

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-tradeable 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

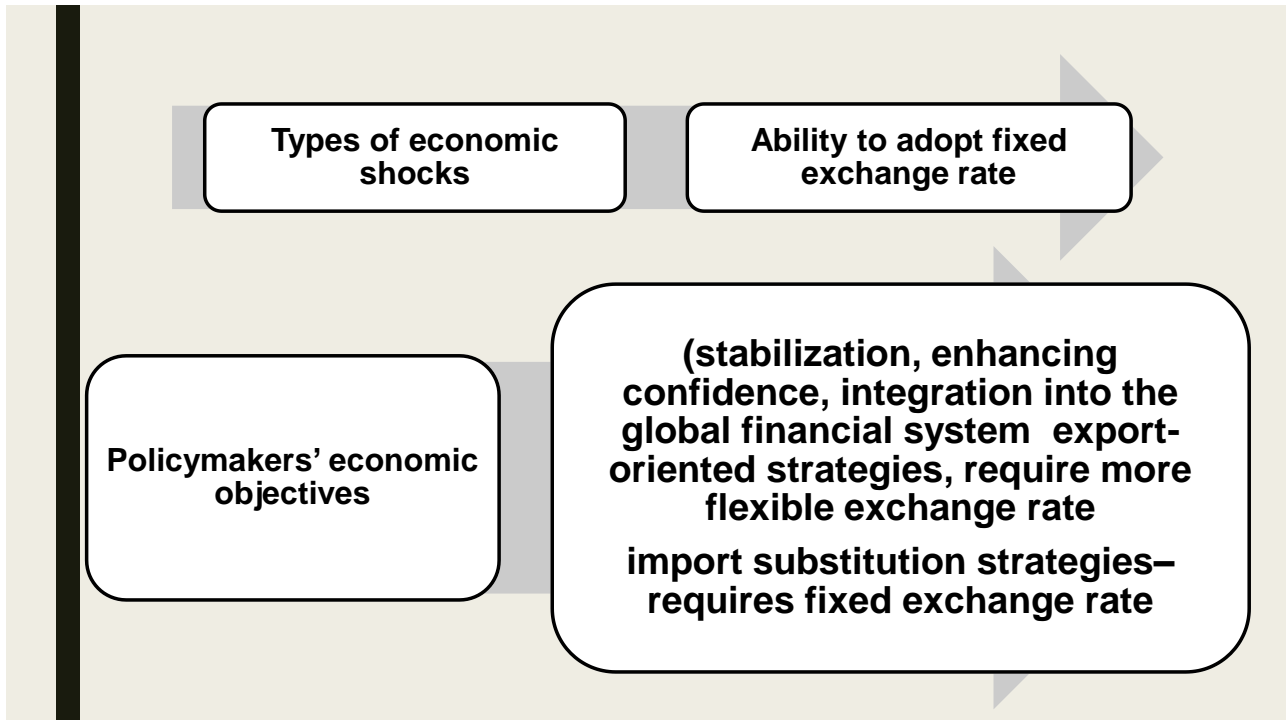
Requires adopting more flexible exchange rate

Higher Degree of dollarization

Require adopting fixed exchange rate

Higher Soundness of banking system

Requires adopting more flexible exchange rate



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 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 **banking** 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 launching **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 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

Introduction

- 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 full independence of the Central Bank according to the **German model**, or a closer dependence from the political authority according to **the French model**. The first view prevails.

Thank you