The Renaissance and its Discontents: Continuing the legacy of ineffective FDI and Debt Policies

"The FDI Mirage"

The dominant neoliberal economic theory has always perceived foreign direct investments (FDI) as beneficial for growth. However, a major pre-requisite that is often overlooked is how crucial the host country's management of FDI is and how detrimental the mismanagement of FDI can be as in the case of Egypt. Before delving into the specifics of the Egyptian case, a few misconceptions that need to be addressed.

One is the expectation that there billions of dollars worth of investment out there for Egypt to easily attract. However, figures of the UN Conference on Trade and Development (UNCTAD) contradict this. Direct foreign investment around the world dropped by 18 percent in 2012, to rates lower than a decade ago for developed countries[1]. Moreover, according to the UNCTAD World Investment Report (2011), the share of FDI to developing and transition economies represented only the 52% of global flows. Meanwhile, there is strong competition for what is left between emerging economies in Asia and Latin America. It is noteworthy that the top recipients of investment are the countries that also export it[2].

Egypt like so many other countries during the last few decades has radically opened its borders to FDI by liberalizing trade and financial policies (e.g. liberalization of the exchange rate, the lifting of tariffs and barriers to trade and privatization) with little social gain. This is because engagement with foreign investment was not driven by a clear strategy for national development. The result of liberalization without vision is usually FDI of little benefit. Much of this FDI involves foreign investment in the petrochemicals sector and takeovers of existing firms with little injection of new technology, as is the case in Egypt. Also, privatization of state owned enterprises that were motivated by fiscal reasons rather than a carefully developed industrial strategy. As a result of adopting a policy of attracting FDI according to the interests of investors at the expense of a home grown economic development vision, Egypt has granted foreign firms unnecessary large subsidies, tax exemptions, and reduced or abolished ownership restrictions, restrictions on profit repatriation, local content requirements, liberalized regulations on technology transfer and granted unnecessary generous exemptions on labor and environment.

The absence of a coherent national and industrial FDI strategy meant that Egypt did not improve its economy by wisely utilizing its investment resources and foreign exchange generated by FDI. Instead the investors maximized their returns and the fruits never trickled down to the rest of the economy. Egypt recorded stellar GDP growth rates of 5% to 8% in the last decade, attracting foreign direct investment of USD13-billion during the 2006/2007 fiscal year,

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1 Wael Gamal. The Mirage of Foreign Investment. Opinion-Ahramonline.Wednesday, March 27, 2013. < http://english.ahram.org.eg/NewsContentP/4/67542/Opinion/The-mirage-of-foreign-investment.aspx>

2 ibid

which meant it was one of the top recipients of FDI inflows in the region at the time. However, the socio-economic conditions continued to deteriorate eventually triggering the 25th of January revolution. A report by published by the board of trustees of GAFI in 2008/2009, illustrates why such impressive investment rates failed to trickle down and bring economic and social development. In addition to reaching the conclusion that foreign investment crowded public investments, instead of complementing them the report highlighted the following factors that further illustrate the failed management of FDI:

One of the findings of the report was the distorted geographic distribution of investments. During the period from 2000-2007, 34% and 30% of new investments were concentrated in Cairo and Giza respectively[3]. Moreover, the report revealed that the economic growth achieved during the period from 1983-2007 was solely through capital accumulation, thus enhancement of total factor productivity, which occurs through widespread job creation, was absent[4]. In assessing the period from 2002/2003-2006/2007 we find that the petroleum and energy sector, a capital intensive sector with minimal job creation, attracted the largest amount of investments, constituting 28%, but provided limited opportunities for employment creation and local linkages[5]. Whereas, investment in manufacturing and mining, two labor-intensive industries, did not exceed 12.3% for the same period[6]. Other reasons cited included the rise of the informal sector and the scarcity of a well-educated labor force were mentioned. If only 10% of the labor force is capable of working in the so-called "modern economy" while the rest is restricted to jobs with low levels of productivity, and hence lower salaries, then the effects of the trickledown will remain withheld[7]. Furthermore, even if the informal sector is capable of alleviating un-employment to some extent, it will nevertheless fail to provide decent jobs that reap the fruits of growth and investments[8].

One would assume these lessons would be sufficient to revise the country's economic development strategy and discontinue a failed legacy of approaching and prioritizing FDI over addressing the real needs of the economy and the people. In a country where over 25% of the population (50% in rural areas and city slums) live below the poverty line and with an unemployment rate of 25% among young Egyptians, the government continues to blindly pursue FDI before upgrading the socio-economic conditions of its people and developing an industrial strategy/vision to ensure investments will endorse the interests of the national economy and not that of investors. As columnist Wael Gamal has written:

"Politics itself is tailored for the sake of foreign investment: reconciling with figures

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3 SeifAllah Rabie. Rising FDI & Economic Growth Rates. Why Are We Not Feeling It? The Chronicles. Fall 2009

http://www.aucegypt.edu/research/ebhrc/publications/Documents/Rising%20FDI.pdf

4 Ibid

5 Ibid

6 Ibid

7 Ibid

8 Ibid

from the former regime to boost the confidence of foreign investors; mega projects and plans for the Suez Canal to attract them to invest their money with us...meanwhile, foreign policy is primarily drawn up according to its immediate effect on the subsequent flow."[9]

Moreover, there doesn't seem to be the slightest of attempts to at least direct investments in sectors that would create employment opportunities and domestic linkages. As following the Presidential elections, a sizeable medium-term FDI pipeline appears to be taking shape, focusing mainly on the hydrocarbon sector (which accounted for 60% of FDI in FY2008-10) as the Egyptian General Petroleum Corporation recently awarded 11 concessions to foreign oil companies. Repeating the same mistakes is not only restricted to focusing on the wrong sectors but also focusing on attracting foreign investment without addressing the real needs of the economy and people and without a vision or strategy. According to figures from the Central Bank of Egypt, in 2011/12, some $11.5 billion in foreign investment entered Egypt in addition to $2.2 billion in the first quarter of this fiscal year[10]. At the same time, however, around $9.6 billion in investment fled the country (including illicit capital flight). This caused net foreign investment to drop to only $1.9 billion[11]. While during the first quarter of this fiscal year, the net reached only $108 million after some $2.1 billion left[12]. This clearly indicates that no matter how much money comes in, it will continue to escape in light of the lack of any management of the economy exercised by the government.

What alternative FDI strategies are there?

Of course FDI can be beneficial to developing countries if properly managed by host governments. It is important to note that the experience of emerging markets proves that FDI enters rather than creates economically dynamic countries. Economic growth leads to FDI and not the other way around. A developing country will be in a position to exercise bargaining power if its economy is on a solid footing in the first place. It is critical for Egypt to have a government that is coherent and that it is politically and administratively capable of exercising its bargaining power when dealing with investors. This entails many factors to consider when designing an FDI policy, which include; the type of industry and firm and the regulatory and tax regimes in which the investment is undertaken. FDI policy should be seen as an integral component of a country's national development strategy and should be integrated with industrialization and other economic goals.

As illustrated by Ha-Joon Chang and Ilene Grabel in "Reclaiming Development: An Alternative Economic Policy Manual" there are several examples of countries that have built their industrial foundation on the basis of restrictive policies towards FDI (e.g. Japan, Korea and Taiwan). These countries permitted FDI only

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9 Wael Gamal. The Mirage of Foreign Investment. Opinion-Ahramonline.Wednesday, March 27, 2013.<
http://english.ahram.org.eg/NewsContentP/4/67542/Opinion/The-mirage-of-foreign-investment.aspx>

10 ibid

11 ibid

12 ibid

in certain sectors, and in many cases prohibited more than majority foreign ownership in key sectors. Policymakers in these countries mandated local content requirements (i.e. specified proportion of local inputs used in the production process) in subsidiaries of TNCs. The governments also established limits on royalties that could be paid on technology licenses by local partners of TNCs. More importantly these governments designed their FDI policies with several objectives in mind. Policy was designed to encourage FDI only in sectors where benefits outweigh costs; to ensure corporations transfer the right types of technology at the right price and to maximize the technological spillovers to the local producers and prevent the TNCs from repatriating too much of their earnings to restrict their export activities of their local subsidiaries and to maximize the income and exports generated by TNCs. These measures do no contradict with adopting more liberal policies in sectors that are not considered strategic or where the country cannot establish a competitive advantage in.

Quelling the fear of host developing countries, evidence shows that foreign investors do not shun countries that regulate FDI. In fact it is not an effective strategy for attracting FDI. Even the World Bank an institution often associated with liberal policies towards FDI have argues that specific incentives and regulations governing direct investment have less effect on how much investment a country receives than has its general economic and political climate and its financial and exchange rate policies[13] . China and Vietnam are examples of countries successful in attracting FDI despite the fact that they regulate it fairly aggressively. Investors find them attractive because of their large domestic markets, rapid economic growth and relatively well educated labour force or what is described as a good work ethic. Singapore and India also illustrate the importance of a well-educated labour force in attracting FDI[14].

Finally, one thing Egypt has become very much aware of is that FDI sometimes causes substantial outflows of capital, which occurred amid the beginning of the revolution. This puts pressure on the local currency and the balance of payments (as seen in the Malaysian experience, or what forced Algeria to exercise a rule that half the profits must be re-invested locally)[15]. These outflows occur whenever profits associated with foreign investments are taken out of the country where they are initially earned. Multi and transnational corporations are able to withdraw large pools of capital from host countries because of the lack of restrictions on profit repatriation. Additionally transfer pricing enables these corporations to repatriate pools of capital that exceed the profits they have actually earned in the host economy[16]. Management of terms of FDI can prevent or mitigate it's to potential to generate resource outflows. Policy makers need to devise a strategy to reinvest the export earnings generated in order to generate new industrial capabilities[17].

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13 Ha-Joon Chang & Ilene Grabel. Reclaiming Development: An Alternative Economic Policy Manual. Zed Books Ltd. 2004

14 Ibid

15 Wael Gamal. The Mirage of Foreign Investment. Opinion-Ahramonline.Wednesday, March 27, 2013.<
http://english.ahram.org.eg/NewsContentP/4/67542/Opinion/The-mirage-of-foreign-investment.aspx>

16 Ibid

17 Ibid

The Debt Cycle[18]

Currently, the level of debt has exceeded 100% of GDP, with GDP growing at 2.1% and the current account deficit reaching 2.3%[19]. Whereas, the majority of this debt is domestic debt and not external debt as was the case during the late 1980s the total level of debt remains precariously high and unsustainable. One would have been encouraged by Egypt's ability to weather the storm after the similar experience it recovered from in the early nineties, had it not been for the 'get out of jail card' that facilitated the economy's recovery without an output collapse or currency and financial sector crisis. This 'get out of jail card' was Egypt's military intervention in the Gulf war at the time, which resulted in a massive debt write-off of nearly 24 billion USD by the Paris Club debtors.

Alarmingly, the successive governments that have taken charge since the revolution have all elected to seek and accumulate more loans on both the domestic and external fronts. The lack of transparency over the continuous borrowing process coupled with the lack of any comprehensive economic plan or strategy have placed the economy on a seemingly fast track ride to default. With the socioeconomic conditions continuing to deteriorate, the accumulation of debt with no transparency, plan or inclusive decision making process is contributing to the deteriorating economic conditions and the further impoverishment of an already vulnerable majority.

The borrowing must be stopped until the following issues have been addressed:

1. Development of guidelines and principles to govern the borrowing process. The necessary mechanisms should be developed to enable legitimately elected authorities to monitor and govern the debt incurrence. A national dialogue to discuss the economic policies adopted, the possible solutions and the development of a national economic plan. The borrowing process in addition to all other economic decisions should stem from this plan.
2. A Debt Audit to evaluate the legitimacy of Egypt's public and private debt
3. Transparency with regards to the level of debt, obligations/terms of each loan, how they are being utilized and how they will be repaid.

Debt situation

According to the Central Bank of Egypt, as of September 2013, domestic debt had reached approximately 1.5 trillion EGP (218 billion USD) and external debt is amounting to almost 45 billion USD (approximately 310 billion EGP), bearing in mind that debt servicing levels had already exceeded 30% of the total expenditures in the 2011/2012 budget. The more alarming fact is that the significant intake of loans has not been used to finance investments in social services, productive sectors or job creation that would ultimately revive growth, generate returns to repay the debts and lead to more sustainable growth.

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18 Mohammed Mossallem, In the Absence of a Comprehensive Economic Strategy and Planning: Is Egypt's Debt Policy a Recipe for a Disaster? The Egyptian Initiative for Personal Rights, December 2012.

19 The Economist Intelligence Unit. Egypt Country Report October 2013.Economist Intelligence Unit Limited 2013.

Instead, the debt has been used to repay existing debt in addition to other forms of current expenditure with the aim of reducing the deficit. In reality, however it seems to be contributing more to widening the deficit. In 2012/2013 the actual budget deficit was 239 billion EGP (13.8% of GDP), increasing by 43.9% from the deficit for 2011/2012, which was 166 billion EGP. The government's total expenditure in 2012/2013 increased by 23.7% from the previous reaching 583 billion EGP. According to the Ministry of Finance 59% of the annual increase in total budget expenditure was due to subsidies and public debt repayments. Contrary to economic logic that would dictate discontinuing debt accumulation and exploring alternative policy measures once the debt has grown beyond the government's capacity to service in the medium and long term, both domestic and external debt have continued to exacerbate. Moreover, unlike the domestic debt, the terms of the external debt being raised are vague to say the least. This massive increase in debt is leading to the continuance of the unequal distribution of income. A large portion of the government's expenditure is directed towards the external creditors in the shape of debt service payments and little government programs are dedicated towards ensuring that the more vulnerable segments of society and under privileged who are more likely to be affected by the economic situation are protected. In fact, it will clearly become even more skewed, with interest rates for domestic debt ranging from 10-12% and the 3 billion USD annual interest payments for external debt expected to increase with the significant inflow of debt in the current fiscal year. This surge in debt servicing obligations comes at the expense of spending on education, health and other social sectors, which mostly benefit the poorer segments.

The crucial issue at hand is not just the size of debt, but also the exclusion of the local stakeholders from the decision making process, the lack of transparency and governance over the borrowing process in addition to the absence of a comprehensive economic strategy in which these loans are embedded. All of which reflect shortsightedness and negligence of the weight of the burden to be shouldered by future generations in repaying these loans. This future and present is certainly far from that which galvanized the 2011 Revolution.

Issues with the existing loan strategy[20]

Transparency: Level of debt, terms, and guiding principles

Unfortunately, the post-Revolution regime continues to operate with the same lack of transparency and accountability that the January 2011 revolution had risen against. The UN Conference on Trade and Development (UNCTAD) principles on promoting sovereign lending and borrowing is a very useful tool to measure the level of transparency and degree of accountability practiced by the authorities. Some of the guiding principles and their implications are clearly relevant to the situation in Egypt and can be used to highlight the major issues pertaining to the lack of transparency and accountability. While the emphasis might be on external debt, several of these principles apply to domestic debt as well. For example, Governments are agents of the State and, as such when they

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20 Mohammed Mossallem, In the Absence of a Comprehensive Economic Strategy and Planning: Is Egypt's Debt Policy a Recipe for a Disaster? The Egyptian Initiative for Personal Rights, December 2012.

contract debt obligations they have a responsibility to protect the interest of their citizens. For instance when debt service competes for limited public resources with financing other core state functions[21]. The UNHCR had clearly stated that states have a primary responsibility for ensuring human rights, and should ensure that obligations arising from external debt agreements do not undermine their responsibility[22]. Moreover, since taxpayers of a country will bear the responsibility of covering the repayment of the debt, their representatives in the parliament (or any other form of legislature) should be involved in decisions about how to incur debt. Some of the tools mentioned in the guidelines include legislatively specified debt ceilings and borrowing objectives. Thus, it is crucial that new mechanisms/legislations are developed to ensure that the borrowing process is monitored by an elected parliament which should also have a key role in the decision making process.

In this past two years however, citizens in Egypt have been completely excluded from the decision-making process around these issues. A matter only made worse by the absence of any legislature. Another relevant guiding principle is with regards to the disclosure process. This stipulates that relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower and be universally available and freely accessible in a timely manner through online means to all stakeholders, including citizens.

This is another major issue pertaining to transparency of the loan process, given that debt information is usually revealed in a sporadic manner with inconsistent figures quoted by different media outlets. Calculating the level of accumulated debt thus becomes an investigative and often complex process. When the Ministry of Finance eventually releases the information, it appears in a rather untimely manner and the terms of these loans remain obscure and are not always accessible.

Over and above, and specifically in the case of external debt, incomprehensible reporting standards usually lead to the understatement of the external debt figure released by the authorities.

With regards to avoiding over-borrowing, the guidelines also indicate that a government should seek a sovereign loan if it would permit additional public or private investment, with a prospective social return that would at least be equal to the cost of borrowing. With Egypt's debt exceeding 100% of the GDP, the borrowing has been mainly used to maintain the level of foreign currency reserves and cover the large chronic deficits. These measures effectively impose a tax on future generations of citizens and are highly inconsistent with a sustainable economic policy. Furthermore, using external debt to finance current expenditure could lead to a severe debt spiral in the not so distant future which

21 The UNCTAD principles on promoting responsible sovereign lending and borrowing. Explained and assessed from the perspective of Eurodad's Responsible Finance Charter. A briefing paper by Bodo Ellmers and Konstantinos Todoulos; May 2013 < http://eurodad.org/1545448/>

22 See UNHRC's Guiding principles on foreign debt and human rights, in particular 18; http://www.ohchr.org/Documents/HRBodies/HRCouncil/RegularSession/Session20/A-HRC-20-23_en.pdf

is very similar to what happened in the late 1980s following the oil glut in 1986 and the subsequent drop in revenue. Finally, without addressing such guidelines that involve all the stakeholders and holds the government accountable towards them, the borrowing process will remain undemocratic; irresponsibly violating the economic and social rights of the Egyptian people and burdening generations with further debt instead of directing the spending towards improving their standard of living.

When evaluating Egypt's debt policy we should also refer to other guidelines especially those developed by Civil Society Organisations. While the UNCTAD principles represent an important initial step towards reforming cross border finance in the direction of more responsibility there are several gaps due to the narrow focus on preventing a debt crisis and not considering the role of effective public finance in allowing for debt sustainability. The Eurodad Charter on Responsible Financing [23] goes beyond the "do no harm approach" as it also addresses the effectiveness of public finance in general and the need to ensure that irresponsible lending practices and their costs do not undermine state capacities to fulfill other core state functions such as public service provision and poverty eradication[24]. The Charter goes beyond sovereign lending and borrowing as it covers investment contracts and addresses the risks of increased blending of public funds and private loans. The Charter also covers additional areas that are closely related to lending and investment e.g. procurement and taxation. All these issues are just as crucial as sovereign borrowing when evaluating the sustainability of Egypt's public finance policies. The issue of public procurement for instance is quite controversial as many sovereign lenders attach harmful procurement conditionality to loans or tie development loans to the purchase of goods and services offered by lending countries' businesses[25]. The Eurodad charter in this case states that procurement should be transparent, accountable, fully united and conducted through the borrowers' own procurement system. It also allows for preferences for domestic industries if it makes development sense.

III. Conclusion and way forward

As Egypt strives to meet its short-term challenges of a deteriorating economy and increasingly poor socio-economic conditions, it will need a long-term strategy to secure inclusive economic growth. Less attention should be paid to the interests of creditors and local investors and more to developing existing resources, increasing productivity, job creation and genuine economic reform. In this respect, there are successful models over the last decade such as the experience in Latin America. Since the start of the new millennium, several Latin

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23 http://eurodad.org/13540/

24 The UNCTAD principles on promoting responsible sovereign lending and borrowing. Explained and assessed from the perspective of Eurodad's Responsible Finance Charter. A briefing paper by Bodo Ellmers and Konstantinos Todoulos; May 2013 < http://eurodad.org/1545448/>

25 Ibid

American countries have managed to reduce inequality and sustain faster and more inclusive growth through the deployment of more equitable social, taxation and economic policies. As for the immediate actions, the policy of simply borrowing and attracting FDI in a haphazard manner should be stopped until clear priorities and principles are articulated and a more balanced, inclusive and sustainable economic development program is in place. This would ultimately require a coordinated effort and strong partnership between the government, private sector and civil society.

In an attempt to achieve that the following recommendations are proposed:

-Adopt a more inclusive and participatory approach to the decision making process. This should start with a more credible and genuine national dialogue with the stakeholders, which should include and not be limited to a broad representation of civil society organizations official and independent unions/syndicates, political parties and economic experts of all ideological backgrounds. Based on this dialogue and after taking the interests of all the stakeholders into consideration, a national economic development plan tackling the long term and short term issues should be developed by the government. Going forward all economic activities and decisions should stem from this plan.

-In the absence of an elected parliament the dialogue should also aim to develop and adopt clear guidelines for borrowing or receiving aid, with existing guidelines that can be used as references including the UNCTAD guidelines, the Eurodad Charter on Responsible Financing in addition to the Paris Declaration when it comes to aid. The guiding themes of which are centered on transparency, ownership, alignment, harmonization and results. The guidelines developed from the dialogue should be complemented with the necessary mechanisms and legislations to enable the next elected parliament to monitor the borrowing process effectively.