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To Float or Not to Float: That is no Longer the Question for Egypt

Policy Viewpoint reflects the views of ECES on key policy issues in Egypt. Its content and recommendations, which are based on research findings, are endorsed by the Center's Board of Directors.

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In a surprise move, as recommended by theory and best practice, the prime minister announced the floatation of the Egyptian pound on January 28, 2003. To the government credit, the shift to a flexible exchange rate regime did not come in the wake of financial and/or banking crises, in contrast to what happened, for example, in Mexico in 1994, Brazil in 1999, and more recently in Argentina. Rather, the shift came as an attempt to resolve policy inconsistency originating from a combination of exchange rate rigidity, reluctance to use international reserves to support the peg to the dollar, and an attempt to reduce the interest rate to activate the economy. Something had to be done, and floating was believed to be an important part of the answer.

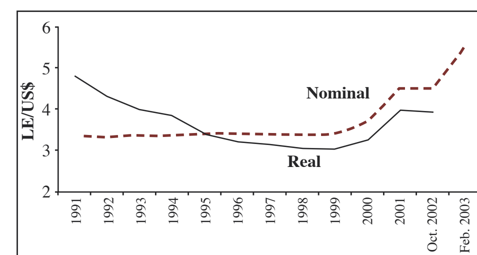
Is this the end of the story? Not quite. On one hand, the shift to a flexible exchange rate regime renders irrelevant the question: To float or not to float. For the Egyptian economy, the loss of credibility resulting from regime reversal is too high to even ponder the question. On the other hand, the shift gives birth and viability to the question of how to make the float work. After all, floating gives monetary authorities the opportunity to conduct active monetary policy, which requires the choice of a new nominal anchor, a new monetary rule, a well-founded understanding of transmission mechanisms, and an institutionally-strong central bank. The success of the new regime depends on the extent to which these requirements are met and how well the currency market is allowed to work.

This edition of *Policy Viewpoint* is an attempt to contribute to the effort of making the new regime work. It focuses on three questions. First, how well has the new regime worked so far? Second, what are the likely consequences of the float? Finally, what is the recommended course of action for monetary policy in the short and medium runs?

I. How well has the new exchange rate regime worked so far?

It has only been a few weeks since the government shifted to a flexible exchange rate regime. It is therefore too early to assess the exchange market, let alone measure the effects of the new regime on inflation, output, and trade. What seems evident however is that there is no sign of significant overshooting (i.e., a decline in the value of the pound beyond equilibrium), contrary to prediction and observed exchange rate behavior elsewhere following currency floatation. In fact, the official value of the pound went from LE4.64/US$ on January 28, 2003 to LE5.52/US$ on February 25, 2003, a depreciation of 19 percent. In Brazil, the depreciation of the *real* was 87.5 percent between the beginning of January 1999 and the peak of the rate during the same month. The modest depreciation in Egypt can be traced in part to the fact that the pound was devalued by 36 percent during 2001-2002. (See Figure 1 for nominal and real exchange rate developments in Egypt during 1991-2003). In addition, prior to the float banks were allowed to charge a commission that made their LE/US$ rate similar to that of the parallel market.

Figure 1. Nominal and Real Exchange Rates in Egypt*, 1991-2003



*Real Exchange Rate = Nominal Exchange Rate x (Industrial countries consumer price index/Egypt consumer price index.)

Source: IMF, *International Financial Statistics* (IFS), different issues.

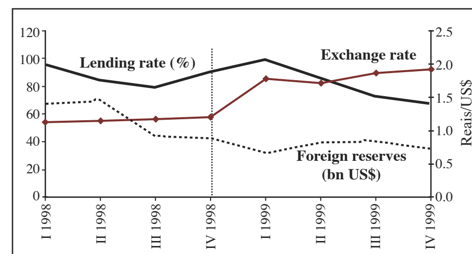
There is another reason, however, for the modest depreciation following the float. Namely, the exchange market does not seem to be working well yet. Otherwise, how else can one explain the inability of some firms to obtain foreign currency from banks at the announced rates. Or why some transactions still take place in the parallel market at rates higher than the average rate announced by the Central Bank. Or why the conversion of dollar-denominated deposits to pound-denominated deposits has not been significant, despite an interest rate differential of about 8 percentage points. In comparison, the devaluation of 1991 led to a fall in the level of dollarization from 53.7 percent in 1990/91 to 37.3 percent in 1991/92. Clearly, there are some imbalances, and the question is how to address them.

One approach is administrative in nature; the other is market based. The administrative approach involves rationing foreign currency according to priority goods or customers, or forcing foreign currency earners to surrender their proceeds. The problem with this approach is that it has been tried in the past with limited success. It did not lead to stability in the exchange market nor efficient allocation. Instead, a parallel market developed, even though punishment was severe. This approach further goes against the spirit of exchange rate flexibility and delays the process of converging toward exchange rate equilibrium. For these reasons, it is worth experimenting with the market-based approach, which rests on the principle of making it attractive for market participants to go through the official channels. It involves such measures as allowing the rate to float with minimum restrictions, while intervening indirectly, for example, by making more dollars available through open market operations if market rates deviate considerably from equilibrium. Other measures include fostering competition, not collusion or tacit agreements, among banks with respect to quoted rates or spreads. To ease the pressure on the pound, the authorities could raise the interest rate temporarily and/or secure additional resources from abroad.

Reliance on market forces and competition does not mean that the market needs no rules. On the contrary, market participants should operate according to a clear set of rules, for example, regarding disclosure, cash transactions, inter-bank dealings as well as dealings between banks and customers. Perhaps it is also time to reconsider the relationship between banks and the Central Bank, which seems to be clouded by the dual role played by the Central Bank as a regulator and a virtual owner of state-owned banks following the abolishment of the Ministry of Economy.

Concern about overshooting and exchange rate volatility should not be a deterrent to relying on markets. Overshooting has been a common feature of countries that have shifted from a fixed to a flexible exchange rate regime. The good news is that this phenomenon is temporary, and the exchange rate (and accompanying high interest rate) come down once market participants believe that the exchange rate reflects economic fundamentals (as illustrated by the example of Brazil in Figure 2). As for volatility of the exchange rate in the medium run, the best course of action is to follow a well-specified monetary rule, as discussed below.

Figure 2. Overshooting in Brazil after Floating the *Real* in January 1999



Note: Roman numerals indicate respective quarter.
Sources: IMF, IFS, March 2002.

II. What are the likely consequences of the new regime?

The shift to a flexible exchange rate regime in Egypt is consistent with recent trends in emerging countries. According to the IMF, the percentage of developing countries reporting a flexible exchange rate regime went up from 11 percent in 1976 to 62 percent in 2001. Correspondingly, the ratio of countries reporting exchange rate pegs came down from 86 percent in 1976 to 35 percent in 2001. Hence, there has been a hollowing of the middle.

More importantly, the shift to a flexible exchange rate regime in Egypt has the potential to boost confidence and attract capital inflows, enable the economy to better absorb real external shocks, and to stimulate exports. Furthermore, the new regime will enable the Central Bank to play the role of a lender of last resort, thus be in a position to steer the economy in the desired direction. Against these benefits, it has been argued that the shift to a flexible exchange rate regime could fuel inflation, lead to contraction of output, and negatively impact certain groups of society. Are these adverse effects likely to be significant in Egypt? Not as much as feared.

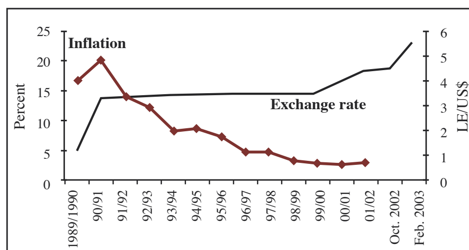
Inflation

Available empirical evidence suggests that countries with flexible exchange rate regimes experience higher inflation than countries with fixed exchange rate regimes. Egypt is expected to be no exception. Casual observation of price movement following the float indicates that this is actually happening. The questions are how high will inflation go, and how will inflation be controlled under the new regime.

There are reasons to believe that the pass-through from depreciation to inflation in Egypt will not be very high. Beside the weak link between inflation and nominal exchange rate

(Figure 3), the Egyptian economy is not very open, with imports of goods and services accounting for around 23 percent of GDP. Also, the floatation was preceded by a series of devaluations, suggesting that significant further devaluation is not necessary to make up for the delay in exiting the fixed exchange rate regime. Unlike most Latin American countries, wage indexation is not a systematic feature of contracts in Egypt, which reduces the room for spiral inflation. Additionally, the floatation came at a time of economic downturn, with economic growth hovering around 3 percent compared with an average of 5 percent during most of the 1990s. Therefore, shifting demand from imported to locally-produced goods is not likely to be as inflationary as it would have been had the economy been at full employment. Finally, the Central Bank has declared that controlling inflation is now the target of monetary policy (Abu El Eyoun, 2003).

Figure 3. Nominal Exchange Rate and Inflation* in Egypt, 1989/90-2001/02



*End of period.
Sources: Ministry of Foreign Trade, *Monthly Economic Bulletin*; Ministry of Economy, *Quarterly Economic Digest*.

Output contraction

Beside the fear of inflation, it has been argued that the shift to a flexible exchange rate regime could be contractionary. Overshooting would push firms with dollar liability to bankruptcy and lead to a fall in output. Higher interest rates to prevent significant depreciation would discourage investment and lead to lower growth. And low export elasticity could mean that firms would not be able to take advantage of a more competitive exchange rate. While these arguments cannot be dismissed lightly, they are not supported by evidence, especially over the medium to long runs. The experiences of Mexico and Brazil in the 1990s are cases in point.

With respect to Egypt, there are no studies of the relationship between exchange rate regimes and output. However, a number of factors suggest that significant contraction is not likely to happen following the float. To start with, the percent of dollar liability of firms (measured by loans in foreign currency over total loans) is less now than it was a few years ago, coming down from a peak of 30.6 percent in 1994 to 21.2 percent in 2002. As such, while some firms are expected to run into difficulties following the depreciation, most of them will not. Second, the initial interest rate differential between deposits in Egyptian pounds and deposits in dollars is relatively high, thanks to a consistent decline in interest rate in the US. As a result, interest rate in Egypt may not need to shoot up to prevent capital flight and avoid sharp depreciation. Finally, even if the elasticity of exports in Egypt were low, the depreciation of the pound would still make it more attractive for firms on the margin to export. In the medium run, the new regime could contribute to higher growth if it succeeds in boosting exports and attracting FDI.

Distributional effects

The clear winners from the new regime are exporters and firms in the tourism sector, given that their revenue in local currency is expected to go up. The potential losers are firms with dollar liability and earners of fixed income, especially civil servants and pensioners, as they see inflation erode their real income. Importers will pay higher prices for imports, but the impact on them depends on whether they are able to pass the increase in prices to consumers. The net impact on the government budget is also ambiguous. It depends on the expected increase in revenues from higher import duties and greater dividends/transfers from the Suez Canal and exports of oil and gas, compared with the expected increase in expenditures to meet external debt obligations and the additional cost of imports of basic goods.

To ameliorate the negative impact on earners of fixed income the government announced that it would absorb the price increase of imported basic goods (e.g., wheat, sugar, edible oil). However, this may not be adequate and at least a partial salary increase is worth considering. As for firms with dollar liability, there was an announcement that they would have to meet their debt obligations to banks in the currency of borrowing. Accordingly, firms in this category that earn revenue in local currency will experience difficulties and may require workout plans with their creditors to make it through the transition.

III. What is the recommended course of action for monetary policy in the short and medium runs?

In the short run, experience suggests that the best course of action for Egypt involves allowing the exchange rate to float with minimum restrictions, even if it involves overshooting. In parallel, the interest rate could be increased temporarily, along with injections of hard currency (through the use of reserves, borrowing from abroad, or privatization) to prevent the exchange rate from taking the full hit. Such a package seems desirable with or without the support of international institutions. However, if a war erupts in Iraq, there is a strong case for seeking financial support from abroad. After all, losses associated with a war in the region are transitional in nature and have little to do with the fundamentals of the economy.

Beyond the short run, the conduct of monetary policy under a flexible exchange rate regime requires a new vision, which has already been articulated by the Central Bank (Abu El Eyoun, 2003). The next step is to translate this vision into specific choices of a nominal anchor, a rule for optimal intervention in the exchange market, a new rule for conducting monetary policy, and ways to strengthen the institutional capacity of the Central Bank. Below is a brief discussion of these issues, while further details can be found in Cardoso and Galal (2002).

Nominal anchor

Nominal anchors are needed to guide expectations. The most popular choice of a nominal anchor among developing countries under a flexible exchange rate regime is inflation-targeting, given its transparency and observability.The preconditions for adopting inflation-targeting are: freedom from commitment to another nominal anchor (i.e., exchange rate or wages), and the ability to carry out independent monetary policy, especially from fiscal considerations. By shifting to a flexible exchange rate regime, Egypt has satisfied the first condition. However, it remains to be seen whether the new banking law will provide the Central Bank with adequate independence.

Intervention in the exchange rate

Even under a fully flexible exchange rate regime, the float is hardly ever clean in practice. Under inflation-targeting, most central banks intervene because the exchange rate affects inflation through its effect on relative prices of domestic to foreign goods, which in turn affects domestic and foreign demand for domestic goods, hence aggregate demand and inflation. In addition, the exchange rate affects the consumer price index (CPI) directly through its effects on the prices of imported goods.

Beside the links between inflation and exchange rate, intervention may also be desirable to avoid long-term swings in the exchange rate resulting from volatility of capital inflows. The solutions advocated to avoid misalignment are “floatation bands” with clear boundaries but crawling centers around equilibrium exchange rate, or “monitoring bands” with no commitment to defend the band but to intervene tactically within the band.

Monetary rules

Implementing inflation-targeting requires adopting one version or another of Taylor’s Rule. According to this rule, interest rate could be set taking into account output gap (the difference between actual and potential GDP), the deviation of expected inflation from target, and the deviation of exchange rate from target. Inflation target need not be annual CPI or a single number. Instead, it could be a range for a number of years.

The Central Bank

Central banks usually go through significant transformation to be able to handle monetary policy under flexible exchange rate regimes. The transformation process includes internal reorganization to place emphasis on policymaking, upgrading staff skills to provide in-depth analysis and forecasts, and alignment of incentives to attract and motivate personnel. Research departments and policy committees play an important role in the new central bank.

Such a process has already been started in Egypt with a number of initiatives to upgrade skills through training, improve the timeliness and accuracy of information through the use of information technology, and the creation of a policy committee. But major challenges remain, especially with respect to staffing, incentives, and the capacity of the research department.

Concluding Remarks

Egypt has experimented with a variety of exchange rate regimes over the past 15 years. Up until 1991, a multiple exchange rate regime prevailed. The exchange rate was then unified, devalued, and kept fixed to curb inflation. The fixed regime was abandoned in favor of an intermediate regime in January 2001. But the new regime was never put to the test, which eventually gave way to a floating regime in January 2003. The key challenge now is making the new regime work.

The preceding analysis offers suggestions regarding the conduct of monetary policy under the newly-adopted exchange rate regime in both the short and medium runs. Key to the success of the new regime, however, is how expectations will be managed. And here is where the announcement of a consistent macro framework with clear targets, the adoption of market-based exchange rules, and possibly the support of international institutions could make a big difference. The sooner such measures are taken, the sooner the benefits from the new regime could be realized.

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