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**THE ROLE OF THE PRIVATE MANUFACTURING SECTOR
IN ECONOMIC DEVELOPMENT IN EGYPT**

by

Loutfi A. Mazhar

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THE ROLE OF PRIVATE MANUFACTURING SECTOR IN THE ECONOMIC DEVELOPMENT IN EGYPT

Preamble

International experience demonstrates that globalization leads to greater convergence in competitive economic performance between world economies.

In order to compete and grow successfully, all countries will have to open up to trade, investment and business networking. This increasing economic openness and integration will impose new requirements on world markets, which desire to attract foreign investments.

Speed, product and service differentiation, new technology and innovations, ability and flexibility, and strong customer orientation will be increasingly important, in addition to the focus on cost and quality.

The ability of countries and companies to participate effectively in economic integration (example Euro Med Association Agreement) will depend on ability of government, private sector and business associations to create the conditions and institution to compete effectively in the world markets and create an environment conducive for greater economic development.

Egypt private sector has been expanding much faster than the public sector in its contribution to GDP in the past decade. Its contribution has increased from 61% in 1992 to 70% of GDP in 1998 representing a growth rate of 7.6% over 1997. When the annual growth rate of private sector's output is weighted by its relative share in GDP, the contribution to GDP growth increased from 2.1% in 1993 to 5.3% in 1998. This reflects the magnitude of the capital investment that was added to the Egyptian economy over the past decade. The annual average of investment has increased from about 4.5 billion dollars in the period 1991 / 96 to 13 billion dollars in 1999.

Table (1)
Private Sector contribution to the Economy of Egypt
1992 – 1998

	<u>1991 / 96</u>	<u>1998</u>
Growth rate of GDP at factor cost (%)	3.1	7.6
Contribution to GDP at factor cost (%)	61	70
Investment annual average in B\$	4.5	13.0 (1999)
Share in trade deficit (%)	75 (a)	76(b)

Source: Central Bank of Egypt, annual report

(a) Data is for 1994

(b) Share in Imports 61% and in Exports 36% for 1998

This sector is currently at the crossroads facing serious structural challenges that need to be carefully examined.

The main challenges are:

- The sector is increasingly coming under pressure from external competition, with the gradual removal of foreign trade barriers.
- Absence of a friendly institutional infrastructure that could provide necessary support and incentives for the sector to improve their economic performance and competitive standing.
- Inherit weakness in the sector's organizational structure, absence of good management practices and work procedures that would make their own existence vulnerable under the pressure of the consumers' growing demand for higher quality and competitive prices.

Unless all the stakeholders take corrective actions, the sector will face serious challenges that could lead to their demise.

This paper assesses the role of Egypt's private manufacturing sector in enhancing Egypt's productivity capacity both on the macro and sectoral levels. It emphasizes the role of the government and business associations in improving the allocation of resources, thereby expanding employment opportunities, raising living standards, increasing exports, improving efficiency and productivity, and acquiring new technologies.

Government and business associations should also cooperate in developing an industrial policy for Egypt. The absence of such policy leaves investment misguided and in many cases misplaced. The policy should draw a map for Egypt's manufacturing sector, identify its competitive advantage, suggest the sectors where SME's could be potentially competitive and the opportunities for linkage at local and regional level among many other areas that are vital for the development of the Egyptian industry at large.

Section I

The Role Of The Private Manufacturing Sector In Egypt's Economic Growth

In 1998 / 99 manufacturing sector had become the highest contributor to value-added at the national level, followed closely by commerce and agriculture. (see table 2)

Table (2)
Contribution by Sector in Egypt's GDP

	<u>1998 / 99</u>
Agriculture	17%
Commerce	17.4%
Manufacturing	18.9%

By and large, the private manufacturing sector was the main contributor behind this growth in the sector value-added as it contributed nearly three fourth of the total manufacturing output in 1997 up from 58% in 1992. Significant growth in private sector share occurred in food industries (from 53% to 75%) and chemical industries (from 47% to 68%).

The high growth of private manufacturing sectors (28% in 1997) (see table 3) became the driving force in the growth of the manufacturing sector. The private manufacturing sector, as one of the major contributors to the private sector growth is currently contributing nearly three fourth of the total manufacturing output or about 15% of the GDP up from 9% in 1996.

Table (3)
Private manufacturing sector performance

	<u>1996 / 97</u>
Growth rate (%)	28
% of total manufacturing output	74
% of share in GDP	15

The favorable performance of the private sector is mainly attributed to:

- Improved efficiency in operations
- Higher diversification in activities

The efficiency improvement is demonstrated by the increase of 30% in value-added by labour and 113% increase in the value-added by invested capital.

The contribution of the sector to productivity (see table 4) is measured by:

- Labour productivity which, measures the average output of labour (VA/L)
- Productivity of capital invested by measuring the incremental output to capital ratio (IOCR)
- Ratio of value-added to total wage, i.e. the average productivity per Egyptian pound spent on labour (AV/W)

However, it can be argued that higher labour productivity is not necessarily a good indication of efficient resources use since it may hide uneconomic capital intensive (labour saving) technology. It can also be argued that low labour productivity may be desired for labour abundant economies such as Egypt's case.

The average incremental output to capital ratio (ICOR) has increased during the period 1991 – 96 to 0.19, implying that one additional unit of capital generates 0.19 unit of output, which could appear modest, yet it is high in growth percentage when compared with the industry negative figures reported for the industry in the period 1987 / 90.

The value-added to total wage (or average productivity per pound spent on labour) has increased by 365 while total real wage bill increased only by 3 percent, it reached 2.93 for private sector exceeding the public sector productivity of 1.70 for the same period.

Table (4)
Productivity Indicators (1991 – 96)
Private Sector

VA/L (average output of labour)	6187	
IOCR	0.19	
VA/W (average productivity per pound spent on labour)		2.93

VA = real value-added or the total product at factor cost deflated by the whole sales price index.
Source: CAPMAS' National Economic Statistics

The percentage distribution of manufacturing value-added shows an increase for private contribution from 45 percent in 1991 / 92 to 70 percent in 1998 / 99. (see table 5)

In employment, the public sector's share, though declining, is still dominant by 60% according to the latest published data for the year 1995 / 96.

The private sector has consistently higher labour productivity as compared with public sector (as shown in table 5).

Average productivity of capital measured by the total value-added divided by the value of fixed assets at year-end. Private sector has a higher average than that for the public sector.

The private manufacturing sector has been consistently increasing its share in industrial exports relative to total industrial sales during the nineties, and grew from 23% in 1994 to 36% in 1998.

Table 5
Private Manufacturing Sector
Relative Position with Public Sector
(1996)

	<u>Private</u>	<u>Public</u>
Relative share in GDP (total production at factor cost 1996)	70%	30%
Labour (at constant 91 / 92 price)	40%	60%
Export % of total manufacturing	36%	64%

(1998)

The Structure of Egypt's private manufacturing sector has changed considerably since 1988. During the first half of the 1990's, the sector became more diversified than in the late 80's. The activities have diversified away from traditional activities such as food and textile industries to higher value-added activities like engineering. In terms of the generation of employment, textile and food employ more than 50% of the manpower employed by the whole private manufacturing sector.

The basic metal sub-sector is the most capital intensive, i.e. highest invested capital per unit of labour (about k\$10/labour).

Comparing the value-added per sector between the periods of economic reform (1988 – 91) and (1992 – 96 post reform), we find that engineering had shown the strongest growth among the sub-sectors. It reached K\$30 in constant 1987 / 88 prices, while second highest is the food industry with a value-added of K\$23 followed by textile at K\$18.

Structure of exports and imports of private manufacturing sector shows that engineering accounts for 26% of the value of imports of raw material and intermediates of the entire private sector. This is followed by food industries with 20%, basic metals 16%, chemicals 15% and textile 14%.

On the other hand, exports from same sub-sectors shows that textile exports 41% of total manufacturing sector exports followed by basic metals 14%, non-metals 13%, chemicals 12%, food 12% and engineering 6%. Textile and non-metals share a positive trade balance per unit value-added, while the rest of sub-sectors show a negative balance which implies that the import substitution policies that have been in effect over the past years continues to have an adverse impact on manufacturing sector competitiveness.

Three major factors share the responsibility of growth of value-added from the demand side. These are:

1. Growth of exports
2. The growth of local consumption from domestic production
3. The change in linkage patterns between local manufacturers

Growth of Export

Private manufacturing sector is responsible of 75% of total exports by the private sector. Textile represents 32% in total private sector exports followed by chemicals 17%, food 6.5%, non-metals 7.9%, basic metals (6.9%).

Total private manufactured exports grew at an average annual rate of 12% during 1995 – 98.

Sources of Growth in Local Demand

Local production is the major supplier meeting domestic demand for manufactured products. Naturally, this steady demand becomes the main driving force that stimulates the local production of manufactures. The correlation between these two variables is above 95%. Part of this higher

correlation is due to the fact that the production of local firm is targeting the local market with no plans of exporting. Egypt still has relatively high nominal tariff of weighted average rates 28% and high effective rates of protection (Nathan Associates, 1998) all these factors increase the cost of exporting to Egypt. This fact has a negative impact on the growth of market penetration index of Egypt. (See table 6).

The market penetration index shows that there is a general tendency to intensify the share of the imported component in the structure of domestic consumption of manufacturing products.

Table 6
Egypt Market Penetration Index (MPI)

<u>Sub-sector</u>	<u>Imports to local consumption</u>		<u>Market penetration index</u>	
	<u>1988-90</u>	<u>1991-95</u>	<u>MPI</u>	<u>Imports/ Output</u>
Food	18	21	22	26
Textile	5	12	5	10
Wood	65	74	194	298
Chemicals	22	23	28	28
Non- metals	23	11	34	12
Basic metals	29	33	40	39
Engineering	42	53	83	110

Based on the above data it can be concluded that the weight of imports in satisfying local demand is high for certain sub-sector such as wood and engineering. The high ratio of imports of wood is justified by the basic fact that natural resources vary by country. The high imports of engineering products/ components demonstrate that industrialization in Egypt is still at its early stages, since these parts and components are based on high levels of technology, skills and innovations. On the other hand, the increase of imports of components is a sign of the recent phenomena that contributed to the increase in intra trade and global production sharing (Yeats.1998).

Linkages Between manufacturing Sectors

For any manufacturing activity, the sum of local components measures the local dependency ratio of this activity. Positive changes in these ratios would result in reduced transaction costs for the investors. Moreover, increases in the dependency ratios would result in reduced transaction cost in local firm, which in turn would lead to reduced lead time to procure inputs for the production process.

For example dependency ratios are high for leather goods: leather shoes (69), steel industry (60). Rubber and plastic (51) ready wear garments (54), while they are low for furniture (20). Two types of manufacturing with low dependency ratio transport equipment (7) and machinery & equipment (29), both offer good opportunity for creating local industry for the manufacturing of engineering components which could also open a window of export opportunities through contracting, and partnership with foreign partners through outsourcing.

Section II **The Role of the Government in the Economic Development of Egypt**

II. 1. Government and Macroeconomic Policies

Macroeconomic stability is important for economic development, particularly for sustaining market competitiveness. This can be achieved by adopting policies that are seeking changes in the economy's structure of production and consumption by increasing the efficiency and flexibility of manufacturing to respond to market changes.

The fundamental choice here lies between the use of fiscal policy and the use of monetary instruments with implications for the extent to which intervention favours production versus consumption.

II. 1. a. Financial Systems

Monetary policy should be set by an independent central bank insulated from political pressure. Being shielded from political pressure, its policies would be seen by the financial markets as more credible.

Fiscal system should be immuned from inappropriate government interventions to change taxes for political reasons or apply tax retroactively. In fact, fiscal policy should be used to attract investments, and therefore once implemented; it influences the economic growth positively.

The most common component of fiscal reform could be:

Shifting revenue collection from import and export taxes to domestic sales and excise tax in order to influence consumption of certain goods, adopting value-added taxes, restructuring taxes on personal income and profit.

Studies suggest that fiscal policy is better suited to steering nominal demand, because once implemented, it affects the economy more swiftly than changes in interest rates. Furthermore, the effects of monetary policy tend to be spread less evenly across the economy than those of fiscal policy. For example, high interest rates and hence a stronger exchange rate squeezes manufacturers more than other business sectors.

II. 2. Government Policies and Competitive Economy

Government policies can contribute dramatically to growth. Competitive economies require not only stable and sound macroeconomic conditions, but it also depends on the degree to which the economy is integrated with the global market. This measured by the relative size of exports and the magnitude of FDI both are regarded as two important indicators for economic openness as well as international competitiveness.

Competitiveness in export growth and in attracting FDI can be achieved through relative cost advantage, exchange rate and aggressive trade development (Chinese experience). However, relative cost or price alone does not determine long-term competitiveness.

As a rule, countries that gain market share, also display faster productivity growth and rapid increase in technological capability.

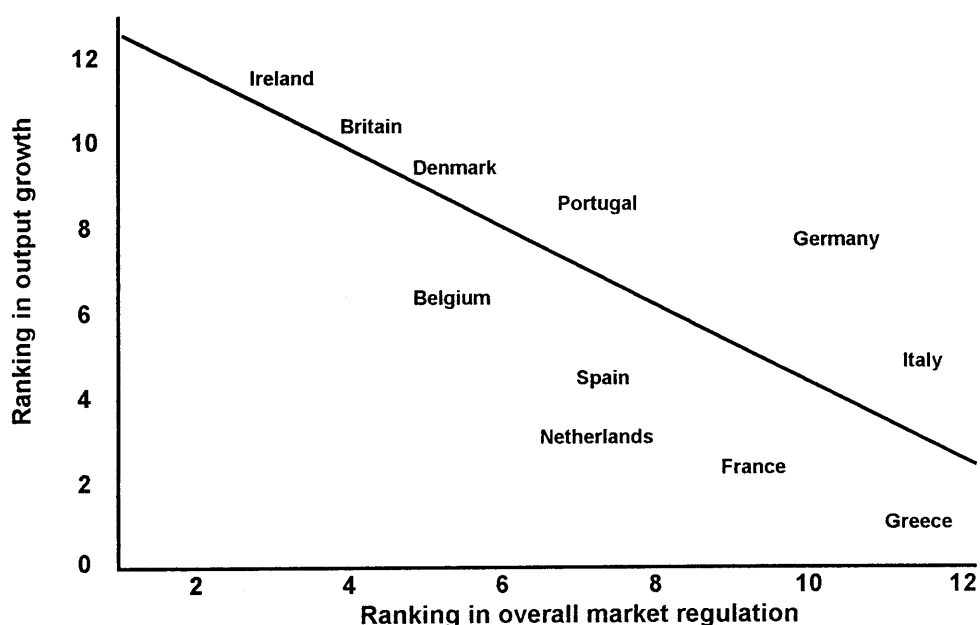
Flexibility in labour legislation, harmonious industrial relations, and lower taxes all support higher economic growth.

The Determinants of Government Policies on Competitiveness

- 1st. Better management of national economy by containing inflation, avoiding sudden currency devaluation, and collapsing external demand and domestic recession.
- 2nd. Removal of all barriers to information.
- 3rd. Applying good accounting practices and good corporate governance across all type of economic activities.
- 4th. Creating supportive institutional environment, institutional barriers arise from poor corporate governance and weak financial institutions.
- 5th. Balanced employment standards and regulations where pay is relative to performance.
- 6th. Focusing on solving most critical micro issues to economic growth and competitiveness such as:
 1. Priority to education and training and create a link between education and labour market.
 2. Judicial and political institutions to provide law “transition costs” and to protect property rights and exact legislation on competition.
 3. Bureaucracy and lack of transparency in government decisions and communication.

Many studies have shown a negative correlation between market regulations and output growth (figure 1). The countries with least regulations enjoyed the highest growth in output per person.

Figure 1
Output growth and Market Regulation



Source: World Bank, 1997

Section III

Challenges to Business Development

The major challenges faced by manufacturing industry are in such critical areas as:

III. 1. Financing

Access to finance at competitive interest rates for working capital and investment is an obvious requirement for creating and sustaining export competitiveness. Although banking systems in Egypt provide easy access to capital, yet a large number of entrepreneurs face difficulties in financing their business activities and in particular export credits at a reasonable and competitive cost.

III. 2. Marketing and Export

The most difficult step is still the first one - securing market entry and building credibility. The institutional support available in Egypt lacks on the ground experience and knowledge of the world markets and norms that govern international trade. Absence of well-reputed trading companies with experience in international trade is an impediment to sustain a position in the world markets.

III. 3. Business Development

The major challenges to the development of the manufacturing industry are:

a. Absence of good vision and undefined company mission

What business are they in, what is the fundamental purpose of their existence, how do they serve customers and what in their unique value?

b. Absence of well-considered strategy

What is required to achieve the mission, what is their distinct competence and competitive advantage?

c. Undefined organizational structure

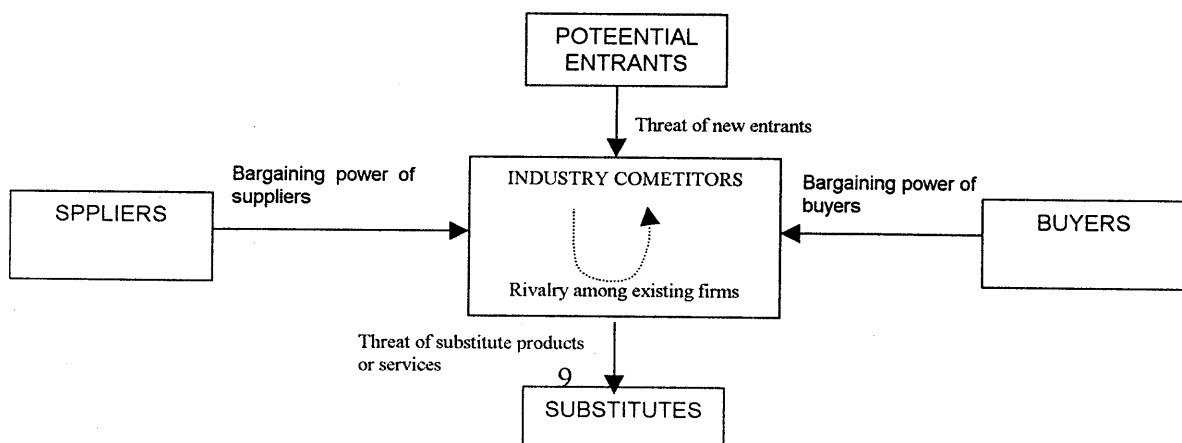
What are the characteristics of the business, what are their business values, what is the style of their leadership, how do they value their employees, how do they support creativity and initiatives?

III. 4. Building-up Company Competitiveness

For the purpose of this paper, we will only concentrate on the issues related to competitiveness.

Porter in 1990 integrated thinking on firms' competitiveness in terms of his famous "diamond" representing the five sources of competitive pressure; these are: rival company, potential new entrants, suppliers, customers, and substitutes.

Figure 2



Porter believes that any company has three generic strategies available for dealing with these competitive pressures. They are:

- Cost saving by careful management across the value chain (not price war)
- Differentiation by introducing special new features or design
- Focus on narrow market segments (niche) and achieve excellence there.

Of course, the choice of competitive strategy depends upon the structure of the industry in which the company competes (local or foreign market) and its position within the industry.

A structure analysis of the industry should answer questions concerning threats of new entrants and substitute products, the bargaining power of suppliers and buyers, the rivalry between existing competitors. These forces influence the prices that company can charge, the cost it has to bear and investment required to compete in that industry. Hence, such analysis will determine company profitability.

Egyptian entrepreneurs need to apply such business analysis techniques before taking any step in entering a new market local or foreign. They have also need to apply same analysis on potential entry by foreign producers or new investors targeting Egyptian market. They have to pay attention to define clearly their competitive advantages in cost and quality within the existing and targeted markets. They have to define which product varieties the market will accept, who are their distribution channels, types of buyer by geographical area within the same market. They have to choose the appropriate strategy that will serve best their objective such as differentiation strategy, cost leadership strategy, focused differentiation and cost-focused strategy.

III. 5. How to pre-empt new competitors and preserve your market position?

- ◆ This question reflects the concerns raised by the Egyptian industrialists towards the expected competitions coming from foreign markets and in particular from EU member countries after Egypt's entry into EuroMed Association Agreement.
- ◆ It has become critical for the manufacturing sector to look inside their own manufacturing plants for their method of operation, management practices, control and governance procedures... etc, In short, they need to look into every little activity: how it is carried out, is there a better way to do it cheaper and at better quality? etc.
- ◆ It is also suggested that each industry has to identify the potential entrant, its competitive advantage, what market segment, what niche it would be possibly targeting, and what activity within the value chain it has to focus on, that if it really wants to survive.
- ◆ Local industry should believe that they are formidable competitors as they are already established market participants; they have loyal customer base and brand recognition.
- ◆ Local industry has to assess the threat by following each source of information outward from its market, paying particular attention to "phantom firms".

- ◆ Develop a counter action plan based on the following:
 - Identify a consumer need that is not being met and establish the value the new activity will create and at what cost.
 - Identify how unique this new activity is and determine how long it can be expected to generate decent returns.
 - Plan for the right time to close down this new activity and have the next new activity ready to be launched when the current one begins to fail.
 - Monitor rival's competencies.
 - Respond by pre-empting competition, discovering newness in product or process innovation, which would open the door for stepping away from existing activity, exactly as a new contract might.

Section IV

The Role of Business Association in the Economic Development of Egypt

The private manufacturing sector was able to achieve high growth rates that activated the development and growth of Egypt 's economy in the past decade.

However the local market was the driving force underpinning these high rates of growth. Contribution of exports to growth was very limited.

Unless serious steps are taken by the state and private sector to increase the demand side through promoting exports, future growth of the private manufacturing sector becomes uncertain.

Such uncertainty will even become greater in the coming years when more barriers to trade will be reduced or eliminated and competition from foreign products crowded out domestic products.

To give an example where business associations could help in developing the economy of Egypt, we suggest four programs covering the critical factors to the improvement of Egyptian industry's competitiveness.

IV. 1. Improve productivity

Business association should run programs to upgrade basic production capabilities. These would include productivity improvement, promotion of total quality management (TQM), compliance with product quality standards, promoting design and R&D capabilities. Work with the government to establish productivity and technology development centers. It should also promote links with technologically advanced foreign partners, for possible partnership with local industries.

IV. 2. Improve competitiveness

Since competitiveness means the ability of the industry to take the most advantageous position or niche in rapidly changing environment, industry would expect their business association take the lead to offer services and support to member firms in the fields of organization of production, product and services development, value chain management systems, cooperative networks and alliances, human resources management.

It also called upon to participate with the government in creating the institutional framework for national competitiveness strategy, which is based on sound fiscal policy, better management of national economy, and balanced employment and human resources development policies.

IV. 3. Promote exports

While manufacturing industries receive more than half of total investments, manufactured products account for only a third of total exports.

Based on such weak performance in exports, business associations need to assist local industries in identifying the strength and weakness in Egyptian products, and identify the opportunities offered by export markets.

Create a ranking system within the industry and among the products for each sub-sector, according to the scale of their degree of competitiveness and draw a development strategy for the top one third of the ranked group.

In addition, they need to work with the government in assessing the merits of trade agreements (bilateral or multilateral) and identify the threats and opportunities associated with each agreement and explain them to the local industry.

It is also important develop export promotions strategy for each sub-sector in the target markets and to identify what assistance is needed from the government in terms of data collection or facilitating entry to foreign markets.

Then set a collective export target by involving all the stakeholders. Monitor progress and evaluate and publish results. It is also important to assist in solving trade disputes by creating a dispute settlement resolution mechanism through a collective agreement between the business associations in targeted export markets.

IV. 4. Targeting FDI for opening new export markets

While current FDI inflows have met the objectives of job creation and output expansion, most manufacturing projects have so far failed to boost exports. Such trend is worth investigating and raises another questions, which is, why Egypt does not attract investment in "offshore products" aimed at European or North American markets?

One reason arises from limited involvement of TNC's in manufacturing with export potential, such as food, textile, electronics and garments. The lack of FDI in such sectors also explains the difficulty of achieving good supply chain management when Egypt is not participating in the international value chain, at the firm level. Manufacturing enterprises need to raise productivity, improve product quality, product design and upgrade production management and work practices, raising organizational and managerial capabilities, and increase expenditure on R&D from the current low level of 0.2 percent of GNP or he natural level and 0.04 % of the GNP at the productive enterprise level.

Business association should take the lead in promoting investment in Egypt in cooperation with partner associations in the targeted markets.

Developing a plan for attracting FDI to Egypt is a must. The plan should identify the candidate fields of investment. It is important to involve all the stakeholders in this planning process. A short feasibility study should be prepared for the selected projects, emphasizing key competitive advantages the investors will enjoy as compared with the second best alternative location for same investment.

When preparing the framework for such plan, we should take account of the fact that FDI follows growth and does not lead it. This means that expansion of Egypt economy is a prerequisite for attracting FDI. Markusen (1997) identified country characteristics for attracting FDI. High-income countries are always major receivers of direct investment. Availability of skilled labor is another major factor in the investment decision in any market. In addition to other determinants such as host country economic liberalization, flexible business legislation and regulation, openness to global market, equal treatment with nationals... etc.

Therefore, business associations need to work with the government to improve the investment climate in the country in order to attract quality foreign and national investments.

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