

**EXPORT PROMOTION POLICIES: TRANSACTION COSTS AND EXPORT  
CHANNEL CHOICES IN EGYPT**

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**ABSTRACT**

*Given increasing evidence of the relative importance of transaction costs in international market penetration by LDC exporters of manufactured goods, this paper attempts to identify the sources and nature of these costs and, based on the findings, to recommend policies capable of helping LDC exporters in overcoming these transaction cost-based obstacles to such exports. It does so by taking advantage of the results obtained from questionnaires addressed to samples of both producers of manufactures exports and trading intermediaries in Egypt.*

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## I. INTRODUCTION

In a world without transaction costs but with perfect markets, the penetration of international markets would be a simple matter of production cost; thus, comparative advantages would determine which producers penetrate international markets and when. Yet, despite remarkable technological improvements relevant to the costs of international transacting, especially with respect to communications and data storage, and considerable relaxation of exchange controls and the like, the costs of international transactions are generally far from negligible.<sup>1</sup> In particular, from around the world there is growing evidence that reforms designed to provide the right economic environment for the local production of exportables and incentives for exporting are insufficient in themselves to generate rapid export growth (Keesing, 1979; Morawetz, 1981; Dean, Desai and Riedel, 1994 and Greenaway and Morrissey, 1993). In some respects, moreover, the transaction costs of international marketing may even be increasing over time, preventing otherwise beneficial transactions from taking place. Unless the high transaction costs in international marketing are recognized and appropriate strategies are designed for dealing them, even the best of general macroeconomic and trade policy reforms may be doomed to failure. The costs of reform failures are high--as are the costs of failing to try.

The purpose of this paper is to use Egypt as a case study to: (1) develop socially relevant but testable hypotheses concerning the ways and means of exporting, (2) test the validity of such hypotheses, and (3) derive practical policy proposals for what can be done to help producers in Egypt and other developing countries (LDCs) take better advantage of international market opportunities.

Our presentation is organized as follows: The various components and sources of transaction costs in international marketing are identified in the remainder of the present section. The choice of Egypt as a case study is justified and background information provided in Section II along with some specific transaction cost-based hypotheses. The interview strategy and sample are briefly described in Section III; and the main findings are presented in Section IV. Finally, in Section V we present the policy implications of the analysis.

## **Transaction Costs in International Marketing**

Several different types of transaction costs can be identified. First, there are the costs of obtaining information about market conditions in any given foreign market (quantities and qualities desired and the prices prevailing of each different quality), and of course reciprocal costs for agents in foreign countries. Second, there are the costs of information about government regulations and other policies in both the foreign market and the home market (including exchange rate policy, exchange restrictions, tariff and non-tariff barriers, and health and environmental regulations). Because implementation of these rules and actual practice can vary substantially from what the laws or rules say, knowledge of the official documents is far from sufficient. Third are the costs to each potential party of identifying appropriate trading partners in these markets. Fourth, there are the costs of negotiating, writing and enforcing contracts between the parties, including those associated with the resolution of disputes. Fifth, because of the generally long lag between the placement of an export order and its receipt and final payment, there are the costs of financing the transaction and of bearing the risks of default at subsequent stages.

Among the factors tending to make these costs much higher than those with respect to domestic transactions are: language, cultural and taste differences, differences in laws and the way disputes are resolved, differences in income and information sources, differences in the way markets operate and in the extent and character of competition, and difficulties of enforcing contracts across countries, and hence higher risks of payment default.

These transaction costs are not merely static; rather they change substantially over time as circumstances change. For example, they may be expected to increase with changes in the identities of the trading agents, in the environmental conditions which surround them, and in the character of the respective markets. Even if an exporter has all the right information about all the relevant factors in a particular market at one point in time, the rapidity of change undermines the adequacy of his information about relevant future conditions in that market. Indeed, for any individual country, over time there are two important trends tending to raise transaction costs for developing country exporters: (1) the growing relative importance in developing country exports of quality-differentiated and increasingly specialized products for which it is difficult to distinguish between contract fulfillment and non-fulfillment (deliberate or otherwise), and (2) the growing use in developed countries (at both the national and subnational levels) of

various non-tariff barriers to trade, including environmental regulations, which are subject to more abrupt changes over time than tariff barriers.

Another such factor is the asymmetry of information that characterizes many of the relationships, actual or potential, among the different agents. As is well-known, asymmetries of information give rise to problems of adverse selection and moral hazard, and such asymmetries are likely to arise simultaneously in several different components of transaction costs. For example, at the level of the rules and regulations, countries may want the conditions to look different than they really are, or be unwilling to enforce existing laws. Likewise, the agents charged with the responsibility of implementing the rules may have little incentive to do so, and indeed may have the incentive to leave the interpretation of these rules sufficiently ambiguous as to generate rents for themselves. Even more relevant and important, each potential trading partner has better information about his own characteristics and propensities (appropriate to defining the terms of the contract) than the other party, inducing adverse self-selection for any given terms. While in principle contracts could be written in sufficient detail so as to be complete and self-enforcing, in practice because the costs of doing so are excessive, actual contracts are necessarily incomplete and hence vulnerable to opportunistic behavior. Moreover, because of the lags between the time of writing the contract and that of delivering on it, and then again before payment is received, each party may have the incentive to default in some way on the terms of the contract (i.e., to practice moral hazard or opportunistic behavior relative to the other party).

These problems are often further compounded by the fact that many of the information costs and enforcement costs are subject to economies of scale, economies of scope and externalities. The externalities imply that the incentives for investing in such information and in adequate enforcement mechanisms and insurance may well be insufficient (because their benefits leak out to others in the form of externalities). The economies of scale and of scope imply that, although there may well be a role for intermediaries specializing in the production of these relevant services, competitive markets for such services may not exist. Instead, these services may be monopolistically supplied, but thereby creating the basis for government regulation and intervention.

Still another complication arises from the multiplicity and magnitude of the risks involved in such contracts. Because of the importance of these risks, once the contracts are in place, one or another of the parties to the contracts may seek to obtain insurance against these risks. As with other types of insurance, such insurance is especially subject

to asymmetries of information, and hence is vulnerable to both adverse selection and moral hazard.

Naturally, the magnitude and frequency with which these problems are confronted may vary considerably by the characteristics of the markets, countries, particular transaction partners and the ever-changing environmental conditions. Likewise, various types of market and non-market institutions may arise to cope with these problems. Yet, despite its obvious relevance to international transactions, surprisingly little attempt has been made to use the transaction cost perspective to generate testable hypotheses concerning the penetration of international markets, to test them, and to derive from the test outcomes practical policy implications.

## **II. THE EGYPTIAN CASE STUDY AND TRANSACTION COST-BASED HYPOTHESES**

Prior to the mid-1980s, to maintain conformity to the country's development plan and maintain its international terms of trade, Egyptian trade was virtually monopolized by the public sector. Both exports and imports were highly concentrated on a few commodities from which Egypt's private sector was either formally or informally prohibited from participating (World Bank, 1994). Beginning in the mid-1980s, the bans on private trading have been gradually removed. Indeed, by 1992 the private sector was allowed to trade in all commodities except exportable cotton. Yet, since experience in exports is extremely limited in many sectors and few Egyptian producers of exportables can communicate in English or other foreign languages, it should be quite clear that even today in most sectors an Egyptian producer wanting to export faces relatively high transaction costs of the types identified in the preceding section.

Under a completely unfriendly environment for international trade, the high transaction costs might well simply mean little interest in penetrating international markets. Nevertheless, the external environment for international trading activities in Egypt has been very substantially improved. Indeed, beginning in the 1980s, the country undertook a series of policy reforms aimed at opening the economy up and liberalizing policy in many dimensions. Among the trade policy reforms were (1) the tariffication of many non-tariff barriers and the streamlining of procedures, (2) the virtual elimination of prohibitions on both imports and exports, (3) several major devaluations, and (4) the progressive lowering of tariff rates and the narrowing of their dispersion across commodities. The trade policy reforms, moreover, have been accompanied by macroeconomic reforms over the fiscal and monetary policy, the achievement of

exchange rate convertibility, and the liberalization of regulations on foreign investment and financial markets (Abdel-Khalek, 1995).

Yet, despite these reforms and other policies designed to stimulate exports, and especially those of light manufactures, exports in current U.S. dollars have grown rather slowly (3.1% per annum since 1980 [World Bank, World Development Reports]). Part of the explanation for the slow growth in exports in the 1980s is attributable to the fact that the more substantial of the reforms mentioned above were made only beginning in 1991. Other reforms, such as the creation of the Export Promotion Center, however, began as early as the early 1980s. Moreover, despite some growth of nontraditional exports in recent years, exports remain highly concentrated on oil and cotton which together account for well over 60% of the country's exports.

For these reasons, Egypt would appear to be an extremely interesting and important case for investigating the role of transaction costs in trade channel choices. The transaction costs to domestic producers of penetrating international markets would seem high and likely to vary considerably from the few sectors with experience in exports to the many with little or no such experience. Indeed, Egyptian exporters are said to complain of the difficulty of obtaining information on tariffs and non-tariff barriers abroad, foreign standards, lack of personnel trained in international marketing, cumbersome duty-drawback and temporary import admission regimes, fees and delays for custom inspections and excessive paperwork, all components of transaction costs.

Besides the high but varying transaction costs on international transactions, there are several other reasons for making the Egyptian case study interesting and important. (1) Egypt is the second largest economy in both the continent of Africa and the Arabic-speaking world. (2) Egypt is actively trying to promote trade with a wide variety of countries, the developed market economies of Europe, North America and Japan, Eastern European countries including Russia, other Arab countries, and sub-Saharan African countries, and in a variety of sectors, all at the same time. (3) It is a country in which there already exist many intermediaries ranging from state and private trading companies, large domestic firms with subcontracting relationships, foreign export agents and private consultants, to multinational enterprises. Egypt also makes use of a variety of transaction modes, ranging from ordinary market transactions between independent parties, to intrafirm trade, barter trade and various forms of countertrade. Which of these seem to be

most effective and why? How does the experience vary across commodity and country markets of destination?

To make explicit our assumptions about transaction costs, we suggest that the **transaction costs** involved in any particular transaction between trading partners in different countries would **rise with**: (a) **differences between the countries** in terms of income levels, economic systems, and environmental conditions and with the degree of irregularity in transactions, (b) **differences between the buying and selling agents**, by firm size, ownership type, and primary function, and experience, and finally, (c) **the relative importance of non-price competition in the product market concerned**, such as quality, timing, styling, etc., and especially with the extent that such non-price considerations are difficult to monitor. Over time, as experience with exporting to any given market increases, the transaction costs are likely to fall. Other things being equal, the higher the transactions costs of any given transaction relative to the ability of the producing firm itself to bear them, the greater will be the degree of intermediation required in such markets.

From these general principles we derive the following specific hypotheses relevant to Egyptian exports of manufactures (whose transaction costs may be expected to be relatively high but varying by commodity, market and firm type.

(H1) With respect to manufactures characterized by moderate product differentiation and moderate-to-high costs of information about foreign markets and regulations, because of economies of scale and scope in obtaining such information across markets, one could expect the choice of export channel to vary by the size of the producing firm. Small firms should be expected to rely on intermediation by trading companies but large firms to export directly. The large firms, moreover, might further internalize their benefits from investments in marketing information by themselves acting as intermediaries for other (presumably smaller) exporting firms.

(H2) For any given size of exporting firm, the use of intermediation would be expected to vary with the degree of product differentiation. For highly differentiated products, for which the attributes of quality, styling and timely delivery are important but also relatively costly to assess, one might expect to find considerable use of specialized intermediaries, such as specialized foreign traders and buying agents. For those production activities which can be conveniently divided into stages, one might also expect to find subcontracting organized either by the foreign buyers or large domestic firms (Mead, 1984). In such cases, the intermediaries would be expected to communicate in detail the specifications desired in the foreign market and to manage the transactions

themselves or through other intermediaries. For more homogeneous manufactures, however, such intermediation would be unnecessary.

(H3) For any given product, but with information and experience varying from one geographic market to another, the greater the degree to which exporting firms operate in environments and have domestic customers similar to their foreign customers, the lower the transaction costs and hence the more likely that producing firms, even small ones, will be able to export directly (i.e., without intermediaries).

(H4) The more experience the producing firm has in any foreign market, the lower the firm's costs of transactions in that market and the greater the likelihood of direct exports.

(H5) The better are the capabilities of the producing firm in terms of better foreign language ability, overseas experience and travel and familiarity with foreign markets and technology, the lower are the transaction costs hence greater ability to export directly or quasi-directly.

(H6) If the foreign importer is a state trading company, the more likely the intermediary chosen by the exporter is likely to be a public sector trading firm in that country.

(H7) Finally, in the case of a new and differentiated product for which there is no international marketing expertise either externally from domestic intermediaries or within the firm, it is very important to establish a reputation for high quality. Because of the importance of economies of scale in information generation and externalities, relatively direct channels (Channels 1 or 2) may have to be chosen despite the high transaction costs. To bear such costs and to internalize the benefits as much as possible, such firms may have to be of rather large size.

### **III. METHODS AND PROCEDURES**

Since no published data on the various relevant characteristics of the manufacturing firms and their foreign partners and markets exists in Egypt, separate questionnaires were developed for use in collecting information from both producing firms and trading intermediaries. These questionnaires are available on request from the authors in Appendices A and B, respectively. The information collected from producing firms included the choice of export channel, the means of identifying the trading partner, the nature of problems encountered in both the export transactions and finance, the type of products and markets, relevant regulations, various characteristics of the firm such as its age, export experience, legal status, the volume and frequency of its export transactions, and its degree of satisfaction with the export channel.

Producing companies in four manufacturing sectors were selected for interviews: leather products (footwear), textiles, garments and ceramics. The first three of these sectors were chosen because of the fact that they are already fairly important export sectors and that each involves the use of a variety of channels. Ceramics was chosen because it is an especially new line of exports for Egypt (exports having begun only in 1990) and hence with especially high transaction costs. A total of 25 different producing firms were interviewed, eight in leather products, six in textiles, thirteen in garments, and one in ceramics. (Some of the firms interviewed were counted twice because they produced both textiles and garments).

Because of the small numbers of exporting firms in most of the sectors, no attempt was made to choose the firms randomly. Rather, an effort was made to interview firms of all the different types and sizes represented in the sector. Hence, in the footwear industry which consists of 30 medium-sized, fully mechanized firms with employees ranging from 80 to 200, 200 small firms with 20-80 employees, and 25,000 microenterprises (workshops), one medium-sized firm, two small firms and four microenterprises (all private) were selected for interviews. In textiles, four large firms (all public sector) and each with more than 200 employees and two smaller private firms were interviewed. In garments, four large public sector firms, two large private firms, three medium-sized private firms and four workshops were interviewed.

The questionnaire for the trading intermediaries was applied to representatives of each of the types of trading companies operating in Egypt, ranging from small private firms (with but 3-5 employees) to very large public firms with thousands of employees and many branch offices abroad. Such firms were asked rather similar types of questions as the producing firms, but also ones about the nature of their contractual relations, the degree of cooperation with government authorities and the sources of transaction costs involved in their export activities. Nine such trading companies were interviewed: three (of the 13 existing) large public firms, three relatively large private firms and three small private firms.

The broad lines of the findings were substantiated with other open-ended interviews with officials from the Egyptian Federation of Industries, the Cairo Chamber of Commerce, the Egyptian Center for Export Promotion, the Egyptian Ready Made Garment Export Association and the Arab Federation for Textiles.

#### **IV. RESEARCH FINDINGS**

Due to the small numbers of exporting firms in each sector and the fact that they were not randomly selected, the results are summarized in tabular form and analyzed qualitatively rather than quantitatively. Each of the hypotheses under scrutiny here, namely hypotheses H1-H7 in Section II above, has two components. The first is that transaction cost considerations are important and vary in ways suggested. The second is that, as a consequence of the way in which these costs vary from product to product and market to market, relative to the various internal marketing capabilities of the producing firms, the extent to which the exporters use trading intermediaries and the type of intermediary chosen is determined through a process of minimizing the total transactions costs involved. For this reason, the findings of this section are divided into two subsections: one dealing with evidence concerning the magnitude and character of the transaction costs of exporting, and the other concerning the variation in the choice of export channels across markets, commodity groups and over time.

### **The Magnitude and Character of the Transaction Costs of Exporting**

One source of evidence on the importance of the transaction costs in exporting is that most producing companies indicated that they would much prefer to be able to export directly, but that few are able to do so because of the considerable costs (such as hiring knowledgeable personnel with excellent and multiple foreign language abilities and purchasing quality control equipment and foreign standards) which would be required for them to do so. Among the benefits which the Egyptian export-producing firms indicated they would enjoy by direct exporting are (1) freedom from the need to pay the very sizable commissions which they presently pay to the trading firms and other intermediaries,<sup>2</sup> (2) reduced risk of default by the various intermediaries in their contracts with the producing firms, and (3) the rather low appreciation which the producing firms often express in their interviews for the quality of the services provided by the intermediaries.

Shortcoming (1) speaks for itself and directly confirms the importance of transaction costs. With respect to the perceptions by producing firms of shortcomings (2) and (3), there would seem to be a number of factors lying behind these perceptions. We mention only those which would seem to be the most important and well-verified. With respect to risk of default, a major factor would seem to be improper representation of the producer by the intermediary which can result in the producer's loss of reputation and hence also lost future as well as current sales.

Another factor contributing to both (2) and (3) is that the private trading firms are excessively oriented toward the handling of imports, experience in which doesn't carry over to exports to any large extent. Indeed, less than 20% of private trading firms are

specialized in exports and of the others almost all their business is in importing. Moreover, even among those which do engage in exports, they are criticized by producing firms for failing to take a long-term perspective in which reputation for quality would be important, concentrating instead on making a quick and easy sale in the short-run at the expense of more permanent future sales.

In the case of the large and generally quite experienced public trading companies, the chief shortcoming seems to be that most of their experience has been with countertrade and barter trade. In such trade the initiative generally comes down from the top levels of government and is of limited relevance to market-determined transactions.

A natural result of the perceived high risks to the producers of such transactions through intermediaries is that even between firms and trading companies and within the trading companies themselves, the transactions and communications are often between persons related to one another along personal or family lines. While this practice may diminish the perceived risks of opportunism in such transactions, it also has the unfortunate effects of preventing the markets for intermediary services from becoming as competitive as they otherwise might have become and of raising commission rates.

Consistent with (H2) above concerning the effect of product differentiation and quality heterogeneity on transaction costs, the transaction costs were found to be considerably higher for the less homogeneous garments, footwear, and ceramics than the more homogeneous textile exports. Contributing to the higher transaction costs on non-homogeneous products are (1) higher information costs because of the fact that fashions which vary so much both over time as well as from one market to another and slight departures from the optimum design or delivery time can greatly lower the desirability of the product, and (2) higher costs of standards testing and quality control which often require considerable delays.

Despite serious efforts on the part of the Egyptian government to encourage exports and facilitate procedures, two main shortcomings in the Egyptian environment remain which contribute to the high transaction costs. The first is that the way in which Egypt's laws and procedures work in practice (especially in securing export permits and shipment times) is often quite different both from how in theory they are supposed to work and from practice in other cases. This implies that administrators of the rules have better information on actual practice in an individual case than the administered, an obvious source of asymmetric information and hence of adverse selection and moral hazard. Neither party in such situations has an incentive to disclose their private information, thereby allowing the information costs to remain high or even grow over

time. Second, as hypothesized above, the externalities arising from such information tend to make for underinvestment in information.

A third factor tending to raise the transaction costs of international transactions for Egyptian producers is the differences in environments across the different foreign markets to which Egypt exports. Not only do these different environments vary significantly in various ways, but also information about them and experience in them is rather fragmented. This greatly reduces the extent to which economies of scope in exporting to various markets or even in obtaining information about these various markets can be realized.

Still another factor contributing to the generally high reported transaction costs is the rather short experience in exporting. Since during the 1960s and 1970s, Egypt's exports were largely directed toward the centrally planned economies of Eastern Europe and China, the gradual re-orientation in exports toward the advanced market economies has meant that such experience is limited and hence transaction costs particularly high. Even though exports to the potentially lower transaction costs Arab markets are relatively important at the present time, experience in exporting to these markets is not as great (and hence transaction costs in such markets are not as low) as might have been expected because of the boycott of Egypt by most Arab countries during the late 1970s and early 1980s subsequent to Egypt's participation in the Camp David Accords. Even in the case of trade to Eastern Europe in which Egypt is perhaps more experienced than many other countries, the transaction costs of such trade are currently higher than might have been expected because of the dramatic changes in economic rules of the game and trading mechanisms that have occurred in such countries. Indeed, the managers of several of these trading companies confided that they didn't even know what institutions in some of these countries were currently handling trade and hence with whom they should try to develop contacts.

In general, it seems clear from the interviews as well as the facts of changes in the pattern of exports and in the mechanisms used in carrying out those exports that the transaction costs are generally high and vary in ways suggested by the hypotheses of Section II. Therefore, we go on to the hypothesized effects of high transaction costs and the variations therein on channel choice.

## **Determinants of the Choice of Export Channel**

Our interviews revealed that the producer of exportables generally is able to choose among a number of alternative channels for exports. Indeed, collectively at least, sample producers used one or more of the eight different channels depicted in Figure 1 for getting their products to foreign buyers. These range from direct exports (Channel 1) and quasi-direct exports (via a foreign trading company, Channel 2) to indirect exports through various kinds and numbers of intermediaries, such as a local public institution, producers' or exporters' associations (Channels 3 and 4) and public or private trading companies (Channels 5-8).

The summary data provided in Figure 2 show in tabular form how these choices of channels vary across producing sectors, firms sizes and markets. The importance of the magnitude of unit transaction costs in the choice of export channels can be seen in a number of ways. First, notice that direct exports and/or quasi-direct exports (Channels 1 and 2, respectively) are rather commonly used by producers in all sectors for exports destined to markets in other Arab countries by large, medium and small producers, and even in some cases by workshops or micro-enterprises. Yet, to reach the higher transaction cost markets of the USA and Western Europe, these direct channels are commonly used only by large and sometimes also medium-sized firms. Indeed, the use of the quasi-direct channel (Channel 2) is more common than that of Channel 1 in most such cases. In the higher still transaction cost markets like Eastern Europe and sub-Saharan Africa, medium and even large firms use the more indirect channels such as Channels 6 and 8. All these findings provide strong empirical support for H1 (concerning the impact of the size of the producing firm), and H3 (dealing with the effect of market familiarity). Not surprisingly, the interviews demonstrated that firms which export to several different markets are likely to use different channels for different markets.

Second, the entries of the figure show clearly that small and micro-enterprises are rarely able to export except to Arab markets, once again supporting H3 (concerning the influence of market familiarity). When they are able to export anywhere else (primarily Western Europe), consistent with H2 (concerning the effect of product differentiation) they are able to do so almost exclusively through private trading companies, local public institutions and producers associations (Channels 3, 4, 5 and 7). From the interviews it was learned that in such cases the trading companies handle all the transaction costs; the workshops and small enterprises merely produce according to the specifications provided by the intermediaries (private trading firms or producer association). In the case of

footwear, the trading company even provides the leather and the export finance.<sup>3</sup> There are two exceptions in this regard where the producing firms remain somewhat more active in the process. One is the case of garment exports via the garment exporters association. The association helps the firms in identifying and negotiating with foreign buyers and allows the small firms to participate jointly (as subcontractors) in large export orders, thereby taking advantage of scale economies in the marketing phase. The other example is the case of exports of footwear via Channel 4 in which the specific institutions involved have helped the producers in attending international trade fairs and identifying foreign buyers, but otherwise interfering little in the firm's activities. While in these two cases the firms remain more active in the export process and can thus learn more with experience in exporting, they are also left with rather high transaction costs and hence considerable difficulties in successfully exporting.

Not only does the choice of channel vary by the size of the producing firm, but so too does the nature of the service provided by the channel. For example, when medium-sized firms use Channels 5 and 7, they are far less dependent on the trading firms. Indeed, the role of the trading firm may well be limited to identifying the buyer in return for a commission. More recently, even the use of public trading firms by medium-sized producers is becoming increasingly like that of the private trading companies in which buyers are identified in return for commissions.

The pervasive lack of usage of large and experienced public trading companies by micro and small producers is rather striking. The closest to usage of a public sector institution that any small firm in the sample came is the aforementioned use of Channel 4 in particular, the Chamber of Leather Products and the Leather Products and the Leather Division of the Egyptian Center for Export Promotion, by small footwear producers. Both these institutions were said to help such firms attend international trade fairs in their lines of activity and to identify foreign buyers. As mentioned above, a major limitation of public trading firms seems to be their lack of experience in market trading. Consistent with H6 (concerning the influence of the identity of the foreign partner), their main use lies in exports to Eastern Europe and sub-Saharan Africa, which, at least until very recently, have been conducted with foreign governments or their state trading companies in which market prices and other market considerations have played a comparatively minor role.

At the other end of the spectrum, and again consistent with H1 (concerning the effect of firm size), large producing firms tend to export directly through Channels 1 or 2, depending on the market. Their size allows the existence of a large export department which can handle marketing in a professional manner and can thereby reduce the

transaction costs of international marketing to reasonable and manageable levels. The choice between export Channels 1 and 2 can also be affected by the producing firm's degree of risk aversion since use of a foreign trading company often insures the producer against the risk of payment default by the foreign buyer and reduces the risks that may arise over disputes and their settlement. Quite naturally, the commissions charged by such foreign trading firms for these insurance and dispute resolution services involve an implicit risk premium.<sup>4</sup>

Third, consistent with H2 (concerning the effects of product differentiation) and H1 (concerning firm size), one can see considerable variation in the choices of channels from one sector to another and that these choices vary according to transaction costs and internal marketing capabilities of the firms. For example, in the textile sector characterized by a high degree of product homogeneity and hence relatively low transaction costs and the dominance of large firms, six different channels are used (Channels 1, 2, 5, 6, 7, and 8). Even among the more highly product-differentiated sectors like footwear and garments, thanks in part to the variety of different firm sizes involved in exporting and considerable experience, no less than seven different channels are used. At the other extreme, however, and also consistent with H4 (concerning experience in the market) in the newly established ceramics industry, where both firms and local intermediaries presumably lack experience, only Channel 2 (foreign trading company) is used for exports to markets outside the Arab world.

Fourth, although not evident directly from Figure 2, the interviews also demonstrated that among small and medium-sized export producers, the education and experience of the owner can also make an important difference with respect to the choice of export channel and the nature of the services obtained through the channel. Consistent with H5 (concerning the firm's internal capabilities), cases were encountered in which educated and ambitious owner-managers of small producers can engage in direct exports, though not necessarily at first export but later on as a result of learning by doing.

All interviews revealed rather clearly that both the choice of export channel and the transaction costs of exporting are dynamic rather than static. Firms change their channels of export as they grow larger and become more capable of handling more of the dimensions of such transactions by themselves. Consistent with H4 (concerning the effect of firm experience) there is a reduction in transaction costs as experience in exports is gained. Firms with experience in exporting often take advantage of their experience by becoming intermediaries for other producers. Even if a formal relationship with an intermediary remains for some time, the character of that relationship may change with

experience. For example, experienced exporters may start to disregard the advice offered by the intermediaries.

Also consistent with H4, this increasingly direct approach to international marketing is more likely to occur when there is more or less continuous contact between producer and foreign buyer (which is likely to occur with less homogeneous products). Consistent with H1 (concerning firm size), it is more likely to happen when the producer attains a relatively large size and the ability to arrange export finance on its own; consistent with H5 (on the effects of the firm's internal capabilities), it is more likely to happen when the owner-manager is well-educated and has foreign language and other capabilities, and consistent with the learning advantages of H4, when the role played by the trading intermediary is not so pervasive as to altogether prevent learning by doing in exporting by the producer.

## **V. IMPLICATIONS FOR POLICY AND FURTHER RESEARCH**

In view of the considerable qualitative empirical support from this Egyptian case study for (1) the importance of transaction costs, (2) hypotheses H1-H6) above, and (3) the various problems in exporting identified (sources of transaction costs), we make the following policy recommendations:

(1) Given the diminishing importance of barter trade with Eastern Europe in the overall exports of Egypt, the activities of Egypt's public sector trading companies should be substantially reoriented or reallocated. Those remaining in the public sector should be assigned new roles within the overall aim of promoting exports. Chief among these roles would be the provision of assistance both to small and medium-size producers desiring to penetrate new international markets, and to all firms desiring to export to markets not covered by private trading firms, such as those in sub-Saharan Africa. Other public trading companies should be gradually privatized, and split up into smaller units, each specializing in certain geographic and product market niches according to the comparative advantages of existing firms and their personnel.<sup>5</sup>

(2) A market for information services should be encouraged so as to provide the incentive for firms to invest more substantially in the creation of information as well as in its storage and dissemination. Since there is at present considerable duplication of effort with respect to data collection on export markets but also inadequate information by potential users as to how to get it, this recommendation need not require additional expenditures on information.

(3) In view of the present heavy concentration of trading companies on imports at the expense of exports, greater specialization in exports and particularly in long-term export development should be encouraged. This could be done by increasing the incentives for trading firms specialized in exports and decreasing those for trading firms engaged partly or wholly in import activities. In addition, to foster long-term export development, special tax incentives could be given to those export-oriented trading firms which succeed in increasing their exports to designated markets at rates equal to or above a prespecified target.<sup>6</sup>

(4) Given that trade fairs have been an important source of ideas and contacts for Egyptian exporters, and that some of the benefits emanating from such activities leak out in the form of externalities, we propose that the initial participation of a firm in an international trade fair should be subsidized. Such subsidies would be low in cost, and since the extent to which the benefits are externalities would fall with firm size, we would recommend that the percent of such expenses subsidized should fall with firm size.<sup>7</sup>

(5) In contrast to the experience in East Asian countries, where finance has become automatic and virtually instantaneous for a firm with a verified export order, several of the Egyptian exporting firms reported trouble and long delays in getting access to export finance. It is recommended that the systems used in the East Asian countries be copied so that Egyptian firms not be disadvantaged with respect to export finance facilities relative to their competitors in East Asia.

(6) In view of the fact that a number of Egyptian exporters reported having failed to receive payment for their exports, apparently because they had not properly understood export procedures, training programs for exporters should be encouraged. These programs should provide actual or potential exporters with up-to-date information about export procedures<sup>8</sup>, the sources of transaction costs and the more technical aspects of international marketing requirements.

(7) In view of the apparent usefulness of the Garment Exporter Association to garment exporting firms,<sup>9</sup> the formation of other such exporter associations should be encouraged through favorable tax treatment and perhaps also by subsidizing technical assistance in their formation stage supplied by the successful garment and other associations.

(8) In view of the dynamics of transaction costs and the importance of learning by doing in export transactions, it is highly desirable that there be close interaction between exporting firms and their intermediaries so that the former could be encouraged to reduce their use of trading intermediaries over time, leaving the intermediaries to concentrate primarily on new exporters and old exporters to new markets. Producer associations and

chambers of the relevant producer groups within public sector agencies could play an important role in accomplishing this.

A factor which could render potentially very costly either insufficient or insufficiently prompt attention to these recommendations is that the transaction costs of exporting do indeed turn out to rise as product homogeneity declines. Since oil and cotton, which at present constitute about 60% of the country's exports, are much more homogeneous than virtually all other potential exports, the mix of Egypt's exports is virtually certain to move in a way which will raise the average transaction costs per unit of exports.

Since these recommendations are based almost exclusively on a single Egyptian case study of export producers and intermediaries, strictly speaking they apply only to Egypt. Yet, in view of the similarity of the conditions of Egypt to other developing countries, especially those of North Africa and the Middle East, the presumption is rather good that similar diagnoses and policy recommendations would apply to other countries of the region.

Clearly, more research would be necessary to establish the applicability of the findings of this paper to countries outside of North Africa and the Middle East. In view of the apparent fruitfulness of this case study's interviews in providing evidence relevant to the evaluation of such policy proposals, and the rather low cost of conducting the necessary field research, further research along similar lines in other countries can be recommended. Such research would seem especially warranted in countries which may have had export experience quite different from that of Egypt, e.g., with different types of channels, focussing on different products and geographic markets (e.g., engineering products directed to Japan and originating in sub-Saharan Africa or Latin America).

Yet, even before that further research is carried out, since (as noted above) some of the recommendations are supported by similar research findings recently obtained in other countries, some of the recommendations would appear to be of general relevance to developing countries, and hence worthy of serious consideration.

## Footnotes

\* Associate Professor, Department of Economics, American University in Cairo, and Professor, Department of Economics, University of Southern California. The authors express their gratitude to Nicolas Sanchez, Brian Levy, and two anonymous referees for their useful comments on earlier versions of the paper, and to the managers of producing and trading companies who gave so generously of their time and effort. This is a revised version of a paper presented at the 70th Western Economic Association International Conference in San Diego, California, July 5-9, 1995.

<sup>1</sup> Support for this proposition is readily available from a variety of sources. One of the most telling perhaps is the persistently low share of the eventual sale price of a good exported by a developing country which is received by the developing country producer or its local agent (e.g., Wortzel and Wortzel (1979)).

<sup>2</sup> The commissions reported in the sample were as high as 15% of the total value of exports. The lowest commissions reported (3%) were for the public sector trading companies. The commissions for the private trading companies are higher and vary more with the extent of service provided and the reputation of the firm.

<sup>3</sup> The dependence on the trading companies by workshops in the footwear industry is sufficiently great that the workshops often have no idea of the identities of their foreign trading partner. The trading company helps to assure quality control by restricting the producing workshop to the use of but a single design. As a result, the workshop is not concerned if the trading company should sell its output on the domestic instead of the international market.

<sup>4</sup> Two factors which contribute to risk aversion among textile exporters and hence their reliance on such services via Channel 2 are the capital intensity of the sector and the fact that the firms are public enterprises whose managers may worry about the possible consequences of export and hence financial failures. Since smaller firms may tend to be more risk-averse than large ones, differences in risk aversion across different firm size classes may also help explain why the commissions charged by such trading companies are generally higher for small producers than large producers. Other factors contributing

to such observed differences in commissions across size classes are differences in scale (because of economies of scale in marketing activities), in ownership (public sector Egyptian firms being deemed less risky by foreign trading companies than private firms), in the extent of transaction repetition, and closely related with that in the extent to which transaction costs fall with experience.

<sup>5</sup> Such an incentive system was used to advantage by the Korean government in achieving its export growth targets with respect to the private general trading companies which were established for that purpose along the Japanese model in the late 1970s [Cho (1987); Kim and Nugent (1994)].

<sup>6</sup> This recommendation also receives strong backing from some recent case studies of small and medium sized exporters of manufactures (SME exporters) undertaken in Colombia, Indonesia, Japan and Korea (Levy et al. 1994, Berry and Escandon, 1994, Berry and Levy, 1994, Itoh and Urata, 1994 and Kim and Nugent 1994). Indeed, these studies showed such participation to be almost universally highly evaluated by the SME exporters.

<sup>7</sup> The comparative success of this association relative to the many others, however, can be attributed to several rather special factors, among which are that (1) it includes several large producers with good access to high levels of government, (2) its exports are quite important to the Egyptian economy and (3) its exports are largely to the U.S., a country whose market is deemed very important to Egypt and which has close political ties with Egypt (implying that Egypt has good access to the relevant information and to the means of correcting problems arising at the U.S. end).

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