



ACHIEVING RAPID GROWTH: THE ROAD AHEAD FOR EGYPT

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Distinguished Lecture Series 3

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تقديم

ما هو الطريق الأمثل للتنمية؟ كثيراً ما يطرح هذا السؤال، أو أسئلة مشابهة مثل : لماذا لا تتبع مصر نماذج التنمية التي أتبعها بعض النماذج الآسيوية مثل كوريا ؟ أو لماذا لا نتخذو مصر حذو ماليزيا للنهوض باقتصادها؟ وماذا عن تطبيق النموذج الصيني؟ إن طرح هذه الأسئلة ليس بالضرورة صحيحاً؛ فالدول لا تتطابق مع بعضها، وإن تشابهت في نقاط انطلاقها ومواردها الطبيعية فإنها تختلف في قيمها وثقافتها، وهكذا تظل هناك دائماً أوجه للاختلاف و التمايز.

ما هي إذن الأسئلة التي يجب أن نطرحها لكي تضعنا على الطريق الصحيح للتنمية ؟ في هذا الكتيب يحدد لنا الاقتصادي العالمي "جيفري ساكس" هذه الأسئلة ويحاول الرد عليها. فيسأل عن ماهية العوامل التي تؤدي لاختلاف معدلات النمو بين الدول، ويستفهم عن السياسات التي تؤدي إلى نجاح أو فشل هذه الاقتصادات، ويستفسر عن مقومات برامج الإصلاح التي تنطلق باقتصاد دولة ما إلى معدلات تنمية سريعة.

في البداية يقبل "جيفري ساكس" بأن الدور القيادي للدولة في عملية التنمية كان مناسباً في فترة ما بعد الحرب العالمية الثانية، لما تميزت به هذه الفترة من سيادة أيديولوجية سياسية واقتصادية معينة. لكن اتضح أن دول شرق آسيا، وغيرها من الدول سريعة النمو، قد اتبعت استراتيجيات مختلفة عن ذلك تماماً. فقد اعتمدت هذه الدول على القطاع الخاص كمحرك أساسي للنمو، وفي المقابل قلصت دور القطاع العام وخفضت معدلات الضرائب. وبالإضافة إلى ذلك فتحت هذه الدول أسواقها أمام رأس المال الأجنبي والمنافسة العالمية. وبناءً على هذه النتائج قدم "ساكس" عدداً من النصائح التي قد تساعد الاقتصاد المصري على اللحاق بركب الدول سريعة النمو.

أثارت محاضرة "ساكس" أسئلة و تعليقات مختلفة. فقد تساءل البعض عن مدى تعارض الإسراع في عملية الإصلاح مع الالتزامات الاجتماعية للدولة، وعلق البعض الآخر على نجاح التجربة الكورية رغم الانفتاح الجزئي لأسواقها. كما جاءت مداخلات مشاركين آخرين معنية بدور الاستثمار الأجنبي في تشييط النمو الاقتصادي.

إن قراءة محاضرة "ساكس" وما تبعها من مناقشات تؤكد على أن الفرصة سانحة لمصر لزيادة معدلات نمو اقتصادها، إذ أنها تتميز بقربها من السوق الأوروبية كما تتمتع بقاعدة صناعية عريضة و ثروة بشرية ضخمة، إلا أن استغلال هذه الفرصة يشترط تحديات هامة أمام صانع القرار للوصول إلى معدل نمو مطرد يبلغ ٧٪ أو يزيد. فضلاً عن ذلك فقد نجح "ساكس"، من وجهة نظري، في طرح الأسئلة الصحيحة القادرة على تحديد المسار السليم للنمو و التقدم.

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FOREWORD

In search of a path to development, it is not unusual for smart politicians, academicians and policy makers to ask the *wrong* questions. In Egypt, for example, one often hears such questions as: should Egypt pursue the reform strategy followed by Korea? Or, is Malaysia's path more suitable, given that Egypt seems to have more in common with that nation? What about the Chinese model, since China has been successful despite gradualism and significant state ownership? These are the wrong questions, in my view, because no two countries are exactly alike. Countries may have similar resource endowments but vastly different initial conditions (e.g., per capita income, human and physical capital, etc.). Even with the same resources and initial conditions, they are likely to differ in cultures and value systems. There is always one difference or another that precludes copying another country's model.

What then are the *right* questions? From the perspective of formulating pro growth strategies and policies, one might ask: what factors explain the variance in growth across countries? Or, what policies (and initial conditions) differentiate the successful from the unsuccessful performers? Or, what are the features of reform strategy which have been shown to transform countries from slow to fast-growing economies? In this publication, Jeffrey Sachs answers such questions.

He first concedes that the state-led growth strategy may have been reasonable in the decades following World War II, given the intellectual and political realities of the age. However, he shows that the very fast-growing economies, including those in East Asia, followed a different strategy. Put simply, these countries opened their markets to international competition and capital flows, maintained small governments and lower taxes, and allowed the private sector to be the engine of growth. He then makes a number of recommendations to help Egypt join the club of very fast-growing economies.

Sachs' presentation at ECES evoked intense discussion. The participants asked about such issues as the speed of reform versus social commitments, the role of foreign direct investment in promoting growth, and why some economies, such as Korea, grew rapidly although they were not completely open.

My reading of Sachs' presentation and his answers to the participants' questions is simply one of hope and challenge. On the one hand, he contends that the prospects for fast growth in Egypt are real, given the country's proximity to Europe, diversified industrial base, and stock of human capital. On the other hand, he stresses the enormous challenges facing policy makers if Egypt is to grow at 7 percent a year for a sustained period of time. Most important perhaps, Sachs undoubtedly asks the *right* questions.

Ahmed Galal
Acting Executive Director, ECES
June 1996

ABOUT THE SPEAKER

JEFFREY SACHS

Director, Harvard Institute for International Development

Jeffrey Sachs was cited by *The New York Times Magazine* as "probably the most important economist in the world". *Time* magazine referred to him in 1994 as "the world's best-known economist".

Sachs received his BA, MA and Ph.D. from Harvard University, and subsequently joined the Harvard faculty, becoming a full professor in 1983. In addition to his academic work, he serves as an economic advisor to several governments in Latin America, Eastern Europe, the former Soviet republics, and Asia. In the late 1980s, he advised the governments of Bolivia, Argentina, Brazil, Ecuador and Venezuela on financial reforms. As an advisor to the president of Bolivia, Sachs helped design and implement one of the most effective stabilization programs which reduced Bolivia's annual inflation rate from 40,000 percent to 10 percent, and cut the commercial bank debt in half.

Among his accomplishments in the Eastern European arena, Sachs was an economic advisor to Poland's Solidarity movement and later to Poland's first post-communist government. In the early 1990s, he led a team of advisors for Russian President Boris Yeltsin on macroeconomic stabilization, privatization, market liberalization, and finance. He has also advised the Slovene, Estonian, and Mongolian governments.

Sachs has published dozens of scholarly articles, and contributes to several international publications. His published books include the textbook *Macroeconomics in the Global Economy* and *Poland's Jump to the Market Economy*. He has received many awards and honors, and is a member of the Brookings Panel Of Economists and the Board of Advisors of the Congressional Budget Office. His current research interests include the "transition" economies of Eastern Europe and the former Soviet republics, the international debt crisis, and macroeconomic policy.

PART I

ACHIEVING RAPID GROWTH: THE ROAD AHEAD FOR EGYPT¹

1. Introduction

Egypt's performance in the past 30 years in raising living standards has been inadequate, and has lagged behind many other developing countries. Table 1 shows a comparison of Egypt's economic performance with that of seven very fast growing economies (VFGEs). We see that Egypt's economic performance has fallen short of the VFGEs not only in the growth of per capita gross domestic product (GDP), but also in other measures of human development such as literacy, life expectancy, and infant mortality rates. Per capita growth in the 1990s has been even more disappointing than indicated by the table. Recent estimates by the IMF (1996) suggest that Egypt's per capita GDP has declined by around 3 percent between 1990 and 1995.²

It is now widely understood that Egypt's relatively poor economic performance is related primarily to the choice of economic strategy followed after the 1952 Revolution. The strategy, which may be called state-led industrialization, was based on *high protectionism, planning, and detailed domestic regulation of the economy*. Not only did SLI fail to deliver the goods in purely economic terms, but it also contributed to widespread administrative inefficiency. These profound failures of SLI can be noted throughout the developing world, and have prompted dozens of governments to undertake fundamental reforms of economic strategy.

After a quarter century of high growth in East Asia, a decade or more of rapid growth in other developing countries such as Chile and Mauritius, and a multitude of studies on comparative economic growth, the roots of rapid economic growth are fairly clear. This paper summarizes the lessons from the fast-growing economies, and applies a cross-country econometric analysis to examine Egypt's economic potential under alternative policy choices in the future. The main conclusion is that Egypt can expect per capita economic growth of a mere 2.6 percent per year

¹ The author is grateful to Ahmed Galal and other participants for comments, corrections, and suggestions. Of course all remaining errors are those of the author. This work is part of a larger project on growth-oriented reforms being carried out with Dr. Andrew Warner of HIID. Related HIID studies include papers on Sub-Saharan Africa, South Africa, Central Europe, India, and Mozambique.

² The IMF (1996), Table A6, p. 123, records the following percentage growth rates of real GDP: 1991, 2.1; 1992, 0.3; 1993, 0.5; 1994, 2.7; 1995, 3.2. Population growth is estimated at 2.0 percent per year.

Table 1. Rates of Growth and Social Indicators of Egypt and Selected Fast-growing Economies

Country	GNP per capita annual growth rate % 1980-93	Life expectancy at birth (years)		Infant mortality per 1000 births		Adult literacy rate	
		1960	1992	1960	1992	1970	1992
Chile	3.6	57	74	114	16	89	95
Hong Kong	5.4	65	79	44	7	na	na
Indonesia	4.2	41	62	139	66	54	84
Korea	8.2	54	71	85	11	88	97
Malaysia	3.5	54	70	73	14	60	80
Singapore	6.1	64	75	36	6	na	na
Thailand	6.4	52	69	103	26	79	94
Egypt	2.8	46	64	179	67	35	49

Source: United Nations, Human Development Report, 1994 and 1995 and World Development Report, 1995.

under a continuation of current policies (which have partially reformed, but not ended, the SLI system), but could raise the overall per capita growth rate to as much as 6.3 percent per year under extensive market reforms. An increase in per capita annual growth from 2.6 to 6.3 percent per year would lead to a cumulative 110 percent increase in per capita GDP after 20 years, which is more than double the per capita GDP from the current trajectory.

2. The Legacy of Egyptian Socialism

After the Revolution of 1952, Egypt gradually became one of the many developing countries that adopted the economic strategy of state-led industrialization (SLI). This combination of policies became the favored strategy of post-colonial countries around the world, even the long-independent developing countries of Latin America. SLI was adopted in one variant or another in most of the developing world, including Egypt under Nasser, India under Nehru, Indonesia under Suharto, Tanzania under Nyerere, Argentina under Peron, and Brazil under Getulio Vargas. Most of these countries identified their policies as socialist, but not Marxist-Leninist. Indeed, SLI policies were often explicitly identified as a third option between the capitalist first world and the communist second world. Another couple of dozen countries, constituting fully one third of the world's population, followed the Soviet Union in imposing a much stricter Marxist-Leninist model, based on nearly complete state ownership of industry and a rigorous one-party dictatorship (for a list of Marxist-Socialist states as of the mid-1980s, see Kornai, 1994). In the People's Republic of China, and much of Africa, the Marxist-Leninist model was imposed by a revolutionary government

supported by the Soviet Union. In Central and Eastern Europe, the model was imposed directly by the Soviet Union.

The choice of SLI in Egypt and elsewhere is understandable when viewed within the context of the choices facing the leaders of developing countries, and especially of new post-colonial nations, at the end of World War II. At the core, SLI was a defensive reaction against the capitalist first world, including both governments and multinational enterprises. Egypt had experienced some 2,600 years of occupation, since the conquest of Pharaonic Egypt by the Assyrians in 671 BC. More recently, in the period between 1882 and 1948, Egypt was under the effective control of the British government, though formally Egypt had regained national independence in 1922. Like other newly independent countries, Egypt experienced prolonged depredations at the hands of the imperial powers. Often, the effective or even *de jure* colonial power was not even a foreign government, but actually a foreign corporation. In India's case, the original colonial power was the East India Company, and it was only in 1858 that the British government itself became the *de jure* colonial authority. In the case of Egypt, the politics and financial problems surrounding the Suez Canal played a continual role in undermining Egypt's sovereignty. Thus, the notion of foreign investment as a helpful or even benign force for economic development was generally dismissed in the newly independent countries. Rather than attract foreign investment, most SLI countries nationalized existing investments; in Egypt this involved nationalization of the Suez Canal in 1956, and nationalization in the 1960s of most sizable firms.

Extensive engagement in foreign trade also seemed to be a dubious proposition. Not only did foreign trade appear to threaten the subservience of the newly independent nations to the former colonial masters, but foreign trade itself had collapsed between 1914 and 1945, under the weight of two world wars and the Great Depression. As of the early 1950s, only a handful of countries had convertible currencies. The British pound and almost all European currencies were inconvertible. Global trade was managed through state-to-state settlements, and at a very low level as a percent of national income. There was widespread skepticism that multilateral trade would be reestablished as a vibrant force in the world economy. In summary, neither inflows of foreign capital nor a development strategy based on free trade seemed a sensible approach to economic development for fragile, newly independent states in what seemed to be an essentially hostile world.

At the same time, economic theory and the alleged lessons of industrialization of the Soviet Union seemed to point to a model of rapid development based on state ownership and extensive

barriers to trade. John Maynard Keynes had concluded that capitalism was inherently unstable, and therefore needed the strong hand of the government to preserve full employment. In the depths of the Great Depression, in a famous speech in Dublin on national self sufficiency, Keynes (1933) preached the need for experimentation with new economic systems, and even the desirability of relatively autarkic economic development (though by the end of World War II, he was again championing, and helping to design, a new international monetary system based on open multilateral trade). Many other economists had concluded that some form of planning was needed not only to avoid extreme fluctuations in unemployment, but also to take advantage of the economies of scale of modern industry. P. N. Rosenstein-Rodan (1943), for example, wrote of the need for a 'Big Push' in industrialization, presumably led by the state. Development planning models, based on input-output models and simple dynamic equations for economic growth, seemed to offer a scientific base for state leadership in the economy. And the apparent success of the Soviet Union in industrialization (now known to have been greatly exaggerated by the official data, and in any event achieved with horrific cruelty and loss of life) seemed to demonstrate that effective planning was possible.

Only a handful of developing countries chose an open-market system instead of SLI or Marxism-Leninism. In a recent study of the postwar histories of more than 90 developing countries, Sachs and Warner (1995) found fewer than 20 developing countries that were always open to international trade in the post-war period or from the time of their independence (if that is more recent). Sachs and Warner classified a country as open if it had these four criteria:

- average import tariff rates of 40 percent or less on intermediate and capital goods;
- import quotas and licenses covering 40 percent or less of total imports;
- a black market exchange rate premium of 20 percent or less on average;
- no state monopolization of trade in the leading exports.

Of course, Egypt failed these criteria by a wide margin, since import tariffs were well above 40 percent and import licensing covered virtually all of international trade until the 1990s. Note that openness is only one measure of market orientation. Others include the role of the private sector, the extent of state planning, the degree of administrative regulation of domestic investment, and legal restrictions on labor market activity, such as minimum wage regulation and limitations on the dismissal of workers (many of these other aspects of policy are discussed later). Nonetheless, the degree of openness is a good *overall* indicator of market orientation. The open economies have

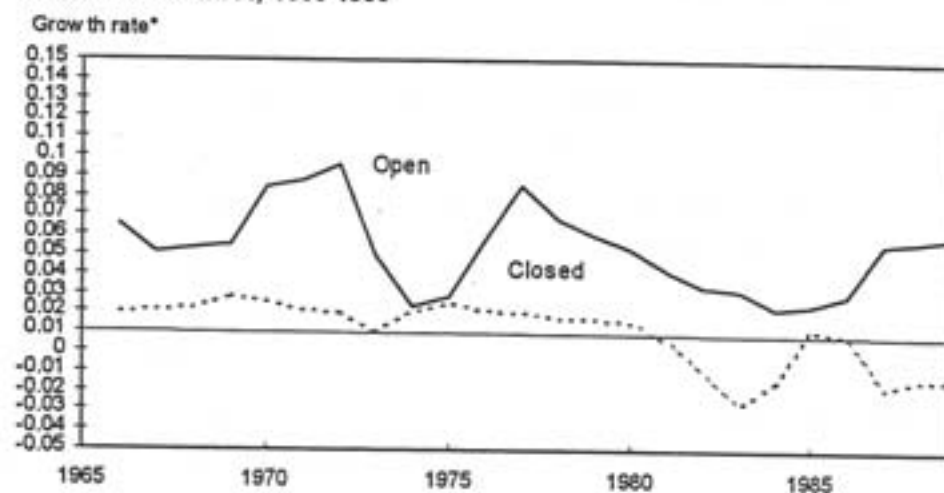
tended to be much more market oriented on the other dimensions of policy, while the closed economies generally pursued a full array of SLI policies.

In East Asia, Malaysia, Singapore, and Thailand were among the few countries that maintained open trade (though Thailand just squeezed in, under the 40-percent-tariff threshold). Indonesia, South Korea and Taiwan pursued SLI policies in the 1950s, but then opened in the 1960s, well before most other developing countries. The switch from SLI to a more open, market-oriented strategy was related to severe economic failures (very high inflation in Korea and Taiwan in the 1950s, and in Indonesia in the mid-1960s), as well as pressures and inducements from the US. If there is one overriding reason why all six of these East Asian countries chose more open, market-oriented strategies while most other developing countries did not, the best answer probably lies in the area of national security. All six countries looked to the UK and US for military defense and internal security. The US in particular, through foreign aid and technical assistance, helped to nudge Korea, Taiwan, and Thailand into relatively open trading regimes.

The choice of SLI in Egypt and elsewhere might well be understandable, but the results were very poor indeed. Closed, state-led economies fared very badly in the past 40 years, lagging far behind the economies that maintained open trade and market-based strategies. Figure 1 shows the worldwide experience in simple terms. Here we see the average growth rate of 40 developing countries that chose a closed model, and eight developing countries that were always open to international trade in the period 1966-89. Clearly, the open economies grew much faster than the closed economies in every year. In fact, the growth rates of the two groups came close only in two years—1974 and 1975, when the major increase in world oil prices temporarily reduced the growth of the open economies. Closed economies, by contrast, tended to absorb the oil shock by greater internal subsidization of energy prices, and by high foreign borrowing. This protected growth in the short term, but eventually contributed to a fiscal crisis in most of these countries.

The results of SLI were even worse than indicated by low average growth rates. Almost every country that pursued SLI, or a more extreme Marxist-Leninist approach, ended up with a severe macroeconomic crisis in the 1980s or 1990s. Typically, governments pursuing SLI looked to foreign borrowing as the way to speed growth or to forestall recessions (as in 1974-75). These governments borrowed heavily in the 1970s and 1980s, and ended up in fiscal crises by the end of the 1980s. Table 2 gives some evidence on this point. Of the 17 developing countries that had an open economy in the 1970s, only one (Jordan) succumbed to an extreme macroeconomic crisis.

Figure 1. Average Growth of Eight Always Open and Forty Always Closed Economies, 1966-1990



* Figure shows three-year moving averages.

Source: Author's calculations using version 5.6 of the data in Summers and Heston (1991).

Table 2. Developing Country Openness and Macroeconomic Crisis

Openness	Macroeconomic crisis in 1980s	No macroeconomic crisis in 1980s
Open in 1970s	1	16
Not open in 1970s	59	14

Source: Sachs and Warner 1995, p. 56

Of the 73 developing economies that were closed, a remarkable 59 experienced an extreme macroeconomic crisis in the 1980s (and several more succumbed to extreme crises in the early 1990s). Sachs and Warner (1995) define an extreme macroeconomic crisis as one of three events:

- inflation in excess of 100 percent per year;
- a rescheduling of foreign debt;
- a default on foreign debt.

It is an interesting feature of political economy that almost all countries that embarked on SLI in the 1950s and 1960s stayed with their SLI arrangements until hit by severe macroeconomic crises. One might have expected that many countries would undertake economic reforms in time to *avoid* a

severe crisis, but this rarely happened. The lesson, it appears, is that while SLI began in most countries on the basis of economic and political *ideology*, it was sustained on the basis of powerful vested *interests* that fought within the political system for the preservation of state benefits and protection. SLI nurtured entire sectors of inefficient, import-competing enterprises and trade unions, whose survival then depended on the continuation of state support and protection. Both the enterprises and the unions became key campaign financiers of the main political parties, both government and opposition. Civil servants with responsibility for government's management of the economy become an important interest group in their own right. Even though a strong majority of interests might benefit from liberalization, the potential winners from liberalization tend to be politically disorganized and often even unaware of the potential gains, and therefore incapable of mobilizing an effective political opposition. The incumbents, moreover, use their incumbency, including control over state revenues, to repel challenges from any potential opposition. Generally, only after government finances are in extreme crisis are the advantages of the incumbents reduced sufficiently to allow challenge to the prevailing system.

Egypt, unfortunately, proves true to the general patterns of SLI countries, both in the onset of crisis, and in the delays in starting fundamental reforms. Periods of rapid growth under SLI were followed by periods of macroeconomic crisis. While the timing was often linked to military and political events in the Middle East, especially war with Israel (with all of the implications for state finances, tourism, Canal revenues, and workers' remittances), the underlying weakness of the SLI-based economy was more fundamental than conjunctural. Egypt grew fairly rapidly in the early 1960s, but then stagnated between 1967 and 1974. In 1974, President Anwar Sadat initiated liberalization, known as the Open Door Policy and promulgated in Law 43, which aimed to attract foreign private investment. But these reforms were modest, and did little to change the basic orientation of the SLI system. The economy grew rapidly between 1974 and 1981, following a boom in foreign exchange receipts (including oil, Suez Canal revenues, tourism, and workers' remittances), but the boom faded in the early 1980s, and the economy again fell into a prolonged period of stagnation. As in many other cases of SLI, the government continued to try to boost short-term economic performance by heavy foreign borrowing. By the late 1980s, the state's foreign debt burdens threatened macroeconomic stability. In 1987, the Egyptian government entered into an 18-month IMF program, followed by a rescheduling of debts in the Paris Club. The IMF program led to very modest reform measures, insufficient to stabilize the economy or restart economic growth.

With a deepening macroeconomic crisis in 1991, the government signed a three-year IMF/World Bank agreement, triggering a round of debt cancellation in the Paris Club. A new three-year program was signed in September 1993.

Since the start of the 1991 program, Egypt has achieved some important success in dismantling parts of the SLI system. It has eliminated most of the previous system of licensing international trade and domestic investment. Importantly, the Egyptian pound has become convertible for most current account transactions. Yet Egypt's reforms have remained limited, perhaps going far enough to lift Egypt's medium-term growth rate to around 5 percent per year, but not to achieve the rates of 8-10 percent per year that Egypt is capable of achieving, given its low per capita income levels, its generally favorable structural conditions, and especially its close proximity to Europe—a huge advantage in generating export-led growth.

3. Factors in Achieving High Economic Growth

While Egypt made substantial progress in market reforms during 1991-96, much remains to be accomplished. By identifying several common features of policies in the fastest-growing market economies among the middle-income countries, we can identify the priority areas for Egypt's future economic reforms.

Economic theory teaches that economic growth is based on three main factors:

- the accumulation of the factors of production, including both human and physical capital;
- the efficient allocation of resources within the economy;
- the improvements in technology over time.

The theoretical and empirical debate centers around the choice of economic institutions (e.g. markets versus government allocation, open trade versus protectionism, etc.) that can most effectively deliver these three components of growth. One general implication of economic theory is that poorer countries such as Egypt that follow appropriate policies can expect to grow more rapidly than richer countries. In the current economic jargon, the poorer countries can expect to converge with the richer countries in per capita income levels. Such convergence occurs mainly because of the first and third factors of growth. Poorer countries tend to accumulate capital more rapidly (in terms of percentage growth of the capital stock) than do richer countries, because poorer countries tend to have lower capital-labor ratios and higher rates of return on new investments, both of which

promote a rapid increase in the capital stock. With regard to technology, poorer countries can make use of the technological advances of the richer countries, without having to reinvent these technologies.

These tendencies towards convergence have clearly played an important role in the rapid growth of the VFGEs. But convergence can be achieved only when there are effective economic and governmental institutions supporting rapid capital accumulation, the efficient allocation of resources, and the rapid diffusion of technology from the more advanced economies. Worldwide experience, interpreted by economic theory, suggests that the following institutional arrangements have been key to rapid economic growth.

- *Openness of the Economy.* The quintessential feature of the VFGEs has been the rapid growth of manufacturing exports, shown in Table 3 for the period 1985-94. This growth has been supported by trade policies that allowed manufacturing exporters to operate at (nearly) world prices, both for inputs of capital and intermediate goods, and for the sale of exports on world markets. The VFGEs have avoided the kinds of SLI trade policies that undermine the capacity of manufacturing exporters to obtain necessary inputs at world prices, or that penalize exporters through heavy taxation of exports (effective taxation of exports can arise through: tariffs and quotas on inputs, inconvertibility of the currency, state monopolization of exports on unfavorable terms for exporters, or explicit taxation of exports).

Table 3. Growth in Manufacturing for Selected Fast-growing Economies and Egypt

Country	Average annual growth rate 1985-94
Chile	26.3
Hong Kong	21.4
Indonesia	33.2
Republic of Korea	14.1
Malaysia	29.2
Singapore	20.2
Thailand	33.7
Egypt (for the period 1986-94)	1.0

Sources: World Bank, *World Development Report*, 1980 and 1995, and World Data CD-ROM, 1995.

The exact form of the trading regime has differed across the VFGE countries, but the following elements have been common features:

- convertibility of the currency for current account transactions;
- zero or low tariffs (and the absence of licensing) for capital goods and intermediate inputs, and modest tariffs for most consumer goods;
- implicit or explicit subsidization of exports;
- other institutions supportive of manufacturing exports (especially export processing zones).

In general, the VFGEs have been quite open to trade both for imports and exports, especially in comparison with other developing countries. Limited industrial policies, where they exist, have mainly supported manufacturers not through protection of home markets, but through promotion of export activities. As discussed later, the efficacy of industrial policies is itself open to question.

Openness, and the orientation to manufacturing exports, has made several contributions to growth. First, it has helped to ensure the efficient allocation of resources, through specialization, comparative advantage, and dynamic 'learning by doing'. Second, openness has promoted domestic competition by limiting the market power of domestic firms, and by providing a rigorous international yardstick of performance. Third, openness has promoted the rapid accumulation of capital through foreign borrowing and foreign direct investment, which is then serviced by the rapid expansion of exports. Fourth, openness has promoted the rapid improvement of technology through the importation of foreign technologies. Technology may be imported directly through merchandise trade (e.g. in the form of machinery embodying a new technology), or it may come via foreign direct investment. In either case, openness has greatly enhanced the domestic economy's awareness of, and access to, technological advances in the rest of the world.

Table 4 shows that Egypt's average tariff rate of around 30 percent vastly exceeds the average tariff rates of the other economies. These high tariff rates continue to undermine labor-intensive export-led growth for Egypt.

Promotion of Saving through Fiscal Policy. All the VFGEs have high rates of saving (see table 5), considerably in excess of Egypt's saving rate. Note an important definitional distinction. Gross *domestic* saving, which is reported in the table, is calculated as gross *domestic* product minus domestic consumption. Gross *national* saving is calculated as gross *national* product minus

Table 4. Average Tariff Rates in Egypt and Selected East Asian Economies

Country	Average tariff rates (%)
Indonesia	6.00
Republic of Korea	4.00
Malaysia	9.00
Thailand	9.30
Egypt	30.00

Source: UNCTAD -Trade Analysis and Information System data on CD-ROM, 1995.

Table 5. Savings Rates in Egypt and Selected Fast-growing Economies

	Gross Domestic Saving (percent of GDP)			
	1960	1970	1980	1993
Chile	25	20	16	24
Hong Kong	6	25	24	31
Indonesia	8	14	30	31
Rep. of Korea	1	15	23	35
Malaysia	27	27	32	38
Singapore	-3	18	30	47
Thailand	14	21	22	36
Egypt (gross domestic saving)	12	9	16	6
Egypt (gross national saving)	na	na	na	18

Sources: World Bank *World Development Report*, 1980, 1982, and 1995, for domestic saving. World Bank Country Operations Division for Egypt, 1995, for estimates of gross national saving in 1993.

consumption.³ In the case of Egypt, gross national product considerably exceeds gross domestic product because of large net transfers from abroad, mainly workers' remittances. Therefore, national saving, currently around 20 percent of GDP, is much higher than domestic saving, which is currently around 10 percent of GDP. There is no important difference in the measures for the other countries.

³ The calculation of gross national saving reported in the table excludes official grants. If official grants (i.e. foreign aid) were included as part of national saving, the saving rate as a percent of GDP would rise by approximately 4 percent of GDP during 1990-94.

The high saving rates in the VFGEs contribute to rapid capital accumulation, and thereby to rapid economic growth. High saving rates were not always the case in the VFGEs. The general pattern is that saving rates rose in the course of growth, from modest levels in the 1960s to rates exceeding 30 percent of GDP in the 1990s. Egypt's national saving rates have been closer to 20 percent of GDP, or less in recent years, while the domestic saving rate has typically been 10 percent of GDP or less.

National saving is the sum of government saving and private saving. Government saving, in turn, is the excess of current government revenues over current government expenditure. The largest difference between Egypt and the VFGEs in overall national saving rates has been the *government saving rates*. The VFGEs have sizable government saving as a percent of GDP, while Egypt's government saving has been negative until recently. Following the restrictive budgetary measures of the early 1990s, the Egyptian government is now saving around 5 percent of GDP. The private saving rate has declined at the same time, however, so that national saving remains below 20 percent of GDP.

On a cross-country basis, high government saving is related to low overall levels of government spending as a percent of GDP, as shown in table 6. In the VFGEs, total government spending as a percent of GDP tends to be low, between 15 and 30 percent of GDP. Egypt's overall government spending, by contrast, is around 35 percent of GDP, after having been cut from an astounding 49 percent of GDP in 1988! Governments that have high levels of government spending tend to have low rates of government saving, as has been the case with Egypt. When expenditures are high, tax revenues lag behind expenditures because of political resistance to high tax rates, as well as increasing tax avoidance and evasion.

Figure 2 shows a scatter plot of government spending versus government saving, both measured as a percent of GDP. We see that, indeed, *countries with lower rates of government spending tend to have higher rates of government saving*.

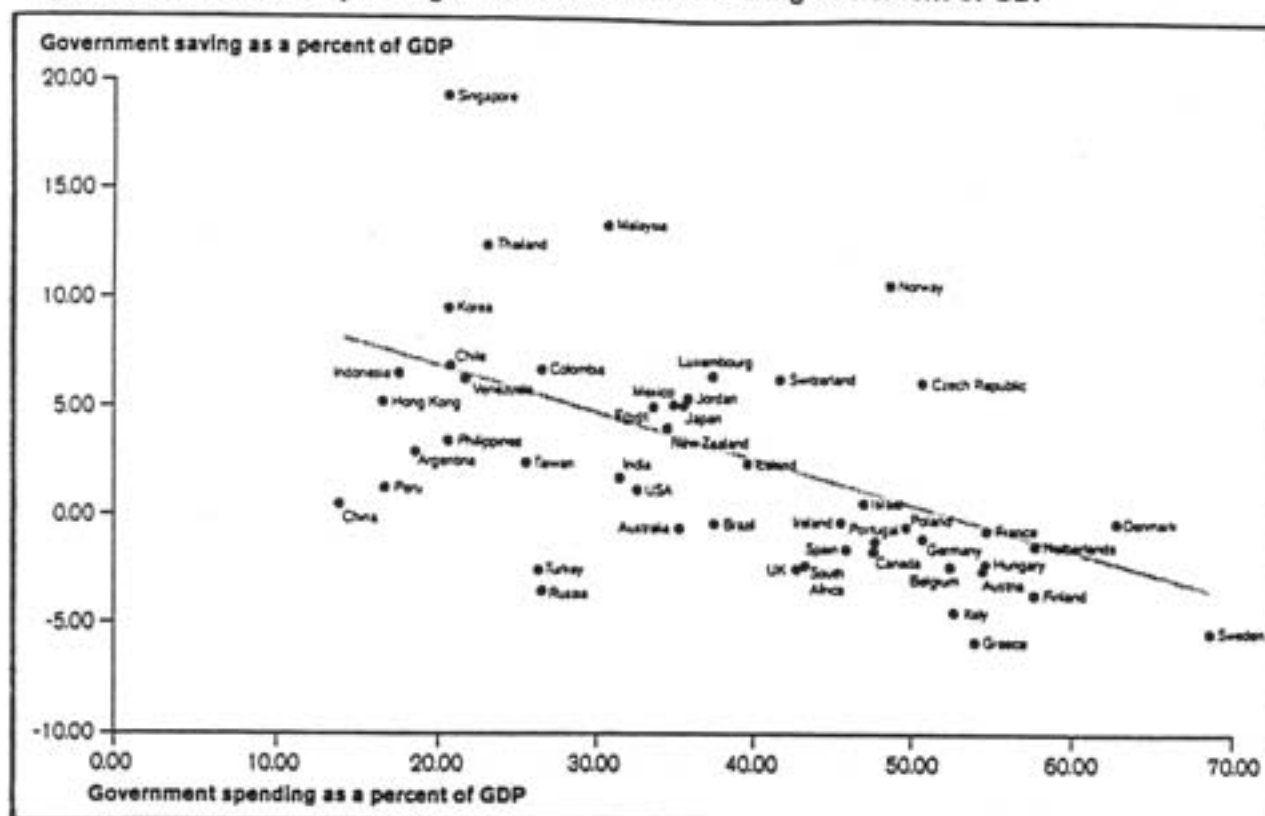
In many of the VFGEs, private saving rates are also unusually high. This is partly a result, rather than a cause, of rapid growth, since high rates of growth stimulate private household saving and retained earnings by firms. High private saving rates also partly reflect the development of financial market institutions that are effective in mobilizing household saving, such as the micro-finance institutions in Indonesia (e.g. Bank Rakyat Indonesia) which mobilize the saving of millions of rural households. More generally, throughout the VFGEs, households are responsible for their

Table 6. Government Spending as Percent of GDP in Egypt and Selected Fast-growing Economies

Country	1993
Chile	20.8
Hong Kong	16.6
Indonesia	17.1
Republic of Korea	20.3
Malaysia	30.6
Singapore	20.4
Thailand	22.1
India	31.7
Egypt	35.0

Source: Government Finance Statistics Yearbook, IMF, 1994.

Figure 2. Government Spending Versus Government Saving as Percent of GDP



Source: IMF World Economic Outlook Database, and author's calculations.

own retirement saving, and cannot expect large budgetary transfers from the state. In some countries, such as Hong Kong, Korea, Mauritius, and Taiwan, state-provided pensions are either very low or essentially nonexistent. In Chile, Malaysia, and Mauritius, the state has implemented a mandatory private saving system which requires that a fraction of earnings be deposited into an individual retirement account. The amount of savings available upon retirement is determined solely by the individual's contributions over the working life, plus accumulated income on contributions.

Cross-country evidence suggests that generous pay-as-you-go state pensions, as in Western Europe, tend to depress household saving rates, while household responsibility for retirement (whether through low state pensions or mandatory private savings) tends to raise household saving rates. Figure 3 shows a scatter plot relating the coverage of state pensions (relative to average

Figure 3. State Pensions and Private Savings



Source: IMF World Economic Outlook Database, and author's calculations.

income) to the private saving rate in the economy. The negative relationship suggests that countries with more generous state-provided pensions have lower private saving rates. Egypt has attempted to maintain a generous state pension system.

High Degree of Internal Competition. The VFGEs promote efficient allocation of labor across sectors through a variety of market-supportive policies, some of which stand in sharp contrast to Egypt's policies. First, the engine of growth in VFGE industrialization (and especially in manufacturing) has been the *private sector*. While some of the VFGEs experienced a brief phase of import-substituting growth before opening the economy, the rapid growth of manufacturing exports is almost entirely due to private enterprises.

As shown in table 7, *the role of state-owned enterprises (SOEs) as a proportion of overall employment, output, and investment is low in the VFGEs, and is still remarkably high in Egypt.* According to the World Bank (1995) study *Bureaucrats in Business*, by Galal and colleagues, employment in state-owned enterprises in Egypt in 1990 accounted for 13.2 percent of total employment; SOE value-added was 32.8 percent of GDP; and SOE investment was an astounding 51.9 percent of total investment expenditure. Given the speed of privatization in the Central European transition economies, it is likely that Egypt's state sector, as a percent of GDP, is now larger than any in Central Europe.

Second, as already noted, the private firms in the VFGEs are exposed to the rigors of international competition, either in competing with imports, or as exporters on world markets. Even when firms receive protection on the domestic market (in East Asia, this is mainly the case of final consumer goods, such as automobiles), the protected enterprises still tend to be *exporters* which receive protection in the home market but are nonetheless disciplined by competition in foreign markets in which they also operate. Protectionism, when it exists, is usually in service of export promotion (see Krugman, 1987) rather than for protection of the domestic market *per se*.

Third, the private firms in the VFGEs operate in a regulatory environment which offers high flexibility for wage setting and the hiring and dismissing of workers. In the VFGEs, union bargaining, when it exists, takes place at the level of the enterprises, rather than at the regional or sectoral level as in many cases in Western Europe. Therefore, the terms of collective bargaining agreements are set according to market forces felt at the enterprise level. Union power tends to be low, and legislation has tended to restrict the range of issues covered by collective bargaining, thereby granting high flexibility to management (e.g. in the dismissals of workers). Workers have

Table 7. Share of State-owned Enterprises in Employment, Output, and Investment in Egypt and Selected Fast-growing Economies, 1990

Country	Employment (% of total employment)	Value-added (% of GDP)	Investment (% of total investment)
Chile	1.1	12	9.4
Hong Kong	na	na	na
Indonesia	1.2	13.0	5.0
Republic of Korea	1.9	10.2	3.3
Malaysia	na	na	3.9
Singapore	na	na	na
Thailand	0.9	5.4	4.9
Egypt	13.2	32.8	51.9

Note: Output for Indonesia is for 1989; na = not available.

Source: *Bureaucrats in Business*, World Bank Policy Research Report, Oxford University Press, 1995.

few guarantees of long-term employment, with the partial exceptions of Korea since the late 1980s, and Japan. In most of East Asia, firms can reduce their workforces with short notice and modest severance payments.

Egypt stands as the extreme outlier regarding labor regulation, since workers in the formal sector have a virtual guarantee of continued employment. Layoffs require lengthy and costly legal procedures, and are rarely if ever forthcoming. Moreover, entry of new enterprises into many sectors of the economy is restricted by licensing requirements, state monopolization of key economic activities, and administrative red tape (including the need to make multiple payoffs). The results of Egypt's highly regulated labor and product markets have been devastating. Formal-sector employment in Egypt is low, in large part because so much urban employment is carried on outside of formal registration. Unofficial unemployment is put at 20 percent or higher.

Social Policies Targeted to Human Capital Accumulation. The VFGEs have avoided large-scale redistributive transfers, i.e. state pensions, welfare spending, or heavy budgetary subsidization of particular sectors of the economy. By avoiding Western European-style social welfare systems, the VFGE economies have maintained relatively low rates of government expenditure and taxation as a percent of GDP. This restraint in government expenditure has helped the VFGE governments to preserve high rates of government saving while also avoiding highly distortionary rates of taxation. On the other hand, these governments have made major commitments to human capital accumulation via spending on primary education and health. The most notable success has been to

achieve high rates of literacy, in comparison with Egypt, where literacy rates continue to lag far behind (see table 1).

Small Government and Low Marginal Tax Rates. We have noted repeatedly that the VFGE economies have avoided the fiscal burdens of heavy government spending. The counterpart of relatively low government spending as a percent of GDP is relatively low rates of taxation. For example, corporate tax rates in the VFGEs are generally in the range of 15-30 percent, compared with basic corporate rates between 34 and 42 percent in Egypt (depending on the sector of economic activity). These high corporate tax rates are surely a disincentive to domestic and foreign corporate investment in Egypt. Similarly, Egypt imposes very high payroll taxation in the formal sector, as opposed to low or even zero payroll taxation in the VFGEs. On monthly salaries up to 337 Egyptian pounds, employer contributions are 26 percent and employee contributions are 14 percent. On monthly variable pay (e.g. incentive bonuses), employer contributions are 24 percent and employee contributions are 11 percent, up to 500 Egyptian pounds.

Industrial Policies. The VFGEs have been marked by private-sector orientation, high rates of national saving, and intense competition in product and labor markets. It is often claimed that in addition to (or even instead of) these market forces, the key to rapid industrialization in the fast-growing East Asian economies (six of the eight VFGEs) rests on special industrial policies of the government. Amsden (1989) and Wade (1990) are widely cited advocates of this position. What is the evidence in favor of or against the role of industrial policies in East Asia?

The starting point for analyzing industrial policies in East Asia should be the recognition that there is no single East Asian model. The extent of government intervention in industry has differed markedly. Korea has surely been the most interventionist, rather closely modeling its industrial policies on Japanese institutions. Taiwan probably comes next in the extent of government intervention in industry, though with considerably more market orientation and reliance on small, family businesses as opposed to the large industrial conglomerates (*chaebol*) supported by state policies in Korea. Southeast Asia, by contrast, has shown considerably less government intervention in industrial policies than has Northeast Asia (Japan, Korea, and Taiwan). Hong Kong, for example, has maintained completely free trade, with zero tariffs, quotas, and licenses on merchandise trade. Singapore as well has essentially maintained open trade, though with more government intervention via tax policies and other incentives. Indonesia, Malaysia, and Thailand

have also pursued rather modest programs of industrial policy in comparison with Northeast Asia. All three have maintained relatively open trade since the 1970s, based on convertible currencies, modest tariff rates, and relatively free markets for capital and labor. While these three Southeast Asian economies have all engaged in some efforts to identify and promote industrial winners, most industrial growth, *and especially labor-intensive export growth*, has taken place under market pressures. Direct government support for winners has mainly come in the high technology and heavy industry sectors, and with mixed success.

Despite the wide variety of industrial policies—especially the differences between Northeast and Southeast Asia—there is much less variety in outcomes; all of the countries succeeded in export-led manufacturing growth. The evidence suggests that it is the *common* features in East Asia—*currency convertibility, moderate tariffs, strong private sector orientation*—rather than specific industrial policies, that are behind the widespread successes in the region. This conclusion is supported by several recent studies which have analyzed industrial policies on a more detailed sectoral basis. Most of these show modest or negative contributions of sectoral industrial policies to productivity growth. For example, a comparison of growth of free-market Hong Kong with moderately interventionist Singapore finds higher productivity growth in Hong Kong (Young, 1993). A detailed study of sectoral productivity growth in Korea finds that sectors targeted by industrial policy incentives (e.g. subsidies, tax benefits, etc.) experienced lower, not higher, rates of productivity growth. A study of the most interventionist period in Korea, the so-called Heavy and Chemical Industry drive of 1973-79, finds a mixed record of industrial policy (see Stern, Kim, Perkins, and Yoo, 1995). The authors conclude that many of the successful government interventions in Korea were in fact needed to offset other distortions in the Korean economy, and that the interventionist policies would not have been needed at all if Korea had been more thoroughly market oriented from the start. In other words, Korean industrial policy in the 1970s should be viewed as a second-best policy to overcome other existing distortions in the market, rather than to supercede the market. Recent research on the Japanese economy, allegedly the original site of successful industrial policy, has also turned up negative conclusions about the productivity effects of industrial targeting (Weinstein, 1995).

While East Asian economies have differed widely in the scope and ambition of industrial policy, it is true that a few institutions of industrial policy have been widely applied, and deserve a sympathetic look. Most importantly, *virtually all of the East Asian countries have utilized export-*

processing zones (EPZs) or other special economic zones (SEZs) to help attract foreign investment and to initiate the process of manufacturing export-led growth. These zones have not aimed to pick winners in the classic sense of industrial policy. Rather, they have attempted to carve out a geographical zone in which export businesses can conduct profitable export-oriented activities, exempt from costly regulations, tax laws, and labor standards that apply more generally within the country. The EPZs are helpful in getting foreign direct investment underway, and in providing a demonstration effect that can act as an inducement for further policy reforms. They will fail, however, if they are viewed as a substitute for broad-based liberalization, that is, as an excuse not to undertake liberalization measures that extend throughout the entire economy.

More generally, the relatively successful industrial policies have a few common characteristics:

- they have aimed to promote exports rather than to protect the domestic market;
- they have provided *limited* subsidization on the basis of *monitorable, measurable, successful* performance (e.g. the growth of exports) rather than to cover losses;
- they have been temporary rather than permanent subsidies (e.g. a five-year tax holiday for new export firms).

Is East Asia Really a Model for Rapid Growth?

A widely read article by Paul Krugman (1995) has called into question the growth performance of the East Asian economies. Krugman argues that East Asia's growth resulted from capital accumulation, rather than from improvements in productivity. He goes on to compare this growth with the growth of the Soviet economy, which was similarly based on the rapid accumulation of capital. His implicit conclusion is that East Asian growth is neither a model for other countries nor sustainable. Krugman misses the essential point of East Asian growth. Unlike Soviet capital accumulation, the accumulation of capital in East Asia has been carried out mostly under market forces, and especially under international market forces. The investments are therefore tested repeatedly by the marketplace. The Soviet economy eventually collapsed in part because the structure of production drifted farther and farther away from the needs of the society. In the end, the Soviet Union was producing nearly twice the steel of the United States, for an economy roughly one-seventh the size in terms of purchasing power. It was not surprising, therefore, that when the bureaucrats stopped demanding the steel after 1991, market demand for steel could not compensate, and the steel sector suffered a very sharp decline. There is absolutely no reason to suspect that East

Asia would similarly be subject to a collapse of demand, since industrial production has been responsive to market demand on an ongoing and intensive basis.

4. Chinese Growth and Lessons for Egypt

If market competition and openness are a *sine qua non* for rapid growth, then China's experience of the past 17 years—since the onset of Deng Xiaoping's market reforms in 1978—cries out for explanation. How is it that a country still pursuing a socialist model, albeit one with Chinese characteristics, has achieved such rapid growth? Unlike the other East Asian economies, China has maintained a major role of the state in guiding investment, and a major role of state-owned enterprises in the economy. Is China an exceptional case in East Asia, or an exception that proves the rule?

While China has indeed protected its large state-owned industrial sector, the source of dynamic growth in China lies in the *non-state sector*, which has operated much closer to market forces. Indeed, outside of the state-enterprise sector, the Chinese economy has much in common with the other East Asian economies, especially when these other economies were at an earlier stage of development. While China's non-state economy operates without many of the legal underpinnings of a more advanced market economy, the non-state sector is subject to the strong market competition, international trade, and low taxation that are hallmarks of the fast-growing market economies of East Asia. Despite appearances, Egypt may be *less* market oriented than China, because China's non-state sector is relatively unconstrained by government regulation, while Egypt's non-state sector continues to be tied down by extensive regulations that hinder its development.

The key, then, to understanding China's economic success lies in understanding the limited role of the state-owned sector (see Sachs and Woo, 1994, for a more detailed discussion of China's recent growth experience). When Deng Xiaoping began market reforms in China in 1978, state-enterprise employment was approximately 18 percent of the total Chinese labor force. Approximately 71 percent of the population was engaged in peasant farming, and another 10 percent or so operated in various non-state activities outside of agriculture, especially urban collective enterprises attached to state enterprises, and industrial township and village enterprises (see Sachs and Woo, 1994, for details on this breakdown of the labor force by type of activity). China's gradual reforms after 1978 have involved the liberalization of the non-state part of the economy, while preserving the socialist character of the pre-existing state-owned enterprises.

Roughly 20 percent of the labor force has been maintained in the socialist sector, while a little more than 80 percent of the labor force has operated in the non-state part of the economy.

Considerable evidence confirms that it is China's non-state sector, largely operating under free-market rules, rather than China's state sector, that has been the source of China's dynamism. First, the state-owned sector has continued to make large losses, despite more than 10 years of experimentation by the government with alternative incentive schemes for management and workers. Second, the productivity growth in the state-owned sector has lagged far behind the productivity growth of the non-state sector, and according to some calculations, total factor productivity growth of the state sector has been close to zero. Third, the non-state sector accounts for the explosive rise of Chinese manufacturing exports. For example, the share of small-scale, rural enterprises (the so-called township and village enterprises, or TVEs) in total exports has grown from 16.4 percent in 1980 to around 44.4 percent in 1993. Another large share of exports has come from special economic zones (SEZs), coastal open cities, and economic and technological development zones (ETDZs), all designed to encourage manufacturing exports. These special areas have received various kinds of favorable tax and regulatory treatment, such as tax holidays and duty-free access to imported inputs and capital goods needed for export production. The SEZs and other special areas are akin to the export processing zones that had been used in other parts of Asia as part of their initial export-led growth. Fourth, overall GDP growth has been much faster in regions with a high proportion of employment in non-state enterprises (see Xiao, 1991) and in the SEZs (Wei, 1995).

A major aspect of China's dynamism is the low rate of taxation of non-state enterprises. Since Chinese government spending is a remarkably low 14 percent of GDP, China can maintain very low tax rates on average throughout the economy. As already noted, many non-state enterprises are almost completely exempt from taxation, at least in their first few years of operation, as the result of special tax privileges associated with special economic zones. China's labor markets are also highly flexible in the non-state sector. While workers in the state sector are accorded generous job guarantees in both China and Egypt, workers in China's non-state sector do not receive guaranteed employment. One result has been the rapid growth of employment in China, since firms can hire workers without fear of being stuck with unwanted labor in the future due to restrictions on dismissals. Formal sector employment has increased dramatically, from 95 million in 1978 (9.7 percent of the economically active population) to 148.5 million in 1994 (19.2 percent of the

economically active population). Most of the rest of the labor force is still in peasant agriculture. The solution to the economic paradox of rapid growth in socialist China is therefore threefold:

- the socialist sector is a very limited part of the economy, perhaps 20 percent as measured by employment;
- the non-state sector has been given ample freedom of economic activity, including favorable incentives such as in the SEZs, so that China could emulate the export-led manufacturing growth of the rest of East Asia;
- political decentralization of economic decision-making has strengthened the hand of regional governments relative to the central government, to the benefit of market reforms.

5. What is Left to be Done in Egypt?

Egypt has experienced extensive deregulation, especially regarding international trade, since mid-1991. The results of market liberalization have been encouraging. GDP growth is back above 3 percent per annum, after nearly zero growth in 1992 and 1993. The recovery in growth, though still modest, has been accomplished while preserving moderate rates of inflation and sustainable levels of foreign exchange reserves and the balance of payments. Thus, the first stage of Egypt's market liberalization must be judged a success. When evaluated by the standards of the VFGEs, however, it is clear that there is still much to accomplish if Egypt is to achieve sustained high rates of economic growth. Egypt's growth rates fall far short of the VFGEs, despite the fact that Egypt is a much poorer economy, and therefore should be able to achieve even *faster* growth than the VFGEs in view of the tendency towards economic convergence (catching up) among market-oriented economies. The relatively slow growth is most likely the result of continuing shortcomings in Egypt's market institutions. Egypt continues to be trapped by preconceptions of earlier years and by the vested interests fostered by SLI.

One simple gauge of Egypt's growth prospects on the basis of current policies is a cross-country growth equation, which relates a country's per capita economic growth to its initial income level and several policy indicators, including: the national saving rate, an index of openness to trade and financial flows, an index of labor market flexibility, and the level of government expenditure as a percent of GDP. We expect to find that growth is higher for poorer countries, and for higher saving rates, greater openness, more labor market flexibility, and lower government expenditure as a

percent of GDP. (See Appendix 1 for details of the regression results and the underlying variables). On the basis of this regression estimate, we find a predicted per capita growth rate for Egypt of 2.61 percent per year on the basis of current policies. Now, suppose that each of the key policy variables were to take on the average values of the VFGEs. Given Egypt's initial income level, the predicted per capita growth on the basis of VFGE policies on saving, tariffs, labor market flexibility, and government spending would be 6.33 percent per year. While these results are admittedly crude, they help to establish that further reforms would have significant effects on raising Egypt's growth rate in the medium term.

We would underscore the following seven priority areas for further reforms.

Openness. Egypt's tariff rates are still among the highest in the world, and continue to block Egypt's attractiveness as an export platform for labor-intensive manufacturing production. Further steps towards openness should include: reductions of tariff rates to the averages in the VFGEs (between 0 and 20 percent); the implementation of export processing zones on a wider scale within Egypt, but as a complement rather than a substitute for wider liberalization; the further deregulation of FDI in industry, infrastructure, and financial services; and a more flexible exchange rate system (e.g. a crawling band exchange rate as in Chile, Poland, and other successful reform economies) to prevent chronic overvaluation of the national currency.

Fiscal Reform. With Egypt's overall national saving rate below 20 percent, rather than the 30 percent or higher seen in the VFGEs, there is a strong case for higher levels of government saving based on further reductions in government spending. Government spending as a percent of GDP could be reduced by cuts in subsidies, and by the use of privatization revenues to reduce public sector indebtedness, and thereby to reduce the interest burden of the public debt. Cuts in government spending as a percent of GDP would permit a reduction of tax rates to more internationally competitive levels.

Deregulation and Privatization of State Monopolies. Egypt's state-owned enterprises do serious damage in two ways. First, many of them are inefficient and loss-making. Second, these firms tend to be protected as monopolies, especially in the areas of finance (including banking and insurance) and infrastructure, including telecommunications, port facilities, and road building. An end to the state monopolization of these sectors is crucial to permit new, private firms to introduce competition

and higher productivity into these sectors. Privatization of the existing state-owned enterprises is therefore desirable both on fiscal as well as efficiency grounds.

Labor Law Reform. One great irony of Egypt's economic policy is that a desperate shortfall of job creation in the formal economy is combined with highly restrictive labor legislation that substantially raises the costs of hiring new workers. As we have noted, formal sector employment is low and unemployment very high. Most importantly, the continuing barrier to the dismissal of unwanted workers in Egyptian establishments paralyzes firms in hiring new workers. Labor-intensive manufacturing exports require competitive and flexible enterprises that can vary their employment according to changes in market demand and changes in technology, so Egypt remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labor force. An important step could be taken by designating a significant number of export processing zones in which the restrictive labor legislation would not apply. A more general approach would be to give continued protections to formal-sector workers that are already employed, while liberalizing the hire and dismissal of new workers in the future. The third, and most desirable kind of change, would be to abandon the general restrictions on hire and dismissal, and instead allow hiring and dismissal decisions to be made at the level of the enterprises as part of the collective bargaining agreement between enterprises and enterprise-level unions, without the interference of government.

Social Policy. The government needs to provide larger resources for primary education and primary health. Expenditure on *girls'* education has an especially high social return, since female literacy supports better family health, lower infant mortality, lower population growth through reduced fertility rates, and greater labor market productivity of women.

Infrastructure. Serious infrastructure constraints can only be overcome if the government creates a regulatory and economic environment conducive to large-scale inflows of foreign private investment in critical areas of infrastructure. This is especially true in areas such as telecommunications and transport (including port facilities), which provide the vital links between Egypt and the world market.

Financial Market Reform. Egypt's banking and insurance sectors were nationalized several decades ago. While a number of other countries also undertook such actions, for instance Mexico, France, and Chile, they have by now reversed this policy. Egypt, by contrast, still relies heavily on state-

owned banking and insurance. The results are significant losses in the banking sector and heavy inefficiency in the delivery of financial services.

6. The Need for A Comprehensive Growth Strategy

Egypt's macroeconomic strategy in recent years has produced mixed results. On the one hand, Egypt has overcome major macroeconomic imbalances, and has established relative stability and moderate growth. On the other hand, the growth remains too slow to have any major impact on Egypt's crippling poverty and rising unemployment. The biggest problem with the recent strategy has been an excessive focus on stabilization and too little emphasis on long-term economic growth. This is not to say that budget balance is unimportant: we have seen that government saving is indeed an important component of an overall growth strategy. The problem, rather, is that the macroeconomic programs have not been sufficiently ambitious, and the growth targets have been low (e.g. 5 percent per year, or less than 3 percent per capita).

Another problem is that issues tend to be handled in a piecemeal fashion. For example, there has been a long-standing debate about the exchange rate, with the Egyptian government resisting vigorously any devaluation of the currency. The whole issue would look very different, however, if the exchange rate were considered as part of an overall growth strategy. In that case, the need to make the exchange rate system more flexible (e.g. by adopting a crawling band exchange rate, rather than a simple peg) would become more evident. Even without a devaluation, there might be grounds for a consensus on making exchange rate arrangements much more flexible in the future.

At the current stage of reforms, Egypt needs to set further reform actions (on privatization, trade policy, fiscal policy, the exchange rate, infrastructure, labor market policy, etc.) in the context of a *comprehensive growth program*. Such a program would start with an ambitious but realistic growth target, say 8 percent per year on average over the course of the next five years. Then, policy makers and the international financial community (donors and the IFIs) would work backwards, considering the range of fiscal, monetary, structural, and aid policies that could support the ambitious objectives. By moving forward on a *package* of measures, with a clear and ambitious *growth target* (rather than simply the objective of stabilization), the Egyptian government would find it much easier to construct a coalition of interests in support of the needed changes. The reforms would not seem arbitrary or simply dictated from the outside. They would have a clear and monitorable objective: higher growth and more employment creation.

With an ambitious growth target, and a realistic reform strategy, Egypt could look forward to rapid and sustained economic growth. Given the progress of Egypt's reforms to date, and the possibility of added reforms in the near future, Egypt could well become one of the world's fastest-growing countries in the next decade. To do less would jeopardize another generation to unnecessary poverty, unemployment, and instability.

Based on recent cross-country growth models, we estimate a rudimentary cross-country growth equation in which per capita economic growth is a function of initial per capita income, the national saving rate, and an index of market efficiency based on data from the World Economic Forum's (WEF) Global Competitiveness Report. The efficiency index is the sum of three indexes jointly prepared by the Harvard Institute for International Development and the World Economic Forum. The three indexes measure: openness of the economy to trade and financial flows; the size of government in the economy; and labor market flexibility. We add the three indexes for openness, government, and labor markets to create an overall index of market efficiency. The index is created to give a higher score for: *more* openness, *smaller* government (as measured by government expenditure as percent of GDP, and various rates of taxation), and *more flexible* labor markets. To give a sense of Egypt's relative ranking, in a sample of 49 countries, with a rank of 1 being the best performance and 49 the poorest performance, Egypt ranks 22nd on openness; 31st on size of government; and 40th on flexibility of labor markets. The East Asian economies rank higher on all counts. The average score of the East Asian economies would rank 25th on openness; 3rd on size of government; and 9th on flexibility.

The basic regression is shown in table A1. As expected, initial income enters with a significant negative coefficient: poorer countries tend to grow more rapidly, all other things equal. Also, as expected, more efficient economies (i.e. those with a higher score on the efficiency index) tend to grow more rapidly. According to this equation, Egypt's growth is held back by its relatively poor ranking on the various components of market efficiency. To estimate the growth consequences of Egypt's efficiency index, we use the regression estimates to calculate two growth rates: (1) the predicted growth for Egypt given current income levels (GDP per capita at purchasing power parity in 1993) and current market efficiency; and (2) the projected growth rate for Egypt for current income levels but an improved market efficiency index equal to the average for the East Asian economies. According to the regression estimates, improvement in Egypt's market efficiency to East Asian standards would raise annual per capita growth by some 1.9 percentage points per year, to an overall predicted rate of 4.55 percent per year. If Egypt also had the saving rate of the seven Asian economies, per capita growth would reach 6.33 percent. The calculations are shown in the second part of table A2.

Table A1. Regression Estimates (Dependent variable: Real per capita GDP growth 1992-95)

Independent variables:	
Log initial income	-1.17 (-2.58)
Saving rate (1995)	0.098 (2.20)
Efficiency index	2.75 (3.17)
Constant	4.59 (2.18)
R ²	0.404
N	42

Source: author's calculations.

Table A2. Growth Counterfactuals

	Egypt	Seven Asian economies
Log initial income	2.77	3.67
Saving rate 1995	16.84	35.01
Efficiency index	-0.142	0.563
Growth 1992-95	-0.26	6.33
<hr/>		
Egypt's predicted growth rate 1992-95 =	2.61	
Predicted growth if Egypt had efficiency index of the seven Asian economies: $2.61 + 1.94 =$	4.55	
Predicted growth if Egypt also had the savings rate of the seven Asian economies: $4.55 + 1.78 =$	6.33	

Source: author's calculations.

PART II

THE ROAD AHEAD FOR EGYPT: VARIATIONS ON THE THEME

After his presentation, Sachs responded to remarks and questions from the audience. Participants in the discussion were Said El Naggar from the academic community, Arvind Subramanian from the IMF, Faika El Refaei from the Central Bank, Werner Puschra from Friedrich Ebert Stiftung, Youssef Boutros Ghali and Ali Soliman from government, James Whittington from the foreign media, and Abdel Aziz Hegazy, Fouad Sultan, Ahmed Kadry, Taher Helmy, Gamal Mubarak, and Ahmed Foda from the private sector. (See appendix for a complete list of the attendees.) The following is a summary of the discussion.

Participant: Your historical perspectives on the development of economic policy making are very interesting. You have showed that open economies in general fare much better than closed economies. But not all countries on your list of high-performing open economies are open in all aspects. Korea is open regarding exports, but imports are very restricted. One cannot buy a Japanese car in Korea. Also its labor market, which you say is a very important factor, is highly inflexible. Individual labor rights are among the strongest in the world, and it is practically impossible to fire anyone there. Rather than comparing Egypt with Korea today, it is more appropriate to look at those countries when they started their economic growth, and compare them with Egypt. Looking at savings rates, we find that Korea started with 2 percent in the 60s, and took 10 years to reach 18 percent, and until the 80s and 90s to reach more than 30 percent. What can Egypt do to achieve high growth? With what measures did those countries start their take-off processes? In which ways were they open, and in which ways closed?

Speaker: The definition of an open economy is a bit complicated, but it covers tariff rates, quotas, exchange rate convertibility, monopolization, and export taxation. Hong Kong was totally opened—zero tariffs. Singapore was totally opened, Malaysia almost totally, Indonesia very opened, Taiwan moderately, and then Korea relatively closed, with higher tariffs on consumer goods. I don't recommend Korea's approach because the evidence shows that protection lowered productivity in some sectors in Korea. But even with Korea's relative closure, and certainly in its high growth

period, Korea was more open and less protective compared to the rest of the developing world—including Egypt—not for Japanese automobiles but for the vast range of capital goods, intermediate inputs to production and consumer goods. It is true that since its democratization in 1988, Korea has intensified labor rights to an extent that I believe may be harmful for their enterprises. But in the very high growth period, there was suppression of trade unions so they didn't have such protective labor rights. Recently Korea also started a generous pension system, and I don't know whether they will be able to surmount their problems later.

Korea is quite singular, but if there is an analogy it would be Japan, because both were relatively closed for East Asia, yet open compared to the rest of the developing world. Japan was considered by many people to be a great model in the 1970s and 80s but has been in a recession for five years; the rigidities of its system are clearly causing problems.

Participant: Malaysia, one of the high-growth countries, has a 34 percent corporate tax, not far from Egypt's corporate taxation rates of 32-42 percent, which you consider to be too high. How much importance do you attach to the tax rate among all the elements for growth?

Speaker: Malaysia is a very interesting and successful economy. They started as a natural resource-based economy and shifted to become a major manufacturing exporter. Their extraordinary boom in consumer electronics was achieved by having a free trade zone in Panang devoted to electronics. The governor decided to make the zone an export-led growth model by having zero tariffs and taxes on imported inputs, promoting exports, and very generous tax terms for foreign investors. They started with assembling, with components, then moved on to design their own technologies and produce more sophisticated goods. They picked a geographical area and a particular sector, and made it very open, with very flexible labor, low wages, very low input prices, no payroll taxation, virtually no corporate income taxation for quite a while for the new enterprises, and an efficient trade administration. That is what fueled the manufacturing boom and the growth in Malaysia.

Every country has its taxation, but what really counts is the overall interaction of these taxes and the efficiency with which they are implemented. It depends on the package; i.e. whether you have corporate tax and a payroll tax; high individual taxation and also a VAT, etc. You have to look at all taxes, not just one.

Participant: I agree with your description of the changes in strategy throughout the developing world in the period that followed World War II, and I agree that the model of state-led industrialization was a dismal failure. I believe that privatization is the key to development and high growth, not only because of public sector inefficiencies and corruption, but because there is an obvious correlation between a dominant public business sector and a lack of competitiveness which is institutionalized into its policies. A dominant public sector is geared for monopolization and inward looking-strategy. Our tariffs and trade policies are still highly restrictive, because Egypt's economy, especially manufacturing, is still dominated by the public sector. As a result, there is an inability to gain a position in the export market. A dominant public sector also means big government. Privatization and a flexible labor policy should be top priorities of our economic policy. Regardless of ideology, I don't believe that you can have growth with a large public business sector.

Speaker: I think you are absolutely right that a dominant public sector changes the political economy. Apart from the direct costs of the inefficiency and the absence of free entry and competition, there are the political costs; the whole system gets twisted to accommodate the state sector, and resistance to change sets in. No public sector in the world is making adequate returns right now. There are a few monopolistic enterprises that might be able to show positive cash flow, but state-owned industry usually loses money. The reason in my opinion is that you can't have layoffs in public enterprises, because politicians can't bear layoffs. If a company is in trouble, they give it more protection, more bank credit, budget subsidies, but they don't want layoffs. No country has succeeded in reforming state enterprises; no government of any kind has made them efficient. France failed to reform its state enterprises, and China has been failing for 15 years to reform state enterprises. However, China has maintained its inefficient loss-making state sector because, unlike Russia or Poland, China's state sector has a relatively small share of total employment and its share of GDP is shrinking.

Participant: You mentioned that Egypt has a lot of potential for growth but you are pessimistic that it can reach a growth rate of 8 percent in the next few years. Could you elaborate on that?

Speaker: One reason Egypt has potential is because of the importance of geography. I think your geography is very good. The regional trade not yet taking place within the Middle East is a source for new growth, and probably more important is the potential for trade with Europe.

When Poland opened up to Western Europe in 1990 they experienced an incredible boom in exports. Once they made the environment flexible and friendly enough for investment—with easy taxes, transport, average tariff rates, access to intermediate inputs, etc.—German firms came in huge numbers to invest, because wages in Germany are \$18 to \$30 an hour, higher than current wages in the United States. This is a big advantage for Egypt with respect to making the environment right for major production activities directed at European markets. But you can't do this with a 29 percent tariff rate, not to mention other problems. People will go to Poland instead, and why not? Poland is nearby and much more open. But your labor costs are even lower, your transport costs are very low, you have a wonderful port, you have skills, and you are just across the Mediterranean from the European market. It is surprising actually that you don't have that kind of dynamism, considering the geographical component. Mongolia is 1200 kilometers from the nearest sea. Bolivia is 14,000 feet above sea level in the Andes Mountains, with no coastline. Those countries have geographical obstacles to growth, but Egypt has a fantastic advantage.

Participant: There seems to be consensus about the rules for achieving growth. One problem facing Egypt is the bureaucrats managing the system and their ability to understand these rules. The East Asian countries started from scratch, and they were able to recruit highly professional bureaucrats to make the legal and regulatory framework friendly for business. Egypt's bureaucrats were brought up in a closed economy, and they strongly resist even the directives coming from the political authority to open the economy. Bureaucrats account for 27 percent of Egypt's labor force.

Speaker: Bolivia ended all licensing on foreign trade in one day—August 29th, 1985. Poland literally went to openness in one day, although they had a deeply-entrenched communist bureaucracy since 1946. On January 1st, 1990, all the legislation on licenses, restrictions, foreign exchange convertibility, was done away with. This was known as “the Big Bang”. There was a whole ministry with nothing to do. Bureaucracy does fight back and try to find ways to close up again, but it is possible with liberalization to take big steps. What is much harder is good administration of the things that need to be done. There is no overnight way to make primary schools more effective, to make primary health services reach the poor and the countryside, to collect taxes effectively, because those are complex systems. Some areas need the bureaucracy. I would distinguish between systems that you want to take away and those you need to keep. The tactics to reform differ. Some reforms need the bureaucracy while others can be imposed by

leadership. But quick reform needs a coherent team. I am a strong believer that if you want to reform, just do it. Don't announce that you will do it over six years, because that will invite opposition, and you will get antibodies all around to stop the process, and reform will never happen. You need system change, such as computerization of tax administration and so forth, but all the computers in the world won't work if the tax rates are too high. It is an interplay of political tactics, economic logic and detailed bureaucratic reform, and each has its weight.

Participant: We have been talking about economic growth for the past 15 or 20 years, but how many steps have we achieved? You defined the main points that should be addressed, such as government expenditure, savings, labor legislation, etc. We have a wealth of thinkers to help in these things. What is really necessary is a commitment to start.

Speaker: Egypt certainly has no shortage of skilled economists. What Egypt has been missing is putting together this comprehensive view, though it may be getting closer. So the issue is not economic advice, but goal and vision, particularly the need to aim high. An IMF program is not a vision or a growth program, but rather piecemeal steps, some good, some bad, and the "vision" is typically stability or stabilization. With all due respect to the IMF, these programs are too lazy. They are more concerned with budget deficits than growth; they want to achieve a budget target, or get inflation to come down, and they hope that growth will come as a consequence of that. In addition, other factors, such as the legacy of regional problems, and the riots Egypt experienced in 1977 when price reform was attempted, and then dependence on foreign aid—these things cost Egypt years of growth.

You do need to start with a vision of what you want to achieve; i.e. to reach 8 percent growth within 2 years, with export-led growth heavily related to regional and European trade. You need a reasonable practical timetable, not a matrix of 86 impossible objectives. Start with an ambitious vision and then set the timetable. Don't say you will start with 4 percent growth and maybe raise it to 6 percent by 1998. Don't set the goals too low. Some areas are complex politically or economically, or both, but some areas are simple.

Participant: It is generally true that IMF stability programs concentrate on macroeconomic stability for countries in crisis. But I think it is fair to say that the last IMF program with Egypt, which began in 1993, and the program the IMF is currently discussing with the Egyptian government, focus very much on getting growth up to the ambitious levels which Egypt needs and is

capable of achieving, and on identifying key policies to create critical mass for growth, not simply reducing the deficit.

Participant: Egypt has had lengthy discussions and negotiations in its long-standing debate with the IMF over the devaluation issue. What is your opinion on that?

Speaker: It is a big trap to get locked into a commitment to a nominal exchange rate. Whether or not the rate is correct now, the system is too rigid. You need a more flexible arrangement where the idea that it could move is normal, not traumatic. If the terms of trade move against you, if there's a cut in tariff rates, or if inflation creeps up, the rate should move. I believe in using a nominal exchange rate as an anchor at the beginning of a stabilization program, but you are way beyond that now.

There is an image problem, too. I think the touchstone of stability is commitment—to exports, to growth, to job creation, to profitability. Countries that follow this logic do it in different ways, but they do it, and they benefit. Hong Kong has a fixed rate but a very open economy. Argentina tried a currency board, after the disaster of 40 years of hyperinflation, but the costs are tremendous now. GDP was down maybe 7 percent in 1995 and it is not coming up, despite the best hopes and efforts of Cavallo. Others had some sort of flexible system such as crawling pegs. Probably the most prudent of all is having a range where you don't allow too much appreciation or depreciation. Chile has followed that policy for the last 15 years, and it has protected the profitability of its exports against overvaluation. I think that the problem here is not the level of the exchange rate, but the system and the politics involved. You have to find a way to change yours, because it is not a viable long-term arrangement.

Participant: We hear of what needs to be done in terms of liberalization, privatization, and devaluation to get 8 percent growth, but what price has to be paid to reach those objectives, and can we afford this price? In reducing the budget as well as in liberalizing the labor market, how can the social effects be managed properly? For example, could we afford the negative effects on local industry following liberalization and tariff reduction? Each country has to judge whether the price is affordable or not. Maybe Mexico could afford certain problems that would lead to setbacks in other countries. I think that the speed at which we adhere to the international consensus of policy is governed very much and almost essentially by the interim costs. Do we bear the interim costs today for prosperity tomorrow, or do we take it in doses, which makes interim costs lower but puts

prosperity further away from us? I think most reforming countries have the vision, but then they look at the interim costs.

Speaker: It is very important to think carefully about the implications of a policy package. I doubt that delay is a solution. Egypt cannot go on with 1 or 2 percent per capita growth, with high unemployment, intense poverty, lack of formal job creation. Egypt did not go slowly in the right direction—Egypt went in the wrong direction, slow or fast. It has turned more towards the right direction recently, but not enough. This is not an export-oriented economy. It is dominated by the public sector, it is still relatively closed and it has many problems. There is a real choice of tactics and strategies—no one operates in the same way—but waiting is a tactical mistake. You have been waiting since the 1970s, and the problems are growing in unemployment, and in the widening gap between Egypt and the successful economies. There are the costs of adjustment, but the short term adjustment varies according to the package of measures, the sequence, and the legacy of the country. The experience is hard to generalize, because social costs are complex, and different countries have different legacies. But there are choices, and I doubt there is good reason for delay.

Social costs are usually a very sensitive issue for the government, because generally they refer not to the very poor but to the politically sensitive lower- and lower-middle classes, the employees in state enterprises for example. The social costs of exchange rates are much more complex than they appear, because you benefit certain groups. But you can shift from general subsidy or general overvaluation of the exchange rate to more targeted compensatory measures. When you look at the experiences of 25 countries around the world that have undergone liberalization, you find that they didn't get a big rise of unemployment or a big downturn as expected in most cases. Eastern Europe was different because they had built up industry too much and that needed to come down. But in countries like Turkey which have undergone liberalization, we never see sharp negative effects. We see growth almost from the start. It is important to refer to international experience and look carefully at different groups, and to use consistent, informed political and economic judgment in formulating a package. Egypt has reserves and stability, so you have some time to devise your package, but not 10 years, because you really need to grow.

Participant: When we ask the government to reduce or remove the sales tax on capital goods, the government reminds us that the IMF wants the budget deficit reduced, and that reducing taxes and tariffs means reducing government revenues. Rather than turning to the private sector to solve the problem of the budget deficit, the government should reduce spending, get out of business, and let

the private sector be the engine of growth. That means privatization, which Egypt is embarking on, and getting the private sector involved in infrastructure hopefully. Is there a broad formula, and any particular sequencing, to proceed with the reform process and to implement economic reform policy?

Speaker: How to do it is obviously challenging, but the essence is the first three steps. The first is the vision and the commitment to the process. It may be obvious that the vision is growth, but I don't believe that most government policies clearly have this vision. Put high targets like getting the economy growing at 8 percent annually and think of how to proceed within that context.

The second step is setting goals that deal with the quantitative implications. How can the government spend more on investments while trying to cut taxes? If you want to cut taxes, which you should, you must cut government spending, and to do so you must institutionally change the balance between what the government and the private sector do. Privatization could raise several billion dollars, and that is a consequential percentage of GDP which might be helpful in extending the compensatory social policy, or even better, in retiring high interest public debt. Since you are paying 8 percent of GDP in interest payments, retiring part of this debt will cut government spending from the high 30s to the mid 20s. That means you need a debt policy related to privatization revenues. People here are so pleased with the "18 months of import coverage" in foreign exchange reserves, and that is an important cushion for Egypt internationally. But there may be room for fitting that into an overall macroeconomic framework to ease the fiscal burden by retiring high interest rates on internal debt, rather than getting low interest rates on foreign debt. So all of these pieces are interlinked, though none can be proved decisively to get a specific result.

The third step is formulating a package of measures. I would stress, in addition to vision, the package; there is no sense in having an endless debate about whether or not to devalue the exchange rate in a vacuum. It depends on labor market policy, trade policy, the growth target, the social compensatory policy, and all the other things you do. You can't debate just one thing, or ask the government to cut taxes alone. You have to think about the overall strategy before discussing a particular point. What package will achieve your goals? If you are going to deal with government spending, you have to deal with taxation and investment; if the government is cutting spending on infrastructure, investment has to come from the private sector.

I strongly believe that a free market is the only real choice. If the government is absolutely determined, it is possible to do things over three or four years. I generally like fast reform because,

first, if the house is on fire because you have hyperinflation, you really must do something immediately, but that is not the argument for moving quickly in Egypt. The reason here is that announcements do not work. There is no way to guarantee that if you take one step, the next will be taken, so if you are going to do it, do it now. It is very difficult to announce in advance certain kinds of steps. You are not going to announce that you will devalue in three months. The Russians said in 1991 that they would end price controls in six months. The shops were emptied immediately, and that was the beginning of the end.

Participant: Did those open economies really succeed and achieve their growth from savings within or from direct foreign investment, donations and grants from the outside world? I believe in savings, but savings of 35 or 37 percent as in Korea cannot be achieved from internal resources at the beginning. Can you elaborate on the role of aid and foreign investment?

Speaker: First of all, growth does not come from aid. The Marshal Plan aid was about 5 percent of GDP of the recipient countries. When aid is done right, it gives enough political stability for fundamental changes. When aid is done wrong, it postpones adjustment for decades. It should be carefully coordinated with the growth strategy and then phased out. In the Taiwan and Korea cases, it was generous, timely and limited. That is a wonderful model actually. I am very much in favor of debt reduction as a counterpart of reform, because I view the aid/debt syndrome as an unfortunate historic episode where a strategy was taken but failed, leaving so many countries to try to get out of debt. Most countries have needed aid at some point, but they shouldn't live on it.

Singapore, the number one competitive country in most of these surveys, has rapid, dynamic growth at 8 percent, and six billion dollars of foreign direct investment per year. Ninety percent of Singapore's manufacturing is exports from foreign multinational firms. So the country is heavily invested. Now look at the living standards in Singapore (see table 1). Between 1970 and 1992, life expectancy for Singaporeans went from 64 years to 74.8 years. Infant mortality dropped from 36 per thousand to six per thousand. So they have had incredible improvement of living conditions, and they did not lose their sovereignty. Singapore is as strong, self-reliant and independent as any country in the world. And the countries that have kept out foreign investment are struggling today. There are very few countries that developed without heavy foreign investment. (Korea and Japan did it through heavy borrowing.) Most of the fast-growing countries achieved growth on the basis of foreign multinationals, and more and more in the modern period, if you want to grow rapidly you need the multinationals for the capital, technology, markets, management, and organization they

bring with them. The world system has a very complex division of labor, and roughly 30 percent of world trade is within affiliates of multinationals. If you want to be in these markets and deeply engaged in world trade, you need integration in this highly networked international economy.

Participant: How can Egypt attract more multinationals?

Speaker: Attracting foreign direct investment is a very competitive process these days, because a lot of countries want to do it. Mainly you need the underlying conditions of the market; favorable legislation on labor, investment, and taxation, macroeconomic stability and an exchange rate committed to being flexible and guaranteeing profitability of the export sector. Then, of course, the process of foreign direct investment needs to be simple, transparent, open, without a lot of arbitrary regulations. In my opinion, Egypt is extremely well-suited to attract foreign direct investment because of its geographical position. You can reach all parts of Europe easily. So this can become a very important place for operations of any European firm, or Korean firm with operations in Europe. The Euro-Med Agreement will be important in bringing openness to industrial trade and encouraging foreign firms to invest and base their European production operations here. This is what happened in Eastern and Central Europe.

I would like to mention the labor market. India has labor laws similar to those of Egypt; you can't fire anyone in India without permission from the local government, and I don't know of one case in the last 50 years where the local government has given permission. When I went to India to start a joint venture between Harvard and an Indian institute, I could not hire a graduate student temporarily to do research, because once someone is hired they are permanent. Then people complain that they can't make jobs, yet many academics in India are against public reform because it seems so harsh.

Egypt faces competition for labor-intensive production from the most flexible places in the world where the enterprises can change quickly. If you are in textiles, fashions change, designs change, and you have to change quickly, but you can't do it with these kinds of restrictions. When no legal formal jobs are created, it costs you in economic growth.

Participant: How much do poor distribution of income and the high level of illiteracy prevent Egypt from achieving the growth rates enjoyed by East Asia?

Speaker: I don't think that these are obstacles for getting growth going, but they are imperatives that should be addressed over time in the course of any sensible set-up of the economy. A major

commitment to quality primary education, for girls as well as boys, in a fairly well-functioning economy will narrow income inequality. Another important remedy is producing jobs through rapid growth based on labor-intensive employment. A high level of illiteracy among the young resulting from overpopulation is a problem, because you cannot participate well even in the simplest assembling process without some basic literacy. So that should be addressed without question, but I doubt it is an obstacle or a prerequisite for growth right now. I think commitment to education is important, and that commitment exists here, but the quality needs to be improved.

Participant: While I agree with most of your recommendations, I think it is wrong to compare Egypt with countries like Singapore or Hong Kong, especially considering population. If all countries had opened up at the same time, would it have been so easy for those countries to grow? I would like to mention some of the issues that make Egypt a special case. We should indeed open up, but we are not as free to open up today as the small countries you mentioned, because of our social overhead. Furthermore, Egypt has initiated incentive policies that you didn't mention, such as 5 to 10 year tax holidays. The annual cost of these tax holidays is considerable. Also, we are one of the few countries in the region that grants 100-percent tax-free interest.

Speaker: With regard to global competition, I strongly suggest that Egypt get started. I don't think it is impossible under the current circumstances. Look at China, a country with 1.3 billion people. China has managed to achieve 9 percent growth on average since 1979, with a huge expansion in the world trade system. If China can increase its exports by tens of billions of dollars without being closed up, then Egypt can certainly do the same kind of thing, especially with your access to the European market. Vietnam, a mediocre reformer, is achieving 8 percent growth now, and it is a big, populous country. So it is not a matter of size.

Egypt is not without resources, management, access, or markets. What works against you is the overhang of policies, of debt, of social commitments, as you said, and so forth. But you really need to make the commitment to rapid growth, because the current strategy is not producing jobs, ending poverty or improving social conditions. I don't want to oversimplify, but these reform policies would probably not be as crippling as they might look, especially in the context of a package. It is not true that nobody gets hurt in the due course of reform, but without reform everybody gets hurt. You have the potential to achieve rapid growth, but you are not now in a viable position for growth.

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