

The Arab Republic of Egypt

Lindsay Vacek
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Is there something that can explain why the amount of Egyptian pounds per dollar has gradually increased from 1995 to 2004? In fact, there are many explanations for changes in exchange rates; these include the interest rate differential and the inflation rate differential.

As seen in **Figure 1**, based on the discount rates of Egypt and the United States from 1991 to 2006, it appears as if the discount rates of the two countries are converging. In this graph, the discount rate of Egypt has a downward sloping trend, beginning at 21.3% in September 1991 and ending at 9% in June 2006. The discount rate in Egypt only changed about once every one to two years. In the past decade each change has been a 1% decrease.

The discount rate in the United States has remained fairly stagnant since 1991. The trend shows minor fluctuations around 4%, with more of a decrease in the rate between September 2001 to September 2004, and this most likely due to the Federal Reserve trying to stimulate the American economy after 9-11. After this period, the United States experienced an increase in the discount rate through 2006, leading to a smaller interest differential with Egypt.

Figure 2 shows the interest rate differential ($R - R^*$) between the U.S. and Egypt. As the discount rates of the two countries converge, the differential becomes smaller. The rate is negative because of the large discount rate in Egypt; however, as Egypt has been lowering the rate, the trendline of the interest rate differential is approaching zero. The current discount rate, as of March 19, 2008, for the United States is 2.5% and that of Egypt is 9%.

Other interest rates in Egypt are shown in **Table 1** and **Figure 3**. It may be noticed that the discount and deposit rates are decreasing, while the T-bill rate is increasing, and the lending rate is flattening. One explanation for this could be the fact that the Central Bank of Egypt (CBE) is trying to influence people to trade in their dollar-denominated assets for Egyptian pounds in order to create a more stable economy and raise the value of the Egyptian pound.

Another way to explain the change in E is by using the inflation differential. **Table 2** and **Figure 4** show the percentage change in the CPI annual average for Egypt and the United States from 1995 to 2005. The annual percentage change of the inflation

rate for the U.S. has been increasing at an average rate of .05. Egypt's annual percentage change of the inflation rate has an average increase of almost .55; however, this is skewed due to the massive inflation of 16.2% in 2004. The expected inflation in Egypt around 2004 would help to explain the devaluation (appreciation) of the Egyptian pound (USD) at this time (**Figures 5 & 6**).

The inflation rate differential ($\pi - \pi^*$) can be seen in **Figure 7**. This differential has remained relatively small, between zero and two percent, except for the large increase in 2004. Inflation has been a little higher in Egypt in these years, which is why the differential is negative.

It was in 2004 that Egypt decided to tighten monetary policy; however, this was unable to lower the inflation rate into single digits – the annual CPI inflation rate was approximately 12% (**Table 3 & 4, Figure 8**). In 2005, there was a decline in prices, and inflation rates were brought under control (WTO, 2005).

According to the IMF, as of 2004, monetary policy in Egypt needed to be more forward-looking and banks were encouraged to communicate short-term monetary policy strategy. By doing so, the CBE would gain credibility and transparency, so as to help inflationary expectations (IMF, 2005).

Historically, throughout most of the 1980s, nominal interest rates ranged between 5-13% for deposits and 11-17% for loans. The International Monetary Fund insisted that Egypt raise interest rates, but the government was hesitant to do so for fear of slowing economic growth (Country Studies). The government increased the money supply between 1980 and 1988 at a rate of 23% per year, resulting in the CPI rising 336% during this time. A time of stagflation characterized Egypt as they were entering a time of low growth and high inflation (Country Studies).

As of 2005, there were no forwards, options, interest rates, or swaps markets in Egypt. The reasons for this include the “inability for market participants to short EGP Treasury instruments” (Halford, 2005). There was also little liquidity in monetary instrument with maturities greater than one year, a lack of hedging interest, and legal enforceability issues. At this time hedging transactions did occur, but they were fairly one-sided, for example, going long in one currency and short in another currency (Halford, 2005).

The lack of forwards markets could be due to the fact that Egypt does not, in reality, have a free float. Mohieldin commented, “What we have, effectively, is more of a managed float rather than a free float” (AmCham Egypt, 2004). One of the main strategies of the CBE to implement a free float is to increase interest rates on bank deposits, doing so would make it more attractive for people to convert their dollar denominated assets into Egyptian pounds. Mohieldin said that this change should be sudden and unanticipated.

In order for this to work, depositors must not anticipate the devaluation of the pound to be more than the interest rate differential, or they will keep funds in dollar accounts. This is what happened in 2003 with the massive inflation and devaluation of the Egyptian pound (AmCham Egypt, 2004).

According to Alaa Abou-Alam, interest rate increases would have to be drastic in order to have a real impact on the currency – around 15-20% might influence people to change their holdings into Egyptian pounds. However, artificially inflating interest rates does not work (AmCham Egypt, 2004).

The downside of increasing interest rates is that it tends to retard investment and new businesses because of the huge borrowing cost. In the long-term, it is argued that this will cause the exchange rate to stabilize, and investors will be able to borrow at preferred rates (AmCham Egypt, 2004).

The interest rate differential and the inflation rate differential both help to explain the percentage change in E over this time span. The CBE is trying to adjust these rates in order to stabilize the economy and gain credibility. This takes time, but the Egyptian government is doing what it can to make it happen.

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