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An Assessment of the Effectiveness of the Inflation Targeting Policy on Achieving the Monetary Policy Goals in the Egyptian Economy

Summary of Master Thesis Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Science in Economics

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Introduction

1-1. Overview

Over the last two centuries, markets have proved a mighty engine for economic growth in industrial countries, yet markets can't operate without a legal and regulatory structure and many public goods will not be provided by private sector. Here comes the rule of the government as a regulatory member in the economy which has some tools to achieve four major functions; improving efficiency, reducing economic inequality, stabilizing the economy through macroeconomic policies and conducting international economic policies .The government has two main regulatory tools to achieve the four major goals previously mentioned; fiscal policy and monetary policy.

The Monetary authority has two ways to conduct a monetary policy; contractionary monetary policy and expansionary monetary policy. The most important goal for the monetary policy is to control the inflation rate in the economy. The economic profession as also become more supportive of price stability as the long run primary goal for a central bank. Indeed, in recent years we have seen many central banks pursuing a strategy of raising interest rates in order to prevent an increase in inflation arising from an overheated economy. The monetary authorities must have an accurate assessment of the timing and the effect of their policies on the economy, thus requiring an understanding of the mechanisms through which the monetary policy affects the economy. Monetary transmission mechanisms (MTMs) discussed in Al Mashat and

Billmeier, (2007), that could be summarized in the following six channels, the direct (interest rate channel), exchange rate channel, the

asset price channel, the bank lending channel, The balance sheet channel, the expectation channel.

The monetary authority faces number of constraints when applying monetary policies that limit and add complicity to fulfil goals. For example, there is a short run tradeoff between inflation and unemployment. So the monetary authority have to make a choice between lower inflation in short run and higher unemployment, or higher level of unemployment and lower level of inflation. This negative relation was first' concluded by Philips,. (1958), after studying UK data. Solow and Saniuelsson, (1960), also concluded the same result when they studied US data.

Over the past few years a large number of industrial countries have adopted inflation targeting (IT) as their framework for monetary policy and now an increasing number of emerging market countries also adopting IT (Charles and Inci, 2009). The widespread adoption of IT has been partly due to perception that the IT countries have been successful at reducing inflation with relatively lower cost of forgone output compared to non IT countries. There are two set of circumstances in which countries have adopted **IT**. The first one is when countries have already achieved their desired rate of inflation and see IT as a way of maintaining that rate. The second one is when the rate of inflation is significantly above the long term inflation objective- mainly in emerging market economies- and IT regime is adopted as a way of bringing about a reduction in inflation to the long-term targeted inflation rate.

Literature on IT emphasize that it improves the transparency and credibility of monetary policy. In general, countries adopting IT regularly

provide the public with frequent information about the goals and conduct the monetary policy actions accordingly the transparency of ET reduces the inflationary bias of monetary policy since financial markets should quickly spot any inflationary opportunism. In this way, improved transparency enhances the credibility of monetary policy (Crowe ,2006). Strengthen the credibility of monetary policy is generally seen in the literature as a development that should improve the unemployment-inflation trade off since a given change in inflation would be associated with a smaller change in unemployment. In other words, Phillips curve would be steeper (Desimonë ,2001).

12. Problem definition

In Egypt, during the 1 980s, the economy suffered from macro imbalances, reflected in high and volatile rate of inflation (Noureldin ,2005a), growing deficits in the balance of payments and government budget. These were accompanied by rapid economic growth, averaging 8.5% annually from the mid 70s to the mid 80s, due mainly to foreign investment. In the second half of the 80s investment and GDP growth declined, accumulated debt reached II .4 billion \$ in 1990 and the burden of foreign debt hàdbecome unwieldy (Korayern ,1997). In 1991 the government signed agreements with the IMF and the World Bank aimed rectifying the macro imbalances. These agreements are known as, the economic reform and structural adjustment program (ERSAP).

Starting 2002. inflation development in Egypt was subject to unexplained anomaly. in reaction to successive devaluation in exchange rate starting 2000-2001, inflation of the whole sale price index (WP1)

started to increase reaching double digit figures in 2003-2004. However inflation rates of the consumer price index (CPI) showed mild increase despite growing anecdotal evidence of strong inflationary pressures after the devaluation (Noureldin ,2005b).

As the Central Bank of Egypt (CBE) announced in January 2005 the intention to adopt it as a new monetary policy regime, there has been a continued controversy about its ability to conduct forward looking monetary policy' with the required level of sophistication currently observed in IT central banks. Under the new regime of inflation targeting, the nominal exchange rate will be no longer the nominal anchor as it will be replaced by the CBE targeted rate of inflation. Several reforms have been taken in the institutional structure of the CBE to ensure wider degree of independence, which is considered one of the fundamental prerequisites of IT. Another step towards fulfilling IT prerequisites was CBE Announcement of introducing core price index in 2009 that excludes fruits, vegetables and highly volatile components as well as items in which prices are regulated by government that will help to distinguish trends of inflation from transitory movements.

1-3. Research objectives

The objectives of this research are fourfold: the first objective is to give a critical review of all theories and models that tried to explain the inflationary behavior through the history of economic thought. The second objective is to examine the monetary transmission mechanisms in Egypt against the background of the central banks adoption of a light version of IT, as a convergence phase towards the full implementation of full-fledged inflation targeting (FFIT), once IT prerequisites are met (e.g.

central bank independence, free floating exchange rate, and ensuring a wide degree of accountability and transparency of the monetary policy). The third objective is to review the prerequisites of inflation targeting in order to analyze to what extent they are met in Egypt and examine whether the Egyptian economy, in its current status, is ready to move to inflation targeting. It also aims at identifying the adjustments that are necessary for a smooth transition towards inflation targeting. The fourth objective is to build a macroeconomic model to test the sensitivity of inflation rate (π) toward changes in a sample of economic indicators during the last decade, these variables include nominal interest rate (i), nominal exchange rate (e), economic growth (y).

1-4. Research hypothesis

This research addresses important empirical questions regarding the relationship between inflation rate and other economic variables by extending the model presented in Al Mashat and Billmeier, (2007), with, replacing some variables and applying it on the time period conducted in this research. The research hypotheses to be tested are the following:

- A. Using interest rate as an operational target allows a smoother transition towards IT.
- B. Intervention of the government in foreign exchange market creates an obstacle in fulfilling the needed prerequisites to adopt IT.
- C. Operational changes occurred in the structure of the CBE enough to ensure Central bank independency.

1-5. Research outline

This research consists of five main chapters beside an introduction. Chapter two presents the literature review, which introduces the main

literature, theories, and contributions that represent the evolution of monetary policy through economic history, while focusing on the main monetary regimes adopted through history to constrain inflation. Also in this chapter main institutional and economic prerequisites for a successful adoption of IT will be discussed, based upon similar experience of IT adoption of some selected emerging economies, Brazil, Turkey, Pakistan, Chile and Romania. Chapter three will give a general background for the main reforms that took place in Egypt for the purpose of adoption IT, with examining the main MTMs in Egypt against the background of the CBE adoption of IT. This chapter will cover a period starting from 1991- the date of launching of the Economic Reform and Structural Adjustment Program (ERSAP) - passing with the date of CBE announcement of IT **adoption in Egypt in 2005**, till the year 2010. During the period under study a critical analysis will be presented to assess the main monetary reforms that took place during the last two decades and the effect of those reforms on achieving monetary policy goals.

Chapter 4 introduces the data descriptions, sources, and the Vector Autoregression (*VAR*) methodology to estimate the pass-through effect on inflation rate, as a result of changes in sample of chosen economic indicators, running from January 2000 to December 2010. The variables contained in the VAR consist of Economic growth(*y*). Inflation rate (*p*), average daily interbank rate (*ir*), exchange rate (*er*). Chapter five reports a list of concluding remarks, suggestions and policy implications for CBE to successfully complete the transitional period, and fulfill the needed prerequisites to adopt IT.

1-6. References

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المخلص العربي

على غرار الكثير من الدول النامية أظهر البنك المركزي المصري في التقرير السنوي عام ٢٠٠٥ عن "عزمه لاتباع سياسة استهداف التضخم متى تم تحقيق كافة متطلبات ومقومات هذا النظام وهذا سوف يؤدي إلى دعم مصداقية وشفافية السياسة النقدية في مصر، خلال الفترة الانتقالية سيتم استخدام أسعار الفائدة قصيرة المدى للتحكم في معدلات التضخم، كما يتم ملاحظة المعروض النقدي التي تؤثر في معدل التضخم". سياسة استهداف التضخم تعني **Medium term** الإعلان عن معدل تضخم معين لاستهدافه خلال فترة متوسطة المدى التزام البنك المركزي بالحفاظ على ثبات الأسعار هو الهدف الأساسي للبنك المركزي ولكن على وقياس **CPI** عكس التوقعات، ارتفعت معدلات التضخم في قياس مؤشرات سعر المستهلك نتيجة لتخفيض سعر الصرف حتى وصل إلى أرقام ثنائية بلغت **WPI** مؤشرات سعر المنتج ٢١,٧% و ١٦,٩% بالتوالي خلال عامي ٢٠٠٣ و ٢٠٠٤ واستمر في الارتفاع حتى عام تلقي هذه الدراسة (Rania (2008) ٢٠١٠ مما خلق ضغوط تضخمية في الاقتصاد المصري الضوء على ظاهرة التضخم كواحدة من أخطر المشاكل الاقتصادية العالمية، حيث تناول هذه الدراسة التطور الفكري للسياسات النقدية عبر التاريخ وكيف تناولتها المدارس الاقتصادية المختلفة. حيث تهدف هذه الدراسة إلى الآتي: توضيح أدوات السياسة النقدية الأخرى (سعر، مع الرصد التاريخي **MTMs**) (الصرف، العرض النقدي) وقنوات انتقال الأثر في مصر (لتطورات السياسة النقدية في مصر منذ عام ١٩٩٠- تاريخ عقد اتفاقية الإصلاح الاقتصادي و) - مروراً بعام ٢٠٠٥- إعلان البنك **ERSAP** التكيف الهيكلي مع صندوق النقد الدولي المركزي التوجه نحو سياسة استهداف التضخم- حتى عام ٢٠١٠. كما تهدف أيضاً إلى توضيح ماهية سياسة استهداف التضخم وما هي أهم المقومات الواجب توافرها لكي يتم تطبيق سياسة استهداف التضخم بصورة مؤثرة وفعالة بالاستفادة من تجارب دول نامية أخرى. والتحقق من مدى قابلية الاقتصاد المصري في الوقت الحالي لتطبيق سياسة استهداف التضخم.