Private Sector Access to Credit:

An Assessment Based on Survey Data

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Outline

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II. The extent of the Decline of credit to the private sector
III. Exploring the reasons behind credit slowdown
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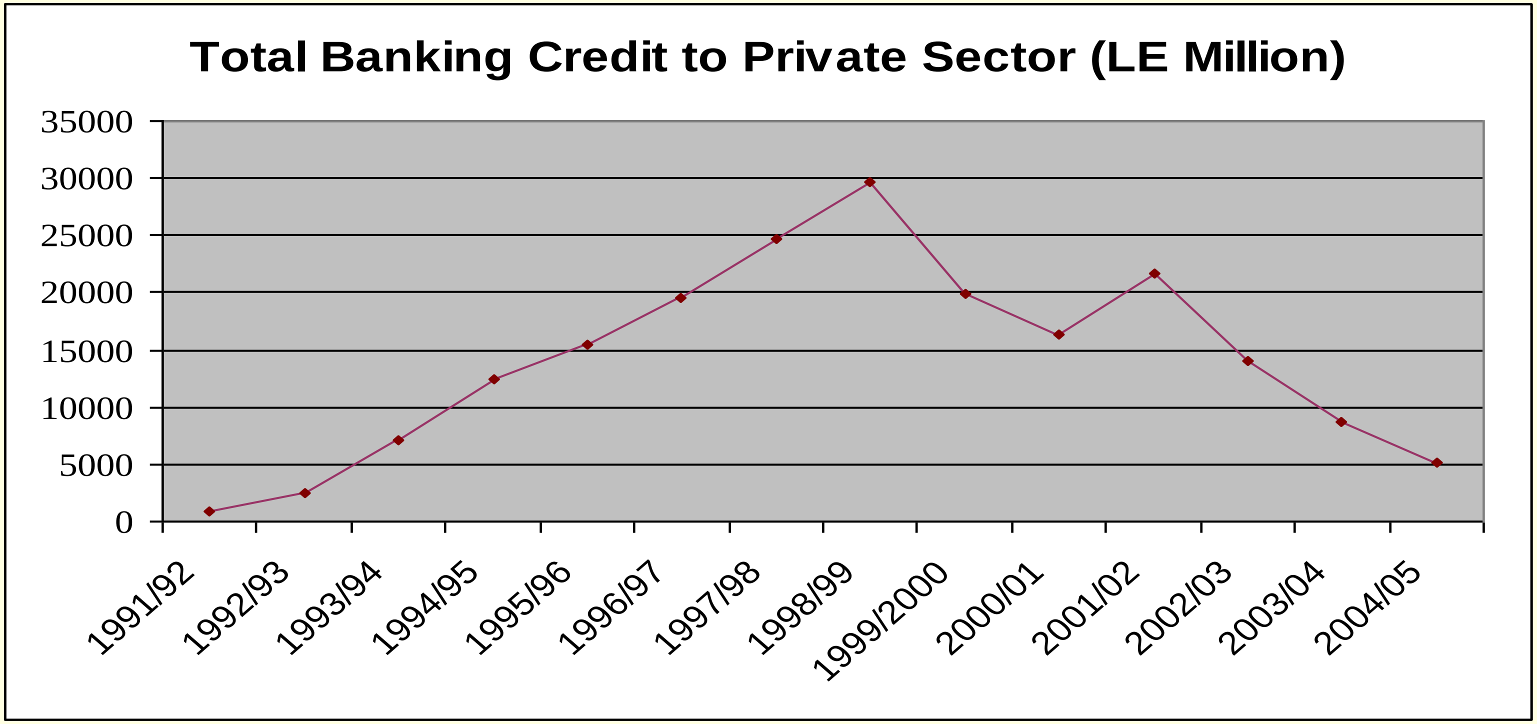
I. Introduction

- Private sector should invest around LE 68 billion to achieve a 6 percent growth rate (Ministry of Planning 2005).
- Yet, private sector’s investment in Egypt stands merely at LE 50 billion.
- Increasing this investment requires facilitating private sector access to credit.

I. Introduction

- However, there has been a downward trend in the volume of credit to the private sector.



Source: Author's calculations based on CBE.

I. Introduction

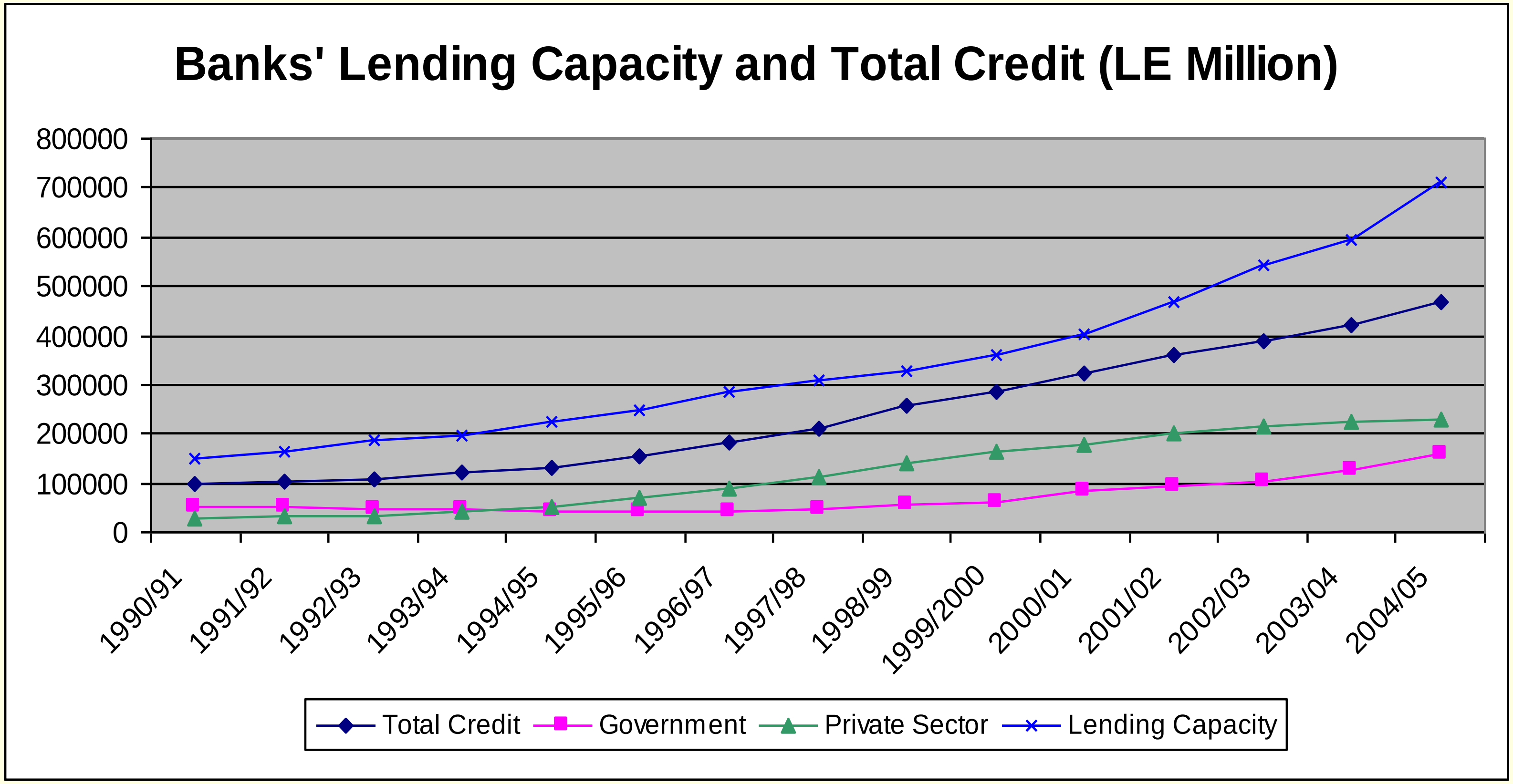
- According to the World Bank (2005), Egypt ranks very low as to the ease of doing business and getting credit.

	Ease of Doing Business	Ease of Getting Credit
Egypt	141	142
Jordan	74	65
Sudan	151	123
Israel	29	12
Korea	27	25
Malaysia	21	6
Mexico	73	68
Chile	25	32
Romania	78	74

Source: World bank (2005)

II. The extent of the Decline of credit to the private sector

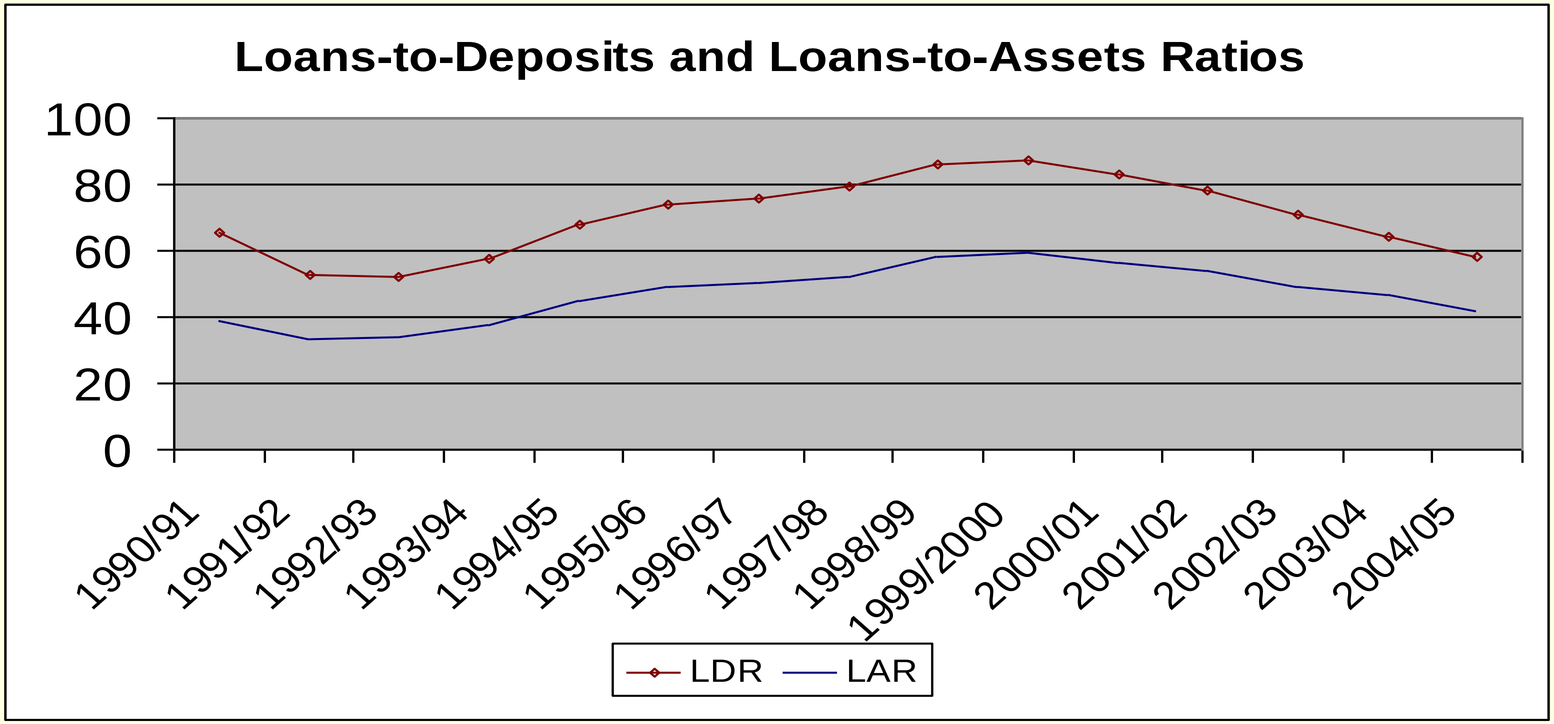
- Low usage of lending capacity.



Source: Author's calculations based on CBE.

II. The extent of the Decline of credit to the private sector

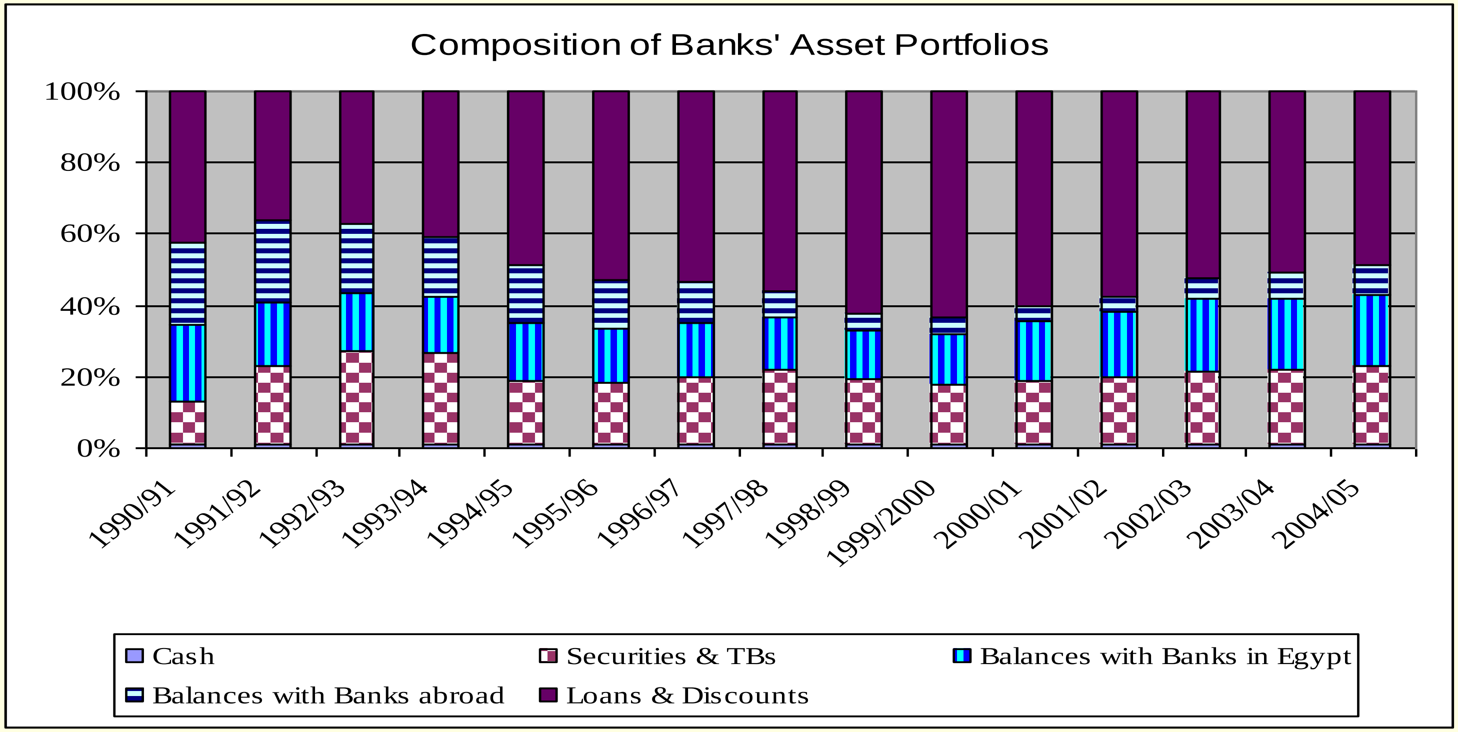
- Banks' LDR and LAR have been declining sharply since 1999/2000.



Source: Author's calculations based on CBE.

II. The extent of the Decline of credit to the private sector

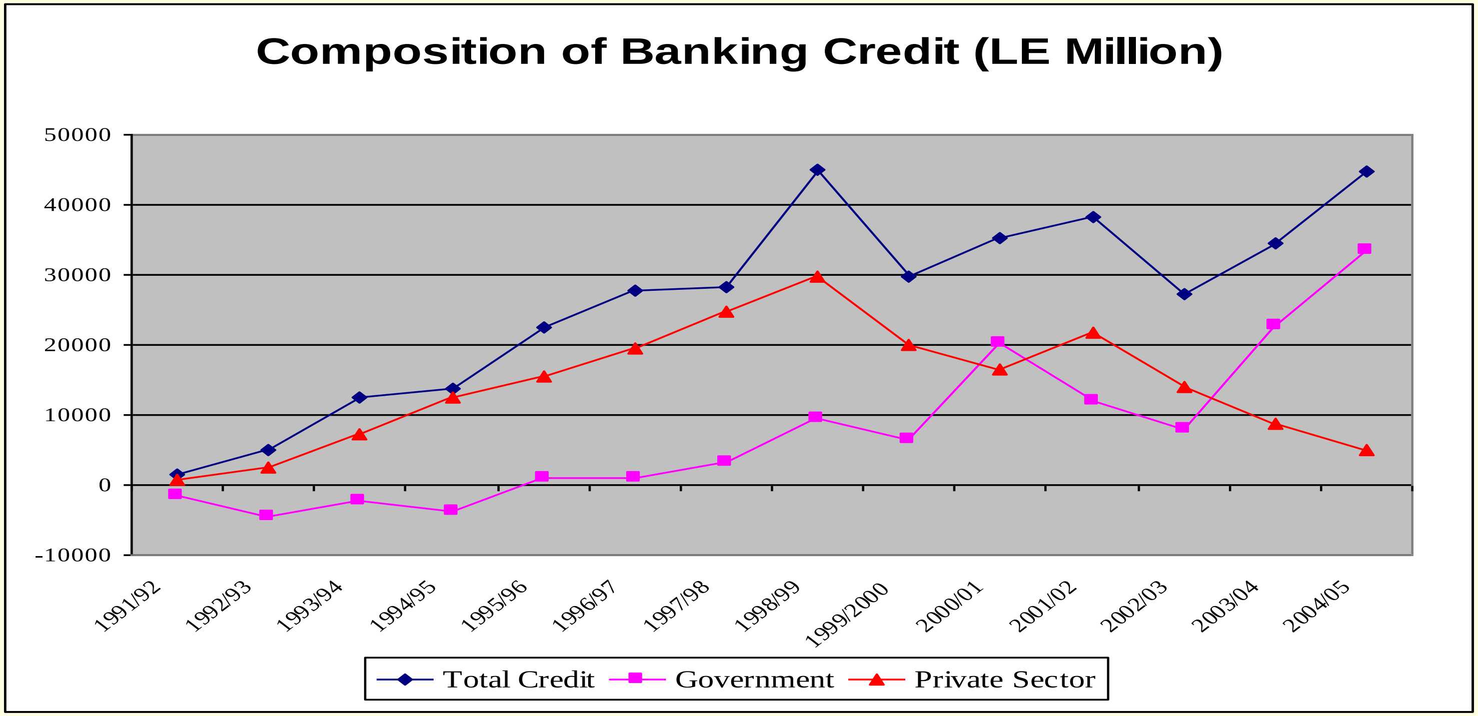
- The share of securities and treasury bills has been increasing since 1999/2000.



Source: Author's calculations based on CBE.

II. The extent of the Decline of credit to the private sector

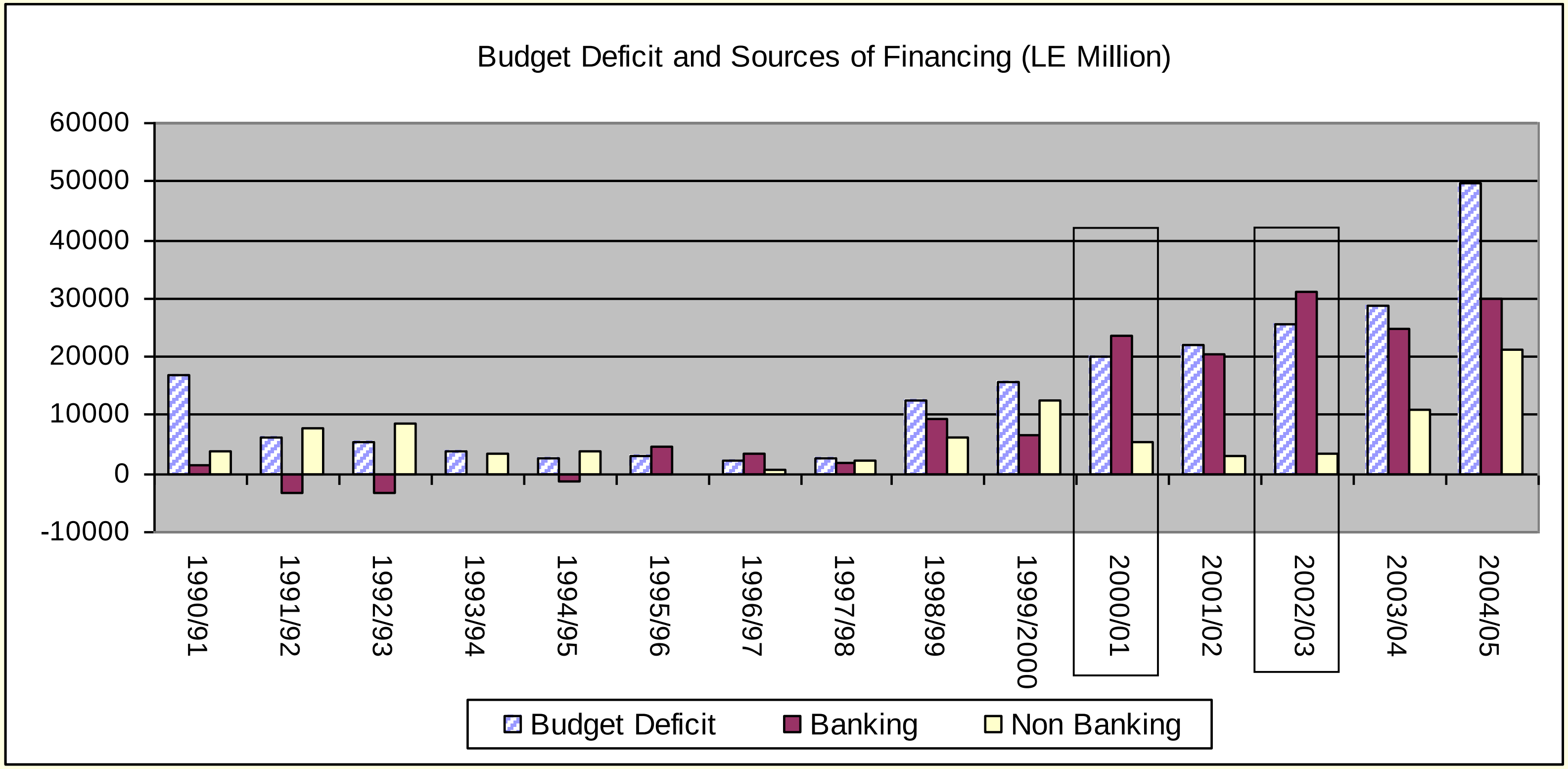
- Credit to the private sector has dramatically declined compared to credit extended to the government.



Source: Author’s calculations based on CBE.

II. The extent of the Decline of credit to the private sector

- Government borrowing from the banking sector sometimes exceeds the size of the budget deficit itself.



Source: Author's calculations based on CBE.

III. Exploring the Reasons behind the Credit Decline: Theory

- The decline in bank credit to the private sector could be due to:
  A. Supply factors (credit crunch)
  B. Demand factors (credit slowdown)
  C. Both

III. Exploring the Reasons behind the Credit Decline: Theory

<u>***A. Supply Factors:* Credit Crunch**</u>

- Tight monetary policy
- Risk-averse behavior of commercial banks as a result of an adverse selection problem
- Excessive public borrowing (crowding out)
- New credit standards set by bankers
- Regulatory capital constraints on banks' balance sheets

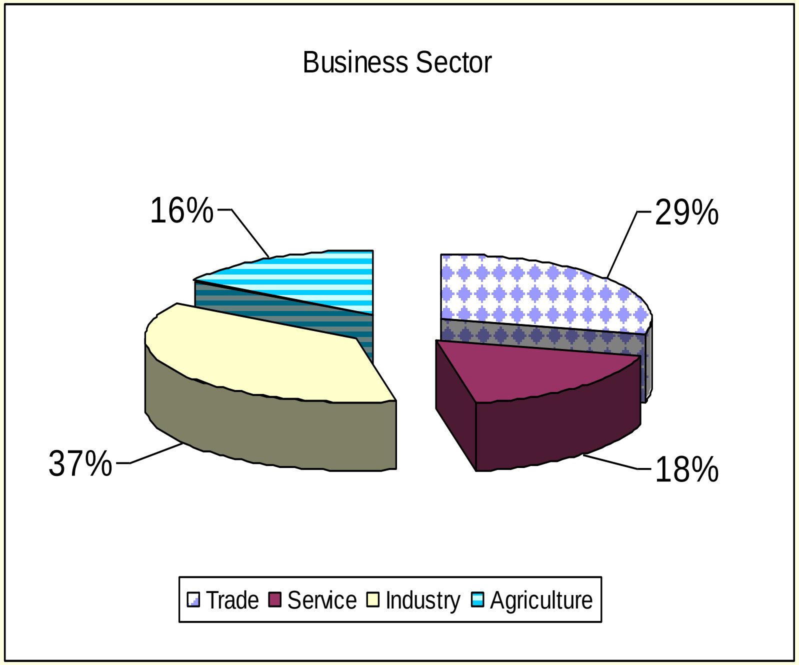
III. Exploring the Reasons behind the Credit Decline: Theory

B. Demand Factors: Credit Slowdown

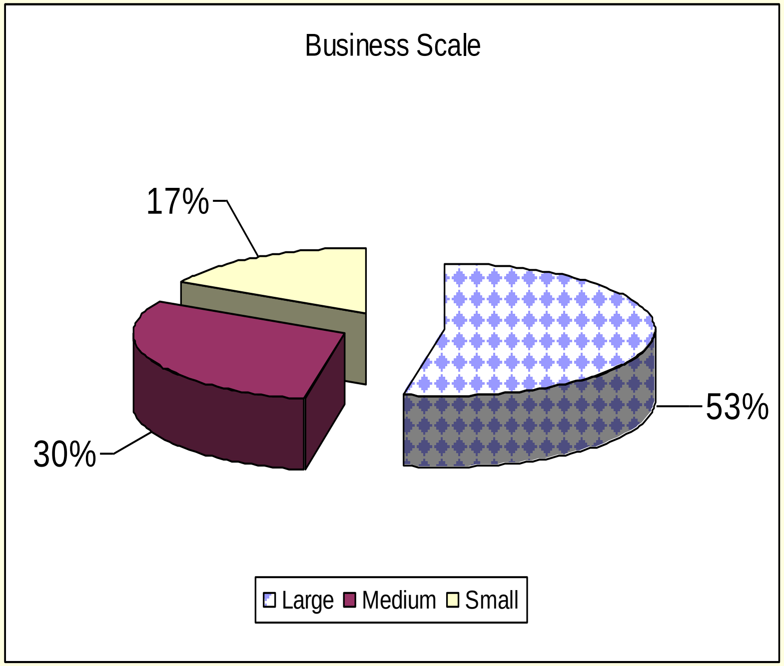
- *Macroeconomic perspective:* firms' uncertainty about the economic outlook
- *Microeconomic perspective:* increase in private sector indebtedness
  - Adjustments by firms to reduce the debt-equity ratio

III. Exploring the Reasons Behind Credit Decline: Survey of Firms

- Sample size: 350 firms

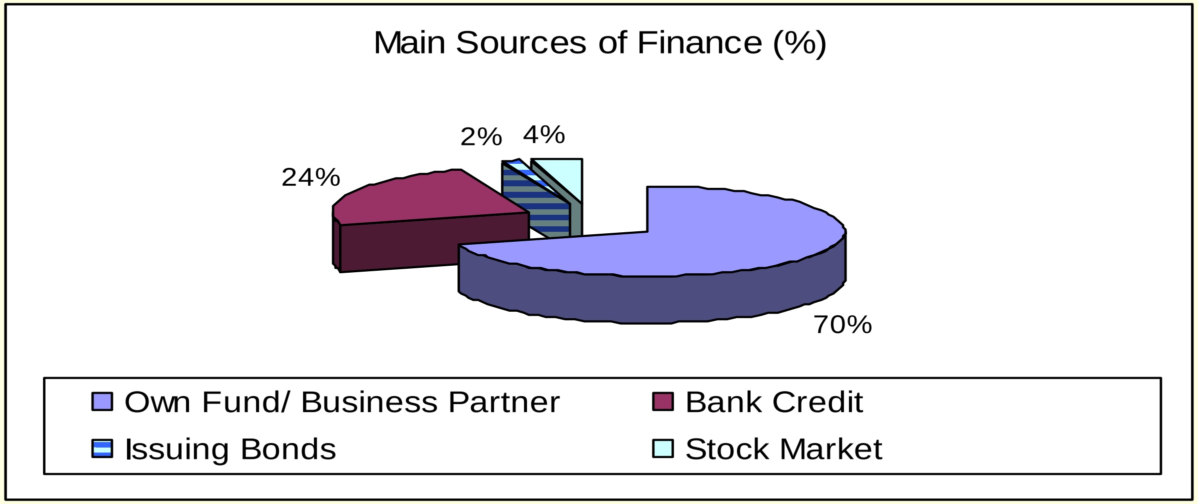


Source: Survey results.



Source: Survey results.

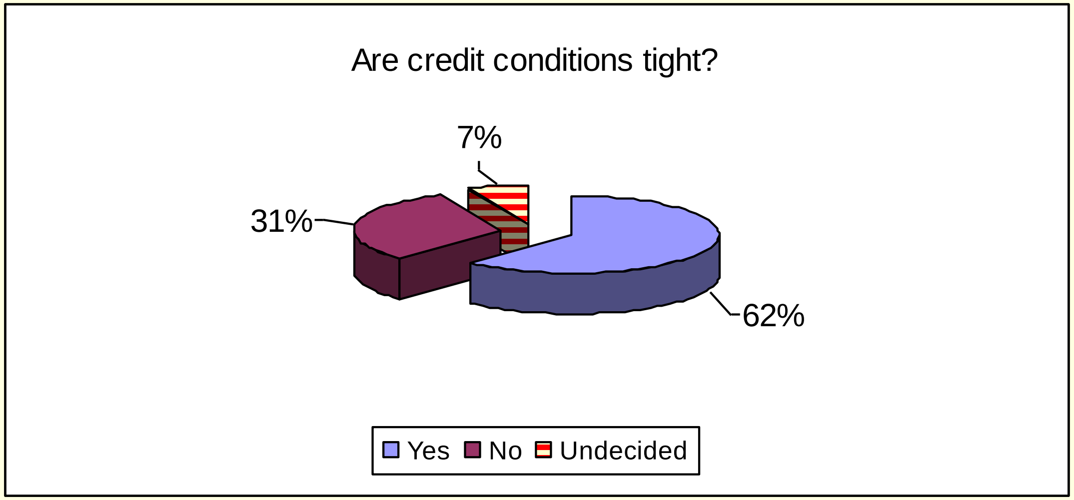
III. Exploring the Reasons Behind Credit Decline: Survey of Firms



Source: Survey results.

- Firms use their own funds as the main source of financing
- Bank credit is the main source of *external* financing

III. Exploring the Reasons Behind Credit Decline: Survey of Firms



Source: Survey results.

- Tight credit conditions are not only experienced by new borrowers but also by old ones.

III. Exploring the Reasons Behind Credit Decline: Survey of Firms

<u>Credit conditions tightened:</u>

1. Relatively high interest rate on loans
2. Higher collateral requirements
3. Shorter maturity of loans

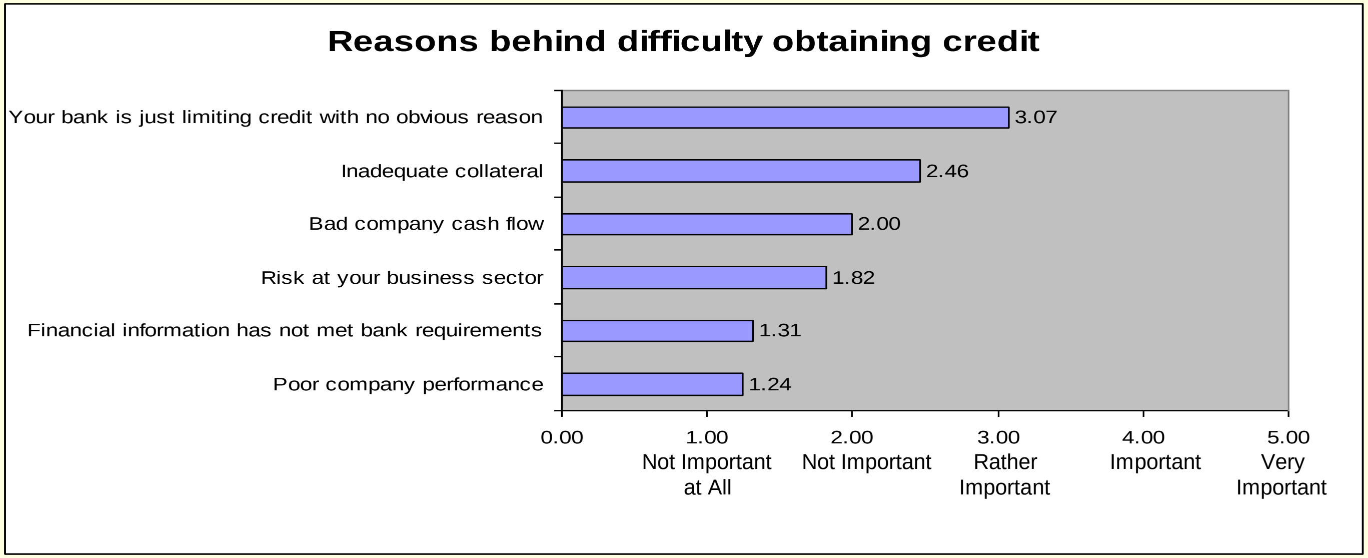
III. Exploring the Reasons Behind Credit Decline: Survey of Firms

<u>Obtaining credit:</u>

- Over the last year, 33% of firms had difficulties obtaining credit.

  - Firms in the trade sector find it relatively more difficult
  - Medium-size firms have the most difficulty

III. Exploring the Reasons Behind Credit Decline: Survey of Firms



Source: Survey results.

1. No obvious reason (credit rationing)
2. Inadequate collateral
3. Firms' financial viability (Yet, 67% of surveyed firms have had sales increase over the last three years)

⇨ Credit decline is not due to demand factors.

III. Exploring the Reasons Behind Credit Decline: Survey of Banks

- Hypothesis: Credit crunch?
- Findings:

a) Interest on risky loans has been tightened.

b) Non-interest criteria have tightened especially collateral requirements and maturity of loans.

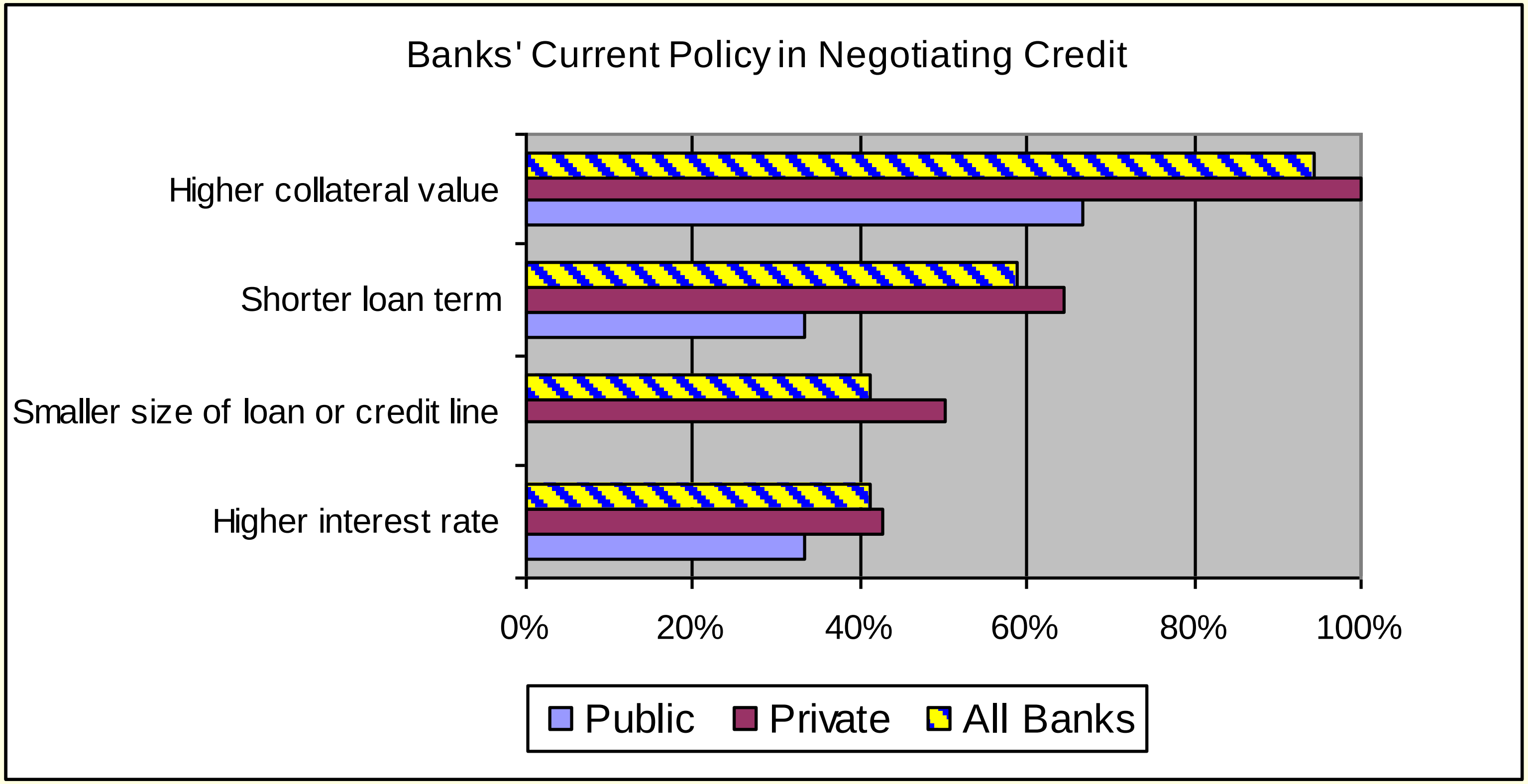
III. Exploring the Reasons Behind Credit Decline: Survey of Banks

c) New borrowers are the most likely to be rejected.

d) Banks are becoming more *risk-averse*:
   - Banks prefer to hold more liquid and less risky assets.
   - The main factor in evaluating credit risk of new borrowers is the credit payment record.
   - Banks are more likely to approve credit if borrowers are willing to provide higher collateral values or accept shorter loan terms.

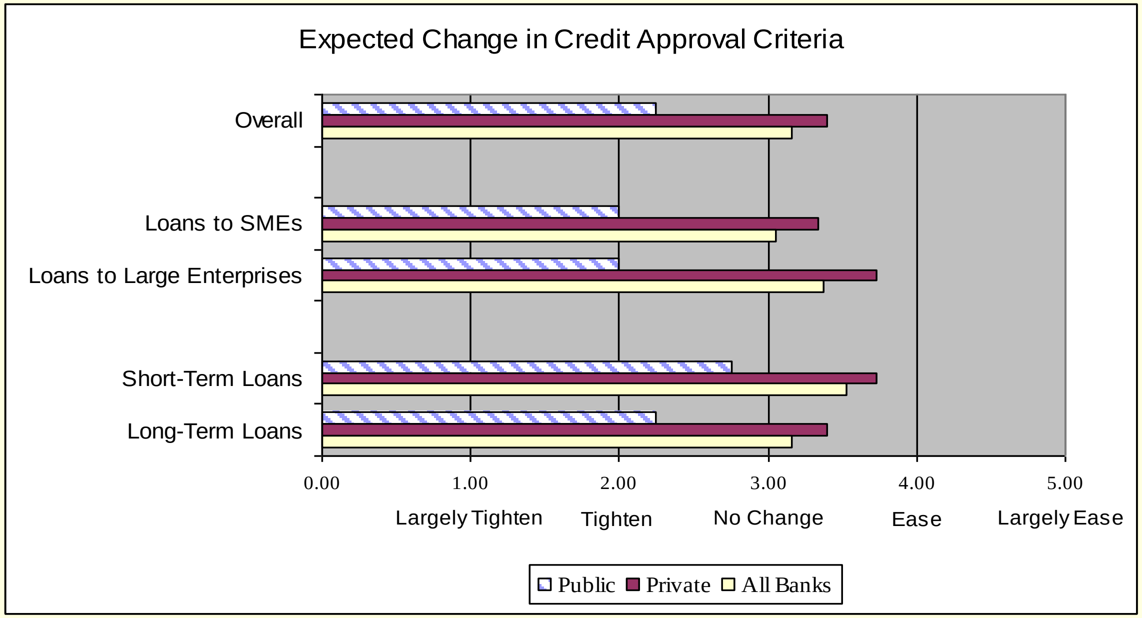
III. Exploring the Reasons Behind Credit Decline: Survey of Banks

- Public banks seem to be more strict than private banks in approving credit.



Source: Survey results.

III. Exploring the Reasons Behind Credit Decline: Survey of Banks



Source: Survey results

- Public banks are expected to tighten criteria for approving loans.
- Private banks might become more flexible in approving credit than their public peers.

III. Exploring the Reasons Behind Credit Decline: Survey of Banks

Main reasons why banks approve less credit:

- The slowdown of economic activity
- Tight regulatory requirements, especially for public banks
- Lack of financial information about new borrowers
- High ratio of NPLs
- Deterioration of credit worthiness of old borrowers

⇨ Results support the credit crunch hypothesis.

III. Exploring the Reasons Behind Credit Decline: Interpreting Results

- The credit crunch is triggered by an information problem.
- The marked rise in interest rates due to the NPLs crisis in 2001/2002 caused an adverse selection problem.
- The rise in interest rates makes it more difficult for banks to distinguish between “risky” and “safe” borrowers.

III. Exploring the Reasons Behind Credit Decline: Interpreting Results

- As a result, even though banks' liquidity increased substantially, banks were more hesitant to extend new credit to the private sector.
- Hence, banks are using the available resources to buy less risky assets.
- The unified Banking Law, passed in 2003, may have aggravated banks' risk-aversion behavior.

IV. Conclusion:
Implications for Monetary Policy

- Results show that the interest rate is not the primary criterion used by banks to approve credit.
- This hinders the operation of the *credit channel* in the process of monetary policy transmission.
- So, an expansionary monetary policy would not help.
- The increase in banks' assets would not be used to extend credit.
- Instead banks will tend to invest their excess liquidity in low risk assets.

IV. Conclusion:
Recommendations for the Banking Sector

- Establishing credit bureaus to share information on borrowers.
- Merging small-and-medium-size banks not large-size ones.
- Establishing credit guarantee schemes, particularly to SMEs and export-oriented enterprises.
- Developing new securities, such as corporate bonds.

IV. Conclusions:
Recommendations for Firms

- Diversify sources of external financing.
- Account for risk elements in managing cash flows.
- Increase efficiency by undertaking joint-venture businesses.

Thank You!