



PRIORITIES FOR MONETARY POLICY: THE SCOPE FOR INFLATION TARGETING

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OUTLINE

- 1. Overview of monetary policy in Egypt*
- 2. Recent development in monetary policy objectives*
- 3. Major monetary indicators*
- 4. Impact of fiscal dominance on monetary policy*
- 5. Impact of monetary policy on the macro-economy*
- 6. Policy recommendations*

1. OVERVIEW OF MONETARY POLICY IN EGYPT

- A. Monetary policy framework*
- B. Monetary Policy Strategy*
- C. Monetary Policy Implementation*

A. MONETARY POLICY FRAMEWORK

- The monetary policy has remarkably progressed since early 2004.
- Remarkable changes reshaped strategy, including the ultimate target, the intermediate target and the operational target.
- The implementation framework and the communication strategy have been modernized.

B. MONETARY POLICY STRATEGY

Ultimate targets

Achieving and maintaining price stability has become the primary objective of the monetary policy.

Intermediate target

The intermediate target needs not be a *single variable*. In fact, the CBE in its monetary statement refers to the 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.

Operational target

Overnight interbank rate.

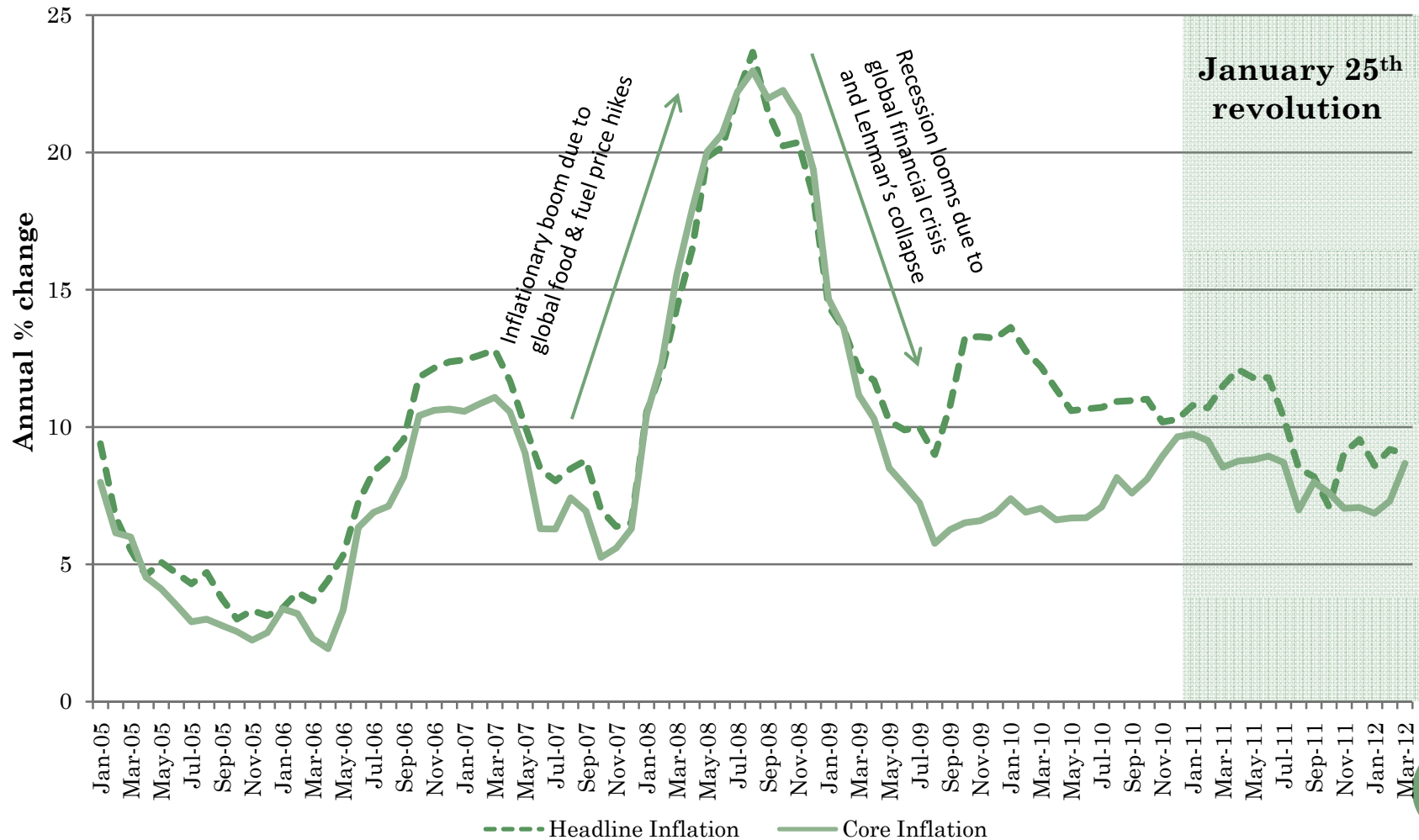
C. MONETARY POLICY IMPLEMENTATION

- The CBE uses two standing facilities (an overnight lending facility and an overnight deposit facility) as its main policy instruments, providing the outer bounds of a corridor within which the *overnight interbank rate* will fluctuate.
- The CBE manages market liquidity through its *open market operations*.

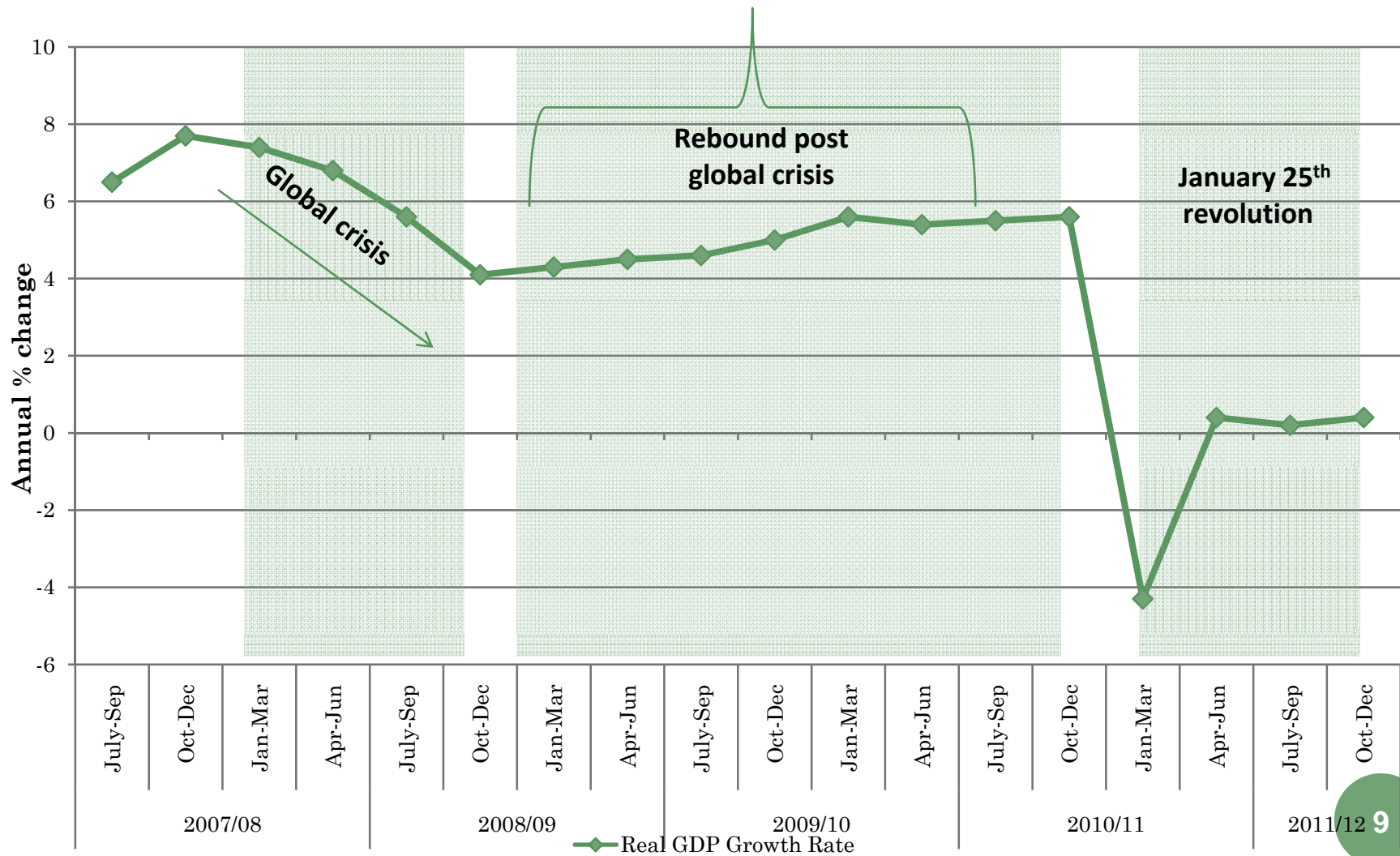
2. RECENT DEVELOPMENTS IN MONETARY POLICY OBJECTIVES

- A. Price stability*
- B. Economic growth*

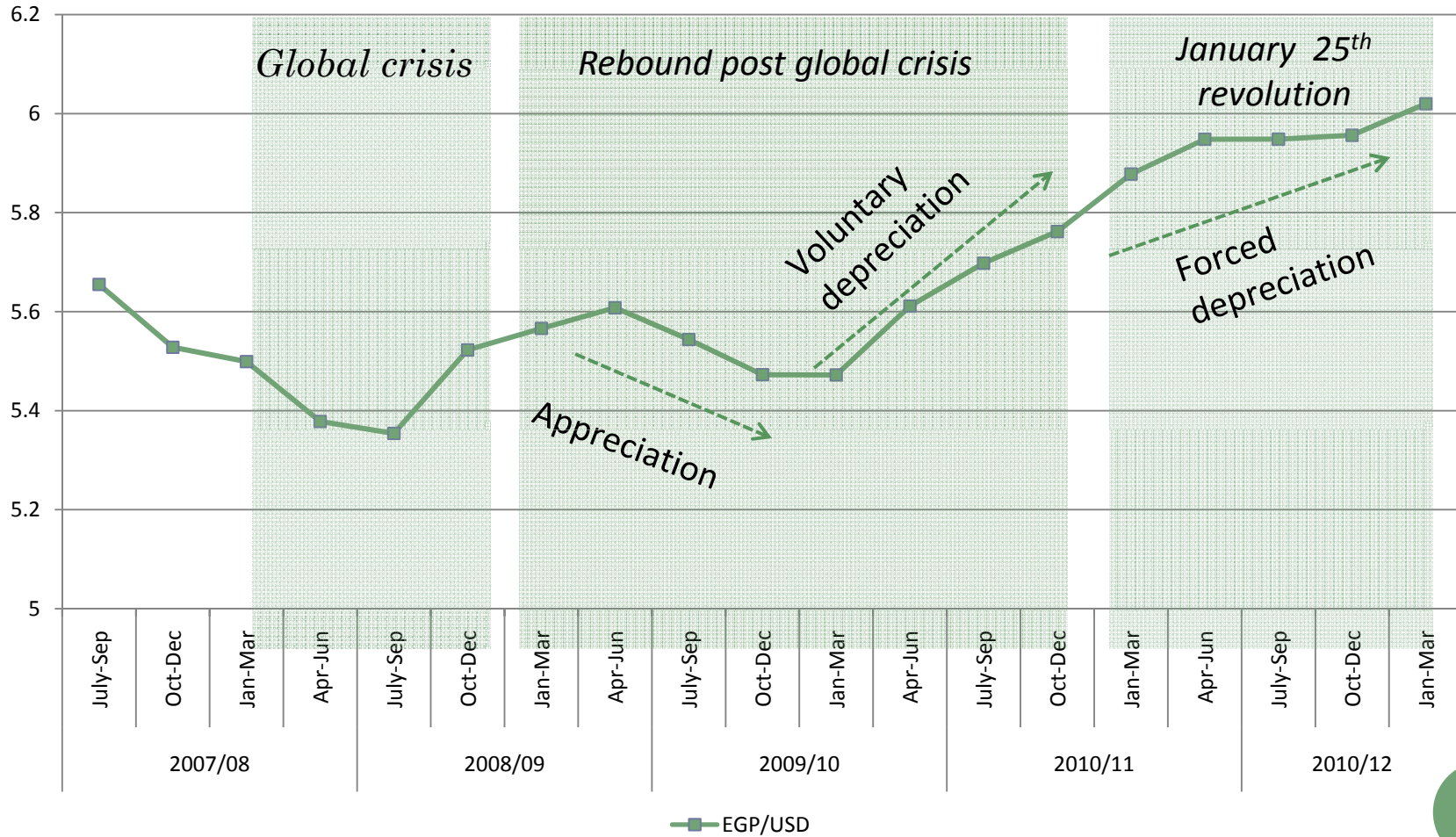
Inflation has varied over time with international shocks and domestic pressures. More recently, post the revolution, inflationary pressures have developed, reflecting higher international prices, depreciation of the pound, coupled with supply shortages.



Real growth proved to be resilient during the global crisis and recovery regained momentum in 2010. However, post the revolution, the economy underwent severe contraction on account of slowdown in domestic and external demand.



Post the revolution, depreciation of the pound corresponds to weak economic growth, intensified by the slowdown in external demand and capital outflows



3. MAJOR MONETARY INDICATORS

- A. Policy Rates
- B. Monetary Survey & liquidity

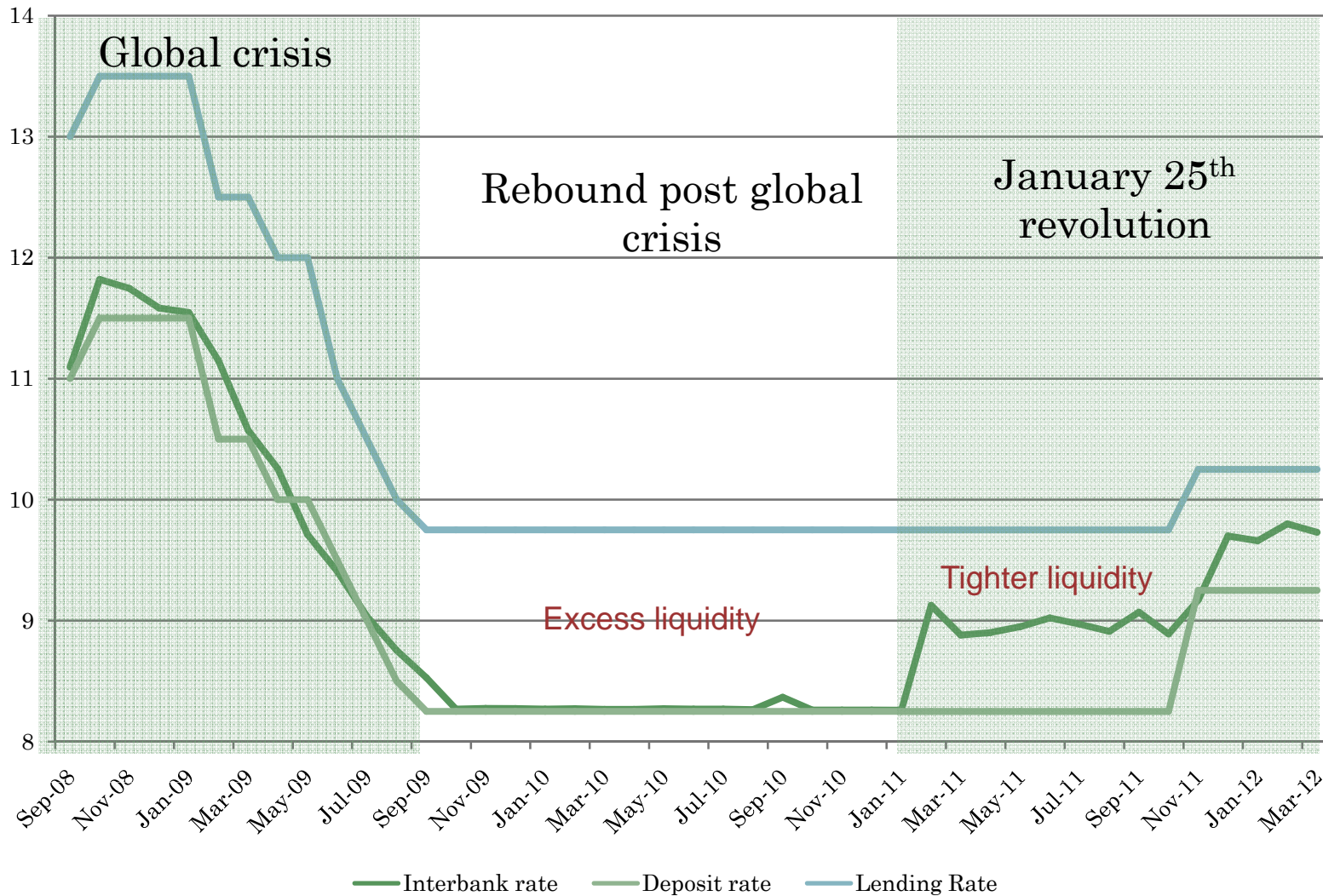
A. POLICY RATES

- ❑ Recent directions of monetary policy.
- ❑ Policy rates & growth rate.
- ❑ Policy rates & inflation.
- ❑ Policy rates & exchange rate.

RECENT DIRECTIONS OF MONETARY POLICY

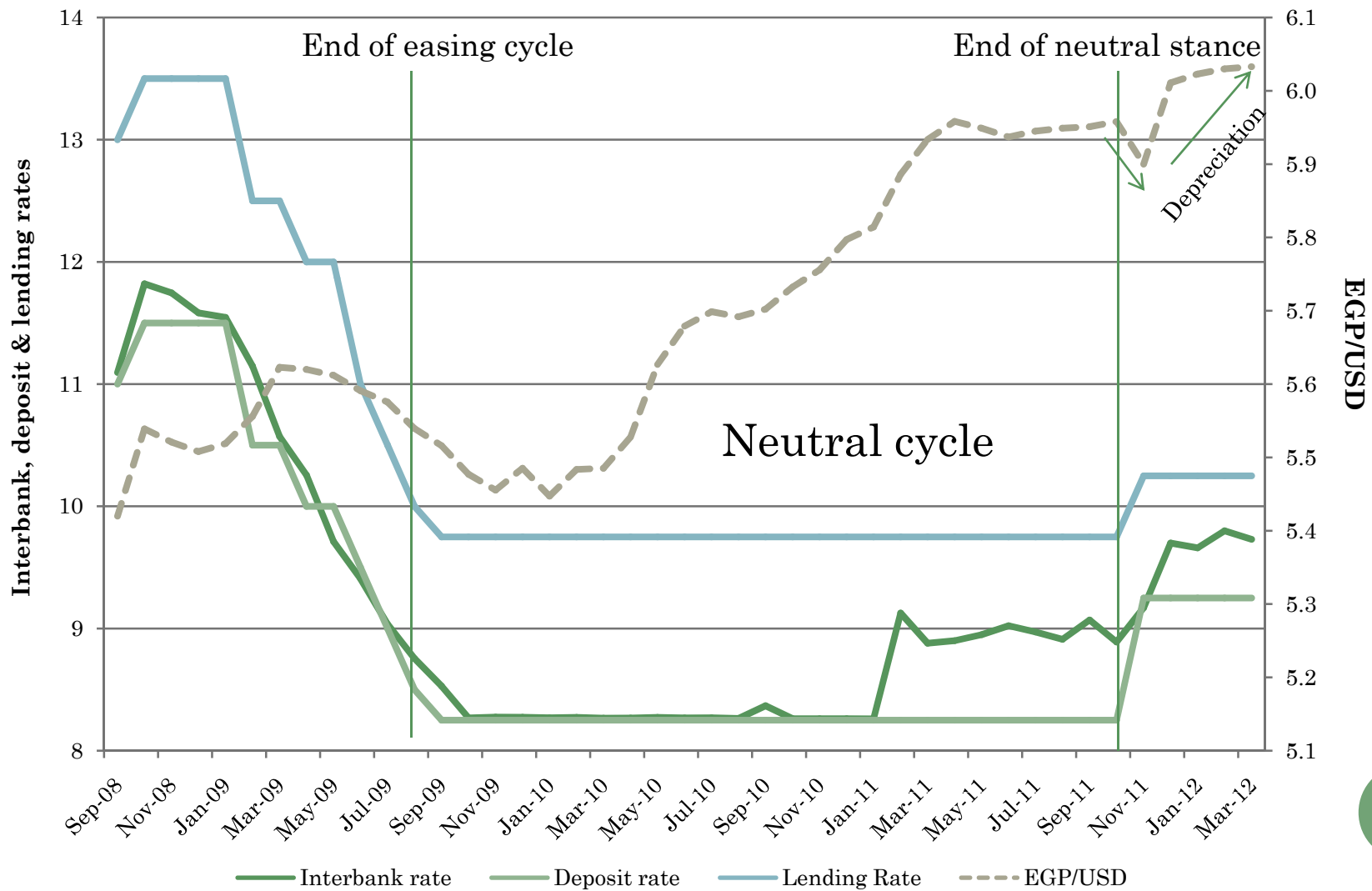
MPC Meetings	Overnight deposit rate		Overnight lending rate		7- day repo		Discount rate		Required reserve ratio (domestic currency deposits)	
	Rate (%)	bps (% change)	Rate (%)	bps (% change)	Rate (%)	bps (% change)	Rate (%)	bps (% change)	Rate (%)	bps (% change)
End of Easing Cycle 17- Sep- 2009	8.25	-25	9.75	-25	--	--	8.5	--	14	--
Introduced 7-day Repo 22-Mar-2011	8.25	--	9.75	--	9.25	--	8.5	--	14	--
End of Neutral Stance 24-Nov-2011	9.25	100	10.25	50	9.75	50	9.5	100	14	--
Easing Liquidity Constraints 22-Mar-2012	9.25	--	10.25	--	9.75	--	9.5	--	12	200

Following successive easing to stimulate the economy during the global financial crisis, and subsequent prolonged neutral stance, the central bank opted to raise the interest rate recently to stem the risk of depreciation



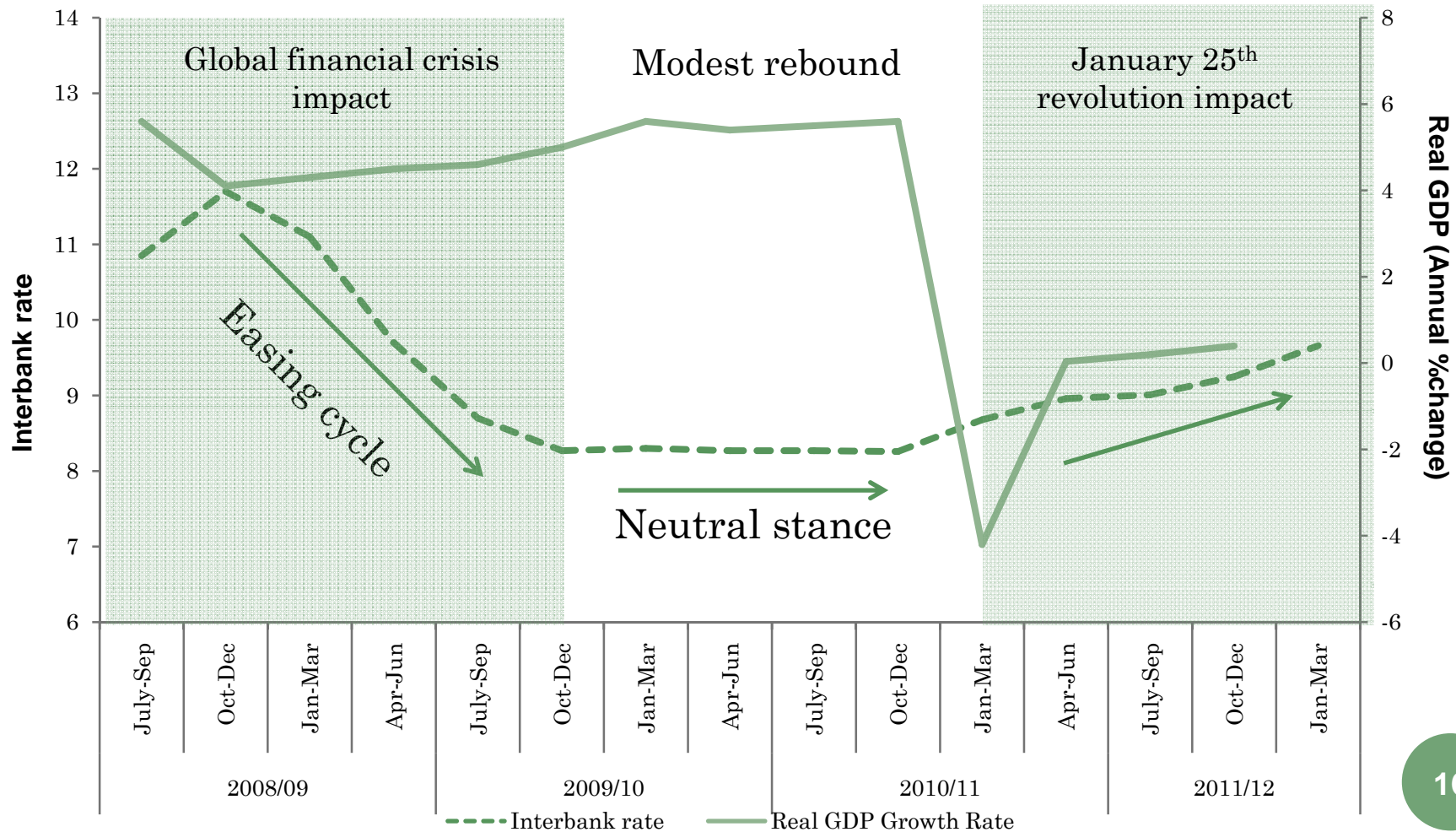
Data Sources: Ministry of Finance

However, these attempts couldn't stem further depreciation of the pound owing to successive external pressures

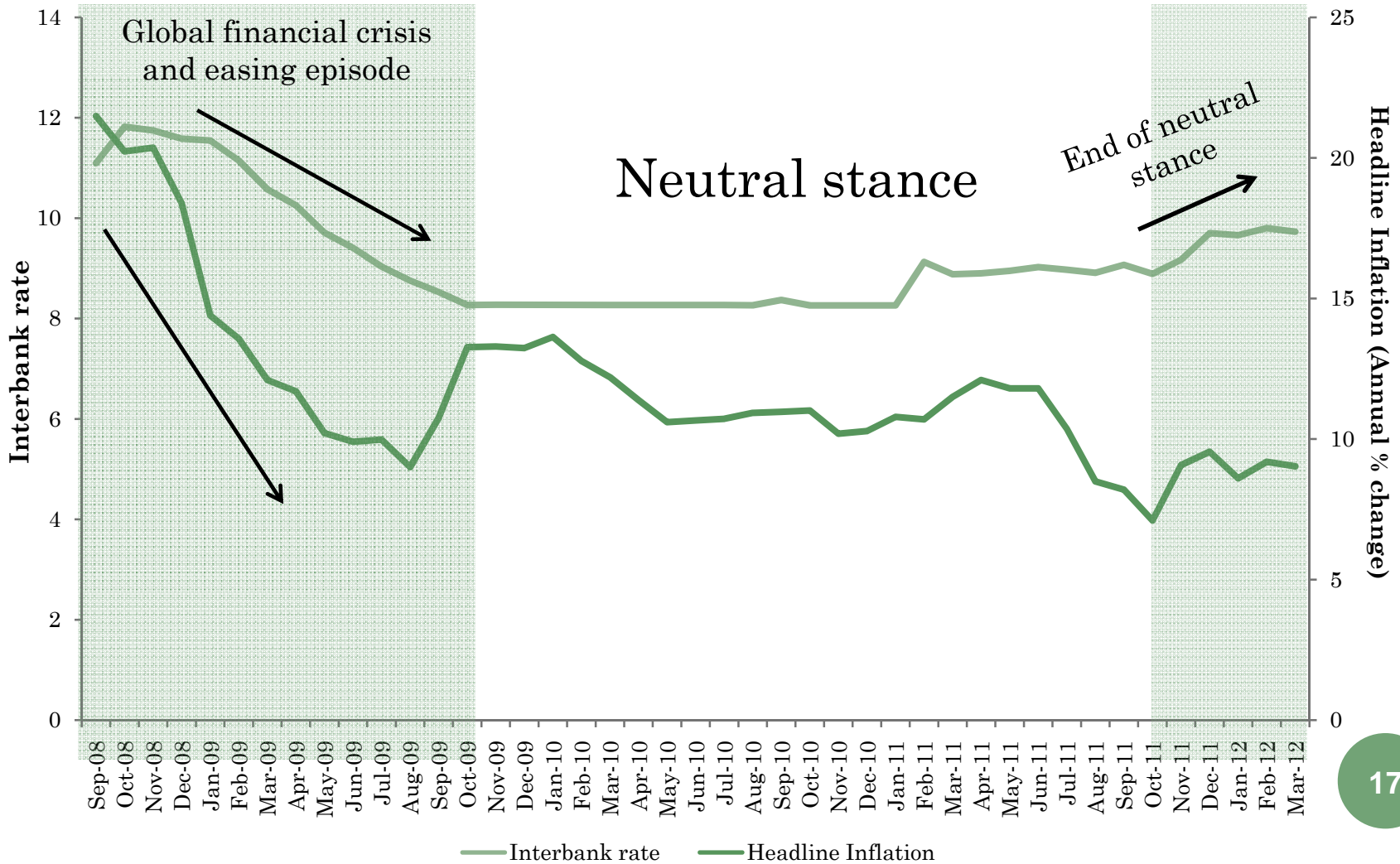


Data Sources: Ministry of Finance

The monetary policy was focused on fighting inflation and changed course during the global financial crisis to stimulate growth. The easing cycle continued to weather the impact of the global shock on the economy through September 2009.

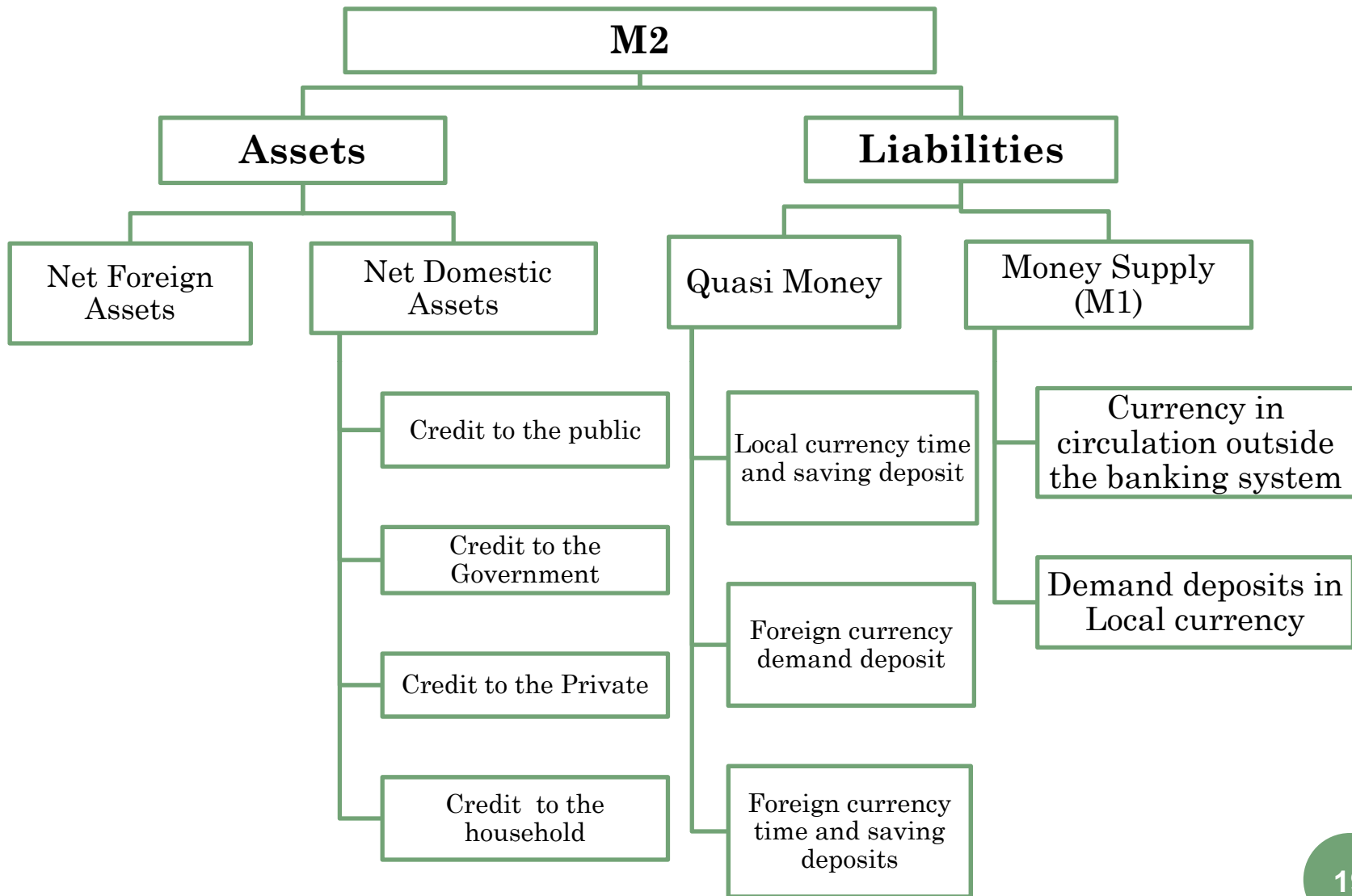


As evidence of recovery was in place, a neutral stance was in effect to strike a balance between stemming inflationary pressures and supporting growth recovery



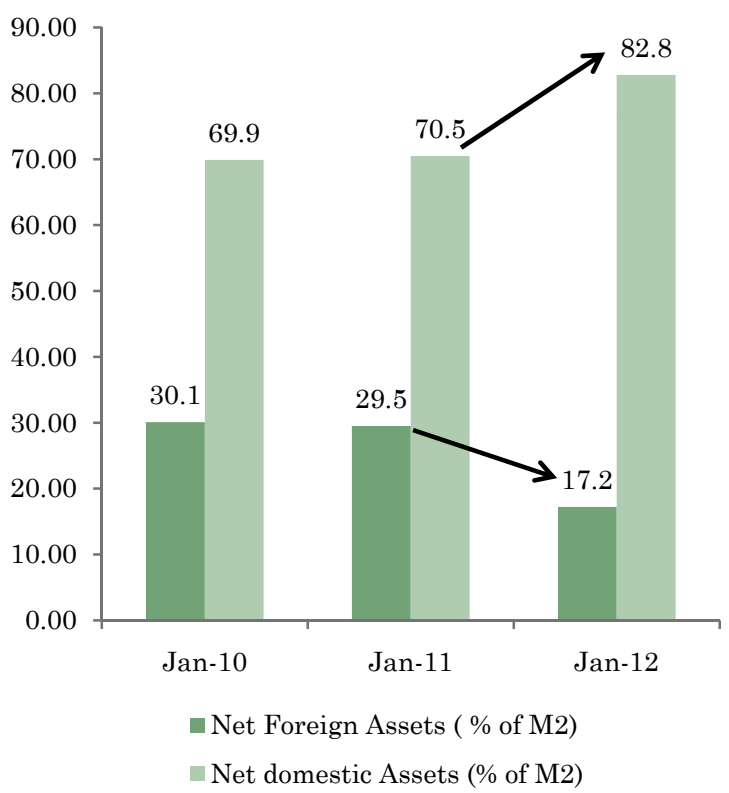
Data Sources: Central Bank of Egypt & Ministry of Finance

B. MONETARY SURVEY & LIQUIDITY

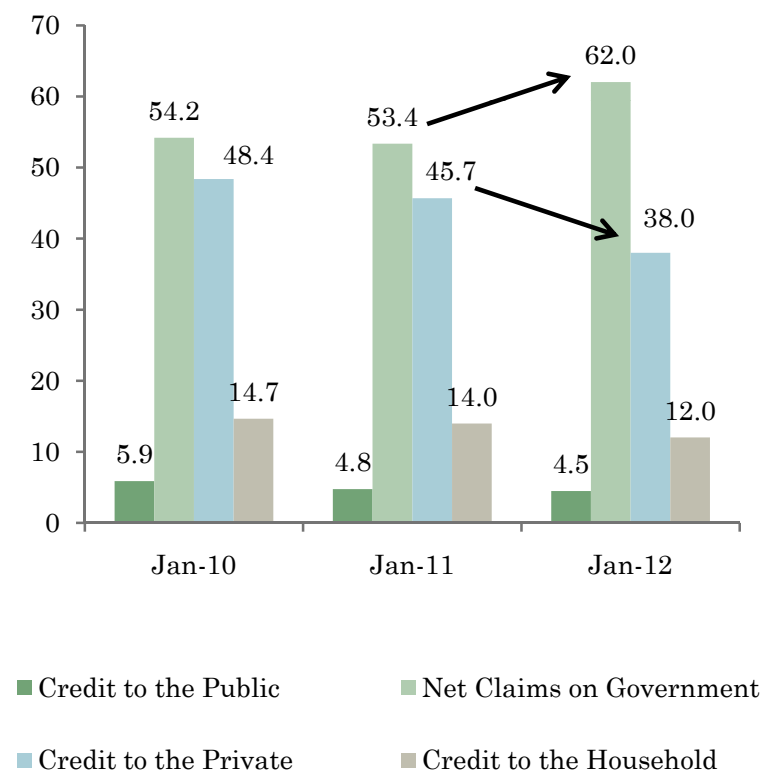


Following the revolution, there has been a significant reduction in net foreign assets at a time when the increase in net domestic assets reflected sharp rise in net claims on government, coupled with a slowdown in credit to the private sector

Assets (% M2)

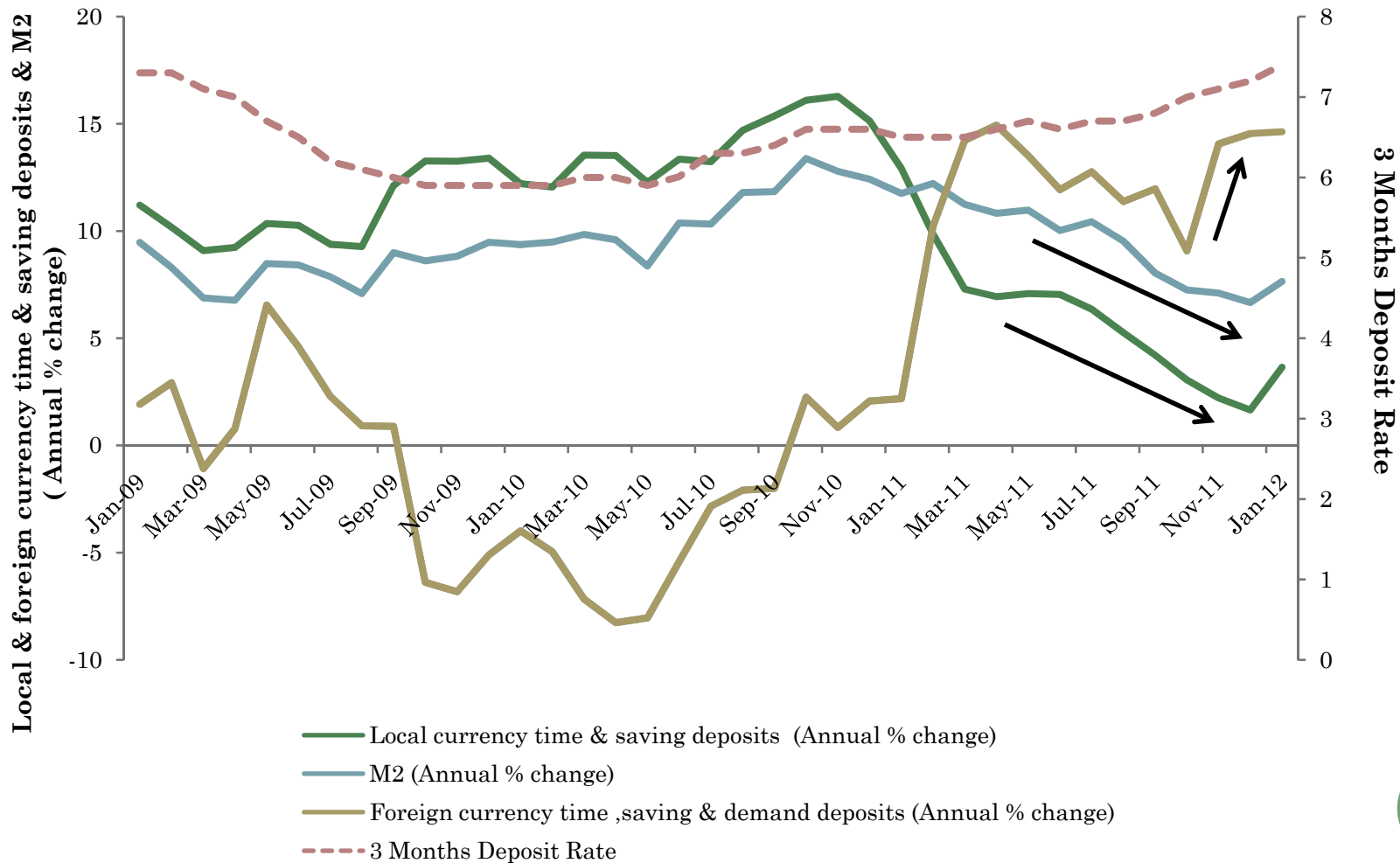


Domestic Credit (% of total domestic assets)



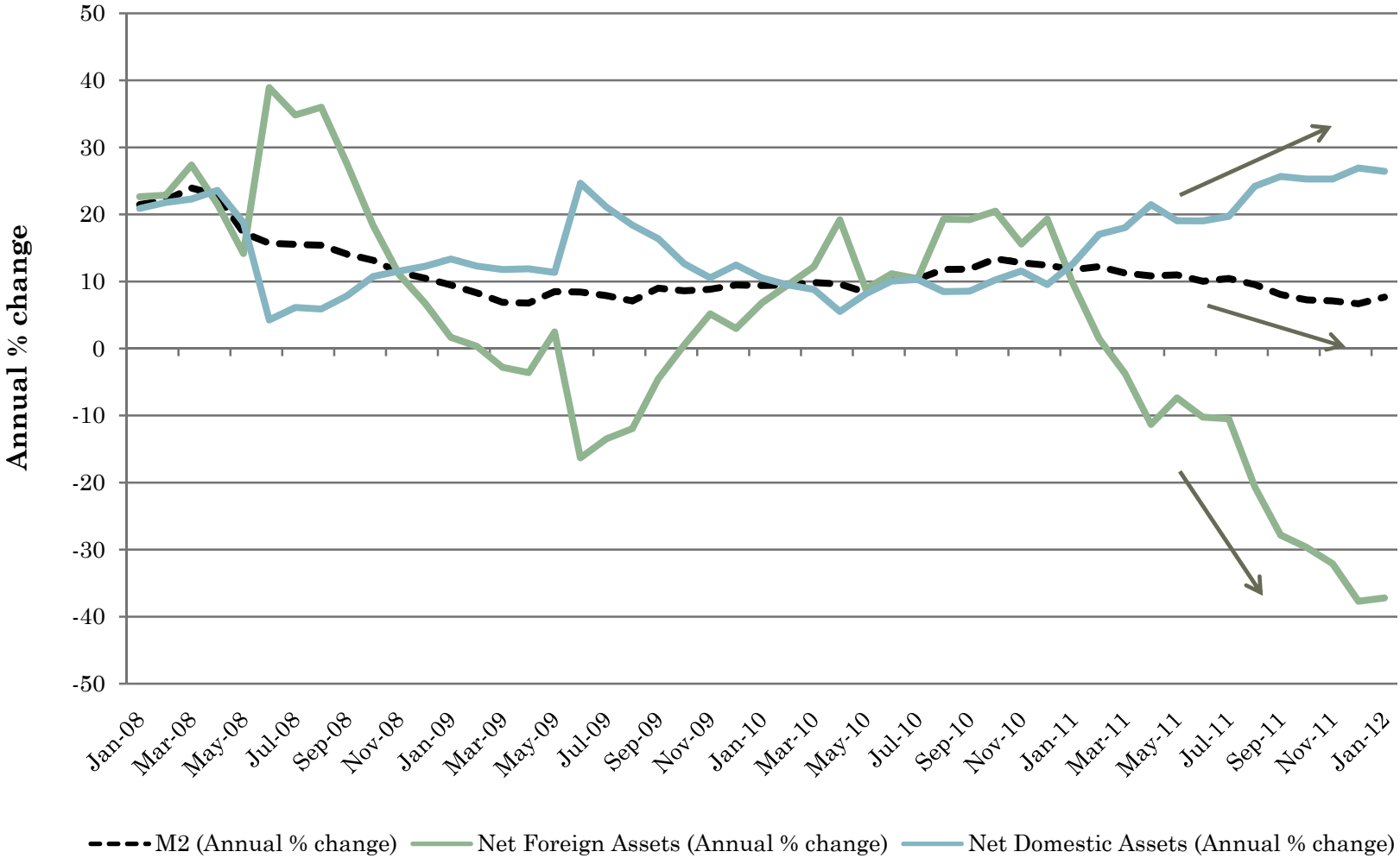
Data Sources: Central Bank of Egypt

More recently, liquidity shrank in the banking system despite higher interest rate on deposits, reflecting significant decline in local currency deposits, and a clear evidence of increase in foreign deposits



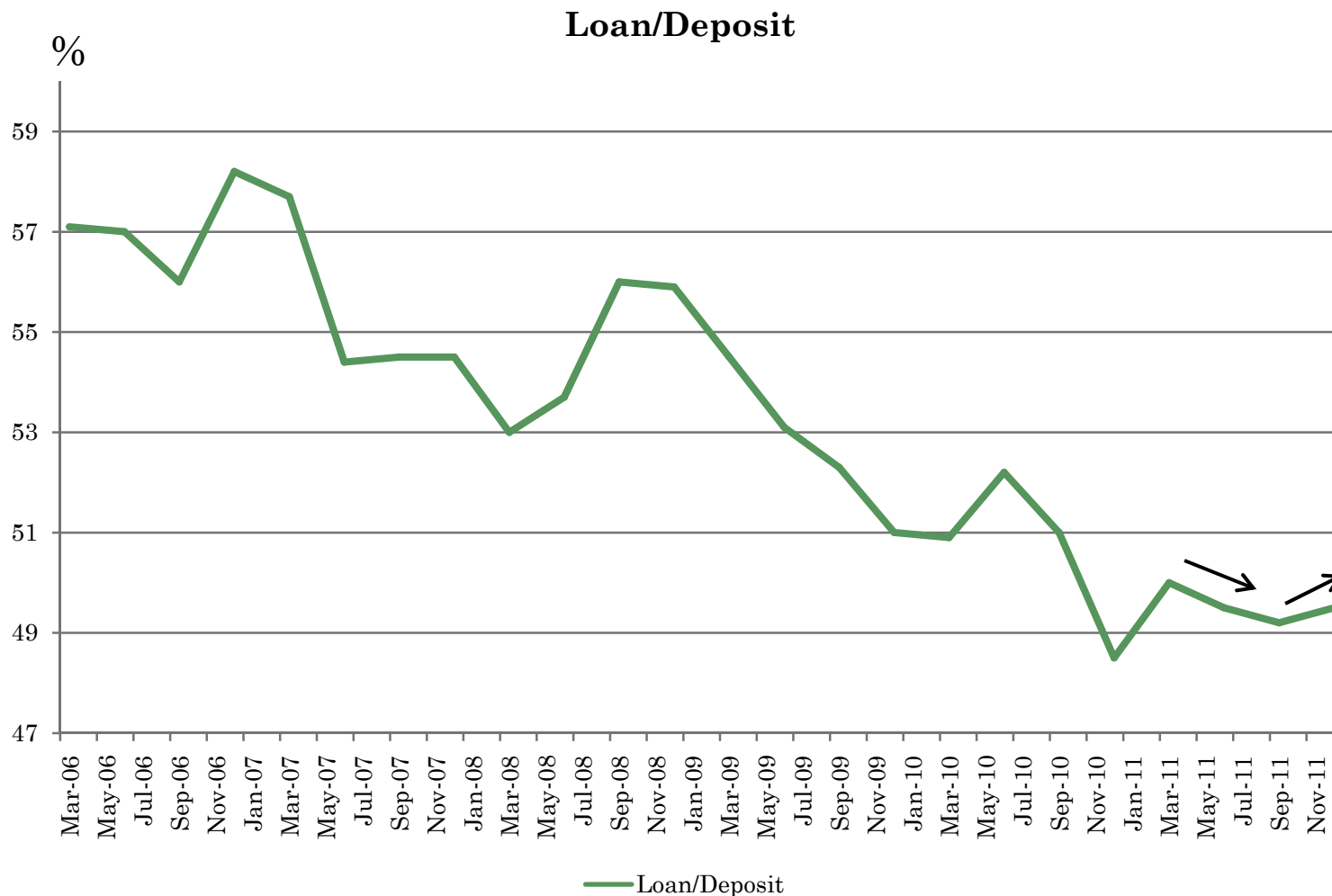
Data Sources: Central Bank of Egypt

The major force behind liquidity shortfall and dollarization is significant decline in net foreign assets, at a time when government borrowing has significantly increased



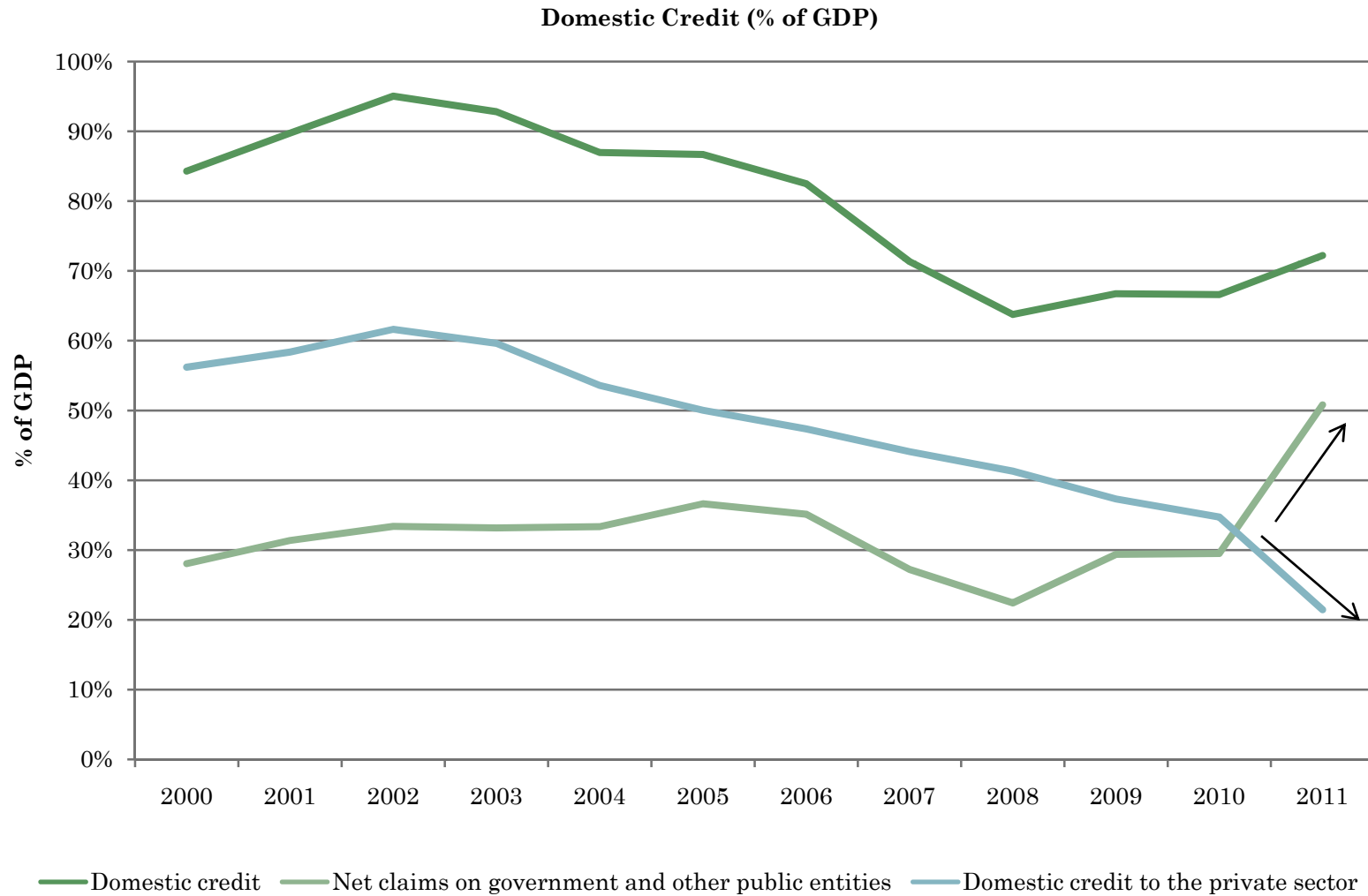
Data Sources: Central Bank of Egypt

Moreover, financial intermediation has weakened successively overtime, reflecting continuous reduction in the loan to deposit ratio and ineffective banking intermediation



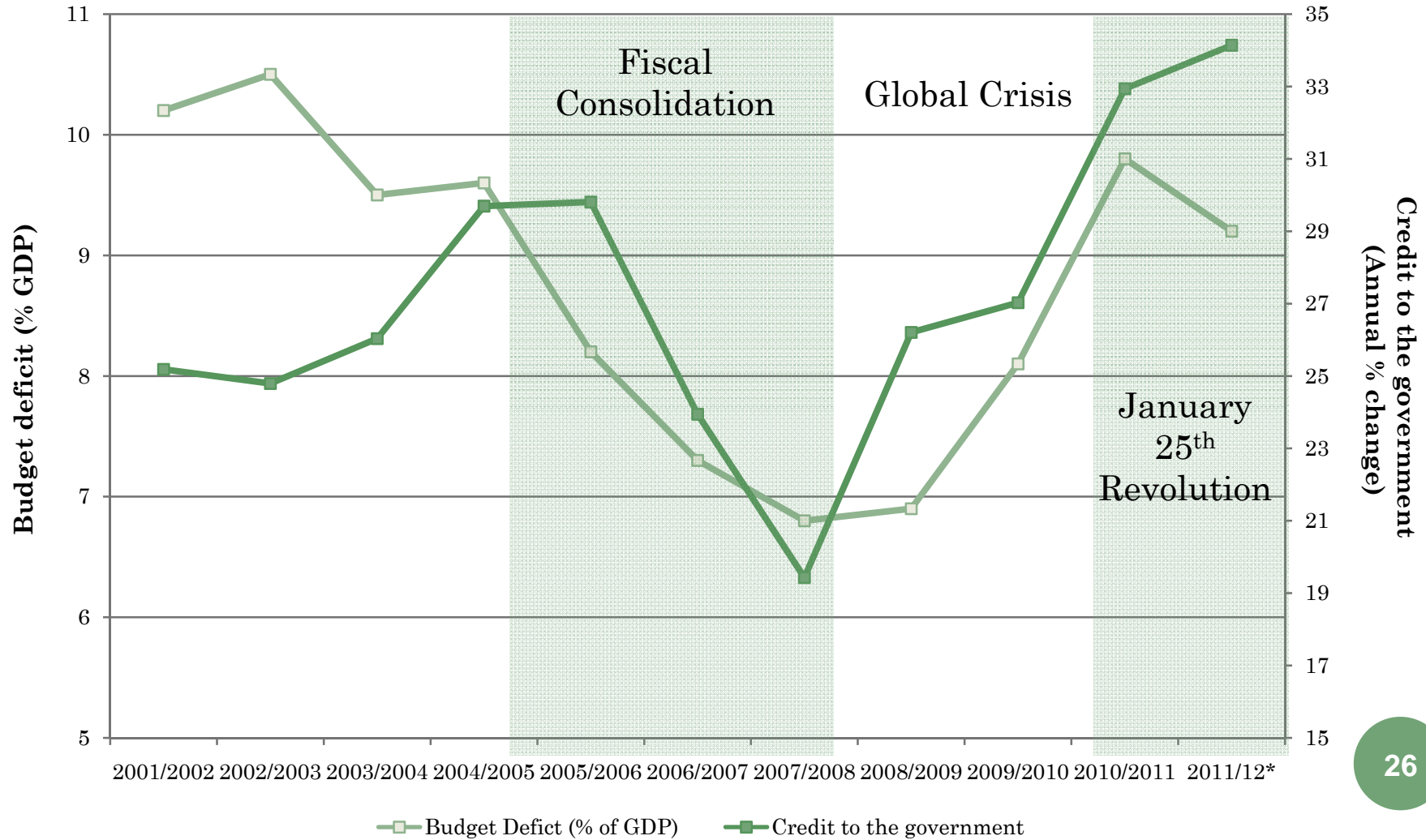
Data Sources: Central Bank of Egypt

In parallel, credit expansion has surged, reflecting primarily higher credit to the government, that crowded out private credit growth



4. IMPACT OF FISCAL DOMINANCE ON MONETARY POLICY

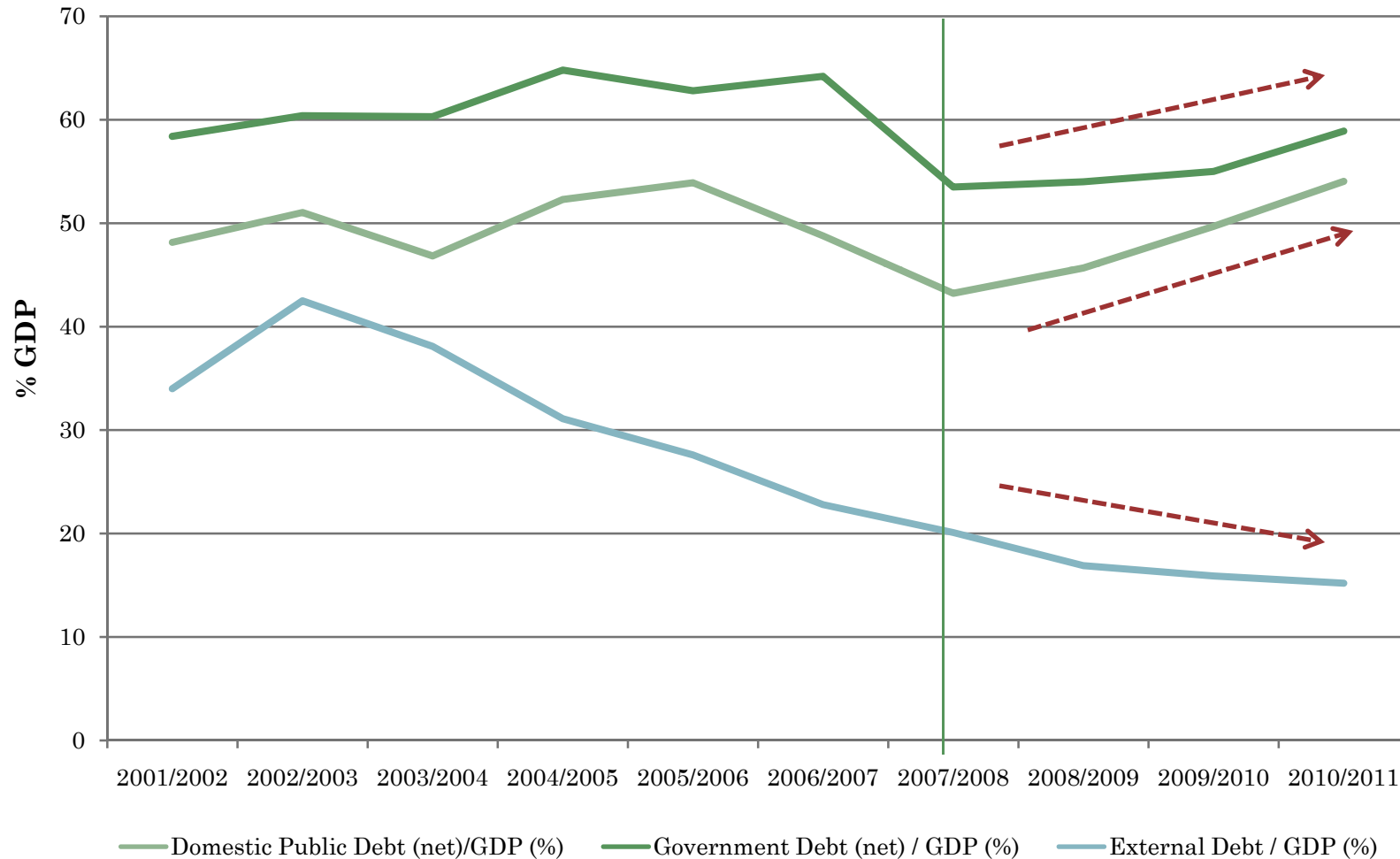
The government depended overtime on domestic borrowing in financing growing budget deficit, crowding out available resources that could have been utilized to finance private activity



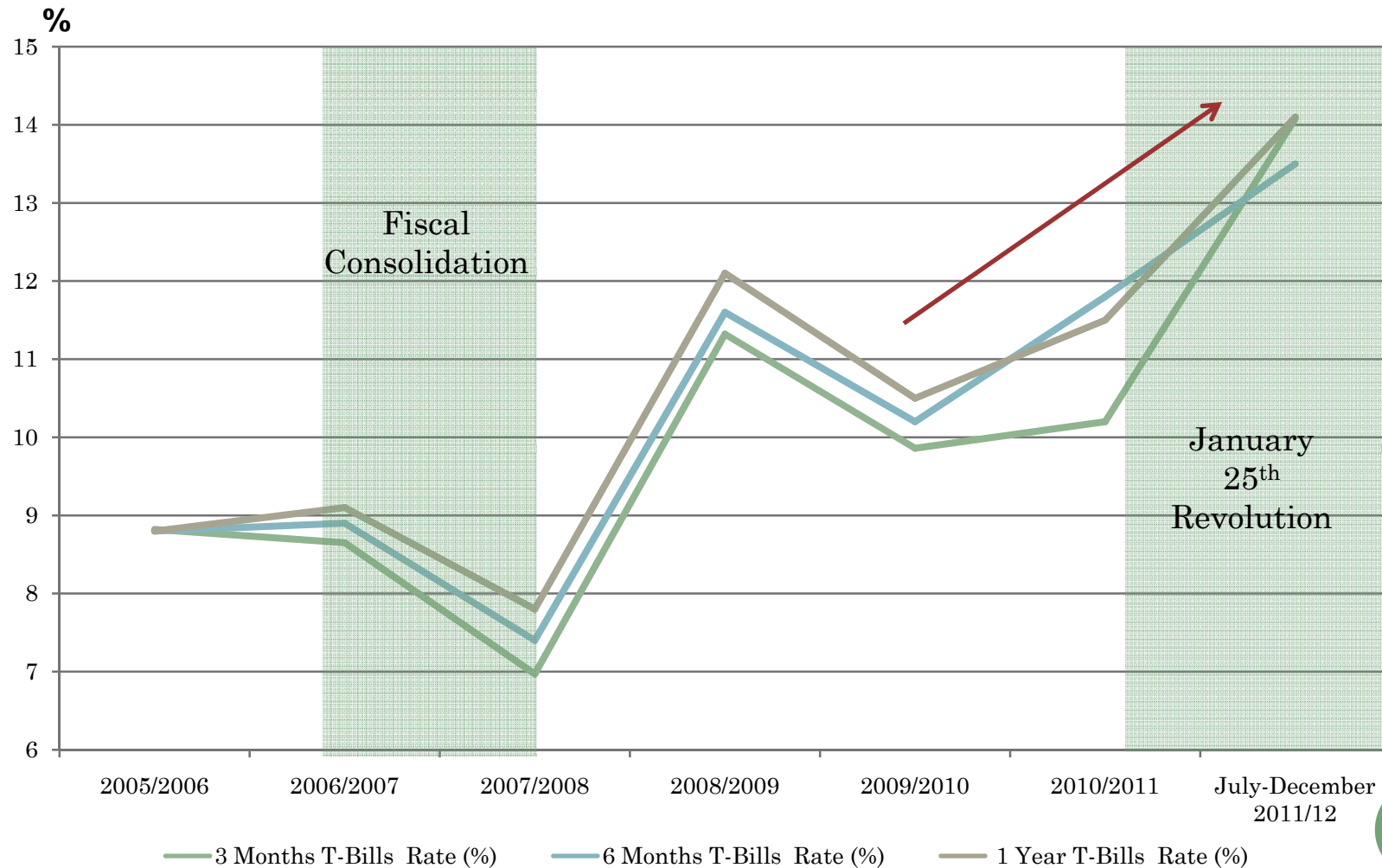
Data Sources: Ministry of Finance

* Forecasted budget deficit & latest figure for credit to the government (July –January 2011/12)

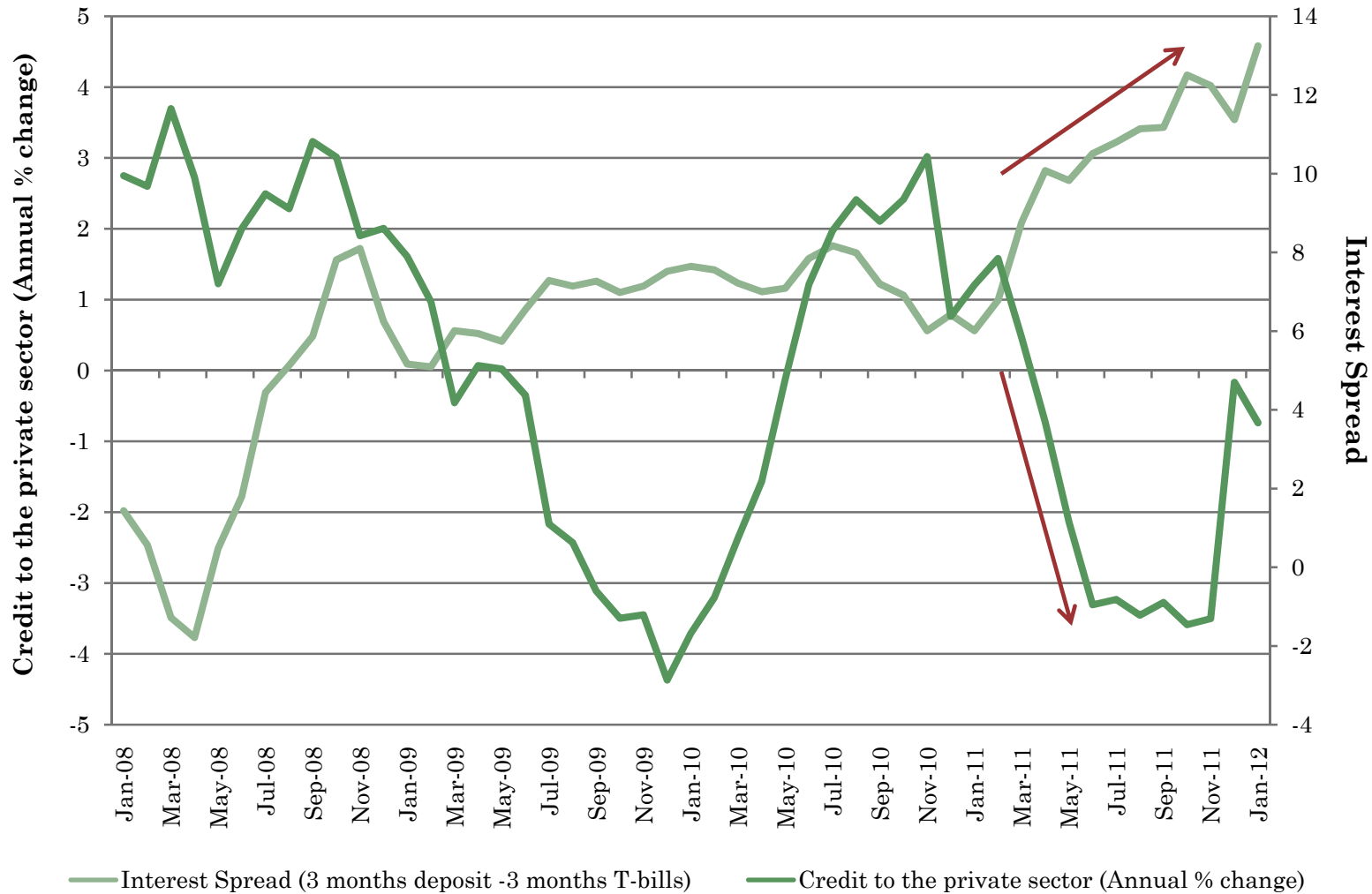
In parallel, the ratio of public domestic debt to GDP has increased overtime with successive increase in the fiscal deficit since FY 2007/08



Along with increasing credit to the government and the decline in liquidity in the banking system, the interest rates on government's borrowing have continued to surge recently



Banks have preferred sovereign lending, reflecting higher interest rate spread at the expense of crowding out available credit to the private sector



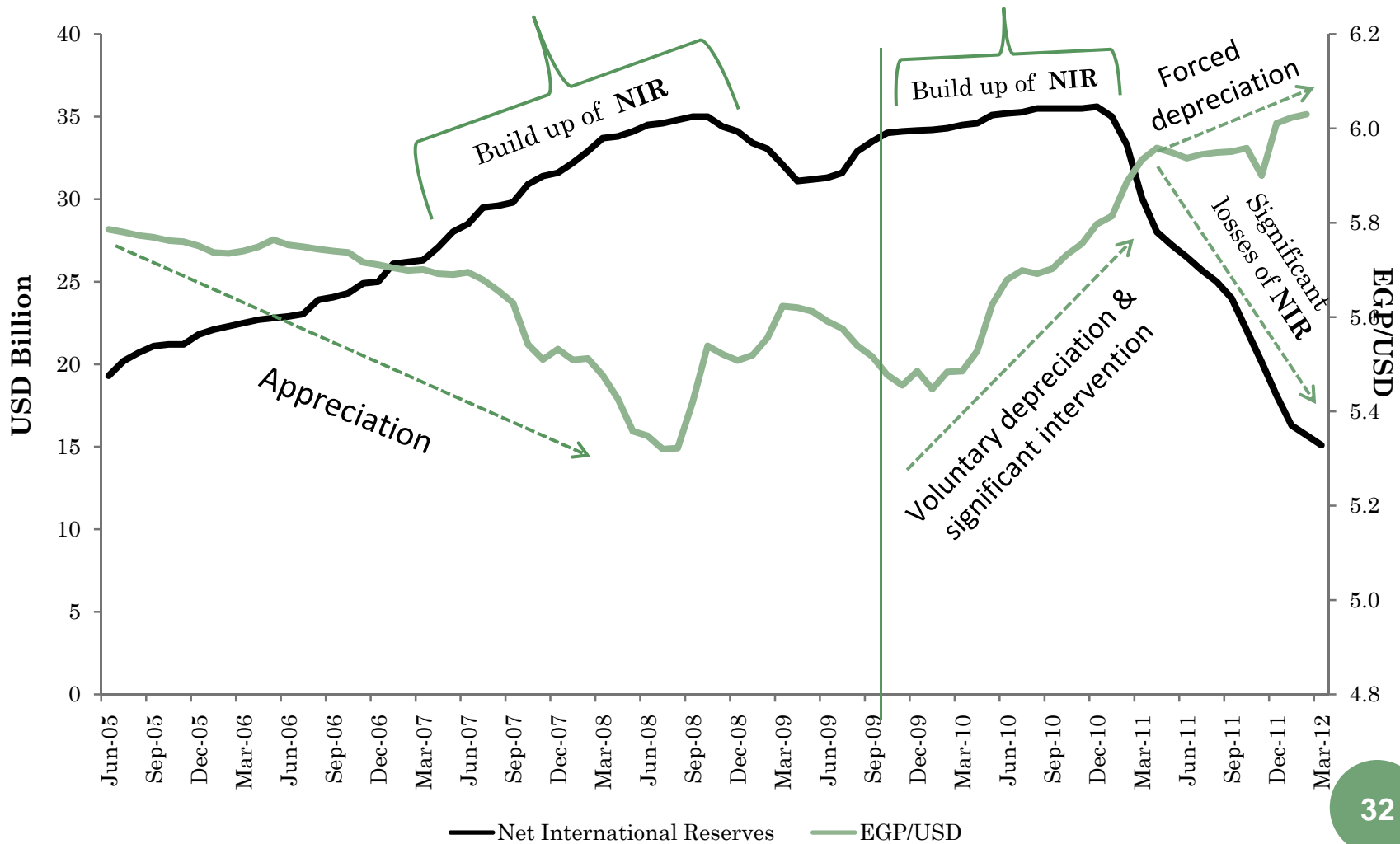
Data Sources: Central Bank of Egypt & ECES calculations

5. IMPACT OF MONETARY POLICY ON THE MACRO-ECONOMY

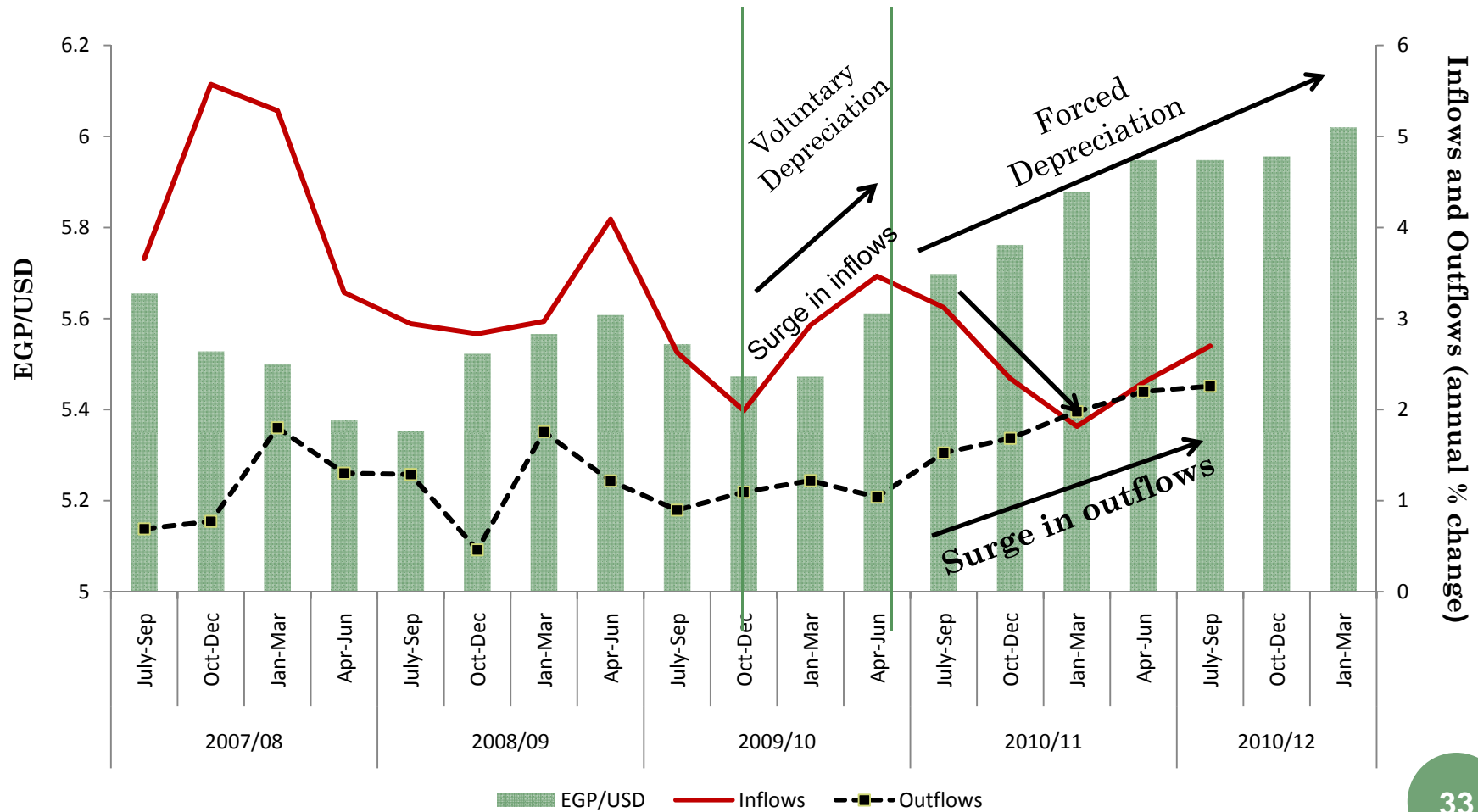
- A. External Stability
- B. Price Inflation
- C. Economic Growth

A. EXTERNAL STABILITY

Significant intervention was pursued to stem appreciation before the revolution, resulting in a build up of international reserves. However, the central bank has lost significant reserves to stem depreciation pressures post the revolution



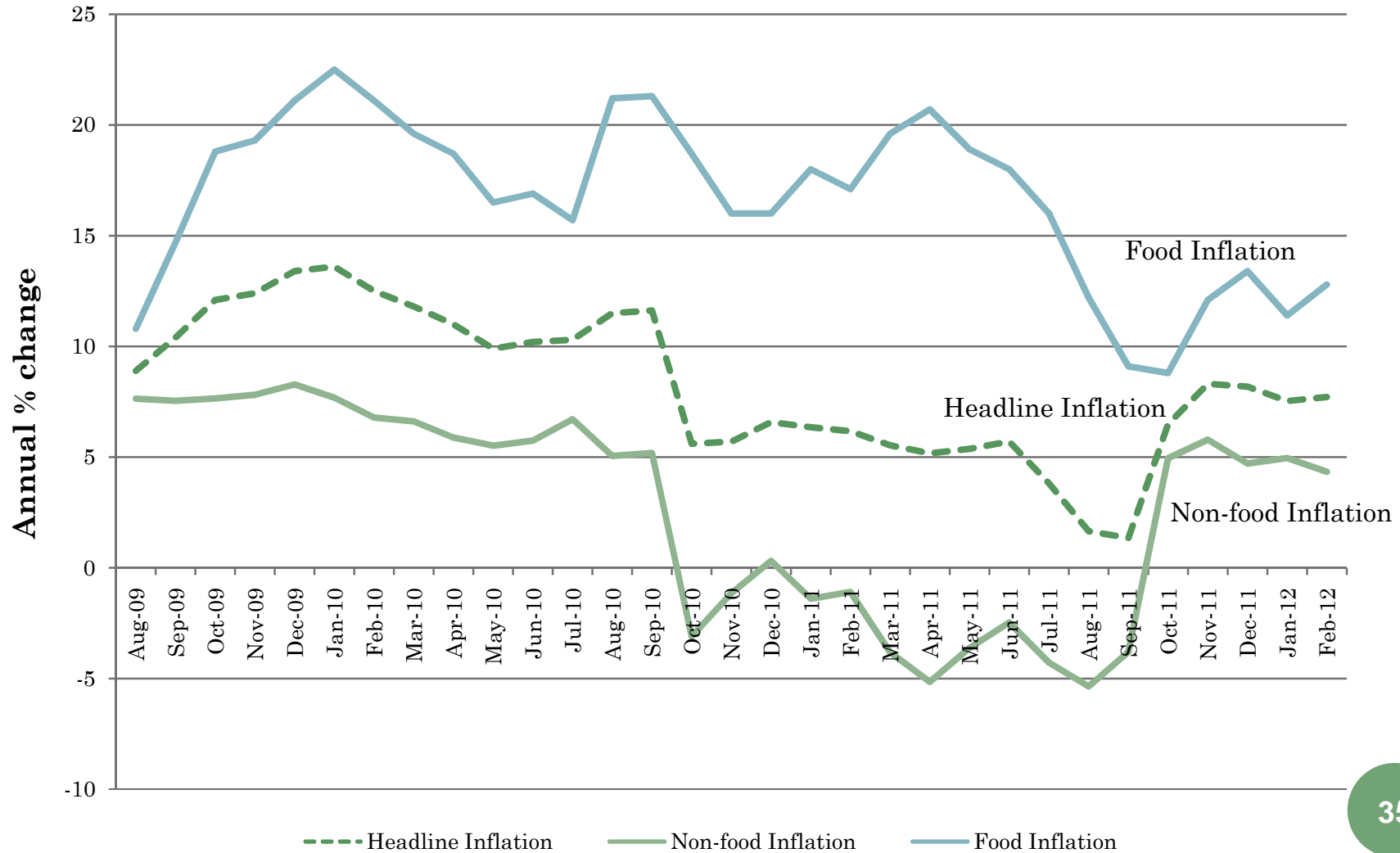
The main pressures on the exchange rate post the revolution are significant increase in financial outflows, along with significant slowdown in inflows.



B. PRICE INFLATION

- ❑ International Price Shocks
- ❑ Domestic Credit
- ❑ Exchange Rate

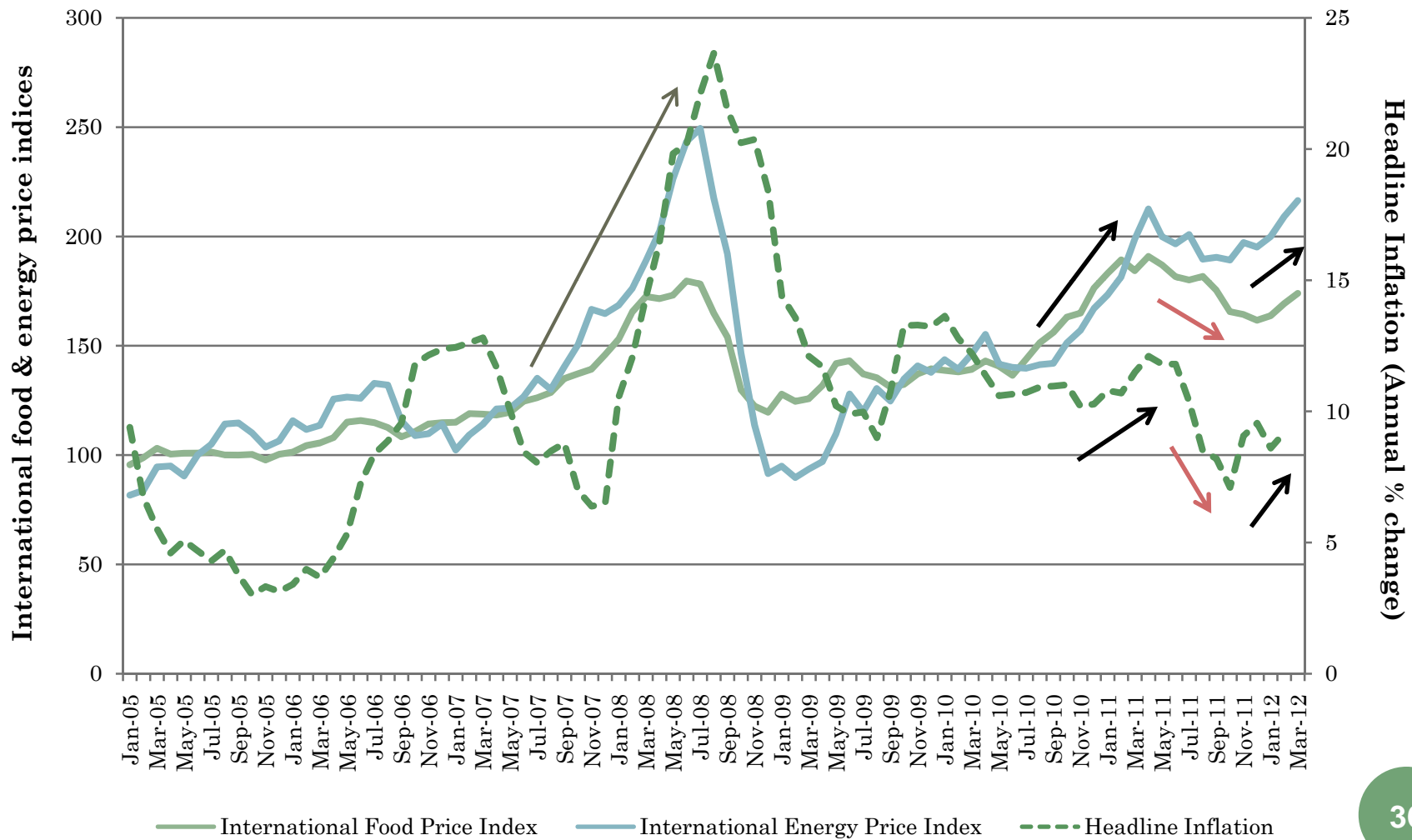
Headline Inflation has exhibited extensive cyclicality, mostly driven by food price inflation



*Food weight = 39.9% (of headline index)
 Non-food weight = 60.8% (of headline index)

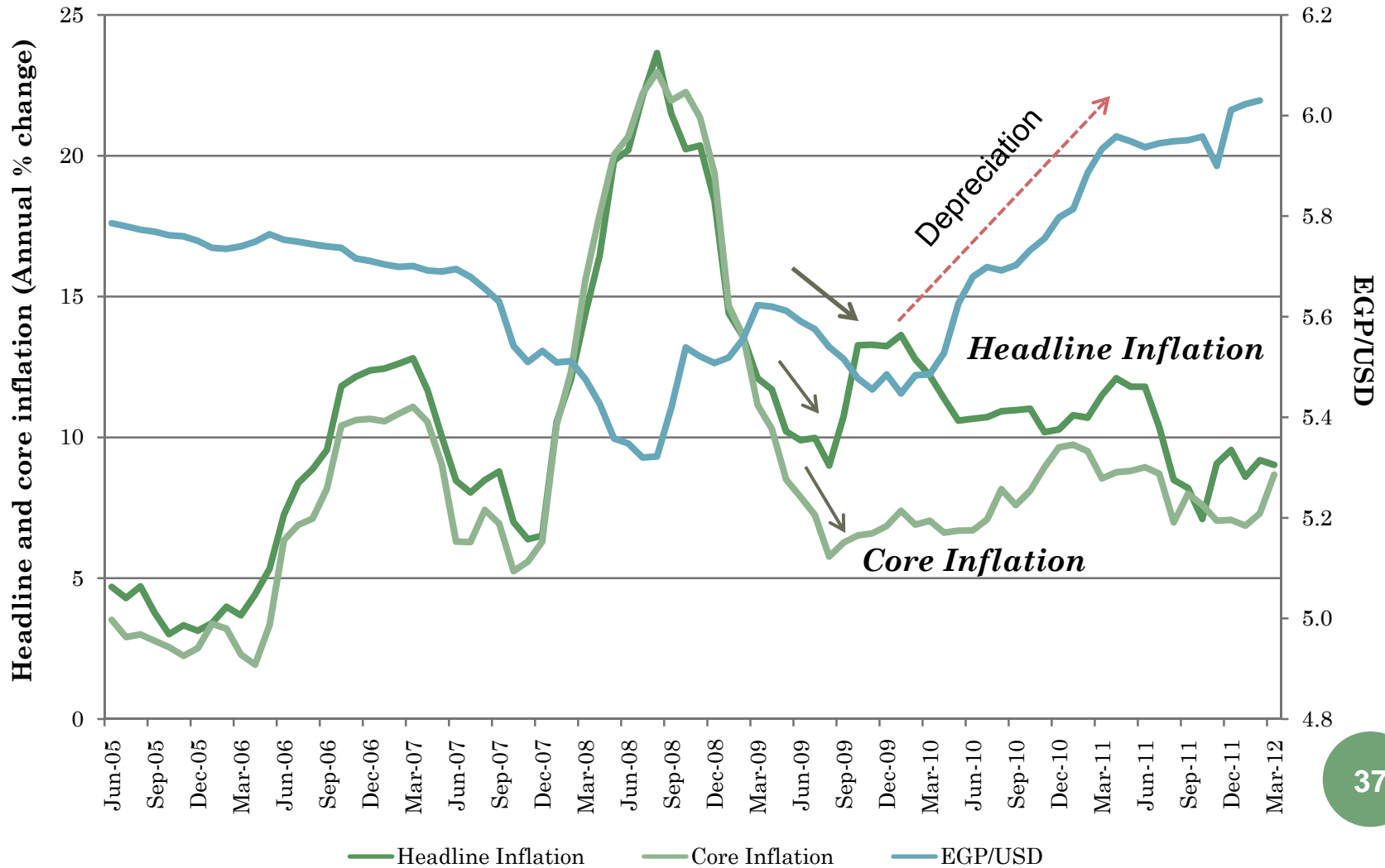
Data Sources: CAPMAS & ECES calculations

Further complicating the effort of the central bank to target inflation, headline inflationary pressures mimic fluctuations in international food and energy prices, notwithstanding excessive fuel subsidies in Egypt



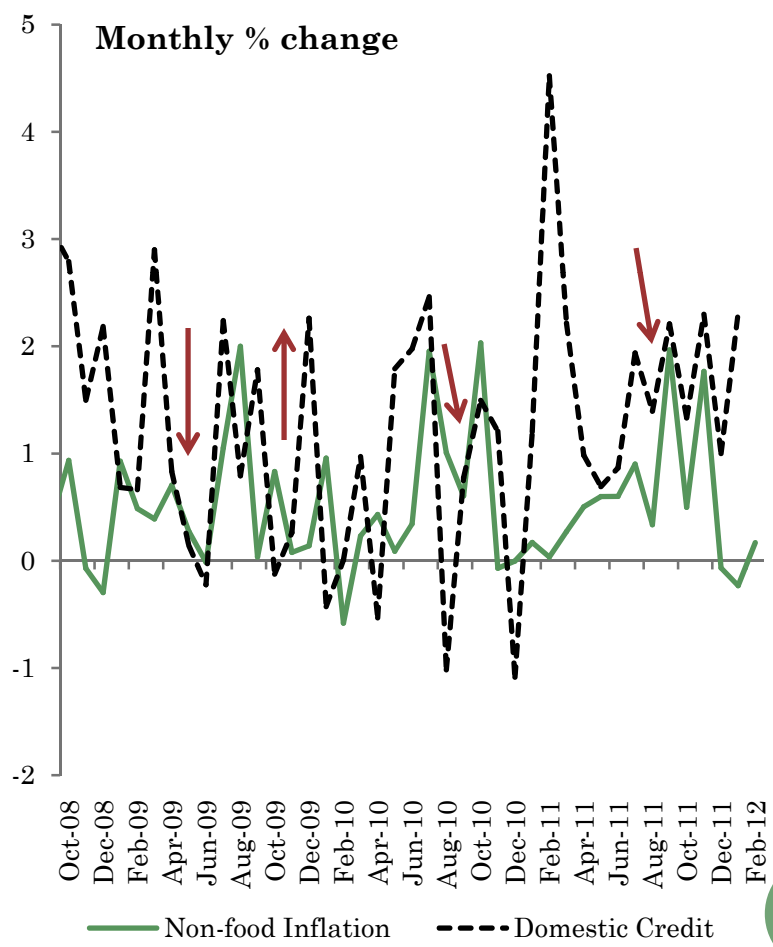
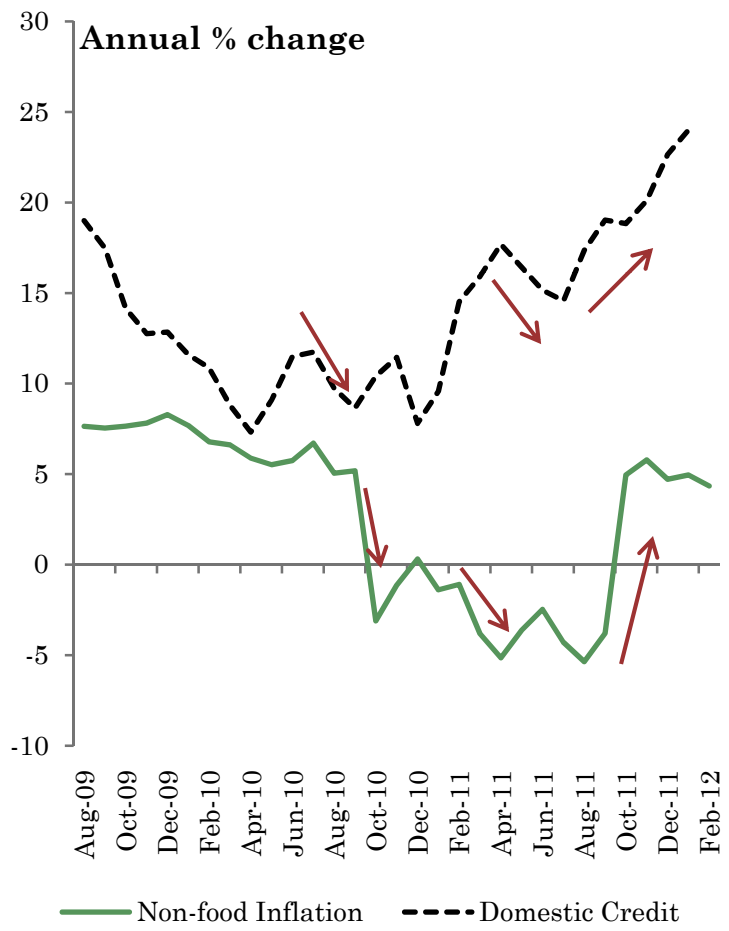
Data Sources: Central Bank of Egypt and International Monetary Fund

Depreciation of the pound created further increased inflationary pressures, reflecting high exchange rate pass-through



* Core index excludes fruits , vegetables and regulated items

Moreover, instability in domestic credit growth has resulted in successive fluctuations in non-food price inflation, providing same scope for inflation targeting by the central bank



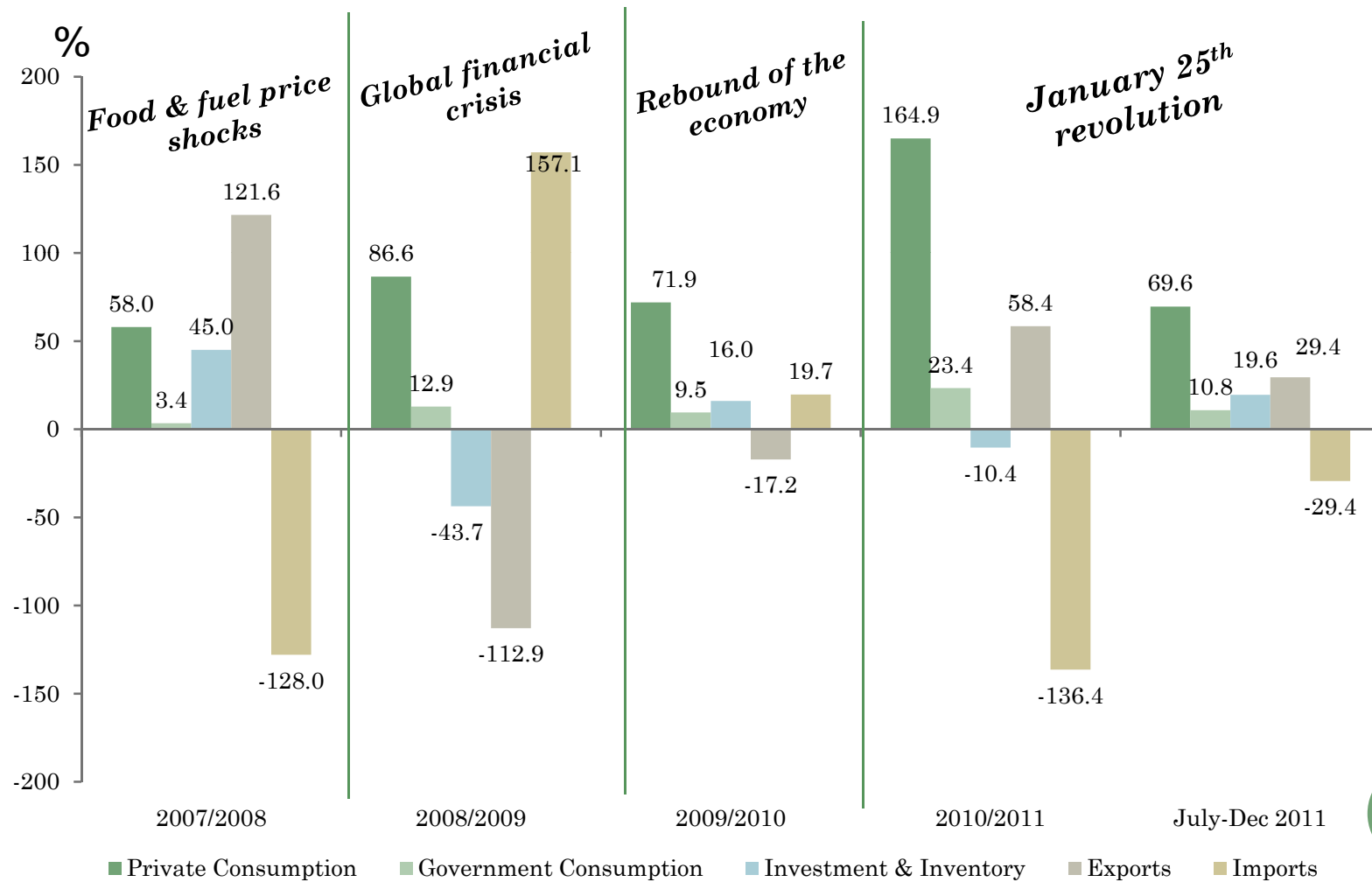
Data Sources: CAPMAS & ECES calculations

C. ECONOMIC GROWTH

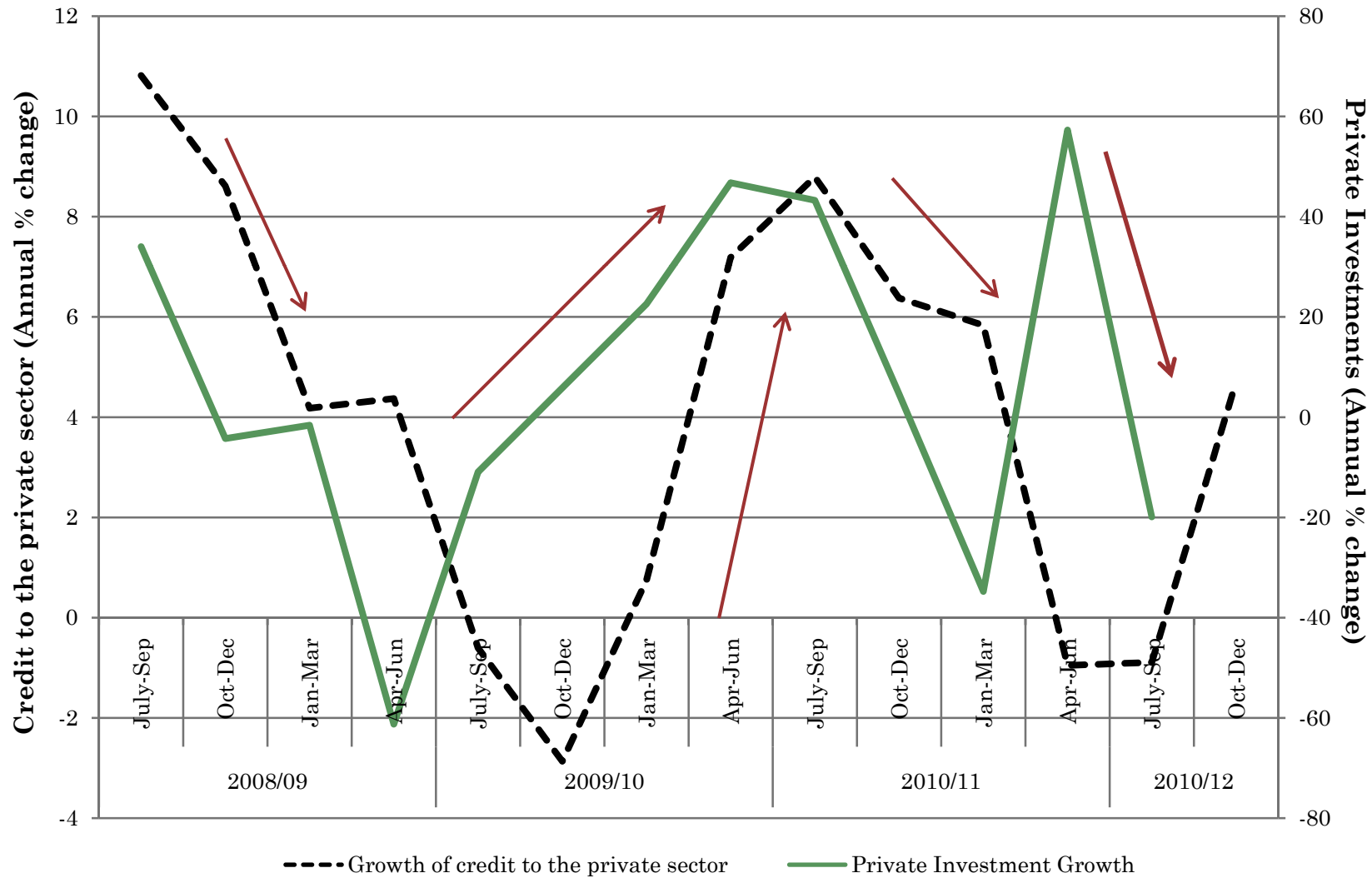
- ❑ Monetary policy and private consumption growth
 - Depreciation
 - Private credit growth
- ❑ Monetary policy and government spending
 - Credit to the government
 - Public consumption
 - Public Investments
- ❑ Depreciation and export growth
- ❑ Depreciation and Import Growth

Growth is primarily dependent on private consumption, supported by exports and investments growth

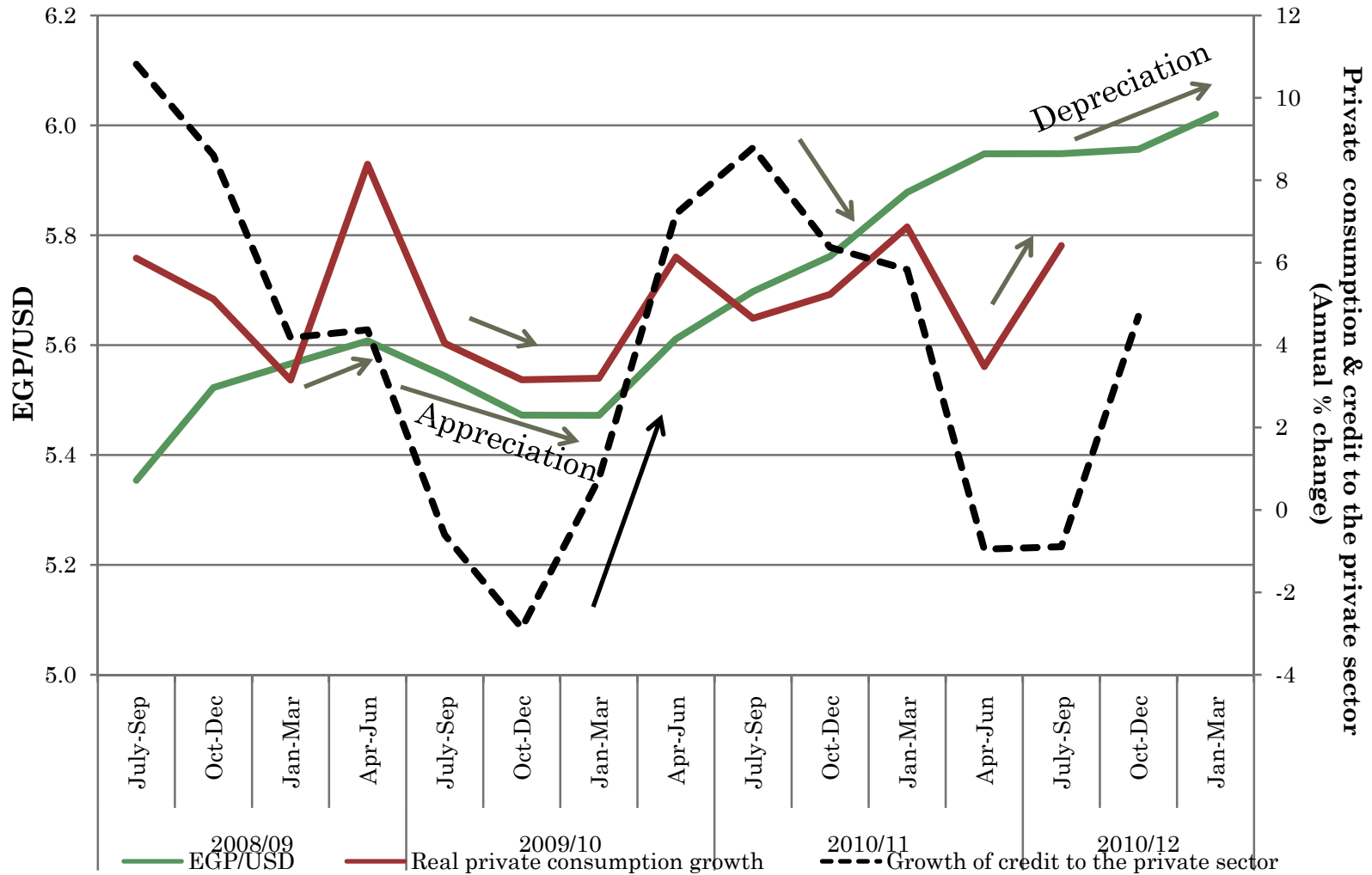
Contribution to real GDP growth



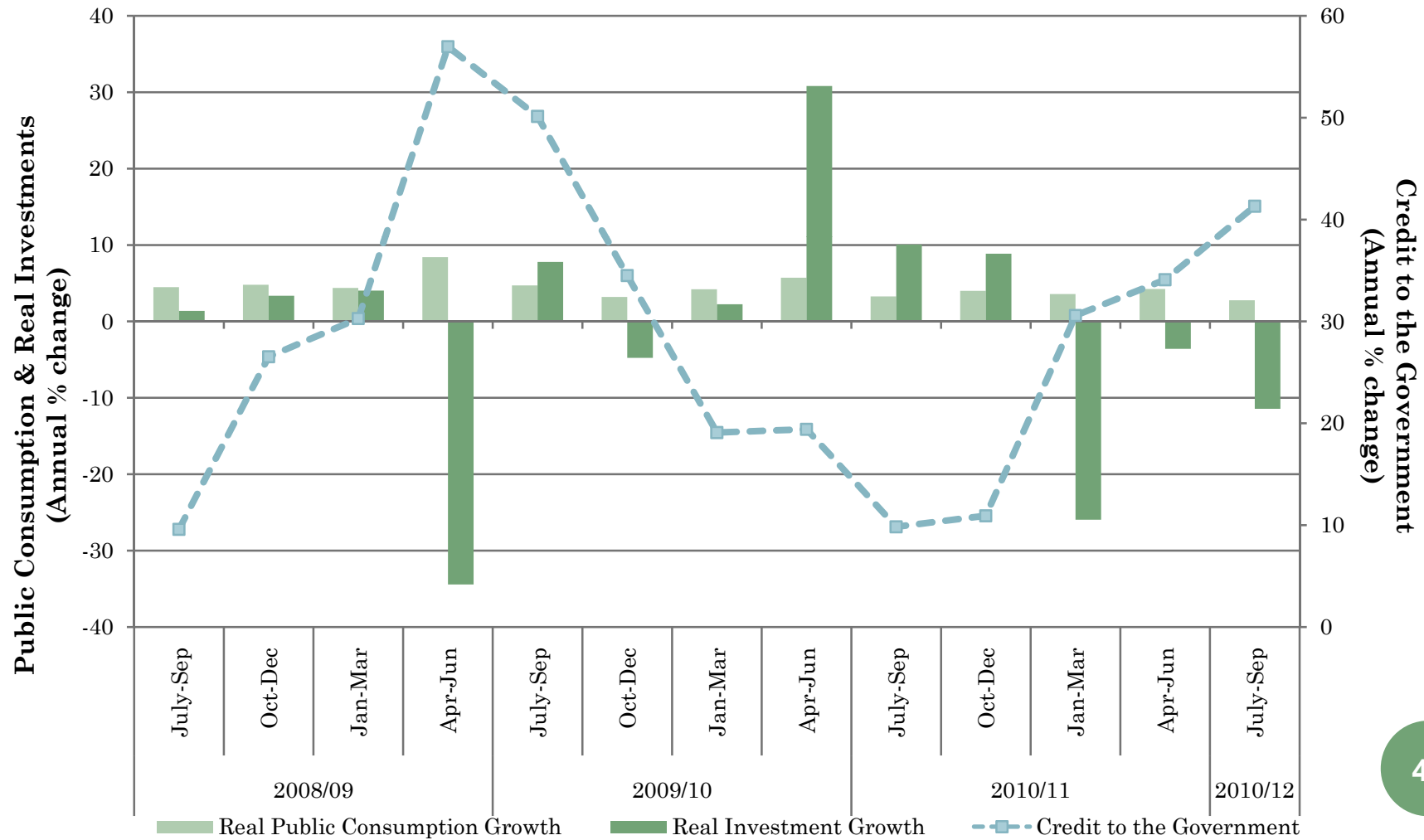
Overtime credit to the private sector has contributed to cyclicality in private investment growth



Private credit growth helps stimulate growth of private consumption, which appears resilient to episodes of nominal depreciation

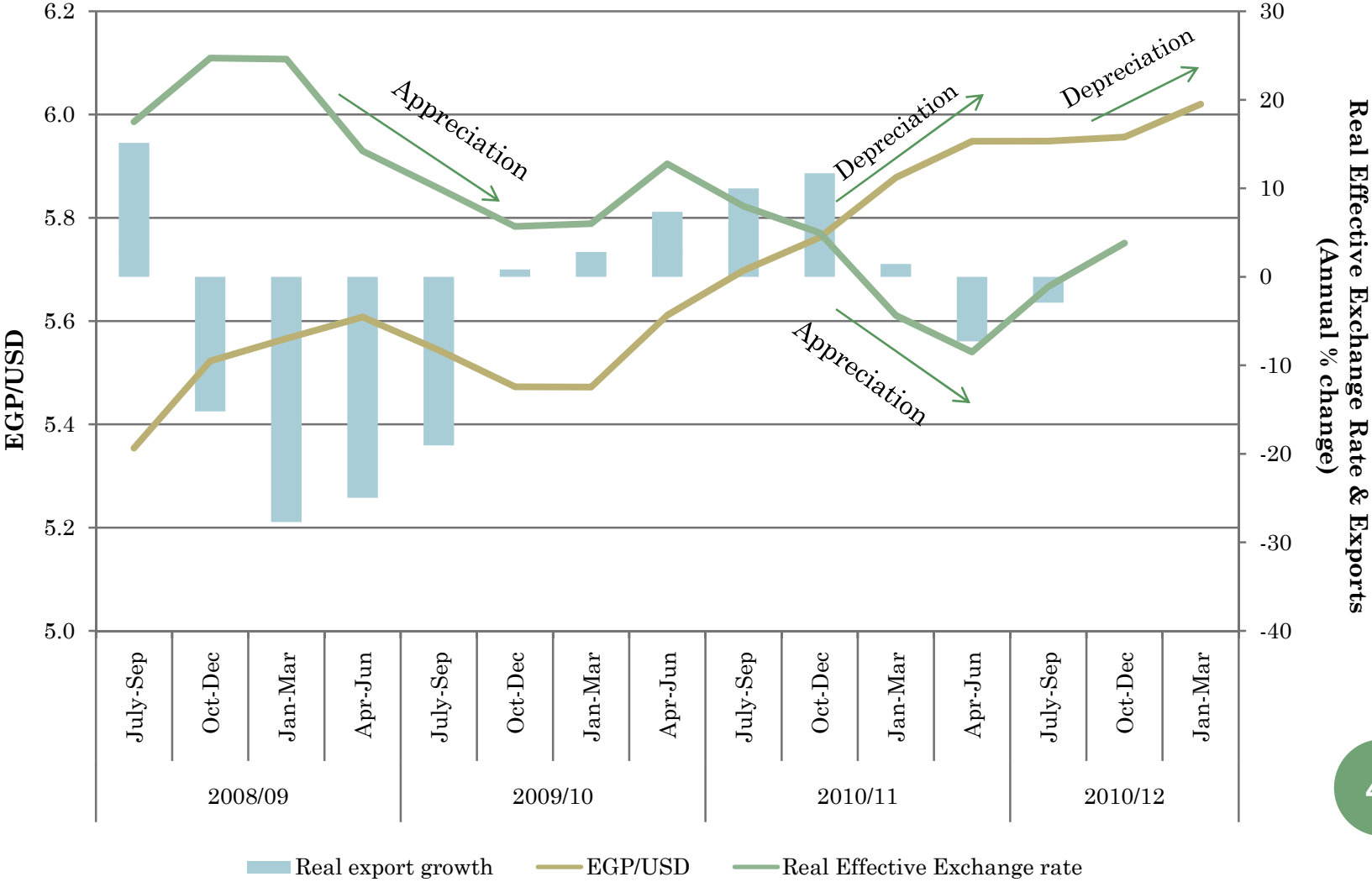


Credit to the public sector has helped primarily finance growth of public consumption, while public investment has been shrinking recently



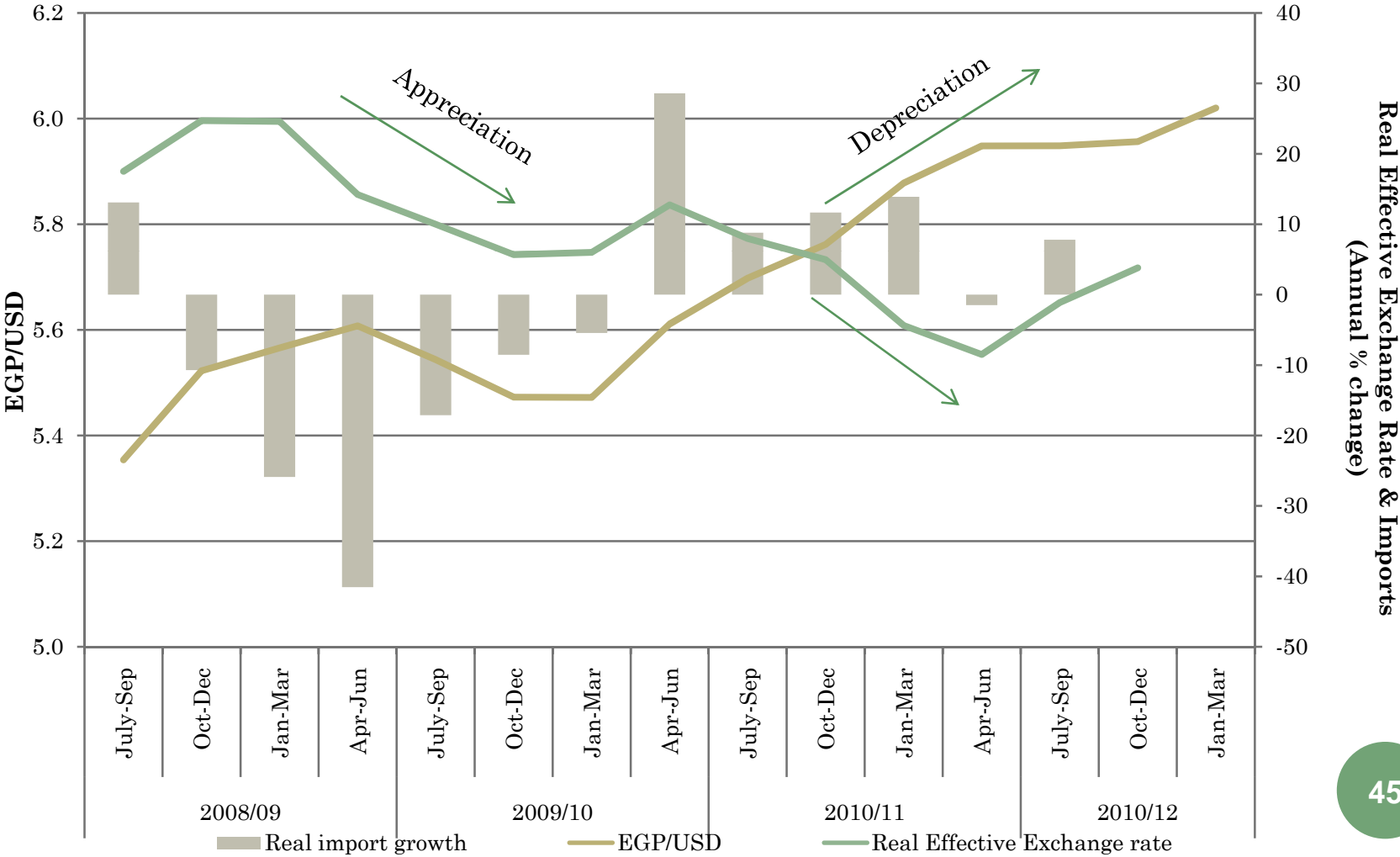
Data Sources: Ministry of Planning & CBE

Nominal depreciation helps boost export competitiveness, although real appreciation limits the scope to mobilize exports



Data Sources: Ministry of Planning & Bruegel

Imports are inelastic to nominal depreciation, boosted by real exchange appreciation



Data Sources: Ministry of Planning & Bruegel

6. POLICY RECOMMENDATION

- International price shocks, external shocks and significant exchange rate pass-through have undermined success to fight inflation
- Priorities of monetary policy should be focused on inflation targeting to increase competitiveness and contain inflationary expectations.
- Management of the exchange rate policy in line with the underlying fundamentals is necessary to sustain economic growth, contain the inflationary cost of imports and mitigate the risk of supply-side shocks on the economy towards striking the balance between export promotion and containing inflationary expectations.

POLICY RECOMMENDATION (CONTINUED)

- To enhance efforts to fight inflation, regulations should aim at eliminating distortions in distribution and enforcing surveillance.
- To enhance efforts to promote growth and efficient intermediation, priorities should be established to avail credit to the private sector, particularly to SME, and offer tax incentives for business firms that are tied to the employment agenda.
- More importantly, fiscal consolidation is a must to provide a bigger scope for independent monetary policy, reduce the cost of domestic borrowing, and avail more credit in support of private sector activity.