Egypt's Economic Reform:

Is It for Real?

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Brief Analysis

Throughout its reform program, Egypt has established a pattern of reform that avoids the problems of the Southeast Asian economies in three key ways:

First, Egypt has not run a large deficit in the balance of payments current account. Egypt's current account deficit is of the order of a couple of hundred million dollars per year, less than half a percent of GDP. Over the next five years, Egypt projects that the current account will go into a deficit of two percent of GDP, which is a healthy deficit for a growing economy.

> Second, Egypt does not have any significant external debt. Egypt's external debt in nominal terms is about $28 billion, but in market value terms it is only about $19 billion, because much of the debt is at a low interest rate (for instance, most of the loans from the U.S. government). Against these, Egypt has external reserves at the central bank of $20.5 billion; therefore, Egypt is a net creditor to the world of $1.5 billion. More important than the low level of Egypt's debt is its good composition: 95 percent is long- or medium-term, and borrowing by Egypt's private sector is very small (on the order of $500-$600 million).

Third and even more important, Egypt has understood the central importance of governance. The Southeast Asian economies were brought to their knees not only by large current account deficits, financed to a great extent by short-term debt, but even more importantly by problems in governance. There was a complete absence of collective decision-making, the presence of pervasive corruption, monopolies, and extensive intervention in economic processes.

> Egypt's reforms are now concentrating on institutions. Ultimately, the cause of growth is not the economic decisions as much as the institutions that produce the economic decisions. The principle that governs the reform of Egyptian governance is basic transparency in decision-making. This requires conveying information to the public, establishing a process of accountability, creating a process of follow-up, and shedding the government bureaucracy. Egypt is striving to create a pluralistic environment that regulates business, not one that stifles entrepreneurship.

Pushing Along Three Dimensions

Egypt's economy needs to move forward in three key areas:

Export Promotion: The Egyptian market of 62 million people is too small to generate 7 to 8 percent growth every year for the next 10 to 20 years; therefore, Egypt needs markets abroad. In order for this to happen, Egypt needs to improve quality, productivity, technology, and improve the institutions that make foreign markets accessible to domestic products-accessible in the sense that the designs, the packaging, and the actual essence of the product are drawn from foreign markets. This is a state of mind, an attitude, and again it is a result of establishing strong institutions. The process is slow, though it can be jump-started by using foreign technology and foreign marketing firms. Ultimately, however, if the mindset does not change, the export growth is not going to last.

Savings: Egyptian savings are about 18 percent of GDP, which is not enough to generate the target 8 percent growth. Eight percent growth is generated at a savings rate of 25 percent of GDP. In order to reach this, Egypt must do two things: it must get its financial institutions at par with international norms, and, even more difficult, assist Egyptians in their savings. Egyptians are not offered the proper vehicles for saving in terms of liquidity, risk diversification, and access to financial markets. It is time to start worrying about Egyptian savings habits, instead of worrying about Egyptian consumption habits as has been the case for the past 30 to 40 years.

The Nature of Growth: Generating 7 to 8 percent growth is not enough. It is also necessary to generate an elevated quality of growth, a growth from the grassroots (the small enterprises) rather than just at the tip of the economy (the large corporations). Egypt is developing a fairly detailed policy for addressing the needs of small and micro enterprises. Over 90 percent of employment in the private sector is in enterprises that have fewer than 15 employees. No more than 7 percent of these enterprises have access to bank credit, and no more than 10 percent have any relationship with any type of financial institutions, be they formal or informal institutions. Egypt must bring these enterprises, which at present are fairly marginal, into the formal system without any financial burdens on them. Once Egypt integrates these enterprises and rescales the economy to include them, the impact on the formal economy will be profound.

The Peace Process, Regional Integration, and Egypt's Economy

The peace process is not important for Egyptian economic reform. Egypt has been trying to sell itself as "a great house in a lousy neighborhood," and it has to a large extent succeeded. Egypt's economy must establish itself independently of what happens in the neighborhood. Egypt has waited long enough for the process to resolve itself, and as far as the economy is concerned, it cannot wait anymore. As much as Egypt thinks peace is essential for the stability of the region, Egypt does not think that its economic progress is contingent on that process. The Egyptian economy is oriented toward the global economy; it is not focused on the regional economy, be that Arab or Israeli.

The economic integration of the Middle East need not wait for the appearance of peace. Most of the countries in the region are at peace, and yet their level of economic interaction is low. Those countries can begin to integrate economically, with that integration extended to the other regional states when they abide by accepted rules of international behavior.

> The barrier to closer Israel-Egyptian economic cooperation is the hostility of ordinary Egyptians. The Egyptian government has no objections at all to Israeli trade and investment, but businessmen are reluctant to buy Israeli inputs because of their fear that Egyptian workers will refuse to work if they see Israeli materials being used.

As far as Arab integration is concerned, the main obstacle has not been the lack of political will, for the will has been there, but rather the lack of policies and institutions that facilitate integration. Today, more of the Arab economies have the prerequisites for economic integration: economic stability, a dependable regulatory structure, and liberal market-oriented principles. In that sense, the Middle East is a lot closer to establishing free trade in the Arab world. The Arab League has agreed to the principles of a free trade zone and a number of countries have put in motion the processes that will make this a reality. Before long, we could see the first steps towards a free trade area in the Arab world, which would begin the movement towards an integrated economic market.

This Special Policy Forum Report was prepared by Eytan Fisch.

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