# Egypt's Request for Country of Operations Status

## Technical Assessment*

**27 September 2011**

*** This document is provided as background reference material exclusively for participants to the EBRD SEMED Partnership Assembly on 28 November 2011. It was produced by EBRD Management for discussion with the Bank's Board of Directors at an earlier date, and may contain information that is out of date.**

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# 1. Introduction and Overview

Egypt has requested to become a recipient country of the EBRD. In accordance with Resolution No.134 of the Board of Governors approved during the Annual Meeting in Astana, the Bank is committed to giving early consideration to this request.

As set out in the Report of the Board of Directors to the Board of Governors of 28 July 2011 (BDS11-187) and consistent with the respective resolutions and amendments to the Agreement Establishing the Bank (AEB), it is expected that the Bank would follow a three-phase process in becoming active in Egypt. In the first phase, the Board of Directors would consider the use of cooperation funds; in the second phase, once the amendment of Article 18 AEB has been accepted by members, the Board of Governors would consider the use of Special Fund resources for special operations; in the third phase, once the amendment of Article 1 has been accepted by members, the Board of Governors would consider granting recipient country status to Egypt and therefore allowing the use of ordinary capital resources for ordinary operations.

This Technical Assessment (Update) has been prepared in order to allow the Board of Directors to make an informed decision at the first stage of the process. It will be further updated ahead of the second stage and replaced by a “regular” Country Strategy for Egypt in the third stage. Additional updates either orally or in writing, for instance on progress towards implementing the political aspects of the Bank’s mandate, will be provided to the Board of Directors periodically whenever warranted. These would allow the Board to calibrate the Bank’s activities in accordance with events.

Based on the Board of Governors’ Resolution in Astana, the Bank has now conducted assessment missions to Egypt, consulted with the authorities, benefited from the views of numerous other parties and conducted an initial scoping of demand for the Bank’s services. The Deauville Partnership process has offered the opportunity to build a strong basis for cooperation with other IFIs. The Technical Assessment thus serves not only to deepen the Bank’s understanding of the situation in Egypt, but also to identify an initial set of priorities for action that could be financed with cooperation funds. While not a Country Strategy in the strict sense (since that would require recipient country status), it should therefore be seen to discharge some of the practical purposes of a Country Strategy.

The paper has four main sections. Section 2 provides an update of political developments and the current status of Egypt’s progress towards pluralism and multi-party democracy. It is meant to inform the Bank’s judgement on whether Egypt is on a trajectory that will allow it to meet the political aspects of Article 1 within the not-too-distant future. The assessment is based on the Bank’s established methodology for country strategies, and in particular, presents an analysis “criteria by criteria” as envisaged in the 1991 policy on Implementing the Political Aspects of the Bank’s Mandate (BDS91-16). In addition, the section takes into account some of the specificities of the political environment in Egypt with which the Bank has been less familiar in its existing region of operations.

Section 3 sets out an assessment of Egypt's progress in economic transition. Given that the Bank has had little prior knowledge about Egypt, and absent the background usually contained in the Bank's Transition Reports, the section also presents some of the history of reforms in the country and is supplemented by considerable sectoral detail in Annex 1. The section describes a country that is "midway" in transition and where significant transition gaps persist despite considerable reform efforts in the past. But it also notes that the manner in which some of these past reforms were implemented, and other necessary measures left untouched, may have contributed to insufficient job creation as well as a general perception of unfairness and exclusion. Ensuring that reforms promote a market economy that is fair and inclusive is a top priority of the authorities and must also guide the EBRD's engagement in Egypt.

Section 4 describes progress made in ensuring that the Bank's potential engagement in Egypt is closely coordinated with other IFIs. The work done so far, including under the aegis of the Deauville Partnership, should provide comfort that the Bank will focus its activities on those areas in which it has skills and capabilities that are complementary to other IFIs. Steps have also been taken for the Bank to join, and in some cases lead, joint initiatives among the IFIs in Egypt and elsewhere in the new region, once it has the mandate to do so.

Finally, section 5 presents the results of a scoping mission that assessed opportunities for the Bank to promote Egypt's transition through operations. It identifies project areas that address transition gaps and where the Bank's specific business model, on its own or jointly with other IFIs, would add value. While the Bank will not be in a position to finance projects during the first stage of its engagement, this review helps to inform the selection of possible technical assistance and similar activities, which are also outlined in this section. Altogether, there would appear to be considerable demand that meets the criteria for a Bank engagement, and the section provides for a broad range of possible initial operations by the Bank.

# 2. Political Assessment

## 2.1 Introduction

The events of January and February 2011, in which large-scale street demonstrations resulted in the resignation of Egypt's President Hosni Mubarak, have created a new political reality in Egypt. Although the future direction is somewhat uncertain, the prospects for a more democratically governed Egypt appear stronger than at any time since President Mubarak came to power 30 years ago. The assessment of Egypt's political system in light of Article 1 covers the system in place before the recent events and the system that is emerging today.

## 2.2 History

When former President Mubarak came to power in 1981 Egypt had a Constitution that provided for guarantees of political and civil rights under a strong presidential system of government. Several Articles in the 1971 Constitution were considered contentious by Egypt's opposition parties and checks and balances in the system were limited. However, by far the most problematic issue was the Emergency Law instituted soon after President Mubarak was inaugurated, which suspended many of the rights and freedoms guaranteed under the Constitution. The extraordinary circumstances under which Hosni Mubarak became president, following the assassination of his predecessor Anwar al-Sadat, provided the rationale for the imposition of emergency legislation in 1981. Despite legitimate concerns regarding the need to combat terrorism and drug trafficking in recent years, the sweeping powers contained in the Emergency Law became increasingly difficult to justify and explain during President Mubarak's thirty years in office.

The provisions of the Emergency Law allowed the imposition of administrative detention for 45 days without trial (renewable indefinitely), curtailed the right to freedom of expression and assembly, enlarged the conditions under which the police could lawfully use force against Egyptian citizens, and permitted a special "security court" to issue rulings that often circumvented constitutional and international safeguards. Freedom of the press was restricted in practice, mainly through the state's dominance of broadcast media and monopoly of printing and distribution for both public and privately-owned publications. The media landscape was divided unequally amongst state-owned broadcast and major print media, news outlets owned by large political parties, and some small independent privately-owned newspapers. The three leading daily newspapers were state controlled. The dominant state-controlled media empire strongly influenced the public discourse and supported the former regime.

Elections conducted under these circumstances were neither free nor fair and were characterised by significant government interference in the electoral process. In 2007 a constitutional amendment banned religion-based parties, which included the strongest opposition party Muslim Brotherhood. Members of that party, along with others deemed by the authorities to be antagonistic towards the regime, were often subjected to harassment, arbitrary arrest and imprisonment. The last elections held under President Mubarak's rule in 2010 were seriously flawed with opposition party observers and candidate representatives blocked from polling stations and independent monitors not permitted to observe the process.

## 2.3 Recent political reforms

The 18-day uprising in Egypt in January and February 2011, which resulted in the forced resignation of President Mubarak, has ushered in an era of political reform that is still incomplete. Several specific features of the early transitional period in Egypt – as a post revolutionary society that is building new political institutions from scratch and dealing with the complex task of dismantling the old system of governance, as a country where the military plays a central role in political life and where the role of religious parties are still to be worked out – have to be weighed up carefully before reaching even tentative conclusions about the country's political trajectory.

*Constitutional reform, elections and political party formation*

When then-President Mubarak stepped down on 11 February 2011, power was transferred to the Supreme Council of the Armed Forces (SCAF), a 20 member body that had been meeting at times of national emergency and is led by Field Marshal Muhammed Hussein Tantawi. The military leadership stated that it would remain in control during a transition period until free democratic elections could take place. The Constitution was suspended and the Parliament was dissolved. The prior cabinet under Prime Minister Ahmed Shafiq was allowed to continue to serve as a caretaker government, though in early March PM Shafiq resigned and the Transport Minister, Essam Sharaf, was asked to take his place and form a new government. A major government re-shuffle was carried out in July, partly in response to protests over the composition of the government, delays in fully dismantling the old regime (and removing its remnants from key positions in government and the judiciary) and putting in place the institutions and people to replace them.

A major milestone in the political reform process was the initial changes to the Constitution immediately following the revolution. A Constitutional Reform Committee, led by Tarek el-Bishry, a respected retired judge, drafted Constitutional amendments that were put to a national referendum on 19 March 2011.

The Constitutional amendments addressed eight articles of the Constitution, including:

- reducing the presidential term in office from six to four years and instituting a two-term limit;
- changing the criteria and the requirements for running for the presidency to allow for more open competition;
- reinstatement of full judicial supervision of elections;
- strengthening parliament's power to approve a state of emergency request by the President and limiting it to 6 months, after which extensions must be put to a public referendum;
- guaranteeing constitutional human rights provisions even in cases of alleged terrorism.

The Constitutional Reform Committee had a limited remit to address the major obstacles to democratic governance, free and fair election and the rule of law. Articles related to freedom of expression and association and media freedom are expected to be part of a more thorough reform of the Constitution by a Constituent Assembly to be named by the new parliament after elections. Critics of this process, including several of the smaller and less established political parties, have questioned the composition of the Constitutional Reform Committee (it was handpicked by the military leadership) and whether a 'quick fix' to the Constitution to enable early elections, before tackling the fundamental question of what type of democracy Egypt should build (parliamentary or presidential), was the best way forward.

Notwithstanding these reservations, the referendum held on 19 March was successful. The referendum was carried with 77 per cent voting in favour on a turnout of 40 per cent, which was higher than in previous Egyptian polls. The voting was largely calm and consistent with good practice in elections, though some irregularities were reported by observers. Voting rules were relaxed to allow around half the population the right to vote – extending the franchise to anyone over 18 years of age with a national identify card. Significantly, and in contrast to its recent past, the Egyptian people had an opportunity to participate in an electoral process whose outcome was not known in advance.

The next step is for Egypt to hold parliamentary and presidential elections. The original date for parliamentary elections of June 2011 was postponed to September and then again postponed to November, to allow more time to prepare the process and for parties to organise themselves. As announced by the SCAF on 27 September, the elections to the lower chamber (People's Assembly) will be held over three rounds starting on 28 November and ending on 3 January 2012. The election to the upper chamber (Shura Council) will start on 29 January. Both houses are expected to hold their inaugural sessions in mid to late March. There are 52,000 polling stations around the country. Each stage of the election will require around 10,000 judges to supervise the process. The new parliament is expected to elect a 100-member Constituent Assembly to draft a new Constitution, a process which is expected to take up to one year. No date has been set for Presidential elections and a full transfer of power.

On 3 July, the SCAF issued a decree defining a new electoral system, which allocates half the seats according to a first-past-the-post system in single-mandate districts and half through proportional representation according to party lists. Subsequent to that, in the face of pressure from political parties that expressed concern over the possible return to power of former political elites through the single-mandate races, the Government introduced amendments to the law under which 2/3 of the seats would be allocated through proportional representation and 1/3 in single mandate districts and also that political parties could field candidates in the single mandate races. This satisfies some but not all political forces in the country. A new law on political parties was also introduced, which relaxes conditions for forming new parties. Parties must have 5,000 registered members from 10 provinces (with a minimum of 300 from each) to take part in elections, which could make it difficult for smaller parties to participate; however, the threshold for parties to enter parliament is set at 2 per cent, which is relatively low.

The process of developing a more pluralistic political system began almost immediately. In anticipation of fresh elections, activists, businessmen and community leaders quickly started forming new political parties. On 19 February a Cairo court approved the establishment of the Al Wasat (Centre) Party, which had been awaiting registration for 15 years. Al Wasat, a splinter group of the Muslim Brotherhood, is considered a moderate Islamic party. The Muslim Brotherhood itself, the country's longstanding Islamist party, announced the establishment of the new Freedom and Justice Party (FJP), while several splinter groups have formed separate, mainly moderate Islamist parties. A small fundamentalist Salafi party, Al Nour, has also been established. The Free Egyptians Party was started by Egyptian billionaire and Coptic Christian Naguib Sawiris, and supporters of the former head of the International Atomic Energy Agency Mohammed El Baradei started the Al Adl (Justice) party. Users of Facebook, a social-networking site often credited with helping to organise the movement that toppled the Mubarak regime, have organised a new party under the name "25$^{th}$ January Party" after the date of the first protests. With around 25 parties having been formed since 11 February, it seems likely that many will form electoral coalitions. Liberal secularist parties are congregating around the Egyptian Bloc, while the FJP is forming a National Democratic Alliance for Egypt Bloc.

*Civil society, media and human rights*

Egypt has had a tradition of active civic life, with more than 20,000 registered NGOs, but before now they had not been permitted to have a role in the political process and came under heavy controls due to the Emergency Law and a restrictive NGO law. The street demonstrations that began in Cairo and quickly spread to Alexandria and other Egyptian cities are evidence of a healthy degree of civic activism that is a necessary component of a pluralistic, multiparty democracy.

Since the transfer of power to the SCAF, the spirit of protest has continued but several limitations remain in place that have sparked criticism from NGOs and others. Groups that have been critical of the SCAF during the transition period to civilian rule, especially their treatment of thousands of civilian detainees being tried in military courts, have come under particularly heavy scrutiny and NGOs complain of a smear campaign against them. The SCAF explicitly raised the concern that one group – the April 6 Movement – was serving "foreign agendas". Subsequently, the State Security prosecution opened an investigation into the foreign funding of NGOs and the Central Bank has requested that all domestic banks in Egypt report to the Central Bank and the Ministry of Solidarity and Social Justice on NGO account transfers. The law on NGOs (the 2002 Associations Law that has not been amended) requires groups that receive foreign funding to first seek government approval through the Ministry of Solidarity and Social Justice, which can be a means to restrict the activities of critical NGOs.

Since the transfer of power, reform of the state-owned media – including through de-regulation, liberalisation, recruitment policy and journalist training – has not progressed, but the media landscape is more pluralistic and open than in the past. The influence of internet-based news and social networking sites as a source of information is clearly a potent counterbalance to state dominance of the media, though broadcast and print media still have a lot of influence over public opinion.

The largest state-run and private media outlets quickly switched their positions after the revolution to support the new authorities. A key challenge will be to overcome the deeply ingrained habit of self-censorship even after overt state controls are removed.

## 2.4 Status of political transition

The political transition in Egypt is at an early stage. Some important milestones that the Bank uses to assess compliance with Article 1 have been reached while others have not.

*Political accountability*

**Elections**. The preparation for the country's first ever free national elections is proceeding in a normal fashion, albeit with delays. The delays have been introduced to allow more time for technical preparations and for political parties to form and campaign. The military leadership appears to be committed to holding elections as soon as feasible and to hand over power. Necessary laws on the electoral system and political parties have been put in place which provide for political competition and contestation and an election commission to oversee the process has been formed. Constitutional reforms have been approved through a referendum, which further guarantee basic elements of democratic governance and contested elections. The referendum appears to have met international standards and reflects the will of the electorate, which overwhelmingly supported the proposed reforms. Domestic observer groups – media, parties and NGOs – will monitor the elections later this year, and, in a reversal of an earlier ruling, international observers are also likely to take part. Representatives of organisations with good sources of information and expertise on the holding of democratic elections – the EU, UNDP and National Democratic Institute – have been involved in training domestic observation teams and expect the elections to be mainly free and fair, despite the obstacles the authorities face with election administration.

**Representative government and an accountable executive**. Egypt does not currently have a representative government or an accountable executive. Ultimate political power continues to reside with the military junta until elections can be held and power transferred to civilian leaders and institutions. The military's legitimacy derives from its conduct during the revolution and not from a national plebiscite. It is normal for countries that have been through a revolution to have an interim government in place that maintains continuity in providing basic public goods and services until new elections can be held. The SCAF and the government are mainly held accountable through the civic activism of well-organised groups who have used street demonstrations to communicate their preferences, to which the leadership has been generally responsive.

**Separation between the state and political parties**. The former ruling National Democratic Party was disbanded and dozens of new parties have been formed in recent months. The process of creating and strengthening political parties after many years of political inertia will take time and expectations for this dimension of multiparty democracy should remain realistic, especially in light of the experience of the former communist countries where the party systems after 20 years of transition are in some cases far from mature.

*The rule of law and corruption*

**Constitutional rule and means of redress**. The Emergency Law which had superseded all other constitutional rights was suspended in practice and the SCAF had publicly vowed to revoke the law before elections, in line with the reforms to the Constitution passed in March. However, recent violent protests in Cairo directed at the Israeli embassy have triggered a re-enforcement and extension of the Emergency Law. Following large scale protests at the end of September, the SCAF announced that it was considering a suspension of the Emergency Law in time for the beginning of parliamentary elections on 28 November. Separately, President Mubarak has been placed under house arrest, his assets frozen and his trial on charges of corruption, abuse of office and ordering the killing of protesters during the revolution began on 3 August. Former Interior Minister Habib al Adly and several security officials from the former government are also on trial for abuses committed before and during the revolution.

**Independence of the judiciary, equal protection under the law and fair criminal procedure**. Judicial reform and reform of other institutions underpinning social order has not been undertaken systematically. However, the Interior Ministry and police forces have been purged of elements guilty of the worst excesses during the previous administration and the revolution. Most political prisoners were released. For the first eight months following the transfer of power to the SCAF, there were serious concerns that thousands of civilian detainees were to be tried in military courts and that their full civilian rights were not being respected. The SCAF was under pressure to review this policy, and in early October indicated that henceforth detainees who are not accused of violating military laws – such as assaulting servicemen or damaging military property – would be referred to civilian courts.

**Separation between business and politics**. Since the transfer of power, several former regime officials and business elites close to the Mubarak family have been dismissed, arrested or are under investigation. The key reforms needed to promote good governance, transparency and integrity – reforms to public administration, reducing administrative barriers to trade and investment, competition laws and public disclosure to name a few – have not been taken up by the interim authorities whose main focus has been to prepare for elections and the transfer of power.

*Civic and human rights*

**Freedom of speech, media, association and assembly**. These are being respected far more today than under the previous regime, but there are some clear limitations still in place. Reporting on the military and the activities of the SCAF is scrutinised closely and criticism can result in harassment or arrest, in accordance with laws still on the books making it an offence to report on the military without permission. There is a need for training to improve professional standards and for the development of a professional code of conduct. It should become a top political priority of the civilian government after elections to pass new laws on freedom of the press and NGOs.

These should also become the subject of further constitutional guarantees by the Constituent Assembly that will write a new Egyptian Constitution.

**Freedom of conscience and religion**. Freedom of religion is now practiced more freely than under the previous regime, which banned certain groups and repressed others. However, there have been instances of sectarian strife, mainly between Islamists and Christian Copts; extremists have played a role in these. A large-scale protest in Cairo in October turned violent and resulted in the death of 25 people, mostly Coptic Christian protesters. The authorities' actions in dealing with the unrest raised many questions on the use of lethal force. Full guarantees under the law for religious freedom and against discrimination on the basis of faith will need to be established under the new Constitution.

**Gender equality**. Under President Mubarak, women enjoyed firm protections under the law and efforts were made to promote gender equality. Women played a strong role in the revolution, but some feel that women's empowerment has suffered in recent months. There were no women on the commission to reform the Constitution before the referendum in March and only one woman minister in the government today compared to four before the revolution. The new electoral law removes the 64-seat quota for women in parliament, but it does require that each party list contains at least one female candidate.

## 2.5 Assessment

The transitional authorities have undertaken important commitments to democratise political life in Egypt and reform the system: beginning to dismantle the repressive system in place before the uprising and transfer of power, adhering to a clear timetable for constitutional amendments, paving the way for credible parliamentary elections. In recognition of the progress already made to develop democratic institutions, and the commitments undertaken to make further progress in this direction, Egypt has been invited into the G-8's Deauville Partnership. This important reference point supports the conclusion that Egypt is engaged in a transition towards a free, democratic and tolerant society, but there is clearly much more to be done to solidify this process. Some of the commitments to democratic institution building and pluralism have not yet been realised and further political volatility in Egypt cannot be ruled out.

Institutions of democratic governance are being slowly put in place, but some questions persist as to whether these will be adequate to deliver a democratic system in substance as well as form. The main accountability mechanism for the moment is the activism of well-organised civic groups. Revocation or at least suspension of the Emergency Law is a pre-requisite of credible, free and fair democratic elections.

The future role of the military, which played an important and positive role during the uprising, is not yet clear. The military leadership does not appear to have a clear vision or political agenda, other than to turn over power to civilian rule in due time; however, the security situation on the ground is tenuous and questions on the appropriate timetable for handing over power have caused frustration and contributed to instability.

Frustration about systematic corruption and the unequal distribution of benefits from Egypt's economic growth was a major contributor to the protests that ultimately removed President Mubarak from power. When a legitimate government is put in place, it must become a top priority to deal with remnants of the old system that produced high levels of corruption and cronyism. Otherwise, social discontent could once again destabilise the system.

# 3. Transition Assessment

This section provides a summary assessment of the state of reform and transition of the Egyptian economy. The outline of the latest reforms and forward looking elements - in the context of the Deauville Partnership - builds on Egypt's own priorities as described in "Egypt, the way ahead – facing current challenges and building for the future"[1]. A more detailed sector-level analysis is presented in Annex 2.

## 3.1 From state dominance to incomplete reform, 1953-2010

The starting point of Egypt's modern economic history was the socialist state created by General Gamal Abdel Nasser during his 17 year rule of Egypt (1953-1970). This blended elements of a centrally planned economy – including nationalisation of all industrial plants, banks, and insurance companies, and a state employment guarantee for university graduates – with import substitution and trade protection policies characteristic of many other developing countries during the period. Industrial exports were oriented mostly towards countries in the Soviet bloc.

Between Nasser's death in the early 1970s and the 2011 Tahrir square revolution, Egypt embarked on a gradual return to a market-based model, punctuated by setbacks and macroeconomic crises. Broadly, five phases can be distinguished:

- *Partial reforms followed by debt crisis, 1970 until late 1980s*. Low growth and fiscal pressure originating from the 1973 war with Israel triggered a reform program, the "Open Door Policy", which reduced exchange controls, relaxed restrictions on the private sector and invited foreign capital, while maintaining import protection with high import tariffs and price distortions for energy, agricultural products and capital. By 1984, growth accelerated to 9 per cent on the back of rising global oil prices, capital inflows and loose fiscal policy, which was accompanied by the rapid accumulation of public debt. After oil prices collapsed in 1986 and the fiscal deficit widened to above 15 per cent of GDP, Egypt could no longer service its external debt, leading to a 1987 Paris Club debt restructuring.
- *A first comprehensive reform effort, 1991-98*, triggered by a second Paris Club deal and a new IMF-supported programme. One third of state-owned enterprises were privatised between 1991 and 1998 and commercial principles were introduced in some others. Many investment and production controls were abolished, government monopolies dismantled, and average tariffs reduced. The fiscal deficit was reduced from 17 per cent of GDP in 1990 to 2.5 per cent in 1994, mostly by cutting public investment. Capital account restrictions were eased, current account restrictions removed and the exchange rate unified. In response (and helped by a better external environment), growth accelerated to 5.5 per cent in 1997 and unemployment declined.
- *Stagnation in response to slower growth and economic and political shocks, 1998-2003*. External shocks such as lower oil prices and the "sudden stop" in

[1] Presented under the Deauville Partnership to the Finance Ministers Meetings, Marseille, 10 September 2011.

emerging market capital flows following the 1997-98 Asian and Russian crises were compounded by home-grown problems, such as the 1997 Luxor terrorist attack and a domestic financial scandal in 1998-99, which revealed unsound banking practices. The result was capital outflows, lower growth, and pressure on the fiscal accounts. A 2001 devaluation restored external competitiveness, but public finances continued to deteriorate, reaching a deficit of 9 per cent of GDP by 2003, as a result of increases in subsidies, public sector wages and infrastructure spending.

- *A second comprehensive reform round, 2004-2008.* These reforms continued on the path initiated during the 1990s, with additional privatisation, tariff reductions and removal of FDI restrictions, but went much further with respect to financial sector reform (including the privatisation of the third largest bank), improvements in the business environment (a.o. improving conditions for start-ups and creating a competition agency), and fiscal-structural reform (which included significant energy retail price rises in 2005-06).
- *Reform standstill, 2008-2010.* Although Egypt weathered the global financial crisis well, with growth slowing but remaining positive in the range of 4-5 per cent year-on-year (Table 3.1), the crisis also led to a standstill and some backtracking on reforms. Fiscal expansion took the form not only of accelerated investment spending and new PPP projects, but also the introduction of export subsidies, and the exemption of a wide range of investment goods from sales taxes. Even fiscal reforms without any budgetary impact in 2008/09 were postponed, and so was the move toward inflation targeting, which the central bank had been contemplating since the early 2000s.

Egypt's reform attempts prior to the Tahrir square revolution resulted in one undisputed success story: external liberalisation. Most direct barriers to foreign investment in Egypt were removed, and both tariff and non-tariff trade barriers are low compared to most transition economies. Average tariffs have been below 7 per cent since 2007. In other areas, however, reforms remained incomplete to varying degrees. This is taken up in Section 3.3 on transition gaps.

## 3.2 Recent developments and reform plans

Between the spring of 2009 and the onset of the demonstrations, capital inflows, exports, and growth rebounded. Financial markets recovered, growth in tourism receipts was back to 2005 levels and Suez Canal receipts back to 2006 levels. Real GDP growth exceeded 5 per cent last year, and inflation began to rise again as domestic demand recovered and global commodity prices soared.

Inevitably, the disruptions and increased political and economic uncertainty that accompanied the February revolution have had an economic cost. Tourism has collapsed, and business operations were disrupted, including as a result of bank closures. At the same time, there were no panic withdrawals from the Treasury bill market or the banking system.

Real GDP contracted by 4.2 per cent y-o-y in the first quarter, driven by a steep decline in investment expenditures, tourism receipts, manufacturing and construction. Latest estimates indicate a contraction of 3 per cent in the first half of 2011 and an annual real GDP growth in FY2010/2011 of a mere 1 per cent, as compared to 5.2 per cent the year earlier. Unemployment jumped from slightly over 9 per cent in 2010 to almost 12 per cent by end-June 2011, and it is likely to rise further if economic recovery does not accelerate.

A combination of high (though declining) international commodity and food prices and domestic supply shortages due to unfavourable weather continue to keep headline inflation at around 10 per cent (10.4 per cent y-o-y in July). Nevertheless, the Central Bank has kept key interest rates on hold in view of the downside risks to output. Supported by foreign exchange market intervention and capital controls, the exchange rate gradually depreciated but has remained broadly flat since mid-April.

However, the balance of payments worsened significantly due to a sharp decline in revenue from tourism (arrivals shrank by 29 per cent y-o-y in June) and capital – both FDI and portfolio – outflows. At the same time, revenues from the Suez Canal have recovered, following a recent removal of tax exemptions and transit fee discounts for certain vessels. Nonetheless, international reserves dropped by about USD16.5 billion between January and June 2011 to reach USD26.5bn (equivalent to 5 months of imports). The short-run risk of a balance of payments crisis is nevertheless limited by low external debt, still adequate reserves (covering three times short term external debt), a captive and liquid banking system that meets most public financing needs, and pledged donor support.

The banking sector remained stable, the deposit base largely unaffected and dollarisation increasing only slightly. However, bank lending to the real economy has come to a halt and is negative in real terms; there is a risk of continued crowding out of private sector credit by the funding needs of the government, which are to be met primarily from domestic sources.

The fiscal deficit widened to about 10 per cent of GDP in FY2010/2011 as a result of lower revenue collection and emergency spending, including a 15 per cent increase in public sector wages and pensions, and ad-hoc payments to compensate damaged businesses and newly unemployed workers. The budget for FY2011/12 aims at reducing the fiscal deficit to 8.6 per cent of GDP, and financing it primarily from local sources (namely banks), as well as support from Gulf Arab states, other donors and some IFIs. [2] The lower fiscal deficit is mainly to be achieved through lower expenditures, abandoning some investment projects. On the revenue side, the government has increased taxes on tobacco and the (previously flat) income tax rate is increased from 20 per cent to 25 per cent on companies and individuals earning more than EGP10 million. Major structural reforms, including transition to a VAT-like consumption tax and reform of the subsidy system are delayed. However, the government announced the introduction of a new minimum wage of EGP 704 per month (equivalent to USD 116) as well as a maximum wage for public sector workers, at 20-30 times the minimum wage depending on the pay grade.

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[2] The government announced in July that it would not enter into an agreement with the IMF that it had previously negotiated and it would also abandon planned budget loans from the World Bank (together around USD8 billion). Egypt has, however, sought concessional bilateral financing and grants, including USD14 billion from Saudi Arabia and Qatar, and USD2 billion from the United States.

Against the backdrop of this challenging environment, the Egyptian government presented a candid, broad-based and comprehensive reform programme at the Deauville Partnership meeting in September 2011, which is summarised in Box 3.1. Its key objectives include improved governance, social inclusion, private sector led growth with job creation and regional and global integration.

**Box 3.1: Egypt's Economic Policy Programme under the Deauville Partnership**

Egypt's medium-term policy programme supports good governance frameworks, economic and social inclusion, job creation, private sector led economic growth, and regional and global integration. The programme has three main pillars, which are underpinned by a list of specific plans and measures:

1 **Promoting Growth and Employment** through (i) **labour-intensive investments** via advancing business friendly policies and public investments; (ii) **SME support** as a main contributor to employment and growth; (iii) **trade facilitation**, with looking for increased opportunities for exports in G-8 markets and extending the Qualified Industrial Zones (QIZ) umbrella to new areas; (iv) **education and human development** through a comprehensive strategy to promote higher education and vocational training; (v) **research and development**, technology transfer, and innovations, including in green economy; (vi) **labor market enhancements;** and (vi) **civil service reforms,** including reforming the government sector wage structures and employment policies.

2. **Improving Social Safety Nets and Social Equity,** primarily through improving (i) **health care**; (ii) **corporate social responsibility,** with new contract for corporate social responsibility in areas of human development, health services and community development; (iii) **food security,** including through new investments to upgrade the production value chain: and (iv) **social safety nets**, envisaging a **s**ubsidies reforms that will have to advance in parallel with a strengthened social safety net, including through a better social security system, pro-poor programs, advanced targeting mechanisms, and efficient distribution channels.

3. **Promoting Macroeconomic and Fiscal Sustainability** via (i) **higher public revenues** through tax reforms; (ii) streamlining **energy subsidies** from their current inequitable and inefficient forms, while introducing adequate social safety nets to alleviate social costs on the most vulnerable; (iii) **fair pricing of natural resources;** (iv) **pension reforms;** (vi) **public financial management and public asset management** improvements**;** (vi) **monetary policy** with advancing the central bank's independence as well as policy framework to reduce inflation inertia; (vii) improving the regulatory frameworks and markets structures in **banking and the nonbanking sectors;** and (viii) **good governance and transparency** through amending an anti corruption law known as *"Treason Law"* to limit conflict of interests, abuse of power; develop a code of ethics, etc.

The focus of the programme is on the major tasks facing the government and the public sector. Very positively, it highlights ways ahead to address reform obstacles in some key areas, which were not directly dealt with before. For example, there is a clearer approach to reduce subsidies through the development of targeted social safety nets. Another example is the outline of corporate sector energy reform. The document is less elaborate on the role the private sector is expected to play and how the governments intend to foster it. Some of the vital elements of private sector development are not yet specified, such as improving independent regulatory agencies in key sectors (telecom, power, etc) and measures to strengthen competition in several sectors.

**Table 3.1: Egypt: Selected Economic Indicators**

**Egypt: Selected Economic Indicators**

| | Average 2000-04 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 [1] |
|---|---|---|---|---|---|---|---|---|
| **Output** | | | | | | | | |
| GDP growth (%) | 3.9 | 4.5 | 6.8 | 7.1 | 7.2 | 4.7 | 5.2 | 1.0 * |
| GDP (USD Billions) | 88.4 | 89.6 | 107.4 | 130.3 | 162.4 | 188.0 | 216.6 | 171.1 |
| GDP (LE Billions) | 396.1 | 538.5 | 617.7 | 744.8 | 895.5 | 1042.2 | 1206.7 | 1021.5 |
| GDP per capita USD | 1344.9 | 1282.8 | 1506.0 | 1771.6 | 2160.3 | 2455.8 | 2788.8 na | |
| | *(In per cent of GDP)* | | | | | | | |
| Agriculture, Irrigation and Fishing | 16.4 | 16.1 | 15.5 | 15.8 | 14.5 | 14.3 | 14.0 | 15.2 |
| Mining, including petroleum refining | 9.0 | 6.6 | 0.6 | 9.2 | 8.3 | 8.9 | 16.6 | 16.6 |
| Manufacturing, excluding petroleum refining | 16.9 | 16.4 | 16.2 | 16.3 | 16.3 | 16.2 | 15.8 | 15.3 |
| Construction and Building | 4.4 | 4.3 | 4.6 | 5.0 | 5.4 | 5.7 | 4.6 | 4.4 |
| Suez Canal | 2.7 | 3.3 | 3.3 | 3.6 | 3.9 | 3.5 | 2.2 | 2.2 |
| Other services | 48.5 | 49.3 | 48.8 | 48.9 | 49.2 | 49.4 | 44.3 | 45.8 |
| Public sector | 33.9 | 38.3 | 39.7 | 37.6 | 38.4 | 37.2 | 37.3 | na |
| Private sector | 66.1 | 61.7 | 60.3 | 62.4 | 61.3 | 62.8 | 62.7 | na |
| **Employment** | *(per cent)* | | | | | | | |
| Labour force | 2.5 | 2.5 | 2.4 | 2.5 | 3.3 | 3.2 | na | na |
| Participation rate, in % of total population ages 15+ | 29.8 | 30.1 | 30.3 | 30.4 | 30.7 | 31.0 | na | na |
| Unemployment rate, in % of labour force | 9.8 | 9.9 | 9.5 | 9.1 | 8.3 | 9.4 | 9.2 | 11.3 |
| **Prices and interest rates** | *(Average annual percentage change)* | | | | | | | |
| Consumer prices (annual average) [2] | 3.8 | 8.8 | 4.2 | 11.0 | 11.7 | 16.2 | 11.7 | 11.8 * |
| Consumer prices (end-year) [2] | 4.6 | 4.7 | 7.2 | 6.6 | 20.2 | 10.0 | 10.7 | 13.5 * |
| Interest Rate on T-Bills (91 days) | 8.4 | 10.1 | 8.8 | 8.7 | 7.3 | 11.3 | 9.9 | 10.2 |
| **Monetary sector** | *(In per cent of domestic credit)* | | | | | | | |
| Net claims on public sector [3] | 35.5 | 42.3 | 42.6 | 38.2 | 35.2 | 44.0 | 46.9 | na |
| Government securities [3] | 45.0 | 66.7 | 58.1 | 52.3 | 47.5 | 57.2 | 56.8 | na |
| **Government sector** [4] | *(In per cent of GDP)* | | | | | | | |
| General government balance | 7.0 | 9.6 | 9.2 | 7.3 | 6.8 | 6.9 | 8.1 | 8.2 |
| General government revenue | 21.0 | 20.6 | 24.5 | 24.2 | 24.7 | 27.1 | 22.2 | 14.6 |
| General government expenditure | 30.4 | 30.0 | 33.8 | 29.8 | 31.5 | 33.7 | 30.3 | 22.9 |
| Net Domestic General Government Debt | 44.7 | 41.5 | 53.6 | 49.6 | 42.7 | 44.7 | 47.6 | 49.6 |
| **External sector** | *(In per cent of GDP)* | | | | | | | |
| Current account | 1.3 | 3.2 | 1.6 | 1.8 | 0.5 | -2.3 | -2.0 | -2.3 * |
| Trade balance | -9.8 | -11.6 | -11.2 | -12.4 | -14.4 | -13.3 | -11.6 | -10.8 |
| Services balance | 6.3 | 6.7 | 7.8 | 8.8 | 9.2 | 6.6 | 5.0 | 4.0 |
| Net transfers | 4.6 | 6.1 | 5.2 | 5.4 | 5.7 | 4.4 | 5.0 | 5.4 |
| Foreign direct investment, net | 0.7 | 4.3 | 5.8 | 8.1 | 7.4 | 3.6 | 2.6 | 0.8 |
| Other financial flows | -2.8 | -2.5 | -4.1 | -5.8 | -4.7 | -3.0 | 0.5 | -1.8 |
| External debt stock | 34.3 | 31.1 | 27.8 | 22.8 | 20.1 | 17.0 | 15.9 | 15.1 |
| Debt Service (% Exports of G&S) | 10.7 | 0.4 | 6.6 | 6.8 | 4.5 | 6.2 | 6.6 | 0.7 |
| **Exchange Rates** | | | | | | | | |
| Official Exchange Rate (LE / US$) | 4.6 | 6.0 | 5.7 | 5.7 | 5.5 | 5.5 | 5.6 | 5.9 |
| Parallel Exchange Rate (LE / US$) | 5.4 | na | na | na | na | na | na | na |

Source: Ministry of Finance, Central Bank of Egypt, World Economic Outlook (IMF).

Note: For lack of data, 2000-2004 averages for output indicators, labour force growth, general government revenue/expenditure share in GDP calculated based on 2002-04 data, and for other employment, government sector indicators and parallel exchange rate averages calculated based on 2001-04 data.

1/ reflects FY 2010/2011 Q1-Q3 (July-March) preliminary data. * indicates estimates for total FY 2010/2011

2/ Starting January 2005, data is based on weights derived from 2004-05 income and expenditure survey using January 2007 as a base month. Prior to this date, the basket and weights were derived from 1999-00 income and expenditure survey using 1999-00 as a base year

3/ Data from Banking survey.

4/ Break in series. Starting 2001-02 the budget is presented according to the IMF 2001 GFS Standards, modified to cash principles. The new classification was adopted by the Egyptian Ministry of Finance by Law 87/2005.

## 3.3 Transition gaps

As documented in the sector review in Annex 1, there are significant transition gaps across virtually all sectors of the economy, with particularly large challenges in agriculture, general industry, energy, water and wastewater, waste management, urban transport, railways, MSME finance and non-bank financial services.

- In agribusiness, inefficient irrigation, small scale land plots and lack of training have contributed to low yields and a weak distribution network restricts the growth potential of productive farms.
- In manufacturing and services, the privatisation agenda remains unfinished, the competition agency is not fully independent, and weak contract enforcement and high firm closure cost discourage participation in the formal economy. Deficiencies in property registration and other weaknesses in the business environment also hamper development in the property sector.
- Lack of regulatory independence is an issue in most regulated industries, including the telecommunications, natural resources, power, railways, road, and urban transport sectors.
- The energy and infrastructure sectors remain to be unbundled and fully commercialised. Although the authorities are intent on introducing PPP schemes and expand private sector involvement, the state retains a significant influence.
- Municipal services require significant investment to provide better access and improve service quality. Urban traffic management and inadequate solid waste management (SWM) are the top priorities among urban environmental issues. However, further tariff reforms will be needed to improve the sustainability of municipal services going forward: water is virtually free for small-scale agricultural irrigation and drinking water.
- Fuel subsidies distort both corporate and household energy consumption. Tariff reform and reform of input pricing is necessary in all the sub-sectors of energy and infrastructure, in telecommunications, and agriculture.
- An unfinished privatisation agenda in the bank and non-bank financial sectors hinders access to finance for a broad segment of the economy. The insurance, mortgage and leasing markets are underdeveloped compared to the existing EBRD COOs.
- Improving access to finance for MSMEs is one of the key reform challenges in the financial sector. While MSMEs account for over 90 per cent of active enterprises in Egypt and contribute to over 75 per cent of total employment, loans to SMEs account for only 6 per cent of total banking loans. Poorly developed credit bureaus and weak contract enforcement are among the key obstacles to the further development of MSME finance.

The overall picture that emerges from the sector assessments is of an economy in "mid transition", in which significant gaps remain notwithstanding important reform efforts in the past. In many sectors, the state continues to play a strong direct role in pricing and production decisions that are best left to the private sector. Public services (water, power, roads) tend to be underpriced. About a quarter of GDP is accounted for by state-owned commercial companies, including in manufacturing, where state ownership cannot be construed as serving a public good or a social purpose. State ownership is predominant in the telecommunications, natural resources and power sectors and large in the banking and passenger railways sectors. The public sector share outside agriculture, which is predominantly private in Egypt, is 43 per cent. Among EBRD countries of operation, only Bosnia and Herzegovina, Belarus, Tajikistan, Ukraine and Uzbekistan (and presumably Turkmenistan, for which comparable data is not available) have higher state shares in non-agricultural value added (see Chart 3.1)

At the same time, the state's role as regulator, guarantor of competition, and enforcer of contracts tends to be weak. In many sectors regulatory functions are not fully separated from state operations. Individual industries, especially in mining and some areas of the manufacturing sector (textiles), are dominated by a few oligopolistic or monopolistic groups closely connected to the former government. These are protected by implicit subsidies such as under priced energy inputs provided by state-owned companies or negative real interest rates on loans provided by state-owned banks. Market-based transactions are impeded by weak contract enforcement, ranked 143rd out of 183 countries by the 2011 World Bank's Doing Business indicators.

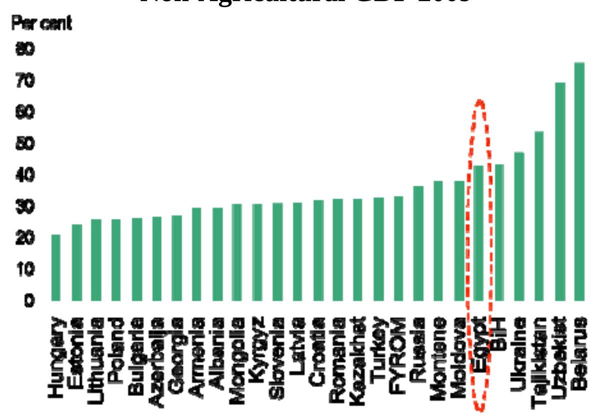
## 3.4 Assessment and risks

As shown in the last two sections, there continue to be large transition gaps and reform needs in Egypt. These transition gaps must be considered within a context of acute social stress and against the background of the perceived lack of fairness of some of the earlier liberalising reforms. Privatisation was seen to benefit well-connected elites, and job creation suffered as large segments of the economy, especially smaller businesses, did not benefit from the opportunities opened by reforms. These were, however, pathologies linked to the implementation and focus of reforms, and in fact their incompleteness, rather than inherent in market-oriented economic systems. Market economies can be fair and inclusive. Ensuring this is a top priority of the authorities and must also guide the EBRD's engagement in Egypt. Transparent and open privatisation in sectors where private dynamism and inventiveness can produce better outcomes, modern corporate governance that respects the rights of employees, competition policies that curtail monopolistic rents, a banking system that caters to the needs of smaller businesses, regulation that ensures social affordability while promoting efficiency and curbing corruption, are all aspects of well-functioning market economies that will need to be strongly emphasised in designing future reforms.

The mixed success of Egypt's past reform efforts is explained in part by the constraints that reformers were facing within the Egyptian political system. First, while their mandate was to liberalise and reform to generate growth and employment, these efforts could not go against the direct interests of influential and politically connected businesses and individuals as well as the military. This may explain why some sectors remained protected notwithstanding the creation of a central competition authority. Second, in the absence of effective targeted social safety nets, it was very difficult to undertake reforms with potential social consequences – such as reducing food or energy subsidies – which risked political unrest, particularly in light of Egypt's fast population growth, high youth unemployment, and high poverty rates. In the absence of cost-effective instruments for social protection, the state depended on blunt and wasteful fiscal instruments to maintain social order. This explains why fiscal-structural reforms became stuck.

Looking forward, in line with Egypt's own road map under the Deauville Partnership, the key priority for the future is promoting private sector led, inclusive growth. Crucial elements include the improvement of the business climate and the creation of a dynamic private sector to lower barriers to entry, advancement of the privatisation process and the creation of a level playing field through independent effective regulators. Improving access to finance, in particular for small and medium sized enterprises, through improving risk assessment and management technology at the banking level (switching from only collateral based lending to a proper risk scoring technology) will play an important role in fostering growth and reducing unemployment. The private sector can also play a broader role in food and water security and, in the form of well designed public private partnerships, the provision of infrastructure and utilities. Especially in the energy sector this needs to be embedded in a reform of the inequitable and inefficient subsidy system that distorts incentives and production processes. There is a large potential in fostering energy efficiency and advancing renewable energies. The reduction of the level of subsidies, in particular to the corporate sector, will give the government more fiscal room to invest in targeted subsidies and areas such as health and education.

**Chart 3.1. Public Sector share in Non-Agricultural GDP 2009**




Notwithstanding the February revolution, several political constraints remain in place today. Most importantly, social constraints to reforms have become, if anything, more acute. There remains a fundamental problem of "social support transition" – how to replace a wasteful and distortionary system of social protection with a better targeted alternative. Similarly, any government will be constrained in undertaking measures, such as privatising or restructuring state-owned enterprises that add to unemployment, particularly youth unemployment, in the short run. Conversely, measures that reduce unemployment, particularly youth unemployment – such as vocational training to reduce skill mismatches – will be critical not only in themselves, but because they will allow more vigorous reform in other areas. EBRD operations in Egypt and other southern and eastern Mediterranean countries will need to reflect these needs and constraints.

# 4. Cooperation with other International Financial Institutions

## 4.1 An unprecedented coordination effort under the aegis of the G8

Several international financial institutions (IFIs) and major regional and bilateral organisations are currently active in Egypt. As emphasised by EBRD Governors in Astana, it will be important to avoid duplication and competition and to ensure that any potential activity of the EBRD brings specific value-added based on the mandate and competencies of the EBRD. Field missions from Banking, OCE and the Political Counsellors offered numerous opportunities to meet our sister institutions in Cairo.

This natural coordination process has been strengthened under the aegis of the Deauville Partnership, announced in May by G8 leaders. A follow-up Ministerial meeting in Marseille on September 10 formalised the Partnership and involved actively the World Bank Group, the AfDB, the EIB, the IsDB, and the Arab regional Funds (Arab Fund for Social and Economic Development; Arab Monetary Fund; and the OPEC Fund), in addition to the EBRD.

The MDBs and regional financial institutions signed a Joint Statement in support of the Deauville Partnership, committing to strengthened cooperation in the four partner countries – including Egypt. For this purpose, they created a “Coordination Platform” dedicated to (i) facilitating information sharing and mutual understanding, (ii) coordinating monitoring and reporting on the implementation of the Deauville Partnership, and (iii) identifying opportunities for collaboration on financing, technical assistance, and policy and analytical work. The group will be led by one of the participating IFIs on a rotational basis (starting with the AfDB).

The World Bank also coordinated a MDB Action Plan, whereas the AfDB put forward a Private Sector Development Initiative, which is still being discussed by MDBs and would consist of various joint initiatives on which the interested MDBs would work together. The EBRD is a full participant in these endeavours, subject to confirmation by shareholders of its engagement in the region.

In addition to these broad-based efforts, the EBRD signed Memoranda of Understanding with the AfDB and IsDB, respectively. An MoU with the EIB is, of course, already under implementation and will be adjusted to take account of specificities in the new region. The MoUs with AfDB and IsDB provide a general framework of cooperation in common countries of operation (in the case of IsDB this extends beyond North Africa to Central Asia and the Caucasus). The types of cooperation envisaged include: information exchange, secondments, joint training, coordinated technical assistance and co-financing. The MoU with AfDB also includes an offer from AfDB to make available office space pending the establishment of EBRD offices. Overall the MoUs confirm the complementarity of EBRD and the other institutions and the shared intention to use their skills and experience to advance their respective mandates.

## 4.2 IFI and major bilateral financing activities in Egypt

It should be noted that given the rapidly evolving situation in Egypt, most IFIs are still in the process of reassessing their strategies. Some IFIs have indicated that they did not expect that their strategic directions would be significantly altered. Others consider that it is still too early to assess and define the operational implications of recent events for activity in the coming years. Based on the Deauville coordination platform, the Bank will update the forward view of other IFIs as their plans are formulated over the coming months reflecting the directions of the Egyptian authorities.

IFI annual business volume reached a high of €5.2 billion in 2010 (including roughly €1.2 billion in the private sector) for a total portfolio in the country estimated at €18.7 billion. The African Development Bank, the EIB and the IBRD account for a large share of this volume. Most organisations have recently ramped up their activities and/or their forecasts for Egypt, leading to the very high figures announced in the context of the Deauville Partnership ($ 38 billion for the four countries over the next 3 years). Egypt itself estimated its financing needs at $ 45 bn over the same period (including $ 23.5 billion of budget support). Egypt will clearly remain a strategic priority for IFI investments in the coming years.

However, it has to be noted that the 2011 activity level remains uncertain and is unlikely to fully reflect future trends. The Revolution created an unstable environment which has partly disrupted the steady flow of projects and financing. Most activities have now resumed, as illustrated by the three examples below.

- AfDB signed in August 2011 a USD550 million loan to finance the bulk of a new 650-megawatt power plant in Suez, 150 kilometres east of Cairo. The investment, the largest by the AfDB in Egypt, will tap the country's abundant natural gas resources to produce clean energy.
- Despite the recent rejection by the Government of World Bank and IMF budget and balance of payments support, IBRD project financing continues. In FY11, the IBRD approved a total of $630 million for 3 operations, including a $200 million operation after the Revolution. In FY12, the Bank is expecting to receive a formal request for a $200 million Labor-Intensive Works program, and is ready to support Egypt with $1.1 billion for three projects in the energy sector. The IBRD also remains available to provide budget support (DPL) − if and when requested − with a focus on economic governance, transparency, and job creation.
- The EIB project pipeline remains strong and the Bank anticipates continuing to finance key infrastructure projects, with some reorientation of activities towards the priorities of the interim administration (like housing and employment). There are also signs that commercial banks have an increased appetite for EIB loans and guarantees. As far as risk capital operations are concerned, the underlying assets of the portfolio have seen limited impairment, but private sector business generally has slowed down and the more adverse fundraising environment is challenging funds' ability to reach target size.

**Table 4.1: Summary of the activities of IFIs in Egypt**

| | Portfolio | ABV | Forecasts | Main sectors of activity | Private sector operations |
|---|---|---|---|---|---|
| **World Bank (IBRD)** | $3.8 billion for 18 projects | Average of around $1.1 billion (with a sharp increase in FY10 to $2.2 billion) | Expect to finance $0.7 to $1 billion of investment projects on a yearly basis | Infrastructure (e.g., power, transport, irrigation), and financial Sector. | N/A |
| **IFC** | $874 million in 33 companies | Around $315 million in 2010; already $155 million in 2011 | Around $350 million per annum over the next 3 years | Around half of IFC investments are in equity, either directly in large companies (cement, refining, and banking) or through equity funds | 18 projects over the last 3 years |
| **AfDB** | $2.65 billion comprising 10 sovereign loans, 2 non-sovereign loans and 14 grant financed operations | Average $500m per annum; reached a record of almost $1 billion in 2010 | Volume is expected to grow following the recent capital increase with the Bank's 2011 lending volume in the range of $1 billion as well | Power supply (62%) | 13.5 % of the active portfolio. 3 projects since 2007 |
| **EIB** | EUR 5.6 billion since the onset of EIB operations in Egypt in 1979, of which EUR 3.3 billion since the launch of FEMIP in 2002 | Average annual business volume between 2008 and 2010 was around €400 million. EIB volume reached a high of €900 million in 2010 | In 2011, the EIB expects to approve approximately EUR 800 million. | Private (including equity investment) and Public sectors.<br><br>By industry: infrastructure (power, water, renewable energy, environment), corporate and SME | Over the last 3 years, the EIB committed EUR 404 million in 8 private sector projects with one project in the petro-chemical sector accounting for 87% of private sector financing |

| | Portfolio | ABV | Forecasts | Main sectors of activity | Private sector operations |
|---|---|---|---|---|---|
| **IsDB** | $4 billion | $480 million on average, with a peak at 810 million in 2010 | 3-year financing package worth at least $2 billion | Energy, transportation, education, MSME, trade, agriculture, water and health | 52 % |
| **Arab Fund for Economic and Social Development** | $4.0 billion | $324 million in 2010 | $ 1.2 bn over 2011-2013 | Power, industry and mining sectors | No recent project |
| **OPEC Fund (OFID)** | $405 million for 20 loans | $160 million in 2010 | | Energy, Social , Agriculture, Trade Finance | 18.5 % of the portfolio. 2 projects in total |
| **Arab Monetary Fund (AMF)** | 10 loans in total | The last AMF loan to Egypt was approved in 2004 for an amount of $115 million | N/A | Provide financial assistance to correct balance of payments disequilibria and implement structural reforms towards the modernization of financial systems | N/A |
| **KfW/DEG** | €1,2 billion | €390 million in 2010, compared with an average annual business volume of €170 million | | Water and energy sectors (with a focus on renewable energy) | The current DEG portfolio amounts to €50 million with annual commitments of around €20 million. |
| **AFD** | €400 million | €400 million in 2010 | Portfolio should reach €650 million over 2011-2013 | Infrastructure, job creation, environment | 10-15 % via Proparco |

## 4.3 Scope for cooperation on projects

While IFI financing in Egypt is substantial in the aggregate, the country would still appear to be "under-banked" by IFIs. Egypt's GDP is around $250 billion. The IFI business volume at its peak represents thus less than 3% of GDP. In the private sector, the share is less than 0.7%.[3] From this "macro" perspective, the Egyptian market should thus offer opportunities for increased IFI engagement and cooperation.

Cooperation will build on each institution's specific competencies and business model. The EBRD's business model was described in detail in "Fighting the crisis, promoting recovery and deepening transition" (BDS09-54) providing the basis for the formulation of the medium term operational priorities of the Bank endorsed by Governors in May 2009. These include institutional, mandate and operational attributes such as, *inter alia*, its transition focus, respect for additionality, capacity to evaluate, structure, mitigate and take debt and equity risks, experience in supporting local (less experienced) and smaller businesses, ability to support different ownership models, and ability to intervene directly at company level to promote high quality standards in areas such as governance.

In preparing this technical assessment, the Bank has consulted closely with all IFIs active in the region. Based on the response, there would appear to be a broad range of opportunities for cooperation, some of which are set out in Section 5 below. Cooperation will be particularly helpful in overcoming major regulatory hurdles, e.g. in fostering the commercialisation of utilities. Under the AfDB-led Private Sector Initiative, the EBRD has been asked to take the lead in exploring the scope for joint initiatives on "Local currency and capital markets" and is expected to participate in exploring others, including joint guarantee facilities, liquidity support for banks, PPPs and work on the investment climate.

There could also be room for EBRD to co-finance larger projects, either in the public sector or with private companies, in infrastructure and energy. In the context of the Deauville Partnership Action Plan, the EBRD has been flagged as a potential partner for the AfDB-World Bank SME Facility; the Arab Financing Facility for Infrastructure (AFFI); and the World Bank-led MENA Concentrated Solar Power Program.

[3] For comparison, the ratio of EBRD private sector investment to GDP averaged 0.65% in 2010 for its existing region of operations, reaching around 1.5% in countries such as Bulgaria, Georgia and Moldova. In large countries, this ratio was around 0.5% in Romania and Ukraine and 0.2% in Russia.

# 5. Opportunities for EBRD operations in support of Egypt's transition

## 5.1 Operational themes and technical cooperation framework

### Operational themes

The Egypt technical assessment prepared in March 2011 contained an initial review, based on a desktop exercise, of possible focal areas for a future Bank engagement. These have now been further refined and adjusted following an operational mission to Egypt and a more detailed analysis of transition gaps. They also draw on the authorities' priorities as communicated during the mission and set out in a paper presented for the Deauville Partnership ('**Egypt, the Way Ahead: Facing current challenges and building for the future**'; see box 3.1).

The guiding principle remains that, in close coordination and cooperation with IFIs already established in Egypt, the Bank would focus on areas in which it can provide added value in view of its transition mandate and its specific competences and attributes. The Deauville IFI coordination platform and the work on joint initiatives will help in putting this approach into practice.

Based on the work to date, the following operational themes have been identified to guide a potential engagement by the Bank in Egypt:

- **financing and improving conditions for investments in the private sector, with particular emphasis on SMEs,** to support transition and job creation;
- **enhancing the agribusiness value chain** to improve food security, strengthen the distribution chain, and develop a sector that accounts for a high share of employment;
- **modernising the financial sector** so that it can contribute more fully to economic growth by strengthening its capacity and diversifying the range of financial products offered, including risk capital;
- **increasing the role of renewable energy and improving energy efficiency** so as to support energy security and enhance economic competitiveness with a cleaner environment;
- **supporting reform and commercialisation of the transport and power sectors** including the mobilisation of private sector infrastructure investment for accelerated development; and
- **upgrading municipal infrastructure**, based on decentralisation and commercial principles, to provide wider access to better quality urban services to the population.

In the build-up phase, there will be a particular focus on private sector / SME support, including agribusiness, and on the financial sector. Furthermore, in each case the "horizontal" focus will be on project structures and instruments that draw on the Bank's specific attributes and strengths.

These operational themes support the implementation of Egypt's medium-term policy programme and particularly of its priority areas for collaboration under the Deauville Partnership. These include the promotion of growth and employment, financial sector reforms, investment promotion, SME development, technology transfers, including in the field of the green economy, and institutional development, including strong legal frameworks and good governance. The programme prepared by Egypt explicitly supports private sector led economic growth and includes a pipeline of PPP projects.

As noted in Section 4, the Bank is committed to participating in joint initiatives with other IFIs active in its potential new region of operations. These include local currency and capital market development and the possible design of joint guarantee schemes, on both of which the EBRD is expected to take a leading role, as well as regional cooperation on SME investment vehicles, liquidity facilities for banks, PPP development, capacity building programmes, work on business climate and possibly further initiatives. These are not specifically taken up in the following but should be seen to complement the Bank's plans in Egypt.

The Bank's operations in Egypt, at both the initial and later stages, will seek to address issues of gender equality and women's entrepreneurship, within its mandate and in keeping with the Bank's Gender Action Plan. This could include studies that complement what is already known about the role of women in the economy and society and ways to enhance their participation in the labour force, technical assistance to encourage MSMEs in the informal sector to become officially registered, as well as tailored projects that would accompany future investments – e.g., with intermediary banks on lending to women-owned businesses, with corporate clients on improving their human resources policies, and in municipal projects ensuring benefits are equally shared between men and women.

Finally, it is worth emphasising that the themes and potential activities described in this section have been formulated on the basis of the knowledge available to date in a situation where the Bank does not yet have direct operational experience in the country and no local presence. Accordingly, they constitute an initial basis for the start of activities in Egypt and are likely to be enriched as the Bank's operational knowledge and experience build up.

Annex 2 presents a tabular summary of challenges, investment priorities and related TC.

**Technical cooperation framework**

The operational themes guide the initial definition of Technical Cooperation (TC) assignments which could be launched as soon as the Board authorises the use of cooperation funds in Egypt. Based on its operational experience, the Bank has developed a range of TC mechanisms which generally fall into the following broad categories:

**Regional or sector studies:** overarching reviews of particular areas or sectors, intended to inform the Bank and its interlocutors and to facilitate the identification of specific opportunities. This might include for example a market survey of energy efficiency investment opportunities., or survey of women's entrepreneurship and access to finance

- **Capacity building and environment enabling:** targeted assistance to create an environment more conducive to transition or to facilitate particular reforms. This might include for example reform of securities law or support for PPP development. This category can also be viewed as covering TAM/BAS activities which are essentially stand-alone.

- **Project preparation and implementation:** assistance to support a particular project, during both preparation and implementation. An example of the former might be a feasibility study for a wastewater treatment plant investment and of the latter, technical assistance to a small bank following an equity investment by the Bank.

These categories can be thought of as following a natural sequence in the order in which they are presented above: the first step for the Bank is to understand the general area in which it is operating, to identify opportunities and to share its experience with its interlocutors. The next step is to focus on specific sub-sectors where a need is identified and the Bank's involvement is appropriate and lay the groundwork for successful interventions. Often, particularly in the infrastructure sector, significant policy dialogue is required, long in advance of any project commitments, in order to create an environment in which projects can proceed. Finally TC is deployed to ensure the success of specific projects or enhance their transition impact.

In practice of course there is considerable overlap so that one assignment may fall into more than one category. Similarly in some cases certain steps in the sequence will be unnecessary or can be pursued concurrently. This EBRD TC "toolkit" provides a framework within which the TC assignments outlined below have been identified and prepared. The initial TC activities identified for each operational theme are presented in the sequence described above with the volume and nature of TC assignments varying for each operational theme. It should be understood that TC that belongs in the first two categories may not result in investment projects during the initial stages of the Bank's engagement, but is no less urgent given the significant lead times involved if the Bank is to respond appropriately to Egypt's medium-term challenges in the coming years.

## 5.2 Supporting private sector development and job creation

### Transition challenges

There is still a significant degree of state involvement in the Egyptian economy with 150 often less-than-efficient state-owned industrial companies and a further 300 in which there is a degree of state ownership. Following an active phase of privatisation, the programme stalled three years ago and privatisation is off the political agenda for the foreseeable future. At the same time there are world class private companies and a well capitalised and liquid banking system which meets many of the needs of larger corporates for investment and working capital finance.

Nevertheless, the banks are highly selective in their lending practices and mid-sized and smaller companies find it difficult to get funding from the banking sector. The SME sector is split between those of medium size, located mainly in Cairo and Alexandria, and a large number of small businesses with much more limited sales and few (1-20) employees. The vast majority of these are not registered as companies, and many are barely more than sole proprietorships. A major policy challenge will be to encourage these enterprises to start operating in the formal sector.

Political instability, lack of access to credit and the poor business environment were noted as the main challenges for businesses. Egypt ranks 94th in the World Bank's "Doing Business" survey for 2011. Whilst starting a business and trading across borders are relatively easy, many other aspects of doing business such as obtaining credit, enforcing contracts and closing a business are ranked well within the lower half of countries surveyed.

There are more than 50 consulting companies in an industry that has developed over the last 10 years. The quality of consultants and the value of their services are not consistent. Most local consultants lack the skills to offer specialised services such as management quality certification, MIS implementation, and properly developed business plans.

Against this background, some of the key transition challenges for the Bank are:

- widening the availability of finance for mid sized and smaller corporates;
- increasing the productivity and efficiency of the sector including by formalising and improving management, reducing energy intensity and promoting higher levels of R&D;
- improving the business environment by implementing modern competition policy, improving contract enforcement and bankruptcy procedures and reducing bureaucracy and;
- as and when appropriate, restructuring and privatising state-owned companies, particularly in the textile and petrochemicals sectors.

**Potential investment areas**

The financing needs of medium and smaller sized SMEs would be addressed primarily through the Bank's proposed programmes for financial institutions (presented in Section 5.4 below). The main financing gap that can be filled by direct Bank financing is for mid-sized companies with sales in the range €2 to 15 million, through both equity and debt instruments. The Bank could extend to Egypt one or more of the instruments it has available for direct financing to medium sized corporates – principally the Local Enterprise Facility. The junior Stock Exchange (Nilex) could provide an exit route for equity investments in mid caps.

On a selective basis, where the Bank's specific competences and status are particularly relevant, the Bank could also finance larger corporates including, but not limited to, family owned businesses that have reached a size where they want to internationalise their sources of finance and/or involve the Bank as a minority investor prior to an IPO. The Bank may have a role in providing mezzanine finance which is not widely available. There may also be opportunities for the Bank to finance foreign strategic investors entering Egypt for the first time, particularly those from the Bank's countries of operations, as well as to finance Egyptian companies investing in the Bank's countries of operations.

Sectors where there are opportunities for EBRD to finance larger corporates include pharmaceutical manufacturing, food and non food packaging and private sector textile companies. Further sectors are likely to be identified once the Bank is fully operational in Egypt. There is likely to be scope for joint transactions with other IFIs, though mostly at the upper end of the size range.

**Technical co-operation**

At this stage it is not anticipated that region or sector wide studies are required for this operational theme and initial TC activities will therefore focus immediately on improving the business environment and supporting individual companies. These activities will therefore include:

- The key channels for providing TC of this nature to companies in the Bank's existing region of operations are the TAM and BAS programmes, which could be deployed rapidly in Egypt as well. Sectors recommended for the programme include Agribusiness, Tourism, Textiles and Furniture where TAM/BAS could add value, especially in meeting quality standards and improving products for export to the EU.
- Based on an initial review, there is a wide range of needs for TAM assistance, especially helping to restructure company management and operations for growth and finding export markets. For BAS, advisory services should focus on raising quality standards, introducing MIS, branding, finding export partners, and supporting local franchise development. Regions recommended include Alexandria, Port Said and Damietta (for the furniture cluster) in the north and Asyut in the south. Once the Board approves the use of cooperation funds in Egypt, the TAM programme could be operational before the end of 2011 with BAS following early in 2012.
- The Bank will also seek TC support for its programmes to enable it to finance smaller companies directly such as the Local Enterprise facility (LEF).
- For larger private companies outside the Agribusiness sector, the Bank does not normally use TC to support project preparation and implementation but expects the client to cover these costs. For equity investments, the Bank does use TC selectively to reduce the cost to a client of appointing world class non-executive directors to its board or for improving financial management systems. Project-specific TC may be used selectively for such purposes in Egypt.

In addition, the Bank's Legal Transition Team is initiating an assessment of Egypt's commercial laws. Based on this work, the Bank will pursue opportunities for legal policy dialogue and TC to support its investment strategy.

## 5.3 Enhancing the agribusiness value chain

### Transition challenges

The agricultural sector is of fundamental importance to the Egyptian economy with primary agriculture alone accounting for 14% of GDP and 33% of employment. Cotton accounts for a large part of agricultural employment and is an important export industry but has been declining due to a lack of investment and resources. A high percentage (45%) of food is imported resulting from the very low percentage (3%) of land that is cultivated, inefficient farming practices and high population growth. Egypt is the largest importer of wheat in the world. The Government has a target to reduce the percentage of imported food to 25% over the next ten years.

The current irrigation system consumes up to 90% of Egypt's water supply, and the availability and efficient use of water for irrigation will play a key role in the future development of the agricultural sector in Egypt.

Against this background, the key transition challenges identified in the sector can be summarised as:

- modernising farming practices, including irrigation practices and the proper use of pesticides;
- ensuring the sector is competitive without subsidies and export bans, as these inevitably decline;
- upgrading processing, logistics and retail distribution in order to reduce wastage, currently perhaps as high as 50% of production;
- further reducing the ownership role of the state in the sector in order to promote efficiency and limit reliance on subsidies;
- consolidating a sector that remains fragmented at all levels in order to take advantage of economies of scale and facilitate modernisation.
- streamlining regulation to ease the process of owning and leasing agricultural land.

### Potential investment areas

Based on initial contact with the authorities, other IFIs and companies active in the sector there appears to be significant scope for the Bank to help address the above transition challenges, with an emphasis on the processing sector, the establishment of modern food retail chains, logistics/distribution and agricultural infrastructure (partly through SME facilities to local banks).

Several areas of focus for potential investments have been identified, and would in some cases be conducted jointly with other IFIs. Typically these focus on upgrading infrastructure at various points in the agribusiness supply chain. These include modernising and expanding food production facilities, investing in cold storage, upgrading hygiene standards and improving the quality of the supply chain at the level of producers.

Other potential investments relate to improving the financial strength of agribusiness enterprises (for example pre-IPO equity) or improving the structure of the sector such as co-investment in acquisitions, investing in a private equity fund focused on agribusiness, and supporting private investors in acquiring state- and partly state-owned food processors.. There may also be opportunities for projects supporting consolidation of suppliers in primary agriculture, processing, packaging and distribution.

**Technical Cooperation**

Reflecting these challenges and project opportunities, the Bank's early priority for technical cooperation in the agribusiness sector would be to survey the key area of food security and focus quickly on capacity building and project preparation by disseminating best practice. Initial TC operations would include:

- A feasibility study to identify operational and institutional weaknesses in agribusiness value systems where targeted investments by EBRD and commercial clients can improve food security.
- Training for SMEs in the agribusiness sector to improve production methods, operational and financial management, and to increase operational standards for better access to export markets.
- In cooperation with processors and traders, help improve the quality of raw materials, storage methods and irrigation methods for water conservation.

## 5.4 Modernising the financial sector

**Key transition challenges**

*Banking sector*

There is still a high degree of state ownership in the banking sector in Egypt with the three state-owned banks having a market share of 45 percent. Most Egyptian banks are relatively liquid, rely on local currency deposits for funding, and in principle have room to extend loans as well as to lengthen maturities.

However the ratio of loans to deposits is low with banks preferring to buy Treasury bonds. Most loans are short term, with little medium term lending although maturities can extend to over 10 years in selected cases. Constraints on longer term lending vary with the availability of funding, project characteristics and the creditworthiness of borrowers. Although larger companies are well served by the banking sector SMEs find it difficult to get bank financing. The Government is trying to address this problem through the Banque du Caire which has been designated as an SME bank.

Against this background, key transition challenges in the financial sector are to:

- broaden financial access for SMEs and individuals;

- deepen financial intermediation by addressing impediments to the extension of private sector credit, including the lack of credit information and the high cost of underwriting and servicing; and
- reduce state control of banking by further progressing with the privatisation process.

*Equity funds*

While Egypt's private equity industry was among the first in the region, the industry is dominated by a small number of recognized fund managers and large single deals, resulting in an investment level much higher than the MENA average. Overall, however, the industry remains under-developed.

While the majority of fund managers are home-grown (i.e. created by Egyptian professionals, incorporated in Egypt or with significant investments in the country), a number of international players operate in the country with a strong local presence. Institutional investors and high net worth individuals from Egypt and the Gulf States have traditionally been the most significant sources of funding. Diversification of the product offering remains low. Investment strategies are mainly focused on capital growth and regional/ global expansion. The venture capital industry is at an early but developing stage in light of the government focus on telecommunication and IT. Against this background, key transition challenges are to:

- support quality institutional private equity funds in this segment; and
- restoring international and regional investors' confidence in equity funds and enhancing governance standards.

**Potential investment areas**

*Banking sector*

Reflecting the transition challenges and based on contacts with the authorities, other IFIs and banks in the country, potential business opportunities in the financial sector include:

- Providing term finance to local banks for lending to MSMEs with either a risk-sharing component, or a first-loss cover to enhance the risk appetite of the banks. The Bank would first assist local banks to introduce appropriate methodologies for processing MSME loans in a timely and cost-efficient manner complementary to the activities of other IFIs, such as IFC, with Banque du Caire as a potential first candidate.
- Targeted financing for certain categories of MSMEs, by ensuring that a portion of the EBRD loans is: (i) on-lent outside the main cities, particularly in the poorer and more disadvantaged southern part of Egypt; and (ii) on-lent to female entrepreneurs, to the smallest farmers and traders, and to young entrepreneurs, in order to reduce unemployment while fostering start-ups. Again, this will be complementary to IFC's operations.

- Supporting local microfinance institutions by providing long-term financing and technical assistance to improve their lending methodologies and increase their outreach. This activity will help broaden financial access to MSEs, especially outside main cities. Supporting micro-enterprises, self-employment and start-ups will also help address the high level of unemployment.
- Undertaking long-term equity investments in medium-to-small size banks, with the objective of creating an "MSME champion". Such investment will improve competition in the MSME sector and will play a demonstration role to encourage other banks to tap this niche.
- Improving access to mortgage financing and insurance products (including to support affordable housing). The levels of penetration of mortgage and insurance products are very low, at less than 1% of GDP. Mortgage financing is especially relevant as the housing and construction sector is a strong catalyst for rapid and large-scale employment. Supporting private insurance companies will also help diversify the offer of products away from the two state-owned companies, which dominate the sector.
- Improving access to leasing products would complement the needs of both the MSME sector, as well as the retail sector.
- EBRD's syndicated A/B loans structures would be attractive in Egypt to restore investors' confidence. Syndicated A/B loan structures would help attract foreign commercial funds, thereby leveraging EBRD's funding and helping to strengthen cross-border interbank relationships.
- Establishing a Medium-Sized Co-Financing Facility (MCFF) would address the needs of both the smaller Egyptian banks, as well as medium-sized private sector companies by enabling banks to provide larger loans without having to structure complex co-financing packages.
- In the longer term, EBRD may also play a role in supporting the privatisation of the state-owned banks. This will require the return of confidence in the privatisation process, by both potential investors as well as the Egyptian public. In this regard, EBRD's strict requirements in terms of transparency would facilitate addressing existing concerns.

It should be noted that IFIs active in the private sector in the region are considering options for the establishment of a joint guarantee fund, which would of course benefit Egypt as well.

*Equity funds*

There has been less detailed exploratory work in this area, as it lends itself less well to activities in the cooperation funds stage. However, it is clear that there is significant interest in collaborative approaches among the IFIs. Broadly speaking, the Bank would seek to:

- engage an active dialogue with locally-based funds or regional funds with Egyptian focus that are currently seeking capital. Such funds are likely to be: (i) generalist and focused on SMEs with a growth investment strategy; and (ii) focused on infrastructure and communications where Egyptian private equity is an important source of capital;

- play a leading role in cooperation with other IFIs in supporting the growth of the private equity asset class and develop a stable international, regional and local investor base.

Early commitments to private equity funds that are fund raising and where other investors with similar standards to the Bank's have already undertaken due diligence may enable the Bank to make a quick start in providing new capital to private companies in Egypt.

**Technical cooperation**

The Bank's initial TC support for financial institutions is designed to help address the challenges set out above and prepare for the Bank's future investment in this sector. As a first step Egypt will benefit from planned regional TC operations that will analyse the capacity of selected banks to benefit from various specialised credit lines (including the possible need for first loss cushions and/or risk sharing); provide support for enhancing financial infrastructure such as credit bureaus; and prepare banks for the Trade Facilitation Programme. More specific TC operations would complement the work carried out in these studies by both strengthening the business environment and providing targeted project-specific support:

- Assistance to the three largest Microfinance Institutions (MFIs) in their transformation and business plans so as to meet the requirements of the MFI Law and Supervisory Authority Regulations.
- Direct assistance to MSMEs, customers of partner banks and selected other potential recipients aimed at building capacity for future MSME loans under credit lines.
- Support for Banque du Caire in formulating and implementing its strategy to become a key provider of SME financing.

## 5.5 Energy efficiency and clean sources of energy

**Transition challenges**

The fundamental issue from both an economic / public finance perspective as well as from the perspective of energy efficiency remains the energy subsidy system which is a key driver of the fiscal deficit, has a huge opportunity cost in terms of public spending and provides the wrong incentives for energy use. For example, Egypt has become a net importer of energy when it has the potential to be a net exporter if energy were priced at world market levels. Whilst the importance and urgency of addressing this issue is acknowledged by policymakers, there is a general consensus that the current political and social context may not provide a basis for this issue to be tackled in the short term.

Nevertheless, the Bank will seek to use its experience in the energy efficiency field to build an energy efficiency dimension into its operations as far as possible as well as supporting renewable energy projects.

### Potential investment areas

Opportunities for energy efficiency are likely to exist in the Bank's operations in Agribusiness, Manufacturing and Services, Power & Energy, Municipal Services, Transport and through specialised credit lines with banks. However the point at which the cost of an energy efficiency investment outweighs the benefit will be lower than in markets where energy costs are closer to world market levels. Opportunities would be scoped in the context of a market study TC described below.

Egypt has plans to implement large scale renewable energy projects both to exploit its resources, notably in wind and solar, and to alleviate pressure on domestic natural gas production. The Bank will explore opportunities to support these, particularly where they are developed in the private sector. The Bank will also take into consideration activities undertaken in the context of the Climate Investment Funds and examine opportunities to contribute to these activities.

### Technical co-operation

As an area where the regulatory framework is critical the Bank's TC approach is expected to follow the framework sequence of scoping, complemented by institutional reform and project specific support. On that basis TC operations are likely to include:

- An initial TC assignment would be a market study to assess the potential for and obstacles to energy efficiency and renewable energy in Egypt in industry, small business, infrastructure and the built environment, taking into account the activities of other IFIs and bilateral agencies.

- The results of the study will guide the identification of priority areas of activity, including follow-up work on policy dialogue and structuring commercial financing arrangements as well as a framework facility for energy audits and water use audits for private sector clients.
- The role of renewable energy could be very important and will benefit from a separate TC study to assess the demand pattern for solar power and to identify the optimal size of wind energy projects, for their contribution to the energy mix and to explore opportunities for local manufacturing.

## 5.6 Reform and commercialisation of transport and power infrastructure

### Key transition challenges

The large infrastructure sectors of transport and power are dominated by state owned enterprises with significant involvement and control by the central state authorities. Although the authorities are keen to introduce PPP schemes and expand private sector involvement, significant transition challenges remain and these will need to be addressed in parallel to any direct support for PPP initiatives and private sector investment. This sector offers considerable scope for joint initiatives and projects with other IFIs, and discussions with this purpose are underway in the context of the Deauville Partnership.

Roads are the dominant form of transport, and the Government is promoting private investment in the sector through PPPs, with several projects under preparation. Railways are especially relevant for low-income Egyptians; railway modernisation is financed with donor funds and World Bank sovereign loans. The Government is seeking greater private sector involvement in port development as well as to strengthen port authorities and separate the regulatory and commercial functions. Inland waterways require urgent attention with a focus on navigational safety. The shipping sector has seen substantial private sector investment. The aviation sector is growing in importance, both for cargo and tourism, and requires on-going modernisation and development.

Private sector involvement in the power sector has by contrast been more limited. The Egyptian power sector remains dominated by state-owned companies with only a few distribution companies and three generating plants in private hands. There has not been any effective unbundling with almost all ownership and control vested in a single holding company which is in turn wholly owned and controlled by the Ministry of Electricity. The regulator has strictly limited powers and in particular is not responsible for tariff-setting. At the end of 2009 draft legislation to liberalise the sector was prepared but is now on hold. The system has been a major recipient of IFI support historically but continues to need significant levels of investment to meet rapidly growing demand, develop renewable energy sources (particularly wind and solar) and increase efficiency. The scale of this required investment, especially in view of Egypt's precarious fiscal situation, requires the involvement of private finance, for example through IPP schemes.

Significant transition gaps exist and wide reaching reforms are required across both transport and power to ensure that the resources spent achieve the desired efficiency and commercialisation goals. Key transition challenges include:

- economic distortions in the sector with prices for public services including transport fares and electricity kept artificially low with operators subsidised by the State; fuel subsidies add to these distortions;
- the inefficiency of public sector entities, with a high level of overstaffing and a lack of managerial responsibility or autonomy creating the need for commercialisation, effective unbundling and privatisation when appropriate;
- fragmented and very complex institutional arrangements preventing a coherent sector policy approach (for example, four ministries are involved in the management of the road network while at the same time the regulatory agency requires substantial capacity building and more independence); and
- limited participation of the private sector in the provision of transport infrastructure and services, with PPP structures desired but not yet widely used and funding limitations in place that require lending in local currency only.

### Potential investment areas

Overall infrastructure investment gaps remain large but there is also significant IFI involvement in this sector. The Bank would concentrate on those areas in which it could provide added value with its business model and transition focus.

The Bank's initial investments would be tailor made to address the specific requirement and operating characteristics of each sub-sector. In the roads sector, because of the need for local currency financing, it is proposed that initially the Bank could focus on providing coordinated TC support to the Government. Bank investment could therefore focus initially on financing private sector port operators, possible non-sovereign lending to selected entities (Suez Canal Authority), financing of fleet replacement for transparent private inland river and coastal shipping companies with a focus on safety, environmental protection and energy efficiency, and funding for private auxiliary operators as well as non-sovereign operations with selected entities (e.g., Cairo Airport) in the aviation sector. On a very selective basis, the Bank should also consider providing sovereign loans in parallel with other IFIs when there are critical financing gaps and relevant transition-related factors.

In the Power and Energy sector, subject to the conclusions of the TC funded study, the Bank could focus on those power generation projects under construction where there is a critical financing gap, generation projects which are being developed under an IPP or similar framework involving the private sector and network projects that enhance energy efficiency (for example smart metering), quality of supply or renewable energy penetration.

### Technical cooperation

The proposed initial TC support in this sector reflects the above identified gaps and is designed to promote sector reforms and structural change, as well as the strengthening of regulatory bodies and the legal framework to promote market transparency and financial sustainability. The Bank's goal is to create an environment which will lead to the broad engagement of the private sector in the provision of infrastructure and infrastructure related services.

The Bank's involvement in the **transport sector** would follow a two-pronged approach of (i) engagement with existing private operators as well as selected public entities, combined with (ii) extensive technical cooperation (TC) support for PPP preparation as well as sector reform preparation in coordination with other IFIs active in the sector. More specifically, the proposed initial TC support in the transport sector is focussed on the development of the institutional and regulatory framework required to enable projects, as follows:

- In the road sector, structuring support for road PPPs in cooperation with the IFC/World Bank and EIB including updating tolling and fuel excise methodologies plus support for regulatory and sector reform to strengthen institutional capacity
- In the rail sector TC that complements that being provided by the World Bank for example in respect of separation of infrastructure and operations, tariff

reform, track access methodology and the scope and structure of the Public Service Obligation

- Technical and institutional support for reforms and potential future PPP/concession initiatives in the port, inland waterway and aviation sectors.

In the **power and energy** sector, initial TC would begin with assessments of and reform-oriented policy dialogue in subsectors, in view of the need to create an enabling environment for the Bank's projects[4]. These would be complemented by a focus on project preparation. Specific assignments will therefore include:

- a technical, financial and legal assessment of electricity distribution utilities, including a review of the investment requirements up to the distribution transmission interface and network regulation;
- technical assistance to prepare for corporatisation of transmission and system operation; and
- a Best Available Technology (BAT) and environmental assessment of thermal power plants under construction to assess suitability for EBRD financing.

## 5.7 Upgrading and decentralising municipal infrastructure

### Key transition challenges

Municipal services in Egypt all face urgent demands for investment to provide better access and improved quality. In urban transport, Egypt's two largest cities, Cairo and Alexandria, suffer from high levels of traffic congestion, air and noise pollution, poor public transport systems, high accident rates and under investment. There are currently two underground lines in Cairo and a third one is under construction.

The water sector confronts a number of complex challenges including increasing water demand; excessive usage, high losses, interrupted service, quality concerns, insufficient re-use and deficient billing systems. Wastewater service coverage is low, even in urban areas although increases are planned in the next few years. Maintenance is poor and there has been insufficient rehabilitation of existing services. Solid waste management is rudimentary. One of the first private projects in the sector is being developed by Citadel Capital, a private equity firm based in Cairo.

Against this background, the following are some of the transition challenges in the municipal sector that will be relevant in designing the Bank's priorities:

- Non-sovereign financing is not widespread in Egypt and has not been a focus of IFI activity in the country, reflecting limited or no scope for engagement at that level for risk. The Bank can therefore play an instrumental role in developing decentralised financing solutions that will be complementary to the efforts of

[4] The Bank intends to prepare a booklet outlining lessons learned by the EBRD in the Power & Energy sector with the objective of influencing policy makers and industry players.

other IFIs in the country. Sub-sovereign structures will encourage improved cost recovery and commercial discipline.

- The need for investment in mass transit systems and bus operations development in Greater Cairo and Alexandria to solve the severe congestion problems and to improve air quality. This must be supported by rationalisation measures such the introduction of e-ticketing systems, as well as institutional development, decentralisation and commercialisation of urban transport, including introduction of PPPs.
- The need for investment in water supply and wastewater collection and treatment facilities. Whilst there are several projects under development, the government is also seeking to introduce PPPs in the sector.
- There is an urgent need to establish modern integrated waste management facilities to recycle and process both municipal and other waste and to introduce service contracts in accordance with international standards.

**Potential investment areas**

To meet the investment needs of the municipal sector, the Bank's priorities in Egypt would include support for decentralisation, commercialisation and modernisation of infrastructure and development of the PPP market. There are urgent investment needs in the urban transport, water/wastewater, solid waste management and social infrastructure sectors where the Bank could play an important role because of its sector knowledge and commercialisation experience.

The Bank could: (i) on a non-sovereign basis, support financially viable public sector entities committed to restructuring and commercialisation; (ii) fund the development of private sector participation, where adequate; and (iii) selectively consider participation in sovereign loans in parallel with other IFIs as and when there are critical financing gaps. Potential investment opportunities, subject of course to further review, include development of light rail and dedicated lane bus transit schemes in Cairo, renewal of the bus fleet and introduction of integrated e-ticketing in Cairo and the development of a mass transit system in Alexandria.

In the water and wastewater sector, the Bank could support commercialisation of the state-owned entities to encourage improved cost recovery and commercial discipline The Bank's primary focus would be on supporting PPPs but in the short term it could consider providing sovereign-backed financing in the water and wastewater sector for necessary restructuring and priority projects in parallel with other IFIs. Potential investments could include two wastewater treatment plant PPPs, as well as a sovereign project in Middle Egypt, a desalination project on the Mediterranean coast, the Rosetta and Damietta water dams and the lake Project in the Mediterranean coastal area.

The Bank can assist the Government with structuring solid waste management projects on a non–sovereign basis. The Bank could support the Government's PPP programme in solid waste by conducting an active policy dialogue combined with technical co-operation to assist in the preparation and implementation of PPP tenders in accordance with best international practice and then providing finance to the private partners. A few solid waste management projects are being considered by the Government and are expected to be approved shortly as PPPs.

### Technical Cooperation

Reflecting these challenges, the Bank’s priorities for TC in the municipal infrastructure sector will again begin with a sector-wide assessment, on which more targeted capacity building and project preparation activities will build. Operations will therefore include:

- A thorough analysis of the current framework for financing municipal projects and the reforms necessary to make sub-sovereign financing approaches bankable.
- Support to the Egyptian Government’s PPP unit including preparation of PPP projects.
- Feasibility studies and project preparation for urban transport projects including the multimodal ticketing system for Cairo.
- Solid waste management feasibility study and project preparation.

# Annex 1: Sector Assessments

## A 1. Corporate Sectors

### A 1.1 Agribusiness

*Transition gap: Large*

*Key challenges: (i) tackle subsidies on electricity and water; (ii) increase yields in the agricultural sector through training, improved water management and better access to finance; and to (iii) develop modern processing, logistics, and distribution systems.*

Agriculture accounts for little less that 14 per cent of Egypt's GDP but absorbs about a third of total employment. Recent government policies have aimed at reducing dependency on imports[5] in particular wheat imports. Egypt is the largest importer of traded wheat in the world. The production of cotton, a key cash crop, has been declining significantly due to lack of investment and resources but still accounts for a large part of agricultural employment and is an important export commodity. Egypt ranks seventh among the global cotton exporters.

The average size of land holdings is very small and relatively unproductive, with a majority of farms below 0.42 hectares and producing mainly for local and domestic consumption. Obstacles to increasing yields seem to include lack of training and inefficient irrigation systems. In addition, access to rural credit remains limited, and most working capital needs of farms and agribusinesses are met from own resources. There is no fully functioning warehouse receipt system in place although there is some warehouse receipt finance mostly by international banks.

Liberalisation and economic integration with the EU have reduced average tariffs on most agricultural imports in Egypt. Excluding beverages and spirits, the highest tariffs (of around 30 per cent) are applied to certain fruits, meats, cut flowers and prepared foods (from cereals). However, the government still provides substantial support to the agricultural sector through subsidised electricity and water (which is provided almost free of charge). Furthermore a scheme of price guarantees exists for cotton and wheat. An export ban on rice has been in place since 2008. Fertiliser production is still predominately state-controlled and sold at subsidised prices. Certain food products, such as bread, sugar and oil, are heavily subsidised for low-income groups.

In the agribusiness sector processing, logistics and retail distribution activities remain underdeveloped, partly as a result of the lack of adequate infrastructure. Around 80 per cent of retail is still unorganised (reflecting the large number of low income consumers that are reluctant to buy processed and packaged foods). International supermarket chains have so far not been particularly successful in penetrating the

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[5] According to a May 2009 memorandum of understanding, between the Egyptian government and the International Centre for Agricultural Research in the Dry Areas initiating a ten-year wheat improvement programme, the aim is to render Egypt 75 per cent self-sufficient in the next decade, compared to the current ratio of 55 per cent, through investments in land and land reclamation.

market and there are only 2-3 retail chains across Egypt, mainly concentrated in Cairo. Although the creation of a Food Safety Agency was announced in 2008 it has so far not been established and quality and hygiene standards need significant improvement.

### A 1.2 Manufacturing and Services

*Transition gap: Large*

*Key challenges: (i) enhance the business environment by implementing modern competition policy, improving contract enforcement and bankruptcy procedures and reducing bureaucracy; (ii) increase the productivity and efficiency of the sector by introducing modern management practices including energy efficiency and promoting higher levels of R&D; and (iii) when the political climate allows, privatise and restructure most remaining state-owned companies, particularly in the textile and petrochemicals sectors.*

Manufacturing accounts for about 17 per cent of the country's GDP and 43 per cent of total exports. The state still controls about 16 per cent of the sector. Large-scale privatisation, launched in the 1990s, is incomplete with around 150 companies still under the control of nine public holding companies including those in the petrochemicals, pharmaceutical and textile sectors. Further privatisations were envisaged but progress has been slow in recent years and privatisation is currently off the political agenda as it is associated with corruption under the previous regime. Pre-privatisation restructuring poses a major challenge. In the textile sector in particular, the dominance of publicly owned but inefficient spinning and weaving companies creates bottlenecks for the textile industry.

Egypt has been a member of the WTO since inception and has gradually integrated with the EU under the Association Agreement that has been in place since 2005. The simple average MFN tariff of 9 per cent for non-agricultural products is lower than that in Russia. The highest average tariffs are applied to clothing with 28.8 per cent. Prices are liberalised in the manufacturing sector, but there are distortions from substantial energy subsidies resulting in higher energy intensity compared to OECD countries, but at par with the level of transition countries in SEE. R&D is mainly publicly driven, and with expenditures at around 0.2 per cent of GDP, Egypt compares less favourably to the Bank's countries of operations.

The general business environment and market-supporting institutions need further development. Competition policy is guided by the competition law adopted in 2005, and it is overseen by the Egyptian Competition Authority (ECA). However, ECA is not fully independent and the extent of its enforcement authority and mechanisms is unclear. A non-binding corporate governance code exists for both private and state-owned enterprises, but its implementation could be further improved.

The 2011 World Bank Doing Business survey ranked Egypt 94th out of a total of 183 economies covered in the survey. The ranking was very high in terms of 'opening a business' (18th), but very low in terms of 'closing a business' (131st) and enforcing contracts (143rd). Judicial procedures tend to be lengthy, costly and subject to political pressure. Bureaucracy is a major issue for foreign companies with substantive delays for all types of transactions. Corruption seems to be mainly low-level, but it is cited as a major obstacle to doing business by local entrepreneurs. According to Transparency International's 2010 Corruption Perception Index, Egypt ranked 98th out of 178 countries – below Bosnia and Herzegovina (91st) but above Kazakhstan and Moldova (105th).

### A 1.3 Real Estate

*Transition gap: Medium*

*Key challenges: (i) developing the office and retail segments; (ii) simplifying and speeding up the process of acquiring construction permits and property registration; (iii) creating a comprehensive and accessible property register; and (iv) improving the framework for foreclosures in order to facilitate the development of the mortgage market.*

The tourism sector seems to be relatively well developed, with many international operators present. Instead, there is insufficient supply of modern class-A properties and a large share of offices is located in buildings designed as residential properties. However, supply is increasing and there are substantial investments in the main cities. A number of large local developers operate in the market. The tourism sector, one of the key sectors of the economy, is more developed, mostly privately run but relatively heavily regulated (with significant administrative barriers especially for smaller companies). A number of leisure groups (such as Travco Group) control a large portfolio of hotels and cruise ships. The state still retains ownership stakes in a number of properties through the Holding Company for Tourism, Hotels and Cinema (including a number of 4 and 5 star hotels and land plots in prime locations). International hotel operators are active in the country (including through management contracts with state owned hotels). The mortgage market is underdeveloped (mortgages represented less than 1 per cent of GDP in 2010).

The supporting institutions to the real estate sector need further improvement. Access to land for development is difficult as property registration is incomplete and the system of title deeds as well as clear rules for tendering and acquisition have not yet been fully established. Dealing with construction permits is a significant problem – according to the 2011 World Bank Doing Business survey, acquiring a construction permit takes on average 218 days and is very costly (Egypt ranked 154th out of 183 countries on this dimension).

### A 1.4 Telecommunication

*Transition gap: Medium*

*Key challenges: (i) privatise the fixed-line incumbent and facilitate competition in the fixed-line segment; (ii) progress with tariff rebalancing; and to (iii) improve Intellectual Property rights, which are necessary for the development of the knowledge economy.*

The fixed-line segment is dominated by the state-controlled incumbent Telecom Egypt which enjoys monopolistic power over the network. The extent of the incumbent's control over the network has been evidenced by the ability of the state to almost completely block the country's access to the internet during the recent political crisis. Fixed line penetration is relatively low at about 15 per cent. Broadband internet penetration is very low, at about 1.5 per cent, and the internet take-up by businesses is very slow. Local internet content market has not yet developed.

Three operators compete in the fully liberalised mobile segment. The sector has been influenced by the entry of major foreign strategic investors but the state still retains a large minority stake (through the fixed-line incumbent Telecom Egypt) in the second largest operator Vodafone Egypt. Mobile number portability has not been implemented yet. Mobile penetration has been rising rapidly, reaching about 75 per cent in 2010.

Based on legislation adopted in 2003, the telecommunications sector is regulated by the National Telecommunications Regulatory Authority (NTRA), with financing separated from the state budget. Intellectual Property rights protection remains very week.

## A 2. Energy Sector

### A 2.1 Natural Resources

*Transition gap: Large*

*Key challenges: (i) increase competition upstream and downstream by restructuring and unbundling the vertically integrated, state-owned companies that control the extraction and distribution of petroleum, gas and other mineral resources; (ii) tackle fuel subsidies and ensure gas tariffs reach cost-recovery levels, while at the same time improving the system of targeted transfers to the most disadvantaged; (iii) strengthen the legal and regulatory framework, including setting up an independent regulator; and (iv) increasing the transparency of revenue flows from extractive activities.*

Mineral resources account for about 45 per cent of Egypt total export revenues and almost 15 per cent of the country's GDP. Due to declining oil production and growing domestic consumption, Egypt has become a net oil importer. However, with the discovery of new gas fields in the Nile Delta, it has the potential to increase its existing gas exports. About 33 per cent of gas production is exported. Of this around 70 per cent is exported as LNG, mainly to the US, Spain, Italy and France, and the rest is exported by pipeline to Israel, Jordan, Syria and Lebanon via the Arab Gas Pipeline (AGP). The country is a major transport corridor for both oil and gas: 14 per cent of the world's LNG trade and almost 5 per cent of seaborne oil trade transits through the Suez Canal, while the SUEZ-Mediterranean (SUMED) pipeline is the major conduit for Persian Gulf oil. Fees collected from the operation of these two transit routes are a significant source of revenue for the Egyptian government. The country has the largest refining capacity in Africa with nine refineries and a crude oil processing capacity of 760,000 barrels per day.

The Ministry of Petroleum and Mineral Resources is in charge of managing the mineral industry in Egypt through five independent state-owned entities: the Egyptian General Petroleum Corporation (EGPC); The Egyptian Natural Gas Holding Co (EGAS); the Egyptian Mineral Resources Authority (EMRA); Ganoube El Wadi Petroleum Holding Co. (Ganope) and the Egyptian Petrochemical Holding Co. (Echem).

EGPC manages the upstream oil exploration and production activities, including awarding new licences, other than in Southern Egypt. Alone, it accounts for about 20 per cent of the oil output and controls the bulk of Egypt's refining capacity, with a market share of 86 per cent. Private sector participation and international oil companies (IOCs) play a significant role in the upstream oil and gas sector, on a production sharing basis (PSAs) with EGPC, EGAS and Ganope. The downstream oil sector is liberalised but dominated by state-owned incumbents owned by EGPC. Seven out of nine gas distribution companies are privately operated since 1997, and LNG terminals are majority private owned. Going forward, a significant challenge for the sector is to further liberalise the sector and create a more competitive environment both upstream and downstream. This could be achieved by implementing ownership unbundling for EGPC's subsidiaries in charge of refining, distribution and marketing activities.

The presence of heavy fuel subsidies has also significantly hampered the development of an efficient and competitive downstream oil and gas distribution sector because final consumers pay only about 7 per cent of the production cost of LPG, 52 per cent of that of gas used for electricity production, and 67 per cent for fuel oil. Domestic fuel prices remain thus well below international prices (LPG is 75 per cent below; oil and gasoline about 30 per cent below international comparators). Subsidies are highly regressive and a drag on the budget. In the FY 2009/2010, it is estimated that subsidies for petroleum products accounted for 5.5 percent of GDP or 15 per cent of total spending. The government's plan, launched in 2007, to gradually increase domestic gas prices to actual costs by 2010 has been delayed by the financial crisis and the elimination of fuel subsidies postponed to 2014.

The current energy policy of the government is to allocate one third of proven natural gas reserves to the domestic market, one third to future generations and the remaining to exports. The country's Energy Strategy until 2030 was under preparation before the crisis erupted. It should become the framework for energy sector liberalisation, including the elimination of energy subsidies. It should also provide for the establishment of an independent oil and gas regulator, as this function is currently retained by the state-owned energy companies who issue licences and allocate energy subsidies. The Ministry of Petroleum was also preparing a new draft law for the extraction of mineral resources. The low transparency over licensing and revenue distribution is a major challenge for the sector. The country is neither EITI compliant nor a candidate country.

## A 2.2 Power

*Transition gap: Large*

*Key challenges: (i) structural modernisation including commercialisation, effective unbundling and privatisation; (ii) development of a market system that promotes investment in new generation capacity; (iii) the removal of cross-subsidies and the implementation of cost reflective tariffs; and (iv) establishment of a credible, independent regulator.*

Access to electricity is high in Egypt, with around 99.4 per cent of the population connected to the electricity system. Generation mostly comes from thermal gas plants. However, the country has witnessed a rapidly growing demand and has recently suffered from intermittent blackouts and rationing due to insufficient capacity during peak periods. The country has hydro generators, 490 MW of wind power and is completing a hybrid solar (20 MW) and combined cycle (120 MW) power plant. There are three Independent Power Producers (IPPs), representing 10 per cent of generation capacity, who have participated in 20 year Build, Own, Operate and Transfer (BOOT) schemes and there are plans for further BOOTs, beginning with the Dairut project. In addition, the Government had been developing ambitious plans for a nuclear power plant to come online by 2019.

The Egyptian power sector is functionally unbundled but remains almost entirely state-owned with only 10 per cent of generation under private sector control. Despite the unbundling, operational control is in practice centralised in the hands of the state-owned Egyptian Electricity Holding Company (**EEHC**). A single-buyer market design is in operation but there is no competition among incumbent companies and all tariffs are regulated.

Tariffs are not cost reflective so that electricity prices are comparatively very low, relying on both explicit (fiscal transfers) and implicit (cheap gas prices) subsidies. In particular, industrial and domestic consumers receive low cost power. In 2007, the Government proposed the phasing out of cross subsidies by 2013 but delayed the implementation of the policy. In aggregate, the network is well interconnected with its neighbours and the country was a net exporter in 2009. However, network reinforcement is needed to facilitate transit flows and accommodate growing demand.

The regulator, the Egyptian Electric Utility and Consumer Protection Agency was created in 2000. It allocates licences but has no tariff-setting powers. A new Electricity law was endorsed by the Cabinet in 2008 and proposed a number of reforms including the privatisation of minority stakes, third-party access, feed-in-tariffs and more effective unbundling. The law also envisioned the creation of a bilateral trading market with a balancing mechanism and the progressive liberalisation of the supply market. However, the progress of reforms has been halted by recent events and therefore large challenges remain for the sector.

### A 2.3 Sustainable Energy

*Transition gap: Large*

*Key challenges: (i) the implementation of a robust legal framework that will promote the development of renewable generation and energy efficiency; (ii) tackling cross-subsidisation and subsidies; (iii) the introduction of tariffs that allow for cost recovery; and (iv) the introduction of an agency with responsibility for the achievement of national targets.*

Overall the challenges in the Sustainable Energy sector are significant. Egypt ranks among the 11 countries in the world showing the fastest growing GHG emissions. Energy and carbon intensities are both relatively high in Egypt although electricity consumption and CO2 per capita are relatively low. Egypt has prepared a National Energy Conservation plan to deal with energy efficiency. However, there is no body responsible for achieving the target and no specific legal foundation for the policy. The low cost of energy and high level of subsidies is a significant structural barrier to the promotion of energy efficient behaviour.

Egypt has a significant potential in hydro, wind and solar. Hydropower has already been promoted with 2.78GW (11 per cent) of generating capacity mostly from dams on the Nile River and there are limited possibilities to increase this. The 2007 Egyptian energy strategy stipulates a 20 per cent target for renewable generation by 2020. The country is promoting a number of initiatives including DESERTEC and Mediterranean Solar Plan to promote the production of renewable energy for export but these remain some way off. Legislation that would have provided subsides for renewable generators, both in the form of grants and feed-in-tariffs, and priority despatch seems to have been halted by recent events. Consequently renewable energy promotion at the moment is focused on state-sponsored, and largely state-owned, wind developments.

## A 3. Infrastructure

### A 3.1 Railways

*Transition gap: Large*

*Key challenges: (i) the corporatisation and further restructuring of the Egyptian National Railways (ENR), including full separation of infrastructure from operations, and costs optimisation; (ii) tariff reform to improve the fare box ratio; (iii) strengthening the regulatory and institutional framework by separating the policy making, regulation and operation functions into distinct entities; and (iv) granting third party access to the network.*

The Egyptian National Railways (ENR) is the vertically integrated rail incumbent owned by the Ministry of Transport. ENR has a market share of about 40 per cent in passenger traffic but only about 3 per cent of freight. Third party access to the track is not envisaged, but private sector participation is legally allowed in the construction and operation of new lines.

In 2008, ENR was reorganised along strategic business lines to prepare its corporatisation: long-distance passenger services, short-distance passenger services, freight services and infrastructure services. In spite of this reorganisation and the relatively high ridership (the highest in Africa), the company is loss making, largely due the high headcount costs and low revenues. Tariffs are low compared to costs – freight tariffs are EUR 0.24 per tonne-km (half of the MENA average), EUR 0.007 per passenger/km in third class and EUR 0.03 in first class. The level of fare evasion is very high. Subsidies are paid according to a Public Service Obligation contract.

A National Authority for Railway is the formal regulator of the sector. However, policy making and operations are not fully separated.

### A 3.2 Roads

*Transition gap: Medium*

*Key reform challenges: (i) full separation of regulation from operations; (ii) divesture of the road maintenance companies; (iii) improved financing through higher tolling rates and/or transport fuel excises; and (iv) implementation of PPPs.*

The road network of Egypt comprises some 54,000 km of roads, of which the main roads (25,000 km) are under the control of the General Authority for Roads, Bridges & Land Transport (GARBLT), a subsidiary of the Ministry of Transport, and the rest under the responsibility of 22 local administrations. While the extent of the road network has grown significantly in recent years and seems to provide adequate cover, many roads are insufficiently maintained and road safety is poor by international standards and congestion is reported to be a problem particularly in Greater Cairo.

Market supporting institutions and the regulatory framework need further strengthening. In particular, the policy making and regulatory function needs to be formally separated from operations, as GARBLT is the holding company of the four largest road and bridge construction companies that undertake most of the construction and maintenance work.

Road funding is provided by budget transfers and road tolls, which are common but relatively inexpensive in comparison to other MENA countries. Fuel excises are low and do not provide enough resources for the sector.

There is a national PPP coordination unit within the Ministry of Finance. One road PPP has been completed and there is a pipeline of several road PPPs, although implementation over the past decade has been slow.

### A 3.3 Water and Wastewater

*Transition gap: Large*

*Key challenges: (i) tariff reform to improve the sustainability of services; (ii) restructuring and commercialisation of water utilities (reduction of losses, labour restructuring and productivity improvements); (iii) increased decentralisation of operations by granting more autonomy to local municipalities; and (iv) further development to PPPs financing of water and wastewater treatment plants.*

Water use efficiency is a key problem in Egypt. Although access to water is widespread (99 per cent of the population has access to water and 85 per cent of households are connected to piped water), consumption is wasteful. The International Water Agency estimates that annual consumption at 68.3 $km^3$ is about 10 $km^3$ above sustainability levels and probably not adequate to adapt to future climate change. Fifty years ago, the country had 2,100 cubic metres of water per capita annually; now it has less than 800 cubic metres and is below the UN's water poverty line of 1,000 cubic metres of water per person per year. The world average is more than 7,000 cubic metres, according to the UN. Access to sanitation is much poorer: only about 70 per cent of the population has access to any form of sanitation and 36 per cent of the population has access to sewerage.

The sector was partially unbundled, but remains relatively centralised. The Holding Company for Water and Wastewater (HCWW) incorporates 23 maintenance and operations companies supplying around 90 per cent of the population with a workforce of 98,499. Investment is undertaken by the National Organisation for Water and Sanitary Drainage, except in Cairo and Alexandria which have two utilities each – one for water and one for wastewater. Operational performance is relatively reliable (four days of insufficient supply per months), but water losses are relatively high at 20-50 per cent. Financial performance in the sector is very weak due to low tariff based revenue and low productivity. Metering is not widespread. Investments are financed by the central government, sometimes through IFI or donor financing.

There is some private participation in the sector. There are three wastewater-plant PPPs under preparation and several private contracts for meter installations. HCWW has outsourced customer care and billing to a private company. There are plans to further expand private sector involvement, possibly through management contracts and leases.

Tariffs are very low and do not reflect the cost of resources or the sustainability component. At EUR 0.04 per $m^3$ of water, tariffs are very low even compared to MENA standards and cover only about 35 per cent of costs, whereas wastewater tariffs are charged as a 25 per cent surcharge on water bills and only cover 10 per cent of costs. Operators receive operating subsidies from the government.

Although a formal regulatory agency was established (Egypt Water Regulatory Agency), it is still not fully operational

### A 3.4 Solid Waste Management

*Transition gap: Large*

*Key challenges: (i) development of an appropriate mechanism for solid waste management (SWM) cost recovery, based on the "polluter pays" and "user pays" principles; (ii) further development of regulations for SWM to provide legal support for the planning, application and administration of modern SWM targeted at reducing the amount of waste generated in the country and promote recycling; (iii) institutional changes in the relationship between operators; and (iv) develop capacity to privatise the waste management sector at the national and local levels.*

The Egyptian authorities rate inadequate solid waste management (SWM) as the top priority among urban environmental issues. Sub-standard SWM systems have a serious negative impact on both public health and economic development. Open burning of solid waste contributes to air pollution and increased respiratory problems. Illegal dumping of waste in public areas and improper management of solid waste, and its commingling with medical and hazardous wastes, lead to serious health problems, lost workdays, and decreased labour productivity.

The Egypt Environmental Affairs Agency (EEAA) has compiled a series of guidelines for the effective implementation of solid waste management, especially for the recycling and treatment facilities, landfill design and operations. Local governments (governorates) are fully responsible for all SWM activities in the localities under their jurisdiction. The governorates' duties include planning, institutional and financial organisation, tariff setting, permit issuance, contracting, operations monitoring and control, law enforcement, and public awareness. A national SWM strategy was adopted in 2000. It reinforces the roles of governorates in services delivery and gives support to private sector participation. Annual public SWM expenditure for 2003–2008 has been estimated at USD 182 million.

Traditionally, solid waste management infrastructure has been financed through central government allocation. Cost recovery for SWM services has been undertaken at the local level through imposition of a 2 per cent levy on the rental value of housing units. In 2000, at the governorate level, SWM fee collection through electricity bills was introduced. Private sector participation in SWM is being promoted through 'zabbaleen' (waste collectors), national private operators, and international firms. To date, there is some private sector involvement in Alexandria, Cairo, Giza urban districts I and II, Suez and Aswan. Contract durations range from 10 to 15 years. A ministerial SWM committee to facilitate and monitor private sector participation at the governorate level has been established.

### A 3.5 Urban Transport

*Transition gap: Large*

*Key challenges: (i) reforming the institutional relationship between operators and public authorities, including the need to separate the regulatory from the operational functions; (ii) tariff reform to improve fare box ratios, subject to affordability* *constraints; (iii) capacity building to improve planning capacity, and (iv) tackling high congestion and emissions in larger cities through a combination of regulatory and market-based instruments.*

Service provision of urban transport is decentralised. Cairo and Alexandria both have a Transport Authority that however acts as both a regulator and operator of the sector.

Private sector participation – mainly minibuses - is widespread and estimated to have a 56 per cent share of public transport in Greater Cairo. However service and safety standards could be improved. The metro network is underdeveloped by international standards and there is a shortage of high capacity buses (development needs), but some modern technologies have been introduced on a pilot basis (e.g. 100 compressed natural gas buses are operated in Cairo).

Public operators need substantial financial support (USD 130 million in direct subsidies in 2006 and USD 1.5 billion in indirect fuel subsidies in 2005). Investment is financed by grants to the public operator. The World Bank is providing carbon finance for vehicle scrapping.

Congestion and air pollution are major problems in Egypt's large and rapidly growing cities, particularly in light of the increasing motorisation. Regulation and operation are not separated, service and emission standards need improvement and operator revenues are not cost-based and unpredictable, hindering investment.

## A 4. Financial Institutions

### A 4.1 Banking and Finance to MSMEs

*Key Challenges: (i) broaden financial access to SMEs and individuals, in particular by improving financial literacy on bankability of SMEs; (ii) deepen financial intermediation by addressing impediments to the extension of private sector credit, including the lack of credit information and the high cost of underwriting and servicing; and (iii) reduce state control of banking by completing the privatisation process..*

**Banking**

*Transition gap: Medium*

The financial sector in Egypt has a history of state ownership. As late as 2004, only 30 per cent of banking assets were held by private banks and 57 per cent of banking assets were in four state-owned general purpose commercial banks (Bank of Alexandria, National Bank of Egypt, Banque du Caire and Banque Misr). The Government also owned three specialised state-owned banks (for industry, real estate, and agriculture) and held stakes in a number of 'joint-venture' banks.

In 2006, the government privatised Bank of Alexandria. It also divested public sector shares in 13 joint-venture banks, allowing for the entry of international players. The share of assets held by private banks reached 55 per cent in 2009. The privatisation of Banque du Caire, Egypt's third largest state-owned bank, was postponed in May 2008 when the Government was unable to negotiate a satisfactory price with bidders. Prior to the events of 2011, the authorities still planned to sell the government's shares in United Bank of Egypt and Arab African International Bank by the end of 2011. The following table summarises the ownership and market share of the top 12 Egyptian banks:

| Bank | Assets EGP BN | Market Share | Major shareholders |
|---|---|---|---|
| National Bank of Egypt | 279 | 25.5 | 100 per cent Government- owned |
| Banque Misr | 173 | 15.8 | 100 per cent Government- owned |
| Commercial International Bank | 66 | 6.04 | BNY Mellon (10.45 per cent), Actis (9.3 per cent), Dubai Capital Group (5.24 per cent) |
| National Societe Generale Bank | 55 | 5.04 | Societe Generale (77.17 per cent) |
| Arab African International Bank | 46.5 | 4.25 | CBE (49.37 per cent), Kuwait Investment Authority (49.37 per cent) |
| Banque du Caire | 40 | 3.7 | 100 per cent Government- owned |
| HSBC Bank Egypt | 36 | 3.3 | HSBC Holdings (94.5 per cent) |
| Bank of Alexandria | 34 | 3.11 | Intesa Sanpaolo (70.25 per cent), Government (20 per cent), IFC (9.75 per cent) |
| Credit Agricole Egypt | 23 | 2.11 | Credit Agricole S.A. (40 per cent), Mansour & Maghraby Investment and Development S.A.E. (17.5 per cent), Credit Agricole CIB (13.1 per cent), |
| Faisal Islamic Bank of Egypt | 22 | 2.01 | Dar-Al Maal Al- Islami Trust Group (49 per cent), Egyptian Alwakf Authority (15.4 per cent), Ithmaar Bank B.S.C. (9.3 per cent), Dar-Al Mall Al-Islam (9.1 per cent), DMI Administrative Services SA (9 per cent) |
| Barclays Bank Egypt | 18 | 1.65 | Barclays Bank PLC (99.9 per cent) |
| BNP Paribas | 17 | 1.56 | BNP Paribas (95 per cent), Banque Misr SAE (4.4 per cent), Employees Fund of Banque du Caire (0.4 per cent) |

Most Egyptian banks are relatively liquid, rely mostly on local currency deposits for funding and, in principle, have room to extend loans as well as to lengthen maturities. However, the ratio of loans to assets is relatively low, at 39 per cent, and securities and investments in Treasury Bonds account for a significant part of bank assets. Most loans are short term, with little medium term lending. The constraints on longer term lending are not only related to the availability of funding but also the types of projects being financed and the creditworthiness of potential borrowers.

Non-performing loans (NPLs) stood at 22 per cent of total loans in 2004, attributed largely to a long period of lax financing of state-owned projects and enterprises. A

NPL management unit was created at the CBE in order to clear banks' balance sheets. As a result, NPLs declined to an estimated 14 per cent as of March 2010.

Banking penetration is low compared to regional peers. It is estimated that only 10 per cent of Egyptians have a bank account. As of June 2010, there were 3,502 branches, for a banking density of 4.5 banking units per 100,000 inhabitants (compared with 15 in Romania or 44 in France).

In September 2004, the Central Bank of Egypt (CBE) implemented the first stage of banking reforms, which were centred on four pillars: (i) consolidation and privatisation of the banking sector, (ii) financial and managerial restructuring of state-owned banks, (iii) addressing of the issue of nonperforming loans, and (iv) upgrading of the Supervisory function at the CBE.

Currently, the CBE is implementing the second stage of the banking reform plan. This stage (2009 – 2011) aims at raising the efficiency and soundness of the Egyptian banking sector, and enhancing its competitiveness and ability for risk management. In parallel to this reform, the implementation Basel II standards is expected to be finalised by December 2011.

**Finance for Micro, Small and Medium-sized enterprises**

*Transition gap: Large*

Improving access to finance for MSMEs is one of the key reform challenges in the financial sector. MSMEs account for over 90 per cent of active enterprises in Egypt and contribute to over 80 per cent of GDP and 75 per cent of total employment. However, according to a survey by NILEX[6], SMEs account for only 10 per cent of total capital accumulation in Egypt and, while 75 per cent of SMEs apply for banking loans, 92 per cent of applications are rejected. As a result, loans to SMEs account for only 6 per cent of total loans.

There is presence of microfinance NGOs and a law on microfinance, which would allow for the commercial expansion of the sector, was going through the Egyptian Parliament before the events of January 2011. By the end of 2009, the total number of active microfinance borrowers exceeded 1.4 million (of which 50 per cent women) and the total outstanding portfolio reached approximately EUR 283 million. More than 400 institutions in Egypt offer microcredit programmes, including four banks (of which two public banks (Banque du Caire and Banque Misr). NGOs account for 68 per cent of the outstanding loan portfolio, while banks and service companies account for the remaining 26 per cent and 6 per cent, respectively. In spite of this large number of institutions, the market studies indicate a very significant supply gap.

In order to improve SMEs' access to finance, Egypt has tried to favour the development of non-bank financial services that are better suitable to SMEs, such as leasing and factoring, as well as to improve the Credit Information Infrastructure with

[6] NILEX is a specialised exchange for SMEs, launched on 3 June 2010 to enhance financial intermediation and facilitate access to finance.

the I-Score Credit Bureau[7]. In November 2008, the General Authority for Investment launched a Small and Medium Investment strategy, organised around four pillars: promoting an entrepreneurship culture, creating competitiveness poles, improving access to finance and developing business development services. In December 2008, the CBE exempted banks' lending to SMEs from the 14 per cent reserve requirement and reduced the cost of funding by 1.5 per cent, in order to encourage banks to allocate more of their lending to SMEs. However, so far, these reforms have not resulted in a substantial change in SME financing. Consequently, in May 2011, the Government has announced that it would ask Banque du Caire to focus on SMEs.

Underwriting and servicing small loans is seen as unprofitable for Egyptian banks. A few banks are moving into mid-market and some small enterprise lending, reportedly managing on a portfolio basis due to the highly variable credit quality. Constraints to lending to MSMES appear more related to the institutional capacity and risk appetite of the private banking sector, as well as low bankability and low financial literacy of MSMEs, rather than liquidity. Historically, Egyptian banks have remained risk averse and relied on collateral requirements rather than cash flow projections and interest rates to discriminate between credit opportunities, which are symptomatic of weak institutional risk management.

Additional constraints also relate to inadequate local regulations, which set some minimum criteria for an MSME to be considered as "bankable". Among these criteria, the main hurdle is the requirement to have at least three years of audited financial statements, for companies that request a loan above EGP 100,000 (USD 17,000).

This is compounded by a lack of information on potential borrowers. For example, the Credit Bureau gathers information on individuals, not companies. Banks can use bureau information to assess the creditworthiness of micro-enterprises but do not have information they would use for small businesses. Access to finance for MSMEs might be improved by programs that would expand the availability of credit information, provide credit guarantees/risk sharing, or and reduce the cost of underwriting, for example by introducing methodologies that improve the lender's capacity to process and service large numbers of small loans.

### A 4.2 Insurance and Other Financial Services

*Transition gap: Large*

*Key Challenges: (i) increase the penetration rates for insurance and encourage a more dynamic sector by privatising the dominant state-owned insurer; (ii) expand the availability of leasing, particularly to small businesses and individuals; and (iii) develop further the institutional frameworks for mortgages, including land registration and long term funding.*

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[7] A government initiative started in 2007 which entails information collection and sharing by 25 banks and the Social Fund for Development (SFD), the I-Score Credit Bureau provides information on borrowers and credit scoring services.

## Insurance

The insurance market and other non-banking financial institutions are underdeveloped in Egypt compared to the EBRD region. The penetration ratio is low, with insurance premia at only 1 per cent of GDP (0.6 per cent for life insurance and 0.4 per cent for non-life insurance). These levels are close to Georgia, FYR Macedonia and Turkey in the EBRD region, which all have premia at around 1 per cent of GDP.

The industry is dominated by two large state-owned companies that control approximately 60 per cent of the market, the privatisation plans for which are unclear. The state-owned Insurance Holding Company is the largest player with about 40 per cent of premia and 75 per cent of assets, as of end-2008. Multinationals are present, and include MetLife, Allianz and ACE. The minimum paid-up capital for insurance companies was increased to USD 12 million in 2007, which led to some restructuring within the sector. As a result, there are currently a total of 29 insurance companies in Egypt.

The regulatory framework has been strengthened with the establishment in 2009 of the Egyptian Financial Supervisory Authority, which supervises the non-banking financial sector. It replaced the Egyptian Insurance Supervisory Authority, the Capital Market Authority and the Mortgage Finance Authority, and regulates the leasing activity as well.

## Mortgage finance

The mortgage sector in Egypt is small and relatively underdeveloped. As of June 2010, there were 13 mortgage finance companies. Mortgage loans extended by both banks and mortgage finance companies stood at a mere 0.36 per cent of GDP at the end June 2009, below Azerbaijan at 0.7 per cent of GDP, Mongolia at 1.9 per cent and Hungary at 16.7 per cent. The average size of the loans extended by mortgage finance companies was EGP 120,370 (or less than 15,000 euro) with an average loan maturity of 16 years in 2009.

The Egyptian Mortgage Refinance Company (EMRC) was established in June 2006, with the objective of providing long-term finance to mortgage finance companies and banks operating in this field, which are among its funding members. EMRC was meant to issue bonds collateralised by real estate loan portfolios, in order to help enhance the bond market and provide long-term finance for mortgages. However, so far, it has not issued any bond.

Reforms in the sector were also aimed at simplifying the procedures of credit rating and income proof, and at capacity building for brokerage and real estate appraisals. However, mortgage finance remains underdeveloped in Egypt, despite the reforms. Among the reasons for this, bankers suggest that interest rates around 12.5 per cent are not attractive for borrowers. On the lending side, the costs of underwriting, lengthy foreclosure process, and less than 30 per cent of property being properly registered, limit the banks’ scope to underwrite mortgages.

## Leasing

Although the volume of leasing contracts doubled from 2004 to 2009, the total leasing portfolio is EGP 8.5 billion (USD 1.5 billion), equivalent to approximately 0.3 per cent of GDP or approximately 2 per cent of the total loan portfolio. This compares to 3-5 per cent in the more developed of the Bank's countries of operation and 10-15 per cent in developed markets.

Cars, real estate and production lines each make up around a quarter of leased contracts in Egypt. Equipment makes up the remaining 27 per cent, of which 21 per cent is in heavy equipment, driven by the growth in the real estate segment. Commercial leasing competes directly with bank lending; leasing companies target large clients, which generally can, and prefer to, borrow from banks. There is virtually no retail leasing and very little leasing to small companies.

## Pension Funds

In Egypt, public pensions are provided through three mandatory social insurance schemes: the Government Employees Pension Fund, the Pension Fund for military personnel, and the Public and Private Enterprises Employees Pension Fund (PPEEPF). The PPEEPF also manages special schemes for employers and self-employed, individuals working abroad, as well as casual and informal sector workers. Alternative social insurance schemes can be established on a voluntary basis by companies employing at least of 100 workers and with total capital of EGP 10 million.

Voluntary occupational pension plans have been established in Egypt since 1975. They are known as Special Insurance Funds (SIF) and are licensed by the supervisor. Although the law prescribes voluntary membership in SIFs, in practice participation becomes quasi mandatory due to related mode of financing of most pension funds through specific allocations from companies' activities surpluses. In addition, almost all trade unions in Egypt may sponsor occupational plans which provide flat-rate pensions (and under certain condition lump sum payments) to adherent members after the attainment of retirement age. As a result, there were 632 Special Insurance Funds in 2010. However, total subscriptions and contributions accounted for only EGP 3.3 billion (or 0.27 per cent of GDP). The large majority of the Funds' investments were made in government securities (more than 70 per cent of total assets), with the rest kept as bank deposits.

The Country's private pension industry is also nascent, with the latest available data suggesting that only 4.6 million people (5.6 per cent of the country's population) are enrolled in a private pension scheme. Total private pension savings amounted to EGP 26.7 billion (USD 4.9 billion) as at the end of 2008, equivalent to approximately 3 per cent of GDP. This is very low relative to levels in developed countries (over 50 per cent), and even relative to some of our COOs (5-20 per cent). The private pension industry is dominated by defined benefit plans, with more modern defined contribution plans only recently introduced.

Over the past few years, the Egyptian government has embarked on a pension reform process that aims to improve public pension funds performance and reinforce the administration and management capacity of the private pension industry, as well as strengthen supervisory control over pension schemes. In June 2010, the Egyptian Parliament passed a pension reform law that will replace the current public pay-as-you-go (PAYG) pension system with a system of individual accounts on January 1, 2012. Specific regulations concerning the system were due before Parliament by the end of 2010.

### A 4.3 Private equity

*Transition gap: Medium*

*Key Challenges: (i) develop institutional quality private equity funds in the medium size and SME segments; (ii) broaden the range of products; (iii) regain international commercial investors' confidence and attract more local institutional investors as the insurance and pension segments grow; and (iv) enhance governance standards.*

The private equity market in Egypt looks similar to that of Turkey. The country has been on the radar screen of large international players and regional funds, which target larger cap deals. However, political uncertainty around the region continues to have a short-term negative impact on investor sentiment: international investors have baulked at the political risks, leading some major fund managers to pull back. As a result, there is a potential loss of momentum in the market.

Private equity has reached a number of sectors, including telecoms and IT (mainly venture capital investments in start-ups or small companies), agribusiness, basic materials (such as cement, fertilizers or steel), financial services and oil and gas. Over half of the funds in Egypt focus on buyouts; growth capital accounts for close to 17 per cent of the funds. However, the number of country-dedicated fund managers has declined drastically in recent years, with only 2 country-focused funds present since 2009 (compared to 9 in 2006). In 2009, an estimated USD 3.8 billion in private equity investments was done in Egypt, equivalent to just over 2 per cent of GDP. While this is much higher than the MENA average (approx. 0.11 per cent in 2009 and 0.04 per cent in 2010) and private equity investments seen in the EBRD's countries of operation in 2009, such level is distorted by one large deal (Citadel Capital's deal for USD 3.5 billion to finance building a refinery in the Mostorod district of Cairo). Excluding this one-off large investment, the penetration level points at the need to further develop the middle and small size segment of the market. The private sector in general, starting from the large caps to the middle market and SME segments are underserved, as are specialty niches such as venture capital, mezzanine, and distressed assets funds. As deal volume has dropped off during the Arab spring, there should be significant 'dry powder' for private equity investment.

### A 4.4 Capital markets

*Transition gap: Medium*

*Key Challenges: (i) improve the functioning of the government bond market as a basis for money market and corporate bond development by building a reliable sovereign yield curve and liquid secondary markets; (ii) develop the corporate bond market as* *an alternative to bank-led finance; and (iii) build the institutional investor base (insurance, pension funds).*

### Money market

A persistent structural surplus of liquidity – emanating from high capital inflows and the heavily managed exchange rate regime – has impeded the development of well-functioning money markets. While the Central Bank of Egypt (CBE) has tried different instruments (e.g., tradable CBE certificates of deposit, CBE auctions of non-negotiable deposits), the sterilisation of capital inflows has not been fully effective.

### Bonds

Egypt's domestic debt market is small relative to other emerging markets. Tradable domestic debt represents about 26 per cent of GDP, almost all of which is government. By contrast, domestic debt is more than 50 per cent of GDP in the Czech Republic, Malaysia, and Thailand. Commercial banks are the main investors in government securities, holding about 55 per cent of total Treasury bonds.

Although Egypt's government has established the basic building blocks for a government securities market, Egypt still lacks a reliable local currency yield curve. The lack of a reliable yield curve has, along with other factors, discouraged the issuance of corporate bonds in Egypt, which could provide a useful additional source of long-term financing for fixed capital formation. As a result, corporate bonds represent only EGP 5.3 billion (0.44 per cent of GDP) and the market is at a very early stage of development

### Listed securities (stocks, bonds and mutual funds)

The Egyptian Stock Exchange (EGX) is the oldest exchange in the MENA region. It comprises two segments: the main market, where a total of 212 companies was listed by the end of 2010, and NILEX, for small and medium capitalisations. Total market capitalisation rose to about USD 70 billion by the end of December 2010 and the turnover ratio stood at 43 per cent. NILEX is a much smaller exchange, with only 17 companies listed as of December 2010, and 13 traded. Market capitalisation stood at EGP 1 billion (0.08 per cent of GDP).

Although total market capitalisation as a percentage of GDP is similar to that of Turkey (about 40 per cent), Egypt's stock market is less liquid and quite concentrated: the main Index, EGX 30, represents around 50 per cent of total market capitalisation. There have been only 15 equity offerings in the past 5 years, of which 11 have been IPOs. The valued traded of the capital market is dominated by Egyptians, mainly retail investors. Institutional investors accounted for only 36 per cent of total trading. The market has been closed in the aftermath of the political turmoil.

**Box A1: Environment for local currency development**

Since the reforms of the mid-2000s, regulation has supported local currency use. Reserve requirements on foreign exchange deposits were set at 25 per cent as compared to 20 per cent on local currency. In 2003, the government introduced a ban on foreign exchange loans to borrowers without foreign exchange income.

**Money and capital markets**

Money and foreign currency markets are underdeveloped. The *money market* is highly illiquid because of excess liquidity in the banking system. As a result, the money market benchmark index CAIBOR is not representative, especially beyond the one-week maturity, and is rarely used for pricing financial transactions. The range of instruments in the *foreign exchange market* is limited - only the spot market and non-deliverable forwards are available – as the trading of foreign exchange forwards and swaps is restricted by a mixture of restrictions on swaps transactions with nonbanks and moral dissuasion by the central bank against forwards for speculative purposes.

The Egyptian pound is fully convertible. *Spot foreign exchange* transactions occur in relation to an underlying investment flow (as opposed to very short term speculative flows), such as when securities (T-bills) are bought or sold. Prior to the events of January 2011, the market was liquid with a daily trading volume of $200-300 million.

Before January 2011, the *non-deliverable forward market* was moderately liquid. Liquidity has since deteriorated materially, as participants are reluctant to quote and dealing interest is largely one-sided (selling EGP).

Overall, ***money market development*** is comparable with that of Ukraine or Georgia, as measured by the EBRD Money Market Development Index (Chart A1). Market infrastructure for government debt, both primary and secondary, is reasonably well developed but the market is illiquid beyond the shortest term. Local currency government debt is sizable in both relative and absolute terms but it is heavily tilted toward shorter maturities.

By size, the stock of ***local currency public debt*** ranks after Turkey and Poland (Chart A2). The authorities have taken significant measures to develop the market, including issuing and reissuing benchmark size issues, lengthening maturities, and introducing a primary dealer system. By 2007, three quarters of domestic debt was standardised. The average maturity of standardised debt increased from less than 1 year in 2004 to 2.1 years in 2007. Nevertheless, the market is still heavily tilted toward the shorter term. Secondary market turnover is thin in securities with maturities longer than 6 months since banks – as the largest holders of domestic government debt – have little incentive to trade given their excess liquidity. In contrast, secondary trading in the shorter-term treasury bill market is active. As a result, there is no reliable yield curve available beyond the shortest-term that could benchmark the pricing of long term funding and lending. Egypt ranks 7$^{th}$ when compared with EBRD COOs on the EBRD's government bond market development index, on a par with Romania and Ukraine, and behind Hungary, Poland, Turkey, Russia, Kazakhstan and Bulgaria (Chart A3).

Finally, the ***insurance sector and pension sectors*** are underdeveloped, together holding assets of around 6 per cent of GDP (see Chart A4)**.** Insurance assets are mostly held in central bank deposits, partly because corporate bond issues are rare with an outstanding stock around 2% of GDP. Pension funds assets are often used to finance different government investment programs through the National Investment Bank.

**Chart A1: EBRD Money market development index**

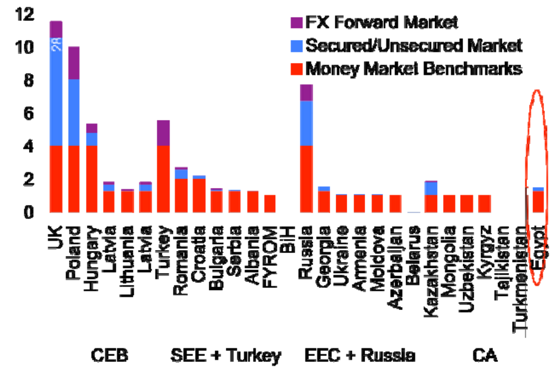
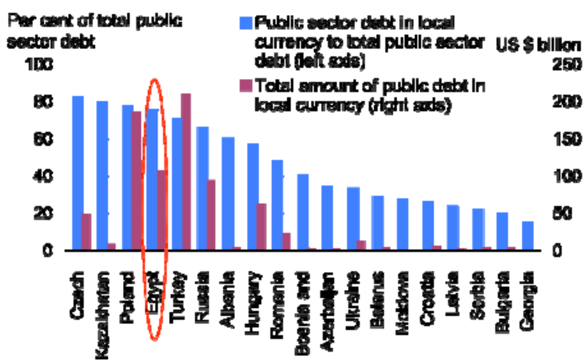



**Chart A2: Public sector debt in local currency**




Source: EBRD calculations based on information from country authorities and money market participants.
Sources: IMF country reports, International Financial Statistics, national authorities.
Note: Data refers to end-2009. For Belarus, Bosnia and Herzegovina, Bulgaria, Czech Republic, Latvia, FYR Macedonia, and Uzbekistan, data reflects estimates for 2009.

**Chart A3: EBRD Government bond market index**

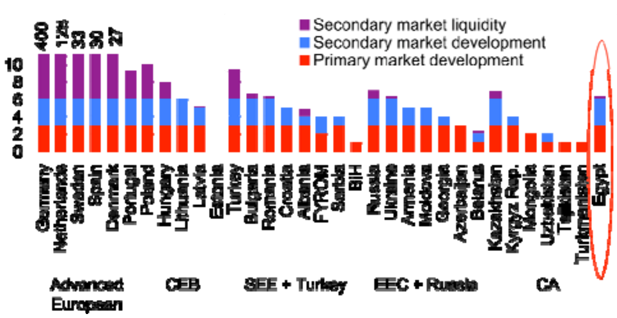
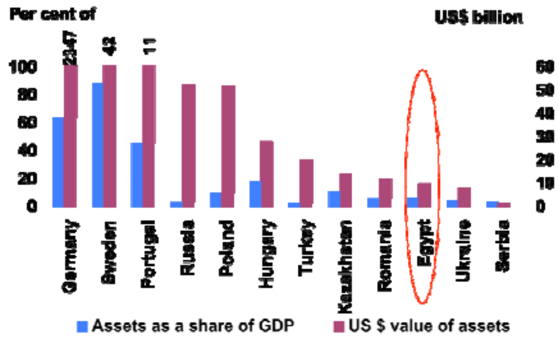


**Chart A4: Assets of insurance and pension funds**




Source: EBRD calculations based on information from country authorities and money market participants.
Source: OECD, National authorities, IOPS, Egypt MinFin.
Note: Data refers to end-2008 (end-2007 for Romania).

# Annex 2: Summary of challenges, opportunities and priorities

**Table A 1: Summary of challenges, opportunities and priorities**

| Operational priority | Transition challenges | Potential investments | TC priorities* |
|---|---|---|---|
| Supporting **private sector** development and job creation | • State involvement<br>• Large informal sector<br>• Poor business involvement<br>• Limited access to finance for MSMEs | • Direct financing for MSMEs<br>• Long-term or mezzanine finance for selected larger corporates<br>• Support for privatisations | • TAM/BAS (CBEE)<br>• Prepare for equity investments (TAM) (PPI)<br>• Support for financing facilities (CBEE)<br>• Expansion of the LEF Facility (PPI) |
| Enhancing the **agribusiness** value chain | • Outdated farming practices, especially in water use<br>• Distortionary subsidies and export restrictions<br>• Inadequate mid- and downstream logistics | • Investments in processing, logistics and distribution – directly and through SME facilities<br>• Support for sector growth and restructuring, including privatisations | • Training to raise standards (CBEE)<br>• Food security studies (RSS)<br>• Policy dialogue to enhance the role of the private sector (CBEE)<br>• Technical, managerial and financial management improvement in view of project preparation in agribusiness SMEs (PPI) |
| Modernising the **financial** sector | • State involvement<br>• High liquidity but limited access to finance, especially long-term, other than for the best credits<br>• Private equity sector is underdeveloped and over-concentrated | • MSME facilities through local banks and microfinance institutions<br>• Equity investments in medium-size banks<br>• Improving access to mortgage, insurance and leasing products<br>• Support for privatisations<br>• Support wider and deeper penetration of private equity funds | • Technical assistance to "MSME champion" banks (CBEE)<br>• Technical assistance to microfinance institutions (PPI)<br>• Building capacity for future MSME loans under credit lines (PPI)<br>• Legal transition work on secure transactions, land rights etc. (CB/EE) |

| Operational priority | Transition challenges | Potential investments | TC priorities[*] |
|---|---|---|---|
| Increasing the role of **clean sources of energy** and improving **energy efficiency** | • High levels of subsidies<br>• Consequent high levels of inefficiency | • Energy efficiency investments across all sectors, together with energy efficiency credit lines<br>• Support for large scale renewable energy, particularly utilising Climate Investment Funds | • Market and regulatory studies for energy efficiency and renewable energy (RSS)<br>• Energy auditing framework (CB/EE)<br>• Follow-on assistance for specific projects or policy dialogue (PPI)<br>• SEFF project preparation (PPI) |
| Supporting reform and commercialisation of **transport** and **power** infrastructure | • State domination with consequent inefficiencies<br>• Poor regulatory framework<br>• High levels of subsidies<br>• Inadequate infrastructure constraining growth | • Financing for private sector/PPP investments<br>• Targeted sovereign operations linked to structural reforms<br>• Investments in energy efficiency, quality of supply or renewable energy | • Technical assistance for sector reform and PPP preparation and implementation (CB/EE)<br>• Private Sector Transport Market Opportunities Mapping (RSS)<br>• Study on electricity networks investment requirements and possibilities for corporatisation (RSS)<br>• Policy dialogue transferring the Bank's transition and liberalisation experience in its existing region (RSS)<br>• BAT and environmental assessment of existing thermal plants under development (PPI) |
| Decentralising the development of **municipal infrastructure** | • Inadequate infrastructure – poor quality and high levels of inefficiency<br>• Centralised control and financing<br>• Very limited private sector involvement | • Investments linked to decentralisation and commercialisation<br>• Financing for private sector/PPP investments<br>• Targeted sovereign operations linked to structural reforms | • Sector analysis and assessment of the potential for decentralisation and commercialisation (RSS)<br>• Support to the Egyptian Government's PPP unit including preparation of PPP projects (CB/EE)<br>• Feasibility studies and project preparation for specific projects (PPI) |

[*] Rough categorisation of TC assignments: RSS = regional or sector studies; CB/EE = capacity building or environment enabling and PPI = project preparation or implementation.