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*Policy Viewpoint reflects the stance of ECES on key policy issues in Egypt.*

#### **ECES MANAGEMENT**

*Magda Kandil, Executive Director  
and Director of Research  
Omneia Helmy, Deputy Director for  
Research and Lead Economist  
Magda Awadallah, Deputy Director  
for Finance and Administration*

*This issue of Policy Viewpoint was written by Magda Kandil, Executive Director and Director of Research, the Egyptian Center for Economic Studies. Ziad Amer provided research assistance.*

## **Monetary Policy in Egypt: Recent Challenges and Future Priorities**

Over the past two decades, the Egyptian economy has become more integrated into global markets and, therefore, more exposed to business cycle volatility. In this environment, there is a need for a broader view of monetary policy, with greater priority attached to stabilizing output around its potential, alongside the control of inflation. Specifically, larger capital inflows exacerbate volatility of the exchange rate, requiring central banks to mitigate erratic changes in the exchange rate. Monetary policy will need to lay the primary role of stabilization policy, as it is much more flexible than fiscal policy, which suffers from different types of implementation constraints. However, the challenge of relative price shocks in Egypt has increased in recent years through steep increases in commodity and vegetable prices. These increases were associated with spikes in inflation. Unfortunately, these shocks have not dissipated quickly, threatening to raise inflationary expectations.

This edition of *policy viewpoint* will review recent developments in ultimate and operational objectives of monetary policy and the challenge of persistent relative price shocks. The analysis will review the transmission mechanisms of recent relative price shocks and other multiple shocks complicating the conduct of monetary policy. It concludes by assessing the adequacy of conventional monetary policy instruments and the need to utilize non-traditional tools to eliminate structural distortions and increase the effectiveness of traditional monetary policy instruments.

### **MONETARY POLICY FRAMEWORK**

Monetary policy in Egypt has markedly progressed since early 2004. Remarkable changes reshaped strategy, including the ultimate target, the intermediate target and the operational target. The ultimate target establishes priorities for the end results of monetary policy. The intermediate target establishes monetary policy objectives that are capable of influencing the ultimate target. The operational target establishes instruments that the Monetary Policy Committee targets in its regular meetings towards achieving intermediate and ultimate targets. To enhance the effectiveness of monetary policy towards achieving its objectives, the implementation framework and the communication strategy have also been modernized.

The ultimate targets of monetary policy in Egypt are now focused on achieving and maintaining price stability as the primary objectives. Having graduated from a fixed exchange rate policy, central banks in many countries have focused their attention on price stability towards a full-fledged implementation of inflation targeting to strike a balance between domestic priorities and external stability. As for the intermediate targets, in its monetary statement the Central Bank of Egypt (CBE) refers to developments in money supply and credit, as well as a host of other factors, including inflation forecast and output gap forecast, which may influence the underlying rate of inflation.

Monitoring domestic liquidity is key to the effective transmission of monetary policy instruments towards achieving the ultimate targets. The operational target is the overnight interbank rate. Specifically, the CBE uses two standing facilities (an overnight lending facility and overnight deposit facility) as its main policy instruments, providing the outer bounds of a corridor within which the overnight interbank rate fluctuates. The interbank market enables banks to manage their liquidity in light of demand developments. The interbank rate would be closer to the floor set by the CBE, i.e., the deposit rate, if excess liquidity in the banking

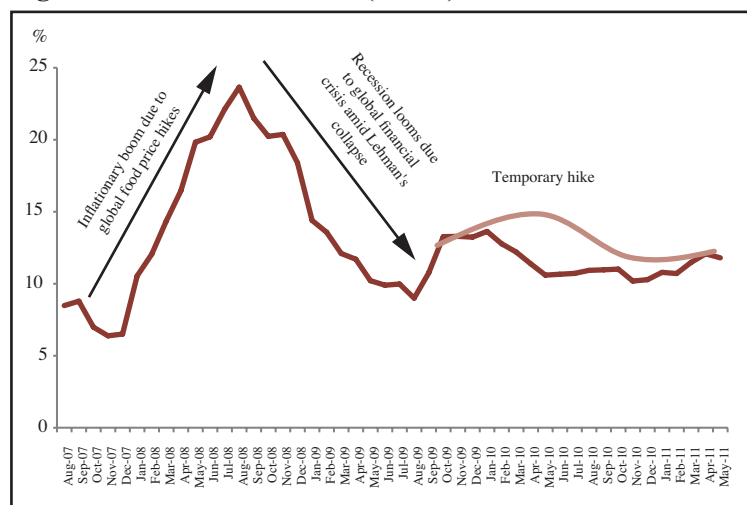
system exceeds potential demand for borrowing suggesting idle capacity during periods of a slowdown. To reinforce its ability for effective liquidity management, the CBE conducts open market operations, buying or selling government securities, to inject or absorb available liquidity. Monetary policy decisions are taken by the CBE's Monetary Policy Committee (MPC). The MPC issues a communiqué immediately after its meetings to inform the public and anchor inflationary expectations.

### RECENT DEVELOPMENTS IN ULTIMATE AND OPERATIONAL OBJECTIVES

A review of recent directions of monetary policy reveals the challenges to strike a balance between fighting inflation and stimulating growth in the face of global shocks and limits on the effectiveness of monetary policy instruments.

Inflation has varied over time with international shocks and domestic pressures. Indeed, inflation surged on account of high international prices, but moderated with the slowdown in the economy and a gradual vanishing of the base effect. More recently, however, inflationary pressures have developed in the wake of the January 25 revolution, reflecting higher international prices, depreciation of the Egyptian pound, supply shortages and higher spending by the government for consumption-based support (Figure 1).

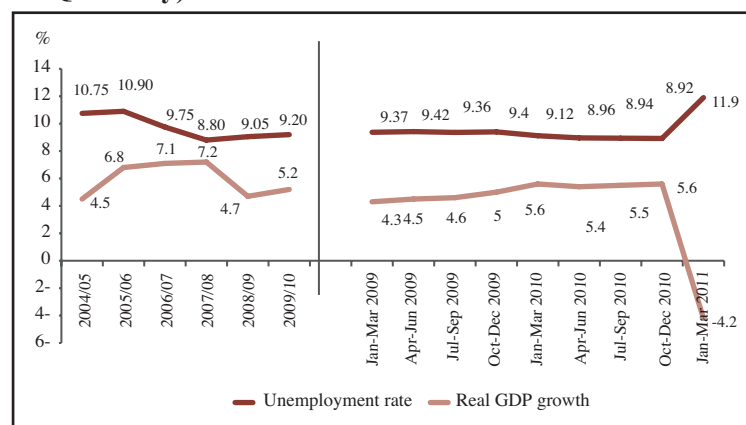
**Figure 1. Headline Inflation (Y-o-Y)**



Source: Central Bank of Egypt; inflation statistics.

Thanks to fiscal stimulus and accommodating monetary policy, real growth proved to be relatively resilient during the global crisis and recovery regained momentum in 2010. Nonetheless, it was not generating enough jobs. In the wake of the January 25 revolution, the economy underwent severe contraction on account of slowdown in domestic and external demand and lingering disruption of production activity (Figure 2).

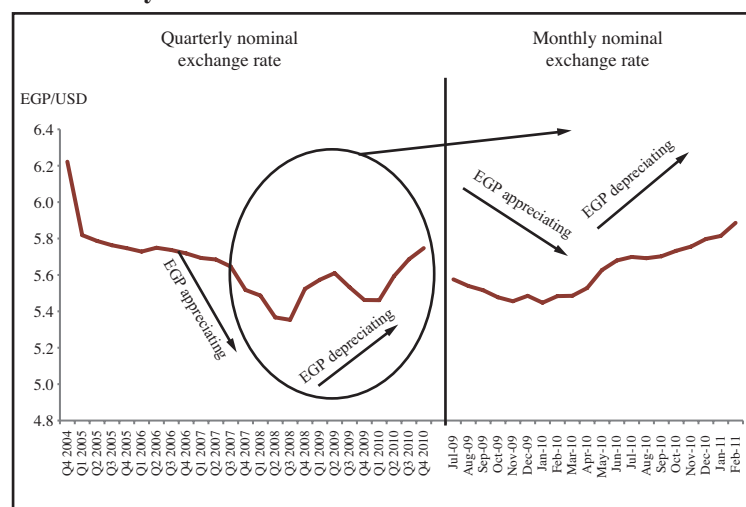
**Figure 2. Real GDP Growth and Unemployment (Annually v.s Quarterly)**



Source: Central Bank of Egypt (Monthly Statistical Bulletin); and Ministry of Finance (Financial Monthly).

Exchange rate policy has been designed to strike a balance between the priorities of containing inflationary pressures and supporting economic growth. Appreciation of the exchange rate is necessary during periods of high inflation to reduce the cost of imports. In contrast, depreciation could be desired to stimulate export competitiveness during periods of slow growth. Indeed, the appreciation episode of the Egyptian pound, relative to the US dollar, corresponds to high inflationary cycles, while the depreciation episode corresponds to weak economic growth, which has been intensified by the slowdown in external demand and capital outflows in the wake of the January 25 Revolution (Figure 3).

**Figure 3. Nominal Exchange Rate (EGP/USD), Quarterly v.s Monthly in Percent**

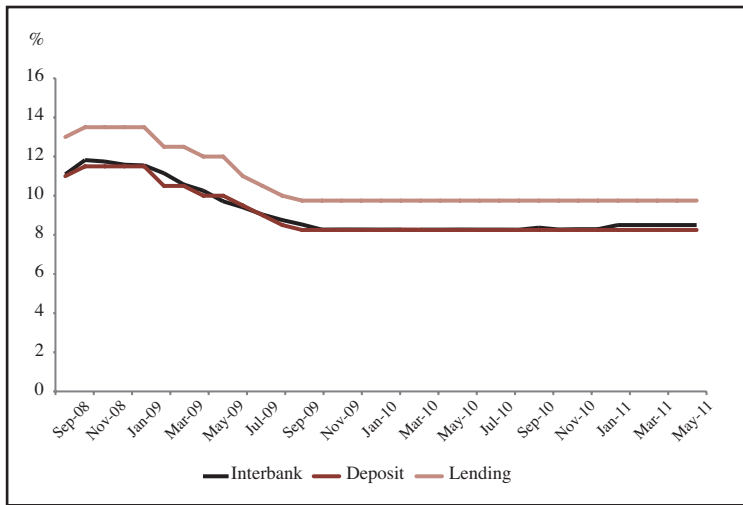


Source: International Financial Statistics; and Central Bank of Egypt (Monthly Statistical Bulletin).

The direction of monetary policy instruments has been stipulated by the economic cycle. In the face of the global financial crisis, monetary easing was pursued to stimulate demand for credit and private sector growth. As the economy

started to show signs of recovery, the easing cycle ended in September 2009. Subsequently, no further changes were announced in the policy rates, implying a neutral stance, as the CBE has opted for non-traditional methods to arrest inflationary pressures to avoid raising the interest rate at the risk of slower growth recovery. Indeed, a review of the implementation tools of monetary policy indicates that a neutral stance has been in effect, following a prolonged expansionary cycle, which has been extended post the January 25 revolution to support economic recovery (Figure 4).

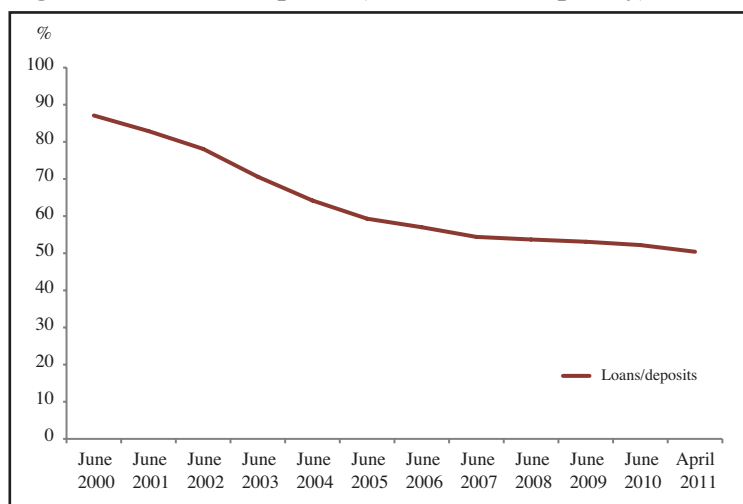
**Figure 4. Interbank, Deposit and Lending Rates**



Source: Central Bank of Egypt (Monthly Statistical Bulletin).

Despite persistent expansionary monetary policy, the demand for credit was not elastic to the reduction in the interest rate, challenging the effectiveness of monetary policy. Indeed, excess liquidity has been evident, as judged by persistent reduction in the ratio of loans to deposits, reflecting lack of leveraged investments and ineffective intermediation function

**Figure 5. Loans to Deposits (Indicator of Liquidity)**

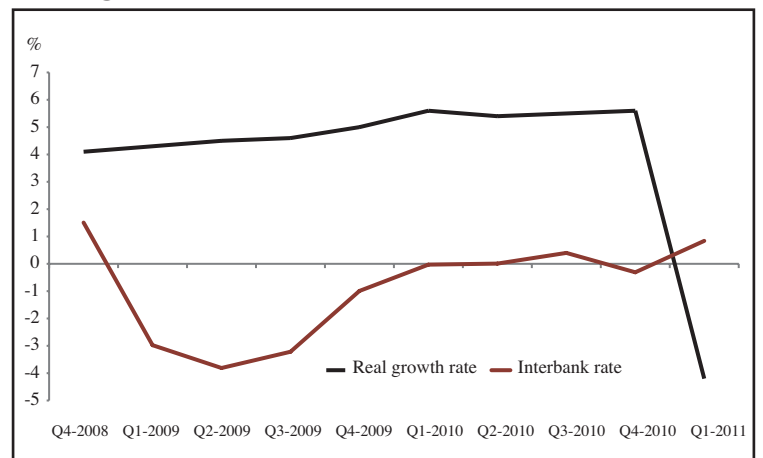


Source: Central Bank of Egypt; Monthly Bulletin.

(Figure 5). Excess liquidity reinforced financial stability post the January 25 revolution.

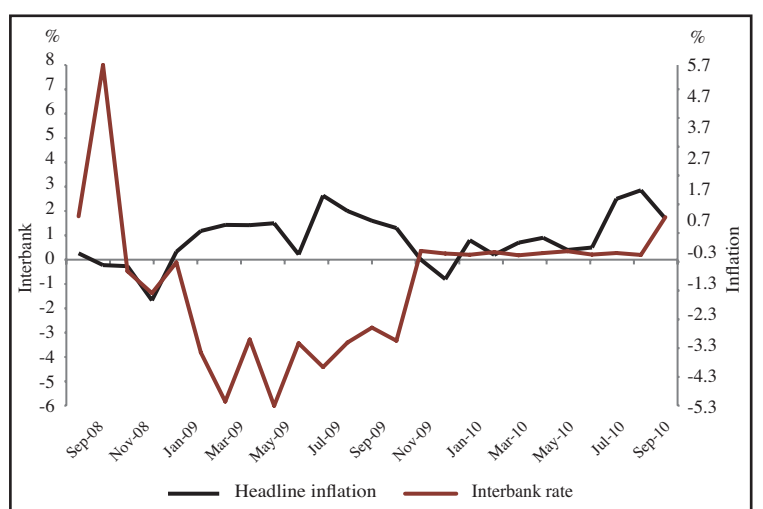
Nonetheless, excess liquidity in the banking system has limited the effectiveness of monetary policy easing. It reflects failure to capitalize on available liquidity in the form of credit extended to the private sector, particularly small and medium enterprises (SMEs) towards mobilizing economic activity. Indeed, real growth steadily picked up with a lag in response to successive monetary easing (Figure 6). However, in the face of slow demand for credit, the CBE's efforts to control supply-side inflationary pressures have resisted an increase in the policy rate to preserve economic recovery (Figure 7).

**Figure 6. Real Growth Rate with Quarterly Average of Overnight Interbank Growth Rate**



Source: Central Bank of Egypt (Monthly Statistical Bulletin); and Ministry of Finance (Financial Monthly Report).

**Figure 7. Headline Inflation and Overnight Interbank Interest Rates**



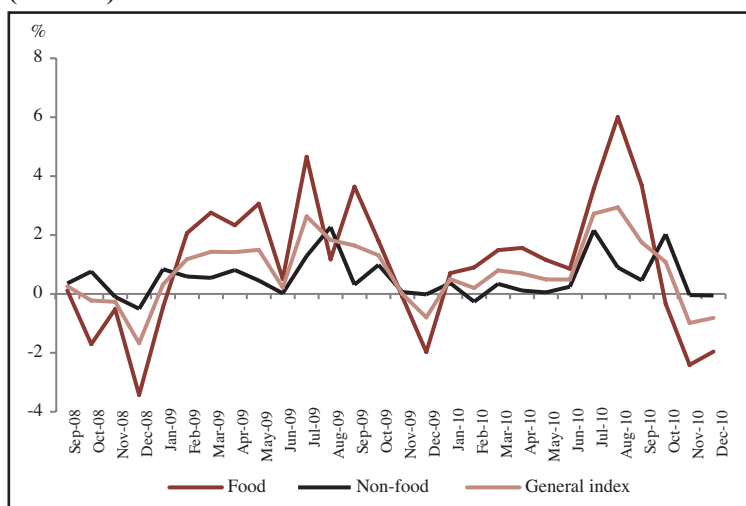
Source: Central Bank of Egypt (Monthly Statistical Bulletin).

**THE CHALLENGE OF PERSISTENT RELATIVE PRICE SHOCKS**

Traditional monetary policy instruments could prove inadequate in the face of persistent relative price shocks. Given the domestic propagation mechanism, the adverse effects of international price shocks are long-lasting and challenge the conduct of monetary policy.

The consumer price index in Egypt consists of food items, mainly bread, fruits and vegetables (39.92 percent of headline weight) and other items.<sup>1</sup> Headline inflation has exhibited extensive cyclicality, mostly driven by food. In addition, there is significant correlation between food and non-food inflation (Figure 8).

**Figure 8. Headline Inflation, Food and Non-food Inflation (M-o-M)**



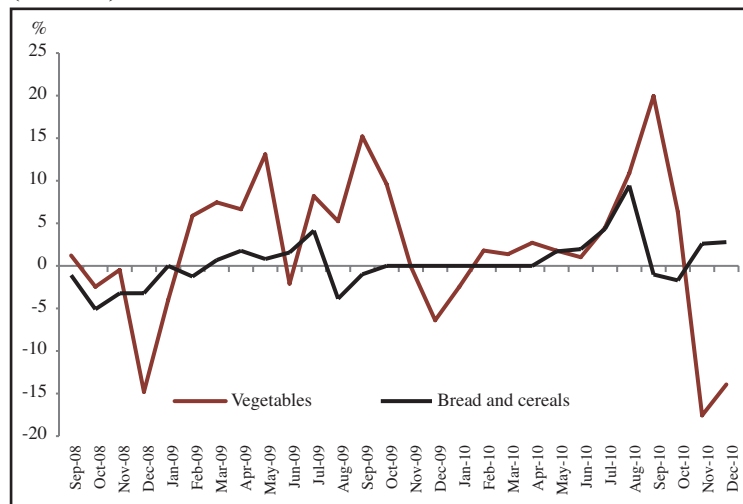
Source: CAPMAS.

Note: The breakdown of headline inflation into food and non-food is intended to highlight which component has more impact on headline inflation.

Recent developments in bread & cereal and vegetable price inflation rates present a number of interesting facts that are worthy of careful consideration towards maximizing the effectiveness of monetary policy. First, bread & cereals and vegetable price inflation rates are somewhat correlated and represent potential sources of higher inflationary expectations (Figure 9). Bread prices are considered an anchor for basic prices and inflationary expectations. Indeed, bread price inflation is passed through to non-food price inflation with a lag (Figure 10).

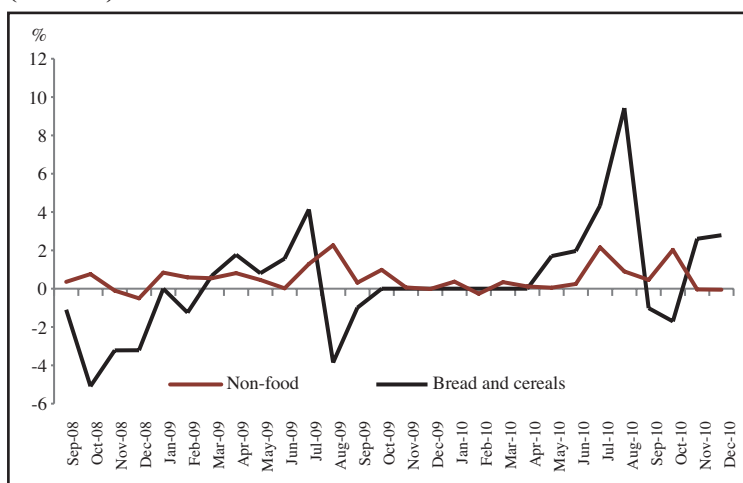
<sup>1</sup> The index is based on CAPMAS data series from August 2009 till December 2010 (latest available data on the disaggregate level). The old weight for food and beverages is 43.88 percent and was based on the 2004/2005 household expenditure survey. It was applied on inflation figures up until July 2010. The new weight (39.92 percent) is based on the 2008/2009 household expenditure survey and is applied to inflation figures starting August 2010.

**Figure 9. Bread & Cereal and Vegetable Inflation Rates (M-o-M)**



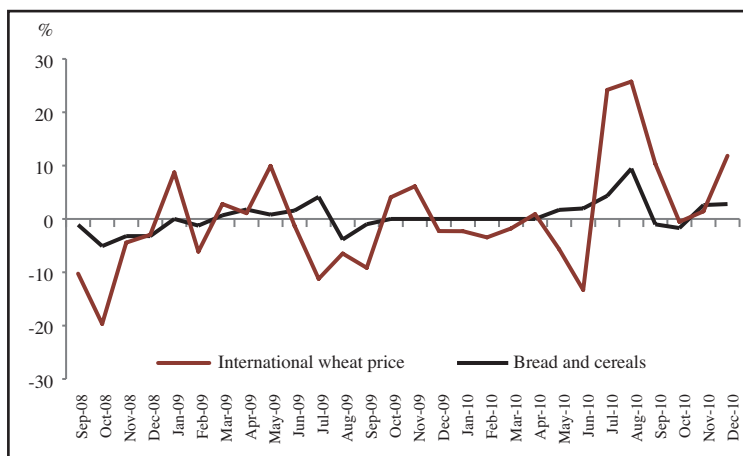
Source: CAPMAS.

**Figure 10. Bread & Cereal and Non-Food Inflation Rates (M-o-M)**



Source: CAPMAS.

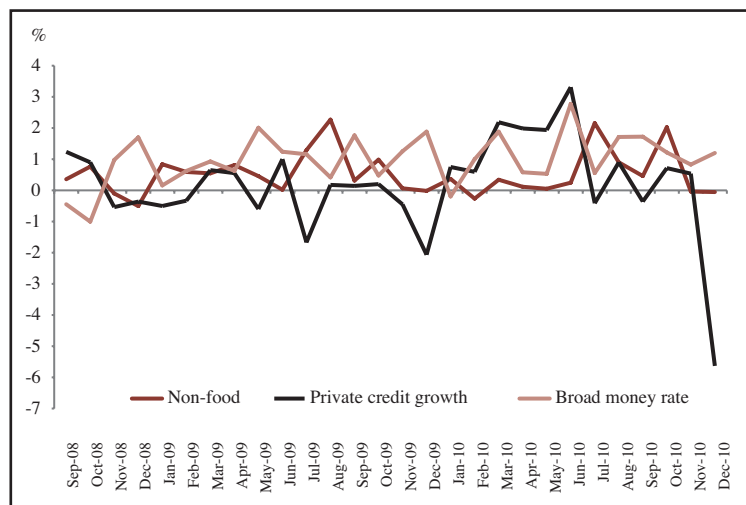
**Figure 11. Bread Inflation (M-o-M) and Growth in International Wheat Price**



Source: CAPMAS.

Moreover, there seems to be exogenous shocks that affect the price of bread & cereals (Figure 11). Indeed, there is a quick and strong pass-through of international wheat price to the price of bread. In addition to the impact of basic prices on non-food inflation, the latter is affected by economic activity, providing a scope for effective monetary policy. To illustrate, broad money growth and the underlying growth of domestic credit are transmitted to non-food price inflation with a lag (Figure 12).

**Figure 12. Non-Food Inflation (M-o-M), Broad Money and Private Credit Growth**



Source: CAPMAS.

### THE TRANSMISSION MECHANISM OF RECENT RELATIVE PRICE SHOCKS

Relative price shocks for wheat are considered somewhat permanent due to: (i) global warming and resulting drought, (ii) sustained growth in emerging and developing economies; (iii) increase in demand for oil seeds and grains for bio-fuel production, (iv) subsequent shift in land use from wheat and other crops to bio-fuel grains, (v) fertilizers' price increase, and (vi) increasing transportation costs worldwide.

Bread and cereals price shocks are usually associated with dominant inflationary pressures. Bread and cereals price movement is propagated to other prices in the economic system rather quickly, raising the price of many inputs and intermediate goods. Following the shock, there is a relatively larger decrease in supply due to the propagation of the shock into many input requirements, establishing priorities to fight inflation.

Similarly, relative price shocks are considered somewhat permanent for vegetables due to: (i) increased exports of vegetables, (ii) food manufacturing is gaining momentum, (iii) global warming, (iv) fertilizers' domestic price has increased and (v) tighter regulations concerning the use of insecticides, which resulted in reduced availability and higher costs.

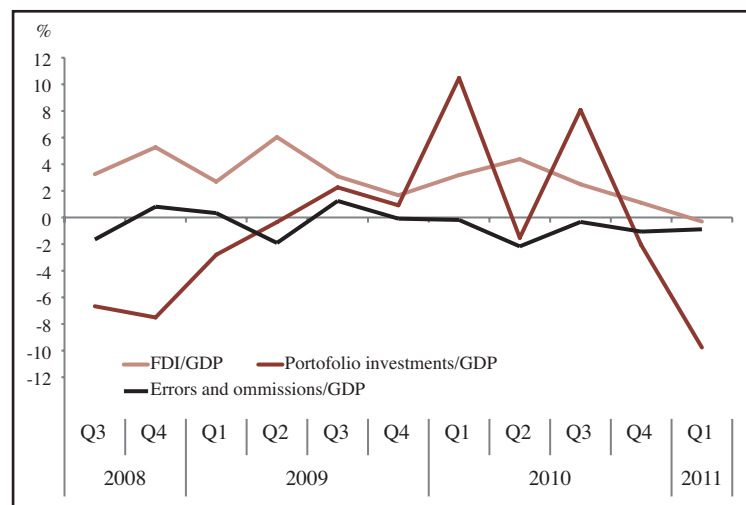
In contrast to bread and cereals price shocks, vegetable price shocks are usually associated with dominant output contraction. Higher prices of fruits and vegetables reduce real income and constrain consumers' demand. Following the shock, there is a relatively larger decrease in demand due to the purchasing power effect, establishing priorities to revive growth.

### OTHER MULTIPLE SHOCKS COMPLICATING THE CONDUCT OF MONETARY POLICY

The conduct of monetary policy becomes even more complicated in the face of external shocks that could threaten external stability and increase domestic pressures in the face of excessive exchange rate fluctuations. While trade flows and other flows in the current account could be influenced by domestic policies, flows in the financial account are subject to more random fluctuations in response to global conditions and concerns about domestic stability that have developed in the wake of the January 25 Revolution.

Net FDI did not recover to the pre-global financial crisis levels. Moreover, portfolio investments remain erratic, reflecting investor uncertainty (Figure 13). Indeed, FDI flows have been further eroded and financial outflows have increased, further complicating the design of monetary policy and challenging external stability, in the wake of the revolution on January 25.

**Figure 13. Investment Disaggregates to GDP**

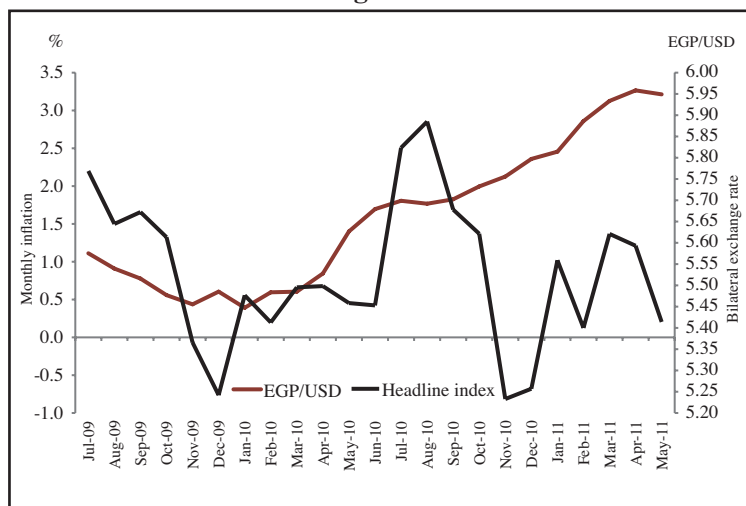


Source: Ministry of Finance (Financial Monthly).

Fluctuations in the nominal exchange rate are even more complicated by corresponding inflationary pressures that could be reinforced by exchange rate movement given the openness of the Egyptian economy. Fluctuations in the exchange rate could threaten external stability and challenge the attainment of domestic priorities for the central bank. The recent depreciation trend of the Egyptian pound raises the cost of imports, increasing inflationary pressures at a time when foreign prices could be on the rise, particularly food prices (Figure 14). Despite recent depreciation of the pound relative to the dollar, appreciation

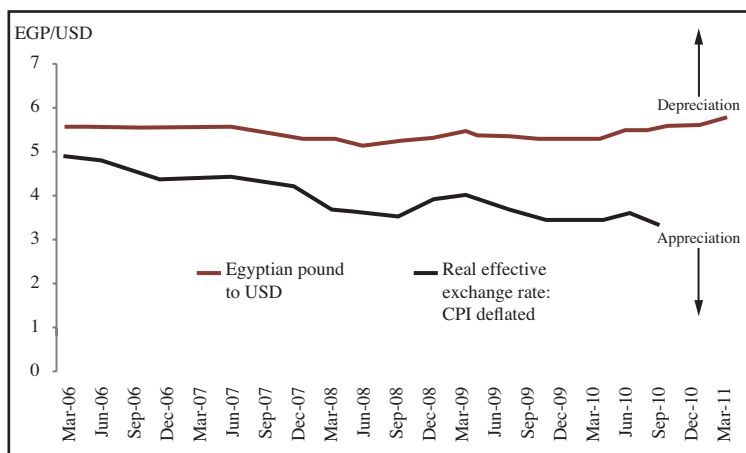


**Figure 14. Headline Inflation (M-o-M) vs. Nominal Bilateral EGP/USD Exchange Rate**



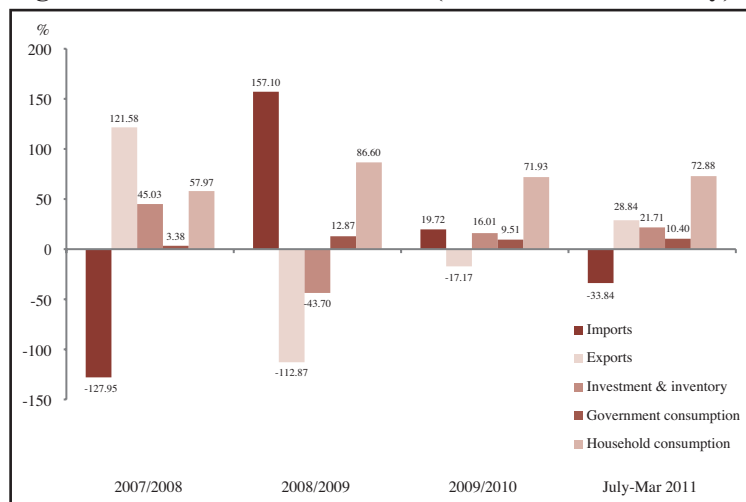
Source: Central Bank of Egypt (Monthly Statistical Bulletin) and inflation statistics.

**Figure 15. Real Effective vs. Bilateral EGP/USD Exchange Rates**



Source: CEIC data.

**Figures 16. Contribution to GDP (Annual and Quarterly)**



Source: ECES calculations; and Egypt’s Ministry of Economic Development.

of the real effective exchange rate threatens competitiveness (Figure 15).

According to the underlying spending components, growth has been largely dependent on the increase in private consumption (Figure 16), which has been adversely affected by high unemployment and deterioration in the standard of living in a high inflationary environment. Post the January 25 Revolution, priorities should be focused on targeting higher investment to increase the job content of growth towards sustaining output recovery and boosting international confidence in the resilience of the Egyptian economy.

**CONCLUSION AND POLICY IMPLICATIONS**

Looking forward, monetary policy priorities should remain focused on maintaining price stability to contain inflationary pressures and preserve competitiveness towards supporting economic growth and stabilizing economic fluctuations to reduce uncertainty. Shortcomings in the financial intermediation process should also be addressed to enhance the transmission mechanism of monetary policy and mobilize private credit growth, particularly in support of small and medium enterprises. Exchange rate policy should aim at striking a balance between promoting exports and containing inflationary pressures to preserve competitiveness and revive external demand.

But persistent relative price movements challenge the conduct of monetary policy. So, it boils down to how to accommodate the shock and to what extent the shock is perceived as permanent. Permanent shocks demand a change in the orientation of monetary policy, namely factoring in their impact and setting a realistic horizon for inflation targeting. In addition, structural policies should aim at addressing persistent rigidities, namely through: (i) addressing structural distortions that affect distribution mark-ups, and (ii) enforcement of monitoring schemes and market regulations to ensure more competitive markets. Transitory shocks can be accommodated through non-traditional policy tools, for example: (i) export and import regulations, and (ii) providing temporary liquidity cushion.

The utilization of non-traditional tools would help eliminate structural distortions and increase the effectiveness of traditional monetary policy instruments to target inflation and stabilize growth, while ensuring that the exchange rate policy is consistent with the underlying fundamentals to align external stability with domestic priorities for monetary policy.

**For more information about ECES contact:**  
 The Egyptian Center for Economic Studies  
 Nile City Towers, North Tower, 8<sup>th</sup> Floor  
 Corniche El Nil - Cairo 11221 - Egypt  
 Tel.: (202) 2461 9037 Fax.: (202) 2461 9045  
 E-mail: [eces@eces.org.eg](mailto:eces@eces.org.eg) URL: [www.eces.org.eg](http://www.eces.org.eg)