1999, including tighter origin rules for imports and requirements for importers to put up 100 percent cover when opening import letters of credit. These measures added to an already cumbersome trade system burdened by complex quality controls and inefficient customs procedures. Finally, the conversion by the commercial banks of NFA into NDA on a large scale had implications for the quality of their portfolios. While all the indications are that the Egyptian banks remain in relatively strong positions (see below), the foreign asset cover of the banks' foreign currency liabilities fell significantly (from more than 50 percent in 1996/97 to some 15 percent in 1998/99) while the increase in banks' local foreign currency denominated lending predisposed the banks to higher risk (especially given the long-term exchange rate peg) (Chart 8).

Chart 8. Commercial Banks' Foreign Currency Operations*



Note: *End-June data.
Source: Central Bank of Egypt.

Developments during 1999/00 and more recently contain a number of encouraging signs. In particular, the balance of payments position appears to have improved. For 1999/00, the overall external deficit declined to about $2 billion due mainly to a strengthening of the capital account. Moreover, draw-downs by the commercial banks of their net foreign assets came to an end while the Central Bank resorted increasingly to its own foreign assets to finance the external gap. After reaching a low of $1.8 billion in August 1999, net foreign assets of the commercial banks began to recover while the Central Bank's foreign reserves began to fall. For 1999/00 as a whole, the commercial banks replenished their NFA by about $1 billion, while the Central Bank lost some

$3 billion of reserves (bringing NIR to about $15 billion at end June 2000 —still a fairly robust 10 months of imports).

Behind the improvement in the external position was a marked decline in domestic credit growth during 1999/00, which eased to 9 percent toward the end of the fiscal year from its peak of 21 percent in May 1999. Tighter monetary conditions were most apparent during January when interest rates in the inter-bank market escalated to 17 percent; they subsequently fell back to around 8 percent in September. Paradoxically, however, treasury yields showed little or no increase despite the tight liquidity and the fact that net redemptions came to an end in May 1999. This is partly because the biggest holders of government debt in the primary market are the four government-owned commercial banks and their decisions to purchase t-bills do not appear to be motivated entirely by commercial considerations.

More recently, several factors have combined to put a brake on the loss of net international reserves of the Central Bank: while indications are that import demand remains subdued, other elements of the current account (especially earnings from tourism) appear to be strengthening and contributing to an improvement in the current account position. Meanwhile, in March 2000, the syndicate of foreign exchange bureaus abandoned its restraint on exchange rate movements, and this contributed to a modest depreciation. As of November 2000, the pound has reportedly been trading in the range of 3.80-3.90 per dollar in the dealers market.

Despite these encouraging signs, however, a number of problems remain. In particular, the situation in the foreign exchange market remains confusing with divergences between the official exchange rate (currently about LE 3.48 per dollar) and the market rate, and continued reports of delays in obtaining foreign currency. Recent reported actions by the Central Bank to limit withdrawals from foreign currency deposit accounts (later retracted) and to circumscribe domestic transactions denominated in foreign currency, suggest that the authorities are continuing to resort to non-market based solutions to monetary and foreign exchange policy problems.

More generally, perceptions that the pace of structural reform has slowed cloud the prospects for an acceleration of growth over the medium term. To some extent the apparent stalling of structural reform in Egypt may have been attributable to preoccupation

with the political calendar, especially the referendum on the presidency (in November 1999) and the parliamentary elections in October/November 2000. Now with these events behind it, the new government is well placed to reactivate the process of structural reform and to rationalize and fortify fiscal and monetary policies.

IV. The Challenges Ahead

The experience of the past few years has brought out the need for a more flexible market-responsive monetary and exchange rate policy. With this end in view, actions are needed to enhance the instruments of monetary policy available to the Central Bank; to decentralize and privatize the financial system; and to increase transparency along with continued improvements in the regulatory/prudential system.

Monetary Policy

Recent experience demonstrates that, going forward, greater flexibility will be needed in interest rates in order to ensure that monetary policy can underpin efforts to limit the loss of external reserves and to support the exchange rate system. This will necessitate a number of steps to strengthen the Central Bank's capacity to implement monetary policy. In the first place the Central Bank needs to be equipped with a portfolio of marketable securities for conducting open market operations. (Currently the Central Bank conducts only repo operations, but not reverse repos). And decisions to enter the market for purposes of monetary management should rest with the Central Bank rather than with the Ministry of Finance. Second, variations in monetary conditions should be permitted to influence yields in the treasury bill auctions; the costly rigidity of t-bill interest rates in the past few years indicates that the auction system does not function in a market-responsive manner. And finally, the secondary market for government securities needs to be developed and expanded so as to deepen and broaden the financial market and thereby enhance its functioning.

Modernizing the Financial System

Although the liberalization of entry to the banking system during the 1970s resulted in the establishment of 26 joint-venture banks, these institutions were subject to equity holdings by the state banks, the NIB, and the state insurance companies. In recent years, significant progress has been made by the government toward divesting public ownership in these banks. Currently, the state banks retain majority holdings in only two joint-venture banks,

and have reduced their minority holdings to less than 20 percent in all but two of the remainder of these institutions. The government remains committed to completing the process of divestiture, but a timetable has yet to be announced.

Meanwhile, the four major commercial banks remain wholly government-owned. Although legislation was enacted in 1998 to allow for privatizing banks (and insurance companies), the process has stalled on concerns that public support is lacking. Be that as it may, efforts to modernize the banking system need to be stepped up. Privatization, at a time the government deems opportune, could well be a catalyst in this direction. Efforts to modernize (and privatize) the state-owned insurance companies could also be stepped up given the underdevelopment of the industry and the great potential for a dynamic insurance industry in mobilizing capital domestically and contributing to financial deepening of the economy.

Prudential Regulation and Supervision

Further steps are needed to enhance banking supervision (including transparency) and to strengthen compliance with prudential standards. Over the past few years, the regulatory framework of the Egyptian banking system has been broadly aligned with international practice, but there is room for enhancements in the quality and quantity of financial data reported by banks. Since 1997, the banks have been required to produce financial reports in accordance with international accounting standards (IAS). And since 1998, the Central Bank has published aggregate data on key performance ratios for the banking system (Table 5). With a view to strengthening banking supervision, on- and off-site supervision manuals have been revised, and an early-earning system is being developed.

Table 5. Indicators of Banking Performance (percent)

	97/98	**98/99**	**99/00**
Net profit/Equity	..	14.7	16.1
Net profit/Assets Average	..	0.9	0.9
Net Interest Income/Assets	1.3	1.4	1.5
Non-interest Income/Assets	1.7	1.9	1.8
Provisions/Assets	7.1	8	7.9
Loans provisions/Loans	10.4	9.7	9.9
Equity Capital/Assets	5.4	5.5	5.6
Securities/Assets	9.1	11	10.5
Deposits/Assets	65.7	67.5	68.1
Loans/Deposits	79.6	86	87.1

Source: Central Bank of Egypt.

Although data are not published on a regular basis, the risk-adjusted capital adequacy ratio for the banking system as a whole was 10.6 percent at the end of 1996, up from 10.0 percent a year earlier.[5] All four public sector banks and all but three (small) joint venture and private banks met the Basle 8 percent minimum capital adequacy ratio at the end of June 1997. Recent indications are that the share of non-performing loans to total bank assets is on the decline, and banks reportedly comply with all provisioning guidelines; total provisions were equivalent to about 80 percent of non-performing loans at the end of June 1997. Based on published financial statements, most of Egypt's joint-venture banks are highly profitable, with rates of return on equity of 20 percent or more. By contrast, the state commercial banks have been much less profitable, with returns ranging from 5-10 percent in the late 1990s.

Concluding Comments

- During the stabilization years (through 1996/97) Egypt achieved considerable success in reducing macroeconomic imbalances and in establishing conditions for sustainable growth. In this process, monetary policy played a key supportive role to the major fiscal adjustment in combination with the exchange rate anchor.
- Over the past three years, the emergence of balance of payments deficits and pressures on the foreign exchange market did not elicit the policy responses that would have been expected. Efforts have been made to keep interest rates from rising while holding the line on the exchange rate. The magnitude of the external deficit has been disguised by the fact that the commercial banks have come up with most of the financing (helping to moderate the loss of official reserves). Although this process appears to have come to an end, the underlying external deficit remains relatively large and the Central Bank is continuing to lose reserves while uncertainties persist in the foreign exchange market.
- There is a need for more flexibility in the policy response. Interest rates should be allowed to respond to market forces and monetary/exchange rate policies need to be coordinated in an effort to avert a further decline in reserves. Action is also needed to bring the fiscal deficit back within its targeted range.

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[5] Handy et.al. (1998).

- Over the medium term, efforts need to be concentrated on modernizing the financial system, through innovations in monetary policy instruments and institutional development. More broadly, there is a need for the government to reactivate the process of structural reform in order to enhance prospects for growth and employment opportunities in the Egyptian economy.

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