MULTIPLES GROUP
PRIVATE EQUITY & INVESTMENT BANKING

SNAPSHOT

Issue #9

Egypt's Free Floating Exchange Regime:
Causes and Consequences

January 2017

Table of Contents

Introduction

The Central Bank of Egypt (CBE) made the decision to float the currency from a previously fixed position during early November 2016; which was one of the necessary steps required to receive the IMF loan. The move towards a freely traded currency to stabilize the economy weakened by a dollar shortage and social unrest. With the aim to draw foreign capital back into the economy, the IMF states that such movements will improve Egypt's external competitiveness, support exports, tourism and attract foreign investment.

Q 1

What are the Different Types of Exchange Rate Regimes?

Floating Exchange Rate

- A currency regime where the price is set by the Forex market based upon the supply and demand of the currency compared to other currencies. There are two different types of floating that differ in mechanism and impacts.
  - Free Floating: An exchange rate that is entirely market determined.
  - Managed floating with no predetermined path for the exchange rate: The Monetary authority attempts to influence the exchange rate without having a specific exchange rate path or target.

+ Freedom in setting domestic economic policy, whereas Central Bank does not control the exchange rate directly but uses interest rate to cover inflation. It is mostly evident in countries with economic flexibility to adjust against exchange rate fluctuations.

+ No need to keep surplus currency reserves to maintain a given currency peg as the exchange rate value is determined solely by market forces.

− No guarantee for business as rates fluctuate in response to volatile currency markets, foreign investors will especially be unable to make a quick judgement on their investment outcomes.

− Countries which depend heavily on imports particularly natural resources tend to experience cost-push inflation which can severely impact growth.

Q 1

What are the Different Types of Exchange Rate Regimes?

Fixed Exchange Rate

- A currency regime which fixes the rate to a determined peg, basket of currencies or another measure of value such as gold. For countries to apply such regime successfully, they must have a sustainable inflows of currencies and large reserves to protect their home currency. There are numerous types:
  - Exchange arrangements with no legal tender: The currency of another country serves as the sole legal tender, or the member of a currency union, implying the complete surrender.
  - Currency board arrangements: A currency regime based on clear commitment to a specified currency at a given rate.
  - Crawling Pegs: A currency is adjusted in small amounts at a fixed rate or in response to quantitative indicators such as past inflation.

+ Offers stability, strong incentive for inflation control and some immunity against speculation. This can be attractive to investors.

+ Allows protection against speculation since the currency is not fully determined by the market.

− As the interest rate is used to control currency levels, it is very difficult to use interest rates as part of economic policy.

− Governments require large foreign currency reserves to maintain the set peg which is costly.

Q 2

What are the Trends in Global Exchange Rate Systems?

North America

Both Canada and The US have floating exchange rate systems.

European Union

Using the Euro as their singular currency, 6 members with an independent floating currency.

South America

Two of the region's biggest economies, Brazil and Argentina have free floating exchange rate regime.

Middle east

GCC countries have fixed exchange rates.

Levant countries Particularly Jordan and Lebanon possess fixed currency systems.

Asia

Two of the region's biggest economies India and China have very different exchange rate systems with India possessing a free floating and China fully fixed exchange rate.

Q 3

Why Did Egypt Implement a Floating Exchange Rate?

The implementation of a flexible exchange rate system is part of a set of conditional measures by the IMF for a 12 BN USD extended fund facility due to the following guidance.

IMF Guidance
➢ The IMF program consists of Subsidies Removal, Taxation, Privatization and a floating exchange rate. ➢ IMF official reports acknowledge Egypt's weak external position, foreign exchange reserves and growth. Such have been hindering competitiveness and business operations causing the Central Bank to lose its reserves. ➢ A flexible exchange rate regime determined by market forces is advocated to improve Egypt's external competitiveness, support exports, tourism, attract foreign investment and foster job creation for the country.

Q 3

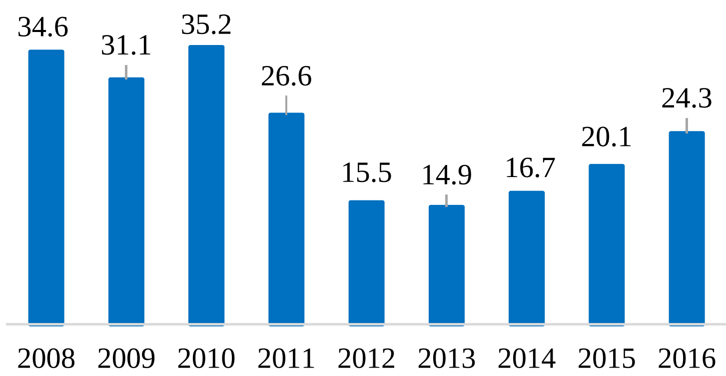
Why Did Egypt Implement a Floating Exchange Rate?

The Egyptian Government floated the currency as part of IMF conditionality on the 30th October 2016, the EGP previously operated in two parallel markets. The exchange rate is now double the previous official rate, with weakened black market presence.

Increase Competitiveness, Exports, Tourism and Foreign Direct Investment (FDI)

- Egypt has consistently witnessed low and falling levels of foreign currency reserves given political and regional instabilities, a weak investment climate, security concerns and weakening competitiveness.
- A currency devaluation can increase the competitiveness of exports and lower the cost of tourism for foreign arrivals.
- In the short term, floating will support portfolio investors, without significant impact on the FDIs.
- Weaker currency removes the exchange rate risk for investors and buyers of government bonds.

Foreign Currency Reserves BN



Q 3

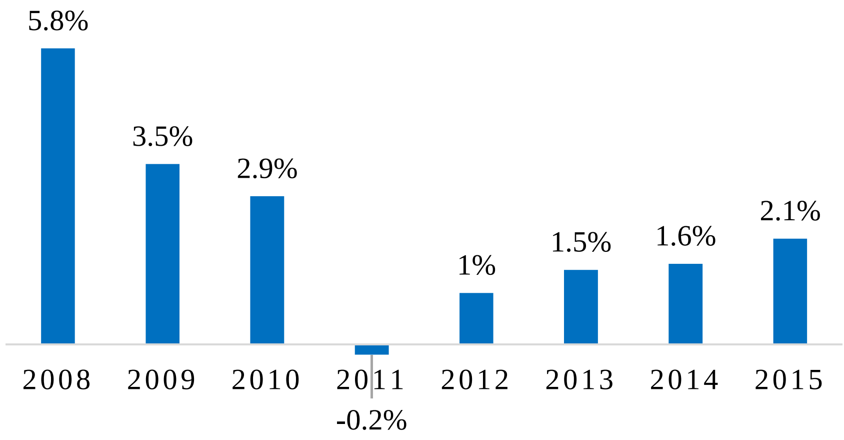
Why Did Egypt Implement a Floating Exchange Rate?

The floating was one of the conditions required by the IMF among the required economic reform program components.

Removal of the Black Market

- Foreign currency shortages led to an emergence of a black market for the dollar, with the parallel rate double the official rate.
- The IMF states that the flexible exchange rate system will encourage people to buy and sell dollars, injecting more money into the economy.
- How effectively this will happen remains uncertain with the next coming years vital in determining its success.

FDI Net Inflows % of GDP



Q 4

What Have Been the Immediate Impacts?

Positives

The official decision to float Egypt's currency was implemented on 30th of October 2016, with some immediate positives.

Highest Performing Stocks	➢ Egyptian stocks immediately advanced after the currency float with the EGX30 at 3.4%. ➢ On **the 3rd November** stocks jumped to 8% with the .EGX30 14-day relative strength index reaching overbought territory. ➢ About 454 MM stocks were traded on the main forum, the most since August. ➢ The stock market performance reflects a rising demand for the Egyptian stocks and for assets in general.
Weakening the Black Market	➢ The currency devaluation brought the EGP official rate closer to its black market counterpart, narrowing a gap which has deterred foreign investors. ➢ Portfolio investors were encouraged to invest more than 1 BN USD throughout Nov and Dec.

Q 4 What Have Been the Immediate Impacts?

Constraints

There are also some visible constraints after the implementation of the currency float.

Rapid Currency Devaluation	➢ Immediately after the decision to float the currency, the EGP experienced a drastic loss to its value of around 45% .The USD was previously valued at around 8.88 EGP reaching to 19.10 EGP after the float, increasing the cost of financing debt, constraining the Egyptian economy throughout 2017. ➢ This rapid devaluation caused loss of confidence in the currency, which will take time to recover as further control is expected in the coming months.
Inflationary Wave	➢ The devaluation of the EGP immediately increased Egypt's already high inflation levels with the IMF predicting rates of 17-18% by the end of 2016 and throughout 2017- Inflationary pressures cost businesses, due to cost and price adjustments potentially deterring investment.
Constrained Purchasing Power	➢ High inflation and low wage rates will exacerbate the vulnerable poverty situation, household budgets will be further constrained, limiting the purchasing ability for basic goods and services pushing more people into poverty. ➢ Such could intensify social and political instabilities, widening dissatisfaction and tension against government policy.

Conclusion

The free float of the EGP aims to improve Egypt's external competitiveness by supporting exports, tourism and foreign investment. In doing so, the Egyptian government is targeting the creation of jobs and strengthening Egypt's external position to solve persistent macroeconomic instabilities. The immediate consequences of such movements have shown some potential for economic progression, potentially resolving the foreign exchange crisis. However, the huge inflationary constraints on the purchasing power of households will likely worsen social and political tensions. Therefore, the ability of government and institutional policy makers to effectively accommodate for the inflationary challenges on households will greatly determine the macroeconomic success of the currency free float.

Thanks … End

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