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Workshop 4

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***Monetary Policy and Central Banking in the Middle East and North Africa:
Policies, Politics and Prospects***

directed by

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Workshop abstract

The aim of this workshop is to stimulate and provide a forum for research on monetary policy and central banking in Middle Eastern and North African (MENA) countries. This is an important area in which both policy and research are lagging. Most MENA countries have exchange rate pegs which have been adopted more by default than as the result of a conscious evaluation of the alternatives, and few have any other intermediate targets for monetary policy. At the same time there is relatively little research on the nature of the monetary policy frameworks of most of these countries (the partial exceptions are Turkey, Lebanon, Egypt and Iran), or on their implications for income distribution, poverty or stability. We know of almost no work for the MENA countries on the question of how monetary policy should respond to asset prices, which has become an important issue in monetary policy debates. And there is clearly scope for much more research on the appropriate exchange rate regime for different MENA countries. Our aim in organising this workshop is to encourage and bring together papers which will fill in some of these gaps, drawing on the gradual increase in recent years in the amount of research being carried out on these issues, including that by PhD students, in universities, research institutes, central banks and international organisations, both in the region and elsewhere. Our hope is that the papers will turn out to be of sufficiently high quality and coherence that they can serve as the basis for an edited volume on monetary policy and central banking in MENA countries.

Workshop description

The workshop will seek papers mainly (but not only) in the following five aspects of monetary policy: First, the recent and ongoing development of monetary policy frameworks in MENA countries; second, the political economy of central banking and monetary policy in the MENA region and the impact of monetary policies on income distribution and poverty; third, the relationship between the development of financial markets and the monetary transmission mechanism; fourth, the role of monetary policy in the MENA region in causing or dampening macroeconomic fluctuations and the appropriate response of monetary policy to asset prices; and fifth, the exchange rate regime choices facing MENA countries, particularly in the light of the possible impact of the Euro-Med Agreements and the Eurozone on monetary policy conduct in the region.

1. The Development of Monetary Policy Frameworks

Economists have made enormous strides in the last two decades towards understanding what monetary policy can and cannot do and how it can best be organised, but inevitably most of this work has focused on the industrial countries. While the economies of the MENA region remain under-researched in general (compared, for example, to Latin America or India), this is particularly true of the macroeconomic and monetary area. On Turkey the Central Bank has produced a number of research papers (eg Emir and Karasoy, 2000; Ozatay, 2005) and other economists have made contributions (eg Celasun and Rodrik, 1990; Canova and Favero, 2005). There are a few good papers available on Iran (eg Pesaran, 2001). Some good work has been done on monetary policy in Lebanon (eg Dibeh, 2002; Makdisi, 2004) and in Egypt (eg Abdel-Khalek, 2001; Ikram, 2006). However, the quantity of research on these countries is limited and that on other Arab countries is even more so. Moreover, the Bank of England survey (Mahadeva and Sterne, 2000) which gives basic information on monetary policy targets and central bank independence for some 90 countries, includes only Bahrain, Egypt, Jordan, Kuwait, Lebanon and Turkey from the MENA region.

Under this heading we will therefore be looking for papers which analyse the recent and ongoing evolution of monetary policy frameworks in MENA countries, including: the (rather limited) moves in the region towards operating on market interest rates as opposed to quantitative limits on bank lending; the nature of the intermediate targets for monetary policy if and where they exist; the extent to which commitments to fixed exchange rates have pre-empted other choices in monetary policy strategy; the (rather limited) extent to which bond markets, in which the government could borrow from the private sector rather than the banks, have been developed; and the evolution of relationships between central banks and governments. Such papers will be largely empirical, and might be either comparative or single country case-studies.

2. The Political Economy of Central Banking and Monetary Policy

Research on the political economy of central banking and monetary policy has highlighted the importance of politics and institutions in the determination of monetary policy in both developed and developing countries. According to various perspectives in this line of investigation, the role of various social and political groups, central bank independence vis-à-vis the state, and private sector preferences are all important in the determination of central bank policy stances such as inflation-fighting or output stabilization (Epstein, 1992; Cukierman, 1994; Henning, 1994; Franzese, 2002). Maxfield (1998) has also shown that in developing countries the international dimension to the politics of central bank independence and currency values is significant. Moreover, the resultant

monetary policy adopted by central banks such as inflation-targeting or commitment to output stabilization has tremendous social and economic effects. For example, Elson and Cagatay (2000) argue that in the 1990s a ‘deflationary bias’ in macroeconomic policy in many developing countries caused high interest rates, tight monetary policies and fiscal restraint that had a negative impact on unemployment. Also under this heading, debates (that potentially have relevance to MENA economies) on the appropriate institutional and legal set up of central banks can shed light on the interaction between central banking and economic development. In a recent paper, Epstein (2005) has argued that central banks have played historically (and should play in the future) an active role as agents of economic development. Another interesting topic under this heading is the investigation of the relationship between central bank independence and democracy (Blinder, 1998).

In the MENA region the political economy of monetary policy has not received much attention. In a working paper, Abdel Rahman (2000) has studied, using Partisan Theory, the different policy stances of political regimes in affecting output growth, inflation and political cycles, focusing on finance and monetary policy in the MENA region. Other examples of papers on the subject include Dibeh (2002) which studies the inflationary period of the 1980s and early 1990s in Lebanon. Mitchel (1999) has linked the monetary restraints practiced in the 1990s in Egypt to the triumph of neoliberalism in the political imagination of Egypt. A recent study links political violence in Egypt to currency choice which may have significant monetary policy implications (Fielding and Shortland, 2005).

We will be seeking papers that investigate the issues under this heading in the MENA as a whole or in the form of country case studies. Of primary interest are the relationships between central bank independence and economic outcomes and between central bank independence and democracy: is higher central bank independence associated in MENA countries with lower inflation and more stable output? are central banks more or less independent in countries where democracy is more strongly embedded in the constitution and the social consensus? We would also be interested in papers on the role of political and economic interest groups in the shaping of monetary policy, and on the role of financial openness and capital flows in constraining the monetary policy choices available to central banks.

3. Money and Financial Markets and Their Role in the Transmission Mechanism

The importance of financial market development in facilitating economic policy and economic growth is widely accepted. The development of efficient and liquid money markets – that is, markets for short term securities such as Treasury bills, Certificates of Deposit, and inter-bank deposits – allows monetary policy to operate through interest rates, whereas in the absence of such markets policy has to work through quantity effects (eg direct controls on the quantity of bank credit) and exchange rates. Similarly the development of efficient and liquid government bond markets allows governments to borrow from the private sector, while the absence of such markets means governments can borrow domestically only from the banking sector (which implies increases in domestic credit or the money supply). Thus the absence of developed government bond markets implies unhelpful constraints on the linkages between monetary and fiscal policy. In most of the MENA countries these markets remain relatively underdeveloped, though this is less true for some (e.g. Turkey, Egypt and Lebanon). At the same time corporate bond markets are even less developed, while many stock markets are heavily insider-dominated; this has implications for the sources of financing for firms, and for the way in which monetary policy impacts upon them. In general the formal financial sector in MENA countries is subject to heavy regulation, and the less regulated

informal sector, where it exists, is typically centred on money-changing and does not serve as a significant source of finance for firms (or governments).

The development of financial markets in MENA countries has not been the subject of intensive research; for example, a search in the ERF working papers database turned up only two papers under the heading of financial markets, and none under money or bond markets. And work on the impact of financial markets on the monetary transmission mechanism is even more scarce (but see Sourial, 2002, on the credit channel in the transmission of monetary policy in Egypt).

We will be seeking papers on the transmission mechanism in MENA countries with particular reference to the extent of the development of money and bond markets. For example, papers may address the question of whether monetary policy is entirely a matter of quantities (DCE) or whether there are important price effects; or the question of how much flexibility exists in practical terms in the relationship between monetary and fiscal policy (i.e. how completely do budget deficits determine monetary growth?).

4. Monetary Policy, Macroeconomic Fluctuations and Asset Prices

Many countries in the MENA region have ongoing histories of macroeconomic instability (Celasun and Rodrik, 1990; Makdisi, 2004; Ikram, 2006). In this respect, it is important to study the role of monetary policy in causing or dampening such instabilities. The role of monetary policy in macroeconomic fluctuations has been discussed widely in the literature in developed countries (Canova and Nicolo, 2002; Sims, 1998). The cost of disinflationary policy in the developed countries has been large although not as devastating as early estimates have predicted (Blinder, 2005). The prime example of such a policy was the Volcker experiment in the USA in 1979-81 in which monetary contraction aimed at fighting the 1970s inflationary situation caused unemployment to vary between 7% and 10% from 1979 to 1986 with significant output loss. In a recent paper, Ersel and Kandil (2000) have shown that in some countries in the MENA region monetary policy has an effect on output and economic growth. The structure of the economy and the agents' expectation formation allows for even anticipated changes in money supply to have an effect on output. Hence, as the central banks become more independent and monetary policy geared more towards inflation-fighting in the MENA countries, the impact of such policies on output, unemployment and social welfare becomes an important object for study.

The globalization of financial markets has eroded the differences in the scope and severity of financial crises that existed between different regions of the world. For an example which is highly relevant to the workshop, international capital flows have destroyed the East Asian exception and transformed the region in a way that is comparable to Latin American financial markets (Kaminsky and Reinhart, 1998). The development of financial markets in the region has accelerated in the past 10 years. Financial market developments in Turkey, Egypt, Lebanon and Tunisia probably represent the most advanced. This trend presents new challenges for central banks and monetary policy in the region. The prospect of currency crises and financial market collapse puts further pressure on central banks to develop policies and mechanisms to prevent market crashes. New developments in monetary policy thinking that have emerged after the bubble of the 1990s provide the basis for asset market-macroeconomic interactions and interfaces. In a recent speech in Singapore, Jean-Claude Trichet, President of the ECB, considered the topic "asset price bubbles and monetary policy" to be one of the most challenging issues facing a modern central bank at the beginning of the 21st century. In this respect, economists have started investigating the proper monetary policy tools for preventing bubbles (Bernanke and Gertler, 1999; Cecchetti et al. 2000; Detker and Smets, 2004). Research on this subject

in the MENA region, however, is almost non-existent. A working paper by Sourial (2002) has shown that the stock market in the future may play an important role in monetary transmission in Egypt, while Kara and Ogunc (2005) have studied the exchange rate-prices pass-through for Turkey. But there is clearly scope for more work on the effect of asset price movements and on the appropriate policy to offset or pre-empt the adverse consequences.

5. Alternative Exchange Rate Regimes for the MENA Region

Most MENA countries have pegged their currencies more or less continuously to the US dollar, although more of their trade is typically with European Union countries than with the US (Frankel and Rose, 2002, noted that Egypt and Turkey had more trade with the Eurozone than with the dollar zone, and predicted on that basis that they would gain more from joining EMU than from dollarisation). The Euro-Med Agreements which have been signed in recent years between the EU and Algeria, Egypt, Jordan, Lebanon, Morocco, the Palestinian Authority, Syria and Tunisia are likely over the next decade to have a significant positive influence on the flows of trade and investment between the EU and these MENA countries. In addition, the emergence of the euro and the Eurozone mean that there is now, for the first time, a substantial and viable alternative anchor currency for these countries and, indeed, for the other MENA countries. On the other hand some observers have pressed for greater flexibility in MENA exchange rates (Jbili and Kramarenko, 2003). It is important, therefore, to consider the desirability of a peg to the euro, as well as that of other alternative possible exchange rate regimes, such as regional currency unions, on the one hand, and genuine floats, on the other.

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Abstracts of directors' individual papers

Alternative Exchange Rate regimes for MENA Countries: Gravity Model Estimates of the Trade Effects

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A recent literature sparked by Rose (2000) has found large effects on trade from membership of currency unions. Frankel and Rose (2002) examined the effect of currency unions on trade and economic growth, and with respect to the MENA countries found that since both Egypt and Turkey had more trade with the eurozone than with the dollar zone they would benefit more from adopting the euro than from dollarisation. In a recent paper (Adam and Cobham, 2006) we estimated a gravity model which includes not just currency unions but a full menu of 21 different bilateral exchange rate regimes, from both countries being members of the same currency union through each pegging to different anchor currencies to both having freely floating exchange rates. The model allows us to investigate in more detail the effect of alternative exchange rate regimes, allowing for the changes in the regime between a country and each of its trading partners.

In this paper we will employ the same methodological approach to focus specifically on the effects of alternative exchange rate regimes for the various MENA countries, making use of a dataset updated to include the first five or six years of European monetary union. Based on an estimated gravity model we will simulate countries' likely trade patterns under different assumptions about their exchange rate regimes. In particular we will examine the effect of pegging to the euro rather than pegging to the dollar, which is what most MENA countries currently do, and we will also consider the impact on trade of regional currency unions which have been proposed elsewhere (Gulf Cooperation Council, Maghreb, the Levant countries in the context of a peace agreement, etc). We will do this by generating estimates of the likely trade patterns of MENA countries for (a) *ceteris paribus* changes in individual country regimes and (b) joint changes in the regime of a likely set of countries, in the cases of (i) pegging to the euro, (ii) euroisation, (iii) dollarisation, (iv) regional currency unions and (v) free floats.

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The Rise of Central Banking in Lebanon: Lessons for MENA Countries

Ghassan Dibeh

Most MENA countries have either adopted or are in the process of adopting economic and financial market reforms that include the conduct of monetary policy and the role of central banks in economic policy making (for reforms in Egypt, see Galal and Lawrence, 2005). The main elements of monetary policy reforms involve the legal status of central banks and their independence vis-à-vis political authorities and financial markets and the choice of monetary policy objectives such as inflation targeting, output stabilization or external balance. Such choices will have important effects on inflation, economic growth and income distribution in MENA countries (for effect in transition economies, see Cukierman et al, 2002). This paper is divided into two parts: the first part studies the political economy of the rise of central banking in Lebanon, a country with a tradition of free market policies; and the second part draws lessons from this experience for MENA countries. The political economy of the rise of an independent central bank in Lebanon shows that the Banque du Liban (BdL) established in 1964, twenty years after independence, was greatly influenced by the banking system, the most influential economic player at the time, and by the political-economic matrix of finance-industry relations and labor market conditions. This has led to a rise of a largely independent central bank that had the objectives of fighting inflation, maintaining the value of the Lebanese currency and achieving balance of payments equilibrium. The conduct of monetary policy in 1964-71 reflected this independence and the anti-inflation bias of the BdL. During the sixties, the BdL followed a noninterventionist policy except during the Intra bank crisis that threatened the banking system with bankruptcy. This incident enhanced the micro functions of the BdL through increased regulation of the banking industry. However, on the macroeconomic level, the BdL did not wield any of the traditional tools of monetary policy. The BdL conducted a deflationary policy hindering the usage of counter-cyclical measures at its disposal. Monetary aggregates grew at lower rates than in the period preceding the establishment of the BdL. In the 1960's, the growth rate of the economy slowed significantly. This is not surprising since an excessive concern with inflation may result in a monetary policy that lowers growth rates and increases unemployment levels (Epstein, 2003).

The second part of the paper then derives lessons from the Lebanese experience for the MENA countries. The current state of central bank independence in the MENA is assessed. The paper constructs a central bank independence index (Cukierman, 1992) for selected countries in the MENA: Lebanon Tunisia, Egypt, Morocco, Algeria and Syria. The central bank independence index will be constructed as a function of legal, institutional and operational setup of central banks in these countries. The relationship between the degree of independence and inflation performance and economic growth in the past two decades is investigated. The relationship between central bank independence and the political-economic regimes on one hand and the central bank objectives such as inflation targeting, output stabilization or external balance and currency values will be also studied.

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