Egypt's Exchange Rate Predicament:
An Attempt to Determine the Current Equilibrium Exchange Rate and its Future Outlook
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Speaker:

- **Dr. Diaa Noureldin,** Assistant Professor, Economics Department, AUC

Discussants:

- **Mr. Ahmed Issa**, Chief Executive Officer, Retail Banking, CIB
- **Mr. Mohamed Abou Basha,** Senior Economist, EFG-Hermes
- **Mr. Mohamed Farid,** Chairman, Dcode Economic Consulting and Modeling

Main points:

- Way beyond being a relative price, the exchange rate has recently gained exceptional attention in Egypt. This roundtable discussed the findings of a forthcoming ECES working paper that looks into the equilibrium exchange rate (that clears the market internally and externally) and offers a near-term outlook.
- The empirical analysis is based on an error correction model. The paper uses the fundamental approach (how the exchange rate relates to certain economic fundamentals) to estimate the equilibrium exchange rate. There are six main fundamentals used: The productivity differential (the difference in productivity levels between Egypt and its trading partners), investments, net foreign assets, commodity terms of trade, government consumption and trade openness.
- The paper poses critical policy questions, including:
    - How strong is the link between the exchange rate policy and fiscal policy now?
    - Why is inflation in Egypt stubbornly higher than the average inflation of its trading partners?
    - Can monetary policy beat the impossible trinity (fixed exchange rate regime + free capital movement + independent monetary policy)?
    - How can monetary policy be conducted in the absence of a nominal anchor? Can an inflation-targeting regime work in Egypt?
    - Does the economy gain or lose if the nominal exchange rate appreciates today to its equilibrium value?

Commentary and discussion:

- **The amount of cash that Egyptians keep out of banks explains much about the forex market in Egypt.** Egyptians are massively dollarizing since the revolution. The foreign currency deposits in the banks grew by almost 100 percent in the last 6 years reaching around USD 50 billion; there is still a lot of money that is kept out of banks feeding the foreign currency demand..

- **Over the past few months, minor movements were seen in the currency exchange rate**. Despite private capital portfolio inflows of USD 11 billion , there is still huge demand for foreign currency, mainly from multinationals that owe money to their parent companies and have a lot of trapped cash since 2011.

- **An Egyptian pound appreciation might deal a "double whammy" to Egyptian manufacturers.** Egyptian producers since the 1960s have been facing local inflation and cheaper imports (in real terms). We reached a point where producers stopped producing due to the higher local prices and started only importing final goods. Meanwhile, at current prices, Egyptian manufacturers are able to produce and export at competitive prices. If the Egyptian pound appreciates again, local producers might not be able to compete.

- **What matters right now in Egypt is that job creation** and a free-floating currency (and an expected appreciation in real terms) might actually lead to job losses due to its negative impact on Egyptian manufacturers. Considering the current high inflation rates, Egypt might consider a weak currency policy to protect producers and accordingly protect job creation in Egypt. In that case, we should get the most benefit out of it by adopting coherent and non-contradictory policies.

- **It's very important that we focus on targeting inflation in order not to undo all the competitive advantage that Egypt gained from the recent flotation.** The current situation is quite different from that in 2003 in terms of what happened globally. In 2003, it was a global upcycle for the entire global economy, and inflation rates were higher. At that time, Egypt managed to accumulate significant foreign reserves and current account surpluses. This time, however, the gap is expected to close quickly due to lower global growth and inflation rates. Although Egypt is currently an attractive destination for investments, higher inflation rates relative to the very low global rates might quickly offset the positive effect of the recent flotation.

- **Structural problems are Egypt's main drivers of inflation, in addition to high budget deficit since the 1960s and the local saving rate that is not sufficient to fund the deficit.** It's important to look into the current structural deficiencies and the economy's ability to substitute imports and invest in local components that would bring cost down and meet growing demand. Absent these structural and institutional reforms, the benefits from the recent flotation might turn out to be very limited and a currency bottleneck is likely to recur.