ARAB REPUBLIC OF EGYPT

THE INSTITUTE OF NATIONAL PLANNING

Memo No. 1599

The Economic Reform Policies and their Impacts On The Balance Of Payments' Adjustment In Egypt

By
Dr. Magdi Khalifa

Dec.1998

CAIRO
SALAH SALEM St-NASR CITY

***The ECONOMIC REFORM POLICIES and Their Impacts On The BALANCE OF PAYMENTS' ADJUSTMENT** IN EGYPT*

Pre By
Dr.MAGDI KHALIFA
Senior Expert in Institute of National Planning

Content..

Introduction

The Egyptian economy is undergoing comprehensive economic reforms, the Economic Reform and Structural Adjustment Program *(ERSAP)* was formulated in November 1989, but the actual implementation began in March 1990. The program objectives were to create a decentralized, market oriented, and stimulate medium and long term growth. The program was supported by an *IMF* stand-by loan of 278 million *SDRs* in May 1990. The World Bank approved a structural adjustment loan of US $300 million shortly afterwards (1).

The program has pointed out some main items such as reform of exchange rate system, reform of public enterprises, domestic price liberalization, foreign trade liberalization, encouragement of private sector investment and production and finally, to set up a Social Development Fund *(SDF)* to be ready to deal with the negative impact of economic reform policies especially on the poor people (2).

Economic reform of foreign trade policy has been started in 1974, when *law No. 34* was issued . This law was issued for two reasons, first the law allows the private sector and individuals to import and export according to foreign currency equilibrium, second it allows Egyptian citizens who have foreign currency to use it to finance imports . Before that, the government organizations monopolized all foreign trade processes, such as foreign currencies transactions, exports, imports, foreign transactions and also capital transactions whether under direct or indirect governmental supervision . Almost all import and export enterprises were taken over by the government and the foreign trade regime was completely centralized until 1972, depending on budgeting of foreign exchange, import quotas and others governmentac control's, forms.

Egypt had participatively in *The Uruguay Round*, and it's foreign trade policy of free regime has started actually with the beginning of the seventies. Egypt started to adapt the open door policy since 1974 to reform the economic policy, to encourage foreign investment and to liberate foreign trade.

The economic reform policy for trade liberalization has been achieved through three panels. First, new imports & exports procedures, second, exchange rate adjustment and third, balance of payments adjustment. But all of them worked through the fiscal and monetary policy adjustment.

The balance of payments' adjustment was one of the important objectives for foreign trade liberalization and economic reform policy in Egypt, because the balance of payments reflects the economic reform success. Therefore, this study is organized in two sections. The first section will present the economic reform policies which have direct impact on the balance of payments which are mainly foreign trade policy and exchange rate adjustment policy.

Section two will deal with the direct impact on the balance of payments that is to say the proceeds from exports or the payments for imports whether visible or invisible.

Section one : The Economic Reform Policies

The balance of payments is considered a good summary for the proceeds of international transactions between one country and other countries during a specific period typically one year. Also we can say the transactions between the resident and unresident and vis versa , expressed in commodity or monetary terms..

In general, the balance of payments includes three balances , commodity transactions, services transactions and capitals transactions . Some of them are visible and the other are invisible . Therefore, when we are going to talk about the balance of payments we consider three balances:

* Trade balance which includes export and import of commodities (visible)
* Services balance which includes invisible imports and exports.
* Capitals balance which includes capitals inflows.

According to the above mentioned categories , there are many economic policy aspects that could affect the balance of payments such as trade policy which has a direct effect on the trade balance and hence on the balance of payments . Also the fiscal and exchange rate policies which have direct effects on trade, services and capital balance and on the balance of payments .

In this section of the studys we will discuss the performance of the above mentioned policies according to the economic reform policy aspects and the impact of this performance on the balance of payments during the last ten years . Therefore this part will include foreign trade policy reform and exchange rate policy reform .

First: Foreign trade Adjustment policy

Currently , free trade doctrine became one of the most important aspects in this century because most of the advanced countries turned toward the regional blocs such *as EC* , *NAFTA* , *AFTA* and others , to create mass production and competitive markets and also to connect their mass production by mass consumption.(3).

One of the main developments that characterized the world trading system is the expansion of existing regional trade. A number of regional trade agreements are under active discussion or have been agreed upon such as the protocol between the *EC* and The European Free Trade Agreement *(EFTA)* to form European Economic Area *(EEA)* . Also North American Free Trade Agreement *(NAFTA)* which extends Canada , *USA* Free Trade Agreement to include Mexico , The *USA* has proposed an enterprise of the Americas Initiative which would liberalize trade and assist the trade to flow easily between countries of north, central and south America.

In fact there are many regional agreements among developing countries but, most of them so far, are not active in the trade business such as the Common Arab Market . The agreement of this market has been signed in 1964 but still the Arab intra- trade is about 8% of total Arab trade . The regional blocks don't work actively between the developing countries for many reasons some of them are political and the others are economical .

Actually, the free trade theory has , become one of the important issues in the new world economy for both countries whether developing or advanced because under the protectionism regime all countries lose in the long term , although some of them may drive some short run gains.(4).

Almost all countries of the world joined the *GATT* Rounds according to a report issued by the Overseas Development Institute, London 1994, the share of developing countries in foreign trade increased from 21% of the total trade in 1973 , during the *Tokyo Round* , to 26% in 1986 during the *Uruguay Round* . In 1993 , their share became 27% , and 28% of imports..
The *WORLD TRADE ORGANIZATION (WTO)* held the first ministerial meeting in Singapore during the period from 9-13 December 1996 the outcome of the meeting was declared together with the organization's future in 2000 .

Thirty eight out of 128 countries agreed to liberalize trade in the field of information technology and telecommunications by the end of year 2000. But China announced its refusal to abolish customs on information technology products. The participants raised different viewpoints in relation to labour rights and standards, but the final recommendation submitted the argumentation's to the International Labour Organization *(ILO)* in Geneva , being the competent authority.(5)

Furthermore a lot of recommendations were issued to support the free trade doctrine which is the final target of all trade organizations .

Egypt has been considered one of the active countries in the international trade negotiations whether in *Tokyo Round or Uruguay Round GATT negotiations and The World Trade Organization.*

In Egypt the foreign trade policy reform started with the beginning of the seventies when *No. .137 was issued in 1974.* Exports & imports regulations and money procedures were established . This law allowed the private sector and normal persons to import and export according to the foreign currency equilibrium market capacity it. Also allowed person who have foreign currency to use it to import finance .

It became possible for an individual to finance imports or exports without governmental interference , but imports should take place according to the imports list declared by the government foreign trade department .

The economy started a massive structural adjustment process towards laissez- faire economies, which will need a lot of procedures whether on the production side (*supply*) or the consumption side (*Demand*) . Production standards should be raised to a level to meet world standard level and to meet the world demand through the high competitive quality as well as technical specifications .

The government has to set up temporary procedures for consumer and commodities protection during the transitional period . Therefore during trade liberalization period adjustment reforms go within two sides the production which is not our point and the market which is our target .

The Egyptian government started to liberate the foreign trade sector through reducing restrictions and constrains on imports and exports .

In 1979, the private sector and particularly persons who are working abroad were allowed to exchange and get foreign currency through public commercial banks.

Such procedures make individuals sure of having foreign currencies and to use them in selling or buying from abroad and also help to invite the businessmen to come back and start business without any risk. Also they encouraged small exporters and importers who have savings abroad to join the foreign trade business and take place in Egyptian market especially they have a good experience with the local market and the global market .

Through the period from 1972 to 1980 many adjustments have been taking place to reform the foreign trade sector whether in trade organizations or in the export and import procedures or in the tariffs structure .Therefore in Uruguay Round / Egypt has sought improved market access for items of major export importance , such as textiles , clothes and agriculture . And also in the tariff negotiations Egypt has included in its agreement list a 50 % tariff reduction in August 1986 and a 30 % across the board tariff reduction in June 1989.

By the decision of August 1986, the customs tariffs were reduced by 50% across the board, at the same time the exchange rate used customs valuation was also devalued by 48% against the US dollar . Comparing the 1986 tariff reform to the 1980 tariff structure it has been estimated that the weighted average rate of nominal protection fell from 48.1 % to 47.5 % and the standard deviation from 52.1 % to 47 % . However the weighted average nominal rate on the US dollar value of imports increased from 34 % to 64.6 %. (6)

In 1986, ministerial decision number 187 was issued to dismantle all additional taxes on imports such as economic development duty (10 %) , and others. The last decision followed by the decision number 305 in 1989 for making another reduction of tariffs again. The reduction amounted to about 30 %, But through these reforms the local production has taken into consideration and also these reforms have linked to the share of local input materials in the finished product .

Ministerial decision number 333 of 1986 was issued to allow all products to be freely imported foreign exchange is available except for products enumerated in the negative list .

The negative list included 548 products of which half were non durable consumer goods. By the Beginning of May 1990, the removal of list items started and by the end of 1991 the previous list turned to include 105 commodity only.

In 1987 , law number 93 was issued to allow the private sector to have free determination of export prices and the private sector was allowed to use the exports prices decreed by ministerial committee only as a guidance . This law paved the road to more depth in foreign trade liberalization especially as it gave more freehand to the exporters to maximize their profits and also this law was considered one of the important procedures of exports promotion.

Furthermore in 1988 the private sector was allowed to set up agreements for equivalent transactions through the public sector, this gave more orientation to the private sector in foreign trade the however during year it was under public sector supervision because this period was a transitional, stage. Also in 1989 tariffs were reduced again by about 30 % with a slightly smaller reduction in the high tariff categories. But in 1990 the foreign trade management allowed to the private sector to set up equivalent transaction agreements directly with other countries without any interference from the public sector.

In 1991, law number 46 was issued to make more reform in exports procedures . The law reduced the tax on exports and gave exporters tax grace periods up to five years with some conditions, one of them was increasing exports This law settled a lot of suspended problems between exporters and governments and encouraged exporters to increase their exports. . Also the 1991 import and export regulations included a list of 13 items which may be imported in secondhand condition.

By the bginning of 1992, the government started to play another role in foreign trade business as a promoter. In this year, the government established two important organizations for foreign trade business , one of them was *Bank for Export Development (BED)* and *Egyptian Company for Exports Guaranty (ECEG)* . The principal goal for both organizations were reducing exports risks and promoting exports . But the *BED* took place before the *ECEG* . *BED* paved the road for establishing the company for protecting the exporters and also the *BED* money .

Furthermore, in 1997, a decision was issued to reduce import tariffs again by 10 % for all imported commodities starting July 1997 , especially for small projects inputs and main industrial inputs. The decision included 35 commodity most of them are used as inputs for industries whether small or big but this was considered one step towards more foreign trade liberalization and encourage industrial production for more efficiency.

The study of Egyptian macro economic achievements has forecasted that Egypt will have to export 40 % of industry output by the year 2000, in order to overcome its balance of payments deficit. But after the above adjustments in foreign trade policies and the private sector, public sector export decreased . At the same time the private sector started to be successful in exporting non traditional goods in both sectors agricultural and industrial

Egypt's economic reform adjustments were directed towards autonomous trade liberalization and should lead to greater efficiency in the economic activities and improve market opportunities for trading partners. (7). But beyond a doubty all foreign trade reforms will direct the economy towards development through three paths : the first path is to encourage the production power to produce the high standard level to have link with the global market and can take place in the global competition , i.,e., will direct the production power to the efficiency , the second path is to promote the exports proceeds because the foreign trade business will be wealthy and will direct the balance of payments deficit to surplus ,the last path is the reforms in foreign trade policy which will assist *the Central Bank* through the surplus in the foreign currencies and which also will support the fiscal policy.

Secondly: Exchange Rate policy Adjustment

In most of the countries the official exchange rate changes frequently in accordance with some rules, which often links changes of the official exchange rate to the difference between domestic and foreign rates of inflation's . Such rules are justified on the grounds that they help in mainting competitiveness, because they keep the real effective exchange rate close to its purchasing power parity level .

The efficiency of exchange rate management led to the achievement of some targets for its real value. Macroeconomic adjustment to both internal and external disturbances differ sharply from that which occurs under fixed exchange rate. Real exchange rate targeting is likely to have a direct impact on inflation rate and the two sides of balance of payments . The direct impact on the inflation process will be reducing the inflation rate through the real prices of commodities. For the balance of payments, the real exchange rate will increase exports' value and will decrease imports' value whether for visible or invisible goals or services a result , the balance of payments deficit will decrease.

For the above reasons developing countries are generally referred to as real exchange rate rules. Most developing countries frequently adopt the real exchange rate rule in conjunction with an *IMF* and *World Bank* supported adjustment program. This entails that policy makers manage the nominal exchange rate in such a way as to keep the real exchange rate from appreciating relative to some initial baseline value . (8)

Egypt is one of the developing countries which adapted the real exchange rate through the Economic Reform and Structural Adjustment Program (*ERSAP*) to promote foreign exchange transactions through real prices for local production. The adaptation of real exchange rate took place by degrees through a number of procedures that started in May 1972.

In fact, Egypt has started the liberalization of the exchange rate since 1968, when the monetary authorities allowed persons who were working outside the country to open foreign currency accounts with 35 % incentive of exchange rate to use the equivalent only not as direct use, but it was the first step to encourage the private sector to use its resources in foreign trade finance .

In May 1972, the monetary authorities started to increase these incentives from 35 to 50 % and in March 1973 , furthermore, it was increased to 58 % . Also the monetary authorities in Egypt canceled the exchange rate announced and kept the ratio of incentive which was added to the Central Bank exchange rates .

In 1973, law number 477 was issued to set up the parallel market for foreign currency to assist the monetary authority in facing the deficit of foreign currency especially after the 1973 war which was followed by a big deficit in foreign currency resources .

Actually the parallel market is consided the first and real step for the exchange rate liberalization in Egypt which announced sell and buy prices for the foreign currencies and the equilibrium market powers took place for the first time in foreign currencies market in Egypt.

Therefore, the law determined the main resources for the market which were the following :

Proceeds of non Traditional Exports .
Proceeds of Tourism .
50 % from the increases above exports targets.

The previous law was followed by numerous laws that were issued to develop the foreign currencies market and to reform it to be more flexible with the world market and world changes and also to create capability for facing the increase in imports.

Therefore the main resources of parallel market increased again and reorganized to include the following :

* Proceeds of visible and invisible exports with the exception of cotton, rice and oil exports .
* Proceeds of Suez Canal transition fees.
* Proceeds of Somid oil line.

In 1976 , law number 97 was issued to reorganize the foreign currency market which allowed individuals or authorities, except public and governmental authorities, to have foreign currencies accounts and to keep foreign currencies without giving explanation to the monetary authority .

The previous law paved the road to liberate the exchange rate in Egypt and gave more insurance to persons who have foreign currencies to use them in the market and also encouraged persons who have foreign currencies outside the country to bring them to the local market without any fear .

According to the above law, commercial banks were allowed to work in foreign currencies business whether in terms of deposits, current accounts or foreign exchange transactions without any constraints .

Moreover the foreign currency parallel market was decided to expand its function to cover visible and invisible transactions either exports or imports with using one exchange rate.

Law number 43 was issued in 1974 to attract foreign investments and allowed for establishing investment and business banks, these encourages the expatriates labors to transfer their salaries and capital transactions revenues to the local banks and took place in imports finance, and also became foreign currencies reservations in local banks. Under the previous conditions the foreign currencies should be increased in line with policy makers expectations but the result was not exactly as the policy makers expected there are some positive impacts and other negative impacts .

The positive impacts of the above mentioned law on new foreign investment policy led y, Egypt to enjoy rapid economic growth and significant social progress in the late 1970s and early 1980s.. Current account receipts grew strongly because of exports, Suez Canal revenues, tourism and workers remittances. .The exogenous foreign exchange earnings led to a real appreciation of the exchange rate .(9)

On the other hand, the negative impacts of the above law is that most of the productions of new projects established under the above law were directed to meet local consumption, not to export . It addition to that, imports of production inputs for new projects under this law increased the pressure on the balance of trade and thus indirectly affecting the balance of payments . Also the law allowed investment banks to transfer out foreign currencies which increased the deficit of the balance of payments .

Also growth in external resources declined sharply and income from oil resources began to fall in 1982, therefore the foreign debt doubled between 1982 and 1986, while the growth rate in *GDP* decreased through the period from 1984 to 1990. In 1986, Egypt became one of most heavily indebted countries in the world with a debt to *GDP* ratio reaching 150 %.(10) .

Consequently , monetary authorities issued the January decisions of 1985, which were issued to cancel imports without changing the currency system . In that time the importers became responsible for financing their imports by local currency, but with new exchange rate determined to be LE 1.238 for US dollar i.e. reduce the value of the local currency from LE 0.7 / $ to LE 1.238 / $.