



**The Egypt-EU Partnership Agreement  
and Liberalization of Services**

**Mahmoud Mohieldin**

Working Paper No. 9

February 1997

The author is a senior economist with the Egyptian Center for Economic Studies, and assistant professor at the Faculty of Economics, Cairo University. He is indebted to Amr Amin, Ahmed Galal, and Bernard Hoekman for helpful suggestions and discussions, and to Hala Fares for excellent research assistance. Any errors in analysis, emphasis and opinion are solely the responsibility of the author.

## Abstract

This paper addresses question about Egyptian service industries that arise in the context of the proposed Egypt-EU trade agreement. Will Egyptian service industries- particularly financial services- be able to cope with liberalization? What are the potential gains from such liberalization, and to what extent do inefficient service impose a burden on Egyptian firms and put them at a disadvantage in global markets?

The paper concludes that the protection of services has significant costs that hinder efficiency, production and competitiveness. The Egypt-EU association agreement, however, is not likely to result in significant liberalization of trade in services. Thus considerable effort at the domestic level is required to achieve liberalization in the services sector.

## ملخص

تحاول هذه الدراسة أن تجيب على تلك الأسئلة التي برزت في سياق إتفاقية المشاركة المصرية- الأوروبية؛ على سبيل المثال: هل يمكن لقطاع الخدمات الإنتاجية بشكل عام، والخدمات المالية بشكل خاص، أن يحتوى آثار تحرير التجارة؟ وما هي المكاسب المحتملة من هذا التحرير؟ وإلى أى مدى تشكل عدم كفاءة قطاع الخدمات عبئاً على قطاعات الإنتاج في مصر وتحد من تنافسيتها في الأسواق العالمية؟

تذهب هذه الدراسة إلى أن حماية قطاع الخدمات قد تسببت في تدنى الكفاءة النسبية له ورفعت من تكلفة المخلات في قطاعات أخرى تعتمد عليه. وتؤكد الدراسة على أنه ليس من المتوقع أن تؤدي إتفاقية المشاركة المصرية- الأوروبية إلى تحرير ملموس للتجارة في الخدمات، نظراً لإكتفائها بمقررات "الإتفاقية العامة للتجارة في الخدمات" GATS. وتأسيساً على ذلك، فإنها تضع مسئولية إصلاح قطاع الخدمات على عاتق جهود وإجراءات التحرير والإصلاح التي يتم إتخاذها في الإطار المحلي في مصر.

## 1. Introduction

The term 'services' commonly refers to a variety of economic activities such as accounting, distribution, banking, insurance, tourism, health, education, transport, computer and information services, telecommunications, etc. Services provide essential linkages among economic agents and enable proper market functioning. Growth in the value of services trade worldwide has exceeded that of merchandise in recent years, reflecting advances in information, telecommunications and transport technology. These have transformed services from largely nontradable activities with low productivity-growth potential, to a sector comprising a variety of fast-growing, knowledge-based products.

Two characteristics distinguish services from goods: First, *intangibility*: services change the 'condition' of persons or goods belonging to an economic unit, by the activity of other economic unit(s) (Hill, 1977).<sup>1</sup> Second, *non-storability*: services are consumed as they are produced.<sup>2</sup> Thus, service transactions usually require that the provider and consumer of the service interact, and often give rise to government intervention to reduce the quality uncertainty that may be associated with intangibility. A result is that, for effective liberalization, the harmonization of national regulatory systems and agreements to recognize the standards of partner countries may be essential. Negotiations to liberalize trade in services and harmonization efforts may be more feasible in a regional arrangement, such as the proposed Egypt-EU association agreement, than in a multilateral context.<sup>3</sup>

This paper addresses two questions that arise in the context of this agreement. First, will Egyptian service industries in general, and financial services in particular, be able to cope with liberalization? Second, what are the potential gains from such liberalization, or alternatively, to what extent do inefficient services impose a burden on Egyptian firms and put them at a disadvantage in global markets? Section 2 reviews recent developments in world trade in services, highlights the main impediments to trade imposed by governments, and discusses their rationale. Section 3 discusses trade in services between Egypt and the EU and the services dimension of the proposed partnership agreement. In Section 4, the role of services in the Egyptian economy is explored. Section 5 analyzes the Egyptian financial services industry. Section 6 concludes.

---

<sup>1</sup> *The Economist* magazine defines a service as "something you can buy or sell but cannot drop on your foot". *Law Journal Extra*, Vol. II, No. 1 (1996), p. 1.

<sup>2</sup> Fieleke (1995), p. 25. These characteristics induced early economists like Adam Smith to state that services "seldom leave any trace or value behind them".

<sup>3</sup> Hoekman and Sauve (1994), pp. 1-3.

## 2. The State of Services in International Trade

Despite the inclusion of trade in services in every country's balance of payments, for a long time services were largely ignored by trade economists, reflecting the presumption that they were nontradables. Since the late-1970s, however, the literature on trade in services began to grow enormously. In part, this was in response to the absence of rules on international trade in services and the value of such trade. The need for physical proximity between the providers and recipients of a service implies that for trade to occur, often either the provider or the recipient of a service must move to the other's location (Sampson and Snape, 1985). The various options are shown in Table 1.

**Table 1. Classification of Services Trade**

	<b>Consumer does not move</b>	<b>Consumer moves</b>
<b>Producer does not move</b>	<i>A</i> (e.g. financial services)	<i>B</i> (e.g. tourism, education and health)
<b>Producer moves</b>	<i>C</i> (e.g. labour movement and foreign direct investment)	<i>D</i> (e.g. a tourist going to a foreign-owned hotel in a third country)

Sources: Adapted from UNCTAD and World Bank (1994), Box 1.3, p. 9.

Five categories of policy instruments can be distinguished as impediments to services trade:

1. quantity-based measures, which restrict the volume or value of transactions;
2. price-based measures;
3. requirements of physical presence in the relevant market;
4. measures concerned with standards, certification requirements and industry-specific regulations; and
5. government procurement and subsidization.

Quantitative restrictions and standards are the most important access restrictions in the services context. Although import tariffs rarely impede trade in services, price controls are common. These involve either price setting by government agencies and/or price monitoring and approval procedures. Barriers to trade in financial services include discrimination against services supplied to domestic customers by firms based abroad; prohibition on the establishment of branches by foreign providers; restrictions on the activities of foreign firms

in the domestic markets (e.g. limits on the number and location of branches); and restrictions on the employment of foreign staff and their movement in the host country.

Such restrictions are imposed for different reasons.<sup>ξ</sup> First, the fact that industrial countries enjoy a comparative advantage in services has often motivated the protection of the financial service industry in developing countries. Even if a developing country manages to accumulate the physical and human capital required to become competitive in a service industry, *reputation* will be important in contesting markets. Thus, efficient new entrants in the market of international financial services may not be able to compete with well-established firms, especially when customers cannot easily differentiate between the products supplied by the new and old firms. The interaction between government and firms may then determine the winners and losers of trade (Yoffie, 1993). Such infant industry arguments are bolstered by the experience of many developing countries, before and after independence, with foreign banks. These were accused of concentrating on short-term credit (usually directed towards financing of trade) and cream skimming.<sup>ϑ</sup> Other reasons for establishing barriers to trade in financial services include a desire to control a key sector of the economy to safeguard national sovereignty and security, and the pursuit of policies favoring the employment of nationals (see Schultz, 1993). Whatever the rationale for discriminatory policies, the Uruguay Round of multilateral trade negotiations led to the creation of the General Agreement on Trade in Services (GATS) which has as its objective the progressive liberalization of trade in services. As discussed in the following section, this agreement is of particular importance in the context of the proposed partnership agreement between Egypt and the EU, as it is likely to govern the liberalization of trade in services between the two parties.

### **3. The EU Partnership Agreement and Trade in Services**

To determine the magnitude of trade in services, a direct measure of the value of imports and exports of each internationally traded service is required. In the case of financial services, for example, this measure should include all fees and charges received by domestic banks from nonresidents and must cover the value of all financial intermediation services. Currently no such data exist; indeed, in many cases the measurement of domestic financial service transactions leaves much to be desired.<sup>ψ</sup> Most of the data required for estimating trade flows

---

<sup>ξ</sup> For similar argument in the case of Arab countries, see Mohieldin and Wahba (1996).

<sup>ϑ</sup> See for example Germidis and Michalet (1984).

<sup>ψ</sup> On this issue see Appendix (A) in Whalley (1995) and Arndt (1984).

are also unavailable for Egypt, as statistics on receipts and payments of foreign exchange do not distinguish between the different components of financial and banking services. As Egypt, along with its trading partners, starts to implement the recent changes to the IMF's Balance of Payments Manual, necessary statistics on trade in financial and other services may become available. Meanwhile, the shares of Egypt's receipts and payments of foreign exchange can be used to demonstrate the importance of trade in services between Egypt and the EU (Table 2).

**Table 2. EU Share of Foreign Exchange Flows Related to Services, 1984/5-1993/4 (%)**

<b>Main Traded Services</b>	<b>Receipts</b>	<b>Payments</b>
Insurance	11.83	4.57
Suez Canal Tolls	25.83	----
Tourism	18.57	21.62
Interests, Profits, etc.	15.25	31.99

*Sources:* Calculated from CAPMAS Annual Bulletin of Receipts and Payments of Foreign Exchange, several issues.

### ***Trade in Services in the Proposed Agreement***

Tunisia and Morocco recently signed virtually identical association agreements with Europe. It is very unlikely that Egypt will reach a significantly different agreement in the area of trade in services. Neither the Tunisian nor Moroccan agreements make any specific commitments to liberalize trade in services. Both agreements only refer to the commitments and obligations of each party under the GATS.<sup>y</sup>

The GATS consists of three main elements. First, a framework agreement lays down general principles and rules to be applied to all measures affecting services trade, including most-favored-nation treatment (MFN). The second element, which is the heart of the agreement, consists of sector-specific commitments on national treatment and market access, listed in a schedule submitted by each country. The third is an understanding that periodic negotiations will be undertaken to liberalize trade in services. The GATS covers the four modes of supply distinguished in Table 1. This goes beyond transactions recorded in the balance of payments, as local sales of foreign affiliates are included. However, unlike Part IV of the GATT, the GATS does not provide for favorable treatment of developing economies. It also does not impose great obligations on them, unless they 'commit' themselves to do so in

<sup>y</sup> See Article 31 of the Association Agreement between Europe and Tunisia; which, in this respect, is identical to that of Morocco.

their offers.<sup>^</sup> The commitments of the Middle East and North African countries, including Egypt, do not imply much, if any, liberalization (Hoekman, 1995). The same conclusion then applies under the association agreements with Europe. MENA countries made limited commitments that covered only 16.5% of the maximum possible of their services sectors, while the EU scheduled 57% of its services (Table 3).

**Table 3. Commitments on Market Access for Services (GATS)**

<b>Country Group</b>	<b>Number of commitments in services</b>	<b>Services commitments as share of maximum possible (%)</b>
<b>High-income countries</b>	2423	53.8
<b>Developing countries</b>	2159	17.2
<b>North America</b>	193	59.9
<b>Latin America</b>	738	15.3
<b>Western Europe</b>	2002	59.2
<b>Central Europe</b>	351	43.6
<b>Africa</b>	396	9.8
<b>Middle East and North Africa</b>	106	16.5
<b>Asia</b>	796	26.0

*Source:* Mohieldin and Wahba (1996), p. 5. The regional classification is that of the GATT Secretariat.

Mediterranean countries subjected only 6% of their services sectors to the national treatment and market access principles, as opposed to 26% for the EU. EU sensitivity towards services-related labor movement partly explains this limited commitment.

Egypt presented offers which are somewhat more comprehensive than those presented by most developing countries. Compared to the other five Arab GATS members, Egypt has the highest level of 'no restrictions' applied on market access and national treatment (Hoekman and Primo-Braga, 1995, p. 28). However, because of low sectoral coverage of commitments and due to the relatively more restrictive measures which apply to foreign commercial presence and natural persons in the scheduled sectors, a commitment to significant service liberalization is not evident.

#### **4. Competitiveness and Producer Services in Egypt**

The Egyptian economy is increasingly becoming services-based. The contribution of services to GDP, including social and producer services, increased from 51.5% in 1985 to 61.0% in

<sup>^</sup> For further discussion of GATS commitments see Hoekman (1995) and Altinger and Enders (1995).

1994, with an average annual real growth rate of 1.3% during the 1990-94 period. This is higher than the growth rate of industry, which was only 0.3%. The sector's share in fixed capital formation averaged 46% during the 1982-92 period, and it employs more than 45% of the workforce.<sup>9</sup> Exports of commercial services are estimated at \$9.9 billion in 1994/5, i.e. almost double the value of merchandise exports. Thus, while Egypt was not listed among the 50 leading merchandise exporters in world trade in 1994, it ranks 26th in terms of commercial service exports. Table 4 illustrates the progress that Egypt has made in this respect since 1975 compared with selected countries. Egypt's revealed comparative advantage (RCA)<sup>10</sup> in commercial services also increased, rising from 2.4 to 3.1 during 1985-92 (Table 5).

**Table 4. Leading Exporters of World Trade in Commercial Services (US\$ billions and percentage)**

Exporter	Rank				Value	Share
	1975	1980	1990	1994		
USA	1	2	1	1	178.2	17.0
France	2	1	2	2	91.8	8.7
Germany	4	4	3	3	63.1	6.0
UK	3	3	4	5	57.5	5.5
Japan	7	6	5	6	57.2	5.5
Italy	6	5	6	4	59.4	5.7
Singapore	17	15	12	12	25.7	2.4
Canada	12	14	13	15	17.6	1.7
Mexico	15	18	18	16	14.4	1.4
S. Korea	3	20	19	14	18.8	1.8
Taiwan	26	30	21	--	----	----
Turkey	36	57	23	24	10.0	1.0
Greece	20	22	24	25	8.8	0.8
China	--	28	26	--	----	----
Portugal	27	31	27	28	7.1	0.7
<b>Egypt</b>	<b>32</b>	<b>29</b>	<b>28</b>	<b>26</b>	<b>8.0</b>	<b>0.8</b>
Finland	24	27	29	32	5.4	0.5
Malaysia	47	41	31	31	6.3	0.6
India	28	26	32	27	7.5	0.7
Brazil	25	34	36	35	4.7	0.4
Ireland	34	39	37	30	3.6	0.3

Sources: World Bank and UNCTAD (1994), p. 15, and WTO (1995), pp. 15-16.

<sup>9</sup> See World Bank (1995), p. 160 and the annual report (1995) of the Central Bank of Egypt.

<sup>10</sup> RCA is calculated as  $[X_{ij}/Y_j]/[X_{iw}/Y_w]$ , where  $X_{ij}$  is exports of product  $i$  by country  $j$ ,  $Y_j$  is total exports of products by country  $j$ , and  $w$  stands for world trade; see Hoekman and Primo-Braga (1995), p. 7.



In the absence of precise measures of relative competitiveness, Table 5 provides an indication of the variation in specialization in commercial services between the selected countries. The higher the RCA, the greater the observed competitiveness of the country; any value greater than one indicates relative specialization. In the Egyptian case this reflects Suez Canal dues, remittances of Egyptian workers abroad, and tourism.

**Table 5. Revealed Comparative Advantage in Commercial Services in Selected Countries**

Country	1985	1990	1992
<b>Egypt</b>	2.42	2.96	3.1
<b>Turkey</b>	1.32	1.76	1.65
<b>Tunisia</b>	1.98	1.58	1.49
<b>Morocco</b>	1.72	1.58	1.36
<b>Jordan</b>	3.28	2.83	2.48
<b>Mexico</b>	0.84	0.81	0.76
<b>Korea</b>	0.96	0.74	0.66
<b>Japan</b>	0.65	0.66	0.61
<b>UK</b>	1.30	1.16	1.08
<b>France</b>	1.47	1.32	1.39
<b>Italy</b>	1.13	1.12	0.57
<b>Germany</b>	0.79	0.65	0.62
<b>Greece</b>	2.05	2.47	2.69
<b>Spain</b>	1.86	1.71	1.69

Sources: Calculated using data from IMF (1995), International Financial Statistics Yearbook, and Hoekman and Braga (1995), p. 32.

Despite Egypt's relative specialization in services, many producer services, such as insurance, telecommunications, ports and transportation are of low quality and/or high cost, in part because of state monopolies or state-dominated oligopolistic market structures. State monopolies in these sectors are protected by artificial barriers to trade, based on non-economic criteria such as national security and 'strategic' interests, which are exaggerated in some cases to justify state control. Lack of competition and contestability have resulted in poor quality and high costs. Users of these services, especially exporters in the agricultural, manufacturing and services sectors, are put at a comparative disadvantage, given that they have to cope with higher transaction costs.<sup>11</sup>

<sup>11</sup> On this issue see Schouten (1995).

### *The Case of Maritime Transport*

Despite Egypt's strategic location, its enormous spending on transport infrastructure, and the size of the sector,<sup>14</sup> both the quality and cost of transport services remain unsatisfactory. Law 12 of 1964 created state monopolies, across the board, of all port services. Article 7 of this law determines that "maritime transport activities, including freight forwarding, loading and unloading, catering of vessels, maintenance of maritime supplies, [...], shall be restricted to persons or entities registered by the Egyptian Public Organization for Maritime Transport, created by the Ministry of Transport to administer this law".<sup>15</sup> Moreover, the shared ownership and interlocking directorship between the state operating companies and port authorities have restrained competition and reduced incentives to maintain port facilities or improve operating practices.<sup>16</sup>

The comparative cost of shipment and loading in Egypt in 1994 was higher than that of Jordan, Syria and Turkey by approximately 27%, 22% and 19% respectively.<sup>17</sup> Port service fees are some 30% higher than in other ports in the region. While freight costs to Europe, for example, are lower than other countries, the costs of loading and stevedoring are higher, which make the total cost in Egypt the highest compared to other countries in the region.<sup>18</sup> Transport costs account for 11% of the CIF cost of imports, and 10% of the cost of imported inputs, and hence reduce the ability of Egyptian exporting industries to compete internationally.<sup>19</sup>

Deregulation of potentially competitive transport activities and stimulating private sector participation are required to enhance competition. Private participation within an adequate regulatory framework has resulted in improvement in the quality of provided services and lower costs in other developed and developing countries.<sup>20</sup> Although private provision of port and related infrastructure may not be economically efficient due to large sunk costs, operating and equipping facilities via leases and concessions would make services contestable.<sup>21</sup>

---

<sup>14</sup> The relative importance of the transport and telecommunications sectors reached 6.7% of the GDP; if we include the Suez Canal, the figure increases to 10.5%.

<sup>15</sup> Cited in Nathan Associates Inc (1996), p. 38.

<sup>16</sup> *ibid.*, p. 5.

<sup>17</sup> Federation of Egyptian Industries (1995), p. 15.

<sup>18</sup> The shipment cost of a 40-ft. container to Europe is US\$ 1300, compared to \$1700 and \$1800 from Turkey and Cyprus, respectively (Schouten 1995, p. 37).

<sup>19</sup> Nathan Associates, *op. cit.*, p. 47..

<sup>20</sup> See Glaiser, Starkie and Thompson (1990), pp. 5-7.

### *The Case of Telecommunications*

Another example of high transaction costs and modest quality of service can be found in another state monopoly, ARENTO (Arab Republic of Egypt National Telecommunications Organization). Public Law 153 grants ARENTO exclusive responsibility for establishment and operation of the national telecommunications network and for international interconnection.<sup>19</sup> As Table 6 shows, revenue of the telecommunications sector as a percentage of GDP is quite high, ranking second after that of the UK. But while high revenue in the case of the UK can be justified by performance and quality of service, this is not the case in Egypt.

Compared to the other countries, Egypt has the second lowest ratio of telephone lines per 100 inhabitants, and the longest waiting list and time required for installation of new lines. The state monopoly fulfills only 65% of the applications for new lines and is not addressing the large unexpressed demand. Previous studies<sup>20</sup> on the cost of service/rate emphasize that almost all services provided by ARENTO require significant price reform policy. The absence of such a policy and the continued transfer of revenues to other government ministries is jeopardizing the required expansion and maintenance of services. Due to the resulting budgetary constraints, ARENTO cannot deal with the persistence of underinvestment.

**Table 6. Comparative Data on Telecommunications: Egypt and Selected Countries 1994**

Country	Revenue GDP (%)	Phone lines per 100 inhabitants	Wait list for phone lines (thousands)	Satisfied demand (%)	Waiting time (years)
<b>Egypt</b>	2.2	4.26	1277.300	65	5.8
<b>Morocco</b>	2	3.75	107.700	90.2	0.7
<b>Tunisia</b>	1.5	5.38	126.000	79	2.8
<b>Turkey</b>	1.5	20.1	691.100	94.6	0.5
<b>S. Korea</b>	2.1	39.7	----	100	----
<b>Mexico</b>	2.1	9.25	196.900	97.7	0.2
<b>France</b>	1.8	54.74	----	100	----
<b>UK</b>	2.5	48.87	----	100	----
<b>Germany</b>	2.1	48.31	---	----	----

<sup>19</sup> World Bank (1994), pp. 120-121.

<sup>20</sup> K & M Engineering and Consulting Corporation (1994), p. I-4.

<sup>21</sup> See for example K & M Engineering and Consulting Corporation (1994), p. I-21.

<b>Italy</b>	1.7	42.94	38.00	99.80	0.1
--------------	-----	-------	-------	-------	-----

Sources: ITU (1995), and the German-Arab Chamber of Commerce.

As in the case of transport, competition and private participation are needed in the telecommunications sector in order to lower the cost of services and improve quality. These objectives can be achieved by a mix of the following measures:<sup>22</sup> commercialization of services and transforming ARENTO into a business-oriented organization; liberalization of the sector by allowing open entry and respecting market forces; and privatization through encouraging private sector investment in the infrastructure of the telecommunications sector. An appropriate regulatory regime must be put in place to ensure that new suppliers of services interconnect effectively with the incumbents. In a study of seven developing countries, Galal and Nauriyal (1995) have shown that in the absence of adequate regulation in the telecommunications sector, investment and productivity tend to be relatively low and private sector returns are relatively high. Chile illustrates that if problems of asymmetric information, pricing and commitment can be addressed through appropriate regulation, producers obtain reasonable rates of return, private investment increases, and consumer satisfaction increases.

## 5. The Financial Services Industry in Egypt

As mentioned above, the proposed partnership agreement refers only to the GATS when it addresses the liberalization of trade in services.<sup>23</sup> Egypt's commitments under the GATS regarding the liberalization of financial services are quite limited compared to its 'commitments' under the current Economic Reform and Structural Adjustment Programme, which was launched in 1991 with technical and financial support from the IMF and the World Bank.<sup>24</sup> This emphasizes our earlier argument that the degree of liberalization of trade in services under the partnership agreement is not sufficient to improve efficiency. Any meaningful reform must rely mainly on efforts undertaken domestically. In this section the main features of the financial system in Egypt are described. The formal financial system includes a shallow insurance market, an emerging securities market and a relatively active banking system.

### *Insurance*

<sup>22</sup> See the position of ARENTO regarding these measures in ARE (1996), 'The National Telecommunications Policy of the Arab Republic of Egypt'.

<sup>23</sup> See for example Article 31 of the EU agreement with Tunisia.

<sup>24</sup> For a similar argument see El-Refaie (1996), pp. 27-30.

The insurance market comprises nine insurance companies, including one reinsurer, four insurance pools and the government insurance fund, in addition to 350 private insurance funds. Of the nine insurance companies, four are state-owned. The market is dominated by three state-owned companies which manage 85% of general insurance and 94% of life insurance. Setting of entry barriers is left to the discretion of the Insurance Authority, which decides if a company is eligible to enter the market or not. Foreign ownership is only allowed in free zones. Under the GATS, however, foreign presence in the domestic market in the form of joint ventures under the 49-percent rule will be allowed within five years.<sup>٢٥</sup>

### ***The Egyptian Securities Market (ESM)***

The ESM, established in 1883,<sup>٢٦</sup> was subjected to state intervention which had a devastating effect on its operations and its role in financial development. The size of the market, measured by the ratio of market capitalization to GNP, is 14%, low by emerging market standards.<sup>٢٧</sup> The ESM has been the source of less than 5% of new funding for both the public and private sectors during 1989-91. Furthermore, only 3% of the LE 39 billion of savings was mobilized through the securities market during the same period. These figures are in stark contrast to the performance of the market in the pre-nationalization period (1958-61), when it provided some 25–50% of new capital raised by the private sector alone.<sup>٢٨</sup> Official attempts since the early 1970s to revive the ESM have not resulted in any meaningful improvement in performance. The market's negligible role in savings mobilization and its relative insignificance as a source of capital can be attributed to both demand and supply side problems.

Credibility is a major issue on the demand side. ‘Egyptianization’ in the 1950s, followed by nationalization, expropriation and sequestration in the 1960s, created a credibility problem that remains an important impediment after more than three decades. Furthermore, over the years, heavy losses in the remaining joint-stock companies in the 1970s and the 1980s; “hit-and-run” activities which flourished in the early years of the open-door policy; and the sudden rise of Islamic investment companies which collapsed in the late 1980s, have all had negative impacts. Moreover, the media has long emphasized that heavy speculation, especially in the

---

<sup>٢٥</sup> For further details see World Bank (1993), Chapter VII and Egypt's schedules under the GATS. The author understands that the 49 percent rule is currently under revision.

<sup>٢٦</sup> The Egyptian Securities Market was established in 1883 in Alexandria, and was followed in 1890 by one in Cairo.

<sup>٢٧</sup> Egyptian Financial Group (1996), p. 51.

<sup>٢٨</sup> CBE (1988), p. 254, and CBE (1993), pp. 55-59.

price of cotton in the early years of the ESM, was behind the bankruptcy of many wealthy families and the collapse of several businesses.

Neither the lack of investors nor shortage of capital explains the low profile of the ESM. The remarkable growth of the money market and the various inflation hedges that emerged in the last two decades reveal that there is a potentially active demand for securities. The problem therefore is primarily on the supply side. These problems include: the prevalence of state-owned enterprises (SOEs); relatively low costs of bank funding for enterprises; over-listing of closed companies with non-traded securities; limited variety of instruments; market illiquidity; unfavorable tax treatment of securities; inadequate information disclosure; absence of a uniform standard of accounting; and lack of anti-fraud measures. Many of these problems are currently under consideration by the government, and some of them, e.g. the capital gains tax, have been resolved. The securities market is starting to sense the new government approach in reviving the activities of the market.

### *The Banking System*

The partial liberalization measures of the 1970s encouraged establishment of foreign, private, and joint-venture banks. The number of banks registered with the Central Bank of Egypt (CBE) increased from 7 in 1974 to 81 in 1995. The banking sector currently consists of 28 commercial banks, four of them public; and 32 investment and business banks, of which 21 are branches of foreign banks. There are also 21 specialized banks.<sup>49</sup> The increase in the number of banks resulted in a rise in the number of branches to 2,241 in 1995.<sup>50</sup> However, banking density, at 0.38, is still modest. Most bank branches tend to concentrate in Cairo, Alexandria, and the Suez Canal governorates. Branches of public sector commercial banks dominate the banking system, especially considering public banks' participation in joint-venture banks, which is enforced by law.<sup>51</sup> Public sector commercial and specialized banks, excluding their part in joint-venture banks, accounted for 62% of total banking assets in 1991.<sup>52</sup>

The structure of the banking system and the geographic concentration of branches indicate a highly segmented market with a lack of competition. The relatively large branch networks

---

<sup>49</sup> Specialised banks include one industrial bank, two real estate, and 18 agricultural banks based in governorates, including the Principal Bank for Development and Agricultural Credit.

<sup>50</sup> See CBE, annual report 1994/95, p. 122.

<sup>51</sup> During the writing of this paper the bank laws concerning this point were under revision.

<sup>52</sup> See World Bank (1992), vol 2, p. 27.

of a few public sector banks allow them to dominate public savings mobilization. Other banks target mainly big savers. Financial services are still basic with very limited innovation, though joint-venture banks are in a better position. Public banks have been protected by an array of regulations and preferential treatment;<sup>44</sup> for example, branching by private banks was more restricted than that of public banks, and pension funds of the public sector had to be deposited with public banks. Private banks were denied stakes in public sector companies.

The situation in government-owned financial intermediaries in Egypt before the 1991 reforms can be summarized as follows: low resource mobilization; low profitability; low capitalization ratios and insolvency; complicated bureaucratic procedures for loan processing, and operating inefficiency; allocation of resources on the basis of non-economic criteria; reduced autonomy; poor quality of personnel, overstaffing and weak management. To some extent this continues to be the case. Public banks in Egypt have been more prone to government interference in credit and planning decisions than private banks. Consequently they have had relatively high levels of nonperforming loans, most of them theoretically government guaranteed. Incentives to maximize profits, or even to minimize losses, barely exist in public banks, with obvious implications for balance sheets as nonperforming loans and bad debts accumulated.

It is not just the absence of competition, but also the lack of contestability that cause problems. Contestable markets (threat of entry) can promote efficiency, encourage innovation and give highly favorable welfare outcomes.<sup>45</sup> For a market to be contestable there should not be any significant entry barriers. In a contestable environment, the only way for incumbent firms to prevent additional entry is to offer no incentive for potential entrants. This can be achieved by efficient pricing and allocation of production among incumbent firms to eliminate significant excess profits. However, in practice there may be different barriers preventing potential firms from entering the market, even in the presence of high excess profits. Large economies of scale and high sunk costs, in addition to other entry costs, are examples. In the case of banking, government regulations through permits and licenses are the most important barriers. The main reasons offered for such regulations are: concern about possible cream skimming by private and foreign banks; fear of establishment of dominant positions; concern about hit-and-run activities; a desire to protect the interests of the incumbent banks—especially the public ones; and attempts to prevent capital outflows. While

---

<sup>44</sup> For further details see World Bank (1992), pp. 1-41.

some of these issues may justify restricting entry in the banking sector, such restrictions deny competent banks the opportunity to help improve the efficiency of intermediation.

An efficient market cannot be achieved in the absence of an adequate exit mechanism. Banks in Egypt are not allowed to fail. Unfortunately this has not been accomplished through prudential policy or measures that enhance the efficiency of banks. Instead, inefficient banks are allowed to continue to operate through support from the CBE and the rest of the banking system. Fear of public misunderstanding of the failure of one bank (implying that others might follow) made the banking system adopt a form of collective responsibility. Under this approach, insolvent banks were left to operate through support from the banking system; measures like restructuring, mergers or liquidation were not applied. The result was encouragement of inefficient banks to continue violating credit standards by high risk lending and bidding for deposits. Moreover, bank clients had no incentive to distinguish between efficient and inefficient, or sound and unsound banks.

However, the government is not formally obliged by law to protect deposits, and the extent of coverage is left to its discretion. Thus, it was felt that it may be better to transform the implicit deposit protection scheme in Egypt to an explicit one. A deposit insurance fund was established in 1993 but is not operating yet. Any deposit insurance scheme cannot operate effectively without satisfactory prudential measures to reduce moral hazard problems and improve the soundness of the banking system. In accordance with the financial reform programme, the banking units in Egypt were recapitalized and Basle guidelines were applied. However, bank supervision still suffers from various limitations.<sup>٤٥</sup> First, the CBE does not enjoy reasonable autonomy from the government. Second, the huge increase in the number of operating banks was not matched by a corresponding increase in either the staff of the Bank Control department or its resources. Third, in many cases, the effective supervision of banks has been compromised by political pressure. Fourth, privileged private sector borrowers were also allowed to borrow despite their poor financial condition and insufficient collateral. In 1989, so-called sick balances reached 26% of total advances to private and investment sectors, of which 56.4% belonged to only 3% of defaulters.<sup>٤٦</sup>

### ***Intervention in the Portfolio Composition of Banks***

---

<sup>٤٤</sup> For an analysis of contestable markets see Baumol, Panzar and Willig (1982).

<sup>٤٥</sup> For further discussion of this point see Mohieldin, op. cit., pp. 17-18.

<sup>٤٦</sup> NBE (1989), pp. 142-143.



Banks in Egypt are required to hold a minimum of government securities as one of the components of the compulsory liquidity ratio. The liquidity ratio of 30%, imposed on domestic and foreign currency deposits, was introduced in 1958, and did not change until 1991 when it was reduced to 20% as part of the reform programme. Although the minimum liquidity ratio did not change over the 1960-90 period, the actual spread averaged 48.7%. Thus there was an average of 18.7% excess liquidity during the last three decades. In some years actual liquidity was more than double the minimum liquidity ratio. Excess liquidity reveals inefficiency in the intermediation process that forces banks to hold relatively high proportions of liquid assets.

The rise of excess liquidity in Egypt can be attributed to the inclusion of government securities and bonds in components of the liquidity ratio, to the extent that they became major items in bank portfolios. The rising usage of treasury bills by the government to finance its budget deficit, especially when the foreign credit market became more restrictive, increased their share in bank portfolios. Banks were normally attracted to risk-free treasury bills which offer high, tax-free interest rates. Moreover, high liquidity ratios may reflect the monetary authority's concern regarding low capitalization and insolvency of some operating banks. They also indicate increasing perceived risk on the part of investors and banks.

### ***High Required Reserves Ratio***

In Egypt, as in many other LDCs, the use of reserve requirements against bank liabilities goes beyond their traditional role as a monetary instrument and a prudential measure. They have been used to control the quantity of money and credit; affect the liquidity of the banking system; tax financial intermediaries; and most importantly, generate revenues to finance budget deficit.<sup>34</sup> High reserve requirements decrease loanable funds available for investment. Depending on the elasticities of demand for deposits and loans, the bank can pass part, or all, of the tax burden to depositors and borrowers in the form of a bigger spread between rates of deposit and lending.

Reserve requirements in Egypt were imposed on both local and foreign currency deposits in the form of reserve balances with the CBE. While required reserves on the former are not remunerated, on the latter they are at the LIBOR. The required reserve ratio was set by the CBE in 1960 at the relatively low level of 12.5%, then in 1962 was increased to 17.5% of

---

<sup>34</sup> See Morris et al (1990), pp. 44-5.

deposits. During the period 1966-78, it became 20% and then reached its high level of 25% during 1979-90. Later, under the financial reform programme, it was reduced to 15%.

Given the levels of real deposit rates and required reserve ratio, the spread under zero-profit assumption<sup>¶¶</sup> was 4 percentage points in 1990, i.e. before financial reform. However the actual spread was as high as 8.4. The difference between the actual and zero-profit spread, can be explained, in addition to bank profits, by high intermediation costs and banking inefficiency. The decline in the required reserve ratio to its current level of 15% was not reflected in a significant reduction in the spread. While the nonprofit spread decreased to 1.43 in 1995, the actual spread was 6.12. This means that the difference between the actual and non-profit spread after financial reform has increased by 0.3 percentage points where it should decline. Such high spreads and significant differences between zero profit and actual spreads, before and after reform, are symptoms of lack of competition in the banking system and high intermediation costs.

The magnitude of reserve requirements indicates whether they are used for prudential purposes and as instruments of monetary policy, or mainly to generate income for the budget. In developed economies the ratios of required reserves are much less than in LDCs. For Canadian chartered banks, the reserve requirement is 10% on demand deposits, and the monetary authority has been considering a policy to phase out reserve requirements.<sup>¶¶</sup> The Bank of England imposes a reserve requirement ratio as low as 0.35% of deposits to finance its operations.<sup>¶¶</sup> In contrast, the reserve requirement ratios in most LDCs are much higher, as shown in Table 7.

**Table 7. Required Reserve Ratios in Egypt and Selected LDCs**

Country	Year	Ratio	Remuneration
Egypt	1991	15	Only on foreign currencies
Bolivia	1991	20	yes
India	1992	15	yes
Kenya	1993	8	no
Paraguay	1993	30	no

<sup>¶¶</sup> In a perfectly competitive banking system in which profits are zero, the real interest rate spread can be calculated as follows:  $i_l - i_d = [k/(1-k)] i_d$ ; where  $k$ ,  $i_l$  and  $i_d$  are the required reserve ratio, lending rate and deposit rate respectively. Hence the spread increases if  $k$  increases. Also if the deposit rate rises so does the spread. For further discussion of this issue see Mohieldin (1994), pp. 10-11.

<sup>¶¶</sup> Champ and Freeman (1994), p. 121.

<sup>¶¶</sup> See Hardy (1993), p. 10.

Peru	1991	15	yes
Sri Lanka	1992	12	no
Tunisia	1992	2	no
Venezuela	1993	12	no

Sources: Hardy (1993) Appendix I, pp. 25-31, and CBE annual report 1995.

It is widely accepted that the interest rate spread is a good proxy for competition and efficiency of intermediation. Table 8 shows that despite financial reforms, Egypt's banking sector still suffers from inefficiency and lack of competition, which are negatively reflected in mobilization of savings and investment. Thus, while reform measures in Egypt have focused on improving a few financial variables such as increasing nominal interest rates above inflation rates and reducing the required reserve and liquidity ratios, they have not been profoundly concerned with the uncompetitive conditions of the banking system.

**Table 8. Real Interest Rate Spreads in Egypt and Selected Countries**

	1990	1991	1992	1993	1994	1995	Period average
<b>Egypt</b> <sup>§)</sup>	8.4		9.6	7.2	5.1	6.1	7.29
<b>Jordan</b>	3.9	7.4	6.8	6	6	6	5.98
<b>Morocco</b>	0.5	0.5	0	0	10.5	0	1.94
<b>S. Korea</b>	0	0	0	0	0	0.2	0.04
<b>Spain</b>	5.8	4.2	4	3.3	2.4	2.5	3.7
<b>UK</b>	2.8	1.6	2.2	2.2	2.1	2.6	2.25
<b>USA</b>	2	2.7	2.7	2.9	2.6	3	2.64

Source: IMF, International Financial Statistics Yearbook 1995 and 1996.

The remedy for these problems does not lie solely, or even necessarily, in changing the ownership of banks. It is rather the economic environment and mechanisms according to which public banks operate that emphasize the negative effects of inefficiency and hinder competition.<sup>§)</sup> This is evident by the fact that the inefficiency of some private banks in Egypt exceeds that of some public banks.

## Concluding Remarks

<sup>§)</sup> For comparison we use the IFS figures to calculate spreads. CBE figures for lending and deposit rates produce high spreads, but less than those reported for Egypt in the table.

The GATS, as a first multilateral attempt to establish disciplines for liberalization of trade in services, is only a start. A considerable amount of effort is required to achieve liberalization in the sensitive sectors of financial services, transport and telecommunications. In order to expand its sectoral coverage and reduce various restrictions on modes of supply, Egypt, as a developing country, needs to be convinced of the benefits of services liberalization. Relatively high transactions costs that result from inefficiencies in banking, telecommunications or transport, reduce the competitiveness of production sectors. The protection of intermediate services, in the interest of such objectives as political control, also has significant costs that hinder competitiveness. Efforts are required to modify the regulatory framework under which these sectors operate to allow for competition for the market and in the market. By removing barriers to trade in intermediate services, producers may have access to a variety of services that modern international markets can provide.

The sectoral coverage of Egypt's commitments under the GATS is relatively low. Restrictive protectionist measures continue to be applied in scheduled sectors, including financial services. As the Egypt-EU association agreement is not likely to go beyond the GATS, it will not result in significant liberalization of trade in services. In the case of financial services, liberalization of trade and allowing foreign firms to establish are not enough to weaken the monopolistic structure, or to improve efficiency in financial intermediation. The experience of Egypt, after approximately two decades of opening its financial market to foreign banks, illustrates that incumbent banks may squeeze out new entrants or collude with them. Further efforts are therefore required at the domestic level to improve competition in the financial market and reduce the role of the public sector.

In the context of the proposed agreement with Europe, Egypt has three options: First, to attempt to converge on the intra-EU situation, i.e., free trade; second, to negotiate specific arrangements for further liberalization of trade in services within the context of the agreement; and finally, to limit liberalization to whatever is negotiated over time in the GATS. The first is clearly too ambitious at this time, not just because of the implied commitments and obligations on Egypt, but also because the EU is unlikely to accept it. The second choice is the one Egypt should pursue. However, under the prevalent circumstances it is not unlikely that Egypt will follow the Tunisian-Moroccan path and 'choose the third best'.

---

☞ Killick (1993), p. 272.

## References

- ARE, 1996, 'The National Telecommunications Policy of the Arab Republic of Egypt'.
- Arndt. H.W., 1984, 'Measuring trade in financial services', *Banca Nazionale Del Lavoro*, Vol. XXXVII.
- Baumol, W., C. Panzar and R. Willig, 1982, *Contestable Markets and the Theory for Industry Structure*, New York: Harcourt Brace Jovanovich.
- Central Agency for Public Mobilisation And Statistics (CAPMAS), 'Annual Bulletin of Foreign Exchange Receipts and Payments', several issues (1986-95).
- CAPMAS, 1995, *Statistical Yearbook*, June.
- Central Bank of Egypt, *Annual Reports*, several issues.  
 \_\_\_\_\_, *Economic Review*, various issues.
- Champ, B. and S. Freeman, 1994, *Modelling Monetary Economics*, John Wiley and Sons, New York.
- Egyptian Financial Group, 1996, 'Egypt: A New Age; Guide to the Egyptian Capital Market'.
- El-Refaie, F., 1996, 'The GATS and its implications on the banking sector in Arab countries', paper presented at the Conference of the Economic Dept., Cairo University, January.
- Endres, A. and L. Altinger, 1995, 'The scope and depth of GATS commitments', mimeo.
- Federation of Egyptian Industries, 1995, 'Maritime transport services from the point of view of exporters: the problem and suggested solutions', November (in Arabic).
- Fieleke, N., 1995, 'The soaring trade in nontradables', *New England Economic Review*, Nov.
- Galal, A. and B. Nauriyal, 1995, 'Regulation of telecom in developing countries: outcomes, incentives and commitment', *Revista de Analisis Economico*, Vol 10, No 2.
- German Arab Chamber of Commerce, 1995, 'Egypt: business and production factor costs'.
- Germidis, D. and C.-A. Michalet, 1984, *International Banks and Financial Markets in Developing Countries*, Paris: OECD.
- Glaister, S., D. Starkie and D. Thompson, 1990, 'An assessment: economic policy for transport', *Oxford Review of Economic Policy*, Vol. 6 no 2.

- Hardy, C., 1993, 'Reserve requirements and monetary management: an introduction,' IMF Working Paper WP/93/35.
- Hoekman, B., 1995, 'An assessment of the Uruguay Round Agreement on Services', in Will Martin and Alan Winters (eds.), *The Uruguay Round and the Developing Economies*, Cambridge: Cambridge University Press, forthcoming.
- Hoekman, Bernard and P. Sauve, 1994, 'Liberalizing trade in services', World Bank Discussion Paper. Washington D.C.: The World Bank.
- Hoekman, B. and P. Braga, 1995, 'Trade in services, the GATS and the Arab countries', mimeo.
- International Finance Corporation, 1993, *Emerging Stock Markets Factbook*, Washington: IFC.
- International Monetary Fund, 1995, *International Financial Statistics Yearbook*, IMF.  
----- 1996, *International Financial Statistics Yearbook*, IMF.
- International Telecommunications Union, 1995, *World Telecommunication Development Report*.
- K & M Engineering and Consulting Corporation, 1994, 'Policy reform and institutional development assessment', report for ARENTO.
- Killick, T., 1993, *The Adaptive Economy: Adjustment Policies in Small, Low-Income Countries*, Washington D.C.: The World Bank.
- Mohieldin, M., 1995, 'Causes, measures and impact of state intervention in the financial sector: the Egyptian example', Working Paper 9507, Economic Research Forum For Arab Countries, Iran and Turkey.
- Mohieldin, M. and J. Wahba, 1996, 'The Uruguay Round and trade in financial services in the Arab countries', Discussion Paper in *Economics and Econometrics* No. 9617.
- Morris, F. et al, 1990, 'Latin America's Banking System in the 1980s: a cross country comparison,' World Bank Discussion Paper No. 81, The World Bank, Washington DC.
- Moshirian, F., 1994, 'Trade in financial services', *The World Economy*, May, 17:3, pp. 347-62.
- Nathan Associates Inc., 1996, 'Egypt: options for increasing market competition in maritime

- port services', Report prepared for the Government of Egypt.  
National Bank of Egypt, *Economic Bulletin*, various issues.
- Sampson, G. and R. Snape, 1985, 'Identifying the issues in trade in services', *The World Economy* **8**, June, pp. 171-82.
- Sapir, A. and C. Winter, 1994, 'Services trade', in D. Greenaway and L. Winters, eds., *Surveys in International Trade*, Oxford: Blackwell.
- Schouten, B., 1995, 'Transaction costs to private exports', World Bank draft for discussion, February, Cairo, Egypt.
- Schultz, S., 1993, 'Barriers in services trade: the state of negotiations and prospects', *Intereconomics*, September.
- SRI International, 1995, 'Achieving Egyptian export growth', March, Report submitted to the Egyptian Ministry of Economy.
- UNCTAD and the World Bank, 1994, 'Liberalizing international transactions in services', United Nations.
- Whalley, J., 1995, 'Services in the Uruguay Round and beyond', UNCTAD Project on the Implications of the Uruguay Round on Developing Countries.
- Whalley, John (ed.) 1989, *The Uruguay Round and Beyond: The Final Report from the Ford Foundation Project on Developing Countries and the Global Trading System*, London: Macmillan Press Ltd.
- World Bank, 1990, 'Arab Republic of Egypt: country economic memorandum; economic readjustment with growth', Washington: World Bank.
- \_\_\_\_\_ 1992, 'Egypt financial sector report-banking sector'. Draft-February.
- \_\_\_\_\_ 1993, 'Egypt: financial policy for adjustment and growth', Report No. 10790-EGT, Washington: World Bank.
- \_\_\_\_\_ 1994, *World Development Report*, Oxford: Oxford University Press.
- \_\_\_\_\_ 1995, *Trends in Developing Countries*, Washington DC: World Bank.
- World Trade Organization, 1995, 'International trade trends and statistics', Economic Research and Analysis Division and Statistics and Information Systems Division.

World Trade Organization, 1995, 'Communication From the Arab Republic of Egypt'.

Yoffie, D., 1993, *Beyond Free Trade: Firms, Governments and Global Competition*,  
Boston: Harvard Business School.