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Monetary and Exchange Rate Policies – Egypt's Version of the Mundell Trilemma

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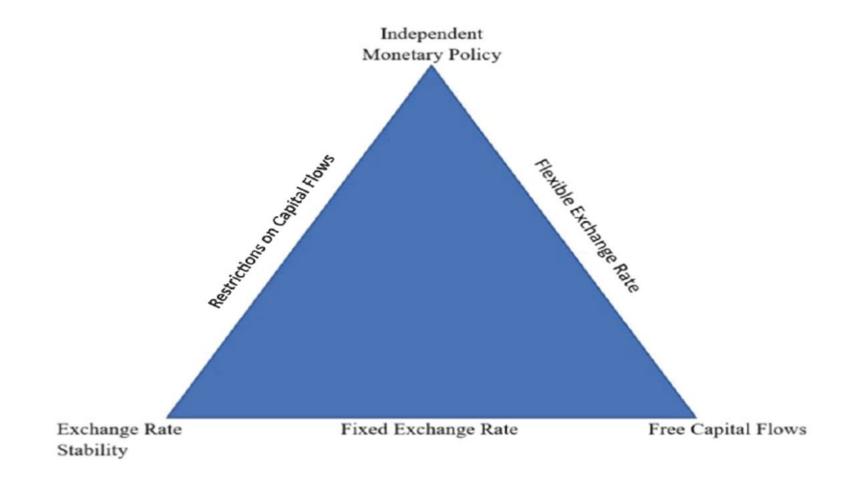
Part VI: Macroeconomic Policy

24) Monetary and Exchange Rate Policies – Egypt's Version of the Mundell Trilemma

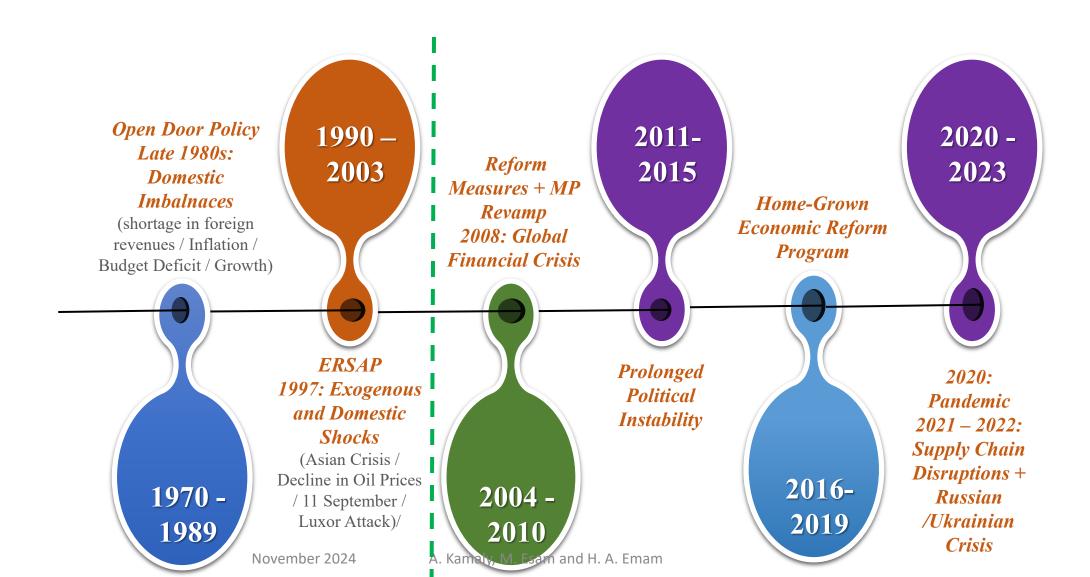
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Mundell Trilemma (Impossible Trinity)







Stable ER – Low degree of monetary independence & Capital mobility

1970 - 1989

Ineffective MP
Fiscal Dominance
Crowding Out

Law 120 - 1975

- Multiple CBE objectives NOT including price stability.
- CBE executes and implements (not set) MP and ER Policy.
- CBE can freely use MP instruments.

Monetary Policy

- Monetary Targeting Regime
- Direct MP tools (IR limits and preferential IR / Limits on credit Expansion)
- Indirect tools (discount rate/reserve requirements)
- Fiscal Dominance

Exchange Rate Policy

- Two Official Pools (CB pool and Commercial pool)
- Authorities set official rates
- Illegal nonbank market

Capital Flows

- Partial liberalization of capital account led to a surge in capital inflows.
- Reversal of capital inflows in late 1980s.

Stable ER – Mild Capital Mobility – Monetary Dependence

1990 - 2003

No price stability Rigid IR Structure No indication of MP stance

Presidential Decree 59 - 1993

- Multiple CBE objectives NOT including price stability.
- CBE executes and supervises (not set) MP and ER Policy.
- CBE can freely use MP instruments.

Monetary Policy

- Multiple Conflicting Objectives (Growth / Inflation / ER).
- Monetary Targeting Regime (operational target: IR Excess Reserves).
- Abolishing credit ceilings liberalization of deposit and lending rates.
- Shift to Indirect tools (T-bills auctions/discount rate/reserve requirements/repo and reverse repo / domestic currency interbank).

Exchange Rate Policy

- Unification of exchange markets with CBE intervening to preserve an implicit band in 1991.
- Revival of the black market with 1997 shocks + draining of reserves.
- Dejure managed floating regime in 2003.

Capital Flows

- Till 1997, massive capital inflows through CBE repatriation mechanism.
- Starting 1997, capital flight.

2004 - 2010

Law 88 - 2003

- Price stability and assuring the soundness of the banking system (non-conflicting objective).
- CBE sets and executes MP and can freely use MP instruments.
- CBE regulates, manages, and supervises the foreign exchange market.

Monetary Policy

- Complete revamping with the announcement of price stability objective.
- Intention to adopt IT in the medium term.
- Implicit nominal anchor.
- Price targets/launch of corridor system / new instruments like CBE CDs and Notes/launch of yield curve for T-bills.
- MPC undertakes policy rate decisions.
- Promotion of CBE transparency and research agenda.
- Launch of TSA in 2006 to control CBE financing to government and dampen fiscal dominance.
- In 2009, the CBE relied on interest rate cuts and open market operations to mitigate the crisis.

Controlled ER –Free Capital Mobility – Constrained MP Independence

2004 - 2010

CBE worked on achieving price stability and growth

Exchange Rate Policy

- Launch of the interbank currency exchange market in 2004.
- Black market ceased to exist and exchange rate was unified.
- Direct Foreign exchange intervention in 2009 to fight speculative attacks

Capital Mobility

Mostly capital inflows except during the global financial crisis.

Managed ER – Low Capital

Mobility - Independent

MP

2011 - 2015

Output stabilization and ER manipulation

Law 88 – 2003

Egypt's Constitution

• The constitution referred to CBE as the independent authority responsible for setting and implementing the supervision of MP.

Monetary Policy

- Juggling between sluggish growth / surging inflation / deteriorating domestic currency.
- New MP tools, like, 7-day and 28-day repo operations and deposit auctions. In addition to IR and reserve requirements alterations.
- CBE provided direct and indirect credit to the government and supported the price of government securities.

Exchange Rate Policy

- The resurgence of the black market with the dwindling reserves.
- CBE intervened in the market through, direct FX sales in 2011, Regular FX auctions, exceptional FX auctions, repatriation mechanisms, and supplying foreign currency to the public sector.
- Obliging banks to direct FX receipts towards strategic needs

Capital Flows

• Low capital mobility due to foreign currency squeeze, capital controls, and instability.

Managed Floating ER –Free

Capital Mobility – MP

Independence

2016 - 2019

Law 88 – 2003

• Same legal framework with a new law being drafted.

Monetary Policy

- Modernized MP framework with price stability being the ultimate objective.
- Hybrid system of monetary targets (IR and reserve money).
- Announced targets for inflation, target bands, and achievement horizon.
- CBE and MoF agreed to contain TSA to the legal limit and minimize new issuances of indirect credit. .

Exchange Rate Policy

- More flexible ER system.
- The black market disappeared.
- CBE refrained from intervening in the foreign exchange market.

Capital Flows

 Significant capital inflows due to high interest rates and exchange rate stability.

Juggling between controlling exchange rate, capital mobility and monetary independence

2020 - 2023

Law 194 – 2020

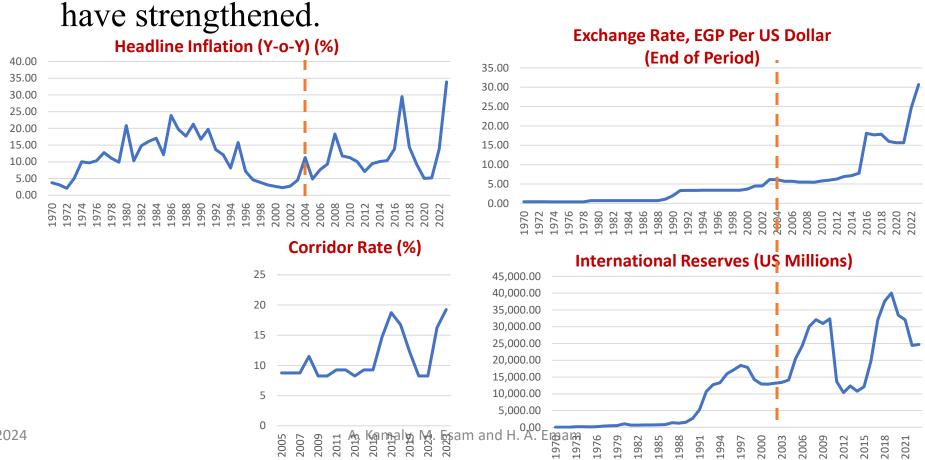
- Price stability and ensuring the soundness of the banking system (nonconflicting objective).
- CBE formulates and implements MP.
- CBE determines and implements FX policy.
- Monetary Policy
- Price stability is the ultimate objective of MP.
- Both conventional and unconventional MP tools (policy rate cut/credit initiatives/measures to boost domestic liquidity / Equity support fund to support unjustified selling waves).
- Incentivize electronic banking activities.

- Exchange Rate Policy
- In 2020, the CBE and GoE tapped the international market for financial assistant and issued Eurobonds.
- CBE intervened directly in the FX market in 2020.
- In 2021 2023, ER was devalued four times and the policy rate increased but those measures were delayed and not successful.
- Thus, the black market revived again.

Capital Flows

• Issuing measures of Capital Controls.

Since 2004, interlinkages between exchange rate, international reserves, and the conduct of monetary policy



Exchange rate acted as a transmitter and amplifier of financial shocks.

Despite various reforms, economic policy in Egypt has been drafted with the same modalities across five decades.

- Defending EGP through reserves
- Preserve MP Independence
- Safeguard capital flows

Onset of Crisis

Dwindling reserves

- Issuance of Capital Controls
- MP dependence
- Revival of black market

- Exchange Rate devaluation
- MP and ER policy fails to restore confidence or stability

Loss of Credibility

Reform Program + IMF

- Reorientation of the monetary and exchange rate policies towards more aligned priorities while considering the Mundell trilemma.
- The CBE needs to further adhere to the price stability objective and inflation targeting prerequisites in terms of transparency and credibility to better anchor inflation expectations and reduce the second-round effect of exchange rate volatility.

- Any degree of fiscal dominance has to be avoided
- Promoting a Crisis Early Warning System to facilitate the adoption of more proactive monetary and exchange rate policies.

Thank You