EGYPTIAN PRIVATE ENTERPRISES IN THE AFTERMATH OF THE REVOLUTION: AN INVESTMENT CLIMATE UPDATE

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Introduction: The January 25th Revolution is an enormously important political event for Egypt, but attention to its economic consequences is also vital. The Egyptian revolution reflected a popular movement in favor of dramatic changes in the way citizens were governed and the way resources and opportunities were distributed in society. Expectations were extremely high, especially among the youth, for a new era of a more responsive government and an economy that offered employment, more inclusive growth and stability. Prior to the revolution, Egypt had high unemployment rates. The unemployment rate for 15 to 24-year-olds in particular was estimated at 33%.

Along with profound changes resulting from the revolution there were accompanying substantial economic disruptions. Unemployment has been sharply exacerbated by the estimated loss of almost two million jobs in tourism and the crash in remittances resulting in part from the return of over 80,000 Egyptian workers from Libya. Tales of disruptions, supply interruptions, property crimes, and financing problems abound. In addition, in response to a public outcry over excesses of the prior regime, a number of investigations were launched, which included prosecutions of some prominent entrepreneurs; reversal of select land allocations and licensing approvals, and reversal of at least one major enterprise privatization.

Initially, the events of the Revolution and its aftermath imposed a substantial shock to the economy. Private firms reported significant setbacks in terms of sales and exports. Given that their use of capital and labor has shifted less than sales, productivity (output/inputs) sharply declined. Smaller firms suffered especially badly, reporting larger declines in sales and slower recovery.

Firms’ own identification of constraints place uncertainty at the top of their problems – uncertainty about the macroeconomic situation, including aggregate demand and prices, uncertainty about the unstable political situation and uncertainty about the regulatory policies they face – including potential changes and arbitrary administration. By 2012, concern about corruption had risen to the top 3 constraints, and concern with crime and theft rose to the top five for the first time, suggesting an overall decline in the state of crime prevention, security and legal observance. Transport, which had not been a leading constraint before 2011, now rose to the seventh most commonly identified serious constraint.

The “bad news” of the aftermath of the revolution was a period of economic disruption, where private demand sharply contracted and the output of firms fell substantially. Given that most firms tried to maintain their levels of capital and labor, this meant...
a sharp decline in productivity. By 2012, sales and productivity had recovered part way to their former levels, but firms had clearly made some labor force reductions and continued to confront lower demand. The decline in growth expectations and a pervasive sense of uncertainty suggests a strong need for a new Government to encourage private-led growth and to take key actions to signal credible commitment to this strategy.

Private enterprises in June 2011: In June, 2011, a Rapid Assessment survey of 360 enterprises found that firms confronted a significant worsening of certain constraints to their operation, led by macroeconomic uncertainty (especially reduced demand, but also inflation), political instability, and regulatory policy uncertainty. Firms in tourism were especially likely to report a worsening of uncertainty and instability. Many firms had lost substantial days of business to civil disorder, and 14% had experienced a significant loss due to crime. Some firms experienced disruptions in supply logistics, while many experienced a higher cost of finance. Sales for the sample of firms were down by an average of 20%, although SMEs reported suffering a considerably higher sales decline than did large firms and the average tourism firm reported losing the great majority of its sales. Exports for the sample of firms had declined by an estimated 45%, with firms of all sizes experiencing a substantial decline. Firms in construction and tourism reported the greatest reductions in employment. However, with regard to sales, exports and investment, firms were quite optimistic about recovery and predicted rapid growth within two years. Regarding employment, firms responded that the general economic situation in Egypt and wage inflation would have the strongest impact on their hiring of additional workers.

Private Enterprises in April 2012: In March and April, 2012, at the request of General Authority for Investment (GAFI) for an update on the performance of firms in the latter part of 2012, the World Bank surveyed 295 of the respondents to the 2011 Rapid Assessment by telephone. The sample, distributed across the same six cities, comprised 14% microenterprises, 39.7% small enterprises, 33.5% medium enterprises and 22.9% large enterprises. 66% of firms were in manufacturing, while 34% were in services and construction.

If the first half of 2011 was a story of decline, the second half was, for all categories of firms, a period of recovery (figure 1). Driven by a strong improvement among large firms with large sales value, sales for the entire sample was 14% higher in the second half of 2011 than in the first half. For the entire year of 2011, large firms sampled actually experienced a small, nominal increase in sales (2%), but the average micro, small and medium firms reported a substantial decline in their sales (figure 1, “unweighted”). This overall trend was marked by substantial losses in the first half of the year, and modest gains in the second half of the year.

Figure 1: Weighted firm sales increased in the second half of 2011 compared to the first half.

Expectations for 2012, already shaped by the first quarter’s experience during the April survey, had moderated but were positive with a return to positive sales growth overall, a recovery of exports to their pre-revolution level and a modest upturn in investment. However, the picture for employment was less positive – firms reported that, for the year, the total number of jobs in the sampled firms

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3 Surveys do not reflect exit’s impact on employment and oversample certain rarer types of firms, so the experience of the sample cannot be directly extrapolated to the macroeconomy.
declined 9.4%. This reflected a 9% decline among large firms, 11% for medium firms, 21% for small firms and 23% for the microenterprises surveyed. Expectations for job growth for 2012 were low, except among small firms, which expected a significant rebound.

By the time of the 2012 Rapid Assessment (in a period with numerous uncertainties about the Parliament, Presidential elections, the Constitution and the interim Government), political instability had risen in rank to a dead tie with macroeconomic uncertainty. Each were identified by an extraordinarily 95% of respondents as major or severe constraints to their operation. Corruption was now identified by 85% of firms as a serious problem, a huge increase.3 A substantially higher proportion of firms also identified “regulatory policy uncertainty”, “crime, theft and disorder”, “informal sector competition” and “transport” as serious. One quarter of responding firms had now experienced a significant crime, resulting in a substantial average loss. For the first time, transport problems emerged among the top 7 constraints identified by firms. Addressing these priority constraints poses a critical challenge.

Productivity in Egypt after the Revolution:
Private-led growth is critically related to the ability of private firms to increase productivity. The immediate effect of the dramatic fall in demand in the aftermath of the Egyptian Revolution was a precipitous fall in productivity. As firms kept investment and labor force as stable as they could, sharply reduced sales meant that less output was being realized per unit of input. Thus total-factor productivity (TFP) in sampled enterprises in June 2011, after having shown encouraging growth in 2008, showed a dramatic decline. TFP could not be tracked in 2012, but evidence on labor productivity is encouraging. Overall, labor productivity for the cross-section of surveyed enterprises, which had fallen dramatically as measured by the 2011 survey, had recovered to above its rate in 2004 and 2006, although not to its level measured in 2008.4 Sectoral analysis shows this pattern throughout, although a weaker rebound in the chemicals/pharmaceuticals sector and a strong rebound in metal industries. The overall picture is one of recovering but not fully recovered productivity. Egypt has not yet reached even its level of four year ago, much less resumed its trajectory of productivity growth. This places added urgency on an agenda of investment climate reform and strengthened market support institutions and services.

Expanding Access to Finance
Egypt stood out for the unusually low rate of access to bank loans experienced by private enterprises. Overall, the percentage of firms with a loan in both rapid surveys was higher than that measured in 2008. In the April 2012 survey, 24.5% of firms reported having a loan or line of credit, including 13% of microenterprises, 16% of small enterprises, 22% of medium enterprises and 48% of large ones. In the earlier 2011 survey, 21% of firms reported having a loan or line of credit. This reflects a substantial increase in access since 2008 when 13.4% of firms reported having a loan or line of credit. Why has financial access broadened recently? Part of the explanation is continued policy and programmatic reforms to expand MSME access to finance, such as the expansion and extension of credit information and launch of an SME database in all governorates, and the Central Bank of Egypt’s clear strategic priority on SME finance. Another lies

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3 Respondents’ evaluation of constraints to their operation is understood to relate directly to the marginal shadow cost of the constraint to the firm. An increase in severity would indicate the cost imposed by the constraint – either directly or through foregone opportunities – has grown.
4 The data does not specify why productivity rebounded, although the most likely explanation is better sales in the second half of the year. Cost-cutting and a reduction in production disruptions may also have contributed.
in counter-cyclical strategy pursued by some state-owned banks in order to build market share. They have consciously expanded SME lending at a time of economic hardship and Government crowding out in financial markets.

Nonetheless, the reported average amount of bank finance received remains small, amounting to 2.6% of working capital and 1% of investment capital. Of firms that didn’t have a loan in 2012, the overwhelming majority reported they had never applied for one. In 2011, high interest rates deterred 11% of firms without loans from applying, but by 2012 only 1.4% reported this was the main reason for not having a loan. In 2011, 48% of firms expected interest rate to fall, but in 2012, only 6% expected this. Instead, in 2012, 80% of firms expected interest rates to hold steady. Finally, although in 2011 about 30% of firms faced some restrictions on their access to foreign exchange, by 2012 this was at only 5%.

New Insights on SMEs - Breeding “Gazelles”: Unemployment is MENA’s central challenge and at the heart of the discontent associated with the “Arab Spring”. To face the challenge of unemployment, conditions are needed that promote innovation and encourage fast-growing SMEs that research points to as the most significant job creators. An expanding literature on “gazelles”, finds that “5 to 10% of firms deliver 50 to 80% of employment generation”. This minority of firms achieves rapid growth over a sustained period.

A unique analysis of panel manufacturing data from 2008, 2006 and 2004 explores the characteristics of fast growing manufacturing SMEs in Egypt, defined by job growth. In this work, the probability of a firm being a “gazelle” and the probability of a firm being an innovator was predicted through a variety of firm characteristics. Generally, gazelle firms were characterized by higher levels of employee education and training, more foreign technology, external auditing, using email or a website, being less than 10 years old, being small, and with reliable power supplies. However, gazelle firms were also more likely to have received a high number of inspections and were actually less likely to have received a bank loan than non-gazelles.

Since innovation is closely associated with productivity growth and competitiveness, the analysis also explored the characteristics of firms that innovate. Two significant features were a higher likelihood of offering employees formal training exports of at least 10% of sales value. An earlier multilinear regression analysis also found three strong correlates of innovation: domestic competition, international competition, and informal competition.

These findings point to key areas for a medium-term agenda encouraging employment growth and innovation led by SMEs. These include:

- Strengthening higher education and worker training, and the link of skills supply to private demand.
- Assuring easy access to foreign technology and a legal environment conducive to technological licensing.
- Investing in international standards of corporate governance.
- Policies encouraging ICT investment and competitive provision of internet services.
- Further efforts to remove barriers to entry and encourage market dynamism through legal and regulatory reforms and an active competition policy, involving a combination of trade, investment and regulatory policies that encourage flexible operation and ease of entry and exit, with an active competition authority empowered to address anti-competitive behavior.

It also points to the need for improved competition in financial services, and competitive forces more generally, to address the needs of fast-growing SMEs.

5 Gazelles are generally defined in terms of sustained growth of 20% or more over a period of four years. In the case of Egypt, employment growth was used as the metric to judge “Gazelle” status.