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Egypt's Financial Liberalisation:
Why Didn't It Do What It Said It Would On The Box?

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List of Acronyms

CBE	Central Bank of Egypt
EGP	Egyptian Pound
ESRAP	Economic Reform and Structural Adjustment Programme
EU	European Union
FDI	Foreign Direct Investment
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
IFI	International Financial Institution
IMF	International Monetary Fund
MENA	Middle East and North Africa
NBE	National Bank of Egypt
SME	Small and Medium Sized Enterprises
USD	United States Dollar

Abstract

Since 1991 Egypt has undertaken economic and financial liberalisation under an International Monetary Fund (IMF) led structural adjustment and economic reform programme known as ESRAP. This paper zones in on financial liberalisation under this programme, examining the structure of Egypt's banking sector, domestic credit and financial access. It is seen that post-liberalisation, while private banks have grown, as has credit, stock market activity and direct investment flows, this improved financial depth and access has been limited to Egypt's well-connected elite class and not the wider private sector or the household realm. This is a function of weak economic rationale for financial liberalisation such that it leads to vulnerability, exposure to volatile capital flows and liberalisation's flimsy theoretical foundation that is built on the notion of an efficient market and the impossible trinity of sovereign monetary policy, exchange rates and capital mobility. Furthermore, liberalisation reforms gloss over domestic context including societal structure that spans integrated and non-integrated members and other elements of political-business kinship. A combination of these facets has meant that neither has financial liberalisation eradicated imperfections nor resulted in a free flowing circuit of capital for all segments of Egyptian society, hence better mobilisation and allocation of capital, savings and investment is still craved.

Keywords

Egypt, Financial Liberalisation, Social Structures, Financial Repression, Structural Adjustment, Financialisation

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Chapter 1 Introduction

Egypt is at a precipice today. The countrywide revolt that started on 25 January 2011 and led to the ousting of the 30 year-old Mubarak regime on 11 February has exposed the country to a host of political, economic and financial challenges. One aspect that appears will remain in the new Egypt is a commitment to a market economy, as will the drive towards making the country a favoured investment destination[1], as mentioned by the country's interim Finance Minister Hazem el-Beblawi. Given this commitment, this thesis will zone in on Egypt's financial sector that has witnessed liberalisation largely under the country's economic reform and structural adjustment programme (ESRAP) from 1991 onwards. Financial liberalisation under this programme was meant to eliminate repressive financial practices, deepen the banking and financial sector and promote economic growth. By tracing this process of financial liberalisation, this paper will contribute to the conversation on whether further liberalisation should be a part of Egypt's financial future.

Since its ESRAP programme, real GDP in Egypt has grown at a compound annual growth rate (CAGR) of 5%[2]. Also, the poverty headcount[3] has dropped from around 32% in 1991 to 21% in 2008. Both these positive improvements would suggest the mainstream view of financial liberalisation resulting in economic growth has been realised in Egypt. However, when narrowing in on the post-reform financial sector, while the country now has an active capital market, a greater number of private banks, a floating exchange rate and liberal interest rate market, some elements of shallow financial depth and weak access remain. For instance, these include: i) a large section of the economy including the small and medium sized private sector firms and the household sector being credit hungry, ii) bank lending, investment activities and the capital markets being skewed to the connected elite, iii) a gap persisting between loans and deposits and iv) few savings options for consumers, a lowering savings to GDP ratio and a relatively low investment to GDP ratio.

[1] Accessed on Nov 7 2011<http://www.almasryalyoum.com/en/node/478698>

[2] Real GDP is from International Financial Statistics, with 2005 used as the base year, fiscal year for Egypt is from 1 July to 30 June. This CAGR is calculated from 1991 i.e. the year ESRAP began until 2010

[3] Poverty headcount is obtained from World Development Indicators and shows the proportion of the population living under USD1.25 and USD2 Purchasing Power Parity (PPP) per day

Given the renewed commitment that Egypt's interim government has shown for a market economy that may well likely include further liberalisation reforms, it is important to take a step back and thus question, why does Egypt's financial sector look like this today, when financial liberalisation was meant to have resulted in a free flowing and efficient circuit of capital to all rungs of its society? This paper will first present an empirical analysis to understand Egypt's financial liberalisation process and then ask the question why did financial liberalisation not work out as expected in Egypt? In order to gnaw at this broad question, the following sub-questions will be asked. These are: i) has financial liberalisation failed in Egypt because liberalisation itself has little theoretical validity and economic rationale? and/or ii) are there elements of power and politics that are embedded within Egypt's financial, economic and social spheres that wield noteworthy influence?

Deepening the understanding of financial liberalisation from this angle is important for Egypt. This is because if the country chooses to pursue further liberalisation, without acknowledging the deficiencies of the previous rounds of such reforms, it may end up exacerbating the noted outcomes of low financial depth and access. It is thought that previous rounds of financial liberalisation in Egypt did not pan out as expected because untailored mainstream policies glossed over the domestic context, suggesting reforms would benefit society equitably. This context is that of a country that since shedding colonial rule in 1952 has had three autocratic regimes that have flirted with nationalisation (under Nasser) and liberalisation (Sadat and Mubarak era). Thus not only is the current financial sector a product of this context but also the application of generic policies has not recognised that Egyptian society, like most capitalist ones, is a stratified one. Thus it is perceived that the potential positive impact of liberalisation policies has been funnelled through this stratification, resulting in greater capture at the higher end of society.

Therefore, the aim of this paper is to anchor the exploratory data analysis in the rich body of academic literature, to understand if indeed this claim of overlooking the domestic context and perceived importance of embedded factors related to power, wealth and governance structures can explain why Egypt's financial liberalisation have not yielded the desired outcomes. Moreover, given the country's vulnerability to crises and increased exposure to external geopolitical and economic shocks, there would also be some validity to the idea that financial liberalisation has little theoretical and economic rationale. Therefore, while it would be recognised that financial growth remains important for development, the focus for developing countries like Egypt should move away from liberalisation and towards domestic resource mobilisation and strengthening the domestic financial structure first.

There are two aspects for the reader to be cognisant of from the onset. Fist, while the concepts of capital and finance as well as related theories are widely discussed and heatedly debated, this analysis will be isolated on the functioning of capital and money, rather than these conceptualisations. Moreover, while the notion of financial liberalisation is broad and could involve examining the functioning and structures of Egypt's entire financial system, the analysis will zone in on certain elements including the banking sector, financial access and some macroeconomic variables.

Secondly, a majority of the data has been calculated from publicly available electronic databases including the Central Bank of Egypt, Egypt Ministry of Finance and Egypt Ministry of Investment. In addition, in some instances where a Middle East and North Africa (MENA) region comparison was warranted, the IMF World Economic Database was tapped into. The fiscal year in Egypt runs from 1 July to June 30 and is thus different from the calendar year. Wherever possible, data was compared with similar information within academic journals/or books, thus providing some degree of comfort to their accuracy. Nonetheless, it should be noted that similar to other emerging markets, Egypt is still working towards improving the overall business climate and the access to information and its quality. Hence this aspect of data accuracy and availability needs to be noted.

In terms of the structure of this paper, in Chapter 2, a literature review will be presented. It shall outline the mainstream and the heterodox views on financial liberalisation. Within each of these sections, further sub-sections delving into particular academic positions will be presented. Next, in Chapter 3, the Egyptian case shall be discussed. The country's economic and financial history will be described, along with details of the ESRAP programme.

In Chapter 4, an empirical analysis of Egypt's experience with financial liberalisation shall be presented. This analysis forms the background for answering the research question of why Egypt's financial liberalisation did not work out as planned? In answering this question, banking, financial sector and macroeconomic variables will be analysed. At the same time, this analysis will be framed in the context of Egyptian economy in terms of its make-up as well economic policies and reform that have been undertaken. Also, this Chapter will link up with ideas presented by academics in Chapter 2, with the intent being to examine the data analysis through the lens of the mainstream and heterodox views on financial liberalisation.

Finally, in Chapter 5, a synthesis in terms of the exploratory analysis and the literature will be presented. The purpose is to address the research questions and see if one can indeed conclude that financial liberalisation did not work in Egypt because of both; liberalisation having little theoretical and economic rationale, as well as the embeddedness of prevailing and institutionalised power structures. It can thus help with the current conversation on Egypt's future economic, financial and political direction.

Chapter 2 Literature Review

2.1 Introduction

In this chapter, academic literature that is both favourable and unfavourable on financial liberalisation will be discussed. Additionally, given that the question of liberalisation is related to the underlying role that the financial sector plays in economic development, this deep array of academic literature will also be tapped. In terms of sequencing, this chapter will consist of sub-sections including: i) mainstream work that suggests financial sector development, liberalisation and reform are necessary and positive for economic development, ii) critiques of the finance-economic growth nexus, including literature that discusses the negative effects of financial liberalisation, particularly in developing country contexts and iii) economic growth preceding financial sector growth and liberalisation, with a greater emphasis being placed on the role of domestic resource mobilisation.

2.2 Mainstream Position

Finance is Essential for Economic Growth

The mainstream view is that financial sector liberalisation and reform are positive and necessary aspects to attain economic growth. This favourable view is built on seminal early contributions on the asserted underlying positive relationship between finance and economic growth. Notable work on this subject can be attributed to the likes of Gurley and Shaw (1955) and Goldsmith (1969). For instance, they describe "development as being about finance as well as goods" and that the process of development is accompanied by the "institutionalisation of savings and investment" (Gurley and Shaw, 1955:515). Similarly, Goldsmith's cross-country studies showed "a strong positive trend in the ratio of financial institutions' assets to gross domestic product" suggesting higher incomes lead to greater financial development (1969:45) and hence establishing a positive link between finance and economic growth. Since, a multitude of papers have covered this link, attempting to explore the direction of this causality, as well as the importance of other related/unrelated factors affecting the link.

Ross Levine built on some of this seminal work and illustrated a framework to show why financial markets arise, what purpose and functionality finance serves and also how this leads to economic growth. The functions of financial systems are broken down into five key functions including: i) trading, hedging, pooling and diversifying of risk, ii) resource allocation, iii) monitoring and corporate control, iv) mobilising savings and v) facilitating exchange of goods and services (Levine, 1997: 6). This framework is important to bear in mind while understanding the nature of financial liberalisation, as policies related to this conceptualisation would call for removal of market frictions, deepening of financial markets, smoother financial functions and thus stronger growth.

The above theoretical body underpins the ensuing literature that explicitly describes how financial development and thus economic growth can be attained via greater financial liberalisation. For instance, empirical studies such as by Greenwood and Smith (1997) and Shleifer and Vishny (1996) statistically show that lower financial repression and liberalisation allow for enhanced financial intermediation, reduced transaction costs and information asymmetries, thus deeper financial development and economic growth (Waheed and Younus, 2010:449). Similarly, Klein and Olivei's cross-country regressions show "statistically significant and economically relevant effects of open capital accounts on financial depth and economic growth" (2008:874).

An important theoretical contribution that directly relates to the academic conversation on financial liberalisation is the seminal work by McKinnon and Shaw. Both writers spoke against the use of financial repression i.e. "indiscriminate distortions of financial prices that gravely retard the development process" (Shaw, 1973:3). The underlying logic of liberalisation was to remove interest rate ceilings, allow for better intermediation between savers and investors, deepen maturity intermediation and thus enhance efficiency of the financial sector (Fry, 1997:757-759). Effectively, market forces rather than government policy should regulate the financial markets.

Underlying Liberal Orthodoxy becomes Policy…

These ideas of liberalisation became powerful during the 1970's and coupled with the efficient market hypothesis allowed associated free-market policies to become more widespread. In fact, as Palma says,

> "*A powerful fight took place during the 1970s between those interests backing the welfare state (working class, some industrial capitalists, some political parties and intellectuals) and those wanting to dismantle it (financial rentiers, other industrial capitals, some political parties and intellectuals, including most economists)" (2009:840)*

The latter side won and ideas that markets were 'efficient' and "prices fully reflected all available information" became prominent (Fama, 1970:383).

Hence, while this literature is more than half a century old now, it has been instrumental in laying the theoretical foundations for financial reform and liberalisation across the globe from the 1980's onwards. For developing countries, financial liberalisation was either self-induced or pushed via structural adjustment programmes under the World Bank and International Monetary Fund (IMF). The advocacy included liberalising interest rates so as to increase competition and deepen the banking sector, and secondly to remove other repressive ceilings and reverse requirements, so as to deepen the wider financial system (Fry, 1989:14). At the same time, by way of being in their growth phase, post-liberalisation developing countries were touted as attractive candidates for capital allocation. This is because liberalisation would allow capital to flow to these high-return environments and thus facilitate virtuous growth. It was this same strand of thought that compelled Egypt to undertake economic and financial liberalisation from the 1970's onwards.

… Despite Some Caveats

While mainstream consensus remains fixed on the above described liberal ideas, authors such as Mishkin (2007), Stiglitz (2008) and Rodrik (2009) highlight the vulnerability of uncontrolled capital flows and the risks associated with unfettered capitalism, hence outlining a role for state control. For instance, Stiglitz suggests that the Asian financial crisis that was experienced after financial liberalisation, in particular capital market liberalisation, was a result of hurriedly pursuing this liberalisation without first putting a strong regulatory framework in place (2000:1075). Moreover, Stiglitz calls for a distinction to be made between the types of capital flows being liberalised, suggesting short-term investment flows should be discouraged or better regulated, while longer-term foreign direct investment (FDI) flows have a more compelling investment case (Ibid., 2000:1075).

In addition, other academics suggest that issues related with underlying empirical testing including the varied choice of proxies of financial depth/development, cross-country studies and time-series sometimes showing conflicting results and other issues relating to endogeneity (Bloch and Tang, 2008:250) weakens the investment case for financial liberalisation. In fact, these authors suggest that while financial development is an important part of the growth process, attention needs to be directed towards exogenous factors like the institutional environment, stable political situation, well-designed industrial policies (Ibid., 2003:250). Bolbol, Fatheldin and Omran (2005) provide a similar conclusion for Egypt by calling for the improvement of the institutional climate, undertaking greater bank reforms and privatisation to achieve the best possible outcomes of financial liberalisation.

After all, Liberalisation also Reduces Poverty & Inequality

Despite these qualifications, the mainstream position continues to assert that not only is financial development essential for economic growth but also that financial liberalisation is a key component of this development process. Furthermore, a positive relationship between financial development and liberalisation and poverty reduction is suggested. Again, this research largely builds upon the seminal early work (McKinnon Shaw, Levine etc) that was described above, while weaving in the distributive aspect of growth.

For instance, the 2002 report 'Growth is Good for the Poor' is regarded as cornerstone evidence for showing that factors such as 'openness to international trade, macroeconomic stability, financial development, moderate government size and strong institutions' are conducive for economic growth (Dollar and Kraay, 2002: 196). In this large empirical study of 92 countries over four decades, the authors depict that "greater integration and openness benefits the poor in society as much as everyone else", suggesting a positive correlation between a liberalised economy and poverty (Ibid., 2002:198).

Similarly, in a an empirical study of 83 countries, while testing the relationship between finance and income inequality, Clarke, Zou and Xu depict that in addition to improving growth, greater financial liberalisation leads to lower inequalities in the long run and that financial development does not only benefit the rich (2006:595). Also, Levine shows "a robust negative relationship between financial development and poverty alleviation that holds even when controlling for average growth, initial income, initial poverty and a full range of country traits" (2008:8), adding that improvements in the financial system can increase both efficiency and equity. Finally, Jeanneny and Kpodar show that "the poor benefit from the availability of a better banking system that facilitates transactions and provides savings through the McKinnon conduit effect", and hence despite the detrimental cost of greater financial instability that stems from greater financial development and openness, they assert that the benefits outweigh the cost (2011:160).

Similarly, in a 2008 paper written on the Egyptian case, the authors provide "evidence of causality from financial development to economic growth" supporting the hypothesis that investment efficiency can be enhanced through greater private investment (Abu-Bader and Abu-Qarn (2008:897). The authors thus recommend further liberalisation, "restricting government involvement in financial systems, enhancing market competition, improving the quality of institutions and the allocation of resources" (Ibid, 2008:898).

2.3 Moving to the Other End of the Spectrum

While the economic orthodoxy remains in favour of financial liberalisation, underpinned by the positive underlying relationship between finance and economic growth/poverty reduction, many critical voices remains. These are those who are critical on the role of finance in economic growth, particularly in terms of the direction of its causality and other empirical doubts. Then the second set builds upon this scepticism, questioning whether this dubious relationship can in turn reduce poverty.

Academics that are critical about financial liberalisation specifically provide a series of arguments to substantiate this claim. These will be discussed under the following sub-sections including: i) financial liberalisation leads to increased vulnerability and crises, ii) the flimsy validity of the theoretical position on financial liberalisation iii) the manner in which liberalisation is undertaken affects outcomes and iv) the persistence of poverty and inequality.

In addition to this literature, financialisation shall also be discussed. While the notion of financialisation is one that has recently entered academic discourse and there remains debate on its conceptualisation, at one level, it could be viewed as an outcome of more than three decades of financial liberalisation and unfettered neo-liberal economic ideology. Thus, while developing countries such as Egypt may be at an early stage of their financialisation cycle, given their ongoing pursuit of economic and financial liberalisation, understanding the depth of this concept may provide interesting insights.

Financial Liberalisation Leads to Increased Vulnerability

The first strand of critique comes from academics that highlight the inherent vulnerability linked with increase financial liberalisation. It is depicted that not only has financial liberalisation been at the root of many recent banking and financial crises, but that banking sector problems could lead to currency crises, thereby creating more fragility (Arestis, 2003:1). Similarly, some suggest that as liberalisation encourages both short-term and long-term capital flows, greater exposure to short-term investment flows that are pro-cyclical and fickle, results in greater instability and negative growth (Stiglitz, 2000:1080). The mainstream response to these increased episodes of crises following liberalisation tends to be that better sequencing of the reforms needs to occur (Allegret et al, 2003:77). However, the quip back is that even when better sequencing does occur, financial liberalisation in emerging countries that occurs under external influence, results in the abolition of traditional co-ordination mechanisms, with vulnerability prevailing.

Others discuss these ill effects by highlighting examples of financial liberalisation in developing countries. For instance, one paper that examines the role of financial liberalisation on wage levels in Turkey, shows that "increased global trade had a negative impact on the wage shares in the medium run during the post-trade liberalisation period in Turkey" (Arestis et al, 2011:10). Likewise, in an analysis on South Korea, it is depicted that the state-led, bank-based and closed financial system was instrumental in fostering the country's development record. However, financial liberalisation from the early 1990's not only exposed Korea to the Asian financial crisis but also negatively affected the long-term rate of capital accumulation (Crotty and Lee, 2002:327).

A similar picture is etched in Malaysia. This country like Egypt gained its independence in the 1950's and started undertaking liberalisation in earnest in the 1980's. It is seen that financial liberalisation may have benefited exports and foreign direct investment, but it also led to increased financial fragility, real exchange rate appreciation and made the country vulnerable to the 1997 Asian financial crisis (Ang and McKibbin, 2007:218).

Bringing this literature even closer to the Egyptian context is made possible by looking at examples of economic and financial liberalisation undertaken within the Middle East and North Africa (MENA) region. In fact, liberalisation efforts in Egypt along with Tunisia, Morocco and Jordan are well-regarded success stories by the IMF (Pfeifer, 1999:23). However, the flipside to this mainstream account is a rich picture painted by a number of heterodox authors that describe underlying reasons for this apparent success. For instance, in a recent study on structural adjustment including financial liberalisation in these 4 countries i.e. Egypt, Jordan, Morocco and Tunisia, the authors show that while reforms resulted in growth spurts, this was not sustained growth. Zoning in on their analysis on Egypt, they suggest that since the country received substantial aid packages and debt forgiveness, it was able to evade further recession (Harrigan and el-Said, 2010:17). This reference to debt forgiveness and aid is a piece of Egypt's successful reform story that tends to be excluded from the mainstream account of financial liberalisation in Egypt. It also helps to expose that when studies extol developing countries' experiences with financial liberalisation, one needs to be aware of the whole picture, rather than take the indicators at face value.

Overall, these heterodox academics show that financial liberalisation has created greater vulnerabilities for developing countries. Also, one needs to be critical of the way liberalisation is extolled to understand the whole and not peripheral story. While in theory, this should weaken the investment case for liberalisation; the fact that it remains the economic orthodoxy, speaks to deeper, potentially ideological reasoning.

Theoretical Shortcomings

As one of the main research questions asks whether financial liberalisation has not worked out in Egypt because the notion of financial liberalisation itself has little theoretical validity and economic rationale, this second sub-section shall draw on academic work that can help address this question.

Palley (2009) engages in a detailed and interesting dialogue on liberalisation reaching the conclusion that while financial liberalisation and mobility are today's economic orthodoxy, the economic case is flimsy. His view is based on arguments including: i) the way orthodox theory discusses the impossible trinity of fixed exchange rates, sovereign monetary policy and capital mobility as if they are of equal standing, when clearly the former two are more critical and ii) that liberalisation leads to greater macroeconomic problems including unemployment and inflation since it tends to be undertaken not to overcome a shortage of domestic savings but to generate more foreign exchange to purchase foreign produced goods (2009:25).

Given these elements that make a weak economic case for liberalisation, he asserts that financial liberalisation has become today's orthodoxy because of ideological arguments of increasing financial sector competition, promotion of personal freedom and improved governance (Ibid., 2009:22). Along the same lines, Stiglitz argues that the financial liberalisation thesis is upheld due to "ideology or of special interests, and not on the basis of careful analysis of theory, historical experience or a wealth of econometric studies" (2000:1076). These views are also based on detailed analysis of cases of liberalisation gone awry.

The next theoretical inconsistency relates to the broader context of how financial repression is understood. To re-iterate, financial repression refers to the outcomes of state intervention in the financial sector, as well as other elements that limit the efficiency of the financial sector. Thus it is suggested that developing countries are plagued by weak financial markets caused by financial repression in the form of interest rate ceilings, high reserve requirements, credit allocation restrictions, all of which lead to low savings, low investments and credit rationings, with liberalisation being the solution (Shaw, 1973:3).

What is problematic about this statement is that the market is described as if it were a natural phenomenon. More so, no distinction is made between a market for tangible industrial products and the less tangible market for finance (Diaz-Alejandro, 1985:9). In reality, this notion of a perfect market is an unrealistic assumption because perfect competition does not actually exist in all countries and markets, particularly financial markets (Arestis, 2006:12). Given the embedded institutional make-up or other political factors, markets can be controlled oligopolistically pre and post liberalisation, such that if financial reforms do not take into account the underlying structural framework, it is reasonable to think then that the results could fall short of expectations.

For instance in a study on Turkey's experience with financial reforms, the authors depict that while financial reforms that eliminated the fixed interest rate regime and allowed real interest rates to turn positive, credit rationing still persists in the banking sector (Guncavdi et al, 1999:223). Similarly, Marois confirms that because developing countries tend to be characterised by banks that handles large amounts of official government debt and are also linked to the largest economic groups, liberalisation and reforms just help to revamp rather than uproot "existing institutionalised sets of existing social power relations" (2009:23). Thus the mainstream positive view on financial liberalisation appears to be based on an idealised notion of the market, while the relationship between causes and symptoms remains unaddressed.

There is another irony that is worth highlighting. When Goldsmith (who wrote some of the seminal work upon which financial liberalisation is based) discussed financial development, his opinion was that this process related to changing financial structure (1969:37). On the one hand it is true that when Goldsmith was talking about financial structure, this was focused on the make-up of the system and financial variables. On the other, those academics who built on this work and then proposed financial liberalisation reforms did not take this notion of structure a step further by acknowledging the interaction between these financial structure variables and the societal dimensions of the variables themselves.

In conjunction with blanket assumptions and causes of financial liberalisation, the mainstream position also proposes that reforms will benefit society equitably. This view ignores the make-up of society and thus pretends that all countries are made up of undifferentiated masses. In reality however, there is a spectrum of differentiation. Sunkel provides an illustrative class structure composed of: i) integrated entrepreneurs, ii) integrated middle class, iii) integrated workers, iv) non-integrated entrepreneurs, v) non-integrated middle class, vi) non-integrated workers and vii) marginalised (1973:169). He goes on to suggest how the process of modernisation (one could include financial development and financial liberalisation as part of this modernisation effort) results in further internal polarisation. This is because there are those rungs of society or the above mentioned class structure that are incorporated into the new modern system because they fit into the model's rationality, while there are others who are expelled from the new structure either because they do not fit or do not have the capacity to adapt to the changes (Sunkel, 1973:169).

Taking this idea of a differentiated societal structure can further be deepened by adding the notion of "politically embedded cronyism" that refers to power transferring from the incumbent state to a few politically selected firms as a means of retaining political power (Adly, 2009:8). Both these facets i.e. Sunkel's notion of a differentiated class structure and the above notion of power reorganisation have been witnessed in Egypt. This is through the skew of bank credit leaning towards politically connected large corporate sector elites, non-transparent privatisations and persistent monopolistic and oligopolistic pricing behaviour (Ibid., 2009:11). Some also suggest that the last two decades of liberalisation have allowed for increased collusion between businessmen and bureaucrats, thus turning the state into an active promoter of these business interests (Joya, 2011:370).

Another aspect that is curious about the advocacy of financial liberalisation, is that no industrial country has ever come close to this laissez-faire financial model, with governments maintaining monopoly over cash management, regulating banks, managing fractional reserve requirements and providing supervision for the overall financial system (Diaz-Alejandro, 1985:5). Even today, developed countries continue to provide government support for their banking sectors and capital markets, such as the large bailout packages given in the wake of the 2007-08 financial crisis. Moreover a number of banks were nationalised at the time of this crisis. Ironically when developing countries have faced similar situations, structural adjustment rather than such socialisation of debt has been the prescription. This double standard also helps to expose the theoretical weakness of financial liberalisation.

How Liberalisation is Undertaken Effects Outcomes

In addition to greater vulnerability stemming from financial liberalisation and limited theoretical validity, a third argument against financial liberalisation that heterodox academics present is that financial liberalisation recommendations are broadly untailored i.e. without any cognisance of the domestic context. This may contribute to the failure of these policies, but more importantly by glossing over the internal make-up and structure of a domestic economy, broad-based financial liberalisation reforms are baseless to begin with.

For example in an a 2002 empirical study that looks at six developing countries including Egypt, Greece, Thailand, Philippines, Korea and India, the authors conclude that when estimating the effects of financial restraints such as restrictions on deposit/lending rates and reserve and liquidity requirements, success of the financial liberalisation programme depends on the institutional set-up, type of regulation etc (Arestis et al, 2002:119). This line of thinking begins to recognise the wide degree of difference between the types of structures and institutions in place amongst countries. Hence if one defines an institution as a "regularity in social behaviour agreed to by all members of society" (Schotter in Allegret et al, 2003:75), external financial liberalisation recommendations that ignore these processes of social interaction could explain why liberalisation has failed in many developing countries.

Thus, as the structural and early development economics such as Lewis, Prebisch, Singer and Furtado would assert, the domestic context and internal structure of an economy is crucial to understand. This is important because structures of power, wealth and governance tend to be complex, while other institutional differences such as rule of law, politics etc are also just as important. Given the differences in financial and economic maturity between developed and developing countries, these elements could vary considerably.

Not only is interpreting these different characteristics integral for understanding the way in which "conventional theories of growth and modernisation" such as financial liberalisation are applied, but more importantly for grasping the nature of underdevelopment in a developing country context (Sunkel, 1973:133). This is also because these idiosyncrasies may result in the policy package having unintended results. For example, liberalising interest rates would increase prices domestically, thereby aggravating weak aggregate demand and increasing unemployment, while similarly liberalising exchange rate moves could cause currency appreciation, export weakness and lower investment (Palley, 2009:25), all of which are undesirable consequences for a growing economy. Some of these consequences apply to Egypt.

Persistence of Poverty and Inequality

The fourth argument of heterodox academics is that financial liberalisation is not a panacea and not only increases fragility, but also deepens poverty and inequality in developing countries. For example, Arestis and Caner show developing countries that experiment with financial deepening and bank reforms, does not mean the poor having greater access to credit, and rather they experience a reducing proportion of labour in national income (2009: 240). In another paper, these same authors undertake further empirical work to depict that while "capital account liberalisation may improve the allocation of capital" these improvements in the financial system primarily benefit the rich and those who are politically connected (Arestis and Caner, 2010: 320). They also show that capital account liberalisation increases poverty, given the poor in developing countries need to benefit from strong domestic policies before being able to benefit from greater international capital flows (Ibid., 2010:321). This facet also touches upon the earlier described differentiated spectrum in terms of market incorporation that different classes of a society enjoy.

In an empirical study, using a panel data sample of 53 countries, developed and developing, another set of authors explore the link between financial development and inequality. They conclude that if countries are below a certain threshold of financial development, due to fixed costs in financial service provisions or minimum size requirements of pooling funds for better allocation or unequal access exerted by embedded political factors, financial liberalisation and development does not improve poverty or inequality (Kim and Lin, 2011:324). Similarly, other academics suggest "unequal access to political influence produces unequal access to finance, which can reinforce any economic inequality" (Claessens and Perotti, 2007:760).

These above described negative consequences of financial liberalisation in the form of only the elite class benefiting resonate with the Egyptian case. For instance, it is discussed that financial sector reforms have benefited members of Egypt's entrepreneurial elite more than the wider private sector (Roll, 2010: 356). This has come in the form of access to credit, ability to list on the stock markets, avail of tax reforms and tax holidays for example, with these benefits being enjoyed less because of economic rationality and more so because of personal relations (Ibid., 2011:357).

Similarly, while Egypt's economic growth progress since its ESRAP programme kicked in shows a positive trend, other academics depict that as this GDP growth was not "balanced or all inclusive" it resulted in "unprecedented socioeconomic and political deterioration that gradually pushed the country towards an inevitable explosion" (Kandeel, 2011:37) and hence the 2011 revolution. Others also suggest that the recent revolution saw the exposition of the two Egypts; one being the "stable, prosperous and progressive Egypt propagated by the state and the other being the poor, suffering and repressed Egypt (Ibrahim, 2011:1347). Similar to other financial liberalisation experiences, Egypt's efforts appear to have played a role in the persistence of poverty, unequal opportunities and polarisation of its society.

2.4 From Financial Liberalisation to Financialisation

While the concept of financialisation does not fit in squarely with this research question on financial liberalisation, it is nonetheless delved into because this recent domain of academic literature contains radical critiques of the finance-economic growth nexus. Moreover, while not all developing countries are fully financialised, as globalisation through finance has become more commonplace, it could elucidate some thought-provoking elements.

First, the conceptualisation of financialisation is not in set in stone. Stockhammer describes financialisation as "changes in the financial sector spanning: i) changes in household behaviour, particularly taking on debt, ii) shareholder-value orientation and increased financial activity by non-financial firms, iii) a shift towards household rather than business credit and iv) a shift to investment banking and fee generating activities (2010:1). Others frame financialisation as a process by which finance penetrates all aspects of society, providing new sources of profits for the capitalist class through revamped mechanisms of finance and the rise of financial expropriation (Lapavitsas, 2009:126). He also discusses the broader context that gave rise to financialisation, describing the background of "hesitant productivity growth, altered work practices and shifts in productive capacity" (Ibid., 2009:126).

In another interesting and poignant paper, Lapavitsas discusses how increased prominence of the financial sector has "integrated developing countries more closely into world capital markets since the early 1990s", while also obliging these countries to hoard the dollar i.e. world money "in order to be able to participate in international capital flows" and "sustain reserve accumulation through some interest rate sterilization" (Lapavitsas, 2009:127). This plugging in of developing countries into the global finance-dominated accumulation regime has thus created new structures of dominance and expropriation.

Therefore, the broad takeaway is that while a country like Egypt which may not mirror the characteristics of financialisation as listed by Stockhammer, it is participating in this process at some level. This is as Lapavitsas suggests by way of liberalising its financial sector through encouraging foreign ownership (particularly in the banks), promoting international institutional investor ownership in its capital markets and increasingly amassing foreign currency reserves and losing some monetary sovereignty. Hence, financialisation is occurring in Egypt, albeit at a different scale. Thus for local policy makers who are currently charting the country's financial future, being aware of these dynamics and the potentially devastating effects is of some importance.

2.5 Focus on Getting the House in Order

The literature discussed earlier showed the negative effects (increased vulnerability, crises, deepening of poverty and inequality) of financial liberalisation, as well as its limited theoretical validity. Given this critique, in this sub-section, authors who recognise the importance of financial development for economic development, but recommend an inward-looking approach will be discussed. These authors highlight the need to strengthen the domestic financial structure and the broader economic context prior to engaging in full-scale economic and financial liberalisation.

Back in the 1950's, Joan Robinson described how financial development should succeed economic development, such that "where enterprise leads, finance follows" (Robinson, 1952:86). The idea behind this was that the financial sector does not create growth, but rather that the development of the broader economy creates demand for finance and hence that financial sector development needs to follow economic development. This line of thinking can be taken in conjunction with the rich body of literature presented by the structuralists and early development economists. The work of Lewis, Singer, Furtado and Sunkel that discuss the nature/structure of domestic finance, the role of strong domestic financial systems, mobilisation of domestic resources and saving, development banking and the centre-periphery paradigm are all insightful. Their message is that while the financial sector is important in understanding economic growth, a strong emphasis needs to be placed on the domestic financial structure and functioning to attain suitable results.

Moreover this inward looking approach also points to the importance of domestic finance and resources. For instance, Jan Kregel's paper "Nurkse and the Role of Finance in Development Economics" highlights that sustained industrialisation requires long-term capital formation. One of the ways includes tapping into "disguised unemployment and thus savings potential" (Nurkse in Kregel, 2007: 11). Thus, for a developing context like Egypt with a large youthful population, this idea of leveraging its demographic structure to reap deep financial dividends in the form of savings is important to understand.

2.6 Concluding Remarks

While the mainstream position and indeed policy orthodoxy remains steadfast in its view that financial liberalisations offers greater opportunities than risks, on balance, there is a wider spectrum of work that shows that this position is weak and not tightly economically grounded. Moreover, the recent financial crisis has allowed for renewed debate on capital controls, liberalisation and revisiting the global financial architecture's fluidity. The question to ask then is if developing countries are aware of the risks of financial vulnerability, crises, impact on poverty and inequality, then why do they push ahead with liberalisation all the same?

In the case of Egypt, this question shall be addressed by looking at the country's financial and economic history that follows in the subsequent chapter. Understanding Egypt's experience with financial liberalisation rests on deepening ones knowledge of the underlying context of these reforms. This context will be described in Chapter 3. In addition to the economic and financial journey, some embedded facets of Egyptian society shall also be revealed. These factors in conjunction are deemed to be useful in understanding both; why financial liberalisation has occurred in Egypt and also how and why financial liberalisation has fallen short of expected outcomes.

In addition, taking this step to understand the process of liberalisation is integral for Egypt today, given the country has depicted a commitment to remain a market-oriented economy. More so, since its January 2011 revolution, Egypt's fiscal deficit has worsened, with an estimated funding gap of USD12 billion in 2011 and USD10 billion in 2012 (Galal, 2011:6). Egypt can either take IMF help and renewed structural adjustment, or regional aid from the Gulf Cooperation Council (GCC)- with some pledges of aid already having been made by Qatar, Saudi Arabia and the UAE (Khalaf et al, 2011). While IMF assistance has been resisted, should the situation worsen, it might be forced to take up this help. Thus, understanding the country's past experience with such reforms has much importance for any potential related actions.

Chapter 3 Digging into Egypt

"*Concealed anger, suppressed despair, unreleased tensions, all things people had been nursing in them, had suddenly burst in their bottle, exploding like a hurricane of demons*"- *Naguib Mahfouz*

The words of this famous and Nobel winning Egyptian writers' words were referring to the 1952 revolution that saw the country gain its independence from the British via a military coup. It would seem that the same sentiments could be used to describe the 2011 revolution that occurred around 60 years later. In January 2011, Egypt was one of the central actors in the string of popular opposition movements across the MENA region, in what has come to be known as the 'Arab Spring' of 2011 (Dixon, 2011:309). This started out as social unrest in Tunisia where after days of protests the President was overthrown. This movement and sentiment quickly spread through the region, with Egypt being the second country in the first quarter of 2011 to witness mass protests, demonstrations, a social revolution and thus a regime change. Interestingly, just as Egypt is cited as a success story with respect to economic and financial liberalisation, Tunisia too is cited as a resounding success. However, revolutions that overthrew long-standing governments in both countries point to some latent societal discontent.

In fact, a phrase that was chanted during the Egyptian revolution was the Arabic word "Kefaya" meaning "enough". In unison, the Egyptian people raised their voices to end "oppressive economic marginalisation and political exclusion (Kandeel, 2011:37). While one focus of the current debate on the Egyptian revolution is this societal discontent behind the uprising, another is the future direction- economically and financially that Egypt needs to take to recover from the revolution. This paper focuses on this second debate. Given that Egypt has experimented with both inward and outward-looking economic policies over the last sixty odd years, the present situation presents a unique opportunity for policymakers to charter a new, potentially more sustainable course of action.

3.1 Egypt's Economic and Financial History

In this sub-section, Egypt's economic and financial journey will be sketched so as to illustrate the underlying context that financial liberalisation has been undertaken against. This approach elucidates reforms that have been adopted and their interaction with wider societal dimensions. Between Egypt's first military coup-led revolution in 1952 and the 2011 peoples' revolution, the country has traversed a wide economic spectrum. This 60-year period can be divided into the following phases: i) pre-1952 revolution, ii) under President Nasser from independence in 1952 to 1970, iii) from early 1970's when President Sadat was in power, until his assassination, iv) from 1980-2011 under President Mubarak and v) post-2011 revolution onwards.

In each phase, key milestones that pertain to the financial sector will be pointed given this area is the core of this paper's analysis. While the bulk of the analysis focuses on data derived from 1990 onwards, the historical backdrop is important to bear in mind, given the role it is likely to have played in shaping the financial sector as it prevails today.

Just a Colony like All Others

With respect to the pre-revolution colonial and monarchical period, there was limited nationalistic sentiment in the country and hence economic development did not feature strongly (Amin, 2011:47). Instead, consistent with the case of other extractive colonies, economic policies were not geared towards changing the economic structure productively, or about attaining sustainable rises in economic growth or better redistribution (Amin, 2011:46).

In this pre-revolution period, Egypt's financial sector remained geared towards serving British demand for cotton and other demands of its coloniser. To this effect, the British set up commercial banks in 1850, with the sole aim of serving the fast growing cotton sector (Mohieldin, 2000:3). In the same century, a landmark occurrence for the country was the opening of the Suez Canal in 1869. As the economy started to grow on the back of these sectors, given limited local banking capacity, Egypt remained over reliant on finance houses and old merchant banks of City of London.

In an interesting piece analysing the profitability of the Suez canal as an investment, the authors conclude that based on the financing structure, long gestation period of this investment and the fact that tariff rates were not in Egyptian control, meant that this large infrastructure project was a stellar investment for the British and French, rather the Egyptian government which racked up debt instead (Hansen and Tourk, 1978:956-7). This illustrates the county's reliance on external funding and also how the ownership and profitability structure of key Egyptian assets were girded by unfavourable terms.

Lack of domestic capital thwarted attempts to set up government-owned commercial banks and hence foreign flows continued filled the funding gaps. External debt ramped up and led to Egypt's first debt crisis in the 1870 (Mohieldin, 2000:4). Finally, in 1898 the National Bank of Egypt (NBE) was established. This was based in Cairo but owned and managed by British citizens. Similarly in the early 20th century, Banque Misr was created in 1920, followed by Credit Agricole d'Egypte in 1931, with the latter being geared towards servicing smaller scale farmers (Issawi, 1954:212). With the creation of these two banks, local landed elites were sending out a message that Egypt was working towards having more control of its own economy (Tignor, 1966:41). While specialised banks were set up, from the onset, lending was skewed towards larger corporate entities (Mohieldin, 2000:8). Hence, by the time Egypt gained its independence from the British in 1952, while it is noteworthy that NBE, Banque Misr and other specialised state owned banks were around, reliance persisted on foreign banks to plug credit needs (Issawi, 1963:40).

Egypt Nationalises under Nasser

Once the military coup d'état took place in September 1952, the band of offers that took the helm resorted to state capitalism as means of filling the political and economic vacuum, with this leading to a focus on "distributing gains to all groups except exploitative capitalists, adopting and aggressively development industrial policy and a populist consumption policy" (Cooper, 1982:22-23). Hence, Egypt put in policies of agricultural reform, land redistribution, universal healthcare and education, raising the minimum wage, all with the intention of better levelling of vertical distribution of income, and horizontal income equalisation between rural and urban areas (Ibid., 1982:36).

Post-independence a strategic asset that was nationalised was the Suez Canal. Moreover, five-year industrial plans came to be the norm, while the state also provided education, health and other social services. Other private firms were also swooped under the nationalisation programme. This phase of nationalisation, while creating a sense of domestic pride, also established a colossal bureaucracy (McDermott, 1988:122).

With regards to the financial sector, the pre-revolution dominance of foreign owned banks started to be reduced. For example, Law 22 of 1957 was established to remove British and French ownership in the corporate and banking sector. Similarly, greater control was bestowed upon NBE, giving it functionality as a Central Bank, with better governance over the credit market (Mohielden, 2000:10). However, despite these steps towards banking sector nationalisation, given Nasser's drive to create a well-oiled centrally planned economy, almost all capital was being directed to public projects and the public deficit, hence the private sector remained credit-starved. Also, given the limited banking sector competition and regulation, elite-biased lending persisted.

Simultaneously, Nasser's foreign policy for Egypt was creating a new image for Egypt in the Arab world. Some suggest that in particular, the nationalisation of the Suez Canal became a symbol of Arab victory. By doing so, Egypt had not only asserted its sovereignty over its territory but also shown that the Arab countries were a force to be reckoned with, hence making Nasser a hero for the Arab world (Mansel, 2010:279). With the development of ideas on non-alignment and turning away from the West, under Nasser, Egypt also started to be more active in the region politically (McDermott, 1988:121).

However in 1967, when Egypt went to war with Israel it was badly defeated. Thus unfortunately, the economic legacy that Nasser passed on to the next leader, President Anwar Sadat, was weak. While the economy had experienced strong growth from 1956-1967, it was plagued by large increases in external debt primarily due to the greater military spending, aid retrenchment and other political issues (Amin, 1995:24). Also, the 5-year economic plans were cancelled and all available resources were directed to warfare, resulting in acute financial shortages, trade deficit and a fiscal crisis.

Sadat dips a few Toes into Liberalisation

With the economy being in this shaky position after the Arab-Israeli war of 1967, Nasser attempted to resign, but due to public demand stayed on as Egypt's leader until 1970 when he died. Not only did Nasser's sudden death in September 1970 bring an end to an era of intensive political activity, but also the country's nationalistic stint came to an abrupt halt (Dekmejian,1975:302). In an effort to rejuvenate this economy, Sadat acquiesced to America's demands of making peace with Israel, ceasing activities as a nationalistic Arab presence and opening the doors to foreign goods and investment (Amin, 2011:53). Not only did this mark an economic shift, but also a political one that involved deeper ties with the US.

Deeper liberalisation policies started to be undertaken under the banner of Egypt's 'Intifah' or 'Open-door policies' from 1974 onwards. Sadat's October Paper in 1974 marked this shift towards a capitalist path of development (Lorfgen, 1993:407). The driving force of this change was to boost the private sector, encourage foreign investment and leverage Egypt's natural resources and human capital base (McDermott, 1988:133). The political context also needs to be borne in mind, such that within the region, the Gulf Co-operation Council (GCC) countries were mostly only recently independent, while Lebanon (the region's investment darling) was facing civil war. Thus, under Sadat, Egypt tried to pitch itself as a safer investment climate and undertook reforms to make investments attractive (McDermott, 1988:134).

A series of financial sector reforms started to be implemented from 1974 onwards. These included: i) Law 43/1974 that reduced Egyptian ownership to 51%, allowing foreign ownership of the remaining 49%, ii) Law 120/ 1975 that gave the Central Bank of Egypt supervisory and regulatory power over the banking sector, while also making it an independent legal authority, iii) Law no. 43/1974 that liberalised the foreign exchange market and some import commodities, while also providing incentives/subsidies for domestic and foreign private companies and iv) Law 32/1977 that provided further tax exemptions and benefits for private firms (Mohieldin, 2000:14). Foreign and joint venture banks started to be set up to benefit from these incentives and reforms.

Over this period, economic growth showed a positive trend. In fact, over the 1973 to 1981 period, the positive growth in real GDP reflected the impact of externally- facing sources of GDP including oil earnings, worker remittances, tourism and Suez Canal tolls (Soliman, 1999:12). Hence, this led to a rentier style economic model that was backed up by a social contract whereby rentier income pacified the public and ensured extended support for the incumbent regime (Harrigan and el-Said, 2010:1).

But Full Liberalisation was Mubarak's Legacy

While economic growth was strong from the 1970's, by the late 1980's, this momentum had died. The downward trend was triggered by lower oil prices from 1985 onwards, but its full extent was postponed by heavy foreign borrowing that overshadowed this decline in external revenues (Soliman, 1999:23). In 1991, when it entered economic reform and structural reform (ESRAP) package with the IMF, Egypt was suffering from "unsustainable debt levels, inflation, a wide current account deficit and an undiversified economy" (Harrigan and el-Said, 2010:3).

An underlying story tends of why Egypt entered the ESRAP package tends to get buried in the footnotes (Mitchell, 1999:458). Mitchell describes how liberalising financial reforms pursued since the Intifah had allowed the number of commercial banks to rise from 7 in 1974 to almost 81 by 1990, with a speculative credit boom following, such that by 1989, 26 percent of private and investment loans were in default (Ibid., 1999:458). These defaults coupled with "global deregulation that allowed for a surge in private foreign currency transfers from expatriate Gulf workers" that dried up when the Gulf War hit in 1991, resulted in a crisis in Egypt's financial system (Ibid., 1999:459).

Also, the mainstream account fails to point that while Egypt adopted liberalisation when it was in a deep economic crisis, it is just as important to acknowledge that this type of external and untailored programmes can only occur where states are repressive enough to insulate themselves from nationalist pressures (Burkett, 1987:16). It would seem fair to suggest then that the Egypt state can be considered a capitalist one in the sense that its main function is to preserve the existing social order in which the bourgeoisie is the dominant class (Soliman, 1999:44). While it was widely accepted that Egypt needed these reforms given the appalling economic situation, the fact that no public debate was conducted to go over the economic merits or the conditions attached to it, points to some hidden intents (El Ghonemy, 2003:80). This deeper intent appears to include recovery of the creditor's debts and the state wanting to preserve the interests of elite Egyptian capitalists.

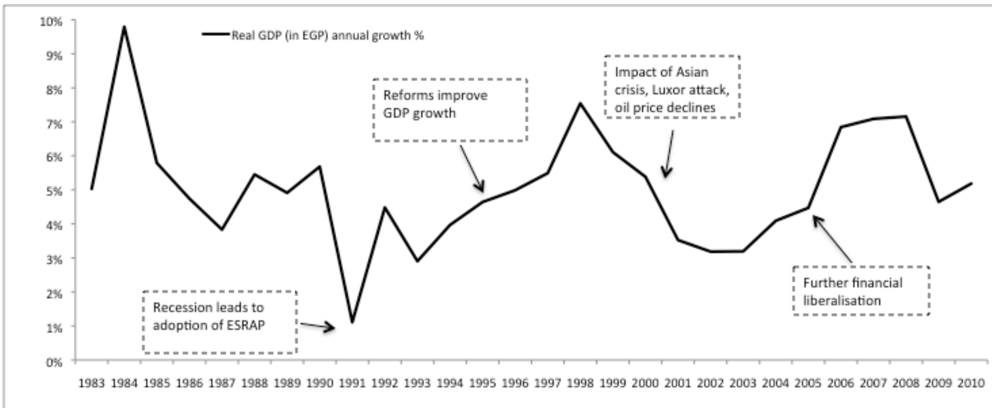
3.2 Zoning in on the Liberalisation Reform Programme

It is first important to point out that while the 1991 ESRAP programme was Egypt's first official stab at structural adjustment, by this time it had already taken three standby loans (in 1976,1978 and 1987) from the IMF, bridging a path for towards further reforms (Awad, 2010:27). ESRAP consisted of reforms including: i) macroeconomic stability, ii) domestic price reform, iii)tax reforms, iv) financial liberalisation, v) trade liberalisation, vi) banking sector reforms, vii) interest rate liberalisation, viii)greater private sector development and ix) lower state control. It consisted of two phases. The first (1991 to 1996) was focused on making Egypt's economy a purely market-based and export oriented one with a greater role for the private sector, while the second (1997-2000) placed greater emphasis on macroeconomic stability and further financial reform and liberalisation (Al Mashat and Grigorian, 1997:3).

Under the stabilisation package, Egypt was asked to: i) establish external and internal balance, ii) achieve lower inflation, iii) undertake currency reforms to accelerate exchange stabilisation and iv) remove price distortions (Harrigan and el-Said, 2010:4). Particular reforms included: i) Law 230/1989 that provided tax exemptions to private firms for a period between 5 to 10 years, ii) Law 203/1991 that launched the official privatisation programmed of public firms, and iii) Law 95/1992 that was meant to revive the inactive capital market and regulate security issuance (Mohieldin, 2000:16). With regards to the banking sector, these changes allowed for increased foreign capital and private control as will be illustrated in Chapter 4.

Looking at economic growth, as depicted in Figure 3.1 below, when the structural adjustment programme was introduced in 1991, Egypt was at one of its lowest points economically. To reiterate the fiscal year in Egypt runs from 1 July to 30 June. All analysis presented are based on this fiscal year data.

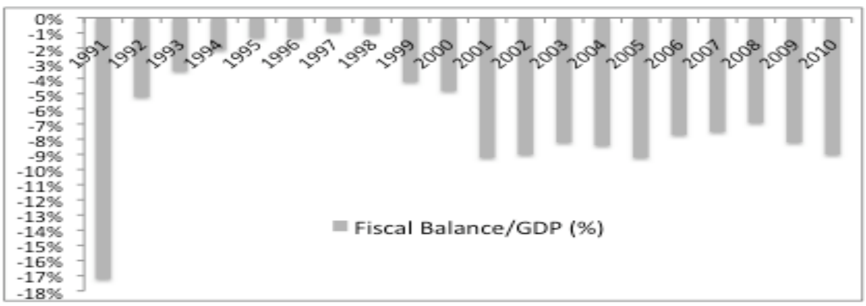
Figure 3.1
Real GDP Growth



Source: Author's calculations based on data from International Financial Statistics (IFS), 2005 is the base year

This strong economic growth and reduction in the country's fiscal deficit are reasons why Egypt's structural reform package is considered a success. With respect to the deficit, in 1991 when Egypt entered ESRAP, its fiscal deficit to GDP was at one of its highest levels of 17.2% As Figure 3.2 shows, Egypt successful brought down this imbalance, such that it was drastically reduced from 17.2% in 1991 to about 5% the next year.

Figure 3.2
Fiscal Balance



Source: Author's calculation based on data from Central Bank of Egypt

However, this favourable account hardly mentions that this success came at the behest lower public spending and massive debt relief for supporting the allies in the Gulf War (Harrigan and el-Said, 2010:5). Debt relief allowed the country's debt service burden to improve and for foreign exchange reserves to build up, thereby making the post-reform fiscal position look more favourable (Logfren, 1993:411). At the same time, inter-generational costs of reduced public investment are not recognised as an opportunity cost of this reform.

Beyond the economic growth trend, if one takes a look at the sectoral composition of GDP, changes in the structure of the economy can be witnessed such that the tertiary or service sector now account for close to 50% of GDP. In 1980, the financial sector accounted for less than 0.1% and it now comprises 4% of GDP. Other service sectors that increased prominence include tourism, real estate, construction, transportation and communication, while agriculture and industry have taken a smaller role. Hence over the course of liberalisation, the structure of the Egyptian economy has changed.

Even more Liberalisation from 2004

Moving into the 2000's Egypt kicked financial and other economic reforms into higher gear. These particularly occurred under the charge of Prime Minister Ahmed Nazif (who is currently under investigation for corruption charges). One of the first changes to occur was the currency devaluation in 2003. Then under the financial sector reform programme in late 2004, further reforms included large-scale bank privatisation, reducing state ownership in banks and strengthening of overall regulatory capacity (Mohieldin and Nasr, 2007:712). Additional reforms included Law 91/2005 that reduced the corporate tax rate from 32-40% to flat 20% rate for all firms, with personal income tax also being reduced to a flat 20% and greater liberalisation of the capital markets (Mohieldin, 2000:18).

As illustrated in Figure 3.1 above, an economic upturn was experienced, with this really taking shape from 2004 onwards. These initiatives continue to be described with the same gusto and positive breath, as the ones in previous years. However, while it is recognised there was economic growth and poverty reduction in this period, inequality also increased (Marotta et. al, 2011: 20). Moreover, while it is claimed that growth was broad based, it reflects externally driven growth from a rise in foreign direct investment (FDI), tourism, greater remittances from the Gulf migrant workers and higher hydrocarbon prices. Also, with one of the recipients of FDI into the country being the real estate and tourism sector, it appears that this investment is helping create a physical divide in Egypt. These developments have acted as havens of comfort for the rich while inner-city slums and squatter settlements increase for the poor (Adham, 2005:23). This conjures up the image of inner and outer living and hence inclusion and exclusion, thus not really broad-based equitable growth.

Taking this more critical look and looking behind the positive veneer of data, one can see some truth to the claim that “Egypt has developed, but Egyptians have not” (Bush, 2011: 305). The 2011 revolution appears as proof of this disconnect between on the ground life and headline growth and can perhaps be linked to the adoption of a development model that “favoured the ruling elite and large private businesses” and hence “relied excessively on market forces, without effective measures to curb abuse of market power, prevent corruption” (Kandeel, 2011: 4). Using the underlying context that has been sketched in this chapter, the next chapter shall flesh out the country’s experience with financial liberalisation, with the intention of understanding if like the economic growth picture, Egypt’s experiment with financial reform has also just been one of headline positivity.

Chapter 4 Analysis

In this section, an exploratory data analysis approach is used to explore the outcomes of Egypt's financial liberalisation experience. This analysis has been segmented into three sub-sections. First, banking sector variables spanning the banking sector structure, credit, bank density, loan and deposit activity and other facets of financial sector depth and access shall be explored. The aim is to understand whether financial liberalisation allowed the Egyptian financial sector to deepen and widen access. The second stage of the analysis will involve looking at macroeconomic variables including real interest rates, investments and savings data so as to assess whether liberalisation has allowed for a better mobilisation and allocation of savings and investments. The third stage of analysis will look at Egypt's balance of payments position. The aim here is to link up the financial and banking sector picture and the main conclusions obtained in these two sub-sections with this macroeconomic picture. An overall intent of this chapter is to anchor the data analysis within the context of the mainstream assertions in favour of financial liberalisation and the heterodox critiques of financial liberalisation discussed in Chapter 2.

To recollect, the mainstream position proposes financial liberalisation as a means of removing market imperfections and causes of friction such as interest rate ceilings, exchange rate rigidity, credit ceilings, state intervention etc so as to attain an optimal allocation of savings and investment. In turn, this more fluid market is meant to increase financial depth and widen financial access, thereby creating a smoother flow of capital and allowing for economic growth and potentially even poverty reduction.

On the other hand, heterodox views are critical of financial liberalisation on the basis that a number of developing countries that have undertaken these reforms have experienced increased vulnerability and financial/or banking crises. Others assert financial liberalisation is based on weak theoretical and economic rationale, while another set of academics suggest that as mainstream financial liberalisation tends to be untailored to the domestic context, this glosses over embedded and institutionalised power and governance relations. Hence, related reforms are not based on a deep understanding of why the financial sector is not working optimally.

Therefore, in this Chapter, data analysis shall examine the Egyptian context and ascertain whether the mainstream or heterodox position holds greater weight. To reiterate all data has been collected from publicly available databases including the Central Bank of Egypt, Ministry of Finance and IMF. Once this data was downloaded, the researcher has processed it by calculating requisite ratios such as savings to GDP etc. As in Chapter 3, data in Egypt is presented on a fiscal year basis that runs from 1 July to 30 June.

4.1 Banking Sector and Capital Markets

Banking Sector

Table 1 below shows how the Egyptian banking sector has transitioned over the last 30 years. Under the umbrella of liberalisation policies that involved encouraging private and foreign investment, there has been a decline in the number of banks across Egypt. This has been the product of banking consolidation, bank closures and other merger and acquisition (M&A) activity.

Table 1
Banking Sector Structure

	1980	1990	2000	2010
Public Commercial Banks	4	4	4	5
Private Commercial Banks	15	40	24	27
Private Business & Investment Banks	7	11	11	0
Off-shore Business & Investment banks	22	22	20	7
Specialised banks	4	4	3	0
Total	**52**	**81**	**62**	**39**

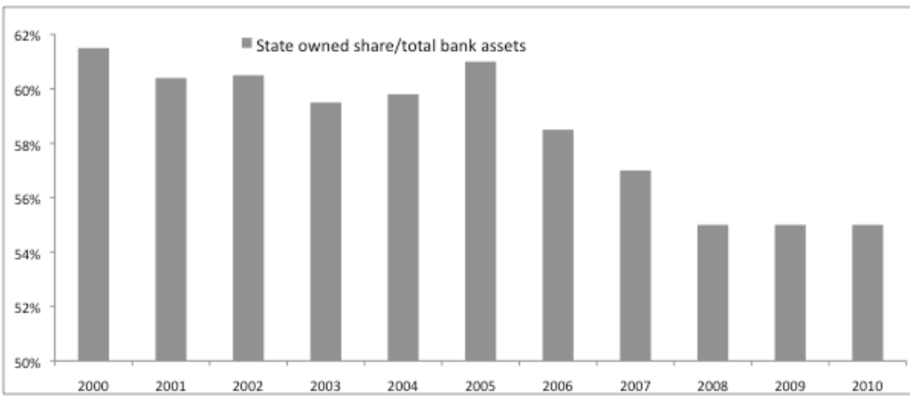
Source: Author's reproduction based on data from Central Bank of Egypt

Thus it appears that from the situation described earlier in Chapter 3, where it was shown that Egypt did not have a single domestically owned bank until the early 20th century, there has clearly been improvement. From having a banking system that was purely foreign-owned pre-independence to being Egyptianised and state-owned under Nasser, the 1970's and then 1990's banking sector reforms and privatisations have allowed the number of private owned commercial banks and investment banking operations to increase. However, what this structure hides is that while transnational ownership has gone down, it has taken a different form. This is such that while in pre-independence Egypt, foreign capital and management constituted the major share in banks, today these proportions are simply lower. Particularly through merger and acquisition (M&A) activity that occurred in the 2000's, foreign banks have bought shares in Egyptian banks being privatised.

As some frame it, such privatisation has been an adjustment of existing relations between public sector business barons and their partners in the private sector (Mitchell, 1999:460). Thus, one could question whether reforms have actually allowed for a change in mindset, operational efficiency and credit allocation or if this is just a matter of swapping hands and ownership without addressing the underlying structural issues. While beyond the scope of this research, one would need to assess the operational efficiency, credit reach and consumer access of these banks before and after privatisation to better ground this claim. Nonetheless, this story of banking reforms has been experienced in other developing countries like Mexico and Turkey with similar results. For instance, in Turkey like in Egypt, financial liberalisation that reduced the proportion of state ownership in the banking sector, allowed for a shift in power and ownership relations to foreign banking conglomerates who thus hold more institutionally concentrated power over the development fortunes of Turkish society (Marois, 2009:19). Similarly, Stein's empirical and analytical work that analyses the World's Bank recommendation of internationalisation of developing country banks, comes to the conclusion that the pursuit of orthodox liberalisation reforms including domestic bank privatisation is not conducive to domestic development goals (2010:271).

With Table 1 showing that liberalisation has allowed privately owned banks to grow as state ownership in these banks was privatised, in Figure 4.1 below, the proportion of banking assets held with the public sector is depicted. It shows that while the proportion of assets held by state banks has been declining, the public sector still holds more than 50% of banking assets. Here the mainstream position on financial liberalisation would assert that further bank privatisation should occur so that the inefficient, poorly governed and managed state banks could be weeded out (Mohieldin and Nasr, 2007:725). However, such recommendations naturally assume that the private sector will always work better than the state sector, while also not acknowledging that state-owned backs direct credit to important industrial sectors. Moreover, bank ownership is one piece of the puzzle and similar privatisations as the Turkey example above just allowed for a reshuffling of ownership, with the real question remaining does liberalisation and new ownership result in a banking sector that provides credit to the parts of the economy that need it? This question will be addressed in the next section, when looking at the distribution of domestic credit in Egypt.

Figure 4.1
State Ownership of Total Banking Assets

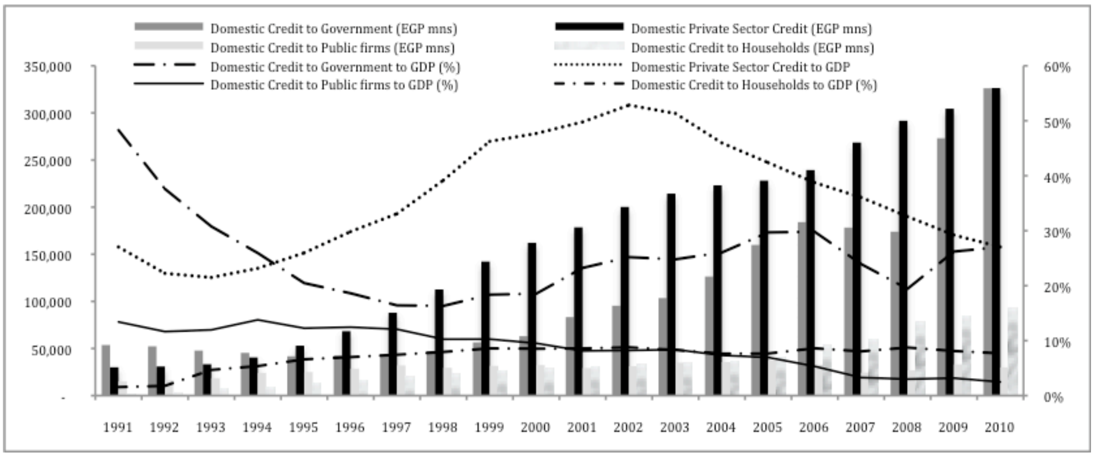


Source: Author's reproduction based on data from Central Bank of Egypt

Credit Measures

In terms of domestic credit, as illustrated in Figure 4.2, credit to all four sectors- government, public businesses, private businesses and households has increased post-liberalisation in absolute terms, albeit with credit towards the household sector having the smallest share. Furthermore, credit to the government has been reduced and been replaced with a positive movement into the private sector from about 1994 onwards. Credit to public firms as a proportion of GDP has gone down, while the proportion of credit directed to the household sector has the smallest share.

Figure 4.2
Domestic Credit



Source: Author's calculations based on data from Central Bank of Egypt

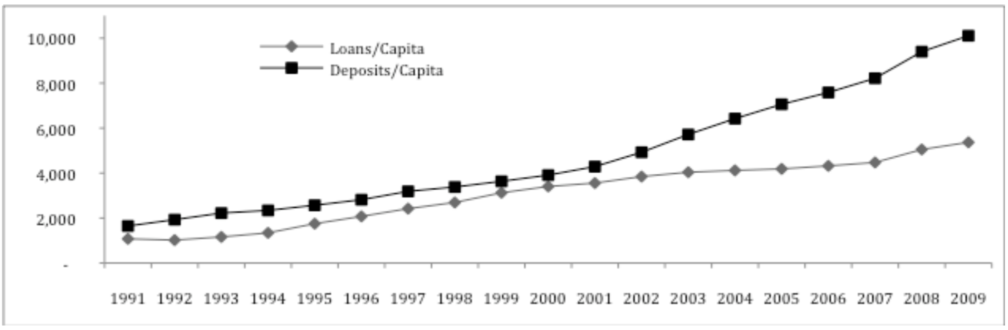
Given the absolute increases in credit, one can say that liberalisation has improved the depth of domestic credit. However this data does not shed light on which segments of Egyptian society this increased credit has been directed towards. Given there are no official estimates of this break-up, the researcher makes reference to what some academics have to say on the subject. A general finding is that higher private sector lending has not found its way to the wider private sector including the large slew of small and medium enterprises (SME's), for whom bank reforms were meant to ease credit restrictions[4]. Instead main recipients have been members of "Egypt's entrepreneurial elite connected with the Mubarak regime, such that 343 clients received 42 percent of the overall credit facilities allocated to the private sector, with 28 clients from this group receiving 13 per cent of the overall credit" (Roll, 2010:356). Mainstream academics that propose financial liberalisation in Egypt also recognise that directed and insider-based lending has occurred on a non-commercial basis (Mohieldin and Nasr, 2007: 711).

While those on the right assert that restricted credit persists because privatisation needs to be pushed further, those on the left are critical of how the system works in this unjust fashion. The point to note is that liberalisation has increased the volume of credit in Egypt and yet a large portion of Egyptian society has not seen any substantial improvement in financial depth or access. Instead the elite bias of credit suggests that an underlying aspect to be acknowledged is that Egypt's societal structure consists of an embedded political-business elite kinship. Hence, perhaps positive effects of liberalisation have not been far-reaching, less so because of the process of liberalisation itself, but because of how that process interacts with this domestic context.

[4] Based on a conversation with an analyst at a MENA bank, informant wishes to remain anonymous

Next Figure 4.3 that compares loans and deposits per capita shows a gap between the two. Looking at these ratios can further one help understand the financial depth of Egypt's sector, with deposits per capita being a measure of increased entrance of funds into the banking sector, with loans per capita measuring the level of lending activity. Figure 4.3 shows deposits exceeding loans meaning that the volume of loans being extended is less than what is deposited in the system. The gap between the two variables was closing towards the end of the 1990's but has since widened.

Figure 4.3
Loans versus Deposits per capita

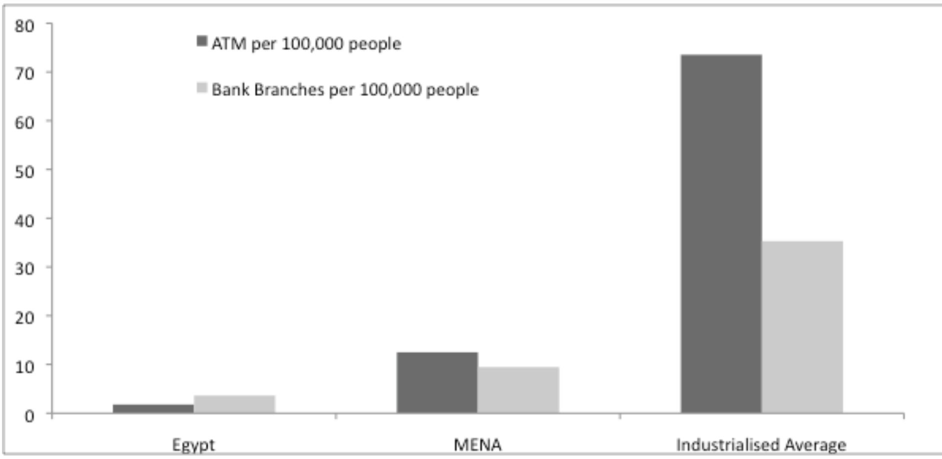


Source: Author's calculations based on data from Central Bank of Egypt, loans and deposits in EGP

Looking at face value at this figure would allow one to conclude that Egypt's credit market is distorted and underpenetrated. However, there are some contextual factors that need to be considered. The first aspect that might explain this low level of lending activity is the role played by reserve requirements. While these have been reduced from the 30% rate that was in place between 1960 and 1990, it still stands at 14%, which could also explain that the potentially 'available' loans is restricted by this reserve requirement, while also recognising that loans will be a multiple of deposits in the system. Secondly, the widening gap may also reflect renewed caution on the side of banks, after the banking crisis of the late 1990's where a large proportion of loans allocated to well-known businessmen turned into non-performing loans (NPL's) (Roll, 2010:357). Nonetheless, caution appears to prevail today but the wider private (small and medium enterprises) and household sector (depicted in Figure 4.2 that get a small share of credit) are bearing the brunt of it.

Next, Figure 4.4 shows the number of bank branches and Automated Teller Machines (ATM's) available per 100,000 people. Not only are both these indicators for Egypt significantly lower than the MENA regional average but also well off the industrialised city average. This shows is access to financial avenues remains few, rather than having improved as should have been the case under financial liberalisation.

Figure 4.4
Comparing ATM and Bank Branch Density

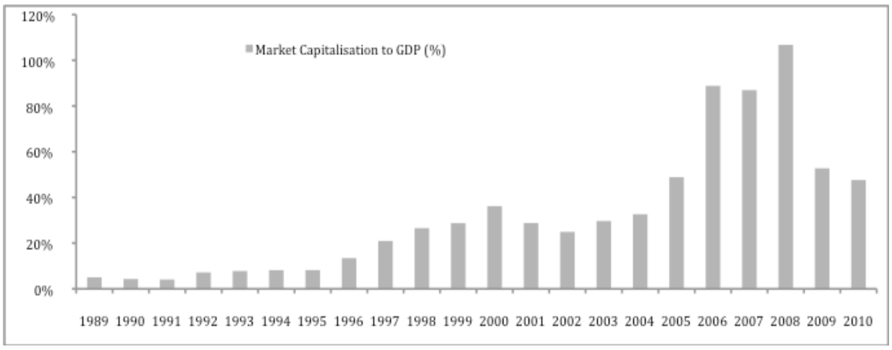


Source: Recreated from World Bank report 'Access to Finance and Economic Growth in Egypt'

Capital Markets

Another prong of Egypt's financial liberalisation programme was to improve capital market activity. Egypt's stock exchange is one of the oldest in the MENA region such that in 1888, the Alexandria exchange was established, while in 1903 the Cairo Exchange was formed. The latter has today become the Egyptian Exchange and is the country's nationwide capital market today[5]. Despite this heritage, prior to entering the liberalisation phase, owing partly to the Nasserite nationalisation phase, the capital markets had reduced their prominence. With Law No 95 of 1992, the authorities made a concerted effort to revive the capital markets, with Figure 4.5 showing rising market capitalisation to GDP.

Figure 4.5
Market Capitalisation to GDP



Source: IMF World Economic Outlook Database, accessed October 22 2011

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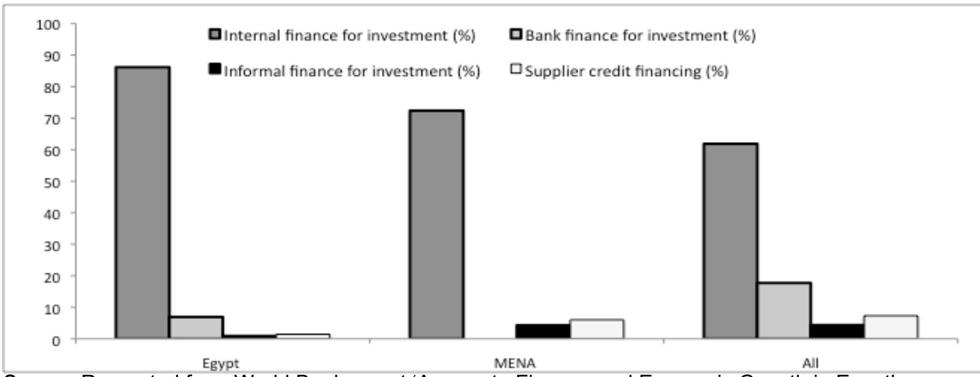
[5] From the Egypt Capital Market Authority (CMA) website, http://www.efsa.gov.eg/content/efsa2_en/efsa2_merge_page_en/cma_merge_page_en.htm, accessed on November 4 2011

At the same time, the fact that this ratio touched more than 100% in 2007 could be a sign that the stock market was overheating and the subsequent retrenchment in this ratio shows some cooling of investments and fund withdrawal. So liberalisation has allowed the stock market to increase its prowess but nonetheless, there is some volatility as seen with the onset of the 2007-08 global financial crisis. This kind of capital flow vulnerability is presented as one of the criticisms of financial liberalisation presented by heterodox authors as outlined in Chapter 2.

Another aspect to consider in conjunction with this rise of the capital markets is whom they have been able to serve. Figure 4.6 shows how Egypt has one of the highest rates of internal financial investment i.e. businesses that use retained earnings rather than other sources of funding (bank loans, capital markets and other sources) to undertake business investment. Thus, if formal enterprises are credit constrained in this way, perhaps the situation for informal firms and other household based ventures might be even harder.

Figure 4.6
Types of Funding Used by Egyptian Businesses

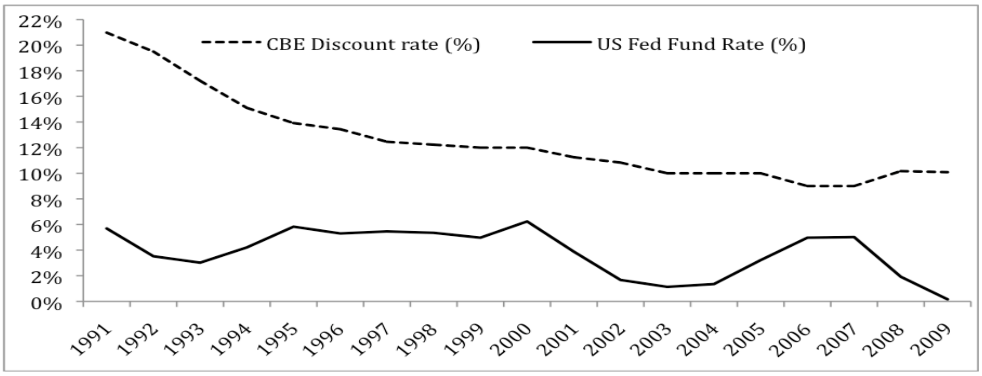


Source: Recreated from World Bank report 'Access to Finance and Economic Growth in Egypt'

Thus the Egyptian capital market appears to be an investment vehicle less so for the wider corporate sector, with some academics suggesting revival of the stock market has benefited the elite class disproportionately. For instance, Hearn et al point out that "owing to the high cost of equity, only large, well-known enterprises were able to use the stock market as a financing tool, with most of these being important entrepreneurs and business families" (2010:492). For example by 2008, companies controlled by the Sawiris family, one of Egypt's most important business families, "had an aggregated market capitalisation of more than EGP90 billion or USD16.3 billion which corresponded to 19 percent of total market capitalisation" (Roll, 2010:359). At the same time, while there is currently another exchange in Egypt called the Nilex that was created for allowing the listing of small and medium businesses, this stock market only has 10 companies listed on it. Hence, it has not really gained traction and this segment of the private sector remains credit starved.

Another aspect to look at is the fluidity of capital stocks. To do this, first the interest rate differential will be presented. For Egypt, the Central Bank of Egypt discount rate is used and the benchmark rate used is the United States effective Federal fund rate. Figure 4.7 depicts this differential.

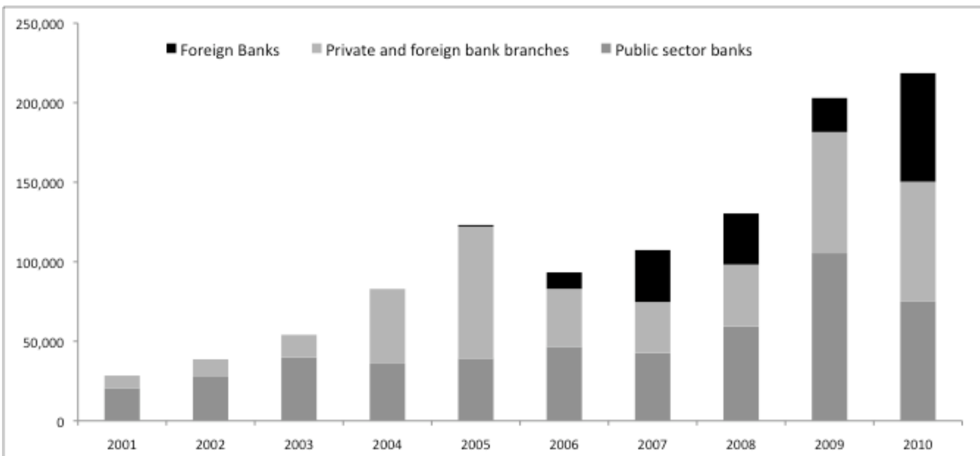
Figure 4.7
Interest Rate Differential



Source: CBE, US FFR from http://www.federalreserve.gov/releases/h15/data.htm, accessed 28 October 2011

Figure 4.7 shows a sizeable interest rate differential enjoyed by Egypt. While this has narrowed over the course of interest rate liberalisation, it persists. As discussed in Chapter 2, the mainstream view would suggest this differential is precisely what financial liberalisation wishes to capitalise on, such that return- seeking capital would find its way to this high interest rate environment. Indeed this interest differential has led to increased capital inflows and carry trade activity (Wigglesworth, 2011). In fact, by 1995, liberalisation reforms had allowed Egypt's debt and equity markets to increase prominence (Abdel-Baki, 2010:530). A debt instrument that has seen increased foreign ownership recently are Treasury bills (Figure 4.8 below).

Figure 4.8
Ownership of Outstanding Treasury Bills



Source: Author's calculation based on Central Bank of Egypt data, all amounts in EGP millions

While this helps to show the post-liberalisation increased attractiveness of the Egyptian financial sector, it is also important to be aware that this attractiveness brings added vulnerability with it. For instance post the 2011 revolution, foreign investors have reduced their exposure to these Treasury bills. Moreover, given the political uncertainty that still prevails, debt spreads are likely to continue to widen, with local banks mopping up the excess quantities. The fact that foreign investors are one of the first to exit their investments in Egypt points to inherent vulnerability related to these foreign financial flows, which is one of the critiques that heterodox authors present against liberalisation as discussed in Chapter 2.

4.2 Savings and Investment

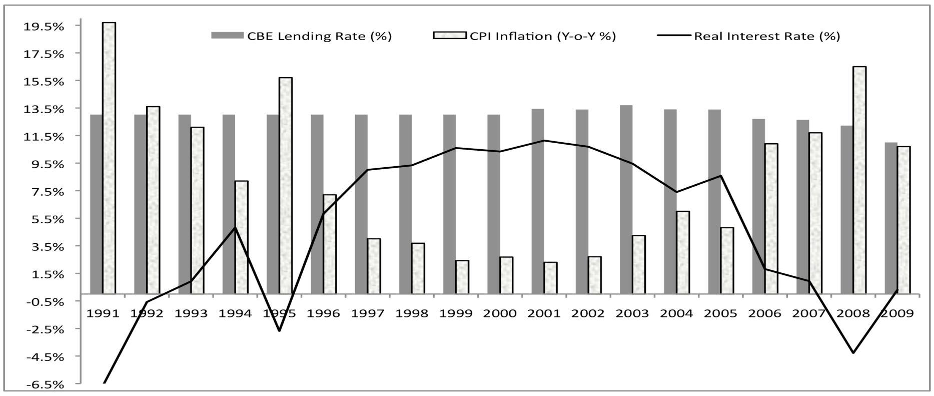
Real Interest Rates

The move towards financial liberalisation from the 1970's onwards described in Chapter 2 occurred to curb the enactment of state policies that impede financial deepening. Hence, interest rate ceilings and subsidised credit came under fire (Burkett, 1987:3). With regards to interest rates, the critique was that a regulated rather than market-based interest rate environment lead to distorted mobilisation and allocation of savings. Thus, interest rate liberalisation was meant to allow real rates to rise to a level that can encourage investment of both domestic and foreign capital, boost savings, prevent capital flight an encourage foreign investment (Pfeiffer, 1999:23).

When Egypt entered its ESRAP programme in 1991, its real rate of interest was negative[6] i.e. that the rate of inflation was greater than the lending rate at the time. Thus, one of the first reforms of the stabilisation package called for the removing interest rate ceilings, so as to allow this rate to increase and thus remove its distortive impact on capital mobilisation and allocation. In Figure 4.9 that follows, the progression of this real interest rate is sketched.

[6] Real interest has been calculated here as the CBE's lending rate less the annual inflation rate also obtained from CBE. While it would be ideal to calculate the real interest rate based on bank lending rates, this data was not unavailable, hence the CBE lending rate has been used as a proxy. This lending rate is at the rate at which the central bank lends to commercial banks

Figure 4.9
Real Interest Rates



Source: Central Bank of Egypt, real interest rate is author's calculation

As Figure 4.9 above shows, while the lending rate has largely remained in the same domain of the reform period, real interest rates changed from negative to positive. This has come at the behest of lowering inflation trends. In terms of the more or less constant lending rate, this could be a reflection of the central bank wanting to have a tight monetary policy and thus by keeping the lending rate constant avoid speculative investment. Another reform that allowed the CBE to positively affect monetary conditions once interest rate ceilings were lifted was the use of open market operations including the issuance of Treasury bills (Awad, 2010:31). Additionally, macroeconomic stability in the form of an improved fiscal position helped the downward inflation trend to last from 1991 until the end of the decade.

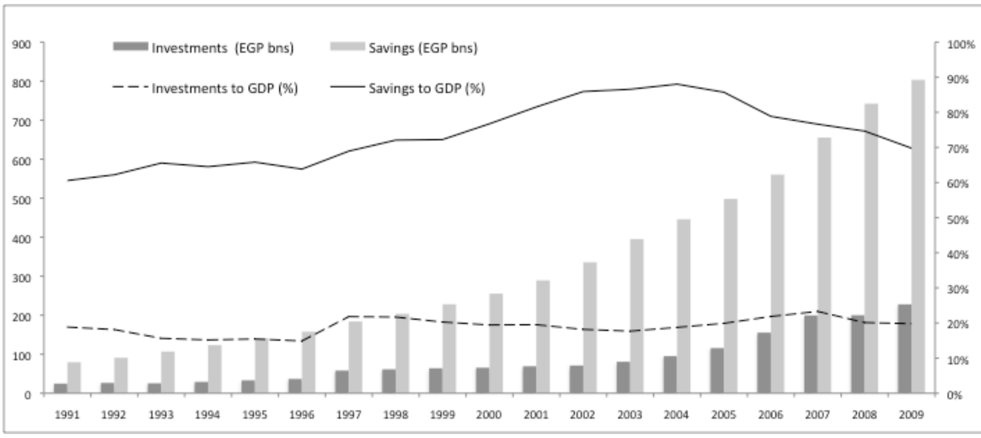
Inflation started to rise in the next decade, first due to geopolitical affairs including the 9/11 attacks and thereafter mostly due to food inflation-domestic and imported as well as higher energy costs. With inflation being higher than the prevailing lending rate, real interest rates turned negative again. In terms of the food inflation, this can be seen as unsavoury consequence of the structural change in the economy, such that with a smaller agricultural sector Egypt has become increasingly dependent on food imports. Hence, its ability to weather food price increases has become more limited.

Savings

Given this real interest rate environment, the next aspect will be to examine if this trend translated into a positive trend in terms of savings and investments mobilisation and allocation. First savings will be examined. In Figure 4.10, the absolute volumes of savings and investments in EGP millions, as well as the proportion of savings and investments to GDP respectively are portrayed. For the volume of savings, which was obtained from the CBE, the data includes: i) instruments held within the banking system (time and savings deposits in domestic and foreign currencies), ii) investment certificates and

iii) post-office savings deposits[7]. For investments, the volume of fixed capital formation as a measure of tangible investment was used.

Figure 4.10
Savings and Investments



Source: Author's calculations based on data from Central Bank of Egypt

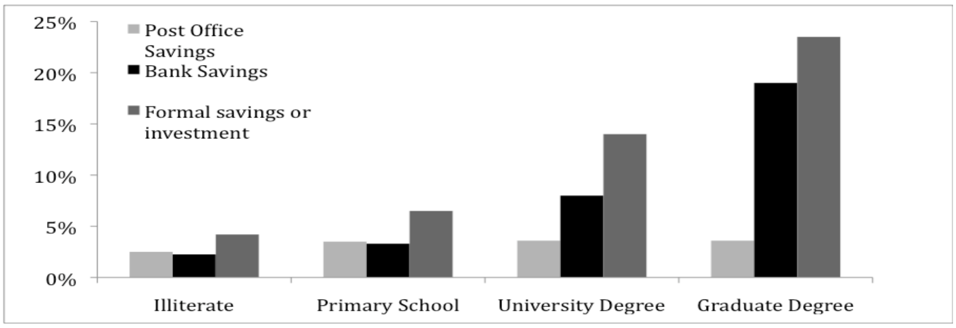
Figure 4.10 above shows that since liberalisation, absolute volume of both indicators has risen, with savings to GDP rising until 2005 and then declining thereafter. The ratio of investments to GDP has hovered in the 20% range over the entire period, actually declining in the first four years after liberalisation commenced in 1991. Another interesting trend is that while savings to GDP has experienced a sustained increase for the most part, the investment trend is not similarly positive. For example, from 1996 onwards when the savings to GDP continues its upward climb, the investment to GDP ratio does not show a similar upward trend.

As such, there appears to be no positive correlation between savings and investment. It would thus appear that Egypt was not suffering from the classical situation of a paucity of savings to finance investment, but rather than the increased savings (which presumably also increased to avail of the higher real interest rate environment) have not been translated into investment. Hence liberalising reforms appear to have allowed for a better mobilisation of savings, but with theses higher savings not feeding into investments, perhaps non-financial factors are at play.

[7] It is recognised that this measure of savings is a literal rather than aggregate measure of savings and as such does not include aspects such as company retained earnings, credit, foreign savings etc., which would comprise aggregate savings and thus allow for the equilibrium of savings and investments.

In terms of the types of savings, a steady rise has been witnessed in domestic deposits and post office savings deposits. These products do not require high financial sophistication. Figure 4.11 below shows the types of savings vehicles used in Egypt, with these types depicted on the basis of education achievement.

Figure 4.11
Looking at Financial Sophistication



Source: Recreated from World Bank report 'Access to Finance and Economic Growth in Egypt'

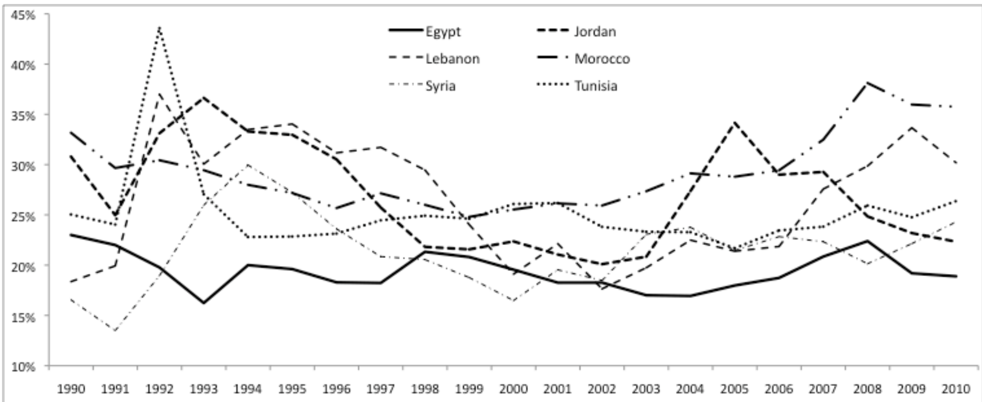
Figure 4.11 above shows such that even for those citizens who have a high level of education i.e. a post-graduate one, the usage of formal savings investments does not exceed 20%, and it is around half that level for undergraduates. Thus this chart helps to show the prevalent level of low level of financial sophistication in Egypt. When this facet of the make-up of the financial sector is understood in conjunction with the low ATM and bank branch density, along with the data on limited domestic credit to the household sector and the high use of internal financing, a picture starts to fall in place.

This image is that liberalisation has allowed credit depth to increase and the banking structure has changed in favour of more private ownership, hence theoretically more competition and access. However, if one were to look at these indicators on face value without acknowledging the make-up of Egyptian society, a crucial aspect is missed out. This is that there is a complex web of inclusion and exclusion at play here. Up until the January 2011 revolution, inclusion relied on one being connected with the Mubarak and resulted in improved access to credit, the capital markets and other sources of capital. However, for those not included within this circle, there continue to remain other hindrances affecting access to the more liberal financial sector.

Investments

As depicted in Figure 4.10 earlier, investment to GDP has hovered in the 20% range for the last 20 years. In terms of comparison, looking at this indicator for Egypt versus other similar countries in the MENA[8] (excluding the GCC and other oil producers), shows how Egypt has the lowest investment to GDP ratio (as depicted in Figure 4.12 below):

Figure 4.12
Egypt versus MENA Investments to GDP



Source: IMF World Economic Outlook Database, accessed 22 October 2010

With Morocco, Jordan and Tunisia having undertaken similar liberalisation reforms around the same time i.e. the early 1990's as Egypt and experiencing higher ratios of investment to GDP, this points to something occurring within the Egyptian context that has curbed a greater rise in investments.

To recap, the hindrances towards wider financial access and increased financial depth that were fleshed out in these first two sub-sections included: i) private and foreign banking ownership that has allowed for a change of ownership not necessarily mentality and improved credit allocation ii) continued state ownership of banking sector assets, iii) elite biased credit and capital market activity, iv) limited credit activity going towards the small and medium sized business sector and household sector, v) low ATM and bank branch density, vi) high reserve requirements, vii) low financial sophistication and viii) high reliance on retained earnings to fund investments. In addition to these micro-level elements, a role has undoubtedly been played by broader macro factors. These shall be discussed in the following sub section.

[8] While the IMF provides this data based on national sources, there are variances in measurement (for eg. fiscal year usage versus calendar year usage) that must be considered when comparing data. Oil producing GCC countries have been excluded, given they are not directly comparable to Egypt's more diversified economic base

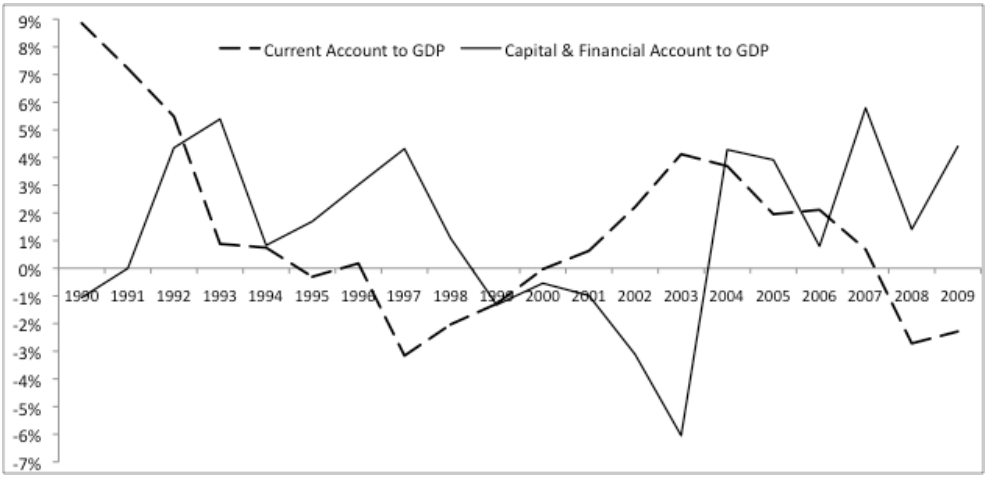
4.3 External Environment

As was described in the first two sub-sections, there are certain factors at play that have stunted Egypt's financial liberalisation. Stunting here means that financial depth and access have not reached their full potential. In this sub-section, macroeconomic indicators including Egypt's balance of payments data will be explored. The intent is to understand whether the broader macroeconomic picture has also played a role in stunting Egypt's financial liberalisation. This could be a reflection of events specific to Egypt as well as global occurrences.

Balance of Payments Analysis

A proposed benefit of liberalisation was that Egypt would attract greater foreign investment and be more integrated to the global economy, with exports rising. Taking a look at disaggregated balances of payments data helps to see if this was realised.

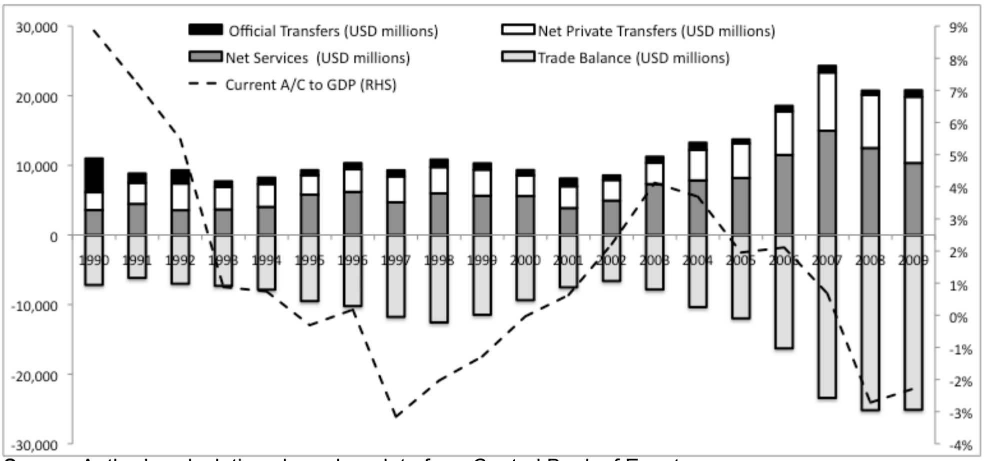
Figure 4.13
Current, Capital & Financial Account to GDP



Source: Author's calculations based on data from Central Bank of Egypt

Figure 4.13 shows that once the ESRAP was in place from 1991 onwards, Egypt's current account balance has witnessed a declining trend, going negative from 1996 onwards and only turning positive again in 2000 onwards. This positive trend lasted until the 2007/08 financial crises. In terms of the capital account, the trend line is positive until 1998. Then the East Asian crisis and 9/11 attacks result in outflows from the region, making the capital account to GDP ratio negative. On the back of renewed liberalisation efforts from 2004 onwards, the capital account turned positive again and has remained so, albeit with volatility. What will be important to ascertain is whether these inflows came on the back of internal strengths of the Egyptian economy, or the easier access provided by the liberalisation reforms, or even broader factors i.e. the state of affairs in the global financial arena at the time, and other external conditions.

Figure 4.14
Current Account Details

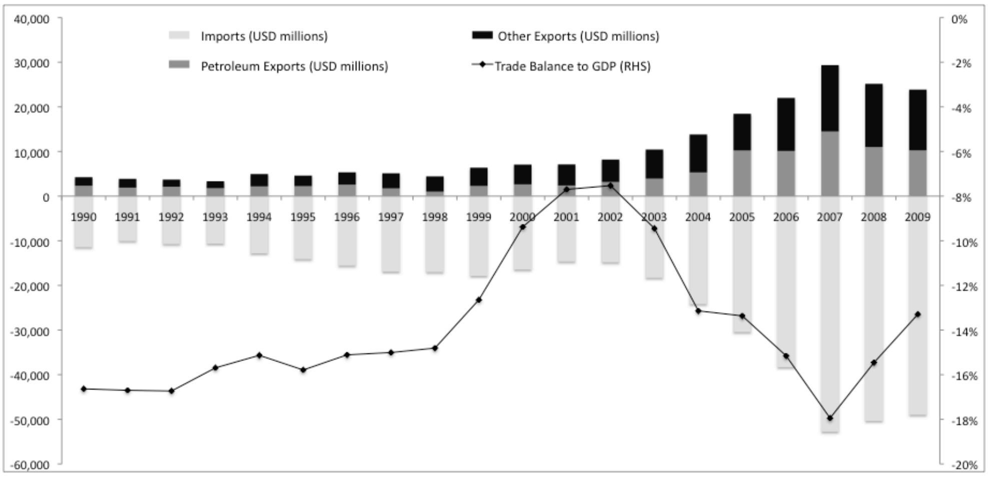


Source: Author's calculations based on data from Central Bank of Egypt

When looking at the breakdown of the current account as shown in Figure 4.14, post-liberalisation Egypt continues to have a negative trade balance and remains a net importer rather than net exporter. Service transfers that include contributions from the Suez Canal and tourism, two large income generators for the country, have been on the rise. Official transfers have been on the decline in line with broader global aid flows, and private transfers (mostly worker remittances) have increased their prominence.

Zoning in on the trade balance, as shown in Figure 4.15 below, while there has been a rise in both petroleum and other exports, the growth in imports has been stronger. In terms of this imbalance, on the one hand this could reflect the impact of easier access to imports for a country that had hitherto closed off such access, and on the other that opening up the capital account allowed for a large inflow of foreign capital, caused a real appreciation of the exchange rate making exports underperform.

Figure 4.15
Closer Look at Egypt's Trade Balance

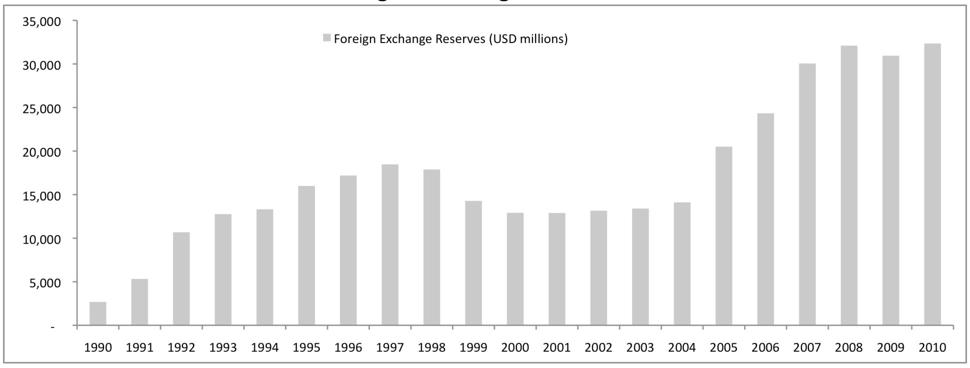


Source: Author's calculations based on data from Central Bank of Egypt

Export weakness could also be viewed through the lens of the critiques of financial liberalisation. This in the sense that financial liberalisation policies tend to be recommended in a restricted fashion i.e. the attention is focused on the financial sector. However, given the interplay between the financial sector and the broader economy, policies and reforms need to be interactive with industrial policy so as to ensure they are in sync and thus derive stronger outcomes. Thus if liberalisation policies were recommended as part of a broader policy package with a sound developmental and industrial policy at the core, perhaps the outcomes would be different.

What is interesting is that when looking at the accumulation of foreign exchange reserves as depicted in Figure 4.16 below, a favourable trend is witnessed. This build up of foreign exchange reserves appears to reflect the positive contributions from Egypt's externally oriented sources of income including the Suez Canal, tourism and remittances. Moreover, given the external nature of these sectors, they are more vulnerable to global demand and pricing trends as well as geo-political factors. Also, it is this build up of reserves, which underlines the country's import trend (as in Figure 4.15).

Figure 4.16
Foreign Exchange Reserves

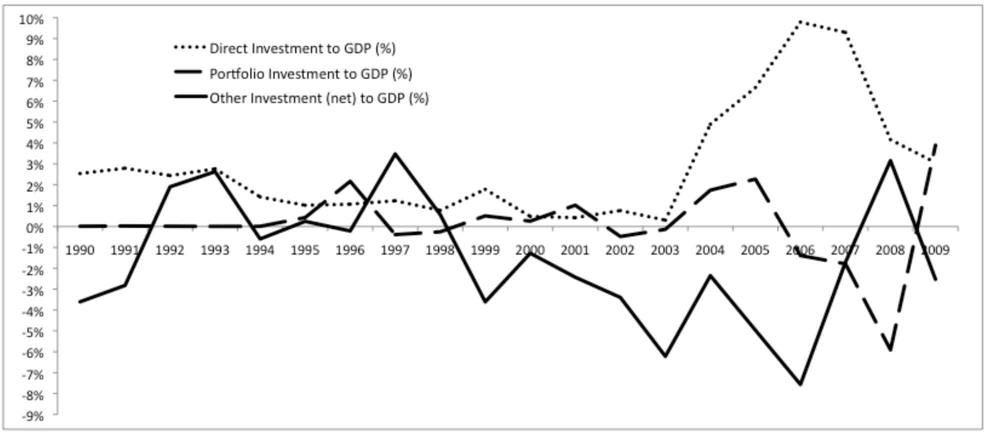


Source: Reproduced from data in International Financial Statistics (IFS)

Thus, while some heterodox academics would suggest that it is precisely this generation of foreign exchange and ability to import capital goods, run a trade deficit and thus industrialise the economy that an emerging economy needs, the problem remains that while liberalisation policies helped generate these important flows, this improved international financial mobility is equated with domestic financial deepening (Palley, 2009:27). However, the international and domestic sphere remains disconnected and herein lays one of the problems with these policies.

Next, taking a deeper look at the capital and financial account reveals the following picture, as shown in Figure 4.17

Figure 4.17
Breakdown of Capital and Financial Account

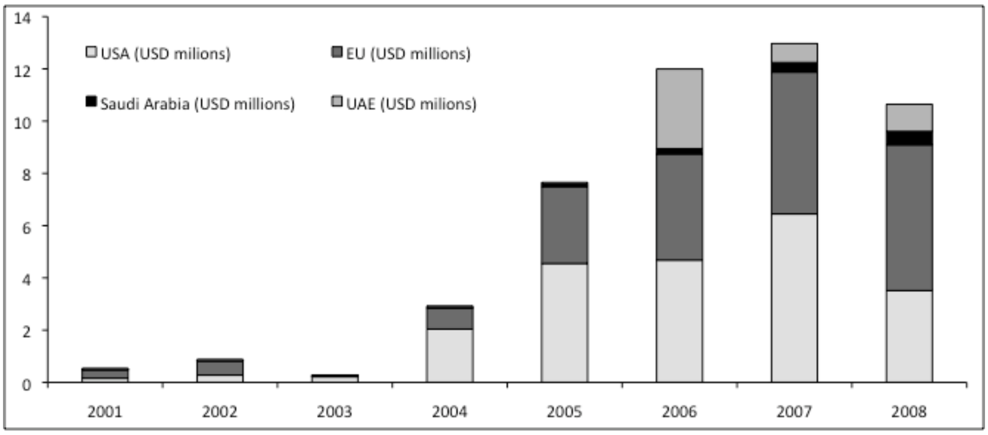


Source: Author's calculations based on data from Central Bank of Egypt

Figure 4.17 shows that direct investment shows a strong and positive trend, while portfolio and other investment (mostly debt) show a more mixed one. With regards to portfolio flows, the impact of fund redemptions due to the global financial crisis has caused portfolio investment to decline from 2007 onwards. While a breakdown of flows was not available, perhaps these outflows also relate to short-term hot money flows, with this type of capital flight being one of the reasons cited by the likes of Stiglitz as outlined in Chapter 2, as being a negative aspect of financial liberalisation. In terms of the motivation of the funds entering Egypt, while the data itself cannot confirm this, it should be noted that from 2004 onwards, up until the recent 2007/08 global financial crisis there has been a generally favourable investment mentality that resulted in large amounts of capital floating across the globe, with large funds flowing into emerging markets and developing markets such as Egypt. Thus the investment boom experienced here seems to be partly explained by liberalisation reforms from 2004 onwards, but just as much by the bullish global investment theme.

Given the strong direct investment trend particularly the investment boom from 2004 onward, with FDI to GDP peaking at c9%, it warrants a closer look. Figure 4.18 shows the volume and sources of the foreign direct investment that found its way into Egypt just before and after the 2004 liberalisation reforms. Figure 4.18 shows the largest sources of FDI into Egypt have come from the United States (US) and the European Union (EU), with the United Arab Emirates (UAE) also contributing more strongly in 2006.

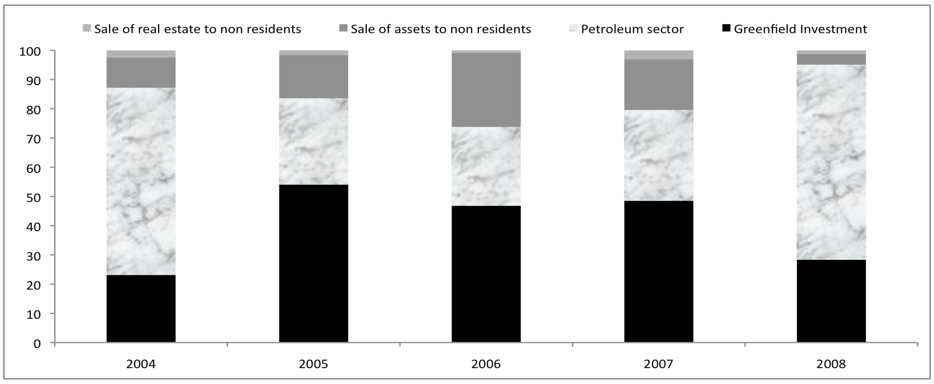
Figure 4.18
Inflows of Foreign Direct Investment



Source: Author's reproduction of data from Central Agency for Public Mobilisation & Statistics (CAPMAS)

In terms of the make-up (represented in Figure 4.19), while there have been year on year fluctuations, on balance, Greenfield investments and petroleum sector investments have made a combined solid contribution. In addition, the sale of assets to non-residents represents mergers and acquisitions (M&A) activity, with some occurring within the financial and banking sector.

Figure 4.19
Foreign Direct Investment by Type



Source: Author's reproduction from Egypt Ministry of Investment

Overall, the FDI trends and particularly the recent contributions from the UAE and Saudi Arabia could be construed as Egypt being viewed as a more viable investment opportunity on the back of liberalisation reforms. At the same time, if one looks beyond this headline positivity of this direct investment, one can assert that Egypt's success on attracting foreign direct investment from the Gulf countries had less to do with internal structures of strength such as the efficiency of its financial sector, and more so with the "boom of the oil market and the good fortune of its neighbouring GCC countries" (Achar, 2009:1). This alludes to the fact that while it is recognised that liberalisation reforms made it easier for foreigners to invest in Egypt, it is important to distinguish between push and pull factors. The pull factors being whether Egypt is truly envisaged as a safe and attractive investment decisions, with the push factors being the resource glut experienced by the country's richer neighbours that resulted in some of these excess funds finding their way into Egypt.

4.4 Key Takeaways from Exploratory Data Analysis

This chapter has depicted that the Egyptian financial sector is a product of the legacy of the pre-independence colonial structure, Nasser's statist reforms as well as the various liberalising financial and economic reforms that have been undertaken since the 1970's. With respect to liberalisation reforms that started to take distinct shape from 1991 onwards under Egypt's ESRAP programme with the IMF, the exploratory data analysis has shown that even after more than twenty years of these reforms, the country's financial sector, particularly the banking and capital market environment are largely available for the connected elite class of society, rather than the wider private sector including small and medium enterprises and the household sector. The latter two segments of Egyptian society have not any seen substantial improvement in financial access or credit availability and financial depth. The overall conclusion derived is that Egypt's financial liberalisation efforts have not resulted in the ultimate goals of removing all market frictions and deepening the scope and access of the financial sector.

Furthermore, opening up the capital account has successfully allowed for increased portfolio and direct investment. The former appears fickle in nature, confirming one of the critiques of financial liberalisation presented by heterodox academics, while the latter's investment boom reflects the glut of oil wealth since 2004 rather than a concerted perception change in the investment value proposition of Egypt. Liberalisation and greater exposure to the global economy has increased inflation in recent years, thereby reducing purchasing power of the average Egyptian and increasing exposure to food insecurity.

The ongoing process of financial liberalisation has influenced these wider macroeconomic trends but external geopolitical and economic events (such as the East Asian crisis of 1996/7, 2001 9/11 attacks in the US, Iraq war, 2007/08 financial crisis) have also played a role. It also points to the trouble faced by developing, peripheral economies like Egypt, where monetary policy and other aspects of the financial sector are exposed to external factors. This invokes the theoretical inconsistency sketched by Palley (2009) in Chapter 2, where he discussed the impossible trinity of exchange rates, sovereign monetary policy and capital mobility. While liberalisation policies purport that all three facets are of equal standing, the first two affect industrial policies and overall macroeconomic stability. Thus, the trade deficit faced by Egypt along with increased vulnerability to global shocks substantiates these ideas.

Chapter 5 Synthesis and Conclusions

The previous chapter empirically sketched Egypt's experience with financial liberalisation. It was observed that post-liberalisation, not only has the banking sector structure changed with increased private and transnational ownership but also private sector credit has risen. However, this credit increase has mostly found its way to large corporations and Egypt's well-connected elite rather than the wider private, SME and household sector. It was also illustrated that most businesses use retained earnings rather than other sources of funding (bank loans, capital markets, etc.), substantiating this notion of credit rationing. Furthermore, Egypt has the lowest number of ATM's and bank branches per 100,000 people when looking at both the MENA and industrial country averages. Overall, these factors painted a picture of poor financial access and limited financial depth, with financial liberalisation reforms mostly benefiting Egypt's connected upper class and even polarising Egyptian society.

Another interesting finding was that while savings have increased over the last twenty years, with the savings to GDP ratio being above 60%, the ratio of investments to GDP has hovered in the 20% for broadly the entire period since reforms began in 1991. Also, from 1997, when savings to GDP began a concerted climb, investments did not see a similar rise. This lack of positive correlation between the two variables suggests that Egypt does not face a situation of insufficient savings to finance investment. Rather abundant savings are not being translated into investments, helping to show reforms have not resulted in an optimal allocation of savings and investment.

As promised, liberalisation has increased capital inflows. On the one hand, there has been higher FDI in the form of Greenfield operations and M&A activity; on the other it has resulted in increased volatility from hot money and portfolio flows. Also, with the structure of the Egyptian economy changing over the course of liberalisation to lean towards the service sector (transportation, communication, real estate, tourism and finance) and worker remittances comprising the majority of private transfers, Egypt's economic base is now more externally oriented and thus susceptible to global shocks.

Interestingly, while analysis of the microenvironment in terms of the domestic banking and financial sector helped show that financial liberalisation efforts have not removed all market frictions, the macroeconomic indicators were not similarly emphatic. Instead the trends of higher portfolio and direct investment could partly be explained by improved attractiveness of the country post-liberalisation and partly by the oil boom of the mid 2000's, low interest rates in the developed world and the bullish global investment climate. The mixed response of macroeconomic indicators highlights that when examining financial liberalisation, one must distinguish between the importance of the domestic context and the role played by the external environment.

Overall, while the macroeconomic variable analysis was less crystal clear, the banking and financial sector analysis helped make the case for why it is asserted that financial liberalisation in Egypt has not worked out as planned. The research paper then questioned if financial liberalisation did not work out because liberalisation itself has little theoretical validity and economic rationale or if there were elements of power and politics that are embedded within the financial and economic sphere that wield noteworthy or greater influence? It appears to be a mixture of both elements.

In terms of financial liberalisation having limited economic rationale and theoretical validity, three arguments help substantiate this claim. The first relates to the critique of financial liberalisation put forward by heterodox academics in Chapter 2. It was discussed how developing countries that have liberalised their financial sector have seen banking/financial sector crises and increased exposure to global shocks. Both these facets were witnessed in Egypt, and evidenced by the banking crisis of the late 1990's, capital account volatility, cooling of market capitalisation to GDP ratio post the 2007-08 global financial crisis, increased food import costs, appreciation of its real exchange rate that has contributed to the trade deficit persisting.

Secondly, as outlined in Chapter 2, there are some theoretical inconsistencies to note. It was first described how liberalisation reforms build on seminal work that portrays a positive relationship between finance and growth, suggesting that markets work efficiently. However, as argued by heterodox academics, while the relationship between finance and economic growth is recognised as being important, there are a host of empirical issues (measurement errors, types of indicators chosen etc) that do not provide a clear linkage from finance to growth. Moreover, there are doubts about the notion of a perfect market with other academics highlighting that the market for finance is not the same as the market for consumer products. Also financial liberalisation is equated with financial deepening, when the first focuses on capital mobility and the latter is about improving domestic resource allocation, which are clearly quite different. Thus following liberalisation reforms based on this weak foundation appears fraught with flaws.

Other subtler reasons to show the limited theoretical and economic rationale for liberalisation are the ways the mainstream extols Egypt's financial liberalisation efforts. For instance, the IMF considers the ESRAP package successful because of the immediate reduction Egypt's fiscal deficit. However as outlined in Chapter 3 and 4, this reduction came at the behest of reduced public investment, debt forgiveness and increased political alignment of Egypt with the US. Similarly, Egypt's reform is extolled for its gradual approach. However as outlined in Chapter 3 prior to the 1991 programme, the country had already taken three standby loans from the IMF, thus paving this path. This discourse itself and the story it chooses to tell adds to the point being made regarding limited economic and theoretical rationale.

Then with respect to the second claim that financial liberalisation did not result in all the expected outcomes due to embedded elements of power within the societal structure, two arguments support this notion. Firstly, in Egypt reforms appear to have allowed for a reorganisation of the network of finance rather than a widening of the network. This consequence is reflective of the generic nature of mainstream policies that appear to be made in a vacuum. These policies are not mapped with the inner societal structures. As described in Chapter 2 by Sunkel, this societal picture is that of a country consisting of integrated and non-integrated members. In Egypt's case, the main beneficiaries and integrated sects of society include those with connections to the political elite, with others being non-integrated. Such a societal structure has allowed patterns of inclusion and exclusion to prevail and hence persistent of credit rationing. Thus, applying standard policies in societies (like Egypt's) composed of different social classes appears bound not to work.

Secondly, the notion of politically embedded cronyism echoed in Chapter 2 rings true. To recap this referred to transference of power from the state to a well-connected elite and business class to maintain the incumbent state's power. This linkage between the state apparatus and business interests relates to embedded aspects of the socio-economic structure of Egypt's economy and financial sector that orthodox liberalisation policies take no note of.

In conclusion, financial liberalisation has not worked out as expected. However, this had less to do with the way reforms were undertaken but more so reflects the limited economic rationale of financial liberalisation given the financial vulnerability that occurred after liberalisation, as well as the impact of deeply embedded social and political aspects of Egyptian society. So where to from here for Egypt's financial sector? With the ousting of President Mubarak and many of his political and economic associates on trial for alleged corruption, there is a clear opportunity for the country to create a more equitable cycle of wealth creation and distribution. While there is little visibility on the type of government that will replace Mubarak's autocratic and business elite favouring regime, the hope is the next team will favour the wider society.

Finally, while academic debates are not crystal clear on the causality and sequencing of financial development and growth, it is widely recognised that capital and the financial sector are important for growth. Egypt needs to heed lessons from its previous liberalisation experiments before jumping in the same direction again. It is perhaps time for this country of 80 million people, with around half consisting of people aged between 15 and 45 to leverage of this demographic potential. This could happen by heeding the ideas of the structuralists and their notions of tapping into disguised employment and mobilising domestic resources (as discussed in Chapter 2). This inward-looking approach combined with sound industrial policy, some guaranteed employment and more productive-sector based job growth could better mobilise and allocate capital, savings and investment under a developmental model that can provide growth, finance, equality and dignity for all Egyptians.

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