المركز المصرى للدراسات الاقتصادية
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The Egyptian Center for Economic Studies

# Policy Viewpoint

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## Competitive Devaluation and Egypt's Export Potential

Recent global developments have brought to the fore concerns about increased competition to boost exports by resorting to competitive devaluation, also known as beggar-thy-neighbor policies or currency wars. Many emerging countries, including Egypt, have been struggling to cope with the resulting pressures that have escalated in the form of a surge in capital inflows that exercise pressures on the exchange rate and threaten competitiveness. Following an overview of the state of play in the global economy, this edition of *Policy Viewpoint* considers the implications for Egypt of a currency war. It demonstrates that the main challenge to Egypt's competitiveness is high inflation. Failure to mobilize exports through depreciation could pose a challenge to competitiveness. Moreover, depreciation could fuel inflation and prove to be a threat to competitiveness in light of Egypt's high dependency on imported intermediate goods. To conclude, the exchange rate policy should be managed to strike a balance between promoting growth and containing inflation, in line with the underlying fundamentals and priorities for domestic policies. This balance is, however, continuously challenged in the face of persistent capital flows that move around the globe in search of high returns. To stem the risk of hot flows, temporary measures may include capital controls and/or taxes and incentive schemes that vary with the type of inflows. However, persistent flows would demand policy adjustments, namely fiscal consolidation, to achieve sustainability and ensure external stability over time.

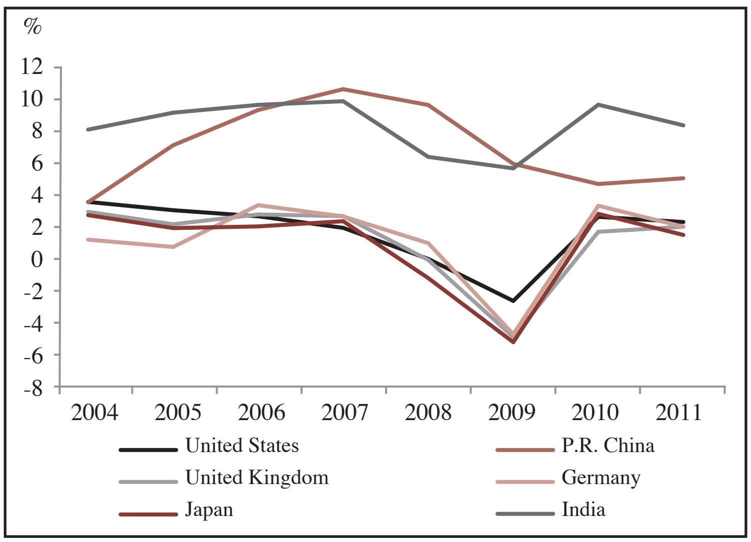
### What is a Currency War?

A currency war is largely a political term, also known as competitive devaluation—a condition in the international monetary system where countries compete against each other to achieve a relatively low exchange rate for their home currency so as to help: (i) boost exports, (ii) curb imports, (iii) improve the trade balance, and (iv) boost economic growth.

More recently, however, the race to competitive devaluation has accelerated, led by the U.S. and China, which triggered concerns by the Brazilian Finance Minister, Mr. Guido Mantega, "We are in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness. The advanced countries are seeking to devalue their currencies." The comments were made in response to the US dollar depreciating by 25 percent against the Brazilian Real in recent months, weakening Brazilian export potential.

Underlying competitive devaluation are three major forces. The first is China's drive to keep the yuan at an artificially low level to maintain a comparative advantage of exports to major markets, particularly in the U.S. The second is the US continued "quantitative easing" to secure a speedy recovery of the economy. As the Federal Reserve maintained a strategy of buying up government bonds and other debt, it increased domestic liquidity and contributed to continued depreciation of the US dollar. This strategy coincided with a deliberate attempt by the U.S. to shift the orientation of the growth strategy towards securing higher export growth, awaiting signs of robust recovery in domestic demand. The third factor is the drive by major emerging economies, led by Korea, and Brazil, to continuously intervene in the foreign exchange market to stem appreciation pressures of their currencies in the face of capital inflows that have surged on account of a wider interest rate spread. The widening spread was further accelerated through "carry trade," a phenomenon that incentivizes buying debt in currencies of countries that maintain low interest rate and lend the proceeds in currencies where the interest rate is significantly higher. It is worth noting that Europe has refrained recently from participating in competitive devaluation as the continent struggled to contain the risk of sovereign and private debt crises on the stability of the euro and currency union.

**Figure 1. Two-Speed Recovery with Emerging Markets Leading Global Growth (Percentage Growth Rate)**

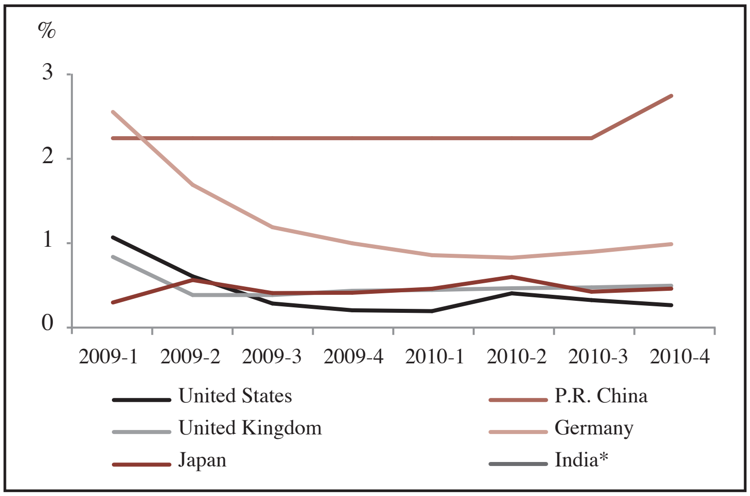



*Source:* IMF *World Economic Outlook* (October 2010).

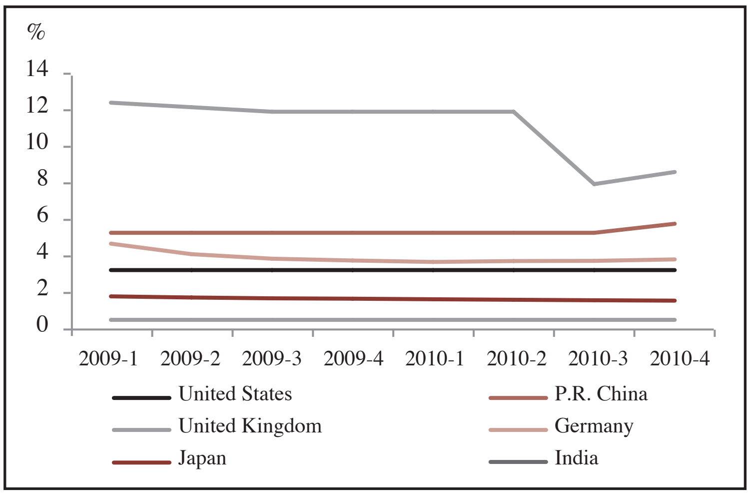
Amidst these global developments, developing and emerging countries have been struggling through frequent exchange rate interventions to maintain export competitiveness. While many of these countries surpassed advanced countries in leading global recovery (Figure 1), interest rate spreads in these countries have widened on account of stronger growth, higher inflation and high public debt. The spread was further exacerbated on account of a slower growth in advanced economies, led by the United States maintaining a quantitative easing cycle that forced further reduction of the interest rate (Figure 2).

**Figure 2. Widening Interest Rate Gaps across Countries (Percent Per Annum)**

**a. Deposit Rate**



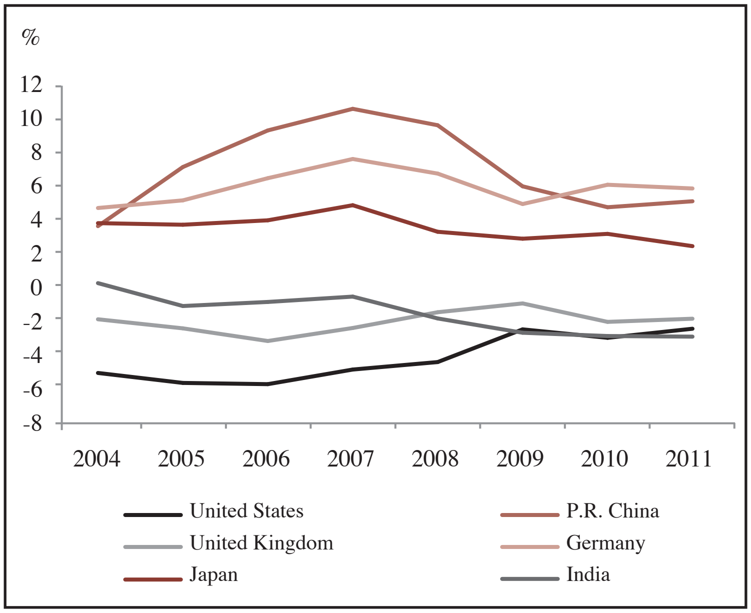

**b. Lending Rate**




*Source:* IMF *International Financial Statistics* (November 2010).
* No data are available at the time of publication.

Trade imbalances further exacerbated tension in the face of competitive devaluation. Surplus countries, led by China, Germany and Japan have long maintained their desire to secure export competitiveness by stemming appreciation pressures (Figure 3). The strategy was managed by China, in particular, through the purchase of US government debt that forced the depreciation of the yuan via the flow of money back to the U.S. to maintain necessary financing for persistent current account deficit. As China and the U.S. shared common interests, persistent global imbalances proved to be sustainable before the financial crisis. China enjoyed growth driven by higher exports and persistent current account surplus and the U.S. enjoyed growth driven by higher domestic consumption and spending, necessitating a wider current account deficit that was sustained on account of external financing flowing in search of a safe haven and attracted to the strong fundamentals of the U.S. economy. While the global imbalances may not have been at the root of the global financial crisis, they exacerbated the magnitude and duration of the crisis as excessive leveraging in the U.S. proved to be too costly for those who have purchased high US debt.

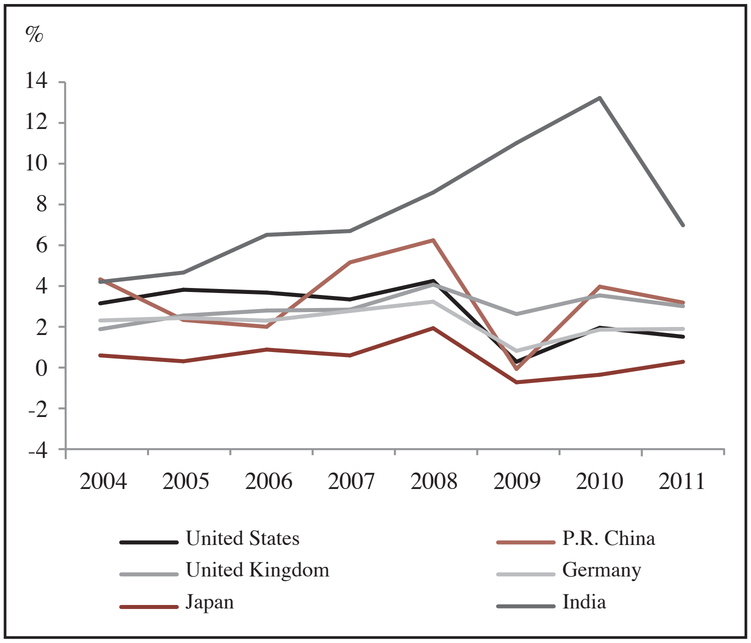
**Figure 3. Current Account Balances in Selected Major Economies (% of GDP)**




*Source*: IMF *World Economic Outlook* (October 2010).

In the wake of the global economic crisis, demands for correction of global imbalances have been voiced. At the core is the need to correct for domestic imbalances towards addressing persistent imbalances in surplus and deficit countries. The former group will need to give up excessive export orientation strategy by mobilizing domestic spending and reducing private savings. The latter group will need to manage growth without excessive domestic spending, which may require more attention to export orientation, a track that the U.S. has already started. While, in general, inflationary pressures have not presented a strong challenge to competitiveness (Figure 4), persistent drive by the U.S. to depreciate the dollar, coupled with overheating in high growth economies, led by China and India, have posed a risk to competitiveness in the face of real exchange rate appreciation (Figures 5 and 6).

**Figure 4. Inflation in Selected Major Economies (Percentage Change)**



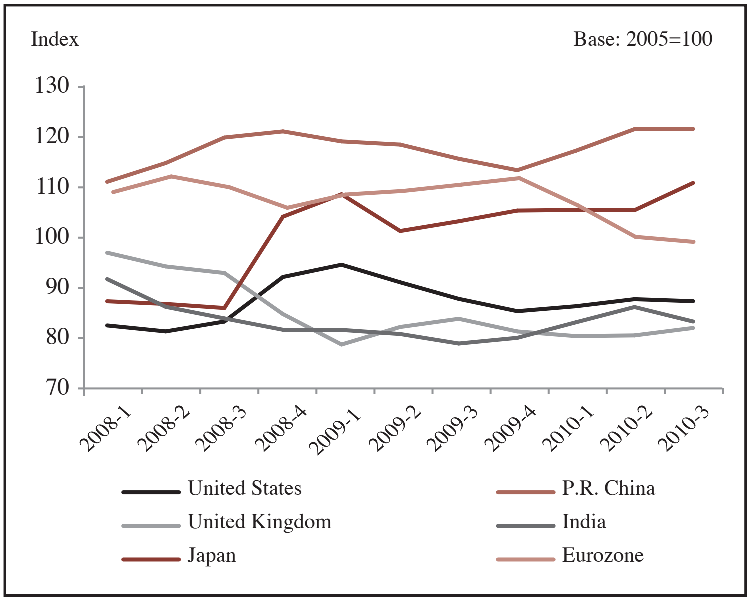

*Source:* IMF *World Economic Outlook* (October 2010).

## Global Coordination after the G-20 Meeting in Seoul

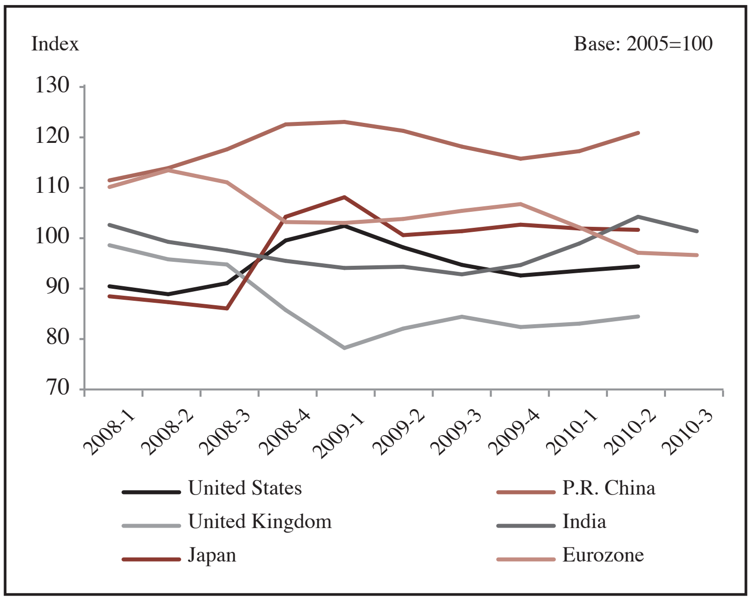
At the last G-20 meeting in Seoul held in November 2010, little progress was made to reach a firm commitment to avoid economic protectionism in the form of competitive devaluation or enacting tariffs. Nonetheless, the meeting was considered an important step forward to avoid a currency war as China has agreed to move toward a more market-oriented exchange rate regime. Moreover, major

**Figure 5. Relative Inflation and Challenges to Competitiveness**

**a. Nominal Effective Exchange Rate**




**b. Real Effective Exchange Rate**



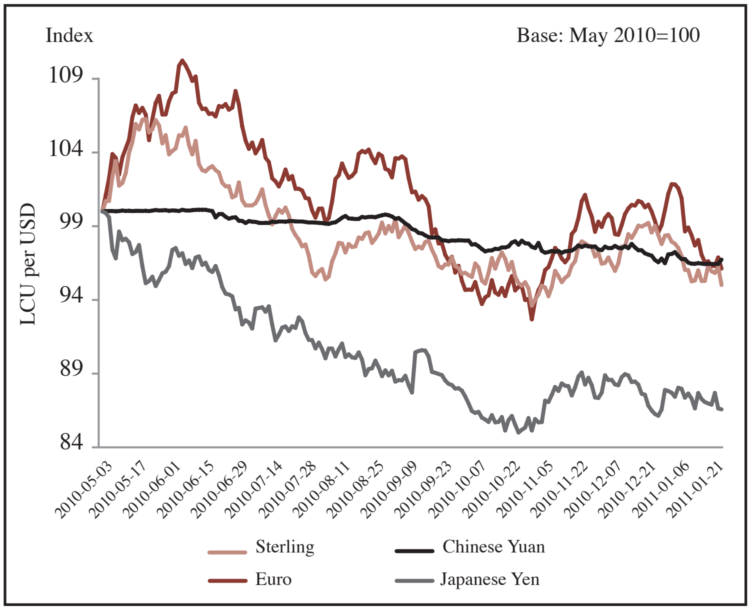

*Source:* World Bank Databank (December 2010).

contributors to global imbalances have agreed to pursue policies conducive to reducing excessive imbalances.

## Egypt in a Global Context

Where does the Egyptian economy stand among major trading partners and international players? More specifically, if countries continue to pursue policies of competitive devaluation, what are the potential implications for the Egyptian economy?

**Figure 6. Exchange Rate of the US Dollar vs. Major Currencies**




*Source*: Bloomberg.

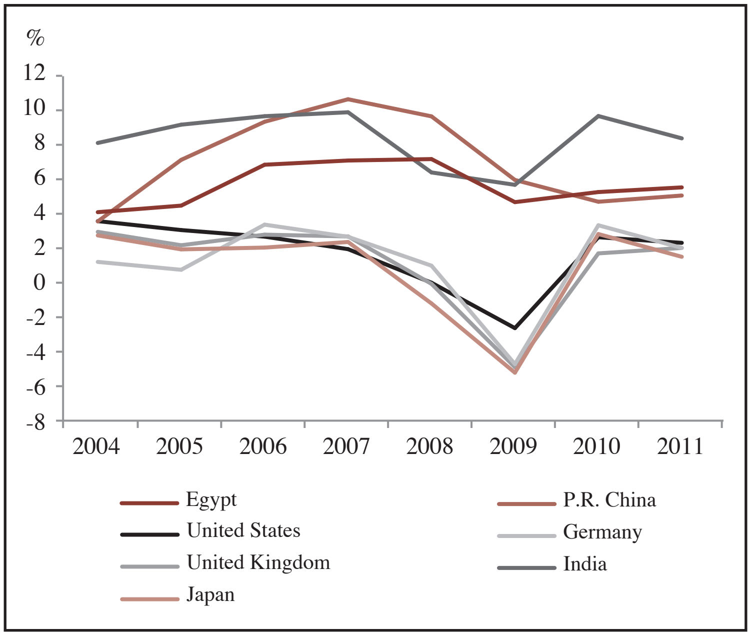
The European Union is the largest trading partner for Egypt (Table 1). To address concerns about competitiveness, three factors are worthy of consideration: (i) fluctuations in the Egyptian pound with respect to the US dollar in response to natural trade and financial flows, as well as interventions by the central bank, (ii) fluctuations in the US dollar with respect to the euro and other major currencies in response to relative domestic policies, and (iii) relative inflation in Egypt, compared to major trading partners.

**Table 1. Egypt's Major Trading Partners**

| Rank | Country | Share of exports (2009) - % |
|---|---|---|
| 1 | European Union (27 countries) | 35.4 |
| 2 | India | 6.3 |
| 3 | United States | 4.9 |
| 4 | Saudi Arabia | 4.8 |
| 5 | Japan | 3.3 |
| **Rank** | **Country** | **Share of imports (2009) - %** |
| 1 | European Union (27 countries) | 27.1 |
| 2 | United States | 10.8 |
| 3 | China | 8.4 |
| 4 | Saudi Arabia | 5.9 |
| 5 | Russian Federation | 4.3 |

*Source:* World Trade Organization, *Egypt Country Profile*.

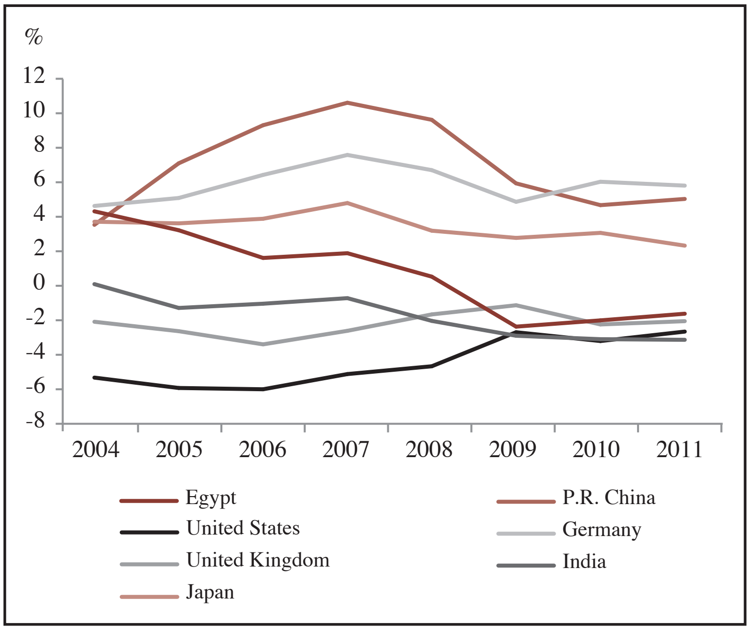
**Figure 7. GDP Growth Rates in Egypt and Other Emerging Countries**




*Source:* IMF *World Economic Outlook* (October 2010).

Egypt has maintained relatively higher growth rates before, during and after the global financial crisis (Figure 7). Nonetheless, the country has not realized its potential, particularly as it relates to external competitiveness and export growth. In fact, the external position of Egypt has deteriorated over time in response to higher growth, which contributed to higher imports relative to exports, switching the current account surplus into deficit more recently (Figure 8). Addressing the deficit demands domestic policy adjustments, coupled with an export-oriented strategy.

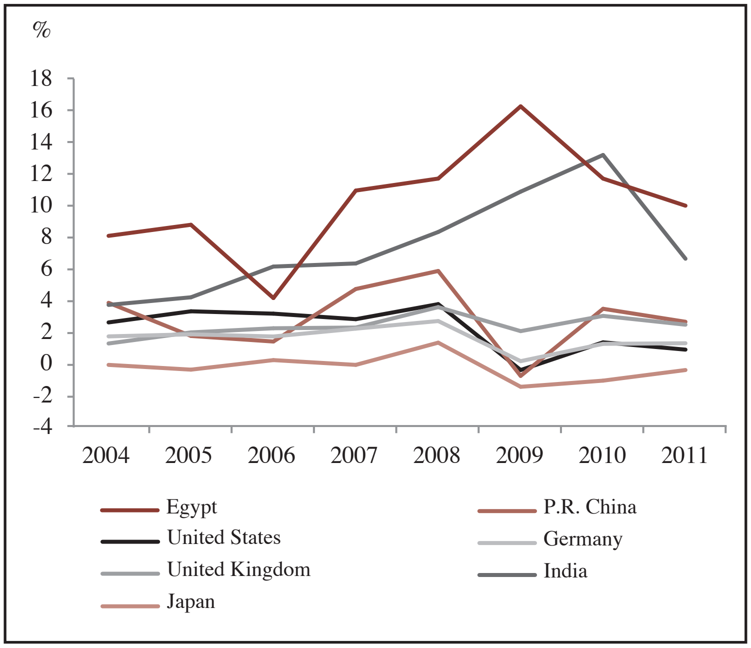
**Figure 8. Current Account Balance in Egypt and Major Trading Partners (Percent of GDP)**




*Source:* IMF *World Economic Outlook* (October 2010).

Underlying Egypt's export competitiveness is relative price inflation and the exchange rate policy. A comparison of inflation rates in Egypt and major trading partners reflects the widening gap, which poses continued threat for Egypt's competitiveness (Figure 9). Indeed, while Egypt's nominal effective exchange rate is the lowest among its trading partners, factoring in relative price inflation puts the real effective exchange rate at the highest relative position (see Figure 10). That is, Egyptian goods are the most expensive to buy in export destinations, compared to major trading partners. Despite deliberate efforts to maintain nominal competitiveness, the recent surge in relative inflation has put the real effective exchange rate on an upward appreciation trajectory, threatening competitiveness.

**Figure 9. Inflation Rates in Egypt and Major Trading Partners**

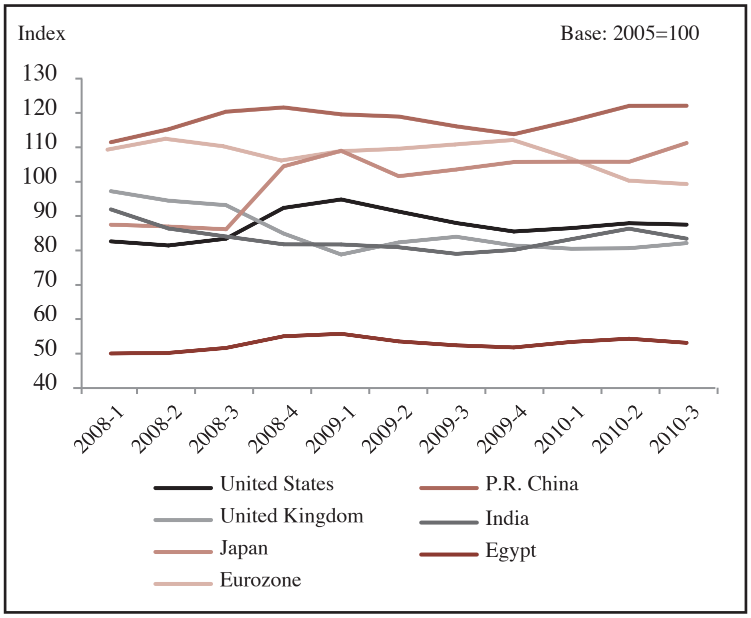



*Source:* IMF *World Economic Outlook* (October 2010).

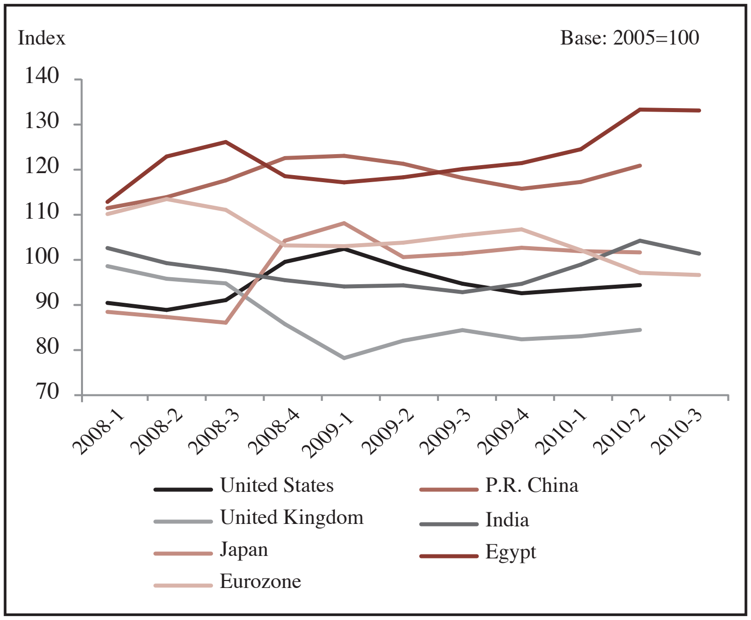
A strategy that aims at further depreciation of the domestic currency towards more export competitiveness could be problematic on two accounts. First, depreciation may not secure higher competitiveness for Egyptian exports, without a comprehensive strategy to enhance

**Figure 10. The Impact of Higher Inflation on the Exchange Rate**

**a. Nominal Effective Exchange Rate**




**b. Real Effective Exchange Rate**



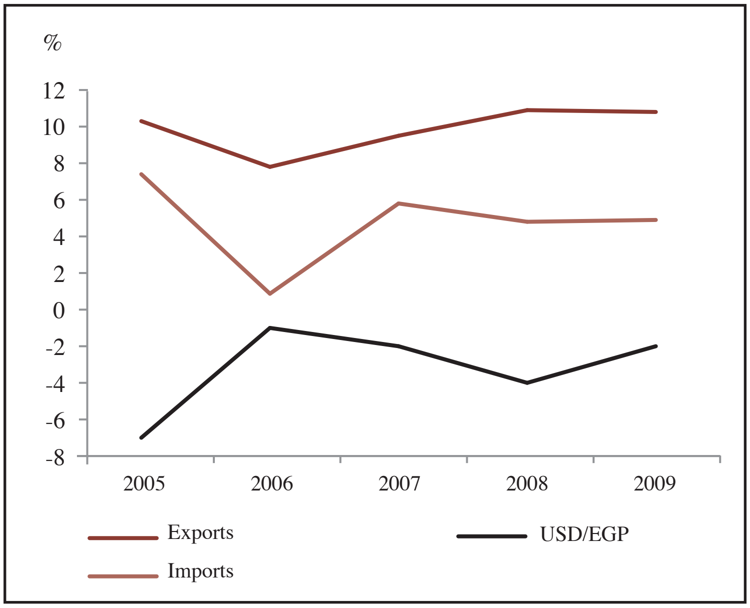

*Source:* World Bank, *Databank* (December 2010).

quality and improve market access. Second, depreciation may increase inflationary pressures as higher costs of imports are passed through to the domestic economy. In a scenario where imports are inelastic, reflecting high dependency on imports of intermediate and basic goods, depreciation would increase the value of imports and the cost of imported goods. To verify, a few observations are in order of the change in exports and imports, with respect to a trading partner as a share of total values, in response to movements in bilateral exchange rates.

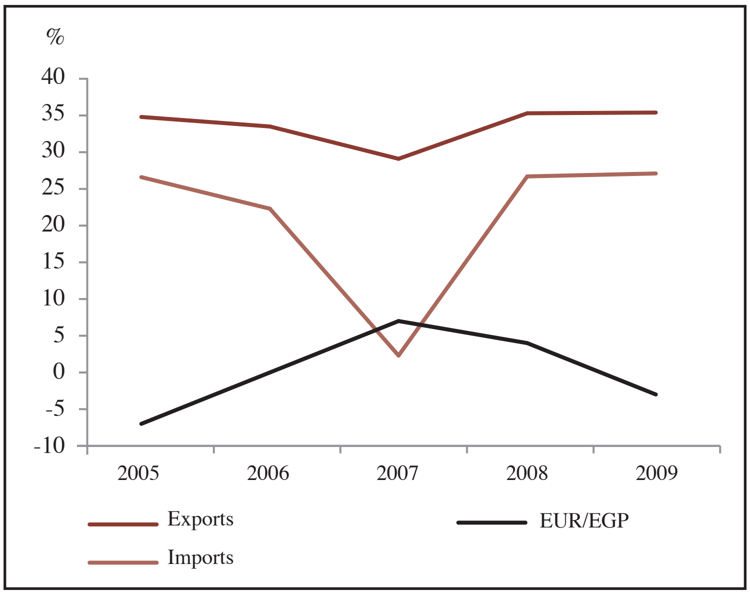
Appreciation (depreciation) of the Egyptian pound with respect to the US dollar forced a significant reduction (increase) in the share of exports to the U.S. Nonetheless, imports proved to be inelastic (Figure 11a). To the contrary, cyclicality in imports appears to follow that of exports, signifying the high share of imported intermediate goods.

**Figure 11. The Impact of Bilateral Exchange Rates on Trade with the U.S. and the Eurozone**

**a. United States**




**b. Eurozone**

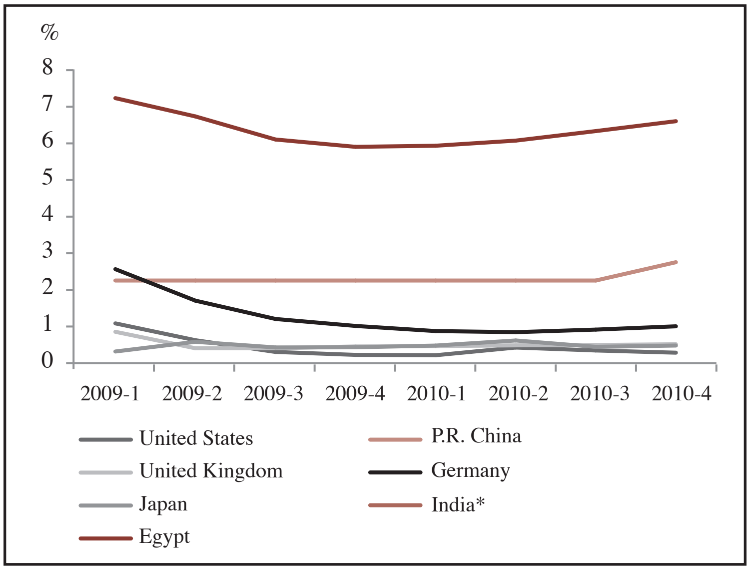



*Source:* UN Comtrade Database; IMF *International Financial Statistics*; World Bank.

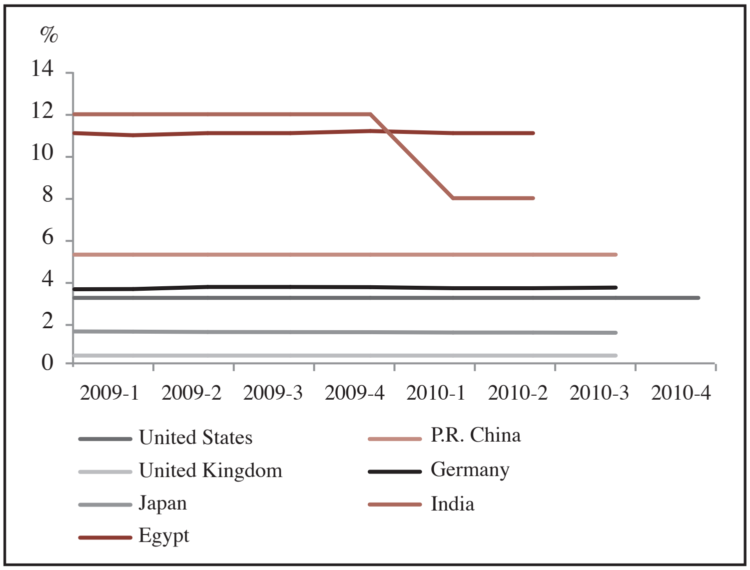
Similar patterns appear with respect to bilateral exchange rate movements of the Egyptian pound relative to the euro (Figure 11b). Depreciation (appreciation) accelerates (decelerates) the share of exports to the Eurozone. Nonetheless, imports pick up despite depreciation, in line with the growth of exports.

**Figure 12. Deposit and Lending Rates in Egypt and Selected Major Economies (Percent Per Annum)**

**a. Deposit Rate**




**b. Lending Rate**




*Source:* IMF *International Financial Statistics* (November 2010).
* No data are available at the time of publication.

Under a liberalized financial account, fluctuations in the exchange rate are impacted by inward and outward financial flows. Egypt's interest rates are significantly higher, compared to major trading partners, reflecting higher inflation and risk premium (Figure 12). Moreover, the interest rate spread, the difference between lending and deposit rates, is higher in Egypt, reflecting structural distortions in the intermediation function, enabling banks to maintain a high markup.

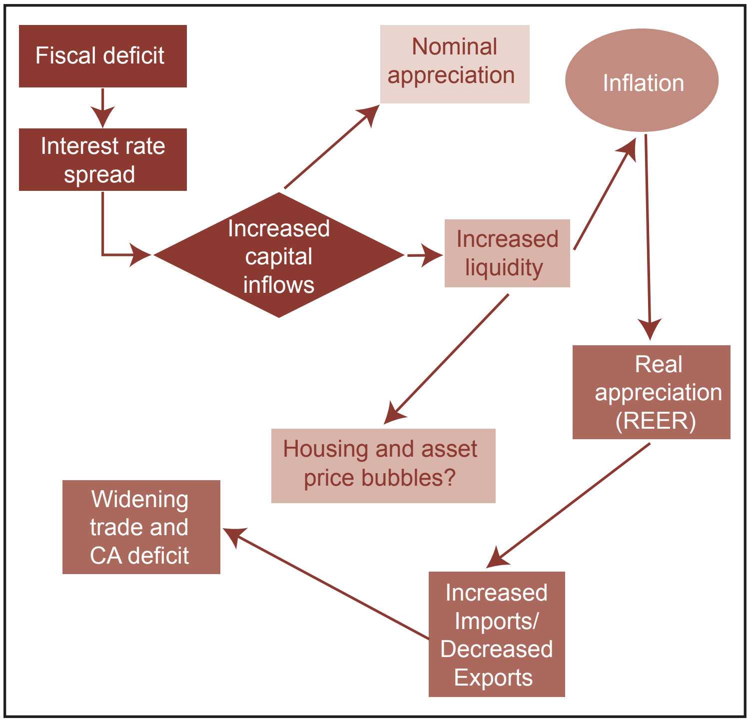
## Competitive Devaluation: Implications for Egypt

In the face of continued quantitative easing in the U.S., a wider interest rate spread would trigger higher capital inflows to Egypt. The surge of inflows increases appreciation pressures of the nominal exchange rate. Moreover, higher domestic liquidity increases inflation, further appreciating the exchange rate in real terms and threatening competitiveness. The implications are: wider trade deficit and housing and asset price bubbles. If the central bank intervenes to stem appreciation, domestic liquidity increases, necessitating sterilization via the sale of government securities. Accordingly, persistent efforts to stem appreciation cannot be sustained without rising fiscal cost and a wider deficit. Moreover, high inflation and currency appreciation could slow down economic growth. In an extreme case, this scenario could further escalate into a currency crisis.

## A Scenario of a Currency Crisis

In a scenario of continued buildup of public debt, a widening interest rate spread could pose a potential risk for fiscal and current account sustainability (Figure 13). Insolvency risk may trigger a sudden stop of capital inflows and a surge in outflows. A severe depreciation may escalate into a currency crisis in the face of mounting external liabilities. While capital controls could act as a security buffer in the short term to stem the risk of a sudden stop, a sustainable solution warrants fiscal consolidation to narrow the interest rate spread by correcting domestic and external imbalances.

**Figure 13. Scenario of a Currency Crisis**




*Source:* Prepared by author.

## What are the Implications of Egypt Joining a Currency War?

To stay competitive in the face of global pressures, further depreciation of the Egyptian pound would be necessary. However, depreciation could increase inflationary pressures, further threatening competitiveness. Hence, nominal depreciation may not be the optimal strategy to achieve competitiveness. Instead, the exchange rate policy should aim at striking a balance in line with domestic priorities: leaning towards depreciation to stimulate growth during a downturn while opting for more appreciation to stem inflationary pressures during periods of steady growth. However, depreciation alone may not be sufficient to stimulate competitiveness towards higher growth, absent efforts to improve quality and efficiency and access to new markets.

## A Strategy to Deal with the Implications of a Currency War in Egypt

In the face of a surge in capital inflows, Egypt needs to formulate a strategy to manage these flows effectively by increasing incentives for long-term inflows and taxing hot inflows. While capital controls could be considered in the face of temporary pressures, persistent pressures demand domestic policy adjustments by resorting to fiscal consolidation to decrease the risk premium in interest rates. In parallel, trade policies should aim at containing the risk of currency war in major markets by increasing access to new markets and upgrading quality. Moreover, efficient management of higher liquidity in the financial system demands more stringent prudential oversight to ensure financial stability in the face of short-term capital flows.

## Conclusion

Maintaining a strong Egyptian pound would help curb inflationary pressures and the cost of intermediate goods. As higher inflation continues to threaten Egypt's competitiveness, targeting a gradual reduction in inflation over time should reinforce competitiveness and stem appreciation of the real effective exchange rate. To reinforce competitiveness, a strategy that entails engaging in bilateral and regional trading agreements should serve the mutual interests of trading partners, without the need to race for competitive devaluation that could escalate into a "currency war." Through these agreements, each partner would capitalize on its comparative advantage that reflects cost and quality. To conclude, policy priorities should target the exchange rate in Egypt in line with underlying fundamentals to increase credibility of domestic policies and anchor agents' inflationary expectations.

*This Policy Viewpoint was written by Magda Kandil, Executive Director and Director of Research (ECES). Matthew Martinec provided research assistance.*

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