Q&A on Devaluation

What Is A “Strong Currency”?

Currency strength expresses the value of the national currency and its purchasing power when traded against products and services or against other currencies. It can be considered an indicator that reflects factors such as overall economic performance (stability) or interest rates, and to compare economic and trade productivity between different countries.

How Is the Strength of a Currency Determined?

A higher exchange rate does not necessarily indicate a stronger currency when we assess it at a given point in time. Evaluating the relative strength of a currency over a long period is done through observing supply and demand changes, monitoring inflation and interest rates, and the perceived governance stability.

Can a “Weaker” Currency Be Better?

The effects of strengthening or weakening a currency may vary depending on economic conditions as well as economic policies. A country that embraces export-led growth, such as China, may prefer to depreciate its currency to keep domestically produced goods and services cost-effective and continue to attract foreign buyers. Thus, a relatively weaker currency will promote exports and boost the economy through foreign currency reception and GDP growth. On the other hand, countries that aim for supply-led growth, such as the United States, are interested in having a high currency value that enables them to enjoy strong purchasing power and import products in large quantities. Therefore, it is important to determine the desired growth pattern and policies from which the value of the currency will be determined.

What Does “Liberalizing the Exchange Rate/ Floating a Currency” Mean?

This means the forces of supply and demand will determine the price of the currency. A floating currency should witness different values according to the season of peaks and depressions with sources of foreign currency. This is different from devaluation, which is the deliberate downward adjustment of the value of a country's money relative to another currency. Devaluation is used as a monetary policy tool in a fixed or semi-fixed exchange rate regime.

<u>What Happened to the Egyptian Pound?</u>

The Egyptian pound (EGP) dropped dramatically against the dollar after the Central Bank of Egypt ended a managed exchange rate regime and announced the liberalization of the exchange rate on October 27, 2022, as the Egyptian government secured a three-billion dollar loan from the International Monetary Fund (IMF). The government referred to this shift as moving into a "durably flexible currency regime".

The Egyptian pound has lost around 24% of its value since its March 2022 flotation, and many experts such as Fitch Solutions believe that it will continue to weaken until the IMF agreement comes into force in December due to imbalances in the currency market.

This is considered to be the fifth major flotation of the EGP. The first major flotation of the pound was in October 1991, the second in January 2003, the third in November 2016, and the fourth in March 2022. These were not totally free flotations. However, we can consider them to be "managed flotations," meaning the central bank intervenes by selling more when the demand increases and buying more when the supply is boosted, therefore keeping the exchange rate stable within a certain time frame.

<u>Are There Opportunities in Flotation?</u>

The advantages of flotation largely depend on the strength of a country's economy and the targets it aims to achieve. There is opportunity in the devaluation of the Egyptian pound against the dollar and other hard currencies in regards to the export sector, the tourism sector, and remittances.

In terms of exports, the devaluation of the Egyptian pound makes exported Egyptian commodities cheaper, thus more competitive vis-à-vis similar commodities from other countries. In terms of tourism, devaluing the pound will make Egypt a cheaper and thus a more attractive tourist destination, boosting tourism and injecting foreign currency into the economy. The same goes for remittances, which will increase in value with a devalued EGP, implying that more money will arrive from Egyptians living in countries with a stronger currency.

Experts believe that such a decision would also limit the import of luxury goods, reduce the travel and spending of Egyptians abroad; pushing people to buy local products and create more jobs locally.

On a country level, it is claimed that such a measure will help the country restore liquidity in markets, increase foreign cash flows, restore investor confidence in the country's economy, resolve the foreign currency shortage crisis, and get rid of the Egyptian pound subsidy bill that it carried for decades.

What are the Repercussions of Flotation?

Adopting a flotation policy where the USD price rises in exchange for the local currency will inflict further budget deficit as foreign debt payments become more costly.

Another challenge pertains to growth rates of USD income-oriented industries. The price gap between the exchange rate of the pound before and after the float will distort growth rates,due to all sectors operating in the local market. This then achieves dollar incomes, records a huge increase in revenue growth denominated in local currency, and causes very large distortions in macroeconomic calculations, growth rates, as well as in income distribution and evaluation of the value of in-kind assets. This is a classic consequence of flotation, where the monetary shock has price implications and economic repercussions on income distribution, resource allocation, and other effects that are difficult to quantify.

Major economic sectors, namely industrial, food, and agriculture sectors, are the most affected by the floating of the pound, owing to the high prices of raw materials imported from abroad, hence causing a large trade deficit due to a high import bill (where imports are almost double the exports). In Egypt, during the last flotation in March this year, all local products prices increased by varying percentages, ranging between 25% and 50%. Although not imported, the increase in prices lies in the fact that the production inputs are mostly imported, and therefore the prices of these locally produced products have increased.

The biggest setback of flotation, however, is the loss of the purchasing power for those earning in Egyptian pounds. Another setback is the dramatic fall of the value of Egyptians' savings. The decline of the local currency to unprecedented levels in history continues and will be accompanied by sustained inflation.

And although the government announced an increase in the minimum wage for public employees, from EGP 2,700 to EGP 3,000 and fixed current electricity prices for households through June 2023; still, the minimum wage value is eroding. The minimum wage in July 2013 was EGP 1,200; equivalent to almost 170 USD at that time. The minimum wage in November 2022 is EGP 3,000; equivalent to $123. An eroding minimum wage can only cause hardship in a country where 60% of the population is already poor or vulnerable.

How Can We Look Ahead?

With the new loan and flotation decision, the importance of having priorities on the government's agenda for the coming period becomes essential. Improving public financial management, strengthening the industrial sector, improving the business and investment environment, and enhancing the role of the private sector (micro, small and medium; not only large) are necessities that can ensure Egyptians do not pay the price of the floatation twice. Goals that aim at developing local resources in a way that reduces the burdens on citizens and creates new job opportunities should be incorporated in a plan to add value from our existing resources and to make up the foreign resource gap.– This can be achieved through increasing exports, developing the tourism sector, and achieving added value from existing resources and capabilities. – Most importantly, constructing a more robust structure for social spending and social protection, while developing education and health services to become more inclusive, is the only way forward for a country that needs to get out of the debt loop.