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Banking Sector in Egypt

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Executive Summary

Egypt's financial system plays a central role in the process of economic development, as the banking system is one of the major contributors to the strength of that development. Bank performance enhancement, information system development and human resource optimization should be among the objectives for banking sector in Egypt.

In Egypt, the banking sector has gone through many phases since the establishment of the first bank in 1856, Followed by the emergence of nationalization of all banks by law 117/1961 and the establishment of the Central Bank of Egypt (CBE) in 1961, then the re-emerge of private sector and joint venture banks during the period of the Open Door Policy in the 1970s. In addition to this, the Egyptian banking sector has been undergoing reforms and privatization since 1991.

The legal environment is changing to meet the development needs of the banking system. The new banking law 88/2003 has definitely addresses very important reforms. One of its implications is the improvement of capitalization of operating banks that led to a wave of mergers and acquisitions (one of the most important expected mergers will be between two public banks in 2006), so banks would be able to fulfill the minimum capital requirement. The new law addresses the independence of the CBE by granting more supervisory authority regarding inter-bank activities and maintaining price stability. In 2002, international rating agencies Standard and Poor's (S&P) and Fitch both downgraded long-term foreign currency earnings from BBB- to the speculative grade of BB+. Despite the issuing the new banking law in August 2003, S&P also downgraded Egypt's long-term sovereign local currency rating from BBB to BBB- and revised the outlook for all of its local and foreign currency ratings from Stable to Negative. Reasons cited by both agencies were chiefly the expanding fiscal deficit and domestic debt, followed by continuing problems in foreign exchange availability, and the overall slowdown in economic reform.

In general, Private Banks are performing much better than public banks, which can be attributed to the sizable additions they had to make in recent years to loan-loss provisions, the existence of high competition and well managed and trained staff. However, all banks in Egypt combined maintained the minimum requirements of the liquidity ratio which reflects that since the year 2000, the banking system experienced a high level of liquidity, as evident in the rising liquid assets-to-total assets ratios, fewer banks borrowing from the Central Bank, and decreasing inter-bank rates. Egypt also complied with the Basel I Committee solvency criteria of capital adequacy ratio 8%, although in 1996 the CBE set 10% as a minimum ratio for all banks operating in Egypt. In addition Egypt is preparing to comply with the Basel II Capital Accord in 2006.

This paper provides an intensive overview of the main development of the Egyptian banking sector as it involves a description analysis, which includes short term economic that shows an expansionary monetary policy is effective for Egypt. However, this easy monetary policy should be carefully planned target by the Central of Egypt and according to time constraint. This is because unplanned and persistent easy monetary policy, could lead to persistent inflation and more Egyptian pound depreciation. And for medium term economic stabilization, the new banking law encourage mergers and acquisitions so that banks would be able to meet the new minimum capital requirement and this big banks can then acts as a catalyst for a big push in the Egyptian economic development. And it show that enhancing the efficiency of the banking system can affect economic growth permanently, as mobilization of savings is not enough according to the traditional growth theory. Finally, this paper also utilizes a SWOT analysis to assess the strength and weakness and highlights the opportunities and threats that must be taken into consideration in the future.

I- Introduction:

The Egyptian banking sector is the nexus of its financial system. The link between banking sector development and economic growth is unique. Economic growth can not be achieved without investment, which in turn can not be realized without the mobilization of savings. Therefore, a sound banking sector is essential for carrying out government economic policies to achieve low inflation, high employment and sustainable growth. This paper will focus mainly on the banking sector, rather than on the financial sector. This is because it dominates the financial system in Egypt, and for its important role in *development* needs of the economy. This paper is mainly divided into six sections. The paper begins by reviewing the historical development of the banking sector from both the structure and legal frameworks (involving the recent legal reform associated with the New Banking Law 88 of 2003). The second section is for the main indicators that relate to the banking sector which assesses its performance and vulnerability. This involves indicators, namely; capital adequacy, asset quality, management soundness, earnings, liquidity and sensitivity to market risk. The third section involves a description analysis, which includes short term economic policies (mainly monetary policy and exchange rate policy), medium term economic stabilization and long term economic implication for the banking sector. This paper asks questions like; does reshaping the banking sector by privatization promote a more contestable banking system, and can banks act like catalysts in the big push for modernizing certain sectors in the economy? This paper utilizes, in the fourth section, a SWOT analysis to assess the strength, weakness, opportunities and threats to the banking sector in Egypt. Section five entails a number of interrelated and simultaneous strategies to achieve development objectives. Finally, the sixth section is the conclusion.

II- Historical Development and Legal Framework:

Bank establishment and foreign control

The first financial institutions to emerge in the process of economic development in Egypt were foreign-owned commercial banks. The first of these banks was the Bank of Egypt¹ which was established in 1856 with no agreement on the size of its capital. The objectives of this bank were: to fund the cultivation of cotton (for which the demand increased due to the American civil war in the beginning till the mid of 1960s), to encourage trade especially between Egypt and Britain and to finance the government current spending through the purchase of Treasury Bonds. Due to debt problems and crisis in 1870s, many foreign banks that were established, were short lived and were liquidated. Therefore there was an essential need for an institution to play a role of a state bank or in other words to be as a bank of the government. Consequently the National Bank of Egypt (NBE)² was established in 1898, even though it was owned and managed by British citizens³. The NBE acted as the bank of the government, an exclusive private issuer of banknotes⁴, and financial adviser to the government. However, the NBE did not function as a bankers' bank, last resort lender or controller of credit supply; but as a commercial bank, participated with other foreign commercial banks to provide short-term finance for cotton cultivators. After that, the 1919 Egyptian revolution inspired a campaign to establish a pure Egyptian bank as a necessary element of economic independence. It was realized that operating banks concentrated on short term financing that that was not compatible with industrial projects.

¹ The bank's head office was in London, with a main office in Alexandria and a branch in Cairo.

² NBE was established as a commercial bank with a capital of £1 million, with the head office in Cairo.

³ During the 1940s, the management and capital of the NBE was nationalized.

⁴ This was the first time for banknotes to be used, as the Egyptian monetary system was previously based on gold and silver.

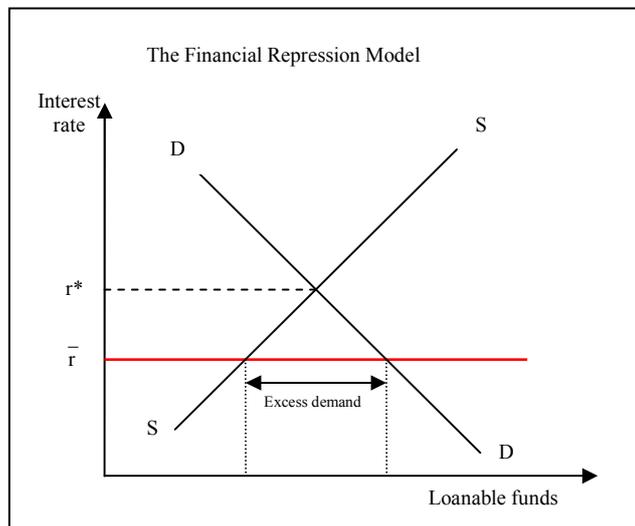
Thus, Banque Misr was founded in 1920 and became second only to NBE. However, due to the bank's continued practice of short term borrowing and excessive long term lending, the bank suddenly found itself facing difficulties and involved in high risk activities in the late 1930s. Finally, the distinctive role of Banque Misr started to vanish and Banque Misr ended up acting like the rest of commercial banks (Mohieldin, pp.3-9).

Nationalization and the socialist era

After the 1952 revolution and under the central planning and domination of the public sector, Nationalization of the banking sector began with the introduction of the law 22/1957 which specified that the capital of operating banks should not be less than L.E. 500 thousand, in the form of shares owned by Egyptians, and that all operating foreign banks should be sequestered. The rest of the operating banks had to take the form of joint stock companies, within five years. The government wanted to have more control over the credit market. So the NBE, as a Central Bank, was granted more power by the Law 163/1957 which added to its existing objectives the authority to determine interest and discount rates; act as a supervisory authority for bank registrations, opening of new branches and mergers; and control of the credit market using reserve and liquidity ratios. In 1961 the NBE was divided into two banks; one retained the original name and continued as a commercial bank, the other became the Central Bank of Egypt (CBE). In the same year laws were passed to safeguard the creation of a centrally planned economic system, one being Law 117/1961 which nationalised all banks. By the end of 1963, after liquidating some of the small banks and merging others, the banking system consisted of only five public commercial banks. In addition to these there were several other banks, an agricultural bank, and industrial bank and three real estate banks. By 1974 there were just four commercial banks and three specialised banks. This government intervention, during the 1960s was not necessarily corrective as it was mainly driven by ideological motives, which left the entire banking system publicly owned and managed (Mohieldin, pp. 10-12).

“Infitah” or open-door policy

The government started to adopt what has become known as the “*Infitah*” or open door policy putting into consideration that improvement in the structure of the banking system and a reform of credit policy was essential in order to find new resources of finance and encourage the private and foreign capital to participate in the development process. To move towards this policy some laws were enacted beginning with law 43/1974 that allowed foreign capital to enter joint-venture commercial banks with up to 49%⁵. Law 120/1975⁶ defined the legal status of CBE, gave the banking system more freedom in conducting its business, reinforce the CBE’s ability to manage monetary policy and more provisions than those given by law163/1957. However during this



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⁵ That led the number of operating banks to increase rapidly from 7 banks in 1974 to 81 banks in 1991.

⁶ It defined the nature of operating all banks. It identified 3 types of banks: commercial, business and investment, and specialized banks; or it can be classified as public sector, private and joint venture or foreign according to ownership.

period, Egypt faced basic macroeconomic imbalances between saving and investment and exports and imports that resulted in low productivity, high inflation and weak economic management. Moreover, the Egyptian financial sector was stifled by interest-rate ceilings (as a source of financial repression), high reserve requirements, besides the few public sector banks were still dominating the process of savings mobilization. And for example, the Commercial International Bank (CIB), the first joint-venture bank to be established in Egypt in 1975⁷, came under 100% Egyptian ownership in 1987 (El-Shazly, p.2; Mohieldin, p.14; AmCham, p.8, Demetriades, p19 and Todaro, p.667).

The ERSAP

As a result of the economic and financial difficulties of the late 1980's, Egypt had to embark on a Structural Adjustment Program (ERSAP) under IMF and World Bank supervision. The program was divided into two phases. The first phase of ERSAP (1991-1995) focused on financial and banking sector reform, exchange rate liberalization and fiscal and monetary contraction. The second stage of the program (1995-1998) focused on creating the necessary environment for FDI inflows. This included trade liberalization, financial sector reform and investment reform. Under ERSAP I, specific measures were taken to reach a more liberalized banking system such as liberalizing interest rates to reduce demand for credit and encourage more savings. By June 1992, a positive real rate of return was attained through an increase in interest rates on domestic currency deposits, combined with lower inflation rates. Direct ceilings on bank lending were eliminated in 1992 and 1993. In 1993 branches of foreign banks were allowed for the first time to conduct business in Egyptian pounds. Moreover, all preferential treatments granted to the public sector in the terms and conditions of loans were removed. In 1994, the four public sector banks were requested to reduce their shares in joint venture banks to less than 51% then to 20%. Majority foreign ownership (more than 49% foreign ownership of joint venture banks) was also permitted under Law No. 97/1996, which also liberalized charges and fees for banking services. On aggregate, the outcome of the first phase of liberalization was positive with GDP growing steadily during this period.

ERSAP II focused on increasing competitiveness by broadening and deepening the financial system through privatization and enhancement of private sector participation in commercial banking, securities, and insurance companies. However, privatization lagged behind as none of the four banks was privatized even after the regulatory preparation through the issuance of Law No. 25/1998. In 1997, there was the start of a liquidity crunch caused by shortages in foreign currency. These shortages were mainly due to the drip in tourism revenues after the November 1997 terrorist attack in Luxor, the emerging markets crises, the drop in remittances from Egyptian expatriates, in addition to the decline in Suez Canal receipts and the drop in oil prices, which all came at once. The slowdown caused investment funds from international financial institutions to drop. (AmCham, p.9 and Mohieldin, pp.17-19).

Recent Legal Reform

After public discussions for almost two years, the new banking law No.88 was passed in June 2003, and its executive regulations were issued on March 2004. This law addresses many of the deficiencies in previous laws governing the banking system. One of the immediate implications of the law is the improvement of capitalization of operating banks. The law will also indirectly result in enhancing competition in the banking sector through lowering and eliminating barriers, which limited operational flexibility. Moreover Law 88/2003 abolished the distinction between specialized, business, and commercial banks; and the special treatment of public banks. Inherent in its executive regulations, Law 88/2003 gives the CBE the formulation and the implementation

⁷ A 51-49% joint venture between the NBE and the US-based Chase Manhattan Bank.

of monetary policy with the primary objective of keeping price stability. The CBE achieves this by using the instruments of the overnight deposit and lending rates in addition to other instruments to manage liquidity such as the reserve requirement ratio; CBE credit and discount rate; open market operations (deposits acceptance, reserve repositories of treasury bills and outright sales conducted between the CBE and banks). The law also gives electronic signatures legal power, which will facilitate e-commerce and e-banking services. Another recent legal reform was the passage of the anti-money laundering (AML) law. Even before the issuance of the law, banks were required to obtain sufficient information and documents to meet the 'know your customer' principle. The main monetary policy parameters under the new Law No. 88/2003 are (1) the reserve requirement ratio held by banks at the CBE is 14%. The CBE lending & discount rate is 10% per annum. (2) Rates for overnight depositing and borrowing are 9.5% and 12.5% respectively as of June 2005, and (3) the Open market operations conducted by the CBE aimed to absorb banks' excess liquidity. LE 10.9 billion deposits were blocked according to the market mechanism as of June 2004 (AmCham, pp.14-15 and ERF, p.65).

III- Quantitative Indicators:

The Central Bank of Egypt assesses the soundness of banking system performance by tracking a set of internationally organised indicators, namely capital adequacy, profitability, liquidity, reserve requirement ratio and risk. These variables can be used as an early warning signal that a banking system is likely to experience difficulties. However, these indicators can still give a rough indication of areas of vulnerabilities.

Capital Adequacy

Capital is crucial for banks since it acts as a cushion against shocks and allows banks to continue honouring claims. There are two aspects of capital adequacy in the Egyptian case. First the minimum capital volume required from banks to start business, and second the minimum capital ratio required to support given levels of operation. Regarding the first requirement, normally referred to as the entry requirement, the CBE imposes an initial capital requirement of LE 500 million for domestic banks, and US\$ 50 million for branches of foreign banks according to the new banking law 88 of 2003 from the previous levels of LE 100 million for domestic banks and US\$ 15 million for branches of foreign banks. Considering the second requirement, banks registered with the CBE, excluding foreign branches, are obliged to abide by a ratio of capital to total assets, where the assets are weighted in terms of the risk they carry (capital risk indicates how far asset values may decline before the position of a bank's depositors and other creditors is put at risk). The minimum ratio set by the CBE is 10% since 1996, previous to this all banks operating in Egypt were required to comply with the Basel Committee solvency criteria of capital adequacy ratio of 8%. In 2003, the ratio in all banks combined reached 11.2%. The number of banks whose capital adequacy ratio ranged from 10-15% amounted to 17 banks. Banks accounting for ratio above 15% were 15 in number while the rest (10 banks) had a ratio of less than 10% (CBE, p.54; ERF, pp.51-52; Bahaa Eldin, pp.123-124 and El Refaie, pp.47-51).

Profitability

Profitability reflects the size of bank profits and the bank's ability to augment its equities and distribute dividends on its shareholders. Profitability indicators include returns on assets (net income to assets ratio), returns on equity (net equity to asset ratio) and interest rate spreads. In the 1990s, returns on assets and equity increased. However, they deteriorated during the period from 2000 to 2003, where private banks are performing much better than public banks that can be attributed to the sizable additions they had to make in recent years to loan-loss provisions. Interest rate spreads, narrowed initially in mid-1990s until it stabilized, in nominal terms, at a relatively

high level in the late 1990s. However, since 2000, spreads have been narrowing, reflecting improvement in the intermediation process of the banking system, but lower profitability. This could be attributed to lack of competition. Spreads varied widely, but on aggregate, public banks registered lower interest rate spreads than private banks. The lower interest margin of public banks could be attributed to the interest rate concessions and repackaging of loans that have been recently restructured (ERF, p. 57 and El Refaie pp. 50-51).

Profitability indicators

Year	Return on Assets (ROA)		Return on Equity (ROE)	
	Public Banks	Private Banks	Public Banks	Private Banks
1994	0.2	1.7	4.1	28
1995	0.2	1.72	5.1	21.49
1996	0.25	1.65	5.87	20.19
1997	0.37	1.96	7.83	21.12
1998	0.42	2.03	9.27	19.04
1999	0.43	1.5	10.37	20.35
2000	0.51	1.46	13.48	20.38
2001	0.42	1.4	12.65	18.42
2002	0.38	1.35	10.86	16.02
2003	0.36	1.33	10.85	16.01

Source: ERF, p.57.

The relatively low profitability of Egyptian banks in comparison to other Banks in the MENA region is due to several reasons (AmCham, p.20):

- High Interest Rate on loans, hence less demand on loans.
- Limited financial instruments in Egypt.
- The rise of Non-profit loans and increased loan provisioning.
- Mortgage loans and financial lease contracts are not by large operational within the Egyptian Banking system, despite their high returns.
- The Slowdown of the Egyptian Economy over the past four years which effected local liquidity.

Liquidity and reserve requirements ratio

All banks combined maintained during June 2004 the minimum requirements of the liquidity ratios (liquid assets⁸-to-total assets ratios) for local currency (20%)⁹ and for foreign currencies (25%). Within the context, the average liquidity ratio was 31.9% in local currency, and 58.2% in foreign currencies. The banking system in Egypt has been characterized by high liquidity during the first half of the 1990s that declined slightly over the second half of the decade. Since the year 2000, the banking system experienced a high level of liquidity, as evident in the rising liquid assets-to-total assets ratios, fewer banks borrowing from the Central Bank, and decreasing inter-bank rates (ERF, p.57-58; Bahaa Eldin, p.125 and CBE, p.56).

All banks combined observed the minimum reserve requirement ratio 14% in 2004. Reserve requirements indicate whether they are used for prudential purposes and as an instrument of monetary policy, or for generating income for the budget. In developed countries the ratios are much smaller than in less developed countries. Required reserved ratios in Egypt increased from

⁸ Short term securities.

⁹ It was reduced to 20% in 1991 from 30% imposed on domestic and foreign currency deposits in 1958.

12.5% in 1960 to 25% between 1979 and 1990. Then it was reduced to 15% due to the financial reform (Bahaa Eldin, pp. 125-126 and CBE, p.56).

Risk Management

The banking system in Egypt is confronted with various financial market risks. First, credit risk (the ratio of medium and long-term loans to total assets) was on aggregate low in the early 1990s, as banks were inclined to limit their medium-quality loans. In 1996, the ratio of medium- and long-term loans to total assets increased substantially. In 2000, the ratio for business and investment banks have remained in the range of 11 and 14%, while that for public banks have increased significantly to reach 22%. Risks were particularly high, since banks went into the cycle of high credit expansion rates, while the economy was going through a liquidity shortage, and several private firms were showing signs of distress. Second, since banks in Egypt are allowed to engage in stock market trading, banks are also exposed to equity risk. Banks can hold up to 40% of capital in individual financial and non financial enterprises with an aggregate limit of 100% of capital. These limits are considered high by international standards. Moreover, the CBE, aware of the fact that the volatility of the stock market can affect the soundness of the banking system, requires banks to apply 'suitable' margins on lending for purchases of equities or in lending against equities, and also watches closely the developments in such lending, which by the end of 1999 accounted for 2.4% of banks' total loans portfolio. Market risk is the loss related to the value change of a financial instrument or a portfolio due to a change in the value of market variables, such as interest rates, credit spreads, equity and commodity prices, and exchange rate. Operational risk is the risk of loss resulting from inadequate internal processes or systems, human factors, or external events. This may be controlled through increasing the focus on technology upgrades and staff training (ERF, pp.60-61 and AmCham, p.23).

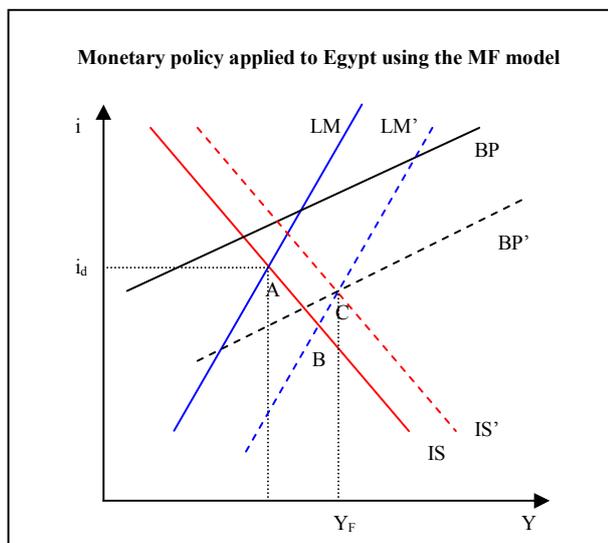
IV- Description Analysis:

This section involves a description analysis, which includes short term economic policies, medium term economic stabilization and long term economic implication for the banking sector.

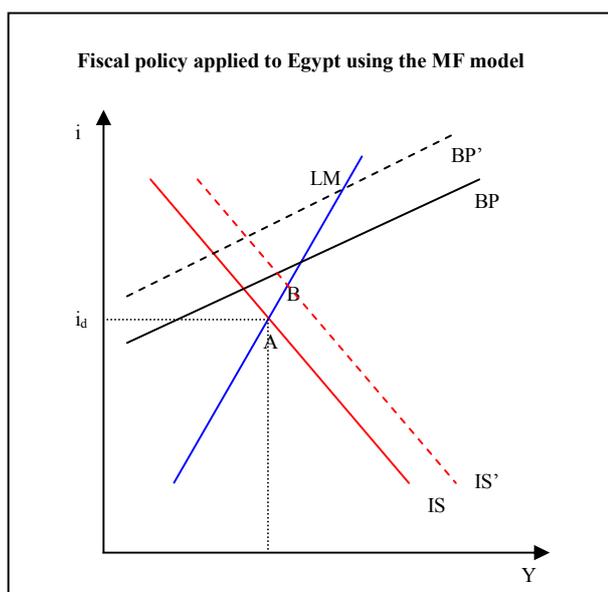
IV-1 Keynesian Short-Term Policies

The final target of the monetary policy adopted by the CBE has been to maintain price stability. Its instruments included the reserve requirement ratio; the CBE discount rate; and the open market operations. During the Fiscal Year (FY) 2003/2004, the reserve requirement ratio held by banks at the CBE remained unchanged at 14%. The CBE lending and discount rate was also stable at 10%. The open market operations conducted by the CBE aimed to absorb banks' excess liquidity. In order to reach inflation rate that really expresses prices in the domestic market, the CAPMAS issued a new series of consumer prices. According to the data available from this series, the inflation rate amounted to 4%. The average interest rates on loans of one year or less ranged between 13% and 13.5% (CBE, pp.18-19). This part utilizes the IS-LM-BP model (Mundell-Fleming model) to show how Egypt can use monetary and fiscal policies to achieve a balanced economy depending on its current situation. Egypt starts at point A with domestic unemployment and a balance of payments deficit of about US\$ 158.3 million during the FY 2003/2004 (CBE, pp.68-69). What will Egypt require to achieve both internal and external balance?

Suppose Egypt starts from point A, an easy monetary policy that shifts the LM curve to LM' tends to lower the interest rate in Egypt reaching point B. This would lead to a capital outflow and a tendency of the Egyptian pound to depreciate (if the Marshall-Lerner condition is satisfied) which shifts the IS curve to the right to IS' and the BP curve shifts to the right (due to currency depreciation) in such a way that the IS', the LM' and the BP' curves cross at point C.



On the other hand, Suppose Egypt uses the expansionary fiscal policy that shifts the IS curve to IS'. The intersection of the broken IS' curve with the unchanged LM curve at point B indicates a tendency for Egypt's interest rate to rise. This leads to massive capital inflows and appreciation of its currency, which discourages exports and encourages imports, and shifts the IS' curve to the left (besides the crowding out effect) and back to its original IS position.



Thus, monetary policy is effective and fiscal policy is ineffective for Egypt. However, this easy monetary policy that should be implemented by the Central Bank of Egypt must be carefully planned target and according to time constraint. This is because unplanned and persistent easy monetary policy in Egypt, could lead to persistent inflation and the Egyptian pound depreciation (Salvatore, pp.630-643 and Mishkin, pp.590-591).

IV-2 Structural Medium-Term Analysis

The Egyptian banking system consists of the CBE and 46 banks, as of July 20, 2005. Unlike the old distinction between commercial, investment and specialized banks which the new banking law abolished, these 46 banks are divided between banks operating in Egypt amounting to 39 in number and seven branches of foreign banks. The 39 banks operating in Egypt are divided into 7 state-owned banks (the big four Commercial Banks and three specialized banks) and 32 joint venture and private banks. The total number of branches in Egypt reached 2,826 as of March 2005 in addition to 39 branches that are licensed to operate overseas. In 2004, commercial banks alone operated 1,308 or 47% of total bank branches in Egypt, with an increase of 201 branches over the previous year. For that same year, the seven public sector banks operated 71% of the total 2,783 branches nationwide, which show that state-owned banks continue to dominate the banking sector in Egypt. The combined market share of the 7 state-owned banks is 59.9% of deposits and 61.3% of loans as of February 2005 (AmCham, p.11).

Mergers and Acquisitions

Mergers and acquisitions are highly encouraged by the CBE through the new Unified Banking Law No. 88/2003. The GOE's September 2004 banking reform plan aims to reduce the number of banks in Egypt within a five-year period. The Unified Banking Law stipulates that paid-in capital should increase to a minimum of LE 500 million for Egyptian banks and \$50 million for branches of foreign banks operating in Egypt by July 2005. The new law also allows full foreign ownership of capital, (100%) thus facilitating foreign entry into the market. However, due to the large number of banks operating in Egypt, the CBE stopped granting new licenses a few years ago. No new licenses were issued during the last 10 years. Thus market entry has only been through acquisition of existing local banks. Several commercial and investment banks will not be able and/or willing to increase their capital to the required level. These banks are forced to merge, consolidate or close. Banque Misr was thus prompted in September 2004 to absorb Misr Exterior Bank for failing to meet the new banking law's minimum capital requirement of LE 500 million, with a capital adequacy ratio of at least 10% (AmCham, p.13-14).

Banks as catalyst for the "big push"

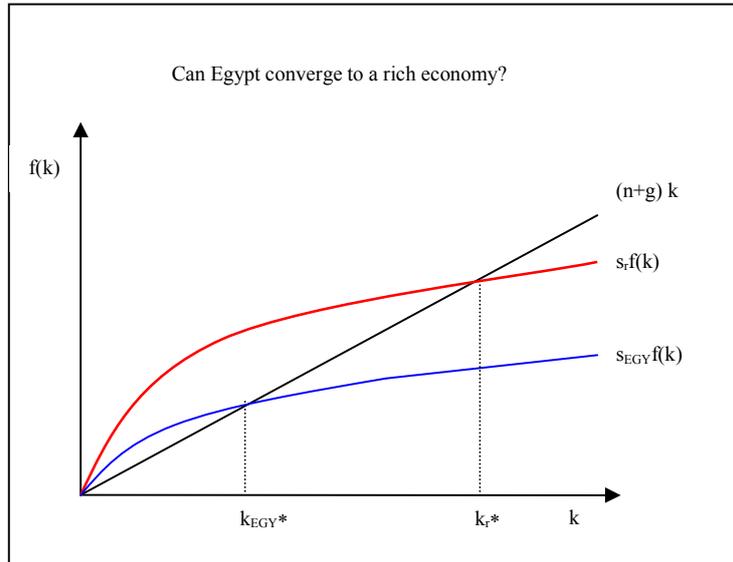
Economic development may require a critical mass of investments to achieve industrialization through a 'big push'. Banks as private economic institution, motivated by profits, may help achieve a 'big push'. Banks played a significant role in process of industrialization. In particular, the emergence of private industrial credit banks in 19th century in Europe. An association between rapid industrialization and the emergence of large and influential banks can be a historical evidence for banks' role in the big push. Large banks especially may be instrumental in fostering industrialization. Banks induce industrialization by coordinating investment decisions. Through the terms of their loans, banks can induce a selective subset of firms in the economy to invest. This changes other firms' expectations, and they decide to invest as well. In order to function as a catalyst, a bank needs to satisfy two requirements. It has to be sufficiently large relative to the economy, so as to be able to finance a critical mass of firms. And it needs a sufficient amount of market power to recoup the costs of inducing coordination. Large banks can offer loans with low interest rates, or loans which shelter entrepreneurs from the risk of losses. The bank incurs losses on these loans, but if it is large enough, and with sufficient market power, it can recoup them from the profits it makes on all other firms, once industrialization happens. Therefore, Banks are a natural candidate as coordinating agent. Firstly, by nature of their risk-sharing activities, banks are in contact with a large number of firms. And they may have preferential access to sensitive financial and business information, which may lower their costs of identifying the right firms to coordinate. Secondly, through the provision of funds, banks can influence firms' decision to invest (Da Rin et al., pp1-3, Roe, pp.88-89 and Basu, pp.24-27).

IV-3 Neoclassical Long-Term Economic Implications

Depending on the theoretical framework, the effects of banking markets on growth can be transient or lasting. In traditional growth theories, the effects are transient, present only during the transition to an economy's steady-state growth path. In the new theories of endogenous growth, the effects can be lasting, possibly taking the economy to a permanently higher growth path. According to the neoclassical model of economic growth consider a permanent increase in the savings ratio. This may be brought about by an increase in savings because of an expansion in the branch network of the banking system. A higher savings ratio implies that more resources are available for investment in each period; thus a higher stock of capital per head becomes sustainable in the steady state and consequently a higher level of long-run output per head.

Consider two economies that are identical in all respects except in their ability to mobilize savings, that is, economies that have identical production technologies, the same rate of

population growth, and the same depreciation rate but different savings rates. Egypt, with an underdeveloped banking system, has a low savings rate. As a result, its level of capital per head is low, and its level of output per head is also low. The second economy, with a highly developed banking system, is successful in mobilizing savings. As a result, its savings ratio is much higher, its capital per head is high, and it has a higher level of per capita income. Assume that Egypt's (the poor) economy's banking system undergoes major reforms as effective and efficient as the one in the rich economy. The savings ratio increases substantially, and so do resources devoted to capital accumulation. Thus, the capital stock per head begins to grow rapidly, as does output per head. Egypt's economy's level of output per head has converged to that of the rich economy. Although the banking system may not be able to influence the growth rate permanently, it can permanently affect the level of output. The banking system may influence the growth rate permanently through improving the average productivity of capital and channel investment funds (Demetriades, pp. 9-15 and Todaro, p.669).



V- SWOT Analysis:

The SWOT analysis is very useful for closely examining the banking sector in Egypt. The purpose of doing the SWOT analysis is to identify actions that will capitalise on strengths and correct weaknesses.

<i>Strengths</i>	<i>Weaknesses</i>
<ul style="list-style-type: none"> • The private banking system is competitive. • Improvement in market conditions and exchange rate stability in 2004. • The new Banking Law includes excellent steps to reform the banking system. • Market entry is possible through acquisition of existing banks. • The cost of exiting includes the normal liquidation costs, and compensation for employees with no penalties. • Egypt's population is concentrated in Cairo and Alexandria, thus the cost of developing a branch network is relatively low. • Egypt's removal from the FATF's money-laundering blacklist. 	<ul style="list-style-type: none"> • Low level of deposits per capita. • Mismatching, i.e. long-term lending versus short-term funding. • Commissions and banking fees are high. • Heavy reliance on inter-bank. • Over-regulation and overly centralized and controlled regulatory decision-making. • The salary level is relatively low, which deters the talented employees needed to improve and upgrade the industry. • Bureaucratic barriers to entry constrain innovation and development. • Public sector domination leads to price distortions and misallocation of resources. • Lack of instruments for hedging compared to the world market, since many treasury products and derivatives are prohibited by the CBE.

<i>Opportunities</i>	<i>Threats</i>
<ul style="list-style-type: none"> • Innovation and development as the Egyptian banking system is still relatively underdeveloped, e.g., a wide range of products and service, including products aimed at SMEs, retail banking, investment banking and project finance. • Innovations in Retail banking. • Presence of expansion opportunities for local banks in potential regional markets such as Sudan and Libya. • Establish regional banks to finance the activity of multinational corporations in the region. • Increase the currently modest level of Arab banking assets. • A stronger capital base from M&As would allow for an increase in banking assets. 	<ul style="list-style-type: none"> • Market entry through new license is closed, which is also an obstacle to foreign acquisition of the local ventures due to overvaluations. • Continuation of bureaucratic delays will hinder private sector investment. • Continued public sector domination will hamper reforms. • Local banks are required to manage “old problems” and compete in higher growth areas simultaneously. • Tax amounts are highly contested between banks and the Tax Authority and could be a major problem as a potential unclear liability for any acquisition. • Political unrest and economic instability. • Expected Banking crisis due to unplanned privatization.

VI- Development Strategies:

The overall vision for developing the banking sector in Egypt entails achieving three main objectives: bank performance enhancement, information system development and human resource optimization. This entails a number of interrelated strategies for this overall vision to materialize as well as it has its positive impacts on the Egyptian economy.

<i>Objectives</i>	<i>Strategies</i>	<i>Impacts</i>
<i>Bank performance enhancement</i>	<ul style="list-style-type: none"> • Lowering and eliminating barriers. • Decrease interest rates on loans. • Mergers and Acquisitions. • Planned Privatization of state banks. • Adopt a variety of customer relationship management systems. • Introduce new types of loans (e.g. education, tourism, car and home). 	<ul style="list-style-type: none"> • Increasing competition. • Promoting economic efficiency. • Reducing government interference. • Raising funds for the government. • Increase banks’ profitability. • Encourage foreign investments. • Introduce a wider range of services.
<i>Information system development</i>	<ul style="list-style-type: none"> • Increase investment in bank’s technical infrastructure (more IT spending). • Build a system of client history. • Utilize e-banking services. 	<ul style="list-style-type: none"> • Better liquidity. • Risk management. • Exchange data. • Reduce costs. • Apply risk forecasting methods. • Improve efficiencies • Provide competitive advantages. • Foster transaction facilitations and security measures.

<i>Human resource optimization</i>	<ul style="list-style-type: none"> • Intensive training and re-training programs (e.g., banking business, foreign language courses, IT & computer). • Reduce the huge wage gap between public and private sectors. • Choose best skilled and educated managers. 	<ul style="list-style-type: none"> • Keep operating personnel up with change in business environment. • Raising the efficiency of working staff. • Reduce operation risk and human error.
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The banking system may influence the growth rate permanently through one or more of the following channels:

1. Improving the average productivity of capital. The financial system is responsible for channeling funds from surplus to deficit units via collecting information and evaluating alternative investment projects (screening). They may also engage in monitoring borrowers to ensure that the loaned funds are efficiently utilized. Another way to improve the productivity of capital is by inducing individuals to invest in riskier but more productive technologies by providing risk-sharing opportunities.

2. Channel investment funds. In the context of endogenous growth models, increases in the efficiency of the banking sector are likely to have lasting effects on the steady-state growth rate. Such increases may be secured by all the factors that make the banking sector internally more efficient, such as improvements in management that come about by appointing better-educated manager, improvements in staff training, the adoption of modern technology, the adoption of flexible working practices, and the removal of bureaucratic rigidities and controls.

VII- Conclusion:

Public banks in Egypt tend to have a lower incentive to identify problem loans, to minimize costs, and to innovate because they are confronted with little competition; their losses are often covered by the government. In that respect, it is worth noting that privatization of public banks should not be one of the government’s priorities. The focus should be more on changing the management of these banks. Promoting more effective market discipline in the financial system could be supported by privatizing the banking sector, promoting a more contestable banking system, and moving toward a more competitively neutral regulatory environment. Removing the links between the ownership of private banks on one hand, and public banks and the government on the other, would increase the competitiveness of the banking system and enhance potential financial innovation. In that context it is crucial for the government to privatize public sector shares in joint venture banks.

Egypt’s reform plan is to increase the efficiency in the sector, by mergers and acquisitions, which will pave the venue for Egypt to becoming a regional financial player; hence laws and regulations governing this issue should target to accelerate the process rather than hindering it. Moreover, human resource development and an industry wide rise in remuneration and salaries are required to stop cross border brain drain.

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