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OF STATE INTERVENTION IN
THE FINANCIAL SECTOR: THE
EGYPTIAN EXAMPLE**

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Causes, Measures and Impact of State Intervention in the Financial Sector: The Egyptian Example*

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Abstract

This paper discusses the reasons for state intervention in the financial sector in Egypt and analyses major tools of intervention such as setting ceilings on interest rates, imposing high reserve requirements, developing directed credit schemes and intervention in the portfolio composition of banks, in addition to the extraction of revenues from inflation tax. The main consequence of state intervention in the financial sector are investigated, including the thriving of informal finance, the rising use of inflation hedges, currency substitution, and capital flight. The paper also discusses the structural and institutional problems of the banking system and securities market in Egypt, caused primarily by repressive state intervention.

ملخص

تناقش هذه الورقة أسباب تدخل الدولة في القطاع المالي في مصر وتحلل الأساليب الرئيسية للتدخل، مثل تحديد سقف أسعار الفائدة، واشتراط وجود احتياطي كبير، وتطوير خطط الائتمان الموجهة، والتدخل في تكوين محفظة الأوراق المالية لدى البنوك، بالإضافة إلى استخلاص بعض الإيرادات من ضريبة التضخم. وعلاوة على ذلك، تقوم الورقة بتمحيص النتائج الرئيسية لتدخل الدولة في القطاع المالي، والتي تتضمن ازدهار القطاع المالي غير الرسمي، وزيادة استخدام إجراءات الوقاية من التضخم، واستبدال العملات، وهروب رؤوس الأموال. كما تناقش الورقة المشكلات الهيكلية والمؤسسية للنظام المصرفي، وسوق الأوراق المالية في مصر والتي تسبب فيها أساساً الكبح المالي الذي تمارسه الدولة.

"If as in the 18th century, the existing mercantilist economy seemed to be inefficient, then the prevalent mood was for greater freedom. If as in the late 19th century, the existing liberal economy was perceived not to have solved the problems of poverty and insecurity, then the mood was for intervention. If as today, the interventionist economy is perceived as having failed and governments having grown too large, then the mood is for liberalism."
R. M. Hartwell (1989)¹

1 Introduction

Financial sectors in LDCs have always been subject to substantial government intervention in its structure and mechanisms. Such intervention is not of regulatory or corrective nature but mainly repressive, if one uses the terminology of the Stanford School. In many developing economies, governments impose an array of measure that deviate the operations of the financial system away from the market discipline and result in various distortions.

The state intervention in the financial system can be explained by different arguments: such as the condition of the financial market in LDCs after independence, the impact of the dominating ideologies during late 1950s and 1960s, and/or anti-usury laws, but the main common cause, we argue, was financing the budget deficit.

The state intervention in the Egyptian financial market, took various forms that include setting ceilings on interest rates, high reserve requirements, directed credit schemes, ownership of banks, intervention in the portfolio composition of banks in addition to extracting revenues from inflation tax. In this paper we estimate the government revenues generated from applying these repressive methods. Considering the volume of these revenues is particularly important as they are likely to be lost in a liberalised economy, and measures could be required to reduce the need for them and/or substitute them from unrepresive sources.

Moreover we analyse the impact of the state intervention on the structural and institutional characteristics of both the banking system and the securities markets. The paper discusses these problems from the perspective of the type of policy action and restructuring measures required in the financial system. Further we highlight the main consequences of state intervention, such as capital flight, currency substitution, the thriving of informal financial activities and the rise in the use of inflation hedges in Egypt. These problems signifies the need for a change of the role of the state in the financial system to become a steward of reform and restructuring and to enable the financial system to act as an agent of change.

2 Reasons for financial repression

2.1 The Condition of the banking system after independence

One of the reasons behind the Egyptian government's intervention in the operations of the credit market can be attributed to a market failure problem and its negative effects on the efficiency of financial intermediation, i.e. the mobilisation of savings and the allocation of loanable funds.²

When Egypt started to modernise its economy in the 1950s, after gaining its political independence, the financial system was comprised of foreign owned commercial banks, with the exception of Bank Misr and some scattered Egyptian shares in few financial units. The activities of these banks were concentrated in short-term trade and commercial credit. There was also geographical concentration as most of the banks were established in Cairo and Alexandria with very few branches in other big urban centres. The financial system was segmented and shallow in the sense that either some financial services and instruments did not exist at all in some areas, e.g. insurance services, or they existed but

¹ Hartwell (1989), p. 118.

² See Killick, 1993, pp. 254-262, for further analysis of market failure problem and its impact on the financial system.

were in an inadequate form, e.g. agricultural credit banking.

Encouraged by segmentation and shallowness, operating banks behaved in an oligopolistic manner. This was facilitated by the absence of a formal legislator. The National Bank of Egypt, as an acting Central Bank, was not adequately empowered to exercise the known functions of a well established monetary authority in terms of supervision and regulation.

Asymmetric information, regarding both the services of the financial sector and potential borrowers, was a result of such oligopolistic environment and a cause for other problems, such as adverse risk selection and the application of non-price criteria for the allocation of credit, i.e. depending on the reputation of the borrower, political pressure,... etc.³

All these characteristics are symptoms of market failure which called for corrective intervention by the government. However the intervention, especially during the 1960s was not necessarily corrective as it was mainly driven by ideological motives, which left the entire financial system publicly owned and managed.

2.2 The impact of ideology

The repression of the financial sector was one of the components of overall interventionist policy embraced by the government in the 1960s under the conviction of socialist ideas as a remedy for economic problems. According to these ideas, the public sector was considered the engine of economic growth. Whereas the private sector was regarded as both economically inefficient, in undertaking the large projects of the ambitious development plans, and politically unreliable because of its close association with the former regime. Hence there was a series of Egyptianisation, de facto nationalisation, of foreign owned enterprises, including financial intermediaries in late 1950s and the comprehensive nationalisation measures of early 1960s.

Consequently publicly-owned banks comprised the entire financial system until 1975, and despite the allowance for some foreign and private banks to operate, public banks have been its dominant component afterwards. Although owning financial intermediaries by the state cannot be always considered a facet of financial repression, we argue that the way they functioned in Egypt, as in other LDCs, made them a catalyst for repression and a promoter for its unfavourable effects. In this environment it is hard for the private sector to compete for credit, simply because credit is administratively allocated to the so-called priority projects.

2.3 The influence of Keynesian ideas

Egyptian policy makers, like many others in the rest of the developing world, were influenced by Keynesian arguments during its heyday during the 1950s and 1960s. According to Keynes, excessive liquidity-preference pushed real interest rates historically above the full-employment equilibrium level. As a solution for liquidity-preference, described as "the outstanding evil [and] the prime impediment to growth of wealth"⁴, Keynes proposed interest rate ceilings. This proposition was in accordance with his advocacy of the Gesellian stamp tax on money which was designed to reduce the demand for liquidity by raising the opportunity cost of holding money.⁵

Further, Tobin (1965) in his model of money and economic growth demonstrated that a higher return on capital relative to money leads to a higher capital/labour ratio, higher productivity of labour and improvement in per capita incomes. This necessitates either a reduction in deposit interest rates or taxing money à la Gesell.⁶

The views of Keynes and Tobin, among other economists, constructed a general wisdom, in most developed and developing countries including Egypt, that low nominal interest rates are necessary for growth. Hence the widespread use of interest rate ceilings as a main tool for financial repression.

³ See Killick (1993), op. cit, p. 256.

⁴ See Keynes (1936), p. 351.

⁵ On Gesellian Stamps and its support by Keynes see: Keynes (1936), pp. 353-8, Shaw (1973), p. 93. and Fry (1988), p. 5.

⁶ For a discussion of this point see Fry (1988), pp. 5-6.

2.4 Regulations against usury

Imposing controls on interest rates were consistent with religious and political objections to high interest rates which are considered as usurious. Although Islam considers the charge of an interest rate, regardless of its level be it high or low, as a form of usury, Egyptian authorities do not adopt this view. Rather they seem more influenced by the view that high interest rates are usurious while relatively low rates are not, hence their advocacy of interest rate ceilings. The establishment of a 7% ceiling on interest rates in the Egyptian Civil Code reflects this understanding.

In addition to the religious rationale, usury laws were advocated for a long time by policy makers, who accepted the view of Adam Smith (1776) which stated that usury ceilings would direct loanable funds to 'productive investments' and away from 'poor-risk spendthrift' borrowers.⁷ This view is an early precaution of today's ideas about adverse risk selection.

2.5 Financing budget deficit as a main reason for financial repression in Egypt

Deficit finance is a familiar phenomena in most LDCs. For a long time this financing tool was accepted to the extent that it was considered "the most useful method of promoting economic development in LDCs"⁸. The frequent use of deficit financing was justified by the insufficiency of private investment for several political, economic and institutional factors. Therefore augmenting the rate of net investment in the economy depended on government's efforts. But a typical LDC's government lacked sufficient resources to finance public investment and spending, hence it normally resorted to deficit finance.⁹

Despite realising that deficit finance has adverse effects, e.g. its inherent inflationary potential, it was argued that such effects can be contained if deficit financing is used within safe limits. Such limits depend on different factors, e.g. the growth rate of the economy, the degree of monetisation in the economy, the extent of restrictions imposed on the close substitutes for government money.¹⁰ However it was difficult to adhere to these limits, and recently budget deficits received much of the blame for mixed economic problems that troubled developing economies in the 1970s and 1980s.¹¹

Depending on the means of financing, i.e. printing money, domestic borrowing, and/or foreign borrowing, budget deficits show up in one or more of macroeconomic imbalances: inflation, foreign exchange shortages, crowding out of private investment and/or foreign debt crisis.

Thus there was a call for revising deficit finance, once seen as natural and even essential instrument for financing development.¹² Cutting budget deficits of LDCs has become the *sine qua non* of stabilisation and structural adjustment packages proposed by the IMF and the World Bank. Moreover, the controversy among rival schools is not about the issue of keeping a high budget deficit or not, but mainly it is about two questions. First, what is the appropriate size of budget deficit in terms of

⁷ On the impact of usury laws on credit availability and allocation see Villegas (1989) and Blitz and Long(1965).

⁸ Quoted from Jhingan (1986), p. 364.

⁹ For further discussion of deficit financing and its role in economic development see Kulkarni (1966), pp.16-37.

¹⁰ On the related issue of inflationary finance see Nichols (1974), pp. 423-30.

¹¹ See for example: Easterly and Schmidt-Hebbel (1993), pp. 211-213.

¹² Deficit finance and Keynesian economics were linked together for a long time because of the Keynesian proposition that output is driven by demand which can be altered by government action, via taxation and public spending. Despite such association it has been recently established that Keynes himself did not recommend government deficits as a tool of economic policy. See The New Palgrave (1988), pp. 764-5 and Kregel (1985), p. 32.

consistency with stability? Second, how deficit cuts should be done with minimum negative effects?¹³ Needless to emphasise that the perceived change regarding deficit finance is part of the whole review of the function of the state in economic development.¹⁴

Figure (1) shows the development of the budget deficit in Egypt over the period 1974-90. The average budget deficit as a percentage of GDP was 21.8% and ranging from 15.9% to 30.5%. As shown in the figure, data obtained from the IMF's Government Financial Statistics, which used different deficit definition from the one used by the country's statistical authorities, show lower deficits with an average of 12.5%. But even according to these conservative figures the Egyptian budget deficit was high by most international standards.

Several factors have contributed to the variation of the magnitude of the Egyptian budget deficit during the past three decades which can be summarised as follows:

The instability of government revenues due to the fact that the main sources of revenue in the economy, to a great extent, are exogenously determined. These revenues are oil receipts, the Suez Canal dues, remittances of Egyptian workers abroad, and tourism, in addition to foreign grants.

The economy's exposure to external shocks, e.g. the worsening of terms of trades during the 1970s and 1980s, the increase in international interest rates in early 1980s.

The extent of government intervention in the economy and its control over expenditure, e.g. food subsidies.

The malfunctioning of the tax system, the accumulation of arrears and the relatively large length of collection lags.

The impact of political issues on the budget deficit are hard to neglect in any country as they may force the government to spend more than it should and/or tax less than it can. In Egypt political aspects influenced the size of the budget deficit further in the sense that they delayed, and even prevented, specific budget reform measures. For example the riots of 1977 prevented the government from proceeding with an IMF stand-by-agreement, aiming at reducing subsidies to control the budget deficit.

The method of financing the budget deficit had also an impact on the size of the deficit, i.e. the inflationary impact of money creation and the increase of vulnerability to external shocks associated with external financing.

3 Adopted interventionist methods to finance budget deficit

The extent of reliance on any of the methods of financing the budget deficit, i.e. foreign, bank and non-bank financing varied over the period of 1960-90. Deficit financing on average was predominantly domestic. The government relied heavily on non-bank and bank financing, contributing respectively by an average of 39% and 38% of the total budget deficit. Part of the financing came from borrowing abroad, especially during late 1970s and 1980s, and contributed by an average of 23% during this period. However we focus on the role of financial sector in financing the budget deficit through interventionist methods.

3.1 Seigniorage

Although the term bank financing is used in literature to indicate deficit financing through money creation, in practice there is a difference between the two. The Central Bank of Egypt (CBE), like any other central bank, does not resort to money creation unless its reserves of liquid assets are not sufficient. The CBE accumulates these assets mainly through its imposition of reserve requirements ratios on the deposits held with the banks, and by borrowing excess liquidity of commercial banks. Normally the central bank borrows from deposit banks at a lower rate of interest than the rate it receives from the government for purchasing its issued bonds.¹⁵ However the Egyptian government revenue from money creation (seigniorage)¹⁶ was an important source for financing the deficit.

¹³ See Dornbusch (1990), p. 29 and On the issue of deficit reduction and its effects see Taylor (1990), pp. 223-8.

¹⁴ See the World Bank (1988), pp. 43-54.

¹⁵ Noshay (1990), pp. 2-3.

¹⁶ For further discussion of seigniorage see Fischer (1982), Mankiw (1987) and Klein and Neumann (1989).

Following Fischer (1982) we calculate seigniorage (S) as an incremental change of monetary base (M)¹⁷ over a discrete period divided by the value of nominal GDP (Y) over the same period.

$$S = \Delta M / Y \quad (1)$$

As shown in figure (2), seigniorage revenue varied considerably during the period under study. During the 1960s it was, on average, low and reached its highest levels in the late 1970s and early 1980s. But generally the ratio of seigniorage to GDP is high by international standards as shown in table (1).

The World Bank (1988) classified LDCs into three groups according to the level of their seigniorage revenues: low, moderate and high. Using the same method and data sources our results for Egypt show that it lies in high seigniorage group. It was second highest after Bolivia which had an extremely high inflation rate that exceeded 500%. Further Egypt's seigniorage was higher than that of Argentina which had an inflation rate approximately 18 times higher.

Generating a high seigniorage revenue with a relatively modest average inflation rate of 15.2% is explained by the high ratio of currency holdings to GDP which had an average of 25.1% during 1980-85 compared with 3.8% and 6.1% for Argentina and Bolivia.

The impact of the relatively high monetary ratio to GDP on government revenues can be explained further by analysing the extent of reliance on inflation tax in Egypt over the period 1960-90.

3.2 Inflation tax

As argued by Blanchard and Fischer (1989), inflation tax is "related but not necessarily identical to seigniorage"¹⁸. Inflation tax as a loss of the value of real balances M/P can be presented as $\pi M/P$, where π is inflation rate. While seigniorage is $\mu M/P$ where μ is money growth. Thus inflation tax and seigniorage can only be equal when $\pi = \mu$ which holds in the steady state, i.e. economic growth is zero, and not generally¹⁹.

Thus we calculate the inflation tax for Egypt over the period 1960-90 as follows:

$$I = M [\pi / (1 + \pi)] \quad (2)$$

Where M is reserve money defined here as the monetary base, which consists mainly of notes and coins in circulation outside banks + vault cash held by banks + banks' deposits with the CBE i.e. reserve requirements. π is the change of the consumer price index CPI. Our results are presented in figure (3) and table (2).

Figure (3) shows inflation tax as a percentage of GDP. Inflation tax with an average of 0.6%, was relatively low during the 1960s, with the exception of 1965 due to an increase in inflation rate. In 1962 and 1968 the inflation tax was surprisingly negative, because the change in the CPI during these two particular years was negative.²⁰

¹⁷ Note that for the value of M we use the end-of-year currency outside banks.

¹⁸ Blanchard and Fischer (1989), p. 198.

¹⁹ *ibid.*

²⁰ Although we accept that published figures on inflation suffer from a downward bias over the period under study due to technical and political reasons, we find that the negative inflation figures for 1962 and 1968 are really unusual in any economy especially if it is a developing one. One possible reason behind these irregular figures is the fact that the country suffered from some political drawbacks in the two preceding years 1961 and 1967. In 1961 there was the political and economic unrest because of the mass nationalisation measures, in 1967 there was the problem of the war. While we doubt that these two reasons had a lagged disinflationary impact on the economy, we argue that the data were used to give an impression of stability in the economy. However we had no choice but to use the published figures: Our data source is the IFS, 1990 and 1991 Yearbooks, line 64.

Because of a rise in inflation rates and the ratio of reserve money to GDP, the 1970s observed a rise in inflation tax but it was relatively moderate as its average was 1.9%. However the inflation tax did not reach its high levels until the 1980s. The average during this period, 6.1%, was extremely high and reached its peak in 1986 at 9.5% of GDP.

As shown in table (2), because the average of both of inflation rates and reserve money ratio were high during this period, this resulted in a high level for the inflation tax. However it is the high ratio of reserve money which enabled Egypt to maintain high inflation tax at relatively low inflation rates. To clarify this point we make a comparison between Egypt and other LDCs.

For comparison reasons we consider here the inflation tax as a percentage of GNP. From table (3) it is clear that Egypt had the highest inflation tax compared to the selected countries. Further it exceeds the value of inflation tax in countries with substantial inflation rates like Argentina, Mexico, Peru and Zaire. The Egyptian authorities via tight control over domestic prices, including interest rates and exchange rates, as discussed below, extracted a high enough inflation revenue from the inflation tax without the need to increase money printing excessively and by that it did not experience a Latin American inflation rate.²¹

Even if we accept that inflation rate data are not necessarily accurate in Egypt, we realise that the most aggressive estimates did not exceed 50% in any year during the study period. It is indeed the wide inflation tax base in Egypt that enabled the government to extract a substantial revenue at relatively low inflation rate. As shown in table (3), while Egypt had one of the lowest inflation rates among the selected countries, it had the highest ratio of reserve money at 44.8% which was approximately seven times higher than that of Argentina or Mexico. Clearly if the size of reserve money was lower in Egypt, the inflation rate required to reach the same inflation tax, should have been several times higher.²²

While the issue of how Egypt managed to keep such high ratio of money balances is discussed in the following section, we show here what would happen if reserve money balances were lower.²³ We provide a simulation for the inflation rates required to reach the actual inflation tax at different reserve money ratios in the corresponding years. We exclude the two years which had negative inflation rates and calculate the inflation rate π , from equation (2), as

$$\pi = (I/M) / [1 - (I/M)] \quad (3)$$

Where

I is the inflation tax
 M is reserve money.

Over the period 1960-90, we find that at one-half the size of reserve money holding, inflation rates should increase from the actual average of 10.4% to 25% in order to extract the same inflation tax revenue (see fig. 4). At one-third of reserve money, average inflation rate should rise to 45.7%. In the fiscal year 1987, which had the highest inflation tax at an actual inflation rate of 23.9%, at one-half and one-third of reserve money the inflation rate in this year would have been 62.8% and 137.4% respectively.²⁴

²¹See Dinh and Giugale (1991), p. 10.

²²It seems that there was an implicit contract between the holders of domestic money balances as a group and the government. Under this contract the latter keeps inflation under control and the former keep their deposits even under relatively low rates of interest.

²³See also Dinh and Giugale (1991), p. 15.

²⁴This assumes a non-inflation sensitive money demand function. results would be different if we use for example a Cagan money demand equation.

3.3 Interest Rate Ceilings

Unless a country faces unlimited supply of foreign finance, the budget deficit competes by one way or another for scarce domestic loanable funds.²⁵ Egypt, like several other LDCs, adopted various measures to limit this competition. One of these measures was the imposition of interest rate ceilings, to keep the cost of its borrowing low.

For a long time, deposit interest rate in Egypt was controlled by a Civil Code which did not allow returns on deposits to exceed 7% per annum. In accordance with the *Infitah*, open door policy, the Central Bank of Egypt, in 1975, was exempt from applying the Civil Law regulations regarding the low maximum of 7%²⁶. Nevertheless deposit interest rate, did not reach this figure until 1979, as a result of the CBE adoption a policy of gradual increase of interest rate as shown in figure (5). Gradual increase of nominal interest rate continued until 1982, but from this year to 1988 the rate was fixed at 11%, and the rate reached its maximum at 12% in 1990.

Due to the exceptionally low inflation rates of the 1960s and the early 1970s real interest rate was positive in some years.²⁷ However real interest rates were mostly negative during the study period. The gradual rise of nominal interest rates, during the partial liberalisation period that accompanied the *Infitah* policy did not prevent the real interest rate from being negative and declining during the 1970s and 1980s.²⁸ It is interesting to find that real interest rates during the *Infitah* period of 1975-90 were generally lower than in the socialist period of 1961-74.

This problem can be explained by several factors: First, the inflationary pressures that resulted mainly from external shocks, the devaluation of the pound, freeing the prices of some goods and services and reducing the volume of subsidies. Second the *Infitah* policy did little to the liberalisation of the banking system. As discussed above, despite the rise in the number of foreign and private banks, the public sector banks continued to dominate the banking system. Further, by law, public banks had shares in the capital and participated in the management of the newly established private and foreign banks which were only allowed to be established as joint ventures. Thus competition was extremely lenient. Third, price competition was not possible under the existence of interest rates ceilings. Hence the growth of nominal interest rate was far behind the accelerated inflation rate.

Figure (6) compares deposit real interest rate in Egypt and the USA, which can be considered as a rough proxy for international interest rates. While real interest rates in the USA were positive in the most of the period 1960-90 as they averaged 2.03%, they were mostly negative in Egypt and averaged -2.91. Whereas real interest rates in Egypt were more volatile with a standard deviation of 4.45, in the case of USA standard deviation was just 2.13. Such variability of real interest rates has adverse effects on the preference of financial assets in savings portfolios as opposed to other substitutes like commodities.²⁹

²⁵ Fry (1992), p. 7.

²⁶ This was possible after issuing law no. 120 for 1975.

²⁷ Real interest rate was surprisingly higher than nominal interest rate in 1962 and 1968 because of the unusual negative change of the CPI during these two years which is discussed above.

²⁸ We argue that real interest rates in Egypt were lower than what reflected in figure (7) and table (6), simply because of the downward bias of official inflation rates. Such bias is mainly due to two problems: first the exclusion of many items from the basket of goods and services used to calculate the CPI, many of these excluded items, e.g. leisure goods, private vehicles and their maintenance, private schooling and private health care, their prices changed drastically during the study period. Second the reporting only of the changes of administered prices and neglecting their actual change which occurs in the active black market. But as mentioned earlier the highest estimate for inflation in Egypt did not bring it near the Latin American figures and thus real interest rate were lower, but not substantially so, than the presented figures.

²⁹ See Seck and El Nil (1993), pp. 1873-4.

Table (4) provides a comparison between real interest rates in Egypt and selected countries for specific periods. During the period 1970-80 real interest rates for all selected countries, except Egypt, were lower than those of the 1980s. However the Egyptian figure, compared with that of Turkey, Peru and Uruguay, during the 1970s can be considered moderate. During the 1980s Rising inflation with almost fixed nominal interest rate resulted in the deterioration of the average real rate of interest in Egypt, while the rest of the selected countries witnessed increases in their real rates of interest.

We realise from figure (7) that financial savings in the form of domestic currency deposits continued to grow, with very few exceptions, despite the negative returns in the respective years. This phenomenon can be explained by one or more of these factors: Money illusion, inflation as a motive for saving, a favourable return-risk relationship, lack of alternatives and relatively moderate inflation rates, in addition to the so-called widow-orphan type of depositors.³⁰

3.3.1 Government revenue from interest rate ceilings

While there is no explicit tax levied on deposit interest rates, since 1981, the gap between the administered rate and the market rate can be viewed as a tax.³¹ The government managed to extract this implicit tax revenue over the period 1960-90, by setting ceilings on interest rates below market clearing rates.

When there is also a ceiling on lending rates additional implicit tax is levied. Depending on the availability of credit and the terms of borrowing from the banking sector, the private sector can obtain part of tax revenue in the form of a subsidised lending rate. However as noted in the works of McKinnon and Shaw, under the credit rationing associated with the distortion of interest rates, only few favoured borrowers share with the government in its implicit tax revenues extracted from ceilings on borrowing and lending rates.

Constrained by the availability of data³², we focus here on the government revenue from financial repression through deposit interest rate ceilings. By adapting the method used by Giovannini and de Melo (1991), we calculate such revenue, as a percentage of GDP, by considering the difference between foreign and domestic real interest rates multiplied by the stock of financial savings held with the formal sector over the period 1960-90. Given that deposits denominated in foreign currencies, mainly US dollars, receive the LIBOR rate we exclude them and consider only those denominated in the domestic currency.

Thus we calculate the revenue from repressing interest rates (RT) as follows:

$$RT = D \cdot (\delta_d - \delta_i + x); \quad (4)$$

where D is domestic currency deposits
 δ_d is real domestic interest rates
 δ_i is real international interest rates (returns on US T. Bills)
 x is the appreciation or devaluation of the Egyptian pound against the US dollar.

Figure (8) shows the evolution of such revenues as percentage of GDP over the 1960-90 period. They were higher in the 1970s and 1980s than in the 1960s, for two reasons first the lower real interest rates

³⁰For further discussion of this issue see Mohieldin (1993), pp. 7-12.

³¹See Chamley and Honohan (1990) for a discussion of explicit and implicit taxation of the financial assets.

³²In a study by Giovannini and de Melo (1991) they measured the government revenue from financial repression as the difference between the foreign and the domestic cost of borrowing multiplied by the stock of domestic government debt. They consider such difference as an implicit tax on government debt holders in an environment characterised by restrictions on the international flow of capital and different forms of financial repression. They put two criterions for the inclusion of countries in their analysis, first keeping a stock of commercial debt that exceeds \$ 200 million. Second the availability of disaggregated data on the stock and cost of domestic debt. Egypt, which matches the first criterion, was not among the selected countries presumably because it failed the second criterion along with other 13 LDCs out of 38.

during these two periods as discussed above, second the increase in the base of the implicit tax, i.e. the domestic currency deposits.

Moreover adjusting interest rate differentials with the parallel market exchange rate³³ produces higher revenues. Hence by imposing exchange rate restrictions and controls over the flow of capital, the government managed to increase its revenue from given size of deposits and interest rate ceilings.

It is surprising to find negative revenue from repression in some years. For the non-exchange-rate-adjusted figures, this is attributed to the exceptionally high positive real interest rates, i.e. when the change in the CPI was negative in 1962 and 1968. For the exchange-rate adjusted figures, the negative revenue can be attributed to the same reason in addition to the appreciation of the pound during these particular years.

Table (5) gives the averages of government revenues from repressing interest rates for different periods. The non adjusted figures give lower average revenues for all periods than the figures adjusted with the official and the parallel market exchange rates.

We realise that the average revenue reached its highest levels during the 1980s which witnessed further decline in the domestic real interest rates and the adopted policy of devaluation. It is worth noting however that the official exchange rate-adjusted figures were higher than the figures adjusted with the free market exchange rates. This is attributed to the series of sudden official currency devaluation of the pound. So while the parallel exchange rate was decreasing gradually, the official rate decreased in an abrupt manner during late 1980s and 1990 till the gap between the two rates narrowed. At the end of the period the two rates were almost equal thanks to the exchange market reform measures and the unification of the exchange rates in 1990/91. This was reflected in the adjusted figures of the repression revenue as shown in table (5).

With appreciation of the difference of the implicit tax base in our study and that of Giovannini and de Melo (1991), we consider their results here as an indication for the significance of the financial repression tax. They found that the revenue of such tax, as percentage of GDP, ranging between 0 in the case of Indonesia to 6% in then case of Mexico and Zimbabwe.

The unweighted cross-country average was about 2% of GDP. In our study which considers only one type of interest rate differentials that of deposit interest rates and one type of assets, bank deposits the average was 2.76% of GDP for the 1960-90 period. The average revenue was much higher during the 1980s, reaching 6.69%. Thus depending on the availability of data, if the wider approach of Giovannini and de Melo is used, we argue that the repression tax in Egypt would be among the highest in LDCs.³⁴

3.4 High reserve requirements

In most of the LDCs the use of reserve requirements against banks 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.³⁵ Reserve requirements proved to be more flexible way of generating income than changes in taxation for example. However high reserve requirements decrease loanable funds available for investment by reducing the fraction of given volumes of deposits and by reducing the equilibrium volume of deposits through decreasing the profit-maximising deposit rate.³⁶ Hence they are considered as a leakage in the intermediation process.

Only under especial characteristics of the demand and supply for assets and liabilities of banks, as

³³We use here parallel market exchange rate because they are more realistic than the official rates.

³⁴ See country results for repression tax in Giovannini and de Melo (1991), pp. 31-35 and also (1993), p. 960.

³⁵ See Morris, et al (1990), pp.44-45

³⁶See Fry (1988), p. 108 and Courakis (1987), p. 150.

shown in Courakis's partial equilibrium model,³⁷ the adverse effect of reserve requirements on the volume of deposits may not hold. The profit maximising deposit rate and hence the volume of deposits may increase with a rise in the required reserve ratio if the demand for loanable funds is interest inelastic relative to their supply. However this case is considered an exception.

Reserve requirements, as one of the components of the monetary base, contribute to the government revenue from the inflation tax. On the other hand they reduce bank profits by the size of the difference between the interest paid on reserve requirements by the central bank and the opportunity cost. Further, depending on the elasticities of the demand for deposits and the demand for 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 carry a very low or zero interest rate in LDCs. Hence they are viewed as an implicit tax, and the higher the reserve requirement ratio, the bigger the distortion imposed on financial assets. They are set at high levels in many LDCs not mainly for prudential purposes but rather for financing the budget deficit.

The magnitude of reserve requirements indicates whether they are used for prudential purposes and an instrument of monetary policy, or mainly for generating income for the budget. In developed economies the ratios of required reserves are much less than LDCs. For example, as at of 1992, in the USA on the first \$42.2 million the reserve requirement is 3%, for amounts in excess of \$42.2 the ratio is 10%. 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.³⁸ In the UK the bank of England imposes a reserve requirement ratio as low as 0.35% of deposits to finance its operations.³⁹ In contrast we realise that the reserve requirement ratios in most LDCs are much higher as shown in table (6).

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 remunerated at the LIBOR.

Required reserves were computed with the lagged accounting system widely practised in other countries.⁴⁰ Applying this system prevented banks from rushing to meet the end of the period Reserve requirements which may cause abrupt shifts in the inter-bank interest rates. The penalty for non compliance was twice the discount rate.

As shown in figure (9) the required reserve ratio was set by the CBE at a relatively low level in 1960 at 12.5%, then in 1962 it increased to 17.5% of deposits. During the period 1966-1978 it became 20% and then reached its high level of 25% during the period 1979-90. It is interesting to realise an increasing use of one of the financial repression measures during the *Infitah* period of the 1970s and 1980s more than the socialist period of 1960s.

The actual required reserve ratios were higher in several years than the legal ratios, which were already high by international standards. While the average of the legal ratio was 21.1% over the period 1960-90 the actual ratio was 23.6%. Moreover the latter was more variable as its standard deviation was 8.95 whereas the standard deviation of the legal ratio was 3.6 which added difficulties to the decision making of banks. While the contribution of reserve requirements to the Egyptian government revenue from the inflation tax is analysed above, we show here their impact on interest rate spread.

Following McKinnon and Mathieson (1981), in a perfectly competitive banking system in which profits are zero, the relationship between real lending rate i_l and deposit rates i_d is:

$$i_l = [1/(1-k)] i_d \quad (5)$$

³⁷ See Courakis (1984) and (1987).

³⁸ Champ and Freeman (1994), p. 121.

³⁹ See Hardy (1993), p. 10.

⁴⁰ World Bank (1992), p. 22.

where k is equal the required reserve ratio.

Therefore from equation (5) the spread is:

$$i_l - i_d = [k/(1-k)] i_d \quad (6)$$

Hence the spread increases if k increases. Also if deposit rate rises so does the spread.

Figure (10) shows the evolution of real interest rates spread during the period 1976-90⁴¹. Given the levels of real deposit rates and required reserve ratio, the average spread under zero-profit assumption, was 1.7 percentage points. However the actual spread was as high as 4.4. The difference between the actual and zero profit spread, which was on average 2.62, can be explained, in addition to bank profits, by high intermediation costs and/or banking inefficiency.

The spread in Egypt is high compared to other countries as shown in table (7). With the exception of Turkey, the spread in Egypt was higher than the rest of the selected countries, more than three times higher than that in the case of the USA. This can be considered a reflection of the reserve requirement implicit tax.

In the Egyptian case the required reserve ratio was reduced from 25% to 15% in 1991, in accordance with the recent financial reform measures, nevertheless this was not reflected in a significant reduction in the spread. As shown in table (8), the zero-profit spread decreased from 1.37 in 1990 to 0.61 in 1992 because the reduction in the required reserve ratio was higher than the increase in real deposit rate. The actual spread decreased as well to 2.78.

Nevertheless the difference the actual and the zero-profit spreads at 2.2 in 1992 was significantly different from its average during the 1976-90 period. Such high 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.

While the reform measures aimed towards improving some variables such as increasing nominal interest rates and reducing the required reserve ratio they were not profoundly concerned with the uncompetitive conditions of the banking system and its oligopolistic structure dominated by the big four public banks.

3.5 Intervention in credit allocation

Several LDCs have allocated credit, directly and/or indirectly, to specified sectors and large projects chosen by economic planners. In a sample of eleven Asian countries Fry (1992) distinguishes between six categories of intervention: Subsidised loan rates for priority sectors, differential rediscount rates, directed budget subsidies, credit floors, credit Ceilings and the proliferation of specialised financial institutions. Subsidised loan rates for priority sectors was the most extensively used instrument in all sample countries.⁴²

The World Bank (1989) reports extensive use of directing credit in different countries through various schemes: In Pakistan 70% of new lending was targeted by government in 1986. In India 50% of bank assets had to be placed in government bonds and 40% of the remainder had to be directed to priority sectors at controlled interest rates. In Brazil government credit in 1987 extracted 70% of the outstanding credit. In early 1980s in Turkey 75% of advances made according to government direction or preferential rates or both.⁴³

Such intervention may restrict funds available to other sectors and raise the costs of the remaining loanable funds. If there is a use of ceilings on lending rates costs of borrowing will not rise but credit would be allocated according to non-price criteria i.e. quality of collateral, political pressures, reputation, loan size and possibly 'benefits' to credit officers.

⁴¹ Lending rates before 1976 are not available.

⁴² The sample included Bangladesh, India, Indonesia, Korea, Malaysia, Nepal, Pakistan, Philippines, Sri Lanka, Taiwan and Thailand, Fry (1992), pp. 11-13.

⁴³ World Bank (1989), p. 55.

Hence government intervention in the allocation of credit may result in the following:

- Directing most of the available loanable funds to finance budget deficit and crowding out private investment.
- The concentration of the remainder of credit among the privileged groups in the society.⁴⁴
- Privileged recipients of credit may apply a round-tripping mechanism⁴⁵ by exploiting the complex set of differentials in borrowing and lending rates.
- The rest of credit applicants may be forced to resort to informal sector money lenders.
- Further credit rationing may occur through an excessive use of non-price criteria as a form of credit rationing.⁴⁶
- Rent seeking behaviour on the part of credit officers may be encouraged in such environment.
- Unless directed credit schemes are effectively and carefully managed they may affect adversely income growth and its distribution.⁴⁷

In Egypt, intervention in the credit market took different methods according to a convention that market forces are not efficient allocators of resources.⁴⁸ Credit control methods were used to augment other quantitative control measures that were in use, like the required reserve ratio. Further the use of some repressive measures necessitated the use of credit control methods to contain their adverse effects. For example interest rate ceilings made lending rates low and hence resulted in an artificial excess demand for credit. This problem called for the CBE's intervention through a rigid system of rationing on credit available for the private sector.

From table (9) we can distinguish between two main instruments used to control credit. First an overall credit ceiling of 65% of deposits until 1988, lowered afterwards to 60%. Second a supplementary method of sub ceilings on credit to the commercial private sector.

Moreover the government determined the structure of lending rates according to the type of the economic sector. The two main determinant factors of interest rate structure are first the social return on investment estimated by the Ministry of Planning and second the gradual increase in deposit interest rates i.e. the cost of funding.

From 1977 to 1981 the CBE set specific floors and ceilings on lending rates to all sectors, leaving banks with limited range of one to two percentage points. From 1982 to 1989⁴⁹ the CBE intervened further by determining interest rates for credit advanced for each sector according to maturity of loans, leaving banks with even more limited discretion regarding credit decisions.

The distribution of credit between the private and public sectors reflects the government policy towards both sectors and their perceived role in development. Over the period 1960-90 the private sector extracted an average 27.8% of bank credit while the rest, 72.2%, was directed to the public sector. As shown in figure (11), in 1960 the private sector obtained 44.9% of total credit but with the adoption of socialist interventionist policies from 1961-74 the private share in total credit deteriorated.

We notice that the government claims regarding the encouragement of the private sector, since the

⁴⁴ Killick (1993), p. 271.

⁴⁵ Roe (1989b), p. 79.

⁴⁶ Fry (1988), p. 18.

⁴⁷ For examples of successful directed credit schemes e.g. when there is a lack of venture capital, see World Bank (1989), pp. 57-59 .

⁴⁸ For a discussion of selective credit controls in LDCs, see Coats and Khatkhate (1980), pp. 25-28.

⁴⁹ The interest rate structure of 1989 continued till January 1991 when the CBE took a decision to liberalise interest rates leaving banks free to determine the interest rates on loans and advances as part of the recent financial reform programme. See: the Central Bank of Egypt, Economic Review vol 28 no. (2) and vol 32 no. (1)

launching of *Infitah* measures, were not reflected in significant improvement in the allocation of credit between the public and private sectors.⁵⁰ The private sector's share in loanable funds continued in declining until it reached its minimum of 15.5% in 1980. It improved slightly during the 1980s but was far behind its pre-socialist period level.

The intervention of government in the allocation of credit distorted competition amongst the public sector units and the private sector. Moreover they had adverse effects on innovation and efficiency of the banking sector. Some of the bank managers interviewed by the author pointed out that credit decisions were hardly practised in the banking units. Credit officers were price takers in the sense that the interest rate structure was determined by the CBE and they had very limited margin to manoeuvre within. Banks to a great extent were working like post office savings funds.⁵¹

Unless there is a need for corrective government intervention to overcome market imperfections, the elimination of directed credit system, is advocated for two main reasons: First in order to improve the allocative efficiency of credit. Second to improve the portfolio problems of banks that resulted from lending to projects irrespective of their returns or economic viability.

Nevertheless we argue that a hasty abolition of direct controls on the allocation and the expansion of credit may have its detriments. If most of the credit officers are inadequately trained and lack experience in a credit market that for long had its prices and quantities determined by the CBE, it would be critical to leave the allocation of credit suddenly to their discretion. On the other hand the credit market in Egypt requires more than sufficiently trained bankers, as discussed above it is hard to ignore the importance of prudential regulation, monitoring and screening of credit transactions, given the costs of default, asymmetric information, uncertainty.⁵²

3.6 Regulations on the portfolio composition of banks

This is another widely used repressive measure. In the study of Hanson and Neal (1986), they emphasised that all countries in their seven representative low and middle income countries⁵³ applied this method to direct credit mainly to finance budget deficits and large projects.

In Egypt banks were 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 and remained at 30% the actual spread was highly variable as shown in figure (12) and its average was 48.7% i.e. there was an average of 18.7% excess liquidity during the study period. In some years the actual liquidity was even more than the double of the minimum liquidity ratio.

Excess liquidity in Egypt⁵⁴ can be attributed to several factors that support the arguments of the financial repression school regarding the adverse effects of government intervention in the mechanisms of the credit market:

First, the inclusion of government securities and bonds in the components of the liquidity ratio, to the

⁵⁰ It is worth noting that the private sector's share of credit is not a sufficient evidence for crowding out. In a recent study it has been shown by using the error correction approach and the unrestricted dynamic modelling, that "the government did not crowd out established firms in the credit market and by maintaining artificially low interest rates, implicitly subsidised their borrowing..[and] made many inefficient investments financially profitable". See Shafik (1992), p. 94.

⁵¹ An interview with Mr Abd-Al-Salam Al-Anwar General Manager of Hong Kong Egyptian Bank (5/5/1993), and Mr Hamdy Musa General Manager of Export Development Bank of Egypt (22/3/93).

⁵² On risk and financial fragility associated with credit markets see the comprehensive study of Davis (1992).

⁵³ These countries were Bangladesh, Kenya, Nigeria, Peru, Thailand, Turkey, and Uruguay.

⁵⁴ For a discussion of the problem of excess liquidity in other LDCs see for example Nissanke (1993).

extent that they became major items in banks' portfolios. Government securities and bonds are less risky than lending to the private economic sectors.

Second, the rising usage of treasury bills by the government to finance its budget deficit especially when the foreign credit market became more restrictive in the 1980s. Banks were normally attracted to the risk-free treasury bills as they offer high, tax-free interest rates.

Third, the application of credit ceilings and restrictive policy of sectoral credit allocation imposed limits on banks' lending abilities.

Fourth, under asymmetric information banks, fearing to face problems of moral hazard and adverse risk selection, may choose not to raise interest rates, within the limits of CBE interest structure, when there is an excess demand for credit.⁵⁵

Fifth, like high reserve requirements, high liquidity ratios may reflect the monetary authority's concern regarding low capitalization and insolvency of some of the operating banks, and thus restore to this easy method, which in fact penalise the solvent banks, instead of requiring insolvent banks to improve their capital requirements and keep adequate provisions⁵⁶.

Sixth, excess liquidity in banks portfolios can be a reflection of unstable economic environment and increase perceived risk on the part of investors and banks.

Lastly, excess liquidity may also reveal inefficiency in the intermediation process that force banks to hold relatively high proportions of liquid assets.

4 Problems of the Egyptian banking system under state intervention

4.1 Dominance of public banks

The dominance of government-owned banks in developing countries are identified with familiar problems which take two forms: First, internal management problems resulted from lack of incentives, political interference, overstaffing and lack of managerial and banking skills. Second, the general economic environment and policy background according to which public banks are assumed to operate.⁵⁷

After a series of Egyptianisation and nationalisation measures in the late 1950s and 1960s, Egypt was left with four publicly owned commercial banks and five specialised banks. The market was highly concentrated. Competition was limited further by the application of sectoral and, then, functional specialisation which made the system a sectoral based mono-bank one.

The introduction of the *infatih* policy and the establishment of a large number of private and joint-venture banks resulted in an increase in the number of banking units without a significant decrease in market concentration. According to the banking law, public banks had the majority of joint-venture banks, so we find that more than 90% of the assets of the commercial banks are publicly owned.⁵⁸

Although the Egyptian banking system consisted of 98 banks, in 1990, the four large public sector banks accounted for 55% of the total assets of the banking system, apart from their participation in joint venture and specialised banks. These banks through their relatively large networks of branches dominate the retail business. The domination of public banks in a highly concentrated market resulted a frail competition and limited innovation.

Moreover branches of the public sector commercial banks dominated the banking system, forming

⁵⁵See Stiglitz and Weiss (1981).

⁵⁶See World bank (1992), p. 13.

⁵⁷Fry (1990), p. 15.

⁵⁸See World Bank (1992), vol 2, p. 4.

58.5% of total branches. The dominance of the public sector is emphasised when we take into account public banks' participation in joint-venture banks. In terms of bank assets we realise that public sector commercial banks account for 55% and the public specialised banks account for 7%. Other commercial and business banks account for 38%. Thus the share of the public sector was 62% in 1991, excluding its part in joint-venture banks.⁵⁹

Public banks were protected by an array of regulations and preferential treatment⁶⁰:

- Branching by private banks was more restricted than branching of public sector banks.
- Credit ceilings were set in a way that favours public banks.
- Payment of interest on current accounts was prohibited, benefiting public sector banks in two ways. First, they did not bear any costs for keeping such deposits which belonged mainly to the public sector enterprises. Second, private banks were not able to compete for these accounts by offering higher interest rates to depositors. We found that a typical public sector bank like the NBE had 27.1% of total deposits in a form of current accounts in 1991 while the ratio in the Delta Bank, a joint-venture bank, was only 9.7%.⁶¹
- Private banks were denied the opportunity to provide certain financial service to the public sector companies without the acceptance of their public banks.
- Pension funds of the public sector had to be deposited with public banks.
- Private banks were denied stakes in public sector companies.

The conditions of government-owned financial intermediaries in most LDCs, which more or less describe the prevailing conditions Egypt, can be summarised as follows:⁶² (i) low resource mobilisation; (ii) low profitability; (iii) low capitalization ratios and insolvency; (iv) complicated bureaucratic procedures for loan processing and operating inefficiency; (v) allocation of resources on the basis of non-economic criteria; (vi) reduced autonomy; (vii) poor quality of personnel, overstaffing and weak management.⁶³

Public banks in Egypt, as in other LDCs, were more prone to government interference in credit and planning decisions than private banks. Consequently they had relatively high levels of nonperforming loans, most of them are theoretically government-guaranteed. Data on non-performing loans were not published and hence does not allow for analysis for the solvency of banks but they are estimated to range between 30%-45% of books loans.⁶⁴ Their portfolios were poorly diversified and suffered from excess liquidity.

Although Egyptian banks in general, during the period 1986-90 report low operating ratios by international standards according to a World Bank study⁶⁵, private banks were more efficient and profitable than public banks. Publicly-owned banks, as part of the whole state owned enterprises, had their profits and losses internalised in the state budget. Under this system the state and profit-making enterprises cross-subsidise the loss-making projects, in a way that discouraged efforts to maximise efficiency.⁶⁶

⁵⁹See World Bank (1992), vol 2, p. 27.

⁶⁰For further details see World Bank (1992), pp. 1-41.

⁶¹Annual reports of the NBE and the Delta Bank 1991.

⁶²Cited in Fry (1991) from a study by Morris (1985) on the Indian financial system.

⁶³On bank efficiency losses and rules for restructuring banks in transitional economies see Sheng (1990).

⁶⁴The 30% estimate is the World Bank's (1992), p. 36. with reference to other countries with similar structure to Egypt, the range 40-45% of total loans are personal estimates of some of the bank managers interviewed by the author.

⁶⁵See World Bank (1992), pp. 31-33.

⁶⁶For a similar argument in the context of transitional socialist economies, see Sheng (1990), p. 13.

Incentives to maximise profits, or even to minimise losses, barely existed. In the words of Flemming (1993) *"If losses will be covered [...] why should management minimise them? If loss-making enterprises will be bailed out in the end why should bank manager discriminate on his lending between good and bad risks?"*⁶⁷ Thus non-performing loans and bad debts were accumulated to the extent that it was difficult to clean up the balance sheets of such banks. It is worth mentioning that this particular problem is one of the main reasons behind the reluctance of the government to privatise banks.

It is worth noting that the Egyptian banking system suffers from a mixture of both of the domination of public banks and a high degree of concentration. This mixture discourages competition on one hand, and the heavy barriers to entry which makes incumbent banks uncontestable on the other hand. Thus reform measures should be taken at two levels. First at the banking system level to enhance competition, make banks contestable and assure prudential regulation. Second at the bank level to maintain managerial autonomy and efficiency.

We argue that the remedy of these problems does not lie necessary in changing the ownership of banks. It is established that it is not the type of ownership *per se* which determine whether a bank would be an aspect of repression, it is rather the mechanism according to which public banks operate that emphasise the negative effects of repression and hinders competition.⁶⁸

4.2 Heavy barriers to entry

It is argued that contestable markets and potential firms' freedom of entry promote efficiency, encourage innovation and give highly favourable welfare outcomes.⁶⁹ 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 give no incentive for potential entrants to do so. This can be achieved by efficient pricing and allocation of production among incumbent firms to eliminate significant excess profits. However in practice there are different barriers to entry facing potential firms and preventing them from joining 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 of such barriers.⁷⁰ But in the case of banking government regulations through permits and licenses are far more important than other barriers.

The main reasons for restrictive regulations regarding new entry can be summarised by five factors:

- Concern of cream skimming by private and foreign banks.
- Fear of acquiring dominant positions in the domestic market.
- Concern of hit and run activities.
- Protecting the interests of the incumbent banks, especially the public ones.
- Concern regarding the possible allocation of domestically mobilised funds abroad.

While most of these issues justify restricting entry in the banking sector, it is worth noting that indiscriminate restrictions denies the banking market the chance of allowing competent banks to have a role in it and the possibility of improving the efficiency of intermediation.

4.3 The absence of an adequate exit mechanism

We argue that an efficient market is not achievable in the absence of an adequate exist mechanism. In Egypt banks were not allowed to collapse. Unfortunately this was not accomplished through

⁶⁷See Flemming (1993), p. 9.

⁶⁸Killick (1993), p. 272.

⁶⁹For an analysis of contestable markets see Baumol, Panzar and Willig (1982).

⁷⁰On entry barriers see Bain (1956) and Tirole (1989), chapter (8).

prudential policy or measures that enhance the efficiency of banks. Instead, weak banks were allowed to continue in business by support from the CBE and the rest of the banking system. Fear of public misunderstanding that the failure of one bank implies that others might follow in the future made the banking system adopt a form of collective responsibility. According to this approach insolvent banks were left to operate through support from the banking system, while adequate measures like restructuring, merging or liquidation were not applied.

This policy resulted in the following:

First, the encouragement of inefficient banks to continue their violation of credit standards by involving in high risk lending and bidding for deposits. Even under the application of interest ceilings, a bank like the Bank of Credit and Commerce International, which was registered in Egypt as a joint-venture bank was paying a higher interest rate on deposits than other banks, by 0.5-1 percentage points, until its collapse in 1991.

Second, banks' clients failed to distinguish between an efficient and inefficient bank. This is because all banks are supported by an implicit rescue mechanism in which bad banks are cross subsidised by good ones.

Under the implicit deposit insurance scheme, the depositors of the collapsed BCCI were protected by moving their accounts to Bank Misr at their full nominal values at the date of the BCCI's collapse. Registered banks were asked to contribute 0.5% of their deposits towards the funding of this operation in addition to a one billion pound interest-free loan to Bank Misr to accept the 'transfer' of BCCI accounts to its branches.⁷¹

However under an implicit scheme the government is not obliged by law to protect deposits and the extent of coverage is left to its discretion. Moreover it is argued that a "well functioning [explicit] deposit insurance scheme is likely to produce faster, smoother, and more predictable resolutions of failing bank situations than an implicit system"⁷²

Thus, it was felt that it may be better to transform the implicit deposit protection scheme in Egypt to an explicit one, and a deposit insurance fund has been established in 1993. Nevertheless it is worth noting that the proposed deposit insurance scheme has its own drawbacks. For example explicit insurance is more costly than the implicit scheme. The former requires the establishment of a separate institution, with its own management and staff, which incur high operating costs for monitoring banks and managing its funds.

The explicit deposit insurance scheme may encourage moral hazard problem⁷³ and banks might be involved in riskier operations, which requires further monitoring. Moreover it may discourage clients from making efforts to distinguish between a weak and a sound bank as both are covered by the same insurance scheme.⁷⁴ We argue that any deposit insurance scheme cannot operate effectively without satisfactory prudential measures to improve the soundness of the Egyptian banking system.

4.4 Prudential regulation problems

Laissez-faire banking cannot provide a stable monetary framework or a sound financial system⁷⁵ There are two arguments normally given to justify the regulation of the financial sector in general and the banking system in particular.

⁷¹ I am indebted to Mr Ali Negm for this piece of information.

⁷²Mas and Tally (1990), p. 44.

⁷³It has been argued that deposit insurance was largely responsible of the so frequent collapses of the S&L Institutions in the USA where there has been calls for reforming such scheme. See For example Jafee (1989) and White (1989).

⁷⁴For further discussion of the problems of deposit insurance and possible solutions see Dybvig (1993) and Flood (1993).

⁷⁵Park (1991), pp. 334-335.

First, it is argued that banks are inherently unstable and subject to interruption and failure.⁷⁶ Bank failures may generate externalities, in the form of additional losses born by the economic system as a whole. This requires either the intervention of the central bank as a lender of last resort or the establishment of a deposit insurance scheme, or both. Nevertheless such intervention may encourage banks to involve in riskier operations, which in turn requires further intervention to deal with this moral hazard problem, by monitoring banks and reducing excessive risk.⁷⁷

Second, the banking service is based on the acquisition of greater knowledge in a way that enables bankers to know much more than customers. In such a case of asymmetric information, conflicts of interest can frequently occur as the separation of the functions of bankers and customers is expensive because of the existence of high transaction costs. The customer has little power to assess the qualifications and monitor the performance of the professional, this necessitating regulatory control.⁷⁸

Prudential regulation, through its impact on innovation, market practices and transaction costs has a far-reaching effect on the efficiency of the financial system. Prudential regulation differs from country to country according to its overall legal structure, social background, political structure and economic system. Nevertheless the claimed aim of a prudential policy can be summarised in preventing systematic risk and minimising financial instability, and assuring that intermediaries are adequately capitalised and professionally managed.⁷⁹

However in financially repressed economies prudential principles and the quality of supervision might be sacrificed in the cause of channelling loanable funds to priority projects and funding budget deficits. Moreover in such circumstances prudential measures may be confronted with conflicting goals and the role of prudential policy may be ill-defined, which, in turn, would impair the safety and soundness of the banking system.

4.4.1 Capital adequacy

In most LDCs banks are undercapitalised so that capital is insufficient for meeting actual and potential losses.⁸⁰ There are two aspects of capital adequacy. First the minimum capital volume required from banks to start business, and second, the minimum capital ratio required to support given levels of operation.⁸¹ Regarding the first requirement, normally referred to as entry requirement, the CBE imposes an initial capital of £E 100 million on banks as a criteria for their authorization. This is considered sufficient and comparable with international standards of US\$ 15-30 million (approximately £E 50-100 million).

Considering the second requirement, Egyptian banks maintained capital adequacy ratios ranging between 6% and 7% of total assets, i.e. less than the Basle Committee (1988) standard of 8%. Under the impression that public banks are by definition owned by the government, which is assumed to come to their rescue if necessary, such banks lack incentives to minimise losses. However as a part of the financial reform programme started in 1991, all operating banks were required to raise their capital adequacy ratios up to the risk-based Basle Standard according to an agreed schedule.

4.4.2 Loan provisioning

Provisioning creates discipline in banks' operations and reflects their actual financial condition. We can distinguish between two forms of provisions: general provisions and specific provisions. Under general provisions it is assumed that even the highest quality loans in the bank's portfolio may incur some loss, hence a small percentage, say 1%, of total loans is held by the bank. Specific provisions

⁷⁶ibid, p. 335.

⁷⁷Goodhart (1989), pp. 194-195 and pp. 203-204.

⁷⁸ibid., p. 195 and p. 207.

⁷⁹Polizatto (1990), p. 1, World Bank (1992)b, p. 13.

⁸⁰Polizatto (1990), op. cit., p. 4.

⁸¹See Morris (1990), p. 65.

can be classified in four categories: current, sub-standard, doubtful and lost loans. Accordingly specific provision ranges between zero percent in the case of current loans to 100% in the case of lost loans.⁸²

Banks in most LDCs fail to mandate realistic provisions to cover possible losses according to the classification of loans. As a result their balance sheets do not reflect their actual positions and profits are exaggerated and their solvency may be at stake.⁸³ It is difficult in the case of Egypt to know how serious the issue of solvency is, as information on the nonperforming loans and soundness of loan portfolios are not published. Further until 1992 banks did not apply international standards on their loan classification, possibly to avoid provisioning for the public sector nonperforming loans.⁸⁴ The application of adequate classification and provisioning of loans should be accompanied by an improvement in the functioning of the legal framework concerning bankruptcy procedure, liquidation of collateral and debt recovery.⁸⁵

4.4.3 Information disclosure

Publishing an adequate level of information is essential to help depositors and borrowers distinguish between banks according to their performance and facilitate their scrutiny by relevant authorities and bodies, like rating agencies. Egyptian banks are reluctant to disclose information beyond what they supply in their annual reports. Moreover such reports are not uniform in the information they provide, which makes comparison difficult.

Some banks published only balance sheets without income statements in a way that is difficult to determine their financial condition or whether they incurred a profit or loss. Banks faced with difficulties delayed the publication of their annual reports and/or hid essential information in fear that the disclosure of a negative outcome might lead to a deposit run and/or deny them the ability to raise fresh funds.

If banks are to work according to market forces and competition, then their actual and potential clients should be able to choose rationally between them. This necessitates disclosure of adequate information on their activities⁸⁶. We argue that bank reports in Egypt do not fulfil this objective and hence require extensive modification:

- First, bank reports have to be published quarterly or, at least biannually, to ensure an up-to-date and more frequent flow of information.
- Second, It is normally expected to find in bank reports information on the quality of bank portfolios, adequacy of provisions, detailed outcome. Whereas such essential information were hardly ever found in these reports, they specify significant parts to cover what so called current developments in the world, regional and domestic economies which can be obtained in a more rigorous and extensive form from specialised sources. We suggest that the CBE should provide some guidelines regarding the information published in these reports, so ensuring their comparability.
- Third, arrangements should be taken to prevent, or at least minimise, the problem of window dressing, defined as the manipulation of published information by banks to give a better picture than the reality of their condition.⁸⁷

4.4.4 Quality of supervision

The main objectives of financial supervision are monitoring bank activities and accounting procedures,

⁸²See Morris (1990), p. 60.

⁸³ Polizatto (1990), p. 6.

⁸⁴A suggested solution for bad loans, on public sector enterprises, is to auction off these loans before privatisation and the share of loss should be covered by an allocation of government bonds. See Steinherr (1993), pp. 1045 and 1055.

⁸⁵See World Bank (1992), p. 36.

⁸⁶See Morris (1990), p. 67.

⁸⁷See Allen (1992), for a theoretical and empirical analysis of bank window dressing.

assessing the quality of assets and ensuring that banks are professionally managed. Financial supervision is a delicate task as it should be undertaken in a way that promotes the soundness and stability of the banking system without hindering the efficiency and the managerial autonomy of banks.⁸⁸ Several conditions are required in order to achieve a sufficient quality of supervision:

- . The supervisory regulations ought to be sufficient.
- . Supervisors must be given adequate training and have adequate resources.
- . Supervisors should have sufficient autonomy from political interference and bureaucratic pressures.
- . The supervisory body must have enough power to enforce its decisions without the need to refer to higher authorities. For example, supervisors should be able to impose fines, restrict dividend payments, request administrative actions, force provisions, etc.⁸⁹

In the case of Egypt, bank supervision is vested with the CBE. Supervision is undertaken through off-site monitoring and surveillance of the performance of banks, in addition to on-site inspection of their financial condition. Public banks are also subject to further on-site monitoring by the Central Audit Organization (CAO) which coordinates its work with external auditors.⁹⁰ The CBE's supervision is concerned with the degree of compliance with credit controls, tariff schedules, interest rate ceilings and, to a lesser extent, the assessment of bank solvency. The CAO's supervision is more concerned with the inspection of the compliance of the public banks with the rules that govern the public sector as a whole.

However bank supervision in Egypt suffers from various limitations:

. The CBE is not fully independent from the government as the selection of most of the members of the board of the CBE, since 1984, has been left to the discretion of the minister of the economy.⁹¹

. The huge increase in the staff number of operating banks, from 7 in 1974 to 98 banks in 1991, was not matched by a corresponding increase either in the staff of the Bank Control department of the CBE or its resources. As a result, on-site monitoring of several banks was not undertaken and the CBE was satisfied with the periodic reports of such banks on their activities.⁹² These reports were not necessarily adequate in terms of the quantity and quality of information provided in them. Moreover some of the operating banks, especially the foreign ones, were adopting some new banking techniques and computerised transactions which were not fully grasped by the members of the supervision committees, due to lack of training.

. In many cases the effective supervision of banks, especially the public ones, was compromised by political pressure. Loans to insolvent and ailing public sector companies were allowed under the pressure of their concerned ministries. Figures for non-performing loans are not available but they are estimated to range between 30%-45%.⁹³

. Privileged private sector borrowers were also allowed to borrow despite their poor financial condition and insufficient collateral. In 1989 the so called sick balances reached 26% of total advances to private

⁸⁸On the role of prudential supervision in banking, see Pecchioli (1987).

⁸⁹On this issue of quality of supervision see Morris (1990), pp. 54-57.

⁹⁰World Bank (1992)b, pp. 17-18.

⁹¹Nour-El-Din (1987), p. 10.

⁹²ibid, p. 11.

⁹³The estimate of the World Bank (1992) is 30% while some bank managers interviewed by the author argue that non-performing loans are as high as 40%-45%.

and investment sectors, of which 56.4% belonged to only 3% of defaulters.⁹⁴ Many defaulters fled the country to avoid any legal actions, while others managed to delay legal action for very long periods.

. Although the powers of the League of Banks are much less than those of its predecessor, *Conférence des Banques*, it still has some functions that cause conflict with the CBE. For example, the League of Banks is entitled to investigate and verify the complaints of individuals and institutions concerning the activities of any bank and according to its Banking Charter it resolves disputes.⁹⁵ It also has the right to determine bank charges. Thus some of the bona fide functions of the CBE have been undertaken by another organisation.

We argue that to improve bank supervision the regulatory framework should be clearly defined, the CBE must be more independent, its supervisory team should acquire necessary knowledge and be empowered with sufficient resources. Improvement in bank supervision should not be achieved at the expense of reasonable autonomy of banking units or interference with their decisions. Parallel reform in accounting and auditing practices, and enforcement of the law in the case of default are also required.

5 The Egyptian Securities Market in an era of repressive intervention

For a long time the securities market in LDCs were considered hard to establish, costly to manage, difficult to supervise and, above all, likely to contribute little to economic development. These views have undermined the importance of building robust financial systems in LDCs that include active capital markets.

We argue that imperfections in securities markets do not imply perfection in the bank-based systems. Distortions and imperfections in the banking system are prevalent in developed and developing economies but discouraging or eliminating the banking system has never been the suggested solution. As there are reform measures for the banking system, there are also measures which can be adopted to eliminate, or at least reduce, the drawbacks of securities markets.

Moreover in some circumstances banks would be the optimal allocators of financial resources, in others securities markets would be. Allen (1993) argues that in the case of traditional sectors, such as agriculture, banks are better lenders and monitors by taking advantage of the relatively well-known technology and production function. When there is less consensus on how firms should be managed and how resources should be allocated, a securities market would be a better source of funding and, through its repeated evaluations, is a more efficient monitor and resource allocator than banks.⁹⁶ In other cases a combination of both banks and securities markets finance would be the optimal one.

As shown by Atje-Jovanovic (1993) in an empirical study on 40 developed and developing economies. They applied the Greenwood-Jovanovic (1990) model to search for growth effects and the Mankiw, Romer and Weil (1992) model to search for the level effects. The study finds that securities markets have a significant impact on subsequent economic development in terms of level and growth. However it did not find a similar effect of bank lending.⁹⁷

Traditionally capital market lending, excluding equities, was long term in maturity, at a fixed rate of interest and with an active secondary market. Bank lending was mainly short term, at a variable interest rate and without a secondary market. Moreover some laws and acts, such as the 1933 Glass-Steagall act in the USA, created a barrier segregating commercial banking from investment banking and separating firms selling brokerage services from banks.⁹⁸ This distinction has diminished due to the advances in financial innovation and the encouragement of universal banking. Both banks and securities markets can now offer funding at fixed and floating rates; both for short and long term. Also

⁹⁴NBE(1989), pp. 142-143.

⁹⁵Nour-El-Din (1987), p. 13.

⁹⁶See Allen (1993), pp. 101-102.

⁹⁷See Atje and Jovanovic (1993), pp. 632-36.

⁹⁸See Miller and Pulsinelli (1989), pp. 168-169.

through securitisation, loan swaps and transferable loan contracts, banks started to develop a secondary market for their loanable funds.⁹⁹

Thus, we argue that the advice for LDCs, including Egypt, should be to encourage their securities markets to develop in an adequate regulatory framework, that deter rash speculation and prevent misleading practices.

The Egyptian Securities Market (ESM), was not immune from state intervention which had a devastating effect on its operations and its role in financial development. Since its establishment in 1883¹⁰⁰ until 1959, except in few years due to external shocks, the ESM was witnessing an unremitting growth with increasing numbers of listed companies and traded shares and was of the busiest markets in the world. As shown in table (10) in 1959 the government started a series of interventionist measures that disturbed the mechanisms of the Securities market. Further with execution of the wide nationalisation programme which started in 1961 and the associated destruction of the private corporate structure, there was not a significant role for the ESM which was effectively paralysed and was on the brink of official closure. From 1961 to 1971 only four new companies were established. The number of joint stock companies declined from 925 in 1961 to as low as 36 in 1971. Trading in Cairo Stock Exchange dropped from £E 43.9 million to £E 9.1 million in 1963 to £E 3.6 million in 1971 in nominal terms.¹⁰¹

The ESM has been the source of less than 5% of new funding for both the public and private sectors during the period 1989-1991, with an annual average of 1.2%. Further, only 3% of the £E 39 billion of savings were mobilised through the securities market channel during the 1989-91 period. These figures are in deep contrast to the performance of the market in the 1958-1961 period, when it provided 25% to 50% of new capital raised by the private sector alone.¹⁰² The number of ESM listed companies was 5.6 times greater than in Jordan and Turkey. Nevertheless each of the two countries had a market capitalisation by 30% and 280% larger respectively. Jamaica managed to achieve similar capitalisation to Egypt with just 48 companies.¹⁰³

6. Problems facing the development of the ESM

Despite official attempts since the early 1970s to revive the ESM, they have not resulted in a meaningful improvement in the actual performance of the market. Its negligible role in savings mobilisation and its relative insignificance as a source of capital can be attributed mainly to the following factors:

6.1 Credibility problems

The consecutive measure of Egyptianisation in the 1950s, and nationalisation, expropriation and sequestration in the 1960s, created a justifiable lack of credibility years after the start of these measures and despite successive government assurances of protecting ownership rights. In a number of interviews undertaken by the author with several Egyptian financial sector experts and bankers they agreed that the credibility problem is still a main impediment after more than three decades.¹⁰⁴ It was fuelled over the years by several factors, among them:

. The heavy losses in the remaining joint stock-companies in the 1970s and the 1980s which resulted in low or negative returns for shareholders.

⁹⁹ See Llewellyn (1992), pp. 19-21.

¹⁰⁰ The Egyptian Securities market was established in 1883 in Alexandria and then followed in 1890 by a Cairo one.

¹⁰¹ the National Bank of Egypt (1992), pp. 11-12.

¹⁰² See World Bank (1992c), p. 18, CBE (1988), p. 254 and CBE (1993), pp. 55-59.

¹⁰³ See World bank (1992c), p. 26 and International Financial Corporation (1993).

¹⁰⁴ Interviews with Dr Ashraf Shams-Eldin, director of external relations department, CMA in (17 July 1991); Dr Sultan Abu Aly, former Minister of the Economy (16 March 1993); Mr Mohammed Samy, Director of An Underwriting Company, (17/3/1993).

- The hit-and-run activities which flourished in the early years of the *Infitah* policy capitalised on soft regulations and incomplete laws. Investors in many companies never recovered their funds because of such activities.

- Inconsistent government policies, accumulation of foreign debt, expectations of further devaluation of the pound, and fears of inflation created a general environment of uncertainty. This in turn reinforced savers' preference for the money market with its higher return in the short run, and foreign currency denominated instruments. Dollarisation, dealings in the informal financial market and depositing funds abroad were rampant in this environment.

- The rise and, then, the decline of Islamic Investment Companies which collapsed in late 1980s resulting in immense losses to depositors savings.

- Dealing in the securities market is considered by a large group of potential investors, as a form of gambling, which is prohibited by religion. Moreover the media has for a long time emphasised that heavy speculation, especially in the price of cotton, in the early years of the ESM was behind the bankruptcy of many wealthy families and the collapse of several businesses. It is claimed that the media has exaggerated this, discouraging savers in participating in its activities.¹⁰⁵

It is not the lack of investors or shortage of capital that make the number of ESM's individual and institutional investors as low as five thousands. The Islamic Investment Companies depositors were numbered more than 500 thousand before the beginning of their collapse in 1988. This reveals that there is a potential active demand for securities and that the problem lies primarily in the supply side¹⁰⁶ as discussed further below.

6.2 The prevalence of public sector enterprises (PSEs)

Economic indicators emphasise the dominance of the public sector. The *infitah* policy launched in the mid 1970s did not change the dominant role of the public sector enterprises. Ten years after the start of *infitah* and attempts to encourage private and foreign investment, the 370 PSEs accounted for 82% of capital stock, 70% of total investment, 90% of total exports and 54% of employment in 1985.¹⁰⁷

Since their establishment in 1961, the PSEs relied on the banking sector in financing its capital requirements. The ESM was left to deal in a limited volume of government issued and guaranteed bonds used mainly to finance the budget deficit.

On the other hand, despite the fact that small projects, i.e. those with less than 50 workers, escaped nationalisation measures, the ESM did not serve them. These projects specialised in services and light industry, with a scale of activity that did not require ESM financing. They were established by own finance, mostly family finance, and retentions were used for their expansion. When necessary these projects obtained loans from the banking sector.

However the government adopted a programme of privatisation¹⁰⁸. Under this programme most of the PSEs are offered for sale according to a medium term schedule.¹⁰⁹ The government claimed that the

¹⁰⁵ This was emphasized in our interview with Mr Samy.

¹⁰⁶ In an interview with Mr Motaz Mansour, Managing Director of Misr Iran Development Bank (5/5/1994), he strongly confirmed this point, mentioning that the main effort is needed in the supply side and it is just a matter of time to convince potential investors of the soundness of the ESM, if it is already there.

¹⁰⁷ World Bank (1990), p. 34.

¹⁰⁸ On the concept of privatisation see Hartley and Parker (1991); on the type of ownership and efficiency see George and Lynk (1992) and on the economic implications of privatisation see Vickers and Yarrow (1988).

¹⁰⁹ As described in the World Bank (1991) appendix IV, the first step of privatisation was taken in the FY 1990/91 by selling 2,000 small local government-owned enterprises and the start of selling large hotels. The second step was programmed for implementation in FY 1991/92 and includes the following:

- Continuation of the sale of local government owned enterprises.
- Sale of public sector shares in Law 230 companies.

privatisation programme was capable of improving the efficient use and allocation of limited resources, thus contributing to more rapid economic growth. Further it was argued that it would correct the fiscal imbalances through enhanced revenues.¹¹⁰

Due to the vested interests¹¹¹ along with concerns of political instability, fear of worsening the severe unemployment problem, already 17.5%, privatisation of PSEs has been lagging behind its schedule. On the other hand evaluation of projects prepared for sale, taking sale decisions and methods of privatisation appeared problematic and practically difficult, especially in the absence of a sound securities market which has been the backbone in successful privatisation processes in other countries.

6.3 Relatively low costs of bank loans

The imposition of interest rate ceilings made the cost of available loanable funds artificially low. As shown in our study until, 1991 the CBE was responsible for determining the interest rate structure according to which lending rates for different sectors were strictly applied. Such rates were generally below market levels and included substantial subsidies for borrowers. Under these circumstances it was difficult for the securities market to compete freely with the banking system to attract 'borrowers'. If ceilings on interest rates are lifted and the cost of borrowing becomes more realistic, there would be an incentive for companies to rely on the ESM to provide them with their capital requirements.

6.4 The problem of closed companies

In 1993 the total number of companies listed on the Cairo Stock Exchange was 654, 76.2% of which were closely held companies. Closely held companies are defined as those having 15 shareholders or less, usually members of the same family, whose shares are not normally offered for public dealings. These companies had approximately 70% of the £E 8.4 billion total capital of the market¹¹².

Tax and company laws 157/1981 and 159/1981 encouraged the establishment of joint-stock companies by offering tax incentives and allowed listing of securities provided that they had three or more shareholders. Consequently around 80% of the listed companies during the period 1981-1991 period were closely held. Shares of closely held companies are exclusively traded among the incumbent holders. The prevalence of such shares contributes very little to the supply of tradable securities.

However, the problem will not be solved by mere legislation against the formation of closed companies as happened in the past. We argue that measures to promote the activities of the ESM and strengthen the investment environment would increase the number of registered companies with openly-traded securities and hence the relative importance of closely held companies will decline. Moreover the elimination of fiscal disincentives and reduction of the high costs of trading in securities, along with other measures, may encourage the existing closed companies to go public.

6.5 Distortive incentives

We argued previously that the listing of joint stock companies was encouraged by tax incentives. But we realise that such tax incentives resulted in a loss of budget revenue without widening the ownership base. Moreover they caused an "over-listing" of closed companies with untraded securities which affected adversely the performance and growth of the ESM. If such distortive incentives were abolished the ESM would witness an improvement in the long run. There would be loss of ESM listing fees revenue but the ESM could compensate that from dealings related revenue in a form of transactions costs. Such activity-related revenue will grow over time and be accompanied by a rise in market turnover. Neutrality of fiscal measure would again be necessary.

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- Increase the private sector share in Law 97 companies which have private shareholders.
 - Lease of under-utilised production capacity and sale of surplus of assets.
 - Entire sale of small profitable public sector companies.

The third step was to continue and reinforce the privatisation programme in FY 1992/93.

For further details of the privatisation programme see the NBE (1994), pp. 9-23.

¹¹⁰The government in such claims is following the World Bank view, expressed in the World Bank (1990).

¹¹¹ On this issue see El-Naggar (1990), pp. 50-52.

¹¹² Figures are calculated from the 1992/3 annual report of CBE.

6.6 Market illiquidity

Because of the dominance of the shares of closed companies and founders, the ESM suffers from a narrow base of tradable securities. It is reported that in any given year during the 1980s, an average of just 20% of listed securities were traded. Average trading for listed shares was 19% and ranged from 7% in the tourism and forest products sectors to 50% in the insurance sector.¹¹³

Untraded securities deplete the administrative resources and do not contribute to market liquidity, adversely affecting the growth of the market. Shortage of adequate liquidity prevents the ESM from serving potential investors and makes attracting funds of other financial intermediaries difficult.

6.7 Tax treatment of securities

While interest on bank deposits are exempted from all forms of explicit taxes, securities continued to be subject to various taxes, such as taxes on earnings from moveable properties, annual stamp tax and duties on dealings in securities. Moreover a tax of 2% was levied on the difference between selling and buying prices, which combined with the 1% fixed commission on both sides of transactions increased the costs of dealing in securities.¹¹⁴

Thus the tax code in Egypt was discriminatory in the sense that it favoured the banking savings instruments, where it should not, in principal, distort the relationship between risk and return.¹¹⁵ Such a distortion prevented savers from making a rational selection for their portfolios from freely competing financial instruments.

Under the Egyptian tax structure, income generated from the least risky financial instruments, like treasury bills and bank deposits, is not taxed, while earnings from relatively higher risk instruments like corporate-issued shares and bonds are subject to different taxes.¹¹⁶

Consequently, the net yield curve with regard to risk and maturity is a declining one. This tax discrimination makes corporate shares and bonds relatively unattractive instruments for potential savers. A hypothetical corporate bond should, *ceteris paribus*, offer a 23% rate on a coupon in order to match the after tax yield on treasury bills, i.e. the hypothetical bond should offer 6% per annum above the medium term lending rate which cannot be acceptable to a corporate borrower. Accordingly the supply of corporate bonds would not be viable unless this is rate close to the cost of borrowing from the banking sector. On the other hand corporate bonds will not be attractive for individual and corporate investors (purchasers), unless their after-tax, risk-adjusted return is similar to the yields on T. bills and bank deposits.¹¹⁷

Thus an improvement of the tax structure, aiming at neutrality and non discrimination is a necessary measure for any meaningful improvement of the ESM.

6.8 Inadequate regulatory and organisational structure

Adverse effects of imprudent regulation were not remarkably felt in the previous years, arguably because of the low profile of the ESM and its limited operations. However an active market requires an adequate regulatory structure. We realise that the ESM suffers from several regulatory problems, the critical ones are discussed below:

6.8.1 Multifarious supervisory bodies

Before the recent reorganisation of the ESM, it suffered from a complex and incomplete legal framework. Four separate authorities have been involved in the supervision of ESM, namely the Ministry of the Economy, the Investment Authority, the Capital Market Authority (CMA) and, to a lesser

¹¹³ World Bank (1992c), annex II.4.

¹¹⁴ This tax was applied in June 1994 despite the repeated claims by the government for efforts to encourage the ESM. See Al-Ahram Newspaper (16/6/1994).

¹¹⁵ On the discrimination against securities markets in LDCs see Van Agtamel (1984), pp. 2-8.

¹¹⁶ See World Bank (1992c), *op. cit.*, p. 41 and NBE (1992), p. 21.

¹¹⁷ See World bank (1992c), pp. 41-46.

extent, the Central Bank of Egypt.¹¹⁸ Lack of coordination, overlapping of responsibilities and several cross relationships between these authorities left the ESM without properly supervision.

The CMA is granted extensive and discretionary powers over the operations of the securities market without being adequately accountable for its conduct. Moreover the CMA is effectively a division under the Ministry of the Economy. Its board and president are appointed by the minister of the economy which reflects the great extent of government involvement in the management of the CMA and hence the securities market.¹¹⁹ We argue that in order to ensure the autonomy of the securities market, its supervisory body should be independent of any governmental affiliations and should be directly accountable to Parliament.

6.8.2 Inadequate guidelines for information disclosure

Despite the smallness of the ESM the information system does not sufficiently cover its activities, while computation of its database and operations has not yet been introduced. Financial information barely exists. Prospectus disclosure is brief, regular financial reports are hard to be found, information on takeovers are kept in the domain of insiders' network¹²⁰. This lack of disclosure does not bring public confidence, but rather gives the impression that the ESM is an exclusive club.

6.8.3 Lack of measures to improve operational efficiency

The inactivity of the ESM over the last three decades is responsible for its undeveloped method of operation. New techniques and modern methods in the profession have not been applied. Transactions and the transfer of securities ownership are manually processed. Securities' documents move via a courier between respective agents seeking signatories. Authorisation of documents go through long bureaucratic procedures resulting in loss and delay costs. Moreover the market suffers from a scarcity of skilled staff, brokers and other professionals.¹²¹ The CMA being primarily concerned with amendments in laws and regulations did not pay sufficient attention to the training of required personnel.

6.8.4 Absence of a uniform standard of accounting

There does not exist a unified accounting standard to be followed. Public sector participants in the ESM follow the Code of Accounts supervised by the Central Audit Organisation. Private sector participants are required simply to follow any recognised standard of accounts. Hence there are vital differences between financial statements produced by different participants. Investors find it difficult to make any meaningful comparison given such differences.¹²²

6.8.5 Lack of anti-fraud measures

It is not clear from the new law 95/1992 and its executive bylaw that adequate provisions were made against possible fraud. Active securities markets normally have anti-fraud measures as they frequently discover various mischievous practices such as: insider trading, nondisclosure of the status of companies in times of trouble, publishing misleading statements, hiding important information e.g. risk involved, transaction fees.

7 Consequences of repressive state intervention in the financial sector

We argue that the unsatisfactory conditions of formal sector, signified in a malfunctioning banking system and a non functioning securities market, persuaded significant group of savers to search for

¹¹⁸ See NBE (1992), op. cit., p. 22.

¹¹⁹ See the comment of Mahmoud Wahba on the responsibilities of the CMA, Al-Ahram Newspaper 13/2/1994.

¹²⁰ See World Bank (1992c), pp. 22-24.

¹²¹ An interview with Dr Shams-El-Din Director of international relations CMA (20/8/1991).

¹²² *ibid.*, p. 24.

alternatives. These alternatives can be grouped under inflation hedges¹²³ and informal sector dealings, in addition to capital flight. Thus, with the exception of depositing money abroad, the portfolio selection model faced a saver in Egypt was comprised of similar categories of assets described by Tobin (1965). We analyse below the consequences of repressive state intervention in Egypt highlighting the main problems of the banking system and the securities market.

7.1 The thriving of informal financial activities

The existence of the informal financial sector can be attributed to two main factors. The first factor can be explained by a broad application of Goodhart's law that states that 'any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes'¹²⁴. Thus the informal financial sector, being the unregulated sector in the economy, attracted several depositors for its higher returns on 'deposits'. The second factor can be ascribed to dualities in the economic, social and cultural structures. Hence informal transactions occur regardless the state of development or the conditions of the formal sector.

The informal financial activities reached its peak in Egypt by the establishment of the Islamic Investment Companies IICs¹²⁵ in the early 1980s. While the exact figures, by the very nature of informal activities, are not known estimates for the number of their depositors reached half a million, deposited approximately £E 4.5 billion in 1988, i.e. the equivalent of more than 12% of time and savings deposits held with the banking sector.¹²⁶

However, the IICs are just part of the whole informal financial sector that include other agents and different activities: e.g. money lending, pawn broking, RoSCAs, .. etc. While it is not possible to know the exact size, significance and impact of such transactions at the macro level we conduct a survey to help us to analyse informal transactions at the household and village levels.¹²⁷

7.2 Inflation hedges

In the absence or lack of savings instruments inflation hedges like gold, real estates and durable goods become substitutes. Even with the availability of savings instruments like bank deposits, the importance of such substitutes as saving instruments cannot be ignored. For example hoarding of gold continues in the presence of bank deposits for several reasons. First tradition may slow the transition to new forms of saving¹²⁸. Second low and/or negative real returns of formal saving instruments, or unstable political and economic environment may keep gold as a viable store of wealth. Third, gold helps fulfilling other motives which can not necessarily met by keeping other assets.

¹²³ An Inflation Hedge is described as 'an asset that enables households and other investors to reduce the risk of loss of purchasing power stemming from uncertainty about the prices of consumer goods'. Gold, indexed financial assets, commodities, real estates are considered forms of inflation hedges. See the New Palgrave Dictionary of Money and Finance (1992), Vol 2, p. 405.

¹²⁴ Goodhart (1987), p. 96.

¹²⁵ The IICs are considered informal due to the fact that they have escaped any form of regulation and have not come under the monetary authority's supervision or even company laws. Most of IICs practices can easily be classified under the black market activities of the informal sector, e.g. tax evasion, bribery, theft of state land, violation of import restrictions, illegal foreign exchange dealings. Further they adopted pyramid schemes to pay outstanding dividends out late comers' deposits. For further analysis of the activities of these companies see Abdel Fadel (1989) and Mohieldin (1994).

¹²⁶ *ibid.*, op. cit., pp. 30-36.

¹²⁷ *ibid.*, pp. 8-20.

¹²⁸ See Kettel (1982), p. 119.

The private demand for gold is controlled by different motives¹²⁹. First, saving motive, according to this motive gold can be liquidated at any time as it help, like any other saving instrument, smoothing consumption over time. Second, insurance motive under which gold can be only liquidated in the case of unexpected shock. Third, showing off, according to this motive gold can be used as a indication of wealth and societal status. The satisfaction that stems from the possession and display of gold is hard to ignore especially in developing societies under what known as the psychic income.¹³⁰ Fourth, speculation. Like particular assets and commodities gold can be kept with a motivation that its price will appreciate in the future. Fifth, safekeeping,¹³¹ traditionally gold is purchased and hoarded as a way of safekeeping, especially when the banking habit is weak, taxation is excessive and/or the financial system is not stable.

Thus, we argue that negative real interest rates in Egypt contributed to hoarding gold as an efficient store of value. Where banking services were not adequately available, like in remote areas, gold again can play its traditional role. Even if banks were available, according to the view that dealing with interest rates is a form of usury, gold continued to be the 'lawful' substitute. Egypt for a long time had an active gold market which added to the desirability for gold as store of wealth. Buy-back arrangements and pawnbroking were widely practised making gold highly liquid.¹³² However we argue that gold functions effectively within certain limits of wealth. If the accumulated wealth is so big to the extent that hoarding gold would be costly, unsafe and risky, savers move to other inflation hedges like real estate.

7.3 Currency substitution

The case in which local residents hold part of their wealth in foreign money, is known as currency substitution. When there is extreme instability, e.g. high inflation, rapid devaluation, foreign currency may be used as a medium of exchange not just a store of value.¹³³

While the return on domestic currency deposits in Egypt was controlled by ceilings, foreign currencies deposits, introduced since 1974, received internationally competitive returns. Accounting for exchange rate depreciation shows that the return on domestic currency was significantly lower than foreign currencies. In this environment currency substitution was active.

Figure (13) shows that private sector holdings of foreign currencies deposits increased rapidly since 1980¹³⁴ from 41.6% of total deposits to 52.9% in 1990. After 1985 the speed of currency substitution, increased due to further devaluation of the pound and decline in real rates of interest. The growth of currency substitution, *de facto* dollarization, during this period cannot be attributed solely to negative real interest rates as at it was in general a period of deteriorating financial and economic conditions. This phenomenon is a response to an economy that suffered from inflationary pressures, worsening external position, because of the burden of external debt, and greater political uncertainties.¹³⁵ Money substitution was possible because of the inflow of remittances of Egyptian workers abroad, and tourism in addition to the increase of the number of foreign companies that pay salaries in foreign currencies.

7.4 Capital flight

Since the declaration of the Bank of International Settlements, BIS, in 1984 that total deposits of Latin

¹²⁹ Generally the demand for gold can be divided into industrial use of gold and speculative demand, see Lipschitz and Otani (1977) for an estimate for the demand of gold.

¹³⁰ See Drake (1980), p. 127.

¹³¹ Kettel, op. cit., p. 119-121.

¹³² Drake (1980), p. 126.

¹³³ Sachs and Larrain (1993), p. 237.

¹³⁴ Figures for the 1974-80 period are not available.

¹³⁵ El-Erian (1988), pp. 92-93.

American individuals ranged between 30-40% of the external debt of their countries,¹³⁶ the phenomenon of capital flight attracted significant interest in research. Nevertheless estimates of capital flight vary considerably, due to its nature and methods of estimation.

To distinguish between normal capital movement and the problem of capital flight the analysis should be undertaken in the context of the state of development of the economy and in consistency with the economic and policy question of the country concerned.¹³⁷

The phenomenon of capital flight is influenced by several economic and political determinants. The degree of economic and political stability and the efficiency of policy management were some of the main determinants of the phenomenon. For example under the so called the revolving door, Boyce (1992), shows that there is debt-driven and debt-fuelled capital flight. The first is when capital flees the country in response to economic circumstances that accompany the build up of external debt, e.g. artificial overvaluation of the currency followed by devaluation. The debt-fuelled capital flight is the case when debt provides corrupted officials with the resources needed for capital flight.¹³⁸

Negative real interest rates provide savers with reasons for searching for alternatives for domestic bank deposits. Depositing money abroad is clearly one of these alternatives. Figure (14) shows again the difference between international and domestic real interest rates. The difference is calculated as

$$(\delta_i - \delta_d + x);$$

where δ_i is real international interest rates (returns on US T. Bills);

δ_d is real domestic interest rates;

x is the appreciation or devaluation of the Egyptian pound against the US dollar.

We realise that, in almost all years of the study period, real international interest rates were significantly higher than the Egyptian rates. On average the real interest rate in Egypt was lower by 5.21 percentage points. Adjusting interest rate difference with changes in foreign exchange, yielded higher gap as the domestic real interest rate was on average lower by 10.6 percentage points over the period 1960-90.

Thus real interest rates differentials provided savers with an incentive to deposit their deposits abroad. However this incentive cannot fully explain the high capital outflow because, as mentioned above, since 1980 foreign currency deposits with internationally competitive returns were introduced as part of the *Infitah* measures. Generally, political instability, gloomy expectations regarding the performance of the economy, lack of credibility in government policies in addition to corruption can explain, along with interest rate and exchange rate mischievous policies, the high estimates of capital outflow.

In one study the estimate of capital flight was approximately 34% of external debt during the period 1976-82¹³⁹. The other estimate was approximately US\$ 40 (£E 70.4) billion in 1988 which was close to the total of the outstanding external debt.¹⁴⁰

Following Dooley et al (1986), also Pastor (1990), we calculate capital flight for Egypt during the period 1980-90.

$$CF = (\Delta OD + FI) - (AC + \Delta RS) \quad (4)$$

Where ΔOD is the change in outstanding debt,
 FI is foreign direct investment,
 AC current account deficit/surplus, and
 ΔRS is change in reserves

¹³⁶See the annual report of the BIS (1984).

¹³⁷Pastor (1990), p. 2.

¹³⁸Boyce (1992), pp. 337-9.

¹³⁹See NBE (1988), p. 239.

¹⁴⁰ibid., p. 231. This estimate is close to an estimate given by a former prime minister of Egypt who was in office in mid 1980s.

We realise, from figure (15) that the accumulation of capital flight increased during the 1980s reaching its maximum in 1989 with an estimated figure of £E 63.32 (US\$ 32.6) billion. However due a decrease in the outstanding debt in 1990, thanks to the Paris club negotiations and the writing of some of the debt by the USA and the Gulf states during the Gulf War, and an improvement in the current account deficit capital flight decreased.

From table (11) we realise that with the exception of Chile which had a negative capital flight. All countries experienced capital flight but with various magnitudes. Egypt had the highest ratio of capital flight to the change in external debt. Both Egypt and Venezuela had estimates of capital flight that exceeded the change in their external debt by 52% and 32.1% respectively.

Given its estimated magnitude, we argue that the remedy for the capital flight problem in Egypt does not rely only on the improvement of real interest rates. Such reform may be useless in the presence of distortions in the foreign exchange rate market, expectations for further devaluation and higher inflation rate, poor investment climate and/or corruption. Hence reforms are needed at both the economic and political levels to reduce the size of capital flight. Such reforms are required to bring confidence in the economy and credibility of the economic policy.

8 Concluding remarks

In this paper we have demonstrated that not only was repressive financial intervention prevalent in Egypt, the government had an incentive to maintain this intervention, given the large budget deficit.

The bank financing of budget deficit took explicit forms like extracting revenue from money creation and the inflation tax. The average seigniorage revenue was as high as 2.69% of GDP during the 1961-90 period while the inflation tax averaged 2.98% of GDP during the 1960-90 period. Both are substantially high by international standards. However Egypt managed to generate such high revenues at low inflation rates thanks to the relatively large monetary base.

By imposing ceilings on deposit rates the government managed to generate additional revenue from financial repression estimated at 2.76% of GDP over the period 1960-90. The negative real interest rates did not prevent some growth of financial savings, attributed *inter alia* to different factors like money illusion, lack of alternatives and restrictions on substitutes.

There was an extensive use of the required reserve ratio beyond its function as a measure of monetary policy and a prudential method, mainly to finance budget deficit. This resulted also in a relatively high spread. Government intervened as well in the allocation of credit and the composition of bank portfolios to fulfil the same objective, financing the large fiscal deficit. Moreover to facilitate its control over the credit market government owned some financial intermediaries through nationalisation.

Figure (16) compares government revenues extracted from the repressive measures analysed above with explicit, direct and indirect, taxes¹⁴¹ over the period 1960-90, as a percentage of GDP. It should be noted that the some of the financial repression do overlap, e.g. inflation tax and reserve requirements, hence caution is required when comparison is made between them.

Further, to facilitate its control over the credit market the government owned some financial intermediaries through nationalisation. Such intervention had its limitations concerning both the internal management of banks, their solvency and operating efficiency and the condition of the banking system as a whole which has suffered from lack of competition and various distortions. The paper has shown that despite the *infatih* measures, the banking system continued to suffer from various problems such heavy barriers to entry, absence of an adequate exit mechanism, and preferential treatment of the public sector banks in addition to inadequate prudential regulation.

On the other hand the securities market, as a result of the Egyptianisation and nationalisation measures of the late 1950s and the 1960s, and the reliance of the dominant public sector on the banking sector for funding, the ESM was near official closure. Despite the successive government's attempts, during the 1970s and 1980s, to revive the ESM the improvement its role and performance was not significant. The paper shows various aspects of distortions in the ESM. These problems are primarily supply side or supply-side driven, which implies that institutional restructuring should of distinctive importance in the reform programme.

¹⁴¹ Data on taxes are obtained from the World bank (1992c).

The unsatisfactory condition of the financial system resulted in unfavourable consequences. Hoarding of gold and some durable goods and demand for real estate, as forms of inflation hedge, have increased. The state of the Egyptian financial sector also contributed to the problems of currency substitution, capital flight and the rise of informal financial activities, signified in the flourishing of the Islamic Investment Companies during the 1980s.¹⁴²

We argue that the involvement of the state is not necessarily limited in the move towards a liberalised economy, but it is its function that changes. As summarised by Sheng (1990) *"in a market economy, the state has to enforce certain contracts. It has to protect private property rights and ensure that the laws and regulations are symmetrical, [...], treating both public sector and private enterprises on equal competitive footing"*. Such change in the role of the state involves the financial sector in four main ways. First, channelling loanable funds into budget deficit finance, in a way that reduces money creation until the deficit itself can be controlled.¹⁴³ Fiscal deficit reduction is considered a necessary prerequisite for financial reform, otherwise elements of the latter, e.g. higher interest rates and loss of repression revenues, can create fiscal burdens that are hard to deal with.¹⁴⁴ Second, advancing finance to the growing private sector. Third according to this change, the financial sector itself is subject to an array of liberalisation and institutional restructuring measures. This argument puts the financial sector in the forefront of the reform programme as an 'agent of change'¹⁴⁵.

However, with consideration of the state of the financial system in Egypt, it does not appear that financial liberalisation alone could bring a remedy for its problems discussed above. Several measures should be taken along with liberalisation. Sound macroeconomic policies, expedient fiscal practice and controlling the budget deficit are items of one bundle of prerequisites. The second bundle includes prudential regulation and adequate monitoring and supervision without the interference with the managerial autonomy of intermediaries. Moreover institutional restructuring is required to support liberalisation, in addition to the improvement of managerial skill and staff training. As long as these conditions are not satisfied and adequate restructuring is not achieved, the reform programme is likely to be counterproductive.

¹⁴²For an analysis of the Impact of repressive state intervention in the financial sector on saving, investment and short run economic growth in Egypt, see Mohieldin (1995).

¹⁴³Harvey and Jenkins (1994), p. 1.

¹⁴⁴Roe (1993), pp. 10-11.

¹⁴⁵See Wijnbergen (1993), p. 9. Note however that in his study he focuses on the role of commercial banks.

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**TABLES
AND
FIGURES**

Table (1)

Average Revenues from Seigniorage as a percentage of GDP in Egypt and selected LDCs (1980-85)

	Egypt	Korea	Nigeria	Mexico	Turkey	Argentina	Bolivia
Seigniorage	4.26	0.5	0.8	1.5	1.2	4	6.2
Inflation	15.2	9	16	58	46	274	506
Currency/ GDP	25.1	4.3	7.2	3.7	3.8	3.8	6.1

Source: For Egypt: own calculations; data obtained from IFS lines 14a, 64 and 99b.

For the other LDCs: World Bank (1988), table 3.1, p. 61

Table (2)

Average inflation tax revenue in Egypt 1960-90

Period	Inflation tax /GDP%	Inflation rate	Reserve money / GDP%
1960s	0.63	2.86	23.8
1970s	1.93	7.78	25.5
1980s	6.09	17.31	41.8
1960-90	2.98	9.57	31.1

Source: Own calculations; data obtained from IFS lines 14, 64 and 99b.

Table (3)**Inflation tax in Egypt and selected LDCs as percentage of GNP (1987)**

	Egypt	Argentina	Ghana	Mexico	Nigeria	Peru	Turkey	Zaire
Inflation tax/ GNP	8.6	4	2	3.7	0.9	4.8	2.8	4.2
Inflation rate	23.9	174.8	34.2	159.2	9.7	114.5	55.1	106.5
Reserve money/ GNP	44.8	6.3	7.9	6	9.6	9.1	7.9	8.2

Source: For Egypt: the author's own calculations; data obtained from IFS lines 14, 64, and 99a.

For other LDCs: World Bank (1989), table 4.5, p. 63

Table (4)**Average real interest rates for selected countries**

Country	1970-80	1980-90	1985-90
Egypt	-3.8	-5.73	-6.06
Turkey	-21.67 *	-4.04	-3.7
Chile	..	8.23	4.68
Korea	0.16	2.7	4.87
Kenya	-5.79	0.22	2.66
Peru	-17.13	..	..
Uruguay	-15.71	..	..
UK	-4.86	2.4	2.5
USA	0.001	4.08	3.72

Calculated from IMF, International Financial Statistics Yearbooks, 1989-91; figures for Peru and Uruguay are from Hanson and Neal (1986).

* Figure for Turkey is for 1974-80.

Table (5)

**Government revenue from deposit interest rate ceilings
as a percentage of GDP**

Period	Adjusted with free exchange rate	Adjusted with official exchange rate	Not adjusted
1960-90	2.76	2.9	1.34
1960-69	0.7	0.42	0.21
1970-79	0.51	1.23	0.52
1980-90	6.69	6.67	3.11
1980-85	6.02	2.53	2.12
1986-90	7.48	11.6	3.82

Source: Author's own calculations, data obtained from: The CBE annual reports and
and Economic Review and International Financial Statistics.

Table (6)

Required reserve ratios in selected LDCs

Country	Year	Ratio	Remuneration
Bahamas	1991	5	No
Bolivia	1991	20	Yes
India	1992	15	Yes
Kenya	1993	8	No
Paraguay	1993	30	No
Peru	1991	15	Yes
Sri Lanka	1992	12	No
Tunisia	1992	2	No
Venezuela	1993	12	No

Source: Hardy (1993), Appendix I, pp. 25-31.

Table (7)
Real interest rates spreads in selected countries (1987)

Country	Real Spread
Korea	0
Portugal	4.4
Singapore	3.2
Turkey	15
Japan	3.4
UK	0.2
USA	1.3
Egypt	4.43

Source: IMF International Financial Statistics Yearbook (1992) and Seck and Nil (1993), p. 1868

Table (8)
Zero-profit and actual spreads before and after reform

Year	Zero-profit spread	Actual spread	Difference
1976-90	1.78	4.4	2.6
1990 (before reform)	1.37	5.99	4.6
1992 (after reform)	0.61	2.78	2.2

Table (9)
Methods of controlling credit
expansion

Year	Method	Comments
1974-75	Maximum of the quantity of credit advanced	The CBE determined the size of credit available for the private, public and cooperative sectors.
1976	Fixed loan-to-deposit ratio of 65%.	The CBE adopted this method in 1976 without determining the sectoral share of credit.
1977	Fixed change in credit-to-change in deposit of 40%	Governmental sectors were excluded.
1978	Fixed loan-to-deposit ratio 56% to the private sector.	Private and joint venture banks were allowed a greater limit of 75% for private sector loans.
1981-88	Fixed loan-to-deposit ratio of 65%	This instrument was supplemented by sub ceilings on credit to the commercial private sector of 12% and the household sector of 10%.
1988-90	Fixed loan-to-deposit ratio of 60%	The instrument was supplemented by a maximum of 8% growth rate per annum for loans advanced to the commercial private sector.

Source: Central Bank of Egypt, different reports on credit and bank developments.

Table (10)
A Summary of the main laws and decrees which affected the ESM

Law	Impact
7/1959	Determined the maximum of distributable profits per the nominal value of the share.
11/1961	Amended law 26/1954. Allocated 25 % of net profits to workers.
116/1961	Interrupted dealings in the two exchange markets of Alexandria and Cairo for two months.
117/1961	All banks (18), insurance companies (12) and other companies (52) were nationalised.
118/1961	Stated that 85 companies should have a minimum of 50% public ownership.
119/1961	Determined that the maximum market value of owned shares not to exceed £E 10000 per shareholder in 139 companies. Amounts in excess of the limit were sequestrated.
121/1961	Nationalised the four cotton pressing companies.
38/1963	Nationalised cotton mills.
65/1963	Nationalised the pharmaceutical companies.
72/1963	220 companies specialised in chemical, metal, engineering, textiles products were nationalised.
73/1963	Terminated mining and oil exploring contracts and nationalised mines and quarries.
77/1963	25 of the companies governed by law 118/1961 were fully nationalised, including transport companies.
78-81/1963	Added 20 companies to the list of fully or partly nationalised companies.
65/1971	Aimed at restoring confidence of Arab and foreign investors in the economic system by protecting all new investment from nationalisation.
43/1974 & 32/1977	Granted incentives and privileges to foreign investors. Some of foreign exchange market restrictions were removed to facilitate the purchase of securities.
520/1979	This presidential decree established the General Capital Market Authority.
157/1981	Granted joint stock companies tax incentives
159/1981	Amended law 26/1954 to facilitate the establishment of new joint stock companies and raising funds for the existent ones. Extended most of the tax privileges of law 43/1974 enjoyed by foreign investors to indigenous ones.
146/1988	Regulated Islamic Investment Companies.
230/1989	Allowed the issuance of variable return certificates by ESM. Enhanced the role of the Investment Authority to encourage foreign and domestic investment..
203/1991	Transferred public sector companies to public holding companies as a step towards privatisation.
95/1992	This Capital Market Law aimed at stimulating the capital market under the reform programme supported jointly by the World Bank and the IMF.

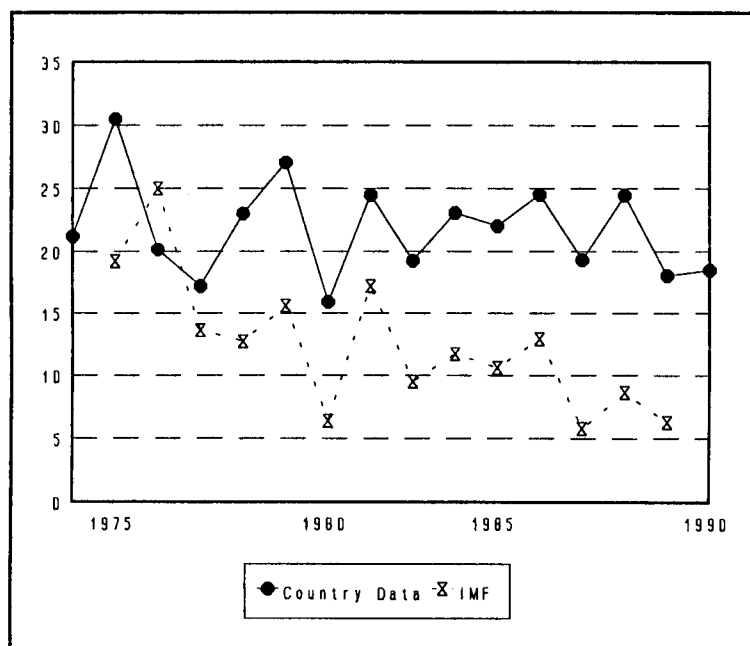
Source: compiled by the author from different issues of the Economic Bulletin of the NBE and the Economic Review of the CBE.

Table(11)
Estimates of capital flight in Egypt and selected LDCs

Country	Period of estimation	Average capital flight in percentage of change in external debt
Argentina	1973-87	61.3
Brazil	1973-86	16.1
Chile	1973-87	-19.3
Mexico	1973-87	63.9
Peru	1973-87	19.9
Venezuela	1973-87	132.1
Egypt	1980-90	152

Source: for Egypt as in figure (15), for the rest of the countries, Pastor (1992), p.3.

Figure (1)
Egyptian budget deficit as a percentage of GDP,
according to two different sources



Sources: Data obtained from the World Bank Country reports on Egypt 1988 and 1990, and from Ministry of Finance (shown as country data), and from IMF Government Financial Statistics (shown as IMF).

Figure (2)
Revenue from seigniorage as a percentage of GDP:
Egypt 1961-90

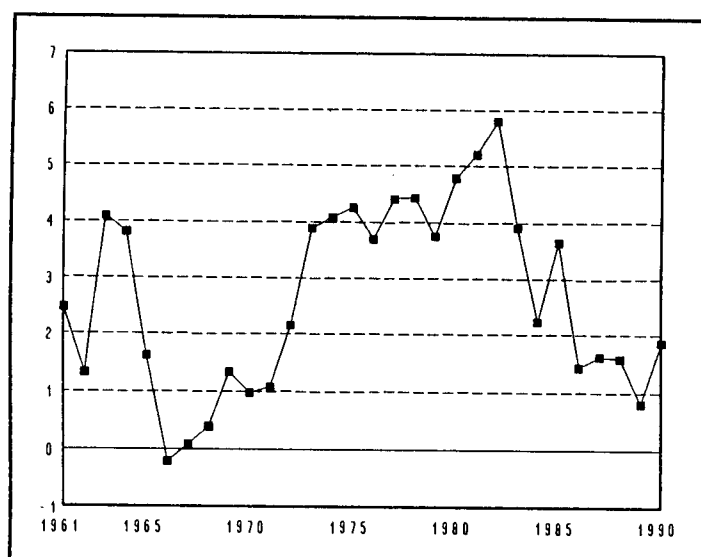


Figure (3)
The Inflation tax as a percentage of GDP
1960-90

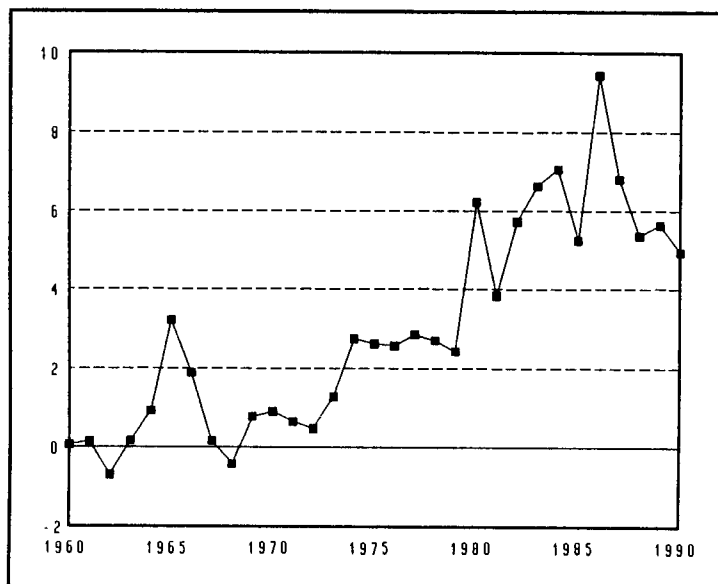


Figure (4)
Inflation rate for alternative reserve
money balances M

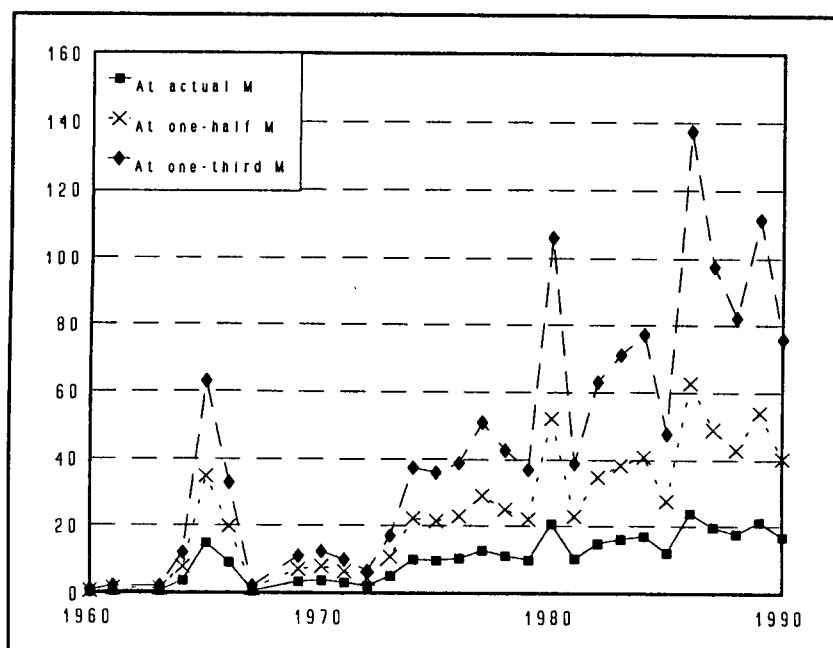
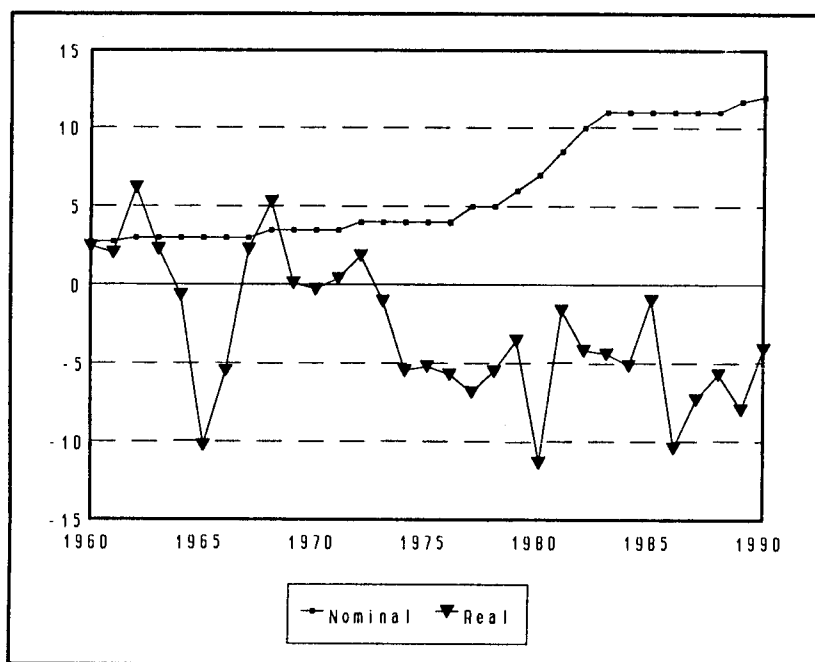
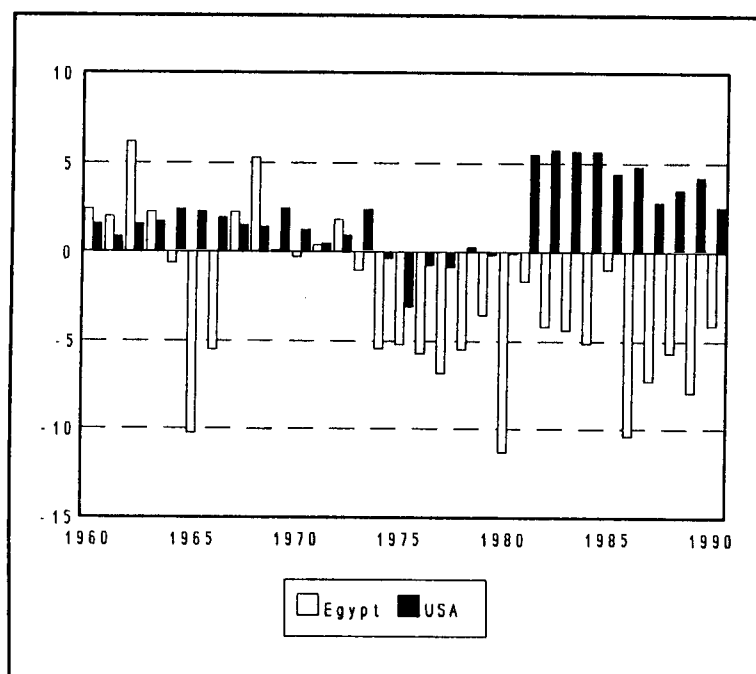


Figure (5)
Nominal and real interest rates



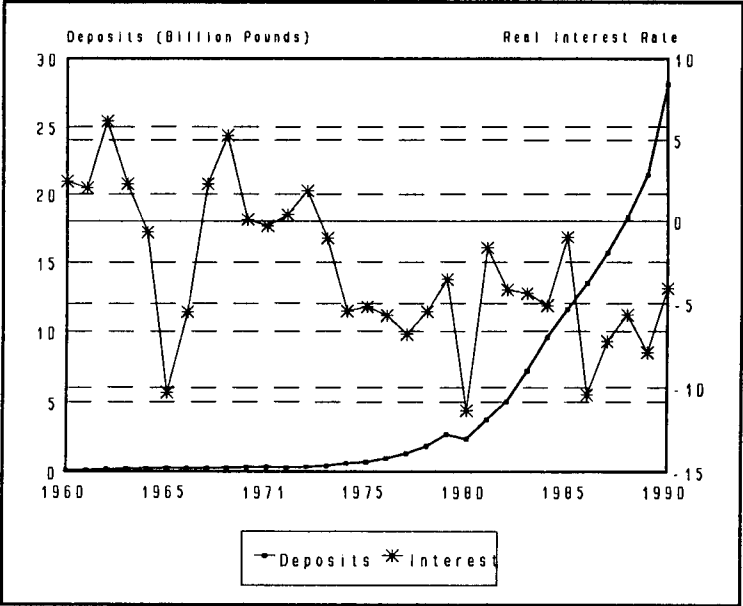
Source: The The Central Bank of Egypt and the IMF, International Financial Statistics

Figure (6)
Real interest rates in Egypt and USA
1960-90



Source: IMF, International Financial Statistics, 1990 and 1992 Yearbooks and the CBE annual reports.

Figure (7)
Domestic currency deposits and real interest rates 1960-90



Source: IMF, International Financial Statistics, Yearbook, 1990 and 1992.

Figure (8)
**Government revenue from interest rate ceilings
as a percentage of GDP**

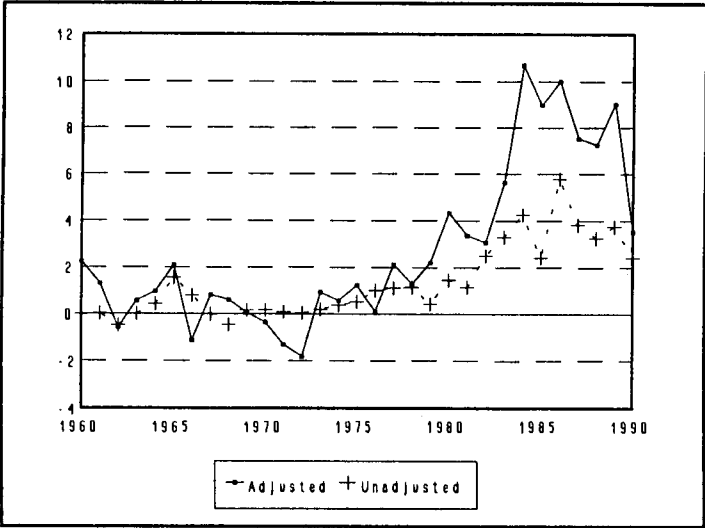


Figure (9)
Actual and legal required reserve ratio 1960-90

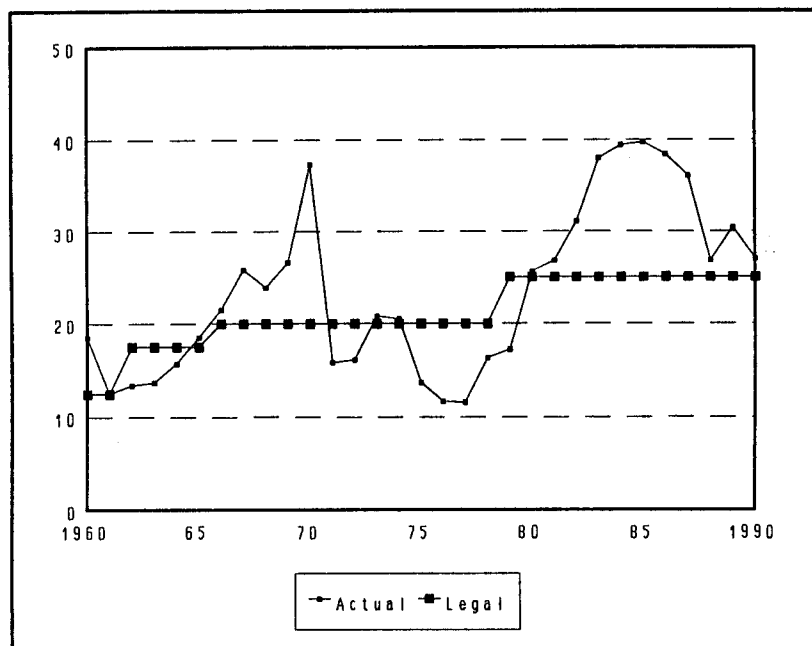


Figure (10)
Zero-profit and actual spreads 1976-90

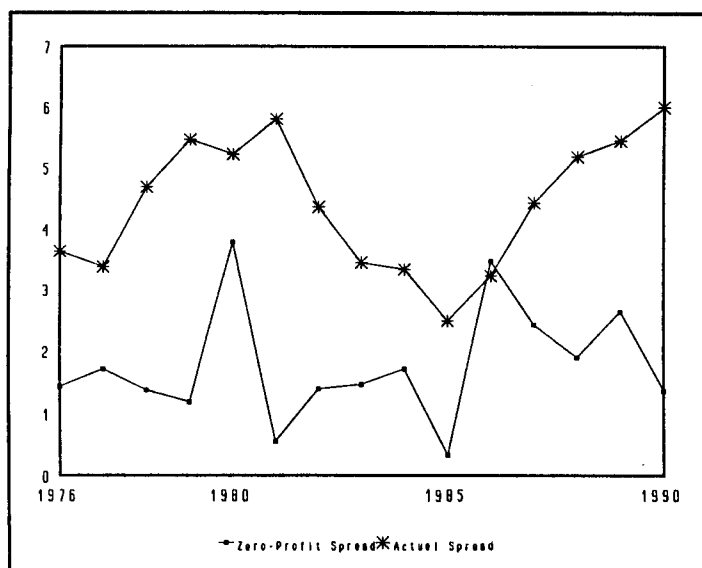
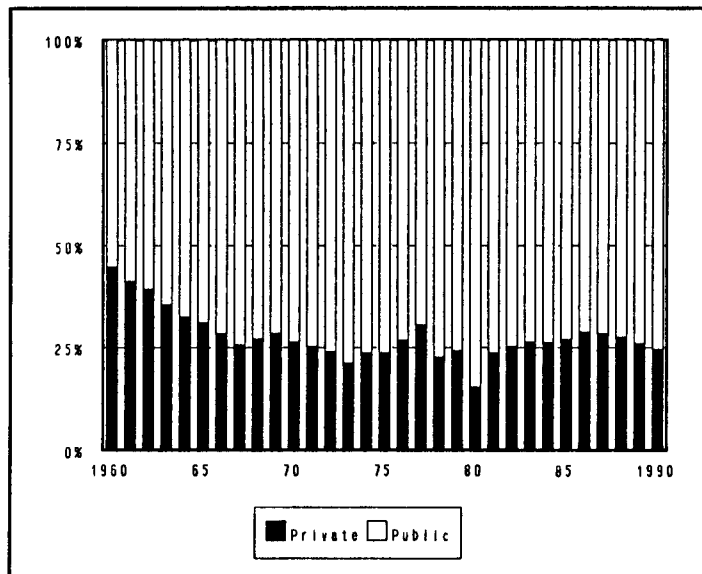


Figure (11)
Private and public credit in Egypt 1960-90



Source: IMF, International Financial Statistics, Yearbooks 1989-92.

Figure (12)
Minimum, actual and excess liquidity ratios 1960-90

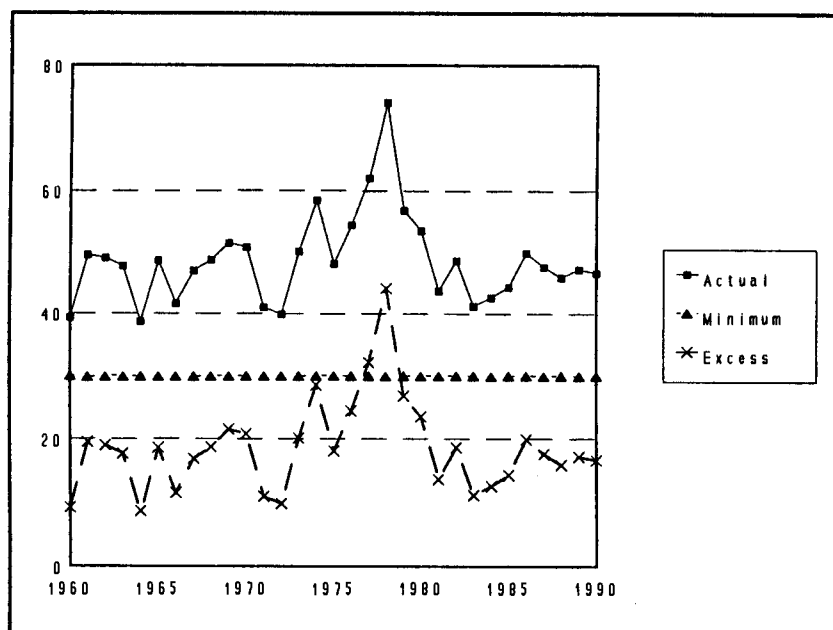
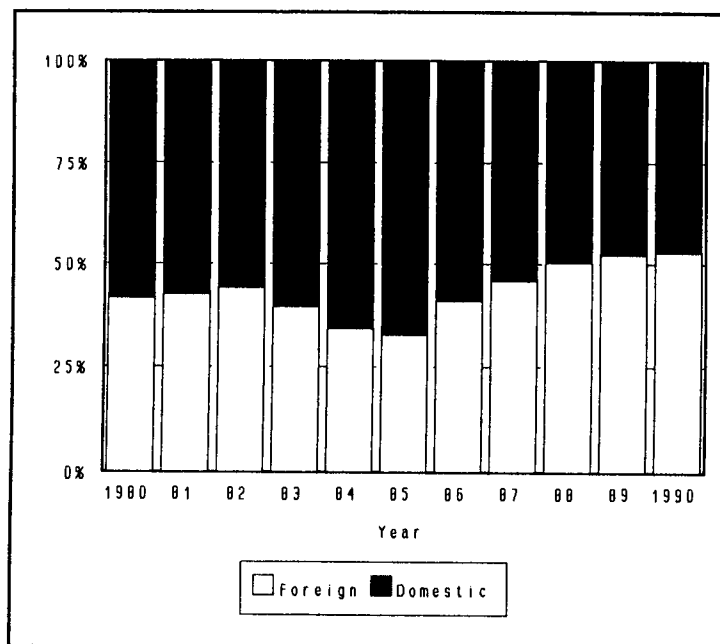


Figure (13)
Foreign and domestic deposits 1980-90



Source: IMF, International Financial Statistics, Yearbooks 1990 and 1992.

Figure (14)
Interest rate differentials 1960-90

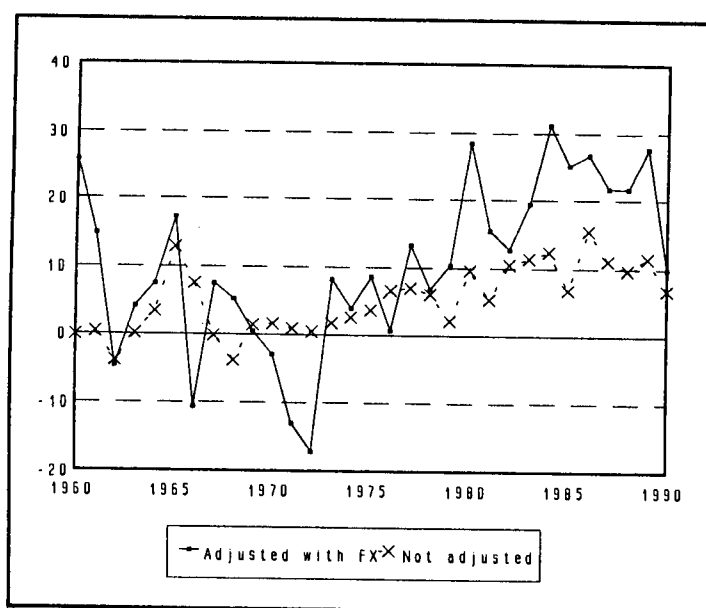
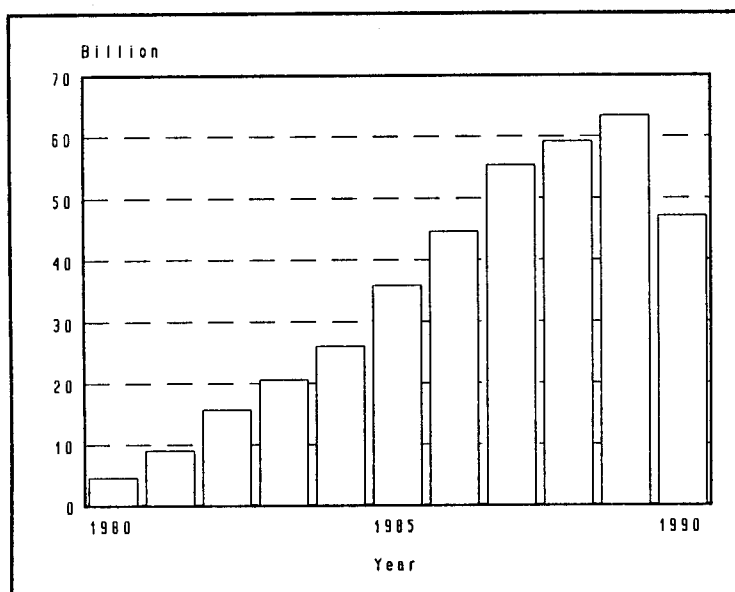
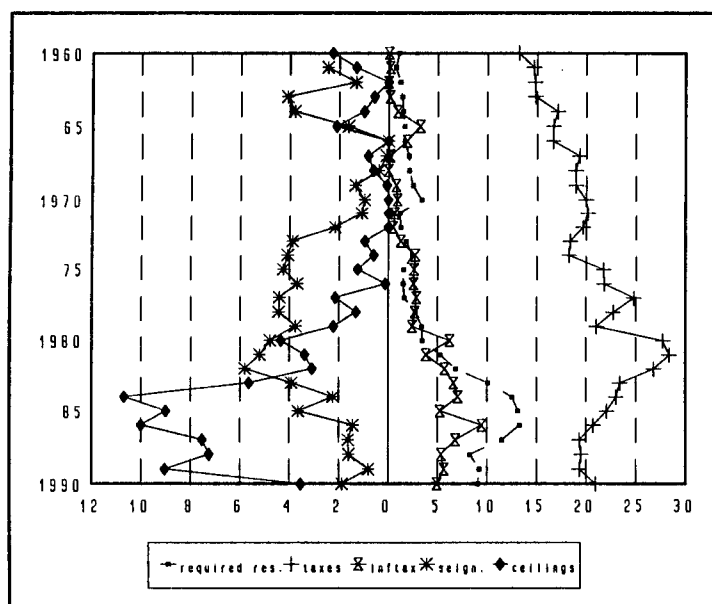


Figure (15)
Capital flight from Egypt 1980-90



Source: Authors own calculations, data obtained from the World Bank, World Tables.

Figure (16)
A comparison between government revenue from financial repression and taxation (% of GDP)



Source: Author's own calculations; (required res.) is required reserves, (taxes) are direct and indirect taxes, (inftax) is inflation tax, (seign) is seigniorage and (ceilings) are interest rate ceilings.

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