The American University in Cairo
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business forward

Structural Reform Amidst a Volatile Global Outlook

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Authors:
Dina Abdel Fattah, assistant professor of economics and chair of the department of economics, AUC School of Business
Roberto Cardinale, assistant professor of economics, AUC School of Business
Noha Omar, assistant professor of economics, AUC School of Business

Editor:
Ghada Nadi, managing editor, Business Forward, AUC School of Business

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THE CONTEXT

This annual economic year-in-review video was developed by Business Forward, Dcode Economic & Financial Consulting and the Department of Economics, AUC School of Business.

Egypt's Economy Between Two Global Crises

Egypt is currently grappling with internal and external shocks. It is not the only country that is trying to develop its coping strategy with the multiple external shocks resulting from Covid-19, disturbance to global supply chains and the Russian-Ukraine conflict. An additional internal burden is created with the multiple losses to the value of the currency, the ever-increasing inflation rates and the accumulating debts at a time when the real value of the debt is always rising with the loss of value in the local currency. The situation of the external debt is not on its way to improve; on the contrary, the pattern of growing debts since 2015 is expected to continue in the coming years.

The Egyptian pound witnessed successive devaluations losing over 240 percent of its value since 2016 to stand at 30.94 per US Dollar in March 2023, according to the Central Bank of Egypt (CBE), with another anticipated devaluation very soon. Due to the limited availability of foreign currency, the budget deficit and the service of the external debt, Egypt was forced to continue to borrow from different sources today only to repay later at a more expensive cost of foreign currency.

The size of Egypt's external debt stands at USD 155.7 billion as of June 2022. Together with the increase in the annual headline inflation rates, the CBE was pressured to continue to hike the interest rates, negatively impacting an already vulnerable private sector. Headline inflation continues to hike reaching over 30 percent in March 2023. Food inflation has recorded a rate just above 60 percent reflecting an increase in prices of food commodities. Nominal prices of food have more than doubled affecting the ability of people to cope with food inflation. This reflects the instability and the weak performance of the Egyptian economy, which continues to result in the accumulation of external debt and the continuous pressure on the local currency.

This white paper aims to contextualize the problems of why we continue to borrow as well as provide recommendations for addressing the root causes of the problem. These recommended solutions could be summarized in essentially increasing the capacity of the country to export. Moving toward this big goal requires addressing the production capacity of Egypt to produce as well as ensuring the ability of producers to sell to both the local and global markets.

PROBLEM MANIFESTATION: LOW CURRENCY VALUE

While the quantification of the benefits versus costs of currency floatation is out of the scope of this paper, it is important to highlight how free flotation is challenging for Egypt, which despite having a large industrial base - more than 30 percent of GDP - shows some vulnerabilities. These are here identified to originate from difficulties concerning industrial competitiveness and production diversification. The devaluation of the local currency presented additional challenges for the survival of the private sector in Egypt. The limited ability to import critical inputs for production has led to shortages in certain sectors fueling additional inflationary pressures. These pressures have led to the deteriorating purchasing power of local citizens, and are negatively impacting the financial returns to investments.

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The current context of international price volatility of key commodities and inputs for production, caused by high international demand as well as limited supply capacity, congested infrastructure and political instability in key trade routes, further intensifies the inflationary pressures.

On the other hand, it is worth highlighting that the transition from a fixed to a floating currency in Egypt has involved opportunities, starting from the possibility of benefiting from the IMF loans in a critical period, to avoiding large expenses in foreign currency by the CBE to keep the local currency at the pegged value. In addition, the resulting devaluation of the local currency ideally should lead to increased competitiveness of Egyptian exports and to attracting foreign investments due to comparatively lower business operating costs. However, the local currency devaluation comes with drawbacks that implicitly and explicitly affect private sector activity, in turn limiting export capacity and the ability to attract foreign investment.

PROBLEM MANIFESTATION: HIGH EXTERNAL DEBT

Egypt's external debt makes up around 34 percent of Egypt's GDP, which is considered a moderate debt to GDP ratio. Egypt's debt service has significantly increased from USD 3.09 billion to USD 26.29 billion dollars between 2013 and 2022. What aggravates the situation for Egypt is the inefficiency in the management of the debt and the structure of the debt. Egypt's debt service coverage ratio (DSCR) is more than 40 percent of debt service. The more alarming situation is highlighted in the increasing share of short-term debts to the total external debts from 7 to 17 percent between 2013 and 2022. Short-term debts with their quick repayments are considered a heavier burden on the economy.

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The real problem with Egypt's external debt situation is the lack of structural competitiveness represented primarily in the low private savings and incomes, making borrowing inevitable. The root causes of the problems that led Egypt to borrow one time after the other can be summarized in the limited ability of the country to increase its sources of foreign currency.

ADDRESSING THE ROOT ISSUE: INDUSTRIAL POLICY

For stabilizing the economy and reaping any potential benefits of the external debt, the Government of Egypt (GoE) should work on widening and diversifying its economic pie and increasing its reserves of foreign currencies by focusing primarily on increasing exports and reducing the budget deficit. For doing so, the GoE needs to focus on its regulatory role while providing the necessary support to have the private sector lead the economy. Accordingly, the GoE needs to ensure an investor friendly environment. It also needs to benefit from the implicit opportunities of the devalued local currency through identifying the country's competitive advantage and value added in relevance to its trade partners and incentivize the private sector to direct its investments to these sectors.

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While adequate macroeconomic reforms are the essential drivers of Egypt's success towards financial stability, particularly in the short term, industrial competitiveness is the major long-term solution to build a resilient economy and prevent financial and monetary shocks in the future. For this reason, this report presents strategies to increase industrial competitiveness and improve the balance of trade, discusses State-Owned Enterprises (SOEs) as potential leading players in Egypt's industrial upgrade, and explores how to reform them in ways that reconcile the interests of the state and the private sector.

Industrial policies to improve the balance of trade

The deficit in the balance of trade is a major contributor to the recent devaluation of the local currency. Exports are an essential source of income and foreign currency for the country, providing the needed support to the local currency. However, in the last decades the trade balance has been witnessing an increasing deficit, a trend that has intensified in the last 20 years reaching 13 percent of the GDP, amounting to USD 40 billion. This increasing deficit plays a significant role in the loss in local currency value. With an increasing import bill, there is an increasing demand for foreign currency, reducing the demand on the local currency. As per the market forces of supply and demand, this reduced demand means a lower price for the local currency.

ADDRESSING THE ROOT ISSUE: INDUSTRIAL POLICY

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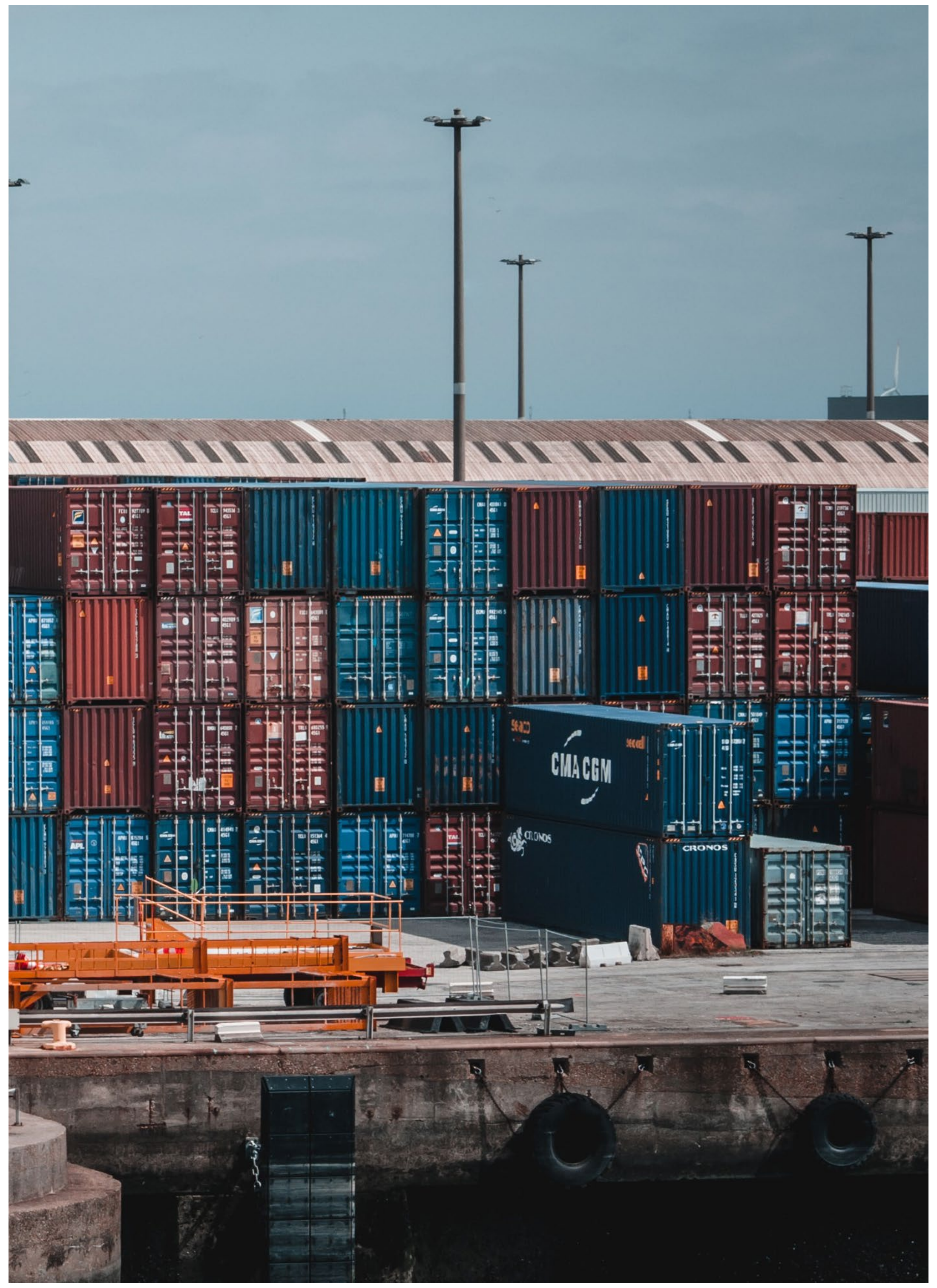
This cyclical drop in the value of the local currency is spreading instability across the economy. This is aggravated by the loss of industrial competitiveness in international markets for exports, as well as the limited ability to produce a wide range of products - mostly essential inputs for production - which represents two major threats to the economy. First is the lost opportunity to integrate in international markets and to increase the country's revenue generated from exports, a fundamental source of support to the local currency. Second is the increased vulnerability resulting from being subject to international price volatility of imported inputs. This was recently witnessed as a result of global supply chain disruptions and the geopolitical stabilities that lead to wide shortages in global markets.

Addressing these challenges, the GoE should be able to prioritize public investments, incentivize sectors where competitive advantages (in production and exports) are identified while adopting regulatory reforms that aim to specifically address the previously defined threats to the economy. Previous experiences of other countries show that targeted reforms avoid the risks of large-scale industrial failures and high upfront costs that come with the establishment of new sectors. International partnerships in areas such as technological upgrading of already competitive sectors would help reduce production costs, improve product quality, and increase export revenues, at a lower cost and risk.



ADDRESSING THE ROOT ISSUE: INDUSTRIAL POLICY

These interventions would not prove successful without transforming Egypt's industrial policy. The industrial policy should envisage a vertical or horizontal transition to interdependent sectors with higher value added. For example, a vertical transition from finished textiles to the production of machineries that produce them. This strategy may be faster and safer, as knowledge and assets within existing sectors are used as a starting point to climb the ladder of technological developments, moving forward from competing with developing countries for the production and export of goods with lower value-added, to competing with intermediate to advanced economies by leveraging on the country's strengths, such as the abundance and lower cost of labor and other resources. This would extensively improve the terms of trade.

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The other important policy strategy is to target those sectors from which essential inputs used by industry, or as final goods for Egyptian consumers, are imported at high costs. Lack of adequate production diversification on essential inputs is the other essential cause of the trade deficit, which in turn causes currency devaluation. It is essential to identify which imports affect the balance of trade the most and try to build a domestic production capacity to replace those imports. If this is too difficult or costly, a second-best option would be to secure those goods through long-term contracts or partnerships with producers. An example of success in doing so is in the energy sector. Thanks to successful concession agreements with global industry players, Egypt has recently become self-sufficient again in oil and gas, which is proving an essential stabilizing factor for the balance of trade and the overall economy especially in the current context of booming international energy prices.

ADDRESSING THE ROOT ISSUE: PRIVATE SECTOR ACTIVITY

Reforms of State Owned Enterprises

One of the conditions of the recent International Monetary Fund (IMF) loan is to reform State-Owned Enterprises (SOEs), mainly through privatizations. According to the IMF, this will not only reduce the public debt, but will also improve the performance of the privatized enterprises, increasing the competitiveness of the Egyptian economy. However, recent studies show that privatization allows for only a temporary reduction of public debt while the transition to private ownership is not a guarantee of improved performance. In addition, privatization of strategic companies might result in the loss of their industrial policy relevance, and in capital outflows (due to distribution of dividends) if shareholders are abroad while customers are domestic.

While privatization alone is not a guarantee of success, there are different ways to successfully reform SOEs with the purpose of balancing the long-term industrial vision of the state with the interests of the private sector, thus attracting private capitals to also serve the public interest. Partial privatization and mixed (state-private) ownership could be an ideal governance for the state to avoid losing control of the companies in question. In fact, state shares can guarantee continuity in the pursuit of other important public policy goals – employment, innovation, public service – which under full private ownership might be compromised for the sake of profit.

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> ”

Additionally, state shares are a guarantee of financial stability for the company, therefore an incentive for private investors – the new minority shareholders – if they gain confidence that their interests are safeguarded, and their voice is heard by the management. At the same time, partial privatization is likely to bring performance improvement as private shareholders require corporate reforms that increase profitability and accountability, especially when listing on stock exchanges.

An important factor to consider when reforming SOEs is whether state ownership in a given sector leads to crowding-out or crowding-in of private investments. Usually, in higher-risk sectors such as capital and technology intensive ones, state investments attract private investors as well as public-private partnerships, that otherwise would not be drawn to these sectors, thus creating a crowding-in effect. In less risky sectors, companies can be more easily privatized, and more space can be given to the private sector to take over former SOEs. In this case, the prevalence of SOEs in such sectors is creating a crowding-out effect.

Other important factors are market structure and regulation. While natural monopolies might be more easily managed with SOEs, private monopolies can always be regulated, although information asymmetry might become a problem for the state. In markets where competition is possible, SOEs and private companies can compete,

ADDRESSING THE ROOT ISSUE: PRIVATE SECTOR ACTIVITY

or collaborate as suppliers/contractors along the supply chain. State investments towards innovation in SOEs can be a major driver to overall sectoral innovation as they require several private contractors to upgrade their standards and technology to meet the criteria of quality.

Private investments inflowing from abroad to partially privatized SOEs can have both pros and cons. While foreign capital inflows are a positive sign, if they come from financial investors, their goal will be to maximize profitability, which might in some cases come at the expense of employment and long-term strategic investments for innovation. On the other hand, if they are strategic investors such as foreign industrial groups, their contribution can also be in the form of technological transfer, long-term industrial investments and facilitating access to export markets, in addition to contributing their financial capital.

The lack of transparent dialogue between the private sector and the GoE to maximize information sharing, technical support to identify major impediments in legislation and bureaucratic processes is slowing down production and limiting the potential of private sector expansion in Egypt. Improving the trade balance by boosting exports will come with unleashing the potential of the private sector, as opposed to limiting imports that results in downsizing production that utilizes these imports.

Achieving the much needed integration in African markets requires a carefully designed strategy that is built on analyzing the demand and the gaps in those markets, and adopting a specialized production approach to fill those market needs. In other words, responding to the demand in the different African markets rather than exporting whatever is produced.

A framework to promote an ecosystem of limited government interference complemented by strong governance and the adoption of Environmental, Social and Governance (ESG) policies is essential in expanding the private sector. Therefore, a strong analysis of emerging sectors and appropriate investment in new markets with high potential - such as digital infrastructure and the app economy - can provide employment opportunities to youth, provide innovative solutions and create a new competitive edge for the Egyptian economy.

Despite the rebound in its activity following the ease of COVID-19 restrictions and its positive contribution to the country's balance of services, Egypt's tourism sector contributes only 1 percent of global tourism. Fulfilling the full potential of this strategic sector to generate foreign exchange requires a deeper understanding of the pull and push factors affecting the tourist's experience, while taking into consideration the different needs of human resources for the different tourism activities. The recently discussed direction of capitalizing on idle residential property to provide more lodging options meeting the diverse needs of tourists coming to Egypt could be an effective direction. This should be coupled with a strategy to address the skills, work ethics and attitudes of labor engaged in the different sectors directly and indirectly linked to the tourism sector. The tourism sector is known to create jobs both directly in the sector and indirectly in sectors linked to tourism. Structural transformation in the skilling and training of workers is needed to equip the sector with the needed resources to allow it to achieve its potential in the medium term.

Consultative exercises to identify gaps and inefficiencies that hinder productivity and exporting potential need to be prioritized by the GoE, which will also lay the ground for establishing appropriate governance and Key Performance Indicators (KPIs) to measure the progress of private sector development.

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