VOLUME 11 NUMBER 1 Feb 2019
ISSN 2076-9202 (Print)
ISSN 2218-046X (Online)

International Journal of Information, Business and Management

ELITE HALL PUBLISHING HOUSE

International Journal of Information, Business and Management

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ISSN 2076-9202

International Journal of Information, Business and Management

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ISSN 2076-9202

International Journal of Information, Business and Management

Publisher: Elite Hall Publishing House

Web: http://ijibm.elitehall.com
ISSN 2076-9202 (Print)
ISSN 2218-046X (Online)

EGYPT CURRENCY CRISIS: ANALYSIS OF THE CAUSES

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Abstract

Currency crisis is a currency market disturbance where speculative foreign exchange strike leads to a devaluation or comes to a point when the authorities sell their foreign exchange reserves or raise interest rates to defend their exchange rate. Currency crises are usually defined in the context of the financial crisis, including a ban and debt crisis (Claessens and Kose, 2013).

Considering the fact that Egypt is a small and open economy, it was hit by a sharp decline in food, energy and other commodity prices in 2007/2008. Given that the middle group of Egyptian society spends about 45% of its income on food products, this brought economic policy under tough pressures and demanded a quick response to mitigate the shock in order to maintain social and economic stability. Evaluation of existing crises can explain the disruptions in the financial system or collapse of the exchange rate. Also, here we determinate the reasons and implications of Egypt currency crisis, as the crucial role of the foreign exchange reserve for a country in such a circumstances.

Key words: currency crisis, factors, exchange rates, Egypt.

1. Introduction

Economic theory did not encounter specific definition about currency crisis that is acceptable as universal. However, when we think about currency crisis the first thing we recall is a massive escape of investors from the currency for which they fear will depreciate thus affecting that this devaluation to really happen at a more financial repressive dimension than usual. In such a situation currency loses its stability and confidence, and if there are no sufficient international reserves then this can result in serious financial crisis. Economic losses caused by currency crisis are spending the fiscal costs of restructuring the financial sector, a fall in economic activity, a distortion in distributable income, a decline in credibilityemphasize the importance of crisis prevention and the use of all available tools that can help in early identification of the financial weaknesses of the crises system. For this reason, some kind of systems could identify the vulnerability indicators or predict a currency crisis in order to take on time true measures to avoid the crisis. Utilizing theoretical knowledge about currency crises and focusing on the evaluation of existing theoretical

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maintenance has negative and negligible effects on other macroeconomic variables. This was the collapse with the Exchange Rate Mechanism (ERM), which was associated with inadequate consequences of raising the interest rates needed to avoid a successful speculative attack in a situation of high unemployment. In other words, the decision to abandon the current regime is related to the comparison of benefits (for example, the benefit derived from the theory of the optimal currency area) and costs (for example, due to a reduction in the reputation of economic policy) for maintaining a fixed exchange rate, together with a certain economic situation - unemployment, problems in the banking sector or high public debt. In the second generation of models, economic policy is not predetermined, but responds to changes in the economic system, and private investors base their expectations on such behavior by economic policy makers. The expected change in the exchange rate regime will affect those variables (for example, higher wages, lower employment, higher interest rates) which change increases the costs of maintaining the liquidity regime. When these costs become too high, economic policy holders can decide to devalue the currency and so will verify the currency crisis of market participants. Therefore, the currency crisis in terms of the model of the exit clause appears in a situation in which speculators, together with the given conditions in the economic system, consider that they are economic bearers of the policy on the margin of exploitation of the exit clause (Krueger, Osakve, Strana, 1998).

The model of third generation relies on interpretation of the causes of the currency crisis and the effect of infection. There are various explanations for transferring crises from one country to another. One of the interpretations relies on the negative impact of the same exogenous shock in several countries. The crisis can also be transmitted through trade links when the currency depreciation of a country means reduced competitiveness of another country. Financial interdependence can contribute to the expansion of the crisis when problems in servicing external debt in some countries force external creditors to repay loans to some other countries. Currency crisis in a particular country can worsen the perception of the state of the economic situation in the country with similar characteristics of the system. Explanations of the effect of infection contain elements of the first and second generation of the currency crisis model (Peacenti and Till, 2000).

3. Overview of Egypt currency crisis

Over the past few years, the Egyptian economy has felt the culmination of more than 15 years of continuous reform efforts. The reform program dates back to the 1990s when Egypt launched economic reforms and a structural adjustment program (ERSAP) aimed at stabilizing the economy and boosting economic growth. The program helped to improve growth to 5.9% in 1999/2000, compared with 1.9% in 1991/92. In the background of several external and domestic shocks, the reforms were halted, but since 2004 there has been a new trajectory for sustainable and better diversified growth in the Egyptian economy.

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However, through reforms, emerging global turbulences, such as the notable rise in world food and energy prices (2007-2008) followed by global financial changes that continue to date, have increasingly challenged the ability of economic policy to fulfill its goal. In response to such crises, there was a need for harmonization of the economic policy to mitigate its adverse effects on the economic and social sides. The implemented package of measures in response to shocks was a general direction undertaken by the government to implement fiscal consolidation, respond flexibly to the challenges arising from them, and help fruiting growth in order to obtain a certain level of revenue. Faced with the global financial crisis, the government was also prompted to respond quickly with the introduction of a fiscal stimulus package worth 1.5% of GDP for accelerated implementation of infrastructure projects to preserve the growth momentum. Considering the fact that Egypt is a small and open economy, it was hit by a sharp decline in food, energy and other commodity prices in 2007/2008. Given that the middle group of Egyptian society spends about 45% of its income on food products, this brought economic policy under tough pressures and demanded a quick response to mitigate the shock in order to maintain social and economic stability. Measures for mitigating the crisis are being developed as a solution. Characteristic of this law was that it aimed to increase sustainable resources in order to finance the additional costs associated with adjusting the salary framework for employees in the state, increasing the minimum wage for employees, higher pensions, as well as to pay additional amounts of rice, sugar and cooking oil through the system of ration cards. In doing so, the social package was fiscally neutral and in that way helped in maintaining adequate social and economic balance.

2008 is year when the global financial crisis starts, which is a double challenge for Egypt. In this year, rising prices have fueled domestic inflation and the fall in global demand, which undermined growth and caused an increase in unemployment in Egypt. Thanks to sound regulations and strong banking, sectoral oversight and early reforms, the Egyptian economy was immune to the first effects of the rapid collapse of global financial markets. However, over time, the effects of the global financial crisis began to spill over into the real economy, and the government reacted by designing a package. The purpose of this package was to maintain demand, along with other specific measures and place the target on those sectors that were directly affected by the crisis. The decrease in foreign demand meant slowing down the export of goods and services, reducing economic growth and increasing the unemployment rate.

4. Analysis of the Causes

Egypt had problems with its governing currency system at the end of 2012. Since 2003/2004, the stability of the exchange rate system depends on the capacity of the Central Bank to accumulate large foreign reserves that would cover 9 or 10 months of annual imports. The central bank can use these

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reserves to meet the demand for dollars needed to pay for imported goods, and therefore can effectively defend the value of the pound. For a net food and fuel importer such as Egypt, the management of the exchange rate was important to control inflation, and in particular the price of primary products.

During 2011 and subsequent political turmoil, growth rates dropped significantly as well as foreign exchange reserves. The reason for this was that Egypt suffered from a decline in capital and a dramatic decline in foreign direct investment and the tourism sector. Between 2011 and 2012, the Central Bank used its reserves to defend the value of the pound by financing the import of basic food products and fuels by state agencies. By December 2012, the foreign reserves had a $ 35 billion contract compared to January 2011 to $ 15 billion. This reduced the capacity of the Central Bank to meet the demand for dollars. However, the largely politically motivated expansion of foreign loans gave aid in the form of long-term deposits in the Central Bank and artificially maintained the system's life. In July 2013, Egypt received about $ 8 billion, mostly from Qatar, and to a lesser extent Turkey. After the collapse of Muhammad in 2013, these special relations abruptly broke down (much of the Qatari deposits and loans were returned), be replaced by even greater support from Saudi Arabia, the UAE and to a lesser extent Kuwait.

5. Ending of Egypt crisis

During the period 2011-2016, Egypt received a total of $ 29 billion in aid, cheap loans, long-term deposits in the Central Bank and free oil and gas shipments (Sobh, 2016). The absence of an economic vision by the management and the unwillingness to stem costs, however, meant that the lost opportunity of these unprecedented inflows was lost. Until GCC support came, which could help mitigate the contractionary impacts of savings and facilitate the implementation of reforms to address the longstanding structural weaknesses in Egypt's finances. Aware of the volatility that may come with rising prices and dismissals of civil servants, they want to build support for a new military-backed regime, so the new leadership chose to use these funds instead of avoiding reforms.

Governor of the Central Bank of Egypt, Tarek Amer said that the prices will drop in 2018, and Egypt's financial crisis is over.

The situation in Egypt in 2017 had these characteristics:

-GDP in 2017 significantly increased compared to 2016

- the prices will drop in 2018 and will return to the normal rate before the fluctuated exchange rate.

-the prices jumped double and triple successively to the liberalization of the egyptian pound against foreign falsities.

- subsidies have been reduced for oil products and electricity, and subsidies for petroleum products have almost been removed in the last 3 years.

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-the increase in prices almost affected all products and services.

-the import dropped from $ 4.3 billion to $ 3.8 billion

-the gdp growth now shows good signs to start importing

- the budget is under control

-now there is only one market-official, and the black market is significantly limited

-AC-Ghitany discusses the value of the currency that is in the main focus of all citizens, 1 $ = 17.5-18 EGP and if it reaches 14-15, it will be a significant progress to start in the face of inflation and reach 32%

-in July 2017, the price of electricity and oil grew again

- market prices depend on price measures.

The currency can be improved against the US dollar, yet it still stands at 15-17 EGP which means prices will not drop significantly. The market will need a lot of time to adjust to the price change. In November 2016, Egypt announced a fluctuation of the currency against all foreign currencies as part of a package of economic reforms to receive a $ 12 billion loan from the proudly produced by the IMF (Christine Lagarde and Stamley Fisher) because this is considered "Egypt will increase its competitiveness to the outside ".In August 2016, the IMF sees and gives a loan of $ 12 billion. According this, Kristin Lagarde stresses the currency crisis and has suggested a rapid devaluation to tackle the widening gap between official and black market prices.-On the black market at a moment prices are just high, i.e. the trading of the dollar, which already the turning of import and businesses on the black market, due to a lack in the Central Bank, makes the businesses unachievable.

What kind of measures IMF asked for?

All details have not been published. However, the package consists of austerity measures, reduction of subsidies to consumer goods, privatization of state-owned enterprises in line with the IMF's vision of an economic free market. Egypt borrowed money from abroad to meet the terms of the IMF loan. The creditor requires Egypt to increase its foreign exchange reserves before sending the money. In September Egypt gets a loan of $ 2 billion from Saudi Arabia used to provide regular monetary injection to increase the Egyptian economy:

- to build its foreign reserves

- it is believed that egypt needed $ 6 billion before getting it from the imf

-to increase external competitiveness, with “Hoating currency” to support (encourage) exports, tourism, and to attract FDI.

According to Auesh, an Egyptian analyst, the IMF loan will reduce the pressure on Egyptian pounds but will take time to see the effect.

6. Foreign exchange reserves as a solution

When a devaluation is expected on the market, downward pressure on the currency can only be settled (neutralized) by increasing the interest rate. In order to increase the rate, the Central Bank must reduce the money supply, which in turn will cause an increase in demand for the currency. The bank can do this by selling foreign reserves to create an outflow of capital. When a bank sells part of its foreign

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exchange reserves, it receives a payment in the form of a domestic currency, which keeps it outside the turnover as a means. Also, the reliance on the exchange rate can not last forever, both in terms of the reduction of foreign reserves, as well as economic and political factors, such as the increase in unemployment. Devaluing the currency through an increase in the fixed exchange rate results in domestic goods being cheaper than foreign, which increases demand for workers and increases the output. In the short run, devaluation also raises interest rates, which must be settled by the Central Bank by increasing the money supply and increasing foreign reserves.

As it is mentioned above, earlier the suspension of the fixed exchange rate can "eats" through the foreign exchange reserves of the country quickly, and devaluing the currency can bring back the reserves.

Egypt's imports at a time of lack of foreign exchange inflows. They were used to support the Egyptian pound against the US dollar to postpone the effect of the low demand on the Egyptian pound. President Abdel Futtaha Al-Sisi is elected in 2015 and Governor of the Central Bank was Hishaiu Ramez . He was replaced by Tegic Amel in November 2015. The purpose of the two governors was to increase foreign reserves. At the end of 2016, Egypt has the highest amount of foreign exchange reserves of $ 24.26 billion in the last 5 years. The lowest amount of foreign exchange reserves was in June 2013 with amount of 14.94 billion. If we make comparison, in 2014, foreign exchange reserves are beginning to grow as a result of grant from Saudi Arabia, Kuwait, the Emirates and the Adriatic. Governor Rames faces the goal - an increase in foreign exchange reserves due to the pressure of a piece of foreign currency due to:

- small export
- world trade movements hit the revenues of the sued canal
- the presence of tourists

Prime Minister Holding gives a statement that in December in Egypt, a World Bank enters a loan tranche, and then from the African Development Bank.

Foreign exchange reserves are increasing due to 4G licenses for mobile network operators, although from the sale of treasury bills in the US dollar and euros. Remittances to Egyptians working overseas are rising by 33.2% or $ 1.7 billion, a total amount of $ 422 billion.

Natec condemns this increase in foreign reserves for several reasons:

- Egypt has the worst imports
- the lack of foreign currency and imports affects the production of many goods to those who import
- inflation (the demand for goods and services is still high, which affects the rise in prices and inflation)
- Egyptians lost almost 25% of their money due to the high inflation rate

Expectation of the IMF is rise of gross foreign reserves of Egypt on record $ 29 billion in the fiscal year 2017/2018 and for the fiscal 2018/2019 on $ 33 billion. If we compared the rise of foreign exchange reserves as much as it is, it’s not sufficient in the realization of the obligation to service the public debt. If the reserves are compared with the external debt, they are 50% less than the debt. The only solution for solving the problem with the foreign currency is the export, and of course attracting FDI and

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improving the investment climate. Also, the arrival of remittances as the arrival of foreign aid will contribute to resolving the crisis, but at a slower rate as Egypt has more short-term liabilities and government funding for which foreign exchange reserves are used.

7. Conclusion

The prediction when a country enters a currency crisis involves an analysis of various i.e. complex ranges of variables. There are several common factors that relate to recent crises: the countries borrowed a lot (current account deficits); the value of the currency is rapidly increasing; the insecurity associated with the Government's activities makes the investors nervous. The high level of public debt increases the cost of defending the exchange rate, but increases the dangers of speculative attacks. A high unemployment rate leads to difficulty in defending the exchange rate with a higher interest rate. The fact that the government will not tolerate a high unemployment rate may lead to currency depreciation (Lestano and Jacobs, 2007). When the expectations for the devaluation embedded in the nominal interest rate, the greater the interest cost of the debt will lead to an increase in the cost of maintaining the exchange rate. Speculative attacks can occur even when the currency is overvalued. The overvalued currency causes current account deficits, and in some cases deflationary pressure that leads the monetary authority to assess that the cost of defending the exchange rate is greater than the benefits. Expectation of the IMF is rise of gross foreign reserves of Egypt on record $ 29 billion in the fiscal year 2017/2018 and for the fiscal 2018/2019 on $ 33 billion. The only solution for solving the problem with the foreign currency is the export, and of course attracting FDI and improving the investment climate. Also, the arrival of remittances as the arrival of foreign aid will contribute to resolving the crisis, but at a slower rate as Egypt has more short-term liabilities and government funding for which foreign exchange reserves are used.

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