

# Monetary Policy in Egypt




## Recent Challenges and Policy Implications

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# Overview

- Motivation.
- Monetary policy framework.
- Objectives of the presentation.
- Recent developments in ultimate and operational objectives.
- The challenge of persistent relative price shocks.
- Transmission mechanisms of recent relative price shocks.
- Other multiple shocks complicating the conduct of monetary policy.
- Policy implications.

# Motivation

- The Egyptian economy  more integration into global markets  higher business-cycle volatility.
- Increasing the need for a broader view of monetary policy objectives  with greater priority attached to *stabilizing output* around its potential, alongside the *control of inflation*.

# Motivation

- 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 play the *primary* role in *stabilization policy*, as it is much *more flexible* than fiscal policy, which suffers from different types of implementation constraints.

# Motivation

- Moreover, the challenge of relative price shocks 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.

# 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.

# 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.

# 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*.



# Communication Strategy

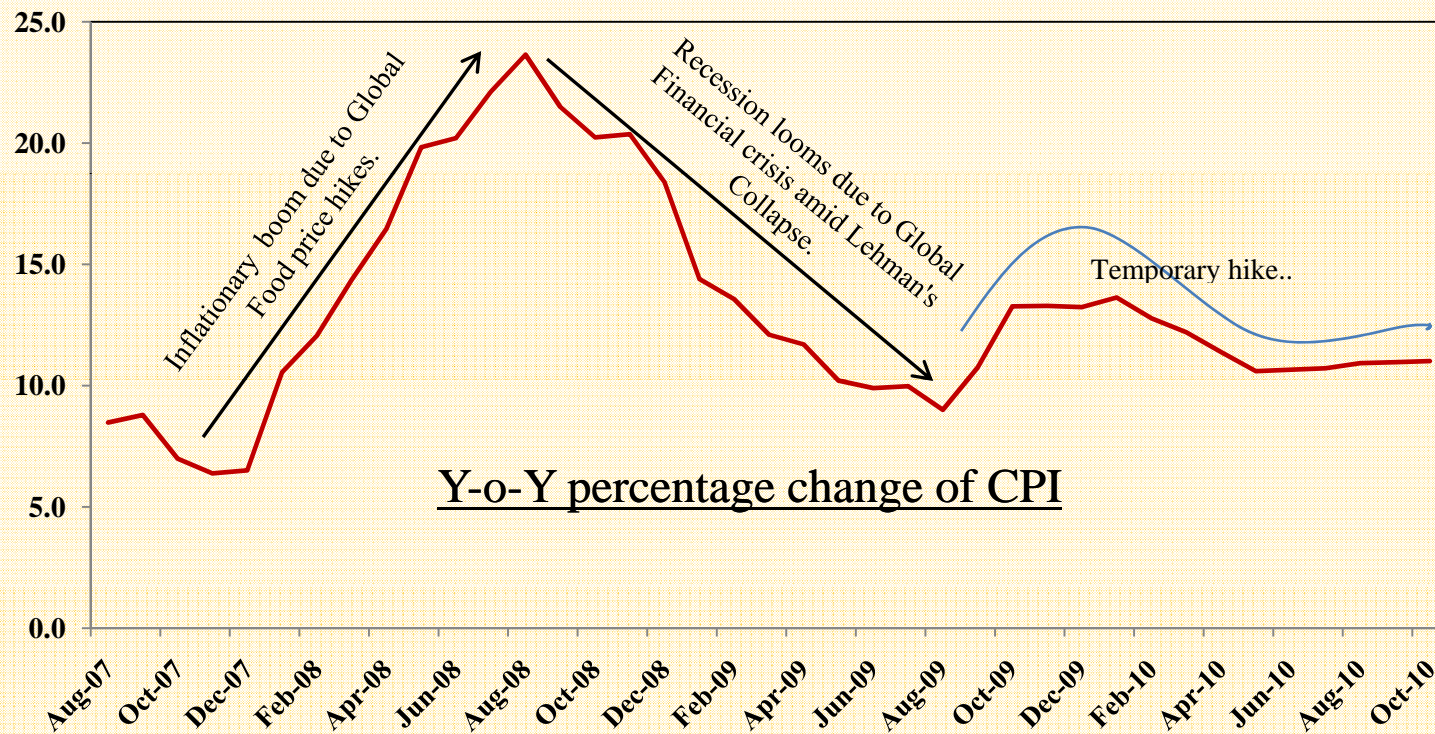
- Monetary policy decisions are taken by the CBE's Monetary Policy Committee (MPC). The MPC issues a communiqué immediately after its meetings.
- Inflation report is expected to be published at some point in time.
- In addition, an inflation and growth expectations report which conveys the firms' feedback might be released in the future.

# Objectives of the presentations

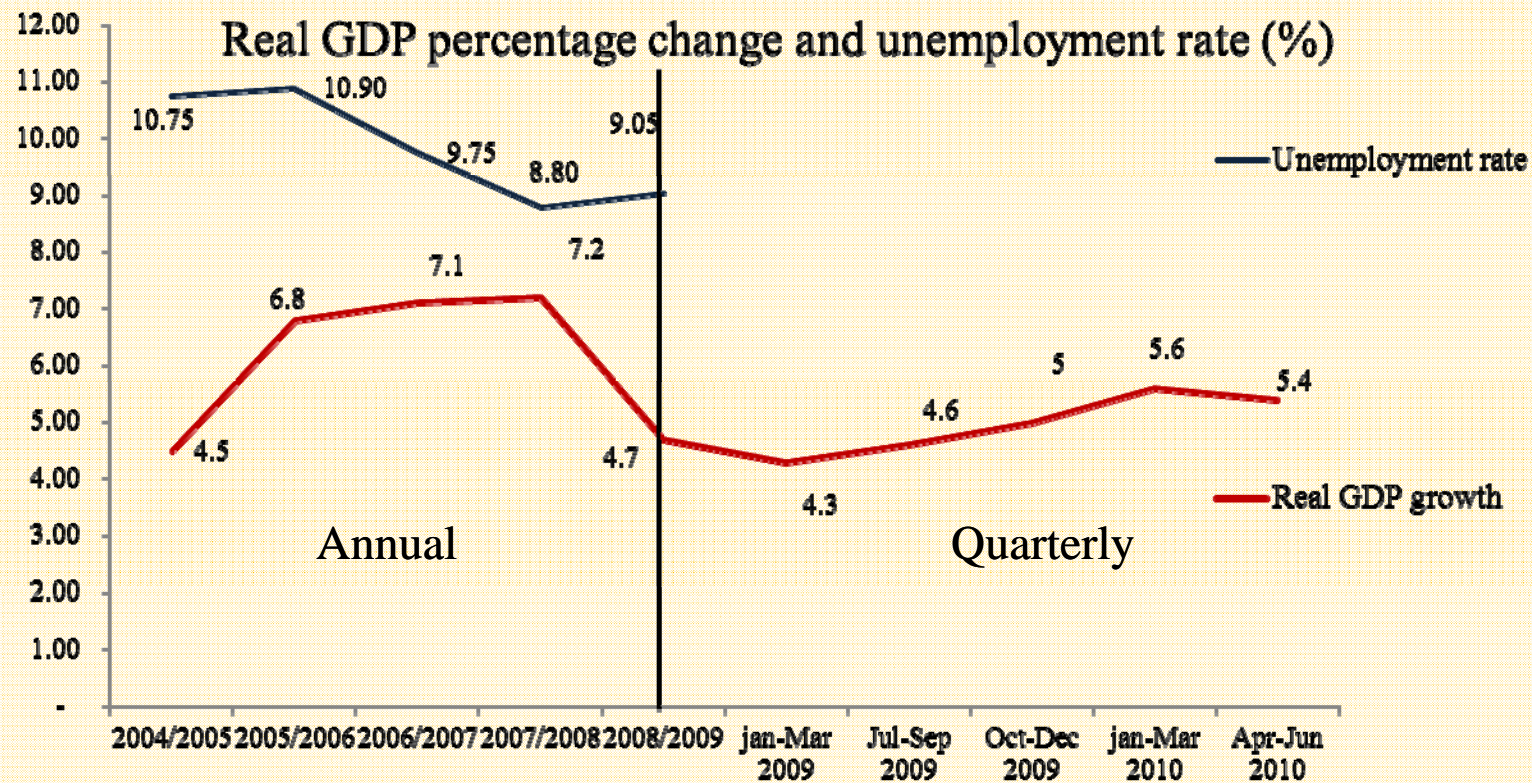
- To provide evidence of the persistent and potentially long lasting relative price shocks.
- Assess how such shock poses a challenge to the current monetary policy framework.
- Assess how other multiple shocks complicate the conduct of monetary policy.
- Assess the adequacy of conventional monetary policy instruments.

Recent developments in *Ultimate* &  
*Operational* Objectives

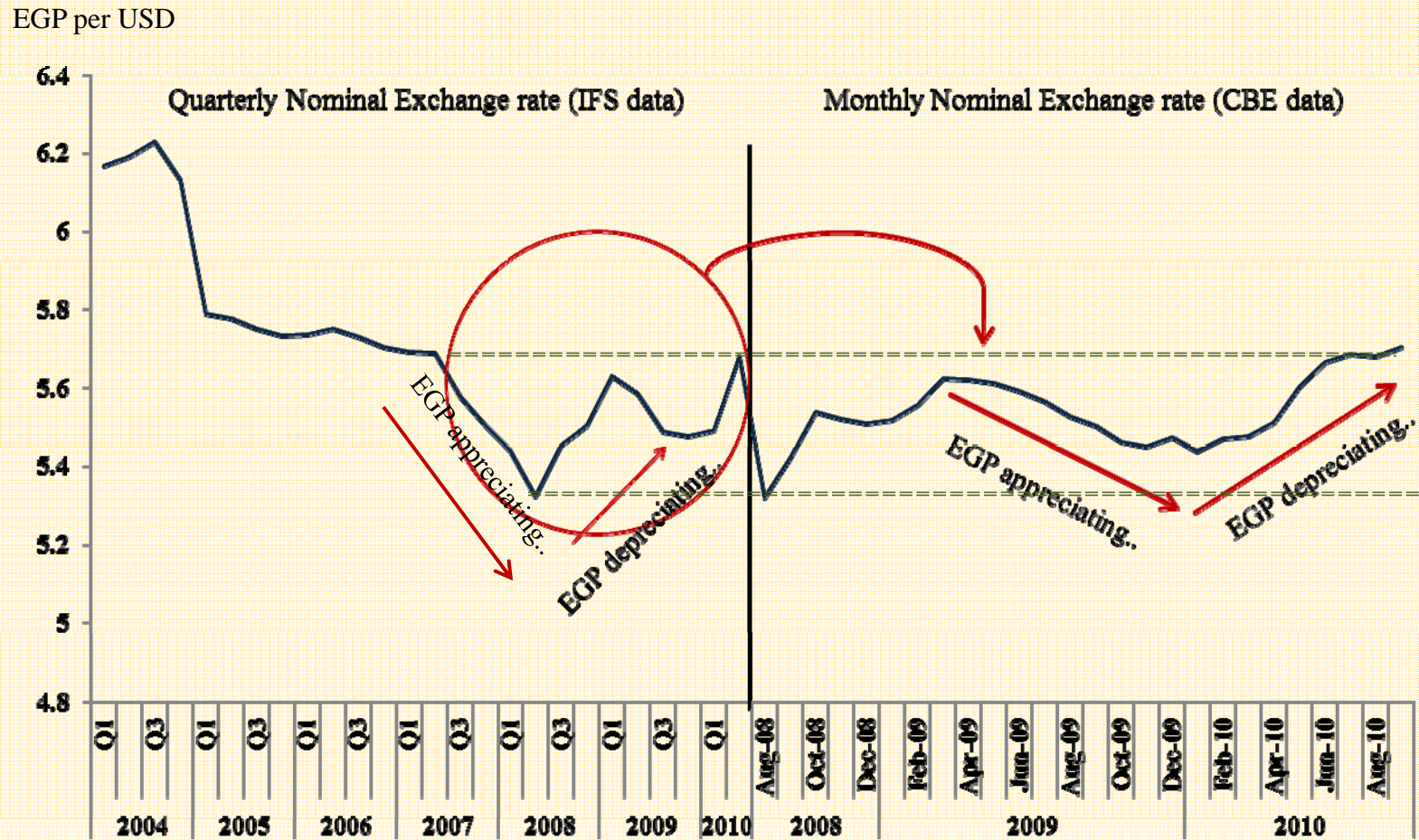
Inflation surged on account of high international prices, but moderated with the slowdown in the economy and a gradual vanishing of the base effect.



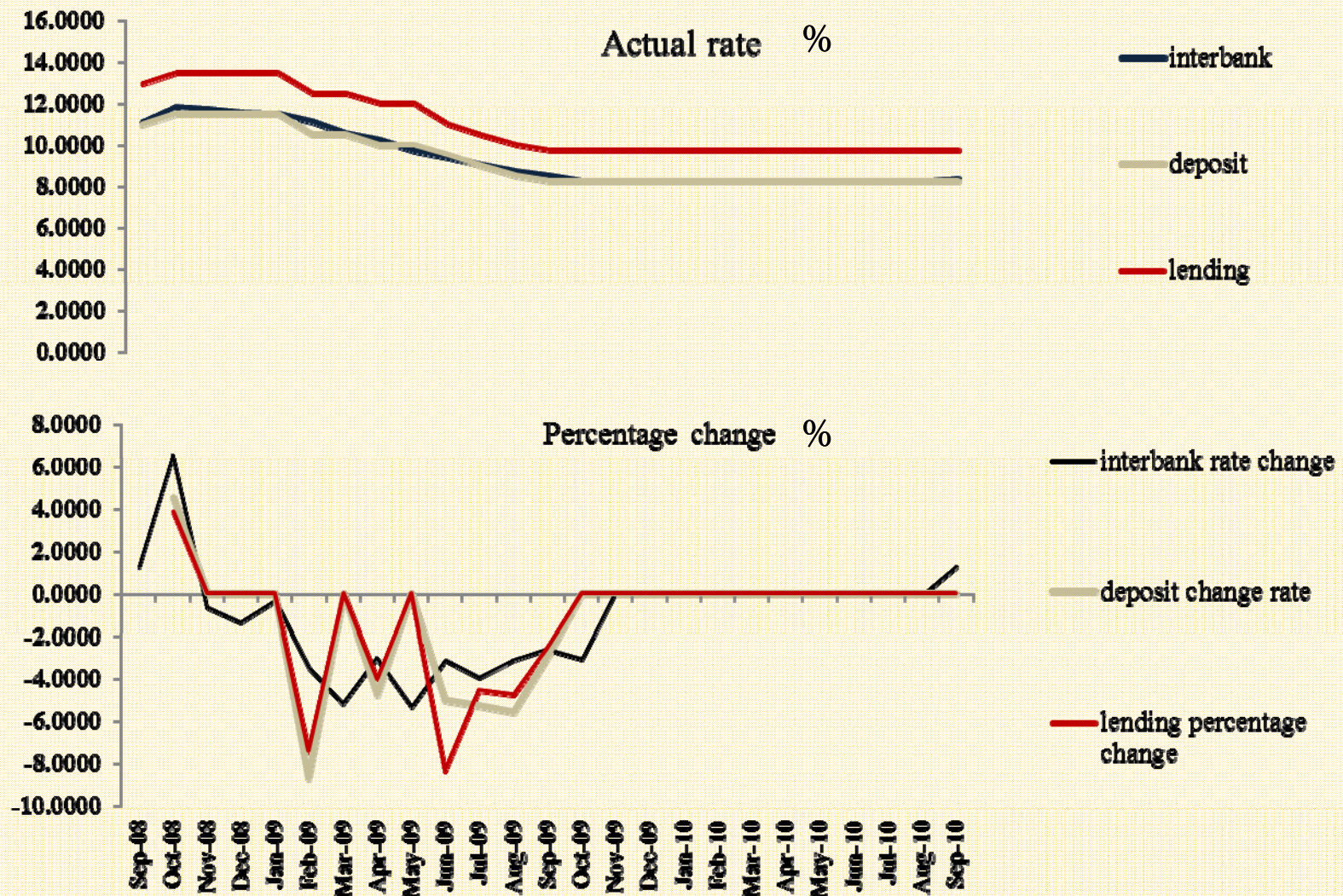
Real growth proved to be resilient during the global crisis and recovery has gained momentum in 2010. Nonetheless, it is not generating enough jobs.



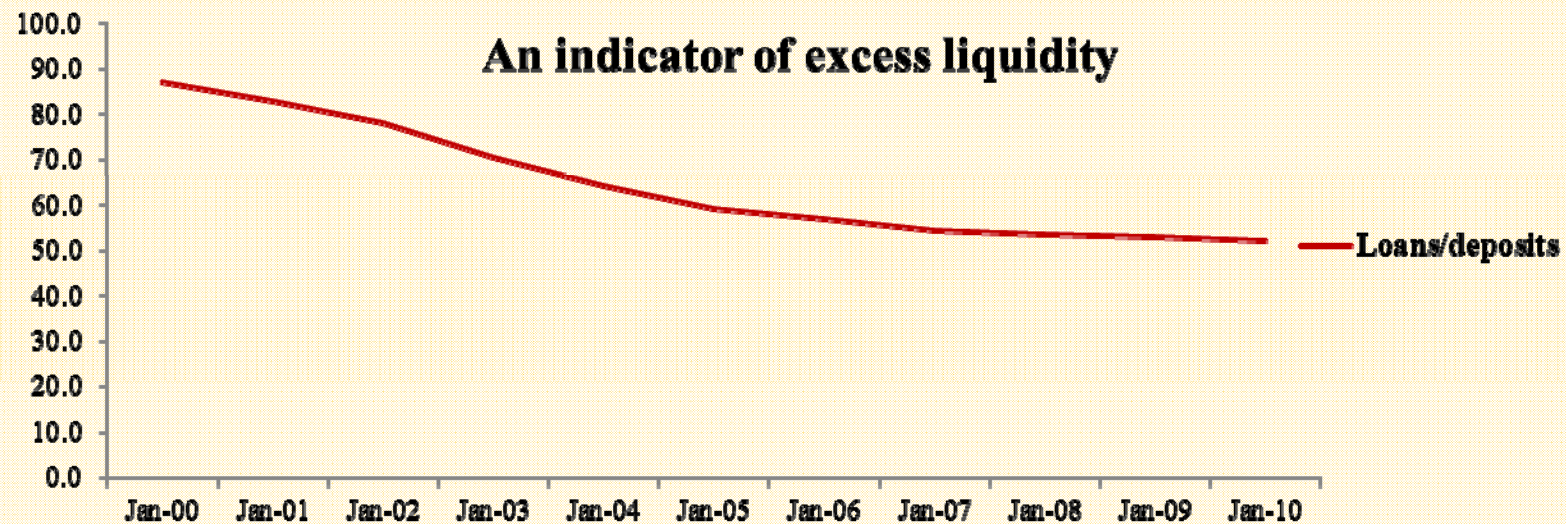
The appreciation episode corresponds to high inflationary cycles, while the depreciation episode corresponds to weak economic growth



Implementation tools: following a prolonged expansionary cycle, a neutral stance has been in effect.

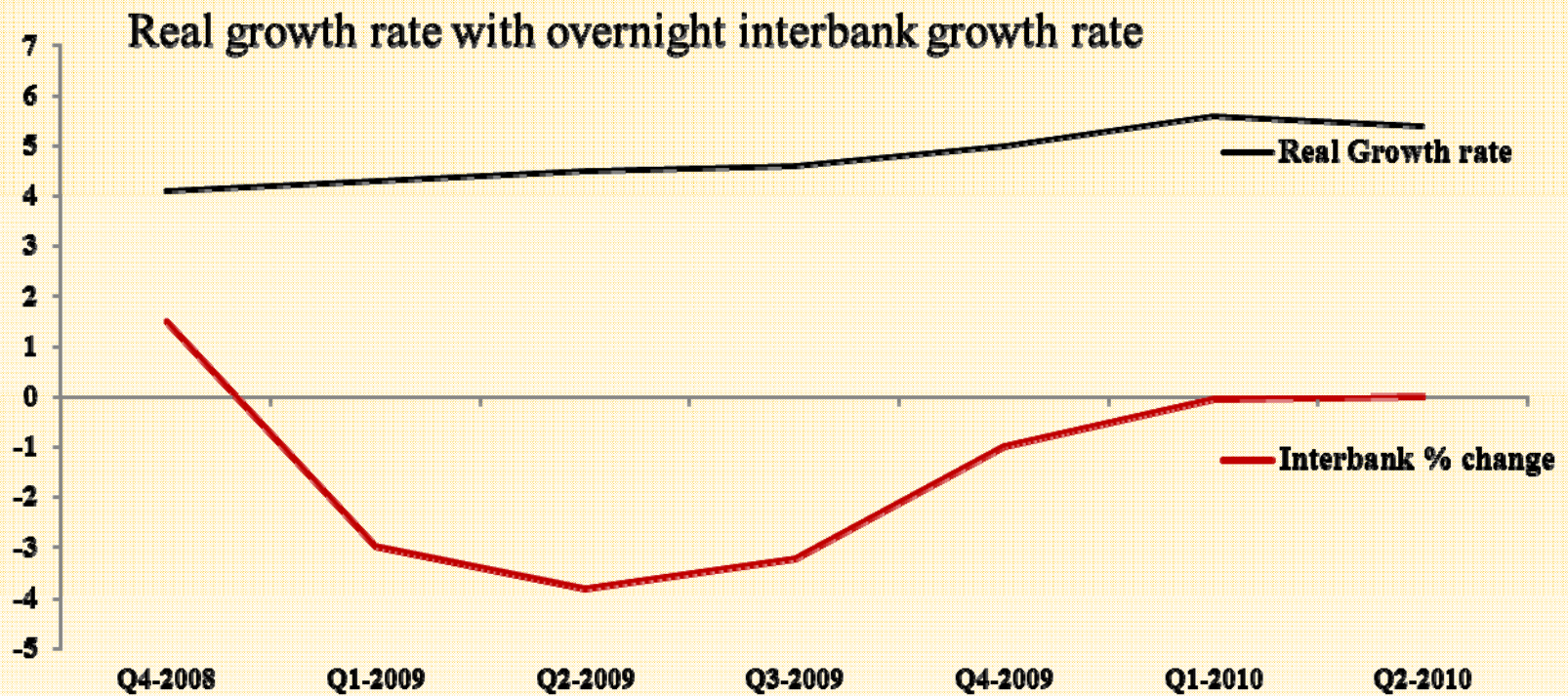


# Nonetheless, excess liquidity is evident...lack of leveraged Investments

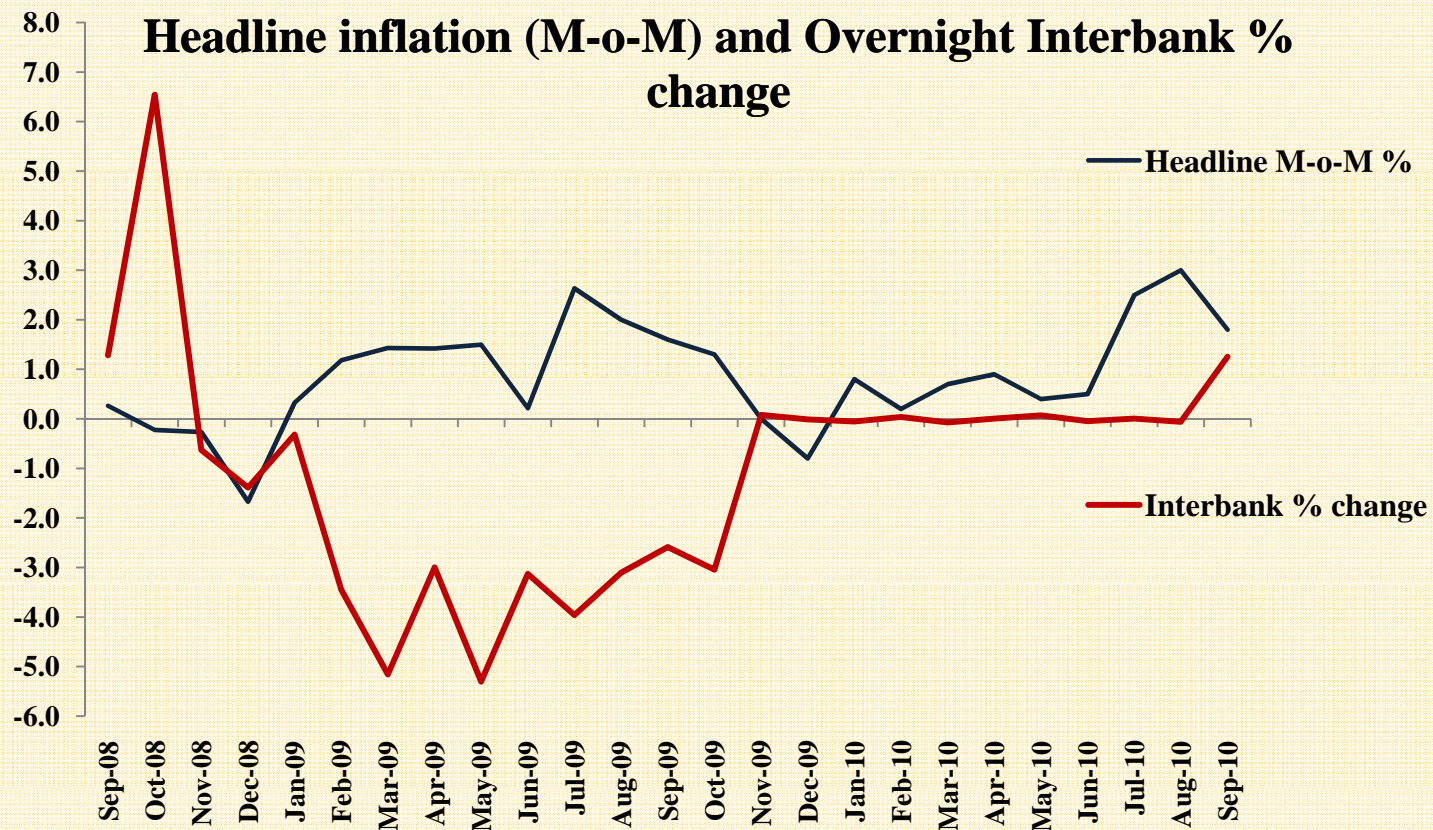




Real growth has steadily picked up with a lag in response to successive monetary easing.



Efforts to control recent evidence of supply-side inflationary pressures have resisted an increase in the policy rate to preserve economic recovery



The challenge of  
*persistent relative price shocks*

# Consumer Price Index

## 1- Consists of the following:

- Food (39.2% of headline weight)

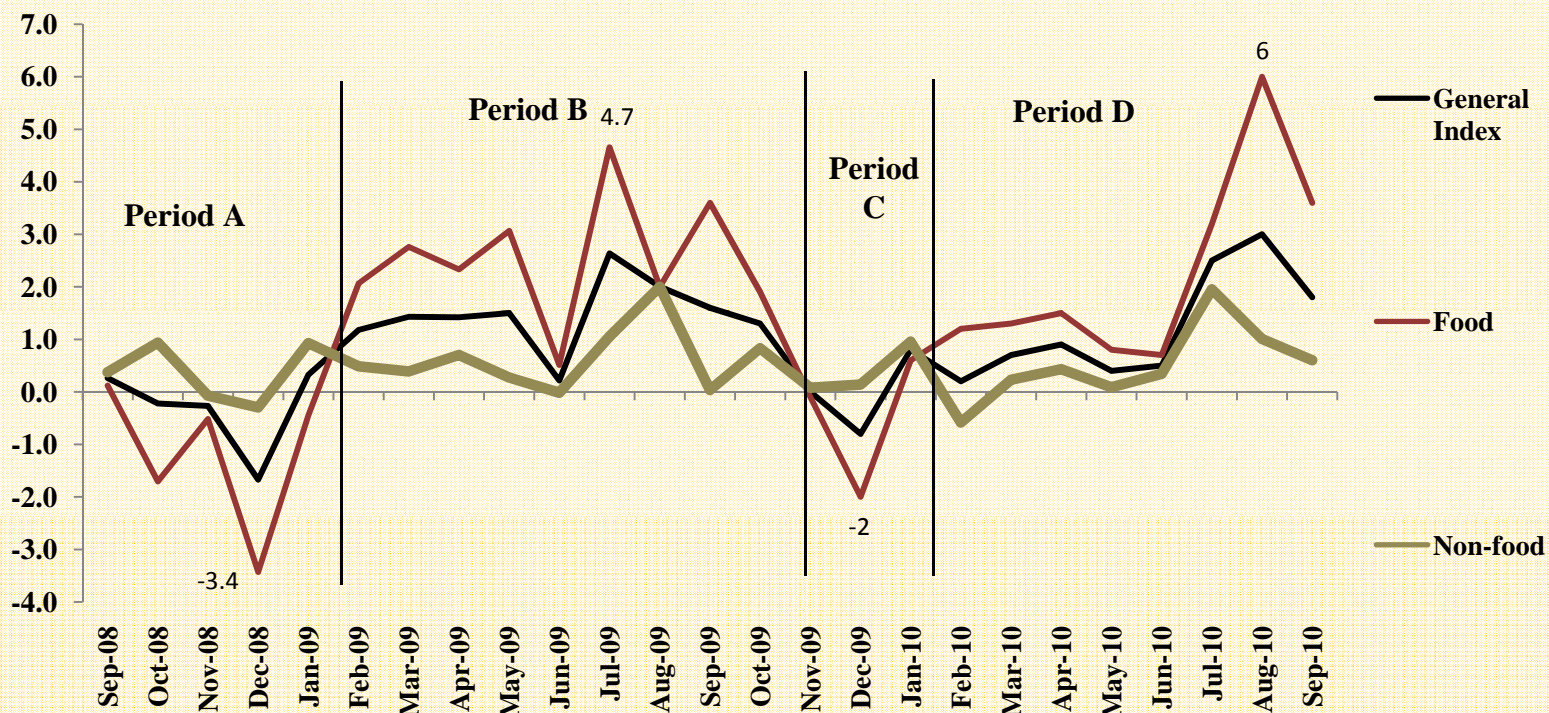
 bread, fruits and vegetables.

- Other Items\* (60.8% of headline weight):

\* An index based on CAPMAS data series from August 2009 till present, using the year over year price changes, we devised the headline index as well as its components and then devised the month to month price changes which is used in this presentation.

# Headline inflation has exhibited extensive cyclicality, mostly driven by food..

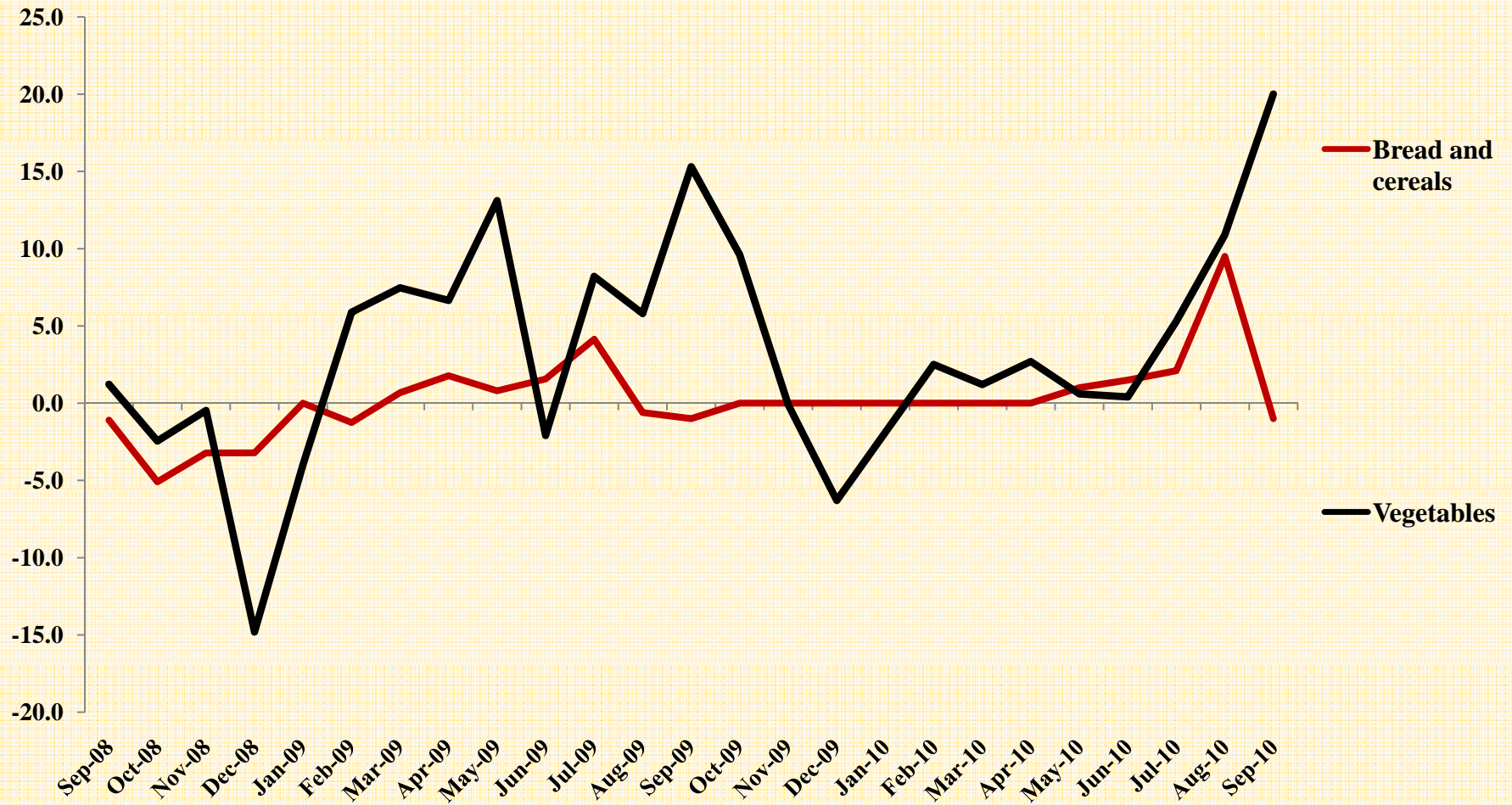
In addition, there is a significant correlation between food and non-food inflation.



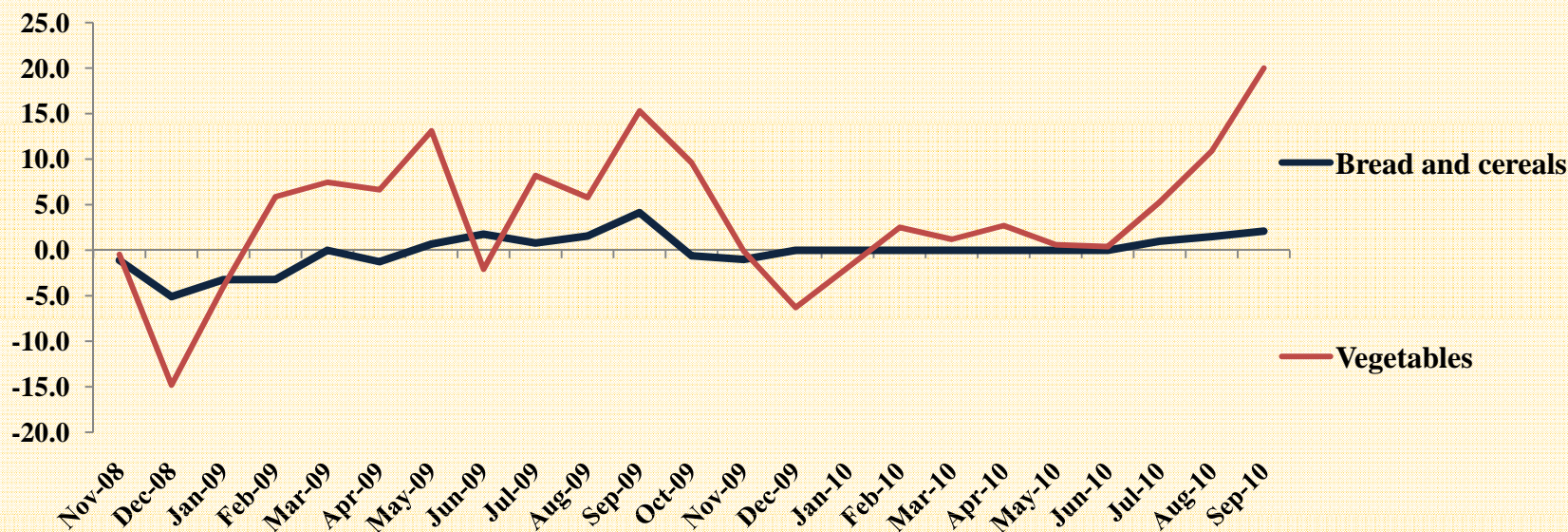
\* Significant at 10% level. \*\* Significant at 5% level. \*\*\*Significant at 1% level.

Correlation Matrix (zero lags)	Headline (m/m)	Food (m/m)	Non-food (m/m)
Headline (m/m)	1	0.96***	0.64***
Food (m/m)		1	0.39**
Non-food (m/m)			1

# Recent developments in bread & cereal and vegetable price inflation



Bread & cereals and vegetable price inflation rates are somewhat correlated and potentially, sources of higher inflationary expectations..

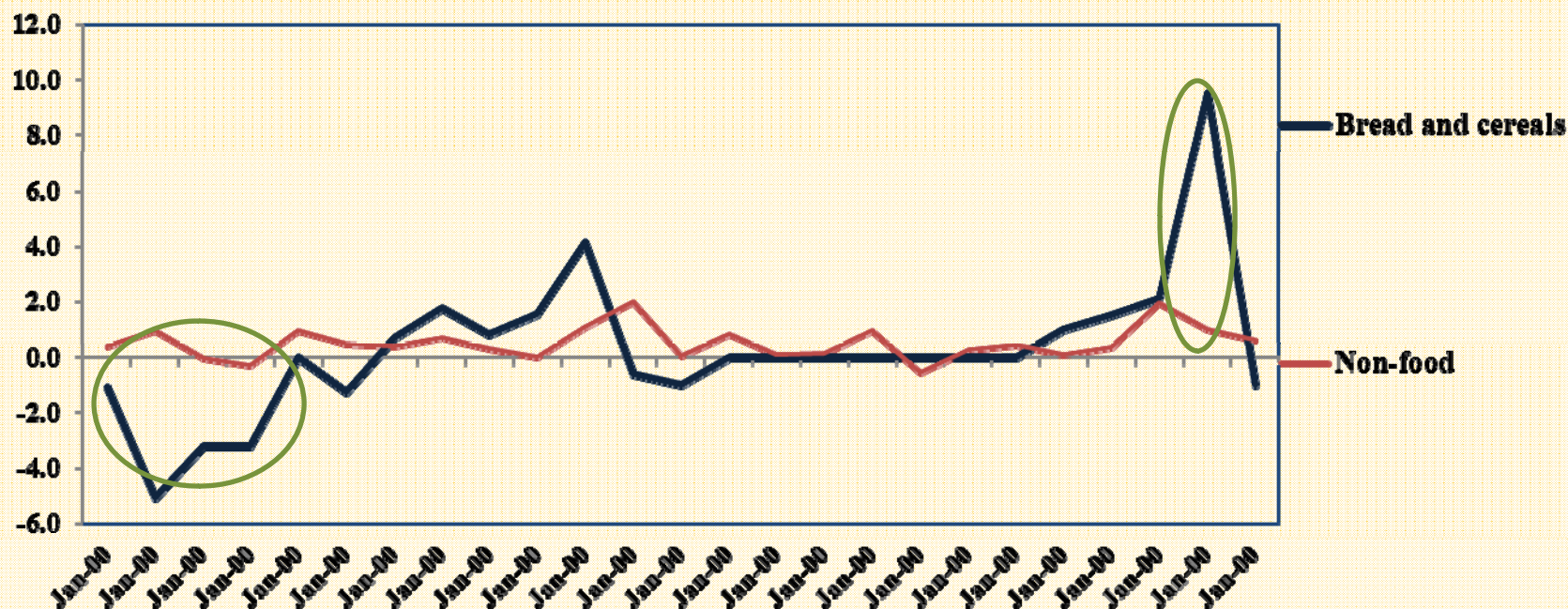


Lags of bread	Correlation between vegetables and bread (m/m)
0	0.35*
1	0.63**
2	0.66**
3	0.39*
4	0.11
5	-0.30
6	-0.18

Lags of vegetables	Correlation between vegetables and bread (m/m)
0	0.35
1	0.13
2	0.19
3	-0.01
4	-0.06

\* Significant at 10% level. \*\*Significant at 5% level

Bread price inflation is passed through to non-food price inflation with a lag. Moreover, there seems to be exogenous shocks that affect the price of bread and cereals.



Lags of Bread	Correlation between bread and non-food)
0	0.27
1	<b>0.36*</b>
2	0.21
3	0.13
4	0.07

Lags of vegetables	Correlation between vegetables and non-food)
0	0.27
1	-0.02
2	-0.02
3	0.23
4	-0.06

\* Significant at 10% level. \*\*Significant at 5% level

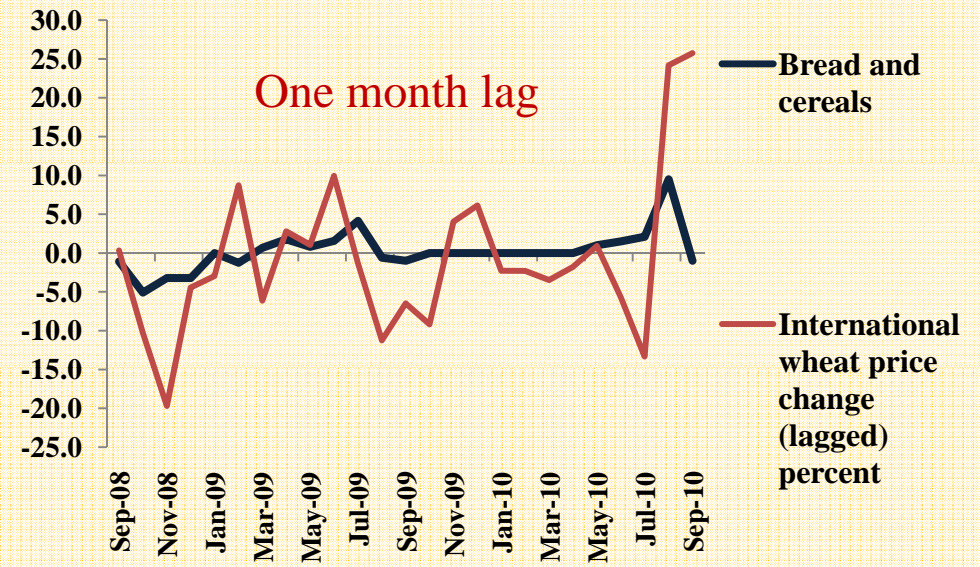
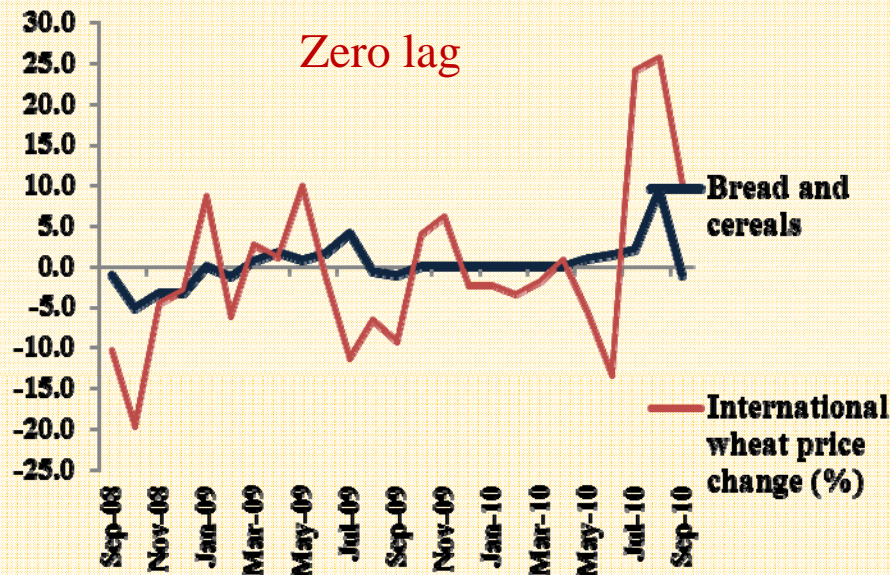


There is a positive correlation between bread price and international wheat price.

Correlation Matrix	bread	Vegetables	Non-food
EGP/USD change	-0.23	-0.15	-0.14
M2 change	0.17	0.10	-0.39
world wheat price change	<b>0.57***</b>	0.31	0.30

- \*Significant at 10% level. \*\*Significant at 5% level. \*\*\*Significant at 1% level.

# There is a quick and strong pass-through of international wheat price to the price of *bread*.



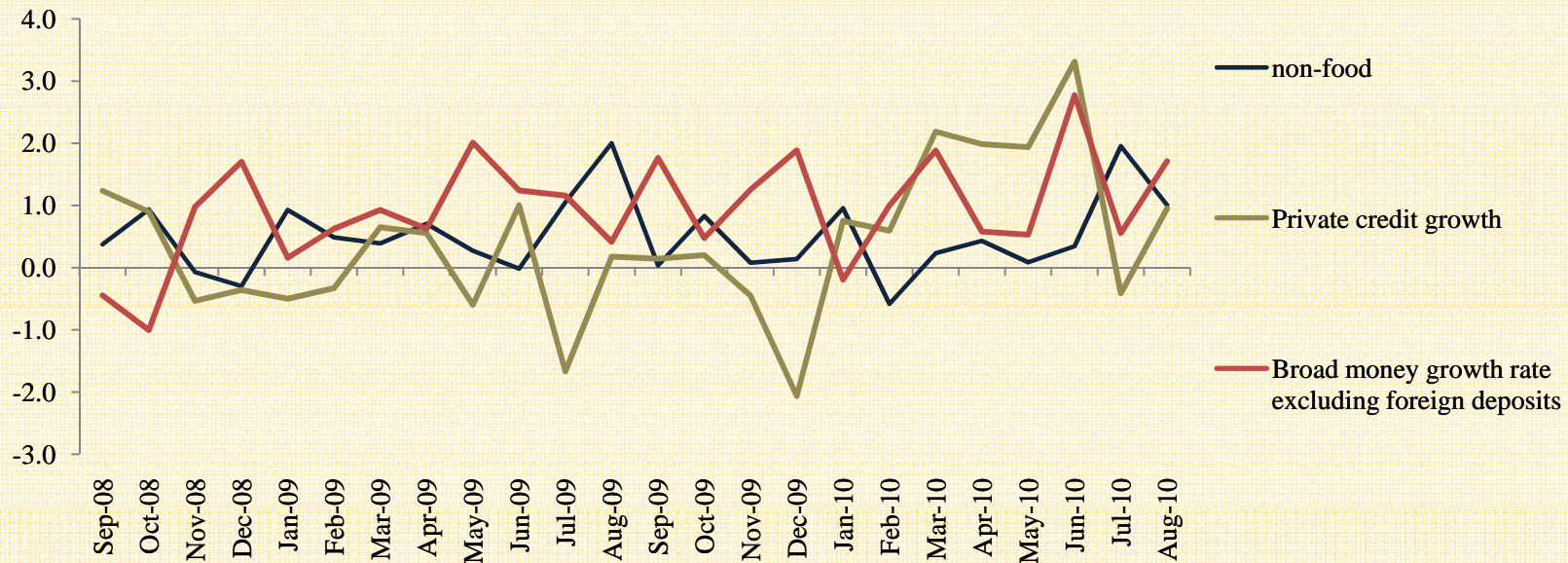
➤ However, **bread subsidies** seem to be **stabilizing** bread price in Egypt relative to the international price hikes.

Lags of international change in wheat price	Correlation between bread and international growth rate of wheat price
0	0.57***
1	0.48**
2	0.03
3	0.15
4	0.21

\* Significant at 10% level. \*\* Significant at 5% level. \*\*\*Significant at 1% level.

## Possible other hidden lag effects?

Broad money growth rate passes through to non-food price inflation with a lag.




• Significant at 10% level. \*\* Significant at 5% level. \*\*\*Significant at 1% level.

Lags of credit growth rate (change %)	Non food & private credit growth rate
0	-0.12
1	0.00
2	0.29
3	0.11
4	<b>0.53**</b>




Lags of broad money growth rate (change %)	Non food and broad money growth rate
0	-0.39
1	<b>0.47**</b>
2	0.21
3	-0.02
4	0.17

Transmission mechanisms of  
*recent relative price shocks*

# Why are relative price shocks considered somewhat permanent for wheat?

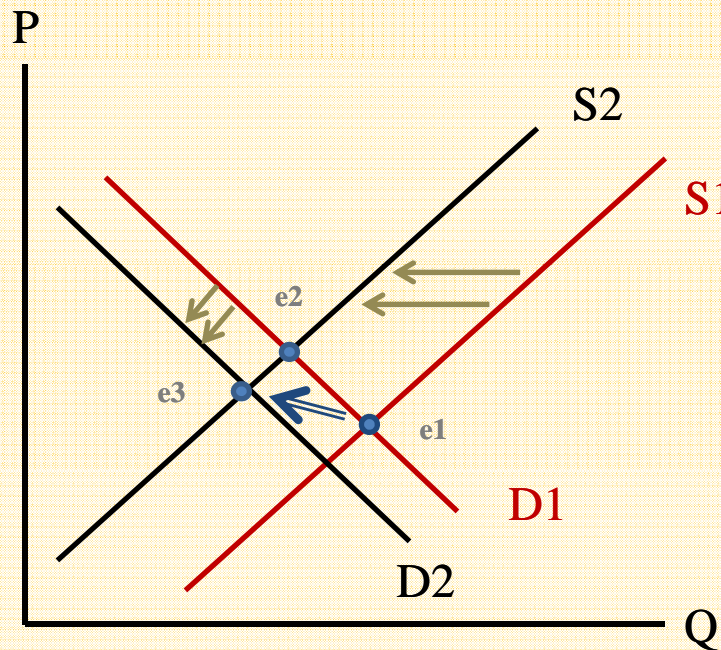
- Global warming  Droughts.
- Sustained growth in emerging and developing economies.
- Increase in demand for oilseeds and grains for bio-fuel production.
- Subsequent shift in land use from wheat and other crops to bio-fuel grains.
- Fertilizers' price increase.
- Increasing transportation costs worldwide.

# Why are relative price shocks considered somewhat permanent for vegetables?

- Exports of vegetables have increased.
- Food manufacturing is gaining momentum.
- Egypt, significantly affected by global warming.
- Fertilizers' domestic price increase.
- More tight regulations concerning the use of insecticides  Shortage of availability   
 Higher costs.

# Effect of bread and cereals price shocks on inflation and output growth..

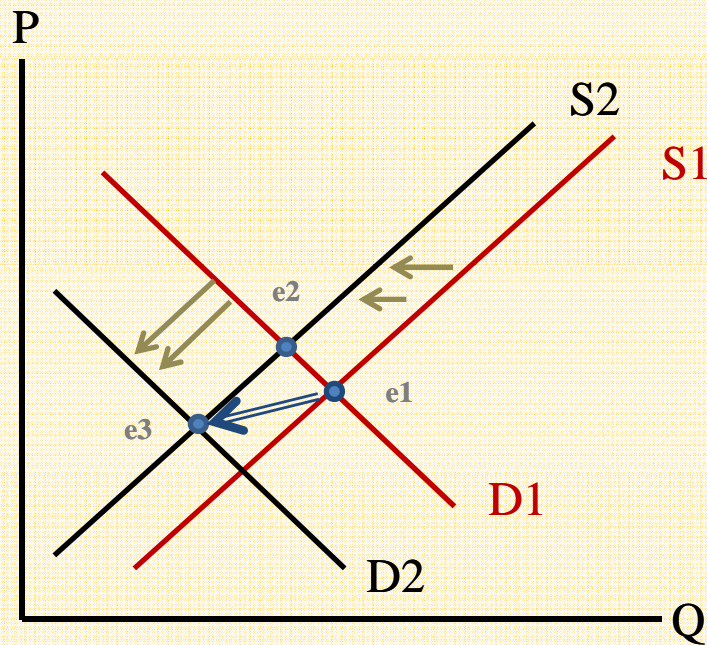
*Dominant inflationary pressure*



Relatively larger decrease in supply due to the propagation of wheat price shock into many input requirements, establishing priorities to *fight inflation*..

# Effect of vegetable price shocks on inflation and output growth..

*Dominant Output Contraction..*

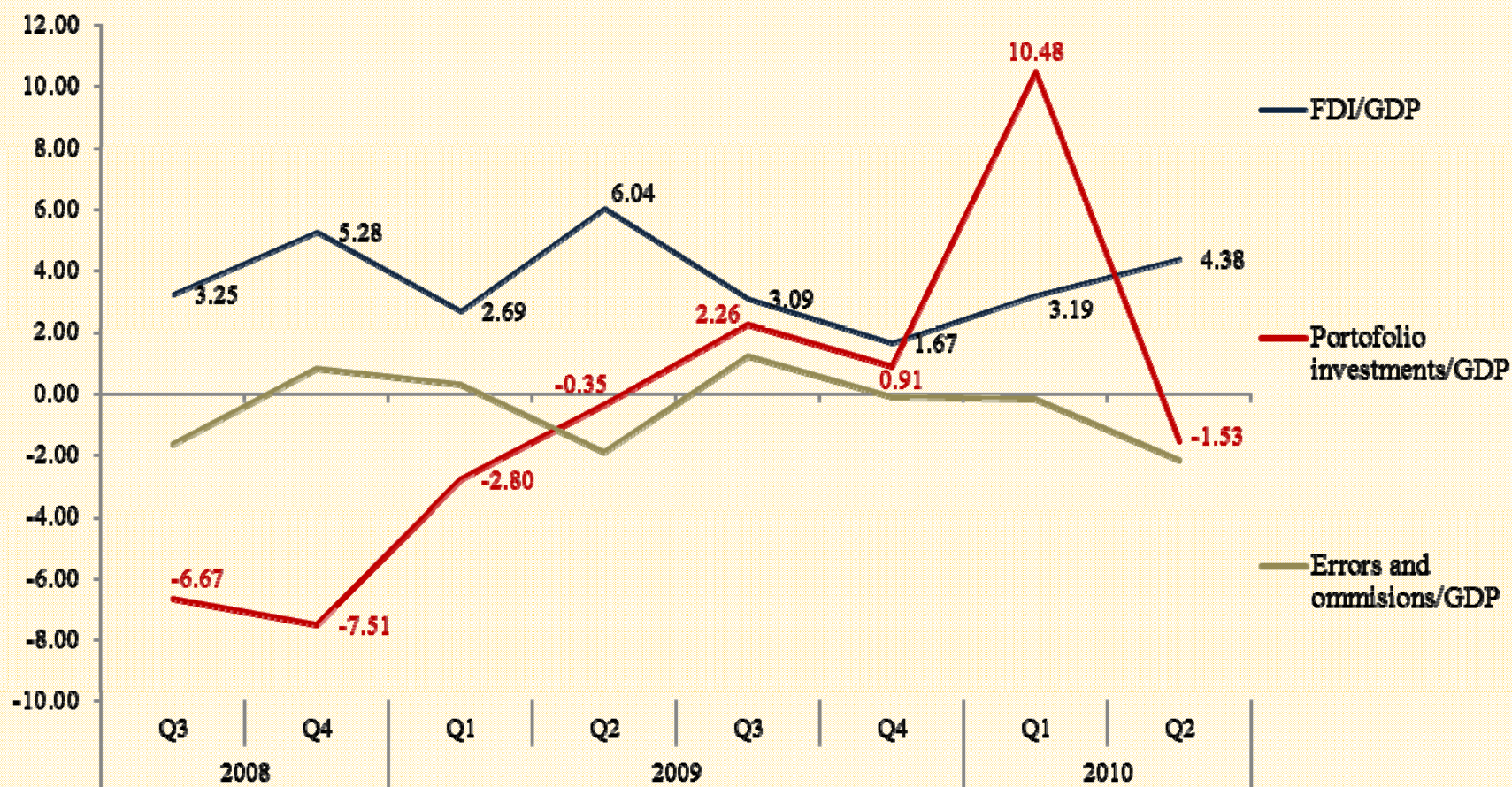


Relatively larger decrease in demand due to purchasing power effect, establishing priorities to *revive growth..*

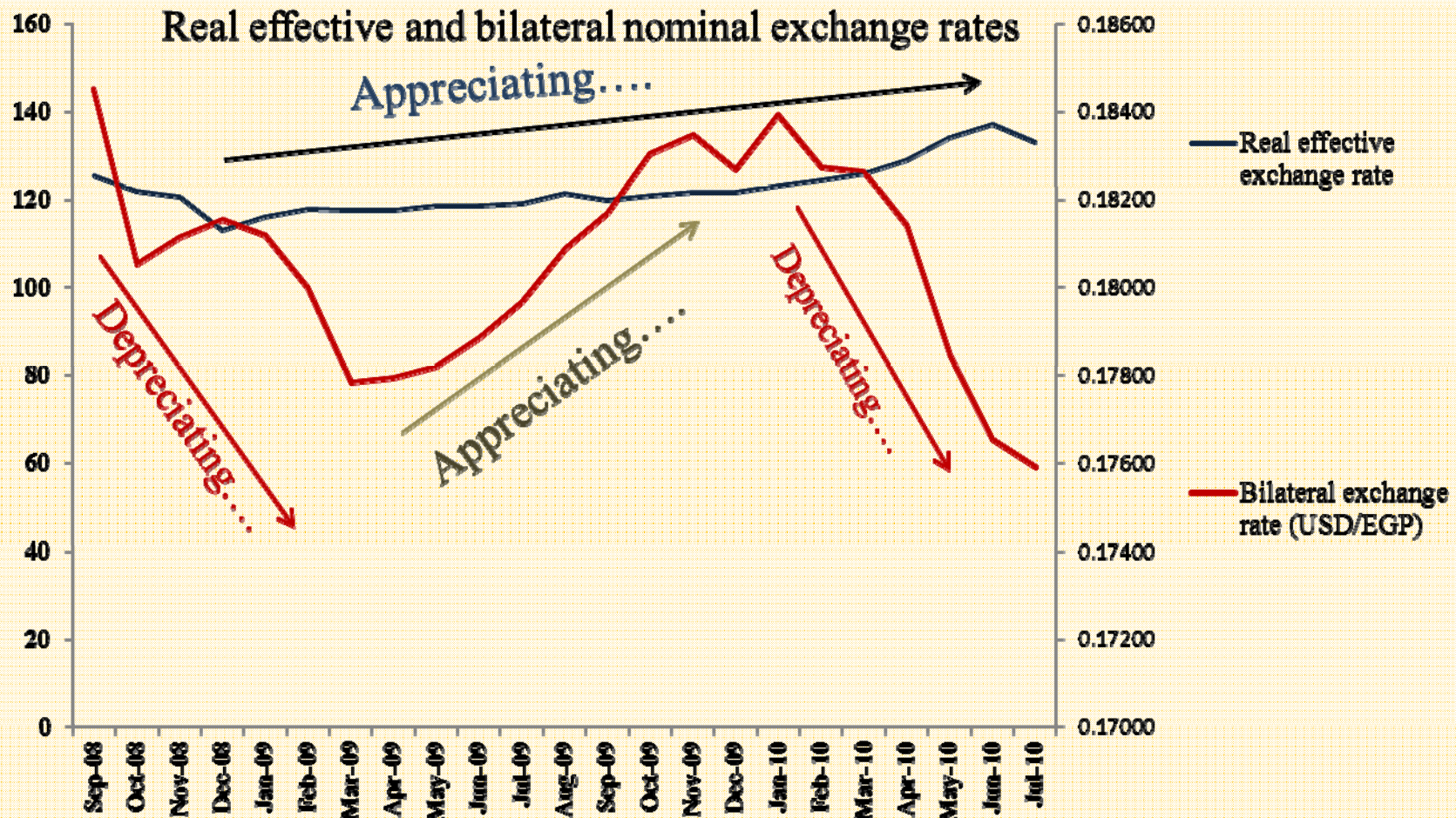


Other multiple shocks *complicating the  
conduct of Monetary Policy*

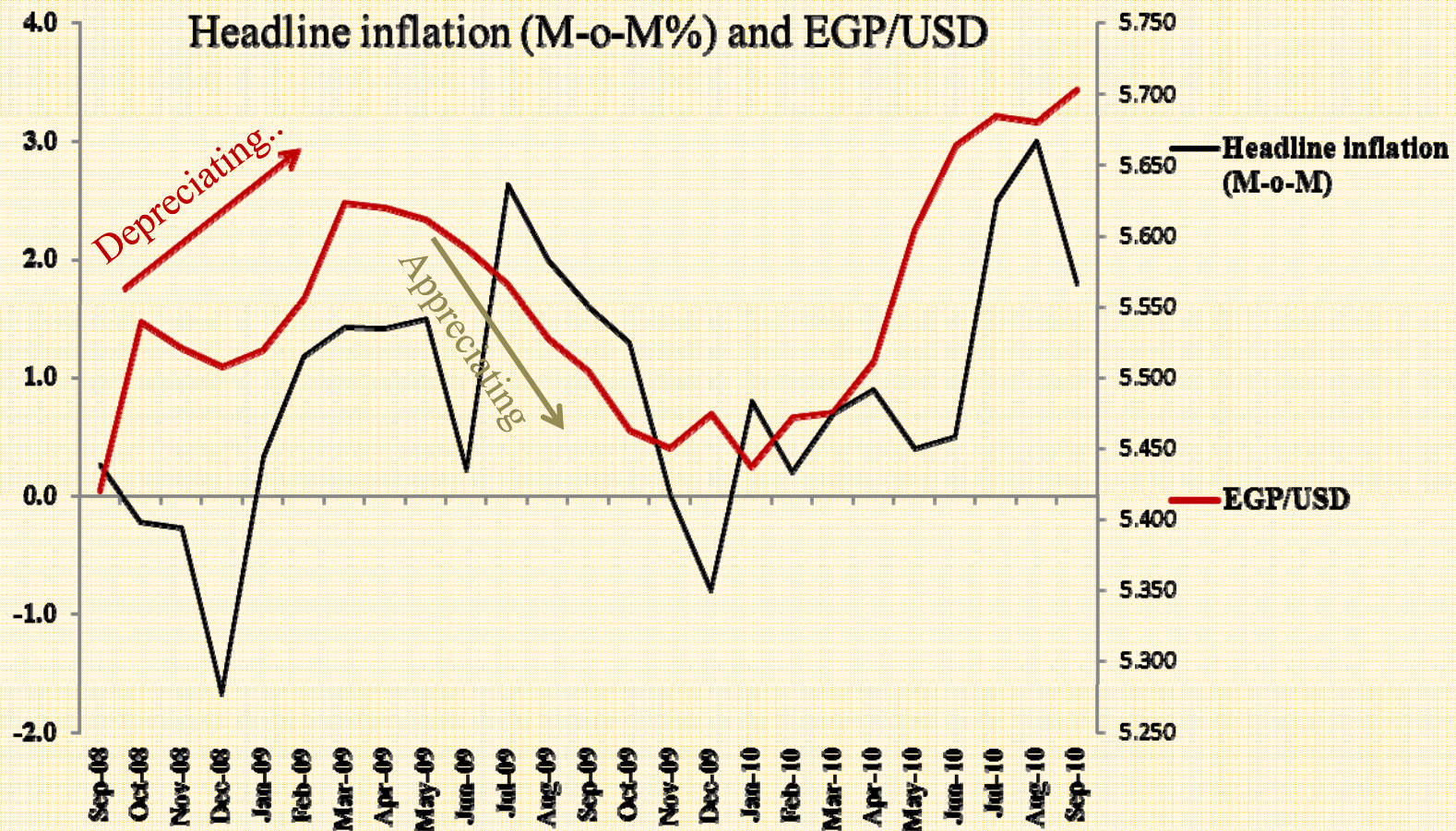
Net FDI heading back towards pre-crisis levels..  
Nonetheless, portfolio investments remain erratic reflecting investor's uncertainty..



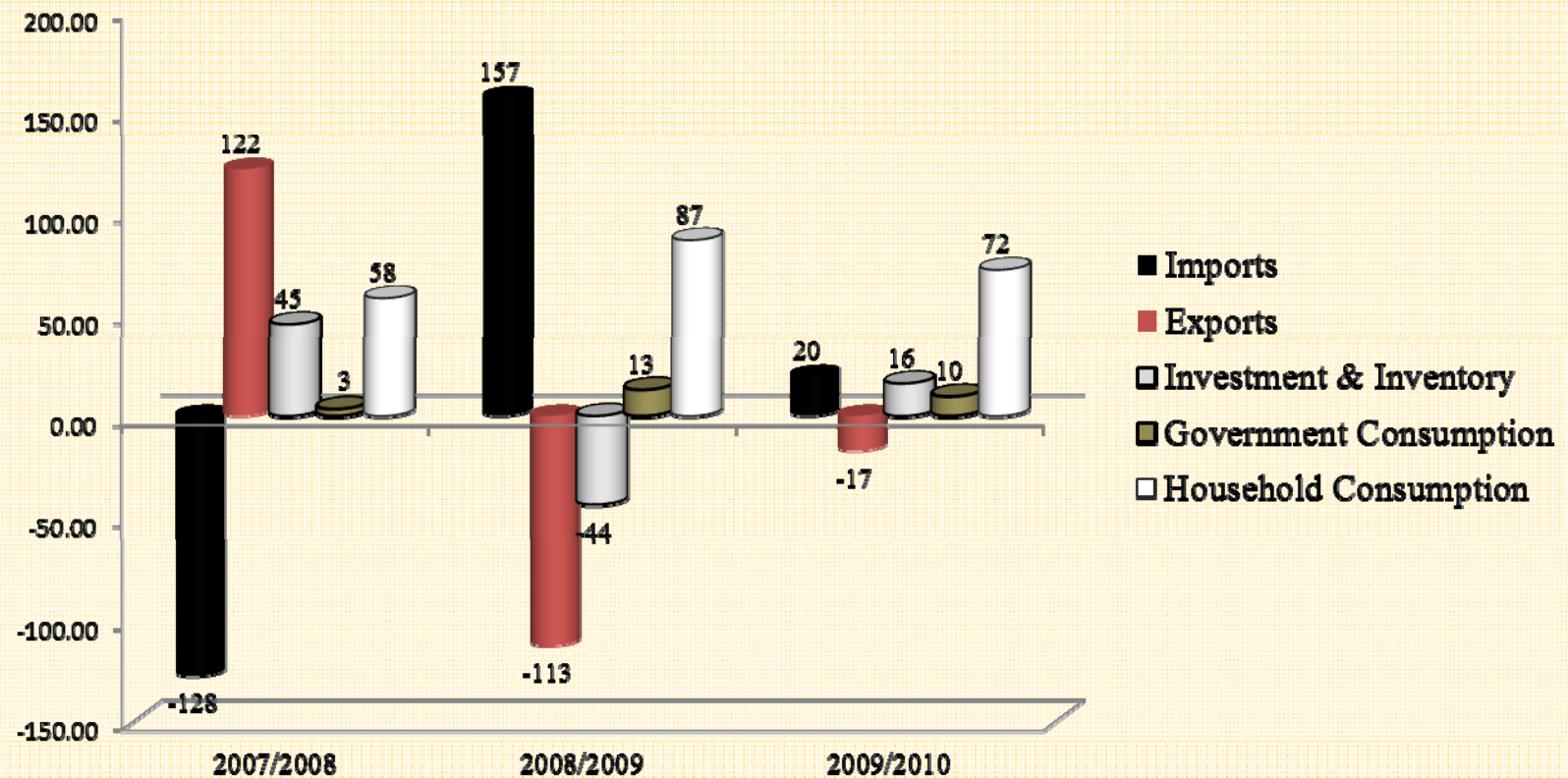
Despite recent *depreciation* of the pound relative to the US dollar, *appreciation* of the real effective exchange rate *threatens competitiveness*.



The recent depreciation trend of the Egyptian pound could prove to be inflationary at a time when foreign prices are generally stable, except for food prices..



Growth, according to underlying components, has been largely dependent on the increase in private consumption which cannot be sustained going forward...



# Policy Implications

- Priorities should remain focused on:
  - price stability to contain inflationary pressures and preserve competitiveness towards supporting economic growth.
  - In addition to stabilizing economic fluctuations to reduce uncertainty.
- Nonetheless, shortcomings in the intermediation process should be addressed to enhance the transmission mechanism of the monetary policy and mobilize private credit growth.
- Exchange rate policy should aim at striking the balance between export promotion and containing inflationary expectations.
- However, persistent relative price movements challenge the conduct of monetary policies

# Policy Implications

- 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 impacts and setting a realistic horizon for inflation targeting, in addition to structural policies aiming at addressing persistent rigidities, namely:
  - *Addressing structural distortions affecting distribution mark-ups.*
  - *Enforcement of monitoring schemes and market regulations to ensure more competitive markets.*
- Transitory shocks can be accommodated using non-traditional policy tools; for example:
  - *Export and import regulations.*
  - *Availing temporary liquidity cushions.*