

# Egypt: The Environment For Adjustment To Trade Liberalization

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## ABSTRACT

*This paper investigated the potential effect of market failures in labor and capital markets in addition to market failure due to high transaction costs on the transitional path to trade liberalization. All three types of market failure were found to reduce the speed of adjustment to free trade and contribute to high adjustment costs. The paper also examined the consistency of the macroeconomic environment with the objectives of trade liberalization. It is postulated that a macroeconomic environment that is basically recessionary is likely to lead to high adjustment costs.*

## INTRODUCTION

Free trade, a policy stance that is hardly new dating back to the classical economists has been traditionally advocated mainly on the basis of the conventional static gains from trade - those arising from a more efficient reallocation of resources - and owes its more recent revival to what has come to be known as the dynamic gains from trade - those arising from the reallocation of investment resources or in response to increasing productivity as emphasized in the new growth theories. However, while the theoretical evidence seem most compelling, moving from the realm of theory to practical implementation raises a number of concerns particularly for countries that have adopted inward oriented strategies – and Egypt is no exception- over a relatively long period of time coupled with heavy reliance on tariff and non tariff barriers for the purpose of promoting an indigenous industrial sector. These concerns are basically related to the problems and costs of adjustment to trade liberalization.

The few qualitative studies addressing problems of adjustment - most of which dates back to the early seventies - hypothesized that imperfections in labor, capital and product markets are the main factors contributing to high adjustment costs to trade liberalization. A leading World Bank empirical study (Michaely et al, 1991) revealed that the transitional costs of adjustment to trade liberalization are usually manifested in rising unemployment rates, balance of payment problems and declining industrial output. Meanwhile, the magnitude of these costs depends on the nature of the economic environment - existing market arrangements, the institutional setting, macroeconomic policies etc. - within which trade liberalization is implemented.

In particular, empirical evidence reveals that the success of many trade liberalization attempts have hinged on the ability of efficient import substituting and expanding export industries to quickly absorb the resources released from declining industries. This minimizes pressure on the balance of payment and reduces the incidence of transitional unemployment. The World Bank study confirms that these are two of the main factors underlying the failure or at least the partial reversal of many trade liberalization attempts. (Michaely et al, 1991). The *speed* of adjustment is the critical element in this analysis. Naturally, the speed of adjustment will be influenced by the economic environment within which trade liberalization takes place.

In light of these considerations, some of the broad characteristics of the economic environment for the Egyptian economy will be analyzed in this paper. Whether markets work well or not, is a question of central importance. To the traditional types of market failures acknowledged in the literature, this paper adds the class of market failures arising from high transaction costs as a possible factor influencing adjustment. The focus, in general, will be on identifying the constraints -if any- that might impede the efficient adjustment to trade liberalization and assessing the degree of consistency of the macroeconomic environment with the objectives of trade liberalization.

The rest of the paper will be organized as follows. How market failures influence adjustment is taken up in section one. In section two the state of the working of markets in Egypt will be examined. Macroeconomic policies will be analyzed in section three. Finally, section four presents the conclusion and policy implications.

## **SECTION I**

Since the inception of the General Agreement on Trade and Tariffs (GATT) in 1947, reducing trade barriers became the top priority goal of the major industrialized countries. Successive rounds of negotiation over the span of almost half a century achieved little towards the complete elimination of these barriers. In anticipation of high adjustment costs, many countries developed or underdeveloped alike, either chose to abandon the whole idea of free trade, were slow to introduce trade reform or quickly opted for policy reversals as soon as problems of adjustment loomed ahead. The recurrence or persistence of problems of this kind suggests that more research is certainly needed to identify the factors underlying this phenomenon along with the appropriate adjustment policies before it becomes too optimistic to quest for a free world trading system.

The task of identifying the factors that lead to adjustment problems becomes relatively straight forward if it is possible to sketch the details of an ideal economic environment, one that facilitates the release of resources from lower to higher productive use and therefore minimize on the adjustment costs to trade liberalization. Deviations from this ideal environment points to the respective factors and provides grounds to anticipate adjustment problems ex ante. In other words, the factors responsible for these deviations are the very same ones that lead to adjustment problems. The larger are these deviations, the larger will be the magnitude of adjustment costs. Details of micro and macro nature are both relevant. Discussion of the macroeconomic details will be deferred to the section on the Egyptian economy. This is partly because they have been emphasized elsewhere (Michaely et al , 1991) and partly because it will be more illuminating to illustrate their importance with an actual case study. Below, the emphasis will be on some microeconomic details. Allowing for a more general exposition allows in turn for broader generalizations to the experience of other countries. Hence a separate section was necessary.

### **Adjustment To Trade Liberalization: Microeconomic Conditions**

It is beyond dispute that under conditions of perfect competition and perfect foresight, market forces will always provide the most efficient adjustment mechanism through signals embedded in changing relative prices and job opportunities. The reallocation of resources - under these conditions - will be *frictionless and instantaneous* (Bank and Tumlir, 1986) precisely because markets are presumed to work well. There are no barriers to entry and exit, prices are sufficiently flexible, information is perfect, externalities are absent and the cost of market contracting is zero. Even the most basic of institutions e.g. firms, money, public regulations etc become irrelevant in this setting basically because the optimality of the perfectly competitive system rests in part on the assumption that institutions do not play any role in the determination of equilibrium prices. (Furubotn and Richer, 1991)

In this environment, firms will contract or exit if losses are incurred while more efficient firms will expand and new entry will occur as profitable opportunities persist or widens. Losses can be merely incurred due to unfortunate circumstances or can simply reflect the release of resources into more profitable uses. The rate of exit or decline which thus occurs independently of economic conditions prevailing (like a recession) can be defined as the *natural rate of decline*. The reallocation of resources will be frictionless and instantaneous, but will nonetheless involve costs that are inevitable and are to a large extent part of the working of the market economy where success is rewarded and failure penalized. (ECC, 1988)

Recognizing the limitations of this ideal economic environment, which being neoclassical in spirit abstracts from many of the realities of the economic system, particularly from institutional structure, - a factor that is known to influence both incentives and behavior - (Furubotn and Richer, 1991) provides the starting point in the analysis of adjustment problems to trade liberalization. In reality, markets can and do fail and institutions influence incentives and behavior all of which will have profound implications for, the speed of adjustment, the properties of the adjustment path to trade liberalization and the magnitude of adjustment costs.

The main point is that as we move to environments where markets are imperfect (labor, capital and product markets) uncertainty and risk increases and prices lose much of their informational content (Bank and Tumlir, 1986) creating distortions to the adjustment process. Problems of adjustment typically occur when distortions and presumably the lack of perfect foresight, create divergence between the private and social perceptions of the costs and benefits of adjustment, preventing -in turn- the optimal allocation of resources. In this case, not only will the adjustment process be less than instantaneous, but instantaneous adjustment might not be the socially optimal policy. (Mussa, 1982)

Many of the factors that impede the working of the market mechanism are institutional in nature. Allowing for more institutional detail in the analysis is essential to understanding problems of adjustment in general. Relaxing the assumption of zero cost of market contracting is considered a potentially powerful factor that contributes to the deviation of the social benefits and costs of adjustment from the private costs and benefits. Considering this category of market failures provides more scope to analyze and emphasize the influence of the institutional environment and institutional arrangements on the path of adjustment to trade liberalization. We will begin the discussion by the more traditional types of failure in factor markets.

#### *Labor Market Failures*

Sources of market failures in labor markets are numerous, ranging from the asymmetry of information about the future pattern of comparative advantage, externalities in the accumulation of human capital - which is usually responsible for under investment by both employer and employees in firm specific skills - to congestion problems that increase the costs of search by workers. (Trebilcock et al, 1990)

A number of institutional factors can further inhibit the efficient working of the labor market. On the demand side, these include wage rigidities due to wage indexation or pressure from labor unions in addition to social security regulations which constraint the ability of firms to alter the size of their labor force especially where adjustment entails downsizing. Other restrictive practices include cumbersome administrative dismissal (and hiring) procedures which usually provides wide scope for government intervention. (Banks and Tumlir, 1986). Market failures also arise when pensions deter firms from hiring elderly workers (Wonnacott and Hill, 1987). On the supply side, a number of studies have confirmed that unemployment insurance (especially for unskilled workers) and the subsidization of housing costs in certain regions can reduce the incentives for dislocated workers to seek reemployment in regions other than their home ones. (Banks and Tumlir, 1986)

#### *Capital Market Failures*

Inadequate collateral or credit rationing are among the leading causes of market failures in capital markets. This implies that some borrowers will be rationed out of the capital market constraining their ability to finance investment for expansion or restructuring. The credit constraint is likely to be even more binding for labor where funds are needed to cover the costs of retraining or reallocation. (Wonnacott and Hill, 1987).

Like wise the case with labor markets, several institutional factors contribute to imperfections in capital market. Complex systems of taxation renders the process of ranking alternative investment opportunities according to private and social profitability intrinsically difficult. In environments characterized by excessive inflationary pressures, a tax system where depreciation allowances are based on historical values of the capital stock reduces the after tax profitability of investment and tilts it in favor of short term projects. Investment demand can be also curtailed when regulations that restrict market entry encourage collusive behavior on behalf of lending institutions and consequently lead to high interest rates. Low administered interest rates reduce the volume of savings and thus available finance. The cumulative effect of these policies tends to reduce the sources of mobility in the capital stock, both the outflow (depreciation) and the inflow (new investment). (Banks and Tumlir, 1986)

Market failures in both labor and capital markets essentially reduces the mobility of factors of production. When the mobility of factors of production is reduced, adjustment to changing economic circumstances - at least in the short run - can lead to excessive costs. These costs arise in the form of disallocation cost measured by the amount

of output sacrificed as labor and capital released from declining activities remain idle and in the form of adjustment costs measured in terms of the resources sacrificed to retrain labor, reorganize production operations and reorient the capital stock within the same firm, intra-sectorally or intersectorally (Richardson, 1980).

#### *Market Failures due to Transaction Costs*

Analyzing adjustment problems under conditions of market failures of the variety discussed above has been the main occupation of the literature addressing problems of adjustment to trade liberalization. Market failures in labor and capital markets - which mainly arise as a result of price rigidities - were the prime factors impeding instantaneous and frictionless adjustment. Notwithstanding the significant contribution towards understanding problems of adjustment, and although institutional factors were found to be responsible in many cases for imperfections in both labor and capital markets, the literature suffers from several caveats. Because the literature deals mostly with developed countries, the institutions of which are in general sound, the way in which institutions influence the path of adjustment did not receive adequate attention. In particular, one class of market failures those that arise -on lines of transaction cost theory- due to high transaction costs have been virtually neglected.

The main idea underlying the theory of transaction costs is that under the assumptions of asset specificity, bounded rationality and opportunism, the perfectly competitive model is no longer a realistic representation of the economic environment within which trade liberalization will take place. It is no longer realistic either to assume perfect foresight. The competitive model must essentially be replaced by the governance model which renders deviations from the neoclassical ideal referred to earlier more pronounced. Adjustment within the framework of these imperfect market alternatives is neither instantaneous nor frictionless. (See Williamson, 1985, Klein et al, 1978, Crocker and Masten, 1991). According to the theory of transaction cost, institutions influence equilibrium prices. In many respects prices are expected to deviate from competitive prices. For example, firms charge prices that are higher than competitive levels to safeguard investment in specific assets. (Williamson, 1985) which can contribute to costly misallocation of resource. (Klein, 1984)

The main point is that the more important asset specificity is , the more important the share of an economy's activity that is characterized by sunk cost – which acts as a strong barrier to exit and thus entry- and thus the slower the speed of adjustment and the higher is the cost of adjustment. In particular the process of transferring released specific resources from inefficient to efficient activities will be hindered and consequently released resources are likely to stay idle. It follows that instantaneous and frictionless adjustment to free trade is not possible. The cost of adjustment will be higher the larger is the share of an economy's activity that is characterized by sunk cost.

## **SECTION II**

The analysis conducted in section one proves that an economic environment characterized by well functioning markets and well developed institutions is an important prerequisite for the efficiency and sustainability of the adjustment path to trade liberalization. As Egypt moves further towards integrating its economy in world markets, further reduction in tariff rates are expected to take place, it is thus necessary to examine the nature of the economic environment and how it conforms with or deviates from the ideal model sketched in the preceding section. The pertinent question is whether markets work well or not. It is also necessary to examine the extent to which the macroeconomic environment is consistent with the objectives of trade liberalization. The First question is taken up in this section.

Egypt's experience with free markets is quite new. Before 1974, and for roughly a decade and a half, an economic system based on central planning prevailed. During this period, a massive wave of nationalization of domestic and foreign private enterprises laid the ground for the creation and growth of a large public sector. Prices of numerous products in addition to key macroeconomic variables like interest rates and exchange rates were administratively set. A program of guaranteed employment for university graduates by the government and a policy of credit rationing implied that labor and capital resources were largely administratively allocated.

With the initiation of the Open Door Policy in 1974, a development strategy based on free markets was instituted. Although the Open Door Policy clearly assigned the leading role in the development process for the private sector, the public sector nonetheless continued to play the dominant role. Moreover, prices as well as resource allocation remained to be administratively determined through out 1974-1986. This policy was gradually abandoned under Egypt's structural adjustment program which was implemented following the slowing down of economic growth starting the eighties and the rising foreign indebtedness.

However, lacking dynamism is considered one of the striking features of domestic markets in Egypt. One main reason for lacking dynamism is the presence of barriers to entry and exit.

### **Barriers To Entry And Exit**

#### *Investment regime*

Two main aspects of the investment regime act as strong barrier to entry. The first is the excessively high capitalization requirements, especially deterrent of small enterprises. (Goans, J. 2002). The second is related to local content requirement. In 1997, Law 8 which granted foreign investment - for the first time - national treatment was introduced. Although local content requirement has been abolished in accordance with the Trade Related Investment Measures (TRIM) agreement, to qualify for custom exemptions, local content requirements are set as high as 60% for some industries (United Nations, 1999).

#### *Imperfect Labor Markets*

A number of legal, regulatory and institutional factors that act as strong barriers to entry and exit. Among the most important of these barriers are those imposed by Labor laws.

Until the initiation of law 12 in 2003, the principal labor law governing employer/employee relationship in Egypt was Law 137 of 1981. According to this law the hiring or dismissal of employees under permanent contracts by firm must take place through the Ministry of Man power. For this same category of employees, the firm must abide by social security laws. Dismissal is subject to very stringent and cumbersome administrative procedures. Only upon the approval of a stoppage committee formed by a Ministerial decree, are firms allowed to alter their labor force. Contractual obligations of the firms remain in effect even under conditions of liquidation or bankruptcy ( in the latter case as long court as appointed trustees are able to run the firm contractual obligations remain binding and only when the court approves asset liquidation of a bankrupt firm can employment contracts be terminated) until the stoppage committee finalize it's decision. Again only for reasons completely outside the control of employers (natural disasters, wars, etc.) are final closures and thus termination of contracts- becomes possible. Finally, minimum wage legislation exist varying by industry, occupation and region and they are frequently adjusted for the cost of living. (Assad, 1993)

Law 137 of 1981 has had quite a different impact on private versus public sector and formal private versus informal private sector. Establishments belonging to the informal private sector which accounts for 30% of total employment outside agriculture (establishments with less than ten employees), are generally not required to abide by the labor law. For the formal private sector, hiring on the basis of temporary contracts was the most commonly used method for circumventing this law whereby only 15-20% of formal private sector outside agriculture are covered by permanent contracts. In contrast there is no scope to circumvent the labor law in the case of the public sector where employment -except for construction- takes place only under permanent contracts. While employment under temporary contracts have reduced incentives for private firms to invest in training for sector specific skills, permanent employment contacts for the public sector have reduced its ability to adjust the size of its labor force in the face of changing economic conditions. (Assad, 1993). Meanwhile, introducing new technology to restore competitiveness is obstructed due to costly dismissal procedures. Labor regulations has been also responsible for the increasing capital intensity in the private sector. (Fawzy, 1999).

A number of health, environmental and safety regulations are also imposed by the labor law. The cost of abiding by the law for larger firms increases further if one takes into account the cost of training employees which as

mentioned above many firms are hesitant to undertake since the possibility that these trained employees would leave the firm remains open) given that support services for technical, vocational and administrative training is lacking for Egypt's Labor force, half of which is illiterate. All the above factors, particularly those pertaining to labor law contributes to the existence of large *sunk costs* that impedes both the entry and exit of firms. In general, this has rendered markets in Egypt noncontestable and comprised a form of protection enjoyed by existing firms as opposed to new entrants. (World Bank, 1994).

The new labor law, law 12 of 2003, have greatly simplified dismissal and hiring procedures but does not apply in retrospect, i.e. applies only to permanent contracts concluded after 2003.

### *Merger and Bankruptcy*

Several other factors act as barriers to efficient exit. These include as discussed above labor regulations in addition to a legally complex merger and bankruptcy procedures. For example, the firm cannot take a decision -sell, merge, and change the product mix- which might involve changing the size of its labor force without the approval of the stoppage committee. (World Bank, 1992).

The bankruptcy law<sup>2</sup> is too strict in terms of the sanctions imposed in the wake of insolvency. For example, debtors will be expelled from the commercial register, are deprived from the right to do business or occupy certain jobs. "Debt discharge" is not allowed even after liquidation and creditors receive their share of liquidated assets. Rehabilitation is not possible unless debt is repaid or after three years from the ending date of bankruptcy. For these reasons, debtors will avoid or delay adjudication as bankrupt, retard the process of administration of assets that follows bankruptcy or avoid exiting in general. (Nathan Associates, 1998).

Some provisions - like partial discharge of debt - necessary for allowing debtors to continue in business and reorganize or restructure the firm while under the protection of the bankruptcy court are absent from the law. Troubled, but potentially viable firms are thus forced to exit. Lengthy, complicated and costly liquidation procedures due to the lack of special bankruptcy rules as well as specialized courts prevents the prompt reallocation of both physical and labor assets of an inefficient bankrupt firms to higher uses. As such, the bankruptcy law discourages entrepreneurship by increasing the risks associated with doing business, acts as a strong barrier to - exit and in turn entry - and retards the efficient reallocation of resources. (Nathan Associates, 1998).

In order to understand the impact of such impediments on adjustment it is useful to examine how they have affected the private sector so far. Both the investment regime and the regulatory framework within which the private sector was - and still is- operating had important repercussions not only on the type of activities favored by the private sector but also on the size structure of establishments. The private sector in Egypt is dominated by small scale enterprises (firms with less than ten employees) which accounted for 98.3% of establishments of the private sector and accounted for 77.3% of the total employment in 1996. (Handoussa, 2002). Its early flourish goes back to the 1960 where small size informal private enterprises were the only means of survival during an era of nationalization and central planning. With the liberalization of 1975 several factors have helped reinforce this structure: (World Bank, 1994)

*First:* The investment incentive package introduced was primarily designed to benefit medium to large scale projects. For example, licensing approval -before 1991- was contingent on the use of serviced land located in new urban cities where full ownership is first set on probational basis and is denied if the project is not set within three years. In the outset, this has meant that land cannot be used as collateral. Moreover, the cost of registration fees for land is very high equal to 12% of its assessed value. (Law 6/1991 gave a temporary 50% reduction in those fees for land registered through 1994). These high fees are sizable costs to cash constraint small scale enterprises.

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<sup>2</sup> Egypt is currently drafting a new bankruptcy law

*Second*, the private sector regulatory framework has inhibited the growth of small scale enterprises to medium or larger scale. To mention but a few, the high cost of abiding by the regulations imposed by labor laws can only be avoided by small size.

*Third*: Again because of the weak state of the judicial system, banks over collateralize to secure their debt and thus most of bank lending is directed towards medium to large enterprises and is mainly of short run maturity (five years).

*Fourth*: A very restrictive legal framework for securitization impairs the ability of firms in general and small scale enterprises and new firms - that lack any credit history - in particular to mobilize lending.

Barriers to exit and entry is one important factor responsible for the lacking competition in domestic markets. The effect of lacking competition was reflected in the high prices and poor quality of most goods and services produced in Egypt. One area where this evident in the services sector (Financial intermediation, insurance, business services, telecommunications, transportation etc.) For firms, the cost of the poor quality of services corresponds to an implicit tax estimated to be equivalent to 15% tariff. Because of the importance of services inputs in a wide range of industrial activity, this implicit tax has substantially reduced the effective protection they enjoyed. (Hoekman, 1997).

Barriers to exit, entry or alter size reduces the degree of “dynamism” in the economy. (ECC, 1988). Firms that are small in size are unable to and do not have any incentive to expand which implies that markets provide little if no scope to benefit from economies of scale, while firms that have to downsize in order to be able to compete or restructure are constrained from doing so. Low dynamism ultimately reduces the speed of adjustment of the economy in response to changing economic conditions and impedes the release of resources out of inefficient activities to higher uses.

### **Market Failures Due To Transaction Costs**

Adjustment problems will be further accentuated due to the condition of asset specificity which serves as an important barrier to exit and entry and a leading cause of market failures as highlighted in section one. This is true to the extent that the share of the economy’s activities that is characterized by sunk costs is large and to the extent that other aspects of the regulatory and institutional environment impose high transaction costs on those who engage in economic activity.

To begin with, it must be noted that court jurisdiction in Egypt is extremely inefficacious and business surveys have proved that its is one of the most binding constraints facing private investors. Resolving disputes is very costly in terms of time and resources. It usually takes around four years on average to settle disputes compared to one year outside courts. Contract and law enforcement in general is very weak. Expropriation risk is high. The current legislation - inherited from the central planning era - which is also more suited to a closed economy is deemed incompatible with an opened market economy. (Fawzy, 1999). Transaction costs arise because laws are complex, procedural requirements are enormous and the system itself rests fundamentally on the premise that the government is responsible for assuring “propriety” of any action. In general, such characteristics have only served reinforce government control over business activity (Goans, 2002) and thwart the forces of competition. Property rights are not well defined. Some of the articles in the constitution asserting collective ownership of means of production continue to exist. (Hillal, 2002). Although Egypt is a signatory to the main international patents, trademarks and copyrights convention, violation of copyright laws especially in the areas of video and audiocassette and disks, medical textbooks and computer software is considered a major problem for business involved in these activities. As a result Egypt has been on the United States ‘watch list’ and ‘priority watch list’ which pertains to countries that does not provide adequate intellectual property protection according to Section 301 of the United States Trade Act of 1988. The problem is less severe in cases of protection of trademarks and industrial designs and models but law enforcement is rather weak as courts have little experience in dealing with infringement cases. The lack of supporting infrastructure and the weakness of the judicial system acts as a strong barrier to investment in research and development and inhibits innovation. It is not surprising then that expenditure on research and development by both private and public sectors in Egypt is below the benchmark 1% of GDP set for developing countries. (United Nations, 1999).

The environment is highly uncertain, a feature that is ranked by investors as another important binding constraint to doing business in Egypt. Inconsistent policies are frequently initiated. Policy reversal is very common since there are no national (law, constitution) or international restraints (foreign aid that is tied to economic rather than political conditions., strong commitment under the GATT/WTO etc.,) to prevent such reversals. (Galal, 1996).

The institutional environment exemplifies most of the features that discourages investment in specific assets; high uncertainty, weak property right and law enforcement in addition to a letter of law that is too strict (labor law, bankruptcy law) (Williamson, 1991) all of which could be taken as indications that asset specificity is not so important in the Egyptian economy. While there is preliminary crude evidence that in the case of the private sector both human and physical asset specificity is not significant given the small informal nature of establishments, it is not clear whether this is true in the case of the public sector which continues to account for the major share of economic activity. However, even if asset specificity is not significant, by its very nature, public ownership implies that the high powered incentives of the market are totally suppressed, a major factor that reduces the speed of adjustment to free trade. Meanwhile, and as mentioned earlier, an institutional environment with the above undesirable characteristics rules out revitalization as a viable adjustment strategy whenever it is necessary to invest in specific asset.

Several other aspects of the institutional and regulatory environment are responsible for high transaction costs. To mention but a few, firms incur transaction costs from the very first minute a decision is made to enter the business to the very last minute until - if conditions dictate so - it exits the market. During the course of its activities, transaction costs are incurred as tax obligations are met, as inputs that cannot be procured domestically are imported and as part or all of its output is exported.

Forming a new enterprise is subject to lengthy and costly procedural requirements. (Goans, 2002). Exiting involves considerable transaction costs primarily because those who are responsible for administering liquidation of a bankrupt firm receive fees that are deducted from the value of liquidated assets, the size of which increase as this process lasts longer, creating strong incentives for costly delays and reducing the amount creditors can ultimately receive. (Nathan Associates, 1998).

Problems arising in the implementation of tax laws are typical with most other laws. The perceptions of the business community is that even when the right laws are enacted there are usually problems with implementation and enforceability. For example, there is considerable lag between the enactment of laws and the issuing of executive decrees. This leads to ample room for discretion by the implementers and consequently lead to high transaction costs. Besides there is lack of qualified personnel for implementation. This causes problems especially when laws are vague or contradictory. (Ghoneim, 2002).

Trading<sup>3</sup> involves substantial transaction costs mainly due to administrative red tape. Strikingly enough, administrative red tape have rendered the major incentive introduced to offset the antiexport bias of the trade regime - the temporary admission and drawback mechanism- ineffective. Besides the limited scope of benefiting from these incentives in terms of eligibility (when first introduced they were not extended to indirect exporters and remains to be granted only if the local content of the final product is 20% while non sale indirect taxes cannot be refunded) they are characterized by administratively cumbersome procedures. The resulting transaction cost along with other forms of existing administrative barriers to exporting is estimated to account for 10-15% of the export price. Importing activities share similar burdens. These include low quality/high cost port services - raising the CIF cost of imports by over 10% - and cumbersome import clearance procedures equivalent to a tariff of 15%. (World Bank, 1997a).

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<sup>3</sup> Egypt is drafting a new custom law and the authorities are trying to simplify custom clearance procedures, but the outcome is still to be seen

### **Microeconomic Conditions: The Implications For Adjustment**

At this point, the answer to the question posed in the beginning of this section can now be safely asserted to be negative; given the above evidence markets in Egypt *do not* seem to work well. This is true for product (some goods are still subject to price controls), labor and capital market. Market failures arise because of the presence of barriers to entry and exit, price rigidities and high transaction costs, all of which provide grounds for anticipating high adjustment costs to trade liberalization. Whether the prevailing macroeconomic conditions will provide more evidence in support of this last result is an issue that remains to be examined and will be undertaken in the next section.

### **SECTION III: MACROECONOMIC CONDITIONS**

In the analysis of the adjustment costs to trade liberalization, it is natural to expect that macroeconomic conditions influence the adjustment path. After all, adjustment costs are ultimately manifested in falling output, rising unemployment and increasing pressure on the balance of payment all which are macroeconomic variables.

Besides favorable initial conditions on account of these three variables, macroeconomic conditions conducive to minimum adjustment costs encompass all conditions or policies that promote economic growth. Only then can expanding efficient import substituting and export industries absorb resources released from inefficient activities, the incidence of transitional unemployment be reduced and pressure on the balance of payment be relieved. (Michael et al., 1991). In what follows developments in some of the macroeconomic variables and policies that are important in this regard will be analyzed.

#### **Real Exchange Rate Appreciation**

An overvalued exchange rate is one of the main factors that contribute to a macroeconomic environment that is not favourable to low adjustment costs due to its important role in stimulating exports. Since the exchange rate unification in 1991, Egypt has adopted a managed float regime with the nominal exchange rate pegged to the U.S. dollar. To maintain a stable exchange rate, the authorities intervened -on several occasions by buying dollars -which were mainly flowing as a result of revival of Egypt's stock market- Despite partial sterilization, the resulting increase in the money supply fueled inflation which in turn translated into an appreciation of the real exchange rate against the dollar (Abdel Khalek, 1995) by roughly 33.05% between 1991-1997. Another factor responsible for real exchange rate appreciation vis a vis a basket of currencies of Egypt's major export competitors was an increase in the value of the dollar relative to other currencies. (Kheir ElDin and El Shawarby, 2002).

Since 2001, Egypt has moved from a fixed exchange rate regime to a more flexible one in which periodic adjustment to the official rate will take place whenever market forces - as envisaged by the central bank - dictate so. (Bennet, 2002) The nominal exchange rate has since then dropped to 5.7 LE/\$ in 2006. However, the phenomenon of real exchange rate appreciation continues to persist whereby the real exchange rate appreciated by approximately 49% against the US dollar over the interval 1999-2005. Real exchange rate appreciation has been one of the main reasons behind the concentration of private investment -at least medium to large enterprises- in the nontradable sectors (World Bank, 1997b) and continues to discourage production for exports.

#### **Monetary And Fiscal Policies**

One of the main goals of the reform efforts since mid eighties was achieving monetary and fiscal stringency in order to reduce the rate of inflation. Since then a considerable decrease in the rate of growth of monetary aggregates took place. Annual rates of growth in the money supply M1 (excluding demand deposits in foreign currencies) declined from 7.21% in 1986 to (-4.03%) in 1991, showing positive and increasing rates of growth afterwards, but declining to -6.71% by 2000 and further to 5.6% in 2003. However, the rate of growth in the money supply increased to 121% in 2005. The annual rate of growth in domestic credit decreased from 18.77% in 1986 to 7.89% in 1991 increased to 13.3% in 2003 and declined to 4.2% in 2005. Lending interest rates increased from 15% in 1986 to 20.3% in 1992 decreased to 13.5% in 2003 and witnessed no change since then.

The annual rate of growth of the money supply was curtailed as the budget deficit - and thus its monetization - fell dramatically from (-5,494) million LE in 1990 to a surplus of 1828 million LE in 1995. However, the budget deficit climbed to (-9946) million LE in 2003. Meanwhile the rate of inflation (measured as percentage change in the consumer price index at 2000 prices) fell from 12% in 1993 to 4.2% in 2003, but increased to 28% 2005. (It must be noted however that the rate of inflation depends on the nature of the basket of goods chosen to calculate index prices). Rising budget deficits and inflation will no doubt jeopardize stability and thus shake investor's confidence in the Egyptian economy when it is most needed.

### **Aggregate Demand**

Aggregate demand including imports for goods and services ( in constant 2000 prices) exemplified modest rates of growth through out much of the period 1999- 2005. These rates have varied between 7.42% to 8.63% respectively. Wide spread excess capacity in the industrial sector signals insufficient demand as one of the main factors influencing capacity utilization. The annual rate of growth in exports of goods and services (in constant 2000 prices) have declined from 35% in 2004 to 13% in 2005.

Given that the bulk of merchandise exports consists of crude or refined petroleum it is difficult to foresee any revival of aggregate demand based on manufactured exports especially since the bulk of Egypt's manufactured exports enjoy some form or another of preferential treatment (Generalized System of preferences) which will soon be eroded as a result of trade liberalization world wide. (Yeats, 1998). On the other hand, stringent rules of origin continues act as powerful constraint facing exports of manufactured goods under the association agreement between Egypt and its major trading partner the European Union.

### **Current Account**

The situation on the current account front is to a considerable degree favourable. Although the trade balance has been consistently in deficit since 1999, Egypt has been running current account surplus since 2002. The current account surplus amounted to 3922 million dollars in 2005. However, the overall balance of payment registered a deficit of (584) million dollars, but is considerably lower than in 1999.

### **Macroeconomic Conditions: The Implication For Adjustment**

The above figures provide clear evidence of a macroeconomic environment that is basically recessionary. Empirical analysis identifies a recessionary environment (weak domestic and external demand) as one of the most important factors contributing to the presence of high adjustment costs to trade liberalization. (Michaely et al , 1991) Under such circumstances it is hard to expect that trade liberalization will have a significant impact on investment allocation and consequently on growth especially as the phenomenon of real exchange rate appreciation continues to persist.

Contraction in those sectors adversely affected by competition from imports will not be counteracted by expansion in the more competitive sectors. As a result, released resources are very likely to remain idle. Furthermore, a sluggish supply response is very likely to aggravate pressure on the balance of payment and jeopardize the sustainability of all efforts to liberalize trade. In fact, and since the very first attempt to liberalize trade in 1986, the macroeconomic environment has not been consistent with the objectives of trade liberalization.

## **SECTION IV: CONCLUSION AND POLICY IMPLICATIONS**

This paper aimed at identifying the factors that might impede efficient adjustment to trade liberalization for the Egyptian economy. In general, an economic environment hampered by market failures and plagued by inefficient institutions reduces the degree of dynamism in the economy and thus certainly raises concerns about the costs of adjustment to trade liberalization. It is important to recognize – at this stage - that most of the problems discussed in this paper have been also discussed elsewhere and were in general considered among the main factors responsible for the sluggish response of the Egyptian economy to reform. What this paper has served to highlight is that these

problems are likely to contribute to high adjustment costs and thus jeopardize the sustainability of reform efforts. However, the correct policy response is not to abandon liberalization all together but to carefully plan the correct timing and choose the path of tariff liberalization along with the set of adjustment policies that minimizes the magnitude of any adjustment costs.

In particular, reform on both the microeconomic and macroeconomic level is needed. In this regard, removing the institutional sources of market imperfections in the labor market like minimum wage legislation is necessary. Stringent hiring and firing procedures must be simplified. The bankruptcy law must be modified along the lines of laws prevalent in developed countries so as to facilitate exit. Capitalization requirement has to be reduced to encourage entry by small scale enterprises. In the mean time, competition law must be put in place. One way to deal with imperfections in the capital market arising due to collateral requirements is through the government providing credit guarantees to firms that cannot tap capital markets.

The most important macroeconomic area of reform is exchange rate policy. Egypt should adopt a flexible exchange rate system so that the exchange rate reflects the true scarcity of foreign currency. Any devaluation occurring will automatically help relieve pressure on the balance of payment by making imports expensive and exports cheaper. This will makeup for any reduction in tariffs following liberalization and will consequently provide the necessary protection for efficient import substituting industries. At the same time, this policy will enhance expansion in the export sector. Nevertheless, to prevent any overvaluation of the currency due to capital inflows, the Central Bank should interfere by buying dollars when necessary.

It remains to discuss the relevance of Egypt's reform experience to other developing countries. What is so evident about this experience is the absence of a *comprehensive* vision for reform. For example Egypt launched institutional reform a decade and a half after adopting the World Bank and IMF structural adjustment and stabilization package in 1991 and only when its negative repercussions on growth and resource allocation became hard to ignore. Passing new laws is not, however, the end of the story. Resistance by those who benefited from vague and complicated laws – the civil servants or the implementers in general- through side payments and bribes have proved to be strong. In fact, reform of the civil service should have accompanied and perhaps preceded institutional reform. So far it is not clear how the government intends to deal with this problem. To conclude, the overriding impression of Egypt's experience is that reform on many fronts came late, was incomplete and slow. This breeds an economic environment that is likely to give rise to high adjustment costs to trade liberalization.

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