

The Global Financial Crisis: Lessons for Egypt

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Let me first say on behalf of my colleagues from Harvard and other colleagues arriving here from the United States what an honor it is for us to be at this gathering, which has assembled so many of Egypt's government, business and academic leaders. Minister Atef Ebeid has also raised the challenge for us today because he has proven to us—and it makes me a little bit nervous—that things said in this room are remembered even after five years. Usually we feel a little bit safer than that, but with such careful attention and wonderful hospitality from our Egyptian colleagues, we have to be extremely precise and extremely careful to get it right because no doubt what we get wrong will also be remembered. We will do our best, Mr. Minister, to help you think through, at least in some small way, the highly complicated challenges that are facing Egypt and virtually all economies in the world.

It is also a sign of the times, and one of my major themes, that while it was once routine to begin conferences with a moment of silence, we now begin with a moment to silence your cellular phones. This is the changing world we live in. We are living in the most networked global society that ever existed and it changes everything. My major theme this morning is that at the very core of Egypt's economic challenge is the question of how Egypt networks with the rest of the world. For Egypt's long-term growth, it is the connection between this country and the rest of the world that, in my opinion, will determine the success which we believe in or the failure which we fear and try to avert. All through history it has been true that it is impossible for any country to stand alone; but never has it been so true as now, that the fate of an individual country's economy, society, stability, even culture and scientific progress depends on the nature and quality of its relations with the rest of the world.

Economists used to have a rather simple-minded view of economic growth: at the core of economic growth is simply investment. So if you can make more investment, you can

¹ Jeffrey Sachs is the director of the Harvard Institute for International Development (HIID); email: jsachs@hiid.harvard.edu.

have more economic growth. Joseph Stalin took this idea to its most extreme and destructive illogic, by thinking that if he could squeeze the peasantry enough, generate sufficient surplus and build enough factories, he would make the Soviet Union a great economy. We know today that it is not simply the quantity of investments, but the quality and nature of the investments, and even more importantly, the quality and nature of the economic linkages within a society and between a society and the rest of the world that determine the quality of life and the extent of economic progress. Much more important than the sheer physical volume of investment is the generation and diffusion of knowledge, the gains from specialization, and the benefits of being part of a large networked global system.

In a world in which both politics and technology are intensifying the global networks, the question that all countries face is how best to integrate the society and the economy into that global market space and marketplace. What the Asian experience has shown is that this must be done with care, because globalization is a double-edged sword. This is something we have known throughout history and poignantly in the history of this country as well. It is hard to think of another place in the entire world that has been more of a crossroads than Egypt.

Throughout 7,000 years of history Egypt has stood at the crossroads of great events transpiring between Europe and Asia. But that network has always proved to be double-edged. I think back 130 years ago to the opening of the Suez Canal in 1869. The Canal was financed by foreign borrowing. That inflow of foreign capital might have looked promising in the short term and surely did produce a physical investment of high return. The benefits for Egypt, however, were rather problematic. It did not take many years for that loan to go into default, and for Egypt in effect to lose its political sovereignty to the British Empire. Today the fate of countries in excessive debt is even worse—they fall into the hands of the International Monetary Fund.

How does a country maintain its strength, vitality, independence, and capacity while at the same time doing what it must do which is immersing itself in the global economy? There is no choice but to face up to that paradoxical challenge. The *Financial Times* publishes a list of the 500 largest publicly-traded corporations in the world. If Egypt wants to get a sense of the state of the world economy and the need to be

internationalized and integrated, this is a useful resource. Among the 500 largest companies, more than 99 percent of the value is found in the richest countries. The so-called advanced economies—whether they are defined by membership in the Organization for Economic Cooperation and Development or whether they are defined according to the World Bank's list of richest countries—account for about 14 percent of the world's population. They account for 99.4 percent of the world's largest 500 companies. Currently, the Middle East has just two companies on that list of 500, one in the United Arab Emirates and one in Saudi Arabia. Together those two companies have a market capitalization of \$20 billion out of the total capitalization of the top 500 companies of \$12 trillion.

This demonstrates where the money, the technology and the market power lies right now. This is no secret, but is simply a dramatic illustration of the reality of the global marketplace. I think it is a reflection of a deeper truth. For a country like Egypt to achieve its long-term growth, it is going to need the technology, the markets and the market access that comes with healthy connections with the advanced economies. But Egypt must do this carefully. With the world changing so fast, we do not even know exactly what 'carefully' means. Virtually no one saw the Asian crisis coming, and I will count myself among those who failed to see the crisis. While many of us saw weaknesses in Asia—at our institute, which works extensively in Asia, we could see many problems, and we wrote widely about them—we did not foresee the collapse; nobody foresaw the collapse.

We are living in an uncertain period and we have to do our best to understand how such events occur. How can countries take advantage of the world economy, as Asia did successfully for 30 years, but at the same time, avoid the mistakes that Asia made recently? On a broad level, I firmly believe that Egypt is in an excellent position to take advantage of the global network economy. This is an important starting point. I can not say that is true of every place that I have visited. Economics is like real estate. The first three benefits for an economy is location, location, location, and Egypt has it. Not only are we outside of the freezing temperatures of the Alps, but Egypt sits in a crossroads of international trade. It has a short shipping distance to the world's largest integrated market of the European Union. It has one of the most famous ports in all of the world

history in Alexandria, as well as important ports along the Red Sea and the Suez Canal. It has the essential attribute for success.

Second, Egypt has an incredible skill base and is known for the skills of the elite. In recent history, the skills have outrun the economy itself, so Egyptians are often economic leaders in other parts of the world where their skills have been in more demand until recent years. Egypt is a great provider of skills throughout the Middle East, in the United States and elsewhere. The question is how to harness those skills better for the Egyptian economy itself.

Third, Egypt is a country with a most remarkable quality of tradition. Traditions and cultural continuity play an enormous role in economic success. Of course, this is also the country that invented bureaucracy. Egypt has had 7,000 years to practice it, and does it extremely well. But the bureaucratic order is not necessarily ideal for the international network economy. One of the biggest challenges Egypt faces is to benefit from its traditions and to modernize the tradition of bureaucratic government. It is a difficult task, but I would say it is a central task for Egypt.

The reforms started in the early 1990s have definitely paid off in two ways. First, they helped Egypt to avoid a deep crisis. Second, they helped the country to begin a period of more rapid growth. It is fair to say that Egypt has not yet arrived economically at the place that it wants to be or needs to be. Growth is neither fast enough, nor reliable enough to produce the jobs needed by this growing population or to raise the living standards as rapidly as is possible, and growth is deeply desired. If I could put in a nutshell the one central problem that remains to be overcome, it is that broadly speaking, Egypt remains a high-cost environment in which to do business. It is still a high-cost business environment in many different ways. The cost of transactions, the cost of shipping, the cost of some key infrastructure—all of these make Egypt too high-cost to attract foreign investment and to hook into the global network effectively enough to enjoy the 7 or 8 percent per year growth rate—on a reliable basis—to which this country aspires.

Each year when we make our international rankings at Harvard, together with the World Economic Forum, Egypt is far from the bottom of the list of countries, but also too far from the top of the list. In the 1998 report, Egypt ranked 38 out of 53 countries. This ranking suggests that the costs of doing business in Egypt remain too high. This hinders

investment and impedes the crucial linkages that Egypt needs with the rest of the world.

I want to discuss three main areas: first, the macroeconomic dimension, then the microeconomic dimension and third, the business dimension. The macroeconomic dimension is relevant because of the Asian crisis. Our research at Harvard in recent years suggests that while the Asian economies had many microeconomic shortcomings, the biggest problem of the last two years was macroeconomic mismanagement and macroeconomic instability at the global level. That is the first theme that I would like to discuss. How can Egypt best avoid hitting a sharp bump in the road of the kind that Indonesia, Korea, Malaysia, and Thailand hit in 1997 and 1998? That was quite a big bump. These are countries that were growing fairly regularly at 8 percent per year and in 1998, had minus 8 percent growth—something that we can hardly imagine happening and that we surely want to avoid at all costs.

How can such a remarkable jolt happen to successful economies and how can it come in such an unexpected way? This is the real question. The first issue that Egypt must consider is simply how to avoid such a crisis. These crises, as best as we can determine, truly are avoidable but they require some foresight in order to avert them. It is important to watch out for the pressures that can build up and can explode in this kind of dramatic macroeconomic event. Why do successful economies sometimes completely collapse in that way? I think the answer lies in the very success of the economies themselves. It is precisely because those economies were so successful for so long that they became incautious and foreign investors became reckless and created the circumstances in which that kind of collapse could occur. In essence, the success of the Asian economies attracted a tremendous amount of capital from abroad. Everybody wanted to lend to Asia. Everybody wanted a piece of the success, but the nature of the lending was very risky and the way the lending was managed was quite cataclysmic in the short term.

The essence of what happened in Asia is that in the early 1990s, about the same time that Egypt was undertaking its macroeconomic reforms, the Asian economies began to open their banking sectors and their private capital markets to inflows of foreign loans. International lenders knew about Asia's success and they felt it was relatively risk-free to lend to Asia. The money came pouring in. In 1996, just the year before the crisis, five developing countries in Asia—Indonesia, Korea, Malaysia, the Philippines and

Thailand—attracted about \$100 billion of private sector capital, most of it from private international banks and mostly as short-term loans. Now, just as it was not sound to finance the Suez Canal with short-term debt, it was not wise to finance East Asian growth with 30-day bank loans. Everybody was so optimistic and lacking in caution that by the middle of 1997, when this crisis exploded, those five countries had attracted \$275 billion of bank loans of which \$175 billion were in short-term loans. At the time, the foreign exchange reserves of those five countries totaled approximately \$100 billion. So the short-term debt exceeded almost by two to one the short-term assets available to the country to repay the debts in the case that the foreign creditors decided to pull out their money. And sure enough, in the middle of 1997, the foreign creditors decided to withdraw their money. This was triggered by two events.

First, the devaluation of the Thai baht of July 2, 1997 made public the fact that Thailand had run out of most of its foreign exchange reserves defending an overvalued currency. When the devaluation occurred, investors got nervous. The second event was the arrival of the IMF team in Thailand. This is like going home and finding a few ambulances in front of your house—it does not calm your nerves. The IMF smelled gas, felt that something was wrong, and decided to light a match to find out what it was. It called for the closure of 58 finance companies in Thailand. It took a short trip to Indonesia and advised the Indonesians to close down 16 commercial banks immediately. There was no deposit insurance, so the chances of panic were high, but the IMF apparently did not worry about that. The IMF then went to Korea the following month and advised the Koreans to close 14 merchant banks. By the end of three months, the combination of short-term debt and the International Monetary Fund's advise produced one of the greatest financial panics in modern history with virtually all the bankers trying to get out of the region as fast as possible. You had a healthy region with some increasing problems suddenly suffering from an utter collapse of international confidence—that was a self-feeding process.

I like to tell my students the story of the two men that are camping in the American West. They are out in a tent one night and are sleeping peacefully. All of a sudden they are startled awake by a grizzly bear outside their tent. One of them starts to put on his Nike running shoes and the other friend says, "What are you doing? You can't outrun a

bear!" The first replies, "I don't have to outrun a bear, I just have to outrun you." That is how bankers behave: they just have to outrun their colleagues. They are running out of Brazil. They ran out of Indonesia, Thailand, and Korea faster than you could blink. International bank lending swung from about a \$55 billion inflow in 1996 to minus \$25 billion in 1997. They will call your loans under the right circumstances. The right circumstances are when the short-term debt is so high that they look around and say to themselves that only the first ones out can save themselves. That is what causes panics.

How does a country get into a position of such vulnerability? In a ratio, there is a top and there is a bottom. So if the ratio of short-term debt to reserves is very high, one must look both at the debt and at the reserves to understand how the ratio got so high. Undoubtedly, mistakes were made both on the top and the bottom of that fraction. With respect to the debt, Asia made a fundamental mistake that Egypt has not made: it opened up its capital markets completely and exuberant international bankers who did not know much about Asia, except that it was growing, were eager to lend a substantial amount of short-term funds. Over and over again in history, short-term borrowing has proven to be a disaster; so keeping limits on short-term borrowing makes ample prudential sense. It is a good idea for governments and central banks to tell their banks: 'stay out of trouble; you are not allowed to borrow short term except for some very limited trade finance.'

There is also the problem of the ratio's denominator: the reserves. The reserves were low in Thailand, later in Korea and now in Brazil, because of the exchange rate system. Those countries thought that stability would come from pegging the exchange rate permanently by linking it to the dollar. But when the markets turned on Thailand in 1996, the dollar strengthened significantly compared to the yen, the Thai real estate boom started to falter, and when some of the big firms in Korea went bankrupt; the currencies proved to be overvalued. So even before the crisis, depositors were converting their money into dollars, running down the reserve levels, making the countries more and more vulnerable to that grizzly bear at the door of the tent, hence financial panic. The fixed—or pegged—exchange rate system increased the chances that the country would fall down in its reserve levels.

The same thing happened in Brazil last fall in a kind of slow motion replay of this crisis. Again, the IMF gave the wrong advice in the lead-up to the crisis. It told Brazil to

maintain its fixed exchange rate and that the IMF would lend it \$40 billion to defend it. That was a poisoned chalice: taking money from the IMF to defend an overvalued currency does not work. So in the case of Brazil, just as in the case of Thailand and Korea, the speculators came to understand very well that the currency was overvalued, they started to convert their deposits into dollars and the reserves went down. In just three months, between October and January, Brazil spent \$40 billion defending its currency before it collapsed. How could \$40 billion be spent when everybody know that the currency is overvalued? There is only one way, and that is if the IMF rushes forward and gives \$40 billion more. Eventually, Brazil nearly ran out of money, the currency collapsed and now they are in a deep crisis.

Simply put, the lessons are: do not borrow short term and do not believe that exchange rate pegs are, should be, or can be forever. When there are signs of growing overvaluation, do not waste and risk reserves defending an overvalued currency. Let out the pressure gradually and slowly according to market forces; do not build up pressure until it finally explodes. That is, unfortunately, what Thailand and Korea did. Face the facts early and there should not be problems when sitting on the stronghold of reserves. If all the reserves disappear, then a truly massive crisis will occur. Macroeconomically, the lessons are not hard to see even if it is hard to predict exactly when a panic is going to occur.

There is another essential point to realize. It is not good enough to say, okay, the world is a dangerous place; we will do it on our own. This is simply impossible; perhaps unfortunately, but it is. The necessary technology, markets, scale of production, and networks are not to be found mainly within the Egyptian economy. They are found between Egypt and the rest of the world, mainly in the Middle East and in Europe, because geography matters. Egypt needs the world, but it needs to connect in a healthy way, with a flexible exchange rate regime and prudent short-term borrowing, but with great commitment to making the most of networking with the rest of the region—North Africa, the Middle East, Europe—the region for which it is a crossroads.

To make those connections work more effectively, it is important to recognize that there is a lot of work to be done. It is fair to say that between the early 1950s and 1991 the Egyptian economy had largely cut itself off from world networks. Reconnecting those

linkages takes time and effort, and those linkages are not yet strong enough. Egypt is, however, well positioned to do rebuild them. I work in many places where it is almost impossible to make the linkages. Mongolia, for example, is 1,500 kilometers from a port. What kind of linkages can you make? In many places in Central Africa, there are no linkages because it is too expensive, too dangerous, or too costly to make them. The geography benefits are absolutely clear, but it is time to harness them more fully.

I would like to make several other points that come from our study of competitiveness. The first is the recognition of the strong engineering talents in this country. The ability to harness the technology, to be host to foreign direct investment, to have alliances with international firms—clearly this is all present in Egypt but not yet operational enough. Where are the weaknesses? Our report highlights several which are quite similar to earlier reports. First, in our networked economy, information technology itself is crucial. Egypt does not rank high as a country that has embraced, adopted, and is utilizing the new information technologies. It is near the bottom of the list in Internet usage, computerization of society, costs of networking, telecom's cost-effectiveness. Simply, the information technology itself is a critical area where national policy should harness foreign capital by opening the sector, making it completely competitive, encouraging low-cost Internet service providers and working with schools, the Ministry of Education, and the private sector to enhance computer literacy and information technology throughout the Egyptian society. This is crucial for networking effectively with the rest of the world.

Let me give you an anecdote which as business leaders you know, but I cannot help but stress it for the government officials and businesspeople as well. I recently visited a modest apparel company in Mauritius. This is a company that cuts fabrics, makes clothing and sells it mainly in the U.K. markets. This is the kind of business that one would expect to flourish in Egypt. They were telling me that they are facing increasing competitive pressures in global apparel. And even though they have been established for 20 years and have good relationships, they are being pressured by their buyers in London to improve the timing of deliveries, the reliability of deliveries, and the information flows on the progress of every order. So they have installed a business intranet, that is, an electronic network for their suppliers and themselves, so the supplier can easily find out

exactly the status of the order: when the ship is leaving, whether the mails or cotton have arrived, whether the stitching has been done; exactly the progress of an order in real time. The microchips on the products are tracking the order all the way from the Indian cargo ship, to Mauritius, to London. They said they have to do this because if they are not fully technologically integrated with their buyers in London, they will seek different producers that are closer and more reliable from a logistical point of view.

My point is that this is a humble firm. This is not the highest of high technology, but the business cannot survive in this world without harnessing the information technology at absolutely lowest costs. It required local programmers and low-cost Internet service providers to make this necessary network with its buyers. We are all going to be in that situation soon. Is Egypt networked? And the hardware and software aspects of that are critical. Egypt scores much too low in these respects.

Second, in general, the competitiveness survey suggests that the adoption of technology here is too slow. Egypt needs a more ambitious technology policy. All over the world, the strongest technology policies are those that link local universities and local business as the cornerstone of technology improvement. This is unusual in most countries because in most parts of the world, universities are too political and isolated from the business sector. But in the successful economies, business-university links are critical. Whether it is Route 128 in Boston with its numerous universities or Silicon Valley with Stanford University, those linkages are critical. They need to be harnessed more in Egypt. I do not believe that all the focus should be primary education. I think focusing on primary education is important, but higher education is crucial to harness technology and to make the linkages with competitive businesses.

Third, and finally, it is clear that the cost of contracting in Egypt—that is, the cost of writing contracts and, worst of all, trying to enforce them in court—is far too expensive for an effective economy. The court systems are near the bottom of the international rankings. The honesty, the impartiality and the efficiency of the process ranks low. Without contracting, without the ability to enforce contracts, it is hard to have a complex division of labor in society and it is difficult to attract international business. The judicial system needs to be overhauled quickly, to get it working properly and to carve out an efficient business court system. Four, five, six years waiting for a settlement is not

adequate in a modern economy. This is highlighted clearly in our surveys.

Let me stress again that through prudent policies, Egypt can avoid the crises that have hit so many other emerging markets. Egypt has taken a sound step in being extremely cautious on short-term borrowing. Caution is necessary for remaining monetary and financial policies as well. These serious crises can be avoided by ensuring that the banking sector is healthy, that the exchange rate remains market-determined and flexible enough to avoid big shocks, and by pursuing long-term capital rather than short-term capital. Finally, avoiding crises is hardly enough for a great country like this. Egypt needs long-term, rapid and sustained economic growth. This requires science, technology and most importantly, close, active, and fruitful linkages between Egypt and the rest of the world. The rest of the world is eager for these linkages and I am sure Egypt is too. For this we can be deeply optimistic about Egypt's future prospects.