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# Financial Sector Reforms in Developing Countries with Special Reference to Egypt

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## INTRODUCTION

Financial reforms, and financial liberalization in particular, have been at the root of many recent cases of financial and banking crises as a number of studies have demonstrated (Diaz-Alejandro, 1985; Burkett and Dutt, 1991; Gibson and Tsakalotos, 1994; Arestis and Demetriades, 1997; Chang, 1998). In fact, another recent study (Demirgüç-Kunt and Detragiache, 1998a, 1999) based on 53 countries for the period 1980-1995, has shown that banking and financial crises are more likely to occur in liberalized financial systems (see, also, Caprio and Klingebiel, 1999). This result is supported by Kaminsky and Reinhart (1999), who argue that banking sector problems precede currency crises with the latter helping to deepen banking crises in a vicious circle. Financial reforms in many countries allowed real interest rates to reach levels exceeding 20 percent per annum in some cases, and in other cases banking and financial crises led to currency crises. National governments either abandoned attempts at implementing financial liberalization (in some cases countries even

reimposed controls) or were forced to intervene by nationalizing banks and guaranteeing deposits.

This paper draws on this experience in an attempt to show that the main reason behind these crises is the application of a theoretical framework that is predicated on a number of assumptions that are problematic, and are based on weak empirical foundations. Consequently, it should not be surprising that the reforms have led to many instances of unsuccessful implementation of financial reforms and to many cases of severe financial crises. We will also argue that the case of Egypt is particularly interesting in this regard since although financial reforms have taken place, the experience has been rather different. There has been no financial crisis during this period, although it should also be pointed out that the period of reforms has not been quite completed yet.

We begin this paper with an examination of the experience of a number of countries that implemented financial reforms and were faced subsequently with severe financial crises. This is followed by a discussion of the theoretical problems of the model that underpins the reforms as we see them. This is essentially the model based on the work of McKinnon (1973) and Shaw (1973), and summarized in Hussein (2000). It will be argued that it is the problematic nature of the model underpinning the reforms that is the fundamental cause of the crises. This leads us conveniently to the issue of financial reforms in Egypt and whether the argument of the paper sits comfortably with the evidence afforded by the experience with financial reforms in this country. A final section summarizes and concludes.

## RECENT BANKING AND FINANCIAL CRISES

We draw on two periods and report the experience of a number of countries to make the point. The first covers the long period 1977 to 1996 and comments on the experience of 23 countries as in World Bank (1997). The second refers to the more recent period, 1997 to 1998, which is known as the South East Asian crisis. There are, in fact, certain common features of these crises worth summarizing (see, also, UNCTAD, 1998, p.VII): they have been preceded by financial reforms and deregulation; excessive lending on certain categories of assets, such as property and stocks; sharp increases in capital inflows which lead to currency appreciation and deterioration of the current account; reversal of capital flows are associated with currency depreciation, leading to capital losses (in the case of unhedged exposures) with the depreciation becoming a free fall owing to heavy demands for foreign exchange. We elaborate on these features in what follows in this section.

### The 1977-1996 Period

Table 1 reports a number of countries that faced banking and financial crises, and the costs of resolving them. The latter is the authorities' estimates of the costs incurred in restructuring their financial sectors.[1] They are the direct fiscal and quasi-fiscal costs of bailouts, as a percentage of GDP. In the same Table, in brackets, non-performing loans as a percentage of GDP (estimated at the peak) are reported. We restrict the analysis in this sub-section to the

period prior to 1996. The countries in this category also implemented financial reforms prior to the crises. This Table reveals the enormity of the costs of bank crises. The direct cost of resolving the crises as a percentage of GDP ranges from 10 percent in the cases of Hungary, Tanzania and Brazil to a staggering over 50 percent for Argentina. Their experience was catastrophic. Interest rates exceeded 20 percent, a number of "bad" debts and waves of bank failures and other bankruptcies ensued, along with extreme asset volatility. The whole financial system reached a near collapse stage. As a result the real sectors of the affected economies entered severe and prolonged recessions. On the whole, financial reforms in these countries had a severe destabilizing effect on the economy. What typically happened in these economies was that financial reforms unleashed a massive demand for credit by households and firms that was not offset by a comparable increase in the saving rate. Loan rates rose as households demanded more credit to finance purchases of consumer durables, and firms plunged into speculative investment in the expectation that government bailouts would prevent bank failures.

In terms of bank behavior, banks increased deposit and lending rates to compensate for losses attributable to loan defaults. High real interest rates failed to increase savings or boost investment--they actually fell as a proportion of GNP over the period. The only type of savings that *did* increase was foreign savings, i.e., external debt (Grabel, 1995). This, however, made these economies more vulnerable to oscillations in the international economy, increasing the foreign debt to reserves ratio. This, combined with deteriorating service obligations, increased the likelihood of currency crises as explained above. Financial reforms thus replaced domestic with international markets. Long-term productive investment did not materialize to a large extent either. Instead, short-term speculative activities flourished whereby firms adopted risky financial strategies, thereby causing financial and banking crises and economic collapse.

Returning to Table 1, we note that the countries reported there comprise a sample of them that experienced the more serious banking crises identified in a survey-study by the IMF (1996) and elsewhere (see, for example, Lindgreen et al, 1999). In all the cases summarized in the two publications just cited, the direct losses sustained by governments in these crises exceeded 3 percent of GDP. Table 1 summarizes those countries which had to devote more than 10 percent of GDP to the resolution of banking sector crises; there were, in fact, fifteen cases falling into this category for the period 1977 to 1996. This experience suggests that in the case of developing countries both relative to the experience of developed countries and in comparison to their experience in the preceding three decades, the degree of severity of these crises was particularly pronounced (World Bank, 1997). The magnitude of these crises is also significant. In addition to the figures just quoted, the IMF (1998) survey reports that at least two thirds of its member countries experienced significant problems in their banking sectors over the period late 1977 to 1996, and that of these one-third warrant the designation "crisis." Equally serious is the finding that in Africa and Asia as well as in the transition economies of central and eastern Europe, over 90 percent of the respondents had at least one serious banking crisis over the same period.

The resolution costs of financial sector crises cannot be taken as an accurate guide to losses in economic welfare. They could be larger than the economic welfare losses if the real assets financed by failed banks remained and continued to yield returns in the future. They could be smaller in view of the cumulative misallocation of financial resources represented by bad loans. The more inefficient and feeble financial intermediaries are, the higher the cumulative misallocation is expected to be. There may also be indirect adverse consequences for longer-run growth where participants have asymmetric information. Moral hazard and adverse selection, two important implications of asymmetric information, reduce exchange below the levels allowed by better information (Arestis and Demetriades, 1998).

The experience of banking and financial crises we have discussed in this section, points to four striking findings (see, for example, IMF, 1996; World Bank, 1997). The first is that the banking crises over the period examined were both frequent and severe. The second is that the costs of these crises to the local economies were substantial and caused or exacerbated downturns in economic activity. The third finding is that these serious episodes of banking crises have no parallels in monetary history, and cannot be construed as simply a return to the type of crises of earlier periods. The IMF (1996) report conducts comparisons of potentially similar episodes across time periods and can find *no* historical precedent for the dismal track record of banking crises reported in Table 1. The fourth finding is that given the relative severity of the problem, along with the increasing weight and integration of these developing countries in international financial markets, potential spillover effects to industrialized countries become a real possibility.[2]

**The South East Asian Experience (1997-1999)**

Prior to 1997, the South East Asian countries (for our purposes we restrict ourselves to the five most-affected: South Korea, Indonesia, Thailand, the Philippines, Malaysia) had had "a miraculous three decades: incomes had soared, health had improved, poverty had fallen dramatically.....Some had not suffered a single year of recession in 30 years" (Stiglitz, 2000, p.1). On 2 July, 1997, however, these countries experienced severe banking and financial crises. Table 1, under South East Asia and for the period 1997-99, reports the cost of resolving that crisis. Two types of costs are cited. The fiscal and quasi-fiscal costs as a percentage of GDP and in parenthesis the non-performing loans as a percentage of GDP. Here again these costs are very high, well in excess of 10 percent. Table 2A, which contrasts real GDP growth in the five most affected countries with that in the "emerging markets" group of countries as a whole, indicates the size of the real sector effects of the credit boom years of 1995 and 1996, the crisis years, and post-crisis years. This Table may appear to suggest that the South East Asian countries have now been able to overcome most of the crisis. There are, however, still severe problems. Stiglitz (2000) concludes on the post-crisis situation by suggesting that "Close to 40 percent of Thailand's loans are still not performing; Indonesia remains deeply mired in recession. Unemployment rates remain far higher than they were before the crisis, even in East Asia's best performing country, Korea.....Thailand, which followed the IMF's prescriptions the most closely, has performed worse than Malaysia

and South Korea, which followed more independent courses" (p.6). Table 2B delves further into the costs of the crisis. It reports the overall cost to the economy of a banking crisis. These are welfare costs and are proxied by losses in GDP as described and reported in Hoggarth et al (2000).[3] GAP(G) and GAP(L) are the cumulative differences between trend and actual output growth, and trend and actual level of output respectively. Trend is the average arithmetic growth in the three-year prior to the crisis in the case of GAP(G), and the trend in GAP(L) is based on the Hodrik-Prescott filter ten years prior to the crisis. The end of the crisis is defined when output growth returns to trend in the case of GAP(G), and GAP(L) uses a "consensus" crisis endpoint from a range of case studies. The losses reported are very high. Even higher are the 1999 estimates of the IMF also cited in Table 2B.

During the 1990s these countries undertook extensive financial deregulation (examples of relevant studies include, Chang, 1998; Jomo, 1998; Wade, 1998; and Arestis and Glickman, 2000).[4] They removed or loosened controls on companies' foreign borrowing, abandoned co-ordination of borrowing and investments, and failed to strengthen bank supervision. Firms were thus able to borrow abroad without government control or co-ordination. They actually discovered that they could borrow abroad half as cheaply as they could domestically. As a result, large capital flows took place, which promoted extension of bank lending; a credit boom ensued. Investors who transferred vast amounts of capital to South East Asia also helped the credit boom. The better returns in these countries when markets elsewhere offered less profitable opportunities, especially in the industrialized countries owing to slow economic growth there, was a significant contributory factor. Low interest rates in the industrialized world, led investors to search for higher returns, and these South East Asian countries offered fertile ground. The high growth rates and high interest rates of these countries, and the economic problems in Latin America, produced large interest rate differentials which international investors exploited. The 10-year experience of currency pegs, which implied fluctuations relative to dollar of less than 10 percent, was another significant contributory factor (UNCTAD, 1998).

Large net private capital inflows took place, escalating foreign debt with most of it being private and short-term (maturing in twelve months or less). Indeed, three of the countries discussed here were among the world's top six recipients of private foreign capital inflows. In 1996 Indonesia received the world's third largest share of private foreign capital flows ($17.96 billion), Malaysia the fourth largest share (16 billion), and Thailand the sixth largest share ($13 billion). World Bank (1997) reports that net inflows of long-term debt, foreign direct investment, and equity purchases, were only $25 billion in 1990 and exploded to more than $110 billion in 1996. These enormous amounts of foreign funds were often at interest rates, which reflected only a very modest risk premium relative to safe returns on investment in the lender country. The low risk premiums may have reflected a belief that even without explicit depositor's insurance, the governments of these countries would not allow bank failures, so that effectively lenders had a government guarantee. Given lenders' low risk premiums, even a slight increase in their perception of risk was likely to lead to substantial capital outflow.

Prior to 1996 those developments did not appear to have caused any obvious problems, simply because the inflows were utilized essentially for investment purposes. In 1996 and 1997, however, most of the inflow was directed at speculative activities, essentially on real estate and equities (between 1996 and 1997 the inflow was of the order of $109 billion, 11 percent of before-crisis aggregate GDP).[5]

When the bubble burst, property prices fell substantially and the share of non-performing bank loans rose dramatically. Vulnerability was heightened as banks and their corporate customers, in an effort to lower borrowing costs, undertook most of their foreign borrowing at short maturities and foreign currency. A serious unfolding contagion of financial disturbance across countries ensued. The contagion was helped by the fact that the region's currencies were on the whole pegged to the U.S. dollar (an important mechanism in their attempts to develop their economies in a globalized world) which prevented the currencies from moving in response to domestic fundamentals. A *currency crisis* in Thailand in the summer of 1997 (when the baht was devalued) was spread almost overnight to Malaysia, Indonesia and the Philippines. In November 1997 South Korea's currency was under heavy pressure from speculators who believed it to be overvalued. The won was devalued but the IMF had to be called in to help finance its short-term debts. Several major firms were declared insolvent and by mid-December smaller firms were failing at the rate of 50 per day. Short-term interest rates soared to just over 30 percent.

The most commonly held view is that the South East Asian crisis was the result of intrusive governments which were practising over-regulation of the economy throughout the region along with deeply rooted corruption, and forcing banks to lend to unprofitable firms. The solution should thus be to create a "genuine" free market economy through an even more extensive liberalization of finance, international trade and labor market. More privatization and more extension of free markets is what is paramount in this view. One response would be to point out that the IMF-inspired $110 billion package for South East Asia is quite obviously a major intervention in the workings of the free market in any case. Another is to ask the question of why corruption became catastrophic so suddenly in 1997 after a long period of high growth, and, indeed, after investors had already committed vast amounts of funds to these economies and for a long time.

A more promising response is to look closely at the origins of the crises, which would reveal a different story. It would suggest that the fundamental reason for the crisis is insufficient regulation rather than under-regulation (see, also, Singh, 1998; Chang, 1998).[6] There was too little government control over the financial liberalization process, which these countries had implemented before the crisis. In all the South East Asian countries measures were introduced to liberalize their financial and banking systems; there was both internal and external financial liberalization. Internal financial liberalization allowed domestic banks to become heavily involved in foreign operations and allowed them to get involved in riskier domestic lending activities. The promotion of stock markets alongside external financial

liberalization contributed to the creation of an attractive investment climate for international portfolio investors. Speculative booms ensued which promoted higher rates of leveraging by the private sector. Exceptionally high leverage, of course, often is a symptom of excessive risk taking and leaves financial systems and economies vulnerable to loss of confidence.

Financial liberalization does not lead necessarily to an orderly system of market supervision and management. Indeed, such attempts lead to structural inadequacies in the regulation and supervision of financial institutions and make financial systems vulnerable to shifts in international speculator sentiment. A very good example is Thailand which liberalized its financial system (with Thai banks lending to property developers to support vastly over-priced office blocks, and lacking in expertise in terms of collateral evaluation), only to discover that foreign capital brought its economy to near collapse and sparked the whole South East Asian crisis (see, for example, Jomo, 1998). Another good example is South Korea where during the five-year period prior to the crisis the government relaxed its control over the financial system significantly and in 1993 the process was accelerated. In addition, relaxation of state control over large-scale firms took place. In fact, the *Economic Planning Board,* the main body for making economic strategy since the early 1960s, was merged with the *Ministry of Finance* to form the *Ministry of Finance and Economy,* thus emphasizing the demise of indicative planning. Capital account liberalization implied inadequate monitoring of foreign borrowing activities, especially by the inexperienced merchant banks. For example, on the eve of the South Korean crisis there was a huge mismatch in the maturity between their borrowings (64 percent of their foreign borrowings were short-term) and lendings (85 percent of them were long-term). A rapid accumulation of debts ensued which reached a total of $116 billion (November 1997) with roughly 70 percent of them being less than a year's maturity. This is explained by the more extensive liberalization of short-term than long-term foreign borrowings (Chang, 1998).

The lesson to take away from the South East Asian crisis is that high growth rates and low unemployment were built on a weak financial infrastructure. In any case, these South East Asian economies are different from other economies. They have high levels of saving recycled as loans to corporations and companies are closely linked with governments. This difference would imply that financial liberalization would have higher costs and smaller benefits in Asia than elsewhere (Wade and Venoroso, 1998, p.5). It is no wonder that Malaysia reimposed wide-ranging capital controls on the 1st of September 1998 (and financial markets there soon recovered and allowed interest rates to fall). So much so that even IMF officials now argue that capital controls may be the least damaging way out of these crises. Leading economists, too, argue in favor of capital controls (Krugman, 1998). UNCTAD (1998) summarizes the argument by suggesting that "In the absence of global mechanisms for stabilizing capital flows, controls will remain an indispensable part of developing countries' armory of measures for the purpose of protection against international financial instability" (p.XI).

## THE PROBLEMATIC NATURE OF THE THEORETICAL MODEL

The gist of the theoretical analysis of financial reforms is quite straightforward: liberalize financial markets and let the free market determine the allocation of credit. With the real rate of interest adjusting to its equilibrium level, low yielding investment projects would be eliminated, so that the overall efficiency of investment would be enhanced. Also, as the real rate of interest increases, saving and the total real supply of credit increase which induces a higher volume of investment. Economic growth would, therefore, be stimulated not only through the increased investment but also by an increase in the average productivity of capital. Moreover, the effects of lower reserve requirements reinforce the effects of higher saving on the supply of bank lending, while the abolition of directed credit programs would lead to an even more efficient allocation of credit thereby stimulating further the average productivity of capital. The way this would be achieved is equally straightforward: remove interest rate ceilings, reduce reserve requirements and abolish directed credit programs.

In two recent papers Arestis and Demetriades (1998, 1999) work out the key assumptions of the theoretical model underpinning financial reforms, which are found to be highly unlikely to be met in the real world. The more important ones are those of perfect information, profit-maximizing competitive behavior by commercial banks and the assumption of institution-free analysis (including the scant attention paid to the role of stock markets). We may also add a further reason which is attributed to lack of due consideration of the microeconomic aspects of the theoretical model underpinning financial reforms.

Stiglitz and Weiss (1981) demonstrated that asymmetric information leads to two serious problems: adverse selection and moral hazard. The implication of the presence of these problems is that the informational asymmetries of higher interest rates, which actually follow financial reforms and financial liberalization policies in particular, exacerbate risk-taking throughout the economy, thereby threatening the stability of the banking system, which can easily lead to frequent financial crises. Profit-maximizing competitive behavior by commercial banks is particularly unrealistic in the case of developing countries. The banking sectors in these countries are oligopolistic, in which case financial reforms may well lead to increased spreads between lending and deposit rates without increased financial deepening (Demetriades and Luintel, 1996). It would not be unreasonable to argue that threatened banks attempt to recoup losses by increasing lending rates and/or reducing deposit rates to savers. This is particularly possible in the oligopolistic environment of the developing country banking sectors. A relevant further consideration is the undue attention paid to microeconomic aspects of financial reforms. One such microeconomic phenomenon is bankruptcy and the fear of default, both of which are rarely, if at all, incorporated in the analysis of financial reforms. Wholesale financial reforms based on models that do not pay due attention to these details could cause serious problems. The experience of South East Asia is a very telling case (Stiglitz, 2000, p.6). The institutional framework surrounding the banking sector is paramount and assuming an institution-free approach to financial reforms could lead to expensive policy mistakes. For example, ignoring the role of banking supervision by central banks proved very costly in the period 1977-1996 especially in Latin

America. It is now widely accepted that financial reforms need to be preceded by improved quality of regulation (World Bank, 1989). The more recent South East Asian crisis has demonstrated weaknesses in the legal framework, including the non-existence or deficiency of bankruptcy laws and procedures as well as deficiencies in banking regulation. A further example is that financial reforms have paid little attention to stock market development despite the enormous growth of stock markets over the last twenty years (Arestis and Demetriades, 1997, 1999).

Stock markets assume an important role following financial reforms in developing countries, for at least three reasons. First, the higher interest rates, which are usually associated with financial reforms, especially the liberalization of the banking system, encourage firms to issue equity. Second, stock markets provide an important channel by which international investors gain access to developing economies. Third, they are often imposed, explicitly or implicitly, conditionally as part of financial liberalization packages. Increased stock market capitalization, as a result of domestic or foreign inflows, increases the resources available for investment. Furthermore, deep and liquid stock markets enhance an economy's ability to diversify risk and improve the allocation of capital. Thus, stock markets are potentially important mechanisms for promoting economic growth. However, the extent to which stock markets in developing economies are successful in this endeavor depends crucially on how efficient they are in pricing risk. This, in turn depends on a whole range of institutional factors, including the legal framework within which they operate, enforcement of contracts, bankruptcy laws, transparency etc. It is now well known that stock markets in many developing economies are not able to price risk accurately and suffer from excessive volatility, lack of transparency and insider trading (Singh, 1998). Furthermore, Arestis, Demetriades and Luintel (2000) emphasize the negative effects of the volatility of expectations, thereby questioning the importance of stock markets in the process of economic growth and development.

Despite these problems, financial reforms had a relatively early impact on development policy through the work of the IMF and the World Bank. Perhaps in their traditional role as promoters of free market conditions, they were keen to encourage financial reforms, especially financial liberalization policies, in developing countries as part of more general reforms or stabilization programs. Events following the implementation of financial reforms did not justify the theoretical premises. A number of factors were blamed for these events, including differential speeds of adjustment, competition of instruments, macroeconomic instability and inadequate bank supervision. There occurred a revision of the main tenets of the thesis. More precisely, these revisions followed the experience with financial reforms over the period 1977-1996 as analyzed above.

Caprio et al (1994) reviewed financial reforms in a number of primarily developing countries, with the experience of six countries studied at some depth and length. They conclude that managing the reform process rather than adopting a laissez-faire stance is important, and that sequencing along with the initial conditions in finance and macroeconomic stability are

critical elements in implementing successfully financial reforms. It is thus recommended now that gradual financial liberalization--if not very little--is to be preferred. In this gradual process a "sequencing of financial liberalization" (for example, Edwards, 1989; McKinnon, 1993) is recommended, emphasizing the achievement of stability in the broader macroeconomic environment and adequate bank supervision within which financial reforms were to be undertaken (Cho and Khatkhate, 1989; McKinnon, 1988; Sachs, 1988; Villanueva and Mirakhor, 1990). Employing credibility arguments, Calvo (1988) and Rodrik (1987) suggest a narrow focus of reforms with financial liberalization left as last. These *post hoc* theoretical revisions were thought of as sufficient to defend the original thesis despite its disappointing empirical record.

Further revisions were suggested following the South East Asian crisis. Moral hazard arguments leading to the so-called "overborrowing syndrome" have been employed (McKinnon and Pill, 1997). These arguments are associated with "private" monetary intermediaries, both national and international, because their deposits are insured by governments, and international institutions in their turn would resort to helping governments in financial difficulties if necessary. Consequently, the modern version of the liberalization thesis represents an attempt to account for the implications of imperfect information and, to some extent, institutions. Assuming that sequencing is capable of producing a stable macroeconomic environment and that strengthening banking supervision is sufficient to address the moral hazard and adverse selection problems in bank lending, it is in principle possible to design a programme of reforms that does not result in financial crises. The experience so far with financial liberalization, however, may suggest otherwise. Even where the "correct" sequencing took place (i.e., Chile), where trade liberalization had taken place before financial liberalization, not much success can be reported (Lal, 1987). The opposite is also true, namely that in those cases, like Uruguay, where the "reverse" sequencing took place, financial liberalization before trade liberalization, the experience was very much the same as in Chile (Grabel, 1995). The experience with financial reforms in developing countries in the 1980s and 1990s suggests a marked increase in the frequency and severity of financial crises (Lindgreen, et al, 1996; Demirgüç-Kunt and Detragiache, 1998b). Indeed Demirgüç-Kunt and Detragiache (1998a, 1999) demonstrate that in the case of 53 countries covering the period 1980-1995, banking and financial crises are more likely to occur in liberalized financial systems with weak institutions The stronger the institutional environment is, the lower the probability that financial liberalization would affect the banking sector adversely. Relevant institutional characteristics include: respect for the rule of law, a low level of corruption, good contract enforcement and effective prudential regulation and supervision. These results support the view that financial liberalization should be approached cautiously, especially where institutions are not fully developed.

The most recent crises in the South East Asian countries, in which the initial macroeconomic conditions were very favorable, have shown that even in the best of circumstances, financial liberalization remains a treacherous policy exercise. It is actually surprising that analyses of the Asian crisis have revealed weaknesses in banking supervision and have blamed the moral

hazard in "implicit" deposit insurance as the main culprits. This is so since it is not so long ago when the dominant view on Korea, Thailand and Malaysia was that these countries benefited from strong institutions, including the civil service and government (World Bank, 1993). This analysis suggests that advocating adequate banking supervision, macroeconomic stability, appropriate sequencing of reforms, and "transparency," although useful and necessary, are clearly not sufficient to prevent financial crises. Recent experience suggests that the list should be a great deal longer, and even then there is no guarantee that it would be exhaustive. Strong and uncorrupt institutions, including the civil service and the central bank, a well functioning legal system that effectively enforces contracts and property rights, effective bankruptcy laws and procedures, are amongst some of the items to be added. Ensuring that the items on the list are adequately addressed well before reforms take place, is probably the best strategy to avoid crises in the future under these circumstances. Also of equal importance is that the assumptions underlying the theoretical framework of the reforms should be scrutinized closely in an attempt to ameliorate the serious problems identified in this and the other studies referred to above.

## THE EGYPTIAN EXPERIENCE WITH FINANCIAL REFORMS

### Institutional Arrangements

The Egyptian experience with financial reforms is very interesting. As Hussein (2000) reiterates, the more recent financial reforms have been going on in Egypt since 1981, but more intensely since 1991, and are expected to be completed by 2001. The period 1981-1991 was characterized by an attempt to create more financial intermediation. Even so, during this period the state-owned banks, which carried out some 80 percent of the financial activities, dominated the financial sector in Egypt (see, also, El-Refaie, 1998). Financial reforms must have been very slow, or perhaps cautious, in that during that period Egypt was financially repressed still rather heavily. Hussein and Mohieldin (1997) are very explicit on the issue: "The government set ceilings on deposit and lending nominal rates, imposed a relatively high ratio of required reserves, determined the allocation of credit to particular projects and intervened in the portfolio composition of banks" (p. 5). In 1991, however, Egypt embarked on an extensive financial, and in more general terms, economic reforms as well as structural adjustment programs. The reforms were to some extent in accordance with the IMF and the World Bank prescriptions, themselves based on the McKinnon/Shaw model. One may identify two stages in this process.

The first stage of the reforms (1991-1996), and the most important, comprised almost all of what has come to be known as the orthodox IMF/World Bank macroeconomic stabilization programs and the inevitable restructuring of the banking and financial sectors as well as capital markets. More precisely, they included substantial reductions of the fiscal deficit and monetary restraints, financial liberalization measures and major restructuring of the capital and foreign exchange markets. A *de facto* unified foreign exchange market was established in February 1991, in which banks were allowed to set buying and selling rates free from administrative controls. In addition, exchange rate controls were abolished and convertibility

of the Egyptian pound on both the current account and the capital account was achieved; at the same time an exchange rate anchor was introduced.[7] The convertibility of the currency enabled Egypt to enjoy exchange rate stability since 1991, along with positive real interest rates, both of which encouraged significant capital flows. But although portfolio investment jumped from a very low level in 1994/5 to nearly $1.5 billion in 1996/7, it fell again the following year rather substantially (Smith, 1999, p. 9). The reforms of the period 1991-1996 also included financial liberalization measures. In 1992 interest rate ceilings were abolished for both the private and the public sector; lending limits to the private and public sectors were also eliminated in 1992 and 1993 respectively. Treasury bill issues were introduced on a weekly-auction basis in an attempt to create a market for these financial assets where interest rates would be determined by the forces of demand and supply.

The second stage of the reforms (1996-2001) continued with the liberalization of prices, but also embraced foreign trade liberalization along with the beginnings of privatization and deregulation. It was early during this period that the *Social Development Fund* was inaugurated to alleviate specifically the side effects of the reforms. The fund spent $800m in grants and soft loans between 1997 and 2000. It claims to have provided 300,000 permanent and 150,000 temporary jobs (Smith, 1999, p. 10). Further encouragement towards private sector participation in economic activity is now being implemented so that by the year 2001 the private sector would control around 80 percent of the economy. Banks, insurance companies and big state-owned companies have been earmarked for privatization.

**Performance of Financial Reforms**

This short review of the Egyptian experience with financial reforms points towards a striking feature. This is the avoidance of serious problems in the financial system. Egypt over the period under scrutiny suffered no major banking or currency crises, and yet financial reforms have taken place. Indeed one might suggest that although the financial reforms as such were no different from similar experiments in many of the developing countries reported in Table 1, the Egyptian experience has been successful. We refer to two Tables to make the point. The first is Table 3, which reports the spread between lending and deposit rates in Egypt and in other countries for comparison. The second is Table 4 (as in Subramanian, 1997), where a number of financial system indicators are presented which refer to the period of financial liberalization. Taken together, Tables 3 and 4 suggest that four indicators are of particular significance.

(1) The *spread* between lending and borrowing rates which widens at the beginning of the period under scrutiny to reach a peak of 8.30 percent in 1992, but subsequently narrows to reach a low 3.40 percent in 1999. This low percentage is noteworthy in that it contrasts favorably with spreads in other countries as shown in Table 3. Not only are spreads in Egypt lower than in the developing countries cited in this table (the comparison with Jordan is particularly pertinent[8]), but also of developed countries, with the exception of Spain. (2) The size of *overall provisioning*[9] by the banking system as a whole (Table 4) increased initially as a percentage of loans and then declined, reflecting improved loan quality. This is

consistent with the rising share of credit accounted for by the private sector, indicating a reduction in the share of non-performing loans. (3) The *profitability* of the four public banks between them representing 60 percent of the Egyptian banking system, increased steadily, save for 1991/92 which is an exceptional early increase in the period (due to recapitalization, see Subramanian, 1997, p. 33). (4) The indirect *bank-specific assistance* in the form of Treasury bills, the bulk of which has been held by commercial banks.[10] Table 4 shows that in 1990/91 roughly 78 percent was held in the banking system, increasing to nearly 89 percent by 1995/96, with income from these holdings increasing from 0.4 billion to 2.6 billion respectively (with the equivalent percentages to GDP being 0.4 and 1.2). The entry "Increase in provisions" for the government securities in the same Table, clearly implies that banks did not seem to "provision themselves" against bad debts and yet the spreads were not high by comparison with other countries (Subramanian, 1997, p. 35). As Begg (1996) shows, the prevalence of wide spreads in a number of transition economies reflected the need to cover against bad debts and strengthen capital adequacy. The issue of Treasury bills enabled the banks to avoid "high provisions" and the need for wide spreads between lending and deposit interest rates.

**Explaining the Performance of the Financial Reforms**

The interesting question is, of course, the possible explanation for the apparent success of the Egyptian financial reforms, especially so in view of the observation that in other countries similar reforms resulted in the severe problems alluded to above and evidenced by Table 1. It may not be surprising actually that the financial reforms have avoided severe problems in view of the "cautious" way they have been implemented. It was suggested above that caution is of paramount importance in the implementation of financial reforms. Indeed, Egypt may very well be a good example of what is precisely meant in this context.

It is readily accepted in Egypt that a full dose of financial reforms should not be undertaken in view of the inevitable fierce competition from the international financial markets. So, for example, financial liberalization has only been given a cautious approval and implementation (Hussein, 2000, is a good example). As a result the financial reforms have been implemented without any great sense of urgency. "Gradualism" and "caution" have been the key words. In this process Egyptian banks have had to deal with issues such as mergers and acquisitions, improving the quality of services provided along with cost reductions, enhancing their capital adequacy ratios and addressing the problem of non-performing loans. These are important ingredients of successful implementation of financial reforms.

It would thus appear that reforms have been slow or cautiously implemented. In fact, Roe (1998, p.95) lists a number of financial reforms still to be undertaken. Smith (1999) suggests that "The legal and regulatory systems still remain enmeshed in their ancient cobwebs..... The government still employs, in one way or another, nearly one-third of the work force of 22m; another third work on the land" (p. 4). The institutional framework of the country, however, appears to be strong enough to withstand shocks to the economy. We may mention the recent experience of the country to make the point. There have been three episodes that hit harshly

the economy over the 1990s. First, revenues from tourism went down dramatically following the murder of 58 tourists at Luxor in November 1997; second, the price of oil (half of Egypt's exports) continued to tumble for a long time before the recent upsurge; and third, the Asian crisis produced a drop in both portfolio investment and Suez Canal dues. It would appear, though, that these shocks have been absorbed easily in view of the country's institutional strength (Smith, 1999).

In terms of the theoretical problems identified earlier, the problems with perfect information and profit-maximizing competitive behavior are potentially there, although it should be recognized that the Egyptian authorities through their intervention and cautionary manner in doing so, may have recognized the limitations of these two assumptions. The building up of strength in the institutional framework of the country sits very comfortably with the arguments advanced in this chapter. A further consideration may be pertinent. This is the recognition that bankruptcy and the fear of default can cause serious problems. The Egyptian authorities, unlike the South East Asian authorities, with their cautious approach to financial reforms may have mitigated the severity of this problem.

Ultimately, though, the success of financial reforms depends on the level of interest rates achieved following their introduction and implementation. On this score we entirely agree with Hussein and Mohieldin (1997) who, in their empirical work on the Egyptian experience with financial repression, show that "a *ceteris paribus* increase of the real interest rate may be as deleterious as setting it too low" (p. 19). Indeed, such an increase "would lead, *inter alia,* to discouragement of investment and further deepening of the problem of excess liquidity of the banking system, which, in turn, would encourage banks to apply imprudent activities" (op. cit., p. 20). The setting of the appropriate rate of interest is an issue not amenable to generalizations. It depends crucially on the specific historical and institutional characteristics, as well as on the macroeconomic and financial conditions of the country concerned. For example, in the case of Egypt, Hussein and Mohieldin (1997) are right to suggest that "further comprehensive institutional and policy changes, that go beyond the mere liberalization of some financial variables, are required" (p. 20).

One such institutional and policy change may very well be some degree of financial repression along the lines suggested by Stiglitz (1998), when he argued that "there are a host of regulations, including restrictions on interest rates or lending to certain sectors (such as speculative real estate), that may enhance the stability of the financial system and thereby increase the efficiency of the economy. Although there may be a trade off between short-run efficiency and this stability, the costs of instability are so great that long-run gains to the economy more than offset any short-term losses" (p. 33). Another is the further development of the financial sector. In this sense the emphasis in the 1980s and 1990s on strengthening the banking sector, probably at the expense of the stock exchange, can be construed as a major policy innovation. It has contributed substantially to the strengthening of the institutional framework of the economy, and at the same time enabled the country to avoid the potential speculative excesses that could have been induced by the operation of a stock market at a

grand scale.

## SUMMARY AND CONCLUSIONS

We have drawn on the experience of a number of countries that implemented financial reforms over the last twenty years or so. That experience was marred by serious banking and financial crises, and a number of reasons have been put forward to explain it. The Egyptian experiment with financial reforms is rather different. No serious banking or financial crises took place, and this calls for some explanation. We suggest that the "cautious" approach pursued by the Egyptian authorities, along with the enhancing of the institutional strength of the economy, could explain this experience.

Further development of the financial sector and comprehensive financial liberalization measures, however, cannot be viewed as panacea. A strong regulatory framework is also paramount. Demirgüç-Kunt and Detragiache (1998a, 1999) in their study of 53 countries, for the period 1985 to 1995, show that, although financial liberalization increases the probability that banking crises will occur, their severity can be substantially lower in countries where the regulatory environment is strong. They suggest that "Such institutions include effective prudential regulation and supervision of financial intermediaries and of organized security exchanges, and a well-functioning mechanism to enforce contracts and regulations" (p. 2). Inadequately supervised, newly privatized and inexperienced banks operating in a regime of financial reforms, induce excessively high real interest rates. A degree of control over lending and deposit rates may very well be necessary under these circumstances. The aim of interest rate controls would be to prevent interest rates from reaching excessively high levels. This study has argued that the Egyptian authorities are well disposed to accepting the policy implications of these arguments and findings.

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| **Table 1** | | | |
|---|---|---|---|
| **Costs of Resolving Banking Sector Crises Amounting to More Than 10 percent of GDP (Non-performing Loans as a percent of GDP in Brackets)** | | | |
| **Country and Time Period of Crisis** | | | **Direct Cost of Banking Crisis (percentage of GDP)** |
| **LATIN AMERICA** | | | |
| | *Argentina* | 1980-82 | 55 |
| | *Chile* | 1981-83 | 41 |
| | *Uruguay* | 1981-84 | 31 |
| | *Venezuela* | 1994-95 | 18 |
| | *Mexico* | 1995 | 15 |
| | *Brazil* | 1994-96 | 10 |
| **AFRICA** | | | |
| | *Cote d'Ivoire* | 1988-91 | 25 |
| | *Benin* | 1988-90 | 17 |
| | *Senegal* | 1988-91 | 17 |
| | *Mauritania* | 1984-93 | 15 |
| | *Tanzania* | 1987-95 | 10 |
| **SOUTH EAST ASIA** | | | |
| | *Indonesia* | 1997-99 | 45(55) |
| | *Malaysia* | 1997-99 | 12(na) |
| | *Philippines* | 1997-99 | 17(na) |
| | *South Korea* | 1997-99 | 15(16) |
| | *Thailand* | 1997-99 | 25(52) |
| **MIDDLE EAST** | | | |

| | | | |
|---|---|---|---|
| | *Israel* | 1977-83 | 30 |
| **TRANSITION ECONOMIES** | | | |
| | *Bulgaria* | 1995-96 | 14 |
| | *Hungary* | 1991-93 | 10 |
| **EUROPEAN UNION** | | | |
| | *Spain* | 1977-85 | 17 |
| Source: World Bank (1997); IMF (1999a); Hoggarth et al (2000); Lindgreen et al (1999). | | | |

**Table 2A**

**Emerging and South East Asian Economies:**
**Real GDP Growth (Percentage Change on Previous Year)**

| | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001e** | **2002f** | **2003f** |
|---|---|---|---|---|---|---|---|---|---|
| **Average Real GDP Growth** | 4.5 | 5.1 | 5.0 | 1.2 | 3.4 | 5.6 | 2.8 | 3.3 | 4.5 |
| **South East Asian Economies*** | 8.3 | 7.1 | 4.1 | -8.1 | 7.0 | 7.3 | 2.7 | 5.1 | 4.6 |

Source: IIF (2000, Table 7, p. 10; 2003, Table 3, p. 4)
e = estimate, f = forecast
* Indonesia, Malaysia, Philippines, South Korea, Thailand.

**Table 2B**

**South East Asian Economies: Overall Costs of Financial Crisis (Output Gaps)**

| Country | Date of Crisis | GAP(G)* | GAP(L)** | IMF*** (1999-2002) |
|---|---|---|---|---|
| **Indonesia** | 1997 - | 24.4 | 15.5 | 82 |
| **Malaysia** | 1985 - 88 | 14.5 | 31.5 | na |
| | 1997 - | na | na | na |
| **Philippines** | 1981 - 87 | 38.2 | 111.9 | na |
| | 1997 - | na | na | na |
| **South Korea** | 1997 - | 16.7 | 14.3 | 27 |
| **Thailand** | 1997 - | 24.0 | 27.7 | 57 |

Source: Hoggarth et al (2000); IMF (1999a).
*Cumulative difference between trend and actual output *growth* during the period of crisis (as in IMF (1998)).
** Cumulative difference between trend and actual output *level* during the period of crisis.
***These are forecasts of the output gap as the cumulative difference between the level of actual output and the assumed trend level (on the basis of a 4 percent annual trend growth in output) -- as in IMF (1999a).

**Table 3**

**Spreads Between Lending* and Deposit** Rates in Selected Countries**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| Jordan+ | 4.80 | 5.70 | 5.50 | 5.50 | 5.46 | 5.25 | 5.44 | 5.58 | 6.38 | 5.87 |
| Poland | ----- | 7.70 | 7.20 | 7.30 | 6.60 | 6.70 | 6.10 | 6.50 | 5.90 | 5.80 |
| Czech Republic | ----- | ----- | ----- | 7.67 | 6.05 | 5.12 | 5.75 | 5.63 | 4.07 | 4.22 |
| Slovak Republic | ----- | ----- | ----- | 6.39 | 5.24 | 7.84 | 4.62 | 5.15 | 6.17 | 5.56 |
| Hungary | 4.10 | 4.70 | 8.70 | 9.70 | 7.00 | 6.50 | ----- | 3.30 | ----- | ----- |
| Albania | ----- | ----- | 2.10 | 2.30 | 3.90 | 4.40 | 7.80 | 4.10 | ----- | 12.20 |
| Estonia | ----- | ----- | ----- | ----- | 11.6 | 7.30 | 7.60 | 13.60 | 8.60 | 7.66 |
| Italy | 7.29 | 7.26 | 8.65 | 6.08 | 5.01 | 6.03 | 5.57 | 4.92 | 4.72 | 3.80 |
| Spain | 5.36 | 3.91 | 4.35 | 3.15 | 2.25 | 2.37 | 2.38 | 2.12 | 2.09 | 1.76 |
| Denmark | 6.02 | 4.02 | 4.30 | 4.00 | 4.00 | 6.80 | 6.40 | 5.00 | 4.80 | 4.70 |
| Sweden | 6.76 | 8.54 | 7.40 | 5.30 | 5.73 | 4.95 | 4.91 | 4.51 | 4.30 | 3.93 |
| Egypt | 7.00 | 7.00 | 8.30 | 6.30 | 4.70 | 4.80 | 5.60 | 5.10 | 4.00 | 3.40 |

Source: IMF (1999b).
*Upper margin on commercial bank loans to the general public, except for Jordan where it is the average interest rate on loans.
**Upper margin offered on fixed term deposits for less than one year, except for Jordan where it is the average interest rate on deposits.
+ The Jordanian "spread" does not include the commission rate, which is fixed at 1 percent. If it were to be included, the "spread" should be higher by 1 percentage point.

| Table 4 | | | | | | |
|---|---|---|---|---|---|---|
| **Selected Banking System Indicators (In billions of Egyptian pounds, unless otherwise indicated)** | | | | | | |
| | **1990/91** | **1991/92** | **1992/93** | **1993/94** | **1994/95** | **1995/96** |
| **Share of total credit to private sector (in percent)** | 28.8 | 27.3 | 27.9 | 31.7 | 38.4 | 42.8 |
| **Overall Provisioning (as percent of loans)** | 11.3 | 15 | 16.7 | 16.4 | 14.8 | 13.9 |
| **Stock of government securities** | 3.1 | 12.6 | 23.5 | 28.9 | 25.1 | 26.8 |
| **Percent of total** | 77.7 | 73.8 | 76.9 | 82.1 | 84.1 | 88.6 |
| **Income from government securities** | 0.4 | 1.3 | 3.5 | 3.6 | 2.8 | 2.6 |
| **As percent of GDP** | 0.4 | 0.9 | 2.2 | 2.1 | 1.4 | 1.2 |
| **Increase in provisions** | 1.2 | 1.8 | 2.6 | 2.0 | 2.7 | 2.1 |
| **As percent of income from government securities** | 300 | 138 | 74 | 56 | 96 | 81 |
| **Pre-tax profits of 4 public banks** | 1.4 | 2.8* | 1.7 | 1.9 | 2.2 | 2.7 |
| Source: Subramanian (1997)<br>* Exceptional increase owing to the 6 billion Egyptian pounds recapitalization. | | | | | | |

## NOTES

1. Hoggarth et al (2000) define these as "various types of costs involved with rehabilitating the financial system, including both bank recapitalization and losses incurred through protecting deposits either implicitly or through explicit government deposit insurance schemes" (p.6).
2. IMF (1996) reports that developing countries actually receive about 40 percent of global inflows of foreign direct investment and of almost $260 billion of net portfolio flows over the period 1990-95. They have outstanding liabilities to banks (which report to the IMF) of over $717 billion, which is about $46 billion more than their claims on those banks. In addition, they account for the majority of IMF drawing rights since the late 1970s, and purchase about 25 percent of the exports of industrial countries.
3. There are a few issues and a number of problems in the construction of the measures of

welfare costs of a banking crisis reported in the text. They are discussed in Hoggarth et al (2000).

4. There were no apparent reasons to liberalize the financial and capital markets, other than international pressures (Stiglitz, 2000). In fact, the South East Asian countries had already been running surpluses, with relatively low and falling inflation rates, and saving rates running at record levels of 30 percent or more (Stiglitz, op.cit., pp.1-2).
5. One exception to this was South Korea where foreign borrowings financed investments in tradeable sectors rather than real estate developments (as in the rest of the South East Asia) or imports of consumer goods (as in Mexico and other Latin America countries)--see, for example, Chang (1998, p.1555).
6. Even Soros (1997) recognizes the validity of this proposition when he calls for the formation of an "International Credit Insurance Corporation" to regulate and supervise international capital flows. This recognition by someone like George Soros, demonstrates the importance of curbing financial systems. Also of interest is the recent experience of Chile, where a transaction tax and a requirement that investors deposit 30 percent of their funds with the central bank for one year have been introduced. This imposition came about after a similar crisis in Chile, and so far this country has avoided the South East Asian type of financial crises.
7. There is the intriguing question of why an exchange rate anchor in preference to either a price/wage or a money-based stabilization program. An interesting explanation is provided by Subramanian (1997) who suggests that a most compelling argument is "perhaps the Egyptian context, and the history of exchange shortages and crises, which made the exchange rate an important symbol of stability in itself; exchange rate stability was a consummation devoutly to be pursued and not just a means to achieving broader price stability. Moreover, contemporaneous movements in the nominal rate in the late 1980s and inflation meant that the pass-through effect to domestic prices was perceived as important and an exchange rate anchor was seen as having merit in containing this source of inflationary pressure" (p. 23).
8. Jordan went through a similar experience to that of Egypt's in terms of financial reforms. In September 1988 the authorities in Jordan liberalized the deposit rate of interest, and in September 1993 abandoned direct controls and credit ceilings.
9. Loan loss provisioning should be the relevant variable in the context of the argument in the text. However, since data for this variable do not exist, the data in Table 4 refer to overall provisioning. Subramanian (1997) suggests that in fact "changes in overall provisioning during this period should broadly correspond to changes in loan loss provisioning, which is likely to have been the main impetus for greater provisioning" (p. 32, fn. 18).
10. The point should be made that a high percentage of the banking sector's asset holdings is in Treasury bills. It increased from 8.3 percent (of total security holdings) in 1991 to 53.9 percent in 1996. At the same time banking holdings of government securities and shares declined from 74.2 in 1990 to 17 percent in 1996 (government securities) and from 22.6 percent in 1990 to 12.9 percent in 1996 (shares) - see El-Refaie, 1998, Table 3.2) It follows that Egyptian banks opted for *safe holdings* in short-term government

assets over the period.

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Source: Hoggarth et al (2000); IMF (1999a).
*Cumulative difference between trend and actual output *growth* during the period of crisis (as in IMF (1998)).
** Cumulative difference between trend and actual output *level* during the period of crisis.
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**Table 3**

**Spreads Between Lending* and Deposit** Rates in Selected Countries**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| Jordan+ | 4.80 | 5.70 | 5.50 | 5.50 | 5.46 | 5.25 | 5.44 | 5.58 | 6.38 | 5.87 |
| Poland | ----- | 7.70 | 7.20 | 7.30 | 6.60 | 6.70 | 6.10 | 6.50 | 5.90 | 5.80 |
| Czech Republic | ----- | ----- | ----- | 7.67 | 6.05 | 5.12 | 5.75 | 5.63 | 4.07 | 4.22 |
| Slovak Republic | ----- | ----- | ----- | 6.39 | 5.24 | 7.84 | 4.62 | 5.15 | 6.17 | 5.56 |
| Hungary | 4.10 | 4.70 | 8.70 | 9.70 | 7.00 | 6.50 | ----- | 3.30 | ----- | ----- |
| Albania | ----- | ----- | 2.10 | 2.30 | 3.90 | 4.40 | 7.80 | 4.10 | ----- | 12.20 |
| Estonia | ----- | ----- | ----- | ----- | 11.6 | 7.30 | 7.60 | 13.60 | 8.60 | 7.66 |
| Italy | 7.29 | 7.26 | 8.65 | 6.08 | 5.01 | 6.03 | 5.57 | 4.92 | 4.72 | 3.80 |
| Spain | 5.36 | 3.91 | 4.35 | 3.15 | 2.25 | 2.37 | 2.38 | 2.12 | 2.09 | 1.76 |
| Denmark | 6.02 | 4.02 | 4.30 | 4.00 | 4.00 | 6.80 | 6.40 | 5.00 | 4.80 | 4.70 |
| Sweden | 6.76 | 8.54 | 7.40 | 5.30 | 5.73 | 4.95 | 4.91 | 4.51 | 4.30 | 3.93 |
| Egypt | 7.00 | 7.00 | 8.30 | 6.30 | 4.70 | 4.80 | 5.60 | 5.10 | 4.00 | 3.40 |

Source: IMF (1999b).
*Upper margin on commercial bank loans to the general public, except for Jordan where it is the average interest rate on loans.
**Upper margin offered on fixed term deposits for less than one year, except for Jordan where it is the average interest rate on deposits.
+ The Jordanian "spread" does not include the commission rate, which is fixed at 1 percent. If it were to be included, the "spread" should be higher by 1 percentage point.

| Table 4 | | | | | | |
|---|---|---|---|---|---|---|
| **Selected Banking System Indicators (In billions of Egyptian pounds, unless otherwise indicated)** | | | | | | |
| | **1990/91** | **1991/92** | **1992/93** | **1993/94** | **1994/95** | **1995/96** |
| **Share of total credit to private sector (in percent)** | 28.8 | 27.3 | 27.9 | 31.7 | 38.4 | 42.8 |
| **Overall Provisioning (as percent of loans)** | 11.3 | 15 | 16.7 | 16.4 | 14.8 | 13.9 |
| **Stock of government securities** | 3.1 | 12.6 | 23.5 | 28.9 | 25.1 | 26.8 |
| **Percent of total** | 77.7 | 73.8 | 76.9 | 82.1 | 84.1 | 88.6 |
| **Income from government securities** | 0.4 | 1.3 | 3.5 | 3.6 | 2.8 | 2.6 |
| **As percent of GDP** | 0.4 | 0.9 | 2.2 | 2.1 | 1.4 | 1.2 |
| **Increase in provisions** | 1.2 | 1.8 | 2.6 | 2.0 | 2.7 | 2.1 |
| **As percent of income from government securities** | 300 | 138 | 74 | 56 | 96 | 81 |
| **Pre-tax profits of 4 public banks** | 1.4 | 2.8* | 1.7 | 1.9 | 2.2 | 2.7 |
| Source: Subramanian (1997)<br>* Exceptional increase owing to the 6 billion Egyptian pounds recapitalization. | | | | | | |

## NOTES

1. Hoggarth et al (2000) define these as "various types of costs involved with rehabilitating the financial system, including both bank recapitalization and losses incurred through protecting deposits either implicitly or through explicit government deposit insurance schemes" (p.6).
2. IMF (1996) reports that developing countries actually receive about 40 percent of global inflows of foreign direct investment and of almost $260 billion of net portfolio flows over the period 1990-95. They have outstanding liabilities to banks (which report to the IMF) of over $717 billion, which is about $46 billion more than their claims on those banks. In addition, they account for the majority of IMF drawing rights since the late 1970s, and purchase about 25 percent of the exports of industrial countries.
3. There are a few issues and a number of problems in the construction of the measures of

welfare costs of a banking crisis reported in the text. They are discussed in Hoggarth et al (2000).

4. There were no apparent reasons to liberalize the financial and capital markets, other than international pressures (Stiglitz, 2000). In fact, the South East Asian countries had already been running surpluses, with relatively low and falling inflation rates, and saving rates running at record levels of 30 percent or more (Stiglitz, op.cit., pp.1-2).
5. One exception to this was South Korea where foreign borrowings financed investments in tradeable sectors rather than real estate developments (as in the rest of the South East Asia) or imports of consumer goods (as in Mexico and other Latin America countries)--see, for example, Chang (1998, p.1555).
6. Even Soros (1997) recognizes the validity of this proposition when he calls for the formation of an "International Credit Insurance Corporation" to regulate and supervise international capital flows. This recognition by someone like George Soros, demonstrates the importance of curbing financial systems. Also of interest is the recent experience of Chile, where a transaction tax and a requirement that investors deposit 30 percent of their funds with the central bank for one year have been introduced. This imposition came about after a similar crisis in Chile, and so far this country has avoided the South East Asian type of financial crises.
7. There is the intriguing question of why an exchange rate anchor in preference to either a price/wage or a money-based stabilization program. An interesting explanation is provided by Subramanian (1997) who suggests that a most compelling argument is "perhaps the Egyptian context, and the history of exchange shortages and crises, which made the exchange rate an important symbol of stability in itself; exchange rate stability was a consummation devoutly to be pursued and not just a means to achieving broader price stability. Moreover, contemporaneous movements in the nominal rate in the late 1980s and inflation meant that the pass-through effect to domestic prices was perceived as important and an exchange rate anchor was seen as having merit in containing this source of inflationary pressure" (p. 23).
8. Jordan went through a similar experience to that of Egypt's in terms of financial reforms. In September 1988 the authorities in Jordan liberalized the deposit rate of interest, and in September 1993 abandoned direct controls and credit ceilings.
9. Loan loss provisioning should be the relevant variable in the context of the argument in the text. However, since data for this variable do not exist, the data in Table 4 refer to overall provisioning. Subramanian (1997) suggests that in fact "changes in overall provisioning during this period should broadly correspond to changes in loan loss provisioning, which is likely to have been the main impetus for greater provisioning" (p. 32, fn. 18).
10. The point should be made that a high percentage of the banking sector's asset holdings is in Treasury bills. It increased from 8.3 percent (of total security holdings) in 1991 to 53.9 percent in 1996. At the same time banking holdings of government securities and shares declined from 74.2 in 1990 to 17 percent in 1996 (government securities) and from 22.6 percent in 1990 to 12.9 percent in 1996 (shares) - see El-Refaie, 1998, Table 3.2) It follows that Egyptian banks opted for *safe holdings* in short-term government

assets over the period.