The Nexus Between Growth and Private Sector Advocacy in the Banking Sector: A Practical Application to Egypt

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Abstract

The study develops an advocacy construct using Confirmatory Factor Analysis. The empirical results show a strong relationship between advocacy and growth, albeit not on inflation rates, suggesting that an innovative set of public policy instruments is needed to promote private advocacy efforts and to institutionalise private-public partnerships. This is an innately pressing mission for the new government to mitigate the impact of the double-digit inflation that has prevailed since the Triple-F – food, fuel and finance – Crisis of 2006. Hence, the prime aim is to design a future roadmap for the endorsement of effective growth alliances between businesses, bankers and policymakers.

1. Introduction

The eighteen-day nationwide adamant sit-ins at the main squares of Egyptian cities at the dawn of 2011 caught the world off guard. Never had political experts expected such a determined uprising by what was perceived to be a politically dormant nation to topple the thirty-year Mubarak autocratic regime. Similarly, economic analysts were surprised at the fury of a people whose economy was able to sustain an average annual growth rate of 5 percent since the nineties. But what could have caused the anguish and torment that were equally displayed by the underprivileged Egyptian masses and the more affluent intelligentsia? The root causes of the problem date back to the early nineties, when the International Monetary Fund obliged Egypt to adopt the Structural Adjustment Programme, pledging imminent prosperity, immense inflows of foreign investment and technology transfer, albeit that the outcome was at odds with the promises, since the program led to high redundancy rates, food insecurity and widening inequity (Naim, 2002). Unemployment levels reached 9% in 2010, but the precarious time bomb was youth joblessness, which skyrocketed to 38% in 2010 (UNDP, 2010). The gradual removal of food subsidies left 39% of Egyptian children stunted and 40% of females suffering from acute anaemia (FSAMU, 2009). The mounting food prices culminated in the violent food riots of 2008.

The banking sector has always been a vital source of finance for Egyptian businesses since deposits make up 101% of GDP (CBE, 2011). After the bank failures of 1997 and 2003, the Central Bank of Egypt (CBE) instigated bank
reforms in 2004, reducing non-performing loan (NPL) portfolio from 34% to 14.7% of GDP in 2010 (IMF, 2010). To ensure the sustainability of any democratic regime, it is imperative to design advocacy coalitions that contribute to socioeconomic development rather than abuse their relationships with policymakers and bankers.

Apart from favouritism in allocating credit, the Egyptian banking sector plays a poor intermediary role since the domestic saving/GDP ratio dropped to 13.6 in 2010 in comparison to 16.3 in 2007. Similarly, the investment/GDP ratio fell from 20.9 to 17.1 for the same period (CBE, 2011). The loan/deposit ratio also reached 48.5 in 2010 (CBE, 2011). Another serious concern is the excessively high level of bank density of 22.3 (CBE, 2011), which does not smooth the progress to a better quality of banking services (Maggi and Guid, 2009). The second set of problems pertains to the misallocation of credit away from the industries that enhance job creation and economic growth. Construction, tourism and agriculture are the sectors that mostly promote employment and growth, yet do not have adequate access to bank credit. Moreover, the costliness of bank loans is among the determining factors that are apt to stifle investment and economic growth. Berger et al. (2004) stipulate that cronyism undermines the market mechanism and does not allow ex ante domestic lending rates to be positively related to the market return. Instead, the lending rate would be set as per the mutual agreement of the tri-partied cronies – government ministries and the central bank, banks, and large businessmen. Lastly, the mediocre levels of banking regulation and corporate expose depositors’ funds to immense risks. Curiously, even at the brink of introducing Basel Accord II, the global economy was battered by the most severe global financial crisis ever. There are no corporate governance guidelines for Egyptian banks that prohibit conflicts of interest and the separation between bank ownership and management.

To adequately address all three sets of problems, it is essential to convert crony alliances into growth-enhancing coalitions. This article examines the effect of private sector advocacy in the Egyptian banking sector on enhancing and maintaining equitable macroeconomic performance, with the prime aim of designing an Egyptian-centric roadmap outlining precepts of good advocacy. The reason for selecting the banking sector is that it mobilises more than 75% of national savings. This article is topical for a nation that is grappling with making a swift transition towards democracy and inclusive sustainable growth. The fact that political upheaval has spread to other nations speaks to the heart of a similar set of pervasive predicaments infesting these economies. Hence, the experience of Egypt is apt to provide a useful example to other emerging economies sharing similar circumstances.

The rest of the paper is divided as follows. The second section delineates the existing types of relationships and coalitions that the private sector has successfully carved out within the Egyptian banking sector. The third section introduces the econometric model. The final section concludes with policy implications.

2. The business environment and private sector advocacy in the banking sector

Network theories of policymaking assert that the advocacy coalitions between private and public actors could either be abusive or growth-enhancing (Heintz, 1988). In the most repressive regimes with higher propensities for corruption and crony alliances, both private businesses and politicians endeavour to mutually exploit and share each others’ political and financial resources (Blumenthal, 1980). Conversely, under autonomous regimes there is scope for more active dialogue and collaboration (Schrage, 1990). In the case of service sectors, innovative forms of flexible linkages, individual alliances and professional networks have evolved (Davis and Meyer, 1998). When applied to the banking sector, private sector advocacy involves using persuasive measures and strategies to shape and reshape banking regulations at the central bank and individual bank levels through collective bargaining by trade associations and lobbying by private businesses (Grayson and Hodges, 2001).

The main goal behind building such a coalition for the management of the individual bank is to sustain growth and profitability (Kaufman and Seelig, 2001). But the type of coalition – be it a growth alliance or an abusive partnership – hinges upon the structure, maturity and depth of the banking sector. Another determinant of the type of partnership is the efficacy of regulators and corporate governance processes (Mostovicz et al., 2011). In poorly regulated and highly concentrated banking sectors, where large corporate clients comprise the backbone of banking operations, there is a higher tendency for advocacy efforts to give birth to abusive partnerships and public-private alliances are perceived to be dominated by cronies’ capitalism and rent seeking (Schneider, 1998). With the rise in the incidences of bank failures in emerging economies and with the maturity of regulatory legal edicts, growth alliances have started replacing exploitative partnerships (London, 2008).
Where reforms have been ineffectual, collective bargaining institutions remain superficial, hence forcing private producers to establish informal alliances and coalitions with regulators and bankers (Rosenbaum, 2006). Some of these alliances are adopted to promote profitability for both private entrepreneurs and banks (Knoke, 1990). The ideal way to spur economic growth in such transitional societies is to engage the private sector (Rondinelli, 2002). The first alternative is for private businesses to enter into a formal working relationship with ministerial agencies (Fox, 2001). If the government does not show interest in establishing formal partnerships, collaborative pressure groups could be formed to influence bankers and policymakers to adopt policies that are fully supportive of the social and civic agenda (Andrews and Edwards, 2004). One example is the formal alliance between business membership organizations on the one hand and bankers and regulators on the other hand (Leftwich, 2009). Therefore, prior to influencing decision-making and credit allocation, the business community should assess where its interests lie and communicate its position to the community, bankers and the government (Doner and Schneider, 2000). Amid the rising demands for all-inclusive reforms in developing nations, the most viable avenue for banks is to attain a larger customer base rather than form abusive alliances with a narrow base of high net-worth customers, but this could be a taxing task given the complex mix of client segments and product lines (Schmid et al., 2008).

2.1. The evolution of alliances in the Egyptian banking sector

The banking reform plan and the stringent capital requirements imposed by the CBE have shown success in reducing the number of banks from 57 in 2004 to 39 adequately capitalised banks in 2010. To ensure that the interests of all players are satisfactorily voiced, the CBE has engaged private bankers and representatives of business membership organizations (BMOs) whenever it planned to introduce reforms or to draft new laws. Thus, the door was opened for the evolution of growth alliances between BMOs and the respective ministries. This led to the co-existence of cronyism and growth alliances within the Egyptian banking sector. While large businesses exert pressures on both the policymakers and the banking institutions, SMEs try to pressurise policymakers through sporadic collective actions. Also, large businesses either directly pressurised banks to access credit or indirectly approached ministries and the CBE to unevenly extend permits to their businesses and to compel banks to give them loans. As such, it becomes imperative to measure the efficacy of private sector advocacy to dilute cronyism.

3. The empirical model: Confirmatory Factor Analysis

The outcome of the competition of both parties over scarce bank loans hinges on the success of businesses and BMOs in sharing control of the levers of representative economic decision-making. This is the most vital step to disband the illicit collaboration between government officials and their business cronies to influence policy-shaping and bank-lending decisions (Gilpin et al., 2011). The existence of cronyism entails that ex ante domestic lending rates might not be positively related to the market return, but could be set by mutual agreement of the relevant cronies – the government, banks, and businesses. Earlier research did not attempt to develop advocacy indicators, making it difficult to gauge its impact over time. The reason is that advocacy is an abstract and theoretical concept that is not easily measured. In this article, advocacy is measured using Confirmatory Factor Analysis (CFA). A single latent variable – advocacy – is assumed to underlie or cause four observed variables. Factor analysis examines if the variables load as expected on the number of factors and if the measures comprising a latent variable belong with one another. The data collected for the variables is transformed into a cardinal index. The latent variable approach is used to evaluate the extent to which advocacy indicators capture similar information. Even though the CFA technique has not been used before in measuring indicators of advocacy, the exploratory variables are selected in accordance with some of those proposed in the literature. Hence, this study subjects the construct of the advocacy indicators to a CFA to provide a more stringent test of the tenability of the four-factor structure.

Indicators of advocacy are chosen as follows: the ease by which businesses access credit (BCA), the interest rate spread (IRS), loans extended to GDP growth-promoting sectors (GPS), and loans extended to job-generating sectors (JGS). The first indicator examines how alliances between bankers and policymakers facilitates and expedites access to credit. Secondly, the spread between the borrowing and lending rates is used as a proxy for credit allocation because it represents an ex ante measure of the national price of commercial credit (Johnson and Mitton, 2001). The last two indicators are commonly used by individual businesses and BMOs to pressurize
ministries and central bankers to devise policies and extend incentives to direct loans to sectors that enhance macroeconomic performance. Moreover, the loans extended to growth-promoting sectors are considered as an important indicator of favourable private advocacy efforts by businesses and trade unions (Rennhack, 2000). Equally important for emerging economies, which have predominantly young populations and large labour market participation, are the loans extended to job generating sectors. The sample size is 247. Table (1) shows high correlation coefficients among advocacy indicators. The univariate skewness of each variable is equal to 0.937 in absolute value and the univariate kurtosis of each variable is 1.188 in absolute value.

| Table (1) Correlations among advocacy indicators |
|-----------------------------------------------|
| BCA  | IRS | GPS | JGS |
| Getting Credit Indicator (BCA)               | 1    |     |     |
| Interest rate spread (IRS)                  | 0.83 | 1    |
| Loans to businesses promoting sector growth (GPS) | 0.91 | 0.72 | 1 |
| Loans to job-generating sectors (JGS)        | 0.88 | 0.83 | 0.89 | 1 |

All variables are highly significant at p<0.01.

\[ A = \Lambda \xi + \delta \]  

(1)

where, \( A \): vector of variables measuring the indicators of advocacy  
\( \Lambda \): the matrix of corresponding unknown factor loadings capturing scale indicators and the strength of the relationship to \( \xi \)  
\( \xi \): indicators of the exogenous latent variable of advocacy  
\( \delta \): vector of measurement errors  

\( A \) and \( \xi \) are deviations from their means. The following accompanying assumptions are made:

\[ E(\delta) = 0; \quad E(\xi') = 0 \]

Equation (2) measures the population covariance matrix \( \Sigma \),

\[ \Sigma(\theta) = E(\Lambda \xi') = \Lambda \Phi \Lambda' + \Theta \]  

(2)

where, \( \Phi \): The covariance matrix of \( \xi \) and \( \Theta \): The covariance matrix of \( \delta \)

Then, the maximum likelihood function is used to estimate the equation.

\[ F_{ML} = \log|\Sigma(\theta)| + \text{tr}[S\Sigma^{-1}(\theta)] - \log|S| - q \]  

(3)

where, \( \Sigma(\theta) \): implied covariance matrix  
(\( S \)): sample covariance matrix  
(\( q \)): number of indicators

The questionnaire was piloted during March-June of 2011. The items included in the questionnaire test the process and depth of advocacy pressures by business firms on bankers, policymakers and central bankers. The questionnaire uses a five-point Likert scale, ranging from 1 (strongly disagree) to 5 (strongly agree). Out of 330 questionnaires, only 247 usable questionnaires were included representing 74.85%. In addition, a personal interview was conducted with bankers and businesses in order to exclude the risk of bias in the answers. The measurement model using confirmatory analysis demonstrates a good fit with the sample data. The results show that all 11 items converge into a single advocacy construct. Based on the overall assessment of model fit indices, advocacy efforts have a substantially positive impact on macroeconomic growth, albeit that it has not shown a strong impact on reducing the interest rate spread or inflation. To confirm the results, the maximum likelihood method of estimation was used in conjunction with the Satorra-Bentler (2001) scaled \( \chi^2 \), which corrects for non-normality. The \( \chi^2 \) test statistic is significant but was substantially reduced (Satorra–Bentler \( \chi^2 = 816.71 \), df = 371, and p < .001).

4. Conclusion and Policy Implications

Among the prime factors that triggered the Egyptian Revolution are poor political representations, the lack of transparency, staggering inequity, and rampant cronyism. Private interests would no longer be allowed to hijack
societal rights, corruption must be undermined and bank funds should be impartially allocated. But concurrent with
the crony relationships in the Egyptian banking sector, two factors have resulted in the rise of growth alliances and
good private sector advocacy practices since the turn of the century. First, the level of cronyism that peaked since
the appointment of the so-called “businessmen cabinet” in 2005 led to the emergence of counter-groups undertaking
a broad range of initiatives to foster fair competition and entrepreneurial activity. Moreover, a counter-corruption
movement evolved after the Bank Reform Plan of 2004, wherein some ministries and central bankers started
inviting the business community in shaping policies, procedures, national strategies and even laws.

The research reveals that good advocacy measures have a positive impact on accessing bank credit and directing
loans to businesses that enhance sectoral growth and job-generation. However, advocacy has shown a negative
effect on the cost of credit, which is apt to cause price hikes. High interest rates could undermine the ability of small
businesses to access bank credit. To improve the working environment there is a number of vital issues that need
immediate consideration. First, the CBE should give incentives to banks to increase the loan-deposit ratio from the
current low level of 48.5. It must also provide directives to lend growth-promoting and job-generating sectors. Being
the prime agent of combating inflation, the CBE should not resort to aggressive contractionary monetary policies that
are apt to further increase interest rate spreads and cause a slowdown in economic growth. Finally, businesses
should insist on collaboratively designing and implementing sound corporate governance guidelines to ensure that
internal bank governance complies with both the goals of stakeholders as well as societal aspirations.

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