Exchange Rate in MENA

Exchange Rate Regimes

Exchange Rate -Definition

The price of a nation's currency in terms of another currency

There are two approaches to express the exchange rate:

The price of a unit of foreign currency is expressed in terms of the domestic currency.	The price of a unit of domestic currency is expressed in terms of the foreign currency.

a base currency vs. a counter currency

Example, US$1 = EGP16.5 (Here the base currency is the US dollar and the counter currency is the Egyptian pound)

Note that:

Most exchange rates use the US dollar as the base currency and other currencies as the counter currency.

Classifying Exchange rate regimes

Fixed Exchange Rate | **Flexible Exchange Rate**

Fixed Exchange Rate

Advantages

- Provide a nominal anchor for monetary policy
- Reduce transactions costs and exchange rate risk

Disadvantages

- Loss of monetary policy autonomy
- Loss of exchange rate as a shock absorber
- Danger of speculative attacks by currency holders

Flexible Exchange Rate

Advantages

- Monetary Policy independence (discretionary policy)
- Automatic adjustment to trade shocks

Disadvantages

- Exchange rate uncertainty
- Need to find a less obvious anchor (→Consequences for inflation)
- Danger of speculative bubbles represented in inflationary trends.

The Impossibility Trinity

A country must give up one of three goals:

1. Exchange rate stability
2. Monetary Independence
3. Financial Market Integration (absence of capital control)

Exchange Rate in MENA

Introduction

The exchange rate matters in MENA since it is an **important price** in the economy.

Changes can cause substantial reallocation of resources and production between **the tradeable** and **non-tradeable** sectors of the economy.

Tradable sectors : the industry sectors whose output in terms of goods or services are traded internationally, e.g. the manufacturing industry.
The non-tradable sectors: they consist of locally-rendered services, including health, education, retail and construction

- **Any single exchange rate regime, on its own, cannot be considered a credible substitute for sound underlying economic policies.**

While adopting specific exchange rate regime, there is a need for:

1. **Sound financial policies**
2. **Supportive structural policies**
3. **Continuity in the efforts in achieving an optimal exchange rate regime in a country.**
4. **Greater coordination of monetary and exchange rate policies**

Factors affecting exchange rate regimes

A number of factors have been identified as determinants of the relative desirability of alternative exchange rate regimes among Arab countries.

- level of international reserves
- Macroeconomic conditions
- Openness of the economy
- Degree of capital mobility
- Degree of dollarization of financial system
- Soundness of banking system
- Types of economic shocks facing the economy
- Policymakers' economic objectives and supportive policies

- Higher level of international reserves → Ability to adopt fixed exchange rate
- More stability in macroeconomic factors → Ability to adopt fixed exchange rate
- Higher degree of trade openness → Requires adopting more flexible exchange rate

- Higher Degree of capital mobility → Requires adopting more flexible exchange rate
- Higher Degree of dollarization → Require adopting fixed exchange rate
- Higher Soundness of banking system → Requires adopting more flexible exchange rate

Types of economic shocks

Ability to adopt fixed exchange rate

Policymakers' economic objectives

(stabilization, enhancing confidence, integration into the global financial system export-oriented strategies, require more flexible exchange rate

import substitution strategies– requires fixed exchange rate

The classification scheme of exchange rate in Arab countries

It is distinguished between two main groups:

- **The first group**

It includes countries that follow pegged exchange rate regimes.

In these countries, the local currency is either pegged to

a single currency

The SDR

other weighted composites formed from the currencies of major trading or financial partners

The **Special Drawing Right (**SDR) is an **international reserve asset**, created by the IMF in 1969 to supplement its member countries' **official reserves**. The value of the SDR is based on a **basket of five** major currencies—the U.S. dollar, euro, the Chinese yuan, the Japanese yen, and pound sterling.

- **The second group**

It involves countries adopting more flexible forms of exchange rate regimes:

Managed floating

Independent floating

Most Arab countries belong to the first group as 12 of them follow a pegged regime.

Exchange Rate Regimes in Arab Gulf Cooperation Council (AGCC) Countries

- **Saudi Arabia**: Saudi riyal is officially pegged to the SDR
- **Qatar**: Qatar riyal is officially pegged to the SDR
- **Bahrain:** Bahrain dinar is officially pegged to the SDR
- **U.A.E.**: U.A.E. dirham is officially pegged to the SDR
- **Oman**: The Oman riyal is officially pegged to the dollar
- **Kuwait**: The Kuwait dinar is determined on the basis of a fixed-but adjustable relationship between the dinar and a weighted basket of currencies.

After year 2000

The AGCC countries decided a strategy to formalize a common peg to the **dollar** as an initial step toward a possible common currency area in the future.

Regarding the second group of Arab countries adopting a floating exchange rate regime

Most of these countries adopted a managed floating exchange rate regime:

- **Tunisian Dinar**
- **The Algerian dinar**
- **Egyptian Pound: During 2000, Egypt departed from the peg to the U.S. dollar adopted in early 1991. in late 2016, Egypt announced more flexible exchange rate (market-determined).**
- **The Lebanese lira**
- **Mauritanian ouguiya**

Exchange Rate Systems in Arab Countries

	Jordan	UAE	Bahrain	Tunisia	Algeria	Djibouti	Saudi Arabia	Sudan	Syria	Somalia	Iraq	Oman	Qatar	Kuwait	Lebanon	Libya	Egypt	Morocco	Mauritania	Yemen
Fixed exchange rate	1	1	1	0	0	1	1	0	1	0	1	1	1	1	0	1	0	1	0	0
Managed Floating exchange rate	0	0	0	1	1	0	0	0	0	0	0	0	0	0	1	0	1	0	1	0
Independent Floating exchange rate	0	0	0	0	0	0	0	1	0	1	0	0	0	0	0	0	0	0	0	1
Acceptance of the obligations of IMF (freedom of currency transfers)	1	1	1	1	1	1	1	0	0	0	0	1	1	1	1	0	0	1	1	1

Bloomberg Business

Egypt took the dramatic step of allowing its currency to trade freely as it announced measures to stabilize an economy crippled by a dollar shortage that has raised concern about social unrest.

Stocks jumped the most in eight years and the pound slumped after the central bank's decisions, which included raising its two benchmark overnight interest rates by three percentage points. They came after months of negotiations with the International Monetary Fund over a $12 billion loan that's seen as crucial in western capitals to preventing an economic meltdown that could destabilize the most populous Arab country.

A key measure of success will be whether banks could provide enough dollars to meet pent-up demand. With investors and tourists staying away, Egypt has relied on billions of dollars of aid from Gulf monarchies lately.

Bloomberg Business

Other decisions by the central bank include:

- Abolishing the "priority imports list"
- Banks and other market participants are at liberty to trade at any exchange rate
- The central bank will continue to monitor market activity and hold multiple price auctions when deemed necessary
- Cash deposit and withdrawal limits for companies importing non-basic goods are maintained at $50,000 monthly for deposits and $30,000 daily for withdrawal

The Economist

- In October 2015, Saudi Arabia's central bank spent $7 billion of foreign reserves financing the kingdom's deficit. If it ran short, it would have no choice but to abandon the riyal's long-standing peg to the dollar.
- On November 24th the price of buying a riyal in a year's time fell to its lowest level since 2002. In this regard, futures for other Gulf currencies have also sagged.

- There is little reason for Gulf countries to devalue.

Their main export is priced in dollars, so a devaluation would do little to boost competitiveness.

- De-pegging would lead to uncertainty about the exchange rate, which might discourage the diversification away from oil that Gulf governments are so desperate to foster.

- Moreover, other than Kuwait, which pegs the dinar to a basket of currencies, all of the Gulf countries have had the same fixed exchange-rate regime since at least 2003. It is not clear that they have the bureaucratic capacity to switch to a a basket of currencies, managed floating or independent floating.

Common Currency

Definition

a system of money shared by two or more countries.

Advantages of a Common Currency

- **Reduction in exchange rate risk**
  - Eliminates the risk of exchange rate variability, which increases capital market stability
- **Reduction in transactions costs**
  - There is no exchange of currencies among members, so transaction costs are reduced

Disadvantages of a Common Currency

- **Loss of independent monetary policy**
  - With a common currency monetary policy is the same in all countries because there is **one** money supply and **one** central bank
- **Loss of national symbol**
  - Losing a national currency may be a loss of national identity or heritage

Optimal Currency Areas

- **An optimal currency area is** a group of countries suitable to adopt a common currency without significantly jeopardizing domestic policy goals.

Criteria for optimal currency areas:

- ✓ Similar composition of industries
- ✓ Significant mobility for factors of production (labor and capital)
- ✓ Diversified economies

GCC Monetary Union

Introduction

- GCC is an economic, political, social, security, regional organization, however the economic side has the most attention.
- During the first two decades since GCC establishment the emphasis was on cooperation and coordination related to a number of social and economic and political issues.
- But in the last few years the emphasis was shifted towards more integration, and the process of integration gains momentum.

Towards GCC Monetary Union

- Harmonization of fiscal and monetary policies.
- Article (22) of economic Agreement (1981) stated that:

"Member states shall seek to **coordinate** their **financial**, **monetary** and b**anking** policies, and enhance cooperation between monetary agencies and central banks, including the endeavor to establish **a unified currency** in order to further their desired economic integration".

- In 1983 the monetary Agencies and Central Banks Governors Committee was established.

- This committee’s main task is to implement Article 22.
- Governors’ committee held its first meeting in April 1983 and formed sub-committees to coordinate GCC policies in **banking supervision**, **payment system**, **ATM’s** and prepare for **monetary union**
- Between 1985-1988 the Governors’ Committee had a condense discussion on **a common peg** for GCC currencies.
- Most of member states, then, agreed to peg their currency to **SDR** but there was no concuss.

- **Monetary union** idea was debated in early 90’s . But governors and finance ministers decided to delay the discussion to later date.
- In 2000 GCC summit, heads of states agreed on **the US dollars** as **a common peg** for GCC at this stage.
- They also directed the governors and finance ministers to come up ,in the next summit with time table for **establishing a monetary union** and launching GCC **unified currency**.

- -In December 2001 the heads of states agreed upon a timetable for establishing **a monetary union** and lunching **a single currency**.

The timetable stipulates:

- -The GCC states will formally peg their currency to the **US dollar** no later than January **2003.**
- **Note:** All the six members states had implemented this.

- **The single currency** for GCC member states was expected to be be introduced no later than January 2010
- For preparation and implementation of this timetable a high level from **central banks** and **finance ministries** had been formed in 2010.
- This **committee** works under the supervision of **Governors' committee** and headed by the governor of the state that holds the GCC presidency for that year.

European Monetary Union

The following topics are considered:

- How the European Single Currency Evolved
- German Monetary Dominance
- How and why did Europe set up its single currency?
- The Euro and Economic Policy in the Euro Zone

How the European Single Currency Evolved

European Currency Reform Initiatives, 1969-1978

- The **Werner** report (1969)
  - It set out a blueprint for the stage-by-stage realization of **Economic** and **Monetary Union** by proposing a three-phase program to:
    - Eliminate **intra-European exchange rate** movements
    - Centralize **EU monetary policy** decisions
    - **Lower remaining trade barriers** within Europe

The European Monetary System, 1979-1998

- Seven countries (Germany, the Netherlands, Belgium, Luxemburg, France, Italy, and Britain) participated in an **informal joint float** against the dollar.
- Most exchange rates could fluctuate up or down by as much as **2.25%** relative to an assigned par value.
- This served as a first step towards a more comprehensive **European Monetary System** (EMS).

During 1980s and 1990s,

- **Capital controls** were essential ingredient in maintaining the system until the mid-1980s.
- However, After the mid-1980s, these controls have been abolished as part of the EU’s wider program of **market unification**.
- During the currency crisis that broke out in 1992, Britain and Italy allowed their currencies to **float.**
- In 1993 most EMS currency bands were widened to ± 15% in the face of continuing speculative attacks.

- **In 1992,** the EU countries have tried to achieve greater **internal economic and monetary unity** by:
  - **Fixing** mutual exchange rates
  - Direct measures to **encourage the free flow** of goods, services, and factors of production
- **Notes:**
- The process of market unification began when the original EU members formed their **customs union** in 1957.
- **The Single European Act** of 1986 provided for a free movement of people, goods, services, and capital and established many new policies.

The EU "1992" Initiative

- Accordingly, EU countries agreed to Join A monetary Union in which national currencies are replaced by **a single EU currency** managed by **a sole central bank** that operates on behalf of all EU members.
- **Three stages towards the Euro:**
  - All EU members were to join the EMS exchange rate mechanism (ERM)
  - **Exchange rate margins** were to be narrowed and certain macroeconomic policy decisions placed under more **centralized EU control**
  - Replacement of **national currencies** by **a single European currency** and authorizing all monetary policy decisions to ECB.

- In **2002** national currencies are replaced by the Euro. The switch was a complex and difficult operation and was handled with a degree of success.

The ECB and the governance of the Euro.

Maastricht Treaty negotiations. Two different **views**:

- **The German model**: the full independence of the Central Bank
- **The French model**. a closer dependence from the political authority.

European Union countries have progressively narrowed the **fluctuations** of their currencies against each other.
This ended with the birth of the euro on January 1, 1999.

German Monetary Dominance

- **Germany**
- **During 1980s and 1990s, German Monetary Policy was characterized by** (or has the reputation for) **:**

1. **An independent central bank.**
2. **Low inflation.**
3. **Tough anti-inflation policies.**

German Monetary Dominance

– By fixing other European countries' currencies to the DM, the other EMS countries in effect imported the German Central Bank's policies as an inflation fighter.

Inflation rates in EMS countries tended to **converge** around **Germany's low inflation rate**.

EU countries toward the single shared currency for four reasons:

1. To enhance Europe's role in the **world monetary system**
2. To turn the European Union into a truly **unified market**
3. Greater degree of **European market integration**
4. **Same opportunity** to participate in monetary decisions
5. Complete freedom of **capital movements**
6. Guarantee of **Political stability** of Europe

The Euro and Economic Policy in the Euro Zone

The Maastricht Convergence Criteria and the Stability and Growth Pact

❑ Convergence Criteria

- The Maastricht Treaty specifies that EU member countries must satisfy several **convergence criteria** in terms of:

1. **Price stability**
2. **Exchange rate stability**
3. **Budget discipline**

Price Stability

- Maximum inflation rate 1.5% above the average of the three EU member states with lowest inflation

Exchange Rate Stability

- Stable exchange rate within the ERM without devaluing on its own initiative

Budget Discipline

- Maximum public-sector deficit 3% of the country's GDP
- Maximum public debt 60% of the country's GDP

❑ Stability and Growth Pact (SGP)

– A **Stability and Growth Pact (SGP)** in 1997 sets up:

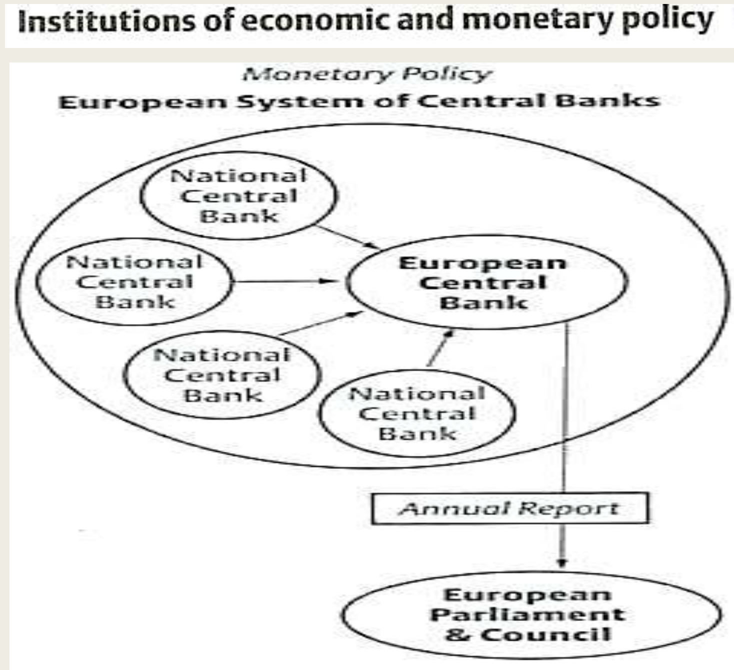
- The **medium-term budgetary objective** of fiscal positions (balance or surplus).
- A timetable for the imposition of financial **penalties** on countries that fail to correct situations of "excessive" deficits and debt.

The European System of Central Banks

- It consists of the **European Central Bank** in Frankfurt plus **national central banks** of euro zone.
- It conducts **monetary policy** for the euro zone.
- The ECB sets its own **inflation target** (its main purpose being the achievement of price stability).
- **Market interventions** by the ECB are carried out through national central banks.

- The ECB has **no direct power** over **fiscal policies** of the member states. (It can, however, issue recommendations).
- **National governments** are barred from intervening on matters of **monetary policy**.
- **Monetary financing** of **public expenditure** is forbidden.
- **National central banks** remain in charge of banking supervision.

- **Monetary policy** is designed to be **independent** from political pressures. (The ECB President and Executive Board are appointed for eight years).
- **<u>However</u>,** It is dependent on politicians in two respects:
  - The ESCB's members are politically appointed.
  - The Maastricht Treaty leaves exchange rate policy for the euro zone ultimately in the hands of the political authorities.



The Eurogroup.

- The Eurogroup is composed of the finance and economics ministers of the countries that have adopted the Euro. The President of the ECB takes part in its meetings, which are scheduled once a month.
- **The Eurogroup is responsible for:**

  A) Monitors **fiscal policy** in the member states.

  B) In charge of setting **the Euro's exchange rate policy** (the Euro runs a flexible exchange rate)

  C) Rules on admitting other countries in the Euro.

Thank you