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Harnessing the storm

Any crisis brings both challenges and opportunities, writes Minister of Investment **Mahmoud Mohieldin**. To emerge healthier and stronger from the current financial turmoil we must learn from past mistakes and the experience of others


Mahmoud Mohieldin

Fifteen years ago a Chinese friend of mine at the University of Warwick used to repeat a Chinese saying: "May you live in interesting times". At the time I didn't know whether it was a good wish, a prayer, or a prophecy. On asking him whether what he intended was good or bad, he always replied that one day I would know.

Today, when interesting times have arrived in the form of a global crisis, I appreciate the positive part of the Chinese saying. Living through the crisis is an achievement in itself for many people. Surviving the crisis and learning from it is another. The kind of experience we are gaining, and the actions we need to take to avoid repeating the same mistakes in the future, could come to constitute virtues.

The causes of the current crisis are a textbook example. First make the markets inefficient. This is done simply, by creating distortions, and by a lack of dependable information on which decisions can be based. Then the bad can be sold as good, high risk as low risk, sub-prime as prime. Next make regulations ineffective: it is easy to pretend to adhere to best practice while doing the opposite.

Inefficient markets and ineffective regulations are the two main ingredients of any crisis. Just mix them and wait. Such is the lesson we didn't learn from the crises of 1907 and 1929, and from the more recent emerging markets crisis in 1997.

One common feature of all crises is that they do end. The bad thing about this is that the end is not fair. Many people will pay the cost of recovery who were not involved in the development of the crisis. They may well never have heard of sub-prime markets or of Lehman Brothers.

Today we are seeing interesting proposals for reform and stimulus packages as well as attempts to bail out institutions. My concern, though, is about more fundamental issues.

We will soon be seeing double digit budget deficits in many OECD countries. In the developing world and emerging markets the negative impact of large and unmanageable budget deficits has long been understood.

They fuel inflation and crowd out the private sector. When developed countries start to run huge budget deficits we will see a global crowding out effect. It will be very difficult for any developing country to get the funding it used to get.

A second issue of concern is the threat of investment protectionism and growing resistance against mergers and acquisitions of some assets by foreigners. Though there is some hope in OECD initiatives on freedom of investment the tendency towards protectionism remains alarming.

There are unhappy signs of the return of mercantilism that will complicate the lives of traders even further. Protectionism comes with populist justifications such as that tax payers, who are picking up the bill for any bail outs, expect their money to be spent at home. Protectionist policies may make headlines and do the trick in the short term for some politicians but history shows that they work against the benefit of everybody in the long term.

We are seeing a variety of inward-looking measures on the part of many developed countries. Together with the ongoing failure of the Doha round of the WTO the future flow of trade is at risk.

Some responses to the crises lay the ground for future problems for very obvious reasons. We are creating a moral hazard by failing to put in place effective safeguards or screen and monitor what exactly is being bailed out. It is very likely that we will see the emergence of financial zombies, lame ducks in the financial sectors of many developed countries that will have a serious impact on international finance. The problem of inefficient and confused financial institutions is going to be with us for some time yet.

Meanwhile, projections for the net flow of capital to emerging markets are far from encouraging. The Institute of International Finance (IIF) expects that the net flow of capital to emerging markets this year will fall to $165 billion, a decline of 65 per cent compared to 2008 and of 82 per cent when compared to the boom year of 2007. Then emerging markets saw $929 billion of net capital inflows. Countries in the region that used to attract decent injections of capital inflows, including FDIs, portfolio investment and syndicated loans, will find it much more difficult in the next few years.

Against this background the very notion of "doing business" is being challenged. Yet I do like to emphasise that we are carrying out reforms of business environment for the sake of small and medium enterprises, for companies that have no privileges, for companies that can't survive or grow without a path for their very existence being facilitated.

We must continue removing obstacles, getting rid of bottlenecks, dealing with inefficiencies, and create a competitive platform for businesses. We must do this for the emerging generation of entrepreneurs who are pushing for competitiveness, government openness, greater competition and contestability. This new generation is different from the old generation of business associated with the partial liberalisation measures of the 1970s and 1980s. They were very much dependent on protectionism and direct and indirect government support.

In Egypt, 90 per cent of corporations have issued capital of less than LE10 million ($1,8 million. Seventy per cent have issued capital of less than LE1 million ($182,000). In implementing reforms and improvements to procedures governing starting a business, issuing permits and registering property we are serving the majority of companies in the business sector which contribute to job creation.

Over the past four years Egypt has been listed among the world's top 10 reformers of the business sector three times. Saudi Arabia, Morocco and Tunisia have also made significant reforms in four major areas in doing business. Yemen has managed to move up 128 points in the area of starting a business.

Some reform measures are easier to implement than others. Reforming procedures for starting a business, for example, requires a clear mandate, supportive legal framework, coordination, and the necessary software to establish a one-stop-shop. Nor is getting credit such a big deal. It is not really a problem of availability but of the procedural steps necessary to improve access, which includes the operation of credit bureaus and other institutions. But there are other, more complicated reform areas, not only in this region but in other emerging markets. They include the flexibility of labour markets and the complications of hiring and firing; contract enforcement and the processes for closing a business which need sophisticated legal arrangements, bankruptcy procedures and clear exit mechanisms. This relates not only to bankruptcy codes but to mergers and acquisitions and to liquidation procedures.

Countries in the region are learning from each others' experience and are positively competing. One example of this happened two years ago when Egypt reduced minimum capital requirement from LE5,000 to LE200. Other countries in the region picked up the signal and went further, completely eliminating any minimum capital requirement.

Egypt's reforms are made within the context of a comprehensive reform agenda which has resulted in 25 per cent growth in domestic private sector investments during the last four years, and enabled us to achieve high and sustainable real economic growth. The international ranking of Egypt as an FDI recipient has improved as per the UNCTAD report from 126 in 2003 to 20 in 2008.

The reform efforts and the fundamentals of private sector-led growth are now being challenged. Developing countries don't have the luxury of time to spend on the same old market versus state debate. Obviously we need both -- the state to play a regulatory role and protect rights and the markets for their efficiency in allocating resources and enhance competition and productivity.

In our culture we believe that "with hardship comes ease". And with the obvious challenges of fighting poverty and unemployment there are also opportunities.

First there is the decline in food prices. In Egypt inflation will have fallen from double to single digits within the coming few weeks which is good news for low income groups.

Second, the decline in the price of building materials will have positive implications for the infrastructure projects which are being encouraged by the government's stimulus package. Supported by coherent social policies, they will ultimately benefit the poor and underprivileged, providing them with road networks, clean water supplies and sewage systems and public goods and services that enhance opportunities for all members of society to benefit from sustainable development.

Third, although Arab countries with surpluses received a big hit because of falling prices of oil and other financial assets, the fact is that if the price of oil drops to just $25 per barrel proceeds until 2020 it will not only equal receipts over the past 15 years but exceed them by 25 per cent. Surpluses will be looking for opportunities, particularly in tangible investments and the productive sectors of the real economy.

Meanwhile, we need to learn from others' experience of sustainable development, including Asian countries, which shared five fundamentals on their path of high growth.

- Openness and integration with the rest of the world. As I said calls for protectionism will not be good for developing countries which cannot sustain growth on the basis of their own resources. They need further capital inflows to supplement domestic savings, they need to export to enhance the effective demand for their products and, more importantly, they need transfer of knowledge.

- Macroeconomic stability, including price stability and controlled budget deficits.

- The accumulation of savings which allowed them to invest in infrastructure and in human capital through high quality education and health services.

- Resource allocation through efficient markets and effective regulations.

- Leadership with the vision to see through crises and committed to achieving the objectives of sustainable development.

We must work more, and faster, to prepare for the recovery which will come eventually. We must develop the infrastructure of our economies and enhance the quality of governance. Nor can we afford to take our eyes off the ball of sustainable growth which will avail decent job opportunities for all, stabilise the macro-economy and reduce inflation. To fulfil these objectives we need to resort to common sense and flexibility, boost the spirit of cooperation and openness and reject calls for futile intervention measures.

This article is based on a speech given at the Regional Forum on the Investment Climate in the Southern Mediterranean Region and the Middle East held last week in Rabat.