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The Egyptian Center for Economic Studies

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Business Barometer

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Issue No. 27

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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ECES Management

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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. Starting July 2011, the Business Barometer is based on a modified sample survey in terms of firm size, comprising 218 large firms, 57 medium firms and 199 small firms.

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 first quarter of 2011. It also summarizes their expectations for overall future economic performance as well as their own activities for the remainder of 2011. This edition comes out earlier than scheduled to reflect the impact of the 25th of January Revolution on the business environment in Egypt.

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

The *Business Barometer* (BB) reflects the views of 474 firms regarding the overall performance of the economy and their own activities during the first quarter of 2011 (January-March) as well as their expectations for the remaining three quarters of 2011 (April-December). The surveyed firms cover manufacturing (50 percent), construction (12 percent), tourism (8 percent), transportation (11 percent), communications (6 percent) and financial intermediation (13 percent). Unlike previous editions of the BB, the current edition is based on a modified sample survey in terms of firm size, comprising 218 large firms, 57 medium firms and 199 small firms. The purpose is to diversify the evidence.[1]

Although the January 25 Revolution is bound to have far-reaching positive effects on all aspects of life in Egypt, its immediate economic effects were turbulent as typically expected in countries witnessing political change. Such adverse effects, however, constitute a temporary phase that countries typically experience in their pursuit of political stability and economic prosperity. Egypt's real GDP in the third quarter 2010/11(January-March 2011) witnessed a sharp contraction, registering -4.2 percent compared to 5.4 percent in the corresponding quarter in 2009/10. This unprecedented drop in growth performance can be attributed to the fall in investment and net exports of goods and services, which declined by 26 percent and 3.6 percent respectively, in real terms, compared to the third quarter of the previous year. On the contrary, final consumption was the main supporter of economic growth, as both private and public consumption grew by 3.5 percent. According to the IMF estimates, the expected average growth rate for the whole year 2010/11 is one percent.

After an initial drop in the aftermath of the Revolution, the stock market has started to rebound gradually, even though its performance has been shaky and has yet to recover to its pre-January 25th level. Inflation registered 10.8 percent and 10.7 percent in January 2011 and February 2011, respectively, and then started to pick up, registering 11.5 percent in March and 12.1 percent in April. This is in consequence of supply shortages, depreciation of the Egyptian pound subsequent to large capital outflows and a drop in inflows of foreign receipts, and rising international food and energy prices. Coupled with the slowdown in growth, this portends a situation of stagflation. It is worth noting that the projected increase in the fiscal deficit is likely to translate into increased inflationary pressures.

The effects of recent events on the current account have been mixed. The trade deficit, measured in US dollars, narrowed by 23 percent during the third quarter of 2010/11 compared to the corresponding quarter of 2009/10. Exports increased from $5.5 billion in the third quarter of 2009/10 to $6.2 billion in the corresponding quarter in 2010/11, registering 14.6 percent growth. This is due to the increase in petroleum exports, as their average quarterly prices increased by 36 percent throughout these two quarters. Non-petroleum exports remained stable at $3.4 billion, which is probably due to the recovery in the US and Europe compared to last year. This, coupled with the fact that most exports fall under pre-placed purchase orders, helped maintain non-petroleum exports at their levels of last year, despite the adverse effects of the overall economic slowdown. On the other hand, imports decreased during the same period from $12.1 billion to $11.3 billion (a 6 percent decline). This was mainly due to the decrease in non-petroleum imports, which was possibly caused by the depreciation of the Egyptian pound, coupled with interruption of banking activity and banks' reluctance to undertake new letters of credit. Yet these effects were mitigated by inelastic demand for most of non-petroleum imports. However, the service deficit widened by 49 percent. This is particularly due to the slowdown in tourism, which registered a 34 percent of negative growth. Despite the unrest in neighboring Arab countries, remittances remained stable at $2.8 billion

[1] The sectoral structure of the sample is in line with that of the population. However, due to data shortage, the structure by firm size is different.

during this quarter compared to the corresponding quarter.

In light of the large capital outflows ($5.5 billion) along with the halt in new FDI that followed the Revolution, the capital account registered a deficit of $4.6 billion. Given deterioration in the financial balance together with the widening current account deficit, the balance of payments registered a large deficit during January-March 2011 of $6.1 billion, which is equivalent to 11.4 percent of quarterly GDP (LE 316 billion),[2] compared to a 0.2 percent of GDP surplus in the corresponding period of 2009/10. This was reflected in a reduction of foreign reserves from $36 billion in December 2010 to $27.2 billion in May 2011.

Regarding the fiscal balance, revenues decreased by 18.5 percent in the third quarter of 2010/11 with respect to the corresponding quarter of 2009/10, while expenditures were reduced by only 9 percent, which increased the deficit. The drop in public revenues was caused by the drop in taxes, driven by the fall by 43 percent in income tax, and the drop in property taxes by 36 percent. On the other hand, the decrease in expenditures was caused by the decrease in "subsidies and social grants and benefits" by 38 percent and the decrease in investment expenditures by 16 percent. The decrease in subsidies and social benefits consists of decreases in subsidies to non-financial public corporations, particularly the Egyptian General Petroleum Corporation (EGPC).[3] Yet these decreases were mitigated by the 34.5 percent increase in interest payments, in addition to increases in workers' compensations. While for the first three quarters of 2010/11 the budget deficit is 6.9 percent of GDP, it reached 10 percent of GDP during January-March 2011. The gap is expected to widen even more by the end of 2010/11 given the rise in public spending to which the government has committed, coupled with the increase in domestic and international prices.

Many of these factors are gradually improving, and there are strong prospects for recovery. Yet normalcy is only expected after the successful holding of the parliamentary and presidential elections due in September and December 2011, respectively.

Responses of firms in the sample were, in general, affected by the economic slowdown, which was reflected in production, sales, prices, wages, investment and employment. Tourism, transportation, communications and financial intermediation were among the sectors that were affected the most. Moreover, although firms were highly uncertain about the economy during April-December 2011, their expectations were generally better than their evaluation for the first quarter of 2011. Surprisingly, the above-mentioned sectors are those which have the best expectations for April-December 2011.

The remainder of this edition of *Business Barometer* presents the main findings of the survey under four main headings: the level of economic activity (overall growth, production, sales, inventory and capacity utilization), prices and wages, investment and employment and finally the constraints facing the surveyed firms.

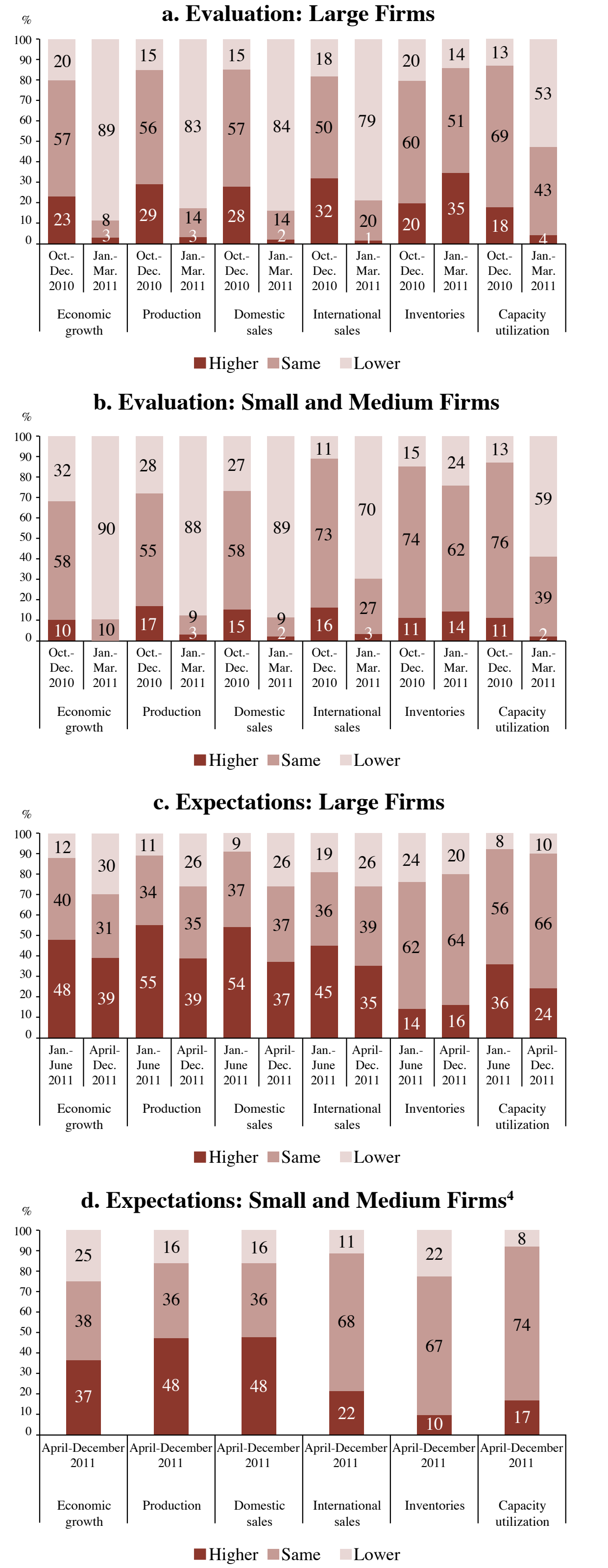
Level of Economic Activity

Figure 1 describes the trend of all economic activity variables, namely, firms' perceptions of economic growth, production, domestic and international sales, capacity utilization and inventory. Figures 1a and 1b show the evaluation of the period January-March compared to October-December 2010, for large firms and small and medium firms, respectively. Figure 1c shows large firms' expectations for April-December 2011 compared to their previous expectations for January-June 2011. Figure 1d finally shows small and medium firms' expectations for April-December 2011 only, as these firms are surveyed for the first time.

[2] The exchange rate at end of March 2011 was 5.92 LE/US$.

[3] Data for the breakdown are only available for July-March 2010/11. They show a 18.4 percent decrease in subsidies to non-financial public corporations during July-March 2010/11 compared to July-March 2009/10.

Figure 1. Economic Activity



Source: Survey results.

[4]Small and medium enterprises are newly introduced to the sample. Hence, no expectations are available for this new subset in the current BB results.

Sharp decline registered in all economic activity indicators

Figures 1a and 1b show a sharp decline in economic activity, as illustrated by the overwhelming increase in firms reporting a drop in economic activity indicators during January-March 2011 with respect to October-December 2010, coupled with a decrease in those reporting improvements. This pattern applies across small, medium and large firms.

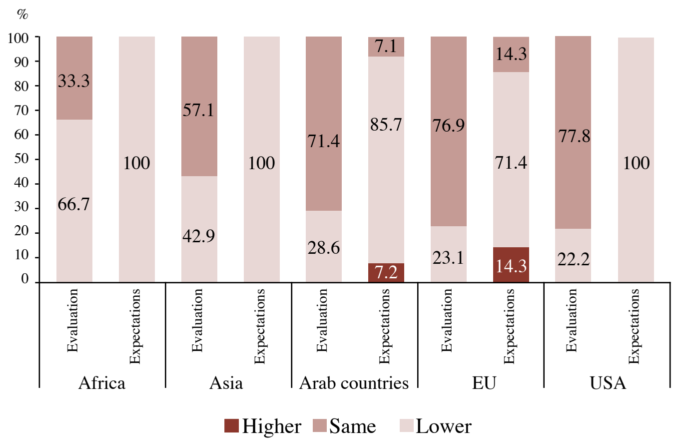
With respect to *economic growth*, the number of small, medium and large firms reporting lower growth increased three to four folds in January-March 2011 compared to October-December 2010 (Figures 1a and 1b). This is in line with the estimated growth contraction after the Revolution. At the sectoral level, the percentage of firms reporting a decrease in economic growth was the highest in tourism, communications and transportation, due to demand disruption and weak security in the case of tourism.

The same trend applies to *domestic sales*. A considerable share of large firms as well as small and medium firms reported a decline in domestic sales in January-March 2011. Construction and financial intermediation sectors reported the highest decline followed by firms working in tourism.

As for *exports*, survey results indicate that 79 percent of large firms reported a decline in exports compared to only 18 percent in the last quarter of 2010. The same applies to small and medium enterprises, where 70 percent of small and medium-sized firms reported a decline in international sales in the first quarter of 2011 compared to only 11 percent in the last quarter of 2010. Communications firms reported the highest decline in exports. The major export constraints that firms reported included the increase in input prices, sudden government export ban decisions and restrictive government procedures.

Regarding the geographical distribution of exports, survey results indicate that the largest decline was in exports to the US and the EU, followed by Arab and Asia countries (Figure 2). As for the period April-December 2011, all firms anticipate stable exports to the US, Asia and Africa, while 7 percent of firms expect an increase in exports to the Arab countries and 14.3 percent expect an increase in exports to the EU. The low level of expected increase to the Arab countries is due to uprisings in the Arab region, while firms' high export expectations to the EU are due to optimism of the EU recovery from the sovereign debt crisis.

Figure 2. Geographic Distribution of International Sales



Source: Survey results.

The *production* decline shown in Figures 1a and 1b is a reflection of demand disruption at home as well as lower service exports following the Revolution. The highest decline in production was reported in financial intermediation, followed by construction and tourism sectors.

As for *capacity utilization*, more large firms expect a decline at the expense of those anticipating stable levels, compared to October-December 2010. A similar pattern applies to small and medium-sized firms. The highest decline in capacity utilization is in the tourism sector due to the decline in the sector's activity.

Finally, the percentage of large firms reporting an increase in *inventory* has increased in January-March 2011. This is consistent with the decline in sales. A similar but weaker trend is evident for small and medium-sized firms (Figure 1b).

Dim expectations albeit better than the evaluation

In general, expectations are lower than in the previous survey, reflecting the impact of the recent upheaval on the economic outlook (Figure 1c). However, expectations for April-December 2011 are far better than the evaluation of January-March 2011, indicating strong recovery prospects. As small and medium firms are surveyed for the first time, no history of their expectations is available. While their expectations are similar to those of large firms, they fared better compared to the January-March evaluation.

Regarding views about *economic growth* during the period April-December 2011, 39 percent of the large firms expect an increase in economic growth, which is lower than their expectations before the Revolution where 48 percent of firms were expecting an increase in economic growth (Figure 1c). This is due to the uncertainty that prevailed following January 25. However, as mentioned previously, their expectations for the period April-December 2011 are still far better compared to their evaluation of the period January-March 2011, indicating that improved expectations are not a function of improved outlook as much as a deterioration in the benchmark performance in the first quarter of 2011. A similar trend holds for small and medium firms, as 37 percent of SMEs expect an increase in economic growth (Figure 1d).

Firms' views about economic growth were the most positive in communications and financial intermediation followed by tourism. This reflects expectations of improved security and pickup in economic activity after the parliamentary and presidential elections due in late 2011.

Regarding *domestic sales*, 37 percent of large firms and 48 percent of small and medium ones expect them to increase in the period April-December 2011. The expected increase reflects firms' positive expectations about the recovery of the Egyptian economy and pickup of domestic demand. Positive expectations were particularly reported in communications, followed by financial intermediation and tourism.

Based on survey results, 35 percent of large firms expect an increase in *exports* in the period April-December 2011. This percentage is lower for small and medium firms where only 22 percent of firms expect an increase in exports while 68 percent expect them to remain stable. Small and medium firms expect to take longer to recover from the effects of the Revolution, reflecting their reluctance to increase production until the economy shows stronger evidence of recovery. Firms' expectations for exports are the most optimistic in the communications and financial intermediation sectors.

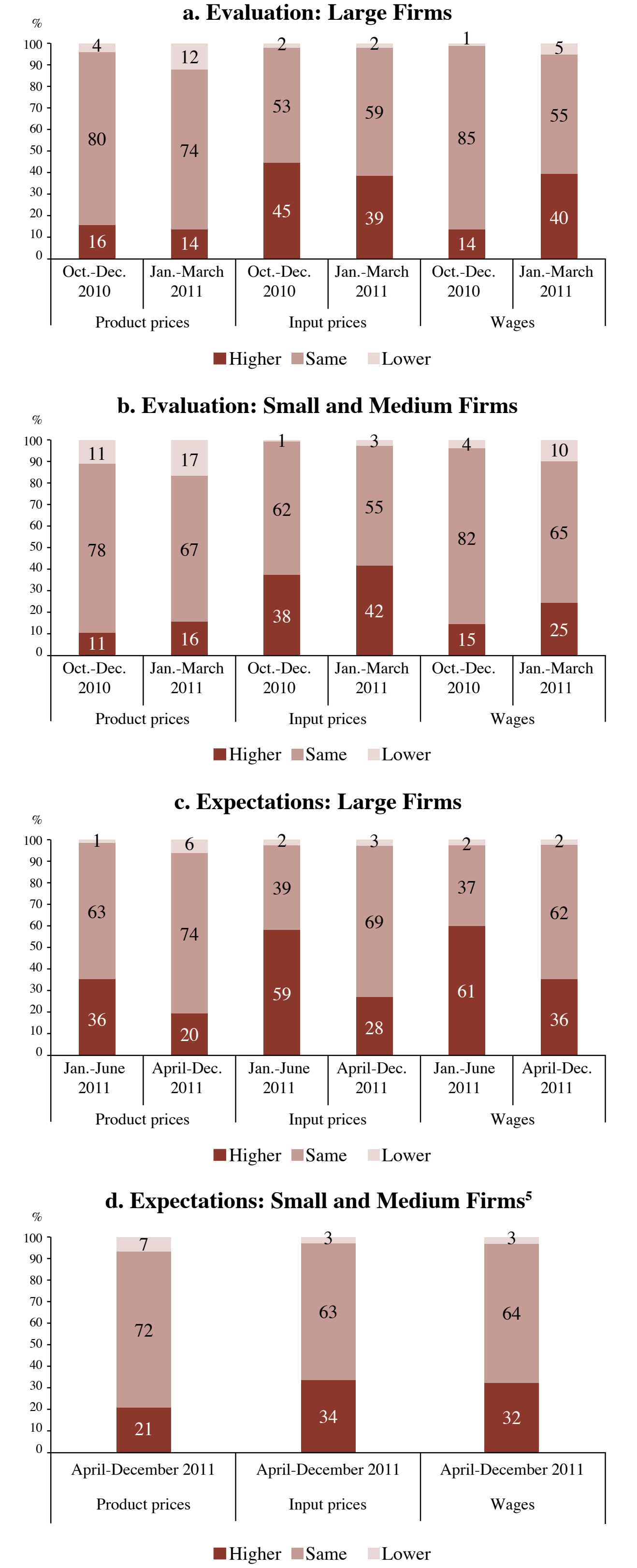
Expectations for domestic sales and exports are similar to those of *production*, as 40 percent of firms reported an increase and 26 percent a decline. The most positive production expectations were reported in communications followed by financial intermediation and tourism, which is in line with the previous indicators.

Regarding *capacity utilization*, the number of large firms anticipating stable levels increased, indicating firms' intention not to increase their level of capacity utilization until the economy exhibits stronger signs of recovery. Similarly, the majority of firms expect *inventory* levels to remain stable, which is consistent with expectations of stable domestic and international sales reported by a large number of firms.

Prices and Wages

Figure 3. Prices and Wages

a. Evaluation: Large Firms



Source: Survey results.

5 Benchmark data are not available.

Stable output prices, input prices and higher wages

The majority of firms reported stable *output prices* during January-March 2011, with more firms reporting a decrease in prices compared to October-December 2010, including large firms as well as small and medium firms (Figures 3a and 3b). This represents evidence of the slowdown witnessed in several sectors of the economy after January 25. In fact, the number of firms reporting a decline in product prices is high in several sectors: 48 percent in tourism, 32 percent in communications and 17 percent in transportation. As previously mentioned, these sectors were severely affected by the revolution.

In the manufacturing sector, stable prices were consistently reported across most of the subsectors, driven by the recent slowdown in domestic demand in the aftermath of the Revolution, together with the fact that prices are sticky (downward). Among the subsectors that reported relatively large decreases in output prices were glass, rubber and paper, indicating more flexibility to adjust prices towards stimulating demand. Food processing firms reported relatively large increases in their prices, which is expected as the turbulence caused sharp supply cutoffs while demand is relatively inelastic. This explains the general pickup in inflation in March 2011, as mentioned in the overview.

As for *input prices*, a large number of firms reported stable and increased prices, although the tendency towards higher prices in large firms was weaker in January-March 2011 relative to October-December (Figure 3a). The largest reported increases were in manufacturing (55 percent) and construction (25 percent), due to the high cost of raw materials which are to a large extent imported in both sectors.

Concerning *wages*, significant increases were reported in the first quarter of 2011 relative to the previous quarter. This trend was particularly strong in large firms as many firms typically give their annual salary increases at the end of December. However, the share of firms reporting a wage decrease went up for large as well as small and medium firms. The upward trend in wages was observed in almost all sectors, especially manufacturing. Tourism was the only exception as more tourism firms reported a decrease than an increase, which is consistent with the significant adverse effect on this sector's performance in the wake of the Revolution.

Expectations of decreased prices and wages

Expectations of large firms with respect to prices and wages changed considerably after the Revolution (Figure 3c). Comparing April-December with January-June shows a significant decline in the number of firms expecting price and wage increases.

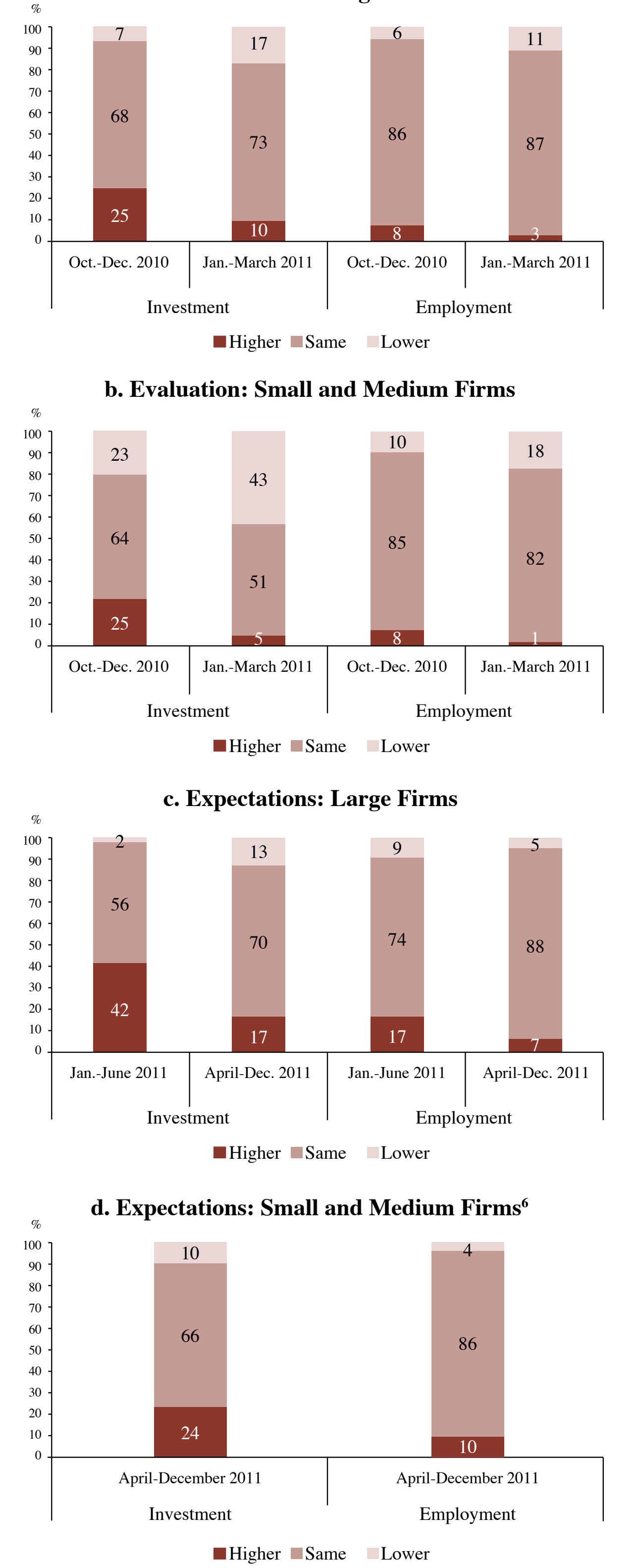
This trend is particularly obvious in input prices, as more than 90 percent of firms expect input prices to remain stable. Conversely, manufacturing subsectors strongly expect higher input prices, which is likely due to exchange rate depreciation.

However, we would have expected higher inflationary expectations given the rising international prices, the depreciation of the pound and the wide fiscal deficit in the draft 2012 budget.

Regarding wages, relatively more manufacturing firms expect them to increase, whereas the telecommunications firms reported modest expectations compared to the average, which is in line with lower output prices anticipated in that sector. Small and medium firms' expectations follow the same pattern as large firms.

Investment and Employment

Figure 4. Investment and Employment
a. Evaluation: Large Firms



Source: Survey results.

[6]Benchmark data are not available.

Lower investment and employment

The percentage of large firms reporting an increase in *investment* went down considerably in January-March 2011 compared to the preceding three months (Figure 4a). This drop is more significant in small and medium firms, coupled with a significant increase in firms reporting investment reduction (Figure 4b). These firms are usually more vulnerable to business cycles, which is likely to have been exacerbated by difficult access to credit. The largest fall in investment was in machinery and equipment, because such type of investment is easy to stop, followed by investment in buildings and land which are not as easy to scale down. Across sectors, tourism and telecommunications witnessed the highest investment decline, followed by manufacturing and construction. In the manufacturing sector, the same finding holds for heavy industries, glass and transportation equipment.

The overall slowdown in economic activity took its toll on employment. More firms reported employment layoffs and fewer firms reported employment increases compared to October-December 2010, which was particularly obvious in small and medium firms. In all sectors, firms reporting a decrease in employment were more than those reporting an increase, particularly in telecommunications and tourism, where 32 percent and 23 percent of firms reported a decrease in employment, respectively. As previously noted, these two sectors were among the most affected by recent events.

Lower prospects albeit better than January-March evaluation

Large firms anticipate lower investment and employment for April-December 2011 compared to January-June 2011, with declining prospects for demand, and hence production and sales, during the remainder of 2011 (Figure 4c). This is not surprising in light of the projected one percent economic growth at the end of fiscal year 2010-2011. Added to this is the prospect of higher inflation, which adversely affects domestic demand as it erodes real income and undermines private consumption, as well as threatens export competitiveness via appreciation of the real exchange rate. However, like previous indicators, expectations for April-December investment and employment are better than the January-March evaluation, reflecting an optimistic view about the economy.

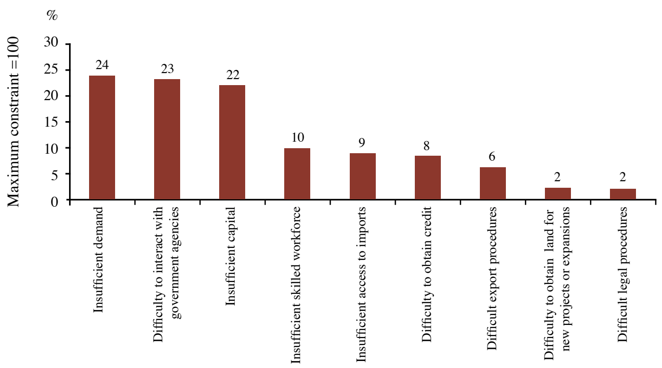
Business Constraints

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

Figure 5 illustrates the main obstacles to doing business ordered according to their degree of severity. The most severe obstacle reported in this survey is insufficient demand, which was expected in light of the adverse repercussions of the Revolution. The second major constraint is the difficulty to interact with government agencies. The third major obstacle facing business is insufficient capital, which has been further constrained after the Revolution in light of banks' reluctance to extend credit to the private sector.

Business constraints also varied according to types of firms. While difficulty to interact with government agencies was the most severe constraint reported by small and medium firms, insufficient demand was voiced as the most severe constraint faced by large firms. On the other hand, private firms consider interacting with government agencies as a major constraint while public firms do not consider it a constraint.

Figure 5. Major Constraints Facing the Business Sector



Source: Survey results.

Concluding Remarks

This issue of Business Barometer has discussed the repercussions of the January 25 Revolution on the economy, as viewed by large as well as small and medium firms, in terms of their performance during the first quarter of 2011 and their expectations for the remaining three quarters of 2011. The results indicate a decline in most indicators during January-March 2011, particularly in economic growth perceptions, production, domestic sales and exports. Sectors that were affected the most included tourism, financial intermediation, communications and transportation. Large firms' responses were generally similar to those of small and medium firms, except for investment where small and medium firms were relatively worse off.

With regards to expectations, firms' outlook for April-December 2011 was less positive than in the previous survey. However, this outlook is still better compared to the January-March evaluation. In a nutshell, economic recovery is conditional on political stability; the shorter the period of political uncertainty, the better the prospects for rapid and sustained economic recovery.