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# Evaluation of the monetary policy performance in Egypt during the period (2004-2010)

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**ABSTRACT**

*In Egypt, the early 1990s through the present have witnessed important change in the Egyptian economy in general and the monetary policy in particular. These changes go along with the world economic trends in line of the financial liberalization policies and the economic globalization. That period has witnessed as well the agreement with the international monetary fund (IMF) and the World Bank to perform three reform financial, economic and structural programmes. Some of them were performed successfully. The central bank performed a banking reform programme to restructure and develop the banking system including the central bank itself in line with new legislations according to the act of central bank and the banking system. In addition, there is a new trend in the field of monetary policy development to transfer into anti-inflation approach which is adopted by many of the developed and emergent countries in accordance with the Egyptian central bank independence. In this light, the research problem can be restricted in an essential question: What are the most effective and affective variables of the monetary policy instruments in Egypt during the study period and what are the function indicators on the success extent of the monetary policy in achieving its objectives?. The research is based on the main hypothesis that the effectiveness of the used monetary policy instruments depends on the extent of providing the legal and institutive environment and the selection of flexible and potential instruments in the proper times. The main research objective is to evaluate the monetary policy performance through defining the suitable monetary policy for the Egyptian economy circumstances during the period (2004-2010). This is done through the display of the development stages of the monetary policy in Egypt and its legislative and corporative framework; the indication of its pillars and how to manage the monetary policy in Egypt during the research period. The research aims as well to determine the performance evaluation indicators of the monetary policy in Egypt during the period (2004-2010) and finally conclude findings and draw suitable recommendations.*

**KEYWORDS: monetary policy-Egypt- instruments and indicators- Evaluation**

**Introduction:**

The monetary policy plays an important role in directing the state economic policy through controlling the size of payment means by affecting the credit and interest rate size. Hence, it affects investment and its growth in addition to creating a balance between quantity of money supply and quantity of goods and services supply in order to preserve economic stability, increase the growth rate and employment and income levels. The monetary policy can be defined as the porgrammes and procedures which the monetary authorities adopt to organize cash in the society and achieve the desired objectives. In most countries the central bank performs these procedures. In other words, they are the taken procedures by the monetary authorities which intend to make an effect on the economy in order to ensure the exchange rates stability. In this light the monetary policy concept should include a number of important elements, namely (Waleed Al-Wakeel,2003): procedures and actions performed by the monetary authorities, effect on the monetary variables in the banking and non-banking systems, achieve certain objectives determined by the monetary authorities. The central bank adopts a strategy in order to realize the monetary policy objectives through starting to select one of the monetary policy instruments (quantitative or qualitative), then the first object followed by the middle one through the last objective. This requires that the central bank uses monetary objectives related to each other in order to realize the last desired objective. The success of using these instruments depends on the extent of response by the individuals and economic and banking institutions to accept these procedures. Whenever they are inadequate to achieve the required effect on the loans quantity or the trends and their distribution, the monetary authorities should adopt other procedures related to direct control such as direct interference in the commercial banks works and the moral and ethical persuasion. Generally, there is an agreement that the final objectives of the economic policy in general and the monetary policy in particular should include: achieving stability at the public level of prices, full employment, realization of high growth rate and equilibrium of balance of payment (Tarek Abdelfattah Moursy,2007). Therefore, the monetary policy is procedures, rules and judges followed by the state through the central bank to affect and control the credit in order to achieve the economic stability and avoid the crisis which may jeopardize the national economy.

In Egypt, the early 1990s through the present have witnessed important change in the Egyptian economy in general and the monetary policy in particular. These changes go along with the world economic trends in line of the financial liberalization policies and the economic globalization and the transformation from a closed socialist economy dominated the public sector to an open economy based on the market economies and the leading of the private sector. That period has witnessed as well the agreement with the international monetary fund (IMF) and the World Bank to perform three reform financial, economic and structural programmes. Some of them were performed successfully. The central bank performed a banking reform programme to restructure and develop the banking system including the central bank itself in line with new legislations according to the act of central bank and the banking system. The most important of these legislations is the central bank the banking and monetary system act no. 88, 2003 which is mainly concerned with the central bank independence and its supervision powers in addition to rules and basis of foreign monetary treatment and enforce the working banks in Egypt to increase their capitals to LE half billion in minimum in order to support the banks capitalist rules and increase their capital adequacy (Soheir Matouq,1999). In addition, the government decree to liberalize the LE exchange rate at the end of January 2003 to be determined according to demand and supply rules. The government aims to maintain the credibility and reality of the exchange rate to get rid of non-official currency market and avoid speculations. It also aims to encourage direct and non-direct foreign investment attraction, restore market liquidity at the foreign exchange market, and provide an opportunity to reduce the interest rate in order to help activate the economic activity wheel. The efficient success of this procedure leads to the issuance of the Prime Minister's decree no. 506, 2003 in relation to organizing the treatment of foreign monetary resources; it is binding for ministries, public economic and service corporations, public sector companies, public works sector and the private sector to transfer 75% of their foreign currencies revenues to the banks in a contribution to increase the state resources of foreign monetary.

**Research objectives:**

The main research objective is to evaluate the monetary policy performance through defining the suitable monetary policy for the Egyptian economy circumstances during the period (2004-2010). This is done through the display of the development stages of the monetary policy in Egypt and its legislative and corporative framework; the indication of its pillars and how to manage the monetary policy in Egypt during the research period. The research aims as well to determine the performance evaluation indicators of the monetary policy in Egypt during the period (2004-2010). This is done through defining the most important indicators of the monetary policy during that period to show the extent of its effectiveness; the most important of them are inflation rate, gross domestic product growth rate, international reserves, foreign exchange market, dollar-interbank, balance of payment, local public

debt and foreign debt and finally conclude findings and draw suitable recommendations.

**Research approach:**
The study has relied on the economic descriptive and quantitative matrix when analyzing the economic variables in Egypt in order to answer the research problem and verify the correctness and incorrectness of the research hypothesis and achieve the research objectives. The economic variables in Egypt are closely related to the work nature of the monetary policy. The research has used as well statistical techniques such as the percentage score to analyze the published data in the economic and statistical reports and newsletters of the central bank, the central system for public mobilization and statistics, the cabinet, information center and decision making support in Egypt. It has relied as well on available research sources either certain Arabic or foreign books, studies and scientific research in this field.

**Research limitation:**
The research limitation is restricted to the time period of (2004-2010) related to analyze the performance and indicators of the monetary policy in Egypt and examine the extent of its success in achieving its objectives.

**Research plan:**
the research consists of six parts, namely:

First: Stages of the monetary policy development in Egypt.

Second: the legislative and corporative framework of the monetary policy in Egypt.

Third: the main pillar of the monetary policy in Egypt

Fourth: Evaluation of the monetary policy instruments in Egypt during the period (2004-2010).

Fifth: Evaluation indicators of the monetary policy in Egypt during the period (2004-2010).

Sixth: findings and recommendations.

First: Stages of the monetary policy development in Egypt: The monetary policy development can be divided in the framework of economic reform policy into the following three stages:

**First stage (1991-1997):** this period witnessed exchange rate stability of the Egyptian pound in which it was considered as the main focus of the monetary policy. Through this stage the central bank began to transform from the direct tools to indirect ones in executing the monetary policy. It witnessed three financial reform programs besides part of the structural amendment program. This period includes the prices liberalization, public sector restructure through privatization processes, following up restrictive financial and monetary polices in order the prices liberalization do not to lead to inflation waves. The liberalization of return prices on the deposits and loans, the modernization of new funding mechanism to finance the public budget seasonal deficit through issuing various-terms treasury bonds. In addition, to the banking sector reform, implementation of international standards for capital adequacy according to the Basil committee rules; liberalization of currency exchange rate through establishing primary and secondary market with price difference between the two markets that does not exceed 5%. Finally, this stage includes liberalization of capital account and strengthens the money market authority. The monetary policy aimed at that stage to control the monetary expansion and maintain exchange rate stability, absorb liquidity surplus. The treasury bonds played at that stage an important role in activating the monetary market among banks to execute the monetary policy (Fayka El-Refai,2008).

**Second stage (1998-2002):** this the period which followed the end of financial reform program successful implementation. It witnessed internal and external shocks of the economic situations. At that stage the country suffered fluctuation of the Egyptian pound exchange rate; deterioration of external financial situation; large shortage of liquidity and economic stagnancy. The stage included a total deficit of the payment balance. The public budget and the government public debt increase, the monetary policy aimed at that stage to pump liquidity to activate economy and maintain the exchange rate stability, reduce inflation rate and increase the product growth rate. The monetary policy was not clear in relation to the exchange rate, but contradictory so it led to successive fluctuations of exchange rate and hence it was put aside as a main focus of the monetary policy. The world reserves and foreign monetary played a main role at that stage to execute the monetary policy.

**Third stage (2003-2010):** at that stage the central bank transformed from using the exchange rate as a main focus of the monetary policy, it began a preparation stage of the monetary policy depends on anti-inflation, creation of new operation objectives in accordance with the market mechanisms. The stage witnessed radical change in the banking system included several processes of sale, merge, and possession of banks; and the implementation of the act of banking system and the central bank and issued monetary in the mid 2003. the monetary policy at that stage aimed to prices stability through reducing inflation to a stable reduced level while maintaining the high investment and economic growth rates. The return prices of transactions between the Egyptian central bank and banks and the insertion of what is known as "the corridor technique" in order to achieve that objective. The focus is placed on the third stage that witnessed important developments in the monetary policy in Egypt as it is considered as the period which covered the time period limitation of the research.

**Second: the legislative and corporative framework of the monetary policy in Egypt:** According to the banks act of 2003, the main objective of the monetary policy is prices stability. The central bank devises the monetary policy objective in collaboration with the government through a coordinating council formed according to the republic president decree. The bank specializes in devising and executing the monetary, credit and banking policies. Article no. (6) stipulates that the central bank issues the securities related to what is suitable to the nature of its money, activity and involvement in the open market processes. Therefore, the Egyptian central bank sought to achieve a low and stable level of the inflation rate which contributes to confidence-building and helps achieve high rates of investment and economic growth.

The central bank declares its transformation from considering the exchange rate as the main focus of the monetary policy following the issuance of the Egyptian pound floating decree in January 2003. It lets the rate to be determined by demand and supply of the market. The bank started working in two directions: first, devising a long-term preparation plan to adjust the environment to adopt the anti-inflation approach' and second to develop the monetary policy in the pre-stage of implementing the anti-inflation approach. As for procedures to adjust the environment to adopt anti-inflation approach strategy, the central bank has been implanting since 2003 a number of programs; the most important of them are as follows (Egyptian parliament,2005):

- Developing the financial sector to provide a suitable mechanism to transfer the monetary policy tools. In this regard, a large scale banking reform program is implemented including the privatization of a number of banks and merge and possession of some other banks and confiscation of others. A market money development program is implemented in collaboration with international parties.
- Adopting several procedures to curb the bad credit phenomenon and fill in the gap accompanied the lending processes.
- Establishing a follow-up stumbling debts unit to handle the situations of stumbled debtors and clean up the banks credit portfolios.
- Making necessary arrangements for the main dealers to activate the primary and secondary market for governmental securities.
- Improvement of the macro-economy database and sustain the monetary policy transparency.
- Development of the monetary policy sector and improve the research and analytical experience of its staff.
- The monetary policy has a direct effect on the price stability and the inflation or diminish' extent of delinquency, the monetary policy affects the available or probably available credit size by the commercial banks.
- The effectiveness of implemented monetary policy depends on providing legal and institutional atmosphere and the selection of possible tools and their elasticity on the proper time.
- Anti-inflation as a final objective of the monetary policy is the centre axis and anchor of the monetary policy instead of the ex-

change rate as the case of the economic reform program. Thus, prices stability becomes the main concern of the central bank as a final strategic objective of the monetary policy in Egypt. However, the exchange rate is implied as the anchor of the monetary policy ahead despite the Egyptian central bank declaration that the main axis of the monetary policy is targeting inflation ahead.

- The adoption of institutional steps and operational steps as a new framework of the monetary policy in Egypt through creating a coordinative council headed by the prime minister in January 25 2005 and the inclusion of the corridor system since the mid 2005.
- Carrying out compulsory and voluntary merging processes between a number of banks has led to reducing the number of working banks in Egypt.
- The interest rate rise of the Egyptian pound deposits has led to minimize the dollarization phenomenon and develop the local deposits market in line of mobilizing and attracting savings.
- The inflation rate rise following the exchange rate liberalization because of the central bank concern of the higher growth rate than reduce the inflation rate even if the benefit distribution of that growth is imbalanced. In addition to other reasons related to supply side and imported inflation which interprets the inability of the monetary policy to realize its objective.
- The realization of high growth rate of the GDP during the research period of time despite the world financial crisis effects and impacts because of the successful implementation of the first economic reform stage and banking system development besides the stable confidence in the foreign exchange market.
- The world reserves size increase to the central bank reached about US$ 35.2 billion (which covers about 8.6 months of commodity imports) at the end of June 2010 by an increase reached US$ 3.9 billion estimated 12.5% during 2009/2010. The rise is attributed to the foreign currencies increase equal to US$ 2.3 billion, Egypt allocations increase of special withdrawal rights equal to US$ 1.1 billion. In addition to the gold value increase equals to US$ 0.5 billion as a result of its reevaluation at the end of June 2010 as usual at the end of every fiscal year. In addition, the balance of payment realized surplus during that period.
- The adoption of the managed floating policy of the exchange rate has led to appreciate the Egyptian pound against the foreign currencies since the beginning of 2005 till 2010. In addition, the central bank successful management of the foreign exchange market through the dollar interbank market. This has contributed to confirm the dealers' confidence and lessens their worries about probable fluctuations that may affect the Egyptian pound.
- The Egyptian balance of payment has realized surplus during the research duration except in 2008/2009 because of the world financial crisis impacts.
- The large domestic debt rise (LE 888.7 billion) and the external debt (US$ 33.7 billion) and the external debt service burden decline (at average and long terms) by 16.3% to be restricted to about US 2.6 billion in 2009/2010.

In light of the previous results, the research recommendation can be summarized as follows:

- The activation of legislations related to the monetary policy particularly the necessity to preserve the central bank independence in light of the latest decisions in this concern.
- The continued and managed floating policy of the exchange rate to preserve the exchange rate stability, combat against inflation and reduce the public budget deficit appreciate the Egyptian pound against the other foreign currencies.
- The activation of monetary institutions related mechanisms to transfer from the decision making status to more effective execution channels according to the monetary policy objectives.
- The necessity of coordinating between the monetary policy and other policies to support the structural reforms of the Egyptian economy.
- The adoption of scientific techniques to curb the resulted risks from exchange rate changes or the interest rates by using financial geometry.
- Clear concentration on targeting inflation as a main axis of the monetary policy to curb the inflation rates increase.
- Encouragement of exports and curbing imports in order to lessen the trade balance deficit and preserve the realized surplus of the balance of payment.
- Curbing the external and internal loans to finance the public budget deficit and search for national financing resources through encouraging the private local and foreign investment.

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