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CAPITALISM IN EGYPT

Ishac Diwan and Marc Schiffbauer

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## Abstract

In Egypt, the bulk of bank loans during 2003-2010 went to politically connected firms. At the same time, the banking sector was liberalized increasingly operated around competitive and profit-maximizing principles. A key puzzle that the paper tries to answer is why private banks may lend in preferential ways to politically connected firms (PCFs) in such an environment. Using a rich corporate dataset, we find that politically connected firms did not have higher profitability compared to non-politically connected firms. This suggests that PCFs were perceived to have lower risk. Indeed, we find evidence that this was the case, and that lower risk reflected higher access to bailout guarantees (implicit or explicit), as happened in earlier periods, and/or higher perceived growth opportunities.

**JEL Classification:** G3, P16

**Keywords:** State-Business relations; Egypt; cronyism; banking

## ملخص

حصلت الشركات المرتبطة سياسيا على الجزء الأكبر من القروض المصرفية خلال 2003-2010 في مصر. وفي الوقت نفسه، كان القطاع المصرفي قد حرر بشكل متزايد حول مبادئ التنافسية وتعظيم الأرباح. اللغز الرئيسي الذي تحاول الورقة الإجابة عليه هو السبب الذي يجعل البنوك الخاصة قد تقرض بطرق تفضيلية الشركات المرتبطة سياسيا في مثل هذه البيئة. باستخدام مجموعة بيانات غنية عن الشركات، نجد أن الشركات المرتبطة سياسيا لم يكن لديها ربحية أعلى مقارنة مع الشركات غير المرتبطة سياسيا. هذا يشير إلى أن الشركات المرتبطة سياسيا كان ينظر إليها على أنها ذات مخاطر أقل. وفي الواقع، نجد أدلة على أن هذا هو الحال، وأن انخفاض الخطر ينعكس بشكل أعلى على الوصول إلى ضمانات الإنقاذ (صریحة أو ضمنية)، كما حصل في فترات سابقة، و / أو ارتفاع فرص النمو المتصورة.

## 1. Introduction

The banking sector was liberalized in Egypt in the mid-2000s, a period that saw the emergence of dynamic and seemingly competitive private banks, with several foreign banks entering the market. This then suggests that bank lending during this period needs to be largely explained by profitability considerations. If politically connected firms (PCFs) managed to attract a large share of private banks credit, as we show was the case, then some mechanisms must have existed to boost their attractiveness to private banks.

This is in sharp contrast to the cronyism of the 1990s, which was much more centrally connected with directed state credit. Back then, banking was dominated by the state. The 1990s was a period of opening up of the economy and of privatizations, which benefitted the rise of crony interests, much of it financed through state banks.

The extension of credit to connected firms in a liberalized financial regime raises new and interesting questions. It would be surprising that deregulated banks, especially those in the private sector, could be influenced directly by politicians to lend more to PCFs. In reality, a few of the private banks came to be controlled by politically connected families and public banks, which retained nearly 35% of the credit market, did finance some of the large PCFs (Skafianakis 2004, Roll 2011). But in addition, most of the private and independent banks had their lending portfolios dominated by loans to these PCFs.<sup>1</sup> In fact, commercial banks in Egypt had in the late 2000s one of the highest loan portfolio concentrations in the world, while smaller firms, and unconnected firms receiving a very small share of private sector credit (World Bank 2011).

In addition to the issue of ownership and direct control of banks' lending decisions, which can explain why public banks and connected banks lent primarily to connected interests, there are two possibilities, not mutually exclusive, that can explain why private banks found it more profitable to lend disproportionately to PCFs. First, PCFs may have higher profits due to the privileges they receive, making them the best clients from private banks' perspective. Second, PCFs may have appeared less risky. Private commercial banks were relatively new to Egypt, and courts have been notoriously slow at recouping unpaid credit. Moreover, private banks in the Middle East tend to operate in an environment of huge policy uncertainty. Facing more risk, private banks might adopt a more conservative approach to lending that privileges low risk, low return investments to high risk, high return ventures, favoring the stability offered by political connections over profitability. PCFs could have appeared to be less risky due to their owning of better collateral, or their large and seemingly protected market share, or possibly to their privileged access to (possibly implicit) government guarantee that they would not fail, or that they would be bailed out if they did.

Overall, the findings of this empirical analysis support the contention that PCFs receive larger loans than non-connected firms, and that they are more likely to operate in sectors, which contain a greater proportion of firms with access to bank loans. Probing the possible drivers of lending to PCFs further, the paper does not find that the profitability of PCFs has tended to be higher than that of non connected firms. Instead, our results tend to favor the second explanation based on risk as the likely driver of bank lending.

The paper draws on our recent work on cronyism in Egypt, and in particular, on Diwan, Keefer, and Schiffbauer 2015, and Chekir and Diwan 2014. These papers identified a dataset of connected firms in Egypt, evaluated the value of connections using an event study around the 2011 uprisings, studied several mechanisms that provide privileges, and showed that cronyism reduces competition and growth.

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<sup>1</sup> Private interviews with banks in Cairo, 2012.

The paper is organized as follows. In section 2, we review the global literature on political connection and access to finance. In section 3, we describe what is known about the evolution of cronyism in Egypt, and we review the parallel changes in the financial sector introduced by the market reforms that started in the early 1990s. In section 4, we describe our data and identify the PCFs in Egypt, and we show that PCFs in Egypt had much higher leverage than non-connected firms. In section 5, we ask whether this is due to their profitability. Section 6 looks at whether excess borrowing can be attributed to a perception by the markets that these firms had lower risk. Section 7 concludes with some considerations about the relation between financial systems and power relations.

## **2. Cronyism and Banking**

The literature on political connections has focused on two separate concerns: the mechanisms used to favor some firms and exclude others, and the effect of political connections on firm's profitability. In trying to understand why PCFs receive more credits from private banks, we need to address both these issues simultaneously.

A large literature has also addressed specific mechanisms through which firms may gain from political connections (e.g., Cull and Xu 2005 for China; Johnson and Mitton 2003 for Malaysia; Khwaja and Mian 2005 for Pakistan; Leuz and Oberholzer-Gee 2006 for Indonesia; Claessens, et al. 2006 for Brazil; Rijkers et al. 2014 for Tunisia, and Faccio et al. 2006 based on cross-country panel data; see also Boubakri et al. 2010 and Goldman, et al. 2008). Many mechanisms that confer an advantage to politically connected firms have been studied, including tax advantages, greater unchecked market power, preferential access to government contracts or to subsidies, and preferential regulatory treatment.

One of the most studied mechanism concerns access to finance. Many studies find that PCFs have higher debt to equity ratios (Cull and Xiu 2005, Khwaja and Miang 2005, Faccio 2003). But this begs the question of why banks would lend to such firms. Many of these studies have focused on loans from public banks, which can be directly pressured to lend to politically connected firms. In the case of private banks, two possible explanations are discussed in the literature: these firms are more profitable, or they have higher chances of being bailed out if they fail.

Access to private finance would be facilitated if connected firms had higher profits than non-connected firms. Researchers have asked how politically connected firms perform relative to non-connected firms. The performance effects of cronyism are, in theory, ambiguous. On the one hand, PCFs benefit from privileges. On the other hand, they may also be obliged to compensate politicians for the favors granted them in costly ways, for example by creating more jobs than business conditions merit, or by financing the electoral campaigns of their political allies, which educes their profitability. A priori, the net effect can go either way, depending on the specifics of the bargaining between patrons and their clients (Schleifer and Vichny, 2004).

Most researchers have found that connected firms perform better (Roberts 1990 and Goldman et al. 2009, for firms in the U.S., and Ramalho 2003 for firms in Brazil). Authors taking a more historical approach (Ferguson and Voth 2008, looking at Nazi Germany, and Haber and Maurer 2007, examining connected firms under the dictatorship of Porfirio Díaz in México) have reached similar conclusions. Boubakri et al. (2009) document more clearly the causal path from connections to performance by finding that firms improve their financial performance after establishing connections.

But a few studies have found that connected firms can end up with less value than comparable non-connected firms. Bertrand et al. (2007) find that firms managed by connected CEOs in France create more jobs and pay higher wages than non-connected firms. But this does not

mean that the value of connections is negative. Using a large cross-country panel, Faccio (2007) concludes that while connected firms have higher value than non-connected ones, they perform worse than unconnected firms on a rate of return basis. Her results suggest the possibility that the connected firms in her sample have higher values because they also receive implicit bail-out guarantees, which are reflected in the value of the firm, but not in their return on assets. Only a few studies have studied bail-out guarantees as a mechanism of privilege by documenting how connected firms exhibit higher default rates and receive more frequent bailouts (Faccio et al, 2006, Khawaja and Miang 2005).

Beginning with Fisman's (2001) seminal contribution, scholars have tried to estimate the positive value of political connections by investigating movements in the stock prices of connected relative to other firms in response to exogenous changes in the probability of regime change. This premium can be due to either extra profits due to privileges, or to implicit bail-out guarantees priced by the market ex-ante, both of which would disappear when these connections are severed. In Egypt, Chekir and Diwan (2012) estimate the value of political connections to be between 13 to 16 percent of the firms' value, close to Fisman's estimates of the value of connectedness in Suharto's Indonesia. Acemoglu et al (2014) find broadly similar results for Egypt. But a priori, this premium can be attributed to excess profits, bailout guarantees, or a combination.

### **3. Cronyism and Banking in Egypt**

The Middle East literature on Arab capitalism contains rich analyses of how autocrats allowed business elites to dominate the business sector in exchange for support for the regime. Qualitative research has documented barriers to entry that excluded opponents and provided privileges to a small coterie of friendly capitalists (Henry and Springborg 2010, Owen 2004, Heydeman 2004, King 2009). In Tunisia, the Ben Ali and Trabelsi families monopolized business opportunities and even expropriated the real estate and business holdings of wealthy elites. Similar stories about favoritism and insiders abound in Syria, Libya, Yemen, and Algeria, where political cronies seem to control large chunks of the private sector (Albrecht 2002, Alley 2010, Haddad 2012, and Tlemcani 1999).

In Egypt, the market based reforms initiated in 1991 led to a large expansion of cronyism. While Sadat's opening advantaged a handful of private businessmen, Mubarak cultivated a larger group of cronies that took advantage of the withdrawal of the state from several sectors that were formerly considered strategic to expand their business interests rapidly during the 1990s (Owen 2004, Henry 1996). While political motives are hard to pin-point, it is noteworthy that cronyism arose in the Middle East in response to economic with no political liberalization. For many analysts, economic liberalization had to advantage a close circle of trusted allies and to at the same time exclude from the heights of the economy autonomous interests that could strengthen the opposition (Henry and Springbord 2006, Owen 2004, Kienle 2004). Indeed, firms suspected of sympathies with Islamic parties were at various times repressed in Egypt (Henry and Springborg 2010, Osman 2012).

In the early 2000s, the country's policies shifted towards accelerated privatization and financial sector and trade reforms. Politically connected firms were able to capture much of the new opportunities created by liberalization (Roll 2011, Diwan et al 2014). Connected interests especially thrived in the "businessmen" cabinet headed by Ahmad Nazif from 2004 to 2011 (Kienle 2004, Sfakianakis 2004), as they managed to expand massively in real estate and construction, tourism in coastal areas, the oil and gas sectors, the banking sector, and telephony, as well as in local distribution of international consumer brands (Roll, 2010; Loewe, 2013).

Government decisions were key in all of these areas – tourist resorts and housing projects were built on formerly government-owned land; investments in oil and gas required government approval; new banks or factories in specific manufacturing sectors such as cement required

government licenses. Connected firms could leverage their connections to ensure that international brands seeking to enter Egypt would grant them exclusive distribution licenses, shielding them from competition.

Connected businessmen were well-placed to influence these decisions: they were not only personally well connected with the political leadership, but they themselves also occupied important post in government, the ruling party, parliament, and various influential boards and committees (Demmelhuber and Roll, 2007; Roll, 2010; Loewe, 2013). Trials of leading businessmen since the uprisings of 2011 have shed light on land appropriation at below-market prices; the manipulation of government regulations to stifle competition; subsidized borrowing from state banks; and privileged access to subsidized energy and state procurement contracts (Adli 2013).

The focus of this paper is on how these connected interests managed to have preferential access to finance, in an environment where the financial markets were seemingly liberalized. This is in sharp contrast to an earlier period, where the financial sector was closely guarded, and where financial decisions followed tightly government decisions.

To recall, the management and control of financial sector in Egypt evolved in parallel to the evolution of productive structures. Pre-Nasser, a private sector of conglomerates dominated the banking sector and supported the country's industrialization along a German model of a banks' dominated economy - Talaat Harb's Bank Misr playing a prominent role in this expansion (Henry 1996, Cammett et al 2014). The nationalization of industry and banks in the early 1960s by Nasser was followed by a reorganization of production and finance in a centralized top-down manner – and the establishment of four large public sector banks organized among sectoral lines, in addition to various smaller regional banks.

After hesitant reforms in the context of Sadat's Infitah in the late 1970s, which allowed for the establishment of several joint venture banks – public sector and foreign interests, more important reforms had to await 1991, when facing financial crises and large foreign debt, Egypt undertook deep adjustment and structural reforms. One of the key reforms concerned the liberalization of bank deposit (and lending) rates, which managed over time to attract large amounts of remittances and capital flight, and that played a central role in stabilizing the balance of payment (Cammett et al 2014). The banks' regulatory framework was also tightened by strengthening reserve requirements, increasing capital adequacy, and restricting lending to single borrowers, in an attempt to avoid the constitutions of large NPLs as had been the case in the past. The capital markets were also revived.

But until 2003, these reforms had limited impact on the way the financial sector worked. By the early 2000s, bank credit had risen to about 70% of GDP, close to middle-income averages, and lending to the private sector had reached about half of banks' portfolios (World Bank 2008). But public banks had remained dominant, and channeled much of their resources to either public sector entities, or to politically connected interests. The four main public sector banks continued to dominate the banking scene, but they had low profitability due to their heavy lending to SOEs (Henry 1996). These were followed by the "Infitah banks", mostly joint ventures between Egyptian interests and foreign banks with better returns on assets. A "third sector" of smaller private banks had mostly low returns and largely served connected interests. The large public sector banks partially owned most of the private banks. Politically connected businessmen were more interested in quick profits, and in diversification abroad, and they only invested marginally in these banks' equity. Instead, their strategy relied on getting maximum influence (and borrowing) for minimal investment. As a result, the banking sector was fragmented in the 1980s, unlike in Turkey, Morocco, or Tunisia, where it was more heavily capitalized. There was a growing sector of Islamic financial institutions, which benefited from financial deregulation and especially from the differential exchange rate system, drawing on



migrant remittances from the Gulf. This system was however effectively closed down by the Central Bank in the late 1980s, partly in an effort to improve regulation, and partly for political reasons, to shut down sources of finance for Muslim political parties (Henry and Springbord, 2006). By the late 1990s, NPLs were high again, estimated at 24% of banks' assets (Roll 2011).

The reforms initiated in 2003 were more serious. A new banking law aimed at consolidating the industry by privatizing state ownership and reducing the number of banks. The number of banks fell from 62 to 39 (by 2008), foreign ownership increased and came to control 15 banks, one of the 4 state banks was privatized, and public banks sold their interests in the private and joint-venture banks. By 2008, the private banks controlled more than 50% of deposits, and their lending constituted about 65% of total bank lending (World Bank 2010). NPLs fell to 15%, due to and tighter quality controls, as well as to banks recapitalization. Overall credit fell (by mid-2005, to about 50% of GDP), as a result of tighter regulations, and the private sector share of lending remained at about 50% of total lending.

It is noteworthy that the improvement of the quality of private banks portfolio was partly funded by government bailouts and recapitalizations. In 2004, the central bank law was changed to allow for out-of-court settlement, and a special unit was created at the central bank to lead the effort of reducing NPLs. Debt to equity swaps were negotiated with connected businessmen in the absence of any transparency, and the financial press at the time was replete with suggestions that those deals benefitted handsomely some high-level indebted entrepreneurs (Roll 2011).

Yet, in spite of the existence of a seemingly more competitive and liberalized credit system, in 2010, Egypt had the most concentrated lending portfolio of the MENA region. The top 20 exposures adding up to more than 50% of banks portfolios (World Bank 2011, Figure 4.9). At the same time, while the ratio of lending to the private sector over GDP was at about the lower-middle income level (at about 30% of GDP), the WBES reveal that only 5% of firms had a credit line in 2010 – the corresponding figure for lower-MICs is five times larger. In the next section, we show that most of this credit went not just to large firms, but indeed to the politically connected few of them. We then investigate in the following sections the mechanisms that permitted this, in spite of what looked like a liberalized banking system.

### ***3.1 Do connected firms have better access to credit?***

To examine the extent and nature of insiders' privileges, we first need a dataset of politically connected firms under the Mubarak regime in Egypt, and information about their firms' borrowing and performance. In Diwan et al (2014), we created a list of 32 politically connected businessmen (all were men) by interviewing managers of banks and private equity funds, lawyers and NGOs (e.g., anti-corruption organizations). We pruned the list to include only those businessmen who had, or whose immediate family members had, influential political posts in the ruling party or in the government.<sup>2</sup>

We then matched the list of politically connected businessmen to firms listed in the Orbis database. The Orbis database includes information on the board members, managing directors, or major shareholders of 854 firms that are currently or were formerly traded on the exchange. The names of 32 of the businessmen identified in step one unambiguously matched the names of board members, managers, or major shareholders of 104 firms. Since many of these firms were holding companies or investment funds, we used the Internet to identify the names of subsidiaries (up to two tiers), which we then matched with firms in the Orbis database. The

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<sup>2</sup> Out of the 32 PC businessmen, 18 were ministers or led the policy committee in the National Democratic Party (NDP) after 2001 and controlled two-third (307 of the 469) of the firms we ultimately identified as connected. The policy committee is a crucial body at the NDP and is the source for most of the government's actions (Demmelhuber and Roll, 2007; Roll, 2013). The other 14 businessmen are either long-term friends of Hosni Mubarak from military times or co-founders of a large investment bank partly owned by a Cyprus registered company owned by the Mubarak family.

process yielded a total of 469 firms that are unambiguously controlled, directly or indirectly, by a connected businessman.<sup>3</sup> Politically connected firms are especially concentrated in tourism (hotel and restaurants, tour operators, transport), real estate, construction, wholesale & retail trade, mining, finance, business services, and manufacturing sectors. Out of the total set of connected firms, there are 22 firms traded on the Egypt Stock Exchange (out of a total number of 122 traded firms). Data on firm performance is available in the Orbis database - it contains employment data for 20,000 establishments between 2003 and 2012; operating revenues for about 700 large establishments; and profits for about 400 large establishments.

If politically connected firms have policy advantages over unconnected firms, they should be able to accumulate larger market shares and scale than would otherwise be the case. Employment and revenues should therefore be greater. The Orbis data has employment data for around 20,000 establishments. On average, the 436 connected firms in this dataset (33 connected firms have no employment data) have 941 employees compared to 253 employees among the remaining establishments. Orbis consolidated revenue data, available for 678 firms, reveals that 67 connected firms with data had revenues of \$172 million, on average, four times higher than the 611 unconnected firms between 2003 and 2010.

Our analysis will not just compare the performance of connected with unconnected firms, but also the performance of sectors according to the concentration of cronies in the sector. The analysis is feasible because of substantial dispersion in the intensity of political connections across sectors. Firms in Egypt operate in 320 non-farm, non-government 4-digit ISIC Rev.4 sectors. The PCFs that we have identified are active in about half of these.

Abundant anecdotal evidence indicates that PCFs in Egypt have superior access to credit. In our dataset, 85% of the loans carried by firms in 2010 were on the books of PCFs. This confirms that the loan portfolios of banks were extremely concentrated and were tilted massively to PCFs. This concentration can be due to two possible reasons. First, it could be that they are able to borrow more than their competitors in their sector of operation. And second, it may be that PCFs tend to be disproportionately in capital-intensive sectors. Below, we show that both mechanisms were at play in Egypt in the 2000s.

First, we can compare firms' borrowing in the Orbis database, controlling for sector of operation, as well as other firm characteristics such as age, to check if connected firms borrowed more than those without political connections within particular sectors of activity. The results of these regressions, shown in Table 1 confirm that PCFs carry much more debt than non connected firms. More specifically, we measure that the PCFs have a debt to equity ratio that is larger than unconnected firm by 40% for the larger set of 469 PCF, and by over 100% (i.e double) for the smaller set of 22 firms traded on the EGX. These are clearly extremely large differentials, especially that we are controlling for the sectors in which these firms operate.

Second, we can use the World Bank Enterprise Survey (WBES) data to learn more about the type of firms that get more credit, i.e, check if sectors that end up more politically connected are also sectors that are more dependents on loans. The WBES data include data from 3,040 firms in 91 4-digit (ISIC Rev. 3.1) manufacturing sectors. Moreover, while the WBES is a survey, it covers most large firms within a sector, which typically includes the connected firms in sectors where these firms are present.

The WBES has detailed 4-digit industry-level information on access to credit. We look at responses to the questions: "Does your establishment currently have a loan from a financial

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<sup>3</sup> The set includes: 47 PCFs with a politically connected general manager; 140 with at least one connected board member; 334 firms with ownership stakes by at least one connected businessman or firm; and 172 firms with ownership stakes by a private equity fund owned, in turn, by at least one politically connected businessman.

institution?” We can then ask whether WBES respondents in sectors with more PCFs are more likely to report that they receive loans – but we cannot be sure that those firms that report having received benefits are politically connected as WBES respondents are anonymous. We do this by asking whether firms in sectors with more politically connected firms enjoy greater access to loans by estimating probit regressions that assess whether the probability that a WBES firm respondent reports access to credit increases when it operates in a sector containing more politically connected firms:

$$Pol_{ij} = \beta_C connected_j + \beta_x X_{ij} + \beta_s S + \varepsilon_{ij} \quad (1)$$

The dependent policy variable  $Pol_{ij}$  is a dummy variable for firm  $i$  in the sector  $j$ . It equals 1 if the firm has a bank loan, respectively, and zero otherwise; *connected* measures the number of politically connected firms by type in the sector  $j$ .  $X_{ij}$  is a matrix of the firm level control variables (firm size and age), and  $S$  is a matrix of sector dummies.<sup>4</sup>

The results, in Table 2, show that firms in sectors with more politically connections are more likely to report that they have obtained a bank loan. The results are robust to controlling for sector-specific effects, firm size and firm age. In effect, it seems as if PCFs enter preferentially into sectors that are more intensive in their use of capital in order to take advantage of their comparative advantage at assessing loans.

In conclusion then, it is apparent that PCFs managed to take massively larger loans than unconnected firms, both because they have an advantage at borrowing within the sectors in which they operate, and because they also tend to enter into capital-intensive sectors. The question this poses is how they managed to improve their lending prospects in the liberalized financial market environment of the end of the 2000s.

### 3.2 Is it profitability? Firm performance and political connections

The profitability (profits/assets) of connected firms could be larger than that of non connected firms, on account of the various privileges they receive, unless they have other disadvantages that reduce their profits. Diwan, Keefer, and Schiffbauer (2015) presented evidence that, in the 2000s, connected firms enjoyed ample policy advantages including protection from foreign competition, better access to energy subsidies and land, and less exposure to the arbitrary application of business regulations, all of which boosted their profitability relative to non-connected firms.

Profits data in the Orbis data-base are available only for 288 firms. Of these, the 49 connected firms had average net profits that were *13 times* higher than the profits of the other firms taken together. But at the same time, these firms tend to be much larger, and highly capital intensive, and they may have had to repay the favors to politicians in various ways, and so the return to the capital they use, which is the performance measure most relevant for their bankers, may be small.

Table 3 presents the results of a more rigorous comparison of profitability of connected and unconnected firms in our small and larger PCFs samples. In the large dataset of firms we use, and within 4-digit sectors, the 469 PCFs we had identified have no advantage in terms of their return to assets (RoA), and a slight advantage in terms of their return on equity (RoE). When focusing on the largest 22 PCFs which are traded on the EGX, performance is even weaker relative to the non-connected firms – they have a lower RoA, with the difference significant and large at -1.6 percentage point. But there is no significant RoE (dis-) advantage to PCFs.

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<sup>4</sup> Thus, (1) tests if, within the same 2-digit sector, WBES respondents in 4-digit industries with more political connections report greater access to credit than those in related 4-digit industries without connections. Overall, we observe 80 4-digit sub-sectors in 23 2-digit manufacturing sectors with available information on the policy variables. All estimations include standard errors clustered at the 4-digit sector level to account for shocks common to firms in 4-digit sectors.

Thus, minority shareholders were not expropriated as they benefitted from higher leverage (and a premium on the pricing of these earnings, see below). This in itself is not contradictory since PCFs have much higher leverage, and so as long as the interest rate charged on their loan is low enough, more leverage leads to higher ROE, and in effect, the shareholders' gain is the bankers' loss – or the state loss, if banks perceived the state to be backing up these loans with an implicit bail-out guarantee. But clearly, we can also conclude that the superior ability of PCFs to obtain large credits is not due to their superior profitability.

We can also test more directly whether there is a relation between the overall level of debt carried by a firm and its level of profitability. We seek to explain variations in the debt ratio of firms in relation to whether they have political connections and their profitability. The problem with these tests is that the number of observations shrinks because a small number of firms report their profits. So only use the larger dataset for this exercise. The results, in Table 4, are clear: debt does not rise with profitability, measured in several ways – it actually decreases.

If it is not profitability that allowed PCFs to borrow so massively, what it is then that created incentives for banks to lend them? Before exploring risk considerations, we ask here to what extent this could have been due to their direct influence on banks. Clearly, the 3 large public sector banks continued to be a channel for state influence on business even during this period (Roll 2010). There are indeed several known cases where large PCFs emerged due to financing by public banks. The most well known case is probably that of Ahmed Ezz, who built a steel empire that monopolized the Egyptian market based on public sector bank's loan (Werker et al 2014, El-Naggar 2009:40).

But public sector banks do not explain the whole story, given the massive advantage of our PCFs found above. Another question is whether connected interests controlled directly private banks. But it seems that only a handful of the main connected groups had control of an important bank – in our Orbis data, we could only find 4 such cases, out of the 36 main banks with information in the database. The main case is that of Credit Agricole Egypt, which belonged in parts to two large and well connected businessmen, Mansoor and Maghrebi, and which served their corporate interest well by allowing them to develop a mortgage market to finance their sprawling real estate business (Roll 2010).<sup>5</sup> But the contrast with Turkey, or Morocco, where large industrial groups tend to be organized around a large bank is striking. Unlike these countries, it appears that connected capitalists in Egypt did not engage in a strategy of capital accumulation. Indeed, many engaged in diversification abroad, perhaps to enhance their bargaining power as clients (Roll 2010).

We can check in our Orbis database whether the financial institution with some participation by connected interests are different from other financial institutions with no such interests (see Table 5 below). It turns out that these politically connected financial institutions tend to be smaller, but they did not have a lower rate of return than non-connected financial institutions, unlike the situation described by Henry (1997) in the 1980s and 90s. In the main, this confirms that control over banks was not the principal strategy followed by PCFs to control access to bank finance.

Thus, there is no escape from the conclusion that even though PCFs were not more profitable, they still manage to attract an inordinate share of total bank lending on what must have been profitability considerations. It is as if by the late 2000s, the PCFs were seen by banks as the only credible clients that they could find. Indeed, in those years, most of bank lending to the

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<sup>5</sup> A few PCFs more controlled various financial institutions such as equity funds (in our database, 55 out of 1232 financial institutions listed in Orbis).

private sector took the shape of loan consortiums where several banks came together to organize a large loan to a PCF (personal interviews).<sup>6</sup>

While the banking sector remained fragmented, another difference with Morocco and Turkey was the increased role played by the equity market in facilitating PCFs' access to finance, and indeed, several of the largest PCFs raised funds through IPOs, which facilitated larger bank lending by building up their equity.<sup>7</sup> Much of this expansion happened under the leadership of a very well connected investment bank, EFG Hermes, which was owned in part by several of the best-connected families (Roll 2010). The Egyptian stock markets developed considerably in the 2000s, partly as the result of the entry of foreign investors into the market, and this largely advantaged connected interests. The value the 22 PCFs that traded on the EGX grew to represent between 40 and 50% of the market value between 2008 and 2010 – in 2003, the median PCF listed on the EGX was only 10% large than the median NCF, while by 2010, the asset size differential had grown to seven times.

### ***3.3 Are connected firms perceived to be less risky?***

If they were not perceived to be more profitable, were PCFs perceived to be less risky? It is noteworthy that legal rights are difficult to enforce in Egypt's judicial system. The World Bank Doing Business Report measures the quality of legal rights connected to banking as an index between 0-12. The score for Egypt was 2 in 2010, compared to an average score of 5.2 for lower-middle-income countries. Operating as they were in an environment with weak legal recourse in case of default, if banks perceived PCFs to be less risky clients, this would make them more attractive borrowers compare to non connected firms.

We investigate here various possible aspects of this. First, do PCFs have larger collateral, as a result of preferential access to land? Second, we look at other indications of lower risk by comparing the PERs of PCFs and non-PCFs.

Abundant anecdotal evidence indicates that politically connected firms in Egypt have superior access to land. Court disputes initiated after the fall of the Mubarak regime indicated that the government sold land to the politically connected and provided guarantees that it would build connections with the necessary electricity, telecommunication, and transport infrastructure. These guarantees increased the value of land, allowing the businessmen to use it as collateral for getting large bank loans that far exceeded the initial purchase value of the land. The relation between land and credit is interesting to study because loans are often booked in Egypt using land as collateral, a procedure that gives the loan some legal weight given the poor state of the judicial system. Thus, it may well be that PCFs privileged access to land compensates for their low profitability to make them very attractive borrowers to bankers.

To see if PCFs have better access to land, we also use the WBES, and we ask whether firm respondents from sectors with more PCFs are more likely to report that they received land from the government by looking at responses to the question: "Does your establishment own or lease the majority of its land? From whom have you gotten the land (people, government, for free, other)?" Out of 3,036 manufacturing firms, 1,431 reported acquiring land: 933 obtained the land from the government (of which 57 obtained it for free). As before, we classify WBES firms according to their (4-digit) industrial classification and aggregate firm reports of access to land. Then we ask whether sectors with more PCFs enjoy greater access.

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<sup>6</sup> The reason for this organization was mainly the limitations imposed by capital adequacy rules, which prevent a bank from lending more than 5% of its assets to a particular firm.

<sup>7</sup> Many large firms were listed at stock exchanges in Egypt since gains from selling shares of listed companies are exempted from taxation. Reportedly, several politically connected firms exploited this legal tax loophole to avoid paying taxes for M&A transactions; i.e., instead of selling firms directly, which is taxable, the transaction was conducted as an untaxed market transaction by first listing the company for sale at the stock exchange.

We test this relation by estimating probit regressions that assess whether the probability that a WBES firm respondent reports access to land increases when it is operating in a sector containing more politically connected firms, using equation (1) above, but where the dependent policy variable  $Pol_{ij}$  is a dummy variable for firm  $i$  in the sector  $j$  which equals 1 if the firm bought land from the government or received it for free.

Table 6 shows that firms in politically-connected are more likely to report that they acquired land from the government. Thus, we can conclude that even if PCFs did not have higher profits than non-connected firms, it may be that their easier access to land collateral made them more valued customers for private banks.

Access to more collateral thus seems to be a part of attraction of PCFs to banks. This points to the importance of mechanisms to reduce the risk of lending for banks, given an environment with poor legal rights. Clearly, there are other ways in which PCFs can be perceived to be less risky than comparable non-connected firms besides their preferential access to collateral. The preferential access to policy-makers can reduce riskiness in a host of ways, from securing stable or rising market shares in an uncertain environment, to influencing policy in ways that advantages PCFs, and to bail-out possibilities when PCFs fail. There are many examples of such support received by PCFs in Egypt in the 2000s, which are well documented in the literature. This includes direct financial bail-outs of private firms, as happened during the two waves of banking reforms in the early 1990s, and the early 2000s (Henry 1998, Roll 2010). This also includes policy changes that advantage PCFs when their financial situation weakens – a good example, among many others, is the changes introduced in the anti-monopoly laws to advantage the Ezz Steel empire when its financial returns declined (Osman 2013).<sup>8</sup>

In order to ascertain if banks saw PCFs as possessing an advantage over non-connected firms in terms of risk, we can look at the way equity markets valued them. In particular, one can look at “price to earnings ratios” to check if PCFs were priced at a premium in ways that suggest the market was perceiving them to be less risky. The price to earnings ratio (PER) is defined as the market value of the firm (which we evaluate at the average quarterly price), divided by total yearly earnings. A high PER indicates that the market perceives a firm to be either less risky, or to possess superior growth opportunities in the future. In order to verify whether PCFs systematically have higher PERs than non-connected firms, we again run regression model similar to equation 1. The results of the PER regressions in tables 7 show that the PCFs traded at a considerable PER premium of 7.7 points during the period 2007-10.

In a recent paper, Chekir and Diwan (2014) construct an event study around the 2011 events and show that the 22 PCFs which traded on the EGX lost on average 13 to 16% of their value *on account* of their political connections. These results then suggest that much of the value that was lost in the 2011 event may have been the pricing premium enjoyed by the PCFs until that date. Indeed, the same event study methodology was used to test whether the value lost by PCFs included a positive market assessment of bailout guarantees (or growth potential) by including, instead of a dummy variable to identify the CFs, the PER as well as its interaction with the PCF dummy, in the following form:

$$CAR = f(PER, CF*PER, SEC, time, error) \quad (2)$$

The results are shown in table 8. They reveal that stock prices fell more for PCFs that had a higher PER, and so suggest that for the market, these values were driven mainly by the loss of implicit guarantees, or growth potential, which came with the firms’ political connections. When valued at the median PCFs, the loss on the PER account adds up to about half decline in the value of these stocks.

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<sup>8</sup> And indeed, as a head of the policy committee in parliament, Ezz oversaw himself this change in legislation.

#### **4. Conclusions**

In Egypt, the bulk of bank loans during 2003-10 went to politically connected firms. At the same time, the banking sector was liberalized and recapitalized, and it increasingly operated around competitive and profit-maximizing principles. This suggests that PCFs were either perceived to be more profitable, or less risky. Using a rich corporate dataset, our results demonstrated that PCFs tended to have lower to equal profitability than non-connected firms, in spite of the valuable privileges they enjoyed. They also suggest that PCFs were perceived to have lower risk, either because of the land collateral they possessed, or more generally, lower risk, as reflected by their higher PERs - and indeed, these PERs collapsed after the 2011 uprisings when these connections were severed. These higher PERs indicate either higher access to bailout guarantees (implicit or explicit), as happened in earlier periods, or more growth opportunities in the future.

It thus appears that following a first phase in the 1990s when connected firms were directly supported by state-owned banks to become dominant in an increasingly liberalized economy, they were in a position to benefit more than non-connected firms from a second phase of financial liberalization. In this second phase, the privileges they received outside the financial sector were sufficient to make them more attractive to banks than other non-privileged firms. In this respect, a history of earlier bail-outs must have also mattered.

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**Table 1: Debt Levels of PCFs**

	EGX data-set*	Full data-set
PC firms	1.083*** (0.167)	.403* (1.89)
No. of obs	381	589
Sector dummies	Yes	Yes
Year dummies	Yes	Yes
R-squared	0.123	0.394

Source: Orbis establishment database. Note: The establishment data are pooled across years (2003-2011). We reports the coefficient and *t*-statistic on the politically connected dummy variable from an OLS regression of the debt to equity ration on the dummy variable, which is equal to 1 for politically connected establishments and 0 otherwise. Total debt to equity is measured at book value. For the full data-set, we have used debt over total revenues given data availability. \*, \*\* indicates that the coefficients are significant at the 5%, 10% level.

**Table 2: Political Connections in Sectors and Credit**

	Obtained Bank Loan
No. of PC firms	0.019**
In sector	(2.21)
No. of observations	3,003
Sector dummies	Yes
R-squared	0.070

Source: World Bank Enterprise Survey (WBES) data for Egypt 2004-2008 and sample of politically connected firms. Note: Number of politically connected firms is the number, in our database, in each 4-digit sector. We also control for the number of employees and firm age (effects not shown). All regressions include 2-digit sector dummies. Standard errors are clustered at the sector level. \*, \*\* indicate significance at the 10%, 5% level, *t*-statistics are reported in parentheses.

**Table 3: Within-Sector Differences, Politically Connected and Other Firms**

	Full set		EGX set	
	Return on Assets	Return on Equity	Return on Assets	Return on Equity
PC firms	.510 (0.81)	3.62** (2.61)	-1.614* (0.838)	1.681 (2.206)
No. of obs	667	3,590	1,049	1,041
Sector dummies	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes
R-squared	0.194	0.049	0.160	0.088

The establishment data are pooled across years (2003-2011). We report the coefficient and *t*-statistic on the politically-connected dummy variable from an OLS regression of the performance variable on the dummy variable, which is equal to 1 for politically connected establishments and 0 otherwise. RoA stands for Return on assets, calculated at book value. RoE stand for returns on equity, also computed at book value. \*, \*\* indicates that the coefficients are significant at the 5%, 10% level.

**Table 4: Borrowing and Profitability**

	ln (long term debt/rev)		
PC firms	.753** (4.54)	.504** (2.31)	.670** (3.58)
ln(profits/assets)	-.113** (-5.35)		
ln(profits/rev)		-.096** (-6.03)	
ROE			-.025** (-3.81)
No. of obs	377	589	567
Sector dummies	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes
R-squared	0.556	0.437	0.452

Notes. Orbis establishment database. The establishment data are pooled across years (2003-2011). We report the coefficient and *t*-statistic on the politically-connected dummy variable from an OLS regression of the performance variable on the dummy variable, which is equal to 1 for politically connected establishments and 0 otherwise. RoE stand for returns on equity, also computed at book value. \*, \*\* indicate that the coefficients are significant at the 5%, 10% level.

**Table 5: Profitability of Financial Institutions and Political Connections**

	<b>ln(empl)</b>	<b>ln(assets)</b>	<b>ln(rev)</b>	<b>ROE</b>
PC banks	.253 (1.45)	-1.38** (-9.00)	-.554** (-2.72)	4.87 (0.75)
No. of obs	380	380	398	373
No. of PC banks	36	53	67	52
Year dummies	Yes	Yes	Yes	Yes
R-squared	0.107	0.099	0.091	0.023

Notes. Orbis establishment database. The establishment data are pooled across years (2003-2011). We report the coefficient and *t*-statistic on the politically-connected dummy variable from an OLS regression of the performance variable on the dummy variable, which is equal to 1 for politically connected establishments and 0 otherwise. RoE stand for returns on equity, also computed at book value. \*, \*\* indicate that the coefficients are significant at the 5%, 10% level.

**Table 6: Political Connections in Sector and Land**

	<b>Acquired Land from Government</b>
No. of PCFs	0.015*
In sector	(1.75)
No. of observations	3,015
Sector dummies	yes
R-squared	0.194

Source: World Bank Enterprise Survey (WBES) data for Egypt 2004-2008 and sample of politically connected firms. We also control for the number of employees (size) and firm age (effects not shown), as well as 2-digit sector dummies. Standard errors are clustered at the sector level. \*, \*\* indicates significance at the 10%, 5% level, *t*-statistics are reported in parentheses.

**Table 7: Price Earnings Ratios and Political Connections**

	<b>PER</b>
PCF	7.772** (3.868)
FE	Sectors, years
Obs	479
Adj Rsq	0.014

Notes. OLS, Standard errors in parentheses. The PER is the price to earnings ratio, calculated at the median stock price during the year. We also control for Ln(assets), the log of the total assets, and market share is share of total income of a firm over the total income of all firms in the industry. \*\*\*  $p < .01$ , \*\*  $p < .05$ , \*  $p < .1$ .

**Table 8: Decomposing the 2011 Market Reaction**

	<b>CAR</b>
PCFs	0.187* (0.109)
PER	-5.99e-05 (0.000472)
PCF*PER	-0.0190*** (0.00576)
Observations	75
R-squared	0.424

Notes: Source. Chekir and Diwan 2015. Ordinary least squares with sector fixed effects. Standard errors in parentheses. CAR is the cumulative abnormal return starting 8 days before the market closed on January 23 and 8 days after it reopened on March 23. The PER is the price to earnings ratio, calculated at the median stock price during the year. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .