المركز المصرى للدراسات الإقتصادية

ECES

The Egyptian Center for Economic Studies

Currency War: Implications for Egypt

January 2011

Introduction

RECENT HEADLINES:

- "*Undeclared currency war*"
  - Guardian – October 6, 2010
- "*G20 seeks to avoid currency war*"
  - AlJazeera – October 23, 2010
- *"Currency wars threaten global economic recovery"*
  - BBC News, October 6, 2010
- "*China warns against rapid rise in yuan*"
  - Guardian – October 7, 2010
- "*Fears of global currency war rise*"
  - Financial Times – October 12, 2010

MAIN ISSUES

- What is the currency war about?
- How would it impact the Egyptian economy?
- Which policy options best mitigate the implications on Egypt?

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:
  - **Boost exports**
  - **Curb imports**
  - **Improve the balance of trade**
  - **Boost economic growth**

THE COMMENT THAT STARTED IT ALL…

- "*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.*" – Mr. Guido Mantega, **Brazilian Finance Minister**
  - Comments made in response to US Dollar **depreciating 25%** against the Brazilian real in recent months, weakening Brazilian export potential

The tension builds…

THE CURRENCY WAR WAS TRIGGERED BY:

- **US trade deficit with China,** as a result of keeping the Yuan at an artificially low level.
- US "**quantitative easing**" to buy up government bonds and other debts, and lower the value of its dollar.
- "**Competitive Devaluation**" by other countries (Japan, Korea, Brazil) to retaliate.

PRIMARY CONCERNS

- China's **unwillingness to allow the Yuan to rise** more rapidly
- Rich world's monetary policy – printing money to purchase government bonds – **quantitative easing**
  - **Euro has soared relative to dollar** as European Central Bank has expressed less interest in these actions
- Developing countries response to these actions
  - **Foreign exchange intervention** to maintain export competitiveness

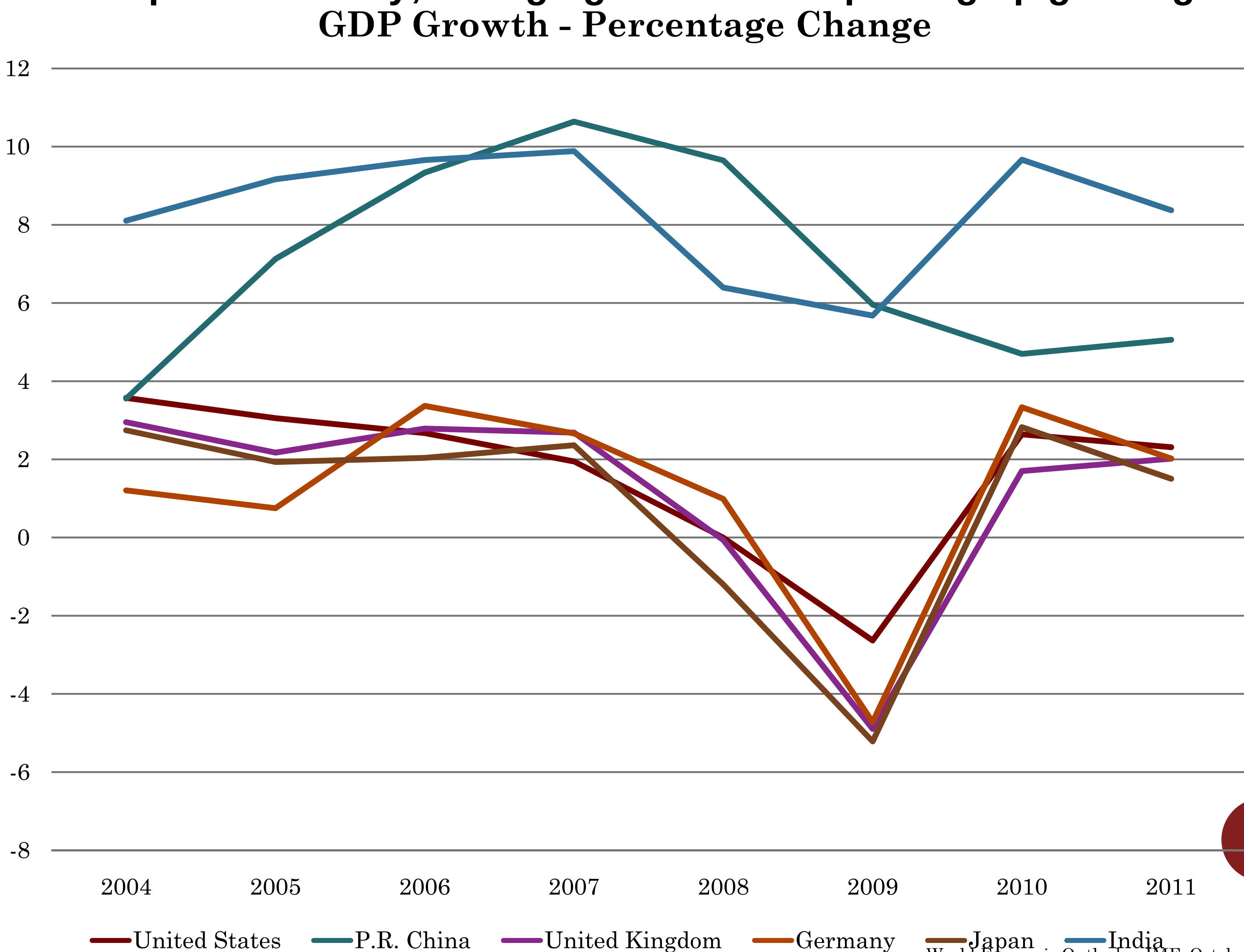
WHY THE CONCERN?

- **Existing imbalances between structure of trade** flows between industrialized and industrializing countries:
  - **Imbalances in interest rates**
  - **Growth forecast discrepancies**

- Emerging economies' concern over an **undervalued Yuan** dampening competitiveness
- **US** quantitative easing depreciating exchange rate

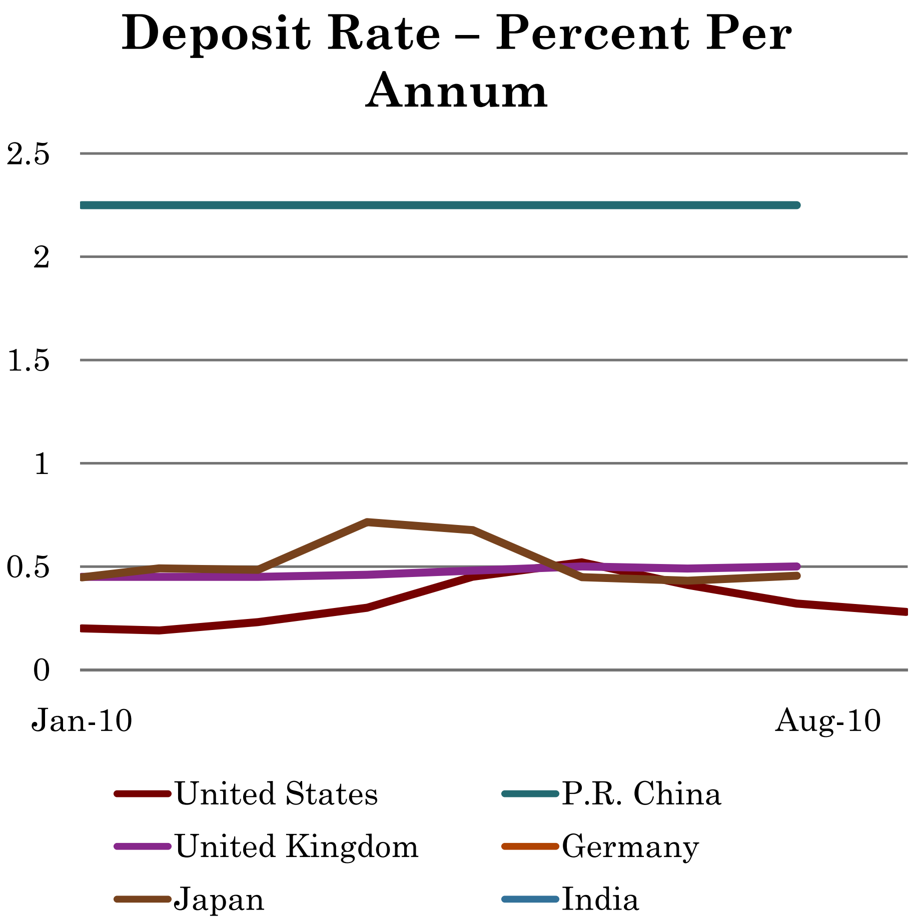
- Recent **foreign exchange interventions** by Japanese central bank
  - Maintain Yen competitiveness and Japanese export position

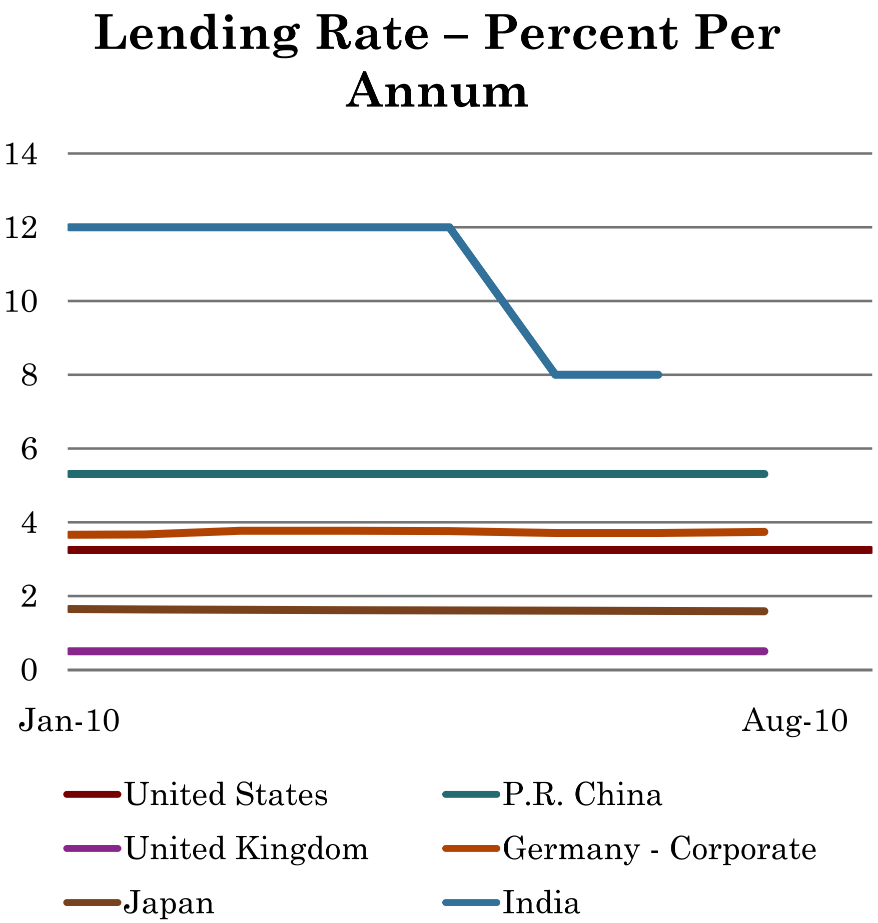
A two-speed recovery; emerging markets are picking up global growth



World Economic Outlook – IMF, October 2010

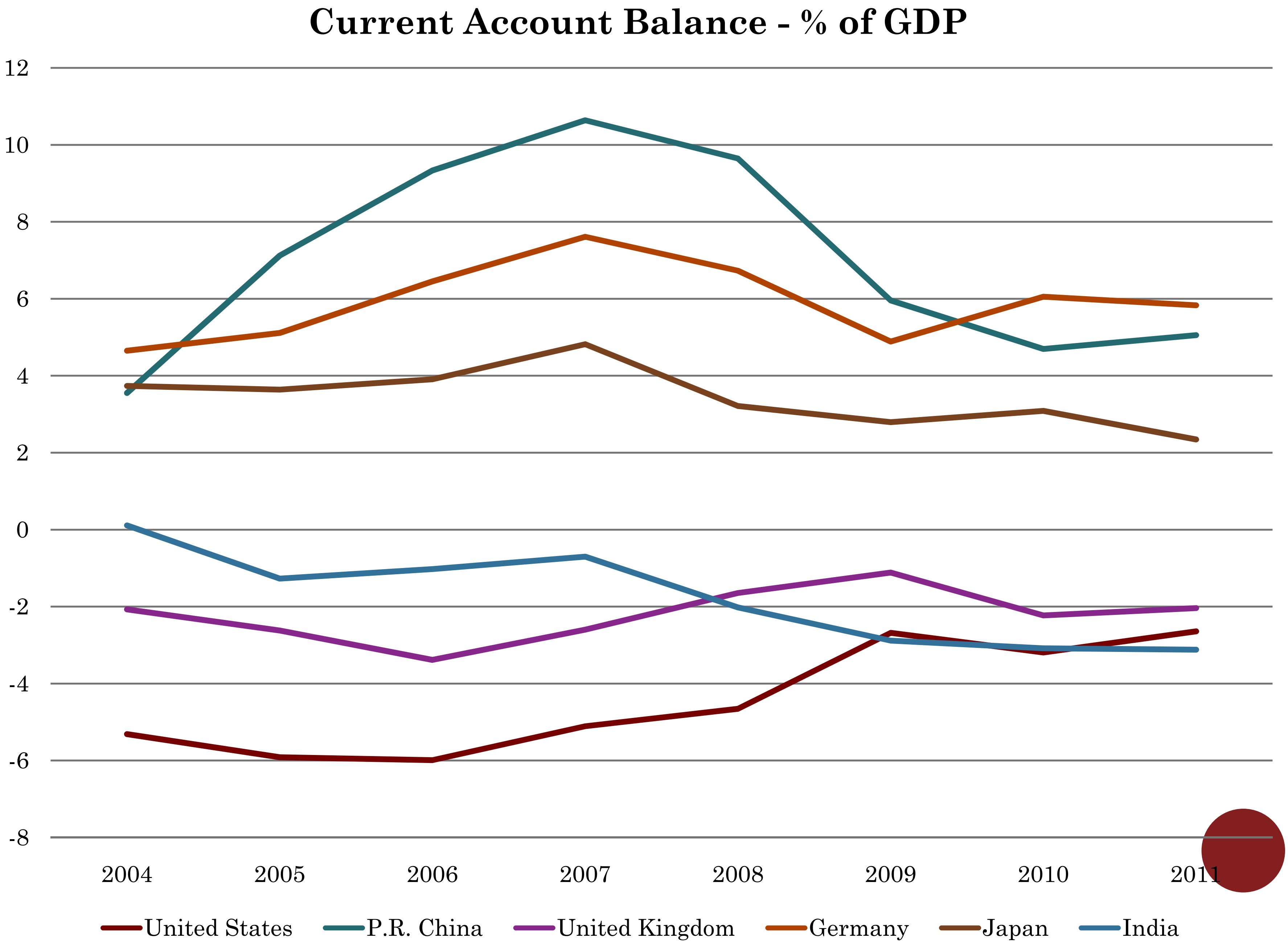
A widening gap, reflecting continued quantitative easing in the US, Although monetary policy has been neutral in most countries.





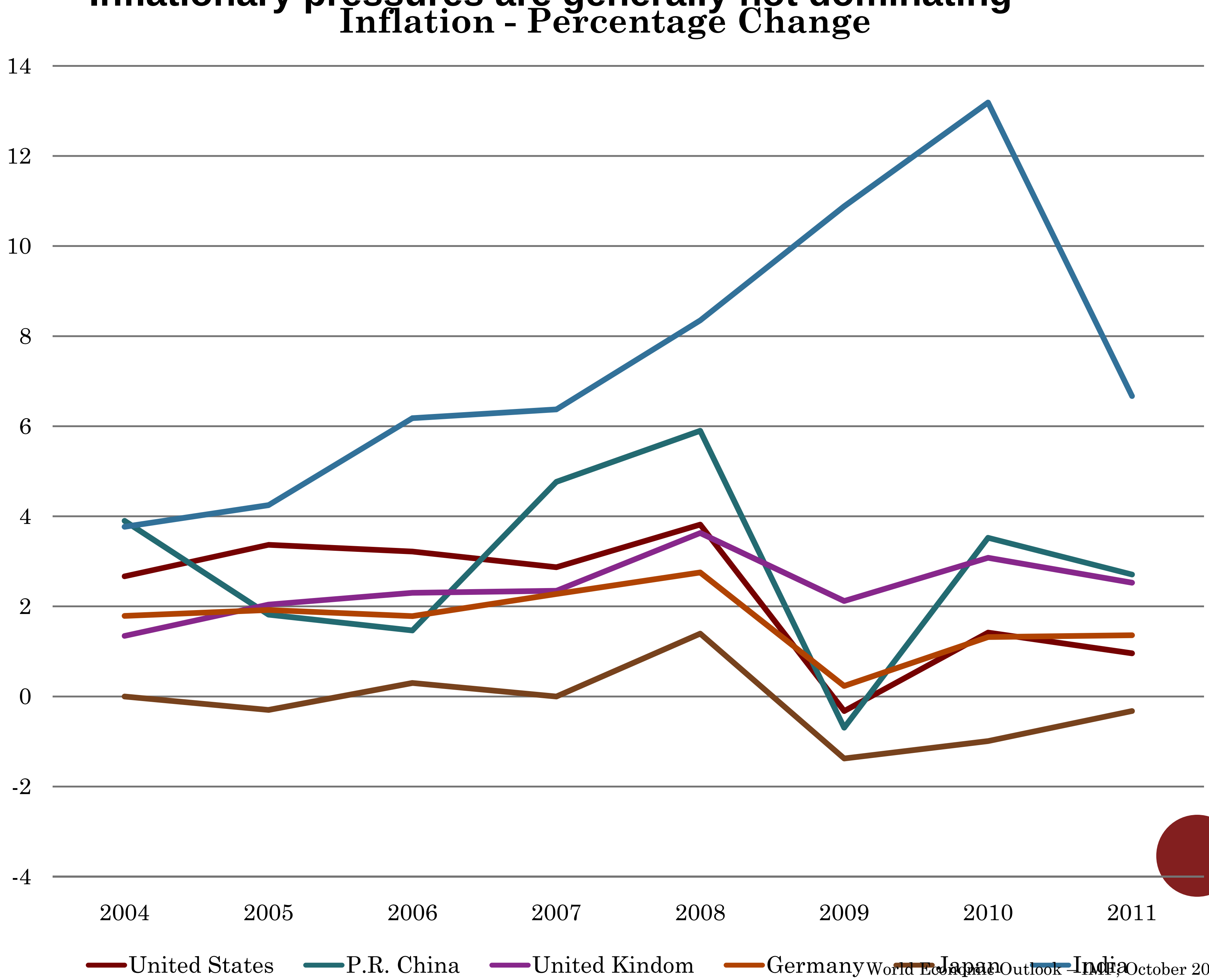
International Financial Statistics – IMF, November 2010

Surplus countries benefit from larger imports in deficit countries



World Economic Outlook – IMF, October 2010

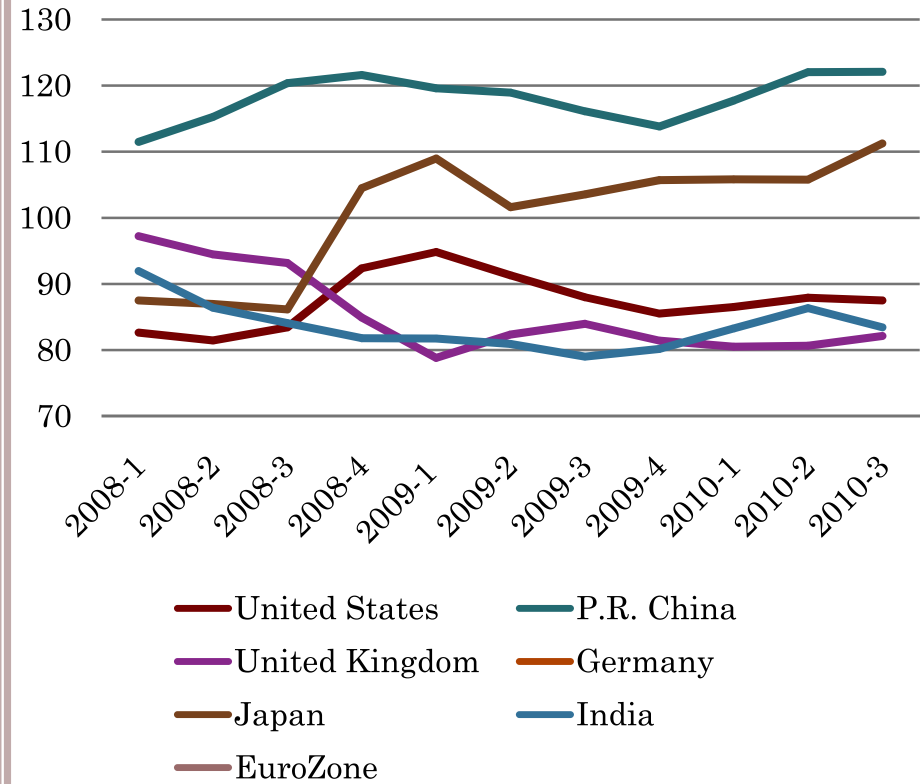
Inflationary pressures are generally not dominating



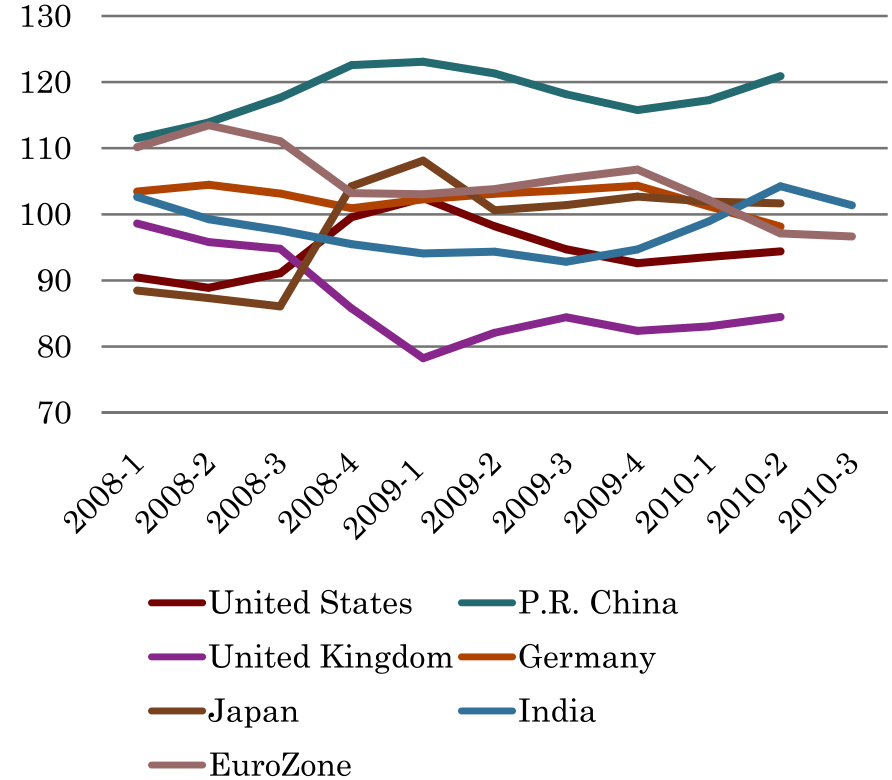
World Economic Outlook – IMF, October 2010

Challenges posed by relative inflation despite continued efforts to Preserve competitiveness

Nominal Effective Exchange Rate



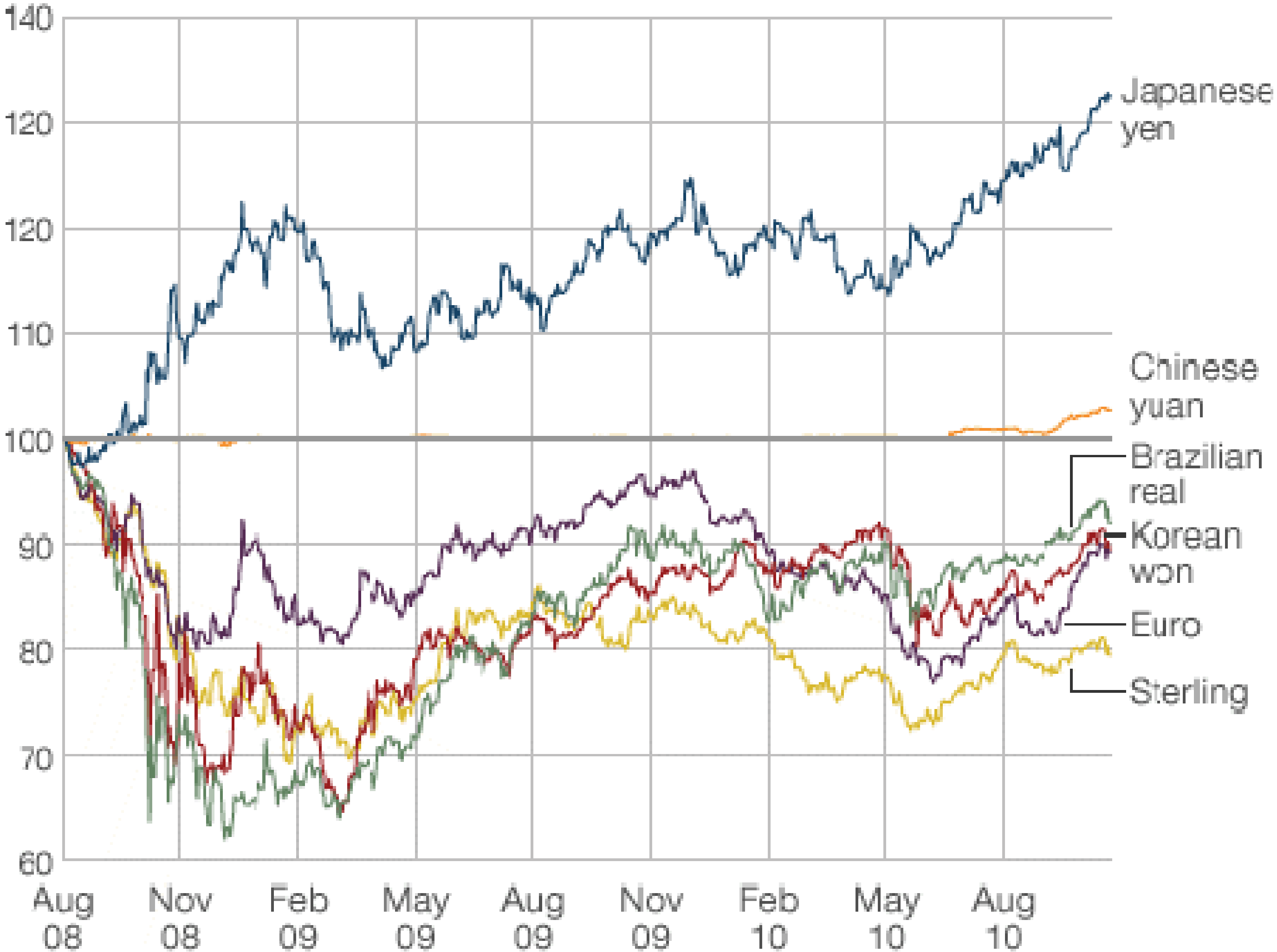
Real Effective Exchange Rate



Databank – World Bank, December 2010

Exchange rate against dollar

Dollars per currency*



*Rebased at 100% on 1 August 2008

Source: Bloomberg

Implications for Egypt…

HOW DOES EGYPT FIT INTO THE PICTURE?

- Between major trading partners and international players – Where does the Egyptian economy stand?
  - **Trading partners**
  - **GDP growth**
  - **Inflation**
  - **Exchange rates**
  - **Current account balance**
  - **Interest rates**
- If countries continue to pursue policies of competitive devaluation – **What are the potential implications for the Egyptian economy**?

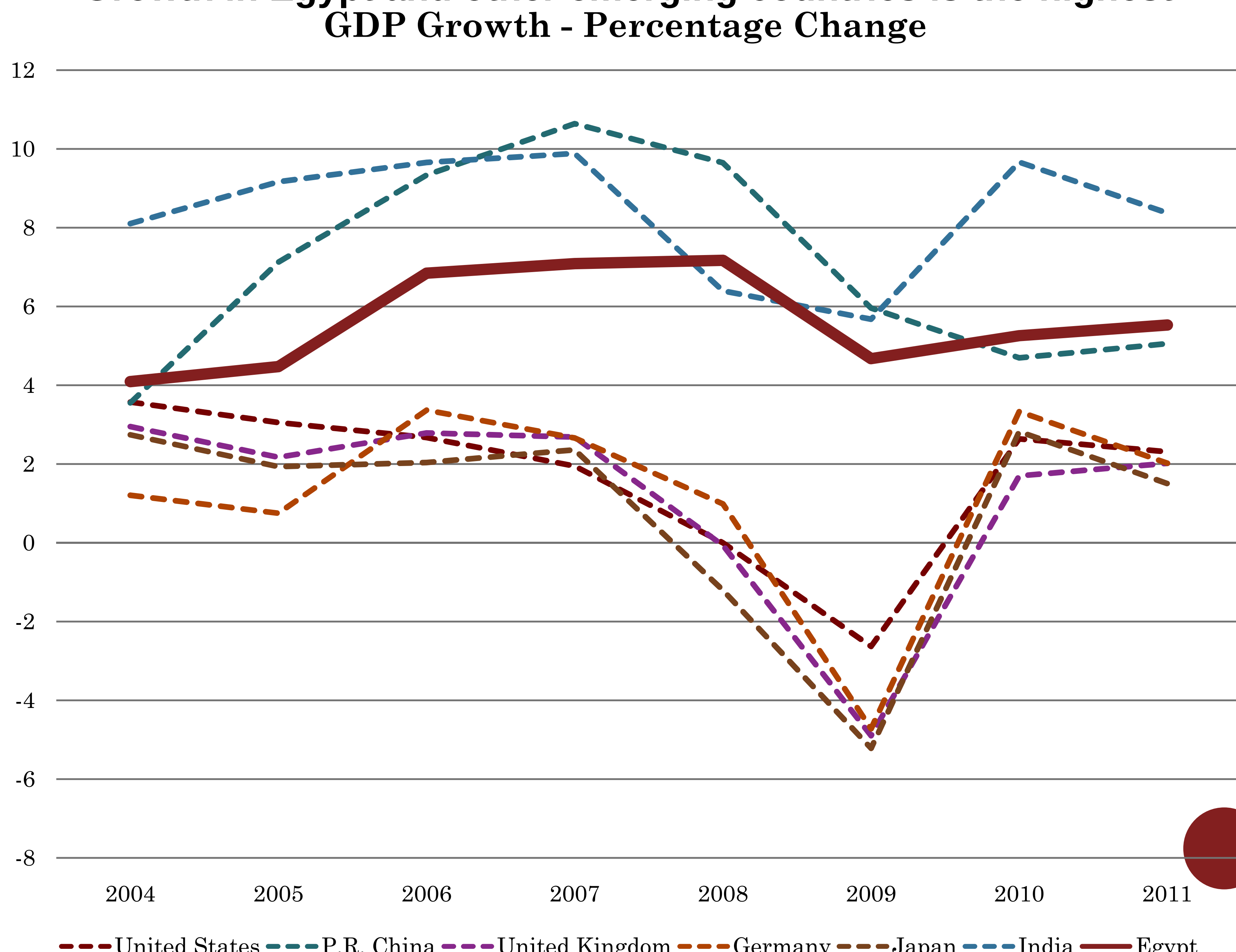
Egypt's major trading partners:

Rank	Country	Share of Exports (2009)
1	European Union (27)	35.4
2	India	6.3
3	United States	4.9
4	Saudi Arabia	4.8

Rank	Country	Share of Imports (2009)
1	European Union (27)	27.1
2	United States	10.8
3	China	8.4
4	Saudi Arabia	5.9
5	Russian Federation	4.3

World Trade Organization – Egypt, Country Profile

Growth in Egypt and other emerging countries is the highest



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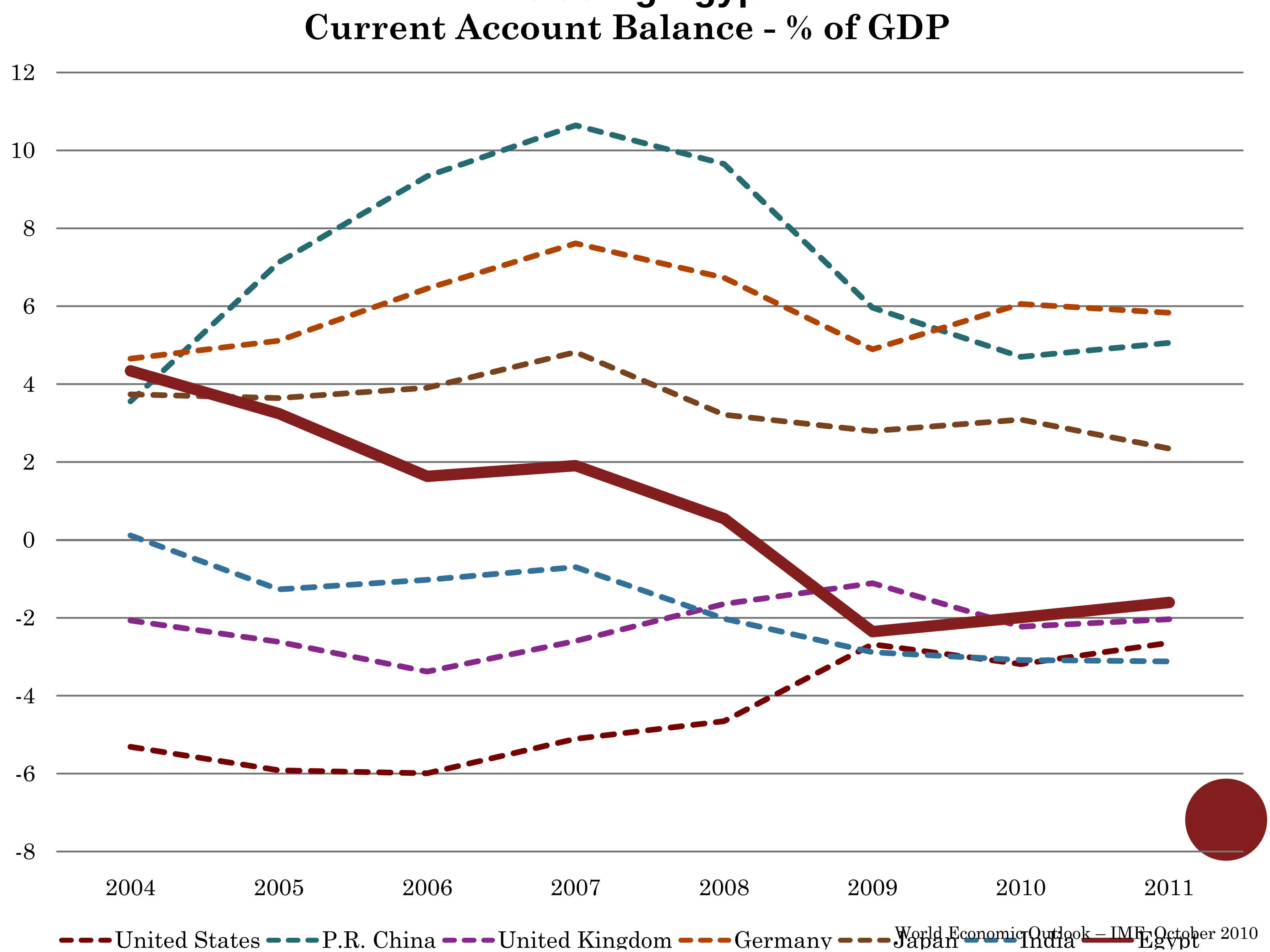
Surplus countries are targeting higher imports from deficit countries, Including Egypt



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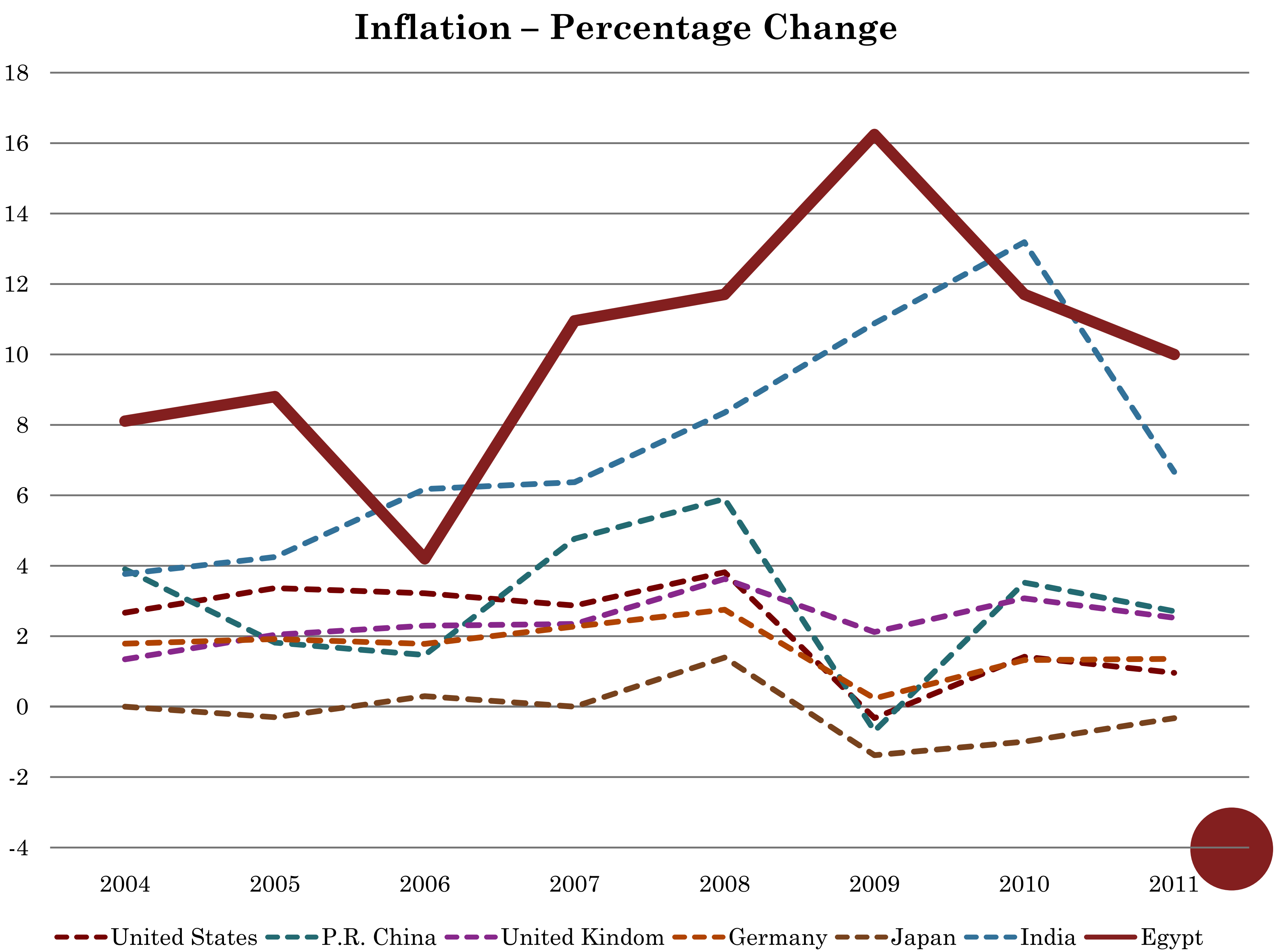
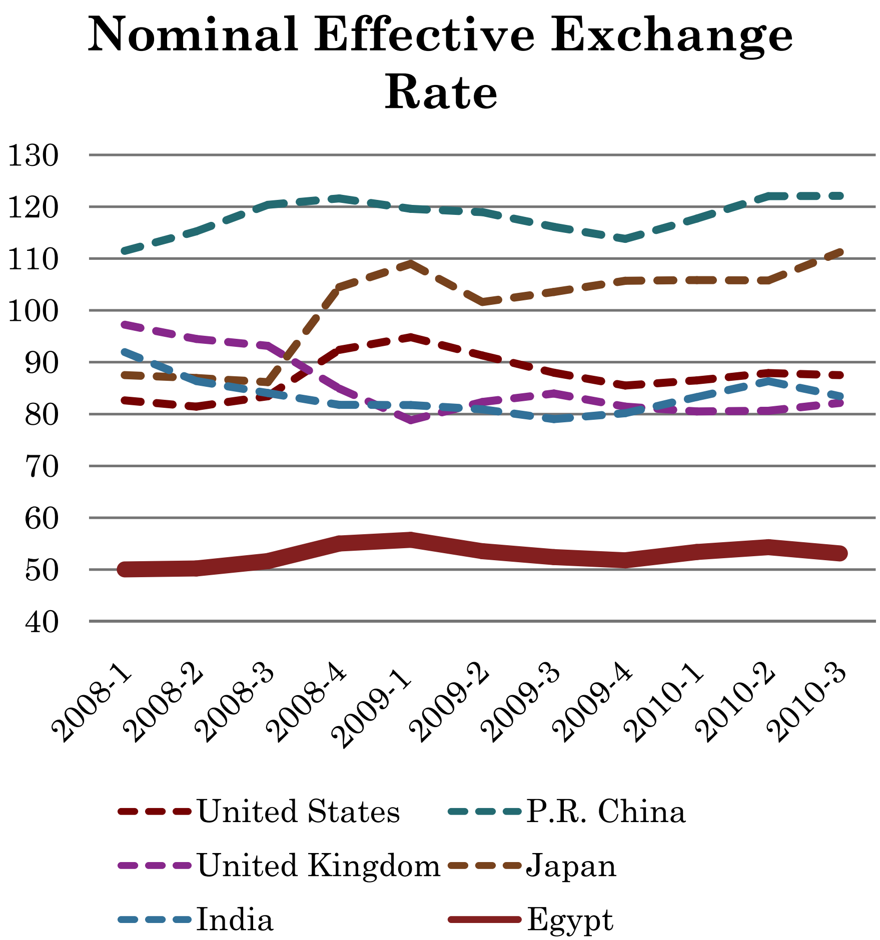
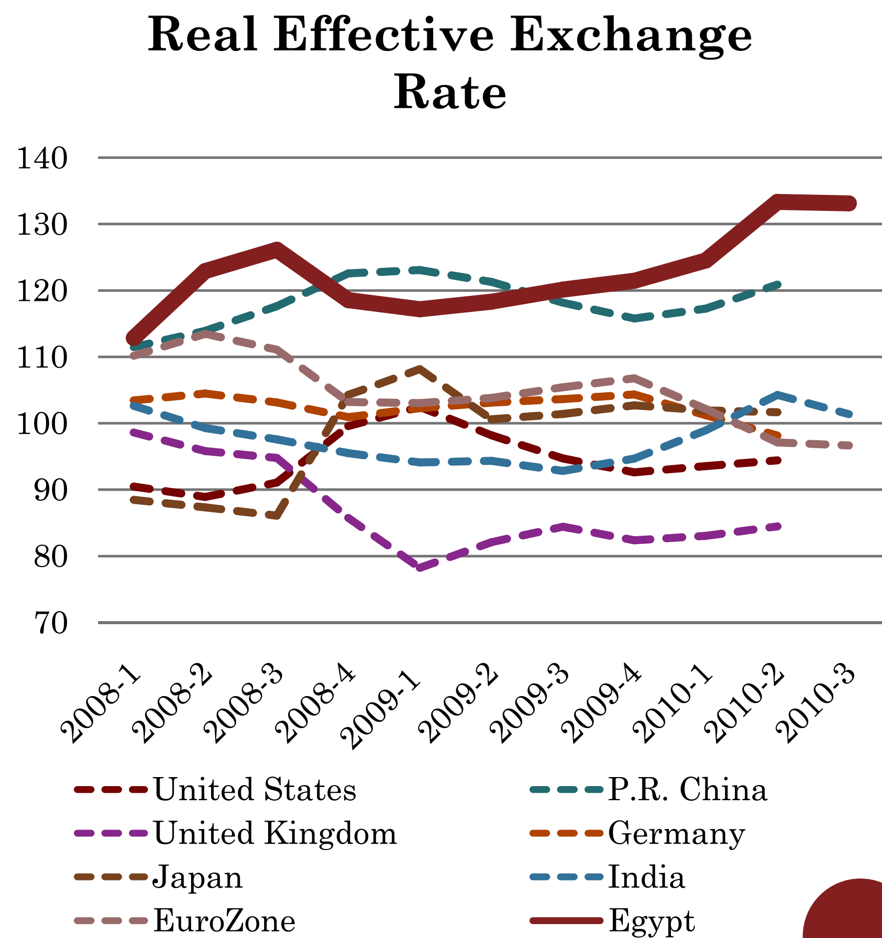
High inflation in Egypt threatens competitiveness



World Economic Outlook – IMF, October 2010

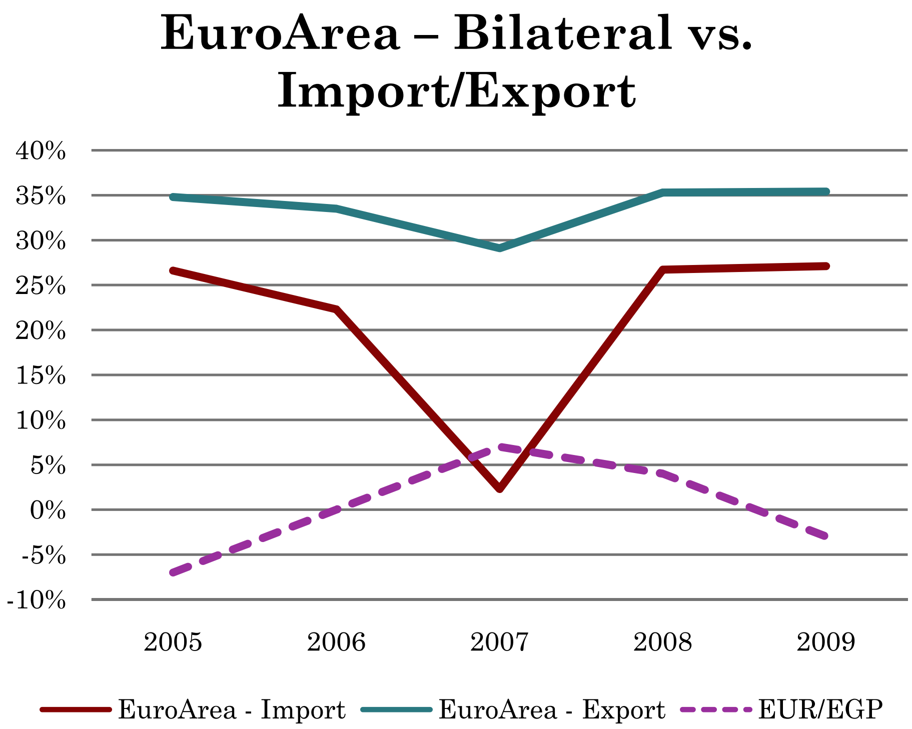
Efforts to preserve competitiveness are challenged by higher Inflation, appreciating reer in Egypt

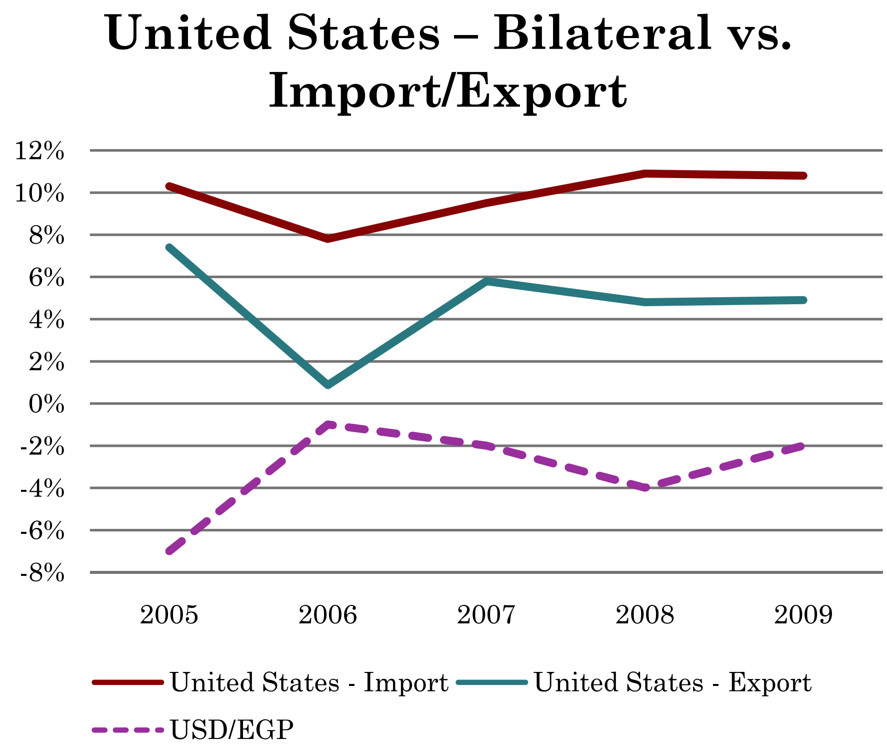




Databank – World Bank, December 2010

Exports dip in response to appreciation and recover with Depreciation; imports appear to be inelastic

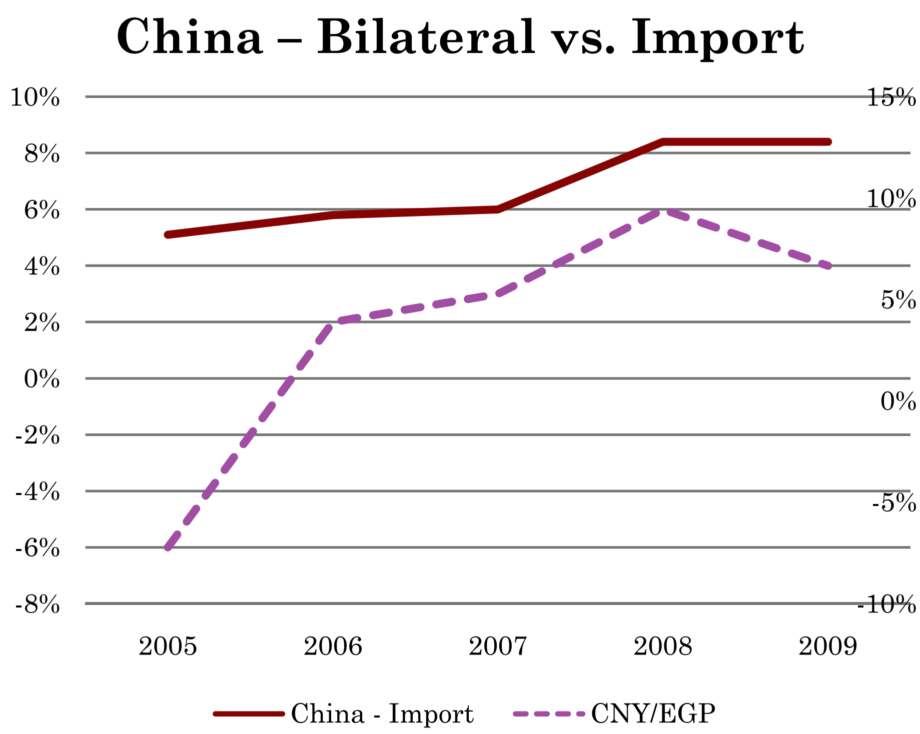


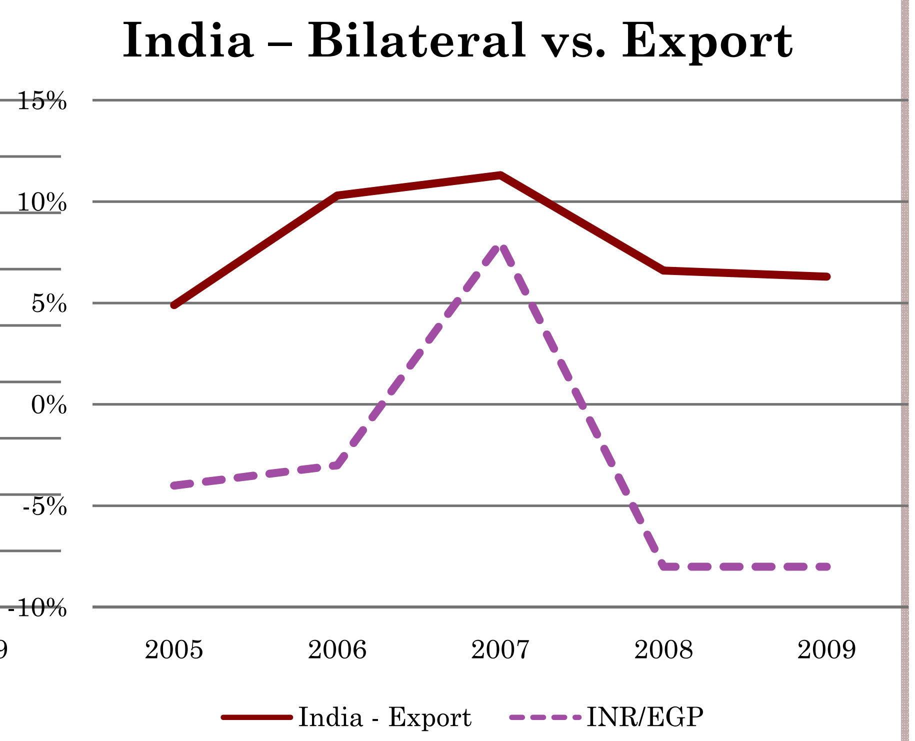


•Import/export data – change in the share of import/export of the total value for Egypt with respect to a trading partner
•Exchange rate data - % change from previous year

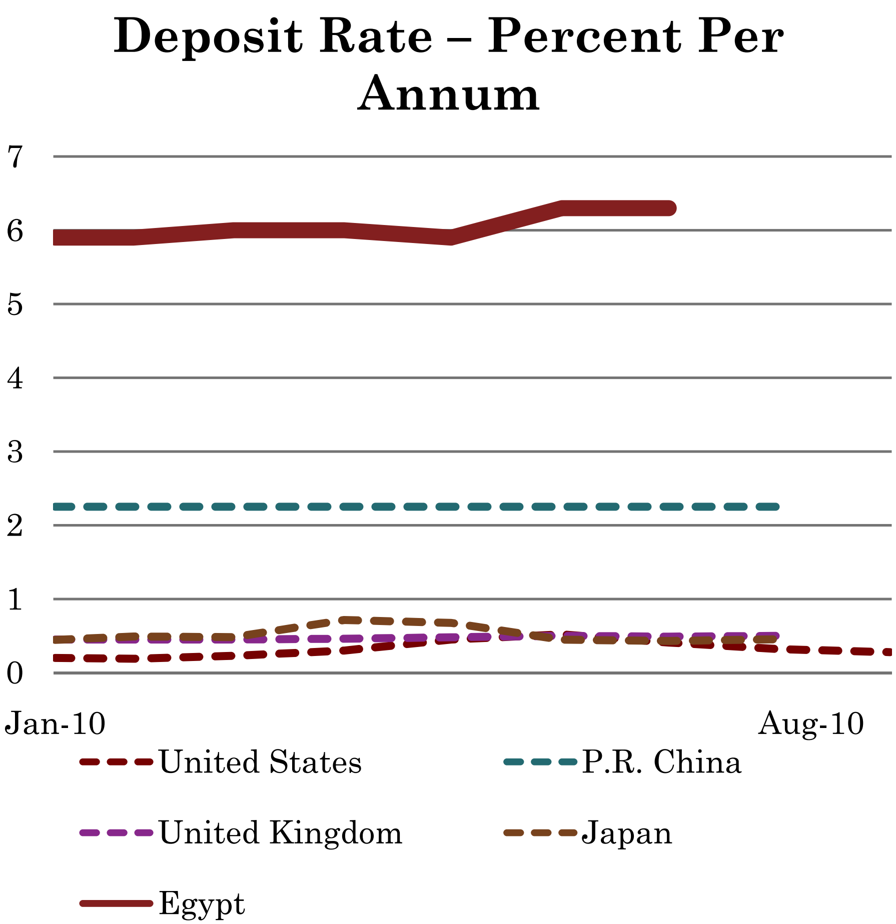
UN Comtrade Database, IMF – IFS Statistics, World Bank

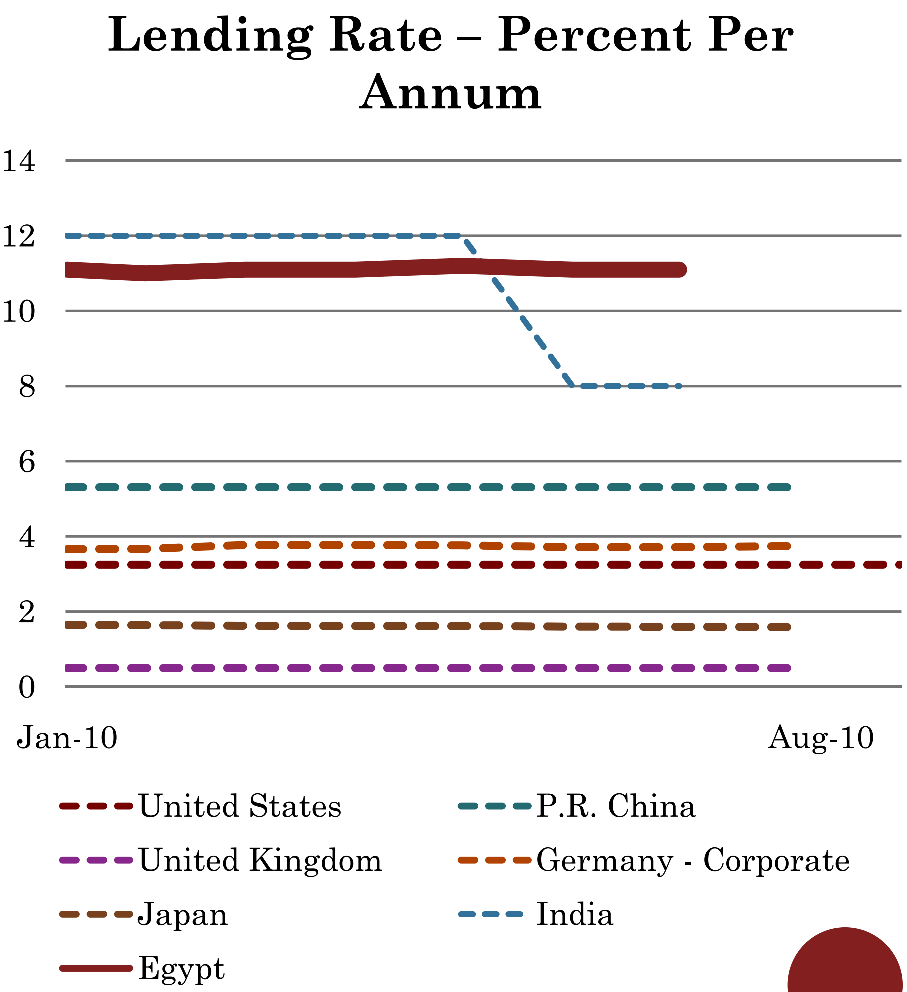
Imports from China surge with appreciation; exports to India appear inelastic





Deposit and lending rates and the interest rate spread are high in Egypt

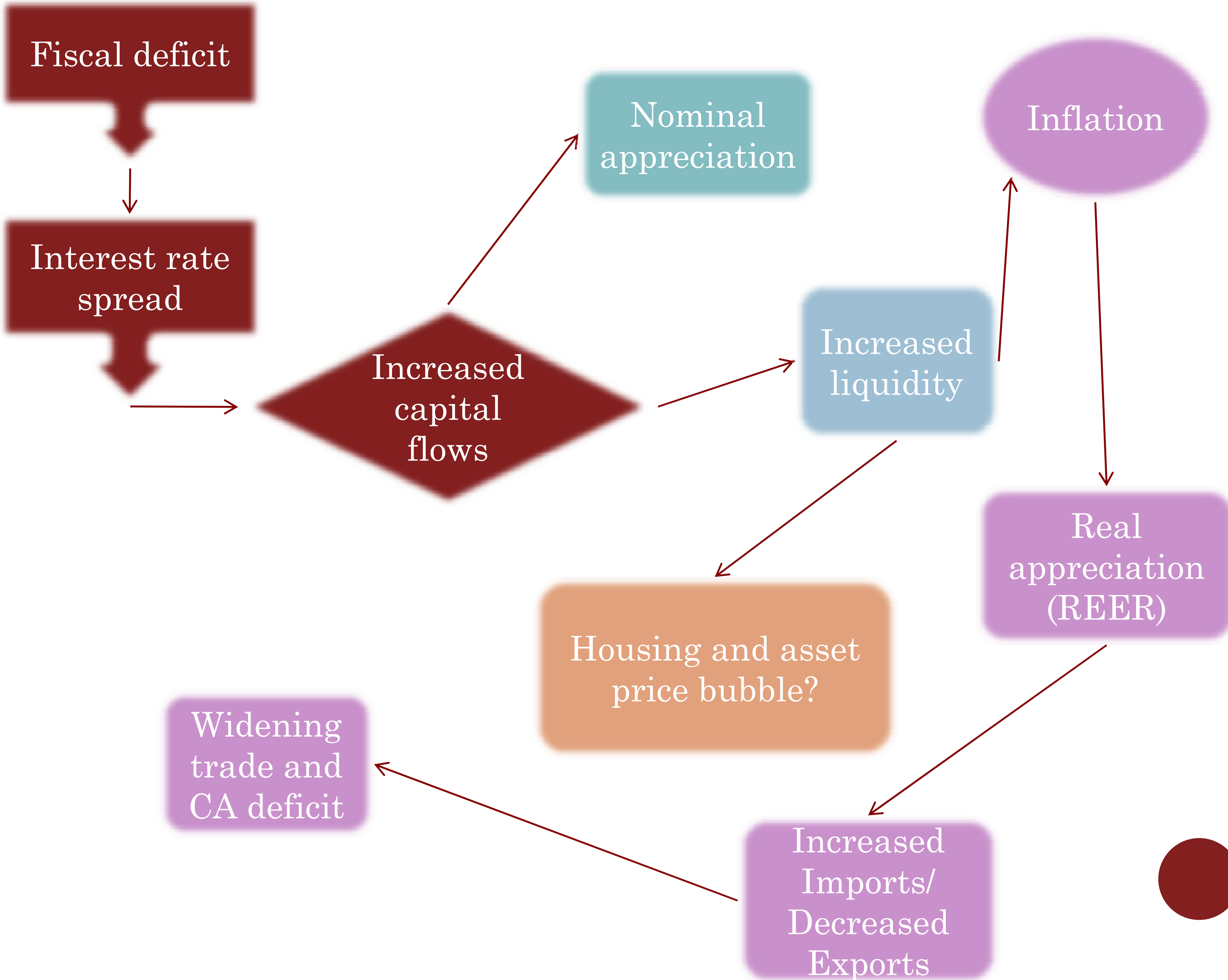




International Financial Statistics – IMF, November 2010

FOR EGYPT, A CURRENCY WAR WOULD IMPACT:

- ***A surge in capital inflows*** attracted to higher interest rates,
- ***Appreciation*** of the Egyptian Pound,
- An ***increase in domestic liquidity***,
- ***Higher inflation***, appreciating REER,
- Loss of competitiveness, ***wider trade deficit***,
- Housing and asset ***price bubble***,
- ***Intervention*** **and** ***sterilization***,
- ***Higher fiscal cost*** and a wider deficit,
- ***Slower growth***,
- Risk of ***sudden stop*** and a currency crisis.


Fiscal deficit
Interest rate spread
Increased capital flows
Nominal appreciation
Increased liquidity
Inflation
Real appreciation (REER)
Housing and asset price bubble?
Widening trade and CA deficit
Increased Imports/ Decreased Exports

A Scenario of CURRENCY CRISIS:

- *Higher public debt widens the interest rate spread* with **potential risk for fiscal and current account sustainability**.
- **Insolvency risk** may trigger a ***sudden stop*** of capital inflows and a surge in outflows.
- A severe depreciation may escalate to 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 sudden stop, a *sustainable* solution warrants *fiscal consolidation* to **correct domestic and external imbalances**.

CONCLUSIONS

DEALING WITH THE IMPLICATIONS OF A CURRENCY WAR, EGYPT NEEDS TO:

- *Manage capital inflows effectively*, increasing **incentives for long-term flows** and **taxes on hot inflows,**
- ***Capital controls*** could be considered in the face of ***temporary*** pressures,
- However, **persistent** pressures demand *domestic* ***policy adjustments,***
- Namely, ***fiscal consolidation*** should aim at decreasing the risk premium in interest rates,
- *Trade policies* should aim at **increasing access to new markets and upgrading quality**,
- *Prudential oversight* to **ensure financial stability** is necessary in the face of short-term capital flows.

RECENT SEOUL-G20 OUTCOMES:

- ***Little progress on a firm commitment to avoid economic protectionism*** – *competitive devaluation or enacting tariffs*
    - Still, UK Chancellor of the Exchequer – George Osborne, stated an "**important step forward**" had been taken **to avoid a currency war** and address global trade imbalances
- Seoul ***Consensus on restructuring IMF***
- *Commitment by China to* ***move toward a more "market-oriented"*** exchange rate regime
- Pledge to **pursue policies** "*conducive to reducing excessive imbalances*"

IF EGYPT WERE TO JOIN THE CURRENCY WAR

- ***Further depreciation of the Egyptian pound*** would be necessary to ensure competitiveness of exports, in light of high relative inflation.
- However, ***depreciation could increase inflationary pressures***, further threatening competitiveness.
- Hence, *exchange rate policy should aim at striking a balance,* ***in line with domestic priorities.***
- Moreover, ***depreciation may not stimulate export growth,*** absent efforts to *improve quality and efficiency and access new markets.*

IF EGYPT WERE TO MAINTAIN ITS CURRENCY STRENGTH…

- ***Currency strength would help curb inflationary pressures*** and the cost of intermediate goods.
- Targeting a ***gradual reduction in inflation over time should reinforce competitiveness*** and stem appreciation of reer.
- ***Engaging in bilateral and regional trading agreements*** should help mutual interests of trading partners, without currency war.
- *Each partner would capitalize on its comparative advantage*, **reflecting cost and quality.**
- Policy priorities should *target the exchange rate in **line with underlying fundamentals*** to increase credibility and anchor expectation.

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