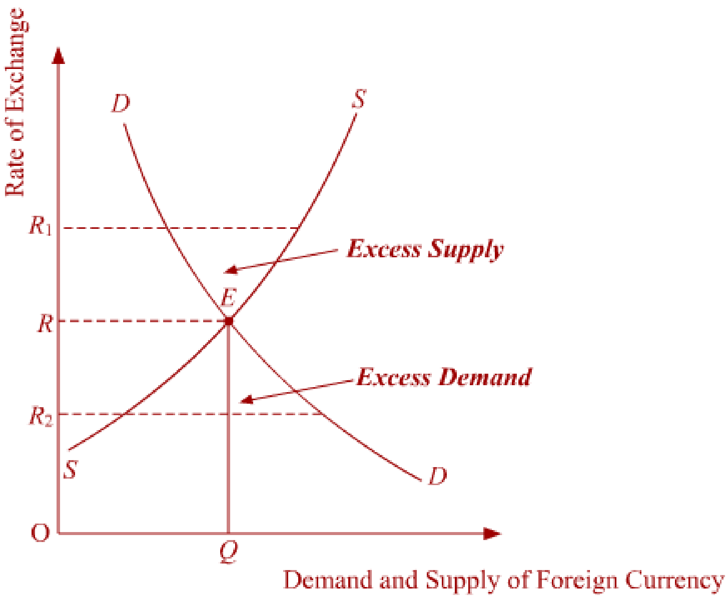
Exchange Rate Situation Explained

Recently the Acumen team has witnessed the social media uproar at the recent CBE decision to devalue the Egyptian pound. Most of the comments we read were negative, statements regarding loss of wealth were very popular as were accusations of either treason or stupidity with regard to the sequence of events. Hence, we find this a timely opportunity to explain to the non-economists the background behind the decision, the key principles and the inter-relations between the various governmental economic decisions. Finally, we will pose what we believe is the ideal policy package that needs to be adopted alongside the recent devaluation for it to yield the desired results.

SOME DEFINITIONS TO BRING EVERYONE UP TO SPEED:

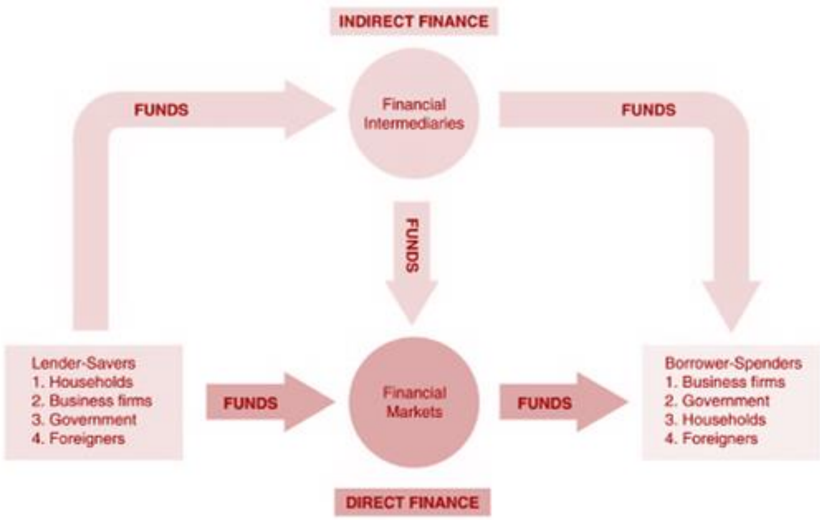
Exchange Rate: –



- The exchange rate is basically how much a currency is worth in terms of another currency. So there is no absolute exchange rate and there no better or worse exchange rates in absolute terms.
- Exchange rates do not necessarily reflect the country's economic wellbeing. For example; before France adopted the Euro, the French Franc exchange rate to the Egyptian pound was 2:1, which means that the value of the Franc was lower than the value of the Egyptian one. Does that mean that back then the Egyptian Economy was doing better than the French economy? No, it doesn't. The size of the French GDP in 2001 was $1.38 Trillion while the Egyptian GDP was $98 Billion, so the size of the French economy was 14 times bigger than the Egyptian, still the Franc was half the value of the Egyptian pound.

- For the past period the Egyptian pound was "overvalued". This means that it was artificially fixed at a rate similar to R1 on the previous graph. This results in a surplus of Egyptian pounds and a shortage of dollars, as there are many people wishing to buy dollars at the announced rate but very few willing to sell at this rate because they feel their dollar savings are worth more given the shortage of dollars in Egypt.

Interest Rate: –



- The interest rate, set by the Central Bank, is the price of money in the market. Let us consider the money as a commodity like any other good or service in the market. The interest rate is hence the price of borrowing money and the price for depositing money, i.e. the value you get from depositing your money at a bank for somebody else to use it as credit.
- The game of changing the interest rates, or as the economists call it the monetary policy, is a tool to control economic growth. But why would any country want to control economic growth? Economic growth brings inflation with it. The more the economy produces, the more money employers and employees make, the higher their spending power, and accordingly the higher the demand on products and finally the higher their prices.

Is there a relationship between the interest rate and inflation in the country? YES!

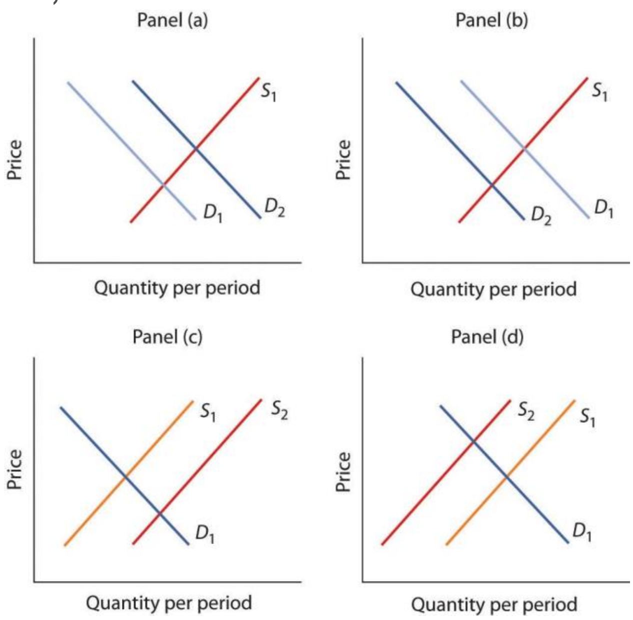
- When the interest rate goes down, people tend to use their savings because they believe that leaving the money in the bank is not good enough (opportunity cost is too high) and this spending creates economic activity and hence inflation.

Can countries totally avoid inflation?

- No, but countries usually work on limiting inflation to a single digit number i.e. below 10%. The inflation rate in Germany for example was 0.23% in 2015 while in Egypt it was 11%. Growing economies tend to have higher inflation rates compared to already-big economies and growing economies tend to have higher interest rates compared to developed economies. High interest rates do not encourage investment, it makes the cost of borrowing high and it encourages rent economies, meaning it encourages people to put their money in the bank and live off the interest they are getting. So in conclusion: Lowering interest rates can/will cause inflation if no other measures were taken to limit inflation.

What are the determinant of the exchange rate and when is it bad or good?

- The foreign currency again is like any other good or service, their prices is strongly affected with its supply and demand. When the sources of foreign currency in Egypt failed to bring in dollars like tourism (terrorism & ineffective traditional approaches to promoting tourism), foreign direct investment (confusing processes, political unrest & lack of visibility regarding means of repatriating profits), as well the revenue of the Suez Canal (external reasons that include slowed international trade and low oil prices). When the available amount of dollars in the market declined, it's price went up and it became less and less available. Knowing that foreign currency is needed for import purposes the CBE started using the reserves (what should sustain the country in crises).



- At other times, such as in the Chinese experience, a country may choose to undervalue its exchange rate in order to maintain export competitiveness.

COMMON SOCIAL MEDIA COMMENTARY:

"Our wealth has just dropped by the 15% rate of the devaluation."

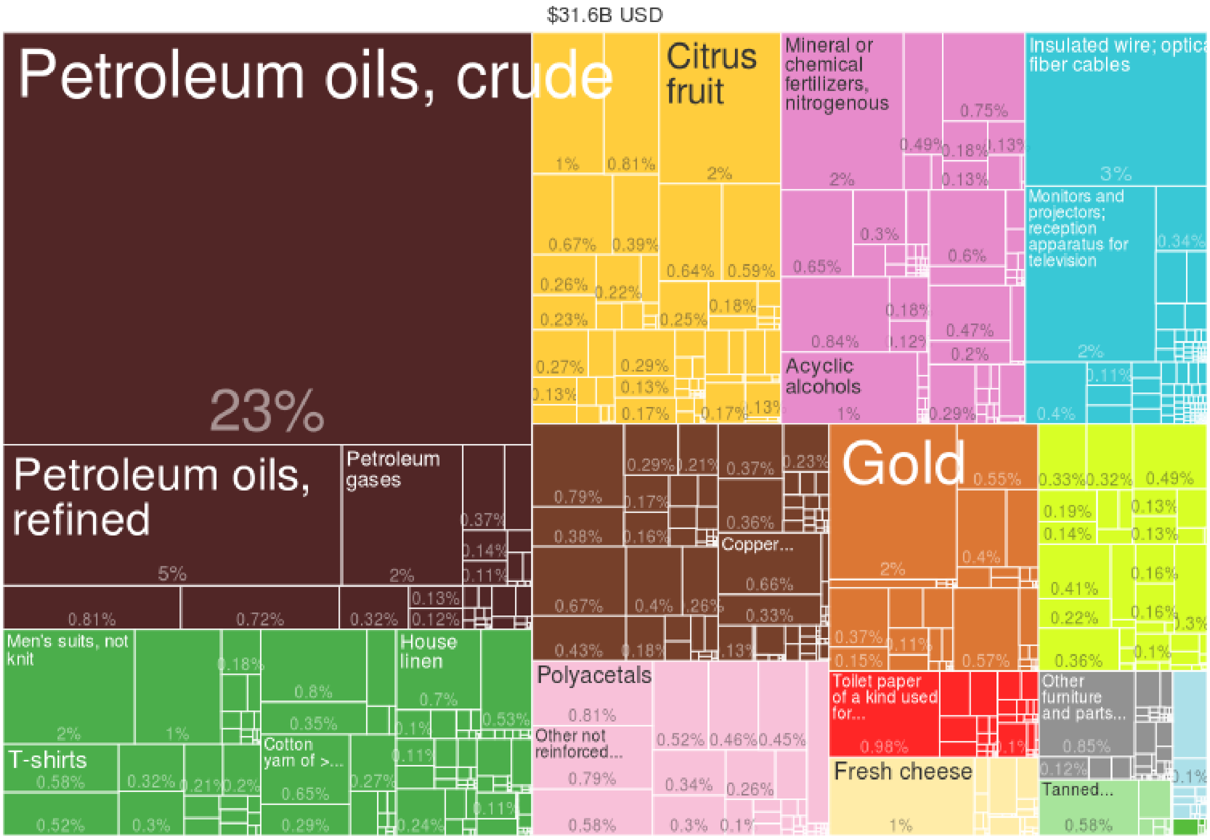
- This claim is built on a series of hypothetical assumptions. The first being that the entire universe of goods and services that can be purchased in Egypt are imported or entirely made up of imported components. The second being that these importers were purchasing at the official exchange rate instead of at the black market rates and passing on that cost to the end consumer. So in essence your cost of living should not vary dramatically while you are on Egyptian soil as you have already suffered the dollar black market over the course of the last year in terms of inflated prices, product shortages and lengthy product wait times. For those seeking to travel abroad that is a completely different ball-game as the devaluation has indeed reduced your purchasing power in a global context.

"They devalued after stating that they would not."

- This is reflective of the government's potential return to a Henry Kissinger's philosophy of constructive ambiguity. This is a strategy built on incomplete sharing of strategies & intents in order to avoid public reaction and speculation prior to the actual event.

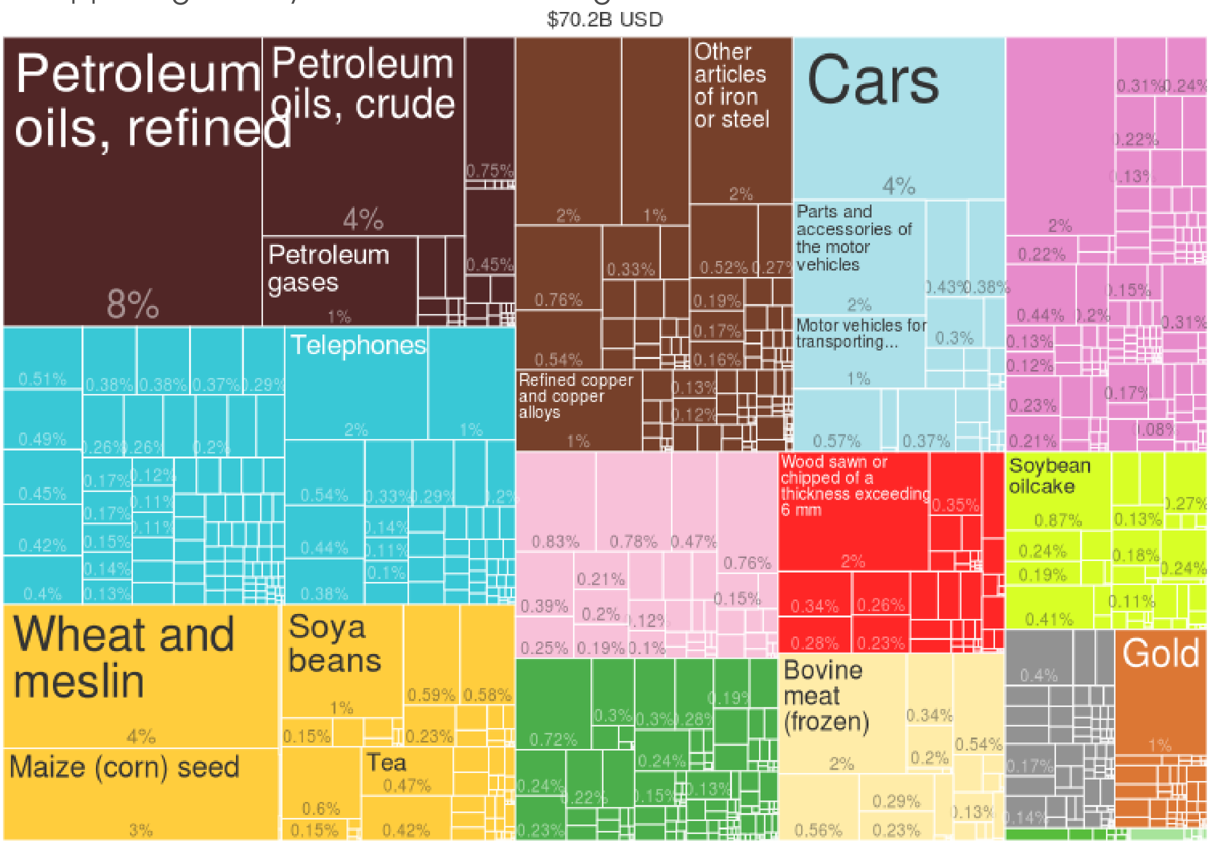
POLICY PACKAGE:

- This decision (love it or hate it) is a short term fix. Its impact on stabilizing the currency exchange will erode by the minute if we do not start establish sustainable means of creating a steady and growing inflow of foreign currency into Egypt. This trade balance is determined by the nature of our imports as well as the competitiveness of our exports.



- This graph showcases the current nature of Egyptian exports in 2014. You will notice that the largest boxes (i.e. the bulk of our exports) are raw and unprocessed materials. This low level of value addition reduces the value of our exports and hence our ability to obtain foreign currency.

- According to the CBE monthly publication, Egypt's imports currently stand at 31 times our exports for the first quarter of the fiscal year 2015/2016. This is only partially offset by our services exports. This results in a negative national net balance of 3.6 billion USD. Accordingly, for the devaluation to work, investments need to be targeted towards capitalizing on the current shortages of imports of raw materials at the moment in order to build a domestic industry that is capable of supporting the key manufacturers along the value chain.



- Meanwhile, you will notice that Egypt's imports (depicted above) are a mix of components for manufacturing and finished goods with rare cases of entirely raw agricultural or unprocessed imports.

For more about the competitiveness of Egyptian exports we invite you to explore Harvard University's Atlas of Economic Complexity: http://atlas.cid.harvard.edu/

- Furthermore, coordinated efforts need to be dedicated towards enhancing the business climate and creating a welcoming and inviting space for foreign & domestic investors to improve the value added on our production & exports. This includes simplifying procedures, reducing fees, improving information availability, facilitating new avenues for access to finance, supporting SMEs, and rebranding Egyptian products globally such that "made in Egypt" transforms from a stigma to a marketing platform.

- The logistics infrastructure in Egypt needs revamping in order to reduce waste, lead times and cost of the goods sold/exported. This includes investing in better roads/routes out of the delta area and towards the new Suez Canal ports, investing in cold storage hubs in the agricultural governorates and potentially investing in cargo railway routes to expedite the time to and from ports.

- Tourism needs to make a come-back, yet policies to address that necessitate a different post all together. We promise to write one soon showcasing some more unconventional means to promote tourism in Egypt.

- Finally, and we can't stress this enough, it is about having a clear vision, a consistent message and sustainable and systematic application of the various policies. Such that the recent devaluation does not go to waste.