Summary of the Roundtable Discussion on:

"Impact of Repeated Increases in Interest Rate on the Egyptian Economy: Short and Medium Terms"

ECES, Wednesday, 19 July 2017
from 9.30 am to 11.30 am

Speakers:

- **Dr. Ahmed Fikry Abdel Wahab**, Board Member, Federation of Egyptian Industries
- **Dr. Diaa Noureldin**, Assistant Professor, The American University in Cairo
- **Mr. Mohamed Abu Basha**, Senior Economist, EFG Hermes
- **Mr. Mohamed Farid Saleh**, Chairman & CEO, Dcode Economic and Financial Consulting
- **Ms. Zeinab Hashim**, CEO, Abu Dhabi Islamic Bank

Moderator:

- **Mr. Alaa Hashim**, Board Member and Treasurer, ECES

Facts:

- The foreign exchange crisis in Egypt began in 2013, when the foreign currency was insufficient to cover trade commitments. The only way out of the crisis was to liberalize the exchange rate, which was followed by the government's decision to reduce subsidies due to a large budget deficit. These economic reforms triggered price increases, followed by the Central Bank's decision to raise interest rates.

- The Central Bank of Egypt (CBE) raised the interest rate from 13 percent to nearly 20 percent in order to absorb excess liquidity from the market. This situation resembles what happened during the Carter administration; when money supply rose, interest increased to 20 percent compared to the norm of 3-5 percent.

- The CBE previously tried to absorb liquidity from the market without raising the interest rate through investment certificates at an interest rate of 20 percent. Raising the price corridor affects consumers and leads to an increase in the T-bills interest rate, negatively affecting the state budget.

- The CBE press release of May 2017 specified the following reasons for raising the interest rate:
  - Increased money supply (M2) due to the rise in both net foreign assets and local currency borrowing from the private sector;
  - Higher growth rates starting from the quarter that witnessed reforms and the following quarter, according to the Ministry of Planning.

- According to the CBE, the economy is facing a reform shock (liberalization of the exchange rate coupled with addressing the budget deficit), and it is only normal for demand, growth and liquidity to slow down. However, data does not reflect this slowdown. Growth is accelerating, and if it continues at this pace, inflation will rise further over the coming period. The Central Bank's attempt aims to curb private-sector's accelerated borrowing, and at the same time there is not enough data to explain the reasons and motives for growth, for which the decision was taken.

Speakers:

- Monetary policy has channels through which it can affect the economy (exchange rates, asset prices, and interest rates). Some studies in Egypt have concluded that the interest rate's impact is weak and that the most influential effect on the economy is that of the exchange rate. With the issuance of CBE Law 2003/2004, the role of monetary policy changed from defending the fixed exchange rate to inflation targeting.

- It is not necessary for the corridor price be linked to the interest on T-bills, which relies on the volume of liquidity in banks and the country's needs.

- Egypt has pegged its exchange rate to the dollar for many years (De facto Peg). Beside energy prices, the dollar is used by many as an indicative price to price products. Any shortage in the US dollar that changes its rate leads to an inflationary wave that is greater than justified by economic fundamentals: for example, if the exchange rate moves by 60 percent, the increase in prices may reach 80 percent and 90 percent.

- The Egyptian economy suffers from high inflation and a growth rate of 3-4 percent. It is not clear if growth is inflationary, and whether the economy has a positive or negative gap? In the case of a positive gap, interest rates are raised to absorb demand.

- The impact of raising interest rates on consumption and investment in Egypt:
  - The magnitude of this impact depends on the elasticity of each sector: the household sector is expected to reduce its indebtedness and spending, the business sector will hesitate to make any new investment decision, while the impact on the government is unclear because it has a chronic deficit that it may have to finance through high interest rate.
  - For the manufacturing sector, the impact of raising interest rates depends on the financial structure of companies. If the company is more dependent on equity finance, the impact will be limited, but if the greater reliance is on debt the impact will be significant and will affect the cost, which will be passed through to consumers in the form of higher prices.
  - The current climate does not encourage large investment inflows and may represent a disincentive to small investors.

- Managing inflationary expectations is crucial. High inflation expectations lead to higher current consumption for fear of future price increases. This could trigger inflation rates of 100 percent and 200 percent (hyperinflation), although high prices were expected to reduce aggregate demand.

- Inflation poses a major problem for investors. Investors need predictability in terms of policies and prices.

- Inflation cannot be controlled in Egypt through monetary policy.

- Curbing inflation requires addressing the real sector of the economy such as domestic trade. Egypt needs to increase productivity by focusing on agriculture and industry. Growth determinants are linked to productivity over the long term. Egypt is suffering from a sharp decline in productivity. The current investment pattern focuses on real estate investment with no corresponding investment in the agricultural and industrial sectors.

- Per capita income dropped in Egypt after the January Revolution due to higher rate of population growth than the GDP growth rate. Egypt is currently experiencing per capita income growth because GDP growth is greater than population growth. Compared to other countries, Egypt has fallen behind. Egypt's comparators are now Pakistan and the Philippines compared to Chile and South Africa 10 years ago.

- Countries that have succeeded in making a quantum leap in growth rates for an extended period are those that have managed to maintain high saving rates. The saving rate in Egypt is now a low of 6 percent (due to the budget deficit) and there is lack of separation between fiscal and monetary policies.

- The private sector needs credit to grow. It currently accounts for only 22 percent of credit. While credit to private sector as a share of GDP in Egypt amounts to 20-30 percent, it exceeds 60 percent in Turkey and Morocco and over 100 percent in South Africa and Chile.

Discussion key points:

- The way out for the economy is to attract foreign direct investment to specific industries, and to follow predictable policies that would instill certainty among investors.
- Attracting FDI is a reflection of large domestic investments.
- Information availability is of the essence as well as a real investment map in the context of value chains rather than whole sectors.
- There should be incentives to attract investors to sectors that the state wants developed.
- There are many obstacles to investment currently, most importantly the cost of financing due to the continuous rise in interest rates.
- While the liberalization of the exchange rate has led to a depreciation of the pound, it increased the competitiveness of the economy. However, we must not exaggerate its implications for growth. It is important to note that this advantage will erode if high inflation rates persist, as the bulk of production inputs is imported, increasing the cost.
- The growth spells that Egypt witnessed were temporary because real and institutional reforms were not implemented. It is necessary to complete economic reforms and implement these reforms in the real economy sector, not just in the financial sector.
- Society should shift to a cashless economy to increase the efficiency of the monetary policy.
- The parliament should conduct a policy review with a view to accelerating the issuance of pending laws required for institutional reform, such as the bankruptcy law, the mechanism of land allocation, and licensing.
- Officials should be empowered to be able to take decisions without hesitation.