ARAB REPUBLIC OF EGYPT

التخطيط القومى

THE INSTITUTE OF
NATIONAL PLANNING

Memo. No. 1214

SOME PROBLEMS FACING THE EXTERNAL FINANCIAL POSITION OF EGYPT

BY

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December, 1977

CAIRO
SALAH SALEM St.-NASR CITY

SOME PROBLEMS FACING THE EXTERNAL FINANCIAL POSITION OF EGYPT

A Research Paper

By

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October, 1977

FOREWORD

Perhaps the most serious defect of post-World War II planning in developing countries was the adoption under the prodding of international agencies, of the policy of import substitution to the neglect of the export sector and wider participation in international markets. Compounded with inflexible exchange rates, domestic fiscal and monetary mismanagement, and a misplaced faith in central planning, this policy led to the stagnation of traditional industries and the private sector.

Professor Yousry Ismail's concern with the foreign trade and payments sector of the Egyptian economy is therefore a welcome recognition of its importance in development. While it is only a short, the study provides a basis for inter-relating domestic economic policies with international policies to achieve rapid and stable growth of the Egyptian economy.

As a post-doctoral fellow at the University of Pittsburgh, Professor Ismail's interests have led him to include studies of multi-national corporations and project analysis as well as trade and payment problems. We are extremely pleased that he chose to spend a period of his study in this country with us to our mutual benefit, and hope this marks a beginning of a long-lasting interchange with Egyptian universities and the University of Cairo in particular.

Raymond L. Richman

Raymond L. Richman
Professor of Public and
International Affairs and
Professor of Economics

ACKNOWLEDGMENT

In this acknowledgment I would like to thank Professor Raymond L. Richman, Professor of Public and International Affairs and Professor of Economics in the University of Pittsburgh for his help to finish this research paper. I am indebted to Professor Richman for the patience and feedback in elaboration and evaluation of this research.

Also I would like to give thanks to Professor Said El Naggar, Executive Director in The World Bank for providing all the technical facilities needed.

My thanks to Ms. Buncher who typed this paper, my sincere acknowledgment .

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Preface:

Recent development of the study of business administration is directed to the international fields such as international finance, international marketing and multinational corporations. In this research we are dealing with one of these fields which is international finance.

The reason of this recent development is the change towards operating across the national boundaries. As the main objective of operating in other environments is to increase profits, the corporate financial manager has become concerned with the international economic changes that affect the international business. The deficit in the balance of payments, the fluctuating foreign exchange rates, and the power of multinational corporations have become an important problem facing companies which operate internationally.

This new field so called "International Business Finance" provides a framework to understand the environments where the international business operates. It provides different methodologies to resolve the problems facing the corporate financial manager. The framework of this field covers both the macro and micro economic environment. The macro economic environment studies the balance of payments and government policies. The micro economic environment analyses how the corporate manage its exposures to foreign exchange risk and faces its demand for foreign funds.

Introduction

The external financial position of any country could be studied through the analysis of the following variables:

- The international trade movement with other countries that show its inflows and outflows of goods and services.
- The ability of the country to meet its foreign exchange obligations.
- The influence of foreign transactions on income and development of the country.

The record that illustrates these transactions is the balance of payments of the country. The balance of payments shows all transactions between the residents of one country and the residents of other countries. It includes several accounts which record these transactions and indicate its current external financial position and whether it is a surplus or a deficit country.

Any country that has commercial relations with other foreign countries, has to sustain a sound financial position to facilitate further dealings and create a situation of trust in its economy and currency which in turn depends upon its exports, investment, income and other inflows of foreign exchange, and the deficit in the balance of trade ....etc. A Country with increase in imports over exports and a persistent deficit, may not be able to prevent its financial position from declining. Such a country needs a short-run stabilization program and a long-term plan to repair its situation. Egypt as one of the developing countries faces a persistent deficit in the balance of payment because of the continuous increase in imports over exports, in addition to other problems concerning the GNP and the structure of the economy as a whole that influence its financial positions. This situation needs a rapid solution to continue its economic development.

Accordingly the objective of this research is to analyse the external financial position of Egypt showing the main problems that face the economy, which have led to persistent deficit in its balance of payments and suggesting the different ways for repair and improvement.

This study is divided in two main parts. The first part presents the theoretical background which includes the following topics:

a. Definition of the balance of payments.
b. The transactions of the balance of payments.
c. How to analyze the financial position of a country.
d. The reasons for a deficit.
e. How to correct the deficit.

The second part is the applied study for Egypt. This part includes the following subjects:

a. The basic statistical data and information.
b. Analysis of the problems facing the external financial position.
c. Results, projection and suggestions to improve the financial position.

Part One: Theoretical Background

The International Financial Position and the Balance of Payments

I. Definition of the Balance of Payments:

"The balance of payments is a system of accounts designed to show how a nation finances its international activities and what role the country plays in the world economy."[1] It shows the flows of economic transactions in monetary units between the residents of the reporting country and the residents of other foreign countries during a certain period of time. "The main purpose of keeping this record is to inform all concerned authorities of the international position of the country to help in reaching decisions on monetary and fiscal policy on the one hand and trade and payment questions on the other."[2] Concerning monetary and fiscal policy, the balance of payments is a systematic statistical record showing the flows of payments and receipts that measure the basic inflows and outflows which constitute the foreign exchange budget of the country. The balance of payments also answer the questions of trade and payments as it shows the monetary authorities what the country requires to meet all due payments in foreign currency. "The balance of payments of a country is

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[1] Stefan H. Robock; K. Simmonds; Jack Zewick, International Business and Multinational Enterprise, New York, Richard D. Irwin, 1977, p. 57.

[2] C.P. Kindleberger, International Economics, Illinois, Richard Irwin, Inc., 1973, p. 303.

very similar to a statement of sources and uses of funds of a firm."[3] For a country, sources of funds represents an increase in external purchasing power. This increase comes from the increase in liabilities to foreigners (or a decrease in assets) as a result of exporting and obtaining loans. Uses of funds of a country is a decrease in the country's purchasing power that results from increasing assets (decreasing liabilities) because of imports and repayment of loans.

II. The Transactions of the Balance of Payments:

The balance of payments includes all economic transactions that can be valued in terms of money. These transactions between the residents of one country and the residents of another country are tabulated in the following accounts which are kept in standard double-entery bookkeeping system:

a. The current account.
b. The capital account.
c. The official reserves.

A. The capital account: It includes three types of accounts that are:

1. The balance of trade: This balance records the trade in goods which composed of exports and imports. Exports are source of funds. Imports are uses of funds. When exports exceed imports, there is a surplus in the balance. On the other hand when imports exceed exports there is a deficit in the balance.

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[3] Rita M. Rodriguez and E. Eugene Carter, International Financial Management, New Jersey, Prentice-Hall, 1976, p.9.

2. The balance of invisibles (services); It shows all kinds of flows of services like travel expenses, interest, dividends.....etc. Every country has payments and receipts resulted from receiving or offering services.

3. The unrequetted transfers: (unilateral transfers): This account shows the flows of all kinds of unrequetted money, gifts to or from other foreign countries, and money inflows from emigrants or money outflows from immigrants.[4]

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[4] The current account is the point of juncture between the international payments statistics and national income accounts. Gross national output (GNP) consists of:

$$GNP = C + I + G + (X-M)$$

where C = Private consumption
I = Investment
G = Governmental consumption
X = Exports
M = Imports

The current account balance in the payment statistics is closely related to the concept of net foreign investment appearing in the national accounts. After we subtract the value of output donated abroad by government from the balance of goods and services, we get in the current account balance a measure of the net increase in the country's claims on foreigners, the net payments due to the country for goods and services sold abroad. These net claims - net foreign investment - appear in the national accounts as a component of gross investment of the country.*

*See: C.P. Kindleberger, op.cit., pp. 306-309.

B. The Capital Account:

The capital account includes the following transactions:

1. Long-term capital movements.
2. Short-term capital movements.

1. Long-term capital: It shows the flows of capital movements that have a maturity longer than one year. It could be divided to private and governmental capital transactions including loans, financial support and credits by government agencies for longer than one year.

2. Short-term capital: Short term capital movement induced by transactions referred to as compensatory or accommodating accounts. Such movements may be caused by credit suppliers, short-term loans....etc.[5]

C. The Official Reserves:

The country's reserves look like the cash and near cash assets of the firm. They provide the liquidity to pay for imports of goods, services and investment. The reserves are officially treated i.e., they are government owned assets and all transactions are done by the government (National or State Bank). They consist of all convertible holdings by the government that include:

1. The foreign convertible currencies.
2. Gold.
3. The monetary gold.
4. Special drawing rights (SDRs) or paper gold.[6]

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[5] Stefan H. Robock; K. Simmonds; Jack Zewick, <u>International Business and Multinational Enterprises</u>, <u>op.cit</u>., p. 64.

[6] SDRs are the assets created by the international Monetary Fund and allocated among the member countries according to special rules. See:

IMF, <u>Special Drawing Rights</u>, No.13, 1970.

III. How To Analyze The Financial Position of a Country:

As we mentioned before the double entry system is the technique used in balance of payments bookkeeping. This means that debits are equal to credits. The balance of payments always balances. In order to analyze the financial position of any country there must be some measures derived from the balance of payment. "The question which is asked usually is what are the changes in the Country's account of international cash and near cash?"[7] To answer this question we have to separate the accounts in the balance of payment into two groups as follows:

1. Those whose changes are included in existing economic transactions that are called autonomous accounts (the accounts above the line).

2. Those that change mainly or as result of necessary financing that accompanies the first group that are called the compensating or accommodating accounts.

The autonomous accounts determine whether the balance of trades is in surplus or deficit. The compensating accounts show how the balance of payment surplus or deficit is financed. If autonomous payments exceeds autonomous receipts during a specified period i.e., the balance of payment is in deficit. On the other hand if the autonomous receipts exceed

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[7] Rita M. Rodriquez and E. Eugene Carter, International Financial Management, op.cit., p. 16.

autonomous payments, the balance is in surplus. A surplus in autonomous accounts is accompanied by an increase in foreign reserves (or decrease in foreign liabilities) in the compensating accounts. A deficit in autonomous accounts is accompanied by a decrease in the country's purchasing power, a decrease in foreign reserves or an increase in foreign liabilities to foreigners. For the purpose of the analysis we have to use some measures as we said before. These measures are the results of the trade account, the current account and the basic balance[8] that are interrelated. In other words the analysis has to focus on these transactions that determine the surplus or deficit (autonamous transactions) which comprise the basic balance that are:

1. The current account.
2. The long-term capital account.

Finally the analysis of the financial position determines if there is a serious problem, in which case the analysis of recent changes and trends could be continued. These changes include the different measures of the financial position, the capability of the country to meet its obligations, the country's profitability and the limitations on foreign

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[8] We add the long-term capital balance to the current account to obtain the basic account considering that LTC is autonomous transaction.

and domestic investors, the borrowing capacity of the country, to what extend the country can depend upon aids and unrequited transfers, the future economic development of the country....etc.

IV. The Reasons for Deficit:

The main reason for deficit in the balance of payments is the rapid increase in imports to a degree that they exceed exports of goods and services and receipts of capital inflows. Most of the developing countries are facing this problem because of the following:

1. The increase in demand compared with supply of goods and services.
2. The inability to increase production because of the shortage of investment.
3. the inability to produce at low costs to achieve reasonable profitability from exporting. The high cost of production caused by:
   - The low productivity.
   - The high prices of material imports.
   - The absence of new technology.
4. The decrease in foreign exchange inflows because of the absence of long-term investment abroad.

At the same time such countries are facing the problem of continuous increase in population coupled with a low level of income. The import substitution regeme does not work because of the increase in demand and consumption, and increase in imports of capital goods which increase the deficit.

V. How to Adjust the Deficit:

There is more than one mechanism to adjust the deficit in the balance of payments. However, it is not helpful to apply them in case of an existing persistent deficit. These mechanisms are:

1. The changes in interest rates.
2. The changes in incomes.
3. Allowing exchange rates to change.
4. The gold standard.
5. The modified gold standard base.

1. Changes in interest rates:

Capital always flows from the low interest rate country to the higher interest rate assuming that other factors remain the same. In case of deficit (where there is low interest rate) money tends to flow to the surplus country[9] (where there is higher interest rate). Money supply in the deficit country will put upward pressure on interest rate. In the surplus country money supply will increase downward pressure on interest rate. This will encourage capital flows to enter the deficit country seeking for the higher interest rate which helps in restoring the balance.

2. Income changes:

An income increase can hlep in improving the financial

[9] Unless the government counteracts these flows.

situation if the government is sure that most of this increase will be directed to saving and investment. But in most of the developing countries most of the increase in personal incomes are directed to consumption as personal incomes are below a certain level. The impact will be an increase in imports and deficit.

3. Allowing exchange rates to change:

The change of foreign exchange rates serves to restore the prices of exports and imports. When the rate of exchange of a country rises the prices of its exports, exports go up and imports go down. The elasticities of demand and supply for foreign exchange are important to determine the range of variation. If the demand and supply elasticities are high, the rate tends to move within narrow limits. If the elasticities are inelastic the range of variation may be large. The increase of exports will increase the inflow of foreign exchange.

4. The gold standard:

Under this rule the adjustment in the balance of payments is made in gold. The domestic money supply is determined by the amount of gold that the country possesses. The exchange rate of each currency is fixed in terms of gold into which each currency is convertible. In case of deficit gold outflows will take place to finance the deficit. Accordingly the following changes happen.

> Contraction of domestic money ⟶ increase in interest rate ⟶ decrease in investment ⟶ decrease in income ⟶ decrease in prices ⟶ capital inflows take place to the higher interest rate ⟶ imports will decrease because of the decrease in income ⟶ exports will increase because of the increase in foreign exchange prices.[10]

The opposite will happen to the surplus country. But according to this rule the burden is carried by the national economy of the country. The economy will expand and contract in response to the changes in the external balance. The main criticism points to this adjustment are:[11]

a. "Monetary policy should not be used to offset the gold flows.

b. The governments are expected to sit quietly while the economy goes through a period of high unemployment to reduce incomes in case of deficit, or a period of high inflation in case of surplus.

c. The adjustment is left to automatic forces instead of policy makers. The discipline imposed by this rule is not reasonable politically because of the responsibility of the governments today for full employment and development wide price stability."

5. <u>The modified gold standard base</u>: (Bretton Woods System)

According to this adjustment exchange rates are determined on a modified gold standard base. In addition to gold, this system includes foreign currencies and

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[10] Rita M. Rodriquez and E. Eugene Carter, <u>International Financial Management</u>, <u>op.cit.</u>, p. 70.

[11] Rita M. Rodriquez and E. Eugene Carter, <u>International Financial Management</u>, <u>op.cit.</u>, p. 70.

resources issued by the IMF (SDRs[12]). According to this system the foreign exchange rate for each currency is initially fixed in terms of its par value and the US dollar or gold. The market exchange rate is allowed under the IMF rules to fluctuate only within a narrow margin around the par value of the currency. "When the exchange rate of a currency approaches the limits of the allowed band to fluctuate, the country is expected to intervene in the foreign market by buying or selling the given currency."[13] When market forces indicate upward pressure on the value of the currency, the monetary authorities are expected to offer more for sale vis-a-vis other foreign currencies and the opposite in care of downward pressure. "Fixed rates are maintained by monetary authorities using the official reserves of the country to face market fluctuations."[14]

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[12]The resources of IMF are money received from member countries (quotas). Countries can draw upon short-term balance of payment deficit. A country quota must be deposited 25/gold + 75/ in the country's own currency. The member country can draw up to the amount of gold subscription at any time and is counted among its reserves. A country can draw upon its credit tranch 200/ of the quota. Approval from the IMF is needed before changing the par value of the currency.

See: IMF, <u>The Funds Concepts of Convertability</u>, No.14, 1971.

[13]Rita M. Rodriquez and E. Eugene Carter, <u>International Financial Management</u>, <u>op.cit.</u>, p. 72.

[14]Rita M. Rodriquez and E. Eugene Carter, <u>International Financial Management</u>, <u>op.cit.</u>, p. 72.

According to this rule a deficit country looses foreign reserves, and a surplus country accumulates foreign reserves. The criticisms of this system are:

a. The system is not effective in case of persistent deficit.

b. The system is not applicable for the country which runs out of reserves and the currency of the country is not convertable.

Accordingly two alternatives were added to repair the imbalances that are:[15]

a. "In case of deficit a country can choose either to deflate the domestic economy or devaluate its currency.

b. In case of surplus a country could either inflate the domestic economy or up evaluate its money."

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[15] Rita M. Rodriquez, E. Eugene Carter, International Financial Management, op.cit., p. 72.

Summary of the First Part

The external financial position of any country could be studied through the analysis of its international trade movements, the ability of the country to meet its foreign exchange obligations, and the influence of foreign transactions on income and development.

The record that illustrates these transactions is the balance of payments of the country. The balance of payments shows the flows of economic transactions between the residents of one country and the residents of other countries through three main accounts. These accounts are the trade account, the capital account, and the official reserves.

To analyses the financial position we have to separate the accounts of the balance of payments in autonomous accounts which determine whether the balance is in surplus or deficit, and the accommodating accounts that show how the surplus or deficit is financed. The current account and the long-term capital account comprise the basic balance or the autonomous accounts. The analysis of the balance of payments depends upon studying the recent changes and the future trends including all factors causing changes in the financial situation.

The main reason for deficit in the balance of payments and the problems facing the financial situation of the country are the increase of imports over exports and the shortage of capital and foreign exchange inflows.

There is more than one mechanism to repair the deficit and improve the financial situation like:

a. The changes in interest rate.
b. The changes in income.
c. Allowing flexible exchange rates.
d. The gold standard rule.
e. The modified gold standard.

Any one of these mechanisms or more could be adopted to improve the financial position of the country. Some of them (number d and e) could not be adopted when the reserves run out or as a result of persistent deficit and the currency of the country is not convertable as the case of Egypt.

Part Two - The Applied Study on Egypt

I. Basic statistical data and information.

1. The economy of Egypt since 1961:

Starting in July 1961 the public sector has dominated most of the economic activities in Egypt. These activities are industry, foreign trade, banks, transport, wholesale trade and tourism. The agricultural sector was the only sector that continued to be dominated by the private sector. There were some small scale industries. Also owned by the private sector but working under the control of the public sector. The petroleum industry was and continues to be a mixed ownership system between the government and foreign companies.

2. The economic development of Egypt:

Egypt started its development in 1957 by putting and implementing the first five-year industrial program. Some of the projects of this program which were under implementation in 1960 were included in the ten-year economic development plan that started in 1960. The main objective of this plan was to double income in ten-years. This plan was divided to two parts. The first part covered the first five-years 1960-1965 and was constructed in detail. The implementation of the first five-year plan was accomplished by new investment in heavy and light industry as well as the agricultural and services sectors. Import substitution was one of the planned objectives in this plan. The second five-year plan 1966-1970 was determined as a framework only until knowing the feed back of the first five-years plan. Unfortunately the second five-year plan was substituted by yearly plans for partial and sectoral development because of the war circumstances that faced Egypt in 1967. Accordingly investment was determined in the annual budget for development purposes. The circumstances of the political situation led to a continuation of the same policy for economic development based on annual budgeting plans till now.

As a result of its economic development, Egypt achieved a respectable annual GNP growth rate that reached 6.7% on the average during the period 1968-1971 which increased up to 7% approximately during the period 1972-1975 (table 1). At the same time the rate of increase of population decreased from 2.54% during the period 1960-1970 to 2.24% during the period 1973-1975. Concerning the first period, percapita income was stagnant where it reached L.E. 83 on the average (equals to $191). But percapita income increased in the second period 1972-1975 to L.E.106 on the average (equals to $270) because of the increase in GNP. Table No. 1 shows the changes in GNP and percapita income.

The increase in GNP of Egypt happened because of the yearly investment that was accured. The percentage of investment to GNP reached 14% in the period 60=1971 then

Table No. 1
Egypt: Rate of Growth of Income and Per Capita during the Period 60-76

Year	GNP Million L.E.	Rate of Growth %	Population Million	Growth Rate	Per-Capita Income L.E.	Per-Capita Income $	Average
60-61	1494		26.2	2.54 % yearly	57	131	83 L.E. 191 $
65-66	2420		29.6		82	188	
66-67	2490	3	30.3		82	188	
67-68	2510	1	31.1		80	184	
68-69	2660	6	31.8		84	193	
69-70	2927	10	32.6		90	207	
70-71	3086	5	33.4		92	211	
71-72	3275	6	34.2		96	220	
72	3380		34.8	2.24 % yearly	97	247	106 L.E. 270 $
73	3626	7	35.6		102	260	
74	3849	6	36.4		106	270	
75	4118	7	37.3		110	281	
76	4406	7	38.0		116	296	

Source: 1. Egypt, Ministry of Planning, Annual Economic Development Reports, 1965-1975.

2. Egypt, Central Agency for Public Mobilization and Statistics, Statistical Yearbook, 1975.

Notes: 1. Rate of exchange during the first period one L.E. = 2.3$.
Rate of exchange during the second period one L.E. = 2.555.6$.

2. 1976 estimated.

3. Average growth rate of GNP during 1968-1972 = 6 + 10 + 5 + 6 = 27 ÷ 4 = 6.7%

decreased to 12% on the average during the period 1972-1976. At the same time the rate of savings fell between 9 % and 14.5% during the period 1960-1971 (10.4 % on the average), then decreased to 7% in the period 1972-1976 because of the increase of consumption, prices of consumer goods, increase in government expenditure. The difference between Investment and savings which reached 5.5/ on average during the 1972-1976 indicates the difference between imports and exports of goods and services (investment gap). Table No. 2 shows this analysis.

3. The balance of payments:

The balance of payment of Egypt shows a deficit during the period 1960 till now. This deficit is the main constraint on the economic development of Egypt which led to a decline in the financial situation because of the following factors:

a. The continuous increase in imports over exports.
b. The underutilitization of the capacity of production.
c. The limited ability of borrowing in hard currency.
d. The shortage of foreign exchange inflows.

Table No. 3 shows summary of the balances of payments during the period 1960-1975. Table No. 4 shows also the balances in details during 1969-1975. It is clear from Table 3 and 4 that the deficit in the trade balance increased until it reached its worst situation in 1975 (L.E. 929 million). In addition the capital account shows very low flows except in 1975.

Table No. 2
Egypt: GNP-Consumption-Investment-Savings
during the Period 1960-1976 (L.E. Million)

Year	GNP 1	Consumption 2	Investment 3	Savings 4	4 ÷ 1 %	3 ÷ 1 %	3 ÷ 1 %
60-61	1494	917	167	167	11	11	0
65-66	2420	2097	446	324	13.4	18	4.6
66-67	2490	2153	386	362	14.5	15.5	1.0
67-68	2510	2325	342	209	8.3	13.6	5.3
68-69	2660	2452	318	253	9.5	11.9	2.4
69-70	2927	2657	416	295	10.0	14.2	4.2
70-71	3086	2860	437	279	9.0	14.1	5.1
71-72	3275	3091	420	248	7.5	12.8	5.3
72	3380	3168	418	222	6.6	12.4	5.8
73	3626	3394	446	251	6.9	12.3	5.4
74	3849	--	481	269	7	12.5	5.5
75	4118	--	514	288	7	12.5	5.5
76	4406	--	550	308	7	12.5	5.5

Source: 1. Egypt, Central Agency for Public Mobilization and Statistics, Statistical Yearbook, 1975.

2. Egypt, Ministry of Planning, Follow-up Economic Development Plans, 1965-1975.

Notes: 1. 1976 estimated.

Table No. 3
A Summary of the Balance of Payment
during the Period 1960-1975
(L.E. Million)

Years	Exports	Imports	Trade Balance	Services Net	Transfers Net	Current Account	Capital inflows net	Over-all Balance
1960	203.7	(269.0)	(65.3)	30.7	4.4	(30.2)	10.8	(19.4)
1961	164.9	(248.6)	(83.7)	22.3	5.4	(56.0)	31.6	(24.4)
1962	145.2	(308.5)	(163.3)	30.8	12.8	(119.7)	78.8	(40.9)
1963	228.8	(405.8)	(177.0)	50.2	(0.4)	(126.4)	97.2	(29.2)
1964	227.6	(402.8)	(175.2)	47.5	5.4	(122.3)	113.0	(9.3)
1965	246.8	(417.0)	(170.2)	56.5	8.7	(105.0)	67.9	(37.1)
1966	259.5	(414.3)	(154.8)	74.3	5.2	(75.3)	50.4	(24.9)
1967	258.7	(415.2)	(156.5)	26.9	58.3	(71.3)	39.6	(31.7)
1968	288.7	(369.1)	(80.4)	(27.4)	110.4	2.6	6.1	8.7
1969	319.7	(418.4)	(98.7)	(33.6)	128.8	(3.5)	(37.0)	(40.5)
1970	355.4	(517.8)	(162.4)	(38.3)	134.0	(66.7)	4.4	(62.3)
1971	369.7	(540.8)	(171.1)	(40.0)	121.3	(89.8)	23.2	(66.6)
1972	353.7	(559.2)	(205.5)	3.0	128.2	(74.3)	61.8	(12.5)
1973	396.3	(622.3)	(226.0)	2.7	253.7	(30.4)	(35.9)	(5.5)
1974	653.0	(1140.0)	(487.0)	(47.0)	405.0	(129.0)	69	(60.0)
1975	613.0	(1542.0)	(929.0)	(39.0)	420.0	(548)	16	(532.0)

Source: IMF, International Financial Statistics, 1977.

Table No. 4
Egypt: Balances of Payment in Detail
during 1969-1975 (L.E. Million)

Items	69	70	71	72	73	74	75
1. Trade Balance	(98.7)	(162.4)	(171.1)	(205.5)	(226.0)	(487)	(929)
Exports	319.7	355.4	369.7	353.7	396.3	653	613
Imports	418.4	517.8	540.8	559.2	622.3	1140	1542
2. Services	(33.6)	(38.3)	(40.0)	3.0	2.7	(47)	(39)
Receipts	67.2	76.4	79.2	134.1	166.4	277	421
Payments	100.8	114.7	119.2	131.1	163.7	324	460
3. Unrequitted Transfers	128.8	134.0	121.3	128.2	246.3	405	420
Private	3.5	1.7	4.8	2.5	2.3	16	35
Governmental	125.2	132.3	116.5	125.7	244.0	389	385
4. Current Balance	(3.5)	(66.7)	(89.8)	(74.3)	23	(129)	(548)
5. Capital Account	(37.0)	1.8	11.0	53.9	(27.8)	74	30
6. Long-term Capital	(5.3)	10.6	(11.4)	32.3	23.2	(61)	230
7. Short-term Capital	(29.4)	(4.8)	26	19.2	(46.2)	135	(200)
8. Others	(2.3)	(4.0)	(3.8)	2.4	(4.8)		
9. Errors Commission	(0.1)	(4.8)	(3.5)	(1.5)	(0.7)	(5)	(14)
10. Total 4+5+9	(40.6)	(73.3)	(75.3)	(21.9)	(5.5)	(60)	(532)
11. Allocation of SPRS		10.9	8.7	9.4	--	--	--
12. Overall Balance 10 + 11	(40.6)	(62.4)	(66.6)	(12.5)	(5.5)	(60)	(532)
13. Monetary Movements	40.6	62.4	66.6	12.5	5.5	60	532
Commercial Banks (net)	14.7	13.9	(15.3)	(6.3)			
Credit Facilities net	10.6	26.3	50.0	34.0	5.5	60	532
Reserves & Foreign Exchange	15.3	22.2	34.6	(15.2)			
International Banks			(2.7)				

Source: IMF, International Financial Statistics, Feb., 1977, p. 469.

Note: The rate of exchange that is used is one L.E. = 2.5556$.

In 1975 the long term capital (net inflows) reached L.E.230 Million while the short-term capital (net outflows) reached L.E.200 Million consisting mainly suppliers credits.

II. Analyzing the Main Problems:

During the period 1960-1975 Egypt entered two wars, the first in 1967, the second in 1973, in addition, to Yemen fighting in 1962. Also the policy of import substitution failed to generate new exports and decrease imports of food stuffs and equipment. In addition there were limited inflows of foreign exchange. All these led to the deficit in the balance of payments. It was planned in the five-years economic plan 1960-65 that the production of the new projects would be able to repair the deficit situation by increasing exports and import substitution. But the increase of population, the idle capacity the losses and military hardware expenses, and the increase in grains imports increased the deficit. It was necessary to obtain the hard currency needed to cover these expenses. Accordingly this situation forced Egypt to borrow on a short-term basis which led to a worse situation similar to that of a firm that depends upon short-term credits to finance its investment. The main structural problems that faced Egypt were and are:

1. The need to finance agricultural and industrial development: As a result of the foreign currency shortage there was insufficient supplies of raw materials and spare

parts, in addition to the under utilization of capacity. In spite of the rise in industrial production from L.E. 2498 Million in 1972 to 2700 in 1973[16], an additional increase could have been achieved by using idle capacity. Also there were some semi-established projects because of the shortage of hard currency. Moreover, industries that should be integrated for different kinds of supplies rarely achieved such objective and there was a continuation in imports to overcome the bottlenecks. "All these created some kind of inferior quality and overprices of some kinds of domestic production that didn't find hard currency markets."[17]

The high quality kinds of industrial products were listed in the bilateral commercial agreements with the Soviet Union and Eastern Europe. But the agricultural sector continued to make up the bulk of all Egypt's exports as shown in Table No.5 where it reached between 59% and 66.3% of total exports during the period 1970-1973. The main exportable product was cotton whose exports reached between 43% and 51% of total exports during 1970-1973. Meanwhile, the industrial exports comprised between 29% - 35% of total exports during the same period.

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[16] Egypt Central Agency for Public Mobilization, op.cit., p. 206.

[17] American Universities Field Staff Report, Egypt Economic New Look, John Waterbury, vol. xx No.2 North East Africa Series, 1975.

2. Hard currency losses since 1960:

The 1967 war caused two main kinds of losses. The first was the substantial loss of hard currency as a result of closing the Suez Canal which amounted to approximately L.E.4 billion during the closing period. In addition Egypt lost approximately L.E.2 billion that are the revenue

Table 5
Composition of Main Exports
During 1976-1973 (L.E. Million)

Items	1970	71	72	73
1. Agricultural exports:	212.4	227.7	211.3	269.2
2. Raw Cotton exports	147.9	175.0	162.0	191.9
3. Others (rice-onion-orange, veg. pototoes ...etc)	64.5	52.7	49.3	77.3
4. Fuel	15.8	2.9	23.3	64.7
5. Semi-finished products	42.5	41.7	48.4	54.4
6. Finished Products	60.3	70.8	75.6	75.8
7. Total	102.8	112.5	124.0	130.2
8. Total exports	331.0	343.1	358.6	444.1
1 ÷ 8	64%	66.3%	58.9%	60.6%
2 ÷ 8	44.6%	51.0%	45%	43%
7 ÷ 8	31%	33%	35%	29%

Source: Egypt Central Agency for Public Mobilzation and Statistics, Foreign Trade Statistics, 1975.

of Sina oil fields. Also the sharp drop in tourism activity after 1967 increased the losses of hard currency that could be obtained. "These losses were partially offset by the annual subsidies amounted L.E.210 million."[18] Military expenses also increased the deficit in 1967 and later.

3. <u>The external debts:</u>

> "The external debt was estimated between L.E.1.7 billion and 2.2 in 1974 which is equal to a percentage between 44% - 57% of the GNP of that year. In 1965 the debt stood at L.E.600 million, that is about one third of GNP, but servicing debt at that time amounted to only L.E.15 million or 2.5% of the debt. Today not only has the debt at least tripled but the burden of servicing is also falling due in even larger installments. Theoretically 55% of the debt incurred in the early and mid-1960's was to have been paid off by 1974. In 1974 servicing debt amounted to L.E.170 million or nearly 26% of the total value of Egyptian exports in the same year."[19]

As foreign exchange was difficult to obtain until 1973, Egypt faced a financial problem that could not be handled

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[18] American Universities Field Staff Report, Vol.XX No.2, 1975, op.cit., pp. 3-11.

[19] The non-military debt to socialist countries is generally put out L.E. one billion. Another billion or so is owned to western sources including IMF and IDP, while another L.E.200 million are tied up in long-term deposits made by Arab oil producing states in Egyptian banks in the fall of 1974. The Military debt to the USSr may be on the order of L.E.2 billion.

See: American Universities Field Staff Report, Vol.XX No.2 1975, op.cit., p. 2-4.

easily. The only alternative was the agreements with the Soviet Union and Eastern European Countries tying Egypt exports to these markets and leaving the country dependent on what is frequently regarded as inferior technolgy and equipment. In addition it was difficult to have foreign exchange capital inflows from the foreign private sector since nationalization in 1961 and later led to the flight of foreign capital.

4. <u>The pattern of exports and imports</u> :

a. Prices of the main exports and imports: Cotton is a main product affecting the exports of Egypt. From Table No.4 we see that the exports increased in the period from 1971 to 1975 except 1972. This happened because of the increase in cotton prices. For example while cotton exports decreased from 6070 thousand metric Kantars in 1972 / 1973 to 4069 in 73/74, the value of cotton exports increased from 161.5 million to 72/73 to 239.1 in 73/74 because of the price increase from L.E.26.6 per kantor to 58.8 in 1973/74, an increase of 121%.[20]

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[20] Source of data: The Egyptian General Cotton Organization.

The imports started to increase also from 1973 to 1975 as follows:

Year	Imports	Percent
72	L.E.559.2 million	100
73	" " 622.3 million	111.3
74	" " 1140.0 "	203.8
75	" " 15420.0 "	275

The increase in imports was 11.3% in 1973, 103.8% in 1974 and 175% in 1975 compared with 1972. The reason for this increase was the upward trend of international prices particularly wheat prices. The value of wheat imports increased from L.E.49.4 million in 1972, to 176 in 1973 then to 215 in 1974. In addition there was an increase in the intermediate commodities imports as shown in Table No.6.

Table No.6

The Composition of Main Imports
(L.E. Million)

Items	1976	71	72	73
Fuel	28.2	28.0	21.1	7.0
Primary Commodities	45.8	79.9	66.6	80.6
Intermediate goods	128.6	150.0	169.5	131.8
Capital goods	79.9	81.7	77.8	79.2
Consumer goods	59.5	60.4	55.8	62.5
Total	342.0	400.0	390.8	361.1

Source: Egypt - Central Agency for Mobilization and Statistics, Foreign Trade Statistics, 1975.

In general the rate of increase of imports exceeds the rate of increase of exports. Accordingly, the deficit increase in the trade balance. The increase in export prices was offset by an increase of prices and quantities imported.

b. The direction of exports and imports: The direction of exports and imports were one of the reasons of the shortage in the foreign exchange inflows. Approximately three quarters of the exports during 1970-1973 were directed to bilateral agreement countries as shown in the next Table No.7:

Table 7
Direction of Main Exports during 70-73
(L.E. Million)

Items	70	71	72	73
1. Exports to Convertible Currency Countries	74.3	79.8	92.5	152.1
2. Exports to Bilateral Agreement Countries	256.7	263.3	266.1	292.0
3. a. To Russia and Eastern Europe	191.5	194.9	205.0	231.2
4. b. Others	65.2	68.4	61.1	60.8
5. Total	331.0	343.1	358.6	444.1
3 ÷ 4	58%	57%	57%	52%
3 ÷ 2	77.5%	77%	74%	66%

Source: Egypt, Central Agency for Mobilization and Statistics, Foreign Trade Statistics, 1975.

But more than half of the total exports were directed to Russia and Eastern Europe. As shown in Table No.5 approximately half of the exports between 1970-1973 is cotton which is the essential component of exports. Half of these cotton exports were directed to Russia and Eastern Europe under bilateral agreement conditions as shown in Table7. The composition of imports shows that the main item was intermediate goods that are necessary for running the factories (Table No.6). Between 40% - 52% of total imports came from Bilateral agreement countries and more from 31% to 26% of total imports came from Russia. and Eastern Europe as shown in Table No.8.

Table No. 8
Direction of Main Imports During 1970-1973
(L.E. Million)

Countries	1970	1971	1972	1973
1. Convertable currency Countries	163.5	223.2	216.7	215.6
2. Bilateral agreement Countries	178.5	176.8	174.1	145.5
3. Total	342.0	400.4	390.8	361.1
4. Russia and Eastern Europe	106.1	117.9	110.7	94.5
1 ÷ 3	47.8%	55.7%	55.4%	59.7%
2 ÷ 3	52.2%	44.3%	44.6%	40.3%
4 ÷ 3	31%	29.4%	28.3%	26%

Source: Egypt, Central Agency for Mobilization and Statistics, Foreign Trade Statistics, 1975.

It is clear from Table No.7 and 8 that imports from Russia and Eastern Europe were less than Egyptian exports to this block. At the same time there was complete dependence and strong economic relations with them. The increase percentage between the exports, to Russia and Eastern Europe, and the imports from this area felt between 41% to 60% as shown in the next table (values of L.E. Million):

Year	(1) Exports To	(2) Imports From	Percent 2-1
1970	191.5	106.1	55%
1971	194.9	117.9	60%
1972	205.0	110.7	54%
1973	231.0	94.5	41%

This means that this block was drawing more than their exports to Egypt which put additional pressure on the government to complete its increasing imports by importing from convertable currency countries. This increased the short-term borrowing or suppliers credits which affected the financial situation.

5. <u>The Sprawling Public Sector</u>:

In addition to the above problems there is the sprawling extended public sector in Egypt with its powerful listed interests supervised by a governmental staff. This staff spent important training and working times in the public service activities which have a different system of administration than the suitable system that is necessary to manage the production units. Accordingly the diseases of bureaucracy were transferred to the vital projects that have to achieve the real development. The increasing low level of wages and salaries determined on a fixed basis to all the activities of the public sector were not met with high productivity as it is an obligation that the government has to cover as a result of the full employment policy. "In addition, the social commitment led the government to maintain subsidies estimated at L.E.625 million in 1975 for some basic goods."[21] These obligations transferred substantial funds from direct, investment to local consumption that led to an increase of imports and deficit problems.

III. Results, Projection and Suggestions to Improve the Financial Position :

1. The general objectives:

After 1973's war a new stage was started for the Edgyptian economy. The main issues were concentrating on the need of a new development strategy that depends upon the following gactors:

a, Expanding the private sector.
b. Encouraging the foreign private investment.
c. Improving the climate for better relationships with oil producing Arab countries, Western Europe, USA and Japan.

The main objectives were to improve the external financial position of Egypt and repair the deficit by increasing inflows of foreign currencies which have its impact on economic development.

In 1973 President Sadat formulated the long-run objective of the economic and social development in the so called October working paper. This paper speaks of the open door economic

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[21] American Universities Field Staff Report, op.cit., p.5.

policy to attract Arab and foreign investment to work within a framework of a national plan. The paper speaks of improving the relation with Arab countries to attract their surplus resources, encouraging the inflows of resources and technology of foreign investors, developing industrial exports to finance the increasing imports, establishing new free zones to help in development, encouraging tourism, and oil exploration.

Our previous outlook concentrated upon the problems facing the external financial position of Egypt which included the deficit in the balance of payments as a result of hard currency losses, the need to finance agricultural and industrial development, the increase of the external debt, the pattern of exports and imports and the sprawling public sector. The outlook of these problems in the light of the general objectives (that are shown in the October paper) and the theoretical background and projection led to some results and suggestions to improve and adjust the financial position of Egypt. The suggestions are divided in two main parts that are:

- the main suggestions for adjustment
- other helpful procedures

2. Main suggestions for adjustment:

The Egyptian economy can achieve a higher growth rate and the deficit problem could be resolved gradually if the government succeeded in doing the following:

a. Attracting foreign capital inflows to utilize it in the most profitable activities to be able to re-pay back the installments and the interest rate.

b. Increasing domestic savings to be able to limit consumption and increase investment.

c. Determining certain priorities of the development projects to avoid bottlenecks and idle foreign capital.

d. Using the cheap domestic factors of production (labor, raw material) in participation with the advanced technology and management technologies and raw material from Western Europe, Japan and the USA.

But the starting point is very difficult as Egypt has to break the vicious circle first to remove the rust off the wheel, then push it to move and later it will turn autonomously. The first step depends upon the size of resources needed, its sources, the priorities of the new suggested projects to help in improving the financial position.

The projection of the future deficit in the balance payments can help in determing primarly the size of needed resources. This projection shows us that the imports of all kinds (consumer goods, capital and intermediate goods, primary goods) will increase if it is determined to implement an economic development plan because of the high increase of imports mainly of capital goods and equipments. At the same time according to the yearly investment budgets exports could be increased as the same rate by increasing the volume of exports or the increase in international prices. The next table No.9 shows the results of the projection.[22]

Table No. 9

The Projection of Future Deficit in the Current Account (L.E. Million)

Year	Exports	Imports	Deficit	Unrequitted Transfers	Deficit
1976	713	1655	942	420	522
1977	791	1914	1123	420	703
1978	870	2172	1302	420	882
1979	948	2431	1483	420	1063
1980	1027	2689	1662	420	1242
1981	1105	2947	1842	420	1422

From the above Table No.9 the deficit in the trade balance will be increased gradually from L.E.942 million in 1976 to 1842 in 1981. The adjustment of the deficit depends upon the

[22]The trend equations of exports y=241.2 + 78.6x where y refers to exports and x refers to time. The trend equation of imports is y=106 + 258.3x where y refers to imports and x to time, using the five years data 1971-1975 in Table No.4.

unrequited transfers, in addition to long-term capital flows. The unrequited transfers increased from L.E.405 million in 1974 to 420 in 1975. Assuming the following considerations:

a. The unrequited transfers remain the same.

b. The yearly investment that reached L.E.500 million in 1976 (Table 2) will remain the same to sustain the normal rate of growth.

c. The incremental capital output ratio in Egypt is two.[23]

Accordingly to repair a deficit of L.E. one billion additional needed investment will reach L.E.2 billion which can be divided at L.E.500 million yearly during the next four years.[24] This means that for the next four years a total investment of L.E. one billion is needed (500+500) every year to repair the deficit situation and sustain the normal growth. After these four years investment can be adjusted to the normal amount to be able to repair new deficits and sustain higher rate of growth.

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[23] This ration is calculated from the date in Table No. 2 during the period 1965÷1976 according to the formula: investment÷increase in GNP.

[24] Assuming that most of the inputs will be imported.

investment must be directed to profitable exporting projects that depend upon advanced techniques and low cost of factors of production whether agro-based or light industries. The development of the agricultural sector will help to a great extend in solving the problem.

3. Other helpful procedures:

The adjustment depends upon applying the mechanism of changing the foreign exchange prices and changing the interest rate in addition to other techniques. The machanism of changing of incomes, the gold standard and the modified gold standard were excluded as the resources of gold and foreign exchange are not available and the increase of incomes is not acceptable.

a. The foreign exchange price changes: one of the main obstacles that was facing the private sector and putting limitations on exports, was the foreign exchange prices. Now there are two exchange rates for the Egyptian pound, the formal rate (L.E. one equals \$2.56) and the parallel or encouraging rates (L.E. one = \$1.55) in addition to the free (black market) rate (L.E. one = \$1.33). The suggestions by the IMF to apply the parallel rate were mainly to eccourage the exports. But this decision will not be effective in repairing the deficit unless there are some changes and flexibility in determining other prices of commodities and profitability. The system in Egypt is working according to fixed prices and one rule for salaries and wages. If the foreign exchange rate is overvaluated against the L.E., the local prices have to go up in the same direction as part of the raw materials are imported. Also the wages have to move up to face the increase in prices. These procedures are not easily undertaken at once as it will affect the prices and income distribution which work under fixed price policy. Accordingly if the prices of foreign exchange goes up and also for domestic prices still without any increase in wages, the government will be directed towards a new policy of subsidising essential goods. So the parallel rate of exchange was adopted within a very limited use. Accordingly any increase in the foreign exchange prices or any generalization for the parallel rate or floating the Egyptian pound will lead to a complicated problem if there is no arrangement to increase the production and GNP through developing the economy.[25] So the parallel rate for the private sector mainly

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[25] The new system of the parallel market started in September 1973 where the official rate is governing most of the governmental transactions. The parallel rate is L.E. one = \$1.55 mainly for the private sector. The main purpose is to increase the foreign currency inflows and encouraging exports and make these flows available to increase production. The issued law determined the sources and uses of this parallel market.

is a suitable policy for the next five years. The new joint ventures and foreign investment policy will occur its effect gradually on wages and incomes during the next years that will allow any changes in the rate of exchange of the Egyptian pound.

b. The interest rate changes:

The low interest rate in Egypt will not encourage the capital intensive techniques to enter. As capital inflows are needed for economic development, adjustment in the interest rate must happen from time to time whatever for domestic savings or for hard currency deposits to be able to increase the domestic investment and foreign capital inflows. The investment policy adopted by the banks must be directed towards the profitable projects to achieve a high rate of return to allow paying the high interest rate.

c. Changing the commodity prices:

For some products the local prices are less than the international prices, accordingly adjustments have to be applied to reflect the world prices.

d. Changing the direction of exports:

The main purpose of exporting goods is to achieve profits and have inflows of hard currency to be used in financing hard currency obligations. Shifting the Egyptian exports from bilateral commercial agreement markets to convertible currency markets will increase the inflows of foreign exchange in addition to the flexibility to deal with the best markets.

e. Evaluating the policy of subsidies:

As we said the subsidies in 1975 were estimated at L.E.625 million where 75% of it goes to food stuffs. The main objective of subsidising people is to help the unable person to have the commodity at lower prices because of his low wage or pension. To determine which class will benefit from subsidies, it is necessary to divide citizens to people above the line (able) and people below the line (unable). After that it is easy to determine the way to offer this subsidise whatever it will be an increase in the wages and pensions below certain limits or continuing the same system to the unable class by selling the commodities at lower prices. Taking into consideration that subsidising able citizens increase the consumption expenditures and the vis-a-vis saved part maybe directed to imports that increase the deficit problem.

f. Evaluating the profitability of the public sector units:

As a result of the fixed prices policy, some production units of the public sector suffering from the problems of low level of profitability and losses in addition to liquidity problems. Also the overstaff and low productivity participated in this problem. The public ownership must not be one of the reasons that lead to low profitability compared with the private ownership. In all countries of the world prices increases as the cost of production increases. But the obstacle in Egypt is the fixed prices rule, the large size of employment in the public sector, and the inability to adjust salaries and wages vis-a-vis the increase in prices. The solution may be directed towards decreasing the responsibility of the government for there huge members of employees. This need and evaluation of the profitability of the public secor production units, keeping the profitable units and reprivate the units that achieve persistant losses, at the same time the government have to be sure that the taxes system is effective and will increase its resources. In that case the burden may be loaded on the domestic consumer as a result of increasing the prices and also firing some workers. But the insurance system can cover to some extend the fired workers also a chance of work in the new projects could be arranged in addition to the high demand from Arab countries on the Egyptian workers that could be arranged between governments. This solution will decrease the losses of the public sector, increase the resources of the government and decrease its responsibility, lightned the pressure on the public expenditures and help in increasing investment by the government and by the new owners. Taking into consideration that the government can participate in the capital of any unit to assure that the changes will not have strong effect on the domestic consumer.

Summary Of The Applied Study

Egypt is facing the problem of declining its external financial situation since 1960. The balance of payments shows a persistent deficit because of the following reasons:

a. The need to finance the industrial and agricultural development meanwhile there are not enough foreign exchange flows because of the shortage of exports. As imports increased gradually since 1960 till now the deficit in the balance of payments increased also.

b. The hard currency losses are a result of military expenses, the Suez Canal losses since it was closed in 1967 till 1974, and the losses of Sina Oil Fields.

c. The increasing size of external debt.

d. Egypt is considered one product exporting country that is cotton. A large percent of cotton exports and high quality kinds of production were directed to bilateral commercial agreement countries which decreased the funds of foreign exchange.

e. Depending upon short-term credits to finance the investment and other obligations for economic development.

f. The sprawling public sector that is suffering of the overstaff problem, bureaucracy in decision making system, low productivity and low quality over priced products in some cases, depending upon subsidies for same kinds of production, fixed prices for production and one rule for wages. These decreased the exports to foreign currency markets and put limitations on the size of investment.

g. The food stuffs subsidies that led to increase in imports and consumption on the account of new investment.

A stabilization program was necessary to repair the deficit in the balance of payment and save the financial position of Egypt. Our theoretical study shows the techniques that could be followed to adjust the deficit. In the light of the general objectives for improving future financial positions and economic developments of Egypt, October Working Paper clarified the importance of the economic open door policy to attract Arab an foreign investment to work within a framework of a national plan. The projection of future deficit, assuming that all factors remaining the same and the services account will be balanced, shows that Egypt needs in the next four years L.E. two billion as a minimum to overcome the deficit and continue developing the economy at the same growth rate.

These resources have to be arranged by increasing the inflows of foreign exchange from oil producing countries, USA and Western Europe whatever these transfers are unrequitted or long term loans. Other suggestions are summarized as follows:

a. Continuing the policy of the parallel rate of foreign exchange to increase exports, but without generalization on all governmental transactions and without additional increase in this parallel rate against the L.E.

b. Increasing the interest rate on deposits of foreign currency to attract new inflows and on domestic savings to encourage domestic investments.

c. Changing the commodity local prices to reflect the world prices.

d. Changing the direction of exports to increase the inflows of foreign convertable currencies.

e. Evaluating the subsidizing policy to achieve the real purpose and objective of such grants.

f. Evaluating the profitability of the public sector units for the purpose of reprivate some of there units to decrease the government losses.

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