Private Sector Diagnostic: Egypt

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Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

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EGYPT

Executive Summary

Egypt's fast growing population and high unemployment pose significant growth challenges, requiring a more developed and vibrant private sector. The private sector already plays an integral role in the economy, providing the lion's share of employment, yet lacks dynamism, and is not competitive, with limited exports. Private sector development remains hampered by low access to finance, policy uncertainty and macroeconomic vulnerabilities. There is significant potential for private sector investment to meet the country's growing demand for energy and fostering a greener economy. There is also ample scope for the private sector to address skills mismatch challenges, and enhance training.

Well-functioning market-based economies that are competitive, well-governed, green, inclusive, resilient and integrated are critical to creating jobs, growth, and shared prosperity. This report on Egypt aims to identify challenges and opportunities to enhance the business environment and support the transition to such an economy, with a particular focus on the role of the private sector. The report draws on the EBRD's expertise and experience in the country as well as on in-depth analysis of a wide range of data from national and international sources and surveys to complement existing evidence.

Egypt's fast growing population and high unemployment pose significant growth challenges and require a more developed and vibrant private sector. Egypt's population is estimated to reach 140 million people by 2050, exerting significant pressure on resources and services including land, water, energy, transport, health and education. Unemployment is high at nearly 12.4 per cent at end-2016, and even higher at 25.3 per cent for women , and 42 per cent for youth Moreover, Egypt has one of the lowest female labour force participation rates globally at just 24 per cent. The need to create jobs is pressing: given the large annual influx of 600,000 new entrants into the labour market, Egypt would require an average annual GDP growth rate of 4 per cent just to absorb new entrants and a sustained GDP growth rate of at least 6 per cent per year to reduce the unemployment rate to 6 per cent by 2020. This compares to an average annual growth rate of 2.5 per cent over the last five years. Meanwhile, the government has a narrow margin of manoeuvre to increase spending or expand employment in the public sector given the high fiscal deficit (12.5 per cent of GDP in FY2015/16) and rising public debt levels. Therefore the private sector increasingly needs to become the engine of economic growth and job creation.

Despite these pressing needs, Egypt did not manage to achieve a structural transformation in contrast to emerging market peers. Emerging market peers such as Turkey and Thailand underwent a significant structural movement of labour towards more productive modern industries - led by the private sector - helping them to outpace Egypt's growth and development levels. Limited openness to trade and low access to finance in Egypt have been among the key impediments to such a transformation. Strengthening the role of the private sector by addressing these impediments will help to improve productivity and hence overall GDP growth.

Successful international experiences of significant reductions in unemployment highlight the key role of a business-friendly environment. Historically, a few countries have experienced successful periods of sharp reductions in unemployment associated with acceleration in GDP growth, a significant increase in investment, a decline in government spending and a surge in trade. Cases include Chile in 1982 where unemployment fell from 19.6 per cent to 8.7 per cent in 4 years and Sweden in 1997 where unemployment halved within a similar timeframe. A key precondition observed in these countries is rapid growth in private sector investment thanks to improvements in the business environment to encourage private sector development.

The private sector in Egypt already plays an integral role in the economy, providing the lion's share of employment. With a share of GDP at around 60 per cent and an employment share of 74 per cent[1], private sector activity has shown resilience even in the face of turbulence in recent years. Private sector activity is also fairly diversified, with the manufacturing, agriculture, retail trade and construction sectors as the major contributors to private sector output. The retail trade and manufacturing sectors in particular contribute to private sector GDP (40 per cent) significantly and account for 73 per cent of the total number of firms.

However, the private sector landscape lacks dynamism. Entry and exit rates are low relative to peers, with only three limited liability companies created annually on average for every 10,000 working-age persons, compared to an average of 20 in developing countries. Enterprise dynamics are weak with a comparatively low probability of growing and generating new jobs over time. Small and micro companies form the vast majority of private sector firms, reaching 97 per cent of the total number and providing nearly two-thirds of total paid jobs. Of these small firms, micro enterprises are the largest source of employment. Their employment share in Egypt (around 68 per cent) surpasses other MENA countries, where it stands at 40 per cent in Jordan, 37 per cent in Tunisia and 34 per cent in Turkey.

Private sector firms are uncompetitive, with only a small share exporting to global markets. Only 5 per cent of Egyptian firms are engaged in export activities, a particular concern given that exporting firms tend to employ more young skilled workers and women and offer more training opportunities compared to non-exporting firms. Poor export performance is partially sustained by the tendency of firms to focus their activities locally given the large size of the domestic market. In addition, the economy is characterised by a high level of protection through tariff and non-tariff barriers, and a lack of supporting structures to facilitate firms' expansion to global markets – especially for small and medium-sized enterprises (SMEs), who are resource-constrained. Competitiveness has also steadily eroded as a result of real exchange rate appreciation since the mid-2000s in the context of high inflation and limited exchange rate flexibility.

Key Cross-Cutting Obstacles to Private Sector Development

Important reforms have recently been adopted to improve the investment climate and increase the efficiency of the economy. At the macro level the most notable development has been exchange rate liberalisation. This has eased foreign exchange shortages which have been constraining private sector activity. It will boost export competitiveness, increase the economy's flexibility in response to external shocks, bolster official reserves and improve investor confidence. In addition, bold energy subsidy reforms have been enacted to bring energy prices closer to cost recovery levels and alleviate distortions of the production structure. Reform measures have also been introduced to enhance the business environment,

[1] Authors' calculations based on Egypt's Labour Force Survey 2013.

including a stepped-up dispute resolution mechanism, improvements to the competition law, new laws on microfinance, mineral resources and pledges over movable assets, legislative changes to begin opening up the gas and electricity markets to new entrants, regulatory measures aimed at reducing certain concentration risks in the banking system and various legislative reforms in the non-banking sector. In addition, a number of initiatives have recently been introduced to improve SMEs' access to finance (including the Central Bank's recent support scheme targeting around 350,000 such enterprises), and to streamline the cumbersome procedures involved in obtaining an industrial license. Finally, the Suez Canal Zone's development, with major improvements to infrastructure, will offer improved conditions for private sector investment in trade-related industries.

However, private sector development remains hampered by a number of key challenges that cut across different sectors. Top constraints were identified following a judgement-based approach which relied on the assessment of EBRD staff (including economists, banking teams and sector and legal experts) as well as the consultation of policymakers and private sector firms in Egypt. The key challenges identified are:

- **Low access to finance constrains private sector development**. This is the result of high public borrowing crowding out the private sector, a lack of long-term funding instruments for banks as well as deeper structural issues related to the financial infrastructure. The latter include low credit information coverage, weak creditor rights, the absence of a collateral registry for movable assets and inflexible use of movable assets as collateral. SMEs have disproportionally low access to finance – their share of loans represents only 5 per cent of the total – and current lending practices are not responsive to their needs. Women-led SMEs in particular face large obstacles in accessing bank finance due to a number of issues, principally the lack of collateral. Moreover, domestic debt markets are dominated by government bond issuance, and capital markets regulation needs to be modernised to better channel savings into productive long-term investments.
- **Policy uncertainty and macroeconomic vulnerabilities are among the key challenges for the private sector.** Policy and regulatory uncertainty is a key concern for investors and one which dilutes the impact of favourable reforms. Consequently, it has been one of the drivers of Egypt's sub-par performance in attracting foreign direct investment (FDI) relative to peers. Macroeconomic imbalances – both fiscal and external – also raise vulnerability concerns. The fiscal position remains very weak with high and rising deficit and public debt levels and little room for growth-enhancing and private sector enabling spending on infrastructure and education. Moreover, double-digit inflation adds further uncertainty to firms' planning and investment decisions. Addressing these macroeconomic imbalances and vulnerabilities would encourage investment and create conditions for stronger growth.
- **The private sector suffers from a legacy of complex, burdensome business regulations and an uneven playing field**. Industrial licensing and land allocation processes are particularly cumbersome and insolvency procedures are lengthy and

tend to criminalise business failure. The size of Egypt's informal economy – around 40 per cent of GDP – is a reflection of the high costs associated with formalisation and interaction with the complicated regulatory environment. Regulatory enforcement standards are insufficient to ensure a level playing field for all firms. Despite the recent strengthening of competition policy, the enforcement capacities of the Egyptian Competition Authority remain constrained by a lack of clarity over its jurisdiction, limited technical and budgetary resources and a reliance on courts which may not have the relevant competencies. The legacy of opaque laws and regulations and overlapping supervisory powers weaken accountability and lead to uneven implementation of regulation. Non-tariff measures and privileges historically protecting politically-connected firms distort competition. Despite a privatisation drive in the 1990s, state dominance remains relatively high in sectors such as power, manufacturing and banking. The lack of a level playing field distorts firm entry and exit. Investment climate bottlenecks have a disproportionate effect on women-led SMEs which often have fewer resources to navigate the system[2]. The economic returns generated by a model of accountable, rules-based institutions over one with significant discretionary power by public officials are demonstrated by the experiences of East Asia. Progressing further in this vein should be a key priority for Egypt.

- **In the energy and infrastructure sectors the lack of adequate market-based incentives holds back investment and much-needed private sector participation.** In the energy sector, contractual uncertainty, payment arrears and relatively uncompetitive pricing have until recently impeded the private sector's willingness to proceed with the significant investment needed for further exploration and development of natural resources, though there have recently been moves in the right direction. Similarly, transport and municipal infrastructure tend to be state-administered and service provision is characterised by the absence of market-based mechanisms for the pricing and delivery of services. In the energy and infrastructure sectors regulated tariffs are low and often below cost recovery levels (although there have been recent rises as a result of reforms). This constrains the operational and financial sustainability of state-owned enterprises, leading to insufficient maintenance and investment and hence efficiency losses. As well as continuing with tariff reforms, governance reforms to commercialise public service provision are critical to improve operational and financial sustainability, facilitate greater private sector participation, unlock higher investment and deliver much-needed improvements in service quality.

- **Several factors hold back the development of domestic value chains.** A weak contractual environment and ineffective enforcement of quality and safety standards have been identified as major concerns that push Egyptian firms to more vertically-integrated forms of production or high import dependency, resulting in limited positive spill-overs across the domestic value chain, and local suppliers being mostly

[2] For example, it takes female-headed firms an average of 86 weeks to resolve disputes about overdue payments – much longer than the 54 weeks taken by their male-headed counterparts.

present in low value-added activities. Upgrading towards more knowledge-intensive activities and high value-added services would help improve firms' competitiveness.

Sector-specific Challenges

Sector-specific challenges pose an important barrier for unlocking the potential of the private sector. Challenges spanning the energy, infrastructure, financial institutions, industry, commerce and agribusiness sectors point at weaknesses in the legal and regulatory framework and its implementation, governance, administrative procedures and pricing.

Energy:

- **The energy market is characterised by a number of structural challenges**, **despite recent reform efforts.** These include the lack of full access by the private sector to hydrocarbon import and transmission infrastructure; low tariffs that do not fully reflect real and opportunity costs; legal restrictions on the import and supply of oil and gas outside of state-owned enterprises (though this is planned to change); the lack of an independent regulator; limited availability of price and cost data of interest to investors; and inadequate enforcement of environmental, health and safety standards. These constraints also characterise Egypt's electricity market to a significant degree. Addressing them would both improve overall efficiency in Egypt's energy system as well as facilitate greater investment and participation of the private sector.
- **Contract sanctity in upstream oil and gas is relatively weak.** Continuing payment arrears to oil and gas producers and some ongoing disputes regarding the redirection of export volumes to the domestic market have in certain cases weakened the private sector's appetite to invest. Addressing these issues would improve the investment climate, reduce risk premia and potentially unlock multi-billion private sector investments in further exploration and production in Egypt.
- **A stable regulatory and contractual framework for renewables is required to promote private sector investments.** This would allow the development of the first private renewable energy projects under a feed-in-tariff scheme and build on that experience to inject more competition (including price competition) for renewable energy capacity development in the future.

Infrastructure:

- **Tariffs in transport and municipal infrastructure are currently low.** Reforms are critical to enable public sector operators to finance operational, maintenance and investment costs in order to reverse the trend of declining service quality. While tariff reforms would also encourage the efficient use by customers, users of certain key

public services face affordability constraints, creating a complex socio-economic context for policy-makers. This makes it imperative to clearly communicate the benefits of sustainably-financed infrastructure to end-users.

- **Funding sustainability for public services remains a challenge.** Given tariff constraints, greater clarity on the public sector funding of infrastructure services is critical. Services ranging from intercity rail, metro and bus services, for example, require long-term public sector commitments to underpin operational improvements to close chronic financial gaps.
- **The uptake of private-public partnerships (PPPs) is low.** To address the underlying drivers areas for improvement include strengthening the capacity of the PPP Central Unit to allow it to prepare complex projects and further developing PPP financing schemes, particularly in the transport sector where they are not yet widely used.
- **The quality of public service provision remains poor and inefficient.** Low tariffs, weak governance and a lack of incentives to control costs and inefficiencies (such as high losses in the water network) in state-owned holding companies constrain the quality of public service provision and operational and financial sustainability. This poor quality disproportionately affects both the poor and women. Greater decentralisation of operations to grant more autonomy to governorates could also help improve service delivery.
- **The challenges in the water sector are pressing.** As a result of sustained population increases coupled with unsustainably high water consumption growth, Egypt now has less than 800 cubic metres of renewable water available per capita per year, down from 2,100 fifty years ago. This is below the UN's water poverty line of 1,000 cubic metres per capita per year. The country already abstracts 98 per cent of its annual renewable water, and the situation is projected to worsen as a result of climate change as precipitation decreases and temperatures rise[3]. The introduction of multiple desalination plants to alleviate this need is critical, in addition to improving the efficiency of existing water operations. Access to sanitation is an even more pressing challenge. Thirty per cent of households do not have access to any form of sanitation with stark regional disparities.

Financial Institutions:

- **The framework for securities restricts access to finance.** Smaller borrowers typically face high collateral requirements and many types of assets cannot be used because of problems with foreclosure or loan recovery procedures. In particular, the legal framework for using movable assets as collateral is underdeveloped. The recently introduced Law No. 115 of 2015 is aimed at addressing problems in the legal framework governing securities which have an especially large impact on SMEs

[3] There has been an observable long-run decline in precipitation of 1.2 per cent and a temperature increase of 3.3 per cent.

creating a new regime of pledging a wide range of movable assets, introducing a centralised security registration. However, it still remains to be seen how and when this law will be implemented.

- **Bankruptcy procedures are outdated.** Bankruptcy procedures are lengthy and bureaucratic. They do not facilitate the debtor's restructuring or the effective reorganisation of viable businesses and there are insufficient out-of-court options for debtors and creditors.
- **Regulatory obstacles to the development of non-bank financing constrain access to finance for SMEs in particular.** Problems in the legal framework governing factoring and leasing (such as excessively formal rights assignments) as well as low usage of electronic invoicing are obstacles to a more widespread utilisation of non-bank financing options.

Industry, Commerce, Agribusiness:

- **Industrial licensing procedures are overly complex and burdensome.** The new draft law to ease industrial licencing procedures does not go far enough in terms of establishing clear and enforceable deadlines for the government to abide by, decentralising licensing at the municipality level and clarifying the relationship between this new law and the extensive existing legislation on industrial licensing.
- **Tariff and non-tariff barriers to trade are high and have recently risen.** Egypt has one of the highest non-tariff measure frequencies in the world, which historically tended to disproportionately protect politically connected firms. Moreover, both tariff and non-tariff barriers have recently risen as a result of controls to mitigate balance of payments pressures. Greater trade openness can boost growth, lower prices for consumers and improve productivity[4]. International trade can ensure this by facilitating technological development, increasing competitive pressures and opening up more channels for capital accumulation.
- **The enforcement capabilities of the Egyptian Competition Authority (ECA) and the judicial system in competition cases are limited.** These include institutional impediments such as the lack of legal clarity over the ECA's jurisdiction in regulated sectors, the lack of ECA's fiscal and technical resources and insufficient capacity in the judicial system to competently and effectively assess competition cases in a timely way.
- **The legislative framework impedes the effective operation of farming cooperatives**. Although farming cooperatives have the potential to significantly improve agricultural productivity by overcoming land fragmentation and utilising economies of scale, their effective operation is hampered by regulations. Possible

[4] Anderson and Babula, "The Link Between Openness and Long-Run Economic Growth", Journal of International Commerce and Economics, 2008

improvements include allowing them to establish or participate in companies, directly importing and exporting products and raising funds to support their activity.

- **Skills mismatches and labour market information deficiencies are constraints, particularly in the manufacturing sector.** Technical and vocational training (TVET) is particularly important for the private sector, but despite some recent positive changes in the governance structure of the TVET system several overarching issues remain. These include a lack of responsiveness to employers' demand for particular skills, concerns over the quality of TVET and its attractiveness to many students and a lack of capacity among some of the system's key stakeholders. Reform has been slow, hampered by the lack of a coherent vision for the TVET system. A dedicated Ministry for TVET was created in 2014 but abolished within a few months, undermining the coherence of policymaking.
- **Resource efficiency is low.** Fuel subsidies and patchy and poorly implemented regulations relating to energy efficiency (such as minimum energy performance standards) have led to a concentration of production in energy intensive sectors, discouraged efficient energy usage and resulted in high carbon emissions. Water efficiency is also low as a result of low tariffs, poor water infrastructure that leads to high network losses and insufficient incentives at state-owned enterprises to address these inefficiencies. Recycling is not widespread even amongst large international companies due to a combination of regulatory gaps and the lack of a robust supply chain for technology and service providers.

Selected Private Sector Opportunities

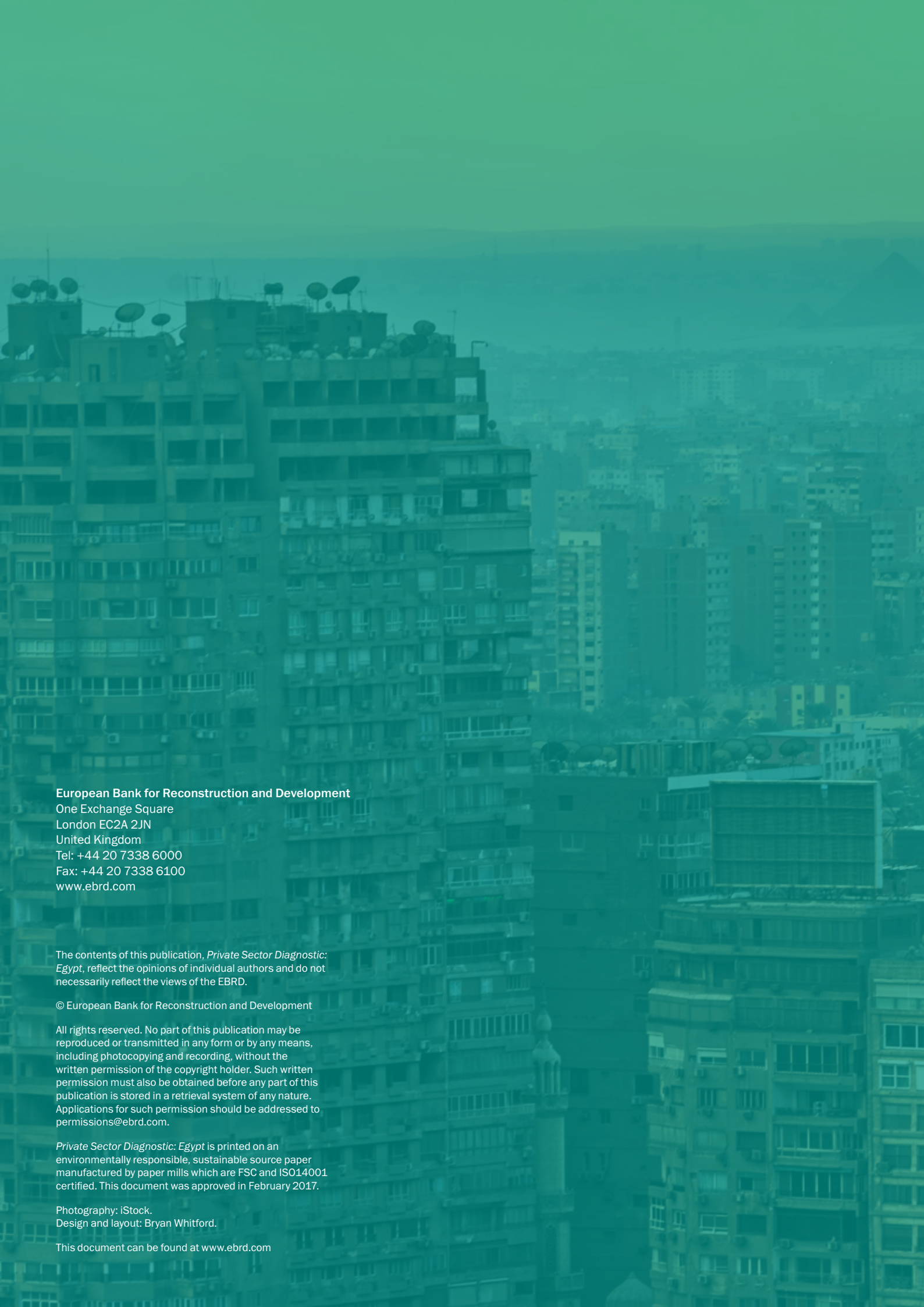
There is ample scope for greater private sector involvement in delivering a more client-oriented service, based on market rules of allocation and clients' needs. A number of sectors, notably transport and municipal infrastructure, are characterised by the absence of market-based mechanisms for the pricing and delivery of services. They remain hampered by inefficiency, insufficient client orientation, a lack of proper maintenance and poor operational performance. Allowing for more private sector participation, alongside key policy and institutional reforms, has the potential to bring a more market-oriented approach to the provision of services.

The private sector can play an important role in addressing skills mismatch challenges and enhancing training and skills standards to better match the requirements of the labour market. Engaging the private sector in the development of skills standards, teacher training and career guidance is important to enhance the employability of young people entering the labour market and to address key skills shortages that hamper business growth and innovation.

The Suez Canal Corridor Area Project offers numerous opportunities for the private sector. The project enables the country to further foster the Suez Canal region's role in international trade and to utilise the waterway's geographic location beyond the transit of ships and towards the development of industrial and logistical activities. The

announced simplified framework can provide opportunities for the private sector to invest notably in value-added services pertaining to the logistics and maritime industry.

There is significant potential for private sector investment to participate in ongoing efforts to meet the country's growing demand for energy and foster a greener economy. Ensuring a predictable and attractive investment climate would help attract significant foreign direct investment and better utilisation of the country's oil and gas resource base. In the longer term, Egypt faces the challenge of transitioning to a more environmentally sustainable economic model. A range of energy efficiency and renewables investments are already financially viable under current conditions in the industrial, commercial, and residential sectors, especially if accompanied by more coherent regulation and better monitoring and enforcement. However, a more pronounced shift to a greener economy – with the help of the private sector – requires a transformation of markets, regulatory framework, behaviours, products and processes to ensure that the costs of environmental damage are taken into account in policymaking, regulated, enforced, and that the associated fiscal revenues are put to other productive uses.



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