The Political Economy of Governance in the Euro-Mediterranean Partnership

Macroeconomic Policy Standing Group (MPSG)
Working Paper 1

The Euro-Mediterranean Partnership as Macroeconomic Policy Anchor

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"The policy outcomes are the result of two factors: the preferences of the actors involved and the prevailing institutions …" Tsebelis 2002:33

I. Introduction:

The Euro-Mediterranean Partnership (EMP) can be viewed as the cornerstone of the EU's policy consistency towards the Mediterranean region, which has been recently developed towards deeper economic integration and shared responsibilities through the European Neighborhood policy (ENP), which pursue the objective of associating and stabilizing its partner states.

However, some scholars have argued that the new policy is unlikely to work because of the lack of the member-ship incentive. In response, Moschella (2007) shows that there is no robust evidence that can support such an argument. In addition, he interprets the ENP as the mark of the shift from a policy-change towards policy-level, where the level of institutional and political capacity of the neighbor country shapes the nature of its relationship with the EU. In other words, the content of the relationship is made conditional upon the level of institutional and political capacity of each partner thereby suggesting "a policy with variable geometry", Tulmets (2006).

In simple terms, Fantini and Dodini (2006) expect that the ENP can have an impact on economic growth through three interrelated channels:

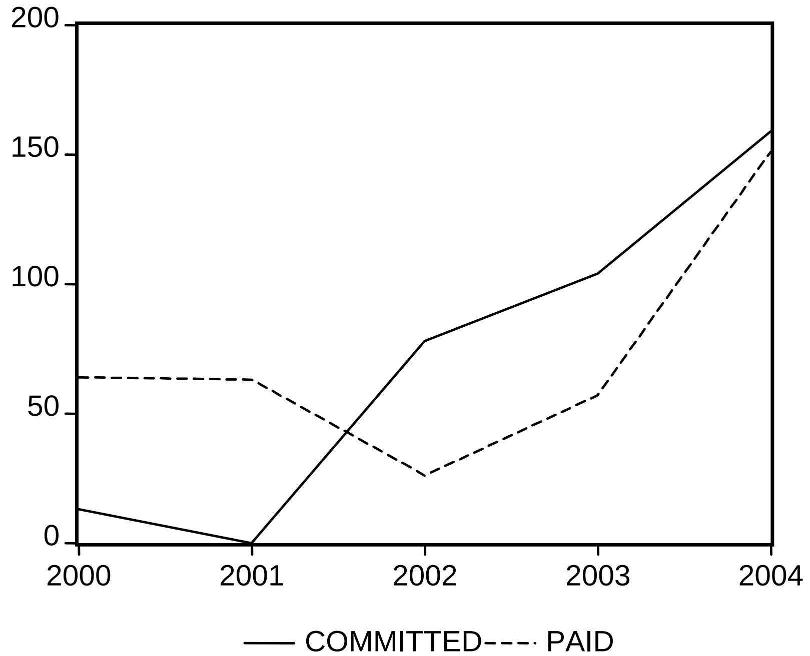
- Structural reform by upgrading the regulatory framework.
- Macro-policy anchor by adhering a sound monetary and fiscal policies.
- Trade and factor movement by reducing tariff and non-tariff barriers.

There is a wide consensus in the literature that structural reform, sound macro policies and trade liberalization are essential to growth. In this context, it is believed that the EU could play a crucial role in fostering structural reform by opening the prospect of participating in the EU internal market to neighborhood countries (NCs). The ENP aims to replicate this effect and also expects to promote sound macroeconomic policies in the NCs. The action plans foresee that the NCs have to commit to sustainable monetary and fiscal policies. However, nothing concrete on macroeconomic policies making to achieve this aim has been formulated in the EMP strategy thus far.

II. Egypt at Glance:

Egypt is one of the beneficiaries of community assistant among other Mediterranean partners as the EU is the largest second donor to Egypt. The Euro-Mediterranean agreement between the European Commission (EC) and Egypt was signed in June 2001 and entered into force in June 2004. The action plan for this agreement sets out a comprehensive list of priorities, all of which are important. One of the most important priorities is economic development and reform. The agreement aims at improving macroeconomic stability and promoting growth and employment. The macroeconomic stability can be pursued by reducing the inflation rate and gradual achieving price stability through following inflation targeting policy. Also, continue the efforts to reduce the central government deficit and to the consolidated public deficit. Figure (1) shows the community and macroeconomic assistance of the EU to Egypt based on the data from the country report of the ENP in 2005.

Figure (1): The Community and Macroeconomic Assistant (MEDA I & MEDA II) in Million Euro



Source: Country Report on Egypt. (2005), "European Neighborhood Policy"

Achieving macroeconomic stability through maintaining low level of inflation and unemployment in the presence of moderate economic growth rates is a cornerstone in achieving economic prosperity. Figure (2) plots the bank deposit rate and inflation rate during the period 1980 – 2006. It shows that the inflation rate was at its minimum level of 2.2% in 2001, going down from 23% in 1986. However, Egypt could not maintain this low level of inflation achieved in 2001 as the inflation went up again to 11.2% in 2004 with deposit rate equaled 7.7%, which means that Egypt had negative real interest rates in 2004 and 2006. The unemployment rate was increasing during the period 1997 – 2005 to reach 11% in 2005 then it went down slightly in 2006 to reach 10.6%, as seen in Figure (3). The growth rate of the real GDP declined gradually during the period 1989 (18.8%) to 2002 (2.3%) accompanied with a gradual decline in inflation rate as can be seen in Figure (4). Figure (5) shows that the current account improved since 2001 and it reached its peak surplus in 2003 when Egypt abolished the fixed exchange rate system resulting in a huge depreciation in the Egyptian pound relative to the US dollar (Figurer 6).

Figure (2): Bank Deposit Rate and Inflation Rate in Egypt From 1980 to 2006

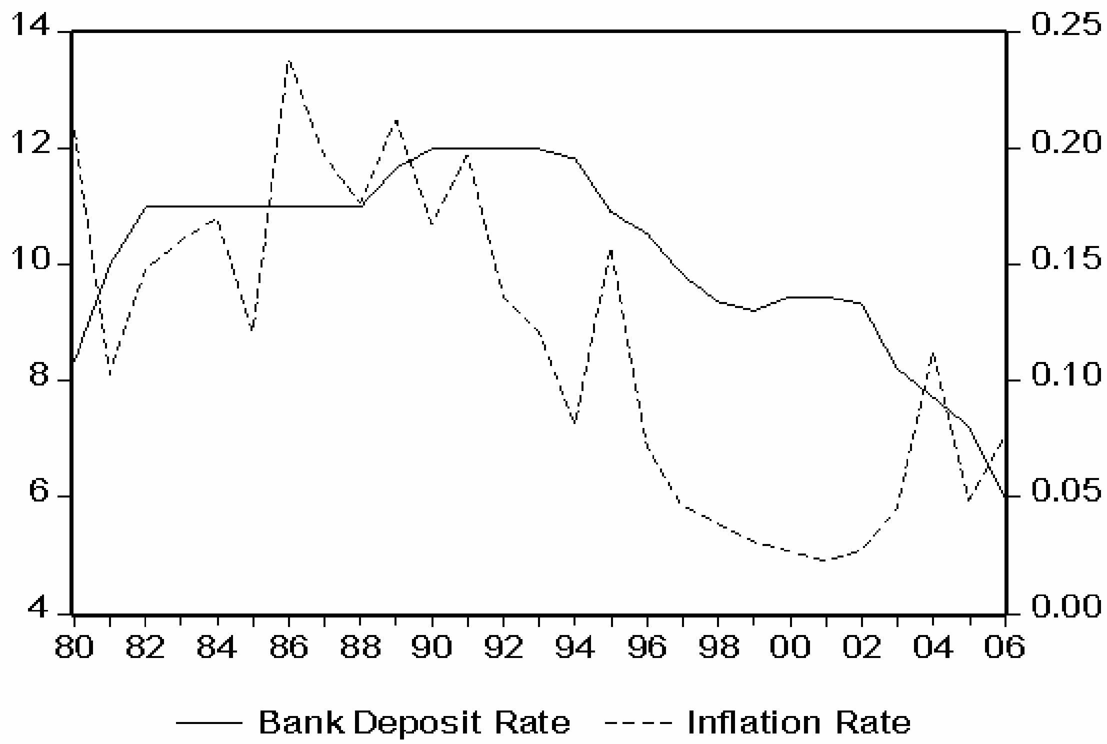


Figure (3): Unemployment Rate in Egypt from 1989 to 2006

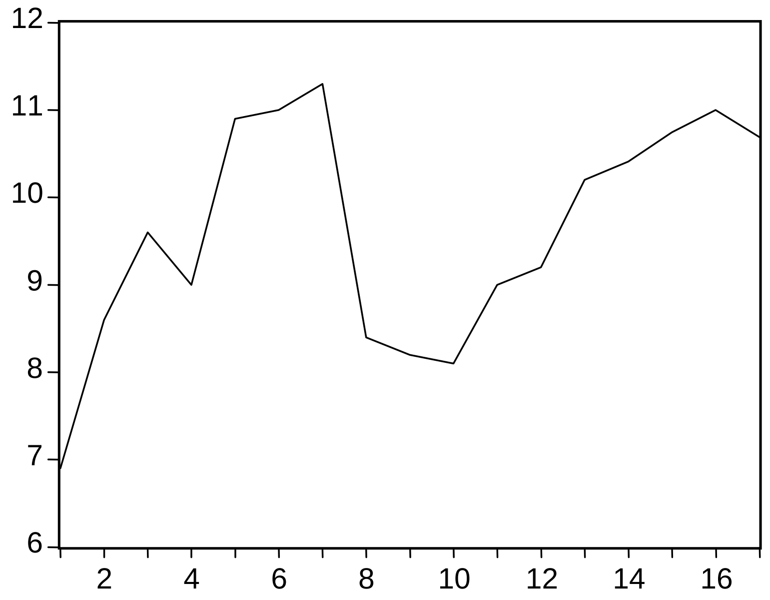


Figure (4): Inflation Rate and Growth Rate of Real GDP in Egypt between 1983 and 2006

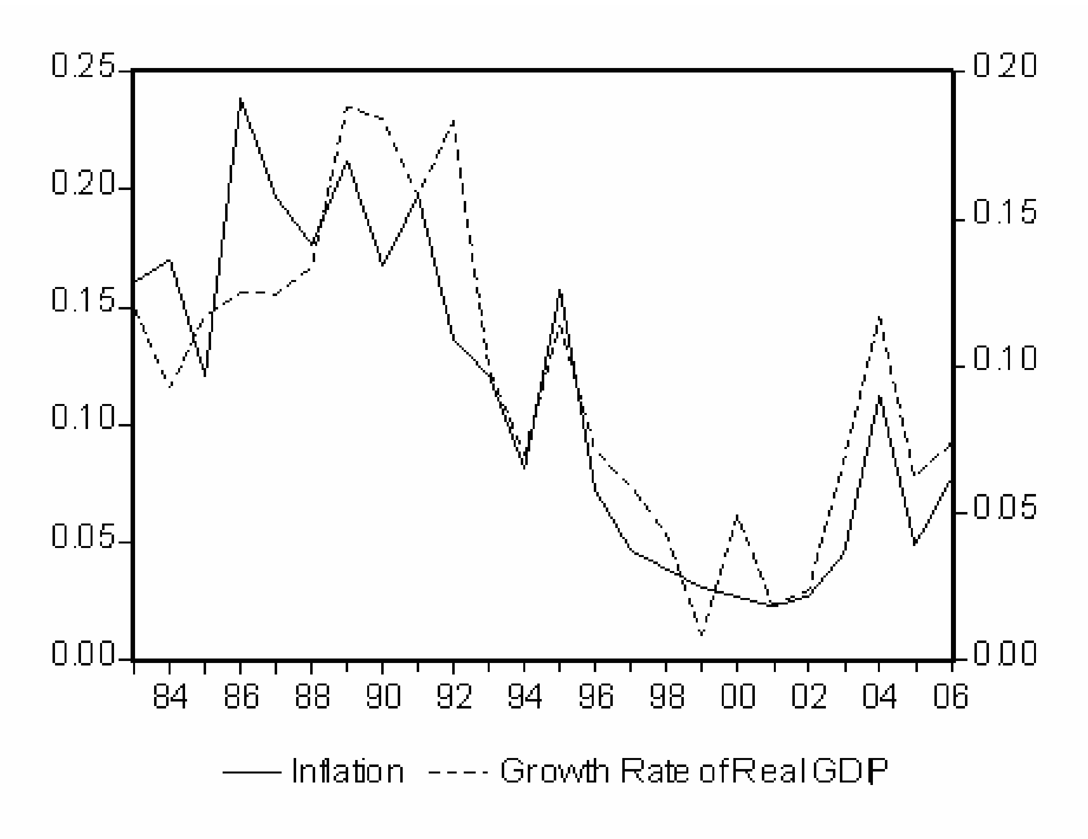


Figure (5): Current and Financial Account in Egypt from 1979 to 2006

($ Billion)

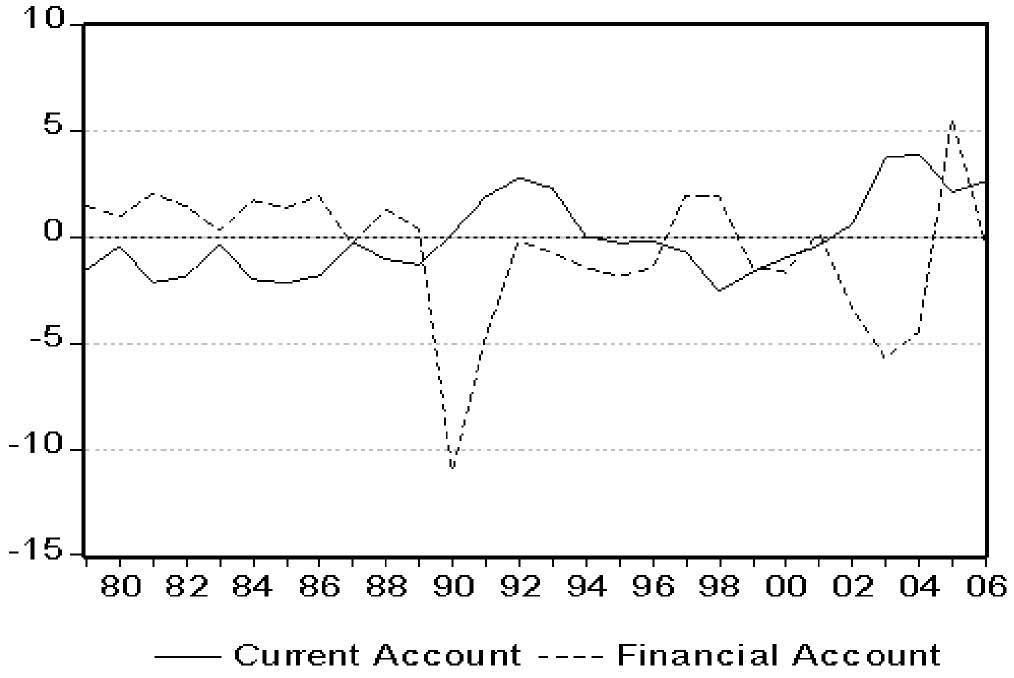
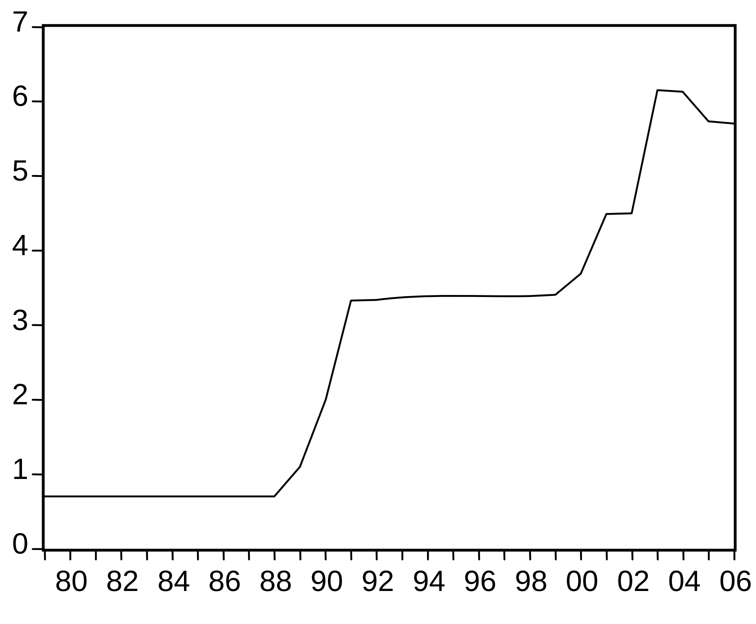


Figure (6): Exchange Rate of US Dollar to Egyptian Pound from 1979 to 2006



Therefore, one of the main objectives of the paper is to conduct an empirical investigation on the effectiveness of the monetary policy in Egypt. We show that the inflation targeting policy is not effective in Egypt. This poses a challenge to sustain macroeconomic stability in both the medium and long term.

Macroeconomic effects of trade liberalization has been investigated in Choudhri, Faruqee and Tokarick (2006). They show that trade liberalization leads to long-run gains, but it can also involve costly short-run macroeconomic adjustment. The welfare effect of trade liberalization is decomposed into: (1) steady-state efficiency and (2) transitional loss associated with wage-price stickiness. They show that the transitional loss is small relative to the gain in efficiency from the steady-state. This transitional loss can be reduced through adopting a flexible price-level targeting policy rule.

In Fantini and Dodini (2006), the ENP is offering the NCs enhanced preferential trade agreement which will grants these countries a stake in the EU internal market, participation in the some of the EU policies and programs, and increasing the technical and financial assistance. The high level of economic integration in form of eliminating tariffs will carry economic costs. Even if there were a safe guard system, this economic integration will increase vulnerability to shocks originating from other ENP countries. The expected increase in economic openness has implications for the stability of macroeconomic policy. A higher concentration of trade with the EU and the euro area could increase risks if the previous trade structure offered a more balanced geographic repartition. Some NCs countries export commodities priced with US dollars while these countries import from EU countries services and commodities prices in Euro. This will exacerbate swings in these countries trade accounts.

Economic integration in form of eliminating tariffs will most probably lead to an increase in the already large fiscal burden due to the fact that government spending cannot be financed through tariffs income. It will also lead to a shock in terms of trade, which will shift economic rents within the Egyptian economy. In order to sustain political support, the government might face a political need of compensating certain interest groups for their economic rent losses. In addition, a shock to the terms of trade might also have an impact on the exchange rate. In this case, the free movement of goods and services will have an impact on the real exchange rate, hence it will influence the nominal exchange rate.

The empirical evidences show that improving liberalization and achieving sustainable growth and welfare cannot be maintained in the absence of macroeconomic stability (Nsouli et al., 2002). Commitment to sustainable fiscal and monetary policy can be seen as necessary precondition for the implementation of the EU action plans with their neighbors. This is not only due to the direct positive spillovers effect of its economic growth but also because of its indirect effect of maximizing the potential positive gains from the liberalization of capital movements.

Moreover, it is worthy to understand that the continuation of unsustainable macroeconomic policies have not been ever due to lack of proper economic advice but rather to lack of political will and support for structural reform. This generally entails short-term political costs, while provides benefits in the long term.

Recalling the fact that fiscal deficits have remained high in several emerging economies, preventing debt levels from declining sufficiently, IMF (2007), implying a *de-jure* adoption of the Washington Consensus framework. According to this framework, the fiscal discipline should be the initial step in the stabilization process as shown in Box (1).

Box (1): The Washington Consensus	
Stabilization	**Fiscal Discipline:** Public deficits should be so small that they can de financed without an inflation tax, i.e., by printing money. This implies a primary budget surplus that depends on the amount of debt accumulated. The total deficit after debt service should not exceed 2 percent of GDP. **New Priorities for Fiscal Spending:** Public expenditure should be restructured in favor of spending categories with high economic and social benefits. This implies less resources for administration, defense, subsidies, and the state-owned enterprises and more resources for poverty alleviation, health, education and infrastructure. **Tax Reform:** Taxes should be levied on a broader base and with lower tax rates, which implies an easier tax administration.
Opening Up	

	Trade liberalization: Quantitative restrictions on trade should be transferred into tariffs with a uniform tariff rate of between 10 and 20 percent. The transition process, which can last from 3 to 10 years, may be interrupted if required by macroeconomic imbalances. **Exchange Rate Adjustment:** At least for trade transactions, multiple exchange rates should be given up. The single exchange rate should be on a sustainable level that allows for the growth of nontraditional exports. **Direct Investment:** Foreign direct investment should be treated like domestic investment.
Liberalization	Capital Market Liberalization: Interest rates should be set by the market. The precondition is that reliable institutions exist for controlling the domestic capital market. In case that this is not given, real interest rates should be positive and the same for borrowers with comparable risk. Privatization: State-owned enterprises should be privatized.
Deregulation	The government should abolish regulations which restrict the entry of new enterprises and competition. Regulations are justified only concerning internal security, environmental protection, and the stability of the financial sector. **Property Rights:** The judicial system should supply reliable property rights at moderate costs, which are also accessible for the informal sector.

Source: Rainer Schweichert and Rainer Tiele, 2004, From Washington to Post-Washington? Consensus Policies and Divergent Developments in Latin America and Asis, Institute Für Weltwirtschaft Kiel, Kiel Discussion Papers

Likely, Egypt is still suffering from high debt-output ratio as showed by Alba et al (2004), and only recently tax reform has been initiated with the new ministerial cabinet in 2004; widening the tax base, reducing the rates and introducing the value added taxes to replace cascading sales taxes. Then, the only mean to maximize the efficiency of allocating these resources is to be diverted towards poverty alleviation, health, education and infrastructure, in parallel to a gradual elimination of subsidies.

It is of importance to understand the steps through which fiscal decentralization can be approached in Egypt as one of the channels that could lead to reach the stabilization phase. Indeed, this is highly recommended to be undertaken based on a symmetrical coordination between the fiscal and the monetary policy.

The paper has been constructed based on the following assumption: There is no phase after which the economic reform can be terminated. However, it is usually an on-going process that should be sequenced and repeated within the following chronological order to be able to be *de-facto* adapted to the Washington Consensus road map as follows:[1]

- Phase 1: The Institutional Reform
- Phase 2: The domestic price liberalization
- Phase 3: Fiscal/monetary stabilization and domestic financial system in parallel to each others
- Phase 4: Trade reform process
- Phase 5: Capital flow liberalization and privatization in parallel to each other, since each of them should accelerate the other

However, the fact is that the given sequencing proposed by Funke (1993) has not been ever in place either for developing or the transition economies, as showed in the below table by Nsouli et al. (2002).

[1] For more details concerning contents for each phase, please see Nsouli et al. (2002).

Table (1): Schematic Views of selected Sequencing Proposals.

Category	Institutional Reform	Domestic Price Liberalization	Fiscal/ Monetary Stabilization	Domestic Financial System	Privatization	Trade Reform	Capital Flow Liberalization
Developing Countries							
Corden (1987)			1			1/2	2/3
Edwards (1984,1990)			1	2		3	4
Fiel (1990)			1	1		2	3
Frenkel (1982)						1	2
Krueger (1981/84)			1	1		1/2	2/3
McKinnon (1982)			1	2		3	4
Lal (1987)			1	1		3	2
Schweickert (1993)			1	2		1	3
Economics In Transition							
Buch (1992)				1		1	1/2
Dornbusch (1991)	1	4	2	5	3	4	3/4/5
Fischer/Gelb (1991)	1	2	1	4	1/3	2	5
Gelb/Gray (1991)	1	1	1	3	1/3	1	3
Hinds (1991)	1	2	1	3	1/4	2	
Lipton/Sachs (1990)	1	1/2	1		3	½	
McKinnon (1991)		3	1	2		3	4
Nuti (1991)	1	1	1		2	3	4
Roland (1991)	1	3	3	2/4	2	¾	2/3/4
Rybezynski (1991)	1		3	1	2		
Siebert (1991)	1	3	2	3	3	3	

Source: Funke (1993)

As shown from Table (1), it is obvious that the sequencing of the economic reform differs for both developing and transition economies. The majority of the results confirm that they have initiated by the fiscal and monetary stabilization[2] as the first phase of the reform and is only accompanied by the institutional reform in case of the transition economies. However, still discussing the optimal sequencing format is not the core concern of the paper; we introduce the fiscal decentralization road map in Egypt as another main objective of this paper besides examining the effectiveness of the monetary policy in Egypt.

The rest of the paper is organized as follows: In Section III we examine the effectiveness of monetary policy in Egypt with concentration on the inflation targeting. The road map for fiscal decentralization in Egypt is discussed in Section IV through covering the literature review concerning launching fiscal decentralization. In Section V, we highlight the potential challenges of fiscal and monetary policy interactions, and we clearly define the coordination framework between the monetary and the fiscal policy makers with regard to the reform initiatives undertaken by the new ministerial cabinet in both areas. Finally, conclusions and some policy implications are given in Section VI.

III. Effectiveness of Monetary Policy in Egypt

There is central bank cooperation between European Union and MENA countries to increase the effectiveness of monetary policy in these countries. Euro-Mediterranean Seminars have been initiated in 2004. The purpose of these seminars was establishing a multilateral dialogue between Eurosystem and non-euro area Mediterranean central banks. These seminars are forums for maintaining an intense and open dialogue between the EU central bank and Mediterranean central banks on issues of common interest.

Date	City, Hosting Institution	Participants
January 2004	Naples, Banca d'Italia	MEDA-CB Governors, EC
February 2005	Cannes, Banque de France	MEDA-CB Governors, EC
January 2006	Nafplion, Bank of Greece	MEDA-CB Governors, EC
March 2008	Valencia, Banco de España	MEDA-CB Governors, EC

[2] By the early 1990s, politicians have reduced the stabilization policy to only maintaining price stability, where employment and output stabilization were ignored. This has been interpreted as the main reason beyond the diminishing of the higher growth rates that have been achieved at that time.

On November 13, 2005, the President of the European Central Bank (ECB), the Head of the Delegation of the European Commission in Egypt, and the Governor of the Central Bank of Egypt (CBE) signed a Tripartite Protocol to mark the start of Eurosystem Technical Assistant Program on Banking Supervision in the CBE. This program will be coordinated through a team of two resident Eurosystem staff members based at the CBE. Also, experienced supervisors will conduct visits to the CBE on regular basis to help in advising.

The EU can help Egypt in improving macroeconomic governance, reforming the financial sector, strengthening the role of the private sector, enhancing the business climate, in particular for SMEs, eliminating institutional, regulatory and administrative obstacles with a view to attract increasing national and foreign investments and to create job opportunities, consequently alleviating poverty. In this section, we examine the effectiveness of the monetary policy in Egypt, focusing on inflation targeting policy, an empirical study using quarterly data over the the 1983-2006 period.

Data on nominal interest rates, inflation rate, and money supply are collected from the International Financial Statistics. After correcting for non-stationarity in the data, a vector autoregressive (VAR (1)) model was estimated as follows:[3]

$$\begin{aligned}
R_t &= \underset{-1.246}{-0.006} + \underset{1.822}{0.208}\,CPI_{t-1} - \underset{-0.843}{0.067}\,M_{t-1} + \underset{1.914}{0.185}\,R_{t-1} \\
M_t &= \underset{5.365}{0.033} - \underset{-0.123}{0.017}\,CPI_{t-1} - \underset{-1.314}{0.1304}\,M_{t-1} + \underset{0.951}{0.1146}\,R_{t-1} \\
CPI_t &= \underset{4.642}{0.019} + \underset{2.023^{*}}{0.199}\,CPI_{t-1} + \underset{0.909}{0.0624}\,M_{t-1} + \underset{0.413}{0.034}\,R_{t-1}
\end{aligned} \tag{1}$$

Where:

R = the percentage change in the nominal deposit rate
M = the percentage change in money supply
CPI = the percentage change in the consumer price index (Inflation rate)

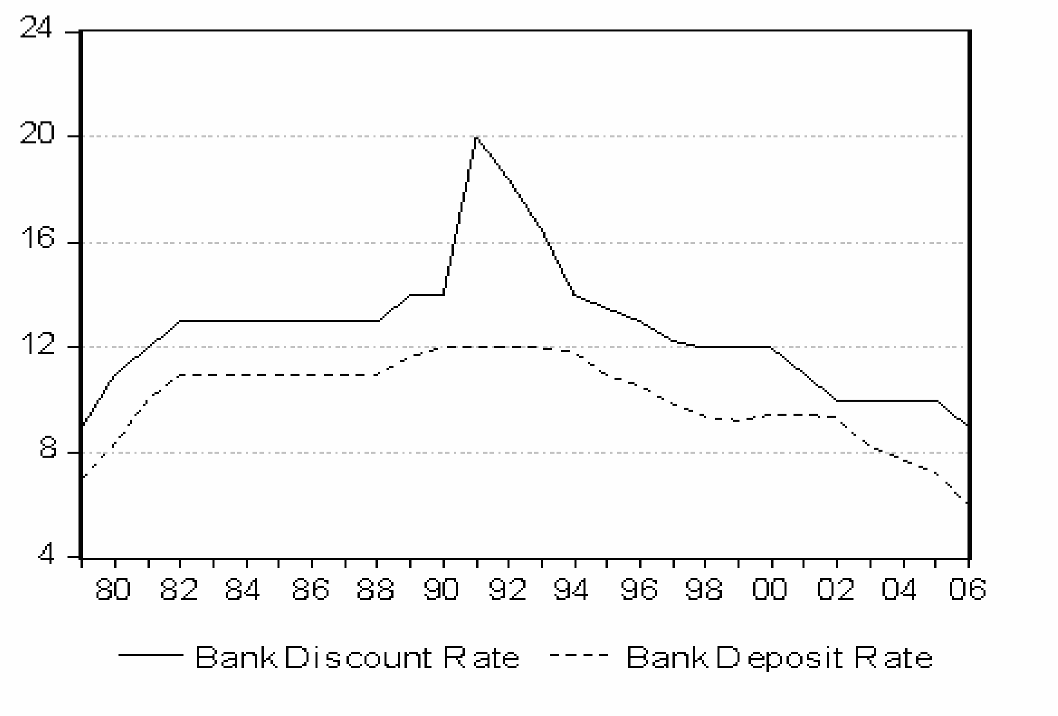
From the estimated VAR (1), none of the coefficients is significant at any level. This means that our main macroeconomic indicators, which are nominal interest rates, money supply and inflation rate, do not affect each others.[4] There is a problem in the transmission channels

[3] Small numbers under the VAR coefficients represent the t-statistics, and the * sign refers to 5% level of significance.
[4] We employ different forms of interest rates (see Figure 7) and we obtain similar results.

between these indicators. The Inflation targeting policy should be based on open market operations where the government controls the inflation rate (final target) through the interest rates (intermediate target). Then, the interest rates are controlled through the money supply (operational target) which is mainly through issuing government securities.

Figure (8) represents the impulse response function of nominal interest rate as a result of a shock in inflation rate. It shows that when there is a shock in inflation rate (increases by one standard deviation in inflation rate), nominal interest rate is expected to slightly go up by only five base points then the effect of the shock dies away after five quarters. Figure (9) shows the impulse response function of nominal interest rate to a shock in money supply. An increase in money supply by one standard deviation is expected to decrease the nominal interest rate by 0.3% then the shock dies away after three quarters.

Figure (7): Bank Discount and Deposit Rates in Egypt from 1979 to 2006



Figures (8): Impulse Response of Nominal Interest Rates to One Standard Deviation in Inflation Innovation

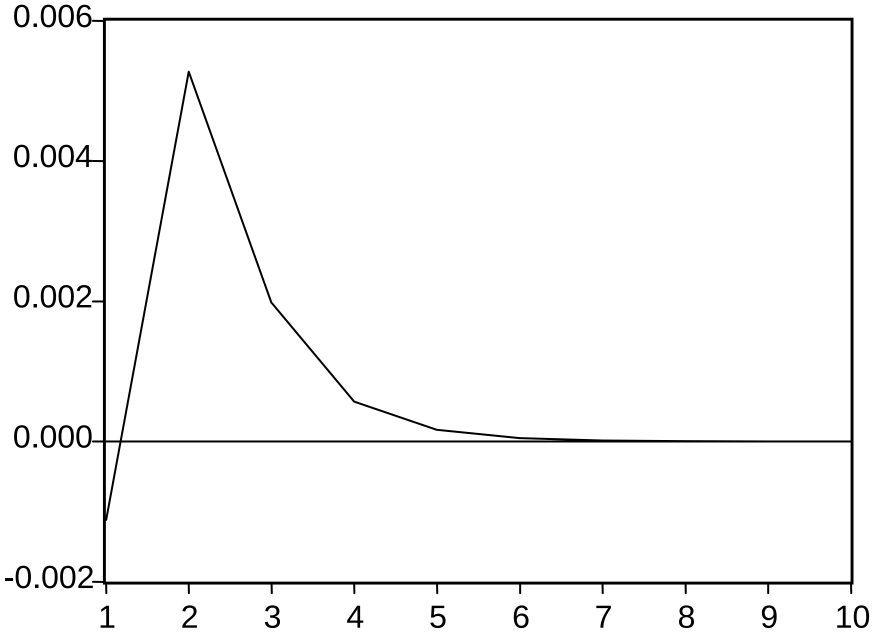
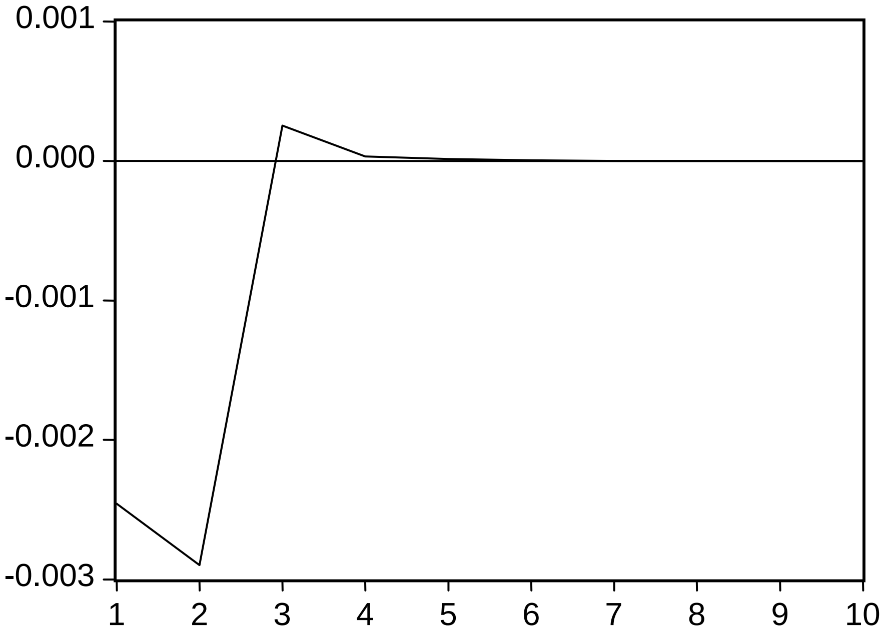


Figure (9): Impulse Response of Nominal Interest Rates to One Standard Deviation in Money Supply Innovation



To investigate the mechanism of the inflation targeting policy in Egypt more, a variance decomposition was estimated as shown in Table (2) below. The variance decomposition shows that volatilities in money supply and nominal interest rate have no effect on the volatilities in inflation. Moreover the volatilities in inflation and nominal interest rate have no effect on the volatilities in money supply. Finally, the volatilities in inflation and money supply have no effect on the volatilities in nominal interest rate.

Table (2): Variance Decomposition Results

Period	S.E	Inflation	Money Supply	Nominal Interest Rates
Panel (A): Variance Decomposition of Inflation				
1	0.03	100.00	0.00	0.00
2	0.03	99.13	0.72	0.15
3	0.03	99.08	0.71	0.21
4	0.03	99.08	0.71	0.21
Panel (B): Variance Decomposition of Money Supply				
1	0.04	0.86	99.14	0.00
2	0.04	0.84	98.33	0.82
3	0.04	0.86	98.31	0.83
4	0.04	0.86	98.31	0.83
Panel (C): Variance Decomposition of Nominal Interest Rates				
1	0.03	0.15	0.70	99.15
2	0.03	3.14	1.56	95.30
3	0.03	3.55	1.56	94.89
4	0.03	3.58	1.56	94.86

Ordering Inflation M R

This means Egypt can not maintain macroeconomic stability even with the support of the EU unless they clean up the transmission channels between the macroeconomic indicators. This can be done through activating the primary dealers system in government bonds which was established in 2004 but is still not active. The narrow maturity spectrum of government securities, coupled with the lack of instrument diversity, continues to plague the development of this government securities market. Although primary dealer system introduction was a timely and important step in creating more efficient debt capital markets, its introduction was not enough to ensure bond market revival.

The Egyptian authorities must continue to refine and enhance the regulatory and legal foundations of the government bond market, work with the Egyptian financial community in education and training, and lastly expand the maturity spectrum and diversity of the current government debt securities. These measures, coupled with the recent introduction of the primary dealers system, will ensure the growth and development of the Egyptian bond market and provide the Egyptian financial sector, and economy, with new and innovative channels for growth. Through activating the primary dealers on government bonds, the government can control money supply. Moreover, a yield curve can be derived from the government bond market which can be used as a benchmark for interest rates. The government also needs to adjust the basket used in calculating the consumer price index to make sure that it contains items that do not have price rigidity.

Eurosystem Technical Assistant Program should help Egypt pursue macroeconomic stability by reducing the inflation rate and gradually achieving price stability. The program needs to provide technical assistance to the ECB on how to efficiently implement its inflation targeting policy and have accurate representative price indicators and further strengthen central bank independence.

IV. Fiscal Decentralization: Egypt Road Map

Fiscal policy is one of the important issues in the ECONFIN Meetings. The discussions at the Euro-Med ECONFIN Ministerial meetings in Rabat (2005) and Tunis (2006) established a network of experts in public finance. There is a need for this network as the challenges faced by the Mediterranean partner countries are similar to the challenges faced by the EU. The quality of public finances and budgetary institutions are important instruments for ensuring the most effective and efficient use of resources to raise the long run growth potential of the economy and tackle the deficit bias. This established network will allow the development of working contacts between experts in the same field and discuss practical issues relevant to the EC assistance. The main focus for this network will be:

- Fiscal consolidation as part of broader reform agenda for public sector reform, growth and employment.
- Efficiency of public spending.

- Budget management systems and institutions

One of the hot topics in fiscal policy to be discussed in this network is (de)centralization. The economic literature on (de)centralization has been sub-divided by Bell (1989) into two methodologically distinct camps: (i) the conventional literature, exemplified by Oates (1972)[5], in which government officials act as social planners maximizing well-defined objective functions; and (ii) the Leviathan literature, exemplified by Brennan and Buchanan (1980)[6], where officials are self-interested individuals who maximize private utility functions.

Tanzi (1996) notes that bureaucrats in local and regional governments may be poorly trained and thus inefficient in delivering public goods and services to the population. When delivered sub-nationally, the per-capita cost of such services is then higher than if they were delivered by the national government, whose bureaucracy may be more efficient. Exactly the same conclusion applies if all bureaucrats are equally efficient but corruption is more extensive at the local and regional levels than at the national level. The cost of sub-national public-good provision is again higher, but currently the differential serves to line the pockets of the bureaucracy rather than to offset technical inefficiencies in production. In both situations, the higher cost of sub-national public-good provision limits the benefits from fiscal decentralization. In developed countries, by contrast, technical efficiency is high across all levels of government, and corruption is mostly absent at both the sub-national and the national levels, so that no such limitations exist.

Tanzi (1996) also argues that taxes levied at the sub-national level may exhibit poor "productivity" relative to national taxes. One reason may be weak administration of income or property taxes by sub-national governments, which allows consumers to engage in substantial and costless tax evasion. This outcome appears to limit the usefulness of such taxes as revenue sources, calling into question the ability of sub-national governments to function as independent fiscal entities. In developed countries, by contrast, evasion of taxes levied by sub-national governments is typically difficult, eliminating this obstacle to successful fiscal decentralization.

[5] On theoretical ground, Oates (1977) shows how decentralized provisions of public services could minimize the welfare loss from the centralized provision of public services. Oates and Schwab (1991) also show that under the assumption that taxes play the same role as prices, "the outcome under inter-jurisdictional competition is identical to the outcome that would emerge if one were to replace local governments with perfectly competitive firm that supplies local public goods to firm and households at marginal cost", (pp. 140-1).

[6] Brennan and Buchanan (1980) argued that government usually adopts the "*Leviathan Approach*" which "systematically seeks to exploit its citizenry through maximization of the tax revenues that it extracts from the economy", Oates (1985, p.748).

In support, Eid (2005) has investigated the level of decentralization in Egypt benchmarked by the "Soufflé theory", using the toolkit approach of assessment, and found that the degree of decentralization is relatively low. This low level of decentralization exists despite the presidential announcement in February, 2005, of amending the constitution to allow more than one candidate to run for the office. In simple terms, all of the decisions and especially the most important ones are made by the central government. Thus, the decentralization of policy development is given to regional level as long as it does not go beyond the guidelines of the national policy (i.e. the budget guidelines for local units are drawn from the models of the States' general budget preparation, which is designed by the Ministry of finance and includes separate guidelines for the current and capital budgets), where the subsystem:

- Has no power and responsibility in policy formulation, but their participation in the decision making of the central authority is very limited
- Are financially dependent on the central authority
- Its degree of free decision making is regulated by narrow choice-set
- The central authority can enforce policies against its will

Moreover, Eid (2005) has examined the impact of the potential fiscal decentralization on the size of the public budget in Egypt in two steps; first by comparing the ratio of its total tax revenue to GDP as well as the ratio of its central tax revenue to GDP to that of the developed economies. The results indicate that the central government's intrusion into economy is larger than what citizens want while local government intrusion in economy is smaller than what citizens want.

Second, using a modified version of Marlow's model that has been initially conducted by Kwon (2002), Eid shows that there is a negative relationship between the level of the central government expenditure and the degree of decentralization. The relationship between the level of local government expenditure and the degree of decentralization is positive even though it is statistically insignificant. Also, the relationship between the level of total government expenditure and the degree of decentralization is negative and statistically significant at 5 percent level. These results imply that the central government had behaved as "Leviathan", and was not responding to the citizens' demands as suggested by Brennan and Bauchanan (1980).

In addition, the author argued that fiscal decentralization might have negative impact on macroeconomic performance as long as the fiscal policy is not organized in a counter-cyclical sense, since excessive spending might take place when:

- Sub-national government pursues expansionary fiscal policy at the time that the national government is pursuing a contractionary policy.
- Expenditure responsibilities are transfers but central government continues providing them in a concurrent manner.
- Revenue sources are reassigned to sub-national governments but they fail to exert adequate fiscal effort.
- Transfers are increased but sub-national governments reduce their efforts to collect from the revenue sources they already control.
- There is high degree of decentralization, thus not leaving to the central government enough room to exercise adequate macroeconomic management.
- Central government fails to impose hard budget constraints on the sub-national governments - local government face soft budgets and can easily borrow[7].

However, most of these deficiencies can be eliminated normally and gradually by processing the privatization program.

> "The more extensive is the process of privatization, the lesser justification there must be for fiscal decentralization. Privatization should be considered as an alternative to decentralization for many public activities", Tanzi (2000, p.6).

Moreover, Tanzi (2000) mentions that decentralization is an alternative to privatization to deliver services to the consumers, and that the choice between both of them should depend on whether a country has state failures or market failures. But, since both might exist in developing countries, it depends on how the government intervention is decided to be organized.
Therefore, for the time being it is highly recommended in our case to adopt the *Scottish decentralization framework*, in which spending is decentralized and taxation is centralized.

There is no reason to think that fiscal decentralization is an accurate indicator of all types of political decentralization. As Scottish devolution shows for example, substantial political decentralization might take place without fiscal decentralization.

Privatization program might be explicitly interpreted as the initial phase of fiscal decentralization as long as it is processed in parallel to:

[7] This can be limited by adopting some kind of *exante* limits on sub-national borrowing and follow the "golden rule" where borrowing is only permitted for investment purposes. In practice, this might be difficult to enforce in absence of a good financial classification and reporting system.

- The effectiveness of the new tax law as well as custom administration computerization.
- The implementation of an appropriate program/performance based budgeting system.
- The effectiveness of the competition law.

In sum, it should be highlighted that improvements in the public financial management system are largely a function of creating the political will to develop reforms and make (and sustain) institutional change. However, it is the distinction between institution and organization and the interplay between the two, which is the key to understanding how the public financial management system can be improved. It is of impotence to understand the role of the government of when and how the economic stabilization can be achieved in order to accelerate the privatization program in an efficient manner. This efficiency in implementing the privatization program can be achieved through maximizing foreign direct investment inflows and minimizing the public debt using the privatization proceeds. Therefore, It is highly recommended to test the efficiency of the privatization program from that perspective in forthcoming research, since it is not the core interest of the given research paper. Our major concern is to refer to the fiscal challenges that limits the ability of the monetary policy maker in identifying interest rates, which is the only available instrument target– in case of adopting the inflation targeting framework as it has been announced since mid-2004 in case of Egypt, even implicitly as a starting phase.

V. Fiscal and Monetary Policy Interaction: Potential Challenges

Egypt has succeeded in reducing the inflation rate as can be seen in Figure (4) from a very high level in the late 1980s. However, the exact policy followed in achieving this low level of inflation is not clear. The interest rates and sovereign spreads, the exchange rate, the aggregate demand, and expectations are the main channels through which the fiscal policy can affect monetary policy.

Sturn and Gurtner (2007) study the effect of fiscal policy on the monetary policy stabilization in Mediterranean countries. They find that fiscal policies have been an important element of macroeconomic stability, as high fiscal deficits were at the root of instability in many Mediterranean countries during the 1980s. With the exception of Algeria and Libya, public debt of all Mediterranean countries was above 50% of the GDP in 2005. This makes these countries vulnerable to shocks and can not absorb shocks without jeopardizing macroeconomic stability and debt sustainability. In this context, Egypt is no exception as it still suffering from a very high public debt. The percentage of domestic debt to GDP in Egypt is 76% while the ratio of external debt to GDP is 35% in 2005 most of it denominated in US dollars. As a result, Egypt is vulnerable to shocks. This limited capacity of Egypt to absorb shocks may jeopardize macroeconomic stability and debt sustainability. In Egypt, a large share of domestic debt consists of non-tradable securities (around one-third) held by the central bank, state-owned enterprises and households, and pension funds. Less than 25% of domestic debt is fully tradable and more than 40% is partially tradable (only among financial institutions). As for domestic debt in Egypt, the share of short-term obligations tends to increase where it stands at 24%. A high share of short-term liabilities increases vulnerability as a large proportion of debt needs to be rolled over in a short period of time and is thus sensitive to increases in interest rates. In the presence of these fiscal vulnerabilities, monetary policy is confronted with the risk of adverse macroeconomic and fiscal developments which could interfere with monetary policy objectives and potentially undermine macroeconomic and financial stability. Adverse fiscal developments, whether triggered by policy slippage or external shocks, can rapidly raise doubts about debt sustainability. These could then lead to an increase in interest rates/sovereign spreads and inflation expectations, to downward pressure on the exchange rate, and ultimately to higher inflation. In countries with exchange rate pegs, the credibility of the external anchor may be undermined.

According to Sturn and Gurtner (2007, p.29) "*In the presence of these fiscal vulnerabilities, monetary policy is confronted with the risk of adverse macroeconomic and fiscal developments which could interfere with monetary policy objectives and potentially undermine macroeconomic and financial stability. Adverse fiscal developments, whether triggered by policy slippage or external shocks, can rapidly raise doubts about debt sustainability. These could then lead to an increase in interest rates/sovereign spreads and inflation expectations, to downward pressure on the exchange rate, and ultimately to higher inflation*".

In the early 1960s, the short run effects of monetary and fiscal policy has been modeled by Fleming (1962) and Mundell (1963) under the assumption of perfect substitutability between domestic and foreign assets and fixed domestic price level. Consequently, in a flexible exchange rate regime, only monetary policy would affect the level of output. However, expansionary fiscal policy would lead to a sizable deterioration of the current account of the balance of payments. Conversely, in a fixed exchange rate regime, only fiscal policy would affect the level of output, while monetary policy would affect the balance of payments through its implications for changes in official reserves.

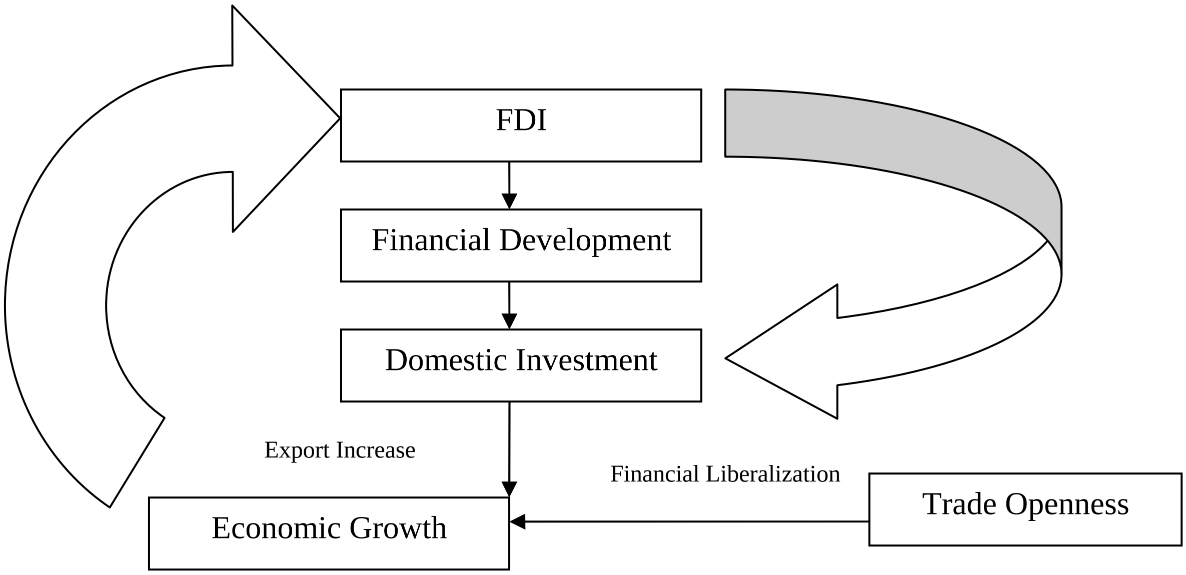
Keeping on their assumption, it is expected that in a small economy like Egypt, when the international substitutability of asset is very high, changes in government debt will affect foreign indebtedness, where a decrease in the deficit lowers domestic expenditures relative to domestic production, thus increase the current account balance. Then, the decline in foreign indebtedness will result in an increase in domestic net income relative to gross domestic product. In addition, when the domestic government debt to-GDP ratio falls, domestic interest rates decline, lead to an increase in business investment and capital stock. Therefore, the economy should get the appropriate "assignment" of policies: Long-run low and stable inflation assigned to the monetary policy and long-run increase in saving, investment and output internally in addition to accumulating wealth from an increase in net foreign assets externally assigned to the fiscal policy. However, both should agreed on the target instrument that is to be used, considering the dynamic process through which both the capital stock and the stock of net foreign assets can be affected.

Recalling the fact of having a very high public debt to GDP ratio in case of Egypt, which should not be financed except through the given channels: privatization proceeds, tax revenues after broadening its basis (i.e. income tax) as well as the VAT system for sales tax as well as any foreign currency inflows either from foreign direct investment or increasing exports. It should be highlighted that using the central bank assets as a source of finance should not be an option, since it is the initial pre-requisite for implementing Central Bank Independence as a path towards adopting a fully-fledged inflation targeting framework in the long term[8].

On the other hand, the interest rate that is expected to stabilize the inflation rate from the monetary policy perspective might conflict with that required to encourage investment. Putting into consideration that the magnitude of interest elasticity of financial savings in Egypt is too small to warrant policy implication, Hassan (1999), where he showed that an increase in interest rate by 1% causes an increase in financial savings by 0.07% and 0.06% in the long and short term, respectively. In support, Eid (2006) showed that domestic investment in Egypt is significantly affected by the foreign direct investment (not the interest rate – the only available instrument for the Central Bank of Egypt) directly "crowding-in effect" and indirectly through the later impact on financial development, which in turn can accelerate the output growth impact of both domestic and foreign investment, that, again positively affecting the foreign direct investment as shown in the following figure.

[8] For more details, see Eid (2001).

Figure (10): FDI, Financial Development, Domestic Investment, Trade Openness and Economic Growth.



Eid (2006) explicitly admits that confirming the continuation of the planned institution and regulatory reform, financial liberalization is expected to increase financial depth in case of Egypt, and should maximize the efficiency of the privatization program. In sum, we can say that financial development is the key for all our problems, but to have a real development in the given sector in a way that might guarantee an improvement in social infrastructure in parallel to raising the competition culture. The development should start from the regulatory agenda, by performing *de-facto* central bank independence with one objective- price stabilization. As for the fiscal policy makers, they could rely on the tax revenues, the privatization proceeds in addition to the other on-going revenue generating channels (i.e. tourism, Suez canal, etc…) as the only available sources of finance for its long term output maximization goal. We should bear in mind that the public debt should be the last resort to finance the government budget, keeping in mind the high level of volatility of this source of finance.

VI. Conclusion and Policy Implications:

Egypt needs to activate the primary dealers system for trading government bonds in Egypt. This will help the government controlling the money supply which is the operational target for the monetary policy. Also, having an active government bonds market will be the base for pricing interest bearing financial instruments. It will be used to derive the yield curve. Besides, it is essential for the government to have reliable methods in measuring the main macroeconomic indicators. Euro-Mediterranean Seminars are important forums for maintaining an intense and open dialogue between the EU central bank and Mediterranean central banks on issues of common interest. Eurosystem Technical Assistant Program should help Egypt pursue macroeconomic stability by reducing the inflation rate and gradually achieving price stability. The program needs to provide technical assistance to the ECB on how to efficiently implement its inflation targeting policy and have accurate representative price indicators and further strengthen central bank independence.

The fiscal policy problems should be solved on a domestic level approach, at least until the public debt reaches an acceptable low level. Indeed, the only benchmark for this given scenario is the EU monetary integration mechanism regionally wise, and the fiscal federalism domestically wise. The EU legislation has been recently developed to strengthen municipal governments in member states, and lay the equity principle, under which the solidarity nationwide is facilitated by the sharing of both tax powers and revenues. On the one hand, the sharing of revenues requires a need from a member state, on the other hand, the action of the public sector should accept that it is *de-facto* limited by the macroeconomic condition of the country. Euro-Med ECONFIN Ministerial meetings established network will allow the development of working contacts between experts in the same field and discuss practical issues relevant to the EC assistance. The main focus for this network will be fiscal consolidation as part of broader reform agenda for public sector reform, growth and employment, efficiency of public spending, and budget management systems and institutions.

Another fundamental principle is the distribution of roles and responsibilities according to the efficiency criterion. The efficiency criterion indicates that lower cost and larger effectiveness is more likely to occur when the responsibility for delivering a service is on hands of the government level. It is, however, important to have a well-defined set of priorities, and to have the capacity of maintaining an efficient public finance management framework as in annex 1.

In brief, the society should be organized in the form of an "Oceanic Circle" whose center will be the individual always ready to perish for the village, the latter ready to perish for the circle of villages, till at last the whole becomes one life composed of individuals, never aggressive but ever humble, sharing the majesty of the oceanic circle of which they are integral units.

Annex 1:

Box (2): Public Finance Management Framework	
Macroeconomic Stability	▪ Identification and assessment of the future implications of current policies. ▪ Recognition of the resource constraint. ▪ Maintenance of an extensive database and profile of all agency expenditures. ▪ Maintain cost data where services funded by public agencies are provided by private and non-governmental sector.
Efficiency Improvement	▪ Measurement and publicizing of the costs of important activities. ▪ Factors or areas contributing to expenditure increase should be identified and addressed. ▪ Pursuit of alternative strategies for the delivery of services when costs tend to increase.
Technical Infrastructure	▪ Establishment of an information system, which makes relevant operation data available to all policymakers and program managers. ▪ Focus on core tasks by central agencies responsible for financial management. These tasks include policies, costs, and the specification of the desired performance levels. ▪ Managerial autonomy for spending agencies in the use of allotted resources. ▪ Selective conversion of accounting systems to an accrual basis particularly in agencies with large inventories. ▪ Eliminate patronage for public service appointment. ▪ Eliminate off budget/off-balance organizations/accounts. Independent audit functions, and strong budget execution.
Accountability	▪ Specific costs and expected performance, as an integrated part of the overall framework of accountability. ▪ Avenues for people to secure information on historical series such as government accounts. ▪ Establish oversight bodies (where none may currently exist). ▪ Disseminate information.

Source: Schaeffer, Michael (2002), "Corruption and Public Finance", Sectoral Perspectives on Corruption, Prepared by MSI, sponsored by USAID, DCHA/DG

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