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The Egyptian Center for Economic Studies

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Business Barometer

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Issue No. 26

Performance and Expectations of the Egyptian Business Sector

The Egyptian Center for Economic Studies (ECES) is an independent, nonprofit research institute. It was founded by leading members of Egypt's private sector in 1992. The objective of the Center is to promote economic development in Egypt by assisting policy makers in developing appropriate policy reforms based on international experience. In pursuit of this objective, ECES conducts applied policy research and disseminates its findings through a select series of publications, lectures, conferences, and roundtable discussions.

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About the Business Barometer

In an attempt to provide timely information about the state of economic activity in Egypt, ECES published the first issue of the Industrial Barometer in 1998. The periodical reported the results of a biannual survey of 165 firms fully drawn from the industrial sector. However, to improve the depth of the report, the survey was expanded in the July 2000 issue to include 35 firms from the construction sector. This step converted the former Industrial Barometer into today's Business Barometer. The survey was further expanded in the July 2002 issue to include 10 firms from the tourism sector. In July 2006, the survey was expanded again to include a total of 320 firms (from 210). In July 2007, another 154 firms were added to the sample. These firms cover the transportation, communications and financial sectors. The new sample includes a total of 474 firms. In addition, a few questions were added to the survey questionnaire regarding the geographic distribution of exports, employment categories, prices of different inputs and types of investments. Starting the January 2009 edition, the Business Barometer includes two indices designed to summarize firms' evaluation and expectations for several successive periods. For detailed information about the sample, questionnaire and calculating the BB indices, visit the ECES website (www.eces.org.eg).

This edition of the Business Barometer reports the results of a stratified sample of 474 public and private firms. The survey covers their assessment of economic growth and the results of their operations in terms of production, sales, inventories, capacity utilization, prices, wages, employment and investments over the second half of 2010. It also summarizes their expectations for overall future economic performance as well as their own activities for the first half of 2011.

The interpretations and comments expressed in this survey are those of the ECES team, and do not necessarily reflect those of the ECES Board of Directors.

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Overview

At a time the Egyptian economy was steadily recovering from the effects of the global economic crisis and subsequent slowdown, it was soon hit by an even bigger crisis following the outbreak of Egypt's popular uprising in January 2011. Prior to these turbulent days, most economic indicators were showing positive signs, but the outlook of the economy soon changed in the wake of the unrest. As a result, Moody's and Standard and Poor's lowered the country's credit ratings, given the likely deterioration in the country's economic fundamentals and the financial health of banks. A timely decision was taken to close the stock exchange on January 27th to prevent a collapse in stock prices, as EGX30 declined overnight by nearly 20 percent compared to January 24th. This shift in expectations is most likely a temporary shock, which will likely dissipate in light of pervasive optimism about political and governance reforms after the successful uprising. To be sure, the speed of the economic rebound will hinge on the drive to press ahead with the necessary reforms and social, political and economic stability.

This edition of *Business Barometer* reflects the views of 474 large firms regarding the overall performance of the economy and own activities during the second half of 2010, and their expectations for the first half of 2011.[1] The surveyed firms cover manufacturing, construction, tourism, transportation, communications and financial intermediation. Overall, the first quarter of 2010/11 (July-September) started with inflationary pressures, with average inflation reaching 11.2 percent compared to 9.4 percent in the previous period. This increase could be explained by the rise in international food and oil prices, the depreciation of the currency and the government's rationalizing of consumer subsidies.

Despite government efforts to contain rising inflation through import liberalization of some products, higher inflation is still expected for two main reasons. Firstly, the depreciation of the Egyptian pound to a near six-year low of EGP 5.958/USD on 8 February 2011,[2] which inflates Egypt's import bill (24 percent of GDP). Secondly, the increase in oil prices due to social and political turmoil in Egypt and some other Arab countries. Oil prices increased to US$ 98.68 per barrel on 16th of February 2011, up from US$ 93.2 per barrel on the 24th of January. These factors will increase inflationary pressures and the cost of subsidies, which will reflect negatively on the government's budget and the fiscal outlook.

In the wake of the political tensions on January 25, the government announced its commitment to (i) absorb price differentials to stabilize subsidized prices, (ii) increase government employees' wages and pensions by 15 percent starting April 2011, (iii) avail compensations to the owners of commercial, industrial and services enterprises who were negatively affected by the recent events and (iv) provide unemployment insurance and compensations to those who lost employment during the crisis, whether formal or informal employees. Such measures put extra strain on the government budget with limited scope to mobilize additional revenues, negatively impacting the fiscal deficit.

On a sectoral level, prolonged political uncertainty would disrupt economic activity and lead to significant downward earning revisions for domestically oriented sectors. The most affected sector is tourism (whose direct receipts accounted for 3.5 percent of GDP in FY 2009/2010) due to a cut-off in tourism arrivals and spending. Sectors such as banks, real estate and construction would be particularly hard hit. The telecommunications sector would be relatively more resilient as demand is not likely to be affected by the slowdown in economic activity, despite significant losses due to the interruption of the internet service during the crisis.

The manufacturing sector has been affected by banks' closure, the decline in demand for non-food products and durable goods, and transportation disruptions due to the curfew. This is despite the measures taken by the Ministry of Finance to expedite the release of imports of strategic goods by postponing the payment of customs duties and taxes, in addition to the facilitation of exit procedures for Egyptian exports.

Political uncertainty could negatively impact foreign direct investment (FDI) inflows, which reached US$ 11 billion in 2009/2010. It is worth mentioning, however,

[1] The *Business Barometer* survey was conducted prior to the events that broke out on the 25th of January. The next edition of the *Barometer* will highlight the effect of the political and social turmoil on firms by comparing their performance and expectations before and after these events.

[2] More recently, the Egyptian pound appreciated to EGP 5.9/USD on 10th of February following the intervention of the Central Bank.

that almost 70 percent of FDI inflows go to the petroleum sector, which is somewhat more robust and less affected by the crisis.

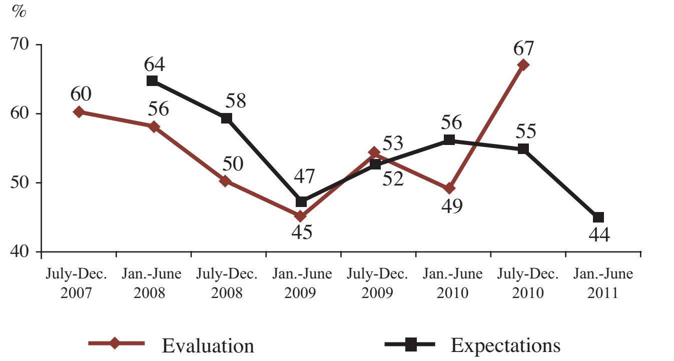
In a nutshell, recent political and social turmoil has had adverse effects on the Egyptian economy, including lower growth, higher inflationary expectations, unemployment and fiscal deficit, and currency depreciation. However, over the medium to long runs it is expected that ongoing political, institutional and governance reforms could bear fruit in terms of increasing investor confidence. Going forward, the economic reform agenda should target expanding investments in labor intensive infrastructure projects and support small and medium industries to stimulate the economy and absorb unemployment.

The Business Barometer Indices

The *Business Barometer* indices (BBI) capture the evaluation and expectations of firms regarding economic growth, production, sales, inventory, capacity utilization, prices, wages, investment and employment. Based on firms' responses, the indices were computed using the principal component analysis method. Figure 1 compares firms' evaluation of their past performance with their expectations over the period extending from July-December 2007 till January-June 2011.

As shown in Figure 1, the evaluation index has increased to 67 percent in July-December 2010, due to the decline in the percentage of firms reporting a decrease in their evaluation of economic variables, on average, and higher trend of stable evaluation. This reflects the impact of stronger than expected economic recovery and the pickup in demand following the slowdown during the financial crisis. Nonetheless, the expectations index has decreased to 44 percent for January-June 2011, significantly below the evaluation index, due to the decline in the percentage of firms reporting an increase in economic variables, on average. The inconsistency reflects increased uncertainty about robust growth going forward against a backdrop of slow recovery in the global economy, which is likely to worsen due to Egypt's political and social turmoil and subsequent uncertainty.

Figure 1. BBI Evaluation and Expectations Indices (%)



Source: Survey results.

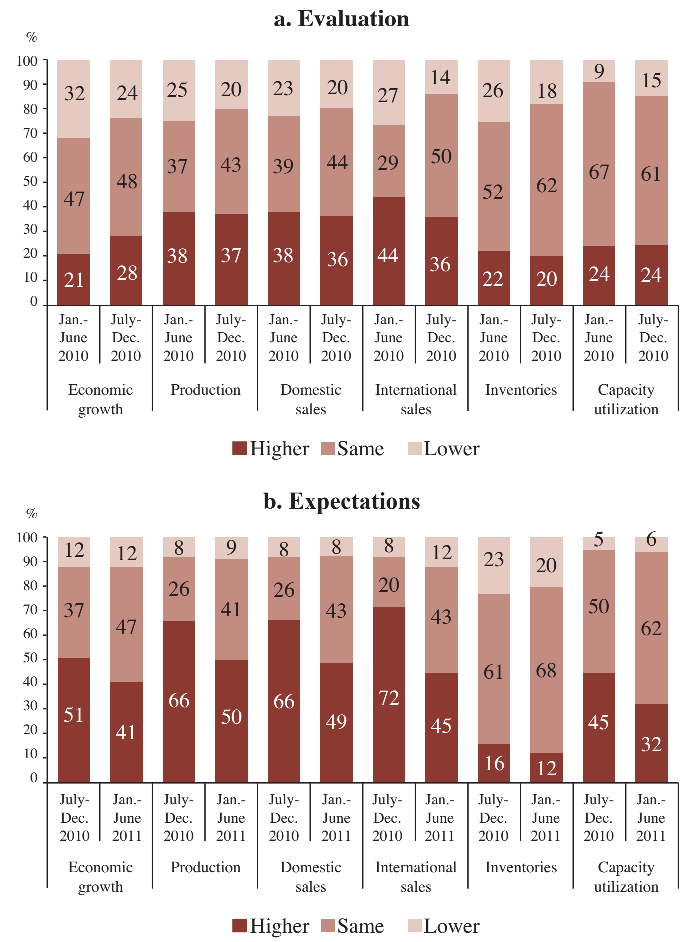
Level of Economic Activity

Economic growth is picking up and stable expectations

With respect to economic growth, the number of firms reporting stable and higher growth has increased. This is in line with the figures reported by the Central Bank of Egypt showing an increase in aggregate real growth in the first quarter of 2010/11 (Figure 2a).

Regarding the next six months, more firms expected stable economic activity compared to the previous survey. Specifically, 47 percent of firms expected stable economic growth, which is consistent with IMF forecasts that economic growth is expected to reach 5.8 percent for 2010/11, which is likely to be revised downward in the wake of the recent turmoil (Figure 2b).

Figure 2. Survey Results: Whole Sample Evaluation and Expectations

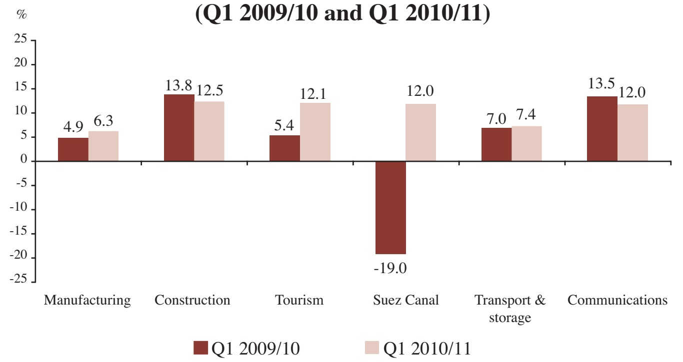


Source: Survey results.

At the sectoral level, almost half of the surveyed firms reported stable economic growth in July-December 2010, compared to January-June 2010. The percentage of firms reporting a decrease in economic growth was the highest in communications, transportation, manufacturing and financial intermediation. In construction, slightly fewer firms reported a slowdown in economic activity, while tourism firms were the most positive, reflecting a quick recovery in the second half of 2010.

For the upcoming six months, firms' outlook for economic growth is the most optimistic in manufacturing, transportation, tourism and construction sectors. This is in line with construction and tourism growth rates, according to the Central Bank of Egypt (Figure 3). This outlook has most likely weakened in the wake of the recent political turmoil.

Figure 3. Real GDP Growth Rates of Key Sectors (Q1 2009/10 and Q1 2010/11)



Source: Central Bank of Egypt (2011).

Stable domestic and international sales with mixed expectations

Concerning domestic sales, 44 percent of firms reported constant sales, while 36 percent reported an increase. Tourism and transportation firms reported the highest increase, followed by the manufacturing sector, with the exception of those working in clothing, printing, plastic and rubber subsectors.

As for expectations, 43 percent of firms expect stable domestic sales in comparison to 26 percent in July-December 2010. Fewer firms (49 percent) expect an increase in these sales compared to 66 percent in July-December 2010. The highest expectations were registered in transportation, manufacturing and tourism firms, reflecting stronger past performance in these sectors. Stable domestic sales can be attributed to the Egyptian import liberalization of some products, crowding out domestic sales, and stable domestic demand as a result of stagnating wages.

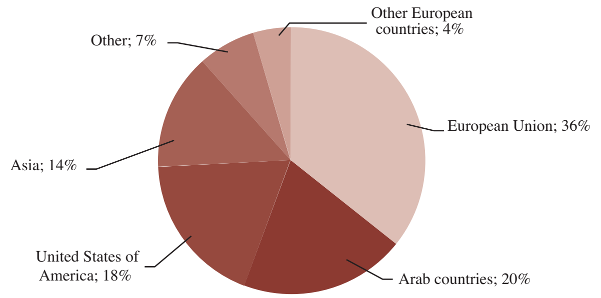
Despite slow growth in the US and debt crises in Europe, Egypt's exports picked up to reach US$ 6.1 billion in the first quarter of 2010/11, an increase of 13 percent relative to the same quarter of the previous year. However, it decreased by 12 percent in comparison to the fourth quarter of 2009/2010 in both energy and non-energy exports (CBE 2011).

The decline in international sales can be attributed to two main reasons. Firstly, weakening demand in Egypt's main trading partners, due to the sovereign debt crisis in Europe and slow recovery in the US. Secondly, the appreciation of the real effective exchange rate of the pound and the adverse effects on the competitiveness of Egyptian exports. Hence, diversifying exports to non-traditional markets and containing inflationary pressures are crucial for promoting Egyptian exports.

According to survey results, half the respondents reported stable levels of international sales while those reporting higher levels declined to 36 percent compared to 44 percent in the previous survey. Communications firms registered the lowest increase in exports, which is consistent with the slow growth rate. Similarly, more firms expect to have stable exports while fewer firms expect an increase in exports.

Figure 4 shows Egypt's main trading partners during 2009/10. Egypt's exports to the EU accounted for 36 percent of total Egyptian exports followed by the Arab countries (20 percent), while those to the US represented 18 percent. Asia's share is 14 percent and is expected to increase reflecting high projected GDP growth (6.7 percent) for Asia in 2011.

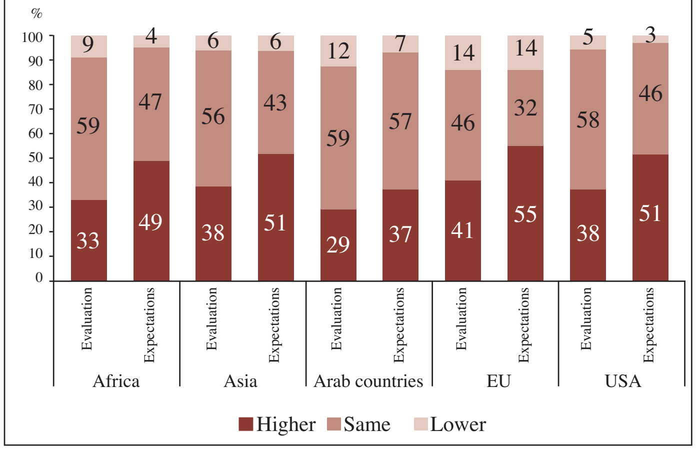
Figure 4. Exports Distribution in 2009/10



Source: Central Bank of Egypt.

Survey results indicate that the largest increase in exports during the second half of 2010 was in the exports destined for the EU, followed by the US and Asia. Indeed, exports to these countries in the first half of 2011 are expected to firm up, with 55 percent of firms expecting higher exports to the EU, and 51 percent of firms expecting higher exports to the US and Asian countries. The lowest expectations are recorded for exports to the Arab countries, with 37 percent of firms expecting higher exports in the first half of 2011 (Figure 5). The outlook for exports to various markets is likely to be revised downward following the recent political and social turmoil in Egypt.

Figure 5. Geographic Distribution of Exports



Source: Survey results.

Stable production in line with stable domestic and international sales

The share of firms (43 percent) reporting stable production increased compared to the previous survey (37 percent). Such increase is a reflection of stable demand at home and abroad after the global financial crisis. On the other hand, 37 percent of the surveyed firms reported an increase in production. The highest increase was evident in the construction sector, followed by manufacturing and financial intermediation firms.

For the next six months, 41 percent of firms expect stable production while 50 percent of firms anticipate an increase in production. This is compared to 26 percent and 66 percent, respectively, in the previous six months. The significant increase in the share of firms expecting stable performance reflects confidence about an impending economic rebound, which is likely to have been shaken by the recent political and social turmoil.

Slight decline in capacity utilization and stable levels of inventory

Capacity utilization exhibits a slightly different pattern than sales and production. The share of firms reporting stable capacity utilization during July-December 2010 declined to 61 percent compared to 67 percent in the previous six months. The low to stable capacity utilization is partially due to insufficient demand; the number of firms reporting an increase remained at 24 percent. The lowest increase was registered in the manufacturing sector, while the highest increase was in the transportation and tourism sectors.

Expectations followed the same pattern as sales and production, with an increase in the number of firms reporting stable capacity utilization to 62 percent. The number of firms reporting an increase declined to 32 percent in January-June 2011 compared to 45 percent in July-December 2010. The highest expected increase is in construction and transportation sectors.

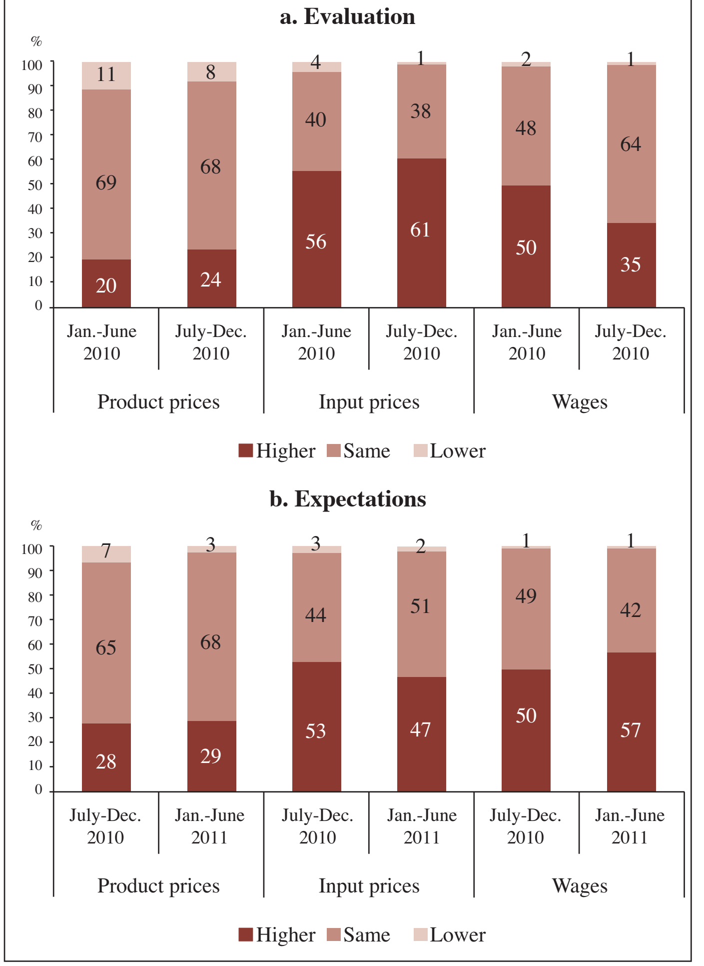
Regarding inventory, the percentage of firms reporting stable inventory increased by 19 percentage points during the second half of 2010, reflecting stable domestic and international sales. Regarding the first half of 2011, inventory is expected to remain stable as more firms expect stable domestic and international sales with fewer firms expecting an increase in both amid concerns about downside risks in the global economy, which may have further deteriorated on account of the recent political and social turmoil.

Stable final product prices and higher input prices with mixed expectations

Survey results indicate that 68 percent of the surveyed firms expect stable product prices while 24 percent anticipate an increase in product prices (Figure 6a). Finance and communications sectors are more aligned towards stable prices for the current period. Firms in the tourism and manufacturing sectors reported increases in output prices with a significant decline in firms reporting lower prices. The increase in tourism prices is mainly attributed to the rebound in growth. Regarding the manufacturing subsectors, the increase in prices in most of these subsectors, specifically cement and fertilizers, is driven by the recent pickup in demand, especially private demand. On the other hand, the increase in the final product prices in the food subsector is largely due to higher international prices.

Regarding expectations for the coming six months, the majority of firms anticipate stable final product prices with a significant decrease in the number of firms expecting lower prices (Figure 6b). At the sectoral level, the majority of firms still expect stable prices. However, compared with the previous survey, the current survey indicates an increase in the percentage of firms expecting higher output prices over the next six months in the manufacturing (i.e., food and leather), construction, transportation and tourism sectors.

Figure 6. Prices and Wages



Source: Survey results.

Regarding input prices, 61 percent of the surveyed firms reported increasing input prices, especially raw material prices. All firms reported such an increase, except for finance and communications firms. In the manufacturing sector, the majority of firms in most sub-sectors (except for wood and non-metals) reported increasing costs of raw materials. Higher input prices are due to the increase in import prices. The depreciation of the Egyptian pound seems to be feeding into higher import prices of raw materials. Given the relatively stable prices of final products, rising input prices may have adverse effects on profitability, forcing suppression of wage increases. This increases constraints on doing business, limiting domestic sales and decreasing export competitiveness.

As for expectations, the picture seems slightly more optimistic with the percentage of firms reporting higher input prices decreasing in favor of more stable prices compared to the last survey. Expectations of price stability dominate in the transportation sector. Furthermore, more firms operating in the manufacturing, construction and tourism sectors expected a stable or decrease in prices, reflecting more upbeat business sentiment regarding future growth and the ability to contain inflationary expectations. In contrast, prices are expected to increase in the financial intermediation sector, which is consistent with the potential tightening of monetary policy and higher interest rate.

Stable wage levels with positive expectations

Wage policies are likely to have been affected by prices. Despite higher input prices, firms may have been forced to stabilize final prices in light of fragile demand and slow recovery. Hence the reduction in wages may have been necessary to mitigate the decline in profits. Because prices in general (and wages particularly) are sticky (downward), 64 percent of firms reported stable wages (Figures 6a). Stable wages may have been reinforced by the high unemployment rate due to slow demand during the financial crisis, increasing the supply of unemployed, which helped to bid down wages and contain salary increases.

Relative to the previous period, fewer firms in all sectors reported paying higher wages over the second half of 2010, while slightly more firms increased their wages in the construction sector. This may have been due to firms not anticipating the decline in demand that unfolded during FY 2009/2010 as the construction sector managed to come out of the financial crisis with strong fundamentals and steady growth, driven by high demand for real estates. It is noteworthy to highlight that firms in the leather, textiles and food sub-sectors of the manufacturing industry reported increasing wages as opposed to other manufacturing sub-sectors. This increase is consistent with the current trend in these subsectors, which witnessed increasing final prices as well as increasing investments.

Regarding wage expectations, 57 percent of firms anticipate wage increases for the coming 6 months (Figure 6b). More firms in most sectors expect higher wages in the first half of 2011. In contrast, construction firms voiced modest expectations concerning future wages, which were aligned towards a stable or decrease in wages. This scenario is expected for firms that faced slow demand in the construction sector during July-December 2010.

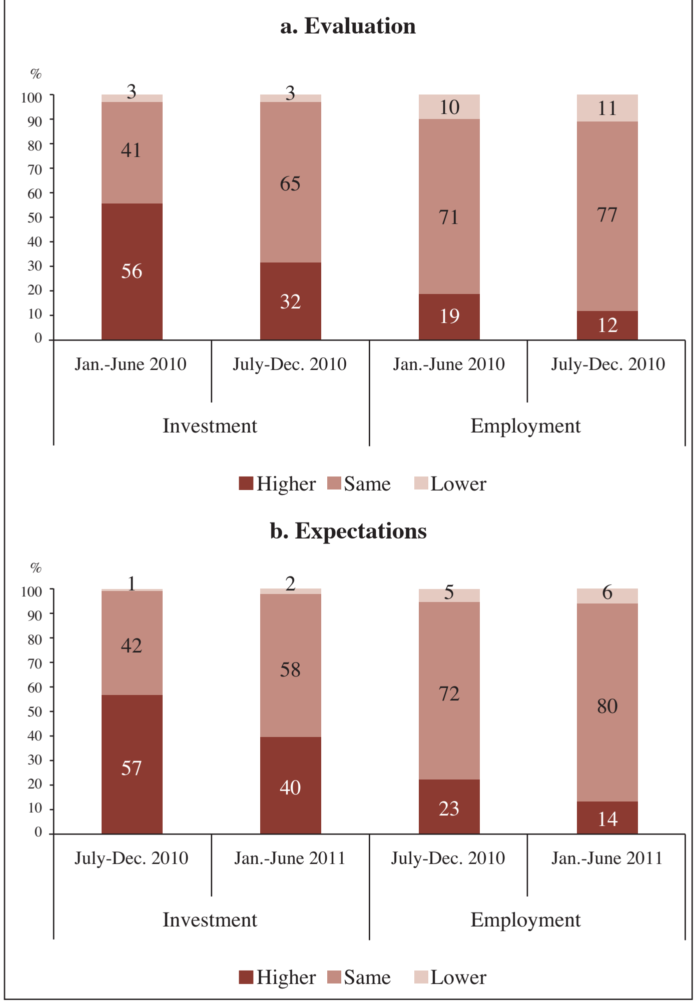
Investment and Employment

Stable investments and employment with mixed expectations

The percentage of firms reporting an increase in investment decreased considerably to 32 percent in July-December 2010 compared to 56 percent in January-June 2010, in favor of more stable investment (Figure 7a). The firms that reported an increase in investment mainly aimed at increasing machinery and equipment.

At a disaggregate level, the majority of surveyed firms in all industries reported stable investment except for the following manufacturing subsectors: wood, leather, cement, heavy industry and paints. In these subsectors, the projected high demand has increased incentives for further investment.

Figure 7. Investment and Employment



Source: Survey results.

Comparing expectations and evaluation for July-December 2010, expectations of increased investments were greatly overestimated, highlighting firms' suspicion in light of fragile, yet increasing demand, the Euro-debt crisis, fears of China's tighter monetary policy, double digit inflation, especially in inputs, and threats to competitiveness in the form of high real effective exchange rate in the face of continued volatility of capital cash flows.

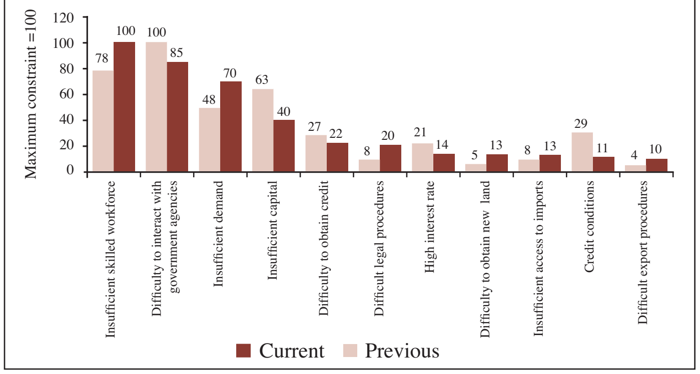
Regarding employment, more firms reported stable employment with the number of firms reporting higher employment decreasing. This is in line with the current trend in investments. At a disaggregate level, industries (except for manufacturing, transportation and tourism) witnessed stable employment in general, whereas in tourism, a higher percentage of firms reported increases in permanent employment[3] (Figure 7a). In the transportation sector, 15 percent of firms reported increases in permanent employment. As for the manufacturing sector, firms in some subsectors reported an increase in permanent employment like beverages, leather, glass and paints, which is consistent with the increase in investments in these subsectors on account of higher demand. Regarding expectations, more firms anticipate stable employment in comparison with the previous survey, which is likely to have been shaken by the recent political and social turmoil (Figure 7b).

Business Constraints

Major constraints: insufficient skilled workforce, difficulty to interact with government agencies, and insufficient demand

Figure 8 illustrates the main obstacles to doing business according to their degree of severity. Starting from the most severe obstacle, the order in the current survey is insufficient skilled labor—specifically insufficient technical labor—difficulty in dealing with government agencies and insufficient demand. The ranking of some constraints has deteriorated in comparison to the previous period such as insufficient demand, difficult legal procedures, buying land for project expansion and difficulty of export procedures. This indicates that doing business in Egypt is still constrained by red-tape despite previous efforts by the government to tackle these issues.

Figure 8. Major Constraints Facing the Business Sector



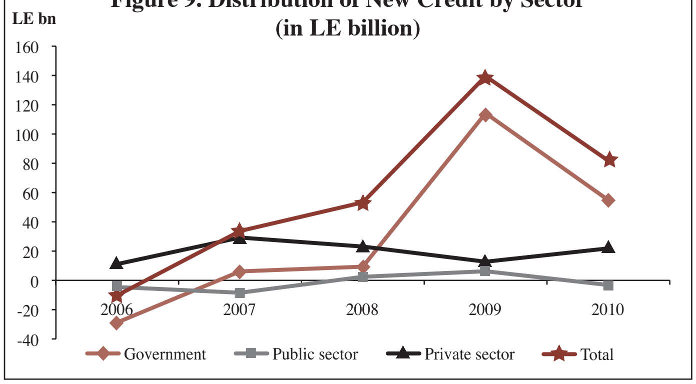
Source: Survey results.

Business constraints differ between public and private sector. The major constraints facing the private sector are lack of skilled labor, quality of vocational training institutes and government bureaucratic policies. The major problem facing public firms is banks' high interest credit facilities.

Sources of Finance

Survey results indicate that bank credit is the least utilized source of financing by private and public firms, while business partners, own funds and the stock market represent a major source of financing. Difficulty to access bank credit reflects the risk-averse strategy where banks prefer lending to the government, indicating the adverse effects of government borrowing on private activity (Figure 9). Ongoing reforms should consider easing constraints on firms' access to bank lending to mobilize private activity in line with economic priorities.

Figure 9. Distribution of New Credit by Sector (in LE billion)

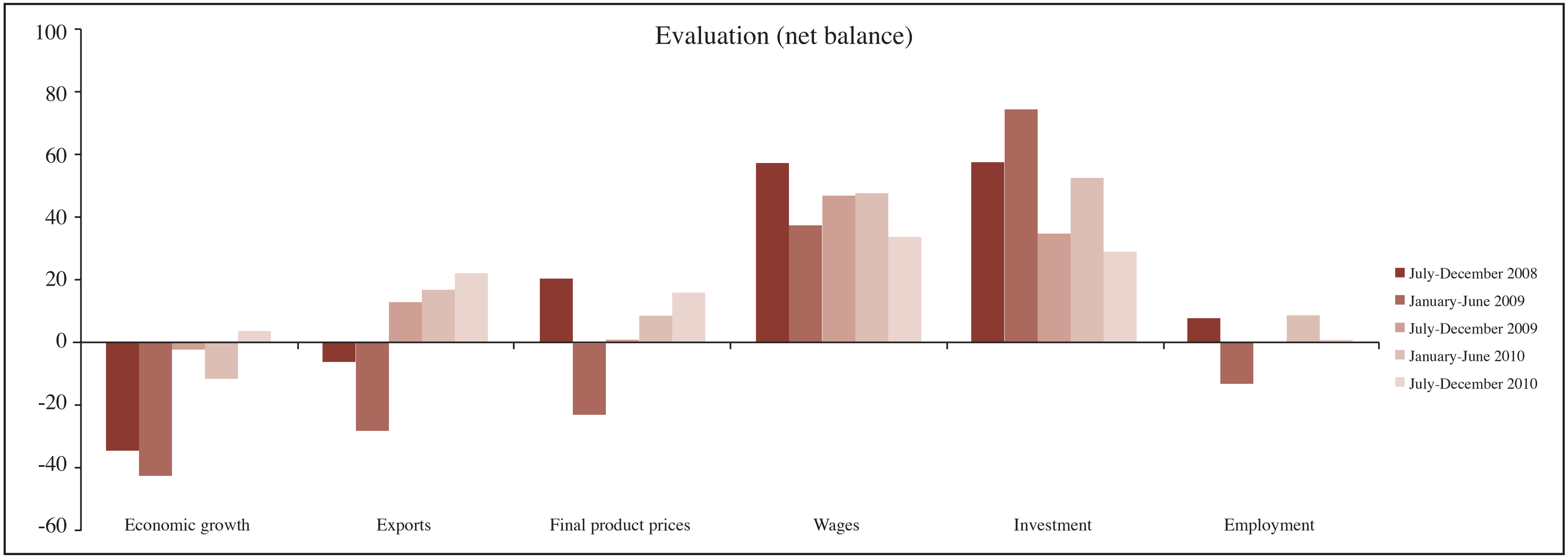


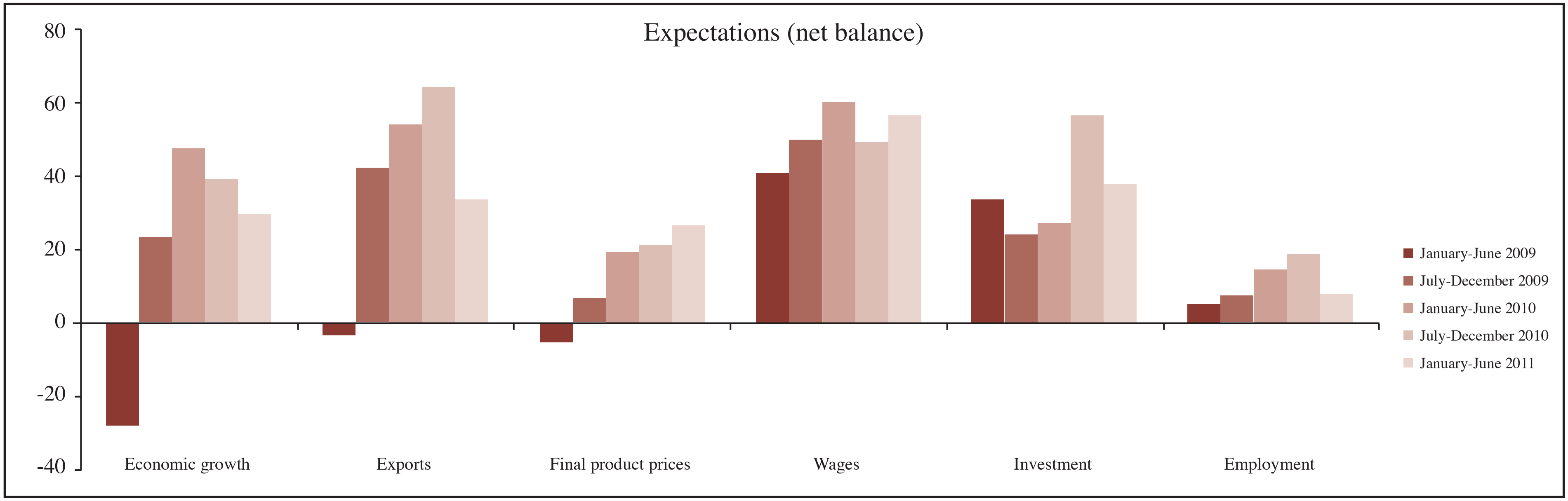
Source: CBE monthly bulletin, January 2011.

[3] Employment comprises four types: administrative temporary, administrative permanent, technical temporary and technical permanent.

Appendix

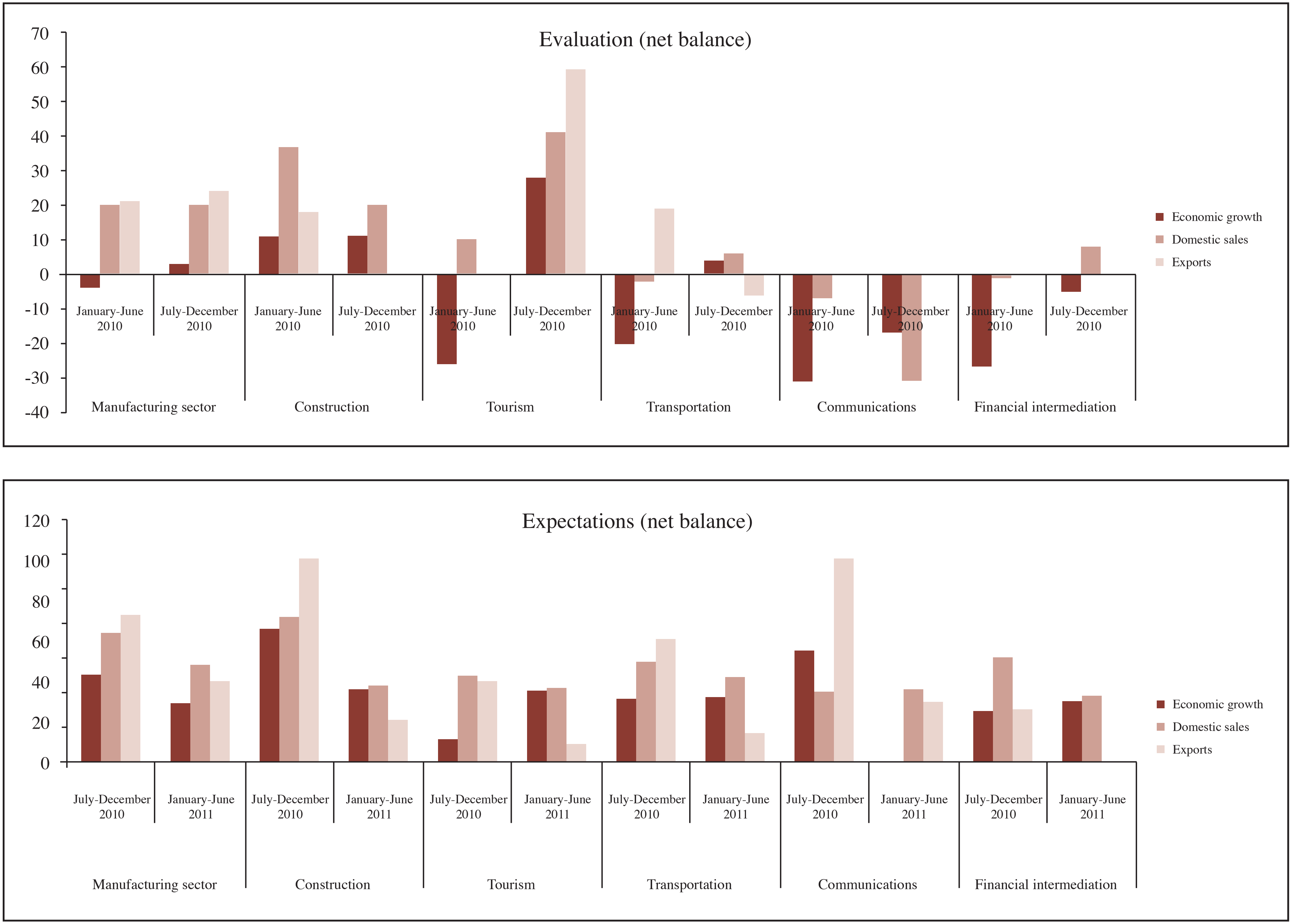
Figure A1. Evaluation and Expectations of Key Performance Indicators (2008-2010)





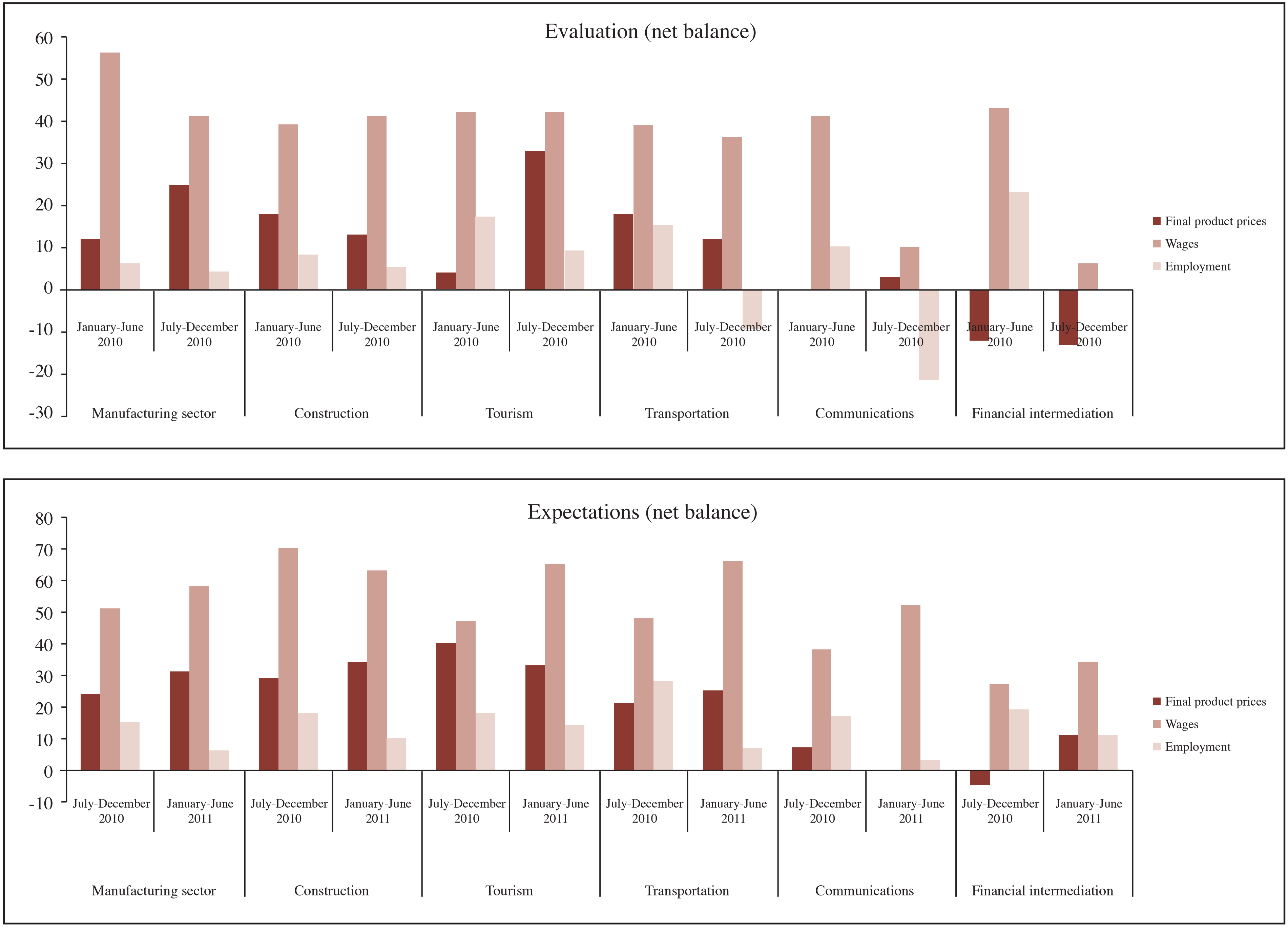
Source: Survey results.
Note: Net balance represents the percentage of respondents indicating "higher" minus the percentage of respondents indicating "lower".

Figure A2. Variations in Evaluation and Expectations of Growth and Sales Across Sectors



Source: Survey results.
Note: Net balance represents the percentage of respondents indicating “higher” minus the percentage of respondents indicating “lower”.

Figure A3. Variations in Evaluation and Expectations of Prices, Wages and Employment Across Sectors



Source: Survey results.

Note: Net balance represents the percentage of respondents indicating “higher” minus the percentage of respondents indicating “lower”.