The Development of the Banking Sector in Egypt

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Abstract

The present research provides a theoretical analysis for the different reforms that had been undertaken in the Egyptian banking sector since the adoption of the open door policy in 1974 until the latest reform plan that had been implemented by the Central Bank of Egypt in 2004 and finalized in the first quarter of 2012. In addition, it provides an analysis for the banking sector development indicators in Egypt. It was found that the different stages of reforms that had been undertaken have resulted in the development of the banking sector in Egypt.

يقوم البحث بتحليل نظري للاصلاحات المتعددة التي تمت في القطاع المصرفي المصري منذ تطبيق سياسة الانفتاح الاقتصادي في عام 1974 وحتى خطة الاصلاح الاخيرة التي تم تطبيقها من جانب البنك المركزي المصري في عام 2004 والتي انتهت في الربع الاول من عام 2012. بالاضافة الى ذلك يقوم البحث بتحليل مؤشرات تنمية القطاع المصرفي في مصر. ووجد ان المراحل المختلفة من الاصلاحات التي تمت ادت الى تنمية القطاع المصرفي في مصر.

Key Words: Banking Sector Development, Reform Plans, Financial Liberalization.

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1. Introduction

The Egyptian banking sector has witnessed several developments over the past decades. The 1970s and 1980s witnessed the entrance of foreign banks under the open-door policy. In the 1990s, the Economic Reform and Structural Adjustment Program (ERSAP) aimed at the liberalization of the financial sector. In the mid-2000s, the Central Bank of Egypt (CBE) has adopted a reform plan for restructuring and enhancing the efficiency of the Egyptian banking sector. This plan was implemented on two phases, where the first phase started in 2004 and ended in 2008, while the second phase started in 2009 and extended to the first quarter of 2012.

Banking sector development means the improvement of the financial depth, access, efficiency, and stability of the banking sector. The financial depth is the size of the banking sector, access is the degree to which individuals can use financial services, efficiency is the efficiency of the banking sector in intermediating resources, and stability is the stability of the banking sector.

The rest of the research is organized as follows: Section two presents the statement of the problem. Section three highlights the hypothesis of the research. Section four shows the objectives of the research. Section five discusses the reform plans that were undertaken in the Egyptian banking sector. Section six analyzes the banking sector development indicators in Egypt. Section Seven provides a summary and conclusion for the research.

2. Statement of the Problem

The Egyptian banking sector has passed through different stages of reforms since the adoption of the open door policy in the 1970s until the latest reform plan that had been undertaken by the CBE in the mid-2000s in response to the commitments of Basel II accord. Thus, the problem of the research can be expressed in the following question:

"Have the banking sector reforms that have been undertaken in the Egyptian banking sector affected the banking sector development?"

3. Hypothesis of the Research

The research is based on the hypothesis that "the banking sector reform plans affected positively the development of the banking sector in Egypt".

4. Objective of the Research

The objective of the research is to discuss the different reforms and the restructuring plans that were undertaken in the Egyptian banking sector since the adoption of the open-door policy in the mid-1970s until the recent reforms in the mid-2000s and to analyze the banking sector development indicators in Egypt.

5. Reform Plans of the Egyptian Banking Sector

This section will discuss the different policies and reform plans that were undertaken in the Egyptian banking sector since the adoption of the open-door policy in the 1970s which involved the entrance of foreign banks till the latest banking reform plan in the mid-2000s.

In the beginning of the 1970s, the Egyptian economy has suffered from low level of domestic savings that were decreased over the 1960s (Hussein, 1999: 10; World Bank database). As a result, the Egyptian government has adopted the open-door policy in 1974 in an attempt to improve the economic conditions and increase economic growth.

The open-door policy encouraged the private sector and allowed the entrance of foreign banks to operate in Egypt beside the state-owned banks, where law no. 43 of 1974 was enacted in order to allow foreign capital to participate in the banking sector in joint-venture banks under the condition that the national ownership to be at least 51% (Algarhi and Nasr El-Din, 2005: 2).

The expansion of the banking sector that resulted from allowing private and foreign banks to participate in the Egyptian banking sector led to an increase in the number of banks operating in Egypt from 7 banks in year 1974 to 81 banks in year 1991 (Moheildin, 2001: 15). Despite the expansion of the banking sector and its partial liberalization in the 1970s and 1980s, the banking sector was suffering from some problems such as high reserve ratios and the lack of innovative financial services.

Public banks were also dominating the banking sector which resulted in inefficient resource allocation as a result of the government intervention in the provision of credit. Hence, savings were not allocated for projects based on the economic return but instead they were allocated for certain projects based on the government decisions. The dominance of public banks allowed them to increase their branch network while private and joint-venture banks were more restricted. (Moheildin, 2001: 15-16).

It can be concluded that the open-door policy has paved the way for a more liberalized banking sector. However, the persistent problems that had not been addressed by the adoption of the open-door policy such as the financial repression measures that were applied since the 1960s, where these measures hampered the full liberalization of Egyptian banking sector. The adoption of the open-door policy improved the economic conditions in the short-run, while in the long run, the persistent problems within the banking sector resulted in the deterioration of the domestic savings which decreased from 18.4% of GDP in 1977 to 13.1% of GDP in 1991 (World Bank database).

At the beginning of the 1990s, the Egyptian banking sector was suffering from over-regulations and government intervention, the presence of financial repression measures, and heavy losses of commercial banks. The government had interfered in order to prevent further losses by injecting 5.5% of GDP for the recapitalization of commercial banks (Ynceler, 1994: 4; IMF, 1997: 31). Thus, the ERSAP had been undertaken in order to liberalize the banking sector from the financial repression practices that were applied since the 1960s. To achieve this objective, the following practices had been undertaken:

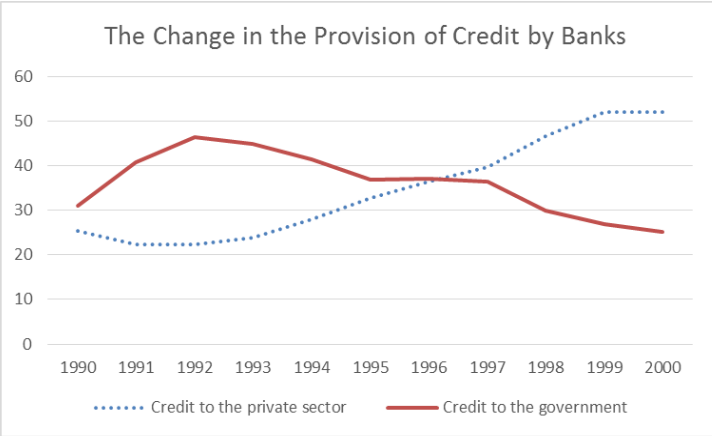
- The interest rates were liberalized which resulted in the decline of the nominal deposit rate from 12% in 1990 to 9.2% in 1999 and the decline of the nominal lending interest rate from 19% in 1990 to 13% in 1999. (World Bank, 1993: xxii; World Bank database).

- The CBE had modified the calculation basis of the required reserve ratio and reduced it from 25% on deposits in local currency to reach 15% in 1991, while the reserve ratio on deposits in foreign currency had been reduced from 15% in 1990 to 10% in 1993 in order to increase the competitiveness of the Egyptian banking sector (Ynceler, 1994: 8).

- Within the framework of the implementation of Basel Committee guidelines, the banking supervision and regulations had been strengthened. (World Bank, 1993: xxxii).

- The liquidity ratio has been modified in order to enable banks to meet the liquidity requirements in both domestic and foreign currency. Thus in 1991, the CBE has obliged banks to have 20% liquidity ratio for domestic currency and 25% for foreign currencies (Ynceler, 1994: 8).

- Credit ceilings have been abolished in order to improve the financial deepening of the banking sector which resulted in an increase in the ratio of private credit to GDP from 22.3% in 1991 to 52% in 1999 (IMF, 1997: 34).



Source: Plotted using data from the World Bank database.

Figure (1): The Change in the Provision of Credit by Banks

Figure (1) shows that at the beginning of the 1990s the provision of credit to the public sector was higher than the provision of credit to the private sector; while in the mid-1990s, the ratio of private credit to GDP increased to reach 36.5% in 1996 and continued to increase over the stabilization period. In the meantime, the ratio of credit to the public sector to GDP declined to reach 37% in 1996 and continued to decline over the stabilization period (World Bank database).

The development of the financial sector in Egypt in the 1990s resulted in an increase in the capital inflows which consequently enhanced the accumulation of foreign reserves as a result of realizing positive real interest rates that was accompanied with a stable exchange rate. This development of the financial sector continued until the Egyptian financial sector had faced a financial crises in 1997 (Hussein and Nos'hy, 2000: 5-6). This financial crisis had resulted in the slowdown of the performance of the Egyptian banking sector, where over the period 1998-2003 the performance indicators had deteriorated, where the profitability of banks had declined considerably in which the return on assets (ROA) ratio declined from 1.91% in 1998 to 0.41% in 2003 and the return on equity (ROE) ratio had declined from 23.87% in 1998 to 7.10% in 2003 (GFDD report, 2016).

The efficiency indicators had worsened over this period, where the interest rate spread (IRS) increased from 3.65% in 1998 to 5.3% in 2003, which indicates a decline in the banking efficiency in undertaking transactions. The stability indicators also deteriorated, where the loan to deposit ratio increased from 46.5% in 1998 to 53.8% in 2003. As a result of this deterioration in the performance of the Egyptian banking sector, the CBE had undertaken a restructuring plan in 2003 to be implemented on two phases.

The restructuring plan had been implemented on two phases in which the first phase was launched in 2004 and ended in 2008. It aimed at restructuring the banking sector and improving its performance. The second phase was launched in 2009 and ended in March 2012. It aimed at improving the efficiency of the banking sector and its ability for managing risks, in order to enable banks to compete regionally and globally and to support the economy in achieving the required growth rates.

The first phase of the reform plan was based on four main pillars which are: Privatization, mergers, acquisitions, and consolidation of the banking sector, financial and managerial restructuring of public banks, addressing the non-performing loans problem, and upgrading the supervision unit at the Central bank.

Within the framework of the implementation of phase (I) of the restructuring plan, the CBE decided to privatize the Bank of Alexandria (BoA). In addition, the CBE has continued to privatize the shares of public banks in joint-venture banks, where over the period 2004-2008 during the implementation of phase (I) of the restructuring plan, the CBE has sold the shares of public banks in 13 joint-venture banks (CBE annual report, 2008: 15-16).

According to law no. 88 for year 2003, the CBE obliged banks to keep a minimum capital requirement of LE 500 million for domestic banks and US $ 50 million for branches of foreign banks. Thus, the CBE has decided to undertake compulsory mergers and acquisitions within the banking sector in order to handle the problem of weak banks that were unable to fulfil the minimum capital requirement and those that were suffering from financial difficulties (Algarhi and Nasr El-Din, 2005: 4).

The CBE has established the Nonperforming Loans Management Unit in 2004 where both public and private banks were required to establish independent Nonperforming Loans Units which were supervised by the CBE unit (CBE annual report, 2008: 18).

The CBE has agreed with the Ministry of Investment for resolving the nonperforming loans of public enterprises in the four public banks which amounted LE 26 billion where it was agreed on repaying the total amount of public enterprises debt prior to the end of 2008 (CBE annual report, 2008: 18). Consequently, the ratio of nonperforming loans to gross loans has declined considerably post to the adoption of banking reform plan from 24.2% in 2003 to 13.6% in 2010 (World Bank database).

The CBE has designed a program by the cooperation of the European Central Bank and the central banks of four European countries which are France, Greece, Italy, and Germany. This program aimed at upgrading and developing the Bank Supervision Unit in order to improve the performance of the Egyptian banking sector (CBE annual report, 2008: 19).

The program was concerned with the adoption of the international supervisory standards, recruiting qualified and professional banking management staff, and improving the performance of the bank supervisory staff which would enable them to undertake the required reforms in the banking sector (CBE annual report, 2008: 19).

By the end of phase (I) of the banking reform, the CBE was preparing for adopting Basel II requirements in the Egyptian banking sector. Thus, the CBE has agreed with the European Central Bank and the European Commission to provide technical and financial assistance for the second phase of the reform program (CBE annual report, 2008: 20).

The second phase of the reform plan was launched in 2009 and ended in 2012. This phase aimed at increasing the efficiency of the Egyptian banking sector, improving its ability for managing risk, and enhance its role in financial intermediation in such a way that benefit the domestic economy and stimulates economic growth. The second phase of the reform plan was based on a number of pillars which are:

i) Restructuring the three specialized public banks managerially and financially which are the Egyptian Arab Land Bank, the Principal Bank for Development and Agricultural Credit, and the Industrial Development and Workers Bank of Egypt.

ii) Following up the results of the restructuring of the four public commercial banks that was undertaken in the first phase of the reform plan on a periodical basis and correct for any deviations.

iii) The adoption of Basel II standards in order to improve the regulatory framework in the Egyptian banking sector. This involves managing all types if risk in order to enhance the banking stability and improve the efficiency of managing capital.

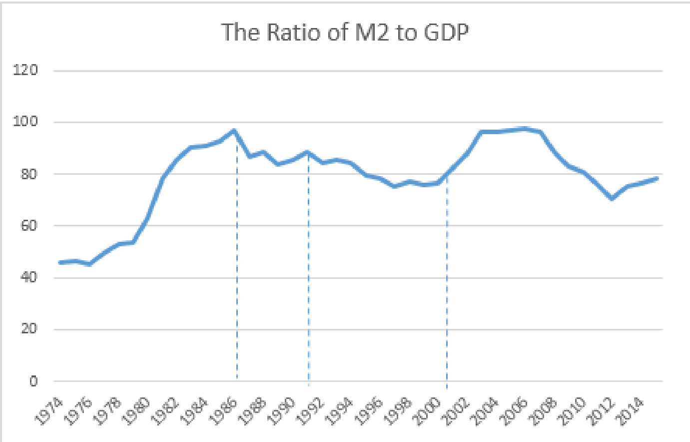
6. The Banking Sector Development Indicators in the Egyptian Banking Sector:

This section will analyze the banking sector development indicators in Egypt which are the financial depth, efficiency, and stability indicators.

1- Financial Depth Indicators:

The financial depth is measured by two ratios which are the ratio of M2 to GDP and the ratio of private credit to GDP.

i) The ratio of M2 to GDP:



Source: Plotted using data from the World Bank database.

Figure (2): The Ratio of M2 to GDP

Figure (2) shows that the ratio of M2 to GDP was increasing over the period of the 1970s and the mid-1980s. This was as a result of the monetary expansion that was conducted during this period, where the ratio of M2 to GDP increased from 46.1% in 1974 to 96.7% in 1986 (World Bank database).

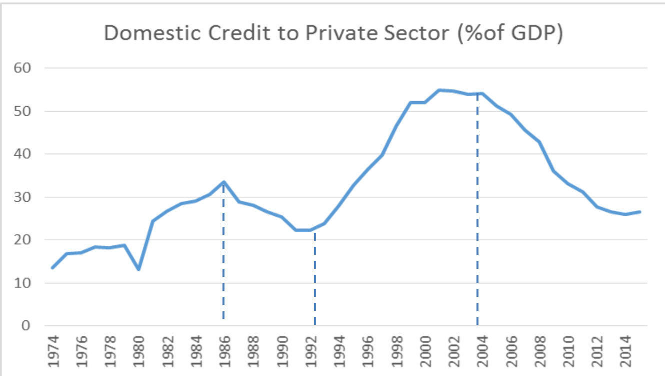
In 1991, during the implementation of the ERSAP, the CBE attempted to decrease the inflation rate that has increased in the mid-1980s, where the inflation rate has increased from 6.1% in 1986 to 9.3% in 1991. Thus, the CBE has conducted a contractionary monetary policy by using multiple tools to reduce the excess liquidity and maintain price stability (Awad, 2010: 30-31). This was reflected in the decline of the ratio of M2 to GDP from 88.5% in 1991 to 76.7% in 2000 (World Bank database).

In the beginning of 2000s, the CBE has adopted an expansionary monetary policy by lowering the minimum lending rate, the required reserve ratio, and the liquidity ratio in order to increase the liquidity in the economy and enhance economic growth (African Development Bank, AFDB, 2003: 127). Consequently, the ratio of M2 to GDP has increased from 82.3% in 2001 to 96.67 % in 2004 (World Bank database).

In 2005, the central bank has adopted the inflation targeting as a new regime for the monetary policy, thus it started to use the indirect monetary tools such as the open market operations (OMO) in order to absorb the excess liquidity in order to maintain price stability. Consequently, the ratio of M2 to GDP declined to reach 70.47% in 2012 (Mabrouk and Hassan, 2012: 30).

In 2013, the CBE has conducted an expansionary monetary policy by reducing the discount rate, the lending rate, and the deposit rate which resulted in an increase in the money supply (African Development Bank, AFDB, 2014: 5). Consequently, the ratio of M2 to GDP increased from 75.2% in 2013 to 78.4% in 2015 (World Bank database).

ii) The ratio of private credit to GDP:



Source: Plotted using data from the World Bank database.

Figure (3): The Ratio of Domestic Credit to Private Sector (% of GDP)

Figure (3) shows that the domestic credit provided by the Egyptian banking sector to the private sector increased steadily over the period of the 1970s and the mid-1980s, while since the mid-1980s till the beginning of the 1990s the ratio of domestic credit to GDP declined considerably from 33.6% in 1986 to

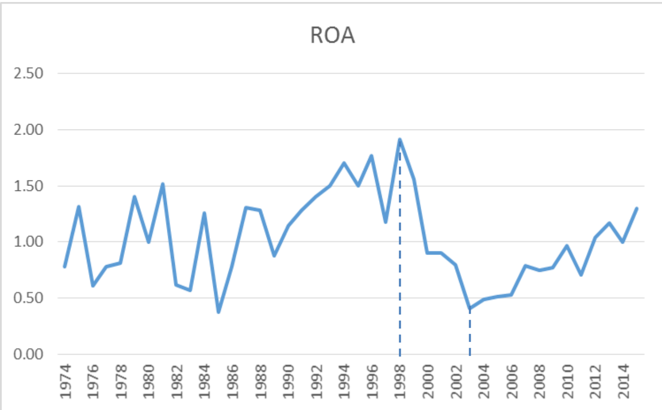
22.2% in 1992 (World Bank database). This decline in the domestic credit resulted from a significant increase in the interest rate (Mabrouk and Hassan, 2012: 22) where the lending interest rate has increased from 15% in 1986 to 20.3% in 1992 which led to an increase in the cost of borrowing and hence a decline in total investments, where the ratio of investment to GDP declined from 34.9% in 1988 to 19.4% in 1992 (World Bank database).

Over the 1990s, the ratio of domestic credit to GDP increased sharply, where the CBE reduced the discount rate in order to encourage investment. Moreover, the implementation of the ERSAP entailed the removal of interest rate ceilings which resulted in a decline in the interest rate on loans (Mabrouk and Hassan, 2012: 24-25), in which the lending interest rate decreased from 20.3% in 1992 to 13.2% in 2001 (World Bank database). Consequently, the domestic credit to private sector as a percentage of GDP has continued to increase until the beginning of the 2000s, where it increased from 22.2% in 1992 to 54.9% in 2001 (World Bank database).

In the beginning of 2000s, the ratio of nonperforming loans to gross loans increased considerably from 13.6% in 2000 to 24.2% in 2003 (World Bank database) which was considered a serious problem that affect the stability of the Egyptian banking sector. Consequently, the CBE rationed the provision of private credit which resulted in the decline of the ratio of nonperforming loans to gross loans from 24.2% in 2003 to 7.2% in 2015 (World Bank database).

3- Efficiency Indicators:

Efficiency of the banking sector is measured by the return on assets (ROA) and the interest rate spread (IRS) (FSDI, 2006:1).

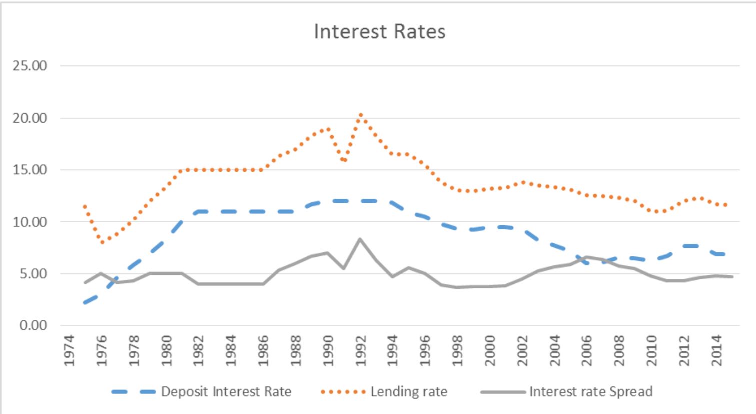


Source: Plotted using data from the World Bank database

Figure 5: Return on Assets in the Egyptian Banking Sector

Figure (5) shows that the profitability of the Egyptian banking sector was fluctuating over the 1970s until the 1990s. It deteriorated considerably since the late 1990s as a result of the poor performance of the public banks. As a result, the ROA has declined from 1.91 in 1998 to 0.4 in 2003 (GFDD report, 2016). The CBE has addressed the problem of the low profitability of banking sector by allowing weak banks to be acquired by strong ones (CBE annual report, 2005: 33). Consequently, the profitability of the Egyptian banking sector has improved where the ROA has increased from 0.4 in 2003 to 1.3 in 2015 (GFDD report, 2016).

For the interest rate spread, figure (6) shows the fluctuations of the lending and deposit interest rates, and the interest rate spread for Egypt over the period1974-2015.



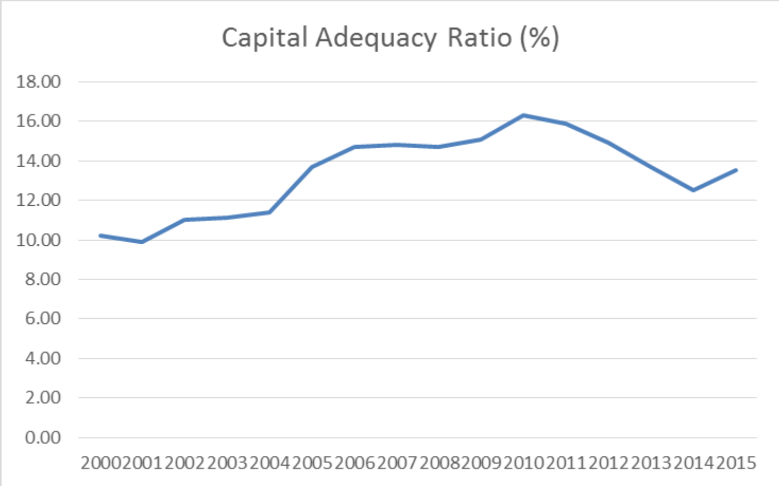
Source: Plotted using data in the World Bank database.

Figure 6: The Lending and Deposit Interest Rates and the Interest Rate Spread of the Egyptian Banking Sector

Figure (6) shows that the interest rate spread is stable over the study period where it is fluctuating around 5% because both the lending and deposit interest rates have the same trend either in case of increasing or decreasing.

4- Stability Indicators

The banking sector stability is measured by the capital adequacy ratio. Figure (7) shows the change in the capital adequacy ratio in the Egyptian banking sector over the period 2000-2015.



Source: Plotted using data GFDD report, 2016.

Figure 7: Capital Adequacy Ratio

In 1988, Basle committee has introduced an approach for calculating the capital adequacy ratio and a recommended minimum capital adequacy ratio of 8% (Bank for International Settlements). In order to adopt Basel II recommendations and ensure an efficient banking sector, the CBE has set the capital adequacy ratio at a minimum of 10% (CBE annual report, 2009: 45).

Figure (7) shows that the capital adequacy ratio for all banks operating in Egypt was recorded at 10.2% in 2000 and continued to increase until it reached 16.3% in 2010, and then it declined to reach 13.5% in 2015 (GFDD report, 2016). Despite this decline in the capital adequacy ratio, banks are still complied with the minimum capital adequacy ratio that was set by the CBE.

7. Conclusion

The main objective of the research is analyzing the banking reforms and the banking sector development indicators in Egypt. Thus, it can be concluded that the entrance of foreign banks to the Egyptian banking sector in the mid-1970s led to enhancing the role of the banking sector in financing the private sector activities. In the early 1990s, the Egyptian banking sector has gained its full liberalization which enhanced its role in financing different economic activities. The reform program in the mid-2000s was designed to allow the banking sector to be more efficient and competitive.

The reforms that were undertaken in the Egyptian banking sector over the study period had led to an improvement in the performance and the development of the banking sector.

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