Should State Firms Borrow Foreign Exchange?

By Khaled Fouad Sherif
Special to the Middle East Times

IN EGYPT, a permanent dependency has evolved between state enterprises and the central government with regard to their requirements for foreign exchange. In many cases, especially during the late 1970s and early 1980s, Egyptian public sector banks were obliged to borrow abroad on behalf of various state enterprises and were then forced to absorb losses when the enterprises in question failed to make adequate returns on their investments.

Even in cases where state firms have been able to repay their foreign currency loans in domestic currency to public banks many of these banks found themselves holding sizable liabilities in foreign currencies, with their corresponding assets in Egyptian pounds.

Since state enterprises in Egypt borrow hard currency from public banks and then are required to return these sums in domestic currency, the public banking system alone is burdened with the problem of obtaining foreign exchange. And the servicing of the debt in foreign currency becomes solely the responsibility of the central government.

Over the past three years, especially, a series of currency devaluations has meant sizable exchange rate losses for state banks and accrued benefits for state enterprises. In Egypt, for example, according to some estimates, the associated foreign exchange losses of the banking system averaged roughly 1.6 percent of gross domestic product (GDP) between 1987 and 1990.

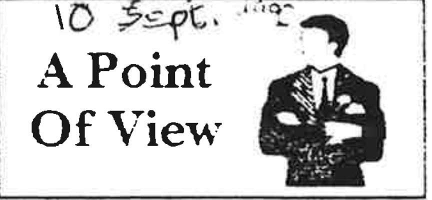
Today, state enterprises are under strict instructions to avoid borrowing from public sector banks to finance their revenue shortfalls, and the objective of removing public firms from the state budget is in effect an attempt to achieve a balance in the accounts or even a small surplus. Yet many public firms, especially those incurring heavy losses, continue to be financed by credit from the banking system in the form of overdrafts.

Thus, monetary growth is still rapid despite the government's stated policy of controlling the fiscal deficit, primarily because of overdrafts and the foreign exchange losses that are borne by public sector banks on behalf of state firms borrowing in foreign exchange.

As long as the government remains the main source of foreign borrowing for state enterprises, monetary growth will likely continue to be a problem over the next several years.

In some cases, though, state enterprises are allowed to borrow foreign exchange directly without having to go through the public banking system. The servicing of the debt in such cases becomes the responsibility of the enterprise rather than the central government.

These kinds of borrowings usually are suppliers or buyers credits and are guaranteed by public sector commercial banks. However, it is not unusual for many public firms to eventually transfer the burden of this debt, along with its servicing, to the central government.



Direct borrowing by state firms is regulated by Circular Number One of 1978, which states that all loans having a maturity that exceeds one year must be registered with the Central Bank. The registration includes various approvals, among them the required endorsement of the loan by the Loans and External Debt Department (LEDD) of the Central Bank.

All loan guarantees by public banks must be approved by the LEDD and all repayment conditions must be endorsed by them as well. Loans of less than one year, though, do not require the approval of the LEDD but are handed to the Foreign Relations Department of the Central Bank for endorsement. Before 1984-85, the provisions of Circular One of 1978 were not implemented strictly, and state enterprises had considerable freedom to obtain external loans directly.

The approval requirements of the Central Bank were simple and they were not a serious burden on state enterprises. This flexibility led to some very unhappy results and most state enterprises which received external loans did not assume the responsibility of servicing them. In many instances they found ways of shifting the burden away from themselves to the central government.

For example, the Egyptian Railways (ER) acquired various external loans in the early 1980s to finance their investment programs in the hope that if fares were raised considerably they would be able to service their debt in local currency.

They hoped to raise enough local currency and then seek the assistance of a public bank to pay off their outstanding foreign exchange liabilities. Even though fares were raised, ER was never able to make even the required Egyptian pound payment to service their foreign currency loan, and the full burden of this debt was eventually shifted to the state. After this incident, in January 1985, the government made it clear to ER that it could no longer directly negotiate foreign borrowing schemes without central government guidance.

All types of foreign loans with a maturity of more than one year were controlled from that date on by a cabinet committee under the auspices of the Central Bank. The major bottleneck now faced by state enterprises is simply finding foreign exchange outside the public sector banking system, which is currently facing serious liquidity problems and is unable to meet the various requirements of public firms. Given Egypt's current creditworthiness problem and its lack of agreement with the International Monetary Fund (IMF), finding this kind of foreign exchange abroad is no simple task.

Of course, there are advantages and disadvantages of both too liberal exchange access guidelines and non-liberal access regulations. By letting state enterprises go to the free market to acquire their own foreign exchange at their own risk without government guarantee and without having to go through the state banking system, public firms are likely to be able to manage their operations better and queuing in line for foreign exchange will likely come to an end.

The government is now saying to organizations such as the IMF that it will soon allow state enterprises to seek their own foreign exchange without being forced to deal with the public sector banking system in an attempt to give these firms more autonomy in managing their day-to-day operations and to avoid bottlenecks now associated with foreign exchange queuing. Is this a good thing?

Probably so, if the government unifies exchange rates in the process and allows for additional price liberalization to ensure that firms come up with the liquidity necessary to not only acquire black market dollars but to service foreign exchange loans that they are likely to obtain under this proposed new system.

Without price liberalization, the government may find in the end that many public firms continue borrowing foreign exchange and shifting the burden to the state, as was the case with ER. Price liberalization will be a key element helping to make this new foreign exchange acquirement scheme work, and it is this kind of autonomy that is also required if state firms are expected to survive on their own without central government assistance.